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THE BIG SECRET ON WALL STREET

The Hundred-Year-Old Money Machine

- This High-Margin Royalty Company Has Years of Growth Ahead
- Profiting Off Land, Oil, and Water in the Desert

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

The Hundred-Year-Old Money Machine

This High-Margin Royalty Company Has Years of Growth Ahead

Profiting Off Land, Oil, and Water in the Desert

The cool winter months are prime building season in steamy Fort Bend County, Texas.

And the Fort Bend School District's latest construction project, a new career and technical center, was on time and on budget... until February 2018, when the backhoe struck bone.

And more bone.

Some 19,570 bones later – comprising 95 complete human skeletons – the Fort Bend construction project was put on indefinite hold while sensational news reports abounded and the Texas Historical Commission pieced together the full story...

The Fort Bend builders had inadvertently unearthed the nation's largest mass grave for slaves: 94 African-American men and one woman, who'd been literally worked to death at Sugar Land, once Texas's largest sugar plantation. The "Sugar Land 95" had harvested sugar cane while chained hand and foot. The chains were buried there, too.

Forensic analysis revealed the victims ranged in age from 14 to 70... and they had all died between 1878 and 1912.

No, that's not a typo. These Americans died in chains decades after the Union army trounced the Confederates to end the Civil War in 1865... decades after slavery had been "abolished" via the Thirteenth Amendment to the U.S. Constitution.

And it was all perfectly legal.

Revisionist historians often gloss over this fact, but the legislators who penned the Thirteenth Amendment purposely left in a loophole that allowed slavery to continue under certain circumstances. After all, without the South's slave-fueled cotton and sugar industries, vast swathes of the U.S. would go bankrupt. (Cotton alone brought in $5 billion yearly in today's dollars, accounting for over 60% of U.S. exports.)

The carefully worded amendment read: "Neither slavery nor involuntary servitude, except as punishment for crime, whereof the party shall have been duly convicted, shall exist within the United States, nor any place subject to their jurisdiction"

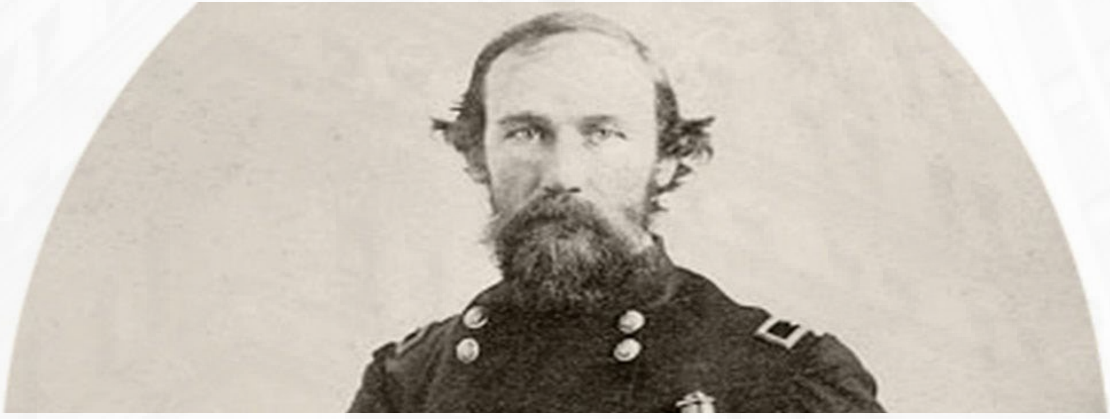
In other words, the government just needed a few trumped-up crimes, a few (thousand) extra convictions, and a handy prison-to-sugar-fields pipeline… and slavery lived on, just under a different name.

That name was "convict leasing" – a spectacularly unjust system that used special "Black Laws" to nail African-Americans for "crimes" like flirting with white women, being unemployed, or standing somewhere a white person didn't want them to. Once the "suspects" (generally, young men in prime working condition) were in jail, the prison would then rent the inmates out to industrial cotton and sugar farms as forced labor.

It was a brutal system, rife with whippings, clubbings, inhumane work conditions, dysentery, and malaria. In Texas alone, an estimated 3,500 leased convicts died between 1866 and 1912, when the program ended – much more than the total number of African-Americans who were lynched in Southern states during the same time period. Most of the inmates at Sugar Land died within two years of arrival. But the most stunning thing about convict leasing wasn't its cruelty…

Do As I Say, Not As I Do

Remarkably, the convict-leasing system was championed by the exact people you'd think would abhor it: the "enlightened" abolitionists who'd made the most noise about freedom and equality for slaves… people who, today, would likely identify as bleeding-heart liberals.



"Pro-black," pro-abolition Texas Governor Edmund J. Davis (more on him in a moment) was one of these oxymoronic characters. He was a white Southerner who'd been opposed to secession and served as a general in the Union Army – and later, as a Union-friendly "puppet governor" after the South surrendered. His fellow Texans saw him as a sellout and a traitor… but "opportunist" might be the better word.

Publicly, Davis championed full equality and citizenship for freed slaves… but, with far less fanfare, in 1871, he leased the entire Texas prison system to a group of Galveston businessmen who needed cheap labor to build a railroad. Despite reports of serious abuse – and convicts cutting off their own fingers to get out of the system – Governor Davis was happy to let the program continue (and to pad the state budget with lease payments that would amount to millions of dollars today).

Why would an avowed Civil War abolitionist support Slavery 2.0?

As we've **written before**, history often comes in uncomfortable shades of gray. And despite lots of cherished American mythology, the truth is, folks like Edmund J. Davis – and the Northern politicians who wrote in the "slavery for convicts" escape clause – weren't really that concerned with freeing enslaved Black people. That wasn't the point of the Civil War. Slavery was a useful talking point to get people riled up… but not the main issue.

The *real* goal was getting the uppity, too-independent Southern states back in line and making sure they didn't disobey orders from the "Big House" – the federal government.

When the North won the war, big government officially trumped states' rights – and in many cases created a dystopian hellscape that was a lot worse than before. (It also laid the groundwork for plenty of other "hidden" forms of slavery in decades to come. For-profit prisons spring to mind. So does the welfare state.)

That overbearing central government handed Texas its infamous "woke" constitution in 1869… setting in motion a seven-year-long disaster that ended with the state capitol door getting smashed in with an axe.

That fiasco also spawned one of the most lucrative land-royalty companies of all time… but that came later…

Where Have All The Cowboys Gone?

Once the South surrendered, Reconstruction, the painful years of post-conflict rebuilding, began. Naturally, it happened on terms determined by the (winning) U.S. government.

Those terms were stern. President Andrew Johnson appointed a temporary governor for each former Confederate state until the states agreed to the Thirteenth Amendment. Once they'd updated their laws (and proven their loyalty to Washington, D.C.'s satisfaction), they'd be allowed to rejoin the Union.

If you've ever met anyone from Texas, you can already imagine how well this went...

Texans aren't fond of being told what to do (remember the Alamo?), and they point-blank refused to ratify the amendment. So in June 1865 – two months after the end of the Civil War – the U.S. government sent 2,000 federal troops down to occupy Texas until the stubborn cowboys came to their senses.

Along with the military presence came the unwelcome person of "traitor" Edmund J. Davis. The federal military held a special "election" in 1869 installing Davis as governor, ginned up a kangaroo constitutional convention, and helped Davis draw up a new, government-approved Texas constitution.

It included the Thirteenth Amendment... and it took away pretty much everything that made Texas, Texas.

Some of the features of this constitution wouldn't look out of place in ultra-liberal Democrat legislation today. States' rights were downplayed in favor of sweeping federal control. Citizens were taxed heavily to contribute to a public-school fund. They were also taxed to pay for a Bureau of Immigration, which would bring in foreigners and settle them within the state. (Just imagine seeing that on the ballot at your next state election...)

Crucially, the constitution forbade Texas from using state funds to support private enterprise like railroads – that would just encourage too much independence altogether.

But the constitution did one thing right: It got the government off Texas' back. With the Thirteenth Amendment finally enshrined in state law, Washington withdrew troops from Texas in 1870 and welcomed the Lone Star State back into the union.

First item on the new state's agenda: vote the hated Davis out in a landslide. (He didn't take kindly to the rejection and, as protest, locked his keys in his former office in the state capitol – that's when the door got smashed with the axe.)

Next up: a brand-new constitution, which was ratified in 1876. It's a limited-government, "don't mess-with-Texas" piece of legislature that's still in place today, with some minor modifications.

While the Thirteenth Amendment (and its regrettable convict clause) remained intact, most of the other nonsense got slashed. One centerpiece of the new constitution was the right to use state funds to improve infrastructure within the state.

Notably, for the first time in state history, it codified "land grants" into law. The constitution allowed the government to offer large parcels of free land as incentives to private railroads to bring their business to the Lone Star State. It was those "great big tracts of land" that enticed robber baron and railroad magnate Jay Gould to Texas in 1880.

Sensing opportunity in the new, railroad-friendly constitution, real-estate-hungry Gould routed several of his train lines through the state in exchange for 16 prime parcels of land per each mile of track he put down.

And many years later, the acres Gould scored as part of that railroad deal would create the capital efficient land royalty company we're analyzing in this issue.

Since then, this business has become one of the longest-running success stories in the American stock market. An initial investment of $3,000 at its formation in the late 1800s would have grown into $2 billion today. And despite its incredible track record of wealth creation, few investors have ever heard of it.

This obscure security has no coverage from Wall Street analysts, for one simple reason: it doesn't need to hire big banks to raise new capital. That's because this incredibly capital efficient business generates all the cash it will ever need, with plenty left over for consistent dividend payouts and share repurchases. In fact, due to its unusual structure, it was originally formed with the sole objective of returning capital to investors.

From Busted Railroad to America's Richest Landlord

The stock we're analyzing is that of the **Texas Pacific Land Corporation (NYSE: TPL)**.

In business for 136 years, the company has a market cap of $35 billion, annual revenue of about $675 million, and profit margins regularly exceeding 60%. It has just 100 employees.

Texas Pacific traces its roots back to the Texas and Pacific Railway Company (T&P), founded in 1871 and acquired by Jay Gould in the late 1870s. The original aim of the company was to build a transcontinental railroad from Marshall, Texas, to San Diego,

California, in order to promote trade between the southern U.S. states and those on the West Coast (and Texas's generous land grant legislation made that goal a lot more realistic).

While a number of Gould's other railway ventures were successful, the T&P didn't pan out. After a series of operational setbacks and financial difficulties, the Texas and Pacific Railway Company filed for bankruptcy in 1885. The railroad had pledged 3.5 million acres of land in west Texas as security for its bondholders. As part of the bankruptcy proceedings, the bonds were converted to shares in a new entity called the Texas Pacific Land Trust, formed in 1888. The Trust took control of the land collateral, and was given a simple mandate: sell off the land and return the proceeds to shareholders.

There was just one small problem. In 1888, there wasn't exactly ravenous demand for the desolate prairie lands in west Texas. In order to avoid dumping the land all at once, no specific timetable was given for liquidation. This allowed the trustees to sell off parcels gradually over time, in order to maximize value for Trust shareholders.

This little piece of legal fine print ultimately transformed a bankrupt railroad company into one of the greatest success stories in American finance. Since the trust wasn't forced to liquidate all of its land at the prevailing 1888 rates of $5 per acre, it ultimately retained ownership of land that today sells for upwards of $50,000 per acre.

But the key to this land's value lies beneath its surface. Along with ownership of the surface-level land, the Texas and Pacific Railway Corporation also received the mineral rights on its 3.5 million acres – meaning any natural resources sitting underground. And though no one knew it at the time, this west Texas land sat atop one of the richest oil deposits in the world.

The Birth of America's Largest Oil Basin

At the turn of the 20th century, Texas was barely on the map in the oil industry, producing less than 1 million barrels in 1900 (today it produces 5x that annual amount every day). Everything changed in 1901, when Anthony F. Lucas drilled what became known as the Lucas Gusher oil well just outside the Gulf Coast town of Beaumont, Texas. Lucas had tapped into the prolific Spindletop oilfield, and released a flood of oil at a rate of 100,000 barrels per day (b/d). The single well produced 17 million barrels of oil the following year, and kicked off the first major oil boom in Texas.

Over the next decade, oil speculators known as wildcatters flooded into south Texas with the hope of striking it rich on the next gusher of black gold. In response to the speculative frenzy, the Texas Pacific Land Trust shifted its strategy from selling its land, to renting it out. The Trust hoped to attract interest from wildcatters searching for new oil and gas prospects across the state. But at the time, no one believed the desolate west Texas prairie fields held any meaningful oil deposits – and so wildcatters settled in other parts of the state. Thus, for the next few decades, the only leasing business the company could drum up came from renting out grazing rights to cattle ranchers.

Finally, in 1920, the oil boom made its way to west Texas. That year, a leasing agent for the Texas Pacific Land Trust named William Abrams struck a deal with the Texas Company, now Texaco, a subsidiary of Chevron, for the mineral rights to a small patch of plantation land in Mitchell County, Texas. On July 20 of that year, the Texas Company injected nitroglycerin into a well drilled 3,000 into the ground, releasing a surge of oil and gas from the wellhead.

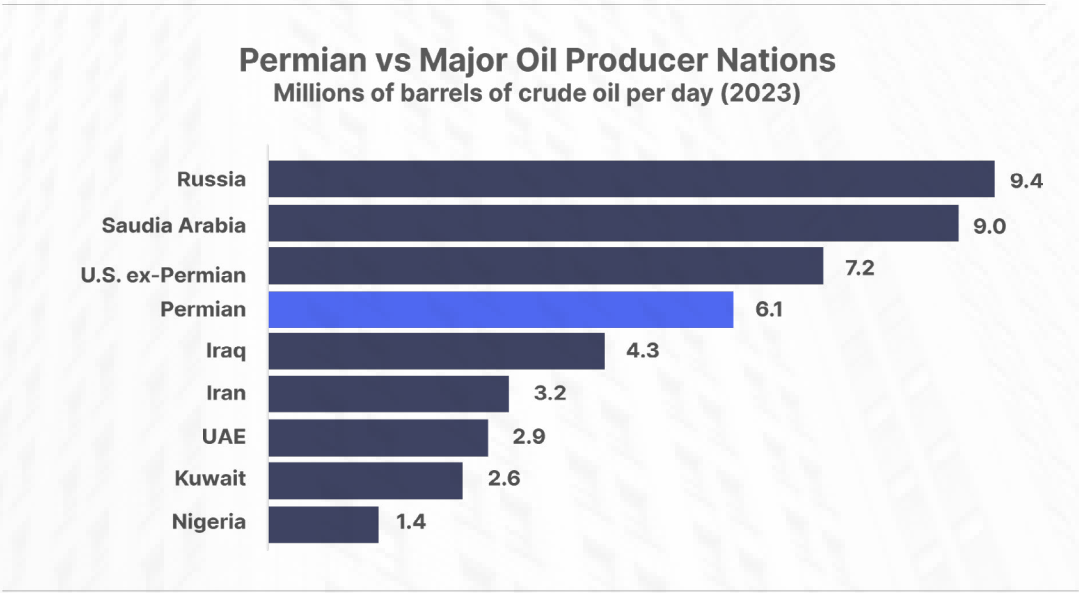
The Texas and Pacific Abrams Well #1 (named in honor of the leasing agent) produced only about 100 b/d. But it was enough to attract wildcatters, who subsequently discovered a huge supply of oil in what became known as the Permian Basin, which today (shown below) spans 86,000 square miles across west Texas and southern New Mexico.

The Permian Basin Spreads Over Two States

The basin's name comes from the Permian geologic era during which it was formed, starting 300 million years ago. Back then, Earth's land mass was concentrated into a single continuous continent known as Pangea. For 50 million years, a vast trove of organic

material was collected, and then trapped, within a complex series of impermeable rock formations. Over the next 250 million years, heat and pressure converted this organic material into one of the world's richest oil and gas deposits.

A century after the first Permian well was drilled, the basin now produces over 6 million barrels of oil each day. If it were its own country, the Permian Basin would be the world's fourth-largest oil producing nation, with 40% more output than Iraq:



The Permian also produces significant quantities of natural gas, with 25 billion cubic feet per day (Bcf/d) of output. That makes it America's second-largest gas producing basin, behind Appalachia at 35 Bcf/d.

As the largest landholder in the Permian Basin, the Texas Pacific Land Trust has reaped a cash flow windfall as oil and gas production soared over the last century.

For most of its life, the Trust operated a very simple business model. It leased its land to oil and gas drillers in exchange for a percentage of the value of the production on its land, known as a royalty. The drillers took all the risk and put up all the capital required to find and produce oil, while the Trust simply collected royalty checks.

If the drillers didn't make any money, the Trust didn't either. But unlike the oil drillers, the Trust didn't lose money if the wells were a bust. And if they did strike it rich, the Trust collected a slice of revenue from every unit of production that flowed from the well, without incurring any of the operating expenses.

The early financial records of the Trust are sparse, and complicated due to a series of stock splits and other corporate transactions. This includes a change in its structure from a trust to a regular corporation in 2021. But from a happy accident of history, we know exactly how much wealth this business generated through the first century of its life.

In 1979, a Wells Fargo banker discovered that there was one unredeemed note from the original formation of the 1888 Texas Pacific Railway Trust. The banker tracked down the name of the owner of the bond, a Dutch sailor, Joseph De Lamar,

who had passed away in 1918. Over the course of 91 years, the converted value of the original note into trust shares, accounting for stock splits and other corporate actions, had ballooned to $3.2 million. And over that same period, the trust also paid out $800,000 of dividends in Lamar's name, which were deposited into a separate bank account.

The original $3,000 note had turned into a tidy sum of $4 million, or a 133,200% total return. Half of the proceeds were distributed to Lamar's daughter, Alice, while the other half was split among several universities. Had the full value of Lamar's windfall remained in TPL shares since 1979, the $4 million would have grown to $2 billion today. In other words, the original $3,000 investment increased in value by an incredible 66,823,313% – an extraordinary accumulation of wealth.

But we believe the best is yet to come for TPL shareholders. The company has transformed itself in recent years, opening up a lucrative new source of high-margin revenue beyond its traditional oil-and-gas royalty business.

In order to understand this opportunity ahead for Texas Pacific, we must first understand the single biggest change in the history of the American energy industry that's taken place over the last 15 years. And more specifically, how the Permian Basin became the biggest winner from this revolutionary shift in oil and gas production.

Peak Oil Myth Busted by the Shale Revolution

For the first 90 years of the Permian Basin's life as an oil-producing region, drillers tapped into the basin's reserves with conventional drilling methods. This involved drilling wells straight down into rock-trapped oil and gas formations, whereby the underground pressure would push oil to the surface.

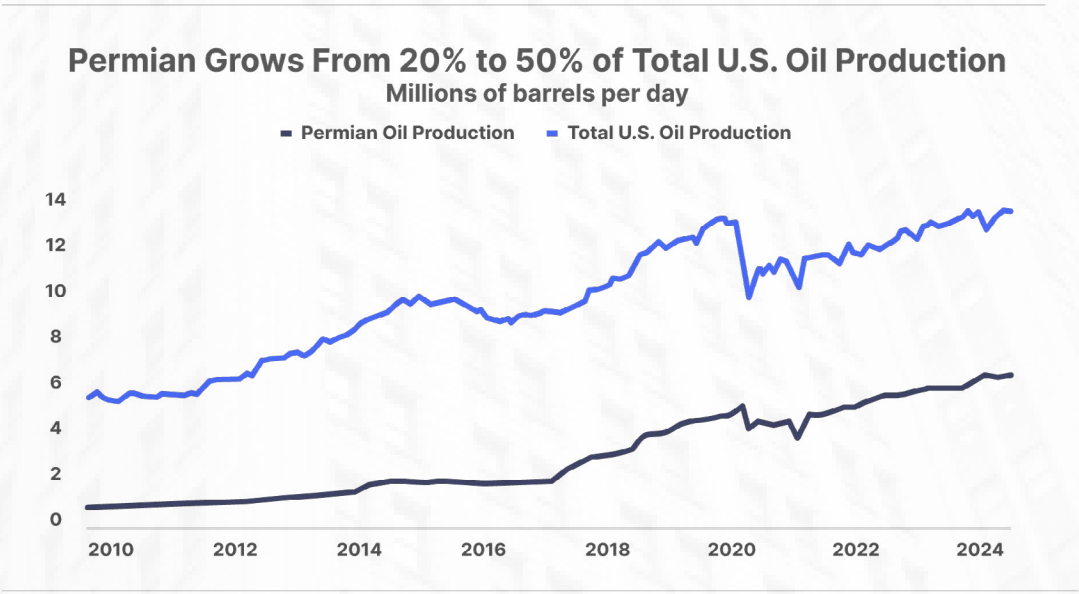
These drilling methods worked well until the 1970s, turning the Permian into America's biggest oil basin, producing 2 million b/d, or 20% of total U.S. oil production. But during that decade, the bulk of America's oil fields entered into a multi-decade decline, sending production down from 10 million b/d to 5 million b/d by 2010. The Permian Basin followed the same path, with output falling from 2 million b/d in the 1970s to around 1 million b/d by 2010.

At the time, conventional wisdom said that America was stuck in a perpetual state of declining oil output, known as the "peak oil" theory. In simple terms, the theory said there was only so much oil available on Earth, and humans had already reached the limit of their ability to pull more out of the ground each year.

But this theory was being proven wrong, with newly introduced hydraulic fracturing and horizontal drilling techniques unlocking massive amounts of oil and gas in previously inaccessible, tightly packed shale rock formations across America.

Of course, we all know what happened next...

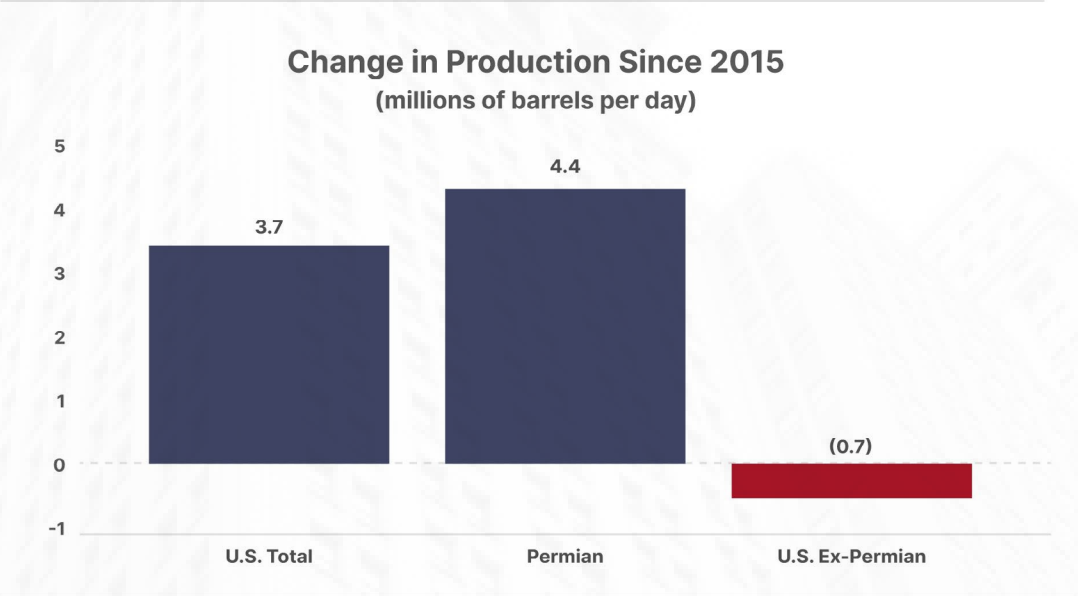
The shale revolution reversed the 40-year decline in U.S. oil production, unleashing a flood of new supply that sent American output soaring from 5 million b/d in 2010 to over 13 million b/d today. By far, the biggest driver of this shale boom has been the Permian Basin, which grew from just under 1 million b/d in 2010 to 6.3 million b/d today. This made the Permian America's most important and largest shale basin by a wide margin, which, as we mentioned before, makes up nearly half of total U.S. oil output, up from 20% in 2010:



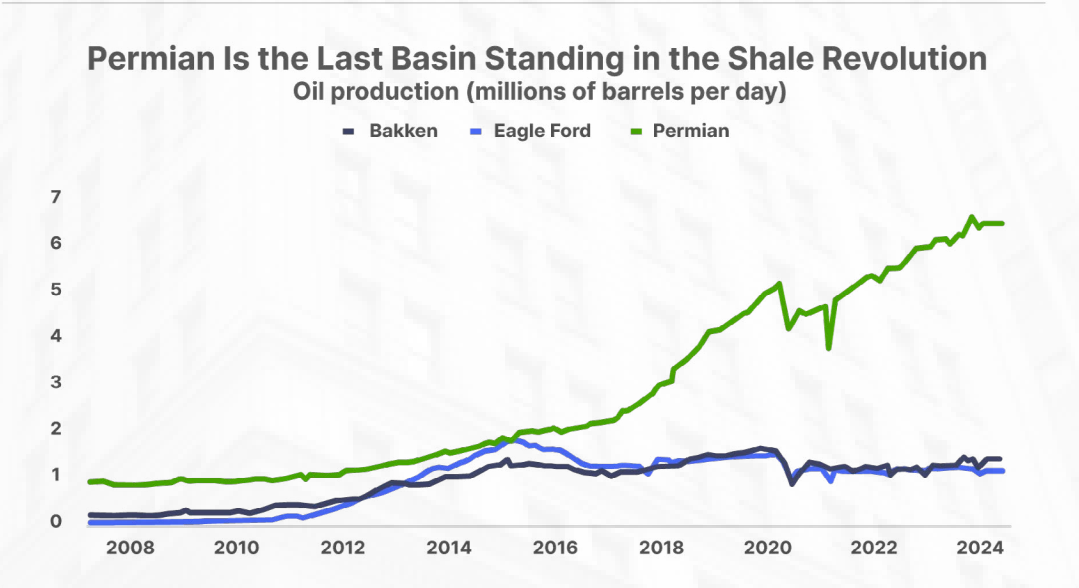
Today, the role of the shale revolution in transforming America into a global energy powerhouse is indisputable. But here's the big secret about this revolution that's gotten little notice from the mainstream pundits: oil production has plateaued in every major shale basin, except for one... the Permian Basin.

The Permian Basin Prevents Peak Oil 2.0

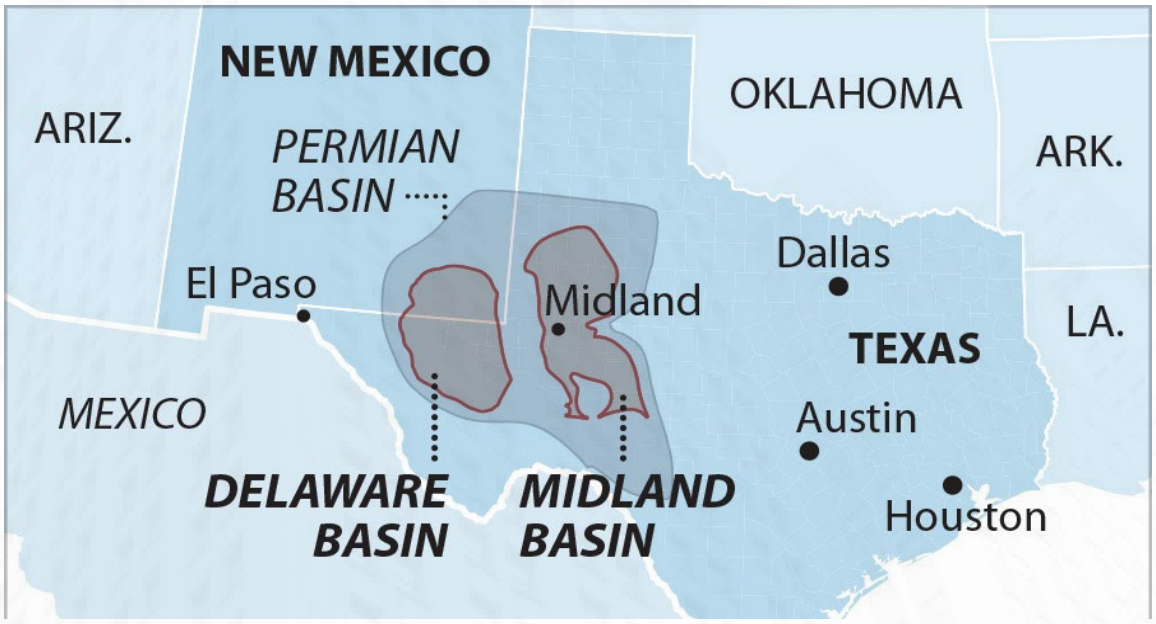
Outside of the Permian Basin, America's oil production has declined for the last decade, with output down by 700,000 b/d, about 10%, since 2015. The Permian's 4.4 million b/d increase in output since then has prevented America from facing the prospect of the peak-oil fallacy again, providing the main engine of growth propelling U.S. production to a new record high since 2015:



Consider the second- and third-largest U.S. shale oil basins behind the Permian, the Bakken in North Dakota and the Eagle Ford in South Texas. The chart below shows that production in both of these basins peaked around 2015, while the Permian's output has more than tripled over the same period:



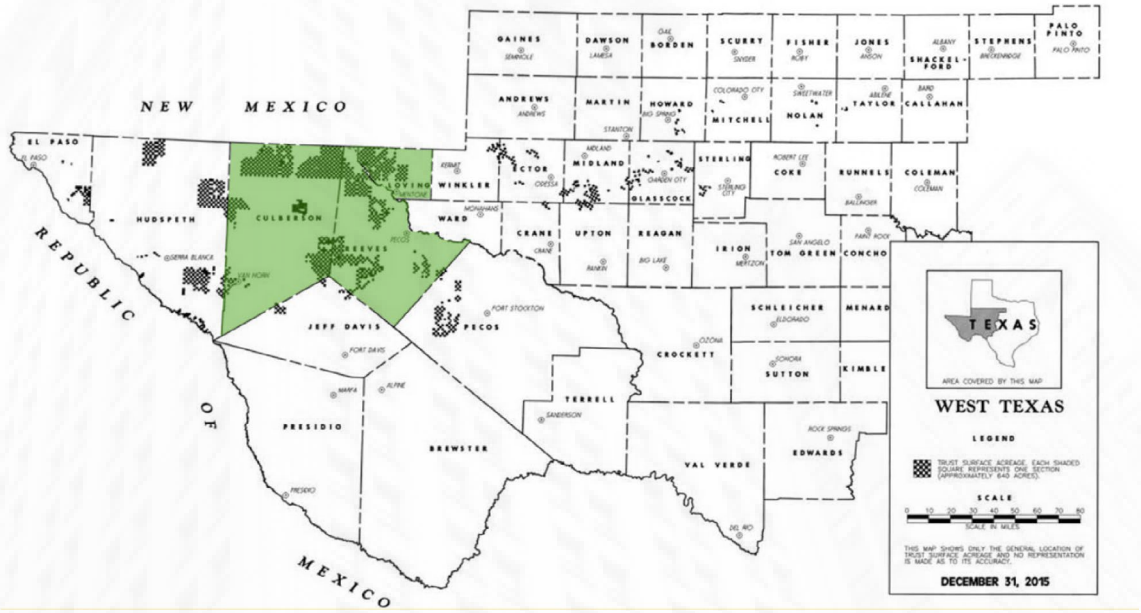
The key feature that separates the Permian from every other U.S. shale basin is the size of its reserves. While many consider the Permian as a single oil basin, the vast geologic formation spans many different deposits. The two key areas include the Midland and Delaware Basins, shown below:



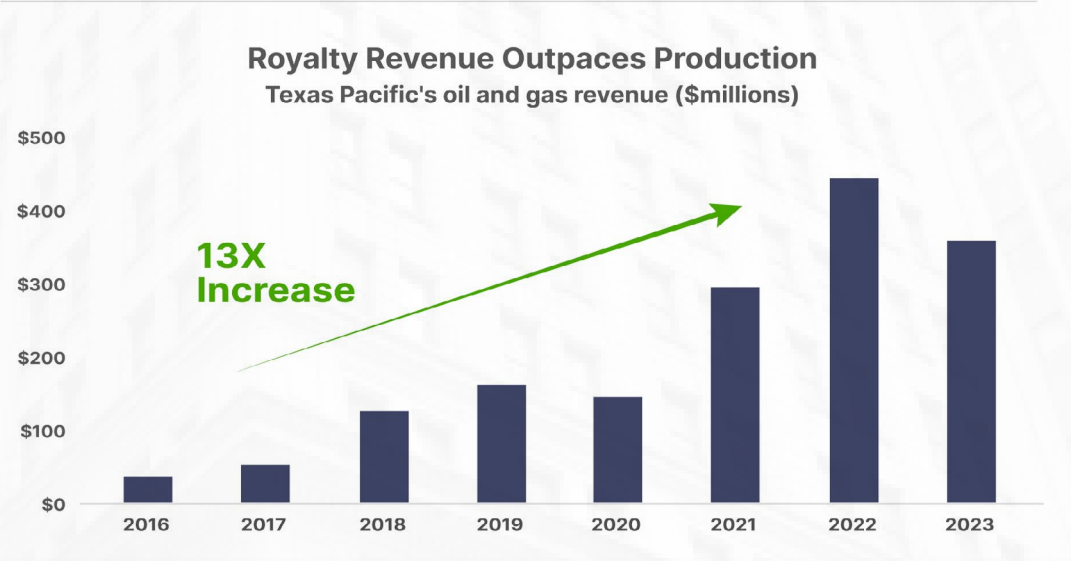
The growth of the Permian is really a story of the Midland and Delaware Basins. The first leg of the Permian's growth was powered by conventional drilling methods in the Midland Basin, starting with the Abrams #1 well in 1920. New production methods unlocked additional shale reserves in Midland starting in 2010, but this was only enough to double total output from 1 million b/d to 2 million b/d by 2016.

The biggest driver of the Permian's shale revolution came in the Delaware Basin, but not until 2016. Until then, the Delaware was largely overlooked and considered dormant after a series of unsuccessful conventional drilling attempts in the 1990s. The challenge lies in the fact that the Delaware Basin hosts some of the deepest and thickest rock formations in the overall Permian Basin.

But in September 2016, oil and gas producer Apache Corporation (APA) made a major shale discovery in Reeves County (highlighted on the map below), an area of the Delaware Basin in North Texas. Over the next several years, similar discoveries were made in nearby areas, including Loving County and Culberson County (also highlighted). These major shale discoveries were found in the heart of Texas Pacific's largest land holdings, with these three counties making up 60% of its total 870,000-acreage position:



Since 2016, production in the Delaware Basin skyrocketed, providing the major driver of the tripling in Permian oil output from 2 million b/d to over 6 million b/d today. And Texas Pacific's royalty volumes grew even faster, with a 13-fold increase from $28 million in 2016 to $357 million in 2023:



This rapid rise in oil and gas royalties is only one way Texas Pacific capitalized on the Permian Shale bonanza, which made up 57% of the company's revenue in 2023. The company also earns a significant source of high-margin revenue from granting access to its surface-level land rights.

Texas Pacific's Acreage Rights Lead to Additional Revenue

Texas Pacific is in a class of its own compared with virtually all other oil and gas royalty operators. That is, it owns both surface-level land rights and subsurface mineral rights – a rare combination of ownership rights that few other companies have access to.

As we mentioned before, as oilfield activity accelerated in the Permian Basin over the last decade, Texas Pacific's revenue from its underground drilling rights increased by 13x. An added bonus is that all this drilling activity has led to huge new demand for surface-level infrastructure like pipelines, utility connections, and roadways. And thanks to its ownership of surface-level land rights, these infrastructure providers must first pay Texas Pacific in order to place any equipment on its land.

Texas Pacific earns revenue from these activities through land leases, and also through easements, which are legal agreements that grant access to do things like run pipelines or build roads across its land.

In addition to granting access to its surface-level land, Texas Pacific also allows companies to harvest the hard-rock calcium carbonate deposits, known as caliche, from its land. This material goes into road-building materials, well-containment construction, and many oilfield-related processes.

The company classifies these activities into a business segment called Surface Leases, Easements, and Material Sales ("SLEM"). In 2023, the company generated $71 million in sales from its SLEM segment, or 11% of total revenue. That's up 130% from the $31 million SLEM generated in 2015.

Here's the best part of the SLEM segment – just like with the oil-royalty business, it requires virtually no capital and has very low operating expenses. Texas Pacific collects fees simply for allowing others to use its land. This puts SLEM on par with the oil-royalty segment in terms of its capital efficiency and profit margins.

As recently as 2015, before the company added new revenue sources, these were the only two operating segments within Texas Pacific's business. These segments generated $79 million in revenue and $50 million in net income in 2015, for an incredible 63% profit margin. Even better, virtually all of those profits turned into free cash flow, since the business only required $100,000 in capex each year.

But the Permian Basin is the gift that keeps on giving to Texas Pacific. Starting in 2016, the company tapped into a huge new source of revenue in what is quickly becoming the Permian's most valuable resource: water.

Selling Water in the Desert

The company's west Texas land that sits atop the Permian Basin is classified as semi-arid. For most of its life as an oil-producing region, this desert-like climate and terrain wasn't much of a problem. Conventional drilling doesn't require much water. It simply involves plunging a hole straight into the ground, and letting the natural reservoir pressure move oil and gas to the surface.

But tapping into shale reserves involves an entirely different process. Fracking requires injecting massive amounts of water-chemical mixtures into the well at high pressures, designed to bust apart shale rocks and release their tightly held oil and gas deposits.

As the shale boom progressed over the last decade, this water-intensive production process started stretching the Permian's already-scarce resources. The strains accelerated when oil producers discovered that they could deliver higher returns from each well by increasing the size of the horizontal wells, while also upping the fracking intensity, which entailed injecting greater amounts of water-based fracking mixtures. The rationale was simple: after committing the upfront investment to set up a drilling operation, creating longer horizontal wells and pouring more fracking fluid into the wells would deliver even more oil at a lower marginal expense.

From 2010 to 2023, the average well length in the Permian more than doubled from 4,000 feet to 10,000 feet (with some operators now testing well lengths exceeding 15,000 feet). As a result, the amount of water used in fracking these wells continued to increase.

In 2010, the average Permian well was fracked with 0.6 million gallons of water. By 2015, this number had grown to 5.4 million gallons. Today, shale drillers are consuming a massive 16 million gallons of water per well, or enough to fill 26 Olympic-sized swimming pools.

This increase in fracking intensity sent water demand for fracking in the Permian surging by 24-fold, from 3 billion gallons per year in 2010 to over 72 billion today.

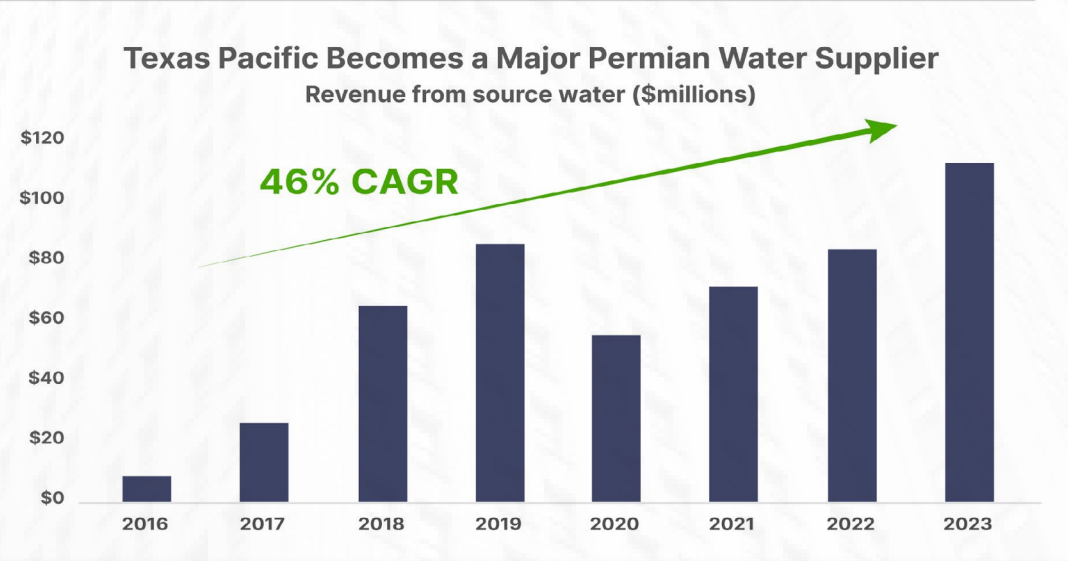
In 2016, Texas Pacific spotted an opportunity to capitalize on this ravenous new demand for Permian water. As it turned out, the company's surface-level property rights also permit Texas Pacific to tap into the aquifers underlying the land (which are separate from mineral rights).

The company formed a limited-liability subsidiary called the Texas Pacific Water Resources ("TPWR") in 2017. Since then, the company has invested $145 million into a series of water wells, storage ponds, and pipelines for producing and delivering water from its land to drillers throughout the Permian Basin.

While this capex spending required to build these wells, ponds, and pipelines made Texas Pacific less capital efficient for a few years, it paid off big time, by delivering a huge new source of high-margin revenue. Texas Pacific sells its source water for $0.50 to $1.0 per

barrel, with direct operating costs of $0.10 to $0.20 per barrel. That works out to around 80% operating margins – on par with some of the world's most profitable and capital efficient business models.

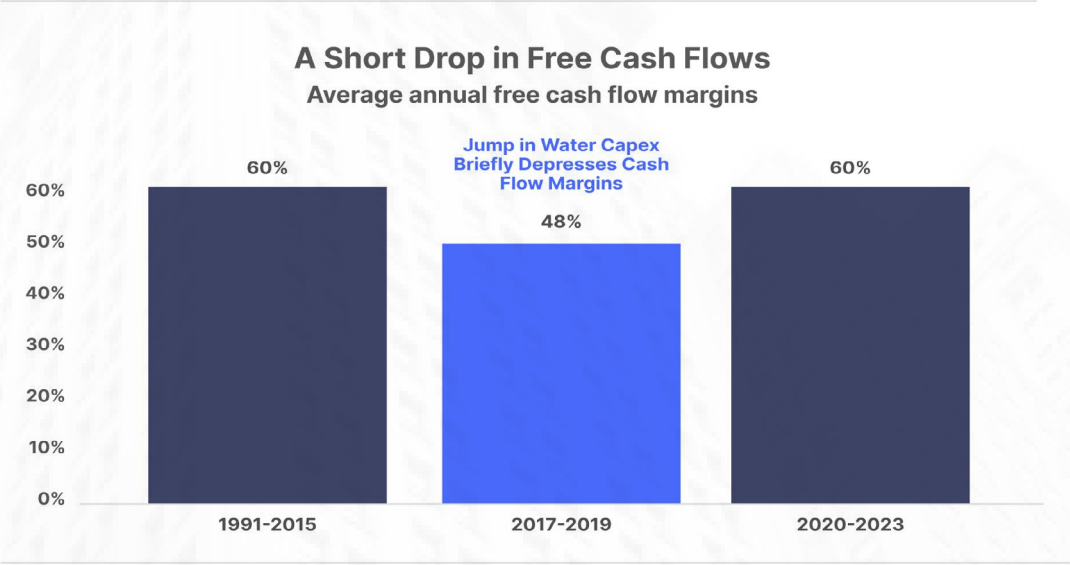
From 2016 to 2023, the company's water sales have increased at a compound annual growth rate ("CAGR") of 46% from $8 million to $112 million. Water sales now make up nearly 20% of the company's total revenue.



Since the inception of its water business, Texas Pacific has invested $145 million in capex and generated over $500 million in water sales. And that revenue will keep coming without nearly as much capex needed.

Most of Texas Pacific's investment into water assets occurred from 2017 to 2019, with the company's capex spending peaking at $107 million in 2019. Today, this segment requires annual maintenance capex of around $5 million to $10 million, with modest additional investments to support growth initiatives. As a result, the company's capex spending dropped to just $19 million.

Meanwhile, Texas Pacific's water sales continue setting record highs. As a result, the company's overall free cash flow margins have returned to their historical average of 60%, following a brief drop to 48% during the peak of its water investments from 2017 to 2019:



But there's another angle to this story that allowed Texas Pacific to retain its world-class margins and capital efficiency, despite the modestly higher capex requirements of its water business.

Capturing Cash Flows From Water Coming and Going

So far, we've only covered half of the water challenges in the Permian, and thus only half of the company's opportunity. The other half comes from water produced alongside oil as a byproduct of the production process, known as "produced water."

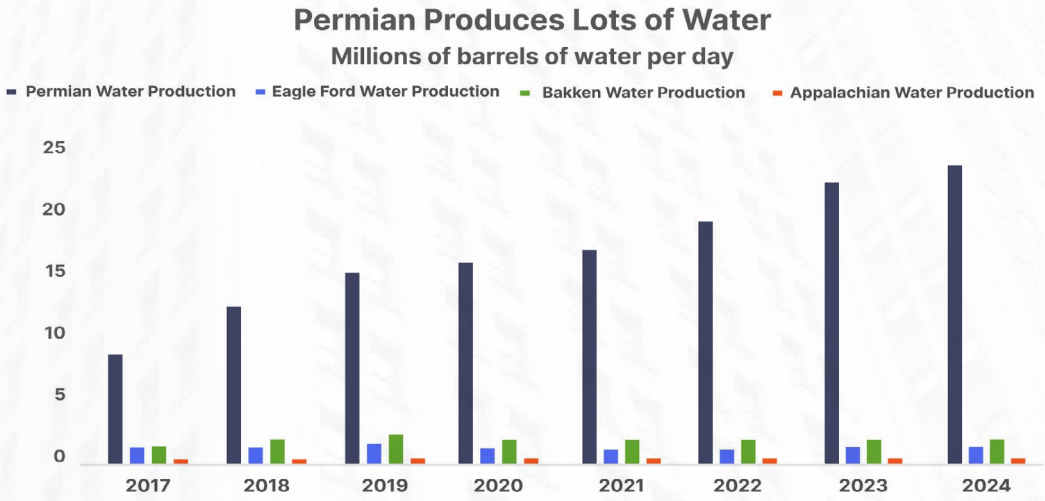
Produced water is a major liability for oil drillers. It comes out of the ground contaminated with drilling chemicals and with a high concentration of salt. This means it can't be dumped back into the ground, or immediately re-used in fracking operations. Instead, it must be transported to a processing facility, cleaned, and then either recycled for reuse or stored underground.

Dealing with produced water has become a major challenge for oil drillers in the Permian Basin. A substantial portion of the water used in fracking shale wells surfaces with the oil during the production process. The geology of the Permian Basin compounds this problem, because its shale reservoirs already contain unusually high levels of water mixed in with the oil.

We can see the extent of these challenges through a metric known as the water-to-oil ratio ("WOR"), referring to the ratio of water to oil volumes produced from oil wells. The average Permian well produces a WOR of 3.2, meaning 3.2 barrels of water is produced along with each barrel of oil. This compares to a WOR of less than 1 in the Eagle Ford and 2 in the Bakken Basin.

But there's one particular region of the Permian responsible for pushing up this average WOR across the basin. And it also happens to be the Permian's most prolific shale-oil producing region: the Delaware Basin. On average, Delaware wells produce a WOR of between 4 and 8, with some individual wells reaching as high as 12. By comparison, the wells in the nearby Midland Basin produce average WORs of between 2 and 3.

As production in the Delaware began taking off in 2017, so too did the amount of produced water in the Permian Basin. Since 2017, produced water volumes have exploded from less than 8 million b/d to an estimated 20 million b/d in 2024, or a 150% increase in just six years. This makes the Permian the largest generator of produced water among all U.S. shale basins by a factor of nearly 10x.



Before the Delaware production boom took off in 2017, the majority of the Permian's produced water volumes were sent into underground storage in salt water disposal ("SWD") wells. These wells are created specifically for the injection and storage of produced water, drilled as we mentioned before, to depths of 4,000 to 10,000 feet in order to avoid the salt water from leaching into and contaminating the water table.

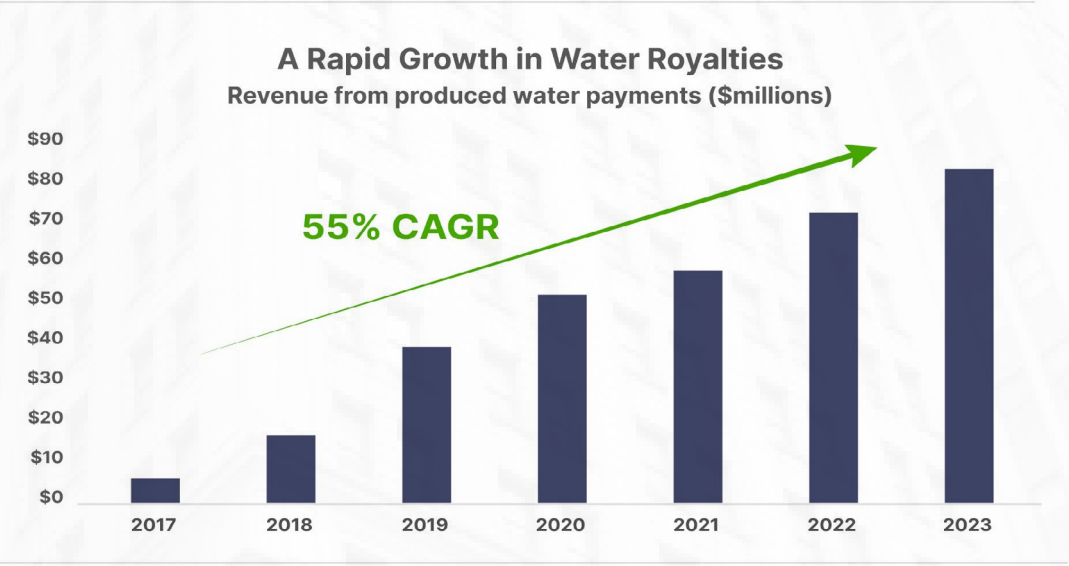
But as Permian's produced water volumes surged, drilling these wells became cost prohibitive. It also became wasteful, as the huge volumes of water sent into these underground wells was water that couldn't be re-used.

As part of Texas Pacific's water sales unit, it began investing in produced water processing and recycling facilities. This allowed the company to begin contracting with the operators drilling on its land to send their produced water through Texas Pacific's pipeline and processing networks in order to recycle produced water back into new supplies of reusable fracking water.

Here's how it works. In order for an oil driller to send produced water to a processing and recycling facility, it first must travel through pipelines. And in order for a company to legally send water through a pipeline across any given piece of land, it must get permission from that land owner. That permission typically requires the payment of a royalty to the land owner. Just like oil royalties, collecting these water royalties for the simple act of allowing oil drillers to flow produced water across its properties comes with zero capital investment.

That's how Texas Pacific parlayed its investments into pipeline networks and recycling facilities from the water sales business into another new revenue stream, of produced water royalties, by capturing the flow of produced water from those drilling on its land back to its recycling facilities. So even though the water sales business required significant capex in 2017-2019, it created substantial growth in additional high-margin revenue from produced water royalties that came with zero added capex.

Since 2017, Texas Pacific's produced water royalty revenue has increased from $6 million to $84 million in 2023. That's a 14-fold increase in just six years, or a 55% CAGR:



From both water sales and produced water royalties, the company earned $197 million in revenue in 2023,, making up 31% of the company's total revenue. That's incredible growth for a business segment that didn't exist a decade ago.

Owning the Most Land Creates the Ultimate Competitive Advantage

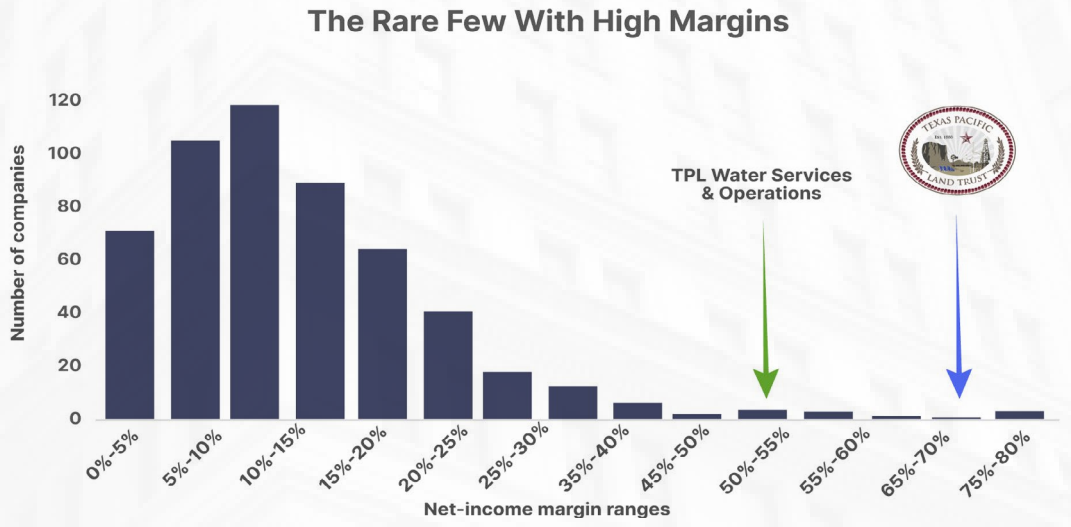
The key competitive advantage enabling the Texas Pacific's rapidly growing water business lies in its vast stretches of contiguous land holdings. Most of the competing water businesses in the Permian must deal with the highly fragmented ownership of different parcels of land when serving its customers. This often means dealing with multiple different land owners in order to tap into their groundwater as well as transport produced water across their properties.

Since the competition must often pay multiple landowners for either their land rights and/or royalties for moving water across their land, this adds an extra cost burden that Texas Pacific avoids.

This explains why the company has become one of the largest and fastest-growing water companies in the Permian, while also generating stellar profit margins. In 2023, the company's water business earned $99 million in net income on the $197 million in sales, or a 50% profit margin.

While this segment's profitability is a bit below the 63% profit margins the company earns from its land business (including oil royalties, SLEM, and land sales), it's still miles ahead of the average business.

The chart below ranks the profitability of Texas Pacific's water and land segments against the distribution of profit margins for all S&P 500 companies. Notice that the profit margins earned by both of Texas Pacific's business segments are among the small minority of extreme outliers that fall on the far right side of this spectrum:



Looking beyond the financials, the water business brings two other benefits to Texas Pacific's overall business. The first is that it diversifies the business and smoothes out the volatility of the commodity price cycle. When the company was primarily an oil royalty business, its revenue could swing wildly from one year to the next based on fluctuations in oil and gas prices. Now that the water segment is producing steady growth and becoming a larger part of the overall business, it's making its overall revenue stream less susceptible to drops in energy prices.

In 2023, for example, Texas Pacific's energy royalty revenue dropped by 21% year-on-year due to falling energy prices. But the company's water revenue increased by 25%, which helped the overall revenue for the business post a decline of just 5%.

The second advantage of adding water sales and produced water services is that this solves two of the biggest obstacles for the companies that pay to drill on Texas Pacific's land. Overcoming these obstacles encourages more drilling on the company's acreage, leading to more oil royalties and SLEM revenue. This helps the drillers grow faster and thus encourages more future revenues across all business lines, and so on in a virtuous cycle.

The Ultimate Inevitable Stock

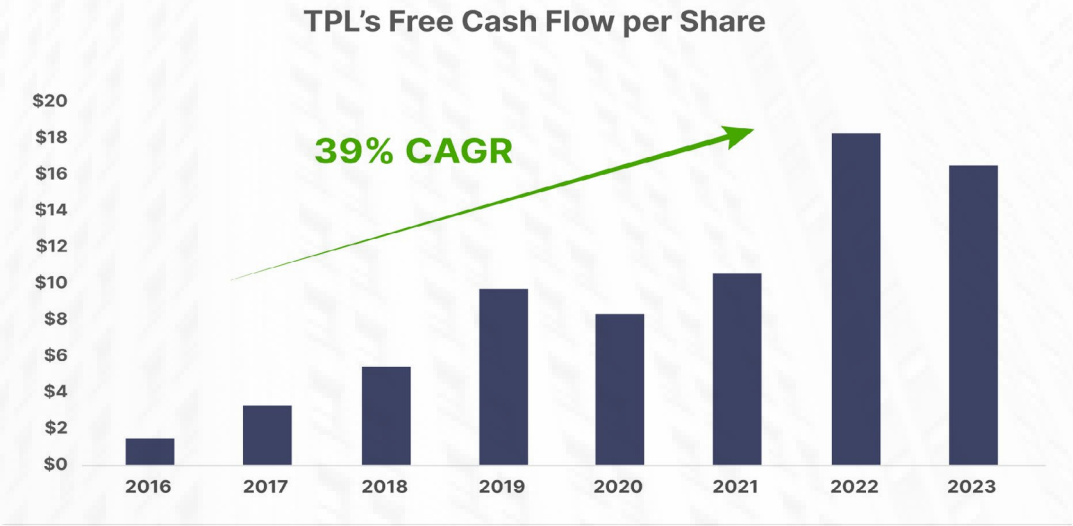
No other company in the Permian Basin offers this full suite of solutions for land leasing, easements, and material sales, plus the full spectrum of water needs. And Texas Pacific can offer it all at highly competitive prices, given its vast land holdings that give it a permanent low-cost advantage over its rivals. That's how the company can make long-term deals with some of the largest and most profitable oil drillers, including Chevron (CVX), ConocoPhillips (COP), and Occidental Petroleum (OXY). Two-thirds of the company's revenue comes from the top 10 largest oil drillers in the world. By partnering with the world's biggest energy companies, we believe Texas Pacific's future success is inevitable.

Over the last decade, Texas Pacific has generated an average of 85% returns on invested capital. That's how it transformed the relatively modest capital investments into its water business into a valuable source of new earnings and cash flows. So even with the slight increase in capital intensity from its water business, the company remains impressively capital efficient. The best indicator of this comes from the fact that Texas Pacific managed to create a new segment that's now 30% of total revenue, all without raising new capital or taking on any debt.

In fact, it did the opposite. Since 2016, when Texas Pacific began investing in its water business, the company has returned a total of $1 billion to shareholders through repurchases and dividends. This continued a 67-year long streak of paying a cash dividend.

Meanwhile, the company has been repurchasing its shares for as long as there's publicly available financial data. Since 1980, the company has reduced its share count by 58%.

The combination of rapid growth, and a capital efficient business model that achieves high returns on investment, is how Texas Pacific has compounded its free cash flow per share by an incredible 39% per year since 2016 – when it first entered the water business.



The combination of rapid growth in free cash flow per share, plus a consistent dividend payout (including periodic special dividends) has quietly made Texas Pacific one of the best performing stocks in the world. Since 2016, the company's share price has delivered a total return of 3,609% or a 52% CAGR. Over the same period, the S&P 500 has returned 238% or a 15% CAGR.

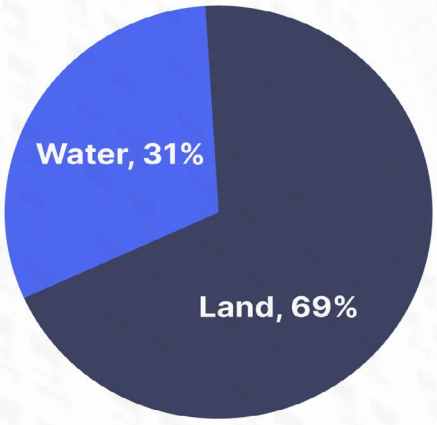
With a record high cash balance of $895 million, which has increased by 200% over the last five years, zero debt, and a capital light business model that produces nearly $500 million a year in free cash flow, we see virtually no scenario where Texas Pacific runs into financial difficulties outside of an act of God.

And with perpetual acreage rights in the heart of America's richest oil deposit, we see a lot of upside ahead.

The biggest opportunity lies in the company's fast-growing water business, which we believe will eventually overtake its land-based business segments within the next decade. This is only a matter of simple math, given that the Permian basin produces three times as much water as oil. Plus, as wells age, they produce higher proportions of water relative to oil. This should provide a steady supply of high-margin produced water royalties that will partially offset the natural decline in oil production from the existing wells across its land holdings.

Meanwhile, demand for fracking water shows no signs of slowing in the Permian, as drillers continue pushing the boundaries on longer horizontal wells and higher fracking intensity. That means more oil and gas to sell and more demand for source water, and more produced water too.

Texas Pacific Segments by Revenue (2023)



We believe this last decade of growth is just the beginning. The only question left to consider is, what's the right price to pay for TPL shares?

At around $1,500 per share, the company's current market capitalization is $35 billion. In 2023, it generated $450 million in net income, putting its price to earnings multiple at 77x.

Over the last decade, TPL shares have traded for an average of 34x earnings. The company's business has improved dramatically over that time period. Nonetheless, TPL shares now trade for more than 70x earnings compared to around 50x earnings in September of 2024 – more than double its average price to earnings the last decade.

From 2017 to 2019, as we detailed above, the company's capital intensity went up as it invested heavily into new water infrastructure. Now, those investments continue generating a growing source of high-margin revenue, while the capital spending required to produce those streams has come down. As a result, the company's free cash flow margins have risen to their highest levels of the last decade, at 66% in 2023.

Plus, the business has also become less exposed to the cyclical swing in oil and gas prices, as its fast-growing water segment makes up a larger part of its business. Given our expectations for this growth to continue, and the company's stellar free cash flow margins, we believe this is a business worth paying up for.

And historically, it's paid to pay up for TPL shares. Consider the following from a Bloomberg article published on May 14, 2018, in which the author noted:

> *"Still, there are warning signs: At current prices, TPL is trading at a price-to-earnings ratio of 46.41, higher than Apple Inc., Facebook Inc., and Google's parent, Alphabet Inc., and resembling valuations seen during the dot-com bubble."*

Since then, TPL shares have returned 712% or a 38% compounded annual return. Over the same period, the S&P 500 has returned 143% or 15% compounded annually.

In other words, it was a big mistake to pass on TPL shares in 2018 for fears of its lofty valuation. Great businesses rarely trade cheap, and Texas Pacific is among the highest quality businesses in the world.

Action to Take: For the latest updates on our open positions and current buy up to prices, please visit our live portfolio **here**.

Porter & Co.
Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us **here**. You can follow me (Porter) on **X** here: **@porterstansb**