HILLIARD LYONS

**Telecommunications**
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COMPANY UPDATE / PRICE TARGET CHANGE / ESTIMATE CHANGE

**Key Metrics**

| | | |
|---|---|---|
| T - NYSE (Price as of 7/25/17) | | $36.22 |
| Price Target | | $42.00 |
| 52-Week Range | | $43.50 - $35.81 |
| Shares Outstanding (mm) | | 6,184.0 |
| Market Cap. ($mm) | | $223,984 |
| 3-Mo. Average Daily Volume | | 21,472,000 |
| Institutional Ownership | | 63.0% |
| Debt/Total Capital (6/30) | | 53.3% |
| ROE (ttm) | | 11.9% |
| Book Value/Share | | $19.83 |
| Price/Book Value | | 1.8x |
| Dividend Yield | $1.96 | 5.4% |
| LTM EBITDA Margin | | 25.7% |

**EPS FY 12/31**

| | 2016 | Prior 2017E | Curr. 2017E | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|
| 1Q | | | | | |
| 2Q | | | | | |
| 3Q | | | | | |
| 4Q | | | | | |
| Year | $2.84 | $2.94 | $2.97 | $3.04 | $3.07 |
| P/E | 12.8x | | 12.2x | | 11.8x |

**Revenue ($mm)**

| | 2016 | Prior 2017E | Curr. 2017E | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|
| 1Q | | | | | |
| 2Q | | | | | |
| 3Q | | | | | |
| 4Q | | | | | |
| Year | $163,800 | | $162,500 | | $164,500 |

***Company Description:*** *AT&T is one of the world's largest providers of pay TV. Additionally, AT&T has more than 132 million wireless subscribers and connections in the U.S. and Mexico; offers 4G LTE mobile coverage to nearly 310 million people in the U.S.; covers 57 million U.S. customer locations with high-speed Internet; and has nearly 16 million subscribers to its high-speed Internet service.*

# AT&T

T -- NYSE – Buy -- 2

## Company reports better than expected earnings on improved margins; maintain Buy rating

### Investment Highlights

- **AT&T reported second quarter earnings of $0.79 per share versus $0.72 per share in 2016's second quarter, and significantly above the consensus estimate of $0.72 per share.** Revenue of $39.8 billion was in line with expectations and compared to $40.5 billion a year ago. Revenues declined by 1.7% on a year-over-year basis, primarily due to declines in legacy wireline services and consumer mobility. Earnings were boosted by improved margins and cost cutting measures. Operating income was $8.6 billion versus $8.1 billion and T's operating income margin rose to 21.6%. Also wireless performed better than anticipated with record wireless service margins and lower than anticipated postpaid subscriber losses. Also, the continued growth of DTV Now, T's OTT (Over-the-Top) video product, is helping to offset DIRECT TV satellite losses.
- **Management reaffirms 2017 guidance.** AT&T continues to expect earnings per share growth in the mid-single digit range for this year. T also expects an expansion in its adjusted operating margin in 2017. The company continues to believe its acquisition of Time Warner will be completed by year-end. The review process continues at the Department of Justice. T stated it has the financing in place to complete the deal.
- **We maintain our Buy rating on AT&T.** We are encouraged by the better than expected second quarter earnings results. The company's cost cutting measures have been effective in combatting the headwinds of intense competition and slow wireless growth. In addition, it appears T's expanded bundling efforts are also bearing fruit. The stock trades at what we believe is an attractive valuation of 12.2x estimated 2017 earnings. In addition, T offers a generous 5.4% dividend yield. Thus, we continue to believe T still has merit for income oriented investors. Our $42 price target implies a potential total return of approximately 21%.

**Note Important Disclosures on Pages 3-4.**
**Note Analyst Certification on Page 3.**

**Second Quarter Results**

We believe it was a solid second quarter for AT&T. T rarely posts a positive earnings surprise but that was the case in this instance. Second quarter earnings were $0.79 per share versus $0.72 per share in the second quarter of 2016, a gain of 9.7%. Earnings were considerably above the consensus estimate of $0.72 per share. Earnings were enhanced by improved margins and ongoing efforts to reduce costs. Revenues totaled $39.8 billion compared to $40.5 billion in 2016's second quarter, a decline of 1.7%. Revenues were in line with expectations and showed sequential improvement from the first quarter, when revenues were $1 billion below expectations. Revenues continued to be pressured by declines in legacy wireless services and consumer mobility. However, wireless performed better than anticipated in the quarter. The company lost 89,000 postpaid wireless customers in the quarter compared to an anticipated loss of 256,000 customers. T believes that its bundling efforts are helping to improve results. This was evident in both T's churn rates and wireless margins. The company experienced its lowest ever postpaid churn for any quarter at 0.79%. Wireless EBITDA (earnings before interest, taxes, depreciation and amortization) margin matched the first quarter's all time high of 41.8% while T's service margin was a best ever 50.4%. The company appears to be making progress in both reducing its costs and retaining its customers.

Operating income in the second quarter was $8.6 billion compared to $8.1 billion in last year's second quarter. Operating income margin was 21.6%, up from 20.1% a year ago. While wireless margins were a key component in the quarter's success, T's Business Solutions segment also experienced margin growth in the second quarter despite a decline in revenues due to declines in legacy wireline services. Entertainment Group revenues and margins were essentially flat from year ago levels. While video subscribers declined as expected, this was partially offset by an increase in DIRECTV NOW and broadband subscribers. The company's International division saw its revenues grow to $2.0 billion from $1.8 billion in the year ago period.

**Outlook**

Management reaffirmed previous 2017 guidance. T continues to anticipate earnings per share growth to be in the mid-single digit range this year. AT&T also expects its operating margin to expand this year. We are raising both our 2017 and 2018 EPS estimates to reflect the potential for continued margin strength. Our 2017 and 2018 EPS estimates go from $2.94 and $3.04 to $2.97 and $3.07, respectively. The company also expects to complete its acquisition of Time Warner by year-end. The review process is currently underway at the Department of Justice. While we feel the odds favor approval, there remains uncertainty. If approved, AT&T feels it will have the proper financing set up to complete the acquisition. We believe that, if approved, the inclusion of Time Warner's operations has the potential to enhance AT&T's long term fundamental outlook by merging Time Warner's content with AT&T's vast distribution capabilities.

**Rating**

We maintain our Buy rating on AT&T. We are encouraged by the company's better than expected second quarter results and improved profitability. Our premise for recommending the stock has been the belief that T will deliver modest but consistent earnings growth and that this will eventually result in the stock trending higher. We believe this scenario remains intact. Having said that, both AT&T and telecom have been poor performers of late. Telecom has been the single poorest performing major sector year-to-date and T shares recently traded at a new 52-week low. However, despite the competitive environment we continue to think T has a positive outlook and one that could potentially be further enhanced by the acquisition of Time Warner. From both a valuation and yield perspective the stock appears attractive. The stock trades at just 12.2x estimated 2017 earnings while offering a lofty 5.4% dividend yield. Dividends have been raised for 33 consecutive years and we expect another increase late this year. We continue to regard AT&T as a suitable holding for income oriented investors seeking modest capital appreciation.

**Valuation**
We are lowering our price target by $1 to $42 to reflect the ongoing challenging telecom environment. The industry remains intensely competitive from a pricing perspective and shows no signs of abating. In recent years the stock has traded between 12x and 16x forward earnings. At a price of $42 the stock would be trading at 13.6x estimated 2018 earnings and near the midpoint of its P/E multiple range. Our revised price target implies a potential total one year return of 21%.

**Suitability**
Our suitability rating for AT&T is a 2. While the company operates in a very competitive environment, its earnings tend to be stable. Moreover, the company generates large cash flows which support its generous dividend payout. Dividends have increased for 33 consecutive years and we expect this trend to continue. We regard AT&T as an appropriate holding for conservative investors seeking income.

**Risks & Considerations**
There are a variety of risks that could negatively impact the stock reaching our price target. There is near-term risk that the Department of Justice may not approve the company's proposed acquisition of Time Warner. From a macro perspective, should the economy continue to grow at a slow pace both the company and the industry could continue to be negatively impacted. The company also continues to face intense competition from Verizon, Sprint, and T-Mobile, and we expect this trend to continue for the foreseeable future. In addition, the wireless industry is a maturing one, offering less growth potential than in years past. We also note the company's wireline segment remains under pressure, particularly its business segments. Also, the company's satellite TV business could be negatively impacted by changing consumer trends. Higher inflation and higher interest rates could also have a negative effect on T's stock price. Finally, there remains Federal regulatory risk.

Prices of other stocks mentioned: Time Warner (TWX-$99.81), Verizon (VZ-$43.98), Sprint (S-$8.70) and T-Mobile (TMUS-$62.36).

*Additional information is available upon request.*

**Analyst Certification**

I, David B. Burks, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

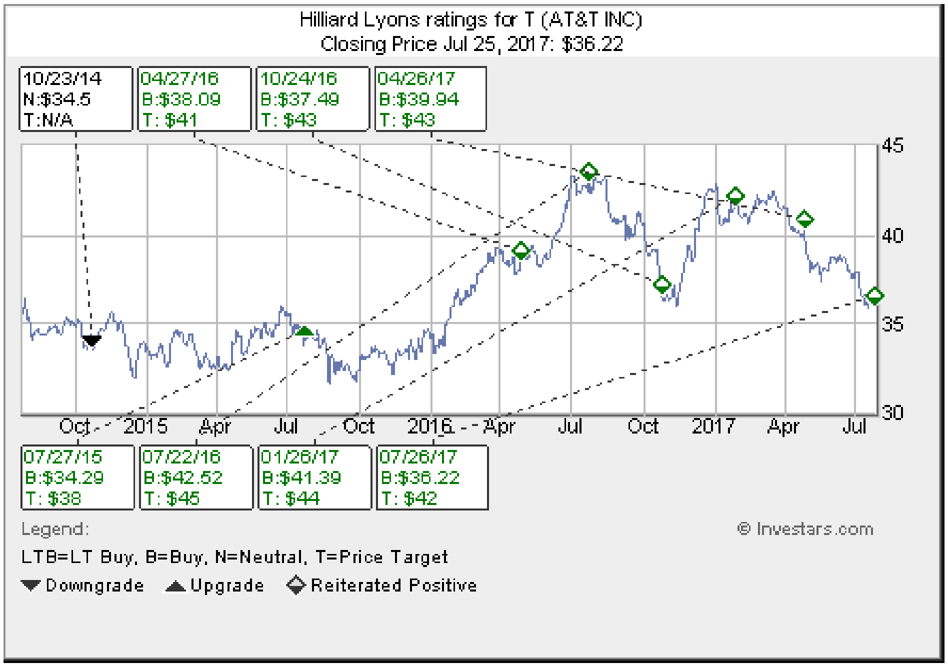
**Important Disclosures**

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

**Investment Ratings**
**Buy -** We believe the stock has significant total return potential in the coming 12 months.
**Long-term Buy -** We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
**Neutral -** We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
**Underperform -** We believe the stock is vulnerable to a price set back in the next 12 months.

**Suitability Ratings**
**1 -** A large cap, core holding with a solid history
**2 -** A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
**3 -** An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

**4 -** Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base




| | Hilliard Lyons Recommended Issues | | Investment Banking Provided in Past 12 Mo. | |
|---|---|---|---|---|
| **Rating** | **# of Stocks Covered** | **% of Stocks Covered** | **Banking** | **No Banking** |
| **Buy** | 36 | 29% | 14% | 86% |
| **Hold/Neutral** | 79 | 63% | 5% | 95% |
| **Sell** | 10 | 8% | 0% | 100% |

*As of 7 July 2017*

## Other Disclosures

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