HILLIARD LYONS

Telecommunications
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COMPANY UPDATE / PRICE TARGET CHANGE / ESTIMATE CHANGE

Key Metrics

T - NYSE (Price as of 10/24/17)		$34.86
Price Target		$39.00
52-Week Range		$34.81 - $41.03
Shares Outstanding (mm)		6,182.0
Market Cap. ($mm)		$215,504
3-Mo. Average Daily Volume		26,675,000
Institutional Ownership		63.0%
Debt/Total Capital (9/30)		56.4%
ROE (ttm)		11.7%
Book Value/Share		$19.83
Price/Book Value		1.8x
Dividend Yield	$1.96	5.6%
LTM EBITDA Margin		25.4%

EPS FY 12/31

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q					
2Q					
3Q					
4Q					
Year	$2.84	$2.97	$2.92	$3.07	$2.97
P/E	12.3x		11.9x		11.7x

Revenue ($mm)

	2016	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q					
2Q					
3Q					
4Q					
Year	$163,800		$161		$164,350

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 mixed third quarter results; maintain Buy rating for income oriented investors

Investment Highlights

- **AT&T reported third quarter earnings of $0.74 per share, flat with last year's earnings and in line with expectations.** However, revenue of $39.7 billion was below the consensus estimate of $40.1 billion. This was a negative surprise and we expect the stock to be negatively impacted. Revenue was below expectations at both T's consumer wireless and entertainment segments. The wireless business was pressured by slow equipment sales. The company had about 2 million fewer phone upgrades so far this year when compared to a year ago. Service revenue continues to be impacted by consumers choosing unlimited plans. Entertainment revenues were pressured by the loss of 89,000 video subscribers in the quarter. The losses were due to cord cutting, tighter credit policy and storm impacts.
- **There were some positives in the quarter.** AT&T Mobility recorded record high wireless margins in the third quarter. T saw a 42.0% EBITDA (earnings before interest, taxes, depreciation and amortization) margin and a 50.4% wireless service margin due to strong cost management. Also, the company achieved a record third quarter postpaid churn of 0.84%, which was better than expected. Although T lost 97,000 postpaid phone customers, this was better than the expected loss of 146,000 customers. Finally, free cash flow grew by 13% to $5.9 billion in the third quarter.
- **We maintain our Buy rating on AT&T but are lowering our price target to $39 due to the challenging business environment.** While revenue pressures persist, we are encouraged by the continued strength in wireless margins. Although the stock has performed poorly this year, it still appears attractive on both a valuation and yield basis. The stock trades at just 11.7x next year's estimated earnings while offering an attractive 5.6% dividend yield. Accordingly, we believe T still has merit for income oriented investors.

Note Important Disclosures on Pages 3-4.
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Third Quarter Results
We believe the revenue weakness will be the primary takeaway from the third quarter. While earnings of $0.74 per share were essentially in line with expectations, revenue was not. Total revenue of $39.7 billion came in below the consensus estimate of $40.1 billion. The shortfall in revenues was primarily attributable to weaker than anticipated revenue in both wireless and wireline along with the entertainment division. Wireless revenues were negatively impacted by fewer equipment sales. The company has had about 2 million fewer phone upgrades so far this year compared to a year ago as consumers are holding onto their phones longer. Service revenue continues to be impacted by customers choosing unlimited plans and reducing overage costs. Wireline revenues continue their long-term secular decline as more consumers adopt wireless exclusively. Also, entertainment revenues were pressured in the third quarter from legacy declines. The company lost 89,000 video subscribers from U-verse and satellite in the period. We believe the decline is largely due to a combination of cord cutting, new stricter credit policies and storm impacts. The legacy declines were partially offset by the addition of nearly 300,000 DIRECTV Now customers in the quarter bringing their total customer count up to 800,000. Entertainment margins declined to 21.3% from 23.5% in last year's third quarter.

On a more positive note, wireless margins were strong in the third quarter. AT&T Mobility posted a record 42.0% EBITDA margin and a 50.4% service expense margin. Results were helped by both strong cost management and lower expense associated with fewer upgrades. The wireless business operating margin expanded to 30.5% in the period. In addition, the company experienced a record third quarter churn rate of 0.84%, which was better than expected. Although the company lost 97,000 postpaid wireless phone customers in the quarter, this was better than the anticipated loss of 146,000 postpaid phone customers. Moreover, T grew its total number of wireless customers by 102,000 in the period. Another positive was the growth in free cash flow. Free cash flow grew by 13% to $5.9 billion in the third quarter.

Outlook
Management reaffirmed previous 2017 guidance. T continues to expect 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. However, we are reducing both our 2017 and 2018 EPS estimates to reflect the challenging revenue environment despite the potential for continued margin strength. Our 2017 and 2018 EPS estimates go from $2.97 and $3.07 to $2.92 and $2.97, respectively. The company also expects to complete its acquisition of Time Warner by year-end. The review process continues at the Department of Justice. While we feel the odds favor approval, there remains uncertainty. If approved, AT&T believes 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. However, it will also result in T having an extremely large $180 billion debt load on its balance sheet.

Rating
We maintain our Buy rating on AT&T. However, we acknowledge the stock has performed poorly on both an absolute and relative basis this year. While the company has grown its earnings by 4% on a year-to-date basis, we believe that continued revenue challenges in both its wireless and now its entertainment divisions has adversely impacted the stock. Yet we believe the company has a solid fundamental outlook. Moreover, the stock appears attractive on both a valuation and yield basis. The stock trades at just 11.7x estimated 2018 estimated earnings. T also carries an attractive 5.6% dividend yield. We believe the dividend is secure and expect AT&T's board to raise it for a 34th consecutive year by the end of 2017. As a result, we continue to view as a suitable holding for income oriented investors seeking modest capital appreciation. Yet we also feel it will be important for the company to deliver modest earnings growth going forward to warrant a continued positive rating on the stock.

Valuation
We are lowering our price target by $3 to $39 to reflect both the ongoing challenging telecom environment as well as current pressures in the company's entertainment segment. In recent years the stock has traded between 12x and 16x forward earnings. At a price of $39 the stock would be trading at 13.1x estimated 2018 earnings and toward the lower end of its P/E multiple range. We believe a multiple toward the low end of this range is justified due to the continued pressure on revenues. Our revised price target implies a potential total one year return of 17%.

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 another increase late this year. 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. Moreover, even if the transaction is approved, there could be integration challenges associated with a business that AT&T has relatively little experience in. 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-$100.50), Verizon (VZ-$49.94), Sprint (S-$7.00) and T-Mobile (TMUS-$62.28).

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 acted as a manager or co-manager of an offering of securities of AT&T in the past 12 months.

Hilliard Lyons expects to receive investment banking compensation from AT&T in the coming 3 months.

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	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 2017

Other Disclosures

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of J.J.B. Hilliard, W.L. Lyons, LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed here.

J.J.B. Hilliard, W.L. Lyons, LLC is a multi-disciplined financial services firm that regularly seeks investment banking assignments and compensation from issuers for services including, but not limited to, acting as an underwriter in an offering or financial advisor in a merger or acquisition, or serving as placement agent in private transactions.