MLP Buybacks

You rarely see MLPs buying back their stock, by contrast to companies in most other industries. Buybacks provide a tax efficient way to return excess capital if the stock is undervalued. Because MLPs invest heavily in CapEx and generally distribute most of their free cashflow to LP unitholders there's rarely any left over for buybacks. In fact, they regularly issue shares to raise capital to invest in projects.

Energy Transfer Equity (ETE) is an exception. In last week's earnings call they announced a $2 billion buyback, to be executed opportunistically. This represents almost 6% of the market cap of the business, and is a tangible example of management's stated view that ETE is under-priced. Meanwhile, ETE's distribution is growing strongly, with a 30% year-on-year rise.

This doesn't mean that ETE has any shortage of projects in which to invest. ETE receives part of the incremental cash generated from the capital expenditures at it's underlying MLPs. In spite of the slowdown in North American shale development, ETE's opportunities are such that they're expecting to invest $7B in new projects at Energy Transfer Partners (ETP), $5B at Regency Energy Partners (RGP), and $2B at Sunoco Logistics (SXL) all of which will generate cash flows for ETE though its Incentive Distribution Rights.

In short, ETE can invest in new projects though its MLPs using the cash flow received at the ETE level to pay distributions, make acquisitions, or buy back its own stock. The prospects in energy infrastructure clearly look good from where they're sitting. We are invested in ETE.

The Hidden Tax Bite of MLP Funds

Master Limited Partnerships (MLPs) are inexorably linked with those annoying K-1s in the minds of many investors, complicating tax reporting. For some people it's one of the few things they know about MLPs and the muttered warning of their accountants to avoid K-1s keeps them away from the asset class. Direct holdings of MLPs are the most efficient way to invest in the sector, and in my experience the K-1s aren't that big a deal. MLPs fully understand the barrier tax reporting represent to many potential investors. As a result, almost all MLPs now provide K-1s electronically and they are issued well before the April tax filing deadline. I've also yet to identify an accountant who will put a price on the additional cost of including a K-1 in a client's tax return. Even at $100 each and a dozen K-1s, it's well worth it for a portfolio of $500K or up invested in MLPs.

Not everybody has that much to invest, and others may nonetheless still prefer a simpler tax return consisting fully of 1099s for their tax reporting. Ten years ago I seeded Alerian Capital Management's hedge fund when I was at JPMorgan. Much time and many expensive hours of tax advice were spent trying to come up with a way of maintaining the tax deferral benefits available to direct investors in combination with the simpler tax reporting of a 1099. The bottom line is, there is no way to do it. In this respect, the tax code is watertight. You can hold MLPs with K-1s, or you can invest through a vehicle that provides 1099s at the cost of a substantially greater tax burden.

For many years the industry didn't spend much energy on the

less efficient, 1099 route. But in recent years that has changed, as it turns out there is a ready pool of buyers who will sacrifice quite a lot for tax simplicity. In fact, the solution is a pretty blunt instrument in tax terms. Holding MLPs in a corporation (a “40 Act Fund”, which is a mutual fund or exchange traded fund), solves the tax problem by simply paying 35% tax on the returns. You can have MLPs with K1s, or 65% of MLPs with 1099s. Many people choose the latter, to the evident amazement of people in the industry. An example is the Mainstay Cushing MLP Premier Fund (CSHAX and CSHZX). I remember Jerry Swank, Cushing’s CEO, at a conference some years ago commenting with incredulity at the interest in a competitor’s exchange traded fund (ETF) which solved the tax reporting problem with the 35% haircut. But consumers know what they want, and Cushing subsequently provided it to them.

I wonder how many really know what they’re buying? CSHAX sports a yield of 6.34%, slightly above the yield on the Alerian Index of 6%. It invests in MLPs. But looks can be deceptive; CSHAX has underperformed the Lipper Energy MLP Fund for each year of its existence. Its expense ratio for 2013 (the most recent year available) was a whopping 9-10% (depending on the share class). Most of this (around 8%) is the “Deferred Income Tax” expense, which is the 35% Federal corporate income tax bite that the fund pays in order to provide those 1099s. 2013 was a great year for MLPs so the tax drag is unlikely to be that high every year. But it will nonetheless be an ever-present penalty, eating up a portion of results year after year. Due to a quirk in the way yields are reported, the 6.34% yield advertised by CSHAX is essentially what the fund pays BEFORE adjusting its NAV down to reflect the tax liability. The net, after tax result to the investor is inevitably lower, and that’s before they pay their own taxes.

Like many things that retail investors buy, it’s disclosed but probably not understood. ’40 Act companies that maintain MLPs

at less than 25% of their holdings qualify for pass-through treatment, which means the deferral characteristics carry through to the investor. It's the best you can do in terms of holding MLPs and avoiding K-1s. We run a mutual fund that offers this structure.

More Useful Earnings and Guidance From the MLP Sector

Among energy infrastructure companies of note delivering earnings this past week was Spectra Energy (SE) and Spectra Energy Partners (SEP), the Master Limited Partnership (MLP) it controls. The results were good, coming in slightly ahead of estimates. More important was that their backlog of new projects remains robust. Last year SE management produced a soundbite "Drive to 35" forecast, meaning they intended to secure $35BN in new projects by 2020. In their Analyst Day (which came a day after earnings), they reported that almost half of this goal is already in hand. This is important because the bear case for MLPs and U.S. energy infrastructure is that future growth will be cut as E&P names respond to the oil collapse by reducing spending. So far that isn't panning out among the individual names we follow that have reported recently. There have been modest reductions in planned capex, such as Kinder Morgan (KMI) reducing new investment related to its CO2 business, but the changes have been minor, <5% of planned expenditure.

SE currently pays a $0.37 quarterly dividend, generating a yield of just over 4%. Management is confident they can grow the dividend at $0.14 annually through 2020 over the next couple of years while maintaining coverage above 1X, which is

growth of around 9%. Also notable was that the majority of the planned capital expenditure (capex) will take place at their MLP, SEP, where it will be funded. In other words, no new equity issuance for SE which owns the General Partner (GP) and Incentive Distribution Rights (IDRs) for SEP. Asset growth at SEP will increase cashflows to its controlling entity SE – just as asset growth at a hedge fund invariably benefits the hedge fund manager. SE does much more than simply collect cash from SEP, but dividend growth at SE is going to be substantially funded by other people's money coming in to SEP.

Plains All American Pipeline (PAA) and its publicly traded GP, Plains GP Holdings (PAGP), both reported earnings. PAA reduced its planned capex for 2015 by 9% compared with 2014 as they reassessed certain projects with today's lower oil price. They also reduced the midpoint of their EBITDA guidance by 6% compared with figures provided in November. This in turn reduced forecast distribution growth at PAGP to a still robust 21%. Management is well regarded and market reaction to this seemed to conclude that they were being conservative. PAGP currently yields 3%, which while lower than many other energy infrastructure securities is still attractive in our opinion because of the very high growth rate. Their 4Q14 distribution was up 27% over the prior year.

In sum, these two businesses are adapting to lower oil prices but are largely continuing along a similar financial path to last year. We prefer the GPs because of their preferential economics and governance rights (just as hedge fund managers are better investments than hedge funds). Of the names mentioned, we are invested in SE, KMI and PAGP.

MLPs Report Encouraging Prospects

It’s earnings season, and last week Enterprise Products Partners (EPD) reported another solid quarter. An appealing feature of EPD is the absence of a General Partner (GP). So unlike many other MLPs, EPD LP unitholders do not suffer a haircut to Distributable Cash Flow (DCF) from GP Incentive Distribution Rights (IDRs) before the cash makes its way to the LPs for their distribution. This allows the growth of DCF from EPD’s portfolio of assets to flow right through to EPD unitholders, thereby giving it a lower cost of capital than would be the case if there was a GP. Insiders also own 35% of the units, a significant alignment of interests.

EPD’s full year results came in modestly better than expected and their distribution growth from 2013 was +5.8%. They also have unusually high DCF coverage of 1.4X which allows them to fund part of their planned growth through this excess of DCF over declared distributions. EPD is positioning itself to support the U.S. shift to role of refined products exporter, and its planned growth capex is on the same trajectory as it was last Summer when oil was above $100 bbl.

Kinder Morgan (KMI) held their Analyst Day on Wednesday and provided further detail on the business following their earnings release the prior week. As they pointed out numerous times during the day of presentations, 85% of their 2015 cashflows are fee-based and a further 9% are hedged, leaving only 6% subject to commodity price swings.

NuStar (NS) was also interesting, in that their reported earnings showed distribution coverage of 1.1, at last sufficient to cover payouts to unitholders. It’s not that long ago that their distribution was at risk, but they have exited the asphalt business, greatly reduced their commodity

sensitivity and focused on the storage business. Analysts on the earnings call were even asking about the timing of a distribution increase. NS has a publicly traded GP called NuStar GP Holdings (NSH). Its current distribution generates a yield of 5.8%, very high for a GP. NSH receives up to 23% of the DCF of NS and it is currently at that level. As the business returns to growth NSH's IDRs, 13.1% LP interest and smaller outstanding number of unit compared with NS should translate into roughly twice the distribution growth rate as that experienced by the other LP unitholders in NS. It's why we prefer the GPs.

We are invested in EPD, KMI and NSH.

Energy Transfer Shows the Power of the General Partner

This morning Energy Transfer Partners (ETP) agreed to merge with Regency Energy Partners (RGP). Terms included an equity swap whereby RGP holders will receive 0.4066 ETP units and $0.32 in cash for each RGP unit they hold. ETP is also assming RGP's debt. Energy Transfer Equity (ETE), ETP's General Partner, already owns the GP and Incentive Distribution Rights (IDRs) for RGP. However, the IDR's were only at the 25% split level with respect to RGP, meaning that ETE was receiving 25% of RGP's Distributable Cash Flow (DCF), whereas ETE is at the 50% splits on its share of ETP's DCF. Simply put, prior to the merger ETE was getting more of each dollar generated by ETP than it was from RGP. Following the merger, RGP's DCF will in effect be subject to the same 50% split at ETP's. ETE has agreed to forego $320 million of IDR distributions over the next five years as a sweetener. It is

nonetheless a nice deal for ETE and the relative performance of the stock prices reflects this. ETE is currently up over 4% reflecting its improved cashflow outlook, while ETP is down more than 5%, perhaps in part because of the issuance of additional units. RGP is up because the terms of the transaction represented a premium to RGP's Friday close. RGP's projected 2015 distribution yield was 8.9% prior to the transaction compared with 6.6% for ETP, so even allowing for the modest premium the transaction is still accretive to ETP. Importantly though, ETE investors most notably including CEO Kelcy Warren did not have to provide any capital to make this transaction happen; it's been funded by ETP, as directed by ETE, its GP. The subsequent entity will also have a stronger balance sheet with a lower cost of debt, making future acquisitons easier to execute.

It highlights the advantages of investing in the General Partners of MLPs. They have all the control, and can execute M&A transactions that improve their economics with little or no obligation to provide additional capital. We are invested in ETE, as is Kelcy Warren who owns almost 80 million units of ETE worth around $4.5 billion. He figured this out long ago.

Kinder Morgan Finds Value in a New Pipeline Network

Master Limited Partnerships (MLPs) have been falling along with the rest of the Energy sector since oil began its plunge last Summer. Following its peak in August, the Alerian MLP Index is down 15.1%. So far it's down 1.6% in January, typically a strong month as retail investors implement asset reallocations settled on over the Christmas holidays. However,

there are some signs of stabilization as the Index was -8.9% for the month by January 13th so has rebounded since then.

We're in earnings season, a time during which those firms with solid fundamentals and limited direct commodity price exposure can differentiate themselves by reporting their results and providing guidance. Kinder Morgan (KMI), although no longer technically an MLP since their reorganization last year, still derives over half their cashflows from natural gas pipelines and is solidly in the midstream sector. During the conference call following their earnings they went through the coverage of their $2 distribution and although there are many moving parts the distribution coverage looks comfortable even with crude oil substantially lower (into the $20s per bbl) and natural gas down to $1 per MCF. Their direct exposure to crude oil and natural gas prices is limited. They reaffirmed 10% distribution growth through 2020. The stock yields 4.7% on its 2015 dividend.

KMI also made their first investment in the Bakken Shale in North Dakota by acquiring Hiland Partners LP, a privately owned MLP with pipeline assets in a still under-served area, from Continental CEO Harold Hamm. The $3 billion price tag will help fund Hamm's expensive divorce.

KMI expects to invest an additional $800M in these new assets, expanding their capacity to transport crude oil from North Dakota. At a time when many are worrying about production cutbacks by U.S. shale producers this decision to make a new capital commitment highlights an interesting advantage pipelines retain over other form of crude oil transportation such as rail or truck. Only around half the 1.2 million bpd of output from North Dakota moves by pipeline, so increasing the Double H Pipeline (for example) from 80,000 bpd to 108,000 by next year will help. Pipelines operate at as little as 25% of the cost of rail and truck. While the latter two can offer greater flexibility, once a pipeline is in place its substantial cost advantage makes it a formidable competitor,

and the long term commitments required of shippers provide far greater certainty about future cashflows. Some have suggested that E&P firms will press their MLP partners for price cuts on transportation, but they're more likely to start by cutting use of more expensive rail and trucking assets. Pipelines are also far safer, with proportionately fewer injuries or spills.

The impact of production cutbacks is more likely to be felt by the higher cost transportation networks such as rail and truck. The area of the Bakken served by Hiland's network has, according to the North Dakota Department of Mineral Resources, an IRR of 10% even with oil as low as $38 bbl. It's one of the more profitable areas, and likely to keep producing output at current price levels. The Hiland acquisition is expected to be accretive to KMI by 2017. The company isn't immune to reassessing its backlog of projects though, and although the figure only fell slightly (from $17.9BN to $17.6BN), $785MM of planned capex was shelved, mostly in its CO2 division where they have more direct exposure to the price of oil. So there clearly are some reductions in planned investment because of the drop in oil. These figures offer a measure of their likely magnitude, at least for a bellwether midstream operator.

In other news, Markwest Energy (MWE) increased its dividend by 4.7% YOY. It currently yields 6.2% based on its expected 2015 distribution. MWE owns its General Partner too, so unlike many MLPs there is no drag on distributions to investors from Incentive Distribution Rights. Consequently, all the growth directly benefits MWE investors.

We own both KMI and MWE in our portfolios.

Look For MLP Earnings To Confirm Business Fundamentals

The General Partners (GPs) of Master Limited Partnerships (MLPs) have in many cases taken quite a drubbing since the Summer when the sell-off in oil picked up steam. Plains GP Holdings (PAGP) for example has fallen 26% over this time. And yet, midstream MLPs have limited direct exposure to commodity prices. Kinder Morgan (KMI) is now a C-corp following the corporate reorganization that simplified their prior structure which had two MLPs controlled by their C-Corp owned GP. While their corporate structure was altered, their business model wasn't. So KMI still earns 54% of its pre-depreciation earnings from running natural gas pipelines with fully 82% of its 2014 cashflows fee-based rather than driven by commodity prices.

Last week PAGP announced an increase in their quarterly distribution of 9.8% year-on-year, which caused the price of its securities to rally. Other GPs and C-Corps that own GPs will similarly be announcing earnings over the next several weeks. Their results and guidance will reflect the toll-like model that midstream MLPs operate combined with the advantaged economics enjoyed by those that control them. Over the past twelve months some of them have enjoyed stunningly fast distribution growth: Williams Companies (WMB) yields 5.1% and grew last year at 36%; Oneok (OKE) yields 4.7% and grew at 63%. Given the recent indiscriminate selling of energy-related stocks, the earnings announcements of these and related companies will provide a useful reminder about their business fundamentals. It will be an area well worth watching.

Linn Energy is Not Your Father's MLP

Master Limited Partnerships (MLPs) are best when they’re boring over the short term. Predictably raising your cashflows and distributions leads to long term excitement at the very reasonable cost of being tedious to watch on a daily basis.

In 2014, Linn Energy (LINE) was the antithesis of this. While most MLPs own midstream energy infrastructure assets with their toll model, LINE is engaged in Exploration and Production (E&P) of oil and natural gas. The consequent commodity price exposure makes both their cashflows and stock price highly volatile. This contradicts the point of owning MLPs, which is to extend the holding period indefinitely so as to maximize the tax shield that the deferral of income affords. The best MLPs are those that are stable, boring and whose valuation doesn’t hit either extreme of rich or cheap. Because selling an MLP usually creates a tax bill, greatly impeding overall returns.

LINE fell 67% in 2014 because of its exposure to oil. It was obviously a great sale earlier last year above $30. It may be a great buy now at around $11, given that they’ve done the inevitable and cut their distribution. But timing MLPs isn’t easy, and investing in businesses like LINE requires some timing skills on the part of the investor because it’s not always a good name to hold. This is LINE’s second collapse since their 2006 IPO. In fact, even a buyer in 2008 at the stock’s absolute low is now barely ahead of breakeven following a six year roller coaster.

So buying LINE may be a good trade as it’s fallen so far. But buying and then inevitably selling it is unlikely to be a tax-efficient investment. Boring is better, and after taxes far superior.

6% Yields on MLPs Are Looking Attractive

Another day and another new low for crude oil. Since stocks are moving with oil, trying to figure out the short term direction of the equity market requires being an oil trader. Few of us are any good at this although it’s easy to have an opinion. For our part, we don’t bet on the direction of oil although many of our investments react to it so we’re certainly experiencing the moves.

Master Limited Partnerships (MLPs) as I write this are close to flat on the year (as represented by the Alerian index). Distribution yields have drifted up to 6%. Midstream MLPs care about volumes of product, crude and refined, that they gather and process, store and transport. Lower oil is currently forecast to add 0.5% to US GDP in 2015 as the tax cut that it represents feeds through to higher consumption. Energy demand is unlikely to fall, and obviously should increase at the margin. Americans will drive a little more and worry a little less about conservation. The outlook for MLPs is generally good.

The shale boom may slow, with reductions in capex and therefore at the margin some growth projects that could fuel faster distribution growth may be delayed or cancelled altogether. U.S. oil production may not grow as fast as expected. Of course, it’s not only U.S. production that may slow. Halliburton announced 1,000 job cuts in response to weaker demand for their services across Europe, Russia, Africa and the Middle East. Day rates for offshore drilling are plummeting as reported by Transocean (RIG) and Diamond Offshore (DO). The U.S. is one of the few places where

productions costs are falling. Range Resources (RRC) has been reducing its output costs of natural gas from SW Pennsylvania by 7% annually for several years.

Seasonally, MLPs typically rally in December and January as retail investors reallocate cash. So far December is not typical. But 6% yields are attractive with even half the growth you thought MLPs might be generating, and there’s certainly no reason to expect any demand destruction which is what most hurts their businesses. Falling asset prices are never pleasant for the holders of those assets. But an unleveraged investment in MLPs at today’s levels is likely to look prescient a year from now.

MLP Seasonals

Seasonal patterns to the returns of most asset classes rarely seem to last beyond their discovery. “Sell in May and Go Away” has been shown to either work or not work depending on precisely when you close the trade out. Rather than the Summer being a bad time for stocks it’s just that September is poor. Whether that’s for some reason or just random is unclear. As so often in statistics, correlation doesn’t mean causality. One month of the year has to be the worst one during which to be invested in stocks. Since 1960 it’s been September. In 2014 September was poor but January was, unusually, worse. There was no January effect this year. September’s poor record could just be random, absent any compelling explanation.

Master Limited Partnerships (MLPs) have a more pronounced seasonal effect, and it’s likely for good reason (i.e. correlation *with* causation). It turns out that December and January together have generated 36% of the return on the

Alerian MLP Index since 1996 (whereas if monthly returns didn’t vary you’d expect only 17%, or 2/12). The reason is probably that retail investors, who tend to predominate among MLP investors, apply long term consideration to their portfolios around year-end. This can be because year-end bonuses alter their net worth and asset allocation, because it’s the end of the tax year or simply because doing the analysis provides a break from all that family time that comes with the holidays.

In any event, we’re heading into a period of time where the seasonals would suggest that, if you’re considering making an MLP investment over the next six months, committing capital in November may well produce a better result than waiting until February. Naturally, there are always the non-seasonal factors to consider and the volatility in energy-related stocks could understandably give anyone pause. The most recent Saudi news that they’ve cut prices for U.S. buyers so as to protect market share looks like a direct aim at North American unconventional production, and is likely to send another wave of worry through related equities.

Midstream MLP companies that have reported earnings in recent days appear sanguine about current oil prices and their effect on their businesses. If you own a pipeline, storage facilities or a gathering and processing network you care most about volumes rather than the value of the product you’re handling. It’ll take some time to see how that plays out in reported profits for the sector. In the meantime, news reports may continue to pressure everything energy related. If the recent pressure on MLPs turns out to be due to misplaced concern that their profits will suffer along with E&P names who have direct commodity price exposure, then returns over the next few months could be good.