COGENT COMMUNICATIONS HOLDINGS, INC.
Form 10-Q
November 01, 2018
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2018

OR

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

Commission File No. 000-51829

COGENT COMMUNICATIONS HOLDINGS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**46-5706863**

(State of Incorporation)	(I.R.S. Employer Identification Number)

2450 N Street N.W.

Washington, D.C. 20037

(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 x No o

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes x No o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o
	Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

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 46,471,871 Shares Outstanding as of October 31, 2018

Table of Contents

INDEX

PART I
FINANCIAL INFORMATION

PART II
OTHER INFORMATION

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

COGENT COMMUNICATIONS HOLDINGS, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

AS OF SEPTEMBER 30, 2018 AND DECEMBER 31, 2017

(IN THOUSANDS, EXCEPT SHARE DATA)

	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 284,558	$ 247,011
Accounts receivable, net of allowance for doubtful accounts of $1,614 and $1,499, respectively	40,993	39,096
Prepaid expenses and other current assets	32,956	20,011
Total current assets	358,507	306,118
Property and equipment, net	381,004	381,282
Deferred tax assets	6,326	17,616
Deposits and other assets	11,482	5,572
Total assets	$ 757,319	$ 710,588
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 8,262	$ 11,592
Accrued and other current liabilities	46,728	47,947
Installment payment agreement, current portion, net of discount of $450 and $337, respectively	8,617	7,816
Current maturities, capital lease obligations	8,665	7,171
Total current liabilities	72,272	74,526
Senior secured 2022 notes, net of unamortized debt costs of $2,887 and $1,870, respectively and including premium of $1,507 and $382, respectively	443,620	373,512
Senior unsecured 2021 notes, net of unamortized debt costs of $1,625 and $2,060, respectively	187,600	187,165
Capital lease obligations, net of current maturities	152,954	150,333
Other long term liabilities	26,717	27,596
Total liabilities	883,163	813,132
Commitments and contingencies:		
Stockholders equity:		
Common stock, $0.001 par value; 75,000,000 shares authorized; 46,461,371 and 45,960,799 shares issued and outstanding, respectively	46	46
Additional paid-in capital	472,817	456,696
Accumulated other comprehensive income foreign currency translation	(8,672)	(4,600)
Accumulated deficit	(590,035)	(554,686)
Total stockholders deficit	(125,844)	(102,544)

Total liabilities and stockholders deficit	$	757,319	$	710,588

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

Table of Contents

COGENT COMMUNICATIONS HOLDINGS, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2018 AND SEPTEMBER 30, 2017

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	Three Months Ended September 30, 2018 (Unaudited)	Three Months Ended September 30, 2017 (Unaudited)
Service revenue	$ 130,139	$ 122,969
Operating expenses:		
Network operations (including $250 and $179 of equity-based compensation expense, respectively, exclusive of depreciation and amortization shown separately below)	54,615	53,584
Selling, general, and administrative (including $4,571 and $3,555 of equity-based compensation expense, respectively)	33,409	32,915
Depreciation and amortization	20,276	19,147
Total operating expenses	108,300	105,646
Gains on equipment transactions	416	397
Operating income	22,255	17,720
Interest income and other, net	1,937	1,632
Interest expense	(12,767)	(12,266)
Income before income taxes	11,425	7,086
Income tax provision	(3,194)	(3,436)
Net income	$ 8,231	$ 3,650
Comprehensive income:		
Net income	$ 8,231	$ 3,650
Foreign currency translation adjustment	(485)	3,790
Comprehensive income	$ 7,746	$ 7,440
Net income per common share:		
Basic and diluted net income per common share	$ 0.18	$ 0.08
Dividends declared per common share	$ 0.54	$ 0.46
Weighted-average common shares - basic	45,105,830	44,767,163
Weighted-average common shares - diluted	45,699,635	45,118,607

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

Table of Contents

COGENT COMMUNICATIONS HOLDINGS, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND SEPTEMBER 30, 2017

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	Nine Months Ended September 30, 2018 (Unaudited)	Nine Months Ended September 30, 2017 (Unaudited)
Service revenue	$ 388,144	$ 359,949
Operating expenses:		
Network operations (including $671 and $431 of equity-based compensation expense, respectively, exclusive of depreciation and amortization shown separately below)	163,868	155,362
Selling, general, and administrative (including $12,629 and $9,175 of equity-based compensation expense, respectively)	100,637	96,165
Depreciation and amortization	60,280	56,583
Total operating expenses	324,785	308,110
Gains on equipment transactions	891	3,543
Operating income	64,250	55,382
Interest income and other, net	3,817	3,502
Interest expense	(37,547)	(36,245)
Income before income taxes	30,520	22,639
Income tax provision	(8,953)	(10,536)
Net income	$ 21,567	$ 12,103
Comprehensive income:		
Net income	$ 21,567	$ 12,103
Foreign currency translation adjustment	(4,072)	11,281
Comprehensive income	$ 17,495	$ 23,384
Net income per common share:		
Basic net income per common share	$ 0.48	$ 0.27
Diluted net income per common share	$ 0.47	$ 0.27
Dividends declared per common share	$ 1.56	$ 1.32
Weighted-average common shares - basic	45,096,472	44,787,067
Weighted-average common shares - diluted	45,591,217	45,083,765

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

Table of Contents

COGENT COMMUNICATIONS HOLDINGS, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018 AND SEPTEMBER 30, 2017

(IN THOUSANDS)

	Nine months Ended September 30, 2018 (Unaudited)	Nine months Ended September 30, 2017 (Unaudited)
Cash flows from operating activities:		
Net income	$ 21,567	$ 12,103
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	60,280	56,583
Amortization of debt discount and premium	1,126	899
Equity-based compensation expense (net of amounts capitalized)	13,300	9,606
Gains equipment transactions and other, net	(727)	(4,394)
Deferred income taxes	7,527	9,835
Changes in operating assets and liabilities:		
Accounts receivable	(2,280)	(4,317)
Prepaid expenses and other current assets	(663)	645
Accounts payable, accrued liabilities and other long-term liabilities	(5,473)	(1,411)
Deposits and other assets	(1,462)	793
Net cash provided by operating activities	93,195	80,342
Cash flows from investing activities:		
Purchases of property and equipment	(39,000)	(35,183)
Net cash used in investing activities	(39,000)	(35,183)
Cash flows from financing activities:		
Dividends paid	(71,371)	(59,824)
Net proceeds from issuance of 2022 secured notes net of debt costs of $1,363	69,862	
Purchases of common stock		(1,829)
Proceeds from exercises of stock options	1,520	919
Principal payments on installment payment agreement	(6,888)	(2,183)
Principal payments of capital lease obligations	(8,158)	(9,368)
Net cash used in financing activities	(15,035)	(72,285)
Effect of exchange rates changes on cash	(1,613)	3,572
Net increase (decrease) in cash and cash equivalents	37,547	(23,554)
Cash and cash equivalents, beginning of period	247,011	274,319
Cash and cash equivalents, end of period	$ 284,558	$ 250,765
Supplemental disclosure of non-cash investing and financing activities:		
Non-cash component of network equipment obtained in exchange transactions	$ 876	$ 3,509
PP&E obtained for installment payment agreement	$ 8,609	$ 6,577
Capital lease obligations incurred	$ 15,074	$ 18,105

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

Table of Contents

COGENT COMMUNICATIONS HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Description of the business and recent developments:

Reorganization and merger

On May 15, 2014, pursuant to the Agreement and Plan of Reorganization (the Merger Agreement) by and among Cogent Communications Group, Inc. (Group), a Delaware corporation, Cogent Communications Holdings, Inc., a Delaware corporation (Holdings) and Cogent Communications Merger Sub, Inc., a Delaware corporation, Group adopted a new holding company organizational structure whereby Group is now a wholly owned subsidiary of Holdings. Holdings is a successor issuer to Group pursuant to Rule 12g-3(a) under the Securities Exchange Act of 1934, as amended (the Exchange Act).

References to the Company for events that occurred prior to May 15, 2014 refer to Cogent Communications Group, Inc. and its subsidiaries and on and after May 15, 2014 the Company refers to Cogent Communications Holdings, Inc. and its subsidiaries.

Description of business

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 services, private network services and data center colocation space. The Company s network is specifically designed and optimized to transmit packet routed data. The Company delivers its services primarily to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations in North America, Europe and Asia.

The Company offers on-net Internet access and private network services exclusively through its own facilities, which run from its network to its customers premises. The Company is not dependent on local telephone companies or cable TV companies to serve its customers for its on-net Internet access services because of its integrated network architecture. The Company offers its on-net services to customers located in buildings that are physically connected to its network. The Company s on-net service consists of high-speed Internet access and private network services offered at speeds ranging from 100 Megabits per second to 100 Gigabits per second of bandwidth. The Company provides its on-net Internet access services and private network services to its corporate and net-centric customers. 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. The Company s net-centric customers include bandwidth-intensive users such as other Internet service providers, telephone companies, cable television companies, web hosting companies, content delivery network companies and commercial content and application service providers. These net-centric customers obtain the Company s services in colocation facilities and in the Company s data centers. The Company operates data centers throughout North America and Europe that allow its customers to collocate their equipment and access the Company s network.

In addition to providing its on-net services, the Company provides Internet connectivity and private network services 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 the 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. Beginning in the second quarter of 2018 the Company began to offer and sell its software-defined wide area network (SDWAN) service.

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 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 annual report on Form 10-K for the year ended December 31, 2017.

The accompanying unaudited condensed 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

Table of Contents

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.

Financial instruments

At September 30, 2018, 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 quoted market prices (Level 1). Based upon recent trading prices (Level 2 market approach) at September 30, 2018 the fair value of the Company s $189.2 million senior unsecured notes was $190.6 million and the fair value of the Company s $445.0 million senior secured notes was $449.5 million.

Gross receipts taxes, universal service fund and other surcharges

Revenue recognition standards include guidance relating to taxes or surcharges assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer and may include, but are not limited to, gross receipts taxes, excise taxes, Universal Service Fund fees and certain state regulatory fees. Such charges may be presented gross or net based upon the Company s accounting policy election. The Company records certain excise taxes and surcharges on a gross basis and includes them in its revenues and costs of network operations. Excise taxes and surcharges billed to customers and recorded on a gross basis (as service revenue and network operations expense) were $3.0 million and $2.7 million for the three months ended September 30, 2018 and September 30, 2017, respectively, and $9.3 million and $8.0 million for the nine months ended September 30, 2018 and September 30, 2017, respectively.

Basic and diluted net 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 dilutive common stock equivalents. 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. The Company s employees exercised options for 14,057 and 12,743 common shares for the three months ended September 30, 2018 and 2017, and exercised options for 44,753 and 30,656 common shares for the nine months ended September 30, 2018 and 2017, respectively.

The following details the determination of diluted weighted average shares:

	Three Months Ended September 30, 2018	**Three Months Ended September 30, 2017**	**Nine Months Ended September 30, 2018**	**Nine Months Ended September 30, 2017**
Weighted average common shares - basic	45,105,830	44,767,163	45,096,472	44,787,067
Dilutive effect of stock options	39,488	32,399	34,644	29,061
Dilutive effect of restricted stock	554,317	319,045	460,101	267,637

Weighted average common shares - diluted	45,699,635	45,118,607	45,591,217	45,083,765

The following details unvested shares of restricted common stock as well as the anti-dilutive effects of stock options and restricted stock awards outstanding:

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Unvested shares of restricted common stock	1,350,320	1,175,235	1,350,320	1,175,235
Anti-dilutive options for common stock	30,836	54,908	47,422	52,064
Anti-dilutive shares of restricted common stock		195	1,348	99,737

Recent Accounting Pronouncements   Adopted

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (ASC 606   ), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers, and also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. ASC 606 replaced most existing revenue recognition guidance in U.S. GAAP. The new standard was effective for the Company on January 1, 2018. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company adopted ASC 606 using the modified retrospective transition method on January 1, 2018 and applied the standard to all of its customer contracts that are not considered completed as of the adoption date. Under the modified retrospective method, the cumulative effect of applying the standard was recognized at the date of initial application and resulted in a reduction to the Company   s accumulated deficit of $14.5 million, recording customer contract costs (a new asset) of $17.3 million, a decrease to deferred revenue of $0.9 million and a decrease to deferred income tax assets of $3.8 million. The Company refers to contract liabilities as   deferred revenue   on the condensed consolidated balance sheets and related disclosures. Results for reporting periods beginning January 1, 2018 are presented under ASC 606, while prior period amounts were not adjusted and continue to be reported in accordance with the Company   s historic accounting under Topic 605, *Revenue Recognition*.

Table of Contents

The effect of adopting ASC 606, changed the period for which the Company recognizes revenue for fees billed in connection with customer installations. Installation fees for contracts with terms longer than month-to-month are now recognized over the contract term which may be a shorter period than the average customer life which was previously used to recognize revenue. The Company believes the installation fee does not give rise to a material right as defined by ASC 606 for contracts with terms longer than month-to-month. Consistent with previous GAAP, the Company is recognizing revenues over the estimated average customer life for installation fees associated with month-to-month contracts, because the fee represents a material right as defined by ASC 606.

Additionally, the Company is required to capitalize certain contract acquisition costs that relate directly to a customer contract, including commissions paid to its sales team and sales agents, and to amortize these costs on straight-line basis over the period the services are transferred to the customer for commissions paid to its sales team (estimated customer life) and over the contract term for agent commissions. The Company previously expensed these contract acquisition costs as incurred in selling, general and administrative expenses. Management assesses these costs for impairment at least quarterly and as triggering events occur that indicate it is more likely than not that an impairment exists.

The impact on the Company s financial statement line items from adopting ASC 606 was as follows (in thousands, except earnings per share). There was no net impact on net cash provided by operating activities.

Financial Statement Line Items		**As Reported September 30, 2018**		**Balances Without the Adoption of ASC 606**
Balance Sheet				
Prepaid expenses and other current assets	$	32,956	$	19,873
Deposits and other assets	$	11,482	$	6,072
Deferred tax assets	$	6,326	$	10,128
Accrued and other current liabilities	$	46,728	$	46,504
Other long term liabilities	$	26,717	$	27,865
Accumulated deficit	$	(590,035)	$	(604,588)
Statement of Comprehensive Income				
Three months ended September 30, 2018				
Service revenue	$	130,139	$	129,964
Selling, general and administrative expenses	$	33,409	$	33,331
Operating income	$	22,255	$	22,158
Net income	$	8,231	$	8,134
Basic earnings per share	$	0.18	$	0.18
Diluted earnings per share	$	0.18	$	0.18
Comprehensive income	$	7,746	$	7,649
Statement of Comprehensive Income				
Nine months ended September 30, 2018				
Service revenue	$	388,144	$	388,112
Selling, general and administrative expenses	$	100,637	$	101,962
Operating income	$	64,250	$	62,893
Net income	$	21,567	$	20,210
Basic earnings per share	$	0.48	$	0.45
Diluted earnings per share	$	0.47	$	0.44
Comprehensive income	$	17,495	$	16,209

		September 30, 2018		**At Adoption January 1, 2018**
Customer contract costs current portion (included in prepaid and other current assets)	$	13,083	$	11,893

Customer contract costs non-current portion (included in deposits and other assets)	5,410	5,400
Deferred revenue current portion (included in accrued and other current liabilities)	4,280	3,846
Deferred revenue non-current portion (included in other long-term liabilities)	1,762	2,865

Service revenue recognized from amounts in deferred revenue at the beginning of the period during the three months ended September 30, 2018 was $1.9 million and during the nine months ended September 30, 2018 was $5.8 million. Amortization expense for contract costs was $4.2 million for the three months ended September 30, 2018 and $12.5 million for the nine months ended September 30, 2018.

Revenue recognition

The Company s service offerings consist of on-net and off-net telecommunications services. Fixed fees are billed monthly in advance and usage fees are billed monthly in arrears. Amounts billed are due upon receipt and contract lengths range from month to month to 60 months. The Company satisfies its performance obligations to provide services to customers over time as the services are rendered. In accordance with ASC 606, revenue is recognized when a customer obtains the promised service. The amount of revenue recognized reflects the consideration to which the Company expects to be entitled to receive in exchange for these services. The Company has adopted the practical expedient related

Table of Contents

to certain performance obligation disclosures since it has a right to consideration from its customer in an amount that corresponds directly with the value to the customer of the Company s performance completed to date.

To achieve this core principle, the Company followed the following five steps:

1) Identification of the contract, or contracts with a customer

2) Identification of the performance obligations in the contract

3) Determination of the transaction price

4) Allocation of the transaction price to the performance obligations in the contract

5) Recognition of revenue when, or as, we satisfy a performance obligation

Fees billed in connection with customer installations are deferred (as deferred revenue) and recognized as noted above. To the extent a customer contract is terminated prior to its contractual end the customer is subject to termination fees. The Company vigorously seeks payment of these amounts. The Company recognizes revenue for these amounts as they are collected.

Recent Accounting Pronouncements to be Adopted

In February 2016, the FASB issued ASU No. 2016-02, *Leases* (ASU 2016-02). ASU 2016-02 will replace most existing lease accounting guidance when it becomes effective. ASU 2016-02 is effective for the Company beginning on January 1, 2019. Early application is permitted. In July 2018 the FASB approved an Accounting Standards Update which, among other changes, allows a company to elect to adopt ASU 2016-02 using a cumulative effect adjustment to the opening balance of its retained earnings on the adoption date. ASU 2016-02 will require the Company to record a right to use asset and a lease liability for most of its leases, including its leases currently treated as operating leases. The Company is continuing to evaluate the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures and the Company will elect to apply certain practical expedients. The Company estimates that the effect of ASU 2016-02 would be to record a right to use asset and lease liability totaling approximately $95 million. The estimated lease liability is not considered a liability under the consolidated leverage ratio calculations in the indentures governing the Company s senior unsecured and senior secured note obligations. The Company will not early adopt ASU 2016-02 and will adopt the standard using the modified retrospective approach with a cumulative-effect adjustment on January 1, 2019.

In September 2016, the FASB issued ASU No. 2016-13, *Financial Instruments Credit Losses: Measurement of Credit Losses on Financial Instruments.* This guidance is intended to introduce a revised approach to the recognition and measurement of credit losses, emphasizing an updated model based on expected losses rather than incurred losses. This new standard is effective for annual and interim reporting periods beginning after December 15, 2019 and early adoption is permitted. The Company is currently evaluating the impact that this guidance may have on its financial statements and related disclosures.

2. Property and equipment:

Depreciation and amortization expense related to property and equipment and capital leases was $20.3 million and $19.1 million for the three months ended September 30, 2018, and 2017 respectively, and $60.3 million and $56.6 million for the nine months ended September 30, 2018 and 2017, respectively. The Company capitalized salaries and related benefits of employees working directly on the construction and build-out of its network of $2.6 million and $2.5 million for the three months ended September 30, 2018 and 2017, respectively, and $7.9 million and $7.2 million for the nine months ended September 30, 2018 and 2017, respectively.

Exchange agreement

In the three and nine months ended September 30, 2018 and 2017, the Company exchanged certain used network equipment and cash consideration for new network equipment. The fair value of the equipment received was estimated to be $1.5 million and $1.0 million for the three months ended September 30, 2018 and 2017, respectively, and $3.0 million and $7.9 million for the nine months ended September 30, 2018 and 2017, respectively and after considering the cash component the transactions resulted in gains of $0.4 million and $0.4 million for the three months ended September 30, 2018 and 2017, respectively, and $0.9 million and $3.5 million for the nine months ended September 30, 2018 and 2017, respectively. The estimated fair value of the equipment received was based upon the cash consideration price the Company pays for the new network equipment on a standalone basis (Level 3).

Installment payment agreement

In March 2015, the Company entered into an installment payment agreement (IPA) with a vendor. Under the IPA the Company may purchase network equipment in exchange for interest free note obligations each with a twenty-four month term. There are no payments under each note obligation for the first nine months followed by eighteen equal installment payments for the remaining eighteen month term. As of September 30, 2018, and December 31, 2017 there was $12.5 million and $10.7 million, respectively, of note obligations outstanding under the IPA, secured by the related equipment. The Company recorded the assets purchased and the net present value of the note obligation utilizing an imputed interest rate. The resulting discount was $0.5 million and $0.4 million as of September 30, 2018 and December 31, 2017, respectively, and is being amortized over the note term using the effective interest rate method.

Table of Contents

3. Long-term debt:

Limitations under the indentures

The Company has $189.2 million of senior notes and $445.0 million of senior secured notes outstanding. The $189.2 million of senior notes are due on April 15, 2021 (the 2021 Notes) and bear interest at a rate of 5.625% per year. Interest is paid semi-annually on April 15 and October 15. The $445.0 million of senior secured notes are due on March 1, 2022 (the 2022 Notes) and bear interest at a rate of 5.375% per year. Interest is paid semi-annually on March 1 and September 1. In August 2018, the Company issued an additional $70.0 million par value of its 2022 Notes at a premium of 101.75% of par value increasing the par value outstanding from $375.0 million to $445.0 million. The Company received net proceeds of $69.9 million after deducting $1.4 million of offering costs. The $1.2 million premium and offering costs are being amortized to interest expense to the maturity date using the effective interest rate method. The net proceeds from this offering are intended to be used for general corporate purposes.

The indentures governing the 2022 Notes and 2021 Notes, among other things, limit the ability of Group (the company owned by Holdings which owns the operating companies) 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 its assets; to incur restrictions on the ability of a subsidiary to pay dividends or make other payments; and to enter into certain transactions with its affiliates. Limitations on the ability to incur additional indebtedness (excluding IRU agreements incurred in the normal course of business) include a restriction on incurring additional indebtedness if Group s consolidated leverage ratio, as defined in the indentures, is greater than 5.0. The indentures prohibit certain payments, such as dividends and stock purchases, when Group s consolidated leverage ratio, as defined by the indentures, is greater than 4.25. A certain amount of such unrestricted payments is permitted notwithstanding this prohibition. The unrestricted payment amount may be increased by Group s consolidated cash flow, as defined in the indentures, as long as the Group s consolidated leverage ratio is less than 4.25. Group s consolidated leverage ratio was above 4.25 as of September 30, 2018. As of September 30, 2018, a total of $163.5 million ($162.2 million held by Holdings in cash) was permitted for investment payments including dividends to Holdings.

4. Commitments and contingencies:

Current and potential litigation

In accordance with the accounting guidance for contingencies, the Company accrues its estimate of a contingent liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Where it is probable that a liability has been incurred and there is a range of expected loss for which no amount in the range is more likely than any other amount, the Company accrues at the low end of the range. The Company reviews its accruals at least quarterly and adjusts them to reflect the impact of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular matter. The Company has taken certain positions related to its obligations for leased circuits for which it is reasonably possible could result in a loss of up to $2.8 million in excess of the amount accrued at September 30, 2018.

The Company is engaged in an arbitration proceeding in Spain in which a former provider of optical fiber to the Company is seeking approximately $9 million for the Company s early termination of the optical fiber leases, which amount the Company accrued in 2015. The Company has counterclaimed for damages and is contesting its obligation to pay the termination liability in an arbitration proceeding in Spain.

The arbitration is being conducted by the Civil and Commercial Arbitration Court (CIMA) in Madrid, Spain.

In the ordinary 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. Judgment is required in estimating the ultimate outcome of any dispute resolution process, as well as any other amounts that may be incurred to conclude the negotiations or settle any litigation. Actual results may differ from these estimates under different assumptions or conditions and such differences could be material.

5. Income taxes:

The components of income before income taxes consist of the following (in thousands):

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Domestic	$ 16,652	$ 12,210	$ 46,234	$ 37,266
Foreign	(5,227)	(5,124)	(15,714)	(14,627)
Total	$ 11,425	$ 7,086	$ 30,520	$ 22,639

On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act (the Act). The Act amended the Internal Revenue Code and reduced the corporate tax rate from a maximum of 35% to a flat 21% rate. The rate reduction was effective on January 1, 2018. The Company s net deferred tax assets represent a decrease in corporate taxes expected to be paid in the future. Under generally accepted accounting principles deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets