Approach Resources Inc
Form 10-Q
May 03, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number: 001-33801

APPROACH RESOURCES INC.

(Exact name of registrant as specified in its charter)

Delaware	51-0424817
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Ridgmar Centre	
6500 West Freeway, Suite 800	
Fort Worth, Texas	76116

(Address of principal executive offices) (Zip Code)

(817) 989-9000

(Registrant’s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if smaller reporting company)	Smaller reporting company
Emerging growth company		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant’s common stock, $0.01 par value, outstanding as of April 30, 2018, was 94,627,262.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Approach Resources Inc. and Subsidiaries

Unaudited Consolidated Balance Sheets

(In thousands, except shares and per-share amounts)

	March 31, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$22	$21
Accounts receivable:		
Joint interest owners	193	117
Oil, NGLs and gas sales	9,521	9,678
Derivative instruments	1,250	1,398
Prepaid expenses and other current assets	1,558	5,486
Total current assets	12,544	16,700
PROPERTIES AND EQUIPMENT:		
Oil and gas properties, at cost, using the successful efforts method of accounting	1,944,388	1,930,577
Furniture, fixtures and equipment	5,689	5,658
Total oil and gas properties and equipment	1,950,077	1,936,235
Less accumulated depletion, depreciation and amortization	(868,923)	(853,359)
Net oil and gas properties and equipment	1,081,154	1,082,876
Total assets	$1,093,698	$1,099,576
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$10,028	$9,450
Oil, NGLs and gas sales payable	5,438	5,363
Derivative instruments	2,430	2,181
Accrued liabilities	8,761	8,073
Total current liabilities	26,657	25,067
NON-CURRENT LIABILITIES:		
Senior secured credit facility, net	290,449	289,275
Senior notes, net	84,260	84,185
Deferred income taxes	80,492	82,102
Asset retirement obligations	11,042	11,065
Other non-current liabilities	604	466
Total liabilities	493,504	492,160
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS’ EQUITY:		

Preferred stock, $0.01 par value, 10,000,000 shares authorized, none outstanding		
Common stock, $0.01 par value, 180,000,000 shares authorized,		
94,605,086 and 94,533,246 issued and outstanding, respectively	946	945
Additional paid-in capital	742,614	742,391
Accumulated deficit	(143,366)	(135,920)
Total stockholders' equity	600,194	607,416
Total liabilities and stockholders' equity	$1,093,698	$1,099,576

See accompanying notes to these unaudited consolidated financial statements

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Approach Resources Inc. and Subsidiaries

Unaudited Consolidated Statements of Operations

(In thousands, except shares and per-share amounts)

	Three Months Ended	
	March 31,	
	2018	2017
REVENUES:		
Oil, NGLs and gas sales	$28,772	$26,355
EXPENSES:		
Lease operating	5,268	4,170
Production and ad valorem taxes	2,500	2,357
Exploration	—	1,043
General and administrative (1)	6,567	5,928
Depletion, depreciation and amortization	15,680	17,962
Total expenses	30,015	31,460
OPERATING LOSS	(1,243)	(5,105)
OTHER:		
Interest expense, net	(5,886)	(5,463)
Gain on debt extinguishment	—	5,053
Commodity derivative (loss) gain	(1,928)	3,444
Other income	1	3
LOSS BEFORE INCOME TAX (BENEFIT) PROVISION	(9,056)	(2,068)
INCOME TAX (BENEFIT) PROVISION	(1,610)	138,700
NET LOSS	$(7,446)	$(140,768)
LOSS PER SHARE:		
Basic	$(0.08)	$(2.00)
Diluted	$(0.08)	$(2.00)
WEIGHTED AVERAGE SHARES OUTSTANDING:		
Basic	94,516,280	70,409,303
Diluted	94,516,280	70,409,303
(1) Includes non-cash share-based compensation expense as follows:	828	1,159

See accompanying notes to these unaudited consolidated financial statements

Approach Resources Inc. and Subsidiaries

Unaudited Consolidated Statements of Cash Flows

(In thousands)

	Three Months Ended March 31,	
	2018	2017
OPERATING ACTIVITIES:		
Net loss	$(7,446)	$(140,768)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depletion, depreciation and amortization	15,680	17,962
Amortization of debt issuance costs	262	219
Gain on debt extinguishment	—	(5,053)
Commodity derivative loss (gain)	1,928	(3,444)
Settlements of commodity derivatives	(1,531)	(961)
Exploration expense	—	1,033
Share-based compensation expense	828	1,159
Deferred income tax provision (benefit)	(1,610)	138,700
Other non-cash items	—	(3)
Changes in operating assets and liabilities:		
Accounts receivable	85	863
Prepaid expenses and other current assets	(466)	(266)
Accounts payable	(1,781)	(3,973)
Oil, NGLs and gas sales payable	72	318
Accrued liabilities	(636)	(97)
Cash provided by operating activities	5,385	5,689
INVESTING ACTIVITIES:		
Additions to oil and gas properties	(13,685)	(13,359)
Additions to furniture, fixtures and equipment, net	(31)	(6)
Change in working capital related to investing activities	8,329	6,479
Cash used in investing activities	(5,387)	(6,886)
FINANCING ACTIVITIES:		
Borrowings under credit facility	29,500	21,500
Repayment of amounts outstanding under credit facility	(28,500)	(19,500)
Equity issuance costs	—	(2,468)
Tax withholdings related to restricted stock	(604)	(93)
Debt issuance costs	(14)	—
Change in working capital related to financing activities	(379)	1,816
Cash provided by financing activities	3	1,255
CHANGE IN CASH AND CASH EQUIVALENTS	1	58
CASH AND CASH EQUIVALENTS, beginning of period	$21	$21
CASH AND CASH EQUIVALENTS, end of period	$22	$79

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$4,174	$4,202
SUPPLEMENTAL DISCLOSURE OF NON-CASH TRANSACTION:		
Asset retirement obligations capitalized	$—	$11

See accompanying notes to these unaudited consolidated financial statements

Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

1. Summary of Significant Accounting Policies

Organization and Nature of Operations

Approach Resources Inc. ("Approach," the "Company," "we," "us" or "our") is an independent energy company engaged in the exploration, development, production and acquisition of oil and gas properties. We focus on finding and developing oil and natural gas reserves in oil shale and tight gas sands. Our properties are primarily located in the Permian Basin in West Texas. We also own interests in the East Texas Basin.

Consolidation, Basis of Presentation and Significant Estimates

The interim consolidated financial statements of the Company are unaudited and contain all adjustments (consisting primarily of normal recurring accruals) necessary for a fair statement of the results for the interim periods presented. Results for interim periods are not necessarily indicative of results to be expected for a full year, due in part to the volatility in prices for oil, natural gas liquids ("NGLs") and gas, future commodity prices for commodity derivative contracts, global economic and financial market conditions, interest rates, access to sources of liquidity, estimates of reserves, drilling risks, geological risks, transportation restrictions, the timing of acquisitions, product supply and demand, market competition and interruptions of production. You should read these consolidated interim financial statements in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the Securities and Exchange Commission on March 9, 2018.

The accompanying interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly owned subsidiaries. Intercompany accounts and transactions are eliminated. In preparing the accompanying financial statements, management has made certain estimates and assumptions that affect reported amounts in the financial statements and disclosures of contingencies. Actual results may differ from those estimates. Significant assumptions are required in the valuation of proved oil and gas reserves, which affect our estimate of depletion expense as well as our impairment analyses. Significant assumptions also are required in our estimation of accrued liabilities, commodity derivatives, income tax provision, share-based compensation and asset retirement obligations. It is at least reasonably possible these estimates could be revised in the near term, and these revisions could be material. Certain prior-year amounts have been reclassified to conform to current-year presentation. These classifications have no impact on the net loss reported.

Recent Accounting Pronouncements

On January 1, 2018, we adopted the Financial Accounting Standards Board ("FASB") accounting standards update for "Revenue from Contracts with Customers," which superseded the revenue recognition requirements in "Topic 605, Revenue Recognition," using the modified retrospective method. Adoption of this standard did not have a significant impact on our consolidated statements of operations or cash flows. We implemented processes to ensure new contracts are reviewed for the appropriate accounting treatment and generate the disclosures required under the new standard.

See Note 2 for additional disclosures required under this accounting standards update related to the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers including disaggregation of revenue.

In February 2016, FASB issued an accounting standards update for "Leases," which amends existing guidance to require lessees to recognize assets and liabilities on the balance sheet for the rights and obligations created by long-term leases and to disclose additional quantitative and qualitative information about leasing arrangements. This new guidance is effective for interim and annual periods beginning after December 15, 2018, and we will adopt it using a modified retrospective approach. Currently, the Company is evaluating the standard's applicability to our various contractual arrangements. We believe that the adoption of this standard will result in recognition of assets and liabilities on the balance sheet for current operating leases. The Company is still evaluating the impact of this new guidance on its consolidated financial statements.

In January 2017, FASB issued an accounting standards update for "Clarifying the Definition of a Business," which provides guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This standard requires entities to use a screen test to determine when an integrated set of assets and activities is not a business or if the integrated set of assets and activities needs to be further evaluated against the framework. We have adopted this standard as of January 1, 2018. Adoption of this standard did not impact our consolidated statements of operations or cash flows.

In August 2017, FASB issued an accounting standards update for "Derivatives and Hedging," which amends existing guidance related to the recognition and presentation requirements of hedge accounting, including eliminating the requirement to

separately measure and report hedge ineffectiveness, and presenting all items that affect earnings in the same income statement line item as the hedged item. This standard is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. We have elected to early adopt this standard in the first quarter of 2018. Adoption of this standard did not impact our consolidated statements of operations or cash flows. Although we have not historically designated our derivative contracts as cash-flow hedges, we designated swap derivative contracts entered in April 2018 as cash-flow hedges. See Note 8 for additional information related to the derivative contracts designated as cash-flow hedges.

Prepaid Expenses and Other Assets

In April 2017, we entered into an agreement that secured pricing of a hydraulic fracturing services crew. Under this agreement, we made a prepayment of $5 million, to be used as we completed wells. We have used $1.2 million of this prepayment related to hydraulic fracturing services provided during the first year of the agreement. In March 2018, this agreement was terminated and $3.8 million of the unused prepaid balance was refunded to us.

2. Revenue Recognition

Revenues for the sale of oil, NGLs, and gas are recognized as the product is delivered to our customers’ custody transfer points and collectability is reasonably assured. We fulfill the performance obligations under our customer contracts through daily delivery of oil, NGLs and gas to our customers’ custody transfer points and revenues are recorded on a monthly basis. The prices received for oil, NGLs and natural gas sales under our contracts are generally derived from stated market prices which are then adjusted to reflect deductions including transportation, fractionation and processing. As a result, our revenues from the sale of oil, natural gas and NGLs will decrease if market prices decline. The sales of oil, NGLs and gas as presented on the Consolidated Statements of Operations represent the Company’s share of revenues net of royalties and excluding revenue interests owned by others. When selling oil, NGLs and gas on behalf of royalty owners or working interest owners, the Company is acting as an agent and thus reports the revenue on a net basis. To the extent actual volumes and prices of oil and natural gas sales are unavailable for a given reporting period because of timing or information not received from third parties, the expected sales volumes and prices for those properties are estimated and recorded.

The following table presents our disaggregated revenue by major source for the three months ended March 31, 2018, and 2017 (in thousands).

	Three Months Ended March 31,	
	2018	2017
Revenues (in thousands):		
Oil	$16,343	$13,694
NGLs	7,332	6,060
Gas	5,097	6,601
Total oil, NGLs and gas sales	$28,772	$26,355

Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

3. Earnings Per Common Share

We report basic earnings per common share, which excludes the effect of potentially dilutive securities, and diluted earnings per common share, which includes the effect of all potentially dilutive securities unless their impact is antidilutive. The following table provides a reconciliation of the numerators and denominators of our basic and diluted earnings per share (dollars in thousands, except per-share amounts).

	Three Months Ended March 31, 2018	2017
Income (numerator):		
Net loss – basic	$(7,446)	$(140,768)
Weighted average shares (denominator):		
Weighted average shares – basic	94,516,280	70,409,303
Dilution effect of share-based compensation, treasury method (1)	—	—
Weighted average shares – diluted	94,516,280	70,409,303
Net loss per share:		
Basic	$(0.08)	$(2.00)
Diluted	$(0.08)	$(2.00)

(1) Approximately 39,000 options to purchase our common stock were excluded from this calculation because they were antidilutive for the three months ended March 31, 2017. No options were outstanding as of March 31, 2018, as they had expired.

4. Equity Exchange Transactions

Debt exchange

On November 2, 2016, we entered into an exchange agreement with Wilks Brothers, LLC and SDW Investments, LLC (collectively, "Wilks") the largest holder of our 7% Senior Notes due 2021 (the "Senior Notes"), to exchange $130,552,000 principal amount of our Senior Notes for 39,165,600 newly issued shares of common stock, par value $0.01 per share (the "Initial Exchange"). On January 26, 2017, our stockholders approved the Exchange Transactions (defined below) and an increase in our authorized common stock from 90 million shares to 180 million shares. We closed the Initial Exchange on January 27, 2017, and paid $1.1 million of accrued interest on the Senior Notes held by Wilks. In connection with the Initial Exchange, a second supplemental indenture became effective, which removed certain covenants and events of default from the indenture governing our Senior Notes and eliminated certain restrictive covenants discussed in Note 5.

On March 22, 2017, we exchanged an additional $14,528,000 principal amount of outstanding Senior Notes for 4,009,728 shares of our common stock (the "Follow-On Exchange").

The Initial Exchange and the Follow-On Exchange (together, the "Exchange Transactions") reduced the principal amount of outstanding Senior Notes by $145.1 million and reduced interest payments by $44.3 million over the remaining term of the Senior Notes. The Exchange Transactions were accounted for as a debt extinguishment. A gain of $5.1 million was recognized on the Exchange Transactions for the difference between the fair market value of the shares issued, a Level 1 fair value measurement, and the net carrying value of the Senior Notes exchanged. We incurred equity issuance costs of $2.8 million related to the Exchange Transactions, which were recorded as a reduction to additional paid-in capital.

The Exchange Transactions triggered a cumulative change in ownership of our common stock by more than 50% under Section 382 of the Internal Revenue Code as of March 22, 2017. This established an annual limitation on the usage of our pre-change net operating losses ("NOLs") in the future. Accordingly, we recognized a write-off of deferred tax assets of $139.1 million.

Acquisition

Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

On November 1, 2017, we entered into a definitive agreement (the "Purchase Agreement") to acquire producing properties directly adjacent to our acreage in the Permian Basin (the "Bolt-On Acquisition"). The Bolt-On Acquisition closed on November 20, 2017, and we issued 7,573,403 newly issued shares of common stock, par value $0.01 per share, with an effective date of September 1, 2017. The purchase price was finalized in April 2018, and we expect to receive 142,362 of the previously issued shares of our common stock, which will be retired, pursuant to adjustments under the Purchase Agreement.

5. Long-Term Debt

The following table provides a summary of our long-term debt at March 31, 2018, and December 31, 2017 (in thousands).

	March 31, 2018	December 31, 2017
Senior secured credit facility:		
Outstanding borrowings	$292,000	$291,000
Debt issuance costs	(1,551)	(1,725)
Senior secured credit facility, net	290,449	289,275
Senior notes:		
Principal	85,240	85,240
Debt issuance costs	(980)	(1,055)
Senior notes, net	84,260	84,185
Total long-term debt	$374,709	$373,460

Senior Secured Credit Facility

At March 31, 2018, the borrowing base and aggregate lender commitments under our amended and restated senior secured credit facility (the "Credit Facility") were $325 million, with maximum commitments from the lenders of $1 billion. The Credit Facility has a maturity date of May 7, 2020. The borrowing base is redetermined semi-annually based on our oil, NGLs and gas reserves. We, or the lenders, can each request one additional borrowing base redetermination each calendar year. Our semi-annual borrowing base redetermination was completed on May 1, 2018, and our borrowing base and aggregate lender commitments were reaffirmed at $325 million.

At March 31, 2018, borrowings under the Credit Facility bore interest based on the agent bank's prime rate plus an applicable margin ranging from 2% to 3%, or the sum of the LIBOR rate plus an applicable margin ranging from 3% to 4%. In addition, we pay an annual commitment fee of 0.50% of unused borrowings available under the Credit Facility. Margins vary based on the borrowings outstanding compared to the borrowing base of the lenders.

We had outstanding borrowings of $292 million under the Credit Facility at March 31, 2018, compared to $291 million of outstanding borrowings at December 31, 2017. The weighted average interest rate applicable to borrowings under the Credit Facility for the three months ended March 31, 2018, was 5.5%. We had outstanding unused letters of credit under the Credit Facility totaling $0.3 million at March 31, 2018, and December 31, 2017, respectively, which reduce amounts available for borrowing under the Credit Facility.

Obligations under the Credit Facility are secured by mortgages on substantially all of the oil and gas properties of the Company and its subsidiaries. The Company is required to grant liens in favor of the lenders covering the oil and gas properties of the Company and its subsidiaries representing at least 95% of the total value of all oil and gas properties of the Company and its subsidiaries.

On December 21, 2017, we entered into a fourth amendment to the Credit Facility. The fourth amendment, among other things, (a) extended the maturity date of the Credit Facility from May 7, 2019, to May 7, 2020, (b) increased the applicable margin rates on borrowings by 50 basis points, (c) required the Company to hedge 50% of the Company's estimated 2018 oil and gas production from proved developed producing reserves and (d) amended our financial covenants as described below. In connection with the fourth amendment to the Credit Facility, we incurred $1 million of debt issuance costs.

Covenants

The Credit Facility contains three principal financial covenants:

- a consolidated interest coverage ratio covenant that requires us to maintain a ratio of (i) consolidated EBITDAX for the period of four fiscal quarters then ending to (ii) Cash Interest Expense for such period as of the last day of any fiscal quarter of not less than 1.75 to 1.0 through December 31, 2018, a ratio of not less than 2.25 to 1.0 through December 31, 2019, and 2.5 to 1.0 thereafter. EBITDAX is defined as consolidated net (loss) income plus (i) interest expense, net, (ii) income tax provision (benefit), (iii) depreciation, depletion, amortization, (iv) exploration expenses and (v) other noncash loss or expense (including share-based compensation and the change in fair value of any commodity derivatives), less noncash income. Cash Interest Expense is calculated as interest expense, net less amortization of debt issuance costs. At March 31, 2018, our consolidated interest coverage ratio was 2.6 to 1.0;
- a consolidated modified current ratio covenant that requires us to maintain a ratio of not less than 1.0 to 1.0 as of the last day of any fiscal quarter. The consolidated modified current ratio is defined as the ratio of (i) current assets plus funds available under our revolving credit facility, less the current derivative asset, to (ii) current liabilities less the current derivative liability. At March 31, 2018, our consolidated modified current ratio was 1.8 to 1.0; and
- a consolidated total leverage ratio covenant that imposes a maximum permitted ratio of (i) Total Debt to (ii) EBITDAX for the period of four fiscal quarters then ending of not more than 5.0 to 1.0, as of the last day of any fiscal quarter from March 31, 2019, through June 30, 2019, thereafter not more than 4.75 to 1.0 as of the last day of any fiscal quarter through December 31, 2019, and (iii) not more than 4.0 to 1.0 as of the last day of any fiscal quarter thereafter. Total Debt is defined as the face or principal amount of debt. Our leverage ratio is currently above the level that will be required as of March 31, 2019. At March 31, 2018, our leverage ratio was 6.9 to 1.0.

The Credit Facility also contains covenants restricting cash distributions and other restricted payments, transactions with affiliates, incurrence of other debt, consolidations and mergers, the level of operating leases, asset sales, investment in other entities and liens on properties.

In addition, the obligations of the Company may be accelerated upon the occurrence of an Event of Default (as defined in the Credit Facility). Events of Default include customary events for a financing agreement of this type, including, without limitation, payment defaults, the inaccuracy of representations and warranties, defaults in the performance of affirmative or negative covenants, defaults on other indebtedness of the Company or its subsidiaries, bankruptcy or related defaults, defaults related to judgments and the occurrence of a Change of Control (as defined in the Credit Facility), which includes instances where a third party becomes the beneficial owner of more than 50% of the Company's outstanding equity interests entitled to vote.

Senior Notes

At March 31, 2018, and December 31, 2017, $85.2 million of Senior Notes were outstanding. We issued the Senior Notes under a senior indenture dated June 11, 2013, among the Company, our subsidiary guarantors and Wilmington Trust, National Association, as successor trustee. The senior indenture, as supplemented by supplemental indentures dated June 11, 2013, and December 20, 2016, is referred to as the "Indenture."

We may redeem some or all of the Senior Notes at specified redemption prices, plus accrued and unpaid interest to the redemption date. The Senior Notes are fully and unconditionally guaranteed on a senior unsecured basis by each of

our subsidiaries, subject to certain customary release provisions. A subsidiary guarantor may be released from its obligations under the guarantee:

- in connection with any sale or other disposition of all or substantially all of the assets of that guarantor (including by way of merger or consolidation) to a person that is not (either before or after giving effect to such transaction) the Company or a subsidiary guarantor, if the sale or other disposition otherwise complies with the Indenture;
- in connection with any sale or other disposition of the capital stock of that guarantor to a person that is not (either before or after giving effect to such transaction) the Company or a subsidiary guarantor, if that guarantor no longer qualifies as a subsidiary of the Company as a result of such disposition and the sale or other disposition otherwise complies with the Indenture;
- if the Company designates any restricted subsidiary that is a guarantor to be an unrestricted subsidiary in accordance with the Indenture;

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Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

- upon defeasance or covenant defeasance of the notes or satisfaction and discharge of the Indenture, in each case, in accordance with the Indenture;
- upon the liquidation or dissolution of that guarantor, provided that no default or event of default occurs under the Indenture as a result thereof or shall have occurred and is continuing; or
- in the case of any restricted subsidiary that, after the issue date of the notes is required under the Indenture to guarantee the notes because it becomes a guarantor of indebtedness issued or an obligor under a credit facility with respect to the Company and/or its subsidiaries, upon the release or discharge in full from its (i) guarantee of such indebtedness or (ii) obligation under such credit facility, in each case, which resulted in such restricted subsidiary's obligation to guarantee the notes.

The Indenture contains limited events of default.

Subsidiary Guarantors

The Senior Notes are guaranteed on a senior unsecured basis by each of our consolidated subsidiaries. Approach Resources Inc. is a holding company with no independent assets or operations. The subsidiary guarantees are full and unconditional and joint and several, and any subsidiaries of the Company other than the subsidiary guarantors are minor. There are no significant restrictions on the Company's ability, or the ability of any subsidiary guarantor, to obtain funds from its subsidiaries through dividends, loans, advances or otherwise.

At March 31, 2018, we were in compliance with all of our covenants, and there were no existing defaults or events of default, under our debt instruments.

6. Commitments and Contingencies

Our contractual obligations include long-term debt, operating lease obligations, asset retirement obligations and employment agreements with our executive officers. Since December 31, 2017, there have been no material changes to our contractual obligations.

We are involved in various legal and regulatory proceedings arising in the normal course of business. While we cannot predict the outcome of these proceedings with certainty, we do not believe that an adverse result in any pending legal or regulatory proceeding, individually or in the aggregate, would be material to our consolidated financial condition or cash flows.

7. Income Taxes

For the three months ended March 31, 2018, our income tax benefit was $1.6 million, compared to an income tax provision of $138.7 million for the three months ended March 31, 2017. The following table reconciles our income tax expense for the three months ended March 31, 2018, and 2017, to the U.S. federal statutory rates of 21% and 35%, respectively (dollars in thousands).

	March 31, 2018	March 31, 2017
Statutory tax at 21% and 35%, respectively	$(1,902)	$(724)
State taxes, net of federal impact	162	41
Share-based compensation tax shortfall	70	290
Nondeductible compensation	57	—
Other differences	3	3
Write-off of deferred tax assets	—	$139,090
Income tax (benefit) provision	$(1,610)	$138,700

On December 22, 2017, the Tax Cuts and Jobs Act was enacted which, among other things, lowered the U.S. Federal income tax rate applicable to corporations from 35% to 21% and repealed the corporate alternative minimum tax.

The Exchange Transactions triggered a cumulative change in ownership of our common stock by more than 50% under Section 382 of the Internal Revenue Code as of March 22, 2017. This established an annual limitation on the usage of our pre-change NOLs in

Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

the future. Accordingly, we recognized a write-off of our deferred tax assets of $139.1 million in the three months ended March 31, 2017.

8. Derivative Instruments and Fair Value Measurements

The following table provides our outstanding commodity derivative positions at March 31, 2018.

Commodity and Period	Contract Type	Volume Transacted	Contract Price
Crude Oil			
April 2018 – December 2018	Swap	300 Bbls/day	$50.00/Bbl
April 2018 – June 2018	Collar	500 Bbls/day	$55.00/Bbl - $60.00/Bbl
April 2018 – September 2018	Swap	1,500 Bbls/day	$60.50/Bbl
Natural Gas			
April 2018 – December 2018	Swap	200,000 MMBtu/month	$3.085/MMBtu
April 2018 – December 2018	Swap	250,000 MMBtu/month	$3.084/MMBtu
NGLs (C2 - Ethane)			
April 2018 – December 2018	Swap	1,000 Bbls/day	$11.424/Bbl
NGLs (C3 - Propane)			
April 2018 – December 2018	Swap	600 Bbls/day	$32.991/Bbl
NGLs (IC4 - Isobutane)			
April 2018 – December 2018	Swap	50 Bbls/day	$38.262/Bbl
NGLs (NC4 - Butane)			
April 2018 – December 2018	Swap	200 Bbls/day	$38.22/Bbl
NGLs (C5 - Pentane)			
April 2018 – December 2018	Swap	200 Bbls/day	$56.364/Bbl

After March 31, 2018, we entered into swaps for the NYMEX Calendar Monthly Average Roll (the “CMA Roll”) covering 2,000 Bbls of oil per day for May 2018 through December 2018 at $0.66/bbl. Swaps for the CMA Roll are pricing adjustments to the trade month versus the delivery month for contract pricing. These derivative contracts were designated as cash-flow hedges. The changes in fair value of the derivative contracts designated as cash-flow hedges, to the extent the hedge is effective, will be recognized in other comprehensive income until the hedged item is recognized in revenue.

The following table summarizes the fair value of our open commodity derivatives as of March 31, 2018, and December 31, 2017 (in thousands).

	Balance Sheet Location	Fair Value	
		March 31, 2018	December 31, 2017
Derivatives not designated as hedging instruments			
Commodity derivatives	Derivative assets	$1,250	$ 1,398
Commodity derivatives	Derivative liabilities	(2,430)	(2,181)

The following table summarizes the change in the fair value of our commodity derivatives (in thousands).

		Three Months Ended March 31,	
		2018	2017
Derivatives not designated as hedging instruments			
Commodity derivatives	Net cash payment on derivative settlements	$(1,531)	$(961)
	Non-cash fair value (loss) gain on derivatives	(397)	4,405
	Commodity derivative (loss) gain	$(1,928)	$3,444

Approach Resources Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2018

Derivative assets and liabilities, at fair value, are included on our consolidated balance sheets as current or non-current assets or liabilities based on the anticipated timing of cash settlements under the related contracts. Changes in the fair value of our commodity derivative contracts, not designated as cash-flow hedges, are recorded in earnings as they occur and included in income (expense) on our consolidated statements of operations. We estimate the fair values of swap contracts based on the present value of the difference in exchange-quoted forward price curves and contractual settlement prices multiplied by notional quantities. We internally valued the option contracts using industry-standard option pricing models and observable market inputs. We use our internal valuations to determine the fair values of the contracts that are reflected on our consolidated balance sheets.

We are exposed to credit losses in the event of nonperformance by the counterparties on our commodity derivatives positions and have considered the exposure in our internal valuations. However, we do not anticipate nonperformance by the counterparties over the term of the commodity derivatives positions.

To estimate the fair value of our commodity derivatives positions, we use market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated or generally unobservable. We primarily apply the market approach for recurring fair value measurements and attempt to use the best available information. We determine the fair value based upon the hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and lowest priority to unobservable inputs (Level 3 measurement). The three levels of fair value hierarchy are as follows:

- Level 1 — Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The shares of our common stock issued in the Exchange Transactions were valued as a Level 1 measurement. At March 31, 2018, we had no Level 1 measurements.
- Level 2 — Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors and current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Our derivatives, which consist primarily of commodity swaps and collars, are valued using commodity market data, which is derived by combining raw inputs and quantitative models and processes to generate forward curves. Where observable inputs are available, directly or indirectly, for substantially the full term of the asset or liability, the instrument is categorized in Level 2. At March 31, 2018, all of our commodity derivatives were valued using Level 2 measurements.
- Level 3 — Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. At March 31, 2018, we had no recurring Level 3 measurements.

Financial Instruments Not Recorded at Fair Value

The following table sets forth the fair values of financial instruments that are not recorded at fair value on our financial statements (in thousands).

	March 31, 2018	
	Carrying Amount	Fair Value
Senior Notes	$84,260	$80,978

The fair value of the Senior Notes is based on quoted market prices, but the Senior Notes are not actively traded in the public market.