BEHIND
THE NUMBERS
Quality of Earnings Analysis
October 4, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Crown Castle International Corp. (CCI)
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 CCI at 4- (Acceptable).

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

Summary

Crown Castle International (CCI) is another cell tower REIT and we recommend readers review our EQ report on American Tower (AMT) too. CCI has many of the same issues and we will cover them more briefly here.

CCI is paying a higher dividend yield of 3.1% and based on AFFO guidance – it pays out 77% of AFFO for the dividend. Its cost of capital is the 3.1% dividend and effectively 3.2% on the debt. This is higher than AMT at 1.7% and 2.4%. CCI results are much more mixed with more earnings misses than beats. For its $26.5 billion in gross equipment assets – it is reporting that maintenance capital spending is a mere 0.3% of assets and going down. We think this inflates AFFO. AMT's sustaining capital spending is routinely 0.8%-0.9%, which we still thought was too low. At 0.9% sustainable capital spending, CCI would be reporting AFFO per share of 9.4-cents lower per quarter. CCI also did not adjust for a one-time payment from T-Mobile to eliminate Sprint equipment in 4Q20. This was a $308 million payment which netted to $286 million. In 4Q20, CCI beat forecasts by 67-cents, with 66-cents coming from this area.

With the exception of some capital spending issues, there is not much in the accounting that has immediate concern for us with CCI. The primary reason for the minus sign in the 4- rating is we could envision higher growth capital spending and CCI will likely borrow that money and debt is already 5.1x EBITDA.

What is strong?

- Although it began operations with a series of large tower acquisitions, CCI has not made a meaningful acquisition since 2017. Thus its growth is largely organic in terms of new construction, co-location of adding more tenants to existing assets, and built-in rent escalators. Cash from operations covers the dividend and a large percentage of the growth capital spending. Also, CCI has seen its ROI consistently improve since 2017.

	1H21	2020	2019	2018	2017	2016	2015
ROI	10.9%	10.5%	10.1%	9.6%	9.1%	8.8%	8.6%
CFO	$1,371	$3,055	$2,698	$2,500	$2,044	$1,782	$1,794
Dividend	$1,163	$2,105	$1,912	$1,782	$1,509	$1,239	$1,116
Cap-Ex	$609	$1,624	$2,057	$1,739	$1,228	$874	$909
Acquisitions	$15	$107	$17	$42	$9,260	$557	$1,102

  CCI would claim that sustaining capital spending would be less than $100 million, thus the cash flow does cover that spending and the dividend. The rising ROI should help support the intangible asset values and CCI adjusts the non-cash straight-line rent out of ROI, which we regard as a positive.

- CCI's debt appears to be in better shape than AMT. Of the $20 billion in debt, only $1.3 billion is floating rate. Maturities are light in 2021 and 2022 with 18% due in 2023 and 15% in 2024. Thus CCI has been able to lower its borrowing costs from 3.85% in 2018 to 3.21% last quarter and those costs may rise slowly going forward. The drop in rates has helped AFFO rise by $128.5 million or 30-cents per share annually. We also like that CCI's debt and revenues are in the same currency. Thus it will not have FX issues, hedging costs, and potential issues should emerging market currencies fall against the dollar.

- The SEC has ended its investigation into CCI's capitalization of expenses for tenant upgrades. The policy looked standard to us where CCI capitalizes new investments in existing towers to add capacity and depreciates it over time. This included materials and labor. The SEC finished its review of the policy in January 2021 and took no action.

What is weak?

- Sustaining Capital Expenditures appear too low to us. The definition of AFFO includes a deduction for some maintenance capital spending. When we see the gross PP&E at CCI of $26.5 billion and it is spending less than $100 million per year and declining – it looks far too low in our view.

	1H21	1H20	2020	2019	2018
Sus. Cap-Ex	$36	$44	$86	$117	$105
AFFO	$1,479	$1,202	$2,878	$2,376	$2,228

  Much like we said with AMT, CCI's growth model, its popularity with customers, and valuation multiples of 25x EBITDA and 25x AFFO requires it to improve its existing infrastructure as well as build new towers. CCI does not break down its discretionary spending between new builds and improvements to existing assets. We believe this type of spending also helps support the $4.2 billion of customer intangible assets. As we noted in the summary above, AMT is spending nearly 3x the amount for sustainable capital expenditures as a percentage of gross PP&E as CCI (0.8% for AMT vs. 0.3% for CCI). And we saw that redevelopment spending at AMT that enables it to add more tenants to existing towers is another 1.0% of spending.

  If we adjust CCI to a spending level of 140-180bp for this type of spending, it would make necessary spending about $300-$400 million higher per year. That would reduce AFFO per share by 69-92 cents. Right now guidance is for AFFO of about $6.85 against the dividend of $5.32. The dividend would still be covered but instead of it being 78% of AFFO, it would be closer to 90%.

- EBITDA and AFFO in 2020 included a significant one-time item. With the merger of T-Mobile and Sprint, T-Mobile is going to deactivate a significant amount of duplicate Sprint equipment on wireless towers. CCI was paid $308 million in 4Q20 by T-Mobile to cancel sprint contracts. Another $54 million came in during the rest of 2020. This $362 million netted out to $286 million after some other expenses and was recorded as other income on the income statement. This was cash, but it certainly is a one-time item. CCI disclosed all this and noted it should be viewed as a one-time event. In 2020, this was 7.7% of EBITDA and 9.9% of AFFO.

- As noted above, CCI has not made large acquisitions for several years. However, past deals included some contracts that were signed below market rates. The company sets up deferred revenue for the difference between fair value and cash flow which are amortized over time into revenues. On the positive side, the annual adjustment is getting smaller over time:

	2022e	2021e	2020	2019	2018
Below Mrk Adj	$48	$53	$58	$65	$69

  On the negative side, we do not see this being adjusted out of the reported EBITDA or AFFO. It would add 1.6% to EBITDA and 2.0% to AFFO.

- Straight-Line Leases are removed from AFFO and ROI, but not EBITDA. This is the same issue we discussed with AMT for rent escalators. If a lease is signed for 10-years with an automatic rent increase of 3% per year, the total cash flow contracted for is added up and divided by the lease term. The net impact is rent is flat over the term, but the cash flow is lower than rent early on and exceeds rent in later years. There are also straight-line leases with escalators for many ground leases on the expense side. AFFO and ROI only record cash rent and expenses:

	1H21	1H20	2020	2019	2018
S-L Rent	-$35	-$23	-$22	-$80	-$72
S-L Exp.	$39	$40	$83	$93	$90
Net	$4	$17	$61	$13	$18

  On the positive side, this has not been a huge part of EBITDA (only 1.6% in 2020 and essentially nothing in 2021 so far.). Also, given that the expense side has been larger than the rent portion, taking it out would actually boost EBITDA not cut it. However, guidance has this situation flipping in 2021 with Straight-Line Rent rising to a -$97 to -$117 million figure and the expense being $63-$83 million.

- Share count has risen faster of late as CCI converted some preferred stock to common. The share count has grown to 434 million shares in 2021 vs. 415 million in 2018. The preferred shares became 8.8 million common shares and shares issued to employees account for the bulk of the rest. We don't see as much alarm here for the dividend given that the preferred stock was earning a dividend higher than the common. Guidance is for 434 million shares for all of 2021 so the growth may have stopped for now.

What to Watch?

- Capital spending may continue to rise going forward especially with the heavy spending by the wireless carriers. We do not have a problem with CCI classifying some of this as growth spending, but it is likely that it will need to finance more of this with debt or equity.

- CCI also has options to purchase many additional towers that it subleases currently for $8.5 billion. The timing for those potential purchases does not begin until 2032. However, these are with AT&T and T-Mobile, who are long-time customers. It would not be a shock if those companies wanted to raise some additional capital sooner rather than later and seek to rework terms of the option to allow CCI to purchase them early. The company would likely need to finance this purchase with additional debt and it is unclear how much more cash flow would rise given that it already collects some rent on those towers.

- Just like American Tower, we believe the wireless companies will focus more on controlling their own costs and try to push back on annual rent escalations for towers or reset rents at lower rates upon renewal with CCI. We are basing this solely on the notion that the mobile carriers are 76% of CCI's revenue so they should have some power in pressuring a supplier. Also, the tower companies post a much higher ROI as they get additional equipment installed on the same tower with minimal added expense – that additional business is coming from the same wireless companies we think could push to have some of that additional ROI rebated back to them.

- Net Debt is at 5.1x EBITDA for CCI, which is using 2Q21's EBITDA * 4 for the denominator. That would exclude the one-time T-mobile payments of 2020. The straight-line rent had a minimal impact on EBITDA in 2Q21 and the below-market leases also may have only impacted EBITDA by about 1%. Those are all positives. The debt covenant requires net debt to remain below 6.5x EBITDA. Without acquisitions, the debt figure is rising from growth capital spending, but that looks manageable.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.