

Verizon Communications Inc.  
 Latest Results: Q4 2014  
 Country: USA  
 Sector: Telecoms  
 RIC (Ticker): VZ.N

**Fundamental Valuation:** --  
**Indigo View:** --  
**Industry View:** **Neutral**  
**Company Rating:**

	LOW	MED.	HIGH
Risk			
Quality			
Valuation			

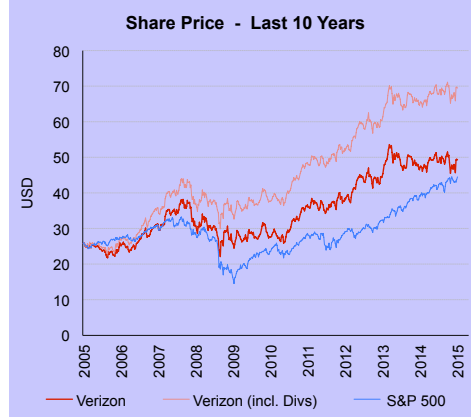
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 Indigo Equity Research Limited  
 www.indigo-equity-research.com

16 Feb 2015

## Snapshot of Q4 2014 - Margin risk due to price war

### Mixed Q4 2014 Results - Strong revenue growth but lower margins

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### Fundamental Valuation

	Bear	Base	Bull
Forecast Share Price	See the full report		
Return (incl. Div.)			
<b>Capital Structure</b>		Per Share (\$)	Total (\$ Bn)
<b>Current Share Price</b>		<b>\$49.3</b>	
Number of Shares (bn)			4.2
Market Capitalization			205.0
Net Cash / (Debt)		-24.6	-102.1
Enterprise Value (EV)		73.5	305.7
Main Shareholder:			--

Consensus Estimates

<b>Financial Results</b>	2014	2015e	2016e
y/e 31 Dec (\$ Bn)			
Revenue	127.1	131.8	134.6
EBIT*	26.4	28.9	30.3
Net Income*	12.8	15.3	16.4
Share Capital	12.3	19.0	26.8
Total Assets	232.7	239.8	247.9
FCF	13.1	13.5	14.9
EPS* (\$)	3.21	3.68	3.96
DPS (\$)	2.16	2.20	2.25
BV per share (\$)	3.09	4.57	6.45

<b>Efficiency Analysis</b>	2014	2015e	2016e
EBIT* Margin	20.8 %	21.9 %	22.5 %
Net Income* Margin	10.1 %	11.6 %	12.2 %
Asset Turnover	55 %	55 %	54 %
Total Assets / Equity	>600%	>600%	>600%
ROE*	103.9 %	80.4 %	61.2 %

<b>Growth Analysis</b>	2014	2015e	2016e
Revenue	5.4 %	3.7 %	2.1 %
EBIT*	3.7 %	9.4 %	4.8 %
Net Income*	61.7 %	19.4 %	7.5 %
EPS*	16.7 %	14.6 %	7.5 %

<b>Valuation Ratios</b>	2014	2015e	2016e
P / Sales	1.6	1.6	1.5
EV / EBITDA	7.1	6.7	6.5
P / EBIT*	7.8	7.1	6.8
PE*	15.4	13.4	12.5
PEG*	0.9	0.9	1.7
P / BV	15.9	10.8	7.6
P / FCF	15.7	15.2	13.7
Dividend Yield	4.4 %	4.5 %	4.6 %
Pay-Out Ratio	89.3 %	59.8 %	56.9 %
Net Debt / EBITDA	2.4	2.1	1.9

Valuation Ratios are based on the current share price.

\* = Excluding Unusual Items

### Significant recent events

- Verizon bid \$10.4 billion 181 licenses in the AWS-3 spectrum.
- Verizon said that it will divest \$15.5 billion worth of assets.

### Investment thesis - Dominant position but unclear long-term prospects

Verizon is a utility with attractive dividend yield (c. 4%) and value investment profile. High dividend pay-out ratios (>60%) and moderate gearing provides little financial flexibility. Growth & profits are driven by wireless data services (eg. LTE) for tablets & smartphones. Verizon is the best managed & positioned US wireless telco in an oligopolistic market. It has the best (post-paid) customers, highest ARPU, highest margins and lowest churn. Wireline is barely profitable and in decline due to broadband competition from cable. Verizon's potential depends much on a few key industry developments: the emerging IoT & telemetric segment, the on-going wireless price war, possible new net neutrality rules, and potential industry restructurings (eg. AT&T & DirecTV merger, Comcast & TWC, ....).

### 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?
- IoT and telematics.

#### Weaknesses

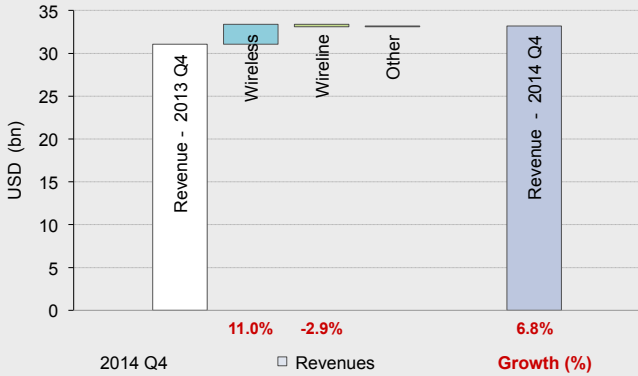
- Maturing US telecoms market.
- Pension deficit.
- Becoming a "dumb pipe".

#### Threats

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

## Q4 2014 Results - Changes Since Last Year (YoY)

### YoY Change in Revenue



### Revenues by Division - Q4 2014

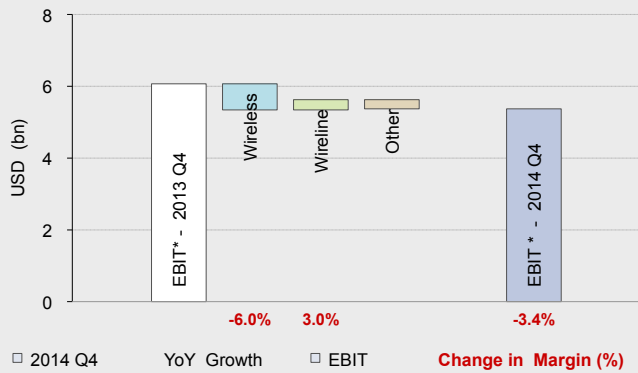
- Total Revenue rose \$2.1 bn (+7%) to \$33.2 bn.
- Wireless Revenue rose \$2.3 bn (+11%) to \$23.4 bn.
  - Post-Paid Accounts rose 1.0% to 35.6 m.
  - Post-Paid ARPA rose 1.0% to \$158.8.
  - Connection Per Account rose 0 (+4%).
- Wireline Revenue fell \$285 m (-3%) to \$9.6 bn.
- Other Revenue rose \$88 m (+93%) to \$183 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.

\* = Excluding Unusual Items (prior year \$3.2 bn gain and \$4.7 bn loss this Q) for pens

### YoY Change in EBIT\* and Margins (%)



### EBIT by Division - Q4 2014

- Q4 Total EBIT deteriorated \$14.2 bn to -\$2.1 bn. Margin fell 45.3% to -6.4%.
- -\$7.5 bn Unusual Items arose at the EBIT level. \$6.0 bn arose in Q4 last year.
- Total\* EBIT fell \$0.7 bn (-11%) to \$5.4 bn. Margin fell 3.4% to 16.2%.
- Wireless EBIT fell \$0.7 bn (-12%) to \$5.5 bn. Margin fell 6.0% to 23.5%.
- Wireline EBIT rose \$285 m (+218%) to \$0.4 bn. Margin rose 3.0% to 4.4%.
- Other EBIT deteriorated \$255 m to -\$0.5 bn.

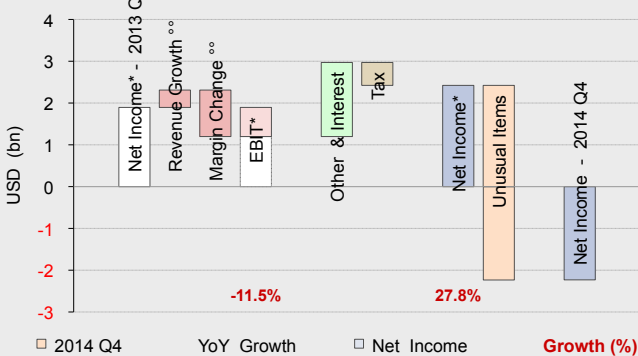
### Notes - Unusual Items arising this Q and the prior year Q.

	2013 Q4	2014 Q4
At the EBIT level: (\$ bn)	6.0	-7.5
At the Net Income level: (\$ bn)	3.2	-4.7

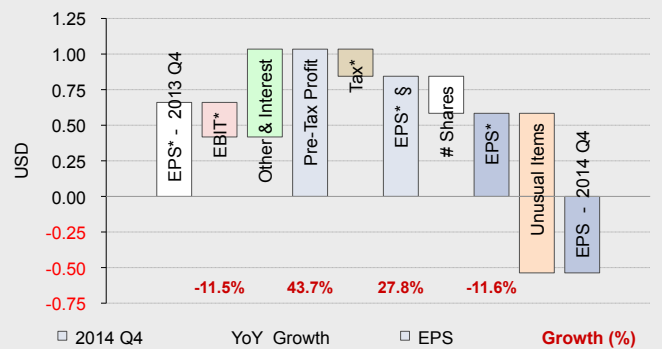
Note: Prior year Unusual Items are excluded from analysis in these graphs.

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

### YoY Change in Net Income



### YoY Change in EPS



Data is stated on a per share basis.

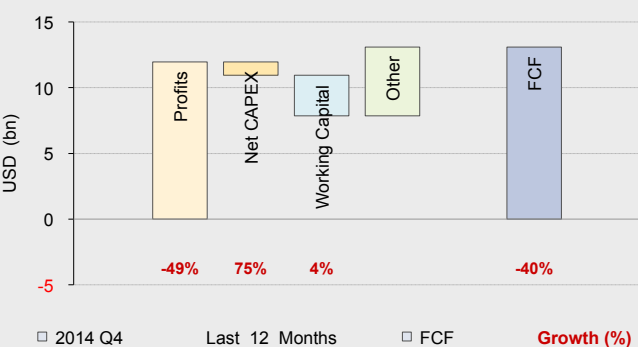
\*\* = Impact on EBIT "Other & MI" = Includes Interest and Minority Items (Vodafone)

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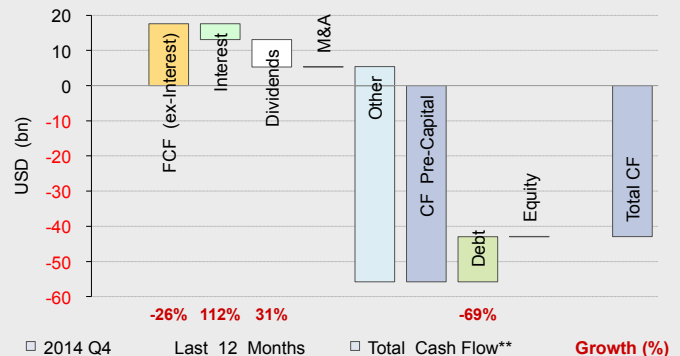
"Other Items" includes non-cash charges. Net CAPEX = Depreciation - CAPEX

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

### Free Cash Flows (FCF) - Last 12 Months

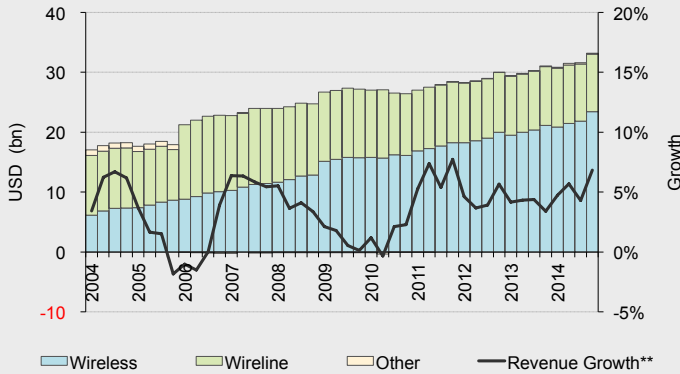


### Total Cash Flows - Last 12 Months



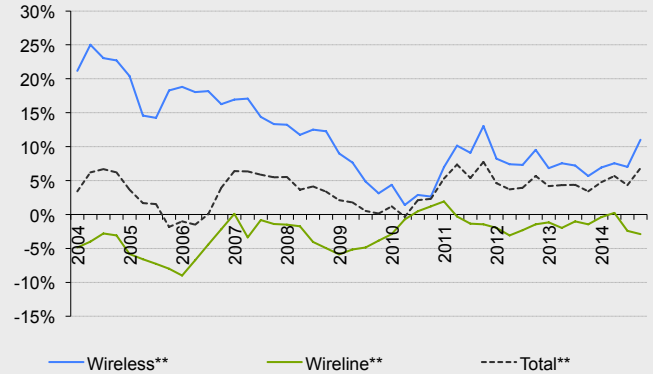
## Historical Financial Results - Quarterly Analysis since 2004

### Revenue by Division



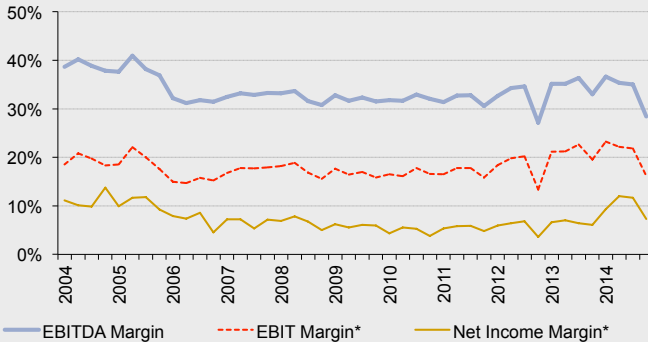
Growth\*\* = Estimated revenue growth excluding major M&A.

### Revenue Growth by Division

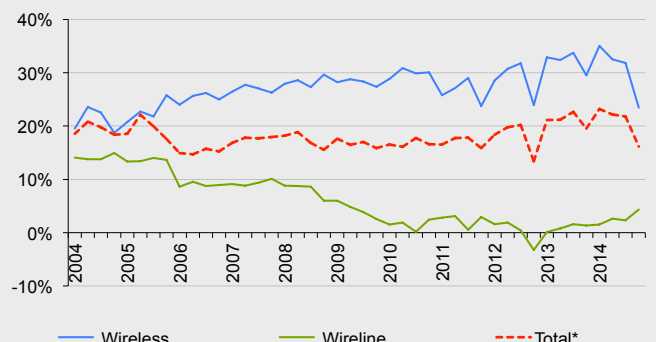


\* = Excluding Unusual Items

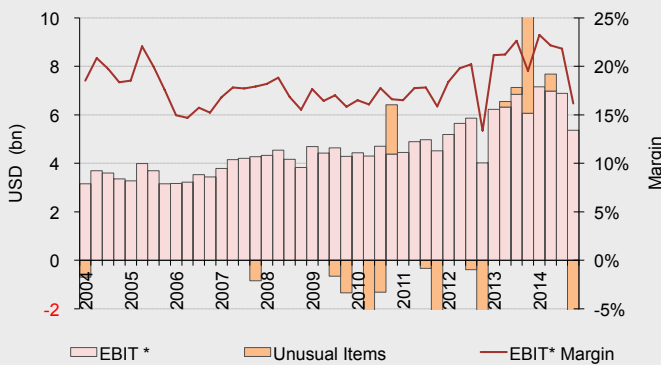
### Profit Margins



### 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:

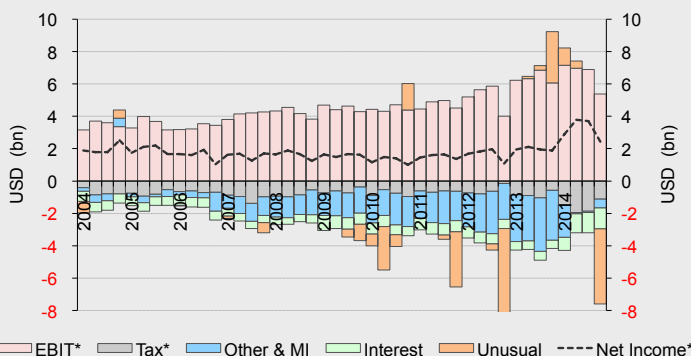
- 1) Q4 2014 included c. \$7.5 bn pre-tax pension charges.
- 2) Q 2012, a \$7.1 bn pre-tax charge was made to cover the under-funded pension plan and \$1.1 bn for early retirement of debt.
- 3) Q4 2011, includes a \$5.6 bn severance & pension charges.
- 4) 2007- 2010 results included a charges related to restructurings, pension costs, severance payments and integration costs.

\* = excludes Unusual Items.

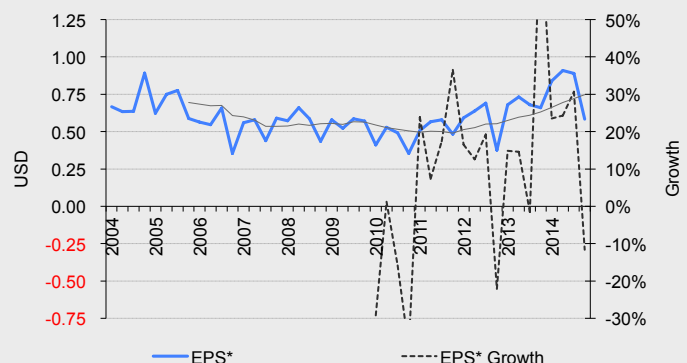
Most Unusual Items relate to one-off and exceptional items.

See Company Profile report for more details of Unusual Items.

### Net Income Analysis



### 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.

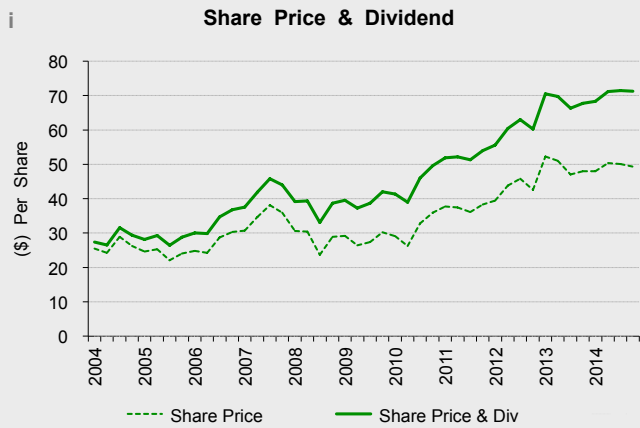
PE  
↓  
Share Price  
↑  
EPS  
↑  
Revenue Growth & EBIT Margin

### Analysis of fundamentals & EPS drivers:

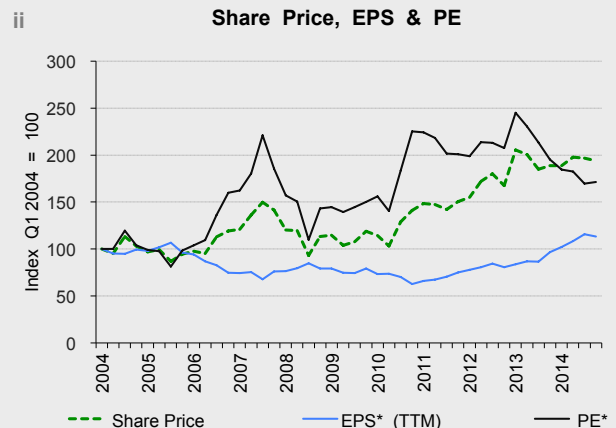
- See the full report.
- See the full report.
- See the full report.

(see also analysis on next page)

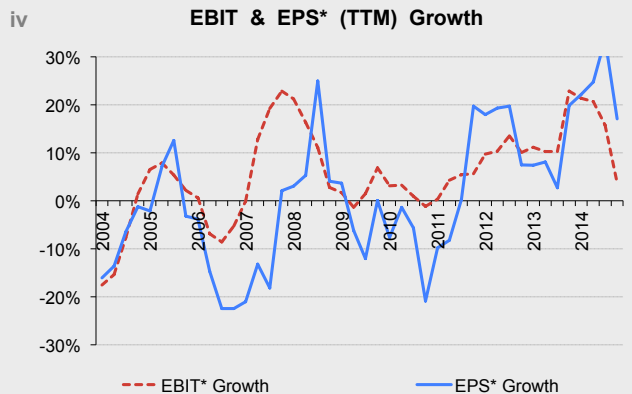
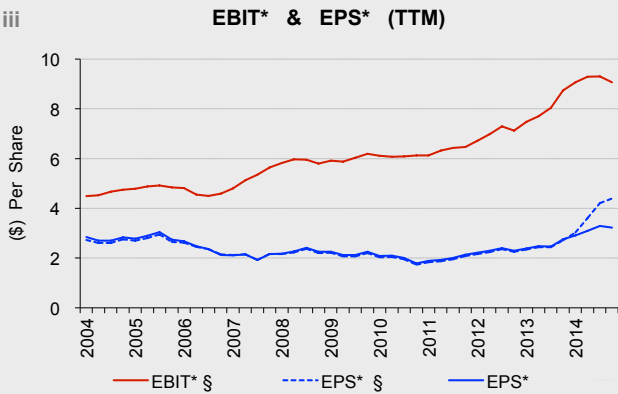
\* = Excludes Unusual Items



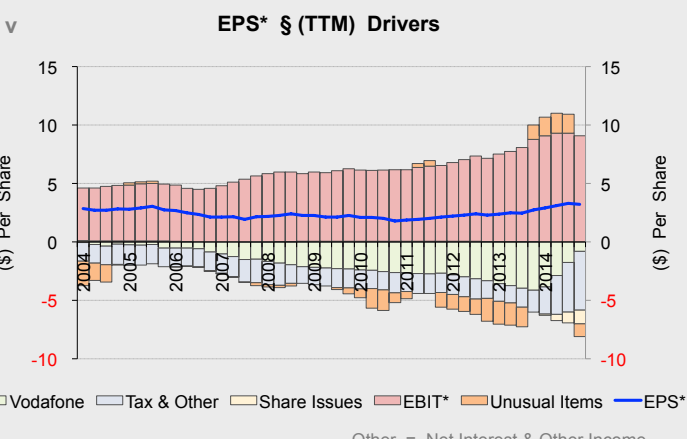
§ = Excluding the impact of any changes in # shares from Q1 2007. Excludes Unusual Items



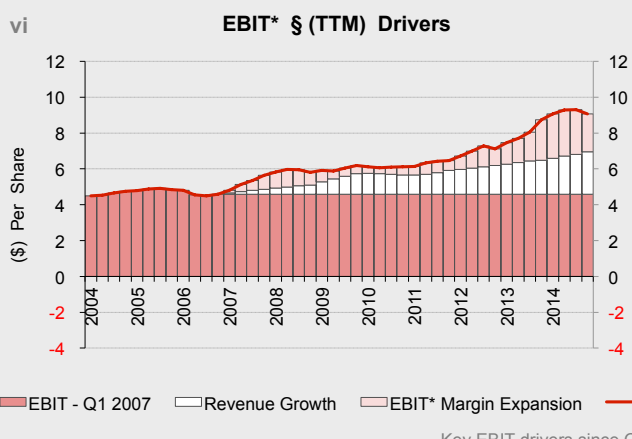
TTM = Trailing 12 months



EBIT\* \$ (TTM) = Trailing 12 months EBIT, excluding Unusual Items & changes in # sha



Other = Net Interest & Other Income



Key EBIT drivers since Q1 2007.

## Valuation

### Fundamental Valuation

See the full report.

### Fundamental Valuation

§ = Estimates for next 12 Months

	Last 12 Months	Base Case §	Change (%)
Share Price (\$)	See the full report.		
Dividends Per Share (\$)	See the full report.		
Return (incl. Div.)	See the full report.		
<b>Key Forecasts:</b>			
Revenue Growth	5.4%	3.4%	-2.0%
EBIT* Margin	20.8%	18.8%	-2.0%
Tax Rate*	29.7%	31.7%	2.0%
EPS*	3.22	3.17	-1.7%
P / Sales	See the full report.		
P / EBIT*	See the full report.		
PE*	See the full report.		

\* = 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:

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

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

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

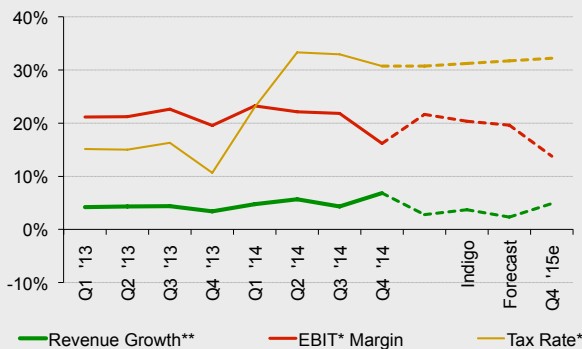
DPS = Dividends Per Share

Δ = Change in a variable

ie. Δ PE = Change in PE ratio

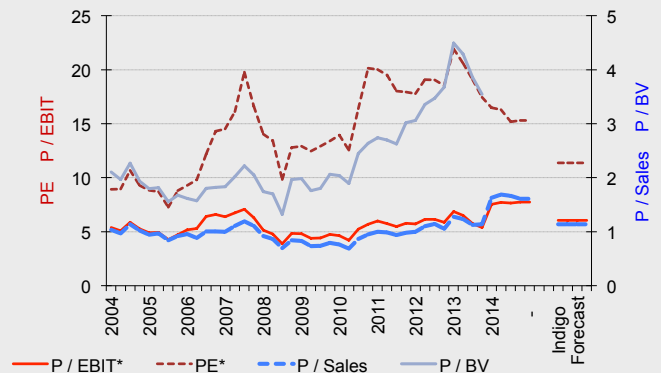
**DISCLAIMER:** The valuations and return calculations only illustrate the potential returns under the hypothetical conditions described and should not be relied upon for any investment decision. This is not an estimate of what we believe may occur, nor a price target nor a recommendation to buy or sell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

### Indigo Forecast Revenue Growth, EBIT Margin & Tax



\* = Excluding Unusual Items

### Historical Valuation Multiples



### DCF Valuation

Current Share Price (\$) 49.3

WACC 6.6%

→ DCF Valuation (\$) See the full report.

### Sensitivity analysis:

The current share price of \$49.31 and FCF in year 1 of \$2.83 imply the following ranges for FCF growth into perpetuity and WACC:

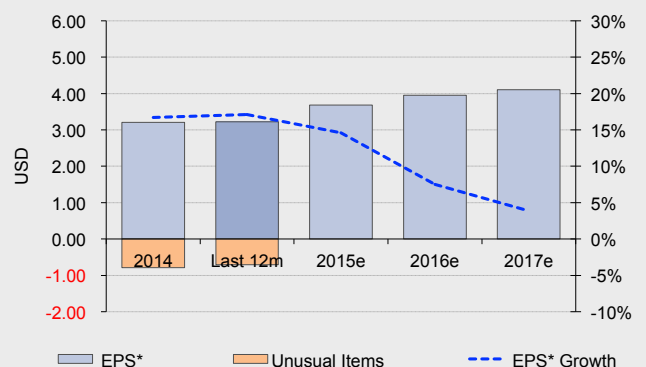
WACC See the full report.

FCF Growth into perpetuity See the full report.

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

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

### Consensus Forecasts - EPS



## 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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