American Electric Power (AEP)

Updated April 25th, 2019 by Samuel Smith

Key Metrics

Current Price:	$85	**5 Year CAGR Estimate:**	7.5%	**Volatility Percentile:**	10.4%
Fair Value Price:	$82	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	80.5%
% Fair Value:	104%	**5 Year Valuation Multiple Estimate:**	-0.7%	**Growth Percentile:**	35.9%
Dividend Yield:	3.2%	**5 Year Price Target**	$105	**Valuation Percentile:**	50.0%
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Total Return Percentile:**	42.6%

Overview & Current Events

American Electric Power (AEP) was founded in 1906, and has evolved its business model along with changing technologies in order to offer customers safe, reliable, and affordable energy. It is one of the largest regulated utilities in the United States and offers electricity generation, transmission, and distribution services in 11 states. Its energy sources are coal (47%), natural gas (27%), renewables (13%), nuclear (7%), and demand response (6%). Its income sources are integrated utilities (51%), transmission and distribution (24%), competitive transmission (14%), and unregulated generation and marketing (11%). AEP's sound business model has enabled it to outperform the broader stock market, as well as the utility sector, by a significant margin over the past five years while also sustaining or raising its dividend every year for the past sixteen years.

AEP recently reported (4/25/2019) Q1 2019 earnings with operating earnings of $1.19 per share, up significantly from $0.96 in Q1 2018. This was possible thanks to approved rate increases, additional cash flows from new investments, and lower operating expenses. Management also reaffirmed full year guidance of $4.10 earnings per share, in-line with our forecast. AEP also reported progress in its regulatory cases, as it received a 9.4% allowed return on its Oklahoma rates, up from the previous 8% allowed Oklahoma returns in the previous 12 months. The company also recently completed the purchase of 724 megawatts of battery and wind assets from Sempra, which enabled management to achieve roughly two-thirds of their goal of investing $2.2 billion in renewables by 2023.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$2.96	$2.53	$4.02	$2.60	$3.04	$3.34	$4.17	$1.24	$3.88	$3.97	***$4.10***	***$5.23***
DPS	$1.64	$1.71	$1.85	$1.88	$1.95	$2.03	$2.15	$2.27	$2.39	$2.48	***$2.68***	***$3.42***
Shares	459	480	482	485	487	489	491	492	493	493	***493***	***497***

One of AEP's major growth drivers moving forward will be its ambitious plans for its renewable power business, as it plans to install 3.9 GW of solar and 4.4 GW of wind power by 2030. A significant sign of its intent to become a major player in the renewable space was its recent acquisition of Sempra Energy's renewable business, which includes joint ownership of 7 wind farms and 1 battery installation. Once this deal is closed and the Santa Rita wind project in Texas is complete, AEP's renewable portfolio will have nearly quadrupled from its current size, with plans to grow it by another four times of its pro-rata size (nearly 16 times its current size) by 2030. The other major growth driver for the company will be its transmission business. Given its large footprint and execution experience, AEP should be well positioned to capitalize on the aging infrastructure in this space and grow considerably.

Management is guiding for a long-term growth rate target of 5%-7% and just raised its dividend by a strong 8.1%, projecting its confidence in executing on its growth initiatives. While its renewables and transmission programs do seem ambitious, the company's low ROIC has led to a 10-year earnings-per-share compound annual growth rate of only ~3.5%. As a result, we will assume that AEP will hit the bottom of its earnings-per-share growth target range at a ~5% CAGR until 2024. Since the current dividend payout ratio is in the company's long-term payout ratio target range, we assume the dividend will grow at the same pace as well.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	11.7	14.2	11	16.4	19.6	16.6	16.2	70	19.2	18.8	***20.7***	***20.0***
Avg. Yld.	3.7%	4.3%	4.1%	4.1%	3.7%	3.3%	3.1%	3.1%	2.9%	3.1%	***3.2%***	***3.3%***

Given the choppiness of AEP's earnings, in particular, the abnormal results in 2016, the ten-year average price-to-earnings ratio is not necessarily a good indicator of fair value for this company. However, other than the 2016 outlier, we can see that its current multiple is at the upper end of its historical valuation range, which appears justified given that we believe it will outperform its historical earnings-per-share CAGR. Given that the projected forward annualized return is 7.5%, we believe that AEP's valuation multiple will remain fairly steady (declining roughly 0.7% per year) through 2024, as it should still be in the middle of its renewable growth program.

Safety, Quality, Competitive Advantage, & Recession Resiliency

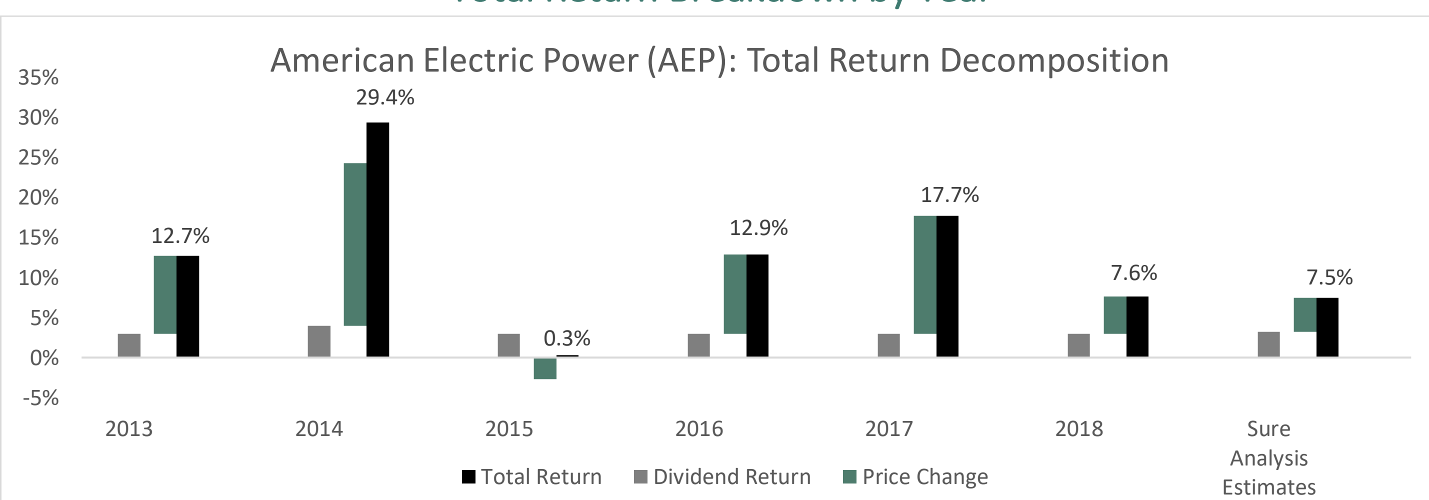
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	55.2%	55.2%	67.6%	48.9%	72.3%	80.7%	54.6%	58.9%	248.9%	61.6%	***62.5%***	***65.4%***

AEP benefits from government-granted exclusive rights and rates that give them service-territory monopolies. AEP also benefits from large scale, which increases its efficiency as its network grows larger. The main risks and catalysts for AEP involve weather, the timeliness and outcomes of regulatory rate decisions, and development execution uncertainty. The good news is that AEP has diversification across 11 states, somewhat mitigating its weather and regulatory risks. Additionally, their aggressive expansion into green energy projects helps offset some of the potential regulatory risks to its traditional energy businesses such as coal. Another positive is that the business is quite recession resistant. While revenues and profits dipped from 2008-2009, the dividend was maintained comfortably and the company's results rebounded strongly in 2010 with little threat to the business. The balance sheet may not look pretty based on traditional metrics, but the steady cash flow of the business is such that it is actually quite resilient.

Final Thoughts & Recommendation

AEP is a solid dividend growth stock with a recession-resistant business model. It can serve as a nice portfolio diversifier, especially for those trying to be more defensive at this point in the cycle. Given its 3.2% dividend yield and 5% expected annual earnings-per-share growth rate, the stock should produce 7.5% annual total returns, after accounting for gradual 0.7% annual valuation multiple reduction. As a result, we think it is fairly valued, making it a hold.

Total Return Breakdown by Year



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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.

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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	14440	13489	14427	15116	14945	14814	16379	16453	16380	15425
Gross Profit	8685	8958	5124	5400	5588	5643	5926	6316	6455	6488
Gross Margin	60.1%	66.4%	35.5%	35.7%	37.4%	38.1%	36.2%	38.4%	39.4%	42.1%
SG&A Exp.	1571	1660	1641	1655	1782	1713	1898	2010	1962	1997
D&A Exp.	2787	2771	2663	2921	2956	3049	3127	3334	3475	3431
Operating Profit	19.3%	20.5%	18.5%	19.3%	19.8%	20.6%	19.1%	20.3%	21.2%	22.2%
Operating Margin	1383	1360	1214	1946	1259	1481	1634	2047	611	1913
Net Profit	9.6%	10.1%	8.4%	12.9%	8.4%	10.0%	10.0%	12.4%	3.7%	12.4%
Net Margin	-1219	-486	226	1013	672	336	367	219	-390	-1529
Free Cash Flow	642	575	643	818	604	678	903	920	-74	970
Income Tax	14440	13489	14427	15116	14945	14814	16379	16453	16380	15425

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	45155	48348	50455	52223	54367	56414	59545	61683	63468	64729
Cash & Equivalents	497	490	294	221	279	118	163	176	211	215
Accounts Receivable	659	584	1769	1728	1676	1703	1689	1609	1758	1661
Inventories	1173	1661	1448	1292	1519	1423	1317	1339	967	953
Goodwill & Int. Ass.	76	76	76	76	91	91	53	53	53	53
Total Liabilities	34445	35208	36833	37558	39130	40328	42720	43778	46048	46416
Accounts Payable	1297	1158	1061	1095	1169	1266	1258	1418	1689	2065
Long-Term Debt	17959	17624	18157	18166	18738	19134	19858	20373	21969	22812
Shareholder's Equity	10693	13140	13622	14664	15237	16085	16820	17892	17397	18287
D/E Ratio	1.68	1.34	1.33	1.24	1.23	1.19	1.18	1.14	1.26	1.25

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	3.2%	2.9%	2.5%	3.8%	2.4%	2.7%	2.8%	3.4%	1.0%	3.0%
Return on Equity	13.3%	11.4%	9.1%	13.8%	8.4%	9.5%	9.9%	11.8%	3.5%	10.7%
ROIC	5.1%	4.6%	3.9%	6.0%	3.8%	4.3%	4.5%	5.5%	1.6%	4.8%
Shares Out.	459	480	482	485	487	489	491	492	493	493
Revenue/Share	35.77	29.39	30.08	31.33	30.81	30.42	33.50	33.54	33.32	31.31
FCF/Share	-3.02	-1.06	0.47	2.10	1.39	0.69	0.75	0.45	-0.79	-3.10

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