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CenturyLink, Inc. (CTL)

Q1 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the CenturyLink First Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. Following management's prepared remarks, we will host a question-and-answer session and our instructions will follow at that time. [Operator Instructions] As a reminder, this conference is being recorded for replay purposes.

It is now my pleasure to hand the conference over to Mr. Tony Davis, Vice President of Investor Relations. Sir, you may begin.

Tony Davis

Vice President, Investor Relations, CenturyLink, Inc.

Thank you, Brian, and good afternoon, everyone, and welcome to our call today to discuss CenturyLink's first quarter 2017 results, released earlier this afternoon. The slide presentation we'll 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 prepared remarks today, we will open the call for Q&A.

As you move to slide 2 in the deck, you'll find our Safe Harbor language. We will be making certain forward-looking statements today, particularly as they pertain to guidance for second quarter and full year 2017, the pending Level 3 transaction, and other outlooks in our business. So 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.

As we move to slide 3, 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 these non-GAAP financial measures and the most comparable GAAP financial measures are available in our earnings release and on our website at ir.centurylink.com.

Now, turning to slide 4, 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 Dean Douglas, CenturyLink's President of Enterprise Markets; and Maxine Moreau, CenturyLink's President of Consumer Markets.

Our call today will be available for telephone replay through May 10, 2017 and the webcast replay of our call will be available through May 24, 2017. 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 today, May 3, 2017 and should be considered valid only as of this date, regardless of the date heard or viewed.

Now, as we move to slide 5, I'll now turn the call over to Glen Post. Glen?

Glen F. Post

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

Thank you, Tony, and thank you for joining us today on our call. As we begin our discussion, I want to remind us all about the significant changes occurring within our business as we move through the remainder of 2017.

As announced this week, we closed the sale of our data centers and colocation business, Monday, May 1 and we continue to expect to close the Level 3 acquisition by the end of September. Both of these transactions align with our strategy announced in late 2015 to focusing first on network and taking a less capital intensive approach to complementary offerings such as hosting, Cloud, IT and Managed Services. And we remain committed to our network focused strategy as we look to the future.

So the company we expect to be by late 2017 will clearly be much different than we were coming into this year. I'll discuss these two transactions in more detail a little later.

So as we move to slide 6, I want to cover a few highlights for the quarter, as well as some important trends in our business. Our first quarter total revenues were below our expectations as we had lower Data Integration, and IT and Managed Services revenues, however, results for core revenue, operating cash flow, and adjusted diluted earnings per share were all within our guidance expectations. When you look a little deeper, we believe the trends we're seeing in our business offer strong validation of the rationale for our investment in high-quality, high-bandwidth, broadband network infrastructure, as well as for the sale of our data centers and colocation business and for our pending acquisition of Level 3.

We believe these steps will position CenturyLink well to become one of the leading network providers to Enterprise customers in the world. Enterprise high-bandwidth data services revenues for the first quarter 2017 are up more than 4% year-over-year and up 2% sequentially. If you adjust for a first quarter 2016 contract termination fee and the transition of a large Enterprise customer from Ethernet to dark fiber in recent months, Enterprise high-bandwidth data services revenue increased 6.5% year-over-year.

So our team is performing well in this part of the Enterprise sector, and we remain confident that the future growth opportunity for these services will remain significant for a number of reasons. First, the average size of new opportunities and deals closed are increasing as we see more Enterprise customers increasingly take advantage of the efficiencies and security our products and services offered. Also our increased focus on customer retention is improving churn, and we are seeing lower credits and adjustments.

In addition, CenturyLink continues to be one of the leaders in network virtualization to the deployment of software-defined networking and network function virtualization capabilities, SDN and NFV, which provides efficiencies for customers and a better customer experience. Also our strong network and cyber security capabilities position us as a leading provider of security services that is so important to enterprises.

And lastly, third-party research reports forecast mid-single digit compounded annual growth rate in U.S. Enterprise high-bandwidth data services through 2021 and mid-to-upper single digit compounded annual growth rates in U. S. Enterprise Markets Managed Network Services through 2021. This forecast give us even more confidence in the opportunity to continue to grow our Enterprise business in the months ahead.

Today, our high-bandwidth data services revenue stream represents approximately 70% of our total strategic Enterprise revenues and over 80%, excluding colocation revenues. But it is important to note that following the close of the pending acquisition of Level 3, we anticipate this revenue stream will represent a much higher percentage of our total strategic Enterprise revenues. And our combined company will have greater scale along with broader and enhanced solutions that should position us to drive future growth in high-bandwidth data services revenue.

Second, our IT Services revenue, which is primarily driven by IT consulting, cyber security, IT services management and integrated SAP solutions is growing. While we do not necessarily expect to be the industry leader in IT services, they are significant value add to our Enterprise network offers and they open the door to opportunities to build stronger relationships with Enterprise customers. In addition, they provide a low capital growth vehicle for our company.

On the other hand, I am not pleased with the performance of our managed hosting business, the sale of our data centers and colocation business created some market confusion and sales momentum disruption in this area of our business. However, we do expect to turn this around in the months ahead.

We recently completed upgrades to improve the capabilities and performance of our dedicated hosting/cloud environment and introduced our new Cloud Application Manager suite. This service enables us to help customers better manage their public, private and multi-cloud environments and it enhances our capabilities to assist businesses in their digital transformation.

Next, Consumer broadband subscriber trends have been improving in the last several quarters and improved it again this quarter. The key thing to note here is that in areas where we are investing in higher speeds, we are growing customers and average revenue per user.

Speed enhancements remains a priority as we enter the first quarter with nearly 9.2 million 40-megabit and higher addressable locations and more than 3.5 million 100-megabits in higher addressable locations, representing an increase of approximately 200,000 addressable locations in each tier during the quarter. Consumer video revenues were down slightly year-over-year primarily due to the restructuring of one of our satellite TV agreements that lowered satellite video revenues in the first quarter by about $15 million.

We expect second quarter broadband and video subscribers and revenues to be negatively impacted by typical second quarter seasonality. We do expect to see improvement in Consumer broadband and video subscribers and revenues in the second half of the year. This improvement is expected to be driven by simplifying offers, customer experience improvements, continued progress on our broadband speed enhancement roadmap and a broader range of video offerings.

Another important thing to note from the chart on this slide is that more than 75% of our strategic revenues today are driven by Enterprise high-bandwidth data services and Consumer broadband services, and we expect this percentage to increase over time.

Next, as you know, revenues from legacy services, primarily switchboard services and low bandwidth data services, have been declining for a number of years due to regulatory change, wireless displacement and technology transition to IP-enabled services. Our focus has been on managing these legacy service revenues and related costs for the cash flows they provide, enabling us to invest in our strategic service offerings and effectively compete in today's marketplace.

We believe the decline in our legacy revenues has been better than most of our peers and we will continue to manage these revenue streams to drive cash flows to invest in strategic services that meet the needs of Enterprise and Consumer customers. However, taken all together, the performance trends in our strategic services that are the growth drivers of our business give us confidence that we have the foundation to deliver good growth and revenues and cash flows.

In addition to these results, our key strategic service revenues give us even greater optimism regarding the significant value creation opportunity associated with the Level 3 transaction.

Now, let's move to slide 7, I want to provide a few additional thoughts on the completion of the sale of our data centers and colocation business, as well as our continued progress regarding the Level 3 acquisition. First, we are pleased to have completed the sale of our data centers and colocation business on May 1. We retained our managed hosting and cloud assets and have entered into a strategic relationship with the buyer to continue to offer colocation services, enabling us to offer our customers a full suite of Managed Services, including network, colocation, hosting, cloud and IT services.

CenturyLink received approximately $1.86 billion of net pre-tax cash proceeds subject to certain post-closing adjustments, and an approximately 10% equity stake in Cyxtera Technologies, the new company formed by BC Partners led consortium. The net after-tax cash proceeds, which are anticipated to be approximately $1.75 billion are expected to be used to partly fund the acquisition of Level 3.

Now, moving to the pending Level 3 acquisition, we're making good progress in obtaining the necessary approvals to complete the transaction. As I am sure you're aware, shareholders of both companies approved the merger in March at each company's respective special meeting of shareholders and several states have already approved or cleared CenturyLink's pending acquisition of Level 3.

Additionally, our integration planning process is going very well. Part of this process is continuing to evaluate the potential annual run rate cash synergies we believe to be achieved from this strategic acquisition. And we are highly confident that we will be able to achieve the $975 million annual run rate operating and capital cash synergies target we provided when we announced the transaction on October 31 of last year.

Additionally, late last week, we announced the new senior leadership team for the combined company that will report to me effective at the time of closing. I believe we have assembled an incredibly talented and experienced executive team that is well positioned to lead the combined company post-closing and drive our increased enterprise focus.

The sale of our data centers and colocation business and acquisition of Level 3 reflect our pivot back to focusing on network and taking a capital-light approach complementary IT and Managed Services. We believe this combination of CenturyLink and Level 3 will create significant benefits and growth opportunities for all stakeholders, including customers, employees and shareholders. This combination will enable us to build scale and deliver agile network-based projects, products and services to customers. We really will be creating a new chapter with the combined company.

We also believe the strategic combination will significantly improve CenturyLink's growth profile, it will better position the combined company to improve its revenue trends and growth. We expect it to be accretive to operating cash flow and generate more than 10% growth in free cash flow per share in the first full year post-closing, including synergies as realized and including integration costs. And we expect to drive significant improvement in free cash flow per share in subsequent years.

Finally, I want to say a word about full year 2017 guidance. As you know, during our fourth quarter earnings call in early February, we provided full year 2017 guidance that included the expected results of the data centers and colocation business for the entire year since the actual closing date of the sale had not been finalized. At that time, we provided monthly revenue, expense and free cash flow estimates for the data centers and colocation business. So if you adjust the previously provided full year 2017 guidance for the May 1 close, by reducing operating and core revenues by $400 million, cash expenses by $200 million to $240 million, free cash flow by $40 million to $80 million and the depreciation expense of $150 million, we currently expect full year 2017 results to come in near the lower end of the adjusted guidance range.

Now, I'll turn this call over to Stewart to discuss the results for the first quarter in more detail and review our second quarter guidance. Stewart?

R. Stewart Ewing

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

Thank you, Glen. Over the next few minutes, I'll review the first quarter results and provide an overview of the second quarter 2017 guidance we included in our earnings release issued today. Please note that I'll be reviewing some of the results, excluding special items as outlined in our earnings release and associated financial schedules.

On slide 9 today CenturyLink reported first quarter results with core revenues, operating cash flow and adjusted diluted EPS, all within our previously provided guidance ranges. The operating revenue came in below the guidance range primarily due to lower-than-expected data integration and IT and Managed Services revenues.

First quarter operating revenue on a consolidated basis was $4.2 billion, a 4.4% decrease from first quarter 2016 operating revenues. Core revenue, which is defined as strategic revenue plus legacy revenue, was $3.8 billion for the first quarter, a decline of 4.4% from the year-ago period. Operating income was $631 million for first quarter 2017. We generated operating cash flow of approximately $1.53 billion for the first quarter and achieved an operating cash flow margin of 36.4%. Cash expenses for the first quarter declined $40 million year-over-year, primarily due to lower salaries and wages expense related to the head count reduction in the fourth quarter 2016.

And free cash flow defined as operating cash flow less cash taxes paid for taxes, interest and capital expenditures along with the cash impact of pension, OPEB cost, stock-based compensation and other income was $492 million for the quarter. Diluted earnings per share for the first quarter was $0.30, a decrease from $0.44 in the year-ago period.

Moving to slide 10 and our Enterprise segment. Under the realignment announced last quarter, the Enterprise segment has been redefined to exclude IT and Managed Services revenue. All historical periods have been restated to reflect this change. In first quarter, the Enterprise segment generated $2.36 billion in operating revenues, which decreased 3.5% from the same period a year ago.

First quarter Enterprise strategic revenues were $1.08 billion, an increase of 2.9% compared to first quarter a year ago, driven primarily by the continued growth in high-bandwidth data services revenues. Legacy revenues for the segment declined 9.3% from first quarter 2016 due primarily to a continuing decline in the voice and low bandwidth data services revenues. Data integration revenues increased slightly year-over-year, and total Enterprise segment expenses were basically flat from first quarter 2016.

Now, turning to slide 11 in the Consumer segment, this segment generated $1.41 billion in total operating revenues, a decrease of 5.2% from first quarter 2016. Consumer strategic revenues declined 1.3% year-over-year to $764 million due primarily to the restructuring of the satellite video contract. Legacy revenues for the Consumer segment declined 9.2% from first quarter 2016, primarily due to access line declines. Operating expenses were basically flat compared to the same period a year ago.

Now turning to slide 12. For second quarter 2017, we expect operating revenues of $4.07 billion to $4.13 billion, core revenues of $3.66 billion to $3.72 billion and operating cash flow between $1.4 billion and $1.46 billion. Adjusted diluted EPS is expected to range from $0.46 to $0.52. As a result of the colocation sale, which took place on May 1, 2017, second quarter results will have approximately $100 million lower total and core revenue and approximately $50 million to $60 million less cash expenses when compared to first quarter 2017.

Excluding this impact, CenturyLink expects growth in strategic revenues in second quarter 2017 to be offset by anticipated declines in legacy revenues, resulting in lower operating revenues and core revenues compared to first quarter 2017. The company expects second quarter 2017 operating cash flow to be lower than first quarter 2017 due to the impact of the sale of the colocation business, the decline in core revenue and higher seasonal cash expenses.

And as Glen discussed previously, we expect our full-year 2017 results to be near the lower end of the adjusted guidance range. We expect our dividend payout ratio to be in the mid-to-high 70% range for 2017. While we continue to face pressure related to strategic revenue growth and our legacy revenue declines, we're confident in our business and our ability to improve the revenue and operating cash flow trajectory over time.

Now I'll ask the operator to begin the question-and-answer portion of the call.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question will come from the line of Simon Flannery with Morgan Stanley. Please proceed.

Simon Flannery
Analyst, Morgan Stanley & Co. LLC
Q

Great. Thank you very much. Good evening. I wonder, Glen, could you just talk a little bit more about what happened between sort of mid-February and currently to talk – to think about going to the low end of guidance adjusted for the data centers sale? And how should we think about your visibility for the rest of the year? And then maybe a little bit more on the merger approval process. What states are – should we be looking for in terms of hitting back September timetable or maybe coming in a little bit earlier? Thank you.

R. Stewart Ewing
Executive Vice President, Chief Financial Officer & Assistant Secretary, CenturyLink, Inc.
A

Yes, so Simon, so we're currently estimating that we'll be about $100 million to $140 million below the previous forecast for the first half of 2017. About $40 million of the variance is related to the Consumer segment. Some of which is related to the restructuring of the video contract that we described, as well as a little bit lower broadband revenues. We expect that to turn around in this back half of the year and I'll talk about that in a minute.

Of that amount, $20 million relates to broadband, again, $10 million in IPTV and $10 million in Consumer VoIP. Approximately $30 million of the $100 million to $140 million relates to IT and Managed Services and about $45 million to lower-margin data integration revenues. So, what gives us the confidence to believe that we'll see improved revenue performance in the second half of the year? Let me talk through for just a minute why we believe that will happen.

Basically, the improvement that we think we'll see in the second half from the first half is about $70 million related to high-bandwidth data services revenue. This should result from the improved sales closed as we saw increased sales in the first quarter and expect the second quarter of sales closed to be our highest level since 2015.

Additionally, we continue to see improvement in our churn rate and reduced customer credits. So, we anticipate a significant portion of the second half improvement to be driven by the improvement in the churn rate. We also expect about $70 million of improvement in IT and Managed Services, due to interest in new a product that we have rolled out, the Cloud Application Manager, and closing the sale of our data centers and colocation business, we believe, will help because it eliminate some of the market confusion that we've had about our staying in the Managed Services and IT Services business.

Also traction by our separate overlay sales force that we put in place in late fourth quarter 2016 and then recent work that we've done to reinvigorate the sales by the top salespeople in our network sales group, who previously had sold Managed Services and IT Services.

We also expect about $90 million of improvement in our data integration revenue performance in the second half of the year. But as you know, this is low margin revenue. So, if we don't achieve this, it'll only have a minimal impact on our operating cash flow.

Simon Flannery
Analyst, Morgan Stanley & Co. LLC

Q

Great. And on the state approvals?

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Yeah, Simon, moving forward, I think we have 14 state approvals or confirmations so far. They're going well. Nothing that's of really major significance there. There is always going to be an outlier to, and you just can't control the regulatory process. But right now, we don't see anything that could – anything that we believe will stop us from closing by the end of September. The DOJ process we've had our second request for information there. We filed the answers to their requests.

We believe that's going well. Don't expect any major issues there. There is certainly a possibility to close earlier than September. But as you know, the regulatory processes, all we can do is aggressively seek those approvals and provide the information they want. And the good thing is, this is not impacting the Consumer business. So we should have less concern from the state regulators than you would in a normal, we would be buying a consumer asset sort of business.

Simon Flannery
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question will come from the line of Mike McCormack with Jefferies. Please proceed.

Mike L. McCormack
Analyst, Jefferies LLC

Q

Hey, guys. Thanks. Maybe just a comment, Stewart or Glen, on your comment regarding legacy losses and how you intend to stem those, sort of the various strategies around that? And then just thinking about the dividend payout ratios, Stewart, what's the comfort level there? It's above the historic trends from what you've been comfortable with previously?

R. Stewart Ewing
Executive Vice President, Chief Financial Officer & Assistant Secretary, CenturyLink, Inc.
A

Yes, so, Mike, with respect to the dividend payout ratio, I mean we're comfortable where it is. Again, with the closing of the Level 3 transaction and the additional free cash flow per share, we will see associated with that, even including the integration cost, we should see the dividend payout ratio decline at least after 2018. And again, I think when we announced the transaction, we said we expected about a 10-point improvement in the dividend payout ratio, I believe, in the first year after we close.

Mike L. McCormack
Analyst, Jefferies LLC
Q

Right.

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

And then Mike, one of the things we're doing on the legacy losses, we're attaching voice to our bundles. It's going to be high-speed Internet bundles, with our video bundles, and we think that's going to help some. And I think it is partially the reason we are ahead of above the industry in terms of – better than industry in terms of those legacy losses. And so we'll keep aggressive marketing in those areas, and we have a strong retention plan as well going on, which we think has been effective and we will improve that in recent months, so that's why we're optimistic we can improve that some.

Mike L. McCormack
Analyst, Jefferies LLC
Q

Great. Thank you guys.

Operator: Thank you. Our next question will come from the line of David Barden of Bank of America. Please proceed.

David Barden
Analyst, Bank of America Merrill Lynch
Q

Hey guys. Thanks for taking the questions. So, I guess a couple, if I could. Just first, if you guys have sized the potential opportunity that may exist from the new BDS reform initiatives that Chairman Pai put out, it would be helpful to kind of get us a sense of that.

Second, I guess I would love to kind of hear your guys', kind of, perspectives on emerging SD-WAN products and whether you guys feel your enough of a kind of competitor, agitator to take advantage of its disruption? Or whether you are more of an incumbent and you're kind of looking at it as a potential threat?

And then last, I just wanted to follow-up, Stewart, on Simon's question. I guess, we went through this math exercise last quarter where the guidance implied that all the rest of the quarters of the year are going to grow. And now we have the first quarter come in pretty much in-line but now, the second quarter isn't growing. It's actually down quite a bit. And the guidance still implies that now from the second quarter midpoint, third quarter and fourth quarter both have to be up $25 million to get to the very low end of the guidance range that you put out there.

So last quarter, 53 days ago, you had that conviction and then it didn't kind of pan out. So kind of what kind of vetting process and visibility do you think you have to say that you think that now, EBITDA is going to grow quarterly from the second quarter into the back part of the year. And thank you, Glen, for the details, but we heard that last quarter too. So, can you kind of tell a different story now about why we think it's actually going to grow? Thanks.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

I'll start with the question on the BDS. We have not really quantified it, but the vast majority of our markets will be considered competitive. So with that in mind, there should be very little impact on us going forward, so we feel really very positive about it. It could have been pretty negative for us – original proposal by the previous Chairman.

But we're very pleased with where we're headed there. And we're pleased with the recognition by Chairman Pai and the FCC of the reality of the marketplace, competitiveness of the marketplace and also recognition of what significant harm can be done to investment and infrastructure and future services for customers by overzealous regulations. So we feel good about where we're headed and with BDS and actually the other regulatory issues facing the FCC.

On SD-WAN, we believe it's a product that we can grow, and our concern is it's more of a competitors' advantage. We see it as an advantage for us. Our customers are wanting that product. And when we sell a product, it's not going 100% from MPLS to SD-WAN. It's usually a hybrid network solution. So we're confident that we can compete in that arena, and we have as good a technology there as anybody in the world, we believe, right now, and have more coverage than most as far as 60% of our major IP Pops are virtualized now are capable of SDN and virtualized services. And we believe that it's going to be a real win for us.

We believe when we complete the full build out of that by 2019, we could see significant impact, positive impact from capital expenditures. We already said at least $200 million reduction in our annual CapEx from the build out of the virtualized networks. So we're very excited about the opportunities here.

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

A

And David, I guess, on the last question, the only thing I could add to the response to Simon was basically, I mean, we've seen improved sales closed during each successive month, during 2017. January started off a little bit slow, a little bit slower than we had thought it would be, but it picked up somewhat in February, March we closed more sales than we did in February and, again, in April, it looks like that's going to be a good month as well.

So we think we're building momentum with respect to the network sales and we're also seeing some of that momentum in the IT and Managed Services as well, especially with the Cloud Application Manager product that we have and that's really, I think, reinvigorated a lot of our salespeople in terms of being able to help them have a product that we can serve our customers with that allows them to move their workloads from one cloud provider to another, from on-premises to off-premises.

So I think that we're more confident now that we have products that we can use to develop the revenue stream and that sales force, the separate sales force that we have, they're doing a good job getting traction. We just put them in place, and it took a little while to get them up-to-speed but they're making progress now, as are some of the top salespeople in the network side that also sell IT Services and Managed Services products.

So that's really why we're more confident now, why we came down somewhat from a quarter ago when we talked is basically more or less just due to kind of the slow January that we had and a little bit slower February than expected. But, again, we think we're making progress there.

David Barden
Analyst, Bank of America Merrill Lynch

Q

Okay. Great, guys. Thank you.

Operator: Thank you. Our next question will come from the line of Batya Levi with UBS. Please proceed.

Batya Levi
Analyst, UBS Securities LLC

Q

Great. Thank you. A question on the expenses and the trajectory for that, the revenues came in lighter than we expected but cash flow was better. You mentioned that you continue to benefit from the wage reduction. First, in the first quarter, are there any one-time benefits on the expense side? And looking out to second, I think you don't have the payroll taxes or merit expenses, but can you bridge us from 1Q to the second quarter expense structure? Thanks.

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

A

So, Batya, we have about a $15 million one-time positive adjustment to expenses in the first quarter related to the taxes, property taxes and sales and use taxes. From the standpoint of going from first quarter expenses to second quarter expenses, first, you need to take about $55 million out related to the colo sale. We had some merit increases that will add about $10 million to expense. The operating taxes, again, that one-time benefit will not be there, so that will be up probably $15 million or so.

We're also, as a result of the colo sale, we're leasing space from the provider, from the data center owner to basically provide the Managed Services and the cloud products that we have, that's about $15 million of an increase in the second quarter. And then there was just numerous other smaller increases that make up the balance.

Batya Levi
Analyst, UBS Securities LLC

Q

Okay, got it. And then one follow-up on your video, I apologize if you mentioned this before. But you had been trailing in OTT for video service, can you provide any update on that?

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

Yes, this is Maxine Moreau. So, we are still in the process of technically trialing the product in four markets. It's going well. We do plan to launch the service in early next quarter. And we will look at the results. We'll evaluate the pricing strategy, the packaging strategy and then we will phase-in the launch over the rest of the year.

Batya Levi
Analyst, UBS Securities LLC

Q

And as you phased out and you also expect to phase out some of the Prism TV markets?

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

What we've done in Prism TV is we did our rate increase in February of this year to capture the higher value customers and so we're targeting those customers differently than we have in the past to maximize the overall customer lifetime value. So our video strategy will be one of offering multiple options to the customers, based on their purchasing needs.

Batya Levi
Analyst, UBS Securities LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question will come from the line of Amir Rozwadowski with Barclays. Please proceed.

Amir Rozwadowski
Analyst, Barclays Capital, Inc.

Q

Thank you very much and good afternoon, folks. Dovetailing on that prior question on the Consumer business, it does seem as we look at some of the revised guidance outlook for the year, it does continue to pressure overall top-line trajectory. Given the shift with Level 3 and the embrace of the enterprise opportunity, what type of opportunities can you have to fully flush out that business? And it sounds like you are targeting – ability to target the higher end customers and perhaps generate a better return on that business. Is there an opportunity set to monetize that business and would love to hear your strategies there.

And then on the prior question on the business data services regulation, just wanted to clarify. Should we think about it as a removal of a potential headwind or an incremental opportunity for you folks going forward? And if it's the latter, does that opportunity improve with the Level 3 acquisition? Thanks very much.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Yeah. So first of all, I guess in the Consumer business you're right, there is continued pressure there. But we think we can turn the strategic revenue portion of the Consumer business around which essentially is broadband by the network expansion that we're doing.

And so, for instance, we now have about 3.5 million living units that can get 100 megabits or better versus 2.6 million a year ago. We've had an increase in the customers who can get 40 megabits or higher. That's increased to about 9 million from about 8.3 million a year ago.

So we continue to do more and more from a network standpoint to provide our customers with the ability to get higher speeds. More of our customers are taking 40 megabits or higher now. Those customers have less propensity to churn and they pay a little bit more than our traditional customers that are starting to roll-off that basically had pretty good discounts when they signed up. So we think we'll see the ARPU change over time and start increasing on the broadband side, and we think we can take some market share away by some of the offers that we are making.

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

A

On BDS, well, we were concerned about the headwind, as a major concern we had. We don't know the selling side of BDS is a huge upside opportunity for us right now, but certainly took away the headwind that we're concerned with was irrational regulation in these competitive markets, so that's the biggest benefits to us right now.

Amir Rozwadowski
Analyst, Barclays Capital, Inc.

Q

Great. Thanks very much for the incremental color.

Operator: Thank you. Our next question will come from the line of Amy Yong with Macquarie. Please proceed.

Amy Yong
Analyst, Macquarie Capital (USA), Inc.

Q

Thanks. Two questions, one on the Consumer side and maybe the leadership transition team. Can you talk about the step-down in your DBS contract, I am sorry, the $15 million hit. Should we expect that the numbers will continue to step down given the new economics? And can you confirm whether or not you're carrying DIRECTV now.

And then my second question is on the leadership structure. What kind of mechanism do you have in place so that there's not too much distraction between both the CenturyLink and Level 3 sales force? Thank you.

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

So, on the new satellite TV agreement, so we did receive an increase in our onetime payments that we receive when we sell that service. So there will be some offset in the coming months because we are selling more of that product year-over-year. So, it won't be $15 million a quarter. It will step down a bit.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Regarding the potential conflict sales force, Level 3 and CenturyLink, that is the number one focus of our integration work really is to try to avoid any impacts on revenues, on sales, on the sales process. Obviously, we have shared similar customers in many cases, we're working with our – we plan to work when we can – work with our customers in that issue. We can't do that until close. But we can begin working on sales with our sales force, rationalizing the number of salespeople we have in certain areas.

It is a major, major focus of ours and the one we'll be spending probably more time than any place else. We have a lot of great sales folks out there. We're going to try to put them in best places where they can be successful and work with them going forward. So, we need all the good salespeople we can have out there and we're just going to work with them to divide up the account, the shared account in some cases,

to optimize those folks who are so capable at working with our customers.

Amy Yong
Analyst, Macquarie Capital (USA), Inc.

Q

Thank you.

Operator: Thank you. Our next question will come from the line of Matthew Niknam with Deutsche Bank. Please proceed.

Matthew Niknam
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, guys. Thank you for taking the questions. Just two, if I could. One on the Enterprise side, some of your larger peers in Enterprise have talked about very soft demand environment on the business wireline front. It doesn't seem like that's the case you talked about increasing number of deals closed in recent months, but just curious whether you're seeing anything similar there?

And then secondly on the consumer broadband front, wondering if you can comment at all on gross adds versus churn and where you may be seeing drivers for some of the softness this quarter. Thanks.

Dean J. Douglas
President-Enterprise Markets, CenturyLink, Inc.

A

So, this is Dean Douglas. With regard to the larger peers wrestling with some softness in the large Enterprise marketplace, we're actually seeing some strength in the large Enterprise marketplace. For example, our MPLS is up 6.1% and that's better than the marketplace in general. And so we really do see strength in that high end data services for our Enterprise customers and we don't see that abating anytime soon.

And the reason I say that is that, we had an extraordinarily strong March as Stewart indicated and we're seeing that same strength in the sales activity going forward in April as well as looking out towards the second quarter.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Probably to add to that, Dean, I'll just say that we have not seen the softness in the market, maybe some have seen, but we have also not seen the great improvement in the market that we would expect with the improved economy. So, we're still waiting to see, we're still seeing elongated decision-making processes. We haven't seen a jump in demand like we would hope to see. So we're hoping we'll see that and maybe it's lagging the overall improvement in the economy, but that's still an upside for us possibly as businesses have more confidence in the better economy.

Matthew Niknam
Analyst, Deutsche Bank Securities, Inc.

Q

And just regarding the Consumer?

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

Yes, regarding Consumer, so in the first quarter, the majority of our benefit we saw was in churn reductions versus inward activity. As you recall, last year, we made some changes to our credit policies which lowered our overall inwards. For the second half of the year, our anticipation is that we'll continue to see improvements in churn, but we'll also drive more inward activity as a combination of a result of the increased broadband enablement that we spoke of as well as we're trialing some new pricing activities that in early stages we're seeing improvement in our inward activity as a result of the simplified pricing offers.

Matthew Niknam
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thanks so much.

Operator: Thank you. Our next question will come from the line of Brett Feldman with Goldman Sachs. Please proceed.

Brett Feldman
Analyst, Goldman Sachs & Co.

Q

Thanks. And if you don't mind I'd like to follow up on Consumer. You noted that in the markets where you have your highest speeds available, you're actually growing your base. And so I was hoping you can maybe talk us through how you think about capital allocation and whether you think there may be an opportunity to either accelerate a fiber buildout or any of the investments you've been making to drive higher speeds in the market potentially by even reinvesting some of the synergies that you think you're going to achieve after the deal closes.

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

Yes, so if you recall last August, when we reported second quarter earnings, Glen walked you through our three-year – actually 3.5-year broadband build plan. We're just now three quarters into that plan and we are on track. Really the determination on future capital allocation will rely on our success in penetrating those network investments.

Brett Feldman
Analyst, Goldman Sachs & Co.

Q

Got it. If you don't mind if I guess, one more follow-up question, you've gotten a question earlier about the integration process and making sure you try to avoid disruption. If you do actually close the deal on the timeline you had expected, which is I guess in the third quarter, can you walk us through what the first couple of quarters will look like from an integration standpoint? How long do you think it's going to take to be with the type of organizational structure and the reassigned assignments that you think you need to execute effectively in the market?

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Brett, I think our target is having the total sales redesign completed by January 1. And that's not going to be an easy process. That's an aggressive process. So we think we can do that and there are always concerns about when you make those kind of changes, bring two companies together, where you're the only two companies in a building or in a business.

So we'll try to work or deal with those issues. But we're really confident that the quality of people we have in this process, with the collaboration that's going already, of course, we cannot talk about individual customers or customers – what we're serving customers, we're making progress probably ahead of the pace normally than I've seen in our previous transactions in terms of identifying opportunities and getting the leadership in place to address the issues that could cause problems as I'm sure everyone is concerned when you bring two companies together, you don't want to lose momentum and that's going to be our objective.

Brett Feldman
Analyst, Goldman Sachs & Co.

Q

Great. Thanks for taking the questions.

Operator: Thank you. Our next question will come from the line of Frank Louthan with Raymond James. Please proceed.

Frank Garreth Louthan
Analyst, Raymond James & Associates, Inc.

Q

Great. Thank you. So, a couple of quick questions. Stewart, you mentioned some credits that you had issues that are not going to repeat. What's sort of the nature of that, and can you quantify that? And with the new sort of reorganizational structure, how long should we expect to see before this reorg begins to show some results, and where should we expect to see that show up first?

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

A

Yes, so, Frank, the credits that I mentioned earlier is part of the conversation associated with why we're comfortable being able to increase revenue on the Enterprise side in the second half.

Really, our credits are related to business customers, and some of those credits have been related to some network outages that we've had in the past. We haven't had those outages here recently and things have improved quite a bit.

Credits related to other things as well, related to managed services and those have declined quite a bit, and we're paying a lot more attention and have increased the level of the person that has to approve a credit and so they are really vetted quite a bit more now than they were in the past, I think. So we are just seeing our credits that we're giving to business customers for different reasons decline and expect to see that to continue to decline hopefully in the second half. And again, a big part of the improvement we think we'll see too is coming from reduced churn that we're seeing in the Enterprise segment.

In terms of the reorg structure and how long we think it will take it to show traction? I don't think it will take that long. I mean, typically we do a great job and with the leaders that we have responsible for the integration, they're making a lot of headway in terms of basically how the integration's going to take place.

We typically get good synergies, quite a bit of synergies in the first year or so, first six months to a year. I think we expect to get 80% of the operating expense synergies over the course of the first three years, but a fair amount of that will be pushed into the first year as we integrate the two companies as we integrate the IT systems, things like that. The ERP system, for instance, we're pretty well on track to hopefully get that changed to where we'll be on one ERP system, except for certain of the overseas areas, international areas by January 1.

Frank Garreth Louthan
Analyst, Raymond James & Associates, Inc.

Q

Okay. And just I wanted to follow up on the residential and I guess maybe the smaller end of the business. It's been a struggle for a while competitively. Is there anything there with the nature of that competitiveness that might have changed? And is there a point where you're better off redirecting resources to other places or do you think that there's something that maybe this reorg or so forth you can do to actually more stem the tide on that end of the business? Thanks.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Frank, what we are seeing, we mentioned earlier, is we're building capacity. We're seeing growth. We're seeing high take rates on the higher speeds. So we're winning the marketplace when we have those speeds out there. The question, as you say, is it capital allocation. The good thing is that a lot of these builds we're doing, not only benefit consumer, they benefit the business as well, SMB, and they put fiber closer to the large businesses where we're going to locate POPs that are just hundreds of feet away. So, to the extent we can build for both consumer and business, it's helpful. We share that cost of those fiber builds. That's a positive.

We always have the opportunity to consider monetization, but right now that business is driving good cash flow. We have a shared network complexities we have to deal with, but it's always an option to look at. But right now, the cash flows coming from that business are strong.

The other thing that we've done on the SMB is basically as part of the reorganization that we did earlier where we separated out the Consumer group and the Enterprise group. SMB had really been served in the past by our folks that ran our call centers and what we're doing now is we've moved that business and responsibility for those customers over to the Enterprise segment. So there are more dedicated resources now that are trying to win the hearts and minds and wallet share of the SMB customers.

Frank Garreth Louthan
Analyst, Raymond James & Associates, Inc.

Q

Okay. Great. Thank you.

Operator: Thank you. Our last question will come from the line of Tim Horan with Oppenheimer. Please proceed.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thanks, guys. Three questions, sorry. Glen, on the integration of the sales force, are you going to pick one company's structure or operating systems and try to go with that or are you just going to kind of pick the best of breed and really kind of merge them together?

And then secondly, on the Consumer front, can you talk about the experience you've had with OTT? I know they're trials, but what the customer – the take up has been. And then also related on Consumer, can you remind us how many living units you have passed? I know you have 9 million with 40 Mbps and above. Maybe what percentage that is of living units and just remind us what percentage that will be in two years to three years? Thanks so much.

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

A

Yes, regarding the structure, we really like the GM structure that Level 3 has in place. And we're going to plan to really build more around that. We still have our focus on SMB and other areas, but we like that local presence really what it provides and we think that makes a lot of sense. We've done a lot of work around that and so to the extent that we look at the structure, the large structure around Enterprise, we expect to go more with the Level 3 plan there, which works for us because it's really been successful I think in getting into local market in the past.

And one thing I'll just point out here again, the impact of this business, today our biggest issue at CenturyLink has been the legacy revenue, we're losing clost to $600 million a year in legacy revenue we know that we can do very little to offset. That requires us to work to reduce cost in the legacy areas and the business while trying to drive growth in strategic revenue. With this acquisition, our legacy revenue will move from 50% of total revenue to 35% of core revenue, so 50% to 35%, a huge impact. And what it does, in essence, it gives us a much stronger opportunity to grow revenue and eventually cash flows as well as a result of the acquisition. So a lot of benefits here including just bringing two great sales forces together and the scale we get along with the operating cash flow accretion we expect to see and free cash flow accretion we see.

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

The over-the-top experience is obviously a skinnier bundle from what they have today with linear Prism TV service. It will be at a lower rate and it will not require truck roll, so it will be something that the customers can sign up online, get their service immediately, they can add on other genre packages, so they can buy as little or as much as they would like, based on the different package offers we have and it will be targeted to those more cost-conscious, tech-savvy type of users.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

And just remind me where you'll be with the 40 Mbps coverage of your living units or homes passed in two years to three years?

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

Yes, so if you recall last year, what we communicated was by the end of 2019, that we would have over 10 million addressable units at 40 Mbps, which is about 85% of our market, about 42% or 11 million would have 100 Mbps and then we'd have about 3 million that would have 1 Gbps or above.

A

About 20%.

Maxine L. Moreau
President-Consumer Markets, CenturyLink, Inc.

A

And we're on track for that build.

Timothy Horan
Analyst, Oppenheimer & Co., Inc.

Q

Thank you.

Operator: Thank you. This concludes our question-and-answer session for today. So now it's my pleasure to hand the conference over back to Mr. Glen Post for closing comments or remarks. Sir?

Glen F. Post
President, Chief Executive Officer & Director, CenturyLink, Inc.

Thank you and I am pleased with the progress we continue to make in transforming CenturyLink into a leading global enterprise network provider. We're encouraged by the continued demand from businesses and consumers for advanced network services and the related trends we're seeing in our business, along with the associated opportunities provided to manage services to help Enterprise customers enable their digital transformation.

And we believe our continued progress in the virtualization of our network, enhancement of our broadband speeds and improving our customer experience through simplification, automation, help position us to drive future growth in our business.

Additionally, the completion of the sale of our data centers and colocation business and the pending acquisition of Level 3 move us forward toward our goal of being one of the world's leading network providers and providing us, I believe, a lot of opportunity to create a really growth-oriented company here that's one of the leading companies in the world in terms of providing networking services to the Enterprise customers.

So, thank you for your participation today and look forward to talking with you in the weeks ahead.

Operator: Ladies and gentlemen, thank you for your participation on today's conference. This does conclude the program and you may all disconnect. Everybody, have a wonderful day.