North State Telecommunications Corporation

A Strategic Evaluation

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Executive Summary

This report was generated as an independent study of the value of the North State operations and assets today and the potential for value-creation over the next five years.

- **Independent report that focuses on value-creation at North State.** Commissioned by one of North State Telecommunications Corporation's (North State or the Company) equity investors, this report was generated by Balhoff &Williams, LLC (B&W) as an independent study of the value of the North State operations and assets today and the potential for value-creation over the next five years. The purpose is to provide clear, thoughtful and constructive *perspectives* for the Company's investors, management and Board of Directors (Board). If North State is interested in discussing *recommendations*, based on a more in-depth assessment of the perspectives and data provided by management and the Board, B&W would be open to offering more specific advice that may or may not be acted upon subsequently.

- **Industry-wide operating trends indicate ongoing and accelerating fundamental pressure on incumbent local exchange carriers.** Virtually all of the U.S. incumbent local exchange carriers (ILECs) are reporting accelerating access line losses, which averaged 6.1% in 2008. The line losses are most severe in the residential markets rather than in the business markets, and apparently are driven by wireless substitution as consumers disconnect wireline services in favor of their cell phones for voice services.

- **Industry-wide broadband growth is promising, but slowing.** While broadband growth has been significant, the pace of growth is slowing in 2008 and 2009. For North State, the broadband slowdown in 2008 was significant, as growth in subscribers eased from 17.3% in 2007 to a mere 0.4% in 2008. At the same time, North State is in the process of committing to a significant network upgrade to provide highly competitive data and video services. However, the national data reveal that access-line losses in absolute numbers are far higher than the new additions of broadband subscribers even at the largest, most committed operators—Verizon and AT&T. When combined with the fact that broadband and related video services are less profitable than traditional local telephone, the pattern suggests a difficult industry path for at least the next several years. There is no clarity about how this pattern will be reversed, short of some unrecognized new technological opportunity.

- **Hyper-competition in certain regions looms as a serious risk.** The ILEC operating model is based on high network investment with relatively low variable costs when a new subscriber is added to a relatively well-utilized network. The model turns against a network company when subscriber losses and revenue declines mount rapidly. In fact, several carriers report that sharp losses of customers and revenues are deeply depressing margins, such as Verizon in New York State (where operating margins have turned negative), Warwick Valley which serves the border of New York and New Jersey, and Alaska Communications Systems in Alaska. While there is no projection that such a scenario will occur in North State's region, the financial risk is more material than it was in the recent past.

- **Many of the federal and state regulatory trends have turned more negative and are not likely to improve.** Key regulatory financial support payments have been critical for the operating models of ILECs that serve primarily low-density and high-cost regions. Those support mechanisms have been (1) access payments and (2) universal service fund (USF) support payments. Access charges are the fees paid by long-distance carriers for the use of the last-mile to the home or business. USF is the support or "subsidy" payment assessed on every local telephone bill, collected by long-distance carriers and directed to specific telephone

companies, generally according to cost-based formulas. For the last several years, there has been increasing political pressure to cap the size of the USF or even cut the funding, and to sharply reduce state access rates, and there is mounting support to further reduce interstate rates. Importantly, the B&W-created forward-looking financial model (described below) in this report assumes no sharp changes to those policy support payments. At the same time, it is the view of most industry observers that support funding will not expand, and likely will decline, potentially by a significant amount over the next years. The net effect of such proposed changes for North State and other carriers would be nearly dollar-for-dollar reductions in cash flows to match the declines in revenues, as there are few operating costs associated with support payments. The potential is that North State could, in an extreme case, lose significant cash flows over the next years as a result of regulatory "reforms." To put the regulatory risk exposure in perspective, North State's USF receipts in 2008 were about $3.5 million, which was 3.4% of total revenues and a much higher 18.9% of operating income. Access revenues are more difficult to predict, but access revenues likely account for 20%-25% of consolidated revenues and the result of a cut in those rates would be negative, and potentially significantly so, to the Company's outlook.

- **North State's operating reports provide insight into the Company's challenges and strategies.** North State has reported 0.6% annual revenue contraction on average over the last five years, with revenues slipping 3.2% in 2008 from 2007. During the same five-year period, the Company's operating costs rose 2.5% on a compound annual basis, while earnings before interest, taxes, depreciation, and amortization (EBITDA) fell 5.0% on an average annual basis, including a 4.9% contraction in 2008. The Company's EBITDA margin slipped each year from 2004 through 2008, falling from 44.0% in 2005 to 36.7% in 2008.

- **The Company's balance sheet remains very strong, but cash flows are weak.** North State has no net debt, which is calculated by subtracting cash on hand from long-term debt. The fact that the Company is capitalized with 100% equity has the result of depressing the equity returns to achieve a very conservative capital structure. The average net debt-to-EBITDA across the industry is approximately 3.0x, while North State and one other carrier surveyed by B&W are the only carriers with negative (very conservative) net debt-to-EBITDA. As a rule, some relatively higher debt level (possibly 30% to 50% of total capitalization) is generally the preferred approach to maximize equity returns for shareholders, although the current extraordinary financial environment has penalized companies with disproportionate risk in the capital structure (i.e., highly leveraged capital structures). North State may be keeping its debt level low during a period when capital investment per line and capital investment as a percentage of total revenues are high relative to the statistics of virtually all the major companies in the industry. North State's per line investment annually was $242 in 2008 ($20 per month), while the investment as a percentage of total revenues has been between 22.6% and 24.5% over each of the last three years. As a result, free cash flows—after cash operating expenses, capital expenditures, cash interest expense, cash taxes, dividends and distributions received—were negative in 2006 and 2007 before becoming marginally positive at $2.7 million in 2008 (primarily helped by significantly lower cash taxes resulting from bonus depreciation and by positive distributions from other non-operating investments.) The capital investment levels are expected to remain near 25% of revenues through 2011, according to management, and then decline sharply thereafter. Cash flows may improve after that time with the reduction in capital investment, but the precise levels are unclear as it is not known how successful the Company will be in generating new revenues and operating profits from data and video customers.

- **North State customer-totals have been declining over the last three years.** North State reports that, over the last five years, the Company added 9,424 broadband customers and 8,113 wireless customers, while losing 28,795 local telephone customers for a

net loss of 11,258 total customers. As noted above, the pattern is consistent with the trends at all the major carriers, including the pattern at Verizon and AT&T, which boast aggressive broadband investments.

- **This report's projection model assumes that the majority of Company's operating trends will continue.** This report provides a five-year projected operating model, cash flow statistics, and selected balance sheet items prepared by B&W. As noted above, the model assumes no material change in the current regulatory regimes affecting access rates or universal service funding, but both of these mechanisms could turn negative over the five years, making the model potentially optimistic. Including assumptions that North State will experience a return to growth in broadband and wireless and will slow the rate of operating expense growth, the model suggests that EBITDA will slip lower by another $5.1 million from 2008 to 2013, compared with a contraction of $8.5 million from 2003 to 2008. The $5.1 million reduction in EBITDA represents 16% of 2013 EBITDA or 14% of 2008 EBITDA, a material decline regardless of the comparison period.

The B&W model suggests that EBITDA will slip lower by another $5.1 million from 2008 to 2013, compared with a contraction of $8.5 million from 2003 to 2008. The $5.1 million reduction in EBITDA represents 16% of 2013 EBITDA or 14% of 2008 EBITDA, a material decline regardless of the comparison period.

- **North State's management has chosen to deploy fiber-to-the-home (FTTH).** Management believes that its ongoing FTTH build-out will pass approximately 75% of the homes in its services area by yearend 2011 and will make the Company much stronger competitively as the fiber sustains growth in video and data services. B&W provides a second analysis—a summary 2014-2018 model and sensitivity table—that indicates that it will be difficult for the Company to expand its consolidated cash flows, as increasing FTTH-driven cash flows may be insufficient to offset losses in core ILEC cash flows. It also appears that it may be more difficult to generate a favorable return on investment. The 2014 to 2018 analysis, however, is far enough in the future that the most balanced acknowledgement is that no one can discern the competitive and technological developments in a rapidly changing industry. Still, the risk is apparent that the initiative will fail to generate a return on the current investment and that corporate value will erode.

- **Three strategic options can be chosen, at least at a high level.** At the most generalized level, North State can stay the course, which includes a relatively aggressive fiber-to-the-home FTTH build-out accompanied by new video services, and assume that gains in broadband and video revenues (and possibly some voice customer "win-backs") will more than offset losses in access lines and high-margin voice revenues, that cash operating expenses can be moderated, and that the cash outflows will be offset by gains that have not been fully realized to-date. A second generalized option is that North State can attempt to target growth in cash flows through acquiring comparably-sized carriers, with a view to creating increased scale and efficiency—akin to the strategic efforts of CenturyLink, Frontier, Windstream, Consolidated Communications and others. The third generalized possibility is that North State could assess the potential to be sold or combined, for example in a stock-for-stock transaction, with other carriers. In every case, the Company is seeking to avoid the erosion of value from the level at which the stock might trade today and to create improved value going forward. This report outlines those options, but avoids recommending one or the other outcome in light of the fact that B&W do not have access to certain proprietary information. Further, such proposals are not the purpose of this report.

- **North State's valuation range.** Based on the industry comparable transactions and without the benefit of further company-specific information, the average and median valuation multiples would suggest that North State is worth approximately $390 million and $367 million, respectively. It could be argued that North State deserves a higher valuation based on certain key criteria that appear more favorable than the average characteristics of other industry ILECs, including better revenue

performance by North State, investment in high-quality plant, the extraordinary balance sheet, and the likely number of larger and interested consolidators in the Carolinas. If the sale multiple of CT Communications, a nearby North Carolina ILEC, were used, for example, North State might be valued around $475 million at the present.

The challenge over the next years for North State will be to identify meaningful value creation opportunities to offset or cope with the negative trends in the business today.

- **Future valuation is likely to be lower.** The valuation of North State could be lower five years from now, depending on several factors, but notably how well the Company's FTTH-based service offering performs in terms of stemming access line losses and driving new revenue opportunities. The reasons that the valuation would *not* contract would be that North State might be able to maintain its cash flow levels near the current run-rate or even expand through a combination of revenue growth based on its new video service, enhanced broadband offerings, reduced customer attrition, and more disciplined cost control once the new services are deployed. However, at the present, broadband growth is not nearly offsetting access line losses at the top line and the figures are worse in terms of cash flows. Management believes these trends can be reversed, but Verizon's FiOS experience to-date over each of the last three quarters (losing a net quarterly subscriber count of approximately 400,000 customers—Internet adds plus video adds less access line losses) indicates that such a reversal could be challenging even if the FTTH-based services were successful. Further, there are serious regulatory risks over the next years, which make it more likely that North State will be impacted negatively by access and/or USF reform. The competitive landscape may or may not turn more negative, but is not likely to become significantly more positive as new wireless technologies are pressing the wireline voice and data services. Finally, it is likely that the number of consolidators will be fewer over the next five years, which suggests that auctions could be less efficient and pricing for ILEC assets will be somewhat more depressed. In short, cash-flow-based valuations suggest that North State's valuation is likely to shrink over the next years, while recognizing the possibility that there might be some opportunity to recoup some portion of that lost value if management's FTTH-based strategy is successful. Regardless of an investor's view of these conclusions, the challenge over the next years for North State will be to identify meaningful value creation opportunities to offset or cope with the negative trends in the business today.

Introduction

The report's purpose is to provide clear, thoughtful and constructive perspectives for the Company's investors, management, and Board.

This report summarizes the findings from B&W's independent financial study of the strategic and operating outlook for North State. The report assesses at a high level the value of North State today and over the next five years. The purpose is to provide clear, thoughtful and constructive perspectives for the Company's investors, management and Board.

The B&W report was commissioned by one of North State's equity investors. B&W's principals have spent more than thirty years focused on the ILEC industry and have dedicated more than ten years to publishing research on and analyzing the distinct characteristics of rural telephone companies. B&W have advised the senior managements of virtually all the major rural telephone companies and many of the smaller rural carriers. The report is intended to evaluate publicly available information about North State, to compare the data to information available about other representative rural carriers, and to assess North State's value creation potential. To the best of B&W's knowledge, there were no preconceived ideas or conclusions about valuations or strategic options on the part of the sponsor of the study. The intent was for an independent third-party to evaluate the Company objectively to consider strategic and valuation alternatives.

Importantly, this report does not necessarily represent the views of management or any of North State's investors, but solely represents the analysis and opinions of B&W.

The authors have used information supplied by the Company, both in written materials and in a face-to-face meeting, and the sponsor-investor. No confidential information has been conveyed to B&W in written or any other form. The authors also have used available information about other "peer" companies in the industry, which include rural carriers that range in size from 21,000 lines to nearly 8 million lines. Additionally, the authors have drawn on their experience and knowledge of critical industry forces gleaned from projects and discussions with senior managements, regulators and other industry participants, such as financial analysts and lending institutions. Importantly, this report does not necessarily represent the views of management or any of North State's investors, but solely represents the analysis and opinions of B&W.

This report is divided into five summary sections: (1) defining the industry forces; (2) analyzing the fundamental operating trends for North State; (3) assessing the strategic and value-generating decisions of other carriers; (4) clarifying the potential for value-creation at North State as it assesses its strategic options; and (5) estimating the current and future value of North State.

It is assumed that there will be additional discussions of the report's insights. Management almost certainly will view its opportunities and financial prospects through prisms different from those that an outsider uses, and the authors recognize that those insights will be additive to the analyses and conclusions. B&W are open to further reviews of the data, opinions and conclusions in this report with North State's investors or management, and stand ready to further an evaluation that is designed to assure that value is maximized for all of North State's stakeholders—customers, employees, leadership, investors, and policymakers.

Defining Industry Forces

The root cause of the industry change is the emergence of newer technology platforms/services that have altered consumer behavior and have enabled growing competition.

The local exchange telephone industry is changing fundamentally. The root cause is the emergence of newer technology platforms/services that have altered consumer behavior and have enabled growing competition. The changing technology landscape has also created confusion regarding the state and federal regulatory systems as policymakers are uncertain about how to change older support (subsidy) mechanisms. Finally, the long-anticipated consolidation within the industry has begun to occur among many carriers, driven by the operating, regulatory, and competitive pressures which almost certainly will affect all carriers.

The key technologies driving the industry changes have been related to Internet Protocol (IP) and wireless services. IP changed the telephone plant from a closed set of switched services reliant on dedicated circuits, and shifted the technology-platform toward a much less expensive and more open system in which digital data could be transmitted flexibly and with additional feature-rich applications. Cable television companies and wireless operators have used the technologies to create new applications based on Internet-enabled products. Some observers have argued that it was the Telecom Act of 1996 that was the catalyst that opened the competitive floodgates and precipitated the change. The reality is that the first-mover was technology, which then prompted the legislators to alter the monopoly regulatory framework. And, most recently, it has been more robust technologies that have made possible the most formidable competitive communications networks.

The simple reality is that technology is changing services, pricing, customer adoption patterns, competitive behavior, regulatory responses, business opportunities, and, importantly, valuations. The operating data for incumbent carriers bear out a change that is not trivial but is fundamental.

The industry's operating results due to shifting technologies are well understood by investors and managements. Switched access lines no longer grow at annual rates of 3%-5% as they did in the 1980s and 1990s, but now generally are contracting annually by 3%-10%. Financial analysts once focused on the line growth metrics as signals of the economic strength of a company's region and as proxies for the projected long-term cash flows. The trend of consistent line contraction began around the turn of the century, and has accelerated nearly every year since then. The reasons for the line losses include competitors offering increasingly attractive pricing schemes, and the availability of bundled services and products distinct from those on the landline voice network—mobility and significantly higher-speed data and video services. This loss of access lines has resulted in pressure on the core revenues generated by ILECs. In addition, revenues have been further reduced as the volume of long-distance minutes has dropped, primarily due to increased texting, emails and wireless voice replacement, even when the customer has not cut off the landline.

Technology is outrunning legacy landline services and is rendering wired voice as a relatively lower-value proposition.

North State certainly recognizes that customers now demand products that have altered the value once centralized in voice communications. Technology is outrunning legacy landline services and is rendering wired voice as a relatively lower-value proposition. While data plus video—provided by telephone companies and cable operators—is important, customers today seem to have an insatiable appetite for wireless services at rates that, while higher than those on the landline, are close to landline prices. Today's wireless communications services offer greater convenience (mobility) and remarkably more functionality in

terms of text-messaging, emails, and video services, all combined in handsets that are the technological version of a Swiss Army knife. This rapid evolution of services and devices is the most serious threat to the traditional wireline voice platform.

This initial section provides summary data related to the forces driving industry change in the two following subsections: consumer trends and regulatory trends. Financial and transactional trends also are important factors in the ILEC industry today, but will be discussed in separate sections of this report.

Consumer trends

The operating challenges and opportunities for ILECs are apparent when one reviews annual industry data related to customer growth. This initial section provides a snapshot of ILEC trends, and it ends with some insight into industry-wide margin weakness that could and, likely will, accelerate. As is apparent in the tables later in this report, North State's operating characteristics, including line losses, reflect pressures similar to those of the overall industry, while the Company's operating margins on a consolidated basis appear to demonstrate margin weakness that is more pronounced than that of many comparable carriers.

Access lines and the impact of wireless services

Virtually all of the U.S. local exchange carriers are reporting significant annual access line contraction, and the losses on average have been accelerating, as is apparent in Table 1. In the earlier stages of line losses—in 2000 and 2001—some industry observers suggested that the line-losses could be explained by competitive local exchange carriers (CLECs) that had initial success in capturing business customers. They also pointed to losses of non-primary residential lines as retail customers were

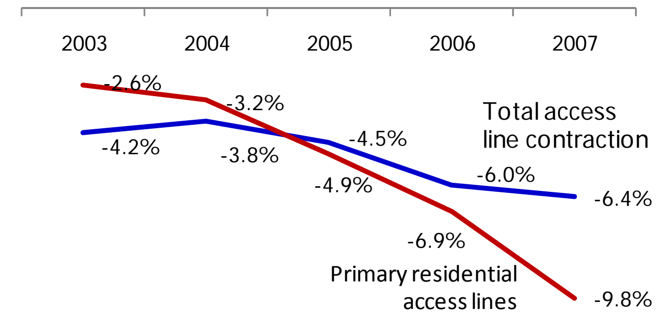
Table 1: Annual growth in access lines

	2005	2006	2007	2008
Alaska Comms.	-3.3%	-2.3%	-4.7%	-6.0%
Consolidated*	-5.2%	-3.4%	-4.2%	
CenturyLink*	-4.3%	-5.4%		-6.4%
D&E	-1.4%	-1.1%	-1.7%	-3.0%
Embarq		-6.1%	-8.6%	-9.8%
Frontier*	-4.2%	-5.0%		-7.2%
HickoryTech	-6.0%	-2.9%	-4.7%	-8.9%
Iowa Telecom*	-3.1%	-2.6%	-4.5%	
North State	***-4.7%***	***-7.5%***	***-6.7%***	***-7.2%***
NTELOS	1.5%	0.3%	0.6%	-1.7%
New Ulm*	-1.8%	-1.2%	-2.4%	
Shenandoah	0.2%	0.4%	-1.2%	-1.3%
SureWest*	-2.0%	-3.2%	-9.2%	
Windstream*	-5.3%			-5.2%
Warwick Valley	-7.0%	-9.0%	-6.6%	-10.8%
Average	***-3.3%***	***-3.5%***	***-4.5%***	***-6.1%***
Median	***-3.8%***	***-3.0%***	***-4.6%***	***-6.4%***

*Acquisitions of NPSI by CNSL 12/07; MadRvr by CTL 4/07; CTCO by FTR 3/07; Baker 8/06 and Bishop 7/08 by IWA 7/08; Hutchinson by NULM 1/08; various by OTT; Everest by SURW 2/08; VCG 7/06 and CTCI 8/07 by WIN.

Source: Company data; Balhoff & Williams, LLC.

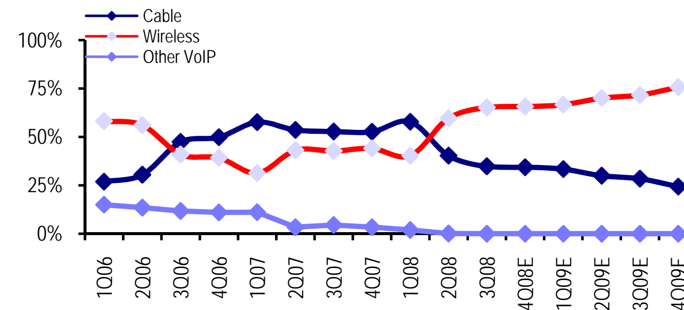
Figure 1: What is driving line loss? Residential lines.



Source: ARMIS data; Balhoff & Williams, LLC.

choosing to purchase wireless services rather than wired services for their teenagers or they were no longer using data/fax lines. However, the losses have mounted in recent years and are concentrated in the residential customer base.

Figure 2: Where do the telco lines go?



Source: UBS Securities, November 2008.

Access line data reveal that in 2005, primary residential lines began to fall at a rate faster than total line loss.

Figure 1 illustrates the mounting residential losses based on data provided by the Federal Communications Commission (FCC). The data are drawn from the FCC's ARMIS reports (Automated Reporting Management Information System) covering 56 local exchange companies. The access line data reveal that in 2005, primary residential lines began to fall at a rate *faster* than total line loss. In fact, business line losses (single line and multi-line) approximately leveled off in 2004, as the annual business declines were 3.3%, 2.1%, 2.6%, and 4.1% for 2004, 2005, 2006, and 2007, respectively. Residential losses became the most important factor driving the overall weakness. The experience is consistent with North State's reports which indicate in 2005 and 2006 that business-line declines were approximately 5.3% and 3.5%, respectively, while total residential lines contracted by 4.3% and 9.7% in 2005 and 2006, respectively.

What is driving the residential line loss? A recent report from UBS Securities (UBS) provides an interesting view of the secular trends. Figure 2 is a re-creation of the UBS data that focus on whether the lost customers are going to cable operators, to other VoIP providers or to wireless companies. UBS' data indicate that wireless had been capturing about 40% of the line losses through 2006 and 2007, but that wireless is now capturing 60%+ of the lost lines, accounting for a larger percentage of the increasing number of lines lost. UBS expects the migration toward wireless to continue, and there is reason (outlined below) that this expectation appears reasonable.

It appears that the share-shift is not the result of "price" but the choice of an attractive set of new services. Residential consumers are "cutting the cord" as they find most notably that wireless voice services, including mobility and integrated data capabilities, are a superior substitute for landline voice services. Fortifying this view, a recent report from *The Economist* puts wireless-only U.S. households at more than 20% of the potential homes, and the rate appears to be rising consistently.

An important question is whether North State can participate satisfactorily in the upside of wireless services based on its owned wireless assets and its joint operating arrangement with AT&T Mobility. As will be detailed later, North State has generated wireless subscriber growth that has been slowing materially since 2005. In 2005, North State's year-over-year annual wireless subscriber growth was 19.0%, slipping to 12.7% in 2006, 9.2% in 2007, and 3.0% in 2008. Thus, while North State is reporting accelerating levels of wireline line losses (around 7% per year), it is also posting slowing rates of wireless growth.

A review of national wireless industry information provides two important insights. First, the two largest carriers—Verizon Wireless and AT&T Mobility—appear to be capturing a larger number of the new customers, that is they are gaining share at the expense of the smaller carriers. North State benefits directly on an operating basis from its partnership with AT&T Mobility, while the Company also indirectly benefits from its Verizon Wireless (formerly Alltel) partnership interest. Second and potentially related to the first insight, customers appear increasingly to be attracted to wireless data services, which are reliant on cutting-edge new integrated handsets and high-speed networks.

Certain wireless industry data are summarized in Table 2. The data are somewhat skewed as there have been several large mergers and acquisitions in recent years, including the Sprint acquisition of Nextel in August 2005, the combination of AT&T and SBC in January 2006, followed by the additional combination of AT&T with BellSouth in December 2006. Finally, Verizon Wireless merged with Alltel in early 2009. Still, the trends reveal the fundamental story.

The wireline carriers should note a more ominous and accelerating shift toward wireless data that is apparent in the financial reports of Verizon Wireless and AT&T Mobility.

Based on the information in the table (excluding T-Mobile and some other small carriers), the industry is concentrating into two carriers. For example, 47% of the net adds in 2008 were captured by Verizon Wireless/Alltel, 52% by AT&T Mobility, and a mere 1% by the remaining small carriers, while Sprint actually lost over 2.7 million customers. Also, the turnover in the customer base (churn) for the largest carriers is very low,

Table 2: General wireless trends

	2002	2003	2004	2005	2006	2007	2008
Wireless Subs							
ALLTEL	7,601,600	8,023,400	8,626,500	10,662,300	11,823,900	12,785,200	
ALSK	82,220	87,017	100,657	117,537	133,988	146,450	149,812
S	14,800,000	20,000,000	24,700,000	39,700,000	40,319,000	41,454,000	38,752,000
SHEN	67,842	85,139	102,613	122,975	153,503	187,303	211,462
T	21,925,000	24,027,000	49,132,000	54,144,000	60,962,000	70,052,000	77,009,000
TDS	4,103,000	4,409,000	4,945,000	5,482,000	5,815,000	6,102,000	6,196,000
VZ	32,500,000	37,500,000	43,800,000	51,300,000	59,100,000	65,707,000	72,056,000
Growth in Wireless Subs							
ALLTEL		5.5%	7.5%	23.6%	10.9%	8.1%	
ALSK		5.8%	15.7%	16.8%	14.0%	9.3%	2.3%
S		35.1%	23.5%	60.7%	1.6%	2.8%	-6.5%
SHEN		25.5%	20.5%	19.8%	24.8%	22.0%	12.9%
T		9.6%	104.5%	10.2%	12.6%	14.9%	9.9%
TDS		7.5%	12.2%	10.9%	6.1%	4.9%	1.5%
VZ		15.4%	16.8%	17.1%	15.2%	11.2%	9.7%
Wireless Subs Adds							
ALLTEL		421,800	603,100	2,035,800	1,161,600	961,300	
ALSK		4,797	13,640	16,880	16,451	12,462	3,362
S		5,200,000	4,700,000	15,000,000	619,000	1,135,000	(2,702,000)
SHEN		17,297	17,474	20,362	30,528	33,800	24,159
T		2,102,000	25,105,000	5,012,000	6,818,000	9,090,000	6,957,000
TDS		306,000	536,000	537,000	333,000	287,000	94,000
VZ		5,000,000	6,300,000	7,500,000	7,800,000	6,607,000	6,349,000
Wireless Churn							
ALLTEL	2.5%	2.6%	2.2%	2.2%	2.0%	1.8%	
ALSK	2.3%	1.4%	1.7%	2.0%	1.8%	1.5%	1.8%
S	3.3%	2.7%	2.6%	2.3%	2.6%	2.3%	2.2%
SHEN	3.4%	2.0%	2.2%	1.9%	1.9%	2.3%	1.9%
T	2.8%	2.7%	2.7%	2.2%	1.8%	1.7%	1.6%
TDS	1.8%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
VZ	2.3%	1.8%	1.5%	1.3%	1.2%	1.2%	1.3%
Wireless EBITDA Margin							
ALLTEL	36.7%	35.3%	34.6%	32.4%	32.9%	26.7%	
ALSK	17.9%	20.6%	20.7%	39.5%	42.1%	41.1%	35.3%
S	23.0%	24.3%	27.9%	30.6%	32.2%	50.6%	47.9%
SHEN	6.0%	19.6%	22.6%	23.7%	26.0%	50.3%	49.7%
T	29.3%	27.9%	23.5%	24.5%	29.4%	33.0%	34.2%
TDS	28.9%	21.4%	24.3%	24.5%	24.3%	24.7%	14.2%
VZ	35.6%	35.4%	37.3%	37.6%	38.1%	38.6%	39.3%

Source: Company data; Balhoff & Williams, LLC.

while the number 3 carrier—Sprint—is reporting substantially higher churn (loss of subscribers) in its customer base. The trends are the same in the first half of 2009, as the two largest carriers have grown stronger, while smaller carriers have weakened.

For the wireline carriers, there is another message that is somewhat ominous as there is an accelerating shift toward wireless data that is not included in this table. The trend is apparent in the financial reports of Verizon Wireless and AT&T Mobility. Both AT&T Mobility and Verizon Wireless are reporting that data services—text messages, graphics, and video—account for well over one-quarter of wireless services revenues compared with results from the first quarter of 2007 when wireless data were 16.0% for AT&T Mobility and 17.4% for Verizon Wireless. In the second quarter of 2009, AT&T Mobility reported wireless data revenues were 28.7% of total wireless revenues, while Verizon Wireless reported data revenues at 29.3% of total revenues on a pro-forma basis (adjusting for the Alltel acquisition). AT&T Mobility reported in the second quarter of 2009 that approximately 35% of its iPhone activations were for customers new to the company's wireless service. Verizon Wireless reported that, in the second quarter of 2009, exclusive integrated handsets accounted for 40% of its device sales. "Smartphones" were 28% of all handset sales for all wireless carriers in the quarter. Verizon Wireless' exclusive Blackberry Storm smartphone, introduced in late 2008, is positioned to compete with the iPhone, while Sprint in 2009 introduced the Palm Pre as its premier smartphone offering. The trend toward wireless data services could simply be a broadening of the data market, which might benefit wireline data providers. However, the trend bears watching as data access over wireless devices attract consumer dollars that might otherwise provide some impetus for wireline revenue growth.

The key messages appear to be that wireless increasingly is concentrated in two major carriers that are capable of investing large sums in data-centric services in terms of network upgrades and exclusive integrated handsets. Voice services based on the wired network are competing with a very powerful combination of voice plus data products in trendy and technologically sophisticated handsets that are controlled by the two large carriers. It appears that the pattern of wireline customer loss resulting from the rise of wireless services is not likely to abate and could accelerate in the near term.

It is likely that the wired market will benefit from the untapped broadband potential, but the growth could be muted by the migration toward wireless broadband.

Broadband services

The business of wired services is changing from voice to data—in terms of growth and value. Voice is still an important wireline telephony product, but the number of customers is shrinking and the perceived value of wired voice services is falling rapidly. Today, customers are seeking higher speed

Table 3: Annual DSL/broadband subscriber growth

	2005	2006	2007	2008
Alaska Comms.	45.1%	22.9%	7.8%	0.3%
Consolidated	42.8%	34.5%	26.3%	37.8%
CenturyLink	74.0%	46.9%	51.0%	15.8%
D&E	65.5%	41.0%	20.8%	12.3%
Embarq		46.8%	25.6%	10.6%
Frontier	44.4%	23.6%	33.0%	10.9%
HickoryTech	24.9%	20.7%	10.8%	7.3%
Iowa Telecom		60.3%	25.6%	20.5%
North State	***20.5%***	***15.7%***	***17.3%***	***0.4%***
NTELOS		54.0%	17.4%	11.5%
Otelco	81.0%	89.3%	19.4%	53.8%
Shenandoah	79.4%	39.0%	23.3%	23.4%
TDS	43.7%	44.5%	26.9%	16.8%
Windstream	63.2%	65.0%	32.8%	12.3%
Average	***53.1%***	***43.2%***	***24.2%***	***16.7%***
Median	***45.1%***	***42.7%***	***24.4%***	***12.3%***

Source: Company data; Balhoff & Williams, LLC.

broadband data services, which clearly represent the major opportunity in the wired business as it is the major opportunity for wireless carriers. The demand for high speed services is expanding at rates reflected in Table 3, and North State has benefited even as voice services are declining. The industry trends are the same—with line losses at least double those of broadband gains, and broadband margins well short of traditional 45%-55% EBITDA margins. Coupled with the consumer demand for bandwidth intensive video products, this shift toward broadband presents an opportunity for wired carriers that possess the most robust data-capable network platforms, but the migration is uncertain and challenging as cash flows slip more sharply in anticipation of future revenue increases. As of the second quarter of 2009, for example, Verizon appeared to be well ahead of AT&T, the two largest carriers that have committed, for years, to major network upgrades in support of broadband. Verizon added a record number of FiOS Internet customers in the second quarter of 2009 and lost 117,000 DSL customers for a net gain of 186,000 broadband customers. If one were to add the 300,000 new video customers to the total, the broadband network added a total of 486,000 video and Internet subscribers. In the same period, Verizon lost 884,000 access lines, resulting in a net loss of total customers on the wireline network. AT&T reported that the number of access lines contracted by 1,613,000 in the second quarter, while wired broadband gains were 112,000. It appears that the net losses for AT&T are deeper than those of Verizon, even if one includes AT&T's positive net change of 248,000 in video customers. This phenomenon will be discussed in more detail in the section of this report analyzing North State's ongoing fiber build.

Table 4: DSL / broadband penetration

	2004	2005	2006	2007	2008
Alaska Comms.	12.0%	18.0%	22.6%	25.6%	27.3%
Consolidated	10.8%	16.2%	22.6%	29.8%	34.7%
CenturyLink	6.2%	11.3%	17.5%	26.0%	32.1%
D&E	7.6%	12.8%	18.3%	22.5%	26.0%
Embarq		9.4%	14.7%	20.2%	24.8%
Frontier	9.4%	14.2%	18.5%	21.5%	25.7%
HickoryTech	14.0%	18.6%	23.1%	26.9%	31.7%
Iowa Telecom	5.8%	12.1%	19.8%	26.1%	31.3%
North State	***12.0%***	***15.2%***	***19.0%***	***23.9%***	***25.9%***
NTELOS		12.2%	18.7%	21.8%	24.7%
Otelco	10.4%	19.4%	23.0%	26.6%	28.1%
Shenandoah	10.7%	19.2%	26.6%	33.2%	41.5%
TDS	6.1%	8.6%	12.1%	15.6%	18.6%
Windstream	8.1%	14.0%	20.4%	27.2%	32.2%
Average	***9.4%***	***14.4%***	***19.8%***	***24.8%***	***28.9%***
Median	***9.9%***	***14.1%***	***19.4%***	***25.8%***	***27.7%***

Source: Company data; Balhoff & Williams, LLC.

It remains probable that customers will want higher and higher speed data (and video) services combined with larger devices such as computers or multi-media displays, making it likely that the market for wired high-speed data remains a growth business.

Broadband growth is promising, but it is not entirely clear how it will play out in the marketplace as wireless data services are increasing throughput, and the carriers are introducing attractive new user devices—Apple iPhones and Blackberry Curves, Storms and Tours, as well as Palm Pre's. Those new devices are attracting larger numbers of subscribers. Still, it remains probable that customers will want higher and higher speed data (and video) services combined with larger devices such as computers or multi-media displays, making it likely that the market for wired high-speed data remains a growth business. This is clearly the view of Verizon and AT&T which own the two largest wireless carriers but still have committed to expensive fiber-based, high-speed plant and services, at least in many of their denser markets.

The trends in the wired broadband market highlight the consumer movement toward both data and increasing speeds, but it is notable that broadband customer growth is slowing significantly as reflected in the table above. In fact, North State's Internet / broadband subscriber growth fell dramatically in 2008 to only 0.4% versus 2007 (although management indicates that broadband subscriber growth rates have improved in the first half of 2009). At the same time, Table 4 highlights that the percentage of homes with ILEC-supplied high-speed broadband services remains well below 35% in most rural markets. As the data indicate, North State's penetration levels were consistent with the comparable company group's average and median statistics in 2004-2006, but began to slightly lag the group in 2007 and 2008. It is likely that the wired market will benefit from the untapped broadband potential, but the growth could be muted by the migration toward wireless broadband.

LEC margins

LEC margins have held up relatively well in urban markets and better still in rural regions.

LEC margins have not weakened as much as the number of lines has declined. In part, the reason is that LECs have managed their expenses and increased sales per line. However, there are some disturbing signals in the market and those signals are indicators of what happens when competition increases in a high fixed-cost business where revenues can drop more rapidly than do costs. The result is a rapid decline in margins when losses of lines and revenues hit a critical "tipping point."

Forces affecting LEC margins

The data indicate that LEC margins have held up relatively well in urban markets and better still in rural regions. The reasons for the stability have been that the carriers have improved their cost structure and sold more products to customers, including features such as Caller ID, Caller Privacy, Call Waiting and flat-rated extended-area calling plans, as well as flat-rated long-distance. At the same time, local telephone service is a high fixed-cost business with relatively high marginal returns once the network is more fully loaded, and with relatively rapid deterioration of those marginal returns once revenues fall below certain levels.

Certain local carriers are reporting a remarkable collapse in their margins as strong competition results in rapid line loss.

EBITDA margins for the local telephone business have been generally 40% to 60% as detailed in Table 5. The table reveals that average and median EBITDA margins for the rural carrier group essentially have been flat for the 2004-2008 period at 43% and 45%, respectively. The table highlights downward pressure at companies somewhat more similar to North State, such as Alaska Communications Systems Group (ACS) (wireline only in the table), HickoryTech, Iowa Telecom, New Ulm and Otelco. In the case of certain other carriers, however, margins have been sustained because the carriers have engaged in acquisitions in which savings have been achieved. Those carriers include Consolidated, CenturyLink (formerly CenturyTel), Frontier and Windstream. The forces that often pressure EBITDA margins are the loss of relatively high-margin traditional ILEC voice services and the addition of lower margin broadband services. The authors do not know the EBITDA margins for North State's broadband business, but, based on B&W's experience, DSL margins—possibly near 20%—are generally insufficient to replace ILEC telephony EBITDA margins that are, again, typically in the 40% to 60% range. In any event, the table indicates that North State's margins have contracted to a meaningful extent over the last five years, which is typical of the shift from higher margin legacy voice operations to lower margin broadband-based business models.

While telephony benefits from low marginal costs when customers are added to well-utilized plant, the opposite can occur when large numbers of customers and related revenues are lost.

Hyper-competition as a warning about the future

While telephony benefits from low marginal costs when customers are added to well-utilized plant, the opposite can occur when large numbers of customers and related revenues are lost. In fact, certain local carriers are reporting a remarkable collapse in their margins as strong competition drives rapid line loss. In such a case, the carriers have high fixed costs and limited ability to reduce semi-variable costs as fast as losses are realized. Hyper-competition has emerged in several geographic locations, including Verizon's New York properties and Warwick Valley Telephone Company's (Warwick Valley's) service area on the border of New York and New Jersey. In addition, Verizon reported a disturbing decline (189 bps year-over-year) in EBITDA margins in its overall wireline business for the first quarter of 2009 (25.1%). The data are worrisome signals.

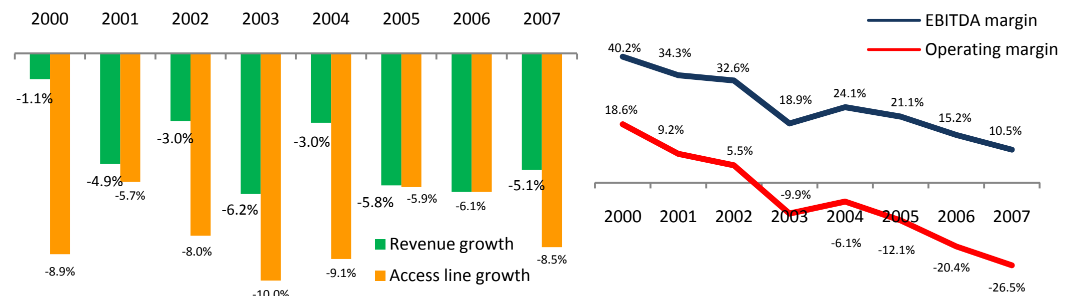
Table 5: Rural carrier wireline EBITDA margins

	2004	2005	2006	2007	2008
Alaska Comms.	29.5%	30.3%	26.1%	27.7%	24.7%
Consolidated	42.1%	41.5%	45.6%	46.5%	43.7%
CenturyLink	52.1%	51.2%	48.6%	50.0%	47.9%
D&E	39.7%	40.4%	42.9%	45.4%	45.1%
Embarq	45.0%	46.4%	44.2%	43.3%	46.4%
Frontier	45.2%	49.7%	55.3%	54.7%	53.8%
HickoryTech	45.6%	43.8%	40.1%	41.3%	39.5%
Iowa Telecom	59.2%	54.3%	53.6%	52.1%	50.3%
North State	***44.0%***	***41.2%***	***40.3%***	***37.4%***	***36.7%***
NTELOS	55.0%	55.7%	55.6%	53.6%	55.9%
New Ulm	42.2%	45.7%	41.1%	37.6%	38.2%
Otelco	55.7%	58.9%	53.1%	48.2%	47.6%
Shenandoah	55.3%	58.8%	62.7%	54.1%	62.4%
SureWest	15.3%	21.1%	34.4%	33.0%	30.5%
TDS	24.1%	35.9%	32.7%	34.0%	35.6%
Windstream	44.9%	44.0%	49.9%	52.0%	52.7%
Warwick Valley	23.1%	9.9%	6.4%	17.3%	15.1%
Average	***42.2%***	***42.9%***	***43.1%***	***42.8%***	***42.7%***
Median	***44.9%***	***44.0%***	***44.2%***	***45.4%***	***45.1%***

Source: Company data; Balhoff & Williams, LLC.

Figure 3 depicts that Verizon NY's access lines fell, in total, by 42.6% from 2000 to 2007. (More recent data are not available.) Notably, Verizon was able to "maintain" relatively better revenue levels (green bars), which only fell 29.6% from 2000 to 2007, but the

Figure 3: Hyper-competition in Verizon's New York Markets



Source: Verizon company reports; Balhoff & Williams, LLC.

ILEC's high fixed-cost business drove margins (line graph) down more sharply. The result was that Verizon NY's EBITDA was lower by 81.6% from 2000 to 2007, while operating income was lower by 200% (falling from $1.5 billion in positive income to a loss of $1.5 billion). It is noteworthy that similar phenomena are unfolding in regions where ILECs face stiff and concentrated competition. For example, Warwick Valley reported a 26.7% decline in access lines, 9.0% shortfall in revenues, but a steep 64.0% collapse in EBITDA, and 114.6% drop in operating income from 2000 to 2007, while ACS reported declining lines (31.3%), revenues (6.9%), EBITDA (33.1%), and operating income (69.2%) in the same period. The message is clear that line loss can or eventually will result in sharply lower profitability due to the fixed-cost nature of the business.

Summary of consumer trends

In summary, the ILEC business is changing rapidly as the core voice business is affected by competition in services. Broadband remains the principal "new" product for ILECs, possibly including video services, but growth has been slowing. Wireless is emerging as the most serious competitor and its competitive impact is felt most significantly in the residential markets. Wireless is likely to be concentrated increasingly in the two largest carriers that benefit from access to capital, network efficiencies, marketing strength, and exclusive access to the most attractive integrated handsets. There is a possibility that the ILECs eventually will benefit from new services where they have a competitive advantage because of their more robust network infrastructure, but such a scenario is not a certainty at this stage. In the meantime, it is realistic to expect that voice line losses will continue and broadband services will expand, likely replacing higher-margin voice revenues with lower-margin data revenues in what is often described by analysts as a "negative mix shift."

Regulatory trends

Regulatory systems are another important factor affecting the future prospects of rural ILECs. In fact, regulation has provided major financial support of the local exchange industry that was critical for the health of the sector over the last century. Policymakers have monitored rates and capital commitments, and assured investment-based-recovery in high-cost regions, while local telephone companies benefited from a predictable business model. Since the early 1990s, however, the regulatory environment has been evolving, most notably for larger carriers such as the Regional Bell operating companies (RBOCs) which began to embrace alternative forms of regulation or deregulatory approaches. The RBOCs have become less dependent on regulation and regulatory support mechanisms, but the smaller carriers that served lower-density, high-cost regions have continued to rely on predictable regulatory systems, most often based on rate of return.

The systems of regulation for all carriers have changed over the last century although the pace of reform has accelerated over the last ten years.

The systems of regulation for all carriers have changed over the last century although the pace of reform has accelerated over the last ten years. Most often, the drivers of regulatory change have been events in which the monopoly systems broke down. A seminal event occurred about forty years ago in 1968 when the upstart long-distance carrier MCI challenged the equipment monopoly and gained the right to use non-AT&T equipment in the famous Carterfone decision. The next major event was the breakup of AT&T in 1983, which was then followed by the Telecommunications Act of 1996 and a host of deregulatory orders from the FCC and state commissions in the late 1990s and 2000s.

Today, the pressures are mounting again for meaningful reforms that could affect the fundamental financial realities of the local exchange business. The changes are likely to occur in three important areas: (1) access charge reforms, (2) universal service funding, and (3) broadband obligations. In all three cases, policymakers appear ready to reduce the financial regulatory supports and to impose new obligations on carriers. Political forces are difficult to predict. At this time, however, it appears that the "reforms" will result in more negative financial outcomes, that is, more competition, increased pressure on margins, and greater obligations to invest in broadband services in unserved and underserved regions. Thus, the probable regulatory changes will mean increased operating risks with lower financial rewards.

Thus, the probable regulatory changes will mean increased operating risks with lower financial rewards.

Access revenues

Access revenues have been an important source of revenue for local exchange companies. The revenues are paid by long-distance companies for the use of the local exchange plant as the calls are originated or terminated on a local carrier's network. Access revenues can account for as much as 30%-40% of an ILEC's local telephone revenues, and are derived from relatively higher rates for calls completed within a state and relatively lower rates for interstate calls.

The greatest regulatory cause for concern today is intrastate access rates which are under increasing pressure.

The greatest regulatory cause for concern today is *intrastate* rates, which are under increasing pressure. In state legislatures and in state commissions across the country, the major long-distance carriers—AT&T, Verizon and Sprint—have mounted campaigns to reduce intrastate access rates to levels that approximate interstate rates. The reductions desired by the long-distance companies can result in 75% or even 80% cuts in intrastate access rates in certain jurisdictions. In the last two years, public service commissions have sponsored access-related proceedings in Texas, Ohio, Minnesota, Washington, Virginia and Wisconsin. State legislatures have evaluated lowering rates in Texas, Michigan, Missouri and Georgia. In North Carolina, there is no official process unfolding for access reform, but certain carriers are reporting that discussions have begun. In private conversations with staff at the State of North Carolina Utilities Commission, there have been questions raised about whether North Carolina intrastate rates should mirror (be reduced to) interstate rate levels. Insiders now suggest that a North Carolina statewide intrastate access proceeding is likely by early 2010 (an assessment with which North State's management appears to concur), but there is no clear plan at the present. Given North State's relatively lower rates in North Carolina compared with other carriers' intrastate access rates, the Company should have lesser exposure to rate reductions than carriers such as Windstream and CenturyLink (based on the rates in the former Embarq service territory). Still, the threat remains that revenues could be impacted.

The federal reforms of *interstate* access rates occurred in 2000 for carriers with prices per minute that were "capped." In 2001, interstate access reform occurred for carriers that were governed by rate-of-return. However, in 2008 and in 2009, the pressures are mounting again to reduce interstate access rates to levels that are marginal ($0.0007 per minute) or even to zero. In discussions with carriers, it appears more likely that reforms may result that will reduce rates sharply over the next 18 months. Most rural carriers have pressed regulators to understand that some "offset" is needed in the form of universal service funding, but the political headwinds are mounting to restrict support funding to levels even lower than the current levels.

It is possible that regulators will "carve-out" smaller carriers such as North State, to manage the harmful effects of rate reductions at least for a period of time. If this were to occur, possibly for five years, the companies might gain relief from access rate

There is real risk that both state and federal rates will slip lower than they are at the present and lower than is implied by the projections in the forward-looking model we have prepared below.

reductions that are imposed more immediately on larger urban or even the mid-size rural carriers. Still, even if there is a carve-out, the pressures appear substantial and it is realistic to suggest that access rates—interstate and intrastate—will be reduced, possibly meaningfully, over time. In the estimates outlined in the projection section below, because of the lack of clear information, B&W has assumed that there will be no major near-term harmful effects due to access rate reductions, but it is worth noting here that there is real risk that both state and federal rates will slip lower than they are at the present and lower than is implied by the projections in the forward-looking model we have prepared below. The projections, therefore, are based on the best information available at the present, while it is noted that the risk is significant.

If access rates—interstate and/or intrastate—were lowered, it might be possible for North State to raise end-user rates to offset the access charge reductions. This is the approach that some policymakers advocate. However, many carriers are reluctant to raise rates, at least to the full extent of access reductions, as management of those companies is concerned about the potential loss of customers to wireless or to cable competitors if pricing does not remain competitive. It is also possible that some of the revenues lost as a result of access charge reductions might be replaced by incremental universal service support mechanisms, as advocated by many of the mid-sized and smaller carriers. However, the political climate around the federal universal service fund (USF) suggests there is little appetite for expanding those support dollars above existing levels. Thus, if access rates actually are reduced, it is possible or even probable that some of the "lost" revenues will not be recouped.

Universal service funding

Federal USF has come under attack as the total obligation has increased from $2.16 billion in 1998 to an estimated $8 billion in 2009.

For the last twenty years, federal universal service funding has been an important pillar of public policy in the form of an explicit fund that provides cost-recovery for carriers serving high-cost regions. Arguably, over the last eighty years, universal service goals have been realized primarily through implicit funding in access rates derived from long-distance services and business subsidies. However, as policymakers have worked to eliminate implicit supports and replace them with explicit mechanisms, the USF has become increasingly important in furthering the policy of telephone services for all, notably as the number of access lines decreases and broadband obligations increase.

More recently, however, federal USF has come under attack as the total obligation has increased from $2.16 billion in 1998 to an estimated $8 billion in 2009. The "tax" imposed on customers' local wireline bills each month rose in the third quarter of 2009 to 12.9% from 11.3% in the second quarter of 2009 (up from 5.9% in the first quarter of 2000), but is projected to ease in the fourth quarter of 2009 to 12.3%. The generally rising contribution factor has attracted growing attention in the press, in part because of the outcry of long-distance companies and consumer groups. Additionally, the private and public pressures continue to increase on Capitol Hill, notably in the offices of committee heads. Finally, certain carriers that have engaged in mergers are reporting that the conversations at the FCC and in federal congressional offices are growing urgent regarding the need for immediate, fundamental reform of the fund.

In 2008, the Universal Service Administrative Company (USAC) reported that it provided North State approximately $3.5 million in USF. While the Company's USF revenues are only 3.4% of total revenues, a more careful review highlights that the loss of those monies would have resulted in a loss of 18.9% in operating income, and North State's 2008 EBITDA margin would have declined from 36.7% to 33.3%. It does not appear likely that North State will lose so significant a percentage, and the

modeling in the later sections assumes no change in the federal USF regime, but the risk remains that reform could materially harm the Company's cash flows. Table 6 provides actual annual disbursements of federal universal service funding to the Company as reported by USAC in its annual reports to the FCC, as well as calculations of USF as a percentage of EBITDA and operating income for North State.

Table 6: North State federal USF receipts

	2004	2005	2006	2007	2008
Interstate common line support	$ 1,672,380	$ 4,739,153	$ 4,326,978	$ 1,146,174	$ 3,458,226
Long term support	$ 1,098,066	$ -	$ -	$ -	$ -
Total	$ 2,770,446	$ 4,739,153	$ 4,326,978	$ 1,146,174	$ 3,458,226
USF as % of EBITDA	6.0%	10.8%	10.2%	2.9%	9.3%
USF as % of operating income	10.9%	21.1%	16.3%	5.3%	18.9%

Source: Universal Service Administrative Company data; Balhoff & Williams, LLC.

In light of the recent trends and the political temper, it appears more likely that universal service reforms will occur and that the funding will be capped at the very least, and possibly reduced over the next years.

The problems surrounding the USF are at least four. First, the fund is growing, which is raising the political pressures to "reform" the policy, in spite of the fact that the real growth is not driven by ILEC supports, but by other problems. Second, the large long-distance carriers have deep political lobbying resources and are using them effectively to attempt to lower support payments and allow the long-distance carriers to price their services at more attractive rates against competitors. Third, the policymakers do not have as profound an understanding of the complex financial forces affecting this relatively small number of customers, at least compared with the understanding of the "Farm Team" in Congress ten or fifteen years ago. And, finally, the rural carriers have been ineffective in providing data to reverse the political forces that have shifted against them.

In light of the recent trends and the political temper, it appears more likely that universal service reforms will occur and that the funding will be capped at the very least, and possibly reduced over the next years. It is somewhat likely that the smallest carriers will be successful in gaining a reprieve for five or ten years, but the forces are moving against significant USF payments in the foreseeable future.

Broadband obligations

Among the most important factors in 2009 affecting small and mid-size rural carriers is the pressure to expand broadband services. In particular, the political drumbeat for broadband has grown louder over the last five years, and the tempo has quickened with the changes in the administration in Washington, DC in 2009. More specifically, most of the rural carriers that maintain an advocacy presence in Washington report that there is a change in perspective regarding broadband and investment policy. The disturbing new element is that policymakers appear poised to push for high levels of broadband availability and faster speeds even if the economics do not support such a policy, and even if no commitment for public funding is available.

Two signals stand out regarding the new broadband climate. First, the Democratic Administration has announced that the FCC will have an experienced and relatively prominent veteran who is to coordinate development of a new national broadband plan. On July 2, 2009, the FCC unveiled its first comments on a national broadband plan that will be sent to Congress by February 17, 2010. FCC commissioners, including the new FCC Chairman Julius Genachowski, suggested that the changes would be sweeping in scope and ambition. In the words of the new Chairman, "Now is not the time for half-measures." The FCC's new broadband chief, Blair Levin, stated that this was an "omnibus broadband initiative," as he outlined the FCC's core objective, which was to ensure affordable and available broadband access for all Americans.

The second signal occurred, in an unprecedented action, when the FCC approved at the end of June 2009 a major transaction between rural carriers, CenturyTel and Embarq Corporation (Embarq). The approval was premised on extraordinary new broadband obligations. The commitments required 100% broadband availability to broadband-eligible access lines within three years of the close of the transaction, 10% of which can be accomplished using alternative technologies and operating arrangements, such as satellite and terrestrial wireless broadband technologies. In addition, there are definitions regarding required broadband speeds, including availability of broadband service with download speeds of (i) 1.5 megabits per second (Mbps) to 87% of the combined company's broadband-eligible access lines within two years of the close of the transaction, and (ii) 3.0 Mbps to 75% of broadband-eligible lines within one year of the close, 78% within two years and 80% within three years. Similar obligations may be imposed in the pending Frontier-Verizon transaction, and the CenturyTel-Embarq commitments probably will serve as a template for the approach that would be used in future transactions pending a more defined national broadband plan.

Federal policymakers effectively are committing the carriers to unfunded broadband mandates in which availability and high throughput is required, without economic review.

As important, the newly-imposed broadband obligations did not include any incremental commitments to provide federal or state economic support. Thus, federal policymakers effectively are committing the carriers to unfunded broadband mandates in which availability and high throughput is required, without economic review.

The transactional obligations are also possibly signals of what might be included in universal service reform. It is very possible that there will be a redefinition of the monies that are allocated to USF in terms of broadband rather than voice, and with little or no incremental funding. In such a case, it becomes more likely that a widespread policy will be imposed and not simply tied to a specific event such as a transaction.

North State already has committed to a significant network upgrade program and FTTH build, and may not be at risk in this new regime. Still, the principle is noteworthy that the current administration is more aggressive in setting policy even without funding supports. Such an approach could have a depressing effect on financial performance and related valuations across the industry.

Analyzing North State's Fundamental Operating Trends

This next section shifts from the broader market and industry influences to an assessment of Company-specific financial and operating performance. North State's historical five-year financial results from 2004 to 2008 are available in a number of publicly available documents. In assessing the Company's historical performance, the authors reviewed annual reports for 2005-2007, the

2004 audit report, and Company-provided, unaudited financial statements for 2008. B&W also met with North State management and gained some additional insights into the Company's views on operations, recent performance, and expected future performance. This section provides a summary of historical results, and a projection of possible financial performance based on the historical data and B&W's best judgment of the future impacts of industry forces. The analyses of historical data address key trends related to the income statement, balance sheet, cash flows and operating metrics, and compares North State's performance with the broader rural-focused ILEC industry. The projections, while summary in nature, make it possible to anticipate probable changes in operations, financial performance, and valuation based on North State's recent results and trends across the industry.

Historical financial trends

Income statement

North State has reported relatively stable total revenues over the most recent five years from 2004 to 2008.

North State has reported relatively stable total revenues, as is apparent in Table 7, over the most recent five years from 2004 to 2008. It is worth noting that 2008 revenues dipped lower, possibly because of the economy (management reports that the Company was negatively impacted by weakness in the furniture industry during 2007 and 2008) and possibly because of industry forces. Total revenues peaked at approximately $107 million in 2005, up from $104 million in 2004. However, in 2008, revenues declined by 3.2% year-over-year, slipping to approximately $102 million. Despite the revenue contraction in 2008, the Company's five-year revenue compound annual growth rate (CAGR) was -0.6%, which was better than the organic revenue loss rates of many comparable companies.

Table 7: North State five-year historical revenues

($s in thousands)	Actual				Unaudited	5-year Change	
	2004	2005	2006	2007	2008	$	CAGR
Local Services	$ 36,123	$ 34,678	$ 33,248	$ 31,712	$ 29,192	$ (6,931)	-5.2%
Network Access & LD Services	34,524	35,163	32,283	31,147	29,003	(5,521)	-4.3%
Sales & Other Services	28,712	32,295	34,903	38,047	39,203	10,491	8.1%
Directory & Other	5,828	5,626	5,715	5,803	6,034	206	0.9%
Uncollectibles	(1,046)	(998)	(1,223)	(1,649)	(1,716)	(670)	13.2%
Total Revenue	**$ 104,141**	**$ 106,764**	**$ 104,926**	**$ 105,061**	**$ 101,716**	**$ (2,425)**	**-0.6%**
YOY Growth Rates							
Local Services		-4.0%	-4.1%	-4.6%	-7.9%		
Network Access & LD Services		1.9%	-8.2%	-3.5%	-6.9%		
Sales & Other Services		12.5%	8.1%	9.0%	3.0%		
Directory & Other		-3.5%	1.6%	1.5%	4.0%		
Uncollectibles		-4.6%	22.6%	34.8%	4.1%		
Total Revenue		**2.5%**	**-1.7%**	**0.1%**	**-3.2%**		

Source: Company data; Balhoff & Williams, LLC.

On an annual (year-over-year) basis, the Company's performance in terms of revenue growth is relatively consistent with industry peers, as reflected in Table 8. Again, the revenue trends are better than the access line trends, in part because of improved sales of bundled services to customers (higher per customer revenues) and because of improved broadband sales.

More refined insights regarding underlying revenue trends can be gained by a review of key revenue categories. Traditional voice telephony services, captured in the Local Services and Network Access & LD Services line items, have been contracting consistently over the period. Local Services revenues were $29.2 million in 2008, down significantly from $36.1 million in 2004, a total decline of $6.9 million and a CAGR of -5.2%. The rate of decline accelerated in Local Service revenues in 2008, when the segment sales fell by approximately $2.5 million, which was lower by 7.9% year-over-year. Network Access & LD Services revenues have fallen approximately $5.5 million over the five-year period, from $34.5 million in 2004 to around $29.0 million in 2008, which is a CAGR of -4.3%. Again, the apparent acceleration of the decline in Network Access & LD Services revenues in 2008 is noteworthy. In the most recent period, Network Access & LD revenues fell by approximately $2.1 million, lower by 6.9% year-over-year. While revenue losses in these categories are typical across the industry, the recent acceleration in core revenue (local, access, regulated component of long-distance) declines for North State is of some concern. In addition, the core telephony revenue declines generally track with the Company's access line loss trends, which will be addressed below.

An important question for the future is whether wireless and broadband growth might be at levels that allow North State to at least stabilize its organic revenue base either because of stronger growth or because of fewer losses in core telephony.

Offsetting the decline in more traditional wireline telephony revenues, North State has reported strong growth in its Sales & Other Services revenues. The revenue category includes both wireless and broadband revenues (as well as most long distance revenues), two growth areas for the telecom industry as a whole. Specifically, over the five-year period, Sales & Other Services revenues expanded at an average annual rate of 8.1%, increasing from $28.7 million in 2004 to $39.2 million in 2008, a $10.5 million increase. The rate of year-over-year growth has been slowing, and dropped significantly in 2008 to 3.0%. Notably, in 2008, growth in Sales & Other Services revenues did not offset the accelerating decline in local, access, and regulated LD revenues. An important question for the future is whether wireless and broadband growth might be at levels that allow North State to at least stabilize its organic revenue levels either because of stronger growth or because of fewer losses in core telephony.

Table 8: Annual ILEC revenue growth

	2005	2006	2007	2008
Alaska Comms.	-2.2%	-3.0%	6.4%	-0.9%
Consolidated*		-0.7%		
CenturyLink*	3.0%	-1.3%		-2.1%
D&E	3.4%	-6.4%	-5.3%	-1.2%
Embarq	-0.8%	2.5%	1.1%	-3.6%
Frontier*	-0.3%	0.4%		-2.2%
HickoryTech	-1.1%	-3.7%	0.4%	-2.1%
Iowa Telecom*	1.5%	1.1%		-1.8%
North State	***2.5%***	***-1.7%***	***0.1%***	***-3.2%***
NTELOS	3.9%	5.3%	4.3%	1.2%
New Ulm*		-3.9%	0.7%	
Shenandoah	5.9%	5.1%	0.2%	0.4%
SureWest*	2.2%	-7.3%	1.9%	
TDS	3.0%	-3.1%	-2.4%	-4.2%
Windstream*	-1.3%			
Warwick Valley	-1.2%	-7.7%	-4.7%	-4.4%
Average	***1.3%***	***-1.6%***	***0.2%***	***-2.0%***
Median	***2.2%***	***-1.5%***	***0.5%***	***-2.1%***

*Acquisitions of NPSI by CNSL 12/07; MadRvr by CTL 4/07; CTCO by FTR 3/07; Baker 8/06 and Bishop 7/08 by IWA 7/08; Hutchinson by NULM 1/08; various by OTT; Everest by SURW 2/08; VCG 7/06 and CTCI 8/07 by WIN.

Source: Company data; Balhoff & Williams, LLC.

Directory & Other revenues have also been a source of growth for North State over the last five years, increasing at approximately a 1% CAGR. The revenue category is relatively small, however, generating annual revenues of around $6.0 million in 2008, up from $5.8 million in 2004. Growth in this revenue category did accelerate in 2008, in contrast with other revenue categories and the directory industry generally. Although it is not noted in the North State reports, directory advertising services generally generate very high cash flow margins which typically are above even ILEC margins. Most industry observers are cautious about printed directory services as consumers seem to be migrating toward online services, which may mean that the growth in the print business may not be sustainable. At the same time, there is the potential for growth in online revenues, but margins are likely to be well lower as the barriers to competitive entry are significantly lower.

While North State's total revenues have slipped only marginally over the last five years, cash operating expenses grew over the period, particularly from 2004-2007.

While North State's total revenues have slipped only marginally over the last five years, cash operating expenses (excluding depreciation and amortization (D&A)) grew over the period, particularly from 2004-2007. Over the five-year period, cash operating expenses rose at an average annual rate of 2.5%, growing from $58.3 million in 2004 to $64.4 million in 2008. Of the $6 million increase, growth in Plant Operations expense accounted for $4.8 million and G&A accounted for another $819,000. It is encouraging to note, however, that the trend of rising cash operating expenses was reversed in 2008 when expenses fell by approximately $1.4 million, a 2.2% year-over-year decline. The reduction in expenses in 2008 appears to have been across-the-

board, with Plant Operations expense falling $469,000, Customer Operations expense declining $612,000 and G&A contracting by $390,000. If revenue contraction continues, it will become increasingly important that the Company continue to exercise the expense discipline reported in 2008. At the same time, it is notable that other local telephone companies—Verizon and Warwick Valley as discussed above—have reported difficulty managing a high fixed-cost business as expense controls often lag access line declines.

The challenge of managing a network business is apparent in North State's recent reports. Operating expense margins (operating expenses as a percentage of revenues) have risen consistently over the five-year period, from 56.0% in 2004 to 63.3% in 2008. Illustrating the pressures, cash operating expenses fell on an absolute dollar basis in 2008, but increased as a percentage of revenue. Specifically, cash expenses declined 2.2% year-over-year in 2008, but rose from 62.6% of revenues in 2007 to 63.3% in 2008.

Table 9: North State five-year historical expenses

($s in thousands)	Actual				Unaudited	5-year Change	
	2004	2005	2006	2007	2008	$	CAGR
Plant Operations	$ 34,832	$ 36,636	$ 38,096	$ 40,131	$ 39,662	$ 4,831	3.3%
Customer Operations	15,896	17,733	15,508	16,688	16,076	180	0.3%
Taxes (other than income taxes)	1,372	1,438	1,428	1,532	1,568	195	3.4%
G&A	6,240	6,979	7,563	7,449	7,059	819	3.1%
Total Cash Operating Expenses	**$ 58,340**	**$ 62,786**	**$ 62,594**	**$ 65,800**	**$ 64,365**	**6,024**	**2.5%**
EBITDA	***$ 45,800***	***$ 43,978***	***$ 42,332***	***$ 39,261***	***$ 37,351***	***$ (8,449)***	***-5.0%***
YOY Growth Rates							
Plant Operations		5.2%	4.0%	5.3%	-1.2%		
Customer Operations		11.6%	-12.5%	7.6%	-3.7%		
Taxes (other than income taxes)		4.8%	-0.7%	7.3%	2.3%		
G&A		11.8%	8.4%	-1.5%	-5.2%		
Total Cash Operating Expenses		**7.6%**	**-0.3%**	**5.1%**	**-2.2%**		
EBITDA		***-4.0%***	***-3.7%***	***-7.3%***	***-4.9%***		
Margins (% of Total Revenue)							
Total Cash Operating Expenses	56.0%	58.8%	59.7%	62.6%	63.3%		
EBITDA	*44.0%*	*41.2%*	*40.3%*	*37.4%*	*36.7%*		

Source: Company data; Balhoff & Williams, LLC.

North State experienced a consistently declining level of operating cash flows and meaningful compression in EBITDA margins over the most recent five-year period.

As a result of the revenue and cash operating expense trends from 2004 to 2008, North State experienced a consistently declining level of operating cash flows, or EBITDA, and meaningful compression in EBITDA margins (EBITDA as a percentage of

revenues) over the most recent five-year period. EBITDA declined from $45.8 million in 2004 to $37.4 million in 2008, an $8.4 million drop reflecting a -5.0% five-year CAGR. In addition, EBITDA margins contracted 730 basis points, falling from 44.0% in 2004 to 36.7% in 2008. As a result of the decline, the Company's operating margins are now low relative to other comparable companies in the industry, as apparent in Table 5 on page 15. The decline in EBITDA likely is attributable to at least two key factors: (i) increasing competition driving expenses to attract, retain and support customers (management reports substantially higher advertising and marketing expenses in recent years to defend market share), and (ii) a "negative mix shift" in terms of the business, as lower-profitability wireless and broadband revenues replace higher-margin traditional telephony revenues.

North State does have significant "below the line" sources of income, coupled with *de minimis* interest expense obligations, which bolsters the Company's bottom line. Specifically, over the five-year period, North State averaged around $1.2 million per year in Interest & Other Income, and $4.0 million per year in Equity in Unconsolidated Earnings (principally from the Company's minority ownership interest in Alltel Communications of North Carolina Limited Partnership). These non-operating sources of income can be somewhat volatile, but they consistently have produced meaningful income in recent years, particularly in 2008.

Table 10: Net debt to EBITDA

	2004	2005	2006	2007	2008
Consolidated	6.0	4.5	4.4	6.4	5.2
CenturyLink	2.3	2.0	2.2	2.2	2.5
D&E	3.5	3.1	3.1	2.7	2.6
Embarq			2.5	2.3	2.1
Frontier	4.5	3.9	3.1	3.6	3.8
HickoryTech	2.9	4.2	4.0	3.2	3.1
Iowa Telecom	3.5	3.6	3.7	3.5	3.8
North State	***-0.3***	***-0.3***	***-0.2***	***-0.2***	***-0.3***
New Ulm	2.6	1.7	-4.8	-1.6	3.7
Otelco	7.5	5.6	6.1	4.7	7.2
SureWest	2.7	2.1	2.0	1.6	3.4
TDS	4.0	2.4	2.2	1.6	2.9
Windstream			3.7	3.4	3.1
Warwick Valley	-0.8	-2.5	-2.2	0.3	-0.6
Average	***3.2***	***2.5***	***2.1***	***2.4***	***3.0***
Median	***3.2***	***2.7***	***2.8***	***2.5***	***3.1***

Source: Company data; Balhoff & Williams, LLC.

Net Income (before preferred stock dividends) has declined steadily since 2004, albeit at a slower average annual rate than EBITDA has contracted, highlighting the benefit of the "below-the-line" income items. Net Income fell $2.5 million from $18.1 million in 2004 to $15.6 million in 2008, generating a CAGR of -3.6%. More positively, however, due to non-operating income, North State's Net Income margins, ranging from 15.4% to 17.6% over the five-year period, are among the highest in the RLEC industry. The insight here is that the Company's core business operations remain under pressure, but the Company's net results are strengthened by non-operating items, including the partnership interest with Verizon Wireless (formerly Alltel).

Balance sheet

North State has among the strongest balance sheets in the mid-sized incumbent local exchange carrier industry.

North State has among the strongest balance sheets in the mid-sized incumbent local exchange carrier industry. The Company has no interest-bearing debt, which is not typical among the mid-sized RLECs, but is favorable in the current economic climate. North State has operating leases for cell tower sites and the obligations have been expanding over the last several years.

Operating lease obligations typically are capitalized and counted as debt from a pure credit analysis perspective. However, the *de minimis* lease amounts (undiscounted payments totaling around $4.8 million at yearend 2007) relative to the overall capitalization of Company (over $135 million in book equity at yearend 2008) make a capitalization exercise fundamentally unnecessary. Traditional credit metrics—coverage and leverage ratios—generate statistics that are not meaningful, as North State has negative net debt (no debt, less significant cash balances)—indicative of the strength of the balance sheet. Table 10 provides the comparable statistics, indicating negative figures for the companies with net cash in excess of debt.

The Company's Cash & Equivalents balance appears sufficient to fund foreseeable working capital needs. The line-item declined from $14.4 million in 2004 to $10.2 million at yearend 2008, up from $7.1 million in 2007. The Company has maintained significant balances of marketable securities on its balance sheet. Current and Long-term Investment Securities (tax-exempt municipal bonds, certificates of deposit, and debt and equity securities) totaled $16.6 million as of yearend 2008, down from $35.9 million at yearend 2005. In addition, North State held Investments in Unconsolidated Entities that were valued at $9.6 million at yearend 2008, principally the minority interest in the Alltel limited partnership. The partnership interest appears to be a particularly attractive asset for North State given the history of consistent cash distributions to the limited partners. Based on discussions with Company management, these cash distributions are mandatory to the extent North State might owe taxes as a result of its ownership interest and are discretionary for amounts above the tax obligations. However, in the past the distributions have been well in excess of the tax obligations and management expects that distributions above the mandatory level will continue for the future. In fact, as a result of the recent acquisition of Alltel by Verizon Wireless and the anticipated synergies, management believes that the performance of the partnership could improve, resulting in higher levels of distributions to North State.

Other indications of North State's balance sheet strength include Net Fixed Assets that have grown consistently over the period, from $116 million in 2004 to $138 million in 2008. The growth in plant reflects capital investment that has outpaced depreciation from 2004-2008, generally an anomaly in the wireline telephony business where capex to depreciation is typically 60%-80%. In addition, prior to 2008, North State had grown its book Shareholders' Equity from $154 million in 2004 to approximately $160 million by yearend 2007. This sort of organic growth in the book equity account, due principally to net income levels in excess of dividends paid, is uncommon among the publicly-traded mid-sized telephone companies which in recent years have suffered declines in book equity as dividends exceeded net income. However, in 2008, North State booked a meaningful $22.6 million reduction in Shareholders' Equity due to a reduction in the value of its pension assets arising from recent financial market turmoil.

Cash flows

Table 11 provides the five-year historical data and a best-estimate of free cash flow.

North State's free cash flow[1] generation from 2004 to 2008 has been relatively unpredictable due to declining operating cash flows and increased investment. Table 11 provides the five-year historical data and a best-estimate of free cash flow. As discussed above, operating cash flows have been declining, which has depressed free cash flow. In addition, the Company has made significant annual capital investments, as indicated in Table 12. North State's capex has risen from 16.0% of revenues in 2004 to a high of 24.5% of revenues in 2007, and then marginally lower to 23% in 2008. For 2006, 2007, and 2008, capex per average line per month has been $17.62, $20.58, and $20.18, respectively, which converts to approximate annual per line investment levels of $211.44, $246.96, and $242.16.[2] These data reflect some of the highest per line investment levels in the industry where average capex per line per year has been about $163 and the median has been approximately $142 for the same three-year period. Also, the levels of total capital investment by North State are high when measured as a percentage of revenues among comparable companies, as detailed in Table 12. Additionally, North State consistently has paid cash dividends to preferred and common shareholders. Over the five-year period, dividend payments averaged about $13 million

Table 11: North State free cash flow historical data and estimates

($s in thousands)	Actual				Unaudited
	2004	2005	2006	2007	2008
Free Cash Flow Estimates:					
EBIT	$ 25,364	$ 22,453	$ 26,485	$ 21,717	$ 18,283
(-) Cash Taxes	(7,883)	(13,297)	(11,134)	(11,409)	(4,998)
(+) D&A	20,436	21,525	15,847	17,544	19,068
(-) Cap Ex, net	(16,706)	(18,473)	(23,678)	(25,688)	(23,437)
(-) Dividends	(13,717)	(13,790)	(12,676)	(12,574)	(12,357)
(+) Distributions	3,293	5,414	4,728	3,826	6,316
Unlevered Free Cash Flow	10,788	3,831	(427)	(6,584)	2,875
(-) Cash Interest Expense	(54)	(194)	(135)	(348)	(183)
Free Cash Flow	**$ 10,733**	**$ 3,637**	**$ (562)**	**$ (6,932)**	**$ 2,692**

Source: Company data; Balhoff & Williams, LLC.

Table 12: Capex as a percentage of revenues

	2004	2005	2006	2007	2008
Alaska Comms.	12.6%	19.1%	16.8%	11.4%	10.4%
Consolidated	12.5%	10.8%	11.7%	11.2%	12.7%
CenturyLink	16.0%	16.7%	12.8%	12.3%	11.0%
D&E	15.9%	18.4%	17.1%	16.4%	15.4%
Embarq	17.0%	14.5%	15.8%	14.0%	12.1%
Frontier	13.6%	12.9%	13.3%	12.3%	12.9%
HickoryTech	21.0%	24.7%	20.8%	15.2%	15.0%
Iowa Telecom	15.3%	13.0%	12.0%	10.7%	11.4%
North State	***16.0%***	***17.3%***	***22.6%***	***24.5%***	***23.0%***
NTELOS	17.4%	22.4%	17.9%	20.2%	28.5%
New Ulm	21.8%	14.5%	12.7%	25.8%	11.8%
Otelco	8.8%	8.7%	9.8%	9.4%	12.0%
SureWest	33.2%	35.2%	29.0%	7.6%	8.0%
TDS	15.7%	14.3%	14.1%	14.9%	17.1%
Windstream	12.8%	13.8%	13.5%	12.1%	10.2%
Warwick Valley	17.7%	9.2%	18.3%	16.4%	15.6%
Average	***16.7%***	***16.6%***	***16.1%***	***14.7%***	***14.2%***
Median	***15.9%***	***14.5%***	***15.0%***	***13.2%***	***12.4%***

Source: Company data; Balhoff & Williams, LLC.

[1] Free cash flow is defined for these purposes as Operating Income (EBIT), plus D&A, less Cash Taxes, less Capital Expenditures, less Dividends, plus Distributions from Unconsolidated Entities, less Cash Interest Expense.

[2] These capital expenditure figures include North State's investments in its wireless network, since the Company does not provide segment level capital expenditure detail. As a result, the per-line data likely are artificially elevated at least to a degree.

per year and ranged from 12.0% to 13.2% of total revenues. The Company received cash distributions from its Alltel limited partnership interest that ranged from $3.3 million in 2004 to $6.3 million in 2008 and averaged $4.7 million per year. As a result of the various factors affecting free cash flow, North State generated significant positive cash flows in 2004 and 2005 (approximately $10.7 million and $3.6 million, respectively), then generated negative cash flows in 2006 (-$0.6 million) and 2007 (–$6.9 million), and returned to free cash flow positive in 2008 ($2.7 million). In the recent past, the Company has had sufficient liquidity in the form of cash and marketable investments to fund cash flow deficits. In the near future, given North State's FTTH build-out plans, capital expenditure levels are expected to rise to around 25% of revenues, placing further pressure on free cash flows at least through 2011. After 2011, management indicates that capital investment should fall to levels closer to industry medians in terms of a percentage of revenues. However, if operating cash flow metrics do not stabilize and dividends remain at historic levels (which is management's stated goal), North State could continue to face negative cash flows on a periodic basis that would require funding through investment sales or financing activities.

Operating statistics

If operating cash flow metrics do not stabilize and dividends remain at historic levels, North State could continue to face negative cash flows on a periodic basis that would require funding through investment sales or financing activities.

North State, like virtually every other wireline telephone company, has been experiencing ongoing declines in core switched access lines. The Company's service territory including High Point, North Carolina, and surrounding areas, is relatively denser than many of the rural carriers, with approximately 143 lines per square mile. As a result of serving a more urban, lower-cost-to-serve market area, North State also faces greater competition than many of its more rural peers. Time Warner Cable (TWC) is the primary residential wireline competitor, with approximately 100% coverage of the Company's service territory and upgraded broadband-capable plant serving all of the in-market customers. Through mid-2009, TWC has captured around 18%-20% voice market share, according to North State's management team. In terms of the business market, North State also faces some competition from CLECs, including twTelecom and Paetec. In addition, given the more populous market area, the Company faces robust competition from both Verizon Wireless and AT&T Mobility for voice and mobile data customers. As a result, the number of the Company's switched access lines has been shrinking at a rate of around 7% per year for the last three years (7.2% in 2008), with a 2004-2008 CAGR of -6.5%. The level of access line losses is relatively typical of the industry, as detailed earlier in Table 1 on page 9 (although North State's line loss rate has exceeded the industry average and median in all years shown, likely due to its more urban service area). The critical question for North State is when or if these line loss rates will moderate, whether as a result of its FTTH strategy or due to other factors. At yearend 2008, the Company had approximately 93,185 switched access lines, down 23.6% from about 121,980 at yearend 2004, a cumulative loss of 28,795 lines over the five-year period. In addition, management has suggested that access line losses will accelerate to a year-over-year loss rate of 7%-9% in 2009, compared to the 7.2% decline in 2008. Table 13 below details the five-year history.

In terms of access line composition, management appears to have made the decision in 2007 to stop reporting independently the Company's number of business and residential switched access lines. As a result, 2006 is the last period for which it is possible to

Table 13: North State historical customer data

	Actual				Unaudited	5-year Change	
	2004	2005	2006	2007	2008	Absolute	CAGR
Customer Data							
Internet / Broadband Subscribers	14,689	17,702	20,480	24,022	24,113	9,424	13.2%
Wireless Subscribers	15,994	19,028	21,445	23,409	24,107	8,113	10.8%
Switched Access Lines	121,980	116,288	107,623	100,379	93,185	(28,795)	-6.5%
Total Connections	152,663	153,018	149,548	147,810	141,405	(11,258)	-1.9%
YOY Absolute Change							
Internet / Broadband Subscribers		3,013	2,778	3,542	91		
Wireless Subscribers		3,034	2,417	1,964	698		
Switched Access Lines		(5,692)	(8,665)	(7,244)	(7,194)		
Total Connections		355	(3,470)	(1,738)	(6,405)		
YOY Growth Rates							
Internet / Broadband Subscribers		20.5%	15.7%	17.3%	0.4%		
Wireless Subscribers		19.0%	12.7%	9.2%	3.0%		
Switched Access Lines		-4.7%	-7.5%	-6.7%	-7.2%		
Total Connections		0.2%	-2.3%	-1.2%	-4.3%		

Source: Company data; Balhoff & Williams, LLC.

Because residential lines are a larger percentage of total lines, the trend suggests that further accelerating total switched access line losses may occur.

calculate specific line composition data and trends. In 2006, North State reported that business lines represented approximately 38% of total switched access lines, while residential lines were around 62%. Management indicates that this 60% residential and 40% business line composition is consistent with what the Company has experienced since 2006 and that it expects this basic composition breakdown to continue for the foreseeable future. However, given the limited data set, it is not possible to evaluate precisely the growth trends in business and residential lines. In 2006, residential switched access lines declined by 9.7%, accelerating from a 4.3% year-over-year loss in 2005. Because residential lines are a larger percentage of total lines, the trend suggests that further accelerating total switched access line losses may occur. Also in 2006, business lines declined at a 3.5% year-over-year rate, a deceleration from the -5.3% annual line loss in 2005. Management states that, in general, residential line losses will be a couple of percentage points higher than business line loss rates. If the 2006 trends continued, at least directionally, in 2007 and 2008, North State's business mix would be trending more toward business customers and away from residential. These dynamics have important competitive and operational implications for the Company's future.

Offsetting the declines in switched access lines, North State has been growing both its Internet / broadband and wireless subscriber counts, although the rate has slowed as indicated earlier in Table 3 on page 11. Internet / broadband customers have increased from 14,689 at yearend 2004 to 24,113 in 2008, an increase of 9,424 customers, and a CAGR of 13.2%. However, in a trend that bears watching, year-over-year growth in Internet / broadband subscribers dropped precipitously in 2008 to 0.4% compared to an annual growth rate of 17.3% in 2007 (although management indicates that broadband subscriber growth rates

have improved in the first half of 2009). Wireless subscribers have increased at almost an 11.0% average annual rate over the five-year period, growing from 15,994 in 2004 to 24,107 in 2008, a cumulative increase of 8,113 customers. As with Internet / broadband subscriber growth, the rate of growth in wireless subscribers dropped significantly to 3.0% in 2008. The annual growth rate in wireless subscribers has been declining consistently, so the 2008 rate may reflect the continuation of an ongoing trend, but management states that wireless subscriber growth rates, like broadband additions, have improved in the first half of 2009. At the same time, North State's wireless relationships may shield the Company from some of the negative effects suffered by smaller carriers.

The number of total connections[3] has been declining in recent years, despite the Company's growth in Internet / broadband subscribers and wireless customers. In 2006, 2007 and 2008, total connections fell at annual rates of -2.3%, -1.2% and -4.3%, respectively, as switched access line losses outpaced customer additions in other segments. The acceleration of total connection losses in 2008 also reflects the fairly dramatic slowing of Internet / broadband and wireless customer growth that occurred in 2008, as discussed above. The ability or inability to offset access line losses with broadband and wireless growth will be important for North State and its investors going forward.

Financial projections

Methodology

In the absence of Company-provided projections or detailed future guidance, and in order to provide some insight into how North State might be expected to perform in coming years, B&W prepared a summary five-year financial projection model for the Company. While Company-specific projections are developed most effectively by management, there is value in an independent assessment of expected results based on historical company performance and anticipated industry trends. In addition, the forward-looking financial data provide a basis for understanding key issues related to value and value-creation going forward. Specifically, North State's financial and operating results for 2009-2013 were estimated using the following methodologies:

While Company-specific projections are developed most effectively with input from management, there is value in an independent assessment of expected results based on historical company performance and anticipated industry trends.

- **Revenues and customers:** Projections for core telephony revenue categories—Local Services, Network Access & Long Distance Services, and Uncollectibles—are based on category-specific revenue per line per month data and projected average annual total switched access lines. As noted above, to our knowledge, North State no longer independently reports business and residential access lines, so total switched access lines must be used in per line calculations for projection purposes. Total switched access lines are projected based on year-over-year growth rate assumptions. Average annual switched access lines were used to calculate historical per line per month revenue data and we then project forward the per-line per month figures for the relevant revenue categories. Sales & Other Services revenues, which principally reflect the Company's broadband and wireless operations, are projected based on Internet / Broadband and Wireless subscriber projections, coupled with annual category revenues per Internet / Broadband / Wireless subscriber. Internet / Broadband subscribers and Wireless subscribers are projected individually based on

[3] Total connections defined as Internet / broadband subscribers, plus wireless subscribers, plus switched access lines.

year-over-year growth rate assumptions, and then are combined, since the Sales & Other Services category contains revenues from both business lines. Average annual combined Internet / Broadband / Wireless subscribers are used to calculate historical per subscriber per year revenue data and we then project the per-subscriber per year figures to estimate Sales & Other Services revenues. Ideally, discrete revenue projections could be made for the strategically important Internet / Broadband and Wireless operations. However, there was not sufficient historical segment detail to utilize such an approach. So, the Sales & Other Services revenue projection was based on the underlying combined Internet / Broadband / Wireless subscriber and revenue per subscriber trends. Finally, Directory & Other revenues are projected using year-over-year growth rate assumptions based on historical growth rate trends, as these revenues typically are not based on access line or subscriber trends; it is notable that these revenues might moderate as customers use more online services, but no such downturn was estimated in this model.

- **Operating expenses:** Cash operating expenses are projected using a percentage of total revenues (margin) approach. Historical margins are calculated for each operating expense category (Plant Operations, Customer Operations, Taxes—other than income taxes, and G&A), and future margin assumptions are inserted into the model based on historical margin levels and trends. Future non-cash Depreciation & Amortization expense is estimated using the same margin-based methodology.

- **Non-operating income and expense items:** The most meaningful "below the line" items are Interest & Other Income and Equity in Unconsolidated Earnings. Interest & Other Income is assumed to decline from the $831,000 reported in 2008, as the Company anticipates that cash and short-term investment balances will decline as it funds the FTTH build. Equity in Unconsolidated Earnings is assumed to be slightly less than cash Distributions from Unconsolidated Entities, and is projected to decline slightly from approximately $4.3 million in 2009 to $3.8 million in 2011 and beyond. The decline reflects B&W's expectation that overall wireless results will slow in coming years as subscriber growth diminishes and the market matures. Distributions from Unconsolidated Entities are estimated to decline from $5.0 million in 2009 to approximately $4.5 million in 2011 and beyond. The five-year historical average for Equity in Unconsolidated Earnings is $4.0 million, while the historical average for Distributions from Unconsolidated Entities is $4.7 million. We note that management believes the cash partnership distributions will be at least at historical levels and may trend upward in coming years, as North State might receive some benefit from improved partnership financial results resulting from operating synergies due to the Verizon Wireless-Alltel combination.

- **Capital expenditures:** Capital expenditures are forecasted as a percentage of total revenues. Historical metrics were calculated, indicating that capital expenditures ranged from 16.0% to 24.5% of total revenues from 2004 to 2008. The projections assume that current elevated capital investment levels will continue through 2011 in order to fund the FTTH build-out, meaning the Company's investment levels will remain well above current industry averages in the near-term. After 2011, we project that capex levels will fall closer to industry average levels. It is noteworthy that many of the publicly-traded rural carriers manage their cash obligations by reducing capital expenditures, which we expect will be the pattern at North State following the fiber investments.

- **Dividends:** Preferred and common stock dividends are projected as a percentage of total revenues, using historical dividend levels as a guideline for future assumptions. In recent years (2006-2008), dividends have been approximately 12% of total revenues.

- **Balance sheet items:** Selected balance sheet items are projected to provide general indicia of any major expected changes in the credit profile of North State. Cash & Equivalents are projected based on the prior year ending balance, plus the Levered Free Cash Flow generated in the current year (as calculated in the model). PP&E, net, (i.e., fixed assets after accumulated depreciation) is projected based on the prior year ending balance, plus current year Capital Expenditures, less current year Depreciation & Amortization. Shareholders' Equity is projected based on the prior year ending balance, plus current year Net Income, less current year Preferred & Common Stock Dividends.

Summary financial model & commentary

There is a real risk (not reflected in the summary projections) that federal and state reforms of intercarrier compensation and universal service support will cause even greater reductions in these important revenue streams and a still larger reduction in operating cash flows.

The summary projections generally reflect the trends influencing the entire local exchange carrier industry, coupled with certain assumptions that reflect North State's FTTH build strategy. The FTTH strategy, launched in July of 2009, involves extending fiber access plant to approximately 75% of the homes served by North State over the next three years (with the project completed in 2011). The Company expects to pass more than 10,000 homes by the end of 2009, and then will pass an incremental 25,000 homes per year in 2010 and 2011. In conjunction with the FTTH build-out, North State is providing a full IPTV video service offering, as well as the capability to provide extremely high-speed data product. While management believes that TWC will respond competitively, the Company's local focus, customer service culture, and ability to offer essentially unlimited numbers of High-Definition channels (which TWC cannot at the present), should position North State well for the future (post-2011). Prior to the completion of the FTTH build, projected revenues are contracting, as access line losses continue, albeit at a declining rate of loss over the projection period as modeled by B&W. Core telephony revenues such as local service, access, long distance, and value added services will tend to mirror these line losses. However, it is assumed that the core revenue loss rates will be slightly higher reflecting ongoing competitive pressures. In addition, there is a real risk (not reflected in the summary projections) that federal and state reforms of intercarrier compensation (access revenues) and universal service support will cause even greater reductions in these important revenue streams and a still larger reduction in operating cash flows. Growth rates in broadband and wireless subscribers are slowing due to competition, increasing levels of penetration, and general economic weakness. As a result, while broadband and wireless revenues may continue to expand—as reflected in Sales & Other Services—the rate of growth has slowed materially in recent years and is likely to remain in the mid-single digits in the near future. After 2011, management is suggesting that North State will return to revenue growth based on the value proposition of its fiber-based plant, as the Company takes video and broadband market share, and line losses are expected to slow (with disconnects offset by some "win-backs" as customers are drawn to the compelling video and broadband offerings). We have modeled the 2012-2013 period to reflect essentially flat revenues, as access line loss rates are lower, broadband and wireless subscribers continue to grow, and per subscriber revenues for broadband and wireless expand due to incremental fiber-based service offerings. Finally, while we have projected flat Directory & Other revenues based on North State's recent historical experience, it is again notable that directory advertising and the directory industry have been declining in recent years and these industry-wide trends could make even modest growth a challenge in the future.

The summary projection model generally reflects financial trends that are typical in the industry. However, there are specific factors outlined below that likely will be critical to North State's financial performance in coming years and, therefore, warrant more detailed discussion.

In terms of operating expenses, the reality is that the communications industry traditionally has been a largely fixed-cost, high capital intensity business. Thus, even in the face of flat-to-declining revenues, carriers often find it difficult to reduce meaningfully cash operating expenses. Again, there is also a "negative mix shift" in terms of operating profitability, as higher margin traditional voice services are replaced by lower margin broadband services. As the broadband-based business becomes a larger and larger segment of the overall enterprise, cash operating expenses as a percentage of revenues are rising for the carriers.

The industry will continue to struggle with slowing revenues and lower-margin services. The result of these forces likely will be increasingly downward pressure on EBITDA margins and operating cash flow, but we have projected some stabilization in revenues and EBITDA in the later years. In addition, due to an assumed material decline in capital expenditures and ongoing cash distributions from North State's wireless partnership interest, the model projects the Company to generate positive free cash flows for 2012 and 2013, after significant levels of negative free cash flows for 2009-2011. It should be noted that there is potential that this outlook is optimistic.

The summary projection model generally reflects financial trends that are typical in the industry. However, there are specific factors outlined below that likely will be critical to North State's financial performance in coming years and, therefore, warrant more detailed discussion.

- **Sales & Other Services revenue growth:** As noted earlier, North State reported significant declines in Local Services and Network Access & LD Services revenues over the last five years. Local Services revenues declined 19% to $29.2 million in 2008 from $36.1 million in 2004, while Network Access & LD Services revenues declined 16% to $29.0 million in 2008 from $34.5 million in 2004. As a result, the combined revenues from these traditional telephony sources fell by around $12.4 million in 2008 versus 2004 levels, but the decline was largely offset by $10.5 million in broadband and wireless revenue growth over the same period. Notably, however, the core telephony revenues have contracted at rates that generally are accelerating over the period, while the rate of growth in Sales & Other Services revenues is decelerating from 12.5% year-over-year growth in 2005 to only 3.0% year-over-year growth in 2008. If the trends continue as expected and as reflected in the summary projections through 2011, North State will suffer a material loss of revenues (approximately $7.3 million) in the next three years, as broadband and wireless revenue growth (around $4.8 million) will be a less effective offset against core telephony revenue declines (approximately $12.1 million). If this is the case, there will be meaningful contraction in operating cash flows (EBITDA) in the coming years. However, management believes that beyond 2011, based on North State's FTTH service offerings, total revenues could begin to stabilize and potentially even drive some revenue growth for the Company. We have modeled moderating revenue declines in 2012 and 2013, along with relatively stable EBITDA, but believe that material total revenue growth and EBITDA expansion remain somewhat speculative at this time.

Table 14: North State model: historical data and B&W five-year projections

($s in thousands)	Actual				Unaudited	Projected				
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Income Statement:										
Local Services	$ 36,123	$ 34,678	$ 33,248	$ 31,712	$ 29,192	$ 26,837	$ 24,720	$ 23,016	$ 21,559	$ 20,302
Network Access & LD Services	34,524	35,163	32,283	31,147	29,003	26,837	24,769	23,108	21,734	20,550
Sales & Other Services	28,712	32,295	34,903	38,047	39,203	40,133	41,693	43,991	46,154	48,299
Directory & Other	5,828	5,626	5,715	5,803	6,034	6,094	6,155	6,155	6,155	6,155
Uncollectibles	(1,046)	(998)	(1,223)	(1,649)	(1,716)	(1,825)	(1,837)	(1,856)	(1,837)	(1,823)
Revenue	**104,141**	**106,764**	**104,926**	**105,061**	**101,716**	**98,078**	**95,501**	**94,414**	**93,766**	**93,483**
Operating Expenses	58,340	62,786	62,594	65,800	64,365	63,260	62,410	61,747	61,463	61,185
EBITDA	**45,800**	**43,978**	**42,332**	**39,261**	**37,351**	**34,818**	**33,091**	**32,667**	**32,302**	**32,298**
Depreciation & Amortization	20,436	21,525	15,847	17,544	19,068	18,635	18,384	18,411	18,519	18,697
Operating Income (EBIT)	25,364	22,453	26,485	21,717	18,283	16,183	14,707	14,257	13,784	13,602
Interest & Other Income	781	1,399	1,699	1,461	831	700	500	290	335	625
Equity in Unconsolidated Earnings	3,170	3,612	3,437	3,577	6,321	4,250	4,000	3,750	3,750	3,750
Gain (Loss) on Investment Sales	(18)	435	(223)	457	114	100	100	100	100	100
Interest Expense	(78)	(103)	(231)	(210)	(30)	(30)	(30)	(30)	(30)	(30)
Earnings Before Taxes	29,218	27,797	31,166	27,003	25,519	21,203	19,278	18,367	17,939	18,047
Taxes	11,111	10,487	12,704	10,428	9,888	8,206	7,460	7,108	6,942	6,984
Net Income	18,107	17,310	18,463	16,575	15,630	12,998	11,817	11,259	10,997	11,063
Preferred Stock Dividends	104	103	102	101	101	100	99	98	97	96
Net Income Available to Common	$ 18,004	$ 17,207	$ 18,361	$ 16,473	$ 15,529	$ 12,898	$ 11,718	$ 11,161	$ 10,900	$ 10,967
Free Cash Flow Estimates:										
EBIT	25,364	22,453	26,485	21,717	18,283	16,183	14,707	14,257	13,784	13,602
(-) Cash Taxes	(7,883)	(13,297)	(11,134)	(11,409)	(4,998)	(8,206)	(7,460)	(7,108)	(6,942)	(6,984)
(+) D&A	20,436	21,525	15,847	17,544	19,068	18,635	18,384	18,411	18,519	18,697
(-) Cap Ex, net	(16,706)	(18,473)	(23,678)	(25,688)	(23,437)	(24,519)	(23,875)	(23,604)	(11,252)	(11,218)
(-) Preferred & Common Stock Dividends	(13,717)	(13,790)	(12,676)	(12,574)	(12,357)	(11,769)	(11,460)	(11,330)	(11,252)	(11,218)
(+) Distributions from Unconsolidated Entities	3,293	5,414	4,728	3,826	6,316	5,000	4,750	4,500	4,500	4,500
Unlevered Free Cash Flow (FCF)	$ 10,788	$ 3,831	$ (427)	$ (6,584)	$ 2,875	$ (4,677)	$ (4,955)	$ (4,874)	$ 7,356	$ 7,378
(-) Cash Interest Expense	(54)	(194)	(135)	(348)	(183)	(183)	(183)	(183)	(183)	(183)
Levered Free Cash Flow	$ 10,733	$ 3,637	$ (562)	$ (6,932)	$ 2,692	$ (4,860)	$ (5,138)	$ (5,057)	$ 7,173	$ 7,195
Operating Metrics - Margin Analysis:										
Plant Ops / Sales	33.4%	34.3%	36.3%	38.2%	39.0%	40.0%	40.8%	41.3%	41.8%	42.0%
Cust Ops / Sales	15.3%	16.6%	14.8%	15.9%	15.8%	16.0%	16.0%	15.8%	15.5%	15.3%
Taxes (other than income) / Sales	1.3%	1.3%	1.4%	1.5%	1.5%	1.5%	1.5%	1.4%	1.4%	1.4%
SG&A / Sales	6.0%	6.5%	7.2%	7.1%	6.9%	7.0%	7.1%	7.0%	6.9%	6.8%
Operating Expenses / Sales	56.0%	58.8%	59.7%	62.6%	63.3%	64.5%	65.4%	65.4%	65.6%	65.5%
EBITDA Margin	44.0%	41.2%	40.3%	37.4%	36.7%	35.5%	34.7%	34.6%	34.5%	34.6%
Operating Income Margin	24.4%	21.0%	25.2%	20.7%	18.0%	16.5%	15.4%	15.1%	14.7%	14.6%
Net Income Margin	17.4%	16.2%	17.6%	15.8%	15.4%	13.3%	12.4%	11.9%	11.7%	11.8%
Capital Expenditures / Sales	16.0%	17.3%	22.6%	24.5%	23.0%	25.0%	25.0%	25.0%	12.0%	12.0%
Dividends / Sales	13.2%	12.9%	12.1%	12.0%	12.1%	12.0%	12.0%	12.0%	12.0%	12.0%
Growth Rates:										
Local Services		-4.0%	-4.1%	-4.6%	-7.9%	-8.1%	-7.9%	-6.9%	-6.3%	-5.8%
Network Access & LD Services		1.9%	-8.2%	-3.5%	-6.9%	-7.5%	-7.7%	-6.7%	-5.9%	-5.4%
Sales & Other Services		12.5%	8.1%	9.0%	3.0%	2.4%	3.9%	5.5%	4.9%	4.6%
Directory & Other		-3.5%	1.6%	1.5%	4.0%	1.0%	1.0%	0.0%	0.0%	0.0%
Total Revenue		2.5%	-1.7%	0.1%	-3.2%	-3.6%	-2.6%	-1.1%	-0.7%	-0.3%
EBITDA		-4.0%	-3.7%	-7.3%	-4.9%	-6.8%	-5.0%	-1.3%	-1.1%	0.0%
Operating Income (EBIT)		-11.5%	18.0%	-18.0%	-15.8%	-11.5%	-9.1%	-3.1%	-3.3%	-1.3%
Net Income		-4.4%	6.7%	-10.2%	-5.7%	-16.8%	-9.1%	-4.7%	-2.3%	0.6%
Capital Expenditures		10.6%	28.2%	8.5%	-8.8%	4.6%	-2.6%	-1.1%	-52.3%	-0.3%
Dividends		0.5%	-8.1%	-0.8%	-1.7%	-4.8%	-2.6%	-1.1%	-0.7%	-0.3%
Selected Balance Sheet Items										
Cash & Equivalents	$ 14,433	$ 11,474	$ 9,807	$ 7,103	$ 10,218	$ 5,358	$ 220	$ (4,837)	$ 2,336	$ 9,531
Current Investment Securities	20,038	27,080	21,847	15,225	9,408	9,408	9,408	9,408	9,408	9,408
Total Cash & Current Investments	34,471	38,553	31,653	22,328	19,626	14,766	9,628	4,571	11,744	18,939
PP&E, net	116,360	114,729	125,091	133,116	138,187	144,072	149,563	154,756	147,489	140,011
Long-term Investment Securities	12,192	8,773	9,976	12,818	7,226	7,226	7,226	7,226	7,226	7,226
Investments In Unconsolidated Entities	13,421	11,593	9,783	9,584	9,589	9,589	9,589	9,589	9,589	9,589
Total Long-term Investments	25,613	20,366	19,759	22,401	16,815	16,815	16,815	16,815	16,815	16,815
Total Cash & Investments (Current & LT)	60,084	58,919	51,412	44,729	36,441	31,581	26,443	21,386	28,559	35,754
Investment Securities	32,230	35,853	31,823	28,043	16,634	16,634	16,634	16,634	16,634	16,634
Shareholders' Equity	153,965	153,022	154,822	159,804	137,245	138,373	138,631	138,462	138,110	137,859

Source: Company data; B&W estimates

- **Cash operating expense & EBITDA margin trends**: A major factor driving North State's financial performance in the coming years is the Company's ability to reduce cash operating costs. Cost control and expense reduction has been and is a key for the industry, given deteriorating fundamentals. It is difficult projecting North State's ability to reduce expenses, but over the 2004-2008 historical period, cash operating expenses grew from $58.3 million in 2004 to $64.4 million in 2008, a 10% ($6.0 million) increase despite flat-to-down total revenues. The growth in operating costs was driven primarily by increases in Plant Operations expenses, with other expense categories rising more modestly. As detailed earlier, rising expenses coupled with falling revenues drove total cash operating expenses as a percentage of revenues from 56.0% in 2004 to 63.3% in 2008. North State's EBITDA margins compressed significantly from 44.0% in 2004 to 36.7% in 2008. The projection model assumes that North State will moderate its rate of growth in total cash operating expenses as a percentage of revenues, and conversely the rate of decline in EBITDA margins. However, the projections still assume that there will be a $5.1 million reduction in EBITDA by 2013, based on total cash operating expenses that shrink by $3.2 million over the projection period as compared to the $6.0 million increase in these costs that occurred from 2004 to 2008. North State will need to be extremely focused on the cost side of the business to manage operating cash flows through operating cost discipline if the projected results are to be achieved.

- **Capital expenditures:** North State's free cash flow generation in coming years will be driven to a large extent by the level of the Company's capital expenditures. North State has invested heavily in upgrading its core fiber distribution plant, most notably since 2006. Over the 2006-2008 period, capital expenditures averaged over $24 million per year, with capex as a percentage of revenue ranging from 22.6% to 24.5%, well higher than the industry average. Based on the FTTH build-out plans, the projection model assumes that capital expenditure levels will be approximately 25% of revenues for 2009-2011, and then will decline to approximately 12% of revenues for 2012 and 2013, which is closer to current comparable company average and median ratios.

- **Dividend policy:** The model assumes that total dividends will remain at 12% of revenues over the five-year projection period, consistent with North State's recent practice. Still, the model suggests that there will be meaningful negative free cash flows after dividends for 2009-2011, but dividend payments remain one of the levers by which North State can manage its cash.

- **Distributions from unconsolidated entities:** The projection model suggests that cash Distributions from Unconsolidated Entities are an important source of cash flow for North State. These distributions arise from North State's 18% ownership interest in the Alltel (now Verizon Wireless) wireless partnership. Any material reduction in the distributions, which are to a large degree discretionary at this time, likely would require an alteration in North State's capital expenditure plans, its dividend policies, or its balance sheet.

Post-2013 growth based on North State's FTTH commitment

North State is making significant capital commitments to its fiber-to-the-home initiative. While specific fiber investment data are not available, management reported to B&W that it believes that the Company will be in a strong competitive position by 2011 to 2013. The data speeds and video services are expected to be superior to those offered by the competitors, although it is difficult

to predict how competitors, including TWC, in particular, will respond in terms of capital investment, pricing or other competitive positioning by that time.

Assuming that there are no significant changes in operating cash flows from other segments of the business, this model suggests that ILEC declines offset by broadband gains result in Total EBITDA that shrink by $1.54 million over the 2014 to 2018 period.

Because management believes that the "window" for revenue growth opens more widely after 2013, B&W has prepared a summary analysis of operating cash flows for the five-year period from 2014 to 2018. The analysis is very summary and speculative because there are numerous variables that might affect the business and the competitive landscape that far in the future. The analysis is focused on the contraction in the traditional voice-based ILEC business, offset by the expected broadband (including video) growth, as described by management. In the B&W 2014-2018 analysis, it is assumed that the wireless market will be nearly mature with very modest growth offset by probable pricing pressures typical in a mature industry, and the directory business would be contracting and contributing levels of cash flows that are lower than those at the present. Thus, the primary movers of cash flows are assumed to be the ILEC business which is shrinking, while the broadband business is expanding.

The 2014-2018 model relies on certain simplifying assumptions, including flat EBITDA margins (which are set at levels consistent with industry expectations), modest improvement in access line losses, and growth for broadband services—video and data—reflecting the discussion with North State's management. B&W also assumed that fiber-related EBITDA margins would be reflective of blended video and broadband margins. The blended margins are estimated to be closer to 30%, but could actually be lower because smaller telephone companies report difficulty generating significantly positive margins for video services.

Table 15: North State ILEC and broadband projected EBITDA, 2014 to 2018

($s in 000s, unless indicated)	2014	2015	2016	2017	2018	Estimated Chg 2014-2018
ILEC						
ILEC access lines	64,086	61,170	58,509	56,081	53,866	(10,220)
Access line growth	-4.8%	-4.6%	-4.4%	-4.2%	-4.0%	
Average access lines	65,684	62,628	59,840	57,295	54,974	(10,711)
EBITDA margin	40.0%	40.0%	40.0%	40.0%	40.0%	
Monthly ARPU ($)	$ 49.30	$ 49.30	$ 49.30	$ 49.30	$ 49.30	
Revenues	$ 38,859	$ 37,051	$ 35,401	$ 33,896	$ 32,522	$ (6,336)
EBITDA	$ 15,544	$ 14,820	$ 14,161	$ 13,558	$ 13,009	$ (2,535)
Broadband revenues						
Subscribers (video plus data)	29,494	30,673	31,900	33,176	34,503	5,010
Growth in subscribers	4.0%	4.0%	4.0%	4.0%	4.0%	
Average subscribers	28,926	30,084	31,287	32,538	33,840	4,913
EBITDA margin	30%	30.0%	30.0%	30.0%	30.0%	
Monthly ARPU ($)	$ 60.00	$ 60.00	$ 60.00	$ 60.00	$ 60.00	
Revenues	$ 20,827	$ 21,660	$ 22,527	$ 23,428	$ 24,365	$ 3,538
EBITDA	$ 6,248	$ 6,498	$ 6,758	$ 7,028	$ 7,309	$ 1,061
Total EBITDA (ILEC + Broadband)	**$ 21,792**	**$ 21,318**	**$ 20,918**	**$ 20,587**	**$ 20,318**	**$ (1,473)**

Source: Balhoff & Williams, LLC estimates.

Table 15 reflects the results of the summary model, depicting the number of access lines that decline by 10,220 over the five-year period, depressing ILEC revenue by $6.3 million and ILEC EBITDA by $2.5 million, based on the assumptions that margins remain stable and access line erosion improves by 20 basis points each year. Offsetting the ILEC decline is an increase of 5,000 in video and data customers, with subscriber growth at a 4.0% annual rate. The model uses blended EBITDA margins of 30.0%. Again, assuming that there are no significant changes in operating cash flows from other segments of the business, this model suggests that ILEC declines offset by broadband gains result in Total EBITDA that shrink by $1.5 million over the 2014 to 2018 period.

What the model does not illustrate is that the consolidated business has further capital investment requirements and that dividend payments will be ongoing, possibly funded in part by below-the-line items such as the Company's participation in the wireless partnership with Verizon. Typically, the connection of a fiber broadband customer also requires a one-time truck-roll and installation of an optical network device for which the expense is $700 to $1,000 today. A more complete financial analysis, if one were able to predict the other elements five to ten years from now, would then calculate the initial investment in network and the annual cash flows to determine the return on investment (which investment would include the significant expenditures

that are projected to occur from 2009-2011). The analysis in Table 15 suggests that the return on investment could be negative unless the performance is better than the scenario outlined below.

To evaluate alternative financial results based on the analysis in Table 15, B&W performed a sensitivity analysis which is summarized in Table 16. The B&W sensitivity analysis tests other annual growth scenarios for broadband and other fiber-related EBITDA margins to calculate the net change in EBITDA from 2014 to 2018. Thus, the columns and rows in Table 16 generate what would be the output in the final column and row (bottom right) of Table 15. Again, there are simplifying assumptions regarding flat EBITDA margins and annual broadband growth in the table. However, the analysis highlights that the loss of ILEC lines, even if moderating from the current level of switched access line losses which are approximately 7%-9% (or from the level of 5.0% projected in 2013) drains significant operating cash flow from the enterprise and the growth in broadband services apparently would not offset those EBITDA declines unless annual broadband growth is at least 8% annually over the period and the blended EBITDA margin for video and Internet is approximately 35% over the five-year period (or 40% EBITDA margins and 7% annual growth). The box that is highlighted in the center of the table is the outcome that B&W believes is realistic-to-optimistic, that is, margins would be approximately 25% to 35% and annual growth would be about 3%-5% in the period in question.

Table 16: Sensitivity Analysis: ILEC/FTTH EBITDA Change from 2014 to 2018

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Annual growth in BB Subs	FTTH Services EBITDA margin				
	20%	25%	30%	35%	40%
1.0%	(2,368)	(2,326)	(2,285)	(2,243)	(2,201)
2.0%	(2,195)	(2,110)	(2,025)	(1,940)	(1,855)
3.0%	(2,014)	(1,884)	(1,754)	(1,624)	(1,494)
4.0%	(1,827)	(1,650)	(1,473)	(1,296)	(1,119)
5.0%	(1,632)	(1,407)	(1,181)	(956)	(730)
6.0%	(1,430)	(1,154)	(878)	(602)	(326)
7.0%	(1,221)	(893)	(564)	(236)	93
8.0%	(1,004)	(621)	(238)	145	528
9.0%	(778)	(339)	100	539	978
10.0%	(545)	(47)	450	948	1,446

Source: Balhoff & Williams, LLC estimates.

Again, it is noteworthy that even if the net change in EBITDA is positive, the case is not necessarily financially sound, as investors will seek a favorable return on invested capital which appears unlikely based on the analysis.

It is likely that North State's transition risk to broadband remains meaningful from a financial point of view.

Significantly, many variables affect this analysis, including pricing, costs for the services and investment. North State apparently has made the decision that it is better to be aggressive in transitioning the business, and the management team may be correct in its assessment. The business case is challenging to project over the next ten years. However, the risks are real as the business is changing from a rapidly declining ILEC model which is characterized by relatively high profitability to a broadband-based business which is currently growing more slowly than it has in the recent past and is characterized by a higher level of competition and relatively lower profitability. Notably, the video business, upon which much of this model is premised, has currently negative or low single-digit EBITDA margins at least at most of the smaller carriers. North State may be different from other carriers, but it is likely that the transition risk to broadband remains meaningful from a financial point of view.

The subscriber trends from Verizon and AT&T further support the North State 2014-2018 analysis that has been projected in summary fashion above.

To complete the analysis in this section, it is helpful to consider what other carriers are reporting regarding the ongoing transition of their businesses to a fiber-based network set of services. As noted earlier and detailed in Table 17, Verizon and AT&T have made significant

Table 17: Verizon and AT&T wireline commitments

	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09
Verizon FiOS						
Homes passed (rounded in 000s)	10,400	11,000	11,900	12,700	13,200	13,800
FiOS homes passed as % of wireline homes	NA	NA	NA	NA	30%	43%
New homes passed in quarter (000s)	1,100	600	900	800	500	650
FiOS Internet						
Total subscribers (000s)	1,787	1,974	2,199	2,481	2,779	3,082
Growth Y/Y	109.5%	87.3%	71.7%	62.7%	55.5%	56.1%
Adds in quarter (000s)	262	187	225	282	298	303
Penetration of homes passed	22.9%	23.5%	20.0%	24.9%	26.8%	28.0%
FiOS video						
Total subscribers (000s)	1,206	1,382	1,615	1,918	2,217	2,517
Growth Y/Y	246.6%	168.3%	125.2%	103.4%	83.8%	82.1%
Adds in quarter (000s)	263	176	233	303	299	300
Penetration of homes passed	18.7%	19.7%	19.7%	20.8%	22.9%	25.0%
Customers with FiOs ARPU/month	$129	$130	$130	$133	NA	NA
Access lines	39,004	38,084	37,072	36,161	35,197	34,313
Quarterly change (net adds in quarter in 000s)	(879)	(920)	(1,012)	(911)	(964)	(884)
Total broadband customers (DSL and FiOS Internet)	8,276	8,330	8,459	8,673	8,925	9,111
Quarterly change (net adds in quarter in 000s)	263	54	129	214	252	186
Net change in wireline (access lines, broadband, video)	(353)	(690)	(650)	(394)	(413)	(398)
AT&T U-verse						
Access lines (000s)	60,415	58,860	57,191	55,610	53,992	52,379
U-verse voice connections (000s)		31	104	224	394	570
U-verse video connections (000s)	379	549	781	1,045	1,329	1,577
U-verse high-speed Internet customers (000)						1,585
U-verse homes passed (000s)		11,000	14,000	17,000	18,000	19,000
Total wired broadband (DSL, U-verse internet/sat.)	14,647	14,693	14,841	15,077	15,436	15,548
Quarterly change (net adds in quarter in 000s)						
Access lines	(1,167)	(1,555)	(1,669)	(1,581)	(1,618)	(1,613)
U-verse voice connections			73	120	170	176
U-verse video connections	379	170	232	264	284	248
U-verse high-speed Internet customers						
Total wired broadband connections	491	46	148	236	359	112

Source: Company data.

commitments to upgrade their wireline operations in denser marketplaces. Verizon has committed to an expensive and high-quality FTTH build-out that is expected to cost more than $20 billion, or approximately $1,700 per home for activated Internet and video services. AT&T is committed to driving fiber farther into its network, but the cost per home is expected to be approximately $300-$400 as the fiber is generally going to a node in the neighborhood rather than to every home.

The data and trends regarding the two initiatives are combined in Table 17. Notably, Verizon has been losing approximately 900,000 access lines each quarter, while adding a net number of broadband-related subscribers (FiOS plus DSL) that was approximately 200,000 over each of the last three quarters. So the change in Verizon subscribers in the most recent quarter was a loss of 884,000 lines offset by net broadband gains that totaled 186,000, a gain of 300,000 video subscribers, for a net loss of 398,000 subscribers. Further, the profitability on the lost customers was almost certainly higher than the margin on the broadband customers gained in the process. AT&T reported a loss of 1,613,000 access lines and a net gain of 112,000 broadband subscribers, further confirming the negative trend reported by Verizon. Importantly, in the case of both AT&T and Verizon, the net broadband gains also included customers who chose to cut off their DSL service to subscribe to the faster Internet or video services.

Again, it is too early to judge the data with certainty, but the trends even at the largest carriers tell a story about a net loss of subscribers even as the business is transitioning to a higher-speed network. The subscriber trends from Verizon and AT&T further support the North State 2014-2018 analysis that has been projected in summary fashion above.

Assessing Rural Carrier Strategic Options

Over the last decade and especially over the last half decade, rural carriers have faced strategic questions that are more profound.

Over the last 100 years, the rural carrier strategic model has been relatively stable. In the early 1900s, telephone networks were built with limited ability to connect to other networks, but the model rapidly migrated to a nationally interconnected system. In the 1910 Mann-Elkins Act, the regulatory jurisdiction for interstate telecommunications was assigned to the Interstate Commerce Commission, making telephone companies "common carriers" that were "to provide service on request at just and reasonable rates, without unjust discrimination or undue preference." Then, in the famous 1913 Kingsbury Commitment, AT&T agreed to provide interconnected long-distance services to independent telephone companies under specified conditions. Various other legislations created stability in the local communications markets, including the 1921 Willis-Graham Act and the 1934 Communications Act. The 1980s were a period when new regulatory systems for rural carriers were created for access charge payments and universal service funding, as the AT&T breakup unfolded. Even the Telecom Act of 1996 was not a significant cause for strategic concern as rural carriers were exempted from the onerous obligations of the new competitive legislation.

In the last century, therefore, rural telephone strategic options generally were related to commitments to new lines of business, adoption of emerging technologies, some opportunistic acquisitions, and potential divestitures based on family or estate issues.

Over the last decade, however, and especially over the last half decade, rural carriers have faced strategic questions that are more profound. Competition is a reality in the form of wireless services and IP-based communications offerings from cable companies, even in regions where rural carriers previously thought no alternative networks could exist. Cost controls, new

products, technology choices, and financial challenges are weighing more heavily. Importantly, all of these strategic issues are raising questions about the valuation of the companies—whether the value is growing, being maintained, or possibly shrinking.

The challenging question for rural carriers in this new world can be stated simply: Is there a realistic value creation opportunity today or in the future? The strategic answer is based on whether the cash flows of the companies can grow and based on what are the probable valuation multiples in the future markets.

This section focuses briefly on operating models, which North State almost certainly has assessed, and on transactional developments which potentially are instructive for the Company.

Strategic operating models

This report does not have as its purpose to detail the data related to specific operating approaches, but it is worth noting that the ILEC business model has changed dramatically over the last fifteen years.

Most ILEC management teams have a good grasp of the emerging operating challenges. This report does not have as its purpose to detail the data related to specific operating approaches, but it is worth noting that the ILEC business model has changed dramatically over the last fifteen years. Identification of new business opportunities, competitive positioning, marketing and service, and effective cost controls are more important today than ever before. At the highest level, carriers are focusing on the appropriate set of products and services for their customers, generally marketed in flat-rated bundles. The other principal service-centered initiative for communications companies today relates to broadband and video-related products. The following comments are brief, but highlight the valuation-related insights in strategic operating choices.

Competitive bundling

Competitive bundling began to emerge as a valuable telecommunications service in the mid-1990s. Custom local calling services were available on the SS7 (Signaling System 7) network in the late 1980s and long-distance services were provided for a century, but bundling emerged as a major factor in May 1998. AT&T wireless announced its OneRate bundled wireless service, including "free" long distance calling. The initiative was the most sweeping effort to combine services to attract new customers and retain current subscribers. From that date, it was apparent that flat-rated plans based on combined services were critical to win in the evolving and increasingly competitive telecommunications markets.

The positive effect was that local telephone companies found that the combination of flat-rated products including extended-area toll calling, long-distance calls, packaged custom-calling services plus local service resulted in expanding revenue per subscriber. Additionally, damaging churn and marketing expenses to retain customers were reduced, further supporting margins. The other effect was that the financial community gained more confidence in the stability and competitive position of the local telephone companies. Valuations of ILECs had weakened after the Telecom Act of 1996, but began to firm up relative to the major competitors, including AT&T and MCI.

Competitive bundling is well understood, but the reality is that carriers need to remain vigilant that they have the correct network assets and the appropriate understanding of what services their customers will demand and value most. Carriers who can employ effective bundling strategies to retain customers and increase their revenues per customer should receive higher

valuations than those who do not effectively utilize this strategy. If there is an emerging threat to the traditional communications bundle, it is the shift toward higher-speed data products, including video.

Broadband and data initiatives

Broadband services are a constantly shifting marketplace for communications customers. The problem is that the demands on the access network and the transport systems are evolving rapidly. The carriers also have differing views about the optimal solutions, including whether they should be incremental in using legacy networks combined with feeder plant or they should migrate toward fiber to the premises. AT&T and Verizon differ in their views of the appropriate strategy (with North State pursuing a strategy akin to Verizon's FTTH approach), and the jury is still out on which approach will prove to be optimal in the long run. Even with significant build-outs of fiber in Verizon's region and AT&T's region, both carriers continue to report meaningful net loss of customers as ILEC line losses significantly exceed broadband/video gains.

A communications provider must have a competitive data product and likely will have to bundle the service with video.

What is clear, however, is that a communications provider must have a competitive data product and likely will have to bundle the service with video. The valuation insights are that cash flows will be affected by the capital expenditures to upgrade network plant and the potential for technological missteps is greater, meaning that valuations can be depressed by the higher risks. The additional broadband risk in 2009 is that the FCC appears poised to require increased levels of broadband availability and speeds. In the case of North State, if its plant is superior (which current levels of investment suggest it likely is), the Company might be assigned a higher valuation relative to the Company's peers, both because of the lower capital / operating risk going forward and the value perceived by another carrier if North State were to merge with or be sold to another company. This is not to argue that all investment is productive, and in fact it is possible that a company may not generate a sufficient return on investment or that a potential acquirer will not assign full value to actual investment. As such, a disciplined approach to incremental investment based reasonably anticipated return on invested capital is appropriate for all carriers.

Broadband capability is likely the major determinant of operating value in terms of the standalone company and is a major driver in terms of potential transactional value.

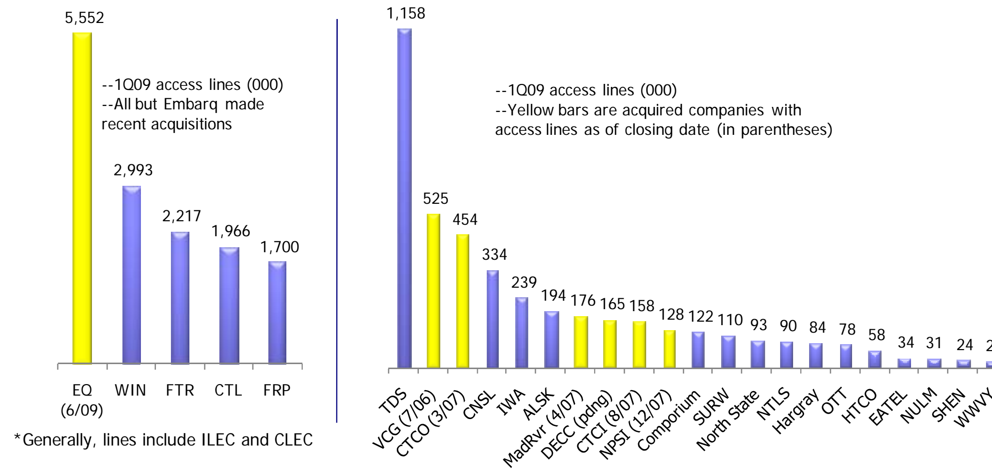
Strategic transactions

Strategic transactional activity has become an increasingly important tool of the telecommunications industry over the last decade. Because organic revenue growth has been more difficult to achieve, because new services often generate lower margins, and because cost savings are a challenge in a network-based business, virtually all of the major carriers have turned to acquisitions to create value. An additional factor driving consolidation has been fear about regulatory reform of key high-cost support mechanisms, including access payments and universal service funding.

Acquisition strategies

Because revenue growth has been more difficult to achieve and cost savings are a challenge in a network business, virtually all of the major carriers have turned to acquisitions to create value.

Figure 4: Major acquisitions of rural carriers since 2006



Source: Company data; Universal Service Administrative Company; Balhoff & Williams, LLC.

In recent years, the non-RBOC portion of the telecommunications industry has segmented into mid-sized carriers (generally a relatively small group of publicly-traded companies such as CenturyTel (CenturyLink as of July 1, 2009), Consolidated, Embarq, FairPoint Communications (FairPoint), Frontier, Iowa Telecom, Otelco, TDS, and Windstream) and smaller RLECs (500+ carriers generally represented by industry associations such as OPASTCO and NTCA). There are also carriers that are large enough to be included the mid-sized carrier segment, but those companies for one reason or another might be viewed more appropriately as special situations—ACS, SureWest Communications (SureWest), Comporium Communications (Comporium), Hawaiian Telcom, etc. In general, the mid-sized carriers actively have pursued acquisitions as a primary mechanism for improving their operational efficiency and generating value for stakeholders.

Figure 4 provides a snapshot of many of the major non-RBOC carriers and, in the yellow bars, indicates the carriers in the group that have been acquired, all by the mid-sized carriers, since 2006. The figure also highlights another key development—that relatively large rural carriers have been sold in the last three years, a phenomenon that is a new and recent development (with the exception of the Centel and Contel sales in the early 1990s).

Some of the more noteworthy transactions, as reflected in the graphic, include:

- Sprint's May 2006 spin-off of its local telephone business to form Embarq (EQ), and then Embarq's subsequent $11.6 billion sale (stock-for-stock plus the assumption of debt) to CenturyTel (CTL) in a transaction that closed June 30, 2009;
- The July 2006 spin-off of Alltel's wireline assets and merger with Valor Communications (VCG) in a $2.0 billion transaction to form Windstream (WIN);

- Citizens Communications' (now Frontier or FTR) March 2007 acquisition of Commonwealth Communications (CTCO) for approximately $1.2 billion;

- CenturyTel's April 2007 $830 million acquisition of Madison River Communications (MadRvr);

- Windstream's August 2007 purchase of CT Communications (CTCI) for $585 million;

- Consolidated Communications' (CNSL) December 2007 $375 million acquisition of North Pittsburgh (NPSI); and

- Windstream's pending transaction to purchase D&E Communications (DECC) for $330 million.

The "targets" within the mid-sized ILEC industry are relatively large but over time are decreasing in size as many of the larger companies already have been acquired.

As is evident in the figure, the "targets" within the mid-sized ILEC industry are relatively large but over time are decreasing in size as many of the larger companies already have been acquired. Ultimately, it appears that even companies the size of Consolidated and Iowa Telecom are more likely to become targets for the "mega-mid-sized companies" rather than surviving as consolidators. Additionally, there have been multiple smaller transactions including the following:

- New Ulm Telecom's early 2008 purchase of Hutchinson Telephone for approximately $78 million;

- Iowa Telecom's July 2008 $44 million acquisition of Bishop Communications and its July 2009 $82 million purchase of Sherburne Tele Systems;

- Otelco's October 2008 acquisition of Country Road's properties for approximately $101 million; and

- Windstream's recently announced and still pending $141 million acquisition of Lexcom, Inc.

Of lesser interest to North State are past and current acquisitions involving RBOC lines. However, the principle is the same as value-focused rural carriers have targeted assets which permit increased scale and efficiency. The recent RBOC acquisitions include:

- CenturyTel's purchase of Verizon lines in Alabama and Missouri in 2002 in separate transactions with a combined value of approximately $2.2 billion;

- Alltel's (now Windstream's) purchase of Verizon lines in Kentucky in 2002 for $1.9 billion;

- FairPoint 's March 2008 tax-free Reverse Morris Trust transaction to merge with Verizon's Northern New England operations (Maine, New Hampshire and Vermont) in a transaction valued at $2.7 billion when announced; and

- Frontier 's May 13, 2009, announcement of an agreement to acquire Verizon's rural operations in fourteen states in a tax-free Reverse Morris Trust transaction valued at approximately $8.6 billion.

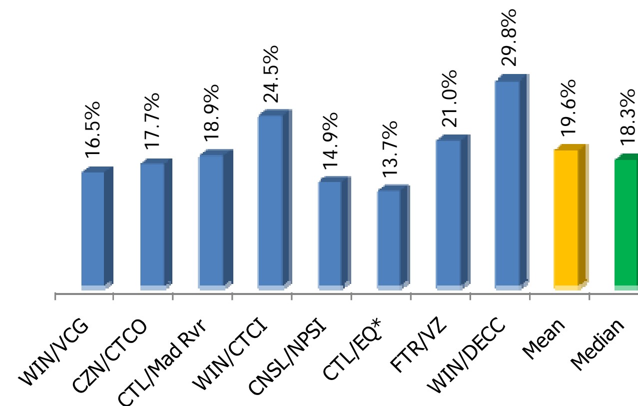
The acquisition strategies pursued by rural consolidators are based on key principles and motivations.

With the announcement of the Frontier transaction, Verizon stated that its program of rural access line sales will be complete and the company will no longer be looking to enter into these transactions. As such, a major source of transactional growth for the mid-sized rural consolidators will not be available. AT&T and possibly Qwest appear likely to divest rural (less dense, higher cost) operations, but there is no real visibility into their plans at the present.

In general, the acquisition strategies pursued by rural consolidators are based on the following key principles and motivations, among others:

- **Increasing scope and scale:** Incumbent telephone carriers commit to acquisitions for several reasons, almost all of which relate to improving scope and scale. The assumption is that spreading fixed costs over a larger customer (and revenue) base permits the carriers to lower unit costs to compete more effectively while generating higher returns. This was an incremental approach to value creation at a time when there was core growth in the local telephone marketplace—through the early part of this decade. However, scope and scale have become even more important as organic revenue growth has disappeared and publicly-traded carriers are compelled more urgently to find strategic opportunities to create value. In fact, many of the carriers candidly admit that at the present only acquisitions can generate the cash flow growth they require to support their ongoing valuations, as depicted in Figure 5. Additionally, the more substantial post-transaction combined entities permit carriers to make the significant network investments required to position the companies for potential growth through providing advanced communications products and services to rural markets.

Figure 5: Synergy targets in acquisitions of rural properties



*CenturyTel in 2Q09 earnings release increased expected synergy to 13.7% from 11.5%.

Source: Company data; Balhoff & Williams, LLC

- **Generating cash flow growth:** With access lines declining, traditional revenue streams (such as access) under assault, and lower margin services replacing traditional higher margin voice services, ILECs and their investors view transactions as an important source of free cash flow growth. Often acquirers see new revenue opportunities for the combined company through improved broadband product offerings / penetration, enhanced bundled service packages, increased sales of value-added services, new product offerings (such as video), and improved customer retention.

However, at the most basic level, companies and investors are focusing on "synergies" by which to generate transaction-related cost savings (both operating and capital), as overlapping assets, systems and overhead functions are streamlined.

The acquiring carriers have focused on the opportunity to save an average 19.6% of the target company's pre-acquisition cash operating expenses, with the median synergy goal of18.3%.

Figure 5 highlights the expected "synergies" that have been targeted and announced in recent transactions. Notably, the acquiring carriers have focused on the opportunity to save an average 19.6% of the target company's pre-acquisition cash operating expenses, with the median synergy goal of 18.3%. The improved operating efficiency of the post-transaction entity provides enhanced cash flow generation which can be used to invest in the network, better serve customers, and compete more effectively. With the exception of the recently completed or announced transactions (no history is yet available for these transactions)—CenturyTel-Embarq, and Frontier-Verizon—the carriers consistently report that they have achieved or exceeded the cost savings targets and, as a result, have enhanced cash flows.

- **Diversifying operations and regulatory exposures:** For some companies, transactions can also be a means for diversifying their operations into new geographies and new products and service offerings (i.e., video or fiber-based transport networks). This diversification will give the combined company an enhanced ability to weather weakness in any single geographic area or product / service offering. In addition, as regulated revenue streams—principally access revenues and universal service support payments—are at risk due to certain reform proposals, some companies have viewed transactions as a vehicle to reduce the relative importance of regulatory revenue streams for the combined entity. Thus, an acquirer that receives a high percentage of its revenues in the form of universal service funding might target a company that receives little USF support, so that the combined entity is relatively less exposed to adverse reforms of the universal service support mechanisms.

- **Enhancing financial flexibility:** Over the last five to eight years, many of the publicly-traded mid-sized companies pursued a capitalization and capital allocation strategy that involved relatively high leverage and significant dividend payout ratios (dividends as a percentage of available free cash flow). However, as the fundamentals of the ILEC business have become more strained and the technological risks of the business have increased, the prudence and sustainability of the model have been challenged. As a result, many incumbent telephone companies have been using transactional activity to enhance their future financial flexibility by limiting or reducing leverage (often targeting investment grade credit metrics) and decreasing dividend payouts as part of the transaction. It has become a priority that, as a result of a transaction, whenever possible the pro forma combined company has a strong financial profile to enhance its flexibility in dealing with an increasingly volatile industry. Stock-for-stock and other deleveraging transaction structures have become more common, while dividend reductions that target more sustainable payout levels have been endorsed by prudent investors.

- **Creating scalable platforms:** Ultimately, many of the rural consolidators are using acquisitions and other transactions to position themselves for future growth and investment opportunities to generate long-term value. These companies believe that size will matter in an increasingly competitive and capital intensive industry. Therefore, the companies with the experience, systems, and demonstrated competencies to continue integrating additional properties into their core operations will be advantaged as the industry continues to consolidate. By creating a more scalable business platform, the consolidators believe they will be best positioned to expand their product and service offerings through new

investments, to deploy advanced technologies, and to capitalize on incremental transactional opportunities that arise over time.

Companies such as Consolidated, Iowa Telecom, and Otelco, have stated their desire to continue to pursue acquisitions, in an effort to grow their companies and likely to add the option for further value creation through becoming more attractive targets for the larger rural consolidators. Larger rural consolidators may look to transactions among their peers or may again pursue smaller transactions for a period. In addition, the directions AT&T and Qwest pursue in terms of divestitures will have important implications for acquisition strategies and activity in the rural local exchange industry in coming years.

Divestitures

High-quality and respected operators such as Valor, Commonwealth, Madison River, CT, North Pittsburgh, D&E, and even Embarq, assessed the evolving telecom landscape and came to many of the same conclusions as the rural consolidators; however they did not view themselves as long-term survivors in consolidation.

Just as companies such as CenturyTel, Frontier, Windstream, Consolidated, and Iowa Telecom have made the strategic choice, at least to-date, to remain independent and acquire other ILECs, other companies decided that their future is best served by becoming part of a larger entity. Part of the motivation was that there was an opportunity to sell at a reasonable or possibly attractive price, but most of the transactions came at the end of a period of strategic assessment regarding alternatives in creating value. So, high-quality and respected operators such as Valor, Commonwealth, Madison River, CT, North Pittsburgh, D&E, and even Embarq, assessed the evolving telecom landscape and came to many of the same conclusions as the rural consolidators—scope and scale will matter as competition and required investment increases, generating value through organic growth is becoming increasingly difficult, concentrated operations and regulatory exposures increasingly pose risks, financial and operating flexibility are strategically important, and a scalable business platform (including expertise in integrating acquired operations) is the key to long-term value creation in rural communications. However, rather than viewing themselves as long-term survivors in consolidation, these companies came to the conclusion that their future prospects—for customers, employees, investors--were better in combination with strong and capable consolidators.

Most of the transactions over the last ten years were cash purchases, meaning the value received by the selling company shareholders was a fixed amount at closing of the acquisition. In those cases, the management team and Board of Directors of the divesting company judged that the sale price exceeded the expected long-term value of the operations as a standalone entity. However, some of the more recent transactions have involved a stock component as part or all of the purchase consideration. In these cases, the selling shareholders have the opportunity to participate in the potential upside if there is improved performance in the combined operations. In addition, if the combined company subsequently were to be part of a follow-on transaction as the industry continues to consolidate, the shareholders of the original target company could receive a second acquisition premium related to their ownership in the combined company. This potential for a "double premium" is a consideration for managements and Boards of certain companies interested in pursuing a divestiture strategy.

Valuation perspectives

While there have been numerous transactions in the ILEC industry over the last decade, the more recent combinations provide better insight into how investors and companies are valuing the businesses, particularly in light of the changing operating and regulatory environment. Thus, the following analysis focuses on transactions since the middle of 2007 (last two years) using

announced transaction multiples (or multiples that can be calculated based on announced data), based on enterprise value to trailing twelve months EBITDA (EV / trailing EBITDA). By way of clarification, investors sometimes focus on multiples *after synergy assumptions,* but it is difficult to get an apples-to-apples comparison as forward-looking EBITDA after synergies is speculative. In addition, we have excluded tax-advantaged transactions[4] and related valuation metrics from the analysis as it is difficult to calculate accurately, based on publicly available information, the value of the tax benefit to arrive at a taxable-equivalent valuation and multiple that is comparable with the majority of transactions which are taxable.

Table 18: Summary of ILEC transaction multiples since August 2007

$s in millions

	All Transactions[1]		Transactions $60-$600 million[2]	
	Transaction Value	Trailing EV / EBITDA	Transaction Value	Trailing EV / EBITDA
Mean	$ 83	8.3	$ 164	8.3
Median	42	8.5	80	7.8
Minimum	2	5.9	60	5.9
Maximum	585	10.6	585	10.6

[1] From 8/31/07 through 9/8/09, there were twenty-two transactions with reported multiples
[2] From 8/31/07, through 9/8/09, there were ten transactions with reported multiples

Source: Company data; Balhoff & Williams, LLC.

During the relevant time period, twenty-two transactions that fit our criteria closed or were pending. As Table 18 indicates, the transactions ranged in size from $2 million to the $585 million Windstream acquisition of CT Communications, indicating a wide range in terms of transaction size. The average acquisition was $83 million, while the median transaction size was $42 million because there were many smaller transactions. In general, the transaction valuation multiples fell in a relatively tight range. The recent minimum EV / trailing EBITDA multiple was 5.9x, while the maximum multiple in the group was the approximately 10.6x; the mean and median multiples were almost identical at 8.3x and 8.5x, respectively.

It is possibly more instructive to review the ten transactions valued between $60 million and $600 million over the last two years (excluding the twelve smaller acquisitions) to provide valuation perspective for North State. As the table indicates, these transactions averaged $164 million in size and the median size was $80 million. Again, the transaction multiples were in a relatively tight range, with mean and median multiples of 8.3x and 7.8x, respectively. The maximum multiple again was approximately 10.6x, while the minimum multiple came in at 5.9x reflecting the multiple to-be-paid by Windstream in its recently-announced and pending $141 million acquisition of Lexcom, Inc. It is notable that Concord, North Carolina-based CT Communications, in August 2007, was purchased by Windstream at a 10.3x EV / trailing EBITDA multiple before synergies. The transaction may be helpful in fixing a value for North State, since CT's service territory in North Carolina is comparable to North State's operations, including geography, similar in size, and high-quality plant. It is also important to recognize that CT's ILEC EBITDA margins were somewhat higher than North State's (CT also operated a number of lower-margin wireline and

[4] The excluded tax-advantaged transactions are FairPoint's acquisition of Verizon's Northern New England operations, CenturyTel's recently completed merger with Embarq, Windstream's pending acquisition of D&E Communications, and Frontier's pending acquisition of Verizon's operations in fourteen states.

wireless businesses), indicating the valuation multiple for North State might be somewhat lower. The other factor affecting CT's valuation may have been the potential number of bidders for the property as several of the major consolidators and several other potential buyers have had interest in North Carolina ILECs. It is also noteworthy that Lexcom's service territory in Lexington, North Carolina, is adjacent to North Star's operations. However, the Lexcom transaction, for reasons that are not evident, will generate a valuation multiple upon closing that is an outlier on the low-end of the multiple range and that is inconsistent both with typical private market multiples and with current public market trading multiples (addressed later in the report). As such, the Lexcom transaction is not likely to be representative of the type of valuation that could be achieved by North State.

The data indicate that ILEC properties have been valued at around 8x trailing EBITDA over the last two years, with some "multiple compression" in the most recently-announced transactions. Still, the more recent transactions have occurred in volatile markets, with limited access to financing. Of the ten consummated taxable transactions valued between $60 million and $600 million in the last two years, four had multiples in the 7x-8x range, five had multiples above the range, and one transaction had a multiple below the range. Therefore, it is reasonable to expect that high-quality operations would attract multiples in the 8x trailing EBITDA range, with some variance depending on the financial and operational characteristics of the to-be-acquired business.

Clarifying North State's Strategic Options

Strategic assessments were not as important for rural ILECs ten or twenty years ago. Today, with shifting capital requirements, contracting core fundamentals, and the possibility that valuations are falling due to pressures on cash flows, a company appears at risk if it is not assessing its options. North State likely has assessed its strategic options which may cover a wide range of scenarios. Most simply, the Company could continue to operate as a standalone company with the expectation that it can generate value based on organic opportunities driven by its to-be-deployed FTTH network. Alternatively, the Company could choose to target potential acquisitions which could augment growth and enhance the value of the underlying assets. Finally, the Company may have evaluated what its operations are worth today or in the next years assuming a sale or merger scenario.

Operating as a standalone company

Over the last years, North State has performed reasonably well, has competed effectively and has dedicated an extraordinary amount of capital to its plant. As discussed previously, North State intends to continue to commit significant levels of capital to its wireline network in the coming years. At the same time, the financials highlight slowing growth initiatives and ongoing losses in the core telephony operations. EBITDA has contracted over the last five years by about 18% and is likely to slip by another 14% over the next five years, assuming that no new negative regulatory developments occur. It is difficult for an outsider to define with certainty all of the Company's opportunities, but it appears likely that North State will experience growing pressures on its cash flows over the next several years. Subsequently, the Company may see improved cash flows as capex declines and potential new revenues are generated from fiber-based video and high-speed data services, but these longer-term positives are more speculative.

If there is not a way to offset fully the core losses, it is inevitable that the Company's valuation will contract over time.

North State's managers and investors will have to assess whether its fiber-based services are likely to accelerate growth businesses and become more efficient in the generation of free cash flow, such that a reasonable return on investment is generated. If the advanced video and broadband services are not effective at a minimum in offsetting fully the core operating and cash flow declines, it is inevitable that the Company's valuation will contract over time. In the end, valuation is a function of the multiple an investor is willing to assign to cash flow generation and the expected trend for those cash flows.

If North State has an opportunity to improve on its organic operations, it will be because the Company is able to attract customers to new services on its superior plant, is able to stem the losses because it provides better value over and against its competitors, and is able to find new efficiencies. Telecommunications historically has provided surprises to the marketplace as fax machines spurred unexpected growth in long-distance minutes of use, as software-based custom calling services provided high-margin ancillary products, as the Internet spawned new and unimagined data services, and as wireless penetration levels exceeded the expectations of most observers. Such an unexpected set of opportunities may unfold and, if it does, there is little question that North State will be well-positioned to capitalize through its essentially "future proof" FTTH network (assuming deployment proceeds as management plans).

It is also fair to say that the operating and financial trends at other companies highlight the growing risks. In addition, any FTTH deployment today involves somewhat of a gamble, as investment costs are substantial and future cash flows are not certain. At the very least, it is prudent that management and investors consider carefully how to position the Company for the possibility that non-organic value creation will be required. This scenario likely involves acquisitions or mergers or sales of assets.

Acquisitions

The consolidating companies' goal is to engage in one of a diminishing set of choices to create value for shareholders and to preserve operating flexibility.

Acquisitions provide a carrier with some optionality in the value creation process. There is the opportunity to extract value from the synergies generated by purchasing another company, while potentially preserving the opportunity to sell an even more valuable company (the integrated and merged company). However, acquisitions carry a degree of execution risk as the cautionary tales of the Carlyle Group (purchase of Hawaiian Telcom) and FairPoint (purchase of Verizon Northern New England) demonstrate.

CenturyLink, Frontier, Windstream, Consolidated, Iowa Telecom, and Otelco all have acquired other carriers with a view to increasing scale, eliminating unnecessary costs, and extracting new value for their investors and customers. Ten years ago, the consolidating companies' motives might have been opportunistic. Today, the goal is to engage in one of a diminishing set of choices to create value for shareholders, to preserve operating flexibility, and to position their companies to best serve customers for the future. At the very least, transactional value-creation is an increasingly important variable for the industry.

One strategic approach for North State is to evaluate the financial value in growing through the acquisition of other attractive communications operations. With around 93,000 access lines and over 140,000 total connections, North State has sufficient scale to play a role, at least in the near-term, as a consolidator of rural operations. Further, the Company's debt-free balance sheet is a major asset if North State were to bid for and finance an acquisition. A key consideration, however, is whether North State believes it has existing core competencies—including management experience, skill sets, and systems—to successfully execute

sizeable or transformational transactions. The carriers that have engaged most effectively in acquisitions evaluated their personnel, access to capital, scalability of their back-office systems, and the compatibility of the target companies.

Potential acquisition targets (or possible merger partners) for North State to evaluate and consider might include:

- Comporium Communications, which is a comparably-sized private ILEC and cable television operator serving somewhat similar markets in close proximity to North State (principally Fort Mill and Rock Hill, South Carolina, both in the Charlotte metro area). At this time, Comporium's long-term strategy is not clearly apparent, but the company may have generational issues and may begin to see the value in becoming part of a larger, more diversified operation. Comporium's combination of ILEC and incumbent cable operations serving overlapping territories would be an attractive addition to North State's operations and would provide some geographical and operational diversity. The cable operations could be valuable in providing important skill sets as North State pursues its full-scale entry into the video marketplace. In addition, it is our understanding that Comporium has little debt, so combining two under-leveraged balance sheets would create a strong platform for additional transactions and an attractive target for the larger consolidators discussed above. However, given that it is a family-owned, private company, Comporium may feel less pressure to act than a comparable public company.

- Otelco, Inc., is a publicly-traded company with operations in Alabama, Maine, Massachusetts, Missouri and West Virginia. The company currently serves approximately 51,000 ILEC voice access lines and 27,000 CLEC voice access lines. Otelco has employed an acquisition-based growth strategy over the years, most recently acquiring three subsidiaries of Country Road Communication, LLC. Otelco's public securities are structured as Income Deposit Securities (IDS), which are composed of one share of Class A common stock and a 13% senior subordinated note with $7.50 principal amount due in December 2019. The IDS structure can be cumbersome, which is the reason that other rural carriers in the United States chose to avoid the unique Canadian-style security. Otelco also historically has been highly leveraged. While Otelco could provide greater scope / scale, some diversification, and greater liquidity to North State, the lack of proximity to North State's operations and the reliance on debt funding may diminish Otelco's ultimate attractiveness as a target

- Hargray Communications Group (Hargray) is a private equity-owned communications operator focused on Beaufort and Jasper Counties in South Carolina (including the Hilton Head resort area), plus the greater Savannah, Georgia market. The company was acquired by Quadrangle Group (Quadrangle) through one of its affiliate private equity funds in 2007. While the sale to Quadrangle was relatively recent, it is possible that Hargray's financial owners could be interested in exiting their investment through a sale or, more likely, combining the company with an entity like North State in order to improve financial flexibility, increase scope / scale, and enhance the combined company's attractiveness to larger consolidators. Hargray has invested in high-quality plant to allow it to offer video services, in addition to high-speed data, similar to North State management's current standalone strategy. The company operates around 80,000 ILEC and CLEC lines in its combined service territories.

- NTELOS Holdings Corp. (NTELOS), is a publicly-traded company that owns and operates two rural ILECs with approximately 40,300 telephone access lines in western Virginia and a CLEC that serves customers in Virginia and West

Virginia with approximately 49,500 access line connections. The company also holds an ownership stake in a 2,300 route-mile regional fiber optic network in the mid-Atlantic region. The company has high-quality access plant, including a growing fiber-to-the-home initiative that provides video services plus data speeds up to 20 Mbps; again, similar to North State's FTTH strategy. In addition, NTELOS traditionally has been one of the most efficient wireline telecom operators, generating among the highest EBITDA margins in the industry. However, NTELOS is focused primarily on its much larger wireless operations. As such, it is possible that the company, along with Quadrangle (which owns a substantial minority interest in the company), would be interested in divesting or combining the wireline operations with another carrier such as North State. With reasonably-sized operations in a neighboring state and high operating profitability, the NTELOS wireline operations could be particularly interesting for North State. NTELOS emerged from bankruptcy and has been limited in terms of potential transactions until 2010.

- Other smaller operations in reasonably close geographic proximity to North State could provide the Company with an opportunity to grow, while possibly gaining some additional scale economies, becoming more efficient, and diversifying risks. Pursuing these smaller targets would represent a more incremental approach to growth and would take more time and effort than a larger transaction, but could be viewed as a less risky approach to enhance operations and defend against growing competitive risks.

Divestiture

Among the carriers closer in size to North State, it is notable that, over the last three years, there have been divestitures by Valor, Commonwealth, Madison River, CT, North Pittsburgh, and D&E.

Some carriers are concerned that the rural operating environment or valuations may not be growing appreciably more positive in the foreseeable future. Most recently, the boards of directors of certain prominent rural companies judged that optimal value would be created through sales of their companies or combinations with other operators. It is possible that some incremental value might have been created, but the calculus included an assessment that the near-term value in a sale outweighed the potential for further value creation over and against the risks of a decline in value. This assessment process appears to have been different from the sales process among rural local exchange carriers in the past when the motivations were more often based on personal factors, such as estate choices, no logical management successors, etc. Today, the sales processes appear to be grounded in strategic choices in light of a changing business and valuation environment.

The authors of this report have worked closely with several of the RBOCs as well as all the managements of the major RLECs. Even the largest carriers have engaged in strategic assessments as the marketplace has changed. Among the carriers closer in size to North State, it is notable that, over the last three years, there have been divestitures by Valor, Commonwealth, Madison River, CT, North Pittsburgh, and D&E.

In reviewing the recent relevant transactions, there are certain motivations and industry trends that appear to have influenced consistently the decision by telecom carrier management teams and boards of directors to sell their often successful businesses to larger carriers. The most frequently cited rationale was to increase the scope and scale of the company, as incremental size allows the pro forma company to (i) better address growing competitive pressures, (ii) provide advanced services through network investment, (iii) reduce risk, and (iv) generate cost and capital savings, and related enhanced cash flows, through greater efficiencies and synergies. The larger combined company is perceived to be better positioned for future growth and

consolidation in an increasingly competitive and capital-intensive industry in which the fundamentals are becoming more challenging. The combined entity also is expected to have greater resources to better serve its customers and other key stakeholders. In addition, the selling carriers often note the benefits of greater diversification—both financial and geographic—in the combined entity. Finally, many of the transactions involve larger carriers purchasing operations that are in close proximity to or are complementary to their existing properties. As a result, sellers with operations contiguous to or at least in the same state as properties owned by major consolidators would appear to be in an advantageous position with regard to generating interest and value through a sale process.

Below are some of the summary details and publicly-disclosed rationales for each major transaction in recent years, many of which we believe may be relevant for North State.

- Valor Communications, a telecommunications carrier with approximately 525,000 access lines in Texas, Oklahoma and New Mexico, announced on December 9, 2005, that it would combine with the spin-off of Alltel's wireline assets to form Windstream. The transaction was structured as a Reverse Morris Trust merger, but Valor clearly was selling itself as the combined company would have around 3.4 million total access lines and Valor shareholders would own approximately 15% of the pro forma entity. Valor was valued, including net debt, at approximately $2 billion. The stated rationales for the combination, emphasized by both companies, included complementary rural footprints, the ability to reduce leverage and dividend payout ratios, increased scale and scope of the combined company, the potential to derive significant efficiencies / synergies, and positioning the combined entity as an industry consolidator. In addition, the companies pointed to larger scale that reduced risk, permitted revenue and earnings diversification, and positioned Valor to provide advanced services as part of a larger company.

- Pennsylvania-based Commonwealth Telephone announced its sale to Citizens Communications (now Frontier) in September, 2006, in a taxable cash-and-stock transaction valued at approximately $1.2 billion. Shortly before the transaction was announced, Commonwealth had announced that it hired an adviser to explore strategic opportunities. Commonwealth operated approximately 316,000 rural ILEC lines and 138,000 edge-out CLEC lines in adjacent markets, and served around 37,000 high-speed Internet customers. In explaining the decision to sell to Citizens/Frontier, Commonwealth's CEO stated, "Having reviewed a number of strategic opportunities, we concluded that this was the right transaction at the right price for our shareholders and other key constituencies. Citizens has done a great job in their current Pennsylvania markets so this acquisition is a logical extension of their reach and provides economies of scale to remain competitive in the long run." It is noteworthy that Commonwealth was one of the best performing mid-sized ILEC operators in the U.S. when it made the decision that its future prospects were brighter when combined with a larger entity than continuing as a standalone operator. The combined company became the 7th largest local exchange company in the U.S. The acquisition expanded Citizens' presence in Pennsylvania and generated meaningful annual cash synergies and operational efficiencies, thus enhancing cash flows. In addition, the transaction maintained balance sheet strength and reduced the dividend payout ratio for Citizens.

- On December 18, 2006, CenturyTel announced an agreement to acquire Madison River Communications in a transaction valued at around $830 million (cash and assumption of debt). Madison River was a North Carolina-based rural

telecommunications provider with operations in North Carolina, Alabama, Illinois and Georgia, serving approximately 176,000 access lines. In addition, Madison River owned a 2,400-mile fiber backbone network. While neither Madison River nor CenturyTel formally commented on the specific rationales for the transaction, the companies have made it clear that the combination increased scope and scale, added attractive markets with good demographics and growth prospects to CenturyTel's operations, and generated potential cost savings / synergies, and thus incremental cash flows, through the increased efficiency of the combined operations. Importantly, CenturyTel also gained ownership of a strategically important fiber network that could be leveraged with the company's other southeastern properties.

- In late May, 2007, CT Communications announced an agreement to sell itself to Windstream for $585 million in cash. CT operated in attractive markets in and around Concord, NC, just north of the Charlotte metropolitan area, and served approximately 158,000 access lines and 29,000 broadband customers. Windstream was viewed as paying a premium valuation for the operations, providing good value to the existing shareholders (approximately a 46% premium to the closing price the day before the announcement and a 31% premium over CT's prior 30-day trading average). In explaining the sale, CT's CEO stated, "Because of our strong operational and fiscal performance over the last several years, we found ourselves in the unique and enviable position of possessing significant cash reserves and very low debt. As such, we found ourselves willing to explore strategic options for our company, and fully believe that this merger will provide the long-term value that our shareholders deserve. Windstream Corporation has achieved a long history of successful operations in the telecommunications industry, and we have been impressed with their strategies to successfully compete and thrive. We are truly excited about the opportunities this partnership creates for the benefit of our customers and shareholders." The acquired service areas complemented Windstream's existing operations in North Carolina, allowing the acquirer to generate significant annual cost savings and capital expenditure synergies. As Windstream's CEO stated, "CT Communications fits strategically with Windstream and advances our strategy of continuing to grow through acquisitions while expanding our free cash flow."

- On July 2, 2007, Consolidated Communications announced an agreement to acquire North Pittsburgh Systems for total consideration of $375.1 million. A portion of the consideration was in Consolidated common stock, providing additional potential upside for North Pittsburgh's shareholders. At the time the transaction was announced, North Pittsburgh operated approximately 61,500 ILEC access lines, 66,300 CLEC access line equivalents, and had 16,300 DSL subscribers. North Pittsburgh's CEO indicated that the transaction would provide an opportunity to expand existing customer offerings, specifically IPTV, and would benefit both customers and shareholders. Consolidated was able to add growing, affluent markets served by an advanced network that could be leveraged to expand service offerings. In addition, Consolidated expected meaningful annual operating and capital synergies, and thereby to enhance the combined company's ability to generate free cash flows. The transaction also provided geographic diversification for both companies.

- On May 11, 2009, D&E Communications, a publicly-traded telecommunications company serving markets in Pennsylvania, announced a $330 million sale to Windstream. The consideration is to be paid partially in cash and partially in Windstream stock, providing D&E's shareholders with potential for additional value should Windstream's stock perform well subsequent to the transaction. The transaction value represented a greater than 60% premium to

D&E's relatively depressed stock price. D&E has approximately 118,000 ILEC access lines and about 44,000 high-speed Internet customers. In addition, D&E operates as a competitive local exchange carrier that serves approximately 47,000 lines. Windstream has around 200,000 existing access lines in Pennsylvania. In announcing the transaction, D&E's CEO stated, "This merger combines best-in-class products and services of two great integrated communications providers. The result ensures a strong and vibrant company that is well-positioned to serve our customers, shareholders and employees today as well as in the future." Providing further color on the transaction rationale and the need for economies of scale in the rural telecom sector, D&E's CEO indicated, "We're too big to be little and too little to be big. … There was a point of view by all of us in the management team and the board of directors that bigger is better." Illuminating Windstream's motivations for the transaction, its CEO said, "These properties significantly expand our operations in Pennsylvania and provide the opportunity to grow cash flow, reduce our dividend payout ratio and create value for shareholders and customers."

- While not what we would characterize as a "major" industry transaction, the rationales for the $141 million pending sale of Lexcom, Inc., to Windstream are consistent with those cited in the transactions above. Lexcom's operations serve 23,000 access lines, 9,000 broadband customers, and 12,000 cable television subscribers in central North Carolina. As stated by Lexcom's chairman and CEO, "The telecommunications industry continues to grow rapidly due to increased technological capabilities and ever-changing habits of users. However, whereby size and scope have become much more important in the industry, the Board of Directors feels that Windstream, especially considering its size and its presence within North Carolina, is positioned to continue providing state-of-the-art services to Lexcom's customers." Thus, even smaller operators are being affected by the industry forces that are spurring the ongoing consolidation trend among larger carriers.

If North State were interested in a merger or a sale, we believe there could be a number of interested companies with somewhat differing rationales. Among the potential suitors are the following companies.

If North State were interested in a merger or a sale, there could be a number of interested companies with somewhat differing rationales.

- Windstream, with around 344,000 lines in North Carolina, including the recently acquired CT (158,000 access lines and 29,000 broadband customers at acquisition) operations in Concord, just southwest of North State's operating territory, and the to-be-acquired Lexcom, Inc., operations in nearby Lexington (approximately 23,000 access lines, 9,000 broadband customers, and 12,000 cable television subscribers). Windstream also recently acquired D&E in south-central Pennsylvania (118,000 ILEC access lines, 44,000 HSI customers and 47,000 CLEC lines at announcement), as discussed above, which is a slightly larger but similar sized company.

- CenturyTel / Embarq (now CenturyLink), with approximately 1.2 million lines in North Carolina, including operations in Asheboro and Kernersville which are contiguous with North State's service territory. Currently focused on the combination of the two companies, but might see North State as a transaction that could be completed even in the context of the larger transaction. As noted above, CenturyTel recently acquired and successfully integrated the Madison River operations (MebTel in Mebane, North Carolina).

- Frontier, which will have approximately 263,000 lines in North Carolina, assuming the transaction with Verizon is completed successfully. A transaction with Frontier probably would require waiting until after the Verizon transaction

has closed in the first or second quarter of 2010 and possibly longer due to restrictions on transactions that accompany the Reverse Morris Trust structure. Frontier has been an active acquirer of smaller companies, as demonstrated by its acquisition of Commonwealth's operations in 2007.

- Consolidated recently executed a successful acquisition of North Pittsburgh, which is similar in size to North State, demonstrating its appetite for transactional growth. We believe Consolidated would like to reduce its overall leverage, making North State's debt-free balance sheet a particularly attractive feature of a combination. In addition, given that Consolidated likely is an attractive future target for several of the larger consolidators (CenturyLink, Windstream, Frontier), a sale to Consolidated creates the potential for a double pay-off for North State shareholders if stock were exchanged as consideration (or partial consideration) in a sale.

- Iowa Telecom, of the likely publicly-traded suitors, may make the least strategic sense, at least at first glance, given the lack of geographic proximity of the company's operations to North State's service area and Iowa Telecom's apparent interest in building its Midwestern presence. An acquisition of North State also would be a larger transaction than the combinations Iowa Telecom has pursued over the last eighteen months. However, North State's debt-free balance sheet could be very attractive to Iowa Telecom as a means to reduce the company's leverage and become more attractive to larger consolidators. In addition, as with Consolidated, there may be the potential for a double pay-off if stock were exchange in a sale and Iowa Telecom subsequently is acquired by one of the larger consolidators.

If North State's Board were to decide, as have a number of other high-quality, mid-sized carriers, that the Company might maximize value for its customers, employees and shareholders by divesting the business to become part of a larger operator, there are multiple logical parties that likely would be interested in a transaction and that could satisfy the goal of maximizing long-term value.

Estimating the Value of North State

A primary purpose is to offer preliminary calculations of North State's value today and in the foreseeable future.

A primary purpose of this report is to offer preliminary calculations of North State's value and compare that value with a valuation might be expected in the foreseeable future. As noted at the outset, the data used in this report are limited, but they permit a reasonable approximation of the Company's current value. Further, if the forward-looking model found on page 32 is generally correct, it is also possible to state that the Company's value is unlikely to appreciate and could diminish over the next several years, unless unanticipated factors drive superior value creation.

Current valuation perspectives

While North State's shares are listed publicly (in the NASDAQ Over-the-Counter Pink Sheets market), the stock is very thinly traded. As a result of the lack of liquidity in the shares, the implied valuation of North State and its equity from the inefficient marketplace is not a reliable indication of the true value of the Company. There are three obvious approaches to valuing North State. The Company can be valued using comparable transaction multiples, which may be the most effective approach as it

reveals the values that a willing buyer and seller have been setting in the marketplace. The approach has additional merit because the transactional market is so active at the present. A second approach would set North State's value based on multiples derived from the trading of more liquid public ILEC securities. The third approach would be to construct a discounted cash flow (DCF) valuation. The difficulty with the DCF in this study is the absence of detailed projections from management, especially as so much of a DCF's value is tied to assumptions about the terminal value. The following discussion focuses on the first two approaches.

Comparable transaction multiple approach

The transactional market has been active and provides good insight into how companies and investors think about the value of ILEC businesses.

As noted above in the section on valuation perspectives, the transactional market has been active and provides good insight into how companies and investors think about the value of ILEC businesses. Specifically, since late August 2007, the ten taxable transactions in the $60 million to $600 million range provide a reasonable indication of North State's potential valuation. Using the various EV / trailing EBITDA multiples—mean, median, minimum and maximum—from this group of transactions, coupled with North State's unaudited 2008 adjusted EBITDA (which includes cash distributions from unconsolidated entities), plus the value of cash and investment securities, generates potential enterprise values for the Company ranging from around $283 million to approximately $490 million, as found in Table 19.

The mean and median valuations—$367 million to $390 million—reflect a reasonable indicative valuation range for North State based on a hypothetical near-term transaction. The valuation appears reasonable, despite the current challenges in the financial markets, given North State's proximity to acquisitive consolidators, high-quality plant, attractive markets, and debt-free balance sheet. In fact, based on the sale of nearby CT to Windstream at a 10.3x pre-synergies multiple, North State might be valued relatively more highly than the mean or median figures, as the CT multiple would imply a value of approximately $475 million. However, North State's below average margins and relatively high line losses could cause the valuation for the Company to tend more toward the mean / median multiple range as opposed to the maximum multiple range. As noted earlier, the minimum

Table 17 utilizes projected 2013 financial data and calculates the variance with the current implied transactional enterprise values.

Table 19: North State valuation using comparable company transactions

($s in 000s, except per share prices)

Unaudited 2008:				
EBITDA		$ 37,351		
Cash Distributions		6,316		
Adjusted EBITDA		**43,667**		
Cash & Total Investment Securities		$ 26,852		
	EV / EBITDA	**Implied EV**	**Implied Per Share Value**	**Premium to Current**
Mean	8.3	$ 390,277	$ 164.67	90.7%
Median	7.8	367,455	155.04	79.6%
Minimum	5.9	283,396	119.58	38.5%
Maximum	10.6	489,722	206.63	139.4%

[1] Multiples are for transactions valued from $60 million to $600 million
[2] Curr. EV estimated at $205 mil. based on 2.37 mil. shares O/S, $75 per share, no debt, & $27 mil. cash & invest.

Source: Company data; Balhoff & Williams, LLC.

valuation multiple is inconsistent with the other multiples in the comparable transaction group, as no other acquisition had a multiple of less than 7.4x. Obviously, the ultimate valuation would depend on the specific acquirer and the achievable synergy opportunities. The far right column calculates the premium that might be achieved through a transaction compared with the current enterprise value estimated using North State's public share price and shares outstanding. As the data indicate, it is not unreasonable to expect that North State might be assigned a value in a transaction that is well higher than the value implied by the Company's publicly-traded shares.

Depending on the directional change in valuation multiples over this period, the decline in enterprise value could be less, but in the authors' opinion, could very well be worse.

It is also instructive to consider how North State's value in a strategic combination might increase or decrease over time. Table 20 provides the same analysis performed in the previous table, only it utilizes projected 2013 financial data and calculates the variance with the current implied transactional enterprise values. For this analysis, the assumption is that the valuation multiples as applied to changing cash flows remain the same as today. This simplifying assumption is unlikely to occur in reality given the numerous factors that will impact ILEC valuations going forward. While it is possible that other factors might influence higher multiples, including the benefit of a recovery in the financial markets, there are also potential pressures on valuations as fundamentals deteriorate and fewer consolidators compete for properties. Still, the approach appears to be informative regarding the trends and North State's value in coming years.

Table 20: Potential North State 2013 valuation based on comparable companies

($s in 000s, except per share prices)

Projected 2013:	
EBITDA	$ 32,298
Cash Distributions	4,500
Adjusted EBITDA	**36,798**
Cash & Total Investment Securities	$ 26,165

	EV / EBITDA	Implied EV	Implied Per Share Value	2013 EV vs. 2008 EV % Change	2013 EV vs. 2008 EV $ Change	$ Change Per Share
Mean	8.3	$ 332,421	$ 140.26	-14.8%	$ (57,855)	$ (24.41)
Median	7.8	313,189	132.15	-14.8%	(54,265)	(22.90)
Minimum	5.9	242,353	102.26	-14.5%	(41,042)	(17.32)
Maximum	10.6	416,224	175.62	-15.0%	(73,498)	(31.01)

[1] Multiples are for transactions valued from $60 million to $600 million
[2] Per share calculations based on 2.37 mil. Shares O/S

Source: Company data; Balhoff & Williams, LLC.

Table 20 illustrates a potential valuation of North State if one assumes that adjusted EBITDA declines by 15.7% and cash and investment securities fall by 2.6% from 2008 to 2103. This is clearly a hypothetical analysis, and invites management and the Board to evaluate whether the cash flow assumptions are reasonable and whether the valuation multiples are likely to become more favorable, less favorable, or remain constant. Holding the multiples constant, the projected declines in adjusted EBITDA and cash and investment securities result in approximately a 15% drop in transactional enterprise value by 2013. Perhaps more striking, however, is the fact that within just five years the analysis illustrates that North State could lose $54 million ($23 per share) to $58 million ($24 per share) in value (based on mean and median multiples), with the possibility that the loss of value

could be as high as $73 million ($31 per share) if the Company were to command a premium multiple. Depending on the directional change in valuation multiples over this period, the decline in enterprise value could be less, but in the authors' opinion, could very well be worse (if regulatory pressures are more strenuous or the competitive environment deteriorates).

Public market multiple approach

Public market telecom carrier valuations have been under pressure in the last twelve months as a result of the profound downturn in the financial markets, as well as the challenged industry fundamentals and general weakness in the economy. However, there has been a rebound in share prices in recent months, providing a much needed lift to sector valuations. Against this backdrop, a valuation of North State using current public market multiples might be closer to the low end of fair value for the Company, but the recent rebound has made market-based valuations more reasonable. In any event, the use of public market multiples provides an important perspective in assessing value.

Table 21: Public market multiples for local telecommunications carriers

($s in millions, except dividends)

	Ticker	Mkt. Cap[1]	Net Debt	EV	2009E[2] Revenue	2009E[2] EBITDA	2009E[2] Dividend	EV / Revenue	EV / EBITDA	Debt / EBITDA	Dividend Yield
RBOCs											
AT&T	T	$ 159,487	$ 69,372	$ 228,859	$ 123,260	$ 41,650	$ 1.64	1.9 x	5.5 x	1.7 x	6.1%
Verizon	VZ	84,066	49,734	133,800	80,195	24,968	1.90	1.7 x	5.4 x	2.0 x	6.4%
Qwest	Q	5,925	12,327	18,252	12,420	4,303	0.32	1.5 x	4.2 x	2.9 x	9.2%
Mean								*1.7 x*	*5.0 x*	*2.2 x*	*7.2%*
Median								*1.7 x*	*5.4 x*	*2.0 x*	*6.4%*
RLECs											
Alaska Communications	ALSK	$ 378	$ 528	$ 906	$ 384	$ 127	$ 0.86	2.4 x	7.1 x	4.2 x	10.2%
CenturyLink	CTL	9,309	8,100	17,409	5,099	2,495	2.80	3.4 x	7.0 x	3.2 x	8.9%
Frontier	FTR	2,264	4,498	6,762	2,139	1,146	1.00	3.2 x	5.9 x	3.9 x	13.7%
Consolidated	CNSL	444	863	1,307	408	168	1.55	3.2 x	7.8 x	5.1 x	10.3%
HickoryTech	HTCO	110	114	224	156	41	0.52	1.4 x	5.4 x	2.8 x	6.2%
Iowa Telecom	IWA	402	515	917	251	126	1.62	3.7 x	7.3 x	4.1 x	13.0%
SureWest	SURW	175	228	403	245	77	-	1.6 x	5.2 x	3.0 x	0.0%
Otelco	OTT	173	261	434	103	47	1.68	4.2 x	9.2 x	5.6 x	12.8%
Windstream	WIN	4,194	5,067	9,261	3,028	1,536	1.00	3.1 x	6.0 x	3.3 x	10.3%
Mean								*2.9 x*	*6.8 x*	*3.9 x*	*9.5%*
Median								*3.2 x*	*7.0 x*	*3.9 x*	*10.3%*

[1] Market Capitalization based on closing stock price as of 9/18/09.

[2] 2009 Revenue and EBITDA based on published analyst estimates; HTCO based on company guidance and B&W estimates.

Source: Company data; Balhoff & Williams, LLC.

Table 21 provides a summary analysis of valuations, valuation multiples, and other key data for publicly-traded telecom carriers.

The RBOC data are presented primarily for informational purposes, as the size and diversified operations of the large regional companies make them less comparable to North State. The analysis and discussion below will focus on the publicly-traded RLECs, which although typically larger than North State are closer in size and have similar business models focused principally on wireline communications in rural and smaller suburban markets. As is evident from the data, the RLECs tend to trade at a premium to the RBOCs based on EV / Revenue and EV / EBITDA due to the perception that the RLECs have more stable operating characteristics and less competitive exposure than the RBOCs. In addition, the RLEC group recently has paid higher dividends to equity holders than those of the RBOCs, as reflected in the median 10.3% RLEC dividend yield relative to the median 6.4% yield for the RBOCs. The RLEC dividend policies are not all positive, as some institutional investors have concerns over the sustainability of the dividend levels and the companies' need to reinvest capital in their businesses. However, there generally has been a higher value assigned to the current return of capital to investors by the RLECs. As a result, the RLEC group currently is trading at median multiples—EV / Revenue and EV / EBITDA—of 3.2x and 7.0x, respectively, compared with the RBOC multiples of 1.7x and 5.4x, respectively.

The importance of deleveraging could make North State an attractive partner for certain of these companies, likely expanding the value of North State on the basis of its debt-free balance sheet.

One other noteworthy statistic in the table is that the RLECs generally have relatively higher leverage, as is reflected in a median RLEC Net Debt / EBITDA ratio of 3.9x. What the table fails to capture is that, as fundamentals have continued to be pressured by competition and economic weakness as well as regulatory uncertainty, many of these companies have pursued more aggressively deleveraging activities, often accomplished through transactions. The importance of deleveraging could make North State an attractive partner for certain of these companies, likely expanding the value of North State on the basis of its debt-free balance sheet.

Table 22: Public market multiples for smaller RLECs

($s in millions, except dividends)	Ticker	Mkt. Cap[1]	Net Debt	EV	2009E[2] Revenue	2009E[2] EBITDA	2009E[2] Dividend	EV / Revenue	EV / EBITDA	Debt / EBITDA	Dividend Yield
Smaller RLECs											
Alaska Communications	ALSK	$ 378	$ 528	$ 906	$ 384	$ 127	$ 0.86	2.4 x	7.1 x	4.2 x	10.2%
Consolidated	CNSL	444	863	1,307	408	168	1.55	3.2 x	7.8 x	5.1 x	10.3%
HickoryTech	HTCO	110	114	224	156	41	0.52	1.4 x	5.4 x	2.8 x	6.2%
Iowa Telecom	IWA	402	515	917	251	126	1.62	3.7 x	7.3 x	4.1 x	13.0%
SureWest	SURW	175	228	403	245	77	-	1.6 x	5.2 x	3.0 x	0.0%
Otelco	OTT	173	261	434	103	47	1.68	4.2 x	9.2 x	5.6 x	12.8%
Mean								*2.8 x*	*7.0 x*	*4.1 x*	*8.7%*
Median								*2.8 x*	*7.2 x*	*4.1 x*	*10.2%*

[1] Market Capitalization based on closing stock price as of 9/18/09.

[2] 2009 Revenue and EBITDA based on published analyst estimates; HTCO based on company guidance and B&W estimates.

Source: Company data; Balhoff & Williams, LLC.

A more targeted assessment of public market comparable companies might focus on the "smaller RLEC" subset of the overall RLEC group to understand the valuations of companies that are more similar in size to North State. Table 22 provides data for the "smaller RLEC" group of companies, which excludes CenturyLink, Frontier, and Windstream, all of which have enterprise values in excess of $6.5 billion. As the table indicates, the "smaller RLECs" trade at a slight premium to the overall RLEC group in terms of median EV / EBITDA multiples. The multiple is 7.2x for the smaller companies versus 7.0x for the broader group, while the median revenue multiple is slightly lower at 2.8x for the smaller companies and 3.2x for the total RLEC group. Additionally, the smaller companies are slightly more leveraged, with a median Net Debt / EBITDA ratio of 4.1x. These data are provided for informational purposes, but the overall RLEC group is used in this report's public market valuation to be conservative and to rely on a broader data set.

Table 23 uses the median public RLEC multiples drawn from the broader set of companies to calculate current (based on 2009 estimated financial results) and future (based on 2013 estimated financial results) enterprise values for North State. As with the transaction value approach, the valuation is based on an adjusted EBITDA figure to incorporate the regular cash distributions the Company receives, primarily from its Alltel / Verizon Wireless partnership stake. In addition, since public market valuations are by definition reflective of the value of a minority interest in the companies, there is an adjustment to add a control premium to correct the implied public market minority interest discount. Finally, we add the expected value of cash and investment securities to get an implied enterprise value. As the table indicates, on an EBITDA basis, North State's implied enterprise value is approximately $383 million today, which is consistent with the mean-median range of transactional values, and reflects a premium of approximately 87% to today's market valuation of North State's illiquid shares. Assuming the median EBITDA multiple were to remain constant, the Company's expected declining financial performance results in a future 2013 value of around $360 million, or a 6% (approximately $23 million) loss of value relative to today's implied value.

On a revenue basis, the table suggests that North State's implied enterprise value is approximately $425 million today, which is toward the higher end of the transactional value range and reflects a premium of approximately 108% over the Company's current market value. The relatively higher revenue-based public market value for North State as compared to the EBITDA-based value derives from the Company's lower-than-average ability to convert these revenues into operating cash flows (i.e., its lower EBITDA margins). Pending a better understanding of the fundamental reasons for North State's lower margins, it is possible that the revenue-based valuation provides a truer reflection of firm value in this instance, assuming there is realistic potential that the Company's margins can be normalized to industry averages through expense reductions or cost controls. Assuming the median revenue multiple remains constant over time, North State's value in 2013 would decline to around $410 million, a 4% (approximately $15 million) loss of value, due to projected falling revenues. Again, unless the deteriorating operating and financial trends can be reversed, there predictably is value leakage, not value creation, over time.

Table 23: North State valuation based on public market multiples

($s in 000s)				2013 EV vs. 2009 EV	
		2009E	2013E	% Change	$ Change
EBITDA Basis:					
EBITDA		$ 34,818	$ 32,298		
Cash Distributions		5,000	4,500		
Adjusted EBITDA		$ 39,818	$ 36,798		
Public RLEC Median EV / EBITDA (9/18/09)		7.0 x	7.0 x		
Implied North State Public Market Value		277,835	256,762		
Control Premium	*30.0%*	*83,350*	*77,029*		
Implied North State Public Market Control Value		361,185	333,791		
Cash & Total Investment Securities		21,992	26,165		
Implied North State Enterprise Value		$ 383,177	$ 359,956	-6.1%	$ (23,221)
Premium to Current[1]		*87.3%*	*75.9%*		
Revenue Basis:					
Revenue		$ 98,078	$ 93,483		
Public RLEC Median EV / Revenue (9/18/09)		3.2 x	3.2 x		
Implied North State Public Market Value		310,035	295,510		
Control Premium	*30.0%*	*93,011*	*88,653*		
Implied North State Public Market Control Value		403,046	384,163		
Cash & Total Investment Securities		21,992	26,165		
Implied North State Enterprise Value		$ 425,038	$ 410,328	-3.5%	$ (14,710)
Premium to Current[1]		*107.7%*	*100.5%*		

[1] Current EV estimated at $205 mil. based on 2.37 mil. shares O/S, $75 per share, no debt, & $27 mil. cash & investments

Source: Company data; Balhoff & Williams, LLC.

Auctions in the future are likely to result in relatively lower prices for ILEC assets.

One other factor is that consolidation is occurring at a relatively rapid rate today. As the rural operations consolidate into relatively few carriers, there is the potential that valuations will be depressed to some degree. The reason is that today there are several consolidators that are vying for the same properties. Five years from now, it is more likely that the number of bidders will be fewer and those carriers' balance sheets may or may not permit fully-priced bids. As a result, the auctions in the future are likely to result in relatively lower prices for ILEC assets.

Summary Observations

North State is an important ILEC in North Carolina, in terms of size and the Company's attractive assets.

North State is an important ILEC in North Carolina, in terms of size and the Company's attractive assets. It is the fifth largest ILEC in the state, trailing AT&T/BellSouth, CenturyLink (Embarq), Windstream and Verizon. The Company's balance sheet is exceptional and its plant appears to be high-quality based on the level of investment reported in the Company's financials.

North State's ILEC operations reflect the pressures besetting the broader industry as the Company is reporting in 2008 that the line loss was 7.2%, revenue contraction was 3.2%, and EBITDA margins slipped to 36.7% which is slightly lower than the industry average. The Company's broadband opportunity appears significant as the broadband penetration rate was about 25.9% although recent subscriber growth has slowed sharply.

North State's regulatory exposure does not appear to be extreme as federal universal service receipts are not high as a percentage of total revenues (3.4%), and intrastate access rates are not as elevated as those of some other carriers that provide service in North Carolina or in other states. Still, a negative reform of either access or USF could cause harm to operating profitability since North State's costs do not go down with either "revenue" stream. The authors believe that negative regulatory reforms are likely over the next five years, but the B&W projection model referenced in this report does not include any such negative impact and it is assumed that changes would be gradual.

The summary valuation exercise that B&W has performed relies on transactional and public market multiples applied to the Company's financials for the most recent period. B&W believes that North State might be valued at around 8.0x EBITDA and possibly up to 10.0x EBITDA under certain circumstances. The rationale for such valuation is that there are several companies that would be attracted to North State's service territory, including companies like CenturyLink, Windstream, Frontier, Comporium, Hargray, Consolidated Communications and others. Additionally, the Company's balance sheet is attractive, particularly in a financial environment in which a consolidator might be seeking to de-lever. Finally, the high-quality plant in an attractive market that is contiguous with other carriers' operations would also be positive features.

It is the authors' opinion that it is more probable that the assets of North State will be valued at a lower level five years from now compared with the valuation today. This report suggests that the valuation might be lower by around 15%, but it is probably more

B&W has created a projection model that builds on industry and Company trends, without assuming any exceptional change in operations or regulation. It is very possible that pending regulatory changes will be negative for the industry, but the model does not assume such an outcome. It is estimated that the Company's adjusted EBITDA will contract about 16% over the next five years in light of current trends. While it is a challenge to predict several years into the future in telecommunications, it appears very probable that negative factors—technology, competition and regulation—will pressure the company, possibly driving down pricing and attracting more competitors. On the other hand, it is possible that new opportunities for fiber-based broadband services will emerge or that the policymakers will provide more support monies in a world in which broadband is important, but such a net positive outcome does not appear as probable as the outlook projected in the model. Thus, it is the authors' opinion that it is more probable that the assets of North State will be valued at a lower level five years from now compared with the valuation today. This report suggests that the valuation might be lower by around 15%, but it is probably more balanced to suggest that the valuation decline is likely to be 5% to 25%. It is difficult to project cash flow expansion over that period in light of the slowing broadband and wireless growth, particularly as highly profitable wireline services are contracting at an accelerating pace.

The report does provide a further summary assessment of the Company's FTTH-based broadband initiative. Again, the future is difficult to assess, but it appears that there is meaningful risk that North State may not be able to achieve an appropriate economic return on its substantial investment in a fiber-to-the-home network. That assessment has certain simplifying assumptions, but B&W believes that the risk of further value erosion is meaningful. However, it is difficult to predict beyond several years in the current dynamic communications environment and new very high-speed data services may drive incremental revenue streams for carriers in the future. If that is the case, North State will be well positioned to take advantage of these longer-term opportunities.

The other major insight of this report is that virtually all of the major rural carriers are evaluating transactions for strategic reasons. With non-existent organic growth, the managements of all of the sizeable carriers have been assessing and are still assessing transactions, which generate operating synergies and permit the carriers to strengthen their balance sheets. The consolidators are focused urgently on identifying and targeting the most attractive and sizeable transactions. The smaller carriers are evaluating whether they can get large enough in the near term to create incremental value—but it is relatively clear to the smaller carriers that they are seeking to avoid the erosion of value as cash flows contract.

The scenarios outlined in this report may not be the only outcomes in the incumbent local exchange industry, but the trends and the strategic patterns are relatively clear today. Value creation appears transactionally-based in an industry with contracting fundamentals. Against that backdrop, this report has attempted to clarify how the market might value North State and what are the alternative value creation strategies that the Company might pursue.

About Balhoff & Williams, LLC

Balhoff & Williams, LLC, is a specialized professional services organization focused on providing financial and regulatory advice regarding the communications and energy industries. The principals of the firm have more than thirty years of combined experience in advising investors, companies and policymakers on complex investment, transactional and policy issues. The principals of Balhoff & Williams have extensive experience serving the telecommunications industry, including RBOCs, independent incumbent LECs, competitive carriers, and wireless operators, with particular expertise related to rural telephone providers. Additionally, we specialize in energy and other utility services industries. Our firm offers an unparalleled combination of experience, credibility, strategic insight and access in a rapidly changing environment.

Michael J. Balhoff, CFA, Managing Partner

Michael J. Balhoff, CFA, is managing partner at Balhoff & Williams, LLC. Previously, Mr. Balhoff headed for 16 years the Telecommunications Equity Research Group at Legg Mason, and covered equities of incumbent local exchange carriers. Prior to joining Legg Mason in 1989, Mr. Balhoff held posts as a graduate and undergraduate professor. He has a doctorate in Canon Law and four master's degrees, including an M.B.A., concentration in finance, from the University of Maryland. A Chartered Financial Analyst and a member of the Baltimore Security Analysts Society, Mr. Balhoff has been named on six occasions as a Wall Street Journal All-Star Analyst for his recommendations of stocks in the Telecommunications industry. His coverage of telecom, and especially rural telecommunications, was named by Institutional Investor as the top telecommunications boutique in the country in 2003. He has also testified multiple times before congressional committees, state regulatory and legislative bodies, is regularly a featured speaker at conferences for investors and policymakers, and is widely quoted in the media, including television, newspapers as well as communications and business journals.

Bradley P. Williams, Esq., Partner

Bradley P. Williams joined the firm as a principal in 2005 and was named partner in 2007. Previously, Mr. Williams was a member of the Strategic Planning & Business Development group at Lowe's Companies Inc., the Fortune 50 home improvement retailer. Prior to joining Lowe's, Mr. Williams worked with Mr. Balhoff in the award-winning Telecommunications Equity Research Group at Legg Mason, focusing on incumbent and rural local exchange carriers. Prior to joining Legg Mason, Mr. Williams was a co-founder of eSprocket / Beachfire, a venture-backed company that evolved into one of the pioneers in mediation technology solutions for the financial services sector. Previously, he served as a financial executive for a Washington, D.C.-based holding company that integrated, through acquisitions, a significant regional freight rail network. Brad began his career as an investment banker in First Union's Capital Markets Group. He has a BA in Economics from the University of North Carolina and a JD from the University of North Carolina School of Law.