Southern Company (SO)

Updated August 10th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	$47	**5 Year CAGR Estimate:**	7.7%	**Volatility Percentile:**	5.8%
Fair Value Price:	$47	**5 Year Growth Estimate:**	2.5%	**Momentum Percentile:**	28.2%
% Fair Value:	99%	**5 Year Valuation Multiple Estimate:**	0.1%	**Valuation Percentile:**	62.7%
Dividend Yield:	5.1%	**5 Year Price Target**	$53	**Total Return Percentile:**	46.7%

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 in the last five years. During this period, it has gained 10% whereas S&P has rallied 72% and the Utilities Select Sector SPDR ETF (XLU) has rallied 42%. There are two reasons for this.

Interest rates are on the rise and hence the dividends of utilities have become less attractive. Utilities are among the most vulnerable stocks to high rates. 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 billion 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 billion 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.

Moreover, Southern has exhibited poor execution in the construction of its Vogtle nuclear units. We mentioned the great delays and cost overruns of this project in our previous research report. 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. The poor execution in this project resurfaced in the Q2 earnings report of the company, which was released on August 2nd. Southern recorded a pre-tax charge of $1.1 billion due to an increase in its estimated cost of this project. The total cost is now more than double the initial estimate reported in 2008 and estimated completion is five years later than projected.

On the bright side, management stated that the projected in-service dates of the two units remained the same. Moreover, thanks to favorable weather and regulatory outcomes in its state regulated electric utilities in Q2, Southern exceeded the analysts' adjusted EPS estimates by a wide margin ($0.80 vs. $0.69). As a result, management has now raised their EPS estimates for this year to $2.97.

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	***$2.97***	***$3.36***
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***

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 management recently stated that it would continue to issue new shares at a similar pace in the upcoming years. In the latest conference call, management stated that it would dilute shareholders by another 2% until the end of the year. Moreover, 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 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	***15.8***	***15.9***
Avg. Yld.	4.6%	5.5%	5.1%	4.6%	4.3%	4.6%	4.7%	4.8%	4.4%	4.6%	***5.1%***	***5.2%***

Southern is now trading at a P/E ratio of 15.8, which is very close to its 10-year average P/E of 15.9. If the stock reverts to its average valuation level over the next five years, it will enjoy a minor 0.1% annualized gain from P/E expansion.

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%	***9.0%***	***10.0%***
Debt/A	71.1%	70.1%	69.3%	68.5%	69.3%	68.8%	69.6%	71.7%	75.5%	76.7%	***78.8%***	***80.0%***
Int. Cov.	4.3	4.0	4.4	5.2	5.6	4.2	4.6	5.3	3.6	1.6	***2.5***	***3.5***
Payout	73.8%	74.6%	76.3%	73.3%	72.7%	74.4%	75.1%	75.7%	78.4%	71.7%	***80.1%***	***82.7%***
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%***

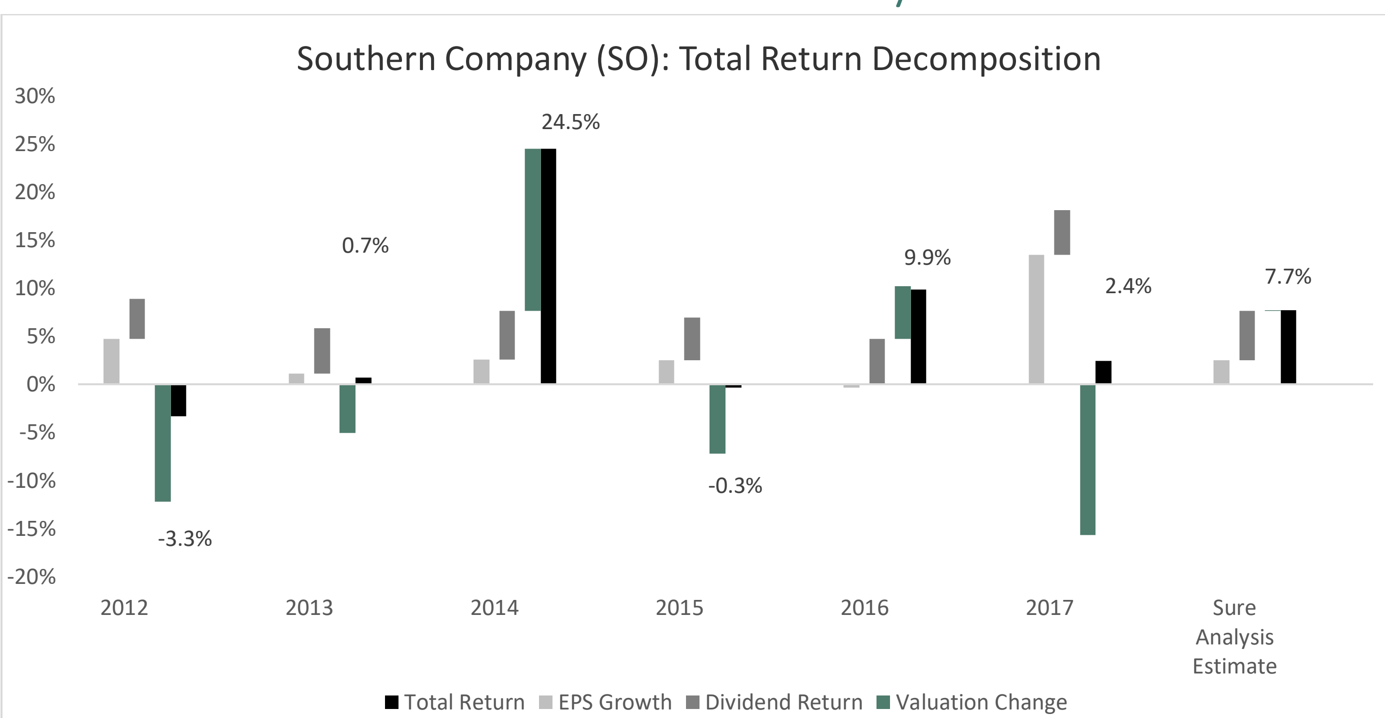
The above table confirms that Southern has stretched its balance sheet lately. Its debt/assets and its payout ratio have climbed to decade-high levels while its interest coverage and its gross profit/assets ratio have fallen near decade lows.

On the other hand, Southern has 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 5.1% dividend yield, which is much higher than that of most utilities and is an almost 8-year high yield for the stock. 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 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 offering an almost 8-year high dividend yield. As a result, it can offer a 7.7% average annual return over the next five years thanks to 2.5% EPS growth, its 5.1% dividend and a 0.1% annualized P/E expansion. Southern looks like a potential buy for investors seeking utility exposure, but there is more risk here than one would expect from a 'boring' utility thanks to the elevated debt level of Southern.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.