Kannan Venkateshwar	+1 212 528 7054	kannan.venkateshwar@barclays.com	BCI, US	Completed: 30-Jan-20, 13:46 GM
Calvin Hou	+1 212 526 8284	calvin.hou@barclays.com	BCI, US	Released: 30-Jan-20, 13:46 GM
Divyaunsh Divatia	+1 212 526 9947	divyaunsh.divatia@barclays.com	BCI, US	
Ashton Welles	+1 212 526 0416	ashton.welles@barclays.com	BCI, US	

Verizon Communications Inc.

VZ: Margin pressure continues

Stock Rating/Industry View: Equal Weight/Neutral
Price Target: USD 55.00
Price (29-Jan-2020): USD 59.53
Potential Upside/Downside: -8%
Tickers: VZ

Overview

Verizon was the fourth straight carrier to beat wireless subscriber expectations. Sub trends, which accelerated y/y on a tough comp, were expected to be robust after the company launched its much-anticipated Disney+ promo in December. However, cost growth once again came in above expectations which led to a miss on wireless EBITDA margin. While VZ has suffered from this more than other carriers throughout the year, and part of this is due to accounting, this theme has appeared to have picked up this quarter industry-wide. The company also missed its service revenue growth guidance.

Going into 2020, VZ will no longer report Wireless segment results separately, which will make it difficult to benchmark organic margin trendlines. This could make for a tricky dynamic given that margin expansion expectations continue to fall but visibility will be limited beginning next quarter.

Sub beat potentially driven by promos: VZ postpaid phone net adds of +790k beat our already optimistic expectations of +747k (consensus +652k) with the second derivative accelerating y/y. Much of this strength appears to be promotional in nature, with VZ not only launching Disney+ in the quarter but also being uncharacteristically aggressive in the handset promotion market as well as on Black Friday. While perhaps some had expected stronger performance on the Disney front considering headlines around Disney+ initial sub ramp, we do acknowledge that Disney+ likely had much more significant uptake on the existing phone base rather than driving gross adds. In addition, last year's Q4 benefited heavily from the successful iPhone launch, which we estimate could have created a comp headwind by as much as ~100-200k subs. If we assume this impact from last year's iPhone on top of organic growth (say +50k), this implies that Disney+ itself could have added ~200-250k subs in the quarter. While this is optically rather small relative to the 20mm Disney+ sub number, we do acknowledge that the sub tailwind was over only one month and it appears that the bundle has had a larger impact on existing account churn. While postpaid phone churn rose seasonally as per usual (+4bps q/q), the magnitude was much lower than T, TMUS (+12bps each) and S (+13bps). This would imply that the tailwind to Disney+ from Verizon came from existing VZ subs which could have contributed 3-4mm to Disney+ subs in the quarter overall. If this estimate is borne out, then Verizon's contribution to growth for Disney+ next quarter will need to be more gross add heavy given the already high penetration of existing base that is eligible. However, Q1 tends to be a seasonally weak quarter for phone net additions which makes this tougher.

Revenue guidance misses: The company surprisingly missed wireless service revenue guidance (+2.7% vs. guidance of +3-3.5%) despite ARPA coming ~in-line. Part of this could be due to account penetration growing faster than expected (3.27 vs. 3.25 lines/account est.) as a result of Disney+ and other promotions which dragged on ARPU despite ARPA coming in better. Another explanation could potentially be wholesale revenue growth slowing on a y/y basis. The dynamic which is likely to get tougher is the tailwind from cable MVNO revenue growth which should slow because of lapping the Charter launch. The competitive environment for retail also looks set to be tougher in 2020 given AT&T comments and launch of HBO Max. The course of the S/TMUS deal could add further to competitive headwinds. Consequently, 2020 looks set to be a tougher year for service revenue growth and the company's revenue growth guidance of low-to-mid single digits may need to lean a lot more on equipment revenues. The ending of Disney+ promotions second half of next year should also help ARPA and therefore service revenue growth but this is simply due to accounting treatment and doesn't really help margins as it is a pass-through (please see How does accounting impact telecom industry comparisons?, Jan 16, 2020 for details).

Margin trends again disappoint: On a reported basis, wireless EBITDA service margin was ~180bps lower y/y due to robust cost growth across all three line items (equipment, SG&A and cost of service). While part of the margin pressure was due to accounting, even excluding this, wireless service margin was nonetheless slightly down for the quarter and was likely ~flat for the year. This marks the first year wireless margin has not expanded y/y since 2014, the year when TMUS began aggressively retaking share and when handset upgrade rates were at their last peak. The difference, however, in industry fundamentals between then and today is quite large in that VZ margin remained flat in 2019 during a relatively benign competitive environment with upgrade rates at an all-time low. This has negative read-throughs heading into the next two years where competition is beginning to heat up and VZ will have difficult cost of service comps in the first half due to Disney+. Execution and visibility, the fountainheads of VZ equity performance, are also likely to be bigger issues given that the company will no longer report wireless segment margin separately.

Wireline deteriorating faster: For several quarters now, wireline EBITDA has disappointed to the downside and this trend appears to have no signs of abating anytime soon. The magnitude of the miss this quarter was quite material with wireline EBITDA coming in 30%+ lower than ours and consensus estimates. This appears to be on the back of robust SG&A growth (ex-accounting impact) which is quite counterintuitive for a business that is secularly declining in the mid-single digit range. Heading into next quarter's resegmentation, this has negative implications with wireless segment results potentially obscured by deteriorating wireline trends on the Consumer and Business segments. Laterally, Verizon continues the trend of acceleration in video declines which adds to the drumbeat from other MVPDs during the quarter. The company's recent change in pricing plan for Fios could also incentivize more cord cutting which is likely to result in the pace of video declines accelerating further in 2020.

Figure 1
VZ Actuals vs. Estimates

download image

Source: Barclays Research, Company Reports, StreetAccount

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Verizon Communications Inc. (VZ, 29-Jan-2020, USD 59.53), Equal Weight/Neutral, A/CD/CE/D/E/J/K/L/M/N

Valuation Methodology: Our price target of $55 is based on ~6.9x 2020E EBITDA of ~$49Bn.
Risks which May Impede the Achievement of the Barclays Research Valuation and Price Target: Risks include heightened competition, macroeconomic pressure, and lower than expected return on 5G initiatives.

Ratings and Price Target History:
Verizon Communications Inc.
Currency=USD

VZ
Source: IDC, Barclays Research

Publication Date	Closing Price	Rating	Adjusted Price Target
14-Oct-2019	59.60		55.00
23-Oct-2018	57.21		53.00
04-Sep-2018	53.19	Equal Weight	50.00
23-Apr-2018	48.66	Overweight	
17-Jan-2018	51.72		56.00
27-Jul-2017	47.81		50.00
14-Jul-2017	43.56		47.00
13-Apr-2017	48.62		49.00

On 30-Jan-2017, prior to any intra-day change that may have been published, the rating for this security was Equal Weight, and the adjusted price target was 52.00.

Source: Bloomberg, Barclays Research

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