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VZ - Verizon at Jefferies Global Technology, Media & Telecom Conference

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Michael McCormack, Jefferies - Analyst

Thanks everybody for joining us and welcome to Jefferies 2014 TMT Conference. We are thrilled to have you all here. We also have a roaming camera crew that will be here throughout the three-day period. Feel free to be animated, talk to them. Make a fantastic video for this conference. We appreciate that.

With that, very excited to have Fran Shammo, CFO of Verizon Communications, with us this morning. Welcome, Fran.

Fran Shammo, Verizon Communications Inc. - EVP and CFO

Good morning, everyone. Thanks, Michael.

Michael McCormack, Jefferies - Analyst

So I think there is a lot obviously going on in the telecom world and I think the thing that is on most people's minds is probably the competitive landscape and you have made a few comments, maybe you can just refresh our thought process on is there a pricing war going on? Are you concerned about low-end competitors? Is this industry as healthy as it was call it a year ago?

Fran Shammo, Verizon Communications Inc. - EVP and CFO

I think first off, the industry is probably more healthy than it has ever been at this point. From a competitive standpoint, the wireless business has always been an extremely competitive business.

If you look at the pricing though I guess I always like to go back in time and try to explain this with voice. If you remember in the early days with voice, voice started very high and as time went on, the voice -- the price per minute actually decreased over time but the volume of minutes continued to increase on the network.

What you are seeing is you are seeing that same type of trend in the data world. So with the LTE network which is four times, five times more efficient than the CDMA network, you are seeing that the data continues to grow but the price per megabit is going to continue to decline and that is just the way it is.

But if you look at the overall pie, the industry is still going to grow because you are going to have all of these not only smartphones but you are going to have tablets, you are going to have machine to machine, you are going to have all these other attachments to the network. If you go to the consumer electronics show, everything that is being looked at from a technological standpoint has some type of an LTE chip embedded in it.

So from just an industry perspective, the industry still has a lot of room for growth.
On the pricing side of the house, I guess I would show it as there has been some pricing moves in the marketplace but the way you have to look at this is with the installment plan and I'm sure we will talk about that, really all that has happened other than a couple of issues is you have taken $20 out of service pricing or $25 out of service pricing and moved it over to equipment revenue.

So the pricing takedown has not been significant because it has really just shifted buckets. It has had an impact on ARPs. It has an impact on service revenue growth but you have to look at it in a more combined basis now. So I think from my viewpoint, the industry is very healthy. I think the industry has a lot of room for growth but the price per megabit will continue to decline.

Michael McCormack - Jefferies - Analyst

So just thinking along the lines of pricing, there have been a few changes frankly back and forth over the past couple of months and you guys have reacted on both the low-end as well as the higher-end family share plan. What was the catalyst for you to react?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Well, coming out of the fourth-quarter if you remember when I was sitting during the fourth quarter call in January, I said look, there has been some pricing moves in the industry. We will react rationally and where we think we need to react. The key to any competitive move is not to overreact to a competitor. You have to watch them, you have to monitor, you have to monitor what is happening to your customer base and what we saw was we did see pressure in our basic phone category and to a much lesser extent in our old 3G network smartphone category.

So the issue we had to address was we were priced out of the market at the low end, so we had to launch our $40 250 Mb smartphone plan and once we did that mid-February and then followed that up with a refresh of our Shared Everything which we now call More Everything.

The moves that we made we saw a definite change in our trending. So I guess you could accuse us of not moving fast enough but again the way we look at this is we take a very measured approach to any moves we make because once you make the move you can't go back. So you have to make a very measured move, make sure you are doing the right thing for your customer but also make sure you are doing the right thing for your shareholders.

So we think we made the right moves, we came out, we exited the quarter a lot better than we entered the quarter and I feel very, very good about the second quarter.

Michael McCormack - Jefferies - Analyst

So along those lines thinking about handset additions which seems to be a key focus for a lot of folks and maybe a couple of things, your comments on whether or not that is a valid metric, a metric we should care about. And then you are just discussing good trends coming out of the quarter and think good about the current quarter so when we think about handset additions or overall net adds, how should we think Verizon is positioned?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes, I always joke, Michael, and you have heard me say this, I think I'm going to stop reporting net adds. It has just been a 20 year metric that I guess drives all of us now because everyone is still focused on that net phone add.

Michael McCormack - Jefferies - Analyst

It could be one last line on my model.
Fran Shammo - Verizon Communications Inc. - EVP and CFO

And really the truth is that net phone adds are going to become more and more competitive more or less than they have been in the past as the penetration rates get up. But what everyone is missing I think is if you look at our first quarter, the piece that was missed is we added 866,000 LTE smartphones in the quarter. So they were quality high revenue type customers. We lost at the low end of the base and so we had a net negative phone add.

The other piece that people are missing I think is all of the other growth prospects that we have. So when you talk about tablets, we had the best tablet quarter ever even without the holiday season. We had -- machine-to-machine continues to grow. We disclosed that we are growing revenue 40% year-over-year and that is going to continue to grow and add value to the Company.

So there is more to the ecosystem than just a smartphone category and that is where I kind of jokingly say maybe I should stop focused on that because really what I'm trying to get everybody focused on is look at what the revenue growth is because that is what is going to matter in the future. It is not going to matter if I add one more smartphone or one more machine-to-machine. Obviously that is a one aspect of growth but the real measurement is revenue and service revenue for us grew at 7.5%. So very, very healthy growth in revenue.

Now that will continue to decline a little bit as installment sale takes over so you will have more equipment revenue. But if you just look at the overall revenue growth, it is still going to be a healthy growth.

Michael McCormack - Jefferies - Analyst

So when you think about overall handset additions and I know we don't want to focus too much on this but as an industry, we have sort of reignited gross add growth and you and I were talking about this last night but are we seeing the sort of blurring of the lines between prepaid, postpaid, what was traditionally a pay in advance type product from a Metro PCS or a Leap Wireless into one big pool of potential customers for Verizon and others?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

I don't think so because again you still have different segments of a customer and there is a certain segment that is still going to want a prepaid phone whether they have no credit, they don't have credit cards, they are strictly a cash type customer. That is still going to be a relative base for the industry. So I don't think you are going to see comingling, you're going to see some people shift from prepaid to postpaid because of the price points. But again, that prepaid market is really addressing that segment that really doesn't have credit.

Michael McCormack - Jefferies - Analyst

So thinking about the planned changes that you made and I know we talked about stopping sort of the basic phone loss or the low-end phone loss. Can you just identify the reaction to your subscriber base or maybe from a gross add perspective as well on those changes both at low as well as the high-end family share plans. Did you see an equal benefit with respect to churn in gross adds?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Again, we have to take a very measured approach here because as you know, we matched some of our competitors' pricing at the higher end and we had to do that because although we still have the best network which was confirmed by third-party studies we still believe that we will never be the lowest end provider because of the amount of investment that we make in our network. But we have to be careful that we don't premium ourselves so far out of the market that people shift over.

So the moves that we have made both at the low end and at the high end and also I guess I would say from a sophistication standpoint on understanding your customer base, understanding who is coming out of contract, who is likely to churn and you need to treat those customers
differently. I think the record shows that we have the most loyal customer base in the industry. We have had always the lowest churn rate. The first quarter was unusually high for us and I would view that as a high watermark for us.

So I think we are making the right moves to bring everything back into where we would expect it to be.

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**Michael McCormack - Jefferies - Analyst**

So when you think about competitive positioning Verizon has always had a view of a superior network. Is that still your key differentiator as opposed to any pricing actions we are talking about?

**Fran Shammo - Verizon Communications Inc. - EVP and CFO**

If you look at as long as I have been in this industry which is a long time, the number one reason of customer churn is because of network quality. The number two reason is because of price. So network is still a very, very important aspect of the product that you sell. I mean let’s face it if you go back in the early days, if you tried to make a call, if it was free it didn’t matter if you couldn’t make the call. Free doesn’t mean anything.

So there is a value that customers are willing to pay for when they want to connect to a data session, it connects, it doesn’t drop. It is what they expect to have and we think that consistent experience across the United States is something that is very valuable to our customer base. So yes, we believe that the superior network is still very, very important for us.

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**Michael McCormack - Jefferies - Analyst**

So I think it has been said that Fran Shammo does not like EIP. So I figure we will bring the elephant into the room now. So with respect to EIP, you guys have started to ramp up a little bit. What is your philosophy on EIP and the benefits to the consumer, to the carrier on a going forward basis?

**Fran Shammo - Verizon Communications Inc. - EVP and CFO**

It is not that I don’t like EIP. It is -- at the end of the day whether it is an installment sale or it is a subsidy sale, they are still two very profitable products for us and I continue to say that Verizon will not be someone who forces a customer into one or the other. So we will continue to give our customers choices if that is what they want. What we have done is once you go through your subsidy program for a two-year period of time if you are out of contract now, you can move into the what we call Edge pricing which is our installment sale to get the benefit of the service pricing.

So I think the way I look at it, Michael, is options for our customers to do what they want to do because quite honestly if you are going to come in and if I have a “free” iPhone 5c on the network, you are better off taking the free phone and paying the subsidy price for two years than if you go on the installment sale because you are going to pay full price for the 5c which is around $450, $500.

So from a consumer standpoint, they are going to have to look at side-by-side comparison and make a decision which way they want to go. For us it doesn’t really matter. It is whatever the customer wants. So it is not that I don’t like installment sales. There is a cash flow impact on the installment sale and that is probably the biggest difference to us on the subsidy model versus the installment sale. But it is not that big of a deal and over time it equalizes itself out. So let’s put it this way, I am indifferent.

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**Michael McCormack - Jefferies - Analyst**

So along those lines, as what are your expectations? I know you set a certain bar for 2Q adds or upgrades and adds coming in on EIP. What do you think the long-term terminal penetration rate is of that?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

I am not sure I can predict what customer uptake will be in installment sale in the future because obviously it may have to do with something new coming to the market. But I do see that in the first quarter we had a 15% take rate on installment sale. The installment sale was for the majority only offered in our direct channel. In the second quarter that will start to be offered in our indirect channels. So we think that the take rate will at least double to 30%. It could be higher than that; it is just an unknown at this point.

Michael McCormack - Jefferies - Analyst

You and I were talking again last night about the impact of EIP on a lot of moving parts. There is a lot of confusion on the modeling part of it and probably understanding from a consumer standpoint as well. But when we think about the moving parts and for you guys you call it ARPA but from an ARPA perspective, how should we think about the impact of EIP as you progress through this year and then obviously into next year as that rate gets higher?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes, so I think there is a couple of important things here. Number one, the accounting for the installment plan is consistent across the industry. So there is no difference in how carriers are accounting for it. The big difference between the carriers are the assumptions that are made behind the accounting and the major assumption is what is the value of the phone at the end of the customer life whether that is 12 months or it is 24 months?

And for us, we are taking a very conservative approach which means I am probably going to book less installment sale revenue up front over the term and we will reconcile at the back-end of the contract once everything flushes itself out. And the reason I’m taking that approach is since this is new and you are building up receivables on your balance sheet, I want to make sure that 12, 18 months down the road I don’t have surprises where I am writing off my balance sheet because I booked too much revenue in the beginning.

So we are taking a very conservative approach on this. So that is one big difference I think that we have compared to the industry.

I have also heard, well, Fran is doing that because he is not going to be able to resell these phones in the marketplace. That is quite the opposite. We have been doing this for years. We have a CDMA technology. I think the largest market in the world is China who is CDMA and all of our phones have GSM in them so they are worldwide phones. So it is not an issue I am worried about how to sell these products in a third-party market. It is an issue of I just want to make sure that we are conservative and don’t get any surprises down the road.

As far as what happens to the actual earnings accretion from this over time, I think you have to be careful because there is some dilution that has been created by the pricing changes and as the base starts to convert to the new pricing, that will offset some of the benefit of the installment sale accounting.

And Michael, I have seen you write some press on this too. I always kind of look at this as what is real and what is not real? And real earnings is really what we are focused on. The installment sale tends to give artificial earnings because of the way it is accounted for but over the economic term of the deal, it all comes out at the end.

So again, I think both are good. I think both are good for the consumer, both are good for the carrier. It is just a matter of which direction it takes.

Michael McCormack - Jefferies - Analyst

So let’s just touch quickly on the whole concept of sort of fake earnings, false earnings. From a cash perspective obviously as you are saying it will normalize out over time. We have written extensively in my past regarding i pain and smart pain and this re-subsidization of a smartphone base and how painful that can be. One of your peers was really feeling the pain from an iPhone perspective. Does this EIP program irrespective of whether you call it fake or real earnings, does it take that risk out of re-subsidization of the base?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

Obviously the installment sale, the benefit of the installment sale is that the consumer is paying the full price of the phone over a period of time so there is no subsidy so we are not taking that upfront loss. The offset to that is they are getting a discount on the service pricing. So one is offsetting the other.

The issue though is that in the installment sale you are creating more earnings upfront than you would have under the subsidy model and the subsidy model in my view is a more actual of what happens economically because you are taking the charge right up front for the subsidy, the cash matches the model.

In the installment sale, the cash doesn’t match what is flowing through the earnings. It will happen over time but there is that mismatch between earnings and real cash. And what I try to tell everyone is if you really want to get down to the -- if you want to look through earnings and get to what actually economically has happened just go to the cash flow statement. That will give you what is cash flow from operations, what is free cash flow and that is really what we are keyed in on.

Michael McCormack - Jefferies - Analyst

And then just thinking about you identified a certain amount of risk attached to providing credit to consumers. You guys have been perhaps a bit more measured than others with respect to credit or those that might be acceptable to the Edge program. How do you size up balance sheet risk and how do you think about cash flow implications of these plans?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Every carrier has their credit models that they use. Obviously we have our own credit models that we use and we've tested these credit models through history. So right now under current course, you can only be accepted on to the Verizon Edge plan if you are what I would call as you call a prime credit customer which is your top-tier credit customer and these are the credit customers that have the highest credit scores, that 100% of the time pay their bills pretty much.

So the risk on the installment receivables side we think is pretty minimal at this point. However, as we go down in market which we will have to do, we will have to revise that credit model to protect ourselves that we are putting up these big receivables and there will be a percentage that goes bad just like in-service revenue today. So it is a matter of what assumptions you use and again I guess I would say we are going to be conservative on those assumptions.

Michael McCormack - Jefferies - Analyst

Then another topic that has come up in the industry is potential either happening currently or potential down the road would be factoring receivables whether it be the current service revenue piece or the equipment piece in some period of time. What is the thought process there for you guys?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

My thought process on that is on a service revenue receivable, they are payable in 30 days. You can go to our days sales outstanding, we average around 40. So to factor a service receivable that I'm going to collect in 40 days really doesn't make much sense to me. Why take a discount on something that I'm going to collect in 40 days.

As far as factoring equipment receivables, that is a whole different thing because these receivables are either 12- or 24-month receivables so there is a lot of credit risk in that depending upon what customers you brought onto that and we will have to wait to see how this plays out. My instincts right now are I am really not enamored by factoring my customer receivables.
Michael McCormack - Jefferies - Analyst

I think another significant topic in Verizon’s being again more measured I think than most with respect to repricing the base seems to be one of the biggest fears out there as we go forward and this plays into the whole competitive landscape in telecom. What is the thought process among Verizon thinking about the existing base, how many customers might qualify for a "reprice" and would you actually get aggressive in that form?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes, so as I mentioned previously, we have allowed our customers who are out of contract who actually bought a subsidy phone are on the subsidy pricing model. If they are out of contract and do not want to upgrade, they are allowed to freely move into the Edge pricing. So that is open to them today. We are not force migrating them, that is the option that they have to do on their own.

We are going in specifically as I said, when we know what our base is, we know what the contracts are, we know what the propensity to churn is, we will proactively go out to our high churn customers who are coming to the end of their contracts and proactively address those customers. But we have been doing this for years. This is nothing new for us.

So we will treat those customers and make sure they get on the right plan so that we protect them and keep them within our base. If you look at our base, we still have 23 million basic phone customers and about 23 million to 24 million 3G smartphone customers. So we have a lot of customers in our base who will become eligible for upgrades into our 4G LTE and we view that as a very good growth potential within our base. So we will protect that base and do what is necessary to protect it.

That doesn’t mean that I’m going to shift millions of customers and force them into an Edge pricing model because what that means is when they want to upgrade they are forced to take the Edge pricing upgrade and we are not going to do that. We’re going to give our customers the choice to do what they want. So we will go through this in a very measured way and we don’t think it is a huge impact to our financial results.

Michael McCormack - Jefferies - Analyst

We are not trying to make anybody too thirsty up here. If there is some water for both of us that would be great.

Then thinking about the margin profile of Verizon, you guys have always been industry-leading with that respect and EIP will have moving parts I am sure. But thinking about moving away from the whole EIP discussion and just into the blocking and tackling of the wireless business, what do you see as the most important cost savings opportunities as we progress over the next year or two?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

If you look at over the last two to three years, we’ve said we have taken $5 billion out of our wireless cost structure and that lull has given the wireless team an equal target for this year. If you look at last year alone, we added over 5 million devices to our network and we actually decreased our call center headcount. And the reason for that is as the technology grows, more and more customers are self-serving, more and more customers are doing more of their service via their mobile handsets which we have enabled.

So as we get much more efficient here, we will take these costs out of our infrastructure. The other thing is just the whole logistics system. I mean if you think about how many upgrades we do a quarter and the return phone and how we deal with those return phones, this is a huge, huge logistics system. So if you take out a penny here and a penny there, this starts to add up to real dollars because you are moving 45 million, 50 million, 60 million units a year through this system.

So there is still a lot of cost efficiency within wireless but one of the biggest issues is moving these 48 million customers into our more efficient network of LTE. That creates a lot of cost efficiencies so we still have a lot of work ahead of us from a cost perspective.
And then thinking about maybe a couple of things here, your current spectrum deployment what you guys have in front of you and then we've got a couple of auctions, one certainly upcoming and one we can discuss whether or not the timing is going to be accurate or not. Maybe your thoughts on your current portfolio, the upcoming auction and then the broadcast spectrum auction where rules have not been established yet; your thoughts on what those rules should look like?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

So let's start with our current base of spectrum. Obviously we launched our LTE network on our 700 MHz license across the country so we are done with our coverage build. We have started to launch our AWS spectrum especially in our major cities and we will roll that across the United States over the next 14 to 18 months.

The next piece though is three, four years out, we are going to need additional spectrum for just the capacity of growth within the data network. AWS, which is coming to auction at the end of this year is good spectrum for us. It fits very nicely into our portfolio. The rules on that have come out so we will be a participant in the auction.

As far as the broadcast license which is targeted for some time in 2015, I can't really comment on that yet because the actual rules have not come out. There has been some pre-discussions on what those rules might be but until the rules come out and they are factual, I can't really comment on what that looks like and how we will fit in that. But AWS right now is what we are focused on.

Michael McCormack - Jefferies - Analyst

Just finishing up on the wireless side thinking about the competitive landscape you and I were talking off-line before just regarding what we view as maybe an unneeded malaise among investors in wireless because of this competitive overlay. How would you frame the industry? You started talking about the fact that you thought it was probably healthier than it has been in a long time but how should investors think about what is going on right now and there is a lot of confusion obviously on accounting and pricing but from an overall perspective, what is the overall view?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Well, if you just look at Verizon Wireless, we had probably one of the strongest financial quarters in our history and not only from a EBITDA perspective, margin perspective because I gave you the numbers. It was 90 basis points that came from the installment sale so if you took that out, we were still at close to 51% margins.

So the business is extremely healthy. Topline growth is really the key here at 7.5% service revenue growth. Overall Verizon at 4% plus on a base of $120 billion so quite honestly, we are doing extremely well and things will settle down and the fundamentals will come back for investors.

Michael McCormack - Jefferies - Analyst

When you think about --not to harp on stock performance too much, but there still is this view I think in the marketplace that flow back from the Vodafone transaction is still creating a headwind for the stock. What is your view on that?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

Well, going into this transaction I said to everybody that we were probably three to four months of flow back. So if you take that, that would be somewhere between mid-May and mid-June and we still do see some specifics where there is some flow back happening but it is starting to normalize out.

If you look at our shares on the London Stock Exchange, they have really slowed considerably so that piece of it is out. But our normal flow we believe should be somewhere between 18 million and 20 million shares a day. So sometimes we hover in that range which is where we should be and then other times we pop up and I think that is just some of the technicals happening and some of the profit taking that is happening with some of the shares that we issue.

So I think maybe another 30 days I think then we should be into a more normal cycle.

Michael McCormack - Jefferies - Analyst

Great. We are going to shift gears and talk about the Wireline side of the business. It is funny, I actually had my team put together last week a view on access line losses just for fun. We haven't looked at that in so long. I only ran that out because all of a sudden consumer has become a great business for you guys, a significant grower.

Just talk a little bit to start regarding FiOS, what you are seeing there. We saw net additions slow down a bit but your penetration is quite high. What is the view as we look out over the next couple of years from a competitive standpoint on flow of net add share?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes, so I think that we believe we will continue to take share in the marketplace. The first quarter, somebody once told me never blame weather for anything but the Northeast corridor was just a really, really tough winter for us and so it definitely had an impact on the number of installs that we could do for FiOS.

Coming out of the quarter, I saw positive things once the weather broke. I think the second quarter will be a better quarter for us. But look, some of our markets are at 40% penetration. We have markets at 50% penetration. So those markets will slow. We still have markets like New York which is still our fastest-growing penetration market so there is still a lot of room for growth in the FiOS area.

You saw us -- we became much more systematic in our price subs to match the content increase so if you looked at it, we did price ups in the fourth quarter last year because the content increase comes on January 1 of each year so we matched that this year. And you saw that come through in the wireline margin with an improvement year-over-year.

So we are improving the business model here. FiOS continues to become more profitable, you talk about cost structure. As we have gone through and migrated 300,000 customers last year from copper to fiber and I think it was 260,000 some the year before that, we are starting to get more and more of our customers on this fiber network and what we see is that the repair rate of that network is really starting to decrease.

So even with the harsh winter we had, our repair levels were considerably lower than a year ago. So what we are doing is working from a cost structure standpoint and generating more cash and that is really what FiOS is doing for us.

Michael McCormack - Jefferies - Analyst

So thinking about the pricing environment, we have seen time and time again over the last call it 10 years with FiOS you get into the marketplace, you offer triple play pricing, the cable company reacts on lower price and you get into this crazy triple play for whatever -- $79, $69. What is the
thought? It seems like cable has gotten more conservative on pricing as has Verizon. As you look forward, is that pricing going to be moving higher, is it stable, what should we think about?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

The cable TV business has always been extremely price competitive and of course you have these ebbs and flows depending upon where people have their adds. But I think the key here is and one thing that we started to do last year is we really started to focus in on the broadband side. And we launched Quantum and that has really driven really good ARPU for us because we make it very simple for people to upgrade. And the interesting thing about this as more and more people get wireless devices and start to run them in their home, they have to put more bandwidth into their home in order to keep all those wireless devices running on the Wi-Fi network.

So that has definitely benefited our broadband product to supplement the LTE network and we always get into this argument of do we like Wi-Fi, do we like LTE? They are complementary products and we always tell our customers when you are in your home, you should be running off of your Wi-Fi network. So FiOS obviously with fiber into the home can offer that speed within a matter of seconds by just clicking an okay button.

So we think that the broadband product has really maybe separated us from our competition. We have continued to increase the speeds and come mid-summer, we are actually going to come out with a new proprietary router if you will that will actually get you to 300 Mb of Wi-Fi speed in your home. So we think that the broadband product has really maybe separated us from our competition.

We will continue to improve our FiOS product and you have to kind of keep continuing to differentiate yourself in the linear TV world in order to continue to be relevant.

Michael McCormack - Jefferies - Analyst

Thinking about Wi-Fi offload, and you brought it up so I will can you continue on with that path for just a second. Thinking about the threat or opportunity for Verizon clearly it has been used from the cable companies as a churn reducing tool. I think you probably view the same thing for FiOS. Is it really replacement for traditional wireless services whether it be data or a data VoLTE type network?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes and I think what we would say is it is complementary. Wi-Fi technologically can't replace wireless. It is not a mobile technology but it is complementary. In your home you are going to run off Wi-Fi, not LTE. We like Wi-Fi especially in very high volume type situations like the Super Bowl, football games, large concerts. I mean you can't build enough capacity to handle that so you need that Wi-Fi offload.

But Wi-Fi if you look at the trends of Wi-Fi growth and LTE growth, they are both going in the same direction so they are complementary. Like I said, technologically we don't believe Wi-Fi is a replacement for wireless. It can't be -- it can't hand off so I think it complementary, it is not replaceable.

Michael McCormack - Jefferies - Analyst

And you touched briefly on linear content and it seems like the viewing behaviors of certainly the younger public is moving away from traditional linear product of call it 500 channels or so. At what point in time -- we have written a lot historically about what we call the golden goose problem which is content is happy, distributors are happy. What breaks this system and makes things more sort of user-friendly for the younger demo and over the top type product? Verizon has made some inroads and some investments there as well so maybe your thoughts on that?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

I think that this will take some time. I always come back to the agreement that we have with the NFL as one of the ones that kind of broke the mold if you will where we can distribute Monday night, Sunday night, Thursday night games or regional games to your mobile handsets and it doesn’t go back to a linear TV subscription. And that is really when the content will disaggregate is when it doesn’t go back to a linear TV subscription. So everything in the marketplace or the majority of everything in the marketplace today is you can get it on your mobile but you have to authenticate yourself back to a linear TV subscription.

I think over time the model will start to break down. I think from a content provider standpoint, they are more than happy to give you their content to go over the top, you are just going to pay double what a linear TV distributor pays because they have this huge partnership that they have to respect because that is where they get all their revenue from so they have to be very careful they don’t disrupt that model. And I totally understand that.

So it is going to take some time to work through. I think though that if you look at -- I am more intrigued with the multicast technology that is coming on wireless which will enable us to in essence give you 24-hour programming extremely efficient in the wireless network. Does that open up a new ecosystem for some of this program? And I think that sports, news, concerts, those types of things where people want to view real-time, I think that will be an ecosystem that can be created around content that doesn’t disrupt or affect the linear TV model. So I think over the next if you want to call it 12 months to 24 months, I think we will see some changes in this ecosystem.

The other thing, Michael, I would tell you is that you mentioned some of our investments. Over the last four years we have been building this platform called Verizon Digital Media Services, and what that platform is, it really is a platform for the content users to put content in. We digest that and digitalize that with no human touch and then deliver that to their end customer with inserted ads, bright formatting and all of this kind of stuff.

So we view that as a very good platform to generate future business for us. But that platform with the addition of Uplink and EdgeCast and now OnCue really sets us up to take advantage of whatever the ecosystem brings to us from an over the top perspective. But at this point I would say it is really going to come down to the content rates.

Michael McCormack - Jefferies - Analyst

You talked briefly, you mentioned the new media service that’s going to be coming out shortly and one of the things that we as a team have written about a lot is broadband consumption in home and I think that is clearly one of the reasons you are moving to this 300 Mb type product for IP distribution in the home.

Your thoughts on what this box can do? We have seen Comcast benefit in a very meaningful way from an X1 rollout. Is this an X1 type product?

Secondarily thinking about [CP] in the home which is something that we have been sort of been semi against moving into more of a BYOD type world, why are we investing in heavy CP and secondary and tertiary televisions? How does Verizon FiOS migrate over time into that kind of world?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

We will come out with what we are calling our video media server midyear this year. And in essence what it is, it is an IP technology to be able to deliver everything via FiOS through IT and the benefit of that is obviously the customer doesn’t need set-top boxes any more with their TV. The house will be run off of IP technology. TVs that are not IP capable will have a little attachment on the back of them that will make them IP capable.

But the real benefit is for the customer is you have just one piece of really equipment in your home. But the benefit to us is the fact that the installed time on a single family home is much reduced so I don’t have to go in and test the coax, this is all IP technology so all I really have to do is connect that media server up to our ONT, light it up, get the IP technology in the home working and we believe that it cuts our install time by about 50%. That is a huge cost benefit for us within the FiOS world.
But it also brings a lot more features, it gives you a lot more capacity. You will be able to DVR multiple TVs with multiple shows so there is a lot of features that come with that media server that can’t be handled within a set-top box.

Michael McCormack  -  Jefferies - Analyst

So we started the discussion regarding FiOS additions and some competitive discussion around pricing but when we think about net adds I think there has been some concern about a slowing down there. And yet you guys have very strong penetration so how should we balance that as we progress over the next couple of years?

Fran Shammo  -  Verizon Communications Inc. - EVP and CFO

I think that if you look at the penetration rates by market you are going to have to have a slower net add growth for us going forward but again I would say that the first quarter was a low watermark for us. I wouldn’t expect that again. But I think as we came into this year we set a target for 600,000 platform adds and that is probably not a bad target for us to strive for. So that is kind of the realm that we should be in.

Michael McCormack  -  Jefferies - Analyst

Thinking about the competitive landscape for FiOS, we have got a lot on the table right now with respect to cable consolidation, trading, etc. What does that mean for Verizon over time if we have a stronger potential for Comcast along the East Coast corridor maybe both from a pricing standpoint as well as product set?

Fran Shammo  -  Verizon Communications Inc. - EVP and CFO

If you look at it, we compete with Comcast today, we compete with Time Warner Cable today, one replaces the other, we compete with one another. So I don’t think it is that disruptive to us here at the near-term. We don’t really publicly state for or against anything. I think that some of the concerns that have been raised over this merger are things that we will watch but at this point we will just see how this plays out.

Michael McCormack  -  Jefferies - Analyst

Thinking about as you move into more urban environments, you have talked about New York being a great opportunity for you. The triple play versus single play, it seems like the younger demographic is more interested in broadband only frankly broadband only -- not even voice and moving away from that linear TV product. So if you think about the margin profile for Verizon Wireline, what are the cost and benefits of moving to that single product portfolio?

Fran Shammo  -  Verizon Communications Inc. - EVP and CFO

Probably about two years ago now, we launched what we called pick your own bundle in the MBUs of New York and what it was you either picked a large TV bundle with a slow speed in broadband or you picked a high-speed of broadband with a very small number of channels which we called the Double Foot. And most people took more speed with less channels and that was really the demographics of what you saw.

So we are really again it is the Quantum broadband that we are really pushing in New York and obviously we have customers who are buying 300 Mb of speed from us and nothing else.

From a profitability standpoint though, that is a highly profitable product for us because there is no content cost related to that. We are perfectly fine with the connection of broadband within these MDUs.
Michael McCormack - Jefferies - Analyst

We have talked and we have spoken extensively in the past about the non-FiOS areas and I guess my second reincarnation as a banker, I will try to help you get rid of those assets. But thinking about what those assets are doing today, is it a significant drag on the wireline business or is it just a cash generative slow declining type of thing?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

If you have seen the access line loss, you have seen over the last two years it has been in a decline type format so we are hovering around that 5% quarterly loss. Look, we will continue to fulfill our FiOS LFAs, our license franchise agreements. We will complete with about 19 million homes passed, that will cover about 70% of our legacy footprint if you will. So 30%, we are not going to cover, that is where we are still going to have copper. We will continue to harvest if you will that copper network and those customers and keep them as long as we can. But we will not be building FiOS out for those areas.

Michael McCormack - Jefferies - Analyst

So moving on within wireline to the enterprise or business customer segment, it is an area that we have spoken a lot about in the past and I think there is a few dynamics going on there that you could address -- government issues, sluggish business demand. Maybe could also just touch on this migration from a legacy product and this is not just Verizon, this is the industry as a whole -- legacy product into IP Ethernet advanced products that carry probably initially a lower price point but then also have price compression over time. How should we think about enterprise turning? What are the key levers there?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

If you go back, I have been in the enterprise business since we acquired MCI back into 2006. So if you look at the platform here, it has been an extremely competitive marketplace. So the key is you have to bring something to the table that differentiates you and I have always said transport is like table stakes and you have to bring more value to that enterprise customer so that they perceive that there is some other value that they are adding.

And I think where we win quite honestly is with our security assets, with our datacenter assets and with our advanced communication assets but it is a very competitive environment. I would tell you that the public sector is still the major drag for us. We include all government agencies in our enterprise reporting, some others included in wholesale and that is really the biggest wall right now. And so I think until things become more certain between the public sector and the private sector, I still think you are going to be in this situation of flatness if you will.

Michael McCormack - Jefferies - Analyst

Thinking about the overall revenue trajectory of wireline, consumer has done really very strong in the past year or so. Is there a point at which you think you can get a little bit of growth there? Is this a GDP type growing wireline business?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

I have been saying this is a GDP wireline growth business for five years so I am sure it will someday be there. But I think that the way I look at it is our consumer market we said would grow 4% plus this year. We reported out 6.2% in the first quarter so that is right on track with where we expected it to be.
Our enterprise business I will tell you if we can get some certainty around tax reform; do we get the depreciation extenders. I think if there is some certainty here where people can sit back over the next 2-3 years and plan, then I think the prospects are better. But with all the uncertainty, we are probably sitting where we are sitting.

**Michael McCormack** - *Jefferies - Analyst*

-- for the year on margin improvement in both wireline and wireless, what are the key triggers. We already talked about the revenue side of the equation for wireline but are there cost-saving opportunities and when we think about longer-term, is this a step-up function in wireline margins or is it going to be just a smooth uptick?

**Fran Shammo** - *Verizon Communications Inc. - EVP and CFO*

I would say this is more of a gradual increase in margin but I would say it is a combination of both. It is topline growth but it is also taking cost structure out. As I mentioned, the migration of copper to fiber has been very big for us. Our Lean Six Sigma projects have really significantly helped us in our capital investment in the wireline which is why I can put more money into the wireless side of the business. There is a lot of things happening. We have been at this for two years and we will come to our third year here with Verizon Lean Six Sigma so these things are starting to actually start to see them now come through to the bottom line and I think you will continue to see that but it is going to be a gradual growth.

**Michael McCormack** - *Jefferies - Analyst*

I think I would be harassed if I didn’t ask you the question regarding industry consolidation on the wireless side and maybe not your thought on any particular transaction but if this industry were to go from four to three players in the marketplace does that change the competitive dynamic for Verizon?

**Fran Shammo** - *Verizon Communications Inc. - EVP and CFO*

I don’t think so. We like the environment with four competitors but if the environment went to three competitors we would continue to compete based on everything our brand stands for which is the quality of our network, the most loyal customer base, giving our customers what they ask for so that is not going to change our strategy.

**Michael McCormack** - *Jefferies - Analyst*

What about M&A more generally for Verizon sort of taking the spectrum acquisition piece out of it. Are their assets that would be interesting for you guys?

**Fran Shammo** - *Verizon Communications Inc. - EVP and CFO*

Obviously the spectrum is the key right now and our key focus from a wireless growth perspective. As Lowell and I always say, there is nothing that we need to execute on our strategies. We have the assets, we think we have the best assets in the industry so we have what we need. That doesn’t mean that there won’t be maybe a little fill-in here or there like and OnCue or an EdgeCast or something like that but we are not talking significant acquisitions.

**Michael McCormack** - *Jefferies - Analyst*

Thinking about the whole issue of net neutrality, I think there are many out there that say the changes taking place might be a bit of a headwind for content providers and potentially a tailwind for folks like yourself. Do you guys view that as a significant opportunity going forward?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

I think we will have to take again a measured approach as to what the rules are when they formally come out and we will interpret those rules and we will see what business opportunities they can bring to the table and I think at this point, I don’t think the rules have been solidified at this point so I can’t really comment on whether that is good, it is bad or it is indifferent.

Michael McCormack - Jefferies - Analyst

And thinking about cash flow obviously with the consolidation of the entire Verizon Wireless asset you are generating very significant cash flow and yet leverage is probably a little bit higher than you would like currently. So thinking about the timeframe there you have identified a four- to five-year period. What are the puts and takes to get you to that timeframe?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Well, coming into the purchase of Verizon Wireless, we said we had four main priorities at hand going forward for at least the next two to three years which was number one, continuing to invest in our networks and our platforms. Number two, acquire spectrum. And number three, deleverage. Number four, dividend policy so that is what we really view over the next two to three years and as we said based on our cash projections, we will be able to get back to an A-rated Company within four, five years.

Michael McCormack - Jefferies - Analyst

And thinking about -- we spent a lot of time talking about EIP and the impact on the financials and there is a lot of moving parts but thinking about that from a cash flow perspective, how much of a headwind do you think that will create for Verizon? You had mentioned that factory might not be something you are interested in. I am assuming that is baked into your thought process when you say four to five years?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

That is correct, that is correct.

Michael McCormack - Jefferies - Analyst

And is that just initially first couple of years will be the biggest headwind with respect to that and then it sort of evens out?

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Yes, I mean the simplest way to look at this is take an individual customer, So an individual customer if you think about it really it is going to be our around a year maybe a little longer where they equalize out where they would have been on a subsidy model so it is just timing but it is nothing that is going to create any type of a headwind. This is a timing issue, it works itself out and over a four- to five-year period it is not going to matter.

Michael McCormack - Jefferies - Analyst

And then maybe just a closing comment on dividend policy, you identified your priorities for use of cash flow but we do get a lot of questions from investors on is there a delta between treasuries and Verizon yield or Verizon’s yield and AT&T’s yield that makes sense. You obviously have the cash flow to do various different things there. What is the thought on dividend policy?
Fran Shammo - Verizon Communications Inc. - EVP and CFO

I think that first, I mean it is a Board of Director decision but I think if you look at the last seven years our Board of Directors have shown that they have a consistent policy in mind. When we announced the Vodafone transaction they once again increased the dividend so I think the history should speak for itself and we know the dividend policy is important to our shareholders. That is the basis of it.

Michael McCormack - Jefferies - Analyst

Great. Thank you very much, Fran, and everybody please enjoy the conference and if you need any help throughout the conference, we have plenty of staffers around. Thanks so much.

Fran Shammo - Verizon Communications Inc. - EVP and CFO

Thank you, everyone.