As of this writing, Texas Pacific Land Trust ("TPL"), a major holding across our strategies, is performing (on a year to date basis) largely in line with the broader energy sector based on the XLE (iShares Energy Sector SPDR). This is counterintuitive, given the material differences in the TPL business model and capital structure (i.e., little to no fixed operating expenses, and net cash on the balance sheet). However, particularly in volatile markets, short and intermediate-term clearing prices for financial assets are seldom set as a function of a rational buyer and seller. Rather incremental prices are set by fund flows, passive vehicles and algorithms. Case in point, TPL has underperformed (year to date) not only major integrated oil companies that operate on their royalty acreages (including Chevron and Exxon), but also even higher cost global peers (such as BP Plc, Total SA and Equinor). These major integrated energy companies have material debt balances, fixed costs and capital expenditure requirements that TPL lacks. Hence, we remain focused on the fundamentals of the company, not short-term stock performance, in evaluating the investment.

Prior to elaborating on the specifics of TPL, it should be recognized that current energy prices are simply not sustainable, as they are not economic for many of the world's producers; particularly not for much of the North American oil production that is outside of the Permian Basin. Consider that North America supplies in excess of 20% of global oil (liquids) today. Even OPEC countries and Russia are straining federal budgets at these levels, since they are dependent on petro-dollars to fund their national budgets. As an example, many estimate that the Saudis need >$80 Brent to fully fund their government.

Returning to TPL, the immediate investor focus should be twofold i.) acreage quality and ii.) operator quality – we omit balance sheet considerations, since TPL has no debt. Regarding the former, TPL has over 19 years of production (at 2018 levels) that breaks even below $40; and holds amongst the best acreage in the U.S. lower 48. In fact, there are few conventional global energy projects that can compete with the economics of drilling this land. If we assume that the regional drilling growth doesn't slow down at all, it will increase approximately 100% compared to 2019 levels by yeareed 2024 (based on recent Chevron guidance). At this point (2x 2019 levels) there will be an additional ~25 years of drilling that breaks even between $40-$60. So, this would be a double off last year through 2024, then maintained at this level through 2050. We should note that this is consistent with Chevron indicating the intention to sustain their production levels of 2024 through at least 2040. If we assume that oil averages $40 in 2020, then gradually recovers to $55 over the next 2 years, and only maintains this price level longer-term (no higher), the NAV of the royalties alone is a multiple of the current market price (separate from the land easement revenue and water business).

Chevron has since adjusted its Permian guidance to include a $2 billion reduction in capital spending and 20% lower 2020 production, relative to earlier guidance. This will likely result in a modest decline in production on TPL land, but preserve years of premier inventory for higher (future) prices.

In terms of the operators, the major operators currently on TPL acreage are Chevron, Exxon, EOG, Shell and Occidental. The quality and balance sheets of the first four are beyond reproach. OXY is a bit more complicated because they recently purchased Anadarko, outbidding Chevron, which leveraged the balance sheet. But the Anadarko acreage is amongst the best in the basin and will, hence, will be their priority asset. As well, Berkshire Hathaway (Warren Buffett) and Carl Icahn each have a vested interest in their success. So, drilling activity may slow on TPL land (assuredly will to a degree) but bear in mind that the U.S. produces approximately nearly 20% of global oil supply[1], and that the lowest cost curve is in the Permian. Should there be a severe and or sustained turndown in energy prices, it will setup for an increasingly likely eventual supply shock that is a mirror of the present situation. It should also be noted that, dire as this may be, in the event that there is a solvency issue amongst these operators, the TPL royalties are perpetual. Hence, a U.S. energy collapse and subsequent oil price surge, would ultimately drive production right back to these acres – at materially higher prices.

In summary, the recent energy market headlines and TPL share price performance may be perplexing to some. We believe that there are various non-fundamental factors impacting prices, but it must be understood that the royalties are i.) perpetual ii.) subject to top tier operators and iii.) amongst the lowest cost curve in the United States. This gives us great confidence that the investment will come to fruition.

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[1] https://www.eia.gov/tools/faqs/faq.php?id=709&t=6