MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades AT&T's senior unsecured rating to Baa2 after court ruling approving merger with Time Warner

15 Jun 2018

New York, June 15, 2018 -- Moody's Investors Service (Moody's) downgraded the senior unsecured ratings of AT&T Inc. (AT&T) to Baa2 from Baa1 due to AT&T's elevated leverage following its merger with Time Warner Inc. (Time Warner, Baa2 stable) for approximately $81 billion. AT&T funded the merger with a mix of 50% equity and 50% cash and the assumption of Time Warner debt. Moody's estimates that the transaction will elevate AT&T's gross pro forma leverage (including Moody's standard adjustments) to around 3.7x at year end 2018 with modest deleveraging prospects in the medium term. Furthermore, the transaction will result in total funded debt of over $180 billion, making it the most indebted non-government controlled, non-financial rated corporate issuer. The sheer amount of debt commits AT&T to sizable annual maturity obligations for the long term thereby making the company beholden to the health of the capital markets. The Baa2 rating assumes the company will demonstrate a solid liquidity profile and ability to meet sizable annual debt maturities at all times. The outlook is stable.

The degree of any leverage improvement will depend upon AT&T's ability to return to wireless service revenue growth while maintaining margins, and its progress stabilizing negative revenue and margin trends in its entertainment and business solutions segments. The company could accelerate deleveraging through the sale of non-core assets but it has yet to execute on several potential options under such a plan. Moreover, the recent federal tax law change improves AT&T's operating cash flow profile and potential ability to pay down debt, however we expect the bulk of this cash flow benefit will be used to fund capital investments. As part of this rating action, Moody's affirmed AT&T's Prime-2 commercial paper rating. This concludes the review initiated on October 24, 2016. Time Warner's Baa2 long-term debt rating and Prime-2 short-term rating were affirmed on October 24, 2016 following the merger agreement.

Affirmations:

..Issuer: AT&T Inc.

....Senior Unsecured Commercial Paper, Affirmed P-2

Downgrades:

..Issuer: AT&T Corp.

....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa2 from Baa1

..Issuer: AT&T Inc.

....Senior Unsecured Shelf, Downgraded to (P)Baa2 from (P)Baa1

....Senior Unsecured Bank Credit Facility, Downgraded to Baa2 from Baa1

....Senior Unsecured Regular Bond/Debentures, Downgraded to Baa2 from Baa1

..Issuer: Pacific Bell

....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa2 from Baa1

Outlook Actions:

..Issuer: AT&T Corp.

....Outlook, Changed To Stable From Rating Under Review

..Issuer: AT&T Inc.

....Outlook, Changed To Stable From Rating Under Review

..Issuer: Pacific Bell

....Outlook, Changed To Stable From Rating Under Review

RATINGS RATIONALE

The downgrade to Baa2 from Baa1 reflects Moody's expectation that AT&T's merger with Time Warner will result in higher leverage for several years until potential cost and revenue synergies and broader organic growth firmly outpace margin pressures, now largely being addressed through network optimization and other cost cutting actions. AT&T's strong competitive position, scale and diversity of revenue result in substantial qualitative credit strength. AT&T, a market leader in nearly all of its businesses, has valuable assets, predictable revenue, healthy margins and a consistent practice of investing for the long term. But these qualitative strengths are offset by weak financial metrics, anemic organic growth and continued vulnerability to business disruption across its end markets. AT&T's immense balance sheet could quickly test the depth of the credit markets under difficult market conditions, and its low free cash flow after dividends limits financial flexibility. AT&T is susceptible to tighter credit conditions, further competitive pressure, technological disruption and macroeconomic trends. Moody's thinks the company's risk profile is asymmetrically skewed to the downside, especially if these potential negative developments were to simultaneously occur.

While AT&T's credit risk is amplified by its balance sheet size and positioning at a low investment grade rating, Moody's thinks the company can pursue multiple actions to buttress its current Baa2 rating. In a downside scenario, AT&T could sell assets, defer and cut capital spending, further shrink operating costs through additional headcount reductions, lower or eliminate its dividend or issue equity capital. Given such a slim margin of safety, AT&T's ratings will be subject to a narrow tolerance relative to our quantitative ratings limits.

AT&T's US wireless, entertainment and business solutions segments face top line weaknesses and margin pressures amidst competitively challenging operating environments, but the strategic merger with Time Warner helps further diversify revenue sources. This business addition ensures economic access to Time Warner's comprehensive and premium content business, affording the company increased control over content costs and distribution rights across pay TV and mobile networks. Time Warner is expected to help drive growth through advertising and data insights derived from the company's customer data profiles, potentially augmenting revenue and aiding churn reduction through an enhanced customer experience. While we note AT&T management expects to achieve a total of $2.5 billion in run-rate cost and revenue synergies within three years of the closing, the bulk of Time Warner's 2017 pre-dividend free cash flow would have been consumed by annual dividend payments associated with AT&T stock issued in the merger, as well as by interest expense on merger-related debt.

AT&T's funded debt balance will exceed $180 billion following the transaction close and annual maturities will average in the $10 billion to $11 billion range. Moody's believes that this creates a risk of diminished capital availability during times of economic stress, particularly since many fixed income investors have limited portfolio capacity to invest in additional AT&T debt and increase single issuer credit risk exposure. The company's common dividend will grow to around $14.5 billion annually from around $12 billion prior to the merger. This large, after-tax cash obligation reduces AT&T's financial flexibility and limits its ability to repay debt. To demonstrate the sustainability of its dividend, AT&T must maintain a reasonable payout ratio. From a credit perspective, the dividend is a cash flow cushion to bondholders and a dividend cut would allow for rapid deleveraging if AT&T were to face pressure from weak fundamentals. Over a longer timeframe, Moody's continues to believe AT&T will need to reduce its cash dividends in order to remain competitive with its new peer group that includes other media and technology giants, many of which have very lean balance sheets.

Moody's expects post the merger with Time Warner that AT&T will maintain good liquidity over the next 12 to 18 months, which currently includes undrawn bank facilities of about $12 billion at merger close with the earliest maturity being December 2020. Moody's anticipates about $5 billion of balance sheet cash post merger close. On an ongoing basis, the company will need to address upcoming maturities as far ahead as possible. Any modest deterioration in liquidity would pressure AT&T's ratings, irrespective of its underlying business trajectory.

AT&T's stable outlook reflects our expectation that leverage will slowly fall towards 3.5x (Moody's adjusted) over the next 12 to 18 months, free cash flow will remain positive, the degree of structural subordination in the consolidated post-close capital structure will be managed down to pre-merger levels and liquidity will remain robust enough to comfortably address upcoming debt maturities and all other business needs.

Moody's could raise AT&T's rating if Moody's adjusted leverage is below 3x and free cash flow improves to at least 3% of debt (Moody's adjusted), both on a sustained basis. Moody's could downgrade AT&T's rating if free cash flow is negative or if Moody's adjusted leverage remains above 3.5x, both on a sustained basis. In addition, downgrade rating pressure could result if margin pressures persist or if liquidity is deemed inadequate and the company is viewed as facing moderate to high refinance risk.

The principal methodology used in these ratings was Telecommunications Service Providers published in January 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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