Sabine Royalty Trust (SBR)

Updated November 22nd, 2022 by Aristofanis Papadatos

Key Metrics

Current Price:	$78	**5 Year CAGR Estimate:**	-4.3%	**Market Cap:**	$1.1 B
Fair Value Price:	$83	**5 Year Growth Estimate:**	-15.0%	**Ex-Dividend Date:**	11/14/2022
% Fair Value:	94%	**5 Year Valuation Multiple Estimate:**	1.2%	**Dividend Payment Date:**	11/29/2022
Dividend Yield:	10.6%	**5 Year Price Target**	$37	**Years Of Dividend Growth:**	2
Dividend Risk Score:	F	**Retirement Suitability Score:**	C	**Rating:**	Sell

Overview & Current Events

Sabine Royalty Trust (SBR) is an oil and gas trust set up in 1983 by Sabine Corporation. At initiation, the trust had an expected reserve life of 9 to 10 years; the current estimated life of the trust is 8 to 10 years. The trust consists of royalty and mineral interests in producing properties and proved oil and gas properties in Florida, Louisiana, Mississippi, New Mexico, Oklahoma, and Texas. It is roughly 2/3 oil and 1/3 gas in terms of revenues. The trust's assets are static in that no further properties can be added. The trust has no operations but is merely a pass-through vehicle for royalties. SBR had royalty income of $60.9 million in 2021 and has a current market cap of $1.1 billion.

In early November, SBR reported (11/10/22) financial results for the third quarter of fiscal 2022. Oil Production grew 7% over the prior year's quarter while production of gas grew 77%. In addition, the average realized prices of oil and gas grew 65% and 142%, respectively, thanks to the sanctions of western countries on Russia, which have led to multi-year high oil and gas prices. As a result, distributable cash flow per unit more than doubled, from $2.39 to $6.13. Thanks to the strong tailwind from the Ukrainian war, SBR is on track to post 10-year high distributable cash flow per unit this year. Based on its distributions in the first eleven months of the year, SBR is offering an annualized distribution yield of 10.6%.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
DCFU	$3.59	$4.03	$4.03	$3.15	$1.88	$2.38	$3.42	$3.02	$2.28	$3.97	***$8.27***	***$3.67***
DPU	$3.70	$3.92	$4.10	$3.11	$1.93	$2.37	$3.35	$3.02	$2.40	$3.22	***$8.27***	***$3.67***
Units[1]	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	***14.6***	***14.6***

The trust does not have earnings per se, but rather is a pass-through vehicle for royalty payments – essentially all the royalty income (cash) it receives is passed through to unit holders. About 5%-8% of royalty income is consumed in administrative expenses. The trust has generated an average annual distributable cash flow of $3.18 per unit over the last decade. However, the cash flows of SBR are extremely sensitive to the gyrations of the prices of oil and gas and hence they have resulted in a markedly volatile performance record. Given the rally of the prices of oil and gas to 13-year highs this year, which have formed an exceptionally high comparison base, we expect a -15.0% average annual decline in distributable cash flow per unit over the next five years. Notably, it is the first time that oil producers are somewhat reluctant to invest in new growth projects due to the secular shift from fossil fuels to clean energy sources. As a result, some investors think that oil prices may remain excessive for years. However, we believe that the well-known cyclicality of oil prices will remain the norm.

Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
P/DCFU	14.3	11.2	10.7	9.9	16.3	16.7	12.0	14.6	13.4	9.4	***9.4***	***10.0***
Avg. Yld.	7.2%	8.7%	9.5%	10.0%	6.3%	5.9%	8.2%	6.8%	7.9%	8.6%	***10.6%***	***10.0%***

[1] Average Weighted Unit count is in millions.

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SBR has traded at an average price-to-distributable cash flow ratio of 12.9 over the last decade. However, this average multiple seems quite high given the risk of a royalty trust. It is critical to note that the trust has a limited lifetime and hence its returns will be greatly affected by the commodity prices that will prevail throughout this period. When the music begins to slow down on one of these trusts (i.e., the end of reserves comes into view) or the market gets the slightest hint that the music will slow, the price of a unit often plummets. As a result, investors should pay extra attention to the valuation of SBR before investing in it. We assume a fair DCFU multiple of 10.0 for SBR. If the stock trades at our fair value estimate in five years, it will enjoy a 1.2% annualized gain in its returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

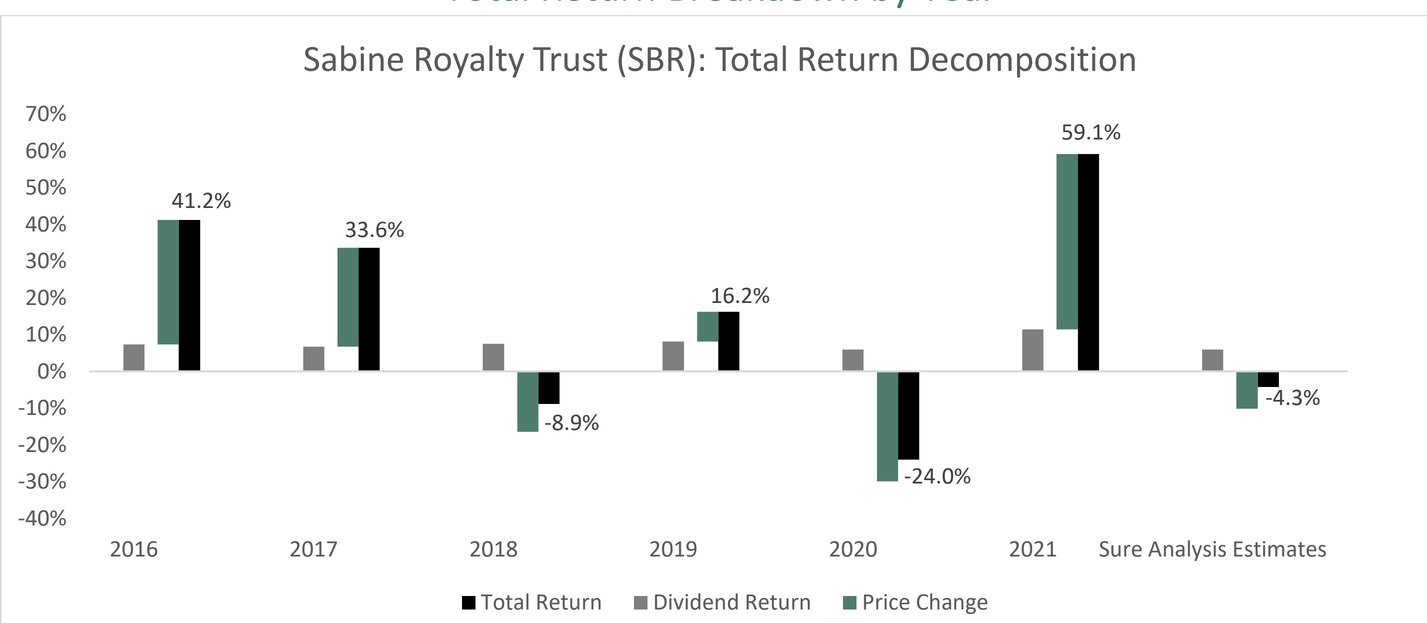
Year	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2027**
Payout	103%	97%	102%	99%	103%	100%	98%	100%	105%	81%	***100%***	***100%***

On the positive side, the trust has been in continuous existence for 39 years paying a 10-year average yield of 7.9%, albeit with considerable volatility in the distributions. Considering that the initial expected life was just 10 years, this longevity is certainly impressive. We also note that the proved developed reserves of oil and gas of SBR have grown 4% and 16%, respectively, since the end of 2017. For some investors, there may be tax advantages resulting from passed-through depletion allowances. However, it is critical to note the pronounced vulnerability of SBR to a downturn in the energy sector, partly due to its limited time horizon. If the energy market incurs a prolonged downturn, it will greatly hurt the returns of SBR. Overall, while the 10.6% distribution yield may entice some income-oriented investors, we believe that the trust is not suitable for most of them due to its huge downside risk in the event of a downturn.

Final Thoughts & Recommendation

SBR is thriving right now, mostly thanks to the conflict between Russia and Ukraine, which has sent the oil and gas prices to multi-year highs. We expect the strong momentum to remain in place in the short run but SBR is highly cyclical and hence it will have significant downside risk whenever the next downcycle of the energy market shows up. We expect the stock to offer a -4.3% average annual return over the next five years, as its 10.6% initial distribution yield and a 1.2% valuation tailwind may be offset by -15.0% decline of distribution. We thus rate the stock as a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	55	61	61	48	30	37	53	47	36	61
Gross Profit	---	---	---	---	---	---	---	---	---	---
Gross Margin	---	---	---	---	---	---	---	---	---	---
SG&A Exp.	2	2	2	2	3	2	3	3	3	3
Operating Profit	52	59	59	46	27	35	50	44	33	58
Operating Margin	95.7%	96.6%	96.1%	95.0%	91.5%	93.3%	95.1%	93.9%	91.6%	95.0%
Net Profit	52	59	59	46	27	35	50	44	33	58
Net Margin	95.7%	96.6%	96.1%	95.0%	91.5%	93.3%	95.1%	93.9%	91.6%	95.0%
Distr. Cash Flow	---	---	---	46	28	35	---	---	---	---

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	5	7	7	6	5	5	9	7	5	16
Total Liabilities	1	1	2	1	1	1	4	1	1	1
Long-Term Debt	0	0	0	0	0	0	0	0	0	0
Partner’s Equity	4	6	5	5	4	5	6	6	4	15
LTD/E Ratio	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	909%	962%	851%	709%	484%	657%	675%	538%	561%	544%
Return on Equity	1065%	1210%	1154%	946%	572%	770%	973%	778%	691%	612%
ROIC	1065%	1210%	1154%	946%	572%	770%	973%	778%	691%	612%
Shares Out.	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6	14.6
Revenue/Share	3.75	4.17	4.19	3.32	2.06	2.55	3.60	3.22	2.49	4.18
DCF/Share	---	---	---	3.16	1.89	2.38	---	---	---	---

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.