

# **The Battle of Southern Company**

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# Shedding Light on Power

At Qube, we view the process of analyzing a stock as a craft. For instance, consider the analyst as a carpenter—shaping a piece of wood (equity) into their vision (valuation). They may follow the general practices of the craft such as not cutting against the grain but, when it comes to selecting their tools; materials; and techniques, it is ultimately up to their own experience and skills. A craft allows flexibility and, for a craftspeople, there is no one “right” way to create.



When it comes to selecting what makes it into Qube’s Kaleo portfolio, however, no one person wields all the power. Instead, we are a team of craftspeople and trust our analysts to design their own narratives under the guidance of one of our portfolio managers and pitch their narrative to our Steering Committee who then vote for or against the inclusion. One such event of the past year stands out, however, for being more thrilling than the usual process of proposing a stock for Kaleo.

We had a student analyst come on board in 2019 who developed an excellent track record. After a couple years with us, he had established enough credibility within Qube to be given the discretion to reject the portfolio manager’s guidance when designing his narrative. The company he pitched? Southern Company (SO).

SO is a king in the space of North American utility companies: servicing roughly 9M homes in the southern US. SO generates more than 44,000 MW of energy sourced from natural gas, coal, nuclear, and renewables. (For context, 1 MW is 1,000,000 watts and can supply more than 650 homes with power.) Further, 12,000 MW of that is sourced from 45 solar facilities and 15 wind farms in Texas, California, and other states. And further still, SO’s gas subsidiary distributes natural gas through roughly 76,000 miles of pipeline.

The Trans-Canada Highway spans roughly 4,900 miles, meaning these pipelines can go across Canada 15 times over.



At its essence, 70% of SO’s business is as a traditional utility company, delivering electricity utility to consumers, while 15% comes from the distribution of natural gas, 10% from building and operating power generating assets for the wholesale market, and 5% from miscellaneous side businesses such as wireless communications.

At the time of the student's analysis, SO was trading at \$67.65 per share. He believed SO's intrinsic value was \$82.40, while the portfolio manager believed it to be \$60.24. As we go deeper into the arguments made for and against Southern Company's inclusion in Kaleo, consider the student to be like Nikola Tesla—a passionate 19th century proponent of electrical modernization who was ready to shake things up. Conversely, the portfolio manager was more akin to Thomas Edison, the former mentor and natural opponent of Tesla, who stood more conservative in his beliefs and entrepreneurial endeavours. Edison advised caution while Tesla was willing to take greater risks in the name of advancement.



### **Thesis 1: Below the Belt, Above the Base**

The geographic shift to the southern states has been slow but sure: a greater degree of migration and reproduction that appears to be accelerating in the face of the overall declining population growth in the rest of the US. In fact, southern cities are averaging a growth rate of 11.8% per annum since 2010, compared to the 9.1%, 3.1%, and 1.5% average growth rates of the West, Midwest and Northeast, respectively.

Where there are consumers, demand is sure to follow, right? Well, Tesla expected Southern Company to experience a minimum of 2% revenue growth annually based on this assumption. Perhaps the sunnier southern states will lead to even sunnier market expectations?

Edison was not willing to concede on this point. Even if these optimistic projections of population growth do pan out, this only proves beneficial to a segment of Southern Company, specifically the 70% of the business that services consumers. Meanwhile, there will be an indeterminate effect on the wholesale side since it is determined by supply and demand, unlike the rate-regulated consumer segment.

Further, there is an argument to be made that the population forecast is an overgeneralization, and there is no specific data to suggest that the major cities in regions serviced by SO are those expected to grow at a higher rate. In other words, there is not enough information to conclude all segments of SO will benefit from general population growth nor can the 2% minimum revenue growth be guaranteed. Although Edison humoured his adversary and left the 2% rate consistent, if we adjusted the Terminal Growth to reflect the 70% segment, we would find the Intrinsic Value to have decreased as such:

	Terminal Growth of 2%	Terminal Growth of 1.4%
<b>Terminal Value of SO</b>	\$182.06	\$166.66
<b>Intrinsic Value of SO</b>	\$82.40	\$71.43

## Thesis 2: Southern Company's New New Green Deal?

As we hopefully approach the exponential part of clean energy demand, so too would there be an exponential increase in renewable energy projects. But the ball is beginning to roll faster thanks to a firm nudge from the Biden administration, which introduced a tax incentive (upwards of a 60% tax credit for 10 years), higher emission standards, and the adoption of electric vehicles in public and private spaces.

As it stands, Southern Company has historically paid a 14% tax rate, which we could expect to remain constant or decrease over the next 30-50 years with the belief that green tax incentives continue. Although the Biden administration's goals of a decarbonized electric grid by 2035 and carbon neutrality by 2050 are aggressive, the \$1 trillion infrastructure plan and \$3.5 trillion spending package have likely carved out significant room for green payment programs, which would increase Southern Company's tax efficiency via lower tax burden and access to financing—as argued by Tesla.

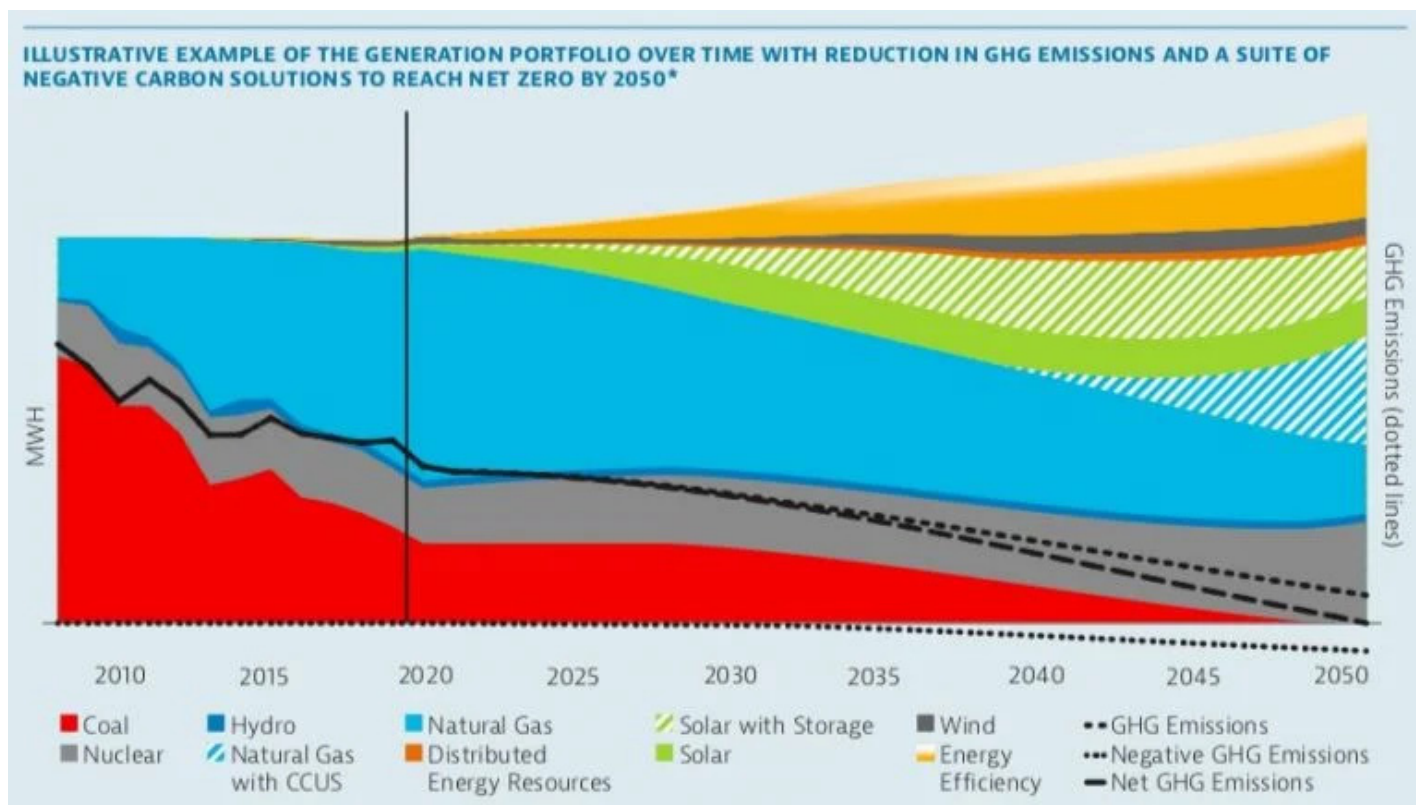
However, the shift to renewables is not a direct benefit to Southern Company's bottom line either—as pointed out by Edison. This kind of transition requires a great deal of capital expenditure, more so than what utility companies are already known for. The political-economic door swings both ways; in a rising interest rate environment, inflexible and costly capital expenditures grow even more expensive. It is unreasonable to expect taxes to stay low and incentives to remain high in perpetuity. Independent of Thesis 1, we see:

	Perpetual Tax Rate of 14%	Perpetual Tax Rate of 21%
<b>Terminal Value of SO</b>	\$182.06	\$168.26
<b>Intrinsic Value of SO</b>	\$82.40	\$73.92



### Thesis 3: Shifting Landscapes and Advancing Fronts

In an evolving world, even the most vanilla utility companies need to undergo radical transformation to survive. In the case of Southern Company, the next 30 years will look nothing like the prior 30. For instance, even though coal may have driven the metaphorical engines of the economy back in Tesla & Edison's time, it appears its heyday is far behind us.



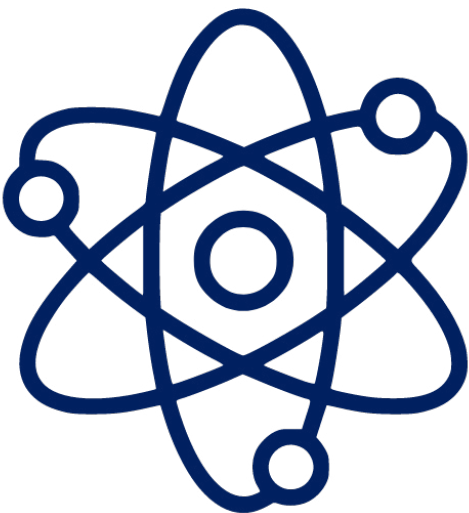
Tesla would argue that though coal was responsible for 80% of energy production in the year 2000, as of the last few years, it accounts for only 20%. Meanwhile, renewables have gone from 1% of the energy portfolio in 2007 to just above 15%. Not only does this shift potentially strengthen SO's bottom line(economically and environmentally), but it also provides them flexibility in meeting energy demand should volatile commodity prices fluctuate to the point where it is prudent to tap into cheaper sources.

As the saying goes: change comes with growth! Thanks to rapid urbanization and the expansion of smart grid networks which replace the 50-year-old infrastructure that currently services the US, Southern Company may have positioned themselves to capitalize on these trends.

Yet, our Edison believes these industry forecasts may not be fully applicable to Southern Company's specific circumstances. The forecasts only determine how much money is being invested into assets, not how much these assets will generate in additional revenue. Further, the benefit can come from reduced cost margins, instead of extra revenue coming in—nor is there any guarantee that a benefit could be found post-construction of the additional assets.

In Weal and Nuclear Woe

On the topic of capital expenditures, Southern Company’s recent project track record does reveal a red mark in Edison’s ledger: the Vogtle Nuclear Plant Project. Starting in 2008, Southern Company intended to build two more nuclear plants in addition to their existing two units. However, over a decade later, and \$20 billion over-budget on their \$14.3 billion estimate, we will not be seeing the two units fully operational for at least another year.



This is compounded by a 2017 blunder that led to a \$3.4B write-off of their Kemper Project. The project attempted commercial scale carbon capture by using cheap lignite coal to produce natural gas to run a power plant. As a result of the project’s failure, questions were raised against SO’s management team. Considering the scales at which costly mistakes attach themselves to these large projects that management approved, Tesla may be growing weary, and Edison could have the last laugh.

The Man in the Political Machine

Compared to the other utility players in the U.S., SO boasts the highest return on equity, while being less reliant on leverage than its peers. In other words, they achieve higher returns with less debt, despite the Vogtle and Kemper project blunders. Why is that? They are a political machine: efficiently managed and maintaining a favorable relationship with their regulators which allows them to negotiate better terms of profitability—at least according to Tesla.

Yet, one of the biggest threats could be a deteriorating relationship with the regulators. The real-world Edison once oversaw Tesla’s work in the early stages of their careers. Eventually, the relationship soured and Tesla was left penniless. Similarly, who is to say that a favourable working relationship between SO and the regulators will exist forever?

Building off Thesis 2, we arrive to the key differences that set apart our narrators:

	CAGR of 4.5%	CAGR of 2.9%
Intrinsic Value of SO	\$82.40	\$65.53
	Sales to Capital of 0.28	Sales to Capital of 0.23
Intrinsic Value of SO	\$82.40	\$60.24

Thesis 4: The Dividend Aristocrat

Finding an intrinsic value is only one part of the craft that is equity valuation. It is also crucial to define a catalyst or an event that would trigger the rest of the market to realize the stock is under-valued. Enter Tesla’s explanation of how SO would potentially soar to his idealized value.

The prestigious “Dividend Aristocrat” club has a high entrance fee: to the tune of a minimum 25 consecutive years of rising dividends. This lofty group hosts roughly 65 members—including Kaleo’s own Clorox Company (CLX), Colgate-Palmolive (CL), S&P Global (SPGI), Target (TGT), and Walmart (WMT), to name a few. With a 4% annual dividend that continues to climb, Southern Company is on a 20-year streak which might get them a golden ticket to the party! Four per cent is nothing to scoff at either; considering the average dividend yield of the S&P 500 is only 1.5%, and the highest investment-grade corporate bond index is only 2.56%.

Becoming a Dividend Aristocrat comes with some excellent membership perks too. Many passive investors will seek out blue-chip companies with high dividend yields. Should Southern Company make it on the shortlist for these investors, we might expect to see a significant enough catalyst carry this utility king to Tesla’s intrinsic target.

Although this catalyst has no bearing on the intrinsic value itself, Edison was of the mind that this narrative was flawed as well. A slow-growth high-dividend equity functions more like a bond relative to other securities. Thus, in a rising rate and/or inflationary environment, these bond-like securities perform worse than other types of securities.

### Dimming the Lights

Ultimately, Tesla’s theses painted an optimistic picture; there is no doubt about that. However, Edison believed the shining lights of SO may have blinded Tesla to some harsh realities.

When it came time to forecast revenues, our analyst was far too reliant on population growth and the industry trend—both of which may have been extrapolated beyond what was reasonable. One would be hard pressed to simply take these forecasts at face value and, when it comes to investing large sums, it is crucial to err of the side of caution rather than zeal.

And so the battle between Qube’s own Tesla and Edison came to an end. Despite being strong in his conviction, the student analyst was unable to sway the committee to his side. Our portfolio manager’s cautious nature ended up guiding our decision to refrain from adding Southern Company into our Kaleo portfolio.

With several months of hindsight, who turned out to be correct? It is still too soon to say. But from its original price of \$67.65, Southern Company was sitting at a value of \$70.04 at the time of publication. But to focus on this specific outcome is to miss the point entirely!



This showdown illustrates an important lesson: There is more to the craft of valuation than simply numbers and science. Under the hood of the Kaleo engine that drives Qube, each of our analysts leave a part of themselves. Their narrations and convictions are the foundation of what defines us. And, even if every proposal does not cross the finish line, it is always a spectacle to witness two powerhouses of our team go head-to-head.

Our rigorous stock selection process gives us the edge over other investment firms. Qube's in-house research program is one of our greatest points of pride. To learn more about how our valuation strategy makes your investments matter, reach out to us by [email](#) or call [\(780\) 463-2688](tel:(780)463-2688).



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