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T - Q1 2020 AT&T Inc Earnings Call

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Co. reported 1Q20 adjusted EPS of \$0.84.



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the AT&T First Quarter '20 Earnings Conference Call. (Operator Instructions) And as a reminder, this conference is being recorded.

I would now like to turn the conference over to our host, Michael Viola, Senior Vice President of Investor Relations. Please go ahead.

Michael J. Viola - AT&T Inc. - SVP of IR

Thank you, and good morning, everyone, and welcome to our first quarter conference call. I'm Mike Viola, Head of Investor Relations for AT&T. And joining me on the call today are Randall Stephenson, AT&T's Chairman and CEO; John Stankey, President and Chief Operating Officer; and John Stephens, our Chief Financial Officer.

Randall's going to begin with an overview of the COVID-19 impact on our employees, our customers and our business. John Stankey then will discuss how we're managing our business through this crisis. And then John Stephens is going to discuss COVID-19 financial impacts, how we're managing our liquidity and capital during this time, and that's going to be followed by a brief look at first quarter results. And then we'll take your questions.

Before we begin, I need to call your attention to the safe harbor statement. It says that some of our comments may be forward-looking and subject to risks and uncertainties, results may differ materially, and additional information is available on the Investor Relations website. And as always, our earnings materials are also available on the Investor Relations page of the AT&T website.

And so with that, I'll turn the call over to Randall Stephenson. Randall?

Randall L. Stephenson - AT&T Inc. - Chairman & CEO

Thanks, Mike, and good morning. We appreciate everybody joining us this morning.



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I want to start with a look at how we're responding to the COVID-19 pandemic. But it's been a chaotic few weeks for all of us, and the COVID pandemic had a significant impact to our first quarter to the tune of \$0.05 per share.

But if we set the COVID-19 impact aside for a moment, the first quarter was pretty much what we had expected. We expected to produce solid wireless results that would cover the HBO Max investment, the net result would be stable EBITDA and EBITDA margins, and that's exactly what we delivered. John Stephens will explain that wireless EBITDA was up 7% for the quarter, and that largely offset the significant investment we made in HBO Max.

So let's talk about how we're addressing the COVID-19 situation. We have about half of our employees working from home, and this ranges from our front-line customer support teams to our executives. For our folks who cannot work from home because they're on the front lines providing essential services, we've instituted several policies to help keep them safe, everything from personal protection protocols and equipment to social distancing and additional cleaning. And we gave all our employees 4 weeks of additional paid excused time off for a broad range of COVID-related needs.

Turning to our customers. It all begins with the AT&T network, the best and fastest wireless network in the country. We're seeing unprecedented volumes of voice calls, text and video streaming, and our network is performing very well. And FirstNet is doing exactly what it was designed to do: Provide critical connectivity to our first responders, health care providers, governments, military, police, fire and EMS. The demand from our FirstNet customers has been tremendous. These first responders are the true heroes, and it's an honor to serve them.

we understand that this crisis is putting unexpected financial pressure on many households and small businesses. So to give them some breathing room, we've adopted flexible payment options, waived late fees and overages, and we've lifted data caps. Connectivity is more essential now than ever, and we want to do what we can to help our customers stay connected through this crisis.

It's impossible to overstate the impact of COVID-19 on all of us. I expect it will have long-lasting implications for many things we used to take for granted, like how we congregate, work, travel, and interact. The economic impact has been swift and there is no consensus on how long this downturn lasts. A lot hinges on when and how we open things back up, when do we have sufficient testing and protocols in place so people feel comfortable returning to work or school or even going shopping. Bottom line, we have very little visibility into the broader economic situation, which makes it impractical to provide detailed financial guidance at this time.

But here's what we've done and what you can expect. As you know, we've suspended share retirements. We have a strong cash position, a strong balance sheet, and our core businesses are solid and generating good cash flow. We're sizing our operations to reflect the new economic activity level, and we're leaning into our cost and efficiency initiatives.

As a result, you should expect the following. We will continue investing in our critical growth areas, like 5G, broadband and HBO Max. We remain committed to our dividend. In fact, we finished last year with our dividend as a percent of free cash flow a little over 50%. And even with the current economic crisis, we expect the payout ratio in 2020 to be in the 60s, and we're targeting the low end of that range, which is a very comfortable level for us. And last, we'll continue to pay down debt and maintain high-quality credit metrics.

AT&T has been through a lot of other crises before. And each time, you've seen us emerge in a stronger position, and I'm confident we'll do it again with this one. So with that, I'm going to turn it over to John Stankey for an operational review. John?

John T. Stankey - AT&T Inc. - President & COO

Thank you, Randall, and good morning, everyone. As Randall said, these are challenging times, and I couldn't be prouder of how our employees have selflessly committed to doing everything they can to keep our society connected, informed and entertained.

For me, the highlights of what have been some pretty tough days are the wonderful stories of our employees on the front line supporting health care professionals, enriching lives and facilitating connections and commerce. This intrinsic tie to the essential functions of everyday life is why I'm heartened by the fact that our core subscription-based businesses, wireless, broadband and enterprise networks, are critical and valued services



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in these times. They connect, inform and entertain our customers. And for our business, they represent more than 60% of revenues and more than 70% of EBITDA. These businesses have proven to be resilient, and they help provide a recurring stream of revenue and solid cash flows even in times of economic stress. They also provide a foundation that can absorb pressure from the other parts of the business that are facing headwinds because of COVID-19.

In the media business, COVID has impacted us on the theatrical and TV side with production studios and theater shut down and less advertising revenues with the postponement or cancellation of sporting events. We also expect our pay TV business to be impacted by the economic headwinds.

As you might expect, we're not backing off our cost and efficiency transformation initiatives that remain largely under our control. If anything, we see this as an opportunity to approach all our businesses differently and better align our work with how COVID has reshaped customer behaviors and the economy.

As I shared previously, we're working on 10 broad areas of opportunity that we expect will deliver \$6 billion in cost savings over the next 3 years and improve market effectiveness, everything from IT and field operations to call centers and retail distribution. Leaders and teams are in place to work the portfolio of opportunities. And we have a solid senior governance structure to guide and resource this work.

Since our last update, I'd like to highlight 2 initiatives that are now underway to yield over \$1 billion in recurring cost improvement and improve our overall customer experience. First is our retail and third-party distribution capabilities. To address our distribution strategy, we'll be adjusting locations, location size, own versus agency mix and point-of-sale support systems and compensation structures.

The second initiative is focused on our field operations, which will benefit from our product evolution to customer self-install, the shift of our broadband base to lower-cost fiber and improved systems and AI capabilities that will reduce truck rolls and eliminate second visits. These efficiencies will enhance our ability to continue to invest in our key growth initiatives.

Our 5G deployment continues, although we continue to navigate workforce and permitting delays. We expect nationwide coverage this summer. We also continue to be opportunistic with our fiber build beyond the 14 million household locations we reach today.

HBO Max continues to be a high priority, and we're set to launch May 27. We were right about the streaming model on HBO Max. Streaming that appeals to all demographics is in high demand. We've announced distribution agreements that cover nearly 50% of the HBO embedded wholesale base and over 2/3 of the retail base with more still to come prior to launch. Now our technical teams are working to finish the platform that will offer one of the best customer experiences in streaming.

We also have great new programs for nearly every key demo, such as Love Life with Anna Kendrick; The Not-So-Late Show with Elmo; the unscripted voguing competition, Legendary, hosted by Dashaun Wesley; and much more. All this, paired with the [day and date] strength, the award-winning HBO programming lineup and curated with one of the highest-quality TV and film libraries available. The studios are dark for now, but as soon as we can resume production, we plan to get back where we left off in March with a steady stream of new offerings in the fall and winter.

We're also deep into planning how priority operations will return to the workplace as we come out of this pandemic. This experience will change many things, including customer behaviors and expectations. We're evaluating our product distribution strategy, relooking at volumes and the required support levels we need in a down economy. We're rethinking our theatrical model and looking for ways to accelerate efforts that are consistent with the rapid changes in consumer behavior from the pandemic. Yesterday's announcement that we'll premier Scoob! direct-to-home for viewing and purchase in the same window, followed by an exclusive streaming premiere on HBO Max, is just one example.

From an operations perspective, we weathered the front end of the storm. Now our focus is on defining and leveraging the new normal across all of our operations. While our subscription model provides important stability in cash flow for us, we continue to work hard in all parts of the business to come out of this crisis stronger than before.

I'd now like to turn it over to John Stephens, who'll provide the financial impacts of COVID-19. John?



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John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Thanks, John. Let's begin by walking through the expected financial impacts from this pandemic on Slide 5. With the uncertainty caused by COVID and the recovery, we have withdrawn all prior financial guidance. No one knows the full duration and magnitude of the situation, but we have been running several different stress test scenarios with varying degrees of severity. Through it all, we expect to come through this healthy and expect that our cash flow will allow us to continue to invest in growth areas, to provide ample dividend coverage and allow us to retire debt. We'll talk more about that in just a moment, but first, there are some short-term and recurring financial impacts we want to discuss.

In mobility, the most immediate impacts are the reduction of roaming revenues as well as a reduction in late fees. The waiving of late fees is a commitment to our customers during these difficult economic times, and roaming should gradually increase as people start to travel more. The first quarter impact of these items was approximately \$50 million, with virtually all of it in the second half of March.

We're augmenting our digital sales team to mitigate the impact of store closures on equipment and service revenues, but we're still forecasting lower wireless gross adds and upgrades. In fact, equipment revenues were down nearly 25% year-over-year in March.

As a result of COVID, we anticipate an increase in bad debt expense across the various businesses, and accordingly have recorded a \$250 million incremental reserve in anticipation of that.

In our Entertainment Group, we anticipate increases in premium TV subscriber, cord cutting as well as lower revenues from commercial locations such as hotels, bars and restaurants. Labor unit costs will increase temporarily from the 20% boost in pay we're providing our frontline employees.

At WarnerMedia, content production has been placed on hiatus, theatrical releases have been postponed and we're seeing lower advertising revenues and lower costs from sports rights.

This crisis has shown the value of premium streaming entertainment, and we anticipate strong demand for HBO Max when it launches next month. Fiber and broadband are more important than ever, and we saw a pickup in demand for both in the quarter. We're also seeing higher demand for VPN bandwidth and security. We do expect a negative impact on small business, which makes up about 15% of our total business wireline revenues. A detailed schedule of the COVID impact is included in our investor briefing.

Now let's walk through our first quarter highlights on Slide 7. Let's start with the financial summary. COVID impacted first quarter results, but we expect the full effect we felt during the second quarter, assuming the U.S. economy and businesses begin to recover in the second half of 2020.

For the first quarter, adjusted EPS was \$0.84 a share, which includes about \$0.05 of COVID impacts. We expect more than half of these impacts will be short term in nature. Revenues were down from a year ago. COVID and FX had about a \$900 million impact on revenues, mostly due to lower advertising from the cancellation of March Madness as well as lower wireless equipment revenues. Much of this impact was offset by lower expenses.

Strong growth in wireless service revenues were offset by reduced video revenues, tough year-over-year theatrical comparisons at Warner Bros. and reduced business in consumer and legacy service revenues. At the same time, corresponding expense reductions generally offset the impacts on operating income. In fact, adjusted operating income margins declined by 20 basis points but were up when excluding COVID impacts.

Our ability to generate cash continues to provide a strong foundation for our capital allocation priorities. Cash from operations came in at \$8.9 billion, and free cash flow was about \$4 billion. The first quarter is typically our lowest free cash flow quarter due to the timing of employee incentive compensation and vendor payments for holiday equipment sales. It also includes about \$1 billion of working capital timing items that we expect to balance out later this year. We also saw COVID-related costs that impacted free cash flow. CapEx was nearly \$5 billion, consistent with last year. Prior to the suspension of share repurchases, we retired about 142 million shares in the quarter. And we retired about 200 million shares since the beginning of the fourth quarter last year.

Let's now look at our segment operating results, starting with our Communications segment on Slide 8. The power of our core business continues to be crucial in these times, and we see the resiliency in our results.



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In mobility, service revenue grew by 2.5% in the quarter. EBITDA of \$7.8 billion grew by more than \$500 million or 7%, and EBITDA margins expanded by 280 basis points. COVID did impact our top line revenue numbers in the quarter by about \$200 million due to lower equipment and roaming revenues. Our subscriber counts for wireless, video and broadband this quarter exclude customers who we agreed not to terminate service for nonpayment. For reporting purposes, we are treating those subscribers as disconnects. Even with that, our industry-leading network and FirstNet drove postpaid phone net adds of 163,000. Postpaid phone churn was down 6 basis points to 0.86%. And our 5G deployment continues. We now cover more than 120 million people in 190 markets, and we expect we'll be nationwide this summer.

In our Entertainment Group, cash generation remains a focus. We added 209,000 AT&T Fiber subscribers and now serve more than 4 million. We continue to drive ARPU growth in both video and IP broadband. In fact, premium video ARPU was up about 10% as we continue to focus on long-term value customers. We launched AT&T TV nationally late in the quarter, and subscriber growth was in line with our expectations, even with COVID impacts. Premium video net losses again improved sequentially. Business wireline performance was solid, with EBITDA and EBITDA margins remaining stable. Revenues were consistent with recent trends as declines in legacy products was partially offset by growth in strategic and managed services. Business wireline continued to be an effective channel for our mobility sales. Including wireless, total business revenues grew 1.7%.

Now let's move to WarnerMedia and Latin America results, which are on Slide 9. Coming into the quarter, we knew we had tough year-over-year theatrical comparisons and some continuing investment in HBO Max. Then the sudden impact of COVID weighed on advertising, specifically around the cancellation of March Madness and television and theatrical production delays. Altogether, COVID had about a \$400 million revenue impact and a \$250 million EBITDA impact on the quarter. And HBO Max is launching next month.

Turning to our Latin American operations. Vrio continues to work against economic and foreign exchange headwinds while Mexico continues to show solid EBITDA improvement. First quarter Mexico EBITDA improved \$63 million year-over-year, and we expect improvement to continue. And even in this economic environment, Vrio continues to generate positive EBITDA.

Now let's go to Slide 10 and talk about how we're effectively managing our capital and liquidity. Even in this economic environment, the company has a strong cash position, a strong balance sheet and substantial liquidity. We've planned for scenarios such as this. While none of us can predict exactly what is going to happen in the remainder of the year, we do know the work we've done in the last few years has put us in a strong position to deal with a wide range of macroeconomic outcomes.

We've reduced debt and restructured our debt towers, derisked our pension plan assets and sold nonstrategic assets. We expect free cash flow after dividends and cash on hand to more than cover our debt maturities this year and through 2023 even in this current economic environment. And we expect to be able to do that even if we choose not to access debt markets while still investing in our key capital projects.

We continue to take a prudent approach, and we have a lot of levers we can pull to optimize our capital structure. In April, we took on a \$5.5 billion term loan agreement at competitive rates to provide additional flexibility. And our revolver is in place like it always has been. We have a long history of not drawing on this facility, and we have no plans to do it now. But this is a \$15 billion facility which provides us significant financial flexibility.

Adding to our financial strength are proceeds from asset sales. We expect to close about \$2 billion in sales from CME, real estate and tower monetizations this year. And you should expect us to continue exploring other opportunities. We expect the sale of our Puerto Rico wireless operations to close in the second half of 2020.

Our strong balance sheet allows us to remain focused on our capital allocation priorities, and we remain committed to: Investing in growth opportunities for the business now and in the future, returning value to shareholders through dividends and paying down debt.

Mike, that's our presentation. We're now ready for the Q&A.

Michael J. Viola - AT&T Inc. - SVP of IR

Operator, we're ready to take the first question.



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of John Hodulik from UBS.

John Christopher Hodulik - *UBS Investment Bank, Research Division - MD, Sector Head of the United States Communications Group and Telco & Pay TV Analyst*

Okay. Great. Randall, obviously, given the size and breadth of the company, you guys have a unique perspective on what's going on in the broader economy. Can you give us a sense on some of the trends that you're seeing in April here?

And then if we can dig a little bit deeper into AT&T, anything you can tell us about trends that you're seeing maybe in terms of wireless or maybe small business or advertising or those areas that might be affected by what's going on with the outbreak?

Randall L. Stephenson - *AT&T Inc. - Chairman & CEO*

Sure. John, I'm probably not going to be able to give you any more insight to what we're all seeing. But look, it's -- what we're seeing, and I would tell you the most disconcerting, troublesome area that we're seeing is what's happening down in small business. Now we tend to underindex the small business, but the small business trends are pretty significant in terms of employee displacements, business closures. And that's the place that was going to drive, I think probably here in the next couple of months, the unemployment issues more than anything. And those are rather dramatic.

On the -- as you move up the stack on business, you're starting to see people, obviously, just like everybody else, get really cautious in terms of how they're deploying capital and spending. From our standpoint, we're seeing -- and you heard John Stephens mention this in his comments. From our standpoint, we're actually seeing businesses begin to step up bandwidth needs as you get into the medium and margin business, particularly around people working at home, consumers doing commerce from home, it's just driving some significant bandwidth enhancement requirements. And we're seeing a lot of that.

The consumer obviously activity-wise, is really, really stagnant. There's no retail, and so the consumer is not out walking the streets and spending in retail. But you're seeing, obviously, the e-commerce trends pretty strong. And that's exactly what we're seeing. But in terms of just the activity, whether it's traditional video, linear activity or whether it's people going in and out of stores, wireless stores, it's just limited capability for customers to do that, and that's exactly what we're seeing.

But man, I'll tell you what we are seeing is the volumes of network usage moving out of urban out into suburban areas, and the volumes have moved into the homes. And we're seeing heavy, heavy volumes on the networks out in homes. This caused us to have to do some enhancement in a quick basis. Stankey and his team have been doing a lot of work to kind of make sure that the networks are being enhanced in areas where you haven't seen volumes like this.

But man, the work volumes, the commerce volumes, the school, video streaming volumes, have moved into the residential areas, and it's really impressive to watch. And it's impressive to see. While economic activity has slowed dramatically, it's impressive to see how much activity is still going on by virtue of the connectivity that's been facilitated into the home. So it's something, obviously, none of us have experienced before. But I would tell you, we, as a company, and I would even say we as an industry, are taking a lot of satisfaction in terms of how these networks are standing up to the shift in volumes and the increase in volumes.

And it should not be missed that this is no accident. The public policy positioning in the United States has been different than it has in most of the rest of the world. And as a result, the incentive to invest and to building capacity and to have cushions of capacity for times like this are playing



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out. And I hope, as we come out of this, our public policy folks will take a hard look at this and recognize that this is important. It's important for a society to have this type of capability and this type of capacity.

And so John, why don't you talk about what you're seeing in general in the business?

John T. Stankey - AT&T Inc. - President & COO

Yes. I would just offer 2 additional thoughts on that. I think as Randall indicated in the wireless space, clearly, new switching and change activity's suppressed. It's largely being suppressed by distribution changes out in the environment. Engagement of the product is not suppressed. Engagement remains incredibly high. And as a result of that, some of the dynamics of customers choosing to go up the continuum of higher-priced service plans to accommodate their increased usage is, in fact, manifesting itself. And that's consistent with one of the expectations that we had in our plans this year as we move through the year.

Probably [softer] in the advertising space. It's going to be soft, and it's probably 2 reasons behind that. One, as you know, there is no sports content. It's one of the best-yielding pieces of inventory that we have access to. And so with that, we're moving from the portfolio, you're going to see pressure as a result of that.

And then secondly, economic activity is down. We have complete segments that have come out of the advertising space. Obviously, travel, there's a suppression of what's going on in automobile, hospitality and lodging. So as that occurs, the scatter market is not as robust as it's been. I don't know what the second quarter will bring at the end. Certainly, ratings are still there. They're stronger than probably expected, but it's a demand issue given the economic activity. So as economic activity goes, I expect we'll see that move back one way or the other.

And then the theatrical business is obviously a stressed business right now. When theaters are closed, it's hard to generate revenue. And don't expect that, that's going to be a snapback. I think that's going to be something that we're going to have to watch, the formation of consumer confidence, not just about going to movies, just in general about being back out in public and understanding what's occurring there.

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

John, if I could. Let me just give you a quick view. Commercial paper markets, bond markets, asset financing markets, and as we've shown, bank term loan markets are all open. There was some rockiness there as we went through March, not for us, but for the overall markets. We always had access. But what we are seeing today is the federal stimulus and the federal reserves action really starting to work its way through the system and things getting back to what I would consider a more normal state.

But I will tell you, those markets are open for us and working, and we're getting to make choices on what's the most efficient, most flexibility in those financing needs that we have. So from that side of the house, I think it's a pretty good story. It's been an interesting few months, but it's -- the policy changes that were made, I think, are having a positive effect.

Randall L. Stephenson - AT&T Inc. - Chairman & CEO

Hats off to the Fed. I would have to give them good marks for how they've managed through this and making sure the capital markets have been able to function.

Operator

Your next question comes from the line of Phil Cusick from JPMorgan.



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Philip A. Cusick - JP Morgan Chase & Co, Research Division - MD and Senior Analyst

Two if I can. First on video, you mentioned faster cord-cutting and commercial issues. What are you seeing so far in April, and as well as AT&T TV Now trends?

And then second, you mentioned some of the financial markets. What does the asset sale picture look like for you now? And working capital was a drag in the first quarter versus a year ago. What has to happen to reverse this?

John T. Stankey - AT&T Inc. - President & COO

So Phil, on the first part, actually, where we stand right now is there has really been no acceleration or change in trends. If anything, it slowed down a little bit as people are engaging more with the product, and clearly at home, having more time, gaining more utility out of it. However, we're expecting that there's going to be a stressed economic environment in the second half of this year at some point. And one would conclude that in a stressed economic environment, there probably are going to be adjustments that people make within their lifestyle and their home. So I would expect that we may see more pressure on that as we move through the year. But we don't know, but would expect that, that's going to be the case. It hasn't manifested itself right now in terms of decisions to remove.

As I said earlier, on the wireless side, inbound activity, new add activity's suppressed right now. You can well imagine with the circumstances around people's homes and entry and the dynamics that are going on, there's just a lower gross activity that's occurring in the industry. I don't feel too bad about where we are in that mix because with the AT&T TV product, as you asked about, that's a great product to have in this situation. It's a low-touch product, oftentimes customer self-install, and so it matches up well to that environment.

But there just is a certain amount of economic activity that's been suppressed there. Our expectations on AT&T TV have been very consistent with what we've seen even with the suppression of the pandemic in the latter part of March, where we were restricted on the certain number of dispatches and some of our capacity there.

So feel pretty good about that launch and where we went. As you know, we have to ramp that throughout the year. So 1 month does not a year make. But we are right on the plan of what we expected in terms of volume. And the customer feedback on the customers we've put on the product has been probably stronger than what we expected. So it's clearly showing that the product is closing some of the gaps that we know the satellite product was a little bit soft on, and we feel really good about that.

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Phil, with regard to the asset sales, I'll give you 2 buckets. One, the sale of CME that -- our European media company is on track. That's about \$1.1 billion in proceeds, debt relief of about \$600 million. We expect that to close in the second half of the year, just going through the normal EU regulatory review. We also have in that bucket some other towers, some remaining towers that we're selling under contract and some remaining real estate. We'd expect those to get closed in the second half of the year. So we're thinking about that as about a \$2 billion cash bucket plus the relief of debt of \$600 million. That's one set.

The second piece is the Puerto Rico wireless operations. That process is continuing to go through the normal federal review process, regulatory. We expect that to close in the second half of the year. And in both -- in all cases, the buyers have the financial resources to close the deal. We have earmarked those funds already. So we don't -- we want to make sure the flexibility for those. We already decided what we're going to do those funds and with regard to reducing some preferred partnership interest.

Lastly, I'll tell you that we are looking at other real estate, other -- evaluating other transactions. There is some slowdown. But as I mentioned before, there still is availability of funds out there, so we're continuing to work through it. And don't have anything additional to announce, but we're continuing to work through it.



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With regard to the working capital. We had about -- we had the impact of COVID on the first quarter's working capital and we had about \$1 billion of what I call timing items that will balance out in the rest of the year. So the one point I think I'd make to you is, if you look back the last 5 years of first quarter free cash flow, this is the second highest we've ever had. Last year was a stellar performance because we had some securitization of receivables and so forth. And we continue to be able to do that, but we haven't -- we didn't add to that balance this year as much as we had in the past. So as such, there's a comparison that's a little differentiated.

But I do want to point out that the expectations or the results we had were expected, other than COVID, and that we expect that to balance out the year. So the cash flow numbers still feel pretty good when you're taking into account this challenging environment.

Operator

Your next question comes from the line of Simon Flannery from Morgan Stanley.

Simon William Flannery - *Morgan Stanley, Research Division - MD*

I wonder if you could talk about capital spending. We just saw Rogers in Canada say year-on-year CapEx will be well below prior guidance. I understand you're not giving guidance, but what's your ability to spend as you were planning to previously, given any kind of restrictions from COVID-19 or maybe fewer housing starts, et cetera? So is it likely that maybe the run rate in the rest of the year will be a little bit below prior trends or prior expectations?

And then on the online channels. Where are you on your kind of proportion of wireless gross adds upgrades that can come through the online channel? Where do you see that going? And maybe the same for broadband.

John Joseph Stephens - *AT&T Inc. - Senior Executive VP & CFO*

So, let me first take the capital issue. What we go through is we regularly do a real scrub of the process. John -- we're working with John's team, the operations folks. We're constantly going through that.

The message we really want to give to you right now is that we can continue to invest and continue to pay down our debt and continue to pay our dividend all in a very flexible environment, in this. So while we're going to scrub capital very, very significantly like we always do, but we're not making any -- we're not announcing any kind of levels today.

With that being said, the critical things that we've had going is the completion of the FirstNet build. And we're staying committed to that. We've talked about 5G being nationwide this summer. So there's those things that we're committed to that we're going to stay committed to. So it'll be an evolving story, but we feel really good about the financial capabilities to continue to invest. And quite frankly the unknown might be is when we come out of this, what will be the new things we want to invest in that will benefit consumers, that will benefit our shareholders? And we're retaining that flexibility.

I'll let John take care of the -- to respond to kind of the online channels and that question, Simon.

John T. Stankey - *AT&T Inc. - President & COO*

Yes. Simon, I would say that it's a can versus want. I mean, we can do virtually everything online. It's what the consumer wants to do that is more the question.

And up to this point in time, prior to the pandemic, consumers wanted to spend more time in retail stores as a percentage of total gross or adds than they did online. It doesn't mean we didn't do online volumes and that there aren't periods of time like when a major device comes out, that,



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that number spikes to a pretty high percentage of mix. Oftentimes, customers just have this desire that they wanted to come in and fit -- touch and feel a device and compare it, look at it, pick up a couple of other items while they were there, and that was the most convenient way for them to do it. I would fully expect that as retail capacity maybe diminishes and as folks start to think differently about their behaviors more broadly, then we're going to see people start to experiment, to use all the great tools that we have out there and all the abilities, to actually complete a transaction online.

And I would tell you, I think that, that in a mixed environment, where a customer does a combination of acquiring the device online and then fulfilling it, we're in a great position because I think you're probably aware, we've been doing a fair amount in market with concierge services, where we've been partnering with third parties to actually deliver the handset into the home, pre-set up, to work with the individual. We've doctored those processes to actually make them cleaner and less contact associated with them to make customers more comfortable about that kind of an approach. We've been moving some of our employees into the mode of being able to do that. We've been shifting stores to curbside pickup where a customer can order online and then drive through the store location and pick it up at the curb in a sanitized bag to get it.

So I think we're prepared to adjust to whatever the customer chooses to do after they decide that they no longer want to suppress buying a handset and they need to go out and do something if traditional retail channels are unavailable.

Randall L. Stephenson - AT&T Inc. - Chairman & CEO

But before you go off that, and Stankey maybe want to follow-up on this. But Simon, back to the issue on the capital spending. The issue that John Stankey and his team are running into right now is, obviously, in our industry, as you know better than anybody, it's not just writing checks for CapEx, it's people out doing things. And it's particularly in terms of new cell site acquisition, which we're doing a lot for FirstNet and enhancing density, these require permitting and government officials. And government officials are sheltered in place. And a lot of the permitting and a lot of the logistics that go into allowing us to invest are a little bit hampered right now.

And so while we have no intention of slowing down on 5G and fiber deployment and such, the reality is that a lot of it is not in our control. We're having to work through some of those issues. So there's probably going to be, relative to what the targets we gave you on CapEx, some downward proclivity on that number just because of logistical issues that we're running into.

Operator

Your next question comes from the line of Michael Rollins from Citi.

Michael Rollins - Citigroup Inc, Research Division - MD & U.S. Telecoms Analyst

Can you unpack how you considered the credit risk across the different operating segments? And can you share with us some of the historical experiences you may have looked to try to estimate the potential impacts?

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Sure. Let me -- Mike, and let me answer the question. First and foremost, the issues with regard to the accounting side in the simplest sense is, out of the existing new rules, we can look forward into bad debt risk as opposed to just relying on history. So that's what we're doing with regard to recording the \$250 million.

What we looked at is, for example, in the WarnerMedia business, we looked at the theater owners that are out there that still may have some payables to us or we have receivables from them. And we went in and said, "In this environment, what is our estimate of collections?" All right?



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On the wireless business, on a month-to-month business so to speak, and whether it be prepaid or whether it be services, there's much more knowledge and much more information on that. What you look to there is on the equipment sales and on the next receivables financing. And we've taken into account what we think is the percentage of those based on their payment history, but based on this new environmental situation, what we think that might be done. So we broke it down into, so to speak, that category.

Initially, on a going-forward basis, we've been accruing up. And outside of that \$250 million, accruing up all those -- I think there's about, for example, 40,000 of postpaid voice customers that we're still providing service to, but that we did -- we counted as disconnects in our numbers. They're not in the 163,000. We're continuing to reserve those.

But we effectively went through that kind of process that I just laid out on mobility and I laid out in the -- in WarnerMedia, and we continue that throughout the process. And so we're going to continue to update that, be careful with that. But we believe we are, if you will, current and got everything from today's receivables and the impact COVID will have on those as we collect them into the future.

Operator

Your next question comes from the line of David Barden from Bank of America.

David William Barden - *BofA Merrill Lynch, Research Division - MD*

I guess doing the math on Randall's comments at the beginning of kind of a low 60% payout ratio, it implies that the new free cash flow guidance for 2020 is between \$23 billion and \$25 billion. John, I was wondering if you could -- John Stephens, I was wondering if you could maybe bridge us between the \$28 billion that you thought the free cash flow would be, and where that \$23 billion to \$25 billion lands us?

And then the second kind of related question would be, I think that there's specific questions about some of the more exotic kind of financial market liquidity situations. For instance, last year, you did a significant media receivable financing. Is the market open to refinance that, to roll that? What does the market for equipment receivables look like? Is it liquid? Is it affordable? If you could kind of walk us through some of those situations, it would be very helpful.

Randall L. Stephenson - *AT&T Inc. - Chairman & CEO*

Dave, let me start, and then I will hand it to John Stephens here to address particularly the financial estimates, but also just the free cash flow number that you backed into.

We're sitting here over the last couple of weeks trying to get our arms around where this economic situation can go. And we bring in the smartest and most genius economists in the world. And you can bring a dozen of them in, and the range of possible outcomes just for the second quarter of 2020 is unbelievably wide. And then you begin to push that out for what the full year 2020 looks like and it remains as wide. And so trying to discern where do you think the economic scenario lands for this year is proving to be pretty difficult right now.

And so as we begin to formulate our actions -- and look, we -- this team here has been through a number of these events. We've been through 9/11. This team's been through the financial crisis. Now we're going through COVID-19. And one thing we really like to do is just let's just shore things up when you have this kind of uncertainty, suspend the share buyback program just to ensure that we have good, solid foundation and cash position as we migrate through this.

Where can this thing go and what are the implications to our free cash flow numbers this year? It's a wide range, David. And we've given you a number that we feel very comfortable that we can hit this year, that payout ratio in the 60s. But our scenarios of possible outcomes are pretty wide. But we think what we've done is given ourselves a target that we feel comfortable in terms of meeting.



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And so there are -- as you know, in these businesses, you've followed these businesses a long time, David, there are a lot of levers to pull that are underpinning the free cash flow number and what happens with capital spending and what can you do on working capital. And John's going to talk to you about working capital and some of our ability to finance some of the receivables and so forth. But bottom line, what we've given you in that 60s kind of range of free cash flow payout, the dividend as a percent of free cash flow, it's a number we feel fairly -- very, very comfortable we can achieve, okay?

So John, do you want to add anything to that? And then talking about...

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Yes. So first and foremost, David, the market is open to us in all forms. Terms aren't exactly the same as they were, all those kinds of things. They changed, and they continue to change as we've gone through the year. But they're very open.

If you look at what our bonds are trading at today, they're a little bit higher, 15, 20 basis points higher than they were in mid-February, but they were dramatically off some of the challenging days of mid-March and the end of March. So my point is the financial markets are open to us, including asset-based financing next receivables, accounts receivable securitizations.

With that being said, as we mentioned in our call, equipment sales are down. So the level we're going to do with that is down. Equipment sales are going to be down, so the demand on the financial markets to pick those assets up is down. So quite frankly, it's a situation where, with demand being down, there may be more flexibility in getting it. Maybe -- I'm not suggesting there, I'm just saying that's part of that overall discussion.

But we certainly -- and we took advantage and we participated in those markets throughout the first quarter and in March as we often -- as we usually do. So there's been -- I don't think there's any limitation there. And as I said, we're seeing the markets even become what I would -- move back towards more operational and more normal operational activity as we get through April. And we -- as Randall said, we applaud the Fed's efforts and the congressional efforts.

Secondly, what I'd go to is when I think about free cash flows, I have taken account a couple of things that we haven't talked about. I don't know what the stimulus bill is going to do with regard to whether it's the PPP loans, the continue to pay your employee loans that a lot of our customers get or it's the unemployment checks that are going out in just record amounts and what will that do to the collections we have with regard to these really great, resilient products like wireless and connectivity.

We've got to take into account whether the deferral of payroll taxes for a company like ours with 250,000 domestic employees, the ability to defer those payroll taxes into 2021 and 2022. Not only on a fed basis, but many states, is really pretty important. Whether the other aspects out there are going to provide us some assistance or provide us some pressure, we're going through that.

With regard to the businesses themselves. WarnerMedia, as John Stankey said earlier, and we talked about the theatrical and the advertising piece of those business, we have to go through that. But quite frankly, you can understand, when you take -- production goes on hiatus, we are paying our people and making sure they're personally taken care of. But a lot of the other costs that are cash outlays go away during that time. And so there's a balance there.

Business. We did see some businesses try to extend their terms, weeks, days and weeks. And we're working through that, but we're continuing to get paid. And so it's just working through that.

But this ability on mobility, which is quite frankly the big engine to deal with the service revenues and collect those, gives me great confidence that we have something to build off of and something to rely on. And when you add broadband, when you add business services, quite frankly, as we're seeing some really reliability in some of our entertainment products, feel good about our ability to manage through this.

We're leaving ourselves a lot of flexibility, as Randall said, because there is a wide range of opinions as to what's going to happen, and we're just working through all the different alternatives, the variances off that base case.



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Operator

Your next question comes from the line of Mike McCormack from Guggenheim.

Michael L. McCormack - *Guggenheim Securities, LLC, Research Division - MD & Telecommunications Senior Analyst*

I guess, John Stephens, the partial quarter impact you're seeing from COVID, is it fair to try to quarter-ize those things to get a forward look into 2Q? Or is there some front-end loading there that we should be thinking about?

And then I guess on the competitive side for wireless, what do you guys think is going to happen over the next, call it, 3, 4, 5 months given the fact that you've got the new T-Mobile out there, but obviously this virus overhang. Should we expect a continued sort of dampening in the competitive landscape as we go through this?

John Joseph Stephens - *AT&T Inc. - Senior Executive VP & CFO*

So on the COVID items, and I think there's some information that we've made public on our IB, Mike. But I'd point it out this way. On the bad debt, so to speak, reserve, what I would expect to see is that is a onetime item for this quarter. That is, so to speak, putting us all on par at the end of the quarter and will include changes in our reserve rates just on a run rate basis going forward.

We'll watch them closely, but I wouldn't suggest necessarily that's going to be a recurring item. There may be higher bad debts. I don't mean to say there won't be. But as I said, too, we've really got to figure out what happens with the stimulus funds that are going out and how that impacts our collect ability and so forth. But I'd expect to do with that.

On our -- what we call our compassion pay, that will go on in some of the, if you will, bonus pay for some of our technicians. That will go on into the second quarter. I don't know. I think John Stankey and his team are going to have to make decisions on how long it goes. I think they're going to evaluate that with regard to the current economic conditions and the state-by-state kind of impacts, shelter-in-place and so forth, but that could continue.

The production disruption costs, quite frankly, could continue. We'll see through that. But as I mentioned before, that's an unusual one that may have a different cash flow impact.

So that's how I think about those things. As I mentioned, we had about 40,000 postpaid voice customers that we've counted as disconnects that we're actually still providing service. That number will grow as we go through time. But that -- but it will get to a peak as we go through this process. So it's a very manageable approach. We have what I'll call similar numbers in video and broadband. But they're -- at this time, within our base of customers, I think we're in a manageable state.

Let me hand it off to John to talk about your -- to answer your other question, Mike.

John T. Stankey - *AT&T Inc. - President & COO*

Yes. Hi, Mike...

Michael L. McCormack - *Guggenheim Securities, LLC, Research Division - MD & Telecommunications Senior Analyst*

John, quickly on the -- I'm sorry, John. On the equipment revenue side, that down 25%. Is that a decent proxy as you think about 2Q?



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John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Yes. Let me answer. We just want to give you -- and John can comment on this. We just wanted to give you a factoid on something that actually happened. I think it's -- if the shelter-in-place orders stay in place and retail stays closed, certainly, you can have a significant reduction. As you know, that reduction in revenues also comes with a significant reduction in expense. And so customers can really streamline their billing relationship with us without necessarily impacting our profitability. So we'll see how that goes. I'm not giving you an answer, Mike, for the specific purpose of it's too unpredictable. But yes, we intended to give you that information about the 25% reduction in March.

John, let me -- let you comment on anything else.

John T. Stankey - AT&T Inc. - President & COO

Yes. I would echo, Mike, that I think to your point of what happens over the next quarter or so, it's -- I would bet on suppressed activity. I think it's, over the next quarter, suppressed because of inability for people to be out and about doing things and being restricted, and still, given the nature of this purchase, maybe wanting to have a little bit more of a physical experience at times.

I would then suspect that as we get to the latter part of the year, you look at discretionary decisions like, do I get the handset in a stressed economic environment? I think that discretionary decision on the purchase of the next handset maybe has a little bit of suppression on it as a result of that. Not use of the service, service is indispensable. But the choice to possibly get that next handset and maybe defer it, given it's an outlay in a household that is trying to make some decisions on discretionary income, is likely to have a downward bias on it.

In terms of the plays we run, our plays remain the same. We -- the strength that Randall talked about, how the network's performing in this moment in time is a testament to what we put in place with the massive increase of capacity and performance that we've been working on through the combination of the FirstNet deployment and deploying our spectrum inventory all at the same time. And you're seeing just the strength of the network and how it's performing right now. And our Net Promoter Score results from our customers and their impressions of the network are improving every month right now. And that's what's giving us that solid momentum you're seeing in customer acquisition. And I expect that as people continue to use the network more aggressively for their indispensable work day in and day out, that we're going to see that impression continue to improve and move in the right direction.

We're going to add to that a boost of adrenaline with the HBO Max promotion that you saw just started yesterday. We're going to start to get pretty loud in the market with that. So the combination of growing the HBO Max subscription base, plus it's tied to promotion with a lot of our wireless products and services, I think, is going to drive up awareness. And there's some great opportunities that pair tablets and devices together and see great entertainment with it and get good values on that, that will be helpful.

Our 5G deployment, as we said, we're going to be out in the summer where we have nationwide coverage, and that will further improve and also allow for a marketing position that I think will be helpful.

And then we're going great guns on FirstNet. And you look at the volumes of what's occurred in the last couple of weeks in the first responder community and some of the awareness that's been building around what the offering is on that product and service and the awareness it's driving, we're going to get tailwinds from that as well and continued great performance. We're now over 1.3 million devices connected to that network, and we're seeing that pace accelerate over the last several weeks. And so not that I'm enamored with the pandemic, but it has helped that product category and the awareness of that product category.

So we're going to run our plays, and we're going to be in a good position because the plays we've set up are built on the strength that we've been working on over the last couple of years to put in place.

Michael J. Viola - AT&T Inc. - SVP of IR

Mike, thanks for your question. Greg, we'll take one last question.



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Operator

Okay. That question comes from the line of Brett Feldman from Goldman Sachs.

Brett Joseph Feldman - Goldman Sachs Group Inc., Research Division - Equity Analyst

Yes. I will like to follow-up just on that question about wireless sales with equipment sales being down. Is that a good way of thinking about how much activity is down? Meaning, you noted gross adds are down, are they down about the same amount, or are disconnects down about the same amount?

And the reason I ask is, as you noted, there's a variable cost associated with all these customer transactions. And so the real question is, is there indeed a cost buffer you're getting as a result of that lower activity level? And are you finding that it is sufficient to offset or nearly offset some of the commitments you've made to your customers by giving them more flexible payment terms and some of the commitments you've made to your employees through the compassion pay? And ultimately, are you comfortable that the durability of your EBITDA stream in wireless is going to play out through multiple scenarios here?

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Brad, this is John. Let me take the first numbers question and hand off to John Stankey for the business question real quick. Think about it this way. Our service revenues are up about \$350 million, our EBITDA was up \$500 million. So we are getting cost savings throughout the operations. I mean, the math works that way. And that's with the inclusion in those numbers of the COVID impacts. So whether that's the bad debt piece that went to mobility, whether that's the loss of international roaming, whether that's the changes in late payment fees, all of that is included. We didn't -- we're not -- that \$0.05 of COVID is in our numbers.

And so I'd just said to you that I think it answers that question directly, that if your service revenues went up, \$300 million, \$350 million, and your profitability went up \$500 million, we're clearly getting efficiencies from a lot of the efforts that have been going on from quarters and quarters, but also from the impact of how we're managing the business.

John?

John T. Stankey - AT&T Inc. - President & COO

Yes, I would -- just to build on what John said, our service revenues are not increasing just in one single category there, they're improving across the board in postpaid. ARPUs are up in postpaid. ARPUs are up in prepaid. We're seeing improvements in our connected devices category. So service revenues are strong across the board.

And I would just say, structurally, Brett, if we step back and think about this from a macro perspective, in an environment where gross add activity is suppressed and churn is going down, that's not a bad economic construct for our business. I mean, that's -- when customers continue to pay their bills, and I think, by and large, what we've seen in past economic stress, the last thing that people don't want to pay is probably their cell phone bill.

And so we feel pretty good about what's going to go on there. And the suppressed activity is a suppressed activity, but we got a great base and an important product. And with the network performance getting better and better, that churn number has been hanging in there and getting a little bit better. I think we feel good about it all the way around.



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Michael J. Viola - AT&T Inc. - SVP of IR

Thanks, Brett.

John Joseph Stephens - AT&T Inc. - Senior Executive VP & CFO

Thanks, Brett, and everybody, stay safe.

Randall L. Stephenson - AT&T Inc. - Chairman & CEO

Okay, very good. And let me just close by the question centered around what are you expecting? And as we said at the very beginning, we're in a world where there's very little visibility in terms of, what the general economic environment is going to be? When is America going to go back to work? That's going to roll out probably by community. It's probably going to be slower than most of us like. How -- what kind of effect does this government stimulus going to have on economic activity? How are the unemployment benefits going to play into this? There's just a lot of unknowns in terms of what's going to play out over the next few quarters. And so that's why we've been a bit defensive in terms of how we positioned AT&T.

We have a good cash position. As you heard John Stephens say, we have ready access to the capital markets. And as you heard John Stankey talk about, the resiliency of these products is really, really impressive. It's really good. And so we were pleased with how we're able to navigate this early on. It's very early, but we're going to continue to invest. You should feel comfortable with the dividend. We're going to continue to be committed to that dividend. And you should see our debt levels come down as we move through the course of this year. And we'll just keep you posted as we work through the balance of this year.

So thank you again for joining us, and we look forward to talking to you next time. Thank you.

Operator

Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using AT&T teleconference. You may now disconnect.

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