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VZ - Q3 2016 Verizon Communications Inc Earnings Call

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Co. reported 3Q16 reported GAAP EPS of \$0.89.



CORPORATE PARTICIPANTS

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

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

Matt Ellis *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

CONFERENCE CALL PARTICIPANTS

Phil Cusick *JPMorgan - Analyst*

Simon Flannery *Morgan Stanley - Analyst*

John Hodulik *UBS - Analyst*

David Barden *BofA Merrill Lynch - Analyst*

Michael Rollins *Citigroup - Analyst*

Craig Moffett *MoffettNathanson - Analyst*

Brett Feldman *Goldman Sachs - Analyst*

Mike McCormack *Jefferies - Analyst*

Tim Horan *Oppenheimer & Co. - Analyst*

Amir Rozwadowski *Barclays Capital - Analyst*

PRESENTATION

Operator

Good morning and welcome to Verizon's third-quarter 2016 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.

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

Thanks, Jay. Good morning and welcome to our third-quarter earnings conference call. This is Mike Stefanski and I'm here with our Executive Vice President and Chief Financial Officer Fran Shammo and Matt Ellis, our Senior Vice President and Chief Financial Officer of Finance Operations and Chief Financial Officer designee. Thank you for joining us this morning.

As a reminder, our earnings release, financial and operating information, the investor quarterly, and the presentation slides are available on our investor relations website. A replay and a transcript of this call will also be made available on our website.

Before we get started, I would like to draw your attention to our Safe Harbor statement on slide 2. Today's presentation includes forward-looking statements about expected future events and financial results that are subject to risks and uncertainties. Factors that may affect future results are discussed in our filings with the SEC, which are available on our website.

This presentation includes non-GAAP financial measures. Reconciliations of these GAAP measures to the most directly comparable GAAP measures are available on our website. The quarterly growth rates disclosed in our presentation slides and during our formal remarks are on a year-over-year basis unless otherwise noted as sequential.



Before Fran reviews the third-quarter results, I would like to highlight a few items from our quarterly earnings. For the third quarter of 2016, we reported earnings of \$0.89 per share on a GAAP basis. These reported results include several significant nonoperational items that I would like to highlight.

Our reported earnings include a non-cash pretax loss of \$797 million. The pretax pension remeasurement adjustment due to settlement accounting resulted in a \$555 million charge, and severance costs related to existing separation plans amounted to \$242 million. The net impact after tax approximated \$500 million or \$0.12 per share.

In third-quarter 2015, earnings included \$0.05 per share of a non-cash charge due to pension remeasurement. Excluding the effect of these nonoperational items, adjusted earnings per share was \$1.01 in the third quarter, a decline of 2.9% compared with \$1.04 per share a year ago.

Additionally in the quarter we executed on our first on-balance-sheet asset-backed securitization transactions totaling \$2.6 billion.

The cash flow statement reflects asset-backed securitization proceeds in financing cash flow rather than operating cash flow. This captioning impacts the free cash flow metric, but overall net cash available remains unchanged relative to off-balance-sheet securitization. We plan to continue to securitize equipment receivables with on-balance-sheet financings in future periods.

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

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

Thank you, Mike. Good morning, everyone, and thank you for joining us today. 2016 continues to be a transformational year for us, just as we had outlined over a year ago. During this transformation we are executing on a very challenging competitive environment, investing and positioning for the future growth, and returning value to our shareholders.

Competitive activity in the wireless market increased during the third quarter as expected, and we responded in a measured way to grow and retain our valuable customer base by introducing new wireless plans and disciplined promotions.

We have been successful in retaining our high-value postpaid smartphone base and improving service revenue trends. In the Wireline market, we returned to a strong quarter of execution following the strike that impacted the second quarter. We grew our Fios base and improved the consumer revenue trend.

We are focused on continuously improving our overall cost structure through process improvements and operating efficiencies. This execution enabled us to deliver overall strong margins and adjusted earnings per share.

We remain focused on our disciplined capital allocation that consists of investing for growth, returning value to shareholders, and preserving our strong balance sheet. Our investments are consistent with our three-tier strategy, starting with investing in our network by expanding our wireless capacity and pre-positioning for future growth in both 4G and 5G.

We continue to lead in all third-party measures for network performance and reliability. We are investing in new growth businesses in digital media technology to extend our ability to monetize the usage on our networks and create new revenue streams from advertising, content rights, telematics and other IoT solutions.

In early September, our Board of Directors approved a 2.2% dividend increase, which raises our annualized dividend to \$2.31 per share. This was the 10th consecutive year that our Board has approved a dividend increase, endorsing their confidence in the strength of our balance sheet and returning value to our shareholders.

Let's move to third-quarter performance in more detail, starting with our consolidated results on slide 6. Our third-quarter results highlight our ability to execute in a challenging environment and drive strong operating and financial results. On a reported basis, total operating revenue



decreased 6.7% in the third quarter. This decrease was primarily due to the sale of the three Wireline markets to Frontier, which closed on April 1, 2016, and the Wireless commercial pricing model change. Excluding the impact of Wireline divestiture, consolidated revenue was down 2.9%.

In terms of Wireless revenue, the service revenue trend was on track with our expectations for the migration of our postpaid subscriber base to unsubsidized price plans and optimization of our current customers to the new pricing plans. Equipment revenue, which started the quarter slowly due to low volumes, ended strong with the introduction of the iPhone 7. Wireline revenue trends were consistent with previous quarters.

Consolidated adjusted EBITDA totaled \$11.3 billion, up 1%, and our adjusted EBITDA margin was 36.5%, up 140 basis points in the quarter. We remain focused on enhancing our overall cost structure by improving productivity and gaining efficiencies in our operations throughout the business, which we expect will enable us to deliver a strong earnings profile into the future.

Let's turn now to cash flows and the balance sheet on slide 7. Cash flows from operations were \$4.8 billion in the third quarter. Keep in mind as we shift to the asset-backed securitization model, there is \$2.6 billion of cash that is reflected in the financing section of the cash flow statement, while in prior periods under the off-balance-sheet securitization model this funding would have flowed through cash flow from operations.

Free cash flow for the nine months of the year totaled \$6.2 billion, which was impacted by our on-balance-sheet securitization transactions. Cash taxes for the quarter were higher compared to a year ago, primarily due to transaction tax payments of \$2.4 billion. This amount represented the majority of total taxes due for the gain on the sale of our Wireline operations to Frontier earlier this year. The remainder is expected to be paid next quarter.

The increase was also affected by certain benefits that we realized in prior periods which did not occur in this period. Capital expenditures were \$4.1 billion in the quarter, driven by increased spending in Wireless for densification and in Wireline for Fios installations, as volumes expanded post-work stoppage.

We now expect full-year 2016 capital expenditures to be at the low end of the range of \$17.2 billion to \$17.7 billion. We ended the quarter with \$106.6 billion of total debt, which includes \$2.6 billion of asset-backed securitization debt, net debt of \$100.2 billion, and a ratio of net debt to adjusted EBITDA of 2.3 times.

The net debt includes the asset-backed securitization debt. We remain on track to return to our pre-Vodafone credit rating profile by the 2018 to 2019 timeframe.

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

Service revenue of \$16.7 billion declined 5.2% for the quarter, compared to a decline of 5.4% in the second quarter. Service revenue plus installment billings increased 2.3% to \$19.3 billion in the third quarter. Service revenue trends are consistent with our expectations as the postpaid base migrates to the unsubsidized price plans.

We now have approximately 60% of our postpaid phone customers on the unsubsidized price plans. We continue to expect that we will return to year-over-year service revenue growth by the end of 2017.

Equipment revenue was \$4.1 billion, down 3.9% due to lower equipment volumes. The percentage of phone activations on device payment plans was about 70% in the third quarter compared with about 67% in the second quarter. We expect the take rate for device payment plans for the fourth quarter to be around 70%, given the higher seasonal consumer mix of volumes.

During the quarter, 6.1 million phones were activated on a device payment plan. In total, we have about 35.8 million phone connections activated on a device payment plan, representing 41% of our postpaid phone base.



Total Wireless operating revenues decreased 3.9% in the quarter to \$22.1 billion. The cost structure in Wireless continues to improve, driven by streamlining of business process improvements in distribution, care, and supply chain, resulting in higher digital customer contact and lower transaction costs.

In terms of profitability, we generated \$9.9 billion of segment EBITDA in the quarter, flat with last year, and we had a segment EBITDA margin of 44.9%, up 170 basis points from 43.2%.

Now let's take a closer look at Wireless additions on slide 9.

Total postpaid net adds, which we do not include any wholesale connections including Internet of Things, totaled 442,000. Within the postpaid net additions, we added 357,000 new 4G smartphones in the quarter, which were partially offset by a net decline of 3G smartphones, resulting in 242,000 net new high-quality smartphones.

Overall, net phone additions were a negative 36,000 due to the offset of basic phones and softer phone gross additions. Tablet net additions totaled 221,000. All other postpaid net additions totaled 257,000, with Verizon Wireless retail hum devices being the primary driver.

Postpaid gross additions were 3.8 million, down from 4.2 million and up slightly from last quarter. Retail postpaid churn was 1.04%, up 11 basis points, driven by tablet churn. As we have previously discussed, we expect this higher rate of tablet churn to continue into the first half of next year as two-year agreements associated with prior tablet promotional offers roll off.

We continue to see strong retention in our retail postpaid phone base. Postpaid phone churn was up 2 basis points from a year ago and remained below 0.90% for the sixth consecutive quarter. Net prepaid additions increased to 83,000 for the quarter, which is a significant improvement sequentially and from the prior year due to the impact of new price plans for our prepaid market.

We ended the quarter with 113.7 million total retail connections, excluding all wholesale connections. Our industry-leading postpaid connection base grew 3% to 108.2 million and our prepaid connections totaled 5.5 million. Let's now take a look at 4G device activations and upgrades on slide 10.

Total postpaid device activations were 10.7 million in the quarter, up 12.2% sequentially and down nearly 7.7% on a year-over-year basis. Approximately 82% of these activations were phones, with tablets accounting for the majority of other device activations. About 6.3% of our retail postpaid base upgraded to a new device in the third quarter. This represents a decline of 70 basis points year over year and up from 5.4% in the prior quarter.

Our upgrades and momentum in the third quarter were negatively impacted by the recall of the Note 7. Additionally, we experienced an iPhone 7 backlog, primarily for upgrades.

Let's move next to our Wireline segment, starting with a review of our consumer and mass markets revenue performance on slide 11.

Consumer revenue increased 0.2% and mass markets, which includes small business, declined 0.5%. Fios total revenue grew 4.4% with consumer Fios revenue rising 4.2%. The growth in Fios was driven by a higher customer base, strong retention programs, and the demand for higher internet speeds. Approximately 16% of our Fios internet base has opted for speeds of 100 megabits or greater.

We continue to see strong demand consistent with prior quarters for custom TV. During the third quarter we returned to normal seasonal volumes ahead of our expectations coming out of the work stoppage.

Fios internet subscriber growth was strong in the third quarter. In broadband, we added 90,000 net Fios customers for the quarter, which were at pre-work-stoppage levels. Overall, net broadband subscribers increased by 24,000 in the quarter. Fios internet penetration was 40.4% in the quarter compared to 40.1%, representing an increase of 30 basis points.

In Fios video, we added 36,000 net customers in the quarter, which was also consistent with pre-work-stoppage levels. Fios video penetration was 34.5% in the quarter compared to 35.4%, representing a decline of 90 basis points driven by increased open for sale markets and softer linear TV demand. We continue to see an opportunity to further penetrate the Fios markets we serve.

Let's turn to slide 12 and cover enterprise and wholesale as well as the Wireline segment in total.

Total operating revenues for the Wireline segment declined 2.3% in the third quarter, consistent with recent trends. In the third quarter, global enterprise revenue declined 3.4% and on a constant currency basis the decline was about 2.9%.

In our Wholesale business, revenues decreased 3.9% in the third quarter. Trends in our Global Enterprise and Wholesale businesses remained consistent with prior periods. However, we expect that in the fourth quarter will see a decline in Wholesale in the range of 7% to 9% due to nonrecurring items in the prior year.

Wireline segment EBITDA margin was 21.2% compared to 18.9% in the period last year, up 230 basis points due to Fios growth and cost management. We believe we will continue to make progress in expanding the Wireline EBITDA margin. As we expected, Wireline capital spending levels increased in the third quarter as we returned to normal operations after the work stoppage in the second quarter.

Let's move next to slide 13 and cover strategic positioning and investments.

Network leadership is our primary objective in the markets we serve. We are investing in our networks and building capacity for the future and positioning our business for new industry growth opportunities. Recently we launched LTE advanced in over 460 markets, delivering improved service to more than 90% of the US population. We are steadily advancing our cloud and software-defined network architecture and moving forward aggressively with our densification efforts and pre-positioning for 5G technology.

Our One Fiber strategy initiative is on track and we are building our next-generation fiber network in the city of Boston. In July, the FCC approved our millimeter wave spectrum band lease agreement with XO Communications, clearing the way for testing 5G technology in different environments.

Our 5G technical trials have been successful and we are now planning our commercial pilot program in 2017 where we will test the technology in different environments with several infrastructure providers to determine ability to scale and operationalize fixed wireless product offerings. Based on the outcome of our commercial pilot program, Verizon intends to be the first company to launch a 5G fixed wireless broadband solution in the United States.

In the third quarter, network usage increased 45%. Digital video is the primary driver of traffic on our network. In order to participate in the digital media value chain, we have assembled assets to grow in the digital media business. We have accumulated a large portfolio of digital rights and invested in specific assets to distribute, publish, and create digital content.

In order to drive incremental value from digital media traffic, we are scaling and leveraging AOL's ad tech capabilities to monetize digital impressions on and off our network. We believe we are strategically well-positioned with the right set of assets to grow in this expanding market.

In the third quarter, AOL's net revenue, measured as gross revenue less traffic acquisition costs, amounted to \$486 million, which represented an increase of approximately 10%. Net revenue growth was primarily driven by advertising revenue from programmatic platforms. Over the next two quarters we expect AOL net revenue to follow seasonal trends, but year-over-year growth to be lower due to one-time benefits in the prior year from the Microsoft deal, especially in the fourth quarter.

We are seeing strong demand from advertisers for AOL's expanding programmatic capabilities and high-quality data analytic tools. We expect that the pending acquisition of Yahoo will further expand our scale in the digital media space. This would place us in a unique position to serve unmet customer needs, participate in digital publishing and video, and to monetize the content.

On the go90 platform, the level of viewer engagement as measured by daily usage has been rising steadily since re-platforming the application earlier this summer. In the third quarter, the average daily usage in go90 surpassed more than 30 minutes per viewer, with less than 20% of traffic served on the Verizon Wireless network. While still early in its product cycle, we are very encouraged by the traction with users primarily attracted by unique content.

For example, in July we introduced an original streaming monthly reality series titled The Runner. Viewers can watch episodes aired three times daily via the go90 app, go90.com, and aol.com. The innovative game format, with an emphasis on live user participation, contributed to strong usage and engagement.

During the quarter, we expanded go90 participation in FreeBee Data 360, a sponsored data service which allows customers to stream live sports, including NFL games, and music without it counting against their Verizon data. We are seeing increased engagement in the application.

In September, with our partner Hearst, we announced the formation of Complex Networks, which brings together Complex and digital video networks RatedRed.com and Seriously.TV. In the United States, Complex reaches more than half of the male 18 to 24 population and it is one of the largest properties for this population. The content produced in this partnership will be available on go90, which we expect will further increase user engagement and traffic growth.

The rapidly evolving Internet of Things market provides us with new business opportunities for our customers globally. We intend to scale telematics, ThingSpace, smart city, and other IoT solutions globally. Organically, IoT revenues were \$217 million, up 24% from the comparable period last year.

Including two months of Telogis activity, IoT revenues were up more than 30% in the quarter. IoT revenues were primarily driven by telematics. Telogis, which closed in July, expands our telematics capabilities targeted for the enterprise space. In July, we announced a definitive agreement to acquire Fleetmatics, a global Software-as-a-Service-based telematics provider in the small- and medium-sized business space, for \$2.4 billion. The deal is expected to close in the fourth quarter of 2016.

In September, we completed the purchase of Sensity Systems, a leading provider of IoT solutions for smart city. This transaction closed in October. The acquisition adds a leading comprehensive suite of smart city solutions to our IoT platform. We are now focused on integrating the assets.

Now let's turn to slide 14 for an overall summary.

As we stated coming into the year, 2016 is a significant transformational year for us. We continued to deliver consistent performance during this transitional period. We are executing in a competitive environment. For the third quarter, despite a challenging competitive environment in Wireless, we added over 442,000 postpaid net customers, retained high-value postpaid phone customers, and improved our Wireless service revenue trends.

In Wireline, Fios performance was ahead of our expectations. In both Wireless and Wireline we have made significant progress on improving our cost structure. We continue to invest in our networks and platforms to be the network leader in the markets we serve and we are setting up the business to return to growth in 2017.

We are focused on developing new business models and revenue streams. In our new businesses we are scaling our media assets and Internet of Things platforms to position us for long-term growth and are demonstrating progress. As we enter the final quarter of the year, we are confident in our ability to execute, deliver results, and return value to shareholders while transforming the business.

We are on course for our 2016 guidance and expectations. Full-year adjusted earnings to be at a level comparable to 2015, excluding the \$0.07 impact of work stoppage. Consolidated adjusted EBITDA margin consistent with full-year 2015. Consolidated capital spending at the low end of the \$17.2 billion to \$17.7 billion range.

We made a full-year total pension contribution of approximately \$750 million, which consists of minimum funding of approximately \$550 million, and a discretionary contribution of about \$200 million. We expect our full-year 2016 effective tax rate to be in the range of 35% to 36%.

While we will be providing more guidance in January, we expect that organically consolidated revenue growth in 2017 will be at a level consistent with GDP growth for that year and adjusted EPS growth will be at normal levels.

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

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

Thank you, Fran. Jay, we are now ready to questions for Fran and Matt.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Phil Cusick, JPMorgan.

Phil Cusick - *JPMorgan - Analyst*

First, Fran, thanks for all your help in the last five years and good luck going forward. Matt, congratulations on the new seat.

How should we think about postpaid phones and accounts going forward? Given what seems like a saturated industry and reinvigorated competition, are you more in a mode to harvest the existing customers than hunting for more share in accounts?

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

Thanks, Phil; appreciate it. Look, as we came into the year we said that one of the top priorities we had was to protect our high-quality base and that's what you are seeing. Look, we want to continue to grow from a net subscriber base, both in phones; but as I've said before, smartphones are going to be a slower growth for the entire industry as it gets more densified.

But just a couple things that happened this quarter that did have an impact on our overall growth. Really it was more from a gross add basis, because as you saw, we gave you, for the first time, our phone churn which is at a 0.90% for the last six consecutive quarters. So you can see that we are continuing to maintain that base and protect our base.

But of course, this quarter some things happened that affected our inward bound or gross adds. One was, as we previously talked, when the competitive world launches new price plans -- and this quarter it was around unlimited and, obviously, we did not respond to that. But as I've said, there's going to be a two- to three-week period of time where there is an impact to our growth. And we saw that. But, as I've always said, after that three weeks everything kind of normalizes back out.

So once we got through that we were off to a really good start with the Samsung Note 7 and then, unfortunately, there was a total recall of that phone which has definitely impacted our growth, because historically Verizon has always been the number one leader in high-end Samsung phones. So that has certainly impacted us.

Then, of course, we had the Apple launch and, as normal, everyone is in a backlog situation. So that's just a couple things.

The other thing we saw this quarter as well was we are totally focused on smartphones. You saw that our net smartphone growth was 242,000 and that's really where we're focused in on. As you saw also, we made some moves in prepaid because where we are losing the subscribers is mostly in the basic phone category and we know that our postpaid pricing is more premium to the marketplace and less attractive to that segment.



So we did launch some new prepaid pricing and what we did see was we saw a double amount of our postpaid subscribers move over to our prepaid, more than we've seen in history. And that accounted for a little less than 50% of our prepaid net adds this quarter.

So we did see some shift in our base, but the good news there is that we did not lose the customer. We maintained the customer, at least on the Verizon Wireless network.

Going forward, as I've always said, we will continue to be very rational in our competitive response. We will respond when we need to. Obviously, we responded on the equipment side of the equation. But as we continue here, unlimited is still not something that we're going to move to.

But, as you saw also, we launched new pricing this quarter which we believe also addressed two of the major pain points for our customers. One was overage. We saw over 7 million of our customers move to the new safe mode plans that we constructed, which will protect them from getting overage charges in the future.

Then, second, we also allow them to now carryover. If they buy an extra gig for the month, if that gig is not totally used we allow them to carry that into the next quarter for usage for 30 days.

We have seen some really positive responses within our base, but obviously there was some impact on the gross adds in some of the competitive environment. We will go into the fourth quarter very strong and, as I said, we will continue to strive to grow all aspects of our business.

Phil Cusick - JPMorgan - Analyst

Thanks, Fran.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - Morgan Stanley - Analyst

Thank you, Mike. Fran, want to add my best wishes to you and thanks for everything.

Following on on the top-line and the growth question, could you just help us bridge the path to the GDP-type growth that you referenced again for 2017 versus the decline of 2.9% normalized for this quarter? Some of it I guess is around the service revenues, but if you could help us with the building blocks and the timing of delivering that.

And then I think you were hoping to give us an update on the data center transaction, if you have any news there. Thank you.

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

Sure. Thanks, Simon. I will take the data center; I will pass the other question on top line over to Matt.

On data centers, we are proceeding with the sale of our data centers. We are currently in negotiations and we should have something to formally announce to everyone here early in the fourth quarter. So more to come on that, but we are progressing with the sale of our data centers. Matt?

Simon Flannery - Morgan Stanley - Analyst

So that's with one party, is it?



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

At this point, yes, we are in negotiations with one individual.

Simon Flannery - *Morgan Stanley - Analyst*

Okay, thank you.

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

Good morning, Simon. So your question about 2017 and where that GDP-like top-line growth will come from, let's break it down by the different parts of the business.

Predominately in Wireless, as we've said, we've been doing this transition. You've seen the year-over-year service revenue trajectory continue to improve. We are at negative 6.2% in the first quarter; that came down to 5.4% in the second quarter and 5.2% this quarter.

So as we go into 2017, we now have 60% of the base on the non-subsidized pricing. That will continue to expand and that will obviously be a contributor to the improvement in revenue next year.

And as Fran mentioned earlier, we expect to get back to year-over-year growth by the end of the year in service revenue. We expect to see consistent trends within the Wireline business, but remember we only have one quarter of Frontier in the 2016 comparison as we get into 2017.

And then, as you saw in our comments, we continue to make good progress in IoT and the video advertising space and we continue to expect those pieces to continue to contribute to the revenue as we head into 2017. So when you add all those things up, we are confident at this point in time that we will be on track to deliver the GDP-type top-line growth and look forward to giving you more color commentary on that in our January call.

Simon Flannery - *Morgan Stanley - Analyst*

Great, thanks for the color.

Operator

David Barden, Bank of America Merrill Lynch.

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

Hello? Jay, let's move to the next question.

Operator

John Hodulik, UBS.

John Hodulik - UBS - Analyst

Great. Fran, again, it's been good working with you for the last five years and good luck in the future.

With the cable companies announcing that they are going to move forward the MVNOs mid next year, is there anything you can tell us about how Verizon sees the economics of those agreements? Obviously, given your unique knowledge of the terms, what do you think -- what kind of impact do you expect it to have on the overall competitive environment that we are seeing in wireless? Thanks.

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

Thanks, John. Look, I'm not going to get into the agreement. Obviously, we're under nondisclosure with Comcast on that agreement and the other cable providers.

But, look, we knew what we entered we bought the licenses back several years ago. This is a wholesale agreement and, as Lowell and I have repeatedly said, we would to the agreement today again if we had to. It's a good agreement for Verizon Wireless. It's a good wholesale agreement.

I can't speak the economics of what they're going to do. You'll have to ask them that question.

But, look, as I've said before, the wireless pie continues to grow. Everyone wants to get a piece of this pie. The industry itself will continue to grow around that pie, so it's not like I believe the industry with the carriers will lose share to anyone. I just think there's going to be more opportunity for growth.

If you look at the future and you think about the LTE densification projects that we have going on and then you look at the whole 5G world for fixed wireless, that's going to enter into a whole new growth trajectory for the entire industry. Again, we will compete against the competition. We will compete against new entrants in the marketplace. We will wait to see what is launched. And, as I said before, we will respond where we need to respond and we will wait to see what happens.

John Hodulik - UBS - Analyst

Okay. Thanks, Fran.

Operator

David Barden.

David Barden - BofA Merrill Lynch - Analyst

Can you hear me now? I should've dialed in with my mobile phone the first time. Again, thanks, Fran, for everything over the past few years.

I want to ask two questions, if I could. Just first on the -- it sounds like the IoT and AOL ad tech, etc., are going to be part of the kind of revenue equation on a go-forward basis. I was wondering if you could talk a little bit about the margin profile of those relative to the margin of the general business as we look at it today.

Then second, specifically on the Wireline margin side, obviously we have the new union contract and we are expecting that to have some follow-on benefits into the second half and into next year. Could you talk a little bit about the cadence at which we might see the margin trajectory of the business start to graduate upwards towards the legacy 23%, if possible? Thanks.

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

Sure, David. Thanks for the questions. I'm going to answer the first one. I'm going to have Matt answer the Wireline one.

On IoT, look, we see the telematics piece of this to be a really high growth engine for us and, as I said in the prepared remarks, we're looking at a 24%, without Telogis, growth rate year over year. And mainly most of that is all driven via telematics and hum, so we will continue on that.

As far as the margin profile goes, look, these companies are still maturing. They are profitable, but we expect that the margin profile will continue to grow as we leverage onto these platforms.

The other thing, too, to note that in the IoT world, since it is a platform-based technology, whether you look at IoT or smart cities, these are all very what I would call minimally capital-intensive type businesses. And that would go for video as well.

When you think about the return on invested capital, you get there much quicker than, say, on a network-based type platform. So we are expecting that the ROI on this will happen relatively quickly, but the margin will come and we will talk more about that as we grow this business.

Matt, on Wireline?

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

Yes, so had a good quarter in Wireline, as you saw. The EBITDA margin improved to 21.2% so you are starting to see some of that improvement we have been talking about, especially as we got out of the impacts from the work stoppage.

As we said, we expect that the new union contract would generate \$500 million of cash savings through the term of the contract spread across 2017, 2018, and 2019, so you should certainly see that come through. We believe that you will continue to see the Wireline margin expand. We had a good expansion in the past quarter and you should see us continue to make progress on that as we go forward into the fourth quarter and then into 2017.

David Barden - *BofA Merrill Lynch - Analyst*

Great. Thanks, guys.

Operator

Michael Rollins, Citigroup.

Michael Rollins - *Citigroup - Analyst*

Thanks for taking the questions. Fran, I also want to extend my best wishes as you approach the upcoming retirement.

If I could just follow-on two questions; first, if you could talk a little bit about where you are in the testing of the 5G services and what you are learning in terms of the capabilities, performance, and the economic model as a potential third pipe into the home.

And then secondly, just going back to the guidance on earnings where you mentioned that you want to get back to normal levels. Given the impact of installment plans and the purchase of the Verizon Wireless minority, it's been a few years since I think you could call the changes normal. So how are you defining what normal earnings growth is for Verizon? Thanks.



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

Thanks, Michael. I'll take the first; I'm going to put the earnings one to Matt.

For the 5G, obviously we've been mainly centered around the lab testing of 5G. We are now moving out into the commercial trial, which we are going to span out across several different cities with several different types of testing with different OEMs. To give you an example, one city may be a very dense city, going into multidivisional areas; another one might be more urban with just looking at single-family homes, so we are going to test this in very different types of commercial environments.

The big issue that still has to be answered, quite honestly, is the scaling of the technology. For each small cell, how much can each small cell deliver to how many households and still deliver a consistent 1 gigabit speed or some speed that is comparable to a broadband connection to the home? So that still has to be answered and we expect to gain more knowledge around that in 2017 with the number of commercial trials that we're going to launch.

So at this point that's really all there is to talk about from a 5G perspective. Matt, I will turn it over to you.

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

Good morning, Mike. In terms of the EPS growth for next year and where that should come out, you start with the top line and we've already talked about how you get to that GDP-type growth next year and the changes year over year that you should expect to see. Then you layer in on top of that the continued cost improvements we talked about in Wireless.

Obviously it started last year with the restructuring of the business. We continue to make good efforts in reducing the cost to run the business, whether that's reducing the number of calls we receive, reducing the transaction times, moving more of the transactions online, etc., etc., and you should see more of that continue.

Wireline we have the full-year benefit of the new union contract coming through. You've seen some of the headcount changes that we talked about that will continue to help us expand the margin there.

And then in the other parts of the business, whether it be the IoT or the videos, we continue to add scale there; the margins there should improve. So when you add those things up you're going to get to an improvement in EPS that we think is in line with what the expectation out on the Street should be.

Operator

Craig Moffett, MoffettNathanson.

Craig Moffett - *MoffettNathanson - Analyst*

Good morning, everyone. Fran, let me add my thanks and congratulations as well and to you, too, Matt.

I wanted to ask about the Yahoo transaction. First, if you could just comment on press reports about the finding of a material adverse condition or a change and if you have any update to offer there. But then more broadly with respect to Yahoo and AOL, can you talk about how the proposed rulemaking at the FCC, whereby, as an ISP, you would likely be held to an opt-in standard for addressability? Does that change your expectations of how you can monetize either the AOL or the Yahoo asset?



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

Thanks, Craig. On Yahoo, look, Lowell and Craig have both commented on this recently, so let me just reiterate what they have said. We are still evaluating what it means for this transaction.

This was an extremely large breach that has received a lot of attention from a lot of different people, so we have to assume that it will have a material impact on Yahoo. Lawyers had their first call yesterday with Yahoo to provide us information, but from what I understand that's going to be a long process. So unless Yahoo comes up with different process, it's going to take some time to evaluate this. Until then, we haven't reached any final conclusions around this issue.

As far as the privacy goes, look, I think there's a couple things here. Obviously we take privacy and security of our customers extremely seriously. We live under the regulation of the FCC, which has a very high standard for carriers around privacy. And what we are looking for is that the FTC and the FCC come out with a common rule that makes it competitive across the entire ecosystem and that the rules are more consistent, so that everyone can compete equally and there is no winners and losers within the ecosystem.

We look forward to reviewing the final order of privacy from the FCC and, hopefully, the FTC and then we will have to react to that. But, look, we are operating AOL today under the current environment and we will continue to operate and, as you saw, we continue to grow AOL under that purview of the privacy regulations. So I think we will just have to wait to see where this all comes out, but we are hoping that it is an equal playing field across the board.

Craig Moffett - *MoffettNathanson - Analyst*

Thank you.

Operator

Brett Feldman, Goldman Sachs.

Brett Feldman - *Goldman Sachs - Analyst*

Thanks for taking my question and once again, Fran, congrats. It's been great working with you. So my question is, if I look at your postpaid ARPA in the quarter, it was actually reasonably stable versus the prior quarter. I was hoping you could maybe just give us a little more color on what drove that, particularly the uptake rate and reaction to the new pricing you put in several weeks ago.

And then just as an extension of that, if we extrapolate the trend we saw here it suggests that maybe you would actually stabilize your service revenues a little sooner than you are talking about. I'm just wondering what you think the opportunity could be there to maybe get to that stabilization a bit faster. Thanks.

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

Matt, why don't you take this one?

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

I think what this one comes back to, Brett, is -- and Fran talked about it. Within the base the continued growth of our 4G smartphone base, we had net adds of 357,000 4G smartphones during the quarter. That is obviously contributing.

We saw very strong adoption from our existing base to the new price plans. We saw a number of those customers step up in terms of the buckets they are purchasing. And so I think you see that we have a very strong relationship with our base and our consumers continue to take full advantage of the network. We've seen video use or total usage on the Wireless network up about 45% this year and you continue to see that show up in the ARPA trend.

So, yes, as you think about heading into 2017, we expect to see -- especially as we've got 60% of the base now on the non-subsidized pricing, we expect to continue to see some strong ARPA trends as we go forward into next year.

Brett Feldman - *Goldman Sachs - Analyst*

Great, and actually just one quick follow-up. You'd mentioned earlier that there were some device supply issues, for example the Note 7 and some of the iPhone 7 models, recently. Have those cleared up?

And maybe just at a bigger picture, do think that over the course of the holiday season you are likely to continue to suffer those supply issues and maybe that could contain some of the upgrades in activity levels we would normally expect?

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

Well, the Note 7 has been recalled totally and won't be relaunched, so obviously that's a permanent change to the lineup. We are bringing in new phones for the fourth quarter.

As always, Apple is always generally in a backlog situation for the industry. I don't expect that to change, at least not early in the fourth quarter. But other than that, Matt, have anything else to add?

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

No, that sounds pretty much it. We would expect Apple to get caught up as we go through the quarter here and we will see how that plays out.

Brett Feldman - *Goldman Sachs - Analyst*

Thanks for taking the questions.

Operator

Mike McCormack, Jefferies.

Mike McCormack - *Jefferies - Analyst*

Great, thanks. Again, best of luck, Fran. It's been great working with you.

On the feature phone base, you have north of 13 million phones out there. How should we think about that? Is that going to be an accelerating loss situation or is there something you're doing there, either with respect to mitigating churn or care or retention efforts? If you can comment on that, that would be great.



And then just on the delta between those that are on unsubsidized plans, the percentage of those on those plans versus those making Edge payments, that gap continues to widen out a bit. Is there retention efforts going on there or is there something else we should be thinking about? Thanks.

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

I will have Matt do the feature phone one. Let me just answer the unsubsidized/subsidized Edge phone.

As you know, we have allowed our base to upgrade and choose whether they take a subsidized or an unsubsidized plan, so that currently is the policy that we have. And we will have to review that policy as time goes here into the fourth quarter, first quarter of next year.

So there may be some shifts within that going forward, but right now that policy still holds. And that's why you see some of the separation between the number of people who have moved to the unsubsidized plan versus the number of people who are currently on a device payment plan. We will update that in the fourth quarter as we go.

Matt, on feature?

Matt Ellis - *Verizon Communications, Inc. - SVP & CFO, Operations Finance*

Yes, so I think what you are seeing on feature phones is -- and Fran mentioned this in our earlier remarks -- that you are seeing some part of the move to prepaid has come from the feature phones. Look, we will have some people who have feature phones in postpaid stay as postpaid customers and we're very happy to -- glad that they will do that, but we also expect to see some of those continue to move into a prepaid environment, which may be a better place for them to be.

We also continue to see people moving from feature phones to smartphones and when we get that we see increased usage with those customers as well. So we will continue to monitor that, but we are happy with the trends where they are going at the moment.

Mike McCormack - *Jefferies - Analyst*

Great. Look forward to working with you, Matt.

Operator

Tim Horan, Oppenheimer.

Tim Horan - *Oppenheimer & Co. - Analyst*

Good luck, guys. Can you get a little more color on the CapEx? It, for you and the whole industry, seems to be coming at the lower end of expectations. I know you focus on SDN and densification a little bit more. Is this a trend that is sustainable?

And related to this, how do you think your network is holding up versus your peers? A lot of your peers are spending a lot less on CapEx, but the RootMetrics and other services are saying that their quality is catching with your network. Any thoughts?

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

Thanks, Tim. On the CapEx trends, I think this was all related to the strike that we experienced in the second quarter and we're not going to be able to catch up on that from an overall or year-over-year perspective. So that's why we've revised guidance to the lower end of our range, but we are still spending around \$17.2 billion this year in CapEx.

The other thing, too, is you have to remember we are spending our CapEx around Wireless for LTE densification. And as we have talked many, many times before, we do our usage projections well in advance of where we believe that usage will come. Obviously, we know that video is the major driver of the usage with a 45% increase year over year. I think the stat now is over 90% of our data usage is on the LTE network.

We see that continuing to increase, so we are really preparing for two years out from where our usage is today so we are densifying the network. And we've seen this movie before where CapEx trends go down and user catches up and then all of a sudden the networks falter.

Look, I think the RootMetrics reports speak for themselves. Once again, we won hands down across the country. That is the brand that we live by and we will continue to build and densify our networks to meet our customers' demand before they actually realize they need it.

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

Jay, we have time for one last question.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thanks very much and once again, Fran, wanted to echo prior comments wishing you the best of luck with your next endeavors and congrats, Matt, on the new role.

I was wondering if we could talk more broadly, Fran, about your M&A strategy. Clearly, you folks have made a concerted effort towards improving your asset portfolio to support both the media co and IoT initiatives. As it stands today, do you see any areas where you may need to bolster your pool of assets in order to move forward with these strategies? Or as you exit this transition year should we consider 2017 more of an integration year for you folks?

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

I think that's right, Amir. I think -- look, we have made some strategic moves here around diversification. We know that the telematics business is a business that has high potential and, if you looked across the industry, there are a lot of competitors in there, but no one really has a big share within that marketplace. We want to gain more share within that marketplace and we think we can with the assets that we have accumulated between Telogis and Fleetmatics here.

So we will continue to move in that direction, but I don't think that there's anything large on the table at this point. We now have to integrate those assets and that's what our telematics group is actually doing right now.

As you saw, we launched hum. Hum came out of the telematics group; although it is, for the majority, sold through Verizon Wireless, it actually is a product to come out of the telematics group. So we will continue to innovate in that area.

You are starting to see us do a little -- a few things around smart cities, because we believe that with the pre-positioning of 5G and the latency issues, smart cities is going to be an area of growth for the future. We have demonstrated with certain cities where we are deploying it now that we can actually save them money on a lot of different things and that their payback is relatively quick. So I think that is just something that we are positioning for the future.

Then around media co, obviously we have the Yahoo asset sitting out there, but to date we have accumulated assets that we believe are really strategic for us to grow this business. And as we've said before, we know that the wallet share of consumer for communications has been flat for relatively the last 15 to 20 years, so we have to think about a different way to monetize our network capability and that monetization will come through advertising.

It's real simple. I mean the equation is, if you get more views, you get more advertisers, therefore you generate more revenue. We see that now with AOL. Even with the 10% increase in revenue year over year, which is the first time we've given that to you, we are starting to see that advertisers are coming to our platforms.

So now we just have to integrate and execute on that model and we believe we have the right assets to do that. The long and short of the answer is there is nothing large out there that we need to be successful with at this point in time.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you. A quick follow-up, if I may, on the media co strategy. It does seem like increasingly many are attempting to gain share from consumers via video; not just some of your peers in the market, but on a whole technology company level as well.

How do you view your positioning and your ability to differentiate going forward? I guess the question I have is what have you learned about your strategy thus far, be it with AOL, Verizon Digital Media Services, or go90? And how is that informing your strategy going forward in your ability to differentiate?

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

I think the big differentiation here, Amir, is we are developing content for short form and really for live. And that's really the differentiation is short form content, whether that's over-the-top or via mobile. Also I think the differentiation for us is the integration across our platform. If you go to AOL now, you're going to start to see Complex come through. You will see RatedRed and Seriously.TV in the future come through on that platform.

If you look at the NFL, we've adopted that into the go90 platform and I know there's been some articles around viewership of NFL. We've actually seen a healthy increase Year over year on our platform around the NFL, so we are headed in the right direction.

The key learnings here have been you need to have the right content that is appealing to the audience that you are going after. You've seen us make moves; you're going to see us move out of certain content that was originally in go90 that just isn't the right content. But sports, news, live, original content is the direction that we are taking on this platform and we think we will be successful with that.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thanks very much for taking the questions.

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

Thanks for all the questions. For one last time I have the privilege to turn the call back to Fran.

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

Thanks, Mike. Before we end, I want to highlight just a few key points.

Number one, we are focused on maintaining leadership in network quality, customer loyalty, and financial performance. Strategically, we are aggressively building new businesses with revenue streams and ecosystems that are expanding the entire industry. I am confident that Verizon will remain a leading player in the next growth phase of the industry and create value for our shareholders.

Finally, I want to thank the Board, our investors, and all of you on this call. It has been a pleasure working with all of you. It has been an honor and privilege to serve as the CFO of Verizon for the last six years.

Thank you again for joining Verizon and have a great day.

Operator

Ladies and gentlemen, this does conclude today's conference call for today. Thank you for your participation and for using Verizon Conference Services. You may now disconnect.

Editor

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On September 9, 2016, Yahoo! Inc. ("Yahoo") filed with the Securities and Exchange Commission (the "SEC") a preliminary proxy statement regarding the proposed sale of Yahoo's operating business to Verizon Communications Inc. ("Verizon") and related transactions, and the definitive version of which will be sent or provided to Yahoo stockholders. BEFORE MAKING ANY VOTING DECISION, YAHOO'S STOCKHOLDERS ARE STRONGLY ADVISED TO READ YAHOO'S PROXY STATEMENT IN ITS ENTIRETY (INCLUDING ANY AMENDMENTS OR SUPPLEMENTS THERETO WHEN THEY BECOME AVAILABLE) AND ANY OTHER DOCUMENTS FILED WITH THE SEC IN CONNECTION WITH THE PROPOSED TRANSACTIONS OR INCORPORATED BY REFERENCE THEREIN BECAUSE THEY CONTAIN IMPORTANT INFORMATION ABOUT THE PROPOSED TRANSACTIONS. Investors and stockholders can obtain a free copy of Yahoo's proxy statement, any amendments or supplements to the proxy statement, and other documents filed by Yahoo with the SEC in connection with the proposed transactions for no charge at the SEC's website at www.sec.gov, on the Investor Relations page of Yahoo's website investor.yahoo.net or by writing to Investor Relations, Yahoo! Inc., 701 First Avenue, Sunnyvale, CA 94089.

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