In early August 2018, Continental Resources Inc. and Franco-Nevada Corp., a precious metals royalties firm, formed a joint venture (JV) to acquire hydrocarbon mineral rights in Oklahoma’s Scoop and Stack plays. Franco-Nevada will contribute about $220 million for the acquisition of existing mineral rights owned by a Continental subsidiary. Franco-Nevada committed, subject to satisfaction of agreed-upon development thresholds, to spend up to $100 million per year over the next three years to acquire additional mineral rights. The existing mineral rights and others to be acquired later will be jointly held through the new company.

Revenues are expected to build as Continental ramps up development of its leasehold position. Franco-Nevada, based in Toronto, intends to fund its investment from cash on hand, partial use of its credit facilities and its projected future growing free cash flows. This new relationship will add to Franco-Nevada’s existing interests in the Scoop and Stack.

“In most cases people buy mineral rights blind, not knowing when, if ever, they will be developed,” said Jason O’Connell, the vice president of oil and gas for Franco-Nevada. “The idea here is to buy the mineral rights for sections where Continental plans to develop. Sure, in offering to acquire those rights we tip our hand a little and possibly pay more than the market price, but there is still a compelling value arbitrage that can be achieved.”

The terms of the transaction are complex, but essentially Franco-Nevada will pay 80% of the cost for the mineral rights being acquired, and then revenues are split 50:50 with Continental if the latter meets certain production targets.

“The transaction is hugely attractive to Continental,” O’Connell said. “They provide the information and they manage the program. We provide the bulk of the investment, and they get half the revenue,” which for Continental is actually reduced outlay. Franco-Nevada is not new to energy, but has focused on gold royalties. In March 2015
at the bottom of the recent oil price decline, the company decided to increase its exposure to hydrocarbons.

“We are long-term investors,” O’Connell said. “We are not looking for profits in three to four years, but in 10, 20, 30 years. That is in contrast to the short-term investment objectives of private equity.”

He also recognized Continental as a producer with experience in mineral rights. “They are already set up with the ability within the company to understand the complexities of mineral ownership. Most producers trying to replicate the idea would have to start from scratch. What they wanted was a strategic partner with long-term capital. That is us.”

History as a guide
There is a long history of operators buying minerals associated with their development, said Frost Cochran, managing director, Post Oak Capital. “Exxon and Chevron are two prime examples dating back to the 1940s and 1950s. They would often buy the mineral rights and sometimes even the surface, especially Exxon. I don’t know of any operators, majors or independents that make a deliberate strategy of buying mineral rights for their own development, at least not in the last few years. But there definitely is a history of that.”

If anything, there is a trend in the other direction, especially for the publicly traded companies. Several sources noted the demand by public investors for cash flow. Owning large mineral holdings means tying down considerable capital, antithetical to a free-cash model. If a minerals purchase were necessary or came with a deal as part of the package, such a position would not be disdained, but at least for the big public operators, mineral rights have not been a part of the strategy.

“As a private operator, starting in the 1990s we would try to accumulate minerals,” Cochran said. “It was not a specific strategy, more of a side line. As a private-equity shop, if associated minerals fell into the lap of our portfolio operating companies, we would keep those when we sold the operation. It was just picking up breadcrumbs. Strategic buyers placed little or no value on mineral rights, so we would retain them as we made our exits from portfolio companies. Mineral rights are severable so we would retain ours in the fund.”

Post Oak is hardly alone, as most of the big Houston-and Dallas-based energy private-equity houses invest in mineral rights. EnCap Investments is considered the largest in that segment, but Quantum Energy Partners, Kayne Anderson, NGP Energy Capital Management and Lime Rock Resources participate, some alongside operating companies and some as discrete and dedicated strategy.

About five or six years ago Post Oak portfolio companies began reporting they could buy minerals as inexpensively as they could lease them. “In many areas, owners had not seen royalties in a long time,” Cochran said. “That gave us the idea to offer to buy mineral rights first, before making a lease offer.”

Five years ago, Post Oak created its first dedicated minerals investment, Saxet Minerals. Post Oak is now on its third iteration with Saxet. “In our last two funds, about 20% of the capital was dedicated to minerals,” Cochran said. “We make cash distributions on a quarterly basis from these investments. Ultimately, we are going to have to decide whether to sell those or roll them into something long-term. Our fund investors have been clear with us that they prefer us not to sell mineral rights.”

That preference reflects an investor base that differentiates Post Oak: “Our limited partners consist almost entirely of tax-exempt U.S.-domiciled endowments, foundations and pension plans,” Cochran added. “Being perpetual institutions, they plan on a multi-decade basis. That is atypical of private-equity funds. Many other funds consist of a mix of sovereign wealth funds, family offices, fund-of-funds, as well as tax-exempt investors that have their own limits for durations.”

Post Oak funds technically run for 10 years plus a two-year extension, but in practice can be rolled into a perpetual vehicle, be distributed in-kind, or extended indefinitely.
Busting mineral myths

The Hefner family has been involved in minerals investing for more than a century. And still, Robert Hefner V, president and CEO of Oklahoma City-based Hefner Energy Holdings LLC, said that as he grew up in the industry, conventional wisdom held that minerals were unable to compete with operated or non-operated working interest, and were not scalable.

“I never bothered to question those two assertions until about 2013, when I invested in some minerals in the Scoop at $100 [per barrel] oil. I noticed, even as oil prices collapsed to $40, my mineral investments were generating strong returns. Since the former was disproven, I then questioned the latter assumption that minerals were not scalable.

“I started investing more in minerals and found that minerals are very scalable. Both of the two common beliefs about minerals were wrong,” Hefner said.

Given his love of history, Hefner has a theory as to why minerals suddenly seem to be on everyone’s mind in the last few years. “You always hesitate to say, ‘This time it’s different,’ but there are things about this cycle that were not present in previous industry cycles, notably horizontal drilling and hydraulic fracturing. The shale bonanza has meant massive capital programs, hundreds of millions [of dollars] for a single unit. That has significantly increased the velocity of the cash flow and the nature of capex. Minerals investing is a capex story.”

Having whetted his appetite busting myths about minerals, Hefner would like to dispense with one other, that investors could run out of things to buy. “There is a $10 billion unfunded market out there in Oklahoma. For all the work that has already been done—LongPoint, Brigham, Saxet, Expro and others—there has been $2 billion spent out of a potential for $12 billion or $13 billion,” he said.

The minerals segment remains “highly inefficient and highly fragmented. So we say, yes, it’s good that more people are investing in minerals; the segment is still under-funded,” he said.

Exit strategies are a complex issue for minerals investors, Hefner noted. “Today, conditions are not favor-
Scoop and Stack areas of the Anadarko Basin. We have also had a few misses, but not too many.”

There are certainly advantages to the increased attention on minerals. According to Meagher, “There is a lot more data available to substantiate an investment thesis. Also, minerals are easy to manage. There is not a lot of operational complexity, making mineral investments an appealing option for diversification, especially for private-equity entities and wealthy families.”

Control and cost of capital
Still, Meagher cautioned investors to remain aware that cost of capital is an important factor. “Mineral owners have no control over what gets drilled and when, so you need a very low cost of capital. Even if a parcel is developed, it may be limited to just a few wells so that the acreage is [HBP]. It is not always going to be a pad program with multiple wells.”

Many investors have also encountered problems managing their expectations, Meagher added. “Someone will see that mineral rights sold for $60,000 per acre in Lea County, N.M., and expect to see similar numbers everywhere. It simply doesn’t work that way due to the diversity of the geology from one basin to another, among other factors.”

Meagher has a theory on why the appetite for mineral investments has grown so rapidly. “When the industry fell on tough times at the end of 2014, a lot of people lost their jobs. Many of them tried to buy minerals just to flip them. The result of all that was more people with industry expertise and time on their hands looking up mineral records. Suddenly, there were more packages on the market. It worked well enough to pay the bills until the recovery.”

Technology also played a part. “It used to be you had to drive to the courthouse and dig through the records. Now almost anyone can pull up the records online,” Meagher said.

With the increase in transaction volumes, it was not long before bigger money started to enter the picture. “Now that the big money is in, I am not so sure it is going to stop. For private equity, the strategy would be their normal M.O. of amalgamating assets and trying to sell up to a public company,” Meagher said. Given the size of the Permian Basin, Meagher believes that it will continue to see mineral investments for many years to come as “other smaller basins may run out of appealing assets to buy.”

Another trend that Meagher identified is operators “getting ahead of their own drillbits by buying minerals rather than leasing them. The challenge for operators, however, is that most are working in only one or a few basins,” making some of the larger multistate mineral packages less appealing, considering their concentrated needs.

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**SELECTED MINERALS INVESTMENT OPTIONS BY OWNERSHIP TYPE**

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<th>Company</th>
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Total $5.300+

Source: Falcon Minerals Corp.