**Recommendation: BUY**

**Total Annual Return Est.:**

|  |  |
| --- | --- |
| 3 yr FV | 22.9% |
| 5 yr FV | **14.9%** |

**Financial Snapshot:**

|  |  |
| --- | --- |
| Price | **$44.73** |
| DCF Value | **$75.22** |
| Buy Target | **$63.93** |
| Sell Target | **$94.02** |
| P/E | **29.5x** |
| Forward P/E | **28.9x** |
| Div Yield | **4.52%** |
| Market Cap | **$127.8 Billion** |
| 52 Wk Range | **$46.4 - $35.2** |
| EPS Growth | **3.1%** |
| PEG | **1.39** |
| Credit | **A-** |
| Current Ratio | **0.96x** |

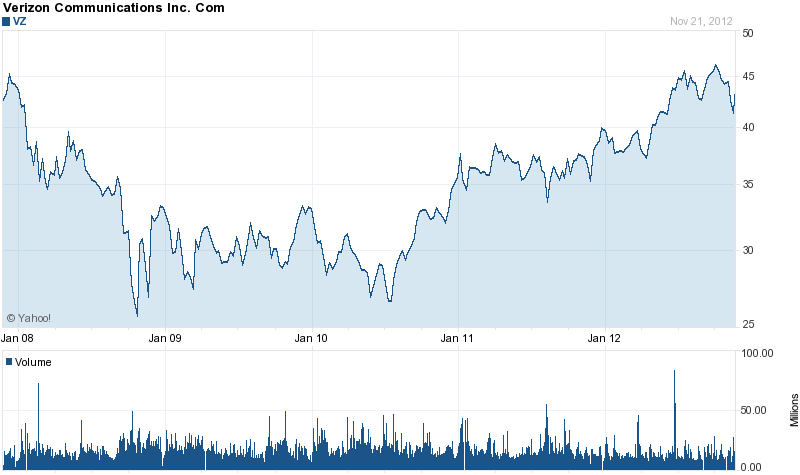
**Investment Theme:** Investing in a stable, high dividend telecommunication company which has available and reliable resources to grow customer base in wireless sub-industry.

**Overview:** Telecommunications sector is witnessing an increasing trend in wireless business. Among the industry’s major players, Verizon has been the most consistent player to invest steadily in a single wireless standard, and has approached the market with a consistent brand message over the last ten years. Verizon Wireless continues to expand its industry leadership, steadily growing market share despite pricing at a premium to its major rivals. The unit also has struck a savvy deal with SpectrumCo, LLC and Cox TMI Wireless to acquire Advanced Wireless Services spectrum licenses. It also entered an agreement with ComCast Corporation, Time Warner Cable, Bright House Networks and Cox Communications Inc to sell one another’s products and services and, over time, the cable companies will have the option to sell Verizon Wireless service on a wholesale basis. If approved by regulators, those agreements will add wireless spectrum and additional marketing muscle, further enhancing Verizon’s competitive position.

Revenue is expected to grow between 3% and 4% annually over the next five years, driven by increases in wireless data services from greater smartphone adoption. Verizon Wireless is believed to have consistently captured more than its share of industry-wide growth among higher-value postpaid customers due to its strength of networks, brand, and device lineup, and customer loyalty, a major driver of profitability.

Verizon’s current price of $44.73 results in a P/E ratio of approximately 29.5x based on current-year EPS estimates of approximately $1.52, with expected EPS to rise to $1.55 in fiscal year 2013. The discounted cash flow valuation assumes a 3% annual revenue growth rate and a WACC of 5.32% - using beta of 0.75, resulting in an intrinsic value of $75.22. If beta of 0.59from S&P stock report is used, WACC will be 4.65%, resulting in an intrinsic value of $103.1.

**2012 Q3 Results:** Verizon had a very successful third quarter. Compared with the period of nine months ended 9/30/2011, revenue of the same period this year grew 4.1%, operating income and net income increased 16.7% and 19.9%, respectively. As a result, basic earnings per common share rose 14.7%, compared with Q3 last year. At the end of the third quarter, the company had 95.9 million retail connections, a 5.7 percent increase year over year, including 90.4 million retail postpaid connections.



Investment Thesis: Among stocks of telecommunications companies, Verizon’s stock is an attractive investment because: 1) the company’s ability to grow its customer base at an impressive pace, taking share from rivals, 2) its capability to extend its industry-leading wireless spectrum position and gain a powerful set of partners, and 3) its financial strength and relative high dividend yield. In an industry where subscriber gains have tapered off because cell phones are almost ubiquitous, Verizon continues to add millions of new subscribers each year, and its customers are the most loyal in the business. With more than 95 million retail customers and coverage of more than 95% of the U.S. population, Verizon Wireless is the clear leader in the industry. A handful of recent developments promise to further extend Verizon Wireless' competitive strengths. A deal to purchase spectrum that currently sits unused from a consortium of cable companies, adding capacity for its LTE network. A joint marketing and product development agreement with the same cable companies would add additional points of distribution and could produce innovative integrated wireless and cable services. Verizon Wireless has agreed to sell some spectrum at auction and swap other licenses with T-Mobile, likely in an effort to gain regulatory approval for the cable agreements.

Pros:

• Verizon has a large and loyal customer base, approximately over 95 million customers, a major driver of profitability.

• The agreed acquisition of next generation wireless spectrum is promising to increase network’s availability and capacity.

• The 4 cable companies and Verizon under the joint venture became agents to sell one another’s products and services. Over time, the cable companies will have the option to sell Verizon Wireless service on a wholesale basic. Cable companies and Verizon have formed a technology innovation joint venture for the development of technology and intellectual property to better integrate wireline and wireless products and services.

• Verizon has the best strategy for the long-term future of its fixed-line business. Its next-generation network, which enables unparalleled data speeds and upgradability, reaches 16.5 million customers.

• The company ranked number one for customer satisfaction from a major consumer publication in 2011

• Its 4G LTE is at the top of PCWorld’s ‘100 best products of 2011’

• The company has robust financial – strong, stable and steady in its performance, cost efficiency, and investment efficiency.

• Steady dividend payout – the average dividends/sales ratio is 5% in the last five years.

Industry Trends: Telecommunication consists of wireless and wireline sub-industries. The wireless has experienced growing competition, lower prices, increased service availability, technological innovation, and a widening variety of product offerings. With wireless becoming increasingly convenient and affordable, call volumes remain on the rise. The availability of 3G and 4G wireless data products, as well as integrated electronic devices for music, pictures, video, and internet access, are generating consumer excitement. In the wireline sub-industry, broadband has become the focus for telecom carriers. Telecom carriers will continue to lose customer accounts due to competition from cable providers. The cable companies, with their large marketing budgets, established customer loyalty, and secure broadband networks, will offer a discounted bundle of telephony service.

Business Summary: Verizon Communications Inc, is a diversified telecom company which has a wireline presence in 28 states and Washington, D.C.; a wireless presence in 50 states and D.C.; operations in 19 countries. Verizon Wireless is the firm’s 55%-owned partnership with Vodafone. In 2011, Verizon’s revenue breakdown was 37% of wireline, including telecom and business, and 63% of domestic. As of June 2012, Verizon Wireless had a 0.8% monthly post-paid churn rate, and its retail post-paid monthly service revenue per user was $56, up 3.7% from a year earlier. The company provided wireline service to 23.3 million voice connections (down 7% from a year earlier). During 2011, Verizon incurred capital spending of $16.2 billion, with nearly $9 billion for wireless operations. In the first half of 2012, overall spending was $7.4 billion, with $3.9 billion for wireless.

Management Review: Ivan Seidenberg led Verizon from 1995 to 2011. Under his leadership, the company invested in fiber, wireless broadband, and global internet networks, making Verizon a national company with a growing global presence. Lowell McAdam, formerly president and COO, replaced Ivan Seidenberg as CEO during 2011. He headed Verizon Wireless from 2006 through October 2010. During the last few years, the board has taken steps to address the measures used to determine bonuses, with earnings per share determine 50% of the award. Equity compensation is largely in the form of performance stock units, which vest based on the performance of Verizon shares. Equity compensation is based on a three-year performance cycle and is paid in a mix of cash and shares. New CEO Lowell McAdam was given a one-time $10 million equity award upon taking the top spot. This award vests over five years, is payable in Verizon shares, and must be held for at least two years after vesting.

Financial Trend Analysis: Revenue has increased over the trailing five years although the growth rate has fluctuated over the same period. Revenue has been up from 2006 to 2009, down 1.2% in 2010, and up again in 2011 and 2012. Gross margin has hinged around 59% of sales. Selling, general and administrative expense has accounted for an increasing portion in income statement. It has risen from 28.3% of sales in 2006 to 32.13% of sales in 2011. As a result, operating margin has decreased from 15.2% of sales in 2006 to 11.6% of sales in 2011. Returns on equity and total capital are following similar trends. Assets turnover is approximately 48% in average over the last five years. Debt/Equity ratio and Debt/Capital ratio have decreased over years. Current ratio is up and down, fluctuating from 0.8 to 1 for the last 5 year period. Interest coverage has ranged from 4.6 times to 9.3 times over the same period due to the volatile annual interest expense and decreasing operating profit.

Financial Health: Since it began offering the iPhone in early 2011, wireless service revenue has been stabilized, increasing about 5% annually, on average, through 2016 expectedly. However, Verizon is still losing fixed-line residential customers and the pace of Internet access and television customer growth has slowed sharply recently. The firm has raised prices to help boost margins and improve the return on its network investment. Enterprise revenue growth has been slow down because of economic weakness. It is expected a pickup in the economy over the next year or so should give enterprise revenue a boost. As businesses use networks to move more data around and drive basic business functions, demand for connectivity among offices and workers should continue to grow nicely. Verizon has an advantage in meeting this demand because of its local networks throughout the Northeast, the reach of its global long-distance network, and its ability to consistently invest in network technology.

Verizon’s strong free cash flow supports continued dividend payments to its shareholders, even as the company plans to pay a dividend to Vodafone for its partial ownership of Verizon Wireless. In September 2011, the company declared a 2.4% dividend increase. Verizon has used asset sales, spin-offs, and cash flow to sharply reduce debt in recent years. The company's consolidated debt load currently sits at a comfortable level.

Competitive Analysis:In wireless segment, only AT&T T can now match Verizon Wireless' scale, Verizon Wireless has several advantages relative to its primary rival. AT&T has attracted a sizable group of customers because of its prior exclusive agreement to sell Apple's iPhone. Since Verizon began offering the iPhone in early 2011, the gap between Verizon and AT&T has widened.

Verizon's wireline segment competes for broadband and telephony customers against cable companies Cablevision and Comcast. At the end of June 2012, it was offering its advanced fiber-based broadband services (FiOS) to 14 million homes and businesses, many of which also had access to FiOS video. FiOS contributed 65% of consumer wireline revenues. As of June 2012, Verizon had a 36.6% penetration rate (5.1 million customers) with its FiOS broadband service and a 32.6% penetration rate for the video service (4.5 million); deployment of FiOS to new markets has slowed from a year earlier, but penetration has continued to edge higher, helped by multi-dwelling units.

Projections and Valuation Summary: The valuation is based on the low end of current estimates of 3% annual revenue growth in a range of 3%-4%. Gross margin is kept in line with historical data, sitting at 59% of sales. As selling, general and administrative expense has increased over the last few years, I estimated that SG&A expense will account for 32.5% of sales. Depreciation expense is calculated by timing projected sales and the average historical percentage of depreciation over sales in 5-year period. The same rule is applied for interest expense. As Verizon is spending a tremendous amount of money to upgrade and maintain network quality, I projected it will spend roughly an amount of 17% of sales on capital expenditure yearly to keep out high competition. Given that the wireless segment is generating tons of cash, Verizon can likely afford enormous capital expenditure.

Adjusting the revenue growth from 3% to 4% results in a fair value of $79.37. However, the valuation is highly dependent on WACC; a change in beta from 0.75 to 0.59 (S&P stock report) lowers WACC from 5.32% to 4.65%, resulting in an increase in intrinsic value from $75.22 to $103.1.

Risk Factors:

• Verizon is confronting to drastic competition in both wireless and wireline segments in a highly penetrated market. Wireless business has to change offered service plans frequently to appeal customers. Verizon Wireless recently has taken the lead in shifting to rate plans that more closely match pricing to customer network usage, but customers, regulators, and the competitive environment may not allow this transition to happen smoothly. Wireline segment is locked in a battle with the cable companies to capture Internet access, phone, and television customers.

• Verizon Wireless' ownership structure presents some uncertainty. Verizon is potentially exposed to illiquidity and operational risks if the relationship with Vodafone doesn’t work out. In addition, over the long term, the firm plans to offer wireless technology in areas that FiOS won't reach. This move will shift revenue to Verizon Wireless, where Verizon only receives a portion of the benefit, and could pressure margins in the fixed-line business.

• The agreement to acquire additional wireless spectrum and the potential formation of the joint venture with other cable companies are subject to approval by FCC and review by DOJ. Verizon Wireless will need all that spectrum, if not more, and likely will need to spend heavily to upgrade its networks as it offers customers more devices that encourage heavy data usage.

• Verizon is facing a declining demand in the wireline enterprise segment due to slow growth of the US economy and weakness in European enterprise.

**DCF Valuation Model:**



**Comparative Valuation Analysis:**



**WACC Calculation: Total Return Calculation:**



**Valuation Assumptions:**



**Income Statement Projection:**



**Historical Financial Data:**









**Notes:**