BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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AT&T (T) 3Q'20 Update
Maintain BUY

We are maintaining our BUY recommendation on T. Adjusted EPS of $0.76 met estimates. It declined from adjusted EPS of $0.94 y/y. The items AT&T adds back looks largely tame. We think a case can be made that between COVID impacts and HBO Max rollout costs – underlying apples-to-apples EPS actually grew about 10-cents in 3Q y/y.

3Q results show many of the same impacts as 2Q. COVID hurt wireless with a loss of international roaming fees from less travel along with T not charging late fees or data overage fees. Where it hurt the most was movies for WarnerMedia not being released.

EPS Adjustments	3Q20	3Q19
GAAP EPS	$0.39	$0.50
Amortiz of Intang.	$0.22	$0.19
Debt Refinancing	$0.14	$0.00
Actuarial Loss	$0.01	$0.21
Merger/Integration	$0.00	$0.04
Adjusted EPS	$0.76	$0.94

- We have issues with companies adding back the amortization of acquired intangibles. The deal consumed cash upfront and the expense lasts for a long time. Had they built it in-house, all the labor and research would have been expensed and not added back. When looking at dividend payout ratios – we are fine adding it back.

- The debt refinancing is a one-time item and it should benefit future results. AT&T refinanced debt and had to pay $1.2 billion in premiums and $0.2 billion in other fees. Interest expense fell by 20bp – which will add 1-cent to quarterly EPS going forward. Also, it reduced debt maturities through 2025 from $66 billion to $33.5 billion. This is a one-time item, we do not have a problem adding back.

- In 2019, AT&T was cutting costs by offering incentives and early retirement to many employees. The level of payments from the pension plan exceeded the normal size and resulted in settlement accounting treatment. This required pension obligations to be revalued each quarter and it also required actuarial losses to be recognized in income. This is a one-time item and recognizing losses is a non-cash event. For comparability, we do not have a problem adding this back.

- Merger costs in 2019 accounted for 4-cents. We believe mergers cost money and require work and other expenses and do not like to see serial acquirers add back these costs if they recur annually. For comparability at AT&T, it does not happen every year, so we understand adding it back.

- In our view, on comparability AT&T could adjust for a couple other items as one-time items too. For example, it is spending $2 billion this year to roll out HBO Max, which was $600 million in 3Q. That is 7-cents of expense in 2020 that didn't happen in 2019 – (we would add- that was modelled into the estimate of $0.76 so it should not be added back to look at whether AT&T beat forecasts). Also, COVID is listed as a $0.21 item for the quarter – the bulk of which hit WarnerMedia revenues. It also wiped out International Roaming fees, late charges, and data overage charges at wireless. That was listed as $430 million in EBITDA or $0.05. Only $0.02 was higher costs for COVID related precautions and overtime.

- We are fine not adding back COVID expenses and that is more conservative. Given that much of it was revenue that should in fact occur – just at a later date regarding movies while some of the sports are gone forever.

So, EPS was down 18-cents. We think HBO Max represents 7-cents of that drop, and if COVID is 21-cents – then EPS from an apples-to-apples comparison is doing better by 10-cents y/y. There are some aspects we can quantify:

- 1-cent came from share repurchases.
- 1.2 cents came from lower interest expense.
- 2-cents came from lower churn rates for postpaid wireless.
- 3-cents from the 4Q'19 cost-cutting program.

Going forward, we expect more y/y declines in interest expense after refinancing and retiring more debt. The 20bp reduction in place adds 1-cent per quarter. Also, with the debt rate at 4.3%, the pretax cost of capital for the dividend is 8.5%-9.0% where the stock is trading. We would expect to see more share repurchases in the future. The fact that debt maturities are smaller now and Free Cash Flow after the dividend is expected to be about $11 billion this year plus $3 billion in asset sales – should make it possible to buy more shares.

The churn rate is falling with a combination of bundling HBO Max, adding First Responders to the system, 5G roll-out, and new phones. The churn rate dropped from 95bp to 69bp y/y. The company has stated that every bp decline is worth $100 million per year at wireless. Looking at EBITDA margins, that should net to about $6 million in earnings per quarter. That area has shown sizeable improvement. The number of subscribers and connections rose 8.9% so this division is still growing. Margin was actually pinched a bit due to higher amortization of deferred commissions – that may not continue as a headwind. Getting the roaming fees, late charges, and overage fees back should also enhance margins as well as revenue.

AT&T started a cost savings program in 4Q19 that was expected to save $1.5 billion by the end of 2020. They said half of that was already in place early in 1Q. The full amount of this would be 4-cents per quarter, maybe 3-cents is already being seen. There is another plan that began at the same time to save $2 billion by 2022. This plan may not have had much impact yet.

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.

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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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