



# American Electric Power (AEP)

Updated August 2<sup>nd</sup>, 2022 by Samuel Smith

## Key Metrics

|                             |        |                                            |       |                                  |                       |
|-----------------------------|--------|--------------------------------------------|-------|----------------------------------|-----------------------|
| <b>Current Price:</b>       | \$99.1 | <b>5 Year CAGR Estimate:</b>               | 4.2%  | <b>Market Cap:</b>               | \$50.6B               |
| <b>Fair Value Price:</b>    | \$85.2 | <b>5 Year Growth Estimate:</b>             | 4.4%  | <b>Ex-Dividend Date:</b>         | 08/9/22 <sup>1</sup>  |
| <b>% Fair Value:</b>        | 116%   | <b>5 Year Valuation Multiple Estimate:</b> | -3.0% | <b>Dividend Payment Date:</b>    | 09/10/22 <sup>2</sup> |
| <b>Dividend Yield:</b>      | 3.1%   | <b>5 Year Price Target</b>                 | \$105 | <b>Years Of Dividend Growth:</b> | 17                    |
| <b>Dividend Risk Score:</b> | B      | <b>Retirement Suitability Score:</b>       | B     | <b>Rating:</b>                   | Hold                  |

## Overview & Current Events

American Electric Power was founded in 1906 and has evolved its business model along with changing technologies 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, natural gas, renewables, nuclear, and demand response.

Its income sources are integrated utilities, transmission and distribution, competitive transmission, and unregulated generation and marketing. AEP's sound business model has enabled it to perform very well in recent years while also raising its dividend every year for 17 years.

AEP recently reported (07/27/2022) Q2 results. Q2 GAAP earnings per share came in at \$1.02, down from \$1.16 in the year-ago period. Revenue increased 21.1% to \$4.6 billion year-over-year. Operating earnings increased to \$618 million from \$590 million in the year-ago period.

Meanwhile, the company reaffirmed its FY2022 operating earnings guidance range of \$4.87 to \$5.07 and long-term growth rate target of 6% to 7%. Lastly, the company projected to close the sale of its Kentucky operations this summer.

## Growth on a Per-Share Basis

| Year                      | 2012   | 2013   | 2014   | 2015   | 2016   | 2017   | 2018   | 2019   | 2020   | 2021   | 2022          | 2027          |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------------|---------------|
| <b>EPS</b>                | \$2.60 | \$3.04 | \$3.34 | \$4.17 | \$1.24 | \$3.88 | \$3.97 | \$4.19 | \$4.44 | \$4.74 | <b>\$5.01</b> | <b>\$6.20</b> |
| <b>DPS</b>                | \$1.88 | \$1.95 | \$2.03 | \$2.15 | \$2.27 | \$2.39 | \$2.48 | \$2.74 | \$2.84 | \$3.00 | <b>\$3.12</b> | <b>\$3.42</b> |
| <b>Shares<sup>3</sup></b> | 485.7  | 487.8  | 489.4  | 491.1  | 491.7  | 492.0  | 493.2  | 494.2  | 496.6  | 503.7  | <b>506.1</b>  | <b>510.0</b>  |

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 acquisition of Sempra Energy's renewable business, which includes joint ownership of 7 wind farms and 1 battery installation. This deal, combined with the Santa Rita wind project in Texas, will nearly quadruple AEP's renewable portfolio 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 raised its dividend by over 5% last year, 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 in the low single digits. Since the current dividend payout ratio is in the company's long-term payout ratio target range, we assume the dividend will continue to grow. For the next half decade, we expect 4.4% annualized growth.

<sup>1</sup> Estimate

<sup>2</sup> Estimate

<sup>3</sup> In millions

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## Valuation Analysis

| Year      | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2027 |
|-----------|------|------|------|------|------|------|------|------|------|------|------|------|
| Avg. P/E  | 18.1 | 15.3 | 18.1 | 14.8 | 50.0 | 17.9 | 18.6 | 20.5 | 19.6 | 18.1 | 19.8 | 17.0 |
| Avg. Yld. | 4.0% | 4.2% | 3.4% | 3.5% | 3.7% | 3.4% | 3.4% | 3.2% | 3.3% | 3.7% | 3.1% | 3.2% |

Given the choppiness of AEP's earnings, and 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 on the high end of its historical valuation range. Therefore, we view shares as overvalued at present and expect the company to face multiple contraction headwinds moving forward.

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

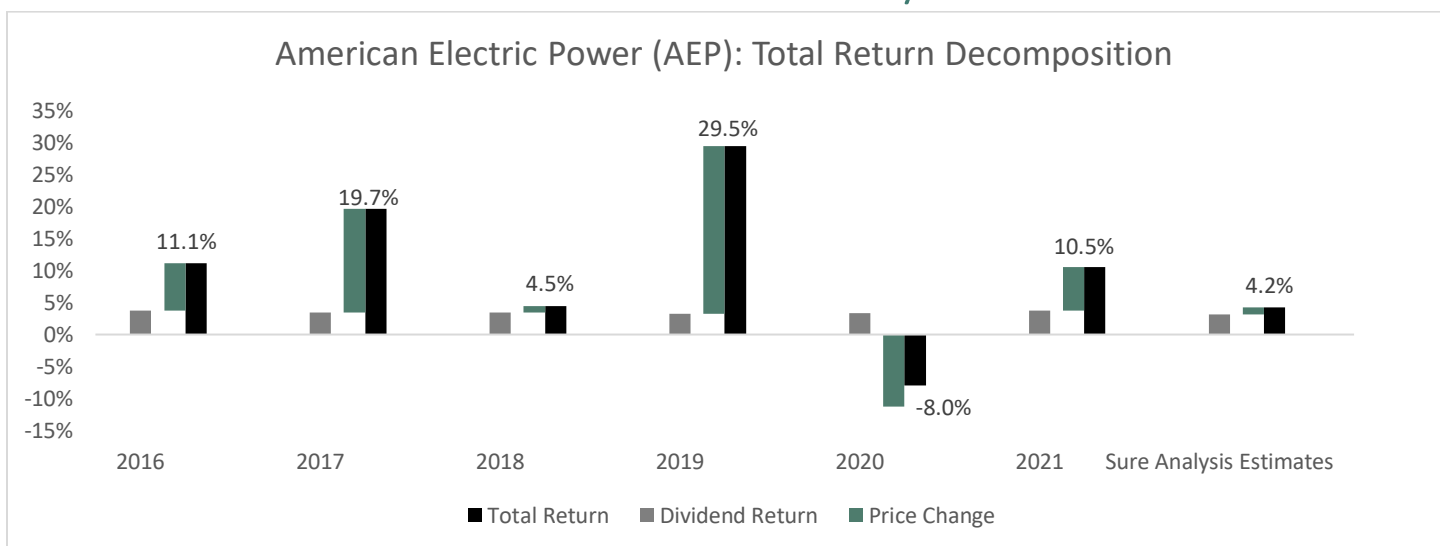
| Year   | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2027 |
|--------|------|------|------|------|------|------|------|------|------|------|------|------|
| Payout | 72%  | 64%  | 61%  | 52%  | 183% | 62%  | 62%  | 65%  | 64%  | 67%  | 62%  | 55%  |

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 numerous states, somewhat mitigating its weather and regulatory risks. Additionally, its 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. 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. Given its 3.1% dividend yield and 4.4% expected annual earnings-per-share growth rate offset by expected multiple contraction headwinds, the stock should produce 4.2% annualized total returns over the next half decade. As a result, we rate it a Hold.

## Total Return Breakdown by Year



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## Income Statement Metrics

| Year             | 2012   | 2013   | 2014   | 2015   | 2016   | 2017    | 2018    | 2019    | 2020    | 2021    |
|------------------|--------|--------|--------|--------|--------|---------|---------|---------|---------|---------|
| Revenue          | 14,945 | 14,814 | 16,379 | 16,453 | 16,380 | 15,425  | 16,196  | 15,561  | 14,919  | 16,792  |
| Gross Profit     | 8,550  | 8,091  | 8,693  | 9,020  | 9,408  | 8,968   | 9,162   | 9,241   | 9,538   | 10,204  |
| Gross Margin     | 57.2%  | 54.6%  | 53.1%  | 54.8%  | 57.4%  | 58.1%   | 56.6%   | 59.4%   | 63.9%   | 60.8%   |
| D&A Exp.         | 1,918  | 1,843  | 2,042  | 2,155  | 2,091  | 2,126   | 2,400   | 2,740   | 2,907   | 3,046   |
| Operating Profit | 2,956  | 3,049  | 3,127  | 3,334  | 3,432  | 3,386   | 2,753   | 2,749   | 2,988   | 3,423   |
| Operating Margin | 19.8%  | 20.6%  | 19.1%  | 20.3%  | 21.0%  | 21.9%   | 17.0%   | 17.7%   | 20.0%   | 20.4%   |
| Net Profit       | 1,259  | 1,481  | 1,634  | 2,047  | 611    | 1,913   | 1,924   | 1,921   | 2,200   | 2,488   |
| Net Margin       | 8.4%   | 10.0%  | 10.0%  | 12.4%  | 3.7%   | 12.4%   | 11.9%   | 12.3%   | 14.7%   | 14.8%   |
| Free Cash Flow   | 672    | 336    | 367    | 219    | (390)  | (1,529) | (1,134) | (1,874) | (2,483) | (1,924) |
| Income Tax       | 604    | 678    | 903    | 920    | (74)   | 970     | 115     | (13)    | 41      | 116     |

## Balance Sheet Metrics

| Year                 | 2012   | 2013   | 2014   | 2015   | 2016   | 2017   | 2018   | 2019   | 2020   | 2021   |
|----------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Total Assets         | 54,367 | 56,414 | 59,545 | 61,683 | 63,468 | 64,729 | 68,803 | 75,892 | 80,757 | 87,669 |
| Cash & Equivalents   | 279    | 118    | 163    | 176    | 211    | 215    | 234    | 247    | 393    | 403    |
| Accounts Receivable  | 685    | 746    | 637    | 616    | 705    | 644    | 699    | 625    | 614    | 721    |
| Inventories          | 1,519  | 1,423  | 1,317  | 1,339  | 967    | 953    | 921    | 1,169  | 1,310  | 989    |
| Goodwill & Int. Ass. | 91     | 91     | 53     | 53     | 53     | 53     | 53     | 53     | 53     | 53     |
| Total Liabilities    | 39,130 | 40,328 | 42,720 | 43,778 | 46,048 | 46,416 | 49,743 | 55,979 | 59,983 | 64,989 |
| Accounts Payable     | 1,169  | 1,266  | 1,258  | 1,418  | 1,689  | 2,065  | 1,874  | 2,086  | 1,710  | 2,055  |
| Long-Term Debt       | 18,738 | 19,134 | 19,858 | 20,373 | 21,969 | 22,812 | 25,257 | 29,564 | 33,552 | 36,069 |
| Shareholder's Equity | 15,237 | 16,085 | 16,820 | 17,892 | 17,397 | 18,287 | 19,028 | 19,632 | 20,551 | 22,433 |
| LTD/E Ratio          | 1.23   | 1.19   | 1.18   | 1.14   | 1.26   | 1.25   | 1.33   | 1.51   | 1.63   | 1.61   |

## Profitability & Per Share Metrics

| Year             | 2012  | 2013  | 2014  | 2015  | 2016   | 2017   | 2018   | 2019   | 2020   | 2021   |
|------------------|-------|-------|-------|-------|--------|--------|--------|--------|--------|--------|
| Return on Assets | 2.4%  | 2.7%  | 2.8%  | 3.4%  | 1.0%   | 3.0%   | 2.9%   | 2.7%   | 2.8%   | 3.0%   |
| Return on Equity | 8.4%  | 9.5%  | 9.9%  | 11.8% | 3.5%   | 10.7%  | 10.3%  | 9.9%   | 11.0%  | 11.6%  |
| ROIC             | 3.8%  | 4.3%  | 4.5%  | 5.5%  | 1.6%   | 4.8%   | 4.5%   | 4.1%   | 4.2%   | 4.4%   |
| Shares Out.      | 485.7 | 487.8 | 489.4 | 491.1 | 491.7  | 492.0  | 493.2  | 494.2  | 496.6  | 503.7  |
| Revenue/Share    | 30.81 | 30.42 | 33.50 | 33.54 | 33.32  | 31.31  | 32.80  | 31.42  | 30.00  | 33.46  |
| FCF/Share        | 1.39  | 0.69  | 0.75  | 0.45  | (0.79) | (3.10) | (2.30) | (3.78) | (4.99) | (3.83) |

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

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