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Author: Cdnclassic

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Disclosure: I am long 26 shares of Texas Pacific Land Corp at an average price of \$1,618

*UPDATED TO INCORPORATE FEEDBACK***

TITLE: The Deep, Hidden Value in \$TPL (Texas Pacific Land Corp) That Could be Worth as Much as 4x the Current Price One Day

TLDR:

Texas Pacific Land Corporation (\$TPL) is the largest private landowner in the Permian basin. It makes money by charging oil producers/pipelines a fee for using their land to extract oil and build facilities on the surface. It is also building out a water sourcing/disposal business which is becoming critical infrastructure in the Permian. The company has no debt and spends very little on capex, making the business model asset-light and extremely valuable in what is known to be a capital-intensive, cyclical industry.

The stock currently trades at around \$1,600 per share, which I believe is a fair price for the value of all PDP wells and near-term, high-visibility undeveloped wells under my base case oil forecast. But what you are also purchasing is the optionality that comes with TPL's undeveloped well locations. **If we were to incorporate the value of these locations, the stock should trade at a price more like \$5,579, or ~3.5x the current price.**

Stress testing the valuation model under different oil assumptions suggests that downside is limited to -28% (\$1,134), while upside in an oil super-cycle scenario could be \$1,819 (with \$6,891 as the full valuation with all undeveloped wells).

I would expect that in the near-term, stronger oil prices, Russell inclusion, interest in "inflation plays", potential inclusion in the S&P, and growing awareness of the company (which should lead to broader sell-side analyst coverage) should support the share price. Though admittedly, valuations do appear somewhat full in the near-term.

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Note: TPWR = Texas Pacific Water Resources

****Some Other Numbers:****

- * Market cap: around \$12bn
- * Shares outstanding: 7.76mm
- * Short interest as % float: 3.56%
- * 30D average volume: 55k
- * Significant insider ownership from Horizon Kinetics: 20.6%
- * Recent insider purchases by the CEO in late-May at a price of ~\$1525
- * 12m Forward P/E: 40.7x
- * 12m Forward EV/EBITDA: 31.8x
- * CY2019 EBITDA Margin: 83%
- * CY2019 Net Income Margin: 65%
- * 5y Average ROE: 90%

****Brief History of TPL:****

TPL has a long history after having been established in 1888 as a trust that held vast amounts of Texas land as a result of the Texas and Pacific Railway going bankrupt. Horizon Kinetics, a long-time major investor in TPL, breaks their operating history down into stages in their [1Q21 investor letter](https://horizonkinetics.com/app/uploads/Q1-2021-Review_FINAL.pdf):

>****Stage 1**** for TPL, the corollary to that early stage for Microsoft, would be the first 125 years of TPL's existence, during which it was essentially unchanged. It just received a relatively constant, modest stream of revenues from grazing fees and easements on its surface acreage, royalties on oil and gas production on properties it had divested in 1955, and periodic land sales. Grazing leases were in effect on over 95% of the Trust's then roughly 2 million surface acres. Most of this revenue was allocated to share repurchases, which had been ongoing since 1888.

>

>****Stage 2**** commenced roughly 8 to 10 years ago, when advances in drilling technology suddenly made available the vast, but very deep, oil and gas reserves of the Delaware Basin that had been uneconomic to reach. A public signal of that change was the June 2013 announcement of a joint venture between Chevron and Cimarex to combine contiguous acreage in the region in order to facilitate capital expenditure plans in the many billions of dollars.¹ That was the starting gun. From those multi-billion-dollar drilling plans, one could readily deduce the very large volumes of oil and gas these companies expected to produce that would be sufficient to provide the level of profit they expected to earn over a period of decades. Those volumes would translate into royalty revenues to TPL, and the scale on which this would take place was simply enormous in comparison to what TPL was at the time.

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Note that I do not ascribe value to any of the future potential uses of TPL's land rights that Horizon Kinetics speculates on (i.e. solar farms, crypto mining, real estate development). But these are obviously attractive opportunities for TPL.

****Step #1: Valuing the Surface Acreage:****

The valuation of the surface acreage (excluding royalty rights) is the easiest of the three segments to value. Land is worth something, even if it doesn't have any economic value per-se. The easiest way to

estimate the value of TPL's 880k of acreage is to look at past land transactions that don't involve royalty interests. The table below shows that over the past few years, an acre has historically transacted at a median price of \$3,803/acre. So assuming a 25% corporate tax rate, the after-tax value of its landholdings should be roughly \$2.5bn. I then apply an uncertainty discount of 35% to account for the fact that not all land is created equal, and without disclosure, it's hard for me to know the true value of TPL's holdings.

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****Step #2: Valuing the Water Sourcing/Disposal Business:****

The valuation of TPL's water business (TPWR) is slightly more complicated, particularly because it is so new. However, TPL provides us with useful information in their investor presentations that can help us value the business.

The water business can be broken down into two segments: disposal and sourcing. Disposal is a service provided by TPWR for oil and gas companies to dispose of the water that is generated as a byproduct of digging up oil. The water is either disposed of by putting it back in the ground, or treated and recycled for the oil production process. The second segment, sourcing, is naturally that: delivering water for oil and gas producers to use while they drill.

TPL's latest investor presentation tells us that they have ~2800 mbb/d of active salt water disposal wells (SWD), and ~2700 mbb/d of permitted SWDs. We also know from their March 2020 presentation that general terms for disposal are for 5-10 year contracts at a price of \$0.10-\$0.20/barrel, and that contracts generally renew with a 15% price hike. Using this information, we can imply that TPL has a ~34% share of SWDs in the Delaware/Midland region (the basins where the majority of TPL land occupies).

I estimate TPL should be the dominant player in these regions, given its competitive advantage, that it owns the land. Because it owns the land, it doesn't have to pay a royalty to another third party, which means its prices can be more competitive than others. So I expect its market share to rise to 65% over the next 10 years.

I obtain produced water volume estimates in the Delaware/Midland regions in 2020 and 2030 from an old Raymond James report on the matter. And I assume that the SWDs operate at a 75% utilization rate to be conservative.

****Net-net: I estimate that TPL has ~\$1bn in potential royalty revenue from its disposal operations in 2030**** (which I will aggregate with its sourcing revenue potential, and discount back to present value).

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Next step is value the sourcing business. TPL also provides us with some useful statistics in their latest investor presentation. We get that they covered around 1300 mbb/d of produced water volumes (40% capture rate in the Delaware, \$0.11/bbl) and around 350 sourced water volumes (30% capture rate in the Delaware, \$0.45/bbl). Note that at the moment, TPL's sourcing only covers the Delaware basin. Given TPL's land ownership rights in Midland, I would expect TPL to grow its footprint there as well.

Similarly, as seen above, terms for sourcing contracts last between 2-15 years. I also assume that these contracts come with renewal at a 15% price hike. I assume a similar mix of produced/sourced water, and I assume that TPL grows its share to 65% of the Delaware/Midland produced water volumes, but 45% of sourced volumes (given there is somewhat less of a competitive advantage for TPL for sourced volumes).

Lastly, I combine the two revenue streams into one. I build in a 60% EBIT margin (achieved in 2019, which may be conservative given my expectations for the oil price and the likely operating leverage that comes with it), and a capex to revenues ratio of 20% (which might be too high given capex should slow to maintenance-type levels as the business matures). And I assign a 12.5x multiple on the terminal value of this business. **And discount everything back to present value to obtain a fair value of TPWR of almost \$5bn.**

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****Step #3: Valuing the Oil and Gas Royalties:****

The last and most important step is valuing the oil and gas royalties. TPL provides us with inventory information. I've recreated that table and backed out the implied EUR (estimated ultimate recovery) of a well in each basin. I assume a 45%/55% oil/gas mix, and I flex the natural gas price on my WTI assumptions using their relationship during the last cycle. We can then plug in assumptions for WTI and simulate a production schedule. Then we simply aggregate up using TPL's well count and discounting it back to present value.

The vast majority of TPL's deep value lies in its gross undeveloped resources, which are immense. Naturally, this portion of the business has the lowest visibility, which makes it hard to want to give the company credit for it today. Maybe over the course of 10 years, shareholders will accrue this value.

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