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Contents

Mondelez International (MDLZ) 3Q'19 Update Downgrade to SELL

We are lowering our Rating on MDLZ to a SELL after 3Q19 results and a target price of $40. We see an expensive stock at 21x forward EPS, trading for 16-18x EBITDA (depending on whether an investor includes or subtracts the equity investments in coffee) that has many signs pointing to weaker growth. For example, the company is cheering that is has reported 4.2% organic growth (before FX) in 3Q19 and YTD, yet just "raised" its forecast for the year to 3.5%. It just reported 10% EPS growth last quarter adjusted for one-time items and FX and 11% YTD and now is expecting 5%-7% growth for the year.

The company appears overly dependent on pricing yet wants to grow by entering more club and discount stores in the US. Overall, we are seeing several areas that are decelerating and becoming headwinds that will hinder past modes of growth. With debt at 3.4x EBITDA the balance sheet is not amazing and as we noted in our March 1, 2019 issue – MDLZ has been restructuring continuously since the year 2000. Readers may want to return to that report to see some of the history as MDLZ continues to report more one-time items for what is now called the Simplify to Grow Program. We do not discuss their one-time items in this report, it looks like all the other programs MDLZ has been a part of over two decades.

- FX is a constant drag on EPS growth and is becoming a larger problem again. Yet, the company insists on adding it back. Just including FX in the mix cuts YTD EPS growth from 11.2% to 3.9%.

- Revenue with FX vs. Constant Currency has shown a widening spread in recent quarters. We see the FX issue hurting MDLZ in all regions of the world except North America. The strong dollar is also hurting its biggest goal – taking pricing.

- A huge issue that we have with the Constant Currency reporting is hyperinflation in Argentina is making Latin America look like MDLZ's strongest and fastest-growing market. That doesn't pass the smell test and looking deeper, the difference between the reported negative revenue growth and adjusted constant currency growth is stark.

- Latin America at only 12% of total sales but is also adding a full percentage point to world-wide pricing change.

- Operating income growth adjusted for one-time items and pre-FX has already slowed from 20% in 2016 and 9% in 2017 to 6% and 4% in 2018 and 2019. Take out just the FX adjustment and operating income growth is now negative. This is a company that is expected to boost growth.

- The Coffee Equity Investments are providing a sizeable amount of reported (not adjusted) EPS – about 11%. They have had years of decent growth too before posting negative growth in 2019. This looks like another headwind and a large percentage of these earnings are non-cash.

- MDLZ has been driving EPS growth with share repurchases. The problem is with the stock price increasing – more options are being exercised and diluting the shares. At the same time, the spending on repurchases doesn't buy as many shares.

- We question if $2 billion+ in annual repurchases is still doable. The company's $1.6 billion dividend consumes 60% of free cash flow now, it's already cut capital spending, and the cash pulled from working capital in 2018 has now stalled and reversed in some areas.

- We also question if retiring stock with a pretax cost of capital at 2.8% makes sense vs. retiring debt or investing more in the company. Without repurchases, EPS growth falls about 2%-3% in this area too.

MDLZ Is Adding Back FX to EPS Even Though It is a Common Expense

In the last 5-6 years, FX has been as much as a 33-cent drag on EPS in 2015. It was 14-cents in 2014. It was fairly benign in 2016-18, but has accelerated considerably in 2019:

	9 mths 19	9 mths 18	2018	2017	2016
Adj EPS pre-FX	$1.99	$1.79	$2.46	$2.14	$1.84
Growth	11.2%		15.0%	16.3%	25.5%
FX impact	-$0.13		-$0.03	$0.01	-$0.06
Growth after FX	3.9%		13.6%	16.8%	21.6%

It is still not back to global crisis levels, but MDLZ is claiming its growth is 11.2% and really it is 3.9% after adding back all the other one-time charges. Also, look at the difference in operating income growth rates with and without FX impacts:

	9 mths 19	9 mths 18	2018	2017	2016
Op Income pre-FX	$3,348	$3,211	$4,578	$4,116	$3,773
Growth	4.3%		6.2%	9.1%	19.8%
FX impact	$185		$257	$3	$171
Growth after FX	-1.5%		4.9%	9.2%	14.7%

The basic business without one-time charges hasn't grown at 10% in years now. It is reporting negative growth with FX impacts being taken into account. We also do not think FX should be added back because this isn't only the US Dollar vs the Yen or Euro. About 40% of the business is to places like Russia, Ukraine, Turkey, Argentina… Places with some bigger problems that may well continue reporting sizeable FX losses.

We consider this a real expense and it quickly cuts the reported growth rate of the business in half or to negative levels.

Argentina and Latin America Reporting is Unrealistic without FX

The company reports organic growth as being the combination of price increases and volume growth. It is touting its ability to take pricing as a sign of strong demand and growth for snacks. However, in Latin America, MDLZ is dealing with Argentina in hyperinflation. It is getting huge price increases. Suddenly, here is Latin America as the strongest market MDLZ serves.

Pricing Gains	3Q19	YTD 19
Latin America	8.9%	10.0%
A/ME/A	1.7%	1.5%
Europe	0.3%	0.2%
N. America	1.9%	2.5%
Reported Growth	2.1%	2.3%
Take out L.A.	1.2%	1.2%

So, if you strip Latin America out of the mix with the hyperinflation – the pricing power gets cut in half. What makes that more amazing is Latin America is only 12% of sales at MDLZ.

The other absurdity to this is while pricing is telling investors this is a strong growth market – the volume figures are showing that it stinks, and the FX hit below the actual growth line shows the organic growth becomes negative rapidly after FX. Latin America lost 14.7% of its sales to FX alone.

Vol/FX	3Q19 V	YTD19 V	3Q19 FX	YTD19 FX
Latin America	-4.6%	-2.1%	-9.2%	-14.7%
A/ME/A	3.6%	3.9%	-3.8%	-5.1%
Europe	4.7%	3.6%	-4.3%	-6.4%
N. America	0.6%	-0.7%	1.4%	0.9%
Reported Growth	2.1%	1.9%	-3.1%	-5.3%

We addressed this issue in-depth in our June 13, 2019 issue. The FX issue we see here is the spread is widening between reported revenue and revenue adjusted to constant currency. The swing is 3-5 percentage points:

	3Q19	YTD 19	2018	2017
Sales Growth	1.1%	-1.1%	0.2%	-0.1%
CC Sales Growth	4.2%	4.2%	2.4%	0.9%

We also think it is important to notice that the strong dollar and competition is denying MDLZ much pricing power in Europe where it is dealing with some more developed countries. Also, the FX hits are not coming from just Latin America. FX is almost completely offsetting the positive volume gains in Asia/Middle East/Africa and Europe.

Coffee JVs Were Providing EPS Growth at MDLZ – That has turned Negative in 2019

We have talked about it in past reports, but MDLZ deconsolidated its coffee business in 2015 and became an equity holder in Jacob Douwe Egberts. In March of 2016, MDLZ exchanged part of its interest in JDE to Keurig Green Mountain as the latter was acquired. This set the value of MDLZ's stake in Keurig Green Mountain at $2 billion consisting of $1.6 billion in equity and $0.4 billion in a loan receivable. In July 2018 Keurig merged with Dr. Pepper Snapple and MDLZ recorded a $778 million gain on the transaction. The Keurig stake is worth about $5.4 billion these days.

We think it is important for investors to recognize that even adding back all the restructuring charges and impairment charges to MDLZ's operating income figures before all the tax law changes – there isn't much growth here and the growth rate is falling:

	9 mths 19	9 mths 18	2018	2017	2016
Adj Op. Income	3163.0	3211.0	4321.0	4119.0	$3,973
y/y Growth	-1.5%		4.9%	9.2%	14.7%

What else has been helping drive EPS growth of 10%+? It's the coffee equity earnings! Most of these are non-cash:

	9 mths 19	9 mths 18	2018	2017	2016
Equity Gains	-$2	$757	$778	$40	$43
Equity Income	$337	$399	$548	$344	$262
Cash Received	$217	$151	$180	$152	$75
% EQ income in cash	64%	38%	33%	44%	29%

When looking at reported EPS – not the adjusted figures – the size of this income is substantial. We will ignore the large gain from merging with Dr. Pepper Snapple and just focus on the Equity income amounts:

	9 mths 19	9 mths 18	2018	2017	2016
Equity Income/Share	$0.23	$0.27	$0.37	$0.22	$0.17
Reported EPS	$2.15	$1.72	$2.28	$1.85	$1.04
% of Reported EPS	11%	16%	16%	12%	16%

MDLZ pulls out part of this income when they compute adjusted EPS. However, we think it is important to recognize this has been a very volatile part of earnings that is now decreasing – it has added 5-15 cents at times and now is a 4 cent drag. At the same time, the KDP is not the only part of the equity investments, but it has been paying a $0.60 annual dividend. That is roughly $116 million in cash flow for MDLZ and is already included in the cash flow.

EPS Growth Is Getting a Boost from Stock Repurchases

Repurchases on EPS	9 mths 19	9 mths 18	9 mths 17	2018	2017	2016
Share Count	1459	1491	1537	1486	1531	1573
Adj. EPS with FX hit	$1.86	$1.79	$1.58	$2.43	$2.14	$1.84
EPS Growth	3.9%	13.3%	10.6%	13.6%	16.3%	21.6%
EPS from Repo	$0.04	$0.05	$0.04	$0.07	$0.05	$0.08
EPS Growth w/o Repo	1.7%	10.1%	7.7%	10.3%	13.6%	16.3%

EPS growth is plummeting in 2019 and yet is still be helped considering the share count is falling to help drive results further. Even the share count tailwind is shrinking at only 2.2% of EPS growth in 2019 so far vs. years of being over 3%.

We have a long history of both praising and criticizing stock repurchases. It really comes down to three points for us:

- Is the stock cheap? Low P/E vs. growth rate, low Price/EBITDA, High Dividend Yield?
- Is the share count falling – or are tons of shares being issued to management at the same time and muting the impact?
- Does the cost of capital and opportunity cost make sense? – Is the company borrowing at 4% to buy back pre-tax 7% dividend cost of capital? Are there other avenues of 15%-20% ROI that money is better spent on the business?

In our view, MDLZ is not a cheap stock. The dividend yield is only 2.2% and the pre-tax yield is 2.8%. The P/E ratio is essentially 20 with low-single-digit growth at best, at 17.8x EBITDA (or 16.4x assuming the sale of the coffee investments) – the case cannot be made that buying all the stock makes sense as the ROI would be in the 5%s on EBITDA.

Is MDLZ simply trying to prevent dilution of management stock options? Are they issuing shares almost as rapidly as they are buying them back? We think the answer to that is yes, especially issuing shares at a discount and buying them back at a premium:

	9 mths 19	2018	2017	2016
Shares Bought	24.0	47.3	50.6	62.0
Price Paid	$47.21	$42.18	$43.51	$41.97
Shares Issued	13.7	10.1	10.4	10.3
Issue Price	$27.46	$25.16	$26.17	$24.09

This concerning because even though the share count is dropping, the company is buying back less stock now as the stock price rises for the first time in years. Also, they are dealing with greater dilution with the higher stock price too. It used to be that to prevent dilution – it had to buy back 10 million shares for a net $17-$18. Or $170-$180 million. This year, the cost may be closer to $320 million.

The cost of capital issue causes us to think the share repurchases also make little sense. At the end of 2018, MDLZ said their weighted cost of borrowing was 2.3% largely because of their use of commercial paper. The biggest part of their bond borrowing was happening at 3.4% and that borrowing was increasing. So, they are borrowing at 3.4%, to retire equity with a pretax cost of capital of 2.8%. Not that the pension shortfall is alarming at just over $1 billion, but MDLZ could be earning 4.8% on pension funding vs. the 2.8% to retire the stock. Listening to management, they see great opportunities for new products, new markets, new distribution systems – the returns there are likely much higher than 2.8% also.

We also Question if MDLZ Can Afford Past Rates of Repurchases

On the surface, free cash flow does not cover the dividend and the repurchases:

	9 mths 19	9 mths 18	2018	2017	2016
CFO	$1,882	$1,885	$3,948	$2,593	$2,838
Cap-EX	$686	$810	$1,095	$1,014	$1,224
FCF	$1,196	$1,075	$2,853	$1,579	$1,614
Acquisitions	$284	$0	$528	$0	$246
Dividends	$1,131	$980	$1,359	$1,198	$1,094
Repurchase	$1,143	$1,650	$2,020	$2,174	$2,601
Dividends % FCF	95%	91%	48%	76%	68%
Repuchase % FCF	96%	153%	71%	138%	161%

The dividends and repurchases routinely add up to more than 100% of FCF. At the same time, the company makes some modest acquisitions to add to growth prospects too. They have already cut capital spending as well. **The current dividend rate is over $1.6 billion per year.**

It gets worse than that. We noted in 2018 that MDLZ was helping cash flow by pulling cash out of working capital. It was factoring receivables, stretching payables and limiting inventory growth. This produced $386 million in cash flow in 2016 and $128 million in 2018. We thought it looked stretched already and in 2019, this source of cash flow has reversed. (We will note that seasonality normally makes working capital increase in 3Q and some of that is reversed into cash flow in 4Q). But, thus far in 2019, working capital has been a $1.3 billion drag on cash flow vs. $1.1 billion in 9-months of 2018:

	3Q19	2Q19	1Q19	4Q18
DSO Trade A/R + Factored	47.2	43.5	50.1	41.5
DSO Factored A/R	10.7	10.7	11.3	11.0
DSI Inventory	65.2	69.4	60.6	56.0
DSP A/P	126.5	134.9	128.7	125.2

	3Q18	2Q18	1Q18	4Q17
DSO Trade A/R + Factored	50.8	46.8	53.7	46.3
DSO Factored A/R	11.2	10.7	11.7	11.0
DSI Inventory	66.9	68.5	61.1	54.3
DSP A/P	126.6	134.1	133.4	120.7

	3Q17	2Q17	1Q17	4Q16
DSO Trade A/R + Factored	50.7	45.6	52.1	43.9
DSO Factored A/R	9.1	9.1	9.0	8.7
DSI Inventory	63.7	67.3	61.0	53.9
DSP A/P	117.8	124.5	114.7	116.1

The size of factored receivables has stalled at this point and is not providing cash. Total trade receivables DSO's are still dropping about 3 days and helping cash flow. Inventory has been rising slightly and payables are now flat. **The net-net of working capital makes us believe this is not going to be a source of cash flow going forward. We think the company has confirmed this with guidance for $2.8 billion in free cash flow for 2019. That is basically flat with 2018.** However, 2018 gained pulled in $128 million from working capital. To make $2.8 billion in 2019, MDLZ is cutting capital spending by $100 million.

MDLZ has helped plug the funding shortfall with asset sales and divestitures, which total $1.8 billion from 2016-3Q19. They spent $1.1 billion on smaller acquisitions so they netted about $700 million over the nearly 4-years. The problem here is the cash from asset sales is getting smaller – it normally is about $100 million per year. Divestitures hurt growth too.

We pointed out in earlier reports that MDLZ was gaining earnings and cash flow by cutting advertising and posting basically flat R&D:

	2018	2017	2016
Advertising	$1,173	$1,248	$1,396
R&D	$362	$366	$376
Sales	$25,938	$25,896	$25,923

The company's last earnings call talked about investing more in those areas going forward. If that is true, it should become a drag on cash flow rather than a tailwind.

So, let's summarize this – Base FCF is $2.8 billion. Earnings are growing at less than 2%, working capital may be a drag on FCF especially seeing the factoring stall between $700-$800 million, Advertising should be a drag, and if capital spending stops falling – it will be a drag. Out of that flat to lower FCF figure, MDLZ is paying over $1.6 billion in dividends (almost 60% payout ratio), and it has to buy at least $300 million in stock to prevent dilution. However, investors are conditioned to expect over $2 billion in annual repurchases, so $1.7 billion in incremental purchases, but the company only has $850 million in cash flow left. That leaves two options- buy much less stock and hurt EPS growth or borrow the money.

Debt is currently $18 billion and 3.4x trailing EBITDA. Debt has already been steadily advancing too. It was $15.3 billion at the end of 2016.

AT&T (T) 3Q19 Update
Maintain (BUY)

We are maintaining our BUY recommendation after 3Q19 results. The company laid out the case we've been making very well. Essentially, AT&T generates a very sizeable amount of cash flow and its capital spending has been elevated as it built out Fiber, the LTE network in Mexico and the 5G network with FirstNet in the US. Going forward, plans for capital spending to decline as free cash flow is forecast to rise above $30 billion by 2022 appear very conservative to us and will drive higher dividends and share repurchases.

For quarterly results themselves, AT&T beat by $0.02 on adjusted EPS that added back a large pension adjustment. The market always focuses on DirecTV subscriber figures and the company has guided to much of the churn that occurred over the last year as they raised prices on customers who were rolling off a discount plan. What continues to go unnoticed by the market is AT&T has raised DirecTV pricing by $9/month per average subscriber during this process. That allowed EBITDA at the Entertainment Unit to remain flat to higher y/y and revenue flat for three quarters now. We still see DirecTV as a minor part of this story at about 6-7% of total EBITDA and the company is now past the bulk of the discount-customer contract-renewals. AT&T is introducing its new streaming video offering, HBO Max, in 2020. We are not going to make many comments on that beyond saying that the cost to roll it out is built into the forecasts they have laid out for the next three years, and we still believe forecasts are conservative. Mobility remains over half of total EBITDA and that continues to add customers even before 5G is fully rolled out.

- **AT&T laid out plans to produce free cash flow of $28 billion, $29 billion and then $30-32 billion from 2020-2022. Of that $90 billion forecast, it plans to spend $30 billion to repurchase essentially 10%-11% of its stock and pay $45 billion in dividends**. And, an additional $5-$10 billion in asset monetization in 2020 will further lower debt levels.

- **Capital spending will remain about $20 billion, but that is lower than the last two years – which will help grow free cash flow. In addition, AT&T debt peaked at $177 billion following the Time Warner deal – it will be $150 billion by the end of this year**

and likely about $140 billion before 2020 is completed. Net of taxes, the reduced interest expense will add about $1.2-$1.4 billion to free cash flow.

- **AT&T also is forecasting $6 billion in higher EBITDA by 2022 from the $60 billion in 2019. This will be driven by 1%-2% annual revenue growth**, which will raise revenues above $190 billion. At current margins, that would add about $2.7 billion to EBITDA. It also expects to have all Warner synergies in place, higher profit levels in mobility and Mexico. That should help by 200bp in margin from 33% to 35% and that would add over $3 billion more in EBITDA and should also help free cash flow.

- **The net result should be a growing dividend from the current rate of 5.4%, EPS growth of 7%-10%, share repurchases driving over 40% of the EPS growth, all for a forward P/E of about 8x. This still looks like a cheap stock.**

- **Adjusted EPS rose by 4-cents in 3Q19 and beat by 2-cents. The major adjustment is amortizing actuarial pension losses into income amounting to 21-cents in 3Q.** This was triggered by offering many employees leaving in 2019 a lump-sum pension distribution. That, in turn, set AT&T up to pay out more in distributions than the service and interest cost. That requires a remeasurement of PBO each quarter for 2019 and losses to be realized. We see this as a one-time item for 2019 and AT&T's pension is well-funded.

- **AT&T is also adding back the amortization of intangibles from the Time Warner deal in adjusted EPS.** A positive is they allocated 60% of intangibles into accounts that will be amortized. The company is also rapidly amortizing key parts of those intangibles. The quarterly cost has already dropped from 25-cents in 3Q18 to 19-cents in 3Q19. We can see it declining to under 10-cents fairly quickly. This is a non-cash expense. Adding it back is actually slowing EPS growth.

Free Cash Flow Forecasts for 2020-2022

AT&T is looking at cash flow forecasts rising about $1 billion per year for the next three years with 2022 perhaps growing to as high as $32 billion. We do not believe this is very aggressive at all:

	2022e	2021e	2020e	2019e
FCF in billions	$30-$32	$29	$28	$28

The first adjustment is 2019's securitization of Warner receivables for $2.6 billion. That could increase going forward, but let's consider that a one-time event. Thus, the easy way to get to flat Free Cash Flow in 2020 is to have Capital Spending decline. We have talked about this in the past. AT&T was accelerating its 5G build-out to save money overall while it built out the FirstNet infrastructure and making one-stop per wireless tower. It also was investing to complete the LTE network in Mexico and fiber buildout. Capital spending is expected to decline in 2020, to $20 billion from $23 billion in 2019 - more than enough to generate flat free cash flow without receivables securitization. (It should also be pointed out that the $23 billion in 2019 will include about $3 billion in capital spending that was accounted for as vendor financing and went through the financing section rather than the investing section of cash flow). But essentially – remove $2.6 billion from securitization and about $3.0 billion in capital spending and free cash flow is flat in 2020 from 2019 on estimates.

We believe these forecasts could be low because AT&T has paid down a considerable amount of debt. The net debt level should be $150 billion to end 2019. That is down from $177 billion following the Time Warner deal. At 4.0-4.5% interest, that $27 billion is $1.1-1.2 billion in lower expense. Net of tax of the tax shield, it's a $850-$960 million positive to free cash flow.

$6 billion of the $27 billion was paid down before 2019 and the rest during 2019 – so AT&T will not see the full benefit from 2019 to 2020. The company's debt goals are to be at 2.0-2.25x EBITDA of $66 billion by 2022 – which would put AT&T at about $140 billion in debt. It plans to pay down as much as $10 billion in 2020 with more asset monetization and that would hit the $140 billion level. That would reduce interest expense net of the tax shield by another $300-$350 million. In our view, AT&T is picking up well over $1 billion in additional free cash flow just from this area too.

What is key to us is the interest savings and the lower capital spending are already largely baked in and there should be minimal risk to beating free cash flow forecasts just with these two areas.

Next, AT&T sees Revenue Growth, Cost Savings, and Synergies

The company is reporting it is on-track to produce $2.5 billion in cost and revenue synergies from Warner. The $1.5 billion in cost synergies represents about 400bp improvement in Warner EBITDA margins. The $1.0 billion in revenue synergies is largely tied to better advertising rates by targeting better fitting commercials for the Turner network. The company sees these synergies fully in place by the end of 2021 and some of the returns can be seen now in Xandr growth.

As it rolls out HBO Max, AT&T is projecting costs of as much as $2 billion in 2020 that will decline to about $1 billion per year in 2021 and 2021. For 2020, the lower interest expense will be necessary to cover this goal along with some of the cost synergies coming through. AT&T has called out the synergy offset as what will pay for much of HBO Max's rollout. **In 2020, is where the greatest risk arises as the synergies will build through the year but the initial spending on HBO Max will be the highest in 2020.**

Plus, the company is projecting 1%-2% revenue growth per year from 2019-2022. That would add $1.8-$3.6 billion in revenue and it amounts to $0.6-$1.2 billion in EBITDA at current 33% margins or $475-$950 million in earnings, which would move to free cash flow. Some of that revenue growth should come from turning on 5G and also selling more equipment as well as HBO Max gaining new customers. It appears that HBO Max will also be used as a loss-leader to sign up more customers for HBO, premium wireless, and broadband customers – all of whom will get HBO Max for free. Others will pay $14.99 per month for HBO Max. Those customer pick-ups will offset HBO Max costs.

We think it is important to note that AT&T is not forecasting a turnaround in legacy businesses like DirecTV or landline phones (DirecTV subscribers may also benefit from getting HBO Max for free via being an HBO subscriber). The 1%-2% total revenue growth is expected to be net of further decay in these areas in the Entertainment unit. Forecasting growth from 5G, equipment sales, and higher broadband usage to replace more of the business wireline and landline residential does not seem like a major stretch to us. Nor does a 1%-2% CAGR for 3-years. **We think investors should also focus on the fact that the legacy units are not nearly the drag many are being led to believe:**

Entertainment	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
EBITDA	$2,620	$2,821	$2,434	$2,155	$2,801	$2,853	$2,400
ARPU Premium TV	$112.45	$112.19	$114.90	$121.76	$114.98	$117.49	$121.35
ARPU IP Broadband	$46.27	$48.32	$49.78	$49.83	$50.10	$50.82	$51.21
EBITDA Margin	22.9%	24.6%	21.0%	18.0%	24.7%	25.1%	21.4%

The Entertainment Group includes DirecTV, Streaming TV, Broadband Internet, Residential landlines, and equipment leasing. The total is roughly $10 billion per year in EBITDA for this collection of business units.

Everyone will point to falling customer totals for DirecTV and landlines as evidence of major decay. What they are not pointing out as frequently is **the success AT&T has had raising prices in both DirecTV and Broadband even though that meant culling off lower margin customers**. Pricing is up 6% and 3% y/y for each. **Nor are people pointing out that total quarterly EBITDA has been flat to up in every quarter y/y this year.** The company has been successful in pulling service costs out of the system at the same time it sees customer churn – the result has been expanding margins.

We don't have any illusions that landline phones will continue to decay. We also expect HBO Max to cannibalize more of the current streaming customer base. **AT&T has been very clear that the promotional pricing contracts would be rolling over in 2019 and they expected to see larger than normal churn. They also pointed out that 3Q19 was the peak period for that and churn should slow. Also, worth pointing out is Broadband – especially Fiber Broadband is growing at over a 40% y/y clip** in terms of clients along with rising prices:

Entertainment (000s)	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
DirecTV losses	(187)	(262)	(346)	(391)	(544)	(778)	(1,163)
Fiber Broadband Adds	226	249	300	259	297	318	318
total Fiber Broadband	1,955	2,204	2,504	2,763	3,060	3,378	3,696

There are still 21.5 million DirecTV users, the normal churn rate is about 300,000 per quarter, that's less than 1.5% churn, vs. the 3.3% and 5.1% seen at the height of the discount contract roll-overs. The higher pricing for both DirecTV and Broadband may well offset the loss of customers and hold EBITDA flat to slightly down. The goal is to continue rolling out more broadband and boost customer totals in the area. That could still be a high growth area.

Looking at the Growth Forecasts and Free Cash Flow – there are five major points:

- AT&T is building in higher expenses for HBO Max roll-out and of as much as $2 billion in 2020 and about $1 billion in 2021 and 2022. HBO Max should attract more customers to 5G, Broadband, and regular HBO via HBO Max and offset some of that cost.

- Forecasts have factored in the rest of entertainment as a drag on earnings – even though higher prices at DirecTV helped keep EBITDA flat to positive amid higher than normal churn. Normalized churn rates could further enhance EBITDA with higher pricing.
- Broadband is growing rapidly in customers and pricing. We would expect 5G to be popular in drawing in customers too – especially FirstNet clients onto family plans, which represent millions of additional mobile clients. 1%-2% growth is not that outlandish and represents $0.6-$1.2 billion in additional EBITDA annually against any drag from DirecTV off a $5 billion base figure.
- AT&T is already gaining some of the synergies in additional advertising revenue and some cost savings from the Warner deal. This with modest cost-cutting, has the potential to add billions to EBITDA and free cash flow – that also outweighs the cost of HBO Max and TV decay.
- The interest savings from debt already paid down is generating almost $1 billion in additional free cash flow now.

Shareholders Will Be Rewarded with the Rising Cash Flow

The company's focus will be on returning cash to shareholders with no major acquisitions made. The forecast is expected to be $30 billion to repurchase 11% of the stock along with $45 billion in dividends over the next three years. That already adds some extra cushion because Free Cash Flow is forecast to be $90 billion including the HBO Max roll-out costs.

We believe the company will seek to lower debt a bit further too after 2019 and an ending level of $150 billion that is 2.5x $60 billion in EBITDA. By 2022, they expect to be at 2.0-2.25x EBITDA of $66 billion. That really only requires about $10 billion of additional debt retirement and AT&T believes it will have as much as $10 billion in asset monetization in early 2020.

Extra cushion may also arise with the share repurchases causing the total dividend outlay to decline: Right now, the dividend is $14.9 billion on 7.3 billion shares. Buying back 770 million shares would put the dividend at the current rate of $2.04 at only $13.3 billion. AT&T can either grow the dividend per share by 13% over the next three years and pay out $15 billion or boost it more modestly by 4-cents per year (2% per year) and still have a dividend outlay of $14.1 billion. That would be lower than what they pay now by $800 million. Under either situation, the dividend payout ratio will be under 50% of free cash flow.

The company's plan confirms what we have been noting about the situation – there is a tremendous amount of cash flow generation here. We were impressed that AT&T could pay down $27 billion in debt at the same time it dealt with elevated capital spending levels to build out new infrastructure and the dividend payout was not strained. Now with the exception of rolling out HBO Max, shareholders should enjoy a period of turning more of the infrastructure assets on and seeing rising cash flow and lower capital spending. It's becoming more like a pipeline business for the next several years.

Finally, the company is going to focus on culling more non-essential assets too as well as more cost-cutting. The result of both situations should mean more cash coming into the company for the benefit of shareholders. It should also mean that $4 billion outlay for HBO Max in the next three years has ample cushion to be paid from existing operations without derailing the $75 billion planned to be returned to shareholders.

No one wants us trying to assess the next popular car or TV show. The point we want to make with the future unknown for HBO Max and competition from Apple, Disney, and others over content and pricing is AT&T's cash flow looks more than strong enough to continue paying a significant and rising dividend as well as repurchasing a sizeable amount of stock with ample cushion to spare even if HBO Max is a net loser for a long time. We also believe AT&T's balance sheet will continue to improve going forward in terms of more cash and less debt. Plus, the company itself is forecasting growth even with HBO Max being a net cost to earnings through 2022.

Pensions, Adjustments, and Earnings in 3Q19

With all the news on the 3-year corporate outlook and returning capital shareholders, we don't want to leave out some details about 3Q results overall. The company beat forecasts by $0.02 with adjusted EPS of $0.94. The adjustments are primarily related to amortization of Warner intangibles and pension adjustments:

EPS adjustments	3Q19	3Q18
Reported EPS	$0.50	$0.65
merger costs	$0.02	$0.04
Gain/Losses	$0.02	-$0.04
Amortz Intangibles	$0.19	$0.25
Pension Loss	$0.21	$0.00
Adj. EPS	$0.94	$0.90

We don't have issues with the 4-cents and 2-cents related to some costs for a $130 billion acquisition. They are prepaying debt, laying off some staff, restructuring some deals. We have seen companies take charges that amount to 20% of purchase prices. In 2018, AT&T had $1.77 billion and in 2019 YTD it has been $0.59 billion. That's 1.8% of the deal price. That's very minor in our view.

Also, for a company that has been selling some assets – they booked a small gain last year and a small loss this year on the asset sales. That also looks immaterial and would qualify in our opinion as one-time items.

Amortization of Intangibles stems from the Warner deal. To the company's credit, it booked $57.2 billion into intangibles that will be amortized into earnings against only $38.6 billion in goodwill that will not be amortized. That's a 60%-40% split. That is actually conservative in our view and certainly most assets at Time Warner were intangible in nature: trademarks, film libraries, distribution networks. We give AT&T kudos for amortizing much more of the cost than claiming it has perpetual value.

Next, the TV and film libraries of already released content are showing rapid amortization. The company listed the amortization period over as long as 10.8 years. In 2018, AT&T amortized $3.0 billion of the $10.8 billion it put on the balance sheet. It appears it continued to further rapidly amortize it in 2019. The remaining accounts are:

Intangibles	allocation	amort time	EPS impact/Q
Distribution Network	$18.00	10.0 yrs	$0.06
Trademarks/Tradenames	$18.10	38.6 yrs	$0.02
Other	$10.20	18.8 yrs	$0.06

Based on the 2018 break down and amortization, it appears the "other" intangibles are being amortized about 3x faster than their estimated longest life too. The other intangibles are closely following their amortization lives. The net result is this adjustment to EPS should decline quickly to about $0.14/quarter and the Other could vanish and make an $0.08/quarter adjustment. Given that all of this represents non-cash expense and AT&T is already seeing the quarter amount fall in a material way – we do not mind calling it out as a line item for earnings. We will give AT&T kudos for more rapidly amortizing these assets and expect the quarterly impact to quickly decline to under $0.10 from $0.25 seen in 3Q18. In the bigger picture, AT&T spent real money on these assets just like it does capital spending – but it's not adding back the depreciation on PP&E in adjusted EPS.

The pension adjustment has to do with offering many employees lump-sum distributions of their pensions who were leaving in early 2019. It would also offer the lump-sum calculation based on higher interest rates and longer mortality rates. AT&T does not have a pension funding problem. It came into 2019 with a PBO of $55.4 billion and assets of $51.7 billion – the underfunding is under 7%.

What happened is many people opted to take the deal and that is making pension asset outflows rise. When distributions exceed service and interest costs for the year – AT&T has to remeasure its PBO every quarter for the year. The remeasurement is coming at lower discount rates that ended 2018 at 4.5% and was cut to 3.7% in 2Q19. When the remeasurements occur, it causes them to recognize actuarial gains and losses that were accumulating in "other income."

The result will be an adjustment for each quarter in 2019 and not only is the PBO discount rate falling, so is the interest rate assumption to calculate pension expense. We accept that this a one-time event for 2019 and AT&T is trying to push people into a lumpsum distribution this year when the outflow will be heavy as they trim employees as part of the merger consolidation.

There should be another one-time charge in 4Q too. Here is what has been booked already in 2019:

Pension Actuarial Hit	3Q19	2Q19	1Q19
Total Cost	$1.9b	$1.7b	$0.4b
EPS impact	$0.21	$0.18	$0.05

Stanley Black and Decker (SWK) EQ Update 3Q '19

Current EQ Rating*	Previous EQ Rating
3-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating on SWK to 3- (Minor Concern) from 4- (Acceptable). While the company's inventory situation seems to be improving, we are concerned about the extension of the restructuring actions and the presence of some new red flags noted below.

- SWK announced its latest restructuring program after the third quarter which is expected to produce $200 million in annualized savings by reducing headcount and rationalizing operations. Management indicated this is a proactive response to headwinds from commodity costs, currency impacts, and tariffs. The company expects pretax restructuring charges of $150 million to be recognized primarily in 2019. The 9/19 quarter contained $74 million of restructuring charges, or about 20% of adjusted pretax earnings for the quarter. This is just the latest of the company's announced restructuring plans. While the company has had unusual charges over the last couple of years, we have been more patient than normal given the divestiture of the security business and integration of acquisitions. However, the size of the charges and their ongoing nature are raising our concern level regarding the quality of charge-adjusted earnings figures.

- We have been tracking the rising inventory levels at SWK for several quarters but have not assigned it a high level of concern given the credibility of management's explanation that it was building levels to support the Craftsman Tool rollout. The string of increases finally reversed in the current quarter with DSI declining by 2.4 days versus the year-ago quarter. This reduces our concern in this area.

- SWK's warranty provision increased by 9% in the 9/19 quarter versus the year-ago quarter. However, warranty usage increased at a much faster rate, causing the warranty allowance to fall to 0.68% of trailing sales versus 0.75% a year ago. Restoring the allowance to its previous level would require an approximate 6 cps in provision expense.

- In previous quarters, SWK had built up its accounts receivable allowance to 6.9% of gross receivables from the previous mid-4% range. However, this began to reverse in the 9/19 quarter as provision expense declined by $2.7 million (1.4 cps).

- Undesignated hedges provided a $2 million gain in the 9/19 quarter versus a $5.9 million loss in the year-ago period. These amounts represent hedges which are essentially marked to market every period as opposed to gains or losses reclassified from comprehensive income when the hedged item impacts earnings. We, therefore, consider this a non-operating item which added about 4 cps to earnings in the quarter.

- Pension expense was a $3.4 million expense versus a $1.3 million gain in the year-ago quarter. This swing was an approximate 2.5 cps *drag* on EPS growth in the period.

- Management cited improved working capital performance as a tailwind to cash flow growth in the year-to-date period. As we noted above, inventory DSIs improved by approximately 2.4 days. However, this was more than offset by a 15-day year-over-year decline in days payable. As we noted in previous reviews, the company restarted its accounts receivable sales program in the 12/18 quarter. Receivables sold but outstanding at the end of the quarter totaled $73 million which is a decent approximation of how much incremental cash was generated through the sales over the year-ago period. This alone accounted for a significant portion of the $222 million improvement in operating cash flow during the nine-month period. However, even after adjustment for the derecognized receivables, DSOs fell by approximately 8 days versus the 9/18 quarter. Management did not discuss the movements in payables or receivables in the 10-Q or conference call. We suspect the huge decline in payables was an unusual timing issue, which was offset by the company pushing to collect on receivables. We will be watching for these items to normalize in the next quarter.

Allowance for Warranties Down

SWK's provision expense for warranties rose by 9% in the three months ended 9/19. However, as the following table shows, warranty payments climbed at a much faster pace:

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Warranties and Guarantees Issued	$30.3	$34.3	$28.1	$28.7
Warranty Payments and Currency	-$36.4	-$32.5	-$28.8	-$30.8
Warranty Reserve Ending Balance	$97.1	$103.2	$101.4	$102.1
Warranty % of Trailing 12 Month Sales	0.68%	0.73%	0.72%	0.73%

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Warranties and Guarantees Issued	$27.8	$29.7	$24.2	$28.4
Warranty Payments and Currency	-$27.7	-$32.7	-$25.6	-$28.4
Warranty Reserve Ending Balance	$104.2	$104.1	$107.1	$108.5
Warranty % of Trailing 12 Month Sales	0.75%	0.76%	0.80%	0.84%

Typically, warranty provision and payments track closely in line. However, over the last several quarters, the allowance for warranties as a percentage of trailing 12-month revenue has been slowly declining. The jump in warranty payments in the 9/19 quarter left the allowance percentage at 0.68%. We estimate it would take about 6 cps in charges to boost the reserve back to the 0.75% level. This could represent and unexpected headwind for earnings in upcoming quarters.

Cintas (CTAS) EQ Update 8/19 QTR

Current EQ Rating*	Previous EQ Rating
4+	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating on CTAS to 4+ (Acceptable) given the lapping of the adoption of ASC 606 which, among other impacts, resulted in the capitalization of costs to obtain contracts.

- CTAS reported EPS of $2.32 which topped the consensus estimate by 17 cps. The effective tax rate of 10% was lower than most analysts were likely expecting. CTAS's tax rate can fluctuate considerably due to the impact of stock option exercises and management estimated in the call that the lower rate added about 6 cps which still makes the earnings beat look high quality.

- DSO jumped by just 1.2 days over the year-ago quarter. Note that the impact of the adoption of ASC 606 has now lapped eliminating the need to adjust receivables for a year-over-year comparison. Also gone is the impact of higher amortization of stock-based compensation due to a shortening of the amortization period last year.

- We are monitoring trends in capitalized contracts costs, deferred commissions, and related amortization expense and are all currently trending well.

- The company has ramped up its share buyback in the last three quarters as it has reduced its leverage to its target range after the G&K acquisition. Free cash flow after dividend and buyback was a negative $455 million. The lower share count added over 3% to earnings growth in the period. Management is now talking potential acquisitions again and we would expect cash spend on the buyback to wane in coming quarters.

Fastenal (FAST) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3+ (Minor Concern).

- Accounts receivable days fell by about 1 day in the 9/19 quarter. However, the quarter ended on a Monday this year versus a Sunday last year, allowing one more day for collection. Management stated in the call that after adjusting for the extra day of collection, DSOs would have been up about a half a day. This compares to approximate 2-day year-over-year increases in each of the last two quarters. We noted in our original review that the shift in the customer base to larger national accounts has resulted in the company getting paid more slowly. The company noted in the call that "customers continue to aggressively pursue longer payment terms and withhold payment at quarters-end. We expect growth in our working capital assets to be more modest in the fourth quarter than it was in the third producing another strong cash flow quarter." This will likely remain an issue for the foreseeable future but for now management appears to be minimizing the cash flow drain.

- FAST is also growing its mix of onsite locations which requires a larger investment in inventories. Inventory days of sales jumped by 5.6 days on a year-over-year basis in each of the last two quarters. In the 10-Q, management attributed the increase to an increase in the installed base of vending machines and onsite locations, to increase support levels, and from inflation and tariffs. More color was added in the conference call:

"Inventories were up 13.4% in the third quarter of 2019. Nearly half of this growth related to inventory to support new Onsites. The remainder relates to higher hub inventories. We planned for growth in inventory to slow meaningfully in the fourth quarter as actions taken earlier in 2019 to reduce overseas purchasing in response to slower demand begins to be felt."

We will be watching to see if the inventory increase comes under control in the fourth quarter.

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 Concerns"	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 may 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 the next quarter. 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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