S&P Capital IQ

CONTENTS

CenturyLink, Inc. NYSE:CTL

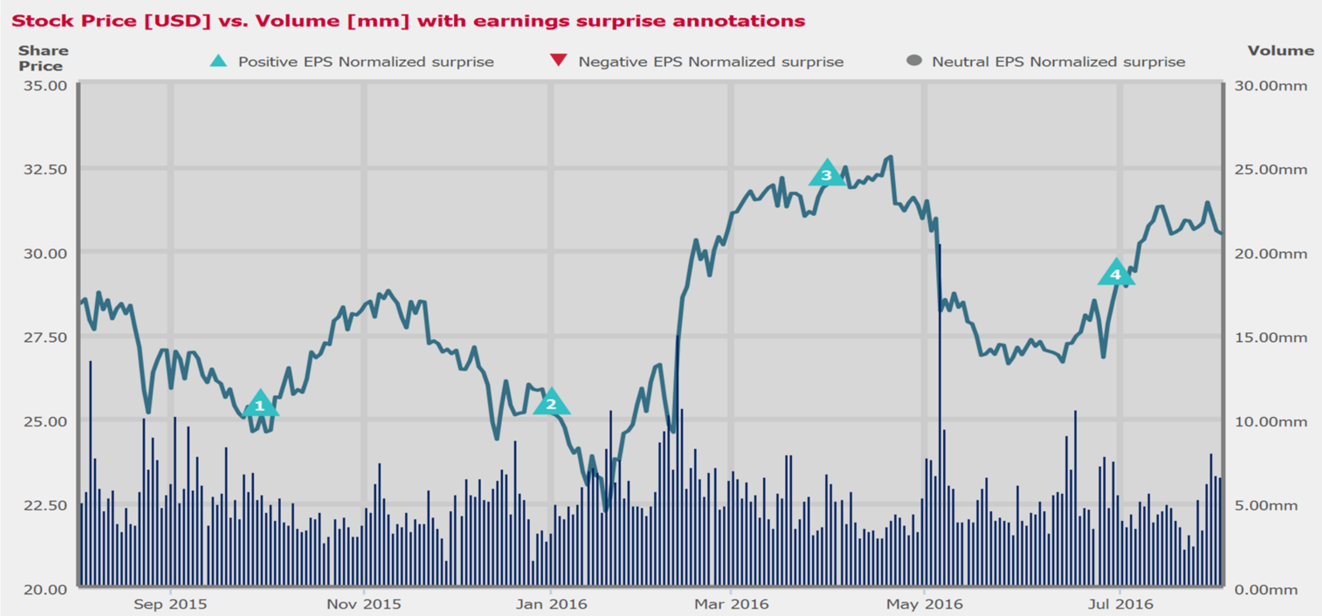
FQ3 2016 Earnings Call Transcripts

Monday, October 31, 2016 12:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2016-			-FQ4 2016-	-FY 2016-	-FY 2017-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.55	0.56	▲1.82	0.64	2.53	2.37
Revenue (mm)	4376.93	4382.00	▲0.12	4383.21	17551.16	17395.93

Currency: USD
Consensus as of Oct-31-2016 10:55 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2015	0.69	0.70	▲1.45 %
FQ4 2015	0.65	0.80	▲23.08 %
FQ1 2016	0.68	0.71	▲4.41 %
FQ2 2016	0.59	0.63	▲6.78 %

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Level 3 Communications, Inc.

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

Operator

Welcome to the conference call and webcast to discuss CenturyLink's acquisition of Level 3 Communications. [Operator Instructions]

At this time, I would like to turn the call over to Tony Davis, CenturyLink Vice President, Investor Relations. Please go ahead.

Tony Davis
Vice President of Investor Relations

Thank you, Kristen. Good morning, everyone, and thank you for taking the time to join our call today to discuss CenturyLink's acquisition of Level 3. Also, CenturyLink and Level 3 announced their respective third quarter 2016 earnings earlier this morning, and today's call will also include a brief discussion of each company's third quarter results. As a reminder, this call is being recorded, and a press release and slide presentation regarding today's news are available on the Investor Relations section of CenturyLink's and Level 3's respective websites.

I would also like to remind everyone that all statements being made during the call that relate to future results and events, including the proposed merger, are forward-looking statements that are based on current expectations. Actual results and events could differ materially from those discussed here. Also, please refer to the information on the disclaimer slides in the presentation, as well as the additional information contained in the regulatory filings for both companies.

Presenting during the prepared remarks portion of our call today will be Glen Post, CenturyLink Chief Executive Officer and President; Jeff Storey, Level 3 President and Chief Executive Officer; Stewart Ewing, Executive Vice President and Chief Financial Officer of CenturyLink; and Sunit Patel, Executive Vice President and Chief Financial Officer of Level 3.

And with that, I'll now turn the call over to Glen Post. Glen?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Thanks, Tony, and good morning. We appreciate you joining us for today's call. This is an exciting today for CenturyLink and Level 3. Together, we will be the second-largest domestic communications provider serving global enterprise customers. We believe we will create significant benefits and growth opportunities for all of our stakeholders, our customers, our employees and our shareholders.

We'll turn to Slide 5. Today marks an important day in advancing our shared visions and strategies. Together, we are creating a customer-centric focus and providing customers leading products and services. We are building scalable and agile network-based services to deliver industry-leading value, and both companies strive to adhere to our core values. Today, we really are announcing a new chapter for both companies.

We'll turn to Slide 7 to provide some key highlights of the transaction. First of all, the combined -- combined, we will create a leading facilities-based enterprise communications provider. We will have a strong financial profile, with pro forma total business revenue of approximately $19 billion and business strategic revenue of $13 billion. Total revenue, including our consumer business, will be approximately $26 billion, with adjusted EBITDA of approximately $11 billion, including synergies. We believe the transaction -- or the strategic combination, rather, will significantly improve CenturyLink's growth profile, and better position the combined company to improve its revenue growth, trend and drive meaningful operating cash flow growth in the first full year of post-closing, including synergies as realized and including integration costs.

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Additionally, we believe the combined company will be able to achieve more than 10% growth and free cash flow per share in the full year post-closing, including synergies as realized, and again, including integration cost. We also expect this combination to drive significant improvement in free cash flow per share in subsequent years.

We will also be able to accelerate approximately $10 billion of Level 3 NOLs. These NOLs will significantly reduce the combined company's net cash tax expense, positioning us to create enhanced free cash flow. With that greater financial flexibility, we expect to significantly lower CenturyLink's dividend payout ratio, and this combination also positions us well for future growth. Together, we expect to be able to leverage Level 3's and CenturyLink's strong product portfolios across our combined customer bases. In addition, the increased network scale will provide advantages for our customers in numerous ways.

Going to Slide 8, the transaction is structured in cash and stock, which we believe provides shareholders both immediate value and the ability to participate in the upside of the combination, as we work to realize the significant and compelling benefits of the transaction. CenturyLink will acquire Level 3 for $66.50 per share, which assumed a 60% stock consideration at $40 per share and 40% cash consideration at $26.50 per share. There's implied equity purchase price of approximately $24 billion and an enterprise value of $34 billion.

Based on those numbers today -- based on those numbers, today's deal represents a premium of approximately 42% based on Level 3's unaffected share price. Once completed, the pro forma company is expected to be approximately 51% owned by CenturyLink shareholders and about 49% owned by Level 3 shareholders. Importantly, the combined company intends to maintain CenturyLink's annual dividend of $2.16 per share. In terms of financing, we have approximately $10.2 billion of financing in place, including a $2 billion unfunded revolver at close.

Following the close of the transaction, I will continue as Chief Executive Officer and President, and we're pleased to have Sunit Patel join us as Chief Financial Officer. Following almost 35 years of -- at CenturyLink, Stewart Ewing has decided to retire following the close of this transaction. Stewart's been an important, really a vital part of our company, of this transaction and every other deal we've completed over the years. He is committed to seeing us through the integration and closing with Level 3. Stewart's a great leader. He is a good friend and our company is much stronger due to his many valuable contributions over the years.

In terms of board composition, the Chairman of CenturyLink's Board of Directors at the time of close will continue to serve as chairman of the combined company. CenturyLink has agreed to appoint 4 Level 3 board members, one of whom will be a representative of STT Crossing Ltd., a wholly owned subsidiary of Singapore Technologies Telemedia. We'll discuss the pathway to closing in detail later in the presentation, but we expect the transaction to be complete by the end of the third quarter 2017, subject of course to the receipt of regulatory approval, shareholder votes and other customary closing conditions. STT Crossing Ltd., which holds 18% of Level 3, has agreed to vote in favor of the transaction.

With that, I'll now hand the call over to Jeff. Before I do that, I just -- I do want to thank him and his team for the extraordinary effort they have put forth on this transaction. We've longed admired Level 3, and I'm excited to -- that we are now combining forces. Jeff?

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

Thank you, Glen. I'm very excited to be here today with Glen and his team announcing this combination. As you can see from Slide 9, we are 2 strong enterprise-focused companies coming together to build an even stronger company able to address the evolving and growing needs of our customers. As Glen mentioned, we believe this is great transaction for our stockholders, customers, employees and industry partners.

As I look at the enterprise marketplace, there are a number of trends that will shape the future of communications. First of all, the demand for bandwidth continues to escalate. The move to IT and IT-based services is not slowing but accelerating. With the Internet of Things, the number of connected

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devices will explode over the coming years. Hybrid computing architectures used by enterprises are driving the introduction of hybrid wide-area networking solutions that bring together multiple technologies to meet customer demand. The advent of technologies like SDN and NFV are redefining the ways customers interface with their networks. And lastly, the need to address all of these trends on a global basis.

The combination of these 2 great companies will enhance our ability to meet the opportunities that these trends create. Whether looking at the network footprint or the breadth of the combined product portfolio, this combined company will provide tremendous benefits to our customers.

CenturyLink's managed services portfolio with Level 3's CDN and IP VPN capabilities all delivered over an extensive local and even global network. Our ability to use advanced threat intelligence and security services delivered by the combined company. This creates a company that will offer customers industry-leading capabilities over a world-class network.

I'd like to take a minute to give my perspective on why this is a compelling transaction for Level 3 stockholders, and why our Board of Directors unanimously approved this transaction. First of all, the purchase price is a premium to where our stock has been trading over the last year, with a meaningful portion of the consideration in cash. Shareholders also have the ability to participate in the upside of the powerful company we are creating together.

I truly believe that our ability to serve enterprise customers will be second to none. Communications is a scale business, and the combination of our substantial networks and platforms will enable us to deliver services to our customers more efficiently and effectively than either company could alone. I believe that our ability to grow will be significantly enhanced as a result of this transaction.

Before I turn the call over to Glen, I'd like to thank the Level 3 employees for their hard work through the years and into the future. Your dedication, vision for the company we are today and your unwavering commitment to our customers has built a great company. I feel lucky to be a part of such an incredible group of employees, and I'm excited to see what the future brings for us. Thank you.

With that, I'll turn the call back over to Glen.

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Thank you, Jeff, and turning to Slide 10. As you can see, CenturyLink and Level 3's businesses are highly complementary. And once the transaction closes, stakeholders will benefit from a more diverse business mix, with pro forma revenue of $24.7 billion, which excludes CenturyLink's other revenue; and total core revenue of $24.2 billion, which excludes CenturyLink's other revenue and data integration revenue. Under these assumptions, we expect more than 75% of our revenues to come from business customers and 65% of our revenues will be strategic revenue.

As Jeff mentioned a moment ago, we will also have the ability to enhance the service and connectivity we provide CenturyLink's large enterprise customer base across Level 3's global footprint. Given the complementary nature of the product portfolios, the combined company will offer an even broader range of services and solutions to meet the demand for bandwidth and new applications in an increasingly complex operating environment.

Turning now to Slide 11, as you can see, a key differentiator for our company will be that of the top service providers in the country, we have, by far, the greatest percentage of our business focused on enterprise customers, and we will become the second-largest competitive provider of network services to businesses in the United States.

Now turning to Slide 12, we highlight the significant total cash synergies we expect to achieve from this transaction, with $975 million, we believe, are very achievable annual operating and capital synergies. We expect approximately $850 million in annual operating cost synergies, mostly from corporate network and operational efficiencies and IT systems consolidation, along with purchasing synergies across our

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advertising and marketing efforts. And we believe we can realize 80% of this annual run rate savings within 36 months after closing.

Our anticipated approximately $125 million in annual CapEx cash savings will come from purchasing synergies, which we expect to be -- to realize fully within 36 months. We currently anticipate that our onetime integration cost to achieve these cash savings will be approximately $685 million, with a majority to be incurred between closing and year-end 2019. Both of our companies have significant M&A experience and a strong track record of execution, with a proven ability to integrate and meet or exceed synergy targets. This gives us real confidence in our ability to successfully integrate our 2 companies.

I'll now turn the call over to Stewart to discuss the financial profile of the new company. Stewart?

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

Thank you, Glen. Expanding on what Glen outlined earlier, as you can see on Slide 13, the result of this transaction is a company with meaningful scale and financial strength, which will enable us to grow and capitalize on these synergy opportunities. The combined company's capital structure will benefit from a strong liquidity profile, including an approximately $2 billion unfunded revolver; free cash flow accretion, with a focus on sustainable free cash flow growth; and improvements in our long-term dividend payout ratio.

Our expected free cash flow generation will grant us a flexibility to continue to deliver solid returns, while positioning us to invest in strategic growth initiatives and opportunities, allowing us to better compete in a complex operating environment. On a pro forma basis, we expect the combined company to have net leverage of approximately 3.7x and our long-term leverage target remains at approximately 3x.

Turning to Slide 14, this is an overview of the pro forma arch structure depicting the combination and the associated new debt raise. The acquisition is structured such that Level 3 will be a subsidiary of CenturyLink post-acquisition. Level 3's current debt will stay in place, and existing Level 3 entities will not incur or guarantee any acquisition debt. Based on expected ratings, change of control puts in the existing Level 3 debt will not be triggered. No consents are required from Level 3 lenders or noteholders for closing the acquisition.

All the new acquisition debt will be raised at CenturyLink, and will rank ahead of the existing CenturyLink notes by virtue of expected guarantees from material nonregulated CenturyLink subs, including the EMBARQ parent, and the newly created Level 3 holdco. The new debt will also benefit from expected pledge of stock of QC and Level 3 Communications Inc. QC, a regulated entity, will not guarantee or provide explicit support for any new indebtedness.

Purchase price will be funded by cash on hand at closing for both CenturyLink and Level 3, as well as committed financing of $10.2 billion from Bank of America Merrill Lynch and Morgan Stanley financing, which includes a $2 billion revolver and $1.2 billion commitment to address upcoming maturities between signing and closing, resulting in incremental funded debt for the transaction of approximately $7 billion.

With that, I'll hand the call back over to Glen.

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Thank you, Stewart. Before this -- turning to growth on Slide 15. The -- before this transaction closes, there are a number of key conditions that must be met, including HSR and FCC review and certain state regulatory approvals. We believe regulators will see the benefits of this transaction once they learn more about the details and the benefits to customers. We look forward to discussing this transaction with regulators. As previously mentioned, the transaction is also subject to approval by CenturyLink and Level 3 shareholders, and we're pleased to have secured a voting agreement in favor of the transaction with STT Crossing Ltd.

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Now turning to Slide 16, and to conclude our remarks pertaining to the transaction before touching on our quarterly earnings, we're confident in the compelling strategic and financial rationale of this transaction and the many benefits it will bring to CenturyLink and Level 3 stakeholders. The combined company will provide our customers with the network they need to improve their lives and strengthen their businesses.

For employees of both companies, we believe this combination will also provide additional growth and advancement opportunities over the years to come, and I look forward to continue to work with our best-in-class team, welcoming the talented members of the Level 3 team. We're truly excited about CenturyLink and Level 3's future as a combined company and sharing those benefits with all stakeholders as we move forward with this exciting combination.

As we transition to third quarter results -- earnings results, I want to provide a few high-level comments about CenturyLink's third quarter results before turning it over to Stewart. We continue to see the benefits of our operational initiatives and network-first focus, and we are making progress on our broadband enablement road map, which we believe is critical to meeting our customer's long-term growing demand for bandwidth. We remain focused on continuing our pivot to higher-quality broadband customers. And while we still have more improvement to achieve on a year-over-year basis, in the third quarter, we added higher ARPU customers, lower churn and fewer high credit risk -- high risk credit customers in the quarter. So we're making that pivot with our consumer base, and we saw those results -- those trends in the third quarter.

Business strategic service revenues grew 5% year-over-year, led by more than 6% growth in high-speed -- high-bandwidth data service revenues. Business revenue was negatively impacted by churn, along with a renewal of several large customers in the quarter, which included some repricing impact. However, we are pleased with these renewals that will help us to maintain long-term relationships and recontract a significant amount of revenue over extended terms.

And lastly, we are pursuing a number of activities with lower expenses, including a significant reduction in nonemployee-related expenses, and also a reduction of 78 -- 7% to 8% in employee-related costs. We remain focused on continuing -- excuse me, these cost reductions are part of our continued effort to keep costs in line with our revenue streams, will position us for the legacy revenue pressures going into 2017.

With that, I'll turn it over to Stewart.

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

Thank you, Glen. Over the next few minutes, I'll review the third quarter results and provide an overview of the fourth quarter 2016 guidance we included in our earnings release this morning. Please note that I'll be reviewing some of the results, excluding special items as outlined in our earnings release and associated financial schedules.

Now let's dive in. Today, CenturyLink reported solid third quarter results, with total and core revenues, operating cash flow and adjusted diluted EPS, all within our guidance range. Third quarter operating revenues were $4.4 billion on a consolidated basis, a 3.8% decrease from third quarter 2015 operating revenues. This decrease was primarily driven by lower legacy revenues and a decrease of approximately $100 million in high-cost support revenues due to onetime out-of-period CAF Phase 2 support payments recognized in the third quarter last year. These decreases were partially offset by higher strategic services revenues. Overall, strategic revenue grew 4.5% year-over-year.

Core revenue, which is defined as strategic revenue plus legacy revenue, was $3.92 billion for the third quarter, a decline of 1.9% from the year-ago period. Operating income was $595 million for the third quarter 2016, while we generated operating cash flow of approximately $1.6 billion during the quarter. Free cash flow, defined as operating cash flow less cash paid for taxes, interest and capital expenditures, along with the cash impact of pension and OPEB cost, stock-based compensation and other income, was $186 million for the quarter.

You may remember last quarter, we had said that we expected higher cash taxes in the third quarter as the tax payment was deferred from the second quarter. In addition, we made a voluntary pension

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contribution of $100 million during the third quarter. These 2 items accounted for over $400 million of lower free cash flow in the third quarter of 2016 as compared to the second quarter.

On a GAAP basis, diluted earnings per share for the third quarter of 2016 was $0.28, a decrease from $0.37 in the year-ago period. Adjusted diluted earnings per share for the third quarter of 2016 was $0.56, a decrease from $0.70 in the third quarter a year ago.

Now moving to Slide 19 in our Business segment. In the third quarter, the Business segment generated $2.61 billion in operating revenues, which decreased $30 million or 1.1% from the same period a year ago. Legacy revenues from the segment declined 7.6% from third quarter last year due primarily to a continuing decline in voice and low-bandwidth data services revenues. Third quarter strategic revenue for the segment was $1.23 billion, an increase of 5.1% compared to third quarter 2015, driven primarily by the continued growth in high-bandwidth data services.

On a sequential quarter basis, we had a headwind from the onetime favorable settlement of approximately $10 billion -- $10 million that was reported in high-bandwidth data services in the second quarter of this year. Data integration revenues increased $10 million from third quarter 2015, due primarily to higher CPE sales. Total Business segment expenses increased $16 million or 1% from the year-ago period, driven primarily by CPE costs related to the higher data integration revenues.

Now turning to Slide 20, the Consumer segment generated $1.47 billion in operating revenues, a decrease of $37 million or 2.5% from third quarter 2015. Strategic revenues in this segment grew 3.4% year-over-year to $789 million, driven by year-over-year growth in broadband and Prism TV revenues. Legacy revenues for the Consumer segment declined 8.3% from third quarter a year ago, reflecting access line declines and lower long-distance revenues. Our operating expenses increased $19 million or 3% compared to the same period a year ago, due primarily to higher content costs related to our Prism TV service.

Now turning to Slide 21. For fourth quarter 2016, we expect operating revenues of $4.28 billion to $4.34 billion, core revenues of $3.86 billion to $3.92 billion, and operating cash flow between $1.58 billion and $1.64 billion. Adjusted diluted EPS is expected to range from $0.53 to $0.59. In the fourth quarter, we expect continued growth in strategic revenues to be offset by anticipated declines in legacy revenues and data integration revenues, resulting in lower fourth quarter 2016 operating revenues compared to third quarter of 2016.

Fourth quarter 2016 operating cash flow is expected to be relatively flat compared to third quarter of 2016, primarily due to the anticipated decline in revenues being offset by lower operating expenses, primarily related to the seasonality of outside plant maintenance and utility costs, along with anticipated lower personnel and CPE costs. Additionally, as it pertains to the fourth quarter, we expect to incur severance costs of approximately $150 million to $200 million related to planned headcount reductions.

These severance costs will be treated as a special item and are therefore excluded from fourth quarter guidance ranges provided. As the fourth quarter guidance implies, we are currently expecting to come in below full year 2016 guidance ranges previously provided for certain financial metrics. This is primarily due to the weakness that we've experienced in customer units during the third -- second and third quarter. We expect our dividend payout ratio to be in the mid-60% range now for 2016.

I'll now turn the call over to Jeff to briefly discuss Level 3's third quarter results.

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

Thank you, Stewart. I'll just dive right into our third quarter results. During the quarter, the benefits of our operating leverage and focus on profitable growth drove solid bottom-line performance. Margins continued to expand, and we saw solid growth in adjusted EBITDA and free cash flow. However, from an enterprise core network services revenue perspective, I'm still not happy with our results. We did not see the improvement in CNS enterprise revenue growth in North America or in EMEA that we expect. Since our second quarter call, we've spent quite a bit of time analyzing our own performance and addressing the issues we've identified. I will let Sunit go into the numbers, but I'll share a few thoughts about North America before handing the call over to him.

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First of all, a logical question is whether the revenue slowdown is associated with a lack of market opportunity for the types of products and services we sell. The answer to this is a firm and clear no. We continue to see market opportunity and demand for the services we provide. As examples, demand for transport services such as waves and dark fiber is strong, and we remain very capable in selling and delivering these services to customers.

Cloud Connect Solutions, IT services, IP VPNs and hybrid LANs continue to address the key need in the marketplace. As a reminder, hybrid LANs are the unique ways we combine a mix of public and private networking services to address customers' desires to support hybrid computing architectures. As a final example, our ability to ramp security, managed services and professional services around these products is a key differentiator, and is also well-received within the market.

I have a great deal of confidence that the market opportunity remains attractive, that our competitive position is strong, that we have the right products and services to meet the needs of this market and that the market is moving toward Level 3's strength and capabilities, not away from us. If you look at the revenue growth from our large multinational customers and the higher-end customers of our target market, you can see that our value proposition clearly resonates with these customers.

As further evidence, in general, sales are good. However, our churn is too high. Over the past year and a half, we made a number of decisions that were relatively small in isolation but have had the cumulative effect of pressuring revenue, particularly with the lower end of the base. These decisions can be broadly grouped into 2 categories. The first, our efforts to move upmarket. I still believe this is the right decision, but as I look back, we made a couple of mistakes that created customer coverage issues. First of all, we took a very aggressive approach and moved 8,000 customers to inside sales. Frankly, we didn't do it as well as we should have and created a communication void at the lower end of our customer base.

With slightly larger customers, but still at the small end, we left those customers in the field sales organization and really lost focus on them as we asked our direct sales force to move upmarket. Again, creating a communication void with these customers. Sunit will share the numbers, but as a result, we saw elevated churn from both of these groups of customers.

The second set of decisions were centered on evolving and rationalizing our product set. We firmly believe in our capabilities and we're excited about moving customers to new technologies. We see great acceptance in the marketplace for these capabilities. However, coupling our desire to move upmarket, with higher sales quotas we assigned to the sales team and with compensation plans rewarding sales more than revenue, we transitioned our customers more rapidly than they would have moved on their own. While we recognize the transition to new technologies is good for our business, accelerating our own customers' transitions faster than their natural rate, results in more work for the operations team while producing a net write-down in revenue. We saw this dynamic effect customers across the various groups Sunit will discuss.

If I can go back, I'd make some of these decisions differently. By being an aggressive company, we moved fast and leaned into growth. Going forward, we have a number of initiatives to address the issues we found. We are implementing a customer retention group within our sales -- inside sales and our field sales organizations to retain customers more effectively. We're augmenting our staff to reach out more frequently and communicate more effectively with smaller customers. We are reestablishing our focus on adding new logos, we've lost a little bit of attention to these.

We are directing our teams to aggressively renew existing services with smaller customers, rather than intending sales or the customers to transition to new solutions today. We still want to transition to new services, but at their natural rate, not at an artificially accelerated rate because of the unintended consequences of other decisions. In addition, we've realigned our sales compensation more heavily weighting revenue than sales. We made process and organizational and structural changes designed to enhance the customer experience and service delivery and service assurance. While I'm optimistic about these changes, churn is the lagging indicator and they'll take time to deliver results.

Before I turn the call over to Sunit to provide the detailed financial results, I'd like to sum up by saying we are intently focused on improving enterprise revenue performance. We believe the market opportunity

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is strong, our value proposition resonates with our customers, and that it's within our own execution to improve revenue growth.

With that, I'll turn the call over to Sunit.

Sunit S. Patel
Chief Financial Officer and Executive Vice President

Thank you, Jeff, and good morning, everyone. As Jeff just mentioned, we had a mix quarter with solid bottom-line performance, highlighted, on Slide 23, by continued margin expansion, double-digit adjusted EBITDA growth and strong free cash flow generation, offset by softness in North America enterprise revenue performance. Overall, total revenue grew 0.4% and CNS revenue grew 1.1%. Enterprise CNS revenue, excluding U.K. government, grew 3.7%. Within CNS, revenue from our large multinational enterprise customers increased 10%. Total wholesale CNS revenue declined 4.2%, primarily due to continued consolidation-driven disconnects.

I'll now shift to our regional results, which can be found on Slide 24. North America CNS revenue grew 1.4% year-over-year. Enterprise CNS revenue grew 3.1%, driven by solid performance from our largest customers, offset by continued pressure from the low end of our base. As Jeff explained, revenue performance at the high end of our customer base is performing well. The challenges we've seen this year are really from the lower end of the base. As you can see on Slide 25, our largest global accounts customers, who make up 17% of our North America Enterprise CNS revenue, grew 1.9% sequentially. In the next year, customers that spend more than $20,000 per month grew 1.2% sequentially. Customers who spend $2,000 -- between $2,000 and $20,000 per month declined 0.6% sequentially. Finally, our smallest customers, spending less than $2,000 per month and representing 5% of the North America enterprise base, declined 18% sequentially.

Moving to EMEA, CNS revenue declined 7.7% with enterprise CNS revenue, excluding U.K. Government, declining 3.7%. In the region, we've been successful with large multinational customers, but they usually order more complex services with longer installation in tools [ph]. Higher churn continues to be a challenge for the EMEA region, and we have implemented several improvement initiatives to improved churn. For the past couple of quarters, we've experienced weakness in conferencing, co-location and lower-speed services.

Going forward, we are transitioning the business to focus on higher bandwidth On-Net services. Usage revenues also weakened in the third quarter driven by some large IP customer rerates. We expect sequential improvement in the fourth quarter. Overall, in EMEA, we are encouraged as enterprise CNS sales bookings in EMEA are up about 40% year-to-date compared to 2015, and we expect improved revenue performance in the coming quarters.

In Latin America, we saw strong enterprise performance, driven in part by the Olympics. CNS enterprise revenue grew 16%, or 13% if you exclude the benefits from the Olympics, which was about $4 million in the third quarter. For the quarter, our overall sales bookings for the company were up both year-over-year and sequentially, and our sales funnel remains healthy. From a product group perspective, IP and data services grew 3%, transport and fiber declined 1%, voice services grew 0.4% and co-location and data services revenue declined 0.2% year-over-year. From an individual product perspective, dark fiber grew 5%, CDN grew 15%, and managed security grew 16%.

Turning to Slide 26, adjusted EBITDA was $716 million for the third quarter of 2016. This compares to $641 million in the third quarter of 2015. The double-digit percentage improvement in adjusted EBITDA was driven primarily by the improvement in network access costs, along with tighter management of operating expenses. We also continued to expand adjusted EBITDA margin, which improved nicely to 35.2% in the third quarter of 2016 compared to 31.5% in the third quarter 2015.

Year-to-date, capital expenditures were approximately 17% of total revenue. During the quarter, capital spending was higher than previous quarters, as we invested to meet stronger demand from fiber and wavelength sales. The company generated free cash flow of $281 million in the quarter compared to $237 million from the year-ago quarter.

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In summary, we remain focused on our revenue performance and have multiple initiatives in place to drive growth. We are excited about the combination with CenturyLink and look forward to what lies ahead.
With that, I'll turn the call back to the operator so we can get to your questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from the line of Simon Flannery with Morgan Stanley.

Simon William Flannery
Morgan Stanley, Research Division

Glen and Jeff, I just wonder what color you could give us about the background to this deal. What made you decide that this was the right structure and how long have you been talking about that? And then any implications to the data center transaction, Glen, as well?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

I'll start, Simon. First of all, the -- Jeff and I have talked from time -- we've known each other for quite some time, and we talk from time to time. A few months ago, we got together and talked about the industry and began talking about the opportunities of putting our companies together, the more we considered the possible benefits, bringing these companies together, the complementary products and services that we were building. We took a hard look at synergy opportunity. We said this is a transaction we have to at least consider. And from that point, we went forward and did a lot of work, and -- over the last several months, and realized that -- and it came to a place we were able to put our companies together. And the structure came about after a long process -- or negotiating price and structure and all this over a long period of time. But it's been a -- and I appreciate Jeff and his team, they've been great to work with and we're looking forward to this leading the transaction. Jeff, you want to...

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

Sure. I think the financial benefits speak for themselves. But there are also the market benefits that I talked about in deciding that we should put the 2 companies together. If you think about those market trends that I mentioned in the prepared comments, every one of those are addressed better by CenturyLink and Level 3 joining forces and building those capabilities together rather than going after them alone. And so as we look at the market and we say how do we win best, how do we not only capture the synergies and take advantage of those types of things, but how do we deliver our products better, how do we deliver our services more effectively to customers, each one of those trends are addressed very effectively by this combination.

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

And Simon, regarding the data center process, that process continues. We expect to successfully complete our process here in the -- during the fourth quarter. The -- although Level 3 has a lot of data centers, a lot of those are network co-location centers and not comparable to the centers that we sow [ph]. I think they have 3 in the United States, they're really more -- they're comparable to the data centers that we were operating. And we -- it just -- it wasn't a major consideration of ours and -- as we looked at the benefits of the transaction. And it certainly -- it's really early stages now. We'll take a look at those in the months ahead and see how we should best rationalize what we have there.

Operator

Our next question comes from John Hodulik with UBS.

John C. Hodulik
UBS Investment Bank, Research Division

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Maybe just a quick question on the dividend. Maybe Glen or Stewart, what's the dividend payout ratio for the combined company at close? Maybe you can also talk about how quickly you think you'll eat through the NOL. And then at that point, what will the dividend payout be after the NOLs has been used?

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

Yes, so John, we would expect to use a little less than $2 billion of NOL in each of the first 4 years, which provides $650 million to $675 million cash benefit from a tax perspective. CenturyLink's dividend payout ratio this year, we mentioned on the call, will be in the low to mid-60s. Next year, because of the cash taxes that we anticipated increasing, our payout ratio is going to bump up to the low to mid-80s. When you get about 4 years out, the dividend payout ratio moves down to about 60%. So it helps our dividend payout ratio about 10 percentage points each year until you get in the first year, really. And then from that point forward, closer to 15 to 20 percentage points a year. And that's with the combination of utilizing the NOLs as well as the synergies that we expect to create or generate.

Operator

Our next question comes from the line of David Barden with Bank of America.

David William Barden
BofA Merrill Lynch, Research Division

Congratulations on the transaction. I guess, a couple, if I could. First, Jeff, could you maybe opine a little bit on kind of what you see as the compare and contrast benefits to a deal with CenturyLink as opposed to, say, a cable company, where you guys would maybe be the enterprise strategy for that company? Could you talk about the breakup fees in this transaction? And then last, maybe Glen, could you talk about how this changes the character of CenturyLink's posture on BDS. As a function of merging with Level 3, would you now be an advocate for more aggressive BDS reform as it would potentially benefit you on a net basis?

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

Sure, so let me talk about the compare and contrast comment you had -- or question you had. I'm not going to look at and talk about other people's business plans, but I'll talk about the business plans for this combined business. And as I look at the challenges that Level 3 has in the marketplace and look at the various competitors that are out there and realize that CenturyLink is a very good fit for us as a partner, and that we are a very good fit for CenturyLink. So I go back to those market trends that we talked about and how do we best satisfy those market trends and address them, and this is the right combination for us to do that. And so I'm very excited about it. I think that we will be able to build and enhance customer experience. I think that we will bring technologies, like SDN and NFV, to bear for our customers and faster than we could of done on our own. And I look at all of those capabilities and know that we're putting 2 excellent companies together, both of which have a very strong enterprise focus. And that joint focus will help drive the enterprise business of the combined business.

David William Barden
BofA Merrill Lynch, Research Division

With respect to the breakup fees of -- with you guys?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Yes. Now the breakup fees will be in the proxy we filed and about at normal ranges of breakup fees, and we'll file that soon. And then regarding the BDS impact, obviously, the BDS process will be overall positive to Level 3. The -- we will -- although -- even with that, we aren't going to change our position here. We are still maybe a year away from close, so we'll work through this process with the FCC and others in the weeks ahead. But we will not change our position.

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Operator

Our next question comes from the line of Frank Louthan with Raymond James.

Frank G. Louthan
Raymond James & Associates, Inc., Research Division

I guess, my question is more for Jeff and Glen. I mean, you look here in the numbers for Level 3, again, a little bit lower estimates and growth was slowing. What confidence can you give us that, sort of on a combined company, you'll see them grow? Usually, when we see some of these combined deals, the growth declines little bit at the outset. On both sides, why is this going to be different going forward?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

I'll take a shot, Jeff, and you can add. First of all, I -- we bring a lot of product enhancements from both companies. We take the best of both worlds, which is important. We'll have an expanded network. And really, for the first time, we will be able to compete in more of a head-to-head basis with our 2 largest competitors. And that's a really big factor here. So we're confident with the product improvements, the bigger network, the -- just the ability to improve the customer experience with our combined systems and processes that it really positions us well for growth in the future. I'm confident that we'll see a lot of revenue synergies. We didn't model any revenue synergies into our pro formas, and looking at this opportunity when to talk about the accretion. But we think there are certainly revenue synergies that we will obtain in the months ahead.

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

And I'd just add that, first of all, in telecommunications, scale and scope matter. And this combination takes 2 fairly large companies and puts them together and brings to bear our ability to really scale each other's strengths. If you look at Level 3, we sell a large number of IP VPNs. When we have to go off-net, that reduces our margin. But it also reduces our ability to really control the customer experience end to end. By combining with CenturyLink, we will be able to put more of those locations on-net, we'll bring their scale to us. If you look at CenturyLink selling to global customers, they have historically a disadvantage in selling in EMEA or Latin America. We'll bring the Level 3 network to their customers and help them extend the products and services in the scope of those products and services. And so I believe scale matters. I believe the scope and the breadth of our product set matters. And then I look at Level 3 and our own performance from now until the time of closing, and I realize that the -- our performance is based on our execution. It's not a market challenge, the market is there. It's not an economic challenge. Our customers need our products and services and they're growing. It's not at a technology challenge. We have the right technologies and the right services for our customers. It's up to us and our execution. And I have very high confidence that our execution is -- that we do very well historically and we'll continue to do very well in spite of the challenges that I discussed in the prepared remarks.

Frank G. Louthan
Raymond James & Associates, Inc., Research Division

Okay, great. And any thoughts on -- or commentary on how this will impact your initiatives on residential -- on sort of the residential fiber and those kind of builds?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Yes, the -- this will not really impact us in a negative way at all. I think, if anything, it really enhances our ability to bring very high-speed products and services to our consumer base, as well as the SMB customers. So we will continue our aggressive approach as we've mixed before -- over the next -- about 2019. And we expect, for our top 25 markets, that we will have over 90% of homes and businesses passed with 40 megabits of more service. We'll have over 70% of those businesses passed with 100 megabits more of service, and then over 20% of those homes and businesses passed with GPON or 1

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gigabit or more. So we are still on track for that and we won't change those objectives, and we think it's very important to our future.

Operator

Our next question comes from the line of Brett Feldman with Goldman Sachs.

Brett Feldman
Goldman Sachs Group Inc., Research Division

So if I go and take a look at Slide 11, where you show how the combined company stacks up in the wireline enterprise segment. One of the things that sort of stands out is that the current top 2 in that sector, AT&T and Verizon, also sell mobility into enterprises. In the case of AT&T, it's actually a fairly meaningful part of how they think about the revenue opportunity in that addressable market. And so as you think about how this deal is going to really elevate the combined business into the league that these guys are playing in, how do you think about the role of mobility being a part of the solution set that you offer? And if it is something you think that's going to be increasingly important, what are some of your options for incorporating that?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

From our standpoint, the primary product or service we provide with mobile is a backup to our fiber network, the backup capabilities. In the SMB space, with think there'll be opportunities perhaps to -- with the advanced 5G services to bring even a different approach, and we would be providing wireless access in some cases. But we're working with the wireless providers. We are a great distribution arm for those companies. And we're talking to them, as we speak, about further partnerships, ability to work together because we have -- we'll have the primary access capability with our fiber, and we'll want to bring -- resell their wireless. We don't see any need at this point to go out and buy a wireless carrier. We think these companies are working well with us, and we're actually making a little money with the reseller ranges we have in place today. So we'll continue to work with them. But it's not a major factor for us and our ability to compete in our view. Jeff, you want to add to that?

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

No, I think that's right. I -- this is not my phrase, I stole it from somebody else in the industry, but I think wireless means exactly what the word implies, which is just a little less wire. Communications wants to get to less as quickly as it possibly can. Our enterprise customers look to us to solve those types of problems for them, not their mobile connectivity, and how do they integrate -- interconnect their employees with their customers, network their systems with their capabilities and tools to deliver their products and services, how do they connect to their customers. And so we will continue to focus on providing those high-end solutions for our enterprise customers, and we haven't seen that impact our ability to grow over the past years. I don't expect it to impact our ability to grow in coming years.

Operator

Our next question comes from the line of Philip Cusick with JPMorgan.

Philip Cusick
JP Morgan Chase & Co, Research Division

So for Glen, you mentioned your Consumer side. Given how small Consumer is of the combined company, does it make sense at some point to spin this off? And for Jeff, CapEx higher really sounds like for dark fiber. You've always said this wasn't your thing, what's changed? And 16% implies a big slowdown in the fourth quarter, why do you expect that to happen?

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

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Yes, Phil, regarding Consumer, yes, today it's still a big part of our operation, and will be going forward. A lot of cash flow there. So -- and we don't have any plans at this point to spin out the Consumer piece. it's certainly -- probably an option for us. But right now, we're excited about that business and the expansion we're doing, the new products we're bringing, the improvements we're seeing in the last quarter with the Consumer business, so we are pleased where we are right now. That's certainly an option for us, but not an objective.

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

Yes. And I'll let Sunit comment on the specifics, but when it comes to CapEx, we've been very, very consistent. We invest to grow our company. We invest to grow free cash flow. So invest to get operational savings, we invest to drive revenue growth, we invest in dark fiber expansions. And our capital as a function of revenue is up slightly versus where we thought it would be for the full year, but it has a lot to do with a lot of success that we see in dark fiber and other things. And Sunit, do you want to get...

Sunit S. Patel
Chief Financial Officer and Executive Vice President

Sure. Yes, I think moving up our CapEx is a positive sign. We've seen very strong demand for 100 gig wavelengths, we've seen very strong demand for dark fiber. So it's to meet orders we have in hand, which is -- which we think is positive. Obviously, there are lead times involved between spending capital and turning up these orders. So we view it as quite positive. On the fiber side, because we are seeing strong demand in fiber and many of our fiber customers pay cash up front, you'll note that we increased the CapEx guidance for the year from 15% to 16% of revenue, but we did not change our free cash flow guidance because we are getting paid in cash for turning up those fiber segments. So it's actually quite a strong sign for both our wavelength business and our fiber business.

Operator

Our next question comes from Nick Del Deo with MoffettNathanson.

Nicholas Ralph Del Deo
MoffettNathanson LLC

This one's for Jeff. So there's a fair amount of uncertainty in the market regarding your longer-term revenue growth outlook given the performance over the last couple of quarters, and you've been clear that you're not happy with where it stands. Even if not in quantitative terms, can you talk a bit about what sort of stand-alone growth expectations you used when assessing the value of your equity? And more generally speaking, why do you think now is an appropriate time to sell the company as opposed to a period in the future where you might have been able to negotiate from a position of greater strength?

Jeffrey K. Storey
Chief Executive Officer, President, Director and Member of Classified Business & Security Committee

First of all, I think that the combination with CenturyLink is the right solution for Level 3. And so I look at our revenue growth and our ability to satisfy those customers and feel that we were negotiating from a position of strength with respect to what type of company could we build. And so I look at -- when we talk about our revenue -- I'm not going to give quantitative numbers. But when we talk about our revenue growth, we have very clear expectations for what's acceptable, where we think we can be. And we look very diligently at what is -- what are those opportunities and are we executing on them effectively. So looking forward, as I mentioned earlier, I am very focused on making sure that we addressed some of the decisions we made that moved us and our focus away from the smaller-end customers. That's been our problem. And if you look at the results that Sunit shared, it very clearly points out that it's not a problem in the market, is not a problem with our products and services. Our hiring customers where we are focused have been growing and growing nicely. Now the lower-end customers, where we took our eye off then, when you stop talking to customers, when you create that communication void, they start to look for other solutions. And we just need to make sure that we are talking to them effectively. We know these are not customers that are early adopters for products and services, but that you have to stay focused

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on them if you want to maintain them. And so our revenue initiatives are more around churn control. We always want to drive sales and we always want to drive the top line growth. The bigger challenge for us right now is that churn in the smaller end of the base. Now Sunit also pointed out that, that small end of the base represents 5% of our revenue. And I'd also point out that it's one of the strengths of CenturyLink, looking after those customers. And so we think there are things about this deal that are very, very good for our ability to grow revenue not only over the course of the next year until this deal closes in the fall of 2017, but beyond that.

Nicholas Ralph Del Deo
MoffettNathanson LLC

Okay. And if I can squeeze one in on NOLs. Are there going to be any usage restrictions post-deal?

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

There are, because of this change of control in Level 3. But on EBIT calculations, we can still use again a little less than $2 billion a year of NOL.

Operator

Our next question comes from Aamir Rozwadowski with Barclays.

Amir Rozwadowski
Barclays PLC, Research Division

A quick housekeeping question, if I may. You mentioned that you expect to get to that leverage target of 3x. How should we think about the pace of progress in getting there? And then, clearly, when we do the math -- and you'd mentioned, clearly you're looking at a lower payout ratio going forward. How should we think about sort of capital allocation strategy? Is it primarily focused on deleveraging the combined balance sheet? Is there an opportunity to grow the dividend? Is it more focused on some of the capital expenditure initiatives that you folks had mentioned in terms of driving the longer-term growth value proposition of a joint entity? Would love color from that perspective.

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

Yes. So it takes about -- I'll take about 4 years or so for us to get back down to an EBITDA ratio 3 to 1 -- 3 to 4 years, which we anticipate we can do. But the good thing about that it delevers from the free cash flow that's generated as well as increasing EBITDA that we expect to have as a result of both growth in the customer base, as well as the synergies that we expect to receive. So -- and achieve. The good thing about this is that because we delever so quickly, it'll give us the luxury of investing where we need to invest to be able to grow our business together faster than we can grow our business separately. From the dividend standpoint, we haven't really discussed increasing the dividend. But again, the dividend payout ratio will decline pretty significantly from 2018, which would be the first full year that we expect to be together after 2021.

Operator

We have time for one more question. The last question will come from the line of Tim Horan with Oppenheimer.

Timothy K. Horan
Oppenheimer & Co. Inc., Research Division

Could we go into the synergies a little bit more in the expense front? Just looking at your expense of network map here, there's kind of a lot of overlap in the long-haul networks. Just their ability over time to maybe realize more synergies from shutting down one or the other of the long-haul networks and -- just any thoughts. Because the synergy number at 3% of revenue seems a little bit low, but obviously, both companies have huge experience here with synergies, but it does seem low.

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Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Yes, Tim, I'll start out. The -- first of all, when we talk about the synergies, the vast majority -- or the majority of the synergies come from network rationalization. But a lot of our -- of the network is not overlap, it's really getting us to new areas, new countries and different parts of the U.S., giving us more options. I'll also add that with the Level 3 network, they have a lot of conduit available, which reduces the cost of build in these areas significantly down to like $0.50 a foot now, when you're -- just pulling fiber to conduit. So tremendous potential there, value creation over time with that asset. But right now, we feel like we've gone through the synergies pretty aggressively. And if there aren't more network synergies there, but we've -- the ones we've identified, we're very confident we'll achieve. Stewart, do you want to add anything or two?

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

Yes, I'll just quickly add, and Glen mentioned network rationalization. And Tim, in your question, you asked about would we shut down one of the long-haul networks. We've acquired a bunch of companies. We've looked at shutting down networks. Sometimes that makes sense. But we're very good at capturing synergies. Both companies have demonstrated the capability over time to do this. And so we're very confident about those. But network rationalization is more about converting off-net to on-net. And that really has a triple benefit to us. First of all, when we convert off-net to on-net, we control the customer experience end to end, we provide a better customer experience. We save money. We're no longer paying somebody else to provide that service for us. And we reduce the revenue of our competitors, because we're no longer paying our competitors to provide that service. And so we focus very aggressively, and I think both companies have this history, focused very aggressively on network rationalization. But it's is usually moving from other competitors on to our backbone to provide a better customer experience.

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

Yes, Tim, we look at the results of their Time Warner Telecom integration and how quickly they were able to convert those tail circuits to on-net, and it's very impressive. They've done a very great job with that.

Operator

And that concludes the Q&A session for today's conference call. It is now my pleasure to hand our conference back over to Glen for any closing remarks.

Glen F. Post
Chief Executive Officer, President, Director and Member of Special Pricing Committee

And thank you. Just in closing, we're confident this transaction significantly increases our scale. It increases our network reach. The combined company will have 75,000 on-net buildings. We'll have expanded products and services, solutions really to meet the global enterprise needs of customers. And we'll have -- we'll create significant synergies. Again, $175 million in cash synergies. We'll have nearly $10 billion in net operating losses to offset our cash taxes. We create the ability to delever from 3.7x, including run rate synergies to 3x or less within 4 years of closing. This transaction significantly improves our dividend payout ratio, approximately 60% level within 4 years post-closing. It strengthens our liquidity profile, including being accretive to free cash flow per share in the first year.

So overall, this is a great transaction I think for both companies in so many different levels, so many ways. So we're looking forward to the months ahead as we move toward the approval -- the proper approvals, bringing these companies together.

I want to thank you for joining our call today, and we look forward to talking with you further in the weeks and months ahead. Thank you.

Operator

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This concludes today's conference call. A replay of the call will be available on the Investor Relations pages of CenturyLink and Level 3. Thank you for attending today's conference call, and have a great day.

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