The Sunday Brief: What is Time Warner Cable Telling Us?
3 February 2013

Greetings from Dallas and Austin, TX, where the weather is dry and the smell of spring is in the air at the Waterloo Ice House in Austin. The mix of beef brisket, tater tots and red cabbage in a soft taco shell – who'd have thought they could create such a good combination?

Thanks for the many comments on last week's "Got Wireless?" article. I did not have time or space to address all of them, and I agree that the article could have gone in depth in more areas. There's more to come, especially in dealing with geographic and spectrum-specific issues.

This week, Time Warner Cable announced earnings. They are usually overshadowed by their larger sibling Comcast (who tends to announce earlier than TWC), but this quarter, TWC led the parade. I find TWC's earnings releases and quarterly earnings calls to be more insightful (vs. Comcast) because they provide a purer insight into cable (vs. cable and NBC Universal) economics.

Here's a brief 4Q financial snapshot (straight from their earnings presentation):

- Revenue grew 9.9%
- Adjusted OIBDA up 5.6%
- Operating Income increased 13.6%
- Adjusted Diluted EPS was $1.57, up 13.8%
- Returned $742 million to shareholders

While the numbers above are impressive, organic growth is not. Excluding the Insight and other acquisitions, there was minimal annual growth. The schedule below (again, from their earnings release) tells the complete story for 2012:

(in millions; unaudited)	Full Year 2012						
	Historical	*Organic*	Acquisitions				Total
	TWC[(a)]	*% Change[(b)]*	Insight[(c)]	NewWave[(d)]	NaviSite[(e)]	Total	TWC
Residential services revenue:							
Video	$ 10,418	*(1.6%)*	$ 462	$ 37	$ —	$ 499	$ 10,917
High-speed data	4,856	*8.5%*	220	14	—	234	5,090
Voice	1,968	*(0.6%)*	127	9	—	136	2,104
Other	61	*24.5%*	3	—	—	3	64
Total residential services revenue	17,303	*1.2%*	812	60	—	872	18,175
Business services revenue	1,792	*22.0%*	55	5	49	109	1,901
Advertising revenue	1,013	*15.1%*	40	—	—	40	1,053
Other revenue	252	*8.2%*	4	1	—	5	257
Total revenue	$ 20,360	*3.5%*	$ 911	$ 66	$ 49	$ 1,026	$ 21,386

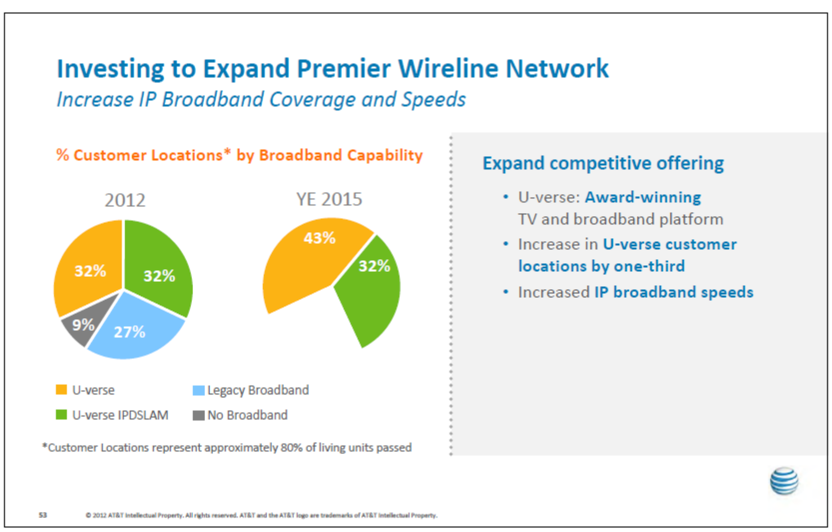
As the table shows, Time Warner's total *residential* growth was a respectable 6.3% or $1.08 billion for 2012. However, $872 million or 81% came through acquisitions and $206 million through organic means. Time Warner Cable's core residential business is struggling to grow. (Note: We chose the annual basis to smooth out any specific quarterly seasonality/ superstorm issues. Fourth quarter growth was actually *lower* than the full year growth at 1.1%).

Let's put the 1.2% residential organic growth in perspective. AT&T grew their comparably-sized full year 2012 consumer markets (wireline) segment by 1.9% with a 4Q 2012 growth rate just over 3.0%. While the percentages are small for both providers, AT&T appears to be turning the competitive corner against cable. Cable's new wireless partner (Verizon) posted even better numbers for consumer retail than AT&T, albeit on a slightly smaller ($14 billion) annualized revenue base. **Bottom line:** Even with some ability to pass on programming price increases (which results in organic video revenue growth), residential revenues for Time Warner are growing more slowly than their two largest telco peers, Verizon and AT&T.

Breaking down the fourth quarter growth figures even further, we see that two line items drove a majority of their growth – political advertising ($55 million) and business services ($106 million; $89 million without acquisitions). On an organic basis, Time Warner Cable recorded $209 million of growth in 4Q. $89 million or 43% of this came from business services, and ~$50 million (23%) came from election-driven political advertising. Two-thirds of their fourth quarter 2012 revenue growth has absolutely nothing to do with traditional residential paid television services, and nearly a quarter of their growth is extremely cyclical, which will make 2013 comparables very difficult.

The days of easy (bundled) revenue growth are over for the cable industry. Voice revenue is profitable but shrinking (as is the addressable market for home telephone services). Video is only as profitable as the ability to improve operations and to negotiate better programming deals. This leaves the crown jewel of Time Warner Cable (and the cable industry in general) – High Speed Data – to grow their business.

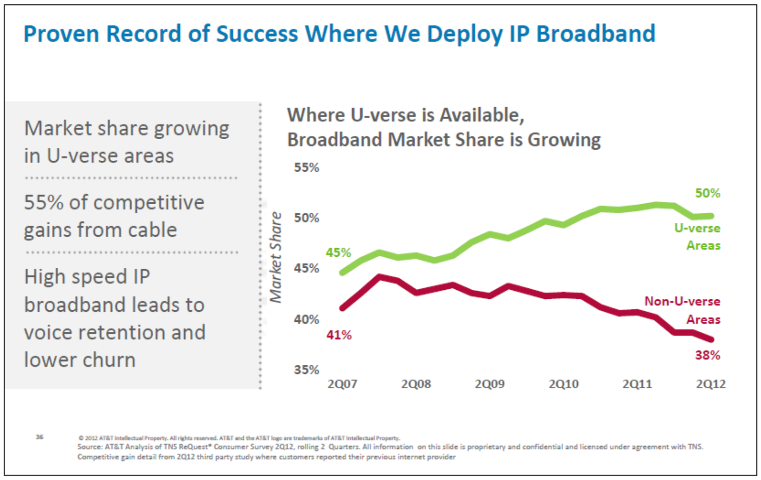
High Speed Data drove more than $5.8 billion in gross margin for Time Warner Cable in 2012, nearly 58% of the company's total. This is up from 51% of the company's total in 2010. When 30% of the revenues make up 58% of the company's gross profit (and likely an even higher number of EBITDA or cash flow), there's an imbalance. And where there is imbalance, there's vulnerability (or, from a competitor's perspective, opportunity). As video and voice subscribers continue to come under pressure with little to no growth, the dependence on High Speed Internet is going to become greater than ever.



No single company has its sights focused more firmly on Time Warner Cable than AT&T, as witnessed in its November 7 investor conference. One of the components of the Velocity IP (VIP) investment program is enhanced DSL. This involves expanding the U-Verse DSLAM (Digital Subscriber Line Add/ Drop Multiplexer). More High Speed Data to more locations, including North/ South Carolina, Texas, Ohio, and Southern California.

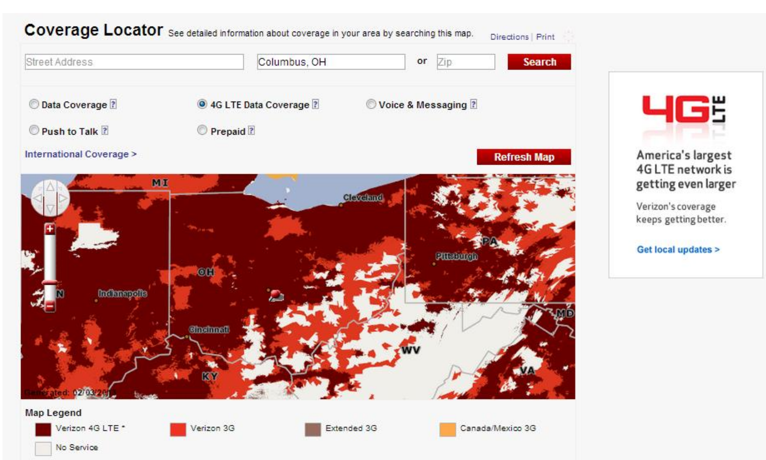
Outside of New York, AT&T could not have aimed this investment more closely at a single cable company than at Time Warner Cable.

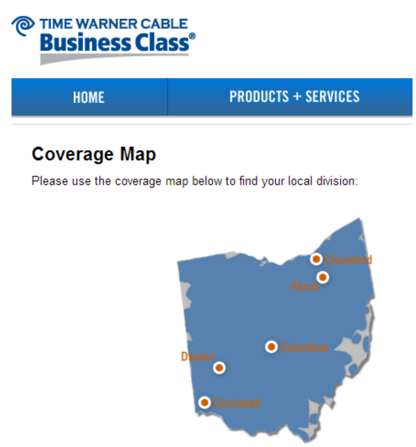
We have discussed the rationale for AT&T's investment in several Sunday Briefs. But, just to refresh, here's why AT&T is moving in this direction:



AT&T is expanding U-Verse to improve the value of the double play (or triple play, with the third component being wireless). When U-Verse is available, broadband (cash flow) follows. Yes, AT&T is taking a play out of the cable playbook and using the effect of combined broadband and IP-based video to grow their footprint. This expansion will put further pressure on High Speed Data margins, which, as we discussed earlier, are very high.

But AT&T's and Verizon's expansions are not confined to wires – wireless expansion is also fueling cash flow growth. The attached pictures show the 4G LTE network deployment as of Feb 2 for Ohio as well as a pretty good proxy for Time Warner Cable's network in the Buckeye State. Verizon has committed to make the lighter (3G) areas LTE-enabled by the end of this year. Verizon's strong data footprint is fueled by Ethernet access provided by Time Warner Cable. In more rural areas (and there are a lot of them in Ohio once you get outside of Columbus, Dayton, Cleveland, Cincinnati, and Toledo), a 10 Gigabyte per month offering for High Speed Data is comparable to the regular unbundled price for either the telco or cable company (if the customer is using less than 10 Gigabytes to their home). This price comparison is important as wireline cord-cutting has increased in rural America (thanks to Wal-Mart Straight Talk's product, which also uses Verizon Wireless as one of several wholesale network providers) and as satellite continues its advance in less dense markets.





Reconciling the Verizon Wireless partnership is more difficult in scale-sensitive rural markets. While Time Warner Cable sees a natural relationship with Verizon Wireless to battle the double (triple with wireless) play in urban Multi-Dwelling Units, what about rural competition? Verizon has a distribution network that understands store-by-store local marketing (including the Home Fusion product). While not enough of a contributor to net additions to make Verizon's earnings release, when a Home Fusion customer is (professionally) installed, it's a lower-churning product than other postpaid options. And, given Verizon's footprint, these are the easiest customers to promote/ upgrade to higher data speeds as their needs grow into streaming video applications. It may not be a deal killer, but Verizon's Home Fusion expansion promises to strain relations between the two companies in upstate New York, Ohio, Kentucky, and the Carolinas.

The problems of slowing growth, profit concentration, and increased competition from wireless and AT&T are not isolated to Time Warner Cable – every other cable operator has them (note: not every cable operator enjoyed the benefits from election-driven political advertising that Time Warner Cable experienced, however).

The buzzword around the cable industry has become "balance." Build a robust network infrastructure, but balance residential and business connections. Invest in new home building (where it is occurring), but balance it with retention and re-acquisition in areas that have already been built out. Invest in organic growth and operational efficiency where it makes sense, but balance it with acquisitions whenever possible. Finally, one idea that has been simmering for a while is regional provisioning and troubleshooting selling consortiums (think the Star Automated Teller Machine Network in banking) that bring together 4-5 cable companies to battle Verizon in the Northeast. This would balance individual with collective efforts to penetrate enterprise accounts.

Time Warner's earnings tell us a lot about the state of the wireline industry. AT&T and Verizon residential franchises are growing faster than cable. Both AT&T and Verizon are investing tens of billions of dollars to increase their 4G LTE footprints, placing pressure on low-GB (read highest profitability) residential and small business customers. Wireline voice is being replaced by wireless and as a result reducing the cable's triple play to a double.

Has cable had their glory days? No, cable's best days are still ahead if they reformulate their recipe for success.

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For more on Time Warner's Earnings, click here for the release, here for the trending schedules, and here for the webcast.