

Diversified Gas & Oil PLC

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

Strategic participation
 agreement with
 Oaktree

RATING

Price Target
 Return Potential
 Risk Rating

BUY
GBP 150.00
 38.9%
 Medium

TURBOCHARGING PARTICIPATION IN SECTOR CONSOLIDATION WAVE

DGOC does not drill wells itself and so output growth (natural gas accounted for 90% of 2019 production by volume) is achieved almost solely through acquisitions. DGOC has made ca. USD1.7bn of acquisitions since its early 2017 listing in London. These acquisitions account for over 95% of current revenue. Current low commodity prices are likely to drive consolidation within the gas and oil sector. The strategic participation agreement announced with Oaktree on 5 October will allow DGOC to access deals on a scale which would not have been feasible on a standalone basis while significantly reducing capital intensity. Under the terms of the agreement Oaktree will contribute funding of up to USD1bn for mutually agreed acquisitions of PDP (produced developed producing) assets with transaction valuations greater than USD250m for a period of three years. DGOC will match the funding provided by Oaktree and will be the operator of any assets acquired. Under the Initial Promote component of the agreement DGOC will receive a 52.5% working interest for a 50% investment and Oaktree a 47.5% interest for a 50% investment. Under the Reversion Promote component of the agreement Oaktree transfers 15% of its working interest to DGOC on achieving a 10% unlevered IRR on its investment. In this scenario DGOC's stake in an acquired asset would rise to 59.625% and Oaktree's stake would fall to 40.375%. Assuming Oaktree and DGOC both invest USD1bn, Initial Promote provides immediate USD50m accretion to DGOC shareholders. Reversion Promote provides opportunity for enhanced longer term economics. We retain our Buy recommendation and GBP1.50 price target.

Right of first offer raises visibility of dividend sustainability/growth Under the terms of the agreement DGOC will also have the right of first offer to acquire Oaktree's interests should Oaktree divest. DGOC and Oaktree will also have the right to participate in a sale by the other party with a third party on comparable terms. (p.t.o.)

FINANCIAL HISTORY & PROJECTIONS

	2016	2017	2018	2019	2020E	2021E
Revenue (unhedged) (\$ m)	17.09	41.78	289.77	462.26	445.93	633.80
Y-o-y growth	171.1%	144.5%	593.6%	59.5%	-3.5%	42.1%
Adj. EBITDA (hedged)* (\$m)	4.30	17.51	146.22	273.27	303.18	304.26
Adj. EBITDA margin	25.1%	41.9%	50.5%	59.1%	68.0%	48.0%
Net income (\$ m)	17.68	27.45	201.12	99.40	317.81	171.01
EPS (diluted) (\$)	0.42	0.23	0.52	0.15	0.46	0.24
DPS (US cents)	1.99	5.44	11.23	13.92	14.75	15.00
FCF (\$m)	4.27	3.83	66.88	244.30	207.12	223.64
Net gearing	429.9%	53.7%	66.0%	67.7%	59.6%	48.6%
Liquid assets (\$ m)	0.22	15.17	1.37	1.66	27.71	33.09

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

RISKS

Acquisitions are a vital part of DGOC'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 Gas & Oil PLC is an established, independent owner and operator of producing natural gas & oil wells concentrated in the Appalachian Basin in the United States. Natural gas accounted for 90% of 2019 production by volume. Field operations are densely located throughout the adjacent states of Tennessee, Kentucky, Virginia, West Virginia, Ohio, and Pennsylvania.

MARKET DATA

As of 06 Oct 2020

Closing Price	GBP 108.00
Shares outstanding	707.27m
Market Capitalisation	GBP 763.9m
52-week Range	GBP 59.60 / 112.50
Avg. Volume (12 Months)	1,729,794

Multiples	2019	2020E	2021E
P/E	9.0	3.0	5.8
EV/Sales	3.7	3.8	2.7
EV/EBIT	6.3	5.6	5.6
Div. Yield	10.0%	10.6%	10.8%

STOCK OVERVIEW



COMPANY DATA

As of 30 Jun 2020

Liquid Assets	\$ 6.72m
Current Assets	\$ 153.30m
Intangible Assets	\$ 0.00m
Total Assets	\$ 2,288.99m
Current Liabilities	\$ 176.34m
Shareholders' Equity	\$ 976.81m

SHAREHOLDERS

Standard Life Aberdeen PLC	6.8%
AXA SA	5.5%
HSBC Holdings PLC	5.4%
Caius Capital LLP	4.8%
Free float and other	77.5%



These components of the agreement enhance visibility as to assets which DGOC can acquire to sustain and grow its existing annualised dividend of USD0.15 (equates to a yield of 10.8%).

Oaktree to contribute own intelligence on acquisitions Given that acquisitions are an integral part of the business model, DGOC devotes considerable resources to assessing potential targets. Management nevertheless believes that Oaktree will be able to contribute additional insight into distressed assets which may meet DGOC's acquisition criteria and also benefit from its Smarter Well Management programme.

VALUATION

We continue to base our valuation of DGOC on a dividend discount model.

Our valuation uses the formula $p^0 = d^1 / (r - g)$ where:

p^0 is our assessment of the fair value of the DGOC 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 GBP1.50 The agreement with Oaktree will likely enlarge the range of acquisition targets available to DGOC. Through its Initial Promote and Reversion Promote components the agreement also raises the probability that any given deal will be accretive to shareholders. Whether or not acquisitions add value for shareholders however, primarily depends on the characteristics of individual transactions. We will adjust our valuation model when acquisitions are made. For the time being we are leaving the values of the inputs in the valuation equation above unchanged on our note of 1 September i.e. $d^1 = \text{USD}0.15$, $r = 11.0\%$ and $g = 3.3\%$. These numbers produce a valuation (see figures 1 and 2 below) for the DGOC share of GBP1.52. Our recommendation remains Buy with an unchanged price target of GBP1.50.

Figure 1: 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	1.3%	1.75	1.52	1.34	1.20	1.09	1.00	0.92
	2.3%	2.06	1.75	1.52	1.34	1.20	1.09	1.00
	3.3%	2.50	2.06	1.75	1.52	1.34	1.20	1.09
	4.3%	3.18	2.50	2.06	1.75	1.52	1.34	1.20
	5.3%	4.39	3.18	2.50	2.06	1.75	1.52	1.34
	6.3%	7.04	4.39	3.18	2.50	2.06	1.75	1.52

Source: First Berlin Equity Research

Figure 2: 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	1.3%	2.26	1.96	1.73	1.55	1.41	1.29	1.19
	2.3%	2.65	2.26	1.96	1.73	1.55	1.41	1.29
	3.3%	3.22	2.65	2.26	1.96	1.73	1.55	1.41
	4.3%	4.11	3.22	2.65	2.26	1.96	1.73	1.55
	5.3%	5.66	4.11	3.22	2.65	2.26	1.96	1.73
	6.3%	9.08	5.66	4.11	3.22	2.65	2.26	1.96

Source: First Berlin Equity Research



INCOME STATEMENT

All figures in USD '000	2016A	2017A	2018A	2019A	2020E	2021E
Revenues	17,088	41,777	289,769	462,256	445,932	633,799
Operating expense	-11,303	-20,908	-107,793	-202,385	-219,984	-237,229
Depreciation and depletion	-4,039	-7,536	-41,988	-98,139	-119,160	-129,523
Gross profit	1,746	13,333	139,988	161,732	106,787	267,047
Administrative expenses	-2,813	-8,919	-40,524	-56,619	-65,696	-63,000
Gain on oil/gas programme and equipment	34	95	4,079	0	0	0
Gain (loss) on derivative financial instruments	-810	-441	17,981	73,854	124,362	-44,314
Gain on bargain purchase	24,293	37,093	173,473	1,540	139,000	0
Operating income (EBIT)	22,450	41,161	294,997	180,507	304,453	159,734
Finance costs	-3,291	-5,225	-17,743	-36,667	-35,398	-34,748
Loss on early retirement of debt	14,149	-4,468	-8,358	0	0	0
Accretion of asset retirement obligation	-797	-1,764	-7,101	-12,349	-17,128	-19,988
Income before taxation	32,511	29,704	261,795	131,491	251,927	104,998
Taxation on income	-14,829	-2,250	-60,676	-32,091	65,888	66,010
Net income / loss	17,682	27,454	201,119	99,400	317,815	171,008
Diluted EPS (in USD)	0.42	0.23	0.52	0.15	0.46	0.24
Adjusted EBITDA (hedged)*	4,297	17,514	146,217	273,266	303,180	304,256
Ratios						
Gross margin	10.2%	31.9%	48.3%	35.0%	23.9%	42.1%
Adjusted EBITDA margin (hedged)	25.1%	41.9%	50.5%	59.1%	68.0%	48.0%
Net margin	103.5%	65.7%	69.4%	21.5%	71.3%	27.0%
Tax rate	45.6%	7.6%	23.2%	24.4%	-26.2%	-62.9%
Expenses as % of revenues						
Operating expense	66.1%	50.0%	37.2%	43.8%	49.3%	37.4%
Depreciation and depletion	23.6%	18.0%	14.5%	21.2%	26.7%	20.4%
Administrative expenses	16.5%	21.3%	14.0%	12.2%	14.7%	9.9%
Y-Y Growth						
Revenues	171.1%	144.5%	593.6%	59.5%	-3.5%	42.1%
Adjusted EBITDA (hedged)	65.8%	307.6%	734.9%	86.9%	10.9%	0.4%
Net income/ loss	n.a.	55.3%	632.6%	-50.6%	219.7%	-46.2%

* 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	2016A	2017A	2018A	2019A	2020E	2021E
Assets						
Current assets, total	4,619	30,342	111,596	160,360	187,683	199,526
Cash and cash equivalents	224	15,168	1,372	1,661	27,713	33,092
Restricted cash	0	744	1,730	1,207	2,064	2,934
Receivables	3,084	13,917	78,451	73,924	92,405	93,000
Derivative financial instruments	0	0	17,573	73,705	55,000	60,000
Other current assets	1,311	513	12,470	9,863	10,500	10,500
Non-current assets, total	81,256	223,308	1,445,376	1,845,580	2,103,359	2,000,574
Oil and gas properties, net	76,793	215,325	1,092,951	1,490,905	1,742,595	1,644,129
Property, plant & equipment, net	3,348	6,947	327,749	341,846	343,995	336,939
Restricted cash	117	0	0	6,505	7,135	8,873
Indemnification receivable		0	2,133	2,133	2,133	2,133
Derivative financial instruments	0	0	21,745	3,803	4,000	5,000
Other non-current assets	998	1,036	798	388	3,500	3,500
Total assets	85,875	253,650	1,556,972	2,005,940	2,291,041	2,200,101
Shareholders' equity & debt						
Current liabilities, total	38,499	15,346	84,471	126,855	168,009	170,255
Short-term debt	27,181	373	286	23,723	57,213	58,413
Accounts payable	4,627	2,132	9,383	17,053	15,000	15,000
Capital lease	169	324	842	798	1,296	1,842
Derivative financial instruments	939	961	0	0	4,500	5,000
Other current liabilities	5,583	11,556	73,960	85,281	90,000	90,000
Long-term liabilities, total	38,214	130,066	723,638	940,950	1,007,753	908,351
Long-term debt	10,113	70,619	482,528	598,778	621,538	505,338
Capital lease	274	836	2,694	1,015	4,146	5,892
Asset retirement obligation	12,265	35,448	140,190	196,871	229,748	266,746
Deferred tax liability	15,148	17,399	95,033	124,112	90,188	58,241
Uncertain tax position	0	0	2,133	2,133	2,133	2,133
Derivative financial instruments	0	1,943	0	15,706	50,000	60,000
Other non-current liabilities	414	3,821	1,060	2,335	10,000	10,000
Shareholders' equity	9,162	108,238	748,863	938,135	1,115,279	1,121,495
Total consolidated equity and debt	85,875	253,650	1,556,972	2,005,940	2,291,041	2,200,101
Ratios						
Current ratio (x)	0.12	1.98	1.32	1.26	1.12	1.17
Quick ratio (x)	0.12	1.98	1.32	1.26	1.12	1.17
Net debt	39,387	58,162	493,998	635,039	665,237	544,858
Net gearing	429.9%	53.7%	66.0%	67.7%	59.6%	48.6%
Book value per share (in GBp)	0.17	0.55	1.08	1.09	1.27	1.27
Return on equity (ROE)	n.a.	46.8%	46.9%	11.8%	31.0%	15.3%



CASH FLOW STATEMENT

All figures in USD '000	2016A	2017A	2018A	2019A	2020E	2021E
Net profit	17,682	27,454	201,119	99,400	317,815	171,008
Depreciation and depletion	4,039	7,536	41,988	98,139	119,160	129,523
Accretion of asset retirement obligation	797	1,764	7,101	12,349	17,128	19,988
Deferred income taxes	14,829	2,250	60,676	32,091	-65,888	-66,010
(Gain)/loss on derivative financial instruments	957	1,965	-32,768	-20,270	0	0
Asset retirement, plugging	0	-78	-1,171	-2,541	-3,100	-3,137
Gain on oil/gas programme and equipment	-84	-396	-4,079	0	0	0
Gain on bargain purchase	-24,293	-37,093	-173,473	-1,540	-139,000	0
Finance costs	3,291	4,510	17,743	36,677	0	0
Cancellation/retirement of debt	-14,149	0	8,358	0	0	0
Changes in working capital	1,754	-1,854	-39,713	21,786	-11,899	-595
Non cash equity compensation	340	59	783	3,065	0	0
Other adjustments	-34	727	0	0	0	0
Operating cash flow	5,129	6,844	86,564	279,156	234,216	250,777
Oil and gas properties and equipment	-862	-2,935	-18,515	-32,313	-24,000	-24,000
Free cash flow	4,267	3,831	66,878	244,302	207,116	223,640
Acquisitions	-8,438	-89,785	-750,256	-439,272	-210,000	0
Increase in restricted cash	-2	-627	-986	-5,302	-1,487	-2,608
Proceeds on disposal of oil/gas properties	93	334	4,079	10,000	0	0
Investment cash flow	-9,209	-93,013	-765,678	-466,887	-235,487	-26,608
Repayment of borrowings	-6,794	-42,514	-280,890	-618,010	-297,000	-115,000
Proceeds of borrowings	14,915	75,000	581,221	765,236	353,250	0
Financing expense	-3,222	-3,298	-15,433	-32,715	0	0
Cost incurred to secure financing	0	0	-17,176	-11,574	0	0
Proceeds from capital lease	435	1,246	4,401	0	3,629	2,293
Repayment of capital lease	-164	-529	-1,093	-1,724	0	0
Proceeds from equity issuance, net	0	76,984	425,601	221,860	81,594	0
Dividends to shareholders	-956	-5,776	-31,313	-82,151	-98,515	-106,083
Repurchase of shares	0	0	0	-52,902	-15,634	0
Financing cash flow	4,214	101,113	665,318	188,020	27,324	-218,790
Other	0	0	0		0	0
Net cash flows	134	14,944	-13,796	289	26,052	5,379
Cash, start of the year	90	224	15,168	1,372	1,661	27,713
Cash, end of the year	224	15,168	1,372	1,661	27,713	33,092

Y-Y Growth

Operating cash flow	n.a.	33.4%	1164.8%	222.5%	-16.1%	7.1%
Free cash flow	n.a.	89.8%	1745.7%	365.3%	84.8%	108.0%
EBITDA/share	n.a.	n.a.	159.5%	12.6%	3.7%	-2.6%

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PRICE TARGET DATES

Unless otherwise indicated, current prices refer to the closing prices of the previous trading day.

AGREEMENT WITH THE ANALYSED COMPANY AND MAINTENANCE OF OBJECTIVITY

The present financial analysis is based on the author's own knowledge and research. The author prepared this study without any direct or indirect influence exerted on the part of the analysed company. Parts of the financial analysis were possibly provided to the analysed company prior to publication in order to avoid inaccuracies in the representation of facts. However, no substantial changes were made at the request of the analysed company following any such provision.

ASSET VALUATION SYSTEM

First Berlin's system for asset valuation is divided into an asset recommendation and a risk assessment.

ASSET RECOMMENDATION

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.

RISK ASSESSMENT

The First Berlin categories for risk assessment are low, average, high and speculative. They are determined by ten factors: Corporate governance, quality of earnings, management strength, balance sheet and financial risk, competitive position, standard of financial disclosure, regulatory and political uncertainty, strength of brandname, market capitalisation and free float. These risk factors are incorporated into the First Berlin valuation models and are thus included in the target prices. First Berlin customers may request the models.

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 September 2020	GBp110.40	Buy	GBp150.00
3	Today	GBp108.00	Buy	GBp150.00

INVESTMENT HORIZON

Unless otherwise stated in the financial analysis, the ratings refer to an investment period of twelve months.

UPDATES

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