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VZ - Q1 2014 Verizon Earnings Conference Call

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## OVERVIEW:

Co. announced 1Q14 GAAP EPS of \$1.15 and adjusted EPS of \$0.84. Guidance was given for 2014 consolidated topline growth of 4%.



## CORPORATE PARTICIPANTS

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## PRESENTATION

### Operator

Good morning and welcome to the Verizon first-quarter 2014 earnings conference call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time.

It is now my pleasure to turn the call over to your host, Mr. Michael Stefanski, Senior Vice President, Investor Relations.

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**Michael Stefanski** - *Verizon Communications, Inc. - SVP, IR*

Thanks, David. Good morning and welcome to our first-quarter 2014 earnings conference call. This is Mike Stefanski and I am here with our Chief Financial Officer, Fran Shammo. Thank you for joining us this morning.

Before we get started, let me remind you that our earnings release, financial and operating information, the investor quarterly, and the presentation slides are available on our Investor Relations website. Replays and a transcript of this call will be made available on our website.

I would also like to draw your attention to our Safe Harbor statement. Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risks and uncertainties. Discussion of factors that may affect future results is contained in Verizon's filings with the SEC, which are also available on our website.

This presentation contains certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are also available on our website. The quarterly growth rates disclosed in this presentation are on a year-over-year basis unless otherwise noted as sequential.

Before Fran takes you through the details of our quarterly performance, I would like to cover a few details about our reported results. For this discussion, let's turn to slide 3.



For the first quarter we reported earnings of \$1.15 per share on a GAAP basis. Our reported results reflect a partial quarter with 55% ownership of Verizon Wireless and just over five weeks with full ownership since the transaction to acquire Vodafone's stake closed on February 21. The weighted average common shares outstanding for the first quarter were 3.430 billion, given the issuance of 1.275 billion new shares of Verizon as part of the deal consideration.

The timing of the closing had no effect on our consolidated income statement or Wireless segment above the operating income line since we have always had operating control of Verizon Wireless. All of the post-closing effects of full ownership are below the operating income line. Our reported first-quarter EPS of \$1.15 includes several non-operational items that I would like to review.

The first item is a gain on the sale of our minority interest in Vodafone Omnitel. This resulted in a one-time, after-tax gain of approximately \$1.9 billion or \$0.55 per share. This is a non-cash item as it was part of the transaction consideration.

The next item is a non-operational charge related to debt redemption. During the first quarter, we announced a partial make-whole redemption and a cash tender offer for various notes with maturities over the next five years and coupons of 5.5% and higher. We redeemed \$5.4 billion of notes through the make-whole redemption and tender offer.

The associated net pretax costs were \$923 million. After-tax, this resulted in a charge of \$575 million or \$0.17 per share. We also incurred interest and financing costs related to the wireless transaction.

As we did in the third and fourth quarters, we are excluding these charges from adjusted results for the period January 1 through the February 21 closing. These transaction costs totaled \$411 million on a pretax basis, resulting in an after-tax charge of \$260 million or \$0.08 per share.

Excluding the effect of these three non-operational items, adjusted earnings per share was \$0.84 for the first quarter, compared with \$0.68 a year ago or growth of 23.5%. Adjusted EPS of \$0.84 reflects 55% ownership of Verizon Wireless for the period January 1 through February 21 and full ownership for the remainder of the quarter. Of course, future quarters will include 100% of the Wireless net income and access to all the Wireless cash flows.

For an illustrative non-GAAP view of adjusted earnings, assuming full ownership of Verizon Wireless for the entire first quarter, let's take a look at slide 4. The elements for this illustrative view are based on the adjustments in the pro forma financial statements filed with the SEC for the periods ending September 30 and December 31, 2013. We also reviewed these transaction effects on our February 24 call when we provided some guidance for items below operating income.

Adjusted EPS of \$0.84 would've been \$0.91 per share, assuming 100% ownership of Wireless for the full quarter. Again, on a non-GAAP illustrative basis.

The adjustments required to demonstrate this are relatively straightforward. The 45% of Wireless net income attributable to Vodafone for the period January 1 through February 21 totaled \$1.2 billion and would be added to adjusted earnings. The transaction-related costs for the same time period would be subtracted.

Accounting for these effects, adjusted earnings would be \$3.8 billion with an effective tax rate of about 35%. The diluted shares outstanding that we used for this illustrative EPS calculation were 4.149 billion shares, which assumes the newly issued shares were outstanding for the entire quarter. In summary, the impact of having 100% ownership of Wireless for only part of the first quarter was worth \$0.07 of earnings per share.

With that, I will now turn the call over to Fran.

**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Mike. Good morning, everyone. As I stated on our last two conference calls, we have great confidence in our ability to generate strong financial performance in 2014. Over the years, our steady and consistent investments in networks and platforms have supported innovative products and services and fueled our growth.

Our wireless and wireline networks will continue to be the hallmark of our brand and provide the fundamental strength upon which we build our competitive advantage. Now that the wireless transaction is behind us, we have the immediate financial benefit of earnings accretion from the deal and full access to the very significant cash flows of Verizon Wireless. As we have previously stated, we are targeting 4% consolidated top-line growth in 2014, with an expansion of our consolidated EBITDA margin.

The ingredients for success are unchanged: solid operational execution and a disciplined focus on meeting our financial objectives and creating value for our shareholders. With an eventful first quarter behind us, I would say we are off to a strong start.

We maintained our growth momentum and delivered excellent top-line and bottom-line results. While the timing of the Wireless transaction closing caused some reporting complexity, our \$0.84 adjusted earnings per share represented growth of 23.5% and would be even greater if you assumed full ownership of Wireless for the entire quarter.

We've consistently delivered high-quality earnings growth with double-digit increases in reported and adjusted earnings per share in eight of the last nine quarters. Our cash flow generation in the quarter was also impressive and we continued to invest in our networks and platforms.

Our Wireless results were very good, with service revenue growth of 7.5% and a service EBITDA margin of 52.1%, an expansion of 170 basis points. In FiOS, our positive revenue growth trends and scale drove a 6.2% increase in consumer revenue. Total Wireline operating revenue declined 0.4% in the quarter, which is our best result in nearly three years.

In terms of profitability, our EBITDA margin was 22.3%, up 90 basis points.

Now let's get into our first-quarter performance in more detail, starting with consolidated results on slide 6.

Total operating revenue grew 4.8% in the first quarter, continuing our consistent top-line growth trend and was our highest growth rate in the past five quarters. Top-line growth was once again driven by Wireless and FiOS. In terms of new revenue streams, machine-to-machine and telematics, while still relatively small, are beginning to emerge and make positive contributions with revenue growth in excess of 40%.

Our focus on operating efficiency and cost controls is enabling our ability to compete effectively and drive consistent, profitable growth. In the first quarter, consolidated operating expenses grew 2%. Operating income growth was 15.1%. We have posted double-digit growth in operating income in eight of the last nine quarters.

Consolidated EBITDA grew 9.3% while our EBITDA margin expanded by 160 basis points to 36.7%. Let's take a look at cash flow results next on slide 7.

When looking at our cash flows, it is important to keep in mind that post-transaction we have immediate access to the full Verizon Wireless cash flows. And apart from a contractual tax distribution in the second quarter for the stub period, we will no longer be making any cash distributions to Vodafone. As a result, the amount of cash available to us will be significantly greater this year.

This is true for the simple reason that under the partnership structure, 45% of excess cash at Wireless would at some point be distributed to Vodafone.

As we discussed on our February 24 call, there will be some lack of comparability between current and prior periods in the statement of cash flows. In 2014, the cash flows from operations line will include higher cash payments for interest and taxes. The cash flows from financing section will have lower cash distributions to Vodafone and higher overall dividend payments to our shareholders due to the increase in shares outstanding.

In the first quarter, cash flows from operations were \$7.1 billion, which included an incremental \$1.3 billion of cash interest payments and \$200 million of pension funding that we did not have in the first quarter of 2013. In spite of these additional uses of cash and higher capital spending, free cash flow totaled \$3 billion in the quarter.

For illustrative purposes, free cash flow available to Verizon in the first quarter was more than \$1 billion higher than a year ago, assuming that 45% of the free cash flow at Wireless would've been distributed to Vodafone. Again, the point here is more free cash flow available at the corporate level than prior to the transaction, even after higher interest payments and cash taxes.

Capital expenditures in the quarter totaled \$4.2 billion, up \$548 million with all the increase in Wireless. With our 4G LTE coverage build complete, Wireless spending is now focused on adding capacity and density to our existing coverage and utilizing our AWS spectrum to further optimize the network. As we have previously stated, our estimate for total capital spending in 2014 will be in the range of \$16.5 billion to \$17 billion.

In addition to the transaction closing, we had a large amount of financing activities in the quarter. At closing, our gross debt was approximately \$114 billion. Since then, we announced the make-whole redemption and a tender offer, did some debt restructuring, and had \$2.5 billion of notes mature.

We ended the quarter with gross debt of just under \$110 billion and net debt to adjusted EBITDA ratio of 2.5 times. Our balance sheet remains strong and we have the financial flexibility needed to grow the business.

Our priorities for cash utilization are unchanged. We will continue to invest in our networks, acquire spectrum, and return to our pre-transaction credit ratings profile within four to five years. We do not need to execute any major acquisitions to drive our business model. We understand the importance of our dividend and our Board of Directors has shown its support by approving dividend increases in each of the last seven years.

In terms of acquiring new spectrum, we will continue to be opportunistic. Earlier this month we signed agreements to acquire the wireless licenses of Cincinnati Bell along with some tower leases. We will continue to look at the secondary market and we will consider the opportunities in the upcoming FCC auctions.

Now let's move into a review of the segments, starting with Wireless on slide 8.

Our consistent investment in Wireless is the foundation of our success and drives our leadership in network quality, reliability, and the overall customer experience. We will continue to build and expand our network advantage in 4G LTE. Our focus is on deploying capital to add density to our network and deliver new services such as VoLTE and multicasting to enrich our customers' wireless experience.

Regardless of what others claim, recent national surveys from widely recognized third-party organizations confirm our leadership. Our own drive testing, which we have been doing for years, shows that we consistently deliver the best customer experience market by market and day by day across the United States.

Total Wireless revenues grew to \$20.9 billion, up 6.9% driven by strong service revenue growth of 7.5%. We generated \$9.4 billion of EBITDA in the quarter, an increase of 11.3%. Our service EBITDA margin in the quarter was 52.1%.

There has certainly been a lot of investor attention centered on the effects of equipment monthly payment plan options for customers. Let me be very clear and provide the financial impact of our Verizon Edge plans for the first quarter.

As you would expect, the number of customer activations on Edge increased sequentially and is also running ahead of our expectations. The estimated EBITDA benefit from the accounting treatment under these plans was worth about \$165 million, which equates to less than 2% of total EBITDA in the quarter. The benefit to our service EBITDA margin was approximately 90 basis points.

While Edge had a favorable effect on profitability, our results demonstrate that we delivered EBITDA growth and margin expansion over and above the benefits of equipment monthly payment plans. Let's now turn to a more detailed look at Wireless revenue per account, beginning on slide 9.



Service revenue in the first quarter was driven by 4G smartphone adoption and tablet growth and increasing data usage. In mid-February, we introduced our More Everything plans, which provide more value through simplified data allowances and more choice for customers.

In addition, we revised our monthly pricing under Verizon Edge for customers who buy their devices on installment payments. Last week we extended this reduced monthly pricing to customers who are currently out of contract. These pricing actions improve the customer value proposition and will help drive further penetration of 4G smartphones and tablets and stimulate usage on our very cost-effective 4G LTE network.

Retail postpaid revenue per account, or ARPA, grew 6.3% to nearly \$160 per month in the first quarter. The lower monthly pricing under the Edge plans had a minimal impact on ARPA this quarter. Going forward, continued Edge adoption will likely have a greater impact on ARPA due to the shift from service to equipment revenue.

Our reduced monthly pricing for out-of-contract customers will also affect the rate of service revenue growth over time.

We ended the quarter with 35.1 million postpaid accounts and connections per account grew to 2.77, up 3.7% from a year ago. More Everything plan adoption continues and we ended the quarter with 50% of postpaid accounts on these shared data plans. A majority of these accounts are in data tiers of 4 gigabytes or higher and usage continues to drive migration to the higher data tiers.

Let's take a closer look at connections growth on slide 10. In the first quarter, postpaid gross adds totaled 3.6 million, up 4.1%. About 56% of our gross adds were smartphones and 33% were tablets and other Internet devices. Retail postpaid churn was 1.07%, up 6 basis points year over year.

On a net basis we added 549,000 new retail connections in the first quarter. Postpaid net adds were 539,000 and prepaid were 10,000. At the end of March, we had 103.3 million total retail connections. Our industry-leading postpaid connections base reached 97.3 million and prepaid totaled just over 6 million.

The first-quarter postpaid add mix included 866,000 4G smartphones and a record 634,000 tablets. We also had 56,000 other connected device adds, primarily home phone connect. These additions were offset by net declines in basic and 3G smartphones resulting in negative total phone net adds.

Our postpaid upgrade rate was 6.5% in the quarter. More than 88% of these upgrades were smartphones. Consistent with our plan to drive smartphone penetration and 4G adoption about 1.5 million or 27% of our smartphone upgrades were from basic phones. More than 50% of the remaining smartphone upgrades were 3G to 4G, which we monetize through higher data usage and lower cost to serve.

Next, let's turn to slide 11 and take a look at device sales and our progress in 4G LTE.

Postpaid device activations, which include both gross adds and upgrades, totaled 9.9 million, an increase of 2%. We had 7.6 million smartphone activations, of which nearly 90% were 4G. Smartphone penetration increased to 72% of our total phones.

We ended the quarter with 61.3 million smartphones and about 64% of those were 4G. So we still have about 22 million 3G smartphones and a little more than 23 million basic phones in our base, which provides us with a good opportunity to move customers up to a 4G smartphone.

We had our best tablet quarter ever, activating 814,000 postpaid tablets, virtually all of which were 4G. This is more than double the amount from the first quarter last year and about 3% more than the fourth quarter. Our postpaid tablet base now stands at 4.3 million, so again we have a great opportunity to expand this category and generate growth in 2014 and beyond.

Overall, 4G device penetration continues to steadily increase. At the end of the first quarter, 49% of our retail postpaid connections were 4G, up from 28% a year ago. Data and video usage on our network continues to rise. Currently about 73% of our total data traffic is carried on the 4G LTE network.



We will continue to focus on extending our network advantage, investing to add density and to optimize our 4G LTE network, ensuring that customers are receiving the quality and consistent reliability they expect from our network.

Let's move next to our Wireline segment, starting with the review of our consumer and mass markets revenue performance on slide 12.

In the consumer business, we continue to see positive revenue trends driven by FiOS. For the last seven quarters, consumer revenues have grown in excess of 4%. In the first quarter consumer revenues were up 6.2%. Mass markets, which include small business, grew 4.9%.

FiOS now represents about 74% of consumer revenue and we are sustaining strong double-digit growth. In the first quarter, FiOS consumer revenue grew 14.6%, driven by customer additions, pricing actions, and Quantum penetration. About 51% of our FiOS Internet customers subscribe to Quantum, with speeds ranging from 50 to 500 megabits per second.

We continue to focus on adding quality customers and generating profitable growth. Residential broadband and video are very competitive markets and we continue to be disciplined and rational in our approach to customer acquisition. In broadband, we added 98,000 new FiOS Internet customers in the first quarter and now have 6.2 million subscribers, representing just under 40% penetration. Overall, net broadband subscribers in the quarter were a positive 16,000.

In FiOS Video we added 57,000 new subscribers in the quarter. Total FiOS Video customers reached 5.3 million, representing 35% penetration.

We also continue to make steady progress with fiber migration. During the quarter we converted about 78,000 customers from copper to superior fiber technology. This network initiative is important as we systematically reduce our dependence on older technologies.

We have begun to see the benefits from a maintenance perspective in what was one of the worst winters in recent memory in the Northeast. Aside from the maintenance savings and improvements in customer satisfaction, conversions to fiber also provide a long-term opportunity for customers to purchase FiOS services, which will result in additional recurring revenue.

Let's turn to slide 13 and review our overall Wireline segment revenue and profitability.

In the enterprise space, we continue to work through secular and economic challenges. In the first quarter, global enterprise revenue declined \$164 million or 4.4%. Revenue declines in legacy transport services and CPE continued to outweigh growth in newer applications, which are smaller in scale.

Strategic services, which include private IP, Ethernet, data center, cloud, security, and managed services, grew 1.8%. This category includes some revenue from the public sector, where we continue to experience revenue pressure. In general, enterprise customers continue to be more focused on improving their cost structure rather than investing for growth, which creates top-line pressure for us.

In our global wholesale business, quarterly revenues declined \$108 million or 6.4%. While we had healthy demand in Ethernet services in the quarter, it was not enough to offset the impacts of technology migration, price compression, and other secular challenges.

From an overall Wireline perspective, total operating revenues were down 0.4%. EBITDA was \$2.2 billion, up 3.4%, resulting in an EBITDA margin of 22.3% for the quarter. Our strategic investments in network technology enable us to deliver reliable and high-quality services and solutions to consumers, small businesses, and enterprise customers. As we scale these key products and services, they will improve our overall revenue mix and drive further operating efficiency.

We are focused on network operating efficiency through improvements in service provisioning and dispatch and repair rates. We remain confident in our ability to increase Wireline EBITDA and expand the margin in 2014. Our financial performance in the first quarter was a good start.

Let's move next to our summary slide. We are off to a strong start, with a 4.8% increase in consolidated revenue and 160 basis point EBITDA margin expansion. We continue to post high-quality, double-digit adjusted earnings growth and have a strong cash position with full access to growing Wireless cash flows. We are on track to achieve our revenue growth, margin expansion, and capital spending targets for the year.

We have good momentum in Wireless and expect to build on that strength, driving further penetration of devices and extending our leadership position in 4G LTE. In FiOS, we expect to drive higher penetration in existing markets and continue to differentiate ourselves with the superior broadband product and our recently introduced FiOS Quantum TV service.

In the enterprise space, we will continue to aggressively market key platforms, demonstrating that we have a unique set of capabilities to provide customer solutions. We remain focused on cost structure improvements to drive productivity and operating efficiencies throughout the entire business, utilizing our Verizon Lean Six Sigma principles.

With that, I'll turn the call back to Mike so we can get to your questions.

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**Michael Stefanski** - Verizon Communications, Inc. - SVP, IR

Thank you, Fran. David, we are now ready to take questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Phil Cusick, JPMorgan.

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**Phil Cusick** - JPMorgan - Analyst

Thanks. So I guess if we just talk about subscribers on both sides; churn up in Wireless leading to some handset share losses this quarter and FiOS softer, too. You seem to be responding to T somewhat with the Edge price cuts recently and allowing people to trade down. How should we think about the impact to ARPA in 2Q and beyond from these trade-down effects?

Then what about responding to cable on the FiOS side? Are you happy with the revenue ramp due to rate increases or do you try harder on subs as we go forward, too? Thanks.

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Good morning, Phil. Look, let's talk about the subs and the churn and then we can talk about the Edge pricing.

First off, I think if you put this quarter in perspective, coming into this quarter from the fourth quarter and the end of the first-quarter call here or the fourth quarter, we talked about how we would take a very rational, disciplined approach in responding to the competitive marketplace. And that's what you saw us do through the quarter.

Now having done that, through January and February we saw a lot of pressure around our basic phone customer base, which is why we launched our low-end 4G price point on More Everything to give those basic customers a chance and a view into getting over to a smartphone on our 4G network. And we saw the improvements through the month of March.

In addition, if you look at our tablet sales, we said coming into this year that tablets would be a major growth trajectory for the entire industry and I think that is what you are seeing. You're going to see that this is a very underpenetrated marketplace and the more we drive tablets into our 4G





network, the more revenue stimulation we create. So we had one of the best tablet quarters ever even without the Christmas season from the fourth quarter.

When you look at the churn, the churn was definitely impacted via the basic phone customer base. We actually had one of the best quarters ever, adding 866,000 4G smartphones to our base, and then another 634 tablets.

So the net effect of the loss was mainly within the basic phone base and some 3G smartphone customers, which led us to then refresh our shared pricing to More Everything. Then we also had to do some response to some of the Edge pricing that the competitive marketplace offered in order for us to be competitive within those high-end data plans.

However, I think it's also important to state that these installment plans, or Edge plan, is a very profitable plan to us. So as we manage the business through prepaid reseller, postpaid subscribers, whether they go on a subsidy model or on an installment sale model, these are all accretive to the business and very profitable plans.

If you look at the ARPA, obviously ARPA, since it does not include equipment revenue, the increase in the take rate of Edge will definitely have an impact on that metric. Do I expect the Edge take rate to increase? Yes, because if you look at the first quarter, most of the Edge product was sold through our direct channel and we will be expanding that to the indirect channel coming here at the very end of the first quarter, mainly in the second quarter.

So the Edge take rate will increase, which will have an impact on service revenue and the ARPA metric. We will have to think about that going into the second quarter as how we report that, but again I feel very confident in coming out of the first quarter with 7.5% service revenue growth and the ARPA growth.

Now as far as the competitive pressures and some of the other moves we've made, look, this goes back to when we first went to shared pricing. We said that it would be dilutive in the short term, but it would drive usage on our network. By moving to Edge and out of contract -- and it's a very small base of customers because you have to be on More Everything and included in the base -- but obviously in the short term this could create some revenue pressure for us.

But, again, it's moving these customers to higher data usage plans, which drive more usage, which in essence drives more revenue. So the guidance we have given you I stand firm on because we have considered all of this into our forecast. I don't really anticipate changing any of that at this point in time.

If I move over to the cable environment with FiOS and the net adds, there were two really main things here that happened. First off, we did a price increase in the fourth quarter and every time we do a price increase we always see some pressure in the churn in the following quarter. But also we had probably one of the worst winters on record here and people did not want us in their houses to install FiOS.

But I think a couple things to point out. One is the competitive pressure from cable did increase in the first quarter. We did not respond immediately because of the environment that we were dealing in with weather. So we waited.

We became more aggressive in March. And I would tell you that exiting the quarter our pipeline has grown and I have a viewpoint that the second quarter will be back on track from a net add perspective. So, Phil, I will leave it at that and hopefully that answers your question.

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**Phil Cusick - JPMorgan - Analyst**

That helps. Thanks, Fran.

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**Operator**

Simon Flannery, Morgan Stanley.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Great, thanks a lot. Good morning, Fran. Just to quickly follow-up on Edge, have you had any change in your view about kind of the sale activity of the Edge product? It seems like T-Mobile and AT&T are pushing these fairly broadly and in the past you sort of said you want to reserve this for your best customers. Any change there?

Then perhaps you could touch a bit more on the network. Where are you on the AWS rollout? Have you solved all the congestion problems you were talking about a couple of quarters ago? Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

First on Edge, look, this is a customer choice. This is not what I want. It really comes into our customer choices. Again, we are going to allow our customers to choose the right plan for them.

If you look at the economics, it depends what phone you choose. So if you decide to take a free iPhone that is out in the marketplace today, you may be better off going on the subsidy plan for two years, end up paying less over time than the installment plan. If you decide to take a very high-end handset, then you may benefit by going to the installment sale. So I think it's a personal choice.

It also comes down to when do you think you are going to upgrade. If you are a customer that wants to hold your phone on for a two-year period of time or longer, it depends what plan you may choose. If you decide you want to upgrade every year, then obviously the installment plan is the plan that you have to select.

This comes down to personal choice and, again, our sales force is not compensated to drive traffic to any one sort of plan. At the end of the day, it's all about customer satisfaction and treating our customers and the choices that they want. Again, the way I look at this is as we manage the business these plans are all profitable plans to us, so it comes down to customer choice.

On the network side of the house, I think that in my script I was pretty deliberate on making some statements there about some third-party studies that were done in the first quarter and I think that speaks to itself as to where we are with our network. We are through the congestion. The network performance is delivering what we expect it to.

And as you see that in our CapEx spending we are going to be more leveled this year. If you know historically we have always had more of a ramp from the first quarter to the fourth quarter. We will be more level with that.

So we are really concentrating on the density and the diversification of the 4G network, especially in the major cities and that's where we have deployed AWS. We will continue to deploy AWS throughout the year, more into the smaller cities and into the rural markets, but right now the concentration is in the major cities like New York, San Francisco, Chicago, etc.

So, Simon, that I think that handles the question. Thanks.

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**Operator**

David Barden, Bank of America.

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**David Barden** - *BofA Merrill Lynch - Analyst*

Thanks for taking the questions. Fran, I apologize, I have to ask one more on Edge, too, which is that one of the things we saw coming out of the AT&T result was that there's really two parts to these installment plans. One is the mechanical part of changing the accounting where you take some of the service revenue and you put it into equipment revenue and that's the relatively easy part.

Another part of the puzzle, though, was that AT&T was very aggressive at pushing this pricing out to people even if they didn't take the installment payment plan because they felt like it was an immunization tool against incremental competition. So could you kind of share with us what we should be expecting from Verizon in terms of not just how the Edge program is going to unfold, but how you're going to use the Edge pricing as a competitive tool if it all?

Then the second question, if I could, was on the Wireline margin side a pretty strong margin, especially for 1Q which historically has seen lots of headwinds for bonuses and FICA and other things. So I was wondering if you could maybe give us a picture of whether we can use 1Q as a starting point for some of the Six Sigma improvements and stuff that you're working on for the rest of the year. Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

All right, David. Good, thanks. On the mechanical side, look, this is a fairly complex accounting for the Edge pricing, but really there's two main components to this.

First is you book up the receivable. You record the revenue over the time, but the amount of revenue that you record is based on the residual value that you assign and the liability that you have set up for that telephone.

I would say that our approach is going to be extremely conservative, so we will probably be recording less revenue up front under the installment sale just so that we can get a feel for what the uncollectability is going to be over time. How much value these phones are going to be worth a year or two years out depending upon how many phones hit the market at the same place. We do think that there could be some saturation effect in the outer years, so we will take a very conservative approach here on the accounting.

As far as the competitive environment, look, I'm not going to speak for anybody else. I think we have shown we will be rational and deliberate on how we respond to the marketplace. We are responding to our customers' request.

This recent move that we made related to allowing out-of-contract subscribers to move over to the Edge pricing I believe is a good move for us, because again it treats our customers the way they want to be treated and it is a retention tool for us. So it will help to deliver a lower churn metric in the future.

And it's up to them whether they want to move. We are not going to deliberately move our customers. It will be totally to their choice. So that's from a competitive environment.

On the Wireline margin, I think that at least everything Lowell and I have been talking about for the last two years is starting to finally come through on the metrics of Wireline. And just a couple things.

I think in the past I would probably be sitting here asking for a pass based on the Northeast corridor storms for the entire winter and one of the worst winters on record. Normally I'd be sitting here talking about repair rates and how much expense we had to incur. And here we sit; with all of the copper-to-fiber migrations that we have done over the last two years, we did another 70,000-plus this quarter. This is really starting to come in through the maintenance side because fiber performs much better during these weather conditions than copper performs.

So I think that all of the Verizon Lean Six Sigma segments -- and I told you I was very confident coming into this year that we could improve the Wireline margin on a year-over-year basis. And I hold to that confidence because of the things that I see between Verizon Lean Six Sigma and also because of the copper-to-fiber migrations that we have able to form.

In addition, of course the good driver of revenue here is through our Quantum products and the uptake of our customers going to the higher speeds and willing to pay more for those higher speeds. Also the congestion in their houses because of the wireless devices they are running off of that Wi-Fi network really demand that fiber into the home that only FiOS can provide. So I think everything together is driving this.

We can talk about the enterprise segment, but as I said coming into the year I think that best we will look at what we did last year. And I think that's where the position will be is we will probably not see any improvement in enterprise in 2014.

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**Operator**

Mike McCormack, Jefferies.

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**Mike McCormack** - *Jefferies & Company - Analyst*

Thanks. Fran, just one thought on smartphones obviously becoming a bigger part of the base. Do you think smartphones are causing shorter handset lives? Meaning as we look at adoption of Edge or other EIP programs, with smartphones needing to be upgraded more often it's actually a better plan for the carriers and particularly for Verizon.

Then secondly on enterprise. If you could just comment -- you made some comments regarding the decline in revenue there. Maybe rank order what you are seeing there with respect to technology change, pricing, and then demand. Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Okay. Look, I think it's way too early to tell yet how the impact of the installment plans will react on the upgrade rate. We have been at this for years and the upgrade rate is pretty steady. We will have fluctuations based on seasonality, but coming out of the first quarter we really didn't see any change in that. But we probably really won't see the impact of early upgrades probably for another six to eight months so I think we're going to have to hold on what the expectation there is.

But I think the other thing, too, though is that, just from an overall product set, smartphones are, as I said coming into the quarter, are going to be a slower portion of the growth I think for the entire industry as we go forward as the penetration grows. But we look to those other facets of the tablets and machine-to-machine and then if you look beyond that with VoLTE and multicast giving our customers even additional features that could potentially drive more usage on the network, so that's really what the future holds for us.

The smartphone category, I do believe that upgrades may increase with Edge, but again I think it's too early to tell.

On the enterprise side, look, I think what we continue to see here is that the United States is the highest corporate taxpayer in the world. And until we fix that situation, with all the discussions in Washington whether extenders will happen, won't happen, whether we will get to tax reform or we won't get to tax reform, there's just too much uncertainty out there for enterprises to really lock down on where they are going in the future.

So I think this is where we are playing right now. The public sector is still a major drag on our results and, as you know, we include the public sector in our enterprise results. That's also now impacting the strategic services because they are also starting to cut and move away from some of the more strategic products.

So I think for this year we just are satisfied with being flat with last year, which is what I came into this year saying. And I think if we can resolve some of the issues and the uncertainties then I think we are on a better path for enterprise. But right now I think we are where we are.

**Mike McCormack** - *Jefferies & Company - Analyst*

Fran, just on the pricing situation, is that a competitive issue or is it just technology change that lowers the price points for the product sets?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Look, we are extremely competitive and have a great product set in our enterprise space. Obviously if we get into the details, if you look at security and look at our cloud services, they are growing. If you look at the Hughes Telematics platform, that's growing in the enterprise space.

But then we have all this legacy voice and core and even within the IP products, you see the price compression happening on those products. And each year it comes up for renewal, you have a price compression so some of it is competitive.

But we are in an extremely competitive environment and, look, people are just cutting. Enterprises are still focused on cost structure. They are not increasing their investments. They are not increasing their spend. So that is where we sit.

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**Mike McCormack** - *Jefferies & Company - Analyst*

Makes sense, thanks, Fran.

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**Operator**

Michael Rollins, Citi Investment Research.

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**Michael Rollins** - *Citigroup - Analyst*

Thanks, good morning. Fran, I was wondering if we could just take a step back in the Wireline business and just talk a little bit about the homes where you don't have FiOS. I think -- and maybe you can give an update on a number. Maybe roughly 8 million homes where you don't have plans to build FiOS.

What do you do in those markets to stay competitive and to try to improve the financial outlook? Or is that a source of even possible asset optimization at some point? Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Sure, Mike, thanks. This could be a record quarter since you didn't ask me about net debt on Wireless, so that's a good thing.

Look, on the FiOS and the copper houses, so within the FiOS footprint as we said we now have less than 1 million homes left that are on copper so we will continue to migrate them. Outside of the FiOS footprint, obviously, really we are taking two measures there.

One is via the Wireless portfolio in replacing some of that old voice -- legacy copper voice with our LTE voice product that Wireless has been selling across the nation for almost two years now called Home Phone Connect. Within Wireline, they have a very similar product called Voice Link, which in essence is the same thing, so we will try to replace that copper legacy with those technologies.

But, look, outside this is kind of where you say you will have to nurture it and harvest what you have. We know that we are not going to be able to compete with speed in that environment and we will continue to do the best we can. Now, there will be certain areas, maybe another year or so, where we may look to extend the fiber a bit and include some small businesses, which we compete extremely well in within the FiOS footprint and they are very profitable customers.



But beyond that, Mike, I think we are in harvest mode and we will continue to do the best we can with the technologies we have as alternatives for our customers.

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**Michael Rollins** - Citigroup - Analyst

Thanks very much.

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**Operator**

John Hodulik, UBS.

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**John Hodulik** - UBS - Analyst

Thanks, guys. Fran, just quickly back to Edge if we could. Can you give us a sense of what the take rates you are seeing on smartphone sales these days? I think you said that it increased with the change in pricing, but if you could give us some color there that would be great.

Then maybe the percentage of smartphones now that are on Edge pricing. And then maybe, if possible, how that is going to evolve over time, especially now that you are moving some of the off-contract customers over to the new pricing.

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Thanks, John. As far as the take rate on Edge, I would tell you that we were less than 15% in the first quarter from a take rate. I expect that to potentially double with the launch of this payment plan option within our indirect channel.

I would also say that it is going to become more and more difficult for us to separate out and give a normalized basis with and without Edge. The reason I say that is, as we start to launch this in our indirect channel, you are going to get into all kinds of confusion of how the commission works, who bought the phone, who's doing -- we will do the installment on that, but we may not have actually sold the phone to the indirect. They may have bought it outright, so there's implications with how compensation will work.

Although we gave you separate data here in the first quarter because it was easy because it was just within our direct channel, I think that is going to become more complicated going out here. So from a take rate perspective it's hard for me to tell what the take rate will be, but I do believe it will probably double into the second quarter with the launch of our indirect channel, John. That's really all I can talk about on the Edge. It's too early for us to tell what the rate will be.

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**John Hodulik** - UBS - Analyst

Okay, but in terms of the percentage of smartphones in the base that are on Edge is it sort of mid-single digits at this point?

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

It's less than 2%.

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**John Hodulik** - UBS - Analyst

Less than 2%, got it, okay. All right, thanks, Fran.



**Operator**

Amir Rozwadowski, Barclays.

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**Amir Rozwadowski** - *Barclays Capital - Analyst*

Thank you very much. Fran, two areas I would like to touch on and this is sort of dovetailing on the prior question. You mentioned that Edge penetration will increase, potentially doubling next quarter. I was wondering if you could give us how much of your earnings growth is attributed to sort of your expectations of rising penetration of Edge.

And then secondly, now that you've fully integrated the contribution of the Wireless business from Vodafone, how should we think about the quarterly progression of earnings now that there's a larger portion of your revenues coming from what one could argue is a less fluctuating wireless business, which may now include less contribution to subsidy costs if Edge penetration rises? Thanks a lot.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Sure, Amir, thanks. On the Edge and the contribution, look, as I just said in the previous question, it's going to be very, very hard for me to start to separate this given the indirect channel.

Look, I think the guidance we have given -- I stand behind the guidance that we've given. We will do our best to try to give some clarity in this going forward. But as I said it's going to be a cloudy environment and it's hard for me to sit here today to say, oh, Edge is going to contribute x basis points of my profitability. I just don't know because I don't know what the take rate will be.

And I want to make sure we talk about take rate, not penetration, so it's going to be the take rate of new additions, not the penetration of the base.

As far as quarterly earnings, this is a great question because historically you would see more of an uptick in second and third quarter. I think now that we have 100% of wireless you're going to see a more consistent earnings per share for us going forward. Other than the fourth quarter, obviously, which is more seasonal so that has its own issues.

But I think you're going to see a more consistent first, second, and third quarter and then the fourth quarter will have its own decline because of the seasonality with that. So that's a good question and thanks for asking.

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**Amir Rozwadowski** - *Barclays Capital - Analyst*

Thanks a lot for your incremental color, Fran.

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**Operator**

Kevin Smithen, Macquarie.

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**Kevin Smithen** - *Macquarie Research Equities - Analyst*

Thanks. Can you talk a little about the recent FCC regulatory comments regarding net neutrality and the broadcast auction rules; what your positions are on this and how you think this evolves over the next several months?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Yes, so I know the FCC was issuing an order today on net neutrality. I have not had a chance to look at the order. We will be excited to read that order and then we can give our comments on that. So unfortunately, being on the call, I have not seen it and been updated on that.

As far as the auctions go, look, I think that we are obviously preparing for those auctions, as I talked about the beginning here, with our gross debt. We are preparing our balance sheet and our financial wherewithal to participate in these auctions coming up.

Look, as we continue to look at these rules and work through these rules, we will continue to behind the scenes, if you will, work with the FCC to get the rules that we need. But it's an important step forward for the pool of spectrum available to meet our customer needs and we will certainly take advantage of what the FCC is working on as far as the auctions go.

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**Kevin Smithen** - *Macquarie Research Equities - Analyst*

And when can we expect to hear more details about your video strategy? I think you said last quarter that it would be soon, so is it still soon or is it very soon?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Kevin, is this on the over-the-top type strategy --?

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**Kevin Smithen** - *Macquarie Research Equities - Analyst*

Yes, and just EdgeCast and VDMS and all of the aggregation of the intellectual property that you bought in the last 12, 18 months.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Yes, so video -- Verizon Video Digital Media Services is ramping up. We are still in what we would call a beta set with a lot of content providers and testing the system. And I believe, as I said before, that revenue will start to ramp in 2014.

So that's the first step in just putting content through and digitalizing that content, potentially inserting ads into that content. Obviously we added the uplink and the EdgeCast assets to that and really that was in preparation to prepare for the over-the-top, if you will. But I think it's still way too early to tell.

On the OnCue acquisition obviously the first priority is IPTV, but as you overlay that to the other asset sets, what I would say is we are in a great position to take advantage of the marketplace when and if content starts to sort itself out from an over-the-top perspective. So that's probably all we would say at this point in time on that one, Kevin.

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**Michael Stefanski** - *Verizon Communications, Inc. - SVP, IR*

David, we have time for one more question.

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**Operator**

Joseph Mastrogiovanni, Credit Suisse.





**Joseph Mastrogiovanni** - *Credit Suisse - Analyst*

Thanks for taking the question. Fran, if I could just follow up to the last question, how should we think about how you are thinking about splitting your budget between the AWS and the broadcast auctions?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Well, I think it's too early to tell. I guess what we are focused on or at least what I am focused on right now is the AWS auction, which we know will happen at the end of this year with the payment being sometime in the first quarter. So that's top priority. And then we will deal with the broadcast licenses after that, within 2015. So right now the priority is AWS.

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**Joseph Mastrogiovanni** - *Credit Suisse - Analyst*

Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thank you.

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**Michael Stefanski** - *Verizon Communications, Inc. - SVP, IR*

That ends our questions. I would like to turn it over to Fran for some closing remarks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Mike. Look, everyone, thank you for joining us this morning.

I think I would just recap and say the first quarter for us was a great start to the year. We consistently invest and focus on the profitable growth to drive strong financial performance in revenue, earnings, and cash flow.

We're focused on customer satisfaction. Our proven ability to scale this business and drive operational efficiencies is in order for us to deliver more value to our customers and compete effectively in all areas of our business.

We continue to focus on our strategy to deliver the highest quality overall customer experience. We listen to our customers, monitor the competitive environment, and respond where necessary in a rational manner. We are very confident in our ability to execute and improve on our business fundamentals, driving consistent customer value while delivering growth in customers, revenues, earnings, and cash flow.

We are very excited about the future of this industry. We are excited about our investment, the innovation curve that we are delivering, the customer satisfaction that we have, and the delivery of value to our shareholders and to our employees, our most valuable asset. So thank you for joining our call this morning and have a great day.

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**Operator**

Ladies and gentlemen, that does conclude the conference call for today. Thank you for your participation and for using Verizon conference services. You may now disconnect.



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