The Sunday Brief: Q1 Earnings Preview – Neapolitan Ice Cream, Vibrating Beds, and a Hint of Sunshine

It's hard to believe we are four days into April. But we are, and, as most of us who have sales backgrounds know, the year is likely made or lost by now for most of the telecom carriers (note: this cuts both ways – not just accounts won, but accounts saved and not lost). The headlines can be broken into three categories: Neapolitan Ice Cream, Vibrating Beds, and a hint of Sunshine.

1. **Neapolitan Ice Cream.** Nothing says fun like Neapolitan ice cream. And watching each of the wireless carriers twist the meaning of a) post-paid, b) pre-paid, and c) wholesale (including M2M) gross and net additions (including churn) will be nothing short of comedy. Verizon, for example, will deftly have to explain their newfound embrace of Wholesale net additions after years of sole devotion to retail (and going out of their way to explain to any analyst who would listen why everyone else was destroying the industry through aggressive Wholesale practices with pre-paid carriers). 45% of Verizon's net adds in 4Q were from the pre-paid wholesale channel; at least 55% will come from this channel in Q1 as Simple Talk takes hold in each Wal-Mart. AT&T will have a slightly different Wholesale flavor – this time, it'll be more of the Kindle/Nook/telemetry and other M2M, which they explained well in 4Q – they had nearly 2 net adds from the reseller channel for every retail net add (retail pre-paid was a negative for AT&T as they shift their strategy in this segment – to Verizon, Leap and Metro PCS). Both AT&T and Verizon have plenty to talk about with their primary Neapolitan flavor – post-paid. ARPUs will be up from Verizon with their surcharge intact for all 3G handsets, and AT&T still has the iPhone, which, as we have discussed previously, has helped ***raise*** the overall voice post-paid voice yields for the company (and voice yields should rise in Q1). Unlike AT&T and Verizon, Sprint and T-Mobile will have to talk about the effect of a retail pre-paid strategy on their respective futures. Sprint also has a lot to talk about with "Any Mobile, Anytime," as well as the expansive Sprint Free Guarantee. They also made a sizeable bet with the Virgin Mobile acquisition, and T-Mobile's new FlexPay changes look more like what Ford Motor Credit did for selling automobiles (not criticizing the strategy – it might be the right move at the right time – but a financing strategy is different than the rest of the markets). **Bottom line:** Careful translation will be needed in Q1 when it comes to "net adds" and the effect on overall profitability. A good rule of thumb is: 1 retail post-paid = 3-4 retail pre-paid = 10-20 wholesale customer net additions from an OIBDA perspective. One last point: watch the subsidies in pre-paid retail. If they are growing, start worrying.

2. **Vibrating Beds.** I never slept in one – they had left motels long before I started a decade of heavy travel. But I have a story that was relayed to me by a friend that summaries the LEC access line situation (and I have it on good authority that this was a true story). A couple was finishing up their vacation by staying in an "upscale" motel and they were upgraded to the honeymoon suite which had a vibrating/ massaging bed. The wife was dreadfully afraid of it, and before turning in asked her husband "Is that bed shaking any more?" Her husband replied "No." The wife laid down, only to leap out of bed and exclaim "I thought you said the bed wasn't shaking any more!" To which her husband replied, "And it's not shaking any less, either."

   This is the situation we are in with two telecom topics: consumer and business access line loss, and business growth. It'll be easy to make the case that access line losses are slowing (there's less of them to lose), but the accumulation of revenue, Subscriber Line Charge, and access fee losses is staggering, not to mention that there's copper, electronics, and systems to be maintained. Regardless of how much Verizon moved up the cost curve, whether it's an annualized 9.2% loss or 10.4% loss (Q1 losses have historically been higher than Q4), they moved *up*, not *down* the cost curve. Verizon is de-scaling the business - the weight of wireline is getting heavier, and the wireless requirement to "make up" the earnings difference grows. Just before their merger, the CFOs of Bell South (Pat Shannon) and SBC (Rick Linder) announced that access line losses were slowing (source: 3Q 2006 conference calls for Bell South and for SBC). Eight million consumer primary and secondary line losses later (and this includes AT&T VoIP line additions as an offset), the losses continue. For more details on the access topic, and the effect on scale, check out the Sunday Brief called "What Qwest Results Teach Us About AT&T and Verizon."

   Retail business conditions fall into the same camp – the business environment, particularly in certain regions of the country (e.g., small businesses in FL and CA) could not get any worse. But with VoIP and wireless as voice replacements, can they get better? A review of all the Q4 statements on business conditions found no quantifiable sign of hope from any incumbent telecom provider. The cable companies are in a unique situation to accelerate their business line growth (Comcast and Time Warner have the most to gain), but committing capital to this segment over cell site backhaul and completion of their next generation high speed Internet platform (called DOCSIS 3.0) has been difficult, until now (we have discussed the opportunity to capital favorability in the slowing residential sector to fund "smart" business growth in previous columns – cable alone has this luxury).

   Bottom line: Two favorite areas that may get less talk time ("not shaking any less") are access line loss and retail business slowness. More transparency on these issues is required, especially for the non-FiOS/ non-UVerse territories. Qwest, CenturyTel, and Frontier may hold more answers to the access line question than AT&T and Verizon.

3. **Hints of Sunshine.** First quarter calls are rarely negative (although some have been less than positive – queue the vibrating bed). Non-government business growth is beginning to return to the economy. As you see in the "Five you may have missed" below, T-Mobile is selling out of the HTC HD2 (even with the Windows Mobile operating system), and Research In Motion had a very strong quarter (re: they are up 40% this year – the two year chart isn't so pretty, but it's been a lot better investment than VZ or AT&T so far this year). Cash balances are beginning to build at some companies ($1.9 billion in short-term investments for RIM, with another $1 billion in long-term investments – we'll discuss Apple and Google in a future column). The Droid and iPhone march on, keeping post-paid churn down and yields up. I believe that it will be the second quarter before we see the full impact of the change, but I think VZ Wireless' 3G surcharge for data handsets will hold. Clearwire will have a stronger quarter, and hype will build on new devices and handsets. And Leap/ Metro PCS will find their base and churn will improve (not much, but it'll get better).

   There *are* bright spots. Recoveries do happen in every economic cycle. But this recovery is business-led, not consumer driven. The reality is threefold: 1) investment still flows into the challengers (Google, Apple, Microsoft, Amazon) far more easily than the incumbent telecom providers; 2) when investment flows into telecom, it's flowing into the smaller, not the larger companies in the respective sector (e.g., Qwest is up 24% this quarter + a 6.1% dividend yield); and 3) cable is finally and unequivocally outperforming telecom (Time Warner up 29% YTD with a 3% dividend yield; Comcast up 12% YTD with a 2% yield; AT&T and Verizon down 6-7% YTD with 6-7% annual dividends). **Bottom line:** Translate sunshine comments carefully. As noted earlier, the easy picks are smaller, less leveraged, and business-oriented.

Sorry for the length, and I welcome your comments. Next week we dive into iPad mania (see my columns called "The Purpose Driven Device" and "A Is For Access") and the future of IP telephony. Happy Easter and Passover to those who celebrate these holidays. May it be a time of family, fellowship, and frolic for all.

Now for five you may have missed:

1. Steve Jobs shows up for 30 minutes to see how those iPad sales are going. Woz also showed up at the mall. Hint: Do a month-long stint at the stores and see how the other half lives.
2. Amazon revised their pricing to reflect iPad business model structures. Still waiting for the other shoe to drop here. *Hint:* tie Kindle purchases to "Prime" status and store credits – please!
3. According to Seeking Alpha, Comcast's value is increasingly driven by voice. In three years, we'll swap voice for commercial services. Pedal faster, Bill (Stemper)!
4. T-Mobile has sold out of their i-Phone killer, the HTC HD2. Saw it at CTIA – to quote a previous column, it's a "Man-Sized" Touch Pro 2. No wonder AT&T's HTC lineup is free on Wal-Mart.com.
5. Google renamed their company Topeka as an April Fool's prank. All roads lead to Google? That's no joke. Hats off to the motley bunch in Kansas who started the initiative.