Operator

Ladies and gentlemen, thank you for standing by. Welcome to the AT&T fourth quarter 2016 Earnings Results Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, instructions will be given at that time. [Operator Instructions]

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

Michael Viola

Okay. Well, thank you, Cathy, and good afternoon, everyone. Welcome to the fourth quarter conference call. Good to have everybody with us. Joining me on the call today is Randall Stephenson, AT&T's Chairman and CEO; and John Stephens, AT&T's Chief Financial Officer. John's going to cover our operational results along with a 2017 outlook and Randall will follow that with an overall business update and then will follow that with Q&A.

As always, our earnings material is available on the Investor Relations page of AT&T website, and that includes our newly redesigned investor briefing which you'll want to take a look at. You can find them at att.com/investor.relations.

I need to call your attention to the Safe Harbor statement on page three, which says that some of our comments today may be forward-looking, subject to risks and uncertainties. Results may differ materially, and additional information is available in AT&T and Time Warner's SEC filings and on the Investor Relations page of each Company's respective websites.

We are also in the quiet period for the FCC Spectrum Auction, so we can't address any questions about spectrum today. And I will also turn your attention to page four, which is information regarding the SEC filings specifically the recently filed form S-4. Again that's on slide on four.

And now, I'll turn the call over to AT&T's CFO, John Stephens.

John Stephens

Thanks, Mike, and hello everyone, and thanks for being on the call today. Before, I turn over to Randall for a strategic view of our Company, I'd like to provide a brief overview of our fourth quarter and full year operational results that are on slide five.

Our teams executed very well in 2016. We grew revenues and on adjusted basis, we expanded operating margins and increased earnings as we had projected. And free cash flow came in at the high end of expectations, even with strong capital investment. On top of that, we made significant progress with our integration of DIRECTV, meeting our cost synergy targets and launching our first over-the-top video service nationwide.

For the fourth quarter, consolidated revenues were down slightly due to fewer upgrade sales and some pressure on our legacy services. But customer gains and growth in video and IT-based services mostly offset these declines. At the same time, we continued to see adjusted consolidated margin expansion, even as we invested in customer growth opportunities in mobility, video and Mexico.

For the fourth quarter, our adjusted EPS was $0.66 or up nearly 5%. This includes adjustments for amortization, our annual mark-to-market pension plan adjustment, merger, integration related items and a one-time tax gain that was excluded.

During the quarter we aligned our depreciation schedules with our updated business cases and engineering studies for certain of our network assets; this lowered depreciation expense on a sequential and year-over-year basis. This impact was offset by investments in strong wireless customer growth, in both U.S. and Mexico, and the development, launch and promotion of DIRECTV NOW. And while we expect those depreciation benefits to continue in 2017, they are expected to be offset by other non-cash items such as reductions in capitalized interest, benefit plan expense and taxes.

Earnings in the fourth quarter were impacted by revenue pressure in our legacy wireline services as a result of lack of fixed business investment as well as competition small business.

Moving to cash flows, we had more than $39 billion in cash from operations for the full year. That's a record for us. This allowed us to return substantial value to shareholders through dividends, while also investing more in capital than we ever had before. Capital investment was 22.9 billion for the year that includes taking advantage of pricing and financing terms from our vendors that made good business sense for us, particularly with bonus depreciations still intact.

Our investments are growth focused. For example, we're ahead of plan with our fiber to the home build. Today, we market nearly 4 million consumer customer locations. Free cash flow was strong, coming in at $3.7 billion for the quarter and nearly $17 billion for the year. That gives us a dividend payout ratio of 70% for the full year. Our net debt to adjusted EBITDA ratio came in at 2.26 times.

Let's now take a look at our operations where you see a consistent story of investment and the subscriber growth it generated. Those details are on slide six.

Let’s start with wireless, which had a terrific quarter. As a reminder, the Company is providing supplemental information for its total U.S. wireless operations. In a traditionally very busy quarter, we had strong subscriber growth, lower postpaid churn, and record margins. EBITDA service margin was the highest ever for both the full year and the quarter. And we also turned in record full year operating income margins. With did this even while investing in growth of our smartphone subscribers with offers such as unlimited wireless with video, and a buy one get one free BOGO offer. This helped grow our branded smartphone base by nearly 1.1 million, when you include customer upgrades.

Churn was a solid story all year and didn’t disappoint in the fourth quarter. Postpaid phone churn was a record fourth quarter low of 0.98% and overall postpaid churn improved year-over-year, in part due to increasing number of wireless and video bundles, and those numbers include churn pressure from our 2G network shutdown with strong sales even with the higher margins and 2G shutdown.

We added 1.5 million total subscribers with more than a 0.5 million postpaid net adds. Branded phone subscribers also continued to grow. We added about 340,000 branded phones in the quarter. We did lose postpaid feature phones in the quarter. However, if you back out our forced turnover, caused by 2G network shutdown, our postpaid phone base was essentially flat. The 2G shutdown impacted net adds or about 22 basis points of pressure to our total churn. We see it most in our reseller and connected device numbers. But the team executed well and the network shutdown is now complete. It's a competitive market and a busy quarter, but our wireless team turned in another solid performance.

It was also a big quarter for our entertainment group. The launch of DIRECTV NOW got most of the headlines. This robust over-the-top offering started strong, adding more than 200,000 paid subscribers in its first months. This gave us a solid video sub growth in the quarter. And we're pleased with the initial results from DIRECTV NOW, but we’re going to be careful with our expectations. Customer promotions and launch pricing helped drive strong growth and still early. We're learning more about the subscriber base and the platform while we are working through the expected challenges that come with launching a new innovative service of this magnitude. Early sub demographics tend to be more urban, younger and apartment dwellers than a typical linear customer.

Entertainment group revenues grew with games and video and IP services. Legacy services are less than 10% of total revenues, but still represent about a 250 basis-point drag on the group's growth rate. AdWorks continues to add scale as well. There was a $1.5 billion business in 2016 with revenues growing at double digit rates. Fourth quarter margins was down year-over-year because we didn't hesitate to invest in growth opportunities. That includes startup and launch costs for DTV NOW and increased promotional efforts to new and existing customers, across our entire product set. There were additional margin pressures as a customer rate increases were less than the content rate increases. This supports our thesis for acquiring Time Warner and strengthening our position in content.

In broadband, overall subscribers were relatively stable in the quarter, while our fiber buildout continues to be a great story. Our penetration of broadband is a full 9 percentage points higher in those markets compared with our non-fiber footprint. After we launch our 100% fiber network in the new market, we're seeing about half of the new broadband customers buying speeds of 100 megabits per second or higher with 30% of the customers taking a gig. And the real kicker is that the vast majority of recent sales in those markets are taking multiple services from us. So, as our fiber deployment accelerates, we're excited about this growth opportunity.

Now, let's look at business solutions on slide seven. Our business segment continues to perform well even as it feels the impact of a lagging economy and the lack of business fixed investment. Wireless growth was solid but not enough to overcome the pressures of legacy services decline. The drop off in business wireline spending was felt in all our business segments. Enterprise is maintaining a leading share position in the tough environment but comparisons were impacted by the second quarter 2016 sale of some of our hosting operations.

Small business is seeing the impact of competition. Strategic business services' growth helped offset some of the decline in business solutions; it was up $230 million or 8.3% year-over-year. These services now represent 38% of wireline revenues and an annualized revenue stream of around $12 billion. Margins expanded as EBITDA grew by more than $50 million, as efficient cost management helped to offset the impact of a slow economy.

We're also seeing continued progress on our network virtualization and our software defined network enabled services. Our virtualization plan is ahead of schedule with 34% of our network virtualized at the end of the year and net NetBond continues to well-received with 19 of the leading cloud service providers now making it available.

Moving to our international operations, Mexico continues to be an investment story, while our DIRECTV Latin America operations continues to manage profitability in a very difficult environment. Mexico has been a remarkable success story. In a little more than a year, we deployed 4G LTE, 78 million people in more than a 160 markets; rebranded our services and stores; and became the fastest growing wireless company in the country. Customer growth is strong. We added 1.3 million new wireless subscribers in the fourth quarter and over 3 million customers for the full year. This strong investment obviously pressures margins but as you can see in several parts of our business, we're clearly willing to invest in growth. In our Latin America video business, revenues grew and operating income increased and the business continued to generate positive free cash flow, despite the challenged environment.

Let's now review our full year results, see how they stack up with the guidance we gave you last January. That's on slide 8.

Our teams did a good job of hitting the targets we set out a year ago. Revenue growth hit our double-digit growth projection, thanks to our DTV acquisition and gains in IP services video. Adjusted earnings came in the middle of our mid single-digit EPS growth target. Adjusted operating margins actually expanded by 60 basis points as efficiencies and cost cutting overcame investment pressure in Mexico and other growth-related expenses.

Capital investment was at the high end of what we expected. We took advantage of vendor offers and bonus depreciation when it made business sense. Free cash flow came in at the high end of expectations, and we accomplished this even after making $750 million in payments to our pension and benefit plans this year. This includes $350 million in payments into our pension plan, as part of our agreement with the Department of Labor from our prior mobility funding. These payments now fulfill our obligation under that agreement a full year ahead of schedule. We have also voluntarily made another $400 million deposit to our employee medical fund. These payments make our benefit plans even stronger; in fact, we do not expect any funding this coming year.

This strong cash generation allowed us to easily hit our annual dividend payout ratio in the 70s. And if you adjust for the voluntary pension and benefit payment, that percentage gets to the high 60s. We also did a nice job of hitting our operational targets. Already mentioned hitting our virtualization goal on our fiber build, we also made significant progress with our 5G trials including a millimeter wave underway in Austin. And our network team accomplished all of this while they had expenses that were down year-over-year.

When you look at everything we are doing with the combination of spectrum, fiber, software and new technologies, you can see why we are confident in our ability to lead in connectivity.

Now, let's take a look at our outlook for 2017 on slide nine.

Our business always has had a lot of moving pieces, but with the new administration taking office, there is even more to think about this year. It's just too early to call the impact of several issues. Tax reform has been a hot button and it makes sense for the company our size with the taxes we pay, would clearly have an opportunity to benefit from the change in tax rate. We're also staring at the potentially better regulatory environment. Positive change in both of these areas would help us deliver faster on plans to innovate and grow our business.

Some are speculating that the economy might grow faster, and there will be an uptick in business fixed investment. That would definitely be good for us. And we are waiting to hear for the final outcome of the first of that process. You know that we are an approved bidder and we are optimistic about our opportunity, but we don’t know the answer to that yet.

We're also in the process of closing our Time Warner transaction. We remain confident that the deal will be approved later this year. These are all potentially very good things for AT&T, but these items are not included in our 2017 guidance. Our outlook is based on what we know today, and here is what you can expect from us in 2017.

First, we see revenue growth in the low single digits. Growth in IP services and video is expected to offset competitive pressures, soft business investment and declines in legacy services. We expect adjusted earnings growth to continue in the mid single-digit range. We also expect continued consolidated operating margin expansion. CapEx is expected in the $22 billion range, similar to last year. And we expect to see continued free cash flow growth with free cash flow in the $18 billion range and continuing our drive towards $20 billion. And we’ll continue to move forward on all the operational initiatives that we have underway with our network. We’ll sharpen our outlook as the year unfolds, that’s a broad view of what to expect from us in 2017.

With that, I'll turn it over to, Randall for a strategic business update.

Randall Stephenson

Okay. Thanks, John, appreciated.

We have a new President and FCC Chairman, Bill. So, I know everybody is talking about tax and the regulatory reform, and you're going to have a lot of questions for us about that. But before we get to your questions, I do just want to take a brief moment and offer some perspective on how AT&T is now positioned in converging telecom media and technology space.

We’ve spent the last few years in a very heavy investment cycle, it’s no secret. We’ve been getting ready for a world where mobile technology and premium video content would intersect. And we've been convinced for a long time that this intersection was inevitable. And when it happened, we wanted to have the foundation laid to make the intersection a very different experience for our customers. And that foundation in our mind begins with a network that’s engineered and designed for the special requirements of video. It has to have deep capacity, it has to have broad distribution. And if you would look at slide 11, you can see that this is exactly the foundation we built.

Our high-speed network is engineered and it’s built for video. It's an LTE network that covers nearly 400 million people in the U.S. and Mexico; there is nobody else that’s even close. We're building out fiber to 12.5 million locations. This network is software defined, and that gives us unique scalability at the lowest cost per megabyte around. It's a network with an elegant path to gigabit speeds and 5G. And in terms of capacity, we're really in the unique position here. We've been invested $27 billion in spectrum over the past five years. And as a result, we have the premier spectrum position in the industry, 40 megahertz of fallow spectrum. And as John referenced, if we're successful with our first net bid, we get access to another 20 megahertz of prime nationwide spectrum for public safety and secondary use.

And as you also heard John say early, our 2G network has now been shut down. And that spectrum is being reformed for future use as well. And then, if you look at our points of distribution, they are second to none. 147 million mobile customers across North America, that includes a leading IoT business; we have 46 million pay TV subscribers in the U.S. and Latin America; 16 million broadband subscribers and we have an OTT platform DIRECTV NOW that's off to a really fast start.

So that’s our foundation and it's an indication of what’s to come. We think this is a very strong foundation. And so, given that, it seems only logical for us to assume an ownership position in the critical application that's going to ride on this foundation, and that’s premium entertainment content, and that’s exactly what we're doing with the acquisition of Time Warner.

And if you look at slide 12, our technology and distribution we think are a perfect fit for the best premium content creator and distributor on the planet. In the telecom, media and technology space, we're building a global leader. And we've been pursuing a strategy to become the premier integrated communications company in the world and DIRECTTV really catalyzed that strategy, and you saw us execute on that last year with our new TV Everywhere application and data free TV and DIRECTV NOW. And that integrated experience helped drive our best ever fourth quarter churn for our U.S. postpaid mobility business. Now, bringing Warner Brothers, HBO and all the Turner networks under the AT&T umbrella is going to allow us to expand the strategy beyond just simple connectivity to deep integration of premium content for our customers. As we look ahead, the strategy is expanded to create the best entertainment and communications experiences in the world, and I am very convinced this foundation has been laid for us to deliver exactly that.

And so, with that, what I want to do is turn over to Mike and be glad to take your questions on the quarter or anything you else you would like to talk about. So, Mike?

Michael Viola

Okay. Cathy, we are ready to take the Q&As. And so, why don't you queue up the first question?

Question-and-Answer Session

Operator

[Operator Instructions] Our first question will come from John Hodulik with UBS. Please go ahead.

John Hodulik

Randall, you brought up two important topics in your prepared remarks, the tax reform and regulatory changes that we are seeing in Washington. Maybe first, from a tax reform standpoint, what's your view on how this unfolds and what it could mean, maybe especially related to guidance for AT&T in 2017 and beyond? And then, obviously, new leadership with the FCC with Ajit Pai, just initial views on what that can mean for telecom regulation in the U.S.? Thanks.

Randall Stephenson

Okay. Thank you, John. I had the opportunity to meet with what was then the President-elect couple of weeks ago, and I got to say I was impressed. I was meeting with the CEO, it was obvious. And the President had a very specific agenda in terms of what he thought was critical, and that was tax reform and regulatory reform, and we spoke at length about each of those. And I would tell you that the man, the President is focused on these. And so, laughed with a degree of optimism that this could actually be pulled off this year.

Now, what does that look like? We've seen the President's proposal; we've seen Paul Ryan's proposal, both of them I think trigger the impact that I have been talking about for quite some time. And that is, if we want to get off this 1% to 2% growth plane, there is nothing that will trigger that like tax reform. I mean, everybody knows the numbers. We have the most uncompetitive tax structure in United States, it’s the highest tax rate in the developed world in the United States. And to bring that into competitive levels, and you pick your number what tax rate you think that is, will have a stimulative effect, we’re convinced. In fact, we know at AT&T, if you saw tax rates move to 20% to 25%, we know what we would do; we would step up our investment levels and there are things we would like to accelerate, if we had a more favorable tax environment. So, John, my guess in terms of where this lands is probably no better than yours. But, I do think a lower corporate tax rate is likely, I think it's more than possible, I think it's likely.

I think there will be some things that will be done to help pay for that. And there is discussion about what there would be denial of deductibility of interest cost, for example, but they are also talking about immediate expensing of capital. So, you have to factor a timing issue or the permanent issue. And then, obviously what nobody really has a good handle on is what happens in the way of trade, border adjustment tax and so forth, and how that plays into this. So, it's really up in the air in terms of what this will look like. But, I would tell you, I'm optimistic something would happen. And as John pointed out, none of that has been factored into our numbers and the guidance that we have given you.

If tax reform does happen this year, the biggest payoff to AT&T, more than just the tax rates is what happens on the business side. I mean, an extra 1% growth in GDP over the next couple of years is rather significant for AT&T. And if a tax rate cut caused all businesses to think about investment the way AT&T is thinking about it, and all businesses begin to invest, that has nothing but a stimulative effect to our customer base. We have a very large enterprise business customer base. So, we think this is nothing but positive. In fact, I told some people last week in Europe that back in July, we had a Board meeting, and after we concluded our long range plan, the Board asked us to lay out for them what a recessionary environment in 2017 would look like. Fast forward to December, the Board wanted to talk about, what an upside scenario in the economy would look like. And nothing happened between those two, except an election and a President who is talking about corporate tax reform. So, I think this is very significant and very, very important.

In terms of regulatory, in terms of what to expect, all I can base my thoughts on, John, are Ajit Pai's writings and his comments. And he obviously was not a fan of the Title II regulation that was imposed on the industry. He felt like it had gone entirely too far; we obviously tend to agree with him on that. We happen to be advocates of net neutrality, just the concept of neutrality but placing utility style regulation on our mobility and internet businesses. There is no way anybody can argue that that is not suppressive to investment.

And so, we're hopeful that Chairman Pai will come in and begin to address some of these issues that are suppressing capital investment. We're also optimistic that he would begin to rationalize some of the regulatory oversight, areas where -- like on privacy. We have two layers of regulation on privacy in this industry, in a world we're moving into media and entertainment and content. The ability to have predictability and understand who oversees the privacy rules and who sets those rules, and so bringing some clarity to that, it just will be very, very helpful to clear the underbrush of regulation, bring clarity and some level of predictability to the regulatory environment. So, we're optimistic in terms of what Chairman Pai would bring to the industry.

Operator

Thank you. Our next question is from Phil Cusick with JP Morgan. Go ahead, please.

Phil Cusick

Can you talk for me about the success of foreign cross selling, broadband and wireless into DIRECTV homes? We haven't really seen the pick up yet of broadband, the way we would expect it with DIRECTV coming in? And how's that been going into wireless as you discount across those businesses; has it been more existing customers that are tying things together or are you really starting to see a cross-selling effect? Thanks, Randall.

Randall Stephenson

I'll tee it up, and then John, I'll let you follow up my comments. But, as we told you, coming into the year, it was going to take time to get the cross-selling, just the plumbing and the mechanics in place to be aggressive on cross-selling. And we are at a place now where the last three quarters we have seen multi product sales just continue to escalate. And they are little bit behind our plan, but I would tell you, the last two quarters are starting to catch up to plan. So, cross-selling on each sale is really getting to levels that we’re feeling more and more comfortable with and better about. So, I think it's really good.

Early on, you hit the nail on the head; it has been our existing customers that are attaching the services to each other. And so DIRECTV customers, who are attaching unlimited wireless with their DIRECTV bundles, but we are seeing some migration of wireless through the DIRECTV product sets s well. And I think the best place is this is manifesting itself, Phil. We were probably not the most promotional in the industry in the fourth quarter. And we set a record low churn rate in the fourth quarter. And it's getting to a point where we are beginning to be able to attach causing effect to a lot of the integrated solutions and the integrated offerings including unlimited data, data free TV and so forth. So, we’re early in the game, the plumbing is now getting put in place and the billing is getting refined; we’re still not completely there on the plumbing, and we’re investing a lot of money to make that happen. But early indications, we’re feeling pretty good, are starting to take hold.

John Stephens

Yes. The only thing I’d add, Phil, is if you look at the churn characteristics and then really strong performance on the mobility side, we attribute some of that to this video bundle with the wireless property. We have about 8 million customers now on that unlimited video bundle, and we believe that that's providing real cross, if you will, product improvement.

Finally, if we look at where we are going with the fiber to the prem on the 4 million homes we are selling into, the vast majority of those high-speed broadband sales are taking multiple products with us. So, that continues to go well, taking not only the broadband but the video and also the wireless. So, that continues to go well.

And then lastly, the attach rates that we are having through both, the video and the -- excuse me, the broadband and the video product continue to improve throughout the year. And so, the efforts that Randall talked about and training -- getting the plumbing right and training the call center people and training the tax and so forth is paying off. We remain optimistic about it; we’re going to be cautious and make sure that we prove it out, but it is going well. And as I say, the strongest point might be the $8 million customers who quickly bundled their video and their wireless offering, and you see it quietly frankly in the churn results we have. It's really very good.

Phil Cusick

If I can follow up, how did the sales of paying DIRECTV NOW customers lineup to either your wireless or fixed businesses?

John Stephens

I think what we will you is that we are still going through all that details and you got to remember the DIRECTV NOW customer sales are much different with regard to the necessity. When you are paying with the credit card online, the information you have with regard to physical location and so forth is different. But, what we are finding is, as we mentioned, they are more urban, they are younger and they are apartment dwellers. And so, they are giving us an opportunity, we believe, to penetrate a market wireless and other products where we don’t -- where we are not as effective as we are in some of the other markets. So, we think it's real opportunity. So far, it is lining up I think as expected in that urban, that multi-dwelling unit, that young marketplace and then a marketplace that, if you will, we have an opportunity to grow share to get to some of the same levels as we have of share in some of the more established markets.

Operator

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

David Barden

I guess, if I could too, the first one for you, Randall, just in terms of Pai’s is pretty clearly stated positions on the open internet order and price regulation, and even things like zero rating. Could you kind of map out a game plan that AT&T would have for taking advantage of that? And what kind of appetite do you see in Silicon Valley in the content community for trying to take advantage of some of the zero rating offerings that AT&T has? And then, second, if I could for you John, on the guide, if you could, maybe unpack the revenue growth outlook a little bit as to what the biggest moving parts are. And if I annualize the depreciation benefit you got quarter-over-quarter, it looks like there is about 1.8 billion of lower depreciation incrementally in 2017 that would otherwise help earnings. I think you said it was going to go away to other non-cash items. If you could kind of lay out what those are would be great. Thanks.

Randall Stephenson

Hi, David. As it relates to our plans, on zero rating under a Pai chairmanship, I’d say that you shouldn't expect that they will change. We were going hard, and we had worked very diligently to put in place a mechanism that makes this capability available to all comers. Anybody who wants to take advantage of zero rating, they can come in and take advantage of the lowest wholesale rate we offer, and they could do the exact same thing. So, we put this in place in a very thoughtful fashion, in a fashion that is consistent with many, many years, in fact decades of precedent in terms of how we implement something like this. And so, we actually were quite confident that zero rating, as we were implementing it, was fine under a Pai chairmanship or anybody else's chairmanship.

Now, the FCC obviously issued a letter the last week of the prior Chairman's tenure, and the letter was critical of it. But we think the letter is without basis, any legal basis. And so, you should expect to see us go hard. We're having some really good success in the marketplace with this. This is a value proposition that our customers area loving. 200,000 DIRECTV NOW subscribers are on it; they are taking advantage of it; it is a very elegant experience if you're a customer that you're watching AT&T content and it's not counting against your data bucket. So, that's a big deal and it's proving to be very advantageous in the marketplace for our customers. So, you should expect to see us continue that and continue to push aggressively on this.

I'll tell you, if you wanted a prospective on 200,000 subscribers and how attractive this was in the marketplace at $35 price point, we launched U-verse back in 2007. It took us a year and a half to get to 200,000 subscribers on U-verse. So that's the elegance of this platform and the attractiveness of it to our customers. So, we're pretty excited about it.

John Stephens

David, with regard to the kind of giving a little some additional insight into the guidance, I'll go about it this way. On the mobility side, we've seen the penetration of mobile share value plans, unlimited plans and these bundled plans increase dramatically over the last three years. So, we're substantially through that migration. And we believe that with that, we have this opportunity to not only retain customers and continue to show good subscriber mechanisms results, but also have an opportunity on the revenue side to prove that out. We're not giving specific guidance on individual items.

Secondly, with regard to the handset business, we did see a year-over-year slowdown in handset upgrades, even in the fourth quarter, even with the launch of a new device, an iconic new device. So, we are learning about what the customers want. We've given them their choice; they shown up with more BYOD; they chosen to hold their devices longer and pay off their equipment installment plans in full. And that's all been good for us; it's been good for our retention, for our customer accounts, for our churn, but quite frankly it will impact depending upon how popular sales are, how many upgrades we have, the revenues going forward from the equipment sales. I'll point out, this year, we had gross adds that grew year-over-year, we had upgrades that were down significantly year-over-year. And so, we are sharing in the new competitive market, but our customers that are staying with us, because of low churn are choosing to hold devices or bring their own devices to us.

On the business side, continue to have good penetration, good success with wireless, Internet of Things, connected devices all the capabilities there. And our outlook is still optimistic about that. The challenges with regard to the traditional legacy business revolves around the economy. We continue to see good success in strategic services, once again the best answer for that might be tax reform from a perspective of as Randall mentioned, if people think similarly to us and take those savings and invest and build their businesses, it will be the best way for us to grow our top line, which will be really good for our customers, good for our shareholders, quite frankly good for jobs, so that that's aspect of it.

On the entertainment side, we're seeing good growth in the speeds that customers are taking on broadband and good response with the ARPUs associated with that. So, we remain optimistic and we're significantly almost completely through the migration to higher speeds that will continue on but we are on the IP broadband platforms.

If you look at the video business, we'll continue to see that video business grow and continue to see -- will learn about what happens with regard to our over-the-top product. And lastly, we have the challenges there of the legacy services that we'll continue to work hard to retain and to migrate into other services but that's the challenge. That's how we unbundle it, that's how we look at it.

The last piece I'll tell you is Mexico or international, Mexico continues to be a tremendous story of customer growth, which should give us the opportunity for revenue increases. The challenges there are quite frankly foreign exchange and what happens with the peso, so that we will see constant currency revenue, growth; we're confident of that. The challenge will be what happens with foreign exchange rates, and we haven't assumed any improvement in our base case. And then DIRECTV in Latin America is just continuing to perform really well from a management perspective in what continues to be a difficult tough economy.

With regard to the depreciation initiative, let me pose it this way. I'm not sure where the number came from with regard to the 1.8, I'd suggest you this. The depreciation benefit year-over-year, we're right around $400 million down, on a sequential basis this year -- and that's in this year's numbers, so that in and of itself goes to the comparison next year. But secondly, with regard to that depreciation, there is also other non-cash items, things like capitalization of interest with regard to spectrum, and as you know, we're putting more and more spectrum to use; changes at our benefit plans and benefit expense, those things will continue to impact it; amortization of customer installation costs; quite frankly income tax rules, all of those matters go to offset the depreciation. I would suggest you say we’re near the number you quoted, but the depreciation aspect of year-over-year.

What I'll really point you out to though is really the asset test for me and is the fact that we're going to -- we've given guidance that we will have free cash flow in the $18 billion range. And you can do the math on that, that free cash flow is consistent if not higher than our guidance with regard to earnings. So, we feel really good about our earnings and particularly feel really good about our cash flows going forward.

Operator

Thank you. And we'll go next to Mike McCormack with Jefferies. Please go ahead.

Mike McCormack

Randall, maybe just a quick comment on the overall competitive landscape in wireless. We saw a lot of different happenings this year, and you guys are obviously doing some bundling, T-Mobile getting aggressive, at least initially that free iPhone deal back in September. Just getting a sense for how would you characterize the industry and how do you think that changes as we look into 2017? And then, maybe just one for John on the economics, as you think about U-verse subscribers moving off the U-verse platform onto DIRECTV proper, what's the sort of economic trade off there?

Randall Stephenson

Hi, Mike. Competitive landscape, it’s really competitive. And in terms of what we think it looks like this coming year, we think it's really competitive this coming year. And it was -- fourth quarter was just a very promotional quarter. All the competitors got very, very promotional, and free devices and buy one get one free type stuff. We were probably less promotional than most and doing that while maintaining what was for us a record low churn rate, we felt really good about.

Our intention, as we move forward, is the same as it was the last quarter, and that is we're going to compete with differentiated solutions. And this integrated solutions for us is really, really important. And as we pointed out and as Phil was probing on, we’re starting to get real traction in the marketplace of integrating our products and solutions, and our churn rate goes down so precipitously, when we get more than one product bundled together and particularly, as we begin to do some creative things like DIRECTTV NOW and the TV Everywhere app on DIRECTTV is proving to be incredibly powerful. This thing -- the last numbers I looked at, John Stephens, you can you correct me if you have more recent information. But the volumes were growing like 40% month over month sequentially, and that’s the amount of consumption that people are using on their iPads and their smartphones and streaming video from DIRECTV on their devices. And that’s why the free data TV is so important, and is such an important variable for our customers.

And so that is how you should expect we will compete again in 2017, we're getting better and better at putting these packages together for our customers, and the customer adoption rates continue to go up. So, I think the next year is going continue to be very promotional; it's going to be probably, time will tell what happens on pricing, but I think you should expect the promotional activity to continue, we will compete with bundling and integrated solutions.

John Stephens

Mike, on the U-verse versus the DTV platform, I think it’s pretty straight forward. One is we still have some content cost differentiation and some package capabilities that are important, and we can achieve those. Frankly, it frees up the data capacity on the wired network, allows us to then provide broadband speeds that are quicker and quite frankly alleviate some of the CapEx in the back office, so to speak, or back into the network, and that's a positive thing. Third, it eventually lead us to the ability to use one graphic user interface support cost, on product support cost and one standard, if you will, face to the customer and those are all important.

The other opportunity though is does give us the opportunity to go to the customer and visit with the customer and make sure we maximize all the products and services we can sell to them including not only the broadband, not only the video, but wireless and others. So, that's how we think about it. We certainly are committed to continuing to provide a quality video product in either case and we are continuing now to, if you will, provide an over-the-top that allows us to do it whether we utilize either a wired or a satellite network. So, we're trying to cover all bases to look at all opportunities.

Randall Stephenson

Mike, I don’t want to bounce around on you but I want to follow up though on the competitive environment because all I spoke of was the consumer side of the market. I want to make sure that we didn’t leave out. The lion share of our wireless business is business side, and we are continuing to grow their very nicely, our wireless business to business customers. And that again, like the consumer side, but we’re much further down the path on integrated solutions in wireless. Because if you think about where this has gone and where we are having our greatest success is our customers, getting them from the mobile device on a secured network VPN connection into the cloud using NetBond and back out without ever touching to public internet. This is proving to be very powerful capability for our business customers. And then, we are having incredible success brining IoT solutions to bear along with this. And we think we’re leading the industry in the Internet of Things capabilities that are integrated in are VPN and in our mobile business together, it's proving to be a really powerful combination for our customers as well. And so, bottom line, the growth of wireless from our B2B side of the house or business customers is continuing to be fairly robust, and it's a terrific business. And that is kind of the big proof point on if you could truly bring integrated solutions to bear, the significance it has in the market, and you compete in the different level, not just on promotions and price.

Operator

Thank you. We now have a question from Amir Rozwadowski with Barclays. Please go ahead.

Amir Rozwadowski

I was wondering if we could touch back on your guidance for 2017, and your guidance calls for adjusted operating margin expansion. How should we think about the trajectory of your wireless business within this context, against a backdrop of what you mentioned will likely be a continued healthy pricing environment for wireless? And then, in terms of your guidance for free cash flow, you are pointing to $18 billion in 2017. Previously, you had suggested that cash flow could reach about $20 billion by 2020 plus. Based on this current trajectory, it seems that that target could be pulled forward excluding Time Warner as well as any tax legislation changes. Is that a fair assumption? And what are the operational puts and takes that could get you there?

John Stephens

Let me take a shot at this. First off, first regarding the margins, as you might expect, we are not going to give individual guidance on margins but I would point out something that I think is straight forward. And that is we have gotten 78 million 4G LTE POPs built in Mexico; we've got a 160 plus markets that we've got distribution, brand, knowledge, sales opportunities, and if you will, effective markets, and we've grow the base of customers to 12 million. So, we expect improvements in Latin America. You guys can see the numbers are clearly just in Mexico particularly, you can see they're clearly displayed with what we did in Mexico. So that will in and of itself, give us a tailwind to improving margins. That's the first point.

Second point, we clearly have momentum in our wireless business on improving margins. The team has shown that every quarter this year going back to last year. Challenges there are the point when we decide to, as they did in some cases in the fourth quarter, decided invest in growth, and we will continue to do that on a very diligent, thoughtful manner. It was very effective in the fourth quarter, the team still came with great record margins. But I don't want to specific statement guidance on margins, because we want to make sure the business units have those tools at their disposal, when they are performing at this level, to invest in growth and get good customer.

So to summarize and really if you look first at the opportunities to get there, it's everything the network operation is doing, the fact that year-over-year our, if you will, back office, our network, our ATNO [ph] costs are down. If you see the heavy lifting work, if you see what's going on in the sales teams and the business unit operations and their tremendous performance on management expense, those all give us momentum. You see what's happening in Mexico in a sense that we have now built that platform out significantly and are ready to start operationalize it; that will give you that confidence. I feel really good about that opportunity.

Randall Stephenson

Amir, to John's comment, he's made it twice, and it bears pairs repeating and maybe emphasizing, and that is there is a lot going on inside this business right now. And by virtue of software defined networking implementation and a lot of the automation that is going on in our network and IT organizations, that big cost structure, the network, the big iron network and all of our IT costs. Year-over-year, they are actually down, and not in consequently, they're down. This cost curve is actually on the run. And I've never seen this in my -- I've been doing this 35 year and I have never seen anything like this. In 2017, we're forecasting the exact same thing and feeling really good about our ability to execute on keeping that cost curve moving down is providing a lot of support in a world of aggressive pricing and so forth to allow us to be competitive in the marketplace. So, that's a really important variable to take note of.

John Stephens

Amir, with regard to your comments, we are guiding to $18 billion in free cash flow, we feel good about that, it comes from all the activities that the entire team has pushed forward this year, really sharp cash flow management, everything from our supply chain, our working capital up and down, our management teams, our sales guys help us with it, everybody up and down the line, the network -- construction guys, managing their inventories, managing everything in the flow, all of that. So, we feel good, feel confident about getting to that $18 billion level. We're not going to guide past next year, but yes, that march or that drive or that progress towards $20 billion is really occurring, and we feel good about the progress we're making.

I don’t know that -- I don’t believe we've given any target of a year to get to any specific level outside of next year. But with that being said, we're expecting the $18 billion range next year and we feel really good about the cash generation opportunities of this business. What Randall just said is just an easy way to give that credibility when the hard costs of this business are going down year-over-year, when the management team is performing at their level, you get momentum, when you get momentum when software network function virtualization up to 34% and have a track now to 75%. And when you see those kinds of things happening, it gives us confidence that we can continue to grow the cash of this business, which is really an underlying support for the overall profitability; it's really the proof of the overall profitability of our business.

Operator

Thank you. And our next question is from Simon Flannery with Morgan Stanley. Go ahead, please.

Simon Flannery

John, I know we've talked a lot about taxes already, but could you just give us a sense of what your cash tax rate is likely to be relative to your book tax rate this year, assuming no changes? And then, Randall, we talked about the economy a couple of times, but you usually give a broader view of what you are hearing from CIOs and CEOs and others in terms of the environment. I thought there were a couple of comments in the business solutions about some pressure in some of the legacy products. Is there any change there or is that sort of business as usual?

John Stephens

So, I'll take a stab with the cash tax question. I'll say it this way, we're not going to give specific guidance on cash taxes. It's clearly included in our overall cash guidance. What I'll suggest you that the depreciation rules, the bonus depreciation rules, we see a lot of benefit to companies that invest in Latin America as we do, but still in place. And there is no significant large changes in our assumptions. And so, I can't point to anything that I would imply would significantly change -- that I could point for an easy significant change in the year-over-year basis. Specifically, we're talking about a $22 billion CapEx range, which is similar to what we spent last year. And as I think we on an every year basis are very, very diligent about managing our cash from the tax side and there is no reason to expect that to change.

With that I'll leave it at that and hand it off to Randall.

Randall Stephenson

On the economy, Simon, we have assumed for 2017 a steady as she goes economic growth rate or GDP growth rate, it's actually a sub 2 is what we have built into our plan, what's built into these numbers that you are looking at here. I would tell you my sentiment I don't think is unique among the CEO community, and that is that I am optimistic as I look forward, and I'm optimistic that if we get line of sight to real meaningful tax reform, if we get line of sight to -- and it won't be when it passes, when we get line of sight, we will begin to think differently about areas we are investing in. I don't think I'm unique in that regard. Conversations I'm having with CEOs, as we get line of sight to this, I think you are going to see people begin to open up the first look and begin to invest at a higher level. And so, once that happens that is -- there is no driver to economic growth like investment. I happen to be a supply side guy, I think the math and the science is with me on that. And as investments ticks up, economic activity ticks up, hiring ticks up; as hiring ticks up, spending ticks up. And so, I'm actually of a mindset that if we get a tax reform, we could exit this year doing something better than what is in this plan. And so, call me optimistic. And if we get tax reform, I do think that there is upside to these economic forecasts. And if we get tax reform, I would suggest that maybe upside to these guidance that we are giving you but it's wait and see.

And I'll also say that it's not an inconsequential attitude, if you will, among the CEO community about the potential in terms of what can happen with regulation. And nobody thinks that regulations should go away. We all believe that the customers still needs protection and safety and all that is so critical. But we've had a regulation that has been just unpredictable; it's interfering with how you think about designing products; it's interfering with how you think about entering new markets. And if you really begin to get confident, the regulatory burden is rationalize somewhat, that in and of itself is going to free up investment. And so, I think as you know, GDP and economic growth is much a function of attitude and confidence as anything else. And I would tell you, a lot of people are feeling confident that there is going to be meaningful tax reform that's going to have its effect, but too early to tell right now. We're kind of -- our guidance is premised on a steady as she goes, but I think there is some potential for upside on the economy, if we get tax reform.

Operator

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

Brett Feldman

I am actually just going to follow up on that because Randall, you said you would see the opportunity to invest more, if there was tax reform. And it sounds like part of that is simply supporting your customers who would probably have more investment needs and more growth. But are there certain business cases that you guys have been looking at where if there is tax reform, all of a sudden the math changes a lot and I'll just make something up, for example, instead of stopping at 12.5 million fiber homes, you would go much beyond that. I am just trying to think about opportunities that are unique to your business where you might accelerate capital if the reforms go the way you hope they would.

Randall Stephenson

So, I can -- you touched on one, would we go beyond 12.5, I don't know, but would we accelerate the 12.5, I think we try to look at whether we could bring some of those forward. We're in the process of deploying 40 megahertz of spectrum, are there some things we would do forward some of the wireless build and bring our speeds, our mobile speeds up considerably. And let's assume, and by the way this is unknown, but we were to win the first net bid, we want to go faster on the deployment of first debt with tax reform. I mean there is just a long list of things that the business cases really good, or you could accelerate some of your build requirements and accelerate the business cases on many of these.

John Stephens

And Brett, I'd offer -- this is exactly what happened this year with our fiber to the prem build. The team hit this year's goal and hit this year's CapEx budget, so to speak, prior to year-end, and they came back and said we can keep going and we can get more done efficiently and effectively but you've got to give us some more money. And we did just that with bonus depreciation in place this year, it gave us that opportunity to justify the business case and move it ahead. That’s one of the variances, if you will, in our CapEx spending, but it's exactly the situation you're talking about.

Randall Stephenson

With that, I believe that will be the last question. And I appreciate everybody participating in this. I've got to tell you, we're feeling really good about what we have built here. And as we look forward to bringing Time Warner into the fold and doing some very unique things with media and entertainment and content in this foundation of networks, we're feeling really, really positive and excited about bringing that together. So, thank you for your attention, and we will talk to you next time. Thank you very much.

Michael Viola

Thanks everybody and on your way home tonight, please remember no text is worth a life. It can wait. Thanks and take care.