Diversified Gas and Oil

Operational update

Strong hedging programme supporting cash flows

Oil & gas

Diversified Gas and Oil (DGO) has announced its Q319 and Q419 production, which averaged 91.1kboed and 96.3kboed in each quarter. DGO's Smarter Well Management programme continues to offset the company's Legacy assets' natural declines, delivering Q419 average production above 70kboed. DGO also presented an updated hedging book that covers c 85% of its natural gas production for 2020 at an average price of c $2.70/mmBtu. Hedging has been part of DGO's strategy, and the company reaffirms its focus on opportunities to increase its hedging and protect future cash flows from natural gas price decreases. The company's share buyback programme is ongoing. We update our valuation to 150.6p/share, from 157.2p/share (-4%), affected by a decrease in short-term gas price assumptions compared to our last note.

Year-end	Revenue* ($m)	Adj EBITDA** ($m)	PBT** ($m)	Net debt/ (cash) ($m)	Capex*** ($m)	Dividend yield**** (%)
12/17	41.8	17.5	(1.5)	55.8	(93.1)	4.9%
12/18	289.8	146.2	71.0	481.4	(766.8)	9.7%
12/19e	523.2	269.1	149.8	637.4	(490.1)	12.4%
12/20e	526.3	267.6	136.8	550.7	(27.1)	12.8%

Note: *Revenue includes hedging impact. **EBITDA and PBT are normalised for exceptional items including acquisition activity. ***Including acquisitions. ****Dividend yield based on dividend declared for the period.

Legacy assets continue to offset natural declines

DGO's Smarter Well Management programme has been proving pivotal in maintaining strong production from the company's Legacy assets, with a production exit rate in 2019 of c 70.2kboed. The sustained optimisation of these assets has offset their natural declines for the sixth consecutive quarter. DGO's H219 realised production, which averaged c 93.7kboed, results in a 2019 average production of c 85kboed, in line with our estimates of c 84kboed for the year.

Hedging portfolio protecting cash flows

Historically, hedging has been part of DGO's strategy and the company reaffirms its focus on opportunities to protect future cash flows, especially in the current low gas price environment. Approximately 85% of DGO's natural gas production is hedged at an average price of $2.70/mmBtu (Henry Hub currently trades at $1.85/mmBtu), while c 50% of all production is already hedge for 2021. This type of preventive measure will allow DGO to protect its revenue stream for 2020 and allow for sufficient cash generation for debt repayment and dividends distribution.

Valuation: Base case 150.6p per share

Our updated base case valuation is 150.6p/share, down from 157.2p/share, on inclusion of updated EIA gas price forecasts of $2.29/mcf in 2020 and $2.62/mcf in 2021, 12% and 8% lower than in our December 2019 note, which is a 9% decrease in our valuation. We also rolled forward our discount date to 2020 for all producing assets and updated DGO's hedging portfolio. We forecast an FY20 dividend yield of 12.8% at the current share price.

20 February 2020

Price	**87p**
Market cap	**£558m**
	US$1.26/£
Net debt ($m) at 31 December 2019	637
Shares in issue	642.8m
Free float	88%
Code	DGOC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(15.5)	(15.9)	(26.9)
Rel (local)	(13.5)	(18.2)	(30.9)
52-week high/low		134p	84p

Business description

Diversified Gas & Oil is a conventional natural gas and oil producer with a main focus on the US onshore. The company possesses long-life, low operational cost, mature producing assets with slow decline profiles in the Appalachian region.

Next events

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Move to Main Market	H120

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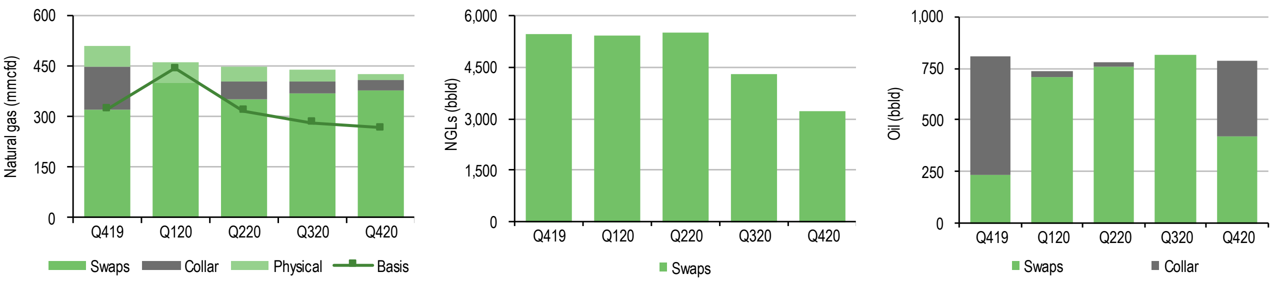
Production and hedging update

DGO announced its Q319 and Q419 realised production, which averaged 91.1kboed and 96.3kboed respectively. This results in a 2019 average production of c 85kboed, which is in line with our December 2019 estimate of c 84kboed for the year. DGO's Smarter Well Management programme continues to maintain strong production from its Legacy assets, which exceeded 70kboed in the last quarter of the year. The continued optimisation of these assets has largely offset what would otherwise have been natural declines in production, for the sixth consecutive quarter.

DGO also highlighted that it is starting 2020 with c 85% of its natural gas production hedged at an average price of $2.70/mmBtu (Henry Hub currently trades at $1.85/mmBtu), which protects cash flows and the company's ability to support the dividend. Hedging is part of DGO's strategy and the company reaffirms its focus on opportunities to increase its hedging and protect future cash flows.

Exhibit 1: DGO's near-term hedge portfolio



Source: DGO

Expanded lending group

DGO's lenders, led by KeyBank National Association, have completed the semi-annual redetermination of its senior secured credit facility and affirm a $650m borrowing base following DGO's successful $200m securitisation financing completed in November 2019. Credit Suisse, Goldman Sachs and Morgan Stanley have come into the lending syndicate, increasing the syndicate to 17 banks, a sign of confidence in the company strategy. The pricing grid for amounts drawn on the credit facility remains unchanged at Libor plus 2.0–3.0%. Borrowings under the company's senior secured credit facility as at 31 December 2019 were approximately $437m.

Directors increase their stakes in the company

On 5 February DGO's CEO Rusty Hutson Jr, COO Brad Gray and CFO Eric Williams purchased 190,000 ordinary shares at an average price of 91.26p/share and members of the board of directors, David Johnson and Martin Thomas, purchased a total of 65,000 ordinary shares at an average price of 92.31p/share. Following this transaction, Rusty Hutson Jr holds 20,510,000 ordinary shares in DGO representing c 3.15% of the company's issued share capital. These initiatives reflect a sign of optimism from the company's management on DGO's current positioning and value proposition.

Changes to estimates

Exhibit 2 provides our updated forecasts for FY19, FY20 and FY21. Our FY19 production forecast slightly increased to 84.9kboed in line with DGO's latest operational updated which included the last two quarters of 2019. Our FY20 and FY21 production forecasts slightly increased to 90.2kboed and 85.5kboed to account for the impact of DGO's Smarter Well Management programme and consequent FY19 production exit rate at c 94.8kboed. Our oil and gas price assumptions, based on the latest EIA estimates for Henry Hub, fell by 12% in FY20 and 8% in FY21. However, revenues and free cash flow (FCF) for the near term are offset by the hedging portfolio, where c 85% of natural gas production is protected.

Exhibit 2: Edison updated forecasts

	New			Old			Change		
	2019e	2020e	2021e	2019e	2020e	2021e	2019e	2020e	2020e
Production (kboed)	84.9	90.2	85.5	83.9	88.3	83.3	1%	2%	3%
Revenue* ($m)	523	526	500	517	520	496	1%	1%	1%
EBITDA** ($m)	279	268	245	273	257	244	2%	4%	1%
Adjusted EBITDA ($m)	269	268	245	263	257	244	2%	4%	1%
FCF ($m) – excluding acquisitions	244	232	184	238	221	178	3%	5%	3%
P&A expenditure ($m)	3.0	3.1	3.2	3.0	3.1	3.2	0%	0%	0%
Revenue/boe ($/boe)	16.89	15.94	16.02	16.87	16.08	16.31	0%	-1%	-2%
Opex***/boe ($/boe)	6.80	6.49	6.80	6.88	6.77	6.90	-1%	-4%	-1%
G&A/boe ($/boe)	1.31	1.25	1.26	1.33	1.28	1.29	-1%	-2%	-3%
Cash costs/boe ($/boe)	8.11	7.74	8.06	8.20	8.04	8.19	-1%	-4%	-2%
Capex/boe ($/boe)	1.01	0.82	0.83	1.02	0.82	0.83	0%	0%	0%
HH gas price assumption ($/mcf)	2.66	2.29	2.62	2.67	2.61	2.85	0%	-12%	-8%
WTI ($/bbl)	57.02	55.71	62.03	56.26	54.43	62.04	1%	2%	0%

Source: Edison Investment Research. Note: *Revenue includes hedging impact; **Edison adjusted EBITDA excludes reported acquisition gains; ***includes lease operating expenditures (LOE), gathering and transportation (G&T), gathering/compression costs (G&C) and ad valorem and severance taxes. HH: Henry Hub.

Valuation

We value DGO using a conventional NAV approach based on the NPV_{10} of the company's producing assets minus overheads and net financial liabilities. The NAV table below, Exhibit 3, provides a breakdown of our valuation by asset, using data available in the company's last published prospectus and CPR as well as state public sources.

We break down the assets into DGO Legacy assets (conventional, late-life, low-decline rate), and the 2019 acquired assets (early-life assets). DGO also owns over 12,000 miles of pipeline with related compressor stations, following the August 2019 acquisitions, which is reflected in our discounted value for payments DGO receives for third-party use of services and midstream assets and respective operating costs in our valuation – currently estimated at an NAV of $49.0m. For all these assets we rolled our discount date forward to 2020 and updated the net debt position to a forecasted year-end 2019 $637m, in line with DGO's latest guidance. We also include the hedging impact based on DGO's latest available information on hedging volumes, as well as the impact of the ongoing 2020 share buyback programme.

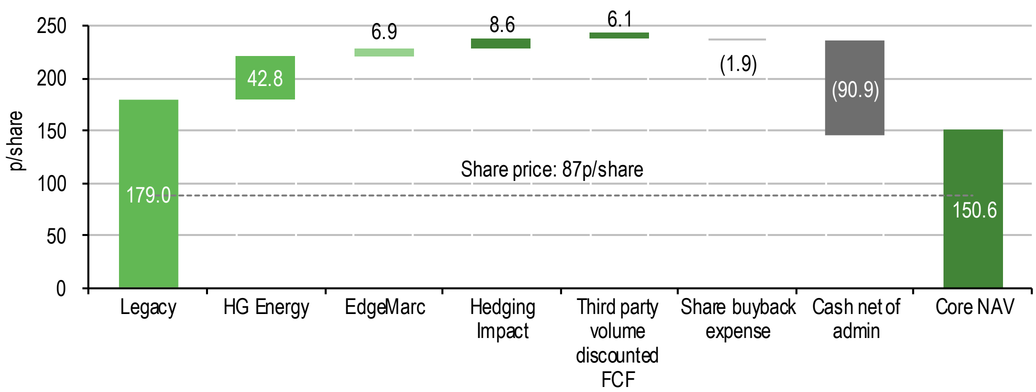
Exhibit 3: Edison detailed NAV breakdown for DGO

Asset	Country	Diluted WI	CoS	Net recoverable reserves	NPV10/boe	Net risked value	Risked value per share
		%	%	mmboe	$/boe	US$m	/share
Net cash/(debt) at end 2019						(637)	(78.7)
SG&A – NPV10 of three years						(98)	(12.1)
Hedging impact						69	8.6
Third-party volume discounted FCF						49	6.1
Share buyback expense						(15)	(1.9)
Production							
Legacy	US	100%	100%	474.6	3.1	1,450	179.0
HG Energy	US	87%	100%	91.5	3.8	346	42.8
EdgeMarc	US	79%	100%	13.4	4.2	56	6.9
Core NAV				**579.5**		**1,219**	**150.6**

Source: Edison Investment Research. Note: Number of shares = 642.8m at 19 February 2020, FX: $1.26/£.

Exhibit 4 breaks down our valuation by asset class showing where our base case core NAV sits relative to the current share price. Our valuation suggests the market is not fully valuing DGO's 1P PDP reserves (579mmboe = 474mmboe DGO Legacy + 92mmboe HG Energy + 14mmboe EdgeMarc), nor its third-party revenues from midstream assets and may be overestimating the NPV of decommissioning liabilities.

Exhibit 4: NAV waterfall



Source: Edison Investment Research

Key drivers of DGO's valuation are the gas price and LOE. Our base assumes a long-term (2022) gas price of $3.10/mcf and short-term gas assumptions based on the EIA short-term energy outlook of $2.29/mcf for FY20 and $2.62/mcf for FY21. Our LOE assumptions are specific for DGO Legacy assets, HG Energy and EdgeMarc. Our LOE assumptions are based on acquisition metrics for HG Energy of $0.63/boe and EdgeMarc of $1.56/boe and we estimate DGO base LOE at $3.6/boe. Our LOE assumption excludes gathering and transport, SG&A and production taxes. The table below provides a base case valuation sensitivity to these key drivers.

Exhibit 5: Valuation sensitivity to LOE and gas price assumption (p/share)

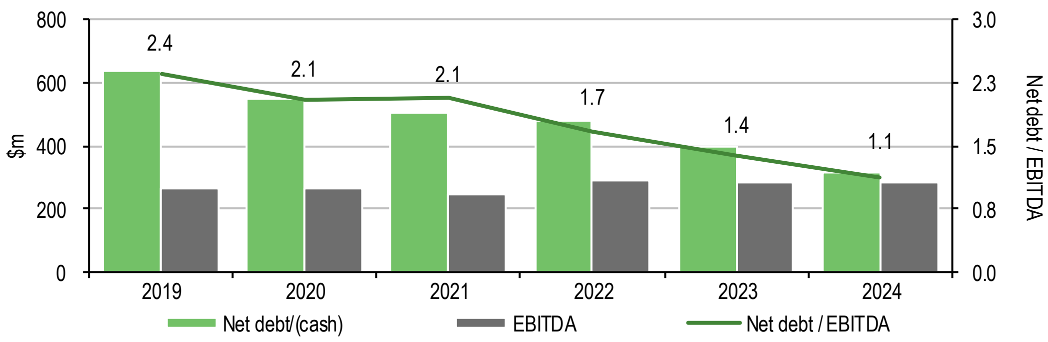
LOE* $/boe	-20%	-10%	0%	10%	20%
$/mcf long-term					
2.48	118.0	105.2	92.3	79.5	66.6
2.79	147.2	134.3	121.4	108.6	95.7
3.10	176.3	163.4	**150.6**	137.7	124.9
3.41	205.5	192.6	179.8	166.9	154.0
3.72	234.6	221.7	208.9	196.0	183.2

Source: Edison Investment Research. Note: *Includes base LOE and G&C and excludes G&T, SG&A and production taxes.

Financials

DGO's key drivers of FCF and dividends will be natural gas realisations and LOE. Below we provide our net debt and net debt/EBITDA based on our underlying commodity price assumptions. We forecast a quarterly dividend payment resulting in an annualised 13.6c/share dividend in 2019, and 14.0c/share going forward, equating to an FY20e yield of 12.8% at the current share price. We previously estimated a 16.0c/share dividend going forward, however, in light of recent the natural gas price decline, we are taking a more bearish approach and keeping the dividend constant at the latest quarterly dividend announcement level. We also assume FCF is used to reduce net debt and gearing with net debt/EBITDA falling from 2.4x in FY19 (management targets less than 2.5x net debt/adjusted EBITDA leverage ratio) to 2.1x in FY20 in the absence of further acquisitions. We believe DGO will continue to mitigate the impact of low gas prices realisations by continuing with its opportunistic hedging strategy, as it did for 2020. For 2021, DGO's hedging portfolio currently encompasses c 50% of its production versus c 85% in 2020.

Exhibit 6: Net debt and net debt/EBITDA estimates



Source: Edison Investment Research

Even though the market has been observing lower Henry Hub prices, the redetermination of DGO's senior secured credit facility in January 2020 reaffirms a $650m borrowing base following the successful $200m securitisation financing in November 2020 and demonstrates the lenders have confidence in DGO's ability to reduce its debt even at current commodity prices. The addition of Credit Suisse, Goldman Sachs and Morgan Stanley into the lending syndicate reinforces the thesis.

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Exhibit 7: Financial summary

US$m	2017	2018	2019e	2020e	2021e
Year-end: 31 December	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**
PROFIT & LOSS					
Revenue*	41.8	289.8	523.2	526.3	500.1
Cost of sales	(28.4)	(149.8)	(288.0)	(294.2)	(288.7)
Gross profit	13.3	140.0	235.2	232.1	211.4
General & admin	(8.9)	(40.5)	(40.6)	(41.4)	(39.3)
Other	(0.4)	18.0	-	-	-
Exceptionals inc gain on acquisitions	37.2	177.6	10.0	-	-
Reported EBITDA*	48.7	337.0	279.1	267.6	245.3
EBITDA*	17.5	146.2	269.1	267.6	245.3
Depreciation	(7.5)	(42.0)	(74.5)	(76.9)	(73.3)
Operating Profit (before amort. and except.)	10.0	104.2	194.6	190.7	172.0
Reported EBIT	41.2	295.0	204.6	190.7	172.0
Net interest	(11.5)	(33.2)	(44.8)	(53.9)	(50.3)
Profit Before Tax (norm)	(1.5)	71.0	149.8	136.8	121.7
Profit Before Tax (reported)	29.7	261.8	159.8	136.8	121.7
Tax	(2.3)	(60.7)	(43.1)	(36.9)	(32.9)
Profit After Tax (adjusted non-IFRS)	(3.7)	10.3	106.6	99.9	88.9
Profit After Tax (reported)	27.5	201.1	116.6	99.9	88.9
Average Number of Shares Outstanding (m)	120.1	386.6	623.3	642.8	642.8
Average Number of Shares Outstanding fully diluted (m)	120.3	387.9	623.9	642.8	642.8
EPS - normalised (c)	(3.1)	2.7	17.1	15.5	13.8
EPS - normalised fully diluted (c)	(3.1)	2.7	17.1	15.5	13.8
EPS - (IFRS) (c)	22.9	52.0	18.7	15.5	13.8
Dividend per share declared (c)	5.4	11.2	13.9	14.0	14.0
Gross margin (%)	31.9	48.3	44.9	44.1	42.3
EBITDA margin (%)	116.6	116.3	53.3	50.8	49.0
Operating margin (before GW and except.) (%)	23.9	36.0	37.2	36.2	34.4
BALANCE SHEET					
Non current assets	223.3	1,445.4	1,834.8	1,785.0	1,737.8
Intangible assets	215.3	1,093.0	1,482.4	1,432.6	1,385.3
Tangible assets	6.9	324.8	324.8	324.8	324.8
Investments	1.0	27.7	27.7	27.7	27.7
Current assets	29.6	111.6	110.2	110.2	110.2
Stocks	-	-	-	-	-
Debtors	13.9	78.5	78.5	78.5	78.5
Cash	15.2	1.4	-**	-**	-**
Other/ restricted cash	0.5	31.8	31.8	31.8	31.8
Current liabilities	(15.3)	(64.3)	(64.3)	(64.3)	(64.3)
Creditors	(15.0)	(64.0)	(64.0)	(64.0)	(64.0)
Short term borrowings	(0.4)	(0.3)	(0.3)	(0.3)	(0.3)
Long term liabilities	(123.1)	(743.8)	(939.0)	(894.3)	(863.1)
Long term borrowings	(70.6)	(482.5)	(637.1)	(550.4)	(506.0)
Other long term liabilities (inc. decomm.)	(52.5)	(261.3)	(301.8)	(343.9)	(357.1)
Net assets	114.4	748.9	941.8	936.7	920.5
CASH FLOW					
Operating cash flow	6.9	87.7	275.6	258.6	210.1
Capex inc acquisitions	(93.1)	(766.8)	(490.1)	(27.1)	(26.0)
Other	-	-	-	-	-
Equity issued	77.0	425.6	171.1	(15.0)	(15.0)
Financing expense	(3.3)	(32.6)	(30.8)	(39.8)	(34.8)
Dividends	(5.8)	(31.3)	(81.7)	(90.0)	(90.0)
Net cash flow	(18.3)	(317.4)	(156.0)	86.8	44.3
Opening net debt/(cash)	37.1	55.8	481.4	637.4	550.7
HP finance leases initiated	-	-	-	-	-
Other	(0.5)	(108.2)	-	-	-
Closing net debt/(cash)	55.8	481.4	637.4	550.7	506.3

Source: DGO, Edison Investment Research. Note: *Includes hedging; **assumes DGO uses all cash balance to pay down debt.

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