Siena Market Line
2nd week of October 2015

Diamondback Energy Incorporated

NasdaqGs:FANG

Analyst: Dominick Iachetta
Sector: Energy

BUY

Price Target: $84.88

Key Statistics as of 10/09/2015

Market Price:	$76.95
Industry:	Exploration & Production
Market Cap:	$5.09 B
52-Week Range:	$51.69-85.82
Beta:	1.39

Thesis Points:

- Increase in horizontal drilling throughout the Permian Basin will drive growth
- Major stake in valuable subsidiary, Viper Energy Partners
- Financial analysis: revenue growth, strong debt to asset ratio

Company Description:

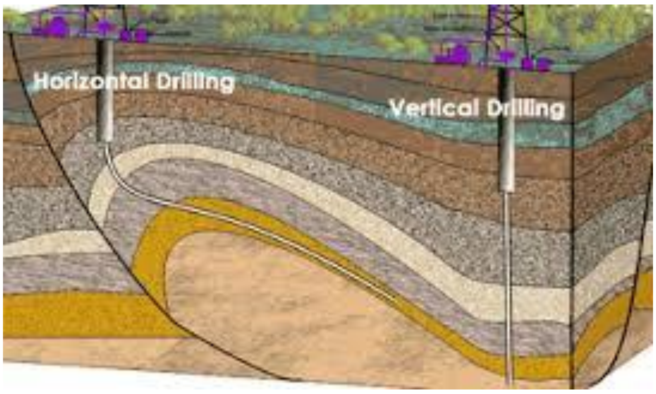
Diamondback Energy Inc. is an oil and natural gas company headquartered in Midland, Texas. The company's focus is on the acquisition, development, exploration and exploitation of on-shore natural gas and oil reserves. The majority of Diamondback's operations are centered in the Permian Basin of West Texas, one of the largest oil producing basins in the United States.

Thesis

I am recommending a BUY for Diamondback Energy based on their increased efficiency of horizontal drilling projects in the Permian Basin, their majority stake in Viper Energy Partners as well as promising growth potential in both the near and long term.

Horizontal Drilling in Permian Basin

Within the last 18 months, one of FANG's primary objectives has been targeting and operating horizontal wells. Although the concept has existed in the industry for quite some time, it has become much more prevalent in recent years due to drastic advances in technology. Like its name indicates, horizontal drilling allows companies to drill at an angle as opposed to straight into the ground. This new practice has helped FANG reach targets which were previously impossible, convert unwanted shale into profitable materials and improve overall drilling efficiency. FANG's horizontal drilling program has been implemented to capture the higher potential upside that already exists on their current properties. By 2015, FANG plans to own and operate between 60-70 horizontal wells, which is an increase from previous estimates. FANG's proven ability to make the transition to this more economic and profitable method of drilling will ultimately result in growth for the company.

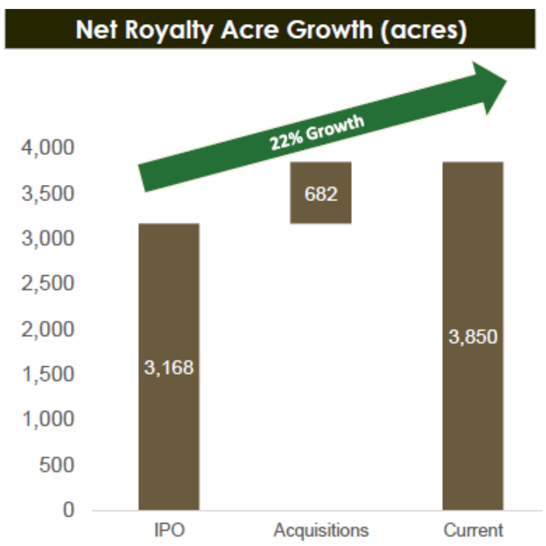


FANG's expanding stronghold in the Permian Basin is also a key value driver for the firm. The Permian Basin is one of the largest sedimentary basins in the United States. Due to the increase in horizontal drilling and other alternate drilling methods, the Permian Basin region is one of the most active oil producing areas in the country. The basin accounts for about 18% of US crude oil production and 23% of the country's oil reserves. In 2007, FANG began its operations with the acquisition of nearly 4,100 net acres in the Permian Basin. In the eight years that have followed, FANG has accumulated over 85,000 net acres in the same region and is constantly seeking new areas within the basin to expand. Two of FANG's four horizontal rigs are located at the Spanish Trail, one of the most oil rich areas of the entire basin. FANG's executive team has extensive experience in the Permian Basin which will allow the company to effectively expand their holdings into new, untapped resources. FANG's assets in the Permian Basin as well as their prospective plays within the region will stabilize the company as it continues on its growth path.

Viper Energy Partners

A major asset that will drive growth for FANG in the near and long term is its fully consolidated subsidiary, Viper Energy Partners (VNOM). Similar to FANG, VNOM owns, acquires, exploits, and develops oil and natural gas properties in areas throughout North America, mainly in the Permian Basin region. VNOM's acquisition strategy is to purchase royalty land in areas that are rich producers in oil and gas. They also accumulate royalty property in areas in which high quality operators, such as FANG, actively develop the land. Based on their royalty status, VNOM does not pay development or operating costs on production, which has lead to very high operating margins for the company. Overall, VNOM's business model has lead them to earn an average of 21.4% royalty interest on the production of land under their supervision. VNOM currently owns 3,850 net royalty acres throughout the Permian Basin and plans to expand this territory in the near future.

The reason that VNOM has such immediate growth implication on FANG is because FANG currently holds an 88% share in the company. VNOM has shown the ability to grow organically due to increased drilling activity from well-proven operators. VNOM currently holds the majority of its net acreage in the Permian Basin region. A major portion of this land area is operated by FANG, as well as RSP Permian. This consistent development on already pre-existing, owned property has helped VNOM grow to be one of the most attractive E&P MLP's in today's market.



VNOM's expansion into new types of drilling and geographic areas is crucial in helping them reach their ultimate growth potential. In total, 551 acres of land currently being operated by FANG have been identified as new, potential drilling locations for the company. Many of these locations are targeted as zones for horizontal drilling. The company's ability to take advantage of these opportunities, as well as their ability to expand into new regions, such as the Delaware Basin, will ultimately help lead to them having long-term, sustainable growth.

FANG and VNOM have a mutually beneficial relationship. Since VNOM's IPO in 2014, FANG has improved on many different aspects of their business. In this time period, FANG's average daily net production has nearly doubled, their operating expenses over time have decreased by 44% and their EBITDA growth has increased by nearly 4 times. VNOM is an extremely underrated asset of FANG. Despite the market uncertainty in the price of oil, VNOM's business model and upcoming ventures will ultimately lead to success and growth. FANG's 88% stake in the company will create value for the parent firm going forward.

Financial Analysis

Throughout the recent past, FANG's revenues have grown at an impressive rate. Due to the implementation of new drilling techniques, 2014 sales revenue totaled \$506 million, a 150% increase from the previous year. Revenue for 2015 is estimated to grow to \$531. Although this rate of growth is negligible compared to years past, FANG's ability to boost sales in the current oil environment is an indicator of the company's long-term stability. Finally in 2016, FANG is estimated to increase sales to \$617 million. Part of FANG's core strategy is to constantly seek acquisition targets with exceptional resource potential. The ability of FANG's executive team to expand into new, prosperous projects will act as at a catalyst for sales in future years.

FANG's growth trajectory has not been accompanied by a major accumulation of debt, which is a very positive sign for the company going forward. FANG's enterprise value has increased from \$681 million in 2012 to over \$5.7 billion currently. This massive increase in enterprise value has only been accompanied by the accumulation of \$718 million in total debt, most of which doesn't come due until 2018. FANG's debt to asset ratio of 23% is extremely important for the company. In 2014, 90% of FANG's total assets were comprised of net property, plant and equipment. FANG's trend of acquiring additional rigs to bolster operations hasn't lead them to accumulate an unmanageable level of debt. Going forward FANG's strong debt to asset ratio demonstrates their ability to build up crucial PPE necessary for operations without taking on excessive debt. This will bode well for them as they continue to expand into new territory and accumulate more resources.

Summary

I am recommending a BUY on FANG because of the firm's growth trajectory and stock's upside potential. Current market conditions make the energy sector a tough play for most crude oil bears. FANG's operations in the Permian Basin, the performance of their subsidiary, Viper Energy Partners, and the firm's strong balance sheet will allow FANG to not only survive these times of uncertainty but will also lead the company to ultimate growth and prosperity.

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Diamondback Energy, Inc.	FANG	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 58.26%	NEUTRAL
		Dominick Iachetta	$76.67	$113.39	$84.88	0%		

General Info	
Sector	Energy
Industry	Oil, Gas and Consumable Fuels
Last Guidance	August 6, 2015
Next earnings date	November 4, 2015
Market Data	
Enterprise value	$5,951.01
Market Capitalization	$624,448.06
Daily volume	8.34
Shares outstanding	66.18
Diluted shares outstanding	57.98
% shares held by institutions	60.72%
% shares held by insiders	0.37%
Short interest	5.45%
Days to cover short interest	2.84
52 week high	$85.82
52-week low	$51.69
5y Beta	1.11
6-month volatility	37.90%

Peers	Market Cap.
PDC Energy, Inc.	$2,408.69
Bonanza Creek Energy, Inc.	$382.07
Carrizo Oil & Gas Inc.	$2,242.24
Gulfport Energy Corp.	$3,780.87
Laredo Petroleum, Inc.	$2,985.62
Bill Barrett Corp.	$264.74
Rice Energy Inc.	$2,498.74
Swift Energy Co.	$30.95
Penn Virginia Corporation	$75.98
Comstock Resources Inc.	$147.00

Current Capital Structure	
Total debt/Common Equity (LTM)	0.36
Cost of Borrowing (LTM)	6.76%
Estimated Cost of new Borrowing	0.00%
Altman's Z	3.19
Estimated Debt Rating	BB
Current levered Beta	1.71
LTM WACC	10.21%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Stice, Travis	Chief Executive Officer, President and Directc	$3,612,054	$2,164,620	$6,597,141
Dick, Teresa	Chief Financial Officer and Senior Vice Presid	$1,204,589	$577,954	$1,927,875
Hollis, Michael	Chief Operating Officer and Vice President	$1,792,987	$813,854	$2,463,311
Moses, Elizabeth	Vice President of Business Development & L	$0	$0	$2,477,875
Pantermuehl, Russell	Vice President of Reservoir Engineering	$0	$775,694	$2,463,311
Holder, Randall	Vice President, General Counsel and Secretary	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-3.67%	3.37%	10.81%	4.18%
Last Quarter-1	-8.85%	9.62%	0.00%	5.33%
Last Quarter -2	-8.01%	-2.72%	-14.29%	3.34%
Last Quarter -3	7.45%	6.13%	1.67%	1.75%
Last Quarter -4	0.16%	0.80%	0.00%	0.25%
Standard error	3.0%	2.1%	4.0%	1.81%
Standard Error of Revenues prediction	3.0%			
Imputed Standard Error of Op. Cost predictio	NM			
Imputed Standard Error of Op. Cost predictio	3.4%			

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Industry ratios over an explicit period of 10 years

General Assumptions	
Money market rate (as of today)	0.25%
Risk-Free rate (long term estimate)	2.96%
Annual increase (decrease) in interest rates	0.0%
Marginal Tax Rate	37.5%
Country Risk Premium	5.5%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$491.17
FY2015	-0.7%	$487.85
FY2016	32.9%	$648.20
FY2017	39.9%	$907.00
FY2018	35.3%	$1,227.26
FY2019	30.7%	$1,603.95
FY2020	26.1%	$2,022.24
FY2021	21.5%	$2,456.26
FY2022	16.8%	$2,870.07
FY2023	12.2%	$3,221.12
FY2024	7.6%	$3,466.43
Continuing Period	3.0%	$3,570.42

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Industry)	Adjustment per year
Operating Cash/Rev.	3.45%	2.82%	-0.1%
NWV/Rev.	0.00%	2.27%	0.2%
NPPE/Rev.	599.87%	233.33%	-36.7%
Dpr/NPPE	7.32%	10.37%	0.3%
NOPAT MARGIN	37.64%	16.70%	-2.1%
Op. Exp./Rev.	-2.13%	64.20%	6.6%
SBC/Rev.	3.21%	1.32%	-0.2%
Rent Exp./Rev.	0.17%	1.06%	0.1%
R&D/Rev.	0.00%	0.26%	0.0%
E&D/Rev.	0.00%	2.16%	0.2%
SG&A/Rev.	2.63%	10.20%	0.8%
ROC	7%	11.55%	0.46%
EV/Rev.	11.33x	3.36x	-0.80x
EV/EBITA	19.45x	12.57x	-0.69x
Debt/Equity	36%	81%	4.4%
Unlevered beta	1.39	0.92	-0.05
Cost of Borrowing	2%	5%	0.4%
Dividends/REV	0%	3%	0.3%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Money market rate
Other claims on the firm's assets	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
100% of all E&P expenses are capitalized and amortized 'straightline' over 10 years
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.335%, 5.5%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value $\sigma(\bar{x})$	$0.09
1-year target price $\sigma(\bar{x})$	$0.10

Valuation

Forecast Year	ROC	WACC	Total Capital	Enterprise Value	Net Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	11.8%	10.2%	$2,968.44	$6,967.63	$56.50	66.18	$135.90
FY2015	6.6%	9.8%	$3,132.69	$3,005.90	$54.98	66.18	$56.29
FY2016	6.8%	9.6%	$3,257.96	$7,953.36	$22.93	66.18	$159.68
FY2017	8.2%	9.3%	$3,542.75	$3,600.99	$29.95	66.18	$71.24
FY2018	9.1%	8.7%	$4,741.50	$10,551.55	$37.62	66.18	$201.90
FY2019	7.8%	7.5%	$5,997.48	$6,148.90	$45.39	66.18	$100.00
FY2020	6.8%	6.8%	$7,194.73	$14,197.01	$52.45	66.18	$252.01
FY2021	6.0%	6.4%	$8,186.95	$8,407.42	$57.92	66.18	$122.39
FY2022	5.2%	6.2%	$8,825.51	$17,263.57	$60.90	66.18	$294.39
FY2023	4.6%	6.0%	$9,119.17	$9,530.38	$0.00	66.18	$129.78
FY2024	3.9%	5.8%	$9,333.79	$19,529.32	$0.00	66.18	$341.95
Continuing Period	11.6%	5.9%	$5,161.80				

Monte Carlo Simulation Results

The $3\sigma(\bar{x})$-adjusted intrinsic value is $77.46; the $3\sigma(\bar{x})$-adjusted target price is $121.34; and the analysts' median target price is $84.92

Sensitivity Analysis

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance