

Telecommunications Services Wireline

Industry Report

EQUITY
RESEARCH

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Statistical Analysis of Access Line Impact on ILEC Financial Results

- ◆ In this report, we look at the overall impact of access line losses on the financial results of the ILECs within our coverage universe. We continue to assert that there are many other factors driving these businesses beyond simple access line trends.
- ◆ We have applied linear regression analysis to the companies and the group going back five years to see where the relationships exist between access lines and the income statement, with some very interesting results. For the most part, access lines were statistically meaningful predictors of revenue; however this relationship was often an inverse one, implying revenue increased as access lines declined. The relationship to EBITDAS and FCF, however, was usually not very strong, making access line trends appear less meaningful to cash flow and dividend stability, in our opinion.
- ◆ Access line losses have displayed a limited impact on the reported results, as sales of unregulated services, special access, and broadband have continued to make up for the declines, and we expect the impact of increasing demand related to wireless backhaul to further insulate the ILECs from lost primary line revenue. For this reason we focused on reported results and not ARMIS data, which believe is misleading.
- ◆ Increased demand for data from businesses in their territory (25% to over 50% of their business) has also offset residential access line losses. As xDSL matures, revenue offsets may be more difficult and could negatively change the revenue and profitability characteristics of the ILECs going forward.
- ◆ Overall, we believe historical trends suggest access lines should not be the sole measure of wireline carriers' business direction, as average revenue per line has consistently trended up as access lines decline, with positive mix-shifts, up selling, and regulatory factors keeping revenue flat to up over the same period. We believe the data we highlight in our report supports this thesis.
- ◆ The companies with reliable data that demonstrate the least impact to revenue, EBITDAS, and FCF are Alaska, Cincinnati Bell, Consolidated Communications and CenturyTel.
- ◆ We note the RBOCs are largely excluded from this report due to a lack of accurate pro-forma data for acquisitions. Additionally, they are highly diversified into enterprise and wireless, making line losses less meaningful, in our opinion. We believe this industry continues to demonstrate positive characteristics beyond access line trends that are keeping models stable, and we encourage investors to consider these trends in analyzing these companies.

Please read disclosure/risk information on page 23 and Analyst Certification on page 24.

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Access Line Trends: Not What They Seem to Be

In this report, we examine the relationships between access lines and telecom companies' financials through the use of linear regressions and scatter plots. In the past, access lines have been viewed as either the key determinant of financial results, or at least one of the most critical factors, with financial models driven by access line trends. Having financial models built on access lines has been troubling to investors over the past six or seven years as access lines have continued to decline. Much to everyone's amazement, the resulting revenue and EBITDAS stability and FCF growth have been quite puzzling, and while we have asserted for several years that access lines have less to do with driving the model than investors think, this has largely been an argument based on our observance of the continued financial stability while lines decline and ARPU steadily grows. Our data suggest that in many instances, the ability of access lines to explain the variance in revenue and cash flow is low or even negative, as we discuss later, implying access lines were not the determinant we had previously thought, or companies have diversified significantly enough to offset the impact of decreasing access lines. These are the questions that form the basis for this report.

In order to determine which parts of the financial results were potentially driven by access lines and to what degree, we ran linear regressions of access lines on a variety of metrics, including: revenue, EBITDAS, operating income, capital expenditures, and levered free cash flow per share. After that data was collected, the output for the linear regressions supplied us with standard regression statistics (multiple R, R^2 , adjusted R^2 , and standard error) along with an ANOVA table (regression coefficients, t-stat, p-value, sum of squares, confidence interval, and mean sum of squares), which we used to evaluate the relationships between access lines and the other data fields.

We found that the relationships that made the most sense to focus on were revenue, EBITDAS, and FCF, and we utilized Multiple R (correlation), R^2 (% of variation explained by variable), and the p-value to determine the amount of variation in these lines due to access line trends. We used a p-value of .05 for the purpose of statistical significance, while Multiple R and R^2 describe how closely related the two data categories are, with the multiple R ranging from -1.0 to 1.0.

Second, using the most recent 21 quarters of reported financial data from the categories above we constructed scatter plots for each relationship between the financial data and access lines across the companies we cover. Trend lines were fitted to each of the graphs along with the equation of the line, giving a visual representation of two data series. The trend line takes the relationship between the two data series into consideration and allows prediction of future data points. Scatter plots are essentially a graphical version of the correlation or multiple R.

Third, for well diversified companies such as Cincinnati Bell (CBB) and Alaska (ALSK) we also show the regression results that exclude the wireless segment for revenue, EBITDAS, and levered free cash flow in order to get a clearer picture on the relationship between the data and access lines purely from a wireline perspective. We are interested in how the line losses impact the wireline business mainly, but this does not tell the whole story, as the wireless businesses are inherently supported by the wireline network. It is important to note that wireless and other operations are key tenants of our diversification thesis, and the resulting statistical analysis supports this view. Scatter plots and trend lines were constructed for this data, and we adjusted some outlying data points and made some adjustments for divested divisions and unusual one time items, which, in our opinion, gave us a better view of the company with regards to its current and future operations. We chose to leave current CLEC operations and CLEC lines in our model as we view

these as one of the few areas of the wireline infrastructure where we can more easily observe an alternative use of the historical incumbent local exchange carrier (ILEC) investment (we suspect there are many others we are less able to observe, as we will discuss later in this report).

We have looked at the industry in various formats, with regressions run on a variety of factors across individual companies, sub-groups, and modifications of the companies to exclude divested assets as well as to exclude wireless where appropriate. We believe that removing wireless in many cases gives an interesting picture into the core wireline operations, as this is the part of the model that we believe comes into question the most, but keeping in mind the inherent diversification wireless brings and is likely to continue to bring in the future.

We focused these regressions on reported financial data as we believe this is the data that investors are basing decisions on. Several flavors of more regulatory related data exist, such as ARMIS data filed at the FCC, but we view Automated Reporting Management Information System (ARMIS) data as having little value. These figures are related to the regulated portion of the ILEC only, thus excluding significant (and permanent) lines of business. We also point out that the ILECs have a motivation to use FCC filing rules to their advantage, making the data look as bad for them as possible as they pursue additional regulatory relief. Therefore, we believe audited financial data from quarterly reports is appropriate for investment decisions.

Lastly, the results for Verizon (VZ) are excluded from this analysis, and only limited data from AT&T (T) is included. The primary reason for this is the data we have for these companies on a pro forma basis (adjusting for acquisitions: AT&T, MCI, AT&T Wireless, and BellSouth primarily, and divestitures: Idearc, international assets, etc.) is limited to the last three years, which does not give us enough data points to make a regression that we can have high confidence in. Similarly, the data we show for Embarq (EQ) is also less reliable due to only having 11 periods of pro-forma data where 20 periods are needed for reliable output. We have shown some AT&T and Embarq regressions later in this report for illustration, but the conclusions drawn in this report are primarily useful in analyzing the smaller carriers where access line trends are more critical. We also point out that it is quite apparent that AT&T and Verizon have significantly diversified away from residential business, and it does appear to be consensus opinion that they are primarily enterprise and wireless plays, making the regulated ILEC portion of its business less relevant to the entire company. The results are very interesting, and we have them summarized later in the report.

Statistical Measures and Definitions Used in This Report

In analyzing the data, we used the output for the linear regressions, standard regression statistics (multiple R, R^2 , adjusted R^2 , and standard error) along with an ANOVA table (regression coefficients, t-stat, p-value, sum of squares, confidence interval, and mean sum of squares), which we used to evaluate the relationships between access lines and the other data fields. Multiple R is the correlation coefficient which measures the tendency of two variables to move together. It is also the square root of R^2 or coefficient of determination. This describes how much of the variance in the financial metrics is explained by access lines. We use an R^2 of 0.4 or higher as our marker for statistical relevance, which corresponds to access lines explaining 40% of the variance in revenue, EBITDAS, and FCF per share. The x variable regression coefficient describes the slope of the line and the relationship between access lines and revenue, EBITDAS, and FCF per share. We used a p-value of .05 for the purpose of statistical significance, while Multiple R and R^2 describe how closely related the two data categories are, with the multiple R ranging from -1.0 to 1.0.

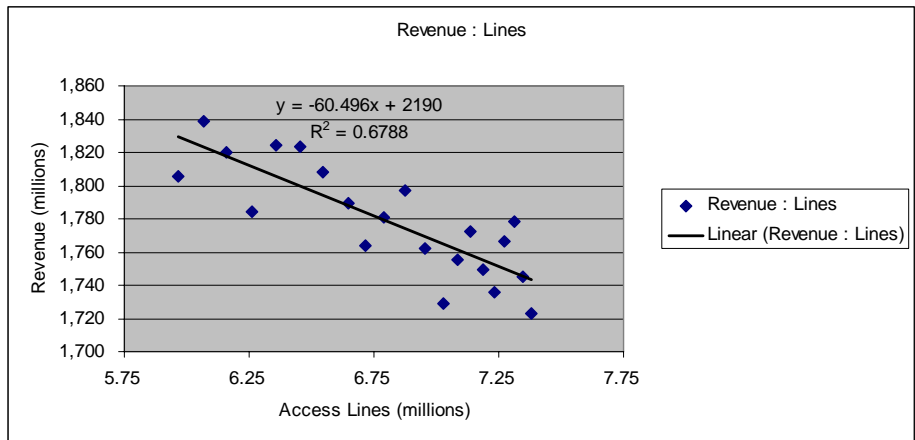
ILECs in Aggregate

In looking at the data for the ILECs, we ran a regression on total access lines and financial data for Alaska Communications Systems, Cincinnati Bell (CTL), Consolidated Communications (CNSL), CenturyTel (CTL), Citizens Communications, and Iowa Telecom (IWA) from 1Q03 through 1Q08 (comments on individual companies and the basis for the numbers we used are included in their individual sections later in this report). These companies were chosen because they all had a reliable set of 21 periods' data. The results tend to support our overall thesis that access lines are not driving the results of these companies to a significant degree.

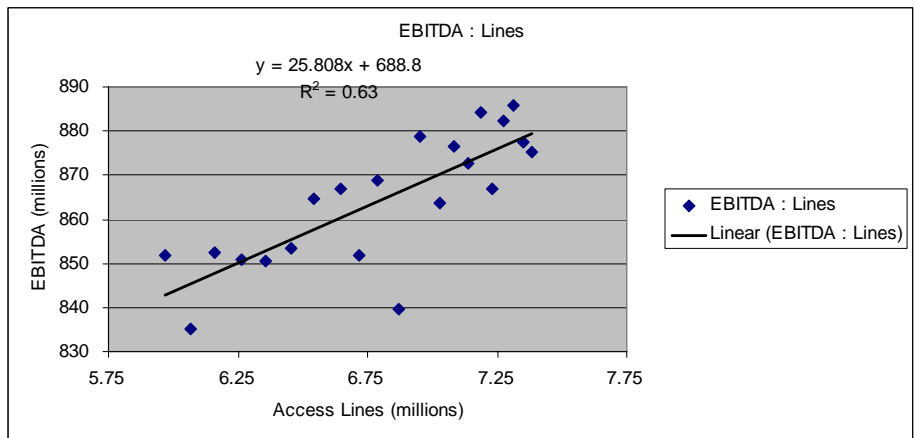
As demonstrated in the following tables, in aggregate, the R² for access lines regressed on revenue was 0.68 but with a negative slope, implying access lines are a poor predictor of revenue in and of itself because it means revenue increases as access lines decline. When we go a step further and run the regression of access lines on EBITDAs (highly important due to the dividends paid and the survivability from an interest coverage and FCF perspective) the R² goes to 0.63 with a positive slope, showing a good ability to explain trends in EBITDAs. The regression coefficient of 25.8 and p-value of 31.8x10⁻⁶ imply the data was statistically significant.

The individual companies showed a wider range of correlations, but we believe this aggregate regression does demonstrate that focusing on access lines would not appear to be the best way to assess the health and direction of the industry.

ILEC Revenue



ILEC EBITDAS



Source: Company reports and Raymond James estimates.

What is Changing?

There are several factors that we believe to be at work within the space that are not directly related to access lines per se. First, the growth in overall data demand has benefited the rural ILECs to a large degree, just as it has for the RBOCs. With ILEC exposure to enterprise ranging from 25% to over 50%, the ability for data and enterprise demand to positively impact these carriers regardless of access line trends is significant. Citizens Communications has stated on its last two earnings calls that, over the past two years, it has replaced an average of 65% of the monthly revenue erosion due to access line losses with growth in enterprise data. Add to this xDSL, long distance growth, and other value added services (voice mail, caller ID, call waiting, etc.), and it is not hard to see how Citizens has maintained relatively stable results in the face of access line declines (for more on Citizens, see individual section later in this report). We do not have statistics like this from other carriers, but we would expect results to be relatively consistent, and would explain at least some of the lost revenue.

Somewhat related to this is wireless traffic growth, which is the flip-side of wireless substitution. Increasing wireless traffic drives wireless backhaul, helping the smaller ILECs. Most of these carriers do not have wireless units of their own anymore, (Alaska and Cincinnati Bell being notable exceptions, and recent advanced wireless service (AWS) and 700 MHz spectrum purchases by others have yet to demonstrate their business models) but they do provide virtually all of the special access circuits for tower backhaul in their markets, and in many cases fiber transport along their out-of-the-way fiber routes within their territory. We believe this has been a significant boost to their revenue and profitability, and with wireless data demand expected to continue, this trend should grow as well. These circuits are not usually visible in the access line counts, but they are clearly helping with top-line trends.

Individual Company Results

The following sections depict our analysis of individual companies:

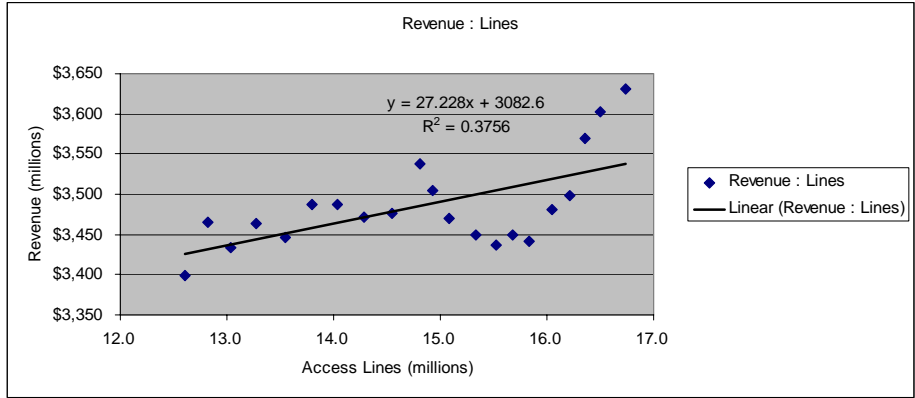
Qwest

Qwest (Q) is an interesting example as it is relatively M&A free over the past few years, does not have wireless (making access lines more directly related to the majority of its business), and has more exposure to residential business, tempered by much less exposure to basic cable penetration within its territory than AT&T or Verizon. We also have some insight into Qwest Corp. from separate SEC filings that give us a partial view of what Qwest would look like as a stand alone RBOC. Corporate allocations and other factors keep this from being a clean picture, but it is interesting nonetheless.

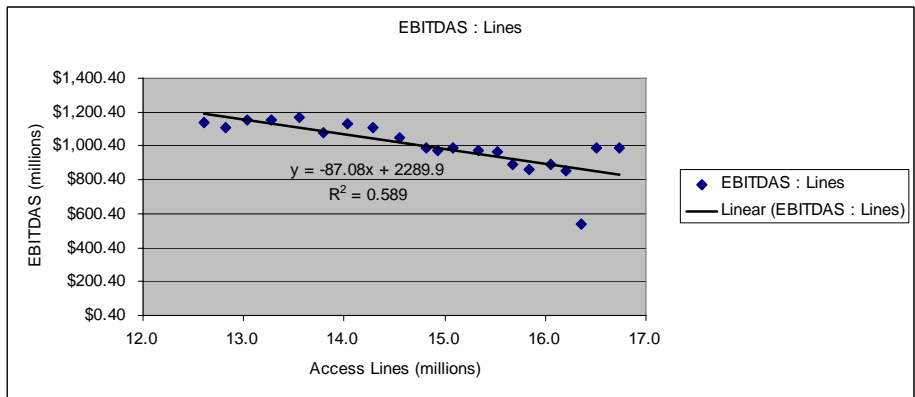
The regressions for Qwest tell us that access lines explain some of the variation of revenue for Qwest, with a regression coefficient of 27.2, as shown in the following table. This is significantly different than 0 given the F-statistic p-value of 0.003. EBITDAS, however, was not explained well by access lines with a -87.1 coefficient as cost cutting, xDSL growth, and increasing trends in revenue from classic Qwest (the long distance and out of region data business) as well as other improvements to the top line more than offset EBITDAS lost from access lines. The regression for Qwest tells us that access lines are not a strong predictor of revenue for Qwest, with an R^2 of 0.376, as shown in the following table. EBITDAS, however, had a large portion of variation explained by changes in access lines with the R^2 coming in at 0.589, but this is negatively correlated with multiple R of 0.77, implying that EBITDAS goes up as access lines decline.

This is partly explained by the increasing trends in revenue from classic Qwest (the long distance and out of region data business) as well as other improvements to the top line and cost controls that were growing alongside the trend in declining access lines. Overall, access lines appear to be accurate predictors of revenue but not EBITDAS for Qwest. Lastly, FCF was not explained well by access lines with a coefficient of -0.06 and an R^2 of 0.04

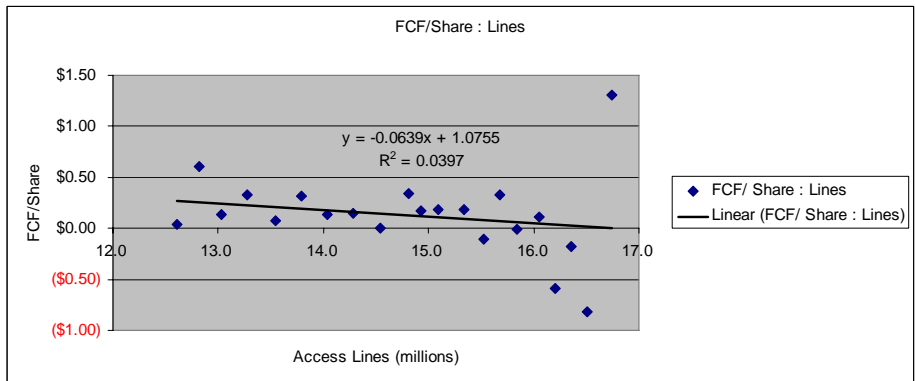
Qwest Revenue



Qwest EBITDAS



Qwest FCF/Share

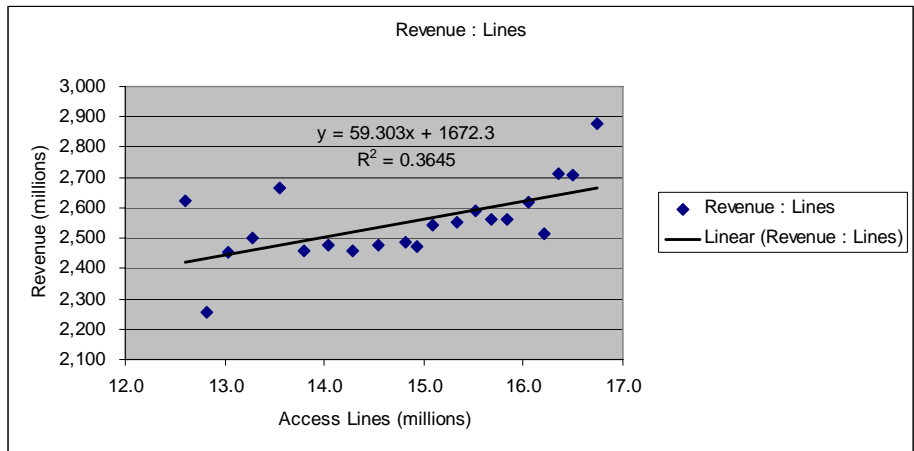


Source: Company reports and Raymond James estimates.

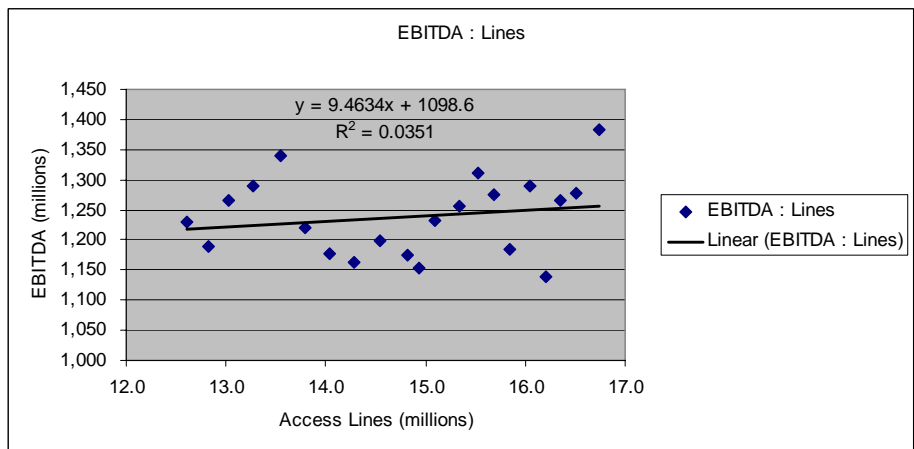
Qwest Corp.

The next slice would be to look at Qwest Corp. Here we get different results, with the R^2 for revenue only slightly better as the classic Qwest results are removed, coming in at 0.364. The EBITDAS, however, is not statistically significant (0.416) with an R^2 of 0.035. The regression for Qwest Corp. tells us that access lines explain more of the variation of revenue than in Qwest International, with a regression coefficient of 59.3, as shown in the table below. This is significantly different than 0 given the F-statistic p-value of 0.004. EBITDAS, however, was not explained well by access lines with a 9.5 coefficient and 0.42 P-value, and an R^2 of 0.035. Again, the cost allocations are somewhat arbitrary and difficult to get additional insight into, but we believe the negative coefficient on the Qwest International regression due to improvements in classic Qwest is removed by looking at this data, which is important. Either way, access lines appear to be accurate predictors of revenue but not for EBITDAS for Qwest.

Qwest Corp. Revenue



Qwest Corp. EBITDAS



Source: Company reports and Raymond James estimates.

**Wireless ILECs –
Alaska and Cincinnati
Bell**

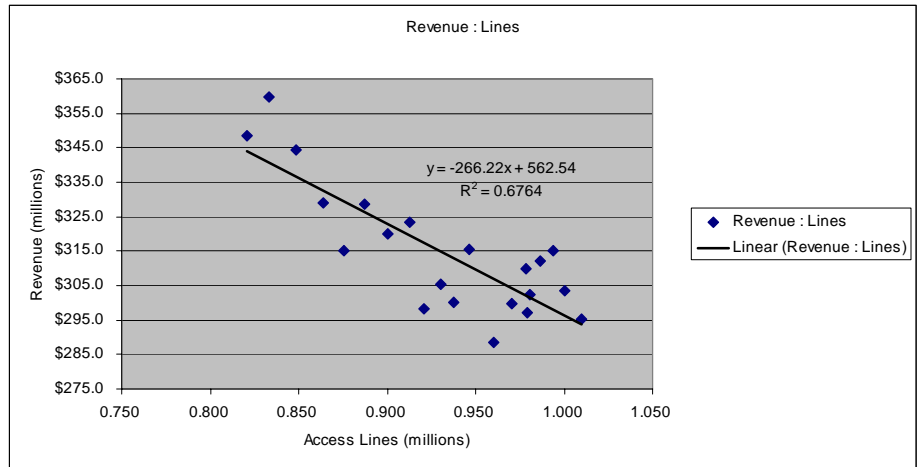
Next we look at two carriers that have significant wireless assets and are diversifying away from the residential business quickly. Alaska and Cincinnati Bell are often mentioned in the line-loss commentary as they appear to be islands in the middle of this storm, and the outcome is often assumed to be more dire for them than for other carriers.

Cincinnati Bell

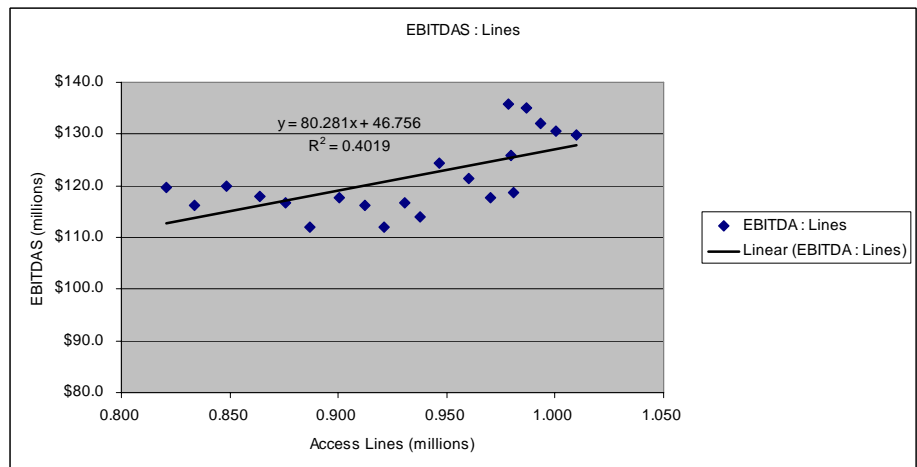
The regression for Cincinnati Bell tells us that access lines do not explain the variation of revenue for the company, with a regression coefficient of -266.2. EBITDAS however, was partially explained by access lines as the F-statistic P-value was 0.002 and a regression coefficient of 80.3. The R^2 of the two series stood at 0.676 for revenue, and 0.402 for EBITDAS, respectively. Overall, access lines appear to be poor predictors of revenue, but good predictors of EBITDAS for Cincinnati Bell.

We believe the negative slope is explained by wireless and data center trends that have been developing over the past five years, with Cincinnati Bell experiencing some declining wireless periods during the regression, while Alaska did not. We believe the data center revenue growth offset the revenue lost from access lines, but that EBITDAS declined given the superior margins of the access lines relative to the data center business. Lastly, FCF was partially explained by access lines with a coefficient of 0.97 and a p-value of 0.02 and an R^2 of .32

Cincinnati Bell Revenue

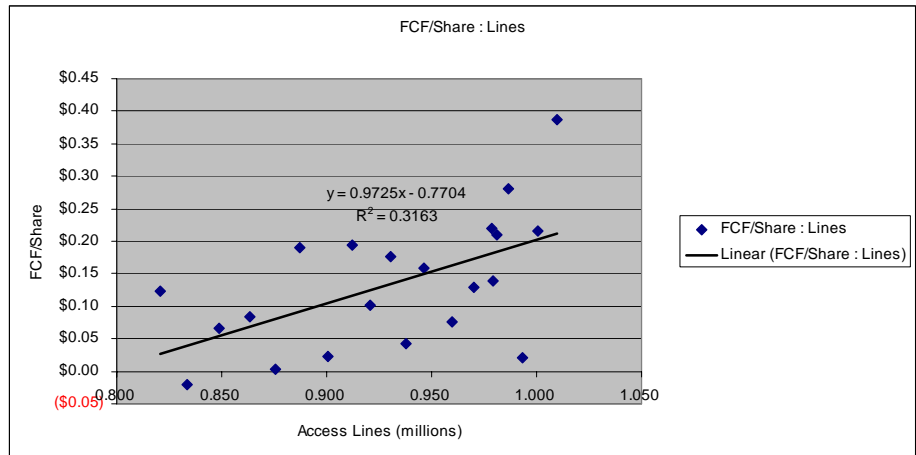


Cincinnati Bell EBITDAS



Source: Company reports and Raymond James estimates.

Cincinnati Bell FCF/Share



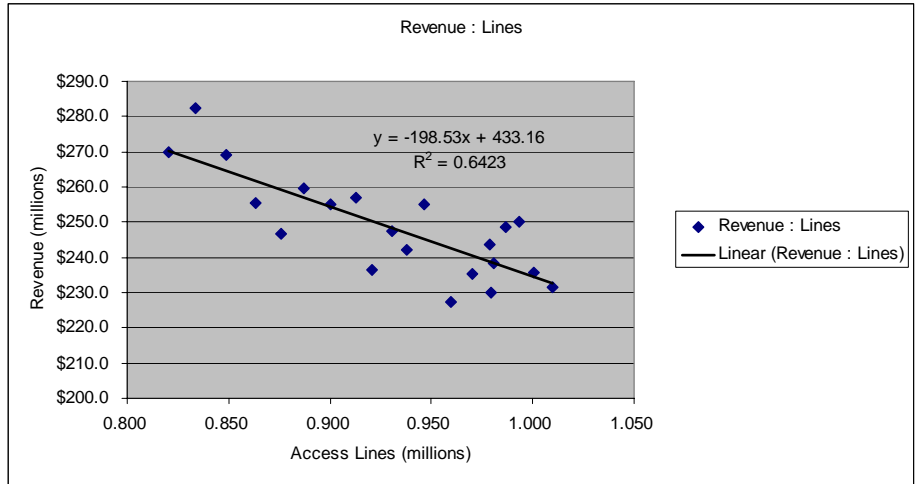
Source: Company reports and Raymond James estimates.

The regression for Cincinnati Bell (excluding wireless) tells us that access lines still do not explain the variation of revenue for the company, with a regression coefficient of -198.5, as shown in the following table. EBITDAS however, was partially explained by access lines as the F-statistic P-value was 0.031 and a coefficient of 46.6. The R² for the two series stood at 0.642 for revenue, and 0.223 for EBITDAS, respectively, implying a large percentage of wireline only revenue was inversely related to access lines, but not EBITDAS. Overall, access lines appear to be poor predictors of revenue, but good predictors of EBITDAS for Cincinnati Bell when the wireless unit is excluded. We believe the data center revenue growth offset the revenue lost from access lines, but that EBITDAS declined given the superior margins of the access lines relative to the data center business.

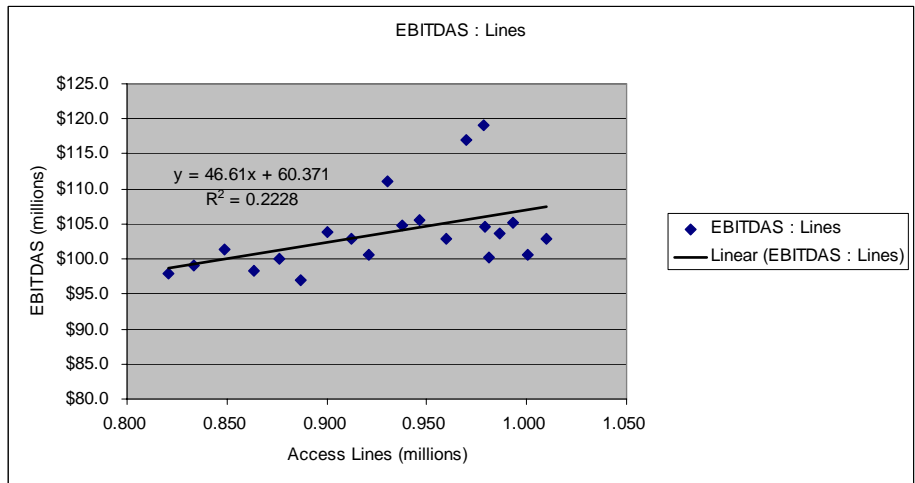
We believe this is due to cost controls and overall positive FCF trends over the past several years through debt refinancing and generally improved business, including the data center business. The general conclusion here is that Cincinnati Bell is diversifying away from the residential phone business, and that access lines are not driving this business to a large extent. We also believe it is a reflection of the company's ability to adjust its cost structure beyond commonly held views that it has a rigidly fixed cost structure. We believe this could be the case for many of the companies we cover.

**Cincinnati Bell -
Excluding Wireless**

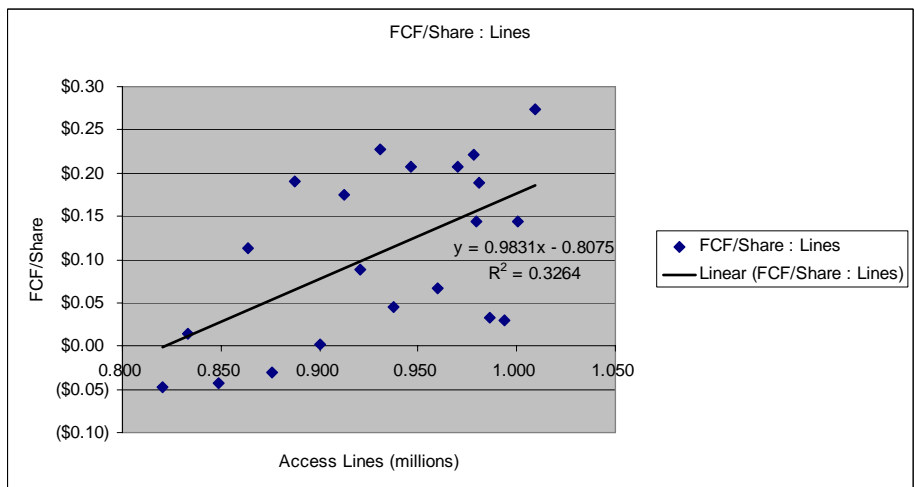
Cincinnati Bell Wireline Revenue



Cincinnati Bell Wireline EBITDAS



Cincinnati Bell Wireline FCF/Share



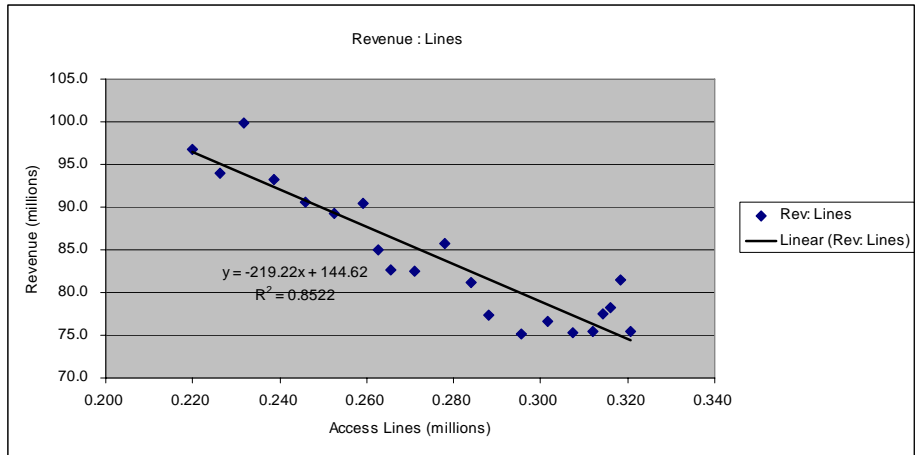
Source: Company reports and Raymond James estimates.

Alaska

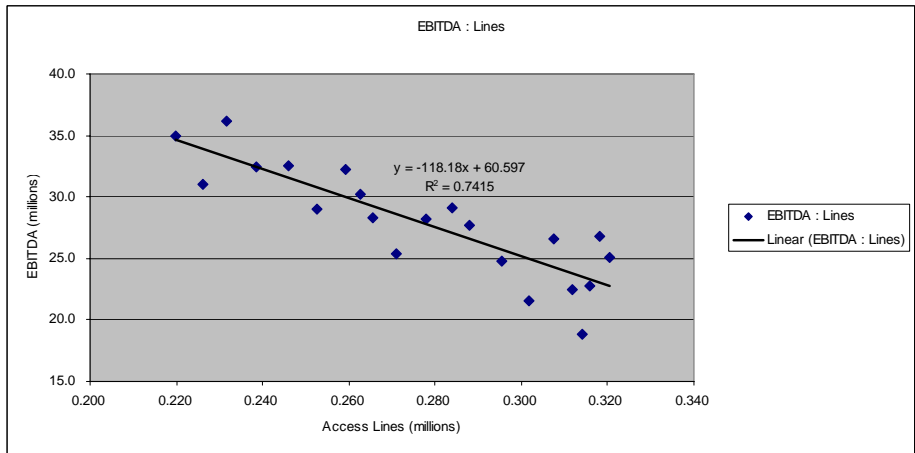
The regression for Alaska tells us that access lines don't explain the variation of revenue or EBITDAS for Alaska, with regression coefficients of -219.2 and -118.2 respectively, and with an R² of 0.85 for revenue and 0.74 for EBITDAS. Overall, access lines do not appear to be accurate predictors of revenue or EBITDAS, as wireless and data growth are overshadowing access line losses. However, it is negatively correlated, implying the counter intuitive concept that as access lines decline, revenue moves up nicely. We believe this is an interesting argument for looking at non-access line related revenue trends that are working below the surface.

Going forward, we believe data will continue to be a larger piece of wireline revenue and decrease the statistical relationship between lines and revenue, boosted by wireless related growth, which has been a strong driver of the business over the past few years. We do note that the results are not statistically significant for FCF per share, with the R² coming in at only 0.122

Alaska Revenue

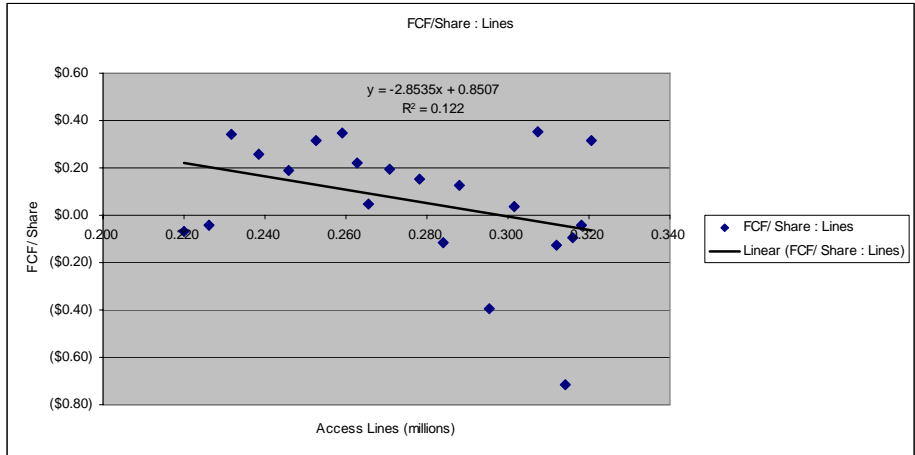


Alaska EBITDAS



Source: Company reports and Raymond James estimates.

Alaska FCF/Share

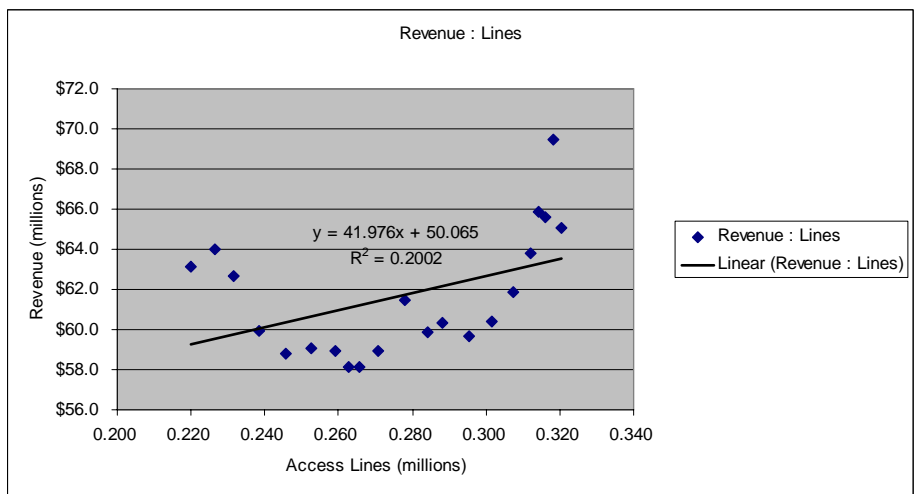


Source: Company reports and Raymond James estimates.

The regression for Alaska (excluding wireless) tells us that access lines partially explain the variation of revenue for Alaska, with a regression coefficient of 42.0. This is significantly different than 0 given the F-statistic p-value of 0.042. The R^2 however, was only 0.2. However, the scatter plot indicates a divergence from the trend as recent growth in data is offsetting access line declines and causing overall revenue growth. EBITDAS was not explained well by access lines as the F-statistic P-value was 0.18 and an R^2 of 0.09. Overall, access lines appear to be accurate predictors of revenue, historically, but not for EBITDAS for Alaska. Lastly, FCF was not explained well by access lines with a coefficient of 0.5, a 0.65 p-value and an R^2 of 0.01.

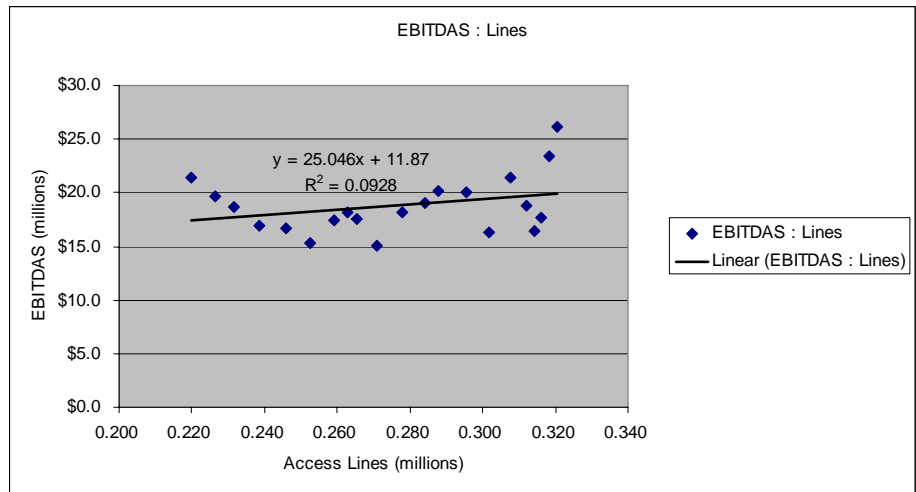
Excluding Wireless

Alaska Revenue Excluding Wireless

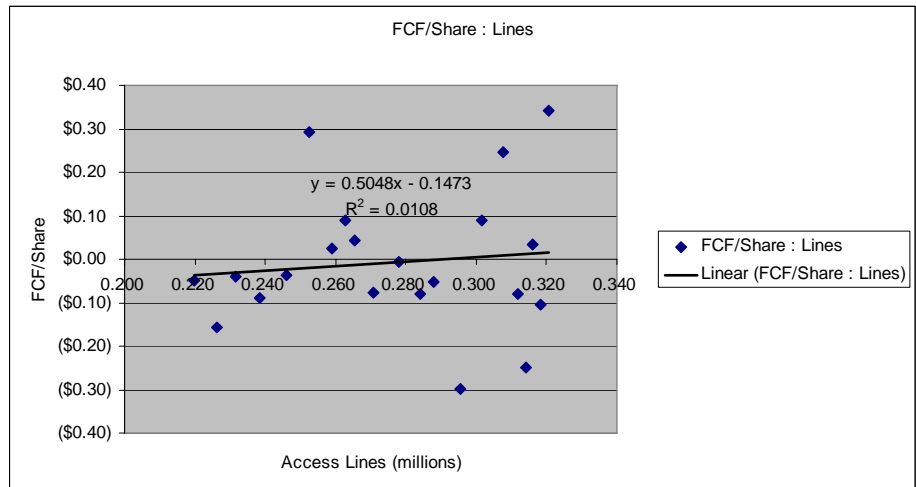


Source: Company reports and Raymond James estimates.

Alaska EBITDAS Excluding Wireless



Alaska FCF/Share Excluding Wireless



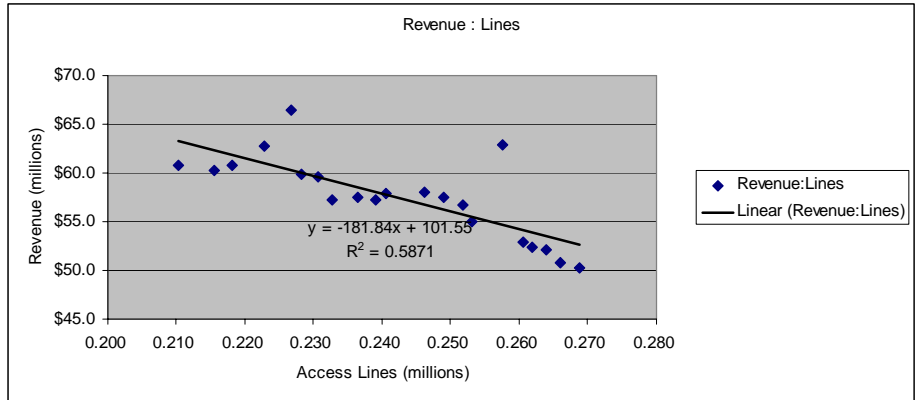
Source: Company reports and Raymond James estimates.

Iowa Telecom

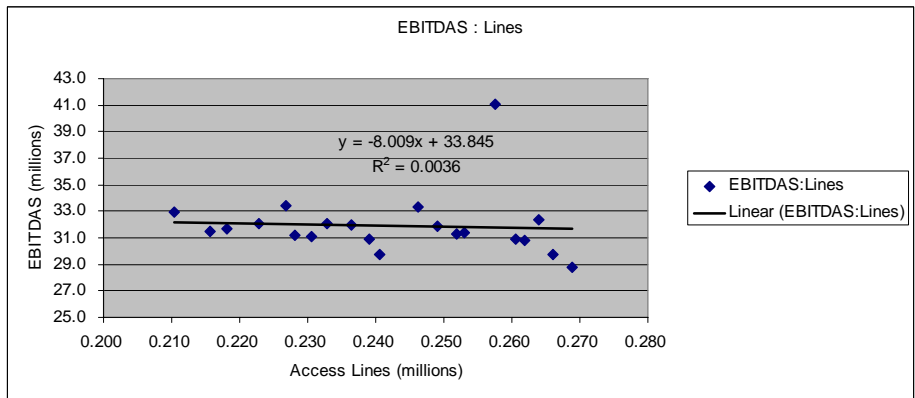
Iowa Telecom displayed another set of data implying the explanation of the variance of revenue and access line trends is high, although the direction is inverted. We note Iowa's results include previous minor acquisitions, Montezuma and Bakers. Iowa displayed a relatively high coefficient of variance of -181.8, which the F-value P-stat of 5.124E-05 being statistically significant. The R² of 0.587 for revenue is significant and suggests access line changes explain a significant amount of variance in revenue. Once again, this relationship is negative implying that revenue grows as access lines decline, making it a poor predictor of results, in our opinion.

EBITDAS results, however, show no statistically significant explanation of variance with an F statistic P-value of 0.7966, and an R² of 0.004. The correlation coefficient of -8.009 is also low, in our opinion, and the negative slope implies an inverse relationship as well. Also, access lines do not appear to provide a statistically meaningful explanation of FCF trends with a coefficient of variance of -2.3093, a statistically insignificant p-value of 0.986, and an R² of 0.0771.

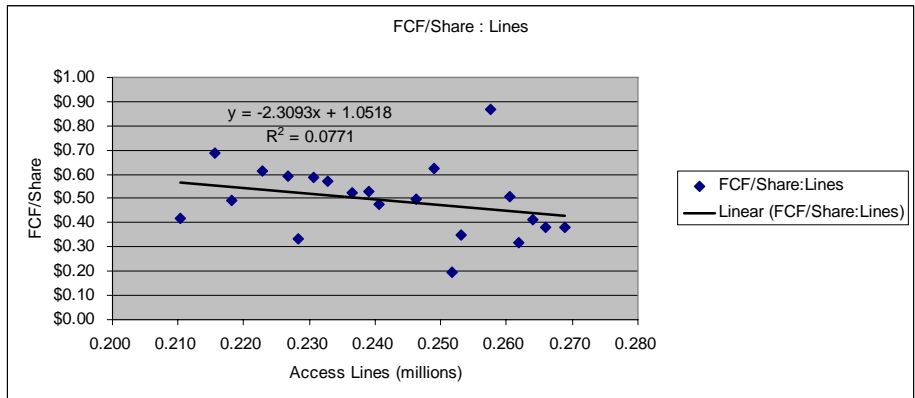
Iowa Telecom Revenue



Iowa Telecom EBITDAS



Iowa Telecom FCF/Share



Source: Company reports and Raymond James estimates.

We believe these trends demonstrate access lines are clearly not driving revenue, EBITDAS, and FCF for Iowa. We would suggest this makes Iowa one of the better stocks to look at regardless of access line trends, particularly as they do not appear to be a meaningful driver of FCF needed to support Iowa's large dividend payout. We do note that Mediacom (MCCC) has just recently entered the market, so arguably the competitive dynamics have permanently shifted, but with an estimated 16-17% customer overlap between Mediacom and Iowa, the overall threat remains low relative to many other rural ILECs.

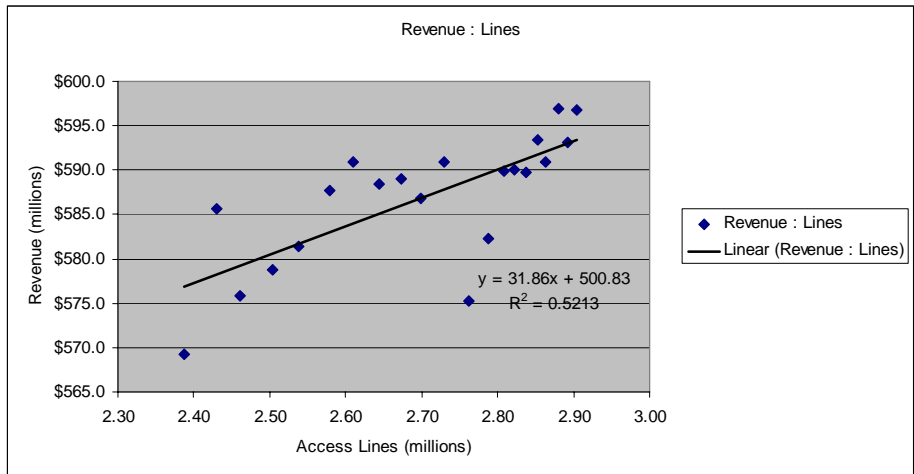
Citizens Communications

Next we move on to Citizens Communications, which always seems to be at the center of the access line debate due to its heavy concentration in competition riddled Rochester, New York, and more recently with its exposure to California and Arizona's housing growth declines. In analyzing this data, we made a few adjustments to the reported results. First, to make the business comparable to the current model, we added back Commonwealth Telephones results to Citizens (to adjust for the acquisition made last year), and removed the impact of Electric Lightwave which was divested in August 2006, and the utility properties that were divested in August 2003 and April 2004. The data is improved for Citizens compared to the company excluding Commonwealth, implying benefits from consolidation.

The regression for Citizens tells us that access lines explain some of the variation of revenue for Citizens, with a regression coefficient of 31.86. This is significantly different than 0, thus useful in explaining the variation, given the F-statistic p-value of 0.0002. EBITDAS was not explained well by access lines as the regression coefficient came in low at 14.3, and the F-statistic P-value was 0.15.

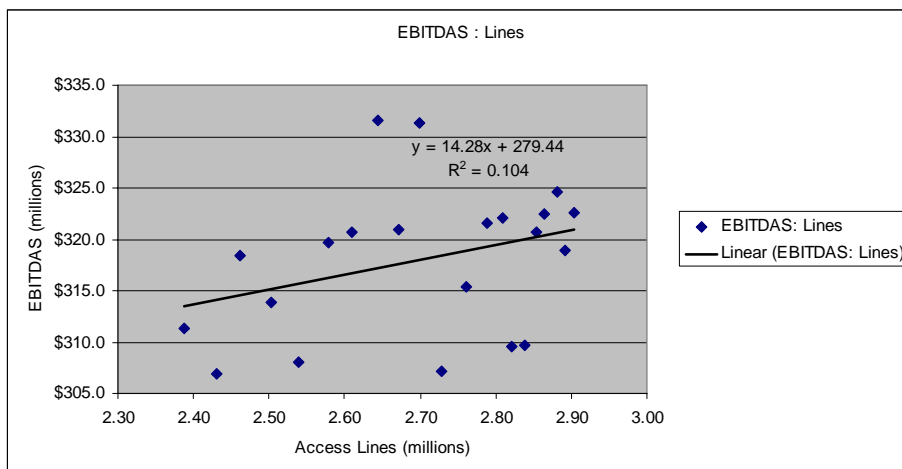
The results are interesting, with a somewhat high R^2 for the revenue regression at 0.52, but a statistically insignificant R^2 of 0.10 for EBITDAS. The relationship for access lines and revenue was positive, however, implying that revenue and EBITDAS do decline as access lines decline. This should be somewhat concerning for Citizens investors, but other factors appear to be at work, such as cost cutting and the aforementioned growth in enterprise data and other revenue not directly related to access lines such as special access and tower backhaul, which are working in favor of investors.

Citizens Revenue



Source: Company reports and Raymond James estimates.

Citizens EBITDAS



Source: Company reports and Raymond James estimates.

Does Regulation Make a Difference?

CenturyTel, Consolidated Communications, Alaska, and for a little while longer, Windstream (WIN) have one additional factor in the revenue and cash flow of their ILECs that differ from the other carriers in this report in that they are regulated as rate of return carriers at the state level, in most, if not all of their markets. Rate of return carriers have cost recovery mechanisms that allow them to adjust prices for certain products as their costs increase, therefore earning an 11.25% return on the assets employed to services these regulated services.

The actual calculation of these prices and returns are not available publicly, so we do not have a good view into regulated intra-state revenue and cap ex versus regulated interstate revenue and cap ex, versus non-regulated business (Internet, CLEC, special access, etc.). However, the results of our linear regressions for these carriers does appear to be better than price-cap carriers (which do not benefit from regulatory cost recovery to the same extent), so we suspect this is a factor in their ability to keep revenue and cash flow moving forward in the face of access line erosion.

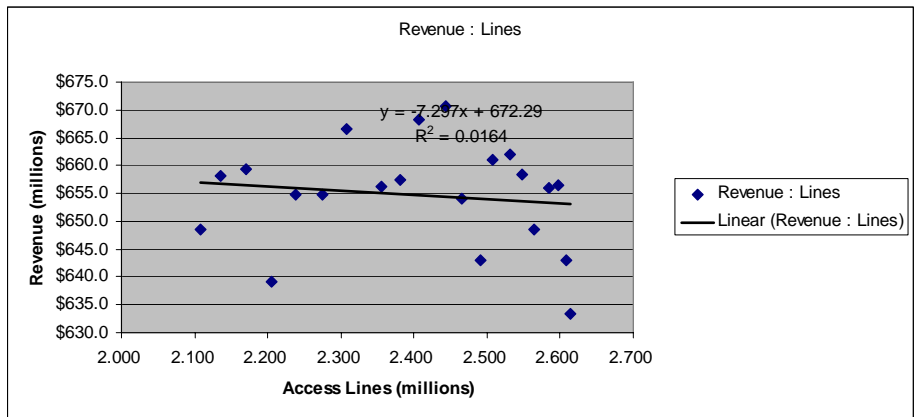
CenturyTel

CenturyTel's results appear to imply that access lines do not drive revenue as the company is able to offset these losses with other services. However the EBITDAS trajectory implies these services are lower margin. We have adjusted the data to include Madison River, which the company acquired in April 2007, and its other business has been relatively acquisition free over the test period with the wireless unit shed prior to our five year data sample.

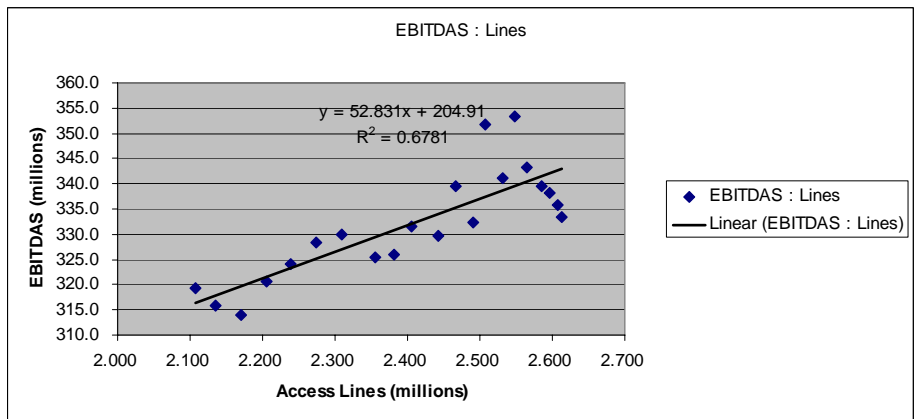
The regression for CenturyTel tells us that access lines do not explain the variation of revenue for the company, with a regression coefficient of -7.3. The R^2 for the revenue regression is also relatively low at 0.016. EBITDAS was explained well by access lines given 52.8 regression coefficient and an f-statistic p-value of 4.5×10^{-6} ; the R^2 for the EBITDAS was 0.68, also implying the explanation of the variance is well tied to access lines. We note the company has done an excellent job of driving CELC and fiber transport revenue but believe the margins are appreciable lower than the ILEC business. Lastly, FCF was not explained well by access lines with a coefficient of -0.68, and an R^2 of 0.13. These results imply CenturyTel is displaying positive trends despite access line declines.

We did make one significant adjustment to the CenturyTel data. In 3Q07, the company received the last significant regulatory true-up of a certain nature that, due to changes in regulation and accounting, we do not expect them to receive going forward. Regulatory true-ups from the Universal Service Fund (USF) and access revenue are a fact of life for ILECs, but this one significantly skewed the data to the extent that the EBITDAS displayed negative slope and the R^2 was not significant. We have excluded this to make the outlook more representative of the future trends, although we did add it back to prior periods where it was applicable because it is legitimate revenue and cash flow that the company is recognizing in its entirety going forward. Other carriers have not had these issues to this extent.

CenturyTel Revenue

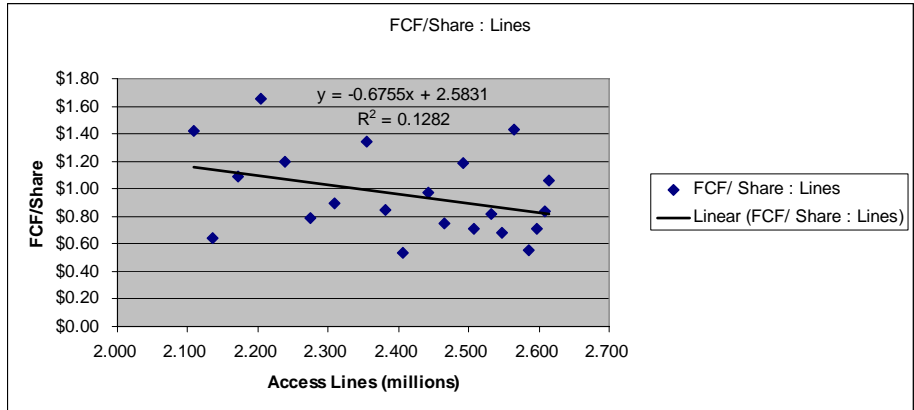


CenturyTel EBITDAS



Source: Company reports and Raymond James estimates.

CenturyTel FCF/Share

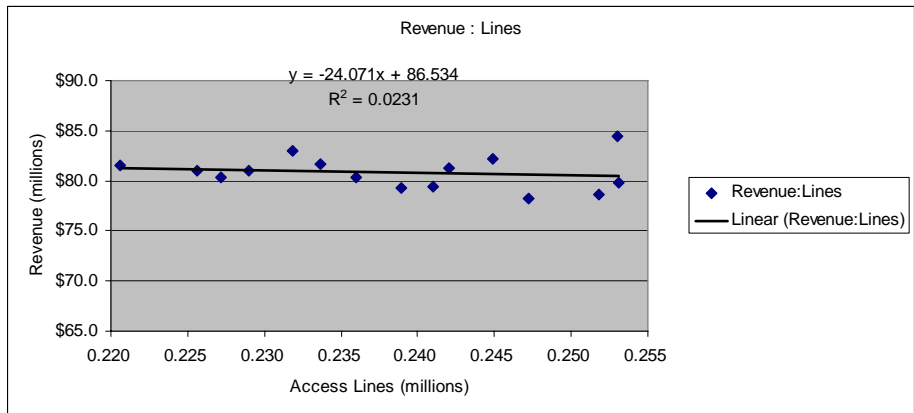


Source: Company reports and Raymond James estimates.

Consolidated Communications

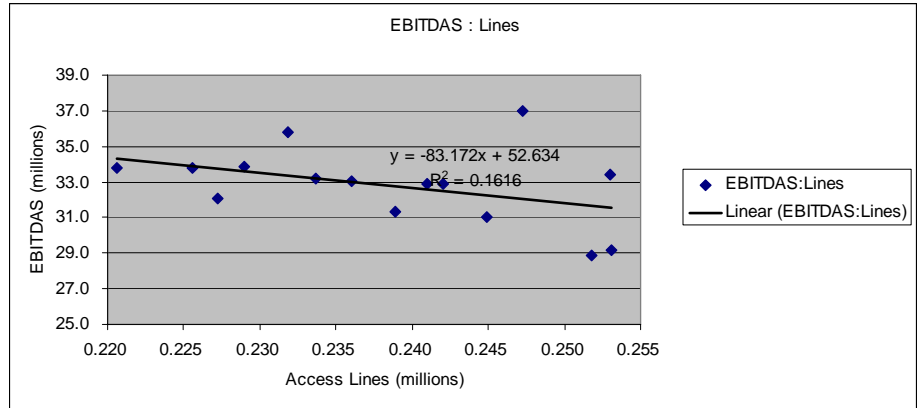
Consolidated Communications is also relatively M&A free over our study period (we have excluded the North Pittsburgh acquisition results from 1Q08 for the purposes of this report), and also a rate of return ILEC. The regression for Consolidated tells us that access lines do not explain the variation of revenue for the company, with a regression coefficient of -24.1, due to the negative slope (implying revenue increases as access lines decline). The R^2 for the revenue regression is also relatively low at 0.02. EBITDAS was also not explained well by access lines given a high f-statistic p-value of 0.14 and the R^2 for the EBITDAS was 0.16, also implying the explanation of the variance is not well tied to access lines. FCF demonstrated similar trends with a regression coefficient of 6.0 and a p-value of 0.38 and an R^2 of 0.06. Again, regression coefficients are negative for revenue and EBITDAS, further implying they are not explained well by access line variations.

Consolidated Revenue

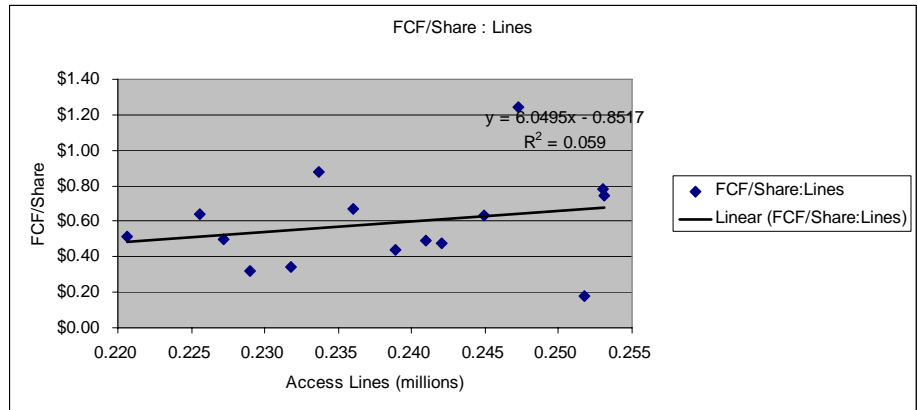


Source: Company reports and Raymond James estimates.

Consolidated EBITDAS



Consolidated FCF/Share



Source: Company reports and Raymond James estimates.

Consolidated has done a solid job of driving xDSL and video revenue over the past few years as it has put the Illinois and Texas properties together, and we also suspect rate of return regulation has been a beneficiary. Consolidated's FCF has benefited from minority wireless partnerships it owns with Verizon, but this revenue does not impact top line or EBITDAS, making Consolidated a very attractive investment, in our opinion.

Inconclusive Companies

We have included AT&T, Embarq, and Windstream with the limited data that we have for them. Due to M&A, we only have limited data back to 2005. Unfortunately, this does not give us full regression data that we can have confidence in. To have full confidence, we would need at least 20 data points, but we have included these data points as a reference due to their impact in the industry, with the caveat that it is not statistically reliable.

Windstream

Windstream will be converting price cap from rate of return, following the FCC's approval of its petition, potentially obviating historical regression results, and rate of return is possibly benefiting the data we do have, given the results of other rate of return carriers. The data we have only goes back 13 periods.

The regression for Windstream tells us that access lines do not explain the variation of revenue for the company, with a regression coefficient of -61.2.

EBITDAS was also not explained well by access lines with a regression coefficient of -17.6. The R^2 for the revenue regression was 0.40 and for EBITDAS was .06.

AT&T The data for AT&T only includes 13 periods due to the M&A activity between AT&T, SBC Bell South, and Cingular Wireless, giving an unclear picture prior to 2005. The regression for AT&T tells us that access lines don't explain the variation of revenue or EBITDAS AT&T, with regression coefficients of -110.0 and -183.0 respectively. Overall, access lines do not appear to be accurate predictors of revenue or EBITDAS, as wireless and data growth are overshadowing access line losses. However, it is negatively correlated, implying the counter intuitive concept that as access lines decline, revenue moves up nicely. We believe this is an interesting argument for looking at non-access line related revenue trends that are working below the surface. However, after excluding wireless, the coefficients flip to 220.0 for revenue and 105.1 for EBITDAS as AT&T's higher rate of access line losses was not able to be offset by other business segments. We believe this is the case among the carriers with more urban markets which have historically experienced access line declines at a higher rate than the rural carriers.

Embarq **The data for Embarq only includes 11 periods of pro-forma data due to their spin out from Sprint (S) in 2005, making it the least reliable of all the data we analyzed. As such, these are not very reliable regressions, and we believe the direction of the company has been fundamentally changing over this time period. Bearing this in mind, we caution investors in using this data to make investment decisions, although it does give a basic framework for items to watch going forward.** The regression for Embarq tells us that access lines do explain the variation of revenue or EBITDAS, with regression coefficients of 95.3 and 56.3 respectively. These regressions are statistically significant at a 95% confidence level given their p-values of 4.8×10^{-7} and .041. Overall, access lines do appear to be accurate predictors of revenue and of EBITDAS to a lesser degree, as Embarq may not have diversified as much as other ILECs, with wireless and data growth to overshadow access line losses. Furthermore, it is positively correlated, implying the concept that as access lines decline, revenues decline. Again we want to caution investors that this regression only includes 11 periods, so the results are not as strong as the other regressions in our report and shouldn't be extrapolated lightly.

Our research suggests that the further down the income statement and FCF model we go, the less predictive the regression is. Once again, despite the company's exposure to residential and cable growth, we point out that it's diversifying away from residential in favor of enterprise and wholesale revenue, and we believe the cost cutting that has been in place over the past two years has helped cash flow as well as made the cost structure more variable.

Conclusions

So what does all of this mean for our coverage universe? In aggregate, the data we have demonstrated in this report suggests ILEC access line changes often explain a larger amount of the changes in revenue than we would have previously suggested according to our linear regression analysis, but that often this relationship is negative. The reason for this inverse relationship is not as clear as we would like (because there are few publicly available data points to support these revenue sources), but we suspect it is due to a couple of key factors.

First, the ILECs have been diversifying away from traditional regulated residential telephone service, which is a positive dynamic for the future of the industry and the companies as a whole, given that access lines are not likely to begin to grow for some time. Some of these are more obvious, such as wireless growth at Cincinnati Bell and Alaska (as well as AT&T and Verizon). Others are less obvious, such as the flip side of wireless erosion, as special access and local and regional transport grow to support wireless carriers. Another less obvious piece is data traffic, especially from enterprise customers that are experiencing growth in demand along with other U.S. businesses in more urban markets.

The most consistent result of our linear regressions was found in EBITDAS and FCF, where the explanation of the variance in these items by changes in access lines was generally very low and/or not statistically significant using the tests and metrics we believed to be most relevant. This is really the key when considering that returning cash to shareholders is a very common theme espoused by management teams in the group. This is mostly done through significantly high dividend payouts, but also through large annual share repurchases that investors have come to expect and have factored into their models and investment decisions. As such, the ability to drive continued positive EBITDAS and FCF is just as critical for both of these investment themes to play out.

The bear case here is really four-fold. First, there is a strong relationship to revenue and access lines and that could eventually catch up with the industry. This leads to the second tenet of the bear case from our data, namely that the EBITDAS and FCF have been protected through cost cutting and efficiencies that have been gained over the past several years, and those will end and the decline will ensue. The third foundation for a bear case is that M&A has been keeping the efficiency curve going for some time, and that it will end and the erosion to the rest of the income statement will begin. The fourth would be that competition is not fully baked into these models, and as competition matures, these results will look quite different.

These are clearly concerns investors need to weigh, however we would argue the following. With regard to the strong relationship between revenue and access lines, if one believes this will catch up, they would need to consider the inverse relationship often observed, and what is causing it, could it change, and when. This is a more difficult item to nail down, but it does underscore that the ILECs are deriving increasing levels of revenue from non-traditional sources and from sources that are not tied to access lines.

Cost cutting is clearly a benefit and has likely driven EBITDAS stability. The question would be what is the profitability of the new revenue sources described above, and how variable are ILEC costs, really? We believe costs are more variable than is often viewed on the Street just judging from reported results (again, a positive case for rate of return carriers where cost adjustment potential is known to exist). We believe cost cutting can continue for some time, and regulatory benefits will not be taken away, as rural ILECs carry significantly more political clout than the average new report might imply.

On M&A, it could be the case that acquisitions have been keeping the industry's efficiencies going for same time, but we do not see irrational prices being paid for M&A, or even a very significant level of it occurring, either. These would be signs of an unhealthy industry trying to stay one step away from the bankruptcy lawyers. Additionally, with hundreds and hundreds of ILECs in the U.S., the length of any merger streak could be very long, and the benefits for the long term appear to strengthen the industry.

The competition aspect is also difficult to demonstrate either way. We do see continued wireless substitution and cable competition negatively impacting the space, and this is likely to continue. Wireless backhaul and transport is offsetting much of this erosion, but the actual relationship is not well known.

The introduction of video and satellite resale agreements is also a potentially positive offset to cable competition, as some carriers (Consolidated, Windstream, Citizens, and AT&T and Verizon to mention a few) have already begun to utilize this as an offset.

So, we view the ILEC industry as being more stable over the next few years than many on the Street give it credit for, especially in terms of EBITDAS and FCF trends that the investment theses are largely built on. We view companies like AT&T, Verizon, Cincinnati Bell, and Alaska as the best ways to invest in the space and avoid negative impact from access line trends. Additionally, we would view negative reactions by the Street to access line trends as buying opportunities for longer-term oriented investors.

We would like to extend a special thanks to Dr. Scott Brown, Raymond James Senior Economist for his help with the statistical analysis, and Mike Ciaccia, for his contribution to the data collection and analysis.

Public companies mentioned in this report.

Company Name	Ticker	Priced as of 06/19/08	RJ&A Rating (if Applicable)
Alaska Communications Systems Group Inc.	ALSK	\$12.60	Outperform
AT&T Inc.	T	\$35.15	Outperform
CenturyTel Inc.	CTL	\$32.01	Market Perform
Cincinnati Bell Inc.	CBB	\$4.11	Outperform
Citizens Communications	CZN	\$11.15	Outperform
Consolidated Communications Holdings	CNSL	\$15.71	Outperform
Embarq	EQ	\$44.71	Strong Buy
Iowa Telecommunications	IWA	\$18.68	Market Perform
Mediacom	MCCC	\$5.87	
Qwest Communications Intl.	Q	\$4.09	Underperform
Sprint Nextel Corp.	S	\$8.28	Outperform
Verizon Communications	VZ	\$36.50	Market Perform
Windstream Corp.	WIN	\$13.05	Outperform

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