Another MLP Simplification Benefits From Favorable Depreciation Rules

Last week Williams Companies (WMB) simplified their structure by acquiring the assets of their Master Limited Partnership (MLP), Williams Partners (WPZ). As was the case with Kinder Morgan's (KMI) move last year, the objective was to move to a simpler structure with a lower cost of equity driven by faster dividend growth supported by a bigger tax depreciation shield. Although the effect wasn't as big as with KMI, WMB was similarly able to take advantage of depreciation rules that allow assets acquired from a partnership to be written up to current market value, thus creating a higher level from which tax-deductible depreciation can be made. This contrasts with the rules that apply when a corporation is acquired, whereby the excess over book value paid by the acquirer is reflected as an intangible asset (goodwill). No similar depreciation of goodwill is allowed. Given the choice, you'd rather buy assets from a limited partnership than a corporation, since in the depreciation rules are more favorable. WMB expects to realize a $2.1 billion benefit over 15 years from this stepped-up cost basis which will support a dividend growth rate of above 10%. Its 4.9% yield looks attractive.

Regular readers of this blog might have started to feel that we never come across an MLP General Partner that we wouldn't like to buy. Although we think the sector is attractive, this isn't true of every security. EQT GP Holdings (EQGP) recently started trading following its IPO. EQM Midstream Partners (EQM) is an MLP focused on natural gas gathering, storage and transmission in the Marcellus shale in SW Pennsylvania and West Virginia. EQGP is its GP, with Incentive Distribution Rights over its cashflows.

We were potentially interested in EQGP depending on pricing. However, its forecast first year distribution of $0.365, even if combined with a heady growth rate of 40%, had us thinking that a mid-$20’s price for the IPO would be a full price but probably justified because of the growth outlook. The IPO buyers regarded us as needlessly conservative however, and EQGP commanded a low $30’s price from inception. Too rich for us; we’ll wait for another pitch.

Of the names mentioned, we are invested in KMI and WMB.