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VZ - Q3 2014 Verizon Earnings Conference Call

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OVERVIEW:

VZ reported YTD adjusted EPS of $2.65 and 3Q14 EPS of $0.89. Expects 2014 consolidated revenue growth to be 4%.

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PRESENTATION

Operator

Good morning and welcome to the Verizon third-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, IR*

Thanks, David. Good morning and welcome to our third-quarter earnings conference call. This is Mike Stefanski, and I'm here with Fran Shammo, our Chief Financial Officer.

As a reminder, 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 also be made available on our website.

Before we get started, I'd like to draw your attention to our safe harbor statement on slide 2. Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risks and uncertainties. Discussion of factors that may affect future results is contained in Verizon's filings with the SEC, which are available on our website.

This presentation contains certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are included in the financial materials we have posted to our website.

The quarterly growth rates disclosed in this presentation are on a year-over-year basis unless otherwise noted as sequential. In terms of our financial results, I will point out that there were no special items included in our reported earnings for the third quarter of 2014.

Earnings per share of $0.89 compares with adjusted earnings of $0.77 per share in the third quarter of last year, an increase of 15.6%. On a year-to-date basis, adjusted earnings per share of $2.65 were up 21.6%. Keep in mind that the $2.65 per share year-to-date result in 2014 does not reflect full ownership of Verizon Wireless from the beginning of the year, since the transaction closed on February 21. As previously noted, full ownership from January 1 to the date of closing would have represented an additional $0.07 of earnings per share in the first quarter.

For purposes of comparability in the Wireline segment, the historical results of the business within the public sector that we sold on July 1 have been reclassified for all periods prior to the sale. These results, which previously were part of global enterprise, have been moved to corporate and other, consistent with how we have dealt with divested operations in the past. You can access this reclassified historical information on our website.

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

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

Thanks, Mike. Good morning, everyone. Our third-quarter results demonstrate the consistency of our performance and our ability to compete effectively and deliver strong operating and financial results. We entered the year with great confidence in our ability to generate strong financial performance in 2014, and our conviction has not changed.

We believe that steady and consistent investments in networks and platforms will drive innovative products and services and fuel our growth. Our Wireless and Wireline networks will continue to be the hallmark of our brand and provide the fundamental strength upon which we build our competitive advantage.

The overall industry is very healthy, and we continue to see strong customer demand for wireless and broadband services. The US market has set the pace for global broadband infrastructure investments. In wireless, all four national service providers are investing in 4G networks, resulting in continued innovation, 4G device adoption, and increasing customer usage.

Our competitive position is strong, and we are focused on executing our strategy of providing a compelling value proposition and a great customer experience on the best, most reliable network.

In the third quarter, we produced very strong customer growth in wireless and FiOS, and sustained our strong growth trends in terms of revenue and earnings. We pride ourselves on being an "and" company, delivering quality growth and profitability. We continue to stand apart from our peers with very consistent, high-quality earnings results. We have posted double-digit year-over-year growth in reported and adjusted earnings and earnings per share in 10 of the last 11 quarters.

In Wireless, we had a very strong quarter of high-quality connections growth and profitability. Retail postpaid device activations of 11.7 million were up 14.9%. This is higher volume than the fourth quarter last year when we activated 11.5 million devices. Retail postpaid net adds totaled 1.5 million, up 63.5% from last year. Year-to-date, postpaid net adds of 3.5 million were up 37.4%, which is roughly 1 million more than a year ago.

Our Wireless EBITDA service margin was 49.5%. This is a very strong result, given the volume of device activations and the relatively low percentage of customers choosing the Edge program in the quarter. In Wireline, we had a strong quarter in FiOS, with 162,000 Internet and 114,000 video net subscriber additions.

Consumer revenues grew 4.5%, as we continue to drive FiOS penetration and customer adoption of our Quantum broadband and video products. Our Wireline EBITDA margin remains stable at 23%.

Our strong cash generation enables us to consistently invest in our networks for future growth and return value to our shareholders. Through the first nine months of 2014, we have invested $12.6 billion of capital and paid $5.7 billion in dividends.

In early September, we were pleased to announce that our Board of Directors approved a 3.8% dividend increase which raises our annual dividend to $2.20 per share. This is the eighth consecutive year that our Board has approved a quarterly dividend increase, and the highest percent increase since 2008.

Now let's get into the third-quarter performance in more detail, starting with the consolidated results on slide 4. On a reported basis, total operating revenue grew 4.3% in the third quarter. If we exclude the revenues of the public-sector business we divested from the prior periods, the comparable growth rate would have been 4.9% for the third quarter and 5.2% year-to-date. Our consolidated top-line growth continues to be driven primarily by wireless and FiOS.

In addition to top-line growth, we continue to focus on driving process improvements and cost efficiencies through our Verizon Lean Six Sigma program. Consolidated EBITDA was $11.1 billion in the quarter, and our EBITDA margin was 35%.

Let's take a look at our cash flow results on slide 5. As I have noted in prior quarters, it is important to remember that the transaction to acquire full ownership of Verizon Wireless created a lack of comparability between the current and prior periods in our statement of cash flows.

Through the first nine months of 2014, cash flows from operations were $23.2 billion. Additional cash outlays this year included $2.5 billion of incremental cash interest payments and higher cash income taxes of $3.2 billion.

In addition, we had $1.5 billion in pension contributions that we did not make in 2013. In spite of these additional cash outlays and higher capital spending, free cash flow totaled $10.5 billion through the end of September.

Capital expenditures for the quarter totaled $4.1 billion and were $12.6 billion year-to-date, up $817 million or 6.9%. We project that capital spending will be around $17 billion for the full year. Our deployment of capital in Wireless has been very consistent throughout the first three quarters of this year.

In the third quarter, Wireless CapEx was $2.5 billion, and through nine months totaled $7.8 billion. We are deploying capital to proactively stay ahead of demand, and our capital investments continue to focus on adding capacity to optimize our 4G LTE network, primarily by increasing network density and deploying spectrum.

We have been actively deploying AWS spectrum across our nationwide footprint and currently have more than 400 markets with AWS, or XLTE, as we've branded it. Our continued deployment of spectrum, along with investments in small cells, distributed antenna systems and in-building solutions will allow us to build upon our network advantage.

In Wireline, capital expenditures totaled $1.5 billion in the quarter and $4.2 billion year-to-date, down $273 million or 6.1%. Our balance sheet remains strong, and we continue to have the financial flexibility to grow the business and pursue our strategic goals.

Gross debt of $109.2 billion was down about $750 million from last quarter. Our net debt position improved to $102 billion, and the net debt to adjusted EBITDA ratio at the end of the quarter was 2.3 times.

Now let's move into the review of the segments, starting with Wireless on slide 6. Our Wireless strategy is built on making consistent network investments and providing a compelling value proposition to our customers. This value proposition includes customer choice and an excellent service experience on the nation's most reliable network.

Our investment strategy is focused on adding capacity to our network to meet increasing demand, which is driven by 4G device adoption and higher customer usage. Growth in Wireless revenue and profitability continues to be driven by our high-quality retail postpaid customer base, where we continue to see very strong 4G device adoption.

As I highlighted earlier, we had another exceptional quarter of smartphone and tablet activations. Customer demand on our network continues to increase at a rapid pace. Our recently announced promotional pricing is designed to provide even greater appeal to our More Everything Plans, which we believe will drive more 4G device adoption and stimulate incremental usage on our more efficient LTE network.

We expect that continued success in driving 4G device activations in the fourth quarter will create profitable growth for us as we enter 2015 and beyond.

Total Wireless revenues in the quarter grew to $21.8 billion, up 7%. Service revenues grew 4.8%, driven by 4G LTE connections growth and higher usage on our network. The declining rate of service revenue growth is attributable to device mix, price changes, and the trade-off between lower service revenue and higher monthly equipment billings for customers on Verizon Edge.

In the third quarter, the percentage of phone activations by customers choosing Edge program was approximately 12%, which was down from about 18% in the second quarter. Based on recent promotional pricing for Edge, the percentage of phone activations taking the installment plan option could more than double in the fourth quarter.

In terms of profitability, we generated $9.1 billion of EBITDA in the quarter, and our service EBITDA margin was 49.5%. The EBITDA benefit in the quarter from the Edge program was approximately $115 million.

Let's now turn to a more detailed look at Wireless revenue per account, beginning on slide 7. Retail postpaid revenue per account, or ARPA, grew 3.5% in the quarter. Growth in ARPA is a function of device adoption, account growth, and increased usage. The continued rapid pace of 4G device adoption is improving the quality of our customer accounts.

In the third quarter, we added 4.4 million 4G smartphones and 1.1 million 4G tablets to our postpaid connections base. All of the important account metrics are improving. We ended the quarter with a total of 35.4 million postpaid accounts, and the number of postpaid connections per account was 2.82, which is an increase of 3.7%. 57% of our accounts are on More Everything shared data plans. The average data usage in More Everything accounts has increased nearly 50% year-over-year.

I would also point out that since the ARPA metric is calculated using service revenue, it does not capture the monthly equipment billings from customers on the Edge program. In the third quarter, these monthly equipment billings totaled about $285 million and were approximately $533 million year-to-date.

Let's take a closer look at connections growth on slide 8. We ended the quarter with 106.2 million total retail connections. Our industry-leading postpaid connections base topped the 100 million mark at 100.1 million, and our prepaid connections totaled 6.1 million. In passing the 100 million postpaid connections milestone, it is worth noting that we have added more than 20 million new connections since 2009, representing a compound annual growth rate of around 5%.

Postpaid gross adds totaled 4.5 million in the quarter, up from 4.2 million in the second quarter and 3.7 million a year ago. Year-to-date, postpaid gross adds were up 15.1%. In terms of the gross add mix in the third quarter, 54% were smartphones and about 36% were connected devices, primarily tablets. Most of the remaining gross adds were basic phones.

Our retail postpaid churn rate of 1% was 3 basis points higher than the third quarter of last year. As I highlighted earlier, retail postpaid net adds in the quarter totaled 1.5 million, compared with 1.4 million in the second quarter and 927,000 a year ago.

Our postpaid net adds mix in the quarter included 2.3 million new 4G devices. Within that total, 1.2 million were 4G smartphones and 1.1 million were 4G tablets. Postpaid phone net adds totaled 457,000, which is comparable to 481,000 in the third quarter last year.

Within the postpaid phone category, the 1.2 million new 4G smartphone adds were partially offset by net declines in basic and 3G smartphones.

Tablet net adds were more than 1 million for the second consecutive quarter. Tablets provide good growth through increased data consumption, lower churn at the account level, and have a lower cost subsidy than smartphones. We have significant headroom in terms of further penetration as our postpaid tablet base was 6.5 million at the end of the quarter. Further customer adoption of tablets clearly represents an incremental growth opportunity for us.

Our postpaid upgrade rate was 7.2% in the third quarter. Once again, these were high-quality smartphone upgrades either from a basic phone, 3G to 4G, or 4G to a newer 4G smartphone. About 1.2 million or 18% of smartphone upgrades this quarter were from basic phones.

Nearly 50% of the remaining smartphone upgrades were 3G to 4G, which we monetize through higher data usage and lower cost to serve. You will recall that in the fourth quarter of 2012, we activated 3.1 million 3G iPhones, as it was the first time we offered a free Apple device to customers signing a new two-year contract.

A majority of these customers will be coming off contract this quarter, providing us with a unique opportunity to drive 4G smartphone adoption. Almost all of our retail connections growth in 2014 have been postpaid.

Through the first nine months, prepaid net adds were only 5,000 compared with 274,000 in 2013. We believe that price-sensitive prepaid customers are moving to the postpaid market.

Next let's turn to slide 9 and take a look at device activations and our continued progress in driving 4G adoption and usage. As I have highlighted, postpaid device activations were very strong at 11.7 million. During the quarter, we activated 8.9 million smartphones and 1.3 million tablets.

Our smartphone penetration at the end of the quarter increased to 77% of total phones. We have 65.4 million smartphones in total, and 48.2 million of them are 4G. A year ago we had 29 million 4G smartphones, so we have made significant progress in driving 4G penetration. And yet, we still have a significant opportunity in front of us, with more than 17 million 3G smartphones and 20 million basic phones in our connections base.

Beyond smartphones, tablets and other Internet devices are contributing to our overall 4G device penetration. At the end of the third quarter, more than 59% of our retail postpaid connections were 4G, up from 38% a year ago.

Data and video usage on our network continues to rise. Currently, about 79% of our total data traffic is carried on the 4G LTE network. As we handle this increased demand, our network continues to be acknowledged as the performance leader in national studies conducted by widely-recognized third-party organizations. We have raised our own network standards, and our performance continues to get better.

Let's move next to our Wireline segment, starting with a review of our consumer and mass markets revenue performance on slide 10. In the consumer business, we continue to see positive revenue trends driven by FiOS. In the third quarter, consumer revenue growth was 4.5%, making it 9 consecutive quarters of growth in excess of 4%. Mass markets, which includes small business, grew 3.2%. FiOS now represents 76% of consumer revenue, and we are sustaining strong double-digit revenue growth.

In the third quarter, FiOS consumer revenue grew 12.3%, driven by customer additions, pricing actions, and Quantum penetration. Strong adoption of Quantum continued, as 57% of our FiOS Internet customer subscribed 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. In the second quarter, we introduced FiOS Quantum TV with enhanced features and functionality in terms of storage, recording capabilities, and control of content.

In July we introduced speed match, a service upgrade that increases customer upload speeds to match their download speeds. This competitive advantage provides FiOS customers with faster and more consistent upload speeds, which is compelling for social media and gaming activities. Our focus in FiOS markets is to drive higher penetration by adding quality customers, generating profitable growth in a very competitive market, and improving our overall investment returns.

In broadband, we added 162,000 net FiOS Internet customers in the quarter and now have 6.5 million subscribers, representing 40.6% penetration. Overall, net broadband subscribers in the third quarter were up positive 69,000, up more than 23%. In FiOS video, we added 114,000 new subscribers, so we now have 5.5 million subscribers, representing 35.5% penetration.

During the quarter, we converted 55,000 customers from copper to fiber, bringing our year-to-date total to around 200,000. This network evolution initiative is enabling us to systematically upgrade the network and provide higher quality of service to customers. 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 11 and cover the enterprise and wholesale business. In the enterprise space, we continue to work through secular and economic challenges. In the third quarter, global enterprise revenue declined $155 million or 4.4%. 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 totaled $2.1 billion and grew 1%. This category as currently defined includes both the IP layer and applications such as data center cloud security and managed and professional services. Revenue from services in the IP layer have been impacted by competitive price compression, which is offsetting growth in application services.

In our global wholesale business, quarterly revenues declined $79 million or 4.8%. Healthy demand for Ethernet services in each of the last two quarters has offset a larger portion than expected of the revenue declines from price compression, technology migration, and other secular challenges.

In the third quarter, Wireline operating expenses declined 1.7% and our EBITDA margin was 23%. As we said, we are making progress but are not satisfied. We have more work to do in order to drive improved profitability in this segment. On a year-to-date basis, the Wireline EBITDA margin was up 60 basis points to 23%.

From an overall segment perspective, our strategy is to continue scaling our FiOS business and improve the enterprise revenue mix by driving growth in the newer strategic services like cloud and security. In addition, we believe that process improvements and retooling efforts using Verizon Lean Six Sigma principles will improve our cost structure and drive operating efficiencies, resulting in a stronger Wireline business.

Let's move next to our summary slide. With three-quarters of 2014 behind us, our financial performance has been strong. We continue to deliver high-quality, double-digit earnings growth and our cash generation is strong, enhanced by full access to all the Wireless cash flows.

These cash flows have allowed us to consistently invest in our networks and platforms for future growth and innovation. In addition, we returned value to shareholders with a 3.8% dividend increase.

We have a strong market position, and that has demonstrated ability to compete effectively and execute our strategy. Our high-quality customer base and Wireless and Wireline networks continue to be the hallmark of our brand, and provide the fundamental strength upon which we will build our competitive advantage.

We are also building for the future through our global platforms in video delivery and machine to machine. New revenue streams from machine to machine and telematics are beginning to emerge. In the third quarter, these revenues were approximately $150 million and totaled more than $400 million through nine months, an increase of more than 40% year-to-date.

Our strong volume growth in both Wireless and FiOS give us great confidence heading into the fourth quarter. We continue to target consolidated revenue growth of 4% in 2014. For the full year, our consolidated adjusted EBITDA margin, as well as the Wireless EBITDA service margin results, will be dependent on fourth-quarter volumes and Edge installment plan take rates. The Wireline EBITDA margin remains on track to expand on a full-year basis.

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. Before taking questions, I would like to remind everyone that we filed an application to participate in the AWS-3 spectrum auction. As a result, due to the FCC's rules, we cannot answer any questions related to the auction or AWS-3 spectrum.

David, we are now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) David Barden, Bank of America.

David Barden - *BofA Merrill Lynch - Analyst*

Thanks for taking the question. So two if I could. First, I was wondering if you guys could just talk a little bit in light of Lowell's comments in the briefing about his conviction level, confidence level about 4Q, about the cadence of competition and how you felt you had to respond over the course of the quarter.

Obviously, things started off fairly stable, and then we had the T-Mobile promotion followed by the Sprint promotion, followed by incremental actions in terms of double data and things like that. So if you could kind of give us a sense as to how the quarter trended and what you are seeing that is giving you the confidence for the rest of the fourth quarter, it would be helpful.

Then second, Fran, I think that we've got a pretty good understanding that smartphone customers have been generating roughly double the value of feature phone customers. You are referencing the 4G smartphone opportunity as being something incremental to the 3G smartphone opportunity. If you could put some numbers around that, that would be super helpful. Thank you so much.

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

Great. Thanks, David. So look, on the competitive front, I think that the takeaway here is that we produced an extremely strong quarter from a growth perspective, and I anticipate you're going to see that across the industry. If you look at, as I said, we see a shift from prepaid to postpaid.

Not necessarily within our base because of the high-quality and strict requirements we have from a credit perspective, but there's still a lot of growth out there. If you look at just the industry itself, you take tablets, you take the video consumption, you look at machine-to-machine and Internet of things, all these things are contributing to our growth.

If you look at machine-to-machine for us, it's the first time we gave you a revenue number, and that's growing at 40% year-over-year. So it's more than just about a smartphone customer. As I've said before, if I could I would stop disclosing net adds. It's all about how we build the base of revenue and how we continue to grow this business into the future.

If you look at the competitive front, there was a lot of movement, but it was not unexpected. As you go into the fourth quarter, this is normally a very high-competitive quarter. It's a very high-volume quarter for ourselves from a holiday perspective.

But I think if you look at us, as we've done in the past we look at what the competition is doing. We take a very rational and logical approach to what we're going to respond to.

If you looked at what we did, we responded with some Edge pricing on a promotional basis that quite honestly puts us back into the market. Given all the moves, we were slightly out of the market. Like, if you saw back in the first quarter of this year we did similar things, and we continued to grow, and we continued to produce the profitability that is expected of our shareholders.

So I think the response you've seen is a logical, rational response. There will be upcoming promotions, I'm sure, from everyone as the holiday season gets closer, and we have our own plans in place to execute on.

So I think from a fourth-quarter perspective you should expect high volume. You should expect from us that our upgrade rate will increase. We have the highest backlog of any previous launch of an iPhone that we have coming into the fourth quarter, which is a high backlog of both new customers and also for upgrades.

So I know that our upgrade rate is going to be fairly significant in the fourth quarter. As we said on the call here, 3.1 million 2012 3G iPhone customers are waiting to upgrade now as they come out of contract. So that's a great perspective, and that leads me into your second question.

If you think about some of the data points we've given you from a 3G smartphone customer to a 4G smartphone customer, the first time we've told you that within our More Everything plans -- which is for the majority 4G smartphone customers -- their usage pattern is going up 50% year-over-year. If you look at tablets, a tablet customer uses more than a 3G smartphone customer.

So if you start taking together with the volume increases and other industries have put out what the usage pattern of video customers are on a 4G LTE network, video is a huge consumption for us. And it continues to increase quarter over quarter, year over year, and that's driving that 50% increase in usage in our 4G base.

So when you combine all of that, every time we can move a customer from a 3G smartphone or a basic phone into our 4G portfolio their usage and revenue goes up. So it's a great combination for us. And I will end the question that says, again, we are focused on the quality of our base and the quality of our adds to generate our growth.

Operator

Phil Cusick, JPMorgan.

Phil Cusick - *JPMorgan - Analyst*

Hey, guys; thanks. Two things. One to follow up, Fran, on something you just said, prepaid customers moving to the postpaid market: is that a good thing, a bad thing? Do you think these customers offer a similar churn level?

They have passed the credit check, right? And do they tend to bring their own devices, or are they taking Edge at a different rate from what visibility you have?

Then second, there's been a lot of articles written lately on asset sales from you, whether that was wireline assets or towers. Can you give us an update on how you are think about that? Thanks.

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

Sure; thanks, Phil. On the prepaid customer move to postpaid, look; I mean, we're just looking at the overall industry and where prepaid growth is from a year ago to where it is today. The assumption is that we do see the prepaid customer moving.

If you look at the entry prices now that are on postpaid -- and this is really around single-line, not multifamily. But if you look at single-line pricing, those price points are pretty darn close to what a prepaid customer would pay on prepaid.

So the hurdle is the credit check. And obviously for Verizon we have not changed our credit profile for any of our customers; it is the same it has been for over a year now, even when Edge was introduced.

So, again, it's not as favorable to us. It was more of where are these customers going, and we think they're going to lower-end type entry point, which is not unusual. I mean, the same thing happened back in the voice world when voice became closer to what the prepaid were.

From a device perspective, some is own device; but others are also buying up into device.

As far as the asset sales go, look, I have nothing to announce today. We have said publicly that we certainly would entertain a sale of our towers if the terms and conditions were right; and at this point we don't have anything there.

As Lowell and I have always said, we continue to look at our portfolio for opportunities, but it has to be at the right time, the right place, and the right price. So therefore there's really nothing to talk further because there's nothing to announce.

Phil Cusick - *JPMorgan - Analyst*

All right. Thanks, Fran.

Operator

Brett Feldman, Goldman Sachs.

Brett Feldman - *Goldman Sachs - Analyst*

Yes, thanks for taking the question. I just want to maybe follow up on the full-year margin guidance. It sounds like -- and correct me if I'm wrong -- but it sounds like it's most sensitive to the Edge take rate. So along those lines, in the past you have been fairly agnostic or you've seemed somewhat agnostic as to whether your customers were choosing a subsidy or choosing Edge.

I'm wondering. Are you changing your thought process there? Meaning are you trying to achieve a desired outcome? You noted that it looks like the take rate could double in the fourth quarter.

And then just broad levels, is there a breaking point? Meaning if Edge were to see an adoption rate above a certain level you probably would have margins that were up; and if it was below they would probably be down? Just to help us with a modeling exercise.

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

Yes, thanks, Brett. Look; there's a bunch of factors entering into the fourth quarter here. As I said, we do think that the Edge rate will take an uptake. You've probably already seen us increasing our advertising around the price points of Edge, which is where the rest of the industry has been advertising around, so we need to be in market with those price points, which is why we launched the promotional pricing that you saw.

But if you look at the 12% this quarter or the 18% last quarter, you can get a flavor on what the impact is to our bottom line, which is 120 basis points this quarter. I think it was 134 basis points last quarter. Beyond that I'm not going to give any further information on that.

But if you think about the Edge take rate, if it doubles then you can kind of extrapolate what that math would be. But then offsetting that will be the upgrades. At this point I don't know where the upgrades will come in, whether it will be Edge or under the old subsidy model.

Again we are very focused on customer choice. We give our customers the choice of the subsidized handset with the higher service pricing; or we give them the Edge, which they pay for the phone over the term, but it gives them the availability to upgrade sooner. So it is a customer choice and it's hard for me to identify what that will be.

But as I said, Brett, we have a very high volume of backlog on the iPhone. We have a bunch of new phones coming out in the fourth quarter from other manufacturers that are extremely good, so I think we will have a great lineup of product.

It's going to be a high-volume, highly competitive time of the year. And beyond that I'm not going to give any specific guidance to margins, but it will certainly be based on those volumes and how those customers come in.

Brett Feldman - *Goldman Sachs - Analyst*

All right; great. Thanks for taking the question.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks a lot; good morning. Fran, you talked about a $17 billion number for CapEx. You're coming towards the end of the XLTE rollout. Is there some opportunity for the -- it seems like the growth rate has slowed, but for some -- the CapEx as a percent of revenues to fall over the coming quarters? Or are we going to continue keeping at this sort of rate as a percent of revenues?

Then on the Wireline side bit of softness in SMB and enterprise. You talked about some of the secular factors. Do you detect any change in macro or in the competitive environment, or is it just more of the same?

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

Sure. Thanks, Simon. On CapEx we said we'd be around $17 billion. As we said that, coming into this year, we were determined to improve our CapEx-to-revenue ratio, and I believe we will do that on a year-over-year basis.

This year we had a much more flatness to our CapEx spending. So if you looked at prior year we always had more of a ramp into the back half of the year. You won't see that this year; so it has become more level.

And I do anticipate that we will be able to continue to improve on our CapEx-to-revenue ratio.

As far as whole dollars go, we said around the $17 billion mark, and I will give you some more guidance in January. But I don't anticipate that that will change pretty materially going into next year. So again, the focus will be to continue to increase that CapEx-to-revenue ratio.

Then on the Wireline side, first, let's talk about the consumer small business area. We did have an inflection point this quarter where we did suffer a 4.1% decline in the small business. Some of that was due to a year-over-year comparison; but some of that was due to some one-time things and I think that will come back in line here in the fourth quarter.

But we did have a very good, strong FiOS quarter at 4.5%. The other thing I would say around FiOS is, if you look at the components of content and our revenue per customer, our revenue per customer is growing nicely and is actually outpacing the cost of content. This year, if you look at our content costs, we are around that 2% to 4% growth rate in content.

So from a competitive standpoint that's an advantage for us to drop our margin to the bottom line on our consumer piece. And if you look at FiOS, FiOS continues to contribute more and more net income quarter over quarter. So that is a positive.

On the enterprise side, look, I think that I feel like I record this every quarter and it does not change. I really don't see much changing in the enterprise spectrum.

If you look at the European market, that is softening for us, and also with the FX impact of some of that softness of where the dollar is. So I think we have a lot of headwinds right now in enterprise; and I will honestly tell you I don't see that changing for at least the next couple of quarters at this point in time.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thank you.

Operator

Michael Rollins, Citi Investment Research.

Michael Rollins - *Citigroup - Analyst*

Thanks for taking the question. Fran, you referenced that the More Everything plans were generating 50% greater usage year-over-year. Is there a way to think about how much revenue that usage is contributing and how you feel that the ability to monetize the growth in consumption as some of the rate plans have promoted higher-usage buckets? Thanks.

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

Yes; thanks, Michael. Look, I'm not going to give you specific how the revenue increases. You can see that in our ARPA, which is growing nicely. If you see the sequential improvement in ARPA this quarter from last quarter, it grew to $161 from $159.

If you look at year-over-year we are up 3.5%. So I think that metric speaks for itself as how we are monetizing the increased usage.

But if you think about this, the 4G LTE network is 3 to 4 times more efficient than prior networks. So I guess I look at it this way: if you go back in time and you go back to the voice world, and you go from the beginning of time to where the voice world matured, what happened was the price per minute decreased and usage increased, and the overall industry increased its revenue because of that increase in usage.

I kind of look at the data world in the same perspective. You are going to see the price per megabit decrease, but the usage is going to outpace that. And at least under our tiered pricing structure in the More Everything plans, each time you upgrade you are going to incrementally pay little bit more for what you use. And that is really what is favoring in on the revenue growth.

But it's also coming over a very efficient network that does not cost incrementally to produce that increased usage. So it is a good combination to have in an efficient network with an ever-increasing consumption rate.

So I do anticipate that the structure works. I think it's going to grow as long as we increase the data bundle usage on a competitive standard basis.

I still think, though, with the increase in usage -- as we said, 50% year-over-year -- you are still going to see a healthy growth in the revenue on an ARPA basis. So I think the combination works, but you will see that price per megabit decrease and with the continued increase in consumption.

Michael Rollins - *Citigroup - Analyst*

Thanks.

Operator

John Hodulik, UBS.

John Hodulik - *UBS - Analyst*

Thank you. Fran, maybe a quick follow-up to Mike's question on the service revenue. I mean some of their margins, there's a lot of moving parts as we look into fourth quarter.

But you saw 100 basis points of service revenue growth deceleration. You are doing -- you're going to be having more Edge come through. Is that the kind of deceleration we should see again in the fourth quarter? Or do all the upgrades offset that? That's number one.

Then number two, Apple obviously recently announced their move to a soft SIM card, at least for the iPads, the new iPads that they are introducing. Verizon was conspicuously absent from the companies in the US supporting that. Can you give a little color in terms of your positioning in terms of that new product? Thanks.

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

Sure, thanks. On the service revenue side, look, there is a lot of puts and pushes here from a service revenue perspective. If you go back, obviously, we had a price change in the first quarter, which is working its way through the system. As we said before we were not going to reprice our base in one lump sum; we would work on that and address those customers that were a high-churn profile and treat them accordingly, which we've done for many, many years.

And we continue to do that, and that puts a pressure on service revenue as we get them into the price plan that's going to keep them on our network.

In addition, Edge has an impact here because you are moving service revenue into equipment revenue. And we gave you those numbers in the upfront comments of how you should think about that.

But that improves the -- if you take those recurring monthly billings on equipment revenue and put them back into the revenue stream, that increases the rate of percentage increase that we have and also increases the service revenue growth year-over-year.

But, look, there is some deceleration here, as Michael brought up on the last one. As we continue to increase the bundles there is going to take a little bit of time before people have to take the next step up.

But I will tell you, this quarter with our NFL agreement and the amount of video consumption we are having, we had one of the best quarters ever of customers stepping up to the next bucket. So again I think all these things factor into it; but Edge will definitely have a deceleration factor on the service revenue.

As far as the soft card SIM card with Apple, we have our own SIM card that we are putting in the devices, both in our indirect channels and our store channels. So that's really all there is to be said on that issue.

John Hodulik - *UBS - Analyst*

Okay. Thanks, Fran.

Operator

Mike McCormack, Jefferies.

Mike McCormack - *Jefferies & Company - Analyst*

Hey, guys; thanks. Fran, can you just hit briefly on the small/medium enterprise marketplace? That seems like you have continued weakness, which you pointed out. How much of that is this technology migration versus the cable competitors starting to move up market a little bit?

Then secondly, thinking about over-the-top, there's been a lot of stuff in the past couple weeks. It seems like it's of a building discussion between HBO, CBS.

How do you guys think about that? I know you bought the Intel On Cue business. When do you get more aggressive there?

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

Okay; thanks, Mike. Look, on the enterprise space I think there's a couple things here. You do have the tech refresh, and obviously as they come off legacy and go into IP, the IP has a lower price point.

Then also, as I said my opening remarks, this IP market is becoming more and more competitive from a pricing perspective. So as -- what we are faced with as we have major customers who are renewing, coming off 3- and 5-year contracts, obviously they are being repriced back into where the IP market is today, which is pretty significantly lower than it was 3 to 5 years ago. So you are having that price compression happen there.

We're gaining new business, but again it's coming in at a lower rate. And we still have that decline of voice and LD that's going away and it just can't offset it.

From a strategic services perspective, we are seeing some good things here. We are also seeing some improvement in the federal space. But as you know, in this business when you start to improve it could take 6 to 8 months before that revenue comes to be, as you implement this new technology.

So there is some glimmer of hope here as the federal government starts to purchase more, but we are probably not going to see any of that until 2015. But then again we are working against a bunch of headwinds as far as repricing on the IP and the tech refresh.

As far as cable and what's happening in the small business, look, as I've said in the previous quarters, where we have FiOS and compete in the small business market we are gaining share. We are losing share outside of that FiOS footprint in the old copper, and I'm not going to be able to compete there with the speed.

So that is something that we're just going to continue to see here into the future around that copper plant. But within FiOS we continue to gain share.

We expand where we can to capture more small business is that footprint, and we capitalize on that. But you have to remember it's only in 13 states.

As far as over-the-top goes, I think that the way I look at this is this is great for the customer. This is great for the industry. This shows that there are new innovative type arrangements that are happening.

As we have said before, we are having discussions with a lot of content providers around innovative models going forward, and I think this sets a lot of stage. So I think it opens up a lot of doors and it's something optimistic for the future of the video business.

Mike McCormack - *Jefferies & Company - Analyst*

Fran, just a quick follow-up on the small/medium piece of it. Do you see cable gaining more capabilities there? Or is it still really relegated to the very small customer base?

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

When they said that they are moving up, my perception of this is, as we look at small/medium business and even to medium business we capture medium business as anyone that has 1,000 or less employees. So it's a pretty different definition of where they are saying they are moving up from, versus where we are playing.

Again within our enterprise business, we are really focused on the major large enterprise customers. And we really deal with that small business, which is what we classify as 20 and below employees, within our FiOS arena. So it is a different spectrum of definition.

But look, they are increasing their capability. They are having success in that what I would consider small business arena, maybe the lower-end, mid business level. But they will continue to do what they do and we will continue to do what we do.

Mike McCormack - *Jefferies & Company - Analyst*

Great. Thanks, guys.

Operator

Kevin Smithen, Macquarie.

Kevin Smithen - *Macquarie Research - Analyst*

Thanks, Fran. Can we talk a little about your net debt targets? Obviously with the spectrum auction coming up, potential asset sales, all this stuff is going to impact your ability to deleverage going forward.

Can you talk a little bit about where we should think about net debt at the end of 2015? And given the lower interest rate environment, does that change your calculus on the amount of leverage you want to leave on the balance sheet?

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

Thanks, Kevin. Here's what I will say, because I'm not going to give any guidance on where I think our debt will be in 2015 at this point. But today where we stand is, as you see, we're at net debt of $102 billion, with our gross debt at $109.2 billion. We have a net debt to EBITDA ratio of 2.3 and a gross debt to EBITDA ratio of 2.5.

I will reference you back to an S&P report that came out, I guess maybe a month ago, on some projections around what they thought we would spend in the future for auctions and also how much debt that they think that we would pay down. The report was extremely optimistic and said that they could see us being upgraded within a 12- to 24-month period of time if things continue.

So I think we are right on track with where we said we would be when we closed on the Vodafone deal. I said that we wanted to get back to an A-rating within 4 to 5 years. The S&P report shows that that could be accelerated based on our performance here.

We are generating strong cash flow. And what I would tell you is we're in a great position to execute on the strategic initiatives that we need to execute on. So we will have more to say on this as we close out this year and come to our call in January.

Kevin Smithen - *Macquarie Research - Analyst*

Just quickly on FiOS, we've seen in the last few years significant price hikes, which as you indicated has more than offset programming cost increases. As you look into 2015 should we expect more of that? Can you continue to have revenue growth outpace cost inflation on the FiOS side?

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

I will give you guidance next call on where we think FiOS growth rate will be. But here's what I will say, is -- last year we did our price increases in the fourth quarter. We're doing that again this year to be ready to absorb the content costs that always happen on January 1. So that is something that you should anticipate and you will see.

Kevin Smithen - *Macquarie Research - Analyst*

Thanks.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - *Barclays - Analyst*

Thank you very much and good morning, folks. Fran, just building on Mike's prior question on the recent developments around over-the-top and unbundling, it seems as though you feel pretty comfortable around the opportunity, particularly given your investment in fiber, in delivering some of these high-bandwidth capability to your customers.

I was wondering, if we think about the competitive landscape and developments like this, does it strengthen your view on the diminishing ability for competitive direct video services like satellite technology to compete in what seems to be an increasing on-demand and OTT world?

Then I guess secondly, if we think about the opportunity on the wireless side, you folks have made a number of tuck-in acquisitions around content distribution. I was wondering how we should think about -- obviously there's the relationship with the NFL -- how we should figure out the opportunities on that front, and when we could start to see some -- either material adoption from customers or some of these new revenue streams come to fruition. Thanks a lot.

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

A couple thoughts here, Amir. Number one is, when I look at the, quote, over-the-top type video area there's two avenues. There's the over-the-top into the home and then there's the over-the-top via wireless. I think over-the-top via wireless you are already starting to see that with agreements like the NFL and some other things.

I also think that with the technology of multicast coming, this will certainly open up doors for more of that content to be delivered over-the-top via the wireless network, because multicast is so efficient in delivering a programming-type service over the LTE network. But of course that will be major around more live events, concerts, sports, those types of things.

As far as over-the-top into the broadband home, I think that what this says is that the content providers have realized that there is a whole population out there that do not subscribe to satellite TV or linear TV, and they are trying to penetrate that Millennial base that does not have these types of offers and wants something smaller, more convenient for them. As I said I think this brings in a lot of innovative-type models of how to really attack some of these other segments of the marketplace that don't have that type of service.

Do I think in the near term this is going to decrease linear TV or satellite TV? No, I don't.

But I think it's another avenue of how we open up the ecosystem with innovative models. And that's something that we are very, very interested in, especially around wireless and even as we go out into more of the broadband-type market.

Amir Rozwadowski - *Barclays - Analyst*

Thank you very much.

Operator

Jennifer Fritzsche, Wells Fargo.

Jennifer Fritzsche - *Wells Fargo - Analyst*

Great; thanks for taking the question. Fran, I realize you can't talk about the AWS-3 auction, but I wanted to explore the broadcast auction. Last time we heard from you, you said you needed to know more about the rules to express your enthusiasm.

We know a little bit more today. I just wanted to take your pulse on what your thoughts are as we look at it today.

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

Yes, Jennifer, unfortunately I can't; I am not actually allowed to. My lawyers are telling me I'm not allowed to answer any type of spectrum questions.

At this point it's still far in the future and we are focused on the current one. So I think at this point I will leave it at that.

Jennifer Fritzsche - *Wells Fargo - Analyst*

Got it. If I could just explore, just an M2M question then, obviously great growth there. You guided or talked about 40% growth year-over-year.

Do you think we are at the point we're seeing this needle move we've often been waiting for? Is this the year, or really accelerate in 2014 -- 2015, rather?

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

Look, I think that as we tried to allude over the last couple of quarters, we gave you growth rate; this quarter we are giving you revenue numbers, and we will continue to do that going forward. As I said before, this is not necessarily about how many connections I put on the network. This is about how many of those connections actually pay revenue and we earn money.

So, as you know, we stopped disclosing connections a while ago, but I will tell you that the connection growth is ever-increasing here. There's a lot of avenues that are being opened up around Internet of Things, around healthcare, around energy management, fleet; so you can go through all the verticals and there's so many solutions that are coming to forbear.

Which is why we -- over I guess now a year-and-a-half ago we opened up our second Innovation Center out in Palo Alto. This is something that we are very, very focused on. I think there's a lot of good opportunity here, and this will certainly be a driver of growth for the entire industry.

The other thing I think that separates us apart from our competition is, obviously with our Hughes acquisition, we play in another tower that no one else plays in. Everybody is playing today in the connectivity tower, but with our Hughes acquisition we are actually playing in the customer service and concierge tower as well and being able to deliver some of that Big Data and looking at ways to monetize some of that data to our end customers, who are really business customers, who are looking at business-to-business versus business-to-consumer.

So this is just another area I think of growth for the industry, and obviously we are capable to capitalize on that.

Jennifer Fritzsche - *Wells Fargo - Analyst*

Great. Thanks, Fran.

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

We have time for one more question, please.

Operator

Jonathan Schildkraut, Evercore.

Jonathan Schildkraut - *Evercore Partrners - Analyst*

All right, thanks for sneaking me in here. Yes, I've got a question on LTE broadcast. I just wanted to get an update on where we were and understand whether implementation go-forward is about technology, or is it about content.

Then, Fran, you made some interesting comments about the growth of video within the data consumption packages that you currently have. I'm wondering if you've looked at what amount of that video could ultimately be sent out over LTE broadcast and the potential implications to margins. Thanks.

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

Sure. Thanks, Jonathan. LTE multicast, the network was ready in August of this past year; so we have built out the network to be able to handle multicast. As you know we demonstrated it back in January with the Super Bowl. So the network is capable.

The chipsets are now being implemented into most of the devices that are coming out in the fourth quarter. Some phones in the third quarter had that chipset, but most will have it in the fourth quarter. Not all.

So, look, the way I look at this ecosystem is it's going to take us about a year before those chipsets ramp. And we have some volume there, which gets the attention of the content provider.

But as I said before, having a lot of great conversations with content providers. They are excited about it. But again, they want to see how many customers actually have the capability to use that technology, and I think that will be a year away.

But I think this opens up a lot of new avenues for us. I don't know yet how the ecosystem will generate revenue on this.

Is it a revenue share model? Is it an advertising model? Is it a consumer pay model? We are not sure yet of how the ecosystem will play itself out, and I think that will come within the next year.

The other critical piece here is that for the first time coming in the fourth quarter we will have an independent third party to be able to tell the content providers who actually watches their shows on a mobile handset, which has never been able to be done before, other than from the carriers. So I think this does again open up some of that ecosystem.

So from that perspective I think we are really in good shape from an ecosystem perspective. As far as the bundling goes and the usage goes, again, we will have to wait to see how this multicast technology comes to market and how it's capitalized on.

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

Thank you. But before we end the call I would like to turn the call back to Fran for a few closing remarks.

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

Thanks, Mike. Thanks, everyone, for joining us today. Here's my closing comments.

I guess I would say, look, we had another strong quarter of operating and financial results. We count ourselves on a quality base and a quality addition. We count on the quality of our network in driving top-line growth and profitability.

By focusing on execution around the assets we already have in place, we are delivering consistent, high-quality earnings and returning value to our shareholders.

At the same time we're developing new products and services in the areas of video delivery, over-the-top, machine-to-machine for future growth and profitability. We have great confidence in our ability to execute on our strategy and grow the business profitably while making the necessary capital investments to position us for the future.

Thank you, everyone, 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.
