



Independent Stock Idea

October 21, 2015

Intraday

San Juan Basin Royalty Trust (SJT) Southwest Bank Potential Successor Trustee

Summary and Recommendation

The trust officer in charge of the **San Juan Basin Royalty Trust (SJT)** for some thirty years has joined the royalty trust group of Southwest Bank, which counts **Permian Basin Royalty Trust (PBT)**, **Sabine Royalty Trust (SBR)** and **Cross Timbers Royalty Trust (CRT)** among its trusteeships. The latest development follows a terse press release by BBVA Compass Bank announcing the sudden resignation of Ms. Lee Ann Anderson (see *McDep Independent Stock Idea*, [SJT Trust Officer Resigns](#), October 1, 2015). Southwest Bank is qualified and apparently willing to serve as successor SJT trustee. Reducing the potential for conflict of interest and having Ms. Anderson continue as the trust officer in charge of SJT are strong reasons for unitholders to desire a change in trusteeship. Though there has been no public indication of a resignation by BBVA Compass, the current trustee of SJT, there is solid historical precedent for that to happen. At the same time, under Section 8.02 of the Trust Indenture, holders of 15% of the units can require the trustee to call a special meeting of all unitholders. Then, under Section 6.05, holders of 15% of the units can nominate a successor trustee. A majority of the units outstanding can vote to remove or approve a trustee.

Precedent for Independent Bank and Continuity of Administration

The precedent goes back to 1980 when the trust was formed that an independent entity, Fort Worth National Bank, became the first trustee. Through successive ownership changes the name of the trustee changed to Bank One around 1994. By 2002, Bank One decided that the royalty trust business did not fit the giant bank's strategy, as we recall, and it resigned as trustee. Upon intervention by unitholders, including McDep Associates, the predecessor of McDep LLC, the successor trustee became TexasBank with long time SJT trust officer, Ms. Lee Ann Anderson, continuing as the SJT trust officer. The unitholders stressed "that a qualified independent bank presents reduced conflict of interest as opposed to a large national organization. We also expect TexasBank to provide continuity in administration."

Scenario Replaying

Since 2002 we have seen a replay of the scenario where an independent bank becomes swallowed up by a huge international, not just national, organization and strains develop in the relationship. TexasBank was acquired by the large regional Compass Bank in 2006 that in turn was acquired by the international giant BBVA in 2007.



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Once again, there is a qualified independent bank with reduced conflict of interest that would be a more suitable trustee. Southwest Bank has demonstrated competence in managing royalty trusts as we know from our work with PBT, SBR and CRT. Moreover, continuity of administration at the highest level of trust officer is assured with Ms. Anderson now an employee of Southwest Bank.

Potential for Conflict of Interest

Oil and gas producers typically pay royalty owners according to a predetermined arrangement. Payments are calculated by producers. Inevitably, there is temptation for the producer to tilt the calculation in its favor. Also, being responsible for operations, the producer usually has superior information. When Southland Royalty created the San Juan Basin Royalty Trust the conflict was not a problem because there were common owners of the producer and the trust. The conflict arose when Burlington Resources acquired Southland Royalty and continued when ConocoPhillips acquired Burlington Resources.

At times, the trustee may have to pursue legal action to resolve a dispute. Then conflicts may intensify if the producer is also an important customer of the bank. Large producers are likely to be doing most of their banking business with large banks. Meanwhile, the larger the bank the less important is the royalty trust to the bank. As a result, we believe that a well-run qualified independent bank is more suitable to be trustee of SJT than a giant international financial service company.

Continuity of Administration Valuable

We would like to see Ms. Anderson continue as the trust officer because we know she has performed well under fire in the past. When coal seam gas was being developed in the San Juan Basin in New Mexico some 25 years ago, Lee Ann stood up to Burlington Resources in challenging their fairness in drilling wells on trust leases. She engaged reputable counsel from Santa Fe, New Mexico and successfully recovered tens of millions of dollars for the trust. There have been multiple challenges over the years with the trustee often recovering sizeable sums for the unitholders.

Strategic Benefit in Combining Trust Management

Southwest Bank is the leading independent trustee of royalty trusts. Ms. Anderson apparently shared best practices in dealing with ConocoPhillips, which is also the main



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producer on the properties of PBT. Combining the experience of Southwest Bank with Ms. Anderson would be beneficial for the unitholders, we believe.

SJT Stock a Pure Play on Natural Gas

While unitholders have control over the selection of trustee, they have no control over natural gas price. Near-month natural gas price has declined about 25% year-to-date. Reflecting moderate operating leverage, our estimate of NTM distribution is down by about 39%. No surprise that the stock is also down about 37% on a total return basis that adjusts for distributions declared.

Looking ahead it seems unlikely that energy stocks will have a third down year in 2016. If the near-term gains are only modest, the relative cost is not great in a diversified portfolio earning 0% on short-term fixed income and lower than historical returns overall currently. More optimistically, energy will be needed for economic growth and natural gas is the most competitive fuel as we see it. Widely hyped politically, wind and solar require increasingly unaffordable subsidies from overly indebted governments. While the subsidies are supposed to be stimulating technological innovation to bring cost down for alternatives, fracking has brought natural gas cost down even more.

On October 20, the SJT trustee declared a monthly distribution of \$0.04 a unit, about in line with our estimate of \$0.41 for the next twelve months. At that rate, distribution yield would be near 5% on current stock price (see table Operating and Financial Estimates on pages 4).

Kurt H. Wulff, CFA

<i>Symbol</i>	SJT	<i>Ebitda Next Twelve Months ending 9/30/16 (US\$mm)</i>	25
<i>Rating</i>		<i>North American Natural Gas/Ebitda (%)</i>	97
<i>Price (US\$/unit)</i>	8.56	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	10/21/15	<i>Adjusted Reserves/Production NTM</i>	8.4
<i>Shares (mm)</i>	47	<i>EV/Ebitda</i>	15.8
<i>Market Capitalization (US\$mm)</i>	400	<i>PV/Ebitda</i>	27.6
<i>Debt (US\$mm)</i>	0	<i>Undeveloped Reserves (%)</i>	2
<i>Enterprise Value (EV) (US\$mm)</i>	400	<i>Natural Gas and Oil Ebitda (US\$/mcf)</i>	1.21
<i>Present Value (PV) (US\$mm)</i>	700	<i>Present Value Proven Reserves(US\$/boe)</i>	22.61
<i>Net Present Value (US\$/unit)</i>	15	<i>Oil and Gas Ebitda Margin (%)</i>	49
<i>Debt/Present Value</i>	0.00	<i>Earnings Next Twelve Months (US\$/un)</i>	0.41
<i>McDep Ratio - EV/PV</i>	0.57	<i>Price/Earnings Next Twelve Months</i>	21
<i>Distribution Yield (%/year)</i>	4.8	<i>Distribution Next Twelve Months (US\$/sh)</i>	0.41
Note: Estimated cash flow and earnings tied to one-year futures prices for natural gas.			
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.			
Estimated present value presumes a long-term price for oil of US\$70 a barrel and natural gas, \$4.50 a million btu			
For historical analysis of SJT since 2000 see www.mcdep.com/4sjt.htm			



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San Juan Basin Royalty Trust										
Next Twelve Months Operating and Financial Estimates										
	Q3	Year	Q2	Q3E	Q4E	Year	Q1E	Q2E	Q3E	Next Twelve Months
	9/30/14	2014	6/30/15	9/30/15	12/31/15	2015	3/31/16	6/30/16	9/30/16	9/30/16
Volume										
Natural Gas (mmcf)	86.0	84.7	81.3	81.4	80.0	80.2	79.2	78.4	78.4	79.0
Oil (mbd)	0.13	0.16	0.19	0.16	0.16	0.16	0.15	0.15	0.14	0.15
Total gas & oil (bcf)	8.0	31.3	7.3	7.6	7.4	29.6	7.4	7.1	7.3	29.2
Price										
Natural gas (\$/mmbtu) (Henry Hub lagged two months)										
Henry Hub (\$/mmbtu)	4.61	4.37	2.79	2.71	2.69	2.98	2.63	2.75	2.71	2.70
Differential (%)	12	7	23	24	19	21	19	15	15	17
Net to SJT (\$/mmbtu)	4.06	4.05	2.16	2.05	2.18	2.36	2.13	2.34	2.30	2.24
Natural gas (\$/mcf)	4.47	4.45	2.38	2.26	2.40	2.59	2.34	2.57	2.54	2.46
Oil (\$/bbl) (WTI Cushing lagged two months)										
WTI Cushing	103.10	97.76	51.06	56.70	45.19	53.45	47.83	49.74	50.98	48.43
SJT	87.58	82.99	37.20	41.31	32.92	39.39	35.25	36.66	37.57	35.53
Total gas & oil (\$/mcf)	4.56	4.56	2.43	2.32	2.44	2.64	2.38	2.61	2.58	2.50
Revenue (\$mm)										
Natural Gas	35.3	137.5	17.2	16.9	17.7	76.0	17.1	18.0	18.3	71.0
Oil	1.0	5.0	0.6	0.6	0.5	2.3	0.5	0.5	0.5	1.9
Total	36.4	142.4	17.8	17.5	18.1	78.2	17.6	18.4	18.8	72.9
Cost (\$mm)										
Severance tax	5.2	19.2	1.9	1.9	2.0	8.3	1.9	2.0	2.1	8.0
Operating	8.3	34.6	7.9	7.4	7.4	30.3	7.4	7.4	7.4	29.5
Total	13.5	53.8	9.8	9.3	9.4	38.7	9.3	9.4	9.4	37.5
Cash flow (\$mm)										
Development	1.2	6.5	5.0	1.6	2.0	13.4	2.0	2.0	2.0	8.0
Net proceeds (\$mm)										
Royalty/Net proceeds	21.6	82.2	3.0	6.6	6.8	26.2	6.2	7.0	7.3	27.4
Royalty income (\$mm)										
Royalty/Net proceeds	16.2	61.6	2.3	5.0	5.1	19.7	4.7	5.3	5.5	20.5
Administration	75%	75%	75%	75%	75%	75%	75%	75%	75%	75%
Administration	0.5	1.7	0.8	(0.0)	0.3	1.7	0.3	0.3	0.3	1.2
Distributable income (\$mm)										
Distributable income	15.7	59.9	1.4	5.0	4.8	18.0	4.4	5.0	5.2	19.3
Units (millions)										
Per unit	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6	46.6
Per unit	0.34	1.28	0.03	0.11	0.10	0.39	0.09	0.11	0.11	0.41

Disclaimer: This analysis was prepared by Kurt Wulff, Manager of McDep LLC. The firm used sources and data believed to be reliable, but makes no representation as to their accuracy or completeness. This analysis is intended for informational purposes and is not a solicitation to buy or sell a security. Past performance is no guarantee of future results.

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