

ESTIMATES PRE-IPO VALUE RANGE GBP 1.16 – 1.22



DIVERSIFIED GAS & OIL
P L C

Tuesday, 20 May 2014

Close Price 20/05/2014	N/A
Value Range Low	£1.16
Value Range High	£1.22
AIM Ticker	N/A
Financial YE	31-Dec
Currency	GBP

Business Activity

Oil and Gas
production company

Key Metrics

MCAP ('000)	£37,946
Net Debt (Cash) ('000)	£9,357
EV ('000)	£47,303
52 Wk Hi	N/A
52 Wk Lo	N/A
Free Float	N/A

Key Ratios

ROCE %	N/A
Net Debt (Cash) /	24.66%
FX Rate GBP/USD	0.5922

Extractives Sector Research

AIM Index

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Diversified Gas & Oil Plc.

Yield plus growth...a precious commodity

Diversified Gas & Oil Plc. (DGO) is an Appalachian basin focused oil and gas producer, based in Birmingham, Alabama (USA). DGO offers roll-up growth with an FCF underpinned yield, a rare small cap characteristic. The Company operates over 1,000 conventional wells with consistent pressure and barrel production year on year in West Virginia and Ohio. The management team has completed over USD 24m of acquisitions since 2006 and is preparing a London AIM IPO. Whilst the UK's Alternative Investment Market (AIM) has many exploration companies, few offer the promise of low risk growth and an FCF supported dividend within 12m of listing.

- Proven reserves before acquisition USD 45m (at USD 80 bbl)
- Producing wells prior to acquisition - 201 oil wells and 647 gas wells.
- Proven reserves *including* acquisition target USD 61m (at USD 80 bbl)
- Proven M&A management team.
- Revenues FY14E USD 14.5m expected to grow to USD 20m FY16E

ACF est. GBP (k)	Revenue	EBITDA	FCF	EPS	EPS (diluted)
2014E	8,125	3,840	1,675	10.199	8.145
2015E	11,572	5,423	5,147	14.404	11.503

Multiples	EV/ Revenue	EV/ EBITDA	EV/ FCF	P/ EPS	P/ EPS (diluted)
2014E	4.99x	10.55x	24.20x	9.55x	11.96x
2015E	3.50x	7.47x	7.87x	6.76x	8.47x

Share Price History	No. of Shares in issue	Fully diluted
NoSh (m) 20/05/14	32	40
Close Price 20/05/14	N/A	N/A
Value Range Low	£1.16	£0.92
Value Range High	£1.22	£0.97
AIM Ticker	N/A	
Financial YE	31-Dec	
Reporting Currency	USD	
NoSh (m) 20/05/14		32
NoSh (m) expected dilution (Exp D)		40.07
NoSh (m) full dilution (FD)		40.07
Key Metrics		adj.
MCAP (m)	£37.95	£37.95
Net Debt (Cash) (m)	£9.36	£9.36
EV (m)	£47.30	£47.30
52 Wk Hi	N/A	N/A
52 Wk Lo	N/A	N/A
Free Float	N/A	N/A
*Key Metrics FCF adj.	2014E	2015E
CPS	16.09	13.51
CPS (Exp D)	12.85	10.79
CPS (FD)	12.85	10.79
P/CPS	7.37x	8.78x
P/CPS (Exp D)	9.23x	10.99x
P/CPS (FD)	9.23x	10.99x

*Note that in the table above we show Free Cash Flow Per Share (CPS) based upon current NoSh, expected dilution (Exp D) and full dilution (FD). P/CPS uses the implied "close price" which is the mid-point of our valuation range as per front page and this page.

Investment Case

Competitive background

DGO is already a consistent oil and gas producer with M&A experience and it plans to pay its maiden dividend within 12 months of listing on AIM. DGO is unlike many AIM listed oil and gas opportunities as these are often pure exploration plays. The company's production facilities are located within the Appalachian basin, a proven low cost mature oil and gas-producing region that has been successfully exploited since 1860, and that touches five US states including the urban conurbation of New York. As such, delivering product to market is straightforward and low cost. The EIA and other bodies in 2014 forecast that US oil and gas consumption will grow to approximately 65% of total US energy consumption by 2025. (DGO also intends to acquire shale assets).

Roll up strategy

Diversified Gas and Oil is targeting high Proved-Developed-Producing (PDP) acquisitions, where it can accelerate and extend production by either deploying new extraction technology or/and refresh decayed infrastructure and poorly maintained wells. The company's growth strategy also has an organic element... DGO will pursue low cost in-fill drilling adjacent to producing wells within the same acreage. The company currently has 41,500 net acres before any further acquisitions.

- **Proven reserves** - USD 45m of proven reserves assuming a conservative average oil price of USD 80 bbl and natural gas well-head price of 3.67 USD/Mcf

- **Experienced M&A management team** - The management team has experience of successfully integrating USD 24m of acquisitions into DGO since 2006.

- **Acquisition targets** – Total USD 45m of acquisition targets. We expect the first acquisition to be BI JOE adding 64 wells and potentially over USD 8m of revenues. DGO has signed an LOI with a second target with expected revenues USD 2m.

- **FCF positive** – FCF USD 2.1m FY13A. We estimate that DGO will quadruple its annual FCF generation to over USD 8.5m by FY15E, up from USD 2.1m FY13A.

- **Dividend Policy** – GBP 1.2m or 3.75p per share within 12-18m.

Catalysts

Successful Pre-IPO raise in the range GBP 3-5m (USD 5-8m), followed by an AIM listing and raise of a further GBP 17-20m (USD 28.7m to 33.8m). Successful M&A. Payment of maiden dividend.

Operational Strategy

Diversified Gas & Oil (DGO) is a conventional oil and gas producer with sales of product to the eastern portion of the United States. This segment of the US market is characterised by demand for high btu gas and medium grade crude oil. The company’s operations are centred in the Appalachian basin (see exhibit 2 below) within the states of Ohio and West Virginia (see exhibit 3 below)

DGO’s business plan assumes an average USD 80 bbl and 3.67 USD/Mcf wellhead natural gas prices. The Company has drilled over 120 conventional wells on its 41,500 acres of leases in West Virginia and Ohio since 2006 and its roll-up strategy envisages acquiring additional producing wells in the Appalachian basin, which includes the New York State conurbation (ready market, easy access). Management is targeting proven producing wells where it can either deploy technology that will improve extraction rates and life of the wells or where it can revamp existing infrastructure to the achieve the same effect.

In order to accelerate DGO’s strategy and take advantage of immediate acquisition opportunities, the company is planning to come to AIM via a pre-IPO and subsequent IPO, raising a total of USD 30m.

DGO’s operational competitive advantage is its ability to exploit low risk existing fields with stable consistent pressure and 10 year plus production horizons (which translates to predictable and consistent production curves for the life of the assets). The company is not involved in high-risk exploration but rather far more predictable long run production, leading to more reliable financial forecasts.

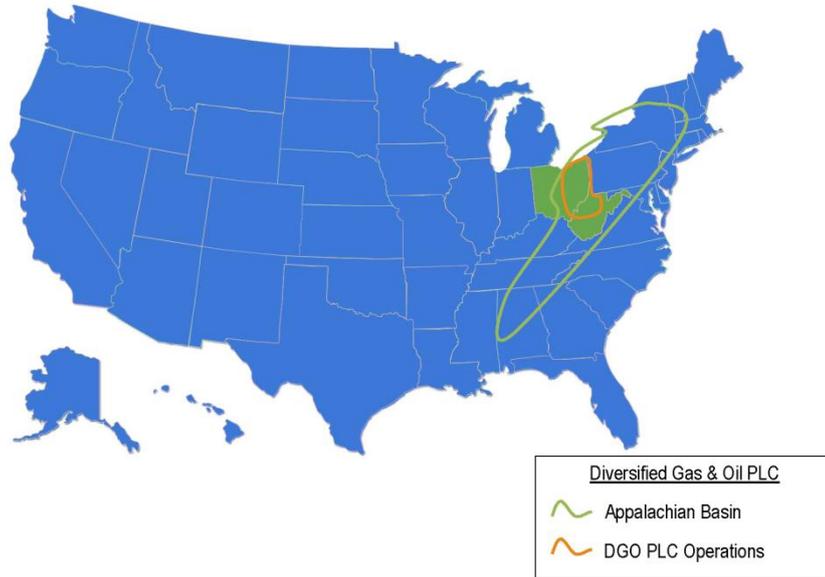
Exhibit 1: Diversified Gas & Oil operations and production

Low risk low cost drilling	Targeting high PDP acquisitions (USD)	Maximising production of neglected wells
Conventional formations: Clinton, Gordon and Benson	25MM - 100MM Non-core assets of larger shale players	<ul style="list-style-type: none"> ● Repairing lines; ● Recompleting wells; ● Reconnecting wells;
Drilling and completion costs USD 200k – 450k	5MM – 25MM Private owners looking to retire/exit and off-radar deals (fewer bidders/less demand)	<ul style="list-style-type: none"> ● Adding compression; ● Placing wells on a swab schedule.

Source: Company Reports.

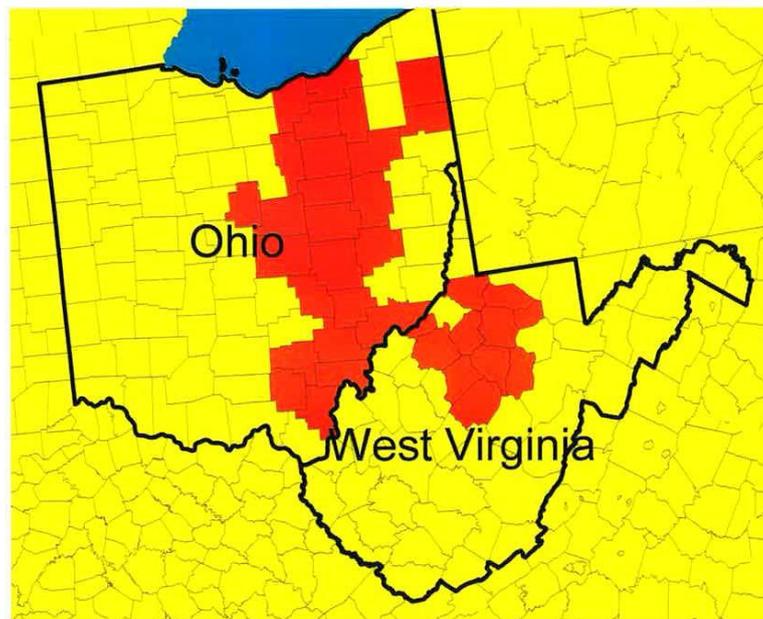
Historical returns on DGO’s PDP strategy are estimated by management to be in the range 15-20%. Oil production currently accounts for 35% of DGO’s revenues FY13A. We expect the revenue contribution of oil production to increase through execution of the current acquisition strategy.

Exhibit 2: DGO's areas of operation in the US



Source: Company Reports.

Exhibit 3: DGO's area of operations within the Appalachian basin



Source: Company Reports.

Management Team

➤ **Chairman, Zadok Hakim.**



Mr Hakim brings global executive experience in energy and telecommunications. In particular Zadok is able to create strategic relationships between governments and corporates. He is an engineer and corporate executive and has served as the Chairman and CEO of CCC Globalcom. He is also currently chairman of Commodity Customer Corp. and JAG Energy. He has a depth of international experience in developing economy regions from LatAm and West Africa through to China. Zadok has both his

bachelor's and master's degrees in Electrical Engineering from F.I.T and is currently preparing his PhD from Nova South-eastern University (NSU). He has a rich and philanthropic personal life.

➤ **CEO, Robert R. Hutson Jr..**



Before founding Diversified Gas & Oil in 2001, Mr Hutson held finance and accounting roles for 13 years at Bank One (Columbus, OH) and Compass Bank (Birmingham, AL). He finished his banking career as CFO of Compass Financial Services. Since 2001, Robert has operated Diversified Gas & Oil and has supervised the drilling of over 125 wells and the acquisition of over US 24m in oil and gas assets in Ohio and West Virginia. Mr Hutson has a B.Sc. degree in Accounting from Fairmont State College, West Virginia. He is a

former CPA (Ohio).

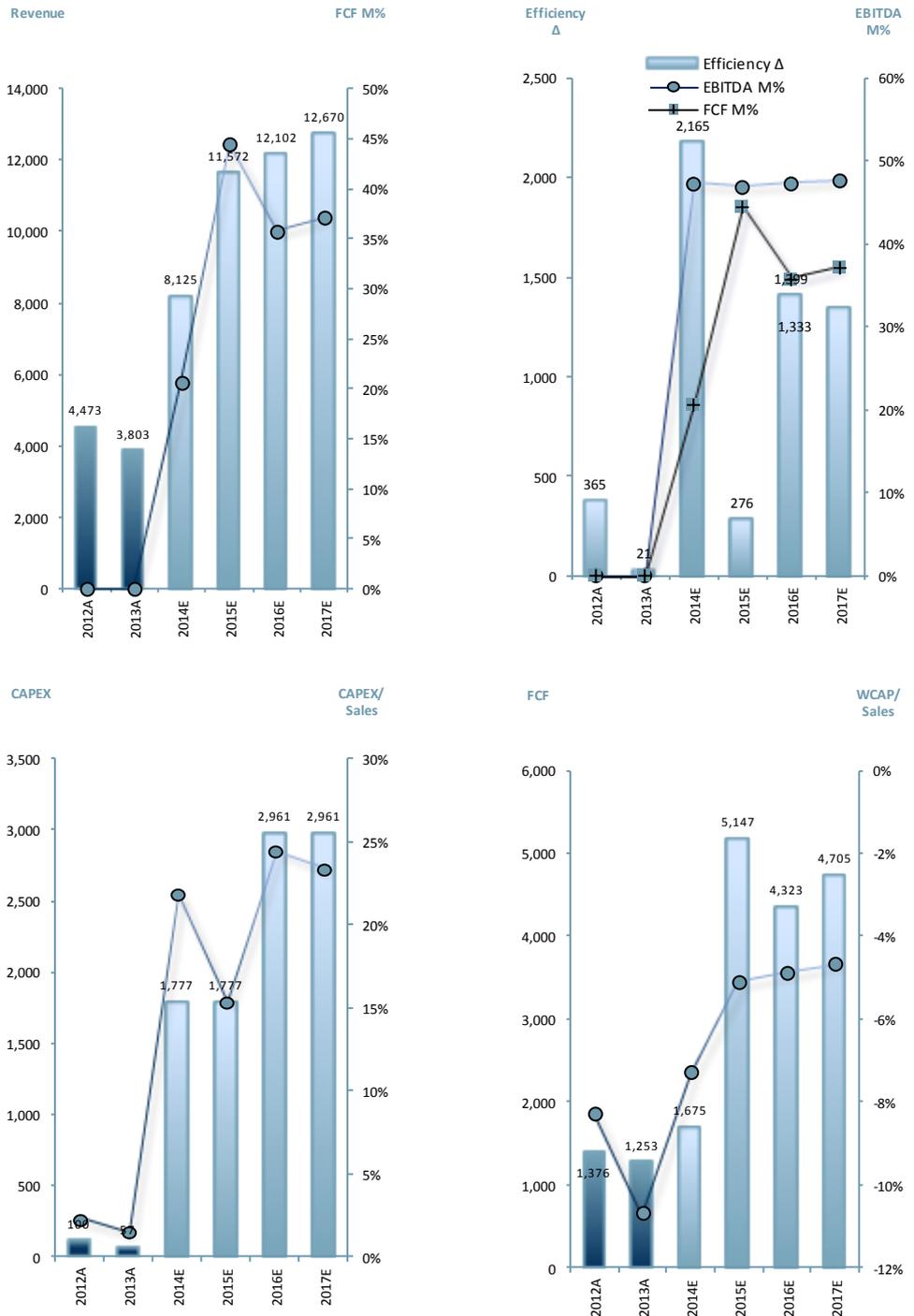
➤ **CFO, Robert M. Post.**



Mr Post joined DGO in 2005 and is a 50% owner with Mr Hutson. Mr. Post was Comptroller for Whiting Corporation for 3 years. He then purchased TramBeam, an overhead crane company, from Whiting Corporation and owned and operated the business for 20 years. Robert sold TramBeam in 2002 to a London based corporation, FKI Industries. He has supervised financial reporting and controls of Diversified Gas & Oil since 2003. Mr Post, along with Mr Hutson, has also helped finance the

company's growth, including drilling and acquisitions. He has a B.Sc. in Accounting from Jacksonville State University, Alabama.

Forecasts



Our forecasts are based upon management guidance and our own sensitivity analysis. We focus on cash proxies (EBITDA) and free cash flow (FCF) measures not least because DGO is a revenue producing and FCF positive business with an acquisition growth strategy and dividend policy. In addition the company's operational strategy is not that of a high-risk exploration play but one of an oil and gas producer.

Valuation

ACF est. GBP (k)	2013A	2014E	2015E	2016E	2017E
Revenue	3,803	8,125	11,572	12,102	12,670
EBITDA	1,274.4	3,840	5,423	5,722	6,038
Net Income	-973.7	3,264	4,609	4,864	5,132
FCF	1,253.3	1,675	5,147	4,323	4,705
CPS (diluted)	3.337	4.179	12.845	10.789	11.743

DGOC LN WACC Calc	*ERP LN
Pre-tax cost of debt	4.0%
ETR	15.0%
After-tax cost of debt	3.4%
Current Leverage	
Debt	25.1%
Equity	37,946
Target Leverage	
D / (D+E)	46.0%
ACF β adj levered	3.33
rf	1.91%
Rm	8.1%
ERP	6.2%
Cost of equity	22.58%
Risk adj.	0.00%
WACC	13.76%

*Bloomberg ticker indicates ACF market ERP

Note: Success in the pre-IPO funding round will significantly reduce our WACC.

We have used an implied beta of 3.33, which we believe reflects a pre-IPO balanced risk adjusted assumption for DGO. Although not a high risk exploration play DGO intends to list on the UK's AIM market in the oil & gas sector. Once DGO completes its pre-IPO raise we would expect to reduce our risk adjusted beta assumption substantively to more accurately reflect the likely lower volatility of the stock and its early dividend payout strategy.

Valuation Range

NPV uFCF ('000)	13,513	
NPV TV (EBITDA (m))	33,790	
EVF ('000)	47,303	
TV Multiple	10.0x	
% TV of total NPV	71.43%	
Net Debt ('000)	9,357	
Fair Value ('000)	37,946	
NoSh (m)	32.00	
NoSh (diluted) (m)	40.07	
Intrinsic Value per Share £	1.19	
Close Price £	1.19	
VR (low - high)	1.16	1.22
VR Spread	5.00%	

Note: implied value range in this ACF research note is based on shares in issue (NoSh 32,000,000) at the date of this note. See table on page 2 above this table note for dilution impacts.

Sensitivity Analysis

We believe our valuation is conservative. We have assumed a relatively high risk beta that would typically be applicable for an exploration play with nil cash flows and only prospective assets. In stark contrast DGO is a FCF generative roll-up and dividend play. Our applied growth rates during 2014E and 15E are driven by acquisition activity. We have assumed, arguably, a rather modest EBITDA terminal value multiple of 10x on a five year horizon (see valuation section above). Our organic perpetuity FCF growth rate forecast is 2% (lower than the USA's long-run GDP growth rate, which we estimate is between 3.5% and 5%). When we substitute our EBITDA TV multiple in the DCF valuation for our FCF perpetuity growth assumption this gives us a DGO value range GBP 1.26-1.31 (see exhibit 3 below). In our view, FCF perpetuity is more closely aligned to investor drivers than EBITDA TV for potential DGO investors.

The exhibit below shows our two-year estimates and multiples based upon the EV (enterprise value) and shares in issue at the date of this note (32m). Note the aggressive contraction of the forward multiples in 15E post the accretive acquisitions expected during FY14E. Our forward EV/EBITDA multiple falls to 8.7x, whereas our EV/EBITDA TV forward multiple is 10x. We conclude therefore that our valuation range is conservative.

Exhibit 4: Multiples based upon mid-point of valuation range

ACF est. GBP (k)	Revenue	EBITDA	FCF	EPS	EPS (diluted)	CPS	CPS (diluted)
2014E	8,125	3,840	1,675	10.199	8.145	5.233	4.179
2015E	11,572	5,423	5,147	14.404	11.503	16.085	12.845

Multiples	EV/ Revenue	EV/ EBITDA	EV/ FCF	P/ EPS	P/ EPS (diluted)	P/ CPS	P/ CPS (diluted)
2014E	5.82x	12.32x	28.25x	11.63x	14.56x	22.66x	28.38x
2015E	4.09x	8.72x	9.19x	8.23x	10.31x	7.37x	9.23x

Source: ACF Research Estimates

Note: The exhibit above shows the forecast multiples applicable to the current number of shares in issue (32m).

Exhibit 5: WACC/Multiple table shows near-term valuation potential

Terminal FCF Growth	Share Price						
	WACC	12.26%	12.76%	13.26%	13.76%	14.26%	14.76%
0.50%	1.40	1.35	1.31	1.27	1.23	1.20	1.20
1.00%	1.40	1.36	1.31	1.27	1.24	1.21	1.21
1.50%	1.41	1.36	1.32	1.28	1.24	1.21	1.21
2.00%	1.41	1.37	1.32	1.28	1.25	1.21	1.21
2.50%	1.42	1.37	1.33	1.29	1.25	1.22	1.22
3.00%	1.43	1.38	1.33	1.29	1.26	1.22	1.22
3.50%	1.43	1.38	1.34	1.30	1.26	1.23	1.23

Source: ACF Research Estimates

Note: The exhibit above indicates the valuation applicable to the current number of shares in issue (32m).

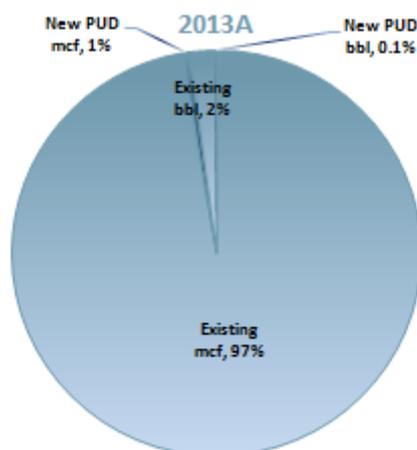
Financial Analysis

- Competitive advantage** – DGO is offering both a record of historical FCF and forecast FCF growth. Based on our discussions with management we forecast a maiden dividend within 12-18 months of the IPO raise. We forecast a sustainable long run dividend policy underpinned by DGO’s already positive FCF profile. Competing AIM oil and gas investment opportunities, broadly, are driven by access to very high risk block rights with “suspected” rather than “proven” or producing reserves. Such investments tend largely to appeal to a retail investor base at IPO. In our view DGO lends itself to institutional investment both at the pre-IPO and IPO rounds based upon its proven and forecast reserves, its historical and future FCF and its commitment (and ability) to pay a dividend within 12-18 months of listing.

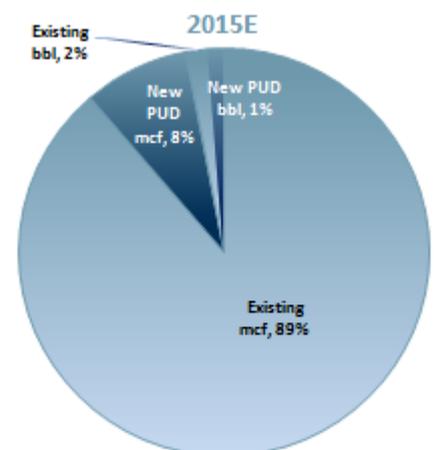
- Revenue growth and mix assumptions** – We have modelled DGO revenues based upon a conservatively increasing gas price. According to EIA forecasts wellhead gas prices rise 13.3% between 2013A and 2015E, annually averaged at 3.15 USD/Mcf 13A increasing to 3.57 USD/Mcf 15E outwards over our 5-year forecast horizon. We assume that the average oil price declines 6.58% between 2013A and 2015E from USD 92.27 bbl FY13A to USD 86.20 bbl 15E outwards. Irrespective of our positive outlook for wellhead gas pricing we expect DGO to de-risk the revenue mix by increasing the proportion of producing and PUD oil assets compared to its gas assets – see exhibit below.

We assume global consumption for industrial use of natural gas will grow at an average 1.5% p.a. and at 2% p.a. for electric power generation out to 2040, which accounts for around 77% of the EIA’s projected total natural gas consumption growth. Whilst we accept that much (up to 75%) of the growth in demand (and accompanying production) will come from non-OECD economies this still leaves 25% to come from OECD economies including North America. As gas is a relatively clean hydrocarbon energy store, we assess that, it (along with nuclear) is a strong candidate as a transition energy feed stock for OECD economies moving to green alternatives over the next 3-4 decades.

Exhibit 6: DGO asset mix 2013A and post acquisitions asset mix 15E



Source: Company Reports.



Source: Company Reports.

- **EBITDA growth** – We forecast a 78% increase in EBITDA during FY14E. We estimate 41% EBITDA growth FY15E assuming successful execution of DGO’s acquisition strategy (see exhibit below); we have subsequently modelled 5.5% EBITDA growth 16E and 17E. We have projected a terminal EBITDA growth rate of 6.6% in the final year of our 5-year horizon to capture further roll-up opportunities and longer term prospects, which we consider to be substantively less than the average EBITDA growth potential of the business over a 10 year horizon. We assume potential EBITDA margins in the range 47-50%, which should more than adequately support a maiden dividend in 12-18 months and a progressive long-run dividend payout policy therein on.

Exhibit 7: **DGO use of funds GBP 20-25m**

Use of funds	Item	Estimated Value
Acquisitions	BI JOE	GBP 13.5m
Debt	Mezzanine debt pay down	GBP 8.5m at 12% fixed
WCAP	Listing costs and WCAP	GBP 3-5m
Total Proceeds	Pre-IPO proceeds GBP 3-5m	Total proceeds GBP 20-25m (IPO proceeds GBP 17-20m total)

Source: Company Reports.

- **D&A** – 20% of revenues. We forecast D&A running at around 20% of revenues during our 5-year forecast period whilst accelerating as a proportion of D&A/Capex (see capex analysis below), which implies a more attractive future capex profile.

- **Capex (Capital Expenditure)** – GBP 1.8m (USD 3m) FY14E. According to management guidance capex will be in the range USD 3m FY14E and 15E, accelerating to a run-rate of around USD 5m p.a. for FY16E and then broadly stable at USD 5m p.a. to the end of our forecast horizon in FY18E.

- **Effective Tax Rate (ETR)** – 15%. We expect a cash effective tax rate (CETR) averaging 15% during our forecast period based upon the range of tax concessions available to on-shore oil and gas producing and exploiting companies in the US. However we have moved the tax rate up to 20% through the P&L (income statement) in 18E as a conservative measure and an acknowledgement that tax policy is subject to change. Because of the lagged relationship between cash taxes and P&L taxes our 18E CETR reflects our 15% assumption.

- **Free Cash Flow and Dividends** – FCF FY14E GBP 1.6m. We forecast FCF margins FY14E at over 20%, rising to 37% by FY17E, which we assess would adequately support management’s proposed fixed dividend payout of GBP 1.2m or 3.75p per share (2.99p per share fully diluted) for FY14E.
- **Acquisitions** – BI JOE Oil. The company has made public its first agreed target – Ohio based oil and gas producing family business BI JOE Oil at an implied offer price of GBP 13.5m for 100% of BI JOE Oil’s stock. DGO has a second acquisition target under consideration via a Letter of Intent (LOI) for an oil and gas producing company called “Fund 1”, which would move DGO from a 10% working interest to 100% control of “Fund 1”. Control of “Fund 1” should add a further USD 2m to DGO revenues. DGO already physically operates the wells for “Fund 1” and the associated numbers for a successful acquisition are included in our forecasts and our pre-new money valuation.
- **Mezzanine debt** – 12% fixed interest rate. DGO is considering paying down the entirety or its mezzanine debt post IPO as part of the use of its IPO funds. The mezzanine debt has a 12% p.a. fixed rate coupon attached, amounting to FY14E interest payable of USD 644,000 (GBP 381,377). Although paying down the entirety of the mezzanine debt will help underpin the dividend strategy, it may also lead to a sub-optimal gearing effect that could, counter-intuitively, raise the company’s WACC. We would want the company to consider re-leveraging at a more favourable rate post the equity raise.
- **Dilution and Options** – Full dilution 25.22%. DGO currently has 32,000,000 ordinary shares (common stock) in issue. The company also intends to issue 5,555,556 preferred shares that can be converted to ordinaries. A further 2,515,556 ordinary shares (common stock) could be issued if all planned warrants were to be exercised. Full dilution is calculated by management at 40,071,112, an increase in ordinaries (common stock) of 25.22%.

Notes [Intentionally Blank]

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