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AT&T (T) Update of 1Q19 Earnings
Maintain BUY

We are maintaining our BUY recommendation on AT&T after 1Q19 earnings which met forecasts. Several positives for longer guidance emerged as well and more reasons to expect the company to beat forecasts. Forecasts only call for annual EPS to grow from $3.52 to $3.58 from 2018 to 2019. The Warner Media deal is 16% of the business has already been accretive since acquired and growing earnings at over 7%. The company is on schedule to realize an annual run-rate of cost savings synergies of $700 million by year-end. That would be 8-cents per share annualized and would be realized in part throughout the year. It is also on track to retire at least $18 billion of debt by year-end – which would also reduce enough interest expense to generate an annual run rate of another 8-cents per share. On top of that, some of the negative issues are showing signs of improving too. This remains a very cheap stock in our view at 8.6x EPS and a 6.6% yield.

- **Debt paydown goals look very likely after recent asset sales.** The company has been preaching rapid debt reduction to about 2.5x EBITDA by year-end. That would mean $18-$20 billion of repayment if EBITDA is flat. Free cash flow of $26 billion looks like a safe bet with $12 billion left after the dividend. For the other $6-$8 billion, AT&T has already completed $3.6 billion in asset sales and pulled $1.3 billion out of working capital.

- **Debt to EBITDA should continue to decline after 2019.** Capital spending is expected to decline later in 2019 and 2020 which helps free cash flow. Getting debt to EBITDA down another 0.25x should only mean about $12 billion debt repayment per year.

- **DirecTV showed some life in 1Q19. Subscriber losses have focused on lower revenue customers, premium customers are staying. ARPU is rising and content costs have declined. EBITDA actually rose $645 million in 1Q19.** About 2/3 of the customers at DirecTV on a 2-year price lock up remain to be dealt with this year, but it appears

that the first batch turned out OK, the DirecTV Now service is expected to grow subscribers in 2H19, and with results of 1Q – AT&T is well on its way to achieving its goal of stable EBITDA in this area.

- **FirstNet and 5G rollout are already helping results but are not being priced in.** AT&T is offering faster speeds for free now in 19 cities and should cover 200 million people in the US by the end of the year. This should help customer growth at mobility. They will also start charging for the higher capabilities in 2020 and beyond and could add to ARPU. The also see this replacing some of the business wireline business.

Debt Paydown Looks Very Certain After Recent Asset Sales

AT&T laid out a goal of reaching about 2.5-2.6x EBITDA for debt by the end of 2019. It is using $60 billion in EBITDA as a forecast. That assumes no growth in the year. The company finished 2018 at $171 billion in debt. That should mean paying down debt to $150-$155 billion.

Free cash flow was expected to be $26 billion with $14 billion going to the dividend. The remaining $12 billion would go toward debt retirement. That left another $6-$8 billion to come from asset sales and working capital. Sales of Hulu and Hudson Yards already produced $3.6 billion in cash early in the 2Q. Reworking collateral for foreign hedges freed up $1 billion in cash in 1Q and another $300 million is expected. Thus, they have already achieved basically $5 billion of that goal. They believe they should reach another $1-$3 billion throughout the rest of the year. AT&T is already at the low-end of the goal and could reach the top-end by year-end. If EBITDA rises at all, that also cuts the debt multiple.

If the company pays down $12 billion in 2020 and 2021, the debt to EBITDA should keep falling to basically 2.25x and 2.0x respectively. Free cash flow would also be helped by falling interest expense, synergies, and declining capital spending levels. The synergies would help EBITDA grow and the declining interest expense and synergies should be earnings tailwinds for growth.

Entertainment Unit – with DirecTV Is Showing Improvement

This is where AT&T has needed to rebuild some credibility with investors after implying that despite raising fees they were not seeing decay in customer numbers as expected. In reality, customer numbers dropped significantly in 4Q18 and EBITDA fell noticeably. The company's forecast changed from stability in summer of 2019 to the end of 2019 for EBITDA.

AT&T TV Unit	1Q19	4Q18	3Q18	2Q18	1Q18
Premium Subs	22,359	22,903	23,294	23,640	23,902
OTT Subs	1,508	1,591	1,858	1,809	1,467
Total Change	-627	-658	-297	80	125
ARPU/Premium	$114.98	$121.76	$114.90	$112.19	$112.45

There are two things happening. In the premium subscribers which is the traditional satellite DirecTV business, has suffered from cord cutting and there was a 2-year price lock on contracts that are rolling off now. Roughly 700,000 rolled off already and another 1.6 million roll off during the rest of 2019. AT&T is keeping some of them at higher price points. Second, the Over The Top (OTT) streaming customers have seen cheap deals expire and AT&T has boosted prices and added premium features like DVR on net.

AT&T has reduced costs on content and other areas. It also has seen broadband bundles help it keep some of the TV viewers. We have pointed out that TV is about 7% of total EBITDA at the company and the full Entertainment Group which includes TV, broadband, and legacy land-line phones is about 15% of EBITDA (It was 19% for 1Q19). Total EBITDA for this unit improved considerably in 1Q:

Ent. Group	1Q19	4Q18	3Q18	2Q18	1Q18
EBITDA	$2,801	$2,155	$2,434	$2,821	$2,620

The company came into the year forecasting they would stabilize EBITDA here at $10 billion and investors would see that by year-end. A sequential jump of $646 million makes that forecast look more realistic now. The company did not boost guidance and noted that the 1.6 million price lock rolling should be complete by November. It is reporting that the people churning are lower-priced customers where broadband bundles are not available, the highest paying customers are staying. Also, bundles with broadband and mobile help retain premium TV customers. Both broadband and faster mobile are rolling out to more areas.

Also, OTT subs should stop falling in 2Q19 and the new price points are adding more customers for that product too according to the management. The content costs have been adjusted down and higher prices are holding well. Y/Y 2Q added 342,000 subscribers last year which is likely a tough comp. After that, the comps are easy for 3Q and 4Q.

First Net and 5G Could Help Mobility Surprise on the Upside

Mobility at AT&T is still 50% of the EBITDA. It is growing customers at an 8% y/y rate the last two quarters. ARPU is up as well. The only aspect that changes the model is equipment sales – do the people buy the phone from AT&T or show up with one. Equipment sales rise and fall based on phone replacement cycles. Currently, equipment sales are lower and EBITDA rose about 2% for 1Q19.

The basic breakdown here is mobility is 50% of the business and it is growing. The key remaining businesses are each about 15%-17% of the business. WarnerMedia is growing. Entertainment hopes to be flat this year after strong growth in 1Q and become a growth area going forward. Business Wireline is a negative growth story and AT&T manages the decay with cost-cutting. If 85% of the business is flat to growing – this should be a gift at 8.6x EPS.

We also believe mobility could see growth pick-up in 2019 and 2020 with the continued roll-out of FirstNet and 5G. FirstNet has 570,000 customers signed up now. That is with about half the roll-out complete. The first responders had been an area of low penetration for AT&T and they could become the dominant player there as this network grows. They are also offering family plans to first responders and believe that getting one is often the equivalent of adding two new customers.

As a result of starting up parts of the FirstNet platform, AT&T is now able to offer 5G Evolution in 19 cities. It expects this to reach 200 million people in the US by year-end. The speeds available now on the first cites are 80-150 mb for data and video downloads. They are seeing customer growth from this now. As this network continues to roll out, more people will be seeing this positive change. There are three things to keep in mind:

- AT&T is not charging for this yet. People with a newer phone are getting this for free. They expect to start having plans for this in a few quarters so ARPU could rise in 2020 and 2021 and boost growth at mobility.

- Randall Stephenson noted they are not aggressively pushing this system yet either, "*The value proposition is now one of quality and speed and delivery of video and* ***we're not going out doing a lot of aggressive promotions and we're not doing pricing to try to get customers to stay and come on to the network. It is happening just organically*** *and by virtue of the strategy that we implemented. The 5G evolution of product that we have out there as we turn all this spectrum up and put the new technology on MIMO and so forth, our competitors hate it, but it is having exactly the effect that you wanted to have. Our customers see this tag and they go do a speed check and they're seeing 80, 90, 100, 150 meg speeds depending on where they are. It is truly a step change difference in product capability. And that is having exactly the effect that we had hoped."*

- This could replace some of the business wireline business in factories, hospitals, and other large organizations. Speed and reliability will be there and it will allow for greater automation. This could transform the last lagging business at AT&T into a new growth area for mobility.

We actually do not think any of this is priced in with the stock at 8.6x EPS. If their largest unit starts to see more accelerating growth in customers and pricing for several years – this is potentially a game-changer. Moreover, this would be starting as the Entertainment Group is also showing stability from its TV unit. Just to put some rough numbers on this – here is the change in thinking that could start to happen in the market for AT&T stock during this year.

EBITDA	% EBITDA	Current Growth	Total Gain	Future Growth	Total Gain
Mobility	50.0%	3.0%	1.5%	5.0%	2.5%
Warner	17.0%	7.0%	1.2%	7.0%	1.2%
Entertainment	16.0%	-2.0%	-0.3%	0.0%	0.0%
Wireline	15.0%	-5.0%	-0.8%	-3.0%	-0.5%
Total			1.6%		3.2%

This is back of the envelope thinking just to show that stability in entertainment and higher growth from 5G could essentially double the EBITDA growth rate. This doesn't assume growth from lower interest expense or cost savings synergies also contributing.

Explanation of EQ Rating Scale

Rating	Description
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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