# Southern Company (SO)

*Updated February 21st, 2019 by Aristofanis Papadatos*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $50 | **5 Year CAGR Estimate:** | 6.7% | **Volatility Percentile:** | 8.2% |
| **Fair Value Price:** | $48 | **5 Year Growth Estimate:** | 2.5% | **Momentum Percentile:** | 79.6% |
| **% Fair Value:** | 104% | **5 Year Valuation Multiple Estimate:** | -0.7% | **Growth Percentile:** | 9.8% |
| **Dividend Yield:** | 4.9% | **5 Year Price Target** | $55 | **Valuation Percentile:** | 45.8% |
| **Dividend Risk Score:** | D | **Retirement Suitability Score:** | B | **Total Return Percentile:** | 31.2% |

## 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 17% whereas the S&P has rallied 50% 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 $10.2 billion of its debt maturing in the next three years. 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 back half of 2022 and will contribute less than 6% of total earnings. In mid-February, Southern reported (2/20/19) financial results for the fourth quarter of fiscal 2018. In the year, revenue rose 2% and earnings-per-share increased from $3.02 to $3.07 thanks to favorable regulatory outcomes and better weather at the state-regulated utilities, which more than offset a 9% increase in interest expense and a 3% increase in the share count.

Management stated that the two nuclear units may come online a few months earlier than the expected November 2021/2022 dates and provided guidance for this year's earnings-per-share between $2.98 and $3.10. Moreover, management expects to continue raising the annual dividend by $0.08 in the upcoming years.

## Growth on a Per-Share Basis

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **EPS** | $2.32 | $2.36 | $2.55 | $2.67 | $2.70 | $2.77 | $2.84 | $2.83 | $3.02 | $3.07 | ***$3.05*** | ***$3.45*** |
| **DPS** | $1.73 | $1.80 | $1.87 | $1.94 | $2.01 | $2.08 | $2.15 | $2.22 | $2.30 | $2.38 | ***$2.46*** | ***$2.86*** |
| **Shares** | 819.7 | 843.3 | 865.1 | 867.8 | 887.1 | 907.8 | 911.7 | 990.4 | 1007.6 | 1034.0 | ***1060.0*** | ***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 3.1% average annual rate in the last five years and management recently stated that it would need to issue another $2.5-$3.0 billion of shares (5%-6% of the current market cap) in the next five years.

Southern has grown its earnings-per-share at a 3.2% annual rate in the last decade and at a 2.6% 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 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Now | 2024 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Avg. P/E** | 13.5 | 14.9 | 15.8 | 17.0 | 16.2 | 16.0 | 15.8 | 17.8 | 15.5 | 14.7 | ***16.4*** | ***15.8*** |
| **Avg. Yld.** | 5.5% | 5.1% | 4.6% | 4.3% | 4.6% | 4.7% | 4.8% | 4.4% | 4.6% | 5.3% | ***4.9%*** | ***5.2%*** |

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Southern is trading at a P/E ratio of 16.6, which is slightly higher than its 10-year average P/E of 15.8. If the stock reverts to its average valuation level over the next five years, it will incur a modest 0.7% annualized drag from P/E contraction.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2023 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Payout | 74.6% | 76.3% | 73.3% | 72.7% | 74.4% | 75.1% | 75.7% | 78.4% | 71.7% | 77.5% | ***80.7%*** | ***82.9%*** |

The competitive advantage of Southern is its state-regulated business, which requires excessive capital expenses for infrastructure and thus poses high barriers to entry to potential competitors. Southern has stretched its balance sheet in recent years. Its debt/assets and its payout ratio have climbed near decade-high levels while its interest expense currently consumes 44% of its operating income, an almost decade-high level. On the bright side, these metrics have improved in the last two quarters thanks to asset sales, whose proceeds have been used for debt reduction.

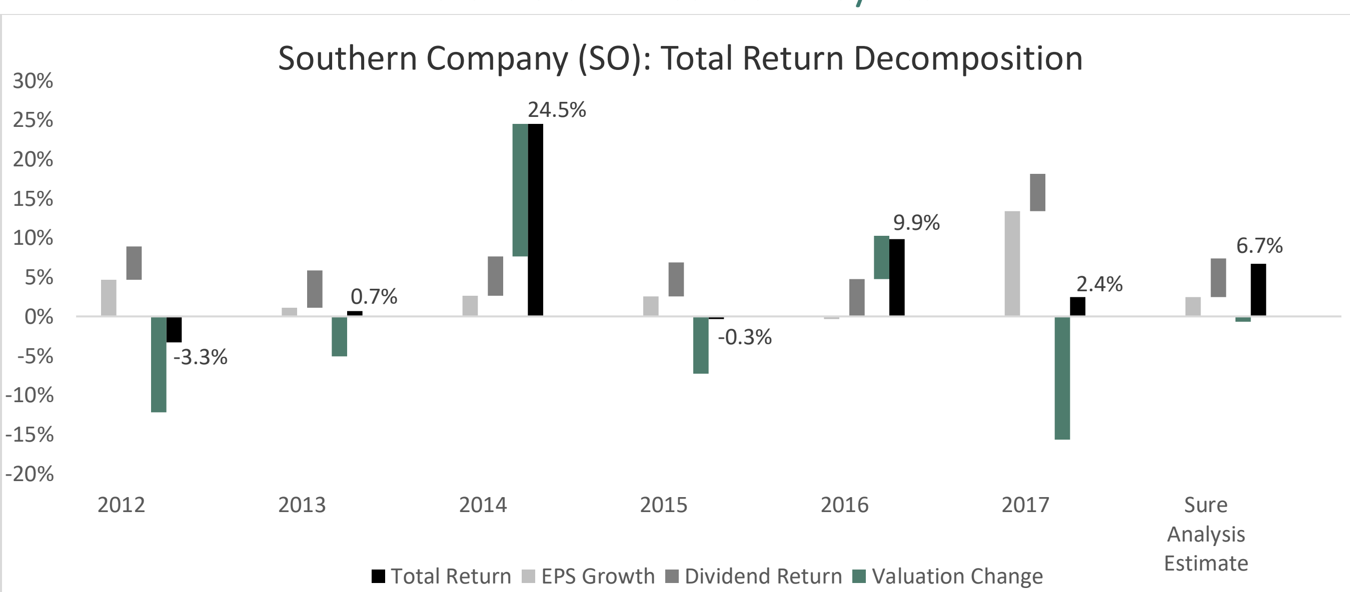
Southern has raised its dividend for 17 consecutive years and has not cut it for 70 consecutive years. Moreover, it currently offers a 4.9% dividend yield, which is much higher than that of most utilities and is an almost 8-year high yield for the stock. Due to the weak balance sheet, dividend growth 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.

## Final Thoughts & Recommendation

Southern has dramatically underperformed the market and its peers in the last five years but has rallied 16% in the last two months. The recent rally has somewhat reduced the attractiveness of the stock, which can now offer just a 6.7% average annual return over the next five years. Southern thus earns a hold rating at its current price. It is also 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.*