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CenturyLink, Inc. (CTL)

Q2 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to CenturyLink's second quarter 2014 earnings conference call. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the conference over to Mr. Tony Davis, Vice President of Investor Relations. Mr. Davis, you may begin.

Tony Davis

Vice President-Investor Relations, CenturyLink, Inc.

Thank you, Sayid. Good afternoon, everyone, and welcome to our call today to discuss CenturyLink's second quarter 2014 results, released earlier this afternoon. The slide presentation we will be reviewing during the prepared remarks portion of today's call is available in the Investor Relations section of our corporate website at ir.centurylink.com. At the conclusion of our prepared remarks today, we will open the call for question-and-answer.

On slide two, you will find our Safe Harbor language. We will be making certain forward-looking statements today, particularly as they pertain to guidance for third quarter 2014 and other outlooks in our business. We ask that you review our disclosure found on this slide as well as in our press release and in our SEC filings, which describe factors that could cause our actual results to differ materially from those projected by us in our forward-looking statements.

We ask that you also note that our earnings release issued earlier this afternoon and the slide presentation and remarks made during this call contain certain non-GAAP financial measures. Reconciliation between the non-

GAAP financial measures and the GAAP financial measures are available in our earnings release and on our website at ir.centurylink.com.

Now turning to slide three, your host for today's call is Glen Post, Chief Executive Officer and President of CenturyLink. Joining Glen will be Stewart Ewing, CenturyLink's Chief Financial Officer. And also available during the question-and-answer portion of today's call will be: Karen Puckett, CenturyLink's Chief Operating Officer; Bill Cheek, President of Wholesale; and Jeff Von Deylen, President of CenturyLink Technology Solutions.

Our call today will be available for telephone replay through August 14, 2014, and the webcast replay of our call will be available through August 28, 2014. Anyone listening to a taped or webcast replay or reading a written transcript of this call should note that all information presented is current only as of August 6, 2014, and should be considered valid only as of this date regardless of the date heard or reviewed.

As we move to slide four, I'll now turn the call over to Glen Post. Glen?

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

Thank you, Tony. Good afternoon, everyone, and thank you for joining us today.

I am pleased with our strong financial performance for the second quarter. We continue to effectively execute against our objectives and make investments that we believe will drive increased revenues.

If we'll turn to slide five, we achieved total operating revenue, operating cash flow, and adjusted diluted earnings per share that all exceeded our guidance for the quarter. For the second quarter of 2014, total operating revenues of \$4.54 billion increased by \$16 million compared to the second quarter of 2013. This 0.4% revenue growth represents a significant improvement from the 1.9% decline in year-over-year revenues in the second quarter of 2013 and 1.2% decline in pro forma year-over-year revenues in the second quarter of 2012.

Our data integration revenues were \$20 million higher in the second quarter of 2014 than in the second quarter of 2013, primarily due to increased CPE or customer premise equipment sales. Our core revenues, which represents strategic and legacy revenues combined, was \$4.1 billion for the quarter and was nearly flat from the year-ago period. This comparison also represents a significant improvement from the 1.6% and 2.2% declines in year-over-year core revenues in the second quarter of 2013 and 2012 respectively.

Now continuing to slide six, I'd like to highlight the key drivers of this continued strong improvement in our revenue trend. The improvement in core revenues was driven by the combination of improved rate of growth in strategic revenue and the lower rate of decline in legacy revenue. Business and core revenue grew sequentially and year over year, driven by business demand for high-bandwidth data services and our bundled service offerings combining network, CPE, software applications, and managed services.

We also continued to see good growth in Ethernet services from our fiber-to-the-tower investments in our wholesale business as we meet the growing data transport needs of wireless carriers. However, wholesale revenue growth continues to be impacted by the migration from low-speed data services to fiber-based Ethernet as well as increased network grooming by wireless carriers.

Managed hosting revenue, including cloud, grew 9.6% year over year while colocation revenue grew approximately 2%, resulting in total hosting revenue growth of 3.2% compared to the second quarter of 2013.

Additionally, if you look at our combined business and hosting segment revenues, we have achieved year-over-year revenue growth for the last eight quarters.

Consumer revenue grew year over year, fueled by continued strength in high-speed Internet and Prism TV customer growth, price increases, and improved churn.

Now turning to slide seven, we continue to transform our company from a provider of traditional network communications to an integrated provider of IP-enabled network, cloud, hosting, and IT services. And we're refining our focus and executing on several strategic priorities. We believe these priorities are key to successfully navigating the continued transformation of our company and driving long-term profitable growth and value for our shareholders.

The first of these is to grow business network solutions. We expect to continue to focus on driving growth in high-bandwidth data services, including MPLS, Ethernet, Wavelength, and voice-over-IP or VoIP services by providing reliable connectivity to meet the growing bandwidth needs of our business customers. In the second quarter, we experienced continued strength in sales for high-bandwidth data services.

Also, as announced yesterday, we're expanding gigabit service to business customers in select locations in 16 cities through our fiber network, providing symmetrical broadband speeds up to 1 gigabit. This expansion provides increased addressable market opportunities for our business sales team and ultra-fast Ethernet quality speeds to our customers, allowing them to cloud-enable their businesses.

We also believe our targeted marketing approach, sales programs, and continued expansion of our sales team as well as continued enhancement of our product portfolio position us well to drive revenue growth. For example, we're seeing continued strong sales results associated with our launch of Managed Office, a solution to integrate network, voice-over-IP, e-mail, and other key business applications for our business customers.

Although slowing somewhat from the levels of the last few years, we continued our fiber deployment to wireless towers to capture the growing demand from wireless carriers for data backhaul. During the second quarter, we completed fiber to 500 towers, for a total of nearly 19,700 total fiber builds.

With respect to our cloud and hosting business, we believe we have the right assets to meet the growing demand for cloud hosting and colocation services we're seeing from businesses ranging from small to global in scale. These assets coupled with our robust network capabilities enable our sales teams to build integrated hosting and network solutions that meet the customers' needs and lower their operating costs while better enabling them to focus on their core businesses.

We continued to enhance our hosting and cloud services platform during the second quarter with the launch of our advanced CenturyLink cloud technology to our Toronto data center, bringing our total to 12 nodes with the new technology. Additionally in the second quarter, we opened a new data center in Minneapolis, offering colocation, cloud, and managed hosting services connected to CenturyLink's IP backbone and global data center footprint. We are further enhancing our ability to compete in the growth of hosting services while building and leveraging our broad IT capabilities to offer mid to large enterprise customers a complete portfolio of IT cloud enablement consulting services.

We have a strong public cloud product, but we are fully aware that there's strong competition in this space. We do believe though that we are well positioned to compete and win in the hybrid cloud market as we offer the full range of network, cloud, managed hosting, colocation, and IT services that we believe our customers want and need. We are rapidly expanding and enhancing our capabilities in the managed hosting cloud space as well.

Continuing on to slide eight and the consumer segment, we continue to see good results in those markets where we have deployed higher bandwidth and IPTV services. For example, since our limited gigabit service deployment in Omaha, the results continue to exceed our expectations in the consumer market, and we have seen good results in the small to medium business space as well.

Yesterday, along with our gigabit service expansion for businesses, we also announced the availability of gigabit service to residential customers in select locations in nine cities, including some of our larger markets like Minneapolis/St. Paul, Denver, Seattle, Las Vegas, and Portland. We also expect to continue to invest in our Prism TV capabilities, with plans to add approximately 300,000 Prism TV addressable homes in 2014. We continue to monitor the success of Prism TV in our current markets and will consider further expansion in the months ahead.

Finally, we are focused on driving improved operating efficiency through a number of methods, including network simplification and rationalization that should improve our end-to-end provisioning time and help drive standardization. Also, we are focusing on process automation improvement through applications and work tools that better drive lower operating costs and that we expect to improve sales efficiency. We continue to modernize our network of replacing ATM with IP technology, which enables higher broadband speeds for customers while adding network capacity to our growing customer base. Since January, we have added over 2 terabytes to our IP backbone, bringing our total capacity to 18 terabytes per second.

And we continue to manage expenses related to legacy services by aligning our expenses and reduced revenues in that sector.

Lastly, we have laid the foundation to migrate our internal IT operations to our cloud platform by investing in virtualization. Since 2011, we have consolidated our internal IT operations from more than ten data centers to four data centers. We are also using a cloud-first approach to rapidly deploy the same innovative platform infrastructure and software-as-a-service solutions across our internal IT operations that we are selling to our cloud and IT hosting customers. We are on track to have 90% of all new and strategic internal IT applications in the cloud by the end of the 2015.

Overall, I'm pleased with the strong results for the quarter. We remain focused across all operating segments and offering our customers high-value products and service solutions along with a high-quality customer experience we believe creates loyalty and improves customer retention. And we continue to invest to drive growth in our business.

With that, I'll turn the call over to Stewart for an in-depth look at our financial results and third quarter guidance. Stewart?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

Thank you, Glen. I'll spend the next few minutes reviewing the financial highlights from the second quarter and then conclude my remarks with an overview of the third quarter 2014 guidance we included in our earnings release issued earlier this afternoon. Beginning on slide 10, I'd like to review some highlights from our strong second quarter results. I'll be reviewing the results excluding special items, as outlined in the earnings release and associated financial schedules.

As Glen mentioned earlier, we generated strong operating revenues and cash flows in the quarter. Operating revenues were \$4.54 billion on a consolidated basis, a 0.4% increase from second quarter 2013 operating

revenues. Core revenue, defined as strategic revenue plus legacy revenue, was \$4.1 billion for the second quarter, nearly flat from the year-ago period. Strategic revenues grew 5.1% year over year and now represent 51% of our total revenue as compared to 48% a year ago. Strength in strategic products such as high-speed Internet, high-bandwidth data services, Prism TV, and managed hosting services continues to drive this growth.

Additionally, customer growth was solid as we added approximately 16,000 Prism TV customers during the second quarter. Due to typical seasonality, high-speed Internet customers declined 2,100 in the quarter, which was better than the loss of approximately 8,400 customers in second quarter 2013.

We generated strong operating cash flow of approximately \$1.81 billion for the second quarter and achieved an operating cash flow margin of 39.9%. The year-over-year decrease in operating cash flow and operating cash flow margin was primarily driven by higher customer premise equipment sales, expenses related to the growth of Prism TV, a higher USF contribution factor, and the continued decline in legacy revenues.

Additionally, we generated \$677 million of free cash flow during the quarter, which is defined as operating cash flow less cash paid for taxes, interest, and capital expenditures, and additional adjustments to other income. Our strong cash flows continue to provide the financial strength and flexibility to meet our business objectives and drive long-term shareholder value.

We continue to expect our dividend payout ratio for full year 2014 to be approximately 45%.

Adjusted diluted earnings per share for the second quarter was \$0.72, including approximately \$0.03 of favorable one-time items. If you exclude these items, we still exceeded our adjusted diluted EPS guidance for the quarter. As we've discussed on prior earnings calls, adjusted diluted EPS excludes special items and certain non-cash purchase accounting adjustments, as outlined in our press release and associated supplemental financial schedules.

We are pleased to announce the completion of our \$2 billion stock repurchase program authorized by our board in mid-February 2013. Although the program was originally slated for a two-year completion timeframe, we executed opportunistically and repurchased 59.5 million shares in less than 18 months. Also during the quarter, we commenced the \$1 billion follow-on program authorized by our board earlier this year. Across both programs, we repurchased 4.5 million shares for an investment of \$160 million during the second quarter, of which 1.2 million shares were under the \$1 billion follow-on program. From the end of the quarter through yesterday, we repurchased an additional 1.4 million shares for approximately \$52 million. We expect to continue our opportunistic approach to repurchasing shares under the current \$1 billion authorization.

Now turning to slide 11, the \$16 million or 0.4% increase in second quarter 2014 operating revenues compared to second quarter 2013 was primarily a result of growth in strategic and data integration revenues that was partially offset by lower legacy revenues due to access line losses and lower minutes of use. The growth in our strategic revenues was primarily driven by strength in high-speed Internet, high-bandwidth data services, Prism TV, and hosting services. Although legacy revenues continue to decline, the decline in the second quarter 2014 was approximately 25% lower than the second quarter revenue decline a year ago. Data integration revenues were higher year over year due to increased CPE sales.

Now turning to slide 12, I'll discuss each of our operating segments, beginning first with the consumer segment. Consumer generated \$1.5 billion in operating revenues, which grew slightly from second quarter 2013. Strategic revenues in this segment grew 8.6% year over year to \$709 million, driven by growth in high-speed Internet and Prism TV customers, price increases, and improved churn. Legacy revenues for the segment declined 6% from second quarter 2013, as access line and long distance revenue declines were partially offset by select price

increases. The comparable year-over-year decline in second quarter 2013 was 9.3%, so a decline in legacy revenues of 9.3% second quarter a year ago versus a 6% decline second quarter this year.

Our operating expenses increased 4.4% compared to the same period a year ago, primarily driven by higher Prism TV costs.

Moving to slide 13, our business segment generated \$1.56 billion in operating revenues during the second quarter, which increased \$39 million or 2.6% from the same period a year ago. Second quarter strategic revenues for the segment increased by 7.8% to \$663 million from second quarter a year ago, driven primarily by strength in high-bandwidth services such as MPLS, Ethernet, and Wavelength. We continue to generate solid growth across the enterprise customer mix and we continue to see an opportunity for further investment in the small and midsize business space to improve our market share and drive further growth.

Legacy revenues for the segment declined 3.9% from second quarter 2013, due primarily to continuing decline in access lines. Data integration revenues grew 12% in second quarter 2014 compared to second quarter a year ago, driven by higher CPE sales.

Total business segment expenses were up 6.6%, primarily driven by higher CPE costs and facility costs associated with the MPLS product growth along with higher employee-related expenses.

The segment margin of 37.9% declined from 40.2% a year ago. This decrease was primarily due to the higher cost I just mentioned along with the continued decline in business segment legacy revenue.

Now turning to slide 14, our wholesale segment generated \$866 million in operating revenues, a decline of 4.8% from second quarter 2013. Strategic revenues for wholesale were \$568 million, nearly flat with the second quarter 2013, as growth in Ethernet services and wireless bandwidth expansion was offset by DS1 disconnects. Legacy revenues declined by 12.1% to \$298 million, reflecting the continued decline in access and long distance minutes of use and the implementation of lower access rates under the CAF order.

Operating expenses for the quarter declined \$18 million or 6% compared to the same period a year ago, driven by lower employee-related and facility cost.

Now moving to slide 15 and our hosting segment, which includes all managed hosting, cloud services, colocation, and hosting related network services revenue; this segment generated \$358 million in operating revenues, representing an increase of 3.2% from second quarter 2013. Year-over-year managed hosting revenues including cloud grew 9.6%, while colocation growth of nearly 2% was impacted by customer churn and price erosion.

Hosting operating expenses increased 3.9%, primarily due to higher employee costs.

Second quarter segment margin for hosting was 26.3%, an improvement from 22.6% in first quarter 2014. We anticipate further segment margin improvement for hosting in the last half the year. Over time, we expect long-term improvement in both revenue and margin trends across the hosting segment, and we continue to leverage these assets to drive additional revenue through cross-selling opportunities in our other segments.

Now turning to slide 16 and our third quarter 2014 guidance, for the third quarter 2014, we project total operating revenues of \$4.47 billion to \$4.52 billion, core revenues of \$4.06 billion to \$4.11 billion, and operating cash flow between \$1.72 billion and \$1.77 billion. Adjusted diluted EPS is expected to range from \$0.58 to \$0.63. We expect third quarter 2014 revenues and operating cash flow to be lower than second quarter 2014, primarily due to the continued decline of legacy revenues and the increased operating expenses related to the normal seasonality of

outside plant maintenance and utility costs. We expect \$20 million to \$30 million of higher seasonal outside plant maintenance and utility cost in third quarter versus second quarter. We also anticipate an additional \$0.02 to \$0.03 per share negative impact in third quarter due to increased depreciation related to capital investment made during the first half of the year.

Finally, as I mentioned earlier, there were approximately \$0.03 per share of favorable one-time items in second quarter which will not occur in third quarter, including approximately \$0.015 of operating expenses and \$0.015 related to the adjusted effective tax rate and interest expense. So we got a benefit in the second quarter of \$0.03 that will not recur again in the third quarter. Our full-year 2014 guidance remains unchanged from that provided on our February earnings call.

This concludes our prepared remarks for today. So at this time, I'll ask the operator to provide instructions for the Q&A portion of the call.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question is from David Barden from Bank of America. Your line is open. Please go ahead, sir.

David W. Barden
Analyst, Bank of America Merrill Lynch

Q

Hey, guys. Thanks for taking the questions. First I guess I have to ask the obligatory question on your reaction to the Windstream PLR [Private Letter Ruling] announcement, what they're planning on doing in terms of separating the company into two parts, and how they used that to finesse a dividend cut into the business. If you can walk us through what you thought along these lines and what you're thinking now that Windstream has this PLR in the wild, it would be helpful.

And then second, there's lots of math we can start doing on the guidance. But maybe, Stewart, just focusing on the revenue guidance, if I look at the third quarter guidance, do the math on the full year and the implied fourth quarter revenue guidance, it implies at the midpoint something like a \$80 million step down in revenues from 3Q to 4Q which, based on the last eight quarters, seems pretty unlikely. So you're steering towards the high end of the revenue guidance at the moment. Could you talk a little bit about what are the focus issues for getting there, and is it possible that we're actually going to see revenue growth this year rather than next? Thanks.

R. Stewart Ewing, Jr.
Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

So, David, first a reaction to the Windstream announcement. We see a lot of opportunity to create value for shareholders by operating our assets as we do today. We're complete. We're pleased with our continued trend toward revenue stability. However, we continually evaluate the best ways to deliver long-term shareholder value. And as such, we'll monitor the Windstream restructuring process as it moves forward. So we'll just monitor it as they move forward and evaluate it over time as opposed to the short time period we've had since its end market reaction that we've had since they announced.

So from the standpoint of the revenue guidance then, we would expect to be towards the top end of the revenue guidance that we gave for the full year. In fact, if you look at all the guidance that we gave related to full year, which we gave early February, we would expect to be at the upper end of that guidance or in at least the top half of

that guidance for each item with the exception of our operating cash flow. And basically the operating cash flow we would expect to be more towards the midpoint, the reason being expenses really related to the higher revenue than we expected, primarily expenses related to CPE and Prism, our Prism TV content cost.

David W. Barden

Analyst, Bank of America Merrill Lynch

Q

Perfect, thank you. And if I could just ask one more clarification, Stewart, just on the numbers, you talked about a \$0.015 benefit to the operating expense items, which I guess would be about \$8.5 million after taxes, maybe \$12 million before taxes. Can you talk about where that shook out in the numbers we saw this quarter?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

Probably \$0.01 of it was due to ad valorem tax true-ups in operating expenses, and the other \$0.005 really related to employee benefits.

David W. Barden

Analyst, Bank of America Merrill Lynch

Q

Perfect, all right. Thanks, guys.

Operator: Thank you. Our next question comes from Simon Flannery from Morgan Stanley. Your line is open. Please go ahead.

Simon Flannery

Analyst, Morgan Stanley & Co. LLC

Q

Great, thanks very much. Good evening. We've seen a number of transactions in the space, including in the CLEC space and the data center space over the last few weeks. Can you just comment on – I'm sure you looked at some of those – how you're thinking about M&A right now and your various parameters there as you think about deploying capital organically versus acquisition.

And you expanded your 1-gigabit footprint. Can you give us a little bit more color around the scale of that, any CapEx implications, and what was really the trigger that got you comfortable with moving forward around the business model for that? Thank you.

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Simon, first of all, really, M&A – how we look at that, first of all, we believe the investments we're making in the business today are really positioning us well to compete and drive revenue growth. We've discussed today and we've seen in our numbers, we enjoy the strategic service products we've developed and are selling and growing well and moving us toward revenue stability. We are obviously monitoring and viewing with interest this consolidation activity and look at numerous opportunities throughout the year.

As I've said, we are open to that. We think there are opportunities that could create growth and drive value for shareholders. As I've said before, our preference for inorganic growth would be for opportunities that fit well with our strategic priorities, those that can enhance our revenue and cash flow trajectory in particular. We've considered investments that would enhance our broadband offering for business or consumers or both. We look at opportunities that would improve our metro fiber capability and opportunities for investments that would expand our data hosting capabilities. We think all three of these could drive growth.

But whatever those opportunities are, we will continue and have continued over the last year or two to use our disciplined approach to these opportunities, which in our view requires several things; first of all, the right strategic fit, especially the ability to improve our growth profile. Secondly, we have to see free cash flow accretion within a reasonable period of time, and then a clear path to creating value for shareholders. So those are basically the three criteria we use, and we look at every opportunity that comes our way with those within that framework. And we think there are potential deals out there, but nothing that we would talk about right now.

Simon Flannery

Analyst, Morgan Stanley & Co. LLC

Q

Thank you, and on the 1-gig product?

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

A

On the 1-gig expansion, we expect to do that within our current budget first of all, within the \$3 billion or so budget we have, so we do not expect a budget expansion for that.

Secondly, we believe the 1-gig – just taking fiber-to-the-home and fiber to these businesses somewhat future-proofs our company and our operations. We've looked at comparing that to fiber-to-the-node, and we believe that in some of these cities we're in that we can drive greater growth and greater consistency of growth through the 1-gig product versus some of the fiber-to-the-node work we've done previously. So that's how we're considering this, and we've had really good success in the markets we've entered with our gig product, so we expect to continue to expand it. Not only that, we're starting this investment with going to the business by taking fiber and gig service to our business customers throughout these markets, and going from there into offering our Prism service in these residential areas as we can take the fiber network we're building for the businesses and take it to these residential areas to drive our fiber products. We're seeing good growth there as well, as we've talked about today already.

Simon Flannery

Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Operator: Thank you. And our next question comes from Batya Levi from UBS. Your line is open. Please go ahead.

Batya Levi

Analyst, UBS Securities LLC

Q

Great, thank you. Maybe a follow up on the CapEx question, can you provide a little bit more color on the breakdown? Which projects do you think will come off the CapEx budget this year, and how much do you expect to spend on fiber next year? And how should we think about further IPTV investments? Thank you.

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

So, Batya, if you think about our capital budget for this year and what we expect to spend in 2014, which again, includes the markets, spending for the markets that Glen just discussed, about half of our capital budget is really what we would consider to be revenue enablement. It's associated with Ethernet, EPLS enablement, our cloud hosting, high-speed Internet enablement. So that would be the category that this would fall in. About 28% of our capital budget is what we'd consider to be success-based, which really is just success-based sales, the fiber-to-the-

tower, our national sales, set-top boxes, things like that. And then about 22% of the \$3 billion is what we would consider maintenance CapEx, which basically just keeps the lights on.

Batya Levi

Analyst, UBS Securities LLC

Q

And IPTV going forward?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

Our capital budget for next year, we would expect it to be within the \$3 billion range plus or minus \$100 million or so probably.

Batya Levi

Analyst, UBS Securities LLC

Q

Okay, thank you.

Operator: Thank you. And our next question comes from Phil Cusick from JPMorgan.

Eric Pan

Analyst, JPMorgan Securities LLC

Q

Hi, this is Eric in for Phil. You guys have seen good growth the last couple of quarters in strategic services. What's driving that momentum? Is it your sales force becoming more effective, or are you seeing a pickup in business spending? Are you selling to new customers or existing customers for the most part?

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Eric, I'll ask Karen to address that.

Karen A. Puckett

Chief Operating Officer & Executive Vice President, CenturyLink, Inc.

A

First off, just the demand for bandwidth products like MPLS, Ethernet has been very good growth for us. We continue to I think take share there relative to large global accounts as well as enterprise. So I would say that would be the key. Our sales organization continues to perform. Our run rates continue to improve. We had stretch targets on them this year, and they're hitting those. And then our managed office managed services, we're seeing – we're very pleased with our file in terms of just IT organization, heads of businesses, really very curious and wanting to outsource more of their IT or infrastructure services. And so we're well positioned we believe there.

Eric Pan

Analyst, JPMorgan Securities LLC

Q

Okay, great. And then your operating expenses were higher probably because of CPE. How much of the growth in strategic revenues are coming from CPE sales versus data and managed services? And how should we think about that elevated level of operating expenses going forward?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

So about \$29 million over what we had expected it to be, operating expenses to be for the quarter were CPE expenses that were in excess of what we anticipated that were driven by the higher sales and higher revenue.

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

A

I'll just add to it on the expense levels. What we're seeing driving most of our expenses are strategic services such as the rollout of Prism. It's driving a lot of our expense growth as well as other strategic services. If you look at where really the expense growth is coming from outside CPE, it's just the sales and marketing and cost of providing these services.

Eric Pan

Analyst, JPMorgan Securities LLC

Q

So should we expect this level to remain high going forward?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

Yes, as our revenue grows with our strategic products, especially the Prism TV products and some of the out-of-market MPLS networks that we're selling where we have third-party costs associated with the last mile, the margin on that revenue is going to be lower than margins on our legacy revenue. So the expenses would grow over time as the revenue grows.

Eric Pan

Analyst, JPMorgan Securities LLC

Q

Great, thank you very much.

Operator: Thank you. And our next question comes from Mike McCormack from Jefferies. Your line is open. Please go ahead.

Michael L. McCormack

Analyst, Jefferies LLC

Q

Hey, guys, thanks. Stewart, maybe just to expand upon that last comment because it looks like the revenue offset is getting to be a flattish type year-over-year growth had an almost equal decline in legacy as improvement in strategic. And EBITDA was down only about \$25 million year over year. I'm just trying to get a sense. I know you've spoken about the significant margin differences in those revenue streams. It would appear based upon the EBITDA decline that the incremental margins might be a little bit tighter than we thought. Alternatively, SG&A might be the driver there. I'm trying to get a sense for what kind of pressure we can see downward on SG&A as we go forward. Thanks.

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

Mike, I think it's more the mix of CPE revenue and the growth that we've seen there over a year ago – or over the last year is really driving the expense growth that you're seeing there and the margin pressure.

Michael L. McCormack

Analyst, Jefferies LLC

Q

Okay. And just secondly on the working capital side, it looks like you had a bit of a headwind in the quarter. Is that just a timing difference that will even out as the year goes on?

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

Yes, it is.

A

Michael L. McCormack

Analyst, Jefferies LLC

Okay. Thanks, guys.

Q

Operator: Thank you. And our next question comes from Frank Louthan from Raymond James. Your line is open. Please go ahead.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Great, thank you. So looking at some of the improvements in the declines in the legacy revenue, can you give us some color on that? Is it just more of a shrinking base there? Is there something else you're doing? And then also on the cost side, you mentioned managing some of the costs in that business. What specific tactics are you doing to take the cost out of that part of the business?

Q

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

So, Frank, on the revenue side, so the second quarter – as the first quarter benefited, the second quarter also benefited from some price increases that we did in third quarter a year ago on some of the legacy products. So we'll cycle through that after the second quarter of this year, and the comps will be a little bit tougher in third quarter. Additionally, we did some price increases early part of this year too that benefited second quarter as well. So I think that's what you're seeing that's helping the revenue decline on the legacy. Additionally, our access line loss rate or our customer loss rate continues to decline somewhat.

A

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

Frank, on the cost side, we're doing continual cost improvement programs, and I talked about some of those; just one from our network, getting away from – replacing ATM with IP technology. We have consolidated data centers over the last year, which are impacted by the legacy revenue losses. We're moving more to cloud-type IT services. That's reducing our cost as well. So we have a lot of these things that are going on that we're specifically targeting, especially areas that are cost drivers in the legacy areas.

A

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.

Okay, thanks. Just to follow up, are there any other cost increases you might be able to push through on some of those legacy products that have relatively reasonably favorable impacts on the churn relative to some other things or any CAF-induced or authorized price increases that we might be able to expect over the next 12 months?

Q

R. Stewart Ewing, Jr.

Executive Vice President, Chief Financial Officer and Assistant Secretary, CenturyLink, Inc.

A

So, Frank, with the access rate reductions that went into effect July 1, we expect to really pretty much be able to offset that through additional ARC [Access Recovery Charge] that we will charge our customers, which effectively is a price increase to the customers. We're also looking at some of our other products too that we could potentially tweak prices on a little bit in the latter half of the year, but nothing significant.

Frank G. Louthan

Analyst, Raymond James & Associates, Inc.



Okay, thanks.

Operator: Thank you and I'm showing no further questions at this time. I would like to hand the conference back over to Mr. Glen Post for any closing remarks.

Glen F. Post, III

President, Chief Executive Officer & Director, CenturyLink, Inc.

Thank you, Sayid. Overall, we're all pleased with our second quarter operating and financial results and continued improvement especially in our revenue trend. We believe the investments in our business continue to transform our company and position us to effectively compete in the marketplace and drive revenue growth from our strategic products and services in the months and years ahead. Thank you for joining our call today and we look forward to speaking with you in the coming weeks.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This concludes our program for today. You may all disconnect and have a wonderful day. Thank you.

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