

S&P Global
Market Intelligence

Sitio Royalties Corp. NYSE:STR

Earnings Call

Thursday, November 7, 2024 1:30 PM GMT

CALL PARTICIPANTS	2
PRESENTATION	3
QUESTION AND ANSWER	6

Call Participants

EXECUTIVES

A. Dax McDavid

*Executive Vice President of
Corporate Development*

Carrie L. Osicka

Chief Financial Officer

Christopher L. Conoscenti

CEO & Director

Jarret J. Marcoux

*Executive Vice President of
Operations*

Ross Wong

*Vice President of Finance &
Investor Relations*

ANALYSTS

Jarrod Cole Giroue

Stephens Inc., Research Division

Neal David Dingmann

*Truist Securities, Inc., Research
Division*

Noel Augustus Parks

*Tuohy Brothers Investment
Research, Inc.*

Wei Jiang

*Barclays Bank PLC, Research
Division*

Presentation

Operator

Hello, everyone, and welcome to the Sitio Royalties Third Quarter 2024 Earnings Conference Call. My name is Bruno, and I'll be your operator for today. [Operator Instructions]

I will now hand over to your host, Ross Wong, Vice President of Investor Finance -- Vice President of Finance and Investor Relations. Please go ahead.

Ross Wong

Vice President of Finance & Investor Relations

Thanks, operator. Good morning, and welcome to the Sitio Royalties Third Quarter Conference Call. We appreciate your interest in our story. By now, it is our hope that you have been through our materials. You can find our recent news release and some supplemental slides on our website under the Investor Relations section.

I'm joined this morning by our CEO, Chris Conoscenti; and our CFO, Carrie Osicka. After our brief prepared remarks, Chris, Carrie and other members of our leadership team will be available to take your questions.

Before we start, I would like to remind you that our discussion today may contain forward-looking statements and non-GAAP measures. Please refer to our earnings release, investor presentation and publicly filed documents for additional information regarding such forward-looking statements and non-GAAP measures.

I will now turn the call over to Chris.

Christopher L. Conoscenti

CEO & Director

Thanks, Ross. Good morning, everyone, and thanks for dialing in today. Sitio is performing exceptionally well, and we continue to show that our proven business model is sustainable and differentiates us from other investment options you have in the energy and minerals ownership sectors. We offer a unique and compelling value proposition today.

Before I cover our third quarter highlights, I want to address what we call the Sitio advantage. It is important that you understand how we run our business and why we think our proven practices will add tremendous value for our owners.

There are 4 key things you need to know. First, Sitio has a proven track record of identifying, underwriting and capturing value-adding acquisitions. The minerals sector remains highly fragmented, and we benefit from robust deal flow. Our high-quality diverse assets provide exposure to both oil and gas as well as to the top producing basins in the U.S. This asset diversity gives us the unique ability to allocate capital to acquisitions with the highest expected returns regardless of location.

Additionally, our thorough and disciplined underwriting process that targets unlevered IRRs in the mid- to high teens perfectly aligns management and shareholder incentives, ensuring that we focus on both near-term accretion and long-term value.

Second, we actively manage our resources using proprietary systems and highly skilled teams. This is a core competency at Sitio. We are far from passive owners, and our people continually seek avenues to capture higher revenues and returns through our disciplined management of our quality minerals. One recent example is how we utilized our proprietary data management systems to track missing payments by operator, well, production month and commodity. This has allowed us to recover approximately \$25 million in missing payments over the last 12 months, which nearly covers Sitio's cash G&A for a full year.

Third, we have a strong capital structure, and our commitment to a healthy balance sheet is unwavering. Over the last quarter, we reduced total debt by nearly \$60 million. Our interest expense on a barrel of oil equivalent basis is 18% lower than it was 1 year ago today. Our well-capitalized balance sheet allows us to weather the inevitable commodity price cycles and provides access to capital at competitive rates.

In today's deck, we show some interesting comparisons of adjusted net debt to free cash flow, both inside and outside the mineral subsector, which highlights that on a free cash flow basis, Sitio's metrics are competitive with public E&Ps. As we said before, for a large acquisition, we would target a leverage neutral to deleveraging consideration mix to strengthen our capital structure further.

Lastly, we understand the importance of returning meaningful capital to shareholders. Our business plan balances disciplined acquisitions with a commitment to return capital through cash dividends and opportunistic share buybacks. Including the third quarter, our return of capital has totaled more than \$765 million since becoming a public company in June of 2022.

Let me shift gears and talk about our recent financial and operating results. Our third quarter performance was solid and marked the third consecutive quarter we have topped our full year guidance estimates. Over the last quarter, we closed on 5 new acquisitions totaling approximately \$22 million. Combined, these deals add over 2,300 NRAs, all in the DJ Basin.

Strong performance on our legacy assets and our third quarter acquisitions have allowed us to enhance our 2024 outlook again and raise the midpoint of our production guidance by 1,000 BOEs per day. By all accounts, 2024 is shaping up to be an excellent year for Sitio.

Financial results for the third quarter were robust, and we view this momentum as sustainable and related to several key factors. First, we saw higher-than-expected production of nearly 38,600 BOEs per day, of which half was oil. Our operators today have more scale, financial strength and flexibility and are producing from top-tier acreage positions. An interesting fact is that the average market cap of our top 5 public company operators on our acreage has more than doubled since the end of 2022. This supports the sustainability of our business model and gives us confidence that our assets will be developed efficiently.

We continue to benefit from E&P consolidation as acreage transitions to better capitalized, more efficient operators or operators who will develop that acreage sooner. For example, Permian Resources' acquisition of Oxy's Barilla Draw acreage in the Southern Delaware Basin, where we own 1,800 NRAs, is great for Sitio. This is an area that wasn't a core focus for Oxy. However, it added more than 200 gross operated locations with high NRIs that immediately compete for capital in the Permian Resources portfolio. As a minerals owner, accelerated development on this acreage will lead to better returns, more near-term cash flow and ultimately increased return of capital for our shareholders.

In the DJ Basin-Watkins area, Civitas recently completed 13 4-mile lateral wells. Seven of these wells are in the Sky Ranch unit, where Sitio owns approximately 240 NRAs. These 13 wells had approximately 5% lower D&C cost per foot than 3-mile laterals and, importantly, allows Civitas to access resource that was stranded due to surface configurations, which is a great example of how longer laterals are helping operators become more efficient, which, in turn, benefits mineral owners. Civitas remains active in this area where Sitio has direct exposure with approximately 1,900 NRAs, including 780 NRAs in the Box Elder CAP, an area that was part of the DJ Basin acquisition we closed in April.

Another example of E&P M&A that should benefit Sitio is Apache's acquisition of Callon Petroleum earlier this year. In 2021, we acquired a 2% overriding royalty interest in approximately 7,200 Callon-operated NRAs in the Delaware Basin. Apache has a stronger balance sheet than Callon and has stated that they expect to create substantial value on the Callon acreage through improved well performance and capital efficiency. Apache estimates they can drill a 2-mile lateral for approximately \$1 million less than what Callon was able to do in 2023. We're excited to see what operational improvements Apache can make on the legacy Callon acreage and the additional value they can create for Sitio.

Operational efficiencies across the industry show that operators are achieving more with less. As an example, from the start of 2023 until the most recent quarter, the rig count on our Permian acreage has decreased 17%, while the total lateral feet drilled has increased 5%. Part of the reason for this is a trend

towards longer laterals. Across the same time frame, laterals of 3 miles or more have doubled and now represent 25% of all wells drilled.

Another trend we've been seeing in the industry is horseshoe-shaped laterals. This allows for the capture of stranded resources due to surface challenges. We own minerals under several operators who are testing horseshoe laterals, and we'll be closely monitoring results.

For the third quarter, the bulk of activity on Sitio's assets was in the Permian and DJ Basins. We had 7.7 net wells turned-in-line in the quarter and a solid 11% increase in our net line-of-sight wells compared to the second quarter. Line-of-sight wells provide us with high confidence in near-term operator activity and the sustainability of our business plan.

Let me quickly close and then open it up for questions. Sitio has a proven model for creating value, which is demonstrated through our strong performance year-to-date. Our team has developed proprietary software and practices to effectively manage our assets and ensure we get the most value for our owners. We are well positioned to be a leader in this highly fragmented industry as it continues to consolidate.

On the operator side, we continue to see assets roll up under bigger, stronger companies with efficient development practices. This ultimately enhances our returns at Sitio and smooths volatility created by short-term moves in oil and gas prices. We are highly confident in the strength and sustainability of our model.

Our focus today is turning to 2025. While formal guidance won't be released until early next year, you can count on us to deliver on our strategy, working to capture high-quality assets where our team can creatively enhance value, maintaining a strong balance sheet that provides access to capital through the cycles, and an ongoing commitment to return capital to shareholders. Operator, we are now ready to take questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Neal Dingmann from Truist.

Neal David Dingmann

Truist Securities, Inc., Research Division

Could you just give me a sense of how you see the M&A market if minerals are as open as ever and where that sort of plays given your financials?

Christopher L. Conoscenti

CEO & Director

Neal, thanks for the question. The M&A market remains really exciting for Sitio. We have an active effort on the outbound business development efforts really led by our senior team, with Dax and Britton constantly staying in contact with mineral owners and sourcing new ideas for Sitio. We also see all the marketed processes, and there's a very robust flow of those at the moment, and we see several more coming. So it's a very active time in the minerals market.

And the most important thing for Sitio remains rate of return. So we focus very closely on near-term accretion and long-term IRRs, and that's the biggest driver. And then we also place a lot of importance on balance sheet strength. So as we look at larger transactions, we're closely focused on both the returns I discussed earlier and making sure that the transactions are leverage neutral or balance sheet enhancing. So we're well positioned with where the balance sheet is today and a lot of opportunities set in front of us.

Neal David Dingmann

Truist Securities, Inc., Research Division

Great to hear. And then just secondly, just on solid activity. Could you just talk about -- it seemed like your line-of-sight wells increased. And just wondering, was this driven by the Permian and DJ? Or what really drove this?

Christopher L. Conoscenti

CEO & Director

Yes, it's a good question. I'm glad you asked. It gives us a chance to highlight Page 6 in the investor deck that we posted on our website today. If you look at the map on Page 6, it paints a really exciting picture for Sitio. And as you recall, the line-of-sight wells on our footprint give us visibility into the next 12 to 18 months of development on our asset.

And a couple of important things to note on that map on Page 6. First is just the sheer number of gross wells that have been spud and permitted across our footprint. And the second thing is just the diversity of where those locations are. It is literally across the entire footprint. So there's no concentration anywhere within our asset. You have Midland Basin, Delaware Basin. You have Texas. You have New Mexico.

And yes, you're right to point out. There is a fair amount of activity in the DJ Basin as well. I'll turn it over to Jarret to see if he has anything to add to the line-of-sight activity.

Jarret J. Marcoux

Executive Vice President of Operations

Thanks, Chris. Just to put some more color around that, we mentioned on Page 7 that we have 9,000 gross line-of-sight wells on a normalized basis. So even on a nominal basis, it's about half that. So when you think about our overall asset, which has over 25,000 producing wells, on a normalized basis, we have 9,000 of those incoming over the next 12 to 18 months. That has us really excited about the future activity on the asset.

Operator

Copyright © 2024 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Our next question comes from Jarrod Giroue from Stephens.

Jarrod Cole Giroue

Stephens Inc., Research Division

So during the quarter, Sitio added 5 acquisitions. You guys added 5 acquisitions in the DJ this quarter. Over the year, you've added a few deals in the DJ. Are you guys seeing a lot of deal flow there? Or these acquisitions just better value for the company? And with that -- in which basins are you seeing the highest deal flow?

Christopher L. Conoscenti

CEO & Director

Yes, it's a good question. If you break it down by just the sheer number of acquisition opportunities, the Permian remains the largest opportunity set. But when you break it down by rate of return and then organically sourced opportunities, the rate of return opportunities in the DJ Basin have been superior recently. So that's why we've directed capital there. And it's really the strength of this business model where we can direct capital to where we get the highest rate of return.

So we're not constrained just to one subbasin of the Permian or to the Permian in general. We can really allocate capital elsewhere. We've looked at acquisitions outside of the Permian and DJ, too. But again, when we run it through the filter of impacts on the balance sheet, impacts on rate of return, it brings us back to the Permian and DJ for the best opportunities for Sitio.

Jarrod Cole Giroue

Stephens Inc., Research Division

Perfect. And then my second question is just about return of capital. I just want to get your thoughts on buybacks versus debt reduction and then if the current allocation of free cash flow is a good go by looking into 2025.

Christopher L. Conoscenti

CEO & Director

Yes, it's a great question because as we have set up our capital allocation strategy, balance sheet protection and return of capital are not mutually exclusive in terms of how we return that capital to shareholders. So we've committed to return at least 65% of discretionary cash flow to our shareholders, and the remaining 35% is retained for balance sheet protection or opportunistic cash acquisitions. And by the way, that 35% retained by Sitio is the highest percentage retained of any of our minerals peers. And so that demonstrates the priority we place on balance sheet strength.

As it relates to how we prioritize -- how we return capital to shareholders, we've committed to return at least 35% of discretionary cash flow in the form of a cash dividend. And just to put that in context, so for this quarter, that implies a cash dividend yield that's 3.5x greater than the S&P 500. So just even the minimum 35% cash dividend this quarter would be 3.5x the S&P 500 dividend yield. And then the other 30% of cash return to shareholders is either in the form of dividends and/or share buybacks. And this past quarter, we bought back about \$29 million of shares.

Operator

Our next question comes from Betty Jiang from Barclays.

Wei Jiang

Barclays Bank PLC, Research Division

So I want to ask about Slide 10, where you guys look at the look-back on your prior acquisition, specifically on the cumulative production outperformance. Look, interesting to see that -- these results in that. Can you talk about which region and assets specifically that's driving that, where you have seen the most outperformance? And then if I look at the comparison of this slide versus the last time you updated,

this number improved as well. So maybe some color on recent deals and what's been outperforming relative to your underwriting assumptions.

Christopher L. Conoscenti

CEO & Director

Yes. Thanks for the question, Betty. We're really proud of the results on Page 10 because we have a pretty rigorous look-back analysis on our acquisitions to see if we need to tweak any of our underwriting assumptions.

And so we view success in our underwriting as being right around the low single-digit percentage positive on that graph on the top right of Page 10. And what that tells us is that the acquisitions are performing in line or better than what we underwrote them for the first 6 months of ownership or 12 months of ownership or 18 months of ownership.

But I'll let Jarret comment a bit on the rest of your question.

Jarret J. Marcoux

Executive Vice President of Operations

Thanks, Chris. Betty, when we look back at our acquisitions, really, the 2 things that we focus on are, are the wells performing better or worse than our underwriting assumptions? Or is it a timing, meaning like the future wells that we're assuming are coming online, are they coming online sooner or later than our assumptions? And those are really the 2 things that really drive these big differences.

And I'll tell you, really, on the well performance side, everything is right down the middle. We don't really see any outperformance or underperformance that's material on that metric. But really, when we think about acquisitions, we make sure that what we are underwriting, the asset can deliver, and that's what we're showing in these charts. So even though we don't have the luxury of controlling the drill bit, we spent a lot of time modeling our own asset and assets we're acquiring to understand what that timing is going to look like.

So I think this performance on the acquisition front is also reflected in, for example, we're enhancing our guidance today, and we underwrite our acquisitions largely exactly the same way that we underwrite and guide to our own assets. So I think you'll see a reflection of our acquisitions coming through also in our own asset.

Wei Jiang

Barclays Bank PLC, Research Division

That's really helpful color. A housekeeping item as a follow-up. So cash tax guidance has varied quite a bit this year. You lowered the last quarter and now raised it. Just what's driving that -- those change? And how should we be thinking about that number going forward?

Carrie L. Osicka

Chief Financial Officer

Sure. Betty, thanks for the question. So last quarter, our projections utilized estimates from not-yet-filed tax returns. We've filed those tax returns. So we're now using updated tax information in our forecast. You may recall in the past, we've talked about the carryover credit related to our corporate merger with Brigham in 2022, which added some complexity to our forecasting this year.

With that said, I do expect us to exhaust that credit this year. So next year should be a lot more straightforward. As you look into 2025, I think it's probably best to revert to kind of the estimated tax rate method in your model. So if the all-in statutory rates are 21% on the federal rate plus 1.5% for Texas margin tax, I would take that all-in statutory rate, and based on the complexion of our shareholder base, I would say 52-ish percent of that all-in rate should guide you in the right direction as to how to think about the future estimated tax rate going forward.

Operator

Our next question comes from Noel Parks from Tuohy Brothers Investment.

Noel Augustus Parks

Tuohy Brothers Investment Research, Inc.

I was really interested to hear your comments on Apache and the Callon assets. And it got me thinking, is it fair to assume that when you have an asset portfolio that has gone through several hands, been sort of coupled together by deals over -- I guess, we're going into the past decade now. Is it the case that you're more likely to see a lot of room for improvement, low-hanging fruit when the assets do get consolidated up?

And I'm thinking in contrast to some of the sort of huge early leasing that was done in the Permian and where it seems that -- and we've seen a lot of deals with assets like that, where it seems that there isn't anything really dramatic happening except maybe just scale efficiencies as far as the progress that they make on productivity. So is my perception right that you kind of have more ragged sets of assets and then more sort of cleanly developed sets of assets and they're sort of in separate camps?

Christopher L. Conoscenti

CEO & Director

Noel, thanks for the question. I'll just make one blanket comment about the operators, and then I'll ask Dax to answer the rest of your question. But the thing we're really happy about with our operator set is how it's migrated over time, and the strength of these operators today, it is light years ahead of where it was even 4 or 5 years ago.

What we really see now is a set of operators that are large enough that changes in commodity prices don't whipsaw around their CapEx budgets. These are people that set up their capital plans under commodity price sensitivities, and they stick to those plans through the cycle. Typically, it takes a very dramatic move in commodity prices for them to alter their capital plans that provides more visibility to the mineral owners and more sustainability to our program as well.

So with that, I'll turn it over to Dax for some additional comments.

A. Dax McDavid

Executive Vice President of Corporate Development

Yes. Thanks, Chris. What we're seeing in general is as these assets change hands, they become more of a priority for the operator that acquired those assets. And that's what Chris got to in our prepared remarks on the transfer of the Barilla Draw from Oxy to Permian Resources.

This is something that is not unique just to the Permian. We're seeing this in all basins. In particular, in the DJ Basin, you see some sale of noncore assets by Civi, where they can reallocate the capital to their priority area being the Watkins area. But those people that bought those assets were able to focus on those and bring value forward for us and for the operator. So it's a good thing that we're seeing.

Also, some of those positions are very legacy for the operators that are selling them, and there's been a lot of improvements in drilling and completion technology since those original wells were drilled. And that's why we kind of mentioned the horseshoe laterals, for example, in our prepared remarks. I mean these wells are cheaper to drill. They're more efficient, and they're able to capture stranded acreage. That was basically unlocking value again. And the cheaper and more efficiently they can do that, the better for them and the mineral owner.

Noel Augustus Parks

Tuohy Brothers Investment Research, Inc.

Pretty exciting. I'm just wondering -- turning specifically to the Permian again. Just your thoughts on infrastructure in the Permian-associated gas and where we're still seeing all these productivity gains happening, larger and larger wells being turned online, although fewer of them sometimes. And against this backdrop of still a couple of tough winters and gas prices not being that exciting, especially regional hubs, so do you see that being an ongoing issue in the basin with -- and what comes to mind is

Matterhorn has come online, and we've heard or people observed that it helped Waha for a short time and then sent it back into a negative direction.

I kind of wonder if that's ultimately irrelevant to the play just with oil prices where they are or, if at some point, it really does sort of wind up being more of an effective ceiling for the play unless a lot more pipeline capital comes into it.

Christopher L. Conoscenti
CEO & Director

Yes. I think the bigger governor on activity is really capital discipline by the operators. And that feels like it's ingrained in them in their DNA now. It's not something that they're just giving lip service to. So I don't see that changing regardless of commodity prices. I think the operators are going to be disciplined around their capital budgets, around their return of capital strategies. And so I think that's going to be the bigger constraint on supply growth from areas like the Permian.

The other comment I'll make is around the midstream companies themselves. I think they've done a much, much better job in the last 4 or 5 years about anticipating these types of needs and planning out new pipelines, reaching FID and signing up new shippers for their volumes and capacity. And that results in these layers of midstream capacity being added over time.

And so just as you commented, with Matterhorn coming into service in September and ramping up its utilization since then, the midstream companies are already talking about Blackcomb behind it, which is another large-capacity natural gas pipeline that's going to take gas from the Permian to the coast.

And so the operators -- the midstream companies are already seeing this dynamic in the basin, and they're already responding to it. They're not waiting until a couple of years down the road when differentials really gap out further and then decide to do something, then it's a waiting period from there. So these plans are already in the works today. So I really want to recognize the work that the midstream companies are doing as well.

Operator

We currently have no further questions. So this concludes today's call. Thanks, everyone. Thank you for joining. You may now disconnect. Thank you.

Copyright © 2024 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

These materials have been prepared solely for information purposes based upon information generally available to the public and from sources believed to be reliable. No content (including index data, ratings, credit-related analyses and data, research, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON "AS IS" BASIS. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. S&P Global Market Intelligence's opinions, quotes and credit-related and other analyses are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence may provide index data. Direct investment in an index is not possible. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

© 2024 S&P Global Market Intelligence.