Southern Company (SO)

Updated May 27th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	$45	**5 Year CAGR Estimate:**	8.4%	**Quality Percentile:**	N/A
Fair Value Price:	$46	**5 Year Growth Estimate:**	2.5%	**Momentum Percentile:**	N/A
% Fair Value:	97%	**5 Year Valuation Multiple Estimate:**	0.5%	**Total Return Percentile:**	N/A
Dividend Yield:	5.4%	**5 Year Price Target**	$52	**Valuation Percentile:**	N/A

Overview & Current Events

Southern Company is a major energy utility, which serves about 9 million customers in the U.S. via its subsidiaries.

The stock has dramatically underperformed the market and its peers in the last five years. During this period, it has lost 1% whereas S&P has rallied 67% and the Utilities Select Sector SPDR ETF (XLU) has gained 34%. Consequently, Southern is now trading around its 5-year lows. There are two reasons behind this vast underperformance.

First of all, Southern has exhibited poor execution in the construction of its Vogtle nuclear units. This project has gone through great delays and cost overruns and thus its cost estimate has climbed to $8.8 B while the two units will not be in full operation until the end of 2022. Even in that year, they will be contributing less than 6% of the total earnings. Thus these units have greatly burdened the company but they will not impart significant growth when they come online.

The other reason behind the poor performance of the stock is the environment of rising interest rates. As interest rates rise, investors can find decent yields elsewhere and hence the dividends of utilities become less attractive. As a result, their valuation has come under pressure. The rising interest rates negatively affect Southern in another way as well. Due to its poor execution and its acquisition of AGL Resources for $12 B in 2016, Southern has almost doubled its net debt in the last five years. In addition, it has a heavy debt maturity schedule, with $14.6 B of its debt maturing in the next five years. Therefore, as the company will not be able to pay off this debt load, it will have to roll it over at higher rates.

On the bright side, Southern has exceeded the analysts' EPS estimates for 5 quarters in a row and their revenue estimates for 7 quarters in a row. In Q1, the company reported adjusted EPS of $0.88, higher than the consensus of $0.84, thanks to favorable weather and infrastructure investments at Southern Company Gas.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$2.25	$2.32	$2.36	$2.55	$2.67	$2.70	$2.77	$2.84	$2.83	$3.21	***$2.90***	***$3.28***
DPS	$1.66	$1.73	$1.80	$1.87	$1.94	$2.01	$2.08	$2.15	$2.22	$2.30	***$2.38***	***$2.78***

The analysts and the management expect the EPS to fall to $2.90 this year, mostly due to the ongoing Vogtle project. Moreover, due to its huge capital expenses and its debt pile, the company issues new shares on a regular basis. It has increased its share count at a 3.0% average annual rate in the last five years and the management recently stated that it would continue to issue new shares at a similar pace in the upcoming years. Furthermore, the company has grown its EPS at a 2.6% annual rate in the last decade and at a 1.4% annual rate in the last five years. Therefore, although the management recently stated that it was targeting 4%-6% long-term EPS growth, it is prudent to expect approximate 2.5% EPS growth over the next five years, particularly given the growing debt burden and the execution risk at Vogtle.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	16.1	13.5	14.9	15.8	17.0	16.2	16.0	15.8	17.8	15.5	***15.5***	***15.9***
Avg. Yld.	4.6%	5.5%	5.1%	4.6%	4.3%	4.6%	4.7%	4.8%	4.4%	4.6%	***5.4%***	***5.3%***

Rising interest rates have exerted downward pressure to the P/E ratios of most utility stocks. As a result, the P/E of Southern has decreased from 17.8 in 2016 to 15.5 now. Nevertheless, it is very close to its 10-year average P/E 15.9.

Therefore, if the stock reverts to its average valuation level over the next five years, it will enjoy just a mild 0.5% annualized gain thanks to the expansion of its P/E ratio.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	19.6%	17.9%	18.5%	11.6%	11.3%	11.3%	10.6%	9.8%	7.9%	9.2%	***9.2%***	***10.0%***
Debt/A	71.1%	70.1%	69.3%	68.5%	69.3%	68.8%	69.6%	71.7%	75.5%	76.7%	***77.6%***	***79.0%***
Int. Cov.	4.3	4.0	4.4	5.2	5.6	4.2	4.6	5.3	3.6	1.6	***2.0***	***3.5***
Payout	73.8%	74.6%	76.3%	73.3%	72.7%	74.4%	75.1%	75.7%	78.4%	71.7%	***82.1%***	***84.8%***
Std. Dev.	17.4%	21.8%	11.3%	9.5%	9.7%	12.8%	10.6%	15.7%	12.9%	11.7%	***12.0%***	***12.5%***

The above table confirms that Southern has stretched its balance sheet lately. Its debt/assets and its payout ratio have climbed to decade-high levels while its interest coverage and its gross profit/assets ratio have fallen near decade lows.

On the other hand, Southern has an exceptional dividend record. It has raised its dividend for 18 consecutive years and has not cut it for 72 consecutive years. Moreover, thanks to the poor performance of its stock, it currently offers a 5.4% dividend yield, which is much higher than that of most utilities and is actually an 8-year high yield for the stock. Thus investors can purchase the stock at an 8-year high yield. Due to the weak balance sheet, dividend growth is likely to be meager (~3% annually) going forward.

Southern is also attractive for another reason, namely its resilience during recessions. In the Great Recession, when most companies saw their earnings collapse, the EPS of Southern fell just 1.3%. Whenever the next recession shows up, Southern will likely outperform the market once thanks to its resilient and predictable earnings and the double boost it will receive from lower interest rates in such an event.

Final Thoughts & Recommendation

Southern has dramatically underperformed the market and its peers so it is now trading around its 5-year lows and is offering an 8-year high dividend yield. As a result, it can offer an 8.4% average annual return over the next five years thanks to 2.5% EPS growth, its 5.4% dividend and a 0.5% annualized P/E expansion. Southern looks like a potential buy for investor seeking utility exposure, but there's more risk here than one would expect from a 'boring' utility thanks to the elevated debt level Southern carries.

Total Return Breakdown by Year