Cequel Communications Holdings I, LLC

Q1 2015 Earnings Call Transcript

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Call Participants

EXECUTIVES

Jerald L. Kent
Chairman, Chief Executive Officer

Thomas P. McMillin
Executive Vice President, Chief Operating Officer

Mary E. Meduski
Executive Vice President, Chief Financial Officer

Peter M. Abel
Senior Vice President, Corporate Communications

ANALYSTS

Michael Kerrane
SunTrust

Presentation

Operator

Welcome, ladies and gentlemen, to the Cequel Communications Earnings call for First Quarter 2015.

[Operator Instructions]

I would now like to turn the call over to Pete Abel, Senior Vice President of Communications. Sir, you may begin.

Peter M. Abel
Senior Vice President, Corporate Communications

Thank you. Good morning, everyone, and welcome to this discussion of the First Quarter 2015 results for Cequel Communications Holdings I, LLC, and its subsidiaries which do business as Suddenlink Communications.

Before we get started this morning, we'd like to remind you that certain statements made during this conference call might be considered forward-looking statements within the meaning of the Private Securities Litigation Act of 1995.

Those statements are subject to the various risks and uncertainties described in our annual report, which is posted to our website. These risks and uncertainties could cause actual future results to differ materially from the results expressed or implied by any forward-looking statements made on this call.

The information discussed today will be based on our earnings release for the three months ended March 31, 2015. Excuse me. Our earnings release, quarterly report and a set of slides for today's call have been invested to the investor relation section of our website at Suddenlink.com.

If you'd like to follow along with the slides for this morning's call, it can be found on the presentations page of the investor relations website. Our earnings release compares actual and pro forma financial and operating results for the first quarters of 2015 and 2014.

Today, our presenters will focus on year-over-year pro forma results. This pro forma information reflects the divestiture of small cable systems on December 1, 2014, and the acquisition of cable systems from Northland Communications on January 2, 2014, and from New Wave Communications on October 1, 2014.

And with that, I'll now turn the call over to our CEO, Jerry Kent. Jerry?

Jerald L. Kent
Chairman, Chief Executive Officer

Thanks, and good morning, everyone, and thanks for joining Suddenlink's First Quarter 2015 Earnings call.

During the quarter, we made excellent progress in each of our business segments. In particular, our results verify the success of our video strategy, we're already seeing returns on our investment in Operation GigaSpeed, and our business services and carrier group is hitting on all cylinders.

On our last earnings call in February, I made some brief comments about our first quarter trends to date. Among other things, I mentioned that, while we might see some lessened residual impact on video units following our Viacom decision, we were once again growing customer relationships at an extremely healthy pace. And that's precisely what happened.

As noted on page 4 of today's presentation, we added over 24,600 customer relationships during the quarter. This is a new all-time quarterly record for Suddenlink, beating the last record which was set in the third quarter of 2014, just before our Viacom decision.

As a result of this new record, customer relationships were up 2.4 percent in the trailing 12 months. Clearly, we've regained our momentum, and we're excited about how all of our services are performing.

I'm also really proud of the way our management team and front line personnel responded to the company's decision to challenge the historical video business model.

Another issue that we discussed in our last earnings call was the decision to delay our annual rate adjustments. Historically, those adjustments would've been completed by the end of the prior year; however, given the significant changes to customer lineups during the fourth quarter, we postponed the normal timing for rate adjustments.

As the impact of our lineup changes subsided, we started communicating rate adjustments in February and implemented them in March and April.

While the changes to our lineups did help mitigate the increase in content costs, our combined basic and retransmission programming costs per basic video customer are still increasing at a percentage rate in the high single digits in 2015. Our rate adjustments were directly related to these continued cost pressures.

Turning now to each of our residential services, basic video declined by 6,400 units during the quarter, a loss of 0.6 percent since December 31st.

Note that we use the equivalent basic unit or EBU methodology. Under this methodology, bulk revenues are divided by the basic rate to arrive at an EBU number. As a result, a higher basic rate results in a lower number of EBUs.

For the first quarter, this loss of EBUs was calculated at approximately 2,200 units. Net of that calculation, we lost about 4,200 video homes during the quarter. Compared to the last several years when our basic video unit average was basically flat, we believe this loss of 4,200 units during the first quarter of 2015 was mainly attributable to our lineup changes in the fourth quarter and the implementation of rate increases.

Now, there's some interesting trends evident in our first quarter results that bear watching. First of all, video churn in the first quarter of 2015 was exactly the same rate as the year ago period, meaning disconnects were back to business as usual. Thus, changes in video activity in the first quarter of 2015 can be attributed to lower connect volume.

But when you analyze the details, our percentage of customers with the highest credit scores in the first quarter of 2015 improved 200 basis points over the first quarter of 2014, and is now at the best level ever.

This means the lower connect volume in the first quarter of 2015 was largely attributable to fewer connects from the lowest credit scores, which represent our highest churning customer segment. If this trend continues, it could have a positive impact on future churn.

With respect to residential Internet, we added 34,500 customers during the first quarter of 2015, which is on par with the year ago period.

Residential Internet customers now total more than 1.18 million, which is up more than 78,000 units, or 7.1 percent, in the trailing 12 months. In addition, phone units rebounded from a slight loss in the fourth quarter to nearly 9,600-unit gain in the first quarter, bringing our total residential telephone customers to more than 557,000, up over 29,000 units, or 5.6 percent, in the trailing 12 months.

As a result, residential PSUs grew nearly 38,000 units during the first quarter, reaching approximately 2.9 million at March 31st. That's up 1.8 percent in the trailing 12 months, and up 2.2 percent with commercial PSUs included.

Speaking of commercial PSUs, our data and phone businesses continue to achieve strong unit growth. As of March 31st, commercial data units were up 10.6 percent and commercial phone units were up 24.8 percent in the trailing 12 months.

Taken together, we believe these results speak to the resiliency of our business and reaffirm the soundness of the strategic investments we're making in our future.

Turning to our financial results summarized on page 5, first quarter 2015 revenue was $588.3 million, an increase of $12.4 million, or 2.2 percent over the year ago period.

This growth rate reflects the earlier mentioned delay in our annual rate adjustments, the fourth quarter loss of video customers, and an over $2.7 million seasonal decline in political advertising sales, given that 2015 is not a major political year and 2014 was a record year for us in terms of political ad sales.

Adjusted EBITDA in the first quarter was up slightly over the year ago period to nearly $222 million, largely on the strength of our customer relationships and unit results.

These revenue and adjusted EBITDA results surpassed our expectations for the first quarter, and as we move forward, we anticipate steady improvements in the year-over-year growth rates for both, driven by the completion of annual rate adjustments and continued growth in our residential and commercial revenues.

I'd also note that in the first quarter this year, we generated significant free cash flow of nearly $26 million, even with the ongoing investments we're making in Operation GigaSpeed.

As noted on page 6, Operation GigaSpeed is our $230 million, three-and-a-half year project to offer a 1-Gigabit service to nearly 90 percent of our customers. We're bringing next-generation broadband speeds to the second tier and suburban communities we serve, well before those speeds are available in many of the larger metropolitan markets served by others.

We believe that Operation GigaSpeed investments will help ensure we retain our strategic advantage of providing a superior broadband service for many years to come. This is a customer-centric strategy, one that helps us distinguish ourselves, grow market share, and keep high-speed Internet a major driver of our business.

We continued our progress on this important initiative, investing nearly $30 million of additional capital expenditures during the first quarter. These investments helped us further prepare for our first 1-Gigabit launches later this year, and in the interim, increase our flagship and top speeds in additional markets.

Our top speed is currently at 400 Megabits per second. Between October 1st last year and March 31st this year, we upgraded speeds to 670,000 internet customers in 37 markets at no additional cost to our customers.

As we make these investments, we continue to monitor the situations surrounding the FCC's Title II decision which was voted on 2 days after our last earnings call. Since then, as I assume most of you are aware, the resulting order has been published in the Federal Register and a number of expected court challenges have been filed. As I said before, Suddenlink fully supports an open Internet and our customers' right to access, on a level playing field, any and all legal Internet services that are available to them today and in the future. But we didn't need Title II to make that happen. Title II remains a “solution” in search of a problem.

There's no paid prioritization. There are no fast and slow lanes and certainly, there's no blocking of legal content by Suddenlink or other Internet service providers. In short, there's no marketplace rationale for the FCC's decision. Even so, the reaction of the capital markets to the published rules has been muted. We're also encouraged that the new rules do not apply to specialized services such as VOIP and IP video, which do not traverse the public Internet.

Still, a number of outstanding questions remain. For instance, the current order forbears on most aspects of rate regulation but not Section 201 of the underlying law. That section prohibits practices and charges that are "unjust" or "unreasonable." This means, instead of rules with certainties, our business strategy can be questioned by government officials on an after-the-fact, case-by-case basis.

The one thing that does remain clear, even now with the order published in the Federal Register, is that there will continue to be great uncertainty as the rules are implemented. In addition to pricing practices, there are questions about pole rates, state PUC jurisdiction, local telecom taxes and the Universal Service Fund. And for those reasons, as I indicated on our last call, we'll continue to reserve the right to make changes to our broadband investments, including Operation GigaSpeed, depending on how this very fluid situation evolves.

In the meantime, we support the lawsuits challenging this overreach of authority and we hope Congress comes together in a bipartisan fashion to ensure the concept of net neutrality, while passing legislation that stops overregulation by the FCC.

With that, I'll now turn the call over to Tom McMillin for a more detailed discussion of our first quarter operating results. Tom?

Thomas P. McMillin
Executive Vice President, Chief Operating Officer

Thanks, Jerry, and good morning, everyone.

I'll start by providing more detail on our customer results starting on Page 8.

At March 31, we had over 1.45 million customer relationships, which were up nearly 34,000 relationships or 2.4% in the trailing 12 months. Aiding this growth in customer relationships was our success in adding 92,000 non-video customers in the trailing 12 months, representing 29.5% year-over-year growth. At March 31, non-video customers represented approximately 28% of residential customer relationships.

Turning to our unit results, which are summarized on Page 9. We approached 2.9 million residential PSUs at March 31, an increase of nearly 50,000 or 1.8% year-over-year. With commercial units, which are summarized on a later page, we gained more than 64,000 PSUs or 2.2% in the trailing 12 months. As Jerry noted, growth in total PSUs is led by growth in residential Internet, which was up more than 78,000 units or 7.1% in the trailing 12 months. As a result, residential data penetration of estimated homes passed was 38.3% as of March 31 this year, up from 36.2% as of March 31 last year.

At the end of the first quarter, nearly 90% of our high-speed Internet customers have download speeds of 15 MB or higher. More than 60% had 30 MB or higher speeds and more than 55% have 50 MB or higher speeds enabled. Our 66.5% sell-in rate of 30 MB or higher services in the first quarter more than doubled sell-in for the same quarter a year ago, and our 55% sell-in rate of 50 MB or higher services was more than 8x higher than the sell-in for the same quarter a year ago. To help continue this progress, we've rolled out a new marketing initiative, starting in March, called the Suddenlink Speed Test Challenge. This program targets non-Suddenlink customers, offering them a way to compare the speeds of their current provider with those available from us. Results to date indicate that our speeds are up to 50x faster than what these non-customers currently have. With this program and Operation GigaSpeed gaining momentum, including our near-term move towards making 50 MB our flagship speed in a growing number of markets, we expect continued success in serving more customers with higher speeds in the months ahead.

In complement to our high-speed Internet service is Suddenlink WiFi@Home. During the most recent quarter, we set two new records for this service. First, our sell-in rate at more than 66% of new high-speed Internet connects was an all-time record. Second, our first quarter net gain of nearly 35,000 Suddenlink WiFi@Home customers was our best quarterly performance ever. In the trailing 12 months, WiFi@Home grew 33.3%, with a net gain of nearly 100,000 units, bringing our total customers with this service to more than 397,000, exceeding 1/3 of all Internet customers.

On telephony, we finished the quarter with over 557,000 residential customers, up more than 29,000 units or 5.6% in the trailing 12 months. As a result, residential phone penetration of estimated homes passed was 21% as of March 31 this year, up from 20.3% as of March 31 last year.

On basic video, we finished the quarter with over 1.1 million customers, down a nominal 0.6% since December 31, which is a greater than 80% improvement over our fourth quarter trend. It's important to note that the trailing 12-month basic video trend will continue to be burdened by the expected bubble of video disconnects we experienced in the fourth quarter last year until we report full year results for 2015.

Next, I'd like to briefly touch on commercial unit results for the first quarter of 2015. On Page 10, we note that our more than 42,000 commercial phone customers at March 31 resulted from adding 8,400 customers in the trailing 12 months, representing 24.8% growth. Over the same period, we added more than 6,000 commercial data customers, ending the first quarter with nearly 66,000, for a year-over-year growth rate of 10.6%. In addition to its impact on the residential side of the business, Operation GigaSpeed is also helping us improve the services we offer our commercial customers, and these enhanced services are fueling our continued market share growth in this segment.

Overall, we've had solid success adding commercial customer relationships, up 7.7% during the trailing 12 months to over 91,000 at March 31. Of those commercial relationships, nearly half were bundled customers, taking 2 or more commercial services from us. In the trailing 12 months, bundled customer relationships increased 17.6%.

We also continue to see solid gains in our Carrier Services group. As of March 31, we had successfully completed and initiated billing for more than 1,700 Fiber-to-the-Tower tenants, with over 120 more on signed contracts and in the process of being installed.

I'd now like to conclude my remarks this morning with a few more details about Operation GigaSpeed, building on what Jerry said and summarized on Page 11. First, the nearly $30 million in capital expenditures we invested in this project in the first quarter supported a number of critical steps, including various network enhancements and CMTS upgrades at 68 headends. In addition, our first quarter GigaSpeed investments enabled the introduction of faster Internet speeds in nearly a dozen more markets, benefiting almost 95,000 additional Internet customers. Project-to-date, as Jerry noted, we have increased speeds in 37 markets for more than 670,000 Internet customers or nearly 57% of our total Internet customers at March 31. In the 37 markets where initial upgrades have been completed, our flagship speed has more than tripled from 15 MB to 50 MB and our top speed increased to 150 MB in most areas, with some markets now offering speeds as high as 300 or 400 MB. Through the balance of the year, we expect to implement speed upgrades in nearly 70 more markets, serving an additional 400,000-plus customers, and our initial plan launches of a 1 GB service also remain on track for later this year.

Most recently, we kicked off of the deployment of HD-DTAs in several markets. This is the first step towards converting our delivery network to all-digital and reclaiming bandwidth that we will re-purpose for DOCSIS services to support our planned 1 GB offering.

Thank you for your time today. I'll now turn things over to Mary for a closer look at our financial results. Mary?

Mary E. Meduski
Executive Vice President, Chief Financial Officer

Thanks, Tom. Today, I'll discuss financial results for Cequel Communications Holdings I, LLC, and subsidiaries for the first quarter of 2015, adding to what Jerry and Tom have already provided. I'll also discuss our balance sheet and liquidity position.

Let's look first at revenue, which is summarized on Page 13. Total first quarter 2015 revenue was $588.3 million, representing growth of 2.2% or approximately $12.4 million over the first quarter of 2014. The year-over-year increase in total revenue was largely attributable to 14.2% growth in Internet revenue and 13.2% growth in commercial revenues, including 16.5% growth in commercial high-speed data, on-net carrier services, and telephone revenue on a combined basis.

Those increases were offset in part by the year-over-year decline in advertising revenue, as Jerry noted, due to the transition from a record-setting political ad sales year in 2014 to 2015, a year with no major elections. Video revenue also declined year-over-year due primarily to video customer losses in the last 12 months, the postponement of our annual year-end rate adjustments and reduced digital and premium revenue. These factors were offset in part by increases in broadcast retransmission revenue and converter rental revenue for HDTV and DVR capable digital converters.

As a reminder, our commercial lines of business, which are embedded in the video, high-speed Internet, telephone service and other revenue categories, are comprised of commercial and bulk video, commercial high-speed data, commercial telephone and on- and off-net carrier services. In the first quarter of 2015, revenue from these commercial sources represented approximately 15.3% of total revenue.

Turning to Page 14. We note that total operating cost and expenses in the first quarter of 2015 were up 3.3% over the first quarter of 2014. This increase was driven largely by increases in labor, marketing and broadcast retransmission expenses, which were offset in part by direct telephone expense savings due to the completion of Operation Reliant migrations in the fourth quarter of 2014.

Labor and employee-related expenses increased due to the impact of annual salary increases and headcount increases, primarily in door-to-door sales and technical operations. Marketing costs increased from the impact of targeted direct mail initiatives to support our offer strategy aimed at increasing market share and growing our customer base.

Total programming costs in the first quarter of 2015 decreased versus the year-ago period, due primarily to the loss of basic video customers in the trailing 12-month period and lower digital and premium expense, offset in part by the aforementioned increase in broadcast retransmission expense, as well as increased expenses associated with programming contract renewals and annual rate escalators, plus expanded carriage and new network launch requirements.

On a per basic video subscriber basis, which controls for video subscriber losses, combined basic and retransmission programming cost increased 7.7% in the first quarter 2015 versus the year-ago quarter. This rate of increase was muted in comparison to recent years due to the replacement of Viacom programming. Note also that our results in the first quarter included $1.2 million of nonrecurring expenses, primarily associated with nominal closeout work on Operation Reliant, following the completion of customer migrations to our internal platforms in the fourth quarter. Since the inception, since Operation Reliant, we've incurred $17.9 million in nonrecurring operating expenses versus our original expectation of $30 million. And we've incurred $18 million in capital expenditures versus our original expectation of $20 million. We do not expect to incur any other nonrecurring operating expenses nor capital expenditures related to Operation Reliant.

Before the impact of the noted nonrecurring expense in the first quarter, adjusted EBITDA for the first quarter 2015 was $223.2 million, up 0.5% over the same period in 2014.

Turning now to Page 15. We note that capital expenditures in the first quarter 2015 were $134.9 million, or 22.9% of revenue, inclusive of $29.7 million for Operation GigaSpeed. Operation GigaSpeed investments are more heavily weighted in the first quarter of the year due to the advanced purchase of customer premise equipment required to realize higher speeds, plus network investments to support our speed upgrades, including preparations for the first launches of a 1 GB service later this year.

Per the guidance offered on our last call, we still expect full year 2015 capital expenditures to be approximately $480 million to $490 million, inclusive of approximately $85 million for Operation GigaSpeed. This range for full year capital expenditures could increase further with the success-based commercial or carrier opportunities. Currently, we expect full year 2015 capital expenditures to represent less than 20% of revenue and to decline as a percent of revenue in future years to the mid-teens as we complete Operation GigaSpeed.

On Page 16, we've summarized free cash flow results. In the first quarter 2015, free cash flow of $25.7 million, while significant, was down from the year-ago period. This decline was largely due to a $39.5 million increase in capital expenditures driven by Operation GigaSpeed and a $4.4 million increase in cash interest expense due primarily to increased average indebtedness. Also impacting free cash flow in the first quarter were other factors we've discussed today, namely, the overweighting of capital expenditures in the first quarter for Operation GigaSpeed and the muting of first quarter adjusted EBITDA as a result of our delay in annual rate adjustments. As mentioned on prior calls, we expect to continue generating significant free cash flow even with the continued investment we're making with Operation GigaSpeed.

Turning to Page 17. You'll see that as of March 31, the face amount of our debt outstanding was approximately $5.08 billion, comprised of $2.31 billion of senior secured term loans at Cequel Communications, LLC, $1.5 billion of 6.375% senior notes at Cequel Communications Holdings I, $1.25 billion of 5.125% senior notes at Cequel Communications Holdings I and $22.1 million of capital leases and other obligations at Cequel Communications, LLC.

At March 31, we had approximately $146.5 million of cash on hand and approximately $482 million available under our $500 million revolving credit facility after taking into account $18 million of outstanding letters of credit. Our secured bank leverage ratio, as calculated under our credit agreement, was 2.46x, which was in compliance with our bank covenant with significant cushion. And our total leverage ratio, as calculated under the indentures governing both the 6.375% and 5.125% senior notes, was 5.49x. At March 31, we had no interest rates hedges in place and our weighted average cost of debt was 4.75%.

Now for a few words about our tax position, as summarized on Page 18. The operating activities of Cequel Communications Holdings I, LLC are included in the consolidated tax filings of our parent company, Cequel Corporation. As of December 31, 2014, Cequel Communications Holdings I and Cequel Corporation had a combined total of approximately $1.64 billion in net operating loss carry forwards. Given these NOLs and the tax basis of $3.52 billion for the consolidated group, we are not expected to be a significant income tax payer until 2021.

Finally, on Page 19, we summarize the reasons we believe our company is well positioned for the future, all of which have been discussed in our remarks this morning.

I'll now turn the call back over to the operator to facilitate questions. I would like to remind everyone that this is a public call and we will generally refrain from discussing information other than what is disclosed in the earnings release and quarterly reports.

Operator?

Question and Answer Session

Operator
[Operator Instructions] And our first question comes from Mike Kerrane of SunTrust.

Michael Kerrane
SunTrust

A question on operations. I know that Verizon has come out and talked about offering a skinnier package of bundles, and I was just wondering if you guys thought that was the trend in the industry and, if that's the case, what the impact would be on revenues and margins?

Jerald L. Kent
Chairman, Chief Executive Officer

I think there is a trend in the industry. I think we're beginning to see the unbundling of the bundle. We see, in addition to Verizon, of course, Sling has an offering, HBO is going direct and has deals, as I understand, with Cablevision and Apple, among others. And I see that some other programmers are considering some direct to the consumer offerings.

So I think it's just the beginning. And I think it will take time, but I think the bundle, certainly, is going to evolve and change. It has to. We've been very vocal about the fact that you can't just continue to have runaway programming costs. At some point, you start pricing people out of the market. We are looking at our own programming agreements and trying to decide what kind of bundles we can put out under our contracts to try to provide more choice and value for our customers. It's a project that's currently underway, and we'll talk more about it and how it affects units and revenues.

I just think that we need to be more customer-centric and that we need to provide value to our customers. If we just continue with the same old business model of double-digit programming cost increases every year and try to pass that on, I think we're going to start seeing a lot more cord-cutting. And so I think, in response, we need to try to provide the right value for our customers and this is the right way to go.

Thomas P. McMillin
Executive Vice President, Chief Operating Officer

Yes. Specific to that Verizon offer, I believe it's priced at $55, so that does not seem, from a price standpoint, that competitive to us. I mean, within our bundles, you can get video for less than $55 and that's our SL200 offering.

Michael Kerrane
SunTrust

That's helpful. One follow-up question I had was on the cap structure. You guys have 6 3/8 bonds due 2020 that are callable in September. I was just wondering if you had thought at all about what your plans are for those.

Mary E. Meduski
Executive Vice President, Chief Financial Officer

We're always thinking about our capital structure and our goal is always to optimize it. We'll have a plan long before our first call date as to whether that makes sense for us or not. But right now, it's premature.

Operator
[Operator Instructions] And I'm showing no further questions at this time.

Jerald L. Kent
Chairman, Chief Executive Officer

All right. Well thanks, everyone, for your continued interest and participation and have a great weekend.

Thomas P. McMillin
Executive Vice President, Chief Operating Officer

Thank you.

Operator
Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.