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In Pursuit of Value

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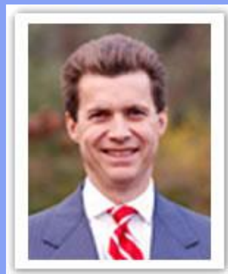


MLPs and Mergers and Acquisitions (M&A)

Since last Summer the collapse in crude oil has arguably been the dominant story driving equity markets. There have been times when it seemed as if almost every member of the S&P500 must have some hitherto undisclosed oil exploration business going on that was dragging its stock price down along with the rest of the Energy sector. Moreover, companies with any actual nexus to the energy complex were assumed to be harmed by falling oil prices almost regardless of whether they produced, moved, stored or refined it.

Away from the headlines about supply exceeding demand and conspiracy theories concerning the Saudis achieving geopolitical goals by not influencing the only thing people think they can influence, some of the shrewder MLP operators have been preparing to create different headlines. The new stories are increasingly about M&A activity. Back in June 2014, WTO oil was at $106/bbl and the coming rout was still ahead of us. The yield on the Alerian index was 5.4% (versus just below 6% now; source: Alerian). Kinder Morgan Partners (KMP) sported a yield of 7% on 2015's company-forecast distribution. Its General Partner Kinder Morgan, Inc (KMI), whose 50% share of KMP's Distributable Cash Flow (DCF) was responsible for the muted growth prospects of KMP's distribution, yielded 5.5% on a then company guided $1.87 distribution for 2015.

Just a few months earlier, during the January conference call following 4Q13 earnings, CEO Rich Kinder had noted the "excellent" financial and operating performance of their business units but also lamented the stock price, saying, "I do believe that particularly at KMI and KMP, these securities are trading at the greatest disconnect to appropriate valuation since the period in 2006, just before we took the first KMI private." One reason was the drag of KMI General Partner (GP) stake in KMP which entitled it to 50% of the DCF generated by KMP, pushing up its yield as noted. Another was the bearish assessment offered by an obscure research firm in Connecticut, to which Kinder alluded by saying, "…you sell, I'll buy, and we see who comes out the best in the long run." Plain-spoken CEOs are so much more interesting.

He'll never touch another energy stock.

By July, in response to a question on the lagging stock price, Kinder said, "Let me just say that we're always exploring operational and strategic opportunities to enhance the value for our investors, including myself. And that includes, among other things, evaluating potential combinations of Kinder Morgan companies." He later added, "…cost of capital plays a role in any M&A activity, and we aim to be as competitive as possible in that...I think M&A is going to be active over the next months and next couple of years, and we certainly want to be a player in that and more to come."

KMP's 7% yield combined with KMI's 50% share of future growth made it hard to make accretive

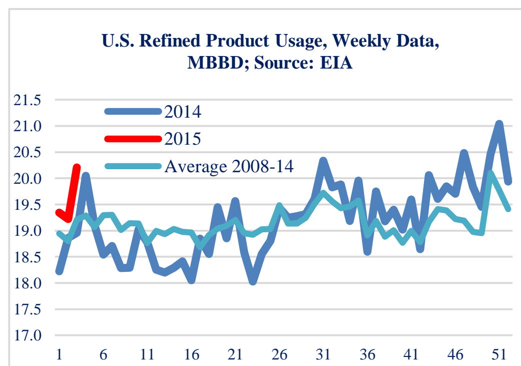
acquisitions because the currency they'd use wasn't as highly valued as some of their targets. Consequently, the subsequent simplification of the four publicly traded Kinder enterprises into one (KMI) was predictable given the CEO's comments. Today, KMI offers a 2015 yield of 4.7% on a dividend now expected to be $2. KMI is the currency to be used in acquisitions, since it owns the assets formerly held in KMP. So Kinder now contemplates a world of midstream assets in which his equity yields 1.3% less than the publicly traded benchmark, whereas last Summer it was 1.6% higher. This almost 3% favorable adjustment makes accretive acquisition more possible and is why they're shopping, recently buying Hiland Partners, LP from Harold Hamm of Continental Resources (CLR). Hiland operates a gathering and processing network in the Bakken Shale in North Dakota. The fact that KMI opted to buy an existing business highlights the difficulties of building completely new operations, with numerous hurdles from permits to the absence of local knowledge or relationships with resident service providers.

Another case concerns Energy Transfer Partners (ETP) and Regency Energy Partners (RGP), both of whom are controlled by Energy Transfer Equity (ETE) through its ownership of their respective GP and IDRs. Last Summer both ETP and RGP yielded 7.3% on company-forecast 2015 distributions. By late January ETP's yield had fallen to 6.6% on a distribution by now increasing at 8.3% (compared with 5.7% previously). RGP's yield had meanwhile drifted up to 8.9%. The 2.3% difference was enough to induce ETP to issue equity to RGP so as to merge, resulting in a stronger balance sheet with a lower cost of capital. Once again, ready for M&A, and the stock of ETE which stands to benefit most clearly from this rose accordingly. CEO Kelcy Warren commented that, "We will absolutely continue to look for external opportunities as you know our philosophy here is, every MLP we believe should have a healthy mix of M&A and organic growth."

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

Greg Armstrong, CEO of Plains All America, LP (PAA) and its GP Plains GP Holdings, LP (PAGP) said in November, "…we have high hopes that this period of depressed crude oil prices and capital markets disruptions will carry with it attractive, reasonably priced acquisition opportunities that PAA will be able to capitalize on by using its strong balance sheet, operational and commercial synergies and extensive acquisition experience."

These firms are all positioning to be the buyers of assets cheapened up by the fall in oil. Bigger companies are also better positioned to take on new projects to add to America's stock of energy infrastructure. What about the other side of these transactions? One potential target is Semgroup (SEMG), which operates gathering, transportation, storage, distribution, marketing, and other midstream services. Its stock has fallen from a high of $88 last Summer to a recent price of as low as $58. Its $3.75 billion enterprise value represents an easily digestible morsel for any of the acquirers listed above, and its relatively small size has left it vulnerable to the recent market volatility. Management is publicly debating with activist investor Thomas Sandell the true value of the company (which Sandell estimates to be above $100 per share) and the most effective way to realize it.



Interest rates remain implausibly low, always an important consideration for M&A activity. At a time when ten year Italian government debt yields 1.6% and similar French bonds 0.6%, both seemingly oblivious to their steadily depreciating currency, ten year U.S. treasuries at 1.8% appear a bargain, at least through the distorted vision required of today's bond investors. In short, it doesn't look as if interest rates will impede debt-financed acquisitions. As shown, the drop in oil has caused a divergence in the cost of capital for companies; limited commodity price sensitivity and robust balance sheets define the buyers.

Finally, domestic energy demand is being stimulated by lower prices. U.S. demand for refined

petroleum products (of which gasoline is just under half) recently exceeded 20 million bbd as shown on the right. Consumption has been trending above the post-2008 Crisis average since last Summer. Demand is responding even though U.S. energy intensity (defined as units of energy consumed per $ of GDP) has continued to fall. We expect to see additional M&A activity in the sector as oil-induced dislocations are resolved.

Of the names mentioned, we are invested in KMI, ETE, PAGP and SEMG.