EDISON

Diversified Gas & Oil

H120 results

Strong balance sheet allows for dividend increase

Oil & gas

Diversified Gas & Oil (DGO) has announced its H120 production, which averaged 95.1kboed. DGO's Smarter Well Management programme continues to offset the natural declines in its legacy assets, delivering average production of 69.4kboed during the period. The financial results were not vastly affected by COVID-19 since DGO's strong hedging programme protects cash flows. Historically low commodity prices led to a decline in unhedged revenues; however, derivative contract settlements stood at $84m, leading to an adjusted EBITDA increase of 11% in H120 vs H119 and free cash flow (FCF) of $119m. Given FCF headroom, the board increased the quarterly dividend to 3.75c. We update our valuation to 139.8p/share (+11%) to reflect the H120 results, updated commodity price estimates and revised operating metrics. DGO will shortly be admitted to the FTSE 250 and the FTSE All-Share indices, effective 21 September, which will increase the company's market exposure and investor access.

Year-end	Revenue* ($m)	Adj EBITDA** ($m)	PBT** ($m)	Net debt ($m)	Capex*** ($m)	Dividend yield**** (%)
12/18	290	146	71	481	(767)	7.9
12/19	462	273	126	637	(467)	10.1
12/20e	400	298	147	678	(240)	10.6
12/21e	651	300	143	622	(30)	11.1

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

100kboed milestone – completed

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 H120 of c 69.4kboed. The sustained optimisation of these assets has offset their natural declines for the eighth consecutive quarter. Additional volumes from the recently acquired Carbon and EQT assets allowed DGO to achieve record production in Q220 and exit the period at c 109kboed.

Quarterly dividend increased by 7%

In H120, DGO assets generated $119m in FCF, c 13% higher than in H119. The increased, hedge-protected and predictable FCF allowed the company to increase the quarterly dividend to 3.75c from 3.5c in Q120. This occurs at a time where most oil & gas peers are cutting, suspending or eliminating their dividends as economic uncertainty due to COVID-19 persists. We stress-test dividend sustainability until 2025 and observe that under our mid-case scenario assumptions, cash dividends would amount for c 46% of FCF from 2022 to 2025, in line with DGO's dividend policy of returning c 40% of FCF to shareholders.

Valuation: Mid-case core NAV 139.8p/share

Our updated base case valuation stands at 139.8p/share, up from 125.4p/share, on inclusion of updated EIA gas price forecasts from 11 August 2020, and updated operating costs based on H120 results and reflecting the impact of the Carbon and EQT asset acquisitions. We also update DGO's hedging portfolio and dividend distribution. We forecast a FY20 dividend yield of 10.6% at the current share price.

9 September 2020

Price	**107.0p**
Market cap	**£757m**
	US$1.26/£
Net debt ($m) at 30 June 2020	756
Shares in issue	707.3m
Free float	88%
Code	DGOC
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	7.9	2.7	0.4
Rel (local)	9.4	10.7	20.8
52-week high/low		116.0p	59.6p

Business description

Diversified Gas & Oil is predominantly 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

FTSE indices inclusion effective date	21 September 2020

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Edison profile page

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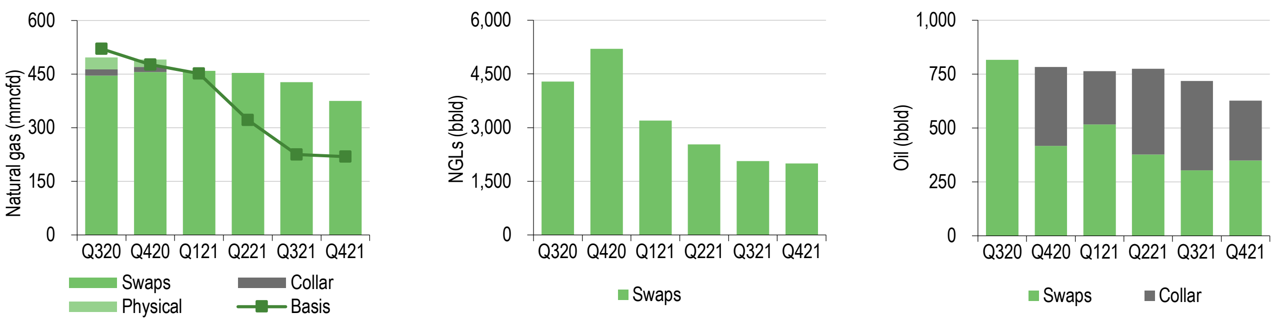
Delivering growth through pandemic

Despite the challenging environment oil and gas companies are facing globally, DGO remained essentially unaffected by the COVID-19 pandemic. It completed two acquisitions and achieved record production levels, with an H120 exit rate of 109kboed. The company observed steady production levels from its legacy assets, maintained at c 70kboed for the eighth consecutive quarter. The recent acquisitions provided strong deliverability after the first full month of production, and management acknowledged that additional opportunities for Smarter Well Management, DGO's bespoke well management approach, have been identified. For financially healthy companies like DGO, the current situation provides rare opportunities for growth.

Historically low commodity prices led to a 23% decline in revenues. However, these were offset by net cash settlements from commodity derivative contracts of c $84m, demonstrating the strength of DGO's hedging programme. This led to adjusted EBITDA for the period of $146m, 11% higher than the H119 results. Revenues and free cash flow for the near term are offset by the hedging portfolio, where c 80% of natural gas production is protected at a floor of $2.69/mmBtu ($2.79/mcf) for 2020 and c 70% at c $2.62/mmBtu ($2.72/mcf) for 2021.

Exhibit 1: DGO's near-term hedge portfolio



Source: DGO, Edison Investment Research

Cash flow generation translates to dividend increase

Since its 2017 IPO, as per its dividend policy, DGO has been distributing c 40% of its free cash flow (FCF) to shareholders via dividends. Strong FCF generation, protected by a robust hedged portfolio allowed DGO to increase its quarterly dividend at a time when most companies are cutting, suspending or eliminating their dividends as economic uncertainty has increased due to COVID-19. The company's resilience in the face of the pandemic allowed for a quarterly dividend increase of 7% from 3.50c/share in Q120 to 3.75c/share in Q220, generating a 2020 dividend yield of 10.6% at the current share price, and a 2021 yield of 10.9%, assuming the dividend remains constant, at 3.75c per quarter, over the period.

DGO is well-positioned for the second half of 2020 as the management team continues its business strategy of focusing on maximising production, minimising operating costs and keeping an eye on the market for additional FCF-generating assets to acquire and expand its footprint in the Appalachian region. Near-term priorities include the continued integration of the EQT and Carbon assets, and identifying Smarter Well Management improvement activities for existing and newly acquired upstream and midstream assets.

Changes to estimates

Exhibit 2 provides our updated forecasts for FY20 and FY21. Our FY20 production estimate remains in line with our previous note at 100.0kboed. We update our operating metrics in line with H120 results. This affects base lease operating costs (LOE), production taxes, gathering & transportation (G&T), gathering & compression (G&C) and general & administrative (G&A) per boe. Higher production resulted in lower operating metrics per boe. Our G&A estimate increases to reflect DGO's realised G&A in the first half of the year. The increase reflects costs associated with the acquisitions and listing on the Main Market of the London Stock Exchange in May 2020. However, the company expects the majority of these costs to be non-recurring. Our FY20 oil and gas price assumptions, based on the 11 August EIA Short-Term Energy Outlook (STEO) estimates, remain virtually the same for Henry Hub (HH) and increased by 10% for WTI. For FY21, the EIA forecasts a 2% increase versus our previous note in HH and a 4% increase in WTI.

Exhibit 2: Edison updated forecasts

	Actual	New		Old		Change	
	2019	2020e	2021e	2020e	2021e	2020e	2021e
Production (kboed)	84.8	100.0	101.5	100.0	102.4	0%	-1%
Revenue* ($m)	536	566	575	564	589	0%	-2%
EBITDA** ($m)	279	298	300	290	305	3%	-2%
Adjusted EBITDA ($m)	273	298	300	290	305	3%	-2%
FCF ($m) – excluding acquisitions	225	260	205	251	215	3%	-4%
P&A expenditure ($m)	3.0	3.5	3.5	3.5	3.5	0%	0%
Revenue*/boe ($/boe)	17.33	15.49	15.51	15.45	15.76	0%	-2%
Opex***/boe ($/boe)	6.90	5.89	5.90	6.42	6.26	-8%	-6%
G&A/boe ($/boe)	1.83	1.34	1.43	1.00	1.20	34%	19%
Cash costs/boe ($/boe)	8.73	7.23	7.33	7.42	7.46	-3%	-2%
Capex/boe ($/boe)	1.04	0.81	0.82	0.81	0.82	0%	0%
HH gas price assumption ($/mcf)	2.66	2.11	3.25	2.12	3.20	0%	2%
WTI ($/bbl)	57.02	38.50	45.53	35.14	43.88	10%	4%

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.

Valuation

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

We break down the assets into DGO legacy assets (conventional, late-life, low decline rate), the 2019 acquired assets (early-life assets) and the recent acquisitions of Carbon Energy and EQT assets. DGO pipelines with related compressor stations are also reflected in our discounted value for payments DGO receives for third-party use of services and midstream assets and respective operating costs – currently estimated at a NAV of $49.0m. We also include the hedging impact based on DGO's latest available information on hedging volumes from 31 July 2020, as well as the impact of the 2020 share buyback programme and the recent equity raise for the acquisition of the Carbon Energy and EQT assets.

We also present our three scenarios with a low case commodity price scenario of HH in 2022 at $2.73/mcf, calculated from a 2020 HH of $2.60/mcf escalated at 2.5% per year; a mid-case scenario with HH in 2022 of $2.94/mcf, calculated from a 2020 HH of $2.80/mcf escalated at 2.5% per year; and a high-case scenario of HH in 2022 of $3.15/mcf, calculated from a 2020 HH of $3.00/mcf escalated at 2.5% per year.

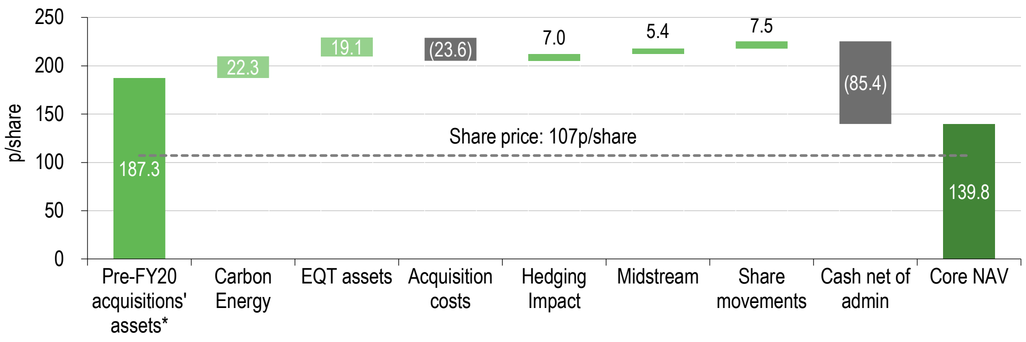
Exhibit 3: Edison detailed NAV breakdown for DGO

Asset	Country	Diluted WI	CoS	Net recoverable reserves	NPV/boe	Net risked value	Low ($2.60/mcf)	Mid ($2.80/mcf)	High ($3.00/mcf)
							Net risked value per share		
		%	%	mmboe	$/boe	$m	p/share	p/share	p/share
Net (debt)/cash end-2019						(637)	(71.5)	(71.5)	(71.5)
SG&A – NPV of three years						(124)	(13.9)	(13.9)	(13.9)
Hedging impact						63	8.9	7.0	5.2
Third-party volume discounted FCF						49	5.4	5.4	5.4
Share issuance/(buyback) expense						67	7.5	7.5	7.5
Acquisition costs						(210)	(23.6)	(23.6)	(23.6)
Production									
Legacy	US	100%	100%	464	2.9	1,365	128.1	153.3	178.5
HG Energy	US	87%	100%	86	3.0	256	25.6	28.7	31.8
EdgeMarc	US	79%	100%	12	3.9	48	4.8	5.3	5.9
Carbon Energy	US	82%	100%	74	2.7	199	19.9	22.3	24.7
EQT assets	US	92%	100%	48	3.6	171	17.4	19.1	20.9
Core NAV				**684**		**1,245**	**108.7**	**139.8**	**170.9**

Source: Edison Investment Research. Note: Number of shares = 707.3m. 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 of 684mmboe nor its third-party revenues from midstream assets.

Exhibit 4: NAV waterfall chart



Source: Edison Investment Research. Note: *Pre-FY20 acquisitions' assets include DGO Legacy, HG Energy and EdgeMarc assets; share price as at 4 September 2020.

The key drivers of DGO's valuation are the gas price and LOE. Our mid-case assumes a long-term (2022) gas price of $2.94/mcf based on a 2020 $2.80/mcf and short-term gas assumptions based on the EIA short-term energy outlook of $2.11/mcf for FY20 and $3.25/mcf for FY21. Our base 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					
2.40	132.9	117.0	101.1	85.2	69.4
2.60	140.5	124.6	108.7	92.8	76.9
2.80	171.6	155.7	**139.8**	123.9	108.1
3.00	202.7	186.8	170.9	155.1	139.2
3.20	226.0	210.1	194.2	178.3	162.4

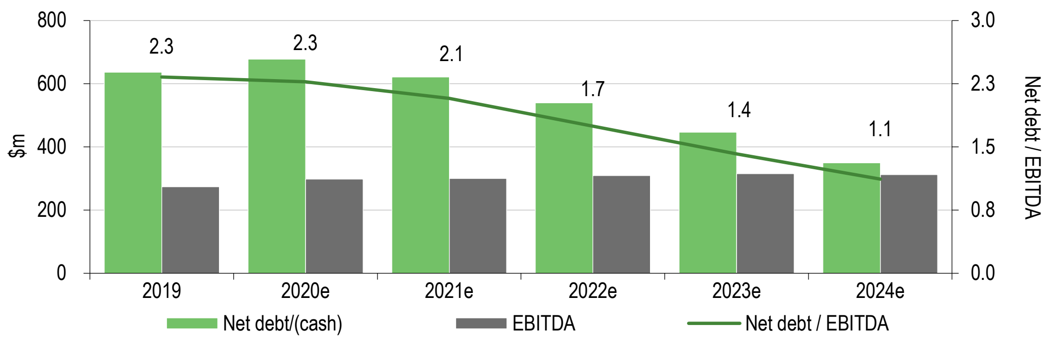
Source: Edison Investment Research. Note: *Includes base LOE and G&C and excludes G&T, SG&A and production taxes

Financials

DGO recently completed upstream and midstream asset acquisitions from Carbon ($110m) and EQT ($125m) financed through a successful $86m (gross) share placing and a $160m (gross) amortising 10-year term loan underwritten by Munich Re Reserves Risk Financing (MRRF). Further details on the acquisition terms can be found in our outlook note published on 15 June 2020.

Key drivers of FCF and dividends for the company will be natural gas realisations and LOE. Below we provide our net debt and net debt/EBITDA forecasts based on our underlying commodity price assumptions. We forecast a quarterly dividend payment resulting in an annualised 14.25c dividend paid in 2020, equating to an FY20e yield of 10.6% at the current share price. Assuming the dividend remains constant (at 3.75 per quarter) in FY21, this would result in an annualised dividend paid in 2021 of 15.00c and a yield of 11.1%. We also assume FCF is used to reduce net debt and gearing, with our forecast net debt/EBITDA standing at 2.3x in FY20 following the recent acquisitions (management targets less than 2.5x net debt/adjusted EBITDA leverage ratio) and falling to 2.1x in FY21. We believe DGO will continue to mitigate the impact of low gas prices realisations by continuing with its opportunistic hedging strategy, as it did in 2020.

Exhibit 6: Net debt and net debt/EBITDA estimates



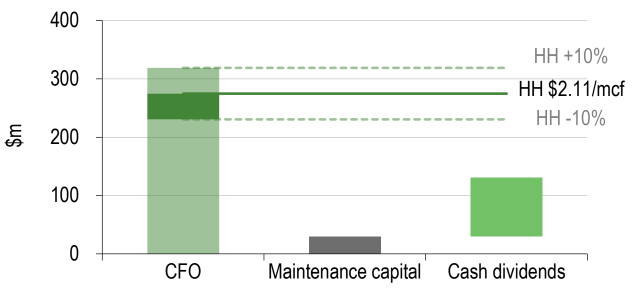
Source: Edison Investment Research

Although the market has been observing lower HH prices, the redetermination of DGO's senior secured credit facility in June 2020 reaffirms a $425m borrowing base and demonstrates that the lenders have confidence in DGO's ability to reduce its debt, even at current commodity prices. The current facility has a maturity date of July 2023, an interest rate of 2.5% plus one-month Libor and is subject to a grid that fluctuates from 2.0–3.0% plus Libor based on utilisation.

Dividend protected by FY20 and FY21 hedges

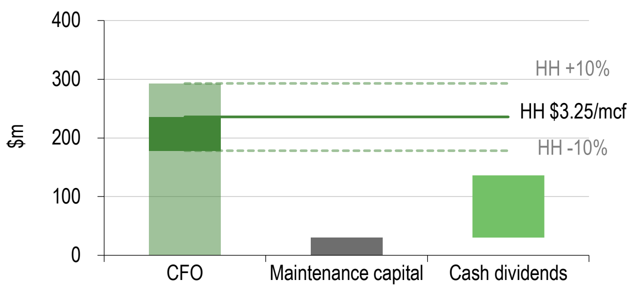
DGO has distributed regular and increasing dividends to shareholders since 2017. Management targets shareholder returns of c 40% of FCF. In Exhibits 7 and 8 we show that at a 10% discount to our current commodity price assumptions and a constant quarterly dividend of 3.75c from Q220, FY20 and FY21 maintenance capex and cash dividends are covered by cash from operations. We have stress-tested our model for commodity prices and observed that we would have to see an average realised HH price of $1.35/mcf in 2020 and $2.67/mcf 2021 for cash from operations to just about cover current capex and dividend assumptions. However, as already mentioned, DGO's floor hedge price for 2020 is $2.69/mmBtu ($2.79/mcf) and $2.62/mmBtu ($2.72/mcf) for 2021.

Exhibit 7: DGO FY20e dividend coverage



Source: Edison Investment Research

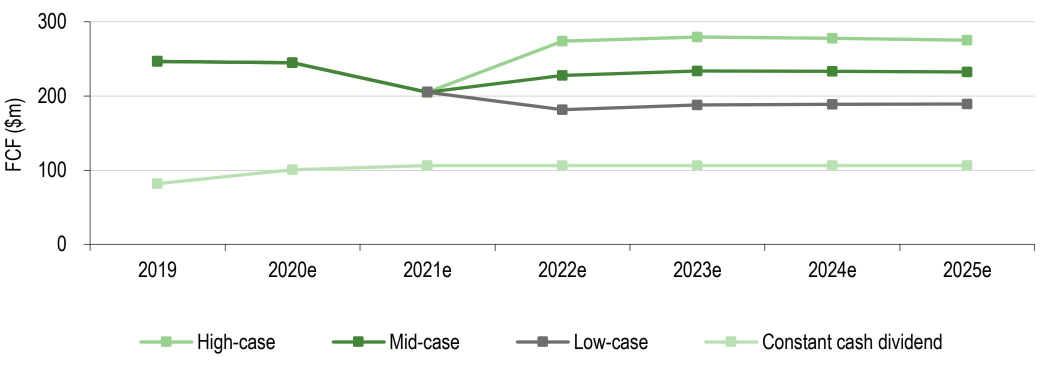
Exhibit 8: DGO FY21e dividend coverage



Source: Edison Investment Research

Exhibit 9 provides a test of DGO's new quarterly dividend sustainability until 2025 under our different modelled scenarios. We highlight that this stress test excludes any future potential share buyback programme or acquisitions. We observe that under our mid-case scenario, assuming dividend payouts remain constant, cash dividends would account for c 46% of generated FCF from 2022, broadly in line with the company's current dividend policy. In our low-case scenario, this would increase to c 56% of FCF from 2022.

Exhibit 9: DGO dividend sustainability



Source: Edison Investment Research

Exhibit 10: Financial summary

US$m	2017	2018	2019	2020e	2021e
Year-end December	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**
PROFIT & LOSS					
Revenue	41.8	289.8	462.3	400.0	651.1
Cost of sales	(28.4)	(149.8)	(300.5)	(309.2)	(314.0)
Gross profit	13.3	140.0	161.7	90.8	337.1
General & admin	(8.9)	(40.5)	(56.6)	(48.9)	(53.0)
Other	(0.4)	18.0	73.9	165.7	(76.3)
Exceptionals including gain on acquisitions	37.2	177.6	1.5	-	-
Reported EBITDA*	48.7	337.0	278.6	298.4	299.6
EBITDA	17.5	146.2	273.3	298.4	299.6
Depreciation	(7.5)	(42.0)	(98.1)	(90.7)	(91.8)
Operating Profit (before amort. and except.)	10.0	104.2	175.1	207.6	207.8
Reported EBIT	41.2	295.0	180.5	207.6	207.8
Net interest	(11.5)	(33.2)	(49.0)	(60.4)	(64.6)
Profit Before Tax (norm)	(1.5)	71.0	126.1	147.3	143.2
Profit Before Tax (reported)	29.7	261.8	131.5	147.3	143.2
Tax	(2.3)	(60.7)	(32.1)	(39.8)	(38.7)
Profit After Tax (adjusted non-IFRS)	(3.7)	10.3	94.1	107.5	104.5
Profit After Tax (reported)	27.5	201.1	99.4	107.5	104.5
Average Number of Shares Outstanding (m)	120.1	386.6	641.7	707.3	707.3
Average Number of Shares Outstanding fully diluted (m)	120.3	120.3	387.9	707.3	707.3
EPS - normalised (c)	(3.1)	2.7	14.7	15.2	14.8
EPS - normalised fully diluted (c)	(3.1)	2.7	14.6	15.2	14.8
EPS - (IFRS) (c)	22.9	52.0	15.5	15.2	14.8
Dividend per share declared (c)	5.4	11.2	13.9	14.3	15.0
Gross margin (%)	31.9	48.3	35.0	22.7	51.8
EBITDA margin (%)	116.6	116.3	60.3	74.6	46.0
Operating margin (before GW and except.) (%)	23.9	36.0	37.9	51.9	31.9
BALANCE SHEET					
Non-current assets	223.3	1,445.4	1,845.6	1,994.6	1,933.2
Intangible assets	215.3	1,093.0	1,490.9	1,639.9	1,578.5
Tangible assets	6.9	324.8	341.8	341.8	341.8
Investments	1.0	27.7	12.8	12.8	12.8
Current assets	29.6	111.6	160.4	173.5	173.5
Stocks	-	-	-	-	-
Debtors	13.9	78.5	73.9	88.7	88.7
Cash**	15.2	1.4	2.9	-	-
Other/ restricted cash	0.5	31.8	83.6	84.8	84.8
Current liabilities	(15.3)	(64.3)	(126.9)	(126.9)	(126.9)
Creditors	(15.0)	(64.0)	(86.1)	(86.1)	(86.1)
Short term borrowings	(0.4)	(0.3)	(40.8)	(40.8)	(40.8)
Long term liabilities	(123.1)	(743.8)	(941.0)	(1,029.7)	(969.8)
Long term borrowings	(70.6)	(482.5)	(598.8)	(637.1)	(580.8)
Other long-term liabilities (inc. decomm.)	(52.5)	(261.3)	(342.2)	(392.6)	(389.0)
Net assets	114.4	748.9	938.1	1,011.5	1,010.0
CASH FLOW					
Operating cash flow	6.9	87.7	279.2	274.6	235.6
Capex inc acquisitions	(93.1)	(766.8)	(466.9)	(239.7)	(30.4)
Other	-	-	-	-	-
Equity issued (net)	77.0	425.6	169.0	66.7	-
Financing expense	(3.3)	(32.6)	(44.3)	(40.7)	(42.9)
Dividends	(5.8)	(31.3)	(82.2)	(100.8)	(106.1)
Net cash flow	(18.3)	(317.4)	(145.2)	(39.9)	56.3
Opening net debt/(cash)	37.1	55.8	481.4	636.7	677.8
HP finance leases initiated	-	-	-	-	-
Other	(0.5)	(108.2)	(10.0)	(1.2)	(0.0)
Closing net debt/(cash)	55.8	481.4	636.7	677.8	621.6

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

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