Published by SL Advisors, LLC

In Pursuit of Value

December, 2017

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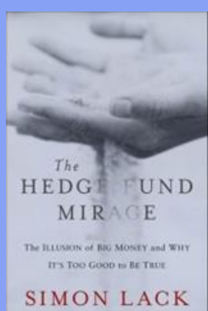

Limited Partners, Limited Rights

Investors in Master Limited Partnerships (MLPs) have more limited rights than most equity investors in corporations. They're called Limited Partners (LPs) for a reason. There's often a General Partner (GP) who runs the business on behalf of the LPs. GPs have preferential economics, governance and information rights, and we concluded many years ago that the GP/MLP relationship looks a lot like the one between a hedge fund manager and his hedge fund (see MLPs and Hedge Funds Are More Alike Than You Think). GPs earn Incentive Distribution Rights (IDRs) rather than the ubiquitous "2 & 20" that has financed so many hedge fund and private equity fortunes. But the result is similar, since IDRs pay the GP more as the profits of the MLP grow.

Most of the big MLPs have simplified their structure in recent years. IDRs have come to be viewed as an unnecessary drag on LP returns, and it's turned out that MLP investors aren't a great source of capital (see Why the Shale Revolution Hasn't Yet Helped MLPs). Simplification usually results in a collapsing of the GP/MLP dual entity into a single one. In such cases the result is often a corporation with no IDRs. The objective is to gain access to a far wider investor base in order to fund growth. Kinder Morgan began this trend in 2014 (see What Kinder Morgan Tells Us About MLPs).

Energy Transfer Partners (ETP) is the largest of the remaining MLPs that retains the old structure, with Energy Transfer Equity (ETE) as its GP. CEO Kelcy Warren understands better than most how lucrative the GP/MLP structure is, since it's created the bulk of his personal wealth which is in invested in ETE. The market price of ETP reflects some skepticism that the current arrangement will persist, as reflected in ETP's 13% yield. Consistent with Kelcy's swaggering posture on such issues, ETP recently raised its payout so as to convey just how confident they are in the safety of the distribution. A merger of the two entities with ETE as the surviving entity would result in ETP LPs receiving ETE units which yield "only" 7%. ETP's high yield presumably reflects the view of many that such a transaction is possible. And yet, we calculate that ETE's 2018 Distributable Cash Flow will jump from $1BN to over $1.8BN, due to the expiry of previously granted IDR waivers and contribution from two major projects being moved into production. This could support a substantial jump in ETE's cash available for payouts, so ETP investors have less to fear in a combination of the two.

One analyst recently suggested that ETP's owners could band together and fire ETE as the GP, thereby unlocking substantial value for themselves at the expense of ETE. Kelcy is not a sympathetic character, and has demonstrated before that he has no fiduciary obligation to ETP, nor even to other ETE investors. The convertible preferreds that ETE issued to insiders in early 2016 are the subject of an ongoing legal challenge in Delaware court (see Is Energy Transfer Quietly Fleecing Its Investors?). This transaction showed that even investing directly alongside management in ETE carries some risk of self-dealing.

In fact, investing with Kelcy is like sitting at a high-stakes poker game with a good hand drawn from a deck of marked cards. You have valuable, well-positioned assets run by a talented management team, and have to balance those against the possibility of Kelcy screwing you if he can get away with it. All these factors need to be considered in sizing your stake. ETP yields 13% because investors don't trust the dealer.

Although the notion of ETP LPs rising up in rebellion and overthrowing their monarch holds some understandable appeal, it faces some substantial challenges. Apart from the requirement that 2/3rds of the ETP LPs vote to fire the GP, a recent ETP registration statement included this language:

Our partnership agreement authorizes us to issue an unlimited number of additional partnership securities and options, rights, warrants and appreciation rights relating to the partnership securities for any partnership purpose at any time and from time to time to such persons, for such consideration and on such terms and conditions as our general partner determines, all without the approval of any limited partners.

ETE can always dilute a hostile group of LPs below the threshold. ETP's attempted regicide would likely trigger a debilitating response.

Such language is not uncommon across the industry. A 2016 prospectus filed by NuStar (NS) is similar:

NuStar Energy's partnership agreement authorizes NuStar Energy to issue an unlimited number of additional partnership securities for the consideration and on the terms and conditions established by the general partner in its sole discretion without the approval of any limited partners.

In The Limited Rights of Some MLP Investors last year we listed further examples of this type of GP protection.

Relatively weak governance rights are by no means unique to that portion of the $300BN publicly traded MLP sector that retains the GP/MLP structure. Around $3TN of capital invested in hedge funds has few rights and certainly worse liquidity. At least you can sell your MLP units if you're unhappy. Hedge funds often respond to adversity by further limiting withdrawals. Private equity offers even less liquidity than hedge funds. Investor attempts to fire such managers are rare because they're futile (see *The Hedge Fund Mirage*, Chapter 7: The Hidden Costs of Being Partners).

Alphabet (GOOG) has long had three share classes, with super-voting powers attached to founders' shares that have the practical result of ensuring minority control even if a substantial majority of aggregate shares are voted in a certain manner. Facebook, Alibaba, Volkswagen and even Berkshire Hathaway are among the large global companies that have multiple classes of equity investor. The Economist recently opined on this (see How tech giants are ruled by control freaks).

The GP/MLP structure can be thought of as providing a preferred return to the LPs with the GP class sitting below them in the capital structure from an economic perspective. This is because the GP's IDR take is linked to distributions paid to LPs, and starts out at 2%. So if distributions to LPs are cut, that can disproportionately lower the GP's IDR take as they fall back down to the lower % splits. Moreover, recent history includes many examples of GP's temporarily waiving IDRs, which benefits LPs over the GP at least in the near. We prefer to own GP's because we believe their superior governance rights translate into better long term value creation, a view widely shared by their management teams. But investors routinely commit capital to equity vehicles that afford them junior rights, from MLPs to the large public companies listed above as well as the entire hedge fund and private equity sectors. It's an imbalance that isn't going away.

We are invested in ETE, and NuStar GP Holdings (NSH, GP of NS)

American Energy Independence Index

The American Energy Independence Total Return Index (AEITR) is being updated daily by S&P Dow Jones Indices. Because energy infrastructure is about far more than MLPs, we believe this index is the best measure of businesses that will benefit from America's evolving energy independence. Energy security is taking on a new dimension in the U.S. because of the Shale Revolution, which is why many large MLPs have converted to regular corporations, so as to access a far larger pool of capital. A new energy future demands a new index. Investment opportunities linked to this index will soon be available.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.