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American Tower Corp. (AMT)- Initiate with NEUTRAL

AMT is a company that appears to have a simple business model with highly predictable results backed by long-term leases with customers. With its REIT structure, it saves on income taxes and pays a 2% dividend that has been growing at 20%. Given that growth rate and the basic results, we think many income investors own this stock. Looking at the debt situation and the cash flows available for shareholders, we do not think 20% dividend growth can be maintained much longer. Fast growth simply relies too heavily on acquisitions, which requires more borrowing and the focus on deals has been overseas where the new cash flow tends to stay.

In many areas, we believe the company's accounting is more conservative than similar types of companies we have seen over the years. We still think investors should be aware of headwinds and lower flexibility that can impact AMT. These are unlikely to derail AMT's operations or the dividend but may crimp its ability to grow the dividend at the rapid pace it has seen recently. We are neutral on this stock.

- Steady growth comes from adding more systems to the same tower (called colocation) and it drives growth at just under 5% at AMT. Price increases are offset by churn but come in steadily at just under 2%.

- Bigger growth requires acquisitions or building more towers and FX to not pull down results. The only way AMT can pay for the former is to borrow money. FX is a wildcard but is more likely a drag given many emerging markets where it operates.

- Reported AFFO to the dividend provides a solid cushion and makes more dividend growth appear easy to achieve.

- Maintenance capital spending and investments in colocation appear higher than what AMT is reporting in AFFO. We think this could lower AFFO by at least $200 million.

- If they don't spend that money and colocation growth doesn't happen, they may see some large intangible assets become impaired which could rapidly cut book value.

- Income taxes overseas appears to be a headwind to AFFO and recent actions will reduce rents on some towers in India by 80%.

- A put option to acquire the remaining Indian partner's minority assets for $400 million has been triggered. That is a cash outflow. There are some troubles for the counterparty in Africa too.

- AMT's debt at 5.0x EBITDA is already steep and nearly all of it is in US dollars.

- Investors should be aware that 35% of operating profits come from overseas and much of that cash flow is staying there. That effectively lowers the surplus EBITDA in that debt-to-EBITDA ratio and it also effectively reduces AFFO for the dividends.

- Some debt is floating rate and 10%-20% rolls over annually, which gives AMT a headwind from rising interest expense that could penalize AFFO more.

Basic Overview of the Operating Model:

AMT gets 99% of its revenues by leasing its towers. These leases are typically greater than 10-years in length with renewal options. Often, they include a rent escalator. There are really only three ways AMT grows:

- Acquire or build new towers

- Add new customers to existing towers or have existing customers add new services to towers – (think operating a 3G network and then adding 4G and now 5G).

- Boost rent with price increases

When we look at the recent results, it is clear that a huge part of growth is coming via acquisition and new construction. The addition of more equipment per tower is a steady area for 4%-5% annual growth. The price increases are net of customer churn that normally runs about 2%. In 2018, India has seen customer consolidation that resulted in heavy churn and drove the escalators to 0%. Had India not seen this, the rate in 2018 would be about 1.7%, within the recent normal range.

	YTD 2018	2017	2016	2015
Property Rev.	$5,211	$6,566	$5,713	$4,680
Y/Y Growth	6.6%	14.9%	22.1%	16.8%
Key Parts				
Acq/New Build	2.6%	6.5%	17.5%	13.2%
Colocation	4.5%	4.7%	4.5%	5.4%
Escalators/Churn	0.0%	1.3%	2.0%	1.4%
FX impact	-1.9%	0.8%	-3.9%	-8.5%

Basic growth here is about 6%-7% without acquisitions and adding new towers with a wildcard from FX. Given that the foreign markets include: India, Brazil, Argentina, Chile, Mexico, Ghana, South Africa, Uganda, and Nigeria – odds are high that FX will be a wildcard in most years in our view. Acquisitions and new building require hefty capital spending. Colocation can require that too if a tower needs to be modified or increased in size. AMT has been a heavy borrower:

	YTD 2018	2017	2016	2015
Cash Ops	$2,485.1	$2,925.6	$2,701.7	$2,166.9
Cap Exp.	$610.4	$803.6	$682.5	$728.8
Acquisitions	$1,437.8	$2,007.0	$1,416.0	$7,020.6
Free Cash	$436.9	$115.0	$603.2	-$5,582.5
Dividends	$994.0	$1,164.4	$993.2	$797.5
Repurchases	$181.2	$766.3	$0.0	$0.0

In 2018, the company converted the preferred stock to common, the dividends reflect the payment on both preferred and common. The company is not covering the dividend from earnings. However, the depreciation figure is so high and acts as a drag on earnings and far exceeds capital spending, we are less concerned about the dividend to earnings ratio at essentially 100% in 2018 and 95% in 2017. AMT will argue that AFFO (Adjusted Funds from Operations) which deducts maintenance capital spending (that's a huge plus in our opinion – kudos to AMT), is a better measure. They see maintenance capital spending at

about $110-$140 million per year and AFFO at $2.8-$3.0 billion net of that spending. The current dividend is $1.4 billion giving them roughly a 50% payout of recurring cash flow.

We will also address Return on Capital. Again, based on operating earnings after deducting the depreciation – ROI is only about 8% in most years. However, using AFFO, which adds back the depreciation net of maintenance spending, and interest expense of that is currently about $840 million per year the numerator becomes $3.6-$3.8 billion. Total capital is $26.7 billion thus making return on capital about 14%.

Cash Needs for Maintenance Cap-Ex May Be Higher than Expected

In looking at AFFO, we have ripped other companies like Welltower for not including maintenance capital spending in their calculations. AMT does add this in, but we think it is too low. The gross amount of PP&E is essentially $17 billion. AFFO has only about $110-$140 million as capital spending. Still leaving out acquisitions and discretionary capital spending to develop new towers and tower sites, here is what else AMT has in capital spending:

	2017	2016	2015
Redevelopment	$138.8	$136.8	$114.1
Capital Improvements	$65.6	$81.8	$42.4
Regional Improvements	$106.4	$139.4	$201.1
Total	$310.8	$358.0	$357.6
Reported in AFFO	$131.2	$126.6	$106.3
Difference	$179.6	$231.4	$251.3

Redevelopment relates to colocation efforts to boost capacity at existing sites. We consider this part keeping the asset attractive to existing customers to use it in the future as it builds out new networks. Otherwise, those networks go elsewhere. These represent the same customer base AMT has in many cases. Capital Improvements enhance existing sites for functionality and capacity – the technology changes. Regional improvements help towers in an area increase coverage and functionality. If the base growth figure for AMT without acquisitions is essentially 1.5%-2.0% in price hikes and 4.5%-5.0% colocation to reach 6%-7% then we believe these capital spending figures should not be considered discretionary.

Acquired Network Intangibles

This is one of the stranger accounts we have seen. When AMT makes acquisitions and allocates the purchase price – it records fair market value to PP&E and other assets. One of these other assets is Acquired Network Intangibles. This represents the value of potential revenue growth from selling additional space on acquired towers to new customers or existing customers who are expanding their services. That doesn't mean that new revenue will be realized – just that the company intends to work to achieve it via colocation that we talked about earlier as one of AMT's three sources of growth.

First off, we will again say this item is a conservative way to account for acquisitions. AMT assigned $4.8 billion to this account and is amortizing it over up to 20 years against earnings. It's more conservative because they could have just put it in goodwill and not amortized it all and thus boosted earnings. As a REIT, and having to pay out 90% of earnings, having this amortization lower income is probably a good way to retain some capital.

Second, this is another reason to record more capital spending against AFFO. The company has already highlighted that it is investing in this area to sign more business. Without that spending, they may not get as much colocation business as planned. In that case, the future cash flows - that are supporting the intangible asset value for Acquired Network Intangibles – come in low and cause write-downs in that asset. That's potentially a big number. This account is at $3.2 billion in value vs. AMT's equity balance of $5.4 billion.

Potentially this may also have some ties to the other big intangible, Acquired Tenant Intangibles at $8.2 billion. That would relate to the value of existing customers who are also the most likely to be colocation clients. Much of the colocation would involve adding the next generation equipment to the same tower and keeping the older generation active as well. So, the property has to meet the client's current and future needs. Plus, we do not view colocation as something that grows forever – there still is only so much space on a tower to sell.

So, while AMT is using a more conservative form of acquisition accounting, it likely does require higher amounts of recurring capital spending to protect against impairments that could have a large impact on the equity value.

Income Taxes May Be Rising

The REIT status of AMT removes the vast amount of income tax that a standard C-Corporation would pay in the US. However, its foreign operations have become larger and they do pay income tax overseas. AFFO starts with net income which deducts income taxes. It then adds or subtracts the change in deferred taxes to determine the cash impact of taxes. AMT's data here is well laid out and the numbers match:

	2017	2016	2015
Income Taxes	$30.7	$155.5	$158.0
Change in Deferred	-$105.8	$59.2	$1.0
Tax Impact on AFFO	$136.5	$96.3	$157.0
Cash paid for taxes	$136.5	$96.2	$157.1

AFFO thus takes into account the cash impact of income taxes. We have no problem with this procedure.

We believe that the income taxes will rise simply as the foreign operations mature. In 2017, the company noted that 44% of revenue was in foreign currency but 51% of expenses were in foreign currency. We are not going to look at this as transaction splitting where a company reports more expense in a high tax area and more revenue in the low tax area. It looks simply like there have been more set up costs overseas initially and management is signing contracts and the company is doing more work in other markets. If the company's operations are largely passive once an asset is in place – essentially build a tower, sign a contract, collect rent for 20-years – we would expect the revenue overseas to rise and the costs decline. That would create more foreign income which is taxed. The percentage of income and assets overseas is rising:

	US PPE	Non-US PPE	US Rev	Non-US Rev	US Op. Inc.	Non-US Op. Inc.
2017	59%	41%	56%	44%	65%	35%
2016	63%	37%	60%	40%	68%	32%

We also noted that AMT has taken several impairment charges in India totaling $360 million during 2017 and 2018. These stem from a customer bankruptcy, another customer boosting churn as it consolidates tower sites, and write-downs of equipment. The ultimate view is that these assets will still be used and gain more customers as new networks are

rolled out and the churn slows. If this works, depreciation on these assets will be lower and thus income higher creating more income taxes in the future.

After 3Q, some more news came in on the Indian assets:

> *"Tata Teleservices Agreements—On October 23, 2018, the Company entered into agreements with Tata Teleservices and related entities for a settlement and release of certain contractual lease obligations effective November 1, 2018. As part of the arrangement,* ***the Company will receive an upfront one-time INR denominated cash payment equal to approximately $320.0*** *million for the termination of lease obligations with Tata Teleservices in India. In addition,* ***the Company entered into new leasing arrangements with a number of Tata-affiliated entities. The Company expects the net impact of these two transactions to represent an approximate 80% reduction in the contracted tenant revenues generated from the terminated leases.*** *In connection with the acceleration of the contractual arrangements, the Company will also revise the amortization of its tenant-related intangible asset with Tata Teleservices."*

So, here comes a $320 million cash payment to terminate leases, which could generate taxes. However, offsetting that is another write-down in asset values coming to reflect lower lease revenue overall. There is also a tax dispute in India for $70 million that the company has won, but the government is appealing. More importantly, India is normally about 10% of AMT's operating income at roughly $400 million. We do not have enough information to evaluate the Tata 80% reduction in rent on terminated leases, but this should be another hit to AFFO.

There are several moving parts to this and taxes are not a major cash expense for AMT. However, many signs point to cash taxes rising in the future.

Minority Interest Put Options Trigger More Cash Payments

Several of the foreign operations at AMT are owned jointly with other companies. Their Indian operations have a put option that allows the minority interest parties to sell their remaining investments to AMT. They exercised this right and will cost AMT $400 million to add to its Indian assets:

> *"Tata Teleservices delivered to the Company notice of exercise of their put options under the Shareholders Agreement with respect to 50% of their combined holdings with Tata Sons of ATC TIPL. Additionally, IDFC delivered notice to the Company of exercise of its put option under the Shareholders Agreement with respect of 100% of its holdings of ATC TIPL. The Company expects to complete the redemption of the put shares, subject to regulatory approval, for total consideration of INR 29.4 billion (approximately $400.0 million) in the first quarter of 2019."*

In addition to India, AMT has a 49% minority interest partner in Ghana and Uganda called MTN Group. We do not know everything about MTN other than it provides cell phone service in Africa – about 1/3 of the EBITDA is from South Africa and they have had several problems with Nigeria. They are on negative watch with Moody's now. They have cut their dividend to focus on debt reduction and FX can play a negative role in their operations of dealing with emerging market currencies. Iranian sanctions make it tougher to access cash flow from there as well. There is not a put option here, but MTN has shown that there are some difficulties to operating in Africa. If it does need some help, it may be possible that AMT gets more involved here. This is purely speculation on our part of a potential wild card cash need.

Issues with AMT's Debt

AMT is carrying 5.0x Debt to EBITDA on a trailing twelve months basis ($21.3 billion/$4.3 billion). That is fairly steep in our view but is below the covenants on the bank lines. The company has to maintain total debt to EBITDA below 6.0x. The company could still borrow $5.1 billion at the end of September or see EBITDA fall by $0.9 billion and remain in compliance. Those are both greater than 20% moves.

We still see issues here, starting with the foreign operations again. Of the $21.3 billion owed, only $622.2 million is in foreign currency at the subsidiary level or basically 3%. With over 35% of the operating profit coming from overseas – this sets up some issues to explore. First, AMT funds the foreign units with intercompany notes. The company says several times in its 10-K and 10-Qs that it does not repatriate cash other than servicing intercompany notes:

"While certain subsidiaries may pay us interest or principal on intercompany debt, it has not been our practice to repatriate earnings from our foreign subsidiaries primarily due to our ongoing expansion efforts and related capital needs. However, in the event that we do repatriate any funds, we may be required to accrue and pay taxes."

"The Tax Act requires a mandatory one-time inclusion of accumulated earnings of foreign subsidiaries, and as a result, all previously unremitted earnings for which no U.S. deferred tax liability had been accrued have now been included in the calculation of U.S. taxable income. Notwithstanding the inclusion of these amounts in the determination of U.S. taxable income, the Company intends to continue to invest these foreign earnings indefinitely outside of the U.S. and does not expect to incur any significant, additional taxes, primarily withholding taxes, related to such amounts."

So, if the bulk of the cash flow from overseas never comes back is it really available to service the debt? Furthermore, could it ever quickly be brought back, much of it would be reinvested into fixed assets. At the end of September, AMT noted it had $1,026 million in cash with $899 million overseas. Of that $899 million, $340 million was in JVs where the partners may have some say in how that cash is allocated. They clearly are not bringing the cash flow back to pay for dividends or stock repurchases or US capital spending. AMT rolls over much of its debt so the cash does not even need to come back to fully fund principal payments on intercompany notes as those notes could be rolled over too.

AMT breaks out operating income but not EBITDA or AFFO by geography. But we know about 35% of operating profit comes from overseas. If that percentage roughly translates to EBITDA, what if one-third of foreign EBITDA is not available, that's about $500 million of EBITDA. Now debt to EBITDA effectively becomes 5.6x instead ($21.3 billion / $3.8 billion). On AFFO that is about $2.8-$3.0 billion and that already factors in the interest expense. If foreign operations are not sending over any additional part of the AFFO, that may reduce AFFO available for stockholders by almost $1.0 billion. Now, the dividend of $1.4 billion doesn't have nearly the same level of cushion and share repurchases from internal cash may not be possible at all. Moreover, there's very little free cash flow to retire debt. Thus, we would argue that this foreign set-up effectively makes the debt load more onerous and the lowers the cash flow available.

There is obviously an FX risk too. They are getting paid in foreign currencies and paying debt dominated in dollars. The company quantified this risk:

> *"As of September 30, 2018, we have incurred intercompany debt that is not considered to be permanently reinvested and similar unaffiliated balances that were denominated in a currency other than the functional currency of the subsidiary in which it is recorded. As this debt had not been designated as being a long-term investment in nature, any changes in the foreign currency exchange rates will result in unrealized gains or losses, which will be included in our determination of net income.* ***An adverse change of 10% in the underlying exchange rates of our unsettled intercompany debt and similar unaffiliated balances would result in $116.3 million of unrealized losses*** *that would be included in Other expense in our consolidated statements of operations for the nine months ended September 30, 2018."*

AMT also securitized future rent payments on thousands of towers for some of its debt. This is $2.7 billion of the $21.3 billion in debt. These securitizations have first priority for all the cash flow generated by the specific towers. The cash flow to debt service needs must exceed 1.3x. AMT has not been in danger of breaching that test. It was over 8x and 12x on the various debt issues at the end of 2017. When the company passes the coverage tests it can access the excess cash flow for its general corporate purposes. We are less concerned about this than accessing the foreign subsidiary cash but is another minor risk factor that AMT may not always be able to fully access its domestic cash flow either.

We also believe rising interest rates are a threat as well. Generally, AMT is rolling over $2-$4 billion of debt annually and prepaying some other notes. Of their $21.3 billion in debt, $4.4 billion is variable rate. Interest expense is running about $840 million annualizing 3Q18's figure. If every year 30% of the debt is subject to higher rates, the interest expense could start to rise. Every 20bp move in interest rates for 30% of the debt adds $13 million to annual interest expense. This could also be a headwind for AFFO for the stock.

Our overall conclusion with the debt is it is not a flexible as it appears on the surface and could effectively be more onerous when factoring in that not all the cash flow is available to service the debt. The cost of funding could be rising and the fact that the company has already tapped some less than straightforward financings such as securitizing future cash flows also point to falling flexibility with the debt. Since this company's primary source of growth is acquisitions and new construction, which it pays for with debt, future growth could be trickier at achieve.

Conclusion:

There are some minor issues +/- here such as many prior acquisitions had AMT prepay for the annual land rights for towers – so that rent is amortized now as non-cash and adds to AFFO. The company also uses a small amount of capital leases and only in the interest expense impacts operating cash flow - the principal payments would appear in the financing section and thus inflate free cash flow.

There are not many near-term accounting issues here. We do think investors should be adjusting AFFO down for more capital spending of about $200 million per year as the cost of maintaining the asset base appears to be at least that much higher than reported in AFFO now. We also think investors should be reducing AFFO by some amount of foreign cash flow that is not available to cover dividends and other shareholder payments as the company does not repatriate the cash. That could be as high as another $0.8-$1.0 billion of AFFO. Taken together, that the $1.4 billion in dividends is being covered by $1.6-$2.0 billion in funds vs. the reported $2.8-$3.0 billion. We have a tougher time expecting 20% dividend growth to last much longer.

It is also difficult to overlook that the biggest source of growth here is acquisitions and the way AMT pays for that is with debt. We see several issues with the debt already such as rising interest rates and less flexibility than it appears given that a large percentage of foreign cash flow is not fully available to support the debt. They can pull more cash back if absolutely necessary subject to FX and taxation risks. That's not to say this company cannot grow – just be aware of the already high debt level and flexibility issues.

Also, be aware that FX is normally a drag on growth – given that the markets include Uganda, Argentina, Ghana, et al, we would expect this to be a common negative wildcard for AMT. Also, while we don't fear counterparty risk much from AT&T, Verizon, or Vodafone – the Indian assets have already had some sizeable renegotiation and JV partners exercised a $400 million put option for AMT to pay. Does MTN Group in Africa have similar potential for a cash call?

Disclosure

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