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REMEMBERING THE FUTURE

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MLPs: Riding Through Bumps In The Road

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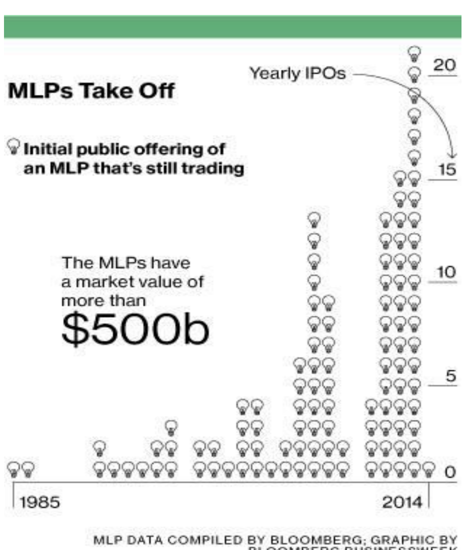
Introduction

Markets coming out of the Global Financial Crisis have seen assets of various breeds shine. The boom in values has been virtually indiscriminate, aided by record corporate profits, easy money from the globe's central banks that keeps interest rates low and bond prices high, and an economic recovery in the U.S. that is inching its way to consolidation.

Master Limited Partnerships (MLPs) as an asset have become one of the most popular in recent years for investors. Funds flowing towards MLPs have consistently risen over the past few years and the issuance of new shares over recent years shows a strong upward trend, indicating a robust appetite for MLPs in capital markets (Figure 1). While only 9% of public companies are organized as MLPs, they raised over 25% of new equity issuance in 2012 according to research by The Economist.

Figure 1: Demand for MLPs Has Led to a Surge in Issuance (Bloomberg)



Master Limited Partnerships blend traits from a mix of other asset types, which while creating appeal among a diverse set of investors, also concurrently leads to confusion and misunderstandings as to what they are, especially when the market falls. Offering yields that compete with corporate bonds some investors interpret MLPs as debt when in fact they are equities. The distributions remitted are often in large part tax deferred, invoking comparisons of REITs even though most MLPs have nothing to do with real estate and are most frequently associated with America's booming oil and natural gas industries.

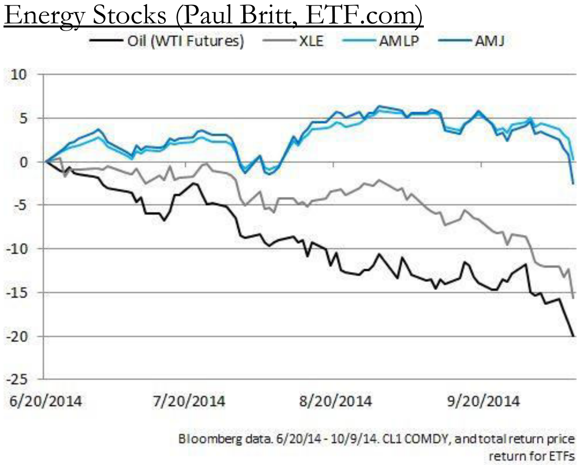
Given the boom in both MLPs popularity for investor's portfolios and the American energy industry our newsletter this month aims to provide a foundational understanding of this investment class. We also touch upon what MLPs are, are not and what are the key qualities to watch out for when incorporating them into a portfolio. While the long-term fundamentals support MLPs there are indications that volatility in these stocks could arise in the near term, something investors should be aware of.

MLPs: What They Are and Are Not

Master Limited Partnerships blend features from a variety of assets that make them an attractive allocation target and bring in investors of different stripes. MLPs are first and foremost a type of legal structure for how firms can organize themselves and commonly reside in the energy sector, in companies that deal with operations such as the transportation, storage, and refining of commodities like oil and natural gas.

Toll stations are a frequent metaphor invoked in discussing MLPs as they collect revenue when commodities travel through its infrastructure network. While the demand for such commodities may be dictated by price, the fees MLPs collect in the majority of cases are not. This is an important qualifier as it provides some cushion against commodity prices (Figure 2).

Figure 2: MLPs Handle Oil's Fall Better Than Energy Stocks (Paul Britt, ETF.com)



A typical structure involves two main players, the General Partner (GP) who holds a small stake (usually around 2%) but manages the firm for a fee and Limited Partners (LP) who provide capital and receive distribution but have no say in how the MLP is run. In addition, the General Partner contains Incentive Distribution Rights, entitling the GP to greater marginal proportions of cash distributions if certain targets are reached for the total distributions given out. This encourages the GP to control costs, grow payouts and efficiently manage the partnership's assets.

So long as a firm generates over 90% of its income from specific activities, usually based on natural resource production per the Internal Revenue Service, the firm can forego corporate income tax and directly pass on income to unit holders (as holders of MLP shares are referred to). This trait obviously provides MLPs a competitive edge to peers structured as a corporation but the tax benefits go further. The large proportion of income that MLPs often distribute (70%-90%) in large part qualify as a return of capital, which is not taxed, but rather reduce an investor's basis in the units. For investors, especially those with long-term horizons, the tax appeal is apparent.

Yields ranging from 5%-7% are not uncommon when it comes to MLPs; some promise to pay investors distributions north of 10%. Given government bonds have seen yields plummet the appeal for assets that offer greater returns has grown and capital flowed towards them; MLP mutual funds have seen their assets rise from $3 billion to $32 billion in just the past four years.

In addition, MLPs have demonstrated an impressive track record of performance, or rather, out-performance relative to the major stock indices. From 2000-2012 MLPs outperformed the S&P500 every year. During 2014 the Alerian MLP Index kept pace with the S&P's rise until the recent sell off in energy assets mid-October, but has still kept up with the Dow.

With ingredients of strong performance over a considerable time period, tax deferral and high yields it is not surprising to hear about strong inflows and high praise of choosing MLPs for portfolio allocation. In March of this year 93 out of 114 Wall St. analysts stated an expectation for MLPs to rise in value over the next year. Even further, all but five MLPs were given purchase recommendations, per Bloomberg.

Part Two: A Secular Trend but Discipline Still Required

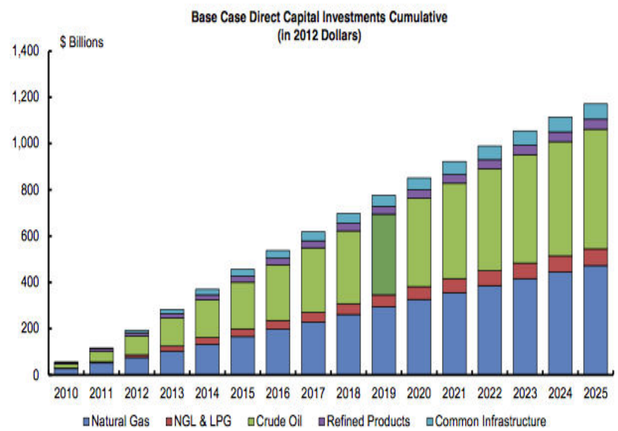
"The trend is your friend" is a well-known Wall St. moniker. Like most shorthand quips it's true, until it isn't. The bullish sentiment in MLPs has brought out polarizing views for Master Limited Partnerships and the direction they'll head going forward.

While the major theme in the world of energy over the past few months has been the dramatic fall in oil prices the narrative in the United States continues to focus upon the revolution in supply brought upon by hydraulic fracturing ("fracking") and horizontal drilling. New production techniques have created a renaissance in the industry; natural gas production has hit record highs this year while production of crude has risen by 50% since 2011. The surge in supply concurrently means greater activity along the infrastructure provided by MLPs. Capital spending in upstream, midstream and downstream capacity has risen 60% since 2010 according to HIS, a leading research and data firm.

The revolution occurring in the energy sector throughout the United States represents a secular trend. According to the U.S. Energy Information Administration's (EIA) 2014 Energy Outlook crude oil production will triple its 2012 levels by 2019 in a base case scenario. Natural gas production rises 20% from 2012 to 2025 as well according to the EIA. Moreover, government regulations mitigating the efficacy of coal as an input, Mexico's need to import natural gas to support the manufacturing sector, and the slow opening of the LNG export industry support long term fundamentals in natural gas. Overall, production is strong, growing, and becoming more efficient setting the stage for an enormous rise in capital needs for the industry (Figure 3).

The trend in the underlying industry clearly supports MLPs in general but risks still remain, primarily because money has been chasing them blind. Chasing the most recent high performer is a known pattern in capital markets; euphoria has plagued asset markets for centuries. As a result, wild capital flows and price swings can surface.

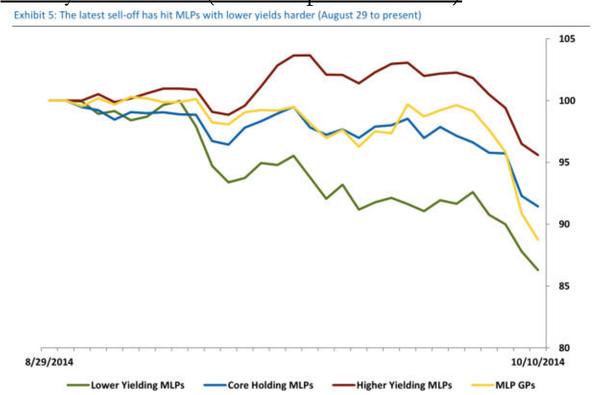
Figure 3: Cumulative Capital Investments To Rise Significantly (IHS)



Investors chasing yield is not surprising. It should be expected in markets of all colors but the effect has been amplified in the backdrop of zero interest rate policy from the Fed. As a result investors with an eye on income have flocked to MLPs. When rates eventually do rise (whenever that may be) investors may question the utility in holding MLPs when there is greater safety in government bonds and thus opt to get out of MLPs.

In addition research by Hinds Howard of CBRE Clarion, an asset management firm, finds that valuation metrics have accounted for a much larger portion of MLP returns than a long term analysis would suggest is customary. Returns for MLPs have primarily been driven by distribution growth historically suggesting the more recent trend of is an anomaly and a reflection of a zero rate world. As a result, MLPs of high valuations and without a strong track record of growing their distributions would be most susceptible to interest rate risk. RBC Capital Markets also finds that these high valuation firms have been the hardest hit in light of oil's recent decline (Figure 4). MLPs with good yields and a proven long-term track record of distribution growth should be the preferred asset in this space as it demonstrates that management has invested capital wisely.

<u>Figure 4: Expensive MLPs (Green Line) Hardest Hit By Fall in Oil (RBC Capital Markets)</u>



Investors also need to pay close attention to cash flow statements when evaluating MLPs. Large amounts of debt is not uncommon with these companies due to the capital-intensive nature of the business. As a result debt metrics on the surface may strike investors as being quite high relative to companies from other industries or even within the industry as a whole.

Robust cash flows that can support capital expenditures and distribution growth are a vital characteristic of MLPs with strong prospects. Cash flows should also be the primary variable used when discussing the valuation of these firms, as opposed to the traditional P/E metric. The large amounts of capital employed by MLPs mean that depreciation costs are higher than other industries. Therefore earnings statements and other income measures can be skewed. Given that most buyers of MLPs are in it for yield what should matter to investors is whether or not there is a viable and sustainable long term pattern of cash coming in and out of the business that reduces the risk of a cut in the payout.

Conclusion

The explosion of a new product amidst a revolutionizing industry that inspires ignorant bliss can be a recipe for an ugly ending on Wall St. Internet stocks without any record or prospect of profits soared simply out of a euphoria for any asset that touched the web.

Rumblings have started to emerge in 2014 about whether similar traits are evident in MLPs. There is growing evidence that funds are flowing to MLPs of all kinds and that investors are not aware of some of the risks involved. MLPs with variable distributions are garnering greater attention and are attracting investors who misunderstand the product; mistaking MLPs as a debt instrument rather than equity is an all too common mistake as well. As a result, capital has flowed to instruments without fundamentals support.

The recent pullback in MLPs demonstrates the risks. A drop of 16% over six weeks from September 1st of this year on oil's slide scared investors who didn't know what they were holding. Future events, such as an interest rate increase or volatility in MLPs with questionable fundamentals could sully the class as a whole and introduce swings inconsistent with the secular trend in energy production in the United States.

The presence of the U.S. as a global energy power is systemic, especially given the technological edge and productivity edge in shale resources relative to the rest of the world. So long as investors do their homework and maintain a long-term perspective they should be able to ride out any near-term volatility in MLPs to their benefit.