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BEHIND THE NUMBERS
Quality of Earnings Analysis

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AT&T Inc. (T)
Earnings Quality Update- 9/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of T at 4+ (Acceptable) and maintain our Top Buy rating.

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

Summary

AT&T (T) beat 3Q21 forecasts by 8-cents again. Just like 2Q, it looks like capitalized interest from the Spectrum buy at the end of the 1Q helped EPS. We know 2Q's benefit was $257 million or 3-cents of EPS and AT&T intended to capitalize the interest until the spectrum was put into service. Without the 10-Q, we are estimating 3Q had essentially the same situation. The beat looks solid, and AT&T has now gone from forecasting flat EPS growth in 2021 to low-to-mid single-digit growth and is now expecting to come in at the high part of that range.

Declining Interest Costs Should Become a Big Driver for EPS going Forward

The below table shows the reported interest expense. The capitalized interest in 3Q21 and 2Q21 is pushing interest expense even lower. In order to estimate the true interest cost, we added the capitalized interest back and annualized the interest expense over the total debt figure – not the net debt figure.

Interest costs are down about 70bp for AT&T. Debt is up about $20 billion.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Debt	$179.2	$179.8	$180.2	$157.3	$158.9	$169.0	$164.3	$163.2	$165.2
Cash	$21.3	$11.9	$11.3	$9.7	$9.8	$16.9	$10.0	$12.1	$6.6
Net Debt	$157.9	$167.9	$168.9	$147.5	$149.1	$152.0	$154.3	$151.0	$158.6
Interest Exp	$1.7	$1.7	$1.9	$1.9	$2.0	$2.0	$2.0	$2.0	$2.1
Int. Rate	4.30%	4.32%	4.15%	4.82%	4.96%	4.83%	4.91%	5.02%	5.04%

Last year, 5.0% on $160 billion was $2 billion of interest costs per quarter vs. today 4.3% on $180 billion being $1.93 billion. That is adding 1-cent to EPS and the capitalized interest adds 3-cents more. We know there is upward pressure on interest rates to rise and the capitalized interest will go away when the spectrum is put into use. However, AT&T should still have a tailwind from falling total interest expense:

- Free Cash Flow of $26 billion for 2021 less $15 billion in dividends is expected to cut debt by $11 billion in 2021. In 2022, there should be additional Free Cash flow of about $9 billion after the dividend.

- Asset sales such as the 30% of DirecTV, Vrio, and other miscellaneous sales already announced should produce $10 billion more that will go toward debt repayment in the next few quarters.

- Already AT&T has about $12 billion in surplus cash on hand from these activities that is reducing net debt and eventually it will retire interest-paying debt soon.

- Also, the Warner will spin-off and take $43 billion of debt with it in mid-2022.

- **Just those announced items should reduce total debt by about $70 billion by the end of 2022. $70 billion at 4.3% is $3 billion in lower interest expense at AT&T or 33-cents of increased EPS. It would also increase free cash flow by $2.4 billion.**

- Given that AT&T has let the cash pile up so far in 3Q where it earns $0 – they are still paying on the full $180 billion right now. Thus, the 33-cents of tailwind would still arrive in the next 5-6 quarters. That's about 9%-10% EPS growth.

- AT&T could potentially beat that $70 billion goal with additional cost-cutting – and they believe they can reach $6 billion in cost reduction with some of that being reinvested in growth plans for the business and the rest toward improving cash flow and debt retirement. So far, growth plans for the wireless unit, broadband, and HBO Max are showing results. It could also find additional assets to monetize.

Earnings Quality Continues to Look Better

We are defining this as the spread between GAAP and non-GAAP EPS:

	3Q21	2Q21	1Q21	4Q20	3Q20
GAAP EPS	$0.82	$0.21	$1.04	($1.95)	$0.39
Impairments	$0.02	$0.52		$2.02	$0.01
Amortz Intangibles	$0.15	$0.12	$0.12	$0.22	$0.22
Actuarial Loss/(Gain)	($0.04)	$0.02	($0.30)	$0.43	$0.01
Other and Debt Refi	($0.06)	$0.02	$0.02	$0.04	$0.13
Taxes	($0.02)	-	($0.02)	($0.01)	-
NonGAAP EPS	$0.87	$0.89	$0.86	$0.75	$0.76

In the 3Q21, there was an extra 4-cents in DirecTV amortization that should disappear going forward. We also believe with the Warner spinoff, much of the remaining amortization of intangibles should disappear from non-GAAP EPS. The “other” is largely gains on the sale of assets.

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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