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AT&T (T) 3Q19 Update
Maintain (BUY)

We are maintaining our BUY recommendation after 3Q19 results. The company laid out the case we've been making very well. Essentially, AT&T generates a very sizeable amount of cash flow and its capital spending has been elevated as it built out Fiber, the LTE network in Mexico and the 5G network with FirstNet in the US. Going forward, plans for capital spending to decline as free cash flow is forecast to rise above $30 billion by 2022 appear very conservative to us and will drive higher dividends and share repurchases.

For quarterly results themselves, AT&T beat by $0.02 on adjusted EPS that added back a large pension adjustment. The market always focuses on DirecTV subscriber figures and the company has guided to much of the churn that occurred over the last year as they raised prices on customers who were rolling off a discount plan. What continues to go unnoticed by the market is AT&T has raised DirecTV pricing by $9/month per average subscriber during this process. That allowed EBITDA at the Entertainment Unit to remain flat to higher y/y and revenue flat for three quarters now. We still see DirecTV as a minor part of this story at about 6-7% of total EBITDA and the company is now past the bulk of the discount-customer contract-renewals. AT&T is introducing its new streaming video offering, HBO Max, in 2020. We are not going to make many comments on that beyond saying that the cost to roll it out is built into the forecasts they have laid out for the next three years, and we still believe forecasts are conservative. Mobility remains over half of total EBITDA and that continues to add customers even before 5G is fully rolled out.

- **AT&T laid out plans to produce free cash flow of $28 billion, $29 billion and then $30-32 billion from 2020-2022. Of that $90 billion forecast, it plans to spend $30 billion to repurchase essentially 10%-11% of its stock and pay $45 billion in dividends**. And, an additional $5-$10 billion in asset monetization in 2020 will further lower debt levels.

- **Capital spending will remain about $20 billion, but that is lower than the last two years – which will help grow free cash flow. In addition, AT&T debt peaked at $177**

billion following the Time Warner deal – it will be $150 billion by the end of this year and likely about $140 billion before 2020 is completed. Net of taxes, the reduced interest expense will add about $1.2-$1.4 billion to free cash flow.

- **AT&T also is forecasting $6 billion in higher EBITDA by 2022 from the $60 billion in 2019. This will be driven by 1%-2% annual revenue growth**, which will raise revenues above $190 billion. At current margins, that would add about $2.7 billion to EBITDA. It also expects to have all Warner synergies in place, higher profit levels in mobility and Mexico. That should help by 200bp in margin from 33% to 35% and that would add over $3 billion more in EBITDA and should also help free cash flow.

- **The net result should be a growing dividend from the current rate of 5.4%, EPS growth of 7%-10%, share repurchases driving over 40% of the EPS growth, all for a forward P/E of about 8x. This still looks like a cheap stock.**

- **Adjusted EPS rose by 4-cents in 3Q19 and beat by 2-cents. The major adjustment is amortizing actuarial pension losses into income amounting to 21-cents in 3Q.** This was triggered by offering many employees leaving in 2019 a lump-sum pension distribution. That, in turn, set AT&T up to pay out more in distributions than the service and interest cost. That requires a remeasurement of PBO each quarter for 2019 and losses to be realized. We see this as a one-time item for 2019 and AT&T's pension is well-funded.

- **AT&T is also adding back the amortization of intangibles from the Time Warner deal in adjusted EPS.** A positive is they allocated 60% of intangibles into accounts that will be amortized. The company is also rapidly amortizing key parts of those intangibles. The quarterly cost has already dropped from 25-cents in 3Q18 to 19-cents in 3Q19. We can see it declining to under 10-cents fairly quickly. This is a non-cash expense. Adding it back is actually slowing EPS growth.

Free Cash Flow Forecasts for 2020-2022

AT&T is looking at cash flow forecasts rising about $1 billion per year for the next three years with 2022 perhaps growing to as high as $32 billion. We do not believe this is very aggressive at all:

	2022e	2021e	2020e	2019e
FCF in billions	$30-$32	$29	$28	$28

The first adjustment is 2019's securitization of Warner receivables for $2.6 billion. That could increase going forward, but let's consider that a one-time event. Thus, the easy way to get to flat Free Cash Flow in 2020 is to have Capital Spending decline. We have talked about this in the past. AT&T was accelerating its 5G build-out to save money overall while it built out the FirstNet infrastructure and making one-stop per wireless tower. It also was investing to complete the LTE network in Mexico and fiber buildout. Capital spending is expected to decline in 2020, to $20 billion from $23 billion in 2019 - more than enough to generate flat free cash flow without receivables securitization. (It should also be pointed out that the $23 billion in 2019 will include about $3 billion in capital spending that was accounted for as vendor financing and went through the financing section rather than the investing section of cash flow). But essentially – remove $2.6 billion from securitization and about $3.0 billion in capital spending and free cash flow is flat in 2020 from 2019 on estimates.

We believe these forecasts could be low because AT&T has paid down a considerable amount of debt. The net debt level should be $150 billion to end 2019. That is down from $177 billion following the Time Warner deal. At 4.0-4.5% interest, that $27 billion is $1.1-1.2 billion in lower expense. Net of tax of the tax shield, it's a $850-$960 million positive to free cash flow.

$6 billion of the $27 billion was paid down before 2019 and the rest during 2019 – so AT&T will not see the full benefit from 2019 to 2020. The company's debt goals are to be at 2.0-2.25x EBITDA of $66 billion by 2022 – which would put AT&T at about $140 billion in debt. It plans to pay down as much as $10 billion in 2020 with more asset monetization and that would hit the $140 billion level. That would reduce interest expense net of the tax shield by another $300-$350 million. In our view, AT&T is picking up well over $1 billion in additional free cash flow just from this area too.

What is key to us is the interest savings and the lower capital spending are already largely baked in and there should be minimal risk to beating free cash flow forecasts just with these two areas.

Next, AT&T sees Revenue Growth, Cost Savings, and Synergies

The company is reporting it is on-track to produce $2.5 billion in cost and revenue synergies from Warner. The $1.5 billion in cost synergies represents about 400bp improvement in Warner EBITDA margins. The $1.0 billion in revenue synergies is largely tied to better advertising rates by targeting better fitting commercials for the Turner network. The company sees these synergies fully in place by the end of 2021 and some of the returns can be seen now in Xandr growth.

As it rolls out HBO Max, AT&T is projecting costs of as much as $2 billion in 2020 that will decline to about $1 billion per year in 2021 and 2021. For 2020, the lower interest expense will be necessary to cover this goal along with some of the cost synergies coming through. AT&T has called out the synergy offset as what will pay for much of HBO Max's rollout. **In 2020, is where the greatest risk arises as the synergies will build through the year but the initial spending on HBO Max will be the highest in 2020.**

Plus, the company is projecting 1%-2% revenue growth per year from 2019-2022. That would add $1.8-$3.6 billion in revenue and it amounts to $0.6-$1.2 billion in EBITDA at current 33% margins or $475-$950 million in earnings, which would move to free cash flow. Some of that revenue growth should come from turning on 5G and also selling more equipment as well as HBO Max gaining new customers. It appears that HBO Max will also be used as a loss-leader to sign up more customers for HBO, premium wireless, and broadband customers – all of whom will get HBO Max for free. Others will pay $14.99 per month for HBO Max. Those customer pick-ups will offset HBO Max costs.

We think it is important to note that AT&T is not forecasting a turnaround in legacy businesses like DirecTV or landline phones (DirecTV subscribers may also benefit from getting HBO Max for free via being an HBO subscriber). The 1%-2% total revenue growth is expected to be net of further decay in these areas in the Entertainment unit. Forecasting growth from 5G, equipment sales, and higher broadband usage to replace more of the business wireline and landline residential does not seem like a major stretch to us. Nor does a 1%-2% CAGR for 3-years. **We think investors should also focus on the fact that the legacy units are not nearly the drag many are being led to believe:**

Entertainment	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
EBITDA	$2,620	$2,821	$2,434	$2,155	$2,801	$2,853	$2,400
ARPU Premium TV	$112.45	$112.19	$114.90	$121.76	$114.98	$117.49	$121.35
ARPU IP Broadband	$46.27	$48.32	$49.78	$49.83	$50.10	$50.82	$51.21
EBITDA Margin	22.9%	24.6%	21.0%	18.0%	24.7%	25.1%	21.4%

The Entertainment Group includes DirecTV, Streaming TV, Broadband Internet, Residential landlines, and equipment leasing. The total is roughly $10 billion per year in EBITDA for this collection of business units.

Everyone will point to falling customer totals for DirecTV and landlines as evidence of major decay. What they are not pointing out as frequently is **the success AT&T has had raising prices in both DirecTV and Broadband even though that meant culling off lower margin customers**. Pricing is up 6% and 3% y/y for each. **Nor are people pointing out that total quarterly EBITDA has been flat to up in every quarter y/y this year.** The company has been successful in pulling service costs out of the system at the same time it sees customer churn – the result has been expanding margins.

We don't have any illusions that landline phones will continue to decay. We also expect HBO Max to cannibalize more of the current streaming customer base. **AT&T has been very clear that the promotional pricing contracts would be rolling over in 2019 and they expected to see larger than normal churn. They also pointed out that 3Q19 was the peak period for that and churn should slow. Also, worth pointing out is Broadband – especially Fiber Broadband is growing at over a 40% y/y clip** in terms of clients along with rising prices:

Entertainment (000s)	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19
DirecTV losses	(187)	(262)	(346)	(391)	(544)	(778)	(1,163)
Fiber Broadband Adds	226	249	300	259	297	318	318
total Fiber Broadband	1,955	2,204	2,504	2,763	3,060	3,378	3,696

There are still 21.5 million DirecTV users, the normal churn rate is about 300,000 per quarter, that's less than 1.5% churn, vs. the 3.3% and 5.1% seen at the height of the discount contract roll-overs. The higher pricing for both DirecTV and Broadband may well offset the loss of customers and hold EBITDA flat to slightly down. The goal is to continue rolling out more broadband and boost customer totals in the area. That could still be a high growth area.

Looking at the Growth Forecasts and Free Cash Flow – there are five major points:

- AT&T is building in higher expenses for HBO Max roll-out and of as much as $2 billion in 2020 and about $1 billion in 2021 and 2022. HBO Max should attract more customers to 5G, Broadband, and regular HBO via HBO Max and offset some of that cost.
- Forecasts have factored in the rest of entertainment as a drag on earnings – even though higher prices at DirecTV helped keep EBITDA flat to positive amid higher than normal churn. Normalized churn rates could further enhance EBITDA with higher pricing.
- Broadband is growing rapidly in customers and pricing. We would expect 5G to be popular in drawing in customers too – especially FirstNet clients onto family plans, which represent millions of additional mobile clients. 1%-2% growth is not that outlandish and represents $0.6-$1.2 billion in additional EBITDA annually against any drag from DirecTV off a $5 billion base figure.
- AT&T is already gaining some of the synergies in additional advertising revenue and some cost savings from the Warner deal. This with modest cost-cutting, has the potential to add billions to EBITDA and free cash flow – that also outweighs the cost of HBO Max and TV decay.
- The interest savings from debt already paid down is generating almost $1 billion in additional free cash flow now.

Shareholders Will Be Rewarded with the Rising Cash Flow

The company's focus will be on returning cash to shareholders with no major acquisitions made. The forecast is expected to be $30 billion to repurchase 11% of the stock along with $45 billion in dividends over the next three years. That already adds some extra cushion because Free Cash Flow is forecast to be $90 billion including the HBO Max roll-out costs.

We believe the company will seek to lower debt a bit further too after 2019 and an ending level of $150 billion that is 2.5x $60 billion in EBITDA. By 2022, they expect to be at 2.0-2.25x EBITDA of $66 billion. That really only requires about $10 billion of additional debt retirement and AT&T believes it will have as much as $10 billion in asset monetization in early 2020.

Extra cushion may also arise with the share repurchases causing the total dividend outlay to decline: Right now, the dividend is $14.9 billion on 7.3 billion shares. Buying back 770 million shares would put the dividend at the current rate of $2.04 at only $13.3 billion. AT&T can either grow the dividend per share by 13% over the next three years and pay out $15 billion or boost it more modestly by 4-cents per year (2% per year) and still have a dividend outlay of $14.1 billion. That would be lower than what they pay now by $800 million. Under either situation, the dividend payout ratio will be under 50% of free cash flow.

The company's plan confirms what we have been noting about the situation – there is a tremendous amount of cash flow generation here. We were impressed that AT&T could pay down $27 billion in debt at the same time it dealt with elevated capital spending levels to build out new infrastructure and the dividend payout was not strained. Now with the exception of rolling out HBO Max, shareholders should enjoy a period of turning more of the infrastructure assets on and seeing rising cash flow and lower capital spending. It's becoming more like a pipeline business for the next several years.

Finally, the company is going to focus on culling more non-essential assets too as well as more cost-cutting. The result of both situations should mean more cash coming into the company for the benefit of shareholders. It should also mean that $4 billion outlay for HBO Max in the next three years has ample cushion to be paid from existing operations without derailing the $75 billion planned to be returned to shareholders.

No one wants us trying to assess the next popular car or TV show. The point we want to make with the future unknown for HBO Max and competition from Apple, Disney, and others over content and pricing is AT&T's cash flow looks more than strong enough to continue paying a significant and rising dividend as well as repurchasing a sizeable amount of stock with ample cushion to spare even if HBO Max is a net loser for a long time. We also believe AT&T's balance sheet will continue to improve going forward in terms of more cash and less debt. Plus, the company itself is forecasting growth even with HBO Max being a net cost to earnings through 2022.

Pensions, Adjustments, and Earnings in 3Q19

With all the news on the 3-year corporate outlook and returning capital shareholders, we don't want to leave out some details about 3Q results overall. The company beat forecasts by $0.02 with adjusted EPS of $0.94. The adjustments are primarily related to amortization of Warner intangibles and pension adjustments:

EPS adjustments	3Q19	3Q18
Reported EPS	$0.50	$0.65
merger costs	$0.02	$0.04
Gain/Losses	$0.02	-$0.04
Amortz Intangibles	$0.19	$0.25
Pension Loss	$0.21	$0.00
Adj. EPS	$0.94	$0.90

We don't have issues with the 4-cents and 2-cents related to some costs for a $130 billion acquisition. They are prepaying debt, laying off some staff, restructuring some deals. We have seen companies take charges that amount to 20% of purchase prices. In 2018, AT&T had $1.77 billion and in 2019 YTD it has been $0.59 billion. That's 1.8% of the deal price. That's very minor in our view.

Also, for a company that has been selling some assets – they booked a small gain last year and a small loss this year on the asset sales. That also looks immaterial and would qualify in our opinion as one-time items.

Amortization of Intangibles stems from the Warner deal. To the company's credit, it booked $57.2 billion into intangibles that will be amortized into earnings against only $38.6 billion in goodwill that will not be amortized. That's a 60%-40% split. That is actually conservative in our view and certainly most assets at Time Warner were intangible in nature: trademarks, film libraries, distribution networks. We give AT&T kudos for amortizing much more of the cost than claiming it has perpetual value.

Next, the TV and film libraries of already released content are showing rapid amortization. The company listed the amortization period over as long as 10.8 years. In 2018, AT&T amortized $3.0 billion of the $10.8 billion it put on the balance sheet. It appears it continued to further rapidly amortize it in 2019. The remaining accounts are:

Intangibles	allocation	amort time	EPS impact/Q
Distribution Network	$18.00	10.0 yrs	$0.06
Trademarks/Tradenames	$18.10	38.6 yrs	$0.02
Other	$10.20	18.8 yrs	$0.06

Based on the 2018 break down and amortization, it appears the "other" intangibles are being amortized about 3x faster than their estimated longest life too. The other intangibles are closely following their amortization lives. The net result is this adjustment to EPS should decline quickly to about $0.14/quarter and the Other could vanish and make an $0.08/quarter adjustment. Given that all of this represents non-cash expense and AT&T is already seeing the quarter amount fall in a material way – we do not mind calling it out as a line item for earnings. We will give AT&T kudos for more rapidly amortizing these assets and expect the quarterly impact to quickly decline to under $0.10 from $0.25 seen in 3Q18. In the bigger picture, AT&T spent real money on these assets just like it does capital spending – but it's not adding back the depreciation on PP&E in adjusted EPS.

The pension adjustment has to do with offering many employees lump-sum distributions of their pensions who were leaving in early 2019. It would also offer the lump-sum calculation based on higher interest rates and longer mortality rates. AT&T does not have a pension funding problem. It came into 2019 with a PBO of $55.4 billion and assets of $51.7 billion – the underfunding is under 7%.

What happened is many people opted to take the deal and that is making pension asset outflows rise. When distributions exceed service and interest costs for the year – AT&T has to remeasure its PBO every quarter for the year. The remeasurement is coming at lower discount rates that ended 2018 at 4.5% and was cut to 3.7% in 2Q19. When the remeasurements occur, it causes them to recognize actuarial gains and losses that were accumulating in "other income."

The result will be an adjustment for each quarter in 2019 and not only is the PBO discount rate falling, so is the interest rate assumption to calculate pension expense. We accept that this a one-time event for 2019 and AT&T is trying to push people into a lumpsum distribution this year when the outflow will be heavy as they trim employees as part of the merger consolidation.

There should be another one-time charge in 4Q too. Here is what has been booked already in 2019:

Pension Actuarial Hit	3Q19	2Q19	1Q19
Total Cost	$1.9b	$1.7b	$0.4b
EPS impact	$0.21	$0.18	$0.05

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.

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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