

## **Mesa Royalty Trust** **Long Reserve Life Reported**

<i>Symbol</i>	MTR	<i>Ebitda Next Twelve Months ending 3/31/06 (US\$mm)</i>	12
<i>Rating</i>	None	<i>North American Natural Gas/Ebitda (%)</i>	76
<i>Price (US\$/sh)</i>	65.90	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	3/23/05	<i>Adjusted Reserves/Production NTM</i>	23.2
<i>Shares (mm)</i>	1.86	<i>EV/Ebitda</i>	10.3
<i>Market Capitalization (US\$mm)</i>	123	<i>PV/Ebitda</i>	9.4
<i>Debt (US\$mm)</i>	0	<i>Undeveloped Reserves (%)</i>	2
<i>Enterprise Value (EV) (US\$mm)</i>	123	<i>Natural Gas and Oil Ebitda (US\$/mcfe)</i>	5.35
<i>Present Value (PV) (US\$mm)</i>	112	<i>Present Value Proven Reserves(US\$/boe)</i>	15.38
<i>Net Present Value (US\$/unit)</i>	60	<i>Present Value Proven Reserves(US\$/mcfe)</i>	2.56
<i>Debt/Present Value</i>	0.00	<i>Earnings Next Twelve Months (US\$/un)</i>	5.62
<i>McDep Ratio - EV/PV</i>	1.10	<i>Price/Earnings Next Twelve Months</i>	12
<i>Distribution Yield (%/year)</i>	8.5	<i>Distribution Next Twelve Months (US\$/sh)</i>	5.62

Note: Estimated cash flow and earnings tied to one-year futures prices for natural gas.  
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### **Summary and Recommendation**

Units of small cap **Mesa Royalty Trust (MTR)** offer a high quality income stream backed by a reported 14 year life index for the Hugoton field of Kansas and longer for the San Juan Basin of New Mexico. Hugoton properties operated by Pioneer Natural Resources (PXD) account for about 38% of value while San Juan Basin properties operated by **ConocoPhillips (COP)** account for about 62% of value. The longest reported reserve life index among peers supports a unit price implying a distribution yield of 8.5% a year. Estimated net present value of \$60 a share presumes a long-term oil price of \$40 a barrel compared to recent quotes for delivery over the next six years above \$50 a barrel.

### **San Juan Share of Distribution Expected to Rise**

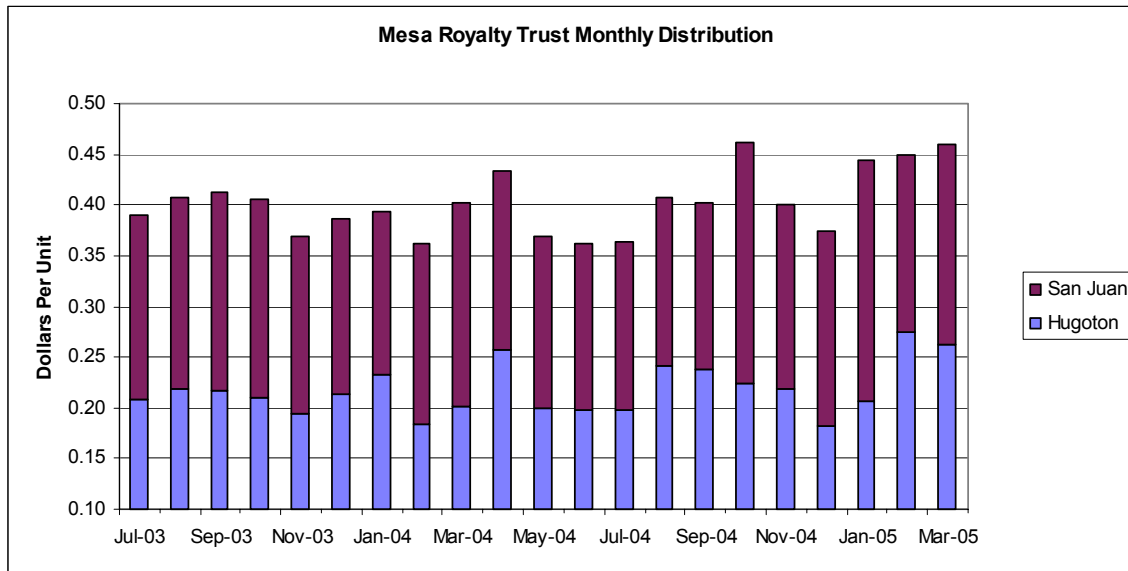
When the trust declares monthly distributions it discloses the amount of royalty income separately for Hugoton and San Juan (see chart Monthly Distribution). No further volume, price or development cost detail is available on a monthly basis. On the cash basis of accounting the distributions can fluctuate for non-predictable reasons in addition to industry conditions. The San Juan contribution to distribution is understated because funds are withheld to develop additional production.

### **Commodity Price Drives Higher Distributions**

MTR's distribution declarations lag natural gas price by about two months. As a result we know the industry conditions that contribute to the distributions to be declared in

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April and May. Beyond that we use futures prices to guide projections (see table Next Twelve Months Operating and Financial Performance). Once a week we publish updated estimates that take account of latest futures for the next twelve months (see weekly analysis *U.S. Natural Gas Royalty Trusts*).



On a quarterly basis, the trustee discloses working interest volumes, prices, expenses and development outlays that allow us to look behind the monthly distribution. It is helpful in understanding the trends to see volume that represents actual production and ongoing cash flow before deductions for capital expenditure. Volumes and prices are disclosed separately for Hugoton and San Juan, but not “capex”. As a result, we calculate quarterly cash flow, Ebitda, on a combined basis for the two producing areas. Ebitda is one of the links to comparing the valuation of MTR with other covered stocks. The other link is reserve life.

### Long Reserve Life Reported

In its annual report just released, the trust discloses reserves of natural gas that amount to 22 times latest year’s production and for oil, 26 times. The typical oil and gas company reports a reserve life index of less than ten times, or ten years. Long life implies that cash flow will last longer and therefore is worth a high multiple.

A life index of about 14 years for Hugoton could be comparable to the working interest basis that operating companies use to report reserves. Because MTR’s ownership of natural gas resources is in the form of a “net profits interest”, the reporting of reserves goes through contortions to report cubic feet that are net of normal expense.

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**Mesa Royalty Trust**  
**Next Twelve Months Operating and Financial Performance**

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>3/31/06</i>
<b>Volume (90% of working interest)</b>										
Natural Gas (bcf)	0.43	0.44	<b>1.77</b>	0.43	0.42	0.43	0.42	<b>1.70</b>	0.42	<b>1.68</b>
Natural Gas (mmcf)	4.7	4.8	<b>4.8</b>	4.7	4.7	4.6	4.6	<b>4.6</b>	4.5	<b>4.6</b>
Days	92	92	<b>366</b>	92	89	92	92	<b>365</b>	92	<b>365</b>
Oil (mmb)	0.02	0.02	<b>0.09</b>	0.02	0.02	0.02	0.02	<b>0.09</b>	0.02	<b>0.09</b>
Oil (mbd)	0.24	0.26	<b>0.26</b>	0.26	0.26	0.26	0.25	<b>0.26</b>	0.25	<b>0.25</b>
Total (bcfe)	0.57	0.58	<b>2.33</b>	0.58	0.55	0.57	0.56	<b>2.26</b>	0.55	<b>2.23</b>
Total (mmcf)	6.2	6.3	<b>6.4</b>	6.3	6.2	6.2	6.1	<b>6.2</b>	6.0	<b>6.1</b>
<b>Price (Henry Hub and WTI Cushing lagged two months)</b>										
Henry Hub (\$/mmbtu)	6.24	5.64	<b>5.74</b>	7.23	6.61	7.46	7.61	<b>7.23</b>	8.25	<b>7.48</b>
Differential (\$/mmbtu)	0.91	0.57	<b>0.81</b>	1.02	0.93	1.05	1.07	<b>1.02</b>	1.16	<b>1.05</b>
Company (\$/mcf)	5.33	5.07	<b>4.93</b>	6.21	5.68	6.41	6.53	<b>6.21</b>	7.09	<b>6.43</b>
WTI Cushing (\$/bbl)	39.71	48.00	<b>39.06</b>	46.07	53.08	57.38	57.75	<b>53.57</b>	57.62	<b>56.46</b>
Differential	14.53	17.72	<b>13.22</b>	15.59	17.96	19.42	19.54	<b>18.16</b>	19.53	<b>19.11</b>
Company (\$/bbl)	25.18	30.27	<b>25.84</b>	30.48	35.12	37.96	38.21	<b>35.41</b>	38.09	<b>37.35</b>
Total (\$/mcf)	5.07	5.06	<b>4.78</b>	5.93	5.72	6.39	6.49	<b>6.13</b>	6.90	<b>6.38</b>
<b>Revenue (\$mm)</b>										
Natural Gas	2.32	2.22	<b>8.71</b>	2.69	2.36	2.72	2.75	<b>10.53</b>	2.95	<b>10.79</b>
Oil	0.57	0.73	<b>2.44</b>	0.73	0.81	0.89	0.89	<b>3.32</b>	0.88	<b>3.46</b>
Total	2.88	2.95	<b>11.15</b>	3.42	3.16	3.62	3.64	<b>13.84</b>	3.83	<b>14.25</b>
<b>Expense</b>	0.44	0.39	<b>1.59</b>	0.53	0.46	0.59	0.60	<b>2.18</b>	0.66	<b>2.30</b>
<b>Ebitda</b>	2.44	2.56	<b>9.56</b>	2.89	2.71	3.02	3.04	<b>11.66</b>	3.17	<b>11.94</b>
Development (90%)	0.25	0.25	<b>0.71</b>	0.26	0.26	0.26	0.26	<b>1.04</b>	0.26	<b>1.04</b>
<b>Royalty Income</b>										
Hugoton	1.27	1.17	<b>4.82</b>	1.39						-
San Juan	0.92	1.15	<b>4.03</b>	1.15						-
Total Royalty Income	2.19	2.32	<b>8.86</b>	2.63	2.45	2.76	2.78	<b>10.62</b>	2.91	<b>10.90</b>
Administrative	0.01	0.01	<b>0.04</b>	0.11	0.11	0.11	0.11	<b>0.43</b>	0.11	<b>0.43</b>
<b>Distributable Income (\$mm)</b>	2.18	2.31	<b>8.81</b>	2.52	2.34	2.66	2.67	<b>10.19</b>	2.81	<b>10.48</b>
Per Unit (\$)	1.17	1.24	<b>4.73</b>	1.35	1.26	1.43	1.43	<b>5.47</b>	1.51	<b>5.62</b>
<b>Units (millions)</b>	1.86	1.86	<b>1.86</b>	1.86	1.86	1.86	1.86	<b>1.86</b>	1.86	<b>1.86</b>
Ebitda Margin	85%	87%	<b>86%</b>	84%	86%	84%	84%	<b>84%</b>	83%	<b>84%</b>

A life index of some 33 years for San Juan is probably not meaningful in a working interest sense. One adjustment we might make is to increase last year's "production" by about 15% to adjust for the reduction in volume related to the development outlays. Reserve life would still be a high 29 years.

Taking the Hugoton reserve life near face value we can readily justify a cash flow multiple of 8 times considering the correlation of values for some 30 stocks we cover (see table Geographic Cash Flow and Present Value). For the San Juan Basin a cash flow multiple of 10.5 times can be justified by a 16 year life in the correlation, much shorter than the 29 year life index in our modified version of reported estimates.

**Geographic Cash Flow and Present Value**

	<i>NTM Ebitda</i> <i>(US\$mm)</i>	<i>Adjusted</i> <i>R/P</i>	<i>PV/</i> <i>Ebitda</i>	<i>Present</i> <i>Value</i> <i>(US\$mm)</i>	
Hugoton Field	5.4	14.3	8.0	43	38%
San Juan Basin	6.6	32.9	10.5	69	62%
	11.9	23.2	9.4	112	100%
Debt (US\$mm)				-	
Net Present Value (US\$mm)				112	
Units (mm)				1.86	
Net Present Value (US\$/sh)				60	

**Discounted Cash Flow Analysis Illustrates Present Value**

The long reported reserve life implies a level of production higher than the normal decline at some point. We expect that production in the San Juan Basin will be enhanced by development spending. Yet the trust does not report any significant quantity of undeveloped reserves in its proven amounts. Hugoton reserves may not be declining as fast as allowable production because MTR is in the heart of the field. We can also see that the installation of vacuum equipment could enhance Hugoton production. All of those considerations are somewhat reflected in the comparatively slow volume decline that we project in the cash flow model (see table Present Value).

The first line of the model is consistent with the projections from the Next Twelve Months table above. Among assumptions for future years is constant oil price at \$40 a barrel. Yet, the price stated in natural gas terms goes up because we build in an increasing ratio of natural gas price to oil price. Though that assumption is not currently supported in the futures market, we believe it remains reasonable. About a quarter of the trust's royalty income is from natural gas liquids whose price depends partly on oil price.

Since no general inflation is built into the projections the discount rate of 7% per year represents a real return after inflation. That is a high rate for a high quality investment. One explanation for why our valuations for royalty trusts are slightly higher than stock price may be that investors need less return to compensate for risk. A 5% real return is more normal for long-term investments. In that case the present value of MTR, if nothing else changed, would be \$72 instead of \$60 a unit. Current stock price in between those bounds may represent an expected real return of 6% a year.

Perhaps the model is too conservative overall. In its 25 years the trust has delivered a real return about equal to its 8% a year expected distribution.

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## Mesa Royalty Trust Present Value

Volume Decline (%/yr):	5	Oil Price Post 2006 (2003\$/bbl)	40
Volume Enhancement (%/yr):	4	Real Discount Rate (%/yr):	7.0
Capex/Cash Flow (%):	10	MTR Price/Henry Hub	0.85
Variable Cost (%):	8.8	Adjusted Reserve Life Index (years):	18.0

Year	Basic (bcf)	Volume Enhanced (bcf)	Total (bcf)	Price (\$/mcf)	Revenue (\$mm)	Fixed Cost (\$mm)	Variable Cost (\$mm)	Cap Ex (\$mm)	Distribution (\$mm)	(\$/unit)	Disc Factor	Present Value (\$/unit)
Total 2006 through 2035; years ending on 3/31												
	35	10	45	7.01	318	44	28	10	235	126	0.48	60.00
2006	2.23	0.00	2.23	6.38	14.25	1.48	1.25	1.04	10.48	5.62	0.97	5.43
2007	2.12	0.08	2.21	5.78	12.75	1.48	1.12	1.01	9.13	4.90	0.90	4.43
2008	2.02	0.16	2.18	5.89	12.83	1.48	1.13	1.02	9.20	4.94	0.84	4.17
2009	1.92	0.23	2.15	6.01	12.90	1.48	1.14	1.03	9.26	4.97	0.79	3.92
2010	1.82	0.30	2.12	6.12	12.98	1.48	1.14	1.04	9.32	5.00	0.74	3.69
2011	1.73	0.36	2.09	6.23	13.05	1.48	1.15	1.04	9.38	5.03	0.69	3.47
2012	1.64	0.42	2.07	6.35	13.11	1.48	1.15	1.05	9.43	5.06	0.64	3.26
2013	1.56	0.48	2.04	6.46	13.17	1.48	1.16	1.05	9.48	5.09	0.60	3.06
2014	1.48	0.53	2.01	6.57	13.23	1.48	1.16	1.06	9.53	5.11	0.56	2.88
2015	1.41	0.58	1.99	6.69	13.28	1.48	1.17	1.06	9.57	5.14	0.53	2.70
2016	1.34	0.55	1.89	6.80	12.83	1.48	1.13		10.22	5.49	0.49	2.70
2017	1.27	0.52	1.79	6.91	12.39	1.48	1.09		9.82	5.27	0.46	2.42
2018	1.21	0.50	1.70	7.03	11.97	1.48	1.05		9.44	5.06	0.43	2.17
2019	1.15	0.47	1.62	7.14	11.55	1.48	1.02		9.06	4.86	0.40	1.95
2020	1.09	0.45	1.54	7.25	11.15	1.48	0.98		8.69	4.66	0.37	1.75
2021	1.04	0.42	1.46	7.37	10.76	1.48	0.95		8.33	4.47	0.35	1.57
2022	0.98	0.40	1.39	7.48	10.37	1.48	0.91		7.98	4.28	0.33	1.40
2023	0.93	0.38	1.32	7.59	10.01	1.48	0.88		7.65	4.10	0.31	1.26
2024	0.89	0.36	1.25	7.71	9.65	1.48	0.85		7.32	3.93	0.29	1.12
2025	0.84	0.35	1.19	7.82	9.30	1.48	0.82		7.00	3.76	0.27	1.00
2026	0.80	0.33	1.13	7.93	8.96	1.48	0.79		6.70	3.59	0.25	0.90
2027	0.76	0.31	1.07	8.05	8.64	1.48	0.76		6.40	3.43	0.23	0.80
2028	0.72	0.30	1.02	8.16	8.32	1.48	0.73		6.11	3.28	0.22	0.72
2029	0.69	0.28	0.97	8.27	8.01	1.48	0.71		5.83	3.13	0.20	0.64
2030	0.65	0.27	0.92	8.39	7.72	1.48	0.68		5.56	2.98	0.19	0.57
2031	0.62	0.25	0.87	8.50	7.43	1.48	0.65		5.30	2.84	0.18	0.51
2032	0.59	0.24	0.83	8.61	7.15	1.48	0.63		5.05	2.71	0.17	0.45
2033	0.56	0.23	0.79	8.73	6.88	1.48	0.61		4.80	2.58	0.16	0.40
2034	0.53	0.22	0.75	8.84	6.63	1.48	0.58		4.56	2.45	0.15	0.36
2035	0.50	0.21	0.71	8.95	6.37	1.48	0.56		4.34	2.33	0.14	0.32

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