



Southern Company (SO)

Updated November 9th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	\$47	5 Year CAGR Estimate:	8.2%	Volatility Percentile:	7.9%
Fair Value Price:	\$48	5 Year Growth Estimate:	2.5%	Momentum Percentile:	30.5%
% Fair Value:	97%	5 Year Valuation Multiple Estimate:	0.6%	Growth Percentile:	8.8%
Dividend Yield:	5.1%	5 Year Price Target	\$55	Valuation Percentile:	54.9%
Dividend Risk Score:	D	Retirement Suitability Score:	B	Total Return Percentile:	43.2%

Overview & Current Events

Southern Company is a major energy utility that serves ~ 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 the S&P has rallied 56% and the Utilities Select Sector SPDR ETF (XLU) has rallied 39%. There are two reasons for this.

First, Interest rates are rising 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 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. The total cost is now more than double the initial estimate and estimated completion is five years later than projected. 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 total earnings. In early November, Southern reported (11/7/18) its financial results for the third quarter of fiscal 2018. Its revenue marginally decreased but its earnings-per-share increased from \$1.07 in last year's quarter to \$1.14 thanks to favorable regulatory outcomes and better weather (from the utility's perspective). These positives were partly offset by a 12% increase in interest expense and a 2% increase in share count. The company exceeded the analysts' earnings-per-share estimates by 6%. Management reaffirmed the expected in-service dates of the two nuclear units and raised its guidance for the earnings-per-share of the full year from \$2.97 to \$3.05 thanks to the above tailwinds.

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	\$3.05	\$3.45
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
Shares	777.2	819.7	843.3	865.1	867.8	887.1	907.8	911.7	990.4	1007.6	1030.0	1140.0

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 need to issue another \$2.4 billion of shares (5% of the current market cap) in the next four years.

Southern has grown its earnings-per-share at a 2.6% annual rate in the last decade and at a 1.4% annual rate in the last five years. Although management targets 4%-6% long-term earnings-per-share growth, we expect approximate 2.5% earnings-per-share growth over the next five years, particularly given the 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	15.4	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%

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Southern is trading at a P/E ratio of 15.4, 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 modest 0.6% 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%	14.0%	12.0%
Debt/A	71.1%	70.1%	69.3%	68.5%	69.3%	68.8%	69.6%	71.7%	75.5%	76.7%	77.0%	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%	78.0%	80.6%
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 near decade-high levels while its interest coverage has fallen near decade lows. On the bright side, these metrics improved in the latest quarter thanks to asset sales, whose proceeds were used for debt reduction.

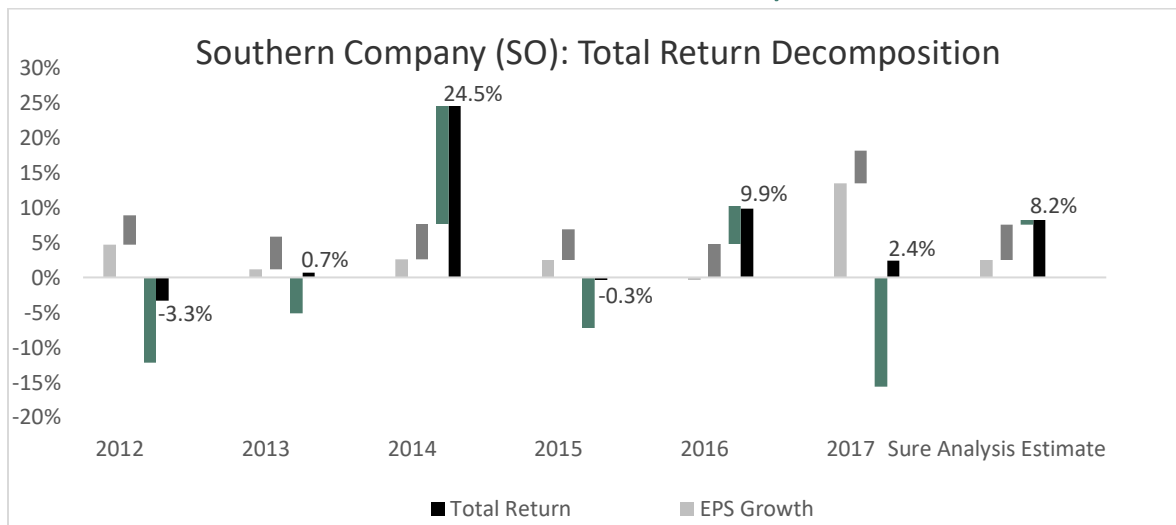
Southern has raised its dividend for 17 consecutive years and has not cut it for 70 consecutive years. Moreover, thanks to the poor performance of its stock, it currently offers a 5.1% dividend yield, which is much higher than that of most utilities and is an almost 8-year high yield for the stock. Due 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 earnings-per-share 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. We recently witnessed this pattern in a small scale, in the correction of the broad market since early October, when the S&P 500 lost 4% but Southern gained 4.5%.

Final Thoughts & Recommendation

Southern has dramatically underperformed the market and its peers and is now offering an almost 8-year high dividend yield. As a result, it can offer an 8.2% average annual return over the next five years. Southern looks like a potential buy for investors seeking utility exposure, but it is riskier than one would expect from a 'boring' utility due to its debt load.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	17127	15743	17456	17657	16537	17087	18467	17489	19896	23031
Gross Profit	9494	9317	10194	10787	10936	11116	11790	12094	13912	15654
Gross Margin	55.4%	59.2%	58.4%	61.1%	66.1%	65.1%	63.8%	69.2%	69.9%	68.0%
D&A Exp.	1704	1788	1831	2048	2145	2298	2293	2395	2923	3457
Operating Profit	3506	3470	3802	4231	4463	3255	3642	4282	4629	2551
Op. Margin	20.5%	22.0%	21.8%	24.0%	27.0%	19.0%	19.7%	24.5%	23.3%	11.1%
Net Profit	1807	1708	2040	2268	2415	1710	2031	2421	2493	880
Net Margin	10.6%	10.8%	11.7%	12.8%	14.6%	10.0%	11.0%	13.8%	12.5%	3.8%
Free Cash Flow	-497	-1407	-95	1378	89	634	569	600	-2416	-1028
Income Tax	915	896	1026	1219	1334	849	977	1194	951	142

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets (\$B)	48.35	52.05	55.03	59.27	63.15	64.55	70.23	78.32	109.70	111.01
Cash & Equivalents	417	690	447	1315	628	659	710	1404	1975	2130
Acc. Receivable	1054	953	1140	1074	961	1027	1090	1058	2206	2413
Inventories	1775	2241	2135	2270	2819	2298	1969	1929	2782	2627
Goodwill & Int.	0	0	0	0	0	0	0	319	7221	7141
Total Liabilities	34364	36461	38123	40607	43770	44407	48932	56218	82967	85153
Accounts Payable	1250	1329	1275	1553	1387	1376	1593	1905	2825	3076
Long-Term Debt	18386	19883	20752	21199	22411	23266	24745	28706	47425	50762
Total Equity	13276	14878	16202	17578	18297	19008	19949	20592	24758	24167
D/E Ratio	1.31	1.28	1.23	1.18	1.20	1.20	1.22	1.39	1.91	2.07

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	3.8%	3.4%	3.8%	4.0%	3.9%	2.7%	3.0%	3.3%	2.7%	0.8%
Return on Equity	14.1%	12.1%	13.1%	13.4%	13.5%	9.2%	10.4%	11.9%	11.0%	3.6%
ROIC	5.8%	5.0%	5.6%	5.9%	5.9%	4.0%	4.5%	5.0%	4.0%	1.2%
Shares Out.	777.2	819.7	843.3	865.1	867.8	887.1	907.8	911.7	990.4	1007.6
Revenue/Share	22.10	19.78	20.86	20.44	18.81	19.40	20.50	19.13	20.77	22.85
FCF/Share	-0.64	-1.77	-0.11	1.59	0.10	0.72	0.63	0.66	-2.52	-1.02

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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