Verizon

Verizon Communications Inc.		**Industry View:**	**NEUTRAL**
Latest Results:	2012 Q4	**Company Rating:**	LOW MED. HIGH
Country:	USA	Risk	
Sector:	Telecoms	Quality	
RIC (Ticker):	VZ.N	Valuation	

INDIGO EQUITY RESEARCH

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Overview - 2012 Q4 Results

Poor 2012 Q4 results - Underlying margins & EPS slump; large write-offs

Overall, Verizon continued to deliver revenue growth but the underlying margins & EPS slumped c. 21% . Large one-off items were incurred; $4.4 bn to fix a pension hole and $0.8 bn to cover the early redemption of debt (amounts are net of tax). The outlook is deteriorating with expectations of slowing post paid subscriber growth, losses in Wireline, margin pressure and increasing competition from Sprint.

- **Q4 Total Revenue rose $1.6 bn (+6%), to $30.0 bn.**
  - Wireless Revenue rose $1.7 bn (+10%), to $20.0 bn; driven primarily by 6% growth in post-paid subscribers and 2% increase in ARPU (while ARPA was up 7%).
  - The decline in Wireline Revenue continued to moderate to just -1%, at $10.0 bn.
- EBIT* fell 11%, to $4.0 bn. Margins fell 2.5% to 13.4%, with $0.3 bn restructuring charges.
  - Wireless EBIT margins fell sharply (-8%) from last Q, to the same level as last year, with the usual Q4 jump in smartphone sales. Margins are expected to rebound next Q.
  - Wireline incurred its first ever operating loss of $0.3 bn; partly due to Super Storm Sandy and the costs of migrating customers from copper to fiber optic.
- **Net Income* fell $0.3 bn (-20%), to $1.1 bn, despite a lower tax*, with a greater proportion of earnings being taken by Vodafone; for its 45% stake in Verizon Wireless.**
- **The underlying EPS* fell -21%, to $0.38 (compared to EPS* last year).**
- The GAAP EPS loss doubled to -$1.48. FCF fell $3.7 bn (-76%), to $1.2 bn. Q4 EPS included -$1.86 in Unusual Items, mostly for pensions and debt redemption charges.

** = Excludes Unusual Items, in both Q4 2011 and Q4 2012.*

Note: Comparisons (eg. growth rates) are stated on a Year-on-Year (YoY) basis.

Significant recent events

- Verizon plans to contribute $7.5 bn in preferred equity to its pension plan.
- Verizon & Coinstar launch online streaming content and DVD rental services (Redbox).

Investment thesis - Dominant position but weakening prospects

Verizon is a utility with an attractive dividend yield (c. 5%) and a value stock investment profile. It is a well managed company and is extending its leading position in an oligopolistic market. It takes the best wireless customers, highest overall ARPU, highest margins and lowest churn. **Its early deployment of the latest wireless technology (LTE) and purchase of wireless spectrum from cable companies has positioned it extremely well to expand market share.** Revenue growth prospects are limited as the US telecoms market matures and lucrative voice revenues are commoditised. Growth depends on the new data services (FiOS and LTE). Verizon hopes to stem the decline and losses in Wireline by converting the 'last mile' to fibre. **Vodafone's 45% stake in Verizon Wireless is a major and increasing drag on EPS growth. The high dividend pay-out ratios of over 75% restrict the capacity for dividend increases.** Market consolidation, regulation and Softbank's investment in Sprint remain industry wild cards. **In summary, Verizon is the best of the US telcos, but growth prospects are weakening.**

SWOT analysis

Strengths

- **Large size (economies of scale).**
- **Leading mobile market share.**
- Key assets (licenses & network).
- Strong recurring revenues & FCF.

Weaknesses

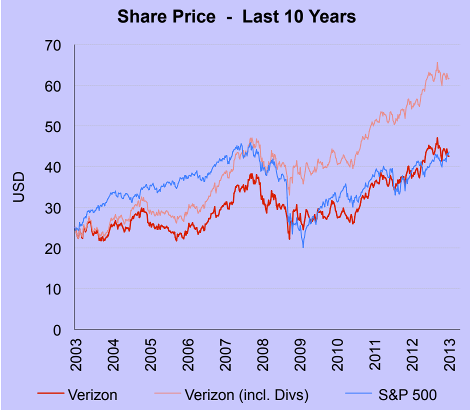
- **Mature US telecoms market.**
- **45% of Verizon Wireless not owned.**
- High smartphone subsidies.
- Wireline is loss making.

Opportunities

- **New data services eg. FiOS & LTE.**
- Conversion of Wireline last mile to fibre to cut costs and boost video services.
- Increasing prices of wireless data plans.

Threats

- Commoditisation of voice & data services; becoming a "dumb pipe".
- **Competition from Sprint (Softbank), Clearwire, VoIP and WiFi.**



Fundamental Valuation		Bear	Base	Bull
(See Page Page 9)				
Valuation	($)	38.9	44.9	51.4
Potential Return		-4%	10%	26%

Capital Structure	Per Share ($)	Total ($ Bn)
Share Price	**42.6**	
Number of Shares (bn)		2.9
Market Capitalization		121.9
Net Cash / (Debt)	-16.9	-48.4
Enterprise Value (EV)	41.2	117.9
Net Debt / Market Cap.		40%
Main Shareholder:		--

Consensus Estimates

Financial Results	2012	2013e	2014e
y/e 31 Dec	($ Bn)	($ Bn)	($ Bn)
Revenue	115.8	120.3	124.3
EBIT*	20.7	24.4	25.9
Net Income*	6.6	8.0	8.9
Capital	33.2	33.2	35.4
Total Assets	225.2	225.3	227.9
FCF	11.4	11.4	13.4
EPS	0.31	2.79	3.10
DPS	2.04	2.12	2.13
BV Per Share	11.59	11.59	12.37

Efficiency Analysis	2012	2013e	2014e
EBIT Margin*	17.9 %	20.3 %	20.8 %
Net Income Margin*	5.7 %	6.6 %	7.1 %
Asset Turnover	51.4 %	53.4 %	54.5 %
Net Gearing	679.3 %	679.5 %	644.0 %
ROE*	19.8 %	24.1 %	25.1 %

Net Gearing = Net Assets / Share Capital & Reserves

Growth Analysis	2012	2013e	2014e
Revenue	4.5 %	3.8 %	3.3 %
EBIT*	10.1 %	17.6 %	6.2 %
Net Income*	8.3 %	21.7 %	11.1 %

Valuation Ratios	2012	2013e	2014e
P / Sales	1.1	1.0	1.0
EV / EBITDA	3.2	2.9	2.7
P / EBIT*	5.9	5.0	4.7
PE*	18.6	15.3	13.7
PEG*	2.5	0.7	1.2
P / BV	3.7	3.7	3.4
P / FCF	10.7	10.7	9.1
Dividend Yield	4.8 %	5.0 %	5.0 %
Pay-Out Ratio	>300%	76.0 %	68.7 %
Net Debt / EBITDA	1.3	1.2	1.1

Valuation Ratios are based on the current share price.

** = Excluding Unusual Items*

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Explanations

Brief business description - Verizon

Verizon is a large US integrated telecommunications operator, providing fixed line, mobile, internet & IT services. Verizon has a national wireless presence, fixed line presence in 25 states and global data network (ie. MCI). Its main offices are in New York. It has about 190,000 employees and is a component of the S&P 500 index.

Explanation of Company Ratings used by Indigo Equity Research Ltd:

Industry View: **ATTRACTIVE**

Company Rating:

	LOW	MED.	HIGH
Risk	■		
Quality		■	
Valuation			■

Industry View = This is an assessment from an investor's perspective of the potential for the industry as a whole to generate profits in the future based on criteria such as: market structure (eg. number of competitors and industry concentration), growth prospects, maturity (stage of the industry life cycle), regulations, technology, disruptive forces, expected changes and speed of any changes.

Risk = The risk of earnings disappointment & volatility as well as the risk of a change in the valuation ratios that impact the company's share price. This depends on items such as revenue growth, profit margin volatility, investor sentiment towards the company etc..... But this does not include the market risk of these elements changing.

Quality = The quality of the company reflects its ability to maintain or increase earnings from its competitive advantages, strategy, brand, management, market position, pricing power, services etc…..

Valuation = This is an absolute measure of valuation multiples of the company, based on a range of metrics (multiples) such as: P/Sales, PE, PEG, P/BV, P/ FCF, EV/EBITDA, EV/Sales, Div Yield …..

Comment on Ratings: These qualitative assessments of "Company Ratings" are made for each company on a relative basis compared to other companies with large capitalizations; but are nonetheless subjective and dependent on the analyst's individual opinion & analysis of the company.

Financial definitions & abbreviations:

FCF = Free Cash Flow
Op FCF = Operating Free Cash Flow
EBIT = Earnings Before Interest & Tax (ie. Operating Income)
EBITDA = Earnings Before Interest, Tax, Depreciation & Amortisation

12m av. = 12 month average (ie. Average for the last 12 months.)
y/e = (financial) year end

EV = Enterprise Value
P = (Share) Price
PE = Price / Earnings
PEG = PE / Growth

BV = Book Value
Div. = Dividend
EPS = Earnings Per Share
DPS = Dividends Per Share

Explanation of what constitutes an unusual or significant item: Indigo Equity Research determined what constituted "Unusual items" in this report on the basis of assessing what items were significantly or materially separate or different to the Company's core business and activities. This a highly subjective assessment made by the analyst on a case-by-case basis.

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