BEHIND THE NUMBERS
Quality of Earnings Analysis

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American Tower Corporation (AMT)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of ETN with a rating of 4- (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

AMT beat FFO (Funds from Operations) forecasts by $0.43, $0.18, and $0.01 for the last three quarters. FFO is largely a basic cash flow measure of net income + real estate depreciation + one-time items like gains/losses or impairments on real estate. With the current quarterly dividend of $1.27 and FFO of $2.73, $2.48, $2.14 for the last three quarters, the payout ratio has a cushion. We have some issues with the REIT metrics but not enough to offset the FFO beats.

The bigger issue we see is the net debt level at 5.7x adjusted EBITDA (it is at that level too for the high-end of 2021 guidance) vs. the goal of 3-5x. The covenant allows 7.5x. Simply pulling non-cash rent out of EBITDA, debt to the trailing 4Qs of adjusted EBITDA rises to 6.5x. Then AMT expects to lose Sprint-related revenues going forward. The company grows via acquisition, and growth capital spending – Free Cash flow after capital spending, dividends, and share repurchases for the last 4Qs is only $831 million. At the same time, AMT spent $12.4 billion on acquisitions. It would appear that more acquisition-related growth will be tough to afford in the next couple of years.

The overriding issue with REIT stats remains the belief that there are very low levels of required spending to maintain the situation and management points to huge cash flow cushion for the dividend using those assumptions. However, the REIT won't trade for 30x AFFO if there isn't

growth. Thus in our view, there are simply too many ongoing costs ignored in REIT stats to maintain not only the business model but also the stock price.

What is strong?

- The high debt figures to EBITDA are skewed a bit by having a large acquisition close in June 2021, which provides 100% of the debt and only a couple of weeks of cash flow. It is possible this could help AMT continue to top forecasts given after completing a $9.4 billion acquisition, guidance for AFFO only rose by $60 million (1.5%) for 2021, and EBITDA guidance is up only 4.6%.

- AMT's low cost of capital at 2.4% on debt and 1.7% on its dividend makes it an attractive way for its customers to use AMT's balance sheet while they focus on a period of heavy capital spending expansion. The customers' heavy network expansion spending means more rent to AMT. That also helps AMT grow into its higher debt level more comfortably.

- AMT is not allocating an inordinate amount of acquisitions to goodwill (we have not seen the Telxius allocation yet). That means it is depreciating PP&E and other intangibles. That at least recognizes some costs of growth through acquisition:

Recent Deals	% to PPE	% Goodwill	% Intang.
Insite	15%	38%	50%
Entel	16%	34%	65%
Eaton	42%	0%	45%
2019 US deals	20%	0%	79%

What is weak?

- Straight-line lease accounting for rent escalators inflates AMT's revenue figure by recognizing non-cash revenue that is not due yet from the tenant. This is GAAP accounting so it's not AMT's fault and it was $322 million in 2020 and $225 million in the 1H21.

- To AMT's credit – it backs out this non-cash revenue from its AFFO stats that are supposed to represent free cash flow without growth projects. AFFO in 2020 was $8.44 and it was hurt by 60-cents in this area. For 1H21, AFFO was $4.85 and it was 43-cents lower by subtracting non-cash rent. However, AMT does not adjust for this in EBITDA. That makes EBITDA nearly 7% overstated in our estimate and would boost the net debt/EBITDA ratio from 5.7x to 6.5x.

- AMT carries an intangible asset called Acquired Network Location Intangibles that is its forecasted value of adding more tenants to acquired towers. In order to reach that goal, AMT needs to invest more in capital spending on the tower called Redevelopment. However, it does not deduct redevelopment spending from AFFO. Thus, there is a $4.2 billion asset that requires more capital spending to justify the valuation, but under the REIT stats, AMT views that spending as discretionary. AMT also touts this as perhaps its most profitable way to grow. Dealing with the reality that this spending is likely necessary and would lower AFFO by about 40-50 cents per share.

- REIT accounting is more aggressive than many other industries when it comes to acquisitions. Most industries still recognize depreciation as a cost and do not add back the depreciation of acquired assets in adjusted results. With FFO and AFFO, AMT adds back the amortization and depreciation of acquired assets and of course doesn't amortize $10.6 billion in goodwill either. Transaction and integration costs are added back too. Other than interest expense incurred on incremental debt, REIT stats do not acknowledge any cost of an acquisition. For a company that routinely makes acquisitions and highlights that as part of the growth model, we think investors should be aware of these other costs too that are being added back to REIT Stats:

Ongoing Costs	**1H21**	**2020**	**2019**	**2018**
Stock Comp.	$70	$121	$111	$138
Impairments	$0	$223	$94	$394
Integration/Acquisition	$81	$24	$27	$34
Total	$151	$368	$232	$565
Total per share	$0.34	$0.82	$0.52	$1.28

What to watch?

- AMT has benefited from falling interest rates. The average cost of its debt was 3.9% in 2018 and after refinancing and the lower market rates – the debt is running 2.4% now. Several signs point to higher interest rates going forward including AMT's expansion overseas. 40% of the debt matures by 2025. Based on current debt levels, 100bp higher debt cost would mean 78-cents of AFFO/share headwind.

- For a company expanding internationally, AMT has not seen many FX issues yet. It reports this in other income/expense and while 2020 saw a large hit – it was essentially recovered in the 1H21. Both AFFO and EBITDA ignore this item, but it may become a larger cost of doing business for AMT.

	1H21	1H20	2020	2019
FX gains (losses)	$242	-$216	$6	-$5

- Following several large acquisitions, we would expect to see Redevelopment capital spending accelerate in coming years. We noted this spending is needed to justify the carrying value of some of the intangible assets, but AMT ignores it as discretionary and does not subtract it from AFFO. We would expect to see the amount of AFFO from this omission increase beyond the current 40-50 cents per share.

- Is AMT overpaying for deals? AMT gives overviews of what it costs to build a tower in various locations in its presentations. For example, in the US/Canadian market it says a tower costs $250,000-$300,000 to build. Yet it paid over $1 million per site for the Insite acquisition. It sees African towers costing $60,000-$120,000 to build. It paid $345,000 to acquire Eaton with 5800 towers there. As a corollary to that – AMT touts its ROI of 10.4% over time. If they are overpaying for assets, that may cause that ROI to decay.

- The Three US wireless carriers are looking for cost savings and they are 55% of AMT's revenues. AMT is publicly showing its business model relies heavily on adding multiple tenants to the same tower assets. ROI of 3% with one tenant can become 24% with three. We do not think the wireless companies have an incentive to push AMT out of business, but we do think they will start to focus on the total amount of rent they pay as leases rollover. T-Mobile is already doing this as it deactivates redundant equipment it acquired with Sprint. One option may be asking for the same pricing for all tenants on the tower. Another thought would be a sliding rental bill for adding additional equipment. They could also ask for rent discounts on older equipment that will be serving fewer of their customers as 5G grows.

- AMT is touting that it has master lease agreements regards thousands of towers with these customers and they include built-in rent escalators. We have seen that in other industries such as Senior Living housing and Movie Theaters and even with a master deal – changes can be made – just look at EPR Properties and Welltower. This is not an immediate concern – but the wireless carriers are looking at largely flat revenues per user as they pay a rising rental cost to house the same equipment on a tower and are paying new rents to install additional equipment. Given that AMT's costs are largely fixed, even minor changes in revenue would have a large impact on EBITDA and AFFO.

Straight-Line Lease Accounting Boosts Revenue

One of the features of AMT's growth is having automatic annual rent escalations built into leases that last 5-10 years. For the US, this is generally a 3% increase per year and in several of the foreign markets it is tied to an inflation index. On the surface, good for AMT – there's nothing wrong with that set-up.

From a GAAP standpoint, AMT uses straight-line accounting to recognize lease revenue. This simply is looking at the total amount of rent that comes in over the life of the lease, and divides it equally by the number of years. On a simple example, let's assume a 7-year lease starting at $100 and increasing 3% per year:

	yr1	**yr2**	**yr3**	**yr4**	**y5**	**y6**	**y7**	**total**
Rent/year	$100	$103	$106	$109	$113	$116	$119	$766

The table shows the cash flows that come in each year. However, straight-line lease accounting views the full amount of lease income coming in equally in each year. So, compared to the cash flow stream, which grows over time – straight-line accounting front-loads the revenue. In this example, $766/7years results in revenue of $109.50 for each year. The company would see a deferred rent asset account increase to reflect that in year 1, it only brought in $100 and recorded $109.50 in revenue and this deferred account would rise until year 4 and then decline as the higher rent payments are collected. The same exercise is done on some ground lease deals that AMT has in place. It records the expense on a straight-line basis, but the cash outflow may be smaller early in the lease. Three key points to make:

- For leases tied to an inflation index – AMT doesn't know what that index will be year to year and therefore cannot estimate the rent increase it may receive. Therefore it does not recognize those leases under this straight-line method. As it operates more in developing markets, this may reduce the total amount of deferred rent in relation to total revenues.

- AMT deserves some credit for being conservative. For its AFFO calculation, AMT backs out the straight-line revenue and expense because it is non-cash income. That makes the AFFO figure a more realistic cash flow figure in our view.

- On adjusted EBITDA, AMT does NOT remove the straight-line items. We think that effectively inflates that figure.

EBITDA	1H21	2020	2019
Starting figure	$2,915.3	$5,156.4	$4,744.5
S-L revenue	-$224.7	-$322.0	-$183.5
S-L expense	$30.4	$51.6	$44.4
real EBITDA	$2,721.0	$4,886.0	$4,605.4
EBITDA lost %	6.7%	5.2%	2.9%

Also, AMT touts its long-term ROI as being about 10.4%. Its calculation is EBITDA less some cash taxes and maintenance capital spending divided by the sum of Gross PP&E + Gross Intangibles + Goodwill. Just adjusting for this straight-line rent would cut 60bp off this result. As we mentioned in “What to Watch” section of bullet points – there are some acquisitions that cost over 300% of what AMT says it would have cost to build the sites. That would also seem to be a way to reduce the ROI over time too. The ongoing transaction, integration, stock compensation and impairment charges we talked about above would also lower ROI. Those costs are running about $300 million per year and would cut another 60bp off ROI.

Redevelopment Capital Spending Should Be Factored into AFFO

AMT has always been very active on the acquisition front to add more towers. The company basically has three ways to grow: raise prices which is the straight-line issue just discussed, add more towers, and add more tenants per tower.

When AMT makes an acquisition, one of the intangible assets where it allocates the purchase price is Acquired Network Location Intangibles. This is the expected value that AMT estimates could be realized via higher cash flows if it builds out the asset and gets more clients on it. This account is currently $4.2 billion.

Given the choice of allocating this to Goodwill and not amortizing it, we think setting up this account is a more conservative choice. The amortization happens over “up to 20 years” and that is still faster than Goodwill when it was expensed.

The issue we see is in order to realize the value of this asset, AMT actually needs to add new business to the towers. This involves capital spending. AFFO is reduced by a maintenance capital spending figure at this point. (We also want to give AMT further credit as being one of the few companies we have seen who includes principal payments on financing leases in the maintenance spending reducing AFFO. It’s a small amount, but that is a conservative policy). AMT has several different categories of spending but two that we think should be deducted from AFFO are Redevelopment Spending and Capital Improvements. Both are specifically focused on enhancing, enlarging existing tower sites to make it possible to add more clients to those assets. That would include sites AMT built itself without this intangible asset tied to them as well as acquired towers that do. However, we think AMT cannot tout its growth plan of adding new clients to existing sites, how that boosts its ROI, and sustain a $4.2 billion intangible asset value – unless it actually spends this money. Therefore, we would argue this is not discretionary spending and it would reduce AFFO.

The capital improvements are being deducted from AFFO already as well as some minor corporate capital spending. We will give AMT some credit there. Here is how subtracting the redevelopment spending from AFFO would look:

	1H21	2020	2019	2018
Capital Imprv	$53.4	$150.3	$160.0	$149.5
Corp. Capx	$2.2	$9.3	$10.6	$9.2
AFFO	$2,179.3	$3,763.5	$3,441.7	$3,190.5
Redev. Capx	$100.0	$179.4	$258.5	$232.4
Adj AFFO	$2,079.3	$3,584.1	$3,183.2	$2,958.1
Reported AFFO/Shr	$4.85	$8.44	$7.73	$7.20
Adj. AFFO/Shr	$4.63	$8.03	$7.14	$6.68

- The annualized dividend is currently $5.08 – so this having AFFO reflect the redevelopment spending would not put the dividend in danger.

- Based on the company's forecast of 2021 AFFO of $9.11-$9.33 per share, redevelopment would cut that by 66-cents and the company is still showing a large dividend cushion.

Debt and Cash Flow May Limit Some of AMT's Growth Plans

AMT made a large acquisition and has spent $12.4 billion in the last four quarters on deals in total. Debt is now at $35.6 billion ($33.7 billion net of cash). That has the net debt to adjusted EBITDA ratio at 5.7x. That is not pushing the limit on credit lines which is 7.5x. However, investors should keep in mind several points:

- AMT's high-end guidance for EBITDA is $5.96 billion for 2021, which is still 5.7x on the debt.

- The company's long-term goal is to be between 3-5x EBITDA.

- As noted above, AMT's adjusted EBITDA includes non-cash rent from the straight-line accounting. Omitting that, adjusted EBITDA is $5.2 billion for the trailing 4Qs or 6.5x. On 2021 guidance – straight line non-cash should be a drag of $400 million making the adjusted EBITDA $5.6 billion for a ratio 6.1x.

It is likely that the AMT will try to grow EBITDA to lower the ratio. It is expected to lose a material sum of revenues from T-Mobile in late 2021 and 2022. Looking at things from a simple sensitivity view – getting debt to 5.0x EBITDA would require it to improve to $6.75 billion in 2022 – a 13% gain from the high-end of 2021 guidance. Or, if EBITDA holds closer to $6.00 billion, AMT would need to retire $3.7 billion of debt. The actual outcome likely requires a combination of the two – perhaps retiring $1.0-$1.5 billion in debt. But there isn't that much free cash after the dividend:

Free Cash Flow	**1H21**	**1H20**	**2020**	**2019**
Cash from Ops	$2,045	$1,789	$3,881	$3,753
Capital Exp.	$603	$425	$1,032	$991
FCF	$1,442	$1,364	$2,850	$2,761
Dividend	$1,096	$934	$1,928	$1,603
Share Repo	$0	$56	$56	$20
FCF after Div/Repo	$346	$374	$866	$1,139

- This does not include any allocation to acquisitions and that is routinely $2-$3 billion per year.
- FCF after the dividend is $831 million for the trailing 4Qs.
- The forward dividend is currently $2.3 billion, which is growing faster than FCF.

We do not think AMT will reduce the dividend. However, the growth rate may suffer slightly. It may also slow some acquisition-related growth and some new construction growth. One of the items that AMT points out is that it has increased its focus on foreign and emerging markets where projects may not come online with the same degree of profitability as rapidly as they would in the US at this point. **At this time, we only want to point out that AMT's internal growth from rent escalation is about 3%. Its remaining growth comes from higher capital spending and acquisitions. They can still support some of that – just perhaps not at past levels and given their debt levels vs. the target** – there is not much spare cash flow after the dividend to spend this freely. It's important to note that net debt to EBITDA at the end of 2019 was 4.75x so it has jumped considerably since then and the dividend outlay is 43% higher since then.

We also think investors should note that AMT has been a big beneficiary of falling interest rates. Interest expense averaged 3.9% in 2018 and 3.4% in 2019. It is running only 2.4% now. AMT has 40% of its debt mature/rollover between 2022-25. It would not surprise us to see interest expense rising again on some of the new debt. A 100bp increase in interest expense cost AMT an extra $356 million per year. That will not impact adjusted EBITDA. However, FFO and AFFO both include interest expense. On the surface that is 78-cents in headwind against AMT's current 2021 AFFO guidance $9.11-$9.33. The 78-cents would not all hit in one year, it would simply become a continual headwind for its earnings and cash flow.

It is also worth noting that 43% of AMT's revenue now comes from foreign assets. Yet very little of its debt is in foreign currencies. It has only started to borrow on a multi-currency credit line that is largely in Euros for $2.6 billion or 7% of its outstanding debt (This funded some of the Telxius acquisition). Going forward, we would expect to see more FX issues impacting earnings and more debt in foreign currencies which may carry higher interest rates too. AMT noted that this is a risk factor too:

> *"We have not historically engaged in significant currency hedging activities relating to our non-U.S. Dollar operations, and a weakening of these foreign currencies against the U.S. Dollar would negatively impact our reported revenues, operating profits and income."*

One of the Biggest Risks We See Is Lease Renegotiation – Longer-Term Issue

While we don't focus too much on valuation for an EQ report – we are amazed that AT&T and Verizon are the largest customers for AMT and have enterprise values of $370 billion while AMT is over $170 billion. Crown Castle and SBA Communications are another $150 billion. This just doesn't pass the smell test to us in terms of enterprise value allocation when the tower companies are completely dependent on the cellular companies and have nearly the same dollar valuation and much higher EBITDA multiples.

We haven't seen something this odd since people used to tout Sabre as being more valuable than American Airlines. The idea that the captive accounting system for the airline is worth more than the airline that pays it always seemed more of a result of poor cost allocation than reality. If American Airlines simply paid Sabre $1 less per ticket issued, it really changed the view of how much the accounting system was worth.

Having the tower companies as off-balance sheet financing for the wireless companies is a good thing for the wireless companies. AMT's cost of capital is 1.7% on the divided and 2.4%

on debt which is less than both AT&T and Verizon. However, we wonder when some the wireless companies will start noting a few items and asking to modify the deals:

- AMT is getting a 3% rate increase every year. AT&T's ARPU is flat since 2018 and VZ's is only up 3% over four years.

- AMT touts that adding new a tenant to an existing tower essentially doubles the revenue earned and costs are almost flat. ROI goes from 3% to 10% by adding a second tenant. A third tenant moves ROI to 24%

- 89% of AMT's US and Canadian revenues come from AT&T, Verizon, and T-Mobile, and that geography is two-thirds of AMT's operating income. In total, those three customers are 55% of AMT's total 2020 revenue.

AMT touts that it has master lease agreement with its larger clients. The goal of that is to have a large portfolio of properties where leases roll over very easily. It is tougher for the customer to pull out 10% of the weaker properties and cherry-pick the stronger ones. It is also tougher for AMT to say "we want to raise the rate 20% on all towers in Missouri." It creates the view that rates can only rise in perpetuity and AMT will get that on all towers.

We have seen master lease agreements for movie theaters, skilled nursing facilities, senior housing, retail store chains, and they are always touted as keeping situations stable with rising fees. However, just looking at the history of EPR and Welltower shows this doesn't always happen. We have seen blocks of leases that had an escalator clause and when it was time to renew, the leases were reset at lower rates. Think of rent rising from $100 to $120 over time, then renewal resets the base rent to $80 again. We have seen give-and-take where landlords are required to make capital improvements to some properties, remove several others – and rent is flat but the tenant agrees to a 7-year lease instead of a 5-year deal. Either way, the ROI to the landlord declines on some properties.

Leases on towers renew every 5-10 years. There's no incentive for the wireless companies to push the tower companies out of business but what we worry about is if they argue that some of the operating leverage at the tower companies should rebate back to the wireless companies? AMT warns of this risk in its 10-K – that customers can share assets and result in lower rent to AMT.

> *"In addition, extensive sharing of site infrastructure, roaming or resale arrangements among wireless service providers, including due to increases in advanced network technology such as 5G, as an alternative to leasing our communications sites, without compensation to us, may cause new lease activity*

to slow if carriers utilize shared equipment rather than deploy new equipment, or may result in the decommissioning of equipment on certain existing sites because portions of the tenants' networks may become redundant."

This is what the T-Mobile/Sprint merger is causing. T-Mobile expects to deactivate and remove a considerable amount of Sprint equipment on towers because they are redundant. T-Mobile has a Master Lease Agreement with AMT too. AMT is forecasting years of heavy churn from this starting in 4Q21 and much of the rest in 2022. They see $375 million of lost revenue coming.

"Additionally, we expect that our churn rate in our U.S. & Canada property segment will be elevated for a period of several years due to contractual lease cancellations and non-renewals by T-Mobile, including legacy Sprint Corporation leases, pursuant to the terms of the T-Mobile MLA signed in September 2020."

The three domestic carriers are $4 billion in revenues to AMT per year and those carriers are looking for $200 million in cost savings. T-Mobile is already looking at the tower situation as a place to reduce costs. AMT runs around touting colocation on towers as the key to riches – its customers have to be aware of this presentation page:

Tower ROI	**1 Tenant**	**2 Tenants**	**3 Tenants**
Cost of Tower	$275,000		
Tenant Rev.	$20,000	$50,000	$80,000
Expenses	$12,000	$13,000	$14,000
Margin	$8,000	$37,000	$66,000
Gross Margin	40%	74%	83%
Margin conversion rate		97%	97%
ROI	3%	13%	24%

- What if the wireless companies start to negotiate that they should all pay a $20,000 price? That drops revenue 25% to $60,000 and ROI falls to 17%.

- What if the wireless companies want to split of the ROI > 15% rebated back to them?

This is not an overnight issue and it may never occur in a meaningful way. But just as higher revenues come with minimal incremental cost – there aren't many expenses to cut if the revenues decline either. The customers want AMT's balance sheet to continue to finance towers so we are not predicting an end of tower demand or deals that bleed AMT dry. Big customers often like to use their buying power to negotiate better deals is what we are saying.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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