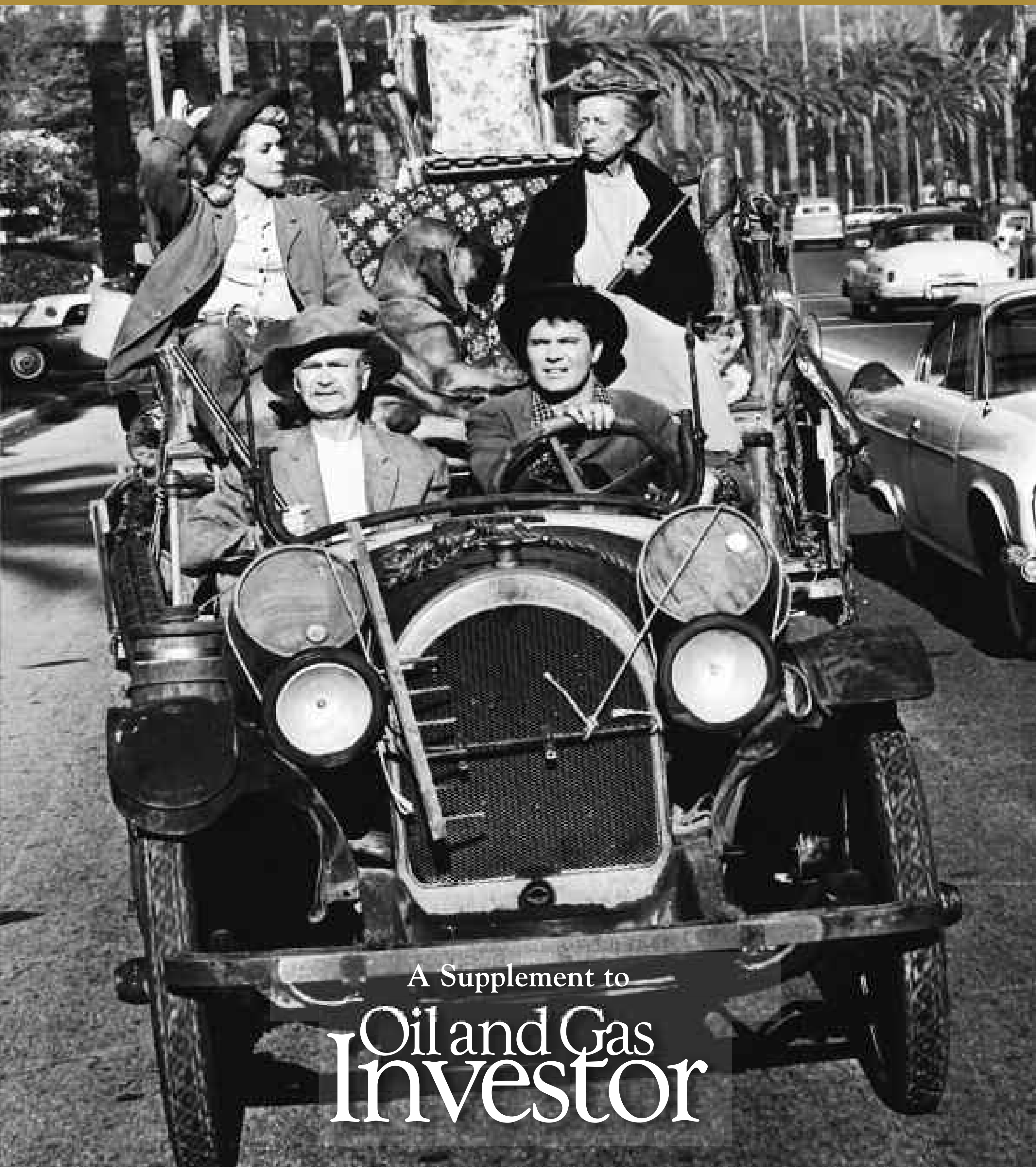
Royalties: A Valuable Investment Opportunity

June 2010



A Supplement to

Oil and Gas Investor

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INTRODUCTION

Investors today have numerous choices when it comes to investing in oil and gas production or in the price of the commodities themselves. They can buy equities, mutual funds, energy-oriented exchange traded funds (ETFs), master limited partnerships (MLPs) and public debt instruments.

But, do not overlook oil and gas royalties. As an investment choice, royalties have always made good sense as part of portfolio diversification.

Today, they seem to make more sense than ever before.

Do you think higher tax rates lie ahead? The tax-advantaged income generated by royalty income will become more attractive if (when) federal tax rates go higher.

Does the stock market scare you? Royalties offer investors an asset class that is not correlated to the moves of the stock market. Royalties posted a positive gain in 2008, a year when the S&P 500 lost nearly 40% of its value.

Do you foresee continued deflation and low interest rates? In this low-interest-rate environment, with fixed income investments paying historically low yields, the significantly higher income streams offered by royalties can help an investor seeking yield.

What about inflation? If one subscribes to the theory that the past two years of economic stimulus by governments around the world will lead to inflation, then once again, it makes sense to add royalties to a portfolio. They have traditionally been a very good hedge against inflation.

How does the role of big government affect investments? Lastly, the hardest to predict event, yet one that is becoming more likely, is big government's taxation on, or cap and trade plans for, energy companies. If governments decide to tax or cap and trade the industry, that will change the fundamental economics for energy producers. This, in turn, will be passed on to consumers in the form of higher energy prices — which actually is a factor that ends up being good for royalty owners. Why? They would see their royalty income checks rise as the price for energy rises.

We believe investors should consider investing in royalties. They provide a direct, low-risk, tax-advantaged way to own a piece of oil and gas production without incurring the costs and risks of drilling.

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THE INVESTING CLIMATE

The world of royalty investing fits in well with the current investing climate.

Traditionally, oil and natural gas investors have worried about a couple of things. First, will the well in which I am participating be successful? Then, what is the price of oil and gas now and in the future?

But recent developments in both politics and the markets have added to the list of questions and concerns. Are oil prices so high they will choke off demand? Does the U.S. have too much natural gas and what do shale plays mean for the future of the industry? How will the aftermath of the tragic BP oil spill in the Gulf of Mexico affect the political and regulatory climate for oil and gas activity? Will proposals put forth by the administration of Barack Obama, particularly for taxes, create a negative climate for oil and gas and therefore a volatile investment climate going forward?

All of these questions are top-of-mind for investors and seasoned oil and gas professionals alike.

For investors who have little exposure to the energy industry, royalties represent a less-risky way to be involved.

This special report will address the ways in which investment in oil and gas royalties fit in this current climate. For investors who have little exposure to the energy industry, royalties represent a less-risky way to be involved. For royalty owners who may be over-weighted in their oil and gas holdings, are concerned about future tax treatment, or have a need for cash, royalties represent an asset that can be liquidated at attractive multiples.

The Political Climate is Challenging

In Washington and state capitals all over the United States, it seems the oil and gas industry has few friends.

In the aftermath of the tragic spill in the Gulf Mexico, people are questioning whether or not the industry takes environmental safety and health seriously. California Gov. Arnold Schwarzenegger reversed a previous announcement to open parts of offshore California to new drilling. President Obama is under pressure to put forward similar moratoriums for the Atlantic seaboard and the Gulf. Environmental groups are emboldened by "new evidence" of industry failures to protect the environment.

Oil and gas industry preferences in the tax code are under similar attack. For the second consecutive budget cycle, the administration has proposed to do away with tax provisions designed to encourage new drilling and investment by the industry. The most noted of these is a proposal to do away with the expensing of intangible drilling costs (IDCs). Enshrined in the tax code for almost a century, doing away with the expensing of IDCs will alter substantially the capital-raising structure of the industry. A host of other similar proposals will have a meaningful affect.

Beyond these energy-specific proposals, the threat of a rising personal income and capital gains tax rate risks materially affecting the ability of the oil and gas industry to raise new capital.

Oil and Gas Pricing

Oil and natural gas prices have experienced a wide range of highs and lows over the past two years. When the broader equities market was down approximately 30% in 2008, oil and natural gas prices witnessed historic highs. In 2009, conversely, oil and gas prices were weaker than at any point in recent memory.

Currently, oil prices seem to be working to break through the $80 per barrel level on a consistent basis. Experts quip about whether or not oil is priced too high. At the same time, natural gas prices have been weak, struggling to stay above $4.50 per thousand cubic feet (Mcf) on any consistent basis. Experts argue whether the abundance of shale gas will keep prices depressed for the long term, or if prices will rise as natural gas adjusts to the new paradigm.

It is in this climate that investors must decide how much energy weighting they should have in their portfolio, and in what form. This report explores options

A ROYAL OPPORTUNITY

Oil and gas royalties offer individual investors high-yield, low-risk investment opportunities that diversify a portfolio.

From left to right, William Swearingen, Alan McClain and David Swearingen of United Capital of Texas

Private wealth counselors are increasingly steering individuals to invest in oil and natural gas royalties as a high yield, yet conservative, investment. Third-party royalty investments enable an investor to tap into the energy market as an inflation hedge—but without incurring the high risks and costs associated with drilling or production operations.

"Investing in royalties is no longer reserved for just the 'super-wealthy' or the largest institutional investors," says David Swearingen, managing director, United Capital of Texas, a division of United Capital Financial Advisers LLC. "We recommend royalty investment as part of a diversified asset-allocation strategy."

United Capital of Texas, a financial advisory practice with offices in Dallas and Houston, manages about $350 million in assets. It typically recommends a client allocate, on average, 10% to 20% to royalty-based investments.

"Of course, the actual amount allocated to a client portfolio will depend on the outcome of United Capital of Texas' in-depth financial planning and risk evaluation, to precisely determine what percentage of assets should be allocated to royalties, as well as determining if other parts of the individual's portfolio are appropriate for their situation," says Alan McClain, managing director of the firm's Houston office. Using in-house investment and energy expertise, the firm helps match investors with attractive opportunities.

Quality royalty opportunities are limited and not widely advertised, he adds.

A good hedge

"Our job as wealth advisers is always to be seeking solutions for our investors' needs," Swearingen says. "In this low-interest-rate environment, we are trying to find non-traditional vehicles that not only offer higher yields, but also provide investors a historically good hedge to inflation.

"Through our research, we've concluded that investing in royalties is something that nearly all diversified portfolios should include. Yields typically far outpace inflation and are a further hedge against rising energy costs, because as oil and natural gas prices rise, so, too, will the return the investors receive, because you are an owner of oil and gas," he says. Royalty owners do not drill or operate wells; nor do they share in any of the costs or liabilities associated with drilling or operating, Swearingen explains.

"This can be a conservative way to invest in energy: no debt, no leverage, and no expenses. Royalties are a non-leveraged asset with no credit or banking risks. What other investments or business arrangements can offer this?"

Swearingen says he thinks most investors don't own royalties simply because they do not know how easy they are to acquire. "One of the hardest tasks for us as advisers is educating investors about how simple royalties are to own. You can own royalties without owning the acreage. There are not many business opportunities enabling the investor to share on the income side, and not the expense side."

Non-traditional income investment

United Capital of Texas makes certain its clients understand that royalties are not traditional, fixed-income investments.

"We prefer to call them 'variable income' investments, since the income generated each month will vary based on changing commodity prices and production volumes.

"The term 'variable' can initially be a turn off because investors immediately think of the affect low commodity prices will have on their yield. However, we believe this variability is a much greater positive than a negative for three reasons: First, even during periods of low commodity prices, royalties have still offered investors superior yields to treasury or corporate fixed income investments (plus, a portion of the royalty income is tax-free). Secondly, periods of low commodity prices are usually short-lived. Lastly, and most importantly, this variability in income works on the upside for investors as well. There is no debating the overall upward trend commodities have always enjoyed, which has translated into larger and larger checks over the years for royalty owners.

"Royalties are not perfect, but when compared to the risks-rewards inherent in traditional fixed-income invest-

ments, it is not difficult to see why royalties should have a place in most investor portfolios," Swearingen says.

When it comes to peace of mind, royalties are not your traditional fixed income investment, he says. "Unlike traditional fixed income investments (which are nothing more than a piece of paper backed by a promise to pay) , royalty payments are much more than just a paper promise. Royalty owners directly own the oil and gas underground, therefore they know from exactly where their investment return will be coming. Its like having money in a vault underground that comes to surface and is paid to the owner. Compare that to a traditional corporate bond that is a paper promise, in a world riddled with excess leverage, corporate misguidance and fraud. It's much easier to analyze where your return on investment is coming from with royalties, and not have to worry about debt, leverage, fraud or corruption."

One of the most overlooked but important factors investors need to understand is that a royalty investor is not only acquiring ownership of existing producing wells on the acreage; it is also acquiring the potential from additional wells developed on that acreage in future years.

"The beautiful part of this is that future wells, and therefore more reserves, are developed by the operator (the oil and gas company) at no cost, risk or liability to the royalty owner. The operator bears all the risks and costs, while the royalty owners benefit from increased cash flow resulting from the new wells," Swearingen explains. This is an important concept and underscores why royalty investors need an adviser to help properly evaluate royalty investments.

Determining how much potential there is for further development of the investor's mineral rights will have a significant impact on the long-term return on investment.

Private or publicly traded?

Investors interested in income from royalties can choose from either a publicly traded royalty trust, or privately placed royalty programs. Each structure has its set of pros and cons.

Privately placed royalty programs are typically reserved for higher-net-worth investors who meet the "accredited investor" guidelines, and are generally offered in the form of limited partnerships or direct title programs. "Generally, we find the privately placed royalty programs offer the investor better diversification across geographic areas, as well

Publicly traded royalty trusts have outperformed the U.S. super majors for a decade. Source: Yahoo Finance

Public Royalty Trusts included in this chart reflect PRTs traded on a United States public exchange with ten years of continuous data available and a market cap of greater than $500MM. Index includes PBR, SJT, SBR and HJT market-cap weighted based on intraday market cap on 4/19/2010. Super majors defined here as U.S. headquartered companies traded on a public exchange with ten years of continuous data available. Index includes XOM, CVX and COP market-cap weighted based on intraday market cap on 4/19/2010.

as significantly more wells than publicly traded trusts offer," Swearingen says.

Some public trusts may focus on royalty from production only offshore in the Gulf of Mexico, or only in the sexy shale-gas plays, "both areas we tend to avoid, and for significantly different reasons. Needless to say, there are other factors that need to be considered, but these are just a few examples of why our clients rely on us to help understand and evaluate royalty investments before they make the investment," he says.

I believe royalties are an important component of my investment portfolio.

— Karl Kurz

"Too many times, investors make their decision based upon which public trust has the highest yield, and this typically is not the best way to make a decision. There is substantially more to consider when investing in a royalty trust than just yield. We would prefer to buy a lower yield with higher-quality assets, a history of reserve replacement and low decline rates," Swearingen says.

Publicly traded royalty trusts are required to publish quarterly and annual reports to shareholders, so there is always plenty of information available for the investor to digest.

"The problem typically lies in analyzing not just the data, but more importantly, in understanding several key factors that only a person with practical experience can know. For example, there are certain geographic areas royalty investors would want to avoid. Additionally, many times we will find that some trusts may have partial ownership in refineries or some working interests and drilling programs that can significantly alter the risk profile of the trust itself," Swearingen says.

"Many times, we find ourselves steering our clients away from certain royalty investments that do not have sound fundamentals, or that have a poor track record of reserve replacements, declining production curves, or unfavorable field locations. This is where our expertise can help determine whether the investor has a poor experience in royalties or a great experience," McClain says.

William Swearingen, brother of David and a managing director at the firm's Dallas office, adds: "Let's not forget about the tax benefits of oil and gas royalty own-

Key Benefits for Investors	
Conservative Side of Energy	No Debt, No Operating Expenses
Monthly Income	Easy to Own, 12 Checks per Year
Tax Advantaged Income	15%-35% Tax Free
Inflation Hedge	As energy prices rise, so do royalty payments

ROYALTY DEFINED

The term "royalties" originated in Great Britain, where for centuries, minerals such as gold and silver were the property of the crown. Those resources could only be mined if a payment, or royalty, was made to the crown. The U.S. is one of the few countries in the world where mineral ownership can be vested in individuals, as opposed to the government.

A royalty refers to the ownership of a natural-resource property, such as a producing oil or natural gas lease. The owner is entitled to a share of the money from oil or gas production from the property, which has been leased to an oil or gas company to drill.

Royalties are a share of production, free of production and operating costs. The royalty amount is usually expressed as a fraction of the total amount of hydrocarbons produced from the leased premises. That percentage is negotiable, but generally, it is at least 1/8 interest, or 12.5%, of the well's production proceeds.

Unless a landowner wants to develop the property himself, he can lease the land to another party for development. In return, anyone operating under a lease, and recovering oil and gas, pays the landowner a royalty, or agreed-upon share of the natural resource. A royalty is the price that the owner of a natural resource charges for the right to develop the resource.

Even if the percentage of gross revenue generated stays constant, the amount of royalty paid to a royalty holder often varies, even from month to

ership. Part of the income stream paid to royalty investors is tax-free, and that amount can range anywhere from 15% to as high as 35% each year, depending upon the depletion allowance." With potential federal tax increases for investment income looming, the tax-advantaged income stream from royalty ownership will become even more valuable.

"We have done extensive research on royalties, but our greatest comfort comes from knowing that our clients, who have spent their entire careers in the oil patch, put their hard-earned money into royalties. To us, that speaks volumes," David says.

Royalty investments have proved attractive to many people knowledgeable about the oil and gas industry, even to people employed by the industry. For example, they are endorsed by Karl Kurz, managing director of CCMP Capital, a leading global private-equity firm.

"I believe royalties are an important component of my investment portfolio. The current yield on royalties is very attractive in a deleveraging, low-growth world that will continue to see low short-term interest rates," Kurz says.

"If one subscribes to a macro view of an inflationary environment driven by the need to tighten liquidity or the monetization of debt, then again royalties, as a global energy commodity, provide an attractive hedge in these inflationary scenarios," he says.

"Lastly, for investors who may be more optimistic than me in a return to a more robust global growth scenario with modest inflationary pressure, then royalties again are an attractive asset, from fundamental supply and demand balances pushing commodity prices higher and thus increasing the returns on royalty investments."

Kurz, based in Houston, is the co-head of CCMP's energy investments. He has more than two decades of experience in the oil and gas industry; most recently serving as chief operating officer (COO) for Anadarko Petroleum Corp.

Noble Royalties' annual yield

Dallas-based Noble Royalties Inc. is the largest privately owned oil and gas royalty management company in the U.S.

Noble Royalties is an aggregator of royalties that began syndicating offerings through broker dealers in late November 2003. Since then, it has returned to investors an annual yield of between 6% and 13%, says Martin Fleming, senior vice president. Its highest return was delivered in 2008 when it yielded 13.8%. But, Noble Royalties is most proud that in 2009, a difficult year for the U.S. economy and for energy commodity prices, it still returned 6.9%.

In 2009, Noble offered third-party investment opportunities totaling about $150 million. While impressive, that still is a "relatively small niche" compared to the investment pool for drilling, which has a higher risk/reward ratio, and is attractive to a different type of investor.

Noble Royalties, which since its founding in 1997 by president Scott Noble has invested $1.2 billion in royalties, says its business strategy is to keep a portion of its overall royalty ownership for itself and to offer the rest to investors.

Royalties in portfolio management

Regardless of whether one invests in publicly traded or privately placed royalties, either structure should give the investor the same core benefits of tax-advantaged

month. Many factors affect the amount paid, because payment is based on the commodity price and volume produced. Mechanical or operational problems or routine maintenance, for example, may temporarily affect production.

An estimated $400 billion of royalties are paid annually. The National Association of Royalty Owners reports there are about 8.5 million private owners of oil and gas mineral and royalty interests. The majority, something over 70%, of the minerals in the U.S. are owned by individuals and leased to companies for development.

Traditionally, royalty interests were held by the property owners. But as commodity prices for oil and natural gas have risen, so too, have third-party royalty-based investments. Generally speaking, a royalty fund is when royalty interests are being bought, sold and held by the fund's sponsors.

The objective of a royalty fund is to generate its revenue from royalties held from different producing fields throughout the country. The main feature of owning a percentage of a royalty fund is that the royalty owner (or interest owner) pays no percentage of operating or developmental costs associated with the production of the oil or gas.

Non-Traditional Income is the asset class for oil and gas royalties. It is non-traditional in the context that monthly distributions are derived from oil and gas production realized during the month, as opposed to a traditional bond interest payment from a corporation, municipality, or the federal government. It is "income" but not "fixed income" in the sense that the monthly distribution depends upon how much oil and gas is produced as well as the price of the underlying commodity, according to David Swearingen, managing director of United

income stream, high rates of cash flow and a hedge against inflation, David Swearingen says.

Oil and gas royalties play an important role in reducing overall portfolio variance. One of the biggest macro-economic risks to energy executives is a prolonged deflationary cycle where energy prices remain depressed, he says.

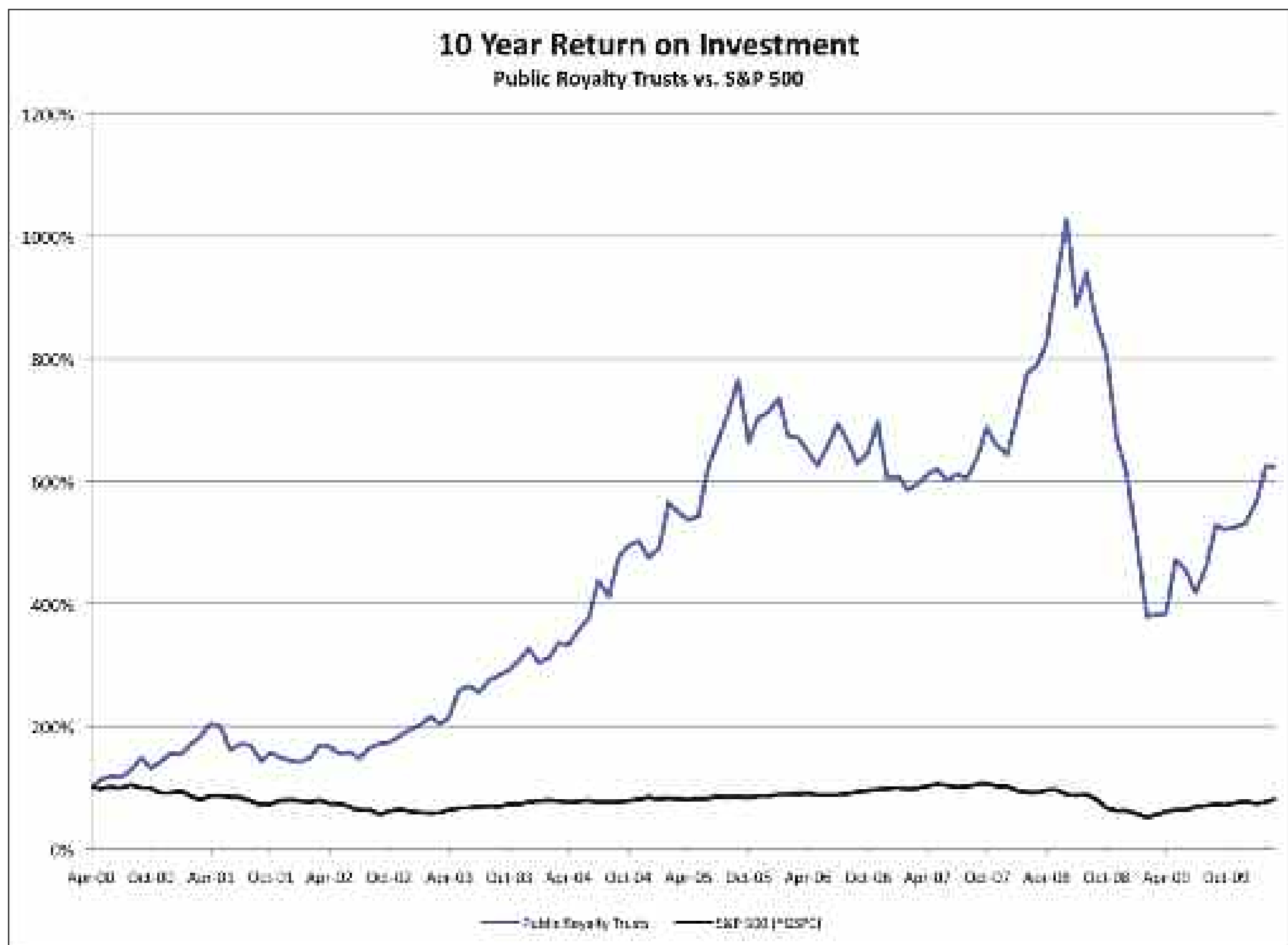
"We have sourced several solutions that help offset that risk, while at the same time have proven to be good investments during normal economic, as well as inflationary, periods in time. It is a win, win, win situation for the client."

In addition to oil and gas royalties, United Capital urges investments in other non-traditional assets not necessarily correlated to the broad equity markets, thereby reducing the overall volatility of the portfolio. "Put simply, our endowment approach is designed in a manner that we do not live and die by the performance of the S&P 500," he says. Each asset class is then weighted in a manner to provide the highest anticipated return for the level of risk that is being taken.

"Royalties are certainly an important part of most client portfolios, and we spend a lot of time and resources evaluating royalty investments for our clients," McClain says. "But royalties are only part of what we do. Several years ago, we had a client tell us that having money should be fun, not a burden. Since then, we have focused in building our business—understanding our corporate executive clients do not have the time to manage all aspects of their financial lives because they are too busy managing their businesses. The end result is, they became frustrated as assets they had worked hard to obtain became a headache.

"We also recognized that the current structures in place at most large Wall Street brokerage firms didn't allow the adviser to fully manage all aspects of the clients' financial lives. Recognizing this, we have built our practice to consist of six wealth advisers, two certified financial planners and a certified public accountant. With a deep bench of experts and knowledge, we are fully equipped to serve all the needs of our clients in house—whether it is a task as simple as portfolio modeling or hedging portfolio holdings, or as difficult as advising on estate planning, charitable giving or family limited partnerships."

"Energy executives have unique situations and have very specific needs that non-energy executives do not," McClain says. "We have worked hard to find or develop tools that can help energy executives reduce their overall risks and exposure to energy specific issues. In fact, we have identified several tools we use to reduce risk and volatility exposure inherent in most energy executive's portfolios due to their restricted shares, stock options and, in some instances, minimum equity-ownership requirements required by their boards." ■



Publicly traded royalty trusts have outperformed the S&P 500 for a decade. Source: Yahoo Finance

TAX BENEFITS OF ROYALTY OWNERSHIP

A "royalty interest" is the right to receive a specified amount of the gross income or production from a mineral property. A royalty interest, as opposed to a working interest, is not charged with the costs of exploration or development drilling, or operation, and is therefore treated as a non-operating interest for federal income tax purposes.

Royalty Interest Depletion Deductions

In addition to the return on their investment, the depletion allowance deduction gives holders of royalty interests a special tax benefit. Mineral-interest holders are allowed an annual depletion deduction equal to the greater of "cost" or "percentage" depletion. Cost depletion allows the mineral-interest holder a depletion deduction based on the ratio between the amount of minerals sold (produced) and the remaining mineral reserves. The percentage depletion allowance is based on the amount of income generated annually from a mineral interest, without regard to the amount of minerals that are exploited.

The Advantage of Percentage Depletion: Like-Kind Exchanges for Royalty Interests

A unique characteristic of the percentage depletion method is that an interest holder can deduct a percentage depletion allowance, even if the deduction exceeds its basis in the depletable property. The excess percentage depletion deductions (1) do not create a negative basis, (2) are not added onto the amount realized upon subsequent disposition of the property, and (3) are not subject to the recapture rules under Section 1254(a)(1).4

In other words, percentage depletion is a deduction without any offsetting increase in future gain recognition!

The unrecaptured depletion deduction ensures that royalty interest owners, aside from any gains on the interest itself, will derive a tax benefit equal to the amount of the allowed percentage depletion deduction.

- Investors in royalty interests can use depletion deductions to offset ordinary income.
- The depletion deduction can be used even if it exceeds the basis in the royalty interest.
- The excess deductions are not offset or recaptured by any future gain recognition.
- Royalty interests may be treated as real property; for purposes of Section 1031. Therefore, investors could fund the purchase of a royalty interest with a nontaxable exchange of appreciated real property.
- A low basis from the appreciated real property would "transfer" to the royalty interest.
- Once the basis in the royalty interest is reduced to zero, the tax benefits to investors are maximized since the depletion deductions will not be offset by reductions to basis.
- Although working interests initially provide a greater return, royalty interests, over time, outperform working interests by providing a consistent cash yield, as well as significant tax benefits. ■

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WHEN IT'S TIME TO SELL: MAXIMIZING VALUE

Noble Royalties is an experienced buyer of royalties, offering sellers lump-sum cash payments.

Most royalty owners are not looking to sell their interests, but some are. Despite the low-risk, high-yield return characteristics of owning oil and natural gas royalties, there are still a variety of reasons why people may wish to sell royalties.

One of the most common reasons is that the royalties are in an estate, and heirs would prefer to receive cash, says Martin Fleming, senior vice president, Noble Royalties, Inc. The company is based in Dallas, Texas, with additional acquisition and engineering staff in a Houston office. Founded in 1997, it purchases oil and gas royalties, provides estate appraisals, and prepares mineral deeds to transfer title to heirs and trusts.

Sometimes royalties are too small to divide among the heirs, or the heirs are not familiar with managing oil and gas royalties. Or, some owners no longer want to manage their oil royalties and want to simplify their investments. Minerals and royalties can become cumbersome to split in an estate.

Additionally, in the current credit market, many exploration and production companies see the sale of royalties or overriding royalties (a third-party interest in royalty interest derived from oil and gas rights) on their books as a great way to strengthen their balance sheet.

Finally, some owners would simply like to receive the cash for an immediate need, says Fleming.

In order to know what your oil and gas royalty is worth, one must look at a number of factors: historical production performance, reservoir characteristics, current oil and gas pricing, concentration risk, age of production equipment, future drilling possibilities, operator, location, size of the land tract, and other restrictions, Fleming says.

To determine a fair sales price for your interest, a registered professional petroleum engineer performs an engineering and economic evaluation, such as analyzing historical production data, calculating production-decline rates, and reviewing historical cash flows. This information is then used to forecast future well performance, calculate remaining oil and gas reserves, and predict future revenues. The objective is to help you understand future risks and uncertainties, while offering you a fair sales price, Fleming says.

If you are in the market to sell your royalty interest, Noble Royalties is prepared to take action. The company has built a reputation for buying valuable properties quickly and paying fair market value. Individuals come to Noble Royalties to quickly convert their income stream into a lump-sum payment through a hassle-free process. "Evaluating and acquiring royalty and overriding royalty positions is what we do," Fleming says.

By being among the most active professional buyers of quality royalty properties, Noble Royalties has built a high-profile position in the energy sector. "Our visibility, name recognition and integrity translate into a steady pipeline of acquisition opportunities," Fleming says.

Valuing acquisitions

The company narrows the field of potential acquisitions by performing rigorous fundamental analysis. It examines potential acquisitions to ensure that they meet stringent criteria in each of the following areas: engineering, geology, land and financial.

Noble Royalties' staff of experienced petroleum engineers performs an exhaustive study of each property to confirm production, quantify reserves, forecast production based upon historical data, and determine the probability of new production or reserves.

The low-risk characterization for third-party royalty investors is an extension of Noble Royalties' company strategy. The company does not drill or operate. Its guiding principle is to create value by exclusively acquiring interests in properties that have consistent production and proven reserves, creating a steady, more predictable return on investment or drilling.

"We look for low-decline properties with minimum capital-expenditure projections for maintenance, therefore maximizing distributable cash, particularly sought by limited partnerships," Fleming says.

Typically, Noble's acquisitions are comprised of hundreds or thousands of producing properties, diversifying risk and reducing the impact of depletion that can adversely affect the performance of smaller properties with low well counts. In addition to acquiring royalty interests in a large number of producing wells, the company also acquires royalties on surrounding undeveloped acres. This allows investors to benefit from the capital expenditures of the owners and operators of the working interests to develop additional reserves and increase production on the property.

Noble Royalties uses decentralized acquisition teams in Dallas and Houston with more than 200 years of collective experience in oil and gas. "We have leveraged this combined knowledge to develop extremely high standards for the properties that we will acquire. In addi-

tion, our analysis is verified by third-party engineering firms to ensure quality investments," Fleming says.

Noble seeks to acquire royalty interest in producing properties with several decades of remaining reserves. Detailed engineering on each property helps to ensure a long-term stream of royalty income to investors. "We focus on acquiring properties that can deliver long-term investment performance to a broad range of investors," says Fleming.

The potential for high yield and diversification allow this asset class to make sense for institutions (pension funds, hedge funds, and endowments), real estate investors (Qualified 1031-Exchange Replacement Property) and high-net-worth individuals seeking income or energy assets in their portfolios. Some oil and gas royalty programs qualify for 1031 exchanges, useful for investors in real estate or other real assets that have large capital tax gains they wish to defer.

"Noble Royalties strives to create value through extensive fundamental research and proven access to high-quality deal flow. Our goal is to consistently deliver attractive risk-adjustment investment performance," Fleming says, adding that about 80% of the deals sourced by the company were never publicly advertised.

"Noble Royalties has the experience and expertise to be successful in all three phases of the royalties business: acquisitions, funding, and management. Over time, as our visibility and credibility as a professional buyer of royalties has grown, our pipeline of opportunities has broadened."

Assessing value

Noble Royalties contracts with Netherland Sewell & Associates and/or DeGolyer & MacNaughton, two of the largest petroleum engineering firms, to verify valuation of its royalty interests.

"Netherland Sewell & Associates and other third-party engineering firms make independent estimates of reserves and future cash flow for all kinds of oil and gas properties, whether the evaluation is for the working interest or the royalty interest, says Danny Simmons, president of the Houston-based petroleum-engineering firm.

"The real difference between royalty- and working-interest evaluations may be the amount of information available to the evaluator. The royalty-interest owner may not have access or copies of all the technical data from the wells and property. If we have access to the operator's or a working-interest owner's information, this is typically all the technical information needed to make our reserve and economic estimates.

"Without this additional technical and economic information, the evaluator may need to use his general knowledge and experience with similar properties along with the limited information that is available from the royalty owner to perform the evaluation," Simmons adds.

"Even though the royalty owner does not pay their share of drilling, completion and operating costs, these costs are still important for evaluating the royalty interest to establish both the economics of future drilling and development as well as to determine the final abandonment rate for the individual wells. As wells are produced and decline, the operators continue to produce the individual wells as long as it is profitable to do so for their interest. All the typical industry-standard evaluation methods are used to estimate the reserves, depending on the maturity level of the individual wells," says Simmons.

"Early in the life of the wells, volumetric calculations and analogy with offset or similar properties are used. As production-performance data becomes available, decline-curve estimates, material balance or other performance methods are typically used to estimate the reserves and future cash flow. Both the amount of reserves and the production profile of the wells as depletion occurs are important to properly estimate the resulting cash flow from the property."

"Some of the higher-quality characteristics for royalty properties are those where the wells have long economic producing lives, shallower decline rates and additional acreage or deeper-formation objectives for future development potential if covered in the royalty-lease agreement. All of the additional development is subject to the operator having attractive economics for the drilling locations dependent on oil and gas prices, cost of drilling and completing the wells, along with the expected reserves and producing profiles of the wells.

"While the royalty owner is not subject to the normal drilling, completion and operating costs, these costs are important to those who actually invest in drilling and producing the wells to provide the benefit of production to the royalty owners," Simmons says. ■

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