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WEALTH ADVISOR INSIGHTS
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EXPERIENCE THE RIGHT PARTNERSHIP™
FIRST QUARTER 2010

WEALTH UNDERGROUND

Mineral rights can provide diversification to a portfolio and potential long-term growth. But few investors have a full understanding of these assets' unique management, tax, and estate planning challenges.

Unlike other forms of real estate, mineral rights—or the rights to commodity reserves still in the ground, like oil or natural gas deposits—rose in value in recent years, thanks to the fact that they are intrinsically tied to the global markets of the commodities themselves. So while daily price fluctuations of extracted oil and natural gas are influenced by worries over Middle East peace or sheer price speculation, overall long-term demand is supported by a fundamental relationship between increasing demand and limited supply.

In fact, the International Energy Agency, a Paris-based energy research organization funded by the world's oil-importing nations, estimated in October that the world needs to find fresh sources of oil equivalent to the output of four Saudi Arabias by 2030 to meet projected demand.

That scenario bodes well for families who own mineral rights—ownership of oil, natural gas, or other raw commodities still in the earth—whether they were acquired through an inheritance of a long-held family asset or through making a new investment. "It is truly a global market. It doesn't matter if you are producing it in your backyard or elsewhere. When the price goes up, it benefits all the producers. There is a finite amount of a resource in the ground. Once it is consumed, it is gone forever," says Edward Trafford, senior investment research analyst, Northern Trust Global Investments.

The groundwork for this dynamic was laid in the 1990s, when the Western world, which had been the primary driver of commodity demand, began to require fewer raw materials. This sparked a period of very low prices around 1999 in which a number of commodities, including oil, hit all-time lows. In turn, this led to a sharp decline in

investment for finding and developing new supply. "Unlike most industries, where supply can catch up to demand relatively quickly, it takes a significant financial investment and quite a few years to find, develop, and start meaningful production from a new reserve or mine," notes Matt Peron, director of active equity research for Northern Trust Global Investments.

Another factor: With a finite amount of commodities in existence, every bit that is pulled out of the earth reduces supply, thereby increasing prices. That would be true even if demand were to remain stable, but overall demand is increasing thanks to the infrastructure build-out and energy needs of the emerging markets, according to Trafford.

Add to this the fact that China is likely to continue diversifying its sovereign wealth fund into basic materials and energy. "That's both an inflation hedge and a means of securing access to needed supply. The result is upward pressure on commodity pricing," Trafford says.

"The economy in emerging markets like India and China is where the United States was 50 years ago. The difference is that it is a bigger population. They are commodity hungry, they are going to drive demand, and demand is going to outpace supply for a while," Peron explains.

EVALUATING THE INVESTMENT

As with any investment, mineral rights require care to help ensure they are a worthwhile allocation of funds and meet an investor's goals. This is especially true today with the boom in commodity prices. Family holdings that may have been overlooked as worth little are potentially now quite valuable.

But the rising market has also brought a number of speculators and inexperienced brokers into the marketplace, more interested in quick financial gain than getting owners the best return for their assets, warns Bill Weege, fiduciary asset manager of Northern Trust's oil, gas, and mineral business. "When someone inherits an oil, natural gas, or mineral interest, he may not understand exactly what he has inherited or how to negotiate an advantageous lease with a potential lessee. It's vital for mineral-rights owners to work with advisors they trust to properly evaluate their holdings and represent their interests in the marketplace," adds Weege, who himself once served as an engineer in the oil industry.

As a very broad rule of thumb, producing royalty interests—where landowners essentially lease their mineral rights to an operating company—are currently valued between six and ten times their annual income stream. But the valuation can vary widely, depending on a number of factors, among them the location of the property and the expectation of future production. Active interest in a working well, where one pays capital and operating costs as well as receives income, will be often valued between three and five times annual revenues.

"But there are a number of assumptions that go into an effective valuation, including price and production," adds Weege. "From an investing standpoint, you try to determine the value of a property from a cash flow analysis. If you have existing production, you do a decline-curve analysis and run an economic evaluation to come up with a present value." These steps are important whether you are planning to hold the property or evaluating it for sale. There is also the fact that if an active interest is held through the end of the asset's working life, it could saddle the investor with paying abandonment costs, such as well-plugging, site-remediation, and equipment-salvaging.

MANAGING THE ASSET

Tax treatment of the investment varies as well.

For instance, royalty interests are generally considered passive investments by the IRS, and therefore the income from those interests is taxed as ordinary income. Active interests that the client owns directly (or through an entity where liability isn't limited) allow current-year losses to be deducted with far fewer limitations.

A common headache for mineral-rights transactions is to ensure that titling is done properly. Property titles will usually distinguish between surface rights and mineral rights, and often those are owned by different entities.

For estate planning purposes, putting natural-resource assets into a limited partnership avoids having to retitle property and refile with local authorities every time someone dies or the property is passed on. "If the properties are all titled into the limited partnership, after death you just redistribute the interest to the beneficiaries," says Weege. "Otherwise, the process of retitling the properties becomes necessary and can be very expensive."

While the nature of such interests necessitates more advisor consultation and oversight, the market is generally proving the effort to be worthwhile, he adds. "Owners and investors who have mineral interests are reaping the benefits."

William Weege

Senior Vice President, Fiduciary Asset Manager, Northern Trust, based in Addison, Texas

Bill manages the Oil, Gas & Minerals Management team at Northern Trust. He began his Northern Trust career in 1992 as a second vice president in minerals management. He was promoted to vice president in 1994. Prior to joining Northern Trust, Bill was a self-employed engineering consultant. He also worked with major and independent oil and gas exploration and production companies as manager and engineer in both domestic and international assignments.

Bill earned a Master of Science degree in management and administrative sciences from the University of Texas at Dallas. He received a Bachelor of Science degree in petroleum engineering from Colorado School of Mines in Golden, Colorado. He is a registered professional engineer in Colorado and California and a member of the Society of Petroleum Engineers and the Society of Petroleum Evaluation Engineers.

Matthew Peron

Senior Vice President, Director of Equity Research, Northern Trust Global Investments, based in Chicago, Illinois

Prior to joining Northern Trust in 2005, Matt worked for Alliance Capital Management. His previous experience includes equity portfolio management and technology sector specialist at Lincoln Capital Management. Matt has been in the financial industry since 1990, when he started his career on Wall Street.

Matt earned an MBA from the University of Chicago and a BS in electrical engineering from Swarthmore College.

Edward Trafford

Vice President, Senior Investment Research Analyst, Northern Trust Global Investments, based in Chicago, Illinois

Edward is an investment analyst in the Equities Research Division within Northern Trust Global Investments. Prior to joining Northern Trust in 2006, he was an analyst on the small cap team at AIM Investments. Edward was an analyst with JPMorgan Investment Management (JPIM) from 2000 to 2004. In 2004, AIM lifted out JPIM's small-cap team, with Edward the sole analyst whom AIM transitioned.

Edward earned a BS in civil engineering with a second major in economics, both from Duke University. He also holds an MBA from the University of Chicago with concentrations in finance and accounting and is a CFA Charterholder.

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