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In this edition of the Value Seeker Report, we analyze an investment opportunity in Diamondback Energy (Nasdaq: FANG) using fundamental and technical analysis.

Overview

- This report is a continuation of the energy theme from our last few posts. Last week we evaluated KMI, a midstream energy company. Now turning our focus to the upstream portion of the energy sector, this week we evaluate the investment merits of Diamondback Energy (FANG).
- FANG is a cost-efficient exploration and production company in the energy sector. The company owns over 347,000 acres in the Midland and Delaware sub-basins, which are highly sought-after regions within the greater Permian Basin.
- In 2019, crude oil comprised 66% of FANG?s production volume on a barrels-of-oil-equivalent basis, while the remaining production consisted of natural gas and natural gas liquids (NGLs).
- Using what we view as conservative forecasts, we arrive at an intrinsic value of $36.32 for FANG?s stock. The stock is trading at $26.19 per share, which implies an upside of 38.7% on top of a 5% dividend yield.

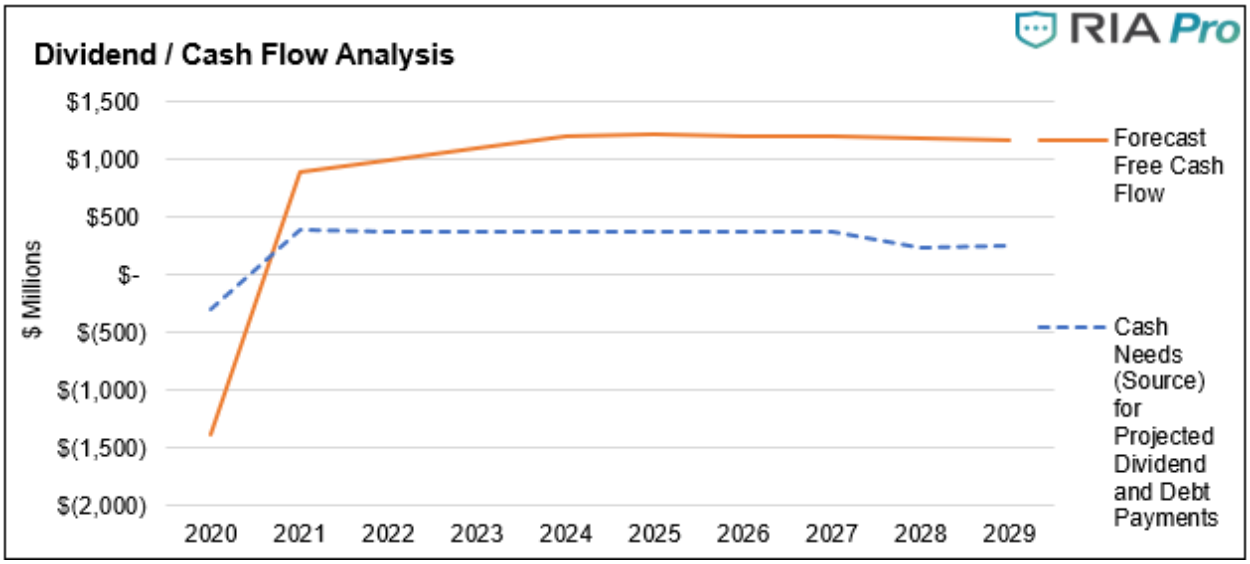
Pros

- As a complement to its status as an efficient operator, FANG operates in areas of the Permian Basin characterized by favorable production economics. The company?s industry leading cost of production allows it to stay in control through rough patches in energy prices, such as we are experiencing now.
- FANG has a substantial backlog of wells with drilling operations finished, waiting for completion. Since wells begin producing once they are completed, FANG?s backlog offers the firm flexibility to ramp up production as energy prices recover. This provides a distinction from other operators who have shut in and/or suspended drilling operations on a substantial number of wells. Shut-ins may damage shale formations, leaving operators to choose between accepting lower volumes or re-fracking the well as they once again ramp up production.
- Based on recent M&A activity in the Permian Basin combined with the characteristics of FANG, it?s not unrealistic that FANG could become a target in a large deal. If this materializes, investors could receive a healthy premium for their shares.

- FANG began paying a quarterly dividend in 2018 and has raised it every year since. The most recent dividend declared is for $0.3750 per share, resulting in total dividends of $1.50 per share in 2020. At the current price, the stock?s dividend yield is 5.1%.
- Serving as another plus for investors, FANG has shifted its focus from growing operations to generating cash flow and protecting the dividend. Management has made it clear that it does not believe it needs more scale to drive further cost efficiency. As CEO, Travis Stice recently stated:

  ?We will protect our dividend, spend maintenance capital at most, and use excess free cash flow to pay down debt. If our expected free cash flow will not cover our dividend, then we will cut capital to ensure our dividend is protected.?

- According to our forecasts, FANG will produce free cash flow in excess of the amount necessary to raise its dividend by $0.04 per share annually through 2029.

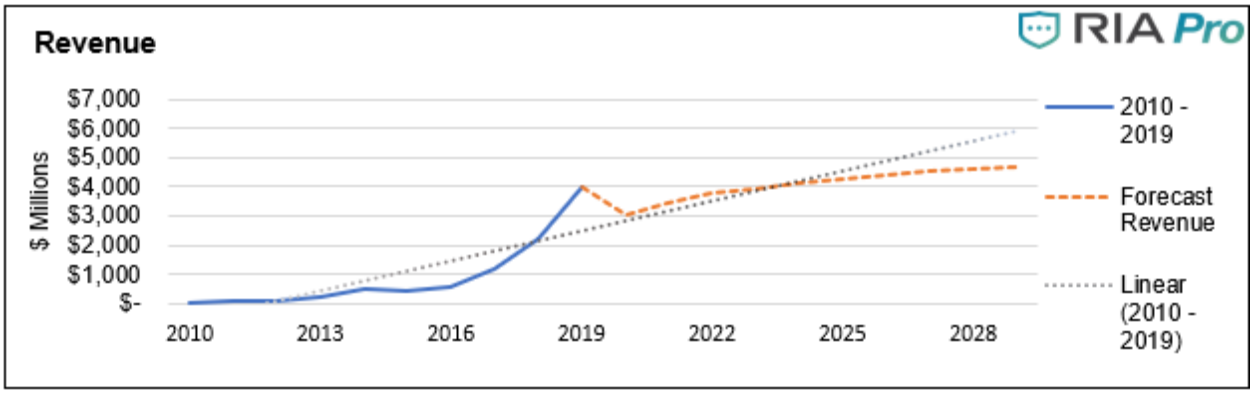


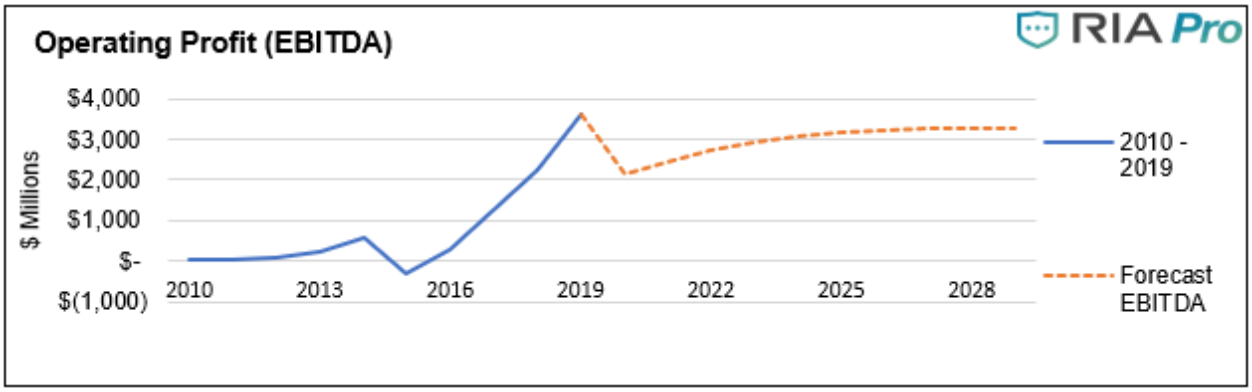
Cons

- The outcome of the 2020 United States presidential election is viewed by the market as a binary ?good or bad? outcome for energy companies. Regulations that could be introduced under a possible Biden administration may have a negative effect on the profitability of exploration and production companies, especially those in the fracking sector.
- On top of other potential headwinds, demand weakened by COVID is preventing a recovery in FANG. Further lockdowns in Europe do not paint a pretty picture of what may be in store for the United States? winter season. With COVID resurgences and a lack of stimulus, demand recovery at any time soon is not promising.
- FANG has earned a Times Interest Earned (TIE) ratio of -28.11 for the trailing twelve months. This should raise some alarms regarding liquidity. However, this is somewhat of a false-con, as the deeply negative TIE ratio has come about because of substantial write-downs in the value of oil & gas properties. We do not want to brush off this information, but we want to make the distinction that they are non-cash expenses. Further, as of September 30th, FANG has $2B of borrowing capacity available, should the need for cash arise.

Key Assumptions

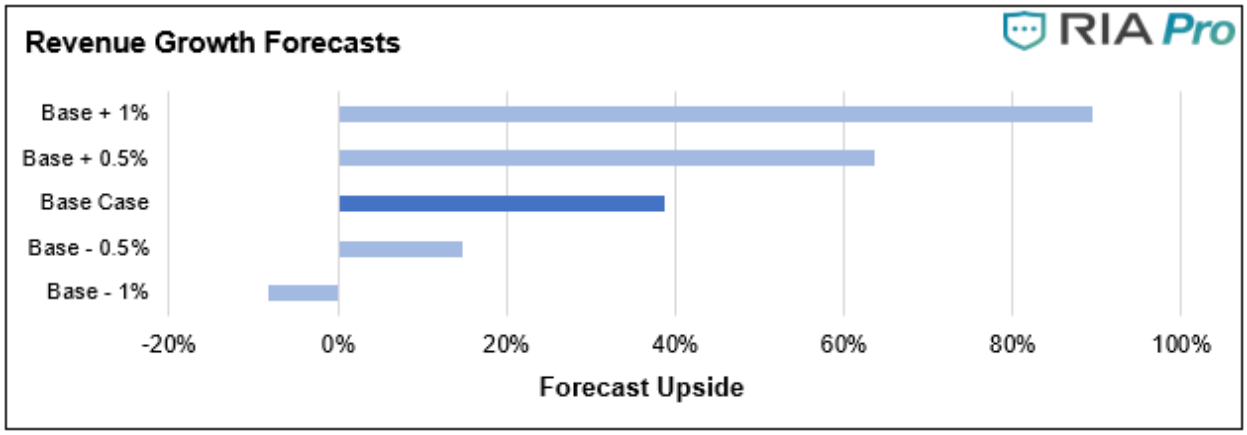
- Continuing with the assumptions of our last two reports, we assume a Biden victory for the presidency and a divided congress.
- Our forecast for revenue growth in 2020 is based on three quarters of results and management?s commentary in FANG?s 3rd quarter earnings call. Just as in our report on KMI, we assume a slow recovery in demand spanning into 2023. We forecast revenue growth to then fade slightly through 2029 as society transitions to green energy. Our forecasts of revenue are illustrated below.
- We forecast a substantial hit to margins in 2020 as COVID takes its toll on demand. We assume margins will then recover with revenue through 2024, before entering a decline as the United States begins shifting to green energy in the following years. The chart below shows our forecasts of operating profit compared to historical figures.

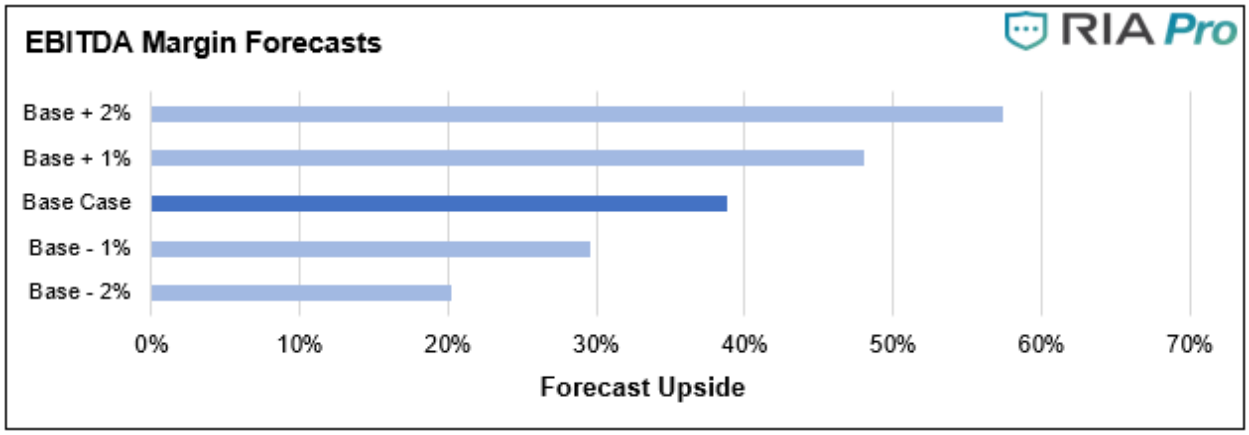


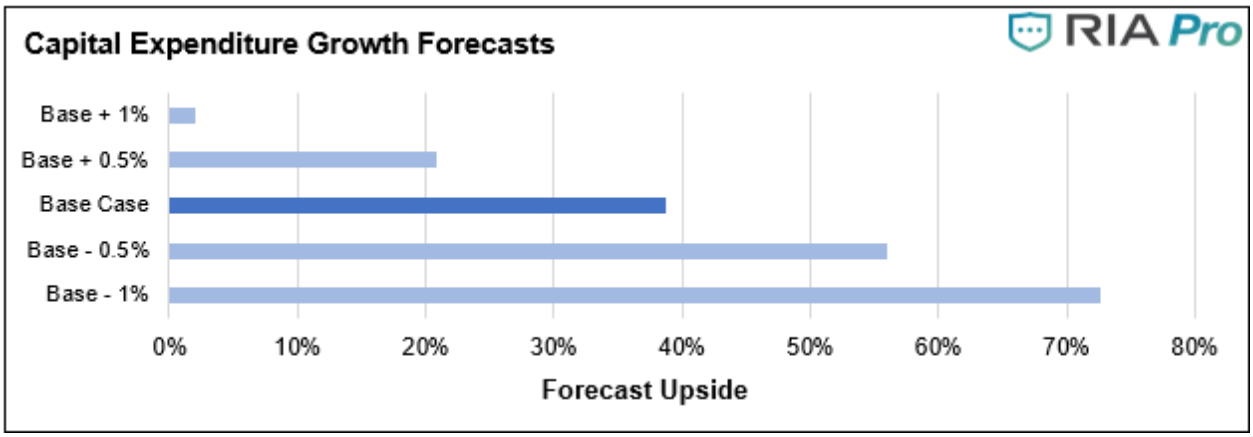


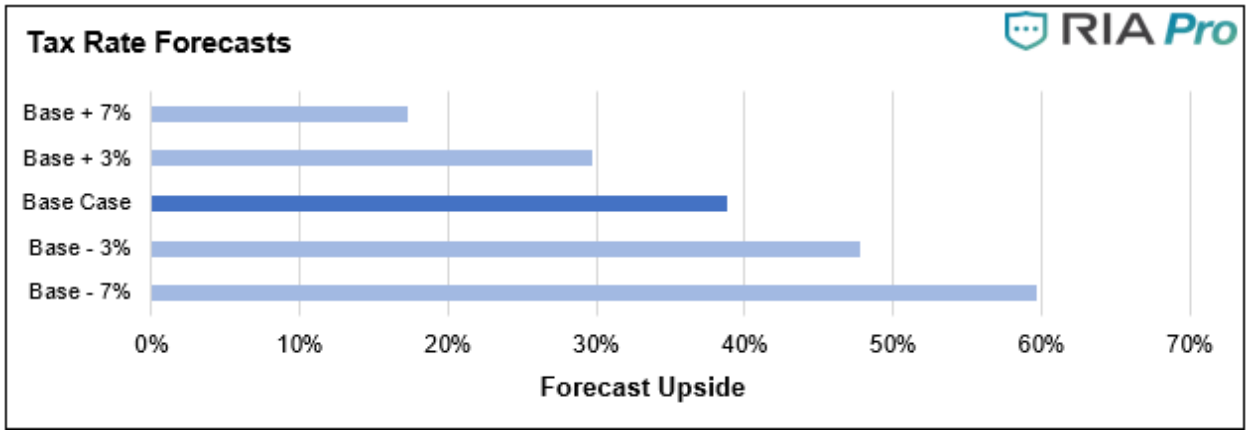
Sensitivity Analysis

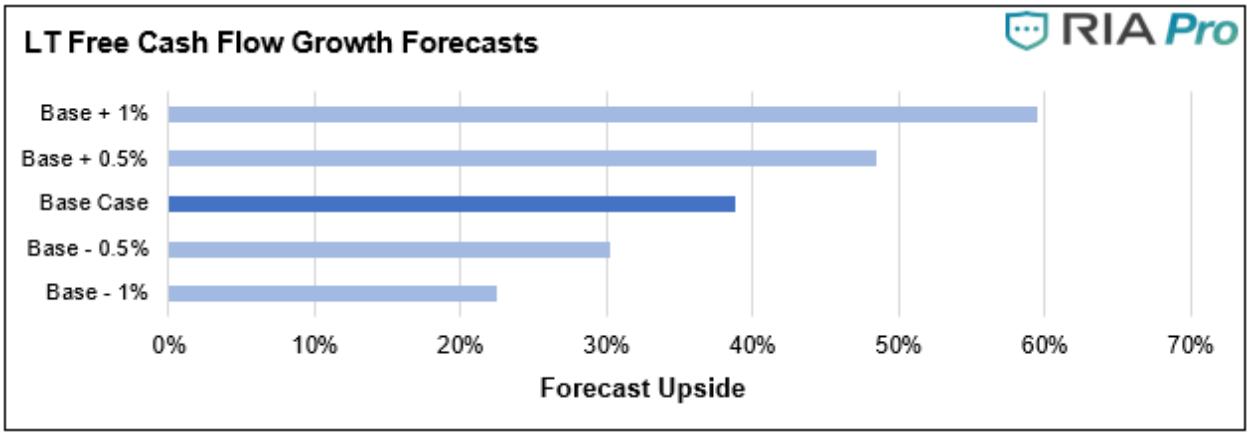
- A brief note on why we present sensitivity analysis can be found here.
- Aside from COVID, the major concern for the market appears to be the looming transition towards green energy by the U.S. However, we see slight upside even when we drop our long-term FCF growth rate assumption to 0% (Nominal).


Revenue Growth Forecasts
RIA Pro
Base + 1%
Base + 0.5%
Base Case
Base - 0.5%
Base - 1%
-20%
0%
20%
40%
60%
80%
100%
Forecast Upside


EBITDA Margin Forecasts
RIA Pro
Base + 2%
Base + 1%
Base Case
Base - 1%
Base - 2%
0%
10%
20%
30%
40%
50%
60%
70%
Forecast Upside


Capital Expenditure Growth Forecasts
RIA Pro
Base + 1%
Base + 0.5%
Base Case
Base - 0.5%
Base - 1%
0%
10%
20%
30%
40%
50%
60%
70%
80%
Forecast Upside


Tax Rate Forecasts
RIA Pro
Base + 7%
Base + 3%
Base Case
Base - 3%
Base - 7%
0%
10%
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30%
40%
50%
60%
70%
Forecast Upside

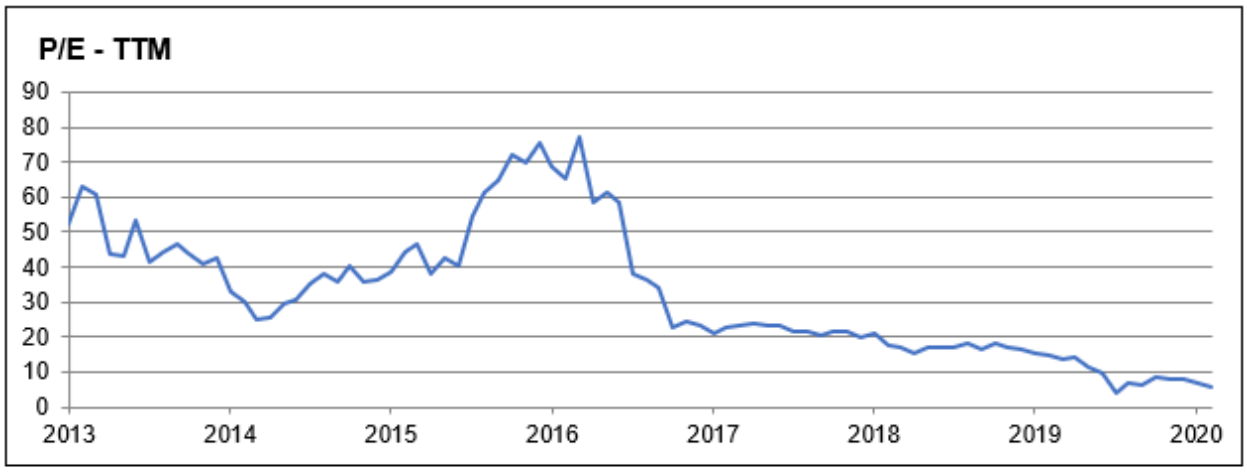


Technical Snapshot

- The technical snapshot for FANG does not appear much different from the snapshot we did last week for KMI. The stock has been in a downtrend since mid-June and below its 50-day moving average since late-June. The main difference is FANG lacks the long-term support that we saw in KMI.
- The stock will encounter support near $25.50, and face resistance at the 50-day moving average near $30 per share. Investors may wish to exit the position if the stock makes a sustained break below $25.50.

Value Seeker Report Conclusion On FANG

- The market?s lack of appetite for energy exposure has led to some firms falling well below intrinsic value. With a forecast upside of 38.7%, we believe FANG is one of them.
- Unfortunately, due to the market?s narrative for energy and the election, prices may get worse before they improve. As we alluded to last week, we think there is a lot of value in the energy space, but the market may not agree with us for some time. As such, we believe we are fighting an uphill battle for the time-being and investors should be cognizant of the risks.



Source: Zacks Investment Research

Fundamental Ratios	
Price / Sales TTM	1.31
Price / Earnings TTM	5.24
Current Ratio (Quarterly)	0.45
Quick Ratio	0.47
Times Interest Earned (TIE) Ratio TTM	-28.11

Latest Report Date	Ticker	Last Close Price	Intrinsic Value	Forecast Upside Remaining	Original Conviction Rating	Current Conviction Rating	Currently Held in RIA Pro Portfolio?
8/6/2020	T	$ 27.51	$ 38.09	38.5%	3-Star	2-Star	No
8/13/2020	XOM	$ 33.17	$ 55.42	67.1%	3-Star	2-Star	No
8/28/2020	VIAC	$ 31.29	$ 36.70	17.3%	4-Star	2-Star	No
9/3/2020	DOX	$ 57.52	$ 76.76	33.4%	3-Star	3-Star	No
9/11/2020	CVS	$ 61.41	$ 85.35	39.0%	3-Star	3-Star	Yes
9/18/2020	PETS	$ 30.73	$ 41.14	33.9%	3-Star	3-Star	No
9/24/2020	SPB	$ 63.33	$ 61.18	-3.4%	4-Star	4-Star	No
10/2/2020	DKS	$ 56.82	$ 68.76	21.0%	4-Star	4-Star	No
10/9/2020	WCC	$ 52.15	$ 61.42	17.8%	4-Star	4-Star	No
10/30/2020	KMI	$ 11.90	$ 13.98	17.5%	3-Star	3-Star	No
11/6/2020	FANG	$ 26.20	$ 36.32	38.6%	3-Star	3-Star	No

For the Value Seeker Report, we utilize RIA Advisors? Discounted Cash Flow (DCF) valuation model to evaluate the investment merits of selected stocks. Our model is based on our forecasts of free cash flow over the next ten years.