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AT&T (T) 4Q Update
Maintain BUY

We are maintaining a BUY recommendation on AT&T after it beat EPS estimates by 1-cent. The market continues to hate the results for TV and the transition to HBO Max streaming. AT&T also laid out guidance for a backloaded 2020 based on heavy investment for HBO Max in the 1Q and 2Q before launch in May. We understand those concerns are out there (and have been for years) and continue to believe that investors are ignoring that the core communications business is growing with higher free cash flow and the balance sheet has improved considerably. The stock is still only 10x forward EPS, 7x EBITDA with a 5.5% yield. We think the low valuation gives plenty of cushion to live with the lumpiness of early 2020.

We have talked about many aspects of the entertainment business in the past and the transitions – but we think if investors focus on some key points for the communications business the value becomes apparent. We are going to keep this update short as we have covered some of these topics in-depth recently. One area we are going to add more discussion to is copper-wire retirement which can further reduce costs at AT&T.

- **Wireless is $30 billion of the company's $60 million of EBITDA. It has 166 million subscribers and connected devices. The connection rate is growing over 3 million per quarter.** Capital spending has been higher there with the FirstNet and 5G build-outs and that should decline going forward boosting free cash flow. Gross capital spending is expected to be about $20 billion in 2020. There should also be $1 billion in government reimbursements on FirstNet. That should be over $2 billion lower than 2019's figures of $23 billion with $1 billion of FirstNet reimbursement.

- **FirstNet build-out is now 75% complete. That results in new customers connecting in an area where AT&T previously had very little exposure.** Direct people such as police, firefighters, FBI gives a pool of 3 million people that can connect and many will connect with multiple devices. Also, another 8 million people at hospitals, utilities, disaster relief, etc. also have the potential to join FirstNet. Then AT&T can offer those people family plans too.

- **5G will be nationwide this summer. That should spur more demand for AT&T wireless and they will also be offering people HBO Max at the same time as well as new smartphone upgrades.** That should also help push more people toward more premium unlimited plans – where penetration is only 50%.

- **Considering a higher number of people on AT&T's network and many more likely to be postpaid accounts and others tied to work and/or bundles – the churn rate should decline at the same time the customer numbers are rising. On the 4Q19 call, the company noted that a reduction of 1bp of churn is worth $100 million annually.** Churn is running just over 100-130bp now. It is worth noting that postpaid accounts pay about 10% higher revenues and typically have a 20-25bp lower churn rate.

- **To us, the discussion of AT&T should start with the fact that the largest unit is growing. It has multiple near-term catalysts to continue growing.** It has catalysts to upsell people to higher revenues and has catalysts to reduce costs already at work – the EBITDA margins are rising y/y now.

- **Retiring copper lines is happening – AT&T wrote off $1.3 billion of copper facilities in 4Q.** This has implications for pulling costs out of the Business Wireline division which does about $10 billion in EBITDA and the legacy voice business located in the Entertainment unit. This is a hidden way for AT&T to boost margins over time we spoke of when we first wrote the company in the summer of 2018.

- **AT&T is operating two phone systems – legacy copper and new fiber.** The number of users on copper is declining, but the maintenance costs often require the same investment to serve 10,000 people or 1,000. Copper uses higher cost labor, uses electricity, and is often above ground and suffers storm damage. Fiber is the reverse of that and has a higher capacity as well.

- **The FCC wants to accelerate broadband rollout and availability and in 2017 passed rules to streamline the process to make it easier for telecom companies to retire rather than maintain and repair copper and allow that money to be invested in higher ROI areas** like fiber. The FCC goal is to get more people covered by high-speed broadband and fiber. Since 2017, it has worked to reduce regulations even more that kept copper lines going. New rules allow for greater freedom to abandon copper and replace it with fiber in last-mile loops and rural areas too. It is highlighting again that the old rules locked companies and customers into supporting old technology rather than embrace new technology.

- **The FCC highlighted that phone companies could save $40-$50 per home per year in maintenance costs if they were allowed to fully transition away from copper when these changes to old regulations were debated.** This is not going to be a snap of the fingers and copper is turned off – but we see that as a long term source of cost savings as copper retirement continues. **On the 4Q19 call, AT&T highlighted it expects to save $1.5 billion in costs in 2020 largely with a 4% reduction in labor costs.** It highlighted another $2 billion in cost reductions by 2022 from areas that included "modernizing our information technology" and "thinning the product portfolio." To us, it should like some of the copper retirements is appearing in these areas.

- **Interest expense will be down in 2020. The company paid down $20 billion in debt during 2019. That alone will boost free cash flow by at least $600 million.** Debt payments will likely in the $6-$7 billion range this year – so that frees up $14 billion in free cash flow too for 2020, plus the company is starting with $7 billion more in cash.

- **Mexico became EBITDA positive in 4Q19 too** – as the heavy capital spending was completed and added more subscribers. That unit had a -$547 million in EBITDA in 2018 and -$216 million in 2019. It looks set to be a positive figure for 2020. There is a nice swing to take note of too.

Our Conclusion:

We think there is significant cushion built-in to AT&T to deal with all the commitments and a lumpy 1H that includes the roll-out of HBO Max startup costs and the transition of more current TV customers to HBO Max. On top of that, the Entertainment unit that receives all the negative attention – posted flat EBITDA last year of $10 billion. ARPU for TV is up 8% and broadband up 3%. That is hardly the collapse the media has forecast 2+ years.

Here are the negatives for 2020 based on our estimates:

- $800 million EBITDA hit for making WarnerMedia shows exclusive to HBO Max before the rollout

- $200 million EBITDA hit in 1Q as that is the last period of roll-off from discounted TV plans
- $2.0 billion in costs for HBO Max

That's $3.0 billion in negatives for cash flow – call us optimistic and say it's $3.5 billion.

Here are the positives for cash flow for 2020 from 2019:

- $600 million lower interest expense
- $300 million improvement in Mexico EBITDA
- $1.5 billion of cost savings already identified and half already implemented
- $2.0 billion in lower capital spending
- $4.0 billion in lower debt payments – reduced asset sales (Debt payments of $20b in 2019 become $6b so +$14b) and (asset sales of $18b in 2019 become $8b or -$10b)

That's $8.4 billion in positive swings for cash flow in 2020. The positive cash flow swings do not assume: growth in the wireless unit from FirstNet or 5G or reductions in churn or upgrading more people to unlimited and postpaid plans. They also assume no revenue from HBO Max.

Obviously, there is a transition going on here. The stock price continues to reflect that with a low valuation and above-average yield. The area of concern is TV which is about 7% of EBITDA and transitioning to streaming. **This stock continues to be taken to the woodshed over deals from years ago. We understand that and we were not the biggest fans of the acquisitions either. But the question to us remains, what else is here?**

Against the TV negatives, the groundwork has been laid for the largest unit at 50% of EBITDA to realize some solid gains this year from multiple avenues. We think that is being ignored. We also think investors are glossing over that the balance sheet and liquidity have been improved significantly and the amount of cash being returned to shareholders is rising rapidly. **Even if Warner and TV were split off and took $70 million of the remaining debt – the rest of AT&T would have a growing EBITDA of $40-$45b that would probably trade at a higher multiple.** At 8-9x EBITDA and only $80 million in debt– the communications and broadband assets are likely worth more what the whole company is trading for now. Plus, throw DirecTV away, we know Warner has good assets and was trading at a higher multiple before all this. There's probably still a $7/share value right there.

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.

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