Verizon

INDIGO EQUITY RESEARCH

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Verizon Communications Inc.		**Industry View:**	**NEUTRAL**
Latest Results:	**Q2 2013**	**Company Rating:**	LOW MED. HIGH
Country:	USA	Risk	■ □ □
Sector:	Telecoms	Quality	□ □ ■
RIC (Ticker):	VZ.N	Valuation	■ ■ □

Company Profile - Wireless momentum continues

Strong Q2 2013 Results - EPS up 22% with higher margins

Q2 Revenue rose 4%; EBIT rose 16% with 2% higher margins. GAAP EPS rose 22%. EPS was up 14% excluding a $0.05 per share gain related to pensions. These strong results were driven by Wireless' improving margins and modest revenue growth. Faster wireless data services (LTE / 4G) are stimulating demand for more connections per account, with "Share Everything" plans; as smartphones and tablets proliferate. This has pushed post-paid ARPA higher. In contrast, Wireline continues to deteriorate gradually. Margins are improving as the sales mix shifts towards (higher-margin) wireless revenues.

Verizon's consistent & strong EPS performance since 2011 looks set to continue, as it outperforms AT&T. The valuation remains undemanding despite rising multiples.

- **Q2 Revenue rose $1.2 bn (+4%) to $29.8 bn.**
  - Revenues were driven by: Wireless rose $1.4 bn (+8%), and Wireline fell $0.2 bn (-2%).
  - Wireless revenues were driven by 1.0% more Post-Paid Accounts and 6.0% higher Post-Paid ARPA. In turn this was from 5% more connections per account.
- **EBIT* rose $0.7 bn (+12%) to $6.3 bn. EBIT Margin* rose 1.4% to 21.2%.**
- Amounts due to Minorities (Vodafone) increased by $0.5 bn (+20%) to $3.0 bn.
- **EPS* rose 14%. Q2 GAAP EPS rose $0.14 (+22%) to $0.78.**
- FCF rose 1% to $5.4 bn. FCF (after dividends) fell 4% to $3.9 bn.

** = Excluding a $0.05 per share gain related to pensions.* *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 has a potential c. $10 bn liability for contracts to purchase mobile phones in 2013.
- Verizon says that it is interested in buying out Vodafone's 45% of Verizon Wireless.

Investment thesis - Dominant position but weakening long-term prospects

Verizon is a utility with an attractive dividend yield (c. 4%) and a value stock investment profile. **Verizon Wireless is well managed and has a 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 dividend pay-out ratios are high (>75%); but low gearing provides financial flexibility. Lastly, industry consolidation, convergence with cable, and regulation remain wild cards. **In short, Verizon is the best managed and positioned of the US telcos.**

SWOT analysis - Key current drivers & catalysts

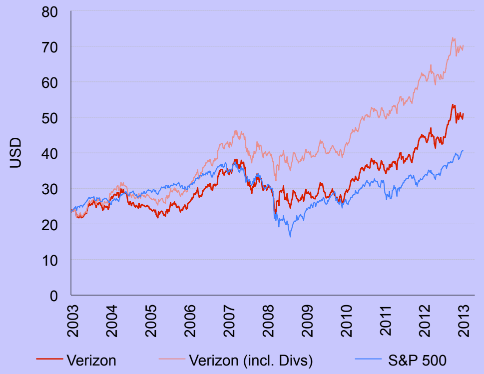
Strengths
- **Large size (economies of scale).**
- **Leading mobile market share.**
- Strong recurring revenues & FCF.

Weaknesses
- **45% of Verizon Wireless not owned.**
- High smartphone subsidies.
- Wireline is loss making.

Opportunities
- **New data services eg. FiOS & LTE.**
- Increasing margins with higher prices and more favourable wireless data plans.

Threats
- **Increased competition from Sprint (Softbank / Dish?), Clearwire?**
- Apps (eg. WhatsApp), VoIP & WiFi.

Share Price - Last 10 Years



Fundamental Valuation			*(See Page 33)*
(12 month outlook)	**Bear**	**Base**	**Bull**
Forecast Share Price	$51.3	**$57.3**	$63.7
Return (incl. Div.)	5%	**17%**	29%

Capital Structure	Per Share ($)	Total ($ Bn)
Current Share Price	**$51.0**	
Number of Shares (bn)		2.9
Market Capitalization		146.5
Net Cash / (Debt)	-16.5	-47.3
Enterprise Value (EV)	49.0	140.7
Net Debt / Market Cap.		32%
Main Shareholder:		--

Consensus Estimates

Financial Results		2012	2013e	2014e
y/e 31 Dec		($ Bn)	($ Bn)	($ Bn)
Revenue		115.8	120.5	125.2
EBIT*		20.7	24.8	27.8
Net Income*		6.6	7.9	9.2
Capital		33.2	35.3	38.7
Total Assets		225.2	227.4	231.2
FCF		11.4	13.3	13.8
EPS	($)	0.31	2.80	3.22
DPS	($)	2.04	2.07	2.13
BV Per Share	($)	11.59	12.31	13.49

Efficiency Analysis	2012	2013e	2014e
EBIT Margin*	17.9 %	20.6 %	22.2 %
Net Income Margin*	5.7 %	6.5 %	7.3 %
Asset Turnover	51.4 %	53.0 %	54.1 %
Net Gearing	679.3 %	644.6 %	598.2 %
ROE*	19.8 %	22.3 %	23.8 %

Net Gearing = Net Assets / Share Capital & Reserves

Growth Analysis	2012	2013e	2014e
Revenue	4.5 %	4.0 %	3.9 %
EBIT*	10.1 %	19.8 %	11.9 %
Net Income*	8.3 %	19.9 %	16.8 %

Valuation Ratios	2012	2013e	2014e
P / Sales	1.3	1.2	1.2
EV / EBITDA	3.8	3.4	3.2
P / EBIT*	7.1	5.9	5.3
PE*	22.3	18.6	15.9
PEG*	3.0	0.9	0.9
P / BV	4.4	4.2	3.8
P / FCF	12.9	11.0	10.6
Dividend Yield	4.0 %	4.0 %	4.0 %
Pay-Out Ratio	>300%	73.9 %	66.1 %
Net Debt / EBITDA	1.3	1.1	1.0

Valuation Ratios are based on the current share price.

** = Excluding Unusual Items*

  Sources: Verizon, Indigo Equity Research

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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**

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

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