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Wireless earnings roundup: Smartphone sales skyrocket, but will the carriers' bet prove out?

One year ago, after Verizon announced that it would begin selling Apple's iPhone, ETI predicted (Views and News, January 2011) that the big winner as Verizon and AT&T would now be vying for iPhone subscribers would be ... *Apple*. All of the Big-Four wireless companies have now reported their 2011 year-end financial results. While revenues and subscribers were up, profit margins were distinctly lower, as costly smartphone subsidies cut into the carriers' bottom line. Meanwhile, Apple announced record profits, driven by massive sales of iPhones. The carriers continue to suggest that its only a matter of time before these smartphone subsidies turn into profits, but with device manufacturers rolling out newer and better phones several times each year, and with even stronger consumer expectations of "new every two" promotions, those long-awaited smartphone profits are looking more like that pot of gold at the end of the rainbow.

T-Mobile is the only major carrier without an iPhone deal. Instead, it has been aggressively marketing Android phones with HSPA+ advanced data speeds. T-Mobile's fourth quarter earnings announcement made it clear that carriers were in a "damned if you do, damned if you don't" position. AT&T, Verizon, and Sprint all suffered as a result of having to fork over huge sums to Apple for iPhones, recovering only a fraction of those outlays in up-front payments by customers. T-Mobile, on the other hand, lost over 800,000 subscribers in just the fourth quarter, in part because it *didn't* offer the iPhone.

Revenues are up ...

AT&T increased its annual wireless segment total revenues by 8% to $63.2-billion (including gross handset sales revenues, but not offsetting these by handset costs). AT&T's revenue increase was driven by a 1.8% increase in postpaid Average Revenue per Subscriber (ARPU) and a 15.3% jump in annual data service ARPU, driven by increasing smartphone adoption. As of year-end, 57% of AT&T's subscriber base now use a smartphone, and only 29% use a phone without some form of data capability. 72% of AT&T's subscribers were on some form of a data plan. Large increases in data revenue were offset by decreasing voice revenues (down 5.3%).

Verizon Wireless similarly reported a 10% increase in total wireless segment revenues for 2011, to $70.2-billion. The carrier experienced a 2.4% increase in total ARPU, driven by a 14.3% increase in data ARPU. 44% of Verizon's wireless customers used a smartphone. 8% of Verizon's customer base is now comprised of Internet only devices. Data revenues were offset by a 5% decline in voice ARPU.

Even Sprint, despite its constant struggles, managed to increase its total 2011 wireless revenue by $1.7-billion to $30.3-billion. Sprint, the only carrier left with some form of an unlimited data offering, saw less of an increase in data ARPU than AT&T and Verizon, but did increase data revenues with a new premium data offering.

T-Mobile, reeling from the abandoned AT&T takeover attempt, saw a small decline in total revenues despite substantial subscriber losses. The number four carrier saw data ARPU increase nearly 10%, but total ARPU remained flat year over year.

... but profits are down

AT&T's $4.7-billion in increased revenue translated into only $12-million – barely more than a rounding error – in increased segment income. Verizon did not fare much better, with its $6.7-billion jump in revenues translating into only some $400-million in increased net income, while its operating margin fell 3.1 percentage points. Sprint's profit actually fell by $260-million, despite posting increased revenues. All three carriers posted massive increases in equipment subsidies, which they claim will be recovered over time. The latest iPhone 4S retails for $650 without a carrier subsidy, but sells for $200 with a two-year contract. That means carriers need to recover $450 in extra data charges from subscribers *just to break even on the handset*. That translates to $18.75 a month (over the standard 24-month term contract) just to recover the subsidy price paid to Apple. And that is before any service-related expenses, as well as those needed to support network upgrades, capacity expansions, and just basic operating costs. Making the justification even harder is that Apple, Motorola, HTC, and other smartphone manufacturers are releasing new and upgraded models *at least* every year, if not more often, such that it seems unclear that carriers even have two years to recover their subsidy. Both AT&T and Verizon routinely offer a new handset subsidy in the months *prior* to a contract renewal, in order to lock in another two year commitment. While it helps the carrier retain subscribers, this practice makes it even less likely that the carriers can earn a profit on smartphones.

AT&T's lowest-priced data plan for an iPhone (200 MB) starts at $20 – recently up from $15. At $15, AT&T could not possibly earn a profit over a two year contract, and it seems unlikely that the $20 price point would be earnings-positive either. Even with the more realistic $30 plan, which provides for 3 GB of usage, it is unclear where AT&T expects to make a killing on its service offering, especially in the face of declining voice revenues.

Verizon's data pricing is slightly more aggressive, but it is unclear whether the bulk of consumers will need more than 2 GB of data, presently priced at $30. When AT&T ended its unlimited data offerings, it suggested that no more than 2% of its customers ever exceeded the 2 GB threshold. The demand for Verizon's $80, 10 GB plan remains questionable.

Sprint, with its unlimited data plans for smartphones, has an even harder time justifying the iPhone subsidy price, since it stands no chance of collecting bonus data overage charges as long as the unlimited plan continues to be offered.

T-Mobile's earnings margins dropped as well during 2011, but not by the same magnitude as its rivals, and in a year when it was the only major carrier to actually lose subscribers. T-Mobile's financial results are almost definitely skewed by the failed merger with AT&T. T-Mobile had decreased the quantity and agressiveness of its marketing efforts during the period when the merger was pending regulatory approval. Still, its seems that the company will face the hard choice of whether, in the face of subscriber attrition, to offer the most popular smartphone despite very questionable economics.

The proliferation of available wi-fi has also made it difficult for carriers to recover investment in data services. Many cellular-capable devices (think iPad) generate little or no carrier revenue as consumers, feeling squeezed between their cell phone dataplans, and wireline broadband expense, seem content to use additional devices in wi-fi-only mode.

Is it possible for carriers to profit from smartphones?

Pending major changes to the business model, the carrier/handset manufacturer dynamic, or the regime of handset subsidies and a two year replacement cycle, we don't think so. The carrier subsidy required to induce customer adoption of the most powerful and popular handsets makes it very difficult, at current pricing levels, for wireless carriers to make any reasonable level of profit after first earning back the subsidy. Although there are Android-based phones with lower prices, the US consumer preference for iPhones is clear.

Carriers could improve the economics of the smartphone business in three ways:.

1. Strongarm handset manufactures to lower the carriers' out-of-pocket costs (and required subsidy)
2. Eliminate handset subsidies, or pass on a larger share of handset costs to customers.
3. Make a major business model innovation, such as extending the period between available subsidies, changing the way in which consumer packages are priced, or taking an airline approach to levying fees.

It seems unlikely that Apple would acquiesce to carrier requests for a major discount, although if Apple were faced with the elimination of carrier subsidies, it might change its tune. In Europe, where consumers generally pay the full rack-rate price for handsets out of pocket, lower priced Android phones have attained well above 50% share of the smartphone market while the iPhone, retailing at the equivalent of US $650, has seen lower uptake rates (around 5%) than in the US (nearly 30%). As we discuss below, however, carriers are now focusing more on retaining customers than acquiring new ones, so it is unclear that any carrier would want to require big upfront payments from otherwise loyal customers.

That leaves option three. Carriers have, for the most part, maintained legacy pricing structures centered around the sale of voice plans, while data and SMS are seen as bolt-on options. As cellular voice traffic declines and data demand increases, carriers could opt for new pricing plans that offer attractive options that maximize data revenues while easing the transition from voice revenues.

The years of endless growth are over

Although AT&T, Verizon, and Sprint all added new customers last year and will probably do so again in 2012, the massive growth in wireless subscribership experienced over the previous decade (wireless subscribership increased by 232% nationwide between 1999 and 2009) is over. All four of the major carriers together served nearly 291-million connections. The total US population is only 313-million (a figure that includes infants and small children) and there are other smaller carriers. There is clearly an upper limit to the number of additional handsets the US market can support.

The carriers' latest financial releases acknowledge this reality, which necessarily requires a shift in focus from acquiring new customers to retaining existing subscribers and finding new things to sell them. AT&T stated that "the wireless industry continues to mature. Accordingly, we believe that future wireless growth will increasingly depend on our ability to offer innovative services and devices. To attract and retain subscribers, we offer a wide variety of service plans in addition to offering a broad handset line. Our postpaid subscribers typically sign a two-year contract, which includes discounted handsets and early termination fees. We also offer data plans at different price levels to attract a wide variety of subscribers and to differentiate us from our competitors. Many of our subscribers are on family plans or business plans, which provide for service on multiple handsets at discounted rates, and such subscribers tend to have higher retention and lower churn rates. As of December 31, 2011, 86% of our postpaid subscribers are on family plans or business discount plans."

Although the family plan is not a new pricing structure, it is a good example of the type of innovation that the carriers must undertake in order to retain subscribers and increase profitability. As the number of cellular-enabled devices proliferates, carriers might look towards selling fewer full-priced plans, but offering consumers "family of devices" plans. Offering cheaper incremental data service to existing customers for devices like iPads might help boost adoption of such data plans, while covering part of the capital expenditures necessary to support 4G service. Such a plan, where each incremental device generates revenue for the carrier, would also increase the uptake of such devices by decreasing incremental cost to consumers, and increase switching costs to each consumer by virtue of multiple device tie-ins.

About ETI. Founded in 1972, Economics and Technology, Inc. is a leading research and consulting firm specializing in telecommunications regulation and policy, litigation support, taxation, service procurement, and negotiation. ETI serves a wide range of telecom industry stakeholders in the US and abroad, including telecommunications carriers, attorneys and their clients, consumer advocates, state and local governments, regulatory agencies, and large corporate, institutional and government purchasers of telecom services.