AozoraStep

March 31st 2025

Exit Diversified Energy: The numbers raise some question marks

Company:	Diversified Energy (DEC)	**Market Cap:**	$13.44 ($1.023bn)
Industry:	Oil and gas producer	**Production:**	1.1Bcfe/d (75% gas, 25% oil)
Country:	US	**Net Debt:**	$2.6bn
Date:	31st March 2025	**Adj. EBITDA:**	$973m (10% depreciation)
Dividend:	$1.16 (10%)	**Free cash flow:**	$420m (before ABS amort.)
Entry:	$12.95 ($987m)	**Exit:**	$13.38 or $1.02 bn (+3.3%)

*Estimated guidance as of March 2025 and current oil and gas prices

Why exit Diversified Energy?

- $300m bond issuance at 9.75% came as a surprise to me and I suspect that they could be in breach of their RBL and unable to pay a dividend otherwise
- Given that management has not been transparent on the equity and bond issuance, there remains a question mark on governance
- Federal land sales might accelerate under Trump in an effort to boost production, which could make their planned acreage sales at risk of falling through ($40-45m included in their $420m FCF guidance)

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The $300m bond issuance

Diversified Energy was one of the most difficult companies I have ever analysed due to their frequent acquisitions and equity issuances. At one point, I also felt some of their practices appeared like financial Shenanigans. However, their debt repayment, shareholder returns with a strong EV/FCF valuation made it also a compelling investment, especially with a view of higher U.S. natural gas prices. The complexity of this company made me a bit uneasy about any potential surprises that I would not expect, such as the equity issuance[1] after the Maverick acquisition[2]. The 9.75% $300m bond issuance[3] was another such surprise and led me to exit the position. During a call with management after the results, my main target was to verify some of the financials with them. But they advised me to check the numbers with the analyst instead – this was already unusual. The Credit Facility also appears vulnerable to a covenant breach at the current leverage (net debt/adj. EBITDA) ratio of 3.05x and I do not quite understand how it was not already in breach at year-end.

Diversified Energy's Credit Facility

Credit Facility

The Group maintains a revolving loan facility (the "Credit Facility") with a lending syndicate, where the borrowing base is redetermined semi-annually or as needed. The Group's wholly-owned subsidiary, DP RBL Co LLC, serves as the borrower under its Credit Facility. The borrowing base is primarily determined by the value of the natural gas and oil properties that serve as collateral for the lending arrangement, and it may fluctuate due to changes in collateral, which can result from acquisitions or the establishment of ABS, term loans, or other lending structures.

In August 2022, the Group amended and restated the credit agreement governing its Credit Facility. This amendment aligned the agreement with the Group's ESG initiatives by incorporating sustainability performance targets ("SPTs") similar to those included in the ABS IV, VI and VIII notes, and extended the maturity of the Credit Facility to August 2026. During the semi-annual redetermination in October 2024, the borrowing base was reaffirmed at $385,000.

The Credit Facility carries an interest rate of SOFR plus an additional spread ranging from 2.75% to 3.75%, depending on utilization, and is payable quarterly. As of December 31, 2024, available borrowings under the Credit Facility were $86,690, which includes the impact of $13,910 in letters of credit issued to certain vendors.

The Credit Facility contains certain customary representations, warranties, and both affirmative and negative covenants. These covenants cover areas such as maintenance of books and records, financial reporting and notification, compliance with laws, maintenance of properties and insurance, and limitations on incurrence of indebtedness, liens, fundamental changes, international operations, asset sales, certain debt payments and amendments, restrictive agreements, investments, restricted payments, and hedging. The restricted payment provision governs the Group's ability to make discretionary payments, such as dividends, share repurchases, or other discretionary payments. DP RBL Co LLC must meet the following criteria to make discretionary payments: (i) leverage is less than 1.5x and borrowing base availability is >25%; (ii) leverage is between 1.5x and 2.0x, free cash flow must be positive, and borrowing base availability must be >15%; (iii) leverage is between 2.0x and 2.5x, free cash flow must be positive, and borrowing base availability must be >20%; (iv) when leverage exceeds 2.0x, restricted payments are prohibited.

Additional covenants require DP RBL Co LLC to maintain a total debt to EBITDAX ratio of no more than 3.25 to 1.00 and a current assets (with certain adjustments) to current liabilities ratio of no less than 1.00 to 1.00 as of the last day of each fiscal quarter.

As of December 31, 2024, the Group was in compliance with all covenants for its Credit Facility.

Source: Diversified Energy Annual Report 2024

[1] https://polaris.brighterir.com/public/diversified_gas_and_oil/news/rns/story/x2pmo7w
[2] https://polaris.brighterir.com/public/diversified_gas_and_oil/news/rns/story/xpv7njx
[3] https://polaris.brighterir.com/public/diversified_gas_and_oil/news/rns/story/xlo067x

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Important feedback from other investors

At a dinner meeting in the city with a different company, I've met one investor and asked him about his views on Diversified. This particular investor was quite close to the management of Diversified and thought their Asset Backed Securities are attractive as an investment. However, he was not fond of the equity story due to the potential decommissioning liability. Whilst I was aware of the historic issues they faced from methane leaks due to their aging wells, I believed that with the Trump administration back in power, this would not be a risk in the near term & due to their well retirement company Next LVL, which serves other customers as well, the decommissioning costs would be more neutral. However, the investor asked me a crucial question: How many wells do Diversified Energy operate? I did not know the answer. Whilst Wikipedia states they have over 70,000 wells[4], Diversified confirmed in June 2023 that they own over 50,000 wells[5] (which is likely well over 70,000 today). At a decommissioning rate of 215 wells a year, it would take 325 years to decommission all these wells compared to the 73 years (year 2098) from their annual report[6]. This would mean that they retire around 958 wells a year. Given that it cost Diversified $8.37m to decommission 215 wells, it would cost $37.33m per annum to decommission all wells at an equal rate per annum until 2098. While the decommissioning liability is a risk I underestimated, I see this as being unaccounted for by the market for the time being due to the Trump Presidency.

[4] https://en.wikipedia.org/wiki/Diversified_Energy
[5] https://www.div.energy/2023/06/27/largest-well-owner-in-appalachia-charts-path-to-net-zero-by-looking-for-leaks
[6] https://d1io3yog0oux5.cloudfront.net/_ec8d3baaf92f46d7aee321ea3a6de212/dgoc/db/604/6013/report/2024+Annual+Report+-+Diversified+Energy.pdf p. 30/31

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Diversified Energy's debt profile

Debt type	$ m	Coupon	Annual repayment	Interest payment
Term loan II	84	8.58	1	7
Credit facility	200	7.58		15
ABS 4	80	4.95	20	4
ABS 6	242	7.5	35	18
ABS 8	586	7.28	31	43
ABS 9	75	6.891	15	5
ABS 10	530	6.4	66	34
Deferred consideration	113	9	40	10
Maverick debt	700	9.83	58	69
Cash	-3			
Net debt	2607		265	217

Source: Diversified Energy annual results 2024, Maverick acquisition announcement (includes personal assumptions)

https://polaris.brighterir.com/public/diversified_gas_and_oil/news/rns/story/w6o6zkw

https://d1io3yog0oux5.cloudfront.net/_7c9749735024bcddd4c871afbf5cfa84/dgoc/db/604/6013/report/2024+Annual+Report+-+Diversified+Energy.pdf

Diversified Energy's new debt profile

Debt type	$ m	Coupon	Annual repayment	Interest payment
Credit Facility	0	7.58		
Term loan II	84	8.58	0.5	7
Senior Secured Bond 2029	300	9.75		29
ABS 4	80	4.95	20	4
ABS 6	242	7.5	35	18
ABS 8	586	7.28	31	43
ABS 9	75	6.891	15	5
ABS 10	530	6.4	66	34
Deferred consideration	113	9	40	10
Maverick debt	600	9.83	50	59
Cash	-3			
Net debt	2607		257	217

Source: Diversified Energy annual results 2024, Maverick acquisition announcement

https://polaris.brighterir.com/public/diversified_gas_and_oil/news/rns/story/xlo067x

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U.S. gas storage levels improve

U.S. natural gas storage tanks have been filling at the 2nd fastest pace in 15 years over the last two weeks amidst warmer than usual weather. This has led to a more average gas in storage level towards the end of March. I still believe U.S. natural gas prices could rise further, especially in the cooling season during peak summer months, because we will have more LNG export capacity online and almost no natural gas producer is looking to increase production in the U.S. this year. In addition, U.S. trading partners will likely seek to lower their trade surplus with the U.S. by purchasing more LNG, which Europe needs anyway due to low gas in storage. Therefore, the macro factors are still positively aligned with Diversified Energy. Next to the debt issuance, my other new concern regarding Diversified Energy is that Trump is likely looking to open up more federal lands and waters to oil and gas drilling[7]. Although this should not affect prices immediately, it could impact the $40-45m in annual land sales that Diversified Energy has targeted and included in its $420m free cash flow guidance. In summary, the uncertainty about the land sales and the surprising debt issuance (both in my opinion) attaches some risks to the company that makes it somewhat less attractive.

U.S. natural gas storage levels are improving

Two weeks ending	Sum of Change (bcf)	Sum of Total Lower 48 (bcf)
26-Mar-10	24	1,638
25-Mar-11	6	1,622
23-Mar-12	60	2,429
22-Mar-13	-157	1,781
21-Mar-14	-107	895
20-Mar-15	-32	1,479
25-Mar-16	-10	2,468
24-Mar-17	-193	2,049
23-Mar-18	-149	1,383
22-Mar-19	-83	1,107
20-Mar-20	-38	2,005
26-Feb-21	-436	1,845
25-Mar-22	-25	1,415
24-Mar-23	-119	1,853
22-Mar-24	-29	2,296
21-Mar-25	46	1,744

Source: EIA

[7] https://www.cnbc.com/2025/03/19/trump-to-meet-oil-executives-to-discuss-agenda-as-tariffs-weigh-on-prices.html

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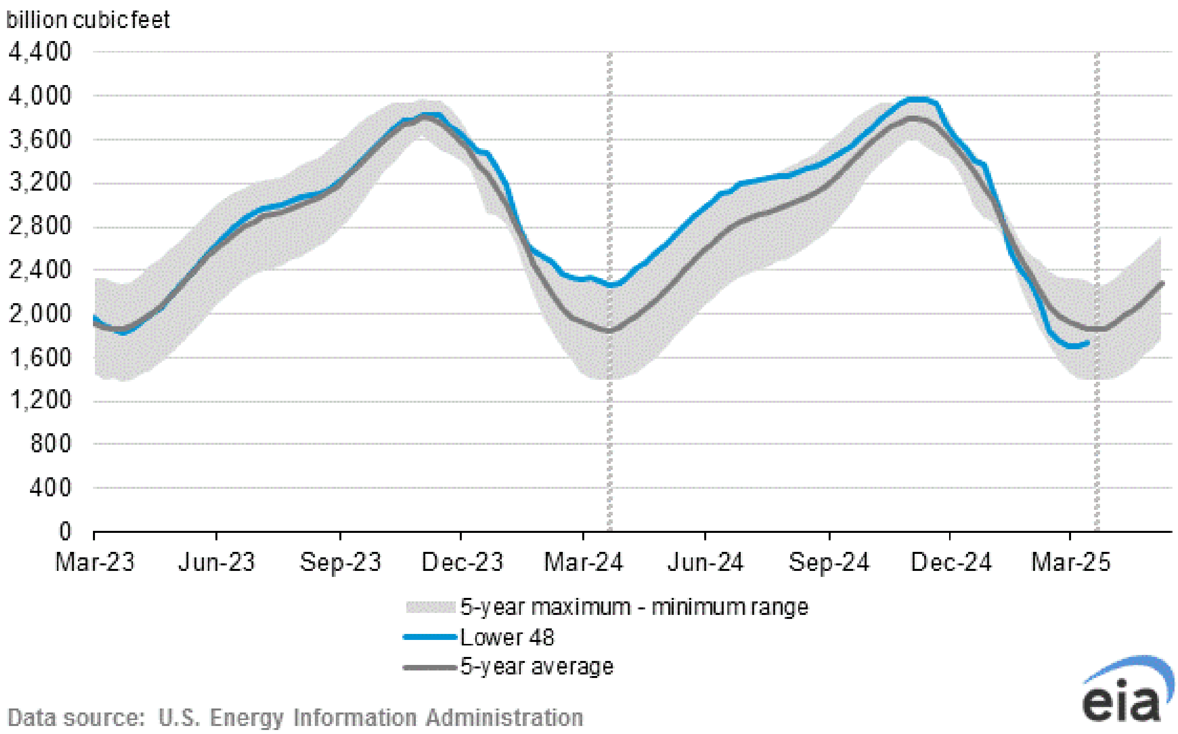
Working gas in underground storage compared with the 5-year maximum and minimum



Data source: U.S. Energy Information Administration

Note: The shaded area indicates the range between the historical minimum and maximum values for the weekly series from 2020 through 2024. The dashed vertical lines indicate current and year-ago weekly periods.

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