Operator

Ladies and gentlemen, thank you for your patients and standing by, and welcome to the AT&T first quarter 2018 earnings call. At this time, all of your participant phone lines are in a listen-only mode. And later, there'll be an opportunity here for your questions. Instructions will be given at that time.

I would now like to turn the conference over to our host, Michael Viola, Senior Vice President of Investor Relations. Please go ahead, sir.

Michael J. Viola - AT&T, Inc.

Okay, thank you, Justin. Good afternoon, everyone. Welcome to our first quarter conference call. Like Justin said, this is Mike Viola. I'm Head of Investor Relations for AT&T. And joining me on the call today is John Stephens, AT&T's Chief Financial Officer. John's going to cover our results and provide business updates, which will include progress on FirstNet, and then we'll follow that up with a Q&A session.

As always, our earnings materials are available on the Investor Relations page of the AT&T website. That includes our news release, investor briefing, 8-K and a variety of associated schedules. Before we begin, I want to call your attention to our Safe Harbor statement. That says that some of our comments today may be forward-looking. As such, they're subject to risks and uncertainties, and those results may differ materially. And additional information is always available on the Investor Relations website.

Also, I want to remind you that we're in the quiet period for the FCC CAF-II auction and so we can't address any questions about that today. And so now, I'd like to turn the call over to AT&T's CFO, John Stephens.

John J. Stephens - AT&T, Inc.

Thanks, Mike, and thanks for joining us on the call today. Let me begin with our financial summary, which is on slide 3.

As we mentioned last quarter and noted it in 8-K filed last month, AT&T was required to adopt several new accounting standards this year. These new accounting standards deal with reporting issues around revenue recognition, pension costs, financial instruments, and cash receipts on installment receivables. These changes have some impact on our income statements and our cash flows.

And in connection with adopting the new standard on revenue recognition, the company will now record Universal Service and other regulatory fees on a net basis, consistent with how we have traditionally reported other pass-through items like sales taxes. This specific change will reduce both revenues and expenses by a little more than $900 million this quarter, but will not – they will not impact operating income or net income for the quarter.

In addition to GAAP, we're providing comparable historical results to help you better understand the impact on financials from revenue recognition. We will be referring to these historical results in our comparisons during this call.

Tax reform gave us the opportunity to invest and grow our customer base. These investments drove a significant year-over-year improvement in postpaid phone net adds, the second-highest broadband quarter in 3 years and solid growth in video, as we transition our TV business.

Our adjusted EPS for the quarter was $0.85, up about $0.15 with benefits from tax reform and revenue recognition, offsetting the costs of investing in our growing customer base and a small amount of pressure from the new financial instrument reporting rules.

Adjusted consolidated operating margins in the quarter were up year over year on a reported basis, but down on a comparable basis. Our increased sales activities this quarter drove much of the pressure we saw, as did continued transition of video from linear to over-the-top services. But at the same time, we did see margin improvements in business wireline and international.

Next, let's cover revenue, which was $38.9 billion, down from a year ago. Higher wireless equipment and strategic service revenues partially offset declines in legacy services, the ongoing impact of the video transition and our decision to no longer pursue some low-margin businesses. Cash flow statements have been recast to show the impact of the new accounting standard with installment receivables, so year-over-year cash flow results are comparable.

The first quarter is traditionally our lowest free cash flow quarter and this year is no different. Several items impacted free cash flow, including our annual employee bonus program, a larger than usual handset payment from the very strong gross add and upgrade performance during the light holiday season in the fourth quarter and continuing into the first quarter.

We also had unreimbursed FirstNet expenditures in this quarter. Offsetting some of this pressure was a tax refund we received in the first quarter, which was generated by the passage of the tax reform act in late December of last year.

We're still on plans to meet the free cash flow guidance we gave you in January. That guidance of free cash flow in the $21 billion range included the pressure from the receivables accounting change. Capital spending was $6.1 billion in the quarter.

Let's now take a look at our operations, starting with Mobility, where the team turned in solid customer growth. Those details are on slide 4. AT&T's domestic Mobility operations, as you know, are divided between the Business Solutions and Consumer Wireless segments. For comparison purposes, we're providing supplemental information for its total U.S. wireless operations.

Strong sales activity in a usually quiet quarter helped drive a turnaround in postpaid phone net adds. Postpaid phone net adds showed a more than 300,000 phone improvement compared to the year ago first quarter, which is now more than 700,000 year-over-year improvement in the last two quarters.

Prepaid phones also came in strong, with about 190,000 new subscribers, and that's helped our Cricket customer base grow. And today, its total is 9 million customers. Congrats to our management team that runs Cricket. And we increased our branded smartphone base by nearly 500,000, topping 73 million by the end of the quarter.

Churn keeps improving. We had another record low first quarter postpaid phone churn of 0.84%, improving both year over year and sequentially. Altogether, we had more than 2.6 million new subscribers, that's domestic subscribers, with gains in postpaid, prepaid and connected devices, more than offsetting our continued losses in resellers.

Revenues were up more than 3% in the quarter, thanks to our strong smartphone sales, while service revenues were essentially flat sequentially. We're confident that service revenues will improve throughout the year and still expect that we'll be positive for the full year on a comparable basis. There are several reasons for that.

First, we're now through the toughest year-over-year compare as we lap the introduction of unlimited plans that came out in the first quarter a year ago. We're adding postpaid, prepaid and connected devices, subscribers at rapid rates, and the pressure from reseller is stabilizing. Recent new product offerings will also help. Our strong sales activity also had an impact on margins. Postpaid smartphone gross adds and upgrades increased by about 500,000 year over year.

That's an upgrade rate of 4. 3%, which was higher than last year, still service margins came in at 48.1% on a comparable basis. Our long-term strategy to build our branded phone base and improve churn with bundled services continues to pay off. Postpaid smartphones have increased by almost 2 million in the last two years. Prepaid smartphones have also increased at a solid clip, growing by 3.4 million in the same timeframe. That's more than five million growth in overall domestic smartphone base.

At the same time, a growing number of our existing Mobility customers are bundling their wireless with our video and our broadband services. These are the most valuable customers with churn significantly lower than single-service customers. These results are very encouraging and gives us the confidence to continue to carefully invest in our customer base.

Now let's take a look at our Entertainment Group results on slide 5. The positive impact of TV and broadband promotions and our ability to bundle services can be seen in our Entertainment Group results. Total video customers, broadband connections and bundles all grew. DIRECTV NOW continued its solid run of subscriber growth. More than 300,000 DTV NOW subs were added in the first quarter, giving us nearly 1.5 million customers in service.

This over-the-top video growth has helped us manage the industry-wide transition of linear TV subscribers to over-the-top services. Looking at total video subs, we actually have more subscribers today than we did two years ago because of the success of DIRECTV NOW. This is especially important at a time when the industry is seeing increasing pressure from customers cutting the cord.

Transitions such as this are never easy, but we have shown that we're able to do this time and time again, whether it'd be with our voice or broadband or wireless services. We don't expect video to be any different. We do expect revenue and margin pressure as we manage through this, especially this year, but we're excited about DIRECTV NOW's product improvement and our new user interface that we're beta testing right now and expect to roll out soon. This has cloud-based DVR capabilities and supports an additional video stream per account. Later this year, we expect a more robust VOD experience and new pay-per-view options to be released.

These new services will add new revenue streams and help counter some of the revenue and margin pressure we are dealing with. The over-the-top model also is low touch, with significantly lower subscriber acquisition cost and less capital investment.

As we manage the over-the-top transition, we are completing our broadband transition from DSL to IP broadband. About 800,000 of our residential broadband customers are still on legacy DSL. That compares very favorably to about 4.5 million legacy DSL customers just four years ago, so we are managing through this transition. This has helped drive growing broadband momentum for us. We had 154,000 high-speed broadband net adds in the quarter and 82,000 total broadband net adds.

Our fiber build now passes more than 8 million customer locations, nearly all consumer, and you see its impact on our broadband numbers. Customer response has been terrific. In areas where they have marketed fiber for the last two years, our penetration rate is nearly 50%. That's quite a bit higher than in our non-fiber markets and leaves us a lot of room to run over the next couple years.

Now let's look at Business Solutions results on slide 6. As a reminder, wireless subscribers and specifically individual wireless subscribers who buy off a company plan have been moved from Business Solutions to Consumer Mobility. Historical financials have been recast to reflect that change. Business Solutions revenues were down slightly, as gains in wireless and strategic business services helped offset declines in legacy services.

Wireless revenues were up nearly 4%. Equipment revenues were up with increased sales, while service revenues were essentially flat. Wireline revenues were down about 3% year over year, an improvement over recent quarters and similar to what we saw in the fourth quarter. This improving trend in wireline is encouraging, and this comes before any expected bump from business activity that we might see with tax reform.

Another positive is the significant improvement in business wireline margins, where EBITDA grew year over year and margins were up 190 basis points on a comparative basis. The team continues to do a great job in driving cost management initiatives.

We're also beginning to see operating expense savings from our move to a virtualized software-defined network. More than 55% of our network functions were virtualized at the end of 2017, and we expect to have 65% virtualized by the end of this year, well on our way to meet or exceed our goal of 75% virtualized by 2020.

Our international business also turned in another strong quarter, thanks to solid revenue gains in Mexico. These results are at the bottom of slide 6. Revenues were up more than 7%. EBITDA was up significantly, thanks to strength in Latin America and improvements in Mexico. Subscriber growth continues to be strong in Mexico. We added more than 500,000 new subscribers in the quarter and more than 3 million in the past year and now have 15.6 million customers in total.

Reported service revenues were down slightly due to our first quarter decision to shut down a wholesale business that we inherited from Nextel. Without that roughly $90 million reduction in revenues, reported service revenues were up year over year. And our Latin America satellite operations continue to be profitable and generate positive free cash flow.

Over the last few quarters, we explored the possibility of issuing an IPO for our DIRECTV Latin America video properties, but ended up withdrawing our offer. We just didn't believe it was the right time to transact. Current market conditions obviously played a role, and trade, interest rates, market volatility and foreign exchange all played their part.

DIRECTV Latin America has been a steady performer for us, contributing both profitability and free cash flow. We'll continue to look for ways to unlock the value of those properties for investors while increasing our optionality.

Now, I'd like to provide you updates on our Time Warner acquisition and our goal to build the world's premier gigabit network. Those details are on slide 7. I'm not sure I need to update anyone on the status of our bid to merge with Time Warner, but here's the latest.

Both sides are wrapping up their cases and are now preparing for closing arguments on April 30. After that, we'll wait for the court's ruling. Based on the court's determination, we stand ready to close. Funding is in place, even after we settle the special mandatory redemption bonds. There's not much more we can add at this point.

I'd also like to update you on our ongoing efforts to improve our networks. FirstNet continues its strong start. We launched the first and only nationwide FirstNet dedicated network core last month. This network core acts like the brains and nervous system of FirstNet and is on physically separate hardware. Only FirstNet traffic will move through this core. This will serve as a springboard for ongoing innovation and advanced functionality, delivering value-added capabilities and benefits that commercial cores can't match. This includes always-on access to priority and ruthless pre-emption.

The FirstNet network also is open for FirstNet-ready and FirstNet-capable devices. These devices support all AT&T commercial LTE bands and the FirstNet Band 14 and meet band priority selection technical requirements. So far, nearly 650 agencies across 48 states and territories are already subscribing to FirstNet services. We see this as a real growth opportunity.

We've also started the heavy lifting of putting Band 14 on our towers. Over the next 5 years, we'll be putting Band 14 on tens of thousands of new and existing sites nationwide. We plan to touch about a third of our cell sites this year alone. Our new Crown Castle agreement will help us speed this process. The agreement simplifies and expands our long-term leasing deal for wireless network infrastructure. This will give us more flexibility as we deploy FirstNet as well as 5G technologies.

We're working hard to build something great for first responders. With the introduction of the FirstNet core, first responders finally have the network that they have been asking for and that they deserve.

In addition to our efforts with FirstNet, 5G and 5G Evolution work continues its accelerated development in several different areas that will pave the way to the next generation of higher speeds and quality for customers. 5G Evolution is made up of carrier aggregation, 4X4 MIMO and 256-QAM technologies, along with LTE-Local Assist Access (sic) [LTE-Licence Assisted Access] or LTE-LAA. These are building blocks towards the transition to 5G and will deliver speeds substantially faster than LTE. 5G Evolution has now expanded to 141 markets, and we expect to reach more than 500 markets by the end of the year.

Our fixed 5G trials also are providing valuable real-world millimeter-wave spectrum experiences both to businesses and residential customers. We're seeing gigabit-plus speeds under line-of-sight conditions to distances up to 900 feet and with extremely low latency rates, some as low as 9 milliseconds. These trials as shown in millimeter-wave is able to penetrate foliage, glass and even walls better than anticipated with no discernible signal performance impacts due to rain, snow or other weather issues.

Granted, these are early results in trial conditions, but we are excited about what we have seen so far. The backbone for 5G or any wireless network is fiber and our fiber network is extensive and growing.

We're on track to surpass our commitment as part of the DIRECTV deal to build fiber to 12.5 million customer locations. We now reached more than 8 million locations with fiber and plan to hit 10 million by the end of this year. This is in addition to the 8 million business locations that we pass today within 1,000 feet with fiber. These 16 million locations and the more than 1 million route miles of fiber in our overall network are the backbone of our network and our move to 5G.

With FirstNet 5G and fiber build, our network development has never moved at a faster pace. We're excited about the progress we're making and even more excited about where our network will be in a very short time.

That's it for my presentation. Mike, I'll turn it back over to you for Q&A.

Michael J. Viola - AT&T, Inc.

Okay. Thanks. Justin, we're ready to take questions.

Question-and-Answer Session

Operator

Certainly. Thank you. First, we have the line of John Hodulik of UBS. Your line is open.

John C. Hodulik - UBS Securities LLC

Okay. Thanks, guys. Maybe first starting on Entertainment Group really on slide 5, John, I just want to make sure I'm reading this correctly in terms of the exhibit you put here. That everything left of that vertical line is historical accounting method. And if that's true the way I'm reading it, can you just confirm that? Yeah.

John J. Stephens - AT&T, Inc.

Yeah. So the historical accounting method is effectively publishing first quarter 2018 results under the old rules, so you've got comparability with last year's first quarter.

John C. Hodulik - UBS Securities LLC

Okay. And I guess, just doing that, it would seem that the Entertainment EBITDA is down in the range of about 19%, if you could confirm that, and then on an apples-to-apples basis.

And then, if so, can you just talk about what's driving that pressure? You talked about DIRECTV satellite subs declining and some of the expenditures you're going through to stand up DIRECTV NOW and the marketing and maybe then move to the new platform. How should we expect those drivers to evolve over the course of the year? The satellite losses are like they're picking up on a year-over-year basis. Should we expect that to continue and put further pressure, I guess, on those margins from that new 22.8% level?

John J. Stephens - AT&T, Inc.

Yes. So a couple of things, John. First of all, I think on a year-over-year basis, our linear video losses are actually less. As you can see on the chart in the middle there, they're actually going down, so that's improving. We've seen some improvement in our churn rate. And as for (24:21)

John C. Hodulik - UBS Securities LLC

I was just looking at the – I was thinking of the satellite-over-satellite number. Like the – I think it was 188,000 versus I think zero you did a year ago. I guess, the outlook is – I guess, your traditional's got a little better, but how do you see the satellite stuff evolving over the next 12 months?

John J. Stephens - AT&T, Inc.

I think we're going to continue to see challenges in the satellite in the linear pay-TV model as we've talked about. We'll continue to see real opportunities to shift to the over-the-top and continue to grow DTV NOW. And then, what we will see is, as we come out with our new platform along that's in beta and then, quite frankly, some updates that we would hope to have by the end of this year, where you'll start seeing things like cloud DVR revenues, pay-per-view revenues, both sports and movies, some of the opportunities for additional streams and then eventually, revenues for advertising and data insights. We'll see a replacement of the margins and a growth in those margins on an extremely low capital expenditure basis. So we'll transition through that. That's what our expectations on that. Am I answering your question, John? That's what I'm trying to do.

John C. Hodulik - UBS Securities LLC

Yes.

John J. Stephens - AT&T, Inc.

That's the process we're going through. It'll be challenging. It's hard work. It'll take us some time, not expect it to be completed this year. But we are optimistic about total video counts growing over 100,000 and the significant year-over-year improvement in total video, almost 300,000 improvement.

John C. Hodulik - UBS Securities LLC

All right. I guess, John, what I'm trying to get at is the margin trajectory from here on new accounting methodology, 22.8%. Should we expect a similar trajectory from this new level as we look out to the year? Or would you expect it to stabilize as we move through the year, just given all the puts and takes?

John J. Stephens - AT&T, Inc.

Yes. I think we'll see some pressure throughout the year, but starting to stabilize at the end of the year.

John C. Hodulik - UBS Securities LLC

Okay, great. Thanks.

John J. Stephens - AT&T, Inc.

I do believe we'll see some ongoing pressure through the year.

John C. Hodulik - UBS Securities LLC

Okay.

John J. Stephens - AT&T, Inc.

Thanks, John.

Michael J. Viola - AT&T, Inc.

Take our next question, Justin.

Operator

Sure. We have the line of Amir Rozwadowski of Barclays. Your line is open.

Amir Rozwadowski - Barclays Capital, Inc.

Thank you very much. And afternoon, John and Mike.

John J. Stephens - AT&T, Inc.

Hi, Amir.

Amir Rozwadowski - Barclays Capital, Inc.

Hi. Wanted to touch base on the Mobility segment. If we think about the competitive landscape and your approach to the competitive landscape at this point, how should we think about the trade-off of subscriber acquisition versus margins? To John's prior question, if we look at it on a like-for-like basis for Mobility, we did see some pressure on a year-over-year basis against the historical margin structure. And just trying to think about the prospects for improving that going forward or how we should think about the puts and takes there.

John J. Stephens - AT&T, Inc.

Yes, Amir, it's a good question. What we're thinking about is we're making the investments in the customer base from, if you will, initial basis. So things like BOGOs or offers on equipment. Getting that and getting the customers in and then having that ability to retain them for what is now 120 months as opposed to moving towards a recruiting tool that would be based on service revenues that would occur every month. So we're taking that investment on an upfront basis where we can identify it, taking that pressure through margin certainly, but then knowing that we have this improving churn and this reliability and the ability then to add other services, whether it be broadband, whether it be video, whether it be wireless.

That's how we're viewing it. So we've got kind of an ability to turn on and off our investment opportunity and our customer growth. We've, so to speak, had it turned on in fourth quarter last year and then first quarter this year, but I think you've seen that over 700,000 smartphone improvement in the last two quarters over the prior year's two quarters.

So if this – take responsibility for that investment today and get it over with and then get the benefits not only over the 10 years we own the – that the customer stays with us, but quite frankly, start getting the benefits from it in the very next quarter or the very next month as you have that investment behind you. That's how we're thinking about it and that's how we go about it.

I will tell you, we're trying different data-informed offers and we're exchanging them when we see things work or not work appropriately, and we'll continue to do that. But the best we can, we've focused on these investments to the customer base that revolve around getting everything upfront, knowing what the total cost is going to be and then moving forward.

From a competitive environment, we've seen some moderating of the competitive environment over the last few months. There continues to be some changes in that and some offers that we see that we're never sure if they are temporary or permanent, but overall, we had seen some moderation in the environment. And we have, as you can see, performed really pretty well with our really, really low postpaid churn growth in prepaid and really, really improved growth in the postpaid phone trends.

Amir Rozwadowski - Barclays Capital, Inc.

That's very helpful, John. And then, to your point on churn, we continue to see a decline on a year-over-year basis. What is your expectation through the course of the year? As you mentioned, we are seeing some changes in the competitive landscape. Is the expectation that you're able to continue to drive churn lower through the course of the year?

John J. Stephens - AT&T, Inc.

We haven't given specific guidance to churn, but let me say this. We're striving to continue to improve churn on a year-over-year basis. Our strategy though really get to what we've seen is when we're able to bundle it with another service, a broadband, a video, wireless, any two or three of those together, we see better churn. And so we also have that and that's a differentiating viewpoint or differentiating capability that we have uniquely that others don't. And so when we can do that, we do have some optimism about the ability not only to maintain these great churn levels but even see some further improvement likely we did this quarter, both sequentially and year over year.

Amir Rozwadowski - Barclays Capital, Inc.

Thank you very much for the incremental color.

John J. Stephens - AT&T, Inc.

Yeah. Thanks.

Operator

Next, we have the line of Simon Flannery of Morgan Stanley. Your line is open.

Simon Flannery - Morgan Stanley & Co. LLC

Great. Thank you. Good afternoon, John.

John J. Stephens - AT&T, Inc.

Hey, Simon.

Simon Flannery - Morgan Stanley & Co. LLC

On the video programming, I think Randall had – was reportedly made their comment around introducing a AT&T watch offering for $15 bundled with wireless. Maybe you could just give us a little bit more color about that and what timing we have around that?

And then coming back to wireless, I noted the upgrade rate ticked up to 4.3% from 3.9%. And I think you'd, in the past, talked about going through this period of very low upgrade rate and then it would start to normalize over time. So it'd be great just to understand was the 4.3% do you think you're getting back to a more normal rate right now and any other color around how long people are keeping handsets or renewing them. Thanks.

John J. Stephens - AT&T, Inc.

Okay. Thanks, Simon. Good questions. So, first of all, our upgrade rate and quite frankly, both the upgrade and the gross adds number, so we had about 0.5 million more devices in the first quarter in the upgrade rates and the gross adds. So we had a big step up. I think that was due to a lot of enthusiasm due to our great offers that the team put out. I think there was some pent-up demand for new innovative devices. And there may have been some change in the fact that devices have gotten another quarter older and people wanted to upgrade. But I think the biggest driver was really our offers. That's one thing.

Two, that's caused some pressure with regard to expenses on this comparable basis. If you use the comparable basis, then a lot of those expenses, particularly with regard to BOGO-type offers, may have fallen to the bottom line and caused some pressure there. So that's a reality. On those, we're more than willing to pay that, if you will, make that investment to get the long-term and, quite frankly, immediate short-term additional revenues.

I don't know that the upgrade rate itself because the age of devices has changed that much. I do believe our offers drove the increase in the upgrade rate. And the new iPhones may have driven some of it because of the limitation and the lateness that they came in, in the fourth quarter, and some of our customers using BOGOs to buy those in the first.

So that's how I view that. We'll continue to watch it. I don't believe we're going to go back to the historic upgrade rates. I think those are clearly a matter of history. And even though the fact that we're talking about 4.3% being a big increase in the upgrade rate gives you the sense of we used to talk about normal upgrade rates being a lot higher percentages.

With regard to the video programming, let me just say this. As we move forward through this year and are able to continue to innovate, we'll have a lot of offers in wireless and broadband and in video. One of those would be the one that you're referring to that Randall mentioned, a DTV watch-type program. We'll leave it to my marketing and sales team to come out with the details on that. I know they're going to do a lot better job than I could. But I think the more important message is that we are willing to innovate. We are willing to try some different things to grow the customer base in the right way and continue to be able to grow the overall business on a bundled basis.

Simon Flannery - Morgan Stanley & Co. LLC

Fair, thank you.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

Next we have Mike McCormack of Guggenheim. Your line is open.

Mike McCormack - Guggenheim Securities LLC

Hey, guys. Thanks. John, maybe just circling back on the Entertainment Group and some of the pressures there, I was just thinking about – I think Randall recently was quoted as comparing it to the legacy wireline voice business of old. And I don't think there's much argument that linear is under tremendous pressure. But as you look at that unit or that segment, how much of the cost is variable? And as you think about the piece parts within that, which parts of it can you reduce with the sub counts versus more structural fixed costs?

And then on the content cost side, which I presume is mostly variable, what benefits you guys are getting as far as cost goes or negotiating power goes with the programmers for the DIRECTV NOW product?

John J. Stephens - AT&T, Inc.

Again, Mike, good question, a couple things. I guess I'd view the cost of this, sorry, on the video entertainment piece of it, on the video side, that content is variable with regard to the packages we sell. But I also think there's some opportunity going forward to be variable with regard to within the packages. And I think we've made reference to possibly some offers, possibly getting to a point where we have differentiated offers and different packages. We have some today continuing to do that. So I think there is some, not only just based on the volume of customers but also based on what the customers want to buy, and we'll continue to look for that.

On the high-speed Internet side or the broadband side, I would suggest to you what we've been building into that 8 million fiber, quite frankly, is something we still have a lot of selling to do into. And so that capital has been spent and that capacity to serve is already out there. We're just in this process of growing this IP broadband base and serving it. So I would suggest to you that could be a change or provide new direction, particularly as we've gotten through the legacy DSL conversions, which has really been absorbing us for the last few years.

On the legacy voice and data, those challenges continue to be there. Those costs either have been managed out or continue to be managed out. So that's how we think about this. But on the video side, the real growth here is going to be in these alternative services, whether it's cloud DVRs, pay-per-views, data insights, advertising, doing those kinds of things while growing broadband at a high-speed level and continuing the success we've had.

And then as you look at that Entertainment Group, bundling the two of those together, but also bundling all that with wireless, and so that's the real strength in it. That's what makes it worth all the efforts that we're going through to transition it. So it's not just one individual piece, but it's the collection of those pieces that make this very attractive.

Mike McCormack - Guggenheim Securities LLC

Great. Thanks, John.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

Next, we have Brett Feldman of Goldman Sachs. Your line is open.

Brett Feldman - Goldman Sachs & Co. LLC

Hi, thanks for taking the question. The first one is just a quick housekeeping question. The new USF accounting, you noted that it's neutral to operating income. Can you clarify? Is it also neutral to EBITDA? I think that might help some comparability.

And then just coming back to the Entertainment segment, the U-verse video base has been remarkably flat. Particularly, I think you added a customer – a couple customers this quarter. I was hoping maybe you could provide a little more insight as to why that is. And is that more directly tied to the adoption of your residential fiber product than perhaps what we're seeing in the satellite trends? Thanks.

John J. Stephens - AT&T, Inc.

A couple of things. One, yes, on EBITDA, the USF revenue and expenses are both in the EBITDA calculations, so they will net to zero. It won't have any change to EBITDA. I will tell you, though, Brett, to be clear, in prior years that USF revenue was in service revenues. And so it impacted service EBITDA margins, not EBITDA itself as a number, but the margins. We believe this will give a better picture of what we actually collect from customers on our behalf versus what we collect on the government's behalf, much like sales taxes, which we had never previously counted as service revenues. So you're right. It does not affect EBITDA, operating income, or EBITDA. The starting point, though, would be, would it have an impact on service revenues.

Brett Feldman - Goldman Sachs & Co. LLC

Got it.

John J. Stephens - AT&T, Inc.

U-verse, I think essentially a couple different things. One, the fiber build and the fiber capabilities, the broadband capabilities make that natural bundle very good. Two, U-verse is in our historic legacy telephone company footprint, where we generally have very good wireless capabilities, distribution, and have had actually better results in bundling when we have all aspects to that. So that's another point.

Brett, I would tell you the need to migrate U-verse in the satellite to take advantage of differentiating content costs is ebbing or is greatly reduced than possibly it was when we first merged with DIRECTV. All of those things are part of the process. And quite frankly, customer satisfaction with the U-verse product is probably the most important consideration. The people are happy. So those are all things that contribute to that aspect.

Brett Feldman - Goldman Sachs & Co. LLC

Just a quick follow-up question. I think you had previously indicated that when the DIRECTV satellite product was being sold in your landline region, you were seeing better results there because you could bundle with broadband. Is that still playing out? Or are you finding that the U-verse video product is still a much more natural bundle with your broadband offer?

John J. Stephens - AT&T, Inc.

I won't say in comparison to the two U-verse compared to satellite, but I will tell you that we do believe that we do better and have better churn stats when we can bundle video, both satellite and U-verse. U-verse cannot by definition, but satellite, we have better churn results and better customer experiences when we can bundle with our IP broadband. And to that point, just another reason for the fiber build and the opportunity that it presents as well as what FirstNet will provide to, quite frankly, all our satellite customer with regard to the potential for much better quality wireless service. So all of that kind of plays together.

Brett Feldman - Goldman Sachs & Co. LLC

Thanks for taking the questions.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Next, we have the line of Phil Cusick of JPMorgan.

Philip A. Cusick - JPMorgan Securities LLC

Hi guys. Thanks.

John J. Stephens - AT&T, Inc.

Hi, Phil.

Philip A. Cusick - JPMorgan Securities LLC

Hi, John. First, a follow-up. You were fairly aggressive in the first quarter in the wireless compared to previous first quarters, but a lot of these promotions fell away in April. Should we think about this as a new level of aggression for the full year or are you just changing up the seasonality? And then, a bigger question, John, the online and addressable advertising business seems to be under fire on a lot of fronts and there's some increased investor preference lately for online subscription businesses. How do the headlines impact your thinking around AT&T strategy of accruing content and the OTT transition and the trade you seem to be making of giving up subscription revenue to drive subscribers in an effort to build the targeted advertising opportunity? Thanks.

John J. Stephens - AT&T, Inc.

So, Phil, with regard to aggressiveness, I would suggest you we have the capabilities to be aggressive in the first quarter. We did that. We tried different things. As you can tell, we did that in the fourth quarter, too. As you pointed out, we changed them as we've gone through to make sure what we were doing was working and was getting the results, not only just results but the results we wanted. And we're continuing to focus on data-informed decisions in that light.

What I'd suggest you is we should continue to see us something like the three offers that we've, I guess, recently put out in the marketplace. In New York, where we're using video as an opportunity to attract customers; in Chicago, where we're using our capabilities with regard to broadband to attract customers; or in Los Angeles, where we're using wireless. We're trying to be market-directed, market-informed and trying to put offers out that'll, if you will, make a difference. You can expect to continue to see us change some things, try some things. We might do a BOGO and then we might do a second one is a 50% fee as opposed to a full BOGO. I think we recently did that with wireless offering.

So you'll see us make changes on a regular basis. We're trying to, if you will, make sure we're willing to invest this opportunity in the customer base to grow the business and the opportunities for the long-term. I don't want to suggest that our, if you will, investment levels will continue to be at the same level they were in the first quarter. We'll go through that process as we go through the year and make the right decisions for the short-term and the long-term for the business. But I do expect we'll continue to look at things on a regular basis as we've been doing even here in April.

With regard to – the recent issues with regard to, I'll call it, customer datas and customer, if you will, rights with regard to that data, we continue to respect our customers. We've been the guys that have been in the business of, if you will, simply put unlisted numbers for 100 years. We understand the customers' data and privacy and how to deal with that. We're the ones who have pushed for a consumer Bill of Rights and pushed that legislative earlier this year, long before this became a headline story of the recent month. So we continue to believe, and, if you will, respecting your customers' privacy and treating them the right way will provide the long-term results.

With that being said, we continue to believe in the processes and practices we have in place as being appropriate. And we continue to believe that there is a space for us as a trusted adviser and a trusted player in the data insights and data privacy space for our customers and for the advertisers who are clearly looking for a trusted partner in that space.

Philip A. Cusick - JPMorgan Securities LLC

Thanks, John.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

Next, we have the line of David Barden of Bank of America. Your line is open.

David Barden - Bank of America Merrill Lynch

Hey, John. Thanks for taking the questions.

John J. Stephens - AT&T, Inc.

Sure.

David Barden - Bank of America Merrill Lynch

So first question would be, if you could kind of maybe elaborate a little bit more on where we are kind of on the FirstNet go-to-market process? Have you stood up a sales force, if you have, what exactly are they selling and to who? And when can we think about the market share opportunity that you have there starting to feather into your kind of gross add market share and net add share in the market?

And then the second is, a year ago, first quarter, the postpaid phone net add market was a couple hundred thousand phones. If we look at what you and Verizon and Comcast have done and make a few educated guesses about T-Mobile and Sprint, year over year, that's going to be 3x to 4x this quarter. And if I look at last quarter, it was actually up 50% year over year. What do you think is kind of driving this phenomenon where the postpaid phone net add market just seems kind of growing out of thin air? Is it the economy? Is it prepaid to postpaid migration? Is it BYOD? I'd love your thought – your theories here to kind of explain it. And then, whether we can maybe assume it's going to continue for the rest of the year or whether this is kind of transitory effect? Thanks.

John J. Stephens - AT&T, Inc.

So I think it depends, David. I don't doubt. Let me say it this way. For us, we're both growing that improved postpaid phone, improved 300,000, while we still had almost 200,000 – I think it was about 192,000, but almost 200,000 prepaid net adds. So, for us, we're seeing continued good – really good performance in prepaid, but really good performance in the smartphone. So we're seeing a total growth in those phones. That's what we're seeing. I think others are seeing some conversion from prepaid to postpaid. I wouldn't – that may be at the customers' decision just based on pricing opportunities or, if you will, plans that are out there.

But we are seeing continued growth in both for us. I do understand your question. And we'll wait and see about what happens with the total marketplace. I don't have a total view of that marketplace because I don't think anybody does because some of the company haven't announced and so forth.

But in our, if you will, piece of the marketplace, you saw us now two quarters in a row over the last two quarters a 700,000 improvement in postpaid smartphones and continuing good performance, solid performance in prepaid. So we believe that we're doing very well in the share part of the game.

I would also tell you there's other aspects of things in the postpaid net adds, as you all know, whether tablets are going, whether and how people count watches and other devices. I'll leave that to you all to decide and to evaluate. But on the phones, we feel pretty good about getting good value for the investment plans we put out there and a great opportunity to generate value, short-term, the month after, with regard to the revenues these guys are going to generate and over the long-term because of our churn being so low.

With regard to FirstNet, FirstNet's something that we're really excited about. We're very excited about getting that, the only exclusive authorized FirstNet core up and running last month. We really do believe that that's critical to be able to provide the services and to provide that quality of service that those first responders deserve and need.

We had set up a FirstNet team last year. An individual by the name of Chris Sambar runs that for us. We added marketing and staff and sales people. We've spent money, if you will, and time over the – at least over the last nine months, if not longer, almost a year, I guess, getting to know our potential clients, getting into the industry, making a bigger effort to be a known player.

With regard to that, as I mentioned earlier, we've actually had about 600 or so, if you will, departments sign up with us. And those 600 departments came from over 48 states because they can use – we can provide the FirstNet quality services on our existing LTE network once we've established this core, which we did last month. So they can get relentless or ruthless pre-emption, and they can get priority services. And that can all work now. We can provide that.

Now, some of those folks that we signed up could have been our customers before they just want to migrate to FirstNet and that'll be part of the process. But quite frankly, I think we've been very pleased about the reception we've been given to at least talk to people that previously weren't our customers.

On a per person basis, if you will, some of your first line, first responder, you're thinking about two or three or potentially four connected points, whether it be a body camera, whether it be a phone, whether it be a tablet for their car, whether it would be some drone or some other device they'd use. But you also look at it from the ability to contact with the smart cities, their employer, so to speak, and whether we can sell other services there. We're also looking for the in-house personnel, the dispatch people that work at the police station or other personnel whether we can have an opportunity to sell there. And of course, there's always the friends and family approach.

So we're very pleased. First of all, we've got a FirstNet team already set up. They're very active. They've already gotten a number of contracts done in over 40 states. And we continue to be very excited about it. We will get a significant amount of the Band 14 up this year, and we are expecting to, at a minimum, meet and hopefully exceed all the milestone requirements that FirstNet has given us. So if I sound pretty positive about it, I am.

David Barden - Bank of America Merrill Lynch

Thanks, John.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

Next, we have the line of Amy Yong of Macquarie. Your line is open.

Amy Yong - Macquarie Capital (USA), Inc.

Thank you. Maybe if you could talk a little bit more about the advertising opportunity and size up the near-term market opportunity for us. How quickly do you think you can wrap this up and then maybe some growth trends that we should be looking at for this year and next? And then just very quickly on the 5G fixed wireless trials, how big is the residential broadband marketing opportunity, as we think about 2019 and beyond? Thanks.

John J. Stephens - AT&T, Inc.

So on the advertising, let me start. I'd point out, this quarter we were up 9% in revenues. We have a base of about $350 million a quarter, in that range. I don't have the specific number at my fingertips here. And we grew at about 9%. So the team is actually proving that this works already with our existing, if you will, inventory of ads that we get as the distributor from the content folks.

So we're making it work. We're getting higher CPMs and getting higher revenue streams and making it more effective. We feel really good about that. As we go through this year, we hope to add a lot more inventory from underneath our umbrella of ownership companies to that, and we'd like to develop that.

If you think about the overall digital market, I don't know the exact numbers, but I think last year, the overall digital advertising market in the U.S. was north of $60 billion, and some estimates will get it in the $80 billion range. We're not what I would call in that piece a significant player. We believe that we can be. We have the capabilities to be. And we've made the investments not only in the personnel and the team that Brian Lesser has established, but we're also making investments in data capabilities and our big data engines inside our company today. So we feel really good about that opportunity.

If you think about linear TV and the opportunity to grow that revenue stream, if you think about digital and the opportunity to grow that, and anything about the opportunity to take all of our digital insights and data insights and help advertisers make sure their advertising is working effectively and efficiently, we believe that there's a real opportunity there. So all of that being done within the appropriate rules and data protection activities. So we feel really good about that.

With regard to the fixed 5G wireless, if you will, our tests have shown it can be done. We can do it. The opportunity there is something that we have to prove out. We're not as excited about the business case. It's not as compelling yet for us as it may be for some. The reason we don't see that, if you will. The question is to get that fixed wireless through to residential, you still have to have backhaul from where the – the 1,000 feet away, the 1,500 feet away, and you still have to have that backhaul infrastructure. So that could be depending upon your ability to successfully pick who's going to buy and how much we're going to need is going to be a very tricky business case.

For us, with this extensive fiber network, we will be able to have that backhaul. With this extensive FirstNet network, we'll be able to have that backhaul. But quite frankly, if we've got FirstNet and we've got fiber there, it may be just as effective and maybe even a better quality product to give those customers fiber-to-the-home.

So we're continuing to work at it. I just don't want to hold it out as – right now, we are more excited, as you can tell, from things I've made about our FirstNet opportunity, about the fiber capabilities that we're building and selling into that, and quite frankly, about the overall 5G Evolution and 5G capabilities in our overall mobility network serving much of the mobile broadband demands that are out there or requirements that are out there.

Amy Yong - Macquarie Capital (USA), Inc.

Great, thank you.

John J. Stephens - AT&T, Inc.

Thank you, Amy.

Michael J. Viola - AT&T, Inc.

Justin, we'll take one more question.

Operator

Certainly. Last, we have the line of Frank Louthan of Raymond James. Your line is open.

Frank Garreth Louthan - Raymond James & Associates, Inc.

Great, thank you. Give us a little bit more color on maybe the free cash flow aspects in your Entertainment business as you're switching more to the DIRECTV NOW product. That would be great. And then on 5G, some of the devices being available late 2018, can you give us a little bit more color on exactly what devices you're waiting for before the launch? Thanks.

John J. Stephens - AT&T, Inc.

Okay. With regard to the 5G, let me make this point. On the 5G Evolution, those devices are not only available now, many of our customers already have them. And so the speeds we get with 5G Evolution by putting up all our spectrum with regard to FirstNet, using 4-way carrier aggregation, which allows us to band the spectrum that we put up now all together, and having 4-way MIMO, which is, if you will, an efficient and quick way to let customers access the network and exit the network, those speeds are working today. And in our test in San Francisco, we got 750-meg speeds on our network. On a full network, that might be 10% to 20% of that level. But we believe we can get 100-meg speeds on our 5G Evolution network with handsets that are already out there today in people's hands, and they're coming through the rest of the handset manufacturer base over time.

So I just want to point that out. That's one of the reasons why the FirstNet with the technology developments of carrier agg and 4-way MIMO and 256-QAM and all these other things combined as well as the new spectrum, Band 14, gives us real excitement about the ability to serve customers really, really well.

On the 5G, I think by the end of this year, we'll have 5G networks up. The device that will be out will probably be pucks and the ability to connect to a puck. And then we'd expect to see what I'll call handset devices or tablets or those types of what I would – I think many of us would normally think of as devices. Those would be out in 2019. And as I think Simon referenced earlier in the call, we've got, if you will, upgrade cycles that are sub-5% a quarter. So there may be some time to getting those 5G handsets up and running, so to speak. So we'll see how that goes, whether that changes the upgrade cycles or not. But all of that for us points to this 5G Evolution can be a really beneficial thing for us because that's available in many, many handsets today.

On the free cash flow side, if you will, Frank, I guess I'll say it this way. Moving to the DTV NOW platform or moving to a thin client platform eventually for the home is really going to change the free cash flow aspects because of the upfront of truck roll cost, the upfront, if you will, climb the roof costs, all of that can change as well as some of the things with regard to billing and administrative costs, the fact that it's an automatic bill or it's a credit card bill, all of those things will change.

But that's one of the attractiveness is about the DTV NOW is the economics about not having that upfront investment. That will turn into savings from an upfront investment from a cash flow perspective. So that's why this thing we strongly believe it will work long term.

With regard to our first quarter free cash flow – and we want to make one point. First of all, first quarter is always low for us because of bonuses and other things. We had a huge handset sales in the first – in the fourth quarter and the first quarter. 500,000 up year over year in the first quarter. 700,000 up year over year in the fourth quarter. And many of those sales in the fourth quarter, we actually paid for the phones this quarter because they were late in the quarter last year when they were sold.

So we had a lot of cash flow pressure from handsets that will reverse itself that'll wash itself out. I just want to point that out. So we feel good about our free cash flow and keeping it in that $21 billion range is the guidance we've given as well as keeping all of our guidance intact.

Frank Garreth Louthan - Raymond James & Associates, Inc.

Okay, great. Thank you.

John J. Stephens - AT&T, Inc.

Thank you, Frank.

John J. Stephens - AT&T, Inc.

With that, I want to thank everybody for being on the call today. We're off to a fast start in 2018, both in growing our customer base and in building the world's premier gigabit network. We continue to add new subscribers in wireless, broadband and video, and we are on track to turn wireless service revenues towards growth this year.

The FirstNet build is kicking in the gear, and we launched the nationwide FirstNet dedicated network core last month. We're working hard to build something great for first responders and early response from our sales activity has been very positive. We're also moving full speed on our 5G evolution and expect to be the first U.S. carrier to introduce Mobile 5G later this year.

Behind all of this is our expanding fiber network, which is the backbone for all our networks, both wireless and wired. And of course, we optimistically await conclusion of our Time Warner court case as a court's decision. One last thought, as you make your way home tonight, please remember, no text is worth a life. It can wait. Please be safe. Thanks again for being on the call and as always, thank you for your interest in AT&T. Have a good evening.