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- Membership
- MLP 101
- Resources
- Events
- Media Center
- Contact

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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.

As with this premier edition, each and every newsletter will also include in-depth interviews with the experts who drive this market. Today we are very pleased to bring you our unique interview with Kenny Feng, CFA, President and CEO at Alerian.

Advisor Access spoke with Kenny Feng about Alerian, which equips investors to make informed decisions about Master Limited Partnerships (MLPs) and energy infrastructure. Over $16 billion is directly tied to the Alerian Index Series, including the flagship Alerian MLP Index (AMZ). Mr. Feng is a former Managing Director and Portfolio Manager at SteelPath Capital Management LLC, a Dallas-based MLP investment manager. Prior to his experience at SteelPath, Mr. Feng covered MLPs, Electric and Gas Utilities, and Diversified Gas Companies at Goldman Sachs & Co in the firm's Global Investment Research Division.

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Advisor Access: What is the current state of the MLP sector?

Kenny Feng: We continue to believe that MLPs are an investment in the long-term build-out of US energy infrastructure. Investors, however, have begun to find that answer fairly unsatisfying with the Alerian MLP Index (AMZ) down 29.3% over the last 12 months. Management teams, research analysts, and portfolio managers alike have taken on a more cautious tone, which we attribute to three factors.

One, in terms of valuations, investors are uncertain about the magnitude of distribution growth beyond 2017. During the last 10 years, MLPs grew distributions at a 7.4% annualized clip. Before this commodity downturn, many investors were willing to project that growth forward without giving it a second thought. Today, even if 6%-plus distribution growth in 2020 still represents the most probable outcome, the degree of certainty around that number is lower, which impacts valuations. The corollary is that MLPs with the greatest visibility to multi-year distribution growth, such as dropdown MLPs, have outperformed in this risk-off energy environment.

Two, in terms of energy fundamentals, investors are waiting for the other shoe to drop. Front-month WTI peaked in June 2014, but US field production of crude oil didn't peak until a year later. With the battering of the rig count more than offset by productivity gains, domestic production has been remarkably resilient, which isn't constructive for oil prices. The US produced 9.117 million barrels per day during the week ending September 11th, which is roughly where we were last December and 5.1% below the peak three months ago. So the supply response has begun. After production stabilizes and starts inching upward again, we think investors will give energy another look. We're not saying that midstream should be lumped in with upstream; we're saying that's what investors are telling us they're doing, even with no correlation between the AMZ and weekly field production and a weak correlation between the AMZ and front-month WTI on a rolling 30-day, 30-week, and 30-month basis. They'd rather miss the beginning of a recovery than risk catching a falling knife.

Read the full interview online or continue reading below

KF (continued): And three, in terms of fund flows, new money isn't coming into MLPs right now for the reasons mentioned above. And if an investment grade name can trade to an equity yield near 9%, it suggests to us that MLP-dedicated managers generally don't have a ton of capacity to step in and provide a valuation floor. Since many MLPs need to tap the capital markets to finance growth projects and acquisitions, follow-on offerings may force investors to sell another MLP position in their portfolio.

The other items getting press attention—House vote on lifting the ban on oil exports, MLP Parity Act, the upcoming FERC five-year review of the oil pipeline pricing index, Fed interest rate hikes, IRS proposed regulations on qualifying income—are all secondary at the macro level to commodity prices.

So what's the good news? MLPs continue to raise their quarterly distributions. They continue to announce new capex projects. Capital markets remain open, and debt financing remains cheap. LNG exports are coming in a few months. Investors are being paid a 7%-plus yield to wait.

AA: It is widely expected that the Federal Reserve will embark on a program of increasing interest rates from their current historical lows. How do you see this affecting MLPs?

KF: Just about every MLP portfolio manager and sell-side analyst has probably put out a piece at this point about how MLP performance isn't correlated to interest rate movements. But it's worth noting that the Fed hasn't raised rates in a decade, and modern MLPs have been around for less than 30 years. So our sample size isn't exactly huge, and even those examples are useful only if you believe that the pace and magnitude of those movements are likely to play out again this time around.

The market has already priced in some near-term increase in interest rates. This is why we dissuade investors from arguing that MLPs are cheap or expensive on the basis of the spot yield spread between the AMZ and 10-year Treasury—it doesn't take future expectations into consideration. If the spread were 100 basis points tighter than usual but rates were expected to come down 200 basis points in the next year, you're probably not going to ignore the second part of that statement and go around telling people that MLPs are expensive on a yield spread basis. So the reverse should also be true. So if we move along the yield curve in a manner resembling what the market expects today, we would expect marginal impact to MLPs on the valuation front.

On the financing front, most of their debt is fixed-rate, so you'll see higher interest payments when those notes roll over, but certainly less than if a higher proportion of their debt were at floating rates. You may also see greater discernment by credit quality. High-yield names with a lot of leverage may be forced to consider strategic alternatives if capital markets tighten or become prohibitively expensive, which could drive M&A activity. It's why three large-cap MLPs have $1 billion-plus 364-day revolvers outstanding, presumably with more coming.

If you expect rates to go meaningfully higher, more than what the yield curve is expecting, then MLPs are likely to perform poorly along with other yield-oriented equities like Utilities and REITs, as well as bonds. That shouldn't be surprising to anyone. If you think rates will be lower for longer relative to current market expectations, and the Fed will be able to clearly communicate that to the general public, then MLPs should be better positioned, all else equal.

AA: Petroleum is now down over 40% this year and at lows (currently under $50/barrel) that haven't been seen since 2009. If prices stay this low for an extended period, how will it affect MLPs?

KF: We believe that investors feel uncertain about the energy macro today, and are requiring higher compensation for that incremental risk. If prices remain low into 2017 because technological advances have driven breakeven costs below those prices, and production has stabilized accordingly near current levels by that time, then MLP valuations should improve. However, if prices remain low because production is still falling and at a slower-than-expected rate, then uncertainty is still present and may keep investors on the sidelines. In the latter case, we would expect larger, well capitalized MLPs to compete with private equity money to acquire assets that may be of a high quality but are also financially distressed.

AA: What effect will the factors mentioned above have on the ability of MLPs to continue increasing, let alone maintaining, distributions?

KF: The answer depends on how interest rates and commodity prices affect capital markets access, which is the biggest risk when you're paying out the vast majority of your cash flow each quarter and consequently need outside capital for capex projects and acquisitions. If financing becomes expensive, then hurdle rates for projects go up, and distribution growth comes down, as we saw in 2009 when MLPs raised their distributions by a cap-weighted average of 2.5%. That said, they still raised their distributions. We would expect the dispersion of distribution growth, and performance as a result, to widen.

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AA: Does the recent flurry of deal making in the MLP space indicate that current valuations seem compelling to industry insiders?

KF: We would hesitate to extrapolate too much from recent activity because transactions involving MLPs happen in all valuation environments. More than 40% of the LP units outstanding are held by sponsors. If that sponsor interest is held by an individual or a family, there may be a motivation to sell due to age or succession plans. If that sponsor interest is held by private equity, there may be a time constraint. If that sponsor interest is held by a publicly traded energy company, there is another group of shareholder interests to satisfy. We're actually surprised that more M&A activity hasn't taken place yet; management teams have noted that bid-ask spreads remain wide.

AA: Thank you, Kenny.