

Gulf Coast Ultra Deep Royalty Trust (GULTU) - A Very Special Situation

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In a recent interview ([here](#)), T. Boone Pickens was asked about Gulf Coast Ultra Deep Royalty Trust (GULTU) and he immediately changed subjects. Odd, isn't it, that a guy who has a lot to say about everything all the sudden doesn't want to talk?

It was his reaction that piqued my curiosity. So I dug in. And what I learned makes me believe Gulf Coast Ultra Deep Royalty Trust is a very special situation.

GULTU was created in connection with Freeport-McMoRan Copper & Gold's acquisition of McMoRan Exploration, which was completed on June 3, 2013. Immediately prior to the merger, McMoRan created a trust and conveyed a 5% gross overriding royalty interest in the future production from 20 specified shallow water ILTC (Inboard Lower Tertiary / Cretaceous) exploration prospects located on the Shelf of the Gulf of Mexico and onshore South Louisiana.

The nature of the overriding royalty interest means that **GULTU owns a share of future production yet doesn't have to pay any of the operating expenses or development costs**. So the holders in GULTU are getting a free ride on the back of McMoRan's exploration and development efforts in the Gulf and Southern LA.

There are a few things that are notable about the Trust:

- The Royalty Trust is a passive entity and has no employees. All administrative functions of the Royalty Trust are performed by the Trustee who gets paid \$150k / year.
- If the Trust lacks sufficient funds to pay administrative expenses, FCX has agreed to pay annual trust expenses up to a maximum amount of \$350,000, **with no right to repayment or interest due**. In addition to this annual contribution, FCX has agreed to lend money, on an unsecured, interest-free basis, to the Royalty Trust to cover additional administrative expenses. **So not only do unitholders get a free ride on McMoRan's exploration and development efforts, but FCX is paying the Trust's operating bills!** This is perhaps the definition of "special situation".
- The only assets of the Royalty Trust are the royalty interests. The Royalty Trust is not permitted to acquire other oil and natural gas properties or mineral interests or otherwise engage in activities beyond those necessary for the conservation and protection of the royalty interests.
- If and when there is cash flow to the Trust, distributions will be made quarterly.
- The Royalty Trust is **not subject to tax** at the Royalty Trust level. Rather, the Royalty Trust unitholders are considered to own and receive the Royalty Trust's assets and income and are directly taxable thereon as though no trust were in existence.
- The Royalty Trust will dissolve on the earlier of (1) June 3, 2033, (2) the sale of all of the royalty interests, (3) the election of the Trustee following its resignation for cause, (4) a vote of the holders of 80% (which after June 3, 2018, shall be reduced to 66?%) or more

of the outstanding royalty trust units held by persons other than FCX or any of its affiliates, at a duly called meeting of the Royalty Trust unitholders at which a quorum is present, or (5) the exercise by **FCX of the right to call all of the royalty trust units at \$10 per royalty trust unit (can only call after June 3, 2018).**

The last part is important: FCX has a call option which means if McMoRan is successful in the ILTC, the upside to unitholders is limited to \$10 / share plus whatever distributions are paid prior to June 2018.

So we have a tax-free entity (pass through) with very little / no costs that owns the following interests:

<u>Subject Interest Name</u>	<u>McMoRan's Estimated Working Interest Related to the Subject Interests</u>	<u>Operator</u>	<u>Royalty Trust's Estimated Overriding Royalty Interests (5% proportionately reduced to reflect the Estimated Working Interest)</u>
Davy Jones	63.4%	McMoRan	3.17%
Blackbeard East	72%	McMoRan	3.6%
Lafitte ^(a)	—	McMoRan	—
Blackbeard West	69.4%	McMoRan	3.47%
England ^(b)	36%	Chevron	1.8%
Barbosa	72%	McMoRan	3.6%
Morgan ^(c)	—	McMoRan	—
Barataria	72%	McMoRan	3.6%
Blackbeard West #3	69.4%	McMoRan	3.47%
Drake	72%	McMoRan	3.6%
Davy Jones West	36%	McMoRan	1.8%
Hurricane	72%	McMoRan	3.6%
Hook	72%	McMoRan	3.6%
Captain Blood	72%	McMoRan	3.6%
Bonnet	72%	McMoRan	3.6%
Queen Anne's Revenge	72%	McMoRan	3.6%
Calico Jack	36%	McMoRan	1.8%
Highlander	72%	McMoRan	3.6%
Lineham Creek	36%	Chevron	1.8%
Tortuga	72%	McMoRan	3.6%

Note: the last 3 (Highlander, Lineham Creek and Tortuga) are located in onshore South Louisiana. The rest are offshore targets. Additional targets acquired by McMoRan on or before December 5, 2017 in the Lafitte, England or Morgan blocks are also subject to an overriding royalty interest by GULTU.

All of these targets are located in the ultra-deep (generally greater than 18,000 total vertical depth), making each well unusually expensive to drill. This means that for McMoRan to go ahead and develop a target, they have to find something truly elephant-sized. And if they do, I

believe unitholders will find their shares at or near \$10 in a hurry.

I have no special insight into the success or failure of individual prospects. But I am aware that recent advances in technology have increased the odds of success for oil exploration companies ([read about some of those advances here](#)). Perhaps what's most interesting to me is that I get to share in the economics of 20 large exploration blocks (with likely hundreds of individual exploration targets) while a large, well-capitalized company pays the bills. It's hard to find a better deal than that in the public markets.

It seems I am not the only investor that finds GULTU "interesting". Big, well known funds have been quietly buying in size. Just take a look at the top shareholders:

- Paulson owns 6% ([source](#))
- Leon Cooperman owns 7.3% ([source](#))
- Mount Kellett has been buying hand over fist and now owns 16% ([source](#))
- FCX owns 27% ([source, p 41](#))

Four investors hold nearly 60% of the stock! At today's price, investors are paying \$680MM for assets that have been assigned an initial value of \$400MM (obviously that value is subject to change with exploration success or failure). One successful well and it's probable that FCX buys you out at \$10 in June 2018. Multiple failures and it's probable that McMoRan continues its work trying to locate that elephant.

In the meantime, GULTU is working on listing their units on the Nasdaq ([source](#)).

Special indeed.