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AT&T (T) – 3Q18 Update

It is clear that AT&T roiled the market with 3Q results showing a huge decline in TV customers despite saying in mid-September (11 weeks into the quarter), that raising its prices did not cause a huge drop off. We'll address this more fully in a moment. The quarter missed on EPS by 4-cents.

We think AT&T still represents a solid opportunity here after the Time Warner deal. We agreed completely with the market that the company likely overpaid there, but the stock already reflected that. One quarter after completing the deal, we are not changing our view that there is value here. In our September 20 report, we expressed our belief its 2019 forecasts were conservative and listed nine areas where it may be understated. Not included in those nine was the TV business, which has been disappointing for some time. AT&T reiterated its belief that it can stabilize the EBITDA there in 2019 and have it stop being a drag. The company confirmed its 2018 guidance at the high-end of forecasts for $3.50 in EPS which would need only $0.84 in 4Q vs. $0.85, $0.91, and $0.90 in quarters 1-3. It also confirmed 2018 guidance at the high-end for free cash flow of $21 billion. With the stock at $30, it trades for 8.6x EPS and about 6.5x EBITDA while paying a 6.7% dividend. This remains a cheap tech play in our opinion.

More importantly, the cash flow here is enormous and it has more levers to grow cash flow. They are on pace to retire about $16-18 billion in debt by the end of 2019, assuming no growth. Keeping the company at the same EBITDA level without any levers helping – that $18 billion would become $2.50 per share in stock value if the company continues to trade at 6.5x EBITDA in 2019. There's 8.3% potential capital appreciation along with a 6.7% dividend. Let's review the quarter:

- The TV business is unlikely to derail the forecasts. AT&T wants to reach a point where the decay in EBITDA stops. The trend is moving in the right direction despite 3Q customer numbers.

- AT&T's forecast for 2018 and 2019 Free Cash Flow forecast remains conservative.
- Completing large projects in 2018 and early 2019 should reduce capital spending in 2019 and boost Free Cash Flow by itself.
- Reviewing the nine areas for improvement in 2019 that doesn't include TV shows AT&T should be in good shape to hit and perhaps beat forecasts.

TV – Entertainment Group Results Dismal – Plan Remains to Stabilize EBITDA in 2019

Investors already knew that the traditional *DirecTV* business was suffering from cord cutting and that the new *DirecTV Now* service that works with broadband was growing rapidly but at a lower price point. The result was a plan where *DirecTV Now* would attract more customers than *DirecTV* was losing. And, *DirecTV Now* required no hardware, installation visits, etc. so it was higher margin. The company was seeing EBITDA drop during this transition and the forecast was that it would level off in 2019 and cease to be a drag on results.

Given that as a background, investors were excited to hear CEO Randall Stephenson announce in September that AT&T raised prices on *DirecTV NOW* and customer totals didn't drop-off. It sounded like AT&T had fixed one of its poorest performing divisions. So, it was a shock when 3Q18 numbers showed an accelerating loss of higher revenue *DirecTV* and *DirecTV Now* did not begin to offset the loss with new customers:

# in 000s	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
Satellite Adds	0	-156	-251	-147	-188	-286	-359
U-Verse Adds	-233	-195	-134	-60	1	24	13
DirecTV Now Adds	72	152	296	368	312	342	49

The drop in EBITDA for the division was also more than pronounced with a drop of $454 million:

Ent. EBITDA	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
EBITDA	$2,955	$3,106	$2,663	$2,368	$2,408	$2,608	$2,209
Margin	23.7%	24.8%	21.4%	18.9%	20.7%	22.3%	18.7%
Y/Y change	n/a	0.0%	-9.9%	-11.2%	-18.5%	-16.0%	-15.7%

The EBITDA drop also came following a sequential improvement in 2Q18. Here is the company's take on the situation:

- There was an extra week of *NFL Sunday Ticket* in 3Q vs. last year which added to costs. That will rebound in 4Q with one fewer week. 3Q17 was higher than normal with a big pay-per-view fight. Without those events, EBITDA would have fallen 14% and marked the 2nd quarter of slower decay.

- Eliminating prepaid *DirecTV* in Puerto Rico cost 32,000 subscribers in 3Q18.

- Reducing promotional pricing in 3Q18 is eliminating high churn, low-value customers

- Adding more *WatchTV* and slimmer packages for streaming has been a growth area that is EBITDA positive. Slimmer packages will control content price and align it with lower price point revenue streams.

- They are lapping a 2-year lock promotion for *DirecTV* and *U-Verse* which should boost prices in those areas.

We agree, eventually this will bottom out. The question is does it bottom out at $1 billion or closer to $2 billion per quarter? There are still over 19 million *DirecTV* customers and just under 2 million *DirecTV Now* customers – the move from the former to the new service will come at a lower price point. Does the expiration of the customer lock-up on a promotional price lead to higher customer losses in 4Q and 1Q? Three areas give some comfort here:

- AT&T's broadband build-out helps it capture its own *DirecTV* cord cutters as well as other cable companies' customers. They do very well at this transition where the broadband is in place.

- There is much more broadband coming online in 4Q18 and 2019. AT&T currently sees a 40% increase in customer locations next year.

- Pricing is rising on TV and Broadband. Broadband numbers are still increasing, and T expects to add 1 million broadband customers this year.

- The company noted that on its forecasts for earnings and cash flow, they are using figures for TV below what analysts are using.

There is likely more room for cost-cutting in this division too given *DirecTV Now* does not have as much in set-up costs or equipment to purchase and retrieve. In the last two years AT&T has cut about 12% of operating costs versus a 9% drop in revenue so that is also a good sign.

We admit that we were excited to hear the statement about raising price and not losing customers because that made one of the warts here less an issue. We are disappointed with these Entertainment results. However, we did not highlight an improvement here as one of the nine reasons AT&T's future earnings and cash flow looked attractive. This one division is still cash flow positive with broadband and the potential for the new advertising analytics to help it out. It is unlikely to offset the other positives.

AT&T's Free Cash Flow Forecasts Still Conservative

For 2018, the company is projecting $21 billion in free cash flow. Through three quarters, it is at $14.4 billion. They will collect $1.3 billion in reimbursed capital spending from the FirstNet contract in 4Q, which gets them to $15.7 billion. Last year in 4Q, AT&T without Time Warner did $4.5 billion in Free Cash Flow which had $1.0 billion in employee bonuses after the tax reform. Just adding that together is $21.2 billion. That doesn't include a 4Q from Warner Media.

For 2019, the forecast is $25 billion. They start with $21 billion in 2018 and add back $2 billion in merger fees related to Time Warner as being one-time in nature. Then, Time Warner only had a 6-month impact on 2018 so they annualize it at a flat figure assuming no growth and get to $25 billion. None of that sounds aggressive to us.

Moreover, the company wants to pay down about $15-$18 billion in debt in 18 months (3Q18-4Q19). It will apply all Free Cash Flow after the dividend toward that. The dividend

consumes $22 billion of cash flow over 18 months. 3Q18 and 4Q18 free cash flow should be over $13 billion plus $25 billion in 2019. Assuming no growth, no asset sales, no cost savings or revenue synergies – this basic plan works in our opinion.

Progress on the Nine Areas for Improvement from September 20, 2018 Report

1. **Mexico** has been an area where AT&T has been investing money and trying to expand operations. It eliminated a wholesale business in the quarter. However, the $3 billion buildout of LTE in Mexico is now basically done. The forecast is they should see improvements to cash flow simply because $1 billion in annual capital spending is finished. Plus, the hope is it will spur more subscriber growth and reduce the EBITDA drain and perhaps turn it positive in later 2019. Here are the recent results for AT&T Mexico:

Mexico	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
EBITDA	-$121	-$109	-$126	-$63	-$96	-$69	-$115
Subs in mms	12.6	13.1	13.8	15.1	15.6	16.4	17.3

Stripping $1 billion in capital spending off, is a positive swing in free cash flow of about $600 million. If they can make the EBITDA drain go away, that's a bonus.

2. **Fiber buildout** is expected to be largely complete by the 1H19. That should help revenues and cash flow with more customers. It should also lower capital spending and boost Free Cash Flow.

3. **WarnerMedia Synergies** – the company's guidance is they are on track for $1.5 billion in cost savings and $1.0 billion in revenue gains over three years. These are not in the AT&T forecast for 2019.

4. **FirstNet is rolling out ahead of schedule.** There are already 250,000 subscribers on it. Revenue and cash flow should be rising going forward. AT&T spent $0.5 billion on support and training on FirstNet that is not reimbursed which won't recur in 2019.

5. **FirstNet rollout saves on capital spending** as AT&T installs 5G equipment on same towers as FirstNet equipment is installed.

6. **5G deployment running ahead too.** 5G will roll out in 12 cities in 2018. More cities will be added in 2019 and new handsets will be available in 2018 for 5G. There is only capital spending for all this in 2018, essentially no revenue and cash flow is forecast for 2019 in the AT&T outlook.

7. **5G Evolution from the spectrum will be in 400 markets by year-end.** The fiber buildout works toward this too. Much faster speeds for customers should bring in new business, slow churn, allow for more mobile entertainment too.

8. **WarnerMedia is growing.** In the 3Q18, revenues were up 6.5% and EBITDA up from $2.5 billion to $2.7 billion. This follows a history of steady growth at Warner. Yet, AT&T's forecast adds no growth in this area.

9. **Wireless was up 2% on service revenue**, had a 9% increase in customers and EBITDA was flat. The EBITDA was impacted by higher iPhone sales as equipment revenues rose 19%. Equipment sales pressure margins. Going forward, equipment sales should decrease, and margins expand. There is no growth forecast here either. 5G, 5G Evolution, Fiber should be helping here.

We believe these areas add up to much more than the TV business problems. The Entertainment Unit did $9.6 billion in EBITDA for the last 4Qs. Even though broadband is expected to grow, let's assume the company sees $1 billion in lower annual results there until it starts to level off toward the end of 2019. That simply won't derail the total company forecasts because too many positives are not built in.

For example, lower Mexico capital spending may be $600 million in the positive and another $500 million is saved from FirstNet training. There's $1.1 billion. The $200 million in EBITDA growth at WarnerMedia was only one quarter. Even the growth slows – a full year of growth there should be a decent figure. Will people sign up for 5G and 5G Evolution and help revenues and cash flow in 2019? Will that cut churn in Wireless?

We don't like the TV results either, but that one segment is being given too much weight in this total equation. If AT&T improves that situation, this company has one more area for growth. If the company doesn't, TV dilutes improvement in other areas, but it's not big enough to offset the gains. In the meantime, find another stock with a reasonable deleveraging plan that could deliver over 8% capital appreciation potential without multiple expansion with the stock also paying 6.7% in dividends, that you can buy under 9x EPS.

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