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Southwestern Energy: Troubled by its bet on natural gas

By Yong Kit Siong

Southwestern Energy Corp (Southwestern), a natural gas exploration and production (E&P) and midstream services company headquartered in Texas, has been the biggest decliner on the S&P 500 energy sector with a 29% drop since the start of 2017 as the price of gas futures dropped 18%.

As a firm believer in hydraulic fracturing and the profitability of natural gas, Southwestern acquired Chesapeake's 413,000 net acres of natural gas assets in West Virginia and Southwest Pennsylvania in 2014. However, the acquisition happened at a time when big market players, such as Chesapeake Energy, BHP Billiton and Exxon Mobil's XTO Energy, had abandoned natural gas business because prices were already twice lower than a few years ago. Unfortunately, the price of natural gas continued to slump further post-acquisition.

As a result of the deal, Southwestern's leverage increased considerably. The deal was completed at an adjusted purchase price of approximately USD 4.975bn, out of which USD 4.5bn were raised from a 364-day senior unsecured bridge term loan credit facility. Analysts on Wall Street deemed the purchase price too high and were doubtful about the deal. The high leverage has had severe consequences for Southwestern. As seen in Figure 1, due to the acquisition of natural gas assets, the debt that the company piled up made its Total Debt to Total Capital, significantly higher than the average of its industrial peers throughout Q3 2015 to Q4 2016, despite efforts to strengthen its balance sheet.

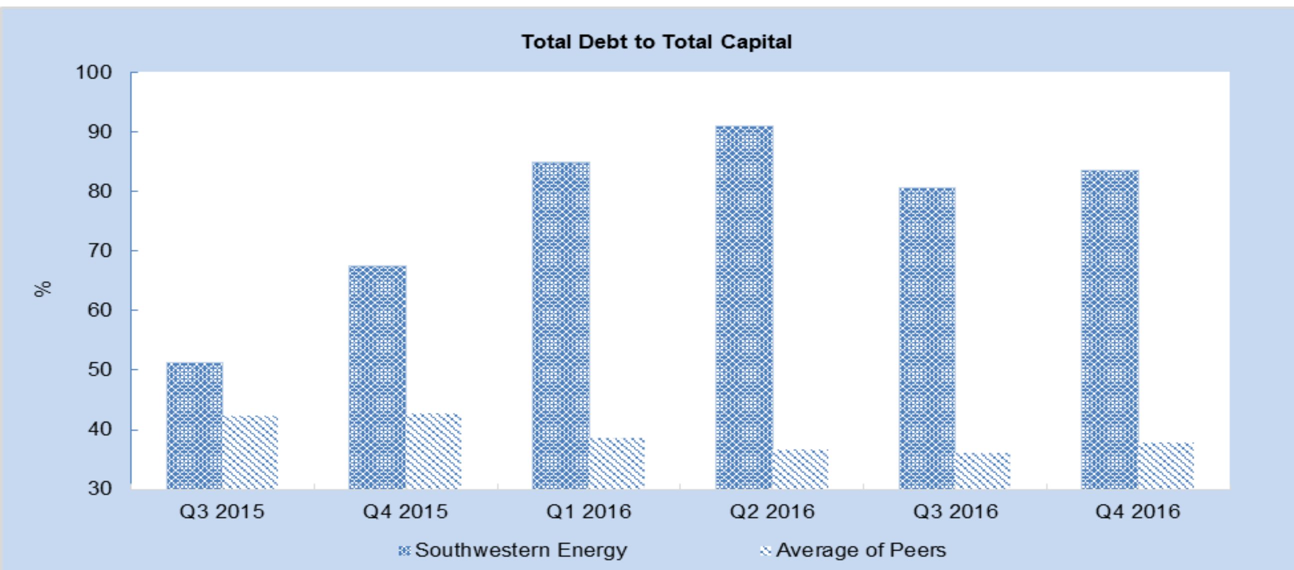

Figure 1: Comparison of Southwestern Energy with its 3 industrial peers (Anadarko, Cabot and EQT Corp) *Source: Bloomberg*

With higher-than-peer leverage, the firm faced higher credit risk in cases of commodity market downturn. As shown in Figure 2, the RMI-CRI 1-year Probability of Default (PD) of Southwestern experienced a relatively high and volatile period from late 2015 to early 2016, coinciding with the period of low natural gas prices. During the same period, the company laid off 1,100 workers and saw its credit rating downgraded by Moody's. Since the beginning of this year, Southwestern's PD also rose from 78.3bps to 235.25bps (as of 28th Feb 2017) as natural gas prices fell again. This negative correlation can be explained by the fact that Southwestern derives more than 80% of its revenue from natural gas.

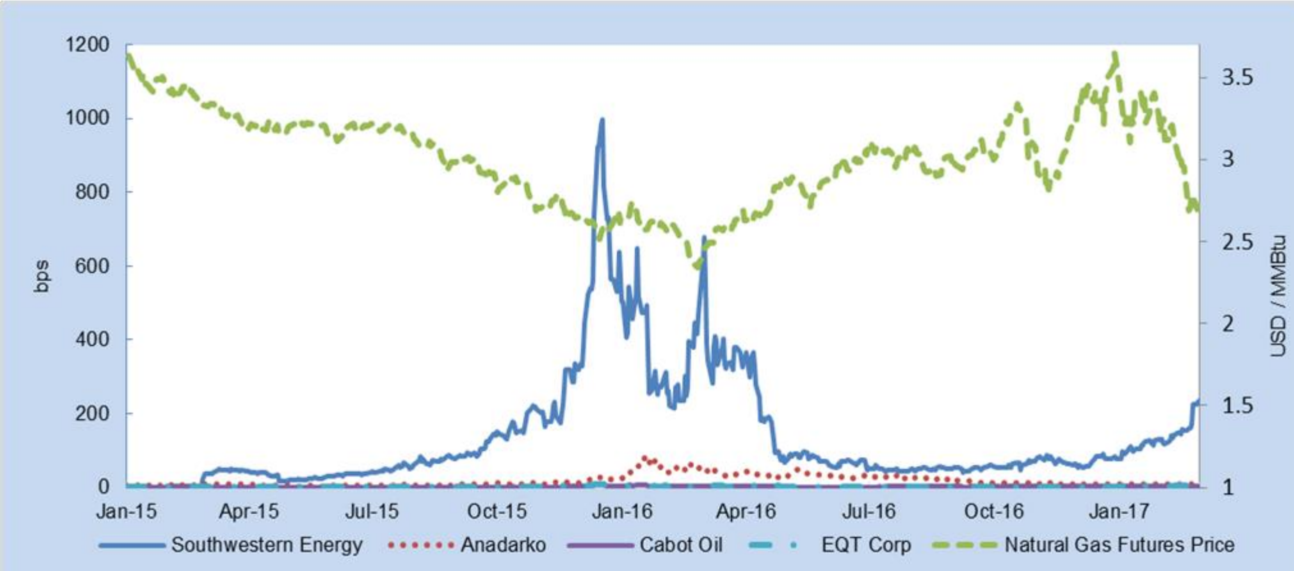

Figure 2: RMI-CRI 1-year PD for Southwestern Energy Corp. and key peers (Anadarko, Cabot and EQT Corp) (LHS). Nymex Natural Gas April17 Futures (RHS). *Source: RMI-CRI, Bloomberg*

In addition to the high leverage, Southwestern Energy's profitability has not been faring well either. Southwestern's net income was negative for all four quarters of 2016 due to impairments on natural gas assets. The firm attributes the improving net loss to lower impairments, reduced operating costs and increased natural gas liquids price realizations, which were partially offset by lower realized natural gas prices and decreased production. Due to the challenging price environment and derivative activities in the first three quarters of 2016, the energy firm's Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) sailed into the negative territory as average realized gas price was adversely affected.

3 Months Ending	Q1 2016	Q2 2016	Q3 2016	Q4 2016
Net Profit/ Losses (USD mn)	-1,132	-593	-708	-210
EBITDA (USD mn)	-950	-362	-636	228

Table 1: Profitability metrics for Southwestern Energy Corp. *Source: Bloomberg*

Looking forward, total capital investment program planned for 2017 is approximately USD 1.175-1.275bn, with USD 975-1075mn funded by expected cash flow and the remaining USD 200mn from its 2016 equity issue. With the investment, Southwestern targets to increase its total net gas and liquids production. However, the declining natural gas price this year due to second warmest February on record has not worked to Southwestern's advantage. Burdened with a high leverage, natural gas price weakness and uncertainty, Southwestern's outlook seems worrying.

Credit News

Ezra's bankruptcy filing could shake sentiment

Mar 20. Ezra Holdings, the troubled oilfield services firm, announced on March 19 that it has filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code. Ezra also said in a separate statement that it will be convening an informal meeting with bond holders of its SGD 150mn of 4.875 per cent notes, which are due next year, to provide updates on the situation. Ezra's bankruptcy, coming after its debt-ridden joint venture Emas Chiyoda filed for bankruptcy protection in the US late last month, is likely to have a trickle-down impact on other firms in the sector, such as local banking and offshore and marine industries. (Straits Times)

Outlook for US corporate profits dims

Mar 20. Analysts have predicted the earnings for S&P 500 index companies to be 9 per cent this year, lower than the expected 12.3 per cent at the start of this year. This is despite optimism on Donald Trump's proposed fiscal policies such as the healthcare reform and corporate tax code reform. Even though the US economy has been stable, analysts and fund managers have noted that investors are getting too optimistic, driving equities prices to a new high. The cyclically adjusted price-to-earnings ratio developed by Robert Shiller has reached its highest point in 15 years this month. (FT)

Default fears resurface over Singapore's looming debt wall

Mar 20. Default fears are resurfacing in Singapore ahead of a wall of maturing corporate debt. Companies excluding banks in Singapore must repay SGD 38bn of local bonds through the end of 2020, after four years through 2016 in which about the same amount fell due, according to data compiled by Bloomberg. Six firms have defaulted on SGD 1.2bn worth of notes since November 2015. Although there has been a rebound in manufacturing and exports in recent months, some of Singapore's small debt-laden companies remain vulnerable. The Singapore government voted earlier this month to enact several changes to Companies Act that are expected to take effect by March 31, aiming to make it easier for firms to restructure debt. (Bloomberg)

Puerto Rico COFINA bondholders ask US judge to rule in debt fight

Mar 19. Bondholders of Puerto Rico's COFINA stated that USD 3.5bn of Puerto Rico's general obligation (GO) debt is invalid as it exceeds the constitutional debt limits. A federal judge in San Juan was requested by the COFINA group, whose bonds are backed by sales tax revenue, to deny the GO group's attempt to stop the Puerto Rican government from paying COFINA debt instead of GO debt. The GO group, however, alleges that the GO debt should be paid ahead of all other obligations as it is guaranteed by the Puerto Rican government. (Reuters)

Fragmented UK would be bad for debt ratings, says Fitch

Mar 15. Fitch Ratings' global head of sovereigns has warned that Britain's exit from the EU as well as a potential separation from Scotland will be detrimental from a ratings perspective. James McCormack, speaking from the IIF G20 Summit in Frankfurt, Germany noted that the separation will raise debt-to-GDP by about 8 to 10 per cent, and the decision of Scotland's First Minister, Nicola Sturgeon to hold another referendum proposing a split of Scotland from the UK will further complicate the efforts of Theresa May's government. McCormack also addressed the debt situation in the US, stating that short-term growth impulse is positive due to enthusiasm surrounding regulatory and tax reform. (CNBC)

Tullow asks shareholders for GBP 607mn to cut its large debt load (FT)

Call to tackle China's soaring aluminium output (FT)

Croatia's Agrokor works on new business model to resolve debts (Reuters)

Regulatory Updates
G20 review of banking rules no rollback of regulation: Weidmann **Mar 19.** G20 members have signaled that banking rules will be reviewed but a complete rollback of hard-fought regulations was not a given, after convening at the IIF G20 Summit. German Bundesbank President Jens Weidmann said on Sunday that G20 finance ministers and central bank governors will look closely at actual impact of reforms, and whether any unintended side effects arose as a consequence of the jointly agreed reforms. The pressure to review the laws came after the new US administration argued that excessive bank regulation was restraining lending and economic growth. Weidmann also commended Germany's G20 presidency, and its role in getting G20 members to adopt non-binding principles to boost resilience of their economies against future shocks. (Reuters)
China bad loan risks under control: banking regulator vice chairman **Mar 18.** According to the vice chairman of China's bank regulator Wang Zhaoxing, China's banking sector's performance has been decent. As China's banks adopt measures to curb the rise of bad loans, the ratio of non-performing loans (NPL) to total loans has stabilized despite the volume of NPLs rising to an 11-year high at the end of June. Vice chairman Wang Zhaoxing told reporters at the China Development Forum that "the risk of bad loans is very much under control" and the "banks' business growth, profitability, and asset quality are very stable and non-performing loan situation is promising". (Reuters)
Europe is worried about Trump's plans to de-regulate banks (CNBC) **Sweden's FSA to draw up proposal for capital rules for pension firms** (Reuters)

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