July 2013

STATE OF THE SECTOR

Telecommunication Services

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KEY TAKEAWAYS

- Earnings growth for the telecommunications sector has been slower than expected, mainly due to compressed margins for wireless services companies.
- In an environment of low fixed-income yields, the high dividend payouts and solid free cash flow for bellwether telecommunications companies have kept the sector's valuations relatively high.
- *Research Spotlight:* Revenue growth for wireless carriers has not kept pace with wireless data consumption growth, but tower operators may be well positioned to take advantage of the ongoing data boom.
- Data service growth, consolidation, and renewed competition among the major wireless carriers will likely shape the sector for the medium term; companies with stronger growth opportunities and more costs to trim may benefit most.

Update on fundamentals

The telecommunications sector continues to be a defensive one for investors. Even during periods of volatility in overall economic growth, factors such as a long sales cycle, ongoing subscription revenues, and the perceived necessity of voice and data services tend to make revenues for the telecommunications sector relatively consistent. Stable but modest top-line growth of 2%-3% a year is the historical norm, and the past two quarters were no exception.

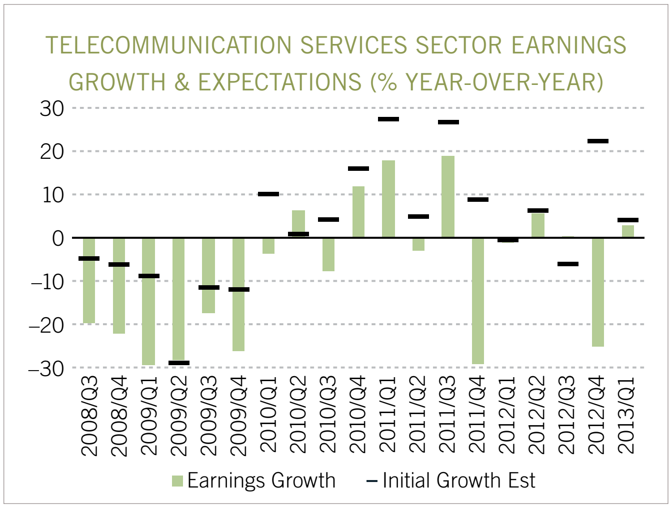
However, revenue growth for the sector has been on the low end of the range lately. Revenue from wired residential voice lines has declined steadily, as wireless subscriptions and Internet voice services have replaced traditional phone lines. Revenue growth from wireline services to enterprise and small-to-medium businesses has continued to be slow. Sales growth in that category tends to lag the cyclical shifts of the economy because new businesses form and existing businesses expand cautiously, later into a recovery. Strong competition from cable television companies that now offer wired data and voice for businesses may present a rising challenge to wireline revenue growth going forward, and bears watching. Additionally, a reduction in federal Universal Service Fund fees negatively impacted revenues mildly, but these savings were passed through to users and did not affect profits.

Earnings Scorecard

Q1 2013	Earnings Growth Actual (%)	Initial Earnings Growth Est. (%)†	Revenue Growth Actual (%)	Initial Revenue Growth Est. (%)†
MSCI U.S. IMI 2500*	3.8	3.6	0.6	1.9
Telecommunication Services	**2.7**	**4.4**	**0.8**	**1.7**
Diversified Telecommunication Services	4.7	4.4	0.8	1.8
Alternative Carriers	N/A	N/A	0.9	2.9
Integrated Telecommunication Services	3.5	1.8	0.8	1.7
Wireless Telecommunication Services	N/A	N/A	0.8	1.1

**MSCI U.S. Investable Market 2500 Index represents the investable universe of companies in the U.S. equity market. Telecommunication services companies of the MSCI U.S. IMI 2500 are classified according to the Global Industry Classification Standard (GICS®). †Initial Earnings Growth Estimate and Initial Revenue Growth Estimate reflect a consensus of Wall Street analysts' expectations prior to the start of the quarter. Data reflect reported operating earnings/revenue for 96% of the MSCI U.S. IMI 2500 and 94% of telecommunication services companies in the MSCI U.S. IMI 2500 Index, combined with earnings estimates for the remaining firms. N/A represents a meaningless growth figure (e.g., negative earnings in denominator). Source: Fidelity Investments, FactSet as of June 17, 2013.*

EXHIBIT 1: Earnings growth for the telecommunications sector was slightly below initial expectations for Q1 2013.



Earnings growth for Q1 2013 based on 94% of telecommunication services companies reported, combined with earnings estimates for the remaining firms. Initial Growth Estimate (i.e., "Expectations") reflects a consensus of Wall Street analysts' expectations prior to the start of each quarter. Source: FactSet as of June 17, 2013.

Fidelity INVESTMENTS

Earnings growth has been slower than expected. The large integrated telecommunications companies have been meeting general expectations for earnings growth, but compressed margins for wireless service providers have depressed earnings growth for the sector overall. Intensified competition for wireless customers—particularly among the major carriers—likely had the largest impact on earnings in that industry, and this trend should continue for the near future. Higher-than-expected acquisition costs have depressed earnings for some of the larger wireless companies in the sector as well.

The wireless services industry continues to evolve. With the U.S. regulatory stance against consolidation of the four major carriers in the U.S., we have begun to see some acquisition interest focused on the marginal players. More importantly, a recent acquisition plan for one of the major wireless carriers, if it comes to pass, may invigorate that company and intensify the competition among all wireless carriers, potentially applying further pressure on future earnings.

Assessing valuation

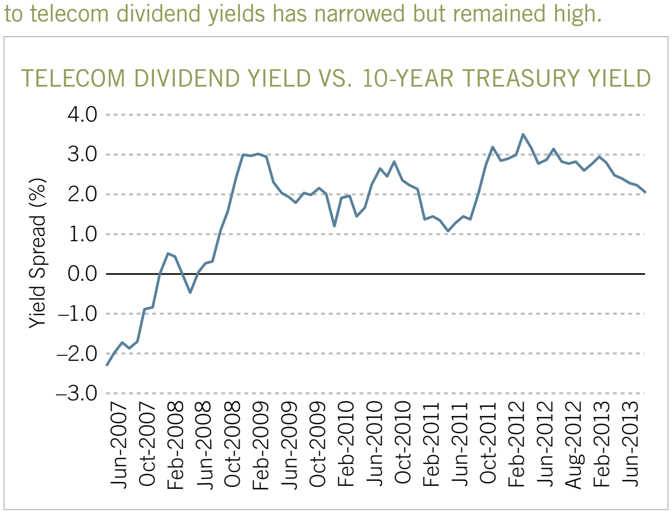
Because businesses in the telecommunications sector usually have high but irregular capital investment needs, earnings growth is not always the best gauge of the sector's performance, and the price-to-earnings ratio (P/E) is not always the best measure of valuation. Instead, stocks in this sector tend to trade based on a combination of dividend yield and recurring free cash flow yield.

In an economic environment of low interest rates for fixed income securities, relative dividend yields seem to have become an important factor in equity valuations. With stable revenues and predictable cash flows, telecommunications companies have tended to offer healthy dividend yields. The sector's yield spread over 10-year Treasury bonds has narrowed recently (see Exhibit 2, below left), mainly due to a slight increase in the Treasury yield. However, the current spread of approximately 2.0% is on the high end for long-term averages, consistent with the recent range. Payout ratios (the percentage of earnings paid out to investors as dividends) for the bellwether companies of the sector have remained near 70%, perhaps suggesting little potential for valuation increases based solely on dividend growth.[1]

Recurring free cash flow yield, which divides the share price into the expected recurring cash flow generated by the company less ongoing capital expenses, is another useful valuation metric for the telecommunications sector.[2] While dividend yield reflects the amount of cash returned to investors, recurring free cash flow yield measures ongoing cash generation that may be used for a variety of business purposes, including dividends but also including expansion, acquisitions, and share buybacks. Recurring free cash flow yield had been at around 7% at the beginning of the year, which is near the low end of the sector's range for the last few years and suggests high valuations.[3] Current estimates for recurring cash flow in 2014 suggest that a slight increase to a 7.5% yield has occurred, but valuations are still relatively high.

Any further increase in Treasury yields would likely challenge valuations for the telecommunications sector. In 2009, when 10-year Treasury yields were above 3%, the bellwether companies in the sector were trading at an estimated 9% recurring free cash flow yield. With 10-year Treasury yields now closer to 2.5%, the current 7.5% recurring free cash flow yield likely reveals investors' willingness to pay more for equities with higher dividend yields in the current environment of low rates.[4] If the perceived risk-free yield represented by Treasury bonds were to increase further, valuations for the telecommunications sector would likely decrease.

EXHIBIT 2: As 10-year Treasury yields have increased, the spread to telecom dividend yields has narrowed but remained high.



Telecommunication services sector dividend yield represented by the average yield of the MSCI U.S. IM Telecommunication Services Index. Source: FactSet, Federal Reserve Board, Fidelity Investments, as of June 17, 2013.

Outlook for telecommunication services stocks

Revenue growth in the telecommunications sector tends to lag during periods of positive GDP growth, and we are likely to see 2013 revenue growth come in at around 2%, at the low end of the usual range. Wireless revenue growth was roughly 5% in 2012, and is likely to be lower for 2013, at around 4%. Wireline revenue continues its secular decline, eroding roughly 1% in 2012 and likely to fall a similar amount this year.

Wireless and wireline data consumption together will likely continue to drive the sector's revenue growth, though at a rate significantly trailing the actual increases in consumption (see *Research Spotlight*, page 3). As broadband data service becomes more and more of a necessity for businesses and individual consumers alike, successful data service providers can expect to earn relatively stable revenues. What remains uncertain is whether service providers can resist deflationary pressures and find ways to grow profits to match consumption growth, especially after

(continued on page 4)

RESEARCH SPOTLIGHT

Mobile Data Consumption Growing Faster than Revenue

Mobile (wireless) data consumption has expanded rapidly over the past few years, and is expected to continue growing. Mobile data traffic in the U.S. grew 62% in 2012 and is estimated to grow nine-fold by 2017, at a compound annual growth rate of 56%.[5] Some of that anticipated growth may come from additional users and more connected devices, but most of it is predicted to come from an increase in traffic per connected device as users demand more and more wireless data. Internet video seems to be the main driver of this demand growth: By 2017, mobile video traffic in the U.S. is expected to account for 66% of all U.S. mobile data traffic, after growing at a compound annual growth rate of 63% per year.[6]

In contrast, service revenue growth for wireless data carriers has not kept pace. Wireless revenue growth in recent years has been driven primarily by smartphone adoption and the resulting addition of new data plans. As smartphone penetration in the U.S. has increased, revenue growth has slowed each year since 2010 (see Exhibit 3, right). Essentially, when consumers first connect a smartphone and sign up for a data plan, they tend to overbuy data service. As a result, when usage increases or consumers add devices to existing data plans, revenues for wireless carriers increase less dramatically then when selling data plans to first-time adopters.

Industry competition in wireless data plans has worked mainly in favor of consumers. Although the two largest carriers have tried to establish usage-based pricing as a way to increase average revenue per account (ARPA), their competitors have responded to consumer demand by continuing to offer lower-cost unlimited plans. Additionally, carriers have offered discounts to encourage quicker customer upgrades to fourth-generation (4G) devices, sacrificing opportunities to establish premium pricing in an attempt to gain market share.

Even if usage-based wireless data plans become more common, Wi-Fi substitution may shrink or eliminate ARPA gains. Because fixed (wired) broadband typically has lower marginal usage costs, wireline providers tend to offer unlimited data plans. Consumers on usage-based wireless plans can reduce usage charges by switching their devices to fixed-access Wi-Fi at home or work, and retail businesses and cable providers are increasingly encouraging customer loyalty by offering out-of-home Wi-Fi hotspots.

Investment implications

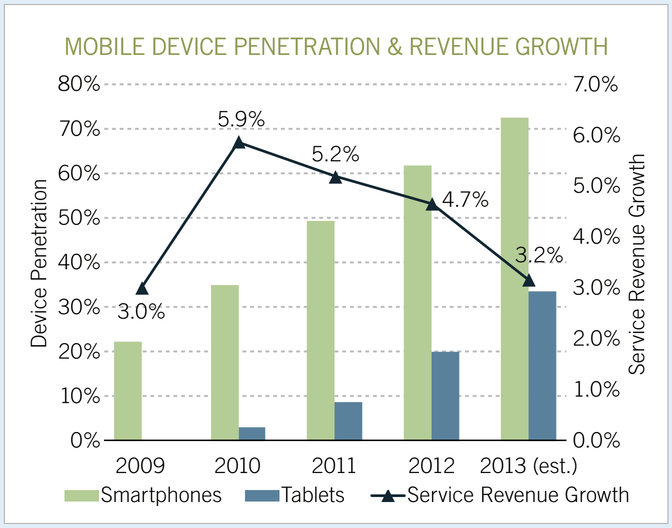
Wireless carriers will likely try to lower costs and increase data pricing if they can, but it may be some time before the market dynamics of the vast wireless data boom become established.

Some of the wireless carriers are just starting to explore other ways of creating incremental revenue from the expanding demand for wireless data. Mobile payment services and cloud storage are two possible sources of additional fees, but it may prove challenging for carriers to enter these businesses. Potential new device subscription fees may come from home security systems, the "connected car," and wearable computing, but meaningful growth in those areas will likely require forging partnerships with other businesses, following advances in technology that are yet to come. Incremental revenue from these initiatives will likely be lower than that of the initial wave of smartphone uptake.

Looking beyond the carriers, the tremendous and growing demand for wireless data is likely to benefit businesses supporting the key infrastructure behind data transmission. For example, the companies building and maintaining cell towers are leveraged to all forms of capacity growth. Increased usage requires better capacity, which requires better coverage and a denser cell-site network. Technology upgrades allowing higher wireless broadband speeds will entail capital spending on towers. Because the wireless carriers now compete on data network performance in addition to voice coverage, tower operators can be important partners to all the wireless service providers at once.

Other factors may continue to benefit the tower business going forward. The regulatory environment seems to favor maintaining a market with more major players, suggesting that the competition for data network quality will persist. Contracts for tower operators give a high level of visibility into future revenues, and escalator or inflation clauses help companies to grow revenues and expand margins. High barriers to entry limit the number of tower competitors in any given market, supporting higher incremental margins for existing companies. With these dynamics firmly in place, tower operators are likely to outpace the wireless carriers in profiting from the current data boom.

EXHIBIT 3: As mobile device penetration has increased, revenue growth has slowed.



Mobile device penetration reflects the percentage of wireless subscribers who have registered a smartphone or tablet with a wireless carrier. Estimates for 2013 as of June 17, 2013 (smartphones and revenue) and March 2013 (tablets). Source: Company filings, Fidelity Investments (smartphones and revenue); Gartner, "Forecast: Desk-Based PCs, Notebooks, Ultramobiles and Tablets, Worldwide, 2011–2017, 1Q13 Update" (tablets).

factoring in the capital expenditures required to provide greatly increased capacity.

Longer term, the relative stability of the overall sector may mask intense volatility for the underlying companies, which have varying levels of exposure to growing or declining segments of the market. Recent acquisition activity around one of the four largest wireless providers in the U.S. may signal the beginning of more consolidation. Over time, reinvigoration of the less dominant players in the wireless industry may reward companies that have better opportunities to expand revenues and cut costs. The ongoing decline of wired voice, and competitive pressures in wired data from cable providers, may continue to challenge earnings growth for companies with high overall exposures to the wireline business.

Author

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Matthew Drukker is a portfolio manager for Fidelity Investments. Mr. Drukker joined Fidelity in 2008 and is responsible for managing multiple sector and industry portfolios related to telecommunications and multimedia.

Endnotes

[1] Source: Company filings, Fidelity Investments, as of June 17, 2013.

[2] Source: Company filings, Fidelity Investments, estimate as of May 31, 2013. The calculation of recurring free cash flow yield requires analytical judgment to eliminate the effects of unusual events and uneven cash flow distributions. Therefore, recurring free cash flow yield is an estimated ratio.

[3] Source: Company filings, Fidelity Investments, estimate as of May 31, 2013.

[4] Source: FactSet, Company Filings, Fidelity Investments, estimate as of May 31, 2013.

[5] Source: "VNI Forecast Highlights," CISCO. http://www.cisco.com/web/solutions/sp/vni/vni_forecast_highlights/index.html. Accessed June 17, 2013.

[6] Source: "VNI Mobile Forecast Highlights, 2012–2017" CISCO. http://www.cisco.com/web/solutions/sp/vni/vni_mobile_forecast_highlights/index.html. Accessed June 17, 2013.

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