Telecom Services

The Picture Should Become Clearer For Video Strategies In 2007

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While telecom services carriers face many key issues (consolidation, pricing stabilization, broadband and wireless data growth, wireless substitution of wireline voice, and expansion of phone service by cable companies), we believe the push into video—and the question of how much to commit to the effort—represents the signature topic for the industry in 2007. With cable companies extending Voice-over-Internet Protocol (VoIP) nationwide and offering attractive triple-play packages of voice/data/video, phone companies know they need to respond but are split on what do. In this period of uncertainty, we believe more conservative video strategies are preferable to aggressive expensive ones—a major component of our preference for AT&T Inc. (T—$34.99; rated Overweight) over Verizon Communications (VZ—$36.66; rated Underweight).

Video is increasingly becoming an important component of phone companies' defensive strategy against accelerating residential access-line declines. With cable triple-play offers now widely available, phone companies are finding that they are losing market share more from fewer gross additions rather than higher churn; in other words, existing customers aren't turning off their traditional phone service in favor of cable VoIP, but potential new customers (i.e., movers) are increasingly taking advantage of the cable choice.

To many moving consumers, getting video hooked up in a new home is more important than phone service—especially since cell phones will adequately substitute until the home phone line is turned on. If the cable company gets the first call and can easily up-sell with a triple-play, the phone company may never receive that second call for service. As a result, phone companies are now under substantial pressure to counter with their own video-inclusive bundles.

Three Choices For Video: Resell DBS, Extend Fiber, Or Rebuild With Fiber-To-The-Home. Recognizing the need for a video-inclusive bundle, phone companies have essentially three choices for offering video (in order from least expensive to most expensive):

- Partner with Direct Broadcast Satellite (DirecTV and EchoStar).
- Extend fiber closer to the customer (such as to the neighborhood node or to the curb) to enable faster broadband speeds and develop switched-video technology (i.e., IPTV) to carry video signals over copper wires into the home.
- Rebuild the network from scratch, deploying fiber-to-the-home.

While DBS partnerships are not optimal (as some customers can't or don't want a dish on their property), they involve no network capital for the phone companies and are thus only minimally EPS dilutive. On the other end of the spectrum, fiber-to-the-home appears economically untenable by our math—we simply can't justify Verizon's expensive, highly dilutive network rebuild (with a planned $23 billion in capex to cover 18 million homes by 2010). By contrast, the fiber-to-the-node strategy of AT&T (a planned $4.6 billion to cover 19 million homes by 2008) does appear to make economic sense—justifiable simply on the basis of attaining faster DSL speeds. However, we remain uncertain whether AT&T's IPTV switched-video platform, currently undergoing trials, will be easily scalable. Nevertheless, we feel more comfortable with the technology risk of AT&T's video strategy than with the expensive and seemingly economically unjustifiable strategy taken by Verizon.

Verizon FiOS Costs Running A Huge $4,700-Plus Per Subscriber Add. Although we admire Verizon's effort to gain a technology edge with fiber-to-the-premise, we continue to believe FiOS (Fiber Optic Service) will prove uneconomical. Based on results in third-quarter 2006, we estimate Verizon is spending over $1,700 of operating costs (marketing, installation, customer care) for each FiOS subscriber added. If adding network capital costs ($900 of capex per premise connected plus $845 of capex per premise passed, spread across the customer base, assuming a long-run 40% penetration), FiOS rollouts are topping $4,700 per subscriber—well above the current $3,500-$4,000 per subscriber valuations for cable companies (which are cash generating today rather than risky and dilutive). If we added the cost of video set-top boxes, the total cost would exceed $5,000 per subscriber (Figure 1).

We believe investors may penalize Verizon in 2007 should the company fail to stem its high operating costs per customer addition. These operating costs have been the primary driver for rising FiOS-related EPS dilution, which has more than doubled over the last year—from 4 cents in third-quarter 2005 to 9 cents in third-quarter 2006. In October, Verizon increased its full-year FiOS dilution guidance to $0.31-$0.32, up from $0.28-$0.30 previously. While Verizon forecasts FiOS dilution for 2007 as “about flat” with 2006 levels, we suspect that dilution will likely be higher due to high marketing and promotion costs.

AT&T Project Lightspeed Remains A Trial. By contrast, AT&T’s Project Lightspeed fiber-to-the-node (FTTN) initiative remains at the small trial stage, with only 3,000 video customers as of September in a San Antonio trial. The company has passed 2.4 million homes with FTTN technology, less than half of the 5.3 million homes passed by Verizon with FiOS. Dilution has also been fairly minimal, with AT&T projecting $0.05-$0.07 EPS impact from Project Lightspeed in 2006, a figure we expect to roughly double in 2007 as service is expanded to additional markets. AT&T’s goal of significant penetration within the 19 million homes passed with the technology by 2008 should only be achievable if the company can prove IPTV switched video (including high-definition capability) is scalable. We believe 2007 will be a “show-me” year for IPTV technology deployment.

DBS Partnerships Arguably Make The Most Sense. In the meantime, we expect DBS partnerships to expand in 2007 as they have proven to be useful for both phone companies and DBS companies to combat the common cable company enemy. Over the last two quarters, phone company bundles have represented nearly two thirds of DBS subscriber additions. (Admittedly, this statistic is overstated because some of the DBS-phone-bundle additions were previously stand-alone DBS customers; Figures 2 and 3.)

BellSouth remains the most successful RBOC (Regional Bell Operating Company) with over 7% of its consumers on a bundled offer with DirecTV DBS service, nearly double the 2%-4% range of its peers. Qwest has begun making a big DBS push, adding 1.4% of its consumers with DBS bundles in third-quarter 2006 alone. We expect AT&T to ramp up its DBS sales

Figure 1. Verizon FiOS Costs Over $4,700 Per Subscriber To Deploy

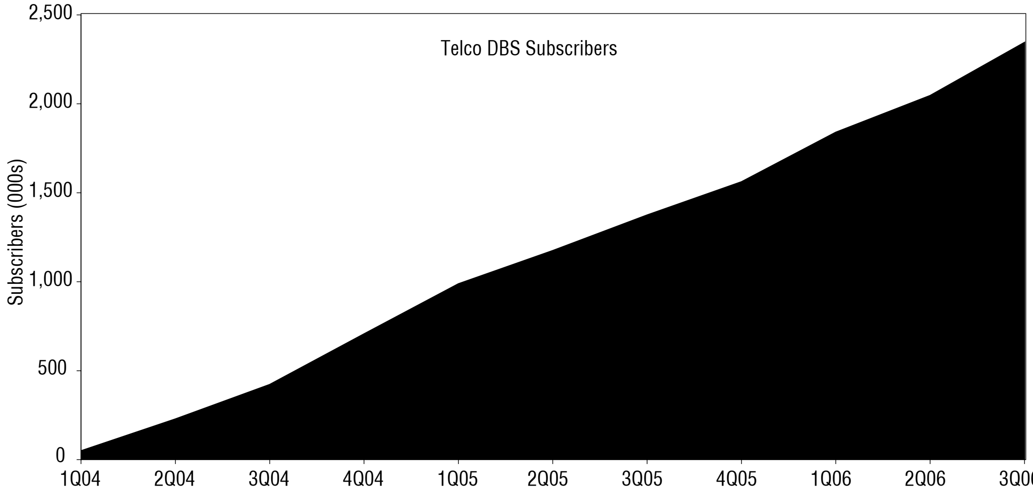
Verizon FiOS Cost Per Subscriber Analysis
(Units Shown)

	3Q06		Note
FiOS cash operating expense for marketing & installation	$304 mil.		(1)
/ FiOS subscriber additions	175,000		(2)
= Marketing & installation operating expense per subscriber added		$1,739	
Capital expenditure per premise passed	$845		(3)
/ Long-run penetration of customer base (assumed)	40%		
= Capital expenditure per premise passed amortized per subscriber		$2,113	
Capital expenditure per premise connected		$900	(3)
= Capital expenditure + operating expense per FiOS subscriber		**$4,751**	

(1) 3Q06 disclosed cash operating expense of $358 million; assume 85% for marketing & installation.
(2) 3Q06 disclosed 147,000 FiOS data subscribers and 63,000 FiOS video subscribers added; assume 56% of video additions also take data.
(3) 3Q06 disclosure.

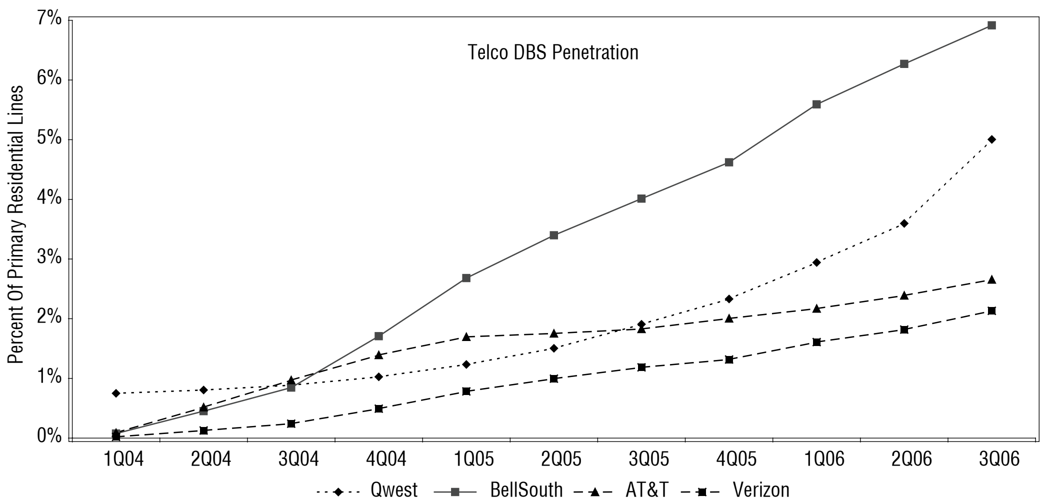
Source: Company reports; Prudential Equity Group, LLC estimates.

Figure 2. Telcos Surpass 2 Million DBS Subscribers…



Source: Company reports; Prudential Equity Group, LLC estimates.

Figure 3. …Led By BellSouth



Source: Company reports; Prudential Equity Group, LLC estimates.

with EchoStar as the companies are now rolling out their joint "Homezone" service, allowing a combined DBS-DSL service with large pay-per-view libraries over an integrated DVR-equipped set-top box.

While it might not represent a perfect option, DBS resale and integration with DSL through Homezone-type services might ultimately turn out to be a better option for phone companies than building out their own video capabilities. Intuitively, it's hard to envision phone companies ever building viable business plans as the fourth entrant in a mature, capital-intensive video market, especially when considering their scale disadvantage on programming costs, which are by far the greatest expense for video providers. If fiber-to-the-home proves too expensive and IPTV too difficult to scale, investors should ultimately expect to see tighter integration between the traditional phone and DBS industries.

AT&T's Risk & Valuation. We rate shares of AT&T Inc.—and its pending merger partner BellSouth Corp. (BLS—$45.44; rated Overweight)—Overweight with a $39 target. We believe the AT&T/BellSouth merger is a smart, logical combination that will have greater scale, plus full ownership of Cingular Wireless. Cingular is showing steadily improving fundamentals with margin gains and churn reductions by realizing synergies from the 2004 AT&T Wireless merger. Although some technology hurdles remain, we believe AT&T's fiber-to-the-node (FTTN) plan is a more sensible incremental approach than Verizon's more expensive fiber-to-the-premise (FTTP) strategy.

We believe there remains upside to our forecast as, much like the AT&T/SBC merger, guidance for post-merger synergies may be upwardly revised after the merger. Based on our estimates, AT&T trades at just 13 times our 2007 EPS, or at a 15% discount to the 16 times S&P 500 P/E. At our $39 price target, AT&T should trade in 12 months at a similar 13 times P/E on our 2008 estimates.

The primary risk to our Favorable industry opinion and Overweight rating on AT&T and BellSouth is that VoIP and wireless substitution could lead to faster deterioration of the core wireline voice market. As RBOCs, AT&T and BellSouth have legal/regulatory issues, including merger approval risk for the pending AT&T/BellSouth merger. As with all companies completing significant mergers, AT&T/SBC has merger execution risk, although we believe the company will be able to reach its targets. In addition, we see technology uncertainty regarding AT&T's Project Lightspeed, especially since the service remains at the trial stage.

Verizon's Risk & Valuation. We rate Verizon Underweight (within our Favorable industry rating) with a price target of $32. We believe Verizon should benefit from industry rationalization, though it could continue to experience more competitive disruption than other RBOCs. Additionally, we are skeptical about the company's expensive fiber-to-the-home FiOS strategy. Verizon has an exceptionally strong wireless unit, though we suspect that (unlike with Cingular), further margin improvement may be limited. We are also concerned that Verizon may ultimately overpay Vodafone for its 45% stake in Verizon Wireless.

Verizon trades at 16 times our new 2007 EPS estimate, in line with the telecom services group's range of 13 times to 21 times. Verizon's 2007E EBITDA multiple of 5.7 times is in line with the group range of 5 times to 8 times. Based on our 2007 estimates, Verizon does have a more modest free-cash-flow yield of 6% (versus AT&T at 7%) as investors may be more optimistic than we are about Verizon's chances of generating returns on the capital-intensive FiOS rollout.

Potential upside risk to our Underweight rating on Verizon is that synergies from the MCI acquisition surpass our expectations or Verizon Wireless continues to outperform competitors. FiOS could also show faster improvement on both take rates and deployment cost reductions.

The research analyst, a member of the team, or a member of the research analyst's household owns Verizon Communications common stock.

ANALYST UNIVERSE COVERAGE: Richard Klugman covers Alltel Corp., BellSouth Corp., Commonwealth Telephone Enterprises, CenturyTel, Inc., Citizens Communications, Embarq Corp., Qwest Communications Int'l, Sprint Nextel, AT&T Inc., Verizon Communications, and Windstream Corp.