**Recommendation: BUY**

**Total Annual Return Est.:**

|  |  |
| --- | --- |
| 3 yr FV | 10.3% |
| 5 yr FV | **7.8%** |

**Financial Snapshot:**

|  |  |
| --- | --- |
| Price | **$42.03** |
| DCF Value | **$50.27** |
| Buy Target | **$42.73** |
| Sell Target | **$57.80** |
| P/E | **16.8x** |
| Forward P/E | **16.4x** |
| Div Yield | **4.33%** |
| Market Cap | **$36.6Billion** |
| 52 Wk Range | **$48.59 - $41** |
| EPS Growth | **2.1%** |
| PEG | **2.90** |
| Credit | **A** |
| Current Ratio | **1.02x** |

**Investment Theme:** Investing in a consistent dividend-growth utilities company which is operating in an above-average population and economic growth area.

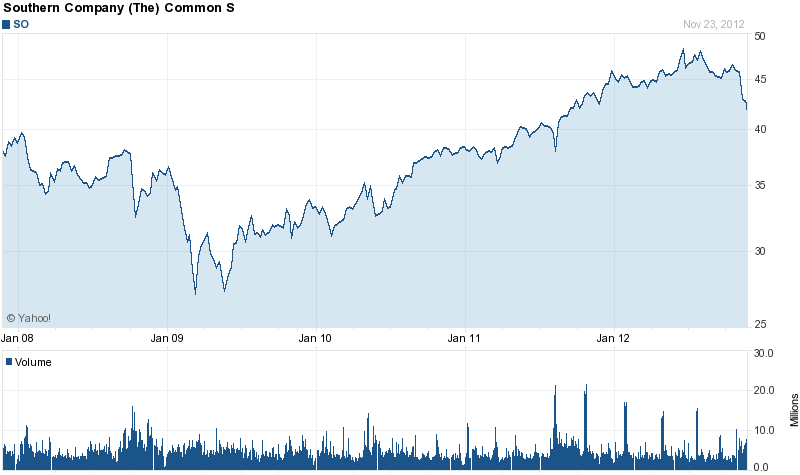
**Overview:** Operating in a volatile market, Southern Company is a well-positioned business that can maintain enviable regulatory relationships and rate structures, along with a commitment to the pure-play regulated utility model. Southern has remained on constructive terms with regulators largely because of its low-cost generating fleet, its commitment to customers, and the business-friendly atmosphere of its service territory. Its subsidiary, Georgia Power is building two nuclear units that are scheduled to begin commercial operation in 2016 and 2017. Mississippi Power, another subsidiary, is building a 582-mw coal gasification plant, which is scheduled for completion in 2014. Unlike many merchant power producers, Southern Power operates with a highly conservative framework. Management builds a plant only if it has long-term contracts already in place. The contracts have an average life of roughly 11 years, and all counterparties have investment-grade ratings.

Revenue is expected to grow between 3% and 4% annually over the next five years, driven by electricity demand from residential, commercial and industrial consumers. While demand from residential customers is weather-normalized and resilient, demand from commercial customer depends on the strength of the economy. Over the next few years, it is expected to see an increased demand from commercial sector when the economy has recovered. Long-term growth in electric utility sales to industrial customers will be much more modest than the growth for the residential and commercial sectors, reflecting the ability of large industrial firms to buy power from alternative energy providers.

Southern Company’s current price of $42.03 results in a P/E ratio of approximately 16.8x based on current-year EPS estimates of approximately $2.5, with expected EPS to rise to $2.57 in fiscal year 2013. The discounted cash flow valuation assumes a 3% annual revenue growth rate and a cost of equity 6.05%.

**2012 Q3 Results:** Southern Company announced third-quarter results that reflected some economic stagnation and weakness in its Southeastern U.S. service territories. Earnings per share for the quarter rose to $1.11,

a nearly 4% increase from $1.07 EPS for the third quarter of 2011. Regulated rates and lower operating expenses more than offset the negative impact of weather after a milder summer. Earnings through the first nine months total $2.24 per share. Southern guided for $0.38-0.40 per share for the fourth quarter.



Investment Thesis: Seeking dividends and capital preservation in volatile markets, I found Southern Company an attractive investment for three primary reasons. First, the company has a long positive relationship with regulators. Regulators determine a utility's rate mechanisms, capital base, and allowed return, which together translate into revenue collected from rate payers. Furthermore, regulation means that Southern Company is able to make up for some of its lost revenue through future rate increases. Second, the company has a relative predictable earnings and dividend stream. It has raised its dividend 11 consecutive years and analysts expect 4% annual growth through 2016. Its payout ratio has fluctuated between 69% and 86% over the last ten years. Southern Company targets its payout range from 70% to 75%. Third, population growth in Southern Company's service territories has continued despite the economic slowdown. New customers are a cheap and easy way for a regulated utility to grow. Among regions, the South has the highest population growth rate in the last ten years. From 2000 to 2010, the South’s population growth rate is 14.3%. Georgia and Florida, two of Southern Company's service territories, have very high population growth rate in the same period, 18.3% and 17.6%, respectively.

Pros:

• Southern Company has a positive relationship with regulators, the essential ingredient for success at a regulated utility. It maintains an office and staff in Washington, D.C., to interact with Congress and with agencies. It supports a number of trade organizations that engage in lobbying activities. The total expense associated with operating its federal affairs program is approximately $10 million annually. It also works with state and local legislators and policymakers.

• The region of the country served by Southern Company is undergoing significant growth, driven by population increases. The United States Census Bureau estimates that between the years 2000 and 2030, some 50% of the population growth in United States will occur in the region that the Census Bureau defines as the South, reaching from the mid-Atlantic to Texas. The Southeast and the Southern Company's territory will enjoy its share of that population growth.

• The company has a relative predictable earnings and dividend stream. It has a strong and steady cash flow from its regulated electric utility operations, its solid balance sheet, and a generally supportive regulatory environment.

• The company's in-house engineering and construction expertise allows it to build plants more cheaply than its peers and lowers maintenance and environmental compliance costs.

• With an average contract duration around 11 years, Southern Company's merchant segment, Southern Power, has lower remarketing risk than most merchant power suppliers.

• The company's management team historically has comprised highly capable and conservative individuals. Many high-level executives running other utilities trace their roots to Southern Company. Management has fostered excellent regulatory relations in its service territory.

Industry Trends: Electricity demand varies by customer sector. While the demand growth of residential customers will remain mostly weather-related, demand from the commercial and industrial sector is dependent on the strength of the economy. The federal economic stimulus package supported renewable energy projects and smart grid projects to advance green technologies and move the nation to a far more efficient and reliable electric system. A self-regulating, electric reliability organization under the jurisdiction of the Federal Energy Regulatory Commission is established to address reliability issues highlighted by the power blackout of August 2003. Public Utility Holding Company Act of 1935 was repealed to pave the way for the entry of new non-utility domestic players into the industry and for additional acquisition activity by foreign companies. Many states are examining the need to reform the cost-based framework.

Business Summary: Southern Company generates and distributes electricity to more than 4.4 million customers in the Southeast. It owns four electric utilities in Alabama, Georgia, Florida, and Mississippi and has more than 43,500 megawatts of generating capacity, the majority of which comes from coal-fired plants. Southern Company also operates a conservative merchant generation segment, Southern Power. Southern is one of the most widely held stocks in the United States.

Management Review: CEO Thomas Fanning served as CFO and COO of Southern as part of his 30-year tenure with the company before his promotion in late 2010. He has executive experience as well, having served as president and CEO of Gulf Power. Southern doesn't appear to engage in aggressive accounting, and executive compensation is targeted at the market median of its industry peer. Former CEO David Ratcliffe received $16 million of total compensation during 2010. This was largely tied to his performance-based bonus, equity awards, and other long-term compensation. More importantly, management has maintained a focus on preserving goodwill and constructive exchange between its utilities and its state regulators, which is a crucial driver of utility returns over the long run.

Financial Trend Analysis: Revenue of an electricity utility company fluctuates with the weather condition and macroeconomic condition. Over the last five years, Southern Company’s revenue has been up from 2006 to 2008, down in 2009, and up again in 2010 and 2011. Gross margin has hinged around 50% of sales. Selling, general and administrative expense has accounted for a decreasing portion in income statement. It has decreased from 23.9% of sales in 2007 to 22.3% of sales in 2011. As a result, operating margin has increased from 21.66% of sales in 2007 to 24% of sales in 2011. However, returns on equity and total capital are slightly decreasing every year because the growth rate of equity and total capital is higher than the growth rate of operating margin. Assets turnover is approximately 30% in average over the last five years. Debt/Equity ratio and Debt/Capital ratio have decreased over years. Current ratio is up and down, fluctuating from 0.95 to 1.05 for the last 5 year period. Interest coverage has ranged from 3.6 times to 4.9 times over the same period due to the volatile annual interest expense.

Financial Health: Like other industry peers, Southern Company spends tremendous amount in capital expenditures. It has projected capital expenditures of about $5.267 billion for 2012 (with $425 million targeted for environmental projects), $4.381 billion for 2013 ($405 million), and $4.341 billion for 2014 ($621 million). Southern Company uses cash from Operating Activities Cash Flow and long-term debt to fund its capital expenditure. The company's customer growth averaged around 1.7% a year in the decade before 2009, driving electricity demand increases of about 2% annually. Although usage dropped substantially in 2009 because of weak industrial demand, industrial users are the least profitable customers. Industrial usage recovered more than 7% in 2010 and a further 3% in 2011. Weather-normalized residential demand has proved resilient, and commercial demand has been slightly stable.

The company's total current liabilities increased to $6.577 billion as of December 31, 2011, from $6.472 billion at the end of 2010. With this increase and the modest increase in its total current assets from $5.883 billion at the end of 2010, to $6.262 billion at the end of 2011, the company reversed its prior trend of having its current assets being exceeded by its current liabilities. However, a $1 billion cash reserve and more than $5 billion in unused credit lines reduce short-term liquidity concerns.

Competitive Analysis:Southern Company’s retail operating companies have provided competitive wholesale power supply to the region by providing a reliable and stable resource. The company has the experience to anticipate market and weather changes and the ability to respond quickly when called upon.

As the agent for Alabama Power, Georgia Power, Gulf Power and Mississippi Power, Southern Wholesale Energy (SWE) markets the retail operating companies' surplus generating capacity to the wholesale market. SWE offers its customers high levels of reliability from a diverse mix of resources, competitively priced products, and flexibility in product offerings.

Projections and Valuation Summary: The valuation is based on the low end of current estimates of 3% annual revenue growth in a range of 3%-4%. With the decreasing trend of cost of goods sold in the last five years, I projected COGS at 34% of sales in average for the next five years. Selling, general and administrative expense was estimated at the average historical percentage of SG&A expense in the last five years, accounting for 28% of sales. Depreciation expense is calculated by timing projected sales and the average historical percentage of depreciation over sales in 5-year period. The same rule is applied for interest expense.

Due to its huge capital expenditure, Southern Company has negative free cash flow and negative free cash flow to equity investors. Therefore, I employed dividend discount model and excess return model to evaluate the company. Instead of WACC, cost of equity is used in these two models. Southern Company has a very low beta, resulting in a low cost of equity. For a more conservative valuation, I use beta of 0.75, which is the highest beta among its peer.

Risk Factors:

• The biggest threat that Southern Company faces is a deterioration of its regulatory relationships in its four retail service territories. As having said, much of the company's success hinges on the relationships it has built through years of low power prices and excellent customer service.

• Much of the company's generating fleet burns coal, so any emission legislation could require expensive compliance that could raise customers' bills and discourage usage. Its fleet is especially exposed to Air Toxics Rule compliance.

• As the industrial growth and strength in the region where Southern Company is operating has been driven to a large extent by exports, export weakness from a slowdown in global economic activity is proving a drag on the company’s performance. A continued lull in global demand for U.S. exports would affect the company more than most of its peers outside the Southeast.

• If tough federal environmental regulations raise investment needs and costs for customers, regulators might be less willing to support above-average allowed returns on equity.

**Dividend Discount Model:**



**Excess Return Valuation Model:**



**Comparative Valuation Analysis:**



**Cost of equity Calculation: Total Return Calculation:**



**Valuation Assumptions:**



**Income Statement Projection:**



**Historical Financial Data:**









**Notes:**