

Verizon Communications Inc.

Latest Results: Q1 2013
 Country: USA
 Sector: Telecoms
 RIC (Ticker): VZ.N

Industry View: NEUTRAL

Company Rating: LOW MED. HIGH
 Risk
 Quality
 Valuation

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Company Profile - Wireless momentum regained

Solid Q1 2013 results - Strong rebound from Q4; 15% EPS growth

Q1 results were driven by wireless margins rebounding from Q4. In turn this was mostly due to higher wireless post-paid ARPAs; with more connections per account. Higher wireless margins show Verizon benefiting from its leading market position & LTE coverage, a less competitive market, better marketing (eg. "Share Everything" plans); and a strong demand for wireless data services from smartphones & tablets. The outlook is good as most of these are not expected to change in the short term. On the negative side, wireline continues to be weak (despite good FiOS performance and copper-to-fiber initiative), and post-paid wireless subscriber growth is slowing.

- Q1 Revenue rose \$1.2 bn (+4%) to \$29.4 bn.
 - Wireless Revenue rose \$1.3 bn (+7%) to \$19.5 bn.
 - Post-Paid ARPA rose 7%; with 1% more Accounts & 5% more Connections Per Account.
 - Wireline Revenue fell \$115 m (-1.2%) to \$9.8 bn.
- EBIT rose 20.0% to \$6.2 bn. Margin rose 2.8% to 21.1%.
 - Wireless EBIT rose \$1.2 bn (+23.0%) to \$6.4 bn. Wireless margin rose 4.3% to 32.9%.
- Amounts due to Minority Interests (Vodafone) increased 31% to -\$2.9 bn.
- Net Income rose 16.0% to \$2.0 bn, helped by a lower tax rate (down 0.6%, to 15.1%).
- Q1 GAAP EPS rose 15.0% to \$0.68, restricted slightly by 1% additional share issues.
- FCF rose \$1.6 bn (+70%) to \$3.8 bn; with positive working capital and lower CAPEX.

ARPA = Average Revenue Per Account

Comparisons (e.g. margins changes & growth rates) are stated on a Year-on-Year (YoY) basis.

Significant recent events

- Verizon quashes rumors of a merger with Vodafone.
- Cable operators are adopting quadruple-play to compete better with telcos.

Investment thesis - Dominant position but weakening long-term prospects

Verizon is a utility with an attractive dividend yield (c. 5%) and a value stock investment profile. This is a well managed company that 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. Verizon's key problems are that the maturing US telco market limits growth prospects. As lucrative voice revenues are commoditised, growth depends on data services (FiOS & LTE). Wireline remains loss making and in decline, despite FiOS & 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. Lastly, industry consolidation, convergence with cable, and regulation remain wild cards. In short, VZ is the best of the US telcos, but growth long-term prospects are weakening.

SWOT analysis

Strengths

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

Opportunities

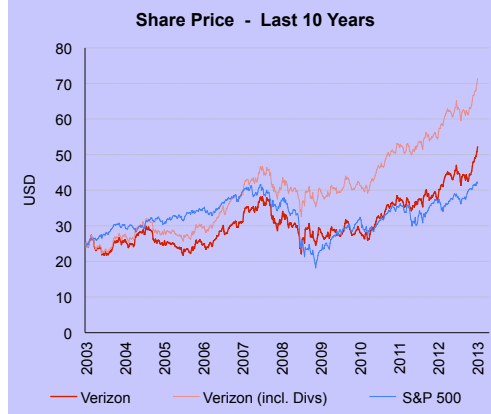
- New data services eg. FiOS & LTE.
- Conversion of Wireline last mile to fibre.
- Increasing margins with higher prices and more favourable wireless data plans.

Weaknesses

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

Threats

- Commoditisation of voice & data.
- Increased competition from Sprint (Softbank / Dish?), Clearwire?
- Apps (eg. WhatsApp), VoIP & WiFi.



Fundamental Valuation

(See Page 32)

	Bear	Base	Bull
Valuation (\$)	51.3	57.3	63.8
Potential Return	2%	14%	26%

Capital Structure

	Per Share (\$)	Total (\$ Bn)
Share Price	52.3	
Number of Shares (bn)		2.9
Market Capitalization		150.1
Net Cash / (Debt)	-16.3	-46.7
Enterprise Value (EV)	49.6	142.5
Net Debt / Market Cap.		31%
Main Shareholder:		--

Consensus Estimates

Financial Results	2012	2013e	2014e
y/e 31 Dec (\$ Bn)			
Revenue	115.8	120.7	125.1
EBIT*	20.7	24.6	27.0
Net Income*	6.6	7.9	9.0
Capital	33.2	33.2	35.5
Total Assets	225.2	225.4	228.1
FCF	11.4	12.2	13.6
EPS (\$)	0.31	2.75	3.13
DPS (\$)	2.04	2.12	2.13
BV Per Share (\$)	11.59	11.57	12.40

Efficiency Analysis	2012	2013e	2014e
EBIT Margin*	17.9 %	20.4 %	21.6 %
Net Income Margin*	5.7 %	6.5 %	7.2 %
Asset Turnover	51.4 %	53.6 %	54.9 %
Net Gearing	679.3 %	679.7 %	641.7 %
ROE*	19.8 %	23.8 %	25.3 %

Net Gearing = Net Assets / Share Capital & Reserves

Growth Analysis	2012	2013e	2014e
Revenue	4.5 %	4.2 %	3.6 %
EBIT*	10.1 %	18.8 %	9.6 %
Net Income*	8.3 %	20.3 %	14.0 %

Valuation Ratios	2012	2013e	2014e
P / Sales	1.3	1.2	1.2
EV / EBITDA	3.8	3.4	3.2
P / EBIT*	7.2	6.1	5.6
PE*	22.9	19.0	16.7
PEG*	3.1	1.0	1.2
P / BV	4.5	4.5	4.2
P / FCF	13.2	12.3	11.0
Dividend Yield	3.9 %	3.9 %	3.9 %
Pay-Out Ratio	>300%	77.1 %	68.0 %
Net Debt / EBITDA	1.3	1.2	1.1

Valuation Ratios are based on the current share price.

* = Excluding Unusual Items

Explanations and Definitions

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

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.

Company Rating:

	LOW	MED.	HIGH
Risk			
Quality			
Valuation			

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

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