**The Sunday Brief: Our Thanksgiving Table**
**18 November 2012**

Greetings from Dallas, home of the LTE North America conference. I had the opportunity to speak to many of you about the effects of smartphones and applications on the upcoming "Signaling storm." It was a terrific breakout session, and kudos to the folks at Informa for putting on a first rate conference.

As the maniacal Black Friday with crazy smartphone offers looms (unless you are T-Mobile, who started the party this weekend with a two-day only free Samsung Galaxy SIII offer), we thought it might make sense to pull back from the day-to-day analysis and take stock of what's moving the industry. This week, we celebrate those things that have made our industry stronger and more vibrant. We call this our "Thanksgiving Table."

**First**, there are low interest rates with good terms that allow companies large and small to strengthen their balance sheets. Nearly every company that has debt in the telecom industry has taken advantage of this phenomenon.

One of the greatest beneficiaries of the corporate debt refinancing trend has been Level3 communications, who restructured about a quarter of their indebtedness ($2.2 billion) in the third quarter and in the process lowered their average interest rate paid by 40 basis points and in some cases extending the maturity of certain debt payments. Here's the third quarter activity snapshot from their earnings release:

The company and its wholly owned subsidiary, Level 3 Financing, Inc., completed the following transactions during the quarter:

- The company issued $300 million aggregate principal amount of 8.875% Senior Notes due 2019, with the net proceeds from the offering being used for general corporate purposes;
- Level 3 Financing borrowed $1.415 billion in two tranches of term loans, with the first tranche of $600 million maturing in 2016 and the second tranche of $815 million maturing in 2019, to refinance its existing $1.4 billion Tranche A Term Loan maturing in 2014 and approximately $15 million of other vendor financing obligations;
- Level 3 Financing issued $775 million aggregate principal amount of its 7% Senior Notes due 2020, and along with cash on hand, redeemed the $700 million of the Company's outstanding 8.75% Senior Notes due 2017, including the payment of accrued interest, applicable premiums and fees; and
- The company used $63 million to fully repay its headquarters' Commercial Mortgage due 2015, including the payment of accrued interest.

This type of transaction was not uncommon in 2012, and is the culmination of over many months of planning and negotiation for Level3. The formula is simple: Issue debt with longer maturities and lower coupons to extinguish near term maturities with higher coupon rates. Sprint had a similar announcement this week on $2.2 billion of debt placement (6% coupon) that allows them to eliminate any fears of repayment in 2014 and 2015.

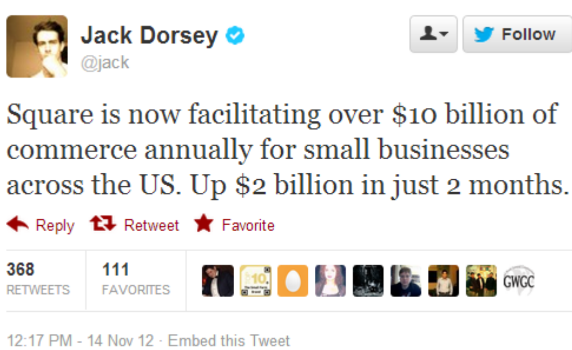
Not everyone is using low interest rates to restructure maturities. AT&T has been using it to finance stock buybacks, and Verizon Wireless, who has very little net debt to begin with, has been addressing their long-term pension needs by outsourcing pension payments to Prudential.

**<u>The bottom line:</u>** 2013 cash requirements related to debt are fixed for all carriers. They are more certain than variable in nature, and they are being increasingly pushed out 3-5-7 years from the previous maturity. This sets the table for focused growth, increased capital spending on strategic areas, and potential M&A activity. CFOs around the telecom industry are full of thanks this year.

**Second**, the collective industry is thankful for the innovation of others as it has embraced the Valley model of "don't invent it here (particularly if it is software)." This division of innovation has kept a healthy balance between entrepreneurs, venture capital, and corporations of all sizes.

One great example of this type of innovation is Square (I linked to their Crunchbase profile so you can see who is invested in the company – it's not the typical "few firms" backers). While others continue to trial and prepare for the mobile payment tsunami, Square has quietly (OK, not so quietly) been implemented in 7,000 Starbuck's locations. That project took three months to implement from the day the deal was signed.

As a sign of Square's success, Jack Dorsey recently Tweeted the following:




Whether Square (this link is to their website) is a blockbuster or merely an intermediate success story as larger players develop new and better business models remain to be seen. But Square's Mobile Card Reader is a low-cost, high impact hit for small businesses. And it's an example of how entrepreneurship drives faster reaction. (Said differently, could you imagine how long it would have taken AT&T to develop, market and implement the Square solution? Sometimes, it's better to have seasoned entrepreneurs at the wheel).

There are many examples of how entrepreneurs are collectively working with larger companies to accelerate product development. In the cable home security space, iControl is driving a lot of innovation with partners Comcast and Time Warner Cable. In the home energy management space, Nest is striking distribution partnerships that include aggregated information sharing with local utilities including Reliant Energy. (The recent CNET review of the next generation Nest can be accessed here). The work done by Rackspace-backed Nicira on software-defined network technology resulted in a huge payout this year as VM Ware purchased them for $1.25 billion (and in the process dramatically improved their portfolio).

**<u>Bottom line:</u>** The "Not Invented Here" mantra is still alive at every large company (especially in engineering and product development departments), but it's beginning to atrophy as they realize that the amount of (private, not government) capital being poured into research and development is encouraging faster invention than any single company can match. Interoperability concerns still exist, but life-changing products are emerging at a faster rate because of open networks.

**Finally**, we tackle the role of risk taking in the telecom and technology industries. 2012 will be seen as the year of business model transformation for many businesses. It was the year Verizon Wireless introduced Share Everything, which simplified voice and text through aggressive (yet highly profitable) unlimited bundles, and attempted to create an easy formula for attaching additional data-hungry devices. While the plan itself is not innovative, Verizon, [staying true to form on billing changes implemented in 2010], took the risk of mandating the plan for all new 3G and 4G customers.

While Verizon's move (see our writeup on 3Q earnings) now looks like a stroke of genius, it was widely criticized in the press when it was announced in June. Here's a sample quote from [Computerworld]:

> "Big steps like [Share Everything], particularly when they come with sharp [price] increases, tend to scare the hell out of existing customers, and Verizon might actually lose a bunch as a result," said Rob Enderle, an analyst at Enderle Group.
>
> The widespread negative reaction by customers on various Web sites seen after Tuesday's announcement "is similar to the Netflix mistake last year that almost sunk that company," Enderle said.


Verizon could have made a colossal mistake, but they didn't (see AP article [here] on the results, see also the chart to the left that clearly shows no cliff-like stock movement that resulted from the September 2011 Netflix announcement). How could Rob Enderle, a well-respected analyst, be so wrong?

Clearly, Verizon did not change their entire pricing structure without a great deal of analysis. They knew that one possible consequence of their action was to scare away high volume (and presumably lower profit-generating) customers.

But Verizon weighed this risk (as they did when they mandated a data plan for every smartphone purchase in early 2010) against increasing 4G LTE network coverage and capacity expectations. To continue to earn higher margins, the data consumed by their customers had to be worth more than 3G data or their competitors' 3G/4G unlimited data. For customers to leave (vs. testing or remaining on 3G), they value equation would need to be extremely unbalanced. A communications plan would need to be in place to prove that Verizon's network (complete with the new iPhone5) was worth the cost.

The results of Verizon's bold move were astounding: 1.54 million net additions to the retail postpaid base, 0.91% monthly subscriber churn (down 0.94% in 3Q 2011), and a sequential increase of $2.10 per account.  Sure, there's still opportunity for Verizon to stumble, but they will have the pricing leverage (and additional cash) on their side.

Contrary to popular belief, the telecom industry is full of risk takers.  It's a different type than the entrepreneurial risk (usually a cross-subsidy or advertising-based variety) popular on the coasts.  But Verizon's risk, combined with the seismic risk AT&T is embarking on with VIP (which we will look at in great detail next Sunday), shows that the industry can change its spots.  It's the willingness to turn the model upside down (and perhaps inside out) that makes it unique in American business.

Low interest rates allow the industry to continue to grow.  Shedding the "Not invented here" mantra allows wireline and wireless product portfolios to grow more broadly.  Calculated risks enable that growth to be increasingly more profitable.  We have set a full table, ready for consumption and perhaps a spark or two of feisty conversation. (After all, what would Thanksgiving be without an occasional family feud?).

Happy Thanksgiving to each of you from the Sunday Brief.  Next week, barring any newsworthy items, we will look at AT&T's Nov 7 news conference in great detail, and discuss the implications of their additional $14 billion of investment on the telecom landscape.    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