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Southwestern Energy Company SWN

Analyst Report

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by [Catharina Milostan](#)

Analyst Note 05-22-2009

Southwestern Energy's [SWN](#) ongoing drilling success, hedging, and cost management give us greater visibility on long-term cash-flow generation and a reason to lower our fair value uncertainty rating to high from very high. Initial proposals to remove favorable energy tax credits, including credits for intangible drilling costs, have not gained momentum among U.S. legislators. Meanwhile, Southwestern continues to boost production as drilling at its Fayetteville Shale enters a more efficient developmental drilling stage from an slower testing phase.

Southwestern Energy's long-term drilling plan for its properties in the Fayetteville Shale in Arkansas and other regions supports long-term production growth plans (see our [May 1 note](#)). Cash generated from new production plus well-placed hedges help to shore up cash needed for projects. Southwestern has about 53% of expected 2009 natural gas production hedged with prices averaging well above market at \$8.68 per thousand cubic feet. Low debt levels give the firm more financial flexibility to raise funds, if needed, for growth. These factors combine to give us greater visibility on future cash flows, reducing the uncertainty of our fair value estimate.

Thesis 02-06-2009

Southwestern Energy's drilling success continues, particularly at its Fayetteville Shale properties in Arkansas. While mindful of challenges in 2009 regarding financial market funding constraints and low oil and gas prices, Southwestern managers remain focused on developing high-returning fields.

Southwestern is a long way from its 1929 roots as an Arkansas gas utility. Well before many gas utility peers, the firm branched out to exploration and production in 1943 and then sold its gas utility in July 2008. Southwestern is now an E&P and midstream company. CEO Harold Korell instilled a return-oriented focus, which led to timely decisions to reduce Gulf Coast and Permian operations in favor of lower-risk and longer-lived Arkoma (Arkansas-Oklahoma) and East Texas properties. This fortunate shift produced steady 10%-plus annual production gains and impressive reserve replacements of more than 300% in each of the past four years.

Southwestern now has several promising fields, especially its Fayetteville Shale properties. The firm got a head start in the Fayetteville Shale when it discovered gas-bearing deposits in 2002 and quietly acquired drilling leases at low costs. The geology of the Fayetteville Shale is similar to the much-lauded Barnett Shale in Texas. Drilling success continues as Southwestern has learned how to optimize horizontal drilling and fracturing methods to boost production. 2008 was a step-up year for the firm as it started

Morningstar Rating

★ ★ ★

Stock Price

As of 05-22-2009
\$40.11

Fair Value Estimate

\$38.00

Consider Buying

\$19.00

Consider Selling

\$76.00

Fair Value Uncertainty

High

Economic Moat

Narrow

Stewardship Grade

B

Bulls Say

- Southwestern has several years of drilling sites at onshore operations, including Fayetteville Shale properties to drive production growth without the need for acquisitions.
- Southwestern's shift to multiwell pad drilling at Fayetteville Shale properties has helped keep well costs low while boosting operating efficiencies.
- Southwestern's methodic approach of using seismic data to analyze well sites and develop field infrastructure has allowed the firm to optimize production.

Bears Say

- Southwestern remains susceptible to a fall in gas prices, causing a potential drop in earnings and cash flow.
- Financial market turmoil may limit Southwestern's ability to secure new financing for growth projects, potentially forcing it to scale back drilling plans.

more efficient multiwell drilling, with plans to continue these drilling methods in 2009. Southwestern has other promising properties including its Overton Field in East Texas and Ranger Anticline in the Arkoma Basin that are worth noting for longer-term production growth potential.

Like its peers, Southwestern will need to navigate a challenging financial market and low oil and gas prices in 2009 and possibly into 2010. Because natural gas production accounts for more than 95% of production, Southwestern is more leveraged to often-volatile gas prices. By concentrating on developing Fayetteville Shale, Arkoma, and East Texas fields, Southwestern's earnings and cash-flow stream are vulnerable to regional pricing or production disruptions. Earnings and cash-flow uncertainty caused by volatile natural gas prices, concentration of growth projects, and constrained financial markets supports our very high fair value uncertainty rating for Southwestern Energy.

Southwestern has done a commendable job shoring up its balance sheet in 2008 with a healthy cash balance and low debt levels. To help fund growth plans, Southwestern sold some Fayetteville Shale properties, its gas utility, and other properties to raise about \$1 billion in 2008. Recognizing limited financing options amid market turmoil, the firm reset 2009 drilling plans to focus on higher-returning Fayetteville Shale properties, while easing up in other regions. Potential efficiency gains continue at Southwestern's Fayetteville Shale properties as it pursues more multiwell drilling and new fracturing and recovery methods developed in late 2008.

Valuation

We're lowering our fair value estimate for Southwestern Energy to \$38 per share from \$47 to reflect our lower gas price estimate. We also adopted a more conservative stance for our base scenario by assuming more drilling cutbacks. In our discounted cash-flow model, our benchmark oil and gas prices are based on NYMEX futures contracts for 2008-10. For natural gas, we use \$5.40 per thousand cubic feet (mcf) in 2009, \$6.80 in 2010 and \$7.20 in 2011. For oil, we use \$48 per barrel in 2009, \$57 in 2010 and \$61 in 2011. We adjust our benchmark pricing to reflect the quality, location, and hedging of the firm's production. In our base scenario, we assume long-run perpetual oil prices of \$80 per barrel and natural gas prices of \$7.50 per mcf. Southwestern's production gains in the Fayetteville Shale were impressive in 2008 where multiwell drilling boosted productivity while lowering costs per well. Plans to lengthen the horizontal portion of the wells plus adding new clustered fracturing methods is expected to drive up well costs to \$3.0 million to \$3.25 million, which is still low relative to other gas shale fields. Southwestern was able to use nearly \$1 billion of net asset sale proceeds to lower debt and build up a healthy cash reserve. This should help support 2009 drilling plans. However, lingering financial market turmoil with depressed gas prices could force more drilling cutbacks later this year. In our low-case scenario where perpetual prices drop to \$50 per barrel for oil and \$5 per mcf for gas, we look for a further pullback in production and margin pressure to reduce our fair value estimate to \$15 per share. Our high case assumes long-run oil prices of \$150 and gas prices of \$15 as well as greater drilling success to drive up our fair value estimate to \$91 per share. Our fair value estimate assumes that Southwestern remains a stand-alone firm. The firm's desirable Fayetteville Shale acreage plus other onshore properties could make it an attractive acquisition candidate when financial markets recover.

Risk

As with other U.S.-based E&P companies, Southwestern Energy's primary risk is a prolonged drop in U.S. gas prices, which could reduce profits, slow development plans, and

- Southwestern may be vulnerable to infrastructure or environmental concerns that could delay project startups and increase operating costs.

limit the value of its properties. The company also runs the risk of delays caused by infrastructure bottlenecks or availability of drilling rigs or crews. Southwestern Energy elected to secure some drilling rigs in Arkansas to alleviate some of this risk.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
Southwestern Energy Company	2,328	14,938
* XTO Energy, Inc.	8,183	25,553
* Quicksilver Resources, Inc.	829	2,015
* Ultra Petroleum Corporation	981	6,849
* DTE Energy Holding Company	9,014	4,957

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

Southwestern Energy takes a return-oriented approach to its E&P operations. The company focuses on present value created per dollar invested, requiring each project to exceed its present value index hurdle of at least 1.3. Southwestern Energy remains focused on onshore U.S. operations in the Mid-Continent or Gulf Coast, with a preference for longer-lived development prospects.

Management & Stewardship

Southwestern Energy's senior management hails primarily from the E&P sector. Chairman and CEO Harold M. Korell joined the company as executive vice president and COO in 1997, bringing more than 30 years of E&P experience. He was appointed president in 1998, CEO in 1999, and chairman in 2002 and spearheaded Southwestern's recovery from its troubled 1998. Korell kept his chairman and CEO roles but shifted the president and COO role to Steven L. Mueller in June 2008. Mueller has more than 30 years of energy industry experience, including working with Korell at Tenneco and American Exploration. As of March 25, 2008, management and directors owned 4.04% of shares outstanding, with Korell owning 1.82%. Korell's total compensation of \$5.4 million in 2007 was not unusual, with performance-based discretionary compensation making up nearly 90%. Annual incentive compensation is subject to a broad list of performance goals including targeted present value added per dollar of capital invested, cash-flow targets, favorable return on equity versus E&P peers, and operating metrics such as reserve replacement, production, and expense-control goals.

Profile

Houston-based Southwestern Energy began in 1929 as an Arkansas gas utility and expanded into exploration and production in 1943. The E&P unit now dominates, generating 96% of 2007 earnings, and the firm sold its gas utility in July 2008. E&P operations are onshore in the Arkoma Basin, East Texas and Permian Basins in Texas, and the U.S. Gulf Coast. In 2007, proven reserves were 1,450 billion cubic feet equivalent and production averaged 311 million cubic feet per day.

Growth

Sale and earnings increased during the last five years because of higher gas prices and production. While oil and gas prices may fluctuate going forward, we look for development drilling in the Arkoma, East Texas, and Fayetteville Shale properties to drive production growth.

Profitability

Southwestern Energy's lower-than-average finding and development and operating costs should drive strong margins. New production expected from existing operations and prospects should lead to even lower costs per unit of production.

Financial Health

Southwestern has a balanced approach, funding capital spending with debt and two equity issues in 2003 and 2005. Its 2005 equity issuance helped to lower debt/total capitalization levels to 9% at year-end 2006. But this climbed to 37% at year-end 2007. Cash proceeds from nearly \$1 billion of asset sales in 2008 was used to lower debt and boost cash reserves, reducing the firm's debt (net of cash)/capitalization level to a lower-than-average 10% by Sept. 30, 2008.

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