Introduction to
Oil & Gas Royalty Ownership

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Welcome

If you’ve been paying attention the past ten years or so, you know that the United States is in the midst of an energy renaissance. What you may not know is that this resurgence in U.S. oil and natural gas production has created a whole new investment landscape, offering risk-adjusted opportunities designed to provide long-term and reliable passive income, tax advantages and appreciation potential.

In this booklet, we explore key facts and points of interest that make Oil & Gas Mineral/Royalty Ownership one of the most unique and flexible investment opportunities available to high net worth investors today.

Mineral/Royalty Ownership Benefits at a Glance...

▶ Reliable Income
Long considered a “mailbox investment,” royalties are paid first from a well’s pre-expensed production revenue. Royalty owners typically receive 12-25% of cash flow after production taxes have been paid.

▶ Long-term Passive Income
Royalty payments are made for as long as an asset produces, which can be upwards of forty years or more in some fields.

▶ Tax Advantages
Royalty owners enjoy a depletion allowance which waives income taxes on the first 15% of royalty income each year.

▶ Asset Value Appreciation Potential
The oil and gas industry is currently in an extended pricing downturn, making the entry costs of asset acquisition lower than what has been seen in years. For investors, this equals the potential to enjoy greater upside as pricing stabilizes and/or returns to the higher numbers seen in the recent past. While pricing will continue to fluctuate, many experts agree that today’s lower commodities pricing represents an attractive opportunity to enter or expand one’s position in the energy industry.

▶ Capital Gains Tax Deferral
As ‘like-kind property,’ oil and gas royalties are eligible for IRC-1031 Exchanges, which provides capital gains tax relief for real estate and energy investors.

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There are three distinct asset classes within the “royalty” space.

When many people think “royalties,” they think of the monthly income received from oil and gas production. There are actually three distinct asset classes within the royalty space, which include both producing and non-producing assets.

Non-Producing Assets

- Mineral interests have a claim on hydrocarbons directly beneath a property’s surface. Producers pay mineral owners for the right to explore, mine and/or mine those hydrocarbons.

By including non-producing assets in an asset portfolio, you own the rights to explore, mine or produce all hydrocarbons underlying your acreage. This provides the advantage of negotiating the actual leases, which opens the door to lease bonuses and delay rentals - extra perks that can substantially impact overall performance potential.

Producing Assets

- Royalty interests receive a percentage of production revenues from the mineral interest owner’s leased investments (the hydrocarbons, as mentioned above).

- Overriding royalty interests (ORRI) are similar to royalty interests in that they receive a stake in a percentage of the production revenues. The ownership percentage, however, is carved out of a producer’s working interest rather than the royalty percentage defined by the lease, thus royalty payments are received only as long as the lease remains in effect. Selling an ORRI in a project or portfolio of projects is an easy way for an operator to boost capital available for exploration, making ORRIs plentiful for purchase.

Mineral ownership offers more control in terms of entering lease agreements with oil and gas companies. Royalty/ORRI ownership, which is more common, is much less complex and provides a fixed royalty rate for immediate income. Royalty/ORRI ownership, however, offers no control over oil and gas lease agreements.

Including a smart combination of non-producing and producing assets can deliver a blend of short, medium, and long term potential revenue streams resulting from producing royalties, periodic payments of lease bonuses, and least extension option payments.
The U.S. Shale Revolution has changed everything

Shale plays are contiguous hydrocarbon-rich formations spanning hundreds, if not thousands, of square miles deep beneath the surface of the earth. Improved extraction methods including horizontal drilling and hydraulic fracking have opened up these long-known oil and gas plays for business - creating a whole new frontier of oil and natural gas production.

Because of the contiguous nature of the rock, shale plays exhibit consistent geology and pressure characteristics, which result in fairly predictable hydrocarbon production. In most cases, it's not a question of whether you'll find oil, it's a matter of how much oil can be produced over the life of a well.

While this is great from a production-potential/risk-reward standpoint for producers – and for royalty owners once that oil and/or gas begins to flow – let's also look at it from a different perspective: product availability. With contiguous plays, third-party reservoir engineers can tell, right up front and with a high degree of certainty, how many hydrocarbons are in the ground. This allows mineral owners to factor out how much their asset is worth. And, because of pooling rules, a mineral owner can choose to carve off a percentage of their ownership amount and sell it for quick cash – while retaining a portion in his or her portfolio.

Key Takeaway: Predictable hydrocarbon production has greatly impacted the availability of royalties – in premium, active locations – in the market.

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Thanks to shale plays, the U.S. Energy Information Administration (EIA) predicts that annual gas production will expand to more than 26 trillion cubic feet (tcf) by 2035 - with shale gas production expected to account for close to 50% of domestic output. Meanwhile, the EIA predicts oil extraction and production from onshore sources will total more than 7 million barrels a day by 2035.

On “pooled” acreage, you receive your share of revenue regardless of where a well is drilled.

Oil and gas producing states utilize unitization or pooling methods to help prevent the drilling of unnecessary wells and to protect the rights of mineral owners. Pooling also helps maximize the recovery of natural resources. What pooling means for mineral and royalty owners is that they’ll receive their percentage share of income from any well producing within these predefined number-of-acre units, regardless of the physical location of the well.

To help ensure smart portfolio diversification, a key to royalty ownership is acquiring small interest positions in as many pooled production sections as possible.

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Royalty owners face no liability and are not responsible for any costs associated with drilling and production.

From capital risk to environmental risks, the oil and gas business is - viewed as a whole - a risky business. Fortunately for royalty owners, risks, liabilities and expenses are borne solely by the working interest owners, i.e. the companies and individuals putting up the money to drill and maintain oil and natural gas wells. In addition to being immune from up-front exploration and drilling costs, royalty owners are also not subject to ongoing capital calls or operator assessments. Other than potential administrative costs associated with managing the asset portfolio, royalty owners contribute nothing outside the initial investment.

When it comes to getting your monthly royalty checks, only Uncle Sam gets his share first.

Much like preferred stock owners, royalty owners are paid first from pre-expensed revenue and typically receive 12% to 25% of cash flow after production taxes have been paid.

Because oil and gas wells are declining assets, it’s smart business to diversify ownership into a large portfolio of wells. In addition, portfolio exposure to non-producing mineral lease ownership is key: the ability to enjoy new revenue streams as new wells are drilled can make the difference between a good investment, and a potentially great one.

How Royalties are Calculated and Paid

Royalties are Cash Payments for the production of oil and natural gas and are paid off the GROSS production, not the NET!

Royalty payments are based on a percentage of the gross oil & gas produced on a property, the terms of which are clearly stipulated in the lease agreement. With the exception of taxes, royalty payments are free from all costs related to exploration and production.* Royalty payments are made by the oil and gas company that has leased the rights to the property and operates the wells.

\[
\text{YIELD} = \frac{\text{PRICE}}{\text{PRODUCTION}} \times \text{INTEREST}
\]

**YIELD:** Gross profits paid to you as the royalty owner

**PRICE:** Market price received for oil & gas produced

**PRODUCTION:** Amount of oil and natural gas produced at the well head

**INTEREST:** Your undivided ownership interest

*The costs of exploration, production and marketing are all assumed by the oil and gas company operating the lease, but other expenses that may be incurred after production can be carried either by the company, the royalty owner, or a combination of both. Be sure to carefully review the royalty clause outlined in your lease agreement for details.
Just like with real estate investing, it’s all about location, location, location.

In the oilfield, and particularly in large, contiguous shale basins, aggressive drilling on acreage is the mechanism behind value creation. Keeping in mind that mineral and royalty ownership is a passive investment,* it’s critical to acquire ownership positions as close as possible to proven acreage where large, well-capitalized operating companies are actively drilling.

The Securities Exchange Commission defines reserve categories as follows:

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<thead>
<tr>
<th>Abbr.</th>
<th>Reserve Category</th>
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<tbody>
<tr>
<td>PDP</td>
<td>Proved-Developed Producing</td>
</tr>
<tr>
<td>PDNP</td>
<td>Proved-Developed Not Producing</td>
</tr>
<tr>
<td>PUD</td>
<td>Proved Undeveloped</td>
</tr>
<tr>
<td>PROB</td>
<td>Probable</td>
</tr>
<tr>
<td>POSS</td>
<td>Possible</td>
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Each category is assigned a value, with PDP (producing wells) being the highest. As new wells are drilled in or around the pooled drilling spacing unit (DSU), reserve types are “proved” thus pushed up the value chain. Possibles (POSS) become Probables (PROB), Probables become Proved Undeveloped (PUDs), etc., and their values are adjusted according.

As continued development “proves up” additional reserves, the market value of royalty interests has the potential to increase, resulting in a better overall ROI.

*While mineral owners do control leasing terms, mineral and royalty owners have no control over property development or leasing commitments.
Minerals & Royalties are considered “real property.”

With ownership conveyed by deed, subsurface minerals and royalties are considered real property and share many positive characteristics with traditional Real Estate:

► **Hard Asset Ownership**

Royalty interests can be a great hedge against inflation, as they aren’t tied to markets.

► **Cash Flow Potential**

Instead of rent from tenants, cash flow is generated from a well’s (or package of wells) monthly hydrocarbon production sales.

► **Underlying Market Value**

Using existing and future commodities pricing markers, the market value of royalty interests can be determined by calculating the estimated value of reserves in place. Much like a real estate development project, value is increased with new development: new wells contribute additional cash flow potential while also increasing the overall asset value of the portfolio.

► **Royalties and Retirement**

For individuals already enjoying retirement, royalty ownership is often considered “mailbox money” designed to help augment their monthly income potential.

For those planning for retirement, income-generating royalties can help significantly amplify retirement savings when used inside an Individual Retirement Account (IRA) or other tax-deferred savings vehicle. By delivering a monthly cash infusion, royalty payments into your IRA provide the means to strategically invest in new opportunities or to take advantage of dollar-cost averaging in existing investments - all tax-deferred under your retirement plan.
Benefits of Exchanging into Oil & Gas Royalties

Royalties are essentially rental payments paid to royalty owners by oil and gas producers based on a fixed percentage of the gross production from the property. As a Royalty Owner, you receive a share of the gross production revenue without paying for any of the monthly expenses associated with future exploration and development on the property.

Capital gains tax deferral
A 1031-Exchange allows investors to diversify their portfolios while deferring capital gains taxes.

Maximum capital available to invest
A 1031-Exchange maximizes the amount of capital available to invest, which helps not only maximize potential personal investment returns, but also helps promote the nation’s overall economic health.

Exposure to non-market correlated cash flow potential
A 1031-Exchange into minerals/royalties provides exposure to non-market correlated cash flow potential. Unlike commercial real estate that is driven by rents, royalty cash flow is generated from a well’s monthly production sales. Additional cash flow may be added as new wells are drilled on the acreage.

Asset appreciation potential
Mineral/royalty ownership in unconventional shale plays provides exposure to upside potential. As continued development “proves up” additional reserves, the market value of royalty interests has the potential to increase, resulting in a better overall ROI.

Key Facts & Points of Interest

Oil & Gas Royalties & the 1031-Exchange

As deeded real property, oil and gas mineral and royalty interests are considered “like-kind” replacement property for the purposes of a 1031 exchange. This means that investors have the option of investing all or a portion of the proceeds from a commercial real estate transaction into oil and gas minerals – all while deferring capital gains taxes.

Like-Kind Replacement Property
Easy Rule of Thumb: If the property sold is deeded and held for investment and/or business-purposes, the capital gains from the sale of that property can be used to purchase another piece of property that will be held for investment and/or business-purposes.
Five Key Things You Need to Know About Executing a 1031-Exchange

Net Selling Price (NSP = selling price less closing costs)

In order to defer all of the capital gains on the property you are selling, you must purchase a replacement property, or group of properties, using an amount equal to your NSP. If you purchase replacement property for less than your NSP, you will owe capital gains tax on the difference.

Qualifying Properties / Qualifying Replacement Properties

To qualify for a 1031-Exchange, the property you are looking to sell MUST be deeded and held for investment and/or business-purposes. Proceeds from the sale of the property can then be used to purchase deeded Replacement Property, which must be held for investment and/or business-purposes.

Qualified Intermediary

Current tax regulations require that you use a Qualified Intermediary (QI) to facilitate your exchange. The QI will prepare the Exchange Agreement, escrow the proceeds, and coordinate the exchange with the closing agents.

45-Day Rule

From the date of the sale of your original property, you have 45 days to identify three (3) replacement properties.

180-Day Rule

You have 180 days from the date of sale of your original property to close on any and all identified replacement properties.

IMPORTANT NOTE

To qualify for a 1031-Exchange, you DO NOT have to exchange into the exact same type of property you’re selling. For example, you could sell an apartment building then roll any capital gains, tax-deferred, into a Triple Net Lease opportunity. Or, you could use your gains to purchase a rental property plus oil and gas assets if you are looking to diversify your portfolio.

Like-Kind Replacement Property Options Include:

- Rental Properties
- Owner-Occupied Business Properties
- Multi-Family Properties
- Commercial Properties or Triple Net Leases
- Tenancy in Common (TIC) Properties
- Condos and/or Hotels
- Oil and Gas Properties
- Raw Land

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Some risks to consider when evaluating oil and gas royalties

1. Royalty owners have no input in the operational decisions in an existing well.

2. Royalty owners have no input to drill additional wells. There is no guarantee additional wells will be drilled and completed.

3. Oil and Gas pricing is volatile

4. Oil and Gas reserves are a declining asset

5. Liquidity may be limited.

6. Overriding royalty interest expires with expiration of the lease.
Contact us today to learn more about how oil and gas royalties may benefit your portfolio

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API Royalties representatives are standing by to discuss your personal investment opportunities