

2016
SHAREHOLDER
UPDATE

Q1



To Our Shareholders:

Following is North State's update of performance and activities for the first quarter of 2016. Due to our added focus and business direction, beginning with the first quarter of 2016, we are revising our revenue reporting segments. Our new reporting segments are:


- *Internet and Communications*—includes revenues from business and consumer wireline Internet, data, entertainment, legacy voice, access services and advertising services.
- *IT Services and Hardware*—includes revenues from collocation, managed and professional services, telecom and IT equipment and unified communications as a service (“UCAAS”).

Additionally, we are reporting revenues in a “Business and Wholesale” view and a “Consumer” view. The reporting segments are refined into “Strategic Revenues,” noting our key strategic growth drivers, and “Legacy Revenues,” noting revenues from sources attached to legacy telecom products and services. We manage our assets on a total company basis; therefore, operating expenses, capital expenditures and other items are reported on a consolidated basis. Revenues from all brands and subsidiaries roll up into this new reporting structure.

Financial results for the first quarter of 2016 are highlighted by strategic revenues of \$18.9 million, an increase of 50% over the prior year—the result of our Stalwart acquisition, in addition to increased demand for IT services and fiber products. Consumer demand for fiber-delivered Gigabit Internet remains strong as we generated year-over-year Internet and Communications revenue growth. Business customers continue to transition to fiber and UCAAS products and are increasingly seeking support as they look to migrate portions of their business to the cloud and manage today's more complex IT systems and infrastructure. At the end of the quarter, 66% of net operating revenues came from strategic products and services. 63% of strategic revenues were generated by business customers.



J. Patrick Harman
Chairman



Royster Tucker III
President & CEO



Jonathan M. Cage
Vice President & CFO

CONSOLIDATED QUARTERLY FINANCIAL RESULTS

North State's consolidated net operating revenues for the first quarter were \$28.7 million, up 27% from the year-earlier period, largely due to the acquisition of Stalwart Systems in July of 2015 and revenue growth across all of our strategic services. Operating expenses, excluding depreciation and amortization, were \$21.4 million compared to \$16.2 million, largely due to the Stalwart acquisition. Net operating income was \$2.5 million compared to \$1.9 million. Net non-operating income was \$1.3 million compared to \$2 million, largely due to lower reported net income from our Verizon Wireless partnership. Partnership results were lower for the quarter due to timing and the true-up of actual results. Net income was \$2.4 million, the same as the prior year quarter. Earnings per share were \$1.04 compared to \$1.09. Cash flow from operating activities was \$8.3 million compared to \$6.7 million. Cash distributions from unconsolidated entities (the Verizon Wireless partnership) were \$1.5 million, the same as the first quarter of 2015. Total cash generation (cash flows from operations plus partnership cash distributions) was \$9.8 million, compared to \$8.2 million last year. Capital expenditures in the first quarter of 2016 were \$4.2 million compared to \$8.0 million. Free cash flow (total cash generated minus capital expenditures) was \$5.6 million compared to \$0.2 million. EBITDA was \$9.0 million compared to \$8.6 million. In May of 2016, a large national bank provided the Company with a non-cancelable commitment letter for the refinancing of the Company's existing term note and line of credit facility. As such, the Company's existing debt obligations have been classified as long-term debt on the accompanying consolidated balance sheet as of March 31, 2016 in accordance with the terms of the commitment letter.

Internet and Communications Segment

- Net operating revenues for the segment were \$19.2 million, up 6.4% from the prior year.
- Strategic net operating revenues from consumers were \$6.9 million for the quarter, up 21.9% from the previous year, driven by increased Internet and entertainment revenue.
- Legacy net operating revenues were \$6.8 million, up 1.7% from the previous year, as favorable access settlements offset declines in revenues from legacy voice and data products.

IT Services and Hardware Segment

- Strategic revenues from business customers comprise this entire segment.
- Strategic net operating revenues from business customers were \$9.5 million for the quarter, up from \$4.6 million in the prior year. This was driven by increased revenue from telecom and IT equipment as well as managed and professional services.

Summary of Statements of Net Income—Unaudited

Amounts in millions except per share amounts

| Three Months Ended March 31, | 2016 | 2015 | Change | % Change |
|---|-------------|-------------|---------------|-----------------|
| Net operating revenue (after uncollectibles): | | | | |
| Internet and communications | \$19.2 | \$18.0 | \$1.2 | 6.4% |
| Information technology services and hardware | 9.5 | 4.6 | 4.9 | 107.6% |
| Net operating revenue | 28.7 | 22.6 | 6.1 | 26.9% |
| Operating expense: | | | | |
| Cost of sales and service | 13.6 | 9.3 | 4.3 | 45.7% |
| Selling, general, and administrative | 7.8 | 6.9 | 0.9 | 12.7% |
| Depreciation and amortization | 4.8 | 4.5 | 0.3 | 8.5% |
| Total operating expense | 26.2 | 20.7 | 5.5 | 26.7% |
| Operating income | 2.5 | 1.9 | 0.6 | 29.1% |
| Nonoperating income | 1.3 | 2.0 | (0.7) | -37.0% |
| Income before taxes | 3.8 | 3.9 | (0.1) | -4.7% |
| Income taxes | 1.4 | 1.5 | (0.1) | -5.9% |
| Net income | \$2.4 | \$2.4 | \$0.0 | -4.0% |
| Earnings per share | \$1.04 | \$1.09 | (\$0.05) | -4.6% |

Summary of Net Operating Revenue—Unaudited

| Three Months Ended March 31, | 2016 | 2015 | Change | % Change |
|---|---------------|---------------|---------------|-----------------|
| TOTAL NET OPERATING REVENUE | | | | |
| Internet and communications: | | | | |
| Strategic | \$9.4 | \$8.0 | \$1.4 | 17.1% |
| Legacy | 9.8 | 10.0 | (0.2) | -2.1% |
| Total internet and communications | 19.2 | 18.0 | 1.2 | 6.4% |
| IT services and hardware | 9.5 | 4.6 | 4.9 | 107.6% |
| Total net operating revenue | <u>\$28.7</u> | <u>\$22.6</u> | <u>\$6.1</u> | 26.9% |
| TOTAL BUSINESS AND WHOLESALE NET OPERATING REVENUE | | | | |
| Internet and communications: | | | | |
| Strategic | \$2.4 | \$2.3 | \$0.1 | 5.2% |
| Legacy | 6.8 | 6.6 | 0.2 | 1.7% |
| Total internet and communications | 9.2 | 8.9 | 0.3 | 2.6% |
| IT services and hardware | 9.5 | 4.6 | 4.9 | 107.6% |
| Total net operating revenue | <u>\$18.7</u> | <u>\$13.5</u> | <u>\$5.2</u> | 38.1% |
| TOTAL CONSUMER NET OPERATING REVENUE | | | | |
| Internet and communications: | | | | |
| Strategic | \$6.9 | \$5.7 | \$1.2 | 21.9% |
| Legacy | 3.1 | 3.4 | (0.3) | -9.5% |
| Total net operating revenue | <u>\$10.0</u> | <u>\$9.1</u> | <u>\$0.9</u> | 10.1% |

Consolidated Balance Sheets—Unaudited

| At March 31, | 2016 | 2015 |
|---|-----------------------|-----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,364,866 | \$ 10,047,052 |
| Investment securities | - | 1,608,610 |
| Accounts receivable, net of allowance for doubtful accounts | 9,874,306 | 7,270,479 |
| Materials and supplies | 2,204,183 | 2,199,498 |
| Prepayments | 2,208,097 | 2,011,066 |
| Income taxes recoverable | 206,788 | - |
| Deferred income taxes | 620,214 | 696,586 |
| Total current assets | <u>18,478,454</u> | <u>23,833,291</u> |
| Property, plant, and equipment | 502,585,924 | 481,602,334 |
| Less accumulated depreciation | 351,017,996 | 335,660,117 |
| Property, plant, and equipment, net | <u>151,567,928</u> | <u>145,942,217</u> |
| Other assets: | | |
| Investment securities | 642,292 | 4,731,125 |
| Investments in unconsolidated entities | 8,864,395 | 9,108,044 |
| Intangibles, net of amortization | 16,261,451 | 15,783,483 |
| Goodwill | 31,794,755 | 27,232,656 |
| Other noncurrent assets | 972,832 | 1,167,914 |
| Total other assets | <u>58,535,725</u> | <u>58,023,222</u> |
| Total assets | <u>\$ 228,582,107</u> | <u>\$ 227,798,730</u> |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Revolving credit note | \$ 4,500,000 | \$ - |
| Current maturities of bank note | 1,375,000 | 5,500,000 |
| Current maturities of capital lease obligations | 148,907 | - |
| Accounts payable and payroll withholdings | 2,243,383 | 3,815,469 |
| Advance billings and customer deposits | 3,342,746 | 3,211,047 |
| Income taxes payable | - | 931,962 |
| Accrued expenses | 5,987,409 | 6,666,443 |
| Accrued taxes | 643,246 | 706,813 |
| Total current liabilities | <u>18,240,691</u> | <u>20,831,734</u> |
| Other liabilities: | | |
| Bank note, net of current maturities | 38,500,000 | 39,875,000 |
| Capital lease obligations, net of current maturities | 5,910,799 | - |
| Deferred income taxes | 25,175,798 | 26,256,800 |
| Accrued pension benefits | 41,759,936 | 31,967,159 |
| Accrued postretirement benefits | 620,092 | 808,406 |
| Other liabilities and deferred credits | 1,377,204 | 655,168 |
| Total other liabilities | <u>113,343,829</u> | <u>99,562,533</u> |
| Total liabilities | <u>131,584,520</u> | <u>120,394,267</u> |
| Stockholders' equity: | | |
| Preferred stock | 1,888,600 | 1,914,900 |
| Common stock | 11,365,255 | 11,393,380 |
| Paid in capital | 58,658 | 54,062 |
| Retained earnings | 116,674,250 | 119,227,104 |
| Accumulated other comprehensive loss | (32,989,176) | (25,184,983) |
| Total stockholders' equity | <u>96,997,587</u> | <u>107,404,463</u> |
| Total liabilities and stockholders' equity | <u>\$ 228,582,107</u> | <u>\$ 227,798,730</u> |

Consolidated Statements of Net Income—Unaudited

| Three Months Ended March 31, | 2016 | 2015 |
|--|--------------|--------------|
| Operating revenues: | | |
| Internet and communications: | | |
| Strategic internet and data | \$ 6,884,750 | \$ 6,166,634 |
| Strategic entertainment | 2,645,014 | 2,148,303 |
| Legacy voice | 8,515,347 | 8,525,035 |
| Legacy long distance | 690,749 | 740,083 |
| Legacy advertising and search | 628,339 | 740,504 |
| Total internet and communications | 19,364,199 | 18,320,559 |
| Information technology services and hardware: | | |
| Strategic telecom and IT equipment | 3,973,872 | 509,338 |
| Strategic colocation | 2,809,319 | 2,788,847 |
| Strategic managed and professional services | 2,234,941 | 822,321 |
| Strategic UCAAS | 470,352 | 449,057 |
| Total IT services and hardware | 9,488,484 | 4,569,563 |
| Total operating revenues | 28,852,683 | 22,890,122 |
| Less uncollectible revenue | 175,611 | 287,147 |
| Net operating revenues | 28,677,072 | 22,602,975 |
| Cost of sales and service: | | |
| General support | 1,699,788 | 1,549,493 |
| Central office | 2,052,512 | 2,140,394 |
| Communication termination | 6,699,367 | 2,816,419 |
| Cable and wire facilities | 778,961 | 877,812 |
| Network operations | 2,338,326 | 1,927,430 |
| Total cost of sales and service | 13,568,954 | 9,311,548 |
| Gross margin | 15,108,118 | 13,291,427 |
| Depreciation and amortization expense | 4,843,733 | 4,465,436 |
| Selling, general, and administrative expense: | | |
| Customer operations | 4,509,729 | 4,555,732 |
| Corporate operations | 2,850,860 | 2,002,665 |
| Taxes, other than income taxes | 420,535 | 343,818 |
| Total selling, general, and administrative expense | 7,781,124 | 6,902,215 |
| Net operating income | 2,483,261 | 1,923,776 |
| Nonoperating income (expense): | | |
| Interest income | 5,962 | 28,604 |
| Interest expense, net of capitalized interest | (383,330) | (222,935) |
| Equity in earnings of unconsolidated entities | 1,650,241 | 2,192,945 |
| Net gain (loss) on sale of investment securities | - | 9,545 |
| Other income (expense), net | (3,593) | 5,517 |
| Net nonoperating income | 1,269,280 | 2,013,676 |
| Income before income taxes | 3,752,541 | 3,937,452 |
| Income taxes | 1,377,690 | 1,463,448 |
| Net income | 2,374,851 | 2,474,004 |
| Preferred stock dividends | - | - |
| Net income available to common stockholders | \$ 2,374,851 | \$ 2,474,004 |
| Earnings per average common share | \$ 1.04 | \$ 1.09 |
| Dividends per common share | \$1.30 | \$1.30 |
| Weighted average common shares outstanding | 2,273,381 | 2,278,839 |

Consolidated Statements of Comprehensive Income—Unaudited

| Three Months Ended March 31, | 2016 | 2015 |
|--|--------------|--------------|
| Net income | \$ 2,374,851 | \$ 2,474,004 |
| Other comprehensive income, net of tax: | | |
| Unrealized holding gains arising during the period, net of tax expense in 2015 of \$15,206 | - | 24,372 |
| Other comprehensive income, net of tax | - | 24,372 |
| Comprehensive income | \$ 2,374,851 | \$ 2,498,376 |

Consolidated Statements of Stockholders' Equity—Unaudited

| Three Months Ended March 31, | Preferred Stock | Common Stock | Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income | | | Total Stockholders' Equity |
|--|--------------------|-----------------|--------------------|----------------------|--|--------------------------|-----------------|----------------------------------|
| | | | | | Retirement Plans | Marketable Securities | Total | |
| Balance, January 1, 2015 | \$ 1,915,200 | \$ 11,395,825 | \$ 53,936 | \$ 119,745,974 | \$ (25,616,655) | \$ 407,300 | \$ (25,209,355) | \$ 107,901,580 |
| Acquisition of stock | (300) | (2,445) | 126 | | | | | (2,619) |
| Net income | | | | 2,474,004 | | | | 2,474,004 |
| Preferred stock dividends | | | | - | | | | - |
| Common stock dividends | | | | (2,962,376) | | | | (2,962,376) |
| Acquisition of common stock in excess of stated value | | | | (30,498) | | | | (30,498) |
| Unrealized gain on marketable securities, net of tax expense | | | | | | 24,372 | 24,372 | 24,372 |
| Balance, March 31, 2015 | \$ 1,914,900 | \$ 11,393,380 | \$ 54,062 | \$ 119,227,104 | \$ (25,616,655) | \$ 431,672 | \$ (25,184,983) | \$ 107,404,463 |
| Balance, January 1, 2016 | \$ 1,888,600 | \$ 11,370,200 | \$ 58,658 | \$ 117,296,892 | \$ (33,011,770) | \$ 22,594 | \$ (32,989,176) | \$ 97,625,174 |
| Acquisition of stock | - | (4,945) | - | | | | | (4,945) |
| Net income | | | | 2,374,851 | | | | 2,374,851 |
| Preferred stock dividends | | | | - | | | | - |
| Common stock dividends | | | | (2,954,966) | | | | (2,954,966) |
| Acquisition of common stock in excess of stated value | | | | (42,527) | | | | (42,527) |
| Balance, March 31, 2016 | \$ 1,888,600 | \$ 11,365,255 | \$ 58,658 | \$ 116,674,250 | \$ (33,011,770) | \$ 22,594 | \$ (32,989,176) | \$ 96,997,587 |

Consolidated Statements of Cash Flows—Unaudited

| Three Months Ended March 31, | 2016 | 2015 |
|---|----------------|----------------|
| Cash flows from operating activities: | | |
| Net income | \$ 2,374,851 | \$ 2,474,004 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,843,733 | 4,465,436 |
| Loss (gain) on sale of investment securities | - | (9,545) |
| Loss (gain) on sale, disposal, and abandonment of other assets | 2,044 | 64,827 |
| Equity in earnings of unconsolidated entities | (1,650,241) | (2,192,945) |
| Deferred income taxes | 722,893 | (463,647) |
| Deferred pension and postretirement benefits | 615,611 | 357,502 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,298,272 | 462,576 |
| Materials and supplies | (369,658) | (533,982) |
| Other assets | 4,834,775 | 4,359,602 |
| Accounts payable and payroll withholdings | (3,117,080) | (2,888,252) |
| Accrued expenses | (181,568) | 1,105,717 |
| Other liabilities | (1,052,880) | (542,431) |
| Net cash provided by operating activities | 8,320,752 | 6,658,862 |
| Cash flow from investing activities: | | |
| Additions to property, plant, and equipment | (4,229,814) | (8,006,276) |
| Cost of removal of telephone plant, net of salvage | 12,364 | (8,953) |
| Proceeds from sale of wireless assets-escrow, net | - | 2,350,000 |
| Proceeds from sale of investment securities | - | 2,080,000 |
| Distributions from equity investments | - | 23,834 |
| Distributions from unconsolidated entities | 1,452,625 | 1,452,625 |
| Net cash provided by (used in) investing activities | (2,764,825) | (2,108,770) |
| Cash flows from financing activities: | | |
| Principal payments on term loan | (1,375,000) | (1,375,000) |
| Principal payments on capital leases | (35,909) | - |
| Loan origination fees | - | (1,606) |
| Acquisition of preferred stock | - | (174) |
| Acquisition of common stock | (47,472) | (32,943) |
| Cash dividends paid | (2,954,966) | (2,962,376) |
| Net cash used in financing activities | (4,413,347) | (4,372,099) |
| Net change in cash and cash equivalents | 1,142,580 | 177,993 |
| Cash and cash equivalents at beginning of period | 2,222,286 | 9,869,059 |
| Cash and cash equivalents at end of period | \$ 3,364,866 | \$ 10,047,052 |
| Short term investment securities at end of period | \$ - | \$ 1,608,610 |
| Total cash, cash equivalents, and short term investment securities | \$ 3,364,866 | \$ 11,655,662 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for (refunds of) income taxes | \$ (3,500,000) | \$ (2,000,000) |
| Cash paid for interest | \$ 365,862 | \$ 227,980 |

I, Jonathan M. Cage, hereby certify that the accompanying unaudited consolidated balance sheets of North State Telecommunications Corporation and Subsidiaries as of March 31, 2016 and 2015 and the related unaudited consolidated statements of net income, comprehensive income, stockholders' equity, and cash flows for the quarter 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 26th day of April 2016.



Jonathan M. Cage
VP-Chief Financial Officer

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Chief Business Officer

CORPORATE OFFICES

111 North Main Street, High Point, North Carolina 27260

Telephone: (336) 886-3600