GRANT'S
INTEREST RATE OBSERVER®
Vol. 37, No. 24c 233 Broadway, New York, New York 10279 • www.grantspub.com DECEMBER 13, 2019

Old Ma Dividend

"I forgot my phone," are the words to ruin a day, and online shopping is fast laying waste to the physical kind (digital sales leapt by 19.4% this Black Friday), but the mobile-phone business is struggling nonetheless. Now in progress is a bearish analysis of AT&T, Inc. (T on the Big Board), the storied dividend aristocrat with less-than-storied prospects.

With its $278 billion market cap, 15th largest in the S&P 500, and $203.7 billion in total debt, the most of any nonfinancial, nongovernmental corporation in the world, Alexander Graham Bell's creation looms over Main Street and Wall Street alike. We write to warn the recipients of Telephone's $15 billion in annual dividend distributions that the old milch cow is riskier than she looks.

Whatever the 1984 court-ordered breakup of the legacy Telephone monopoly might have achieved, it has scarcely stunted the former defendant's growth. In the past 12 months, AT&T produced revenue of $182.4 billion. It employs 268,000 people and boasts four major divisions.

They are 1) "mobility," or wireless telephony, which includes the AT&T and Cricket brands (delivering 39% and 49% of third-quarter revenues and earnings before interest, taxes, depreciation and amortization); 2) the entertainment group, consisting of satellite broadcaster DirecTV, an assortment of so-called over-the-top TV-programming options for dissatisfied cable-TV viewers and high-speed internet services (25% and 15%); 3) the business wireline unit, a provider of voice, data and specialized services (14% and 16%); and 4) WarnerMedia, including the Turner broadcast channels (CNN, TNT, TBS, etc.), HBO and the Warner Bros. TV and movie studios (17% and 17%). Latin America (4% and 1%) and the digital-advertising unit Xandr (1% and 2%) contribute the residual.

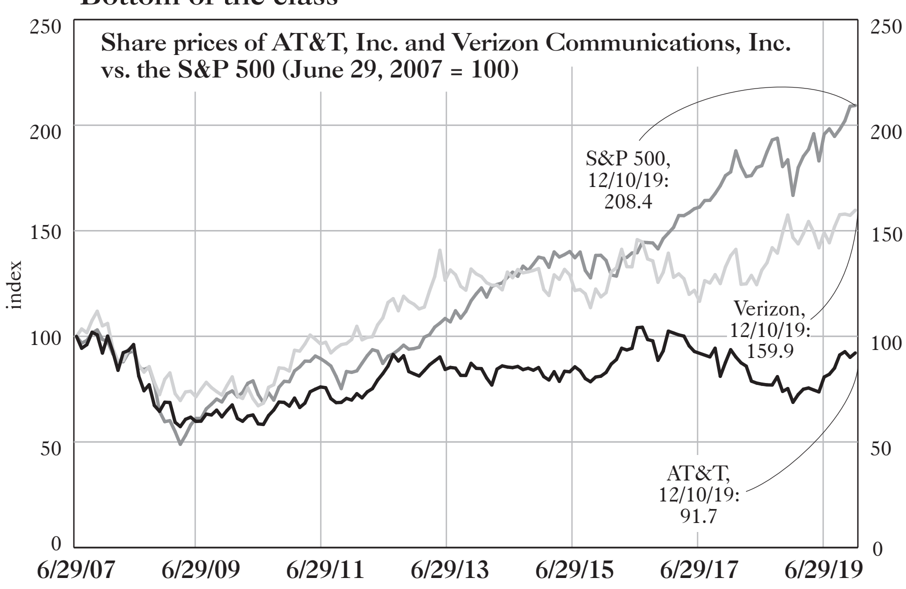
On a standalone basis, the four top units are either the largest (DirecTV and business wireline) or second-largest (mobility and WarnerMedia) of their respective industries. But size avails you little when the standout division generates year-over-year growth in service revenues of only 0.7% (as mobility did in the third quarter). In the same period, the entertainment-group, business-wireline and WarnerMedia divisions suffered revenue declines of 3.4%, 2.7% and 4.4%, respectively. In the absence of growth, leverage becomes more burdensome.

. . .

The bull case on AT&T derives from the bear facts: From June 2007, when CEO Randall Stephenson took the helm, through year-end 2018, AT&T generated a cumulative 27.6% return including reinvested dividends. It lagged not only the S&P 500, with a 113.1% return, but also, and more provokingly, Verizon Communications, Inc., with 158.9%.

"Intolerable and inexcusable" was the essential verbal payload on the Sept. 9 rocket that Elliott Management Corp. fired off to the AT&T board. "AT&T's wireless-service Ebitda margins have always been lower than Verizon's," the letter exactly said, "but last year the gap in service Ebitda margins increased to ~1,500bps on a comparable basis with

Bottom of the class



source: The Bloomberg

historical periods, the largest discrepancy to date and a substantial difference in profitability." Paul Singer's shop speaks with the authority of the owner of $3.2 billion of AT&T common, even if that position represents little more than 1% of the behemoth's market cap.

Under Stephenson, AT&T has diversified—unwisely by Elliott's lights—via acquisitions, including DirecTV ($66.7 billion in 2015) and Time Warner, Inc. ($109.9 billion in 2018). Then there was the 2011 deal that didn't happen, the $39 billion bid for T-Mobile US, Inc. which Stephenson abandoned after deciding that the Federal Communications Commission wouldn't allow it. T-Mobile used the resulting $4 billion break fee—a windfall drawn on AT&T's bank account—to become the third-largest and fastest-growing wireless provider in the United States, from being a sleepy number four.

Perhaps Stephenson was looking over his shoulder at Singer when he signed off on the third-quarter earnings release. For once there was no corporate acquisition to announce but rather a pledge to allocate up to 70% of cash flow (after capital expenditures and dividends) to share repurchases, with the remainder to debt reduction. As to governance, two external directors will join the board and, following Stephenson's retirement (he agreed to stay on at least through 2020), the titles of CEO and chairman will belong to two different people, not one.

By 2022, management predicts, the new plan will deliver a 200 basis-point boost in margins, to 35%, from 33%, and a rise in adjusted earnings per share to $4.50–$4.80 from the estimated 2019 figure of $3.56. Believing it, an optimist might say that the stock trades at 8.2 times 2022 net income.

Count us skeptical, along with our No. 1 informant, Craig Moffett, co-founder and one-half of the nameplate of the research firm MoffettNathanson LLC. Too much debt and too much competition are the underlying problems, EZ credit, perhaps, the remote problem. None is susceptible to a simple fix.

The dual difficulties impinge, for instance, on HBO Max, the new streaming service set to launch in May. Max will combine original content with offerings from HBO, Turner and Warner Bros. and charge $14.99 a month for the package—$5 to $10 more than such rivals as Disney and Netflix (never mind the free content on offer from Verizon and T-Mobile). Given the proliferation of new scripted TV shows over the past several years, it's no surprise that, according to Netflix, the cost of creating video content has gone up by a cool 30% in the past year alone.

It might astonish the inventor of the telephone to learn that his corporate pride and joy intends to create 69 new scripted shows in 2020 and 88 more in 2021, thereby boosting the HBO domestic subscriber base to 41 million in 2022 from 34 million today and—supposedly, when all is said and done—burnishing the top line by $2 billion annually.

Even after a 33% rally this year, AT&T yields 5.4% and tips the valuation scales at 10.7 times estimated 2019 earnings. Of the 33 analysts on the case, 15 say buy, 16 hold and two sell. Insiders have bought a net 32,786 shares over the past year at a cost of $957,563.

. . .

The bear case begins with the balance sheet, which, while $16.2 billion less encumbered than it was immediately following the June 2018 Time Warner acquisition, is still the receptacle of $158.6 billion of net debt, $22.9 billion of pension obligations and $22.3 billion of operating leases, for a grand total of $203.7 billion, or 3.3 times trailing adjusted Ebitda.

Excluding pensions and leases gets you a ratio of debt to Ebitda of only 2.7 times, which is the calculation that AT&T prefers to showcase. Either way, operating income covered interest expense in the third quarter by 3.8 times.

Moody's and Standard & Poor's rate AT&T near the intersection of junk and investment grade, at Baa2/triple-B; Fitch, a couple of notches higher. Led by Neil Begley, the Moody's team pats Stephenson on the back for reducing leverage after the Time Warner acquisition from nearly 4:1 to the current 3.3:1—"no easy task for a balance sheet of this size." And while AT&T continues to carry the biggest debt load in the nonfinancial, nongovernmental corporate world, "it is only fair to note that the company is third in terms of the most Ebitda among global corporates."

With all that said, Begley informs colleague Evan Lorenz that a rise in the ratio of debt to Ebitda to more than 3.5:1 would put AT&T in the crosshairs of a downgrade, while a decline in the ratio to less than 3:1 would likely produce an upgrade.

A projected $28 billion of free cash flow in 2021 means that, for the time being, AT&T can certainly afford its $15 billion annual dividend remittance. "But assume," Lorenz speculates, "that the business continues to deteriorate. Say the rating agencies or the market fret about the still immense debt in the context of little or no revenue growth and that Stephenson or his successor responds by eliminating the dividend and redirecting 100% of free cash flow to debt reduction. It could be done, but that hypothetical $28 billion would reduce total obligations (net debt, pension obligations and operating leases) by just 14%."

The ultimate sources of the dividend, of course, are the AT&T operating busi-

AT&T

all figures in $ millions

	2014	2015	2016	2017	2018	TTM*
revenue	$132,447	$146,801	$163,786	$160,546	$170,756	$182,365
operating income	18,587	20,362	23,543	19,970	26,096	28,794
interest expense	3,613	4,120	4,910	6,300	7,957	8,485
net income	6,442	13,345	12,976	29,450	19,370	16,367
cash	8,603	5,121	5,788	50,498	5,204	6,588
debt	75,778	118,515	113,681	125,972	166,250	165,176
total assets	296,834	402,672	403,821	444,097	531,864	548,796
cash flow from operations	31,338	35,880	38,441	38,010	43,602	48,805
capital expenditures	21,199	19,218	21,516	20,647	20,758	19,746
dividends	9,552	10,200	11,797	12,038	13,410	14,797

* For the period ended Sept. 30, 2019.

source: company reports

nesses, of which three-fifths, as measured by revenue, are dwindling. The business-wireline division is one such shrinking violet, with third-quarter sales and Ebitda waning by 2.7% and 6.8% from the prior 12 months. Larger clients are shifting more work to the cloud, notes Moffett, while new technologies, such as software-defined networking, are commoditizing AT&T's services.

Old-fashioned, real-time, "linear" TV and the satellite segment of pay TV are soft spots, too. Price increases on DirecTV subscriptions totaling $15 a month over the past two years contributed to the loss of 1.16 million subscribers, or 5% of the total, between the second and third quarters. While higher prices deliver a short-term boost to revenue and cash flow, continued customer losses will ultimately pressure earnings.

"With the projected launch of HBO Max next year," Lorenz writes, "you'd suppose that the WarnerMedia division would be flourishing, but it suffered a fall in revenue and Ebitda of 4.4% and 0.8% in the third period, partly owing to adverse comparisons to the success of the 2018 hits *Aquaman* and *Fantastic Beasts 2*. Warner's Turner division, which accounts for 53% of the segment's Ebitda, has a different problem."

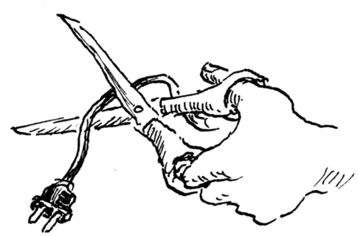
According to Nielsen, 18% fewer viewers aged 18 to 49 tuned into Turner stations in the third quarter than they did the year before. While the 2020 election should give CNN ratings and ad bumps, neither presidential elections nor presidential impeachments roll around every year.

The heavily leveraged AT&T is stuck, Moffett says: "The market is saturated, and growth is very slow. The promises of the internet of things and everything being connected are slowly coming to pass, but they are not generating much revenue for the carriers. To some extent, what you see is what you get: You are in a mature, low-growth wireless market, and AT&T is reasonably well-positioned. It's hard at their size and scale to grow faster than the market, and the market just isn't growing very fast."

Even in the absence of growth, Elliott contends, there's a lot of fat to cut in AT&T's mobility division, for which contention it cites the aforementioned 1,500 basis-point margin shortfall compared to Verizon.

"It's an appealing argument," Lorenz notes, "until you see that, in the latest quarter, AT&T and Verizon reported wireless-services margins of 55.7% and 61.8%, a 610 basis-point spread. You can arrive at a figure close to 1,500 basis points only by ignoring the 2018 adoption of a new accounting treatment for customer contracts or by failing to make allowances for selling phones on the installment plan (*Grant's*, Dec. 23, 2016) and for some other technicalities. As Moffett does the figures, AT&T's and Verizon's margins came in at 58.2% and 62.9% in the third quarter, a difference of just 470 basis points."

Is the mobile market disruptable? Fat wireless-service Ebitda margins, themselves in the high 50% to low 60% range, would lead you to think so. Sky-



high phone charges might confirm your suspicion. Academic studies back up the claim in David Leonhardt's Nov. 10 *New York Times* column that a monthly cell plan with five gigabytes of data costs $61.85 in the United States vs. $33.30 in the UK and $14.95 in France.

Cable-television companies constitute one powerful threat to the status quo. Treating their mobile-phone offerings as the means to the end of customer retention (you're less inclined to cut your TV cord when your cable provider is also your phone vendor), they're more inclined than AT&T or Verizon to drop prices. Then, too, the cable companies may have an edge in eSim, a new technology that permits the routing of calls to the "free-to-broadcast 3.5-gigahertz spectrum" rather than, say, pay a tariff to use AT&T's wholly owned spectrum. Enterprising cable providers, especially the ones serving densely populated cities, can build their own small cell networks, as Altice USA, Inc. is already doing.

. . .

It's a promising setup for a price war. Population growth on the order of 0.6% per annum supports, say, 2 million new phone subscriptions a year, but the industry drives for 4–5 million. "Buy one, get one free" promotions are the customary elixir for raising that number, but—as with many another performance-enhancing drug—you can only take so much of it before encountering nasty side effects.

In the first nine months of 2019, cable-industry competitors—denoted "mobile virtual-network operators" because they lease the wireless infrastructure they use—captured 1.2 million subscribers, or 35% of the total. "If the cable companies are set up to take 1.5 million-plus customers on an annualized basis, and phone-industry growth is heading down to population growth," Lorenz points out, "then little room remains for the four mobile operators to spread their wings."

"Ask yourself what the average wireless CEO will do when they get the phone call in the middle of the quarter that they will badly miss the subscriber expectations," says Moffett. "Is it a) that we better cut costs and ensure that our cost structure is appropriate for this new reality? Or is it b) that we better get more promotional to make sure that we meet expectations? As long as the answer is 'b' instead of 'a,' the industry is bound to be an unattractive place."

Some hope that the pending, still contested T-Mobile–Sprint merger may provide sorely needed competitive relief. On Monday the opening gavel fell on a trial pitting 13 state attorneys general against the tie-up. In a bit of a twist, it's the defendants, not the state AGs, who must show that the deal is not anticompetitive. (Applicable case law under section 7 of the Clayton Act shifts the burden of proof when a merger may result in too much market-share concentration.) As Sprint shares trade 31% below T-Mobile's bid, Mr. Market's convictions are clear enough: The gentleman is pulling for the AGs.

Rejection of the merger would hit Sprint's creditors and equity holders, including click-not-to-pick SoftBank Group Corp. (*Grant's*, Dec. 15, 2017), but would not necessarily favor AT&T. While Sprint's surplus bandwidth includes higher frequencies tailor-made for 5G, the management of that company is debt-constrained; it, even more than AT&T, lacks the financial flexibility to invest in its own network. In bankruptcy, Sprint could right-size its liabilities and emerge a more ferocious competitor. T-Mobile vows to continue to expand its market share, with or without Sprint.

For any who did not avail himself

of the pair trade we proposed in the Jan. 25 issue, a refresher and an update: Sell short the AT&T 4½s of 2048 and go long the Verizon 5.012s of 2049, said we, after which the AT&T 4½s proceeded to rally to 109.91 from 88.25, the Verizon 5.012s to 128.31 from 102.97. Because the Verizon bonds slightly outlegged the AT&T bonds, it is our pleasant duty to report that the trade was profitable to the tune of $3.67.

The 21-point surge in AT&T's paper hardly enhances its investment appeal. The Baa2-rated 4.35% senior unsecured issue of March 1, 2029 changes hands at 110.47 to yield 3.01%, an 117 basis-point pick-up over Treasurys. For reference, the typical triple-B-rated bond trades at a 140 basis-point average spread. A downgrade to double-B, along with a resulting widening of the spread to 211 basis points (the average for that rating category), would imply a $7.49 loss per bond, to $102.98, a case of the loss of almost two years of coupon income.

"A bigger problem for a potential downgrade," Lorenz points out, "is that AT&T's $165.2 billion of gross debt is material relative to the $1.25 trillion U.S. high-yield debt market. Then, too, double-B bonds have traded at spreads to Treasurys as tight or tighter than the aforequoted 211 basis points only 12% of the time in the past 23 years. What spread might investors demand if AT&T expands the size of the junk market by 13%?

"Perhaps it's no coincidence," Lorenz concludes, "that Stephenson, having committed to remain at his post only through next year, may be watching from the sidelines when his successor answers for the success (or the lack of it) of the grand plan for 2022."

•