THE DEVIL'S ADVOCATE REPORT

January 21, 2011

CenturyLink, Inc.

(SELL)

Price:	$43.20	**Ticker:**	CTL
52-Week Range:	$14.16-$46.87	**Dividend:**	$2.90
Shares Outstanding:	303.3 million	**Yield:**	6.7%
Market Capitalization:	$13.1 billion		

Data as of January 20, 2011

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Investment Thesis

CenturyLink is a landline telephone company that currently provides service in 33 states, with Florida and North Carolina accounting for roughly one-third of its business. The company provides local and long distance service, network access to other carriers and businesses, and high-speed internet service. In July 2009, CenturyLink consummated a merger with Embarq Corporation, which was a 2006 spin-off from Sprint Nextel. As a result of the merger, Embarq shareholders owned approximately two-thirds of the combined company.

In April 2010, CenturyLink announced an even larger transaction than the merger with Embarq, a merger with Colorado-based Qwest Communications. The merger with Qwest, expected to be completed in the first half of 2011, is a stock-for-stock transaction in which Qwest shareholders will receive 0.1664 shares of CenturyLink for each Qwest share. The total transaction value is approximately $22 billion, including the assumption of $11.8 billion of outstanding debt held by Qwest. If the transaction is ultimately approved, CenturyLink shareholders will own 50.5% of the combined company, while Qwest shareholders would own the remaining 49.5%. The addition of Qwest will result in CenturyLink becoming the third largest telecommunications company in the country, with roughly 16.6 million access lines and 5 million broadband customers across 37 states.

Over the past decade, the dominant theme in the telecommunications industry has been the growth of cellular telephone service and the decline of landline service. To maintain their customer base, landline companies have emphasized the offering of high-speed internet service, which has helped offset consistent declines in telephone revenue. However, even this service has been cannibalized over the past decade by cable television companies, which began offering television, internet, and phone service (the so-called "triple play"). The competition for high speed internet service is about to increase even more, as wireless companies have begun to offer phones that act as so-called hotspots, allowing users to share their phone's internet connection with their desktops, laptops, and tablets computers. The hotspot capability of new wireless phones, coupled with the roll out of 4G networks that allow enable download speeds that exceed those offered by landline companies, indicate that landline companies will likely lose many internet subscribers over the coming months and years.

Recent reports highlight a critical (and perhaps obvious) trend in the telecom industry, which is the tendency of younger generations of Americans to more quickly abandon wireline service in favor of wireless service. A December 2010 report by the U.S. Centers for Disease Control and Prevention shows that the percentage of younger Americans living in wireless-only households (i.e., no landline phone) is far higher than the percentage of older generations of Americans doing so. In the first half of 2010, 51.3% of Americans in the 25 to 29 age group were living in wireless-only households. By comparison, only 5.4% of those 65 years and older live without landline service. Clearly, the demographic trends are working against landline service providers; over time, as younger generations comprise more and more of the adult population, the use of landline phones will no doubt decline. Yet beyond this demographic shift, it is important to note that the choice to abandon landline service is increasingly being made by *all* age groups. For example, the percent of those age 25 to 29 in wireless-only households is increasing at about 11% per year. The same figure for those age 30 to 34 is about 18%; for those age 35 to 44, a remarkable 28%. Furthermore, a significant percentage of people who still have landline service do not even use the service to make phone calls—their line is plugged only into their computer for internet service. Again, as wireless phones are increasingly able to provide hotspots at data download speeds available on 4G networks, these people may also choose to discontinue their landline service as well.

While these ongoing trends might indicate that landline companies face substantial challenges in the coming years, a short-seller of CenturyLink must contend not only with the cost of borrowing shares, but with the substantial dividend the company pays (due to the owner of the shares). Therefore, the timeframe and degree of the potential erosion in the share price are critical factors for those considering shorting CenturyLink. Based on recent acquisition multiples and current multiples of publicly traded landline competitors, post-merger CenturyLink appears to be reasonably priced. However, it can be shown, employing rather conservative assumptions, that the ongoing loss of landline customers could result in a negative earnings scenario for CenturyLink within the next three years. Perhaps more importantly, a loss of landlines might result in a substantial decline in free cash flow, which could lead to a decrease in the dividend. CenturyLink, with a 6.7% dividend yield, is likely largely supported by yield investors. Therefore, a cut in the company's dividend might serve as a catalyst for a substantial drop in the price of the shares.

In the Valuation section of this report, it will be shown that the combination of decreasing access lines, decreasing revenue per access line (as the company is subject to further pricing pressure by wireless competitors), negative operating leverage, and possibly higher interest rates on CenturyLink's $22 billion of debt could result in negative earnings and a dividend payout ratio that far exceeds 100% of free cash flow as soon as 2013. In order to support the current dividend, CenturyLink would have to: 1) significantly curtail the rate of loss of customers from that seen over the past five years—a substantial challenge given the combination of the displacement technology shift and demographic trends that are now occurring; 2) maintain its revenue per access line, even though the current revenue per line equates to an average monthly bill of $95 per month, versus a typical wireless provider bill (with unlimited local and long distance phone, texting, and internet) of $80 per month; and 3) avoid a significant increase in its cost of debt, even though the three major ratings agencies have recently put the company's credit rating under watch for possible downgrade.

Ultimately, the continued erosion of landline service will likely force CenturyLink to cut its dividend, which might cause yield investors to sell their shares. This could serve as a catalyst in the near term. Longer term, the failure to generate earnings might cause further decreases in the share price. Given these ongoing challenges, CenturyLink is recommended for short sale.

Company Description

History

The history of CenturyLink is rooted in the family of William Clarke Williams, who in 1930 purchased the Oak Ridge Telephone Company near Monroe, Texas. Williams and his wife, Marie, moved the Oak Ridge switchboard into their home, where Marie worked as the operator. In 1946, they transferred the company to their son, Clarke.

At this time, the Bell companies had begun to introduce dial systems, which enabled callers to reach a party without the intervention of an operator. The dial system proved so reliable for Clarke Williams that he decided to buy and upgrade a second telephone company, located in Marion, Louisiana. Soon, Williams began buying more companies located contiguously to the companies he already owned, which would enable him to handle toll calls between more locations and economize on maintenance.

In 1968, with 15 telephone companies in the enterprise, Williams decided to form a holding company and take it public. The new company was named Central Telephone and Electronics, and renamed Century Telephone Enterprises in 1971.

Throughout the 1970s, Century expanded into neighboring Arkansas and acquired telephone properties in Wisconsin and Michigan. In 1978, the company gained a listing on the NYSE, which gave it the recognition and access to funding it needed to continue growing. Over the years, Century gained a positive reputation among independent companies – while other acquirers were known for mass layoffs and other severe tactics, Century was respected for its dedication to existing management and employees. This reputation served the company well, as many small companies chose to deal only with Clarke Williams. By the 1980s the number of independent telephone companies in the U.S. had declined from 7,500 to about 1,500, and Century emerged as one of the largest independent telephone companies in the country.

The rapid growth of Century's cellular operations, particularly between 1985 and 1987, raised concerns that it could easily be targeted for a hostile takeover. Rather than loading the company with debt, a common but risky defense strategy, Century granted four votes to each shareholder who owned the company's stock for more than four years. The strategy was later augmented to ten votes for each shareholder of record prior to May 1987. This action brought a lawsuit from Mario Gabelli, who owned 14 percent of Century's shares, almost all of which had been purchased after 1987. The suit was ultimately dismissed, and Century succeeded in concentrating voting power through its employee stock ownership plan. The result was employee control of 40 percent of the company's voting rights.

Century continued to acquire local-exchange and cellular networks into the 1990s, building regional clusters. In 1997, it bought Pacific Telecom, Inc. (like Verizon, one of the original Bell Telephone spin-offs), for $2.2 billion. With the acquisition, Century gained operations in 12 Western and Midwestern states and Alaska, more than doubling its customer base.

In 2002, ALLTEL acquired CenturyLink's wireless operations, which, at the time, served more than 800,000 customers in six states. The $1.6 billion transaction allowed CenturyLink to expand its landline business, including the acquisition that year of 675,000 landlines in Alabama and Missouri from Verizon for $2.2 billion. In 2007 CenturyLink acquired Madison River Communications for $830 million, which added more than 160,000 rural access lines and an additional 2,400 miles of fiber network.

Business Description – CenturyLink (Pre-Merger)

CenturyLink mainly provides local telephone service in rural areas, as well as network access to other carriers and businesses. It also provides long-distance and internet access, and paid television service through an agreement with DIRECTV. The company currently has approximately 6.6 million voice lines (at September 30, 2010) and provides broadband internet access to roughly 2.4 million subscribers in 33 states, with its primary service areas including Alabama, Florida, Missouri, Nevada and North Carolina.

In July 2009, the company merged with Embarq Corporation, which was a 2006 spin-off from Sprint Nextel Corporation. Embarq had served 5.4 million access lines and 1.5 million internet customers, while CenturyLink (then CenturyTel) had served roughly 1.6 million access lines and 500,000 internet customers. As a result of the merger, Embarq shareholders owned approximately two-thirds of the combined company.

The combination of CenturyTel and Embarq resulted in the fourth largest local exchange telephone company in the country. At the time of the transaction, the average population density of CenturyTel's and Embarq's local exchange markets was 25 and 94 people per square mile, respectively. Therefore, the business of CenturyTel expanded to much more competitive markets (more densely populated areas), exposing the company to higher levels of service terminations. Also, the percentage of CenturyTel's revenue derived from governmental support programs, which compensate telephone companies for operating in less densely populated areas, was reduced.

The following table provides information pertaining to CenturyLink's access lines following the merger with Embarq, at December 31, 2009, and prior to the merger, at December 31, 2008.

State	Post Embarq Merger December 31, 2009 Access lines	% of total	Pre-Embarq Merger December 31, 2008 Access lines	% of total
Florida	1,352,000	*19* %	-	*0* %
North Carolina	1,071,000	*15*	13,000	*
Missouri	548,000	*8*	392,000	*19*
Nevada	523,000	*7*	-	*
Ohio	388,000	*5*	59,000	*3*
Wisconsin	343,000	*5*	368,000	*18*
Texas	303,000	*4*	32,000	*2*
Pennsylvania	271,000	*4*	-	*0*
Virginia	260,000	*4*	-	*0*
Alabama	254,000	*4*	274,000	*13*
Washington	200,000	*3*	147,000	*7*
Indiana	186,000	*3*	4,000	*
Arkansas	182,000	*3*	199,000	*10*
Tennessee	176,000	*2*	22,000	*1*
New Jersey	145,000	*2*	-	*0*
Minnesota	144,000	*2*	25,000	*1*
Oregon	109,000	*2*	62,000	*3*
All other states	584,000	*8*	428,000	*21*
	7,039,000	*100* %	2,025,000	*100* %

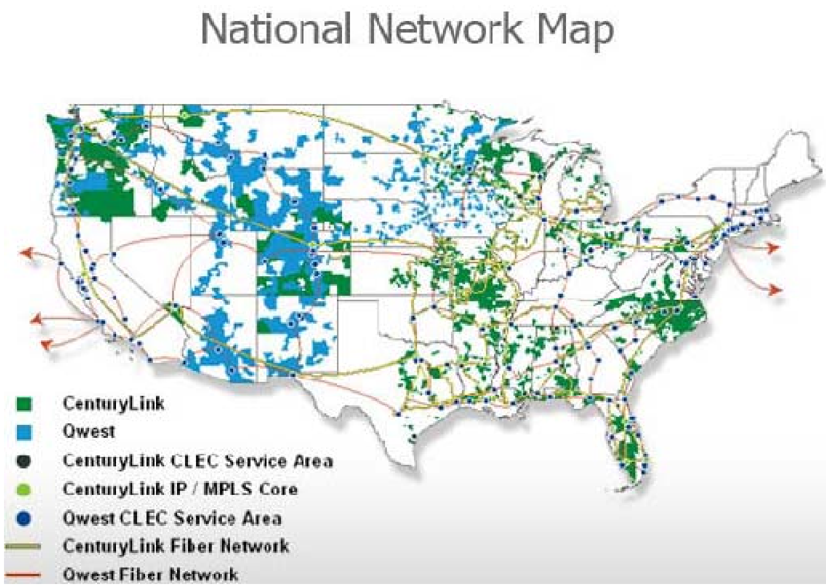
** Represents less than 1% of access lines.*

Overview of Qwest Merger

In April 2010, CenturyLink announced an even larger transaction than the merger with Embarq, a merger with Qwest Communications. The merger with Qwest, expected to be completed in the first half of 2011, is a stock-for-stock transaction, in which Qwest shareholders will receive 0.1664 shares of CenturyLink. The total transaction value is approximately $22 billion, including the assumption of $11.8 billion of outstanding debt held by Qwest. If the transaction is ultimately approved, CenturyLink shareholders will own 50.5% of the combined company, while Qwest shareholders would own the remaining 49.5%. The transaction is subject to final approval by both companies' shareholders, as well as regulatory approvals from the Federal Communications Commission and certain state public service commissions.

The addition of Qwest will result in CenturyLink becoming the third largest telecommunications company in the country, with roughly 16.6 million access lines and 5 million broadband customers across 37 states. The merger will also technically make CenturyLink one of the "Baby Bells", as much of Qwest was once U.S. West after the breakup of AT&T.

The following graphic is a network map of combined CenturyLink and Qwest assets.



CenturyLink expects the merger to result in annual cost savings, or synergies, of approximately $575 million. Management expects these synergies to be achieved primarily through the reduction of corporate overhead, the elimination of duplicate functions and systems, and increased operational efficiencies. Full synergies are anticipated to be fully realized within three to five years. The transaction is also expected to generate annual capital expenditure synergies of approximately $50 million within the first two years.

While these synergies might be realized, a recent case study exhibits the considerable challenges of successfully merging two landline companies. In 2007, Verizon sold its landline operations in northern New England to FairPoint Communications, a company based in North Carolina. The deal included the sale of 1.6 million landlines, and made FairPoint the eighth largest phone company in the U.S. From the beginning, however, FairPoint had problems integrating the acquired assets with its own operations. Among other problems, there were reports of thousands of recurring billing errors, poor customer service, lack of (and delay of) an electronic bill-pay option, slow or intermittent service, and inadequate response to customer complaints and service issues. In October 2009, FairPoint filed for Chapter 11 bankruptcy protection, citing as a primary reason for the bankruptcy the increased competition for telephone customers.

Industry Overview

The longtime monopoly in the telecommunications industry held by AT&T was broken by the U.S. Department of Justice in 1984, and resulted in eight regional Bell operating companies (the "Baby Bells"). These eight companies, along with GTE and MCI, remained the dominant companies in the industry over the next dozen years, until the passing of the Telecommunications Act in 1996. This Act sparked a series of mergers among the Baby Bells that has reduced the number of major competitors from ten to three. As shown in the chart below, CenturyLink's merger with Qwest is the latest in a long series of mergers in the industry.

History of Consolidation Since 1996 Telecommunications Act

Year				AT&T					GTE	MCI
1984	BellSouth	Southwestern Bell	Pacific Telesis	Ameritech	AT&T	US West	Bell Atlantic	NYNEX		
1996	BellSouth	SBC		Ameritech	AT&T	US West	Verizon		GTE	MCI
1998	BellSouth		SBC		AT&T	US West		Verizon		MCI
2006	BellSouth			AT&T		Qwest			Verizon	
2007		AT&T				Qwest		CenturyLink	Verizon	
2011		AT&T					CenturyLink		Verizon	

Over the past decade, the dominant theme within the telecommunications industry has been the growth of cellular telephone service and the decline of landline service. To maintain their customer base, landline companies have emphasized the offering of high-speed internet service, which has helped offset consistent declines in telephone revenue. However, even this service has been cannibalized over the past decade by cable television companies, which began offering television, internet, and phone service (the so-called "triple play"). The competition for high speed internet service is increasing even more, as wireless telephone companies have, in recent years, begun offering monthly plans with unlimited minutes that can be used for local or long-distance calls along with unlimited internet use. Smartphones such as the iPhone, the Droid, and Blackberry, which are designed to facilitate email use, internet use, and a limitless number of applications (i.e., "apps"), have only added to the perception that landline service is nearly obsolete.

Moreover, technological innovation in the wireless industry may only be in its infancy, and will likely result in a further erosion of the number of landlines over the next several years. For example, within the next five years, 4G wireless networks will likely achieve data download speeds that exceed those currently offered by the broadband service of wireline (and cable television) companies. 4G wireless networks offer more than 100Megabits per second (Mbps) in bandwidth, and while wireline companies may upgrade their networks as well, 100Mbps is more than enough bandwidth for consumers to satisfy all of their video, voice and data needs by their cell phone service alone.

While the first 4G cell phone only became available in stores on June 2010, over the next five years most cellular subscribers in the U.S. will likely upgrade to 4G capable handsets. In the end, the "triple play" offering of video, voice and data is nothing other than digital data sent over a high-speed network and, ultimately, all consumers need in order to access these services is a fast data network, such as a 4G wireless network. Consequently, it is likely that wireline companies will continue to lose customers to the wireless providers. Since the U.S. is approaching a 100% wireless penetration rate, almost everyone already has a cell phone, and if that phone can provide internet access, many consumers may not see the need to pay their wireline company for internet service.

Of course, consumers would prefer to share their cell phone's internet connection with their desktops, laptops, iPads and other existing equipment that currently use the internet services from wireline phone companies and cable companies. There are currently only a few mobile phones, such as the Palm Pre, HTC Evo 4G and Droid X, that allow the creation of wireless hotspots with unlimited use of data, which can then be shared with aforementioned devices. This will change with the forthcoming upgrade by Google to the Android operating system, known as Android 2.2, or Froyo, which is expected to enable all Android phones running this software to become wireless hotspots. However, it remains to be seen if carriers will disable or charge subscribers for this feature. If Google's Android provides this service, it is likely that other mobile operating systems will have to offer these hotspot capabilities as well. This, coupled with the ambitious expansion plans of 4G service providers, indicates that landline companies will likely continue to lose internet subscribers over the next several years.

Access Line Erosion
The following table details the consistent erosion of total access lines in the U.S. from 2000 to 2008, as detailed in a September 2010 report by the Federal Communications Commission entitled *Trends in Telephone Service.*

Decrease in Access Lines in U.S., 2000-2008

	Access Lines *(thousands)*	*% Change*
2000	187,581	
2001	179,811	*(4.1)%*
2002	172,246	*(4.2)%*
2003	161,374	*(6.3)%*
2004	154,039	*(4.5)%*
2005	147,993	*(3.9)%*
2006	140,029	*(5.4)%*
2007	131,586	*(6.0)%*
2008	121,675	*(7.5)%*

It is important to note that the rate of decline, according to the FCC, varies by region. In particular, the decline in access lines has been substantially higher in urban areas than in rural areas of the country. Therefore, while the total rate of decline was 6.0% in 2007 and 7.5% in 2008, the rate of decline in metropolitan areas of the country has likely been in the double-digits, while the rate of decline in rural areas has been in the range of 3% to 4%.

A separate report by the U.S. Centers for Disease Control and Prevention in 2010 details the percentage of U.S. households that use only wireless phone service (i.e., no landline telephone).[1] The report showed that overall, 26.6% of households had only cellular phones in the first half of 2010, up from 24.5% in the second half of 2009. This is an 8.6% increase (26.6 ÷ 24.5) over a six month period, which equates to an annualized rate of 17.9%.

The figures are even more telling when broken down by age group. Among 25 to 29-year-olds, 51.3 percent lived in homes with only wireless service in the first half of 2010. This is the first time an age group has had over half living in households without landline service. At the same time, only 16.9 percent of those 45 to 64 years old lived in wireless-only households, although this category is switching to wireless-only service at an annualized rate of 28.6%.

% of Adults Living in Wireless-Only Households

	2nd Half 2009	1st Half 2010	% Change	*Annualized*
18-24 years	37.8%	39.9%	5.6%	*11.4%*
25-29 years	48.6%	51.3%	5.6%	*11.4%*
30-34 years	37.2%	40.4%	8.6%	*17.9%*
35-44 years	23.9%	27.0%	13.0%	*27.6%*
45-64 years	14.9%	16.9%	13.4%	*28.6%*
65+ years	5.2%	5.4%	3.8%	*7.8%*
Overall	24.5%	26.6%	8.6%	*17.9%*

Over the past three years, since the first half of 2007, the overall percentage of adults living in wireless-only households nearly doubled, as shown in the following table. It is important to note that although a smaller percentage of 18-24 year olds than 25-29 year olds live in wireless-only households, this category no doubt includes a higher percentage of adults who are living in their parents' household.

[1] "Wireless Substitution: Early Release of Estimates from the National Health Interview Survey, January – June 2010". Centers for Disease Control and Prevention, December 2010. http://www.cdc.gov/nchs/data/nhis/earlyrelease/wireless201012.htm

% of Adults Living in Wireless-Only Households

	1st Half 2007	1st Half 2010	% Change
18-24 years	27.9%	39.9%	43.0%
25-29 years	30.6%	51.3%	67.6%
30-34 years	16.5%	40.4%	144.8%
35-44 years	10.8%	27.0%	150.0%
45-64 years	7.1%	16.9%	138.0%
65+ years	2.0%	5.4%	170.0%
Overall	13.6%	26.6%	95.6%

The two preceding tables clearly show that age plays a particularly important role in the tendency to abandon landline use. Of those age 65 and older, still only 5.4% live in wireless-only households. It should follow that as the younger generation grows to a larger and larger portion of the overall adult population, the percentage of adults with landlines will continue to decline at a rapid rate.

Financial Review

A review of the recent financial results of CenturyLink actually involves a review of the results of three companies, CenturyLink, Embarq, and Qwest. The three companies all share one common trait, which is the consistent decline in access lines served, and as a result, the gradual erosion of profitability.

Let us begin with a look at Embarq, which merged with CenturyLink in July 2009. As detailed in the following table, Embarq's total access lines declined from 7.5 million at year-end 2004 to 5.7 million at year-end 2008, or a total loss of 24% over four years. The company did manage to increase overall revenue from 2004 to 2006, which was largely the result of doubling its number of high-speed internet service customers in that period from 500,000 to one million. As the company increased its internet service over the five years, its revenue per access line increased from $819 ($68 per month) in 2004 to $1,074 ($89 per month) in 2008. Note that the number of internet customers is a subset of the number of access lines. In other words, of the 5.7 million access line customers in 2008, 1.4 million had high speed internet service. Some of these 1.4 million internet customers may have had both telephone and internet service, while others may have had only internet service.

Embarq Corp. Historical Figures

(in millions)	2008	2007	2006	2005	2004
	Years ended December 31,				
Revenue	6,124	6,365	6,363	6,254	6,139
Operating income	1,633	1,504	1,544	1,552	1,590
Net income	769	683	784	878	917
Total access lines	5.7	6.3	6.8	7.2	7.5
High-speed internet customers	1.4	1.3	1.0	0.7	0.5
Revenue per access line	*$ 1,074*	*$ 1,010*	*$ 936*	*$ 869*	*$ 819*

The next table details the results of CenturyLink. From 2005 to 2008, CenturyLink's number of access lines declined from roughly 2.2 million to 2.0 million – a total decline of about 10%. This is a significantly lower rate of decline than that experienced at Embarq, because CenturyLink's access lines were predominantly located in rural areas of the U.S., while Embarq was in more urban areas. From 2005 to 2008, CenturyLink managed to roughly triple its number of high speed internet customers, from about 200,000 to 600,000. As a result, over those four years, its revenue per access line increased from $1,120 ($93 per month) to $1,284 ($107 per month).

CenturyLink Historical Figures

(in millions)	2010 *	2009 **	2008	2007	2006	2005
			Year ended December 31,			
Revenues	7,093	4,974	2,600	2,656	2,448	2,479
Operating income	2,098	1,233	721	793	666	736
Net income	963	647	366	418	370	334
Access lines	6.6	7.0	2.0	2.1	2.1	2.2
High-speed internet customers	2.4	2.2	0.6	0.6	0.4	0.2
Revenue per access line	*$ 1,075*	*n/m*	*$ 1,284*	*$ 1,244*	*$ 1,169*	*$ 1,120*

** 2010 income statement figures are 9-month run rate figures. Access line and high-speed internet customer count is at September 30, 2010.*

*** The merger with Embarq was completed in July 2009, meaning 2009 income statement figures include the Embarq operations for only about half the year.*

Of the three companies, the erosion of access lines has been most severe at Qwest. As shown in the following table, Qwest's total access lines declined by roughly one-third from 2005 to 2010. The company managed to almost double its number of high-speed internet customers in the same timeframe, from 1.5 million to 2.8 million, although it is notable that it experienced a decline in internet customers from 2009 to 2010.

Qwest Historical Figures

(in millions)	2010 *	2009	2008	2007 **	2006	2005
	Year ended December 31,					
Revenue	11,775	12,311	13,475	13,778	13,923	13,903
Operating expenses	9,676	10,336	11,378	12,022	12,368	13,048
Operating income	2,099	1,975	2,097	1,756	1,555	855
Net income *(loss)*	738	662	652	757 *	553	*(784)*
Access lines	10.2	10.3	11.6	12.8	14.7	15.5
High-speed internet customers	2.8	3.0	2.8	2.6	2.1	1.5
Revenue per access line	*$ 1,158*	*$ 1,199*	*$ 1,165*	*$ 1,077*	*$ 945*	*$ 896*

** 2010 income statement figures are 9-month run rate figures. Access line and high-speed internet customer count is at September 30, 2010.*

*** 2007 net income adjusted by excluding the realization of a $2.1 billion income tax benefit created by net operating loss carryforwards generated from 2000 to 2005. GAAP net income for 2007 was $2.9 billion.*

Finally, let us examine the pro forma estimated financial information of post-merger CenturyLink and Qwest. As previously mentioned, CenturyLink management expects the merger to result in annual synergies of approximately $575 million. Full synergies are anticipated to be fully realized within three to five years following the closing of the transaction. Based on anticipated full synergies and operating results for the 12 months ended December 31, 2009, it is estimated that the combined company would have generated revenue of $19.8 billion, EBITDA of approximately $8.2 billion, and free cash flow of approximately $3.4 billion.

The combined company is expected to have roughly $1.4 billion of cash on its balance sheet and, with the assumption of Qwest's $11.8 billion of debt, total debt of $22 billion. Shareholders' equity will total approximately $52 billion, which will give it a debt-to-equity ratio of about 0.4x.

Valuation

Comparable Metrics

A valuation of post-merger CenturyLink might begin with a review of recent acquisitions in the landline industry. Let us start with the CenturyLink-Qwest merger itself. The total purchase price of Qwest (calculated using the closing price of CenturyLink shares on the day before the transaction announcement), including the assumption of $11.8 billion of Qwest debt, was approximately $22.4 billion. In 2009, Qwest generated roughly $4.5 billion of EBITDA, which means the company was acquired at an EBITDA multiple of 5.0x. Furthermore, Qwest has approximately 10.2 million access lines, which means CenturyLink essentially paid $2,203 per access line.

In 2010, Frontier Communications (formerly Citizens Communications) closed on a deal, announced in May 2009, in which it purchased approximately 4.0 million access lines from Verizon. The lines were located in 14 states, in mostly rural areas. The purchase price for these assets was $8.6 billion, meaning Frontier paid $2,150 per access line, and about 6.1x EBITDA (estimated by the company to be $1.4 billion annually for these assets).

In June 2010, Windstream Corp. acquired Iowa Telecommunications Services for roughly $1.1 billion. Many industry observers believed Windstream paid a high premium for the company, as it paid $4,819 per access line and a multiple of 9.7x EBITDA. However, when one considers the location of the assets, in rural Iowa, the premium was perhaps justified. The following table details the Iowa Telecom landline count from 2005 through 2009. Excluding minor acquisitions the company made in 2008 and 2009, its total number of landlines over the four-year period declined to 236,900 from 258,700, or only by 8.5%. The reader will recall that over a similar period, Embarq saw a decline in access lines of 24% (from 2004 to 2008), CenturyLink's landline count declined roughly 10%, and Qwest's landlines declined by about 33%.

Iowa Telecom Access Line History

2009*	2008*	2007	2006	2005
236,900	230,500	240,700	252,000	258,700

** 2008 and 2009 figures exclude lines acquired by Iowa Telecom in those years. Including these acquisitions, Iowa Telecom had 242,100 and 253,000 access lines in 2008 and 2009, respectively.*

Next, let us view the CenturyLink merger with Embarq, completed in July 2009. CenturyLink paid approximately $22.4 billion for the Embarq assets, which included 5.7 million access lines and annual EBITDA of about $2.6 billion, meaning CenturyLink paid $3,930 per access line and a multiple of 8.5x EBITDA.

The following table summarizes these recent landline acquisitions. The average enterprise value-to-EBITDA multiple of all four transactions is 7.3x, while the average price paid per access line was $3,275.

Recent Acquisition Multiples in Wireline Industry

Acquirer	Target	Date	EV/EBITDA	EV/access line
CenturyLink	Qwest Comm.	June 2011	5.0x	$2,203
Frontier Comm.	Verizon rural	July 2010	6.1x	$2,150
Windstream	Iowa Telecom	June 2010	9.7x	$4,819
CenturyLink	Embarq	July 2009	8.5x	$3,930
		Average:	*7.3x*	*$3,275*

One can compare these average acquisition multiples to the valuation of post-merger CenturyLink, using the implied enterprise value of the company based upon today's market capitalization and pro forma net debt. CenturyLink shareholders will own 55% of the company following the merger with Qwest; at today's market capitalization of $13.1 billion, the implied market capitalization of post-merger CenturyLink is $23.8 billion. Combined with pro forma net debt of $20.7 billion, the implied enterprise value is $44.5 billion, as shown here.

	CenturyLink current market capitalization	$	13.1	billion
÷	Share of combined company		55%	
=	Implied market capitalization of post-merger CenturyLink	$	23.8	billion
−	Pro-forma cash of post-merger CenturyLink		(1.4)	
+	Pro-forma debt of post-merger CenturyLink		22.1	
=	Implied enterprise value of post-merger CenturyLink	$	44.5	billion

Post-merger CenturyLink will have approximately 16.6 million access lines. With an implied enterprise value of $44.5 billion, the enterprise value per access line is $2,680. This value per access line is a bit higher than the price paid for the Verizon rural landline assets acquired by Frontier Communications in July 2010, but significantly lower than the prices paid for the Iowa Telecom and Embarq landlines.

Management estimates that post-merger CenturyLink will generate roughly $7.7 billion of annual EBITDA, if all synergies are realized. With a $44.5 billion implied enterprise value, the multiple of EBITDA is 5.8x. On this basis, the company appears to be valued on the lower end of the acquisition multiples cited above.

For further reference, one can also view the current multiples at which access line companies currently trade. Aside from CenturyLink and Qwest, the only pure-play publicly traded landline companies are Frontier (formerly Citizens Communications, and the acquirer of Commonwealth Telephone in 2007), Windstream, and Cincinnati Bell. The enterprise value-to-EBITDA multiplies and enterprise value-per-access line figures are provided below. Using these figures, post-merger CenturyLink is valued at the lower end of its range of peers.

		EV/EBITDA	EV/access line
Frontier		6.5x	$2,904
Windstream		7.1x	$3,870
Cincinnati Bell		6.0x	$4,542
	Average:	*6.5x*	*$3,772*

Earnings Model and Payout Ratio

While CenturyLink appears to be priced reasonably in relation to recent acquisition multiples and in relation to peers, at issue is the ongoing deterioration of access line companies at the hands of cellular service providers. The following table combines the access line counts of Embarq, CenturyLink, and Qwest (which constitute the post-merger CenturyLink business) since 2005. The company's annualized rate of decline in total access lines since 2005 has been 8.0%.

Access Lines (in millions) of Embarq, CenturyLink & Qwest (i.e., Post-merger CenturyLink)

2010*	2009	2008	2007	2006	2005	*% Decline, Annualized*
16.6	17.3	19.3	21.2	23.6	25.2	*(8.0)%*

** Estimated at year-end 2010, based on 16.8 million lines at September 30th.*

An important ratio to consider with landline companies is the payout ratio. As these businesses are widely acknowledged to lack the prospect of growth, they are often priced as yield vehicles, or bond alternatives. CenturyLink currently pays a dividend of $2.90 per share, for a yield of 6.7%, and management says it will continue paying this same dividend after the merger with Qwest. Pro forma shares outstanding for the combined company will be 581.6 million, meaning the aggregate annual dividend will total $1.7 billion. Assuming the company achieves its anticipated synergies, annual free cash flow is expected to equal $3.1 billion. This results in a payout ratio of 55%, which, for the time being, would appear to be sustainable.

However, with the continuing loss of landlines this $3.1 billion of free cash flow can quickly erode, forcing the company to significantly cut or even discontinue its dividend. The following model provides a very rough estimation of what could happen to the CenturyLink free cash flow over the next five years. The model conservatively assumes that the access line count declines by 6% in 2011, and by an additional percentage point in each of the following years (i.e., 7% in 2012, 8% in 2013, etc). Over five years, this results in a compound annual rate of decline of 8.5%. As shown in the previous table, the experience over the past five years has been an average of 8.0% per annum.

This first assumption warrants further comment. Although CenturyLink's experience over the past five years has been average access line erosion of 8.0%, the rate of decline over the next five years could easily accelerate. The combination of improving wireless technology with demographic trends (the tendency of younger generations to forego the purchase of traditional landlines) could result in a significant acceleration of landline loss. Furthermore, from a pure mathematical standpoint, as the number of landline users declines, further declines result in higher percentage losses of customers (i.e., a decline of 10,000 from 1 million is 1%, while a decline of 10,000 from 800,000 is 1.25%). However, in the interest of conservativism, the following model assumes the rate of decline in

CenturyLink's landlines in the coming five years will more or less mirror the previous five years.

The second assumption in the model is that the annual revenue per access line will decline over time. As competition from cellular companies increases, wireline companies will likely be forced to cut their monthly charges. Thus far, CenturyLink has been able to maintain and even increase its revenue per access line by increasing its number of high speed internet customers. Yet, as customers switch to wireless internet service, this source of revenue should stabilize and even decline, resulting in meaningful declines in revenue per access line. In this model, the rate of decline is assumed to be 2% per annum. However, this assumption also likely errs on the side of conservativism. In 2010, the revenue per access line is estimated to equal $1,150, or essentially a telephone bill of $95 per month. With annual 2% decreases, by 2015 the revenue per access line would be $1,015, or $84 per month. But the typical wireless plan today, including unlimited telephone, texting, and internet use is often only $80 per month.

A third assumption is that because a certain percentage of costs are fixed, operating expenses will decline at a slower rate than the rate of decline in access lines. As access lines are reduced, CenturyLink will certainly see a decline in variable costs associated with those lines. But the company no doubt has a high percentage of fixed costs. A telecom company, particularly with copper/fiber infrastructure, is in fact a high fixed cost business; whether 100,000 or 10,000 customers are on a particular distribution system, the company still has many of the same infrastructure costs. In this model, the rate of decline in operating expenses is half the annual rate of decline in access lines, which implies that fixed costs comprise 50% of total costs. CenturyLink's percentage of fixed costs in relation to total costs may actually be higher than this.

Finally, the model takes into account CenturyLink's annual interest expense on $22 billion in debt. Following the merger, the average interest rate on outstanding debt will be roughly 7.3%. However, as earnings decrease over time, the possibility of credit downgrades by ratings agencies increases. Indeed, immediately following the announcement of the Qwest merger, Standard & Poor's indicated that the company's long-term debt rating of BBB- was placed under watch for a possible downgrade.[2] Therefore it is likely that CenturyLink's cost of debt will increase over time. The company has roughly $1.6 billion of debt coming due in 2011, $1.8 billion in 2012, and $1.5 billion in 2013, which means roughly a quarter of total debt is due within the next three years. It is assumed this debt will be refinanced (not retired), and that the average interest rate will remain at 7.3% in 2011 and increase to 8.2% thereafter.[3] One should also consider that, instead of increasing

[2] Following the merger announcement, Moody's affirmed CenturyLink's debt rating of Baa3, but downgraded its outlook from stable to negative. Fitch Ratings also placed the CenturyLink rating under watch for a possible downgrade.

[3] The weighted average maturity of CenturyLink's outstanding debt is roughly 9 years. At the time of writing, the average interest rate of Industrial sector BBB- bonds with a 10-year maturity was 5.5%, while

the interest rate on borrowings, CenturyLink's creditors might require the company to reduce or even discontinue its dividend. In such a scenario, although there would be no further reduction in free cash flow, the end result would still be a significant decrease in the dividend.

Rather than employing the standard formula for payout ratio (annual dividend divided by net income), free cash flow[4] is substituted for net income, in order to get a more accurate view of the company's ability to service its dividend.

Earnings Model, Reflecting Declining Access Lines and Declining Profit Margins[1]

(in millions)	2011	2012	2013	2014	2015	*CAGR*
Access lines	15.8	14.7	13.5	12.3	11.1	*(8.5)%*
Revenue	$ 17,591	$ 16,019	$ 14,418	$ 12,823	$ 11,269	*(10.5)%*
Operating expenses	(14,402)	(13,898)	(13,342)	(12,742)	(12,105)	*(4.3)%*
Operating income	3,188	2,120	1,075	82	(836)	
Interest expense	(1,612)	(1,811)	(1,811)	(1,811)	(1,811)	
Pre-tax income	1,576	309	(736)	(1,730)	(2,647)	
Taxes (35%)	(552)	(108)	-	-	-	
Net income	1,024	201	(736)	(1,730)	(2,647)	
Dep. & Amort. (2010 level)	4,100	4,100	4,100	4,100	4,100	
Capital exp. (2010 level)	(2,400)	(2,400)	(2,400)	(2,400)	(2,400)	
Free cash flow	2,724	1,901	964	(30)	(947)	
Dividend (2011 level)	1,700	1,700	1,700	1,700	1,700	
Payout Ratio	***62%***	***89%***	***176%***	***n/m***	***n/m***	

[1] *For details on calculations and assumptions, please refer to the preceding discussion.*

Even though rather conservative assumptions are made, the model demonstrates how CenturyLink could face a negative earnings scenario as early as 2013, with the payout ratio that year far exceeding 100% of free cash flow. Note that the compound annual growth rate of revenue is negative 10.5%, even though it is assumed that revenue per access line declines at 2%; this is because the declining revenue per line is coupled with the declining number of access lines. Also note the importance of operating leverage in this type of business. The effect is that operating income declines by 97% by 2014 and becomes negative in 2015.

Again, the preceding model is not intended to detail for readers precisely what CenturyLink is likely to earn each year over the next five years. For instance, more

the average rate on BB+ bonds of the same maturity was 6.4% (according to Bloomberg). Therefore, it is assumed here that a credit downgrade will increase CenturyLink's cost of borrowing by 90 basis points.

[4] Free cash flow is calculated here as net income plus depreciation and amortization minus capital expenditures.

aggressive assumptions regarding the rate of decline in access lines could plausibly have been made. The purpose of the model is to demonstrate the substantial impact on free cash flow resulting from an environment of declining access lines and increasing competition from wireless companies. It becomes evident that CenturyLink may be forced to substantially decrease its dividend within two years. In the current low interest rate environment, and with a 6.5% dividend yield, the CenturyLink share price is likely supported by yield investors. As a consequence, a substantial reduction in the company's dividend could result in a comparable reduction in the share price. Moreover, even those investors not focused on yield will be inclined to sell their shares if the company has trouble generating positive earnings within two to three years.

Investment Summary

CenturyLink is expected to complete a merger with Qwest Communications in the first half of 2011. Based upon recent transaction multiples within the landline telephone industry, as well as the multiples at which landline competitors currently trade, post-merger CenturyLink does not appear to be overvalued.

However, the company operates a business that is in inexorable decline. Its landline telephone service is being cannibalized by wireless telephone service, as more and more people choose to forego having a landline phone. Its other primary source of revenue, high-speed internet service, is also being challenged by cable television companies and more recently, by cellular service providers. As cellular companies upgrade their networks to 4G, which can provide more than enough bandwidth for consumers to satisfy all of their video, voice and data needs, more and more consumers will inevitably choose to discontinue their service with landline companies altogether. Ultimately, the continued erosion of landlines, coupled with the operating leverage inherent in the business model, could result in severely depressed or even negative earnings and cause management to cut the dividend within the next few years. Consequently, the short sale of CenturyLink is recommended at this time.

CENTURYLINK, INC.
PRO FORMA COMBINED CONDENSED BALANCE SHEET
March 31, 2010

(in millions)	CenturyLink	Qwest	Pro Forma Adjustments	Pro Forma Combined
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents	206	1,196		1,402
Accounts receivable	671	1,245		1,916
Other current assets	164	1,564	(110)	1,618
Total current assets	1,041	4,005	(110)	4,936
NET PROPERTY, PLANT AND EQUIPMENT	8,970	12,078		21,048
GOODWILL AND OTHER ASSETS				
Goodwill	10,252	-	10,429	20,681
Other	2,058	3,279	421	5,758
Total goodwill and other assets	12,310	3,279	10,850	26,439
TOTAL ASSETS	22,321	19,362	10,740	52,423
LIABILITIES AND EQUITY				
CURRENT LIABILITIES				
Current maturities of long-term debt	500	2,046		2,546
Accounts payable	335	658		993
Accrued expenses and other liabilities	926	1,886	(148)	2,664
Total current liabilities	1,761	4,590	(148)	6,203
LONG-TERM DEBT	7,221	11,500	819	19,540
DEFERRED CREDITS AND OTHER LIABILITIES	3,838	4,392	(1,506)	6,724
SHAREHOLDERS' EQUITY (DEFICIT)				
Common stock	300	17	272	589
Paid-in capital	6,022	42,294	(32,128)	16,188
Accumulated other comprehensive loss, net of tax	(94)	(487)	487	(94)
Retained earnings (deficit)	3,267	(42,915)	42,915	3,267
Noncontrolling interests	6	-		6
Treasury stock	-	(29)	29	-
Total shareholders' equity (deficit)	9,501	(1,120)	11,575	19,956
TOTAL LIABILITIES AND EQUITY	22,321	19,362	10,740	52,423

PRO FORMA COMBINED CONDENSED STATEMENT OF INCOME
YEAR ENDED DECEMBER 31, 2009

(In millions, except per share amounts)	CenturyLink	Embarq	Qwest	Pro Forma Adjustments	Pro Forma Combined
OPERATING REVENUES	4,974	2,671	12,311	(198)	19,758
OPERATING EXPENSES					
Cost of services and products	1,752	721	4,088	(138)	6,423
Selling, general and administrative	1,014	632	3,937		5,583
Depreciation and amortization	975	488	2,311	327	4,101
	3,741	1,841	10,336	189	16,107
OPERATING INCOME	1,233	830	1,975	(387)	3,651
OTHER INCOME (EXPENSE)					
Interest expense	(370)	(186)	(1,089)	102	(1,543)
Other income	(48)	-	17		(31)
Income tax expense	(302)	(240)	(241)	110	(673)
Noncontrolling interests	(2)	-	-		(2)
NET INCOME FROM CONTINUING OPERATIONS	511	404	662	(175)	1,402
BASIC EARNINGS PER COMMON	$ 2.55	$ 2.81	$ 0.38		$ 2.40