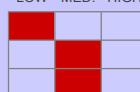


AT&T Inc.  
 Latest Results: Q2 2014  
 Country: USA  
 Sector: Telecoms  
 RIC (Ticker): T.N

Fundamental Valuation: --  
 Indigo View: --  
 Industry View: **Unattractive**  
 Company Rating: LOW MED. HIGH  
 Risk  
 Quality  
 Valuation



N. Landell-Mills CFA  
 Indigo Equity Research Limited  
 www.indigo-equity-research.com

15 Sep 2014

## Snapshot of Q2 2014 - Telecoms price war deepens

### Weak Q2 2014 Results - Margins deteriorate

Indigo's independent, buy-side, fundamental equity research reports are provided in three formats (of varying length & detail):

- Snapshot (c. 6 pages)
- Overview (c. 20 pages)
- Company Profile (53 pages)

Indigo reports can be purchased via subscription or a pay-per-view basis, from the Indigo website: [www.indigo-equity-research.com](http://www.indigo-equity-research.com)  
 Or abbreviated reports can be found on Bloomberg, Reuters, Factiva, Capital IQ & FactSet.

### Significant recent events

- Telecoms price war deepens as AT&T discounts smartphones & iPads.
- AT&T bids c. \$48 bn cash and stock for DirecTV.

### Investment thesis - In a tight corner

AT&T is a utility with an attractive dividend yield (c. 5%) and value stock investment profile. But high pay-out ratios (>70%) and weak EPS growth restrict its capacity to raise dividends. Overall, Wireless has driven revenue growth & margins while Wireline gradually declines. Wireless growth is being driven by rising data usage with a shift to smartphones & tablets.

Since 2010 AT&T's growth & margins have been under pressure. It is in an increasingly tight corner due to a maturing telecoms market, aggressive wireless competition from Sprint & T-Mobile, and increasing wireline competition from cable in the broadband market. Despite its No. 2 position in an oligopolistic wireless market; AT&T struggles with a lack of spectrum, deploying LTE late and Verizon taking the best quality (post-paid) subscribers. **Even with the Dish merger, AT&T will still lack a sufficient competitive edge & scale in video & broadband; which restricts its ability to deliver content to subscribers.**

### SWOT analysis

#### Strengths

- Large size in the Wireless market.
- #2 in an oligopolistic US wireless market.
- High div. yield; but high pay-out ratio.

#### Opportunities

- Shift to usage based plans?
- Project Velocity IP, network upgrades.
- Connected homes & cars?

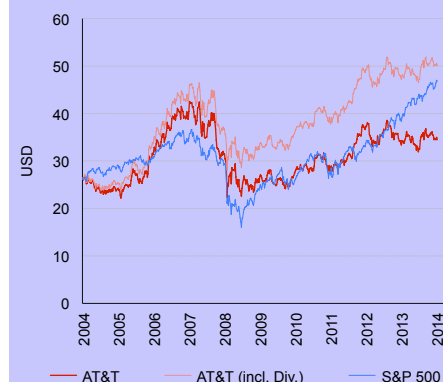
#### Weaknesses

- Mature US telecoms market.
- Becoming a "dumb pipe".
- Outperformed by Verizon Wireless.

#### Threats

- Acquisition of Dish is a strategic error.
- Comcast & TWC merger.
- Cable taking most broadband adds.

### Share Price - Last 10 Years



### Fundamental Valuation

	Bear	Base	Bull
Forecast Share Price	See the full report		
Return (incl. Div.)			
<b>Capital Structure</b>	Per Share	Total	
	(\$)	(\$ Bn)	
<b>Current Share Price</b>	<b>\$34.5</b>		
Number of Shares (bn)		5.2	
Market Capitalization		180.1	
Net Cash / (Debt)		-13.9	-72.7
Enterprise Value (EV)		48.3	252.3
Main Shareholder:	--		

#### Consensus Estimates

Financial Results	2013	2014e	2015e	
y/e 31 Dec	(\$ Bn)	(\$ Bn)	(\$ Bn)	
Revenue	128.8	133.7	136.3	
EBIT*	23.2	24.1	25.1	
Net Income*	13.8	14.1	14.2	
Share Capital	91.0	94.3	98.9	
Total Assets	277.8	282.1	287.1	
FCF	13.9	11.4	11.5	
EPS*	(\$)	2.55	2.68	2.77
DPS	(\$)	1.80	1.85	1.88
BV per share	(\$)	16.90	17.96	19.29

Efficiency Analysis	2013	2014e	2015e
EBIT* Margin	18.0 %	18.0 %	18.4 %
Net Income* Margin	10.7 %	10.5 %	10.4 %
Asset Turnover	46 %	47 %	47 %
Total Assets / Equity	305 %	299 %	290 %
ROE*	15.1 %	14.9 %	14.4 %

Growth Analysis	2013	2014e	2015e
Revenue	1.0 %	3.9 %	1.9 %
EBIT*	0.8 %	4.0 %	4.1 %
Net Income*	1.9 %	2.4 %	0.9 %
EPS*	10.2 %	5.0 %	3.4 %

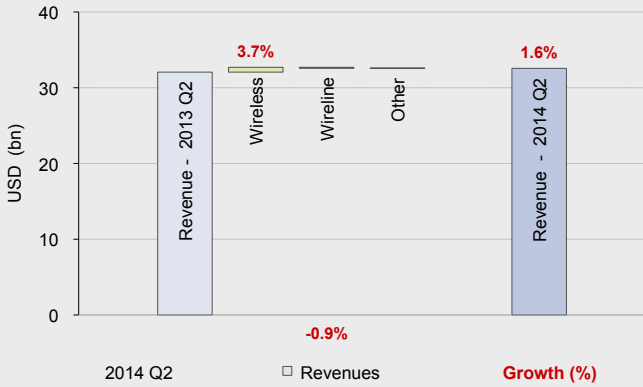
Valuation Ratios	2013	2014e	2015e
P / Sales	1.4	1.3	1.3
EV / EBITDA	6.1	5.9	5.7
P / EBIT*	7.8	7.5	7.2
PE*	13.5	12.9	12.5
PEG*	1.3	2.6	3.7
P / BV	2.0	1.9	1.8
P / FCF	13.0	15.8	15.6
Dividend Yield	5.2 %	5.4 %	5.4 %
Pay-Out Ratio	53.1 %	67.5 %	67.9 %
Net Debt / EBITDA	1.7	1.7	1.6

Valuation Ratios are based on the current share price.

\* = Excluding Unusual Items

## Q2 2014 Results - Changes In Revenue Since Last Year (YoY)

### YoY Change in Revenue by Division



Note: Prior year Unusual Items are not shown in these graphs.

### Revenues by Division - Q2 2014

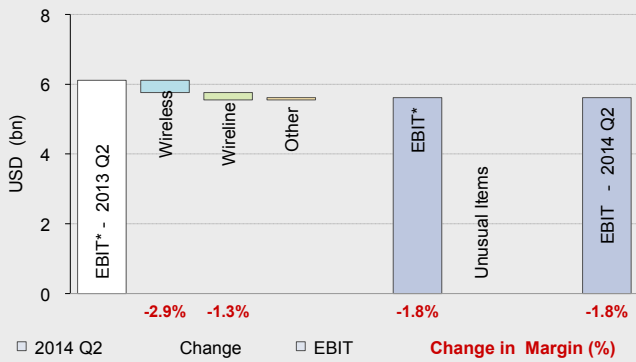
- Wireless Revenue rose \$0.6 bn (+4%) to \$17.9 bn.
- Wireline Revenue fell \$0.1 bn (-1%) to \$14.6 bn.
- Other Revenue fell \$3 m (-27%) to \$8 m.
- Total Revenue rose \$0.5 bn (+2%) to \$32.6 bn.

### Revenues by Product

- Total Data Revenues was flat at \$18.5 bn.
- Total Voice Revenues fell \$0.4 bn (-3.6%) to \$10.1 bn.
- Total Other Revenues rose \$0.8 bn (+26.1%) to \$4.0 bn.

\*\* = Estimated Growth excluding major M&A activities.

### YoY Change in EBIT\* and Margins (%)



\* = excludes Unusual Items.

### EBIT by Division - Q2 2014

- Wireless EBIT fell \$0.4 bn (-8%) to \$4.3 bn. Margin fell 2.9% to 24.1%.
- Wireline EBIT fell \$211 m (-13%) to \$1.4 bn. Margin fell 1.3% to 9.7%.
- Other EBIT improved \$65 m to -\$134 m. 0
- Total\* EBIT rose \$5.6 bn (+8.1%) to \$5.6 bn. Margin fell 1.8% to 17.2%.
- No Unusual Items arose at the EBIT level. None arose in Q2 last year.
- Q2 Total EBIT fell \$0.5 bn (-8.1%) to \$5.6 bn. Margin fell 1.8% to 17.2%.

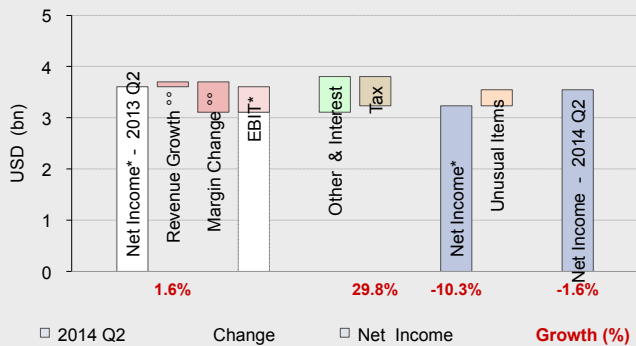
### Notes - Unusual Items arising this Q and the prior year Q.

	2013 Q2	2014 Q2
At the EBIT level: (\$ bn)	-	-
At the Net Income level: (\$ bn)	0.2	0.3

- Unusual Items are detailed in the full (Company Profile) equity report.  
- Growth rates and changes in margins are stated on a YoY basis.

# Shares = Share Repurchase / (Issues)

### YoY Change in Net Income



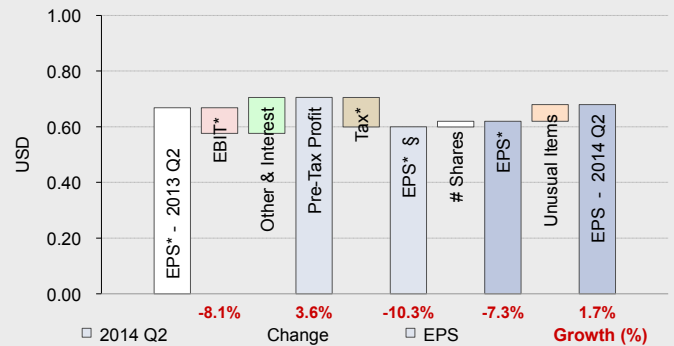
\*\* = Impact on EBIT

"Other" = Other Income & Expenses

"Other Items" includes non-cash charges.

Net CAPEX = Depreciation - CAPEX

### YoY Change in EPS



Data is stated on a per share basis.

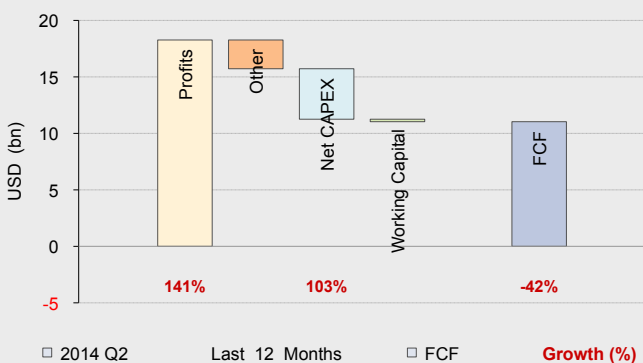
§ = EPS before share repurchases

"Other" = Other Income & Expenses

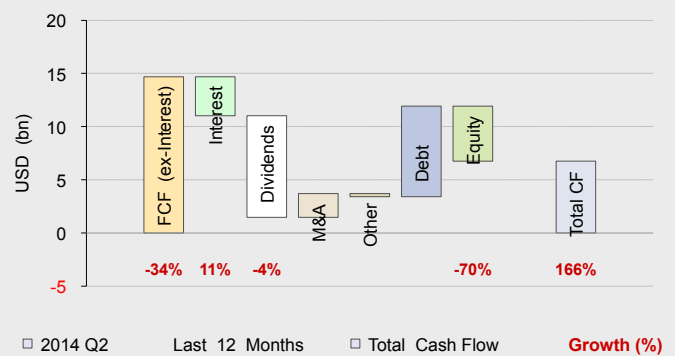
Equity = Share Issues / (Repurchases)

CF = Cash Flow

### Free Cash Flows (FCF) - Last 12 Months

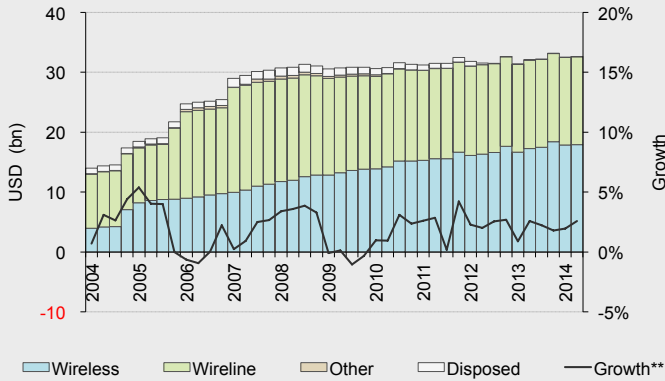


### Total Cash Flows - Last 12 Months



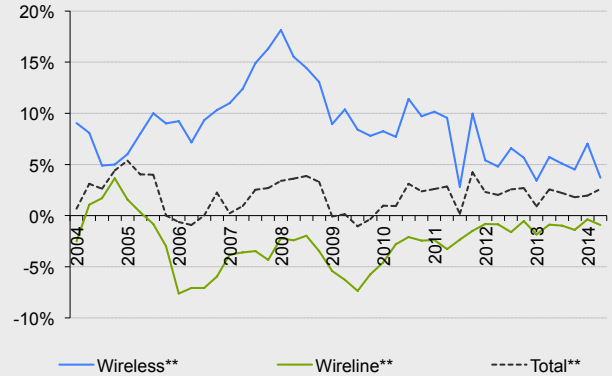
## Historical Financial Results - Quarterly Analysis since 2004

### Revenue by Division

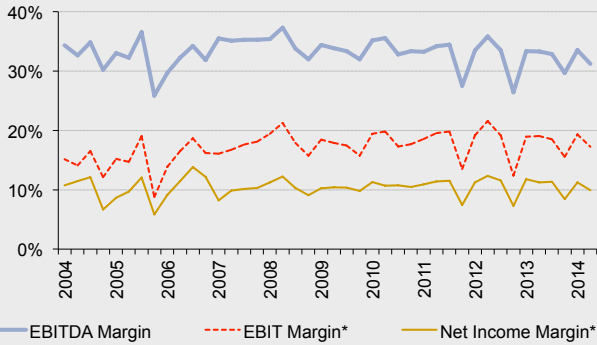


Growth\*\* = Estimated revenue growth excluding major M&A.

### Revenue Growth by Division

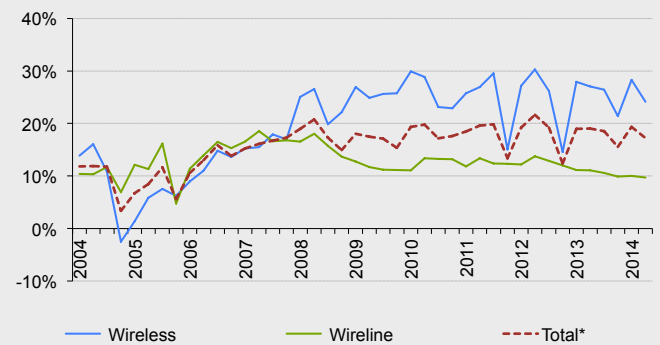


### Profit Margins

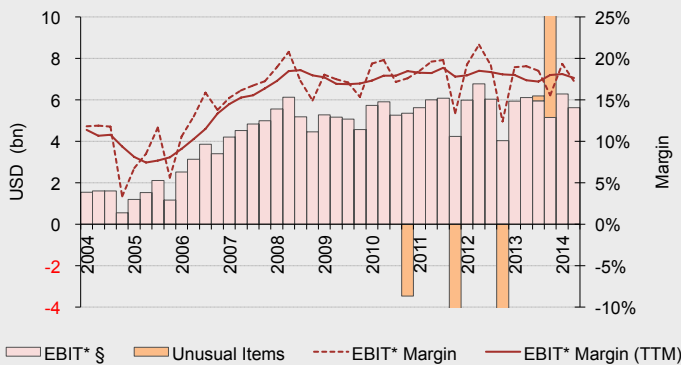


\* = Excluding Unusual Items

### EBIT Margins by Division



### EBIT\* & EBIT\* Margin



TTM = Trailing 12 Months

\* = Excluding Unusual Items

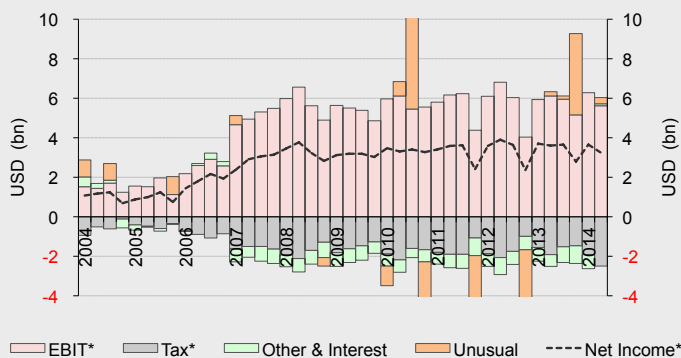
### Key recent Unusual Items:

- 1) Q2 2014 includes a gain on sale of América Móvil shares.
- 2) Q4 2013 includes a net \$4.1 bn, mostly from a pre-tax \$7.6 bn actuarial gain on retirement benefits.
- 3) Q2 2013, a small gain was made on the sale of América Móvil shares.
- 4) Q4 2011, includes \$13.4 bn (pre-tax) charges for asset impairment of the directories business, pension charges & failed T-Mobile acquisition.
- 5) 2010, includes large pensions & severance costs, tax settlement (benefit), and losses on asset sales.

### Notes

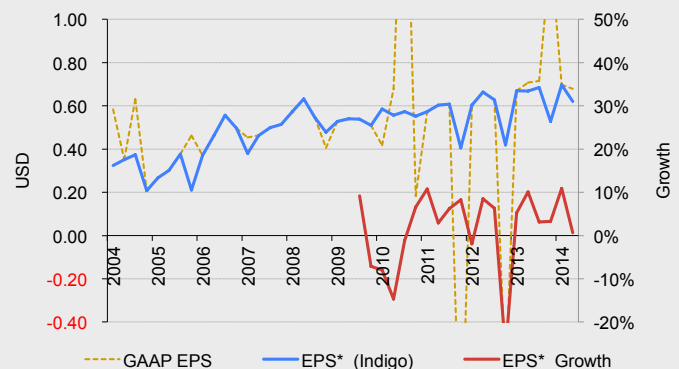
"Unusual" includes one-off, exceptional and extraordinary items. Most Unusual Items relate to acquisitions, disposals or restructurings. See the full report for more details of Unusual Items.

### Net Income Analysis



"Other" includes non-operating items (eg. income from associates).

### EPS\* & EPS\* Growth



\* = Excluding Unusual Items

## Key Fundamental Drivers

### Key long-term, fundamental share price drivers:

(Graph)

- i, ii Share price performance is driven primarily by the PE\* ratio and dividends; and secondly by EPS\* growth. Which is contrast to normal dynamics.
- iii - v EPS\* depends primarily on y EBIT\* growth. Since 2011, EPS has been boosted slightly by share repurchases & lower tax rates.
- vi See the full report.

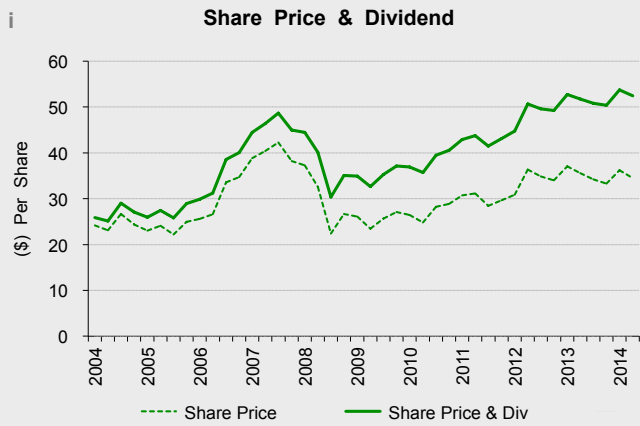
PE  
↓  
Share  
Price

### Analysis of fundamentals & EPS drivers:

- See the full report.
- See the full report.
- See the full report.

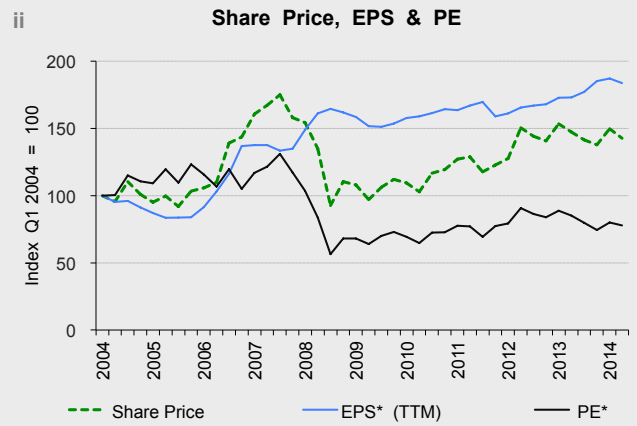
(see also analysis on next page)

\* = Excludes Unusual Items

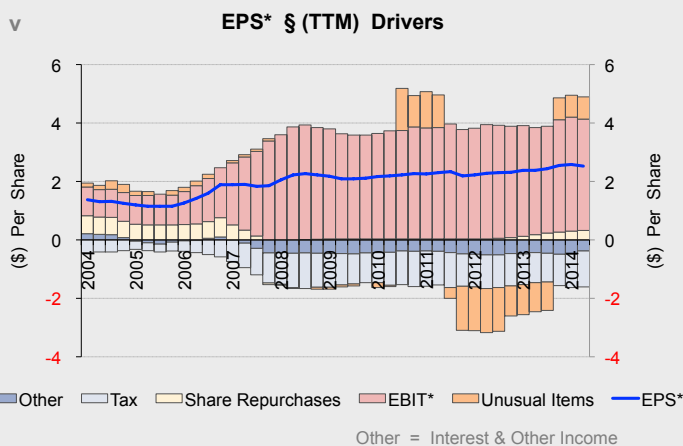
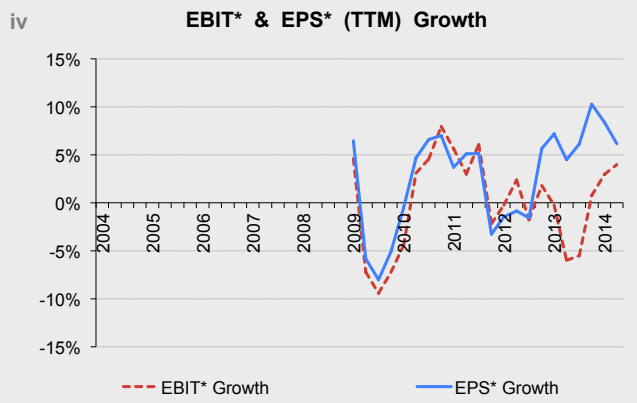
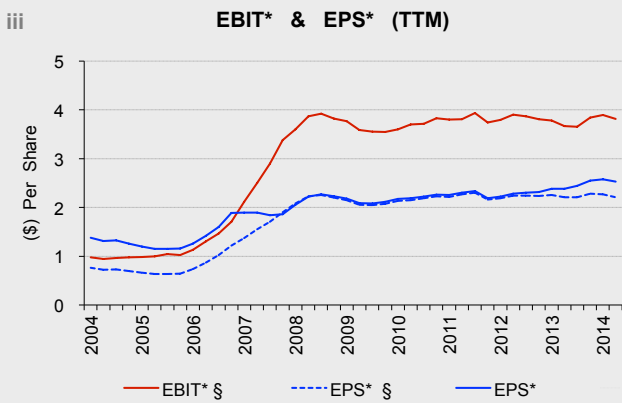


§ = On a constant per share basis from Q1 2007.

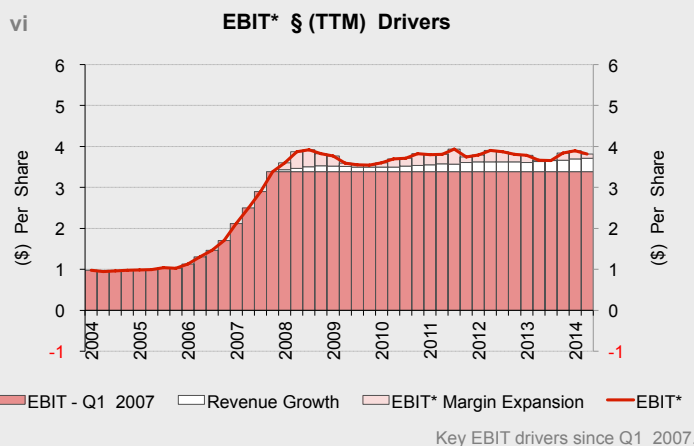
\* = Excludes Unusual Items



TTM = Trailing 12 months



Other = Interest & Other Income



Key EBIT drivers since Q1 2007.

## Valuation

### Fundamental Valuation

See the full report.

### Fundamental Valuation

§ = Estimates for next 12 Months

	Last 12 Months	Base Case §	Change (%)
Share Price (\$)	See the full report.		
Dividends Per Share (\$)	See the full report.		
Return (incl. div.)	See the full report.		
<b>Key Forecasts:</b>			
Revenue Growth	2.3%	1.3%	-1.0%
EBIT* Margin	17.6%	15.1%	-2.5%
Tax Rate*	35.1%	37.1%	2.0%
EPS*	2.53	2.18	-13.8%
P / Sales	See the full report.		
P / EBIT*	See the full report.		
PE*	See the full report.		

\* = Excluding Unusual Items

Note: See the full Indigo report for a more detailed description of the fundamental valuation.

### Fundamental Valuation Methodology

The potential returns under the three scenarios (Bear, Base, Bull Cases) of the Fundamental Valuation above is a calculation based on an estimated change in share price and dividends received. The share price is calculated by multiplying the forecast PE and EPS. In turn, the EPS is calculated based on forecast changes in revenue, EBIT margin, net interest, other income & tax rates, and adjusting for share repurchases. This approach is summarized by the formula:

$$\text{Return} = \text{Dividends} + \Delta \text{Share Price}$$

$$\text{Return} = \text{DPS} + (\Delta \text{PE} * \Delta \text{EPS})$$

$$\Delta \text{EPS} = (((\Delta \text{EBIT} + \Delta \text{Interest} + \Delta \text{Other Income}) * \Delta \text{Tax Rate \%}) / \text{Shares}) * \Delta \text{Shares}$$

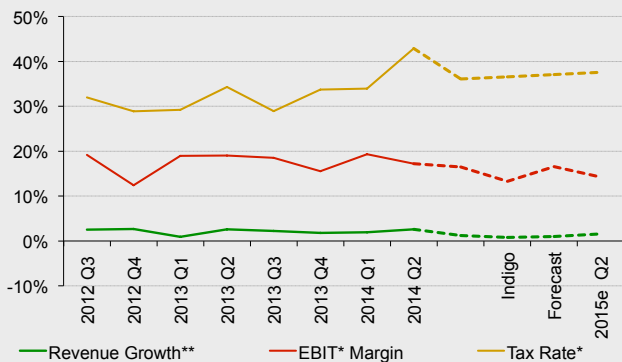
DPS = Dividends Per Share

Δ = Change in a variable

ie. Δ PE = Change in PE ratio

**DISCLAIMER:** The valuations and return calculations only illustrate the potential returns under the hypothetical conditions described and should not be relied upon for any investment decision. This is not an estimate of what we believe may occur, nor a price target nor a recommendation to buy or sell an investment.

### Indigo Forecast Revenue Growth, EBIT Margin & Tax



\* = Excludes Unusual Items

### DCF Valuation

Current Share Price (\$)	34.5
WACC	6.4%
→ DCF Valuation (\$)	See the full report.

### Reality check:

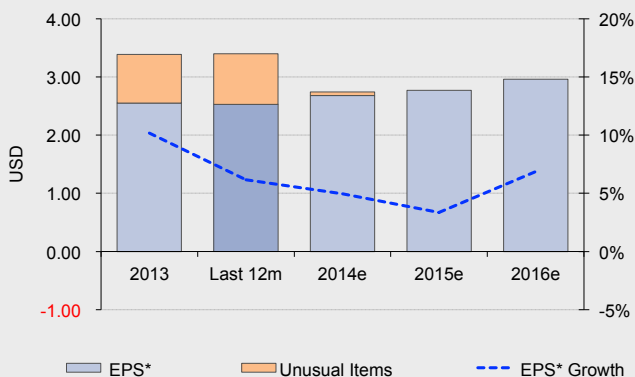
The current share price of \$34.50 and FCF in year 1 of \$2.01 imply the following ranges for FCF growth into perpetuity and WACC:

WACC	See the full report.
FCF Growth into perpetuity	See the full report.

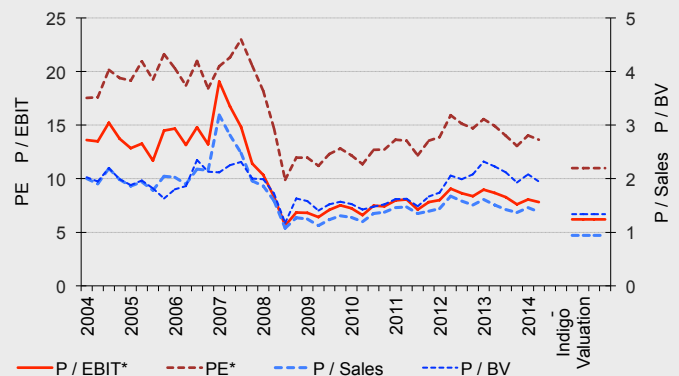
$$\text{DCF Formula: } PV = FCF / (\text{WACC} - g)$$

Disclaimer: DCF valuation is only an illustration of potential valuation.

### Consensus Forecasts - EPS



### Historical Valuation Multiples



## Contents of the Full "Company Profile" Equity Research Report

The full (53 page) Company Profile equity research report can be purchased from our website.  
[www.indigo-equity-research.com](http://www.indigo-equity-research.com)

Description	Page
Investment Thesis & SWOT Analysis .....	Page 1
Contents .....	Page 2
News Flow - Significant Recent Company .....	Page 3
USA Telecoms Industry Significant Recent Events .....	Page 4
<b>Company Analysis</b>	
US Telecoms Industry Overview & key Themes for 2013 .....	Page 5
AT&T - Business Activities .....	Page 6
Management, Executive Compensation & Board .....	Page 7
Balance Sheet & Pension Issues .....	Page 8
Key Divisions .....	Page 9
Business Model - Snapshot of the last 12 Months .....	Page 10
SWOT Analysis .....	Page 11
Key Investment Issues .....	Page 12
<b>Key Fundamental Drivers</b> .....	Page 14
<b>Historical Financial Results - Quarterly Analysis since 2003</b>	
Profit & Loss Summary .....	Page 18
Revenue Analysis .....	Page 19
Revenue Analysis by Division .....	Page 20
Wireless Operational Data .....	Page 21
USA Wireless - Competitor Analysis .....	Page 22
Wireline Operational Data .....	Page 23
EBITDA, EBIT & Pre-Tax Profit Analysis .....	Page 24
Cost Analysis .....	Page 25
Cash Flow Analysis .....	Page 26
Balance Sheet Analysis .....	Page 28
Cash Flow & Working Capital Analysis .....	Page 27
Return Analysis .....	Page 29
Unusual Items .....	Page 30
<b>Valuation</b>	
Fundamental Valuation of AT&T .....	Page 33
DCF Valuation & Reality Check .....	Page 34
Historical Valuation Multiples .....	Page 35
Consensus Forecasts & Valuation Multiples .....	Page 36
<b>Telecoms Industry Analysis</b>	
Overview of the US Telecoms Industry .....	Page 38
Key US Telecoms Trends & Drivers .....	Page 39
Recent USA Regulatory Issues .....	Page 43
A brief history of the US Telecoms Industry .....	Page 43
Description of Telecoms Services .....	Page 44
Telecoms Glossary .....	Page 44
<b>Tables of Historical Financial Results</b>	
Quarterly & Annual Financial Accounts .....	Page 46
Revenue, EBITDA, EBIT, Pre-Tax Profit (by Division) & operational Data .....	Page 47
Explanations, Legal and Important Information .....	Page 53

## Explanations

### Brief business description - AT&T

AT&T is one of the largest US integrated telecoms operator by revenues and a member of the S&P 500 index. Its major business lines include: wireline (fixed line) and wireless (mobile telephony), internet & IT services. The corporate headquarters are in Texas and AT&T mobility is based in Atlanta. It has c. 250,000 employees.

### Explanation of Company Ratings used by Indigo Equity Research Ltd:

**Industry View:** ATTRACTIVE

**Industry View** = This is an assessment from an investor's perspective of the potential for the industry as a whole to generate profits in the future based on criteria such as: market structure (eg. number of competitors and industry concentration), growth prospects, maturity (stage of the industry life cycle), regulations, technology, disruptive forces, expected changes and speed of any changes.

**Company Rating:**

	LOW	MED.	HIGH
Risk			
Quality			
Valuation			

**Risk** = The company-specific risk of a sustained negative change in earnings, valuation ratios & investor sentiment; and thus the share price for more than one Quarter. This risk does not address the market risk. This risk does not include any measure of short term volatility, in the traditional financial academic sense, of less than one Quarter.

**Quality** = The quality of the company reflects its ability to maintain or increase earnings from its competitive advantages, strategy, brand, management, market position, pricing power, services etc.....

**Valuation** = This is an absolute measure of valuation multiples of the company, based on a range of metrics (multiples) such as: P/Sales, PE, PEG, P/BV, P/FCF, EV/EBITDA, EV/Sales, Div Yield .....

**Comment on Ratings:** These qualitative assessments of "Company Ratings" are made for each company on a relative basis compared to other companies with large capitalizations; but are nonetheless subjective and dependent on the analyst's individual opinion & analysis of the company.

### Financial definitions & abbreviations:

FCF = Free Cash Flow

Op FCF = Operating Free Cash Flow

EBIT = Earnings Before Interest & Tax

EBITDA = Earnings Before Interest, Tax, Depreciation & Amortisation

TTM = Trailing 12 Months

Last 12m = Last 12 months

y/e = (financial) year end

EV = Enterprise Value

P = (Share) Price

PE = Price / Earnings

PEG = PE / Growth

BV = Book Value

Div. = Dividend

EPS = Earnings Per Share

DPS = Dividends Per Share

**Explanation of what constitutes an unusual or significant item:** Indigo Equity Research determined what constituted "Unusual items" in this report on the basis of assessing what items were significantly or materially separate or different to the Company's core business and activities. This is a highly subjective assessment made by the analyst on a case-by-case basis.

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