Credit Opinion: CenturyTel, Inc.

CenturyTel, Inc.

Monroe, Louisiana, United States

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Senior Unsecured	*Baa2
Preferred Shelf	*(P)Ba1
Commercial Paper	*P-2

* Placed under review for possible downgrade on June 24, 2008

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Opinion

Rating Drivers

CenturyTel (CTL) is confronting increased challenges to maintain revenue, margins and cash flows at current levels as competition from cable providers and wireless operators expands

CTL has a long history of growth through acquisition and a record of accomplishment in successfully integrating acquired assets, but EMBARQ is its largest acquisition to date and industry fundamentals continue to deteriorate

The company significantly increased its dividend in 2008.

Any significant modifications to the Universal Service Fund ("USF") program or Intercarrier Compensation schemes could have a material impact on the company's earnings and cash flows

The company strives to preserve a strong balance sheet and a solid liquidity profile with the goal of maintaining investment grade ratings

Corporate Profile

The company, together with its subsidiaries, provides an array of communications services including local and long distance voice, Internet access and broadband services, fiber transport, security monitoring and other communications and business information services in 25 states located within the continental United States. CenturyTel also offers co-branded satellite television services under an agency relationship. Headquartered in Monroe, Louisiana, CenturyTel Inc. served approximately 2.0 million access lines as of the end of 4Q'08. LTM to 4Q 2008, CTL generated about $2.6 billion in revenues and approximately $1.3 billion in EBITDA.

Rating Rationale

CenturyTel's ratings reflects its sizeable subscriber base, moderate leverage, predictable cash generating capabilities and our expectations that the company's management will maintain healthy liquidity and a capital structure that is consistent with maintaining an investment grade rating.

In the near term, we expect that access line losses amid increasing competition from wireless service providers and cable companies will continue to pressure revenues. That said, the company's ability to cut costs should enable it to maintain healthy cash flows over the next couple of years.

Over the past several years, CenturyTel has been an active participant in industry consolidation in order to drive revenue and earnings growth. As accelerating access line losses and slowing broadband adoption further diminish the prospects for organic growth, we expect this trend to continue (i.e. the pending EMBARQ acquisition). The high fixed costs of the telecom business mean that acquisitions can yield significant cost savings.

Recent Developments

On June 24, 2008, CenturyTel's ratings were placed on review for possible downgrade because of our concerns that the company's plan to increase its annual dividend from $0.27/share to $2.80/share and accelerate its share repurchase program would cause credit metrics to deteriorate below those consistent with its Baa2 long-term and Prime-2 short-term debt ratings.

On October 27, 2008, the review was extended to include an assessment of the credit implications of the company's plans to acquire EMBARQ Corporation. Under the terms of the agreement, EMBARQ shareholders will receive 1.37 CenturyTel shares for each share of EMBARQ common stock they own. The transaction reflected an enterprise value of approximately $11.6 billion at the time of the acquisition announcement, including the planned assumption of $5.8 billion of EMBARQ's debt. The companies anticipate closing this transaction in the second quarter of 2009.

While uncertainties exist with regard to the new company's leverage targets, future shareholder return strategies, and ability to realize anticipated synergies as contemplated, at this point in time, we believe that the company will be able to sustain credit metrics fully supportive of an investment grade rating. Consequently, any downgrade would likely be limited to one notch, to Baa3.

DETAILED RATING CONSIDERATIONS

COMPETITION IS EXPANDING; REVENUES UNDER PRESSURE

Although CenturyTel still retains a leading market share for traditional telecommunications services in its service territory because of its former monopoly position, its challenges are significant. Like all of its ILEC peers, CenturyTel faces growing competition within its markets from other telecom, cable, and wireless operators. The impact of this competition as well as from a changing technology landscape and a weakened macroeconomic environment have produced a declining trend in revenue as accelerating access line loss rates are not being sufficiently offset by other services.

Its local operations, the source of the majority of revenues, earnings and cash flow, are under rapidly increasing competitive challenges, especially from cable TV providers and wireless operators. The rate of access lines loss continues to accelerate (trailing twelve months access line declines reached 6.4% in 4Q' 2008), revenue growth remains challenging and margin expansion is stalling.

Over the past few years, CenturyTel has attempted to blunt competitive challenges by expanding broadband deployment and deepening its partnership with videowith mixed success. Its broadband penetration (of total access lines) is a relatively high 32% (641,000 customers) and its partnership with satellite TV provider Echostar has been moderately successful with the company increasing its total video subscribers to 118,000 in 4Q `08. While incremental profitability from the resale of satellite TV is minimal, we believe that it does increase customer retention, especially if the customer is also a CenturyTel broadband subscriber.

COST REDUCTIONS ARE KEY TO SUSTAINING CASH FLOW LEVELS

As of the end of 4Q'08, Moody's estimates that about 45% of the company's access lines faced competition from cable voice offerings. We expect this percentage to increase to about 60% over the next twelve to eighteen months. Consequently, access line erosion is expected to trend upward over the next several years compared to the 6.4 % seen during 2008. As such, we anticipate that the company's ability to grow revenues and sustain margins will become increasingly difficult over the next several years.

The shift in the company's revenue profile to a higher percentage of lower margin broadband, fiber transport and video services from higher margin voice services has pressured operating margins. Nevertheless, CenturyTel's ability to control costs (i.e. through headcount reductions, systems and processes improvements, merger synergies and restructuring of its video resale agreement) is providing some offset to competitive inroads and is allowing CenturyTel to maintain its EBITDA margins above 50%.

Management has identified about $400 million of synergies that it expects to realize from its acquisition of EMBARQ. While we expect these to be realized over time, we believe that margins will remain relatively stable over the next couple of years.

BUSINESS MODEL MAY BE EVOLVING

CTL's wireline-only business model is viewed less favorably by Moody's than either a diversified or pure wireless business model since technological change continues at a fast pace and an operator with strong fixed-line and wireless businesses is best positioned to evolve with such changes. The diversified player has a more sound platform for adopting a range of new products. It can strategically invest in emerging technologies and raise investments, depending on market acceptance of the new technologies, widening the opportunity for success.

The company appears to have recognized this reality. In 2008, the company spent about $149 million to acquire wireless spectrum in the 700-MHz auction. While this spectrum overlaps about 53% of its local service area, the company has indicated that it believes there will be opportunities to increase the overlap percentage through trades. We believe that it will be a year, at least, before any significant network presence can be established (and product offerings developed). Consequently, we believe that it will be some time before CenturyTel realizes the benefits from a diversified telecom business model.

ONGOING EVENT RISK DRIVEN BY BENEFITS OF SCALE; EXECUTION RISK WITH EMBARQ ACQUISITION

Over the years, CenturyTel has exhibited discipline in its acquisitions and focused on maintaining adequate financial flexibility and strong liquidity. This philosophy was demonstrated once again when CenturyTel announced its plans to acquire EMBARQ in a stock-for-stock transaction last year. The companies anticipate closing this transaction in the second quarter of 2009.

Although the acquisition of EMBARQ increases CenturyTel's exposure to more competitive urban/suburban markets, the increase in scale is expected to bolster its overall competitive position and increase operational and capital efficiencies, especially those related to network modernization and new product development. Nevertheless, the challenge to CenturyTel of integrating a company twice its size is substantial and will be an additional and significant focus of our ongoing review of its ratings.

SHAREHOLDER PRESSURE LIKELY TO REMAIN HIGH; MANAGEMENT HAS SO FAR BALANCED COMPETING INTERESTS OF BONDHOLDERS AND SHAREHOLDERS

CTL's management has long demonstrated a balanced approach to managing the competing interests of bondholders and shareholders. Over the last few years, CenturyTel has returned the bulk of its free cash flow to shareholders primarily through share repurchases which, in Moody's opinion, has given it the flexibility to simultaneously pursue strategic initiatives (i.e. acquisitions and spectrum purchases) and maintain a strong balance sheet. However, in June, 2008 the company announced a plan to increase its annual dividend from $0.27/share to $2.80/share and accelerate its share repurchase program. The shift in focus toward a more even balance between dividends and share repurchases reduces this flexibility since high dividend payouts are difficult to reverse without inflicting damage to the company's share price.

The combined company's proforma Debt/EBITDA ratio is expected to be about 2.4 x (Moody's adjusted, without synergies) with a dividend payout of about 50% of free cash flow. While the company has indicated its commitment to maintain an investment grade credit profile, we note that competition is accelerating and shareholder pressures are on the increase given the slow growth nature of the business. Consequently, the company's ability to re-strengthen its balance sheet after any future acquisition could be limited. Nevertheless, given the company's balanced approach to its capital structure, strong free cash flow generation and ample liquidity, we expect modest additional debt reduction in 2009.

INCREASED REGULATORY UNCERTAINTY

Approximately 8% of CenturyTel's operating revenues come from the Universal Service Fund ("USF") program and another one-quarter come from access services. ILECs' high-margin revenues from access services are undergoing a secular shift as competition from the expanding number of carriers pressures these rates, particularly on intrastate calls. The Federal Communication Commission is engaged in a comprehensive reform of intercarrier compensation and universal service. The critical nature of these revenue streams was demonstrated when former FCC Chairman Kevin Martin proposed a plan that would have reduced intra-state access rates to inter-state levels and further lowering it to $.0007 over time. The recommendation set off a massive outcry against the proposal by the RLECs and the issue was deferred. Although a revision of existing access revenue rules is unlikely in the near term, modifications are expected in the future. Because these revenues are very high margin, modifications to the current frameworks are likely have a significant impact on all RLECs, potentially negatively impacting CTL's free cash flow generating capacity.

Before the acquisition of EMBARQ can close, numerous regulatory approvals, including those of several state Public Utility Commissions, are required. Conditions that may be imposed by some of these states' regulatory authorities could have a material impact on the combined entities' future operating performance and financial profile

Moody's believes that ILECs are likely to have an opportunity to tap into a large portion of the billions of stimulus funding devoted to broadband expansion. However, rules for funding and criteria for open networks and net neutrality may hold off some buildouts. Details are still being worked on, but ILECs like CenturyTel could be well-positioned to take advantage of either direct grants or tax credits.

Liquidity Profile

CenturyTel generates predictable and significant cash flow from operations, maintains nominal cash on the balance sheet and maintains a committed bank credit facility to support its liquidity.

In connection with the EMBARQ merger, CenturyTel entered into a financing commitment letter that provided for an $800 million bridge facility to fund, among other things, the repayment of outstanding borrowings under the EMBARQ credit facility. Due to the amendment to EMBARQ's revolving credit facility announced in late January, CenturyTel does not expect this bridge financing to be required to consummate the merger. Therefore, CenturyTel has terminated the financing commitment letter. The amendment, which only becomes effective upon the close of the merger, enables the EMBARQ facility, as amended, to remain in place after the close.

Key terms of the amended facility are as follows:

-- Effective upon the CenturyTel-EMBARQ merger close

-- $800 million unsecured revolving credit facility

-- Borrowing cost equal to LIBOR plus 300 basis points at current credit ratings

-- Matures May 10, 2011 (consistent with the existing EMBARQ credit facility)

-- Lender group comprised of 23 domestic and international banks

The following analysis excludes impact of potential merger with EMBARQ:

Over the next twelve months, the company's gross cash flow is expected to be about $850 million to $900 million. During this period, the company's obligations are expected to consist primarily of capital expenditures of about $290 million, 2009 debt maturities of $20 million and dividend payments of around $300 million. The company has suspended its share repurchase program, but may consider making additional share repurchases after the merger is completed.

CenturyTel has a commercial paper program intended for working capital purposes, capital expenditures, acquisitions and debt repayments. The company is authorized to have outstanding up to $1.5 billion in commercial paper at any one time, however, borrowings are effectively limited to the amount available under its $708 million five year revolving credit facility which expires in December 2011. At FYE 2009, CenturyTel had no commercial paper outstanding and approximately $563 million outstanding under it revolving credit facility with approximately $243 million of cash on the balance sheet. The revolving credit facility contains a maximum funded debt (of the parent and its subsidiaries) to LTM EBITDA of 4.0x and minimum LTM EBITDA to interest expense of 1.5x. As of FYE 2008, for compliance purposes, on an unadjusted basis, Moody's estimates that these ratios stood at 2.6x and 6.4x respectively.

Rating Outlook

Pending resolution of the acquisition transaction, ratings for CenturyTel remain on review for possible downgrade.

On June 24, 2008, CenturyTel's ratings were placed on review for possible downgrade because of our concerns that the company's plan to increase its annual dividend from $0.27/share to $2.80/share and accelerate its share repurchase program would cause credit metrics to deteriorate below those consistent with its Baa2 long-term and Prime-2 short-term debt ratings.

On October 27, 2008, the review was extended to include an assessment of the credit implications of the company's plans to acquire Embarq Corporation. Under the terms of the agreement, EMBARQ shareholders will receive 1.37 CenturyTel shares for each share of EMBARQ common stock they own. The transaction reflects an enterprise value of approximately $11.6 billion at the time of the acquisition announcement, including the planned assumption of $5.8 billion of EMBARQ's debt.

The companies anticipate closing this transaction in the second quarter of 2009.

What Could Change the Rating - Up

Given the pending transaction and the ongoing review for possible downgrade, a ratings upgrade is not anticipated.

What Could Change the Rating - Down

The combined company is expected to generate significant operating cash flow, especially after anticipated synergies. In addition, free cash flow levels are expected to also benefit from modest capital efficiencies. Pro forma leverage is projected to be less than 2.5 times Debt to EBITDA (both before and after synergies) and dividends, about $800 million annually, are initially expected to be about 50% of pro forma free cash flow.

However, uncertainties exist with regard to the new company's leverage targets and future shareholder return strategies. These decisions, together with our assessment as to whether CenturyTel will achieve the anticipated synergies will have a critical impact on CenturyTel's ratings. At this point in time, we believe that the company will be able to sustain credit metrics fully supportive of an investment grade rating, and a downgrade would likely be limited to one notch, or Baa3.

Other Considerations

GRID IMPLIED RATING

CenturyTel's mapping to Moody's Rating Methodology for the Global Telecommunications Industry is shown in the grid below. The Methodology implied rating of Baa2 for CTL does not incorporate the proposed transaction with EMBARQ which is expected to close in the second quarter of 2009.