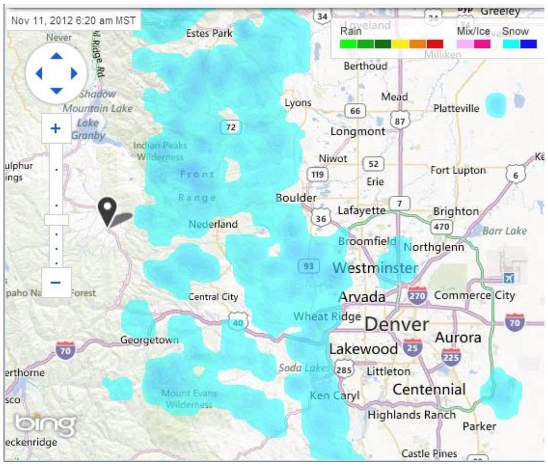
**The Sunday Brief: It's a Wired, Wired World – 3Q 2012 Edition**
**11 November 2012**




Greetings from Denver and Dallas where economic "shoots of grass" signaling a possible recovery are beginning to appear. One of the signs of economic recovery can be found in the picture to the left. It explains why blue = green, especially if you are from Denver.

First and foremost, today is November 11, the day we celebrate the dedication and support of our Veterans. Without you, we would not have the opportunity to freely and openly conduct commerce, create innovative products and services, and spend over $2 billion on presidential election advertising (which, ironically, is going to result in cable industry bonuses, which will result in incremental marginal tax revenue – go figure!). Our country is free because of you. Most of you volunteered to serve our great nation, and we are thankful for your service.

Second, there are many of you who have asked about my column published a few weeks back called "Questions and Priorities Facing the Next Administration." I am not optimistic that a second term will change the nation's broadband priorities, so it is likely that we will still have government-subsidized devices for low-end customers (Sprint's product is called Assurance Wireless) which is filled with fraud, and that we will continue to subsidize rural broadband competition (via grants to BTOP's) even though both Verizon Wireless and, with their announcement this week, AT&T, will cover a substantial portion of the population with LTE speeds. Bottom line: Defer more of your income if you can (then move to Texas where there is no state income tax), and ride the storm. This will be a rough four years for the country and the President, and it's time to create a national culture of accountability.

Last week, we described three trends:

1. Lower interest rates are allowing wireline companies (both incumbents and challengers) to strengthen their balance sheets;
2. Fiber to the Tower (FTTT) construction allowed wireline companies to build the "boughs" and with those components built, the rest of the branches (end office locations) can be considered more easily (and we established that there continued to be a strong addressable market for fiber to the building);
3. These fiber builds were needed for both wireline and wireless profitability as wireless (licensed and unlicensed/Wi-Fi) spectrum demand grew.

This week, we will use Time Warner Cable, Suddenlink Communications, Charter, CenturyLink, and AT&T to prove each of the above theses. In the spirit of keeping it brief, these will be thumbnail views only and we'll expand our analysis through the end of this year and 2013.

First, Time Warner Cable announced earnings that elicited a "meh" response from the Street. Organic revenue growth was a miniscule 0.9% (see table below). Comcast posted a 4.2% comparable (video + high speed Internet + voice) growth figure the previous week, and Comcast and Suddenlink revenue reports were both positive. Residential voice, which appeared to be the next great growth engine, is now shrinking for Time Warner Cable on a comparable system basis. Video also continued its downward slide, leaving the entire residential growth burden (after election-related advertising growth goes back to more normal levels) to the high speed data product.

The bright spot for Time Warner, however, was Business Services, which is now a $1.8 billion annualized revenue stream growing slightly more than 30% annually. Many analysts are asking "Where's the business and enterprise growth for Verizon and AT&T?" A good portion of it can be found in the trending schedules for Comcast and Time Warner Cable (see chart below), who have grown their (organic) business revenues by nearly $250 million over the past year.

Revenues for the third quarter of 2012 benefited from acquisitions, as detailed below.

| *(in millions; unaudited)* | 3rd Quarter 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Historical | *Organic* | Acquisitions | | | Total |
| | TWC[a] | *% Change*[b] | Insight | NewWave | Total | TWC |
| Residential services revenues: | | | | | | |
| Video | $ 2,573 | *(1.9%)* | $ 138 | $ 11 | $ 149 | $ 2,722 |
| High-speed data | 1,209 | *8.0%* | 66 | 4 | 70 | 1,279 |
| Voice | 489 | *(1.0%)* | 38 | 3 | 41 | 530 |
| Other | 17 | *30.8%* | — | — | — | 17 |
| Total residential services revenues | 4,288 | *0.9%* | 242 | 18 | 260 | 4,548 |
| Business services revenues | 474 | *22.5%* | 17 | 2 | 19 | 493 |
| Advertising revenues | 253 | *17.1%* | 11 | — | 11 | 264 |
| Other revenues | 58 | — | — | — | — | 58 |
| Total revenues | $ 5,073 | *3.3%* | $ 270 | $ 20 | $ 290 | $ 5,363 |

[a] Historical TWC amounts exclude the results of (i) Insight Communications Company, Inc. (acquired on February 29, 2012) and (ii) the cable systems acquired from NewWave Communications on November 1, 2011.
[b] Organic % Change represents the change between the Historical TWC amounts for the third quarter of 2012 and TWC's results for the third quarter of 2011 included in the table on page 1.

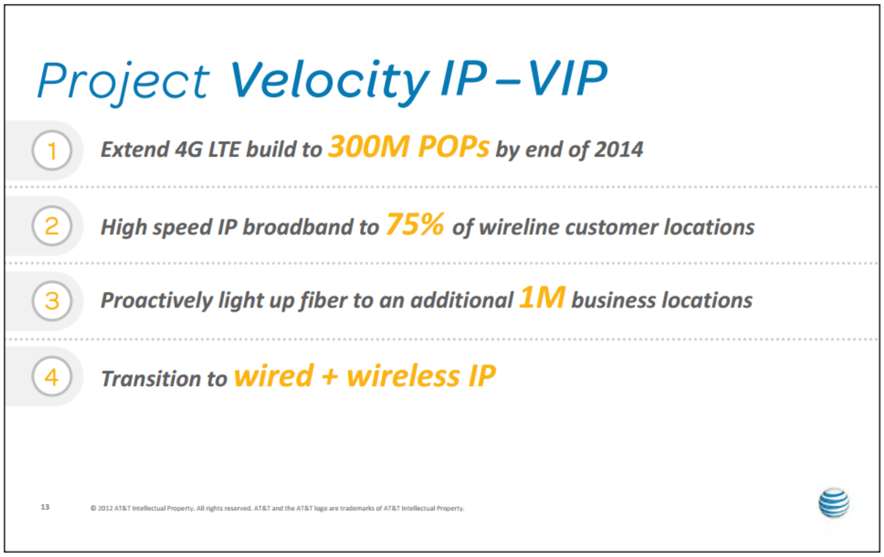
This growth does not come without a capital expense, however, as we described last week. Comcast spent $185 million in the quarter for business services, and Time Warner spent $161 million. These numbers pale in comparison to what AT&T announced they will be spending over the next three years (see "Project Velocity" below), but it would not be surprising to see the cable industry spend $2.1 billion in total in 2013 to support commercial services growth ($1.5 billion from Comcast and Time Warner; $350 million from their largest peers Brighthouse/ Cox/ Cablevision/ Charter; $250 million from the rest of the industry).

To put this in context, this spending would represent more than twice the current capital spending level for Sprint (wireline only) and Level3 *combined*. It would be about $700 million less than the *total* 2012 capital spending for CenturyLink (including Qwest) using their most recent guidance. To borrow from last week's Sunday Brief, cable is actively building the donut. As an industry, they were late to the game on fiber to the cellsite, but they will not be late when it comes to enabling office buildings.

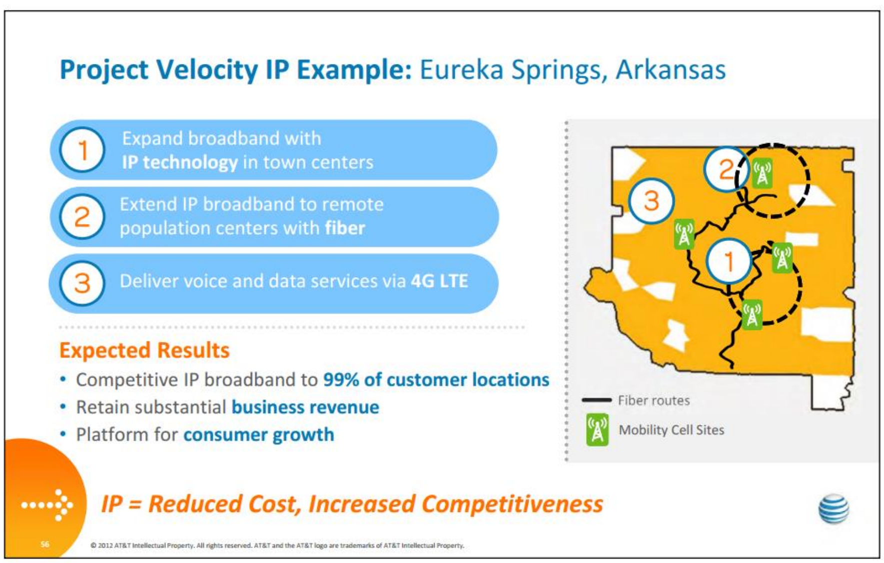
As we have discussed many times in previous Sunday Briefs, cable faces the inverse non-coincident busy hour opportunity – *business earns a profit faster because it can use the switching, interconnection and routing networks that were originally built for their residential counterparts*. The billions spent next year are hyper-local in nature – line extensions, customer premise equipment, and the like. Absent changes to more subsidized pricing models (a highly unlikely event), the cable industry's fueling of business services will likely result in fast and disproportionate profit growth. This will combat the inroads that AT&T and Verizon are making with their own advanced residential services.

This brings us to the Incumbent Local Exchange Carriers (ILECs) and AT&T's historic announcement last Wednesday. CenturyLink's earnings continued show their prowess in managing acquisitions, although they indicated that their top line growth would not turn positive until 2014. They have benefitted, however, from a strategy of robust fiber builds, and disclosed that they will end the year with between 14,000 and 15,000 cell sites in region connected to fiber. As we discussed last week, this fiber build represents the platform (or “bough”) on which premise extensions can be completed for less incremental capital.  CenturyLink’s foresight will make it more difficult for Comcast and Cox to take wholesale share, and perhaps allow CenturyLink once again to effectively compete for retail enterprise IP and cloud services.

This leads us to AT&T’s announcement which was historic in many capacities.  First, they committed to over $66 billion in capital expenditures over the next three years.  That’s the equivalent of two FiOS in about half the time.  That’s a lot of jobs to be announcing the day after Election Day.  Frankly, spending $5 billion per month for 36 months on anything is mind-boggling.




Specifically, AT&T announced two important things:  First, they were going to retrofit their local exchanges that had not been upgraded to U-Verse with a) U-Verse, b) IP Digital Subscriber Line Add/Drop Multiplexers (DSLAMs), or c) Wireless bandwidth from their LTE services.  Second, that in the process of doing this, AT&T will connect an additional 1 million businesses (or as many as 125,000 unique locations) to fiber.  In exchange for doing this, they asked for significant regulatory relief from Time Division Multiplexed (TDM – read old technology) services once new fiber and VoIP-based services were installed.  All of this goes under the moniker VIP – Velocity IP.




To show how this would impact smaller communities, CTO John Donovan described the effect that it would have on Eureka Springs, Arkansas (for more info, click [here](#)).  One fiber plan feeds three distinctly different sources:  Fiber to the Cellsite (Wholesale), High Speed Data (Retail), and 4G LTE Wireless Data (also Retail but could be wholesale).

It was interesting to see AT&T pick Eureka Springs, a town of 2,000 with a tourist/ seasonal communications pattern.  Cox

Communications is the underlying cable provider, and it's likely in their new partnership with Verizon Wireless that they will be the underlying provider of access services to Verizon (Eureka Springs already has 4G LTE in about half of the market area and Verizon has committed to complete coverage in 2013). Even in a town of 2,000 the competitive lines are being drawn.

Today's telecommunications landscape is shaped by capital spending. Whether it's spectrum, line extensions, switches, routers, customer premise equipment, or software, capital provides competitive fuel. Without it, you run a different race, one that relies on regulatory access, roaming agreements, and resellers' economics. That's the race Sprint, T-Mobile/ Metro, and others will have to run without a "third way" alliance.

Next week, we'll provide some final thoughts on the third quarter as well as distribute our inaugural "Thank You" list for the industry. As always, we welcome your comments and questions. If you have friends who would like to be added to this email blog, please have them drop a quick note to sundaybrief@gmail.com and we'll add them to the following week's issue. Have a terrific week!

Jim Patterson
Patterson Advisory Group
jim@pattersonadvice.com
(816) 210-0296 mobile
Twitter: @pattersonadvice