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High Yield | Telecommunications Infrastructure
North America

Level 3 Communications (LVL3)

3Q 2014: TWTC Deal Closes, Integration Begins, We Think the Credit Profile Improves from Here, Buy Long Duration

- Citi's Take** — We forecast solid 3Q results for Level 3 owing to continuing demand for broadband and enterprise communications. Our projections are essentially in-line with consensus. We note consensus has not yet incorporated the tw telecom (TWTC) acquisition (closed October 31st), so our 4Q and 2015 estimates are currently above consensus. LVL3 has integrated numerous assets over its lengthy high yield history which gives us comfort again this time. We project leverage could drop from a pro forma 4.7x to below 3.9x in 2015 owing to cost synergies and revenue growth. We recommend investors consider longer duration opportunities in the capital structure which could benefit from fundamental improvement.
- Credit Implications** — We lower our weighting to Marketweight from Overweight owing to credit performance, and capital structure convexity. We initiate with a Buy on the 5.375% senior OpCo notes due 2022 owing to attractive yield, forecasted fundamental improvements and bond pricing near par. We maintain our Buy ratings on the 7% senior OpCo notes due 2020 and the 6.125% senior OpCo notes due 2021 owing to attractive yield and duration. We initiate with a Neutral rating on the L+350bp senior OpCo notes due 2018 owing to current yield and limited upside potential. We lower our rating to Neutral on the 8.875% senior HoldCo notes due 2019 which first callable June 1, 2015 owing to its relatively low yield and limited upside.

David Phipps

+1-212-816-7022

david.phipps@citi.com

Ashish Nair

+1-212-816-8391

ashish.nair@citi.com

Nicholas Napoleone

+1-212-816-7864

nicholas.napoleone@citi.com

Figure 1. Level 3 Credit Pricing & Recommendations

MARKETWEIGHT Cpn (%)	Description	Rating	Maturity	Moody's / S&P	Amt Out (\$mm)	Current Prices			YTW Date
						Bid	YTW (%)	STW (bp)	
Level 3 Financing (OpCo)									
L+300bp, 100bp	TL B3	Unrated	1 August 2019	Ba2(S) / BB	815	99.50	4.12%		
L+300bp, 100bp	TL B4	Unrated	15 January 2020	Ba2(S) / BB	1,796	99.50	4.10%		
L+350bp, 100bp	TL B5	Unrated	31 January 2022	Ba2(S) / BB	2,000	99.25	4.62%		
L+350bp, 100bp	Sr Nts	Unrated	15 January 2018	B3(S) / B- / +	300	99.75	3.91%	367	15 January 2018
9.375	Sr Nts	Neutral	1 April 2019	B3(S) / B- / +	500	107.00	3.37%	313	1 April 2015
8.125	Sr Nts	Neutral	1 July 2019	B3(S) / B- / +	1,200	106.88	3.57%	332	1 July 2015
8.625	Sr Nts	Neutral	15 July 2020	B3(S) / B- / +	900	109.50	3.95%	355	15 January 2016
7.000	Sr Nts	Buy	1 June 2020	B3(S) / B- / +	775	107.00	4.50%	396	1 June 2016
6.125	Sr Nts	Buy	15 January 2021	B3(S) / B- / +	640	104.88	4.78%	329	15 November 2018
5.375	Sr Nts	Buy	15 August 2022	B3(S) / B	1,000	101.00	5.14%	347	15 August 2019
Level 3 Communications (HoldCo)									
11.875	Sr Nts	Neutral	1 February 2019	Caa1(S) / B- / +	604	108.00	2.88%	265	1 February 2015
8.875	Sr Nts	Neutral	1 June 2019	Caa1(S) / B- / +	300	107.00	4.09%	384	1 June 2015

Source: Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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tw telecom Acquisition

Figure 2. Level 3 + tw telecom Financial Summary

LTM 2Q 2014	LVLT	TWTC	TWTC B/S	LVLT B/S	Combined	PF Adjustments	PF Combined
Revenue	\$6,405	\$1,620			\$8,025		\$8,025
EBITDA	\$1,758	\$553			\$2,311	\$200	\$2,511
Capex	\$787	\$381			\$1,168		\$1,168
Debt	\$7,749	\$1,923	(\$1,777)	\$3,000	\$10,895		\$10,895
Cash	\$637	\$364	(\$364)	(\$200)	\$437		\$437
TWTC Stock Price		\$41.45					
Shares in millions		138					
Equity Value		\$5,712					
Enterprise Value		\$7,271					
LVLT Stock Price	\$45.01		\$45.01		\$45.01		\$45.01
Shares in millions	241		96		338		338
Equity Value	\$10,866		\$4,342		\$15,208		\$15,208
Enterprise Value	\$17,978	\$8,830			\$25,666		\$25,666
Enterprise Value / EBITDA	10.2x	16.0x			11.1x		10.2x
EV / Synergized EBITDA		11.7x					
Debt / EBITDA	4.4x	3.5x			4.7x		4.3x
Net Debt / EBITDA	4.0x	2.8x			4.5x		4.2x
% Equity Ownership	71.4%		28.6%				
EBITDA Margin	27.4%	34.1%			28.8%		31.3%

Source: Company Reports and Citi Research Estimates

Transaction Highlights

At current market values, LVLT paid 16.0x EBITDA for TWTC, or 11.7x fully synergized EBITDA. The combined entity trades at 11.1x, or 10.2x with synergies.

LVLT acquired TWTC with \$1.4 billion cash (\$10 per share), \$4.3 billion stock (0.7 LVLT share for each TWTC share) and assumed \$1.9 billion TWTC debt.

On an LTM basis, TWTC had \$1.6 billion sales, \$553 million EBITDA, 34% EBITDA margins, and spent \$381 million on capex.

LVLT financed the \$1.4 billion cash payment and \$1.8 billion TWTC debt retirement with \$1,000 million 5.375% senior notes and \$2,000 million L+350bp with 1.00% floor. LVLT used \$564 million cash from the combined balance sheets for fees, etc.

Management forecast \$200 million synergies with 70% (\$140 million) attained in the first 18 months (June 2016). LVLT projects \$170 million for integration costs over five quarters.

Timeline

June 16, 2014: LVLT announced plans to acquire TWTC shares for \$10.00 cash plus 0.7 shares of LVLT stock. This cash requirement was about \$1.4 billion.

July 29, 2014: LVLT issues \$1,000 million 5.375% senior notes bonds into escrow.

October 6, 2014: LVLT issues \$2,000 million delay draw L+350 with 1.00% floor.

October 29, 2014: LVLT closes the TWTC acquisition and pays about \$1.4 billion cash for the equity, refinances \$1.8 billion TWTC debt, and about \$565 other cash.

3Q 2014 Preview

Conference Call Details

Wednesday, November 5th, 10am Eastern,
877-283-5145, no passcode

Conference Call Focus Areas

Did 2Q fundamental momentum continue in 3Q?

Did the largest segments (transport & fiber; IP & data services) continue to experience healthy demand (mid-single y/y growth; low double-digit y/y growth).

Does LVL still target \$200 million synergies with 70% in 18 months and \$170 million cash cost by year-end 2015?

Have competition stepped up since the TWTC deal was announced?

Does LVL plan to allow its \$475 million convertibles convert to equity at maturity on March 15, 2015?

Figure 3. Level 3 Financial Summary & Forecasts

	Fiscal Year End			Quarterly				LTM	Fiscal Year End	
	12/31/2011	12/31/2012	12/31/2013	3/31/2014	6/30/2014	9/30/2014	12/31/2014	9/30/2014	12/31/2014	12/31/2015
	2011A	2012A	2013A	1Q14	2Q14	E-3Q14	E-4Q14	LTM	2014E	2015E
Operating Statistics										
Revenue	\$4,333	\$6,376	\$6,313	\$1,609	\$1,625	\$1,619	\$2,248	\$6,455	\$7,102	\$9,007
Growth	18.7%	47.1%	(1.0%)	2.0%	3.8%	3.2%	40.3%	2.1%	12.5%	26.8%
EBITDA	\$958	\$1,459	\$1,614	\$458	\$459	\$467	\$673	\$1,840	\$2,057	\$2,821
Margin	22.1%	22.9%	25.6%	28.5%	28.2%	28.8%	29.9%	28.5%	29.0%	31.3%
Capital Expenditures	\$498	\$743	\$760	\$163	\$241	\$202	\$312	\$795	\$918	\$1,492
% Revenue	11.5%	11.7%	12.0%	10.1%	14.8%	12.5%	13.9%	12.3%	12.9%	16.6%
Balance Sheet										
Cash & Cash Equivalents	\$918	\$979	\$638	\$607	\$637	\$701	\$508	\$701	\$508	\$930
Secured Debt	\$2,796	\$2,712	\$2,697	\$2,693	\$2,691	\$2,691	\$4,691	\$2,691	\$4,691	\$4,691
OpCo Debt	\$6,943	\$7,027	\$7,012	\$7,008	\$7,006	\$7,006	\$10,006	\$7,006	\$10,006	\$10,006
Total Debt	\$8,528	\$8,780	\$8,392	\$8,388	\$8,386	\$8,386	\$11,386	\$8,386	\$11,386	\$10,911
Net Debt	\$7,610	\$7,801	\$7,754	\$7,781	\$7,749	\$7,684	\$10,878	\$7,684	\$10,878	\$9,981
Credit Statistics				LTM	LTM	LTM	LTM			
Total Secured Debt/LTM EBITDA	2.9x	1.9x	1.7x	1.6x	1.5x	1.5x	2.3x	1.5x	2.3x	1.7x
Total OpCo Debt/LTM EBITDA	7.2x	4.8x	4.3x	4.2x	4.0x	3.8x	4.9x	3.8x	4.9x	3.5x
Total Debt/LTM EBITDA	8.9x	6.0x	5.2x	5.0x	4.8x	4.6x	5.5x	4.6x	5.5x	3.9x
Net Debt / LTM EBITDA	7.9x	5.3x	4.8x	4.6x	4.4x	4.2x	5.3x	4.2x	5.3x	3.5x

Source: Company Reports and Citi Research Estimates

Projection Update

We combined LVL and TWTC models beginning November 2014. So that our 4Q forecasts include 2/3s of TWTC income & cash flow in 4Q. Thereafter we added the companies' financials together.

We modelled \$170 million costs over five quarters beginning 4Q 2014 through 4Q 2015.

We model \$160 million of the LVL's \$200 million synergies 1Q 2015 through 4Q 2016.

We assume LVL allows its \$475 million 7% convertibles to convert to equity on March 15, 2015.

Credit Considerations

LVLT remains an acquisitive company and most recently acquired TWTC in a near credit neutral transaction.

LVLT must now integrate the material TWTC which will require integration distractions & costs. This could encourage competitor response.

LVLT historically generated minimal free cash flow.

LVLT's \$16 billion market equity provides about 2.3x asset coverage for the company's \$11 billion debt.

LVLT management has stated a long-term 3 – 4x leverage goal. We estimate pro forma leverage at 4.7x total and 4.5x net.

LVLT's 1Q is seasonally the weakest and this quarter has in recent years reset the bar for the full-year results. The TWTC acquisition could confuse this further.

LVLT bonds have relatively high coupons and currently trade to early call dates.

Level 3 Redeems tw telecom Bonds

We estimate LVLT will pay about \$669 million or a blended 110.7 for its 5.375% bonds and about \$262 million or a blended 115.1 for its 6.375% bonds.

Figure 4. TWTC Bond Redemption Analysis

TWTC 5.375% Bond Redemption

November 30 Redemption

	Total	Make Whole	Claw	Claw %
Bonds	\$604.5	\$392.9	\$211.6	35%
Price	110.689	113.55	105.375	
Value	\$669.1	\$446.2	\$222.9	

TWTC 6.375% Bond Redemption

November 30 Redemption

	Total	Make Whole	Claw	Claw %
Bonds	\$227.5	\$147.9	\$79.6	35%
Price	115.101	119.80	106.375	
Value	\$261.9	\$177.2	\$84.7	

Source: Company Reports and Citi Research Estimates

Figure 5. Level 3 Capital Structure & Liquidity

	9/30/14 E-3Q14	Gross Leverage	Net Leverage	Bid		Rating
				Price	YTW	
Cash & Cash Equivalents	701					
TL B3 L+300bp, 1.0% floor, due 8/1/2019	815			\$99.50	4.12%	Unrated
TL B4 L+300bp, 1% floor, due 1/15/2020	1,796			\$99.50	4.10%	Unrated
TL B5 L+350bp, 1% floor due 01/31/2022	0			\$99.25	4.62%	Unrated
Capital Lease and Other	80					
Secured Debt	2,691	1.5x	1.1x			
L+350bp FRNs due 1/15/2018	300			\$99.75	3.91%	Unrated
9.375% Sr. Notes due 4/1/2019	500			\$107.00	3.37%	Neutral
8.125% Sr. Notes due 7/1/2019	1,200			\$106.88	3.57%	Neutral
8.625% Sr. Notes due 7/15/2020	900			\$109.50	3.95%	Neutral
7% Sr. Notes due 6/1/2020	775			\$107.00	4.50%	Buy
6.125% Sr. Notes due 1/15/2021	640			\$104.88	4.78%	Buy
5.375% Sr. Notes due 8/15/2022	0			\$101.00	5.14%	Buy
Total Level 3 Financing OpCo Debt	7,006	3.8x	3.4x			
7% Sr. Convertible Notes due 3/15/2015	200					
7% Sr. Convertible Notes Series B due 3/15/2015	275					
11.875% Sr. Notes due 2/1/2019	605			\$108.00	2.88%	Neutral
8.875% Sr. Notes due 6/1/2019	300			\$107.00	4.09%	Neutral
Other Debt	0					
Total Debt	8,386	4.6x	4.2x			
Market Equity Value	15,688		8.5x			
less: Cash & Cash Equivalents	(701)					
Enterprise Value	23,372		12.7x			
Liquidity						
Cash & Cash Equivalents	701					
Availability Under Revolver	0					
Total	701					

Source: Company Reports and Citi Research Estimates

LVLT incurred \$3 billion debt acquiring TWTC on October 31st and will have \$11 billion debt. LVLT's nearly \$16 billion market equity provides 2.3x asset coverage.

We project leverage could drop from a pro forma 4.7x to below 3.9x in 2015 owing to cost synergies and revenue growth.

We recommend investors consider longer duration opportunities in the capital structure which could benefit from fundamental improvement.

3Q 2014 Preview

Our \$1,619 million sales estimate is below the \$1,632 million consensus.

We project moderating sales growth owing to on-going weakness in voice and wholesale.

Figure 6. Level 3 Revenue Preview

(\$ in millions)	9/30/2013 3Q13	6/30/2014 2Q14	9/30/2014 E-3Q14	Change	
				Y/Y	Q/Q
Revenue	\$1,569	\$1,625	\$1,619	\$50	(\$6)
Change				3.2%	-0.3%
Colocation and Datacenter Services	\$144	\$146	\$150	\$6	\$4
Change				4.0%	2.6%
Transport and Fiber	\$483	\$508	\$510	\$27	\$2
Change				5.5%	0.3%
IP and Data Services	\$536	\$588	\$590	\$54	\$2
Change				10.0%	0.3%
Voice Services (Local & Enterprise)	\$234	\$237	\$233	(\$1)	(\$4)
Change				-0.5%	-1.8%
Total CNS Revenue	\$1,397	\$1,479	\$1,482	\$85	\$3
Change				6.1%	0.2%
tw telecom	\$0	\$0	\$0	\$0	\$0
Change				NA	NA
Wholesale Voice Services and Other	\$172	\$146	\$138	(\$34)	(\$8)
Change				-20.0%	-5.8%

Source: Company Reports and Citi Research Estimates

Our \$467 million EBITDA estimate is above the \$459 million consensus.

Our estimate includes \$10 million stock compensation which we do not believe is in consensus, so our adjusted EBITDA would be \$457 million which is in-line.

Figure 7. Level 3 EBITDA Preview

(\$ in millions)	9/30/2013 3Q13	6/30/2014 2Q14	9/30/2014 E-3Q14	Change	
				Y/Y	Q/Q
Revenue	\$1,569	\$1,625	\$1,619	\$50	(\$6)
Change				3.2%	-0.3%
EBITDA	\$385	\$459	\$467	\$82	\$8
Change				21.3%	1.8%
EBITDA Margin (%)	24.5%	28.2%	28.8%	431 bp	60 bp
Change				17.6%	2.1%
Gross Profit	\$961	\$1,012	\$1,012	\$51	(\$0)
Change				5.3%	0.0%
Gross Margin (%)	61.2%	62.3%	62.5%	123 bp	20 bp
Change				2.0%	0.3%
Selling, General and Administrative	\$606	\$569	\$555	(\$51)	(\$14)
Change				-8.5%	-2.5%
Selling, General and Administrative ('	38.6%	35.0%	34.3%	-437 bp	-77 bp
Change				-11.3%	-2.2%
Depreciation & Amortization	\$203	\$187	\$187	(\$16)	\$0
Change				-7.9%	0.0%
Stock-based Compensation	\$30	\$16	\$10	(\$20)	(\$6)
Change				-66.7%	-37.5%

Source: Company Reports and Citi Research Estimates

Appendix A-1

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Data current as of 30 Sep 2014

	Rating		
	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	75%	63%	46%
Citi Research US High Yield Issue Coverage	31%	58%	11%
% of companies in each rating category that are investment banking clients	71%	79%	65%

Level 3 Communications Inc (LVL3) — Issuer Portfolio Weighting and Issue Rating History

High Yield Credit Research

Analyst: David Phipps

Issuer		Issue			
Weighting	Date	Coupon	Description	Maturity	Rating
OW	11-Oct-12	4.146%	Sr Nts	15-Feb-15	Buy (1)
					Sell (3)
					NC
		10.000%	Sr Nts	01-Feb-18	Buy (1)
					Sell (3)
					NC
		9.375%	Sr Nts	01-Apr-19	Buy (1)
					Neutral (2)
		8.125%	Sr Nts	01-Jul-19	Buy (1)
					Neutral (2)
		8.625%	Sr Nts	15-Jul-20	Buy (1)
					Neutral (2)
		7.000%	Sr Nts	01-Jun-20	Buy (1)
					Neutral (2)
		11.875%	Sr Nts	01-Feb-19	Buy (1)
					Neutral (2)
		8.875%	Sr Nts	01-Jun-19	Buy (1)
					Neutral (2)
		6.125%	Sr Nts	15-Jan-21	Buy (1)
					Neutral (2)

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Guide to Citi Research High Yield Issue, Leveraged Loan & CDS Ratings:

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