Southern Company (SO)

Updated February 24th, 2020 by Aristofanis Papadatos

Key Metrics

Current Price:	$69	**5 Year CAGR Estimate:**	2.2%	**Market Cap:**	$72.7B
Fair Value Price:	$52	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	2/14/2020
% Fair Value:	133%	**5 Year Valuation Multiple Estimate:**	-5.6%	**Dividend Payment Date:**	3/6/2020
Dividend Yield:	3.7%	**5 Year Price Target**	$63	**Years Of Dividend Growth:**	18
Dividend Risk Score:	D	**Retirement Suitability Score:**	D	**Last Dividend Increase:**	3.3%

Overview & Current Events

Southern Company is a major energy utility that serves ~9 million customers in the U.S. via its subsidiaries. It has a market capitalization of $72.7 billion.

Southern has greatly benefited from the shift of the Fed to a dovish stance since last year. Lower interest rates render the dividends of utilities more attractive. Moreover, they benefit 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 $11.5 billion of its debt maturing by the end of 2022. As it will not be able to pay off this debt load, it will have to roll it over so it greatly benefits from lower rates. Thanks to this tailwind, Southern has rallied 57% off its bottom at the end of 2018, to an all-time high. The rally has also resulted from the progress in the construction of Vogtle, which has markedly improved in the last five quarters.

In mid-February, Southern reported (2/20/20) financial results for the fourth quarter of fiscal 2019. In the year, revenue decreased 8.8% due to the sale of Gulf Power and other assets but earnings-per-share rose 1.3%, to a new all-time high, thanks to growth in state-regulated utilities. Management provided guidance for earnings-per-share of $3.10-$3.22 this year and stated that it still expects to meet its targets for cost and commission date of the Vogtle Plant. Notably, Southern has missed analysts' earnings-per-share estimates only once in the last 12 quarters.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.36	$2.55	$2.67	$2.70	$2.77	$2.84	$2.83	$3.02	$3.07	$3.11	***$3.20***	***$3.89***
DPS	$1.80	$1.87	$1.94	$2.01	$2.08	$2.15	$2.22	$2.30	$2.38	$2.46	***$2.54***	***$2.94***
Shares[1]	843.3	865.1	867.8	887.1	907.8	911.7	990.4	1007.6	1034.0	1052.0	***1070.0***	***1170.0***

Due to its huge capital expenses and its debt pile, the company issues new shares on a regular basis. Southern has increased its share count at a 3.0% average annual rate in the last five years and management has stated that it will need to issue about $2.0 billion of shares (3% of the current market cap) in the next five years.

Southern has grown its earnings-per-share at a 3.0% annual rate in the last decade and at a 2.3% annual rate in the last five years. Management has repeatedly stated that it targets 4%-6% long-term earnings-per-share growth. Due to the debt burden of Southern and its tendency to dilute its shareholders more than its guidance, we expect approximately 4.0% earnings-per-share growth over the next five years.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	14.9	15.8	17.0	16.2	16.0	15.8	17.8	15.5	14.7	17.9	***21.6***	***16.2***
Avg. Yld.	5.1%	4.6%	4.3%	4.6%	4.7%	4.8%	4.4%	4.6%	5.3%	4.0%	***3.7%***	***4.7%***

[1] In millions.

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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Thanks to its relentless rally since the end of 2018, Southern is trading at a 10-year high price-to-earnings ratio of 21.6, which is much higher than its 10-year average price-to-earnings of 16.2. If the stock reverts to its average valuation level over the next five years, it will incur a -5.6% annualized drag due to the contraction of its earnings multiple.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	76.3%	73.3%	72.7%	74.4%	75.1%	75.7%	78.4%	71.7%	77.5%	79.1%	***79.4%***	***75.6%***

The competitive advantage of Southern is its state-regulated business, which requires excessive capital expenses for infrastructure and 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 almost one-third of its operating income. On the bright side, these metrics have somewhat improved lately thanks to asset sales, whose proceeds have been used for debt reduction.

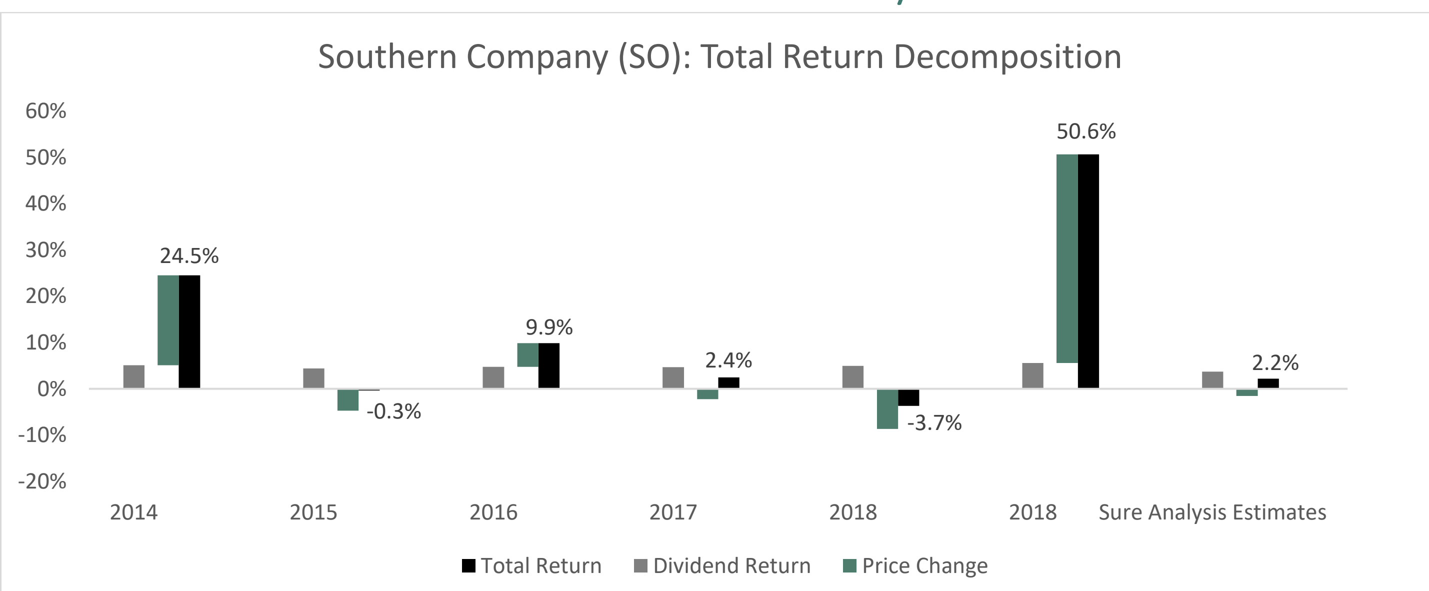
Southern has raised its dividend for 18 consecutive years and has not cut it for 71 consecutive years. Moreover, it currently offers a 3.7% dividend yield, which is higher than that of most utilities. Due to the weak balance sheet, dividend growth is likely to be meager (~3% annually) going forward.

Southern is also attractive because of 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 likely lower interest rates in such an event.

Final Thoughts & Recommendation

The prospects of Southern have greatly improved in recent quarters thanks to the reduced execution risk at its Vogtle Plant and the shift of the Fed to a more dovish stance. With that said, Southern has rallied 57% off its bottom at the end of 2018. This is an unusually rapid move for Southern. As a result, Southern is likely to offer just a 2.2% average annual return over the next five years. As it will have material downside risk in the event of higher interest rates, it receives a sell rating. 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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	17456	17657	16537	17087	18467	17489	19896	23031	23495	21419
Gross Profit	10194	6849	7164	7270	7436	7678	8530	9915	9653	9627
Gross Margin	58.4%	38.8%	43.3%	42.5%	40.3%	43.9%	42.9%	43.1%	41.1%	44.9%
D&A Exp.	1831	2048	2145	2298	2293	2395	2923	3457	3549	3331
Operating Profit	3802	4231	4463	3255	3642	4282	4487	2293	4110	5335
Op. Margin	21.8%	24.0%	27.0%	19.0%	19.7%	24.5%	22.6%	10.0%	17.5%	24.9%
Net Profit	2040	2268	2415	1710	2031	2421	2493	880	2242	4754
Net Margin	11.7%	12.8%	14.6%	10.0%	11.0%	13.8%	12.5%	3.8%	9.5%	22.2%
Free Cash Flow	-95	1378	89	634	569	600	-2416	-1029	-1056	-1774
Income Tax	1026	1219	1334	849	977	1194	951	142	449	1798

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets ($B)	55.0	59.3	63.1	64.5	70.2	78.3	109.7	111.0	116.9	118.7
Cash & Equivalents	447	1315	628	659	710	1404	1975	2130	1396	1975
Acc. Receivable	1140	1074	961	1027	1090	1058	2206	2413	2527	2042
Inventories	2135	2270	2819	2298	1969	1929	2782	2627	2394	2388
Goodwill & Int.	N/A	N/A	N/A	N/A	N/A	319	7221	7141	5928	5816
Total Liabilities	38123	40607	43770	44407	48932	56218	82967	85153	87584	86650
Accounts Payable	1275	1553	1387	1376	1593	1905	2825	3076	3436	2557
Long-Term Debt	20752	21199	22411	23266	24745	28706	47425	50762	46825	46842
Total Equity	16202	17578	18297	19008	19949	20592	24758	24167	24723	27505
D/E Ratio	1.23	1.18	1.20	1.20	1.22	1.39	1.91	2.07	1.87	1.69

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	3.8%	4.0%	3.9%	2.7%	3.0%	3.3%	2.7%	0.8%	2.0%	4.0%
Return on Equity	13.1%	13.4%	13.5%	9.2%	10.4%	11.9%	11.0%	3.6%	9.2%	18.2%
ROIC	5.6%	5.9%	5.9%	4.0%	4.5%	5.0%	4.0%	1.2%	2.9%	6.1%
Shares Out.	843.3	865.1	867.8	887.1	907.8	911.7	990.4	1007.6	1034.0	1052.0
Revenue/Share	20.86	20.44	18.81	19.40	20.50	19.13	20.77	22.85	22.92	20.32
FCF/Share	-0.11	1.59	0.10	0.72	0.63	0.66	-2.52	-1.02	-1.03	-1.68

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