

Diversified Energy PLC

United States / Energy
 London Stock Exchange
 Bloomberg: DEC LN
 ISIN: GB00BYX7JT74

Update

RATING **BUY**
PRICE TARGET **GBp140.00**
 Return Potential 42.1%
 Risk Rating Medium

FURTHER ACQUISITIONS IN NEW FOCUS AREA WILL WIDEN MARGINS

The recent purchase of assets from Tanos Energy Holdings is the third in a series of deals made by DEC since June in its new "Central" Regional Focus Area (RFA) which encompasses Arkansas, Louisiana, Oklahoma, and Texas. We estimate that the new RFA now accounts for around a quarter of DEC's total current production of ca. 130,000 BOEPD. It is also the location of tens of thousands of mature wells (> ten years old). Many of these are up for sale as their owners seek to finance new drilling and so DEC has the opportunity to rapidly achieve scale in the new RFA. As we pointed out in our last note of 14 June, CEO Rusty Hutson has stated that the "new area could eclipse Appalachia in a year or two." Management has also suggested that 2021 could be as busy for acquisitions as 2018 when four significant deals raised DEC's production by 60,000 BOEPD. The Tanos acquisition (and the Indigo acquisition, which was retroactively included in the deal) mark the first co-investments by Oaktree Capital Management under the October 2020 joint participation agreement. This stipulated that Oaktree match up to USD1bn of funding by DEC of mutually agreed acquisitions with transaction valuations greater than USD250m for a period of three years. DEC's spending on Tanos and Indigo for the purposes of the Oaktree deal is USD176m, leaving DEC/Oaktree plenty of financial firepower to take advantage of opportunities in the new RFA. We expect recurring G&A costs to rise by around a third this year (compared with 27% for hedged revenues) as DEC has expanded its organisation to accommodate recent and expected future acquisitions. While this cost item is currently weighing on still-robust forecasted margins of approximately 50% (2021E), we expect profitability to return to historical levels over the next few quarters as increased revenues through acquisitions more than offset incremental administrative expense. Rapid growth in the new RFA, anticipated returns from the smarter asset management programme and exploitation of synergies between newly acquired assets create additional opportunity for margin enhancement in the near term. We maintain our Buy recommendation and price target of GBp140.

FINANCIAL HISTORY & PROJECTIONS

	2017	2018	2019	2020	2021E	2022E
Revenue (unhedged) (\$m)	41.78	289.77	462.26	408.69	844.76	843.13
Y-o-y growth	144.5%	593.6%	59.5%	-11.6%	106.7%	-0.2%
Adj. EBITDA (hedged) (\$m)	17.51	146.22	273.27	300.59	345.44	326.92
Adj. EBITDA margin (hedged)	40.4%	53.3%	53.4%	54.3%	49.4%	45.5%
Net income (\$ m)	27.45	201.12	99.40	-23.47	192.41	162.06
EPS (diluted) (\$)	0.23	0.52	0.15	-0.03	0.24	0.19
DPS (\$)	5.44	11.23	13.92	15.25	16.00	16.00
FCF (\$m)	3.83	66.88	244.30	217.32	271.84	259.63
Net gearing	53.7%	66.0%	67.7%	81.7%	67.1%	59.6%
Liquid assets (\$ m)	15.17	1.37	1.66	1.38	2.86	2.85

* excludes non-recurring items, non-cash equity compensation, includes hedge portfolio gains/losses

RISKS

Acquisitions are a vital part of DEC's strategy for protecting and growing its cashflow. There can be no guarantee that the group will be able to continue to source acquisitions at attractive valuations.

COMPANY PROFILE

Diversified Energy PLC is an established, independent owner and operator of producing natural gas & oil wells in the United States. Natural gas accounts for ca. 90% of total production. Ca. 75% of total production derives from the Appalachian Basin and the balance from the newly entered "Central" Regional Focus Area (Arkansas, Louisiana, Oklahoma, Texas).

MARKET DATA

	As of 22 Jul 2021
Closing Price	GBp 98.50
Shares outstanding	849.43m
Market Capitalisation	GBP 836.7m
52-week Range	GBp 96.40 / 131.00
Avg. Volume (12 Mths)	2,344,490

Multiples	2020	2021E	2022E
P/E	n.a.	5.6	7.1
EV/Sales	4.9	2.4	2.4
EV/EBITDA	6.6	5.8	6.1
Div. Yield	11.3%	11.8%	11.8%

STOCK OVERVIEW



COMPANY DATA

	As of 31 Dec 2020
Liquid Assets	\$ 1.38m
Current Assets	\$ 94.47m
Intangible Assets	\$ 19.21m
Total Assets	\$ 2,291.68m
Current Liabilities	\$ 196.51m
Shareholders' Equity	\$ 886.66m

SHAREHOLDERS

Pendal Group Ltd.	9.0%
Abrdn PLC	5.6%
Premier Miton Group PLC	5.3%
AXA SA	4.8%
Free float and other	75.3%

**Figure 1: Estimated impact of acquisitions on unit adjusted EBITDA (hedged)**

USD/BOE	DEC 2020	Indigo to end 21	Blackbeard to end 21	Tanos to end 21	DGOC 2020 + Cotton Valley + Blackbeard + Tanos to end 21
Hedged revenue	15.14	17.94	17.00	17.63	15.89
Base LOE	2.53	5.34	3.50	2.73	2.74
Gathering and transportation	2.69	2.13	4.72	2.59	2.78
Production taxes	0.38	0.66	1.20	1.63	0.50
Total costs before G&A	5.59	8.13	9.42	6.95	6.02
Recurring G&A	1.33	0.00	0.00	0.00	0.96
Total costs	6.92	8.13	9.42	6.95	6.98
Adjusted EBITDA (hedged)	8.22	9.81	7.58	10.68	8.91

Source: Diversified Energy PLC, First Berlin Equity Research estimates

Figure 1 shows unit hedged revenue and costs for DEC for FY2020 (the most recent available figures) and our assumptions for the recently acquired Indigo, Blackbeard and Tanos assets from date of consolidation until the end of this year. The impact of lower basis differentials at the acquisitions on unit revenues at the expanded company outweighs the impact of the acquisitions' higher unit costs both above and below the G&A line.

Figure 2: Changes to our forecasts

USD 000s	2020A	2021E			2022E		
		FBe Old	FBe New	% Δ	FBe Old	FBe New	% Δ
MBOE	36,538	43,540	43,443	-0.2%	44,783	46,076	2.9%
Total revenue (unhedged)	408,693	763,064	844,756	10.7%	763,440	843,126	10.4%
of which:							
Natural gas	343,425	603,345	661,556	9.6%	623,460	672,260	7.8%
NGLs	23,173	101,122	122,523	21.2%	84,463	112,310	33.0%
Oil	15,064	26,592	28,672	7.8%	26,917	29,957	11.3%
Total commodity revenue	381,662	731,059	812,751	11.2%	734,840	814,526	10.8%
Midstream revenue	25,389	30,405	30,405	0.0%	27,000	27,000	0.0%
Other	1,642	1,600	1,600	0.0%	1,600	1,600	0.0%
Base lease operating expenses	92,286	127,001	124,335	-2.1%	138,257	137,663	-0.4%
Gathering and compression, owned	52,816	73,879	74,632	1.0%	77,827	81,308	4.5%
Gathering and transportation, 3rd party	45,156	63,164	63,808	1.0%	66,382	69,516	4.7%
Production taxes	13,705	24,599	26,641	8.3%	30,000	35,827	19.4%
Recurring admin. expenses	48,740	65,538	65,052	-0.7%	66,840	66,840	0.0%
Total recurring expenses	252,703	354,181	354,468	0.1%	379,306	391,153	3.1%
Adjusted EBITDA (unhedged)	155,990	408,883	492,455	20.4%	384,134	451,973	17.7%
Settled hedges	144,600	-79,341	-144,851	n.a.	-66,647	-125,056	n.a.
of which:							
Natural gas	121,077	-41,978	-99,418	n.a.	-47,081	-92,998	n.a.
NGLs	16,498	-40,709	-50,235	n.a.	-17,777	-29,907	n.a.
Oil	7,025	3,345	4,802	n.a.	-1,789	-2,151	n.a.
Total revenue (hedged)	553,294	683,723	699,905	2.4%	696,793	718,070	3.1%
Adjusted EBITDA (hedged)	300,590	329,542	345,438	4.8%	317,487	326,917	3.0%
margin (%)	54.3%	48.2%	49.4%	-	45.6%	45.5%	-

Source: First Berlin Equity Research estimates



While our FY2021 and FY2022 forecasts show a slight decline in unit adjusted EBITDA (hedged), the effect is likely to diminish from 2022 onward as DEC begins to realise higher prices as some of its lower priced hedge contracts roll over. Pending the use of additional available non-dilutive debt capacity, the company's investments in G&A combined with higher production taxes from higher commodity prices compress margins because DEC's extensive hedging arrangements (ca. 90% of forecast 2021 production is hedged) mean that most of the near-term positive price impact does not flow through to profits. In exchange, however, DEC is able to protect its cash flows and dividend during periods when commodity prices are under significant pressure.

VALUATION MODEL

DEC's target is that not less than ca. 40% of adjusted free cashflow (defined as hedged adjusted EBITDA less maintenance capex, interest expense and well retirement costs) should be paid out as dividends. In our forecasts the payout ratio on this basis at the current dividend level will be 45% this year and 50% in 2022.

Figure 3: Dividend payout and return on capital employed

USD 000s	2019A	2020A	2021E	2022E
Adjusted EBITDA (hedged)	273,266	300,590	345,438	326,917
Recurring capital expenditures	-17,255	-15,981	-17,000	-17,000
Cash interest expenses	-32,715	-34,335	-37,004	-35,016
Asset retirement (plugging)	-2,541	-2,442	-2,450	-2,500
Free cashflow (adjusted)	220,755	247,832	288,984	272,401
Net fixed assets	1,816,982	2,137,188	2,415,232	2,303,048
Net working capital	-18,573	-42,499	-32,804	-28,521
Total capital employed	1,798,409	2,094,689	2,382,429	2,274,526
Average capital employed	1,614,279	1,946,549	2,238,559	2,328,478
Free cashflow (adjusted) ROCE	13.7%	12.7%	12.9%	11.7%
Dividends paid and declared	86,605	104,305	130,186	135,863
as % free cashflow (adjusted)	39.2%	42.1%	45.0%	49.9%
Dividends paid and declared per share (USD)	0.1382	0.1475	0.1533	0.1600
Dividends declared per share (USD)	0.1392	0.1525	0.1600	0.1600

Source: First Berlin Equity Research estimates

We have updated our dividend discount valuation of DEC which is based on the formula:

$p_0 = d_1 / (r - g)$ where:

p_0 is our assessment of the fair value of the DEC share today

d_1 is the value of dividends over the next year

r is the required rate of return

g is the expected long term organic growth rate

Buy recommendation maintained at unchanged price target of GBp140 We derive g from ROCE adjusted for the production decline rate and payout ratio. Following the acquisitions of the assets from Indigo, Blackbeard and Tanos, we estimate 2021 and 2022 ROCE at 12.9% and 11.7% respectively (previously: 12.6% and 12.0% respectively). We have adjusted our estimate for the rate of production decline up from 6.5% to 7.0% to reflect the higher rate of production decline at the new acquisitions. Adjusting the average return on capital employed figure for 2021 and 2022 of 12.3% by 7.0% to reflect declining production produces a return of 4.4%. If we then reduce this number by 40% to reflect the dividend payout, we arrive at a sustainable growth rate in free cashflow (adjusted) of 2.7%. Plugging our estimates for d_1 (USD0.16), r (11.0%) and g (2.7%) into the formula above produces a valuation (see figures 5 and 6 below) for the DEC share of GBp139 (previously: GBp141). We maintain our Buy recommendation at an unchanged price target of GBp140.



Figure 4: Sensitivity of valuation to growth rates and return requirements (GBP)

		return requirement						
		8.0%	9.0%	10.0%	11.0%	12.0%	13.0%	14.0%
growth rate	0.7%	158	139	125	112	103	94	87
	1.7%	183	158	139	125	112	103	94
	2.7%	218	183	158	139	125	112	103
	3.7%	268	218	183	158	139	125	112
	4.7%	349	268	218	183	158	139	125
	5.7%	498	349	268	218	183	158	139

Source: First Berlin Equity Research

Figure 5: Sensitivity of valuation to growth rates and return requirements (USD)

		return requirement						
		8.0%	9.0%	10.0%	11.0%	12.0%	13.0%	14.0%
growth rate	0.7%	218	192	171	155	141	130	120
	1.7%	253	218	192	171	155	141	130
	2.7%	300	253	218	192	171	155	141
	3.7%	369	300	253	218	192	171	155
	4.7%	480	369	300	253	218	192	171
	5.7%	685	480	369	300	253	218	192

Source: First Berlin Equity Research



INCOME STATEMENT

All figures in USD '000	2017A	2018A	2019A	2020A	2021E	2022E
Revenues	41,777	289,769	462,256	408,693	844,756	843,126
Operating expense	-20,908	-107,793	-202,385	-203,963	-289,416	-324,313
Depreciation and depletion	-7,536	-41,988	-98,139	-117,290	-141,074	-150,076
Gross profit	13,333	139,988	161,732	87,440	414,266	368,737
Administrative expenses	-8,919	-40,524	-55,889	-77,234	-80,052	-81,840
Allowance for expected credit losses	0	0	-730	-8,490	0	0
Gain on oil/gas programme and equipment	95	4,079	0	-2,059	0	0
Gain (loss) on derivative financial instruments	-441	17,981	73,854	-94,397	-144,851	-125,056
Gain on bargain purchase	37,093	173,473	1,540	17,172	0	0
Operating income (EBIT)	41,161	294,997	180,507	-77,568	189,363	161,840
Finance costs	-5,225	-17,743	-36,667	-43,327	-37,004	-35,016
Loss on early retirement of debt	-4,468	-8,358	0	0	0	0
Accretion of asset retirement obligation	-1,764	-7,101	-12,349	-15,424	-29,949	-34,763
Other income (expense)	0	0	0	-421	0	0
Income before taxation	29,704	261,795	131,491	-136,740	122,410	92,062
Taxation on income	-2,250	-60,676	-32,091	113,266	70,000	70,000
Net income / loss	27,454	201,119	99,400	-23,474	192,410	162,062
Diluted EPS (in USD)	0.23	0.52	0.15	-0.03	0.24	0.19
Adjusted EBITDA (hedged)*	17,514	146,217	273,266	300,590	345,438	326,917
Ratios						
Gross margin	31.9%	48.3%	35.0%	21.4%	49.0%	43.7%
Adjusted EBITDA margin (hedged)	40.4%	53.3%	53.4%	54.3%	49.4%	45.5%
Net margin	65.7%	69.4%	21.5%	-5.7%	22.8%	19.2%
Tax rate	7.6%	23.2%	24.4%	82.8%	-57.2%	-76.0%
Expenses as % of revenues						
Operating expense	50.0%	37.2%	43.8%	49.9%	34.3%	38.5%
Depreciation and depletion	18.0%	14.5%	21.2%	28.7%	16.7%	17.8%
Administrative expenses	21.3%	14.0%	12.1%	18.9%	9.5%	9.7%
Y-Y Growth						
Revenues	144.5%	593.6%	59.5%	-11.6%	106.7%	-0.2%
Adjusted EBITDA (hedged)	307.6%	734.9%	86.9%	10.0%	14.9%	-5.4%
Net income/ loss	55.3%	632.6%	-50.6%	n.m.	n.m.	-15.8%

* adjusted for non-recurring items such as gain on the sale of assets, acquisition-related expenses and integration costs, mark-to-market adjustments related to the company's hedge portfolio, non-cash equity compensation charges and items of a similar nature.



BALANCE SHEET

All figures in USD '000	2017A	2018A	2019A	2020A	2021E	2022E
Assets						
Current assets, total	30,342	111,596	160,360	94,474	176,305	175,999
Cash and cash equivalents	15,168	1,372	1,661	1,379	2,860	2,855
Restricted cash	744	1,730	1,207	250	519	518
Receivables	13,917	78,451	73,924	66,991	138,540	138,273
Derivative financial instruments	0	17,573	73,705	17,858	17,858	17,858
Other current assets	513	12,470	9,863	7,996	16,527	16,496
Non-current assets, total	223,308	1,445,376	1,845,580	2,196,208	2,539,222	2,497,730
Oil and gas properties, net	215,325	1,092,951	1,496,029	1,755,085	2,017,869	1,909,106
Property, plant & equipment, net	6,947	327,749	320,953	382,103	397,363	393,942
Intangible assets			15,981	19,213	19,921	18,960
Restricted cash	0	0	6,505	20,100	11,827	13,490
Indemnification receivable	0	2,133	2,133	1,837	1,837	1,837
Derivative financial instruments	0	21,745	3,803	717	717	717
Deferred tax asset			0	14,777	84,777	154,777
Other non-current assets	1,036	798	176	2,376	4,911	4,902
Total assets	253,650	1,556,972	2,005,940	2,290,682	2,715,526	2,673,729
Shareholders' equity & debt						
Current liabilities, total	15,346	84,471	126,855	196,506	269,149	256,460
Short-term debt	373	286	23,723	64,959	67,739	59,624
Accounts payable	2,132	9,383	17,053	19,366	40,029	39,952
Capital lease	324	842	798	5,013	10,362	10,342
Derivative financial instruments	961	0	0	15,858	15,858	15,858
Other current liabilities	11,556	73,960	85,281	91,310	135,161	130,685
Long-term liabilities, total	130,066	723,638	940,950	1,207,518	1,320,245	1,300,799
Long-term debt	70,619	482,528	598,778	652,281	680,198	598,714
Capital lease	836	2,694	1,015	13,865	25,343	25,294
Asset retirement obligation	35,448	140,190	196,871	344,242	399,571	461,744
Deferred tax liability	17,399	95,033	124,112	15,746	25,343	25,294
Uncertain tax position	0	2,133	2,133	1,837	1,837	1,837
Derivative financial instruments	1,943	0	15,706	168,524	168,524	168,524
Other non-current liabilities	3,821	1,060	2,335	11,023	19,429	19,392
Shareholders' equity	108,238	748,863	938,135	886,658	1,126,133	1,116,470
Total consolidated equity and debt	253,650	1,556,972	2,005,940	2,290,682	2,715,526	2,673,729
Ratios						
Current ratio (x)	1.98	1.32	1.26	0.48	0.66	0.69
Quick ratio (x)	1.98	1.32	1.26	0.48	0.66	0.69
Net debt	58,162	493,998	635,039	724,757	755,454	665,856
Net gearing	53.7%	66.0%	67.7%	81.7%	67.1%	59.6%
Book value per share (in GBP)	0.55	1.08	1.09	1.04	1.07	1.06
Return on equity (ROE)	46.8%	46.9%	11.8%	-2.6%	19.1%	14.5%



CASH FLOW STATEMENT

All figures in USD '000	2017A	2018A	2019A	2020A	2021E	2022E
Net profit	27,454	201,119	99,400	-23,474	192,410	162,062
Depreciation and depletion	7,536	41,988	98,139	117,290	141,074	150,076
Accretion of asset retirement obligation	1,764	7,101	12,349	15,424	29,949	34,763
Deferred income taxes	2,250	60,676	32,091	-113,266	-70,000	-70,000
(Gain)/loss on derivative financial instruments	1,965	-32,768	-20,270	238,795	0	0
Asset retirement, plugging	-78	-1,171	-2,541	-2,442	-2,450	-2,500
Gain on oil/gas programme and equipment	-396	-4,079	0	0	0	0
Gain on bargain purchase	-37,093	-173,473	-1,540	-17,172	0	0
Finance costs	4,510	17,743	36,677	43,327	37,004	35,016
Cancellation/retirement of debt	0	8,358	0	0	0	0
Changes in working capital	-1,854	-39,713	21,786	-10,129	-9,695	-4,282
Non cash equity compensation	59	783	3,065	5,007	0	0
Cash paid for income taxes			-1,989	-5,850	-6,000	-6,000
Other adjustments	727	0	1,989	-5,800	0	0
Operating cash flow	6,844	86,564	279,156	241,710	312,292	299,134
Oil and gas properties and equipment	-2,935	-18,515	-32,313	-21,947	-38,000	-37,000
Free cash flow	3,831	66,878	244,302	217,321	271,842	259,634
Acquisitions	-89,785	-750,256	-439,272	-223,091	-365,000	0
Increase in restricted cash	-627	-986	-5,302	-12,637	8,005	-1,662
Proceeds on disposal of oil/gas properties	334	4,079	10,000	3,712	0	0
Other acquired intangibles			0	-2,900	0	0
Investment cash flow	-93,013	-765,678	-466,887	-256,863	-394,995	-38,662
Repayment of borrowings	-42,514	-280,890	-618,010	-705,314	30,697	-89,598
Proceeds of borrowings	75,000	581,221	765,236	799,650	0	0
Financing expense	-3,298	-15,433	-32,715	-34,335	-37,004	-35,016
Cost incurred to secure financing	0	-17,176	-11,574	-7,799	0	0
Proceeds from capital lease	1,246	4,401	0	0	0	0
Repayment of capital lease	-529	-1,093	-1,724	-3,684	0	0
Proceeds from equity issuance, net	76,984	425,601	221,860	81,407	215,000	0
Contingent consideration payments	0	0	0	-893	0	0
Dividends to shareholders	-5,776	-31,313	-82,151	-98,527	-124,509	-135,863
Repurchase of shares	0	0	-52,902	-15,634	0	0
Financing cash flow	101,113	665,318	188,020	14,871	84,184	-260,477
Other	0	0	0	0	0	0
Net cash flows	14,944	-13,796	289	-282	1,481	-6
Cash, start of the year	224	15,168	1,372	1,661	1,379	2,860
Cash, end of the year	15,168	1,372	1,661	1,379	2,860	2,855

Y-Y Growth

Operating cash flow	33.4%	1164.8%	222.5%	-13.4%	29.2%	-4.2%
Free cash flow	89.8%	1745.7%	365.3%	89.0%	125.1%	95.5%
EBITDA/share	n.a.	159.5%	12.6%	3.0%	-1.3%	-11.1%

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The recommendations determined in accordance with the share price trend anticipated by First Berlin in the respectively indicated investment period are as follows:

Category		1	2
Current market capitalisation (in €)		0 - 2 billion	> 2 billion
Strong Buy ¹	An expected favourable price trend of:	> 50%	> 30%
Buy	An expected favourable price trend of:	> 25%	> 15%
Add	An expected favourable price trend of:	0% to 25%	0% to 15%
Reduce	An expected negative price trend of:	0% to -15%	0% to -10%
Sell	An expected negative price trend of:	< -15%	< -10%

¹ The expected price trend is in combination with sizable confidence in the quality and forecast security of management.

Our recommendation system places each company into one of two market capitalisation categories. Category 1 companies have a market capitalisation of €0 – €2 billion, and Category 2 companies have a market capitalisation of > €2 billion. The expected return thresholds underlying our recommendation system are lower for Category 2 companies than for Category 1 companies. This reflects the generally lower level of risk associated with higher market capitalisation companies.

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RECOMMENDATION & PRICE TARGET HISTORY

Report No.:	Date of publication	Previous day closing price	Recommendation	Price target
Initial Report	30 June 2020	GBp94.40	Buy	GBp130.00
2...1	↓	↓	↓	↓
2	1 September 2020	GBp110.40	Buy	GBp150.00
3	7 October 2020	GBp108.00	Buy	GBp150.00
4	6 November 2020	GBp115.40	Buy	GBp160.00
5	1 February 2021	GBp115.20	Buy	GBp150.00
6	18 March 2021	GBp112.00	Buy	GBp140.00
7	14 June 2021	GBp100.80	Buy	GBp140.00
8	Today	GBp 98.50	Buy	GBp140.00

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- key sources of information in the preparation of this research report
- valuation methods and principles
- sensitivity of valuation parameters

can be accessed through the following internet link: <https://firstberlin.com/disclaimer-english-link/>

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