

2013  
SHAREHOLDER  
UPDATE

Q3



## TO OUR SHAREHOLDERS

Following is an update of our performance for the three and nine months ending September 30, 2013. Highlighting the 2013 third quarter was continued growth in Strategic Revenues. The sale of our wireless assets closed at the end of July as migration of our former wireless customers to AT&T will take place over the next several months. Our Raleigh data center is operational with groundbreaking of our Charlotte data center to take place in mid-November of this year—completion is anticipated early in the third quarter of 2014. The 50,000-square-foot Charlotte facility will be located on the North Carolina Research Campus. Visit [NCRResearchCampus.net](http://NCRResearchCampus.net) to learn more about the location.

We are pleased with the results of our fiber-based broadband strategy and our entry into the growing data center market. Broadband margins are at an all-time high. Data center margins are strong and at levels we expected. We anticipate some margin contraction here as we go through the start-up stages of our new facilities. Our strategic direction has evolved to a very tight focus on fiber-based products for homes and mid-size businesses and collocation, managed data and cloud services for enterprise customers. Strategic revenues accounted for 64% of net operating revenues in the first nine months of 2013 compared to 59% at the end of the same period in 2012, reflecting on the execution of our strategy to transition North State into a leading broadband and data center provider. With the sale of our wireless assets, we are removed from the volatility that comes with being a small player in the retail wireless market. We remain a player in wireless and mobile data through our Verizon wireless partnership where we participate in both partnership earnings and cash flows. Our capital plans to support future growth are focused on a balance of extending fiber to neighborhoods and businesses, and on investments in our data center operations. Our dividend program is a key element of shareholder value. Our long-term strategy remains focused on maintaining our dividend into the future. As well, we continue to repurchase shares as they come available as a further means of returning cash to shareholders. Thank you for your continued interest in North State.



**J. Patrick Harman**  
Chairman and  
Chief Executive Officer



**Royster Tucker III**  
Vice Chairman, President  
and Chief Operating Officer



**Jonathan M. Cage**  
Vice President, Chief Financial Officer

## Summary of Statements of Net Income with Discontinued Operations—Unaudited

	Quarter Ended September 30				Nine Months Ended September 30			
	2013	2012	Change	% Change	2013	2012	Change	% Change
Net operating revenues (after uncollectibles)								
Strategic	\$14.5	\$13.2	\$1.3	9.3%	\$42.7	\$38.5	\$4.2	10.9%
Residential legacy telecom	3.5	3.9	(0.4)	-8.4%	11.0	11.8	(0.8)	-7.0%
Wholesale	3.6	3.6	0.0	1.3%	10.7	13.0	(2.3)	-17.7%
Advertising and search	0.8	0.8	0.0	0.8%	2.3	2.3	0.0	2.0%
Net operating revenue	22.4	21.5	0.9	4.4%	66.7	65.6	1.1	1.7%
Operating expense								
Cost of sales and services	9.0	10.9	(1.9)	-17.0%	27.0	31.3	(4.3)	-13.7%
Selling, general, and administrative	6.3	5.3	1.0	18.5%	17.9	15.9	2.0	12.8%
Depreciation and amortization	5.3	4.1	1.2	27.2%	14.5	13.5	1.0	7.1%
Total operating expense	20.6	20.3	0.3	1.3%	59.4	60.7	(1.3)	-2.1%
Operating income	1.8	1.2	0.6	59.0%	7.3	4.9	2.4	48.9%
Nonoperating income (expense)								
Interest income	0.0	0.0	0.0	-11.6%	0.1	0.1	0.0	-54.7%
Interest expense	(0.2)	(0.3)	0.1	14.1%	(0.8)	(0.9)	0.1	17.8%
Equity in earnings of unconsolidated entities	1.8	1.5	0.3	18.3%	5.4	4.4	1.0	23.1%
Net gain (loss) on sale of investment securities	0.0	0.2	(0.2)	-99.7%	0.0	0.4	(0.4)	-99.9%
Other income, net	0.0	0.0	0.0	-198.7%	0.3	0.0	0.3	964.6%
Total nonoperating income	1.6	1.4	0.2	10.5%	5.0	4.0	1.0	26.2%
Income from continuing operations before income taxes	3.4	2.6	0.8	32.4%	12.3	8.9	3.4	38.7%
Income taxes from continuing operations	1.1	1.0	0.1	17.9%	4.5	3.3	1.2	36.8%
Income from continuing operations	2.3	1.6	0.7	41.1%	7.8	5.6	2.2	39.9%
Discontinued operations:								
Income from operations of discontinued business segment	0.6	0.9	(0.3)	-38.1%	3.8	3.0	0.8	27.7%
Gain on sale of discontinued business segment	9.2	0.0	9.2		9.2	0.0	9.2	
Income taxes from discontinued operations	3.8	0.3	3.5	991.6%	5.0	1.2	3.8	335.7%
Income from discontinued operations	6.0	0.6	5.4	991.8%	8.0	1.8	6.2	335.7%
Net income	\$8.3	\$2.2	\$6.1	279.9%	\$15.8	\$7.4	\$8.4	113.2%
Earnings per share	\$3.63	\$0.95	\$2.68	282.1%	\$6.88	\$3.21	\$3.67	114.3%
Normalized EPS (excludes gain on sale of wireless assets)	\$1.12	\$0.95	\$0.17	17.9%	\$4.37	\$3.21	\$1.16	36.1%

Amounts in millions except per share amounts

## 2013 THIRD QUARTER CONSOLIDATED FINANCIAL HIGHLIGHTS

Consolidated net operating revenues from continuing operations were \$22.4 million in the third quarter of 2013 compared to \$21.5 million for the 2012 third quarter, reflecting increased revenues from strategic services. Total operating expenses for the quarter increased 0.3% compared to the second quarter of 2012. Cost of sales and services was down 17%, the result of focused cost savings initiatives. Sales, general and administrative expenses were up 18.5%, primarily the result of start-up costs associated with our new data centers and costs associated with increased sales. Depreciation and amortization was \$5.3 million in the third quarter of 2013 compared to \$4.4 million in the third quarter of 2012, an increase of \$.9 million, which was due primarily to the effects of a change in accounting method in the treatment of certain plant assets. Video set top boxes that had been depreciated when placed in service are now being depreciated when purchased in order to better account for the useful life of those assets. Operating income was \$1.8 million compared to \$1.2 million. Non-operating income was \$1.6 million compared to \$1.4 million, reflecting an 18.3% increase in equity in earnings of our Verizon wireless partnership. Income from continuing operations was \$2.3 million compared to \$1.6 million in the third quarter of 2012. Net income was \$8.3 million including the gain from the sale of our wireless assets. Excluding the gain, net income was \$2.7 million, up from \$2.2 million in the year earlier third quarter. Earnings per share were \$3.63, including the gain, and \$1.12, excluding the gain, up from \$0.95 in the third quarter of 2012. EBITDA was \$18.8 million, including the gain, and \$9.6 million, excluding the gain, compared to \$8.2 million in the third quarter of 2012.

Net cash provided by operating activities was \$6.7 million for the third quarter of 2013 compared to \$8.2 million for the third quarter of 2012, reflecting a decrease in the deferred income tax benefits due to the reduction in bonus tax depreciation for 2013

compared to 2012. Cash distributions from our Verizon wireless partnership were \$2.0 million in the second quarter of 2013 compared to \$2.3 million in the second quarter of 2012, reflecting timing differences. Capital expenditures were \$2.3 million compared to \$7.9 million in the same quarter of last year, with the difference primarily related to fiber builds in the third quarter of 2012. Free cash flow (cash from operating activities plus cash distributions from Verizon minus capital expenditures) was \$6.4 million in the third quarter of 2013 compared to \$2.6 million in the third quarter of 2012. Cash dividends were \$3.0 million in the third quarter of 2013, equal to dividends paid in the third quarter of 2012.

## NET OPERATING REVENUES

### STRATEGIC REVENUES

Strategic revenues, generated from business services and residential broadband services, were \$14.5 million in the third quarter of 2013, up 9.3% compared to the third quarter of 2012. Revenues from business services, which include data center services, IP voice, integrated data products, broadband and traditional voice services were \$9.1 million in the third quarter of 2013 compared to \$8.7 million in the third quarter of 2012, driven by a 15% increase in data center revenues generated by DataChambers, our wholly owned data center subsidiary. DataChambers revenues were \$3.1 million in the third quarter of 2013 compared to \$2.7 million in the third quarter of 2012. Wireline business service revenues were \$6.0 million in the third quarter of 2013, flat when compared to the third quarter of 2012. Higher IP voice sales in the third quarter of 2013, which deliver a monthly recurring revenue stream over time, were offset by lower system sales in the quarter, where revenue is recognized at the time of sale. Average wireline revenue per business increased 6% in the third quarter of 2013, reflecting ongoing growth in the adoption of IP voice and high bandwidth broadband and data products.

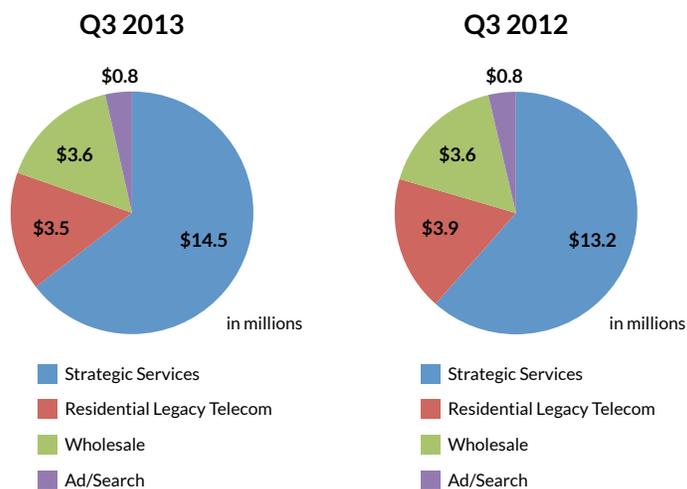
Residential broadband revenues, which include video and broadband Internet services, were \$5.3 million in

the third quarter of 2013, up 17% compared to the third quarter of 2012 as a result of growth in total broadband connections and a 16% increase in average revenue per residential broadband connection. Residential broadband connections totaled 37,997 at the end of the third quarter of 2013, up 2% from the third quarter of 2012.

**RESIDENTIAL LEGACY TELECOM, WHOLESALE AND ADVERTISING & SEARCH**

Revenues from residential legacy telecom, generated primarily from basic residential phone services, were \$3.5 million in the third quarter 2013, down 8.4% compared to the third quarter of 2012. Wholesale revenues, primarily generated from access services, were flat compared to the third quarter of 2012. Access revenues, impacted by federal reform and lower volume, have remained stable over the last four quarters after a sharp decline in the third quarter of 2012. Advertising and search revenues generated from print yellow page advertising, online advertising and search products, were \$0.8 million in the third quarter of 2013, the same as 2012. Growth in online revenues during the quarter offset declines in print revenues.

**Strategic Revenues**



## Consolidated Balance Sheets—Unaudited

At September 30,	2013	2012
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 9,289,793	\$ 3,567,695
Investment securities	13,865,158	-
Accounts receivable, net of allowance for doubtful accounts	8,639,571	9,618,458
Materials and supplies	2,637,853	5,241,922
Prepayments	1,327,453	1,449,441
Income taxes recoverable	383,908	2,387,801
Deferred income taxes	1,003,313	3,719,075
Assets held for sale, net of liabilities	-	10,672,238
Total current assets	37,147,049	36,656,630
Property, plant, and equipment	464,835,625	453,403,373
Less accumulated depreciation	318,638,017	303,577,960
Property, plant, and equipment, net	146,197,608	149,825,413
Other assets:		
Investment securities	4,449,358	3,750,167
Investments in unconsolidated entities	9,363,926	10,165,735
Intangibles, net of amortization	17,728,183	19,024,650
Goodwill	27,232,656	27,232,656
Other noncurrent assets	3,755,633	2,593,709
Total other assets	62,529,756	62,766,917
Total assets	\$ 245,874,413	\$ 249,248,960
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Revolving credit note	\$ -	\$ 5,000,000
Current maturities of bank note	5,500,000	-
Accounts payable and payroll withholdings	2,840,381	2,132,101
Advance billings and customer deposits	3,311,329	3,134,627
Income taxes payable	693,198	166,515
Accrued expenses	4,994,199	6,631,690
Accrued taxes	1,161,023	1,173,839
Total current liabilities	18,500,130	18,238,772
Other liabilities:		
Bank note, net of current maturities	48,125,000	55,000,000
Deferred income taxes	23,801,518	23,377,113
Accrued pension benefits	43,393,375	37,409,165
Accrued postretirement benefits	1,155,579	1,200,131
Other liabilities and deferred credits	774,268	931,084
Total other liabilities	117,249,740	117,917,493
Total liabilities	135,749,870	136,156,265
Stockholders' equity:		
Preferred stock	1,946,300	1,965,600
Common stock	11,443,285	11,463,565
Paid in capital	47,324	45,658
Retained earnings	122,631,501	123,458,874
Accumulated other comprehensive loss	(25,943,867)	(23,841,002)
Total stockholders' equity	110,124,543	113,092,695
Total liabilities and stockholders' equity	\$ 245,874,413	\$ 249,248,960

## Consolidated Statements of Net Income with Discontinued Operations—Unaudited

Nine Months Ended September 30,	2013	2012
<b>Operating revenues:</b>		
Local service	\$ 17,966,983	\$ 18,817,007
Network access	12,364,247	14,753,439
Long distance	2,744,856	2,851,623
Miscellaneous	1,143,811	964,553
Legacy telecom	34,219,897	37,386,622
Broadband	22,655,115	19,346,161
Total wireline	56,875,012	56,732,783
Data center	8,984,881	7,886,354
Advertising and search	2,451,814	2,432,181
Total operating revenues	68,311,707	67,051,318
Less uncollectible revenue	1,583,673	1,432,997
Net operating revenues	66,728,034	65,618,321
<b>Cost of sales and service:</b>		
General support	3,747,666	3,617,825
Central office	6,742,602	8,745,882
Communication termination	7,712,176	8,607,196
Cable and wire facilities	3,055,014	4,310,038
Network operations	5,731,672	5,993,314
Total cost of sales and service	26,989,130	31,274,255
Gross margin	39,738,904	34,344,066
Depreciation and amortization expense	14,501,192	13,537,940
<b>Selling, general, and administrative expense:</b>		
Customer operations	11,647,974	10,398,829
Corporate operations	5,288,094	4,488,493
Taxes, other than income taxes	1,006,472	1,019,604
Total selling, general, and administrative expense	17,942,540	15,906,926
Net operating income	7,295,172	4,899,200
<b>Nonoperating income (expense):</b>		
Interest income	56,177	123,980
Interest expense, net of capitalized interest	(779,807)	(948,687)
Equity in earnings of unconsolidated entities	5,432,108	4,413,403
Net gain on sale of investment securities	475	358,323
Other income, net	308,355	28,965
Net nonoperating income	5,017,308	3,975,984
Income from continuing operations before income taxes	12,312,480	8,875,184
Income taxes from continuing operations	4,509,010	3,296,208
Income from continuing operations	7,803,470	5,578,976
<b>Discontinued operations:</b>		
Income from operations of discontinued business segment	3,817,597	2,989,776
Gain on sale of discontinued business segment	9,208,657	-
Less: income taxes from discontinued operations	5,021,800	1,152,678
Income from discontinued operations	8,004,454	1,837,098
Net income	15,807,924	7,416,074
Preferred stock dividends	46,561	47,041
Net income available to common stockholders	\$ 15,761,363	\$ 7,369,033
Earnings per average common share	\$6.88	\$3.21
Normalized EPS (excludes gain on sale of wireless assets)	\$4.37	\$3.21
Weighted average common shares outstanding	2,290,109	2,294,134
Dividends per common share	\$3.90	\$3.90

## Consolidated Statements of Comprehensive Income—Unaudited

<b>Nine Months Ended September 30,</b>	<b>2013</b>		<b>2012</b>	
Net income	\$	15,807,924	\$	7,416,074
Other comprehensive income, net of tax:				
Unrealized holding gains arising during the period, net of tax expense in 2013 of \$147,134 and tax expense in 2012 of \$81,030		225,501		124,191
Other comprehensive income, net of tax		225,501		124,191
Comprehensive income	\$	16,033,425	\$	7,540,265

## Consolidated Statements of Stockholders' Equity—Unaudited

Nine Months Ended September 30,	Preferred Stock	Common Stock	Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income			Total Stockholders' Equity
					Retirement Plans	Marketable Securities	Total	
Balance, January 1, 2012	\$ 1,985,100	\$ 11,478,450	\$ 43,718	\$ 125,264,278	\$ (23,822,385)	\$ (142,808)	\$ (23,965,193)	\$ 114,806,353
Acquisition of stock	(19,500)	(14,885)	1,940					(32,445)
Net income				7,416,074				7,416,074
Preferred stock dividends				(47,041)				(47,041)
Common stock dividends				(8,948,021)				(8,948,021)
Acquisition of common stock in excess of stated value				(226,416)				(226,416)
Unrealized gain on marketable securities, net of tax expense						124,191	124,191	124,191
Balance, September 30, 2012	\$ 1,965,600	\$ 11,463,565	\$ 45,658	\$ 123,458,874	\$ (23,822,385)	\$ (18,617)	\$ (23,841,002)	\$ 113,092,695
Balance, January 1, 2013	\$ 1,965,600	\$ 11,463,565	\$ 45,658	\$ 116,084,044	\$ (26,160,721)	\$ (8,647)	\$ (26,169,368)	\$ 103,389,499
Acquisition of stock	(19,300)	(20,280)	1,666					(37,914)
Net income				15,807,924				15,807,924
Preferred stock dividends				(46,561)				(46,561)
Common stock dividends				(8,933,386)				(8,933,386)
Acquisition of common stock in excess of stated value				(280,520)				(280,520)
Unrealized gain on marketable securities, net of tax expense						225,501	225,501	225,501
Balance, September 30, 2013	\$ 1,946,300	\$ 11,443,285	\$ 47,324	\$ 122,631,501	\$ (26,160,721)	\$ 216,854	\$ (25,943,867)	\$ 110,124,543

## Consolidated Statements of Cash Flows—Unaudited

Nine Months Ended September 30,	2013	2012
<b>Cash flows from operating activities:</b>		
Net income	\$ 15,807,924	\$ 7,416,074
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,150,519	14,401,480
Change in the allowance for doubtful accounts	(38,000)	-
Gain on sale of investment securities	(475)	(358,323)
Donated land	372,414	-
Loss on sale, disposal, and abandonment of other assets	204,536	329,678
Gain on sale of wireless assets	(9,208,657)	-
Equity in earnings of unconsolidated entities	(5,432,108)	(4,413,403)
Deferred income taxes	(216,204)	5,158,596
Deferred pension and postretirement benefits	1,893,472	1,504,149
Changes in operating assets and liabilities:		
Accounts receivable	351,331	(765,909)
Materials and supplies	2,652,782	773,428
Other assets	(1,994,937)	2,842,045
Accounts payable and payroll withholdings	(1,814,487)	(4,295,459)
Accrued expenses	852,509	1,472,775
Other liabilities	250,119	(2,401,399)
Net cash provided by operating activities	<u>18,830,738</u>	<u>21,663,732</u>
<b>Cash flow from investing activities:</b>		
Additions to property, plant, and equipment	(9,580,447)	(25,956,109)
Cost of removal of telephone plant, net of salvage	26,919	(61,757)
Proceeds from sale of wireless assets, net of expenses	20,891,389	-
Proceeds from sale of investment securities	105,134	5,387,084
Purchases of investment securities	(13,969,068)	(612,207)
Distributions from equity investments	-	161,341
Distributions from unconsolidated entities	5,752,395	5,810,500
Net cash provided by (used in) investing activities	<u>3,226,322</u>	<u>(15,271,148)</u>
<b>Cash flows from financing activities:</b>		
Principal payments on term loan	(1,375,000)	-
Proceeds (repayments) from revolving credit note, net	(6,000,000)	2,500,000
Loan origination fees	(6,082)	(4,210)
Acquisition of preferred stock	(17,634)	(17,560)
Acquisition of common stock	(300,800)	(241,301)
Cash dividends paid	(8,979,947)	(8,995,062)
Net cash used in financing activities	<u>(16,679,463)</u>	<u>(6,758,133)</u>
Net change in cash and cash equivalents	5,377,597	(365,549)
Cash and cash equivalents at beginning of year	3,912,196	3,933,244
Cash and cash equivalents at end of period	<u>\$ 9,289,793</u>	<u>\$ 3,567,695</u>
Short term investment securities at end of period	<u>\$ 13,865,158</u>	<u>\$ -</u>
Total cash, cash equivalents, and short term investment securities	<u>\$ 23,154,951</u>	<u>\$ 3,567,695</u>
<b>Supplemental cash flow information:</b>		
Cash payments (refunds) of income taxes	<u>\$ 6,256,674</u>	<u>\$ (541,867)</u>
Cash paid for interest	<u>\$ 812,347</u>	<u>\$ 904,721</u>

I, Jonathan M. Cage, hereby certify that the accompanying unaudited consolidated balance sheets of North State Telecommunications Corporation and Subsidiaries as of September 30, 2013 and 2012 and the related unaudited consolidated statements of net income, comprehensive income, stockholders' equity, and cash flows for the nine months then ended have been prepared from the Corporation's and Subsidiaries' accounting records. Internal accounting controls and review procedures provide assurance that these statements are materially accurate.

This is the 23rd day of October 2013.



Jonathan M. Cage

Vice President, Chief Financial Officer, Secretary and Treasurer

## BOARD OF DIRECTORS

**J. Patrick Harman**—Chairman  
**Royster Tucker III**—Vice Chairman  
**C. Hayden McKenzie**  
**Jonathan M. Cage**  
**William H. Dula**

**David L. Harman**  
**Coulson S. Mucher**  
**Sarah M. Olson**  
**Lizbeth W. Privette**

## OFFICERS

**J. Patrick Harman**  
Chairman and  
Chief Executive Officer

**James D. McCarson**  
Vice President,  
Corporate Administration

**Royster Tucker III**  
Vice Chairman, President  
and Chief Operating Officer

**W. Mark Dula**  
Vice President,  
Technology and Operations

**Jonathan M. Cage**  
Vice President, Chief Financial Officer

**Richard P. Worden**  
Vice President,  
Sales and Marketing

## CORPORATE OFFICES

111 North Main Street, High Point, North Carolina 27260

Telephone: (336) 886-3600