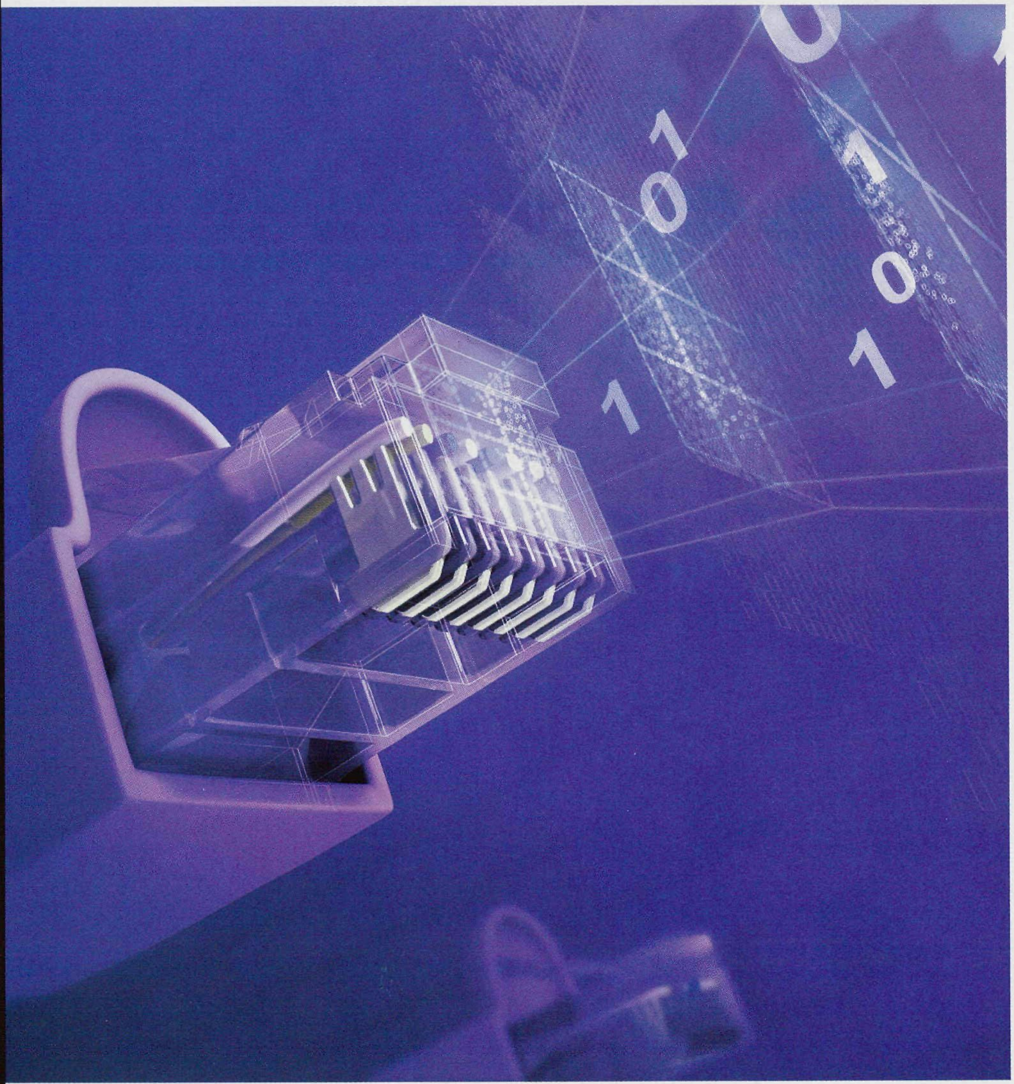
LANDLINES AND LAND MINES



Analysts are mixed on Qwest-CenturyLink merger, but principals see strength in complementary customer bases

BY ERIC PETERSON

The blue beacon of Qwest is gone from the Denver skyline, as memories of the dot-com rise and fall and the trial of Joe Nacchio have gone similarly dim. From the haze emerges CenturyLink, which – after closing on its deal to acquire Qwest in March for about $10.6 billion (and assuming another $11.6 billion in debt) – is the nation's third-largest telecommunications company. Look for the rollout of the CenturyLink brand in Colorado on everything from phone bills to billboards next month.

But the competitive landscape in telecommunications is in the middle stages of a major tectonic realignment, as broadband and wireless providers whittle away at the legacy landline market – one of Monroe, La.-based CenturyLink's strong suits.

And just two weeks before the Qwest-CenturyLink deal was consummated, AT&T stole the M&A spotlight when it announced it was acquiring T-Mobile USA for $39 billion to potentially become the country's largest wireless provider; whether the Federal Communications Commission will approve the controversial deal or not remains to be seen.

But back to CenturyLink. Analyst reviews of the merger with Qwest were mixed. Moody's liked the deal, but warned that the business model must shift away from landlines toward wireless and broadband – or else.

"The long term viability of wire line-only carriers relies on their ability to transform from regulated, voice-centric businesses to de-regulated broadband-focused providers," the debt-rating agency's statement read in part.

Donna Jaegers, a telecom analyst with D.A. Davidson, agreed with Moody's analysis but wasn't ready to recommend the stock. (D.A. Davidson's latest coverage rates CTL as an "underperform.") "Qwest diversifies CenturyLink's risk on regulatory issues," Jaegers says, citing an expected FCC tightening on intercarrier compensation rates later this year. "But other than that, Qwest is a huge melting ice cube because consumers continue to leave the company at a 12 percent pace year over year. CenturyLink has promised $575 million of cost synergies. I think that's realistic, but it's not like there are other layers of cost they can cut after that."

Locally, Colorado lost a significant corporate headquarters, but CenturyLink has no plans to abandon the state. Home to CenturyLink's B2B division, metro Denver is also one of six regional headquarters for the company, along with Phoenix, Minneapolis, Seattle, Wake Forest, N.C.; and Apopka, Fla.

After the merger, Kenny Wyatt relocated from St. Louis to Littleton to assume the role of president of CenturyLink's Mountain Region (Colorado, Utah, Montana and Wyoming), after serving in the same capacity for CenturyLink's South Central division, which was absorbed into the South Region as part of the realignment.

"The two companies essentially went to market differently," Wyatt says. "CenturyLink took a decentralized approach. We're trying to push decisions as close to the local market as we possibly can," in contrast with a more top-heavy model at Qwest. This allows local managers to tailor local packages and products to the particulars of the market, adds Wyatt, contrasting Colorado Springs and Salt Lake City, then Denver and Durango. "That is the key difference of the operating model. We can react based on what the individual market needs are."

Wyatt also says there are no plans to cut any jobs in Colorado, adding that the company is "still working through those decisions." (That said, the rumor mill is awash with talk of pay cuts to come, Jaegers says.)

CenturyLink's pre-Qwest footprint was

largely in the rural market, so management knows all too well that landlines have been losing ground for some time. It's been five years since the number of wireless-only households surpassed the number of landline-only households, and now a full quarter of the population falls in the former category. Verizon and AT&T have divested themselves of large numbers of them in recent years. CenturyLink lost 7.6 percent of its landline customers in 2010 alone, but that figure was smaller than previous years.

But CenturyLink bullishly pursued landline-centric business well before the Qwest deal: In 2009, the company scooped up Embarq, consisting largely of what was formerly Sprint Nextel's landline business. Along with 7.5 million access lines, the $11.6 billion deal brought with it a new moniker, and CenturyTel became CenturyLink.

Today's CenturyLink has more than 15 million access lines in its inventory, behind AT&T (44 million) and Verizon (40 million). While the latter two have been selling, however, CenturyLink has been buying.

Wyatt says he doesn't like the connotation of the term landline. "Both companies invested in a network in the ground. There's copper and fiber. We view it as an asset."

In the face of twin mobile titans Verizon and AT&T – which will be even more titanic if the T-Mobile deal goes through – CenturyLink's wireless portfolio is a trifle: Its 1 million wireless customers are dwarfed by Verizon's 100 million-strong base, even more so by the potential 130 million customers of a merged AT&T/T-Mobile.

While CenturyLink CEO Glen Post has avoided publicly commenting on the issue, a May *Bloomberg* story posited the theory that a CenturyLink-Sprint merger would be his next logical move. With 50 million wireless customers, Sprint holds the tertiary position in the market. And if some other angler nets Sprint, it's a steep drop-off from there in terms of quantity looking at other potential wireless partners for CenturyLink.

Wyatt downplays the possibility of a Sprint deal by giving kudos to CenturyLink wireless partner Verizon and offering a commitment to further investment in wireline upgrades on the company's network. "It's worked well in the past, and that's our strategy moving forward," he says. "That said, we continue to look for other options."

D.A. Davidson's Jaegers likewise doesn't see a CenturyLink-Sprint merger in the cards, citing "savvy" management that won't overpay for compromised goods and a reliance on the marginally profitable Verizon partnership. "About 25 to 30 percent of the homes in the U.S. now only use a wireless phone," she says. Without a strong presence in wireless, CenturyLink is left "trying to cut costs to offset losses in landline revenues."

The enterprise market looks like one of CenturyLink's strong suits, and the company's pending $2.5 billion acquisition of Savvis, provider of cloud computing and colocation services, will further shore up this strength. "We're expecting closing on (the Savvis) deal later this year," Wyatt says, highlighting "bolstered assets" in cloud computing and broadband telephony.

With CenturyLink's Business Markets Group headquartered in Littleton and under the purview of Chris Ancell who served as Qwest Business Markets' executive vice president since 2009, the strategy is to fuse Qwest's Fortune 500 market focus with CenturyLink's small-business emphasis, all the better because the companies had little geographic overlap before the merger. "That's the beauty of the merger of these two companies," Wyatt says of the complementary approaches to the business market.

Jaegers is likewise bullish on the potential of CenturyLink's enterprise-oriented business, labeling it a "helpful acquisition to grow revenues."

Echoing Moody's analysis, Wyatt says broadband is the heart of the company's current and future business. "Our stated strategy is to be the broadband leader in the markets where we operate. That is where our growth comes from in both residential and business."

CenturyLink's broadband spending is slated to increase by 16 percent to about $1 billion this year, and its rollout of bonded DSL – which bonds multiple pairs of typically copper wires going into a home or business into a single DSL line – allows for higher speeds without installing new infrastructure. "It's another tool in the toolkit," Wyatt says.

Wyatt says a faster broadband network allows CenturyLink to offer additional products and services that beef up the bottom line in a way the landline business cannot. Case in point: CenturyLink's Prism TV delivers 200 channels via broadband as well as a multiroom digital video recorder (DVR) and an interactive program guide, allowing CenturyLink the ability to offer a "triple play" bundle that includes video, voice, and broadband without outside help.

"Being able to offer content is important, and it allows us to compete with cable," Wyatt says. "This is a fabulous product." He touts Prism's "game-changing" features thanks to the set-top box's IP platform that ties into the customer's wireless network. "The options are endless. It's very similar to your smartphone." Currently available in eight markets – La Crosse, Wis.; Columbia and Jefferson City, Mo.; Las Vegas; Fort Myers, Orlando and Tallahassee, Fla.; and Raleigh, N.C. – Prism is on pace to have 1 million customers by year's end and will be unveiled in additional markets moving forward. Wyatt says the company does not yet have a timetable for a Colorado debut, also noting that CenturyLink's partnership with DIRECTV is central to the company's future plans, especially in rural markets.

D.A. Davidson's Jaegers says CenturyLink may be "a little late to the party" when it comes to broadband-based TV, noting that Verizon and AT&T unveiled similar services in the mid-2000s and only recently fostered them into the black. "The pay TV model is starting to show some flaws," she says. "Netflix has gone from miniscule streaming traffic to 29 percent traffic from 6 to 10. at night. That begs the question whether you can sell your customers an entertainment product, or will they opt for $8 a month and stream Netflix?

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"Qwest lost a lot of customers to Comcast because they were slow to upgrade to faster speeds," she adds. "Those customers weren't sitting around waiting for Qwest to get there – they went with Comcast. So now CenturyLink will have to compete with Comcast to win them back."