BEHIND THE NUMBERS
Quality of Earnings Analysis

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AT&T Inc. (T)
Spinoff Update

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).

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

Summary

We could not be more pleased with AT&T unlocking the undervalued parts of its business this week. We started following the company after the Time Warner deal and we were like many analysts who did not like the purchase (They bought an asset at 12x EBITDA and rolled it into an entity trading for 6x). However, that already drove the stock price down from $43 to about $30 before we were involved and we saw potential in the sum of the parts.

- We thought Warner was always worth at least $10 per share net of $43 billion in debt (10x EBITDA)
- We valued DirecTV at $0 and AT&T sold a 30% stake for $7.8 billion or $1.09 per share plus it should still get some cash flow from the 70% it still holds.
- Subtract the remaining debt from a growing wireless valuation of 7-8x for another $16-$20 per share.
- A debt-free broadband unit is adding $4 billion in EBITDA and growing – is that worth 8x – there's more than $4 more in share value

- The business wireline is generating $9 billion in EBITDA – maybe that's only worth a multiple of 4x-5x – or $5-$6 per share.

- If Vrio, the Latin American phone system, and Xandr are worth anything, the value here was north of $40.

While people reacted negatively to the spin-off because of an announced dividend cut, we think this misses some key points. Primarily, there is an important value driver from Warner still with AT&T – the HBO Max bundle for the mobility unit that should boost AT&T's profits post spin-off. Retiring so much debt is going to help EPS grow and enable AT&T to invest more heavily in its primary businesses – domestic wireless and broadband – rather than fund the international expansion of HBO. We also think the value being given to shareholders from the spun-off unit is worth much more than the level of dividend reduction.

- The forecasts for the combined media spin-off do not look aggressive to us. A forecast of $12 billion in starting EBITDA looks tame considering the two companies did almost $16 billion in EBITDA pre-COVID.

- We think the spin-off in mid-2022 is more likely to trade on 2023's forecasted EBITDA of $14 billion, not $12 billion and the HBO Max will be a larger unit by then too. Many of the lost areas of COVID such as movie releases and some sports should be recovered too. The current trailing 4-quarters have large shut-down impacts and the initial roll-out costs of HBO Max before revenue started coming in.

- When we view the 71% stake AT&T shareholders will get, we see the valuation being worth about $60 billion plus $43 billion of assumed debt. That alone looks favorable compared to the $109 billion AT&T spent on Time Warner and does not assign value to the HBO Max bundling arrangement that remains with AT&T's wireless unit.

- HBO Max has helped AT&T cut churn at its wireless unit by 25-50bp. Every basis point is about $100 million per year in revenue. It has also helped AT&T boost subscribers and get more signed up for premium service plans. Despite paying fees to HBO Max, wireless is seeing EBITDA and margins rise. This deal will remain in place after the spin-off. We value this deal at about $2 per AT&T share.

- The dividend is getting cut – from $2.08 to about $1.20 per share. However, investors appear to be receiving value much larger than the 88-cents in lower annual income in our view. The new shares appear to be worth $7 to us, which should be helped simply trading these assets at a multiple higher than AT&T's stock. That is several years of 88-cents in annual dividends being received upfront.

- The spin-off will also give AT&T shareholders a bump from the media company taking debt of nearly 5x EBITDA – a higher ratio than AT&T's current debt. Keeping the multiple the same but moving debt from 3.1x EBITDA at AT&T to 2.7x as a result of the spin-off, transfers $2.60 per share to the stock value also. Both companies will see growth simply from deleveraging too.

- Much of the dividend cut is coming from AT&T bumping up its capital spending plans to accelerate growth at wireless and broadband. The dividend cut is $6.4 billion. Capital spending would rise from $17 billion in 2021 and $20 billion in 2019. The IRR on this spending is expected to be mid-teens and will double the size of broadband in under 5-years and expand wireless to 200 million POPs by the end of 2023. That should help growth for earnings and EBITDA.

- This will also enable AT&T to abstain from vendor financing which analysts have looked unfavorably toward as it essentially understates capital spending by moving some of it to the financing section of cash flow. Adjusting for this, gross capital spending will rise but actual free cash flow should not drop as much as many think.

- We think this deal sets up AT&T well to deal in a world where interest rates are no longer declining. Before this deal, AT&T had a flat dividend which has a definite bond-like quality when people value in a world when rates are not declining.

- A huge paydown in debt this year, with the spin-off, and to finish 2022 could set AT&T to eliminate 40% of its debt in under 2-years and also means falling interest expense could add $3 billion to earnings growth. The spin-off also will produce growth via deleveraging.

- The higher investment in wireless and broadband should spur growth and the rollout of HBO Max with more content internationally should help the spin-off growth more and solidify its value to the wireless bundle. Growing earnings and cash flow with lower debt levels already has AT&T talking about growing the dividend post-spinoff, repurchasing shares, or taking debt levels even lower. Faster growth of earnings or dividends could be rewarded by the market especially with two different pure-play investment vehicles.

Supporting Details

The Forecasts of the Media Combination Does Not Look Aggressive

Before COVID, Discovery had EBITDA of $4.7 billion and WarnerMedia did $11 billion. The trailing four quarters includes COVID issues, lack of theater distribution, the loss of some sports and paying to roll out HBO Max. During that time Discovery had $3.9 billion in EBITDA and Warner Media $8.8 billion.

The forecast is for the combination to produce revenue synergies that they do not quantify and cost synergies of $3 billion to have a 2023 combined EBITDA of $14 billion. We think the $3 billion in cost savings sounds high. However, getting to $14 billion from an impaired $13 billion does not sound difficult considering pre-COVID the two companies were already ahead of that target. Even paying for more HBO Max rollout may not deflate the $14 billion figure.

AT&T paid 12.5x EBITDA for Time Warner: $109 billion in the form of $85 million split evenly of cash (which it borrowed) and new AT&T shares plus the assumption of about $24 billion of debt. One of the criticisms of the spin-off is AT&T is selling at a loss. AT&T will receive cash and transferred debt of $43 billion and 71% of the new company. The new company with Discovery's $15 billion in debt is expected to close with Debt/EBITDA of 5x which puts the expected EBITDA in mid-2022 at only $12 billion. That makes the selling price for Time Warner $78.5 billion at 9x EBITDA to $104.1 billion at 12x EBITDA.

The first item we would look at is the new company is expected to do $14 billion in annualized EBITDA by the end of the first six months. The extra $2 billion in EBITDA would already add $12.8-$17.0 billion to the value AT&T is receiving at a multiple of 9-12x. We will discuss below that we think keeping the HBO Max deal for AT&T wireless customers is also adding value. We put that at $12-$16 billion. Thus, we don't think AT&T is losing its shorts on this deal:

NewCo value	**9x**	**10x**	**11x**	**12x**
2023 EBITDA	$14.0	$14.0	$14.0	$14.0
Value of company	$126.0	$140.0	$154.0	$168.0
less initial debt	$58.0	$58.0	$58.0	$58.0
Equity Value	$68.0	$82.0	$96.0	$110.0
71% to AT&T	$48.3	$58.2	$68.2	$78.1
Plus transferred Debt	$43.0	$43.0	$43.0	$43.0
HBO Max Deal	$12.0	$12.0	$12.0	$12.0
Value to AT&T	$103.3	$113.2	$123.2	$133.1

AT&T Will Have the Benefits of a Larger HBO Max for Its Wireless Bundle

In the year since the launch of HBO Max, the number of subscribers for HBO has increased from 33.1 million to 44.2 million. HBO Max has been one area where AT&T has seen some synergistic value from the deal as it offers it to wireless customers. This has spurred growth in numbers of clients and growth for premium service plans at mobility, which is driving revenue in that unit. It has also helped reduce churn among its customer base:

- Postpaid churn is down to 0.76% from consistently being 1.00-1.30% in prior years. AT&T has pointed out that 1bp of churn is worth about $100 million in revenue at wireless and the margin is likely higher margin as it avoids the costs of set-up and activation when a customer stays. The company has pulled 25-50bp of churn out of the unit.

- The service margin at mobility is rising too and is now 57% on a rate of $14 billion per quarter revenue figure. That is still being negatively impacted by the loss of roaming fees and late payment fees. In 2020, AT&T spent about $2 billion on the HBO Max roll-out, which fell largely on WarnerMedia and Mobility. Despite the expense and the lost roaming fees, margins are up, EBITDA is up, and revenues are up.

- Adding Discovery's content to the mix should not hurt the appeal of the HBO Max bundle on the mobility unit.

AT&T's mobility unit will continue to have a tie-up with HBO Max it can offer customers. That looks like some future value from WarnerMedia that will remain with AT&T after the spin-off:

> Per John Stankey at AT&T ***– "[HBO Max] has been a highly beneficial relationship despite some of the commentary that I picked up we get a lot of benefit from churn in our core connectivity business. You know what our customer acquisition volumes have been. So we have every motivation and incentive to keep a differential relationship with the company moving forward.*** *I believe we're going to see new points of aggregation for content as we move forward. I think wireless is starting to demonstrate itself. A wireless subscription is one of those points of aggregation, and it's going to be important that we think about servicing our customers as a result of that.*
>
> *But when you think about what happens here,* ***the opportunity for David to grow this media company globally is what outstrips the value creation from us owning the asset and driving churn and customer acquisition and connectivity domestically in the U.S.*** *and allowing him to go after an opportunity globally that's got a much bigger multiple on it.* ***But our intent is to continue relationship.*** *And then the share owners that stick with the new entity, will, of course, get the benefit of that as it continues to grow in scale through that distribution partnership, and we just think that's a better way for us to handle the capital structure right now given the growth requirements on the new media business."*

Per David Zaslov at Discovery – "***we've seen what John's communications business has done for HBO Max. It's hugely valuable for both. It's a great relationship**. And AT&T is only going to get stronger and more power. It's already the top direct-to-consumer company in America. With an extraordinary brand. So we hope we -- for years to come, we'll be figuring out how to create value for each other."*

When we look at this relationship that will remain with AT&T, it doesn't require capital spending by AT&T yet still helps AT&T add business and do so at higher rates. What is 30bp of churn worth at a 50% margin? That's $1.5 billion per year. What is higher ARPU worth from having customers take premium plans? 53-cents of ARPU is another $0.5 billion per year. In total that would be $2 billion in incremental EBITDA to AT&T from the HBO Max deal. Value that at 6-8x for $12-$16 billion in value still at AT&T after the spin-off. That's worth $1.70-$2.25 per share in our view.

But AT&T's Dividend Will Be Lower…

The howls of the spin-off focus on AT&T announcing it will cut its dividend when the spin-off is complete. The current dividend is $2.08 per share or $15.0 billion in total. The new one is expected to be 40%-43% of free cash flow of $20 billion or about $8.6 billion and translates to $1.20 per share. An 88-cent annual cut.

The first thing we would point out is shareholders are getting some substantial value from this deal. Unlocking the sum-of-the-parts valuation involves changing the form of cash flows. The $2.08 dividend will be paid for another year. Then in exchange for losing 88-cents in annual dividend – shareholders will receive:

- 71% of the new company. The market is saying this equity is worth $5 per AT&T share based on $12 billion in EBITDA at 9x. We'd say it's worth at least $7 using the $14 billion EBITDA forecast at the time and the same 9x multiple. It could be worth as much as $10 per AT&T share with a slightly higher multiple. No matter how this is viewed – NewCo's media assets should trade higher than AT&T's EBITDA multiple of 6-7x. That alone is unlocking value.

- The new company is expected to grow at a faster rate than AT&T, which should support a higher multiple and anticipates that debt will rapidly fall from 5x $12 billion in EBITDA to 3x within 24-months. That would mean EBITDA at NewCo would rise to $19 billion if no debt was actually paid down, or $16 billion if debt was reduced by $10 billion over those two years. Either way, that is sizeable growth and should translate into a higher stock price for NewCo over time.

- A distribution of $5-$7 of NewCo is already worth more than several years of 88-cents of annual dividends. If NewCo grows, the appreciation looks like it should also exceed 88-cents in annual dividends.

- Shareholders also retain stock in AT&T that now loses $8.8 billion in Warner EBITDA, but also loses $43 billion in debt. That's a higher Debt/EBITDA multiple than AT&T as a whole. Just removing the $43 million in debt drops AT&T's debt ratio from 3.1x to 2.7x. Keeping the same multiple on AT&T and using the lower EBITDA – the reduced debt ratio moves $18.5 billion from debt to the stock or $2.60 per share. That's over 3-years of the 88-cents too.

- Plus, AT&T still has the HBO Max bundling deal after the spin-off. That is pushing down churn and boosting ARPU for the wireless unit. Higher EBITDA there looks like that is worth about $2.00 per share also.

Some of the Dividend Cut Is Due to Ramping Up Investment in AT&T

Lower debt levels and not having to devote efforts to media with this deal also has AT&T talking about investing in more growth for its wireless and broadband units. Stockholders have wanted this for years as they derided the DirecTV and Time Warner deals and the debt situation.

According to AT&T, it will seek to double its broadband business from 14 million customer locations to 30 million by the end of 2025. It also plans to deploy the new spectrum it just bought to expand POPs to 200 million by the end of 2023. That should enhance speed, quality, and desirability of the network.

That doesn't happen for free, AT&T expects to boost capital spending to $24 billion from the current level of $17 billion. Thus, when looking at where the dividend cut of $6.4 billion is coming from ($15.0b now to $8.6b expected) – stop attributing it all to spinning off Warner. It's being reinvested in growth. AT&T is touting that investment in these two areas is generating mid-teens for rates of return. That exceeds the dividend yield.

In reality, the bump in spending is closer to $4 billion as AT&T will also clean up the Vender Financing situation that has been on the cash flow statement. In past years, some of the heavy capital spending in current years was being financed by its suppliers. That resulted in lower cash outflow for capital spending, but it also moved payments to vendors out of the investing section of cash flow and into the financing section. Thus, the lower net spending was not including the payments for prior capital spending that were in reality lowering free cash flow. Computer analysis doesn't pick up the true free cash flow figures. Here's what was happening:

	post-spin	2021e	2020	2019
Cash from Ops	$44.0	$43.0	$43.1	$48.7
Cap-Ex	$24.0	$17.0	$15.7	$19.6
Free Cash Flow	$20.0	$26.0	$27.4	$29.1
Cap-Ex	$24.0	$17.0	$15.7	$19.6
Vendor Payments	$0.0	$4.0	$3.0	$3.1
First Net Reimb.	$0.0	$1.0	$1.1	$1.0
Gross Cap-Ex	$24.0	$22.0	$19.7	$23.7

According to the CFO Pascal Desroches – on the change:

> *"Vendor financing right now, we have vendor financing where we're spending on CapEx that doesn't go through free cash flows. And we have CapEx spent for cash. Going forward, our intention is virtually all of the CapEx will be cash CapEx unless we find really, really attractive terms to vendor financing. So the $24 billion is an all in number, and that's how you should take it."*
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> *"Going forward, we intend to phase out most of our vendor financing arrangements. Strengthening our balance sheet will give us greater flexibility going forward. This could give us the option to increase our dividend and/or repurchase shares in the future."*

AT&T Is Set Up Well for the Future

Against the backdrop of some pressure from inflation and higher movement in interest rates, we think AT&T was in good shape already before the spin-off. What attracted many to the stock was the high dividend. However, it wasn't growing the dividend and that was unlikely to change anytime soon. With no inflation and low interest rates – no one cares. With those pressures building, it would likely have reacted as if the stock was really a junior-class bond – fixed coupon and super long maturity.

The way to beat inflation and higher interest rates is with some growth and reducing leverage. There are many areas where this should happen with AT&T and the spinoff:

- AT&T has $169 billion in debt at an average cost of 4.4%. It was already targeting $15 billion in debt reduction this year keyed by the sale of 70% of DirecTV and Crunchyroll. The spin-off will remove $43 billion more in debt in a year. It also sets the company up to have free cash flow after the dividend of $11+ billion per year to retire more debt. AT&T could end 2022 with only $100 billion in debt. That would save $3.0 billion in interest

expense and would add 33-cents to EPS. Cleaning up vendor financing also deleverages AT&T.

- More deleveraging could happen with the pension plan. At the end of 2020, the pension plan was underfunded by $7.6 billion. PBO was $62.2 billion. However, from 2018 to 2019, the discount rate to estimate the PBO fell 110bp from 4.5% to 3.4% and added $8.0 billion to PBO. From 2019 to 2020, the discount rate fell another 70bp to 2.7% and added $5.6 billion to PBO. It would not take much in the way of higher interest rates to reverse this trend and cure the underfunding level.

- AT&T would be in a position to retire more debt or repurchase shares. If they acquire $9.0 billion in stock (at $30), it would add 4% to EPS growth and they could add a nickel/share dividend for 4% dividend growth, while keeping the total dividend outlay flat at $8.6 billion. If they retire $9.0 billion in debt at 4.4%, it would add 4% to EPS growth too. As the CFO noted on the call, *"Strengthening our balance sheet will give us greater flexibility going forward. This could give us the option to increase our dividend and/or repurchase shares in the future."*

- Broadband is expected to double in size in under 5-years at a double-digit ROI – that should be producing growth as should the additional spending at mobility.

- We know HBO Max is producing higher revenue and EBITDA at mobility and HBO Max will add more content. Mobility is also expected to see roaming fees return that have been costing the company earnings already. It should be able to charge more for 5G going forward and it continues to add FirstNet subscribers as well their families. That sounds like growth too.

- The stand-alone media company can tackle international expansion without AT&T paying for it and allowing AT&T cash flow to invest in mobility and broadband. Yet, the media company will likely still have a higher valuation multiple than if it was part of AT&T and should have good growth itself from expansion and deleveraging too.

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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