CenturyLink (CTL)

Updated August 12th, 2018 by Josh Arnold

Key Metrics

Current Price:	$21	**5 Year CAGR Estimate:**	9.7%	**Volatility Percentile:**	87.9%
Fair Value Price:	$15	**5 Year Growth Estimate:**	6.8%	**Momentum Percentile:**	49.0%
% Fair Value:	145%	**5 Year Valuation Multiple Estimate:**	-7.2%	**Valuation Percentile:**	7.5%
Dividend Yield:	10.1%	**5 Year Price Target**	$20	**Total Return Percentile:**	66.3%

Overview & Current Events

CenturyLink traces its roots to 1930 when the Oak Ridge Telephone Company was purchased by the Williams family. They would eventually expand exponentially into what has become CenturyLink, which serves customers in 60 different countries today. It has a $23 billion market capitalization and should produce $24 billion in revenue this year.

CenturyLink reported Q2 earnings on 8/8/18 and results were very strong. Total revenue fell slightly as broadband consumer subscribers fell, but improved profitability helped EBITDA and net income beat expectations. EBITDA margin rose from 35.7% to 38.5% and cash flow improved as well. Management raised EBITDA guidance for this year in addition to higher cash flow guidance given strong profitability in Q2. Our estimate for this year of $1.15 per share remains unchanged as CenturyLink's Q2 was weak from a revenue perspective, but profitability improved.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$3.37	$3.46	$3.41	$1.07	$1.25	$1.64	$2.61	$2.72	$2.45	$1.58	***$1.15***	***$1.60***
DPS	$1.54	$2.80	$2.90	$2.90	$2.90	$2.16	$2.16	$2.16	$2.16	$2.16	**$2.16**	**$2.16**

CenturyLink's earnings-per-share history isn't particularly stellar as it has struggled in recent years with competition as well as profitability. A sharp drop in earnings in 2011 gave way to respectable growth but it doesn't appear it will be able to return to former levels of earnings-per-share in excess of $3 anytime soon; it roughly doubled its share count in 2017 as a result of the Level 3 acquisition. In addition, it took on another $13 billion in debt with the transaction onto a balance sheet that was not in good shape on its own. That has led to a much harder road ahead for net margins as well as earnings-per-share given the higher share count.

That said, we see 6.8% annual growth going forward as it has some catalysts for earnings expansion. Revenue is slated to rise by roughly one-third this year thanks to Level 3 so that will certainly help boost earnings moving forward, as synergies come on line. Management believes it can achieve roughly $1 billion in annual operating savings within three years with Level 3, which would provide significant margin expansion. It would also allow for CenturyLink to potentially reduce some of its considerable debt, which is growing ever more expensive to service. We see a lower tax rate helping to get earnings growth back on track as well as long term demand for its services, although competition is brutal.

The dividend is a hot issue for CenturyLink shareholders as it has been stagnant since a cut in 2013. We do not see the payout rising anytime soon but management has reiterated its commitment to pay the dividend at all costs and avoid another cut. In addition, free cash flow guidance for this year is more than enough to cover the dividend so we see the payout as safe for the foreseeable future. Given the prodigious yield, this is perhaps even more important than earnings.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	10.0	8.9	10.9	36.2	31.4	21.3	14.0	11.6	11.4	13.9	***18.6***	***12.8***
Avg. Yld.	4.6%	9.1%	7.8%	7.5%	7.4%	6.2%	5.9%	6.9%	7.7%	9.8%	***10.1%***	***10.5%***

CenturyLink's price-to-earnings multiple has moved around a bunch in the past decade as the company's fortunes have risen and fallen. It stands at 18.6 now, which is well in excess of its historical norm at 12.8 and as a result, we see it

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falling back to that level over time, creating a 7.2% headwind annually. Its much higher share count and debt totals are likely to keep a lid on the multiple as well moving forward. We see the yield falling as a result of a higher share price and flat payout, but it will still be very strong in excess of 10%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	63.3%	42.1%	63.9%	58.8%	58.4%	58.5%	56.5%	56.5%	55.5%	53.5%	***52.5%***	***52.0%***
Debt/A	62%	58%	56%	63%	64%	67%	69%	70%	72%	69%	***70%***	***72%***
Int. Cov.	3.8	3.2	3.8	1.9	1.9	1.2	1.8	2.0	1.8	1.4	***1.4***	***1.4***
Payout	44%	54%	85%	--	--	132%	83%	79%	88%	129%	***188%***	***135%***
Std. Dev.	40.1%	22.8%	16.5%	20.4%	13.5%	21.3%	19.0%	19.9%	36.3%	36.0%	**38.0%**	**40.0%**

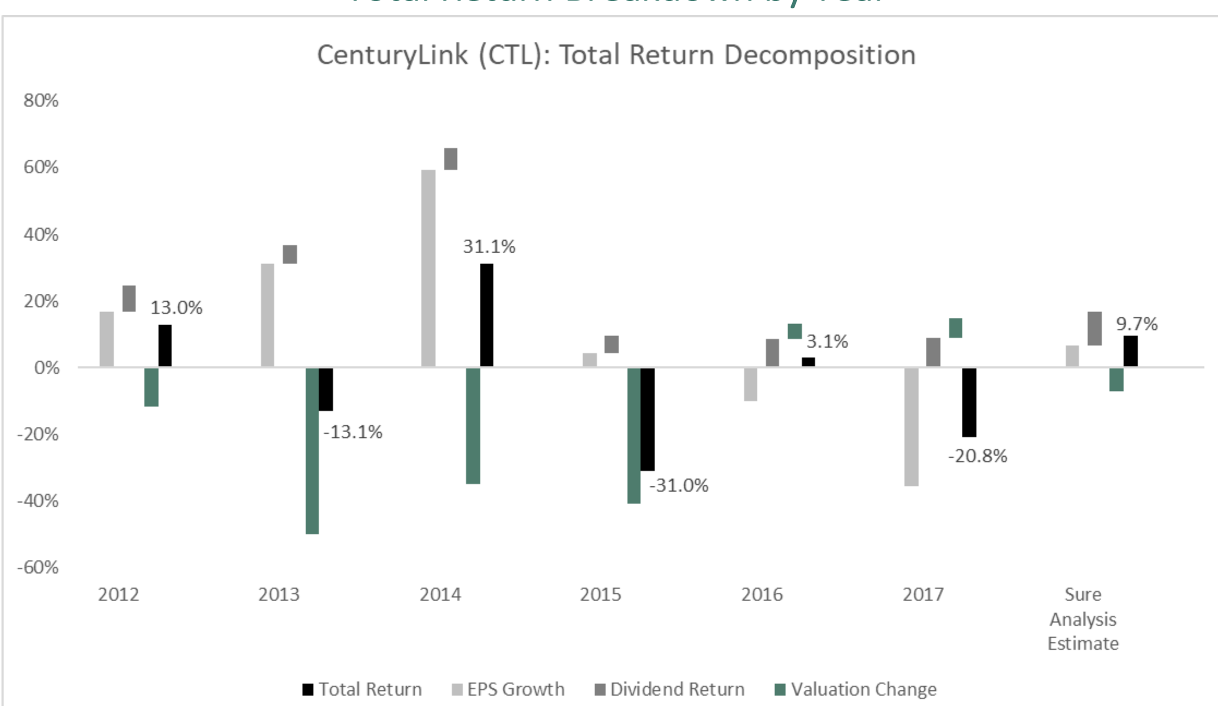
CenturyLink's quality metrics have largely deteriorated in the past decade, which is no surprise given how earnings and the stock have performed. Gross margins continue to fall, and we see that trend continuing, although losses from here should be slight. Debt continues to be a problem, but its debt-to-asset ratio is actually reasonable at about 70%; we do see some upside here as it may be forced to take on additional debt to fund its Level 3 integration. Interest coverage is okay at 1.4 but shareholders would do well to closely monitor that situation as it is moving ever closer to 1. The dividend will not be covered by earnings in the foreseeable future, but we do see the payout ratio falling significantly over time.

CenturyLink's competitive advantage is in its diversified model as well as its massive size and reach. It has the ability to negotiate in ways smaller competitors cannot and its global footprint provides valuable diversification. It should perform well during the next recession as it did in the last one, so that is not a concern at this point.

Final Thoughts & Recommendation

CenturyLink is a stock that is trading well in excess of fair value but that offers decent growth potential and an enormous yield. We see total returns of 9.7% going forward, consisting entirely of the 10.1% current yield, which will be partially offset by the combination of 6.8% earnings growth and a 7.2% headwind from the valuation. The dividend looks safe for now and may be good enough for income investors but keep in mind this stock is not for the risk-averse. This is a high-risk, high-reward situation with many variables so more speculative investors may find it attractive here. We rate the stock a sell today despite the 10% yield, given the high valuation and elevated risk.

Total Return Breakdown by Year



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