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VZ - Q2 2014 Verizon Earnings Conference Call

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OVERVIEW:

Co. reported 2Q14 GAAP EPS of \$1.01, and adjusted EPS of \$0.91. YTD 2014 adjusted EPS was \$1.76.



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PRESENTATION

Operator

Good morning and welcome to the Verizon second-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.

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

Thanks, David. Good morning and welcome to our second-quarter earnings conference call. This is Mike Stefanski. I'm here with our Chief Financial Officer, Fran Shammo. We appreciate you joining us earlier than our usual time 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 statement 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 our Verizon 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 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 special item that is included in our reported results on slide three. For the second quarter of 2014, we reported earnings of \$1.01 per share on GAAP basis. These reported results include a pretax gain

of \$707 million related to the sale of 700 megahertz A Block spectrum licenses. On the after-tax basis, this gain increased reported net income by \$434 million or \$0.10 per share.

As we have done in the past, we have accounted for the gain on the sale of these licenses at the corporate level, so it is not part of our Wireless segment results. Excluding the effect of this nonoperational item, adjusted earnings per share was \$0.91 for the second quarter compared with \$0.73 a year ago, or growth of 24.7%.

On a year-to-date basis, adjusted earnings per share were \$1.76 compared with \$1.41 last year, up 24.8%. Keep in mind that the \$1.76 per share first-half result does not reflect full ownership of Verizon Wireless for the entire first quarter since the transaction closed on February 21. As discussed on our first-quarter call, full ownership for the quarter represented an additional \$0.07 per share of earnings.

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

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

Thanks, Mike. Good morning, everyone. We entered 2014 with a great confidence in our ability to grow the business profitably while making the necessary capital investments to position us for the future. In the first quarter, we closed the Vodafone transaction and delivered strong financial results. On our last earnings call, I indicated that we exited the first quarter with better momentum and expected that to carry forward.

As you can see from our second-quarter results, we delivered on what we said, producing very strong customer growth metrics in Wireless and FiOS and driving excellent topline growth and profitability. We are competing effectively in all markets and executing our strategy, which is focused on providing network reliability and a great customer experience.

Over the past two and half years, we have delivered consistent high quality earnings results with double-digit year-over-year growth in reported and adjusted earnings per share in nine of the last 10 quarters. Our adjusted earnings per share of \$0.91 represented another quarter of more than 20% growth. This sustained earnings growth demonstrates our ability to execute effectively in all parts of the business in a highly competitive environment.

Our consolidated revenue performance was strong with growth accelerating to 5.7%, our highest growth rate in the past six quarters. In Wireless, we had a great quarter of both growth and profitability. 4G device activations were exceptionally strong, resulting in 2.3 million 4G postpaid net adds. Total postpaid net additions topped 1.4 million. Total operating revenue grew 7.5%, with service revenue growth of 5.9% and our EBITDA service margin was 50.3%.

In Wireline, we also had a good quarter, with improved growth and margin expansion. Quarterly operating revenue grew 0.3%, which is a milestone led by consumer growth of 5.3% as we continue to drive FiOS penetration and customer adoption of our Quantum broadband and video products. Wireline EBITDA increased 4.9% and the EBITDA margin improved to 23.2%, up 90 basis points sequentially and 100 basis points year-over-year.

Our cash generation continues to be very strong, enabling us to consistently invest in our networks for future growth and innovation. Free cash flow was \$3.3 billion in the quarter and totaled \$6.3 billion for the first half.

Now let's get into our second-quarter performance in more detail, starting with consolidated results on slide 5. Total operating revenue grew 5.7% in the quarter, continuing our consistent and improving topline growth trend. Revenue increases were once again driven by Wireless and FiOS.

As we indicated last quarter, new revenue streams from machine-to-machine and telematics, while still relatively small, are beginning to emerge and make positive contributions with revenue growth of more than 50% in the quarter.

Our continued focus on driving process improvements and cost efficiencies is also paying off. In the second quarter, adjusted operating income increased 10.4%. To my earlier point about consistent earnings growth, we have also delivered double-digit growth and adjusted operating income

in nine of the last 10 quarters. On an adjusted basis, consolidated EBITDA grew 6.4% to \$11.1 billion. And our EBITDA margin was up 30 basis points to 35.4%.

Let's take a look at our cash flow results on slide 6. As we previously discussed, it is important to note the lack of comparability between the current and prior periods in our statement of cash flows as a result of the transaction to acquire full ownership of Verizon Wireless. 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 half of 2014, cash flows from operations were \$14.8 billion, which included an incremental \$1.2 billion of cash interest payments, \$1.5 billion in cash taxes, and \$800 million of pension funding that we did not have in the first half of 2013. In spite of these additional uses of cash and higher capital spending, free cash flow totaled \$6.3 billion year to date.

Again the key point on cash flows is a simple one. The amount of cash available to us will be significantly greater this year since under the former partnership structure 45% of any excess cash at Wireless would at some point be distributed to Vodafone. So even after higher interest payments and greater cash taxes, we will have more cash available at the corporate level than prior to the transaction.

I would also point out that we received \$2.4 billion in cash proceeds in the quarter from the transaction to sell wireless licenses to T-Mobile. Capital expenditures for the quarter totaled \$4.3 billion and were \$8.5 billion year to date, up about \$900 million or 11.5%.

Wireless capital spending in the second quarter was \$2.8 billion and through the first half totaled \$5.3 billion, well ahead of what we spent through the first half of last year. We are investing to proactively stay ahead of demand. As we've said, our capital investments are focused on adding capacity to optimize our 4G LTE network, primarily by increasing network density and deploying spectrum.

We are actively deploying AWS spectrum across our nationwide footprint and currently have more than 350 markets with AWS or XLTE as we are branding it. The continued deployment of AWS and the addition of small cells, distributed antenna systems, and in-building solutions will fortify our network advantage.

in Wireline, capital expenditures totaled \$1.3 billion in the quarter and \$2.7 billion year to date, which was down \$219 million or 7.4%. Our balance sheet remains strong and we continue to have the financial flexibility to grow the business.

Gross debt of just under \$110 billion was essentially unchanged from the last quarter. Our net debt position improved to about \$104 billion and the net debt to adjusted EBITDA ratio at the end of the quarter was 2.4 times.

Now let's move into a review of the segments, starting with Wireless on slide 7.

Our consistent investment in Wireless is the foundation of our success and drives our leadership and network quality, reliability, and the overall customer experience. Our capital investment strategy is focused on adding capacity to the network to meet increasing 4G device adoption, which will drive higher customer usage.

As I highlighted earlier, we had an exceptional quarter of 4G smartphone and tablet activations, with increases in gross additions and upgrades. We also did an excellent job in terms of customer retention. The increase in device volumes was driven by a combination of factors starting with the compelling value proposition of our new More Everything plans on our high-quality 4G LTE network. As you know, we refreshed our pricing framework and value proposition in the first quarter.

Within these plans, we are providing customers a choice between the traditional two-year service contracts with subsidized devices or Verizon Edge, where customers make monthly installment payments for their devices and receive discounted monthly service pricing.

We are also driving 4G device adoption with attractive tablet offers. Our sales strategy in the second quarter dramatically improved customer growth, which created strong momentum for us as we enter the second half of the year.



Total Wireless revenues grew to \$21.5 billion, up 7.5%. Our service revenues grew 5.9% to \$18.1 billion. This was the first full quarter of discounted service pricing for customers on Verizon Edge. A portion of the sequential decline in the rate of growth was due to the trade-off between lower service revenue and higher monthly equipment billings. The percentage of phone activations by customers choosing Edge increased to about 18% in the quarter, up from about 13% in the first quarter.

In terms of profitability, we generated \$9.1 billion of EBITDA in the quarter, an increase of 6.8%. As I highlighted earlier, our service EBITDA margin was 50.3%, 50 basis points higher than a year ago. The estimated benefit to EBITDA in the quarter from Edge was not significantly different than in the first quarter due to the cumulative impact of service price discounts in the program.

Let's now turn to a more detailed look at Wireless revenue per account beginning on slide 8. Our service revenue growth was once again driven by 4G smartphone and tablet adoption as well as increased data usage. Retail postpaid revenue per account, or ARPA, grew 4.7%, which was down from 6.3% in the first quarter. Again more than half of the decline in the rate of growth resulted from this being the first full quarter of discounted monthly service pricing from Edge. Since ARPA is calculated using service revenue, it does not capture the monthly equipment billings from customers on the Edge program.

In the second quarter, monthly equipment billings totaled about \$180 million, which was significantly higher than the first quarter.

We continue to see good additional device adoption within our customer accounts. We ended the second quarter with an average of 2.8 retail connections per account, an increase of 3.7%. About 55% of our 35.2 million postpaid accounts have subscribed to More Everything share data plans. Increased usage per device and per account continues to drive step-ups to higher data tiers.

Let's take a closer look at connections growth on slide 9. We ended the quarter with 104.6 million total retail connections. Our industry-leading postpaid connections base reached 98.6 million and prepaid totaled just over 6 million. Postpaid gross additions in the quarter were significantly higher both sequentially and year-over-year. Our 4.2 million postpaid gross adds were 18.1% higher than a year ago. In terms of the gross add mix, more than half were smartphones and about 40% were Internet devices, primarily tablets.

Our retail postpaid churn rate of 0.94% was much improved from the first quarter and only 1 basis point higher than the second quarter of last year. As we previously said, postpaid net additions were very strong and totaled 1.441 million, up 900,000 sequentially and about 500,000 from last year.

As I highlighted earlier, our postpaid net additions included 2.3 million new 4G devices. Within that total, more than 1 million were 4G smartphones and 1.2 million were 4G tablets. Postpaid phone net adds totaled a positive 304,000 as the 1 million new 4G smartphones were partially offset by net declines in basic and 3G smartphones.

For the third straight quarter, we had Company record-setting tablet net adds. While 4G smartphones provide the highest value, tablets provided very good incremental value through increased data consumption and lower churn at the account level. Tablets also have a lower cost subsidy than smartphones. We see tablets as a highly profitable growth opportunity with significant headroom in terms of further penetration. Our postpaid tablet base is only 5.4 million, so we have a great opportunity with these devices to generate growth in 2014 and beyond.

Turning now to customer upgrades, our postpaid upgrade rate increased sequentially to 7.1% for the quarter. Once again these were high-quality upgrades. About 90% of all upgrades in the quarter were smartphones. Consistent with our plan to drive 4G smartphone penetration, about 1.4 million or 23% of our smartphone upgrades were from basic phones. About half 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 10 and take a look at device activations and our continued progress in terms of 4G adoption and usage.

Postpaid device activations, which we include both gross adds and upgrades, increased both sequentially and year-over-year. Second-quarter activations totaled 11.1 million, up 10.2%. Smartphone activations totaled 8.3 million, 92% of which were 4G. Our smartphone penetration increased to nearly 75% of our total phones. We ended the quarter with 63.5 million smartphones and about 69% of those were 4G.



So we still have about 20 million 3G smartphones and almost 22 million basic phones in our base, which provides us with a good upgrade opportunity.

Our overall 4G device penetration continues to steadily increase. At the end of the second quarter, nearly 55% of our retail postpaid connections were 4G, up from 33% a year ago. Data and video usage on our network continues to rise. Currently about 76% of total data traffic is carried on the 4G LTE network.

We carry more traffic on our wireless network than any of our competitors. This network advantage continues to be acknowledged by national surveys from widely recognized third-party organizations. More importantly, our own stringent drive-testing shows that we are continuing to improve our network performance.

Let's move next to our Wireline segment, starting with a review of our consumer and mass markets revenue performance on slide 11. In the consumer business, we continue to see positive revenue trends driven by FiOS. In the second quarter, consumer revenue growth was 5.3%, making it eight consecutive quarters of growth in excess of 4%. Mass markets, which include small business, grew 4.2%. FiOS now represents 75% of consumer revenue and we are sustaining strong double-digit revenue growth.

In the second quarter, FiOS consumer revenue grew 13.4%, driven by customer additions, pricing actions, and Quantum penetration. We continue to see strong adoption of Quantum as 55% of our FiOS Internet customers subscribe to the higher speeds ranging from 50 to 500 megabits per second.

We continue to enrich the customer value proposition and drive investment returns by creating new and innovative services on our FiOS platform. We recently introduced FiOS Quantum TV with enhanced features and functionality in terms of storage, recording capabilities, and control of content. While still in the early stages, we are pleased with the initial adoption of this differentiated TV viewing experience by existing and new customers.

In our FiOS markets, we continue to focus on adding quality customers and generating profitable growth in a very competitive market environment. In broadband, we added 139,000 new FiOS Internet customers in the second quarter and now have 6.3 million subscribers representing 40% penetration. Overall, net broadband subscribers in the quarter were a positive 46,000.

In FiOS video, we added 100,000 new subscribers in the quarter so we now have 5.4 million subscribers representing 35% penetration. During the quarter, we also converted about 70,000 customers from copper to fiber. This network initiative continues to be important as we systematically upgrade our network and provide higher quality of service.

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 result in additional recurring revenue.

Let's turn to slide 12 and review our overall Wireline segment revenue and profitability. In the enterprise space, we continue to work through secular and economic challenges. In the second quarter, global enterprise revenue declined \$70 million or 1.9%. Revenue declines in legacy transport services and CPE continue to outweigh growth in newer and more strategic applications, which are smaller in scale.

Strategic services, which include private IP, Ethernet, data center, cloud, security, and managed services grew 3%. In our global wholesale business, quarterly revenues declined \$92 million or 5.5%. While we continue to see healthy demand for Ethernet services, positive growth continues to be more than offset by price compression, technology migration, and other secular challenges.

As I highlighted earlier, total Wireline growth turned positive this quarter. Looking ahead, we expect to continue to see some fluctuations in year-over-year growth rates. We are making progress but are not satisfied. We have much more to do here.

We are focused on continuous improvement, particularly in driving operating efficiencies. Wireline EBITDA increased 4.9% and the EBITDA margin expanded 100 basis points in the quarter to 23.2%. We continue to target increased Wireline EBITDA and margin expansion in 2014.



As Lowell and I have both stated, we continually look for opportunities to streamline the business and monetize nonstrategic assets. To that end, on July 1, we closed a transaction for the sale of a unit within our public sector business with revenues of about \$600 million in 2013, a majority of which was equipment.

Let's move next to our summary slide. As always, the foundation of our success is the steady and consistent investment in networks and platforms. These networks and platforms form the building blocks for the innovative products and services that will fuel our growth and improve the customer experience. Our Wireless and Wireline networks continue to be the hallmark of our brand and provide the fundamental strength upon which we build our competitive advantage.

We had a strong first half of 2014 with consolidated revenue growth of 5.2% and a 36% adjusted EBITDA margin representing 90 basis points of margin expansion. We continue to deliver high quality double-digit earnings growth and we have a much stronger cash position with the full access to Wireless cash flows. We have great confidence heading into the second half of the year and we remain on track to achieve our revenue growth, margin expansion, and capital spending targets for the year.

We have strong momentum in Wireless and expect to build on that strength, driving further penetration of 4G smartphones and tablets, while extending our network leadership position in 4G LTE.

In FiOS, we expect to drive higher penetration in existing markets and continue to differentiate ourselves with the superior Quantum broadband and video product. In the enterprise space, we will continue to aggressively market key platforms, demonstrating that we have a unique set of capabilities to provide for customer solutions.

As always, we will remain extremely focused on profitable revenue growth and will continue to drive network and cost structure improvements, utilizing our Verizon Lean Six Sigma principles.

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

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

Thank you, Fran. David, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Phil Cusick, JPMorgan.

Phil Cusick - JPMorgan - Analyst

Thanks. So one in Wireless and one in Wireline, if I may. Wireless postpaid account growth re-accelerated in 2Q. What do you think drove that rebound in account growth? You said you've had some strong momentum. Can we expect that to continue for the rest of the year? Then in Wireline, revenue was positive for the first time in years and margins improved more than we expected. What should we look for there going forward for both revenue and margins? Thanks.

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

On the account growth, look, I think it was a number of things. I think the key to us right now is I would center around customer choice. We are giving our customers the choice to select what best fits them, whether it's the Edge program or it's the legacy adoption of a subsidy model. As you

can see from a service revenue growth performance, we are really centered around driving the attachment rate of devices, generating more data on the individual network.

So we are attracting customers to our network based on its performance. You can tell that from a customer choice perspective many of our customers selected to stay with the legacy subsidy model. As I said in my prepared remarks, our take rate was only 18% for the quarter. I know I said in the first quarter I expected that to accelerate to 30% with the introduction of indirect channels and the competitive environment. But during the holiday season, we really stuck with our game of giving customers the choice of that Edge program. But we ran a lot of promotions around handsets related to Mother's Day and Father's Day and I think that drove significant traffic to our stores.

So from here you should expect the same thing going into the third quarter that we will continue to address that marketplace.

As far as our base goes, we saw great progress in our base by really reducing the churn and as I said before, we were going to systematically address our base and take care of the customers who were coming out of contract, and we felt that with churn to go somewhere else, we proactively went after those customers and made sure that they were satisfied with their pricing model and with their experience and I think that proved to be the right model for us.

I think we also addressed our basic to smartphone customer base by having a very good quarter this quarter of 1.4 million phones from basic phones up into the 4G smartphone category and also 3G to 4G smartphones. So when you consolidate all of this with the excellent tablet growth quarter we had -- and again I think tablets are extremely good for the industry, not just for Verizon and from an industry perspective, I think everybody will see the same thing that says these tablets are a lower subsidy. They reduce churn in the account level so we see that when someone has a tablet in the account, their churn is lower than the overall churn of the normal customer base. This device drives incremental revenue from an access standpoint.

But more importantly I think and I will give you a data point here, these 4G tablets drive more usage on the network than a 3G smartphone. So when you consolidate that into an account level pricing arrangement, customers buy up because they are using more data. So this is all good and then of course as we mentioned in the beginning from a service revenue perspective and account growth, machine-to-machine is becoming a more important role there.

So I will stop there. I'm sure we will have more questions around Wireless.

From a Wireline perspective, I guess I would put it this way. FiOS continues to be the driver of the Wireline revenue growth, continued to center around our pricing actions on the FiOS platform, continued to innovate and move people into our Quantum broadband, which provides an incremental increase to us. We launched our Quantum TV, which we are very excited with the preliminary results of that into our existing customers and new customers coming to Verizon FiOS.

Then I think also we can't eliminate the copper migrations, because again as we migrate a customer, after we migrate them, there is a very good sell up opportunity within FiOS, and we see that those customers' ARPU increased significantly moving from copper technology over to fiber technology. So again, I think that really fueled the Wireline growth.

As far as the actual increase in revenue, I don't want to discount this because it is a landmark for quite some time but I think we had a lot of good things happen this quarter. We saw better performance in the enterprise space and especially within the wholesale space but I would also caution that some of this was one time. Both with Ethernet connection and fiber to the cell programs when we have strong volumes, which we did in the second quarter, there is a nonrecurring charge that comes with those and that fueled some of the one-time gains here. I expect some of this to carry to third quarter.

But as we said at the beginning of the quarter, you should view the Wireline revenue growth as more of a flat year this year and I think that going from a 0.4 decrease last quarter to a 0.3 increase this quarter I think you will see us fluctuate between those two for the remainder of the year.

So, Phil, I will stop there. Thanks for the question.



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

David, let's take the next question, please.

Operator

Michael Rollins, Citi Investment Research.

Michael Rollins - Citigroup - Analyst

Thanks, good morning, Fran. If I could just ask a couple questions. First on the Wireless side, with respect to phone adds, should that follow some of the historical -- I guess you call it seasonality that you've seen in the past where I think last year you talked about increasing add performance as you moved through each quarter?

On the strategic side, could you talk about maybe what else Verizon could consider from an asset optimization perspective? Maybe just an update on how things like VDMS and connected car are doing? Thanks.

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

Thanks, Michael. On the phone net adds, obviously again as I said, we came out strong during the marketing periods of Mother's Day and Father's Day and normally the second quarter is always better than the first quarter. I think that through this year of obviously for the back half of this year, we are going to have several dynamic devices come to market that will certainly fuel for the industry a lot of opportunity for growth here. So I think from our perspective, we will stay to our game plan. I'm not going to predict at this point what net adds will be from a phone net add for the third quarter that has a lot around the competitive environment and customer base. But I would anticipate that you will see strong performance from Verizon Wireless.

As far as our other strategic areas, so Verizon Digital Media Services launched their commercial service this year. We have a number of customers who are under contract and we are actually starting to generate revenue off of that platform. It's early stages here. There's a lot of opportunity within that platform and we will continue to move on that strategy.

As far as telematics goes, this goes into our machine-to-machine category and as I said in my prepared remarks here, I will tell you this was one of the highest connection quarters we had from a machine-to-machine on a companywide basis, which would include Verizon Wireless, Hughes Telematics, and some of our enterprise customers. That fueled that 50% year-over-year growth. So machine-to-machine continues to be a critical component.

I would also tell you if you have had a chance to visit one of our destination stores with Verizon Wireless, you immediately walk in the store and you can visually see all of the technology around gaming and music and fitness that can be connected to our network. These things are being sold quite substantially on a quarterly basis through our Verizon Wireless distribution stores.

So again, this is a very important category I think not only for us but for the industry and as we have continually said, we believe that machine-to-machine will be a future growth engine for us for years to come and that is consistent with our strategy.

Operator

Simon Flannery, Morgan Stanley.



Simon Flannery - Morgan Stanley - Analyst

Thanks very much, good morning. Fran, you talked about the strong cash flow in the quarter. It looks like there's some opportunity potentially for bonus depreciation to be extended again. You had \$6 billion of cash on the balance sheet here. It looks like you are doing some refis on your balance sheet. Can you just talk about your overall financial strategy, look at an opportunity here to delever a little bit more to refi, but there's also spectrum auctions coming in, and how that all plays into dividend policy? Given the 20% plus EPS growth, is there an opportunity here despite the leverage to maybe see faster dividend growth? Thanks.

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

Thanks, Simon. On the cash flow, yes, obviously we have some significantly strong cash flow here and obviously we said that at the onset of acquiring Verizon Wireless, that we would get 100% ownership of those cash flows. As I said at the beginning of this year, look, the strategy right now for us is to build cash on the balance sheet, to prepare for the AWS auction that's coming in November and that is the strategic initiative we had moving into this year.

So we have gross debt at about the same level. Now that has -- came down from a high of \$114 billion when we closed the Vodafone transaction. That's at \$110 billion but you see us accumulating that cash on the balance sheet to prepare for the auction.

As far as the overall refinancing of long-term debt here, you have seen us be very proactive in the marketplace, taking the opportunity of the low interest rate market, repositioning the debt that we borrowed at the close and repositioning our towers so we are strategically trying to push out the long-term debt longer at a more fixed, lower rate than we had and we will continue to work those towers into the future.

I really won't talk about our future plans at this point. It would be inappropriate to do that.

As far as bonus depreciation goes, look, I am optimistic but I am not, because here we sit in July. There's not much activity moving around this. There's many things that the government has to deal with including the Highway Bill that is pertinent to us because of pension smoothing that's included in that bill. There's also the Internet Freedom Act that has to get passed or else consumers are going to be detrimented here at the end of this year. Then of course we have the overall tax reform and bonus depreciation.

So look, I think we will have to wait to see but as the year runs out, bonus depreciation becomes less and less impactful. So we are hopeful that the government will do the right thing here to stimulate the economy and investment around this, but it's hard for me to predict that. So at this point we are not counting on any decrease in our Federal tax payment because of bonus depreciation. As I said at the beginning of the year, this was about \$1 billion of incremental tax impact to us by not having that bonus depreciation.

As far as dividend policy goes, look I think both Lowell and I have reiterated that we understand the dividend policy is important. Our Board of Directors understands the dividend policy is important. But it is a Board of Director decision, so I can't sit here today and tell you what that policy will be, but we do understand it's important and I think we have reflected our Board has been very aggressive in our dividend policy over the last seven years and so I think that should set the stage for the future.

Operator

David Barden, Bank of America.

David Barden - BofA Merrill Lynch - Analyst

Good morning, thanks for taking the question. I guess two if I could, just first, Fran, obviously there's a lot of focus on the Wireless service margin this quarter. From the comments last quarter that there was an expectation that we were going to get a huge increase in the installment payment plan take rate, there was an equivalent expectation that we were going to get a lot of upfront revenue recognition and that would have helped



the margins a lot. But that obviously didn't really take place. At 18% take rate, that probably gave you a couple hundred million dollars relative to Street expectations.

You said that the installment payment plan impact was about the same this quarter as last quarter but it was net of the service price discounts. Could you parse that out between the impact that you took from a cash perspective of giving lower prices versus the revenue benefit noncash that you got from the upfront accounting-related issues that go into the installment payment plan?

I guess the second question would be more of a strategic one. I know you guys have been working on video and pushing video through the wireless network from a TV Anywhere perspective, buying content, partnering with people through the last couple of years. Could you talk a little bit about with the talk now of consolidation in the content environment how your strategy is unfolding, how you are working to try to bring video content into the wireless environment so you can monetize it over the 4G network? Thanks.

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

Thanks, David. Look, on the service margin I think here's the way I would answer this is that we produced a 50.3% margin on extremely high volume growth under a subsidy model. And I think that's the key for this quarter. So we really didn't get much benefit from the Edge program because the take rate was only 18%. We said that the billings around Edge were \$180 million so you can do the backwards math there. But if you look at the actual EBITDA impact of Edge I said was similar to the first quarter, as far as the pricing refresh that we did in the first quarter to respond to the competitive environment, again there is some impact there from dilution on customers that are moving and that we are as I said, addressing from a churn perspective. But this is all good for us because we maintain those customers on an appropriate plan. They stay with Verizon Wireless. They are adding tablets. They are increasing their ARPU again.

So the way I would venture to say on this one without getting into too much math on service revenue pricing and so forth, if you take the \$180 million and add that to the ARPA, I think you come up with a number that's significantly higher than the 4.7% from a recurring revenue standpoint, if you will. So I think from a 50.3% quarter based on the growth that we had on a subsidy model, I think it's just an outstanding quarter for us from an overall profitability on Verizon Wireless. So I will stand on that one and leave it at that.

As far as content goes, look, I think we have demonstrated through our NFL agreement, some of our IndyCar agreements, and some other agreements that we have around some sporting networks that we will continue to search for those opportunities that make content available to our Wireless customers without a linear TV or satellite TV subscription. And I think that is important for the wireless user. As we see more and more of the younger generation are cutting the cord on their home and want their content either via the Internet or Wireless. That is the strategy that we hold.

If you are asking we do we need to own the content, we continue to position ourselves that we believe we do not need to own content to be successful in this ecosystem, that we just need to get the rights for that content. We understand that content providers want to be paid for those rights and as long as that is a workable commercial model for us, then we will continue on that strategy.

I would also highlight that one of the big things here that's coming to market is of course multicast, which will really enhance the experience for our customers around watching video and also extremely efficient for the wireless industry to provide that video through their network without consuming a lot of spectrum and a lot of capacity.

So we will start to embed chips in our handsets here at the back half of this year. The network will be ready by the end of the third quarter to actually launch multicast. We won't go commercial with that until 2015 but the network will be ready and it's a matter of getting the handsets in customers' hands and then obviously getting the content, which we demonstrated with the Super Bowl this past January for those types of events that we think will be very, very -- really consumed by the consumer on real-time live-type events.

So more to come around the whole video strategy of Wireless, but I think the breakthrough point here will be once multicast technology is up and running and launched.



Operator

John Hodulik, UBS.

John Hodulik - UBS - Analyst

Great. Thanks, guys. Fran, can you give us a sense of what percentage of your postpaid base takes a 10 gigabyte or larger bucket and maybe how that has changed over time? Just trying to get a sense of the upside as you sell more tablets into the base.

And then on the Wireline side, it's more of a follow-up. You saw 100 basis points year-over-year improvement in margins. But you did talk about some one-timers that drove the revenues. Did that also affect the margins or is this 100 basis point improvement sort of a good run rate for what we can expect for the second half of the year? Thanks.

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

First on the 10 gigabyte plan, we don't disclose where our customers sit within the bands, but what I will tell you is that we have quarter-to-quarter over the last three quarters seen an increase in the amount of customers taking the 10 gigabyte plan and pricing up. So we watch on a quarterly basis the number of customers that buy down in data bundles and buy up in data bundles. And over the last several quarters we have had a significant net positive in buying up in data bundles.

So from that perspective, the takeaway will be is that we continue to see an increase in customers buying up in their data bundles and that includes the 10 gigabyte plan.

As far as the Wireline margin, look, we have said from the very beginning of this year, Lowell and I were very opportunistic on increasing the Wireline margin. Now some of this is seasonality. Second quarter is always good. Third quarter tends to have some seasonality into it. But look overall, I think you should see that we are moving the Wireline business in the right direction from a profitability standpoint. And there are a lot of things that we still need to work on. Obviously as I said, FiOS is the big driver on the topline. Copper migrations continues to be an important strategic initiative for us.

But I don't want to downplay the fact that our VLSS, we've been at this for two years and we are now starting to see the benefits of a lot of these projects around efficiencies and cost-cutting starting to come through. So again, that is part of this. You should see us improve our productivity especially around the new Quantum TV, where we can put a media server into the home and start to get some real efficiencies on the install process and we think that will happen entering in 2015. So again, I think that is part of it.

The other thing too is we can't lose sight of the fact that we continue to look at this portfolio and as I said in my prepared remarks, we did divest of a branch of our public sector business, which was about \$600 million in revenue last year. So that will -- you will see the impact of that going into the third quarter. So we will lose that revenue in third quarter, so that's going to show up in our public sector business.

But from an overall margin standpoint, that's going to help the profitability of this Company. This is again looking at nonstrategic businesses that are what I would say is not our niche in the business and we need to divest of them. Lowell and I continue to look at things that we can divest of that are best for overall shareholder value and we will continue with that.

Operator

Mike McCormack, Jefferies.

Mike McCormack - *Jefferies & Company - Analyst*

Fran, just thinking about the net add numbers, the 2.3 million 4G LTE postpaid versus the 1.4 overall, could you just sort of map us through what you are seeing as far as basic and feature phone sub losses or migration? You talked about migrations but just what you're seeing just from a pressure standpoint from competitors.

Then secondly on FiOS, I know you've targeted MDUs more recently. What you are seeing with respect to changing video behaviors among that youth demographic and maybe just a comment on what kind of returns you guys get on a broadband-only sub? Thanks.

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

Let me start with the MDU side. From an MDU perspective, look, this continues to be one of our strongest penetration gains. And as I've said before, New York City is still our lowest penetrated market but it is our highest year-over-year gain. A lot of this has to do with MDUs but this is a challenging business because the average tenant of an MDU in New York I think the last time I looked was eight months. So these units change and of course the strategy, part of this strategy is to accumulate the new residents coming in to continue to use the FiOS demand. But obviously within this younger generation, a year ago we tested the ability to have them select whether they wanted large TV bundles and lower Internet speeds or high Internet speeds and lower TV bundles, and what we saw is the majority of these said -- this segment selected the highest speed that they could get and didn't really care about how many TV stations they got because most of them are consuming their video via the Internet.

So again, this is just another position for us of why we have gone to symmetry within our broadband offers. We just launched that this week so you will see that hitting the consumer market with symmetry on all of our broadband offers. We launched it six months ago in our small business segment. So this is again another strategy which we think is important for that generation who really wants the highest speed that they can get and they want the symmetry in that speed. So that will continue to be an overall concentration for us.

As far as the handsets and all, look, I think that you can probably do the backwards math here. We said that we added 2.3 million 4G LTE phones overall. We said that we had 1 million 4G smartphones net adds for the quarter. So with a 304,000 net number, the majority of those losses were basic phones and then the rest were made up with 3G. So again, you can see that the basic phone category or I would consider this the lower end phone category continues to be the category that we lose. But I will say that we made substantial improvement from what we saw in the first quarter with all of the pricing actions, the retention tools that we put in place and some of the new pricing tools that we put in place. So overall, I think we significantly improved and that came through in the operating results of Verizon Wireless.

Mike McCormack - *Jefferies & Company - Analyst*

Fran, just a quickie on the EIP. Could you just give us a sense for how that paced through the quarter? Was it accelerating throughout? And then what should we think about for the full year on the EIP uptake? What's your expectation?

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

I think I would put it this way. What I saw was in our store channel it was pretty much relatively flat. The increase came through the indirect channel when we launched that. Right now I would say that I think one important piece of information here as well is that on the front line, our sales representatives make the same compensation whether they sell an Edge plan or legacy subsidy model. So there was no difference in their compensation. So again, this comes down to the important ingredient that this is truly a customer choice. The rep shows them both models and the customer chooses.

So as far as going forward, look, I think that we are on pace to be somewhere between this 18% to 20%. But again when you think about the new -- all of the new phones that are coming in the back half of the year through the indirect channel, this could escalate a bit on us. The competitive environment has a lot to do with this but right now under current course and current environment, I think that the 18% to 20% is really where we sit.



Operator

Kevin Smithen, Macquarie.

Kevin Smithen - *Macquarie Research Equities - Analyst*

Thanks. With Edge adoption at just 18%, fall and year-over-year ARPU seems to imply a repricing of non-Edge base. I think you said you had some churn mitigation promotions in the quarter. Could you talk a little bit about that and also where do you expect year-over-year ARPA to stabilize?

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

I think, Kevin, as I said at the beginning, I think you have to do a little bit of backwards math here because the Edge plan if you take that \$180 million billing number that I gave you and you look at ARPA, I think what you will see is if you calculate back in the recurring monthly equipment revenue, which in essence would've been service revenue, I think your percentage increase would be relatively flat with the first quarter and some past quarters.

So again, I think that the service revenue impact and the ARPA impact is really Edge-related. Now there is some of course service pricing discounts in there and we are moving as we said proactively some of our customers who are out of contract and we think that they have a high propensity to churn. We are proactively moving them to the Edge pricing but we are doing it very, very systematically and so there will be a little bit of pressure there. But I think if you do that backwards math that I gave you, I think you will get to the true numbers of what the ARPA growth would have been with this recurring equipment revenue in it.

Kevin Smithen - *Macquarie Research Equities - Analyst*

How should we think about the AWS refinancing? Will this be an additional capital raise or funded out of cash on hand? How should we think about your sort of leverage targets with the spectrum auction? It sounds like you want to be very aggressive with that.

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

I think the way you want to think about this is it is an auction so I'm not going to talk about how we think we are going to pay for that auction because I'm not going to give anybody information of how much I'm willing to spend for the auction. So I think we will just wait there. As I said the strategy is to build cash, prepare for the auction and we will execute accordingly. So more to come on that in the latter back of the year.

Operator

Jonathan Schildkraut, Evercore.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Great, thanks. Two if I may. First, just in terms of the outlook on the topline for the remainder of the year, you guys have had a very strong first half of the year, up almost 6% revenue growth year-over-year in the second quarter and the outlook for the year is only about 4%. I'm wondering if that is just a conservative stance at this point in the year or if there's something that we should look out for in particular as we examine our back half of the year projections?

Then yet another question around EIP. I was wondering if we could get a sense as to where the receivable currently stood or maybe the change in receivable quarter over quarter? Thanks.

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

Sure. Thanks, Jonathan. On the 4%, being the CFO, we generally are conservative so I will stick to the guidance that we gave at the beginning of the year with topline growth of 4% plus. So I will stick to that.

As far as the balance sheet goes, if you look at our balance sheet, the change in the AR is directly related to the Edge program so you can look at that change and pretty much come to your answer.

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

Last question.

Operator

Jennifer Fritzsche, Wells Fargo.

Jennifer Fritzsche - *Wells Fargo Securities - Analyst*

Great, thank you for taking the question. Fran, you mentioned a lot about the AWS-3 auction. I know there's a lot of complications and a lot of blurriness around it but I have not heard you talk openly about the broadcaster incentive auction. Your closest peer obviously made a big monetary number or put a big monetary number with that. And I just was wondering your current thoughts as you stand here today.

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

Thanks, Jennifer. Look, we are focused on the AWS-3 auction and the reason we are focused on that is it will start November 13. Deposits will be required. We actually know exactly what the rules are. The procedures for that auction will be announced sometime in the next coming weeks. So that is really the focal point for us.

As far as the broadcast spectrum goes, look, currently there are no final adopted rules on this, so it's hard for us to sit here and make a comment on something that has not been finalized. So I think that would be premature for us. I know what others have done. But look, we are focused on AWS. We will get through that, we will see what the broadcast spectrum final rules are and then you will hear more from us when that happens. But at this point I'm not going to make any more comments around the broadcast.

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

That is all the time we have for questions today but before we end the call, I would like to turn it back over to Fran.

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

Thanks, Mike. Just a couple quick closing comments. So look, we had an extremely strong first half of 2014 in terms of our volume growth and financial performance. Importantly we closed the Vodafone transaction and now have sole ownership of the Wireless asset.

Through the first half of this year, we have exceeded our revenue growth targets and delivered strong earnings growth. We have great momentum heading into the second half and we are competing well in all of our key strategic areas.

Our cash generation is very strong and we have great confidence in our ability to execute on our strategy and grow this business profitably while making the necessary capital investments to position us for the future. We are excited about our growth opportunities and we will continue to invest, innovate, and deliver for our customers, our shareholders, and our employees.

Thank you so much for joining us today and have a great day.

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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