BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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# Ahead of AT&T 3Q18 Earnings:

In our July 18, 2018 note on AT&T, we pointed out several areas where the company was seeing or likely to see significant increases in cash flow. These included the US tax reform, pension funding, retirement of copper, and the lagging impact of building out FirstNet and getting reimbursed by the government normalizing. The company was forecasting to end 2018 at $21 billion of free cash flow. **Going into 3Q results in about 4-weeks, AT&T seems to be getting more bullish on its situation. It is possible they raise guidance in 3Q or 4Q.**

In the last week, AT&T has given good guidance in several areas and expects to be at a run rate for free cash flow of $25 billion by the end of 2018. This is without any growth in various operations we will describe later in this note. Essentially, AT&T's $25 billion forecast is the $21 billion achieved in 2018 plus $2 billion in merger fees from Time Warner plus the fact that Time Warner is only in place for 6-months of the 12-months of 2018. Annualizing that along with adding back the fees - that's $25 billion in free cash flow. That is actually a very conservative figure. We had them at $23 billion in July which did not add back the $2 billion in fees. The dividend is $15.2 billion. Thus, AT&T is looking at having about $10 billion in Free Cash Flow after the dividend based on the ending 2018 run rate. So the 2019 base case for Free Cash Flow should rise to $25 billion from $21 billion in 2018. Here are some other areas where AT&T should see improvement. These are NOT in that 2019 forecast:

- Completing the build-out in Mexico of the LTE wireless unit. In 2018, this is an area of negative cash flow with heavy capital spending. AT&T projects this will become modestly positive in 2019 on free cash flow simply due to lower capital spending. They are not projecting higher cash flow with improved business results, so this is a conservative forecast.

- Fiber capital spending has been very high in 2018 also. Much of that heavy spending will be complete by 2Q19. That should also boost Free Cash Flow and again there is no forecast for higher revenues yet.

- Wireless service revenue is rising 2%. That metric drives EBITDA expansion too. Post-paid net-additions should be positive at year-end.

- FirstNet will be online, which will also reduce capital spending and any lag impact of capital spending being reimbursed after AT&T spends it. That should help Free Cash Flow as well.

- FirstNet has three other potential positives. First, AT&T has historically had low market share among first responders. Having this network up should allow it to take market share and thus revenue and cash flow. Second, building this network and having the government reimburse the construction – AT&T was able to complete build-out of its own 5G network on the same towers at the same time they installed FirstNet equipment. Thus, AT&T avoided much incremental labor cost in building part of its 5G network too. Third, FirstNet came with more spectrum and AT&T had to add equipment/software to turn that on and did it during the same buildout process. That allowed three new areas for growth to be built at the same time.

- The new spectrum is being turned on for FirstNet is allowing for 5G evolution with much higher speeds for wireless than other companies are offering. Customers are already getting 80mb wireless data speed in some big cities, that should help customer retention and drive more new business. AT&T will have half the US covered with this 5G evolution in early 2019.

- 5G is starting to be turned on as well. New handsets will deploy this year and that could be a growth business in 2019 and beyond.

- No WarnerMedia synergies. The company is forecasting $1 billion in revenue synergies and $1.5 billion in cost synergies over the first three years of ownership. By the end of next year, if there are synergies – there should be some evidence after 18 months. On $31.3 billion in revenue, WarnerMedia had $7.9 billion in operating income or a 25% margin. The company is forecasting $1.5 billion in cost savings or 480bp. Even $300-$500 million occurring would be a meaningful source of new cash flow.

- No WarnerMedia growth is forecasted in the $25 billion figure for 2019. That seems very conservative as this unit has grown consistently:

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Revenue | $31,271 | $29,318 | $28,118 | $27,359 | $26,461 |
| Op. Income | $7,936 | $7,512 | $6,951 | $6,092 | $6,383 |
| Cash Ops | $5,079 | $4,666 | $3,843 | $3,681 | $3,258 |
| CapX | $656 | $432 | $423 | $474 | $568 |
| Acquisitions | $706 | $1,228 | $672 | $950 | $495 |
| Free Cash Flow | $3,717 | $3,006 | $2,748 | $2,257 | $2,195 |
| Revenue Growth | 6.7% | 4.3% | 2.8% | 3.4% | 4.5% |
| Op Inc. Growth | 5.6% | 8.1% | 14.1% | -4.6% | 11.5% |

Again, this is an area where another $300-$500 million of free cash flow growth is not an aggressive forecast.

**There are two other areas where there could be some improvement as well – Video Entertainment and Advertising.** We noticed the following quote in the WSJ last week from CEO Randall Stephenson talking about AT&T raising the prices for DirecTV Now from $35 to $40:

> "*We moved the price up and, being a very price-sensitive market, we fully expected to see a considerable number of customers drop off. We haven't seen that. The consumers, it's obvious they that are finding value in the platform.*"

The company was seeing the number of new DirecTV Now subscribers rise as well as a recovery in income and margins:

| #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 |

| $ 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% |

We showed these figures in our last update on AT&T. The asterisk for 2018 involves using apples-to-apples accounting based on recognizing commissions upfront rather than over time as the new rules require. The company had been expecting the EBITDA decay in video to end by the end of 2018. They had been seeing a 15% y/y decline in EBITDA in video.

These figures include broadband where AT&T reported last week is seeing growth in subscribers and revenue per subscriber. Adding higher fees to DirecTV Now and still adding more subscribers should also help revenue and EBITDA there. The company expects to see video stabilize by year-end and is projecting a flat EBITDA for 2019 that may increase in the second half. Simply having this go stable, it will not be causing a reduction in cash flow going forward. This is not in the $25 billion forecast for free cash flow either.

Finally, the company's advertising model is still in its infancy. With 170 million customer relationships, AT&T has considerable data on what people view, when, where, and for how long. In typical programming with 14 minutes of commercials per hour, AT&T gets 2 of those minutes to run its data over. They are seeing double-digit growth in boosting revenues for just those 2 minutes. The company believes it is still in the learning curve here and will be able to apply these tools to all of the Turner Networks that were acquired with Time Warner. That is 3x the inventory than what AT&T had before. This is where they do expect to see some revenue synergies from the merger and are forecasting a total of $1 billion in incremental revenue over three years. We won't try to quantify this area, but it is something the company is committed to growing and it also is not factored into the $25 billion free cash flow estimate for 2019.

We were not concerned about AT&T meeting its goal of a Debt to EBITDA ratio of 2.1-2.2x within four years down from 2.9x after the Time Warner deal. That only required about $30-$40 billion in debt paydown over four years and Free Cash Flow after the dividend was already running about $8 billion per year. It could now be running closer to $10-$12 billion and that doesn't include several other items listed above. That also doesn't include 5G starting up or more retirement of copper assets, or any growth in AT&T's or Time Warner's business. Any of that should boost EBITDA and cut the debt to EBITDA ratio as well as cut the amount of debt needed to be retired to achieve a 2.1-2.2x ratio. AT&T looks like it will easily make that longer-term forecast.

The goal of 2.5x Debt to EBITDA by the end of 2019 remains a tough goal in our view – but is one AT&T is sticking with despite not completing any asset sales of material size nor forecasting any. They are hedging a little and saying 2.5-2.6x Debt to EBITDA by the end of 2019 at this point and not giving an EBITDA forecast. However, the company is going to apply all free cash flow after the dividend to debt retirement. That may be about $17-$20 million.

We can back into an estimate by taking debt at the end of June of $176.6 billion and forecasting an $18 billion reduction by the end of 2019 for a projected $158.6 billion.

Dividing by 2.5 and 2.6 would give a forecasted EBITDA of $61.0-$63.5 billion for 2019. The proforma EBITDA through the first half of 2018 is $60.2 billion. AT&T only needs 1%-5% EBITDA growth to reach this target. In our opinion, there are enough drivers listed above to achieve that. If they do manage to sell some additional assets, then this goal would be easily reached.

As far as issues with accounting with the merger, Time Warner amortized film costs over a very short period. In their 2017 10-K, they noted that 93% of their film costs for released content would be amortized in under 3 years. Plus, 67% of non-released content would be amortized within 12 months. AT&T reported that it has not changed this policy going forward. However, it did assign $11.3 billion of the purchase price of Time Warner to its released film/television library. This will be amortized over 2-20 years. It will penalize earnings but not cash flow. Another $46 billion was assigned to intangible assets such as distribution networks and trademarks. The total amortization of these assets will be about $4.3 billion per year based on annualizing their first half 2018 pro forma income statement. Even with this increased expense and higher share count, the EPS with Time Warner was essentially flat compared to AT&T on a stand-alone basis.

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