07-Aug-2013

CenturyLink, Inc. (CTL)

Q2 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Tony Davis

Vice President-Investor Relations, CenturyLink, Inc.

GAAP AND NON-GAAP FINANCIAL MEASURES

- 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 www.centurylink.com

Glen F. Post, III

President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

BUSINESS HIGHLIGHTS

Operating Revenue and Adjusted EPS

- We are very pleased with the financial results for Q2 and H1 this year and we continue to make good progress on a number of fronts
- Operating revenues for Q2 were in line with our expectations, while operating cash flow and adjusted EPS were near the high end of our previous guidance
- We believe our investments and our key strategic growth initiatives continue to strengthen our overall product portfolio, further positioning CenturyLink as a leading integrated provider of global network, colocation, managed hosting and cloud solutions
- Demand from business customers for high bandwidth network and data hosting services continues to drive solid sale opportunities for integrated solutions

Q2 RESULTS

Revenue Growth and Expenses

- If you'll turn to slide five and I'd like to begin with highlights from Q2
- We generated solid financial results, with annual strategic revenue growth of 4.1%
- Strength in revenue from high-speed Internet, high-bandwidth data products, data hosting and Prism TV were the primary drivers of this growth
    - Additionally, we have maintained our focus on expenses, as we reduced cash expenses by $45mm or 1.7% from a year ago period, driven primarily by lower personnel and data integration costs

Business Market Perspective

- From a business market perspective, we experienced strong new sales to business customers across the company for network and hosting services in Q2

- Also during the quarter, we made good progress on the share repurchase program we announced in February
- Through August 6, 2013 we repurchased nearly 29mm shares, or 4.6% of our outstanding common stock for a total of approximately $1B
- We have repurchased shares aggressively over the past few months and we expect opportunistically to buy back additional shares going forward
  - We continue to expect to complete the $2B repurchase by February of 2015

Tentative Agreement

- We still anticipate improvement in our strategic revenue growth during H2 this year; however, we do expect this level of improvement to be slightly lower than the more aggressive growth we originally anticipated
- And finally, I'm pleased that we have reached a tentative agreement in contract negotiations with the Communications Workers of America, covering many of our western states
- Our focus during these negotiations has been to align the cost structure and work rules under this agreement with the rest of our organization and the competitive dynamics in the markets where we operate

Broadband Expansion and Enhancement

- If you turn to slide six, I'll provide an update on our key strategic initiatives
- Starting with broadband expansion and enhancement, we continue to make significant investments in this area that we believe will better serve our business and consumer customers
- We ended the quarter with approximately 5.91mm broadband subscribers
- We did experience the first ever decline in broadband net adds in Q2, due to typical seasonality and lower than our normal level of indirect sales
  - While this quarter was challenging, we do expect broadband subscriber net adds to be positive for the remainder of this year

BUSINESS MARKET

- We believe our fiber assets position us well in the business market
- In H1 2013 we put over 1,000 of our fiber fed multi-tenant buildings into our advanced MTU program, which offers customers broadband capabilities of up to 500 megabits of symmetrical service and enhances cloud connectivity for these customers
  - In addition, we plan to leverage our existing fiber to opportunistically expand GPON capabilities into nearby high-density business districts, offering broadband speeds of up to 1 gig

MTU and GPON Program

- Both the MTU and GPON programs offer upstream speeds and business service level agreements beyond what is normally available with cable, and they make these capabilities particularly compelling in the business market where upstream capabilities are critical to enablement of cloud services
- In business areas where we do not offer our advanced MTU or GPON programs, we've extensively deployed Ethernet
  - We currently cover over 2mm business locations with Ethernet capability, with about half of this footprint capable of 20 megabits and higher symmetrical speeds today

- In the months ahead, we expect to continue making investments in our network to enhance speed capabilities required to deliver competitive broadband products and services across our markets

Prism TV Service

- Turning now to slide seven, our Prism TV service continues to perform well and represents a very compelling entertainment alternative to cable TV service in the markets where we offer the service
- We had over 12,000 Prism TV subscribers in Q2, ending the quarter with a total of 132,000 subscribers in service
  - These customers continue to have a high rate of broadband attachment; it was actually 97% in Q2 this year
- And over 50% of these customers are new to CenturyLink
- We now have a penetration rate of nearly 9% across the markets in which the service is available and that includes the newest markets of Phoenix, Colorado Springs and Omaha

TRIPLE PLAY

- Prism TV triple play bundled customers are significantly less likely to churn than single play voice customers
- In Q2, the churn rate for Prism TV triple play customers was over 500BPS lower than the single play voice customers
- We're pleased with the early Prism subscriber growth in Phoenix, our first legacy Qwest market in which we provide this video service
- And in Q2 we also commercially launched the service in Colorado Springs and soft launched in Omaha with our fiber-to-prem service
  - In addition, we continue to enhance our IPTV features by introducing new functionality and applications, including expansion of our TV Everywhere capabilities, video-on-demand library, and a recent successful trial of wireless set-top boxes

Footprint

- Now going to slide eight, a third key strategic initiative is investing in fiber builds to as many towers in our service areas as economically feasible
- During Q2, we completed more than 1,150 fiber-to-the-tower builds, for a total of over 16,700 across our footprint
- We currently expect to complete a total of 4,000 to 5,000 builds in 2013
- As we've discussed with you before, we're experiencing some revenue compression as our wireless wholesale customers transition from copper-based DS1 facilities to fiber-based Ethernet services
  - However, we anticipate that wireless data bandwidth growth will result in expansion of Ethernet consumption, reversing the current revenue compression during 2014

Managed Hosting and Cloud Services

- Now moving on to slide nine
- In managed hosting and cloud services, we continue to believe we are well positioned to capitalize on long-term growth opportunities in this space where we developed and are expanding our strong product offering for businesses of all sizes

- We continue to build upon solid momentum on the past two quarters with solid new sales again this quarter
- Cross-sell or team-selling opportunities for hosting products across our hosting and network sales teams continues to be strong, with sales of hosting services to business customers steadily growing
  - We also continue investing to increase our data center capacity, as well as expand our product portfolio to meet customer needs and expand our market opportunity
- In Q2, we opened a new data center in London, adding approximately 25,000 square feet of sellable floor space
- And for full year 2013, we continue to expect to add a total of approximately 87,000 sellable square feet, of which over 57,000 has been added during H1

Acquisition of AppFog

- Our recent acquisition of AppFog, a rapidly growing platform as a service provider, used by more than 100,000 developers who have deployed over 150,000 applications, represents an excellent addition to our Savvis cloud service suite
- We are offering multiple programming languages and interoperability between public and private cloud environments and AppFog delivers a reliable, scalable and fast platform for developing apps in the cloud
- Combining AppFog's market-leading platform as a service capabilities with our industry-leading infrastructure as a service, Savvis cloud services and our global network, CenturyLink, will enable the developers to securely and reliably operate and connect to applications they build and deploy
  - We look forward to making the full suite of AppFog services available to both our existing and prospective customers in the weeks ahead

SUMMARY

- Finally, in June, Savvis was recognized as a leader in the Gartner Magic Quadrant for European managed hosting, another confirmation of CenturyLink's global leadership position in managed hosting, and overall I'm pleased with the financial results for the quarter
  - We continue to invest to drive growth and are experiencing good traction in those key areas

R. Stewart Ewing

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

FINANCIAL HIGHLIGHTS

Core Revenue

- I'll spend the next few minutes reviewing the financial highlights from Q2 and then conclude my remarks with an overview of Q3 and full-year 2013 guidance we included in our earnings release issued earlier this afternoon
- Starting on slide 11, beginning this quarter we're providing guidance on core revenues
- Core revenues reflect the two largest contributors to operating revenues, our strategic revenues and legacy revenues
  - Strategic and legacy revenues account for approximately 91% of total revenues and are primarily recurring in nature

- Core revenues exclude revenues from data integration, which includes primarily customer premise equipment sales and related maintenance and other revenues, which includes primarily universal service receipts
- As you can see, in the chart on slide 11, the green line represents the annual percent change for core revenues, while the orange line represents the annual percent change for total revenues
- The core revenue trend has improved from a 3.2% decline in pro forma 2011 to 2.3% decline in 2012, and we expect further improvement in 2013, with a decline of 0.9% to 1.5%
- We believe this trend is a more accurate reflection of the underlying business as it takes out the noise of changing USF contribution rates and the lower margin CPE business

Operating Revenue and Cash Flow

- Turning to slide 12, with that let's move to our results for Q2
- I'll be reviewing the results excluding special items, as outlined in the earnings release and associated financial schedules
- As you can see, we generated solid operating revenues and cash flows in the quarter
- Operating revenues were $4.53B on a consolidated basis, and this represents a 1.9% decline from second quarter 2012 operating revenues
- Our core revenues were $4.11B for second quarter, a decline of 1.6% from the year ago period
- Strategic revenue in the quarter increased to 48% of total revenue, from 45% in Q2 a year ago due to growth in strategic products such as high-speed Internet, high-bandwidth data services, Prism TV and managed hosting services
    - Adjusted diluted EPS for Q2 was $0.69
- As we've discussed on prior calls, adjusted diluted EPS excludes special items and certain non-cash purchase accounting adjustments as outlined in our press release and associated supplemental financial schedules

Cash Operating Expenses

- Total cash operating expenses declined from second quarter 2012 to second quarter 2013
- This decline was primarily the result of lower personnel-related and data integration costs
- We generated strong operating cash flow of approximately $1.86B for Q2 and achieved an operating cash flow margin of 41.1%
    - Additionally, we generated $703mm of FCF during the quarter, which is defined as operating cash flow, less cash paid for taxes, interest, and CapExs, and additional adjustments to other income
- Our strong cash flows continue to provide us the financial strength and flexibility to meet our business objectives and drive long-term shareholder value

Strategic Revenues

- Now turning to slide 13, the decline in second quarter 2013 operating revenues compared to second quarter a year ago was primarily a result of growth in strategic revenues that was more than offset by lower legacy revenues due to access line losses and lower minutes of use
- The growth in our strategic revenues was primarily driven by strength in high-speed Internet, high bandwidth business data services, and our data hosting services

Consumer Segment

- Now turning to slide 14, which is our Consumer segment, I'll discuss each of the o perating segments beginning with Consumer
- Consumer generated $1.4B in operating revenues, which represents a decrease of 3% over second quarter a year ago
- Strategic revenues in this segment grew 6.4% y-over-y to $628mm
- Legacy revenues declined – for the segment declined 8.7% from second quarter 2012, due primarily to a continuing decline in access lines, long distance revenues partially mitigated by implementation of the access recovery charge in July of 2012
- Expenses in this segment declined $17mm or 3% during second quarter compared to the same period a year ago, driven mainly by lower bad debt expense, network and facility costs, which were partially offset by higher costs associated with our Prism TV product

Legacy Services Revenue

- Moving to slide 15, our business segment generated $1.53B in operating revenues during Q2, which were slightly below revenues from the same year ago period
- Second quarter strategic revenues for the segment increased by 4.6% to $617mm from second quarter 2012, driven primarily by strength in high-bandwidth services, such as:
  - MPLS
  - Ethernet
  - And Wavelength
- Excluding low bandwidth services, strategic revenue grew nearly 10% from a year ago
- Legacy services revenues for the segment declined 4.9% from second quarter 2012, due primarily to a continuing decline in access line and long distance revenues, partially mitigated by the implementation of the access recovery charge in mid-year 2012
- The total segment expenses declined $6mm, driven by lower data integration and network costs, partially offset by higher facility costs

Wholesale Segment

- Now turning to slide 16, our Wholesale segment generated $910mm in operating revenues, a decline of 3.8% from second quarter 2012
- Strategic revenues for Wholesale were $572mm, nearly flat from second quarter 2012, as declining low-speed transport services revenue offset growth in Ethernet services and data bandwidth capacity expansion by the wireless carriers
- Legacy revenues declined by 9% to $338mm, reflecting the continued decline in access and long distance minutes of use and the implementation of lower access rates under the CAF Order rate step down
- Our operating expenses for the quarter in this segment were $301mm, 3.8% below the same period a year ago, driven primarily by lower facility cost

Data Hosting Segment

- Now moving to slide 17 and our Data Hosting segment, which includes all colocation, managed hosting, cloud services and hosting-related network services revenue
- This segment generated $347mm in operating revenues, representing an increase o f 7 .4% from second quarter 2012 revenues up $323mm

  - This growth came primarily from y-over-y increases of 2.1% in colocation revenues and 20.7% in managed hosting and cloud services revenues
- Second quarter 2013 revenues include approximately $15mm of revenue contribution from the Ciber IT Outsourcing assets acquired in October 2012
- Excluding this revenue, managed hosting revenue grew 7.4% y-over-y
- Data Hosting revenues also grew 4% sequentially from first quarter this year, driven by strength in the managed hosting products
- Data Hosting operating expenses were $273mm in second quarter compared to $239mm in second quarter 2012
  - This increase of 14% is driven by added data center expansion, operations and sales and marketing head count to support revenue growth, including head count for savvisdirect and enabling sales channels along with expenses related to the acquisition of the Ciber ITO assets not present in the prior year period

FY GUIDANCE

Operating Revenue and Adjusted Diluted EPS

- Turning to slide 18, we provide our third quarter and full-year 2013 guidance
- For Q3 2013, we expect total operating revenues of $4.5B to $4.55B and core revenues of $4.09B to $4.14B, and operating cash flow between $1.79B and $1.83B.
- Adjusted diluted EPS is expected to be in the range from $0.59 to $0.64
- Our anticipated sequential decline in third quarter operating cash flow and adjusted diluted EPS, compared to second quarter results, is primarily due to higher seasonal expenses we typically incur in Q3 each year, associated with our outside plants' maintenance and utility costs and increased cost related to our continued investment in key initiatives

YTD Results

- For the full year 2013, the company has updated its guidance to reflect YTD results as well as updated expectations for the remainder of the year
- Full year operating revenues guidance has been lowered slightly to $18.05B to $18.2B
- Although our H1 results were in line with our previous expectations and our H2 forecast reflects improved growth rates for total revenues, we anticipated that these levels of growth will be slightly lower than the more aggressive amounts we originally anticipated
- Some of the primary drivers of this reduced level of growth in H2 are slower acceleration in Data Hosting revenue growth rates, a faster rate of decline in our low-bandwidth services, and lower than originally anticipated federal universal service contribution rates, which really is a flow-through item
  - This level of revenue growth in H2 2013, although still reflecting a positive trend in growth rates is lower than our original projections, and we believe will likely result in a slight decline in 2014 total revenues compared to 2013

CapEx and FCF

- Additionally, we have tightened the ranges for operating cash flow and adjusted diluted EPS
- Even with the revision to our revenue guidance, these new projections for operating cash flow and adjusted diluted EPS are better than our original 2013 projections, due to our control of cash expenses during the year and the impact of our share repurchases

- We also expect CapExs to range from $2.9B to $3B, due to increased investment in broadband capacity, higher than expected success-based business sales, and an increase in new subdivision greenfield fiber builds
    - This increased capital investment also influenced the revision in our FCF guidance for the year

QUESTION AND ANSWER SECTION

David W. Barden
Analyst, Bank of America Merrill Lynch

Q

So, Stewart, 90 days ago you guys came out and raised the expectations for the business and then now we're taking them back down actually pretty much to where they started on EBITDA, but a little bit more on revenues. And we had this line in the sand for trying to get to flattish revenues for a long time in 2014, so something over the last 90 days seems to have really dramatically changed to kind of back away from these kind of long-standing targets, and I guess, obviously everyone is going to run around with their hair on fire until we find out what it is. Could you kind of elaborate on what's going on, that'd be great?

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

A

Yeah, so David, I think the primary things affecting the latter half of the year, number one the FUSC rate is down so that contributes somewhat to the decline in revenue.

David W. Barden
Analyst, Bank of America Merrill Lynch

Q

Can you quantify that, Stewart? How much of that change is related to that?

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

A

That's probably about $20mm or so. The other – let me get it, David, just a second. I think it's $25mm to $30mm, David. And then I guess the other thing that's affecting the last half of the year really is the savvisdirect product that we rolled out. The sales channel through the Internet has not materialized as quickly as we had hoped. We've done a good job, we think, with Savvis in terms of cross-selling. The Savvis products into – and gaining momentum there in Q2 and expect to gain some more momentum in Q3, but savvisdirect probably about $20mm below what we had hoped H2 to be. And then our lower-speed products, lower-bandwidth products, probably about $30mm or so there, primarily again related to a little bit faster conversion by our fiber-to-the-tower, where we're disconnecting the copper circuits and seeing some of the compression a little bit quicker than we had anticipated. So those are really the three primary items that are affecting the latter half of the year.

David W. Barden
Analyst, Bank of America Merrill Lynch

Q

And I guess, Stewart, as a follow-up to that. I mean as we kind of lower the EBITDA expectation and raise the CapEx expectation. I mean it's kind of the scenario that you don't want to see for a dividend-paying company if it kind of continues along these trends. So, as you look into the back half of the year, what are the upside surprises, what are the – as you look into your next 90 days, what are the downside surprises that could potentially emerge here?

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

A

David, frankly, I mean I think we've got everything built in. Again, we lowered EBITDA, but we lowered it basically back to where we started the first of year, an in effect, you know we've got cost in the latter half of the year associated with some of the growth initiatives and we think that I mean they are in fact starting to drive revenue. We're starting to see some of that benefit and we just don't want to back down from the standpoint of reducing the expenses associated with that. On the CapEx side, I mean most of the incremental CapEx where we raised – effectively raised the guidance maybe $50mm or so thereby closing the gap from $2.8B to $3B to $2.9B to $3B is more associated with success that we're having on the customer side in the business segment as well as new home developments or new subdivision developments, which hopefully again over the long-term will translate into revenue opportunities for customers in those areas because we're putting fiber in most of those subdivisions to enable more high bandwidth services to those areas. The third area was basically just capacity growth within the network just for normal growth and – due to really our customers using video streaming I think more as they are across the rest of the industry as well. So again, not a significant increase there and two out of three of those really should result in increased revenue over time and the third increase in bandwidth should help us with being able to add new high-speed Internet customers and maintain the customers that we have.

David W. Barden
Analyst, Bank of America Merrill Lynch

Q

Alright, thanks, Stewart. And if I could just – I promise this is my last one, is just given that you're chewing through the buyback so quickly, are you willing to keep your kind of foot on the gas on that buyback, or given that you're kind of moving into the second billion dollars already are you going to slow it down?

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

A

David, I think that depends on where the stock price goes. I mean, we've essentially been using all of our FCF to repurchase shares. In fact, that's where the incremental FCF has gone in the first six months of the year, and I think it just really depends, we'll be opportunistic in the latter half of the year and next year and we'll – really again just depends on the stock price.

Brett J. Feldman
Analyst, Deutsche Bank Securities, Inc.

Q

I was hoping we could dig into the broadband sub losses a little bit and just a couple questions there. So first of all on the seasonality, could you just remind us, is the seasonal slowdown typically a function of gross adds or churn and to what extent were those sort of similar or different than what you've usually seen? I'm also interested in the impact of the indirect channel; maybe just explain a little more what happened there. And then the last question is, of the customers that you're losing, are you seeing any consistency, for example, they tend to be lower speed customers as opposed to higher speed customers?

Karen A. Puckett
Chief Operating Officer & Executive Vice President, CenturyLink, Inc.

A

Hi, this is Karen Puckett. In terms of seasonality, I mean, seasonality as we've grown in with the Qwest acquisition, we have more snowbird-type states and so we did have a lot of success with snowbirds in terms of getting them in. Typically, that's people going back to the Northeast or to the Midwest as well as college students. So that's typical in terms – and we pretty much told in the last call that upcoming was seasonality. On the indirect side we have a particular partner that basically had some under performance relative to trend rates and that caught us. In terms of the churn to lower – what I would say is the footprint if we look at our fiber-to-the-node footprint, I mean we certainly have better churn and close rates than we do on our ATM footprint. So that is a fact, but we now have 7.4mm households on our fiber-to-the-node product.

Brett J. Feldman
Analyst, Deutsche Bank Securities, Inc.

Q

And so as you think about the back half of the year, you obviously get a seasonal boost in Q3. Is that the principal reason why you're optimistic you'll return to growth or is there any other things going on that should help that through the balance of the year?

Karen A. Puckett
Chief Operating Officer & Executive Vice President, CenturyLink, Inc.

A

Well, we're pretty good on execution in high speed anyway but we have a good track record. So I'm confident that we will be back positive. Obviously, the back half of the year is – we don't have the seasonal situation and we have – always have our plans in place and know pretty much every day where the levers are. So we're confident on the back half of the year.

Phil A. Cusick
Analyst, JPMorgan Securities LLC

Q

I guess two things on the revenue side, first on Prism. Can you give us an update there? You talked about higher investment in H2. Is that a little bit more Prism efforts? And then second on the revenue in 2014. Should we still – is it still fair to expect that at some point in 2014 revenue grows sequentially quarter-to-quarter, or should we be still [ph] assuming we're (32:44) watching it track down through 2014? Thanks.

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

A

Yeah, so your last question I guess in terms of revenue. I guess we're not ready to put a stake in the ground in terms of quarter-to-quarter 2014. But we think we'll be able to give more guidance there certainly, if not at the end of Q3, at the end of Q4 as we normally do. But again, we're just – we're tweaking our revenue guidance a little bit. I mean it's not significant in terms of the real aggregate dollars, you know, dollar change. In terms of higher invest – Prism TV, there's really not any additional CapEx on Prism TV in H2 for the most part. There may be a little bit of increased expenses because we continue to roll out more areas in the Phoenix market and also the Omaha markets and Colorado Springs. So there may be slightly increased expenses associated with Prism in the back half of the year compared with H1.

Phil A. Cusick
Analyst, JPMorgan Securities LLC

Q

Okay. And then as we – despite a little bit of a revenue downtick, we are getting closer to revenue being flat at this point. Is there a significant change in your mindset when you reach that flat revenue? Does that open up things up strategically for you a little bit more? Whether that's acquiring other companies or being a little more aggressive in terms of investing in the business?

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Hello, Phil. I'm not sure that it opens things up necessarily. We're focused right now on our key growth areas, growth objectives, growth strategies as we have been. We believe that there is significant growth there. We don't think we have to acquire in order to drive growth. And with our stock price being suppressed, we believe undervalued right now, obviously that makes a large transaction difficult today. That being said, we will continue to consider inorganic opportunities, but we'll maintain our very disciplined approach in making those decisions. So it's – we'll just see what the opportunities are and then obviously I think if you turn the revenue dynamics around and see revenue flat and eventual growth and certainly the stock price should follow that, but that is obviously a major factor here, in large acquisition decisions.

Simon Flannery
Analyst, Morgan Stanley & Co. LLC

Q

I wonder if we could just talk a little bit more about savvisdirect. Could you just do a little bit of diagnostic on what was the sort of reasons behind the shortfall? Was it sort of a timing of the product? Was it sort of pricing or what are the kind of the feedback you're getting in terms of why that didn't ramp, and is that something that is just delayed a couple of quarters, we should see that benefit in 2014? And then on the union deal, I understand it's not ratified, but is there anything in your 2013 guidance for any benefits from that, or is that all likely to flow through in 2014? Thanks.

Jeffrey H. Von Deylen
President-Savvis, CenturyLink, Inc.

A

Hi, Simon, this is Jeff. I'll take the one on savvisdirect and then pass it to Glen or Stewart on the union question. On savvisdirect, clearly that product is set to – we really rolled that out to deliver an online and web channel platform, which we didn't have in the legacy Savvis cloud platform; it was more of an enterprise play. And so, I think that market is difficult in terms of adoption rate and we are behind some of the – what was pretty aggressive ramp up in growth in H2. So I think it's the right platform, the right capabilities, I just think the uptake and penetration is slower than our original plan. We also think that AppFog, frankly, that acquisition is really strategic to our cloud platform, especially as we think about the enterprise, which is where our hosting services play best, so we're really looking at AppFog with developers together with our entire suite of Savvis cloud products to really give us an opportunity to talk to enterprises and the developers in enterprises where we weren't able to talk to before to accelerate more of that cloud play. So, we're short on the online and web, but frankly think that the play with the developer and strengthening our enterprise portfolio is the right move for us.

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Regarding the union agreement, we have not factored in any benefit or cost to the – in our forecast for the rest of the year, Simon.

Batya Levi
Analyst, UBS Securities LLC

Q

Just one more follow-up on the guidance question, the low end of the new revenue guidance is outside of the prior range. So does this change mean that you expect to come in at the low end of the guidance in terms of revenues, or how could that sort of change throughout H2? And second question on the cost side, you mentioned that you still have more cost-cutting initiatives. Can you provide more color on where they could come from and how do you think about margins going forward? Thank you.

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

A

So Batya, the low end of the guidance being outside of the prior range does not mean that we're basically are targeting the low end of the range. One of the reasons we lowered the top end is because of the [ph] USF (38:39) rate, which again is probably $30mm or so of a shortfall in H2. So, it shouldn't be an indication that we expect to come in at the low end of the range. In terms of other cost saving opportunities, I guess we've been saying the last few quarters that we think our margins will continue to come down slightly. We've been able to – through managing the costs, been able to keep them fairly flat, but I would think that we would still say that just with the margin compression that you see with losing the higher margin revenue and substituting for that the lower margin revenue from some of the services that we're growing, basically you would see some margin compression over time.

Timothy K. Horan
Analyst, Oppenheimer Securities

Q

Obviously, you have the balancing act here between stock buybacks and CapEx, and I know you are spending at the much higher range than your peers, but do you think if you spent a bit more on CapEx to get more of the fiber-out-to-node a little faster that could help the growth rate, and it seems like it would be pretty high return on invested capital, just kind of curious on your thought process of balancing that out. Thanks.

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Yeah, Tim, this is Glen. We debate that on a continual basis; it's a balancing act of how much we spend on CapEx, but yes, there's no question you can [ph] top (40:15) more growth by building more fiber, fiber deeper. The question is what your returns are overall and what's the best use of capital? Capital allocation is one of the most difficult decisions I think our entire industry faces, and one of the potential items we need to look at is fiber-to-the-node or fiber deeper in the network and then fiber-to-the-prem, fiber-to-the-businesses, MTUs. Those are all part of the decision-making process, and what we look at is trying to invest in the areas that can drive the most growth and also have the better – you know solid margins. And that's what we're looking at so just whether – that's a continual decision process for us really.

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

Q

Quick question looking at the Savvis business, it looks like the colocation growth is about 2% y-over-y. Can you talk to us about what's going on there? It just seems like maybe you're not getting as much traction as maybe you had expected. Is there anything structurally there going on or anything from a market perspective, a demand perspective that you're seeing? What's sort of driving that growth rate there?

Jeffrey H. Von Deylen
President-Savvis, CenturyLink, Inc.

A

Yeah, Hi, Frank, Jeff again. On colo I think one of the things we continue to manage through is some large – we talked about this I think in the last call, some large customer churn events. We've got customers like eBay, Yahoo! who are building their own data centers. They are existing customers. They are ultimately going to exit our data centers, so it's about managing them out and then our fill rate back in. So we still feel good about that business and that market. I think we have a tremendous opportunity to add more what I'll call retail customers into that and especially the – as Glen talked about, the teaming success of the CenturyLink customers. So you'll see us continue to expand our footprint in colocation. It'll likely be in markets that are legacy network sites like Minnesota, like Arizona, like North Carolina. So I think we feel good about the market. I think our customer mix is changing. We think that's a higher value and a better margin customer, but we've got to manage through some larger-end customers who have built their own facilities.

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

I might just add to that. Frank, if you look at our cloud services growth is close to 25% and our managed services is the high teens. So, it's really the – some of the local network side that was slower and the colo side that was slower growth for us, and we have not invested as heavily from a CapEx standpoint in the data centers as some other companies have, so we don't expect to have the 15% growth from co-lo side because we don't believe the returns are as good there on a long-term as some of the other opportunities we have.

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

Q

Okay, great. And then looking at the Connect America Fund money you've been offered. Any thought on how much of that looks attractive to you? How much you think you might be taking or when you might be able to give us an update on that?

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Could you repeat that question, please, Frank.

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

Q

Looking at some of the new Connect America Fund money that's been offered, the second release of CAF 1, any thoughts on how much of what is sort of been allocated do you think that you all will choose or any update on when you will be able give us an update on when you might determine how much of that is available to you that you'd be willing to take?

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Yeah, Frank, we expect to have significant amount available in the CAF 2 probably in excess of $400mm. We're not sure yet. That's just kind of an estimate there. It depends on what the terms are. We're hearing pretty positive feedback from the FCC that they really want to encourage investment in low-density rural areas. So, we're hopeful that that could be a catalyst for us as far as expanding our investment in areas that are underserved or unserved really today and we also – on the CAF – latest CAF1, we were allocated $90mm. We're not sure how much of that we'll spend, but we're looking at that as we speak and we'll spend quite a bit of that in the next year or so.

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

Q

I was wondering if you guys could talk a little bit more longer term about ideally how big do you want to see Prism within your footprint in terms of homes passed, and is there a way of thinking about, if you want to get to that point, what the investment implications of that would be?

Glen F. Post, III
President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

A

Yeah, Mike, we try to look at that, and it's really success-based from our standpoint. We've said before, we want to see how Phoenix and Colorado Springs do in these larger markets and because we have Omaha with the gig service now. And we'll make decisions after that. We think around 30% or more of our access lines are suitable for our Prism service. So, we will – that's what's on our radar right now. And we continue to look at compression technologies and other ways to make that footprint even larger, but if we continue to see success in Phoenix and Colorado Springs, then we'll have more reason to go after other markets more quickly.

Glen F. Post, III

President, Chief Executive Officer and Independent Director, CenturyLink, Inc.

CLOSING REMARKS

- Please turn to slide 24 as we close today's call
- Overall, we are pleased with our results for Q2
  - We believe our continued investment in key strategic opportunities continued to help us drive revenue growth and strong financial results and will over time
- Our strategic product and services development continues to strength CenturyLink's competitive position, and our guidance reflects our expectation that our revenues from these strategic services will continue to grow
- The expansion of our Prism TV service and the recent launch of managed hosting and cloud services for small and mid-sized businesses will further strengthen the product portfolio and should provide us additional revenue growth opportunities in 2013 and beyond
  - And lastly, we are pleased with the progress we've made in the share repurchase program since inception in mid-February, and we will continue that program in the months ahead