Operator

Ladies and gentlemen, thank you for standing by and welcome to the AT&T second quarter 2017 earnings call. At this time, all lines are in a listen-only mode. Later, we will conduct a question and answer session. Instructions will be given at that time. And as a reminder, this conference is being recorded.

I'll now turn the conference over Senior Vice President, Investor Relations Michael Viola. Please go ahead, sir.

Michael J. Viola - AT&T, Inc.

Okay. Thank you, Kathy, and good afternoon, everyone. Welcome to the second quarter conference call. Like Kathy said, I'm Mike Viola, Head of Investor Relations at AT&T. Joining me on the call today is John Stephens, AT&T's Chief Financial Officer. John is going to cover our results, and he'll also provide an update on technology and infrastructure as well as an update on Time Warner and the FirstNet process. And then we'll follow with a Q&A session.

As always, our earnings materials are available on the new Investor Relations page of the AT&T website. That's going to include our news release, 8-K, investor briefing, associated schedules, et cetera.

Before we begin, I'd like to call your attention our Safe Harbor statement that's on slide 2. The Safe Harbor statement says that some of our comments today may be forward-looking. As such, they're subject to risks and uncertainties. Results may differ materially, and additional information is available on the Investor Relations website.

So now let me turn the call over to AT&T's CFO, John Stephens.

John J. Stephens - AT&T, Inc.

Thanks, Mike, and thank you all for joining us on the call today. Let's first look at our consolidated financial summary on slide 3. We included both a quarterly and a year-to-date view. While the second quarter provides a good snapshot, the year-do-date view actually provides a more complete picture of how we are performing in a challenging and competitive environment.

Year to date, revenue has been pressured by fewer phone upgrades and declines in legacy services. At the same time, our cost containment efforts are paying off, and it's showing up in our margins and our earnings. What we're doing on the cost side drove a 120 basis point improvement in adjusted consolidated operating margins year to date.

Earnings were strong. After adjustments, second quarter EPS was $0.79, up almost 10% for the quarter and up 7% year to date. There are a few things driving this strong EPS performance; first, as I just mentioned, lower costs. We're taking out operating costs and at the same time providing customers with a better experience through more automation, more digital interactions, more software and analytics, and more of our network functions being virtualized.

Second, our international operations are becoming more profitable. Our satellite business in Latin America continues to be profitable in a tough environment, and we are past the heaviest investment cycle in Mexico.

And finally, there were a few one-time operational items in the second quarter such as operating taxes that did help results. But we also normalized more than $0.03 of items that would have helped even more, including gains from a spectrum slot, asset sales, and a one-time benefit savings. Even with all these moving pieces, we continue to expect adjusted EPS growth in the mid-single-digit range.

At the same time, year-to-date cash from operations is solid. Our increased capital spending is reflected in our free cash flow. But once again, the guidance is unchanged. We continue to expect free cash flow in the $18 billion range for the year, albeit at the low end of the range. The timing of the FirstNet expenditures and reimbursements are expected to impact that number. And we still expect capital spending in the $22 billion range, subject to the FirstNet timing. Some of the differences between adjusted EPS and cash from operations in the second quarter and for the year reflect the depreciation changes we've previously discussed.

I want to say we saw some (4:20) working capital lumpiness in this quarter, inventory and vendor payment changes, which we would expect to sort themselves out as we work our way through the rest of the year. In addition, integration costs, inclusive of the Time Warner deal, have been adjusted out of net income, but still impact free cash flow, same for the settlement payments for our pre-merger DTV legal case with the FTC that was previously announced and accrued. All these impacted the quarter, but we don't expect a repeat for the rest of the year, and we continue to maintain our $18 billion range guidance for free cash flow.

Let's now take a look at our operations, starting with Wireless. Those details are on slide 4. As a reminder, AT&T's domestic mobility operations are divided between the Business Solutions and Consumer Wireless segments. For comparison purposes, the company is providing supplemental information for its total U.S. Wireless operations.

It was another highly competitive quarter in Wireless. Our competitors tried just about every promotion in the marketing book. In fact, one of them even offered to give away their service for free for a year. We were prudent with our promotional activity. Instead, our focus was on giving customers a great video entertainment experience bundled with mobility. Our results speak for themselves. We grew our domestic branded phone base by 178,000, including 267,000 prepaid net adds. We grew our smartphone base by more than 0.5 million. We had a strong year-over-year and sequential postpaid improvement. We added 2.3 million subscribers. And customer loyalty was terrific, with our lowest-ever postpaid phone churn for any quarter at 0.79%.

At the same time, our EBITDA margin matched last quarter's all-time high of 41.8%, and our EBITDA service margin was the best ever at 50.4%. These results speak to the fantastic job our Wireless teams are doing with cost management as well as the underlying strength of our Wireless customer base and business.

Now, let's move to our Entertainment group results at the bottom of slide 4. Revenues and margin were relatively stable. Growth in IP and video services revenue offset legacy declines, and cost synergies and efficiencies offset pressure from content increases and startup costs for DIRECTV NOW. AdWorks revenues are [up] nearly 15% year over year. We continue to do well in addressable and local ad sales, utilizing our customer insights data. Addressable and local ads can generate CPMs that are 3 to 4 times that of our national sales, and we've been shifting more ad inventory to these areas to further improve our top line performance.

Total broadband grew for the third straight quarter, overcoming what is normally a seasonally slow second quarter. The strategy to simplify pricing, cross-sell broadband with TV and wireless service, and expand our fiber footprint has been paying off. We're far down the road in completing our legacy DSL conversions to IP broadband. That conversion, combined with extending fiber to more than 5.5 million customer locations, is strengthening our broadband position. In fact, the number of broadband subscribers on speeds 18 megabits or higher has increased by nearly 1.6 million in the past year.

Traditional video losses continued their recent trends. The second quarter traditionally has seasonal pressures, but we also are feeling the impact of the overall industry trend of more customers wanting mobile and over-the-top offerings. The pace of that change seems to have picked up a bit so far this year.

We continued to improve our traditional TV offers by simplifying the pricing and bundling TV with broadband and wireless, but we also know that traditional TV service is not for everyone. Many are choosing our over-the-top offering, DIRECTV NOW. Half of our DTV NOW subscribers are coming from traditional pay-TV, mainly from our competitors, and the other half had no pay-TV service at all. We introduced this service at the end of last year and have now reached nearly 0.5 million subscribers. This has helped us keep our total video base essentially flat from a year ago.

We continue to refine and improve DIRECTV NOW service. We recently launched our app on additional streaming devices, and we're continuing to increase the number of local channels that are available. And we're also beta testing a new platform that will include a cloud-based DVR. We'll broaden availability of this new video platform later this year.

Speaking of our Entertainment group, it's been two years since we closed our acquisition of DIRECTV. You can see the progress on slide 5. One of the opportunities we highlighted two years ago was the potential of bundling services and its impact both on subscriber trends and churn. Our results tell the story. For example, the number of wireless subscribers who also have a TV service from us has increased by more than 4 million, or up 31%, since the close of the DTV deal. Conversely, TV subscribers with wireless plans have increased by nearly 1 million, or 18%. And the number of TV subscribers in our footprint with high-speed Internet service has increased by 10%.

While this is impressive when you look at all traditional TV subscribers, it's even more so when you break out our DIRECTV and DIRECTV NOW customers. This includes those who have migrated from our IP TV service, which is something we intended. The number of wireless subscribers with DTV has increased by 72%, while the number of DTV subscribers with AT&T Wireless has increased by 1.7 million, or 52%, and the number of our DTV subscribers in our wireline footprint with our IP broadband has grown by more than 2.7 million, to 67% of DIRECTV customers.

Bundling obviously helps subscriber and revenue growth, but perhaps the biggest impact is on wireless churn. We've seen postpaid churn fall 25 basis points since we closed the DIRECTV deal. We're doing this in one of the most competitive environments we've ever seen, and a big reason for this is the increasing attractiveness of our wireless and video bundles. In fact, if you look at any bundled customer, churn is lower when compared to customers with just a single service. These are our most valuable customers. We use the combined appeal of wireless, video, and broadband services to offer compelling packages that can't be easily replicated. It's a great way to differentiate our services in the noisy and competitive wireless and video marketplaces.

We also have been making great headway with our fiber build. We have the largest fiber footprint in the country, and we are ahead of the plan to reach our 12.5 million new fiber customer locations FCC commitment by mid-2019. In fact, by the time it's all said and done, we could be looking at around 14 million fiber-to-the-prem customer locations.

We're also on track to meet or beat the expected cost synergies from DIRECTV. We hit a $1.5 billion run rate with cost synergies at the end of last year, and we're on track to reach a $2.5 billion-plus synergy run rate next year.

Now let's look at Business Solutions results on slide 6. We continue to see the similar historical pressures in our Business segment. Strategic Services and Wireless are working hard to overcome legacy wireline losses. We continue to make incredible strides in cost management while increasing the percent of revenues that come from Wireless and Strategic Services. That's driving higher margins even with wireline revenues declining.

Let me give you one example of what we're talking about. Our legacy voice and data revenues were down more than $500 million year over year. But even with that pressure, EBITDA grew by more than $70 million, and EBITDA margins improved by 150 basis points. We're doing this by driving hard on cost management initiatives. Our focus is having the industry's best cost structure, and one way to do that is by implementing process automation and service efficiencies.

Our industry leadership in software-defined networking also supports our cost management goals. More than 40% of our network functions are now virtualized, and by year end it should be 55%, with a long-term goal of 75% or better.

Moving to our international operations at the bottom of slide 6, we saw solid improvement across our operations. Revenues grew and margins improved in both our Latin America and Mexico operations. In fact, EBITDA and EBITDA margins for our international segment have more than doubled year over year.

We did see an EBITDA benefit from a one-time item in Brazil during the quarter. In Mexico, revenue grew and margins improved both sequentially and year over year. Revenues were up about 10%. We added close to 500,000 new subs in Mexico in the quarter to pass 13 million. Our LTE network now covers more than 88 million people, or just about 75% of the country.

Looking further south, our Latin America pay-TV revenues were up more than 11%. Net adds were down, due mostly to seasonality in Argentina and losses in Brazil, but our video business in Latin America continues to be profitable and generate positive free cash flow.

Before we get to your questions, we'd like to provide an update on several topics that many of you have asked about. Our business update is on slide 7.

First, the Time Warner review process at the DOJ continues. We still expect to close the deal by year end, and we have the financing set up to do so. And our merger integration team is nearly complete with its plans for opportunities that this deal will make possible in advertising, bundling, and providing customers choice. Our goal is to hit the ground running once we receive final approval and build our leadership in the telecom, media, and technology space.

Second, we continue to invest and improve our integrated networks. Our wireless networks reach more than 99% of all Americans. Our spectrum position is broad and deep. In the top 100 metro areas today, we have about 100 MHz of spectrum deployed. This spectrum capacity helps us meet the tremendous demand that the new unlimited plans provide.

At the same time, we have about 60 MHz of additional spectrum. We'll deploy all these bands simultaneously with the FirstNet build. As you know, the cost savings from touching the tower only once are significant.

Our evolution to 5G is underway. While 5G standards are still being finalized, we're laying the foundation for tomorrow's faster wireless speeds today with 5G Evolution.

We also completed a successful trial of LTE-LAA, reaching peak speeds of 750 megabits. This is one of our first steps towards 5G and will provide faster wireless speeds and an enhanced experience for our customers who use our LTE network.

We've already launched 5G Evolution in Austin and Indianapolis and expect to be available in more than 20 markets by year end. We also launched the second fixed wireless trial using Millimeter Wave technology to deliver an ultra-fast 5G network experience to more locations in Austin. The trial participants can stream live TV on the DIRECTV NOW app and experience faster broadband services, all over a fixed wireless 5G signal.

By the end of 2017, we also expect to deploy LTE License Assisted Access and four-way carrier aggregation in areas of some 5G Evolution metros. LTE-LAA combines unlicensed spectrum with licensed spectrum through a carrier aggregation to increase network capacity, providing faster speeds and a better customer experience. We recently tested this technology in San

Francisco, where we observed peak speeds of more than 750 megabits in a trial setting. We plan to expand LTE-LAA testing to additional areas of San Francisco and Indianapolis in the coming weeks.

We continue to move software functions deeper into our network. This gives us incredible flexibility to change network functions almost instantly while providing better customer service and driving cost efficiencies.

We've also embraced edge computing, which will drive low latency for 5G applications such as self-driving cars, augmented and virtual reality, robotic manufacturing, and much, much more. We're just scratching the surface here. Customers demand a powerful network with a seamless integrated solution. This makes our integrated network a powerful advantage for us.

Now, I would like to update you on FirstNet, where we're really off to a fast start. That update is on slide 8. The timeline has been set and the opt-in process is underway. We delivered plans to each state last month. They can opt in at any time. Already, five states have said they're in, Arkansas, Kentucky, Iowa, Virginia, and Wyoming. And we are looking forward to announcing a number of additional states in the near future.

These states are anxious to get started, and so are we. They want the highest quality network available for their first responders as soon as they can get it, not to mention the investment and jobs created by our FirstNet builds. We continue with our discussions with the other states and territories in this initial 45-day review period for the states.

It will be followed by another 45-day response period for FirstNet to answer any questions or concerns the states may have. This will conclude by mid-September. Once that's completed, the official 90-day clock begins for states to make a decision. This is expected to start in mid-September, with final decisions due by mid-December.

Work on the FirstNet network can begin once the state opts in, both hardware and software, and we're setting up a new business operation, sales, marketing, customer care, to serve these customers.

The advantage for the states that opt in quickly are many. First responder subscribers will have immediate access to AT&T's existing nationwide LTE network. Those subs will immediately receive quality of service and priority access to AT&T's $180 billion network. Those subscribers will also have preemption status on our network, which is expected to be in place by the end of the year.

FirstNet and AT&T take on all of the financial requirements of the build. No additional financial resources from the states are required. All of this is a powerful incentive for states to opt in.

The FirstNet build will be an important event for the country, first responders, and the industry. We see this as a great opportunity for efficient expansion, not only by deploying 60 MHz of spectrum, but also by changing the curve of increasing tower costs. The build will require equipment installations and new towers. We've closely watched unit costs and have been focused on creating a diverse community of suppliers and tower companies to increase competition and reduce costs.

We're studying our options. We're looking hard at new relationships. We're open to new or independent operators who may want AT&T as a customer and support a new model. The point is there's more than one way to get this work done, and we are committed to finding a way that meets the needs of our customers while keeping costs in line with industry economics.

So in summary, we had a very good quarter. Our teams are doing a great job of executing in a very competitive environment. Our cost containment efforts are paying off both in margins and earnings, and we're off to a great start with FirstNet.

With that, Mike, I will turn it back to you for our Q&A.

Michael J. Viola - AT&T, Inc.

Okay, Kathy, we're ready for questions, and you can get started immediately.

Question-and-Answer Session

Operator

Thank you. Our first question will come from Amir Rozwadowski with Barclays. Go ahead, please.

Amir Rozwadowski - Barclays Capital, Inc.

Hi, folks. John, I was wondering if we could chat a bit on the progress that you guys are seeing in bundling video and wireless. You folks saw a material reduction in postpaid phone-only churn. Is there any way to quantify how much benefit you've received from bundling DIRECTV NOW in those promotions?

John J. Stephens - AT&T, Inc.

First of all, thanks for the question, Amir. I think the way to look at it, it's really as we displayed on slide five. You can see that overall reduction in the total postpaid phone churn, and you can see the dramatic improvement over the, if you will, two years since the merger. And in those two years, another major activity that's gone on is dramatically increased competition, pricing that's somewhat challenging, people giving away service for a year free. So I think that slide, that presentation, shows it.

If you look up and see the details that we provided or the details I provided in my comments, it's pretty clear this ability to bundle, whether it be TV Everywhere, whether it's DTV NOW, whether it's the ability to get all of your video on your phone is making a huge difference.

Amir Rozwadowski - Barclays Capital, Inc.

Excellent, that's very helpful, and then just a quick follow-up, if I may. How should we think about the different puts and takes on the opportunity set for continuing to expand your margins? We continue to see improvement on wireless margins as a whole. It does seem as though there is an investment taking place on the video side with respect to DTV NOW, and then there is continued margin progress in the international operations. But if we think about the progress and the capabilities going forward, can you walk us through the opportunity set you still see going forward?

John J. Stephens - AT&T, Inc.

Sure, let me go through it this way. On a longer-term view, we're going to continue to see wireless revenue opportunities in prepaid. We're going to continue to see them in connected devices. Quite frankly, for us we're going to continue to see real opportunity not only in the immediate future but over time in FirstNet and what it provides. So those will be very important. And quite frankly, when you have churn at these levels, if you can maintain it, it's a gift that keeps on giving with regard to revenues and margins.

Secondly, if we think about this movement to equipment installment plans, we've essentially gone through that process and have completed that, which had some changes in our service revenue metrics. We've made it through the vast majority of that. So then you go through the next process we're going through with this move to unlimited, and we certainly have been through the higher dollar amounts, if you will, on the customer base by that because our customers are smart and they move quickly. And so that's occurred.

Now we're going through the transition with more customers, some of which who are doing it and causing us, if you will, eliminating some of their overage cost, but some of those customers who are buying up into a little bit of a bigger package just don't have to worry about overages. So that conversion is well through, and we'd expect to see that complete over the next year or so. So from a revenue perspective on a longer-term basis, we feel good.

On the wireless side on the expense piece of it, we still have a significant opportunity. From an overall perspective, we have about 40% of our network functions virtualized, both wireless and wireline. You've seen what's happened and the progress we've made in just getting from 34% to 40%, and we'd expect to get that to 55% by the end of this year and 75% or better by the time we complete. So there's more opportunity with that as well as automation, digitization.

Quite frankly then, as you put all that together, from a total company perspective, our data insights opportunity, our advertising opportunities are significant. And quite frankly, as you saw this quarter, our international operations were getting through the investment cycle. It's gone as we expected. They're particularly in Mexico adding a great number of customers, but across Latin America also. So we're doing well. We just need to get through that process, and those are the opportunities to see costs be managed very well and margins continue to grow.

Amir Rozwadowski - Barclays Capital, Inc.

Great, thanks very much for the incremental color.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question comes from Mike McCormack with Jefferies. Please go ahead.

Michael L. McCormack - Jefferies LLC

Hey, guys. Thanks. John, maybe just a quick comment on the phone adds – phone losses rather on the postpaid side, a bit better than we were expecting there. But I was just thinking about the feature phone base generally. Is there a level at which you think the pressures will start to subside in a much more meaningful way and we can drive towards positive phone adds?

And then maybe just a quick comment on the DIRECTV sub weakness you're seeing there. Obviously, you called out a few things. Where are those customers going? It seems like there's an investment in time and everything else to have the satellite put on the roof. Are these cord cutters, or are they moving to a cable offering?

John J. Stephens - AT&T, Inc.

So let me take the first. First of all, Mike, and I don't want to be stirring turf (28:56) here, but AT&T added contract phone customers for the quarter because our postpaid phone adds in Mexico were positive 100,000 or more. And when you put those together with our domestic base, we were actually positive postpaid phone customers, just to clarify.

On the domestic side, we did see significant improvement sequentially and year over year, over about 250,000 improvement sequentially and about 100,000 improvement in customer count year over year. And really we're seeing that from bundling of services and being able to put this video and other services together with it. So it's working well. As everyone knows, you saw it in the churn numbers. And the best customer is the one you've already got and the one you can hang on to, and that's the most efficient.

With regard to feature phones, we are well through the process. I monitor, if you will, the percentage which is in the mid-90s of phones that we sell every quarter that are smartphones. And it's in that mid-90% range. And then I compare that to our base. And over the last few years, we made significant progress in getting those numbers aligned.

So I think we are getting close to the point where we are through that migration. It's not complete, but I would tell you we made significant improvements over the last few years. Because of that, we retain or have optimism going forward on the ability to show some improving service revenues, and quite frankly, be able to continue to keep churn down because we have customers operating on smartphones and taking advantage of the quality service. So we feel good about that.

And yes, I think, maybe not now, but maybe in the next year or so, we should see a feature phone level that is much more constant and have gotten through this migration. I relate it in a similar way to what we're seeing on the consumer side with DSL broadband, where you've seen we made great strides converting to IP broadband and are getting to a point where we're dramatically through that conversion, which is optimistic for all of us.

On the sub weakness, as I said in the first quarter and will say again, we had a significant number, a higher number than normal, a higher number year over year of involuntary churn. And so we went through that process and decided to take action on those customers. That's one.

Two, we are seeing on an out-of-footprint basis where we don't have fiber, we're seeing sub losses to competitors where they can bundle. We believe we're going to, if you will, arrest that or address that situation as we continue to build out fiber. And quite frankly, not only just the, if you will, 14 million or so fiber-to-the-prem locations we'll get to, but as we mentioned, as we develop 5G wireless technologies that allows for efficient delivery of video over our wireless networks, we'll be able to compete in that environment like no one else on a nationwide basis.

Those are the two things I'd point out to you, Mike, on the sub weakness. I will point out we did have some good growth in DTV NOW, for the over-the-top product pretty much offset the DIRECTV satellite base wireless customers.

Michael L. McCormack - Jefferies LLC

And, John, just real quick on the NFL Sunday Ticket, obviously you're going to be coming up in the third quarter with NFL kicking off. Anything we can be expecting unique on the bundling with that particular product, whether it be with DIRECTV NOW or wireless or anything unique?

John J. Stephens - AT&T, Inc.

Nothing to announce today, Mike.

Michael L. McCormack - Jefferies LLC

Okay.

John J. Stephens - AT&T, Inc.

It's a good question, but nothing to announce today, respectfully.

Michael L. McCormack - Jefferies LLC

Okay. Thanks, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question comes from Phil Cusick with JPMorgan. Please go ahead.

Philip A. Cusick - JPMorgan Securities LLC

Hi, John. Thanks.

John J. Stephens - AT&T, Inc.

Hey, Phil.

Philip A. Cusick - JPMorgan Securities LLC

First to follow up quickly, of the DTV NOW customers, how many of those are bundled with other products that you sell versus standalone? And are you reporting just paying customers, or is it all on the platform?

And then second on FirstNet, with states that are opting in now, when could you start rolling out that new spectrum? And can you talk about the offer to public safety customers in those states? How do those compare to consumer prices? What should we be thinking about in terms of adds coming on as those FirstNet offers start to hit? Thanks.

John J. Stephens - AT&T, Inc.

So the DTV NOW customer rates we're giving is paying customers that bundle with in many cases a large, large percentage of it, top of the head. But we can make sure we get that out appropriately in a post. But the vast majority of those are bundled with our wireless services. But as you know too, it gives us the opportunity. A significant amount of these, 50% or so are customers who have never had a paying video product before or haven't had a pay-TV product, so we're getting the opportunity to not only provide them video but provide them wireless, in some cases broadband, apartment dwellers and others. But we're counting paying customers, not promo customers.

Secondly, we will have the capability to roll out the spectrum once the states opt in. The challenge will be to get the plans finalized and to incorporate the final agreements with the states on coverage and towers and build-out and some of the negotiated terms and make sure we have effective plans for those. But I would certainly expect that we will have the ability to start rolling out spectrum this year. Until the plans are complete, I don't want to predict what we'll have rolled out or how much. We'll certainly do that as soon as we're confident of it, but we'd expect to do that right away.

Secondly, I think the offers will be attractively priced because there will be large numbers of devices, not only phones but cameras and other connected devices that add the ability for us to get good economics on good price points for fire departments, EMTs, police departments, and so forth.

But as much as that is very important to us, the opportunity to then utilize this as a footprint or a starting point to get into smart cities, to be able to help these state, local municipal governments manage other parts of their activities are really important and provide us a great opportunity, as well as just the fact that the increased coverage that may be required by FirstNet will provide us an increased opportunity to sell services to other customers, to provide other IoT services, or quite frankly, to reduce what might be minor amounts in the scheme of things but reduce whatever roaming costs we have left here on the domestic side. But I would expect the prices to be competitive, and certainly today's consumer prices qualify as such.

Philip A. Cusick - JPMorgan Securities LLC

Okay. Thanks, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. And we'll go next to John Hodulik with UBS. Please go ahead.

John C. Hodulik - UBS Securities LLC

Great, thank you. John, maybe first a quick question on the fall-off on the video side. How far through the involuntary churn on the DIRECTV satellite side do you think we are? And then with DIRECTV NOW, given the enhancements, the new content and the DVR, do you think you can get to a point where, given those two issues, you can start to see a blended video sub growth at some point? That's number one.

And then maybe longer term, you guys have talked about a number of initiatives on this call, the spectrum deployment around 5G and FirstNet, edge computing, 14 million customer locations. And I know that SDN plays a role in this, but you spent $22 billion in CapEx it looked like this year, last year. Can you do everything you're talking about doing within that budget, or should we expect spending to ramp as we exit the year? Thanks.

John J. Stephens - AT&T, Inc.

First and foremost, yes, I'd expect we can do it within those kinds of levels. I don't want to give guidance outside of this year, but I don't want to signal in any way, shape, or form any significant changes in CapEx. I certainly believe we can.

I'll note to you that on the FirstNet side, there is a significant amount of efficiency that is achieved by doing this at once, all of the spectrum at once, all the tower climb, all the deployment and so forth. And then secondly, there's a significant co-pay from the FirstNet organization, $6.5 billion. So absolutely we're going to be in a position to do this.

With regard to the video involuntary churn, I would expect we'll see some of this through the remainder of the year, and we would expect that it would to start to ebb as we go through the year. But I would expect we'd have some of it through the rest of the year. And certainly based on what the team has developed, what they've taken from customer insights and customer input, we believe that DTV NOW can certainly grow. And the cloud DVR and a lot of the other features that are coming out are in response to the studies the team has done with regard to what customers want and what would make the product better.

And so absolutely, we've grown 500,000 customers in seven months. It's pretty dramatic growth, particularly when we gave a couple, three months rest there while we tested the platform and really put it through performance testing. So I think there's clearly a demand for it, an opportunity for it and for us that allows us to get to a lot of customers we don't normally serve today, MDUs, millennials, people who haven't bought or haven't been able to have the creditworthiness to buy our premium products. So for us, it's a really attractive next step. Into the future the data insights that we'll be able to get and the ability to add advertising and other sources of revenue off of this will make this profitable while still being able to give consumers great choice and great cost efficiency for them as well as a good product for us.

John C. Hodulik - UBS Securities LLC

Okay. Thanks, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question comes from Simon Flannery with Morgan Stanley. Go ahead, please.

Simon Flannery - Morgan Stanley & Co. LLC

Great, thanks. Hi, John.

John J. Stephens - AT&T, Inc.

Hi, Simon.

Simon Flannery - Morgan Stanley & Co. LLC

On FirstNet, have you finalized how the accounting is going to work? You talked about the $6.5 billion co-pay. So how should we think about it? Is this is going to be grossed-up CapEx, how the puts and takes? I think you made some reference to a working capital impact maybe around the turn of the year. And then there were some media stories about potential org structures after the closing of Time Warner. Maybe you could just address that. Thank you.

John J. Stephens - AT&T, Inc.

So let me just say this on the org structures. Randall Stephenson is still the Chairman and CEO of AT&T, and I expect him to do that for a long time. I don't expect any changes there before or after the Time Warner merger. With regards to the structure of the organization after Time Warner, I think Randall and Jeff Bewkes are going through that, working that process out. And I will definitely leave that to them I think to discuss. Oftentimes, stories are very premature. Those decisions are theirs, and we'll leave it at that.

With regard to the FirstNet, what I expect that we would do is we would disclose the gross amount of CapEx we spend inclusive of FirstNet amounts, then show to the investment community the reimbursement amount that would be recorded – would be expected to be recorded as a, so to speak, contra-CapEx account or reducing the total amount because it's not a cash outflow. It will be a cash inflow to offset the expenses, the expenditures we made, but we would expect to get both of that. Some amount of that $6.5 billion will be allocated to expense, and that expense would go in the same way we would expect to disclose it, give full information about it, be transparent about it. And that would be, if you will, a contra-reduction in our expense lines.

The customer count information and normal service revenues where we record like other customers, and then it's working out with regard to the accounting for the valuation of the licenses that we receive and the payments that we're required to make, the sustainability payments that we're required to make under the fund, and we're working through that. As you can imagine, this is a first of its kind public-private partnership, so we're working with our accounting firm to make sure we have clarity on that as we finalize numbers. We don't have those numbers finalized. We won't have those finalized until the state opt-in – or state and territory opt-in process is complete. So before that time, the actual numbers that we're going to be using will be still uncertain.

Simon Flannery - Morgan Stanley & Co. LLC

And did you mention some timing difference perhaps in the fourth quarter?

John J. Stephens - AT&T, Inc.

So what I'd expect at this time, for example, we want to build a cell site and put up equipment and it costs us $500 and it's reimbursable from the FirstNet fund. We may finish that in month 11 and send a bill in the normal course, just normal processing. We don't get paid for that bill until month one of the next year or month two of the next year. We don't know how that will work yet. We haven't been through that. FirstNet has been very cooperative. We're dealing with this. I'm just suggesting that those may not match up exactly. We just want to be transparent about that. I don't have any prediction that they won't, but just wanted to make sure that this is a case of first impression not only for AT&T but for the FirstNet administrators. So while we've got a great collaboration going on, it's not done yet, and so we want to be careful.

Simon Flannery - Morgan Stanley & Co. LLC

Thanks so much.

Operator

Thank you. Our next question is from Brett Feldman with Goldman Sachs. Please go ahead.

Brett Feldman - Goldman Sachs & Co.

I'll go ahead and stick with the FirstNet theme. So thanks for taking the question. You talked a lot about the timing around starting to build out the network. With states already opting in and with you making your existing network available to the states, when can you actually start marketing the product and bring customers online? Essentially what has to happen between opt-in and going to market? And do you have any estimate for what the addressable market of incremental customers to your business could be over time? Thanks.

John J. Stephens - AT&T, Inc.

So we can start selling into the states. We started making those sales calls right now into the states that have opted in, and they certainly have an organization that was already set up, already ready to run, so to speak, fully prepared to go in our Business Solutions organization, have a whole team ready to do that, and they've been working on it. So, if you will, those sales activities start now, and I will tell you the sales activities work with industry groups already. So that could involve already making contacts, meetings with sales pitches, maybe not specific proposals, but sales pitches to industry groups and departments across the country. So that's been a very active process.

If you will, we haven't given out any specific numbers. I would tell you the opportunity is not only in the millions of potential customers out there with fire, police, safety, and other departments, but also quite frankly for all the related uses and whether we utilize this for a friends-and-family opportunity, whether we utilize this to sell smart cities, whether we utilize this to go in. and where we have an improved network coverage and speed situation because of FirstNet, we go back in and double down on our sales efforts into the existing marketplace. That's what this provides. Whether once we have a FirstNet build complete, what part of that build would be able to handle video. Does this extend our ability to do fixed-to-wireless local loop that we're already doing through the CAF II program and so on and so forth?

So I'm not giving any specific guidance, but I would suggest to you that it is real and it is something that we are excited about, specifically with regard to the police, fire, EMT, what I think people would most think about when they think about first responders. Now we do not have a very large percentage of that market share. We certainly underserve it, just like years ago we underserved prepaid and we've had some great success with Cricket and AT&T Prepaid. Just like our DTV NOW product is getting us into being able to serve customers in the video space where we were very much underserved, FirstNet is going to provide a lot of opportunities for us, but one of them is to serve a market where today we are underrepresented and we believe we can do a great job for those folks.

Brett Feldman - Goldman Sachs & Co.

Just a quick follow-up question, are there any product bottlenecks? In other words, do you have devices you can offer now that support the new spectrum? Is that necessary? Or is this really as quickly as the opt-in states decide they want to go with you, you can start lighting people up?

John J. Stephens - AT&T, Inc.

Yes, there are devices that are ready today, but there will be new devices. The team has been working with the manufacturers. We work in partnership with Motorola and others on developing new devices, new services, whether they be video-placed, camera location-based services, other, whether it be allowing for the devices to actually become report writers or, if you will, event reporting devices to allow the police officers to have more time on the street than back on the desk writing up reports, all of those things that we've been actively working on since the day we started this process, and we feel very optimistic about that. There are products today that we believe we can use to serve. There will be a whole lot more products, a whole lot more products and equipment out there as time goes on.

Brett Feldman - Goldman Sachs & Co.

Great, thanks for taking the question.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question is from David Barden with Bank of America. Please go ahead.

David Barden - Bank of America Merrill Lynch

Hey, guys. Thanks for taking the questions. John, a question on ARPU, it was a noisier than normal quarter with the full quarter effect of the unlimited plus whatever benefits you're getting from tailwinds there, seasonal forces, the EIP migration. But the net of it was it picked up, and we saw one of those last year in the second quarter. I was wondering if you can unpack the moving parts and what we should expect to see that number potentially do over the course of the year, given where we are.

And then the second, if I could, just a housekeeping item. I think, John, you called out two things, taxes and Brazil, as giving some tailwinds in the quarter that weren't normalized. If you could elaborate on those, that would be great. Thanks.

John J. Stephens - AT&T, Inc.

So thanks, David. On Brazil, with regard to it, there was a Supreme Court ruling on a value-added tax matter that was not our case, but it was a case that we also had in front of them. It provided about – right around $60 million worth of benefit to us in the quarter. It's an item that we had been accruing and depositing cash for while we disputed it.

We now determined that we should win that case based of the Brazil Supreme Court ruling, and we booked that through the international LatAm results. We did not receive the cash for that. But it is an item we had been accruing for some time. And the, if you will, expense pressures have been going through, some in 2017, but certainly the vast majority in prior years. So that was that call-out. That is really the major item. But in a company where you file 250,000 tax returns and you operate all across the planet, you've always got tax disputes going on, and sometimes they go in your favor and sometimes they don't. That is what we were trying to say and make sure we were just straightforward.

If you look at our effective tax rate on the income tax side, it's a little bit low, but it's all good work. All the things have been working. We just had a couple of things come together with regard to working some things out with the taxing authorities, but we were just trying to be transparent with that.

David, with regard to ARPU, let me try to go about it this way. First and foremost, the shift last quarter to unlimited had an immediate impact of impacting our overage revenues because the folks most impacted by overage were the ones quickest to go into the unlimited. We've got smart customers. There were also some promotional activity impacts in both quarters. In this quarter, though, we're starting to see those immediate impacts slow down, and now we're starting to see we believe some of the customers, some of the customers buy up to have protection from overage charges. They may have been on a lower plan, but they now seem to want to buy up. Those are a couple of the moving parts.

I will also tell you we are continuing to get further and further towards completion of the equipment installment plan process. I know we've been talking about that for three years now or more. But quite frankly, it isn't complete, but it's near complete, and so that completion helps us compared to the rest in the industry. On the other side, our things like our insurance rate and insurance claim – or insurance processes, we're participating in insurance programs, and some of the administrative charges have helped our ARPU as those things have improved or increased, so that side of it.

On the rest of the service revenues, you'll see that we moved away from reseller, and you've seen that all year – all this year but last year on our reseller counts. We have moved away from that, and that is having a pressure on the overall service revenues. Likewise, we've been having gains in prepaid throughout last year and this year, and that's helping with regard to total service revenues outside the ARPU discussion.

David Barden - Bank of America Merrill Lynch

Great. Thanks, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question is from Matthew Niknam with Deutsche Bank. Please go ahead.

Matthew Niknam - Deutsche Bank Securities, Inc.

Hey, guys. Thank you for taking the questions, just two, if I could. One on enterprise, particularly on the fixed side, you called out weakness in investment and some technology transitions. Just wondering if you can comment on what you're seeing on both the macro and competitive front.

And then secondly on wireless upgrade rates, again you're at record lows. Maybe, John, just wondering if this is more of the new normal, or whether you're expecting maybe a bigger pickup later in the year given some pent-up demand? Thanks.

John J. Stephens - AT&T, Inc.

Sure. So on the upgrade rates, you're right. They were low. They've been low for the six months. For the full year, I would suggest to you, I would expect a pickup in the second half of the year as new devices come out. But I would tell you once – and quite frankly, the longer we get through the equipment installment plan cycle, the more we get back to a normal level where there are enough phones that are three, four – whatever the term might be – years old and need to be replaced, whereas in the first couple of years the phones were still new, and so customers weren't necessarily needing to do it.

Quite frankly, the transparency to customers with regard to what these things cost is impacting their decision-making. It's made it their pocketbook decision. While we would expect those to pick up in the second half of the year, and on overall basis, I wouldn't be surprised next year if it picks up from where it is today. But we would not expect it to go back to pre-equipment installment plan levels. I just wouldn't expect that to happen. For the rest of the year, predictions on what the rate would be would be inappropriate. We don't know how customers are going to take to the new devices, the new offerings and so forth, so we'll wait and see how that will come out.

I will tell you with regard to the new technology aspect, four-way carrier aggregation, the MIMO effect, some of the other things that we're doing with really upgrading our network and improving it, many of those can be taken advantage of with the new handsets. And so we are watching it carefully because we think those customers are going to have an even better experience with the investments we've been making on our network.

With regard to enterprise, what we're seeing is a couple things. There are these annual contracts, whether they be Q3, some are a little bit longer. But as they come up for renewals, there's a step down in these traditional prices. So we've seen a lot of that with regard to voice. And so we're just taking it slow, and we're just going through that. That's one aspect of it. Two, we're able to compete. I don't see it as a losing to competition aspect, but it's just the new pricing levels. Three, we're seeing very little business fixed investment in this space that's generating demand for us or anyone else for that matter. And I think the government's GDP programs, it's why we're so strong on tax reform. It's why we continue to push for tax reform because we think that will generate that investment and help us generate revenue on the top line.

Lastly, I will tell you that we continue to be very favorably received on the combination of our wireless and wireline at the business level, the ability to provide IoT devices and other wireless connections to employees, customers, engineers, HR departments, and so forth, to help them do their jobs, that we are doing what I consider to be just a very good job of continuing to fight the fight and keep customers happy, keep them in their relationship with us, and driving cost out at the same time to actually grow margins. But it's a tough enterprise environment and it's a tough legacy environment. And the team's doing really well to shift that to those Strategic Services into wireless.

Matthew Niknam - Deutsche Bank Securities, Inc.

Got it. Thanks very much, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. Our next question is from Amy Yong with Macquarie. Go ahead, please.

Amy Yong - Macquarie Capital (USA), Inc.

Thanks. Maybe back to the bundle, can you talk about how adding content helps upsell your bundle, I guess specifically the HBO upsell that you started in April? And any early thoughts on what Time Warner brings, any proof points as to what content does for the bundle, and perhaps next steps to the deal and sticking points on conditions? Thank you.

John J. Stephens - AT&T, Inc.

On the Time Warner deal, I won't talk about any sticking points to the transaction. We'll leave that for another day or to when we get it approved. I will make this comment with regard to – Time Warner has got great quality content. Everybody knows that. I think it's undisputed. And so that's going to be great for us to bundle with our products but also great for us to sell to others who may want to bundle their products.

With regard to HBO, quite frankly, customers like it. Customers like the opportunity to have that with their phone. So we're just trying to provide what customers want. I would suggest to you – once again, I know this is simplistic, but the best proof we can give is the ability to look at that churn and see where that smartphone churn has gone, and knowing that a lot of that has to do particularly in this competitive environment. It's a very competitive environment, and why are people staying with us? I think in part it's because they like the ability to bundle, so we are seeing that quite well.

Amy Yong - Macquarie Capital (USA), Inc.

Great, thank you.

Michael J. Viola - AT&T, Inc.

Kathy, we'll take one more question.

Operator

All right, thank you. That will come from Tim Horan with Oppenheimer. Go ahead, please.

Timothy Horan - Oppenheimer & Co., Inc.

Thanks, guys. Thanks, John. It sounds like out of region you want to go with a quad-play wireless product, obviously with DIRECTV. Any sense how long this might take? I know you've done a couple 5G trials, or maybe even can use LTE out of region. I know you said basically half the DIRECTV customers were not paying for TV before. Do you have a sense of maybe what percentage of the customers that are with DIRECTV NOW that are wireless-only?

John J. Stephens - AT&T, Inc.

I don't know, so let me say this. You're hitting it right with the fact of the question of can we generally – I don't want to be on an absolute basis, but generally on a national basis, we use our wireless network starting with our LTE and LTE-LAA with carrier aggregation and so forth, can we provide a connection that would allow for sub (1:00:18) video transport? And we believe we can. The tests that we've done have shown that. Now those are just tests, they're trial markets, and we need to expand them. As you combine the FirstNet build with this, you get more opportunistic because you're going to be out in the network, and you can take advantage of that touches to do whatever else you need to do to improve those capabilities.

Likewise, as we have talked about before, we are a big player in the CAF II funding, and are building a lot of that, and so there's a lot of other items to coordinate with FirstNet with our existing LTE network. We have the technology developments with, if you will, 5G Millimeter Wave, but yes, we can. So that is, if you will, our goal to take this 14 million fiber-to-the-prem type coverage and combine it with a 5G wireless to have extensive coverage across the marketplace and be able to provide not only great wireless, but video and other services, mobile broadband and so forth.

Tim, if I could, I think this is near you. We just got word that New Jersey has now become the sixth state to opt in to the FirstNet. So we continue the momentum, and I wanted to point that out while we're on the call.

Timothy Horan - Oppenheimer & Co., Inc.

Thanks, congratulations. Maybe lastly on the expense front, it looks like the trends have gone a little better on expense management. And I think in the past, you guys have said when you get over 50% virtualization you can really start to see some of the expense benefits. Just maybe any color on your confidence – basically because it sounds like you're sounding more confident on the ability to – virtualization to really reduce expenses?

John J. Stephens - AT&T, Inc.

Tim, we are confident. I think it's a large part the technology, our network guys, as well as our business operations guys, but we are seeing it. It's already happening. The issue with regard to 50% for me, Tim, is the math exercise that we've got most of the investment dollars behind us to get it to 50%. So then we can see the compounding of the savings going forward because we've got so much already done, if you will, in the book, completed. And so it's easier to build on that, whereas today while the team's doing a really good job getting it up to 34% at the end of last year, they were reinvesting to get there, and they're reinvesting money this year to get to 50% – 55% by the end of the year. So it is absorbing some of the cost efficiencies. It's well worth it, great investment. But once you get over that 50% level, it becomes more of a pure – the benefits will exceed any of that additional investment in a clearer picture.

Timothy Horan - Oppenheimer & Co., Inc.

Thank you.

John J. Stephens - AT&T, Inc.

Thank you.

Michael J. Viola - AT&T, Inc.

Okay, Kathy. John, do you want to make some closing comments?

John J. Stephens - AT&T, Inc.

Folks, I appreciate everybody's time, and I want to thank you personally for being on the call today, just a few comments before we go. It continues to be a highly competitive environment, but our cost containment efforts are paying off, and you've seen that in our margins and our earnings. The prudent management of our wireless business led to branded phone growth, record low postpaid churn, and best-ever EBITDA margins.

We also posted solid year-over-year and sequential postpaid phone improvement, and we are really excited about the transformation of our broadband business and the inroads DTV is making as well as the developments in our international businesses. Our strategic moves with Time Warner and FirstNet along with these quality current assets, employees, and customers that we already have are separating ourselves from our competitors and positioning AT&T for the future, so we're very excited about what's yet to come.

Lastly, one last thought before we go. As you make your way home tonight, please remember, no text is worth a life. It can wait.

Thanks again for being on the call and thanks for your interest in AT&T and good night.