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2014 Outlook: Telecommunication Services

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Fidelity sector portfolio manager Matthew Drukker provides his view on the most attractive investment opportunities and the major risks in the telecommunication services sector in 2014.

INVESTMENT OPPORTUNITIES IN 2014

Wireless competition heats up

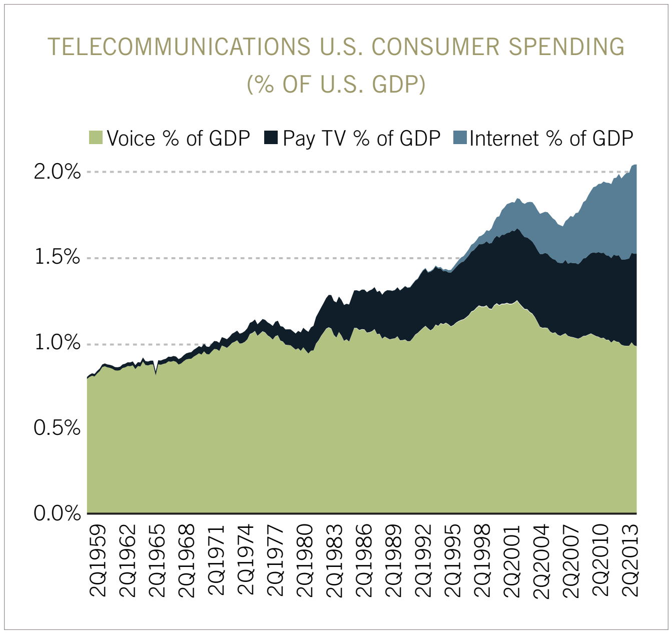
Competition among U.S. wireless carriers looks like it may intensify over the next few years. Just two years ago, it seemed as if the four major wireless carriers were going to consolidate into three. Instead, the U.S. Department of Justice blocked the merger, leaving the industry in its previous structure with four major players, two larger and two smaller. Fast-forward to 2013, when three of the four carriers went through major corporate events: One acquired the fifth largest wireless carrier in an effort to secure a more competitive network; another was majority-acquired by an international telecommunications company with plans to invest heavily in the U.S. operations; the last is in the process of buying out a partner with a 45% stake, which will give the company full control of its wireless division and allow it to converge with its existing wireline (i.e., wired telecommunications) business.

Renewed competition among the major wireless carriers may be great for their customers, but what about for investors? With smartphone penetration in the U.S. already above 70%, revenue growth from new data-plan customers, which historically helped support earnings, may continue to be slow. The two leading carriers are likely to resist discounting handsets and data usage, but may feel pricing pressure from aggressive competitors fighting for market share. Patient investors may want to take a position in one of the less dominant major carriers, but the kinds of share gains that could make a big difference in earnings might take several years to build.

Carriers are now in a race to build out their 4G networks, in an effort to handle the growing demand for wireless data and compete on network quality. Consequently, capital expenditures rose significantly in 2013, and are likely to remain elevated or even rise further. As I have written before, the most immediate beneficiaries might be those who provide the network architecture required for the heavy use of wireless data (see *Leadership Series* article "State of the Sector: Telecommunication Services," July 2013). The companies operating cell phone towers especially stand to gain as the national carriers upgrade their networks. Tower companies often face limited local competition, and can negotiate strong contracts with the wireless carriers. Tower operators with strong management, and those that have already diversified into new markets ahead of the demand, are likely to lead earnings growth.

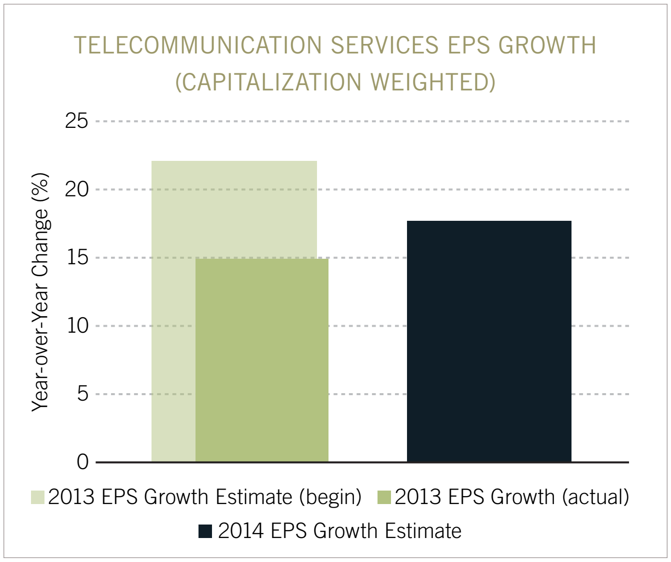
Another important dynamic to watch will be the competition for wireless spectrum, the radio frequencies used for wireless data and voice transmission. Spectrum is naturally constrained by the laws of physics, and regulated in the U.S. through licenses auctioned off by the Federal Communications Commission. As the four major carriers continue to build out their national networks, companies holding spectrum licenses have become the targets of several acquisitions over the past few years. The few remaining independent companies with desirable licenses may be courted by deep-pocketed national carriers willing to pay a premium for network-enhancing spectrum assets.

EXHIBIT 1: After decades of gradual growth, personal consumer spending on wired voice services has been declining steadily, while spending on pay TV and Internet services (i.e., broadband access) has increased relative to the economy.



GDP: gross domestic product. Services data presented quarterly, and seasonally adjusted. Source: Bureau of Economic Analysis, Haver Analytics, Fidelity Investments as of Oct. 2, 2013.

EXHIBIT 2: After overestimating per-share earnings in 2013, analysts' consensus predicts strong EPS growth in 2014.[1]



Estimates weighted by market capitalization of sector constituents as of Oct. 31, 2013. EPS Growth Estimate for 2013 was as of Dec. 31, 2012. Actual 2013 data include estimates for Q4 2013. EPS: earnings per share. Source: FactSet, Fidelity Investments, as of Oct. 31, 2013.

International opportunities

International wireless companies face a different set of opportunities and challenges. European wireless providers may be entering a phase of industry consolidation and an improving regulatory environment, which could lead to higher profits. With the potential for an improved competitive landscape in Europe, one U.S. carrier has publicly expressed interest in acquisitions in the region. In addition, some of the greatest wireless growth potential is in emerging markets such as Latin America, Asia, and Africa. Because smartphone penetration in emerging markets is still very low, the wave of additional revenue that comes from users adding a data plan may be yet to come. Cheaper handsets and built-out 3G networks could help to accelerate the trend. Major Latin American markets illustrate some of the economic tensions in emerging markets. Service revenues there have been increasing in local currency terms, but often at a rate slower than inflation. In general, many international telecommunications stocks have underperformed over the past few years, as global macroeconomic factors have weighed on both fundamentals and valuations. Look for companies with improving cash flows, strong balance sheets, and strategic market positions.

Data takes over the wires

In wired telecommunications, voice service has been gradually declining for quite some time, while broadband data (i.e., Internet services) has been growing quickly. In fact, revenues for residential wired services overall have been growing faster than the economy due to the combination of pay TV and broadband data (see Exhibit 1, page 1). Both of those services (along with voice calling) are often bundled together and sold by one provider—the local cable television company. More and more, cable companies are in competition with traditional wired telecommunications companies, offering voice calling (through voice-over-IP phone lines) and fast Internet connections to customers. Once the cables have been run to a neighborhood, cable companies can add extra services with very little additional cost. As demand for faster broadband continues to surge, cable companies are likely to grow earnings on that segment of their business.

The catch is that cable TV companies are also content providers, in competition with satellite television, fiber-optic TV from telecom companies, and increasingly, the Internet. The effect of this competition is most evident in the escalating cost of acquiring content, as popular television content providers have generally been successful in negotiating higher rates. However, there is some indication that future merger and acquisition activity within the industry may help cable operators in negotiating content costs. In 2014, we may very well see this industry entering a new wave of horizontal consolidation, as smaller providers may need more scale to manage rising content costs and higher expectations of service quality.

It should also be noted that cable companies are making a concerted effort to supply voice and data services to businesses. Although they hold approximately 10% of that market now, their share has been increasing rapidly over the past couple of years. I expect this trend to continue in the future.

RISKS: WHAT TO WATCH IN 2014

Long-term decline for traditional wireline operators

Given the declining customer base and the concordant loss of economies of scale, companies that operate copper wireline to the home—the traditional "phone companies"—face significant secular challenges to both revenues and earnings. Recently, some wireline operators have been projecting that the existing broadband delivery system using regular phone lines (i.e., DSL) can be upgraded into a price-to-performance "sweet spot" that will make it competitive with cable broadband, revitalizing the industry by attracting masses of price-conscious customers. Nevertheless, investors should be skeptical of predictions that new revenue growth could fully counter the effects of long-term secular decline.

The sector is still considered defensive

With its traditional reputation as a defensive sector, telecommunication services on the whole may lag the overall market if the U.S. economy accelerates through 2014. Yield-seeking investors added volatility to the sector in 2013—as bond interest rates fluctuated, many dividend-focused investors bought when rates were low then sold when rates started to tick up. Those market pressures may be more muted going forward, as the biggest telecommunications companies are now trading much closer to historical averages based on earnings, relative to the broad market. This environment is likely to favor an active investment approach, one that concentrates on companies with strong fundamentals and healthy opportunities to boost earnings by increasing revenues.

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

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Neither asset allocation nor diversification ensures a profit or guarantees against a loss.

Because of their narrow focus, investments in one sector tend to be more volatile than investments that diversify across many sectors and companies.

The telecom services industries are subject to government regulation of rates of return and services that may be offered and can be significantly affected by intense competition.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

Endnote

[1] Due to corporate restructuring events and/or other one-time charges at the largest companies in the sector, sector estimates for 2013 and 2014 accounting earnings growth may not be representative of underlying growth in the sector.

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