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# EDITED TRANSCRIPT

VZ - Q1 2016 Verizon Communications Inc Earnings Call

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## OVERVIEW:

Co. reported 1Q16 operating revenues of \$32.2b and GAAP EPS of \$1.06.



## CORPORATE PARTICIPANTS

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**Fran Shammo** *Verizon Communications, Inc. - EVP & CFO*

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**David Barden** *BofA Merrill Lynch - Analyst*

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## PRESENTATION

### Operator

Good morning and welcome to the Verizon first-quarter 2016 earnings conference call. (Operator Instructions) Today's conference is being recorded. If you have any objections, you may disconnect at this time.

It is now my pleasure to turn the call over to your host, Mr. Mike Stefanski, Senior Vice President, Investor Relations.

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**Mike Stefanski** - *Verizon Communications, Inc. - SVP, IR*

Thanks, Tori. Good morning and welcome to our first-quarter earnings conference call. This is Mike Stefanski and I am here with our Chief Financial Officer, Fran Shammo. Thank you for joining us this morning.

As a reminder, our earnings release, financial and operating information, the investor quarterly, and the presentation slides are available on the investor relations website. A replay and a transcript of this call will also be made available on our website.

Before we get started, I would like to draw your attention to our safe harbor statement on slide 2. Today's presentation includes forward-looking statements about expected future events and financial results that are subject to risks and uncertainties. Factors that may affect future results are discussed in Verizon's filings with the SEC.

This presentation includes non-GAAP financial measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures can be found on our website. The quarterly growth rates disclosed in our presentation slides and during our formal remarks are on a year-over-year basis, unless otherwise noted as sequential.

Before Fran goes through these results, I would like to highlight a few items. For the first quarter of 2016, we reported earnings of \$1.06 per share on a GAAP basis. These reported results include a few nonoperational items that I would like to highlight.



Our reported earnings include a non-cash pretax loss of \$165 million for a pension mark-to-market adjustment due to settlement accounting. We expect settlement accounting to impact earnings in each of the remaining quarters in 2016. Additionally, we recognized a pretax gain of \$142 million on a spectrum license transaction.

On an after-tax basis, the loss on settlement accounting amounted to \$102 million, or \$0.02 per share, and the gain on the spectrum transaction amounted to \$88 million, or \$0.02 per share, effectively offsetting each other. Including the effect of these nonoperational items, earnings per share of \$1.06 in the first quarter compared to \$1.02 per share a year ago for a growth rate of 3.9%. There were no special items of a nonoperational nature in the first quarter of 2015.

As a reminder, our Wireline results for the first quarter included the operations from the three states that we sold to Frontier on April 1, 2016. As we have done over the past year, we have recognized a full-quarter benefit of approximately \$229 million pretax, or about \$0.03 per share, due to these assets being classified as held for sale. This compares to \$146 million pretax benefit, or \$0.02 per share, that we recognized in the first quarter of 2015. Additionally, the operations of AOL are not included in prior-period results.

With that, I will now turn the call over to Fran.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Mike. Good morning, everyone. We remain confident in our three-tier strategy for long-term growth, which is to lead at the network connectivity level in the markets we serve, develop new business models through the global platforms in video and Internet of Things, and create incremental revenue opportunities in applications and content.

In terms of progress on this multi-tier strategy, we are focused on network leadership and operating efficiency while we develop new ecosystems in video and the Internet of Things, leveraging our capabilities in the United States and scaling our platforms globally. We are also developing a portfolio of unique content targeted at the Millennial generation so that we can capitalize on the opportunity transforming mobile.

At the network connectivity layer, we consistently invest in our 4G LTE network to accommodate growth in data usage and enable customers to experience an unmatched level of connectivity. National studies continue to recognize Verizon as the overall 4G LTE network performance leader. Having the best network does matter, as reflected in our strong customer retention that we will discuss later.

We are enhancing capacity and coverage by effectively managing our spectrum, further densifying areas of significant usage, and implementing a number of optimization techniques such as carrier aggregation. Approximately 92% of our total data traffic is now on the LTE network. The amount of data on the network increased at a rate of approximately 50% over the prior year.

Over the long term, densification of our Wireless network, particularly in urban and concentrated usage areas, is required to add capacity to manage these growing consumption trends, as well as to pre-position ourselves for the 5G technology of the future.

A key element of this densification strategy is access to fiber. During the quarter we announced our intention to acquire XO Communications, which will provide us the opportunity to deepen and expand our fiber assets nationwide, as well as to lease millimeter-wave spectrum for 5G testing purposes with the option to buy.

We are also very excited about the announcement made last week to deploy a new fiber platform within the city of Boston that will support wireless and wireline technologies to consumers and enterprises across the city in a network-efficient way. This approach gives us tremendous flexibility to innovate, develop, and deliver services with a mix of technologies over the same fiber assets.

In terms of 5G, our technical testing is going well and there is a strong interest and commitment from members of the 5G Forum to prepare for fixed wireless commercial pilots using the technology next year.



Improving our operating cost structure is a priority. We will continue work on our operating model and are confident that we can improve efficiencies as we have done in the past. We remain focused on cost reductions throughout the entire business and are making progress in driving efficiencies, reducing overhead costs, and streamlining support. We have several initiatives that already been taken and others that we plan to implement for 2016 and beyond.

In the fourth quarter 2015, we restructured our Wireless organization to improve our ability to address the changing needs of our customers faster and more efficiently. Additionally, we continue to look at opportunities across all lines of business. You are starting to see these benefits in the first quarter.

Overall, consolidated headcount since the end of 2015 is down approximately 3% as we continue to increase the efficiency of our operations. We expect to receive additional savings from a number of initiatives during the second half of 2016.

We continue to streamline business support functions, utilizing our Lean Six Sigma approach across the business to reduce redundancy, drive consistency, and improve speed of delivery in the market. Across Wireless we have identified opportunities to gain further efficiencies within the store operations, call-center operations, and supply chain processes by simplifying our execution model while improving the overall customer experience.

Network-related opportunities exist for consolidation and elimination of unnecessary facilities to gain synergies and reduce costs. Always more work to be done here, but we are pleased with the continued progress.

Our networks and operating model also enable us to grow and expand our revenue streams through new ecosystems, platforms, content, and solution layers. We are enhancing our overall long-term global digital media strategy, which includes premium content, distribution, and advertising platforms across all screens.

The video platform continues to expand as we add more unique content that appeals to Millennial audiences, such as the partnership recently announced with Hearst. Our joint venture with Hearst includes developing two initial channels of video programming targeting the digital Millennial audience to be distributed across multiple distribution platforms. Additionally, we signed an agreement to acquire an equity stake in AwesomenessTV and entered into an agreement to create new premium content service featuring short-form mobile content that will launch initially on go90.

Just over the last few days we announced the acquisition of a 50% ownership in Complex Media with Hearst. The investments in AwesomenessTV and Complex Media position us as partial owners in the number one digital media brands for young Millennials.

On the go90 application, we remain encouraged by the viewership of go90, but as we have said before, we are still in the very early stages of gaining traction and engagement. Verizon Wireless subscribers now have greater flexibility when streaming live sports, concerts, and original series content within go90 on their mobile devices and can enjoy this content free of data charges with our FreeBee data service. We look forward to expanding our go90 content to other media through our AOL brands and the web later this year.

Within the Internet of Things ecosystem, we continue to develop platforms and our network to take advantage of the opportunities to innovate and offer solutions that address some of the more pressing social, economic, and business challenges. We have launched our own utility, transportation, and healthcare solutions with products like Networkfleet, Grid Wide, Verizon Share, hum, and one of our newest products, Intelligent Track and Trace.

Our ThingSpace platform is set to accelerate the adoption of Internet of Things products and solutions by making it easier, faster, and more accessible to develop applications. New revenue streams from the Internet of Things are going with revenues of approximately \$195 million in the quarter, a year-over-year increase of about 25%. While we build for the future, fundamental execution and quality financial results are a top priority.

Now let's get into the first-quarter performance in more detail starting with our consolidated results on slide 5.

Our first-quarter results demonstrate our ability to compete effectively and execute our strategy in the current market. We delivered strong operating and financial results by growing our quality customer base, expanding earnings, and generating solid free cash flow for the quarter.

Earnings per share grew 3.9% and free cash flow was \$4 billion, which enables us to invest and return value to our shareholders. Total operating revenue in the first quarter was \$32.2 billion, an increase of 0.6%. AOL had its best first-quarter revenues in the last five years, driven by growth in the platform layer.

If we exclude AOL, which was not part of Verizon a year ago, our top-line revenue declined by 1.5% for the quarter. This was due to lower Wireless phone activations on the device installment sales, lower upgrades, and the continued migration of our customer base to unsubsidized pricing.

In Wireline, the higher growth of internet-only activations and smaller video bundles also pressured revenue growth. As we manage through the revenue transformation in the Wireless and Wireline segments and develop new products and services, we remain focused on improving our overall cost structure to maintain our strong earnings profile.

Consistent with the prior year, consolidated EBITDA totaled about \$12 billion and our EBITDA margin was 37.2% in the quarter, which was driven by our ability to manage cost and expand margin, even with the pressure on the top line.

Let's turn now to cash flows and the balance sheet on slide 6.

Cash flows from operation totaled \$7.4 billion in the first quarter, a decrease of \$2.8 billion from the prior year, primarily due to the cash received from the tower transaction of \$2.4 billion in the first quarter of 2015 that was allocated to cash flow from operations. We continued to sell device installment receivables and received about \$2 billion in gross cash proceeds from new transactions in the first quarter. We believe that the underlying quality of our device installment receivables has been instrumental in helping this securitization program be so successful. Free cash flow for the quarter totaled \$4 billion.

We continue to execute a disciplined capital allocation model with the priority to invest for the future. Capital expenditures were \$3.4 billion in the first quarter, which included approximately \$150 million related to the markets that were sold to Frontier. Wireless capital spending totaled \$2.2 billion in the quarter, down about 9.5% from a year ago, which was the result of the timing of investments. We fully anticipate capital spending for the year to be within our guided range of \$17.2 billion to \$17.7 billion.

Our balance sheet is strong and gives us the financial flexibility to grow the business. We ended the quarter with \$109.9 billion of total debt, net debt of \$104 billion, and a ratio of net debt to adjusted EBITDA of 2.2 times.

We completed the sale of properties to Frontier on April 1, 2016. The pretax proceeds from the sale were used to repay outstanding debt in the current quarter. In early April we already executed tender offers and early redemptions to repay over \$10 billion in debt to reduce our total debt balance.

Now let's move into a review of the segments starting with Wireless on slide 7.

In Wireless, we posted a balanced quarter of quality connections growth and margin expansion. Postpaid net adds totaled \$640,000 in a seasonally low volume quarter, excluding all wholesale connections including IoT. Net phone additions were negative 8,000 for the quarter as compared to a negative 138,000 a year ago, a significant improvement over the prior year, driven by customer retention.

Retail postpaid churn was 0.96%, down 7 basis points for the quarter and sequentially consistent. We have taken many actions to improve and simplify our customer experience and provide the best network, which have resulted in improved customer loyalty and satisfaction. We ended the quarter with 112.6 million total retail connections, excluding all wholesale connections.

Our industry-leading postpaid connections base grew 4.4% to 107.2 million and our prepaid connections totaled 5.4 million. Postpaid gross additions were 3.7 million, consistent with the prior year. The majority of gross adds were 4G smartphones and tablets.

The composition of our 640,000 postpaid net adds was very strong. Within the postpaid net adds we added 452,000 new 4G smartphones in the quarter, which were partially offset by a net decline in 3G smartphones, resulting in 284,000 net new smartphones. The remainder of the offset in phone net adds were basic devices.

Tablet net adds totaled 507,000. Other connected devices of 176,000 were added during the quarter, with Verizon Wireless retail hum devices being a large contributor. We are beginning to see traction and increasing demand for the hum product which we introduced last year. Net prepaid devices declined by 177,000.

Let's now take a look at 4G device activations and upgrades on slide 8.

Total postpaid device activations totaled 9.9 million in the quarter, down about 3.9%. Approximately 82% of these activations were phones, with tablets accounting for the majority of the other device activations. We ended the quarter with 73.8 million smartphones in total and our smartphone penetration increased to 85% of total phones. 4G devices now comprise more than 81% of our retail postpaid connections base.

As expected, seasonality and lower customer demand for new devices contributed to the softer volumes of upgrades in the first quarter. About 5.8% of our retail postpaid base upgraded to a new device in the first quarter, which represents a decline from the prior year of 70 basis points.

Now let's review Wireless profitability and revenue on slide 9.

In the Wireless segment, profitability and cash flows were driven by our high-quality retail postpaid customer base. In terms of profitability, we generated \$10.2 billion of EBITDA in the quarter, an increase of 1.7%, and had an EBITDA margin of 46.2%, an increase of 140 basis points.

Total Wireless operating revenues declined 1.5% in the quarter to \$22 billion. Service revenue of \$16.8 billion declined 6.2% for the quarter as a result of the continued migration to unsubsidized pricing. Equipment revenue increased to approximately \$4 billion, up 17.2% for the first quarter.

Service revenue plus installment billings increased 1.6% in the first quarter. We expect that service revenue growth will continue to be pressured as more of the customer base moves to unsubsidized service pricing and that equipment revenues will grow as the activation rate for device payment plans increases. Overall, about 48% of our postpaid phone customers are on an unsubsidized service pricing plan.

As we discussed previously, we believe service revenue will flatten its decline midyear when the base of our customers on the unsubsidized pricing plans exceeds 50%. Over the course of the next year we expect the decline in service revenue will slow, ultimately turning positive by the end of 2017.

The percentage of phone activations on installment plans increased to about 68% in the first quarter, compared with about 67% in the fourth quarter. The first-quarter take rate fell below our expectation of more than 70% due to customer preference, especially on upgrades, which contributed to lower equipment revenue growth. We expect the second-quarter take rate for device installment plans to be around 70%.

During the quarter, 5.5 million phones were activated on a device installment payment plan. We have about 28.8 million device installment phone connections in total, representing 33% of our postpaid phone base.

Let's move next to our Wireline segment, starting with a review of our consumer and mass markets revenue performance on slide 10.

In the consumer business, FiOS remains the driver of revenue growth and now represents about 81% of consumer revenue. In the first quarter, consumer revenue grew 0.8%. Mass markets, which include small business, was consistent with the prior year. During the quarter, FiOS total revenue grew 5% with consumer FiOS revenue growing at 4.7%.

The increased penetration of Quantum and the desire for higher data speeds are the primary drivers of the FiOS growth. At the end of the quarter, about 78% of our consumer FiOS internet customers subscribed to data speeds of 50 megabits per second or higher. Additionally, the increasing

number of customers opting for higher speeds is evident as about 60% of our consumer FiOS internet sales are opting for speeds at 100 megabits and above.

FiOS internet subscriber growth remained strong in the first quarter. In broadband we added 98,000 net FiOS customers for the quarter, which was consistent with the fourth quarter. Overall, net broadband subscribers decreased by 10,000 in the quarter.

In FiOS video, we added 36,000 net customers in the quarter, which improved from 20,000 net customers in the fourth quarter. The consumer revenue growth trajectory continued to decline as customers downsized their existing bundles and core voice services are no longer desired.

We introduced the next generation of our custom TV offering during the quarter, expanding the content and value provided by the original custom TV offer to appeal to an even wider range of value-conscious customers. Customers now have a choice between selecting an essentials plan and a sports and more plan, with the options to select up to three additional packs.

The demand for custom TV remains strong and, during the first quarter, custom TV represented about 38% of our FiOS video sales. Due to the low price of the bundle and the lower content costs associated with the custom TV, a custom TV customer generates less revenue, but contributes more margin than the traditional FiOS video customer.

Let's turn to slide 11 and cover enterprise and wholesale as well as the Wireline segment in total.

The segment EBITDA margin was 23.4% for the quarter, up 70 basis points from the prior year due to strong cost control. Total operating revenues for the entire Wireline segment declined 1.9% in the quarter.

In the enterprise space, secular and economic challenges remain, but we are seeing stabilization in the rate of decline on a constant currency basis. In the first quarter global enterprise revenue declined 3.1%. On a constant currency basis, it was down about 2.6%. In our global wholesale business, revenues declined 4% in the first quarter. Trends for both enterprise and global wholesale remain consistent with 2015 results.

Let's move next to slide 12 for an overview of the Wireline segment post the Frontier transaction.

Now that we have completed the sale of our Florida, Texas, and California properties to Frontier on April 1, 2016, the historical results associated with these three markets will be included in Corporate and Other, beginning with the second-quarter results. For illustrative purposes, on a preliminary basis, we have shown fiscal year 2014 and 2015 and first-quarter 2015 and 2016 recast results. We will also provide nine quarters of recast financials for the Wireline segment, excluding the three markets, later in the second quarter.

Recast total revenue for the first quarter 2016, excluding these three markets, was approximately \$8 billion, which is comparable to the prior year. As previously stated, we think we have tremendous opportunity to further penetrate the remaining properties from Massachusetts to Virginia with our fiber infrastructure and FiOS products. Recast Wireline margin, excluding these markets, decreased as expected, since these properties were more profitable than the properties that remained. Without these properties, the Wireline EBITDA margin for the first quarter was approximately 19%.

We have been working on our post-Frontier-transaction cost structure as part of our overall cost initiatives outlined earlier. As we have stated before, we are committed to offset the financial impact of this transaction, including the stranded cost at the consolidated level. Our efforts in this area can be seen in the fact that the recast Wireline margin expanded by approximately 200 basis points from the first quarter 2015 to first quarter 2016. We recognize that some of the efficiencies and future savings we need in order to offset the impact this year are dependent on the timing and the outcome of our current labor negotiations.

Let's move next to slide 13 for an overview of our liability management.

Subsequent to the Vodafone transaction and at year-end 2014, total debt was approximately \$113 billion and at the end of the first quarter 2016 our total debt was approximately \$110 billion. We have been actively managing our debt portfolio entering into the second quarter of 2016.

In early April 2016 we utilized Frontier proceeds, plus cash on hand, to complete tender offers and early redemptions of \$10.7 billion of face value debt with a cash outlay of \$12.5 billion. Our strategy focused on retiring higher-cost debt with a range of maturities through 2043, thereby improving our maturity profile and achieving lower borrowing costs for the future. The Frontier-related tax obligations, which are payable in the second half of 2016, and our remaining debt maturity of \$2.3 billion in September are both very manageable within our 2016 funding plan.

Through our liability management efforts and our future funding plans, we are on track to return to our pre-Vodafone transaction credit-rating profile by 2018/2019 timeframe. At the same time, we are continuing to execute a disciplined capital allocation model with a priority to invest for the future. Since the Vodafone transaction closed, we have maintained a strong balance sheet, invested in new businesses, improved our debt profile, and returned value to our shareholders, both through an accelerated share repurchase program and through a dividend increase each year.

Let's move next to slide 14 for our summary and 2016 priorities.

We are off to a strong start in 2016 as we executed on the fundamentals of the business: growing high value customers, delivering strong financial and operating results, and generating free cash flows. Our results demonstrate that we are well positioned to compete in a competitive environment, while effectively implementing our strategies. We remain focused on enhancing our networks and platforms to position us for future growth and on further developing new ecosystems.

At the operational level, we are navigating through the transition to the device installment payment model, stabilizing the trend in Wireline revenues, improving our overall cost structure, and ramping new revenue streams.

At this point in the year we continue to expect full-year 2016 adjusted earnings to be a level comparable to our strong full-year 2015 adjusted earnings. However, given the status of our labor contract negotiations, there will be pressure on earnings in the second quarter due to the timing of cost reductions. Depending on the progress of the negotiations, we may need to update the full-year guidance at a later time.

With that I will turn the call back to Mike so we can get to your questions.

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**Mike Stefanski** - Verizon Communications, Inc. - SVP, IR

Fran, thank you. Tori, we're ready to open it up for questions, so if we can take the first question, please.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Brett Feldman, Goldman Sachs.

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**Brett Feldman** - Goldman Sachs - Analyst

Thanks and appreciate the color. I didn't catch it in the release; are you guys still reporting postpaid ARPA? And if so, could you break it out for us?

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Sure. We are going to continue to report the postpaid I-ARPA, but, Brett, we will get that out to everybody so that you can see that.





**Brett Feldman** - *Goldman Sachs - Analyst*

Okay. Then just a separate question. You noted that you are going to be making this investment in Boston. I was hoping you could give us some thoughts around the timing of that so we could think about how that might flow through into CapEx.

And then are you thinking that there could be an opportunity to continue to expand your fiber presence, particularly as you think about densifying your wireless network? Thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Sure, Brett, thanks. Boston is a unique situation. We announced the intent to expand FiOS in Boston; understand that the LFA has to be negotiated with city council and that is a public process that will take approximately six months. We have been in discussions with some broad framework, but we need to go through that process.

It's also important to note that the LFA is only for video linear TV services. It is not required for broadband or 5G, so obviously when we looked at Boston it was a city that we needed to densify for the LTE network. So as we looked at all of our current COs around the footprint and the fiber that we already had there, it kind of was a no-brainer to us to say we can do the fiber build out to expand the LTE densification, but we also can use this opportunity, with only an increment of about \$300 million over the next five to six years, to expand our FiOS footprint.

The \$300 million you're not even going to see it in the Wireline capital numbers; it's already there. And as far as the capital that was going to be incurred on the Wireless side of the house, that was already going to be spent regardless of whether we expanded FiOS. So we will get to this, but we are starting to -- we will start this midyear this year for especially the 5G and 4G LTE densification. We will start the internet capability with passing homes, but for the video product we will have to wait to go through the LFA city council process.

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**Brett Feldman** - *Goldman Sachs - Analyst*

Is this the last significant fiber deployment you would expect to make within your remaining footprint? Or do you think that there is an opportunity to keep doing this in the Northeast?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

I think what we will have to do, Brett, is we will take one city at a time. Obviously we still don't have Alexandria built out or Baltimore, so if we get to a position where we believe we are going to need to invest in densification in those cities, then that's an opportunity for us to take a look at it. But at this time we are concentrating on Boston.

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**Brett Feldman** - *Goldman Sachs - Analyst*

Thanks for taking the question.

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**Operator**

Simon Flannery, Morgan Stanley.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Thanks a lot. Good morning, Fran. Can you just provide a little bit more clarity about your comments on Q2 and the rest of the year? Is it reasonable to take the Q1 margins, the recast margins in Wireline, that you provided as a good guidepost here until you get more cost savings coming through?

Maybe you can just reflect on any particular puts and takes from the strike in terms of extra costs from additional labor you might need to hire or conversely some cost savings. What are you seeing so far in terms of impact on the business in terms of broadband adds, trouble reports, etc.?

Then if you have any update on your data center evaluation, the sale process, thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Sure. Thanks, Simon. On guidance, first and foremost, we are absolutely confident at this point in time, based on everything that we have planned and the timing of the union contract, that we can deliver on the \$3.99 compared to last year. Just to set the record here, again we did not give revenue guidance; we gave EBITDA margin percent guidance and we gave EPS guidance that would be relatively comparable to 2015.

So if you step back a second and look at earnings per share at 2015 coming in at \$3.99, we have to keep in mind that \$0.13 of that was from our assets held for sale, so really the comparable number is \$3.86. As we said, we felt good about growing earnings back to that \$3.99 through our normal operation results of the business.

So if you take that first quarter and move it forward for the first quarter \$1.06, so that would mean we are \$0.04 ahead of the prior year. That \$0.04, which is somewhat attributed to the Frontier properties for the full quarter, will reverse in the second quarter. If you start out your baseline from last year's reported EPS of \$1.04, \$0.04 is taken right off the top for that.

And then as we talked, there is going to be some timing on offsetting the stranded costs. Again I want to reiterate that we have always said that the stranded costs would be offset on a consolidated basis, not within total Wireline segment. So we do have some timing here.

We are looking at business transformation activities. If you look at the Verizon Wireless restructure, that was part of the overall plan to contribute and offset some of the stranded costs. So you can see we're already looking at operational efficiencies on a consolidated basis.

But other things that we are looking at is around distribution centers and call centers. As you know, call centers are a very high turnover rate for employees and with our decrease in calls coming in from our Wireless customers because of more online, more chat, more self-service, we will not hire as many customer call centers and we will achieve this through our attrition rates just naturally within the call center. So there's opportunity to reduce force just through the attrition rate.

Then if you look at our equipment volumes, since the equipment logistics system in Wireless is mostly a variable cost system, as we look to the future and the upgrade volume, which we assume will be lower, there's going to be some cost efficiencies that we gain there. So as we look at this there will be some timing. Q2 will be lower than just the \$0.04, but we're looking at we will regain that in the back half of the year with some of the other things we're doing.

Now finally, obviously on this, the timing of the union agreement, we had planned for that. And if it goes longer, then we would come back in mid-year. But keep in mind that we're looking at this as a long-term agreement for both providing quality jobs for our employees and returning shareholder value to our shareholders. So that's where we stand with guidance. Hopefully, that clears it up a little bit.

On the second question or the second part of your question around the strike, at this point it's too early to tell the impacts. We've deployed thousands of management employees to take on the work. We obviously always during this period of time fall a little bit behind on the install work. We still see good momentum coming in from a sales perspective, so there's a little bit of a backlog there, and we will just have to work through this.

But right now really no financial impact, per se, in the second quarter that I'm anticipating, unless this drags on for a much longer period of time.

On the data center sale, look, this is still I would consider it exploratory. There's a lot of activity going on, but nothing at this point that I'm prepared to announce in a public forum. But we continue to explore that activity.

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**Simon Flannery** - Morgan Stanley - Analyst

Very helpful, thanks.

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**Operator**

David Barden, Bank of America Merrill Lynch.

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**David Barden** - BofA Merrill Lynch - Analyst

Thanks, guys, for taking the questions. I guess two, if I could.

First one, Fran, just following up on that guidance question. You highlight that if you hadn't had the Frontier benefit last year the earnings would've been more like \$3.86. But if I do the math on the impact that Frontier is having on 2016, if you hadn't sold the Frontier asset the earnings would be reasonably materially higher.

And my math is that the year-over-year earnings power of Verizon, had the Frontier assets not been part of the mix here, would've been about 10%. And Street estimates are really only looking for about 3% earnings growth next year. I was wondering if you could kind of comment on what you see as the underlying earnings power of the Verizon business as we think about next year's growth, ignoring the strike issues for a second.

Then just the second question, if I could, would be on upgrade rate. I didn't see it in the notes yet for this quarter, but obviously reports are that it's been lower than normal. I was wondering if you could kind of talk about how you see the cadence or the shape of the year with the iPhone 7 likely coming out in the back part of the year and the amount of upgrades you would see by that point in time, thanks.

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Thanks, David. On earnings, look, we've been pretty open about 2016 and of course we've got a lot of things going in a lot of different directions. Obviously, if you look at it, even with Verizon Wireless and the headwind of the revenue here and the transformation of the pricing model, we're still increasing the profitability of that business. It's really the recurring revenue that we are focused in on and the quality of our customers.

On the Wireline side of house, again you see there is pressure on top line because of custom TV and internet-only now versus triple-play. But again, we're improving the profitability of that business. So for this year we will stick with what we talked about on guidance.

Mike and I have been pretty open and Lowell has been pretty open about 2017. We believe we will get back to a normal growth rate in 2017, but I would not attribute it to anything that we divested or acquired. There's a lot of moving parts here, especially within the strategic portfolio, that's putting pressure on some of the bottom line, so I would not overindulge on the Frontier divestiture.

I mean we've got a really good value for that that we're going to put the cash to work that really benefits the earnings power of this company. And that's the way I look at it.

On the upgrade rate, look, if you look at year over year we're down over 400,000 units on an upgrade rate and obviously that had a lot of impact on the equipment revenue side. But the other thing that we are seeing is our embedded-base customers are selecting the subsidy model on an upgrade basis, which is why the overall device installment plan take rate did not meet our expectation for the quarter of 70% and fell short to 68%.

If you look at that, David, and look back to the earnings power, you would think that the stronger uptake in device installment plan would drive more margin, but in fact, we missed that metric. We did lower and we actually improved our margin overall at Wireless. So there is a lot of moving parts here.

But to your question of where do I think upgrade rates are going to go, at this point, based on what we know, we think that upgrade rates will be relatively the same as 2015. I can't talk to the fourth quarter yet, because I just don't know what the devices are going to look like in our lineup at this point in time.

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**David Barden** - *BofA Merrill Lynch - Analyst*

Great. Thanks, Fran.

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**Operator**

Phil Cusick, JPMorgan.

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**Phil Cusick** - *JPMorgan - Analyst*

Thanks. Two quick ones, if I can. One, can you comment on the FCC special access reforms? How are you thinking about that? Then two, the potential to borrow against handset receivables; what do you think is the cost in that market, Fran, versus the normal bond market?

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Phil. On the FCC special access, look, the FCC will take action this month sometime on special access rulemaking and its tariff investigation into certain discounts that we and other large legacy providers offer for DS1s and 3s.

We have reached out -- we reached a deal with a lot of the CLECs in order to resolve a long-standing and contentious regulatory issue here. Our top priority, though, is to ensure that our business services are a level playing field with all the other competitors including cable companies. We intend to work with the industry and the FCC to develop a framework for that that applies to all competitors equally and relies on the sound public policy to determine where and when regulation is appropriate.

So we will wait to see what the FCC does here, Phil, and then we will respond accordingly.

On the bond market and the recent press reports coming out of Bloomberg, look, we have been pretty open and public that we have been looking at an alternative financing arrangement for our installment sale receivables. The public asset-backed market is an alternative that we've explored. We've had a number of discussions.

We are having discussions continuing with alternative providers and various parties, but at this point in time these are just discussions. It's something we're looking at. We're still doing a lot of analysis around it and at this point it's just something that we continue to look at. Nothing to announce here today that we're going to change anything at this point in time.

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**Phil Cusick** - *JPMorgan - Analyst*

All right, thanks, Fran.

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**Operator**

Mike Rollins, Citigroup.



**Mike Rollins** - Citigroup - Analyst

Thanks, two if I could. First, as you look at the range of possible investments that you can make over the next 12 or 24 months, is there a balance sheet debt level that investors should be keeping in mind in dollars or ratio terms, the upper threshold for what the Company is comfortable with?

Then secondly, as you look specifically at the performance of AOL since you purchased the asset, are there some examples that you could provide on ways in which Verizon has made the performance of that asset better in terms of revenue or cash flow? And how some of the recent content investments might further the performance of that asset? Thanks.

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Thanks, Mike. On the investment side, look, we've been pretty open that our main priority is to get our debt level back to an A- rated company and we are on track to do that. Everything we do that continues to be the top priority.

So even with all of the M&A activity you've seen, if you look back, we started this on a post-Vodafone debt of \$113 billion. We've reduced that to \$109 billion. But keep in mind that with a \$10.4 billion spectrum purchase during that period of time.

That was with \$4 billion of purchase of AOL and some miscellaneous tuck-ins, capital investment, share repurchase, and now we have just sold the Frontier properties that helps bring that debt down even to a lower level. So we are right on course. But that is top of mind at everything that we do and will continue to be a commitment that Lowell and I made that is forefront that we will commit to.

On the AOL performance, look, I think -- I'm not going to get into a lot of details on AOL, but, look, they've had the best quarter in revenue in the last five years. If you go back to the fourth quarter, we said they were up \$300 million year over year. Now, of course, that's seasonal, but that shows you though that the investments that we've made in the platforms, a lot of the tuck-in type investments that we made with acquisitions -- and these are small acquisitions, but they are real critical.

If you just look at the most recent acquisition we just did with RYOT, this is a real, unique 360-degree video production. It is for really Huff Post for them to increase their viability on producing videos for news, but again, this goes to our strategy in attacking a certain population that, quite honestly, Verizon is underpenetrated in. If you look at that acquisition, it directly goes to Gen Z; 73% of their audience is Millennials. So these are real strategic for us to improve the viability of that platform.

The other thing you are going to see us do this year is around go90. The go90 product will start to cross all of the AOL platforms this year. That is going to enhance both the AOL platforms and it's also going to enhance the go90 platform.

Continuing with our strategy we will -- as I said before, we will open the box at some point in time to give you more visibility to this. And I continue to say that that will be midyear to maybe third quarter of this year where we will start to produce some numbers around some of these more specific platforms that we talk about.

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**Mike Rollins** - Citigroup - Analyst

Fran, is there a ratio or set of numbers you could put around how you perceive getting to that A- debt level? Are there indications that you've received for that?

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Sure. If you look at each of the rating agencies, each of the rating agencies have a different approach because some of them include the pension plan unfunded liability. Others include the OPEB unfunded liability. Others don't include any of that. Securitizations, some include, some don't.

So each of them is a different metric, but if you look at our overall GAAP ratio, it kind of follows in task with what we would need to be. And based on the GAAP ratio, you should look at 2.0 to 2.1 type area in order to achieve that A- rating.

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**Mike Rollins** - Citigroup - Analyst

Thank you very much.

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**Operator**

Craig Moffett, MoffettNathanson.

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**Craig Moffett** - MoffettNathanson - Analyst

Good morning. Let me see if I can tie together maybe a question about the FCC and the ongoing discussions about Yahoo. Given that in the FCC right now you've got the privacy NPRM and you've got some uncertainty around whether wireless is or isn't going to be upheld under Title II, how does that inform the way you think about what you might be able to do with AOL directly I guess and also trying to expand the platform of advertising as you might do with Yahoo, if you're the acquirer?

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Thanks, Craig. Look, I'm not going to speak anything to deal with Yahoo, so let's just talk about what we have on the table today.

Under the sponsor data zero-rating type issue, the net neutrality already advocates some of this. We have structured our sponsored data program to comply with all the FCC net neutrality rules. For example, if any party, third-party is interested in that, we will offer that on a nondiscriminatory basis and we've priced it accordingly at a commercially favorable rate that we believe is in direct really compliance with the FCC net neutrality rule.

We think that sponsored data and other freebie data programs are good for the consumer and that regulators will recognize that after concluding their review on our products. So based on the zero data, we will have to wait and see where they come out on that.

As far as Title II goes, look, we agree with the principles with net neutrality rules. The thing that we disagreed with and opposed was applying Title II broadband services and particularly wireless broadband. So we will have to see where this comes out, but reclassifying broadband under Title II was not necessary to ensure an open internet. There's been nothing ever that shows that it has not been an open internet.

This will, obviously, have some negative consequences on innovation as a whole. But, look, we are a company that has operated under regulation for 100 years and has been very successful, so we will wait and see what the FCC concludes and then we will operate accordingly. But it's too early to say what exactly is going to happen here.

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**Craig Moffett** - MoffettNathanson - Analyst

Fran, does the specific limitations that might or might not be imposed on the use of customer data under the privacy NPRM that stems from reclassification, does that impact your ability to monetize an asset like Yahoo or AOL in general to -- as you think about how you would use that for advertising purposes?



**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Look, we at Verizon -- privacy and security has always been top of mind. Normally, we always use an opt-in with our customers or some type of an opt-out feature.

The issue though that we have right now is under the FCC proposed aggressive rules on privacy and data security, that would apply to broadband providers but not companies like Google and Facebook. So if we're going to have rules, we need to make sure we don't single out certain industries to either benefit or not benefit from those rules. And that's something that our legal department continues to work with the FCC on, so we will see where this ultimately comes out. But that's really the crux of the issue for us.

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**Craig Moffett** - *MoffettNathanson - Analyst*

Thanks, Fran.

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**Operator**

John Hodulik, UBS.

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**John Hodulik** - *UBS - Analyst*

Thanks. Fran, maybe you could comment on the competitive environment you are seeing in the Wireless. You guys were able to cut your postpaid handset losses on a year-over-year basis pretty meaningfully. Do you expect that to continue through the year?

Then secondly, prepaid has always been an area where you guys haven't really focused. You continue to lose subs in that space. Meanwhile, I think AT&T and T-Mobile are seeing a lot of growth in that area. Maybe you could compare your views on that market and why you guys don't see that as a source for growth, thanks.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Sure. Thanks, John. On the competitive environment of Verizon, look, coming into 2015 and again in 2016 we said that the top priority would be to maintain the high quality of base. And you see us doing that. We now have 48% of our base over on the new pricing and we continue to push for that.

You saw this 7 basis point decrease in churn for the last couple of quarters. What I would say though is, if you look ahead, last year's second quarter the churn was like at 0.90. I would not anticipate, nor should you anticipate, that we will achieve that churn rate again because things have kind of flattened out now. I would look at the first quarter as a guide to where we will be for the rest of the year from a churn perspective.

Part of that is because we are seeing some increased churn on tablets, which we have talked about before, where we gave a free tablet away and we saw that the customer base just didn't see the value of that tablet when it was free. They signed up for the two-year agreement because they got a tablet for \$10 a month, so \$240, and they disconnected it at the end of the agreement. We stopped doing that promotion for that reason, but you see some of these tablets now coming up on the two-year deal. We anticipate that some of that higher churn in that tablet environment will hit us over the next couple of quarters, so we should be prepared for that.

But as far as the smartphone churn, we are continuing to see improvement in that smartphone churn, which gets us to holding a flat churn rate overall. So I think that is really what's important to us right now is that smartphone churn rate, which is really where we are dedicating all of our concentration and our promos.

On the prepaid side, absolutely. Our retail prepaid is above market. We're really not competitive in that environment for a whole host of reasons and it's because we have to make sure that we don't migrate our high-quality postpaid base over to a prepaid product.

If you look at the competitive nature, they are doing it with sub brands. They are not really doing it with their brands. And quite honestly, we use the Tracfone brand as our prepaid product.

Tracfone has been extremely successful for us. It's not something that we disclose any more on reseller, but it continues to increase on the high-quality base of Tracfone, so that's really where we use and go after the prepaid market. More to come on this during the year, but currently that's how we operate under the prepaid model.

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**John Hodulik** - UBS - Analyst

Okay. Thanks, Fran.

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**Operator**

Mike McCormack, Jefferies.

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**Mike McCormack** - Jefferies - Analyst

Fran, thanks. Maybe just a quick comment on what your view is, maybe more holistically, on the video landscape. What other assets do you think Verizon requires? I'm thinking about FiOS video long term; where does that go?

Then I guess on the service revenue stabilization, that 50% benchmark, what kind of factors have you built into that to get to that expectation?

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**Fran Shammo** - Verizon Communications, Inc. - EVP & CFO

Thanks, Mike. On the video landscape, look, I think we've set the bar on where we're going on video, both in the home and outside the home. In the home, we were the first to come out with our custom TV package which rebundled certain content, and it's been very successful. This quarter, even with the rebundle of custom TV, we had a 38% take rate on that bundle.

What I will tell you is, yes, it does give us some top-line pressure because it's a lower bundle from a revenue perspective, but the content cost is considerably lower. Therefore, it generates actually more margin for us.

It's the right thing to do. This is what customers want. They don't want to pay for 300 channels anymore and only watch 17 on average. We're trying to give customers what they want and that's a fight obviously with all the content providers, but we are doing it within the legality of our contracts. Of course, we won't breach any of our contracts, but it's the way that the environment is moving. So I don't think we're going to change any approach to our in-home delivery.

The other thing is there's confusion out there on the video side, which is everybody wants to talk about taking in-home video to a mobile handset and this is something new. This has been done for the last two years. Everybody who has an in-home subscriber, most rights give them the ability to view that content as long as they subscribe and authenticate to that subscription. They can watch that on their mobile handset.

We are taking really the strategy in a whole different mode. We're going to a mobile-first strategy outside the home. It has nothing to do with in-home content.



Now, some of the content you could watch at home could be on this, like sports. That has been very popular in the go90 environment, but we are looking at a lot of different mobile-first, short clips, news, sports, and if you think about it, original content. If you look at the strategy that we have taken in the last couple of quarters, we have added a lot of content that has nothing to do with in-home.

If you look at our Hearst joint venture, we now have joined in with them to create two very exclusive channels for us: one is called RatedRed, one is called Seriously.TV. And the target population is 12 to 24 years old.

We then -- as I said in my preambled remarks, AwesomenessTV we took a 25% ownership stake because what we saw was there was certain original content that we had contracted with them that they deployed in go90 and we saw viewership really jump when those original contents presented themselves. So this is another one where number one digital brand within the female population of ages 12 to 24; 160 million views, up 53% year over year.

And then finally, if you look at what we just did within the last few days, entering into another joint venture with Hearst and buying Complex, 50% owner. This is another number one digital brand in the male population of 18 to 24. Monthly unique viewers of 54 million and over 300 million views per month.

So this is really where we are taking the video product on mobile, which is very different than what everyone else is talking about. We believe that's where we are going to be a differentiated brand with go90 and AOL and everything else that we are doing around that video platform. So that's kind of where we're at on that.

On the service revenue stability, look, Mike, we've done a lot of modeling. We consistently say as soon as we get to a more than 50% penetration of that base on what I will call the device installment pricing plans, we start to see service revenue flatten out and we start to see accretion at the back end of 2017. We have run a number of models and we consistently see that model towards that end. So that's really where we are at at this point in time.

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**Mike McCormack** - *Jefferies - Analyst*

Great, Fran. Thanks for the color.

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**Mike Stefanski** - *Verizon Communications, Inc. - SVP, IR*

Tori, we have time for one more question, please.

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**Operator**

Amir Rozwadowski, Barclays.

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**Amir Rozwadowski** - *Barclays Capital - Analyst*

Thank you very much and good morning, folks. I was wondering if we could discuss your network plans, Fran.

In the near term, as you mentioned, your CapEx was down high single digits during the quarter, but you remained fully committed towards your guidance levels. What initiatives are top of mind for what seems to be an implied improving spending trajectory through the year?

And I guess longer term I was wondering if you could briefly discuss some of your initiatives on 5G. You folks clearly seem to be pushing a timeline that is well ahead of your domestic peers and most of the global players as well.

What is the impetus for this focus and where would be the time when you expect? What type of assets do you think you need to ensure to be able to get to meet those expectations? Should we expect additional deals like XO or some organic investments in fiber, anything along those lines? Thank you.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Amir. First, on just the CapEx; look, there's some timing here and the reason that is because, if you look at it, in the fourth quarter of last year we really accelerated our spend really in Wireless to prepare for the Super Bowl. And that was a whole densification project on the West Coast around San Francisco and Santa Clara. So really what you are seeing here is a timing issue.

We are right on track with our plans on densification. We are still deploying a lot of small cells, so there is nothing that I'm going to say here that should concern you about our plans. You will see us catch up on that spend in the second and through the third and the fourth quarter, so coming in right on guidance.

Now the only thing I will say here is keep in mind that the first quarter also had \$150 million on Frontier that will disappear in the second quarter. So you could assume that second quarter may be a little lighter than in the past, but again right on track with where we thought we would be.

On the 5G question, look, we are committed to being the first US company to rollout 5G wireless technology. We are currently what I would call doing sandbox; sandbox as in creating innovation centers. We are working with the 5G Technology Forum, which includes all the major OEMs and handset OEMs.

We will evolve this 5G ecosystem rapidly, just like we did with LTE, to ensure an aggressive pace of innovation. Currently, we're testing 5G technologies this year and we aim to have an initial fixed wireless pilot starting in 2017. I want to reiterate that: this is a fixed wireless, which is really one of the first cases that we see. It's really not about mobile. It's really around fixed wireless.

We're helping the industry to adopt the rules on 5G deployment, including the opening of the spectrum bands above the 24 gigahertz. And we are working with the FCC. As you know, with XO we have the ability for an option to buy around the 28 gigahertz, which is currently how we're doing our testing right now.

Then keep in mind that 5G is not a replacement technology of 4G, so this is not a capital-intensive overlay to the 4G network. It really is all about high-speed video delivery over a wireless network in a very, very efficient way. You should think about 5G, again like we did with LTE, where you see those 4 to 5 incremental cost decreases when delivering that video. That's similar to what we will see in the 5G environment.

So right now that's where we're at, but we continue to plow forward and we will be ready to go with the 5G technology.

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**Mike Stefanski** - *Verizon Communications, Inc. - SVP, IR*

Thank you. We will now turn the call back to Fran for some closing comments.

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**Fran Shammo** - *Verizon Communications, Inc. - EVP & CFO*

Thanks, Mike. Look, the first quarter provided strong results to the start of this year. Again, I want to reiterate: we are very confident in our ability to execute on the fundamentals and grow this business profitably amidst the competitive environment and manage through the transition of our business models.

We are also positioning our business for future profitable growth through cost and capital efficiency initiatives and all the new revenue streams that we always talk about. We look forward to a positive 2016 with confidence in our ability to execute our strategy, create value for our customers, our employees, and our shareholders.

Thank you again for joining Verizon this morning. Have a great day.

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**Operator**

Thank you. Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using Verizon Conference Services. You may now disconnect.

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