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INSTITUTIONAL RESEARCH

Technology

COMPANY UPDATE

November 11, 2011

Level 3 Communications, Inc. (Nasdaq/LVLT)

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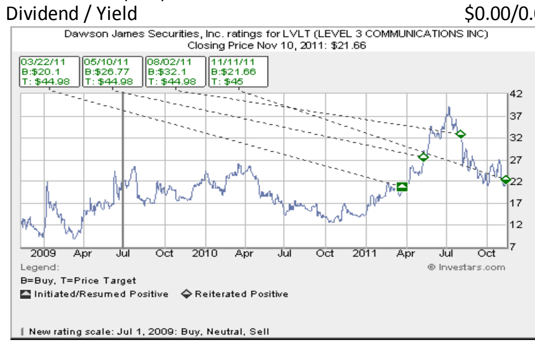
Buy – Turnaround story slowly unfolding as baby steps get a bit bigger with Q3 revenue, gross margin showing continued sequential improvement

Level 3 Communications is a Tier1 Internet Provider & Content Delivery Network

Current Price	**$21.37**
Price Target	**$45.00**

Estimates	F2010A	F2011E	F2012E
Revenue ($Mill)	**$3,651**	**$4,478**	**$6,935**
1Q March	910	929 A	1,690 E
2Q June	908	932 A	1,720 E
3Q September	912	947 A	1,750 E
4Q December	921	1,670 E	1,775 E
Prev. Rev. Estimate ($Mill)*		3,751	3,950
EPS	**($5.62)**	**($5.90)**	**($3.37)**
1Q March	(2.16)	(1.83) A	(0.96) E
2Q June	(1.53)	(1.59) A	(0.89) E
3Q September	(1.46)	(1.75) A	(0.79) E
4Q December	(0.49)	(1.06) E	(0.73) E
Previous EPS Estimate*		(5.85)	(3.75)
P/E (x)	N/A	N/A	N/A
EBITDA/Share	$7.10	$7.47	$7.09
EV/EBITDA (x)	7.0	6.6	7.0

Stock Data	
52-Week Range	$13.05-$40.05
Shares Outstanding (mill)	208
Market Capitalization (mill)	$4,436
Enterprise Value (mill)	$10,280
Debt to Capital (9/11)	107.3%
Book Value/Share (9/11)	($2.52)
Price/Book	N/A X
Average Trading Volume (Mill)(3-month)	2.0
Insider Ownership	15.3%
Institutional Ownership	71.2%
Short interest (Mill)	12.2
Dividend / Yield	$0.00/0.0%



Price target and ratings changes over the past 3 years:

Initiated - March 22, 2011 – BUY - Target $45.00

*Previous estimates do not include Global Crossing merger

Investment Highlights

1) Revenue growth continues to accelerate slightly - Level 3 Communications (Level 3) reported Q3/2011 financial results last week, including revenues of $947 million, up 3.6% year-over-year (versus 2.1% in Q1/2011 and 2.6% in Q2/2001) and a net loss per share of ($1.16) excluding one-time charges associated with the Global Crossing transaction and extinguishment of some debt. Results compare favorably to our estimates of $940 million and ($1.35), respectively. Revenue growth was driven by a 7.4% increase in core network services (versus 4.0% in Q1/2011 and 6.4% in Q2/2011), which exhibited specific strength in large and mid-market enterprise, government, cable, and Europe.

2) Trend in gross margin expansion continues - Communications gross margin increased to 63.1%, up from 62.0% in Q2/2011 and 60.6% in Q3/2010, maintaining a trend of sequential expansion begun in 2010. The company again eked out a modest operating profit of $8 million, up from $2 million in the second quarter after years of operating losses. Unlevered cash flow was $105 million, down slightly from $117 million in Q2/2011, while consolidated free cash flow of ($42) million turned negative from a positive $6 million last quarter. Consolidated Adjusted EBITDA grew to $247 million (excluding $11 million in merger costs) from $234 million last quarter and $218 million in the year ago quarter.

3) Outlook for 2011 reaffirmed for Level 3, mum on Global Crossing – Providing its outlook for the remainder of the year, management indicated it expects continued sequential revenue growth in Level 3's Core Network Services as well as double digit percentage growth in FY2011 consolidated adjusted EBITDA vs. FY2010. Additionally, management reiterated its confidence in achieving cost cutting synergies from the Global merger on the timeline originally laid out when the transaction was announced in April. With regard to the outlook for Global Crossing specifically, however, the company indicated investors would need to wait until overall company guidance for FY2012 was provided for any insight into Global's expected revenue trajectory.

4) Adjusting estimates to reflect merger - After the October 4, 2011 closing of the merger with Global Crossing, we are revising our estimates for Q4/2011 and FY2012. For Q4/2011, we are increasing our revenue estimate from $950 million to $1.67 billion. In addition to the acquisition, part of the increase also reflects a modest bump-up in our forecasted rate of organic growth given the stronger than expected Q3/2011 revenue results. We are also upwardly revising our split adjusted Q4/2011 loss per share from ($1.20) to ($1.06). For FY2012E, we are adjusting our estimated revenue from $3.95 billion to $6.9 billion and our estimated loss per share from a split adjusted ($3.75) to ($3.37). Further, we believe that gross and operating margins will improve over the course of FY2012 as the Company realizes synergies associated with the acquisition.

Conclusion/Stock Valuation

Level 3 Communications is one of the largest internet backbone providers with $25 billion (original cost) invested in their fiber optic network. With the forthcoming mobile- and video-driven boom in internet traffic and the scope and scale gained through the Global Crossing merger, we believe the long awaited turn-around for Level 3 has finally arrived and is now slowly unfolding. We continue to expect the anticipated exponential increase in internet traffic (as forecast by Cisco Systems (NYSE/CSCO/Not Rated) in the Cisco Visual Networking Index: Forecast and Methodology, 2009-2014) over the coming years to help absorb the current oversupply of fiber, enabling management to continue to make good on its stated target of sustained 1% to 2% sequential revenue growth in core network services. Further, once the operations of Global Crossing are more fully integrated we expect revenue synergies to materialize with the more expansive product footprint bolstering incremental revenue growth over the longer term through new customer wins and up-sell opportunities. Moreover, a greater portion of revenue should fall to the bottom line as anticipated cost synergies of the merger are realized beginning as early as Q1/2012. Lastly, we view Level 3 as a compelling alternative vehicle to play the growing trend in cloud computing versus other potential beneficiaries that currently sport lofty price/sales valuation multiples such as Salesforce.com (NYSE/CRM/Not Rated), Amazon (NASDAQ/AMZN/Not Rated), and Rackspace (NASDAQ/RAX/Not Rated.) Thus, we are maintaining our BUY rating and twelve month price target of $45.00 per share (adjusted for the recent 15-to-1 reverse split), or approximately 2X estimated 2011 revenues, discounted by 33% to account for risk associated with Level 3's significant debt burden. (Note we have lowered our risk premium assumption in our valuation methodology to 33% from 50% previously to reflect the improved credit profile of the combined Company (5.3X EBITDA/net debt) following the closing of the Global Crossing deal.)

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Level 3 with other companies in the industry, we believe the primary risks to our price target include the following:

- **Lack of profitability** – Level 3 has yet to produce a profitable fiscal year and there are no guarantees that it will be able to do so in the future. The Company has returned to quarter to quarter sequential revenue growth, but will need to continue to control costs going forward to achieve positive earnings per share.

- **Integration of Global Crossing –** Level 3 finalized the merger with Global Crossing on October 4, 2011. Should the Company fail to integrate successfully the Global Crossing business it could have a negative impact on the Company's operations and financial results. Additionally, the Company may fail to realize expected cost saving synergies or may attain them over a longer time horizon than we anticipate.
- **Industry over capacity** – Our positive investment outlook is in large part predicated on our assumption that growth in internet traffic, particularly that driven by the increasing prevalence of video streaming and internet-enabled mobile devices, will help to absorb excess fiber optic network capacity leading to a more stable pricing environment for Level 3. In the event that growth in internet traffic falls short of our expectations and/or technological advances enable significantly greater data transmission rates over existing fiber, the pricing power of Level 3 could weaken and negatively impact the Company's financial results.
- **Significant debt burden with risk of possible default –** The Company is highly leveraged, with a high debt/EBITDA ratio relative to its peers and a low interest coverage ratio. Failure to roll over the large portion of long-term debt due in 2014 could result in the Company defaulting.
- **Competitive markets –** Level 3 faces significant competition as an Internet Provider from larger companies that include Verizon (NYSE/VZ/Not Rated), AT&T (NYSE/T/Not Rated), and CenturyLink, Inc. (NYSE/CTL/Not Rated). Highly competitive markets have greatly reduced the price of bandwidth since the late 1990's. The company also faces significant competition in the Content Delivery Network market primarily from Akamai Technologies (Nasdaq/AKAM/Not Rated) and Limelight Networks (Nasdaq/LLNW/Not Rated).

Justin S. Colatosti

Level 3 Communications, Inc.
Consolidated Statements of Operations
(In $Millions)

FYE December	2007	2008	2009	1Q10 Mar	2Q10 June	3Q10 Sept	4Q10 Dec	2010	1Q11 Mar	2Q11 June	3Q11 Sept	4Q11E Dec	2011E	1Q12E	2Q12E	3Q12E	4Q12E	2012E
Revenues	$4,269	$4,301	$3,762	$910	$908	$912	$921	$3,651	$929	$932	$947	$1,670	$4,478	$1,690	$1,720	$1,750	$1,775	$6,935
Cost of revenues (excluding depreciation)	1,833	1,809	1,565	383	374	368	365	1,490	372	366	360	840	1,938	850	860	870	880	3,460
Gross Profit	2,436	2,492	2,197	527	534	544	556	2,161	557	566	587	830	2,540	840	860	880	895	3,475
Operating Expenses:																		
Selling, general & administrative expenses	1,723	1,505	1,338	343	338	345	347	1,373	357	357	375	510	1,599	510	515	520	525	2,070
Depreciation and amortization	942	931	915	225	223	215	213	876	204	207	204	285	900	285	285	280	280	1130
Impairment charges & other one-time	12	25	9	0	1	1	0	2	0	0	0	0	0	0	0	0	0	0
Total operating expenses	2,677	2,461	2,262	568	562	561	560	2,251	561	564	579	795	2,499	795	800	800	805	3,200
Income (loss) from operations	(241)	31	(65)	(41)	(28)	(17)	(4)	(90)	(4)	2	8	35	41	45	60	80	90	275
Other Income																		
Interest income/(expense), net	(577)	(570)	(595)	(149)	(145)	(144)	(148)	(586)	(157)	(160)	(178)	(230)	(725)	(230)	(230)	(230)	(230)	(920)
Other expenses, including discontinued ops.	(318)	227	43	(47)	4	(1)	7	(37)	(17)	(20)	(31)	(20)	(88)	(10)	(10)	(10)	(10)	(40)
Income (loss) before tax	(1,136)	(312)	(617)	(237)	(169)	(162)	(145)	(713)	(178)	(178)	(201)	(215)	(772)	(195)	(180)	(160)	(150)	(685)
Provision for income taxes	(22)	0	0	0	0	0	(91)	(91)	27	3	6	5	41	5	5	5	5	20
Net income (loss)	(1,114)	(312)	(617)	(237)	(169)	(162)	(54)	(622)	(205)	(181)	(207)	(220)	(813)	(200)	(185)	(165)	(155)	(705)
Basic income per share	($11.01)	($2.99)	($5.67)	($2.16)	($1.53)	($1.46)	($0.49)	($5.62)	($1.83)	($1.59)	($1.75)	($1.06)	($5.90)	($0.96)	($0.89)	($0.79)	($0.73)	($3.37)
Diluted income per share	($11.01)	($2.99)	($5.67)	($2.16)	($1.53)	($1.46)	($0.49)	($5.62)	($1.83)	($1.59)	($1.75)	($1.06)	($5.90)	($0.96)	($0.89)	($0.79)	($0.73)	($3.37)
Basic shares outstanding	101.2	104.3	108.9	109.8	110.7	111.0	111.2	110.7	112.1	113.6	118.1	207.6	137.8	208.0	209.0	210.0	211.0	209.5
Diluted shares outstanding	101.2	104.3	108.9	109.8	110.7	111.0	111.2	110.7	112.1	113.6	118.1	207.6	137.8	208.0	209.0	210.0	211.0	209.5
Key ratios:																		
Revenue growth (y/y)		0.7%	-12.5%					-3.0%	2.1%	2.6%	3.8%	81.3%	22.7%	81.9%	84.5%	84.8%	6.3%	54.9%
Gross margin	57.1%	57.9%	58.4%	57.9%	58.8%	59.6%	60.4%	59.2%	60.0%	60.7%	62.0%	49.7%	56.7%	49.7%	50.0%	50.3%	50.4%	50.1%
S, G&A/Revenues	40.4%	35.0%	35.6%	37.7%	37.2%	37.8%	37.7%	37.6%	38.4%	38.3%	39.6%	30.5%	35.7%	30.2%	29.9%	29.7%	29.6%	29.8%
Depreciation, amort, non-cash comp	$942	$931	$915	$225	$223	$215	$213	$876	$229	$224	$230	$305	$988	$305	$305	$300	$300	$1,210
Operating margin	-5.6%	0.7%	-1.7%	-4.5%	-3.1%	-1.9%	-0.4%	-2.5%	-0.4%	0.2%	0.8%	2.1%	0.9%	2.7%	3.5%	4.6%	5.1%	4.0%
EBITDA/share	$6.93	$9.22	$7.81	$1.68	$1.76	$1.78	$1.88	$7.10	$2.01	$1.99	$2.02	$1.64	$7.47	$1.68	$1.75	$1.81	$1.85	$7.09

Balance Sheets
($Mils)

Assets:	12/31/10	9/30/11
Cash and equivalents	$618	$1,720
Accounts receivable, net	264	337
Other	90	104
Total current	972	2,161
Property & equipment, net	5,302	5,117
Restricted cash	120	121
Goodwill & intangibles	1,798	1,728
Other assets	163	127
TOTAL ASSETS	$8,355	$9,254
Liabilities:		
Accounts payable	$329	$342
Current portion of long-term debt	180	265
Accrued expenses	230	266
Deferred revenue, current	151	140
Other	66	90
Total current	956	1,103
Long-term debt	6,268	7,420
Deferred revenue, long-term	736	742
Other	552	512
Total liabilities	8,512	9,777
Stockholders' equity	(157)	(523)
TOTAL LIAB & EQ	$8,355	$9,254

Quarterly Earnings Comparisons

	Mar	June	Sept	Dec	Total
Revenues (in 000's)					
2010	$910	$908	$912	$921	$3,651
2011E	929	932	947	1,670	4,478
2012E	1,690	1,720	1,750	1,775	6,935
Earnings per Share					
2010	($2.16)	($1.53)	($1.46)	($0.49)	($5.62)
2011E	(1.83)	(1.59)	(1.75)	(1.06)	(5.90)
2012E	(0.96)	(0.89)	(0.79)	(0.73)	(3.37)

Operating Statistics

	2008	2009	2010
Sales by Type ($000s)			
Core Network Services	$3,136	$2,840	$2,827
Wholesale Voice Services	724	663	650
Other Communications	366	192	114
Coal Mining	75	67	60
Total	$4,301	$3,762	$3,651
Sales by Region ($000s)			
US	$3,975	$3,436	$3,335
EU	326	326	316
Total	$4,301	$3,762	$3,651

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:

Price target and ratings changes over the past 3 years:
Initiated – March 22, 2011 – BUY - Price Target $45.00

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	Company Coverage		**Investment Banking**	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Buy	27	84%	8	30%
Neutral	4	13%	3	75%
Sell	1	3%	0	0%
Total	32	100%	11	34%

Information about valuation methods and risks can be found in the "STOCK VALUATION" and "RISK FACTORS" sections of this report.

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