

Verizon Communications Inc.
 Latest Results: Q2 2014
 Country: USA
 Sector: Telecoms
 RIC (Ticker): VZ.N

Fundamental Valuation: --
Indigo View: --
Industry View: **Neutral**
Company Rating: LOW MED. HIGH
 Risk
 Quality
 Valuation



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 www.indigo-equity-research.com

20 Sep 2014

Snapshot of Q2 2014 - Margin risk due to price war

Strong Q2 2014 Results - Wireless momentum returns

Indigo's independent, buy-side, fundamental equity research reports are provided in three formats (of varying length & detail):

- Snapshot (c. 6 pages)
- Overview (c. 20 pages)
- Company Profile (52 pages)

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 Or abbreviated reports can be found on Bloomberg, Reuters, Factiva, Capital IQ & FactSet.

Significant recent events

- AT&T bids c. \$48 bn for DirecTV.
- AT&T, Sprint and T-Mobile cut prices aggressively as the telecoms price wars picks up.

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. Dividend pay-out ratios are high (>75%); but reasonable 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 AT&T, Sprint & T-Mobile.

SWOT analysis

Strengths

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

Opportunities

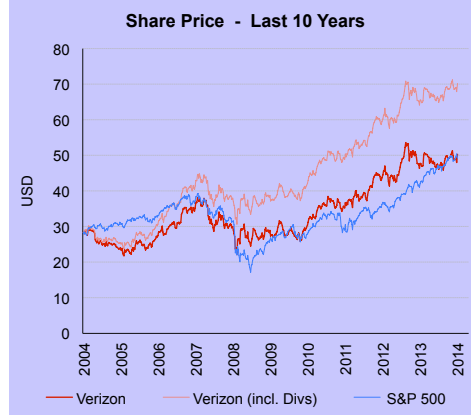
- New data services eg. FiOS & LTE.
- New net neutrality rules?
- Machine-to-machine and telematics.

Weaknesses

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

Threats

- Increasing price competition
- Smartphone subsidies.
- Industry restructuring.



Fundamental Valuation

	Bear	Base	Bull
Forecast Share Price	See the full report		
Return (incl. Div.)			
Capital Structure	Per Share	Total	
	(\$)	(\$ Bn)	
Current Share Price	\$50.4		
Number of Shares (bn)		4.2	
Market Capitalization		209.1	
Net Cash / (Debt)		-24.9	-103.6
Enterprise Value (EV)		75.0	311.5
Main Shareholder:	--		

Consensus Estimates

Financial Results	2013	2014e	2015e	
y/e 31 Dec	(\$ Bn)	(\$ Bn)	(\$ Bn)	
Revenue	120.6	125.7	129.5	
EBIT*	25.5	28.7	30.2	
Net Income*	7.9	14.7	16.3	
Share Capital	38.8	49.1	59.4	
Total Assets	274.1	284.8	295.5	
FCF	21.6	15.2	15.1	
EPS*	(\$)	2.75	3.70	3.92
DPS	(\$)	2.08	2.03	2.21
BV per share	(\$)	13.55	11.85	14.33

Efficiency Analysis	2013	2014e	2015e
EBIT* Margin	21.1 %	22.8 %	23.4 %
Net Income* Margin	6.6 %	11.7 %	12.6 %
Asset Turnover	44 %	44 %	44 %
Total Assets / Equity	>600%	580 %	497 %
ROE*	20.4 %	30.0 %	27.4 %

Growth Analysis	2013	2014e	2015e
Revenue	4.1 %	4.3 %	3.0 %
EBIT*	22.8 %	12.7 %	5.4 %
Net Income*	20.4 %	86.4 %	10.4 %
EPS*	19.9 %	34.5 %	5.9 %

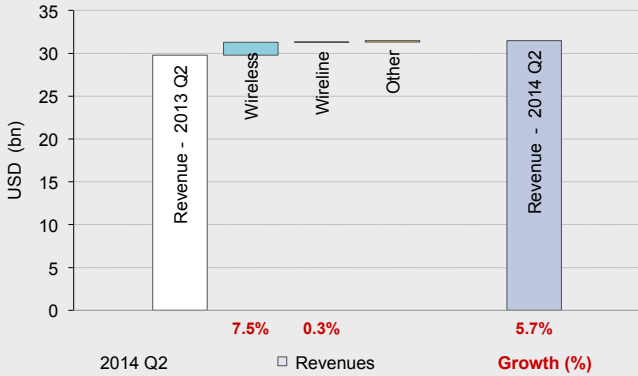
Valuation Ratios	2013	2014e	2015e
P / Sales	1.7	1.7	1.6
EV / EBITDA	7.4	6.9	6.6
P / EBIT*	8.2	7.3	6.9
PE*	18.3	13.6	12.8
PEG*	0.9	0.4	2.2
P / BV	3.7	4.2	3.5
P / FCF	9.7	13.8	13.8
Dividend Yield	4.1 %	4.0 %	4.4 %
Pay-Out Ratio	52.0 %	49.8 %	56.4 %
Net Debt / EBITDA	0.9	0.7	0.4

Valuation Ratios are based on the current share price.

* = Excluding Unusual Items

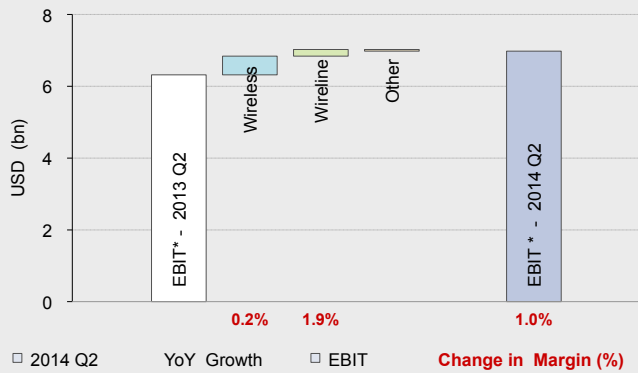
Q2 2014 Results - Changes Since Last Year (YoY)

YoY Change in Revenue



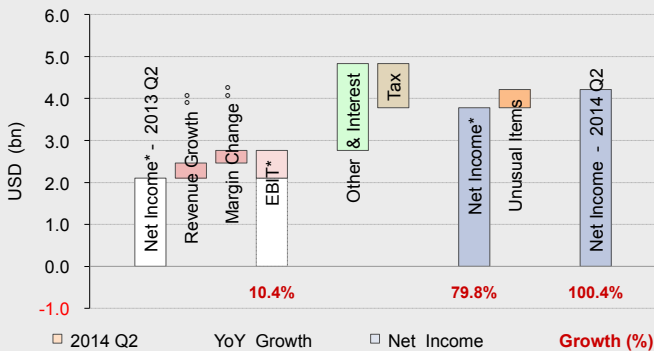
* = Excluding Unusual Items

YoY Change in EBIT* and Margins (%)



Note: Prior year Unusual Items are excluded from analysis in these graphs.

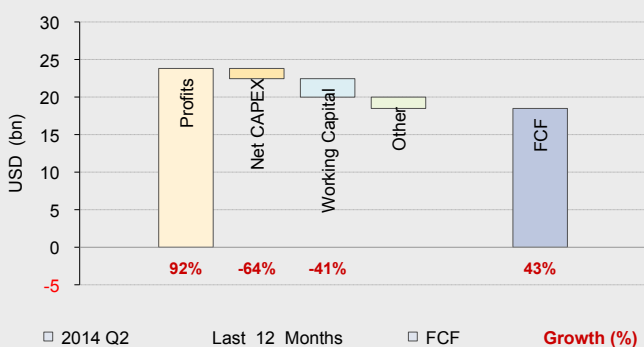
YoY Change in Net Income



°° = Impact on EBIT "Other & MI" = Includes Interest and Minority Items (Vodafone)

"Other Items" includes non-cash charges. Net CAPEX = Depreciation - CAPEX

Free Cash Flows (FCF) - Last 12 Months



Revenues by Division - Q2 2014

- Total Revenue rose \$1.7 bn (+6%) to \$31.5 bn.
- Wireless Revenue rose \$1.5 bn (+8%) to \$21.5 bn.
 - Post-Paid Accounts rose 1.0% to 35.2 m.
 - Post-Paid ARPA rose 5.0% to \$159.7.
 - Connection Per Account rose 0 (+4%).
- Wireline Revenue was flat at \$9.8 bn.
- Other Revenue rose \$165 m (+217%) to \$241 m.

Notes:

- Growth rates and changes are stated on a YoY comparative basis.
- Prior year Unusual Items are excluded from analysis in these graphs.
- Unusual Items relate mostly to Severance, Pension & Benefit Charges.

EBIT by Division - Q2 2014

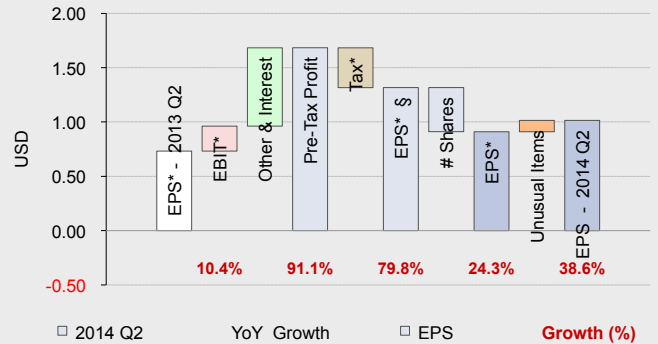
- Q2 Total EBIT rose \$1.1 bn (+17%) to \$7.7 bn. Margin rose 2.4% to 24.4%.
- \$0.7 bn Unusual Items arose at the EBIT level. \$0.2 bn arose in Q2 last year.
- Total* EBIT rose \$0.7 bn (+10%) to \$7.0 bn. Margin rose 1.0% to 22.2%.
- Wireless EBIT rose \$0.5 bn (+8%) to \$7.0 bn. Margin was flat at 32.5%.
- Wireline EBIT rose \$185 m (+250%) to \$259 m. Margin rose 1.9% to 2.7%.
- Other EBIT deteriorated \$46 m to -\$266 m.

Notes - Unusual Items arising this Q and the prior year Q.

	2013 Q2	2014 Q2
At the EBIT level: (\$ bn)	0.2	0.7
At the Net Income level: (\$ bn)	0.1	0.4

§ = EPS before share repurchases / (Issues) # Shares = Share Repurchases / (Issues)

YoY Change in EPS

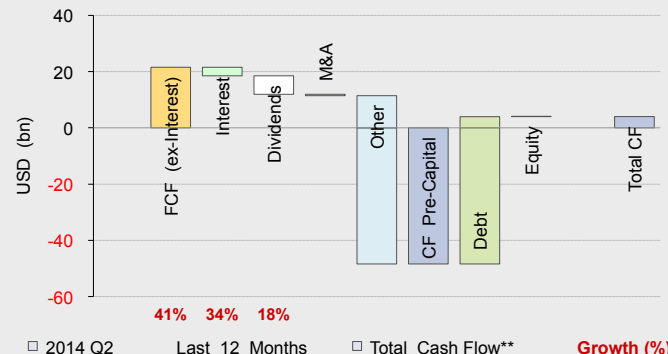


Data is stated on a per share basis.

"Other & MI" = Includes Interest and Minority Items (Vodafone)

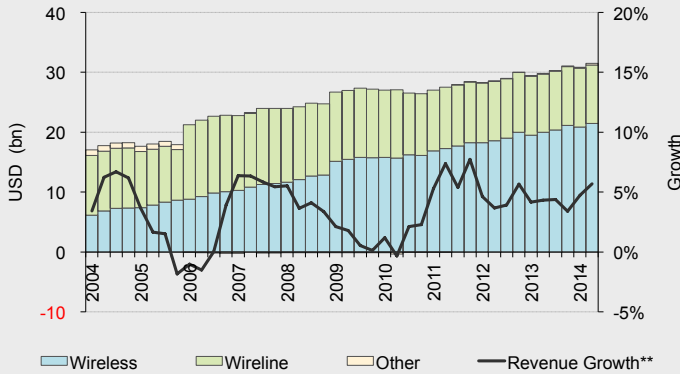
Equity = Share Issues / (Repurchases) CF = Cash Flow

Total Cash Flows - Last 12 Months



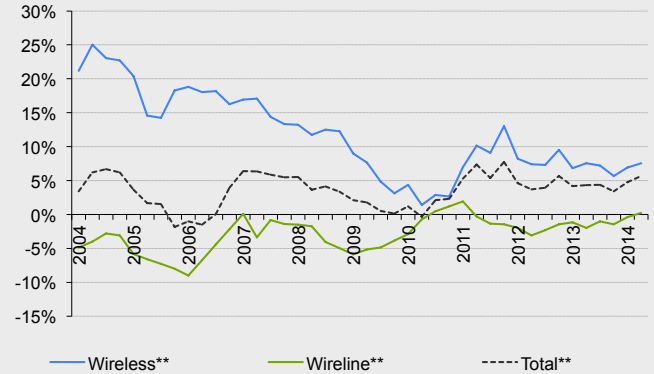
Historical Financial Results - Quarterly Analysis since 2004

Revenue by Division



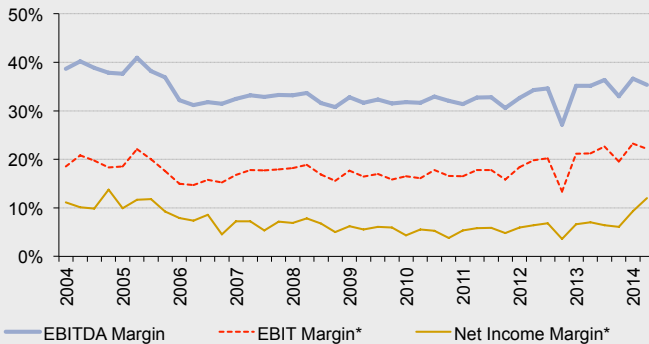
Growth** = Estimated revenue growth excluding major M&A.

Revenue Growth by Division

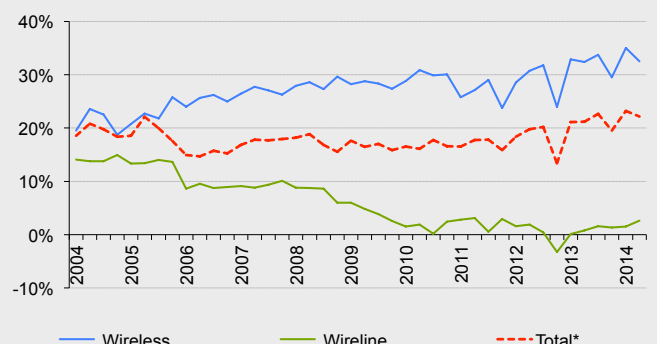


* = Excluding Unusual Items

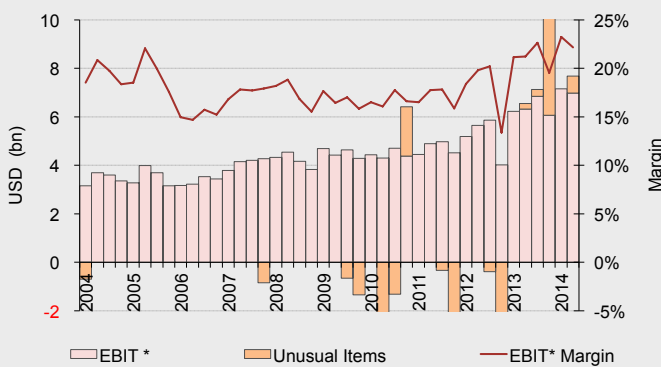
Profit Margins



EBIT Margins by Division



EBIT* & EBIT* Margin



* = Excludes Unusual Items

Key recent acquisitions & disposals:

- 1) In Q2 2005 divested its Directories business.
- 2) In 2006 acquired MCI.
- 3) In 2009 acquired Alltel (wireless operator).

Key recent Unusual Items:

2007- 2010 results included a charges related to restructurings, pension costs, severance payments and integration costs.

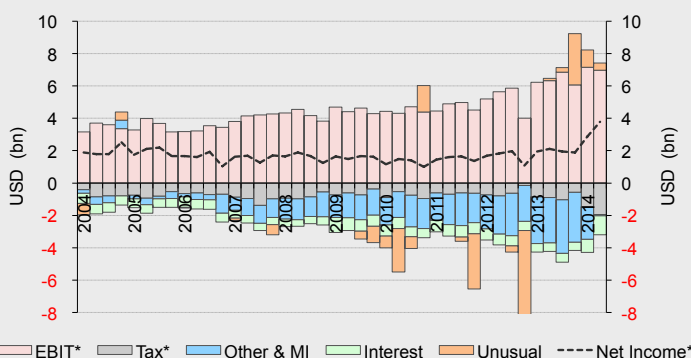
- 1) Q2 2014 includes \$0.4 bn post-tax gain on spectrum sale.
- 2) Q 2012, a \$7.1 bn pre-tax charge was made to cover the under-funded pension plan and \$1.1 bn for early retirement of debt.
- 3) Q4 2011, includes a \$5.6 bn severance & pension charges.

* = excludes Unusual Items.

Most Unusual Items relate to one-off and exceptional items.

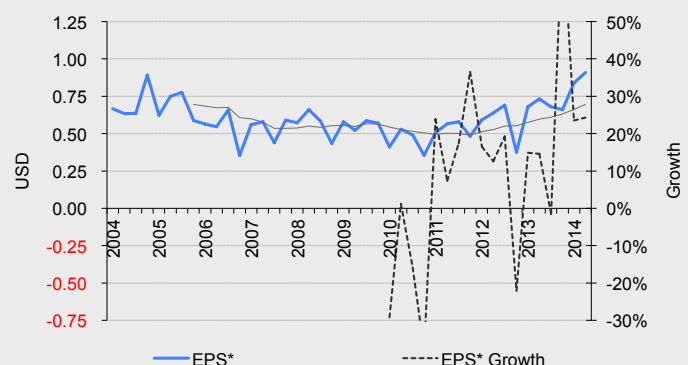
See Company Profile report for more details of Unusual Items.

Net Income Analysis



"Other" includes non-operating items eg. Minority Interest (Vodafone).

EPS* & EPS* Growth



Key Fundamental Drivers

Key long-term, fundamental share price drivers:

(Graph)

- i, ii Share price performance is driven primarily by PE* ratio and dividends; and secondly by EPS* growth (since 2010). This is a contrast to normal share price drivers. Valuation ratios (PE) are at historically high levels.
- iii - v EPS* growth has been driven primarily by EBIT* growth;
- vi See the full report.

PE
↓
Share Price
↑
EPS
↑
Revenue Growth & EBIT Margin

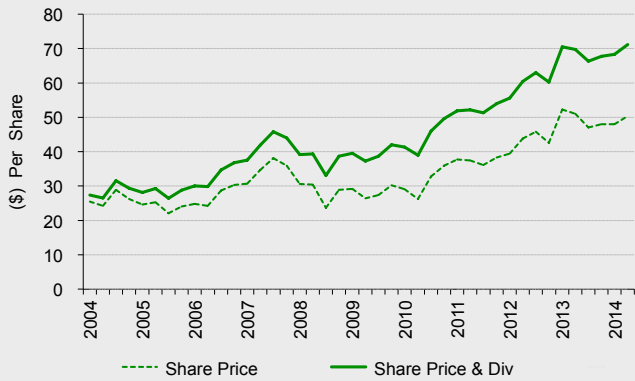
Analysis of fundamentals & EPS drivers:

- See the full report.
- See the full report.
- See the full report.

(see also analysis on next page)

* = Excludes Unusual Items

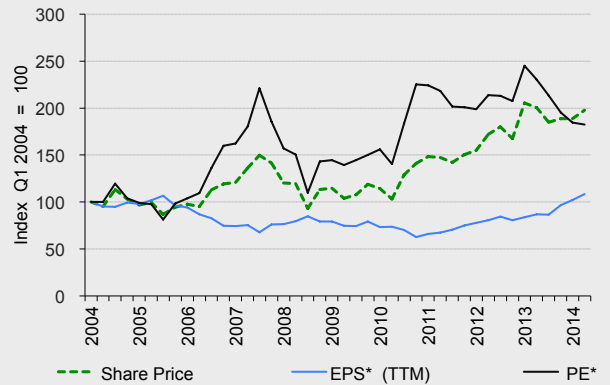
i Share Price & Dividend



§ = On a constant per share basis from Q1 2007.

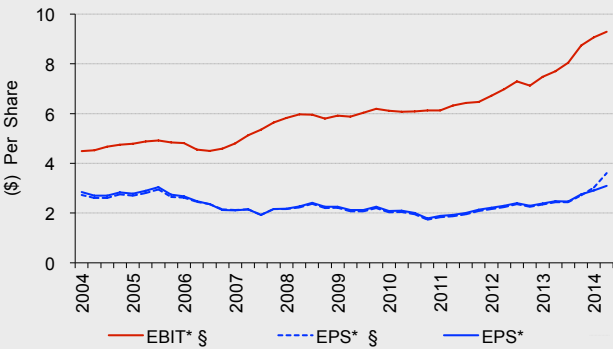
* = Excludes Unusual Items

ii Share Price, EPS & PE

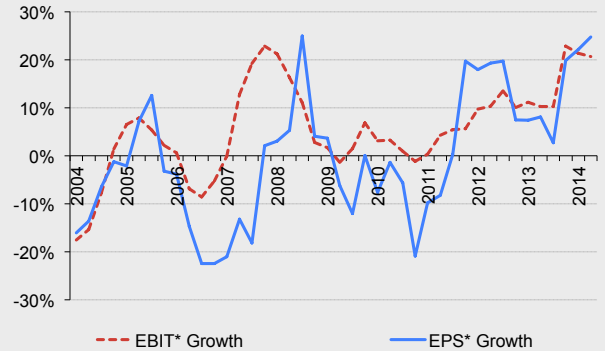


TTM = Trailing 12 months

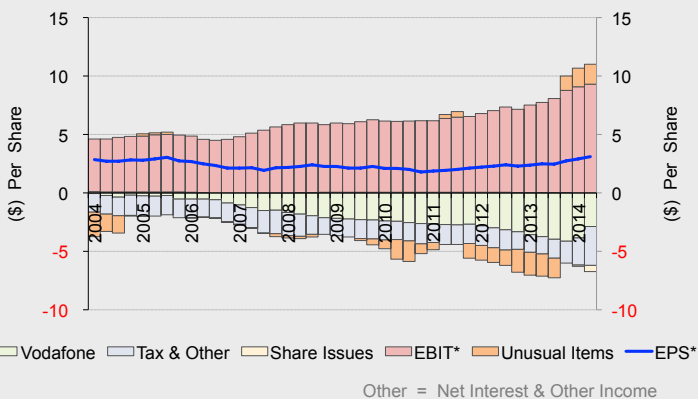
iii EBIT* & EPS* (TTM)



iv EBIT & EPS* (TTM) Growth

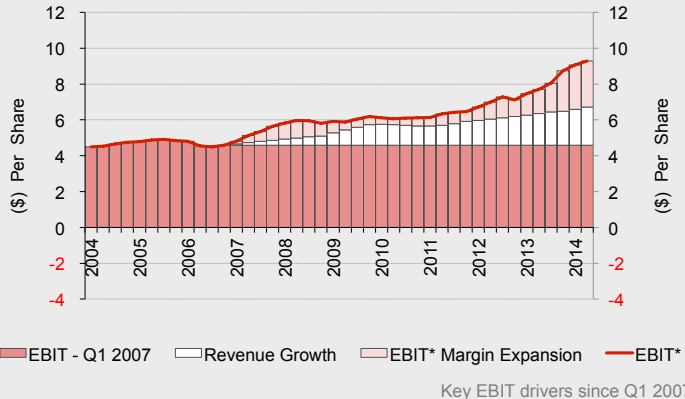


v EPS* \$ (TTM) Drivers



Other = Net Interest & Other Income

vi EBIT* \$ (TTM) Drivers



Key EBIT drivers since Q1 2007.

Valuation

Fundamental Valuation

See the full report.

Fundamental Valuation

§ = Estimates for next 12 Months

Share Price
Dividends Per Share
Return (incl. Div.)

Last 12 Months	Base Case §	Change (%)
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See the full report.

See the full report.

Key Forecasts:

Revenue Growth
EBIT* Margin
Tax Rate*
EPS*

Last 12 Months	Base Case §	Change (%)
4.6%	1.6%	-3.0%
21.9%	18.9%	-3.0%
21.0%	29.0%	8.0%
3.09	3.45	11.8%

P / Sales

See the full report.

P / EBIT*

See the full report.

PE*

* = Excluding Unusual Items

Note: See the full Indigo report for a more detailed description of the fundamental valuation.

Fundamental Valuation Methodology

The potential returns under the three scenarios (Bear, Base, Bull Cases) of the Fundamental Valuation above is a calculation based on an estimated change in share price and dividends received. The share price is calculated by multiplying the forecast PE and EPS. In turn, the EPS is calculated based on forecast changes in revenue, EBIT margin, net interest, other income & tax rates, and adjusting for share repurchases. This approach is summarized by the formula:

$$\text{Return} = \text{Dividends} + \Delta \text{Share Price}$$

$$\text{Return} = \text{DPS} + (\Delta \text{PE} * \Delta \text{EPS})$$

$$\Delta \text{EPS} = (((\Delta \text{EBIT} + \Delta \text{Interest} + \Delta \text{Other Income}) * \Delta \text{Tax Rate \%}) / \text{Shares}) * \Delta \text{Shares}$$

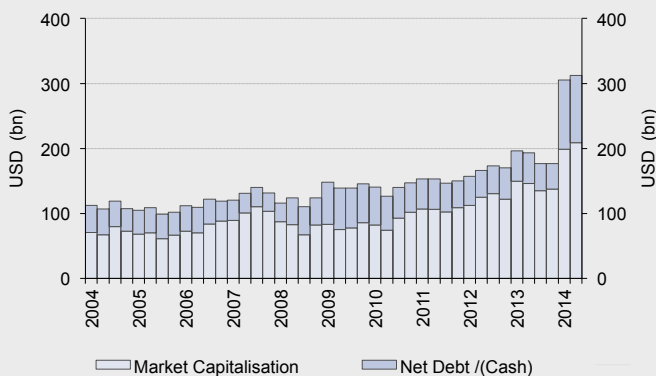
DPS = Dividends Per Share

Δ = Change in a variable

ie. Δ PE = Change in PE ratio

DISCLAIMER: The valuations and return calculations only illustrate the potential returns under the hypothetical conditions described and should not be relied upon for any investment decision. This is not an estimate of what we believe may occur, nor a price target nor a recommendation to buy or sell an investment.

Historical Enterprise Value



* = Excludes Unusual Items

DCF Valuation

Current Share Price	(\$)	50.4
WACC		6.7%
→ DCF Valuation	(\$)	See the full report.

Sensitivity analysis:

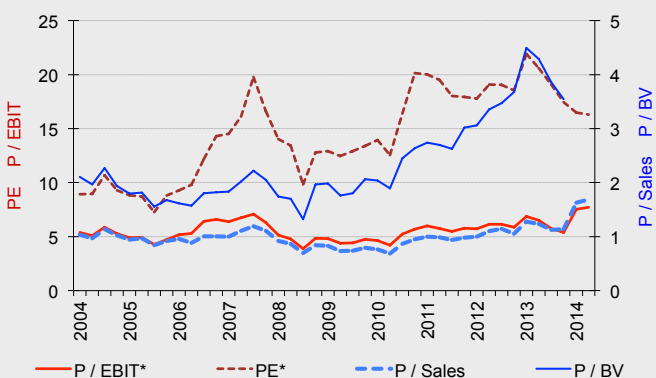
The current share price of \$50.35 and FCF in year 1 of \$4.01 imply the following ranges for FCF growth into perpetuity and WACC:

WACC	See the full report.
FCF Growth into perpetuity	See the full report.

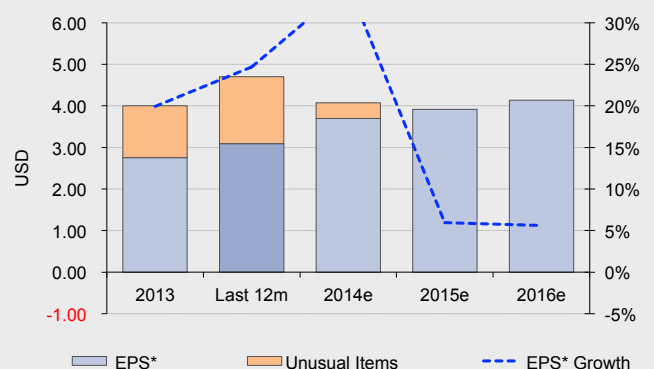
DCF Formula: $PV = FCF / (WACC - g)$

Disclaimer: DCF valuation is only an illustration of potential valuation.

Historical Valuation Multiples



Consensus Forecasts - EPS



Contents of the Full "Company Profile" Equity Research Report

The full (52 page) Company Profile equity research report can be purchased from our website.
www.indigo-equity-research.com

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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

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 company-specific risk of a sustained negative change in earnings, valuation ratios & investor sentiment; and thus the share price for more than one Quarter. This risk does not address the market risk. This risk does not include any measure of short term volatility, in the traditional financial academic sense, of less than one Quarter.

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

TTM = Trailing 12 Months

EV = Enterprise Value

BV = Book Value

Op FCF = Operating Free Cash Flow

Last 12m = Last 12 months

P = (Share) Price

Div. = Dividend

EBIT = Earnings Before Interest & Tax

y/e = (financial) year end

PE = Price / Earnings

EPS = Earnings Per Share

EBITDA = Earnings Before Interest, Tax, Depreciation & Amortisation

PEG = PE / Growth

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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