BEHIND
THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

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AT&T Inc. (T)
Earnings Quality Update- 6/20 Qtr.

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

We are maintaining our earnings quality rating of T at 4+ (Acceptable).

We also leave T on our Top Buy list.

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

Summary

AT&T beat estimates by 9-cents in 2Q21. We had believed that 2021 forecasts appeared too low and after beating forecasts in both 1Q and now 2Q, AT&T raised guidance. Guidance for revenue growth of 1% has been increased to 2%-3%. Adjusted EPS was expected to be flat and now is expected to grow at low-mid-single digits. Free cash flow is also expected to come in about $1 billion higher.

The earnings beat looks solid. T reported that it did capitalize about $250 million of interest expense related to its $23 billion spectrum buy. That helped EPS by just under 3-cents. This interest will become an expense when the spectrum is put into use, so this helper to EPS should decline going forward.

It is also worth noting that closing on the sale of DirecTV has been sped up to August. As a result, AT&T will lose about $1 billion in EBITDA from not owning 100% of DirecTV for the last 5-months of the year. That will be replaced with $1.0-$1.2 billion in higher equity income which will be largely non-cash. That effectively will mean the free cash flow guidance will be about $1 billion lower as AT&T loses EBITDA and loses some interest expense more quickly than forecast. That would effectively make Free Cash Flow forecast the same $26 billion as before the guidance raise.

The flurry of asset sales/mergers continues with first DirecTV, Warner Media, and now Vrio and perhaps Xandr. All of this should make 2021 a messy year on the GAAP earnings front. The three things to keep in mind here are:

- The proceeds from all these sales should retire debt and result in lower interest expense in 2022 and beyond. As we noted after 1Q21 – we believed the company could exceed its debt reduction goal of $15 billion this year from Free Cash Flow after the dividend and from asset sales. It appears on track to beat that target already after the guidance raise and the Vrio deal.

- WarnerMedia will also take another $43 billion in debt with it when it is spun-off next year. Debt could finish 2022 under $100 billion from the current $168 billion. That could remove about $3 billion in annual interest expense from the picture and should boost free cash flow.

- Through all of this, AT&T is improving its earnings quality. We noted previously the process is enabling AT&T to reduce/eliminate Vendor Financing which clouds the true capital spending figure and boosts free cash flow. (Remember, the $22 billion in capital spending forecast for 2021 includes paying $4 billion in Vendor Financing which is effectively prior-year debt. That should help total cash flow in 2022 and beyond). Plus, the largest adjustments between GAAP and non-GAAP EPS have been related to ignoring the amortization of intangibles:

	2Q21	1Q21	4Q20	3Q20
GAAP EPS	$0.21	$1.04	-$1.95	$0.39
Impairments	$0.52		$2.02	$0.01
Amortz Intangibles	$0.12	$0.12	$0.22	$0.22
Actuarial Loss/(Gain)	$0.02	-$0.30	$0.43	$0.01
Other and Debt Refi	$0.02	$0.02	$0.04	$0.13
Taxes	-	-$0.02	-$0.01	-
NonGAAP EPS	$0.89	$0.86	$0.75	$0.76

The impairments are from selling DirecTV and Vrio. Selling assets at a loss is certainly the weakest way to remove amortization, but with the Warner spin-off, much of the remaining 12-cents in amortization should be gone too. Employee separation and changing pension assumptions with moves in interest rates created the issues with actuarial gains and losses in 4Q and 1Q – otherwise, that is tame. Heavy debt refinancing with lower interest rates is another one-time item that is otherwise a low expense. AT&T could emerge from all of this with GAAP and non-GAAP EPS only differing by a few cents with smaller one-time items.

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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