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T.N - Q3 2020 AT&T Inc Earnings Call

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## OVERVIEW:

T reported 3Q20 adjusted EPS of \$0.76.

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by. Welcome to the AT&T Third Quarter 2020 Earnings Conference Call. (Operator Instructions) And as a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Amir Rozwadowski, Senior Vice President, Finance and Investor Relations. Please go ahead.

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**Amir Rozwadowski** - AT&T Inc. - Senior VP of Finance & IR

Thank you, and good morning, everyone. Welcome to our third quarter call. I'm Amir Rozwadowski, Head of Investor Relations for AT&T. Joining me on the call today are John Stankey, our CEO; and John Stephens, our Chief Financial Officer.

Before we begin, I need to call your attention to our safe harbor statement, which says that some of our comments today may be forward-looking. As such, they're 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. I also want to remind you that we are in the quiet period for the FCC spectrum Auction 107, so we cannot address any questions about that today.

With that, I'll turn the call over to John Stankey. John?

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**John T. Stankey** - AT&T Inc. - CEO & Director

Thanks, Amir, and good morning, everyone. I hope you're all healthy and doing well, and thank you for joining us this morning. John and I are going to keep our comments brief so we can spend more time taking your questions. So let's start with Slide 3.

First, our industry-leading network is the driver of our strong wireless customer counts and our healthy broadband and enterprise trends. Our high-quality network underpins our connectivity business and our commitment to customers. Ookla last week ranked AT&T #1 for having the

fastest nationwide 5G network. And for the seventh quarter in a row, we won the overall fastest wireless network, and we're named fastest wireless network for iPhones in the third quarter. J.D. Power last month named us tops in customer satisfaction for residential Internet service in every region we offer that service.

The Net Promoter Scores we're achieving with our fiber product are materially better than cables and are helping drive increasing penetration rates across our markets. I'm really pleased with the great execution from our AT&T Communications team, led by Jeff McElfresh, under some really challenging circumstances.

Second, the transformation of our business continues and is on track with how we set this up for you a year ago. The organization has been working to reduce costs, streamline distribution, remove redundancies and simplify processes and support functions. Our focus is supporting added customer value with an improved customer experience. Accordingly, these efficiencies are being plowed back into growth in our market focus areas.

And third, we're committed to further strengthening our balance sheet and maintaining our deliberate capital allocation. We've made material progress this year with our debt management while generating solid free cash flow to support our dividend. John will provide more detail, but you're seeing a sharply focused capital structure that is strong, resilient and efficient.

We also have a very pragmatic view of the broader economic picture and the COVID-driven challenges we face in some segments, particularly WarnerMedia. In a COVID environment with a tough theatrical business, we made important organizational moves that further position us for growth in direct-to-consumer streaming. Through the pandemic, we continue to invest in HBO Max and continue to grow total HBO and HBO Max subscribers. I'm pleased with how the WarnerMedia team is responding to a challenging environment.

In closing, we recognize that we have more work to do in executing on our vision and earning the loyalty of our customers and investors. I believe this quarter shows we've taken the first few steps in the right direction, but there's more opportunity ahead.

With that, I'll turn it over to John to quickly review the details of the quarter.

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

Thanks, John, and good morning, everyone. As John said, during the third quarter, we made progress on our business priorities, as you can see in our subscriber gains. Wireless growth was stronger than we've seen in quite some time. We added more than 1 million postpaid subscribers, including 645,000 postpaid phones. We also saw solid growth in AT&T Fiber subscribers with more than 350,000 fiber net adds. And our HBO Max activation base more than doubled in the first full quarter since we launched the business. We now have 38 million U.S. HBO Max and HBO subscribers and 57 million premium subscribers globally.

Our cost transformation continues on track. We're already seeing savings achieved from benefit efficiencies and organizational alignments. Our focus on refining our distribution is also paying off. We shifted some stores to third-party dealers, closed others, and we've also been able to streamline our customer experience, especially our digital sales and simplify processes.

We've been very deliberate in managing our debt and focusing on our cash flow. So far this year, we have refinanced more than \$60 billion of debt at historically low rates with about \$30 billion of debt coming due through 2025. This has lowered our near-term debt maturities, giving us ample financial flexibility in the years ahead. We now expect free cash flow of \$26 billion or higher with a full year dividend payout ratio percentage in the high 50s.

Slide 6 illustrates the success we've had this quarter in our market-focused areas. As mentioned, postpaid phone adds were strong. A big factor was postpaid phone churn of 0.69%, our best ever. Prepaid churn was less than 3%, and Cricket churn was even lower than that. Improved postpaid churn was driven by the strength of our network and straightforward pricing plans, including our premium unlimited plan, which includes bundling HBO Max.

Penetration rates for AT&T Fiber are also growing as you can see on the chart on the lower left. We're on track to grow our fiber base by 25% this year, adding 1 million new subscribers.

On the upper-right chart, HBO Max continues to scale. We've overperformed on our initial target of 36 million domestic HBO Max and HBO subscribers for this year. All of this is before we launch our AVOD product in the U.S. next year and before we begin our international deployment of HBO Max, also planned for next year.

As you can see in the premium video chart on the lower right, we continue to make good progress in moving to ratable share losses in our pay TV business, consistent with our share. This is a big step toward what we told you to expect as we exited 2020.

We are focused on high-value subscribers as the industry transitions to over-the-top, which has helped improve churn. The introduction of AT&T TV has helped, particularly in our broadband footprint.

Let's now take a look at our consolidated and segment results, starting with our financial summary on Slide 7. Cash flows continue to be strong even during the pandemic. Cash from operations came in at more than \$12 billion, and free cash flow was \$8.3 billion.

Adjusted EPS was \$0.76 per share. That included COVID impacts from incremental costs and lost revenues. Combined, COVID had a \$0.21 impact to the third quarter EPS, which we did not adjust for. Adjustments for the quarter included \$1.2 billion of debt redemption premiums associated with our debt management activity in the quarter.

Revenues were down \$2.2 billion from a year ago, including an estimated \$2.8 billion of lost or deferred revenue from COVID and foreign exchange pressures. Foreign exchange had a negative impact of about \$300 million in revenue, primarily in our Latin America segment.

Adjusted operating income was about \$8.2 billion, which included the impact of COVID and shift of TV productions in sports to the third quarter. Lower revenues were partly offset by expense reductions. Adjusted operating income margins were down 280 basis points year-over-year but would have been up if you exclude COVID impacts.

And we continue to invest in our growth areas. CapEx was \$3.9 billion, and gross capital investment was \$4.5 billion, a difference attributed to the timing of vendor payments. And we invested about \$600 million in HBO Max in the quarter and are on track with full year estimated investment of \$2 billion.

Let's now look at our segment operating results, starting with our Communications segment on Slide 8. Our core businesses continue to show their resiliency. In Mobility, in addition to strong total postpaid and postpaid phone net adds, we saw a strong demand for data connected devices. We had 730,000 total smartphone net adds, both postpaid and prepaid. Prepaid had a solid quarter with 245,000 net adds, with 131,000 of those phones. Bottom line, we're encouraged by our wireless market positioning heading into the fourth quarter, traditionally the busiest season for device upgrades and people moving to unlimited plans. Total wireless revenues were up year-over-year, thanks to growth in equipment revenues.

COVID impacts came from international roaming as well as waived data overages and late payments. Without the roaming impacts alone, service revenues would have had a healthy growth. Roaming also impacted EBITDA margins, which were down slightly even with much higher sales.

We're pleased with AT&T Fiber net add momentum. We're on track to add 1 million subscribers this year, and the mix shift to fiber has helped stabilize broadband revenues.

Premium video losses were improved sequentially and year-over-year, thanks to lower churn and our focus on high-value customers. The decline is a significant improvement over prior year trends. We continue to drive ARPU growth in both video and IP broadband. In fact, premium video ARPU was up more than 7%. Business Wireline turned in another solid EBITDA quarter. EBITDA was up year-over-year, and margins expanded by 130 basis points despite legacy revenue trends.

Let's move to WarnerMedia and Latin America results, which are on Slide 9. The COVID impact is most evident in our WarnerMedia results. Theatrical and TV production is ramping back up, but theaters remain closed in many parts of the country. Altogether, COVID had an estimated \$1.6 billion revenue impact on WarnerMedia in the quarter.

Sports resumed in the quarter, and programming and production costs associated with the shift of sports into the third quarter impacted expenses. At the same time, sports had a favorable impact on advertising revenues.

HBO Max continue to scale nicely driven by strong wholesale activations. We are also pleased with consumer engagement, which is up nearly 60% from what we saw with HBO NOW.

WarnerMedia's reputation as the industry's highest-quality storyteller was again reinforced, with it leading the industry with 38 Primetime and 15 News and Documentary Emmys. We also saw subscriber turnaround in our Latin America operations. We added more than 400,000 subscribers in Mexico and 200,000 subscribers in Vrio after both showed a COVID slowdown in the second quarter.

Latin America revenues continue to be challenged by foreign exchange, slow economies and COVID. But even with this, Mexico EBITDA improved year-over-year. And Vrio continues to generate EBITDA and cash flow on a constant currency basis.

Now let's go to Slide 10 for an update on our capital structure. Our cash flows continue to be resilient, even with the pandemic. That allows us to invest in the business and comfortably pay for our dividend while also paying down debt. Free cash flow was \$8.3 billion in the quarter and almost \$20 billion year-to-date. In fact, we've reduced net debt by more than \$30 billion since we closed our Time Warner acquisition a little more than 2 years ago.

We continue to be active in the debt market. With interest rates at historical lows, we have been aggressive in refinancing our debt maturities and lowering our coupon rates. As you can see on the bottom chart, our near-term debt obligations have changed significantly since the first quarter. We have reduced debt maturities by almost 50% over the next 5 years. This has extended our average debt maturity, which is a good place to be with rates this low. In fact, we have lowered our average interest rate on debt to just under 4.1%, with the lowest coupon rates we've ever seen. That gives us financial flexibility, not just for today but going forward as well.

In fact, we ended the quarter with nearly \$10 billion in cash on our balance sheet. The \$500 billion of assets on our total balance sheet also gives us ample opportunity to continue to strengthen our cash position by monetizing noncore assets. We expect \$3 billion of previously announced asset sales to close before the end of the year, including CME, which actually closed last week, and our Puerto Rico wireless properties, which we expect to close by the end of October.

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

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**Amir Rozwadowski** - AT&T Inc. - Senior VP of Finance & IR

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

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## QUESTIONS AND ANSWERS

### Operator

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

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

Okay. Great. Maybe on the subscriber side, obviously, solid results really across the board and especially in wireless. Is there anything you guys could point to that really drove the gross add improvement that we saw on a year-over-year basis and the better churn? And do you think those results are sustainable?

And then also on the fiber side, John, you've talked about repositioning the company around wireless fiber and software entertainment. How should we think about the footprint expansion of your guys' fiber network? I mean obviously, you grew a lot in the -- with the requirements for DIRECTV. But how should we look at that over the next few years?

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**John T. Stankey** - *AT&T Inc. - CEO & Director*

So first, on the subscriber side, I think the answer is it's hard work and really good work. This is something that's been in the making for a period of time, where the team has been focused on a variety of different strategies, and I'm not going to point to any one thing. I think we've done a number of things very well, including reengineering our distribution. We have a much broader approach to distribution today and a more effective approach in terms of the efficiency of what it's bringing in. You heard John address some of that in his comments.

We have been very, very focused on making sure we get value to our right customers, and data has helped us do that. And some of the gain you're seeing is that we're being -- we're able to segment the portions of the market that we think we have issues to address on a value basis and get the right kind of dynamics out to those customers through the right kind of distribution.

That's working because we have been very deliberate over the last several years building a much higher-quality network, starting with the FirstNet construct. And that higher-quality network has removed a reason for customers to leave because they're satisfied with the service that they're getting on the network infrastructure.

As COVID hit and the wireless networks became much more suburban-oriented than urban-oriented, our strength in low-band spectrum, our literally undisputed strength in volume of low-band spectrum has helped because the suburban experience is oftentimes a more distributed experience. And when you think about penetrating inside buildings, you need low-band spectrum to do that. Mid-band is not going to do that in a suburban environment and nor is millimeter wave, at least not anytime soon until density starts to pick up.

And so we've been very focused on that, and we intend to be very focused on that moving forward. And I would tell you -- I'll just answer it right now because I'm sure somebody is going to ask. Our promotions that are out in the market and what we're doing with the iPhone launch is more of the same.

We have an incredibly valuable customer base. It's our most important asset for us to focus on. And when we go in and we look at the data and we understand why that base elects not to stay with us, it's not because of customer service or it's not because they don't like the network. It's because more often than not, they see some enticement to go somewhere else. And that's usually a device offer or a belief that they can't fine-tune their plan to meet their economic construct that they want.

And we're now in a position where we can address that. And this offer is going to attack that very point. It's going to ensure that our very best customers, who many have been very loyal to us, these are original iPhone subscribers that have been around a long time, are treated just like a new customer coming into our business. And that they can avail themselves of that opportunity and recommit to us for a very, very long period of time.

And while we're getting to talk to them at that moment, we get an opportunity to chat with them about buying up to unlimited plans, and we get an opportunity to move them up the continuum to our higher-value unlimited plans that include entertainment. And so that's a win-win for us in that construct, and it pays off economically.

Our base is less committed to contract than our competitors. We know that statistically. And part of this is just simply ensuring that our base is sitting in a similar position to our competitors to make sure that we can continue this record-breaking churn that we've set up. And that's a smart economic decision for us. And it's a smart decision and positioning the brand with our customers. And so when we know we can address the #1 reason why people are leaving us and do it this way, and we get that accretion that comes out of buying up on the unlimited plans, getting them to the sticky entertainment, we think that's the right place for us to be.

On your second question regarding fiber, my intent is to exit next year in a construct where we are gaining subscribers, gaining share and growing the broadband business. And our footprint will be engineered to allow that to happen.

Now we still have a lot of fallow fiber that we can sell into. You saw that this quarter. We're selling into our existing footprint of a little over 14 million fiber homes, and we're doing it very effectively. And you heard my comment about how much customers like the product. And that's one of the reasons we're having great success, and we're going to continue to push in that footprint.

We've been adding fiber footprint, as we've talked about, slowly. We're going to pick that up a bit so that we can make sure we're in a share gain position, and we're actually growing the broadband business as we exit next year.

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**Operator**

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

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**Philip A. Cusick** - *JPMorgan Chase & Co, Research Division - MD and Senior Analyst*

John, can you talk about priorities for next year? It sounds -- and you just said like you want to build more fiber. Does that mean that CapEx needs to be higher? Or can you really source that out of wireless CapEx coming down?

And it's great to see video losses were lower even after we normalize out the pledge customers. What were the drivers of that improvement? And how does DIRECTV fit into the company's plans? Is there anything you can say about these reports of a sale?

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**John T. Stankey** - *AT&T Inc. - CEO & Director*

So Phil, we're not giving our guidance on capital for next year at this point. I will tell you that we feel comfortable that we can manage the cash flow equation effectively and do what I just said. I'm not concerned about that part of it. We'll come out a little bit later this year, and we'll give you the guidance and lay out those numbers for you.

But I feel really comfortable, if you kind of look at what's going on, and these customer counts certainly help. I think you're aware, we're working really hard on the cost equation around here, and that's helping us invest in some of the work we're doing in the markets.

We have a very different build in front of us than we've traditionally had. I think if you think about what we've historically been doing on the fiber side, we've had to light up new central offices, kind of new geographic areas, which tends to be a little bit more expensive. We have an opportunity to do some really economic fill in and shorten the cycle from investment to cash that we can factor in on this.

And so we'll give you some direction next year, but I don't think you're going to see an appreciable change in our trajectory as we go through this. And we'll fill in the blanks for you coming forward here.

On the video side, we've been focused on high-value customers. And so some of this, what you're seeing is when we made the shift to kind of get out of the promotional dynamic, and frankly, others in the industry got out of a promotional dynamic where the VMPDs decided to go to a first price that's a little bit more reflective of their cost structure. That normalized a lot of things. We had to work through that for a couple of quarters because it definitely impacts gross. But the gross that we're taking in right now are effective customers, the ones we can make money on, and

they're ones that are not just churning back and forth. And we think that's a much better mix, and you're starting to see us work through that cycle a little bit.

But look, I want to give a lot of credit to the team. As we've been clear on what our direction is, they're focused on ensuring that we run the business the right way, and we've been a lot better at retention.

We have a better product in the market right now for those people that we can pair with broadband. The AT&T TV product is a much more natural fit in terms of how customers want to use a pay TV service today than the satellite product is. And when we compare it with broadband, which as you see, we've got improved volumes on broadband, that helps our video business.

And so as we continue that momentum and we think about what we can do in the next year, that can help the video business as well. I'm not going to suggest to you that it's anything but a mature business. It's going to continue some degree of decline, but we told you we'd like to exit this year with our decline rate looking more ratable to our share. And we're on that march to do that.

We're doing it by some tried-and-true approaches to how we should manage the base, how we should manage our customers, what kind of service we should give them. And the team has done a really nice job of kind of getting back to basics on that and doing the right things around it. And the final question, I'm not going to comment on any speculation at this point.

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#### Operator

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

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

Right on Warner, I wonder if you could just help us think about how things are progressing on the theatrical -- the production for TV and movies. And how you're thinking about that evolving? And any big changes you might have there in terms of how we should think about the future post-COVID?

And then a capital allocation question. I think, John, you talked about the importance of the dividend and the track record of dividend growth. But it looks like you're not really getting paid for the dividend in the current market. How do you balance that versus, say, buybacks? Obviously, you've got spectrum auctions coming up, but leverage, deleveraging, you've addressed a lot of the near-term maturity. So love to think about the priorities and how you think about order of preference there.

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#### John T. Stankey - AT&T Inc. - CEO & Director

So on the Warner side, the -- I'm breathing easier. I think everybody's breathing easier. That's probably a bad analogy in the COVID environment. Feel much better about the restart of production. We exited -- to kind of give you a rough idea, probably about 180 productions of some way, shape or form were underway at February before the pandemic hit. And I would tell you roughly, probably -- I haven't looked at the numbers in the last week or so, but I think we had about 130 productions up and running in some shape or form last week.

So we're well back into that ramp back up. I don't think we have to get back to 180, by the way. We've -- there's some stuff we rationalized. But we're starting to figure out how to do this. We clearly have gotten through most of the hurdles from a civic perspective where the geographies that we operate and produce in are working with us on what the constructs are. And there's no barriers to actually having the work perform.

I think we've got the right guilds and unions squared away. We built in the right processes around testing. We're far enough into and far enough along with work that's going on, where the confidence level of employees is growing day-by-day that we can, in fact, protect the safety of individuals and still get work done.



So feel good about where that's at. I think we're out of the woods at this point from being dead cold in the middle of the pandemic to one where we feel like we can get hours produced and brought forward. And that's going to help our products. I mean it's -- most importantly, it's going to help HBO Max.

Theatrical work is underway as well. We're doing the work for theatrical production. The question is, what does exhibition look like? And that's still kind of one of these things we don't have great visibility on.

If we -- we've done some experimentation. We've tried a few things. I can't tell you that we walked away from the Tenet experience saying it was a home run. I'm happy we did it. I think the team was incredibly creative. I think we learned a couple things about what we can do. I actually believe that if theaters were open nationwide, if California and New York were open, we have some latitude to be able to do some of these geographic-specific releases and work through that. So maybe as we get to a place where there's a little bit more consistent footprint, we can do some more.

I'd say the holiday season is going to be the next big checkpoint to see what occurs and whether or not we can actually move some content back into theatrical exhibition. And we're going to have to maybe make a game-time decision on that based on what's happening in different geographies and what's happening effectively with infection counts in the country. We're still committed to want to try to put some of the content that we think is the most important into a theatrical channel, if that makes sense.

Now at the same time, we're expecting this to be incredibly choppy moving into next year, and guidance and direction we're giving you with the business takes that into account. We're not optimistic. We're not looking that we're seeing -- expecting a huge recovery in theatrical moving into the early part of next year. We're expecting it to continue to be choppy.

And as a result of that, we're having to evaluate all of our options and keeping them open. And the teams kind of work in the A plan, the B plan and the C plan. And as we get through the next month or 2 and we look at what's occurring, we'll call the cards on the A plan and the B plan and the C plan and kind of come back to you. So that's kind of the best I can give you on where we are in restarting that.

The other thing that I would tell you that we have a little bit of lack of visibility on is if you think about the broader media business is what happens with the sports calendar in '21. Clearly, we've seen the leagues demonstrate that they can, in fact, put games on, and they can carry them through.

The timing of those and how many there are and exactly what transpires in '21 and where it falls in the calendar is still a little bit uncertain. And until we have a little better visibility on that, it's hard to give you exact views of what first, second, third, fourth quarter looks like next year. And I think in the coming weeks, we'll probably get a little bit more clarity around that and be able to adjust the plans accordingly. And we've demonstrated that we can, in fact, do the right things around producing those safely and selling advertising into them. We just need to kind of see where the schedules shape out.

On the capital allocation question, I think the way you get paid is you probably execute consistently. And so I'm well aware that right now, there's definitely a discontinuity in the yield versus what we're paying, and I don't like that. I'm sure nobody else out there who owns the stock likes it. And I think the best way for us to kind of address that is make sure that each quarter, we're delivering on what we tell you we're going to do and doing it consistently. And ultimately, I think that problem probably takes care of itself.

But your point is a valid one in the meantime to ask about how we should think about things. And where I've been and where I still sit is I think when we have visibility getting through the COVID cycle, we can make those decisions on capital allocation. I think it's important that we can continue to manage the debt load down, and that's our first priority, to ensure that it isn't the discussion every time we sit down around where this business is at.

We feel comfortable, as John indicated, that we've restructured it in a way that makes sense, that we can manage this business and do the things we need to do to invest in growth. It's given us the space to do that and make sure that we can, in a very disciplined fashion, pay it down. As we get through that, and we have your confidence in that regard, and then we'll start looking at whether or not it makes sense for us to do something different on the equity side.

I'd like to get some of this choppiness of COVID out of the way before we kind of move back into that cycle, so that we can all be confident around what we think from an economic outlook perspective that we're managing into. I have no question we can manage through this cycle and keep the equation in check. I'm really confident of that.

When we get to kind of that discretionary capital allocation piece will be when I'm a little bit more comfortable that we know what the game plan is for the '21 time frame. And I think we're getting a little bit closer to being able to make that call. John, do you want to add anything on that?

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

No. Simon, we've got the balance sheet, the debt towers, the debt maturities in really good shape. A lot of flexibility, not only over the near term as we spelled out on the slides, but quite frankly, over the long term. So we feel very good about that. The bond market has responded very well to it. We'll continue to reduce our debt levels. But we've got a lot of flexibility going forward. And so feel good about that.

The one thing I'd say is this all starts with a cash flow number and the resiliency of our products and services and the resiliency of our customers. And they continue to pay us on a timely basis for our services. This is really, really important. That's the core of it when John talked about, when he's talking about low churn, and it gives us a basis for all of this. So we feel very good about where we're going.

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**Operator**

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

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

So I guess, John Stephens, I guess this question is related to the guidance. So a couple of questions around it. So at the beginning of the year, the math of kind of a low 60% dividend payout ratio was cash flows in the kind of \$23 billion to \$25 billion range. Now it's north of \$26 billion. And so can we talk about some of the drivers of that?

What part of that is related to lower CapEx as a function of vendor financing? What are the cash tax expectations that go into that? And what are the working capital expectations related to the iPhone promotions that John Stankey was talking about earlier, kind of affecting that number and kind of the exit trajectory into next year?

And then I guess you're particularly qualified to answer the other question, which is which we're getting a lot, which is if there's a Dem sweep and the Biden tax proposal goes through, what does that mean for AT&T, who is one of the biggest beneficiaries of tax reform under the current administration. How could that change the cash flow outlook for AT&T?

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

Yes. So first thing, David, let me go back on the cash flow side. It really does start with our customers. And when we came out with our guidance for the year, there was uncertainty and lack of visibility with regard to COVID, so we were careful and prudent with that.

It turns out, our -- and you can see it in the third quarter balance sheet, you can see it in the third quarter results. Our collection rates have been very good. Customers, the resiliency of the products, the appreciation for the service, we're getting paid on a timely basis and at very good levels. And so that's the first point.

The second point is, across the board, there's been working capital efforts, whether it's managing receivables, then managing payables, whether it's tax payments, that all has been done. Some of that came out of the CARES Act with the benefits of, for example, deferring payroll tax payments or deferring income tax payments that were allowed by the CARES Act. All of that's been taken into account.

I think we have a history of being very focused on working capital and focus on cash flow. When we come back to it, though, the resiliency of the products and services, the growth in mobility, the growth in fiber, the strong performance of HBO Max is all leading us to a better revenue stream situation such that we feel really comfortable about going to that \$26 billion or better number.

Now there's still uncertainty. And so there's not a specific number we can pay. And quite frankly, we'll see how sales go and the working capital impacts of the iPhone launch. Feel real good about that. But that's the basis from where we came up to it. All the pieces you mentioned are a part of that. You can look at the disclosures in the -- for the third quarter and the 10-Q to kind of get some of the specifics that you're asking about. Wait until those are out. But those are all taking it into account.

Feel good about dividend payout ratio in that 50s, high 50s rate. And quite frankly, in a pandemic year, that's pretty remarkable. It's really as good as it's been in probably 5 or 6 years. So it's really a sign of a strong balance sheet and a strong business.

On tax reform, quite frankly, the rate issue is obvious, and it's the increase in the rates could cause tax payments go up. It's also a little, quite frankly, the impact on bonus depreciation, the incentive for CapEx. We are certainly one of the larger, if not the largest capital investor in the United States that generates a ton of jobs for our employees as well as for our suppliers' employees. So we're watching that carefully. That's probably a significant issue for the overall economy as well as for any individual company's tax treatment.

Likewise, if you look at it over the last 20 years, that's been supported by both parties, whether it be Democratic or Republican, this incentive to invest. So we'll continue to follow it, and we'll continue to follow the, quite frankly, the infrastructure reforms and whether they decide to include any of the broadband activity in there and whether we can -- that would fit within our efforts to expand our fiber base and expand our footprint. Thank you, David.

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#### Operator

Your next question comes from the line of Brett Feldman from Goldman Sachs.

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

I'm actually going to follow up on something that John was just sort of alluding to. Because you talked earlier about the opportunity to drive higher penetration of the 14 million homes passed with fiber that you have already. But this might be a slightly outdated statistic, but I think there's something like 60 million customer locations in your landline region. So you're maybe only passing 25% of them today with fiber, which would imply you could meaningfully expand the availability of your fiber product in your addressable market if you were to sort of step on the gas there.

So what are the conditions that would encourage you to meaningfully expand that fiber footprint? Does it have to be something on the policy side? Or are there operating items you have greater control over such that you'd be willing to meaningfully increase the fiber-related CapEx?

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#### **John T. Stankey** - *AT&T Inc. - CEO & Director*

Brett, it's a good question. Thank you. I would tell you this. Obviously, the policy in the country where it stands right now is attractive for investment in infrastructure and attractive for investment in fiber. And we think we've had the right kind of formula around that. And I would expect that if there is a new administration, there may be a lens put on that. They may want to put their pen to how they want to tweak it. And certainly, there's some broader things that need to be done in this country. Addressing some of the more hard-to-serve areas and the digital divide dynamics that make that a worthwhile thing for people to have discussion on.

I would tell you, I don't think we need policy to get better. We just need to ensure that the policy doesn't whipsaw back to some place that is inconsistent with incenting investment and infrastructure. Because I believe, right now, there is, to your point, a large incentive for people to go and continue to put money into infrastructure investment. And we would be one of those to do that.

I think good things come from that when we do it. We employ a lot of very meaningful middle-class jobs that pay people well. They come with benefits that allow them to do great things in their lives and better their families' lives. And I think everybody, from a policy perspective, would look at that and say, that's the exact kind of jobs we want. They're the ones that are good for this economy and good for people and have all the characteristics that nobody debates. We want to see the American worker experience.

What I would say from a perspective of step on the gas and what we are working on internally and what I've had the team focused on is our company is in a very unique position of anybody that we compete with in our competitive set. We serve everybody from the smallest residential customer up to the largest corporation and everything in between. And we run, to your point, Brett, one of the largest footprints that still has customers that want to connect to the network on a fixed basis. And so we should be in a very unique position for every trench foot of fiber that we put in the ground of putting more traffic on that fiber and monetizing it more effectively than anybody else, given the breadth of the customer base that we serve and the footprint that we serve, the retail mix that we have as well as the very robust, fixed wholesale mix that we have in serving others' infrastructure.

And my belief -- not my belief. I know that as a company, we probably have not squeezed the lemon out of that juice quite enough. And what I am trying to drive this business forward on is getting much more artful in our engineering to ensure that every trench foot of fiber that we're putting in, we are serving every segment we can serve as effectively as we can, and we're not looking at our investment on a customer segment by customer segment basis, but we're looking at it as a trench foot of fiber that we put in that has a bunch of different access technologies that hang off the end of it. Sometimes it happens to be a millimeter wave site. Sometimes, it happens to be a big cell tower with 4 occupants on it that we sell wholesale into. Sometimes it happens to be a strip mall, where some of those customers want to be served with a fixed connection, and some can get by with simply having a credit card reader attached to a wireless network. And sometimes it's a single-family household.

But we can be the best at doing that. And when I am confident that we are actually engineering and executing in that fashion, I will step on the gas with a way that I think everybody will look at it and say, those returns are so darn good. Why wouldn't you do that?

We've done really well on our investments thus far. Our consumer broadband business is a good business. Our wholesale infrastructure business is a good business. Our private network business that goes to the enterprise customers is a good business. But we're at this moment where fiber is the juice behind every single network that serve this notion of wireless versus fixed is blurring more and more. The millimeter wave dynamic will drive to the integrated fiber network, and we should be the leader in that space. And when I'm confident that we're engineering and operating that way, then I will be very, very robust in how I think about funding our business to do that.

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## Operator

Your next question comes from the line of Kannan Venkateshwar from Barclays.

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**Kannan Venkateshwar** - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

A couple if I could then. Firstly, I mean, when you think about the fiber business, I guess the growth at Verizon yesterday, growth that you guys reported today, and then we also have some forward-looking guidance from the cable companies, which also demonstrates strong growth today. When we look at the overall broadband market, the penetration rates don't have a lot of room to grow overall across the entire market, but everybody is growing really fast.

So I guess, could you give us some color in terms of what the growth source is if it's not coming from others in the industry? Is it things like people moving into vacation homes or a different level of occupancy? So if you could give us some color on the growth sources, that would be very helpful, and of course, the sustainability on the back of that.

And secondly, I guess -- and the NFL is in the midst of negotiating all their rights. Could you give us some sense of what your priorities are with respect to sports rights and how you view that going forward?

**John T. Stankey** - AT&T Inc. - CEO & Director

Hey, Kannan. So look, first and foremost, we are a share taker, and that's where a lot of our growth comes from. I think we've characterized for you that when we are 36 months into penetration on the fiber infrastructure we put in place, we move nearly 10 share points. And that's -- we don't do that often in a product. And that's one of the reasons why I think if we're smart about how we deploy more fiber and do it the right way, we think there's a strong economic equation here.

And when you have a product that's perceived as being a better product from the customer base, and I shared that with you in my opening comments about what our Net Promoter Score metrics are for our subscriber base, that's a good place to be. That's what helps it. And certainly, one of the dynamics that has helped the performance and the perception of our products in the COVID environment is we all sat around for a number of years talking about what is the killer app that drove upstream demand. Because we knew the Achilles heel of certain networks that have been built was restricted upstream bandwidth.

Look, the answer is a pandemic. And the reality of everybody moving to home and sitting on video calls all day, all of a sudden, upstream bandwidth has become pretty important in homes. And fiber, given its symmetrical characteristics is great. And the dynamic around that, I think, has been incredibly helpful, and I expect that our share growth and our opportunity to do well will come from the symmetrical nature of our architecture that we put in place.

And then you can go through a whole bunch of other things that help it out, which is attractive bundling. You've got a great wireless product that goes with it. You have an SVOD product that sits on top of it that makes it attractive. All those things help our market effectiveness, and we can get even more market effective if we have a little less of a patchwork in our fiber footprint.

And it's what I said earlier that you shouldn't think about the next incremental homes we add as being similar to the previous homes because we're now filling in areas where we already have people trained. We have a marketing presence. There's some footprint that's in place. The core central office equipment is already there. So you're literally just having to string fiber and connect it to infrastructure that's already there. And the investment-to-revenue return interval should be shorter. And so those are all good things around that.

And then I would finally tell you, look, I disagree with you. I actually think there's a lot of unconnected households. There's a lot of unconnected apartments. There's a lot of unconnected single-family homes in certain geographic areas of the city. That's why we have a digital divide problem. If you go into South Central Dallas, you're going to find a lot of unconnected living units that are there. If you go into urban Los Angeles, you're going to find a lot of unconnected living units that are there.

I believe some of these architectures that are coming out and frankly, if policy gets right, that you can open up some of these places for growth. The Universal Service program gets reformed into an effective fashion, which I think it's time that from a policy perspective in our country, we should look at that, it makes fixed broadband more affordable. Then people who have made the utility decision to only have wireless in their household because it was good enough now may decide they want to go into the robust area of streaming and distance learning and choose to invest. And we have architectures now with things like millimeter wave that many instances could probably give different price points, attract those segments of the market that have been out of the fixed business with a good enough or reasonable enough broadband offer that I think also has some growth over time.

On the sports side, I think I've said before, and I don't think my point of view changes, that sports content is important to our linear business, our cable networks business to make sure we have enough of it that sustains that business and keeps it an attractive, must-have offering, an offering that our customers want to have in that cable bundle. And we've invested in a way to make sure that, that's the case, and we like our properties.

We like our engagement with the NBA. They're a great partner to work with, the demographic on the sports, great. They're flexible in their approach to things. I think our agreement with Major League Baseball allows us to adjust as viewership dynamics change over time, which is important because I think we're going to see platform distribution dynamics change over time. And they've been a good partner around that, I think will be a good partner moving forward. I think college and what we do with the NCAA and the tournament is just kind of one of those things that culturally is relevant. And I think our mix is really good in that regard.

I don't see going deeper into sports is the direction for WarnerMedia. My view is we need to be -- partner at the right amount, but our goal is not to become known as the sports company. And so I think we've been pretty disciplined around where we choose to get into it. We need to have the right amount in our portfolio. We feel pretty good about where we are about that. And I think that's probably enough.

And in the near term, our goal is to continue to get ourselves into a position where our on-demand platforms and our new distribution platforms, SVOD and AVOD, are scaled. And our strategies on that right now are general entertainment content. And you'll probably see, as we move through AVOD, maybe we do some additional live work that we have coming forward that may not be sports-centric. So more to come on that, but that's our near-term focus as we move forward.

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#### Operator

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

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

Two, if I could. First, I was curious if you could quantify some of the cost-cutting benefits in the third quarter and then size that opportunity of how it might flow through over the next 1 to 2 years. And then separately, one of the responses to the pandemic seems to be an acceleration of companies going digital and to software-based solutions. I was curious if you can unpack for the Business Wireline segment how you think about those opportunities for AT&T to try to take advantage of that acceleration relative to some of the risks you may also have from legacy revenue and any lagging cyclical impacts as companies try to respond to the recession.

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#### John T. Stankey - AT&T Inc. - CEO & Director

Yes. So Mike, let me -- I'll take the second part of that, and then ask John to maybe round out the first part of your question.

So managing through the wire -- the legacy wireline issues in our business segment, that's not anything new. In fact, I think I'd like to kind of declare we're on the downhill side of that issue.

My point of view on what matters to our business, subscribers moving forward, is great connectivity and great infrastructure. And more and more, it's a mix of what they need for their core networks matched with what they need for their wireless services. And not an insignificant part of our strength and our subscriber numbers have come from us marrying those 2 things together.

We're doing much better in the wireless space on customers that we sell other network to. And I believe we have opportunity to do more. And it gets back to my point of view of where we put our fiber and how we deal with the mid-market and how we connect mid-market to the core fixed infrastructure that they need to use for major parts of their business and marry it to the reality that all businesses are mobile in some way, shape or form right now. I think that's our sweet spot moving forward, and that's where our growth can come from. And that's where we have the team focused right now.

And so I think the play in business is a core connectivity play. It gets back to my comments that we are in a very unique position, that if we put that fiber in because of the products and services that we have on core, complex network connectivity that we do so well on with highly secure corporate networks, whether they be midsized or large, plus then what you pick up in the smaller segment of the market for unmanaged broadband connections that come off the back of that fiber mixed with our strength in wireless, that's a winning combination for us. And that's where we should be focused. And in fact, that's where we are focused right now.

And that's what the enterprise organization is spending their time and energy on and how we're equipping our distribution, how we're setting up our distribution channels that both can sell wireless and basic fiber connectivity into these areas. And that will be our meat and potatoes and what that business is built on. And I think that there's nothing more complicated about it than that.

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

John, let me just add. Mike, to your question, we added close to 400,000 nonphone postpaid net adds. A lot of that were the kind of devices that business and education uses. And so we're seeing -- what you are discussing, we are seeing that aspect in our postpaid numbers already. Additionally, we had about 4 million connected devices and other connections in the quarter. So what you're referring to is happening today at different levels certainly of ARPUs, but we are very well connected.

And the last thing I'd say is on the FirstNet business that we have, a lot of the connections, the 1.7 million connections we have, some of those are those connected devices as opposed to just the phone aspect of it. So it's happening now. We're responding, and I feel good about it.

With regard to the cost-cutting activities, let me just point out, we set a target of about \$6 billion or we talked about that target last -- at the beginning of the year and in October on a movement forward. We are continuing to work towards that goal. We've seen some immediate benefits already, and John referred to it: our review of our distribution capabilities, our push towards digital, which is a more streamlined, simpler approach, improving the quality of that. The team has made great progress that customers are happy with, realigning our stores. We have the opportunity that we had, through state mandates, well over 1,000 stores closed that we made. And I think we had a timing opportunity to adjust that and to shift some of that to authorized agents at a lower cost, relocate and close some stores to be very efficient. That's going on.

We told you before that we had virtualized close to 75% of our network activities. We're continuing to do that. I can tell you in my finance organization, we probably have on the new company combined, have 125 or so systems we use. And we've got a plan now to take out and reduce, combine, consolidate probably 2/3 of those, and we're starting on that.

So those are the kind of flavor of the items we're doing. We're confident we're going to get there over the next few years. We've already gotten significant amounts of it through our organizational alignment, through our benefit efficiencies, but you can believe that we'll continue to do that.

The best point I can make to you on these 2 things is these 2: We're in the middle of a pandemic. We added 1 million postpaid customers in mobility. We had significant impacts on our roaming, and our EBITDA was essentially flat. It does that because you do really good cost controls. I could tell you that same story on our Business Wireline. And look at those results, and their EBITDA actually grew and margins grew. That's from these transformational efforts really taking hold and the team really doing a good job.

I can't give you specific dollar amounts by categories. I have those, but we're not disclosing those. We're just working through this whole process. We've got a lot more work to do, but the progress so far is encouraging.

**Amir Rozwadowski** - AT&T Inc. - Senior VP of Finance & IR

Great. And we have time for one last question, operator.

**Operator**

Okay. That question comes from the line of Doug Mitchelson from Crédit Suisse.

**Douglas David Mitchelson** - Crédit Suisse AG, Research Division - MD

For John Stankey, a few questions bundled together. I know the HBO Max initiative is a big initiative for you. If you can update us 5 months in on learning so far, engagement churn, the like. And if you can give us any context you're willing to around the international launches next year. How much of the world will be launched? And you mentioned the advertising-based service. I'm not sure if you're prepared to discuss how that will be different from the existing HBO Max.



And then tailing onto that, if you don't mind, could you carry that into the state of play for the pay TV bundle, given that, in theory, the HBO Max initiative puts pressure on the pay TV bundle but over at DIRECTV and AT&T TV, you're trying to hold the bundle together? Do you see accelerating cord cutting in the future from the current 5% decline level across traditional and virtual MVPDs, given what you're doing and what you see in streaming across the industry? That would be helpful.

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**John T. Stankey** - AT&T Inc. - CEO & Director

Sure, Doug. Let me see if I can kind of tick them off. So on Max, I would say, absent the pandemic, the game has played out much the way we expected it to play out. The piece that the pandemic has put a little bit of a struggle on is it's -- the customer acquisition game is an originals game. The customer retention game in SVOD is a library game.

Our library is performing incredibly strong relative to our customer base. In fact, we've shared with you, we had an objective of how many minutes a day we wanted a customer to engage with Max. We've well exceeded our expectations on that, and it's on the strength of the library. And the best part about that is it's largely our owned library, what we already own the intellectual property on. It's not what we're leasing from others. I think in our top 10 library shows right now, there's one leased piece of content, maybe 2 that make it into the top 10. The rest is our own intellectual property.

So the pandemic put us in a tough spot on originals. We didn't have the funnel. We were running the market and the pandemic got in the way with it. We couldn't finish a lot of the work that we had underway. It's that stream of new originals that allows you to kind of grow the customer base, and the team has done a really good job at doing that. I mean I'm not disappointed. We're well ahead of what our initial plans were that we laid out for you a year ago in October. But nonetheless, we know we probably could have done better if we have the right kind of lineup of robust originals that we had originally slated. And that will now start to ease as production picks up.

So I would say everything is about where I expected it would be. There's some usability issues on the platform that we'd like to improve on the user interface. We made conscious decisions to launch with those to get time to market. Is software being written to improve those? And will you see every 45 days a new release coming out that will make the product even better, and customers will see that occur? Yes. But that's just part of maturing and scaling a product, and I feel good about the ramp. And once we think we've got those things all in alignment and have the right content, it's a good question to ask if -- should customer acquisition pace increase. And I think we'd all like to see that happen when the formula is right.

On international, as we've shared with you before, our focus right now is on Latin America and certain parts of Western Europe. And so that's where you will see the focus in '21 as we roll out. Those teams are mobilized and working on that now. And just like we had a domestic U.S. launch, the same thing has to be put in place in all of these countries to move forward. The subscriber counts that we gave you in October were consistent with what we thought would be our international gains coming from those regions, and we are still holding by those and have no reasons to be in any different place than we were before.

AVOD will be an important feature add on because many of you write about the price point of HBO Max, which I will still maintain, given the premium content as recognized by our performance recently in the Emmys, that there are many customers that want quality and they want to be able to go in and see something that has some depth in it, depth of seasons, and we offer that. And as a result of that, there's a segment of the market that's willing to pay for noncommercial-driven, high-quality content. But there's a segment of the market that probably wants a lower price point. And AVOD not only allows us to broaden the offering, the amount of content we put on the platform, but allows us to hit a different price point and attract different segments of the market in as a result of that.

We think that will be an important market expansion capability for us in accelerating our ability to attack different parts of the market. And frankly, it allows us to think differently about how we use other products and services on the platform when you can use both subscription and advertising to support it. So it's a really important, strategic issue for us to have an ability to use advertising and a scaled advertising play as a means to offer other products and services.



And then your last question on the pay TV bundle. I don't know what the cord-cutting rate is going to be over the next couple of quarters, so to speak. I expect that we saw a little bit of an uptick. I think a lot of that was driven by what I suggested earlier, which is when the virtual MVPDs got out of a highly promotional pricing game, there's the segment of the market that backed out at that point. We saw a little bit of that step-up as a result of it.

I've said before and I still maintain, there's a certain number of sports-consuming households that are going to be the stickier households in the pay TV bundle. That when we kind of get down to that 55 million, 60 million household range, we're probably going to see a little bit of a plateauing as a result of that. That doesn't mean that the bundle stays the way that it is. I think there'll be a number of channels in the bundle that probably fall away over time, and it gets a little bit thinner.

But from my point of view, the reason we're doing HBO Max, and one of the reasons that we expected walking in, is we want to be where the customers want to be. And we're focused on building a platform that's relevant for the next decade. And we have a great opportunity to pick those customers up, to have a great opportunity to have both a subscription and an ad-supported platform that we manage and we control, that we have a direct relationship with the customer on where we not only do the distribution, but we own a large amount of the content that the customer is interfacing with. That is a good place for us to be strategically over time, and we're leaning in to do that.

And I'm more in tune with that being important to us and having a great and growing broadband business that complements it. And that's whether it's broadband by fixed or mobile, that's where our business needs to be, and that's the focus on what we need to do going forward. So with that, Amir, I'm going to wrap it up here, and I think we're done taking questions.

First of all, thank you all for joining in today. I hope that you see that the business is demonstrating that they're working hard, and they're executing with some great team work. And that's yielded the performance in the market that you saw here.

We're continuing to work on our efficiencies and our effectiveness. As John alluded to you, I think we're demonstrating that we can yield those and keep the cash flows coming in the way we expected. And we're plowing those strategically back into the market to make sure that we can continue to grow this business and be competitive. There is no reason that a customer shouldn't choose AT&T, and it's our job to invest in this business in a way that we keep our customers with us, and we can grow our base, and that's what we intend to do.

We'll be disciplined in our capital allocation as we move forward. We've done a great job in restructuring our profile. And as a result of that, we're going to continue to support the dividend and reinvest those free cash flows in a way that grow among those priorities I just talked about.

So it's a tough environment, but I think we're managing well. We've shown a great degree of resiliency. I have confidence we're going get to the other side of this pandemic as we roll through next year. And we have the wherewithal to do that in a way that we can continue to invest in our business strategically.

Thanks for being with us today. I hope the new format that we used today works for you. If you want to give me some feedback, I'm certainly welcome to take it to the extent that you want to give me some thoughts on that. Everybody stay safe. We'll see you next quarter.

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#### 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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