Operator

Ladies and gentlemen, thank you for standing by, and welcome to the AT&T first quarter 2017 earnings 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.

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

Michael J. Viola - AT&T, Inc.

Okay. Thank you, Kathy, and good afternoon, everyone. Welcome to the first quarter conference call. Good to have everybody with us today. Joining me on the call is Randall Stephenson, AT&T's Chairman and Chief Executive Officer; and John Stephens, AT&T's Chief Financial Officer. John's going to cover our operational results first. Randall's going to follow that with an overall business strategy update, and then we'll get to the Q&A session. As always, our earnings material are available on our Investor Relations page. You can find that on att.com/investor.relations.

I need to call your attention to two Safe Harbor statements before we begin. That's on slide 3 and slide 4. They say that some of these comments today may be forward-looking, and as such they're subject to risks and uncertainties. Results may differ materially, and additional information is available on AT&T's and Straight Path's SEC filing and on the Investor Relations page of each company's respective websites. And, finally, we still remain in the quiet period for the FCC spectrum auction.

And so with that I'd like to turn the call over to AT&T's CFO, John Stephens.

John J. Stephens - AT&T, Inc.

Thanks, Mike, and thanks to all of you for being on the call. Before I turn it over to Randall, I'd like to provide you a brief overview of our first quarter results.

We opened the year on a very competitive note. The wireless market moved to unlimited, several over-the-top video players launched new services, and a major cable company announced plans to offer wireless service in an effort to duplicate the integrated experience we offer today. All this reinforced our belief that we are the best prepared for the new world, where capacity, networks, and entertainment intersect.

A year from now, we may look back on the return to unlimited plans as the moment when the battle for network reach and capacity began. In a world of unlimited plans and growing mobile video usage, you need a network and the capacity to handle the load and meet customer expectations for quality service. We have just that, and Randall will talk more about that in just a few minutes, but let's first look at the results for the quarter.

Consolidated revenues were pressured by record low postpaid upgrade rates in wireless and pressure in legacy wireline from grooming, but at the same time, we continue to operate efficiently and drive costs out of the business. Adjusted consolidated margins were up 80 basis points year over year to 20.7%. Credit for this goes to our entire management team but especially to our technology and network ops group and their work on automation, digitization, and network virtualization. We're well on our way to virtualizing 55% of the network functions by the end of the year, and we are seeing the cost and capital savings from those efforts.

We grew adjusted earnings. Our adjusted EPS for the quarter was $0.74, up about 3%. That includes about $0.02 of pressure from storm damage on the West Coast and legal settlements. Also during the quarter, we wrote down the book value of our legacy publishing investment. That was partially offset by gains from a spectrum swap with Verizon. Both of those items were adjusted for EPS purposes.

Cash flows continue to be strong. Cash from operations reached $9.2 billion. Free cash flow was $3.2 billion, the same as last year, even though we increased capital spending to $6 billion for the quarter. We had improved working capital and lower tax payments in the first quarter and chose to reinvest those efforts in the business. While this made first quarter capital spending levels higher year over year, our CapEx guidance remains unchanged.

This also was a key strategic quarter for AT&T. We made several significant moves that put us in a strong spectrum position for the future. We signed an agreement to acquire FiberTower, a holder of 39 gigahertz millimeter wave spectrum, and we were awarded the FirstNet contract to build and operate a national first responders network. And earlier this month we announced our intention to acquire Straight Path. We have now been informed by Straight Path that their board has received a superior proposal. Under our existing contract with Straight Path, we have the right to negotiate with the company over the next five business days to match or exceed the new bid. We will evaluate the situation and make a decision in that timeframe. And we also received the expected $1.4 billion refund of our deposit from the FCC broadcast auction last week. Randall will provide more insight into our overall strategy in a few minutes.

Now let's look at our operations, starting with wireless. Those details are on slide 6. 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.

The reintroduction of unlimited plans made an already competitive market even more so. We were disciplined with our response, which was to launch new Unlimited Plus plans that give customers a $25 credit for bundling DIRECTV or DIRECTV NOW with their mobile service. And earlier this month we announced a limited promotion for free HBO for our Unlimited Plus customers. The changes in the market did impact our postpaid net adds, especially in the first part of the quarter before we began offering our new Unlimited plans. Our moves to combine the value of mobile with video have had the desired positive effect. In fact, trends are now back to where things stood before Unlimited plans were reintroduced by our competitors back in February.

Revenues were also impacted by fewer phone sales. We had our lowest ever postpaid upgrade rate of 3.9% in the quarter, selling 1 million fewer phones than a year ago, while bring-your-own-device customers remained strong. This obviously impacted equipment revenues and to a lesser degree some service revenues. But, despite all the competitive noise in the quarter, we turned in our best-ever EBITDA margins. Our EBITDA margin was 41.8% with wireless service margins of 49.3%.

Postpaid phone-only churn was also a record first quarter low of 0.90%. But with the lower phone sales, we also had fewest postpaid tablet net adds in more than five years, adding about 100,000 new tablets. We did add more than 2 million subscribers, as record connected device net adds and a solid prepaid quarter helped to offset tougher postpaid and reseller results. We also continue to grow our branded smartphone base, adding nearly half a million smartphones in the quarter.

Our Entertainment group also saw competitive pressure. Revenue and margins were relatively stable. West Coast storms did drive up expenses by about $100 million in the quarter, with about two-thirds of that allocated to our Entertainment group and the rest to Business Solutions. But these costs, along with higher content costs and our investments in DIRECTV NOW, were largely offset by merger synergies and disciplined cost management. Linear TV subscriber gross adds were consistent with previous quarters, but with annual price increases due to content costs going up. Churn was up, particularly in markets where we don't have broadband to bundle with video. Competitive pressure from cable and the increasing number of over-the-top video alternatives resulted in our video subscribers declining in the quarter.

We're taking steps to address the situation, including simplifying offers and bundling with unlimited wireless.

At the same time, DIRECTV NOW is an important part of our strategy and continues to add customers. We deliberately pulled back on marketing to give the platform time to mature and improve, and we're seeing just that. You should expect us to be more aggressive with DIRECTV NOW in the second half of the year, with additional features and content. Last week we added 14 FOX affiliates to DIRECTV NOW. You should expect we will be targeting those cities with additional marketing. We're still only five months since the DTV NOW launch, but we like what we see and feel very good about the service and where it's headed.

Broadband had a very strong quarter, with 115,000 subscribers added. Our moves to simplify pricing are paying off, and our fiber deployment is making inroads. AT&T fiber is now in 52 metro areas and marketed to 4.6 million customer locations. We expect to add 2 million fiber locations this year, to reach 6 million by the end of the year, and to meet our 12.5 million merger commitment goal by 2019.

Now let's look at Business Solutions on slide 7. In the business segment, we saw weaker demand than we expected. U.S. business investment as a percent of GDP continues to be low. Growth expectations in the economy have been rising, but we've yet to see that translate into economic gains or demand. We're still hopeful that growing consumer confidence and the possibly of tax reform will turn into increased business investment later this year, but the near-term view is cautious. We also continue to see the impact of technology shifts away from the traditional voice lines and other legacy services.

Customers are still buying our strategic business services, which were up more than $200 million in the quarter. And wireless service revenues grew in the quarter, but lower equipment sales pressured overall results. Like in other parts of our business, we stayed ahead with a relentless focus on cost efficiencies. You can see that in our margins. Margins actually expanded by 90 basis points and were the highest in four years, and that included improvements in both wireline and wireless margins. Our business team is doing a good job in a tough situation. Increasing profitability in a challenging revenue environment is not easy.

Meanwhile, our international businesses had a very good quarter. We grew revenues in both our Latin American and Mexican operations, improved margins and added customers. In fact, EBITDA has more than doubled year over year. We've made a lot of headway in building our network and our brand in Mexico. We now reach 85 million people with our LTE networks;

we've rebranded, updated, and opened new stores and trained our people. We are now actively scaling our customer base to match those investments.

We added 3 million subscribers last year, and we had a good start to this year by adding more than 600,000 new customers in the first quarter. That brings our customer base to 12.6 million. Revenue grew and margins improved both sequentially and year over year. Latin America satellite operations also showed revenue growth and margin expansion. Revenues were up more than 10%, even when excluding the foreign exchange lift in the quarter. The bottom line for our video business in Latin America is that it's profitable and continues to generate positive free cash flow.

Now, before I turn this over to Randall, let me quickly review our outlook for the year. As we told you earlier in the year, when the FirstNet contract was officially awarded, we would update our 2017 guidance, and we'll update again following the close of the Time Warner acquisition. Because the FirstNet state opt-in process is expected to flow into the fourth quarter, FirstNet is now expected to have little impact on our 2017 P&L results. That being said, the FirstNet build efforts and reimbursement process might have a manageable impact on CapEx and cash flows, depending upon the timing of FirstNet reimbursement. So as it relates to guidance we're still expecting adjusted EPS growth in the mid-single digit range. We're expecting adjusted operating margin expansion even in the current competitive environment. Our capital spending guidance remains in the $22 billion range, but with FirstNet it could be at the higher end of that $22 billion range. And free cash flow is expected to be in the $18 billion range, and it may be a little bit on the low end of the range with the timing of the FirstNet reimbursements.

You'll notice that we have stopped providing revenue guidance. The reason is pretty simple: Upgrades rates are hitting record lows. Our revenue forecasts depend on how many phones we expect to sell during the year, and that's uncertain. And we don't know how much demand there will be for any of the new product offerings that come out. Changes in customer phone buying habits have minimal impact on our profitability, but it does make revenue forecasts more unpredictable.

With that, I would now like to hand this over to Randall Stephenson, who is going to provide a strategic update on our overall business. Randall?

Randall L. Stephenson - AT&T, Inc.

Thanks, John. Listen, I thought what we'd do before we get into the strategy update is just – I wanted to just give you my take on the quarter, and there's just a handful of things that stood out. And the first was that churn was up significantly on our standalone pay TV product, and that's where TV isn't bundled with our other services. And that's really what's behind the decline in TV subscribers for the quarter. And so you should expect us to make some adjustments in the market to address that as we move into the rest of the year.

The second thing I'd call out is the performance in cost management. And to grow EPS – and John pointed this out, but to grow EPS and cash flow and expand margins in this kind of competitive environment I think is noteworthy, and it doesn't happen without some really terrific execution in driving costs out. And it's that execution on the cost side that gives us a lot of confidence to reaffirm our profit outlook for the year, and that's a big deal.

My third observation is one that John talked at length about, and that's the return of unlimited plans. And obviously this has made an already competitive market even more so. And our response to the unlimited data plans was probably a little slow. And we lost some share in the quarter, but it was really important that our unlimited offers be unique and play to our strengths. And John talked about this as well a little bit. But we're combining our unlimited with some significant discounts on TV and free HBO, and as these offers are now in the market our subscriber metrics have returned to kind of the same levels they were before all these unlimited offers began.

And kind of the sum of it is it appears the industry has gone through a lot of activity during the quarter and has essentially landed back in the same place where it started. So what the return of unlimited really highlights, and that is the industry's position in terms of network capacity, because if the industry is going to stay with unlimited, we're prepared and can probably sustain it better than anyone else because of our spectrum position. And it is the best in the industry.

And this would probably be a good place to talk about the foundation that we've built for a world of intense video consumption in the world of mobility, and so let's go to slide 10. This network we've built, it was designed for video. And our LTE network covers more than 400 million people in Latin America, and this morning we announced that we're significantly increasing the network speeds in several major cities this year as part of our 5G evolution. And Austin is now live. Indianapolis will turn up this summer, and then at least 18 additional markets will be turned up later this year. And then we have the new Samsung Galaxy S8, which is the first device that's going to be able to take advantage of these higher speeds.

Obviously our satellite distribution is very well-equipped for a world with 4K video, and it covers the U.S. and most of Latin America. We have the largest fiber footprint in the country. We pass nearly 6 million business locations with fiber today, and we're in the process of deploying fiber to more than 12.5 million customer locations by 2019. Now, this fiber footprint is proving to be a huge competitive advantage as the industry is moving towards 5G. We're also leading the industry in software-defined networking, and this is the driving force behind our cost structure. And it's also changing how we deliver new services.

And then on spectrum, it became clear several years ago as we began to anticipate a world of premium mobile video that spectrum would be the difference maker. So we took a deliberate strategic approach to building up our position, and today we have the leading spectrum position in the U.S., and I'm going to discuss that more here in a moment.

All these investments are creating a very unique platform for what we think is a very unique customer base. It's 147 million mobile subscribers, 47 million pay TV subscribers, a fast-growing OTT video service, and 16 million broadband subscribers.

And if you look at slide 11, I now want to drill down on this spectrum position that we've spoken of a lot here on this call. We picked up 20 megahertz of nationwide mid-band spectrum with our WCS acquisition back in 2012. Recall this is where we picked up a lot of companies and the FCC helped us get these licenses for mobile broadband. Then we bought another 20 megahertz of mid-band spectrum in the 2015 spectrum auction, and that block covers virtually the entire country. Then after extensive assessment of the FirstNet RFP, we set winning the contract as a top priority for this company. We worked it hard, and our effort paid off last month. And along with winning FirstNet, we get another 20 megahertz of premium low-band spectrum to build this network. And then any surplus capacity can be used for our commercial customers. And then finally we shut down our analog 2G network last year, and we're redeploying that spectrum nationwide as well.

So you add it all up. We now have more than 60 megahertz of fallow spectrum that we're ready to light up, and we'll be deploying all the bands simultaneously starting this fall when states begin to opt in to the FirstNet. The efficiencies we'll gain from climbing the tower once to put up multiple bands of spectrum, those efficiencies are significant. And we're going to see those cost savings and the network performance materialize immediately and then throughout the life of this multiyear buildout.

And so with that, let's talk about 5G. As you know, it requires higher band spectrum that can transmit huge amounts of data over very short distances. So earlier this year we announced our first millimeter wave acquisition with FiberTower. And this gives us a very nice nationwide deep footprint in the higher bands. We filed for the license transfer, and we expect the FCC to approve this in late summer. Then a few weeks ago we announced our intent to acquire Straight Path and its nationwide millimeter licenses, and there's now a competing offer, as John pointed out, and we're going to be evaluating that over the next few days and decide how to respond. The bottom line: We've built the overall leading spectrum position that's going to allow us to fulfill our goal. And our goal is to put 1 gig speeds in our customers' hands no matter where they are on our network.

Before I get to your questions, I'd like to briefly address what's been going on in Washington, and there's an outline of that on slide 12. It's obviously been an amazing few months in our industry. And there's clearly a return to a lighter touch pro-growth regulatory philosophy, and that's not only in our industry but it's across all industries right now, and we think this is incredibly positive for our country and that it could catalyze the economic growth all of us have been looking for.

On the Time Warner deal approval, it's moving along as expected. The European Commission has approved it. The Department of Justice is now reviewing it, and we're working closely with them to answer any questions that they may have. On the FCC side, since there are no license transfers involved, we don't anticipate the FCC will review it at all. So bottom line, we continue to expect approval of the deal end of this year.

On regulation in general, the changes at the FCC have been quite positive. The controversial rules around business data services that had been proposed earlier have been abandoned, and they've been replaced by a logical, commonsense approach that preserves competition. The proposed set-top box regulations are now off the table.

On data privacy, the president has signed legislation that should give us a consistent set of rules that apply equally to all companies. And then Title II regulation is under review, and I want to be real clear about this. We do continue to support fundamental tenets of net neutrality, and we remain committed to open Internet rules that are fair and equal to all players. However, we do continue to think it's illogical to regulate the Internet using rules that were put in place 83 years ago for the rotary dial telephone. We're hopeful the FCC will follow through on that as well.

On corporate tax reform, we continue to believe that something does get done this year, but the timing and the magnitude of it are anybody's guess. But achieving competitive corporate tax rates, this is probably the biggest catalyst available for our public policymakers if they want to increase capital investment and job creation, so we think this is really important.

And so with that, Mike, I'm going to hand it back to you, and we can go to questions.

Michael J. Viola - AT&T, Inc.

Okay. Kathy, we're ready for the Q&As, and we'll take our first caller.

Question-and-Answer Session

Operator

Thank you. Our first question will come from John Hodulik with UBS. Go ahead, please.

John C. Hodulik - UBS Securities LLC

Okay. Thanks, guys. Maybe first on the -

Randall L. Stephenson - AT&T, Inc.

Hey, John.

John C. Hodulik - UBS Securities LLC

Hi. Hey. How you guys doing? First on the satellite business, or the linear TV, are you guys seeing cannibalization from the DIRECTV NOW product? And the churn you mentioned, is there a way you could ascribe it to maybe traditional competitors versus these over-the-top guys? And have you seen that accelerate since the launch of YouTube TV a few weeks ago? That's first.

And then maybe on the Straight Path and FiberTower deals, could you just comment on how quickly you think that gets deployed? And is the holdings of the millimeter wave spectrum that you would have if you were able to successfully complete the Straight Path transaction, is that sort of what you need to sort of fulfill your sort of 5G initiatives? Thanks.

Randall L. Stephenson - AT&T, Inc.

I'll start, John, and I'll let John Stephens clean up after me, okay? On the satellite question, there's obviously some cannibalization of DIRECTV NOW, but it's fairly nominal, to be quite honest with you. The satellite churn that I referenced, I mean, it is heavily concentrated, John, in those customers where we just have a standalone TV product. It's not bundled with broadband or it's not bundled with our wireless service. And so obviously it's a world where the integrated offers are what's winning in the marketplace. And so you can figure out who we're losing those subscribers to; it's traditional cable players.

And so this is where we're going to have to get aggressive in a number of areas, moving aggressively on bundling these satellite customers with our wireless offers and also doing some new things in the marketplace that we think can shore this up. But it's no secret where these are coming from; it's coming from integrated offers from other players in the market. And where we have multi-product bundles in the marketplace, those customers, the churn rates continue to be very strong. And in fact you saw our postpaid phone churn, 0.9%. You put TV or broadband with it, and those churn rates just get even better. So we continue to be big, big advocates of the integrated bundle and multiple service bundles. And so we don't see that changing. It's going to require us to get a little more aggressive in those single-play, standalone TV offers.

On Straight Path and FiberTower, so we've talked at length about when the standards are going to be out for 5G. I think we're now in 2018 time horizon.

John J. Stephens - AT&T, Inc.

2018.

Randall L. Stephenson - AT&T, Inc.

And so having equipment and handsets, we're talking 2019 before we start deploying in 2020 when you probably have what I would call scaled offerings. If we get both Straight Path and FiberTower accomplished, it pretty much fills our spectrum requirements we need for a long period of time as it relates to 5G deployment, John. So right now this is all preparing for the future of 5G, and the standards are on track, and we hope to be deploying and putting this spectrum to work in the 2018-2019 timeframe, scaling in 2020.

John J. Stephens - AT&T, Inc.

John, with regard to that on – as Randall said, the FiberTower itself gives us a base of 39 gigahertz nationwide to really build on and plan on. And so that in and of itself is a great starting point and gives our network team an opportunity to incorporate that planning into our project evolution and this next-generation network. When you look at Straight Path, it really has two holdings, the 39 gigahertz, which would complement FiberTower's and give us that depth that we would prefer, and so that would be great, but it also adds a strong 28 gigahertz piece, which we could incorporate into our network and use that way, or we could, as we've done in the past, use as an opportunity for spectrum swaps to take advantage of other opportunities.

I can give you a perfect example; this last quarter I mentioned that we had about a $100 million gain on the spectrum swap with Verizon, where we traded some PCS and AWS – three licenses to get both of ourselves in a better position to serve our customers. So that's where I'd leave us. The 39 gigahertz would be a great depth of position, and quite frankly with FiberTower an opportunity to really plan on that build as we go into project evolution.

John C. Hodulik - UBS Securities LLC

Got it. Thanks, guys.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

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

Philip A. Cusick - JPMorgan Securities LLC

Hey, John. You mentioned project evolution. Can we talk about the timing of the FirstNet process and evolution? My impression is you have a lot of pressure to get that deployed, and given the timing of the state build process it could take a while. What are the things we should be watching to see this ramp up, and what happens in states where you don't get the state to come along on your FirstNet effort? And then, Randall, can you just talk quickly about – how do you see – I guess this is also for John, though. Any big issues in the corporate tax discussion that you might see out there, that we should be sort of cognizant of? Thank you.

John J. Stephens - AT&T, Inc.

So, hey, Phil, good afternoon. First of all, in the FirstNet process, we'll post the state plans here in June, open up the opportunity for the states to opt in. We'll actively work with the states, try to answer any questions, concerns they have, stay and (30:06) work with them and with the FirstNet organization, who have been really good to work with, and convincing the states that opting in is the right answer. So we'll go through that process through the summer and hope to get the states to move as quickly as possible with the, if you will, encouragement, that we are ready to go, and the first ones that opt in are going to get that first investment in their state, that build in their state, that job creation in their state. So we think that's a good strategy.

Secondly, with regard to your question about opting out, there's a couple of things that make it challenging, I think, for a state to go down that route. One is, there is a collection of funding that's related to the contract winner, ourselves, with regard to setting some national standards, setting up portals and other abilities to communicate with FirstNet responders, to communicate with states, to set national standards of interoperability, and so forth. Those monies are committed to the award winner and not to the states. Secondly, if the states choose to go it alone, they take the risk of any project cost overruns. And third, they generally don't have – and quite frankly one of our largest competitors doesn't have any owned network in the states to rely on, so they have a huge catch-up to do with a company like ours.

So we feel really good about the process and think that we are going to – we'll be very cooperative, we'll be very encouraging with the states to work with them, to make sure they feel comfortable. But our target is all 56 – 50 states, five territories, and the District of Columbia. We want to win them all, and that's our goal, so that's how we'll go about it.

Randy, you want to take corporate tax?

Randall L. Stephenson - AT&T, Inc.

I'll talk corporate tax. We can tag-team this one, too, because John is actively involved with folks in Congress on this. But, look, there appears to be significant motivation and significant interest by all parties to get our corporate tax rate to a more competitive level, and you can't find anybody in Washington – you might be able to find one or two, but it's rare to find even somebody in Washington who would argue that our tax rates are uncompetitive on corporations. So there is a definite interest in seeing this move.

From a business standpoint, what we're all advocating is really simple: It's got to be a competitive rate, and it needs to be a territorial system for taxing profits overseas. And if it was just a matter of trying to get to a competitive rate, that is probably achievable in short order. If you said what's a competitive rate, 25%, 26%, 27%, that's probably inherently achievable, and that would be very advantageous to the U.S. But I think there are some who aspire to try to do better than that, and you heard the president just this week articulate a desire and in fact challenged his team in the White House to get to a 15% rate.

Now, we would obviously stand up and cheer; we'd be huge advocates of that. But I think the practical reality of getting to 15% is you have to get yourself reconciled to some level of deficits for a period of time as you get the economic stimulation. So can you get some fashion of dynamic scorekeeping to justify it? The second is to get to a 15% rate without just blowing out the budget, you probably have to consider things like either VATs or border adjustment taxes, and we know the emotion that those are met with across the country. Now, we would probably be supportive, candidly, AT&T, if we could get a tax rate to 15%, we would be supportive of those kind of vehicles to make it happen, but we as a business may be in a minority in terms of entities receptive to those kind of vehicles to help get the tax rate down.

So there's going to be a lot of thrashing on this in Congress and with the White House in terms of really what is the objective and if the president is committed to a 15% tax, it's going to have to – it's going to take some kind of really serious changes in how we tax corporations to get there. Which we happen to think would be quite positive to economic growth and capital investment in this country. What would you add, John?

John J. Stephens - AT&T, Inc.

Yeah. I mean, with that economic growth, capital investment drives revenue for us, and that's really as important as the tax savings that driving those revenues would really be significant. And we would be able to invest with the cash flow benefit on a more rapid pace than even we are now.

Randall L. Stephenson - AT&T, Inc.

What's interesting is – you remember the Dave Camp proposal. You can get to a 25% to 28% rate just by getting rid of all the loopholes and exclusions, and that would be nice, that would be really helpful, but – and I think it would stimulate some growth. It's just not game-changer, if you will.

John J. Stephens - AT&T, Inc.

So let me make one other comment about FirstNet to make sure (35:22). We'll make some investments here starting right away with regard to the portals, with regard to the interoperability standard, that kind of equipment, that kind of investment, and that could affect our operating expenses and our CapEx. But we'll get reimbursements from the FirstNet fund, and we're expecting those to kind of generally offset in this year. Secondly, the reason for the not-significant impact on our financial results in 2017 from the overall is that – two things. One, the states opting in probably in the fourth quarter timeframe, at least in large numbers. And two, the spectrum being put to use generally being up and running in probably 2018 and at the earliest late 2017, but probably more like 2018.

In the accounting world, those two things will drive the accounting activity, and so the accounting for the spectrum costs and other things that are involved in this really don't start until you place that spectrum into service or until you've got completion of the state opt-in process. That's why we're saying, while there may be some impact, it's not going to be material. But I will add, if we were convinced that a state was opting in, if they had elected so and we had appropriate approvals from the state and the FirstNet authorities, we would be willing to start that investment process right away. We are anxious to get going, and we have the vendors lined up and the opportunity lined up to get it done.

Philip A. Cusick - JPMorgan Securities LLC

Great. Thanks, guys.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

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

Mike L. McCormack - Jefferies LLC

Hey. Thanks, guys. John, maybe just a quick comment on the wireless share loss, where you're seeing that. Is it more family share plans, or is it single lines and feature phones? And then on ARPU, what should we think about going forward as far as stabilization?

John J. Stephens - AT&T, Inc.

Yeah, sure, Mike. Let me say on the share loss, the feature phone continued to lose, but quite frankly with the unlimited plans being announced, we did see an uptick in the family plan losses and the attention on that. As we've come back with these unlimited plans and specifically with the offers to give the (37:43) $25 credit on DTV or DTV NOW and the opportunity for the HBO feature. We have seen the plans come back down, and we believe that part of the reason that's coming back to, if you will, normal or to pre-unlimited offer rates is because it's holding onto the families. We still need to go through that. It's been just a couple, three weeks, so it's early. But, yes, we did see some impact on both the standalone, if you will, feature phone type that we've seen in the past and the family plan.

With regard to ARPU, I would suggest to you we still have a little bit to go with regard to ARPU because we have really smart customer base, and they go through this process of figuring out which is the best plan for them and going to it, and that'll continue on. Secondly, we still have some customers on plans that have overage. And, as I said, if they're smart customers, they will migrate over to these unlimited plans and work through that.

But we are – I will tell you, if you look at our service revenues for the quarter, about 1% of the decline was really related to a decision we made last year to get out of the resale business in one of our specific large resale contracts, or to reduce that business, because the prices just weren't appropriate, and capacity was going to be important to us for our quality customers. And so we've seen some of the service revenue declines based on our decisions to back off of that reseller market, and I think you saw that in our customer counts. You saw it in our customer counts this quarter, but you saw it in our customer counts at the end of last year in the reseller market. And that was just a solid business decision we made based on realization – ARPU and per meg realization.

Mike L. McCormack - Jefferies LLC

Thanks, John.

John J. Stephens - AT&T, Inc.

Sure.

Operator

Thank you. We now have a question from David Barden with Bank of America. Go ahead, please.

David W. Barden - Bank of America Merrill Lynch

Hey, guys. Thanks for taking the questions. I guess my first one would be, John, for you. If we kind of look at the mid-single digit earnings per share growth target, it kind of implies that we've got to maintain this $0.74 level of earnings for most of the rest of the year, and coming off the kind of all-time low handset upgrade rate, it's more likely than not it's going to be a headwind as we go into the Galaxy and then the iPhone later this year. Can you kind of walk us through the geography of the income statement, where we offset those headwinds and generate the kind of positive mid-single digit earnings growth? And then the second question, if I could, would be maybe either for you or maybe Randall, just on this SD-WAN. It's a big emerging topic, a big conversation about whether it's a threat or an opportunity, especially for an incumbent like yourselves. And finally how real it is as a technology in the world. That would be super helpful. Thanks.

John J. Stephens - AT&T, Inc.

Sure. Let me try the EPS question first, Dave. Let me go to this. If I harken back to a comment I made in a presentation that we had about a penny – $0.02 of pressure in the quarter, a penny from some legal settlements, some IP, and other issues; and quite frankly a penny from some storm costs. And we did not adjust for them. But if you look at our results, taking those out, you see the quarter of $0.76, and you can understand then that the growth rate goes up to just under 6%, and you can understand how we would feel that that quarter supports an ongoing activity.

You're right; we could have a step up in equipment sales and upgrade rates. We're just admitting that we can't predict that at this time. But generally speaking, if that happens, we have significant offsets, whether it be the next accounting, whether it be the revenue recognition, or quite frankly if it's just the benefits of having customer additions and the additional service revenues and so forth. So that's something that does not scare us, so to speak. We can manage through that.

The third thing is, as we mentioned, the entire team here has been really focused on costs. But as we go quarter by quarter, we continue to increase the network function virtualization percentages, and we're on this march from 34% at the end of last year to 55% at the end of this year. So that's just going to continue on in generating savings, and we're getting to that point where the mass or the base of savings that we have, getting it to 40% and 50%, starts overcoming the reinvestment dollars that are required to grow it. So all that put together, that's why we feel comfortable about staying in the hunt for that guidance and keeping things moving forward.

Randall L. Stephenson - AT&T, Inc.

On the SD-WAN, yeah, it's real. It tends to be real down-market, David, and you should assume that we're developing capability ourselves, because it's a viable offer down-market. We're seeing some effect from it. It's not material yet, but we think it's a legitimate capability. We need to be there; we need to have it. And so up-market, the traditional VPN capability is always, we think, is going to be the enduring capability. But down-market, we're going to have to be prepared to compete with this kind of offering.

John J. Stephens - AT&T, Inc.

David, Mike just reminded me – one other thing I'll mention to you is that if you noticed that improvement we had in the first quarter in Mexico and the fact that that customer base is now close to 13 million – I think we're at 12.6 million. And it was an investment cycle all of last year, and it's starting to turn. The team down there is doing well. But I'd suggest to you that's another support for our business proposition for the year. We need to keep working at it, and we need to keep that market strengthening, but we feel good about the fact that that provides us another opportunity.

Secondly, I will tell you that the DIRECTV Latin America properties are just really – it's a lot of elbow grease. It's a lot of hard work, but they're doing well for us in what is challenging environments. But they are producing, and that's helping, too. So they may not be the focus of most of our discussions, but they sure are helping with our efforts this year.

David W. Barden - Bank of America Merrill Lynch

Great. Thank you both.

Randall L. Stephenson - AT&T, Inc.

Sure.

Operator

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

Brett Feldman - Goldman Sachs & Co.

Thanks for taking the question. I'd like to go back and talk a little bit about some of the elevated churn you signaled where you have an unbundled video product. I think it's easy to envision some of the corrective measures you could take within your traditional landline region, especially in light of all the fiber that you're deploying. So I was hoping we could maybe just spend a little bit more time talking about how you think about fortifying the bundle that you can offer outside that traditional region. You talked a little bit about some of the millimeter wave licenses, but is there really a broader set of options you think you have to go into the market to make sure your bundle remains differentiated nationwide?

Randall L. Stephenson - AT&T, Inc.

Yeah, there's a few things, Brett. In the short run, obviously it's bundling DIRECTV standalone with wireless outside of our traditional footprint where we don't have a broadband product. So bundling with wireless is really, really important. That is a part of the customer base, the standalone that has been also somewhat sheltered – is that the right word? – by virtue of being rural in nature. And so being rural in nature, it's harder to find an opportunity to bundle. Well, we have CAF II funding. We are turning up right now, wireless local loop is the term we use, but basically it's a wireless fixed broadband solution. 400,000 that we're turning up. We have an opportunity to turn up a lot of these. As we build FirstNet, by the way, we have to turn up significant improvements to our entire rural footprint, and so having a wireless opportunity to provide a broadband bundle into rural America really can shore up this customer base.

And so traditional wireless – go immediately with bundling traditional wireless. Obviously there are some things we could do just on price, and we'll do some promotional things. But then getting our fiber local loop product that is being rolled out right now, being introduced as we speak, getting it targeted to these customers, can also shore this up. So it's a multi-pronged effort.

And then longer term, you mentioned it. Longer term, 5G. This is the nationwide broadband opportunity. As we turn up 5G, we can now have a very high speed, competitive-with-cable broadband offering in all the major metropolitan countries where we don't have traditional fixed line footprint. So it's about to be a new competitive game as we get into the world of 5G, and we're getting very, very enthusiastic about it. And just what I would call fixed type configurations of 5G will come out before mobile configurations. So 2018, we'll be doing some fixed line deployments of 5G, and you'll be seeing some of that. And even the offerings, the speed increases we're doing right now in Austin that we just announced, we're talking competitive to cable speeds on our wireless network in Austin, soon to be Indianapolis and 18 other markets this year.

So the competitive landscape is changing, and I think – we are convinced it's going to change faster than a lot of people believe it will, that we're going to have some truly substitutable capabilities in the wireless infrastructure with some of our fixed line competitors. So we're optimistic, and we still think the bundle offering is going to be very, very important in the long term.

Brett Feldman - Goldman Sachs & Co.

Great. Thanks for taking the question.

John J. Stephens - AT&T, Inc.

Sure, Brett.

Operator

Thank you. Our next question is from Amir Rozwadowski with Barclays. Go ahead, please.

Amir Rozwadowski - Barclays Capital, Inc.

Thank you very much, and good afternoon, folks.

John J. Stephens - AT&T, Inc.

Hi, Amir.

Randall L. Stephenson - AT&T, Inc.

Hey, Amir.

Amir Rozwadowski - Barclays Capital, Inc.

Understanding that fluctuations in handset sales are the primary driver for your shift in your top line guidance policy, I was wondering if you could provide some color on how you think about the cash flow trajectory of the business? John, I know you mentioned there are some fluctuations depending on the timing of FirstNet reimbursements this year, but how should we think about the long-term ability to grow cash flow organically against this evolving competitive landscape, and potentially inclusive of Time Warner?

John J. Stephens - AT&T, Inc.

That's a good question, Amir. I mean, I feel really good about our opportunities to carry cash flow. And the best way I can explain it is what we saw on margins. The margins improvement was up and down from this cost initiatives, whether we talk about network function virtualization, whether we talk about digitization, whether we talk about automation, whether we – even as we have some challenges with regard to our legacy revenues, we have opportunities then to shed legacy costs.

So I'm comfortable with where we're at on cash flows for the year. I will also tell you, the oddity of it is, handsets slow down, we have the outlay for handsets on an up-front basis, and then receive monthly payments for the – payments over time. So, as that happens, even with our next financing with the banks, it actually can relieve some of the pressure off of the companies because the next outlay for, if you will, the equipment outlay for handsets, actually slows.

You guys know the background on the Time Warner and its capability to generate cash, and its much different capital intensity structure, as well as its great margin business, so we're very excited on being able to combine the two, about being able to farm out some growth initiatives and some cost savings, and so we look forward to that. We are still on a track to grow cash flows that we believe is so important, to not just – and not at all – I mean, it's very important to sustain and continue to grow the dividend. But not just that, but to create real wealth and opportunities and flexibility for the company on a going-forward basis.

Amir Rozwadowski - Barclays Capital, Inc.

Great. And then just one follow up, if I may. Seems like we're beginning to see demonstrable shifts in the regulatory landscape. For example, as you mentioned, Randall, we saw recent developments in BDS legislation, and it also seems like we may see some updated thoughts on the future of net neutrality in the coming days. How do you feel about the prospects of your integrated service provider offering against this shifting regulatory backdrop? In other words, are there new opportunities for monetizing your portfolio of assets in ways that previously may not have been available?

Randall L. Stephenson - AT&T, Inc.

Yeah, it's an interesting question. I would tell you the area that we are most focused on, and we're obviously very cautious about ensuring that we get our customers' consent to use data. But as we bring Time Warner into the family at AT&T, we are convinced that we can really enhance Time Warner's advertising revenue streams by virtue of some of the customer data, the viewership data, that we have on the distribution side of the house.

And, as an example, we have a little advertising business on the AT&T side today. It's about a $1.5 billion business, and it's growing at double digits. And what we're doing with customer consent where appropriate, we're doing addressable advertising, and getting very localized on the advertising that's delivered to our customers. And we're getting revenues per impression that are 3x and 4x what you would consider traditional revenue per impression in this industry.

Well, to what extent can we have that same type of impact on the Time Warner, the Turner Network advertising revenues, which are much more substantial than the AT&T revenue streams? And so there are some opportunities there. As the rules are clarified as it relates to the utilization of data, and then we have our own policies in terms of getting customer consent and working hard to get our customer consent to do this. But this provides new opportunities for new revenue streams and just improving yield on existing revenue streams.

And then obviously there was a lot of consternation at the end of last year with the former FCC surrounding things like sponsored data and set-top box and so forth. Well, all of those issues and those concerns are now gone, and so the ability to do some unique pricing on sponsored data and so forth are now in front of us and available to us, and in a world of unlimited it changes how that looks and so forth. But as we have the need to use flexibility to differentiate our offers, it gives us some new opportunities to do those things. So we're actually very positive.

The thing I'm most encouraged about, though, with the new tone in the FCC, is it probably, Amir, doesn't offer a whole lot of new opportunity for new services, but it takes a decision point out of the investment philosophy. If you want to invest in a new capability, if you want to invest in fixed wireless local loop, if you want to invest in 5G, you don't have this stop, pause, how is this going to be regulated? We have a pretty good idea now that it's going to be regulated with somewhat of a light touch as long as there's competitive alternatives in the marketplace, and that just changes the whole investment philosophy, and I think it's going to free up investment as we move forward. And you combine that with tax reform, I think even this industry that has been the top investor in the country for the last five years, this industry can actually go higher in investment if you get these kind of changes.

Amir Rozwadowski - Barclays Capital, Inc.

Thanks very much for the incremental color.

Randall L. Stephenson - AT&T, Inc.

You bet.

John J. Stephens - AT&T, Inc.

Thank you.

Operator

Thank you. Our next question is from Jennifer Fritzsche with Wells Fargo. Please go ahead.

Jennifer M. Fritzsche - Wells Fargo Securities LLC

Great. Thank you for taking the question. I wanted to ask about fiber. With Verizon's announcement last week, it's kind of a game-changer, as you alluded to, in terms of out-of-network footprint. And as you expand fiber, I assume it's easier to do so in your own ILEC footprint. What are your thoughts on outside that ILEC footprint? Will you pursue a similar path? And does that require further fiber investment or possible acquisitions? Thank you.

John J. Stephens - AT&T, Inc.

So, Jennifer, let me take a stab at it, and I'll ask Randall to comment on it. But first and foremost, I think we need to get some clarity with regard to how we measure fiber and whether you measure it by miles of fiber covered or by strands within the payer, within the fiber itself. That gives a differentiating aspect to the magnitude of the dollars being talked about in the marketplace. But you're right, we're on a significant investment in fiber with the 12.5 million fiber-to-the-prem, but quite frankly, because of our legacy of our business, both the local exchange business which we've held onto in that historic Bell operating company business which gives us a tremendous footprint, but also the legacy Long Lines business, which had fiber throughout the country. And so we do have more fiber than anyone else as it exists today.

What we look at, though – and we're open. We make evaluations on build or buy all the time with regard to backhaul for towers and that kind of fiber initiatives. What we will do is we will look at all the opportunities out there and decide whether it's going to be cheaper to buy or build. But we are open to it. We believe we have a big lead because of what we've been doing over the last five years in our VIP investments. We believe we have a big lead because we have the largest, if you will, legacy consumer business and the footprint associated with the Bell operating companies, and we also have a big lead with regard to the extensive fiber that was part of the AT&T Long Lines business. So when you put all of that together, we feel very good about it. We continue to invest, I would suggest, at – as much as, if not more than anybody's investing right now in fiber. It's very significant.

Randall L. Stephenson - AT&T, Inc.

I mean, we've talked about this for many years, Jennifer, and obviously, we gave some thought and consideration to would we create value if we separated our fixed line and our wireless business a few years ago. And I've got to tell you, the thing that caused you the greatest pause as you thought about doing those things was this wireless business is going to need the fiber access. It's going to need that last mile fixed line access. And so having a big footprint of fixed line access was always going to be critical.

And as we now move into the world of 5G, as we're deploying fiber to 12.5 million homes, it's just – you're looking for the capillaries. If you deploy to a home, what capillaries does that make available for deploying small cells? What capillaries are now being run to businesses? And so it's just – it begins to feed on itself and the incremental costs of that next kind of layer of fiber goes down. And then, as John said, we make literally daily decisions outside our traditional footprint on lease versus buy, and there's plenty of fiber available. Dark fiber is available in virtually all metropolitan areas, and so our ability to buy access to fiber for 5G is readily available. And where the cost or the availability isn't there, we will run fiber. So I think the U.S. is going to see a lot of fiber being deployed over the next few years as a byproduct of 5G, and I like where we stand in that race. I think we start with a head start.

John J. Stephens - AT&T, Inc.

Jennifer, one other thing I'd add is, and this could be repeated kind of on every question we've had, but the FirstNet contract award and the requirements that it provides to build out a nationwide first responder network and the funding that it provides to do that, gives us a great opportunity to incorporate – and the team has done this – incorporate fiber builds and fiber requirements both – not only for FirstNet in and of itself but anything they can leverage off of that. And we do this with building – as we've talked about before with the one tower climb and putting the AWS-3, the WCS spectrum to use at the same time we're doing the 700 MHz, but in all aspects of the FirstNet contract, it's providing us a real opportunity to leverage off the existing fiber and then to further add to what we consider to be the lead in that market that we have.

Jennifer M. Fritzsche - Wells Fargo Securities LLC

Great. Thank you very much for the color.

Michael J. Viola - AT&T, Inc.

And, Kathy, this is Mike. We're going to only be able to take one more call. I apologize to the folks that are in the queue. We won't be able to get all the calls in tonight. But we'll take one more.

John J. Stephens - AT&T, Inc.

John and Randall are taking too much time answering questions, aren't we?

Operator

Okay. Thank you. Then our final question will come from Simon Flannery with Morgan Stanley. Go ahead, please.

Simon Flannery - Morgan Stanley & Co. LLC

Thanks a lot. Many thanks. So, John, I understand the uncertainty around the phone sales. Maybe you could just talk a little bit about what exactly are you hearing from the field? Is this the natural impact of EIP? Is this people – just no form factor change? Do you expect this to come back? The Galaxy's obviously been delayed. Any more color around should we be thinking about there's something that has changed dramatically or this is just a pause and we'll get back to some more normal rates? And then, Randall, just continuing on the fiber, you've talked about the 12 million. What's the strategy for the copper getting the speeds up to have a competitive broadband product there where you may not be planning to roll fiber right now? What can you do with those lines to stay competitive? Thanks.

John J. Stephens - AT&T, Inc.

Let me take the phone sales first, Simon. And quite frankly, you made a lot of the right points. The first thing is we are seeing a change with regard to next, if you will, and the impact that customers have – are understanding the costs of a phone differently; they're reacting differently. We're saying that not only in the slower (1:00:44), but we continue to have in this kind of 400,000 or 500,000 a quarter BYOD devices. So not only are they – when they do buy another phone, they are holding onto the other one and handing it down, giving it to someone else to use. And so we're seeing that. That is an impact of it.

There has been a lot of discussion that most of the changes in the phone's capabilities are software enabled. We talk about it wanting to do it from our network perspective. We're seeing a little bit of it in the handset business, where the upgrades to the capabilities are software focused as opposed to form factors. So that's it. We are actually seeing, so to speak, a slowness in overall consumer activity. It seems like while the consumers – the economics and the consumer world may be improving, it seems like they're being very careful, and so that's a third thing.

We have studied it, everything from the amount of tax refund dollars that impacts and when that comes in to all those things we've looked at. I would suggest to you I think it is a more permanent change in the environment because of the change in who pays for it. I don't believe – I'm not trying to suggest it's going to stay at this 30.9% rate. I would expect that it will come back, not only for new phones coming out but quite frankly, for example, as we, if you will, get our network even hotwired more than it is as the Austin-type situation, where you can get multiple hundred meg speeds on your phones, you'll see people want to get those devices, so I think that'll help. But I clearly believe it is a permanent change from where we were in the subsidy model, and I believe that the upgrade rates will be down on a permanent basis.

Simon Flannery - Morgan Stanley & Co. LLC

Okay.

Randall L. Stephenson - AT&T, Inc.

And the copper plant, Simon, it's real simple. It's wireless. It's 5G and that's, I mean, we'll continue to push the envelope with fiber deeper and deeper, but you get to a place on the fixed line side where it doesn't make sense to keep running fiber and economically. And our default architecture long-term, default architecture, is a wireless architecture, and so the world of 5G, that's when the copper gets replaced with a high-speed wireless offering to the home.

Simon Flannery - Morgan Stanley & Co. LLC

How close does the fiber have to get to the home for that vision?

Randall L. Stephenson - AT&T, Inc.

It obviously depends on what speeds you want, right? But if you think about where we have copper today, you don't have a ton of situations where you need a gig of bandwidth. But, as we said, our objective is to get a gig of bandwidth to everybody we touch. And so in a world of 5G, you should think of a 200-meter propagation, all right, so that takes a lot, but you don't need in suburban and rural America those kind of bandwidths to be competitive. And so you can go to your traditional cell structure, use more traditional spectrum positions, and get very competitive speeds in those areas with wireless, even with an LTE arrangement.

So think about the configuration in Austin. You're going to get some serious, serious bandwidth there. You have the potential for 500 or 600 meg. Now, obviously on a loaded network you're going to get about a tenth of that, but 50, 60 meg? That's a competitive offer, and we think we have a lot of legs with that and that over time just keep pushing the small cell structure deeper and deeper.

John J. Stephens - AT&T, Inc.

We haven't mentioned, and I think you all know this, but with the move towards carrier aggregation and four-way, which the Galaxy S8 has the capability of doing that, with regard to MIMO and the ability to have the on- and off-ramps operate much quickly and move into that QAM 256, all three of those things are now available for us, and we're working this true (1:04:49) our Austin, and we're seeing tremendous, tremendous results there. So that's what's so encouraging about us, particularly about this continuation of wireless and this opportunity to support an overall broadband solution, as well as coordinate it with a FirstNet build that is consistent with the government's requirements.

Randall L. Stephenson - AT&T, Inc.

Okay. Thanks, Simon, I appreciate the question. With that, I want to thank everybody for being on the call and just a couple closing comments. It was a competitive quarter, both in wireless and video for us, and we took some steps and made some adjustments in the market to try and address this, and we'll continue to do that. But at the same time, we were able to grow adjusted earnings and adjusted margins in this environment as we drove cost out of the business, kept going hard on software-defined networking, and a year from now I think we're going to look back on the return to unlimited plans as the moment when the battle for network reach and capacity really began. And we're prepared for the fight, we're ready to go. And so, thanks again for being on the call, and as always, thank you for your interest in AT&T.

John J. Stephens - AT&T, Inc.

Thanks.