AT&T Analyst Report

2017-2018 UConn Student Managed Fund

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UCONN
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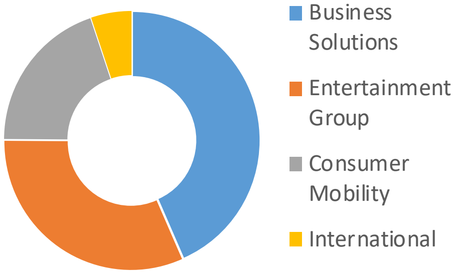
Table of Contents

Report Highlights

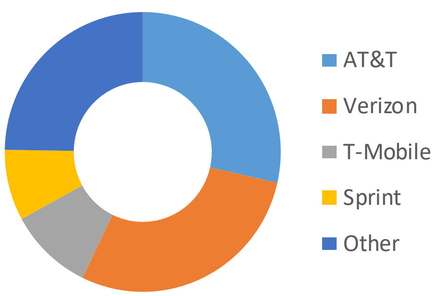
AT&T Corporation (NYSE: T)

Sector: Telecommunications

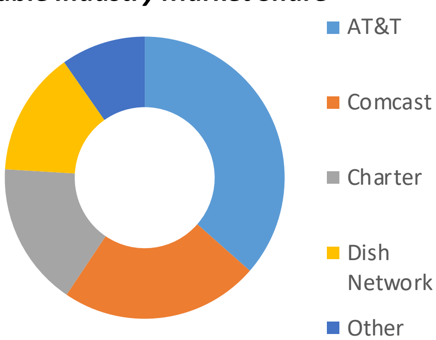
AT&T Revenue by Segment



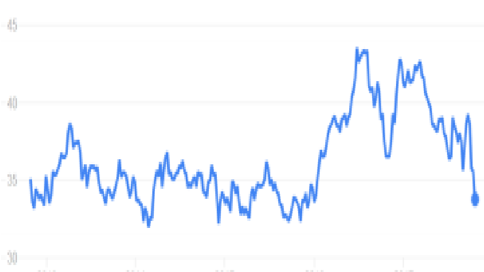
Telecom Industry Market Share



Cable Industry Market Share



AT&T 1-Year chart at purchase



Basis for Recommendation

We recommend a **Buy** rating for T based on a price target of $44.05 per share, offering a 21% margin of safety over the price of $34.76 as of April 20, 2018. Our recommendation is primarily driven by the following factors:

1) Strong Industry Tailwinds – The telecom industry is expected to experience significant growth in the coming years, as the number of mobile digital devices increases, and consumers demand more service

2) Diversified Product Mix – AT&T has a strategic advantage over competitors because of their ownership of DirecTV. This allows the Company to more effectively bundle products and provide consumers with a one-stop-shop experience.

3) Stable Dividend Growth – AT&T is one of the S&P 500 "Dividend Aristocrats" and has increased it's quarterly dividend each year for 34 years straight. This is an important factor to the SMF team because of the guaranteed return on capital. At the time of purchase, the dividend yield was 5.82%.

Business Description

AT&T Inc. is a leading telecommunications company in the United States. AT&T is wireless service and entertainment provider. It is split into four business segments: Business Solutions, Entertainment Group, Consumer Mobility and International.

Industry Overview & Trends

Industry Overview

AT&T competes in the telecom industry as well as the cable industry. The telecom industry is facing a number of mixed long-term trends that promise to have a lasting impact on the major players.

The first trend is the development of the Internet of Things (IoT). The IoT promises an explosion in the number of connected devices, which will all need to be connected through telecom networks.

The next trend is the saturation of the consumer mobility market. This is leaving AT&T and competitors searching for growth in new mobile devices and geographical regions. Finally, competitive pressures in the industry are driving aggressive M&A campaigns. This trend is causing large players to buy up smaller companies to integrate new technology, and it is forcing laggards to consider the option of merging or selling themselves.

The cable industry is also in a period of great change. Consumers are “cutting the cord” at a faster rate than ever before, creating great uncertainty in the cable industry. Current industry players are looking to transition to the new era by offering the same services via the web, while maintaining as large of a traditional cable base for as long as possible.

The biggest threat to established cable providers are the online content providers such as Netflix or Hulu. In the value chain, the content creators are cutting out product deliverers, and are finding ways to ally themselves with service providers to gain a competitive advantage.

Internet of Things (IoT)

The Internet of Things will continue to grow over the coming years. As this technology becomes pervasive, the networks connecting and securing them will be critical to its success. Telecommunications providers will play a crucial role in developing the IoT because each device will need to be connected via a data network. Currently, the IoT is in the beginning stage of adoption. Businesses are driving the development, because they are using the IoT to increase the speed and precision of their work and to cut down on costs. Consumers are also welcoming IoT enabled devices into their homes, however most consumer IoT devices are still novel rather than functional. In order to jump to the next stage in its development, the IoT will need 5G data networks to handle the massive flow of data between devices.

5G Sunrise

Another important element of the telecommunications industry is the introduction of the 5th Generation ("5G") data network. This competitive element has wide-reaching effects, and first mover's advantage will be an important advantage, as most industry spectators speculate that this generation of data network will be the last.

Currently, AT&T is leading the industry by planning to roll out their 5G network in 3 US cities by the end of 2018. Although the first 5G networks will be introduced this year, they likely will not be widely used by consumers for several years, as cellphone companies struggle to keep up with the pace set by the carriers.

The technology has much farther reaching effects than smartphones however; the Trump Administration is considering heavy federal investment into this data network, considering it an important resource to national defense. The administration has likened their investment to the national highway system under President Eisenhower, and they believe that guaranteeing American success in this technology will give the country an important step ahead of Chinese competitors[1].

Competitive Pressure

The telecommunications industry is under increasing competitive pressure. After years of intense competition, the differentiation in the industry has decreased now that most networks provide comparable service throughout the country.

There are currently 4 main competitors in the industry, however there is speculation that the 2 laggards could consolidate in order to compete better. At the same time, the industry leaders, AT&T and Verizon, are both looking to diversify in different ways. AT&T is betting that vertical and geographic integration are the path to success, whereas Verizon is moving horizontally by selling consumer data like advertising giants Google and Facebook. Finally, Comcast is moving into the industry, as the cable and telecommunications industry increasingly overlap.

Industry Overview & Trends (cont.)

Cable Industry

In recent years, the cable industry has been marked by declines in revenue and users, however there are strong underlying trends that should provide growth over the long term for media and entertainment. Although legacy cable service is losing customers, consumer habits have not changed significantly. Americans still enjoy watching TV shows, sports games, and movies just as much as 10 years ago.

First, consumers are “shaving” down cable, rather than “cutting the cord”, meaning they trim the number of channels down to the bare bones. Alternatively, consumers switch to other forms of programming distribution, such as DirecTV Now or SlingTV[2]. This will be a significant source of growth for the Cable industry in the future, as consumers demand more personalized choices for content combined with the ability for higher mobility. In order for content distributors to be successful in the future, they will need to rethink traditional formats to cater to consumers, and take advantage of new technologies such as 4K or 5G to improve the consumer experience.

Investment Thesis

Thesis

AT&T is undervalued and well positioned for future success because:

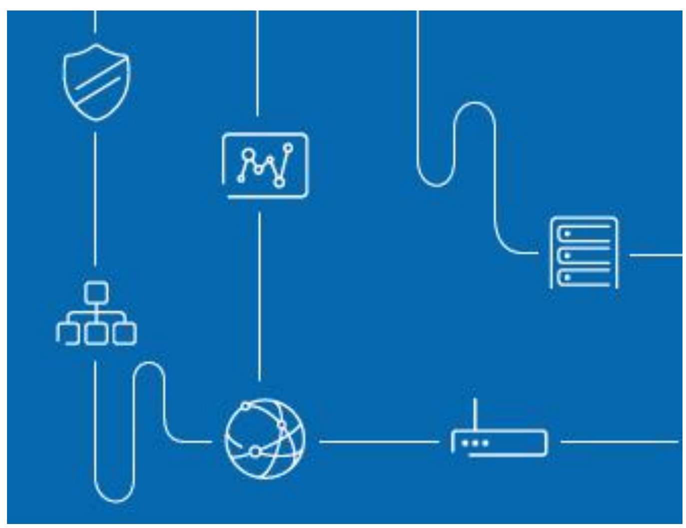
- AT&T is uniquely positioned compared to other major telecommunications carriers due to their investment in TV service and their international reach
- AT&T has a history of strong free cash flow, allowing them to provide a large and stable dividend
- The telecommunications sector is attractive because the consumers will continue to rely on devices that depend on data networks, guaranteeing future demand

Increasing Importance of Telecom

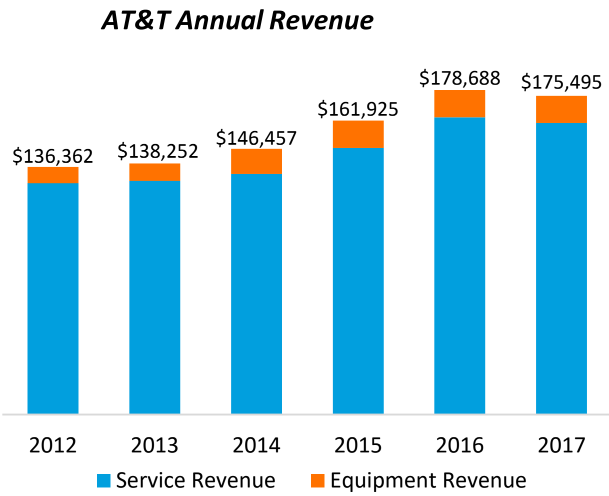
Currently, demand for telecom networks comes from consumers requiring data service for smartphones, or businesses who need their own phone networks. In the coming years, demand will increase overall as consumers will have more devices requiring data service (i.e. wearables, tablets, etc…), and businesses will require more connected capabilities to participate in the IoT. AT&T is best positioned for success in the new competitive environment because of the way they integrate their products together. Additionally, the company gets its largest share of revenue from businesses currently, so they are positioned to take advantage of increased demand from business users.

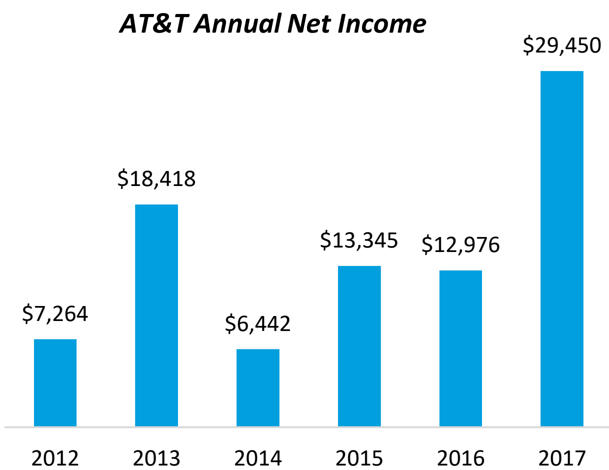
Diverse Product Platforms

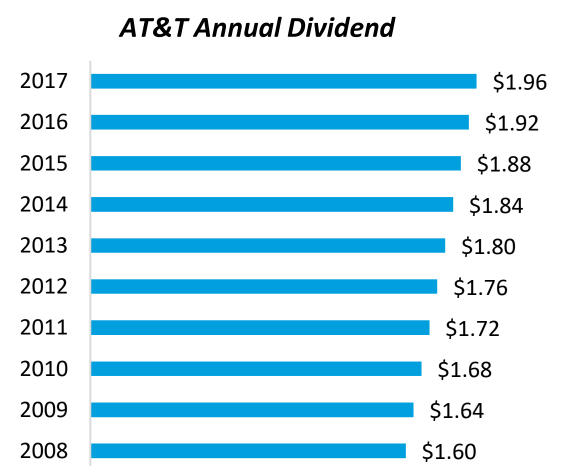
AT&T's breadth in product offerings allows them to give consumers a bundle of products all together in an integrated service. Not only does this provide a one-stop-shop for consumers, but they can also easily connect the services together to make a better experience for consumers.



Financials







Strong Revenue and Profits

AT&T is a financially healthy company with consistent revenue growth. Since 2012, AT&T's revenue has grown at a CAGR of 4.7%. In 2017, AT&T's revenue fell by 1.8%.due to a decline in legacy wireline services. This was partially offset by growth in wireless equipment and the International segment. The slowdown in wireline is not surprising and it is a segment that AT&T has been moving away from. Wireless revenue has been the driving force for growth in the last few years and will continue to have a large impact in the future.

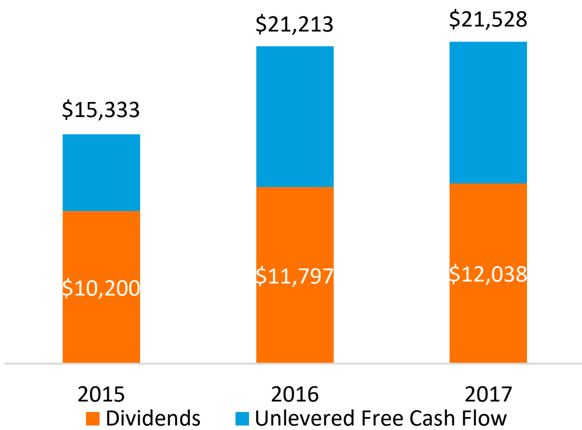
AT&T has been very profitable over the last six years. Net income has been affected greatly by improvements in SG&A. In the most recent year, the new tax reform has been the greatest contributor to the bottom line growth. This translated to a 18% net income margin for the year compared to 8% for fiscal year 2016. The large growth in net income led to a diluted EPS of $4.76 compared to $2.10 from the year before.

Returning Value to Shareholders

AT&T is committed to returning value to their shareholders in the form of share buybacks and dividends. In 2016, AT&T bought back $512 million worth of shares and in 2017 the company spent $463 million.

AT&T has increased their dividends for 33 consecutive years. The dividend yield is currently 5.64% due to a decline in the stock price this year. The dividends of AT&T are especially reliable because they are secured by their strong free cash flows.

AT&T Unlevered Free Cash Flow



Robust Cash Flows

AT&T's free cash flow is their greatest financial strength. This allows them to be acquisitive, service debt, payout a healthy dividend, and buyback shares. The large increase of unlevered free cash flow between 2015 to 2016 is due to effective working capital management. The passing of tax reform will have a substantial impact on AT&T. The savings from the lower 21% corporate tax rate is estimated to be approximately $2 billion. AT&T has projected a large increase in capital expenditures to expand their rollout of 5G partially funded by the savings from tax reform.

Valuation

Valuation Summary

Model	Price	Weight
DCF	$46.39	50%
DDM	$39.90	50%
Target Price	$43.14	
Current Price	$35.14	
Margin of Safety	22.8%	

DCF Share Price Sensitivity

		WACC		
		8.5%	9.0%	9.5%
Perpetual Growth Rate	2.0%	$45.59	$41.00	$37.02
	2.5%	$51.28	$45.90	$41.29
	3.0%	$58.01	$51.62	$46.22

Discounted Cash Flow Model (50% weight)

Our DCF assumes a 4% CAGR for the period between fiscal year 2018 to 2022. The terminal year perpetuity growth is 2.5% and a WACC of 9%. The revenue growth rate is slightly scaled back from the last six year period and is inline with management projections. Overall growth in the telecom space was also considered as the rollout of 5G is seen as a huge potential windfall for the industry. The 2.5% perpetuity growth rate is reflective of the U.S. long-term GDP growth. The WACC that we used of 9.0% is considerably higher than most other estimates for AT&T to take into account the future increase of interest rates as we move away from historic lows.

One of the large drivers of the DCF is the lower tax rate projected following tax reform. The DCF arrived at a share price of $45.90. This was weighted as 50% of our final target price for the stock.

DDM Assumptions

Gordon Growth Model	
Initial Dividend	$1.96
Cost of Equity	7.31%
Growth Rate	2.28%

Dividend Discount Model (50% weight)

AT&T's consistent dividends makes it a good candidate for the Gordon Growth Model. For the most recent year, AT&T paid out a dividend of $1.96 per share. Over the last 10 years, AT&T's dividend has increased by the same amount. The cost of equity was calculated using the CAPM method. The DDM arrived at a price of $39.90 per share. This was weighted at 50% of our target price.

Risks to Investment Thesis

Regulatory Changes

Telecom is a highly regulated industry and new projects must be approved by the U.S. government. The FCC's ruling to repeal net neutrality will have a material change to AT&T's ability to make revenue from their customer base. Even with a federal repeal, several states are looking to pass their own net neutrality laws. The mergers and acquisitions of the industry has been under intense scrutiny of the government.

Competitive Pressure

One of AT&T's biggest risks is the intense competitive pressure in the telecom industry. AT&T holds approximately one third of the telecom market share with the majority of the rest being held by the other three biggest carriers. Verizon and AT&T are the two largest with T-Mobile and Sprint combined being similar in size to AT&T. There is a possible risk in the consolidation of the industry. T-Mobile and Sprint have been in talks to merge several times over the years and recently has reopened conversations. The competition has caused more pricing battles, which has lowered the industry's average revenue per customer.

Appendix A: Income Statement

Consolidated Statements of Income						
Dollars in millions except per share amounts	Three Months Ended December 31,		Percent	Twelve Months Ended December 31,		Percent
Unaudited	2017	2016	Change	2017	2016	Change
Operating Revenues						
Service	**$ 36,225**	$ 37,369	-3.1 %	**$ 145,597**	$ 148,884	-2.2 %
Equipment	**5,451**	4,472	21.9 %	**14,949**	14,902	0.3 %
Total Operating Revenues	**41,676**	41,841	-0.4 %	**160,546**	163,786	-2.0 %
Operating Expenses						
Cost of services and sales						
Equipment	**6,532**	5,667	15.3 %	**18,709**	18,757	-0.3 %
Broadcast, programming and operations	**6,003**	5,612	7.0 %	**21,159**	19,851	6.6 %
Other cost of services (exclusive of depreciation and amortization shown separately below)	**9,797**	9,840	-0.4 %	**37,511**	38,276	-2.0 %
Selling, general and administrative	**10,000**	9,984	0.2 %	**34,917**	36,347	-3.9 %
Asset abandonment and impairments	**2,914**	361	- %	**2,914**	361	- %
Depreciation and amortization	**6,071**	6,129	-0.9 %	**24,387**	25,847	-5.6 %
Total Operating Expenses	**41,317**	37,593	9.9 %	**139,597**	139,439	0.1 %
Operating Income	**359**	4,248	-91.5 %	**20,949**	24,347	-14.0 %
Interest Expense	**(1,926)**	(1,221)	57.7 %	**(6,300)**	(4,910)	28.3 %
Equity in Net Income (Loss) of Affiliates	**20**	41	-51.2 %	**(128)**	98	- %
Other Income (Expense) - Net	**264**	123	- %	**618**	277	- %
Income (Loss) Before Income Taxes	**(1,283)**	3,191	- %	**15,139**	19,812	-23.6 %
Income Tax (Benefit) Expense	**(20,419)**	676	- %	**(14,708)**	6,479	- %
Net Income	**19,136**	2,515	- %	**29,847**	13,333	- %
Less: Net Income Attributable to Noncontrolling Interest	**(99)**	(78)	26.9 %	**(397)**	(357)	11.2 %
Net Income Attributable to AT&T	**$ 19,037**	$ 2,437	- %	**$ 29,450**	$ 12,976	- %
Basic Earnings Per Share Attributable to AT&T	**$ 3.08**	$ 0.39	- %	**$ 4.77**	$ 2.10	- %
Weighted Average Common Shares Outstanding (000,000)	**6,163**	6,161	- %	**6,164**	6,168	-0.1 %
Diluted Earnings Per Share Attributable to AT&T	**$ 3.08**	$ 0.39	- %	**$ 4.76**	$ 2.10	- %
Weighted Average Common Shares Outstanding with Dilution (000,000)	**6,182**	6,181	- %	**6,183**	6,189	-0.1 %

Appendix B: Balance Sheet

Consolidated Balance Sheets		
Dollars in millions		
Unaudited	**Dec. 31, 2017**	Dec. 31, 2016
Assets		
Current Assets		
Cash and cash equivalents	**$ 50,498**	$ 5,788
Accounts receivable - net of allowances for doubtful accounts of $663 and $661	**16,522**	16,794
Prepaid expenses	**1,369**	1,555
Other current assets	**10,757**	14,232
Total current assets	**79,146**	38,369
Property, Plant and Equipment - Net	**125,222**	124,899
Goodwill	**105,449**	105,207
Licenses	**96,136**	94,176
Customer Lists and Relationships - Net	**10,676**	14,243
Other Intangible Assets - Net	**7,464**	8,441
Investments in Equity Affiliates	**1,560**	1,674
Other Assets	**18,444**	16,812
Total Assets	**$ 444,097**	$ 403,821
Liabilities and Stockholders' Equity		
Current Liabilities		
Debt maturing within one year	**$ 38,374**	$ 9,832
Accounts payable and accrued liabilities	**34,470**	31,138
Advanced billing and customer deposits	**4,213**	4,519
Accrued taxes	**1,262**	2,079
Dividends payable	**3,070**	3,008
Total current liabilities	**81,389**	50,576
Long-Term Debt	**125,972**	113,681
Deferred Credits and Other Noncurrent Liabilities		
Deferred income taxes	**43,207**	60,128
Postemployment benefit obligation	**31,775**	33,578
Other noncurrent liabilities	**19,747**	21,748
Total deferred credits and other noncurrent liabilities	**94,729**	115,454
Stockholders' Equity		
Common stock	**6,495**	6,495
Additional paid-in capital	**89,563**	89,604
Retained earnings	**52,029**	34,734
Treasury stock	**(12,714)**	(12,659)
Accumulated other comprehensive income	**5,488**	4,961
Noncontrolling interest	**1,146**	975
Total stockholders' equity	**142,007**	124,110
Total Liabilities and Stockholders' Equity	**$ 444,097**	$ 403,821

Appendix C: Cash Flow Statement

Consolidated Statements of Cash Flows		
Dollars in millions	Year Ended	
Unaudited	December 31,	
	2017	2016
Operating Activities		
Net income	**$ 29,847**	$ 13,333
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**24,387**	25,847
Undistributed earnings from investments in equity affiliates	**174**	(37)
Provision for uncollectible accounts	**1,642**	1,474
Deferred income tax (benefit) expense	**(15,940)**	2,947
Net (gain) loss from sale of investments, net of impairments	**(282)**	(169)
Actuarial loss (gain) on pension and postretirement benefits	**1,258**	1,024
Asset abandonments and impairments	**2,914**	361
Changes in operating assets and liabilities:		
Accounts receivable	**(986)**	(1,003)
Other current assets	**(777)**	1,708
Accounts payable and other accrued liabilities	**816**	118
Equipment installment receivables and related sales	**(263)**	(576)
Deferred fulfillment costs	**(1,422)**	(2,359)
Retirement benefit funding	**(1,066)**	(910)
Other - net	**(1,151)**	(2,414)
Total adjustments	**9,304**	26,011
Net Cash Provided by Operating Activities	**39,151**	39,344
Investing Activities		
Capital expenditures:		
Purchase of property and equipment	**(20,647)**	(21,516)
Interest during construction	**(903)**	(892)
Acquisitions, net of cash acquired	**1,123**	(2,959)
Dispositions	**59**	646
(Purchases) sales of securities, net	**(4)**	506
Other	**1**	-
Net Cash Used in Investing Activities	**(20,371)**	(24,215)
Financing Activities		
Issuance of long-term debt	**48,793**	10,140
Repayment of long-term debt	**(12,339)**	(10,823)
Purchase of treasury stock	**(463)**	(512)
Issuance of treasury stock	**33**	146
Dividends paid	**(12,038)**	(11,797)
Other	**1,944**	(1,616)
Net Cash Provided by (Used in) Financing Activities	**25,930**	(14,462)
Net increase in cash and cash equivalents	**44,710**	667
Cash and cash equivalents beginning of year	**5,788**	5,121
Cash and Cash Equivalents End of Year	**$ 50,498**	$ 5,788