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AT&T (T) 2Q19 Update
Maintain BUY

For over a year now, **AT&T (T -$33.80)** has been hit with negative news related to debt levels surrounding the Time-Warner acquisition and weakness in its TV operation. The company reported considerable progress on both fronts as well as other areas of the company that many investors have been ignoring in the last year.

We maintain our BUY recommendation even after yesterday's pop. The dividend yield is still 6% and well covered. Plus, the stock remains cheap at 9.5x trailing EPS, 6.7x trailing EBITDA, with several areas still pointing to growth in EPS and EBITDA for several years. The company hit EPS targets of $0.89 for 2Q19 and that was with the tax rate coming in higher than expected and cutting EPS by $0.02.

- **Debt targets are likely to be hit.** The Time Warner deal boosted Debt/EBITDA to 3.0x and the market has been skeptical of AT&T cutting it to 2.5x by the end of 2019. After asset sales and improved cash flow, the company looks like it will comfortably reach that goal.

- **$9-$12 billion in debt reduction for 2H19 should be covered by multiple asset sales that are currently being worked on and over $6 billion in free cash flow after the dividend that should come in during 3Q and 4Q.** There is a potential for cash flow to come in higher based on current trends as well. EBITDA above $60 billion also would reduce the amount of debt needed to be paid down to hit a 2.5x target.

- **AT&T is discussing that share repurchases could start in 2019. After this year, the focus on debt reduction will be less intense and should allow repurchases regardless.** Capital spending should also decline as the 5G and FirstNet buildout is completed allowing free cash flow to rise. AT&T sees buying stock at a 6% post-tax dividend cost of capital as an attractive use of cash versus retiring 4%-5% pre-tax debt and investors will likely see some balance in capital allocation to those areas.

- **The TV unit is hitting forecasts of stabilizing EBITDA for early 2019. AT&T has allowed lower paying customers to churn off while retaining others at higher fees.** With half of the 2 million customers seeing an end to their discount fee lock-ups already, AT&T has actually started to grow EBITDA again in this area on fewer customers. Another million customers will be in a position to renew or leave in the 2H of 2019. **Wild cards remain regarding that next million customers and the success of the streaming network's rollout. We think investors should remain focused on the wireless side and less on TV as it is only about 7% of total EBITDA.**

- **Many other catalysts point to growth for EBITDA, FCF, and EPS. FirstNet and 5G are rolling out and should be nationwide during 2020. As it is completed, capital spending should fall and boost FCF for share repurchases and debt retirement.** It also opens AT&T up to millions of First Responders and their families as new customers. Currently, the company is not charging for the higher speeds of 5G Evolution, it should be able to boost fees as 5G turns on and drive growth at its largest unit.

Debt Targets Appear Likely to Be Met and Possibly Exceeded

The Time-Warner deal pushed the Debt to EBITDA ratio to 3.0x. Investors were skeptical that AT&T could reduce debt to 2.5x by the end of 2019 – a $30 billion reduction. Moreover, the concern was share repurchases would be off the table.

Flash forward to 2Q19, the debt reduction has already been $18 billion leaving only about $12 billion to go. EBITDA has increased too, which would allow the debt figure to remain higher than $150 billion and still hit 2.5x EBITDA. We think AT&T could declare victory if debt fell by $9-$10 billion in 2H19, but the $12 billion figure looks more than doable.

The company raised 2019 free cash flow guidance from $26 billion to $28 billion. Much of that increase is due to securitizing acquired Warner Media receivables in the 2Q19. That source of cash will not recur but has already been achieved. It is holding capital spending forecasts the same $23 billion, which excludes $1 billion from reimbursement from the

FirstNet project and does assume vendor financing. So here is a 2H forecast vs 1H realized cash flow:

Cash Flow	2019e	2H 2019e	1H 2019
FCF	$28.0	$13.5	$14.5
Dividend	$14.8	$7.4	$7.4
Avail for Debt	$13.2	$6.1	$7.1

Even without another receivable securitization, the remaining capital spending is a bit lower ($12.6 billion in the 1H19 leaves $10.4 billion for 2H19), so AT&T should produce close to the same FCF in the 2H as 1H. Guidance has been that asset sales of $6-$8 billion would be achieved and $4 billion already has. The company has several more assets such as real estate, 2,300 cell towers, and investments to sell. It also believes it can find a bit more from working capital. Also, they think free cash flow could come in closer to $29 billion as well. Thus, it looks like $6 billion more debt will be paid down via free cash flow. Another $1.0-$1.5 billion could come from cash flow exceeding forecasts. Another $2-$4 billion could come from asset sales. Also, EBITDA appears likely to come in above $60 billion. It's been above $15 billion for 3 of the last 4 quarters and the one that came in below was $14.8 billion.

In summary, AT&T likely needs to retire another $9-$12 billion in debt in the 2H of 2019. It should get over $6 billion from Free Cash Flow. It hinted that the FCF forecast is likely light and it as much as $4 billion more of asset sales in the works.

Buying Shares Also Likely to Begin Earlier than Forecast

After 2019, the company has stated that over several more years, it wants to return the debt/EBITDA ratio to 2.0-2.2x. EBITDA should be growing during that time and debt would likely fall another $10-$20 billion by 2022-23.

Assuming $5-$7 billion of annual debt retirement, that should be easy to achieve looking at FCF less the dividend that is already at about $13 billion annually. On top of that, the capital spending has been elevated as AT&T rolled out the FirstNet network and built out the infrastructure for 5G at the same time. So capital spending levels should be falling off and boosting FCF by several billion dollars per year.

Thus, yesterday the company talked about using excess cash flow after the dividend and meeting debt ratio targets to repurchase shares. John Stephens the CFO mentioned this twice:

> *"Looking at the remainder of the year, we're confident that we'll hit our year-end leverage target.* ***To the extent, we can overachieve with that target you can expect will take a hard look at allocating capital to share buybacks in the back half of the year****."*

> *"With regard to the balance sheet, I think, if you can think about as we talked about after – the fourth year after the close of the deal. We look to be – I'd expect, we'd be somewhere around the 2.0 range or below that gives us great flexibility to pay down debt and take advantage of what now is a higher cash cost of equity capital than the cash cost of our debt capital. So, when you look at out of very methodical basis, right now,* ***the cash flows of the overall operation on an after dividend basis can be enhanced by shifting some of your focus from debt repayment to buyback****."*

The TV Unit Is Hitting Targets But Still has Wildcards

We still think far too much emphasis at AT&T is on the TV unit which is only about 7% of EBITDA. However, investors focus on it and that is unlikely to change in the immediate future. Guidance was for stability to be achieved in 2019 and the results are now showing that. This has been generated by having 2 million customers on lower-priced deals roll-over with churn eliminating some, but others remaining at higher rates.

Ent. Unit	2Q19	1Q19	4Q18	3Q18	2Q18
Premium TV subs	22.9	23.9	24.5	25.1	25.4
OTT TV subs	1.3	1.5	1.6	1.9	1.8
Premium ARPU	$117.49	$114.98	$121.76	$114.90	$112.90
Ent. Rev	$11.4	$11.3	$12.0	$11.6	$11.5
Ent. EBITDA	$2.9	$2.8	$2.2	$2.4	$2.8

The DirecTV Now business is the OTT. It has been losing customers as cheap deal rolls off and not all customers renew at the higher rates. The premium TV has been seeing the same situation and another 1 million subscribers will see cheaper deals expire through the end of 2019. The company and expectations point to more customer decay in terms of number of subscribers. However, the belief is the higher ARPU will become more evident and hold profitability at these levels.

There is more going on here such as disputes with CBS which has several stations turned off on the various forms of DirecTV at this time. AT&T does not see much difference between the offers between the two companies and expects that to be resolved quickly. Another dispute with Nexstar involves carrying local channels in some markets. Nextstar wants a 100% increase in fees that AT&T is not willing to pay. People have work-arounds to receive those channels as they are available for free as over the air deliveries. That dispute does not sound close to being resolved at all as more customers deal with a "stay at a higher fee" decision during the rest of 2019.

Another wildcard is the AT&T streaming product that rolls out as a beta test in a few markets in the coming months and will roll out heavily in 2020. There are no numbers to really go on to evaluate this at the moment, other than to say streaming is becoming a very crowded area and content delivery will vary widely among the various providers. The sheer number of players could make customers more likely to shop around and change providers more frequently. It could also cause more to stick with current systems longer too.

What AT&T has found is that it is much more likely to win and retain customers when it can bundle wireless service and high-speed broadband with TV options. Given that it has faster wireless speeds now with 5G Evolution and will have 5G expanding in 2020 and beyond along with a sizeable broadband footprint and content via HBO and the rest of Warner – it should have some good selling points to make.

At this point we are going to simply say that AT&T is now reaching its goals in entertainment after an ugly 4Q18 and 3Q18. The wild cards related to churn and new product roll-out may have to be experienced for a couple quarters before determining a trend. Also, investors should keep in mind, Broadband is a larger part of Entertainment's EBITDA than TV. Of AT&T's total EBITDA above $60 billion – TV is about 7% of that. Thus, positive or negative – TV shouldn't be viewed as the key business, but it continually gets an overweighting in investor sentiment. The WSJ's headline on the quarter about 2Q19 results was about TV subscriber figures falling for example.

The Bigger Catalysts Should Start Turning On in 2020 and 2021

Beyond hitting the debt reduction targets and starting to repurchase stock at under 10x EPS. We believe there remain some sizeable catalysts here:

1) Capital spending has been elevated with the simultaneous rollout of the FirstNet and 5G infrastructure in the last two years. They are currently about 60% built out and are 9-months ahead of schedule. They expect to be 70% complete by the of this year and have nationwide coverage in the summer of 2020. The capital spending figure may start to decline by several billion dollars next year. That will enhance free cash flow and fuel more debt reduction, share repurchases, and/or dividend growth.

2) FirstNet enables them to add more wireless customers. They started with a low penetration into that market. They should become the largest provider to that area which has 3 million potential new people and are only now starting to see that grow. Some of those will have multiple phones/tablets to enroll. Add to that, second-tier emergency people such as people who restore power in a storm, relocate hospital patients, engage back-up systems for utilities, hospitals, government offices – that is 8 million more people that will have access to the FirstNet system. Then, AT&T can offer plans to the families of those users too. There is a fairly sizable base of new wireless customers from FirstNet that should be driving growth in the coming years.

3) 5G Evolution is up and running in many markets now. Customers with newer iPhones and Samsung phones are already seeing much faster speeds. That should help hold back churn and lower customer acquisition costs. Actual 5G starts rolling out shortly. AT&T will be in a position to start offering faster speeds and charging for it. Wireless is by far AT&T's largest source of EBITDA at essentially half the total. They should be in a position to add customers from FirstNet and raise ARPU in this area. ARPU is essentially $50-55/post-paid customer per month. That's 76 million people. If they can add to the 76 million and add a few dollars of ARPU with 5G – that is growth that adds up quickly.

4) As the build-out is completed, much more of the remaining process requires software rather than hardware installation. The capital needs and cash operating costs should fall on a per unit basis as the revenue stream per new user is increasing.

We still look at this as the stock is under 10x EPS and 7x EBITDA paying 6% in cash to wait and compensate for wildcard news on one of the smallest parts of the AT&T business – TV. Current growth is for single-digit EPS growth, but that should accelerate with the new FirstNet and 5G operations gaining customers and revenue/user. Debt/EBITDA goals are being met and the ratio should continue to fall as EBITDA rises and FCF increases to reduce debt further, plus the company is focusing on future share buybacks of a cheap stock. If EPS grows with acceleration of the wireless unit and share repurchases, the P/E ratio should probably also rise.

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