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A Closer Look

Should You Sell Your Mineral Rights?

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In Brief

- **The old maxim that you should never sell your mineral rights may need updating.**
- **Changing industry dynamics, the influx of investment monies into funds that acquire mineral rights, low borrowing costs, high stock market valuations, and other factors have all combined to drive up demand for minerals and the prices offered for mineral rights.**
- **Unsolicited purchase offers are happening in greater numbers and for greater — sometimes much greater — amounts than in the past.**
- **The upshot? Sometimes selling makes good sense. Indeed, depending on your situation, the sale of your mineral rights can represent a prudent — and even compelling — opportunity.**

Conventional Wisdom Says Never Sell

When it comes to mineral rights, the standard admonition has long been consistent and emphatic: Avoid selling them.

After all, simply owning mineral rights costs you nothing. There are no liability risks, and in most cases, taxes are assessed only on properties that are actively producing oil or gas. (In contrast, owning undeveloped real estate has carrying costs like insurance premiums and taxes.)

Moreover, it's axiomatic that mineral rights are always worth more tomorrow than they are today. In other words, the argument goes, if you receive an unsolicited offer to purchase your mineral rights, you can safely assume that the true value of your rights may well be greater than the amount you're being offered — otherwise, why would the interested party be interested in the first place?

And then there's the flexibility. If you wait, you can always choose to sell later. In the meantime, you can possibly lease your rights (perhaps over and over again), receiving a lease bonus and maybe royalty payments or, if the property is currently producing, continuing to receive royalty payments.

These arguments do make sense in general, but the fact is that the decision to sell really depends on your personal situation, and there can be many worthwhile reasons for selling — especially in the current environment.

But There May Be Good Personal Reasons for Selling

Whether you have an offer on the table or not, you may find it preferable to sell your mineral rights:

- **To pursue other opportunities.** If you have a nonproducing property, you might have to wait years for anything to happen — and nothing may ever happen, even after multiple leases. Even if production occurs, the rewards could always turn out to be less (perhaps much less) than you were anticipating. Putting proceeds from a sale to work in another venture or investment may prove more rewarding than holding out for a questionable payday.
- **To eliminate the administrative hassle.** Keeping up with the paperwork, particularly for rights in numerous and geographically diverse areas in different tax jurisdictions, can be burdensome.

Then, of course, you'll also have to track production on your leased properties — not always an easy task — to make sure you're receiving all of the revenues owed to you. (See *A Closer Look*, "Oil and Gas Advisory Team Leaves No Stone Unturned," for more information about the challenges of revenue recovery.)

- **To make estate planning easier.** Dividing numerous small interests into even more numerous smaller interests can increase administrative burdens when it comes to accounting for taxes on royalties and the eventual sale of those rights. In many cases, it may be preferable to simply sell the rights and distribute the cash proceeds to beneficiaries.
- **To simplify division of assets in a divorce.** Estimating the value of mineral rights, particularly nonproducing mineral rights, is often more art than science. Dividing the cash from a sale is much simpler than attempting to estimate the rights' market value beforehand.
- **To eliminate erratic royalty income.** Depending on your situation, a fixed cash payment in a sale now can be more useful than inconsistent royalty payments over time.
- **To diversify assets, reduce risk, and increase liquidity.** The oil and gas industry is volatile, risky, subject to changing political winds, and therefore the value of mineral rights can swing wildly. A dry hole, even a dry hole drilled on a property adjacent to yours, can shift your fortunes literally overnight. And, like any investment, a concentrated position can increase your risk. Sale or partial sale can diversify risk and increase liquidity.
- **To reduce family tensions.** It is not unusual for the sale of mineral rights to be the most effective way out of an uncomfortable family situation.

And There May Be Compelling Financial Reasons to Sell

In addition to the above (mostly personal) reasons for selling your mineral interests, there may well be financial reasons to consider the sale of your mineral interests. Unsolicited offers are happening in greater numbers and for greater (sometimes much greater) amounts than previously.

Why the upsurge in offers and pricing?

- **Increased productivity.** The decline in oil prices that started in mid-2014 has forced producers to do more with less, and the companies that have survived are getting more production for their drilling dollars.
- **Horizontal drilling.** Most of the purchasing enthusiasm is focused on areas of conventional production (that is, regular vertical wells), where the assumption is that horizontal drilling for shale deposits will eventually occur. This can help explain why rights owners who may have been receiving relatively negligible royalty checks on wells that have existed for decades are suddenly surprised to receive enormous purchase offers. These prospective purchasers are predicting that horizontal drilling into the shale deposits will eventually reach into their property.
- **Risks involved in acquiring minerals are lower.** With new technologies and processes, the role of conventional geology has diminished, and the returns on wells in a given area can be predicted more accurately than ever before.
- **Increased optimism about future oil and gas prices.** When consulting engineers provide an appraisal, they tend to use widely accepted but conservative indices (for example, NYMEX Futures) when projecting future oil and gas prices. Companies, however, base their valuations on their own estimates of where they think prices are going, and they are willing to make bets on their numbers.
- **More money looking for places to invest**. This is at least partly a result of still-low borrowing costs and high stock market valuations prompting investors to look elsewhere for opportunities.

All of these factors have combined to drive up the offering prices for mineral rights. In short, the market has grown larger and more heated.

Considering a Purchase Offer: A Checklist

- What is the true market value of your mineral rights? Have you had your rights appraised?
- Given comparable sales, is the offer competitive?
- What are the risks of declining an offer? Appraised values are not fixed. They can continue to rise, but they can also go down — sometimes rapidly.
- How long would it take to earn more than the offered amount? 10 years? 15 years? What is your age and investment time horizon?
- How reliable is your income stream? How many holdings do you have? How diversified are they?
- What are the opportunity costs of holding on to your rights? What would you do with a cash settlement?
- If your current revenue is good, could you invest the proceeds from a sale in a way that would throw off the sort of revenue you're receiving today?
- What are the tax implications of a sale?
- What are your estate planning needs?

These days, unsolicited purchase offers are often many times the appraised value of the rights. In the past, typical offering prices tended to range from 3x to 5x annual revenues. Today, numbers north of 10x revenues are increasingly common.

Most offers — these can be from an E&P (exploration and production) company currently leasing your rights, but often it's an investing entity in the business of buying mineral rights — are for already-producing interests. Companies usually need to see some cash flow to justify a buy-and-wait approach. However, offers — sometimes quite sizeable — are being made for rights to properties without any current production, although they are typically in areas that are seeing overall strong production.

What if You Receive an Offer?

Mineral rights are complex assets. If you're approached with a purchase offer, it's important to seek out experts in the field for advice. They can help you with commissioning a professional appraisal of the assets. Among the many components involved in an appraisal are leasing activity in the area, new wells being drilled, success rates, potential royalty streams, and lease bonuses.

They can also examine the precise terms of your offer in detail and compare it with similar sales to help gauge its competitiveness. They should also be sure to take a close look at the tax consequences of a sale, particularly if (as is frequently the case) your rights have a low cost basis and a sale would generate sizeable capital gains.

Once you have an appraisal and a clear picture of the merits of the offer from a financial standpoint, including all relevant tax considerations, you can begin to assess it realistically in the context of your personal situation. Maybe a bird in the hand makes the most sense, maybe not, but with all the facts in hand, you can arrive at a decision that's right for you.

If you have already received a purchase offer for your mineral rights or are simply contemplating the sale of your mineral rights and would like more information about your options and the pros and cons of a sale, please reach out to Bessemer's oil and gas advisory specialists or your client advisor.

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