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CenturyLink, Inc. (CTL)

Q2 2015 Earnings Call

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CORPORATE PARTICIPANTS

Tony Davis
Vice President Investor Relations, CenturyLink, Inc.

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

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

William E. Cheek
President-Wholesale Markets Group

OTHER PARTICIPANTS

David William Barden
Bank of America Merrill Lynch

Simon Flannery
Morgan Stanley & Co. LLC

Philip A. Cusick
JPMorgan Securities LLC

Frank G. Louthan
Raymond James & Associates, Inc.

Michael L. McCormack
Jefferies LLC

Batya Levi
UBS Securities LLC

Tim K. Horan
Oppenheimer & Co., Inc. (Broker)

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to CenturyLink's Second Quarter 2015 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

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

Tony Davis
Vice President Investor Relations, CenturyLink, Inc.

Thank you, Saeed. And good afternoon, everyone, and welcome to our call today to discuss CenturyLink's second quarter 2015 results released earlier this afternoon. The slide presentation we will be reviewing during the prepared remarks portion of today's call is available in the Investor Relations' section of our corporate website at ir.centurylink.com. At the conclusion of our prepared remarks today, we will open the call for Q&A.

As you move to slide two, you'll find our Safe Harbor language. We'll be making certain forward-looking statements today, particularly as they pertain to guidance for full year and third quarter 2015 as well as other outlooks in our business. We ask that you review our disclosure found on this slide as well as in our press release and in our SEC filings, which describe factors that could cause our actual results to differ materially from those projected by us in our forward-looking statements.

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We ask that you also note that our earnings release issued earlier this afternoon and the slide presentation and remarks made during this call contain certain non-GAAP financial measures. Reconciliation between the non-GAAP financial measures and the GAAP financial measures are available in our earnings release and on our website at ir.centurylink.com.

Now as you move to slide three, your host for today's call is Glen Post, Chief Executive Officer and President of CenturyLink. Joining Glen will be Stewart Ewing, CenturyLink's Chief Financial Officer. And also available during the question-and-answer period of today's call will be Ross Garrity, CenturyLink's Interim President of Global Markets.

Our call today will be available for telephone replay through August 13, 2015, and a webcast replay of our call will be available through August 27, 2015. Anyone listening to a taped or webcast replay or reading a written transcript of this call should note that all information presented is current only as of August 5, 2015, and should be considered valid only as of this date regardless of the date heard or viewed.

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

Glen F. Post, III

President, Chief Executive Officer & Director

Thank you, Tony. And thank you for joining our call today as we discuss our second quarter 2015 results of operations, provide guidance and outlook for the second half 2015. Before we get into the details of the quarter, I want to highlight a few items that I think are important to keep in mind as we go through our results. First, on the revenue side, our second quarter results were negatively affected by renegotiation of a long-term wholesale agreement that reduced strategic revenue by about $13 million for the quarter and is driving an approximately $40 million reduction on our revenue outlook for full year 2015. This renegotiated agreement locks us into those agreements at market rates for several years, giving us greater ability to grow that business and provide reciprocal access to our wholesale partners network at more attractive rates.

Now we're revising our full year revenue midpoint to $17.8 billion, reflecting the impact of this wholesale issue and the full-year effect of softer-than-expected first half results. Our revised guidance is approximately $45 million below the current consensus Street estimate of $17.85 billion. $40 million of that is associated with the wholesale issue I was just talking about.

However, the bigger issue in the second quarter was really expense. We had a number of non-core items that drove our expenses higher in the quarter, including $20 million in group insurance and pension true-up adjustments and $20 million due to higher-than-expected CPE sales. The balance of our overage is primarily due to not hitting the operating budgets we established for business units for the quarter principally due to higher-than-anticipated employee-related cost. We do not believe this miss reflects anything fundamental in the cost structure of our business. Basically we just didn't get the job done here. We have made a number of key changes and, as we will discuss later, we have put plans in place to address this issue in the second half of the year.

Beyond 2015, we believe we have further opportunity to continue to align the costs in our business to our revenue performance and we will discuss some of this with you later in the call. I wanted to share this with you at the outset of the call as I want to be clear that although our second quarter results did not meet our expectations, I am as confident as I have ever been that we have the assets, the products, the services and the opportunities required to grow our business.

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

Now let me give you a few examples of what we're doing. As of June 30, we have made fiber-based GPON available to approximately 475,000 business locations and we expect to add GPON service to another 25,000 businesses by year end. While there is good demand for this product and given our relatively low penetration, we believe we have strong upside with those investments. We also continue to enhance our core network offerings, including next-generation MPLS, [ph] Ethernet (6:09) and SIP trunking services, as well as plans to enable software-defined networking and network function virtualization capabilities into 43 data centers by the end of this year.

During the first half of the year, we expanded our global data center footprint through expansions in six markets, adding – we added 10.8 megawatts of critical capacity and that brings CenturyLink's global data center capacity to more than 185 total megawatts across our 59 data centers. We still have upside in our existing data center investment as we had over 35% of sellable floor space available as of June 30.

Our revenues from our CenturyLink cloud platform is growing rapidly, more than doubling in the last 12 months, actually 138% growth in the second quarter of last year. Our primary focus in the cloud and hosting space is to strengthen our private and dedicated hosting capabilities. These private platforms require much of the automation and management tools you see in major public cloud platforms, but our focus is on leveraging the CenturyLink cloud platform to enhance our enterprise customers' abilities to turn up and manage both network and hosted workloads in private, dedicated environments, including the enablement of bare-metal services later this year.

However, overall, we have not met our expectations in our managed hosting business. I believe our sales force reorganization contributed to this issue. But I believe the principal driver is that in the latter part of 2014 and early 2015, we defocused our delivery of services on our existing managed platform to focus instead on putting workloads on the CenturyLink cloud platform. The CenturyLink cloud platform is a powerful and dynamic platform but does not yet support all of the functionality our managed hosting customers require. The defocus away from legacy platform was a misstep that has affected our hosting results and we believe we can improve these results by refocusing on delivering services and increasing capabilities on our legacy platform, while we continue to enhance the depth of CenturyLink cloud capabilities.

Finally, we are also seeing good interest in our IT services and data analytics service offerings. Our focus in this area is to provide targeted services to business customers who are underserved by the traditional larger system integrators. Although growing rapidly, this business is small in scale today, but the service offerings give us a good low capital-intensive opportunity to engage at the C level and generate leads in the other parts of our business. Now this capability to provide differentiated end-to-end solutions, including IT consulting, has led to a number of recent wins for CenturyLink to provide a large portion or in some cases all communications, data and IT services for those customers.

Overall, in our Business segment, we have to improve our execution, but we are seeing strength in our sales momentum. For example, second quarter 2015 sales to our enterprise customers were up 10% from first quarter 2015 and up 16% from second quarter 2014 while our commercial sales increased 27% from second quarter of 2014.

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Continuing on now to slide seven, and turning to the Consumer segment, we continue to see good results from those markets we have deployed high broadband speeds and Prism TV services. Specifically in our GPON markets, the take rates continue to be strong and are exceeding our expectations. And because GPON is such a great driver of demand and penetration, we continue to expand our gigabit footprint ending the quarter with more than 600,000 households and 16 markets having access to gigabit speeds. We expect to have gigabit service available to approximately 700,000 households by year-end 2015 with plans of further expansion thereafter.

We're also trialing technologies that enable up to 200 megabit over legacy copper networks. This is in the early stages, but it is showing good promise. We also expanded our Prism TV service in the second quarter, turning up service in Portland, Salt Lake and Minneapolis. We added a total of 175,000 addressable homes in the second quarter, ending the quarter with over 2.6 million Prism TV addressable households. We anticipate expanding Prism TV service to approximately 250,000 additional households during the remainder of 2015 and to reach more than 2.8 million total Prism TV addressable homes by year end.

In addition, we're developing an over-the-top offering that will provide a robust competitive video offering for customers both within and outside our Prism TV market footprint. And finally, we're tightening our credit policies for our Internet-only customers to reduce sales to customers who tend to change Internet providers frequently leaving unpaid balances when they exit.

Now while we expect this change to negatively impact consumer broadband net subscriber additions through the remainder of 2015, we anticipate this adjustment will actually help improve our broadband growth in 2016 due to lower churn. Now this move is unrelated to and will no impact on our marketing initiative for lower income consumers under CenturyLink's Internet Basics program. We remain totally committed to offering affordable broadband access to lower-income households across our broadband service areas.

Now I want to discuss our thoughts around expense control. As I noted above, the principal issue for us this quarter was that our expenses were about $80 million more than we anticipated. About half of that amount is attributable to not managing costs for established budgets. We can and we will do better on this front. For starters, we're implementing plans to reduce planned operating expenses by approximately $125 million in the second half of 2015, including lowering contract labor and professional services cost, a reduction in the number of employees and other expense reductions. Now this is not simply a target. We already have plans in place to address most of that number.

Also independent of any issue around second quarter expense, earlier this year we established a dedicated team whose sole purpose is to identify and drive ongoing efficiencies into our business. This team is reviewing every major process and every significant system to validate its business purpose and whether there is a faster, better way to achieve that objective.

An early example of their work is a recent success in improving certain service intervals by more than 40% by streamlining processes. This will lead to a better customer experience, the need for fewer employees to perform that work, and better margins on that business. We believe there are other opportunities similar to this as well as the opportunity to improve efficiencies by driving additional automation and simplification into our business.

Continuing on to slide eight now. Lastly I'd like to take a minute to discuss our philosophy around our dividend. Given that our path to revenue and EBITDA growth is taking longer than we originally anticipated and that our cash taxes are expected to increase significantly in 2016, we understand that markets focus on the sustainability of our dividend. So I want to be clear here. While no company can credibly say they will never cut their dividend, we see the dividend as a fundamental part of our overall value proposition to shareholders.

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We believe the most financially prudent way to manage our business is to balance our investment velocity with our EBITDA performance so that we can sustain a reasonable return of cash to shareholders while positioning the company for long-term growth. We believe we have a number of opportunities to manage our business in a way that supports the dividends as we work to capitalize on our growth prospects. First, we have made significant investments in our network and data center infrastructure over the last several years and believe we have the flexibility to lower our planned capital budget by about $200 million to approximately $2.8 billion for full year 2015 without significantly affecting our path to growth.

Also, as I noted above, we have instituted plans to reduce our expense outlook by $125 million in 2015. And we have ongoing opportunities to increase efficiencies through automation, simplification and increased focus.

However, we believe the most important thing we can do to sustain the dividend over the long term is to continue our path to revenue and EBITDA stability and growth. As I discussed above, we believe we have very good opportunities to grow our business through driving greater penetration of products and services we enabled over the last several years as well as implementing new services and capabilities we're in the process of rolling out.

So the point I would like to leave you with is, despite the wholesale issues in 2015 and lower-than-expected growth in certain of our strategic products, we believe we have the ability to grow our business and to balance our pursuit of growth with our ability to sustain our dividend. And our view is that managing our business to do this is a fundamental element of our value proposition to shareholders.

With that, I'd like to turn the call over to Stewart.

R. Stewart Ewing

Chief Financial Officer & Executive Vice President & Assistant Secretary

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

Beginning on slide 10, I'll review some highlights from our second quarter results. I'll be reviewing these results excluding special items as outlined in the earnings release and associated financial schedules. Operating revenues were $4.42 billion on a consolidated basis, a 2.7% decline from second quarter 2014 operating revenues. Core revenue, defined as strategic revenue plus legacy revenue, was $4.02 billion for the second quarter, a decline of 2% from the year-ago period. Strategic revenues grew 1.9% year-over-year and represent 53% of total revenues compared to 50% a year ago. Strength in strategic products such as high-speed Internet, high-bandwidth data and Prism TV continue to drive this growth as we added approximately 8,400 Prism TV customers during the second quarter.

Based on our revised go to-market strategy for consumer broadband that Glen discussed earlier, we'd expect HSI net adds to be negative for the second half of the year. We generated operating cash flow of approximately $1.62 billion for the second quarter and achieved an operating cash flow margin of 36.8%. Year-over-year cash expenses were up primarily due to higher employee benefits, Prism TV and other costs which were partially offset by lower Customer Premise Equipment costs related to lower data integration revenues.

Free cash flow was $562 million for the quarter. As a reminder, free cash flow is defined as operating cash flow less cash paid for taxes, interest, capital expenditures along with other income. Our solid cash flows continue to provide us with the financial strength and flexibility to meet our business objectives and drive long-term shareholder value. Adjusted diluted earnings per share for the second quarter was $0.55. As we've discussed on

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prior earnings calls, adjusted diluted EPS excludes special items and certain noncash purchase accounting adjustments as outlined in our press release and associated supplemental financial schedules.

Additionally, under the $1 billion share repurchase program, we repurchased 2.5 million shares for an investment of $90 million during the second quarter. Under the current program started in second quarter 2014, we have repurchased over 12 million shares for approximately $460 million. Our level of share repurchases during the second quarter was lower than prior quarters due to strategic opportunities that prevented us from being in the market for several weeks and our being in a closed window period since late in the quarter. Having moved past those strategic opportunities, we expect to continue to be opportunistic in completing this program within the 24-month period and we plan to set up a 10b5-1 program in the next few days to facilitate the purchase of shares through our third quarter earnings release date.

Moving to slide 11 and our Business segment. In second quarter, the Business segment generated $2.66 billion in operating revenues, which decreased $129 million or 4.6% from the same period a year ago. Second quarter strategic revenues for the segment declined 0.4% to $1.6 billion from second quarter 2014, driven by the declines in low bandwidth data services and wholesale repricing, partially offset by the continued strength in high bandwidth services such as MPLS, Ethernet and wavelength. We continue to generate solid growth across the enterprise customer market and we see an opportunity for further investment in the small and medium-size business space to improve market share and drive further growth.

Our legacy revenues for the segment declined 7.7% from second quarter 2014, due primarily to a continuing decline in access lines. Total Business segment expenses increased from the year-ago period, driven primarily by higher employee-related expenses. The segment margin of 42.6% declined from 45.6% a year ago. This decrease was primarily due to the continued decline in Business segment legacy and low bandwidth data services revenue along with the higher operating expenses described.

On slide 12, I'll provide a little more detail on the revenue mix within the Business segment. High-bandwidth data services revenue grew $65 million or 10% year-over-year compared to second quarter 2014 driven by continued strength in sales to enterprise and government customers. While the growth rate remains solid for high-bandwidth services, it is somewhat dampened by slightly slower growth due to wholesale, renegotiated pricing for Ethernet backhaul services with a large carrier customer.

Low bandwidth data services including private line continued to decline in the second quarter. The year-over-year revenue decline of $81 million or 14% was primarily due to wholesale customers' network grooming efforts and migration to fiber-based services that we've experienced over the past year.

We anticipate this level of year-over-year decline to improve over the coming quarters as we cycle through this period of higher disconnects. Hosting revenues declined $10 million or 3% from the prior year, driven primarily by unfavorable foreign currency impact of approximately $6 million, customer credits and lower non-recurring revenue compared to the year ago period. In the second quarter, data integration revenues decreased approximately $44 million or 24% compared to second quarter 2014 driven by lower CPE sales.

Now turning to slide 13, Consumer generated $1.5 billion in total operating revenues, which was flat with the second quarter a year ago. Strategic revenues in this segment grew 6.9% year-over-year to $758 million driven by growth in high-speed Internet and Prism TV customers and select price increases.

Legacy revenues for the Consumer segment declined 5.8% from second quarter 2014 as access line and long distance revenue declines were partially offset by select price increases. Operating expenses increased $16 million or 2.7% compared to the same period a year ago due to higher Prism TV cost.

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Now turning to Slide 14. For third quarter 2015, we expect operating revenues of $4.42 billion to $4.47 billion and core revenues of $4.02 billion to $4.07 billion, and operating cash flow between $1.62 billion to $1.67 billion. Adjusted diluted EPS is expected to range from $0.53 to $0.58. Our anticipated sequential increase in third quarter operating revenues, core revenues and operating cash flow compared to the second-quarter results is primarily driven by growth in strategic services and select price increases. As outlined in our press release, we've revised our full year 2015 guidance to reflect year-to-date results as well as updated expectations for the remainder of the year.

For full year 2015, we expect operating revenues of $17.7 billion to $17.9 billion and core revenues of $16.1 billion to $16.25 billion. Both have been lowered reflecting first half 2015 actual results along with continued pressure in wholesale private line, hosting and CPE revenues along with the wholesale repricing previously mentioned. Operating cash flow is projected to be $6.7 billion to $6.85 billion and capital expenditures are projected to be approximately $2.8 billion or $200 million lower than our previous guidance of approximately $3 billion.

As you know, on April 29, the FCC offered potential support payments to price cap carriers under Phase 2 of the Connect America Fund program and carriers have until August 27 of this year to notify the FCC of their intention to accept or forego the support in some or all of the eligible states. CenturyLink was offered up to $514 million in support across 35 states, and at this time, we expect to accept at least $300 million of the available support. We continue to evaluate the remaining support payments and expect to notify the FCC on or before the August 27 deadline.

We expect the FCC to begin distributions under the CAF 2 program in September or October of this year timeframe, and expect the initial receipts to include incremental support that trues up the full-year CAF 2 support we ultimately decide to accept to the full year frozen federal USF support that we received today.

We expect minimal capital investments in 2015 related to CAF 2 due to the timing of the program, but we do expect a full year of CAF 2-related capital expenditures for 2016. We currently expect full year 2016 capital expenditures to be approximately $3 billion inclusive of CAF 2 requirements because of the significant investments we have made over the last several years that support our business plans for growth and position us to reallocate capital to CAF 2.

While any receipts from CAF 2 are not included in updated guidance I discussed earlier, we do provide estimated ranges of the potential impact on third quarter and full year 2015 guidance from the CAF Phase 2 support we ultimately accept and receive. We expect to recognize the full amount of CAF 2 support payments as other revenue in the year received.

While we understand the recent area of focus for investors has been whether CenturyLink might implement some type of REIT restructure, we've elected not to pursue that structure at this time for several reasons. These reasons include the complexity and disruption of the transaction structure, the variety of opinions from investors, and a lack of confidence at implementing such a structure would create real long-term shareholder value.

Let me talk a little bit about cash taxes. In terms of cash taxes, we expect 2015 cash taxes to be $25 million to $125 million after considering approximately $150 million to $250 million of 2015 taxes that we expect to pay in March of next year. For 2016, we expect cash taxes to increase to the $1.1 billion to $1.3 billion range, including the deferral of the 2015 cash taxes into 2016 that I just mentioned.

Recently, the Senate Finance Committee passed a bill out of committee that would extend the provisions that expired at the end of 2014, including bonus depreciation retroactively for 2015 and through 2016. This two-year

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bill was meant to push the issue beyond next year's elections. The Finance Committee bill has not yet been considered by the full Senate. The full House has currently extended some selective extenders similar to what they did last year. Bonus depreciation has traditionally been one of these favored selective provisions. Congress went into their August recess last week and the House and the Senate this week, so we don't expect any action on extenders at least until the fall.

In the fall, we currently expect there to be negotiations on all the extenders, but given the support for bonus depreciation, we believe there's a very good chance that it gets extended for at least two years through 2016. Should bonus depreciation get implemented only for 2015, we would expect our 2015 cash taxes to be approximately $25 million to $125 million and 2016 cash taxes between $550 million and $650 million after considering approximately $225 million to $300 million of 2016 taxes that we would expect to pay in March of 2017.

If bonus depreciation is extended through 2016, we expect our cash taxes would decrease by an additional $50 million to $150 million for 2016. So bonus depreciation can have a tremendous effect on our free cash flow.

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

QUESTION AND ANSWER SECTION

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

David William Barden
Bank of America Merrill Lynch

Q

Hey, guys. Thanks for taking the questions. I guess, we kind of gathered from the Analyst Day, it was going be a tough quarter. So thanks, Glen, for kind of giving us that frank rundown.

I guess, Stewart, the way we're now set up with kind of in the middle of the third quarter, the revenue and EBITDA guidance you're giving us kind of in a worst case scenario says that we're going to see flat revenues and rising margins and at the midpoint of the guidance, it suggests we're going to see some pretty strong quarter-on-quarter acceleration in revenues and EBITDA growth heading into 2016. And I guess that that's going to be the big focus for kind of Glen's point about execution and such. So if we go to that page 12, which is really I think on the business services side and we look at that chart, can you kind of walk us through the pieces parts that are going to drive what you seem to think at this stage can still be strong revenue growth kind of heading into the back part of the year and into next? Thanks.

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

A

Yeah. So, David, part of what's going happen is, one, we have adjusted some of our wholesale pricing. We think that we'll start picking up some orders from one of the major carriers that we've not really been picking up over the last four months or so. Additionally, we had a one-time item in the second quarter of about $13 million that we think will improve over the next quarter or two.

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And if you look at our EBITDA from the standpoint of third quarter and fourth quarter, particularly in the fourth quarter, we expect to have implemented some of the steps that Glen mentioned. And our expenses actually from third quarter to fourth quarter come down about $100 million or so. So that provides the higher margins that you'll see on the back half of the year. Additionally, we expect the second half of the year to continue to have good growth from the standpoint of our high-speed Internet revenue as well as private line, too, which is on the wholesale side.

David William Barden
Bank of America Merrill Lynch

Q

So thanks, Stewart. And then, I guess, the second question is just on the CAF 2 piece. So, I guess, if we take out $100 million from the kind of, I guess, $75 million from the midpoint of the EBITDA guidance, we're reiterating the free cash flow guide. So it sounds like with the CAF funding, actually EBITDA and free cash flow estimates will probably end up going up. But there's still this large gap that it seems you need to analyze over the next few weeks. I guess, the key issue for people is going be, is the threshold for accepting this CAF money to make sure that it's accretive to the cash flow profile of the company rather than dilutive, and so that's the number that you're trying to figure out?

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

A

Yeah. That's what we're working through, David. And really trying to look at the effects on 2016 and 2017 of the CAF 2 monies and we really are studying very hard the cost associated with building the network. And we think if we're able to make some progress there, we can [indiscernible] (34:05) CAF 2 monies. Basically the minimum that we outlined in the release today really applies to about 24 states or so, or a couple of dozen states. And there are 11 other states that we're having to study a little bit harder in terms of where we are with respect to the network and how much the build-out would cost associated with those. So we could be slightly cash flow dilutive, but I mean that is what we're trying to solve for.

David William Barden
Bank of America Merrill Lynch

Q

Got it. Okay. Thanks.

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

Simon Flannery
Morgan Stanley & Co. LLC

Q

Thank you very much. You have targeted 2015 as the year of revenue stability. You're not talking about getting to revenue stability long term. Is this something where we think we can see revenue stability in 2016? Or is it going to take longer than that? And then on the dividend, I appreciate the comments around how you're thinking about that and the color on the tax payments. But when you cut your dividend a couple of years ago, you did target or talk about bringing your payout ratio below 60%. So how are you thinking about payout ratios, I guess, on a normalized cash taxes now? And if the dividend payout rises above that level, how do you square those factors? Thanks.

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

A

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Hey, Simon, it's Glen. I'll take the first question regarding revenue stability. First of all, as always, we'll provide guidance for 2016 during our fourth quarter earnings call. But based on the sales funnels we're seeing today, the growth we're seeing in our funnels, the expansion of our GPON and Prism footprint and capabilities, the expected improvement in our cloud and hosting and IT services products, I really believe we're going see revenue stability in 2016, what we're seeing right now.

Simon Flannery — Q
Morgan Stanley & Co. LLC

Okay. Thank you.

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

And, Simon, in terms of the dividend payout ratio, of course, if we do get bonus depreciation, the dividend payout ratio will be approximately 60% or so in 2016 from what we're seeing today. If we don't get bonus depreciation, really there it kind of depends on how much of the CAF 2 monies that we take and what we're able to do with our capital budget. But we probably, for that one year, 2016, would be in the 90% range or so, but that includes the tax payments of $150 million or so – $100 million, $150 million that we said we would be deferring to 2016 that really relate to 2015.

So we have a $100 million pension payment scheduled in there as well that's not actually required. So we feel like we have some levers that we can pull to and, of course, our dividend payout ratio this year is only about 45% or so. So we have plenty of room to pay the cash taxes early if we want to get that out of 2016. So, I mean, we really feel pretty comfortable that there are levers that we can pull to get our dividend payout ratio where it needs to be to where there's not a problem with it in 2016. And again assuming we get bonus depreciation even for one year, it brings the 2016 dividend payout ratio down to around 60% range.

Simon Flannery — Q
Morgan Stanley & Co. LLC

Great. Thank you.

Operator: Thank you. And our next question comes from Phil Cusick from JPMorgan. Your line is open. Please go ahead.

Philip A. Cusick — Q
JPMorgan Securities LLC

Thanks, guys. A couple of things. First on the CapEx reduction. Can you expand on what's changing this year? Or can you cut without really impacting the business at this point? And does the $3 billion guidance assume that that follows through in 2016 or are you sort of pushing things out? Thanks.

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

Yeah. Some of the projects that we're looking at that we've actually cut really relate to what we cut that falls in the revenue enablement bucket. Probably about a third of the cut is there. And these are projects that are really more network related, that give us extra capacity, and we can go a little bit longer for that and related to that. And so we don't – we may need to make some of those next year, but we think we can really pretty safely cut that. So about a third of the $200 million cut is network related. About a third is success based too, which really just reflects the – although we're making our sales for and bookings for the second quarter were 15% ahead of where they were in

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the first quarter, they're still really behind where we originally expected them to be when we set our capital budget for 2015. And then another third of the $200 million really comes from furniture, equipment, vehicles and things like that that we just think we can – not have to do. And some of that really relates to some of the other changes that we're making that Glen mentioned.

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

And, Phil, I just want to be clear on that. The $200 million we're cutting this year, we do not expect to have to add that to capital budget next year. We won't be doing that, so just to be clear on that.

Philip A. Cusick
JPMorgan Securities LLC
Q

All right. Thanks, guys.

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

And again, the $3 billion next year really includes CAF 2. And that's why it would go from, like $2.8 billion to $3 billion. I mean, frankly we're hopeful that next year we could get our capital budget down potentially in the $2.5 billion to $2.6 billion range exclusive of CAF 2.

Philip A. Cusick
JPMorgan Securities LLC
Q

Got it. Thank you.

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

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

Great. Thank you. So, on the buyback can you remind us what the current authorization is and any thought that the board might accelerate that given your confidence to revenue stability and given where the shares are? And then, can you be just a little bit more specific on the cost items? What exactly are you focused on and is any of this head count related? And how that's going to come out as quickly as you've outlined it?

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

Yes, so Frank so the board authorized in February 2014, $1 billion program. I think I mentioned we're about $540 million or so through that. And it expires in essentially May of 2016 and we would expect to complete the program – our current plans are to complete the program by the end. As I mentioned we expect to be back in the market next week and set up a 10b5-1 plan to start the process of repurchasing the remaining shares.

With respect to the cuts, about two-thirds or so of the amounts are really related to contract labor and professional services as well as some employee cost and employee benefits. So that's where about two-thirds of it is. The other third is actually down in – we think network expense as well as property taxes.

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Frank G. Louthan
Raymond James & Associates, Inc.

Q

Okay. Thank you.

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

Michael L. McCormack
Jefferies LLC

Q

Hey, guys. Thanks. Glen, can you just give a little more detail on, I think you mentioned credit policy changes. Just trying to get a sense for, if you're seeing a significant uptick in involuntary churn or is that inside the Prism footprint where you're getting people installed and then sort of abandoning equipment? And then, I guess secondly in giving some thought to your comments regarding over-the-top, Prism TV probably is not as profitable as offering obviously straight broadband although it might have churn reducing benefits and we're seeing AT&T de-emphasizing the U-verse platform. Does it make sense to sort of move away from Prism TV and focus more on developing the over-the-top product and then getting just higher speed data to the homes? Thanks.

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

A

Yeah, Mike. On the credit policy change, that's mostly around this broadband and HSI. We ought to be a little bit out on Prism but more to HSI. We're seeing a lot of churn there. No pay churn is hitting us really more than previously. So we are – that's really the – it's around high-speed data primarily. We're seeing that issue where we're trying to address it.

Michael L. McCormack
Jefferies LLC

Q

Okay.

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

A

And regarding the Prism TV and over-the-top, certainly the programming costs are high on Prism TV. However, if you look at the all-in opportunity there, we bring 52% of the new customers to CenturyLink, 57% are triple play customers and about 97% of those customers have a high-speed data connection. So overall, those are profitable customers for us and we're pleased to get them – we're working hard on the programming costs as our whole industry is, we think it's really an area that we have to change over time. But we think it is a good product for us and driving revenue and cash flows.

The over-the-top is certainly an opportunity. We have some new products coming out over-the-top that we think will be very profitable and we'll include those with our Prism product as well as in areas we don't have Prism and we think there's opportunity there. You're right. There are higher margins with that over-the-top product. So we're looking forward to offering that.

Michael L. McCormack
Jefferies LLC

Q

Glen, just as a quick follow-up, I know in the past you've talked about the sort of time lag or timeframe between revenue stability and EBITDA stability, has that changed in your mind at all?

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

A

No, I think we still think – the 18 month is still that we still think that we'll be looking at that 18 month timeframe give or take a few months, but that's still our target. That has not changed.

Michael L. McCormack
Jefferies LLC

Q

Great. Thanks, guys.

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

A

Mike, one other comment on the over-the-top, it's going to be available to many more households than our Prism TV is available to because you don't need the bandwidth to be able to use the over-the-top product that you need to use the Prism product.

Michael L. McCormack
Jefferies LLC

Q

That's certainly – the cost to connect I assume is going to be quite a bit lower based upon at least the comments from DISH and Sling TV?

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

A

Yes.

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

A

Yeah.

Michael L. McCormack
Jefferies LLC

Q

Great.

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

Batya Levi
UBS Securities LLC

Q

Great. Thanks. Question on the margins. It looks like the guidance for the full year is about 38%, but you're going to exit the year at a higher level given the expense cuts that you talked about. How should we think about margins going into 2016? Where do you think that can get to before we see the EBITDA stability some time in 2018? And second question on the wholesale private line, which you mentioned that it's still a drag on revenue growth, can you quantify what percent of the revenues come from that? And do you see any impact from maybe wireless backhaul that offsets some of that pressure going forward?

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

A

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So, Batya, on the margins, you're right, about 38%. And as we look out, I mean, if we can get to revenue stability in 2016, as Glen mentioned, and basically continue to control our expenses, we're hopeful that the margins next year wouldn't drop that much from where they are this year. And your second question was?

Batya Levi
UBS Securities LLC
Q

Wholesale private line mix.

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

Yeah. So basically we're seeing upgrades from the carriers in terms of wireless backhaul. It's been a little slower than we expected. And I'll tell you, Bill's here. Bill Cheek's here. I'm going to get him to answer the question for you, Batya.

William E. Cheek
President-Wholesale Markets Group
A

Yeah. Batya, Bill Cheek. Wholesale revenues is about – and if you think about wireless backhaul, I think was your question, is about 4% roughly of our total company revenues, so it's really relatively small percentage.

Batya Levi
UBS Securities LLC
Q

Okay. Great. And then maybe just another question on CAF. If you decide to take about $300 million from the new fund, how much of the existing $350 million of frozen support will still be available for you?

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

So with the states where we – if all we take is basically are the two dozen states or so that results in about $300 million, there would be about $100 million of frozen support that we would continue to receive. At this point, it just depends on how long it takes the FCC to write the rules for the auction process and put that in place and actually have the auctions. We believe the earliest that would be would be towards the end of 2016, but it could very well go over into 2017, and then we would also have the ability to be able to participate in those auctions as well. So about $100 million of frozen support that we will continue to receive in addition to the $300 million of CAF 2 funds.

Batya Levi
UBS Securities LLC
Q

Okay. Great. Thank you.

Operator: Thank you. Your final question for today comes from Tim Horan from Oppenheimer. Your line is open. Please go ahead.

Tim K. Horan
Oppenheimer & Co., Inc. (Broker)
Q

Thanks, guys. It seems like the revenue guidance is kind of calling for that this is the bottom quarterly and should increase the next two quarters. Just so I understand that or do you think it could kind of step down on a quarterly basis again next year. And then on just maybe you can walk through the puts and takes on the dividend payout

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ratio. I guess, if we get out to 2017 on more of a normalized cash tax rate or normalized tax rate and all the puts and changes that you are seeing in terms of the margins, what do you think the dividend payout ratio will be at that time and how confident are you in that dividend payout ratio?

R. Stewart Ewing

Chief Financial Officer & Executive Vice President & Assistant Secretary

A

2017, the cash taxes would go up somewhat if bonus depreciation is enacted for 2015 and 2016 and not 2017, then basically cash taxes would go up then, but we still believe that we would be okay and we would be hopeful at that point if we stabilize revenue, we would be stabilizing EBITDA as well. So hopefully that wouldn't be an issue. And you are correct in terms of revenue increasing, basically we expect our strategic revenue to grow somewhat in the third quarter and the fourth quarter and in effect offset the declines that we might see from the legacy services.

Tim K. Horan

Oppenheimer & Co., Inc. (Broker)

Q

Great. And last, should we think of CAF as more of a one time or temporary or do you think it could be kind of more – should we think of it as more ongoing and might be offset when the six year is up that it might continue longer term. Thanks.

R. Stewart Ewing

Chief Financial Officer & Executive Vice President & Assistant Secretary

A

Well, we really – we do believe there will be another program after this program is complete. We are not really sure what the program – we don't know what the program will be, of course, but we think that there may be some opportunity to continue to get some funding to help serve and provide broadband service to rural America.

Tim K. Horan

Oppenheimer & Co., Inc. (Broker)

Q

Thank you.

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

Glen F. Post, III

President, Chief Executive Officer & Director

Thank you, Saeed. As we called out today, we are not satisfied with our results for the quarter and we have plans in place to correct that trajectory, but overall I really believe we have the best portfolio of assets we've ever had at CenturyLink. Now it's really about execution. We are taking these assets and leveraging them to drive revenue growth, EBITDA growth and shareholder value over time. And while though there certainly will be some quarterly ups and downs with some bumps in the road along the way, CenturyLink's long-term trajectory in my view is as positive and bright as it's ever been. So thank you for joining our call today and we look forward to speaking with you in the weeks ahead.

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

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