

Approach Resources Inc. is an independent energy company. The Company explores, develops, produces and acquires natural gas, NGL and crude oil reserves. Approach Resources focuses on pad drilling, horizontal drilling, and hydraulic fracturing operations within the greater Permian Basin in West Texas.

Hold

Current Price: \$1.68
Target Price: \$2.92
Market Cap: 158.7M

Net income: -26.5M | Margin : -24.2%
Free cash flow: -0.9 M
Completed 3 wells in Q2 2018



Thesis: The Permian basin is currently a huge area of interest for oil producers in the U.S and AREX is using an innovative approach of owning 100% of its infrastructure. This approach is beneficial for lowering production cost, but in order to purchase this infrastructure, AREX has incurred significant debts. This has placed them in a place of vulnerability due to the amount of leverage used. Anything from a change in commodity prices to their revolving credit facility limiting the amount they are willing to lend could make this business default very easily.



















Catalysts:

- The completion of the two wells planned for Q3
- Fluctuation in commodities prices
- Paying back their 145.1 million dollar principle debt that will come due in 2020
- Construction of pipeline out of the Permian basin to help reduce current bottlenecks

Approach Resources Current Position

AREX is a great example of why it is so hard to operate a successful oil company in the Permian basin. This business requires enormous capital expenditure to get the business up and running. This unavoidable hurdle is further compounded by the fact that the energy business in Texas is no guarantee. Anything from the fluctuation in the commodities to bottlenecks in bringing your product to market, all have material impact on a business of this size. This company currently has no cash on hand, which is very concerning. Something that stood out in this company's history was in mid-2015, AREX shut down all drilling completion operations until June the following year due to commodities prices being below the cost of production. The market did not react kindly to

this move. Although it kept the company alive, it made their stock price drop from \$9.47 in March of 2015 to \$2.25 when they started drilling again in June of 2016. Ever since then, this company has not been able to regain the ground they lost. This company has major cash flows issues that is constricting its ability to produce at a capacity that would allow them to start chipping away at their huge debts that will come due in 2020. Another business move that could potentially back fire is AREX has gone all in on reducing the cost of producing their products. In 2012 through 2014, they installed large-scale water recycling and disposal systems. This helped greatly reduce their well costs and eliminate a significant portion of their LOE (lease operating expense). The reason why this is a cause for concern is that because their production costs are so low, to lower it any further would cost millions of dollars that this business does not have for only a marginal return. This leaves AREX with only a few options; they can either produce more of their product which is difficult due to their capital restraints, borrow more and go all in on expanding their business, or start to deleverage now by selling some of their PP&E which is negatively impact every aspects of their business. Therefore, unless commodity prices increase to the point where they can operate their business with cash flows from operations, this company is in a dangerous position.

11) Adj Highlights	12) GAAP Highlights	13) Earnings	14) Enterprise Value	15) Multiples	16) Per Share	17) Stock Value	
In Millions of USD	2014 Y	2015 Y	2016 Y	2017 Y	Current/LTM	2018 Y Est	2019 Y Est
12 Months Ending	12/31/2014	12/31/2015	12/31/2016	12/31/2017	06/30/2018	12/31/2018	12/31/2019
 Market Capitalization	254.4	75.1	139.9	279.8	158.7		
 - Cash & Equivalents	0.4	0.6	0.0	0.0	0.0		
 + Preferred & Other	0.0	0.0	0.0	0.0	0.0		
 + Total Debt	391.3	496.6	498.3	373.5	380.5		
 Enterprise Value	645.3	571.0	638.2	653.3	539.2		
 Revenue, Adj	260.9	183.8	96.4	101.0	109.7	120.7	134.3
 Growth %, YoY	44.7	-29.5	-47.5	4.7	7.7	19.5	11.3
 Gross Profit, Adj	105.5	34.4	-10.1	3.9	15.3		
 Margin %	40.4	18.7	-10.4	3.9	13.9		
 EBITDA, Adj	176.3	113.2	40.3	46.6	56.0	61.2	82.9
 Margin %	67.6	61.6	41.8	46.2	51.0	50.7	61.7
 Net Income, Adj	29.2	-15.0	-44.3	-29.8	-26.5	-27.3	-26.2
 Margin %	11.2	-8.1	-46.0	-29.5	-24.2	-22.6	-19.5
 EPS, Adj	0.74	-0.37	-1.07	-0.36	-0.30	-0.30	-0.29
 Growth %, YoY	77.5	-	-189.0	66.3	59.1	17.5	3.4
 Cash from Operations	171.6	102.7	26.1	37.5	35.5		
 Capital Expenditures	-393.5	-151.2	-19.8	-47.1	-36.4	-55.6	-74.0
 Free Cash Flow	-221.9	-48.5	6.3	-9.6	-0.9		

Ownership:

Something every important to note with AREX ownership is as of January 12, 2018, Wilks Brothers, LLC and SDW Investments, LLC ("Wilks") owned 45,239,713 shares of our common stock, representing approximately 48% of AREX outstanding common stock. According to AREX's stockholders agreement with Wilks, Wilks is entitled to appoint three of the seven members of our board of directors. This allows Wilks to exert its will over AREX with little additional effort. Wilks may have interests that do not align with AREX's interests and with the interests of its stockholders, which could have an adverse impact on their operation as a whole. This amount of ownership of AREX by one party could also become a

potential issue if AREX was to be acquired. Wilks is currently subject to a stockholders agreement that caps their share ownership at 48.61% of AREX's outstanding common stock. If Wilks obtains more than 50% of the common shares outstanding, they could force AREX to make financial decisions that their lenders do not agree with, thus cutting off its much needed funding. This could leave AREX dead in the water.

1) Current

2) Historical

3) Matrix

4) Ownership Summary

5) Insider Transactions

6) Options

7) Debt

Compare Current Stats Against 10/28/18

Institutional - Based on Current Filings

Insider - Based on Last 6 Months

51) Institutional

10/28/18

Curr

Change

11) % of Shares Held

26.94

26.94

0.00

12) % of Float Held

57.19

57.19

0.00

13) # of Institutions

117

118

+0.85%

14) # of Buyers

35

35

0.00%

15) # of Sellers

24

23

-4.17%

16) # of New Buyers

11

11

0.00%

17) # of Selloffs

15

15

0.00%

18) % Chg in Inst Positions

+18.36

+18.39

+0.03

52) Insider

10/28/18

Curr

Change

21) % of Shares Held

5.02

5.02

0.00

22) % Chg Insider Positions

+0.63

+0.63

0.00

23) # of Insiders

9

9

0.00%

24) # of Buyers Opn Mkt

0

0

25) # of Sellers Opn Mkt

0

0

26) # of Shrs Bought Opn Mkt

0

0

27) # of Shrs Sold Opn Mkt

0

0

28) Avg Opn Mkt Buy Price

0

0

0.00

29) Avg Opn Mkt Sell Price

0

0

0.00

Top Geographic Ownership (%)

53) Geographic

10/28/18

Curr

Change

31) UNITED STATES

82.3

82.3

0.00

32) Unknown

16.15

16.15

0.00

33) LUXEMBOURG

0.61

0.61

0.00

34) UNITED KINGDOM

0.55

0.55

0.00

35) BELGIUM

0.18

0.18

0.00

36) GERMANY

0.1

0.1

0.00

37) CANADA

0.05

0.05

0.00

38) JAPAN

0.05

0.05

0.00

39) SWITZERLAND

0.03

0.03

0.00

Top Ownership Type (%)

54) Ownership Type

10/28/18

Curr

Change

41) Corporation

50.11

50.11

0.00

42) Investment Advisor

20.46

20.46

0.00

43) Other

9.86

9.86

0.00

44) Private Equity

7.15

7.15

0.00

45) Individual

6.29

6.29

0.00

46) Hedge Fund Manager

3.01

3.01

0.00

47) Pension Fund

2.08

2.08

0.00

48) Insurance Company

0.52

0.52

0.00

49) Unclassified

0.27

0.27

0.00

Search Name		All Holders, Sorted by Size		21) Save Search		22) Delete Search		23) Refine Search	
Text Search				Holder Group		All Holders		Investment Manager View	
24) Color Legend		Shrs Out 94.5M		% Out 47.88		Float/Shrs Out 47.10		SI % Out 8.84	
Holder Name		Portfolio Name		Source		Opt		Position	
				Mixed		All			
1. Wilks Brothers LLC		Wilks Brothers ...		13F				45,239,713	
								47.88	
								7,440,300	
								06/30/18	

Debt



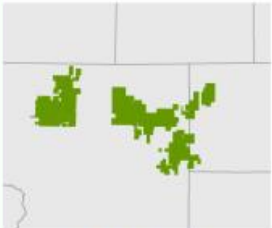

Debt is a major issue for AREX. As of right now, debt is a significant portion of its enterprise value. ~ 72% of this company's enterprise value is represented by debt. Although the dollar value is high, the main area of concern is how the total net amount of debt hasn't changed in over 4 years. This company has many constants that stop it from operating at full capacity. Its lack of access to cash is a major hurdle that must be overcome in order for this business to survive. This is all compounded by the fact that AREX hasn't had a positive net income in over 3 years. Besides the exception of 2016 where they had \$6.3 million in free cash flow, from 2010 to the present this company hasn't generated positive free cash flows. This is a major red flag considering that this business is relying on positive cash flows from operations to fund its current production. AREX is barely covering the cost to operate while having a huge debt burden looming in the near future. This business is contracting due to the huge burden of its debt and if unless there is a major change of current events, AREX will only further bleed value.

Cash from Operations	125.6	171.6	102.7	26.1	37.5	35.5	
Capital Expenditures	-296.8	-393.5	-151.2	-19.8	-47.1	-36.4	-55.6
Free Cash Flow	-171.3	-221.9	-48.5	6.3	-9.6	-0.9	

Cash flows from 2013 to 2018 estimate

Growth potential







Although there are major flaws in AREX, this company still has the ability to grow and prosper. AREX has four strategic pillars for long-term value creation. First, their product mix allows them to diversify their risk from only having one commodity to offer. They have a mix of 40% natural gas, 28% oil and 32% NGLs (natural gas liquids). This allows AREX to not have all their eggs in one basket and adjust to the commodity that provides the best return. The second pillar is their infrastructure. Since it is 100% owned, anything they produce is generating money for their business. Although they have a major debt obligation coming down the pike, this company has positioned its self to be able to react very quickly to changing market conditions. This is because AREX owns all the equipment that is covers the life cycle of production from drilling to transportation of its products. In addition, once it covers the cost of day-to-day operations, any additional revenue generated is profit. Third, AREX's position in the basin is advantageous due to their contiguous acreage that increases operational efficiency. Lastly, their HPB position allows them to collect on legacy production from previous projects. HPB is a provision in oil, gas and material lease that as long as the property generates the minimum paying quantity of gas or oil, they have the right to operate there.

Balanced Portfolio	100% Owned Infrastructure	Contiguous, Low Decline, Low Risk Asset	Portfolio Management
 <p>OIL GAS NGL</p> <p>Balanced production profile offers multiple revenue streams</p>	 <p>Comprehensive infrastructure facilitates efficient cost structure</p> <ul style="list-style-type: none"> •Gas Lift and Gathering •Water Storage & Recycle •Transportation 	 <p>Contiguous acreage increases operating efficiency</p>	 <p>HBP position provides optionality & legacy production generates meaningful cash flow</p>

Competition:

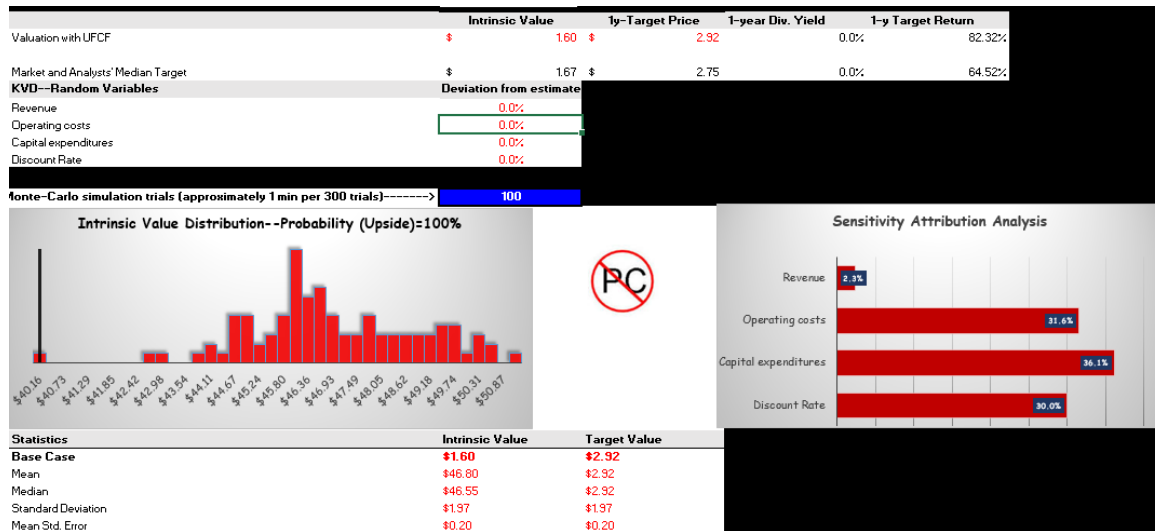
Approach Resources is suffering from economies of scale. Due to their market cap being less than 10% of its closest competitor, everything they do, whether it be negotiating power for land leases or a change in price of its differentials, has a material impact on this company. AREX is suffering because of its use of leverage. They do not want to borrow any more to further increase its' debt obligations, but if they do not obtain more capital to use for day-to-day operations, they cannot produce at a volume that is beneficial to them. Unlike their counterparts, AREX does not have much, if any cash on hand to help cushion the blow of unexpected event like oil price volatility or capitalize on a A&M opportunity. This places them at a significant disadvantage because something such as a merger or acquisition is exactly what this business needs to turn the company around.

Name (BI Peers)	Mkt Cap (USD)	Rev - 1 Yr Gr:Y	ROE	WACC Cost of Debt (After Tax)	Adj ROIC AR	ROIC/WACC Ratio	Debt/Com Eq LF	Tot ¹ Dbt/EBITDA aft CAPEX
Median	7.77B	39.69%	7.79%	3.75%	2.52	0.92	37.35%	-5.16
100) APPROACH RESOURCES INC	148.34M	4.72%	-4.65%	4.44%	-3.04	0.75	64.35%	19.44
101) DIAMONDBACK ENERGY INC	11.28B	129.39%	12.88%	4.62%	7.04	1.22	34.93%	-2.36
102) PARSLEY ENERGY INC-CL...	7.83B	83.27%	8.29%	3.86%	2.54	0.65	39.77%	-2.67
103) PIONEER NATURAL RESO...	25.03B	27.84%	7.29%	3.32%	1.31	0.48	19.90%	-4.89
104) LAREDO PETROLEUM INC	1.24B	7.04%	30.28%	4.03%	9.29	2.04	94.12%	-5.42
105) ENERGEN CORP	7.17B	60.87%	6.73%	3.64%	1.61	1.02	22.85%	-29.38
106) CIMAREX ENERGY CO	7.70B	51.54%	21.40%	3.38%	10.66	2.18	51.54%	-47.06
107) CONCHO RESOURCES INC	28.25B	17.91%	5.09%	3.37%	2.51	0.82	24.55%	-91.96

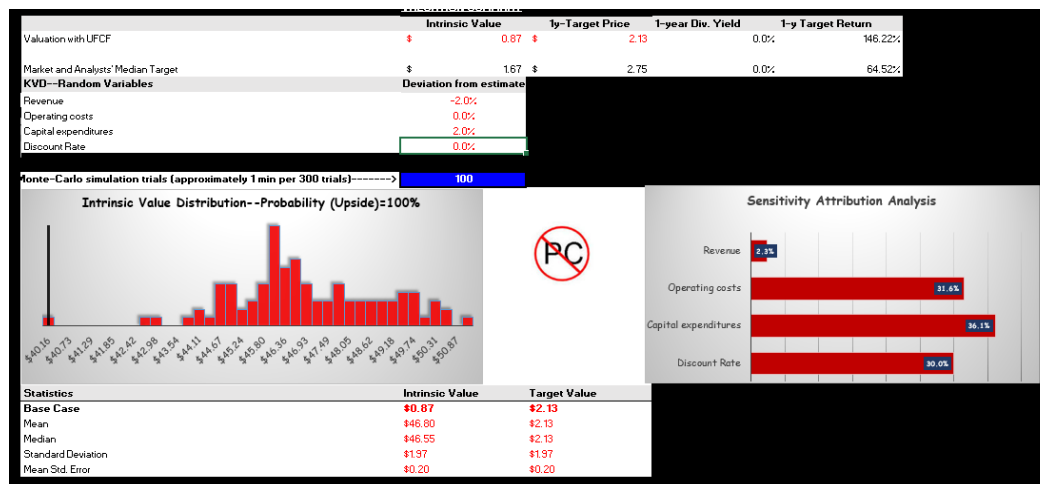
Metric	AREX	Low	Comp Range	High
Est P/E Current Yr	N.A.	4.81		29.70
EV/EBITDAX	31.78	27.92		40.26
Sales Growth Yoy ...	4.72	4.72		129.39
EBITDA Margin (%)	46.17	38.38		77.43
Oil & Gas Prod (M...	11.60k	11.60k		272.33k
				

Base/Bear/Bull cases

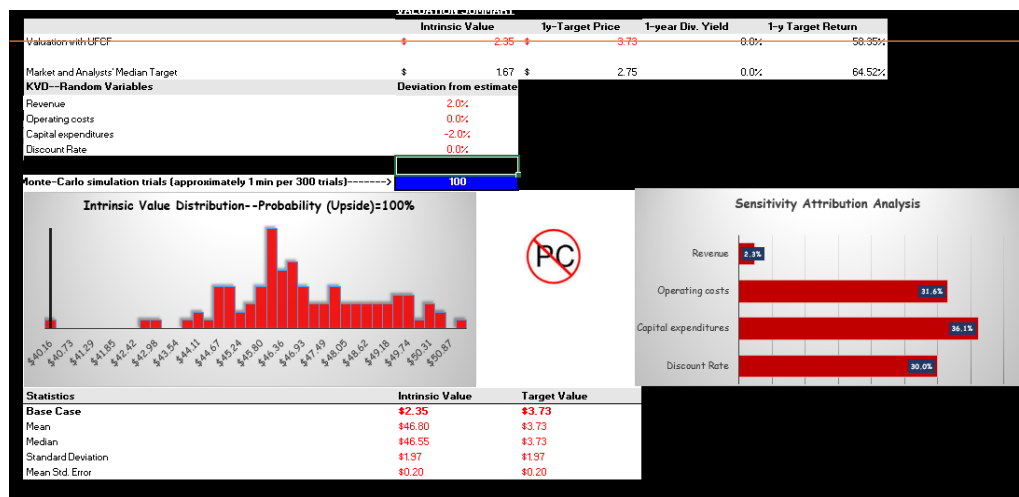
Base case:



Bear case



Bull case:



Conclusion:

AREX as a whole is a company with great large-scale ideas, but lacks the cash flow to realize any major changes. Like was stated before, the thing that plays the largest role in their ability to grow is their huge debt burden. Since this company has not generated any meaningful cash flows to chip away at the looming debt maturity, this will force APEX to make major sacrifices to cover their debt obligation. Whether that be refinancing the debt to stretch out the time horizon or selling off some of its PP&E, unless they can produce enough to cover their debt obligations, they will have to take a significant hit in their bottom line. Another major hurdle is their ownership. Since Wilks owns such a significant portion of this company and is allowed to elect 3 of the 7 board members, they can steer the company in a direction that is in the best interest of Wilks, not AREX. This could mean that Wilks would force AREX to sell its PP&E to cover its debts, which would deal a massive blow to this company as a whole. Not everything is negative. AREX owns its entire infrastructure. This means that if macro factors such as an increase in commodity pricing, AREX would be able to capitalize on this and help alleviate its debt burden. Oil commodity prices have been very low in October, which has had a macro effect on the whole industry. APEX is no exception. Although I believe that we should sell our position in this company due to all the negative attributes, waiting for oil prices to rise to above 70 would allow us to sell at a position to minimize the losses we have incurred.

(AREX)

Analysis by Al Capone

11/3/2018

Current Price:

\$1.67

Intrinsic Value:

\$46.21

Dividend Yield:

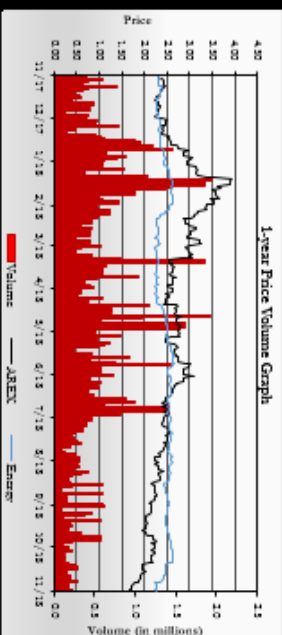
0.02%

Target Price:

\$2.33

Target 1 year Return: 39.5%

Probability of Price Increase: 100%



Description	
Approach Resources, Inc., an independent energy company, focuses on the acquisition, exploration, development, and production of unconventional oil and gas reserves in the United States.	
General Information	
Sector	Energy
Industry	Oil, Gas and Consumable Fuels
Last Guidance	May 8, 2018
Next earnings date	November 8, 2018
Market Assumptions	
Estimated Equity Risk Premium	5.21%
Effective Tax rate	21%

Market Data	
Market Capitalization	\$154.32
Daily Volume (mil)	0.09
Shares outstanding (mil)	91.31
Diluted shares outstanding (mil)	91.47
% shares held by institutions	35%
% shares held by hedge funds	15%
% shares held by insiders	3%
Short interest	5.40%
Days to cover short interest	9.15%
52 week high	35.76
52 week low	\$4.21
Volatility	\$1.61
	85.26%

Industry and Segment Information

LTM Revenues by Geographic Segment

United States--82%

UNKNOW--16%

LUXEMBOURG--1%

UNITED KINGDOM--1%

Peers

Chimex Energy Co.

Laredo Petroleum, Inc.

Concho Resources Inc.

Energion Corporation

Parsley Energy, Inc.

Pioneer Natural Resources Company

Diamondback Energy, Inc.

Porter's 5 Forces (Scores are percentiles)

Bargaining Power of Suppliers--MIDDLE TIER 38

Bargaining Power of Buyers--MIDDLE TIER 64

Threat of New Entrants--LOWEST TIER 29

Threat of Substitutes--HIGHEST TIER 100

Intensity of Existing Rivalry--MIDDLE TIER 42

Overall Position among Peers--MIDDLE TIER 50

Revenue

Operating costs

Capital expenditures

Debt/Equity Ratio

Sensitivity Attribution Analysis

Revenue 23%

Operating costs 34%

Capital expenditures 34%

Debt/Equity Ratio 20%

Quarter ending

6/30/2017

3/30/2017

12/31/2017

9/30/2016

6/30/2016

Mean

Standard error

Management

Chief, J.

Yong, Glingang

Kayler, Sergei

Henderson, J.

Shaw, Ian

ogile, Suzanne

Position

Founder, Chairman & CEO

President & COO

Executive VP& CFO

Chief Administrative Officer & Corporate Sec

Principal Accounting Officer

Vice President of Investor Relations and Corp

AREX (LTM)

Profitability

Return on Capital (GAAP)

Operating Margin

Revenue/Capital (GAAP)

ROE (GAAP)

Net margin

Revenue/Book Value (GAAP)

Invested Funds

Cash/Capital

WWD/Capital

Operating Assets/Capital

Goodwill/Capital

Capital Structure

Total Debt/Market Capitalization

Cost of Debt

CGFS Rating (F-scores, Z-scores, and default Probabil B

WACC

Forecast Assumptions

Revenue Growth CAGR

Average Operating Margin

Average Net Margin

Growth in Capital CAGR

Growth in Chime CAGR

Average Return on Capital

Average Return on Equity

Average Cost of Capital

Explicit Period (15 years)

Continuing Period

Intrinsic Value Distribution--Probability (Upside)=100%

Valuation

3.6%

Operating costs

Capital expenditures

Debt/Equity Ratio

Sensitivity Attribution Analysis

Revenue 23%

Operating costs 34%

Capital expenditures 34%

Debt/Equity Ratio 20%