UNITED STATES CELLULAR CORP
Form 10-Q
August 05, 2016

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, 2016

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
001-09712

UNITED STATES CELLULAR CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware	62-1147325
(State or other jurisdiction of	(IRS Employer Identification No.)

incorporation or
organization)

8410 West Bryn Mawr, Chicago, Illinois 60631
(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code:
(773) 399-8900

	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 registrant was required to submit and post such files).	[x]	[ ]

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

Large accelerated filer	[ ]	Accelerated filer	[x]	Non-accelerated filer	[ ]	Smaller reporting company	[ ]

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, 2016
Common Shares, $1 par value	51,801,561 Shares
Series A Common Shares, $1 par value	33,005,877 Shares

United States Cellular Corporation

Quarterly Report on Form 10-Q
For the Quarterly Period Ended June 30, 2016

Index | Page No.

Table of Contents

United States Cellular Corporation

Management’s Discussion and Analysis of

Financial Condition and Results of Operations

Executive Overview

The following discussion and analysis should be read in conjunction with United States Cellular Corporation’s (“U.S. Cellular”) interim consolidated financial statements and notes included within, and with the description of U.S. Cellular’s business, its audited consolidated financial statements and Management's Discussion and Analysis (“MD&A”) of Financial Condition and Results of Operations included in U.S. Cellular’s Annual Report on Form 10-K (“Form 10-K”) for the year ended December 31, 2015. Analysis of U.S. Cellular’s financial results compares the three and six months ended June 30, 2016 to the three and six months ended June 30, 2015. Calculated amounts and percentages are based on the underlying actual numbers rather than the numbers rounded to millions as presented.

This report contains statements that are not based on historical facts, including the words “believes,” “anticipates,” “intends,” “expects” and similar words. These statements constitute and represent “forward 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.

U.S. Cellular uses certain “non-GAAP financial measures” throughout the MD&A. A discussion of the reason U.S. Cellular 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.

Table of Contents

General

U.S. Cellular owns, operates, and invests in wireless markets throughout the United States. U.S. Cellular is an 83%-owned subsidiary of Telephone and Data Systems, Inc. (“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, 0.4 million prepaid and 0.1 million reseller and other connections
- Operates in 23 states
- Employs approximately 6,400 employees
- Headquartered in Chicago, Illinois
- 6,324 cell sites including 3,988 owned towers in service

Table of Contents

U.S. Cellular Mission and Strategy

U.S. Cellular's mission is to provide exceptional wireless communication services which enhance consumers' lives, increase the competitiveness of local businesses, and improve the efficiency of government operations in the mid-sized and rural markets served.

In 2016, U.S. Cellular will continue to execute on its strategies to grow revenues by increasing its customer base, driving smartphone adoption and ongoing data usage monetization. Strategic efforts include:

- ♦ U.S. Cellular deployed 4G LTE as a result of U.S. Cellular's strategic initiative to enhance its network. 4G LTE reaches 99% of postpaid connections and 98% of cell sites. The adoption of data-centric smartphones and connected devices is driving significant growth in data traffic. At the end of the second quarter of 2016, 76% of postpaid connections had 4G capable devices, with the LTE network handling 89% of data traffic. U.S. Cellular continues to devote efforts to enhance its network capabilities with the deployment of VoLTE technology and plans a multi-year roll out beginning with one market in 2017. VoLTE, when deployed commercially, will enable customers to utilize the LTE network for both voice and data services, and will enable enhanced services such as high definition voice, video calling and simultaneous voice and data sessions. The deployment of VoLTE also will expand U.S. Cellular's ability to offer roaming services to additional carriers.
- ♦ U.S. Cellular continued to enhance its spectrum position and monetize non-strategic assets by entering into multiple agreements with third parties. Certain of these agreements involve the purchase of licenses for cash, while others involve the exchange of licenses in non-operating markets for other licenses in operating markets and cash. The first closing of one of the exchange agreements occurred in June 2016 at which time U.S. Cellular received $13 million of cash and recognized a gain of $9 million. The remaining license purchase and exchange transactions are expected to close in the second half of 2016, at which point U.S. Cellular expects to recognize additional gains. See Note 5 — Acquisitions, Divestitures and Exchanges 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 machine-to-machine solutions across various categories. U.S. Cellular will continue to enhance its advanced wireless services and connected solutions for consumer, business and government customers.

Table of Contents

Terms Used by U.S. Cellular

All defined terms in this MD&A are used as defined in the Notes to Consolidated Financial Statements, and additional terms are defined below:

- 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.
- Auction 97 – An FCC auction of AWS-3 spectrum licenses that ended in January 2015.
- Auction 1002 – Auction 1002 is part of Auction 1000. Auction 1000 is an FCC auction of 600 MHz spectrum licenses being held in 2016 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).
- 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.
- 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.
- 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.
- 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 partnerships with device manufacturers and software developers who offer M2M solutions.
- Net Additions – represents the total number of new connections added during the period, net of connections that were terminated during that period.
- 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 postpaid connections and prepaid connections.
- Smartphone Penetration – is calculated by dividing postpaid smartphone connections by postpaid handset 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.
- 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.

4

Table of Contents

Operational Overview

	YTD 2015	YTD 2016
Postpaid Connections		
Gross Additions	391,000	412,000
Net Additions	26,000	81,000
Churn	1.41%	1.24%
Handsets	1.32%	1.14%
Connected Devices	2.38%	1.92%
Connections – end of period	4,324,000	4,490,000
Retail Connections – end of period	4,692,000	4,903,000

U.S. Cellular believes the increase in net additions in 2016 is a result of competitive services and products priced to offer the best value to customers and expanded equipment installment plan offerings. Postpaid churn continued to decline due to enhancements in the customer experience, targeted retention programs and improvement in the overall credit mix of gross additions.

5

Table of Contents

Smartphones represented 92% and 86% of total postpaid handset sales for the six months ended June 30, 2016 and 2015, respectively. As a result, smartphone penetration increased to 77% of the postpaid handset base as of June 30, 2016, up from 69% a year ago. Smartphone customers generally use more data than feature phone customers, thereby driving growth in service revenues.

Continued growth in customer usage related to data services and products may result in increased operating expenses and the need for additional investment in spectrum, network capacity and network enhancements.

*Postpaid ABPU and ABPA are non-GAAP financial measures. Refer to Supplemental Information Relating to Non-GAAP Financial Measures within this MD&A for a reconciliation of this measure.

Postpaid ARPU and Postpaid ARPA decreased for the three and six months ended June 30, 2016 due to industry-wide price competition, together with discounts on shared data plans provided to customers on equipment installment plans and those providing their own device at the time of activation or renewal. Postpaid ARPU also decreased due to net additions of connected devices, which on a per unit basis contribute less revenue than handsets. These factors were partially offset by the impacts of continued adoption of smartphones and the related increase in service revenues from data usage.

Equipment installment plans increase equipment sales revenue as customers pay for their wireless devices in installments at a total device price that is generally higher than the device price offered to customers in conjunction with alternative plans that are subject to a service contract. Equipment installment plans also have the impact of reducing service revenues as many equipment installment plans provide for reduced monthly access charges. In order to show the trends in total service and equipment revenues received, U.S. Cellular has presented Postpaid ABPU and Postpaid ABPA, which are calculated as Postpaid ARPU and Postpaid ARPA plus average monthly equipment installment plan billings per connection and account, respectively.

6

Equipment installment plan billings increased for the three and six months ended June 30, 2016 due to increased adoption of equipment installment plans by postpaid customers. Postpaid ABPU decreased in 2016 as the increase in equipment installment plan billings was more than offset by the Postpaid ARPU drivers discussed above. Postpaid ABPA, however, increased in 2016 due to the increase in equipment installment plan billings and an increase in device connections per account, partially offset by the Postpaid ARPU and Postpaid ARPA drivers discussed above.

Table of Contents

Financial Overview

	Three Months Ended June 30,			Six Months Ended June 30,		
	2016	2015	2016 vs. 2015	2016	2015	2016 vs. 2015
(Dollars in millions)						
Retail service	$680	$ 734	(8)%	$1,361	$ 1,482	(8)%
Inbound roaming	38	49	(23)%	74	89	(17)%
Other	44	41	10%	86	82	5%
Service revenues	762	824	(8)%	1,521	1,653	(8)%
Equipment sales	218	152	44%	417	288	45%
Total operating revenues	980	976	-	1,938	1,941	-
System operations (excluding Depreciation, amortization and accretion reported below)	193	196	(2)%	376	387	(3)%
Cost of equipment sold	262	254	3%	518	492	5%
Selling, general and administrative	357	364	(1)%	719	731	(2)%
	812	814	-	1,613	1,610	-
Operating cash flow*	168	162	3%	325	331	(2)%
Depreciation, amortization and accretion	154	151	2%	307	298	3%
(Gain) loss on asset disposals, net	5	5	(12)%	10	10	2%
(Gain) loss on sale of business and other exit costs, net	–	(2)	N/M	–	(113)	100%
(Gain) loss on license sales and exchanges	(9)	–	>(100)%	(9)	(123)	93%
Total operating expenses	962	968	(1)%	1,921	1,682	14%
Operating income (loss)	$18	$ 8	>100%	$17	$ 259	(93)%
Net Income	$27	$ 20	37%	$37	$ 185	(80)%
Adjusted EBITDA*	$218	$ 207	5%	$424	$ 418	2%
Capital expenditures	$93	$ 134	(31)%	$172	$ 200	(14)%

* 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.

N/M - Percentage change not meaningful

8

Table of Contents

Service revenues consist of:

- ♦ Retail Service - Charges for access, airtime, roaming, recovery of regulatory costs and value added services, including data services and products
- ♦ Inbound Roaming - Charges to other wireless carriers whose customers use U.S. Cellular’s wireless systems when roaming
- ♦ Other – Primarily amounts received from the Federal USF and tower rental revenues

Equipment revenues consist of:

- ♦ Sales of wireless devices and related accessories to new and existing customers, agents, and third-party distributors

Key components of changes in the statement of operations line items were as follows:

Total operating revenues

Service revenues decreased for the three and six months ended June 30, 2016 as a result of (i) a decrease in retail service revenues driven by industry-wide price competition, including discounts on shared data plans provided to customers on equipment installment plans and those providing their own device at the time of activation or renewal; and (ii) reductions in inbound roaming revenues driven by lower roaming rates. Such reductions were partially offset by an increase in the average connections base and continued adoption of shared data plans.

Federal USF revenue was $23 million and $46 million for the three and six months ended June 30, 2016, respectively, which remained flat when compared to the same periods last year. Pursuant to the FCC's Reform Order (“Reform Order”), U.S. Cellular’s Federal USF support was to be phased down at the rate of 20% per year beginning July 1, 2012. The Phase II Mobility Fund was not operational as of July 2014 and, therefore, as provided by the Reform Order, the phase down was suspended at 60% of the baseline amount. U.S. Cellular will continue to receive USF support at the 60% level until the FCC takes further action. At this time, U.S. Cellular cannot predict the changes that the FCC might make to the USF high cost support program and, accordingly, cannot predict whether such changes will have a material adverse effect on U.S. Cellular’s business, financial condition or results of operations.

Equipment sales revenues increased for the three and six months ended June 30, 2016 due primarily to an increase in average revenue per device sold from sales under equipment installment plans and an increase in the number of devices sold. Equipment installment plan sales contributed $162 million and $69 million during the three months ended June 30, 2016 and 2015, respectively, and $309 million and $137 million for the six months ended June 30, 2016 and 2015, respectively. Equipment installment plans represented 69% of the total postpaid devices sold to end users for the three and six months ended June 30, 2016 and 44% and 43% for the three and six months ended June 30, 2015, respectively. Equipment installment plan connections represented 37% and 20% of total postpaid connections as of June 30, 2016 and 2015, respectively.

System operations expenses

System operations expenses remained relatively flat for the three months ended June 30, 2016 when compared to the three months ended June 30, 2015.

System operations expenses decreased 3% to $376 million for the six months ended June 30, 2016 when compared to the six months ended June 30, 2015. The primary drivers were as follows:

Expenses incurred when U.S. Cellular's customers used other carriers' networks while roaming decreased $12 million or 12% to $90 million driven primarily by lower rates for both data and voice traffic, partially offset by increased data roaming usage.

Customer usage expenses decreased $10 million or 10% to $88 million driven by a decrease in circuit costs from the migration to LTE and lower fees for platform and content providers.

The aforementioned drivers were partially offset by maintenance, utility and cell site expenses, which increased $11 million or 6% to $197 million reflecting higher support costs for the expanded 4G LTE network, increased cell site rent, the completion of certain tower maintenance and repair projects, and other maintenance activities.

Table of Contents

U.S. Cellular expects system operations expenses to increase in the future to support the continued growth in cell sites and other network facilities as it continues to add capacity, enhance quality and deploy new technologies as well as to support increases in total customer data usage. However, these increases are expected to be offset to some extent by cost savings generated by shifting data traffic to the 4G LTE network from the 3G network.

Cost of equipment sold

Cost of equipment sold increased primarily as a result of a 6% and 7% increase in devices sold for the three and six months ended June 30, 2016, respectively. Cost of equipment sold included $174 million and $105 million related to equipment installment plan sales for the three months ended June 30, 2016 and 2015, respectively, and $334 million and $191 million for the six months ended June 30, 2016 and 2015, respectively. Loss on equipment, defined as Equipment sales revenues less Cost of equipment sold, was $44 million and $102 million for the three months ended June 30, 2016 and 2015, respectively, and $101 million and $204 million for the six months ended June 30, 2016 and 2015, respectively.

Selling, general and administrative expenses

Selling, general and administrative expenses remained relatively flat for the three and six months ended June 30, 2016 when compared to the same periods last year.

Depreciation, amortization, and accretion expenses

The increase in Depreciation, amortization, and accretion expenses for the three and six months ended June 30, 2016 is mainly driven by the increase in amortization expense related to billing system upgrades.

(Gain) loss on sale of business and other exit costs, net

The net gain for the six months ended June 30, 2015 was due primarily to a $108 million gain recognized on sale of towers and certain related contracts, assets and liabilities.

(Gain) loss on license sales and exchanges, net

The net gains in 2016 and 2015 were due to gains recognized on license exchange transactions with third parties.

See Note 5 — Acquisitions, Divestitures and Exchanges in the Notes to Consolidated Financial Statements for additional information.

Components of Other Income (Expense)

	Three Months Ended June 30,			Six Months Ended June 30,		
	2016	2015	2016 vs. 2015	2016	2015	2016 vs. 2015
(Dollars in millions)						
Operating income	$18	$8	>100%	$17	$259	(93)%

Equity in earnings of unconsolidated entities	37	36	4%	72	70	3%