Human Governance Report

Outlook: AT&T's Maturity Market Value Opportunity 2-3 years BB+ (10%) 5-10 years BBB (20%)
Significant value gains to be made from AT&T's largely untapped reservoir of human capital.

Performance: AT&T's performance appears adequate in relation to conventional investment norms but its OMR rating of B+ indicates that performance relative to total value potential falls short by a large margin primarily because of its low maturity in Human Governance (HG) and Human Capital Management (HCM). For more information on this point see our explanatory video: '[Seeking true alpha through maturity analysis](#)'.

OMR B+ **GICS Sector** Telecommunication Services **Sub-Industry** Integrated Telecommunication Services	**Summary** AT&T Inc. (formerly SBC Communications) provides telephone and broadband service and holds full ownership of AT&T Mobility (formerly Cingular Wireless).

AT&T inc. T[i]	
Market cap.	$257.52 B
P/E	18.05
Employees	280,000+
Total Revenue	$146.80B
Cost of Revenue	$67.04B
Gross Profit	$79.75B
R&D spend[ii]	$1.70B

Human capital value realisation

Human Capital Risk Assessment		
LOW	**MEDIUM**	HIGH
MEDIUM - Human capital risk profile indicates AT&T's risk will increase as the company strives to implement its strategic shift to a higher, value added, product and service delivery. AT&T is more vulnerable to industry disruptors as a direct consequence of its outmoded utilisation of its human capital.		

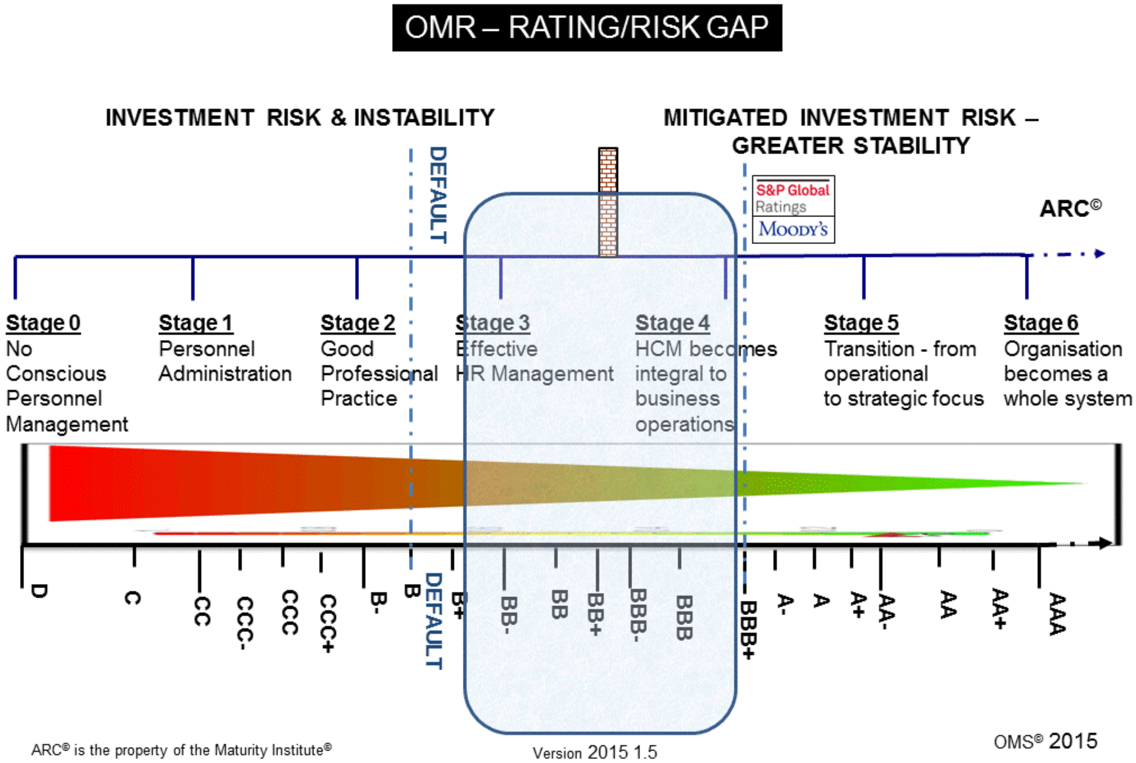
Employee Innovation Rate: 2%
(1 idea per employee per year =100%)

0	10	20	30	40	50	60	70	80	90	100

Return on Equity	Return on Assets	Profit margin	Operating Margin
13.46%	4.82%	8.97%	17.72%

Positioning AT&T on the OMR Scale (see chart below)

- AT&T's B+ is only one grade above 'default': this indicates the use of conventional HR management practices, treating people as a cost rather than valuable human capital
- AT&T are currently unaware of their relatively low maturity level and the implications for value and risk
- Board and Executive unaware of human capital as a source of long term value; leadership mindset and executive management capability would benefit greatly from a fundamental shift in thinking
- There is no attempt to strategically and proactively manage its 280,000 people for maximum value
- At this low level of maturity AT&T's relationship with its supply/value chain is sub-optimal focused on cost efficiency rather than whole system value
- The Rating/Risk gap (shown by the shaded area) indicates the disparity between the traditional financial rankings issued by credit rating agencies and the OMR rating. This signifies a possible increase in risk exposure through using predominantly financial capital as a basis for assessing sustainability of performance



Executive summary

AT&T's strategy is shifting as it seeks to deliver greater value to its subscriber base through technological innovation, continued focus on operational cost minimization and enhanced content. The company appears to be seeking to combine the attributes of a "utility type", capital intensive operation with an innovative and technologically progressive "value adding" culture. With this strategic shift come risks and other value implications that do not appear to be recognised within AT&T:

1. Leadership and managerial capability for significant organizational and cultural change.
2. Potential loss of human capital value contribution through narrowly focused cost cutting goals (of $2.5B) from integration of DIRECTV.
3. Managerial attitude to core business versus growth businesses suggests lack of appetite to seek significant improvements while downsizing.
4. At a time of strategic shift and business integration no one appears to have developed a whole system approach to these changes.
5. International expansion without effectively managing human capital systems across geographical and cultural boundaries will store up problems further down the line in terms of fully integrating technologies and operational capabilities.
6. Superficial commitment to employee development with training spend on activities with no clear value outcomes declared.
7. How to develop a collaborative and cooperative approach, without market dominance, with an increasing number of 3rd party partners necessary to deliver the strategy. This includes DIRECTV but also Intel and others who are centre stage on developing enhanced networking capabilities.

AT&T Overview

The dominant position a monopoly enjoys can create a complacent management culture because of the relative ease by which it can leverage its market advantage. This, especially in a growing market, can produce a culture of mediocrity with lower levels of responsiveness to increasing competitive pressures from new technologies. Analysis of AT&T's current position and performance level suggests that this is still a legacy from its earlier history. If there is a clear strategy at play within AT&T it appears to rest on three pillars: -

- Treating shareholders as the pre-eminent stakeholder group and rewarding them accordingly in the short term, with a commitment to continue this policy
- Using its size, dominant market position and finances to acquire, where necessary, companies that provide instant breadth of technological offering

rather than building its own innovative capability strategically and organically
- Attempting to make significant cost 'savings' through simplistic approaches (e.g. headcount reduction) which will undermine longer-term value

We find evidence that minimal recognition of the potential value opportunity available from its own 280,000 employees, and those employed within its supply chain, is exhibited. No clear Human Capital strategy is outlined and its management policies and practices reveal no prior, underlying hypothesis to justify their use in business value terms. It appears to view its people primarily as a cost, not a source of value, and manages them accordingly.

It is not entirely clear whether there is any over-arching purpose or coherent strategy driving AT&T. Page 2 of the annual report claims that AT&T will *"Connect people with their world, everywhere they live, work and play … and do it better than anyone else."* but we found no clear evidence to support or reassure investors or customers that they will 'do it better' than anyone else.

Key insights and questions for AT&T

- We predict that embarking on a maturity journey and developing effective human governance can increase AT&T's market value by an additional 5 to 10% within 2 to 3 years. Is the AT&T board willing to explore this opportunity?
- How does the goal of shareholder value cohere with the needs of 280,000 employees, 139.6 million customers and the creation of maximum value in the long term?
- Human capital is a significant investment for AT&T yet its contribution to value creation is not specifically identified or measured by the company; nor is the risk it poses to the sustainability and stability of AT&T's business considered. In the light of this report, should the Board now consider and report on the materiality of these issues?

Total value review

Cash flow % capital investments

Capital investment and dividend, together, consume the majority of positive cash flow generated. Following this strategy inevitably requires a strong financial focus on maximizing returns on capital assets.

Value strategy & Human Governance

It is a declared policy that shareholders are afforded primacy yet AT&T's business strategy is not a value maximisation strategy. We find no evidence that human governance or a cohesive approach to strategic human capital management currently features in AT&T's business strategy. This represents a huge missed opportunity for shareholders, employees, customers and AT&T's wider, community of stakeholders.

Under "Our strategy" AT&T aims -

"To become the premier integrated communications company in the world .." stating that it has "...invested in 5 key areas:

1. Lead in connectivity and integrated solutions.
2. Serve our customers globally.
3. Operate with an industry-leading cost structure.
4. Deliver an effortless customer experience.
5. Equip our people for the future."

These five statements may offer a summary of key areas of focus but we find no evidence that they come together as a whole system, either conceptually or operationally. This lack of cohesion produces a much less effective corporate strategy and weakened identity.

AT&T's people are only specifically mentioned once in item 5 and yet it is obvious that each statement has serious people implications, both separately and jointly. For example, item 3 will require a cost control and reduction culture rather than the simplistic headcount reduction policies in place. For "effortless customer experience" AT&T employees need to have the right attitude but customer satisfaction is also dependent on well-designed processes and systems that make the experience efficient and effortless.

There is no acknowledgement that a transition from its legacy, traditional leadership and managerial culture to a more enlightened and heightened capability is required as part of a long term, organizational capability and agility strategy. Even if these issues were fully recognised there is no indication that AT&T has the necessary human capital management capability to address them effectively.

CEO & Chair Randall L. Stephenson holds the joint roles, which is not in keeping with a healthy or value maximising corporate governance and begs many questions. His background as a trained accountant and CFO shows in his narrow focus on employee costs rather than their total value equation.

'Philanthropic' efforts (e.g. education programmes and AT&T Aspire) are launched without any specific value focus or declared hypothesis as to how they fit with AT&T's need to be seen as a long term value creator and generator. Stephenson's actions and pronouncements (e.g. with respect to AT&T employees needing to re-train) are not those of someone who understands the role of human governance at Board level, and AT&T's conventional approach to corporate governance is unremarkable. Its efforts in sustainability and the community, whilst laudable, have yet to be integrated into a whole system management mentality.

AT&T's traditional union relations may be regarded as benign, having resulted from its long corporate history, but what employee relations strategy is necessary for its future? Acceptance of change has to be a norm so how flexible and adaptable does its present and future workforce have to be if it is to "lead" and "serve" as a competitive force in the market in the long term?

Failure to consciously embark on its own journey of maturity, learning all of the value lessons from exemplars such as Toyota (rated A+), will impose a sever limitation on future realisation of AT&T's value potential and increase its business risks in the medium term. Reacting to such issues as they arise, rather than planning for them as part of its business strategy, will leave AT&T well behind the higher competitive curve it is joining. If the pace of technological change is maintained or, more likely, increased, then acquiring new technologies and skill-sets will always come at a premium cost without a concomitant premium value or return for AT&T.

Whole system thinking & management

The concept of whole system thinking does not feature in AT&T's literature even though AT&T's strategy is to provide customers with a whole system solution. AT&T is not alone in being relatively immature, from a whole system perspective, but this means they are drifting towards a customer offer that is not underpinned by whole system people management.

Knowledge, learning, innovation and never ending improvement

The OMR scale has a specific measure for employee ideas and innovation. Only those ideas that are assessed for potential value and effectively implemented are counted. An average of one idea per employee, per year, equates to a rate of 100%. A+ rated Toyota regularly achieves a rate in excess of 500%. AT&T's rate represents a huge value opportunity missed.

There is no evidence that AT&T currently has the necessary elements in place to move towards a significantly higher rate that would feed through to an uplift in performance and market value.

R&D

AT&T already invests significantly in traditional areas of research and development, spending about $1.7B annually (about 1.2% of revenues) but to what extent has it created the right environment for such investment to produce the best results? How does the R&D function integrate, for example, with the sales and marketing functions? What is the process for determining the specific areas for research? How is the R&D function measured and managed? The Annual Report and other company information makes no special case for its R&D function so we must assume it is no more mature nor integrated than any other part of AT&T.

Managing the value of human capital

AT&T remains a company where revenues and earnings come principally from its traditional landline business alongside newer mobile services. With its high employee count, employment costs are a correspondingly high proportion of total costs. OMR analysis asks whether such costs are managed as part of a full, value impact, equation (Output, Costs, Revenue, Quality). For example, if AT&T's business plan were to aim to reduce employment costs by, say, 5% has it calculated what effect this might have on the other value variables? There is no evidence that such calculations exist and, therefore, AT&T cannot express the net value impact of its simplistic headcount/cost reductions.

On M&A, effective integration of the DIRECTV acquisition requires skilful design of integrated human processes and systems. There is no evidence that AT&T has considered these dimensions. Such HG omission is a common source of acquisition underperformance and even failure. Consequently, we consider this to be a material omission.

Brand and human capital value

Maturity analysis eschews any notion of 'intangibility' by clearly demonstrating just how such matters as leadership, culture, human systems, intellectual capital, employee motivation and supply chain relationships are material to company performance and investment decisions. It also allows that a significant proportion of the company's valuation can be attributed to its "brand" so distinctions have to be made.

At year end 2015 AT&T's market value was $214B and its book value was approximately $122.7B, giving an excess of market over book of $92.2B. The value of the AT&T brand varies depending upon what organization is determining the valuation. However a figure of $89.49B is one of the approximate mid-point figures that we have used. By applying this to the difference between market and book values we see the remainder is an AT&T brand value of just $2.71B; with its legacy brand value already factored in. In other words, external observers would give AT&T very little credit for achieving any extra value from its capability in human capital management.

From the cash flow data it appears that the market believes AT&T will continue to invest heavily and, as a direct consequence, sustain its earnings, cash flow and dividends. AT&T leadership has a tough balancing act though; its current levels of cash flow (expressed on an amount per share outstanding) of $6.95 is 80%+

committed to sustaining its capital re-investment program and dividends. Therefore, to maintain confidence with its investors, and keep its share price up, its performance must be at least consistent and ideally on an upward trajectory.

Conclusion

To succeed in its strategic shift from a capital intensive industry to a knowledge-based business AT&T will need to manage all of its human capital, coherently and cohesively, in order to build its "intangible assets". It must consciously and explicitly evolve its corporate governance to embrace and integrate the totality of human governance and effective human capital management practice. In doing so it can make the best of the past and produce the best for the future.

Recent financials reflect almost no added value being generated from its current, low levels of capability in this respect. AT&T's reporting provides pieces of the puzzle but not a holistic picture of how critical these changes will be to its future success. The company identifies a number of risks to future performance in its annual report which include the following:

- Continuing growth in its wireless services will depend on continuing access to adequate spectrum, deployment of new technology and offering attractive services to customers.
- Changes in available technology could increase competition and its capital costs
- The current U.S. economy has changed AT&T customers' buying habits and a failure to adequately respond could materially adversely affect its business.
- Increasing competition for wireless customers could materially, adversely affect its operating results
- Increasing costs to provide services could adversely affect operating margins

While a strategic shift has been recognized and is being acted upon, the focus still appears to be driven by traditional financial and operational approaches. There is not a clearly understood and deployed approach to human governance which would enable AT&T to maximise value and minimise risk as the business moves forward.

OMS Integrated Reporting Team

The team are all members of the Maturity Institute (MI) which aims to maximise societal and shareholder value through effective human governance and human capital management practice. MI adopts a whole system, evidence based approach based around its 10 Pillars and strategic framework. The OMR rating scheme is the property of OMS LLP with approval from MI. To produce an IHGR requires a multi-disciplinary team comprising members who understand each other's expert perspective and combine it with their own to produce a seamless, whole system review. The designers and authors of this IHGR come from a variety of backgrounds combining expertise and many years of experience in accounting, leadership, human capital management reporting and investment analysis.

Nick Shepherd - FCPA, FCGA, FCMC, FCCA
Paul Kearns - Chair, Maturity Institute
Stuart Woollard - Managing Partner, OMS LLP

S&P500 OMINDEX Project

The Maturity Institute, OMS LLP, and Harvard Law School's Pension and Capital Stewardship Project are collaborating on a research program to assess how Human Governance ratings of the S&P500 (and other global stock market indexes) are connected to societal and corporate value outcomes, the materiality of effective human governance and organizational maturity. It will also inform how human capital management practice is linked to financial outcomes, which is of importance to investors.

This report is an abridged and distilled version of a more detailed analysis, which can be made available on request. All information and data was gathered from publicly available sources.

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For any questions regarding this report please contact

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[i] Yahoo finance as at 18th August 2016 except ii below
[ii] AT&T annual report