



## COMPANY UPDATE / ESTIMATE CHANGE

### Key Metrics

AREX - NASDAQ - as of	8/2/17	\$2.94
Price Target		\$12.00
52-Week Range	\$1.35 -	\$4.35
Shares Outstanding (mm)		86.3
Market Cap. (\$mm)		\$253.7
1-Mo. Average Daily Volume		945,351
Institutional Ownership		70.2%
Net Debt/Total Capital	Q2'17	40.1%
ROE	FY'16	-9.3%
Book Value / Share	Q2'17	\$6.37
Price / Book Value		0.5x
Dividend & Yield		NA
LTM EBITDA Margin		55.8%

### Adjusted EBITDA / Share FY 12/31

		Prior	Current	Prior	Current
	2016A*	2017E	2017E	2018E	2018E
1Q	\$0.21		\$0.20	A --	--
2Q	\$0.33		\$0.15	A --	--
3Q	\$0.34	\$0.21	\$0.18	--	--
4Q	\$0.37	\$0.22	\$0.20	--	--
Year	\$1.22	\$0.82	\$0.73	\$0.97	\$0.90
P/E	2.4x		4.0x		3.3x

\* - quarterly figures do not sum on share count change

### Revenue (\$mm)

		Prior	Current	Prior	Current
	2016A	2017E	2017E	2018E	2018E
1Q	\$17.6		\$26.4	A --	--
2Q	\$22.4		\$25.0	A --	--
3Q	\$23.7	\$29.8	\$27.6	--	--
4Q	\$26.5	\$31.4	\$30.1	--	--
Year	\$90.3	\$115.6	\$108.9	\$134.1	\$129.4

**Company Description:** Ft. Worth, TX – based Approach Resources, Inc. is a junior exploration and production company with a focus on west and south Texas. In 2016 the company produced approximately 4.5Mmboe (million barrels oil equivalent), 62% liquids, from its ~800 net wells and had proved reserves of approximately 156Mmboe, 63% of which was oil and NGLs.

### Energy

Analyst: Joel Havard  
 J.J.B. Hilliard, W.L. Lyons, LLC  
 502.588.1833 / jhavard@hilliard.com  
 Institutional Sales Desk: George Moorin  
 502.588.9141 / GMoorin@hilliard.com  
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## Approach Resources, Inc.

AREX -- NASDAQ – Long-term Buy-3

**Q2'17 Volume -6%, Realized Pricing +11% Yr/Yr; Maintain Rating**

### Investment Highlights

- Approach reported Q2'17 adjusted EBITDA / share of \$0.15 compared to \$0.33 a year ago, consensus was \$0.16.
- Production was 11.8 Mboe/d in Q2, up nearly 500 Boe/d from Q1 and the first sequential increase since Q3'15. Eight wells were drilled in Q2 with five completed, bringing the total to ~806. Average realized pricing of \$23.11/Boe was down 10% sequentially, while costs were ~2% higher, both yr/yr and sequentially to \$36.65/Boe. Cash costs were approximately \$14/Boe.
- Debt to total capitalization was 40% at quarter-end. We see cash flows sufficient to cover Capex in H2'17 as this year's drilling program wraps up and calculate liquidity stands at ~\$37M for the second half of the year.
- Management affirmed 2017 production guidance with a midpoint decline of ~5% yr/yr, but sees continued sequential improvement. We are raising our forecast from 11.8 Mboe/d for 2017 to 12.0 Mboe/d, but have reduced our pricing outlook while allowing for continued firming of costs. As a result, we are reducing our 2017 adjusted EBITDA/share forecast from \$0.82 to \$0.73 and our 2018 forecast from \$0.97 to \$0.90.
- We maintain our 24-month target of \$12, at which the shares would trade at an EV/Mcfe of \$0.77, a 71% discount to the sector average of \$2.63, which we believe adequately compensates for the ongoing industry uncertainty. As such, we reiterate our Long-term Buy-3 rating.

**Note Important Disclosures on Pages 5-6**  
**Note Analyst Certification on Page 5**

**ADDITIONAL DISCUSSION**

Taking advantage of pre-payment discounts Approach turned up the Capex throttle in Q2, drilling eight and completing five wells. This nearly completes this year's drilling program and leaves about three completions for the second half. With well performance metrics continuing to improve, we believe the company is positioned to maintain sequential volume growth through year-end.

The company is hedged on ~55% of anticipated 2017 production, with ~85% of gas covered at ~\$2.89/Mcf, ~49% of NGLs at ~\$21/Bbl, and with recently-established hedges, oil is ~26% covered for the second half at ~\$50/Bbl. Hedges cover ~51% of our forecasted 2018 gas production at ~\$3.08/Mcf and ~9% of oil at ~\$50/Bbl.

**SUITABILITY RATING**

Our Suitability rating is 3 on a 1-to-4 scale (1 = most conservative, 4 = most aggressive). This reflects our favorable view of the company's relatively high-performing production development and competitive cost structure in the Permian Basin and relatively healthy balance sheet condition. This is balanced, however, against challenging industry-wide market conditions and a modest hedge position for 2017 and 2018.

**CONSIDERATIONS AND RISKS**

The energy production industry is highly capital intensive and highly competitive and is subject to a range of economic and operational risks. Foremost among these risks may be volatility in the underlying commodity pricing, which is subject to supply and demand fundamentals related to factors such as economic conditions, weather patterns and logistical constraints. The industry is also subject to a range of regulatory risks, including changes in environmental and pollution policies, permitting requirements, and employee benefits obligations. Operating financial risks include success rates and costs related to expansion of the reserve base.

Company-specific risks include a modest hedge position, the potential for capital constraints that could limit AREX's operational flexibility, future pace of drilling or acquisition opportunities. Additionally, a substantial portion of the company's undeveloped acreage lease-holdings could expire through 2017, limiting future growth potential. Finally, smaller-cap stocks can be subject to pronounced volatility and may not be appropriate for all accounts.

*Additional information is available upon request.*

**Approach Resources, Inc. (AREX)**

(\$'s in '000's) FYE Dec.

Income Statement Analysis	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17	Q3'17E	Q4'17E	FY'17E	FY'18E	
<b>Oil &amp; Gas Sales</b>	\$ 258,529	\$ 131,336	\$ 17,615	\$ 22,433	\$ 23,749	\$ 26,505	\$ 90,302	\$ 26,355	\$ 24,969	\$ 27,560	\$ 30,060	\$ 108,944	\$ 129,400	
<b>Costs &amp; Expenses</b>														
Lease Operating	32,701	28,972	6,356	5,234	3,894	3,766	19,250	4,170	4,238	4,390	4,570	17,368	19,010	
Severance & Production taxes	15,934	11,085	1,664	1,855	2,013	2,685	8,217	2,357	2,252	2,340	2,560	9,509	11,000	
Exploration	3,831	4,439	569	1,622	1,047	685	3,923	1,043	2,108	970	990	5,111	4,600	
Asset Impairment	-	221,633	-	-	-	-	-	-	-	-	-	-	-	
G & A	32,104	28,341	6,051	5,832	5,825	7,026	24,734	5,928	6,548	6,370	6,530	25,376	28,060	
D, D & A	106,802	109,319	20,229	19,991	19,422	19,402	79,044	17,962	19,543	20,010	20,610	78,125	84,700	
Operating Profit	\$ 67,157	\$ (272,453)	\$ (17,254)	\$ (12,101)	\$ (8,452)	\$ (7,059)	\$ (44,866)	\$ (5,105)	\$ (9,720)	\$ (6,520)	\$ (5,200)	\$ (26,545)	\$ (17,970)	
%	26.0%	-207.4%	-98.0%	-53.9%	-35.6%	-26.6%	-49.7%	-19.4%	-38.9%	-23.7%	-17.3%	-24.4%	-13.9%	
Investment / Other Gain (Impairment)	(114)	10,735	104	854	(10)	-	948	5,056	-	-	-	5,056	5,562	
Interest Inc. / (Exp.)	(21,651)	(25,066)	(6,298)	(6,808)	(7,067)	(7,086)	(27,259)	(5,463)	(4,916)	(4,870)	(4,820)	(20,069)	(18,250)	
Realized Commodity Deriv's Gain / (Loss)	2,359	52,489	3,500	1,409	781	442	6,132	(961)	3	-	-	(958)	-	
Unrealized Comm. Deriv's Gain / (Loss)	42,113	(33,214)	(957)	(8,076)	760	(3,343)	(11,616)	4,405	1,228	-	-	5,633	-	
Pre-Tax Income	89,864	(267,509)	(20,905)	(24,722)	(13,988)	(17,046)	(76,661)	(2,068)	(13,405)	(11,390)	(10,020)	(36,883)	(30,658)	
Income Tax	33,692	(93,405)	(7,245)	(8,687)	(4,915)	(3,571)	(24,418)	138,700	(4,509)	(4,270)	(3,760)	126,161	(11,497)	
%	37.5%	34.9%	34.7%	35.1%	35.1%	20.9%	31.9%	-6707.0%	33.6%	37.5%	37.5%	-342.1%	37.5%	
Extraordinary Items	-	-	-	-	-	-	-	-	-	-	-	-	-	
Net Income	56,172	(174,104)	(13,660)	(16,035)	(9,073)	(13,475)	(52,243)	(140,768)	(8,896)	(7,120)	(6,260)	(163,044)	(19,162)	
Shares Outstanding	39,418	40,463	41,069	41,564	41,680	41,705	41,488	70,409	86,340	86,460	86,580	82,447	84,500	
EPS - GAAP	\$1.43	(\$4.30)	(\$0.33)	(\$0.39)	(\$0.22)	(\$0.32)	(\$1.26)	(\$2.00)	(\$0.10)	(\$0.08)	(\$0.07)	(\$1.98)	(\$0.23)	
EPS - Operating, Adjusted	\$0.74	(\$0.37)	(\$0.32)	(\$0.25)	(\$0.23)	(\$0.27)	(\$1.07)	(\$0.11)	(\$0.11)	-	-	(\$0.37)	-	
<b>Margin Analysis</b>														
Production Gross margin	87.4%	77.9%	63.9%	76.7%	83.6%	85.8%	78.7%	84.2%	83.0%	84.1%	84.8%	84.1%	85.3%	
Op. Taxes as % of O&G revenues	6.2%	8.4%	9.4%	8.3%	8.5%	10.1%	9.1%	8.9%	9.0%	8.5%	8.5%	8.7%	8.5%	
S, G&A as % of O&G revenues	12.4%	21.6%	34.4%	26.0%	24.5%	26.5%	27.4%	22.5%	26.2%	23.1%	21.7%	23.3%	21.7%	
D, D & A as % of O&G revenues	41.3%	83.2%	114.8%	89.1%	81.8%	73.2%	87.5%	68.2%	78.3%	72.6%	68.6%	71.7%	65.5%	
<b>Rate of Change Analysis</b>														
Revenues	42.6%	-49.2%	-47.1%	-41.9%	-30.0%	4.0%	-31.2%	49.6%	11.3%	16.0%	13.4%	20.6%	18.8%	
Op. Inc.	54.1%	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	-32.3%	
EPS - operating	43.0%	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	nm	-88.5%	
Adjusted EBITDDA	47.5%	-34.4%	-73.9%	-57.9%	-53.9%	-42.6%	-59.1%	62.1%	-5.5%	9.9%	13.3%	19.0%	26.5%	
Shares Out.	1.0%	2.6%	2.3%	2.5%	2.8%	2.7%	2.5%	71.4%	107.7%	107.4%	107.6%	98.7%	2.5%	
Working Cap.	-12.5%	-81.2%	45.0%	35.4%	-5.2%	-13.9%	60.3%	11.7%	33.7%	-20.4%	9.1%	29.8%	7.6%	
Guidance:	Guidance:	vol -11% yr/yr	vol -18% yr/yr	vol -28% yr/yr	vol -17% yr/yr;	Guidance:	vol -11% yr/yr	vol -6% yr/yr						
11/7- vol's +40% on ~70 new wells;	2/25- ~5.5Mmboe; 5/7- 5/8- 4.79Mmboe; 8/5- 4.95Mmboe; 11/5- "lower end" Actual: 5.05 Mmboe @ 69%)	affirm; 8/6- 5.4-5.5; 11/5- 5.4-5.6 Actual: 5.53 Mmboe @ 65% liquids.				3/3- 4.34-4.64 Mmboe; 5/4- affirm; 8/6- affirm; 11/3- affirm; Actual: 4.54 Mmboe @ 62% liquids	1/26- phase 1 of exchange retires \$131M of debt for 39M shares; 3/22- tender phase 2 retires \$15M for 4M shares						Guidance: 3/9- 4.16-4.45 Mmboe; 5/5- affirm; 8/2- affirm; Forecasting 4.31 Mmboe @ 62% liquids	Forecasting 4.59 Mmboe @ 62% liquids

Source: Company reports and Hilliard Lyons estimates

## Approach Resources, Inc. (AREX) (\$'s in '000s)

Cash Flow Analysis													
	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17p	Q3'17E	Q4'17E	FY'17E	FY'18E
Net Inc.	56,172	(174,104)	(13,600)	(16,035)	(9,073)	(13,475)	(52,243)	(140,768)	(8,896)	(7,120)	(6,260)	(163,044)	(19,162)
D, D & A	106,802	109,319	20,229	19,991	19,422	19,402	79,044	17,962	19,543	20,010	20,610	78,125	84,700
Unrealized Commod. Deriv. Loss/(Gain)	(42,113)	33,214	957	8,076	(760)	3,343	11,616	(4,405)	(1,228)	-	-	(5,633)	-
Deferred Compensation Exp.	8,247	7,954	1,550	1,374	1,357	1,998	6,279	1,159	1,029	1,080	1,130	4,398	4,730
Deferred Inc. Tax (Charge)/Allowance	33,717	(93,140)	-	-	-	-	-	-	-	-	-	-	71,565
(Increase) Decrease in Wrkg. Cap.	(6,586)	(37,533)	3,903	4,451	(892)	(2,236)	5,226	1,628	5,240	(4,230)	1,500	4,140	1,374
Operating C.F.	156,239	(154,290)	12,979	17,857	10,054	9,032	49,922	(124,424)	15,688	9,740	16,980	(82,014)	143,208
(Cap. Ex.)	(3,024)	(67)	(3)	(12)	-	(1)	(16)	(6)	(20)	(20)	(20)	(66)	(73)
(Development & Acquisition Exp.)	(390,506)	(151,178)	(4,874)	(6,871)	(5,554)	(2,489)	(19,788)	(13,359)	(24,400)	(15,000)	(12,500)	(65,259)	(71,785)
Asset Sales / (Disposals)	(181)	-	-	-	-	-	-	-	-	-	-	-	-
(Dividends)	-	-	-	-	-	-	-	-	-	-	-	-	-
Free C.F.	(237,472)	(305,535)	8,102	10,974	4,500	6,542	30,118	(137,789)	(8,732)	(5,280)	4,460	(147,339)	71,350
ST Debt Drawn	353,921	272,000	12,600	21,000	7,000	9,500	50,100	21,500	13,500	5,280	-	40,280	-
(ST Debt Repaid)	(203,921)	(149,000)	(13,600)	(18,000)	(7,000)	(11,500)	(50,100)	(19,500)	(4,600)	4,490	(3,790)	(23,400)	(53,513)
LT Debt Drawn	-	-	-	-	-	-	-	-	-	-	-	-	-
(LT Debt Repaid)	-	(8,722)	-	-	-	-	-	(145,050)	-	-	-	(145,050)	-
Stock Issued	-	-	-	-	-	-	-	-	-	-	-	-	-
(Stock Repurchased)	-	-	-	-	-	-	-	-	-	-	-	-	-
Net C.F.	(87,472)	(191,257)	7,102	13,974	4,500	4,542	30,118	(280,839)	168	4,490	670	(275,509)	17,838
Adjusted EBITDA	188,282	123,553	8,698	13,712	14,145	15,468	50,512	14,101	12,963	15,540	17,530	60,131	76,060
Adjusted EBITDA / Share	\$4.78	\$3.05	\$0.21	\$0.33	\$0.34	\$0.37	\$1.22	\$0.20	\$0.15	\$0.18	\$0.20	\$0.73	\$0.90
yr/yr change	46%	-36%	-75%	-59%	-55%	-44%	-60%	-5%	-54%	-47%	-45%	-40%	23%
EBITDDA as % of O&G Sales	72.8%	94.1%	49.4%	61.1%	59.6%	58.4%	55.9%	53.5%	51.9%	56.4%	58.3%	55.2%	58.8%
CF Multiple	1.3x	0.6x											
Balance Sheet Analysis													
	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17p	Q3'17E	Q4'17E	FY'17E	FY'18E
Cash	430	600	840	893	2,708	21	21	79	178	4,670	5,340	5,340	23,200
Accounts Receivable	19,635	11,889	7,372	7,933	8,115	9,639	9,639	8,776	11,800	8,800	9,600	9,600	10,400
Other Current Assets	3,210	7,949	8,004	3,347	2,254	2,250	2,250	1,860	1,900	1,900	1,900	1,900	30,000
Total Current Assets	61,079	20,438	16,216	12,173	13,077	12,494	12,494	10,715	13,915	15,370	16,840	16,840	63,600
Net PP&E	1,331,659	1,154,546	1,138,868	1,124,282	1,109,504	1,092,061	1,092,061	1,086,483	1,089,463	1,094,480	1,096,700	1,096,700	1,092,390
Other Assets	11,692	1,212	-	-	-	-	-	832	2,889	2,890	2,890	2,890	2,890
Total Assets	1,404,430	1,174,984	1,155,084	1,136,455	1,122,581	1,104,555	1,104,555	1,098,030	1,106,267	1,112,740	1,116,430	1,116,430	1,158,880
ST & Current Portion of LT Debt	-	-	-	-	-	-	-	-	-	-	-	-	-
Accounts Payable	33,336	10,799	13,767	10,151	9,098	9,482	9,482	6,982	7,500	7,720	8,420	8,420	9,060
Oil & Gas Payables	8,536	4,245	3,211	4,196	4,171	4,190	4,190	4,507	4,600	4,410	4,810	4,810	5,180
Other Current Liabilities	64,980	13,464	10,971	13,957	13,232	12,697	12,697	14,671	22,400	17,640	19,240	19,240	20,700
Total Current Liabilities	106,852	28,508	27,949	28,304	26,501	26,369	26,369	26,160	34,500	29,770	32,470	32,470	34,940
Credit Facility	150,000	270,748	269,917	273,431	273,561	271,696	271,696	273,831	287,325	297,100	293,310	293,310	239,800
Sr. Notes (Jun'21)	250,000	225,839	226,042	226,246	226,450	226,653	226,653	83,958	82,000	82,000	82,000	82,000	85,240
Deferred Inc Tax & Other LT Liabilities	123,251	41,922	35,325	27,292	22,606	16,885	16,885	155,574	152,120	144,510	137,280	137,280	130,420
Shareholders' Equity	774,327	607,967	595,851	581,182	573,463	562,952	562,952	558,507	550,322	559,360	571,370	571,370	668,480
Book Value per share	\$19.64	\$15.03	\$14.51	\$13.98	\$13.76	\$13.50	\$13.57	\$7.93	\$6.37	\$6.47	\$6.60	\$6.93	\$7.91
Current Ratio	0.6x	0.7x	0.6x	0.4x	0.5x	0.5x	0.5x	0.4x	0.4x	0.5x	0.5x	0.5x	1.8x
LT Debt/Cap.-Net of Cash	24.4%	27.0%	27.4%	27.9%	28.0%	28.7%	28.7%	13.1%	12.9%	12.1%	11.7%	11.7%	8.2%
Total Debt/Cap.-Net of Cash	34.0%	44.9%	45.3%	46.1%	46.3%	47.0%	47.0%	39.0%	40.1%	39.9%	39.1%	39.1%	30.4%
ROE DuPont	7.3%	-28.6%	-9.2%	-11.0%	-6.3%	-9.6%	-9.3%	-100.8%	-6.5%	-5.1%	-4.4%	-28.5%	-2.9%

Source: Company reports and Hilliard Lyons estimates

### **Analyst Certification**

I, Joel K. Havard, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

### **Important Disclosures**

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

### **Suitability Ratings**

- 1** - A large cap, core holding with a solid history
- 2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
- 3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
- 4** - Speculative, due to small size, inconsistent profitability, erratic revenues, volatility, low trading volume or a narrow customer or product base

### **Investment Ratings**

**Buy** - We believe the stock has significant total return potential in the coming 12 months.

**Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

**Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

**Underperform** - We believe the stock is vulnerable to a price setback in the next 12 months.



Rating	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017

**Other Disclosures**

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