

Verizon Communications Inc.

Latest Results: Q1 2014
 Country: USA
 Sector: Telecoms
 RIC (Ticker): VZ.N

Fundamental Valuation: \$36.0
Indigo View: Downside Risk
Industry View: Neutral
Company Rating: LOW MED. HIGH
 Risk
 Quality
 Valuation



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Company Profile - Outlook poor due to price war

Mixed Q1 2014 Results - Wireless momentum slows

Q1 revenue growth of 5% accelerated 1% from last Q. EBIT* grew 15% as margin* rose 2.1%. Q1 EPS* rose 23.5% to \$0.84, restricted by 19% additional by share issues (due to the Verizon Wireless deal); despite a tax rate* up 4%, to 19%.

In summary, continued wireless growth mostly from more tablets drove results. 5% revenue growth was driven by: Wireless (+7%), while Wireline was roughly flat. In turn, Wireless was driven by Post-Paid Connections up 4% (with more tablets) & ARPU rose 3%. Significantly, Verizon lost post-paid subscribers for the first time with increasing competition (Sprint & T-Mobile). Margins rose with operating efficiency & cost controls.

Q1 reported results included the full ownership of Verizon Wireless from February; As well as a net c. \$1.1 bn of Unusual Items consisting of: a \$1.9 bn gain on sale of its stake in Vodafone Omnitel, \$575 m charge for early debt redemption, & transaction costs on the Verizon Wireless transaction of \$260 m; (all figures are given on a post-tax basis).

Our low fundamental valuation is based on the expectation that EPS will be hit by the increasing wireless industry price war and weaker US economic growth; which will push valuation multiples lower. The potential industry restructuring with the proposed Sprint & T-Mobile, and AT&T & Dish mergers remain uncertain wild cards. In addition, we believe that equity markets are significantly overvalued, due to low interest rates and QE (money printing); making a significant market correction in 2014 very likely.

* Excluding Unusual Items (\$1.1 bn gain this Q)

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

Significant recent events

- Verizon completes the purchase of Vodafone's 45% interest in Verizon Wireless.
- Verizon Wireless cuts prices by is c. 12.5%; joining the industry's price war.

Investment thesis - Dominant position but unclear long-term prospects

In short, Verizon is highly cash generative and the best managed & positioned US telco in an oligopolistic market. It has the best (post-paid) customers, highest ARPU, highest margins and lowest churn. It deployed LTE first and reportedly has the best spectrum. Verizon is a utility with an attractive dividend yield (c. 4%) and a value stock investment profile. The dividend pay-out ratios are high (>75%); and low gearing provides financial flexibility. Growth & profits are driven by wireless data services (eg. LTE) for tablets & smartphones. Wireline is barely profitable and in decline due to broadband competition from cable, despite FiOS & converting the 'last mile' to fibre and the new net neutrality rules. Other key industry problems include: a maturing US telco market, the commoditization voice & data revenues as Verizon becomes a "dumb pipe", and increased price competition from Sprint & T-Mobile.

SWOT analysis - Key current drivers & catalysts

Strengths

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

Opportunities

- New data services eg. FiOS & LTE.
- New net neutrality rules?
- Machine-to-machine and telematics.

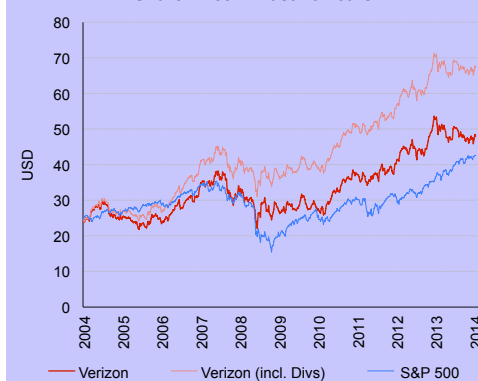
Weaknesses

- Mature US telecoms market.
- Pension deficit?
- Becoming a "dumb pipe".

Threats

- Increasing price competition from Sprint & T-Mobile.
- Industry restructuring.

Share Price - Last 10 Years



Fundamental Valuation (See Page 37)

| (12 month outlook) | Bear | Base | Bull |
|----------------------|--------|--------|--------|
| Forecast Share Price | \$30.7 | \$36.0 | \$41.8 |
| Return (incl. Div.) | -32% | -20% | -8% |

| Capital Structure | Per Share (\$) | Total (\$ Bn) |
|----------------------------|----------------|---------------|
| Current Share Price | \$48.0 | |
| Number of Shares (bn) | | 3.4 |
| Market Capitalization | | 164.7 |
| Net Cash / (Debt) | -31.0 | -106.2 |
| Enterprise Value (EV) | 78.6 | 269.8 |
| Main Shareholder: | | -- |

Financial Results Consensus Estimates

| Financial Results | 2013 | 2014e | 2015e |
|-------------------|---------|---------|---------|
| y/e 31 Dec | (\$ Bn) | (\$ Bn) | (\$ Bn) |
| Revenue | 120.6 | 125.3 | 128.9 |
| EBIT* | 25.5 | 28.2 | 29.9 |
| Net Income* | 7.9 | 14.0 | 15.1 |
| Share Capital | 38.8 | 48.0 | 57.1 |
| Total Assets | 274.1 | 283.7 | 293.1 |
| FCF | 21.6 | 13.7 | 13.9 |
| EPS* (\$) | 2.75 | 4.91 | 5.25 |
| DPS (\$) | 2.08 | 2.12 | 2.20 |
| BV per share (\$) | 13.55 | 14.02 | 16.68 |

| Efficiency Analysis | 2013 | 2014e | 2015e |
|-----------------------|--------|--------|--------|
| EBIT* Margin | 21.1 % | 22.5 % | 23.2 % |
| Net Income* Margin | 6.6 % | 11.2 % | 11.7 % |
| Asset Turnover | 44 % | 44 % | 44 % |
| Total Assets / Equity | >600% | 591 % | 513 % |
| ROE* | 20.4 % | 29.2 % | 26.4 % |

| Growth Analysis | 2013 | 2014e | 2015e |
|-----------------|--------|--------|-------|
| Revenue | 4.1 % | 3.9 % | 2.9 % |
| EBIT* | 22.8 % | 10.8 % | 6.1 % |
| Net Income* | 20.4 % | 77.5 % | 7.4 % |
| EPS* | 19.9 % | 78.6 % | 6.8 % |

| Valuation Ratios | 2013 | 2014e | 2015e |
|-------------------|--------|--------|--------|
| P / Sales | 1.4 | 1.3 | 1.3 |
| EV / EBITDA | 6.4 | 6.0 | 5.8 |
| P / EBIT* | 6.5 | 5.8 | 5.5 |
| PE* | 17.5 | 9.8 | 9.1 |
| PEG* | 0.9 | 0.1 | 1.3 |
| P / BV | 3.5 | 3.4 | 2.9 |
| P / FCF | 7.6 | 12.0 | 11.8 |
| Dividend Yield | 4.3 % | 4.4 % | 4.6 % |
| Pay-Out Ratio | 52.0 % | 40.1 % | 41.9 % |
| Net Debt / EBITDA | 0.9 | 0.7 | 0.5 |

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

EBITDA = Earnings Before Interest, Tax, Depreciation & Amortisation

TTM = Trailing 12 Months

Last 12m = 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 is a highly subjective assessment made by the analyst on a case-by-case basis.

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