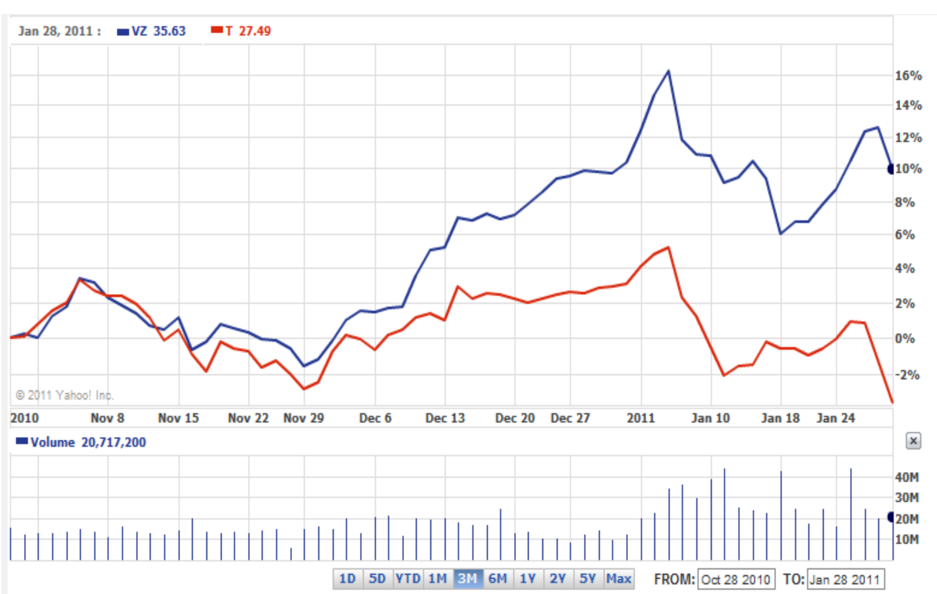
The Sunday Brief: Verizon and AT&T - Two Different Approaches to Shareholder Value
January 30, 2011

Greetings from Kansas City, where we will likely see six more weeks of winter come Wednesday. Speaking of Groundhog Day, we are starting to see two different approaches to shareholder value among the two largest wireless carriers (Verizon and AT&T). One involves using divestitures and excess cash to pay down debt, and then to use the improved financial position to re-lever. This modularity is at the heart of Verizon's strategy. The other is to use additional cash to integrate current assets, providing a platform for continued integration and growth. Unification is at the heart of AT&T's strategy.

I have fallen into the trap of looking at AT&T and Verizon as cut from the same Bell cloth, with the primary difference being different networks and Verizon now occupies AT&T's former HQ in Basking Ridge. After reading through their earnings releases and looking carefully at what they have said (and didn't say) in their commentaries over the past 90 days, I think they are very different companies.

For the record, here are several similarities:

1. Both carriers recorded strong post-paid wireless subscriber gains, driven by smartphone sales (Verizon with Android, AT&T with iPhone).
2. As a result, both carriers recorded strong growth in wireless data revenues ($1 Billion in growth for both Verizon and AT&T). However, both carriers saw decreases in revenues in wireless voice.
3. Both carriers struggled with retail pre-paid net additions (Verizon down 70K, AT&T down 135K). Verizon directly addressed pricing changes they have made to this segment; AT&T did not.
4. Both made terrific strides to reduce debt on their balance sheet, despite strong capital spending levels (Verizon $16.5 billion; AT&T $19.5 billion).
5. Both carriers reduced a large number of employees in 2010 (Verizon down 29,000, AT&T down 16,000 for the year).
6. Both carriers enjoyed some recovery in the business/ enterprise segment which allowed wireline margins to recover.
7. Both pay a very respectable dividend (AT&T at 6.3%; Verizon at 5.5% based on Friday's closing stock price).



However, as the chart to the left shows, the past three months have not been as kind to AT&T as to Verizon (note: the past six month track shows an 18% spread in share return between the two companies). It this solely due to the loss of iPhone exclusivity and the short-term margin impacts to AT&T's 3Q and 4Q earnings as they locked down their iPhone base? Or the rash of reputation-impacting issues related to data congestion that continue to plague AT&T? Or the financial impact of different data pricing policies that this column has explored in detail over the past year?

Changes like the one shown to the left do not come around every day. They are not solely related to the iPhone, but to the order or sequence of their smartphone deployment. Faced with an exclusivity lockout, Verizon created a franchise called Droid. This franchise is not going away any time soon. When AT&T was asked about forming a similar Droid franchise on their conference call this week, CEO Randall Stephenson responded:

In terms of Android, we're probably going to be doing a number of things. Android is going to become a very broad-based OS for our portfolio, and there will be some proprietary label products. But Android is going to be so broad-based, it's going to be hard to put it into one single category. And so you're seeing a number of things we're doing in terms of tablet devices coming out on an Android platform, this new Motorola, which is a really exciting device, the Atrix. That will not be a proprietary brand, but it will be an exclusive to us. And so there's going to be a lot of activity around Android because it is such a broad-based platform that's going to be utilized in a number of different areas and it's going to be a high priority for us as we move into 2011, you're going to see a lot of that activity from us in Android. So that's what you should expect.

Without a doubt, AT&T is going to have difficulty selling the Android without repeating Verizon's (and Sprint's and T-Mobile's) strategy. Droid is a brand, one that shoots lasers at things and blows them up. It's the one that has a world of cool apps. It's Metallica, not the Backstreet Boys. And Droid on 4G is an entirely separate brand, not a mere "GT" to add to your Mustang model, but the Shelby performance brand.

Despite the concern that such an aggressive brand is going to alienate certain demographics, look at the numbers – even when you remove the 65,000 4G aircards and the 49,000 iPad+MiFi/ Samsung Galaxy tablet sales, Verizon still posted 758,000 post-paid net additions. This didn't come from NFL-loving, video game-playing, under-40 males exclusively.

Several of you have asked me how I think the iPhone will do both in the Verizon stores and on the Verizon network. Early sales will be terrific – surprising to those who thought AT&T locked everyone down (AT&T confirmed as much on their earnings call this week). After the initial rush, I still think sales will be strong, because of and not despite the iTunes operating system. When you walk into a store, the rep will first ask "Are you here to convert your iPhone to Verizon?" If the answer is yes, the rep will be well trained to migrate the current iPhone applications base to Verizon so the customer leaves the store with the same icons over their new iPhone 4 (to use the Best Buy term, the customer has a "walks out working" experience).

But if the customer isn't interested in the iPhone, the Droid franchise will continue to be visibly present, if for no other reason than the fact that the in-store rep has had at least 18 months of experience with the Android platform. Apps transfer will be more difficult (but my understanding is not impossible) with the Android devices.

Who loses within Verizon is the third category – the non-iPhone, non-Android smartphone base. This is largely Blackberry, but I would hate to be Palm, Windows Mobile 7 or Blackberry in this situation.

Within the Verizon retail channel, it's going to be very rough to keep a steady stream of sales unless they become the featured "free phone."

AT&T, however, has taken a different stance. They are more broad-based in their approach, and this will continue to be the case. AT&T will continue to prominently feature the iPhone, but they will also feature Dell, Morotola, and other brands. From the excerpt above, there will not be a Droid brand in the same way Verizon is featuring it, and, because of Android's limitations, the applications transfer process will be difficult to implement in-store. In short, it will be easier to transfer an AT&T iPhone customer to Verizon than to move a Verizon Android customer to AT&T.

The lack of an Android franchise is not the only constricting factor, however. There is a much larger hurdle to overcome – asset integration. AT&T has long maintained that the integration of platforms and services is critical to future customer satisfaction and ultimately shareholder value. With asset integration comes streamlined processes and cost efficiencies.

The assumption here is that AT&T has the right set of local assets in the first place. The AT&T franchise includes three of the top four states impacted by the housing crisis: California, Florida, and Michigan (four out of the top six if you want to include Georgia). It includes deep penetrations in states like Kansas, Oklahoma, Kentucky, Mississippi and Louisiana who have not seen the same dizzying levels of competition, particularly in business, that AT&T sees in Los Angeles, Atlanta, Miami or Dallas/ Ft. Worth.

Given the growth of wireless (soon with 4G speeds), as well as the growth of portable computing devices including the iPad, the question to the AT&T Board now becomes "Why not divest?" Could CenturyLink Qwest create more value with the metro assets of Ohio, the Carolinas and Tennessee to more effectively compete against Time Warner Cable and Comcast? Absolutely. Would Insight Communications (the cable provider) be impacted by a Kentucky-wide local franchise service area? Certainly. If the value proposition is that clear, why not duplicate Verizon's actions and jettison several states?

The answer is not clear. Perhaps the buyers need more time to integrate their current and proposed acquisitions. Or the private equity market needed to back this transaction is tapped out. There is no doubt, however, that the value of these assets will continue to decrease when newly consolidated competitors emerge with wireless and wireline data options for both consumers and businesses.

Under pressure from a resurgent Verizon and a recovering Sprint (more about this after Sprint's earnings announcement next week), AT&T faces two strategic choices: a) The level of Android investment, and b) The level and timing of local/ wireline divestitures. These two decisions create options that can yield considerable growth.

Now for five you may have missed:

1. Speaking of options, Verizon decided to by the parent company of the NAP of the Americas, Terremark. I have linked to their transcript of the call. This will be a tricky acquisition to pull off, given the neutrality the NAP has maintained for over a decade. However, it's a very interesting way to play international expansion, cloud computing, and perhaps to satisfy the future needs of both Vodaphone and Verizon.
2. Time Warner Cable announced earnings this week. I have linked into their report as opposed to commentary. Data growth clearly slowed in 4Q, and double-play relationships decreased for

the first time in their history. Commercial revenues continue to grow, however, and profitability stayed high. More on TWC after Comcast reports.

3. As if they needed any more bad news, Blackberry reported a significant outage on Saturday. More about it here from the Wall Street Journal.
4. Comcast takes the reins of NBC Universal – the take from the New York Times.
5. Sue Brothers, the COO of Mobile Symmetry, was named to a prestigious class of entrepreneurs sponsored by the state of Kansas. More about it here from the Kansas City Business Journal.

More on Mobile Symmetry next week (our unofficial motto is "dog that caught the bus"). It's ready for Beta customers – sign in at www.mobsym.com and set up a group!

Jim Patterson
CEO & Co-Founder
Mobile Symmetry
www.mobsym.com
816.210.0296
Click here for our new Facebook site!
Twitter: @mobilesymmetry