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BEHIND THE NUMBERS

Quality of Earnings Analysis

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AT&T Inc. (T)
Earnings Quality Update- 3/21 Qtr.

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

We maintain our earnings quality rating of T at 4+ (Acceptable).

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

Summary

AT&T beat forecasts by 8 cents per share and it looks like a solid beat that still had headwinds in it. For example, the largest contributor of EBITDA and earnings is the mobility unit (wireless) which posted higher results even without at least $100 million (1-cent in EPS) in international roaming fees and late fees against a quarter with them. Debt-to-EBITDA rose to 3.1 times after the $23 billion spectrum purchase. However, AT&T still expects to retire debt via already announced asset sales in 2021 as well as free cash flow after dividends. The forecast is for $15 million in debt retirement and we believe the company can exceed that target.

- Mobility continued building in the quarter on FirstNet and *HBO Max* bundling. Total subscribers and connections rose 1.9% sequentially and 10.0% y/y. AT&T is taking market share at this point. Churn also remains below historical figures, which saves AT&T considerably in replacing customers. Also, the *HBO Max* bundles are driving people to premium wireless plans, which helps on revenue and ARPU too, and offsets the cost of *HBO Max* paid by the mobility unit.

- Mobility financial results looked very strong as well on EBITDA, revenue and margins:

- Revenue was modestly higher y/y – comparing to the last pre-COVID period when there were late fees and roaming fees. Revenue rose even with ARPU down, from $55.68 to $54.10 y/y. That is largely due to the loss of roaming fees. So, there is still a tailwind coming as that business builds again that likely exceeds $200 million per quarter. AT&T is not forecasting roaming to return until late in 2021, but it will have apples-to-apples comps in 2Q-4Q21 as those periods in 2020 had no roaming fees either.

- Service margins also rose 100bp y/y in the quarter. That is also negatively impacted by the loss of roaming fees that are very high margin. AT&T's efforts to remove cost from the system are showing up so roaming fees should also boost margin going forward.

- EBITDA rose 2.3% y/y. Margins were lower as equipment sales remained higher than the year before by 45%. Equipment generates EBITDA but at a much lower margin than service revenue.

- Full 5G should carry higher revenues too and requires customers to adopt newer phones. That seems like another tailwind for revenue and EBITDA for Mobility in 2021 and beyond.

- We believe debt repayment can exceed AT&T's 2021 target of $15 billion. The forecast is for free cash flow of $26 billion and the dividend to consume $15 billion. That leaves free cash flow after the dividend of $11 billion. On top of that, asset sales already announced total $9 billion. Offsetting that $20 billion, AT&T bumped up its forecast for vendor financing payments from $2 billion to $4 billion during 2021 – that leaves $16 billion. The company did not mention additional asset sales but has said on prior calls that it would be opportunistic in selling non-core assets or monetizing real estate, cell towers, etc. Those types of deals would likely be minor, but it is possible that asset sales could exceed current guidance.

- Also looking at guidance of $26 billion in free cash flow and working backwards, AT&T is expecting basically flat free cash flow with 2020, but the moving parts are key. AT&T reports gross capital spending which includes its normal capital expenditures + vendor financing payments + FirstNet reimbursements. During 2021, it reduced the normal capital expenditures by $1 billion and boosted vendor payments by $2 billion since the initial guidance:

AT&T cash flow guidance	2021 current	2021 original	2020 actual
Capital Spending	$17.0	$18.0	$15.7
Vendor Financing Payments	$4.0	$2.0	$3.0
First Net Reimbursements	$1.0	$1.0	$1.0
Gross Capital Spending	$22.0	$21.0	$19.7
Cash Flow from Oper.	$43.0	$44.0	$43.1
Capital Spending	$17.0	$18.0	$15.7
Free Cash Flow	$26.0	$26.0	$27.4

The Cash Flow from Operations is a plug figure using the forecast for Free Cash Flow and capital spending. They are selling a large stake in the video operations. Those generated about $4.0 billion in EBITDA in 2020 and removing that accounts for much of the drop in cash flow in our view. It is $2.4 billion net of the Xandr and external advertising figures that were reported in video. AT&T is boosting vendor payments in 2021 as that helps them gain better terms in the future.

It is also important to remember that AT&T boosted cash flow from operations in 2020 by selling $2.2 billion in receivables. Adjusting for that, forecasts do not look flat.

- Based on the company's forecast for EBITDA from their debt target, they have EBITDA basically declining over $3 billion from 2020. That sounds like a very low target to us:

Debt & EBITDA Target	2021e	2020	2019
Net Debt	$154.0	$147.5	$151.0
EBITDA	$51.3	$54.5	$59.3
Debt/EBITDA	3.0	2.7	2.5

We can see the debt ratio rising because EBITDA fell during COVID in 2020. We understand selling the Video assets being a $2.4 billion headwind, but that gets AT&T to a proforma $52.2 billion in 2020. It looks very conservative to expect EBITDA to decline another $900 million in 2021:

  - WarnerMedia lost theater releases, the NCAA tournament, and other sports. It saved on content production costs, but EBITDA still fell $2.2 billion last year. This year it should get more film releases on movies already paid for. Even if it is backloaded, we would expect improvement in this unit.

  - The Xandr and advertising unit posted a flat year in 2020. It had been growing EBITDA at double-digit rates before COVID.

- The *HBO Max* roll-out was over $2 billion in 2020 starting with revenue of zero. Much of that cost hit at WarnerMedia and Mobility where EBITDA was flat last year. With HBO up 11 million domestic subscribers, AT&T noted direct-to-consumer revenues are up 35%. We know Mobility is seeing higher EBITDA and margins with the bundles. Also, AT&T noted on the call that it has stripped duplicate costs in many areas of Warner's integration and that is expected to pay for much of the HBO Max roll-out costs. If they roll out costs decline and there is revenue from the service and the cost structure is lower – doesn't that add up to higher EBITDA?

- FX has been a headwind in Mexico and Latin American operations. These are minor businesses, but other companies we follow are guiding to FX tailwind in 2021.

- Broadband also continues to grow as well. It is hard to envision wireline and business line phones falling that much more to offset all of these areas.

- We think AT&T could start to outperform this guidance. $90 million is about 1-cent in EPS. Also, the Debt to EBITDA ratio could fall under 3x without much additional effort in our view.

- Debt on a proforma EBITDA was 2.8x at the end of 2020, and the spectrum purchase of $23 billion boosted the debt. If at the end of 2021, debt reduction is $2 billion higher than forecast on flat EBITDA the ratio would be 2.9x. If EBITDA grows more this year (likely more back-loaded), it could almost reach 2.8x – the same as 2020.

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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