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Charter Communications (CHTR) Earnings Report: Q2 2015 Conference Call Transcript

The following Charter Communications conference call took place on August 4, 2015, 10:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Tom Rutledge; Charter Communications Inc; President and CEO
- Stefan Anninger; Charter Communications Inc; VP of IR
- Chris Winfrey; Charter Communications Inc; CFO

Other Participants

- Vijay Jayant; Evercore ISI; Analyst
- Bryan Kraft; Deutsche Bank; Analyst
- Marci Ryvicker; Wells Fargo Securities; Analyst
- Phil Cusick; JPMorgan; Analyst
- Ben Swinburne; Morgan Stanley; Analyst
- Mike McCormack; Jefferies LLC; Analyst
- John Hodulik; UBS; Analyst
- Craig Moffett; Moffett Capital; Analyst
- Kannan Venkateshwar; Barclays Capital; Analyst
- Frank Louthan; Raymond James & Associates Inc.; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

At this time, I would like to welcome everyone to the second quarter 2015 earnings call.

(Operator Instructions)

Thank you. Stefan Anninger, you may begin your conference.

Stefan Anninger (VP of IR):

Good morning, and welcome to Charter's second quarter 2015 investor call. The presentation that accompanies this call can be found on our website, ir.charter.com, under the financial information section.

Before we proceed, I would like to remind you that there are a number of risk factors and other cautionary statements contained in our SEC filings, including our most recent forms 10-K and 10-Q. We will not review those factors and other cautionary statements on this call. However, we encourage you to read them carefully. Various remarks that we make on this call concerning expectations, predictions, plans and prospects constitute forward-looking statements.

These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ from historical or anticipated results. Any forward-looking statements reflect Management's current view only, and Charter undertakes no obligation to revise or update such statements, or to make additional forward-looking statements in the future. During the course of today's call, we will be referring

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to non-GAAP measures as defined and reconciled in our earnings materials. These non-GAAP measures, as defined by Charter, may not be comparable to measures with similar titles used by other companies.

Unless otherwise specified, 2014 growth rates referred to on this call are pro forma for the Bresnan transaction, as if it had occurred on January 1, 2012. Please also note that all growth rates noted on this call, and in the presentation, are calculated on a year-over-year basis unless otherwise specified. Joining me on today's call are Tom Rutledge, President and CEO, and Chris Winfrey, our CFO. With that, I'll turn the call over to Tom.

Tom Rutledge (President and CEO):

Thanks, Stefan. Charter had a strong second quarter, and our results demonstrate that our continued focus on delivering superior products at superior prices is driving our customer and financial growth. We added 34,000 customer relationships, up from 27,000 new relationships during the second quarter of last year. Over the last 12 months, we've grown our residential customer base by 4.6%. Residential PSUs grew by 70,000 during the second quarter, up from 55,000 in the year-ago period, while also growing market share and expanded basic video. And we expect to continue to grow overall video relationships in 2015.

Commercial PSUs grew by 31,000 during the second quarter, up from 19,000 in the second quarter of last year, and revenue grew by 7.6%, and by 7.8% excluding cyclical advertising. Excluding M&A transaction costs, adjusted EBITDA grew by 8.9%. Chris will cover the quarterly results in more detail. Over the last three years at Charter, our growth strategy has been driven by superior products, combined with high quality service, at highly competitive prices. Today, we're the fastest growing publicly traded cable company in the United States, and our customers are increasingly satisfied with both our products and our service.

Getting to this point has been a multi-year process. We increased investment in service, operations, infrastructure and our product set, and fundamentally changed the way we operate the business. We implemented our all-digital initiative over the course of 18 months. Completed at the end of 2014, all-digital has allowed us to unleash the full capabilities of our network, by unburdening it from analog signals, giving us more network capacity to differentiate our products from those offered by satellite and telco competitors. Starting with over 200 channels of HD, more than satellite, and the interactive programming guide and video on demand, using fully featured two-way set top boxes on every TV outlet.

Our minimum internet speed is 60 megabits. And in some areas, like St. Louis, minimum internet speed is 100 megabits. And we have a fully featured voice product. When we combine these products into simple, easy to understand packages that we call Spectrum, those packages have no early termination fees, no modem rental fees, no data caps or usage based pricing. And we offer the Spectrum product set at highly competitive prices, including a fully featured triple play starting package, priced at just $90 a month.

Following the closing, we will continue to take both the Time Warner Cable and Bright House footprints all-digital, in order to roll out our Spectrum product suite, which has been fundamental to our growth and success at Charter. As we complete all-digital and roll out Spectrum, Time Warner Cable and Bright House customers will also get access to our most advanced and latest hardware and applications. Including World Box, our new, more advanced set top box, which uses a downloadable conditional access security system, and is designed to evolve as video services increasingly become IP based.

World Box can be sourced from multiple manufacturers, and we'll also roll out Spectrum Guide, our new and highly advanced cloud-based guide, that can function on all of our two-way set top boxes, regardless of age or processing power. Meaning that customers will have access to the same IP interface they already enjoy on hand-held devices, without having to swap out boxes. The guide will vastly improve search and discovery functionality, which also enables on-demand offerings. And it gives us the

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ability to offer over the top content applications directly on the box, where we intend to provide customers with greater choice when switching [between] traditional video and alternative entertainment.

We'll also improve our Spectrum TV app, which uses the same guide, and offers live feed inside and outside the home, on devices beyond the TV, as well as both video on demand and download to go functionality. We will combine our app with the innovative Time Warner Cable app, to develop a best in class app for consumers. We'll also continue to work to develop a new video product, to serve that segment of customers who want high quality video offerings available on multiple devices, but at a lower retail price than our current expanded offering.

That product still has to offer real value in order for it to succeed, and we're working through programming rights and access platforms to create a product that sells sticks, and can be used for upgrading the full Spectrum product suite. As I noted in last quarter, we haven't found that right mix yet, and we don't think anyone else has either. Our success over the last three years hasn't just been about offering better products, pricing and packaging; it's also been about offering better service. We've done that by investing in call center and field operations infrastructure, and by in-house customer care and field operations work forces.

Over the last three years, Charter has brought back jobs from overseas call centers, and hired thousands of people to improve our service. Our [more] in-house work force is better trained, properly incented and better equipped with standardized tools and test equipment and software platforms. That results in more focus on craftsmanship and management being the factor, at times, to resolution and fewer calls per customer, all of which is driving fewer transactions, higher customer satisfaction, lower churn and a better return on our growth investments.

Using the same philosophy for years, Bright House has been the industry leader in customer service, and we will combine the best practices of our organizations and apply them across New Charter. As part of this effort, New Charter will return Time Warner Cable call center jobs to the United States, and will hire and train thousands of new employees for our customer service call centers and field technical operations. As we look ahead to closing, we're moving forward with our integration plans to put the new Company on a growth path.

Previous deal integration planning and investments we made in 2013 and 2014 have provided a good start, and should accelerate the integration of the new transactions. I believe we're going to create a lot of value for New Charter. From a financing perspective, we've now secured about 90% of the debt financing to fund the cash portions of our transactions. As Chris will discuss, we raised that debt with very attractive rates, and our balance sheet is in a very good place, both with respect to the cost of debt and our maturity profile.

Turning to the regulatory approval process of our transaction for a moment, our transactions will create a highly competitive service provider, with no control of national programming or over the top assets, less video coverage than Comcast or AT&T , less ISP market share than Comcast , Verizon , AT&T , T-Mobile and Sprint. And in June, we submitted a filing to the FCC, which clearly demonstrates why our transactions are in the public interest. That document outlines how our strategy will produce significant benefits for a larger group of consumers. I'll start with broadband.

Charter's slowest broadband tier is 60 megabits. We'll offer that -- this fast minimum broadband speed to Time Warner Cable and Bright House customers. Additionally, Charter will continue Time Warner Cable and Bright House's highly advanced 300 megabit service. New Charter will introduce its current pricing model, which is less expensive for consumers than Time Warner Cable and Bright House's comparable offerings. Our broadband product features straightforward, nationally uniform pricing with no data caps, no usage-based pricing, no modem fees and no early termination fees.

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New Charter will broaden access to broadband by building upon Bright House's broadband program for low income consumers. Consistent with our commitment to deliver superior broadband service designed for data-intensive applications like online video, Charter has long practiced network neutrality. And we will continue to not block or slow down internet traffic, or engage in paid prioritization. And we've consistently invested in interconnection capacity, to avoid network congestion. We've also committed to continue settlement-free interconnection. And if interconnection disputes do arise, we've committed to submitting them to the FCC for resolution, on a case-by-case basis.

These interconnection commitments have been recognized by content and interconnection providers like Netflix and Cogent , who publicly support the approval of our proposed transactions. As I mentioned earlier, we will bring back thousands of new jobs to America, and improve Charter's customer service. In addition to rolling out more advanced services like Spectrum Guide and World Box, New Charter will invest significantly in both in-home and out-of-home WiFi. We'll deploy over 300,000 out-of-home WiFi access points. New Charter will also build out [1 million] in new line extensions of our network into residential areas within our footprint, beyond where we currently operate.

These new facilities will help provide high speed service to rural and other underserved areas. And New Charter will invest at least $2.5 billion the build-out of networks into commercial areas within our footprint, beyond where we currently operate. This will create additional much-needed competition in the commercial services space. For all these reasons, we believe New Charter is in the public interest. With respect to the timing of close, we're working to close our transactions by year end. Now, I'll turn the call over to Chris.

Chris Winfrey (CFO):

Thanks, Tom. Turning to slide 8 of today's presentation, we grew residential PSUs by 70,000 during the quarter. In video, we lost 33,000 residential customers. Excluding bulk customers, however, we lost 28,000 video customers, compared to 44,000 last year, so the trend continues to improve. As Tom mentioned, we continue to expect video customer net adds for the full year. In residential internet, we added 70,000 customers, and we grew residential voice customers by 33,000. Over the last year, our residential customer base has grown by 261,000, or 4.6%.

In a seasonally weak quarter, we grew residential customer relationships by 34,000, and second-quarter residential ARPU rose by 2.5% year over year, driven by sell-in, step-ups and rate adjustments, although at a lower level than last year. Second-quarter ARPU did benefit from the Mayweather/Pacquiao fight, and excluding pay-per-view events this quarter, and in the prior-year period, residential ARPU grew by about 2%. Slide 10 shows our customers growth, combined with our ARPU growth, resulted in year-over-year residential revenue growth of 7%, compared to 6.4% last year.

Turning to commercial, we added 31,000 PSUs versus 19,000 in the prior year. The improvement was driven by the launch of Spectrum pricing and packaging to the small and medium business segment in the first quarter. Commercial revenue grew by approximately 14%, driven primarily by small and medium businesses. Our advertising revenue was virtually flat year over year, and excluding political advertising, ad sales grew by just over 6 percent. In total, revenue was up by 7.6% in Q2, with a lower level of annual rate increases, and more than two-thirds of that growth coming from customer growth.

Turning to operating expense and adjusted EBITDA on slide 11, total operating expensing grew by $118 million, or 8% year over year, of which transition OpEx related to our previous transactions with Comcast accounted for about $17 million. Excluding transition costs, total expenses grew 6.9% year over year, with total programming expense driven by $64 million accounting for about half the year over year increase in total operating expense. The 10.3% increase in programming was driven by contractual rate increases, growth in our expanded video customer base over the last year, higher penetration of our tiers, [farmer

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carrots] and the launch of new channels, as well as the Mayweather/Pacquiao event.

Excluding pay-per-view and a large one-time expense benefit in the second quarter of last year, programming grew by about 8% year over year. Cost to service customers, which includes field operations, customer care and network operating costs, were flat year over year, as we are seeing a significant in service transaction volumes, for the reasons Tom mentioned. Other costs grew by $35 million, or 18% year over year, driven by some additional administrative labor expense, property taxes on previous CapEx, and insurance on a larger service employee base, and increase in bad debt, as well as higher labor costs to support ad sales in commercial.

Excluding transition-related expenses, second-quarter adjusted EBITDA grew by about 8.9% year over year, and even that includes $14 million of one-time benefits in the prior-year expense base, meaning the underlying trend is very good. So as a result of our operating strategy, we're seeing continuous improvement in Charter's operating and financial metrics, and that momentum continues. We'll duplicate that strategy on a much larger set of assets, following our transactions with TWC and Bright House. And we believe we can deliver the type of customer growth and financial growth, along a similar time line as we've seen at Charter, across this larger set of assets.

Not only because we'll enhance the product set and service, but also because New Charter will offer significantly better [DMA] coverage, providing greater marketing efficiencies, larger opportunities in commercial to serve multi-site tenants in the medium and enterprise markets. And of course synergies, both in our operating expense base and our ability to deploy cloud-based capital investments and CPE more efficiently. The TWC and Bright House assets also provide a better starting point than Charter in 2012, given their historical investment and progress in all-digital to date.

Moving to slide 13, second-quarter capital expenditures totaled $432 million, with $28 million related to M&A transactions, mostly as part of the Comcast transactions. Much of the transition capital, as Tom mentioned, includes software platforms that include next generation gateway, and provisioning a service layer, our billing isolation layer, and a new data warehouse, each for multiple legacy billing and provisioning platforms. So these platform investments would have occurred over the next couple of years in any event, and actually provide us a head start to providing a uniform product and service package to TWC and Bright House customers.

The year-over-year decline in total CapEx was driven by the completion of all-digital during the fourth quarter of last year. And excluding all-digital last year and transition CapEx this year, our CapEx was down by just over $30 million, or 7%, despite faster PSU growth in both residential and commercial. So we're seeing the kind of [post-vol] digital decline in capital intensity that we expected, and we'd expect the same to occur after the completion of all-digital at TWC and Bright House. We continue to expect approximately $1.7 billion of capital expenditures in 2015, excluding spending related to acquisitions.

If you look at adjusted EBITDA less CapEx at the top of slide 14, the increased contribution to cash flow was about $191 million, and it's $45 million higher if you exclude the transition costs in both adjusted EBITDA and CapEx I just mentioned. Free cash flow also improved year over year, with EBITDA up, CapEx down, and the working capital headwind that we saw in the first quarter from all-digital now behind us. Free cash flow growth would have been even higher if it were not for $45 million in transition expense and CapEx we just covered.

M&A expenses, which are included below adjusted EBITDA and other expenses, and $100 million of cash interest paid during the quarter, from the $7 billion of escrowed Comcast transaction that we repaid to investors in April. If we turn to our balance sheet, in April, we executed a number of debt re-financings with new notes at CCOH, which reduced our weighted average borrowing cost, which was 5.2% at the end of the quarter. Our current leverage ratio is 4.3 times on an LTM basis, and within our target leverage

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range of 4 to 4.5 times in July.

So after the quarter, we completed over $19 billion of financings for our transactions with TWC and Bright House. That includes $15.5 billion of debt in the investment-grade market, with an average cost of 5.26%, and an average maturity of 15.5 years. That's in addition to the $2 billion of term loan A financing at LIBOR, plus 200 basis points, and $3.8 billion of debt in the term loan market, at an average cost of about 3.4%. So New Charter has access to all pockets of the debt markets, which provides significant flexibility. As Tom mentioned, we've completed about 90% of the debt financing needed at closing, with $2.5 billion remaining, where we will be opportunistic.

Assuming the $100 cash election option for TWC shareholders in the deal, we still expect to be leveraged at about 4.5 times at close. That's based on 2015 estimated adjusted EBITDA, and including $500 million of assumed year 1 synergies. That's at the higher end of our target leverage range, but we will be poise to mechanically deleverage through adjusted EBITDA and cash flow growth. Our targeted leverage for New Charter will remain 4 to 4.5 times, but we look to manage our leverage to the lower end of that range, and we're committed to maintaining an investment-grade index rating at the secured level, with first lien leverage under 3.5 times.

I won't go back through all of our existing tax assets, which are laid out, again, inside the presentation, but I reiterate that both the TWC and Bright House transactions will enhance the value of our existing tax assets. The Bright House transaction actually will create new tax assets, through our partnership structure, that drives value for both New Charter shareholders and Advance/Newhouse. In total, we estimate that New Charter's tax assets are worth approximately $6 billion in net present value.

That's comprised of the over $3 billion of Charter's existing tax assets today, both through our outsized basis and NOLs, the $1.5 billion of excess basis that sits at TWC today. $400 million of value created by the accelerated use of (inaudible) post close, and the approximately $1 billion in net present value that we estimate the Bright House transactions drive, given the tax basis step-up that should result from Advance/Newhouse ultimately exchanging its partnership units into New Charter stock. Operator, with that, we're now ready to open it up for questions.

QUESTIONS & ANSWERS

Operator:

Our first question comes from the line of Vijay Jayant from Evercore ISI. Your line is open.

Vijay Jayant (Analyst - Evercore ISI):

Thank you, I have two. Tom, Time Warner Cable is undergoing a strategy that seems to look very similar to Charter, introduced, I think, last October, and that will transition to rolling off promotions this October. And can you talk about what you think about that strategy? Because it's going to drive a big piece of the growth in 2016, if the transition works well. If you have any thoughts on that? And second, I think you have an [affiliated] deal with a programmer that was supposed to come to an end in July. Assuming there's no channel drop, can we assume that that negotiation went well? Thank you.

Tom Rutledge (President and CEO):

We didn't drop any channels in July, and so to the extent that's a good thing, yes, everything has gone well. In terms of Time Warner Cable's strategy, they do seem to be doing better, much better, in terms of creating unit growth. And obviously, financial growth, as we've shown, follows unit growth. And so we're pleased with the track they're on, and that they're able to keep their focus and grow their business and stay on strategy.

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And as you look at Charter's performance over the last several years, and seen how the curve works, in terms of investment activity and then growth, first starting with customer growth and then followed by financial growth, I think you should expect those kinds of results in the future, on the combined entities.

Vijay Jayant (Analyst - Evercore ISI):

Great. Thank you.

Operator:

Your next question comes from the line of Bryan Kraft from Deutsche Bank. Your line is open.

Bryan Kraft (Analyst - Deutsche Bank):

Good morning, thanks. Just a few CapEx-related questions. I guess first, Tom, how do you think about the set top box cost curves from here? And in particular, do you have any idea as to when Charter will shift away from storage in the box to storage in the network? And I was also wondering just how, exactly, going all-digital impacts your volume of truck rolls over time? And what benefits that could yield to the business? And then lastly, just a quick one on the CMTS you're deploying today. How many channels are you bonding now? I'm just wondering what we're up to now. Thanks.

Tom Rutledge (President and CEO):

Right. On the last one, I believe CMTS bonding is at 24 channels. In terms of storage -- let me start where you started, set top box curve. We continue to see opportunity there, in terms of pricing, and with our downloadable security and our ability to source from multiple locations. And one of the big factors in box cost is storage in the box, the hard drive, and whether that should be in the network or not. I think increasingly, it will move to the network. And to the extent that DVR functionality is still a big demand issue.

And the reason I say it like that is, more and more product is becoming available on demand. And so the opportunity to see anything you might want to see is available pretty much all the time, whether you have storage in a box or not. So my view is that that puts pressure, ultimately, on storage costs, and it argues that storage should move to the network. And I think you'll increasingly see that happen, although we're still putting out lots of DVR set top boxes. And those boxes are continuing to go down in price, down the price curve.

With regard to digital and truck rolls, yes, the all-digital network is a more reliable network, and easier network to monitor. And as a result of that, your ability to look at the whole service infrastructure, and do preventative intelligent maintenance, allows you to reduce truck rolls, in the historic cable television architecture. And so does high quality service, and doing the job right. And we're increasingly taking transactions out of our business, and the ability to turn on and off customers remotely also takes truck rolls out of the business. And none of that existed in an analog world So we expect that the operating cost curve will continue to improve, as a result of the all-digital investment.

Stefan Anninger (VP of IR):

Operator, we'll take our next question, please.

Operator:

Operator. Your next question comes from Marci Ryvicker from Wells Fargo . Your line is open.

Marci Ryvicker (Analyst - Wells Fargo Securities):

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Thanks. I know AT&T just announced a new product. It looks like a quad play for $200. I don't know if you had any time to think about this, in terms of your strategy? If this is something that you would look to do, also? And then related to that, T-Mo has been pretty open about wanting to partner with cable. I think they've suggested Comcast . But given you're not going to be that much smaller than Comcast , what do you think about eventually partnering with a wireless company?

Tom Rutledge (President and CEO):

Look, I think wireless is a component of our service already. We continue to roll out our WiFi product, and the bulk of wireless activity on smartphones today is on the WiFi product that we've deployed. And so I think there are opportunities, business opportunities, to create mobility for us. Whether that's with T-Mobile, or any other provider, for that matter, I think opportunities exist there. And people are trying to figure out the right business models to do that. I do think AT&T's new product, to the extent it's a combination of a bunch of disparate pieces that they've put together, is a good marketing idea for them.

I think those kinds of activities have been done in the past. For instance, the app with TV on a smartphone is available from Charter today. If you want to watch every channel we have, you can watch it on your AT&T or your Verizon or your T-Mo or Sprint smartphone. You can watch TV everywhere, in the house or out of the house. You can watch the whole cable service in the house, or wherever you do business. And so the ability to put content on the smartphone is being done today.

And as I already said, the majority of the data on the smartphone comes from the WiFi network that we've deployed. But the thrust of your question is, should we have a mobile product? And the answer is yes, we should have -- we should ultimately figure out how to create our service infrastructure everywhere we are, and where our customers are.

Marci Ryvicker (Analyst - Wells Fargo Securities):

Got it. Thank you.

Stefan Anninger (VP of IR):

Operator, we'll take our next question please.

Operator:

Your next question comes from the line of Phil Cusick from JPMorgan . Your line is open.

Phil Cusick (Analyst - JPMorgan):

Hey, guys, thanks. I guess first, Tom, can you talk about the long-term potential for Charter and the Time Warner Cable footprints? When you came to Charter a few years ago, you talked about EBITDA per home pass potential at Charter, compared to Cablevision at the time. Is Charter's potential still as high as it was? And is Time Warner Cable's footprint as valuable, given its higher level of competition?

Tom Rutledge (President and CEO):

I think the answer is yes, it is valuable. And I still look at Charter as a diamond in the rough, although we're polishing the diamond. And it's -- we have made improvements in penetration of customers. And -- but there's still a lot of runway ahead of us. And I like our momentum at Charter, and we want to apply the same kind of opportunity against both Bright House and Time Warner Cable assets. If you look at their current penetrations, they're similar to Charter's in almost every way. And so that means that the footprint and the runway is bigger in the combined company, and the opportunity's bigger.

And yes, the fundamental point I was making when I came to Charter, which is that the big opportunity is

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creating customer relationships and growing the EBITDA per home past, meaning having a higher return to the physically deployed assets that already exist by improving the revenue per deployed dollar of asset out there, is another way of describing the same phenomena. Which is, penetration creates an enormous amount of value in a network, and that's where the big upside is. And I still see that as our long-run opportunity.

The way you get there, though, is not an easy path. It means you've got to stand up a better product, you've got to stand up better services. You've got to be able to compete in the marketplace against an array of competitors who will come through time, and you have to be quicker and better. And I think we can do that.

Phil Cusick (Analyst - JPMorgan):

Thanks, Tom.

Stefan Anninger (VP of IR):

Operator, we'll take the next question.

Operator:

Your next question comes from the line of Ben Swinburne from Morgan Stanley . Your line is open.

Ben Swinburne (Analyst - Morgan Stanley):

Thank you. Good morning. Two questions. First, Tom, can you go back to your prepared comments about working to find a new video product at a lower price point than expanded basic? You said you're working through programming rights, but you also said you didn't think anybody had found the right mix yet. And I'm assuming you're including things like Sling from Dish and Internet Plus from Comcast . What would you -- what are you trying to build, if you could control all the pieces of the puzzle? What's your optimal product set look like, from a technology and content perspective? Anything you could share with us would be great.

Tom Rutledge (President and CEO):

Right, I think it's less of a -- it's not really a technology issue at all. There are trends in technology, whether you're using IP or MPEG, or whether you can -- you can put all the products that we currently have today on pretty much any device. So the real question is, what are the rights structures around what you can sell? And it's easy to sell basic-only cable. It's easy to sell basic-only cable with paid TV. But does that really satisfy a broad swath of American consumers? And is that an opportunity? And I think the answer to that is, not really.

There has always been a group of people that will buy that. But if you tell people that's cable, they'll ultimately become dissatisfied with it. So the issue is, can you tailor rich products to specific demographics, and satisfy someone's complete need for consumption of video in a product that's reasonably priced? And that -- and price is the big issue, and it's a difficult thing. Because right now, we have video services that are being sold to 100 million homes in a big bundle, very -- and it's very efficient, from a revenue perspective and from a advertising perspective.

And so it's hard for anyone to want to pull that apart, and find a way to make it work. But it certainly could be -- it's certainly gotten very expensive, and you see, on the edges, people are not buying that full package, because they can't afford it, mostly. And if you could do it less expensively, it'd be very satisfying. And yet, some of the content companies would suffer dramatically in that kind of environment. So that's why we don't have the product yet. And -- but to the extent that content companies are willing

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to create packages that are tailor-able to specific groups of consumers, we'd be interested in trying to do that.

Ben Swinburne (Analyst - Morgan Stanley):

That makes sense. And just quickly, for Chris. On the broadband revenue, you called out, or your slide deck calls out, higher bundle revenue allocation and some price adjustments. Is there anything in the quarter that helped drive the data revenue? I realize product ARPUs don't tell you a lot, but it was a pretty big sequential increase in data ARPU.

Chris Winfrey (CFO):

Yes, so you'll remember, Ben, a couple years ago, we stopped intentionally producing the product ARPU, really focusing people on the residential revenue per household, particularly because of the bundle allocation. And it makes us somewhat irrelevant. What matters is, where are you on triple play? Where are you on single play? What's the revenue per household that you're getting? And that's why the 2.5% year-over-year uplift is really the right metric to take a look at. Now technically, the answer to your question is based on where we're pricing the roll-off -- promotional roll-offs of multiple different products, and then adding to that some of the GAAP adjustments, in addition to the billing adjustments that get made.

You can have real fluctuations in the product revenue that are taking place. Things didn't dramatically change in Q2. And if you take a look, we've continued to grow our extended video customer base. We haven't taken massive -- we haven't taken significant rate increases on any of the products, and yet the video revenue slowed down just a little bit, and the broadband revenue ticked up quite a bit. That is entirely due to allocations, as opposed to some fundamental trend in the business.

Ben Swinburne (Analyst - Morgan Stanley):

Got it. Thank you both.

Stefan Anninger (VP of IR):

Operator, we'll take our next question please.

Operator:

Your next question comes from Mike McCormack from Jefferies. Your line is open.

Mike McCormack (Analyst - Jefferies LLC):

Hey, guys, thanks. Tom, maybe just a quick comment. We're stepping around the issue of the skinny bundles. But what it really comes down to, I think, at some point, is the industry going a la carte. And I guess I'd like your view on what that means, from a distribution standpoint? And clearly, the programmers are probably not incented to go that way, but it seems like that's the way a lot of the new generations or demographic want to go. So some thoughts around that. And then maybe one for Chris, on the margins. In the face of some transitioned costs obviously hitting the numbers this year, how should we think about margins, on a year-over-year basis? And just thinking about the back half? Thanks.

Tom Rutledge (President and CEO):

Mike, the way I would say -- first of all, the way to think about the skinny bundles is, they're still bundles; they just cost less. And maybe they have products that you like to watch in them. But obviously, if you could get the whole package for the same price as the skinny package, you'd like to have the whole package, so you might want to see everything. So everybody wants everything, but it's a cost issue, and it's all stuck together. And when you look at the demographic changes in behavior, some of that is

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situational. People aren't -- don't have houses, don't have big screen TVs, don't have money. And you put all that together, and the only way to get access to video is through over the top or small screen kinds of video services.

That doesn't mean that the big products aren't desirable. It just means that they're very expensive, and that people's lifestyles are putting them in a situation where they don't have access to them. And those life -- and a lot of that is a function of the economic situation. So we would like to have -- if we had our druthers, we'd buy all our product a la carte wholesale, and we'd make the packages up to satisfy the consumers. That's not the way the world works. That's not the way content is sold to us.

We have to take it in big packages. And as I said earlier, it was a very good model. It's peaked, and it's -- but it's difficult to make it get better, and so there's a lot of pressure in the system. My sense is that it isn't all about to fall apart, and that we'll be having this conversation three years from now, because I think there's nothing to incent anyone to pull it apart.

Mike McCormack (Analyst - Jefferies LLC):

Okay. Along those lines, Tom, when you think about HBO Now, and the possibility of others -- and I'm not suggesting ESPN anytime soon. But when those go direct, and I think using Apple as a platform, and saying you need to have an apple product, that's like going direct to consumer. How much power does that give you guys to discuss that kind of a la carte move with Time Warner , for example?

Tom Rutledge (President and CEO):

I -- to the extent that people go a la carte direct, I think they lower their value to us, which is ultimately good for our cost structure. And I think you'd have a little of that already occurring in the system -- ecosystem, to the extent people have leaked out content, out of what they sell us into other spaces. In trying to go after ancillary revenues, they've devalued their core product, and they may or may not be carried in the future as a result of that. And so I think like all things, no trend goes unchecked forever.

Chris Winfrey (CFO):

Also made it less secure.

Tom Rutledge (President and CEO):

Yes, that's true, too, which devalues content.

Chris Winfrey (CFO):

So Mike, your question on margin. First, you're right to point out that, excluding the transition costs, those are exclusively related to the integration process. But in terms of margin as a percent, it's not something that we ever manage, internally, the business towards a percent margin. What we do is, we manage towards cash flow increases and ROI. In some sense, margin percent can be an output or an indicator of that, but it's not how we're looking at it from quarter to quarter. The trends were good.

All that being said, all of our transactions are down, voluntary churn is coming down, non-patron is coming down, service calls are coming down, truck rolls are coming down. And other than programming, it's labor that's the big cost inside the business. And so our efficiency on a cost-per-relationship is getting better. And to Tom's point, as you have more relationships on the fixed plant or asset infrastructure, then your margin is set to increase for both of those. Both as the variable cost per customer coming down, as well as better penetration on the fixed asset. So the trends look pretty good today.

Mike McCormack (Analyst - Jefferies LLC):

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Great. Thanks, guys.

Stefan Anninger (VP of IR):

Operator, we'll take our next question, please.

Operator:

Your next question comes from the line of John Hodulik from UBS. Your line is open.

John Hodulik (Analyst - UBS):

Great, thanks. It looks like the tellcos added quite a bit -- much fewer video subs than we expected here in the second quarter. Are you guys benefiting, to an extent, in terms of less competition from traditional providers? And then second of all, can you give us an update on the Spectrum Guide? How quickly you expect that to be rolled out? And if you expect that to have any positive impact on the sub trends? Thanks.

Tom Rutledge (President and CEO):

Yes, I wouldn't say that the competitive environment has improved, or any better at all. I think our video business, and our whole business, continues to improve. And it's improving because of the investments we've made, and the quality of our product, against our competitors' products. And we -- so we're optimistic about our ability to grow our video business, and we are growing, obviously, our data business and voice business.

That's at the expense of other competitors, but the competitive environment doesn't seem different. In fact, it's increasingly competitive. In terms of our guide, we're deploying it and testing it, and getting ready to operationalize it. Our plan was to do about half of our customer base -- our retained customer base, right, which I guess would be in the range of 1.6 million would be what half of -- what that would have been.

Chris Winfrey (CFO):

Yes.

Tom Rutledge (President and CEO):

And that's still our plan. And we -- obviously, we haven't operationalized it yet, but we plan to shortly. And we'll learn some things, and -- in terms of our speed, and our ability to roll it out, but we think we can do what we said we were going to do.

John Hodulik (Analyst - UBS):

Okay. Thanks.

Stefan Anninger (VP of IR):

Operator, we'll take our next question please.

Operator:

Your next question comes from the line of Craig Moffett from Moffett Capital. Your line is open.

Craig Moffett (Analyst - Moffett Capital):

I wonder if you could go back to the proxy that you filed a while ago, where you talked about capital

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intensity in the out years coming down quite substantially? I'm not asking you to give further guidance beyond that, but just if you could conceptually talk about how the capital intensity of the business, long-term, looks in your eyes? As you -- is there a point when set top boxes are largely out of the equation? And what might capital intensity look like in that scenario?

Tom Rutledge (President and CEO):

Okay, Craig. As you know, I've said capital intensity is coming out of business. I've been saying it for a long time, even while I spend more sometimes. And I still believe, in the long run, that it is true that capital intensity is coming out of the business, for a lot of reasons. One is, if you grow. If you just think about variable capital and fixed capital, if you grow, and all your revenue -- if nothing changed on a per customer basis, if you just grow, your mix of variable and fixed capital changes to the favorable. So it's capital intensive favorable to have growth, all other things being equal, on a network platform.

There's (inaudible) law, with regard to set tops. You can make the case that set tops can come out of the business, and that they will. That just means we're back to cable-ready television, which has been an issue over and over in the business. And the only reason we have set top boxes in because television can't connect to our network and have the full feature set that we sell. We'll always have stranded hardware out there that can't get our services as we sell today. I think the history is that that's always been true, and you've always needed some backward-compatible device to serve television. But the cost of those devices keeps coming down.

The functionality keeps moving toward the cloud, which means that the investments are getting spread out over all the customers in a much more efficient way. And the need for the set top's capability goes down in a cloud-based environment, which means the end user device need goes down, in a cloud-based environment, which means you should have less capital intensity in the business. So I think for a lot of reasons, including our scale opportunities to purchase capital, and all the things I just said, that capital intensity is coming out of the business.

Craig Moffett (Analyst - Moffett Capital):

Is there an offset, from more node splitting and the like, that goes along with significantly higher speeds? Or does that just not rise to the same level of capital intensity as the more video-oriented products that you've talked about?

Tom Rutledge (President and CEO):

I think less -- I think it's less of a factor. And don't forget, as you go all-digital and you add more spectrum, essentially, you can do electronic node splitting. And you don't need to do the physical node splitting, which an analog video product forced you to do.

Craig Moffett (Analyst - Moffett Capital):

Thanks, Tom.

Stefan Anninger (VP of IR):

Operator, we'll take our next question, please.

Operator:

Our next question comes from the line of Kannan Venkateshwar from Barclays. Your line is open.

Kannan Venkateshwar (Analyst - Barclays Capital):

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Thank you. So Chris, just one question from me, which is on the other cost line. That seems to be, again, up about 18% this quarter, and it was up, I think, about 13% last quarter. If you can just help us understand the trend line for that line item, going forward, that would be great. Thanks.

Chris Winfrey (CFO):

Sure. It really has a lot of different categories in it. And for some time, it's been elevated on a year over year. A lot of that historically has come from commercial, which has had similar growth rates. It's still the case, but less as the most material driver. As we, really in the past year, have gotten ready to take on a much larger set of assets, although net set of assets changed upon us a few months ago, we've been fairly disciplined about what we put into the transition expense. So meaning it's exclusively and 100% related to the integration and transition.

And if the transition didn't exist, it would fall apart, fall away, on day one. But it doesn't mean that we haven't been positioning the Company to manage a much larger set of assets, through management infrastructure, and getting ready to be much larger than the original set of Comcast transactions, and that's carried over to today. We've not tried to pull that out and say that was transition expense, because we're utilizing it on a go-forward basis. So that's one.

And the second is, actually, property taxes. In states like Montana, it's been unfavorable towards us, plus the combination of having spent more capital expenditure over the past couple years means that you have a higher basis of assets, which get attached to our property tax. On a relatively small amount of operating expense, it causes it to be outsized, from a percentage standpoint. Those are the big drivers.

It's a hodgepodge; there's not one single factor that is inside there. But those are the type of items that are captured in there. They're just a much smaller category than, of course, programming, or the actual cost to service customers.

Kannan Venkateshwar (Analyst - Barclays Capital):

Thank you.

Stefan Anninger (VP of IR):

Operator, we'll take our final question. Thanks.

Operator:

Our final question comes from the line of Frank Louthan from Raymond James. Your line is open.

Frank Louthan (Analyst - Raymond James & Associates Inc.):

Great, thank you. Can you give us some more color on -- you described, maybe, some line extensions, and things that you might do, in some rural areas. Is that within your footprint? Or would that be adjacent to your footprint? And give us some more color on that. And then, was there any insight to be gleaned from the conditions on the AT&T /DirecTV mergers, how the FCC may be thinking about other video mergers, such as the one you're facing? Any thoughts out of that? Thank you.

Tom Rutledge (President and CEO):

Right. Yes, no, we intend to expand our plan to passings that we don't serve today, and extend physically-based competition in our line extension commitment. In terms of the AT&T deal, it was fairly consistent with what we thought might be in it, based on public speculation. And we're comfortable, having seen it, with our own process before the FCC, and look forward to engaging with the FCC in concluding our transaction.

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Frank Louthan (Analyst - Raymond James & Associates Inc.):

All right, great, thank you.

Stefan Anninger (VP of IR):

All right, thank you everyone.

Operator:

And this concludes today's conference.

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