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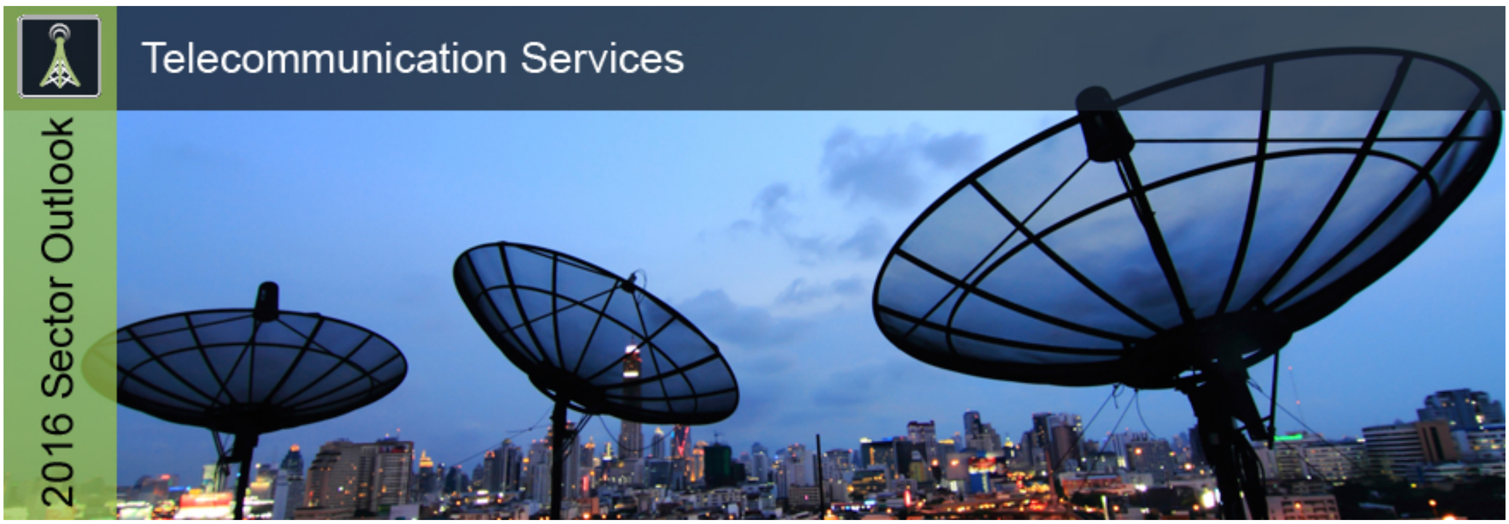
2016 outlook: telecommunication services

Cell tower operators may be an opportunity. Potential earnings growth slowdown's a risk.

BY MATTHEW DRUKKER, SECTOR PORTFOLIO MANAGER, **FIDELITY VIEWPOINTS** – 12/16/2015

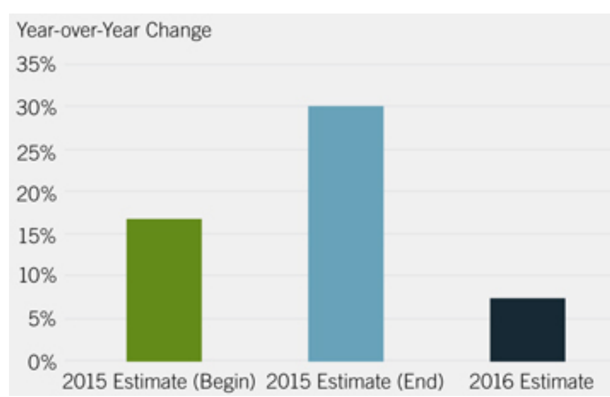
Investing in Stocks   Telecommunications Sector



Wireless carriers continue to compete for customers and spectrum, contending with each other and with potential new entrants such as cable companies. Carriers are increasingly turning to content as a way of differentiating their services. With demand for data growing, cell towers are still a key link in the wireless capacity chain.

Risks include a large spectrum auction in 2016 that could encourage additional spending, and a deceleration in overall earnings growth from previous accounting changes, which may require investors to reset their expectations.

Telecommunication services EPS growth



Investment opportunities

Changing competitive dynamics may favor wireless

Competition among wireless carriers and from potential new services has been growing, and that trend is likely to continue. For the four major U.S. wireless providers, the key trend to watch is whether the two challengers can continue to grow market share at the expense of the two incumbents with the most subscribers. These challengers are subsidiaries of larger companies with deep pockets, but so far they have shown little inclination to support market share gains beyond efforts that are self-funding.

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EPS: earnings per share. 2015 EPS growth estimate (Begin) was as of Dec. 31, 2014. 2015 EPS growth estimate (End) includes reported earnings as of Oct. 31, 2015, combined with estimated earnings for the remainder of 2015. Source: FactSet, Fidelity Investments, as of Oct. 31, 2015.

If pricing pressures between carriers are finally leveling off, this equilibrium could be a positive catalyst for the industry. At the same time, new phone handset financing and leasing options are becoming more common. Without required long-term contracts to make handsets seem affordable, switching costs for customers are falling, which could intensify competition.

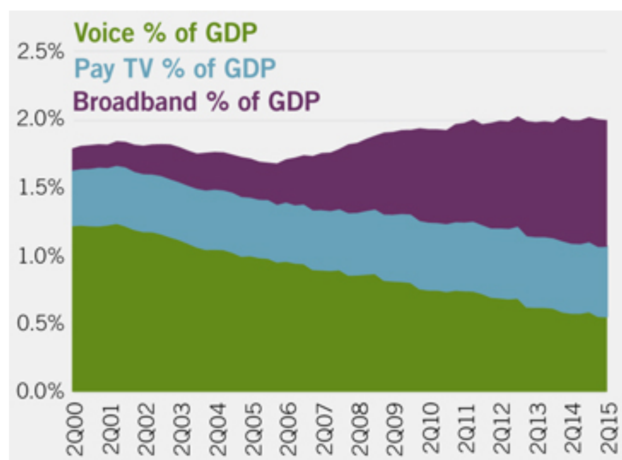
Also, with mobile data as the key draw for customers, cable companies offering broadband and WiFi are testing ways to mimic wireless networks, which may set the stage for new cross-industry partnerships. Carriers that can adapt to these trends more quickly may have an advantage in the near term. Conversely, use of traditional "wireline" continues to decline as consumers shift toward data and wireless, and away from wired voice services (see chart)

Content takes a spotlight

Increasingly, customers are using the Internet to watch video, and they want to be able to go mobile with their content. With 4G networks now built out and growth in mobile devices on data plans slowing down, one way wireless providers can differentiate themselves is by offering access to selected content through their networks. By making deals directly with content producers and with cable and satellite TV content providers, wireless carriers can try to attract customers with "bundles" of content such as streaming entertainment or sporting events, perhaps with no additional data charges.

With the technology for Long-Term Evolution (LTE) multicast nearly in place, wireless carriers could efficiently broadcast events using existing capacity (although wider smartphone and tablet adoption of the technology is still needed). This shift will likely evolve over time, but wireless carriers are investing now for the long term, which could potentially benefit **content producers and providers**—as well as the **carriers** that offer the most attractive content.

Telecom services U.S. consumer spending



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GDP: gross domestic product. Broadband includes wireless and wired broadband access. Figures estimated based on industry and corporate reports. Source: Bureau of Economic Analysis, Haver Analytics, Fidelity Investments, as of Jun. 30, 2015.

Tower company growth may continue as long as capacity is still required

During the past few years, new smartphone and tablet adoption has been the main force behind an ever-increasing need for data capacity. Even though that growth in hardware adoption now shows signs of peaking, demand for larger amounts of mobile data continues unabated. For carriers to send out even more video, internet, and voice data over the networks, they will need to make capital expenditures to build capacity.

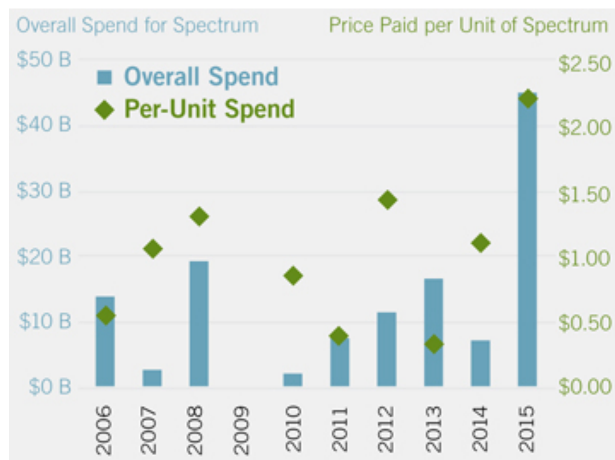
The companies that own, build, and maintain the cell towers that transmit that data will likely continue to benefit from this growth in 2016. Because communities typically resist new tower construction, the **incumbent tower operators** may reap the benefits of strong contracts with the wireless carriers, and will remain a necessary partner in network upgrades.

Risks: what to watch

Spectrum auctions could get expensive

Wireless spectrum, which is the set of radio frequencies used for wireless data and voice transmission, is regulated in the U.S. through licenses auctioned by the Federal Communications Commission (FCC). Like some natural resources or beachfront property, it is an asset with limited supply, and when licenses to use spectrum frequencies come to auction, wireless carriers must bid strategically. With the changing market dynamics and a larger-than-usual spectrum auction in 2015, both the overall spend and the per-unit spend on spectrum hit a 10-year peak (see chart). The FCC is now planning another large auction for 2016, and carriers may need to dig even deeper to maintain their competitive positions and lay the groundwork for the next generation of wireless networks. This spending could strain their balance sheets.

Expenditures on wireless spectrum



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Per-Unit Spend: the average of price paid divided by a standard measure of the potential reach of the spectrum purchased (spectrum megahertz times the population of the area covered). Source: Company filings, Fidelity Investments, as of Oct. 27, 2015.

Accounting changes reset earnings expectations

The majority of wireless subscriptions now use new accounting standards, in which the wireless carrier recognizes revenue from a handset sale in the quarter the sale is made, even though the customer typically pays for the phone in monthly installments. In 2015, this change tended to boost year-overyear revenue and EPS growth for carriers (see EPS chart), despite unchanged business fundamentals. With the bulk of the conversion done, wireless carriers will experience a headwind for revenue and earnings growth in 2016, as fewer subscriptions will be shifted to the new accounting standards upon buying a new handset. However, because actual cash flow is unaffected, dividends should remain relatively stable throughout the year, which may give investors a chance to buy dividend yield inexpensively, especially if slower reported earnings growth depresses valuations.

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