Cogent Communications (CCOI)

Backbone of the Internet

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The Backbone of the Internet
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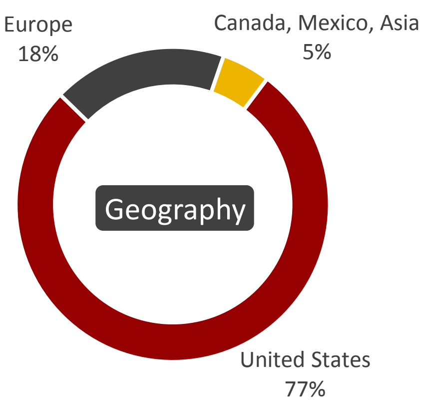
Company Overview

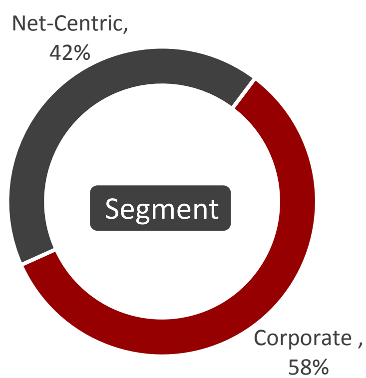
Cogent Communications

Company Description

- Cogent is a leading global provider of dedicated internet access
- Their network carries ~ 20% of global internet traffic
- Cogent's unique business model focuses on becoming a low-cost "dumb pipe" to gain market share for large incumbent players
- Cogent operates in two segments: Corporate and Net-Centric

Revenue Distribution





Market Capitalization

Shares Outstanding (mm)	45.2
Add: Dilutive Securities	0.2
FD S/O	45.4
Price per Share (CAD$/Share)	34.7
Market Cap (MM)	**1575.4**
Add: Total Debt	580.9
Less: Cash & Cash Equivalents	207.3
Enterprise Value	**1949.0**

Valuation Summary

	FY 2013	FY 2014	FY 2015E	FY 2016E
Revenue	**$ 348.0**	**$ 380.0**	**$ 402.9**	**$ 443.5**
YOY Growth %	*9.8*	*9.2*	*6.0*	*10.1*
EBITDA	**$ 110.5**	**$ 112.4**	**$ 131.2**	**$ 150.2**
Margin %	*38%*	*42%*	*43%*	*42%*
EV/EBITDA	**19.0**	**15.9**	**14.8**	**12.9**
EV/Sales	**6.1**	**5.2**	**4.8**	**4.4**

Source: Bloomberg as of 11/08/2015 , company reports

Management

Key Man Risk: Dave Schaeffer

Chairman of the board, CEO & Founder

Dave Schaeffer

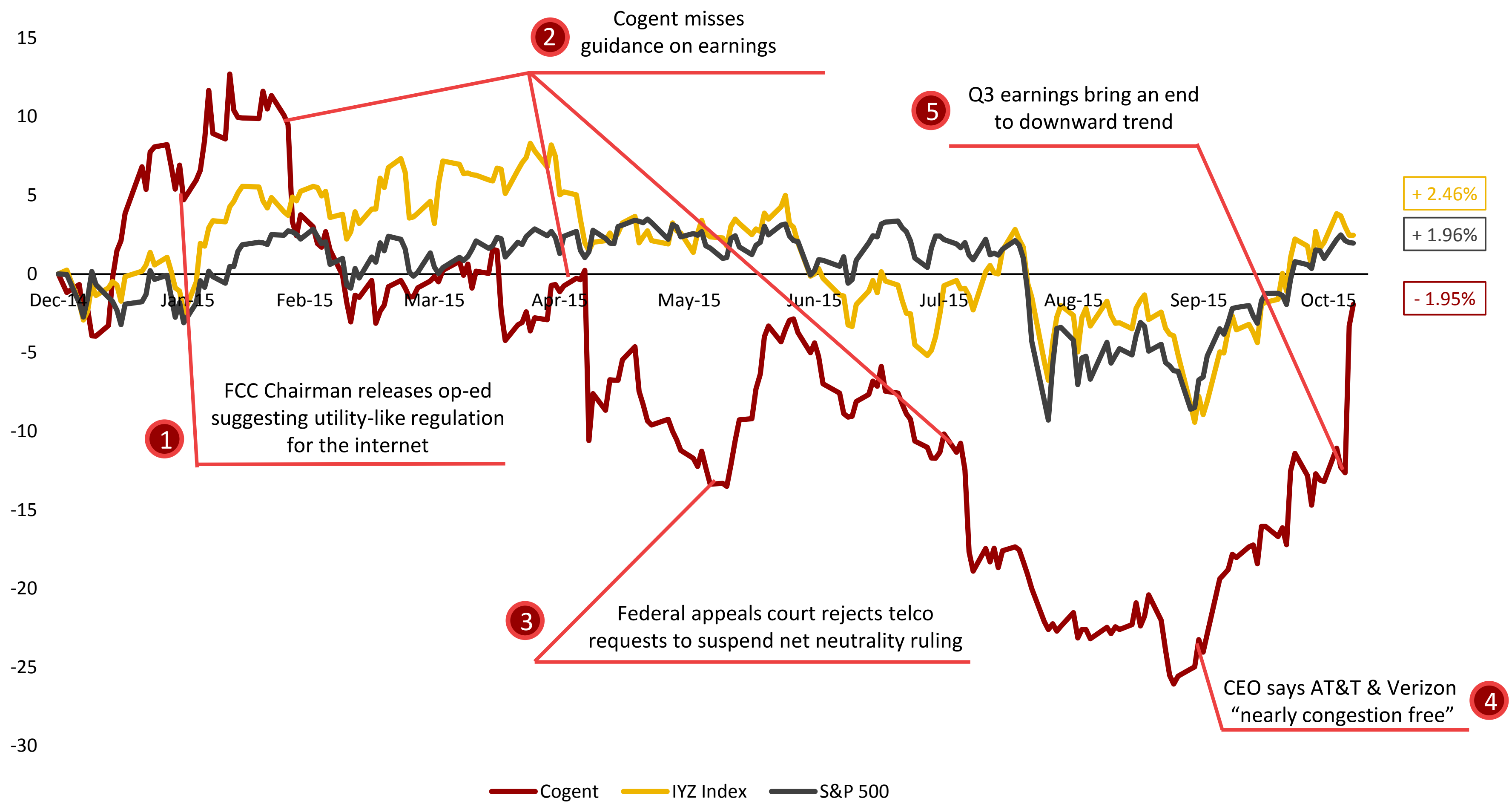
- Founded Cogent in 1999
- B.S. in Physics, Ph.D. in Economics
- 8% ownership of Cogent
- Founded and operated 6 businesses prior to Cogent
- Known for his battles with regulators and big telecom companies, never shying away from a dispute

Feisty Track Record

- In 2002, Schaeffer took Cogent public by acquiring Allied Riser, the target's debt became junior to Cogent's and bondholders sued Cogent who agreed to buy the $140M of debt for $9M
  - Cogent then **sued Allied Riser's Board for misleading bondholders and settled for $5M**
- Later that same year, PSINet (the world's second largest ISP) went bankrupt with $4.3B in debt and $300M in cash Schaeffer played the secured creditors and unsecured creditors against each other and was **able to pick up all of the assets for free** and gain its "peering" status with other large networks
- In 2008, Cogent and Telia (Sweden's largest telecom player), blocked traffic from each other's networks
  - Despite being **60 times bigger than Cogent, Telia folded in 15 days**

Annotated Price Chart

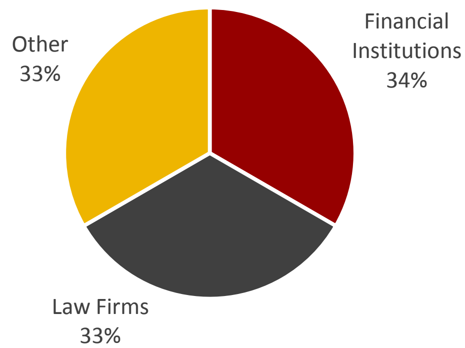
Cogent punished for missing guidance until…



Source: Bloomberg as of 11/08/2015.

Corporate Overview
Strictly business

Who Are The Customers?



What Is Cogent Selling?

	Speed	Price (On 3 Year Contract)
Fast Ethernet	100 Mbps	$700 / month
Gigabit Ethernet	200 – 1 Gbps	$750 - $1500 / month
10 Gigabit Ethernet	2 Gps – 10 Gbps	$1500 - $5000 / month

Competitive Landscape

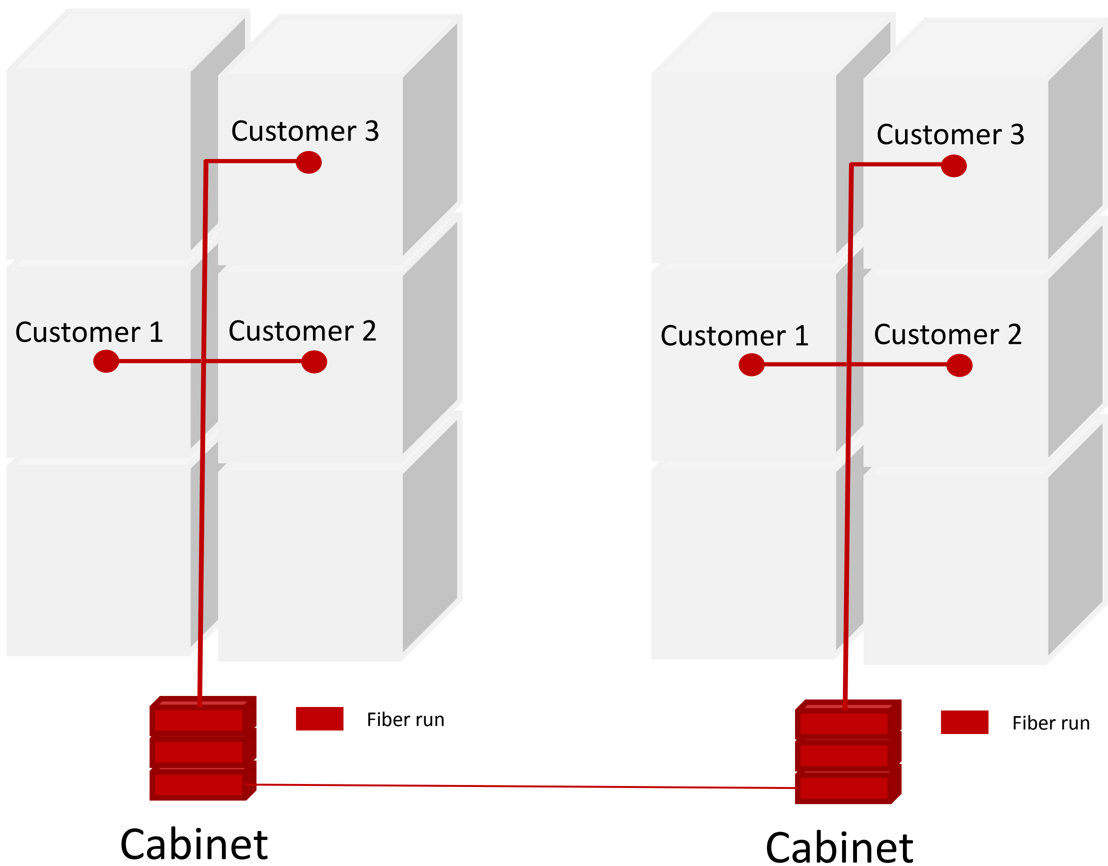
Incumbents		Resellers
at&t	verizon	Granite Telecommunications
CenturyLink	Bell	

Competitive Advantage

- ✓ **Better price:** due to its low-cost structure, Cogent offers cheaper internet access on a $-per-meg basis
- ✓ **Better bandwidth:** because it uses an all-fiber network, Cogent can offer bandwidths 30 to 60 times better than its competitors
- ✓ **More uptime:** Metro fiber ring infrastructure has redundancies that allow data to be transmitted in the opposite direction if fiber is cut

Source: Company Public Documents, RBC

Cogent's On-net internet access business
Selective investments in high ROI corporate buildings



Building Economics

- Average 500,000 sq feet
- $650 to connect new customer
- $400/mo recurring cost to landlord
- Low cable presence in footprint
- 1 in 5 buildings with off-net service
- Little risk of overbuild from competitor
- Voice and other services provided OTT

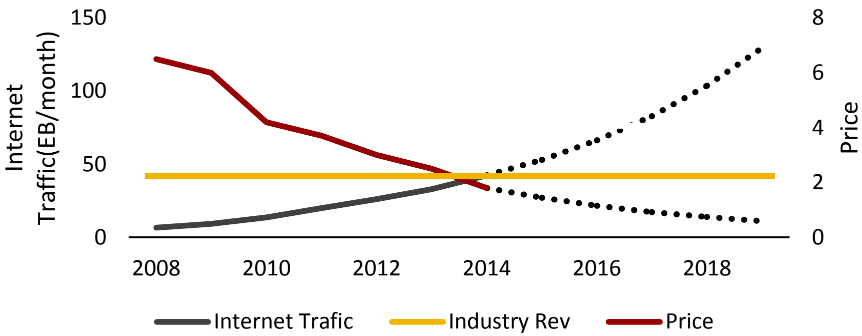
Favorable trends

- Greater bandwidth demand from OTT services (SaaS, VoIP)
- Decreasing competitiveness of legacy copper

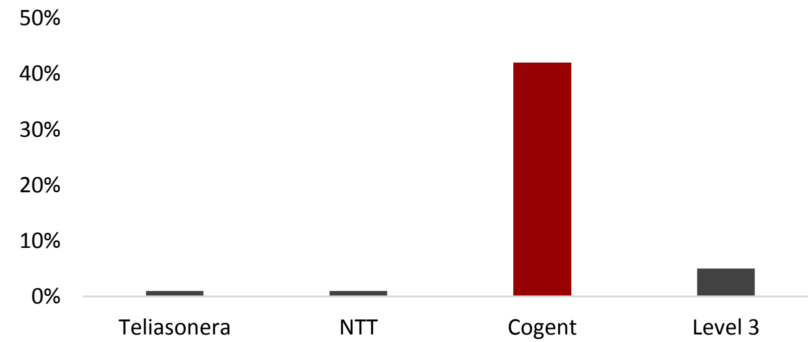
Source: MoffettNathanson, Company presentation

Net Centric Overview
Back from the dead

Flat Net Industry Growth



% Revenue Exposure to Net-Centric



Cost Leadership Growth Strategy

- Cogent sells commoditized bandwidth and competes on price with competitors
- Cogent product is equivalent to their competitors with respect to quality and speed
- Price is 50% of market average

Source: Cisco, Street Research, Company Reports

Rolling up remains of fiber bubble

	Date	Original Investment		PP&E	
Net Rail	Sep-01	$	180.00	$	35.00
Allied Riser	Feb-02	$	590.00	$	335.00
PSINet	Apr-02	$	5,180.00	$	2,175.00
FNSI	Jan-04	$	30.00	$	5.00
Firstmark	Mar-04	$	1,100.00	$	560.00
↓					
Verio	Dec-04	$	5,700.00	$	390.00
TOTAL (mm)		**$**	**14,050.00**	**$**	**4,050.00**
Cogent Cost (mm)				**$**	**60.00**

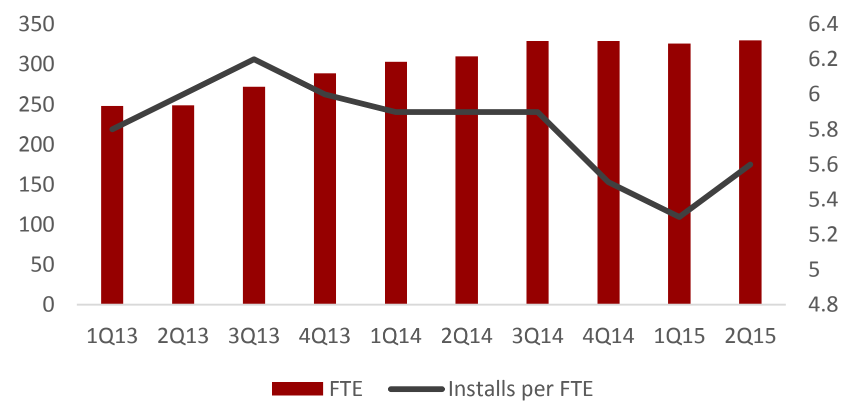
Sales overview

Cogent's economic moat driven by low cost and persistent sales strategy

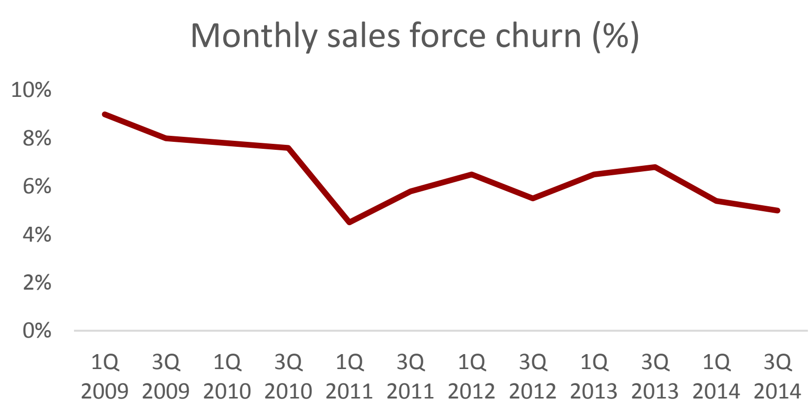
Strategy

- Cogent pursues a classic Porter-esque low-cost strategy after acquiring the majority of its national footprint for pennies on the dollar post dot-com bubble
- Cogent doesn't aim to offer value-added services; it relies on its ability to undercut competitors (by 50%) and expanding its thread
- By managing costs, Cogent ends up spending $2 for every $1 in MRR, compared to the $13 industry average

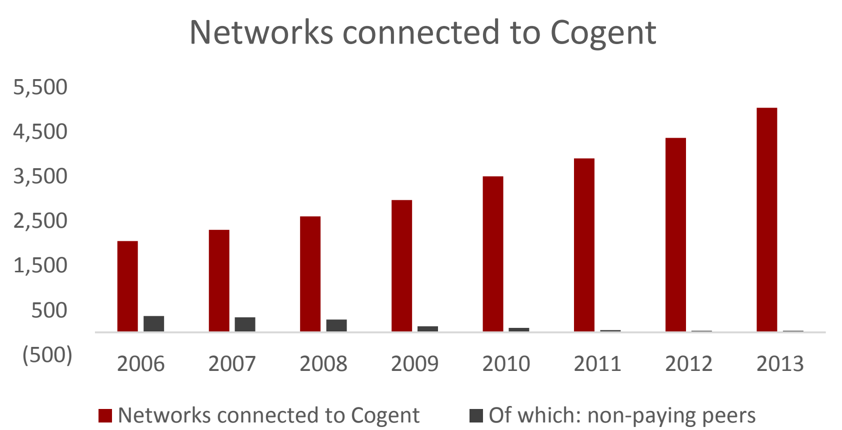
Sales performance dragging due to churn



But average employee tenure improving…



…And economic moat strengthening



Source: Company data, MoffettNathanson research

Investment Thesis

Taken for granted – Delivering the internet everyday

Investment Thesis

Cogent is the only wired player with +10% top-line growth

1 Interconnection settlements should enable top-line growth in net-centric

- Open Internet ruling in February 2015 should put an end to interconnection disputes
- Growth in the Net-Centric segment will return as interconnection points receive necessary capacity upgrades

2 Increased demand for data-heavy services will benefit both segments

- Consumer shift towards online video will greatly increase global web traffic
- Corporate demand for high bandwidth-intensive application (VOIP, remote data storage, distributed computing, cloud services…) will increase demand for Cogent's 100 Mbps service

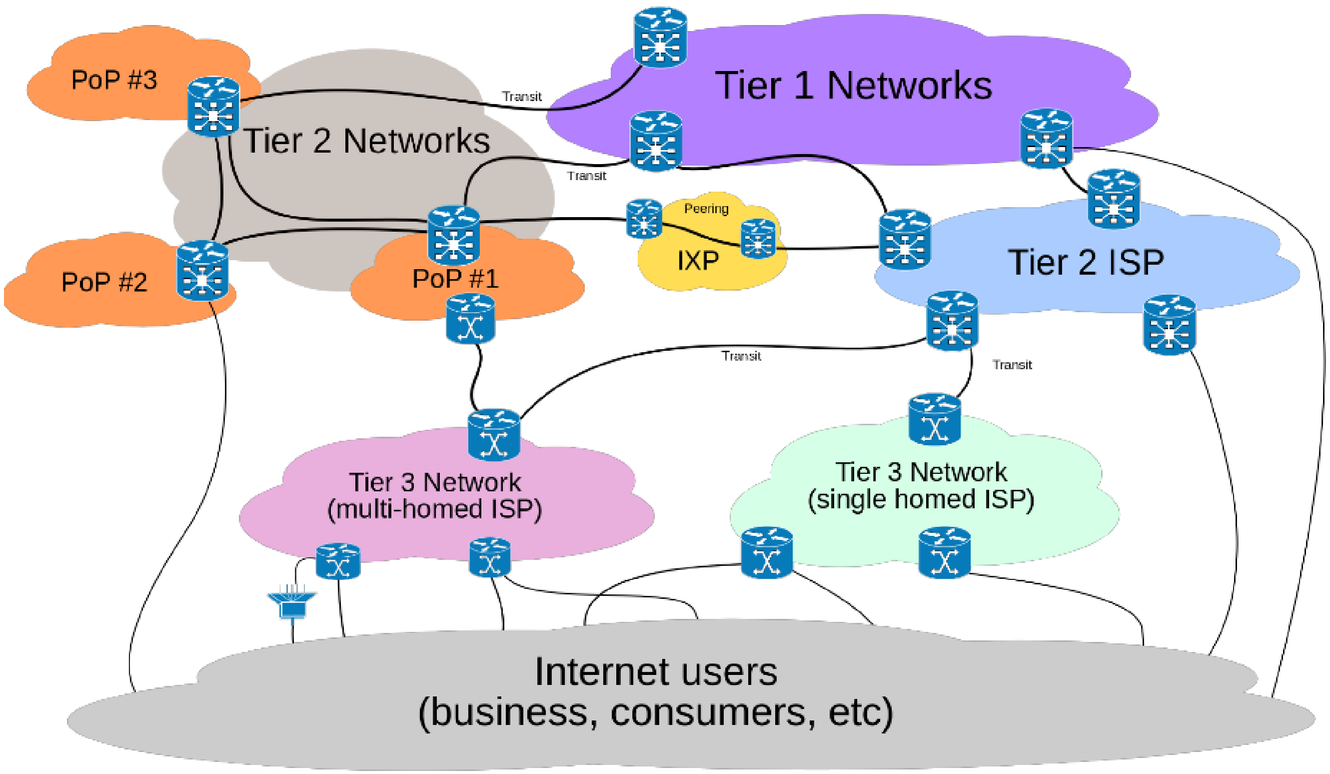
3 Reduction in capital intensity going forward will result in large increases in FCF

- Capital spending will slow down as Cogent reaches all of its target countries and buildings

4 Undervalued despite recent appreciation

- DCF analysis yield a price target of $40 under conservative assumptions, yielding a 15% upside
- Rare double: both a growth (10%+) and dividend (4%) stock

Net Centric Overview
Internet Transit 101



1 Net-centric peering, interconnection, and transit

Interconnection disputes not a long-term concern

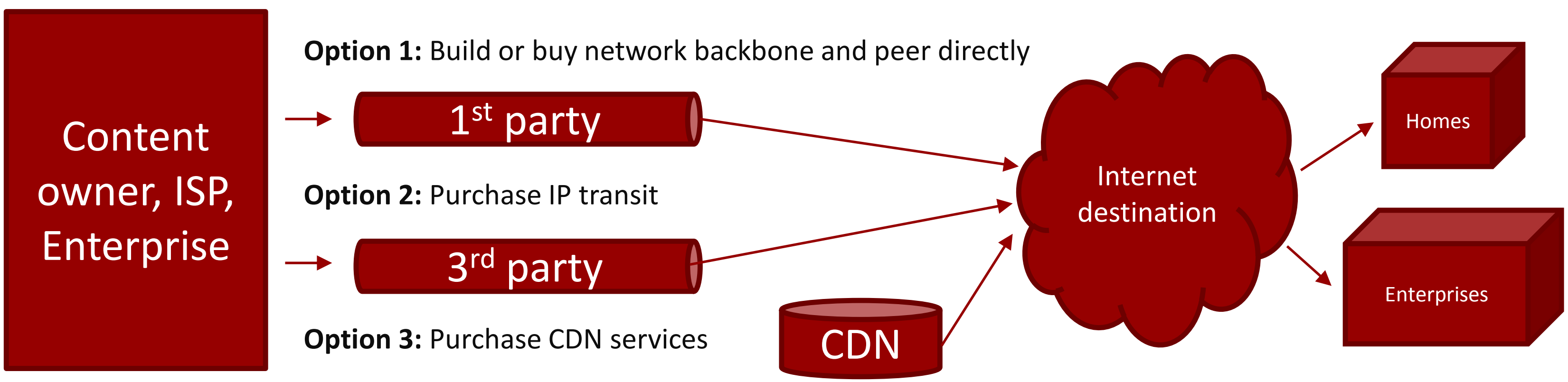
Background

- Interconnection: the linkage of two networks to enable traffic exchange
- One type of interconnection is settlement free peering, where two networks agree to provide access to each other's network at no cost
- Paid peering involves monetary transaction between networks, usually when traffic is imbalanced
- Tier 1 networks do not pay for transit due to their scale

Netflix/Comcast agreement

- In 2014, Comcast and Netflix teamed up to establish a more direct connection between their two networks
- Withholding of interconnection is an example of how strongly telco networks can exert market power
- Cogent stock fell 6.8% on the day of the announcement, as Netflix is foregoing paying for "middlemen"
- However, telecom is very scale sensitive, scale efficiency is Cogent's raison d'être
- Very few companies will build own CDN

Primer on content owner options to move traffic



1 Net-centric peering, interconnection, and transit

Open internet rules a net benefit for Cogent

Open Internet Rules passed in Feb 2015

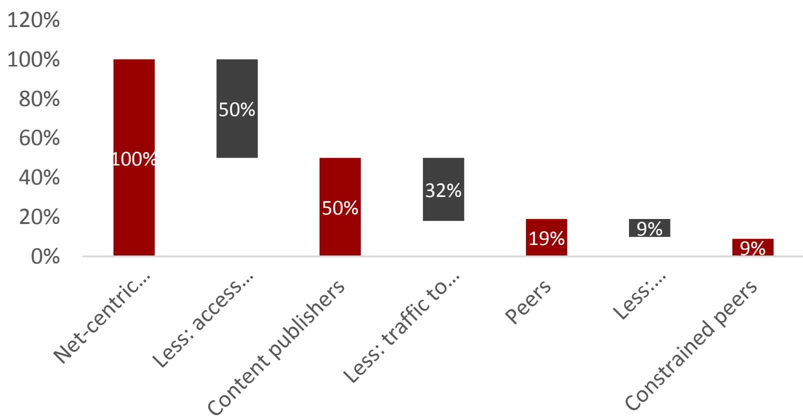
- **No throttling:** broadband providers may not impair transit speed or throughput
- **No blocking:** broadband providers may not block legal content
- **No paid prioritization:** broadband providers may not offer internet fast lanes

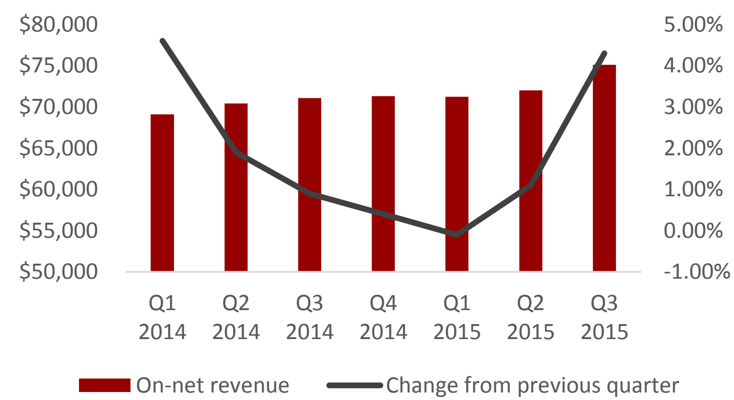
Impact on Cogent

*"The adoption of the Open Internet order and Title II jurisdictional authority were mirrored in the EU and on June 30 the European Commission adopted a set of regulations that were passed by the parliament and the council, and as a result of that we have seen **significant port augmentations**."*

-Cogent CEO Dave Schaeffer

In any case, Cogent's revenue not substantially exposed to constrained peers





Source: FCC, MoffettNathanson research

Data demand growth a strong tailwind for Cogent

Online video driving digital traffic

Online TV Touch Points Increasing

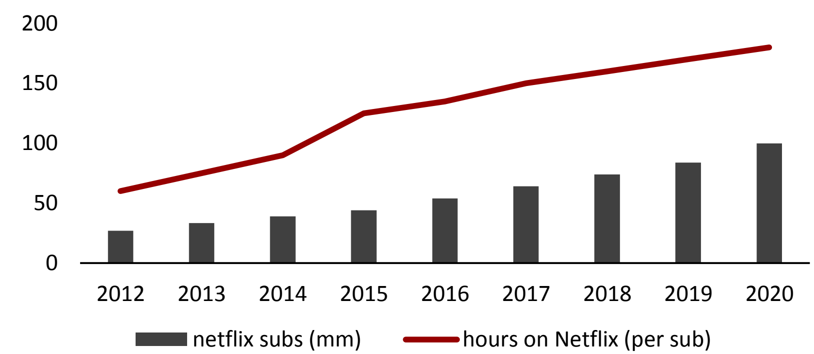
On Demand OTT

Direct to Consumer OTT

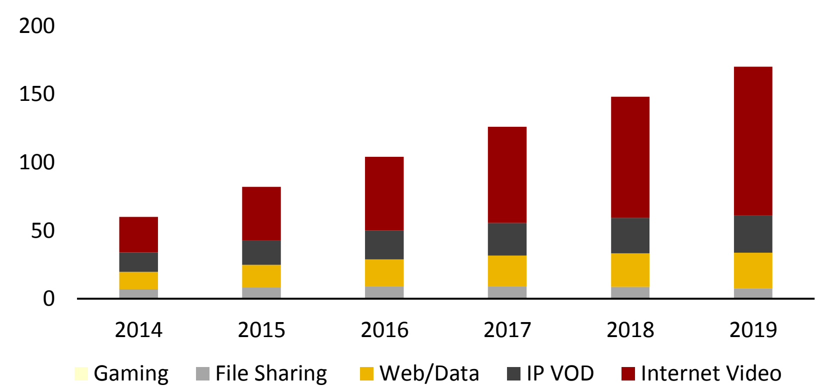
TV Everywhere

Emerging Live TV

Data Usage Expanding on Two Fronts



Online Video Driving Traffic Growth

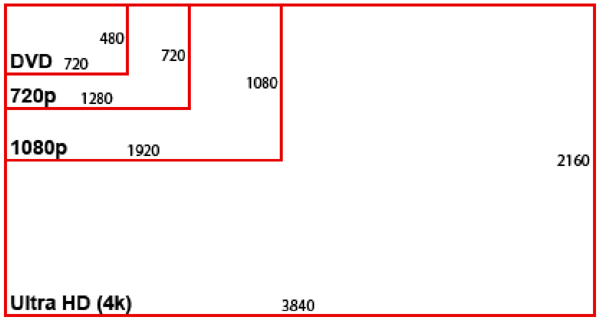


Source: Statista, Street Research, Company Reports

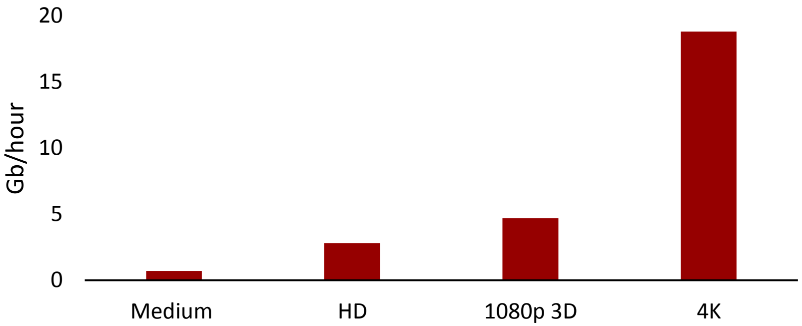
Data demand growth a strong tailwind for Cogent

Video quality improvement a second lever for data growth

4K: The Next Resolution Standard



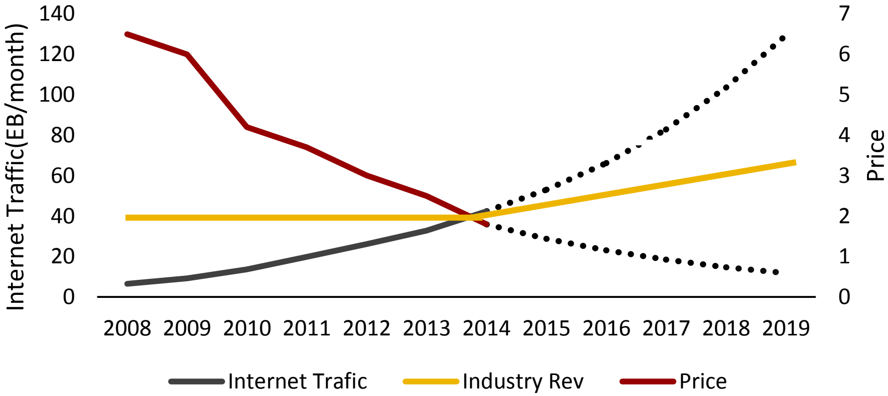
Supersized Bandwidth: 4K Requirement



Penetration Levels Expected to Increase

- Shipments of 4K TVs grew 633% in 2014
- 50% of US homes are expected to own a 4K TV by 2020
- Amazon Prime soon to be offering "Top Gear" in 4K
- Netflix expects 4K to account for 1% of streamed content in 1 year

Traffic Increases Overpower Pricing Declines

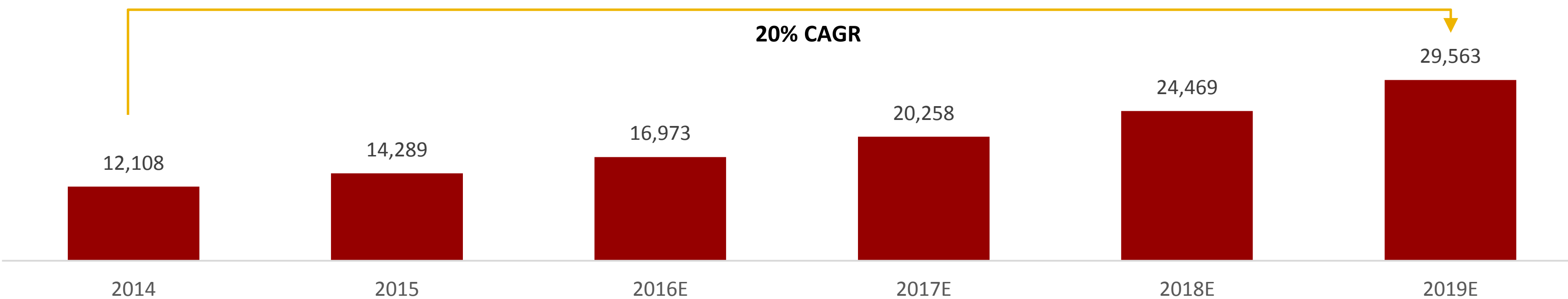


Source: Rtings.com, gigaom.com, TVBEurope, Street Research, Company Reports,

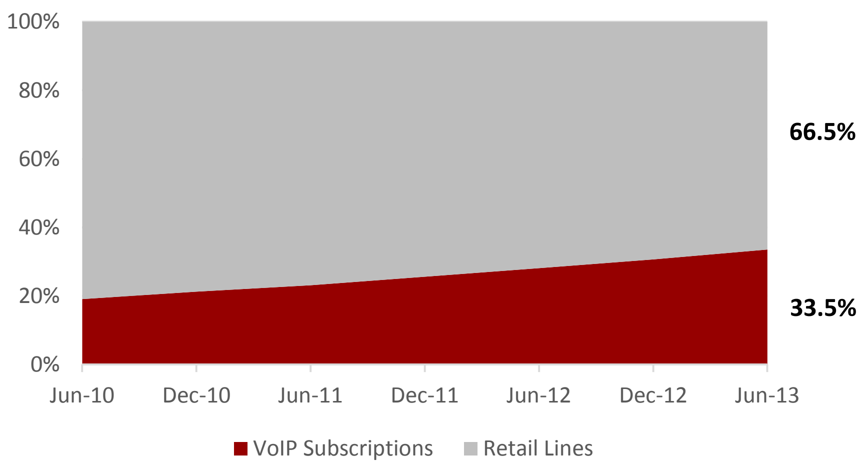
2 Data demand growth a strong tailwind for Cogent

Both VOIP and Cloud services drive demand for Cogent's offerings

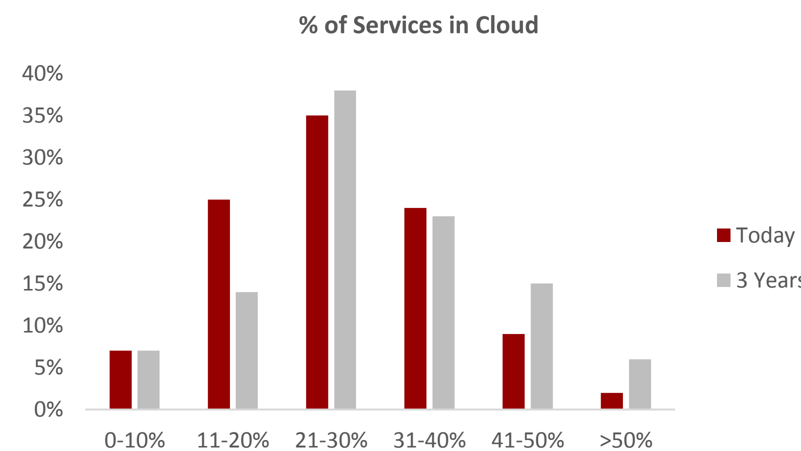
Overall Corporate IP traffic growth (USA)



Illustrative Tailwind 1: VOIP



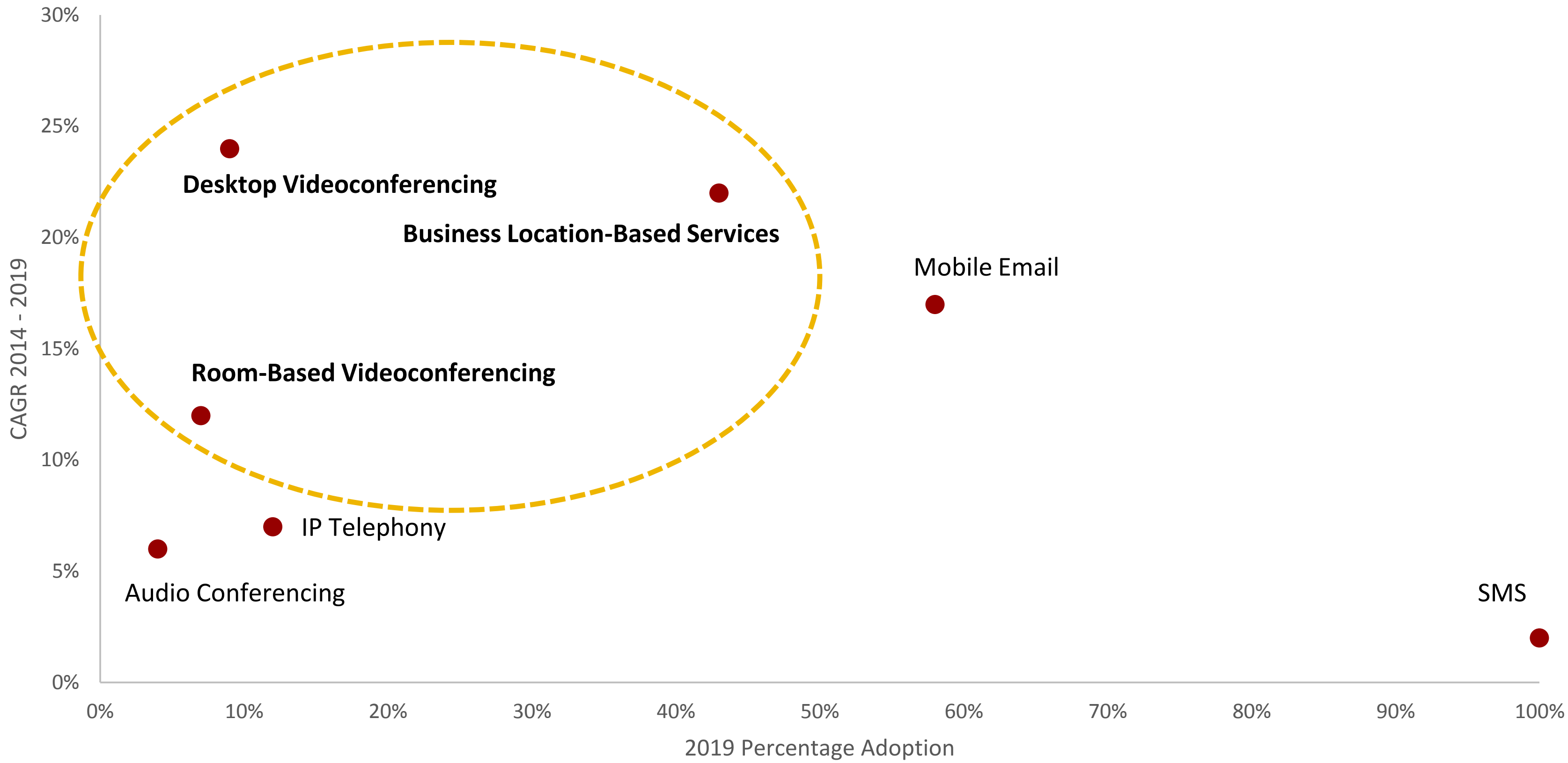
Illustrative Tailwind 2: Cloud



Source: Cisco Internet Report, IBISWorld

2 Data demand growth a strong tailwind for Cogent

Hungry, Hungry, Corporates

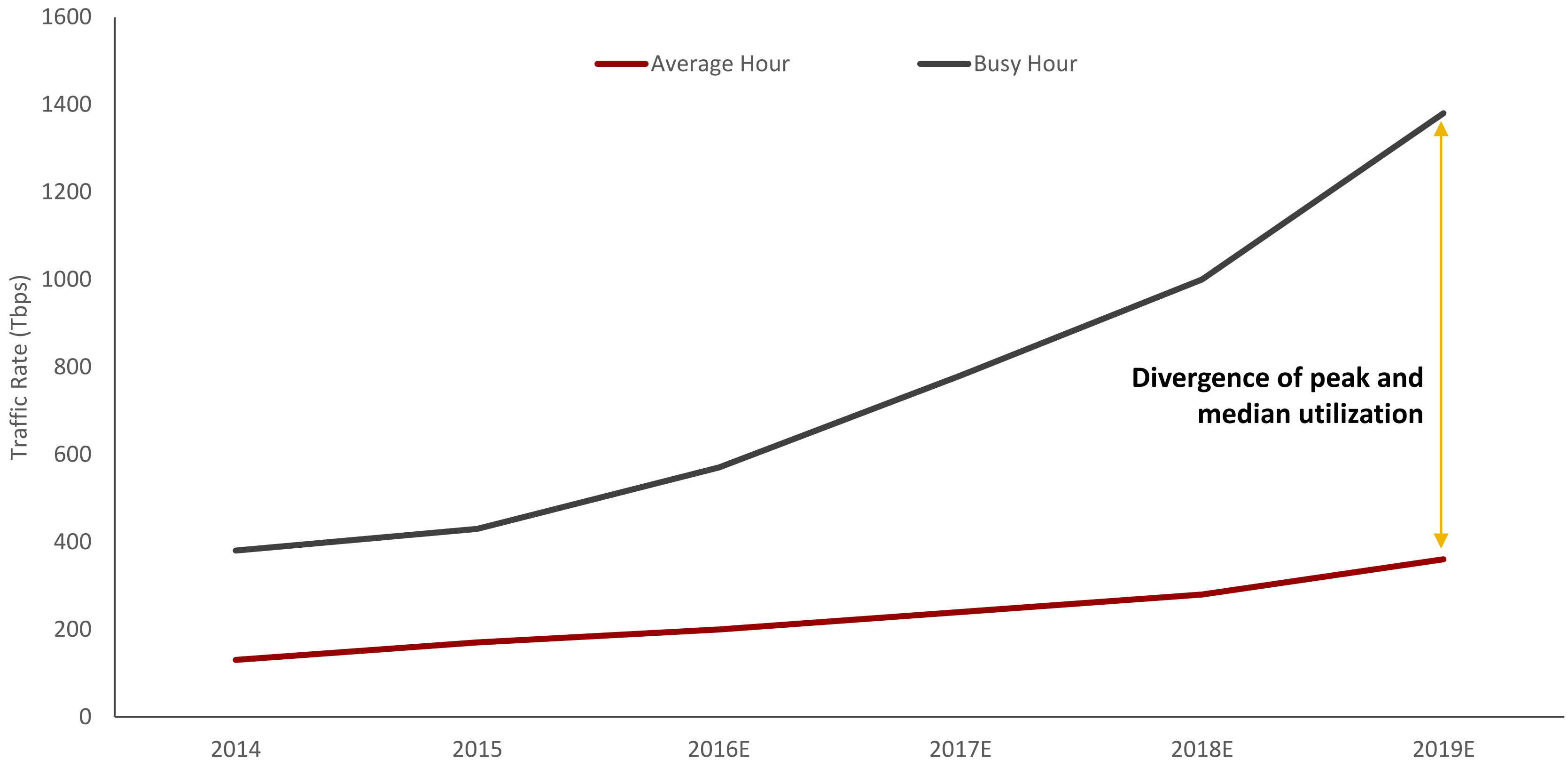


Enterprise services with high data consumption are expected to grow at the fastest rates, driving demand for Cogent's internet access

Source: Cisco Internet Report

2 Data demand growth a strong tailwind for Cogent

Busy Hours Getting Busier

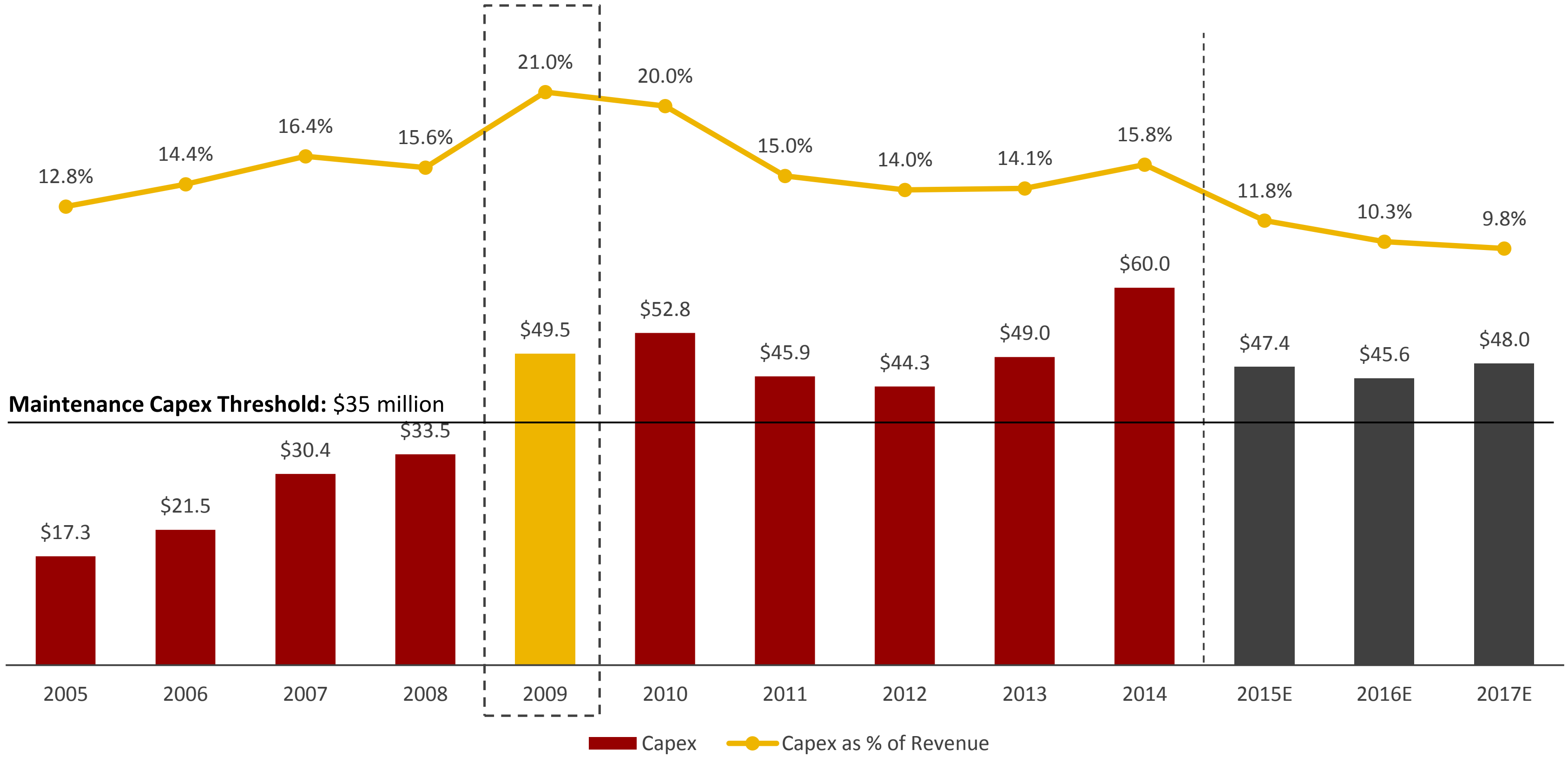


Peak utilization to outpace average utilization driving headline speed requirements past 4Mbps competitor service

Source: MoffetNathanson

3 FCF to benefit from reduction in capital intensity

A return to prior CAPEX level



Revenue growth will not require incremental capex spend, therefore capex intensity should decrease as a % of revenue

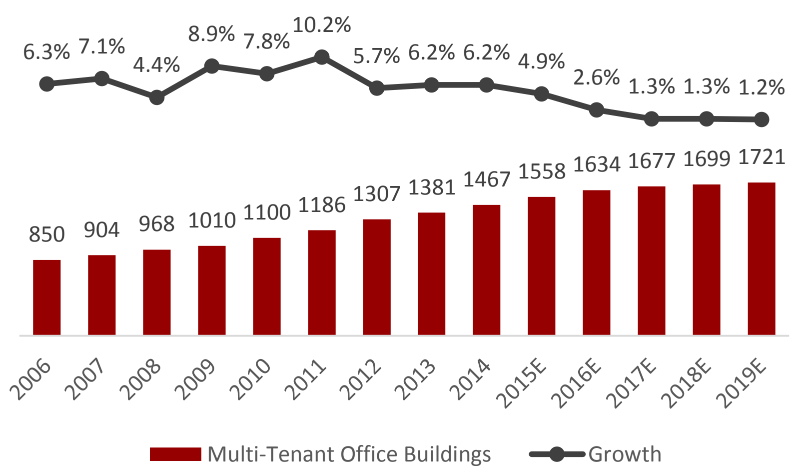
Source: RBC, Company Disclosure Documents

3 FCF to benefit from reduction in capital intensity

Operating leverage a driver for “Costless” Growth?

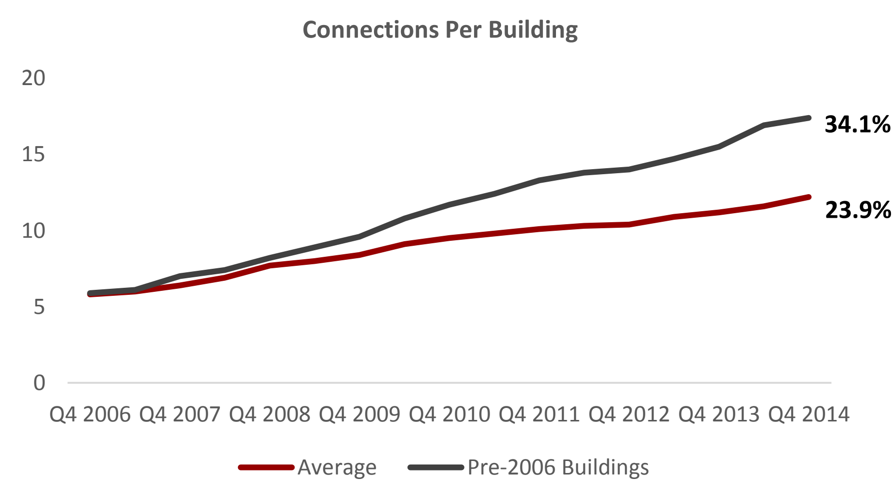
Fewer New Buildings

- The number of multi-tenant office buildings that meet Cogent’s return thresholds and are not yet connected to its network are shrinking at a rapid rate
- New building additions are expected to slow significantly from this point forward
- Capex savings will also pass through to SG&A, where the current sales force can focus on a known segment of unsubscribed customers and headcount can remain stable



Higher In-Building Penetration

- Focus will be on attaining higher in-building penetration rather than more buildings
- Incremental revenue is essentially “costless”, minus the customer acquisition costs
- This strategy moving forward will give Cogent significant operating leverage and add to its low cost economic moat
- We share the view that incremental penetration across existing buildings will be around 1.4 customers per year per building across the entire portfolio (normalized state)



Source: MoffetNathanson

FCF to benefit from reduction in capital intensity

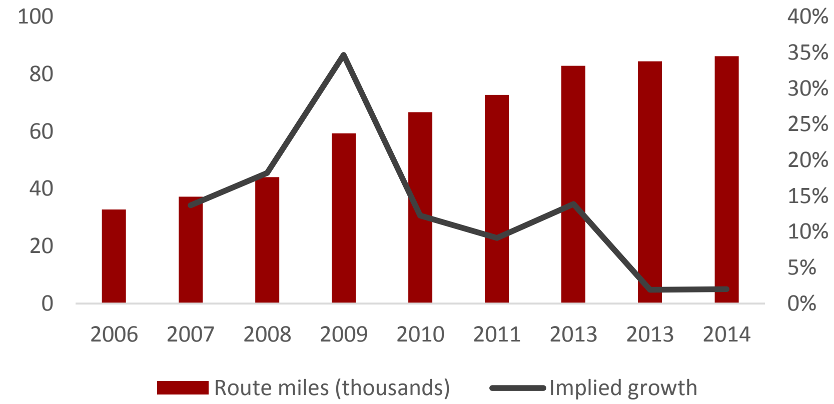
3

Capital lease obligations expected to decrease with lower fiber growth

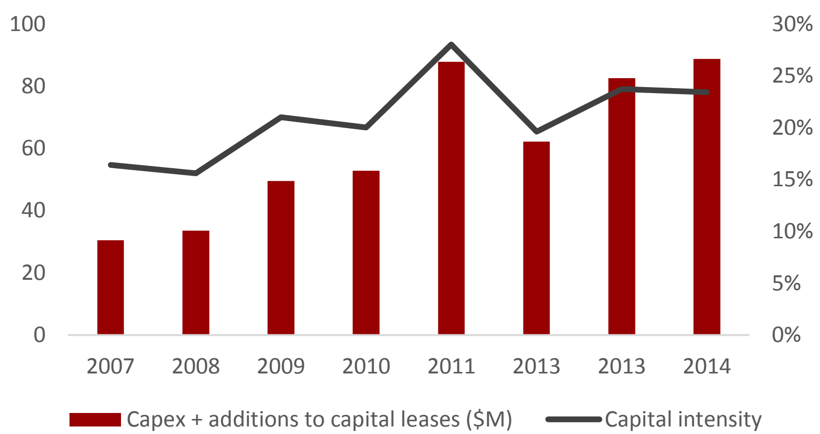
IRU

- Cogent's fiber network composed of indefeasible rights of use rather than owned assets with 250 suppliers (> peers)
- An IRU is a long-term lease (10-20 years), with average life of IRU outstanding for Cogent at 20 years
- Exposed to expiration risk, but this risk is dependent on supply and demand of fiber assets (supply glut)
- IRU's allow Cogent to more flexibly match CAPEX with demand and play lessors off each other to reduce costs
- Why are IRU's not a significant risk for Cogent?

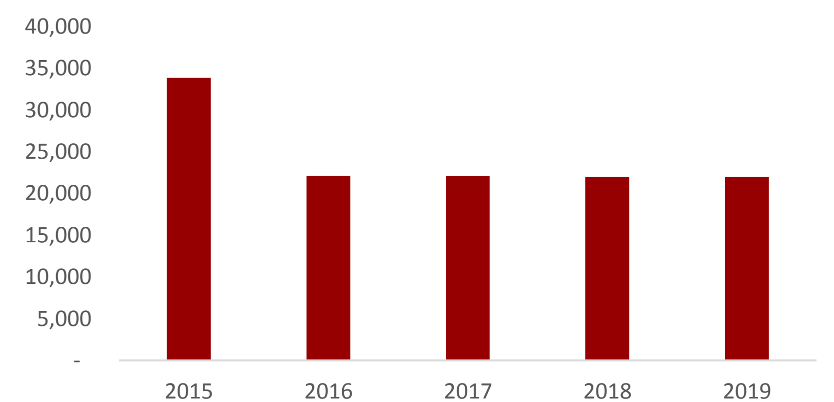
Route miles of fiber and implied growth



Historical CAPEX and IRU adjustment



Future capital lease obligations



Source: Company data

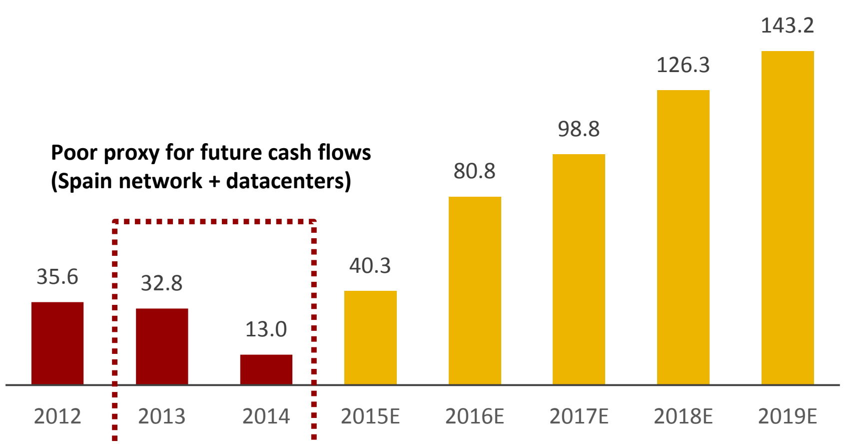
3 FCF to benefit from reduction in capital intensity

Lower Capex, But So What?

Cash Is King

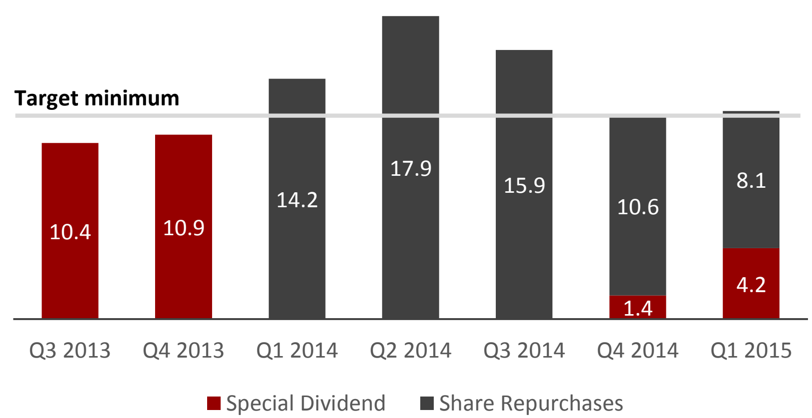
- Cogent has a proven track record of being able to generate levered free cash flows
- EBITDA and EPS are great for valuation – but not true cash figures (not a discounted EBITDA model)
- By 2019E, Cogent will be generating in excess of $140 million in free cash flow every year that can be used to:
  - Repurchase shares, pursue M&A, pay out dividends, or delever the company

Illustrative Free Cash Flow



Clear Path to Shareholder Value Creation

- Free cash flow generation is only good in the context that management is able to make high-return investments or return the cash to shareholders
- Cogent's capital return strategy has two components: a regular dividend and an additional capital return program
- Capital return program targets $12m in excess of the regular dividend to be returned per quarter to shareholders
- In latest earnings call, management has suspended $12m capital return program due to leverage, excise tax, and high litigation costs (we believe this is non-recurring)



Source: Company Disclosure Documents, RBC

Relative Valuation

Trading above “peers” – but with reason

Comparable company analysis

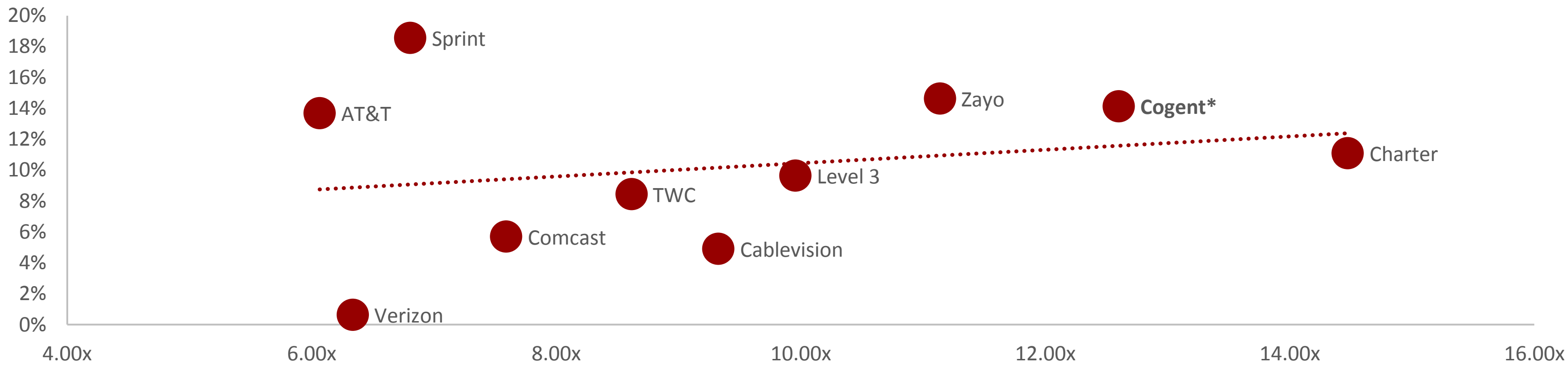
Cogent operates in a field of its own, priced at a premium to telco average

Company	Current	52-Weeks		Market	Enterprise	EV/EBITDA		EV/Revenue		Net debt /
	Price	Low	High	Cap	Value	2015E	2016E	2015E	2016E	EBITDA
Telco and Cable comparables										
AT&T	33.16	30.97	36.45	204,000	325,693	6.89x	6.06x	2.17x	1.97x	1.55x
TWC	188.09	131.00	194.22	53,267	75,518	9.34x	8.62x	3.19x	3.00x	2.85x
Comcast	61.61	50.01	64.99	151,121	198,301	8.02x	7.59x	2.68x	2.55x	1.77x
Cablevision	31.35	17.66	33.28	8,674	17,433	9.78x	9.33x	2.66x	2.62x	4.96x
Verizon	45.78	38.06	51.73	186,273	295,578	6.38x	6.34x	2.25x	2.24x	2.21x
Charter	190.26	142.37	199.00	21,356	54,658	16.08x	14.47x	5.60x	5.17x	6.19x
Sprint	4.53	3.10	5.45	17,976	49,866	8.07x	6.81x	1.44x	1.52x	4.30x
Transit comparables										
Zayo	26.11	22.62	32.18	6,345	9,742	12.77x	11.14x	7.24x	6.39x	3.78x
Level 3	50.86	40.86	57.08	18,120	28,442	10.92x	9.96x	3.45x	3.22x	4.13x
Average						**10.26**	**9.24**	**3.54**	**3.28**	**3.42**
Average (transit only)						**12.69x**	**11.05x**	**5.13x**	**4.59x**	**3.45x**
Cogent	34.70	25.84	40.48	1,532	1,906	14.38x	12.05x	4.71x	4.16x	2.98x

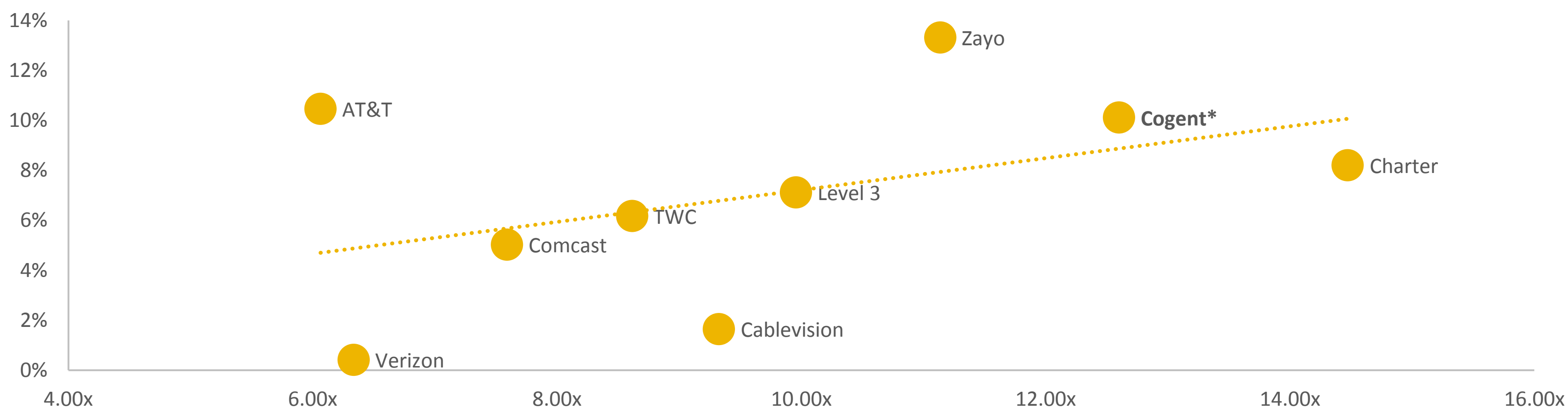
Comparable company analysis

Cogent priced at a discount compared to peers when accounting for growth

Current implied EV to 2016E EBITDA vs. 2016E EBITDA growth rate



Current implied EV to 2016E EBITDA vs. 2016E Revenue growth rate



DESAUTELS Capital Management Gestion de capitaux

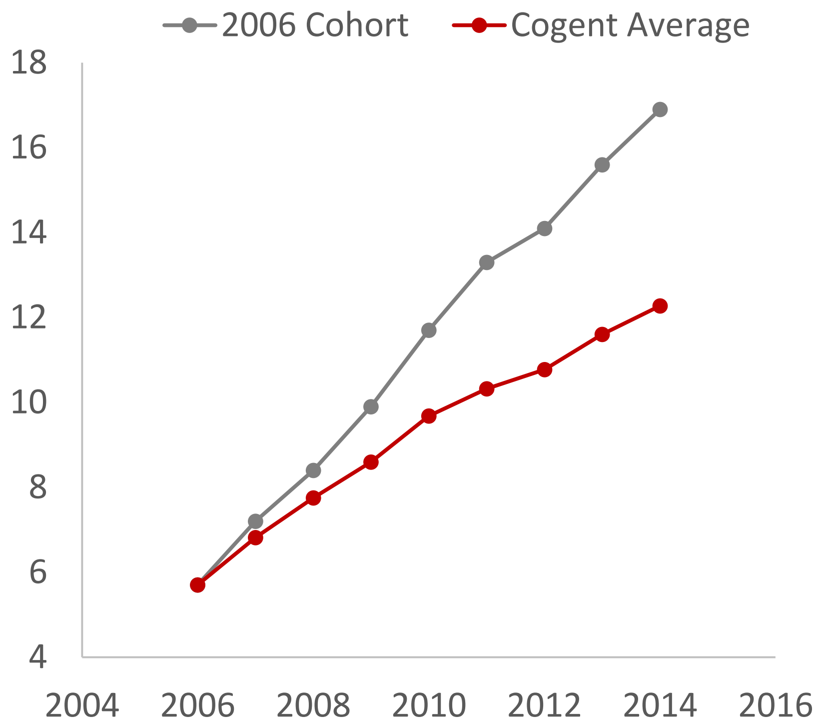
Valuation

$40 price target – 15% upside

DESAUTELS Capital Management
Gestion de capitaux

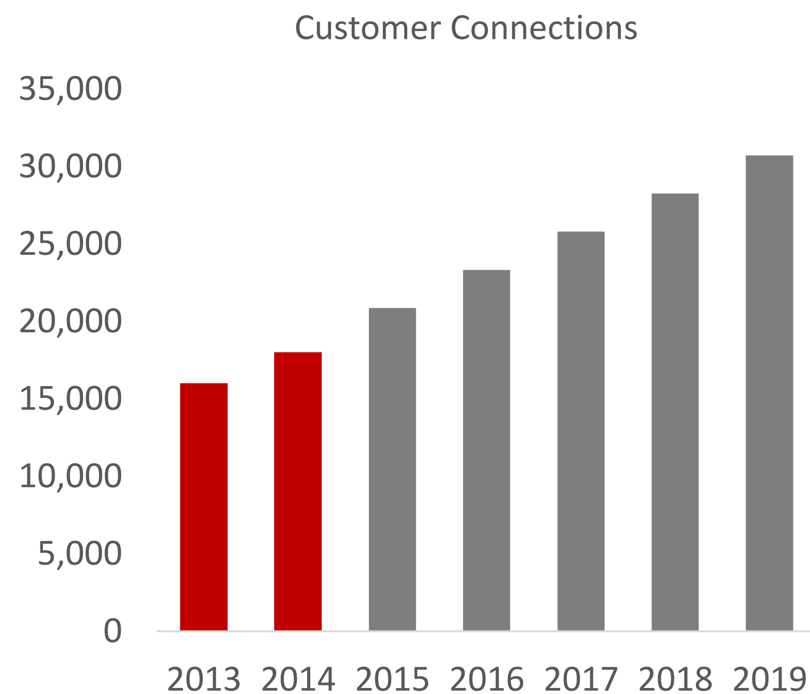
Corporate Segment
Revenue build-up from cohort analysis

Tenants per building analysis



We used historical penetration from 2006 cohort to forecast tenant increases in newer buildings

~2000 new customers every year

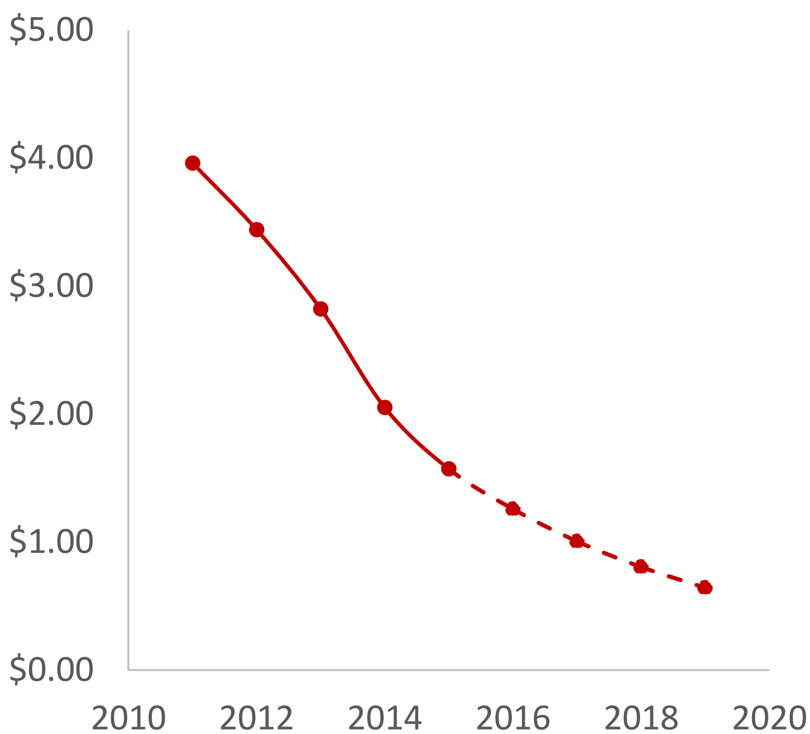


Corporate can achieve 10%+ revenue growth without increasing building footprint

Net-Centric Segment

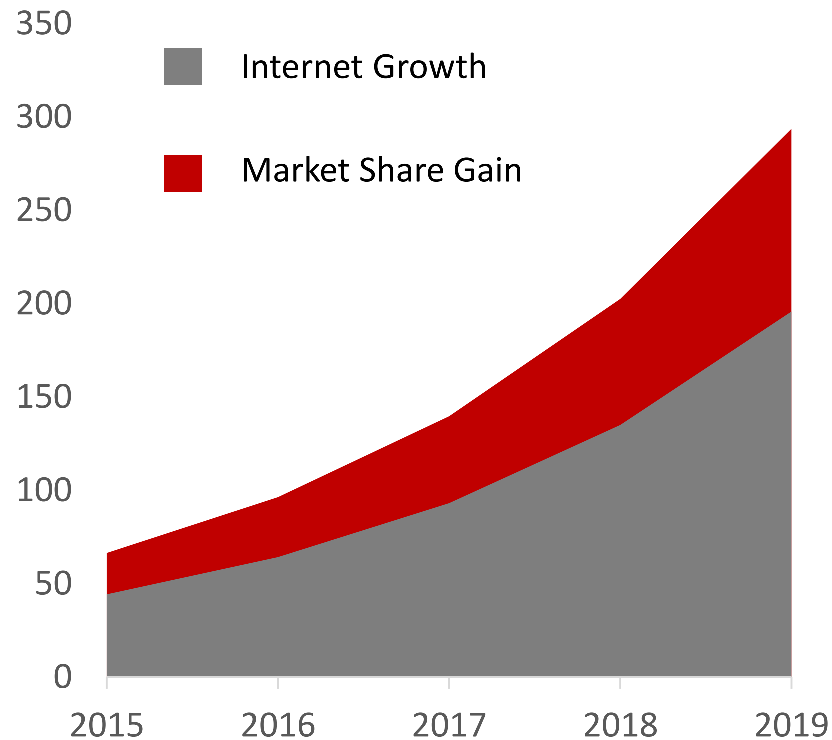
Revenue build-up from price x quantity breakdown

Price curve projections



We have projected costs per Mbps to come down by 20-25% every year

Net-Centric Growth Drivers

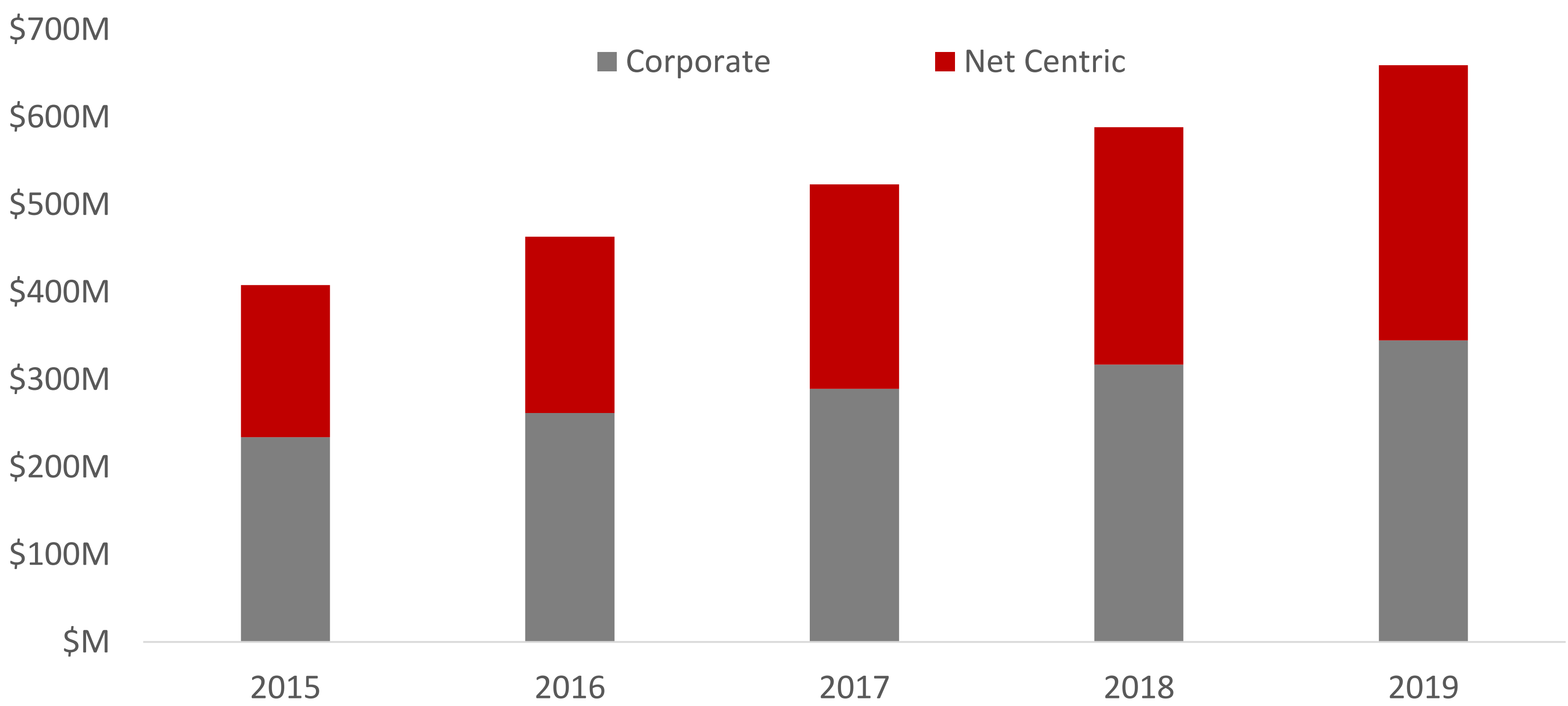


We estimate that Net-Centric growth will be driven 60% by data demand and 40% from share gain

Revenue Forecast

Forecasted growth rates at lower end of management guidance

10.8% Revenue CAGR until 2019



Our projections of 10.8% are conservative, given management's 10-15% revenue growth guidance (Cogent will hit the upper band of guidance in fiscal 2015)

Other Assumptions

We remained conservative with metrics that may inflate share price

Margins	• Given 100 bps decline in margins in past year, we assumed a 100 bps margin improvement as a baseline • Sensitized by +- 100 bps to get a sense of stock price sensitivity
Capex	• Q3 2015 saw a significant drop in CAPEX expense for Cogent driven by less build-outs in corporate segment • We forecasted a relatively flat CAPEX outlook given management indications
Interest Expense	• Management has reiterated its commitment to remain within a 2.5x – 3.5x net debt to EBITDA ratio • We forecasted interest expense with a constant 3.0x ratio and a decreasing cash balance

Sensitivity Analysis

Conservative end of sensitivity analysis still above current share price

cogent

Revenue sensitivity

Tenant growth per year

Traffic growth	1.4	1.5	1.6	1.7	1.8
35%	$36.73	$37.27	$37.81	$38.35	$38.89
40%	$38.99	$39.53	$40.07	$40.61	$41.15
45%	$41.42	$41.96	$42.50	$43.04	$43.58
50%	$44.03	$44.57	$45.10	$45.64	$46.18

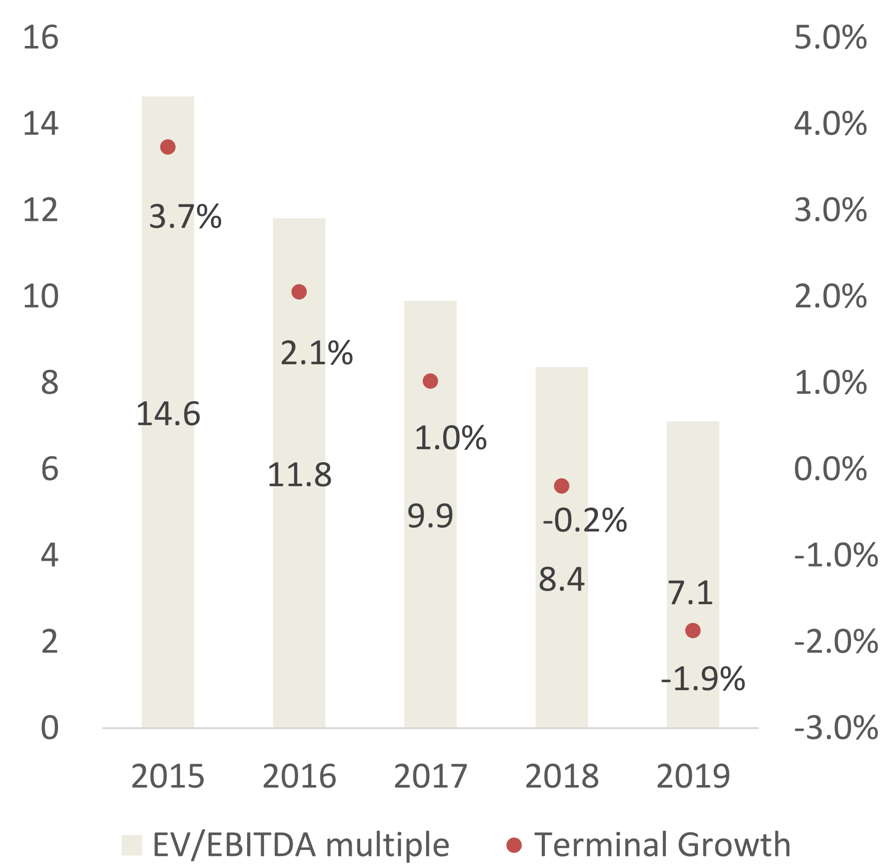
Terminal Value and Margins

Margin expansion (bps)

Terminal growth rate	0	50	100	150	200
1.5%	$31.61	$33.45	$35.29	$37.12	$38.96
2.0%	$34.17	$36.14	$38.10	$40.07	$42.03
2.5%	$37.19	$39.31	$41.42	$43.54	$45.65
3.0%	$40.79	$43.09	$45.39	$47.69	$49.98
3.5%	$45.18	$47.70	$50.21	$52.73	$55.25

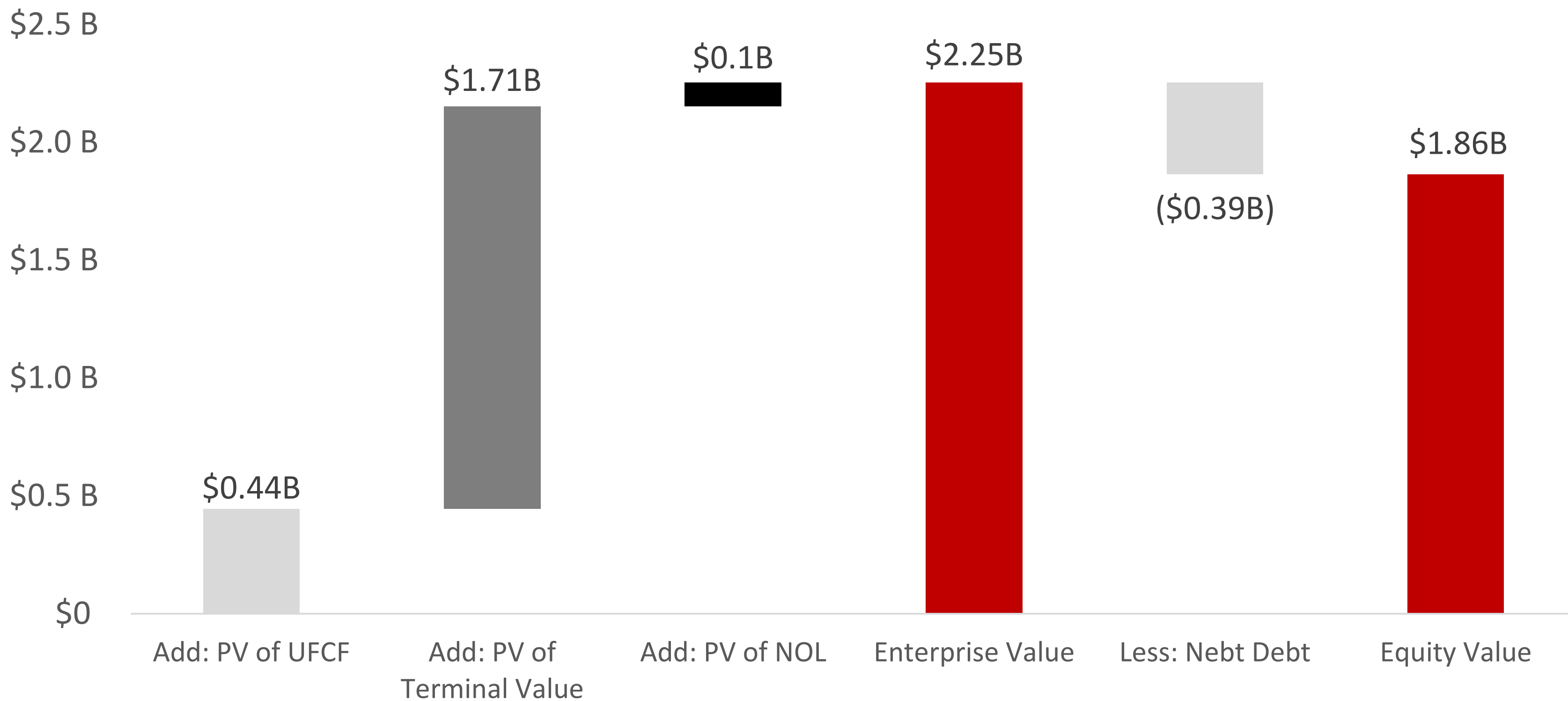
Terminal multiple	0	50	100	150	200
9	$30.18	$31.78	$33.39	$34.99	$36.59
10	$33.29	$35.03	$36.77	$38.52	$40.26
11	$36.40	$38.28	$40.16	$42.04	$43.92
12	$39.51	$41.53	$43.55	$45.57	$47.59
13	$42.62	$44.78	$46.94	$49.09	$51.25

Implied multiple and growth rates



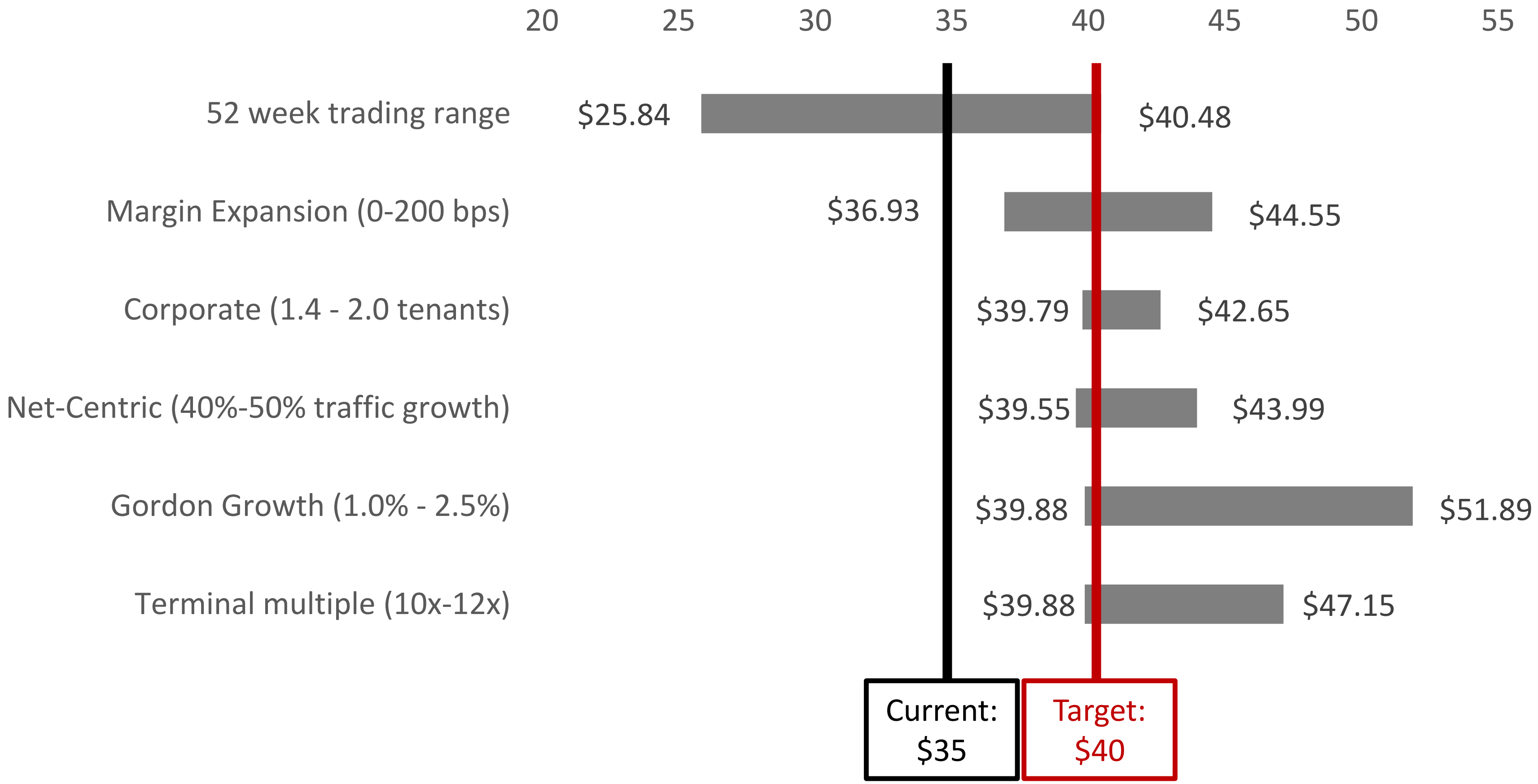
Bridge to Equity Value

We estimate Cogent's fair equity value to be $1.86B



Our DCF analysis yields a price target of $40 per share – implying 15% upside at a 7.3% WACC

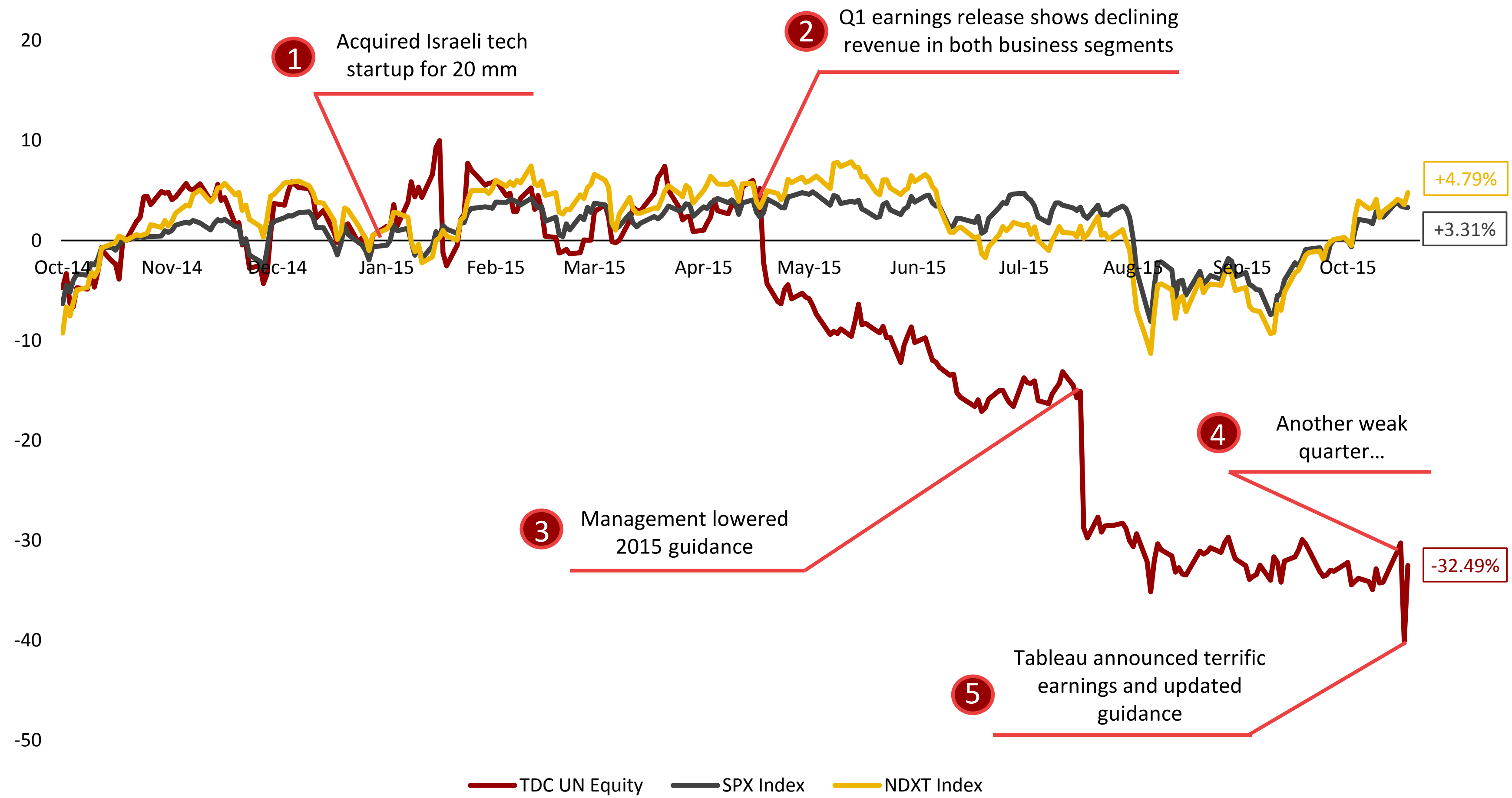
Valuation Football Field



Given attractive valuation TMT analysts recommends initiating a 3% position on CCOI

Annotated Price Chart

Significant depreciation after consecutive weak earnings



Source: Bloomberg as of 10/10/2015.

Teradata
From Hero to Zero

Hold

- Resurgence of DW expenditure in US caused in part by the need for companies to upgrade their aging hardware
- Investments in big data, cloud-based DW lead to revenue growth
- Potential takeover target due to recent sell-off and history of M&A in the space

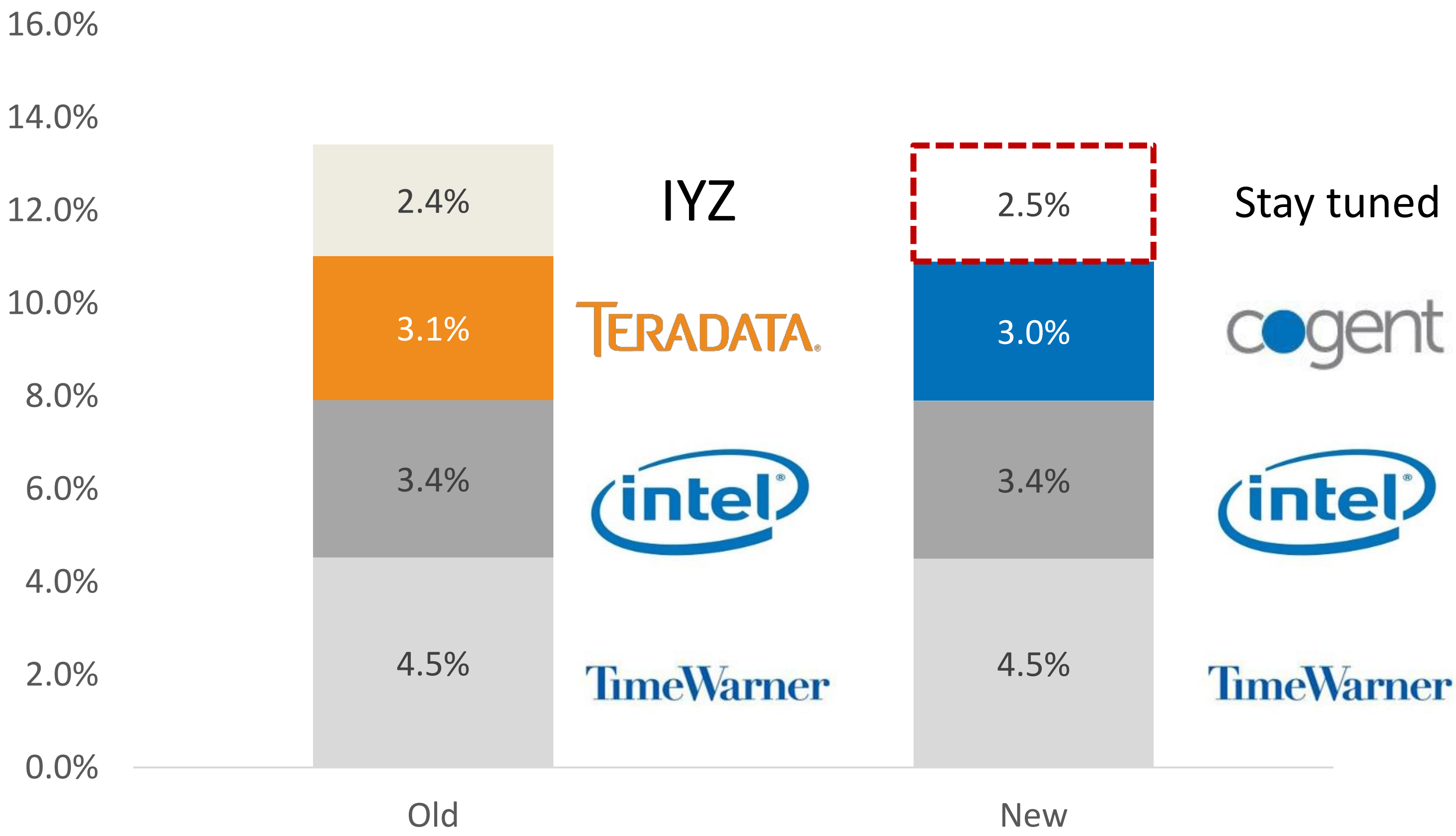
Sell

- Open source and cloud-based alternatives continue to take market share from TDC
- New big data and cloud offerings fail to gain traction vs. competitors
- Margins decline as TDC revenue shifts more towards big data
- Core capabilities of high performance DW products matched by open source alternatives

Overall TDC has announced poor results for several quarters, we are not confident trend will bottom out

New Asset Allocation outlook

Rebalancing the TMT portfolio towards our best ideas



Exit our positions in TDC and IYZ, initiate a 3% position in Cogent & keep 2.5% for later pitch