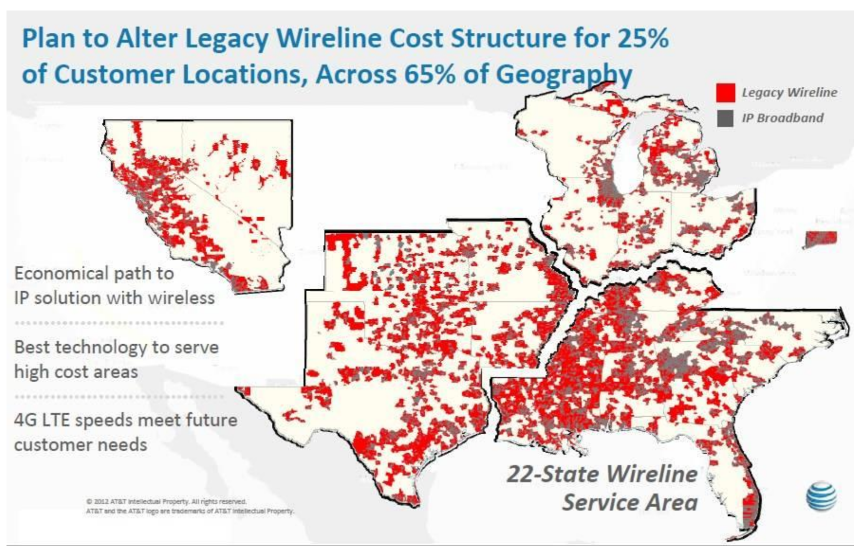
The Sunday Brief: AT&T Goes Organic
25 November 2012

Happy Thanksgiving from Dallas, Kansas City, and Willard (MO). Yes, there are a few geographic locations that do not have adequate wireless data coverage (and have no cable), and, as a result, this week's Sunday Brief is an evening edition.

A few weeks ago, AT&T held an investor conference that was billed as a presentation on how they were going to handle the 20 million or so rural phone lines that they could not cost-effectively address with U-Verse technology. They went far beyond addressing this issue, and, as a result, we will devote this week's Sunday Brief to that presentation and its ramifications for the industry.

To understand the internal implications of AT&T's announcement, we need to understand the primary strategy of AT&T throughout the past decade: Gain unprecedented scale and deliver shareholder value through acquisitions. The formula was simple – buy assets (usually regional local telephone assets), integrate operations, deliver synergies to the shareholders with clockwork, and repeat. SBC built this reputation through the integration of Pacific Bell, Ameritech, Southern New England Telephone, AT&T Long Lines and finally Bell South.



Coupled with this "deliver shareholder value through scale" strategy is AT&T's strong regulatory presence. This exists throughout each of the 22 states where they are the incumbent local exchange provider. To succeed in the local exchange environment, management needed to maintain strong local relationships – the city alderman, the mayor, the governor, and most importantly the state legislature. In one state in the late 1990s, at least 20% of the key legislators were directly related (first cousin or greater) to current AT&T employees. I don't know how one labels such a strategy, but it was definitely a family affair.

This governmental influence continued to grow over the past decade until the T-Mobile merger was denied by the Obama administration. It's been about a year since that event, and the fact that AT&T held their investor conference just after the election is not a coincidence. Team Obama disrupted their pattern of success, and, as a result, AT&T's strategy needed to change.

In addition to the changes described above, the balance of power between handset providers and wireless carriers has also shifted during the past five years. Android and Apple have grown dramatically since the previous AT&T investor conference. Commanding carrier exclusivity, which had helped AT&T in the past with the Motorola RAZR and the Apple iPhone, could not be accomplished in an LTE world.

AT&T would have to win with a different formula, one that coupled their brand awareness, coverage and loyalty in the suburban and rural markets with the construction of barrier to entry that would escape both local and federal regulators and send a clear signal to Comcast and Time Warner that they would need to ante up a few billion dollars more to play at the enterprise table. They would have to grow *organically*.

<u>The result</u>: AT&T announced a sweeping LTE expansion that will cover 99% of their customer locations by the end of 2014, a multi-billion dollar fiber to the business (FTTB) that will cover more than half of all of their customer locations, and an aggressive rebuild of an additional 8.5 million homes on U-verse. In this process, they will spend an additional $14 billion dollars (about $60-65 billion in total) over the next three years, and will petition state and federal governments to serve rural customers with wireless as opposed to wireline broadband.

Consolidated Balance Sheets
AT&T Inc.
Dollars in millions except per share amounts

	9/30/12	12/31/11
	Unaudited	
Assets		
Current Assets		
Cash and cash equivalents	$ 2,217	$ 3,185
Accounts receivable - net of allowances for doubtful accounts of $606 and $878	12,398	13,606
Prepaid expenses	1,337	1,155
Deferred income taxes	1,312	1,470
Other current assets	1,694	3,611
Total current assets	18,958	23,027
Property, Plant and Equipment - Net	108,217	107,087
Goodwill	69,762	70,842
Licenses	52,082	51,374
Customer Lists and Relationships - Net	1,622	2,757
Other Intangible Assets - Net	5,038	5,212
Investments in and Advances to Equity Affiliates	4,563	3,718
Other Assets	6,607	6,327
Total Assets	$ 266,849	$ 270,344

The returns required for this new level of invested capital are daunting. Currently, AT&T has slightly more than $230 billion in net Property, Plant, and Equipment, Goodwill, and Spectrum License assets. Assuming an 8% cost of capital expectation, that's $18+ billion in net income required per year to achieve expectations (AT&T is currently earning slightly less than $15 billion on an annualized basis excluding special items). An additional $65 billion of spending, even with depreciation of the current base, would result in a new base of at least $260 billion by the end of 2015 (re: fiber, towers are longer-lived assets), which will require an additional $2-3 billion of net income (or $20 billion in revenue growth). Overall, after this plan has been implemented, AT&T, to achieve expectations of an 8% post-tax return on invested capital, will need to earn more than $20 billion annually and have revenues (at current profit margin levels) of more than $150 billion.

To put the "more than $20 billion" revenue growth into context, U-Verse is now a $10 billion business. Mobile data is now a $27 billion business. They need to grow roughly another U-Verse <u>*and*</u> grow mobile data by 40% by the end of 2015 <u>*and*</u> preserve margins in the process.

On top of this, AT&T needs to effect the transition to tomorrow's LTE network at breakneck speeds. They need to strengthen their relationships with satellite providers at the same time they are expanding the U-Verse addressable market. And they need to grow strategic enterprise revenues by mid-double digits against a backdrop of economic anxiety and inevitable government spending reductions.

How will AT&T do it? First, they will continue to grow the breadth and depth of their LTE footprint. To do this, they will need approval to implement the WCS spectrum band. Handset providers will need to build this band into future handsets (if they have not done so already), and data transfer between bands will need to be seamless. Usage-based growth on their current coverage area is worth at least $4 billion or 20% of the growth requirement.

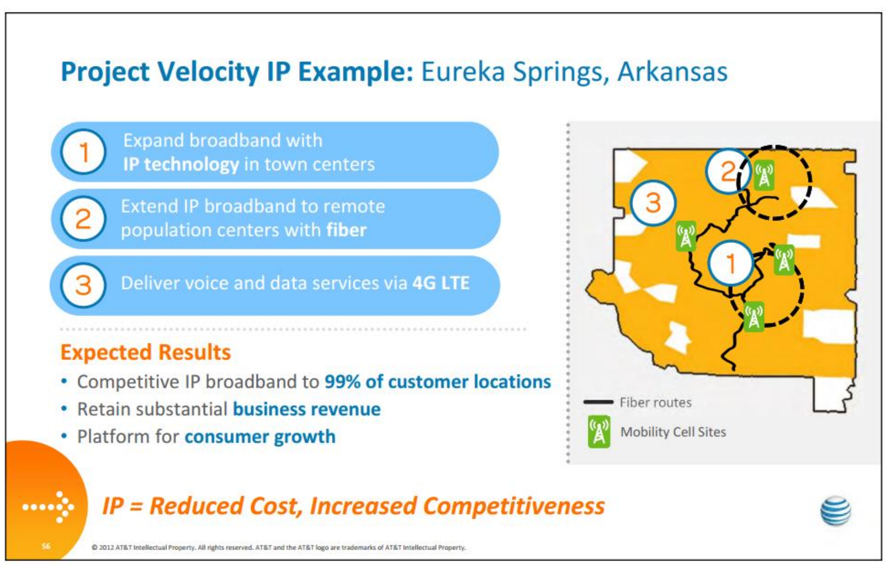
On top of this, AT&T will gain share from their improved LTE coverage throughout their 22-state local market footprint. This is first and foremost a loss containment strategy, but, as we will describe later, also presents some opportunity for incremental LTE growth from their current base. Currently, the local (wireline) voice business is shrinking $2.7 billion annually, while data revenues are only growing $2.1 billion. The customer base is shrinking faster than the costs to operate and maintain the local network.

Let's assume that AT&T, through their LTE investment, sets the objective to turn around the business from shrinking at $600 million/ year to growth of $1 billion. This would involve adding 1.2 million new local (AT&T double play + satellite) customers (at a conservative ARPU of $1300/ customer annually) in addition to maintaining the current revenue levels. Growth of $2 billion would need to result in 2.0 million net new customers. Take out satellite, and the 2.0 million jumps to nearly 3 million (about 1/3rd of the customers AT&T has lost over the past two years).

This large LTE deployment also has a positive effect on the base. To generate an additional $1 billion in revenue, AT&T needs to generate an additional 17 million Gigabytes of monthly LTE capacity that the base will consume because of the continuity of coverage (note: this is a very conservative assumption of $5/ GB, which will likely be higher due to breakage within usage bands, e.g., no one will use exactly one Gigabyte, but will trigger an additional $10 usage tier within their shared plan).

This "network effect" synergy can be seen in several different ways. It would require about 25% of the current postpaid base to trigger a higher usage tier each month (which is entirely possible based on Verizon's early adopter LTE growth). Or it could represent approximately 570 GB per newly deployed cell site (30,000) each month which is also attainable given current data growth rates.

These three examples explain the arduous task of how AT&T will attain $7 billion of the needed $20 billion required to earn an acceptable return on their massive capital investment. Taken separately, growing subscribers and usage in underserved regions of the country should be in AT&T's wheelhouse, and, as AT&T voiced throughout their November 7 presentation, deploying network is a core competence.



We do not have enough space this week to discuss the effects of the fiber deployment, but, as mentioned in the prologue, it's an extremely effective "prevent defense" strategy against cable if AT&T effectively creates an SLA and product portfolio for their customers. As they also mentioned throughout their presentation, the use of fiber for their small cell initiative will also directly improve in-building and near-building coverage.

Given the long-lived nature of the deployed assets, how will we gauge AT&T's success? Early signs will be seen from accelerated U-Verse deployment, LTE (and corresponding share plan) penetration, and business growth. A few friendly state approvals and a Notice of Proposed Rulemaking (NPRM) from the FCC would also be viewed very positively. For a copy of the AT&T's FCC petition, click here.

AT&T's organic, non-exclusive strategy is a big break from their past. The magnitude of their commitment to their current 22-state territory signals that they will not cede new product growth to cable's wired or Verizon's wireless (Home Fusion) products. It relies on effectively introducing value-adding products to a data-conscious base, achieving scale in smaller markets, and getting a green light to replace copper-based wireline services with LTE at their discretion.

Can AT&T achieve this metamorphosis? It's entirely possible, but it will require a lot of internal change orchestration, a daily and relentless reiteration of the "playbook," and success with regulatory powers to drive faster migration to new technology solutions.

Next week, we'll cover product and market positioning for wireless headed into the fourth quarter. Thanks for the comments the past four weeks – we've had a dramatic rise in interest in this column, and we are working diligently to get our new website up and working. Until we do, if you have friends who would like to be added to this email blog, please have them drop a quick note to sundaybrief@gmail.com and we'll add them to the following week's issue. Have a terrific week!

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