INVESTING

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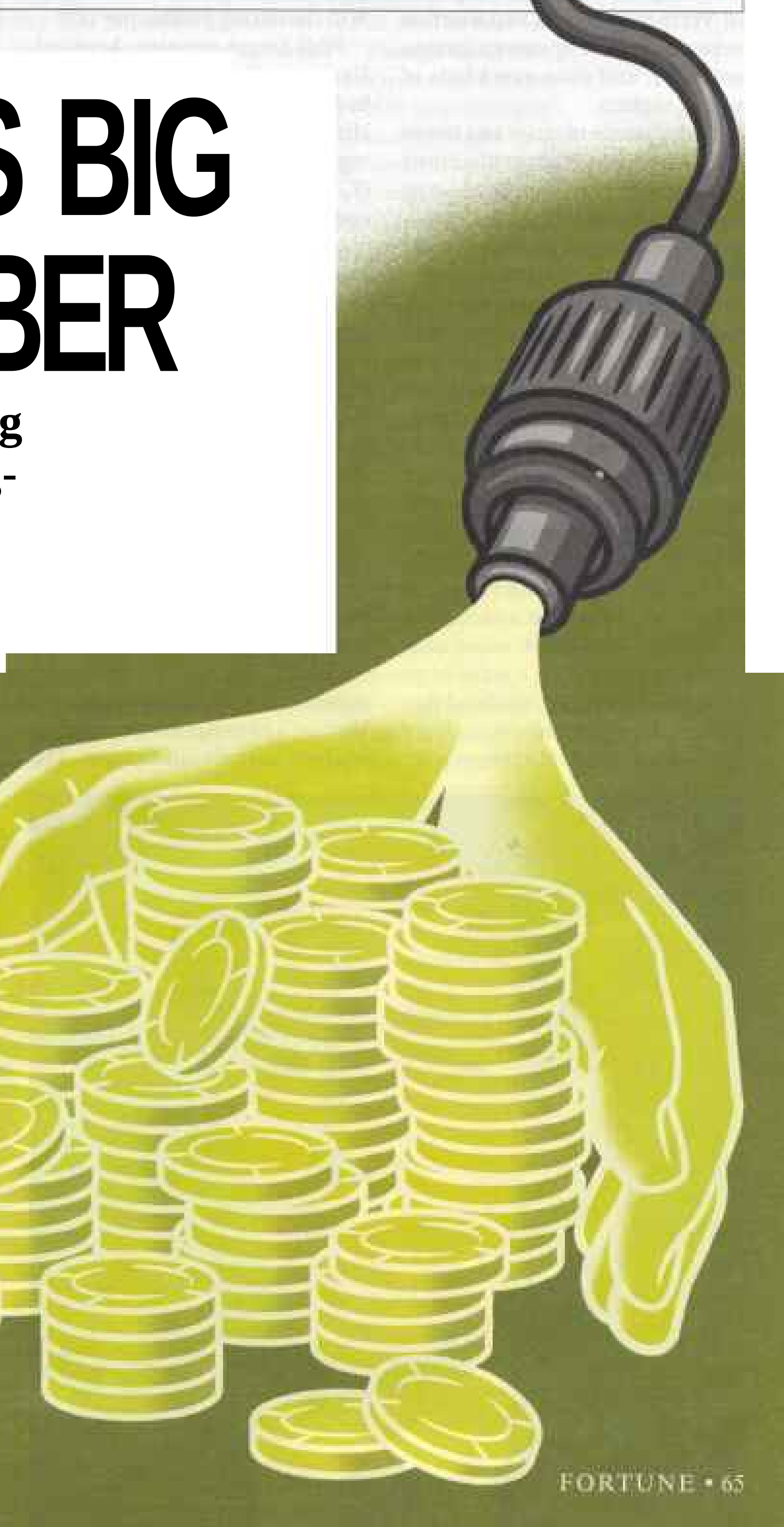
VERIZON'S BIG BET ON FIBER

The phone giant is **spending billions of dollars** on cutting-edge technology. But any payoff is years away.



VERIZON ISN'T going to take it anymore. After years of ceding ground in the broadband wars to cable operators Comcast, Cablevision, and Time Warner Cable (owned by the parent of FORTUNE'S publisher), the New York City-based telco is making an audacious—and very expensive—bet on a new Internet connection that is faster than anything the U.S. has ever seen. The technology, called FiOS (for fiber-optic service), will cost consumers from $40 to $200 a month. The pricetag for Verizon to wire 18 million homes—just over half its market—by the end of 2010: a whopping $23 billion.

The fiber-optic play is the most dramatic ex-

ILLUSTRATION BY CHRISTOPH NIEMANN

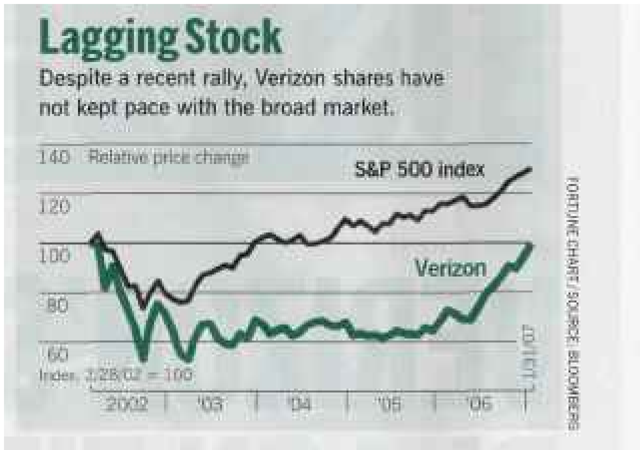
ample of CEO Ivan Seidenberg's efforts to remake Verizon, a vast company with $88 billion in sales last year. Seidenberg is spinning off some rural phone lines and old-line businesses like phone books and investing in boosting the capacity of Verizon's wireless and wireline networks to serve up movies, games, software, and even new kinds of search engines.

In thousands of cities and towns in its territory, Verizon has crews tearing out the copper lines—the so-called twisted pair of wires—used to transport phone calls for more than 100 years and replacing them with hair-thin strands of fiber-optic glass that will download data at up to 50 megabits per second and upload files at ten megabits per second. (According to Verizon, a typical customer with FiOS would be able to download a 90-minute movie in about five minutes, vs. 30 to 60 minutes over a standard cable modem service.)

For Seidenberg, the rollout is a triumph. When he announced the plan in May 2004, some analysts didn't believe he'd actually go through with it: They doubted that conservative, dividend-paying blue-chip Verizon would ever pony up the money for such an ambitious project. Technology types questioned whether a stodgy utility would be capable of offering such a cutting-edge service. Now Seidenberg is delivering on his promise. But the question for investors remains: Will the daring gamble pay off?

Wall Street remains skeptical. Verizon shares (VZ, $38) have had a nice run-up in the past year, climbing about 20% and outpacing the broader market. But AT&T (T, $38), another telco facing stiff competition from cable operators, is up almost 40% in the same period. There are several reasons AT&T is in favor right now, including expected cost savings from its recent acquisition of BellSouth. Its wireless unit may get a boost from Apple's iPhone, due in June. And investors seem to prefer Ma Bell's cheaper approach to selling faster Internet and TV services. Instead of connecting fiber directly to homes, in most cases AT&T is pushing fiber deep into neighborhoods, using its existing copper network to handle the last bit of transport.

There's growing concern among investors that FiOS is going to hurt Verizon's earnings even more than analysts initially anticipated. The



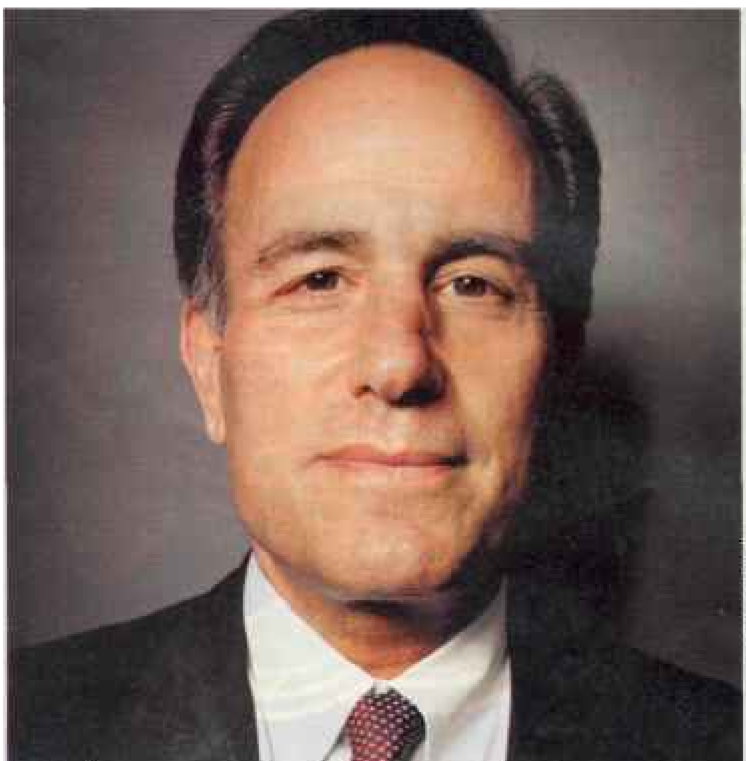
Lagging Stock

Despite a recent rally, Verizon shares have not kept pace with the broad market.

company recently told analysts that costs associated with the fiber project will dilute earnings per share in the "mid 30 cents" range, up from previous guidance of about 31 to 32 cents. But some analysts believe Verizon will have to spend still more to market and install FiOS. "We view this as a multiyear issue," says Citigroup telecom analyst Michael Rollins, who predicts that the pain will carry into 2008. "The market needs to be braced for a longer period of dilution and higher-than-expected costs from this FiOS build." He thinks the impact this year will be about 43 cents a share, and he has a sell rating on the stock.

FiOS is divided into fixed and variable capital expenditures. Verizon has told analysts it expects to spend about $850 per home this year on fixed items such as marketing costs, network gear needed to deliver data and video, and the thick cables of fiber that snake in and around neighborhoods. Then, each time it signs up a customer, the phone company says it will spend an additional $880 on items like pulling fiber directly to the user's house and installing special equipment.

Some analysts believe that Verizon will have trouble keeping those costs down; FiOS is, after all, a new and complex service that can't be switched on remotely the way phone service is: The carrier, for example,



HENRY LEUTWYLER

VERIZON'S VISIONARY
Seidenberg is delivering on his 2004 promise.

tells customers to reserve four to six hours for installation, but the process can take much longer. Francis McInerney, a business strategist who has done consulting for Verizon, says it took three technicians two days to install his connection. (He was part of a field trial, to be sure.) "FiOS is a good service, better than anything you're going to find in this country today," he says. "But the cost of customer acquisition is very, very high."

FIOS IS KEY TO SEIDENBERG'S PLAN TO REMAKE THE COMPANY.

A Verizon spokesman says that over time the company's costs will continue to go down, not up, and that FiOS will generate positive cash flow in 2008 and be profitable in 2009. To become a growth story, though, Verizon will have to use FiOS for more than Internet connections. It will have to develop and sell applications for the FiOS network, much the way it made scads of money selling high-margin features like caller ID and call waiting to its traditional phone customers. One such add-on is a $20-a-month service that records shows and then allows them to be viewed on any of a home's TVs.

But Verizon has more limited experience developing and marketing online fare. Its Verizon Central portal for DSL users, for example, is clunky and a bit confusing. And FiOS's awesome speed presents a potential long-term challenge: It may encourage consumers to download movies, TV shows, and other interactive services directly from the web, bypassing Verizon's video offerings entirely.

For all the risks associated with FiOS, it is clear that Verizon had to do something dramatic to retain and win back customers wooed by the cable guys, who now offer phone service as well as fast Internet and TV. Though it will take years for Verizon to recoup the cost of deploying FiOS to customers' homes, the alternative would have been even less appealing: "They now get $95 a month from me, up from $60," says Daniel Berninger, a telecommunications analyst with Tierl Research, who has both FiOS and Comcast broadband in his Annapolis home. "Without FiOS, I would have gone to Comcast exclusively—and Verizon would have gotten zero from me."

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SMALL-STOCK FOCUS

It Looks Like *Bons Temps* for Bon-Ton

At first glance the numbers for Bon-Ton Stores **(BONT, $43)**, a regional chain with a market cap of $752 million, don't seem promising: same-store sales down 5.8% in December, a net loss of $0.66 in the third quarter, and more than $1 billion in long-term debt. But do the homework, and Bon-Ton starts to look like this season's great buy.

Founded in 1898, Bon-Ton has built a collection of seven regionally branded department store chains, including Bergner's, Younkers, and Herberger's. Its multibrand strategy is a key point of differentiation from big chains like J.C. Penney, Kohl's, and Federated, says CEO Bud Bergren: "Eighty-five percent of the product we carry is not carried in a Kohl's or a Penney's. We give the customer a reason to come to us."

The point of interest for investors, though, is last year's acquisition of 142 stores in Saks Inc.'s Northern Department Store Group, for $1.1 billion in cash. The deal, which doubled the company's size, was responsible for the third-quarter loss. But now that Bon-Ton has integrated the new stores, shareholders should see an increasing benefit from more than $30 million in cost savings that Bon-Ton expects as a result of consolidation of back-office functions.

LOCAL HEROES Bon-Ton's Boston Store in Madison

The deal will also boost the chain's performance. The acquired stores were superior to Bon-Ton's existing ones on a variety of measures, including the private-label business, merchandising mix, and pricing. "Bon-Ton had gotten into the habit of being overly promotional and giving margin away," says Kristin Pak, sector manager for RS Funds. In addition, the acquisition gives the chain an injection of retailing talent: Bon-Ton has replaced many of its own managers with newcomers from the Saks group.

Some key Bon-Ton numbers have already improved. In the third quarter gross margins increased almost three percentage points, to 37%. Sales have jumped. Pak expects that those positive trends will continue, with earnings per share hitting $3 in fiscal 2007, up from her estimate of $2.20 in 2006.

Bon-Ton has used acquisitions as a springboard for growth before. In 2003 it bought Elder-Beerman stores, which took the company from $700 million in sales in fiscal 2002 to more than $1.3 billion in 2004. While the stock has been on a tear, it still trades at only 14 times estimated 2007 earnings, making this an opportune time to shop for shares. —*Corey Hajim*

Fonte: Fortune, v. 155, n. 4, p. 65-67, 12 Mar. 2007.