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AT&T (T)- Maintain BUY

We are maintaining our BUY recommendation on T.

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

Summary

AT&T's adjusted EPS came in at 75-cents for 4Q20 beating by 2-cents. On the surface, the guidance did not look strong calling for 1% revenue growth built by 2% wireless service revenue growth and free cash flow a bit below 2020 figures. Looking more closely, we noted that cash flow in 2020 included $2.2 billion from selling receivables and a lower capital spending figure. Adjusting for that, guidance looks stronger. Also, with $4 billion of Covid cost and lost revenues for 2020, we see some areas where AT&T could exceed guidance such as a return to some roaming fees from basically zero now, a spring with sports on Turner, and actually getting some revenue from new release movies. The focus was also on Debt/EBITDA of 2.7x up from 2019 – largely due to spending $2 billion on HBO Max and the $4 billion in Covid items which helped lower EBITDA by $4.8 billion. Guidance is for debt to fall by $10 billion in 2021, which would reduce the ratio to 2.5x again without EBITDA recovering at all. AT&T also was more vague on the subject as it is currently in a spectrum auction process. It is planning an investor day in 1Q21 that should add more color to the picture. We still think the sum of the parts here exceeds $40 per share with a 7% dividend and several areas of growth.

What is strong?

- Mobility revenue is still being hurt by a lack of roaming fees and late fees. Roaming relies on international travel and late fees were also waived as part of Covid relief for customers. AT&T's 2021 guidance was not greeted well after 4Q for 1% revenue growth that will be anchored by 2% growth at wireless. We think AT&T has already been achieving this guidance for wireless. Look at how much the lack of roaming and late fees has negatively impacted growth in 2020:

Wireless	4Q20	3Q20	2Q20	1Q20	4Q19
Service Rev.	$14,022	$13,883	$13,669	$13,968	$13,948
ARPU change	-1.9%	-2.1%	-1.1%	0.7%	0.4%
Roaming Rev Lost	$230	$270	$225	$0	$0
Y/Y Rev Change	0.5%	-0.4%	-1.1%	2.5%	1.8%
Roaming impact	1.6%	1.9%	1.6%		
Adj. Growth	2.1%	1.5%	0.5%	2.5%	1.8%

AT&T is not expecting to see roaming fees recover in 2021 until maybe somewhat in 4Q. Thus, 1Q21 should see another quarter of more than $200 million in lost revenue compared to a 1Q20. After that, service revenues will be apples-to-apples on comparison and this has been growing at 2% other than the worst period of Covid if the roaming fees are adjusted. To estimate roaming fees – AT&T highlighted the drop in ARPU in each period to be largely due to the loss of roaming fees. We multiplied that drop in ARPU by the number of post-paid customers and multiplied by 3 to estimate a quarterly revenue figure.

- Also, the number of customers and connections is already much higher to start 2021 vs. 2020 as 5G, FirstNet, and HBO Max have helped AT&T add more customers. Some of this is also expected to help ARPU as well. The focus for the company is to continue adding more customers, but it is simply starting from a larger base to drive growth in 2021 for its largest operating unit.

Wireless	4Q20	3Q20	2Q20	1Q20	4Q20	3Q19	2Q19	1Q19
Postpaid Subs	77,164	75,969	74,919	75,148	75,207	75,152	75,478	75,727
Prepaid Subs	18,102	18,100	18,008	17,808	17,803	17,740	17,434	17,012
All Subs/Connections	182,558	176,744	171,407	169,195	165,889	162,300	158,622	154,670
Y/Y Postpaid	2.6%	1.1%	-0.7%	-0.8%				
Y/Y Prepaid	1.7%	2.0%	3.3%	4.7%				
Y/Y All Connections	10.0%	8.9%	8.1%	9.4%				

They have already had the subscriber growth to drive revenue guidance and the ARPU growth is basically flat to positive adjusted for the roaming fees.

- Equipment sales are picking up (which normally are lower margin but add incrementally to profits). Equipment sales in 4Q have been $4.8-$4.9 billion for 3 years before hitting $6.1 billion in 4Q20. This was predicted earlier by AT&T that as more 5G phones became available, it should help them gain more customers and phone sales. Churn has dropped to the lowest level at the end of 4Q, and more than 60% of the post-paid people are on unlimited plans. All of that should help ARPU and grow mobility in 2021.

- Cash flow guidance looks solid taken in context. AT&T reported free cash flow of $27.4 million in 2020 and guided to free cash flow of only $26.0 million for 2021. There are three big parts driving that and cash from operations may improve from 2020.

Free Cash Flow	2021e	2020
Cash Flow Ops	44.0	43.1
Capital Spend	18.0	15.7
Free Cash Flow	26.0	27.4
Capital Spend	18.0	15.7
Vendor Financing	2.0	3.0
First Net Reimb.	1.0	1.0
Gross Capital Spend	$21.0	$19.7
Cash from lower A/R		$2.2

Total capital spending is expected to be higher by $1.3 billion from $19.7 billion to $21.0 billion. Of that amount, it will tap vendors to finance $1.0 billion less in 2021 than 2020, so that is a $2.3 billion larger outlay for 2021. Yet free cash flow is forecast to come in only $1.4 billion below the year before. Thus, cash from operations has to increase to make up the difference. It is also worth noting that in 2020, AT&T sold $2.2 billion in receivables to help cash from operations. That helped bump up free cash flow also. We think viewed in full, cash flow is expected to improve in 2021.

What is weak?

- Video again saw weakness with subscriber losses at a slower rate than last year offset by ARPU rising 5%. EBITDA fell from $4.5 billion to $4.0 billion. All signs point to AT&T running this largely for cash flow and cutting costs to offset decay. It also wrote off $15.5 billion of goodwill and intangibles in this area.

- The potential sale of DirecTV. This has been widely rumored and AT&T will not talk about it at the moment. However, it did separate its video unit from Broadband in 4Q saying it wants to be able to offer broadband customers a cleaner-looking deal without video bundling. The separation also led AT&T to write-off $15.5 billion of goodwill and other intangible assets related to video. Thus, there are signs that AT&T will monetize part or all of this asset and use the proceeds to retire more debt.

This has been the anchor hung around AT&T for years now. It's basically less than 7% of total EBITDA but it is discussed more than wireless in the press. The acquisition clearly didn't work as originally intended and AT&T would take a loss on it. However, at this point, the stock reflects this situation. We actually think this unit could be valued at zero and AT&T is still undervalued.

What to watch

- AT&T bunded HBO Max with wireless plans and that allocates some of the $800 million spent on the Max rollout in 4Q to wireless. This is why service margins were down in 4Q y/y. We think an adjusted figure would be closer to 55%-56% margins with 2% growth in this area. In late July as the MAX rollout was picking up, John Stankey noted all the things coming together for wireless growth:

  > "*we are already seeing the dynamic of the attach rate of the better unlimited and the* ***higher ARPU unlimited plans increasing, and I made that point deliberately because this is where HBO Max and wireless come together nicely.*** *We're giving customers a reason to go up in the more robust unlimited plans, and we're already seeing that penetration increase.* ***We shared with you in October that that was an important driver through a combination of the incentives we would give people on the 5G network to buy into the upper end unlimited plans, as well as how Max complements those****, and we are seeing that success with Max, so check the box on the front end of that.* ***Once we have the right kind of equipment showing up on the 5G side, I think we will see that momentum continue and carry forward.***

- The EBITDA figure for 2020 includes $4 billion in Covid costs – just over $3 billion in lost revenues and just over $900 million in costs. The bulk of that is lost revenue at Warner from not releasing films and lack of sports programming when the NCAA tournament, baseball, many NBA games were all lost. The company also spent $2 billion rolling out HBO Max in 2020. Adjusted EBITDA fell by $4.8 billion in 2020 from $59.3 billion to $54.5 billion. That set off alarms that the Debt to EBITDA ratio rose to 2.7x even on slightly lower debt. Some of the Covid revenue will return in 2021. Also, debt is likely to decline by at least $10 billion in 2021. That would make the debt/EBITDA ratio 2.5x without EBITDA improving at all.

- We still think this is a good "sum of the parts" story. With several infrastructure investment funds buying data centers, warehouses for e-commerce, ports, water systems – shouldn't a huge high-speed broadband system and 5G wireless phone network be viewed as infrastructure? The value of AT&T at $29 is about $373 billion - $208 in stock, $147 in debt, $18 in retirement obligations.

- AT&T bought Warner for $110 billion or 10x EBITDA. It has good content assets and cable assets. Its HBO subscribers are up 25% in the last year. EBITDA was hit hard by Covid but seems likely to rebound. Content is in demand. We don't think it's a stretch that AT&T could see at least the same $110 billion in value.

- Broadband is growing with more customers and ARPU is up 4.6%. Margins are down as it is being bundled with HBO Max too and paying a fee to Warner. It has coverage for 60 million homes now and it's adding 2 million homes of coverage per year. Could someone pay 9x EBITDA without the HBO Max fee? That would be close to $55-$60 billion in value.

- Business line has been doing $13 billion per year in EBITDA for some time. It's not cutting edge tech, but it is generating solid cash flow. Sold at a cap rate of 15% and assuming $1 billion per month for 8-9 years – this is worth $50-55 billion also.

- Wireless has EBITDA without Covid and HBO Max payment of $31-$32 billion per year, growing at 2%. It has a 5G network that is just firing up for customers to pay for. Is this worth at least 4.8x EBITDA? At that price – these four units are worth the total enterprise value of $373 billion. If it's worth 6x, add $5 to the share price, at 7x add $9 to the share price of $29.

- That assumes zero value for the Latin America operation, DirecTV, Viro, and the advertising units, plus even legacy voice lines. These are still producing EBITDA. Video still did $4 billion in EBITDA in 2020. Can all this be worth another $2-$3/share?

- It appears to us that there is still good growth potential for wireless, broadband, and Warner going forward and AT&T intends to keep paying a 7% dividend, retire debt, and monetize some lesser assets to further reduce debt. All of that should work to the benefit of the stock price. Every $7 billion in lower debt adds $1 to the stock price too. It should be in a position to retire $10 billion per year. It will close soon on a $1.2 billion sale of Crunchyroll that will go toward debt repayment.

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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