TELEPHONE & DATA SYSTEMS INC /DE/
Form 10-Q
August 04, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2017

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from
to

Commission file number 001-14157

TELEPHONE AND DATA SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

Delaware	36-2669023
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

30 North LaSalle Street, Suite 4000, Chicago, Illinois 60602
(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code: (312) 630-1900

	Yes	No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.	[x]	[ ]
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the	[x]	[ ]

registrant was required to submit and post such files).

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	[x]		Accelerated filer	[ ]
Non-accelerated filer	[ ]	(Do not check if a smaller reporting company)	Smaller reporting company	[ ]
			Emerging growth company	[ ]

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). [ ] [x]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at June 30, 2017

Common Shares, $0.01 par value	103,371,620 Shares
Series A Common Shares, $0.01 par value	7,244,282 Shares

Telephone and Data Systems, Inc.

Quarterly Report on Form 10-Q
For the Period Ended June 30, 2017

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Telephone and Data Systems, Inc.

Management’s Discussion and Analysis of

Financial Condition and Results of Operations

Executive Overview

The following discussion and analysis compares Telephone and Data Systems, Inc.’s (TDS) financial results for the three and six months ended June 30, 2017, to the three and six months ended June 30, 2016. It should be read in conjunction with TDS’ interim consolidated financial statements and notes included herein, and with the description of TDS’ business, its audited consolidated financial statements and Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations included in TDS’ Annual Report on Form 10-K (Form 10-K) for the year ended December 31, 2016. Certain numbers included herein are rounded to millions for ease of presentation; however, calculated amounts and percentages are determined using the unrounded numbers.

This report contains statements that are not based on historical facts, including the words “believes,” “anticipates,” “estimates,” “expects,” “plans,” “intends,” “projects” and similar expressions. These statements constitute and represent “forw looking statements” as this term is defined in the Private Securities Litigation Reform Act of 1995. Such forward looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, events or developments to be significantly different from any future results, events or developments expressed or implied by such forward looking statements. See Private Securities Litigation Reform Act of 1995 Safe Harbor Cautionary Statement for additional information.

TDS uses certain “non-GAAP financial measures” and each such measure is identified in the MD&A. A discussion of the reason TDS determines these metrics to be useful and a reconciliation of these measures to their most directly comparable measures determined in accordance with accounting principles generally accepted in the United States of America (GAAP) are included in the Supplemental Information Relating to Non-GAAP Financial Measures section within the MD&A of this Form 10-Q Report.

General

TDS is a diversified telecommunications company that provides high-quality communications services to approximately 6 million connections nationwide. TDS provides wireless services through its 83%-owned subsidiary, United States Cellular Corporation (U.S. Cellular). TDS also provides wireline services, cable services and hosted and managed services (HMS), through its wholly-owned subsidiary, TDS Telecommunications Corporation (TDS Telecom). TDS’ segments operate almost entirely in the United States. See Note 10 — Business Segment Information in the Notes to Consolidated Financial Statements for summary financial information on each business segment.

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TDS Mission and Strategy

TDS' mission is to provide outstanding communications services to its customers and meet the needs of its shareholders, its people, and its communities. In pursuing this mission, TDS seeks to profitably grow its businesses, create opportunities for its associates and employees, and build value over the long-term for its shareholders. Across all of its businesses, TDS is focused on providing exceptional customer experiences through best-in-class services and products and superior customer service.

TDS' long-term strategy calls for the majority of its capital to be reinvested in its operating businesses to strengthen their competitive positions and financial performance, while also returning value to TDS shareholders through the payment of a regular quarterly cash dividend and share repurchases.

In 2017, TDS is working to build shareholder value by continuing to execute on its strategies to build strong, competitive businesses providing high-quality, data-focused services and products. Strategic efforts include:

- U.S. Cellular continues to devote efforts to enhance its network capabilities. During the second quarter of 2017, U.S. Cellular commercially deployed VoLTE technology for the first time in one key market and will continue to build out VoLTE services over the next few years. The next commercial launch is expected to occur in several additional operating markets in early 2018. VoLTE technology allows customers to utilize a 4G LTE network for both voice and data services, and offers enhanced services such as high definition voice, video calling and simultaneous voice and data sessions. In addition, the deployment of VoLTE technology expands U.S. Cellular's ability to offer roaming services to other carriers.
- U.S. Cellular continues to enhance its spectrum position and monetize non-strategic assets by participating in auctions and entering into agreements with third parties. In April 2017, the FCC announced by way of public notice that U.S. Cellular was the winning bidder for 188 licenses for an aggregate purchase price of $329 million in the forward auction of 600 MHz spectrum licenses, referred to as Auction 1002. U.S. Cellular made an upfront payment of $143 million to the FCC in June 2016 and paid the remaining balance of $186 million and was granted these licenses during the second quarter of 2017. In addition, U.S. Cellular closed on certain license exchange agreements in the six months ended June 30, 2017, and received $15 million of cash and recognized gains of $19 million. See Note 5 — Acquisitions, Divestitures and Exchanges in the Notes to Consolidated Financial Statements for additional information related to these transactions.
- U.S. Cellular is focused on expanding its solutions available to business and government customers, including a growing suite of connected machine-to-machine solutions and software applications across various categories. U.S. Cellular will continue to enhance its advanced wireless services and connected solutions for consumer, business and government customers.

- TDS Telecom's Wireline business continues to focus on driving growth in its IPTV, broadband, and managedIP services by leveraging its network investments in fiber and copper bonding. With support from the FCC's A-CAM program, Wireline will deploy higher speed broadband services to more rural areas over the next ten years.
- TDS Telecom's Cable business has continued to make network capacity investments and offer more advanced services in its markets in line with its strategy to increase connections and grow broadband penetration.
- TDS Telecom's HMS business is focused on growing recurring service revenues through increased sales of IT solutions including hosted and managed services, colocation services, and cloud computing services.

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Terms Used by TDS

The following is a list of definitions of certain industry terms that are used throughout this document:

- ♦ 4G LTE – fourth generation Long-Term Evolution which is a wireless broadband technology.
- ♦ Account – represents an individual or business financially responsible for one or multiple associated connections. An account may include a variety of types of connections such as handsets and connected devices.
- ♦ Alternative Connect America Cost Model (A-CAM) – a USF support mechanism for rate-of-return carriers, which provides revenue support annually for ten years beginning in 2017. This support comes with an obligation to build defined broadband speeds to a certain number of locations.
- ♦ Auctions 1000, 1001, and 1002 – Auction 1000 is an FCC auction of 600 MHz spectrum licenses that started in 2016 and continued into 2017 involving: (1) a "reverse auction" in which broadcast television licensees submit bids to voluntarily relinquish spectrum usage rights in exchange for payments (referred to as Auction 1001); (2) a "repacking" of the broadcast television bands in order to free up certain broadcast spectrum for other uses; and (3) a "forward auction" of licenses for spectrum cleared through this process to be used for wireless communications (referred to as Auction 1002).
- ♦ Broadband Connections – refers to the number of Wireline customers provided high-capacity data circuits via various technologies, including DSL and dedicated internet circuit technologies or the Cable billable number of lines into a building for high-speed data services.
- ♦ Churn Rate – represents the percentage of the connections that disconnect service each month. These rates represent the average monthly churn rate for each respective period.
- ♦ EBITDA – refers to earnings before interest, taxes, depreciation, amortization and accretion and is used in the non-GAAP metric Adjusted EBITDA throughout this document.
- ♦ FCC – Federal Communications Commission.
- ♦ Gross Additions – represents the total number of new connections added during the period, without regard to connections that were terminated during that period.
- ♦ IPTV Connections – represents the number of Wireline customers provided video services using IP networking technology.
- ♦ Machine-to-Machine or M2M – technology that involves the transmission of data between networked devices, as well as the performance of actions by devices without human intervention. U.S. Cellular sells and supports M2M solutions to customers, provides connectivity for M2M solutions via the U.S. Cellular network, and has agreements with device manufacturers and software developers which offer M2M solutions.
- ♦ ManagedIP Connections – refers to the number of telephone handsets, data lines and IP trunks providing communications using IP networking technology.
- ♦ Net Additions – represents the total number of new connections added during the period, net of connections that were terminated during that period.
- ♦ OIBDA – refers to operating income before depreciation, amortization and accretion and is used in the non-GAAP metric Adjusted OIBDA throughout this document.
- ♦ Postpaid Average Billings per Account (Postpaid ABPA) – non-GAAP metric is calculated by dividing total postpaid service revenues plus equipment installment plan billings by the average number of postpaid accounts and by the number of months in the period.
- ♦ Postpaid Average Billings per User (Postpaid ABPU) – non-GAAP metric is calculated by dividing total postpaid service revenues plus equipment installment plan billings by the average number of postpaid connections and by the number of months in the period.
- ♦ Postpaid Average Revenue per Account (Postpaid ARPA) – metric is calculated by dividing total postpaid service revenues by the average number of postpaid accounts and by the number of months in the period.

- ♦ Postpaid Average Revenue per User (Postpaid ARPU) – metric is calculated by dividing total postpaid service revenues by the average number of postpaid connections and by the number of months in the period.
- ♦ Retail Connections – the sum of U.S. Cellular postpaid connections and U.S. Cellular prepaid connections.
- ♦ Universal Service Fund (USF) – a system of telecommunications collected fees and support payments managed by the FCC intended to promote universal access to telecommunications services in the United States.
- ♦ U.S. Cellular Connections - individual lines of service associated with each device activated by a customer. This includes smartphones, feature phones, tablets, modems, and machine-to-machine devices.
- ♦ Video Connections – generally, a home or business receiving video programming counts as one video connection. In counting bulk residential or commercial connections, such as an apartment building or a hotel, connections are counted based on the number of units/rooms within the building receiving service.
- ♦ Voice Connections – refers to the individual circuits connecting a customer to Wireline's central office facilities or the Cable billable number of lines into a building for voice services.
- ♦ VoLTE – Voice over Long-Term Evolution is a technology specification that defines the standards and procedures for delivering voice communications and related services over 4G LTE networks.
- ♦ Wireline Residential Revenue per Connection – is calculated by dividing total Wireline residential revenue by the average number of Wireline residential connections and by the number of months in the period.

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Results of Operations — TDS Consolidated

	Three Months Ended June 30, 2017	2016	2017 vs. 2016	Six Months Ended June 30, 2017	2016	2017 vs. 2016
(Dollars in millions)						
Operating revenues						
U.S. Cellular1	$963	$992	(3)%	$1,899	$1,962	(3)%
TDS Telecom	281	300	(6)%	580	581	-
All other2	3	3	-	6	7	(4)%
Total operating revenues1	1,247	1,295	(4)%	2,485	2,550	(3)%
Operating expenses						
U.S. Cellular	958	962	(1)%	1,840	1,921	(4)%
TDS Telecom	257	275	(7)%	527	540	(2)%
All other2	4	5	19%	8	8	(3)%
Total operating expenses	1,219	1,242	(2)%	2,375	2,469	(4)%
Operating income						
U.S. Cellular1	5	30	(82)%	59	41	45%
TDS Telecom	25	24	1%	53	41	29%
All other2	(2)	(1)	>(100)%	(2)	(1)	(1)%
Total operating income1	28	53	(47)%	110	81	38%
Investment and other income (expense)						
Equity in earnings of unconsolidated entities	33	36	(9)%	65	72	(9)%
Interest and dividend income1	4	3	15%	8	5	36%
Interest expense	(43)	(43)	-	(85)	(85)	(1)%
Other, net	–	1	>100%	1	–	>100%
Total investment and other income (expense)1	(6)	(3)	(78)%	(11)	(8)	(53)%
Income before income taxes	22	50	(55)%	99	73	36%

Income tax expense	10	18	(45)%	44	31	43%
Net income	12	32	(62)%	55	42	31%
Less: Net income attributable to noncontrolling interests, net of tax	2	4	(49)%	8	6	24%
Net income attributable to TDS shareholders	$10	$28	(63)%	$47	$36	32%
Adjusted OIBDA (Non-GAAP)1,3	$243	$260	(6)%	$523	$506	4%
Adjusted EBITDA (Non-GAAP)3	$280	$300	(6)%	$597	$583	3%
Capital expenditures	$134	$142	(5)%	$230	$267	(14)%

1 Equipment installment plan interest income is reflected as a component of Service revenues consistent with an accounting policy change effective January 1, 2017. All prior period numbers have been recast to conform to this accounting change. See Note 1 — Basis of Presentation in the Notes to Consolidated Financial Statements for additional details.

2 Consists of corporate and other operations and intercompany eliminations.

3 Refer to Supplemental Information Relating to Non-GAAP Financial Measures within this MD&A for a reconciliation of this measure.

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TDS' 4% decrease in operating revenues for the three months ended June 30, 2017 was due primarily to decreases in retail service revenues at U.S. Cellular and equipment and product sales revenues at HMS. TDS' 3% decrease in operating revenues for the six months ended June 30, 2017, was due primarily to a decrease in retail service revenues at U.S. Cellular. Retail service revenues continue to be impacted by industry-wide price competition.

TDS' 2% and 4% decrease in operating expenses for the three and six months ended June 30, 2017, respectively, was due primarily to a decrease in Cost of equipment sold, advertising and commission expenses.

Refer to individual segment discussions in this MD&A for additional details on operating revenues and expenses at the segment level.

Equity in earnings of unconsolidated entities

Equity in earnings of unconsolidated entities represents TDS' share of net income from entities in which it has a noncontrolling interest and that are accounted for by the equity method. TDS' investment in the Los Angeles SMSA Limited Partnership (LA Partnership) contributed $17 million and $20 million in the three months ended June 30, 2017 and 2016, respectively, and $33 million and $40 million for the six months ended June 30, 2017 and 2016, respectively, to Equity in earnings of unconsolidated entities. See Note 7 — Investments in Unconsolidated Entities in the Notes to Consolidated Financial Statements for additional information.

Income tax expense

TDS' effective tax rate on Income before income taxes for the three and six months ended June 30, 2017, was 45.0% and 44.4%, respectively, and for the three and six months ended June 30, 2016, was 36.3% and 42.3%, respectively. Due to difficulty in reliably projecting an annual tax rate, TDS calculated income taxes for the six months ended June 30, 2017, based on an estimated year-to-date tax rate.

The lower effective tax rate for the three months and six months ended June 30, 2016, resulted from a decrease in unrecognized tax benefits due to the expiration of statutes of limitation in certain states in the prior year.

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Net income attributable to noncontrolling interests, net of tax

	Three Months Ended June 30, 2017	2016	Six Months Ended June 30, 2017	2016
(Dollars in millions)				
U.S. Cellular noncontrolling public shareholders’	$2	$5	$6	$6
Noncontrolling shareholders’ or partners’	–	(1)	2	–
Net income attributable to noncontrolling interests, net of tax	$2	$4	$8	$6

Net income attributable to noncontrolling interests, net of tax includes the noncontrolling public shareholders’ share of U.S. Cellular’s net income and the noncontrolling shareholders’ or partners’ share of certain U.S. Cellular subsidiaries’ net income (loss).

Three Months Ended

Net income and Adjusted EBITDA decreased due primarily to declines in operating income levels at U.S. Cellular, which is driven by lower retail service revenues, partially offset by cost saving initiatives and improved loss on equipment.

Six Months Ended

Net income and Adjusted EBITDA increased due primarily to cost savings initiatives and improved loss on equipment outpacing overall declines in retail service revenues at U.S. Cellular.

*Represents a non-GAAP financial measure. Refer to Supplemental Information Relating to Non-GAAP Financial Measures within this MD&A for a reconciliation of this measure.

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U.S. CELLULAR OPERATIONS

Business Overview

U.S. Cellular owns, operates, and invests in wireless markets throughout the United States. U.S. Cellular is an 83%-owned subsidiary of TDS. U.S. Cellular's strategy is to attract and retain wireless customers through a value proposition comprised of a high-quality network, outstanding customer service, and competitive devices, plans, and pricing, all provided with a local focus.

OPERATIONS

- Serves customers with approximately 5.0 million connections including 4.5 million postpaid, 0.5 million prepaid and 0.1 million reseller and other connections
- Operates in 23 states
- Employs approximately 6,100 employees
- Headquartered in Chicago, Illinois

- ♦ 6,421 cell sites including 4,044 owned towers in service

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Operational Overview

	YTD 2017	YTD 2016
Postpaid Connections		
Gross Additions:	320,000	412,000
Handsets	218,000	249,000
Connected Devices	102,000	163,000
Net Additions (Losses):	(4,000)	81,000
Handsets	(9,000)	(17,000)
Connected Devices	5,000	98,000
Churn:	1.21%	1.24%
Handsets	0.99%	1.14%
Connected Devices	2.45%	1.92%
Connections – end of period	4,478,000	4,490,000
Prepaid connections – end of period	484,000	413,000
Retail connections – end of period	4,962,000	4,903,000

The decrease in postpaid net additions for the six months ended June 30, 2017, when compared to the same period last year, was a result of lower handsets and tablet gross additions, partially offset by a decline in postpaid handsets churn due to improvements in both voluntary and involuntary churn.

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Postpaid Revenue

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Average Revenue Per User (ARPU)	$44.60	$47.37	$45.00	$47.76
Average Billings Per User (ABPU)1	$55.19	$56.09	$55.49	$56.08