new|street RESEARCH

Quick thoughts on Elliott's plan for AT&T

September 9, 2019 by Jonathan Chaplin

Like Elliott, we see an opportunity to unlock value in AT&T's wireless business. We highlighted early signs that this business may already be improving in our recent Wireless trends report (LINK). If AT&T can capitalize on their asset advantage in wireless, they ought to be able to recapture much of the share they have lost over the last few years. We see two challenges to Elliott's plan. The first, is getting AT&T's management team and board to shift its course. The second, is that outside of wireless the problems are more structural. It is not clear that these can be easily fixed with better management. Nevertheless, we see opportunities for value creation here too.

The opportunity in wireless

As we highlighted in our recent trends report (LINK), new spectrum deployment may be driving a recovery in subscriber trends at AT&T wireless. If this transpires as we think it should, AT&T would go from losing 0.5MM postpaid phone subs in 2022 to adding close to 1.5MM. Factoring this into our forecast increased our wireless service revenue and EBITDA in 2022 by $2BN (3-6%).

The drivers of the improvement are simple: AT&T is in the process of deploying 60MHz of new spectrum. This should drive about a 60% increase in capacity on AT&T's network (they had about 100MHz deployed previously). The additional capacity will result in improved network performance and faster average speeds for AT&T wireless customers. This in-turn should drive lower churn.

Churn increased at AT&T last quarter; however, the pace of increase has improved sharply over the last two quarters. Only 10% of AT&T's subs are seeing the full benefit of the new spectrum at present. As the deployment continues, and as subscribers adopt handsets that are capable of using the new spectrum, we should see a sharp increase in subs with a substantially improved network experience, which should drive falling churn and rising net adds.

Verizon is in a compromising position. AT&T now has close to a 60% capacity advantage over their largest rival. AT&T has seen their share of postpaid phone subscribers fall from 31% to 29% over the last three years, while Verizon has maintained flat share. If they can drive the improvement in churn we outlined above, they should be able to regain 100bps of share, while Verizon could lose 450bps.

Elliott is correct to point out the margin gap between AT&T and Verizon, though it is more like 550bps than the 1500bps that Elliott cites (there are differences in accounting that must be accounted for). If AT&T closed the gap with Verizon, it could add another $3BN in wireless EBITDA by 2022 (11%). It will be easier for AT&T to improve margins if they start growing the business again (though there will be an initial drag from subscriber acquisition costs). We haven't factored this into our forecast because we didn't expect AT&T's management team to do anything about the margin gap. Perhaps Elliott can change this.

Between a recovery in subscriber growth and margin improvement, AT&T could drive wireless EBITDA of $35BN, which at Verizon's multiple would suggest a wireless business worth $260BN. We believe this is ~15%

higher than the value the business receives today (though disaggregating the values of the different businesses is tough). This would create $5 / share in value for AT&T. It wouldn't quite deliver the $60 / share that Elliott is looking for, but it is better than a kick in the pants.

We maintained a Neutral rating on AT&T after 2Q19 results despite having a forecast that was well above consensus for the wireless business, because we saw greater challenges than the market seemed to be recognizing in AT&T's other businesses. We didn't contemplate management changing its strategy with respect to these businesses; the prospect of that seemed remote. If Elliott can catalyze change, the opportunity is compelling. We will argue below that getting AT&T management to change course will be Elliott's biggest challenge.

The problems (and opportunity) in pay-tv

The DTV acquisition was a mistake from the start, but there isn't much point in lamenting this now. The question is what can be done about it. There is no easy fix; the business is suffering for secular pressures that would be hard to mitigate, even with phenomenal management. We see three potential courses of action to maximize the value of this business:

Option 1: Double down

AT&T ought to combine DTV with Dish's pay-tv business. The synergies would be material at the outset. A bigger pay-tv business would be better positioned to weather secular pressures in two respects: first, they would be in a better position to negotiate with content companies, possibly slowing the growth in content costs that has been eroding margins; second, they would be better positioned to invest in an over-the-top (OTT) platform that might eventually replace some of the subscribers lost by the traditional satellite pay-tv platform.

Pay-tv aggregation and distribution will never be a great business again, but there is an opportunity for a company to develop an OTT aggregation platform that becomes the most widely adopted platform by consumers nationally, and maybe even globally. There would be value in this business. Combined with Dish, DTV should have the lowest content cost in the industry, which would give them a strong advantage – scale is the key to winning in a highly competitive aggregation market. Scale isn't enough though; the companies would have to develop a killer platform that delivers a great user experience.

If AT&T could engineer this transaction while at the same time divesting or spinning out DTV, that would be ideal. Dish probably isn't a buyer of DTV, given their ambitions is wireless; if anything, we would guess that they would welcome a sale of the satellite business as it would fund their adventures in wireless. Perhaps some clever bankers can devise an ingenious structure which would see the businesses combined, and separated from both parents, in a tax-free transaction, with cash flowing back to the parents. We haven't investigated whether such a structure is plausible yet, but we will.

This deal would face stiff opposition [1]. Content companies would hate it. Consumer advocates would hate it too. But the FCC has determined that broadband is available to 93% of households (LINK), which means that 93% of households have access to many different pay-tv services. The companies would have to convince the FCC and DOJ that, through some concessions, households in the 7% of the country that might see pay-tv choices decline from two to one are protected.

Ergen was asked about this on his last earnings call. His cryptic response:

"Well, I'd say it's a little bit simpler. We just don't have a relationship with AT&T."

Our interpretation: AT&T management isn't very fond of Ergen after past deal discussions that proved fruitless, and they don't have much interest in talking to him. We know this, because AT&T management has told us as much. Perhaps Elliott can get them to reconsider. As difficult as the negotiations might be, there is value to be unlocked for AT&T's shareholders.

Option 2: Selling

If a combination with Dish's pay-tv business isn't possible, AT&T ought to explore a sale. The problem is that we don't see any obvious buyers, apart from Dish, and we don't think Dish is a buyer. Though one never knows until one runs a process. Comcast has recently developed an appetite for the satellite pay-tv business in Europe, and they pay high multiples; perhaps they could be tempted to buy this one (we are entirely joking; we would be miserable if Comcast purchased DTV, as would their investors).

We doubt AT&T management would run a process to explore a sale of the business without a strong push, because it would require them to admit that the acquisition was a mistake. This is another area where Elliott might get them to reconsider. Quite simply, the acquisition was a mistake. Admitting the mistake would have no impact on the market's view of management's competence; the market knows it was a mistake. This is reflected in the multiple that AT&T trades at. If anything, unwinding the mistake may help restore confidence in management.

Option 3: Run it for cash

There is a real possibility that there are no buyers willing to pay a fair price for the asset, in which case AT&T will be stuck with it. In this scenario, they should run it for cash…which is more or less what they are doing at the moment. Though we suspect they could extract a good deal more cash from the business if this became their express strategy.

The problem (and opportunity) with Warner Media

It may be too early to say whether the acquisition of Time Warner was a mistake, though the market is skeptical. We have seen few if any synergies between content businesses and distribution businesses in the past (Comcast has shown this). Moreover, there is little reason to believe that AT&T can run this business much better than the guys running it before (Comcast had a much easier starting point with NBCU). If management fails to prove out its thesis in the next couple of years, the company may be better off exploring a sale of this business too. There are many more potential buyers for this business than DTV, though it may still prove challenging for AT&T to recover what they paid.

In the meantime, the outflow of talent from the media business is concerning. It is a talent driven business. Elliott's presentation highlights just how much of the senior talent has left (9/10 top managers are out). The creative class at Warner Media may be encouraged if a media executive with a strong track record and respect within the industry is elevated to run this business. AT&T has hired Greenblatt – he seems like a good option. The creators need to believe that AT&T understands the value of the content creation process and the talent that delivers it.

Competition for talent has never been greater. The industry is about to go through tremendous change. This may not be the right time for AT&T to focus on implementing process and structure, streamlining operations, and cutting costs, all at the expense of the creative process.

The challenge: getting AT&T to change course

AT&T's management believes strongly in AT&T's management. The best evidence of this is in their appointment of a telecom executive [2] to run Warner Media – a business that neither he nor AT&T had much experience with previously. We thought the newly acquired business might do well if AT&T took a hands-off approach, leaving the talent to do what it does. This wasn't the path AT&T chose though, and it seems that the cultures have clashed (LINK).

AT&T's conviction in their own approach is also demonstrated by their response to Elliott: "many of the actions outlined are ones we are already executing", and; "AT&T's board and management team firmly believe that the focused and successful execution of our strategy is the best path forward to create long-term value for shareholders." To paraphrase: "thanks for the note, but we are good [3]".

Shifting this perspective will be Elliott's greatest challenge. If they are successful, the spoils would warrant the effort.

Elliott's track record in telecom deals

With 42 years of investment track record, few investors can claim to be as long-term as Elliott or have such a successful long-term track record. However, by taking a $3.2bn investment in AT&T, representing almost 9% of their AUM, they are making a substantial call. In the telecoms sector, they have been more involved in Europe than the US so far, and they have had some notable successes (as a minority investor in Sky for example), though not every investment has been a home run.

Elliott's recent headline-grabbing position in Telecom Italia is currently trading below their entry price. Elliott's focus here was trying to unlock value by breaking out assets trading on higher multiples than the overall group multiple. The unique process by which Telecom Italia management is elected allowed an Elliott-nominated Board to get effective control of the company, which is clearly going to be a harder goal to achieve with AT&T. While Elliott's initial plans in Italy have been frustrated by local politics and Vivendi (the other large shareholder), Elliott has remained committed to the position and indeed with ongoing discussions between Telecom Italia and Enel OpenFiber, their initial plan to unlock value may still come to fruition.

In terms of showing they are willing to take a long-term stance, Elliott has also remained a 14% minority shareholder in KDG since 2013. While they haven't yet been able to cash in on their position, they have been able to extract an attractive ongoing dividend from Vodafone to make the holding worth their while.

AT&T's track record in telecom deals

It is worth noting where AT&T's strategy has been successful. The AT&T we know today started life as SBC, the smallest and perhaps least well-endowed piece of the "OG" AT&T after it was broken up by the government. Through a staggering string of deals, Whitacre and Stephenson assembled the assets that comprise AT&T today [4] Up until DTV, most of those deals were good. They bought assets that the management team understood well, which added scale and strategic advantage to the assets they already had.

The acquisition of DTV was different in that it was for an asset that the management team didn't know as well, and it did very little for the value of the assets they already owned. The acquisition of Time Warner brought a set of assets even more distant from AT&T's area of competence with even less synergy with AT&T's existing portfolio.

We believe the DTV acquisition was a mistake, and they should sell it if they can. It's too soon to know how the Time Warner acquisition will fare, but if it fails to deliver as management expects they may be better off parting with this too. Hanging on to either asset too long may compound the mistakes. It would be a pity for AT&T to tarnish its legacy as one of the greatest deal makers in history by failing to change course quickly enough on transactions that didn't deliver what they had hoped.

Our updated Global Valuation Comp sheet can be found HERE

Full 12-month historical recommendation changes are available on request

Reports produced by New Street Research LLP. 52 Cornhill, London EC3V 3PD Tel: +44 20 7375 9111.

New Street Research LLP is authorised and regulated in the UK by the Financial Conduct Authority and is registered in the United States with the Securities and Exchange Commission as a foreign investment adviser.

Regulatory Disclosures: This research is directed only at persons classified as Professional Clients under the rules of the Financial Conduct Authority ('FCA'), and must not be re-distributed to Retail Clients as defined in the rules of the FCA.

This research is for our clients only. It is based on current public information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Most of our reports are published at irregular intervals as appropriate in the analyst's judgment. This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients.

All our research reports are disseminated and available to all clients simultaneously through electronic publication to our website.

New Street Research LLC is neither a registered investment advisor nor a broker/dealer. Subscribers and/or readers are advised that the information contained in this report is not to be construed or relied upon as investment, tax planning, accounting and/or legal advice, nor is it to be construed in any way as a recommendation to buy or sell any security or any other form of investment. All opinions, analyses and information contained herein is based upon sources believed to be reliable and is written in good faith, but no representation or warranty of any kind, express or implied, is made herein concerning any investment, tax, accounting and/or legal matter or the accuracy, completeness, correctness, timeliness and/or appropriateness of any of the information contained herein. Subscribers and/or readers are further advised that the Company does not necessarily update the information and/or opinions set forth in this and/or any subsequent version of this report. Readers are urged to consult with their own independent professional advisors with respect to any matter herein. All information contained herein and/or this website should be independently verified.

All research is issued under the regulatory oversight of New Street Research LLP.

© Copyright 2021 New Street Research LLP

No part of this material may be copied, photocopied or duplicated in any form by any means or redistributed without the prior written consent of New Street Research LLP.

---

1. For more detail on the regulatory prospects of a potential DISH / DirecTV deal, please see HERE.

2. Stankey may be an exceptional telecom executive. He has consistently been put in charge of AT&T's most challenging situations; management and the board clearly hold him in high regard. Appointing him to the role of president and making him the heir apparent to Stephenson may be a strong choice. The media business couldn't be more different from telecom though, potentially requiring a different skill set and a different temperament.

3. I couldn't help but be reminded of the "We already have one" moment in Monty Python and the Holy Grail (LINK)

4. This may well be the greatest string of acquisitions ever, at least in our industry. It culminated with the acquisition of Bellsouth, which consolidated control of what is now AT&T Wireless, and the old mothership – AT&T. These last two deals were done a year apart. They were done while Whitacre was still CEO, but Stephenson was already effectively running the company; they were his deals as much as anyone's.