The Sunday Brief: What Does Verizon's Q1 Earnings Tell Us About the State of the Telecom Industry?
22 April 2012

Greetings from Kansas City and St. Louis. Seventeen years ago today (yes, on Earth Day), Martha and I got married in St. Louis. Seems like yesterday we were on our way to Barbados. Thanks for being such a close friend, confidant, wife, mother to a teenager, and Sunday Brief editor.

Speaking of partnerships, Verizon announced earnings this week. The wireless partnership with Vodaphone continues to be strong, with their European counterpart getting the equivalent of a 2 carat 12th anniversary ring in the form of a $4.5 billion dividend payment from the Verizon Wireless joint venture (Verizon Corp. got the remaining $5.5 billion and used it primarily to redeem some higher-coupon debt). Based on the current earnings, the relationship could not be stronger.

Contrast that with the troubled affairs within the wireline division. Using data from his newfound partners Comcast and Time Warner Cable, Fran Shammo told the labor union "You're too expensive" through the first quarter conference call. Investors were clearly led to expect that it would be a long and protracted negotiation. Let the summer fireworks begin!

Based on the data presented, as well as a very detail-rich and thorough conference call (Verizon is by far the leader in information disclosure, even if they decided not to report wholesale connections this quarter), is there anything we can extrapolate to the industry as a whole from this call?

The short answer is yes. There is a lot to learn from this earnings release. Here are a few trends that will carry over into the other carriers:

1. **Subsidies matter.** Selling 1 million fewer iPhones in the quarter really matters, even if that is partially offset by higher LTE sales. Here's a comparison between the two:

Description	4Q 2011	1Q 2012	Difference	Subsidy	Difference
iPhone sales	4.2 million	3.2 million	1.0 million	$400(est.)	$400 million (fav)
4G phones	1.6 million	2.1 million	0.5 million	$250(est.)	$125 million (unfav)
Net effect					$275 million (favorable)

$275 million of quarter-over-quarter favorability is nothing to sneeze at. For Verizon, it represented about 35% of their overall improvement in their costs of goods operating expense, and the quarterly improvement in the cost of goods represented nearly all of their total expense change. If the mix had been towards more iPhones, the near-term profit picture would not have been as bright.

Verizon's CFO goes even further to encourage more competition with the following earnings conference call comment:

I do think, though, it is important that there is a third ecosystem that is brought into the mix here, and we are fully supportive of that with Microsoft. And as we said that we created the Android platform from beginning, and it is an incredible platform today that we helped create, and we are looking to do the same thing with a third ecosystem.

It's a passing comment, but one that clearly shows an active interest in non-Apple sources. Other things equal (meaning same usage, applications, etc.), more (4G) Droids in the product mix yield more value to Verizon's shareholder than more iPhones.

2. **Wireline – still in recovery**. While we mentioned the labor situation above, the real story in wireline is the lack of growth. Here's the not-so-pretty picture:

(dollars in millions)

	2010			2011				**2012**
Unaudited	2Q	3Q	4Q	1Q	2Q	3Q	4Q	**1Q**
Operating Revenues								
Consumer retail	$ 3,350	$ 3,364	$ 3,385	$ 3,383	$ 3,394	$ 3,400	$ 3,429	**$ 3,441**
Small business	720	709	700	695	682	670	684	**662**
Mass Markets	4,070	4,073	4,085	4,078	4,076	4,070	4,113	**4,103**
Strategic services	1,618	1,667	1,726	1,765	1,900	1,926	1,984	**1,969**
Core	2,201	2,174	2,151	2,051	2,056	1,995	1,945	**1,883**
Global Enterprise	3,819	3,841	3,877	3,816	3,956	3,921	3,929	**3,852**
Global Wholesale	2,192	2,157	2,098	2,042	2,030	1,963	1,938	**1,861**
Other	196	215	229	211	185	195	159	**129**
Total Operating Revenues	10,277	10,286	10,289	10,147	10,247	10,149	10,139	**9,945**
Operating Expenses								
Cost of services and sales	5,611	5,658	5,608	5,462	5,504	5,681	5,511	**5,572**
Selling, general & administrative expense	2,359	2,296	2,267	2,290	2,308	2,296	2,213	**2,126**
Depreciation and amortization expense	2,100	2,145	2,161	2,107	2,117	2,119	2,115	**2,090**
Total Operating Expenses	10,070	10,099	10,036	9,859	9,929	10,096	9,839	**9,788**

As we have mentioned in several previous Sunday Brief columns, if all Verizon had was a wireline unit, it would have been sold or restructured by now. Verizon Telecom carries nearly $40 billion of debt, over $30 billion in unfunded pension liabilities, and the VZ dividend. All of this on a $600-800 million annualized operating income stream.

Can the Wireline patient ever leave the hospital? Yes, but it's going to take growth in non-FiOS areas (why this growth has to come from non-FiOS will be the topic of a future Sunday Brief). The main source of growth has to come from Enterprise spending. As the chart above shows, the "Core" enterprise line (think of this as traditional voice and private line services) is dropping as fast as cloud and managed IP services are growing.

Verizon's enterprise unit is in the midst of a large reorganization that will focus on verticals. This will match them up against their competition, focus products to deliver customer solutions, and bridge the gap between the server/ cloud and network layers (think one SLA for all of S. America data delivery). The success of wireline depends on the successful execution of this sales and marketing transformation.

Each day, Verizon's local network becomes less efficient in relation to their cable competitors. Think about it: Verizon is operating both copper (DSL) and fiber (FiOS) networks. They each have network operations and maintenance personnel. They have separate products, IT systems, service centers, and specialty technical support. Even with Verizon's decision to stop DSL sales in FiOS coverage areas (which many of us thought had already been made), they still have territories that will never receive FiOS. Some portion of that product support cost will remain.

Moving back up the cost curve is getting to be very a very expensive proposition for Verizon Telecom. The efforts to invest today will eventually pay off, but the transition to this end state will be much slower than anyone expects.

While Verizon's problems are acute, the enterprise theme will also hold when AT&T releases results this week. The movement from minute-based circuit switched products to connection-based packet based products is in full swing, but there's a few years of network transitions left to complete the conversion.

3. **Size matters, and with size changes come price increases.** Verizon has always had an aggressive and open style of operating their business, and this quarter is no exception. When you are big, you can provide market signals, like the "We'd really like a third competitor, and Blackberry doesn't count" comment discussed earlier. Here's one example of how they are planning to improve FiOS profitability:

   In addition, going into the future, you are going to see -- you may have already saw -- that we are starting to do some price-ups in strategic areas. We've already started that in April, but over the next two quarters, we're going to have several price-ups in our FiOS packages. In addition, we are going to rebundle certain of our packages to better bundle our content in order to make it more profitable, based on the tier that you pick for us.

   I love the term "price-ups." Someone in marketing was transferred to Investor Relations and came up with that term. It sounds so good. Rebundling is a little bit tougher to stomach, but everyone understands rebundling as we have lived through this with Cable and Satellite pricing tier changes.

   Five years ago, raising prices was the last thing anyone thought Verizon, AT&T, or anyone else would do (except for content price increases, which were similar across the transmission mediums). We were in the long distance and price regulation mentality of "can't do it – we'll lose market share or have the regulators all over us."

   That was then. Fees, re-tiering/ rebundling, and other "price-ups" are taking over. With over five million FiOS customers and 36%+ penetration within their markets, the shift from acquiring to optimizing the base has begun. It will be very interesting to see cable's response.

Verizon gave investors an inside peek into the telecom market with their earnings release: A 4G network that's unbeatable and getting stronger. Fewer iPhones in the mix to drag down cost of goods sold. Operating both copper and fiber-based networks to profitability. Managing revenue reductions within the enterprise segment as the world turns to packet-based solutions. Verizon's (and the industry's) plate is full, and new sources of competition (Google Voice, Microsoft Skype, and Facebook) are cash rich and ready to compete.

Next week, we'll look at additional earnings results (including Microsoft, who showed signs of growth with this week's earnings release). Look for an announcement on the new website in next week's Sunday Brief, and feel free to have your friends subscribe directly by sending a request to sundaybrief@gmail.com Have a terrific week!

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