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DirecTV (DTV) Earnings Report: Q3 2014 Conference Call Transcript

The following DirecTV conference call took place on November 6, 2014, 02:00 PM ET. This is a transcript of that earnings call:

Company Participants

- Martin Sheehan; The DIRECTV Group; VP - IR
- Mike White; The DIRECTV Group; President, CEO
- Bruce Churchill; The DIRECTV Group; President - DIRECTV Latin America
- Pat Doyle; The DIRECTV Group; CFO

Other Participants

- Jason Bazinet; Citi; Analyst
- Phil Cusick; JPMorgan; Analyst
- John Hodulik; UBS; Analyst
- James Ratcliffe; Buckingham Research Group; Analyst
- Tom Eagan; Telsey Advisory Group; Analyst
- Mike McCormack; Jefferies & Co.; Analyst
- Craig Moffett; MoffettNathanson; Analyst
- Marci Ryvicker; Wells Fargo; Analyst
- Kannan Venkateshwar; Barclays Capital; Analyst
- Ben Swinburne; Morgan Stanley; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

At this time, I would like to welcome everyone to DIRECTV's third quarter 2014 earnings conference call.

(Operator Instructions)

It is now my pleasure to turn the call over to your host, Martin Sheehan, Vice President of Investor Relations. Sir, you may begin.

Martin Sheehan (VP - IR):

Thank you. Thank you, everyone, for joining us for our third quarter 2014 financial results and outlook conference call. With me today on the call are Mike White, our President and CEO; Pat Doyle, our CFO; Bruce Churchill, President of DIRECTV Latin America; Michelle Locke, CFO of DIRECTV Latin America; and Larry Hunter, our General Counsel. In a moment, I'll hand over the call to Mike, Bruce, Pat, for some introductory remarks, but first I need to read to you the following.

On this call, we make statements that may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve known and unknown risks, uncertainties, and other factors that could cause actual results to be materially different from those expressed or implied by the relevant forward-looking statements.

Factors that could cause actual results to differ materially are described in the risk factors section and

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elsewhere in each of DIRECTV's annual reports on Form 10-K, quarterly reports on Form 10-Q, and our other filings with the SEC, which are available at www.SEC.gov. Examples of forward-looking statements include but are not limited to statements we make related to our business strategy and regarding our outlook for financial results, liquidity, and capital resources.

Additionally, in accordance with the SEC's Regulation G that requires companies reporting non-GAAP financial measures to reconcile these measures to the most directly comparable GAAP measure, we provide reconciliation schedules for the non-GAAP measures, which are attached to our earnings release and posted on our website at DIRECTV.com.

With that, I'm pleased to introduce Mike.

Mike White (President, CEO):

Thanks, Martin. And we're all proud at DIRECTV of Martin and being recognized by Institutional Investor magazine as one of the best IR professionals, and we certainly believe that too.

Thanks all for joining us today. Just start out by saying I continue to be pleased with our quarterly results, particularly given the many headwinds the industry and our businesses are collectively facing.

Now, in the US, it's pretty clear we had a bit of a tougher competitive and consumer economic environment, and I think that weighed on our subscriber results. But I'm sure we'll talk later about the subscriber results; I frankly think they were more of a one-off series of events. Meanwhile, our revenues were solid, while both our earnings and our cash flow were very strong.

In Latin America, local currency results, which is the way we run the business, were also strong. Although foreign-exchange headwinds and the predicted rebound effect of the World Cup weighed on the US dollar and subscriber results, and Bruce will address that as well.

With regards to the AT&T transaction, during the quarter, we completed two important milestones that we needed to, to close the merger. The first was our successful shareholder vote, in which over 99% of our shareholders cast votes in favor of the transaction. And the second was, as I'm sure you've all read, the signing of our long-term agreement with the National Football League to continue our 20-year partnership offering our hallmark NFL Sunday Ticket package.

In addition to that, the Brazilian telecom authority Anatel also approved the transaction during the quarter. This leaves us with the regulatory review process here in the US and in Mexico. We're making progress in Mexico.

As it relates to the US, as I'm sure you're aware, the FCC had halted its 180-day review clock of our transaction at day 76, as they worked through a number of issues with the content providers regarding a review of their confidential contracts and related materials.

Based on the FCC's orders entered earlier this week, we now expect the clock will start again sometime mid-next week. That said, I would remind you, it's not unusual for the FCC to halt the clock in large deals like ours. And it's certainly possible that they will stop the clock again at some point in the future.

But in the meantime, we continue to work diligently with both the Department of Justice and the Federal Communications Commission to fulfill all of their information and data requests, answer their questions, so that we can help them make an informed decision on the merits of this transaction and based on the facts that we're submitting. In summary, I believe the process is going well, and I remain confident that we'll close the transaction sometime probably in the second quarter of next year.

Turning to the US, our financial results were very strong, mainly resulting from our continuing strategy to

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focus on higher quality subscribers. Specifically, we continue to generate mid-single-digit revenue and earnings growth due to the positive effects of disciplined price increases and improved penetrations of our Genie HD-DVR, coupled with the positive impact of our disciplined approach to both new gross adds and cost management. These positive effects drove the fifth consecutive quarter of improved year-over-year OPBDA margins for the US business.

With regards to the subscriber results, as I mentioned at a recent investor conference, the combination of further tightening credit scores on certain customer segments, in particular, I would say lower-income renters; more aggressive offers from the competition, and consumers who continue to be more and more price sensitive, led to a loss of 28,000 net subscribers in the quarter. During the quarter, we saw discounting, and in particular, cash-back offers and bounties that, in some cases, were both significantly higher than a year ago, but also extended that heavily discounted fixed price for two full years.

This, along with consumers who are increasingly under stress from the ongoing weak economy, resulted in more customers than ever shopping for better deals, which caused our monthly churn rate to climb higher than, frankly, we wanted. For these reasons, as well as the industry's programming-cost challenges, our primary goal continues to be attracting high-quality subscribers who generate strong returns and value, while also balancing our churn levels with the retention investments to keep our best customers. By the way, these and several other steps we've taken in our call centers with our information systems have reduced October's churn rate to be more in line with last year, where we'd like it to be. But given the current environment, this remains an ongoing challenge for the business. Having said that, we're making good progress.

These circumstances are also the main driver behind our focus on the overall customer experience and product innovation, both of which are becoming an increasingly important differentiator for our service in the marketplace.

To that end, we continue to launch exciting new products and enhancements for our customers, including several marketing investments we'll be making in the coming months: global viewing, which will allow consumers to start a program on one device and pick it up from the same spot on another, including the set-top box; our new Hispanic OTT service, which will launch towards the end of the quarter and feature both live linear and SVOD content; a new 4K ultra HD-VOD offering for those customers with our Genie HD-DVR; and a DIRECTV 4K-ready television from Samsung.

And on a related note, our DIRECTV 14 satellite is scheduled to be launched next month on December 4th, allowing us to introduce additional 4K channels in 2015, as well as providing important in-orbit backup capacity for our service. So we continue to make good progress in improving the DIRECTV customer experience from both a service and offering perspective, as I said, making us continue to have a true competitive differentiator in the industry.

Turning to Latin America, Bruce will dive into the details, but I'm also pleased with their quarterly results, which continue to be consistent with the key financial and strategic priorities that we shared with you earlier this year. Sky-Brasil drove DTVLA revenue growth of 10% in the quarter, led by continued subscriber growth over the last year and strong local currency ARPU growth. In fact, DTVLA's local currency ARPU grew 15% in the quarter, helping to increase local currency revenue 28%.

This revenue growth combined with disciplined cost management to drive better-than-expected margins when adjusting for a charge related to the decline in the value of the Venezuelan Bolivar as well as last year's [akaja] gain in Brazil. And as we said on last quarter's call, the unexpectedly strong prepaid subscriber additions in the second quarter, caused by the start of the World Cup, did result as expected, in a larger decline in reconnects in the third quarter; in particular in Argentina, as the World Cup came to a close, resulting in a net loss of 119,000 customers for DTVLA in the quarter.

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Finishing up on the financials, given the challenges we face in many of these countries, the team's efforts in improving cash-flow generation, I think, are particularly impressive. Now, as you know one of our main goals this year has been to ensure that DTVLA is self-funded.

As such, through the first nine months of the year and excluding Venezuela, DTVLA has improved its cash-flow generation by over $400 million from a year ago, and is currently positive in the region, ahead of meeting our goal. Finally, DTVLA also continues to raise the bar in terms of the customer experience, as just last month we successfully launched DLA-1 aboard Intelsat's IS30 satellite. DLA-1 will significantly enhance the entertainment experience that's transformed DIRECTV into the preferred pay TV service all across Latin America, ensuring we have a road map of evolution and innovation for the future.

Don't forget that most of the great new US features that I talked about earlier will, of course, be available over time in Latin America. These are features that unlike in the US very few of our competitors in Latin America have or are investing in.

So in summary, I'm pleased with our financial results as we continue to demonstrate our focus on profitably growing our businesses and generating meaningful cash flow. With a positive collaboration, I think the outstanding collaboration I'm seeing between the AT&T and DIRECTV teams that are planning for our proposed combination, I'm even more excited about the opportunities for the combined company to be more competitive and to find new growth opportunities together.

Before I turn the call over to Bruce, I'd just like to highlight another achievement for our company last month. We were added to the Carbon Disclosure Project's climate performance leadership index for 2014, scoring in the top 10% of over 2,000 companies worldwide. This is the third such honor for DIRECTV over the last year, and I think is a real testament to our employees' commitment to social responsibility and creating a truly sustainable business. Congratulations to the DIRECTV sustainability team that work on that for another important accomplishment.

With that, Bruce.

Bruce Churchill (President - DIRECTV Latin America):

Thanks, Mike. As Mike mentioned, Latin America third quarter financial results continued to be strong on a local currency basis, despite some challenging economic conditions in a handful of countries. In addition, as we expected, the completion of the FIFA World Cup drove lower reconnect rates from prepaid subscribers, resulting in a modest loss of subscribers in the quarter.

Local currency revenue growth was a highlight in the third quarter, as we continued to balance the economic tradeoff between increasing prices to keep up with inflation and reducing credits to lower-quality customers, with the inevitable increase in churn that these actions precipitate.

As for profitability, although it's a bit of a confusing comparison, if you exclude Venezuela from the results, as well as the $70 million one-time gain from ECAD from last year's third quarter, DTVLA OPBDA margins were virtually unchanged, demonstrating our commitment to profitably grow this business.

Turning to Brazil, Sky-Brasil gross additions improved on a year-over-year basis for the fourth consecutive quarter, reaching a third quarter record of 521,000, a 7% improvement from a year ago. The higher gross adds were driven by an increase in new HD customers, which increased by nearly two-thirds in the quarter compared to a year ago.

In addition, although the total number of middle-market gross additions didn't change much, the mix did. Fully one-third of the middle-market gross additions were prepaid customers. As I have said before, we think the prepaid model is a better fit for mass-market consumers, particularly in difficult economic times, and leads

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to a better return for DIRECTV because of lower subscriber acquisition and subscriber service expense. So I'm encouraged that our efforts to introduce prepaid in Brazil are gaining traction.

Postpaid churn is still higher than you I would like at 2.72%, up from a year ago, mainly due to the end of the World Cup, as well as our conscious effort to reduce credits to lower valued subscribers. Again, we believe we're making the right tradeoffs between ARPU and churn to improve the overall value of the business.

Summing up, net additions in the quarter totaled 27,000, lifting the Sky-Brasil cumulative customer base to just north of 5.64 million, a 7% increase from a year ago.

Turning now to the financial results at Sky-Brasil, the 7% increase in the subscriber base and 5% higher local currency ARPU drove a 14% increase in local currency revenues versus the prior year.

The ARPU increase was driven by reduced levels of retention credits and a 25% increase in subscribers paying for advanced services, partially offset by the new lower ARPU prepaid offering. As a result, the combination of higher ARPU and our continued focus on cost management drove a 7% improvement in local currency OPBDA, when excluding the $70-million ECAD gain from the prior-year period.

In dollar terms, revenue and OPBDA grew 15% and 8% respectively, as the average value of the [hay-i] increased about 1% versus a year ago, to 2.28 [hay-ies] to the dollar. Overall, Brazil had a solid quarter, and although net subscriber adds are probably slightly behind where we expected them to be, we're on a track to meet our local currency outlook of approximately 10% revenue growth and mid to high single-digit OPBDA growth when excluding last year's ECAD gain.

Moving on to PanAmericana where gross additions fell 12% to 472,000 in the quarter, driven by the end of the 2014 FIFA World Cup, as well as weaker regional macroeconomic conditions and higher credit filters for new customers. The decline was felt about equally across both prepaid and postpaid subscribers, although advanced product sales grew a modest 4%.

Post paid churn increased 11 basis points to a still very low 1.25%, mainly due to the end of the World Cup, the impact of price increases and the challenging economic environment in certain countries. That said, despite a decline in gross additions and the higher churn, PanAmericana generated modest postpaid net subscriber additions in the quarter.

The big swing for the quarters was in our prepaid customer base, where the perfect storm of multiple price increases and the hangover from the World Cup led to both a reduction in sales and lower reconnect rates. The prepaid losses were particularly pronounced in Argentina, which accounted for more than 50% of the prepaid subscriber losses.

Adding it all up, PanAmericana subscriber numbers fell by 146,000 in the quarter to 6.7 million total customers. Roughly 2.3 million, or 35% of that total, are prepaid customers using our on/off metric at the end of the quarter. Using our 90-day metric, the number of prepaid customers would be 3.5 million, an increase of 25% from one year ago.

PanAmericana's revenues in the quarter increased 45% in local currency, generated by a 13% increase in the average number of subscribers and a 28% increase in ARPU, resulting from price increases, along with a 17% lift in customers paying for advanced services.

With regards to OPBDA, the SICAD 1 auction rate we use to translate Venezuelan bolivars to US dollars depreciated from 10.7 to 12 during the quarter. This resulted in a $62-million charge to the revaluation of our net monetary assets in Venezuela. So if you exclude the Venezuela foreign exchange charge, in dollar terms adjusted OPBDA in the quarter increased slightly to $208 million, while adjusted OPBDA margin fell slightly to just below 26%.

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The margin decline was a result of the impact of the Venezuela devaluation on average margins, as well as inflationary pressure on the labor cost in both Venezuela and Argentina. Excluding the Venezuela business entirely, margins actually improved 2 percentage points in the quarter, driven by strong local currency ARPU growth and disciplined cost management.

So in summary, PanAmericana delivered a quarter very much in line with our expectations, leaving us on track to hit the full-year guidance we gave you at the end of the first quarter, roughly unchanged revenues compared with last year, and mid to high single-digit decline in OPBDA.

Lastly on PanAmericana, I wanted to update you on the newest member of the DIRECTV fleet. As Mike mentioned, on October 16th we successfully launched a new satellite for PanAmericana that will go into service later this year. The new satellite will provide us with the capacity to increase substantially our HD offering, as well as expand our SD service.

Wrapping up on the outlook for the consolidated entity, net subscriber additions will likely come in closer to 900,000 for the year. But barring any significant changes in foreign exchange rates during the quarter, we continue to expect revenues in dollars will be relatively unchanged from a year ago, and adjusted OPBDA will decline in the low single digits, excluding the ECAD gain from a year ago. And as Mike mentioned earlier, cash-flow generation is ahead of plan, leaving us on track for DTVLA to be self-funded in 2014.

Finally, I would like to quickly mention Sky Mexico whose results were released by [TeleViva] few weeks ago. Sky Mexico added 160,000 net additions in the quarter, bringing their cumulative total of customers to just over 6.5 million. In addition, Sky generated solid growth in local currency revenues and OPBDA of 9% and 14%, respectively.

Overall, I continue to be pleased with Latin America's performance, in light of the conditions we're operating in. Our team continues to focus on profitably growing the business by balancing subscriber growth, SAC, pricing, and churn levels in a challenging economic and competitive environment.

With that, I'll turn it over to Pat. Pat?

Pat Doyle (CFO):

Thanks, Bruce. The DIRECTV US business delivered yet another quarter of strong financial results, which exceeded our internal expectations, particularly with regards to growth in operating profit before depreciation and amortization, as well as cash flow. The one area of weakness in the quarter was our subscriber results where we experienced a net loss of 28,000 customers in the quarter, driven by a decline in gross additions and higher churn.

Gross additions declined 8% on a year-over-year basis, mainly due to stricter credit policies implemented during the quarter. These stricter credit policies were applied as a result of improvements in our lifetime value, or LTV model, which I mentioned in our last earnings call as likely to create a drag on gross additions. These model improvements allowed us to pinpoint a segment of the population we previously believed to be a value-accretive group, but in reality were negative LTV customers.

As such, we instituted an upfront fee for these prospective customers, which generally causes the customer to decide not to sign up for our service. Hence impacting gross additions, but ultimately, allowing us to save on acquisitions costs that would not be value accretive.

Churn was also a challenge in the quarter, as we saw a 12-basis-point increase in our average monthly rate to 1.73%. The major factors causing the increase were the competitive environment, a challenged consumer, as well as the timing of some of our promotional roll-offs.

As we discussed on our Q2 call, we saw an uptick in the discounting and cash back offers we were seeing

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coming into the quarter, and in fact, some companies are still offering nearly an extra $1,000 of discounts over the first two years of service, compared to their offer a year ago.

In addition, we are seeing that consumers are becoming much more price sensitive in this economic environment. We know this from the nature of the phone calls we receive from our customers, with a higher volume of customer calls relating to the amount of the bill. This has been exacerbated by larger promotional offer roll-offs that are coinciding with a customer's commitment expiration. The net result in the quarter was higher churn and resulting subscriber losses.

Also keep in mind that during Q3 of 2013, there were two major disputes between our competitors and programmers, which caused both lift in our gross additions and also lowered our churn in the year-ago quarter. How much is difficult to quantify, of course.

I should also add that our Q4 gross additions are recovering toward last year's trends, as our sales partners adjust to the updated scoring system, and we freshen up and simplify our offers to drive additional demand. With the good news being that this is resulting in an even better mix of quality subscribers.

In addition, as Mike said, we continue to balance our retention credits and spending with churn to focus on saving our best customers. And we are seeing positive trends in churn so far in the fourth quarter. That said, based on Q3 subscriber results and current trends, we expect subscriber growth to be fairly neutral this year, slightly positive or slightly negative, depending on a number of factors, but particularly on the competitive environment as well as the impact of any programming disputes during the quarter.

Moving on to the financials, revenue growth of 5.4% was very solid, highlighting the strength of the DIRECTV brand in the marketplace, and was driven by ARPU growth of 4.8%, demonstrating our pricing power amidst the challenging US operating environment.

Consistent with recent trends, the key drivers of our ARPU growth were price increases on programming packages, and increased penetration of customers paying for our Genie HD-DVR, as well as our enhanced warranty program.

ARPU also benefited from a 23% increase in ad sales, driven by addressable advertising which roughly doubled on a year-over-year basis for the seventh consecutive quarter. In addition, commercial revenues continued its string of quarterly double-digit growth. These improvements were slightly offset by increased promotions and credits to existing customers, as well as weak pay-per-view event sales.

Last year's third quarter included a very popular Floyd Mayweather fight, where as a similar card under-performed this year. In addition, UFC Mixed Martial Arts under-performed, in part due to the cancellation of one of their events during the quarter.

Moving now to the bottom line, operating profit before depreciation and amortization margin improved for the ninth time in the last 10 quarters, driving OPBDA growth to nearly 11%. Margin improvement was seen across the majority of the P&L, led by upgrade and retention costs, as lower equipment costs were the primary driver in the category. In addition, subscriber services continues to be a good story, as our customer-experience initiatives continue to drive down call volume as well as unnecessary truck rolls.

And in addition to our disciplined expense management, the margin improvement in G&A is mainly resulting from a combination of improving subscriber quality as well as process improvement that have been driving down our bad debt levels despite higher revenues and a still struggling consumer economy. And of course, the lower gross additions resulted in slower growth in our expense acquisition cost, which also contributed to the margin improvement.

Moving on to broadcast programming and other costs. Although pressuring margins slightly, these areas

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continue to perform ahead of our expectations. This was in part due to lower costs for our protection plan, which is being driven by improving set-top box quality. As an example, at this point in its life cycle, the new Genie box has the lowest failure rate of any box we've ever produced, keeping in mind that this is also the most advanced and sophisticated box we have ever designed.

And specifically on content cost, annual programmer rate increases drove our average programming cost per subscriber, or ACPU, up 5.3% in the quarter, lower than our plan. The quarter's performance was driven by three areas: our continuing commitment to hold out against exorbitant price increases demanded by certain programmers; to the point of either dropping or not carrying overpriced channels, several one-time programming adjustments; and the lower event pay-per-view performance in the quarter.

Based on our year-to-date performance in the category, we now expect ACPU growth to be a bit below our 7% to 9% growth-rate target for the full year, keeping in mind that we have several large contract renewals that will take effect in the fourth quarter.

So wrapping up on US, we are right on target to achieve mid single-digit revenue growth and expect to be a bit on the high side of our mid single-digit OPBDA growth target. Combining this with an expected decline in CapEx, and we are on track for high single-digit cash-flow growth in the US following the formula we laid out for you at our Investor Day in December.

Looking quickly at our Q3 consolidated results, adjusting for the $62-million Venezuela devaluation charge in the quarter, as well as a $70-million after-tax gain from the ECAD settlement a year ago, diluted earnings per share grew mid to high teens in the quarter.

In addition, we continue to generate strong free cash flow, as it more than doubled to $792 million in the quarter, driven by higher OPBDA, lower set-top box cost, and the timing of set-top box purchases at DTVLA. Last years free cash flow was also impacted by the $92 million settlement payment to ECAD.

Before wrapping up, I would like to make a few comments about our outlook, which as you've heard, both DIRECTV US and DIRECTV Latin America are on track to meet guidance for all of their key financial metrics. In addition, we now expect to be on the high side of our mid to high single-digit growth target for adjusted EPS from $5.42 a year ago. This excludes the Venezuela devaluation charges in 2013 and 2014.

And we now expect free cash flow growth to increase nearly 20% over 2013 levels. This is up from our early projection of 10% growth. The improvement is being driven in part by the improved OPBDA outlook in the US, as well as a reduction in income tax payments.

Keep in mind, we're up against a very challenging comparison in Q4, as the timing of receipts last year resulted in $1 billion of free cash flow generation. Wrapping up, 2014 continues to look like it will be a solid year. So with that, I'll turn the call back over to Martin.

Martin Sheehan (VP - IR):

Thanks, Pat. Before moving on to Q&A, investors should note that we have members of the media on this call in a listen-only mode. I'd like to remind the media that they are not authorized to quote any participants on this call, either directly or in substance, other than the representatives of DIRECTV . In addition, we are webcasting this call live on the Internet, and an archived copy will be available on our website.

Finally, please limit the number of questions you ask to one or two to allow time for other participants to ask question. Kristie, at this time, we're ready for the first question.

QUESTIONS & ANSWERS

Operator:

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Thank you.

(Operator Instructions)

Jason Bazinet, Citi.

Jason Bazinet (Analyst - Citi):

Thanks so much. I just had a question for Mr. White. Regarding the Hispanic OTT offer that I think you guys publicly said you're planning on launching, can you describe a little bit about who the target customer is? Obviously it's Hispanic, but is it a Hispanic customer that is not part of the pay TV ecosystem today, is that the angle you're going after?

Mike White (President, CEO):

Jason, just like if you hear about -- a lot of the OTT thinking I think is that there's a significant segment of consumers out there that are broadband only. I would also tell you in the Hispanic segment in particular, we've analyzed the Hispanic population. They tend to be above-average users of broadband.

So it will have telenovelas. We're pretty excited about it; it's got a lot of good content from a number of our programming partners. We think it's good value, and I think the platform has been built. I'm excited.

I've seen the demo of the technology. I think we feel really good about that, and we're excited to get that out the door in the fourth quarter. I think we'll get a lot of learnings as we go in 2015 from that initiative. And again, the technology is scalable and could be leveraged on other initiatives down the road.

Jason Bazinet (Analyst - Citi):

Makes sense. Thank you.

Operator:

Phil Cusick, JPMorgan .

Phil Cusick (Analyst - JPMorgan):

Hi, guys. Thanks. Two things. One, if you can talk about the 4K efforts that are coming, what do you see in the pipe for content there? And how many channels could you offer a year from now?

And then second, if you could talk about prepaid in Brazil. You said that was, I think it was one-third of one of the types of gross adds. If you could give a little more detail on where the eventual mix there you think is.

Mike White (President, CEO):

Sure, Phil. I'll start on the 4K thing. Now, let's all keep in mind, we always want to be leading our industry as a company, and 4K is no exception. Now, my understanding of the total number of TVs sold this year is 1 million. So I think -- I know for a fact that a number of the television set manufacturers are hoping to have multiples of that sold in 2015.

Initially, the 4K offering in the fourth quarter is going to be VOD only, so it will be some video on demand. You'll need to have a Genie HD-DVR, as well as a 4K-ready television from Samsung.

Now, for those customers who have that Samsung TV, as well as our Genie HD-DVR, we're going to load a few 4K movies onto the hard drive for instant viewing. In addition, we'll have additional 4K titles that those customers can select, which they could download overnight. The pre-loaded number of movies is of course flexible, so if demand's strong we can pre-load more movies into the hard drive.

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But let's understand, it's very early days for 4K. We've already secured the rights for a number of movies. I think a dozen, Pat, as I recall, something like that.

Pat Doyle (CFO):

A little more.

Mike White (President, CEO):

A little more. And we felt it was important, Phil, to have some, let's call it some content as a starter to get people to see what the experience is all about. Now, once our satellite goes up in December and gets fully deployed in the first quarter of next year, we will have the capacity to both do substantially greater VOD as well as live streaming.

And I'm not going to get into the specific number of channels now. And frankly, I think, to be honest with you, we need to see who's interested in a channel. I'm guessing at least initially it's more likely to be event-driven or VOD-driven, but we'll be prepared to do live streaming next year. Bruce?

Phil Cusick (Analyst - JPMorgan):

Okay. That makes sense. Sounded like you were a little further ahead than that.

Mike White (President, CEO):

Well, that's always our goal.

Phil Cusick (Analyst - JPMorgan):

Okay. Thanks.

Bruce Churchill (President - DIRECTV Latin America):

So on the prepaid, what I said was that total gross adds of 521,000, of which they're split between advanced products and middle market and other. But ballpark, roughly a little less than 400,000 of that 500,000 are middle market and one-third of those were prepaid.

Phil Cusick (Analyst - JPMorgan):

I see.

Bruce Churchill (President - DIRECTV Latin America):

Just to be clear. Right now we have about 350,000 prepaid subscribers in Brazil. So it's obviously a pretty small number because we're just getting started. It's difficult, to be honest, for me to predict how big it could be. As I mentioned, I think we're at about a 35% level in PanAmericana.

Intuitively, I think it will end up long-term being a bit less than Brazil, but it's more intuitive than it is scientific. But we've got obviously, a ways to go.

Phil Cusick (Analyst - JPMorgan):

Thanks, Bruce.

Operator:

John Hodulik, UBS.

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John Hodulik (Analyst - UBS):

Thanks. Getting back to the competitive environment, is the increasing intensity coming solely from the cable companies, or are you also seeing pressure, renewed pressure from the telco guys?

Just looking at the numbers, it looks like cable is really driving the ball forward here. And then lastly, is there any evidence you think in the numbers that you're seeing increasing impact from over-the-top options or cord cutting? Thanks.

Mike White (President, CEO):

Yes, John, I'll take the second part of it first. I think it's still early days to read in. There were so many one-offs in our third quarter. Let's separate gross adds and churn, and Pat touched on it.

But in terms of gross adds, first of all, we were lapping last summer where you had the Time Warner Cable-CBS dispute, and I believe Dish was in a dispute with Raycom, whereas this summer we were in a dispute with Raycom and there were some pretty aggressive bounties being paid by cable companies, in particular, to get satellite customers.

So that, plus our normal process, we always a couple times a year, review our LTV models. And out of that, we both found that, frankly, our high-end customers were actually more valuable and, therefore, we taken some steps to try and do more things with our higher-end customers, sell them more services, because they're even more valuable than we thought.

But we found that that low-end segment of renters was just not profitable at all, because most renters are churning out before the two years is up. And then we continue to see softness in the housing market, particularly first-time buyers.

Now, I would say in terms of the gross add stuff, even now that most of the industry results, if not all, are pretty close to all in, I don't think there was a big shift between cable, telco or otherwise on the gross add side. For us, if you looked at our actual numbers, I don't think there was hardly any shift on the gross adds between channels. The channels were flat.

So as a percent -- so total cable was 55%. That is the gross adds we got. We got 55% of them from total cable, and last year we got 55% from total cable.

Where we did see a slight shift, John, was in churn, and in churn it's certainly true there were 200 basis points higher. So last year I think 39% of our churn went to cable, and this year it was 41%. So it was up just a touch.

But to be honest with you, the whole churn subject, there were a lot of things going on, in particular a couple years ago if you recall, we were doing advanced receiver fee for $25, but we discounted it to $12. So then when we got that -- so when you've got both programming credits rolling off as well as that, that's what we mean by a double roll-off. That created some issues for us.

Now by the way, with our simpler offer this year, we don't do that anyway. We have an everyday low price on the equipment. But the issue popped up in the third quarter; it will continue. But we've taken some steps to adjust some of our tactics, and as I said, October looked good.

Now, we'll see what the rest of the year is, and always you can have -- these programming disputes seem to be an integral part of everyday life for a distributor these days. We're going to do what's right for the company long term. I'm not afraid to take a little churn if it's the right thing to do in any given programming dispute.

That's where we netted out in the quarter. And by the way, both September and October were net positive, just

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for the record. So I think we're on track for the balance of the year, but we did have a little bit of a hiccup in July and August.

John Hodulik (Analyst - UBS):

Thanks.

Operator:

James Ratcliffe, Buckingham Research Group.

James Ratcliffe (Analyst - Buckingham Research Group):

Thanks for taking the question. Two if I could. First of all on the SAC in the US, could you help us break down how much of the year-on-year change was the effect of spreading quasi-fixed marketing across a smaller gross add base, and how much was higher variable cost and what might have been driving that.

And secondly, now that you've -- that baseball season is over, any take on the net impact of not having the Dodgers in LA? Does that inform your thoughts about the value of [RSNs] (inaudible) in terms of customer churn and the like, in general? Thanks.

Pat Doyle (CFO):

James, on SAC, a couple of smaller things. First of all, we're starting to build in our home security business SAC in there, the LifeShield business. That had an effect of the year-over-year of $5, $6, just because it's a new item and it's growing. The fixed SAC, again, was another single-digit dollar increase from last year to this year.

So on SAC, the real drivers where as we reacted to the competitive environment, and Mike said, started the to focus even more on the high-end customers, those tend to come with a higher price tag. And the example I would give you is the consumer electronics channel has been really good for us. We've grown that from low single digits to almost double digits now.

It's a much higher SAC. It includes us paying for in-store labor, but we get the highest value customers out of that channel. So the more you focus and move away from some of the customers that Mike mentioned before and try to attract those higher-end customers, by definition, it will raise SAC when you look at the mix. So that was really the driver.

Like I said, just the fixed SAC and LifeShield are probably between the two of them are $10 or $12 year over year. Most of it was our focus on quality and energizing the sales channels.

Mike White (President, CEO):

On the Dodgers, first of all, I just looked at the churn in the LA DofA, and it was actually less than our total churn for the company in the quarter. We do track it; t was pretty immaterial. I would say in the single-digit thousands, and I would say it wasn't in the high single-digit thousands.

Look, we wanted to carry it. We planned to carry it, and that's part of how we an unusual OPBDA quarter, I think with the programming, which wasn't what we were planning. We actually planned it. We thought we made a fair offer that was more than the Dodgers got from all distributors combined last year, and a significant increase over what we paid last year. It just wasn't something acceptable to Time Warner Cable.

We will have, I'm sure, further discussions in the spring and we're open to it. I think the biggest challenge for all of these is when you get to markets where there are five or six sports teams that the average customer has to pay for, if you took the Dodgers price, $35 a month is what the cost would be for sports. Without a sports tier,

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that's a significant tax on all customers that we don't think is right.

But with that being said, look, we hope that there will be some compromise between the Dodgers and Time Warner Cable or Comcast next year, and we'll certainly, I'm sure, entertain further discussions at that time.

Bruce Churchill (President - DIRECTV Latin America):

Thank you.

Operator:

Tom Eagan, Telsey Advisory Group.

Tom Eagan (Analyst - Telsey Advisory Group):

Great. Thank you. At least one pay TV provider is going to be offering a smaller OTT package soon. Mike, I was wondering do you think that having two packages, one large all inclusive and one smaller could be accretive to revenue? Thanks.

Mike White (President, CEO):

I think, Tom, there's no question, and again, I'll be honest with you, if you looked at -- we track what people say when they leave when they churn out. And in the quarter, we saw a pretty significant increase in those that mentioned price value.

So there is no question I think that customers -- there's a huge segment of customers that are looking for something certainly less than $100 a month, well less than that. Whether that has to be $70, $50, or $30, I don't know, and how you get the right mix of content will be the key. But there's no doubt that there is a set of millennials that may not have a full bundle.

I think, look, we're all in favor of choice, and I think giving the consumer a little more choice I think is a good thing. I think that the tricky part of it is not the technology; it's actually trying to get the right mix of channels, because so many of them are all bundled together, it's hard to say well, gee, I just want channels that appeal to millennials. I could pick out the top 15 channels that appeal to millennials, but I don't think I could get them.

But I think it's in all of our interests to give the consumer a -- we don't have to go to a la carte; I don't think that's in the industry's best interest. But a little more sensitivity to what the customer is paying and give them a little bit more flexibility to choose something closer to the content that they want to watch.

We think it's an interesting opportunity. We're starting with a specialized, what I'll call a specialized -- specialty magazine strategy of going after Hispanics. We'll get some learnings out of that, and we e continue to have discussions about digital rights with all of our partners. As that space evolves, we'll see if it's an interesting opportunity or not.

I think as I said, primarily the challenge is how do you fit the ACPU budget, if you will? You probably can't do broadcast channels, and that's where it gets funky, because I'm not sure without broadcast, the big four broadcast networks, how much demand there will be. It obviously depends on the quality of the content that's in the offering.

Tom Eagan (Analyst - Telsey Advisory Group):

Thank you.

Operator:

Mike McCormack, Jefferies.

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Mike McCormack (Analyst - Jefferies & Co.):

Hi, guys. Thanks. Bruce, maybe you could make a comment about the middle-market push you guys started a couple years back and just give us a sense for how it's tracking versus your expectations. Churn in the quarter, obviously, was probably impacted by the one-third that are taking the prepaid product, and FIFA to some degrees as well.

And then Mike, a comment on the US, you were talking about OTT and more on the millennial side. When you think about the single-product video and the need to take price, do we have a price elasticity problem here in the US that's starting to build? That would be great. Thanks.

Bruce Churchill (President - DIRECTV Latin America):

Starting on the middle market, look, we still obviously very strongly believe that for our product to succeed in Latin America, we need to be able to serve the mass market. Pay TV penetration in the AB households is already very high. So the future growth is going to be about being able to serve profitably customers that are moving into the middle class or what would constitute middle class in Latin America. So I would say in general, it has developed as we expected, and we're pleased with our progress.

Having said that, I hoped to be a little farther down the road on prepaid in Brazil. We tried going for a while without it. It's proven, as we've seen over the last year, to create some problems, and therefore, we have shifted more emphasis to the prepaid model in Brazil and hope that we achieve the same kind of success with prepaid in Brazil that we've achieved in PanAmericana. I just think that's a much better fit between the customer's ability to pay and our ability to service them at the right profit and return on investment level.

Mike White (President, CEO):

Mike, yes, sure, I think I've said it before. Unfortunately, we're a distributor, and Walmart sells eggs and the cost of eggs goes up, the price of eggs goes up. I think as I've said, we expect probably our high-water growth rate in ACPU to be next year, and, therefore, we'll have to take additional pricing next year. And yes, I am concerned about it.

I see the customers that are churning mentioning price value. I see more of them claiming they're going to no pay TV. It's not -- when you look at the total industry, you can't see it in the net-add numbers, by the way.

So it's not -- I don't think it's the end of the world here, but I do think it behooves all of us to recognize that -- back to one of the questions that was asked earlier, that to the extent you can find something for $50 a month, $70 a month, $35 a month, whatever, that you could do on an everyday low price basis with customers, if you can make it a good product, certainly we'll want to play there.

But I do think, yes, I think there is a concern for the industry as a whole, and that's why sometimes it's hard to read trends. A lot of you think that trends are more technology or millennials or whatever, and I would argue there's a much bigger issue, which is the price elasticity challenge when you're trying to raise prices when median household incomes are flat, particularly for those making less than $50,000 a year.

Mike McCormack (Analyst - Jefferies & Co.):

Thinking about the number of substitutes in the marketplace, at what point do you think you can gain more leverage against the programmers to try to reduce that inflation?

Mike White (President, CEO):

Probably when we get more churn.

Mike McCormack (Analyst - Jefferies & Co.):

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Understood. Thanks, guys.

Mike White (President, CEO):

That's probably the reality.

Operator:

Craig Moffett, MoffettNathanson.

Craig Moffett (Analyst - MoffettNathanson):

Hi, Mike, if we could stay with that theme for a second of price elasticity. You've actually been able to grow ARPU enough over the last couple of years, and again this quarter, to keep the gross profit per video subscriber pretty healthy, actually growing.

But as your subscriber growth levels out, you how sustainable do you think it is to keep that number rising, since it requires a larger and larger annual price increase, or whether it's price increase or DVR rental fees or what have you, but higher and higher ARPU growth in order to offset the inevitable rise in programming costs?

Mike White (President, CEO):

Look, first of all, I think this is still a terrific product that our industry sells to consumers, and I think it is probably the golden age of television and the quality of stuff that is on, from Ken Burns' seven-part series of the Roosevelts to Homeland or The Good Wife or The Americans on FX, or you name it. There's probably more good quality programming than there's ever been. I think we have to keep that in mind, Craig.

But I'm not one who believes we have to cut prices by one-third to sustain our business model. But I don't think it's sustainable to have content cost growing 8% to 10% a year, forcing price increases of 4% to 6% a year.

I just don't think that's sustainable over time, but I would also tell you, and I think we've said this before, we certainly don't expect to be on the high end of that range other than next year. So there's no question the distributors I think are beginning to realize all of us, that man, these increases are just not something you can just keep doing.

On the other hand, as a distributor, if the cost of funding goes up, we negotiate as tough as we can to get a fair deal, consistent with the marketplace. If the market speaks, then we have to pass that on to consumers. And ultimately, I think it will be the consumer that will have to be the test on at what point the price versus the value equation gets further out of whack.

But again, I can only tell you the month of October looked good. So it's something to watch for us as an industry, I think. I don't think that double-digit content cost increases is sustainable for the long haul. But as I said, we're not planning that either, so --

Craig Moffett (Analyst - MoffettNathanson):

Okay. Thank you.

Operator:

Marci Ryvicker, Wells Fargo .

Marci Ryvicker (Analyst - Wells Fargo):

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I have two questions. We've talked high level about over-the-top. I'm just curious, Mike, as to your reaction to the announcements from HBO and CBS and probably soon to be Showtime. Secondly, are you in favor of complete unbundling and a la carte, or just smaller bundles?

Mike White (President, CEO):

I think first Marci, on your first question, look, I think we'll have to see. There's no question that all of us would like to have a product, and the content providers, I understand, would certainly like to get their content to be seen by probably 10 million homes, if you will, of millennial renters that don't take pay TV today.

And so I don't have an issue with what they're trying to do, provided that there's no -- they don't price discriminate in a way that we're paying more and our customers have to pay more than they can get the product over-the-top, in which case, I think they'd create a problem. I don't think they plan to do that.

So we welcome more choice and access to content, and I think we do understand with today's millennials, you're going to have to play both ways, both the linear and the digital, and we'll see how it goes.

I think in terms of your second question, I don't think a la carte is the way to go. It didn't work in Japan. I think you probably end up with less diversity of content if you went a la carte. I just think it's like any good thing, too much of a good thing is a bad thing, and I think the bundles have gotten overdone. And I do think, candidly, that there are some areas, sports in particular, that probably should be on a separate tier but isn't. That is what it is today.

I'm just saying, to me that's where I think it's particularly unfair for pay TV providers to have to pay for a lot of that sports content that they really don't want and don't watch. That's how the industry is today.

Marci Ryvicker (Analyst - Wells Fargo):

Thank you.

Operator:

Kannan Venkateshwar, Barclays.

Kannan Venkateshwar (Analyst - Barclays Capital):

First is on the same topic, which is how much leverage do you have in continuing the trend we've seen in the programming cost this year? And are there other areas, like the Dodgers, for instance, now given that you've seen the impact it has on your overall pace, that you see some scope for bringing down the cost?

And related to that, I think you guys experimented with a whole tier for regional sports networks and so on, so if you can share what you saw in terms of trends there, that would be pretty useful. Thanks.

Mike White (President, CEO):

I don't think we've experimented with a tier on our regional sports networks, per se. So I don't -- I think what we did do is some consumer research around the Houston situation to ask, particularly in some of the outer zones, whether consumers would pay anything for it and 99% said no. That was a unique situation, as well by the way, because the way their RSN is structured was picking up consumers in Oklahoma and Louisiana and other places that didn't really care about Houston.

I don't have any other data than I think our traditional thinking has been, on average, 35% or 40% would take a regional sports network. But boy, you get to certain markets, I'm from Boston, I bet it would be higher than that. It really depends.

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I think on the programming cost thing, look, we are taking a very careful look at all of -- and I think all distributors are, in terms of whether the actual channel's viewership comports with what we're paying for. And I would say we certainly don't -- this year is not projectable in terms of ACPU.

I think we were pretty clear on that, and frankly, even fourth quarter you're going to see us right back smack in the middle of our longer-term guidance of 7 to 9. I've said next year I expect to be above that. But I don't expect that double-digit ACPU to be beyond next year.

I think we're all pushing hard to try and find ways to get to a more reasonable place with our programming partners in terms of what their demands are. But that's a negotiation, and it's a marketplace and we'll have to see how that evolves.

Kannan Venkateshwar (Analyst - Barclays Capital):

All right. Thank you.

Operator:

Ben Swinburne, Morgan Stanley .

Ben Swinburne (Analyst - Morgan Stanley):

Thank you. Mike, you didn't mention the NFL this quarter as a reason or a factor in your sub-results. I was curious how that performed versus your expectations. There was some PR noise around the NFL, negative noise, earlier parts of the season.

And second, you and Pat talked about fourth-quarter subscriber trends, but there was a caveat around programming disputes. The one that everyone knows about is the Disney . I just wanted to see p if you had any update on your Disney process.

Mike White (President, CEO):

Ben, the Disney negotiations are continuing. I think they've been very constructive. A deal like Disney is multi-headed process when you're thinking about digital and all the other stuff, but we're quite pleased with the progress that we're making on that.

They've been good partners, as I think you saw, the SEC network was -- we put it up and that was an agreement with the Disney company. And so, I'm very optimistic that we will complete that negotiation.

In terms of the NFL, I appreciate your asking. We were pretty pleased with the NFL. I probably should have mentioned it. We saw a 10% increase in the customers paying, which is a good thing, because we do use it as a first-year free trial, if you will. So we got a 10% increase there.

We had the renewals up 5%. New regular season takers that hadn't taken it before was up 23%. And then the new over-the-top broadband service was small, about 40,000 customers, but we got some really good learnings there.

So overall, we expect the cash that we get from paying subs to increase 13%, when all is said and done, for the 2014 season. So I'm really pleased with it.

I think the impact on gross adds as a free-trial element was probably more muted, to be honest with you. But there were so many other things going on in the quarter, as I said, overlaps versus prior year and what have you, that I'm not sure that I could read anything into that one way or the other. All I can tell you is we're really pleased.

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We were pleased to get our deal done. It's been a 20 -year partnership. We value the relationship with the league, and we were pleased with our paying customers increasing this year by 10% and revenues being up 13%. So that's really good.

Ben Swinburne (Analyst - Morgan Stanley):

Thank you.

Operator:

Thank you. This concludes today's DIRECTV Group's quarter and year earnings conference call.

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