

❖ Contrarian Research Report ❖

Texas Pacific Land Trust

May 8, 1995

Price:	\$20	Ticker:	TPL
52-wk.range:	\$17-\$22	Dividend:	\$0.40
Shares out:	3.075 million	Yield:	2%
Market Cap.:	\$62 million	Debt/Capital:	0%
Book value/Share:	\$3.53	Return on Equity:	46%

How to Buy 1 Million Acres of Fine Texas Grazing Land for \$20.00

Texas Pacific Land Trust is a publicly traded enterprise that is slowly but steadily buying itself out of public ownership. It is accomplishing this by consistently applying its cash flow to the repurchase and retirement of its own shares. Although this process has been ongoing for over a century, it may now have reached a point at which this dynamic begins to naturally accelerate versus the experience of recent decades. It is quite conceivable that, over the next decade or so, the company's assets could become concentrated in the hands of a few share owners. As the shares in question represent some 1 million acres of rural Texas, the magnitude of this accumulation of per-share value could be extraordinary.

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Description

Texas Pacific Land Trust owns the surface estate in over 1.1 million acres of land in 21 counties in western Texas, as well as perpetual oil and gas royalty interests under 472,000 acres of land. Shares of the Trust actually represent Certificates of Proprietary Interest in a Declaration of Trust, dated February 1, 1888, which established this unique entity.

Trust income derives from grazing fees, easement income, oil and gas royalty revenues, interest on cash reserves, and land sales. All of these categories represent significant sources of income.

- Grazing: The land inventory is almost exclusively rural, with grazing leases in effect on 98% of the acreage. Due to normal inflation, easement and grazing revenues have risen over time despite land sales. (For example, grazing revenues have risen 63% since 1980.)
- Oil and Gas: Over the same period, energy revenues have declined in concert with oil prices, which averaged \$26 per barrel in 1980 and only \$15 per barrel sold in 1994. Yet, a greater volume of oil and gas is being produced today than in 1980, and no oil producing interests have been sold.
- Land: Outstanding shares have been reduced by 34% since 1980, or by about 3% per year. However, total land sales amounted to merely 8% of the acreage then held, reducing the land inventory to 1.1 million acres from 1.2 million acres. In essence, the Trust repurchased 16.9 shares for each acre sold, increasing the number of acres represented by each share from 0.26 to 0.37. Shares have been repurchased in all but four of the Trust's 106 years.

The market value of the outstanding shares, at the current \$20 share price, is \$62 million. By extension, investors are valuing the company at \$54 per acre. The Trust's land sale volume and prices vary considerably from year to year. Sales prices in 1994 ranged from \$45/acre to \$7,500/acre and averaged \$192 (versus 1981 sales averaging \$239/acre, within a range of \$35/acre to \$4,000/acre). The highest prices relate to sales to El Paso developers as that city expands eastward near Trust acreage.

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Confidence in the relative safety of this investment resides in the capacity and predilection for share repurchases by a debt-free company selling very near the value of its tangible assets. Relative to the average industrial or service company, Texas Pacific is not subject to typical competitive forces nor to marginal changes in consumer and industrial demand. It has very stable base rents and, unlike most energy companies, which must support high fixed costs, its royalty revenues are purely additive, regardless of volume. Its basic business, land and oil, are classic inflation hedges.

The Final Stage?

The Trustees have not raised the \$0.40/ share dividend since 1984 (and their annual salaries have been fixed at \$2,000 since 1988). This tantalizing departure from the practice of most dividend-paying companies, which *strive* to raise dividends, has significant implications. Given a fixed dividend and a constantly decreasing share count, total dividends paid per year have declined during this time from approximately \$1,630,000 to \$1,267,000. At this juncture, income from grazing, easements and cash reserves -- the *smallest* sources of income -- are approximately sufficient to support the dividend. One can presume that with each passing year of share repurchases, the total dollars paid out as dividends will continue to decline, freeing yet more cash flow for incrementally more share repurchases. The Trust will effectively be able to retire shares and further concentrate the acreage per share at an increasing rate.

Of course, one must include the oil revenues and land sales, which are the most significant sources of revenue. Though volatile, energy revenues exceed the combined revenue of the other operating segments. Land sales, though uneven, add further revenue; in recent decades, land sales have raised between \$400,000 and \$10,000,000 per year.

Engaging in a very simplistic exercise to anticipate how the next fifteen-year period might differ from the one just examined yields startling possibilities. By projecting the last five years' average operating revenues and expenses forward, assuming no earnings growth, and applying profits to share repurchases (at constant prices), the outstanding share base would be reduced by 45%. Were one to assume 3% annual earnings growth, the share base would be reduced by 96%, leaving the remaining acreage and royalty interests of the Trust concentrated in a mere 100,000 or so shares and, the following year, no shares whatsoever.

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The following exercises attempt to gauge potential outcomes for Texas Pacific Land Trust in the coming years. Any number of scenarios are possible and, clearly, events will not unfold in the patterns suggested below (which assume no stock price appreciation, for instance). The purpose of these two simple iterations is merely to provide a sense of the direction and magnitude which are theoretically possible based on the current financial characteristics and policies of the Trust.

Exercise 1.

Assumes no income growth. Applies the average income level of the prior five years toward share repurchases at current prices. Also assumes continuity of the current dividend policy.

	Avg 5 yrs . 1990-1994	1995	1998	2001	2004	2007	2010
Revenues (\$)	5,839,000	5,839,000	5,839,000	5,839,000	5,839,000	5,839,000	5,839,000
Expenses	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000
Net Income	2,751,000	2,751,000	2,751,000	2,751,000	2,751,000	2,751,000	2,751,000
Shares outstanding (beg. yr.)	3,075,305	3,075,305	2,842,580	2,595,611	2,333,525	2,055,397	1,760,246
Dividends Payable (@ \$0.40/sh)	1,230,122	1,230,122	1,137,032	1,038,244	933,410	822,159	704,098
Available for share repurchases	1,520,878	1,520,878	1,613,968	1,712,756	1,817,590	1,928,841	2,046,902
Shares repurchased	76,044	76,044	80,698	85,638	90,879	96,442	102,345
Shares outstanding (end yr.)	3,075,305	2,999,261	2,761,882	2,509,973	2,242,646	1,958,955	1,657,901
As % of 1994 year-end shs.		-2.5%	-10.2%	-18.4%	-27.1%	-36.3%	-46.1%

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Exercise 2.

Same as Exercise 1, except assumes 3% annual revenue growth. This reflects both the current and recent U.S. inflation experience as well as the average rate of rental and land price increases for Trust property during this century.

	Avg 5 yrs 1990-1994	1995	1998	2001	2004	2007	2010
Revenues	5,839,000	6,014,170	6,571,846	7,181,234	7,847,128	8,574,768	9,369,881
Expenses	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000	3,088,000
Net Income	2,751,000	2,926,170	3,483,846	4,093,234	4,759,128	5,486,768	6,281,881
Shares outstanding (beg. yr.)	3,075,305	3,075,305	2,788,261	2,395,760	1,883,199	1,234,324	431,060
Dividends Payable (@ \$0.40/sh)	1,230,122	1,230,122	1,115,304	958,304	753,280	493,730	172,424
Available for share repurchases	1,520,878	1,696,048	2,368,542	3,134,929	4,005,848	4,993,039	6,109,457
Shares repurchased	76,044	84,802	118,427	156,746	200,292	249,652	305,473
Shares outstanding (end yr.)	3,075,305	2,990,503	2,669,834	2,239,014	1,682,907	984,672	125,587
As % of 1994 year-end shs.		-2.8%	-13.2%	-27.2%	-45.3%	-68.0%	-95.9%

Trust revenues and related expenses vary significantly from year to year. In order to not give undue weight to unusually high 1994 revenues, the average results of the prior five years have been used as a starting point for both exercises.

Though such extended exercises cannot hope to be accurate, they are thought provoking. Indeed, a Certificate worth approximately \$350 in 1907, lost and not recovered until 1979, was restored to an heir of the original owner and liquidated in 1986 for an amount in excess of \$5,700,000. Is it possible that there will remain, in the indeterminate future, a final 100 shares representing some 1 million acres of productive real estate? If so, substantial rewards accrue to those with the most patience.

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Statements of Income Years ended December 31, 1994, 1993 and 1992

	<u>1994</u>	<u>1993</u>	<u>1992</u>
Income:			
Oil and gas royalties	\$2,064,324	\$2,166,045	\$2,223,931
Grazing lease rentals	538,106	529,757	528,472
Land sales	5,230,430	1,484,123	386,548
Interest	571,257	535,313	687,401
Easements and sundry income	<u>698,716</u>	<u>547,524</u>	<u>506,261</u>
	<u>9,102,833</u>	<u>5,262,762</u>	<u>4,332,613</u>
Expenses:			
Taxes, other than Federal taxes on income	510,635	525,423	525,470
Salaries	508,200	448,452	416,197
General expense, supplies and travel	475,427	475,953	436,875
Basis in real estate sold	34,886	-	31,217
Legal and professional fees	125,420	168,997	129,995
Commission to local agents	100,424	24,147	11,657
Depreciation	9,847	10,773	12,282
Trustees' compensation	8,000	8,000	8,000
Other	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>
	<u>1,792,839</u>	<u>1,681,745</u>	<u>1,591,693</u>
Income before provision for Federal taxes on income and cumulative effect of accounting change	<u>7,309,994</u>	<u>3,581,017</u>	<u>2,740,920</u>
Provision for Federal taxes on income:			
Current	1,611,105	1,268,852	1,015,288
Deferred	<u>725,220</u>	<u>(186,751)</u>	<u>(282,713)</u>
	<u>2,336,325</u>	<u>1,082,101</u>	<u>732,575</u>
Income before cumulative effect of accounting change	4,973,669	2,498,916	2,008,345
Cumulative effect of accounting change	-	<u>(812,030)</u>	-
Net income	\$4,973,669	\$1,686,886	\$2,008,345

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Balance Sheets December 31, 1994 and 1993

	<u>1994</u>	<u>1993</u>
ASSETS		
Cash	\$232,843	\$47,007
Temporary cash investments	2,000,000	1,950,000
Accounts receivable	227,067	230,727
Notes receivable for land sales	5,347,947	4,823,243
Accrued interest receivable	225,470	210,374
Prepaid expenses	48,365	43,991
Real estate acquired through foreclosure	6,844,336	5,906,109
Water wells, leasehold improvements, furniture and equipment - at cost less accumulated depreciation	45,966	43,837
Property, no value assigned:		
Land (surface rights) situated in twenty-one counties in Texas - 1,106,607.34 acres in 1994 and 1,129,226.05 acres in 1993	-	-
Town lots in Iatan, Loraine, and Morita, Texas - 628 lots	-	-
1/16 nonparticipating perpetual royalty interest in 386,987.70 acres	-	-
1/128 nonparticipating perpetual royalty interest in 85,413.60 acres	-	-
Total assets	\$14,971,994	\$13,255,288
LIABILITIES AND CAPITAL		
Accounts payable and other liabilities	\$104,575	\$171,504
Federal income taxes	218,708	45,976
Other taxes	13,084	13,760
Deferred revenue on land sales	-	745,738
Deferred taxes	<u>3,766,446</u>	<u>3,041,226</u>
Total liabilities	<u>4,102,813</u>	<u>4,018,204</u>
Capital:		
Certificates of Proprietary Interest, par value \$100 each; outstanding 1 certificate	-	-
Sub-share Certificates in Certificates of Proprietary Interest, par value \$.16 2/3 each; outstanding 3,075,305 sub-shares in 1994 and 3,179,205 sub-shares in 1993	-	-
Net proceeds from all sources	<u>10,869,181</u>	<u>9,237,084</u>
Total capital	<u>10,869,181</u>	<u>9,237,084</u>
Total liabilities and capital	\$14,971,994	\$13,255,288