Viper Energy Partners LP - VNOM (6/25/19)

Description: Viper Energy Partners LP owns, acquires, and exploits oil and natural gas properties in North America. As of December 31, 2018, it had mineral interests in 14,841 net royalty acres in the Permian Basin and Eagle Ford Shale with estimated proved oil and natural gas reserves of 63,136 thousand barrels of crude oil equivalent. Viper Energy Partners GP LLC operates as the general partner of the company. The company was founded in 2013 and is based in Midland, Texas.

Ticker: VNOM
Price: $29.52
Market Cap: $1.83B
Performance: +16.4% YTD

Analysis

Before diving into the fundamentals and technicals of VNOM it is first wise to discuss the structure of the business. Viper is a limited partnership formed by Diamondback Energy, Inc (FANG).

Management of a limited partnership rests with the "general partner", FANG in this case, who also bears unlimited liability for the company's debt and obligations. A limited partnership allows for any number of "limited partners," whose liability is limited to the total amount of their investment in the company.

When you invest in VNOM, you are not getting shares but rather you are getting units in the business. Limited partners do not receive dividends but enjoy direct access to the flow of income and expenses. The main advantage of this structure is that owners are typically not liable for the company's debts.

As of March 31, 2019, Viper Energy Partners GP LLC (the "General Partner"), held a 100% general partner interest in the Partnership and Diamondback had an approximate 54% limited partner interest in the Partnership but Diamondback owns and controls the General Partner.

Mineral interest MLPs own mineral and royalty interests in oil and gas properties. These MLPs receive an upfront cash payment, or lease bonus, on the land leased for exploration and production to the third parties. Moreover, they receive a portion of the production or revenues on mineral royalties and other royalty interest. Confusing enough? Yea. Either way, I just wanted to put that out there so you all recognize that it's not your typical investment.

The main reason this was brought up was to make it clear that a limited partnership is a flow-through entity and is thus not a legal taxpaying entity and therefore you won't be seeing consistent and steady dividends from VNOM.

To maintain its pass-through status, at least 90% of the VNOM's income must be qualifying income. Qualifying income includes income realized from the exploration, production, or transportation of natural resources which is exactly the business it is in. In other words, to qualify as a master limited partnership, a company must have all but 10% of its revenues be from commodities, natural resources, or real estate activities.

Quarterly distributions from VNOM are treated as a return of capital (ROC), as opposed to dividend income. So, the unitholder does not pay income tax on the returns. Most of the earnings are tax-deferred until the unitholder sells their portion. Then, the earnings receive the lower capital gains tax rate rather than at the higher personal income rate. As you can see, this setup offers significant additional tax benefits.

For example, in Q1 2019, VNOM paid out a dividend of $0.38/unit. In Q1 of 2018, this number was $0.48 and just last quarter was $0.51 per unit. This was simply because the business generated less income to pass through to investors during that period in time. We will discuss the dividends in more depth later on.

It must also be said that some players are now beginning to change their business structure to a C-Corp as seen by Texas Pacific Land Trust (TPL) and even though not in the industry, Blackstone (BX) due to changes in legislation under President Trump.

With this point covered, let's now dive into the company and how operations are looking.

Fundamental Analysis

VNOM shares have been performing fairly well this year up over 16% but have pulled back quite a bit from this year's highs.

It is to no surprise that VNOM, given its business, is pretty much going to move lock step with the price of oil. As you can see, both move virtually in tandem with one another but if we look at the second graph, we'll see something pretty astounding.

Year-over-year, WTI Crude is down nearly 16% but VNOM has been able to remain positive only falling negative for a brief stint during the big market sell off in late December – all while FANG dropped the same exact percentage as oil.

With regards to the health of the business, things are looking pretty good despite the Y/Y fall in the payout. In Q1, VNOM's average daily production was 19,042 BOE/d (67% oil), and their operators received an average of $45.31 per Bbl of oil, $18.09 per Bbl of natural gas liquids and $2.05 per Mcf of natural gas, for an average realized price of $35.26 per BOE.

During the first quarter of 2019, they had 110 gross horizontal wells with an average royalty interest of 1.6% that had been turned to production on their existing acreage position. Of these 110 gross wells, Diamondback is the operator of 35 with an average royalty interest of 2.4%, and the remaining 75 gross wells, which have an average royalty interest of 1.3%, are operated by third parties.

Additionally, during the first quarter of 2019, they acquired 627 net royalty acres which added a further 55 gross producing horizontal wells with an average royalty interest of 3.6%. In total, as of March 31, 2019, they had 1,243 vertical wells and 2,604 horizontal wells producing on their acreage. There continues to be active development on their mineral acreage as represented by 38 active rigs on their acreage as of April 17, 2019 and 553 active drilling permits which had been filed in the past six months. This is important information because it highlights the fact that VNOM has the ability to bolster production.

Currently, VNOM has an average 3.6% net royalty interest in approximately 113 gross wells and they currently expect it to be drilled by the 38 active rigs mentioned.

	Three Months Ended March 31,	
	2019	2018
Operating income:		
Royalty income		
Oil sales	84%	90%
Natural gas sales	7%	4%
Natural gas liquid sales	7%	6%
Lease bonus income	2%	—%
	100%	100%

The image above, displays VNOM's income structure. Year-over-year, the company is a bit less dependent on oil as it now makes up 84% of income vs. 90% last year. This is due in part to the drop in oil but also a 3% increase in natural gas sales to 7% of total royalty income and a new segment of income from natural gas liquid sales making up 2% of the total.

	Three Months Ended March 31,	
	2019	2018
Production Data:		
Oil (MBbls)	1,147	906
Natural gas (MMcf)	1,872	1,162
Natural gas liquids (MBbls)	254	171
Combined volumes (MBOE)	1,714	1,271
Daily combined volumes (BOE/d)	19,042	14,122
% Oil	67%	71%
Average sales prices:		
Oil ($/Bbl)	$ 45.31	$ 61.41
Natural gas ($/Mcf)	2.05	2.11
Natural gas liquids ($/Bbl)	18.09	23.47
Combined ($/BOE)	35.26	48.88
Average Costs ($/BOE):		
Production and ad valorem taxes	$ 2.15	$ 3.34
General and administrative - cash component	0.75	1.12
Total operating expense - cash	$ 2.90	$ 4.46
General and administrative - non-cash component	$ 0.24	$ 1.01
Interest expense, net	2.65	1.65
Depletion	9.45	9.07

As mentioned in the previous page, VNOM has been acquiring acres and wells at an aggressive pace and this allowed them to shoulder some of the burden of the price drop in oil. For example, as we see above the average price of oil in Q1 2019 was $45.31 vs. $61.41 in Q1 2018, a 26.2% drop Y/Y in the commodity. Natural gas remained pretty level Y/Y and natural gas liquids fell pretty heavy but VNOM did not recognize any profits from natural gas liquids in 2018.

This decrease in average prices received was partially offset by a 34.8% increase in combined volumes sold by their operators on their acres as compared to Q1 2018. VNOM's daily production volumes jumped from 14,122 BOE/d to 19,042.

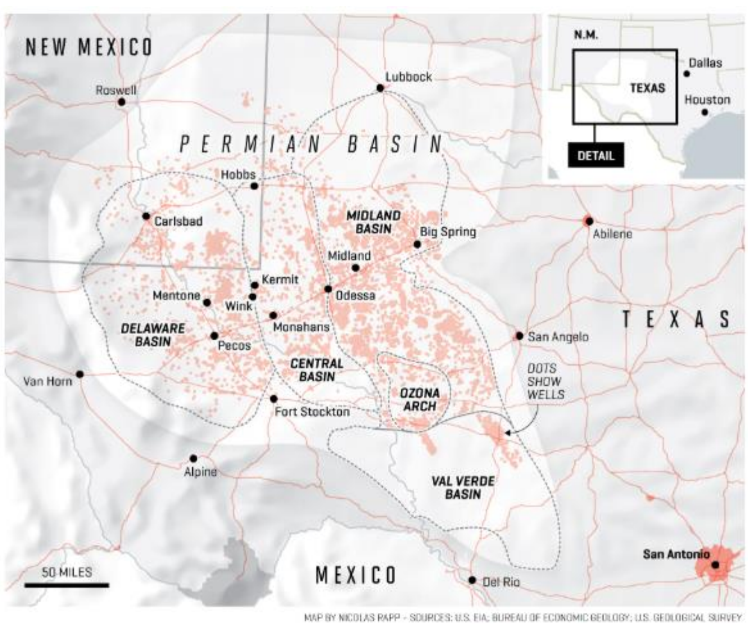
Looking through the 10Q, I found this statement, "Realized pricing is expected to improve beginning in the second quarter of 2019 as Diamondback's fixed differential contracts roll off and convert to commitments on new-build long-haul pipelines or move closer to current Midland market price. Based on current market differentials and estimated in-basin gathering cost, we expect to realize approximately 88% to 92% of WTI in the future remainder of 2019 and approximately 100% of WTI in 2020".

In addition, it appears VNOM's still has a ton of room for continued growth as Diamondback still owns almost 1,200 net royalty acres in the Southern Delaware Basin and over 900 net royalty acres in the Midland Basin. Over 90% of this acreage is operated by Diamondback, which gives Viper a solid pipeline for organic production growth.

We also have to take into account the fact that Diamondback has been acquiring companies left and right which adds even more runway for VNOM. Back in 2018, FANG acquired shale rival Energen Resources in an all-stock deal valued at $9.2B as well as $1.2 billion for Ajax Resources.

As of the end of Q1, Viper guided Q2 and Q3 production between 19,000 to 21,000 BOE per day and reaffirmed their full year production guidance of 20,000 to 23,000 BOE per day, the midpoint of which implies 24% Y/Y growth.

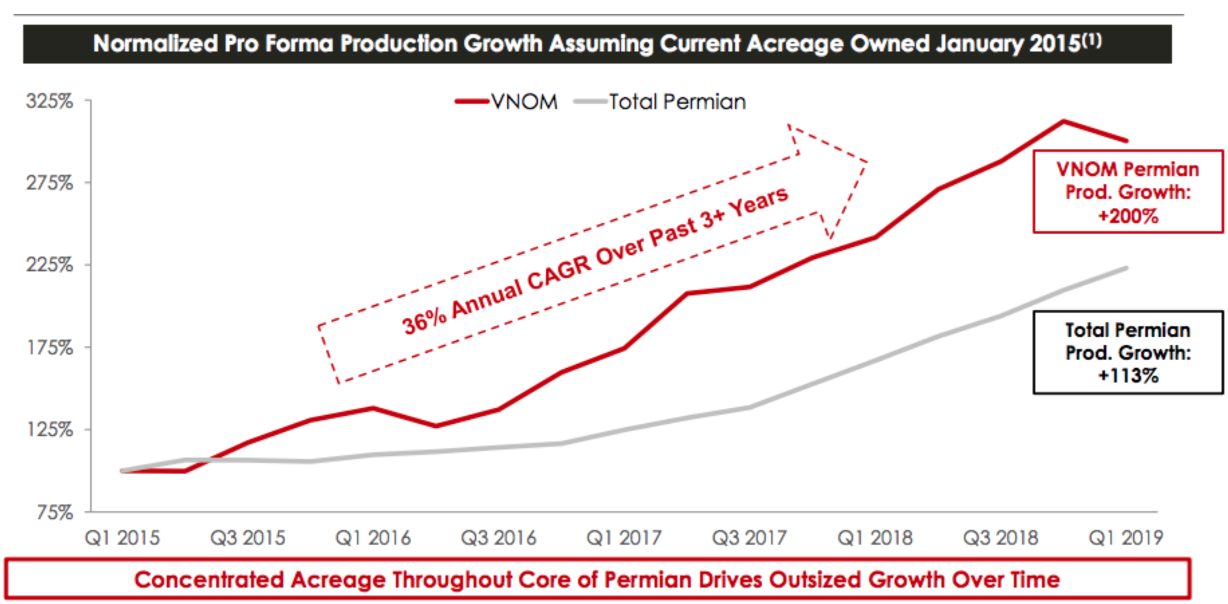
I just mentioned a few areas in which the business is operating but let's just recap this a bit so there's a better picture of what's going on.



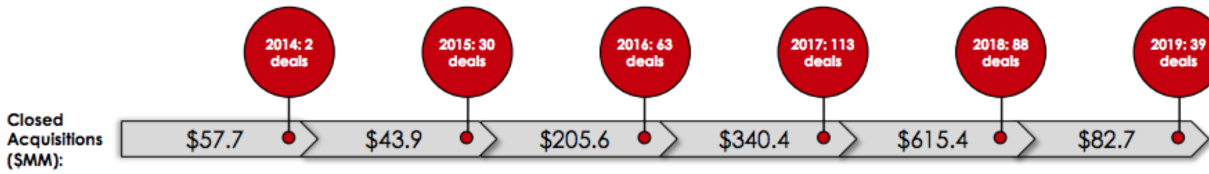
The Permian Basin, as seen above, which is located in West Texas and Southeastern New Mexico, produces more than 30% of the total U.S. crude oil production. The EIA forecasts that Permian production to average 3.9 million b/d in 2019, a 514,000 b/d increase from 2018. To give you some context, if the Permian basin was part of OPEC, it would be the fourth-largest OPEC member, right behind Saudi Arabia, Iran and Iraq. In fact, the Permian basin could soon overtake Iran in terms of oil production.

With prime location comes prime competition, though. VNOM, for the most part, has been issuing shares to acquire these locations and other companies have been investing heavily in the area. For example, much of the reason Chevron wanted to acquire Anadarko was for more access to the Permian Basin but it was Occidental that wound up swooping in to make the purchase of Anadarko. Also, just a few months ago, Exxon Mobil and Chevron both said they planned to grow their Permian Basin production to about 1 million barrels of oil equivalent a day within five years, roughly tripling their current output. Companies like Diamondback and Pioneer are pure Permian Basin plays and competition has and will most likely continue to heat up thus making acquisitions more expensive for VNOM.

As I already alluded to, production in the Permian Basin has been on a tear over the years and VNOM has been all over it too. They have grown their production over 200% since 2015 while total production in the Permian has increased by 113%. VNOM has been very aggressive on this front and has been able to do this via share offerings.

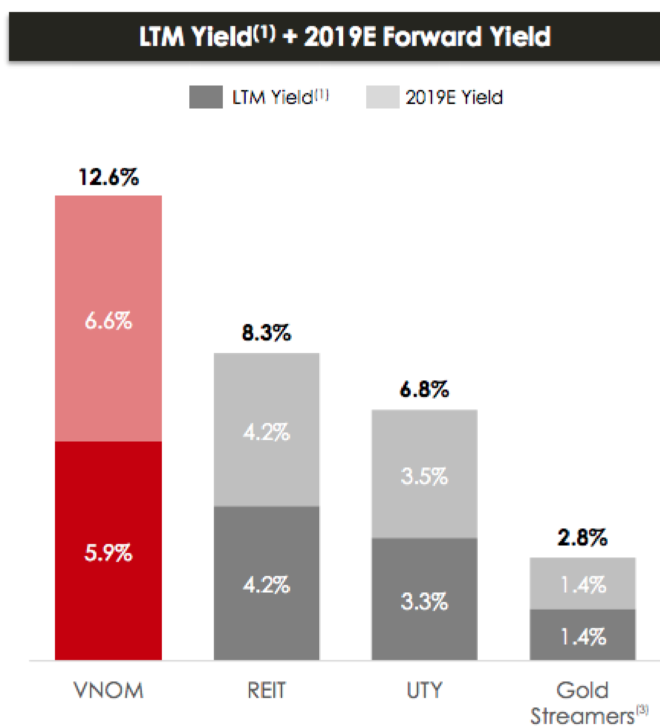


These share offerings oddly enough are taken with open arms by the Street as they support VNOM's strategy of grabbing as much of the Permian Basin as they can. Since going public in Q3 2014, Viper has closed over $1.3 billion in acquisitions across 335 transactions.



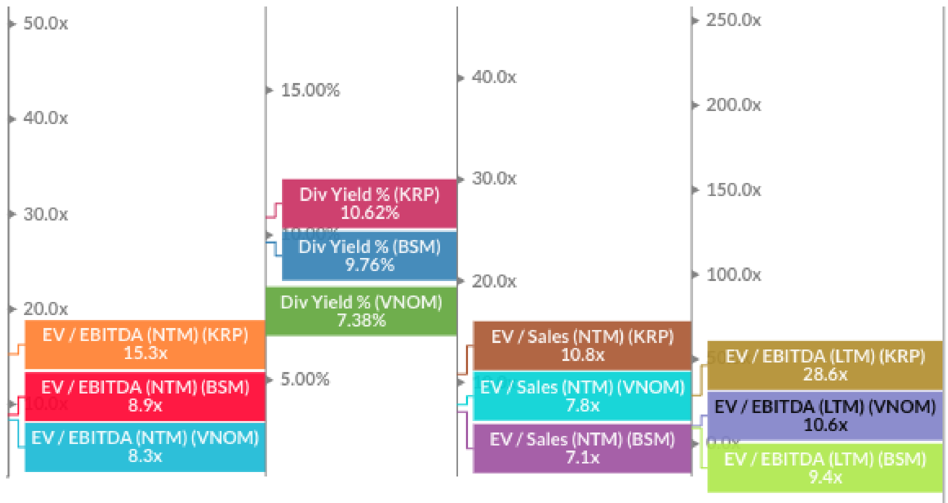
The Street may also be looking at share offerings as a better alternative than debt as VNOM brought in $340M in proceeds from share offerings in Q1 to pay down $313M in debt. As of March 31, 2019, the borrowing base was set at $555.0 million, and they had $157.0 million of outstanding borrowings with $398.0 million available for future borrowings under their revolving credit facility. This equates to a Net Debt / Annualized Q1 EBITDA of 0.6x, which is healthy.

As alluded to earlier, VNOM isn't just an attractive investment from the growth of production on their acres but they are also from the distributions they make quarterly.



At the time of their quarterly report on May 1st, VNOM was trading around $33 per share. Now that shares are around 10% lower the current yield is actually closer to 5.2% if we annualize Q1's payout which was its lowest since Q3 2017. If we take the last twelve months distributions, the yield is 7.03% which is very attractive.

Looking at some competition like that of Blackstone Mineral Partners (BLM) and Kimbell Royalty Partners (KRP), VNOM trades in-between the two.



All three are fairly different, though. For example, VNOM is growing much faster than BSM but BSM is more established with mineral interests in over 20M acres making them the largest player. In addition, BSM employs a heavier hedging strategy than VNOM and unlike VNOM that is based mainly in the Permian Basin, BSM is more diversified spanning over 60 productive basins. KRP is smaller than VNOM and BSM and growing faster hence why they are also more expensive fundamentally.

Some pros looking ahead are the obvious increases in production which can help generate more profits which in turn leads to a higher payout and yield. In addition, if rate cuts do arrive in the future, this will lead to a weaker dollar which usually helps oil as they are generally negatively correlated and will also help spur economic growth and demand for more oil. It can also lead to cheaper alternative financing for VNOM to continue their growth initiatives.

Some cons looking ahead include question marks around the current trade headwinds, overall slowdown in economic growth, growing competition in the Permian Basin, and all-around volatility in the price of oil - all of which can be hurt the price of VNOM as well as the payout as we saw just recently in Q1. Looking deeper out, alternative energy can be a threat but nothing to worry about at this moment in time.

Technical Analysis

VNOM is currently caught in a bad downtrend and is trying to make its way out. What once was an area of support in the 50-day moving average and 200 day moving average is now an area of resistance. VNOM has to push through its upper Bollinger band of $29.74 and then get over $30.38 (50 DMA) in order to get some positive momentum. The issue here is also the fact the stock has hit overbought on W%R and is starting to near the same levels on the RSI and MFI. If it is unable to break through, the next area of support is $29.06 followed by $28.19. Depending on what your goals are here, you can do what CUBE usually does and diversify your entry risk by dollar cost averaging and/or look to add some other names in the space to also offset some risk. Short-term, VNOM needs to get over its 50-day moving average. Longer-term the trend is still up, as the stock has more than doubled since 2017.