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VZ - Q3 2013 Verizon Earnings Conference Call

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OVERVIEW:

VZ reported YTD adjusted EPS of \$2.18. 3Q13 GAAP EPS was \$0.78 and adjusted EPS (excluding certain items) was \$0.77.

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PRESENTATION

Operator

Good morning and welcome to the Verizon third-quarter 2013 earnings conference call. At this time all participants have been placed in a listen-only mode and the floor will be open for questions following the presentation. (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. - IR*

Thanks, Brad. Good morning and welcome to our third-quarter 2013 earnings conference call. This is Mike Stefanski and I am here with our Chief Financial Officer, Fran Shammo. Thank you for joining us this morning.

Before we get started, let me remind you that our earnings release, financial and operating information, 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 later today.

I would also like to draw your attention to our Safe Harbor statement and our other legends on slides 2 and 3.

Information in this presentation contains statements about expected future events and financial results that are forward-looking and subject to risk and uncertainties. Discussion of factors that may affect future results is contained in Verizon's filings with the SEC which are also available on our website.

This presentation contains certain non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures are also available on our website.



Before Fran takes you through the details of our results, I would like to cover a few special items that are included in our reported results. These are displayed on slide 4.

For the third quarter, we reported earnings of \$0.78 per share on a GAAP basis. These results include a net gain on the sale of 700 B block spectrum of \$0.02 per share offset by net incremental interest expense of \$0.01 per share related to the debt we have raised to finance the acquisition of the remaining 45% stake in Verizon Wireless. We have accounted for the gain on the spectrum sale at the corporate level so it is completely excluded from Wireless segment results.

Excluding these non-operational effects, adjusted earnings per share was \$0.77 in the third quarter compared with \$0.64 a year ago. Year-to-date adjusted earnings per share was \$2.18 compared with \$1.87 last year. Our discussion of operating results and growth rates in this presentation exclude the effects of these two items and they are not part of our segment results.

Finally, the quarterly growth rates disclosed in this presentation are on a year-over-year basis unless otherwise noted as sequential.

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

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

Thanks, Mike. Good morning, everyone. In the third quarter our key strategic networks and platforms, Wireless 4G LTE, FiOS and enterprise strategic services drove very strong operating performance and financial results. Our consolidated revenue growth rate increased once again and our focus on cost efficiency and improved profitability resulted in double-digit growth in both operating income and earnings per share which we have delivered in every quarter this year.

Third quarter adjusted earnings per share of \$0.77 was up 20.3%. Year to date adjusted earnings per share of \$2.18 represents 16.6% growth.

In Wireless, we had another very strong quarter of growth and profitability. We posted sequential quarterly improvement in terms of new retail connections and smartphones. Total retail net adds were 1.1 million which included 927,000 high-quality postpaid net adds.

Service revenue growth increased to 8.4%. EBITDA increased 10.7% and our EBITDA service margin was 51.1%. All of this was accomplished with 7.6 million smartphone activations this quarter which was up sequentially and 12.5% higher than last year.

Our Wireline results in the third quarter also showed improvement. Consumer revenue increased 4.3% driven by FiOS penetration. Enterprise strategic services revenue grew 5.2%. Total Wireline segment EBITDA increased 3.8% and the EBITDA margin improved to 22.7%, up 50 basis points sequentially and 100 basis points year over year.

Our strong operating performance and disciplined capital spending is driving growth in free cash flow. On a year-to-date basis, free cash flow increased \$3.1 billion to \$16.6 billion, an increase of more than 23%. All in all, we had a great third quarter capped off by a lot of activity since Labor Day.

We announced an agreement with Vodafone to acquire its 45% interest in Verizon Wireless. The transaction will be accretive to earnings per share, provide additional operating cash flows, and enable greater flexibility to develop converged solutions without any integration and due diligence risks.

The capital market environment was strong and we had a fully executed bridge facility in place at the date of the announcement. We successfully arranged in one day the required permanent bond financing with a \$49 billion debt offering and earlier this month, we signed an agreement for up to \$12 billion in term loans.

Last week we filed a Form S4 registration statement and our proxy statement with the SEC related to the pending transaction.

Lastly in a demonstration of their confidence in the strength of our future cash flows, all Board of Directors approved a quarterly dividend increase for the seventh consecutive year. So we have been busy and productive on the transaction front but as always, our primary focus is driving strong operating results.



Now let's look at our third-quarter performance in more detail starting with consolidated results on slide 6.

Total operating revenue grew 4.4% continuing our solid top-line growth trend. This marks the fourth consecutive quarter of growth in excess of 4%. The increase in consolidated revenues along with effective cost management resulted in 16.8% growth in adjusted operating income in the quarter.

On the same adjusted basis, consolidated EBITDA increased to \$11 billion, up 9.7%. Our adjusted EBITDA margin expanded 170 basis points to 36.3% which is the highest consolidated margin in more than five years.

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 in network quality, reliability and the overall customer experience. We will continue to build on our network advantage in 4G LTE by deploying capital to provide additional capacity and density to our network. We will also be opportunistic in terms of acquiring new spectrum. In short, we will continue to focus on executing our game plan.

Our third-quarter results clearly demonstrate our ability to create strong operating momentum and deliver excellent results. We continue to perform extremely well in a highly competitive market.

Total Wireless revenues grew to \$20.4 billion in the quarter, representing 67% of Verizon's consolidated revenue. We sustained our strong service revenue performance with 8.4% growth, our fourth consecutive quarter of growth in excess of 8%.

EBITDA increased to \$8.9 billion and our EBITDA service margin expanded by 110 basis points to 51.1%. Year to date, our EBITDA service margin is 50.4%. Our Wireless profitability has been very consistent with margins of 49% or higher in five of the last six quarters.

Let's now turn to a more detailed look at Wireless revenue per account beginning on slide 8. Service revenue growth continues to be driven by increasing connections, data usage and smartphone penetration gains. Our Share Everything Plans are driving device adoption and stimulating higher usage resulting in increases in both the number of devices and revenue per account.

During the third quarter, retail postpaid revenue per account, or ARPA, grew 7.1% to nearly \$156 per month. We have 35 million postpaid accounts and average connections increased to 2.72 per account, up 4.6%.

Customer adoption of our Share Everything Plans has been exceptional. In just 15 months, 42% of our postpaid accounts are on these plans. The value proposition is simple and straightforward. Our customers quickly recognize the value of shared data across multiple devices particularly in our 4G LTE environment.

Let's take a closer look at connections growth on slide 9. In the third quarter, retail net additions increased by 1.1 million, up 2.2% sequentially. As I highlighted earlier, we had 927,000 postpaid net adds. In terms of the makeup of these postpaid net adds, we added more than 1 million smartphones which was a 5% sequential increase. Including the decline in basic phones, total phone net adds were 481,000. We added 370,000 new Internet devices including tablets. The remaining net adds of about 76,000 were primarily home phone connect.

We did encounter iPhone supply constraints that created a backlog at the end of September which resulted in some carryover to the fourth quarter. Within prepaid, we added 134,000 new retail connections which was 38% higher than the second quarter.

We ended the quarter with 101.2 million total retail connections. Our industry-leading postpaid connection base reached a 95.2 million with the balance being prepaid.

We maintained a high quality mix within our retail connections growth. Postpaid gross additions increased sequentially to 3.7 million. 73% of these gross adds were phones including 2.2 million smartphones both of which were higher than first or second quarter.

The number of customer upgrades in the quarter remained fairly steady on a sequential basis with a postpaid upgrade rate of 6.9%. The upgrade rate was also slightly affected by inventory constraints.

As you would expect, a significant percentage of our upgrades are smartphones which continue to benefit us from a service revenue perspective. About 33% of customers upgrading to smartphones this quarter were purchasing one for the first time. A majority of the remaining upgrades are moving from a 3G to a 4G smartphone which we are able to monetize through higher data usage and lower cost to serve. And while upgrades are likely to be higher in the fourth quarter, we continue to expect that our annual upgrade rate will be about the same as last year.



Our churn metrics continue to be market leading. Our retail postpaid churn was 0.97%.

Next let's turn to slide 10 and take a look at device sales and our progress in 4G LTE. Postpaid device activations which includes both gross adds and upgrades totaled 10.2 million in the quarter representing both a sequential and year-over-year increase. Similar to first and second quarter, 88% of the activations were phones.

Smartphone activations totaled 7.6 million and 77% of these were 4G LTE. The smartphone mix was fairly balanced once again with roughly 51% of the activations being iPhones. Our smartphone penetration continues to improve and we ended the quarter at over 67%. We also had another strong quarter of Internet device activations which topped 1 million again in the quarter.

4G device penetration within our postpaid base continued at a rapid pace. 38% of our retail postpaid connections are now 4G, up from 33% in the second quarter and 17% one year ago. More than 50% of our smartphones and 70% of our Internet devices are 4G. Currently about 64% of our total data traffic is carried on the 4G LTE network.

Throughout the rest of this year, we will continue to add capacity and optimize our 4G LTE network ensuring that customers are receiving the quality and consistent reliability that they expect from our network and devices.

Let's move next to our Wireline segment starting on slide 11. Our Wireline investments in platforms such as FiOS, global IP, security, cloud services and machine-to-machine enable us to deliver the services, applications and solutions that our customers want. As these services scale, they will become increasingly efficient and will improve our overall cost structure.

In the consumer and mass-markets business, we continue to see positive revenue trends highlighted by sustained FiOS growth. For the last five quarters, consumer revenues have grown in excess of 4%. In the third quarter, revenues were up 4.3% driven of course by FiOS which now represents about 72% of consumer revenue.

Our overall consumer monthly ARPU increased to nearly \$113, up 8.7%. Roughly two-thirds of our FiOS customers are triple play which have a much higher amount of recurring revenue per month. We had a good quarter of FiOS customer growth. In terms of broadband, we had 173,000 new FiOS Internet additions and now have 5.9 million subscribers representing 39% penetration. Overall, net broadband subscribers were a positive 56,000.

In addition to the customer growth and increased penetration, we are also gaining traction with our FiOS Quantum offers for higher broadband speeds. More than half our FiOS Internet sales in the quarter were at speeds in excess of 50 megabits per second and just over 40% of our FiOS Internet customers subscribe to Quantum with speeds ranging from 50 to 500 megabits per second.

The incremental revenue from higher broadband speed is contributing to overall consumer revenue growth. In FiOS Video, we added 135,000 new subscribers in the quarter, up 13.4%. Total FiOS Video customers reached 5.2 million representing 35% penetration.

We also continued to make steady progress with copper migrations. During the quarter we converted about 80,000 customers. Through nine months, we have converted nearly 250,000 customers so we are on track to exceed our target of 300,000 customers for the year. By year end, we estimate that less than 1 million consumer customers will be remaining on copper services within our FiOS footprint.

This network evolution initiative is important for us as we systematically reduce our dependence on older technologies. Aside from the maintenance expense savings and improvements in customer satisfaction, conversions to fiber also provide customers the opportunity to purchase FiOS services which could result in additional ARPU over time.

Another positive result in the quarter was the steady improvement in our residential connection trends. Retail residential connections declined by 4.9% compared with a loss of 6.3% at this time last year.

Let's move to our enterprise markets next on slide 12. In the third quarter, Global Enterprise revenue declined \$113 million or 3%. Legacy CPE sales were down 21% and represented \$91 million of the year-over-year decline. Excluding the quarterly decline in CPE, Global Enterprise revenue was down less than 1%. Keep in mind that our Global Enterprise revenue includes both federal and state government. Strategic services which now comprise 58% of enterprise revenue grew 5.2%.

We continue to work through economic challenges in the enterprise space. In the public sector, we are seeing the effects of sequestering, budget cutbacks and contract renewals. In the private sector, many enterprise customers are more focused on improving their cost structure which puts pressure on our topline revenue. Generally speaking, enterprise customers continue to be cautious regarding new investment decisions.

Moving next to global wholesale, quarterly revenues declined \$113 million or 6.3%. While this quarter is an improvement, the revenue pressure is driven by the continued decline in legacy transport services. As we have stated, our wholesale strategy is to better monetize our global IP and fiber network by driving a more efficient migration to next-generation Ethernet services.

In terms of profitability, while growth in enterprise strategic services is improving the revenue mix, volume declines in the rest of Global Enterprise and wholesale continue to put pressure on Wireline margins. Through our Verizon Lean Six Sigma program, we are making good progress in our cost restructuring programs and retooling efforts which we believe will ultimately improve our operating efficiency.

Let's now turn to slide 13. To summarize our overall Wireline results, total operating revenues were down 1% in the quarter. FiOS and strategic services continued their positive growth trends while Global Enterprise and wholesale were pressured by declines in legacy transport services and CPE. Excluding the decline in legacy CPE, our revenue performance this quarter was essentially flat year over year.

In terms of Wireline profitability, third-quarter EBITDA increased to \$2.2 billion resulting in an EBITDA margin of 22.7%. On a year-to-date basis, the Wireline EBITDA margin was 22.1%. We continue to expect that our full-year EBITDA margin will be similar to 2012 excluding the effects of Sandy from last year's results. We also continue to target improved profitability and margin expansion in 2014.

Let's turn to slide 14 for a discussion of our cash flow results. Our cash generation in the quarter remained very strong. On a year-to-date basis, cash flows from operations increased to \$28.4 billion. Free cash flow increased to \$16.6 billion, up 23%. This does not include the \$1.9 billion of proceeds from the sale of a 700 B spectrum licenses which is included in cash flows from investing activity.

Capital expenditures for the quarter totaled \$4.2 billion and were \$11.8 billion year to date, up 4.3%. We estimate that full-year 2013 capital spending will be approximately \$16.6 billion.

We are very focused on improving investment returns and capital efficiency and expect that our annual CapEx to revenue ratio will improve even with the planned additional spending in 4G LTE.

Wireless capital spending in the third quarter totaled \$2.5 billion. Year to date, Wireless CapEx was \$6.7 billion, 10.8% higher than last year. As noted on our last quarterly call, our 4G LTE coverage build is essentially completed so our capital spending going forward will be focused on adding capacity and density to our existing coverage. We are utilizing our AWS spectrum to further optimize the network and we are already spending some of the incremental capital we allocated to Wireless capacity.

In Wireline, capital expenditures totaled \$1.5 billion in the quarter and \$4.5 billion year to date which was down 3.2% from last year. In terms of the balance sheet, total debt increased to \$99.1 billion due to the permanent financing we put in place related to the pending transaction to obtain full ownership of Verizon Wireless. However, since we do have the cash until the close of the transaction, our net debt to adjusted EBITDA remained quite low at about 1.1 times.

Let's summarize. Our third-quarter results were very strong showing consistent performance in all our key strategic growth areas. In Wireless, continued strong growth in service revenue coupled with high quality connections growth and the success of our Share Everything Plans are driving double-digit growth in EBITDA and very strong cash generation.

We continue to lead the industry in profitability and we are on track to deliver 49% to 50% EBITDA margins for the full year. We also expect to see customer growth increase sequentially in the fourth quarter.

In Wireline, consumer revenue growth of more than 4% continues to be driven by FiOS where we are on track to achieve our net subscriber growth targets. In enterprise, we continue to focus on strategic services and have announced our new Verizon cloud strategy.

In terms of an update on our pending transaction to gain full ownership of Verizon Wireless, our permanent financing is secured and we have taken out our bridge financing facility. An S4 registration statement and our proxy statement were filed on October 8 and are under review by the SEC. You can access these filings on our Investor Relations website or the SEC website.



Efforts are underway to obtain the required regulatory and shareholder approvals. We expect to close the transaction during the first quarter of 2014. Overall a great third quarter. We are focused on continuing our momentum and finishing the year strong.

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

Michael Stefanski - Verizon Communications, Inc. - IR

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

QUESTION AND ANSWER

Operator

Thank you. We will now begin the question-and-answer session. (Operator Instructions). John Hodulik, UBS.

John Hodulik - UBS - Analyst

Thanks, good morning guys. Two quick ones. First on the Wireless margins, Fran, how much of an impact did the EDGE plan and the 24-month upgrade cycle have in the strong margins you guys posted in the third quarter and then how should those issues affect the fourth quarter?

And then I saw you talked about the uptick you had in the Wireless CapEx. You talked about the AWS deployment. Can you give us a little bit more detail on how that gets laid over? And just sort of how quickly can you get some more capacity into the market on the LTE side?

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

Thanks, John. So on the VZW margins, so EDGE keep in mind we launched EDGE at the very end of August. It really didn't pick up speed until September. Our indirect channels did not get it until the very, very end of the quarter. So there really was no impact from the EDGE program to these results. We will see more in the fourth quarter and we will wait to get to that to report it out. But very, very immaterial impact.

On the 24-month cycle, it is very hard for us to determine because again people are proactive on when they upgrade to a cycle basis. Of course it did delay some of the upgrades from going from that 20 month to the 24 month and that went into effect on September 1 so again, only really 30 days of impact there. We will probably see more of that in the fourth quarter.

As far as the VZW margin impact from the two of them, I would say very, very limited in this quarter and you can see why the margin was the way it was just from an overall revenue increase and some of the cost containment measures that we have been putting in place for quite some time. We can talk more about that.

As far as CapEx goes, so here is where we are at. Obviously we know that we have completed the coverage build of our 4G LTE and obviously if you look at our map, it is pretty significant coverage compared to our competitors. And now post June, all of our efforts have gone into the capacity and densification and given where we are if you look at some of the metrics, I mean if you think about 38% of our customers are on the 4G network and they are generating 64% of the data usage, this is a pretty significant volume of usage going through that network.

We know that given the growth of this we have had some densification issues in major cities like New York, Chicago, San Francisco, and we are totally focused on those types of issues. And what you see us doing is being very proactive in more in-building coverage, more densification cell sites, launching the AWS spectrum. So you are going to see that through the fourth quarter and that is why we increased the CapEx spending.



But I think the walk away here is that we are extremely focused on our network, it is our brand. We will continue to perform in this area and also the return here if you think about every dollar I put into that network when you have 64% of the data on a tiered Share Everything Plan, you can see that coming through from our revenues.

So the return on the invested capital is pretty immediate and it is pretty significant. So we will continue to concentrate on that effort.

John Hodulik - UBS - Analyst

Great, thanks Fran.

Michael Stefanski - Verizon Communications, Inc. - IR

Brad, we are ready for the next call.

Operator

Jason Armstrong, Goldman Sachs.

Jason Armstrong - Goldman Sachs - Analyst

Thanks, good morning. A couple of questions I guess focused on Wireline. First, the FiOS volumes very, very strong quarter in broadband. I think it adds up almost 30% year over year. The extent to which video is bundled to this looks like to have taken a bit of a hit in the quarter. I think there is a 40,000 disconnect between broadband adds and video adds on the FiOS side. That is much larger than normal. Can you help us think through that?

And then second just on Wireline margins, good progress in the quarter on margins. The comment on margin expansion for 2014, maybe you can help us think through are there any things that that necessarily relies on? For instance if enterprise is still under pressure next year, does that put pressure on margins or can you grow margins despite that? Thanks.

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

Thanks, Jason. So on the FiOS broadband, we did have a very, very good quarter from a net add perspective especially on a year-over-year basis and especially since when you look back in history, third quarter is normally a very high churn quarter for us.

Keep in mind a couple of things here. So on the broadband side of the house you have to remember that as we do 80,000 migrations from our copper who are voice and DSL only over to FiOS, you are getting voice and FiOS Quantum adds. And as I have talked before, we really don't approach these customers on a TV product for about five to six months and then it takes us about another three to four months of marketing to actually see some success in conversion and we see about a 30% conversion once we do that.

They are really interested in the broadband speed and of course what you see in the Wireline segment today is as we migrate these customers from the copper product to the FiOS product, we are bringing them over at the same price. But what we see is almost immediately with the speeds that they are getting in the FiOS Quantum, they themselves are choosing to upgrade right into that 50 megabits and at times now even into the 75 megabit product. So their ARPU is going up which is generating some of this Wireline increase that you see.

So TV net adds were up 13% year over year. Now granted, some of these adds we got came from some of the disputes that happened in the competitive nature here during the quarter but still even without that, we would've seen an increase year over year in our productivity and our penetration of FiOS. So we are very happy with where we are but TV will always lag when we do these migrations.

On the Wireline margin, look I think I have been pretty consistent here with where we think Wireline is going and I am still very confident that 2014 will show improvement.



And just to keep everyone grounded here, the reason I say this is I am looking at enterprise as being flat with no substantial growth and we can talk about just the continued disruption that is coming out of Washington and the uncertainty and I think that will continue at least in the short term here given what happened last night and extending some of this into the first quarter -- what is going to happen, what is going to happen when we get to December 31 on the cliff jump off as we had last year with some of the tax preference items?

So I still think there is still a lot of swirl going on and just a lot of uncertainty and enterprise is going to sit on the sideline. But as I look at 2014, I am looking at that is going to be flat.

So what do we see? We see continued progress in our FiOS penetration as I said, I am very comfortable with 4% plus growth in revenue here going forward. I continue to think that we will penetrate all of our markets and continue to gain share both in broadband and TV. And also keep in mind as I said before, with the Hughes Telematics acquisition, VDMS and Redbox, they have all been headwinds this year because we have gotten them up to started and we are eating some of the upstart costs with them. That I believe starts to diminish in 2014 which actually helps. And with Hughes, they start to generate more revenues, VDMS starts to generate revenues.

So there is a lot of things happening but I also think we can't lose sight of our Verizon Lean Six Sigma efforts on our cost initiatives that we have in our Wireline business and you are starting to see some of these efforts start to come through on our efficiency side of the house. So we are very, very optimistic that we can continue to move the Wireline profitability forward.

Jason Armstrong - Goldman Sachs - Analyst

Great. That's really helpful. Thanks, Fran.

Michael Stefanski - Verizon Communications, Inc. - IR

Brad, let's take the next question please.

Operator

Phil Cusick, JPMorgan.

Phil Cusick - JPMorgan - Analyst

Hey guys, thanks. You know I think we all continue to be surprised with the Wireless service revenue growth. Can you talk about where customers are in terms of taking more data than the minimum? How many customers or how many families or per device are taking more than sort of a standard 2 gig package per device? And where does 4G usage look now? And if not an actual number then versus where average usage was a year ago? Thanks.

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

Thanks, Phil. So on the Wireless service growth, I think obviously I am not going to get into exactly how many customers break bundles and all of that but I think there is some things that we have to understand here that is driving this.

So first off if you look at this quarter, again we had a very strong quarter with 480,000 smartphone adds that are very high quality and these are all coming in mostly on our 4G and shared price plans. Some of these are 3G phones obviously but the majority is coming in on our 4G product.

The other thing I think you have to understand too is that we are coming up on the anniversary dates of the 3G when the iPhone was launched and those customers now are operating to 4G phones and moving into shared price plans. And if you look at 3G usage and the customers moving into 4G



and they start to utilize this LTE network, they are starting to realize the benefits of that and their usage significantly goes up from where they were in 3G.

So that is stimulating. Even if we come over and I have said before, the way our salesforce is approaching this is they recommend 2 gigs for every device that a customer brings into shared pricing. So even with that, you think about that usage versus 3G device usage that in itself is pretty significantly higher. So that drives the revenue.

Then you look at the tablets and the Internet devices, you get into machine-to-machine connections. Our machine-to-machine continues to escalate quarter after quarter and then of course then we look at the prepaid side of the house.

So I think it is a combination of all of these things that are driving that and when you think about 42% of our base is on shared plans, we still have a long way to go of converting a lot of that 3G product over to the 4G and into those shared plans. So there still a lot of runway here to continue to grow this revenue stream for us.

So that is that. And I think I answered the 4G versus the 3G usage.

Phil Cusick - JPMorgan - Analyst

And then if I could just follow up quickly on your government comment a few minutes ago, it sounds like you are a little cautious on 4Q in terms of enterprise decision-making and things like that. Is that a fair read?

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

Well I think the cautious is, Phil, I don't see anything changing here from 3Q to 4Q. And again you heard me say that keep in mind our federal and state government are in our enterprise segment and that really is declining faster than the rest of the segment right now.

Now the positive to this is that within our cloud services, it is fairly flat so where we see the federal government during the sequestering period pulling back in some areas, they are actually buying some of the data center and cloud products. So there is a balance here but I don't think things get a lot worse but I don't see them getting any better.

Phil Cusick - JPMorgan - Analyst

Thanks.

Michael Stefanski - Verizon Communications, Inc. - IR

Brad, let's take the next question please.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - Morgan Stanley - Analyst

Thanks very much. Good morning. Fran, I wonder if you could update us on the VoLTE rollout and when we are going to start to see that and when you start to see the benefit of lower smartphone costs and lower subsidies going forward? You touched briefly relating to Vodafone about the ability to bring converged solutions together. Maybe you can expand on that a little bit and talk a little bit more about what we might see from the cable joint venture over the next few quarters? Thanks.



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

All right, thanks, Simon. So on VoLTE rollout, we are still on track. You will probably see us have a VoLTE capable handset here in the fourth quarter and as we said that we will light up the VoLTE rollout starting in the first half of next year. So we are still very much on track on that one.

As far as lower smartphone costs and subsidies, look, I think the ecosystem has a lot here. You are going to see a lot of new and innovative products come out in the fourth quarter. But subsidy is done on a handset by handset manufacturer by manufacturer and obviously as you have heard me say before, the more manufacturers we can get into this ecosystem and it really comes down to an operating system, the more competitive nature this market place will become.

So I still believe that that will happen. Obviously you have heard me talk about VoLTE will contribute to some as we start to remove some of the CDMA chips but then there is other technologies like multicast that will be put into the phone. So there is a lot of technologies being removed from the phone but new technologies that are being implemented into the phone. So this is going to be a long path but I do think as I said before, subsidies will gradually come down over the next two to three years.

On the converged solutions side, I mean as far as the joint venture with the cable companies, we have talked about, we still have a distribution agreement with one another and we continue to work with one another to sell each other's products. But the joint venture or codevelopment has been terminated and we are moving in our separate ways on that.

And what you are going to see here is as we talked about Verizon Wireless, the acquisition of Verizon Wireless, we now get to more of a converged middle with our consumer products between FiOS and Wireless and we no longer have the artificial wall up between the affiliate transactions or anything like that.

So I won't talk about what you will see but I think what you will see from us is a move forward of bringing to the customer the best product available between Wireline and Wireless.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

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

Brad, next question please.

Operator

Michael Rollins, Citi Investment Research.

Michael Rollins - *Citigroup - Analyst*

Hi, thanks for taking the question. Two questions. First on Verizon Wireless, if you can give us an update, Fran, on the net debt. And then secondly on the Wireline side, I think you mentioned that you have less than 1 million copper customers in your FiOS footprint if I got that quote correct. Can you talk about the significance of that in terms of the opportunity to take those remaining copper customers and get them over to the fiber? And the potential cost savings that you could generate by moving to fiber and really getting the one network architecture within your FiOS footprint for at least the residential customers? Thanks.



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

Okay, thanks, Mike. So I guess this should be the last quarter I have to answer this question on net debt. So gross debt for Wireless is \$10.2 billion, cash is \$6.6 billion, net is \$3.6 billion.

On the Wireline side, yes, you did get the quote right. So there will be less than 1 million customers that are on copper within our FiOS footprint. And you see us from our migration strategy in the last two years, I think in the last two years now when we exceed our 300,000 for this year, we will have moved close to 600,000 customers from our copper network into our FiOS network. We will continue to approach this migration.

Now if you think that we do 300,000 a year, you are looking at three more years to get that completed. But we will continue to try to accelerate as much as we can and from a cost-benefit obviously what you are seeing is some of those benefits coming through the Wireline results today just from a repair metric, from a truck roll metric, the reliability of this network is drastically different than the reliability of the copper network.

So you are going to see us continue to invest in the FiOS infrastructure. One of the things that we are doing now is the network team has been working over the last year in provisioning the FiOS network into our enterprise and small business customers using the GPON technology. So we fully expect to utilize this FiOS backbone much more than it had been in the past.

So you are going to continue to see this migration and you are going to see the cost benefits coming through our operating results.

Michael Rollins - Citigroup - Analyst

And Fran, if I can just follow up on one other thing. If you think about your Wireline footprint in total, are there any updated views on what you do outside of this core FiOS footprint?

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

Well, what you are going to see us do is obviously now we have done some of this in the past but using Wireless, our fusion technology from a broadband perspective. So when we talk about converged solutions and bringing the best solution to our end-user customer, this goes into what we do with our copper customers outside of the FiOS footprint and what we do for them from a voice perspective and also from a DSL perspective.

And obviously we have home phone connect and we have voice link on the Wireline side that we have already started to sell to our copper voice customers as a substitute to the copper product so we have already done some of this but you are going to see more technology come out here in 2014 that is going to address these issues.

Michael Rollins - Citigroup - Analyst

Thank you.

Michael Stefanski - Verizon Communications, Inc. - IR

Brad, let's take the next question please.

Operator

David Barden, Bank of America.

David Barden - BofA Merrill Lynch - Analyst



Hey guys thanks for taking the questions. Two if I could. Fran, just on the Wireline side, the consumer business has been really on fire the best performing part of that entire segment right now. And it has really been in the last two quarters or so that you have added about a \$500 million worth of run rate revenue in that business. And I know FiOS actually was growing in terms of net adds faster last year on average than it is growing this year. Can you talk a little bit about what the real drivers of that consumer business are and are they extracting -- can we extrapolate those into 2014?

And just teasing apart your commentary about enterprise, if you took out the CPE or kind of talking about enterprise being flattish, Global Enterprise being flattish year over year but obviously government is a weight on that. Then can we interpret that the basic enterprise business coming from non-government sources is actually starting to grow year over year? If you could kind of elaborate on that, that would be helpful. Thanks.

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

All right, thanks David. So on the Wireline consumer business, so look, I think when we size this all up we have some -- we really have three main focuses. As I have talked to before, we have become a very disciplined pricing strategy around our FiOS product. And when we looked at cable a number of years ago, we looked that they were very disciplined in how they did price ups to match their content cost and we were not really good with that but we started this as you know last year very early in the year and we have a strategy going forward. So we will continue to drive that strategy of pricing up the product equivalent to our content cost increases.

If you look at the next level of concentration we have had is we are going after market share. Now as far as slowness in the net adds, there is some seasonality here. There is always something that happens in the environment that causes this. But look, there are some markets that we are over 50% penetrated. So those markets have a slower growth but we are still gaining share in some of our later markets like New York City, Philadelphia, Washington which are in my mind underpenetrated to where they should be.

So you are going to see a little shift. There could be some slowness though as we start to penetrate some of these markets in 50%. But the fact of the matter here is that we still have a long runway. If you look at our 39% penetration, we still have a long way to go from a net add perspective.

But the other thing that is driving this growth and we can't lose focus of it is the migration of these FiOS of these copper customers over to FiOS. And as we convert them as I said, it may take us a little while but then we get that uptick in our TV product along with that.

The other focus that we have to that is not in the topline but really comes in through content, you see us doing some very innovative things around negotiation of content moving away from a per subscriber type content to more of a per viewer type cost of content.

So we are in a lot of conversations with content providers that we are willing to pay for people who watch their programs but we are not willing to pay on an overall subscriber base. We have been successful here with some of the smaller tier content carriers but that is also benefiting the profitability of this product going forward.

So I think there was a whole combination of why we think that we will continue this 4% plus revenue increase with continued penetration and continued profitability in FiOS.

On the enterprise side when we say relatively flat, if you take out CPE our decline in enterprise will be 0.9% this quarter versus -- or 0.8% this quarter versus 0.9% last quarter. So the government is declining faster than that. I wouldn't sit here and tell you that enterprise is growing. We do have certain areas of our business that are growing. If you look at our security product, if you look at our cloud products, if you look at the Terremark product, they are in fact growing. Hughes is growing but then you have the legacy voice and data that is not growing. And that is declining.

So net-net I would say it is relatively flat without the government pressure.

David Barden - BofA Merrill Lynch - Analyst

Thanks, Fran. I appreciate it.



Michael Stefanski - Verizon Communications, Inc. - IR

Brad, next question, please.

Operator

Brett Feldman, Deutsche Bank.

Brett Feldman - Deutsche Bank - Analyst

Thanks for taking the question. When you launched the Wireless deal, you had talked about an objective of getting back to your pre-deal leverage levels. I believe you said about four to five years but correct me if that is wrong. But regardless of the timeframe, I was hoping maybe you could just come back and talk about some of the foundational assumptions that support that goal.

For example, do you expect to see capital intensity continue to improve? I am curious what you are assuming about your ability to maintain or even grow your Wireless margins over that four- to five-year period? And then lastly, can you give us any color on what you have budgeted for spectrum purchases?

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

Yes, thanks Brett. So look, I am not going to get in the details of what we have projected. If you think about everything that we had to consider here, we considered tax, we considered CapEx, we considered the incremental tax rate. As I said, our tax rate will increase to a 35% to 36% range from what we have always guided from a 31% to 33% range. And that is because of the VZW coming over. We had to project out what our interest rate was. We know what that is now based on the offering that we did.

As far as CapEx goes, I have been pretty consistent here. You should consider us improving our CapEx to revenue ratio going forward. You should look at us as to what we have invested this year and we are going to do what we need to do to continue to invest in our networks and our platforms.

But moving out of this, there were three priorities that we set up to come to that four to five years. One was we will continue to invest in our networks and platforms. That is top priority for us. The next is we will continue to invest and buy licenses either opportunistically or in the auctions. I can't tell you what that number is because obviously it is going to be a public auction and we have a lot of strategies around how we acquire licenses. But that was built into our model.

And then finally, the dividend policy is also a very critical piece of this component to our equity shareholders and I think our Board showed that when they increased the dividend at the same time that they announced the deal. They are very confident in our cash flow.

And then finally, we have a commitment that we will delever the balance sheet as quickly as possible.

So look, I think if you look at the performance, if you look at our cash flow and our free cash flow this quarter, I think we are demonstrating that four to five years is within our horizon and we will meet our targets.

Brett Feldman - Deutsche Bank - Analyst

And are you assuming you can maintain margins at roughly the same levels?

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

I am not going to get into giving guidance around margins. I think that our performance speaks for itself and the margins speak for themselves.



Michael Stefanski - Verizon Communications, Inc. - IR

Okay, Brad, next question please.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - Barclays Capital - Analyst

Thank you very much and good morning, folks. Fran, just to follow up on the prior question around VoLTE rollout, what does this mean in terms of network investment here and specifically what I am trying to understand is are you where you need to be with respect to your network in order to provide ubiquitous VoLTE services nationwide or should we expect some additional investment in order to get to that level?

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

So on this one, it is a good question but the issue with VoLTE is coverage and as I have always said, we will not rush the VoLTE launch until we are sure that when you connect up a VoLTE voice call it will be very, very similar to a 3G CDMA call because that is what our customers expect. They know what the CDMA footprint is, they know where they can call. It is an unbelievable network.

We have to make sure that our VoLTE experience is the same and that is why we have taken such a long time and we believe that when we get to the first half of next year, the network will be ready, the experience will be very, very similar and we will be ready to roll this out.

But it is already built into the CapEx that we are spending. You should not see incremental CapEx for rolling VoLTE. It really is around coverage and it is of course, it goes into the densification and capacities.

Amir Rozwadowski - Barclays Capital - Analyst

That is very helpful. If I may just a follow-up here, somewhat of a bigger picture question. As you mentioned, this is sort of the fourth consecutive quarter in which you folks have posted 8% plus Wireless service revenue growth. How sustainable do you think this is going forward and the way I am thinking about it is, what advantages now controlling the full cash flow of Verizon Wireless provide you in driving initiatives to sustain this level of growth?

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

Again it goes back to the earlier answer that there is a lot of things going here and if you look at just sustaining this growth, I think I have been pretty open to say look, I can't sit here and tell you that 8% growth is going to happen forever in Wireless. You are talking a huge base of revenue. So I do think that the growth rate will come down over time.

But look, there is so much technology being developed throughout the world that is running over LTE. If you look at our innovation center in Waltham, and Lowell is out at our innovation center that we just opened up in San Francisco to welcome all the application developers into that center.

So it really comes down to the application developers developing new technologies around LTE. So it is hard for me to determine what this continued growth rate will be but there is a lot of runway, there is a lot of technology and the growth rate is still there.

Now I will tell you that in the short term I do believe that we can continue an 8% growth but over the long term I would tell you that I think that is probably a high aspiration.



Amir Rozwadowski - *Barclays Capital* - Analyst

Thanks for the incremental color.

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

Brad, next question please.

Operator

Kevin Smithen, Macquarie.

Kevin Smithen - *Macquarie Research Equities* - Analyst

Thanks. I wondered if you could review where you are specifically in terms of the AWS rollout? I think it has been quoted that from Nicki Palmer that you are going to end the year at 5000 AWS sites. Where are you at the end of Q3 and can you confirm the 5000 number and what the target would be at the end of 2014?

And also maybe what kind of user speeds uplink and downlink you are seeing in the AWS markets versus the 700 markets particularly in New York, Chicago, San Francisco where you cited higher congestion.

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

Thanks, Kevin. So look, I mean we are not going to get into a speed discussion because speed has a lot to do with nobody is on the network so obviously you are going to generate a lot higher speed. What we are building the network for is a very consistent reliable experience. And we have always said that the network engineers have designed the LTE network when it is fully loaded and that is the key here when it is fully loaded and obviously with 64% of data being driven through that network, it is pretty loaded, you are going to experience on average 10 to 12 megabits.

Now you will get bursts of 20, 30 and I know there was a report that came out with AWS of 80 but there was no one on the network. So I think it would be irrelevant for me to speak to that.

But here is the point. The point is we are doing a lot around our network. We are launching the AWS. As I said we are launching a lot of technologies and the city, the issues that we are currently having in some of the larger cities with the densification, these are starting to be fixed in the third quarter and we are going to make a lot of progress in the fourth quarter. So I think that is really what is important here.

And to me it is kind of irrelevant how many cell sites have what. It all comes down to the quality of the network, the reliability and the consistent performance of that network.

Kevin Smithen - *Macquarie Research Equities* - Analyst

And you touched on the incentive auction. How long do you think this AWS spectrum can carry you and if the AWS -- if the incentive auction gets pushed back for whatever reason, do you have enough capacity in AWS to last you through 2016 and 2015 and what are the scenarios?

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

Yes, well it is not just AWS because we can re-appropriate our CDMA spectrum in the slivers we need over into our LTE network. So as I said before, given the timeframe we are in now we are good for at least three, plus, four years with the spectrum holdings we have. But obviously we are going to participate in the auction. We are going to need more spectrum for the future of our business and we are going to invest in that spectrum.



Kevin Smithen - *Macquarie Research Equities - Analyst*

Thank you.

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

Okay, Brad, next question please.

Operator

Tim Horan, Oppenheimer.

Tim Horan - *Oppenheimer & Company - Analyst*

Thanks, guys, good quarter. Maybe just two Wireless clarifications and an update maybe on what your cloud strategy is at this point. I know you launched a new product. But on Wireless, can you maybe just discuss market share shifts. I know Sprint was shutting down the network and T-Mobile has been making some marketing initiatives. Have you seen any real changes out there in market share?

And then, Fran, I know you talked about the ARPU growth but are you seeing any resistance to the price increases? I mean it seems that ARPU growth is really, really positive for the longer-term trend if it continues and the elasticity doesn't kick in. And then if you can just talk about your new enterprise cloud update that you launched that would be great. Thanks.

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

Thanks, Tim. So on the marketshare side look, we did 927,000 net adds this quarter which was a strong quarter. Obviously we could have done more but there was constraints in the iPhone especially around the 5S and I think that constrained us for this quarter. But that will roll into our fourth quarter here.

So from a marketshare standpoint, we continue to gain market share. I can't sit here and tell you that we don't lose customers to our competitors. If you look at some of the other things that we are dealing with, I mean we do have some low-end if you will some single-line basic phone customers and older 3G smartphone customers. And what we see of the shift here is we are seeing them shift out of postpaid into our retail prepaid products but we are also seeing some of them shift off to some of the lower-end price plans of our competitors.

We did launch some things in September and we saw some improvement there and we will continue to get aggressive with those types of customers here in the fourth quarter.

But from a marketshare perspective, we are gaining marketshare. I think we will still post the best quarter of any competitor out there.

As far as the ARPA trend, this just goes to what I have said before is the focus going forward is not necessarily how many net adds I do, it is how we generate the growth of our topline that produces the margins. And this goes around everything I have talked about this morning with the quality of the network, 3G to 4G, all of these other devices and some of this ARPA growth as we say, it's revenue per account.

These could be, as I said before, these are other devices being attached to the network not necessarily smartphones or tablets. As you know, we sold cameras. We have sold a lot of machine-to-machine technology that are in our stores now. So there is a lot of things that are contributing to this even if it is \$0.50 to \$0.60 a subscriber, it is still generating that revenue coming through that ARPA.

And then on the cloud, obviously for some clarification here I think what you are talking about is on October 3 we launched a paid public beta of our new public cloud infrastructure. We are calling this Verizon Cloud Compute and Verizon Cloud Storage for businesses and governments of all size.



And our technology will give us the ability for this cloud-based infrastructure to handle enterprise-level workloads securely and in compliance with a lot of relevant requirements which will provide flexibility and economic benefits as generic public cloud.

So the launch of this cloud is just the next step in our cloud evolution. You are going to see a lot more of this come through in 2014. We will unveil new features. We have this technology established in seven of our data centers on a worldwide basis. You are going to hear more of this but it is a trial and a beta at this point and I think you are going to see us do a lot more in 2014 and you'll start to see some of the benefits there.

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

Brad, we have time for one final question.

Operator

Jennifer Fritzsche, Wells Fargo

Jennifer Fritzsche - *Wells Fargo Securities - Analyst*

Thanks, Fran. Two quick questions. First on SMB, cable seems to be moving more upstream at least that's some of the checks we are hearing. I am just wondering if you are seeing that and how critical is Wireless as a part of your sales pitch to this segment because that is obviously an advantage for you?

And then quickly on prepay, AT&T has made some more recent comments that they are going to be more aggressive on pricing there probably more through leads. But just your quick thoughts on your prepay strategy here. Thanks.

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

Thanks, Jennifer. So on small business look, I always split this between two segments. We have a segment that is within FiOS and a segment that is without -- outside of FiOS. Obviously Verizon Wireless does an unbelievable job with small business and Wireless product.

But within our footprint within FiOS and outside of FiOS, there's two things. One is within FiOS, we are actually gaining share in the small business environment. The issue is that obviously we have to pass those small businesses with FiOS and quite honestly, that has not been a concentration of ours most of it was to residential homes within our footprint.

So now it is building out all of those malls and so forth. So we have gone down the street. Now the issue is getting that into the small stores of these small businesses.

So within FiOS, we are doing a fairly good job. Outside of FiOS, it is hard for me to compete with the speeds that cable can offer them through the DOCSIS 3.0 technology. So yes we are using Verizon Wireless, we are using Fusion where we can but it is hard to compete because Fusion can't supplement a hardwired broadband connection into a very populated area. So that segment we are losing share; within FiOS, we are gaining share.

On the prepaid strategy, I have said all along we have our prepaid on 3G and the theory here is to keep the 3G network as full as possible to contribute contribution margin since we are not investing in that anymore and we will continue to get as aggressive as we can.

And you can see that over the last year and a half we have become more aggressive in the prepaid environment but we also use our resellers to drive the lower end of prepaid because we don't want the brand of Verizon Wireless connected to that low-end environment with a quality premium network of Verizon.

So that is the differentiation I think between us and our competitors but you can see we continue to make strides in prepaid and we will be as aggressive as possible on the 3G network to be competitive.



Jennifer Fritzsche - *Wells Fargo Securities* - Analyst

Thanks, Fran.

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

Before we end the call, I would like to turn it back over to Fran for some closing comments.

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

Okay, thanks, Mike. Just a few comments here before we end the call. So our industry has a very healthy competitive environment and we are forecasting continued strong demand for our video and broadband across multiple networks. We are executing effectively within this competitive environment, consistently delivering strong results, positioning ourselves for future revenue growth, earnings and cash flow growth. And we will continue to invest in all of our networks to deliver the most reliable customer experience and that is what they expect.

We are excited about the future as we continue to invest, innovate and deliver for our customers, our shareholders and our employees. Thank you for joining the Verizon call this morning 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.

Thomson Reuters Editor

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