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CenturyLink, Inc. (CTL)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to CenturyLink's third quarter 2015 earnings conference call. All participants are in a listen-only mode. Later, we'll conduct a question and answer session. Instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded. At this time, I would like to hand the conference over to Mr. Tony Davis, Vice President, Investor Relations. Sir, you may begin.

Tony Davis

Vice President Investor Relations, CenturyLink, Inc.

Thank you, Sayed, and good afternoon, everyone, and welcome to our call today to discuss CenturyLink's third quarter 2015 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 2, you will find our Safe Harbor language. We will be making certain forward-looking statements today, particularly as they pertain to guidance for fourth quarter 2015 and other outlooks on 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 3, 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 Ross Garrity, CenturyLink's Interim President of Global Markets. Our call today will be available for telephone replay through November 12, 2015, and the webcast replay of our call will be available through November 26, 2015. 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 November 4, 2015, and should be considered valid only as of this date, regardless of the date heard or viewed.

And as we turn to slide 4, I'll now turn the call over to Glen Post. Glen?

Glen F. Post

President, Chief Executive Officer & Director

Thank you, Tony, and thank you for joining our call today as we discuss our third quarter 2015 results of operations and provide guidance and outlook for the remainder of 2015.

Beginning on slide 5, as you know, CenturyLink continues our transition to becoming a leading provider of integrated IP-enabled network hosting and IT services. This transition brings both opportunities and challenges, as we work to find ways to provide our customers the products and services that they need in today's environment. Faster broadband speeds and hosting solutions are at the top of many of our customers' list of needs. We're deploying GPON to consumer and business customers. We're expanding Prism TV availability and providing competitive enhancements to our network, hosting, and cloud services to meet these demands.

In the third quarter, we saw several positive signs that we're making progress in this transition. First, the Consumer segment had a solid quarter, with year-over-year revenue growth of 1.2%. As we continue to deploy GPON and Prism TV to more locations throughout our footprint, we're attracting more high-valued customers. And we have increased our ARPU through the continued launch of GPON, higher value bundle sales, and select pricing increases. Second, the business sales organization realignment implemented earlier this year is now proving effective, as new sales to business customers for the third quarter increased year over year and sequentially. The third quarter marks the second straight quarter of accelerating sales, with particular strength in global and enterprise.

Additionally, in our business sector, we exited third quarter with a strong business sales funnel, including an increased number of large deal opportunities. You will recall last quarter we stated that our operating expenses got ahead of our budgets and that we were committed to addressing that during the last half of the year. We're delivering on that commitment, as we have taken steps to reduce planned operating expenses by approximately $125 million in the second half of 2015. We achieved a portion of this expense reduction relative to plan in the third quarter, but the majority of the benefit will be realized in the fourth quarter of this year.

Also, we are well on track to lower our full-year 2015 planned capital budget by about $200 million, which will result in full-year capital expenditures of about $2.8 billion. We're encouraged by these areas where we're seeing positive momentum. However, the overall revenues for third quarter were below our expectations, primarily due to softness in hosting and long-distance service revenues along with higher credits and other one-time items in the quarter.

If you normalize for the one-time items that total about $20 million to $25 million, operating and core revenues were both at the low end of our quarterly guidance range. Although our third quarter revenue results did not meet our expectations, I'm very confident that we have the assets, the products and the opportunities required to grow our business in the months ahead.

Now turning to slide 6. We believe several key priorities will drive the future growth and profitability of our business. The first is to grow business revenues, driven principally by increased market penetration of our network, hosting, cloud, and IT solution service offerings. With respect to our business network service offerings, we continue to see strong demand from business, wholesale, and government customers for high-bandwidth data services such as Ethernet, MPLS, and business GPON. And we're investing in aligning our business to take advantage of this opportunity.

This quarter, we saw continued strength in our sales momentum. Third quarter 2015 retail network sales were up approximately 15% from second quarter 2015 and up approximately 25% from the third quarter of 2014. Additionally, we exited the quarter with a strong business sales funnel. The sales funnel has continued to strengthen during fourth quarter, and October sales results were the highest of the year.

I want to give you a few examples of what we're doing to drive higher sales over time. As of September 30, we had fiber to the prem, including GPON, available to about 490,000 business locations. There is good demand for this product, and given our relatively low penetration, we believe we have strong upside with those investments. We also continue to enhance other core network offerings, including next-generation MPLS and SIP trunking services and to add new capabilities to our managed office product suite to provide differentiated simplicity for small to medium business customers looking for fully outsourced network, customer prem equipment, cloud, and business application solutions.

We're also seeing increased interest in our managed network service offerings, that is, customers who look to us not only to provide their connectivity, but also to manage their NDN network environment to include monitoring, security, and CPE. Additionally, we have a major focus on leveraging our cloud capabilities to enhance our enterprise customers' abilities to turn up and manage both network and hosted workloads in private and dedicated environments. Over the last few months, we have refocused on our legacy cloud and managed hosting products as part of our hybrid IT strategy. We recently rolled out an enhancement of our legacy cloud product that seamlessly supports SAP workloads and we have seen strong customer interest in this product.

We're seeing growing interest in managed hosting legacy cloud products, as our managed hosting funnel is up almost 60% since August. This funnel growth is being driven by cross-selling across our customer base, including state government, education and a broad range of Fortune 500 and mid-size companies. Finally, we're also seeing good interest in our IT services and data analytics service offerings. Our focus in this area is to provide targeted services to business customers who are underserved by the traditional larger systems integrators.

Although growing rapidly, this business is small in scale today, generating only about $50 million in revenue this year, but these service offerings give us a good low-capital intensive opportunity to engage at the CXO level and generate leads in the other parts of our business. This capability to provide differentiated end-to-end solutions including IT consulting has led to a number of recent wins for CenturyLink to provide a large portion or all communications, data and IT services for those customers.

Now continuing on to slide 7 and turning to the Consumer segment. We continue to see good results in those markets where we have deployed higher broadband speeds and Prism TV services. Specifically in our markets with fiber to the prem, including GPON, the take rates continue to be strong and are exceeding our expectations. And because GPON is such a great driver of demand and penetration, we continue to expand our gigabit footprint, ending the quarter more than 780,000 households and 16 markets that are now fiber-to-the-prem capable. We're also trialing technologies that enable up to 200 megabits over legacy copper networks. Now, this is in the early stages, but it is showing good promise.

We also expanded our Prism TV service to new and existing markets, adding a total of 360,000 addressable homes in the third quarter. We now have nearly 3 million Prism TV addressable homes, which exceeds our expansion target for the year as we pulled forward some 2016 expansion plans into this year. In addition, we're developing an over-the-top platform and finalizing content agreements to enable a robust and competitive video offering for customers, both within and outside our Prism TV market footprint.

And, finally, we are focusing 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. We continue our focus on improving back office processes and systems in an effort to enhance the customer experience and realize expense efficiencies in running the business.

We mentioned last quarter that we had reduced the provisioning time for one of our major products by approximately 40%. And since that time, we've implementing process and system changes to improve the provisioning time for another major product by 30% to 40%. We'll continue to enhance our efforts in this area as we evolve our back-office systems to a more automated approach in the delivery of CenturyLink's products and services.

In addition, we continue to drive network virtualization through the expansion of our software-defined network, or SDN, product and network function virtualization, NFV, capabilities. These enhancements allow customers to remotely establish and manage key network services, such as virtual firewalls, CDN and virtual wide area network services. Our goal is to enable this capability to 43 data centers and approximately 3.1 million businesses by year end.

We have also laid the foundation to migrate our internal IT operations to our cloud platform as we continue to invest in IT virtualization. We are continuing to use 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're selling to our cloud and IT hosting customers. This effort is expected to reduce our IT cost and improve security and drive other efficiencies for us.

Lastly, we continue to make progress in simplifying our processes and streamlining our workflow. Our network inventory consolidation effort, which we have mentioned before, continues to progress well. Additionally, we have implemented an automated sales tool that increased our seller efficiency with anywhere, anytime access to our back-office systems. This initiative has also provided our real-time tracking of opportunities and associated results.

Continuing on to slide 8, I'd also like to briefly comment on the strategic alternative process for our data centers and colocation business operations that we announced today. CenturyLink's board of directors and management team regularly review the company's strategy and consider a wide range of opportunities regarding our business and operations to create value for shareholders. We believe we have the right strategy in combining our network service offerings with the delivery of managed IT and cloud-based services, and our enterprise customers are responding well to our managed services offerings. We expect colocation services will continue to be a service our customers will look for us for, but we do not necessarily believe we have to own the data center assets to be effective in delivery of those services.

Therefore, we have engaged financial advisers, and we've initiated a process to explore the strategic options for our data center assets and operations, which includes 59 datacenters in the U.S., Asia, and Europe, with more than 185 megawatts of power across 2.6 million square feet of raised floor capacity. The review process will involve a full range of options, including but not limited to a partnership or a joint venture, a sale of all or a portion of the data centers, as well as potentially keeping these assets and operations as part of CenturyLink's portfolio. This announcement continues our strategy of proactive portfolio management to drive focus on strategic businesses where we can achieve profitable growth and deliver attractive shareholder value. The process has just commenced, and we have not set a specific timetable for a decision, but we will be updating you on this process as appropriate in the weeks and months ahead.

Now I'd like to turn the call over to Stewart for a discussion of our financial results and guidance. Stewart?

R. Stewart Ewing

Chief Financial Officer & Executive Vice President

Thank you, Glen. I'll spend the next few minutes reviewing the financial highlights from the third quarter and then conclude my remarks with an overview of fourth quarter 2015 guidance we included in our earnings release issued earlier this afternoon.

Beginning on slide 10, I'll review some highlights from our third quarter results. I'll be reviewing the results excluding special items, as outlined in the earnings release and associated financial schedules. Operating revenues were $4.55 billion on a consolidated basis, a 0.9% increase from third quarter 2014 operating revenues. The increase primarily due to the incremental $158 million revenue impact from the acceptance and recognition of CAF phase II funds in the quarter. Our core revenue, defined as strategic revenue plus legacy revenue, was $3.99 billion for the third quarter, a decline of 2.1% from the year-ago period. Strategic revenues grew 0.7% year over year, primarily driven by strength in strategic products such as high-speed Internet, high-bandwidth data, and Prism TV.

In the third quarter, we added approximately 11,300 Prism TV customers. High-speed Internet customers declined about 37,000, partially the result of tightening our credit and collection processes. As a result of these actions, high-speed Internet and Prism TV net subscriber growth was negatively impacted. However, these adjustments had little impact on revenue and should actually help improve our broadband growth in 2016, due to lower churn.

We generated operating cash flow of approximately $1.78 billion for the third quarter and achieved an operating cash flow margin of 39.1%. Cash expenses were nearly flat year over year, primarily due to lower customer premise equipment costs related to lower data integration revenues, which were partially offset by higher employee benefit expenses, Prism TV, and other costs. Cash expenses declined $23 million from the second quarter 2015, as we took measures to reduce planned expenses in the second half of the year. Free cash flow, defined as operating cash flow, less cash paid for taxes, interest, and capital expenditures, along with other income, was $747 million for the quarter. Our solid cash flows continued to provide us the financial strength and flexibility to meet our business objectives and drive long-term shareholder value.

Adjusted diluted earnings per share for the third quarter was $0.70. As we've discussed on prior earnings calls, adjusted diluted earnings per share excludes special items and certain non-cash purchase accounting adjustments, as outlined in our press release and associated supplemental financial schedules. Additionally, under the $1 billion share repurchase program, we repurchased 9.8 million shares for an investment of $263 million during the quarter. Under the current program, started in the second quarter of 2014, we have repurchased 27.5 million shares through November 3 and have approximately $133 million remaining under the repurchase program.

Moving to slide 11, and our Business segment. In third quarter, Business segment generated $2.64 billion in operating revenues, which decreased $137 million or 4.9% from the same period a year ago. Third quarter strategic revenues for the segment decreased 2.1% to $1.6 billion from third quarter a year ago, driven by the declines in low-bandwidth data services, wholesale repricing, and one-time items, partially offset by continued strength in high-bandwidth services, such as MPLS, Ethernet, and Wavelength. Legacy revenues for the segment declined 7.1% from third quarter 2014, due primarily to a continuing decline in access lines and lower long-distance revenues. Total Business segment expenses decreased from the year-ago period, driven primarily by lower CPE cost, partially offset by higher employee-related expenses. The segment margin of 41.5% declined from 44.1% a year ago. This decrease was primarily due to the continued decline in Business segment legacy and low-bandwidth data services revenues.

On slide 12, I'll provide a little more detail on the revenue mix within the Business segment. Our high-bandwidth data services revenue grew $44 million, or 6.7% year over year, compared to third quarter 2014, driven by continued strength in sales to enterprise and governmental customers. While the growth rate remained solid for high-bandwidth services, it was somewhat dampened by renegotiated pricing for Ethernet backhaul services with a large wholesale data customer, as we discussed with you last quarter. High-bandwidth data services revenue for retail network customers, excluding wholesale, grew approximately 8.6% year over year.

Our low-bandwidth data services, including private line, continued to decline in the third quarter. The year-over-year decline of $68 million or 11.8% was primarily due to wholesale customers' continued network grooming efforts and the migration to fiber-based services that we've experienced over the past year. We anticipate this level of year-over-year decline to improve over the coming quarters as we cycle through this period of higher disconnects. Hosting revenues declined $7 million, or 2.1% from the prior year, driven primarily by higher credit reserves, including those related to service outages, and an unfavorable foreign currency impact of approximately

$6 million, which were partially offset by higher nonrecurring revenue. In the third quarter, data integration revenues decreased approximately $32 million, or 17% compared to third quarter 2014, driven by lower CPE sales and maintenance revenues. And, again, these revenues are fairly low margin.

Now, turning to slide 13, Consumer generated $1.15 billion in total operating revenues, an increase of $18 million or 1.2% from third quarter a year ago. Strategic revenues in this segment grew 7.2% year over year to $763 million, driven by year-over-year growth in high-speed Internet and Prism TV customers and higher average revenue per customer through select price increases and higher-value bundles. Legacy revenues for the Consumer segment declined only 4.2% from third quarter 2014, as access line and long-distance revenue declines were partially offset by select price increases. Operating expenses increased $10 million or 1.6% compared to the same period a year ago, due to higher Prism TV costs.

Now turning to slide 14. For fourth quarter 2015, we expect operating revenues of $4.4 billion to $4.45 billion, core revenues of $3.97 billion to $4.02 billion and operating cash flow between $1.72 billion and $1.77 billion. Adjusted diluted EPS is expected to range from $0.62 to $0.67. Our anticipated sequential decrease in fourth quarter operating revenues and operating cash flow compared to third quarter results is primarily driven by the retroactive recognition of CAF-II funds in the third quarter.

That concludes our prepared remarks for the day. 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 comes from Michael Rollins. Your line is open. Please go ahead.

Michael I. Rollins
Citigroup Global Markets, Inc. (Broker)

Q

Hi. Thanks for taking the question. I was curious if you'd talk a little bit more about the thought process of pursuing strategic alternatives for the data center business. Firstly, if you dispose of that, would that include the cloud and hosting business, or would it be colocation only?

Second, could you talk to us about how much capital you've put into that business to-date, including the M&A? And then, third, could you give us an EBITDA figure for that business in terms of the portion that you're pursuing these alternatives for? Thanks.

Glen F. Post
President, Chief Executive Officer & Director

A

Yeah, Mike. First of all, we're not ready to talk about the financials at this point. Obviously, we do disclose the revenue for this business is about $600 million annually today. And the sale of these assets do not include our cloud and hosting operations, strictly the data center operations, the colo business itself. That's what we're selling or looking to sell, looking at alternatives, looking at what the best use of these or management of these assets will be. So that's our view right now. We're just starting this process.

Michael I. Rollins
Citigroup Global Markets, Inc. (Broker)

Q

And can you just refresh our memory with how much of the assets that you physically own maybe versus those that you lease from third parties?

Glen F. Post
President, Chief Executive Officer & Director

A

Mike, most of the assets are leased from third parties. We own several of the data center properties, but just guessing offhand, probably less than 10 or so. Some of the old Qwest data center assets are primarily the ones that we own. Most of the others are leased.

Michael I. Rollins
Citigroup Global Markets, Inc. (Broker)

Q

Last question. As you thought about pursuing strategic alternatives for this part of your business, did you evaluate pursuing strategic alternatives for any other parts of your business? Or is that something that you may consider in the future? And thanks again for answering all those questions.

Glen F. Post
President, Chief Executive Officer & Director

A

Yeah, Mike. We continue to look at all of our assets and look at the opportunities for them. And these are the ones we believe today are the ones we should take a look at. We may look at others in the future. But right now, this is the part of the business that we believe that is not necessarily important for us to own. So this is why we're looking at these assets as far as the strategic alternatives are concerned.

Michael I. Rollins
Citigroup Global Markets, Inc. (Broker)

Q

Thank you.

Operator: Thank you. Our next question comes from David Barden from Bank of America. Your line's open. Please go ahead.

David W. Barden
Bank of America Merrill Lynch

Q

Hey, guys. Thanks for taking the questions. I guess, first, just a follow-up on that. If this $600 million colo business generates a 35% margin and it were to trade at the multiple at which Windstream recently announced their deal, that'd be about $3 billion. And then if you took about half of that and got back to the midpoint of your leverage range, you'd still have $1.5 billion.

What would be your thought process in terms of priorities for allocating that money? 10% of the equity market cap, it obviously potentially creates a lot of options that'd be interesting to discuss.

Second, if you could just give us, more specifically of the $125 million cost cuts, what was in the third quarter? And obviously then we could do the math on the fourth quarter.

And then the last piece would be, Stewart, just on those slides, on 11 and 12, I think that there's a big debate around a company like a CenturyLink, and in particular CenturyLink, is your revenues are coming down, you've had a tough time figuring out what's going to happen on revenue. We're having a tough time. But even tougher has been trying to line up the margins with these different businesses to try to figure out what's important. If CPE comes down, it's not important, but if legacy voice does, it is. Can you put margins around these different buckets so that we could do the math and figure out as we predict what's happening to revenue decline, what's going to happen to margin decline? Thanks.

Glen F. Post
President, Chief Executive Officer & Director
A

David, this is Glen. I'll answer the first question and ask Stewart to address the others. We realize there are a lot of good options for us to use the proceeds from this, if we were to end up selling these assets or leverage them in a way to create cash for the company. But we're not ready to talk about those. They're pretty obvious, some of the options we have. But we believe the opportunity is there and we continue to work with our board over the next few months to decide how to best utilize those proceeds.

Stewart?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President
A

Yeah, so in terms of the cost cuts, basically we did a little bit better than we had expected in the third quarter. But we expect fourth quarter costs to be down in the neighborhood of $100 million, which is the same amount we gave last quarter, between third and fourth. And part of that is seasonal, just related to the seasonality of the business. And the rest of it really relates to CPE and some of the measures that we took to reduce our staff. So, again, probably about another $100 million decline from third quarter sequentially in terms of cash operating expenses.

In terms of the revenue trends and forecasting of the margins, based on our increasing sales funnel and the improving sales trend over the last couple quarters and our improving sales to revenue, or order to cash, we hope to reach – we expect to reach revenue stability during the last half of 2016, so we believe the pressure we're seeing the last half of this year in hosting and wholesale will carry forward into the first half of 2016, which will make the year-over-year revenue comps during that period somewhat challenging. Again, remember, we had the wholesale renegotiation of a contract, too, with a large customer that will cycle through after second quarter of next year. But, unlike previous years, we don't think that next year we will be dependent on significant revenue growth from new initiatives to hit the revenue target in the second half of next year.

In terms of margins, the margins in the Consumer business have been relatively flat, and we would hope to keep the margins there, relatively flat to slightly down, as we'll still see the cycling through of legacy revenue as we drop legacy revenue and replace it with the more strategic revenues such as our Prism TV product. On the Business side, basically, the margin's there. We'd expect to see some continued deterioration there, due to really the same reasons, associated with the loss of legacy revenue and replacing it with the strategic revenues at a lower margin. But we've also done a good job there of controlling our expenses as well, which will hopefully mitigate some of the margin decline that we would otherwise see.

David W. Barden
Bank of America Merrill Lynch
Q

Got it. Okay. Thanks, guys.

Operator: Thank you. Our next question comes from Amir Rozwadowski from Barclays. Your line's open. Please go ahead.

Amir Rozwadowski
Barclays Capital, Inc.
Q

Thank you very much. Just following up on some of the questions around the strategic alternatives that you're currently pursuing. Can you provide us with a bit more color in terms of why do you believe this is the opportune time right now to monetize sort of the colocation services business? I would suspect that given the demand environment, there is healthy demand for those types of services. So would love to hear sort of your thought process on why this is the opportune time.

And I recognize that thinking about sort of specifics around what you could do with that capital building, upon David's prior question, is probably a bit early stage right now, but as you look at your portfolio of assets today, how do you feel about the portfolio assets in terms of the growth opportunities? Because clearly, within the portfolio, there are some key growth opportunities. And how we should think about whether or not there's a potential opportunity to bolt on additional assets or anything along those lines in order to accelerate growth toward your strategic services. Thank you very much.

Glen F. Post
President, Chief Executive Officer & Director
A

Amir, first of all, as you mentioned as far as why now is an opportune time. Valuations are obviously good right now. They can always change, but we know the market's good. But that's just one factor. For us to really grow the business, the colo business, it requires really more CapEx than we've been willing to put in the business. We said that up-front, that we weren't going to invest heavily in the data centers, that we felt they were a synergistic asset that we could grow with the rest of our business.

However, with the valuations, with the – we think our cash flow maybe could be used for investments that can drive higher returns, basically, and drive better shareholder value. So that's why we're looking at it. And we don't think it's – as I mentioned earlier – that it's crucial for us to own these assets in order to provide a full solution package for our customers. So that's why we're looking at it now.

And as far as the asset portfolio, we believe we have a strong portfolio of assets. We can leverage to drive future growth. We don't feel like we are compelled to go out and acquire additional assets or companies. However, we do believe there are some potential acquisitions, inorganic opportunities there that could drive growth. Whatever we do, we'll continue to utilize our very disciplined approach to acquisitions and be sure that we believe they're – investments can really drive long-term shareholder value. So they're fiber assets, assets that could perhaps drive top line growth that would be synergistic to our other offerings, such as our managed cloud offerings, our other network services that we believe we can grow in the months ahead. So those are the types of opportunities for acquiring assets we'd be looking at.

Amir Rozwadowski
Barclays Capital, Inc.
Q

Thank you very much, and one follow-up, if I may. In terms of your operations, you folks had transitioned a bit of your strategy with respect to your sales force in recent quarters. Would love to get an update in terms of how that transition has occurred and in terms of the progress that you've made from that perspective.

Glen F. Post
President, Chief Executive Officer & Director
A

Well, it was a pretty bumpy pride. We said up front it was not going to be – we were going to have some issues with that. It lasted a little longer than we thought. However, if you look at our sales results this last quarter especially, the latter part of the second quarter and going into third quarter and especially into fourth quarter, we're seeing the benefits of those changes really come to fruition. So we believe it is – we're proving that it was the right move. And we're hoping – there are some adjustments we'll make to really fine tune it, but we believe these were positive changes that we're going to see benefit from in the months and years ahead.

Amir Rozwadowski
Barclays Capital, Inc.

Q

Thank you very much for taking the questions.

Glen F. Post
President, Chief Executive Officer & Director

A

Thank you.

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

Simon Flannery
Morgan Stanley & Co. LLC

Q

Great. Thanks a lot. You touched on the revenue growth outlook. Can you talk a little bit about the competitive environment with cable? The broadband market was a little bit soft, or broadband adds were a little bit soft. What's going on there – churn, gross adds? What can you do to return to growth there? And also on the – maybe talk a little bit about Prism. We were talking earlier today on one of the calls about cord cutting by the Millennials and the move to over the top, skinny bundles, et cetera. Any thoughts on some of those offerings? Thanks.

Glen F. Post
President, Chief Executive Officer & Director

A

I'm going to ask Ross Garrity to talk about that for a minute with you guys.

Simon Flannery
Morgan Stanley & Co. LLC

Q

Okay.

Ross D. Garrity
Senior Vice President-IT Solutions

A

Yeah, just in the – hi, it's nice to meet you. In the Consumer market, the competitive environment has remained fairly stable, but we're seeing another round of speed increases coming from sort of cable providers, from the cable providers. But we continue to see success in areas where we've got greater speeds, and we remain challenged in areas without the higher speeds. We are still continuing to see strong penetration velocity, especially in our GPON markets.

In our small to medium business over the last three quarters, we've seen our investments increase distribution and business GPON in advanced capabilities such as our managed office significantly improved our market share trends versus the cable providers. And we expect to see improving sales and market share trends in the segment, certainly going into 2016. So I think the outlook is fairly positive.

Glen F. Post
President, Chief Executive Officer & Director

A

And, Simon, I might add that the change that we made in the credit policies and, really, collections drove probably about 17,000 or so of the 37,000 decline we saw in high-speed Internet customers during the quarter. We are going to focus on really trying to penetrate the areas where we have rolled out GPON. We're also looking at other ways to improve our speeds – continually improve our speeds over copper.

So I think that we'll be able to remain competitive and hopefully become more competitive, actually, than we are today. We're also working on an over-the-top offering that we'll be trialing in the third quarter that we hope to roll out on a trial basis in two or three markets, latter part of this year and early next year, that we think will help us with the Millennials and be a lower-cost option from the standpoint of the way we roll it out than our Prism product is today.

Simon Flannery
Morgan Stanley & Co. LLC

Q

Great. Thank you.

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

Batya Levi
UBS Securities LLC

Q

Great. Thank you. Can you address the slowdown in high-speed retail business revenues that we saw? I think it grew 8.6% versus a trend of double-digit growth. And what are you doing to accelerate that growth again?

And second question on the CapEx. You pulled forward some of the spending into third quarter and you maintained the guide for the year. How should we think about potentially different CapEx buckets for next year?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President

A

So, Batya, the slowdown in high-speed internet revenues, we actually had some pretty large federal items that flowed through in the first quarter and the second quarter that didn't reoccur in the third quarter. So I think that's part of that. But part of what we're doing there, too, on high-speed internet and Ethernet really is really pushing to reduce our provisioning periods, like Glen spoke about earlier during his part. In terms of CapEx for 2016, we're currently thinking about $3 billion, which will probably include $350 million to $400 million of CapEx associated with the rollout of the CAF-II.

Batya Levi
UBS Securities LLC

Q

And just to follow up, this is for 2016?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President

A

2016, yes. CapEx.

Batya Levi
UBS Securities LLC

Q

Okay. Thank you.

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

Frank G. Louthan
Raymond James & Associates, Inc.

Q

Great. Thank you. Can you talk a little bit about what's some other things it might take to get the strategic growth back up? And any kind of contracts or other things you can give to suggest that this has kind of changed? And then can you walk us through how you're going to be deploying the CAF-II funds, when we'll start to see the construction for that? And when do you expect to see revenue? And any chance that those deployments might also include video? Thanks.

Glen F. Post
President, Chief Executive Officer & Director

A

Yeah, Frank, I have a few comments and let Stewart add in for strategic growth back up. If you look at the second half sales growth and funnel expansion, it is creating some improving trends headed into 2016, so we think that's a sign. If you look at our sales, just the sales I mentioned earlier in the funnel, we think that's really a positive.

We're seeing improvement in the front line sales productivity on the Business side. We're seeing higher participation rates or folks hitting our quotas basically. We're seeing growth in our channel partners and alliances there. We expect further growth there in the months ahead. We're also expanding our wholesale product to include HSI and VoIP, Voice over IP. So we expect to enhance our wholesale sales there and revenue.

And then finally, just the continued expansion of GPON and Prism. We've increased our GPON market significantly this year, up to 780,000 households passed. And just that expansion there, along with the business GPON up to about 490,000 businesses now, those give us a lot of potential going forward.

Frank G. Louthan
Raymond James & Associates, Inc.

Q

Okay. And on the CAF-II deployment?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President

A

Yeah, Frank, with respect to the CAF-II deployment, we would expect to really hit the ground running here in late 2015 to 2016, to get some of the construction done and get the living units that are easiest to get to first such that by the end of 2016 we hope to be upwards of 20% or maybe even a little more in terms of the 1.2 million living units passed.

And with the over-the-top product that we're going to roll out, it would be available to CAF-II households where we have 10 down and one up. And some of those households will have more bandwidth than that, too, if they're closer to the node. So, yes, the product would be available there, so would have a video product available.

Frank G. Louthan
Raymond James & Associates, Inc.

Q

Any color on the over-the-top product? Is it just a smaller feature set, or is it a streaming package like Sling? Or what are you thinking about?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President
A

Why don't we ask Aamir Hussain to address that for you?

Aamir Hussain
Chief Technology Officer & Executive VP
A

Yeah, we are actually looking at two different type of products. One is a skinny bundle with local, linear and premium. And it will have upsell opportunity for a kid's package, entertainment package and we are looking at multiple options there.

The second product that we are looking to do is in our franchise markets where we have Prism rights, just taking the same content and offering it on an over-the-top content along with an aggregation of other video services which are used by our customers today.

Frank G. Louthan
Raymond James & Associates, Inc.
Q

Okay, great. Thank you.

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

Michael L. McCormack
Jefferies LLC
Q

Hey, guys. Thanks. Maybe just a quick comment. I know, Glen, you were talking about the consumer credit on the broadband side driving some share loss. I would have thought, I guess, that broadband was nondiscretionary. I guess you don't have a sense for where those folks are going. But can you just explain how much more runway we have on that consumer credit tightening piece?

And then second part, thinking about the Consumer high-speed internet revenues, do you have any sense or you can break down for us between the fiber-to-the-node served homes versus copper-based DSL? Thanks.

Glen F. Post
President, Chief Executive Officer & Director
A

Yeah, Mike. Firstly, on the consumer credit, a lot of folks are just switching back and forth carriers. A lot of that's taking place there. And a lot of nonpaid – we just tightened up on those folks who were not paying, basically, and just switching back and forth. So we think we're through – we know we're through the majority of that, but there could be – we'll continue to see the impact of this going forward, but the majority of what caused the initial hit, I think we're through most of that.

R. Stewart Ewing
Chief Financial Officer & Executive Vice President
A

And on the breakdown between fiber to the node and non-fiber to the node, we really don't break that out. But I can tell you, Mike, that our best penetration really in the market's where we have the higher speeds. And that's why we're focused on investing more in access in 2016 to provide higher speeds for our customers such that it will give us a better opportunity to gain them as a customer.

Michael L. McCormack
Jefferies LLC

Q

Okay. Thanks.

Operator: Thank you. Our next question comes from James Moorman from D. A. Davidson. Your line's open. Please go ahead.

James G. Moorman
D. A. Davidson & Co.

Q

Yeah, thanks. Could you just give us kind of your thoughts on the expectations for a bonus depreciation? Has anything changed in terms of you outlook for cash taxes for next year?

R. Stewart Ewing
Chief Financial Officer & Executive Vice President

A

Yes, so really the outlook for cash taxes is the same as it was last quarter. Basically, our most current information is that we really believe bonus depreciation is squarely in the radar of congressional leaders. The House Ways and Means Committee cleared legislation making 50% bonus depreciation part of the permanent tax code, and the Senate Finance Committee included a two-year extension of 50% bonus retroactive 2015 and 2016 with their extenders package. So we believe the extenders package is going to move along, and we really think that the Senate staff has been really outspoken to our people in terms of getting bonus depreciation this year. So we feel more comfortable that we'll have bonus depreciation in 2015 and 2016 than we did last quarter. And we felt pretty good about it then.

James G. Moorman
D. A. Davidson & Co.

Q

Thanks.

Operator: Thank you. Our next question comes from David Saber from Wells Fargo. Your line is open. Please go ahead.

David Saber
Wells Fargo Securities LLC

Q

Thanks for taking the question. Related to the data center strategic review, I just wanted to ask around your leverage target, which has been three times for some time. Would this potentially change that target? And the only reason I ask is that if you were to receive a large amount of cash, you have very little prepayable debt. So I just wanted to ask around the leverage target in general. Thanks.

R. Stewart Ewing
Chief Financial Officer & Executive Vice President

A

So, David, that's one of the things we'll have to work through as we get further into the process, but our target is really still about three times. We have said we'll allow that to drift up, just if EBITDA deteriorates and we see EBITDA turning around, out to ultimately bring the leverage back down. So we wouldn't really be held by a rating, more or less, in terms of keeping our EBITDA within a ratings range, but we'll just determine once we get closer to the execution of the opportunity of the data centers as to where we might go with the proceeds there.

David Saber
Wells Fargo Securities LLC

Q

Thank you.

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

Glen F. Post
President, Chief Executive Officer & Director

Thank you, Sayed. Overall, I'll just say I believe we have the best portfolio of assets we've ever had at the company. Now it's really about execution. We're taking these assets, leveraging and positioning them to drive future revenue growth, EBITDA growth and shareholder value. While there will be quarterly ups and downs, CenturyLink's long-term trajectory, in my view, is as positive as it's ever been. So look forward to working with you all in the months ahead. Thank you for joining our call today, and I look forward to speaking with you at the fourth quarter call. Thank you.

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