SWN Southwestern Energy®

MFIF Minutemen Fixed Income Fund

Southwestern Energy Company (NYSE: SWN)

Analyst: Khalil B. Fenina

We recommend a market overweight position for SWN's 7.750% 2027 Senior Unsecured Notes. Southwestern Energy Company is an oil and gas exploration and production operator headquarted in Houston, Texas. Its roots can be traced back to 1929, when it was founded as Arkansas Western Gas Company. Today, however, nearly all of the company's proven reserves and operations are in the Appalachian Basin, where it is the third largest producer. With the bulk of its opeations taking place in West Virginia and Pennsylvania, natural gas accounts for approximately 80% of the company's revenue, with oil and condensate representing roughly 18% and 2% respectively. The space is currently undergoing large scale consolidation, something Southwestern has played an active role in. Most recently, the company acquired Montage Resources in November 2020 for $193 million, funded mostly by debt. The sharp increase in revolver balance, as well as the state of the energy sector at the time, resulted in the market viewing this acquisition with skepticism. The implication was an oversight of the merger's resulting synergies, which we believe more than justify the purchase, and which will in fact facilitate debt reduction in the long term. Furthermore, while the company's aggressive cost reduction initiatives are not unique in the industry, Southwestern's efficiency gains through a lengthening of their laterals and double zipper fracking set it apart from its peers. Because of this, as well as a rapid decrease in leverage back to 2019 levels thanks to a strong free cash flow, we believe SWN's 2027 notes will tighten by ~100 bps relative to its peer group as the market fully appreciates the company's efficiency gains, Montage synergies, and free cash flow, and as the energy sector recovers as a whole.

Security Data

Bond Maturity: 10/01/27
S&P Rating: BB-
Rank: Sr. Unsecured
Price: $107.55
YTW: 5.329%
Next Call Date: 10/01/22
Coupon: 7.750%
OAS: 505.43 bps

LTM Adjusted EBITDA	742.00	**Market Cap**	**2,657.36**
		Add: Debt	3,171.00
Current Share Price	3.94	Less: Cash	(13.00)
Shares Outstadning	674.46	**Enterprize Value**	**5,815.36**

Type of Debt	Rate	Maturity	Debt Outstanding	x LTM Adjusted EBITDA	Dirty Price	Yield
Revolving Credit Facility	2.110%	4/15/24	700.00		N/A	N/A
Total Revolvers			**700.00**	**0.94x**		
2022 Sr. Unsecured Notes	4.100%	3/15/22	207.00		101.85	1.901%
2025 Sr. Unsecured Notes	4.950%	1/23/25	856.00		108.98	4.177%
2026 Sr. Unsecured Notes	7.500%	4/1/26	618.00		106.48	3.035%
2027 Sr. Unsecured Notes	**7.750%**	**10/1/27**	**440.00**		**107.55**	**5.239%**
2028 Sr. Unsecured Notes	8.375%	9/15/28	350.00		109.64	6.061%
Total Senior Notes			**2,471.00**	**3.33x**		
Total Debt			**3,171.00**	**4.27x**		

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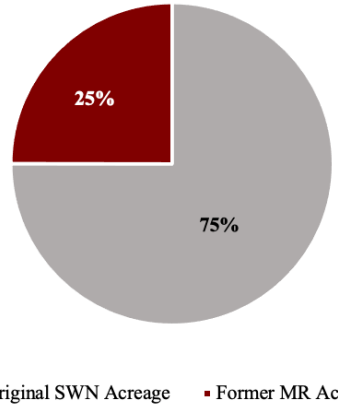
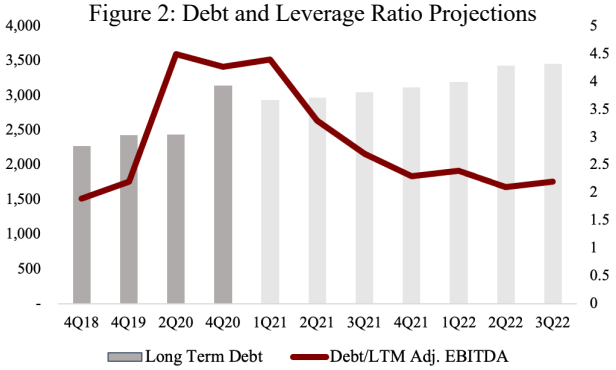
Southwestern Energy has a proven track record as a successful consolidator, and its latest acquisition of Montage Resources is set to continue the company's streak. Excluding some 2,518,519 net acres in the Candian province of New Brunswick, where a moratorium on hydraulic fracking is currently in place, the integration of MR's assets into its portfolio will give the company a total net acreage of more than 781,000 across three states and create a presence for SWN in southeastern Ohio. Company management and consensus expect natural gas output to be ~3 Bcfe/d, making Southwestern the 3rd largest producer in the Appalachian Basin. This will allow for an accelerated achievement of deliveraging goals. Additionally, the significant acreage overlap between the two companies prior to the merger has allowed SWN to capture synergies quickly and efficiently. Despite the merger having only occurred in 4Q20, the company has already used Montage volumes to finalize its own transportation commitments and eliminate excess capacity, creating a much more operationally lean player in the process. Furthermore, its all-stock takeover of Montage Resources (MR) has already afforded Southwestern meaningful benefits worth ~$30MM from SG&A alone, thanks to an aggressive reduction in operational redundancies. To that end, a closer look at the most recent 10-K reveals that the company's employee count at YE20 represented a 2% decline from that of YE19, despite the integration of the Montage workforce. This, along with the retirement of MR's 2023 debt maturity shortly after the deal's closing, underlines the company's success in absorbing their acquiree from both an operational and financial standpoint, and leads us to conclude that the market's lukewarm reaction to the takeunder was partially misguided.

Figure 1: Acreage Prior to Montage Merger



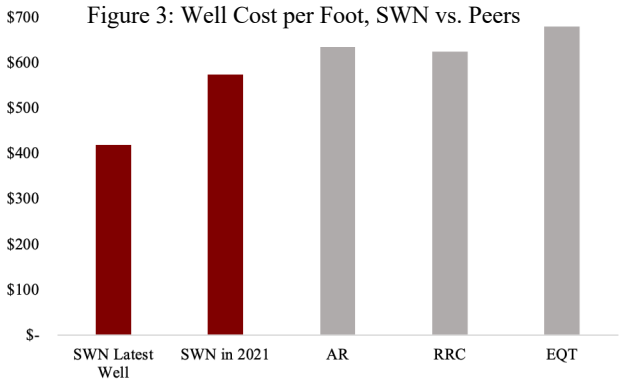
Source:Business Wire, Company Filings

Figure 2: Debt and Leverage Ratio Projections



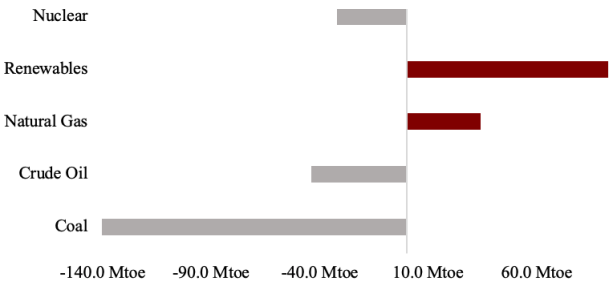
Sources: Company Filings, MFIF Analysis

Figure 3: Well Cost per Foot, SWN vs. Peers



Sources: Investor Relations, WorldOil.com

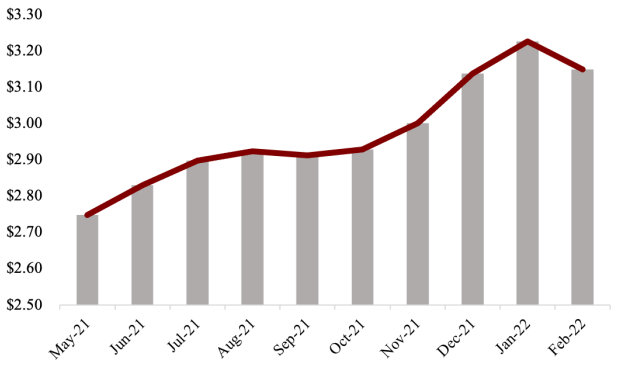
Figure 4: Change in US Energy Demand by Source



Source: International Energy Agency

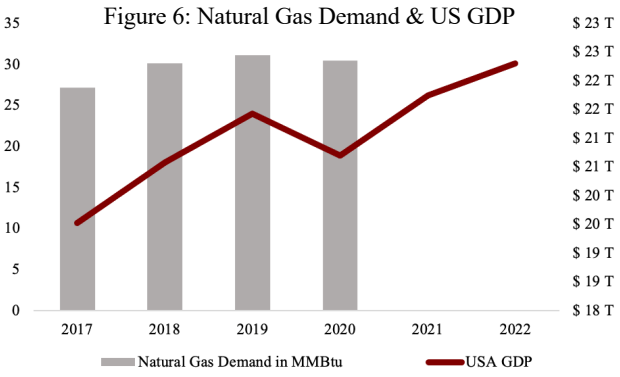
Southwestern has been lengthening the laterals of its wells and implementing its differentiated drilling and completion methods in order to maximize efficiency and postponement of its assets' resource exhaustion. These methods will boost average lateral length in 2021 by 15.1% to 14,000 ft, up from 12,154 ft in 2020. Completion methods such as double zipper-frac are made possible thanks to the company's own fracking fleet which it uses to complement its contractors, creating a shield from well completion price swings and decreasing cycle times. SWN also executes 100% of its well drilling, minimizing project costs and shortening their duration. These initiatives have already afforded the company substantial efficiency gains, and will continue to create benefits as Southwestern moves its in-house drilling and completion operations into the Ohio Utica acreage, which it recently acquired with its takeunder of Montage Resources. As a result, overall average well cost per lateral foot is expected to decrease by 10% in 2021, from $637 in 2020 to ~ $575 in 2021. Furthermore, Southwestern's most recent well operation in Northeast Appalachia achieved a lateral of 19,700 ft, with a record-low cost of $419 per foot. This stands as a testament to the benefits of SWN's cost control efforts, which allow the company to extract more resource from its acreage and have proven their value during the recent periods of unprecedented volatility.

Figure 5: Natural Gas Futures



Source:Bloomberg Terminal

Figure 6: Natural Gas Demand & US GDP



Sources: International Monetary Fund, US Energy Information Administration

SWN's increased scale and production capacity, coupled with its peer-leading efficiency gains, will prove propitious to revenue and, crucially, free cash flow. This, at a time when commodity prices are mostly favorable for the industry, especially those of natural gas to which Southwestern enjoys an outsized exposure. The company is able to maintain positive, sustainable free cash flow at a NYMEX Natural Gas price of $2.60 per MMBtu. With prices currently hovering at around $2.73, SWN is well positioned to reep the benefits of a swift-recovering energy market. Moreover, if futures contracts are anything to go by, prices are expected to increase over the coming months to $2.90 per MMBtu. In a bullish scenario, at $3 per MMBtu, company management believes free cash flow to exceed an impressive $375 MM for the year. The long term outlook for natural gas, SWN's main output commodity, remains positive, much more so than crude. Demand for natural gas in the United States has been growing with the US economy over the last decade, and shrank only modestly relative to the severe contraction witnessed amid the pandemic-realted lockdowns in 2020. As the economy emerges from its current state, demand for natural gas is expected to follow. Worth noting however, is that the current White House administration has clearly stated its ambitious emissions reduction targets. Nevertheless, the small carbon footprint of natural gas relative to that of crude oil has cemented its reputation as a cost-effective alternative to renewables, thus endearing it to policy makers and solidifying its future in the US energy landscape for decades to come. With natural gas demand expected in increase 7% nationally between 2020 and 2029, SWN's cash flows will prove sustainable in the long run.

Bonus Points

- Southwestern Energy is a downside-biased hedger, with 80% of their 2021 projected revenues hedged. In 2020, the company realized a $362 MM gain from its hedging activities alone.
- A strong rebound in NGL demand and prices as the world economy continues its recovery from the pandemic-induced slump will boost the company's revenue and cash flow.
- Despite operating in the E&P space, SWN makes for a surprisingly decent ESG candidate, with its commitments to water conservation being a particular strong suit.

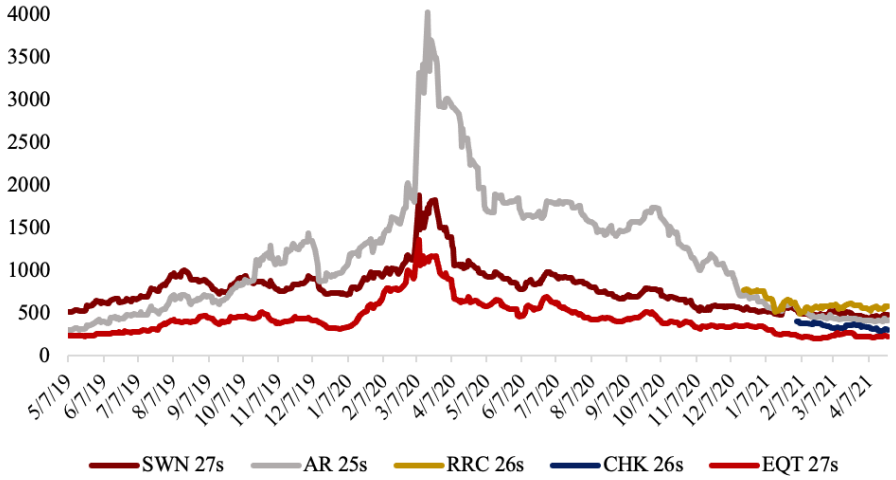
Risks to Thesis

- The free cash flow needed for SWN to deliver on its deleveraging goals is contingent on a minimum $2.60 Bcfe NYMEX. Unexpected shocks to either side of the market could undermine or jeopardize the SWN's plans.
- Differentials in the Appalachian Basin have caused headaches for management in the past. While the majority of its production is hedged against this, such measures may prove insufficient were differentials to widen significantly.
- The increasing popularity of anti-fracking state lawmakers in Pennsylvania, where the company has significant operations, could potentially result in a regulatory headwind in the medium term.

Comps *(USD in millions)*	RRC	SWN	AR	EQT	CHK
Market Cap	2,251.0	**2,667.0**	2,723.0	4,830.0	4,516.0
Debt	3,085.6	**3,171.0**	3,759.0	4,671.5	-
Net Debt	2,627.6	**3,158.0**	3,759.0	4,653.3	-
Enterprise Value	4,878.6	**5,825.0**	6,482.0	9,483.3	4,516.0
Adjusted EBITDA* (LTM)	(57.9)	**742.0**	1,002.0	1,546.6	(8,694.0)
Debt/Adj. EBITDA (LTM)	-53.33x	**4.27x**	3.75x	3.02x	NA
Net Debt/Adj. EBITDA (LTM)	-45.41x	**4.26x**	3.75x	3.01x	NA
Interest Expense	192.7	**182.0**	199.9	271.2	NA
Adj. EBITDA/Interest (LTM)	-0.30x	**4.08x**	5.01x	5.70x	NA
FCF (LTM)	31.0	**(207.0)**	(88.1)	42.2	115.9

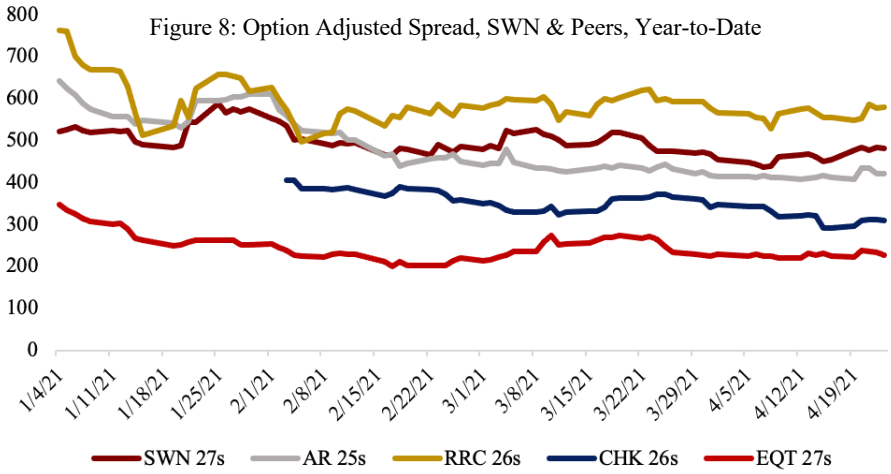
Individual Securities	RRC	SWN	AR	EQT	CHK
Rating (S&P)	B+	**BB-**	B+	BB	BB-
Coupon	9.25%	**7.75%**	5.00%	3.90%	5.50%
Maturity Year	2026	**2027**	2025	2027	2026
Maturity Date	2/1/26	**10/1/27**	3/1/25	10/1/27	2/1/27
Price (Dirty)	111.10	**107.46**	100.44	102.92	106.99
YTW	6.05%	**5.26%**	5.07%	3.41%	3.64%
OAS	556.2	**454.8**	451.2	232.9	301.3
Next Call Date	2/1/22	**10/1/22**	5/24/21	7/1/27	
Spread/Turn of Leverage	-12.25	**106.86**	120.27	77.41	NA

Figure 7: Option Adjusted Spread, SWN & Peers, 2-Y Historical Data



Source:Bloomberg Terminal

Figure 8: Option Adjusted Spread, SWN & Peers, Year-to-Date



Source:Bloomberg Terminal

SWN's 2027 Senior Unsecured Notes are currently trading at an OAS of ~ 505 bps. The notes had been tracking the industry's tightening trend since mid-October 2020, but widened relative to peers as the market expressed skepticism of the Montage Resources acquisition and as Antero Resources (AR) tightened in February after the freeze benefitted the company at the onset of its fiscal year. Southwestern operates exclusively in the Appalchian, and therefore the effects of the winter storm did not meaningfully benefit the company. However, we believe this to be a market overreaction and an underestimation of SWN's superior position to that of AR.

SWN's notes are currently trading extremely tight to those of AR. While Antero Resources does currently enjoy a lower leverage ratio than that of SWN, it does not possess the ability to achieve the degree of efficiency that Southwestern can. While SWN drills 100% of its wells and operates its own in-house fracking fleet, AR has resorted to a partnership with Quantum Energy Partners, a Texas-based private equity firm, to fund its drilling operations. Despite the market's positive reaction to this, we believe it solidifies SWN's efficiency advantage.

Moreover, the company's leverage ratio is on track to improve much quicker than that of EQT or RRC, with researchers at JPMorgan estimating SWN's YE22 Net Debt/EBITDA ratio to be 1.9x, compared with EQT's 2.0x and RRC's 2.8x. Southwestern is also more hedged than most of its peers, with over 80% of its projected 2021 revenues shielded from the downside. That's higher than RRC's ~65%, but lower than EQT's ~95%. Even so, SWN is closest to EQT in terms of its hedging position, with a slightly lower 2022 projected leverage ratio. For that reason, we expect SWN's 2027 Sr. Unsecured Notes to tighten towards those of EQT by ~100 bps over the next 18 months as the market witnesses their rapid leverage recovery in 2021, their efficiency advantage, and fully prices in the synergies resulting from the Montage merger.

Summary Model

SWN Southwestern Energy® MFIF Minutemen Fixed Income Fund

Southwestern Energy Company
NYSE: SWN

	FY2018	FY2019	FY2020	1Q21	2Q21	3Q21	4Q21	FY2021	FY2022	FY2023
Income Statement										
Revenue	3,862.00	3,038.00	2,308.00	1,221.94	1,247.92	1,264.69	1,329.38	5,063.92	4,709.65	4,763.10
Operating Expenses	(3,065.00)	(2,768.00)	(5,179.00)	(1,209.72)	(1,235.44)	(1,252.04)	(1,316.09)	(5,013.28)	(4,662.55)	(4,715.47)
Operating Income	797.00	270.00	(2,871.00)	12.22	12.48	12.65	13.29	50.64	47.10	47.63
Interest Expense	124.00	65.00	94.00	43.78	43.92	43.78	43.92	175.39	171.15	166.90
Pretax Income	538.00	480.00	(2,705.00)	0.11	3.45	9.66	18.99	32.21	97.07	50.85
Net (loss) income	**537.00**	**891.00**	**(3,112.00)**	**0.11**	**3.45**	**9.66**	**18.99**	**32.21**	**97.07**	**50.85**
Depreciation & Amortization	560.00	471.00	357.00	85.55	88.43	91.37	94.40	359.75	402.49	446.28
Interest Expense	124.00	65.00	94.00	43.78	43.92	43.78	43.92	175.39	171.15	166.90
Tax Expense (Benefit)	1.00	(411.00)	407.00	-	-	-	-	-	-	-
EBITDA	**1,222.00**	**1,016.00**	**(2,254.00)**	**129.43**	**135.80**	**144.81**	**157.31**	**567.35**	**670.71**	**664.03**
Balance Sheet Snapshot										
Current assets:										
Cash and cash equivalents	201.00	5.00	13.00	44.73	5.00	5.00	5.00	5.00	5.00	5.00
Accounts receivable, net	581.00	345.00	368.00	577.25	589.52	597.44	628.00	628.00	587.02	612.29
Derivative assets	130.00	278.00	241.00	241.00	241.00	241.00	241.00	241.00	241.00	241.00
Other current assets	44.00	51.00	49.00	49.00	49.00	49.00	49.00	49.00	49.00	49.00
Total current assets	956.00	679.00	671.00	911.98	884.52	892.44	923.00	923.00	882.02	907.29
Property, Plant, & Equipment	4,656.00	5,267.00	4,111.00	4,197.94	4,288.49	4,380.29	4,485.23	4,485.23	4,725.15	4,934.64
Current Debt	-	-	-	207.00	207.00	207.00	207.00	207.00	-	-
Accounts payable	609.00	525.00	573.00	898.81	917.92	930.25	977.84	977.84	914.03	953.37
Total current liabilities	846.00	848.00	1,012.00	1,544.81	1,602.44	1,690.51	1,805.02	1,805.02	1,901.89	2,080.80
Long-term debt	2,318.00	2,242.00	3,150.00	2,943.00	2,981.53	3,057.26	3,124.18	3,124.18	3,491.86	3,631.43
Total Liabilities	3,435.00	3,471.00	4,663.00	4,867.49	4,884.41	4,929.31	4,993.31	4,993.31	4,973.03	5,021.17
Cash Flow Statement										
Cash from Ops	1,223.00	964.00	528.00	337.22	233.72	240.44	265.42	1,076.80	1,016.74	1,051.20
CapEx	(1,290.00)	(1,045.00)	(881.00)	(305.49)	(311.98)	(316.17)	(332.34)	(1,265.98)	(1,177.41)	(1,190.77)
Interest Expense	124.00	65.00	94.00	43.78	43.92	43.78	43.92	175.39	171.15	166.90
Basic FCF	57.00	(16.00)	(259.00)	75.51	(34.34)	(31.95)	(23.01)	(13.79)	10.48	27.33
Payments of Debt	(2,095.00)	(106.00)	(72.00)	-	-	-	-	-	(207.00)	-
Proceeds from Debt	-	-	-	-	38.53	75.73	66.93	181.18	367.67	139.57
Cash from Financing Actv.	(2,147.00)	(115.00)	361.00	-	38.53	75.73	66.93	181.18	160.67	139.57
Credit Ratios										
FCF/Debt	**2.5%**	**-0.7%**	**-8.2%**					**-0.4%**	**0.3%**	**0.8%**
FCF/Interest	**46.0%**	**-24.6%**	**-275.5%**					**-7.9%**	**6.1%**	**16.4%**
Debt/Adj. EBITDA	**1.9x**	**2.2x**	**4.5x**					**2.3x**	**2.2x**	**2.0x**
EBITDA/Interest	**9.9x**	**15.6x**	**-24.0x**					**3.2x**	**3.9x**	**4.0x**

Email Questions to Khalil Fenina at kfenina@umass.edu .