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A very contingent 7%

Evan Lorenz writes:

Last fall, AT&T, Inc. began offering each of its customers the kind of enticing cell-phone subsidies that it once reserved for new signups. What Ma Bell's self-interested generosity means for the wireless industry, for Telephone itself and for the fat, precarious 7% Telephone dividend yield are the subjects before the house. In preview, we reiterate our bearishness toward AT&T (T on the Big Board), re-register our doubts about the sustainability of the current AT&T payout and establish a new position, also a bearish one, on Dish Network Corp. (DISH on the Nasdaq).

As the mobile industry rolls out faster 5G cell service, the big three incumbents have reached something close to network parity. At their recent respective analyst days, T-Mobile U.S., Inc. and Verizon Communications, Inc. both described their businesses as having the "best network," while AT&T claimed to own the "overall fastest network."

This cellular Lake Wobegon won't last long. T-Mobile completed its acquisition of Sprint Corp. one year ago. As a standalone company, Sprint had an overleveraged balance sheet but was rich in the type of higher-frequency spectrum that makes 5G networks sing. A better-financed T-Mobile is now mobilizing that spectrum.

To compete against T-Mobile in a 5G world, Verizon and AT&T spent $45 billion and $23 billion to buy higher-frequency, c-band spectrum last month, but not all spectrum is created equal. The 2.5 gigahertz (GHz) spectrum that T-Mobile is utilizing has a lower frequency than Verizon's and AT&T's and therefore propagates farther. Second, T-Mobile is already in the process of introducing its 2.5 GHz spectrum while its competitors will only begin receiving their spectrum later this year.

As a result, Verizon and AT&T will need to use more densely packed cell sites than T-Mobile does, which adds to their network costs. Verizon told analysts last month that it will spend an incremental $10 billion over the next three years to commercialize the higher-frequency spectrum it acquired in February.

As the price leader, T-Mobile has taken market share for a decade, and now it's offering its cheapest unlimited data plan for $26 per line for four lines. AT&T, on its comparable plan, charges $35 per line. Down the road, T-Mobile will also lead in network quality, a fact that will become more apparent as consumers upgrade to the latest 5G-enabled phones.

"They've been taking share for the past five years with a network that's been inferior to AT&T's and Verizon's," Jonathan Chaplin, who rates AT&T a hold and Dish a buy for New Street Research, tells me. "It's just been priced at a discount. Now, they're going into a period of time where they're going to have a superior network, and it's still priced at the same discount. And that ought to translate into material share gains over the course of the next five years."

It's in this context that we can evaluate AT&T's decision to give current customers a new iPhone or Samsung Galaxy in exchange for a trade-in at a cost of around $800 per user. "We're making smart investments to attract and retain customers with our best-deals-for-everyone strategy," Jeffery McElfresh, the CEO of AT&T's wireless business unit, said last month. Or, as Bernstein analyst Peter Supino, who rates AT&T and Dish holds, tells me, "If you have to spend more to keep your customers, it means you were over-earning before."

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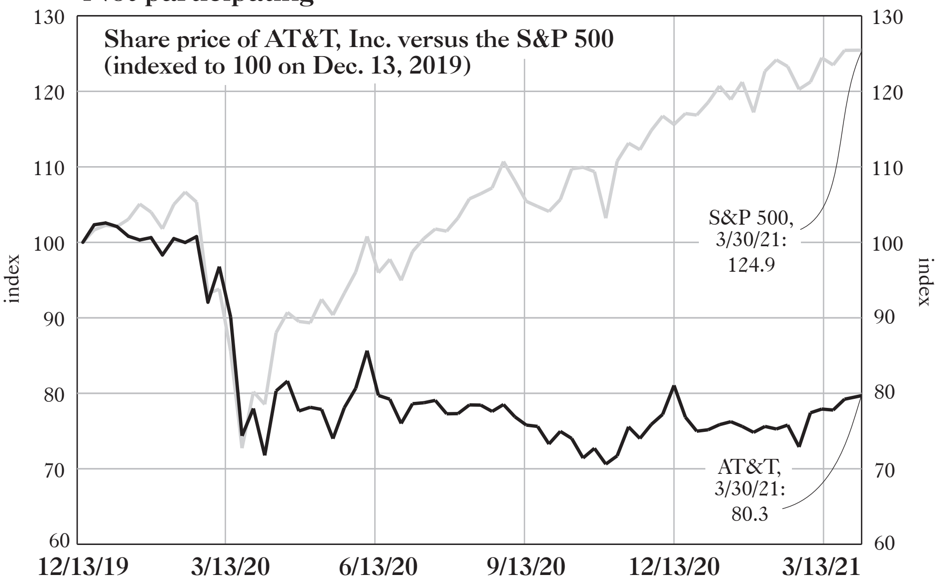
AT&T, the world's largest telecommunications company as well as the world's champion nonfinancial, non-sovereign debtor, is the former Baby Bell that devoured its parent, the original Bell Telephone Company (latterly known as AT&T Corp.), in 2005. After a mid-teens acquisition spree, today's AT&T sprawls across three basic business segments. The communications division (81% of 2020 revenues and 84% of 2020 Ebitda before corporate expenses) comprises the AT&T wireless business, a pay TV division, consumer broadband and a business wireline division. WarnerMedia (17.7% and 15.2%) includes the Turner broadcast channels (CNN, TNT, TBS, etc.), HBO and the Warner Bros. TV and movie studios. The last segment is Latin America (3.3% and 0.5%), which encompasses a wireless division in Mexico and a satellite TV business.

The organization chart will soon become more complicated. On Feb. 25, AT&T announced the sale of a stake in its video unit, which includes Direc-

Not participating



source: The Bloomberg

TV, AT&T TV and U-verse, to TPG Capital. Suffice it to say that details, apart from the $1.8 billion headline price that TPG paid, are complex. The transaction values all of AT&T's video businesses at $16.3 billion versus the $66.7 billion that Telephone paid for just DirecTV as recently as 2015.

Details aside, the structure of the sale underscores how many of AT&T's businesses are competitively ill-positioned or in secular decline—the video unit, which started 2020 with 20.4 million customers and ended the year with 17.2 million, fits the latter description. For the parent, the closing of the transaction will bring some cash but even more debt. "[W]e plan to proportionately consolidate DirecTV when calculating AT&T's credit metrics given its significant 70% economic interest in the company," said Moody's last month.

By the looks of things, AT&T's M.O. is to spend more on its wireless customers to reduce churn in the face a newly invigorated T-Mobile. Besides the generous device subsidies, AT&T is giving away its HBO Max streaming product (normally $14.99 per month) to unlimited-data-plan subscribers. Because customers who purchase more than one service are less likely to switch to a competing wireless provider, the thinking goes, Telephone is also making a big push in its fiber-to-home business to cross-sell broadband.

"I think that the strategy is better than the status quo," Supino opines, "which is milking the business for cash and shrinking faster.... The question is whether it produces economic value growth. And I don't think it will because AT&T is investing from a position of weakness in its three largest businesses."

Even if HBO Max were going great guns, its 4.2% contribution to fourth-quarter revenues wouldn't move the corporate needle by much. Besides, the Telephone front office expects that the Max division won't reach break-even before 2025.

And while Ma Bell is investing heavily in streaming, it lags Disney+ and Netflix in subscriber growth. At the end of the fourth quarter, HBO counted 41.5 million subscribers, up from 34.6 million a year earlier. Disney+, which debuted on Nov. 12, 2019, claims more than 100 million streaming-only customers. Meanwhile, weak ratings and cord cutting pushed the profitable Turner networks to a 0.6% year-over-year revenue decline in the final three months of the year. As measured by revenue, Turner is 70% larger than HBO Max.

AT&T doesn't have the spectrum bank that T-Mobile has, and it isn't spending as rapidly as Verizon to lay down higher-frequency bandwidth. During the March analyst confab, Craig Moffett, co-founder and one-half the nameplate of the research firm MoffettNathanson, LLC, asked Telephone to describe its value proposition. "[T]o serve customers how they want to be served with enough bandwidth and capacity and speed," came the reply from Jason Kilar, head of the WarnerMedia division. Which prompts this comment from Moffett: "Their prices are higher than T-Mobile's, and their network is likely to be a marked disadvantage to both T-Mobile's and Verizon's. It's almost as though they aren't even trying to make a case that theirs will be the best network for anyone."

As of Dec. 31, 2020, AT&T's balance sheet showed net debt of $147.5 billion, operating lease obligations of $22.2 billion and $18.3 billion in post-retirement obligations. As Moody's Investors Service does the counting, total debt footed to 3.6 times Ebitda and will rise in 2021 as AT&T pays for the spectrum it bought in February. A 3.6 leverage ratio is what you typically find with Ba-rated borrowers, not with investment-grade issuers like Telephone.

AT&T's C-suite prefers to look at net debt excluding operating leases and post-retirement benefits. On this basis, the company ended 2020 with a 2.7 times leverage ratio. On the fourth-quarter earnings call, management set a goal of less than 2.5 times by 2024—though, in October 2019, it had set a more ambitious goal (2.0–2.25 times) with a 2022 deadline.

As a line item in the corporate income statement, the AT&T dividend runs to $15 billion a year, or 55% of estimated 2021 free cash flow. To the legion of Telephone's individual and institutional investors, that $15 billion boils down to $2.08 per share per annum, or, at the current $30-plus stock price, a dividend yield of just under 7%.

As a large and frequent borrower, AT&T needs its Baa2 rating. We judge that it needs the rating even more than it needs the gratitude of income-seeking equity investors. I asked Neil Begley, who rates Telephone for Moody's, about the stability of the current rating. "First of all," Begley replied, "their rating is the second-lowest notch in investment grade. So even if they were downgraded a notch, they'd still be investment grade." Then, too, by various qualitative business metrics, said Begley, Telephone shows better than its leverage score. "We're not in the punishment business," he went on. "Our goal is to have the most stable ratings we can and then be forward-looking and predictive." To which he added, "I would say that during Covid, we are being particularly more patient than normal."

So, barring an explicit corporate decision not to deleverage, or such a lengthy postponement of balance-sheet repair that it tests the patience even of Covid-era Moody's, Telephone seems likely to remain investment grade—by a whisker or two. Certainly, the bond market, which prices the AT&T senior unsecured 2¾s of 2031 at a spread to Treasurys that is 12 basis points tighter than the average Baa-rated corporate, exhibits no concern. *Grant's* is concerned—as is Moffett.

"They are trying to fight a war on four different fronts, and all of them are costly," he tells me. "Their balance sheet is overstretched. Now they are trying to fight a streaming war [for which] Disney has set the mark at billions of dollars in annual losses in order to gain scale. They are trying to compete in a wireless business where T-Mobile is moving to a position of network advantage and lower cost. They are competing in a commercial wireline business that is perennially shrinking in the mid single digits. And they are talking about trying to expand their broadband business." Small wonder, as Moffett briefed his clients in January, "For the first time, we're getting the question…why don't they just cut the dividend and get it over with?"

Since *Grant's* first had its say on AT&T (see the issue dated Dec. 13, 2019), the stock has generated a loss of 12.7% versus a 27.7% gain for the S&P 500, both including reinvested dividends. The shares are priced at 9.8 times the 2021 estimate. Of the 31 analysts on the case, eight say buy and six say sell. Just 1.6% of the float is sold short (the dividend yield makes short selling an expensive proposition). Insiders have purchased 142,754 shares at a net cost of $4.2 million over the past 12 months, and no insider has sold a share.

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Reducing the number of national providers to three from four is an obvious blow to the competitive structure of the wireless industry. To pass muster with the Federal Communications Commission and the Department of Justice, T-Mobile sold its postpaid Boost Mobile business to Dish for $1.4 billion and Dish agreed to build out its own nationwide cellular network to cover 70% of the U.S. population.

Dish operates two business segments, pay TV and wireless. The TV unit (which accounted for 73% of fourth-quarter revenues) consists of the Dish satellite broadcasting network and Sling, a video streaming service. Like its peer DirecTV, Dish's video business is shrinking: The satellite division counted 8.8 million subscribers at year end versus 9.4 million at the start of 2020. The wireless division (27%) primarily consists of the Boost acquisition and is weighted towards less remunerative prepaid customers.

A decade ago, Dish co-founder and chairman Charlie Ergen correctly foresaw the value in higher-frequency spectrum. In a pair of transactions in 2011, Dish purchased DBSD North America, Inc. and TerreStar Networks, Inc., two failed satellite communications companies, out of bankruptcy for a combined price of $2.4 billion. The prize: bandwidth that the coming 5G era would monetize.

Over the past decade, Dish has added to its spectrum holdings while trying to realize the value of those assets. Ergen was reported to have bid on T-Mobile and Sprint. He was rumored to be in negotiations to sell Dish to AT&T and Verizon. Ergen's jockeying can irritate the incumbent players. In a 2015 spectrum auction, Dish used multiple entities to bid for bandwidth; Verizon and AT&T complained that this rigged the sale.

The problem with spectrum is that it comes with an obligation to build a network, and Dish faced an initial construction deadline of March 2020. The terms of the Boost acquisition have pushed out the national network-buildout completion date to June 2023.

"Charlie had no choice but to get an extension," Moffett tells me. "It was an existential threat if he didn't get an extension for his buildout when he sat down to become a party to the T-Mobile/Sprint deal, which in some ways was a gift handed to him on a silver platter." The FCC is keen to have a fourth national wireless plan and has banned Dish from selling its spectrum until 2026.

Dish has pegged the cost at $10 billion, the same figure that Verizon estimates it will spend just to bring to market its newly acquired higher-frequency spectrum. In addition, Verizon invests $18.5 billion each and every year to maintain its network. "It is going to cost a lot more than $10 billion," Moffett says of the Dish plan. "They don't pretend that the $10 billion covers operating losses and start-up expenses. They mean just to build out the network itself."

Surprises in construction costs are rarely pleasant ones, as Rakuten, Inc., can attest. The cellular upstart set out to build a Japanese 5G network with a completion date of this summer. Last year Rakuten estimated the cost would total $7.7 billion. Still unfinished, the network is expected to carry a final price tag of as much as $9.9 billion. And prospective subscribers are resisting even the blandishment of a free year of service.

AT&T, Inc. at a glance

all figures in $ millions except per share data

	2020	2019	2018	2017	2016
revenue	$171,760	$181,193	$170,756	$160,546	$163,786
operating income	6,405	27,955	26,096	19,970	23,543
net income	-5,369	13,900	19,370	29,450	12,976
shares (millions)	7,183	7,348	6,806	6,183	6,189
earnings per share	-0.75	1.89	2.85	4.76	2.10
cash	9,740	12,130	5,204	50,498	5,788
debt	157,245	163,147	176,505	164,346	123,513
operating leases	22,202	21,804	—	—	—
post-retirement benefits	18,276	18,788	19,218	31,775	33,578
total assets	525,761	551,669	531,864	444,097	403,821

source: company reports

Dish Network Corp. at a glance
all figures in $ millions except per share data

	2020	2019	2018	2017	2016
revenue	$15,493	$12,808	$13,621	$14,391	$15,212
operating income	2,583	1,879	2,148	1,568	2,319
net income	1,763	1,400	1,575	2,099	1,498
shares (millions)	584	538	526	523	484
earnings per share	3.02	2.60	3.00	4.07	3.15
cash	3,733	2,860	2,069	1,981	5,359
debt	15,702	14,140	15,153	16,203	16,479
operating leases	64	85	—	—	—
total assets	38,240	33,231	30,587	29,774	28,092

source: company reports

As for Dish, its 9 million wireless customers use T-Mobile's CDMA network, which T-Mobile plans to mothball next year. New phones will thus be necessary to assist those customers in navigating the new network, and it will fall to Dish to subsidize the purchases. All of which supports Moffett's point that $10 billion won't even come close to getting the network up and running.

Bulls and bears alike agree that Dish's pay TV is a wasting asset that *might* be worth the $15.7 billion in debt it carries. This is approximately the same sum that AT&T garnered for its pay TV business, even though AT&T ended 2020 with 17.2 million total video subscribers to Dish's 11.3 million.

Perhaps only Ergen knows what type of network Dish intends to build. A competitive retail system would have to cover 95% or more of the U.S. population, not the 70% requirement that the FCC has set. Seven-tenths of Americans are crammed into 86,000 square miles. Given that the next quarter of the population is spread out over 726,000 square miles, the cost of reaching that additional 25 percentage-point increment is shockingly high.

A narrow focus on business customers would be cheaper, but others have thought of that, too. AT&T's business wireline unit delivered $25.4 billion in revenue and $9.8 billion in Ebitda last year. On March 4, T-Mobile announced a new suite of business products exploiting its 5G network.

Instead of playing a guessing game of what Ergen might attempt, Moffett suggests, "you can ask yourself a simple question: Is it a positive or negative net present value project to be a de novo entrant into the wireless market in 2021 when you haven't even broken ground on the network and where the industry as a whole barely earns its cost of capital and is growing at 1% per year?"

To judge by Wall Street coverage, there's no obvious answer. Out of the 21 analysts who cover Dish, 10 shrug their shoulders, three say sell and eight say buy (including Chaplin, who reasons that the risk of failure shrinks before the potential reward of success). The shares change hands at 11.9 times estimated 2021 earnings.

Perhaps the C-suite offers clarity. Over the past year, insiders have sold 484,900 shares for proceeds of $15.2 million. Not one has purchased a share over the past 12 months. With a short interest equal to 12% of the float (Dish, unlike Telephone, pays no dividend), bears and execs seem to agree.

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