



AT&T Inc. (T)

Updated October 25th, 2018 by Josh Arnold

Key Metrics

Current Price:	\$30	5 Year CAGR Estimate:	21.6%	Volatility Percentile:	27.9%
Fair Value Price:	\$47	5 Year Growth Estimate:	6.0%	Momentum Percentile:	35.4%
% Fair Value:	65%	5 Year Valuation Multiple Estimate:	9.0%	Growth Percentile:	47.6%
Dividend Yield:	6.6%	5 Year Price Target	\$63	Valuation Percentile:	95.3%
Dividend Risk Score:	B	Retirement Suitability Score:	A	Total Return Percentile:	97.5%

Overview & Current Events

AT&T is a leading provider of communications and digital entertainment services in the United States and the world, offering internet access, as well as TV and wireless service. The company is the result of a dizzying array of mergers since it was spun off in 1984 and today, it sports a market capitalization of \$220 billion and has \$170 billion in annual revenue. The company reported Q3 earnings on 10/24/18 and results were not taken well by investors. However, AT&T looked good on several important metrics during the quarter. Revenue rose 15% as Time Warner contributed significantly, but was offset by weakness in Latin America and the Entertainment Group. Adjusted earnings-per-share rose 22% to 90 cents as Time Warner added 5 cents, but the legacy business also saw improved profitability. Indeed, adjusted operating margins rose 310bps to 21.9% in Q3, a huge improvement over last year's comparable quarter. Free cash flow was also up 16% to \$6.5 billion and operating cash flows rose 14%. While investors sold the stock, we think the report was solid and validates our long-term thesis that Time Warner is the key to AT&T's growth. AT&T reiterated guidance and we've slightly increased our earnings-per-share estimate for this year to \$3.50 after a nice Q3 report.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	\$2.16	\$2.12	\$2.29	\$2.20	\$2.33	\$2.50	\$2.50	\$2.69	\$2.84	\$3.05	\$3.50	\$4.70
DPS	\$1.60	\$1.64	\$1.68	\$1.72	\$1.76	\$1.80	\$1.84	\$1.88	\$1.92	\$1.96	\$2.00	\$2.50
Shares	5,893	5,902	5,911	5,927	5,581	5,226	5,187	6,145	6,139	6,139	7,260	7,260

AT&T's earnings-per-share have grown steadily in the past decade as it continues to grow its international business and make prudent acquisitions, as well as expand margins via its expense rationalization program. Organic revenue growth is not a primary driver of earnings growth for AT&T and given the size and scope of its business, likely never will be. This is the rationale for the company's purchase of DirecTV as well as the now-complete purchase of Time Warner. Now that the Time Warner merger has been completed, we have upgraded our growth forecast to 6.0% annually. The legacy AT&T business should still produce low to mid-single digit earnings-per-share growth on its own via higher revenue and slightly better margins, while Time Warner's higher rates of growth will help drive an additional 2% or so annually for the consolidated company. Time Warner's superior growth outlook is a major reason why AT&T bought it and we think it will continue to bear fruit in terms of revenue growth and profitability, as we saw in the Q3 report. Importantly, AT&T has produced \$14.4 billion in free cash flow thus far in 2018 with one quarter to go, which is roughly its dividend liability for this year. In other words, the dividend is very well-covered by earnings and free cash flow.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.4	12.1	11.7	13.4	14.5	14.2	13.8	12.6	13.8	12.7	8.7	13.4
Avg. Yld.	4.8%	6.4%	6.3%	5.8%	5.2%	5.1%	5.3%	5.6%	4.9%	5.1%	6.6%	4.0%

AT&T's current price-to-earnings ratio of 8.7 is the lowest it has been at any point in the past decade on a full-year basis, creating a potential deep value situation for investors. This plays into AT&T's conservative, safety-oriented shareholder base as not only does it pay a sizable dividend, but the stock is cheap. We are forecasting 9.0% in annual returns based

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solely upon reversion to the mean for the valuation, something we think is more likely now that Time Warner has come on board. The dividend yield is also at the top end of its historical range at 6.6% and we expect it to fall over time as the stock moves towards our fair value through multiple expansion, outpacing future dividend increases.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	54.1%	58.7%	59.6%	56.7%	56.7%	60.2%	54.6%	54.3%	53.1%	51.8%	51.5%	52.0%
Debt/A	64%	62%	59%	61%	66%	67%	70%	70%	70%	68%	66%	63%
Int. Cov.	6.9	6.5	7.1	2.9	4.0	8.1	3.9	6.0	5.0	3.4	4.0	5.0
Payout	74%	77%	73%	78%	75%	72%	73%	67%	67%	64%	57%	53%
Std. Dev.	46%	26%	15%	18%	14%	15%	14%	16%	15%	17%	20%	19%

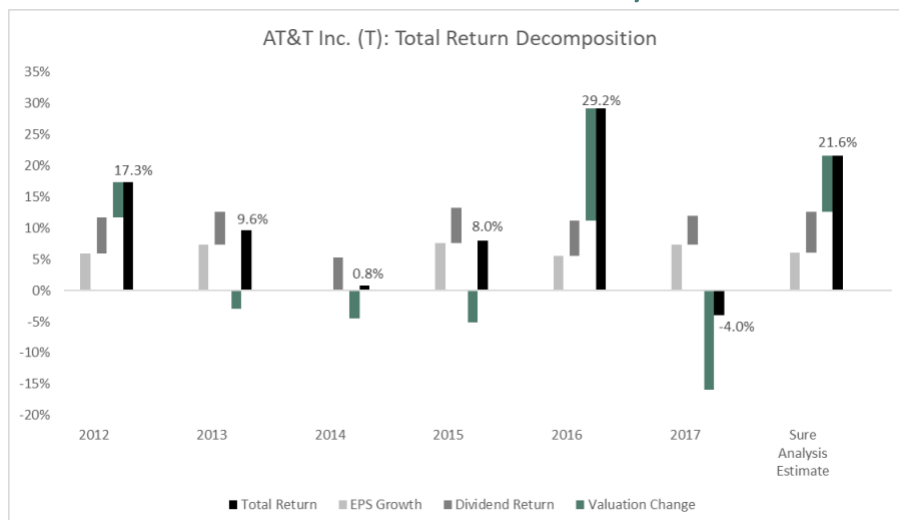
AT&T's quality metrics have declined somewhat in recent years as it has continued to take on debt to fund acquisitions. Indeed, it has one of the highest levels of nominal debt of any company in the US market. Recent increases were driven by funding for the Time Warner purchase, and we think improved earnings prospects will allow AT&T to reduce its debt over time. In addition, we believe improving earnings will afford it growing interest coverage. We expect the payout ratio to fall over time as the dividend rises more slowly than earnings, improving the safety of the dividend and the company's ability to pay down debt.

AT&T's recession resistance will help as well should we see a downturn as its earnings actually grew slightly during the Great Recession. AT&T's principal risks at this point are pricing in its wireless segment and constant investments in infrastructure that are needed to stay competitive. However, diversification into DirectTV and Time Warner will help AT&T mitigate those risks somewhat. This diversification and its sheer scale are major competitive advantages for AT&T.

Final Thoughts & Recommendation

Overall, AT&T looks like it represents strong value as it trades for roughly two-thirds of its fair value. It also offers the safety and income of a 6.6% yield and the prospects of further dividend increases. We are forecasting 21.6% total annual returns over the next five years, comprised of the yield as well as 6.0% earnings growth and 9.0% from multiple expansion. AT&T's reputation for being a safe stock is well intact as it offers the chance to buy a recession-resistant company at a great yield and trough valuation with stronger growth prospects thanks to Time Warner.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue (\$B)	124.03	122.51	124.28	126.72	127.43	128.75	132.45	146.80	163.79	160.55
Gross Profit	74472	71942	74023	71819	72206	77561	72302	79755	86902	83167
Gross Margin	60.0%	58.7%	59.6%	56.7%	56.7%	60.2%	54.6%	54.3%	53.1%	51.8%
SG&A Exp.	31526	31427	34986	41314	41066	28414	39697	32919	36347	34917
D&A Exp.	19883		19379	18377	18143	18395	18273	22016	25847	24387
Operating Profit	23063	21000	19658	12128	12997	30752	14332	24820	24708	23863
Op. Margin	18.6%	17.1%	15.8%	9.6%	10.2%	23.9%	10.8%	16.9%	15.1%	14.9%
Net Profit	12867	12138	19864	3944	7264	18418	6442	13345	12976	29450
Net Margin	10.4%	9.9%	16.0%	3.1%	5.7%	14.3%	4.9%	9.1%	7.9%	18.3%
Free Cash Flow	13321	17111	15692	14633	19711	13852	10139	16662	17828	18504
Income Tax	7036	6091	-1162	2532	2900	9328	3619	7005	6479	N/A

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets (\$B)	265.25	268.31	269.39	270.44	272.32	277.79	296.83	402.67	403.82	444.10
Cash & Equivalents	1792	3741	1437	3045	4868	3339	8603	5121	5788	50498
Acc. Receivable	16047	14845	13610	13231	12657	12918	14527	16532	16794	16522
Goodwill (\$B)	135.54	134.41	134.12	130.19	128.55	131.49	136.66	225.28	222.07	219.73
Total Liab. (\$B)	168.50	166.32	157.44	164.65	179.62	186.31	206.56	279.03	279.71	302.09
Accounts Payable	6921	21260	7437	10485	12076	11561	14984	21047	22027	24439
LT Debt (\$B)	78.84	76.25	66.17	64.75	69.84	74.79	81.83	126.15	123.51	164.35
Total Equity (\$B)	96.35	101.56	111.65	105.53	92.36	90.99	89.72	122.67	123.14	140.86
D/E Ratio	0.82	0.75	0.59	0.61	0.76	0.82	0.91	1.03	1.00	1.17

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	4.8%	4.5%	7.4%	1.5%	2.7%	6.7%	2.2%	3.8%	3.2%	6.9%
Return on Equity	12.2%	12.3%	18.6%	3.6%	7.3%	20.1%	7.1%	12.6%	10.6%	22.3%
ROIC	7.2%	6.9%	11.1%	2.3%	4.4%	11.2%	3.8%	6.3%	5.2%	10.6%
Shares Out.	5,893	5,902	5,911	5,927	5,581	5,226	5,187	6,145	6,139	6,139
Revenue/Share	20.82	20.68	20.93	21.30	21.89	23.91	25.37	26.00	26.46	25.97
FCF/Share	2.24	2.89	2.64	2.46	3.39	2.57	1.94	2.95	2.88	2.99

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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