Company Overview:

Diamondback Energy is a pure play Permian producer with 429k pro forma net acres in the Midland (64%) and Delaware Basins (36%) with mineral rights ownership on certain acreage held indirectly through Viper Energy. The majority of acreage sits in contiguous blocks in Midland, Glasscock, Howard Martin/Andrews counties in Midland side and in Reeves, Pecos and Ward counties on the South Delaware side.

Name	Ticker	Yield	Growth	D + G
Diamondback Energy, Inc.	FANG	2.14%	8.00%	10.14%

Highlights:

The returns strategy of buybacks when FANG shares trade below intrinsic value at mid-cycle oil prices (~$65/bbl) could mean more dividends in the future. We think mid-cycle value is $145–150/share, which FANG shares now trade above given a stronger oil market. Accordingly, we expect a step-down in buybacks, but the 75% FCF payout remains unchanged. For Q3 ‘23, we believe the total return could amount to a 7+% annualized yield, with more weighting to variable dividends. Moving forward, we believe that shareholder yield could contribute a meaningful amount of total return.

Bull Case:

- ***A Strategy of Growth Has Been Replaced by a Strategy of Return on Invested Capital → Yet to be Rewarded by the Market from a Multiples Standpoint –*** We believe that when asset intensive industries change strategy focus from “growth” to “ROIC”, relative performance has not only been better in many of these older, capital-intensive industries than the market overall, they’ve all actually beaten the fastest growing sector as well (technology). Value creation is all about ROIC for asset intensive industries specifically – energy is just 10-20 years late to this game. Many other industries have gone through this transformation of a mindset, all of which, have outperformed: Airlines, Restaurants, Semiconductors, and Railroads.
- ***E&Ps → Cheap Valuations and Growth FCF is a One-Two Punch -*** Absolute EV/EBITDA for the E&P sector is a below 6x, ~1x higher than the 20-year median, but relative to the market, its near 20-year lows. However, the real story of E&P is increasingly on FCF, as the sector has never had a FCF outlook like it does today given the change in management philosophy. Simply put, the E&P sector has the highest FCF yield in the S&P 500…with the cheapest valuation in the S&P 500. A pretty good combination in our opinion.
- ***Free Cash Flow Juggernaut –*** We expect the company to have a free cash flow of $16B over the next five years, that is >60% of the current enterprise value. Furthermore, as you’ve seen with the new variable dividend policy, the company expects to return ~75% of the previous quarter’s FCF. We believe that this will be a major part of the company’s long-term investor return stream.

Bear Case:

- ***Commodity Price Risk -*** Prices for natural gas and oil fluctuate widely, and we believe that Diamondback's cash flow and dividends depend substantially on prevailing oil and gas prices. As a result, current and expected oil and gas prices can significantly influence the price of Diamondback shares.
- ***Exploration Risk -*** Diamondback's business depends not only on commodity prices, but also on its ability to find, develop, and acquire oil and gas reserves that are economically recoverable. Producing oil and gas reservoirs are typically associated with high production depletion rates. Because of this, significant capital expenditures are often required to find, develop, and produce oil and gas reserves to replace those depleted by production.
- ***Expectation Of Faster Acceptance of Green Energy*** – The biggest threat to “dirty” energy has been the argument that Green Energy will overtake fossil fuels – this has been the bear thesis on the space for almost a decade now – compressing multiples across the sector. It has been the sentiment driving the devaluation of these companies. We don’t disagree with this – we are big believers in growth regarding the Clean Energy space. But, in the past, the transition to a new energy source has provided a big boost to the old one. Solving this conundrum — how to supply enough dirty old material to build a new green economy — will require balance. Blocking new mines/rigs will not always be the environmentally responsible move. We believe that governments, and greens in particular, need to recognize that trying to shut down the old economy too fast threatens to push the price of building a cleaner one out of reach.

Overview:

We believe FANG shares should outperform over longer periods of time, even against their peer base. Management has built a solid Permian Basin position with a deep inventory of liquids-rich development opportunities. The company is one of a few that have amassed a combination of quality assets, strong economic growth, minerals ownership, and a water business, which collectively help to provide a competitive advantage. We believe FANG has one of the lowest cost structures in the basin and a corporate cash flow break-even (including dividend) that is among the best in the industry. Not to mention, we believe the management team is rock solid.

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