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AT&T – Time Warner Update 2Q18

As expected, AT&T added more color to the Time Warner deal in the 2Q18 earnings release and presentation. Our concerns on how rapidly debt would be repaid were increased after the discussion:

- The goal was to reduce Debt to EBITDA from 2.9x to 2.5x within one year. After the call, that goal has been pushed out 6-months to the end of 2019.

- We believed a rapid pay-down in debt would require some asset sales in the range of $15-$20 billion to hit their debt reduction target. So far, AT&T has only identified about $2 billion – the sale of some data centers to Brookfield and the sale of Broadcast 600 spectrum.

  It concerns us that they had nearly two-years to find more and couldn't come up with specifics. John Stephens on the call said, *"Well, we have normally planned for asset sales and constantly look at underutilized assets for monetization, for example, the data centers, the broadcast spectrum 600, which is a couple of billion dollars right there, we have under contract and waiting for approvals today. We'll continue to do that. If you want to give a scope to it, as of today, we have about $500 billion in total assets. And so finding a few more opportunities to monetize assets seems to be very reasonable on top of the things that we've kind of commonly done with regard to real estate and other underutilized business in spectrum. So that batch [ph], I'm not giving you any specific number on asset sales, but as we've proven this year, we're going to continue to do that."*

  We have not seen much more on a potential IPO of the Latin American assets of DirecTV and AT&T withdrew an IPO for Vrio Corp in April. Working against the debt paydown, it also bought AppNexus for an estimated $1.6 billion and another company Alien Vault.

- The free cash flow of Time Warner for the next 6 months is expected to go towards covering the integration, one-time payments, and various fees. It does not sound like Time Warner cash flow will start paying down debt until 2019 according to John Stephens, "Our free cash flow guidance at the beginning of the year was standalone. We expect most of the benefit of the Time Warner free cash flow for the last half of the year, about $2 billion, will be absorbed by integration and deal costs, including severance costs, retention incentives, legal fees, bankers' costs and interest expense prior to close."

- AT&T focused more on the debt ratio decreasing due to higher EBITDA and less on debt paydown. We believe some of their plans in that area may be successful, but that takes more time. As we noted, the combined company has about $8 billion in free cash flow AFTER paying the dividend. The company raised its free cash flow guidance on the 2Q18 call and it also mentioned that some of this $8 billion per year would be directed to debt reduction. The targets on Debt to EBITDA falling under 2x a few years out always looked realistic in our view given the cash flow figures that were present before accounting for any cost savings or revenue gains. We still do not see hitting the 2.5x EBITDA target in 18 months without a sizeable asset sale.

Our view of the Time Warner deal remains basically the same other than the goal of rapid debt paydown. The deal was expensive, but Time Warner's cash flow is growing and is large enough to pay the interest ($3 billion) and incremental dividends ($3.6 billion) on the newly issued shares. However, Time Warner's cash flow (EBITDA about $9 billion and Free Cash Flow of about $5 billion) is not large enough to make meaningful debt payments to drive rapid paydown after paying interest and dividends. AT&T's cash flow will provide the bulk of that. Raising the forecast slightly for free cash flow by AT&T remains a good sign. We would also point out again that without tax reform and the pension funding needs declining – this merger would not look as strong.

When we wrote on July 12, 2018 about improvements at AT&T in the last two years that are being masked by the Time Warner merger, we quantified the positives of the improvements in pensions and tax reform. We could not completely quantify the positives of accelerating copper retirement and faster rollout of broadband that is now being pushed by the FCC, but that is happening. Also, the FirstNet rollout, which is being reimbursed by the government is also getting the 5G-network equipment built-out for essentially the cost of parts and getting that network started. (Think in terms of replacing a water pump on a car – by itself, parts, time, and labor that may be $500. But, if you have it done at the same

time the timing chain is replaced it may only cost $50 in incremental parts as the labor and time are already being covered.) So, this is helping lower the costs of installing the next wave of technology. We do not believe that any of that is built into the stock price at this point.

Two other big trends are also not being priced into AT&T's stock in our view. The rollout of DirecTV Now is one, and greater advertising potential across its 170 million customer spectrum of wireless, broadband, and entertainment is another. The company spent a great amount of time on the earnings call discussing how their data analytics work is rapidly improving advertising effectiveness and yields by 3x-5x. They can tailor advertising more individually and having the TV assets moving to broadband they can do even more. The goal is to add revenue synergies as they run this data over the assets at Time Warner. AdWorks revenue was growing at an accelerating double-digit rate before Time Warner. The company believes this can be a game changer when it is run over sports programming and Turner Network properties. We are not going to quantify this in terms of additional cash flow and earnings, but if it works at all – this should be a positive result that grows over time too.

DirecTV Now is expected to give customers more options for TV watching with packages that more closely match what they want to see and lower initial price points. It offsets cord cutting at DirecTV and allows AT&T to pick up new customers, who cut other cable services. A cloud-based DVR service is now available as well as Video on Demand and Sports Packages. The result is DirecTV is adding more customers and the price they are paying is increasing with some of these add-on packages.

Investors have been sour on AT&T because of cord cutting at DirecTV and U-Verse and the idea of replacing them with DirecTV Now at a lower price point was not an apples-to-apples trade-off. Essentially if someone was paying $80/month for DirecTV with a satellite, having him move to DirecTV Now at $15/month was a net loss. There were some positives such as there was no need to send out a service guy to install the equipment or buy the equipment for the satellite service. DirecTV Now works with software and broadband so it's quick and cheap to add a customer. As broadband continues to build-out, DirecTV Now should be an area that keeps growing. More importantly, the growth rate remains strong here, and the lost earnings appear to be slowing:

#s in 000's	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
Satellite adds	342	323	235	0	-156	-251	-147	-188	-286
U-Verse adds	-391	-326	-262	-233	-195	-134	-60	1	24
DirecTV Now adds	0	0	267	72	152	296	368	312	342

The bigger issue is Satellite vs. DirecTV Now – there are 19.9 million Satellite customers and 1.8 million DirecTV Now customers – the latter having rolled out only 7 quarters ago. The company is rolling out more specials for signing up additional DirecTV Now and as noted they now have a DVR option.

The market is pricing the churn away from DirecTV to DirecTV Now as a margin squeeze and money loser. The company is forecasting that the rest of 2018 may be lumpy but after that, it should grow again. Already, the Entertainment Group, which also includes people with high-speed Internet and those with landline phones is seeing income and margins recover:

$ in mm	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18*	2Q18*
Oper. Income	$1,625	$1,461	$1,335	$1,576	$1,642	$1,290	$1,041	$1,125	$1,233
Income Margin	12.8%	11.5%	10.1%	12.5%	13.0%	10.2%	8.2%	9.5%	10.4%
EBITDA	$3,115	$2,966	$2,717	$2,996	$3,100	$2,670	$2,408	$2,437	$2,579
EBITDA Margin	24.6%	23.4%	20.6%	23.8%	24.5%	21.1%	18.9%	20.7%	21.8%

The asterisk for the 2018 quarters reflects using the historical accounting methods so the figures will be comparable. In 2018, AT&T changed the way it allocated regulatory fees and commission expenses. The net impact of the changes is that revenues and expenses are both lower, with income and margins higher:

$ in mm	1Q18	2Q18
Oper. Income	$1,326	$1,452
Income Margin	11.50%	12.50%
EBITDA	$2,638	$2,798
EBITDA Margin	22.80%	24.00%

The company is not back where it was in terms of income and margins yet, but it appears to be moving in the right direction. This could become another area of tailwind for growth or at least remove another negative focus for investor sentiment.

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