

COGENT COMMUNICATIONS GROUP INC

Form 10-Q

August 09, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended June 30, 2012

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File No. 1-31227

**COGENT COMMUNICATIONS GROUP, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Delaware

52-2337274

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(State of Incorporation)

(I.R.S. Employer  
Identification Number)

**1015 31st Street N.W.**

**Washington, D.C. 20007**

(Address of Principal Executive Offices and Zip Code)

**(202) 295-4200**

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, \$.001 par value 47,140,525 Shares Outstanding as of July 31, 2012



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## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

AS OF JUNE 30, 2012 AND DECEMBER 31, 2011

(IN THOUSANDS, EXCEPT SHARE DATA)

|  | June 30,<br>2012<br>(Unaudited) | December 31,<br>2011 |
|--|---------------------------------|----------------------|
| <b>Assets</b>  |                                 |                      |
| <b>Current assets:</b>   |                                 |                      |
| Cash and cash equivalents  | \$ 237,227                      | \$ 238,207           |
| Accounts receivable, net of allowance for doubtful accounts of \$2,914 and \$3,345 respectively                                      | 25,652                          | 25,029               |
| Prepaid expenses and other current assets  | 11,852                          | 10,051               |
| Total current assets   | 274,731                         | 273,287              |
| <b>Property and equipment, net</b>   | <b>304,823</b>                  | <b>307,978</b>       |
| <b>Deposits and other assets - \$453 and \$457 restricted, respectively</b>  | <b>15,663</b>                   | <b>16,386</b>        |
| Total assets   | \$ 595,217                      | \$ 597,651           |
| <b>Liabilities and stockholders equity</b>   |                                 |                      |
| <b>Current liabilities:</b>  |                                 |                      |
| Accounts payable   | \$ 11,287                       | \$ 14,199            |
| Accrued liabilities  | 25,468                          | 21,944               |
| Current maturities, capital lease obligations  | 9,218                           | 11,700               |
| Total current liabilities  | 45,973                          | 47,843               |
| <b>Senior secured notes</b>  | <b>175,000</b>                  | <b>175,000</b>       |
| <b>Capital lease obligations, net of current maturities</b>  | <b>122,350</b>                  | <b>122,996</b>       |
| <b>Convertible senior notes, net of discount of \$12,493 and \$15,366 respectively</b>   | <b>79,485</b>                   | <b>76,612</b>        |
| <b>Other long term liabilities</b>   | <b>11,260</b>                   | <b>11,199</b>        |
| Total liabilities  | 434,068                         | 433,650              |
| <b>Commitments and contingencies:</b>  |                                 |                      |
| <b>Stockholders equity:</b>  |                                 |                      |
| Common stock, \$0.001 par value; 75,000,000 shares authorized; 47,140,525 and 45,893,347 shares issued and outstanding, respectively | 47                              | 46                   |
| Additional paid-in capital   | 491,494                         | 489,021              |
| Accumulated other comprehensive income foreign currency translation  | (2,027)                         | (582)                |
| Accumulated deficit  | (328,365)                       | (324,484)            |
| Total stockholders equity  | 161,149                         | 164,001              |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 595,217</b>               | <b>\$ 597,651</b>    |

The accompanying notes are an integral part of these condensed consolidated balance sheets.

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## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE THREE MONTHS ENDED JUNE 30, 2012 AND JUNE 30, 2011  
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

|  | Three Months<br>Ended<br>June 30, 2012<br>(Unaudited) | Three Months<br>Ended<br>June 30, 2011<br>(Unaudited) |
|--|---|---|
| <b>Service revenue</b>   | \$ 77,817   | \$ 75,580   |
| <b>Operating expenses:</b>   |   |   |
| Network operations (including \$118 and \$126 of equity-based compensation expense, respectively, exclusive of depreciation and amortization shown separately below) | 35,112  | 33,249  |
| Selling, general, and administrative (including \$1,905 and \$1,881 of equity-based compensation expense, respectively)  | 19,401  | 18,926  |
| Depreciation and amortization  | 15,503  | 14,734  |
| Total operating expenses   | 70,016  | 66,909  |
| <b>Operating income</b>  | 7,801   | 8,671   |
| <b>Interest income and other, net</b>  | 148   | 298   |
| <b>Release of lease obligation (Note 2)</b>  |   | 2,739   |
| <b>Interest expense</b>  | (8,988)   | (9,135)   |
| <b>(Loss) income before income taxes</b>   | (1,039)   | 2,573   |
| <b>Income tax provision</b>  | (752)   | (458)   |
| <b>Net (loss) income</b>   | \$ (1,791)  | \$ 2,115  |
| <b>Net (loss) income per common share:</b>   |   |   |
| <b>Basic and diluted net (loss) income per common share</b>  | \$ (0.04)   | \$ 0.05   |
| <b>Weighted-average common shares - basic</b>  | 45,313,804  | 45,021,507  |
| <b>Weighted-average common shares - diluted</b>  | 45,313,804  | 45,548,725  |
| <b>Comprehensive (loss) income</b>   | \$ (4,859)  | \$ 2,960  |

The accompanying notes are an integral part of these condensed consolidated statements.

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## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND JUNE 30, 2011  
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

|  | Six Months<br>Ended<br>June 30, 2012<br>(Unaudited) | Six Months<br>Ended<br>June 30, 2011<br>(Unaudited) |
|--|---|---|
| <b>Service revenue</b>   | \$ 154,704  | \$ 149,039  |
| <b>Operating expenses:</b>   |   |   |
| Network operations (including \$201 and \$266 of equity-based compensation expense, respectively, exclusive of depreciation and amortization shown separately below) | 69,449  | 65,021  |
| Selling, general, and administrative (including \$3,061 and \$3,837 of equity-based compensation expense, respectively)  | 40,743  | 38,465  |
| Depreciation and amortization  | 30,743  | 29,525  |
| Total operating expenses   | 140,935   | 133,011   |
| <b>Operating income</b>  | 13,769  | 16,028  |
| <b>Interest income and other, net</b>  | 524   | 529   |
| <b>Release of lease obligation (Note 2)</b>  |   | 2,739   |
| <b>Interest expense</b>  | (17,982)  | (16,720)  |
| <b>(Loss) income before income taxes</b>   | (3,689)   | 2,576   |
| <b>Income tax provision</b>  | (192)   | (739)   |
| <b>Net (loss) income</b>   | \$ (3,881)  | \$ 1,837  |
| <b>Net (loss) income per common share:</b>   |   |   |
| <b>Basic and diluted net (loss) income per common share</b>  | \$ (0.09)   | \$ 0.04   |
| <b>Weighted-average common shares - basic</b>  | 45,325,427  | 45,017,518  |
| <b>Weighted-average common shares - diluted</b>  | 45,325,427  | 45,575,535  |
| <b>Comprehensive (loss) income</b>   | \$ (5,326)  | \$ 5,667  |

The accompanying notes are an integral part of these condensed consolidated statements.

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**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**FOR THE SIX MONTHS ENDED JUNE 30, 2012 AND JUNE 30, 2011**

**(IN THOUSANDS)**

|  | Six months<br>Ended<br>June 30, 2012<br>(Unaudited) | Six months<br>Ended<br>June 30, 2011<br>(Unaudited) |
|--|---|---|
| <b>Cash flows from operating activities:</b>                     |   |   |
| Net cash provided by operating activities                        | \$ 32,157   | \$ 32,622   |
| <b>Cash flows from investing activities:</b>                     |   |   |
| Purchases of property and equipment                              | (22,864)  | (25,995)  |
| Proceeds from dispositions of assets                             | 121   | 2   |
| Net cash used in investing activities                            | (22,743)  | (25,993)  |
| <b>Cash flows from financing activities:</b>                     |   |   |
| Proceeds from issuance of senior secured notes, net              |   | 170,512   |
| Purchases of common stock  | (1,265)   |   |
| Proceeds from exercises of stock options                         | 158   | 155   |
| Principal payments of capital lease obligations                  | (8,763)   | (7,452)   |
| Net cash (used in) provided by financing activities              | (9,870)   | 163,215   |
| <b>Effect of exchange rates changes on cash</b>                  | <b>(524)</b>  | <b>1,119</b>  |
| <b>Net (decrease) increase in cash and cash equivalents</b>      | <b>(980)</b>  | <b>170,963</b>                                      |
| <b>Cash and cash equivalents, beginning of period</b>            | <b>238,207</b>                                      | <b>56,283</b>                                       |
| <b>Cash and cash equivalents, end of period</b>                  | <b>\$ 237,227</b>                                   | <b>\$ 227,246</b>                                   |
| <b>Supplemental disclosure of non-cash financing activities:</b> |   |   |
| Capital lease obligations incurred                               | \$ 5,735  | \$ 28,567   |

The accompanying notes are an integral part of these condensed consolidated statements.



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**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**

**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of the business and recent developments:**

**Description of business**

Cogent Communications Group, Inc. (the Company) is a Delaware corporation and is headquartered in Washington, DC. The Company is a facilities-based provider of low-cost, high-speed Internet access and Internet Protocol (IP) communications services. The Company's network is specifically designed and optimized to transmit data using IP. The Company delivers its services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations in North America and Europe. We recently began expansion into Japan.

The Company offers on-net Internet access services exclusively through its own facilities, which run from its network to its customers' premises. Because of its integrated network architecture, the Company is not dependent on local telephone companies to serve its on-net customers. The Company's on-net service consists of high-speed Internet access and IP connectivity ranging from 100 Megabits per second to 10 Gigabits per second of bandwidth. The Company offers its on-net services to customers located in buildings that are physically connected to its network. The Company provides on-net Internet access services to net-centric and corporate customers. The Company's net-centric customers include certain bandwidth-intensive users such as universities, other Internet service providers, telephone companies, cable television companies and commercial content providers. These customers generally receive service in colocation facilities and in the Company's data centers. The Company operates data centers throughout North America and Europe that allow customers to collocate their equipment and access the Company's network. The Company's corporate customers are located in multi-tenant office buildings and typically include law firms, financial services firms, advertising and marketing firms and other professional services businesses.

In addition to providing its on-net services, the Company provides Internet connectivity to customers that are not located in buildings directly connected to its network. The Company provides this off-net service primarily to corporate customers using other carriers' facilities to provide the last mile portion of the link from its customers' premises to the Company's network. The Company also provides certain non-core services that resulted from acquisitions. The Company continues to support but does not actively sell these non-core services.

**Basis of presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the unaudited condensed consolidated financial statements reflect all normal recurring adjustments that the Company considers necessary for the fair presentation of its results of operations and cash flows for the interim periods covered, and of the financial position of the Company at the date of the interim condensed consolidated balance sheet. Certain information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The operating results for interim periods are not necessarily indicative of the operating results for the entire year. While the Company believes that

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the disclosures are adequate to not make the information misleading, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in its 2011 annual report on Form 10-K.

The accompanying unaudited consolidated financial statements include all wholly-owned subsidiaries. All inter-company accounts and activity have been eliminated.

### *Use of estimates*

The preparation of consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates.

### *Foreign currency translation adjustment and comprehensive (loss) income*

The Company's only component of comprehensive (loss) income is the currency translation adjustment for all periods presented.

### *Financial instruments*

At June 30, 2012 and December 31, 2011, the carrying amount of cash and cash equivalents, accounts receivable, prepaid and other current assets, accounts payable, and accrued expenses approximated fair value because of the short-term nature of these instruments. The Company measures its cash equivalents at amortized cost, which approximates fair value. Based upon the bid quoted (Level 2) prices at June 30, 2012 and December 31, 2011, the fair values of the Company's \$92.0 million convertible senior notes were approximately \$87.3 million and \$82.3 million, respectively. Based upon the bid quoted prices (Level 2) at June 30, 2012 and December 31, 2011, the fair values of the Company's \$175.0 million senior secured notes were approximately \$186.2 million and \$178.7 million, respectively.

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The Company was party to letters of credit totaling approximately \$0.4 million as of June 30, 2012 and December 31, 2011. These letters of credit are secured by investments that are restricted and included in other assets.

#### *Basic and diluted net (loss) income per common share*

Basic earnings per share ( EPS ) excludes dilution for common stock equivalents and is computed by dividing net income or (loss) available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is based on the weighted-average number of shares of common stock outstanding during each period, adjusted for the effect of common stock equivalents, if dilutive.

Shares of restricted stock are included in the computation of basic EPS as they vest and are included in diluted EPS, to the extent they are dilutive, determined using the treasury stock method. For the three and six months ended June 30, 2012 and 2011, 1.9 million, 1.9 million, 1.0 million and 1.0 million unvested shares of restricted common stock, respectively, are not included in the computation of basic or diluted (loss) income per share, as the shares were not vested. For the three and six months ended June 30, 2011, 0.2 million and 0.1 million unvested shares of restricted common stock, respectively, are not included in the computation of diluted income per share, as the effect would be anti-dilutive.

Using the if-converted method, the shares issuable upon conversion of the Company's 1.00% Convertible Senior Notes (the Convertible Notes ) were anti-dilutive for the three and six months ended June 30, 2012 and 2011. Accordingly, the impact has been excluded from the computation of diluted (loss) income per share. The Convertible Notes are convertible into shares of the Company's common stock at an initial conversion price of \$49.18 per share, yielding 1.9 million shares at June 30, 2012 and June 30, 2011, subject to certain adjustments set forth in the indenture.

The Company computes the dilutive effect of outstanding options using the treasury stock method. For the three and six months ended June 30, 2012 and the three and six months ended June 30, 2011, options to purchase 0.2 million shares of common stock at weighted-average exercise prices of \$13.78, \$13.78, \$17.40 and \$17.26 per share, respectively, are not included in the computation of diluted loss per share as the effect would be anti-dilutive. For the three and six months ended June 30, 2012 and the three and six months ended June 30, 2011, the Company's employees exercised options for 6,815, 18,502, 8,996 and 18,280 common shares, respectively.

The following details the determination of the diluted weighted average shares for the three and six months ended June 30, 2011.

|  | Three Months Ended<br>June 30, 2011 | Six Months Ended<br>June 30, 2011 |
|--|-------------------------------------|-----------------------------------|
| Weighted average common shares outstanding - basic | 45,021,507                          | 45,017,518                        |
| Dilutive effect of shares of restricted stock      | 433,777                             | 464,733                           |
| Dilutive effect of stock options                   | 93,441                              | 93,284                            |
| Weighted average shares - diluted                  | 45,548,725                          | 45,575,535                        |

*Recent accounting pronouncements adopted*

The Financial Accounting Standards Board ( FASB ) recently issued amendments to the presentation of comprehensive income which became effective for interim and annual periods beginning after December 15, 2011. The amendments eliminated the previous reporting option of displaying components of other comprehensive income within the statement of changes in stockholders' equity. Under the new guidance, the Company is required to present either a single continuous statement of comprehensive income or an income statement immediately followed by a statement of comprehensive income. The Company elected to present a single continuous statement of comprehensive income.

In May 2011, the FASB issued ASU 2011-04 relating to fair value measurement (FASB ASC Topic 820), which amends current guidance to achieve common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company adopted this pronouncement for its fiscal year beginning January 1, 2012. The adoption of this pronouncement did not have a material effect on the Company's consolidated financial statements.

**2. Property and equipment:**

Depreciation and amortization expense related to property and equipment and capital leases was \$15.5 million, \$30.7 million, \$14.7 million and \$29.4 million for the three and six months ended June 30, 2012 and 2011, respectively. The Company capitalized salaries and related benefits of employees working directly on the construction and build-out of its network of \$1.7 million, \$3.4 million, \$1.7 million and \$3.6 million for the three and six months ended June 30, 2012 and the three and six months ended June 30, 2011, respectively.

*Release of lease obligation*

In the three months ended June 30, 2011, the requirements for extinguishment were met and the Company was released from an obligation under an IRU capital lease obligation totaling \$2.7 million resulting in a gain. The IRU asset related to this obligation had been fully impaired in 2008 when it was determined that the IRU asset was no longer in use.

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On January 26, 2011, the Company issued its 8.375% Senior Secured Notes (the "Senior Notes") due February 15, 2018, for an aggregate principal amount of \$175.0 million in a private offering for resale to qualified institutional buyers pursuant to SEC Rule 144A. The Senior Notes are secured and bear interest at 8.375% per annum. Interest is payable in cash semiannually in arrears on February 15 and August 15, of each year, beginning on August 15, 2011. The Company received net proceeds of approximately \$170.5 million after deducting \$4.5 million of issuance costs that are included in deposits and other assets. The Company intends to use the net proceeds from the Senior Notes for general corporate purposes and/or repurchases of its common stock or its Convertible Notes, or a special or recurring dividend to its stockholders. In the three and six months ended June 30, 2012 and the three and six months ended June 30, 2011, the Company incurred approximately \$3.8 million, \$7.6 million, \$3.8 million and \$6.6 million, respectively, of interest expense related to its Senior Notes.

*Convertible senior notes*

In June 2007, the Company issued its Convertible Notes for an aggregate principal amount of \$200.0 million in a private offering for resale to qualified institutional buyers pursuant to SEC Rule 144A. The Convertible Notes mature on June 15, 2027, are unsecured, and bear interest at 1.00% per annum. The Convertible Notes will rank equally with any future senior debt and senior to any future subordinated debt and will be effectively subordinated to all existing and future liabilities of the Company's subsidiaries and to any secured debt the Company may issue, to the extent of the value of the collateral. Interest is payable in cash semiannually in arrears on June 15 and December 15, of each year, beginning on December 15, 2007. The Company received net proceeds from the issuance of the Convertible Notes of approximately \$195.1 million, after deducting the original issue discount of 2.25% and issuance costs. The discount and other issuance costs are being amortized to interest expense using the effective interest method through June 15, 2014, which is the earliest put date. In 2008, the Company purchased an aggregate of \$108.0 million of face value of the Convertible Notes for \$48.6 million in cash in a series of transactions.

The debt and equity components for the Convertible Notes were as follows (in thousands):

|                            | <b>June 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|----------------------------|--------------------------|------------------------------|
| Principal amount           | \$ 91,978                | \$ 91,978                    |
| Unamortized discount       | (12,493)                 | (15,366)                     |
| Net carrying amount        | 79,485                   | 76,612                       |
| Additional paid-in capital | 74,933                   | 74,933                       |

At June 30, 2012, the unamortized discount had a remaining recognition period of approximately two years. The amount of interest expense recognized and effective interest rate were as follows (in thousands):

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|  | Three Months Ended<br>June 30, 2012 | Three Months Ended<br>June 30, 2011 | Six Months Ended<br>June 30, 2012 | Six Months Ended<br>June 30, 2011 |
|--|-------------------------------------|-------------------------------------|-----------------------------------|-----------------------------------|
| Contractual coupon interest                    | \$ 230                              | \$ 230                              | \$ 460                            | \$ 460                            |
| Amortization of discount<br>and costs on Notes | 1,456                               | 1,337                               | 2,880                             | 2,645                             |
| Interest expense                               | \$ 1,686                            | \$ 1,567                            | \$ 3,340                          | \$ 3,105                          |
| Effective interest rate                        | 8.7%                                | 8.7%                                | 8.7%                              | 8.7%                              |

**4. Commitments and contingencies :**

*Current and potential litigation*

In the normal course of business the Company is involved in other legal activities and claims. Because such matters are subject to many uncertainties and the outcomes are not predictable with assurance, the liability related to these legal actions and claims cannot be determined with certainty. Management does not believe that such claims and actions will have a material impact on the Company's financial condition or results of operations.

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In the normal course of business the Company takes positions on its tax returns that may be challenged by taxing authorities. The Company evaluates all uncertain tax positions to assess whether the position will more likely than not be sustained upon examination. If the Company determines that the tax position is more likely than not to be sustained, the Company records the amount of the benefit that is more likely than not to be realized when the tax position is settled. This liability, including accrued interest and penalties, is included in other long-term liabilities in the accompanying balance sheets and was approximately \$3.1 million as of June 30, 2012 and \$3.9 million as of December 31, 2011. During the three and six months ended June 30, 2012 and 2011 the Company recognized approximately \$84,000, \$160,000, \$19,000 and \$38,000 in interest and penalties, respectively, related to its uncertain tax positions. During the three months ended March 31, 2012, the Company reversed approximately \$0.7 million of its liability for uncertain tax positions due to the resolution of certain state income tax issues pursuant to the completion of an audit. The Company expects that its liability for uncertain tax positions will decrease by approximately an additional \$2.0 million during the twelve months ended December 31, 2012 due to the expiration of certain statutes of limitation, however, actual changes in the liability for uncertain tax positions could be different than currently expected. If recognized, the total unrecognized tax benefits would lower the Company's effective income tax rate.

A reconciliation of the beginning and ending amount of unrecognized tax benefits (excluding interest and penalties) is as follows (in thousands):

|   | Three Months Ended<br>June 30, 2012 |    | Three Months Ended<br>June 30, 2011 |    | Six Months Ended<br>June 30, 2012 |    | Six Months Ended<br>June 30, 2011 |
|---|-------------------------------------|----|-------------------------------------|----|-----------------------------------|----|-----------------------------------|
| Beginning balance                               | \$ 2,177                            | \$ | 698                                 | \$ | 2,875                             | \$ | 698                               |
| Gross increases tax positions in prior periods  | 72                                  |    |                                     |    | 72                                |    |                                   |
| Gross decreases tax positions in current period |                                     |    |                                     |    | (698)                             |    |                                   |
| Ending balance                                  | \$ 2,249                            | \$ | 698                                 | \$ | 2,249                             | \$ | 698                               |

*Incentive award plan*

The Company has an award plan, the 2004 Incentive Award Plan, as amended (the Award Plan), under which grants of stock and options are made. The Company has granted restricted shares under the Award Plan that are subject to certain performance conditions based upon the Company's operating metrics. The Company recorded approximately \$0 million, \$0.1 million, \$0.3 million and \$0.7 million of equity-based compensation expense related to the restricted shares subject to performance conditions in the three and six months ended June 30, 2012 and 2011, respectively. There was no equity-based compensation expense recorded related to the restricted shares subject to performance conditions for 2012 since it is not considered probable that the performance conditions for 2012 will be met. In the first quarter of 2012, 62,400 restricted shares related to the performance conditions for 2011 vested since the performance conditions were met.

On April 19, 2012, the Company's shareholders approved increasing the authorized shares under the Award Plan by 1.2 million shares. In the second quarter of 2012, the Company granted approximately 1.2 million restricted shares to its employees that will vest over three to four-year periods. These restricted shares were valued at approximately \$22.0 million and will be recognized as equity-based compensation expense on a straight line basis over the service period.

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### *Common stock buyback program*

The Company's board of directors has approved \$50.0 million of purchases of the Company's common stock under a buyback program (the Buyback Program). There is approximately \$45.8 million remaining for purchases under the Buyback Program. The Company purchased approximately 0.1 million shares for approximately \$1.3 million during the three months ended June 30, 2012. There were no purchases of common stock during the other periods presented herein.

### *Dividends on common stock*

On August 7, 2012 the Company's board of directors approved the payment of a dividend of \$0.10 per common share - estimated to be approximately \$4.7 million - to holders of record on August 22, 2012 and payment to be made on September 12, 2012. The payment of any future quarterly dividends will be at the discretion of the Company's board of directors and will be dependent upon the Company's financial position, results of operations, available cash, cash flow, capital requirements and other factors deemed relevant by the Company's board of directors.



Table of Contents**5. Related party transactions:***Office lease*

The Company's headquarters is located in an office building owned by a partnership (6715 Kenilworth Avenue Partnership). The two owners of the partnership are the Company's Chief Executive Officer, who has a 51% interest in the partnership and his wife, Ruth Schaeffer, who has a 49% interest in the partnership. The Company paid \$0.2 million, \$0.3 million, \$0.2 million and \$0.3 million for the three and six months ended June 30, 2012 and the three and six months ended June 30, 2011, respectively, in rent and related costs (including taxes and utilities) to this partnership under a lease that expires in August 2013.

**6. Segment information:**

The Company operates as one operating segment. Below are the Company's service revenues and long lived assets by geographic region (in thousands):

|                 | <b>Three Months<br/>Ended<br/>June 30, 2012</b> | <b>Three Months<br/>Ended<br/>June 30, 2011</b> | <b>Six Months<br/>Ended<br/>June 30, 2012</b> | <b>Six Months<br/>Ended<br/>June 30, 2011</b> |
|-----------------|---|---|---|---|
| <b>Revenues</b> |   |   |   |   |
| North America   | \$ 62,394                                       | \$ 58,871                                       | \$ 124,137                                    | \$ 116,122                                    |
| Europe          | 15,423  | 16,709  | 30,567  | 32,917  |
| Total           | \$ 77,817                                       | \$ 75,580                                       | \$ 154,704                                    | \$ 149,039                                    |

|                               | <b>June 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|-------------------------------|--------------------------|------------------------------|
| <b>Long lived assets, net</b> |                          |                              |
| North America                 | \$ 225,675               | \$ 225,598                   |
| Europe                        | 79,199                   | 82,445                       |
| Total                         | \$ 304,874               | \$ 308,043                   |

The majority of North American revenue consists of services delivered within the United States.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following discussion and analysis together with our condensed consolidated financial statements and related notes included in this report. The discussion in this report contains forward-looking statements that involve risks and uncertainties, such as statements of our*

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*plans, objectives, expectations and intentions. The cautionary statements made in this report should be read as applying to all related forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to these differences include, but are not limited to:*

*Future economic instability in the global economy, which could affect spending on Internet services; the impact of changing foreign exchange rates (in particular the Euro to USD and Canadian to USD exchange rates) on the translation of our non-USD denominated revenues, expenses, assets and liabilities; legal and operational difficulties in new markets; the imposition of a requirement that we contribute to the U. S. Universal Service Fund; changes in government policy and/or regulation, including rules regarding data protection and cyber security; increasing competition leading to lower prices for our services; our ability to attract new customers and to increase and maintain the volume of traffic on our network; the ability to maintain our Internet peering arrangements on favorable terms; our reliance on an equipment vendor, Cisco Systems Inc., and the potential for hardware or software problems associated with such equipment; the dependence of our network on the quality and dependability of third-party fiber providers; our ability to retain certain customers that comprise a significant portion of our revenue base; the management of network failures and/or disruptions; and outcomes in litigation as well as other risks discussed from time to time in our filings with the Securities and Exchange Commission, including, without limitation, our annual report on Form 10-K for the fiscal year ended December 31, 2011.*

### **General Overview**

We are a leading facilities-based provider of low-cost, high-speed Internet access and IP communications services. Our network is specifically designed and optimized to transmit data using IP. We deliver our services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations in North America and Europe.

Our on-net service consists of high-speed Internet access and IP connectivity ranging from 100 Megabits per second to 10 Gigabits per second of bandwidth. We offer our on-net services to customers located in buildings that are physically connected to our network. We provide on-net Internet access to net-centric and corporate customers. Our net-centric customers include certain bandwidth-intensive users such as universities, other Internet service providers, telephone companies, cable television companies and commercial content providers. These customers generally receive service in colocation facilities and in our data centers. Our corporate customers are located in multi-tenant office buildings and typically include law firms, financial services firms, advertising and marketing firms and other professional services businesses.

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Our off-net services are sold to businesses that are connected to our network primarily by means of last mile access service lines obtained from other carriers, primarily in the form of point-to-point TDM, POS, SDH and/or Carrier Ethernet circuits. Our non-core services, which consist primarily of legacy services of companies whose assets or businesses we have acquired, primarily include voice services (only provided in Toronto, Canada). We do not actively market these non-core services and expect the service revenue associated with them to continue to decline.

Our network is comprised of in-building riser facilities, metropolitan optical fiber networks, metropolitan traffic aggregation points and inter-city transport facilities. Our network is physically connected entirely through our facilities to over 1,800 buildings in which we provide our on-net services, including 1,270 multi-tenant office buildings. We also provide on-net services in carrier-neutral colocation facilities, Cogent controlled data centers and single-tenant office buildings. Because of our integrated network architecture, we are not dependent on local telephone companies to serve our on-net customers. We emphasize the sale of our on-net services because we believe we have a competitive advantage in providing these services and these services generate gross profit margins that are greater than the gross profit margins on our off-net services.

We believe our key growth opportunity is provided by our high-capacity network, which provides us with the ability to add a significant number of customers to our network with minimal direct incremental costs. Our focus is to add customers to our network in a way that maximizes its use and at the same time provides us with a profitable customer mix. We are responding to this opportunity by increasing our sales and marketing efforts including increasing our number of sales representatives and expanding our network to locations that we believe can be economically integrated and represent significant concentrations of Internet traffic. One of our keys to developing a profitable business will be to carefully match the cost of extending our network to reach new customers with the revenue expected to be generated by those customers. In addition, we may add customers to our network through strategic acquisitions.

We believe two of the most important trends in our industry are the continued long-term growth in Internet traffic and a decline in Internet access prices within carrier neutral data centers. As Internet traffic continues to grow and prices per unit of traffic continue to decline, we believe our ability to load our network and gain market share from less efficient network operators will continue to expand. However, continued erosion in Internet access prices will likely have a negative impact on the rate at which we can increase our revenues and our profitability. Our revenue may also be negatively affected if we are unable to grow our Internet traffic or if the rate of growth of Internet traffic does not offset the expected decline in per unit pricing. We do not know if Internet traffic will increase or decrease, or the rate at which it will grow or decrease. Changes in Internet traffic will be a function of the number of users, the applications for which the Internet is used, the pricing of Internet services, and other factors.

The growth in Internet traffic has a more significant impact on our net-centric customers who represent the majority of the traffic on our network and who tend to consume the majority of their allocated bandwidth on their connections. Net-centric customers tend to purchase their service on a price per megabit basis. Our corporate customers tend to utilize a small portion of their allocated bandwidth on their connections and tend to purchase their service on a per connection basis.

Due to our strategic acquisitions of network assets and equipment, we believe we are well positioned to grow our revenue base. We continue to purchase and deploy network equipment to parts of our network to maximize the utilization of our assets and to expand and increase the capacity of our network. Our future capital expenditures will be based primarily on the expansion of our network, the addition of on-net buildings and the concentration and growth of our customer base. We plan to continue to expand our network and to increase the number of on-net buildings we serve. Many factors can affect our ability to add buildings to our network. These factors include the willingness of building owners to grant us access rights, the availability of optical fiber networks to serve those buildings, and equipment availability.

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*Three Months Ended June 30, 2012 Compared to the Three Months Ended June 30, 2011*

The following summary table presents a comparison of our results of operations for the three months ended June 30, 2012 and 2011 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

|   | Three months ended<br>June 30, |           | Percent<br>Change |
|---|--------------------------------|-----------|-------------------|
|   | 2012                           | 2011      |                   |
|   | (in thousands)                 |           |                   |
| Service revenue                                   | \$ 77,817                      | \$ 75,580 | 3.0%              |
| On-net revenue                                    | 57,321                         | 58,016    | (1.2)%            |
| Off-net revenue                                   | 19,868                         | 16,786    | 18.4%             |
| Non-core revenue                                  | 628                            | 778       | (19.3)%           |
| Network operations expenses (1)                   | 34,994                         | 33,123    | 5.6%              |
| Selling, general, and administrative expenses (2) | 17,496                         | 17,045    | 2.6%              |
| Equity-based compensation expense                 | 2,023                          | 2,007     | 0.8%              |
| Depreciation and amortization expenses            | 15,503                         | 14,734    | 5.2%              |
| Interest expense                                  | 8,988                          | 9,135     | (1.6)%            |
| Release of lease obligation                       |                                | 2,739     | (100.0)%          |
| Income tax provision                              | 752                            | 458       | 64.2%             |

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(1) Excludes equity-based compensation expenses of \$118 and \$126 in the three months ended June 30, 2012 and 2011, respectively, which, if included would have resulted in a period-to-period change of 5.6%.

(2) Excludes equity-based compensation expenses of \$1,905 and \$1,881 in the three months ended June 30, 2012 and 2011, respectively, which, if included would have resulted in a period-to-period change of 2.5%.

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*Service Revenue.* Our service revenue increased 3.0% to \$77.8 million for the three months ended June 30, 2012 from \$75.6 million for the three months ended June 30, 2011. The impact of exchange rates resulted in a decrease of revenues for the three months ended June 30, 2012 of approximately \$2.1 million. All foreign currency comparisons herein reflect our second quarter 2012 results translated at the average foreign currency exchange rates for the second quarter of 2011. For the three months ended June 30, 2012 and 2011, on-net, off-net and non-core revenues represented 73.7%, 25.5% and 0.8% and 76.8%, 22.2% and 1.0% of our service revenue, respectively. In January 2012, our largest (on-net and net-centric) customer was indicted by the U.S. government and as a result our on-net service to this customer and the associated revenue terminated in January 2012. This customer accounted for approximately 5.5% of our 2011 and second quarter 2011 revenues. The loss of this net-centric customer negatively impacted our revenue growth rate from the second quarter of 2011 to the second quarter of 2012 and will negatively impact our revenue growth rate from 2011 to 2012.

Revenues from our corporate and net centric customers represented 51.5% and 48.5% of total service revenue, respectively, for the three months ended June 30, 2012 and represented 48.8% and 51.2% of total service revenue, respectively, for the three months ended June 30, 2011. Revenues from corporate customers increased 8.6% to \$40.1 million for the three months ended June 30, 2012 from \$36.9 million for the three months ended June 30, 2011. Revenues from our net-centric customers decreased 2.5% to \$37.7 million for the three months ended June 30, 2012 from \$38.7 million for the three months ended June 30, 2011. As noted above, the loss of our largest net-centric customer in January 2012 negatively impacted our net-centric revenue growth rate from the second quarter of 2011 to the second quarter of 2012 and will negatively impact our net-centric revenue growth rate from 2011 to 2012.

Our on-net revenues were \$57.3 million for the three months ended June 30, 2012 and \$58.0 million for the three months ended June 30, 2011. We increased the number of our on-net customer connections by 17.6% to approximately 27,500 at June 30, 2012 from approximately 23,400 at June 30, 2011. The loss of our largest on-net customer in January 2012 negatively impacted our on-net revenue growth rate from the second quarter of 2011 to the second quarter of 2012 and will negatively impact our on-net revenue growth rate from 2011 to 2012. Additionally, on-net customer connections increased at a greater rate than on-net revenues due to a decline in the average revenue per on-net customer connection, primarily from our net centric customers. This decline is partly attributed to volume and term based pricing discounts. Additionally, on-net customers who cancel their service from our installed base of customers, in general, have greater average revenue per connection than new customers. These trends and events resulted in a reduction to our average revenue per on-net connection.

Our off-net revenues increased 18.4% to \$19.9 million for the three months ended June 30, 2012 from \$16.8 million for the three months ended June 30, 2011. Our off-net revenues increased as we increased the number of our off-net customer connections by 9.1% to approximately 4,100 at June 30, 2012 from approximately 3,760 at June 30, 2011. Off-net revenues increased at a greater rate than off-net customer connections due to an increase in the average revenue per off-net customer connection. Off-net customers who cancel their service, in general, have a lower average revenue per connection than new off-net customers who generally purchase higher-bandwidth connections.

Our non-core revenues decreased 19.3% to \$0.6 million for the three months ended June 30, 2012 from \$0.8 million for the three months ended June 30, 2011. The number of our non-core customer connections decreased 18.2% to approximately 500 at June 30, 2012 from approximately 600 at June 30, 2011. We do not actively market these acquired non-core services and expect that the service revenue associated with them will continue to decline.

*Network Operations Expenses.* Our network operations expenses, excluding equity-based compensation expense, increased 5.6% to \$35.0 million for the three months ended June 30, 2012 from \$33.1 million for the three months ended June 30, 2011. The increase is primarily attributable to an increase in costs related to our network and facilities expansion activities and the increase in our off-net revenues. When we provide off-net revenues we also assume the cost of the associated tail-circuits. The impact of exchange rates resulted in a decrease of network operations expenses for the three months ended June 30, 2012 of approximately \$0.9 million.

*Selling, General, and Administrative ( SG&A ) Expenses.* Our SG&A expenses, excluding equity-based compensation expense, increased 2.6% to \$17.5 million for the three months ended June 30, 2012 from \$17.0 million for the three months ended June 30, 2011. SG&A expenses increased primarily from the increase in salaries and related costs required to support our expanding sales and marketing efforts. The impact of exchange rates resulted in a decrease of SG&A expenses for the three months ended June 30, 2012 of approximately \$0.5 million.

*Equity-based Compensation Expense.* Equity-based compensation expense results from grants of restricted stock and stock options. Equity-based compensation expense was \$2.0 million for the three months ended June 30, 2012 and \$2.0 million for the three months ended June 30, 2011. The impact of exchange rates had no material impact on equity-based compensation expense for the three months ended June 30, 2012.

On April 19, 2012, our shareholders approved increasing the authorized shares under our award plan by 1.2 million shares. In the second quarter of 2012, we granted approximately 1.2 million restricted shares to our employees that will vest over three to four-year periods. These restricted shares had an aggregate grant date fair value of approximately \$22.0 million and will be recognized as equity-based compensation expense on a straight line basis over the service period.

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*Depreciation and Amortization Expenses.* Our depreciation and amortization expense increased 5.2% to \$15.5 million for the three months ended June 30, 2012 from \$14.7 million for the three months ended June 30, 2011. The increase is primarily due to the depreciation expense associated with recently deployed fixed assets. The impact of exchange rates resulted in a decrease of depreciation and amortization expense for the three months ended June 30, 2012 of approximately \$0.3 million.

*Interest Expense.* Interest expense results from interest incurred on our \$175.0 million of 8.375% Senior Secured Notes (the Senior Notes ) issued on January 26, 2011, our \$92.0 million of 1.00% convertible senior notes (the Convertible Notes ) issued in June 2007, and interest on our capital lease obligations. Our interest expense decreased 1.6% to \$9.0 million for the three months ended June 30, 2012 from \$9.1 million for the three months ended June 30, 2011. The impact of exchange rates resulted in a decrease of interest expense for the three months ended June 30, 2012 of approximately \$0.2 million.

*Release of Lease Obligation-Gain.* In the three months ended June 30, 2011 the requirements for extinguishment were met and we were released from an obligation under an IRU capital lease obligation totaling \$2.7 million resulting in a gain. The IRU asset related to this obligation had been fully impaired in 2008 when it was determined that the IRU asset was no longer in use.

*Income Tax Provision.* Our income tax provision was \$0.8 million for the three months ended June 30, 2012 and was \$0.5 million for the three months ended June 30, 2011. The income tax provision for the three months ended June 30, 2012 and the three months ended June 30, 2011 includes provisions for U.S. state and foreign income taxes.

*Buildings On-net.* As of June 30, 2012 and 2011, we had a total of 1,799 and 1,669 on-net buildings connected to our network, respectively.

### *Six Months Ended June 30, 2012 Compared to the Three Months Ended June 30, 2011*

The following summary table presents a comparison of our results of operations for the six months ended June 30, 2012 and 2011 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

|   | 2012 | Six months ended<br>June 30,<br>(in thousands) | 2011       | Percent<br>Change |
|---|------|--|------------|-------------------|
| Service revenue                                   | \$   | 154,704  | \$ 149,039 | 3.8%              |
| On-net revenue                                    |      | 114,070  | 114,787    | (0.6)%            |
| Off-net revenue                                   |      | 39,368   | 32,737     | 20.3%             |
| Non-core revenue                                  |      | 1,266  | 1,515      | (16.4)%           |
| Network operations expenses (1)                   |      | 69,248   | 64,755     | 6.9%              |
| Selling, general, and administrative expenses (2) |      | 37,682   | 34,628     | 8.8%              |
| Equity-based compensation expense                 |      | 3,262  | 4,103      | (20.5)%           |
| Depreciation and amortization expenses            |      | 30,743   | 29,525     | 4.1%              |
| Interest expense                                  |      | 17,982   | 16,720     | 7.5%              |
| Release of lease obligation                       |      |  | 2,739      | (100.0)%          |

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|                      |     |     |         |
|----------------------|-----|-----|---------|
| Income tax provision | 192 | 739 | (74.0)% |
|----------------------|-----|-----|---------|

(1) Excludes equity-based compensation expenses of \$201 and \$266 in the six months ended June 30, 2012 and 2011, respectively, which, if included would have resulted in a period-to-period change of 6.8%.

(2) Excludes equity-based compensation expenses of \$3,061 and \$3,837 in the six months ended June 30, 2012 and 2011, respectively, which, if included would have resulted in a period-to-period change of 5.9%.

*Service Revenue.* Our service revenue increased 3.8% to \$154.7 million for the six months ended June 30, 2012 from \$149.0 million for the six months ended June 30, 2011. The impact of exchange rates resulted in a decrease of revenues for the six months ended June 30, 2012 of approximately \$2.7 million. All foreign currency comparisons herein reflect our results for the six months ended June 30, 2012 translated at the average foreign currency exchange rates for the six months ended June 30, 2011. For the six months ended June 30, 2012 and 2011, on-net, off-net and non-core revenues represented 73.7%, 25.5% and 0.8% and 77.0%, 22.0% and 1.0% of our service revenue, respectively. In January 2012, our largest (on-net and net-centric) customer was indicted by the U.S. government and as a result our on-net service to this customer and the associated revenue terminated in January 2012. This customer accounted for approximately 5.5% of our revenues for 2011 and for the six months ended June 30, 2011. The loss of this net-centric customer negatively impacted our revenue growth rate from the first six months of 2011 to the first six months of 2012 and will negatively impact our revenue growth rate from 2011 to 2012.

Revenues from our corporate and net centric customers represented 51.2% and 48.8% of total service revenue, respectively, for the six months ended June 30, 2012 and represented 49.0% and 51.0% of total service revenue, respectively, for the six months ended June 30, 2011. Revenues from corporate customers increased 8.4% to \$79.2 million for the six months ended June 30, 2012 from \$73.0 million for the six months ended June 30, 2011. Revenues from our net-centric customers decreased 0.6% to \$75.5 million for the six months ended June 30, 2012 from \$76.0 million for the six months ended June 30, 2011. As noted above, the loss of our largest net-centric customer in January 2012 negatively impacted our net-centric revenue growth rate from the first six months of 2011 to the first six months of 2012 and will negatively impact our net-centric revenue growth rate from 2011 to 2012.



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Our on-net revenues were \$114.1 million for the six months ended June 30, 2012 and \$114.8 million for the six months ended June 30, 2011. We increased the number of our on-net customer connections by 17.6% to approximately 27,500 at June 30, 2012 from approximately 23,400 at June 30, 2011. The loss of our largest on-net customer in January 2012 negatively impacted our on-net revenue growth rate from the first six months of 2011 to the first six months of 2012 and will negatively impact our on-net revenue growth rate from 2011 to 2012. On-net customer connections increased at a greater rate than on-net revenues due to a decline in the average revenue per on-net customer connection, primarily from our net centric customers. This decline is partly attributed to volume and term based pricing discounts. Additionally, on-net customers who cancel their service from our installed base of customers, in general, have greater average revenue per connection than new customers. These trends and events resulted in a reduction to our average revenue per on-net connection.

Our off-net revenues increased 20.3% to \$39.4 million for the six months ended June 30, 2012 from \$32.7 million for the six months ended June 30, 2011. Our off-net revenues increased as we increased the number of our off-net customer connections by 9.1% to approximately 4,100 at June 30, 2012 from approximately 3,760 at June 30, 2011. Off-net revenues increased at a greater rate than off-net customer connections due to an increase in the average revenue per off-net customer connection. Off-net customers who cancel their service, in general, have a lower average revenue per connection than new off-net customers who generally purchase higher-bandwidth connections.

Our non-core revenues decreased 16.4% to \$1.3 million for the six months ended June 30, 2012 from \$1.5 million for the six months ended June 30, 2011. The number of our non-core customer connections decreased 18.2% to approximately 500 at June 30, 2012 from approximately 600 at June 30, 2011. We do not actively market these acquired non-core services and expect that the service revenue associated with them will continue to decline.

*Network Operations Expenses.* Our network operations expenses, excluding equity-based compensation expense, increased 6.9% to \$69.2 million for the six months ended June 30, 2012 from \$64.8 million for the six months ended June 30, 2011. The increase is primarily attributable to an increase in costs related to our network and facilities expansion activities and the increase in our off-net revenues. When we provide off-net revenues we also assume the cost of the associated tail-circuits. The impact of exchange rates resulted in a decrease of network operations expenses for the six months ended June 30, 2012 of approximately \$1.2 million.

*Selling, General, and Administrative ( SG&A ) Expenses.* Our SG&A expenses, excluding equity-based compensation expense, increased 8.8% to \$37.7 million for the six months ended June 30, 2012 from \$34.6 million for the six months ended June 30, 2011. SG&A expenses increased primarily from the increase in salaries and related costs required to support our expanding sales and marketing efforts and to an increase in bad debt expense of approximately \$1.3 million, primarily related to the loss of our largest customer in January 2012. The impact of exchange rates resulted in a decrease of SG&A expenses for the six months ended June 30, 2012 of approximately \$0.7 million.

*Equity-based Compensation Expense.* Equity-based compensation expense results from grants of restricted stock and stock options. Equity-based compensation expense decreased 20.5% to \$3.3 million for the six months ended June 30, 2012 from \$4.1 million for the six months ended June 30, 2011. Equity-based compensation decreased from the vesting of previous grants and a reduction in equity-based compensation expense related to shares subject to performance conditions. The impact of exchange rates had no material impact on equity-based compensation expense for the six months ended June 30, 2012.

On April 19, 2012, our shareholders approved increasing the authorized shares under our award plan by 1.2 million shares. In the second quarter of 2012, we granted approximately 1.2 million restricted shares to our employees that will vest over three to four-year periods. These restricted shares had an aggregate grant date fair value of approximately \$22.0 million and will be recognized as equity-based compensation expense on a straight line basis over the service period.

*Depreciation and Amortization Expenses.* Our depreciation and amortization expense increased 4.1% to \$30.7 million for the six months ended June 30, 2012 from \$29.5 million for the six months ended June 30, 2011. The increase is primarily due to the depreciation expense associated with recently deployed fixed assets. The impact of exchange rates resulted in a decrease of depreciation and amortization expense for the six months ended June 30, 2012 of approximately \$0.4 million.

*Interest Expense.* Interest expense results from interest incurred on our \$175.0 million of 8.375% Senior Secured Notes (the Senior Notes ) issued on January 26, 2011, our \$92.0 million of 1.00% convertible senior notes (the Convertible Notes ) issued in June 2007, and interest on our capital lease obligations. Our interest expense increased 7.5% to \$18.0 million for the six months ended June 30, 2012 from \$16.7 million for the six months ended June 30, 2011. The increase is attributed to interest expense related to the issuance of our Senior Notes since the Senior Notes were outstanding for only a portion of the six months ended June 30, 2011 and to an increase in our capital lease obligations. The impact of exchange rates resulted in a decrease of interest expense for the six months ended June 30, 2012 of approximately \$0.3 million.

*Release of Lease Obligation-Gain.* In the six months ended June 30, 2011 the requirements for extinguishment were met and we were released from an obligation under an IRU capital lease obligation totaling \$2.7 million resulting in a gain. The IRU asset related to this obligation had been fully impaired in 2008 when it was determined that the IRU asset was no longer in use.

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*Income Tax Provision.* Our income tax provision was \$0.2 million for the six months ended June 30, 2012 and was \$0.7 million for the six months ended June 30, 2011. The income tax provision for the six months ended June 30, 2012 and six months ended June 30, 2011 includes foreign and U. S. state income taxes. Additionally, during the six months ended June 30, 2012 we reversed approximately \$0.7 million of a liability for an uncertain tax position due to the resolution of certain state income tax issues pursuant to the completion of an audit.

*Buildings On-net.* As of June 30, 2012 and 2011, we had a total of 1,799 and 1,669 on-net buildings connected to our network, respectively.

**Liquidity and Capital Resources**

In assessing our liquidity, management reviews and analyzes our current cash balances, accounts receivable, accounts payable, accrued liabilities, capital expenditure commitments, and required capital lease and debt payments and other obligations.

**Cash Flows**

The following table sets forth our consolidated cash flows for the six months ended June 30, 2012 and six months ended June 30, 2011.

| (in thousands)   | Six months ended June 30, |            |
|--|---------------------------|------------|
|  | 2012                      | 2011       |
| Net cash provided by operating activities                          | \$ 32,157                 | \$ 32,622  |
| Net cash used in investing activities                              | (22,743)                  | (25,993)   |
| Net cash (used in) provided by financing activities                | (9,870)                   | 163,215    |
| Effect of exchange rates on cash                                   | (524)                     | 1,119      |
| Net (decrease) increase in cash and cash equivalents during period | \$ (980)                  | \$ 170,963 |

*Net Cash Provided by Operating Activities.* Our primary sources of operating cash are receipts from our customers who are billed on a monthly basis for our services. Our primary uses of operating cash are payments made to our vendors, employees and interest payments made to our capital lease vendors and our note holders. Net cash provided by operating activities was \$32.2 million for the six months ended June 30, 2012 compared to net cash provided by operating activities of \$32.6 million for the six months ended June 30, 2011. Operating activities for the six months ended June 30, 2012 includes a \$7.3 million semi-annual interest payment on our Senior Notes made in February 2012, described further below. Our future operating cash flow will be impacted by these semi-annual interest payments.

*Net Cash Used In Investing Activities.* Net cash used in investing activities was \$22.7 million for the six months ended June 30, 2012 and \$26.0 million for the six months ended June 30, 2011. Our primary use of investing cash is for purchases of property and equipment. These amounts were \$22.9 million and \$26.0 million for the six months ended June 30, 2012 and 2011, respectively. The changes in purchases of property and equipment are primarily due to the timing and scope of our network expansion activities including geographic expansion and adding buildings to our network.

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*Net Cash (Used In) Provided By Financing Activities.* Net cash used in financing activities was \$9.9 million for the six months ended June 30, 2012. Net cash provided by financing activities was \$163.2 million for the six months ended June 30, 2011. Our primary use of financing cash is for principal payments under our capital lease obligations. These amounts were \$8.8 million and \$7.5 million for the six months ended June 30, 2012 and 2011, respectively. Additionally, financing activities include amounts paid under our stock buyback program. During the six months ended June 30, 2012 we paid approximately \$1.3 million for purchases of our common stock. There were no stock purchases in the six months ended June 30, 2011. In January 2011, we issued our 8.375% Senior Notes due February 15, 2018, for an aggregate principal amount of \$175.0 million. We received net proceeds of approximately \$170.5 million after deducting \$4.5 million of issuance costs.

### **Cash Position and Indebtedness**

Our total indebtedness, net of discount, at June 30, 2012 was \$386.1 million and our total cash and cash equivalents were \$237.2 million. Our total indebtedness at June 30, 2012 includes \$131.6 million of capital lease obligations for dark fiber primarily under long term IRU agreements.

### *Senior Secured Notes*

In January 2011, we issued our Senior Notes due February 15, 2018, for an aggregate principal amount of \$175.0 million in a private offering for resale to qualified institutional buyers pursuant to SEC Rule 144A. The Senior Notes are secured and bear interest at 8.375% per annum. Interest is payable in cash semiannually in arrears on February 15 and August 15, of each year, beginning on August 15, 2011. We received net proceeds of approximately \$170.5 million after deducting \$4.5 million of issuance costs. We intend to use the net proceeds from the Senior Notes for general corporate purposes and/or repurchases of our common stock or our Convertible Notes or a special or recurring dividend to our stockholders.

The Senior Notes are fully guaranteed on a senior secured basis, jointly and severally, by each of our existing domestic and future material domestic subsidiaries, subject to certain exceptions and permitted liens. Under certain circumstances, our subsidiaries may be released from these guarantees without the consent of the holders of the Senior Notes. The Senior Notes and the guarantees are secured by (i) first priority liens on substantially all of our and our guarantors' assets, (ii) all of the equity interests in any of our domestic subsidiaries and (iii) 65% of the equity interests of our first-tier foreign subsidiaries held by us and our guarantors. The Senior Notes and the guarantees represent our and the guarantors' senior secured obligations and effectively rank equally and ratably with all of our and the guarantors' existing and future first lien obligations, to the extent of the value of the collateral securing such indebtedness, subject to permitted liens; are structurally subordinated to any existing and future indebtedness and liabilities of non-guarantor subsidiaries and rank equally in right of payment with all of our and the guarantors' existing and future senior indebtedness.

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We may redeem the Senior Notes, in whole or in part, at any time prior to February 15, 2015 at a price equal to 100% of the principal amount plus a make-whole premium, plus accrued and unpaid interest to the date of redemption. The make-whole premium means, with respect to a note at any date of redemption, the greater of (i) 1.0% of the then-outstanding principal amount of such note and (ii) the excess of (A) the present value at such date of redemption of (1) the redemption price of such note at February 15, 2015, plus (2) all remaining required interest payments due on such note through February 15, 2015 (excluding accrued but unpaid interest to the date of redemption), computed using a discount rate equal to the Treasury Rate as of such date of redemption plus 50 basis points, over (B) the then-outstanding principal amount of such note. We may also redeem the Senior Notes, in whole or in part, at any time on or after February 15, 2015 at the applicable redemption prices specified under the indenture governing the Senior Notes plus accrued and unpaid interest, if any, to the date of redemption. The redemption prices (as a percentage of the principal amount) are 104.118% during the 12-month period beginning on February 15, 2015, 102.094% during the 12-month period beginning on February 15, 2016 and 100.0% during the 12-month period beginning on February 15, 2017 and thereafter. In addition, we may redeem up to 35% of the Senior Notes before February 15, 2014 with the net cash proceeds from certain equity offerings at a redemption price of 108.375% of the principal amount plus accrued and unpaid interest. If we experience specific kinds of changes of control, we must offer to repurchase all of the Senior Notes at a purchase price of 101.0% of their principal amount, plus accrued and unpaid interest, if any, to the repurchase date.

We must offer to purchase with the proceeds of certain sales of assets totaling \$20.0 million or greater, Senior Notes at 100% of the principal value of the notes plus accrued and unpaid interest. In the event of default, as defined in the indenture, holders of not less than 25.0% in aggregate principal amount of the Senior Notes then outstanding may declare all unpaid principal and accrued interest on all Senior Notes to be due and immediately payable.

The indenture governing the Senior Notes, among other things, limits our ability and our guarantors' ability to incur indebtedness; to pay dividends or make other distributions; to make certain investments and other restricted payments; to create liens; consolidate, merge, sell or otherwise dispose of all or substantially all of our assets; to incur restrictions on the ability of a subsidiary to pay dividends or make other payments; and to enter into certain transactions with our affiliates. Our payment of dividends, stock buybacks and certain other uses of our cash are limited to an aggregate amount calculated pursuant to the terms of the indenture.

*Convertible Senior Notes*

In June 2007, we issued our Convertible Notes due June 15, 2027, in a private offering for resale to qualified institutional buyers pursuant to SEC Rule 144A. The Convertible Notes are unsecured and bear interest at 1.00% per annum. The Convertible Notes will rank equally with any future senior debt and senior to any future subordinated debt and are effectively subordinated to all of our subsidiary's existing and future liabilities and to any secured debt that we may issue to the extent of the value of the collateral. Interest is payable in cash semiannually in arrears on June 15 and December 15, of each year, beginning on December 15, 2007.

The \$92.0 million Convertible Notes are convertible into shares of our common stock at an initial conversion price of \$49.18 per share, or 20.3355 shares for each \$1,000 principal amount of Convertible Notes, subject to adjustment for certain events as set forth in the indenture. Upon conversion of the Convertible Notes, we will have the right to deliver shares of our common stock, cash or a combination of cash and shares of our common stock. The Convertible Notes are convertible (i) during any fiscal quarter after the fiscal quarter ending September 30, 2007, if the closing sale price of our common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter exceeds 130% of the conversion price in effect on the last trading day of the immediately preceding fiscal quarter, or (ii) specified corporate transactions occur, or (iii) the trading price of the Convertible Notes falls below a certain threshold, or (iv) if we call the Convertible Notes for redemption, or (v) on or after April 15, 2027, until maturity. In addition, following specified corporate transactions, we will increase the conversion rate for holders who elect to convert Convertible Notes in connection with such corporate transactions, provided that in no event may the shares issued upon conversion, as a result of adjustment or otherwise, result in the

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issuance of more than 35.5872 common shares per \$1,000 principal amount. The Convertible Notes include an Irrevocable Election of Settlement whereby we may choose, in our sole discretion, and without the consent of the holders of the Convertible Notes, to waive our right to settle the conversion feature in either cash or stock or in any combination, at our option.

The Convertible Notes may be redeemed by us at any time after June 20, 2014 at a redemption price of 100% of the principal amount plus accrued interest. Holders of the Convertible Notes have the right to require us to repurchase for cash all or some of their Convertible Notes on June 15, 2014, 2017 and 2022 and upon the occurrence of certain designated events at a redemption price of 100% of the principal amount plus accrued interest.

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**Contractual Obligations and Commitments**

There have been no material changes to our contractual obligations and commitments included in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of our annual report on Form 10-K for the year ended December 31, 2011.

*Dividends on Common Stock*

On August 7, 2012 our board of directors approved payment of a dividend of \$0.10 per common share - estimated to be approximately \$4.7 million - to be made on September 12, 2012 - with the record date for such payment to be August 22, 2012. The payment of any future quarterly dividends will be at the discretion of our board of directors and will be dependent upon our financial position, results of operations, available cash, cash flow, capital requirements and other factors deemed relevant by our board of directors.

**Future Capital Requirements**

We believe that our cash on hand and cash generated from our operating activities will be adequate to meet our working capital, capital expenditure, debt service, and other cash requirements if we execute our business plan.

Any future acquisitions or other significant unplanned costs or cash requirements in excess of amounts we currently hold may require that we raise additional funds through the issuance of debt or equity. We cannot assure you that such financing will be available on terms acceptable to us or our stockholders, or at all. Insufficient funds may require us to delay or scale back the number of buildings and markets that we add to our network, reduce our planned increase in our sales and marketing efforts, or require us to otherwise alter our business plan or take other actions that could have a material adverse effect on our business, results of operations and financial condition. If issuing equity securities raises additional funds, substantial dilution to existing stockholders may result.

*Off-Balance Sheet Arrangements*

We do not have relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

**Critical Accounting Policies and Significant Estimates**

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Management believes that as of June 30, 2012, there have been no material changes to our critical accounting policies and significant estimates from those listed in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of our annual report on Form 10-K for the year ended December 31, 2011.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Management believes that as of June 30, 2012, there have been no material changes to our exposures to market risk from those disclosed in Item 7A Quantitative and Qualitative Disclosures About Market Risk, of our annual report on Form 10-K for the year ended December 31, 2011. Based upon the quoted market price (Level 1) at June 30, 2012, the fair value of our Convertible Notes was approximately \$87.3 million. Based upon the bid quote (Level 2) at June 30, 2012, the fair value of our Senior Notes was approximately \$186.2 million.

### **ITEM 4. CONTROLS AND PROCEDURES.**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), an evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, our management, including our principal executive officer and our principal financial officer, concluded that the design and operation of these disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS.**

We are involved in legal proceedings in the normal course of our business that we do not expect to have a material impact on our operations or results of operations. Note 4 of our interim condensed consolidated financial statements includes information on these proceedings.





Table of Contents**ITEM 2. PURCHASES OF EQUITY SECURITIES.**

Our Board of Directors had authorized a plan to permit the repurchase of up to \$50.0 million of our common stock in negotiated and open market transactions. As of June 30, 2012, we had purchased 306,940 shares of our common stock pursuant to these authorizations for an aggregate of \$4.2 million; approximately \$45.8 million remained available for such negotiated and open market transactions concerning our common stock. We may purchase shares from time to time depending on market, economic, and other factors. The authorization will continue through February 28, 2013.

The following table summarizes our common stock repurchases during the second quarter of 2012 made pursuant to this authorization. During the quarter, we did not purchase shares outside of this program, and all purchases were made by or on behalf of the Company and not by any affiliated purchaser (as defined by Rule 10b-18 of the Securities Exchange Act of 1934).

**Issuer Purchases of Equity Securities**

| <b>Period</b>    | <b>Total Number of Shares (or Units) Purchased</b> | <b>Average Price Paid per Share (or (Unit))</b> | <b>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b> |
|------------------|--|---|--|--|
| April 1-30, 2012 | 0  | \$ 0  | 0  | \$ 47,031,077  |
| May 1-31, 2012   | 74,584   | \$ 16.95  | 306,940  | \$ 45,766,777  |
| June 1-30, 2012  | 0  | \$ 0  | 306,940  | \$ 45,766,777  |

**ITEM 4. MINE SAFETY DISCLOSURES.**

Not applicable

**ITEM 6. EXHIBITS.**

(a) Exhibits

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 31.1                  | Certification of Chief Executive Officer (filed herewith)     |
| 31.2                  | Certification of Chief Financial Officer (filed herewith)     |
| 32.1                  | Certification of Chief Executive Officer (furnished herewith) |

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32.2 Certification of Chief Financial Officer (furnished herewith)  
101.1 The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Condensed Consolidated Statements of Comprehensive Income, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) related notes (furnished herewith).

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 9, 2012

**COGENT COMMUNICATIONS GROUP, INC.**

By: /s/ David Schaeffer  
Name: David Schaeffer  
Title: Chairman of the Board and Chief Executive Officer

Date: August 9, 2012

By: /s/ Thaddeus G. Weed  
Name: Thaddeus G. Weed  
Title: Chief Financial Officer (Principal Accounting Officer)

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**Exhibit Index**

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 31.1                  | Certification of Chief Executive Officer (filed herewith)  |
| 31.2                  | Certification of Chief Financial Officer (filed herewith)  |
| 32.1                  | Certification of Chief Executive Officer (furnished herewith)  |
| 32.2                  | Certification of Chief Financial Officer (furnished herewith)  |
| 101.01                | The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Condensed Consolidated Statements of Comprehensive Income, (ii) the Condensed Consolidated Balance Sheets, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) related notes (furnished herewith). |