Advisor-Access.com

Read by more than 56,000 Investment Advisors

Compelling Investment Ideas You Can Share

The MLP Newsletter for Advisors• Summer 2016

In Partnership with

MLPA RESOURCES

About the MLPA
Membership
Public Policy
MLP 101
Resources
Events
Media Center
Contact

MLPA NEWS FEED

MLPA Comments on the Implementation of the New Partnership Audit Regime Enacted as Part of the Bipartisan Budget Act of 2015

Op-ed: MLPs to Play Important Role in Midstream Energy's Future

Op-ed: MLPs Seek Regulation Clarity

MLPA Welcomes Opportunity to Testify Before Internal Revenue Service

As an investment advisor, you have been subscribed to the MLP Newsletter so that you and your clients can stay abreast of this powerful income-generating sector. Published quarterly, the MLP Newsletter will include valuable information about MLPs that you cannot get anywhere else.

The Master Limited Partnership Association (MLPA) is a trade association representing the publicly traded limited partnerships (PTPs) that are commonly known as master limited partnerships (MLPs), and those who work with them.

Today's newsletter features an in-depth interview with Gregory A. Reid, President of Salient's MLP Complex, a diversified asset management firm headquartered in Houston, TX, with approximately $4 billion in MLP assets and $13 billion overall assets under management in alternative and real asset strategies. Greg and his team focus on the midstream sector, and exclude upstream and the more commodity-sensitive MLPs. They consider approximately 25 firms to be best-in-class and use them to build their portfolios.

AA: ***Are MLPs still risky despite the recent recovery?***

Greg Reid: We positioned our portfolios to avoid upstream (Exploration & Production) MLPs and oil field services companies because historically they have been more vulnerable to commodity-price fluctuations. In our opinion, midstream MLPs appear attractive because they offer a compelling risk-reward opportunity within the energy sector. While MLP equity prices are down about 50% from their peak level in 2014, cash flows have remained remarkably stable through this bear market cycle.

We are encouraged by the 51% bounce off February lows in the sector and the healthy recovery of oil, but we do not believe that we are entirely out of the woods with potential distribution cuts. A large factor driving crude oil prices higher is the acceleration of declining product volumes. Moreover, some companies decided to strategically cut their distributions. Through our research and screening process, we try to avoid companies that potentially have to cut distributions.

AA: ***What market conditions are necessary for MLPs to really outperform?***

GR: Investors have found MLPs attractive due to their historically higher yields as compared to other traditional yield-oriented securities and the fact that they are

Newsletter Sponsors

Click on a logo for more information

(NYSE: UAN)

(NYSE: EEP)

(NYSE: ENLK)

(NYSE: EPD)

(NYSE: MMP)

(NYSE: NS)

(NYSE: SPP)

(NYSE: SEP)

designed to generate such consistent cash flows from largely fee-based, multi-year contracts. Therefore, it's no surprise to us that growing oil and natural gas production volumes in the United States have the potential to drive midstream MLPs over the next bull market cycle. Growth will help sustain cash flows and possibly spawn new infrastructure projects. We believe the current decline in U.S. crude oil production could reverse by early 2017.

AA: ***How will the potential for catalysts such as bankruptcies and M&A activity affect MLPs?***

GR: We believe the majority of midstream MLPs will remain fairly insulated from customer bankruptcies. Most midstream MLPs have a diverse customer base, which limits the impact from any one bankruptcy. Ultimately, we think it's likely that instead of bankruptcy, midstream contract disputes will be resolved through negotiations between relevant parties.

With the recent rally in crude oil prices, we have observed an increase in M&A activity in the Exploration & Production industry while deal volume remains muted for midstream MLPs. There still seems to be a wide gap between what sellers believe their assets are worth and what buyers are willing to pay. While we believe there could be some limited instances of midstream M&A, our internal research indicates that traditionally, company management in the midstream MLP sector has favored organic growth opportunities as opposed to acquisitions.

AA: ***How will rising interest rates affect MLPs?***

GR: Our experience has been that MLPs, particularly growth-oriented MLPs, historically speaking have not only held up well in a rising interest rate environment, but they have actually thrived in those periods of time. Granted, our data set is somewhat small given that MLPs have only been around since the 1980s and interest rates have essentially gone down since then. However, there has been one period during which the MLP sector looked similar to today and the Federal Reserve was aggressively raising rates: from 2004-2006, the Federal Reserve raised its target federal funds rate 17 times before making a reversal at its August 2007 meeting.

"...MLPs, particularly growth-oriented MLPs, historically speaking have not only held up well in a rising interest rate environment, but they have actually thrived..."

Diametrically opposed to our experience, conventional wisdom tells us that an income-oriented asset class, such as MLPs, typically underperforms in a rising interest rate environment. Investors flock to newly issued instruments that reflect the higher rates while an existing yield instrument will experience a drop in price, resulting in a higher yield to match the going rate. Since MLPs typically finance their expansion projects through debt and equity offerings, one could argue that MLPs would be particularly vulnerable to rising interest rates as the higher rates would drive up an MLP's cost of capital through higher borrowing costs.

What we found was that during the 2004-2006 period of Federal Reserve tightening, the MLPs that grew distributions the fastest, tended to outperform in most cases while MLPs that exhibited slow or no distribution growth, often lagged. Intuitively, this makes sense. An MLP that is not growing its distribution is effectively a high-yield bond with a "coupon" that is not increasing. We believe it's ideal to avoid the high yield market during a rising rate environment. But when an MLP is increasing its distribution, the incremental cash flow helps to offset the negative impact of rising interest rates.

Currently, MLP investors appear to value cleaner balance sheets and/or superior distribution coverage over distribution growth. However, that has not always been the case and once the fear of widespread distribution cuts abates, we believe growth may come back into favor with MLP investors.

AA: ***What is your outlook for MLPs for the remainder of the year?***

GR: We believe that midstream MLPs will likely track oil over the next several months. Longer-term, U.S. oil and natural gas production growth will be the key driver of opportunity in the midstream MLP sector. While we avoid assumptions on the strength and the duration of the recent recovery, we are encouraged that MLP prices and crude oil prices are currently up approximately 51% and 85%, respectively, since their February lows.

We believe that in February, the energy bear market may have ended and the recovery phase began. Additionally, we believe there is the potential for a multi-year recovery following the brutal 18-month bear market in MLPs and oil prices. Our data shows the AMZ Index fell 62% from its peak in August 2014 to its trough in February 2016 compared to only 55% in 2008, which makes it the worst bear market in the history of the MLP asset class. From a frame of reference and although past performance is not indicative of future results, after the 2008 bear market, MLPs experienced a 5.5-year recovery from 2009 to August 2014 during which the AMZ appreciated over 240%, based on our research. We do think there is a possibility for a similar 3-5 year recovery; however we have much more modest expectations for the total return compared to what we experienced from 2009 to 2014.

"…we believe there is the potential for a multi-year recovery following the brutal 18-month bear market in MLPs and oil prices."

AA: ***Thank you, Greg.***

ABOUT ADVISOR ACCESS

Advisor-Access LLC was designed to bring compelling investment ideas to investors in the form of in-depth interviews with company management and the latest fact sheets and corporate presentations, in a concise format: the critical pieces of information an investor needs to make an informed investment decision.

Copyright © 2016 Advisor Access, All Rights Reserved.