Mineral and Royalty Interests – The Perfect Compliment to a Traditional Real Estate Portfolio

BY SCOTT BERNSTEIN

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When many real estate investors hear the terms oil and gas mineral and royalty interests, they might cringe and possibly even run the other way. The unusual thing is the asset profile is very similar to that of a commercial real estate portfolio, yet delivered in a way which tends to be uncorrelated with traditional real estate yields and valuations. This is why an often misunderstood product set can be a perfect diversification tool to a traditional real estate portfolio.

Mineral Interests and corresponding royalties are considered subsurface real estate and are eligible as replacement real property for 1031 exchanges. The mineral royalty owner (MRO) owns a tract or fraction thereof from the surface of the earth downward. A portion of commodities extracted from the land by an operating lessor (OpCo) is paid to the owner in the form of a royalty. This is similar to a landlord/tenant relationship in a busy shopping center where the landlord negotiates for a portion of the gross sales earned by the tenant.

MROs receive royalties in units of actual commodities, such as barrels of oil as an example, which are then marketed for them by the OpCo as opposed to a portion of revenue from the OpCo. The royalty units are considered property of the MRO once the commodity reaches the earth's surface at the wellhead. This mitigates the MRO's counterparty credit risk exposure to the OpCo and generally makes the mineral royalty investment bankruptcy remote to the OpCo.

Mineral royalty interests do not possess any liabilities which are present in traditional real estate. These are assumed by the OpCo including environmental, mechanical, and maintenance. Ultimately, if a well is drilled and there is a cost overrun, it is completely irrelevant to the mineral holder and 100% the operator's responsibility.

Royalty income earned by MRO's is only 85% taxable per a "depletion allowance" dictated by the IRS. Unlike a standard depreciation deduction which lowers the tax basis of a real estate asset for resale purposes, any tax advantage earned via depletion allowance does not affect the taxable basis for resale. There is an active resale market for mineral royalty properties.

When assessing a mineral royalty acquisition, key questions the potential MROs should ask themselves are:

What is the current monthly cashflow generated from the portfolio?

This addresses the most important binary characteristic about a mineral royalty portfolio: "Is it actively producing oil and/or gas and generating royalty income?" If yes, the oil and gas reserves associated with those producing wells fall into the lowest risk category of reserves known as proved developed producing reserves (PDP). PDP wells tend to produce predictable amounts of oil and gas which provide stable cashflow.

The risk level of PDP wells is low enough that banks accept these wells (and only these) as collateral for reserve based lines (RBL) of credit for OpCos. For investors seeking low risk assets similar to real estate, it is generally advisable to avoid Minerals Royalty packages which do not possess any PDP wells.

If PDP wells exist on a property, it not only provides stable long term cashflow to investors from those wells, but also de-risks the property in general. Un-drilled well locations to be drilled on immediately adjacent acreage to PDP's are considered proven undeveloped (PUD). OpCos are eager to drill PUDs as they are low risk future cashflow generators, which ultimately benefits MROs.

How will this cashflow change in the future?

Two factors affect the cashflow of mineral and royalty packages:

- commodity prices
- production levels

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Commodity prices have a two-fold effect on a project. The most obvious is that the investor receives a royalty which is equal to the units of commodity they are entitled to X the spot commodity price per unit (bbl for oil or mcf for gas). The higher the price, the better for the royalty owner. This is not only true for current production but for future to be drilled production.

When commodity prices are higher, economics of drilling wells are more compelling, and more wells are drilled. This directly affects MROs who benefit from top line increases in production. In this way MROs' and OpCos' interests are aligned.

In all oil and gas wells, daily production diminishes over time due to reduction in reservoir pressure. The rate of decline tends to be the steepest when a well is first drilled and flattens over time. Wells can remain active for over 50 years though, but will not produce at the high rate they initially did. To counteract this, operators drill new wells to keep their current cashflow rising.

After considerable time passes from initial drilling, when daily production rates have dropped, operators often use "secondary recovery" methods which drive reservoir pressure up and seek to increase daily production levels as a result. These provide an avenue for upside in older wells without the need for new drilling. Emerging technologies are continuously being developed to recover larger percentages of oil and gas in a reservoir.

Mineral royalty ownership can be a welcome compliment to a real estate portfolio so long as the investor seeks mineral royalty properties which possess actively producing PDP wells in addition to future development potential. This generates a portfolio component which has stable current cashflow coupled with upside potential through higher commodity prices and future well development.