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CenturyLink, Inc. (CTL)

Q4 2015 Earnings Call

CORPORATE PARTICIPANTS

Tony Davis
Vice President Investor Relations, CenturyLink, Inc.

Glen F. Post
President, Chief Executive Officer & Director

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

Aamir Hussain
Chief Technology Officer & Executive VP

OTHER PARTICIPANTS

David William Barden
Bank of America Merrill Lynch

Amir Rozwadowski
Barclays Capital, Inc.

Simon Flannery
Morgan Stanley & Co. LLC

Batya Levi
UBS Securities LLC

Anastazia Goshko
Bank of America

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

Mike L. McCormack
Jefferies LLC

Frank G. Louthan
Raymond James & Associates, Inc.

Arun A. Seshadri
Credit Suisse Securities (USA) LLC (Broker)

David Saber
Wells Fargo Securities LLC

Brett Joseph Feldman
Goldman Sachs & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Good day ladies and gentlemen, and welcome to CenturyLink's Fourth Quarter 2015 Earnings Conference Call. At this time all participants are in a listen-only mode. Later we will 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 fourth 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 2, you will find our Safe Harbor language. We will be making certain forward-looking statements today, particularly as they pertain to guidance for first quarter and full year 2016 and other outlooks in our business. We ask that you review our disclosure found on this slide, as well as in our press release and in our SEC filings, which describe factors that could cause our actual results to differ materially from those projected by us in our forward-looking statements.

Moving 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 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 moving 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. Our call today will be available for telephone replay through February 18, 2016, and a webcast replay of our call will be available through March 3, 2016. 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 February 10, 2016, and should be considered valid only as of this date, regardless of the date heard or viewed.

Moving now to slide 5, I'll now turn the call over to Glen Post. Glen?

Glen F. Post
President, Chief Executive Officer & Director

Thank you, Tony. And thank you for joining our call today to discuss our fourth quarter results. I will make a few remarks about 2015 and discuss 2016 objectives and our guidance.

Beginning on slide 6, 2015 was really a year of two very different halves for CenturyLink. In the first half, our sales and revenue trends were softer than we had anticipated entering the year. During 2014, as part of our ongoing review of our business, we had identified an opportunity to improve the structure of our sales force and we began to implement this change in late 2014. Our sales organization realignment was more complex, it took longer than anticipated, and by mid-year, operating expenses were out of alignment with our revenue outlook for the remainder of 2015. We began to take aggressive corrective action in the second half of the year and the benefits of the realignment along with new leadership began to take hold and we improved our overall sales performance and we increased our sales funnel opportunities and enhanced our revenue trends.

At the same time, we were also successful in taking cost out of the business. We reduced planned operating expenses in the second half of 2015 by more than the $125 million target we had set in August. These actions helped us deliver very strong results in the fourth quarter as revenues, cash flows and adjusted earnings per share all exceeded our expectations for the quarter.

As we will highlight in more detail later in the call, we saw good performance from our Consumer segment during the quarter. Growth in Prism TV customers along with higher average revenue per customer drove year-over-year Consumer revenue growth. Also for fourth quarter, Business high-bandwidth data services grew approximately 9% year-over-year. So overall, we achieved significant improvement in the second half of 2015 compared to the first half of the year.

Continuing on now to slide 7, we also continued to focus on driving higher speeds across our network as we ended 2015 with 940,000 GPON-addressable households and 490,000 GPON-addressable businesses. And we provided more than 30% of our service area or addressable units with speeds of 40 megabits or higher. We believe that's a speed that in the marketplace is sufficient to address most of our customers' actual needs. Additionally, we completed our $1 billion share repurchase authorization in early December and we returned a total of $2 billion to CenturyLink shareholders in 2015 through dividends and share repurchases.

As you know, in early November we announced we were beginning a strategic review process of our data centers and co-location business. This decision was made as part of our continued efforts to proactively manage our portfolio of assets to best position the company to compete, to achieve profitable growth and drive shareholder value.

We made good progress with process. Since our November announcement, we have established a separate data center/co-location organization including a separate management team. We're also nearly complete with carve-out financial statements for our data centers and co-location business to provide – to potentially acquire our partners. We've spoken to a number of interested parties who expressed interest in all options ranging from an outright purchase of our data centers and co-lo business, a partnership, and/or a joint venture. This is an ongoing process that could result in any one of these outcomes including the potential sale of a portion of or all of our data center business.

Also, as we have said, we could ultimately choose to retain these assets and related operations. As we outlined in November, we believe in the macro trends of the data center co-location industry and the importance of the service in our hybrid IT solutions, but we do not believe we must own the co-location facilities to provide the full range of services our customers need to manage their IT functions. We expect to formally engage interested parties within the next two weeks or so.

Continuing on now to slide 8. As we enter 2016, we thought it might be useful to share with you a broader view of how we think about our business and operational focus for 2016 and beyond. First, I think it's important that we declare for ourselves while we're here and what we are trying to accomplish as an organization. And for us that purpose is to improve the lives of our customers by connecting them to the digital world, whether it's providing connections or services on top of that connection, using the power of the digital world to improve our customers' lives and businesses is really what we're all about.

We expect to accomplish this purpose through a two-part mutually reinforcing mission. First, we provide our customers a gateway to the digital world by enabling fast, highly reliable broadband connections that are automated and easy to use. We also have significant opportunity to take a leadership position on this front, and our principal focus going forward will be to provide our customers the very best network experience.

Second, we will complement our strong access position by deploying less capital intensive investments, higher growth solutions to deliver our customers a full range of technology focused services such as managed network and hosting, cloud IT services and video, along with over the top applications and content. We believe this approach will allow us to deliver the full range of services our customers want while also allowing us to prioritize capital to improve the network services offerings that are at the heart of our customer relationships.

Continuing on slide 9, looking at our purpose from a financial point of view, our focus is to create long term shareholder value through both revenue growth and strong cash flow generation. I want to emphasize this last point. The focus of our business is to drive long term free cash flow generation that enables us to continue to invest in our business and sustain our strong dividend. And we will prioritize investments and operational initiatives to support that outcome. We believe we can accomplish our goals through focus on three key operational initiatives.

First, we will maximize market penetration of our network and adjacent services to drive growth. To accomplish this, we plan to maximize penetration in areas where we have invested in and enabled our broadband capabilities. We will continue to focus our investments on enabling fast, reliable broadband connectivity, and we will enable other technology-focused solutions, such as managed network, hosting cloud, IT services, and video using capital-efficient solutions and partnerships.

Our second key initiative is to create exceptional customer experiences. As part of this effort, we plan to simplify our products, our processes, and our systems, and we will continue our evolution to a single orchestration layer that automates the end-to-end customer experience that enables access to complementary services from multiple providers. This will take time, but we have a roadmap in place to significantly improve our customer experience over the next couple of years.

Finally, we will deploy a disciplined approach to our operating capital investments to deliver profitable growth, first by investing more capital to enable high-bandwidth network connectivity and pursuing capital line investment approaches for our complementary adjacent services. Allocating capital based on the best returns for investment and opportunities and key strategic objectives will be key. We also expect to gain revenue and operating efficiencies and improved cash from operations through more aggressive systems consolidation, automation, and process improvement. We have a clear strategic direction and we believe by focusing on these operational areas we will be able to build on CenturyLink's strong foundation and deliver value to both our customers and our shareholders.

Finally, we are focused on specific actions to drive sales and revenue growth of our strategic products and service in 2016 and beyond. We expect to drive further penetration of our Consumer business and GPON footprint of over 900,000 households and almost 500,000 businesses, and have 3 million households enabled for Prism TV service. And we expect to continue to expand high-bandwidth data services, GPON, and Prism, enabling further revenue upside opportunities.

We also believe we can continue sales momentum from the second half of 2015 and drive increased sales productivity through better go-to-market alignment, leveraging product specialists and enabling additional sales and sales performance tools. And we plan to focus on winning large deals through dedicated teams and system integration and value-added resellers – our system integrators and value-added resellers.

Expanded distribution partners are key to this hitting our goals and driving revenue. And one final item. I'm sure you saw our release this afternoon, announcing our new President of Sales and Marketing and new Chief Marketing Officer. We look forward to Dean Douglas and Bill Hurley joining our team next week. And I'm confident they will be key contributors to helping us achieve the actions I've just discussed. Now, I'd like to turn the call over to Stewart for discussion of our financial results and liquidity position, as well as our guidance. Stewart?

R. Stewart Ewing

Executive Vice President, Chief Financial Officer and Assistant Secretary

Thank you, Glen. Over the next few minutes, I will review the financial results for the fourth quarter, provide an overview of the first quarter and full-year 2016 guidance we included in our earnings release issued earlier this afternoon, and conclude my remarks with a discussion of CenturyLink's liquidity position.

Regarding our guidance, we are pleased that our full-year expectations for 2016 are in line or better than current average analyst estimates. Now moving to slide 11, I will review a few highlights from our fourth quarter results. Please note that I will be reviewing the results excluding special items, as outlined in our earnings release and associated financial schedules. As Glen mentioned earlier, we achieved strong results for the fourth quarter and operating revenues were $4.8 billion on a consolidated basis, a 0.9% increase from fourth quarter 2014 operating revenues. This increase was primarily driven by an increase in higher cost support revenues of approximately $60 million, due to the recognition of CAF Phase 2 support during the fourth quarter 2015, along with strength in high-bandwidth data services and Consumer strategic revenues.

Core revenue, defined as strategic revenue plus legacy revenue, was $4.03 billion for the fourth quarter, a decline of only 0.5% from the year-ago period. Strategic revenues grew 3% year-over-year, primarily driven by strength in strategic products, including high-speed data services, high-speed Internet, and Prism TV.

In the fourth quarter we added approximately 16,000 Prism TV customers, while high-speed Internet customers declined about 22,000 during the quarter, partially as a result of tighter credit standards implemented in mid-year 2015. We generated operating cash flow of approximately $1.82 billion for the fourth quarter and achieved an operating cash flow margin of 40.6%. Cash expenses for the fourth quarter declined $72 million year-over-year, primarily due to lower employee-related costs. And on a sequential quarter basis, cash expenses declined $115 million, or 4.1% from the third quarter of 2015. Free cash flow, defined as operating cash flow less cash paid for taxes, interest, and capital expenditures, along with other income was $591 million for the quarter. Adjusted diluted earnings per share for the fourth quarter was $0.80.

As we've discussed on prior earnings calls, adjusted diluted EPS excludes special items and certain non-cash purchase accounting adjustments as outlined in our press release and associated supplemental financial schedules. Additionally, as Glen mentioned earlier, we repurchased more than 10 million shares for an investment of nearly $280 million during the fourth quarter, which completed the $1 billion share repurchase program.

Moving to slide 12 and our Business segment, in fourth quarter the Business segment generated $2.66 billion in operating revenues, which decreased $43 million or 1.6% from the same period a year ago. Fourth quarter strategic revenues for the segment increased 1.4% to $1.6 billion from fourth quarter 2014, driven by continued strength in high-bandwidth services, such as MPLS and Ethernet, partially offset by the declines in low bandwidth data services and wholesale repricing. Legacy revenues for the segment declined 6.2% from fourth quarter 2014, due primarily to continuing decline in access lines and lower long distance revenues. Total Business segment expenses decreased from the year-ago period, driven primarily by lower employee-related expenses and CPE cost. Our segment margin was 44.1% which was an increase from 43.6% a year ago.

Now, turning to slide 13, Consumer generated $1.51 billion in total operating revenues, an increase of $19 million or 1.3% from fourth quarter 2014. Strategic revenues in this segment grew 6.3% year-over-year to $773 million, driven by year-over-year growth in high-speed Internet and Prism TV revenues. Legacy revenues for the Consumer segment declined only 3.4% from fourth quarter 2014 as access line and long distance revenue declines were partially offset by select price increases. Operating expenses decreased $17 million or 2.8% compared to the same period a year ago.

Now, turning to slide 14, for first quarter 2015, we expect operating revenues of $4.40 billion to $4.45 billion, core revenues of $3.95 billion to $4 billion, and operating cash flow between $1.66 billion and $1.72 billion. Adjusted diluted EPS is expected to range from $0.67 to $0.73. Our anticipated sequential decrease in first quarter operating revenues compared to fourth quarter 2015 is primarily due to declines in legacy, posting, and low-bandwidth data services more than offsetting the anticipated growth in revenues from high-bandwidth data services. We expect first quarter 2016 operating cash flow to be lower than fourth quarter 2015, primarily driven by the decline in revenues I just mentioned along with higher costs. Those higher costs include approximately $35 million from one time favorable expense items in the fourth quarter and in first quarter $25 million of higher payroll taxes and $20 million related to higher marketing costs.

For full year 2016, we expect operating revenues of $17.55 billion to $17.8 billion and core revenues of $17.75 billion to $16 billion. Both are expected to be slightly lower compared to full-year 2015 expected legacy revenue declines, more than offsetting anticipated increases in the level of strategic revenue growth. Our operating cash flow for the full year 2016 is expected to be $6.6 billion to $6.8 billion, lower than full year 2015, primarily driven by the continued decline in legacy and low-bandwidth data revenues. The company anticipates lower depreciation and amortization expense for full year 2016 compared to full year 2015, and adjusted diluted EPS for full year 2016 is projected to be $2.50 to $2.70. The expected lower full year operating cash flow for 2016 along with higher cash income taxes and anticipated 2016 capital expenditures of $3 billion are expected to lower free cash flow to $1.8 billion to $2 billion.

Now, turning to slide 15, since we recently issued $235 million of debt to refinance upcoming maturities, we thought we would provide you with our plans for our maturities over the remainder of the year. Our total debt maturities for 2016 are approximately $1.4 billion. As I mentioned in January, we completed a $235 million debt issuance of 7% Qwest Corp 40-year notes that will be used to refinance an upcoming May 1 maturity. That primarily leaves us with an Embarq debt maturity of a little less than $1.2 billion on June 1. We expect to be opportunistic in the coming months in refinancing some or all of that debt as well at the CenturyLink parent level. It's important to note that with approximately $400 million drawn as of the end of 2015 on our $2 billion credit facility, we have the capacity to handle the June 1 maturity if needed. Additionally, since we completed our $1 billion share repurchase program in early December, we can also use available free cash flow for a portion of the June 1 maturity if necessary.

As is indicated by our 2016 guidance, we expect $600 million to $800 million of free cash flow after the cash dividend, which results in our dividend payout ratio in the low to mid 60% range in 2016, which is very sustainable. So we're confident that our solid cash flows continue to provide us the financial strength and flexibility to meet our business objectives and drive long-term shareholder value.

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: [Operator Instructions] Your first question comes from David Barden from Bank of America.

David William Barden
Bank of America Merrill Lynch

Q

Hey, guys. Thanks a lot for taking the questions. So, I guess a couple of questions, if I could. For Stewart, just first, number one, as we kind of look at the 2016 guide, obviously last year we had an issue with kind of overestimating how the year was going to play out. So I was wondering if you could talk a little bit about what the base case expectations that you've modeled out for the economy and sales force ramp and whether your incoming head of revenue, Mr. Douglas, has bought into these expectations and kind of your comfort level of achievement. That'll be number one.

Second would be on the cash tax outlook and kind of the update on bonus tax depreciation, what's embedded in that free cash flow guidance?

And then the last one, if I could, would just be on kind of the metered data opportunity. I think we've been seeing a lot of the cable companies experimenting with data caps and metering higher-end usage. It seems like the FCC is not pushing back on this and it feels like it could be a big opportunity for telcos to, if nothing else, price underneath the cable umbrella and start to raise rates from high-end users. I was wondering if that's something that you guys are looking at as an opportunity and where it stands. Thanks.

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

A

Yes, so, David, in terms of 2016 revenue guidance, I mean I believe we do feel more comfortable with the revenue guidance that we have this year from the guidance that we provided in 2015. We think we have some things in place from a sales standpoint. Our funnel continues to build and look good. We have a number of big deals that are in the funnel and hopefully we can get to closure with some of those. We're also working on the provisioning, the order to cash, to get the sales that the salespeople make provisioned and into billing quicker and hope to be able to get that done over the course of the next few months to where we can reduce our cycle times there. That will help. The other focus that we have is on churn reduction. So we're working there to try to keep the customers we have and try to make some of the price declines and credits that we've been issuing smaller. So we're hopeful that we're attacking revenue not just from a sales standpoint this year but also from the standpoint of reducing churn as well as getting the orders into cash quicker. And we also have a big deal team that we've talked about before that were launched to pursue larger opportunities.

In terms of the guidance, and the macroeconomic issues, I mean we basically have assumed that the economy stays about like it is at this point. So no real significant changes there. Glen, I'll let you talk about Dean.

Glen F. Post
President, Chief Executive Officer & Director

A

Yeah. We've certainly had discussions with Dean and with Bill Hurley, and at a high level they feel good about what we're projecting. They have obviously not had the opportunity to get into details, but I know we've had discussions with them and they believe we have upside in a lot of areas. But they have not had a chance really to get into details of our projections at this point.

And from the standpoint of – so, just to kind of close out the revenue, we had some revenue growth in the fourth quarter. We did in the first quarter of 2015. We would expect probably second quarter 2016 we would reach a little bit of revenue growth. But in terms – we're going to be so close just in terms of projecting that we're going to hit stability and growth on a sequential basis quarter after quarter. It's really not possible for us to do that now, but we think that with the three-pronged approach that we have to really driving revenue, keeping the revenue we have, getting customers to billing quicker, it will pay dividend for us from the standpoint of getting some real momentum in terms of our revenue growth.

In terms of cash taxes, our cash taxes for 2015 were $63 million. Based on the operating income guidance that we've provided for 2016, we would expect cash taxes to be approximately $400 million at the low end of guidance and about $600 million at the high end of guidance. And as we say, with the free cash flow that that results in after the operating income, your result in the dividend payout ratio being in the low-to-mid-60%s.

I might add that dividend payout ratio in 2017, at this point we would say we would be gunning in the low-to-mid 70%s, because we think that cash taxes will increase somewhat in 2017 just because the impact of bonus depreciation will be less as it matures more.

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

And, then, David, regarding the metered data plans, we are considering that for the second half of the year. We think it's important, and our competition is using metered plans today. And we think it's an area we have to explore and consider. Actually, we will start some trials. Later this year is our expectation.

David William Barden
Bank of America Merrill Lynch
Q

Great. All right. Thanks guys.

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

Amir Rozwadowski
Barclays Capital, Inc.
Q

Thank you very much. Building upon the prior question around sort of thinking about the trajectory of the business from a top-line perspective, how should we think about some of the opportunities that you've had in terms of reducing the costs in the business? And specifically, if you do find yourself in a position where you can get sort of stable top-line growth, can we pull forward the expectation around the ability to return to EBITDA growth and operating income growth for the business?

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

Yes, I mean, we still think that we can hopefully, after we get to some level of revenue stability, continued stability in growth, we can get to EBITDA stability within 12 to 18 months thereafter. But again, as I have said many times before, EBITDA stability is really dependent upon continued movement, continued improvement in sales of our strategic products; over time, a lessening decline in the rate of legacy revenue that we receive; and then also, the third leg of that stool basically is to continue to control our operating expenses to get to EBITDA stability.

Glen F. Post
President, Chief Executive Officer & Director

A

I might add to that, Amir. The simplification of our processes, the automation of a lot of the [ph] end (30:25) process, there's a single-platform, orchestration platform I mentioned earlier. Those are ways that we think we could take significant cost out of the business, as well as create a much better customer experience. So, those are the areas we're looking at for future cost control.

Amir Rozwadowski
Barclays Capital, Inc.

Q

Thank you very much. And then if I may follow up on the exploration of the strategic alternatives for the data center side, it sounds as though you're, based on your prepared comments, moving forward well on that front. Can you talk to us about the interest perhaps you may or may not have seen in the marketplace? There have been a number of folks who either expressed a goal to do something similar or at least have been rumored to potentially be doing something similar. So, would love to hear sort of compare and contrast what you're hearing in the market in terms of receptivity. Would be very helpful.

Glen F. Post
President, Chief Executive Officer & Director

A

Yeah. Obviously we're aware that there's other activity in the market with folks with data centers, co-location businesses out there possibly for sale. But I can tell you this, we are seeing a significant amount of interest right now. You don't know until you get into negotiations, which we hope to start in a couple of weeks, that process. But we are seeing interest from strategic buyers as well as financial buyers and asking a lot of questions, wanting in the data room. Want to start talking with us about the opportunities. So, again, you never know, but the interest level is high right now.

Amir Rozwadowski
Barclays Capital, Inc.

Q

Thank you very much. That's very helpful.

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

Simon Flannery
Morgan Stanley & Co. LLC

Q

Great. Thanks very much. So, the buyback program is over. I understand you're waiting for the results of the data center. But can you just talk more broadly about your leveraged target and given the credit environment out here, how are you thinking about where you want that leverage to be over time in terms of how much of the surface free cash and how much the data center sales might go to maintaining sort of a three turns? Or do you want to bring that down under three turns over time?

And on broadband, can you just update us? You gave good stats on the speeds and the build-out there. How are you thinking about returning broadband to growth? We've seen a pretty tough quarter so far for the telcos relative to cable and we touched on that in an earlier question. But you're obviously getting the speeds up. What can you do on the channel side, marketing side to turn that back to growth, and maybe you can just weave in CAF 2 progress into that. Thank you.

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

Yes, Simon, so the leverage targets, we're still a goal of about three times. But what we said is that as the business – as EBITDA declined somewhat, we were basically willing to go over three times if we saw that EBITDA over time was going to turn around and bring us back to three times or lower. So we will look at the proceeds from the sale of the data. At this point, we don't have any goal to reduce our leverage below three times. I mean we still think with – what we've done with our debt maturities, we have plenty of liquidity and generate plenty of free cash flow. And we'll wait and see what happens with respect to the data center sale, and then we'll decide from there what we do more or less with the $600 million to $800 million of free cash flow that we expect to have in 2016 after the payment of the dividend as well as free cash flow associated with the – as well as the cash associated with potential sale of the data center.

Simon Flannery
Morgan Stanley & Co. LLC
Q

Great.

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

And Simon, regarding the broadband, first of all, we believe that we have real opportunity to take advantage of the investments we've made in recent months in GPON. In Prism, we passed now about 950,000 homes with GPON, with 1-Gb speeds to 780,000 of those homes. That's a 17% increase from the third quarter in terms of GPON homes passed. We grew our Prism markets with GPON capabilities from 600,000 to 700,000 in the fourth quarter. And we're seeing really strong take rates where we have GPON in these homes and businesses, so that's a really positive for us.

We average about right now just – and it's early on. We just released that. We've got about 15% penetration in our GPON markets of the GPON products. As you know, we rolled out this past year – most of that's rolled out the past year. So we're real pleased with that and that opportunity it gives.

Also, if you look at our market share data, our market share in a lot of the cities we're in is very low. We think we have upside there to go into these businesses. And we're also connecting more of the MVUs and MTUs within our markets that we believe will give us a lot of opportunity. We've had very little market share there. More than 30% of our households that we serve are in MVUs. So it's a real market opportunity there as well that we're focused on. So those are some of the things we're doing we believe can turn around the broadband growth.

Simon Flannery
Morgan Stanley & Co. LLC
Q

Great. So that's – someday we may have positive adds for 2016, or is it too early to say?

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

I think we will. It's a little early, but I believe we're on a path for positive adds in 2016.

Simon Flannery
Morgan Stanley & Co. LLC
Q

Great. Thank you.

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

Batya Levi
UBS Securities LLC

Q

Great. Thank you. Two questions. First on the high-speed data growth side. You saw some acceleration in the quarter. Can you provide a split for retail versus wholesale? And do you expect that trend to continue in the first half of the year? Then on CapEx, can you provide some color on where that $3 billion will go in terms of different buckets and how should we think about incremental fiber deployments? And any trends you could highlight in terms of cost of deployment coming down and potentially accelerating that trend? Thank you.

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

A

Yes. So, Batya, in terms of the CapEx color, basically in 2016 a little bit over $2 billion or so of the capital budget will be what we call revenue enablement and support. Probably of that approximately $2 billion, basically broadband enablement and connection and capacity is about a $1.2 billion or so. And then Ethernet and MPLS enablement's probably about $600 million or so. So, we're going to expect to continue to spend capital to bring higher and invest in the access part of our business to basically be able to, through either fiber or other technologies over time, be able to drive higher speeds for our customers.

Glen F. Post
President, Chief Executive Officer & Director

A

And, Batya, on the breakdown between wholesale and retail, we don't have that here, but we can follow up – Tony or someone can follow up with you and get you that information. We just don't have it right here.

Batya Levi
UBS Securities LLC

Q

Right. In terms of the trends going forward, would you still expect that to grow at high single-digits?

Glen F. Post
President, Chief Executive Officer & Director

A

As far as – yes. As far as the – speaking of broadband growth, yes, absolutely.

Batya Levi
UBS Securities LLC

Q

Okay. Thank you.

Operator: And our next question comes from Ana Goshko from Bank of America. Your line is open. Please go ahead.

Anastazia Goshko
Bank of America

Q

Thank you very much. I think you laid out pretty well what the plan is for addressing the 2016 bond maturity, particularly with the state of the credit markets right now. But wondering, one, is there an interest rate level at which you – in your mind it becomes prohibitive to refinance that on an unsecured basis? And have you thought about moving into the secured market, where you would likely get a better cost of capital?

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

A

So, Ana, we have looked at that, and we are continuing to look at it some. And I guess we've not made really any final decisions. But at this point, I mean, we would prefer to stay unsecured, even if it might cost us a little bit more. Again, we can carry – we can really be opportunistic with this next – with a little less than $1.2 billion that we need to raise to refinance the Embarq maturity because, again, we have about $1.6 billion availability on the credit facility. Additionally, our highest free cash flow quarter of the year is the first quarter because basically, our CapEx somewhat gets off to a little bit of a slow start. We just have more free cash flow in the first quarter. We probably generate over 50% of our free cash flow that we're going to generate in the first quarter, really. So, we have a lot of options, and we will look at secured options. But, at this point, we're not leaning in that direction. Not to say we wouldn't go there over time.

Anastazia Goshko
Bank of America

Q

Okay, thank you. And then, also, I think I heard this correctly. So any decisions on further shareholder returns beyond the current dividend? Did you say that you're going to wait until you get through the data center process and potentially through this Embarq maturity as well before you decide what to do with excess free cash flow in the year?

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

A

Yeah. Certainly through the Embarq maturity. And in all likelihood, until we get much more color in terms of what's going to happen with the data center business.

Anastazia Goshko
Bank of America

Q

Got it. Okay. Great. Thank you very much for that.

Operator: Thank you. Our next question comes from Michael Rollins from Citi Research. Your line is open. Please go ahead.

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

Q

Hi. Good afternoon. Thanks for taking the questions. Two if I could. Just first, a housekeeping item. Can you talk about why depreciation may fall in 2016?

And then secondly, if you go back, I think it was a few weeks ago, the company filed a lengthy 8-K describing some changes to the board and pointed to some maybe differences in perspective. Can you provide us with more context maybe, to what happened and maybe some of the strategic issues that the company may or may not be wrestling with in the board room? Thanks.

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

A

So, I'll take the first one, Mike, on depreciation. So, basically, we would expect depreciation and amortization to be down somewhere between $200 million and $250 million, 2016 versus 2015. About $75 million of that decline is really a decline in the customer list amortization that we had that was really part of the purchase price adjustments related to, primarily, the Qwest acquisition and the Embarq acquisition as well. The depreciation rate – the decline in depreciation really is due to some of our assets becoming fully depreciated and retired. So, basically, that decline in depreciation that we have been – that did occur in 2015 is offset to a certain degree by the $3 billion that we expect – the depreciation of the $3 billion we expect to invest in 2016 in our plan. So, really about $100 million to $150 million decline really related to just the depreciation part.

Glen F. Post
President, Chief Executive Officer & Director

A

And, Mike, and regarding Joe Zimmel's departure, first, Joe made a lot of contributions to our company. He was 12 years – 12 years he was here. We appreciate him for that, wish him the very best. As we stated in the 8-K that we filed, really in connection with the annual review of the board slate, the nominating and governance committee recommended, and the board ultimately concluded that Joe should not stand for reelection at the 2016 meeting. The board felt the change would lead to an environment with improved productivity and constructive dialogue. It was really just a board chemistry issue, is what this was.

At no time has Joe raised any issue about the company's accounting or financial reporting either leading up to or following his resignation. Also, Joe didn't raise concerns about the company's strategy or succession planning prior to his resignation, at least not that I'm aware of or the board members were aware of. His principal complaint related to the process the board used to reach the conclusion that he would not be included on the 2016 slate. And I think I'll just leave my comments to that. There's a lot of details in our 8-K we filed on January 25, and you can maybe read all that. But that really contains exactly what happened, in my view. And it includes Joe's comments as well.

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

Q

If I could just follow up with one other question, do you keep tallies internally of the proportion of your footprint where you have a comparable or better speed for broadband that you can market to your customers? And is that something that you can share with us in terms of what that might look like? I realize you shared with us earlier some stats on your GPON and some of the builds there, but more broadly, do you have a sense of just how you fully stack up against the cable competitor?

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

A

First, yes, we do – we have that information, and we use it continually. I don't have it here to go through as far as total overall percentages and speeds, but we have that in the marketing department, sales – we use that continuously. Helps us identify where we build additional capacity, how we go to market, advertising, all of that. Pricing – all of that comes into play. But that's a very important part of our analysis.

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

Q

Thanks very much.

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

Mike L. McCormack
Jefferies LLC

Q

Hey, guys, thanks. Glen, just another though, I guess, on the economy. I think somebody asked earlier, but, any feedback you're getting from your bigger business customers with respect to any skittishness or nervousness on the part of making decisions or slowing down decision making? And the second part, just on the involuntary churn in the high-speed adds, just trying to get a sense for what it is that's going on there and perhaps how long that might persist. Thanks.

Glen F. Post
President, Chief Executive Officer & Director

A

First of all, Mike, on the customer's perspective economy, anybody connected with – any company connected with the oil and gas businesses is skittish right now, obviously, for good reason. So, we're seeing some of that in the oil and gas sector. Fortunately, it's not a major vertical. We do have some customers there, but it hasn't been a major vertical for us.

Outside of that, we're not seeing a lot of concerns out there right now. We'll see what happens the next few months. But right now, we're seeing – we were already seeing long decision-making time frames by businesses the last year or so. So that's not a change, and we're still seeing that. But no major – we're not getting major negative feedback from our customers at this point in time, outside of the oil and gas sector.

As far as the involuntary churn on Internet speed, we hope we've worked through most of that in the fourth quarter. We think that those changes we made last year on the credit requirements and the higher prices, price increases that we had last year, we think we worked through most of that. So hopefully we'll see in the first quarter – that come in, in the first quarter.

Mike L. McCormack
Jefferies LLC

Q

And were those customers, Glenn, folks that had chosen some other provider and just decided to stop paying without disconnecting or is there something else we should be thinking about?

Glen F. Post
President, Chief Executive Officer & Director

A

It was that and just folks who never paid. They just never paid. They'd come in and we'd give service for three or four months and we'd give them time to pay and they weren't, so we put in stiffer requirements.

Mike L. McCormack
Jefferies LLC

Q

Okay, thanks, guys.

Operator: Thank you. Our next question comes from Frank Louthan from Raymond James.

Frank G. Louthan
Raymond James & Associates, Inc.

Q

Great. Thank you. Can you describe a little bit of the product and system simplifications that you're looking at and maybe how long that'll take and ultimately the cost there? And then on the strategic review with the data center, what kind of economic benefits could you expect to see from some sort of a partnership arrangement? I ask that partly because I've actually seen one work, so I'm curious what you think how that might work versus just a n outright sale. Thank you.

Glen F. Post
President, Chief Executive Officer & Director

A

You know, Frank, Aamir Hussain is here, our Chief Technology Officer. I will let him address the product and systems. It's a major undertaking for us. I can tell you this, we're already seeing benefits, but it will be a continual effort over the next two years, two and a half years, really. Aamir, you want to talk about it?

Aamir Hussain
Chief Technology Officer & Executive VP

A

Yeah, both product and systems simplifications don't need to run by a rationalization of the products, networks and the systems and applications we have. The end goal is to reduce provisioning cycles and get revenue in the door as soon as possible. And we have multiple strings. You're looking at products, we are looking at processes, we are looking at systems. We're trying to use our portal platforms and consolidate multiple portals, provide a great customer experience. At the end of the day, the whole lead to cash process is being looked at. And every process within those processes are being combined to create a great experience for the customer. Again, it touches your systems, your processes, getting revenue in the door, and enhancements into our current systems' processes with new technologies to be able to provide better opportunities to our sales and operations folks to provide great customer experiences.

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

A

Regarding the economic benefits on a joint venture on the data centers, it depends on what you mean by joint venture. There's a lot of different approaches to a joint venture, but the main thing we would like to be able to do is continue to have a wholesale opportunity within the centers that we own today. We would like to avoid the high level of capital expenditures that's required. We think we can drive higher returns by investing those dollars in network and other areas. So that's really our view of that. And not only that, the valuations are significant right now, and we think it's a good time. If we're going to consider this, now's the time to do it. We think it's a good business. It is a good business. Margins are good. It's good that we're growing. It's been growing this business some. So it's not worth running from it, but it's just we think the ownership of the assets, we don't think we have to own those assets, so that's really the reason we're looking at all alternatives.

Frank G. Louthan
Raymond James & Associates, Inc.

Q

Okay, great. Thank you.

Operator: Thank you. Our next question comes from Arun Seshadri from Credit Suisse. Your line is open, please go ahead.

Arun A. Seshadri
Credit Suisse Securities (USA) LLC (Broker)

Q

Yeah. Hi. Thanks for taking my questions. The first one, I just wanted to make sure I heard you right. I think you said your preference was to refinance the Embarq notes at the parent level. I just wanted to understand the rationale for that and whether you've thought about sort of doing it – refinancing it at the Embarq level itself or potentially at a sort of an intermediate wholesaler as well?

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

A

Basically we've been trying just since all the acquisitions over the years to simplify our capital structure somewhat. And frankly, really we've looked at the potential of refinancing down at the Embarq level. It creates another public entity that we have to file public filings on and all, and we just think it's not worth the effort of all of that as well as the rate differentials. It's not that significant. So, we've been for the last five years or so been working to refinance debt on Qwest Corp. At Qwest Corp, the debt matures there because it is still investment grade. Everything else is – the parent's non-investment grade. So we've been moving everything up there and we think that – I mean we've had really good rates and good execution over the years. I mean, as I mentioned earlier, we'll see over time if we need to go into more secured product to get better rates. At this time, we don't think we need to. But we'll just monitor that over time.

Arun A. Seshadri
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Appreciate that. And as far as the cash taxes for 2017, I think you said it would be higher than 2016, but do you have sort of a preliminary number? I mean, can we see something in the $700 million-plus range?

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

A

It's – so if you look at your – if you look at pre-tax book income, possibly somewhere in the range of maybe 45% to 55% would be the effective cash tax rate. But it's early yet, and we'll have to see. I'm sure it will change some over the year as we get closer to 2017. But it will go up some. So the benefit of bonus depreciation to us over the life of the program is a little bit over $1 billion. And we figure we got $250 million of the benefit in 2015 and probably $450 million of the benefit in 2016. So we've got – we will have, by the end of 2016, achieved about $700 million of the little bit over $1 billion deferral that we expect to get during the life of the bonus depreciation legislation. And that assumes our CapEx stays at about the same level that it is today.

Arun A. Seshadri
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Great. Thank you so much.

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

David Saber
Wells Fargo Securities LLC

Q

Hi. Thanks for taking the questions. Just a couple of quick ones. In looking at the supplemental info, it looked like there was a sizable working capital outflow, more than $500 million. Just curious if that was an anomaly and if we could expect that to, perhaps, reverse in future periods?

And then, secondly, just back on the Embarq maturity for a second. Stewart, you mentioned perhaps using the revolver as a backstop. So, I guess, I just wanted to ask if that would be used only if the market were closed or would you perhaps look to use that even if the rate environment is still not favorable to you.

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

A

So, the decline in working capital was basically an October 1 maturity of debt that we paid off. So, that's why working capital declined. In terms of the credit facility, we've said we're going to keep about $1 billion dollars of capacity on the credit facility just for things like this, times when the markets are not where we want to issue. With the free cash flow that we'll have in 2016, beyond the dividend payment, the $600 million to $800 million. I mean we're not opposed to keeping it on the credit facility for some time if we need to in order to get a better rate and to get past the – let the high yield markets heal themselves somewhat.

David Saber
Wells Fargo Securities LLC

Q

Okay. Thank you.

Operator: Thank you. And our final question comes from Brett Feldman of Goldman Sachs.

Brett Joseph Feldman
Goldman Sachs & Co.

Q

Thanks. Just a quick housekeeping question. I was hoping you could give us an update on the net funding status of the pension at the end of the year and whether you anticipate making any cash contributions in 2016. Thanks.

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

A

Yeah. No, we will file our K. Yeah. The 26th is our target. So, we'll file our K in a couple of weeks and all the pension disclose – the pages and pages of pension and OPEB disclosure will be in there. So I really don't have that at this point in time.

Brett Joseph Feldman
Goldman Sachs & Co.

Q

And do you have a preliminary estimate of whether you need to make a cash contribution? Or is that still being worked out?

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

A

We do not need to make a cash contribution. We have made voluntary cash contributions of $100 million in 2015, and I think we did the same thing in 2014. We haven't made a decision. We don't need to make a decision on 2016 until September, before we file our tax return. So – but at this point, nothing is actually required.

Operator: Thank you. This concludes our question-and-answer session for today. I would like to turn the conference back over to Mr. Glen Post for any closing remarks.

Glen F. Post
President, Chief Executive Officer & Director

Thank you, Saeed. We discussed with you last quarter that we believed that our investments in network and adjacent businesses, along with our organizational changes and cost control efforts, were beginning to take effect and produce positive results. We believe we can now clearly see the progress and – that progress in our fourth quarter results. We plan to continue to leverage and position our assets and help drive future revenue growth, EBITDA growth, and shareholder value. And although our results may not be perfectly linear in the months ahead, I am confident that we're on a path to long-term growth and value creation.

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. You may disconnect and have a wonderful day.