IN ROYALTY WE TRUST

Overall performance of certain royalty trusts provides an attractive alternative to investing in private-equity funds.

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"This business has been profitable every single month since it was formed in 1987." Those were the words of an Ohio oil and gas operator reflecting on his last 27 years in business. He owns and operates oil and gas wells and gathering systems given up by others as noncore, tail-end properties. It is a truism that good businesses are hard to find. Once found, owning them for a long time can deliver great rewards. His business proves it.

Few private-equity firms can hold great businesses for long periods though. Instead, they typically form 10-year investment partnerships requiring assiduous focus on exit strategies for each portfolio company from the outset. Their dollars briefly take flight before returning to the roost, with benefits.

Unfolding here is a view in favor of long-term oil and gas property ownership as a source of investment cash flow and as an alternative to the exit-focused buy-build-sell strategy. It's not a bad alternative.

So what is the exit strategy for the Ohio operator mentioned here? "In the end there will be nothing left," he said, referring to the fact that eventually all surface equipment and reusable downhole tubulars will be turned back into cash and the green grass will grow anew. In the meantime, these properties provide a multi-decade fountain of capital for reinvestment as their reserve tail extends further in time than any previous owner might have imagined. Everybody discounts the tail.

But depletion happens. Private-equity professionals shrewdly ignore tail value to focus on realizing break-out exit values. Just how shrewd is revealed by the many impressive investment gains realized during the decade just ended in December 2013. For example, newly public Antero Resources delivered roughly a 5x return on investment (ROI) to its private-equity backers, including Warburg Pincus, over the nearly 10-year period culminating in its 2013 IPO. Devon Energy Corp.'s recent purchase of privately held GeoSouthern Energy from The Blackstone Group produced a 5x ROI over a three-year period. And Shell Oil's purchase of KKR-backed East Resources delivered a 3x ROI in just one year. Like a light bulb to June bugs on a summer night, these returns attract institutional capital by the billions.

But the very scale at which large institutional investors allocate capital to oil and gas private equity increases the likelihood they may achieve only average results. They risk owning too much of the market. Oil and gas private-equity funds raised an average of $15 billion per year over the last decade, a daunting sum to deploy effectively in an industry undergoing epic, Schumpeterian change.

How epic? Capital IQ recently reported that the 20 largest, nonmajor exploration companies outspent their cash flow by nearly $12 billion last year and experienced $30 billion of negative cash flow the prior year. This publication recently reported that Global Hunter Securities' database of 87 public E&P companies averaged a 226% capital expenditure-to-cash flow ratio in 2013, a huge use of cash in search of a source. And while some of this capital contributes to building up to those coveted break-out exit values, some also competes with private-equity-backed E&P companies, many of which start up with no cash flow, relying entirely on external funding to achieve above-average investment performance. This pressures returns.

Table 1. Select 2004–2006-Vintage\ Oil And Gas Private-Equity Funds

Number of Funds	16
Total Capital	$25 billion
Average IRR	11.9%
Average ROI	1.4
Average Investment Duration	Three years

Note: Names of individual funds and sponsors not shown, but results are in aggregate. Source: Preqin

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A recent performance review of 16 energy private-equity funds covered by Preqin, an institutional fund-tracking service, demonstrates the challenge of putting this capital to work. Eleven different sponsors formed these 16 funds in the circa-2004 time period. They generated internal rates of return ranging from only minus 2% to as high as 31% over the course of the decade just ended in 2013. Table 1 summarizes their results.

The top-three performing funds in this group delivered IRRs ranging from 26% to 31% and 1.8 to 1 cash-on-cash ROIs, while the bottom-three performing funds ranged from -2% to 7% IRRs and 0.9 to 1.4 ROIs. Eight of the 16 funds performed above the average and eight performed below.

Perhaps the greatest challenge these private-equity sponsors faced was finding and backing those management teams capable of allocating capital effectively within their areas of expertise against intense competition for ideas, land, services and personnel. How can an investor hope to achieve above-average rates of return in the face of such a competitive environment?

Reinvestment risk

Kurt Wulff, founder of McDep Associates in Needham, Massachusetts, has an answer. Wulff is an oil and gas securities analyst and principal investor with experience dating to his start with Donaldson, Lufkin Jenrette in the 1970s. He analyzes and tracks publicly traded oil and gas royalty trusts for his own account and for a stable of paid subscribers to his services at www.mcdep.com. Among the dozens of oil and gas securities he tracks, four royalty trusts appear in Table 2, which illustrates the market capitalization, vintage and returns for each trust during the 10-year period ending December 31, 2013.

The royalty trusts have outperformed the 16 private-equity funds in the study group over the same 10-year period—and have done so while exposing the investor to less risk.

What risks? Well, reinvestment risk, for one. The lower ROI and average three-year investment durations of the private-equity funds necessarily require the investor to repeatedly reinvest larger cash flow increments, more frequently, leading inevitably to the occasional ill-timed or ill-considered investment.

In contrast, the steady trickle of cash from the royalty trust limits such capital misallocations to small 0.5% to 1% of capital increments, allowing the investor more opportunity to regain his or her senses from moments of weakness. Mistakes happen, after all.

Royalty trusts also bear less financial risk because they have no debt. Precipitous commodity price volatility may threaten the leveraged E&P company owner's livelihood, but that same volatility presents unleveraged royalty trust owners an opportunity to buy low and hold high.

Finally, royalty trusts entail little management risk because they have no management, the absence of which leaves the investor free to allocate his cash flow stream as he sees fit. And with all due respect to the proven investment acumen and leadership of both private-equity fund managers and their portfolio company management teams, eliminating both those management layers may appeal to a certain investor subset confident in their own money management mettle.

How can these superior returns lie in plain sight? Simple, Wulff says. Investors assign little value to nonproducing reserves. So any new drilling activity on royalty trust property automatically leads to value accretion, even while distributing cash as monthly income.

He notes that assets owned by Dorchester Minerals and Sabine Royalty Trust consist of royalties, as opposed to net profits interests, so there is really little reportable knowledge about their properties. The trusts only report publicly their proved developed reserves. Yet their production volumes have grown 11% and 7% respectively over the last three years. As the industry's overall production volume has expanded, so has theirs.

Indeed, Sabine Royalty's 10K notes that, when it was formed in 1982, it had 9 million barrels (MMbbl) and 62 billion cubic feet(Bcf),

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Table 2. 10-Year Performance, Select Royalty Trusts

Royalty Trust	Date Formed	Market Cap ($MM)	10-yr IRR	10-yr ROI
San Juan Basin Royalty Trust (SJT)	11/80	822	13%	1.9%
Dorchester Minerals LP (DMLP)	12/01	807	19%	3.0%
Sabine Royalty Trust (SBR)	12/82	750	14%	2.3%
Permian Basin Royalty Trust (PBT)	11/80	621	23%	3.1%

Note: Market caps from 4/14/14. IRR and ROI assume purchase in January 2004 and sale in December 2013, a 10-year hold period with monthly/quarterly distributions received, but not reinvested into the underlying security. Source: Yahoo Finance and SEC filings

Table 3. Royalty Trust Market Capitalization vs. Reserves NPV

	SJT	PBT	SBR	DMLP
Mid-April Market Cap ($MM)	834	623	747	823
NPV10 Reserves ($MM)	395	333	258	271
Market Cap/NPV	211%	187%	290%	304%
Wulff NPV ($MM)	980	839	648	859
Market Cap/Wulff NPV	85%	74%	115%	96%
Three-Year Reserve Growth Rate	-26%	-1%	7%	11%
Est. Distribution Yield	8.5%	7.8%	7.8%	7.2%

Source: McDep.com and Dec. 2013 public filingsZ

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all of which was expected to deplete within 10 years. Since then it has paid out $1.15 billion to its owners and its reserves are estimated at 6.3 MMbbl and 37.4 Bcf, with yet another 10 years predicted life remaining. Since inception, SBR has delivered a 13.7% IRR, beating the S&P 500 by 23% over 30 years.

These royalty trusts look expensive at first glance. A quick comparison of market capitalization to PV-10 of reported reserves shows that the mid-April market was pricing these securities at 2x to 3x the discounted reserve value, a seemingly high price to anyone experienced in reserve acquisition. For perspective, however, Exxon currently trades for 2x its PV-10 reserve value while delivering one-third the cash yield of a royalty trust.

Wulff estimates his own discounted present value using a methodology he developed, which includes a 7% discount factor, not 10%, and a $90 per bbl and $6 per Mcf price assumption beyond the next 12 months, among other things. His net present values more closely approximate the market price of these trusts, as shown in Table 3, as of mid-April.

Trends in capital expenditures and commodity prices significantly impact the perceived value of these trusts, creating opportunities to time their purchase. For example, the San Juan Basin Royalty Trust has reported a reserve decline because the recently soft natural gas market rendered uneconomic a huge volume of future gas production from its reserve tail and reduced cash distributions. The consequent reduction in perceived value and market price may or may not persist and does not reflect the actual volume of gas reserves ultimately attributable to trust properties under the price environment assumed by Wulff.

As another example, Wulff said the Permian Basin Royalty Trust is experiencing reduced distributions currently as an active drilling program on its net profits interest properties charges capital expenditures against otherwise distributable cash flow. When capital spending subsides, distributions may increase and the reserve base may actually have grown.

Entry and exit points

This strategy is not for everyone. To begin with, these four royalty trusts, alone, represent only $3 billion of market capitalization, or only 20% of the $15 billion average annual institutional allotment to oil and gas private equity. Not everyone can execute this.

But Wulff points out that, despite this size challenge, some large investors have capitalized on periods of market price softness to build significant ownership positions. He cites, for example, one New York-based investment firm that early this year reported it had accumulated over 5% of San Juan Basin Royalty Trust, joining two other long-term large owners with 12% and 9% positions in the trust, respectively.

A search of 13-G disclosures also reveals that a LeFrak Companies' affiliate reported acquiring over 8% of Dorchester Minerals in early 2013, and that Houston-based investment firm Fayez Sarofim has been a longtime owner of the Sabine Royalty Trust.

Wulff's system for tracking royalty trust values, along with numerous other oil and gas equity securities, features his own creation, the "McDep Ratio." Quite simply, he derives this ratio from his version of NPV less debt, divided by market cap. A ratio below 1.0 implies undervaluation, while a ratio above suggests the opposite.

The McDep Ratio guides investors to propitious entry or exit points from all the securities Wulff covers, and regular subscribers benefit from a proprietary first look at his research efforts before he later makes the data public on his website. The system works.

Wulff points out that a balanced oil and gas investment portfolio should include some ownership in royalty trusts, as well as other oil and gas C-corp equity securities.

He would also acknowledge the wisdom in further diversifying a portfolio into oil and gas private equities with top money managers, which could lead to the kind of top-quintile results noted from the study group covered here, and which could provide further diversification and higher returns for an investor.

But every investor needs a source of cash. Long-term royalty trust ownership provides a stable, constantly repeating source of cash deep into a reserve tail that the market often underprices—an ideal vehicle for an enterprising oil and gas investor. □

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