



MLPs: FROM BALANCE SHEET RECESSION TO BALANCE SHEET RECOVERY

EXPLORING HOW MASTER LIMITED PARTNERSHIPS
BECAME MASTER LEVERAGED PARTNERSHIPS...

AND HOW THE DELEVERAGING CYCLE THAT HAS
BEGUN COULD DRIVE A 30-50% RECOVERY

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In this unconventional look at the MLP market, we examine the cause of the crash, and why traditional MLP valuation metrics – and the managers who use them – have misidentified the causes of MLP underperformance, and failed to predict the recovery

AS WE ARGUE IN THIS WHITE PAPER, ALMOST ALL THE COMMONLY-REPEATED EXPLANATIONS FOR THE POST-2014 MLP COLLAPSE ARE FALSE. THE LACK OF A COMPELLING NARRATIVE HAS LEFT MLP INVESTORS PATCHING TOGETHER UNSATISFYING EXPLANATIONS FOR LOWER VALUATIONS AND HIGHER YIELDS SINCE 2014.

SELL-SIDE ANALYSTS AND INVESTORS ALIKE HAVE ALTERNATINGLY BLAMED OIL PRICES, FALLING RIG COUNT, DETERIORATING CUSTOMER CREDIT, THE FERC, “TECHNICAL SELLING” OR A “PIPE OVERBUILD” – ALL ULTIMATELY UNFULFILLING ANSWERS FOR AN MLP DOWNTURN THAT IS ENTERING ITS 4TH YEAR.

TAKE, FOR EXAMPLE, OIL PRICE – WTI SITS TODAY EXACTLY AT ITS 10-YEAR AVERAGE: \$74/BBL. THE MLP INDEX SITS 24% BELOW ITS 10-YEAR AVERAGE (262 VS 346).

THE REALITY IS MUCH SIMPLER THAN THE EXPLANATIONS ABOVE: AN UNPRECEDENTED ACCUMULATION OF **DEBT** INCREASED THE INDUSTRY’S RISK PROFILE, UNDERMINING THE LONG-HELD PERCEPTION OF MLP’S STABLE BUSINESS MODEL.

THE RESULT HAS BEEN A NEARLY 4-YEAR DOWNTURN, DURING WHICH “YIELD-BASED” METRICS USED BY MANY MLP INVESTORS HAVE FAILED TO IDENTIFY VALUE IN MLPs.

INSIDE, WE DISCUSS HOW TURNING THE DEBT TIDE CAN RETURN MLPs BACK TO “NORMAL” HISTORICAL VALUATIONS, WHICH SIT 30-50% ABOVE CURRENT LEVELS.

MARK LASKIN AND BRAD OLSEN

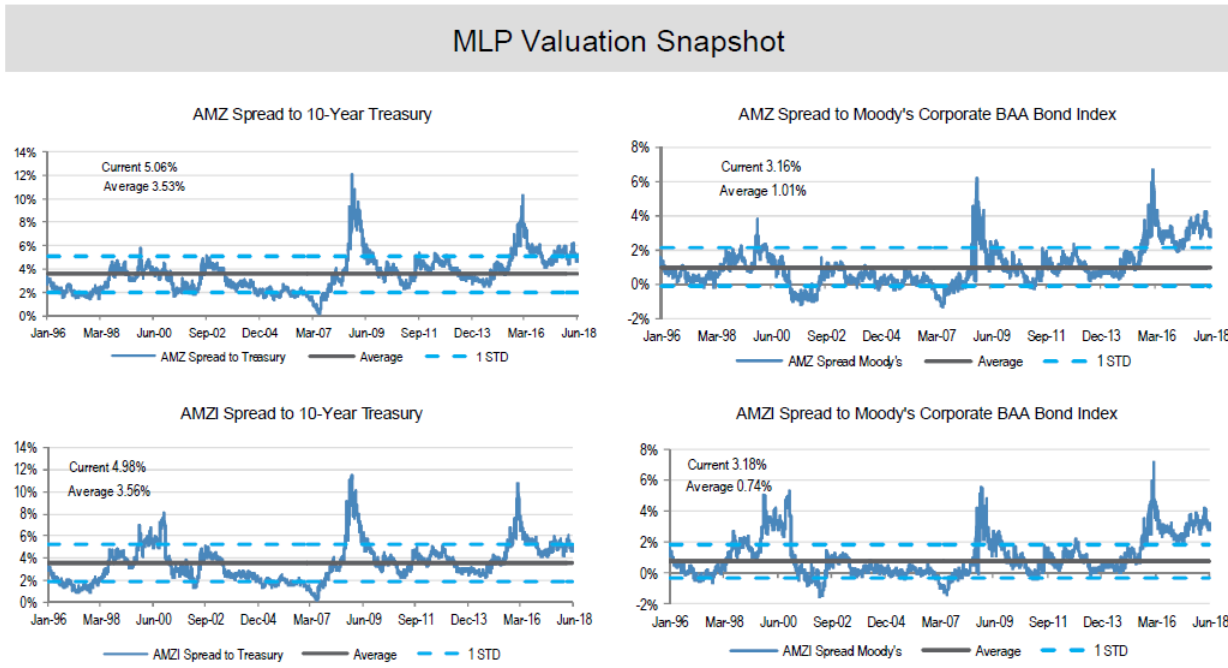
MLPs 2004-2014 – the rise of a “fixed income substitute”

Between 2004 and 2014, energy-oriented master limited partnerships (MLPs) surged in popularity among retail and institutional investors, as 6 to 8% average yields and leverage to the coming North American shale boom attracted investors searching for income in a low interest rate environment.

Given the focus on MLPs’ high yields and the savvy marketing of MLPs as a “fixed income substitute,” MLPs were often viewed and valued similarly to corporate bonds, using “yield spreads” to the “risk-free” US Treasury rate. The MLP yield spread to 10-year Treasury (“MLP-10Y”) has been one of the most pervasive metrics, helped by a strong correlation between MLP-10Y spreads and future MLP returns from 2000-2014.

Despite the collapse in MLP valuations since late 2014, and the failure of historically wide MLP-10Y spreads to indicate “buying opportunities” in MLPs, investors have continued to rely on the yield spread methodology:

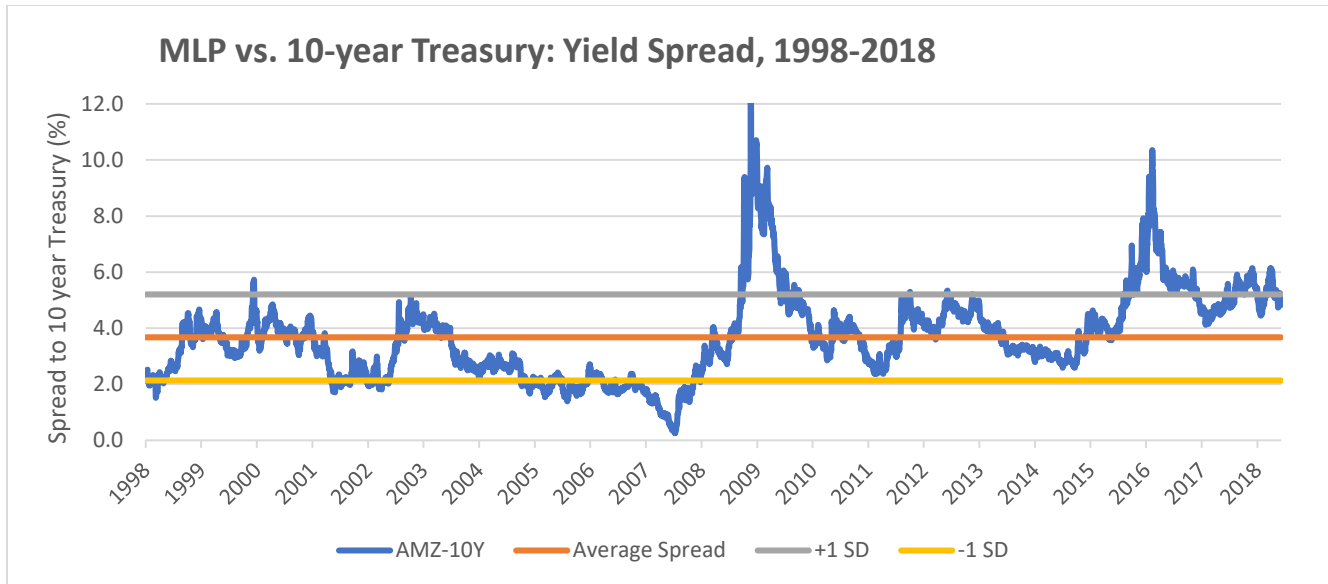
Below is a chart from a 2018 sell side research report, indicative of widely-used valuation methodologies.



Source: JPMorgan

We begin our analysis with a review of why a historically-useful valuation methodology, such as the MLP yield spread vs. the 10-year, has seemingly ceased to function as an indicator of value in the MLP sector.

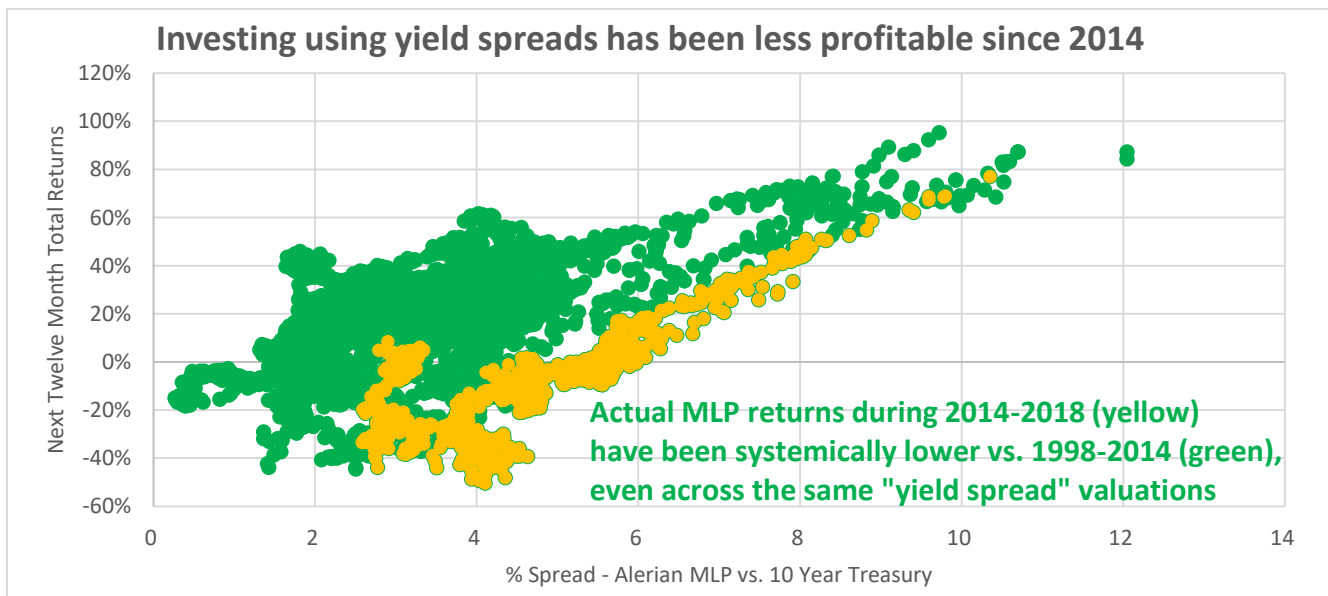
In the case of the MLP-10Y, the difference between the yield of an MLP stock and a 10-year Treasury “risk-free” yield supposedly indicates whether an MLP is cheap or expensive. However, the implied assumption in this methodology is that the underlying riskiness of the MLP has remained constant, while market fluctuations reflect “animal spirits,” or a change in market *perception*, as opposed to an actual deterioration in the quality of the MLP yield.



Source: Bloomberg, Recurrent research

MLPs since 2014 – the breakdown in MLP yield spread valuations

From 1998 through 2014, a 5% MLP-10Y spread would have been 1 standard deviation above average and provided a strong “buy” signal. Since 2014, the average MLP-10Y spread has been 5.3%. The MLP-10Y yield spread indicator, it would seem, has been nearly useless for nearly 4 years.

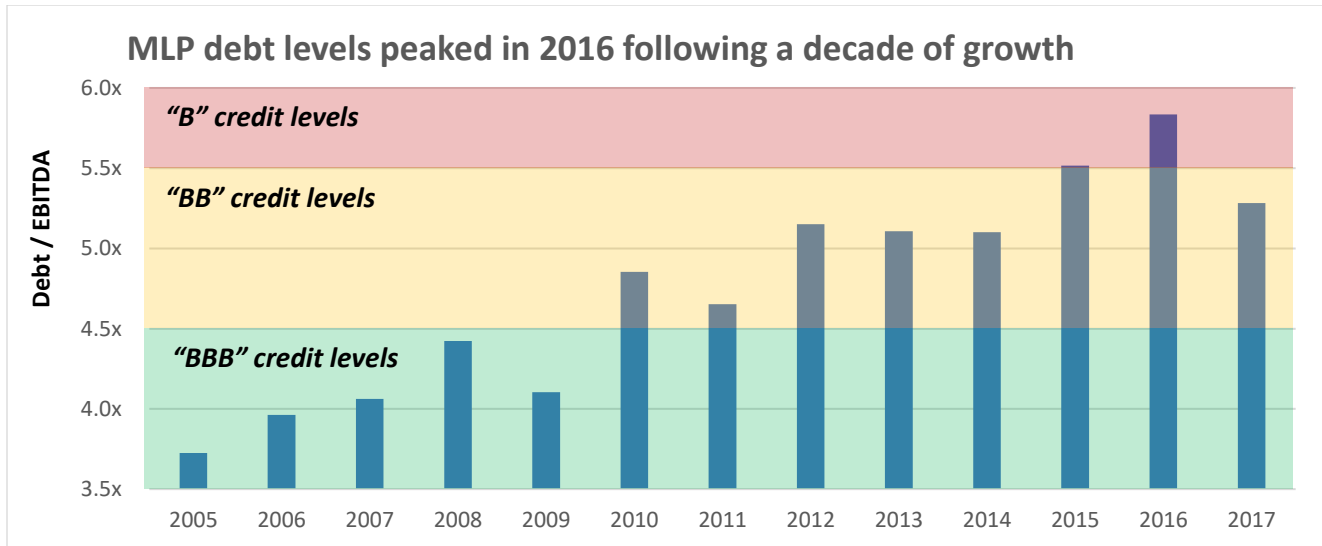


Source: Bloomberg, Recurrent research

MLP debt and credit deterioration as the main cause of lower valuations

Many MLP analysts and investors continue to rely on yield spreads, dismissing persistently elevated spreads as an “unjustified discount” or “market irrationality.” Few have asked how, 4 years after the peak of the oil price, elevated spreads could remain stubbornly in place in an efficient market.

After 4 years, an explanation other than “irrationality” must be seriously considered. So we ask a different question: “Given the increased debt loads in the MLP sector, are wider spreads justified?” To answer that question, we can assess the sector’s credit risk profile to better understand both how efficiently the market valued the sector and what the opportunity is going forward.



Source: Bloomberg, FitchRatings, Recurrent research

In its corporate credit rating criteria, one of the large credit agencies outlines, among many other factors, the debt leverage and dividend coverage criteria stipulated for various credit ratings. If we use this as a broad proxy for the risk levels associated in the midstream sector, and reconsider the above charts, an important dynamic emerges. The entire MLP sector, from 2005 to 2016, moved from “BBB,” or an investment grade credit profile, to that of “BB/B” or a non-investment grade profile.

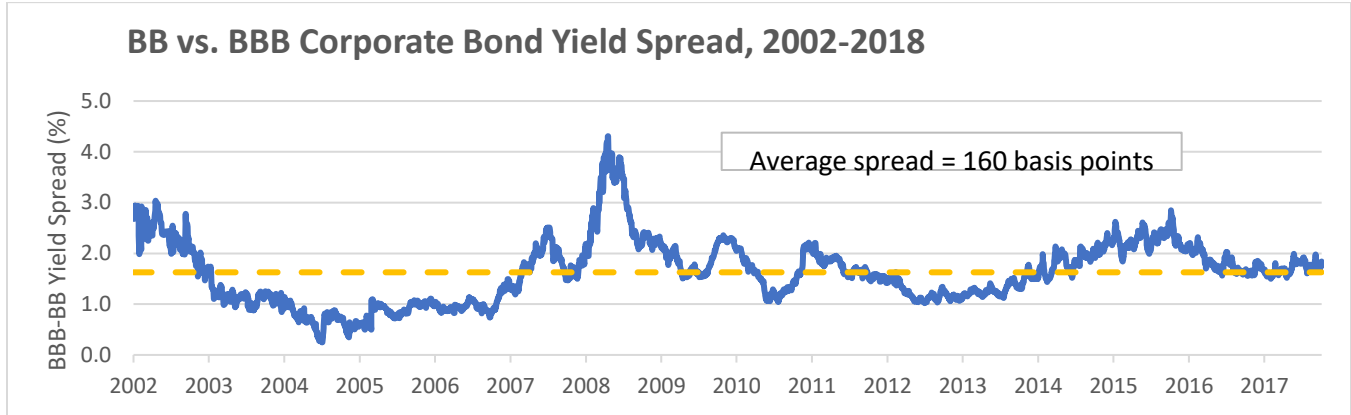
Financial Profile Key Factors - Midstream, Pipelines and Master Limited Partnerships

Appropriate Credit Rating	Total Debt/ Adjusted EBITDA	Available Cash Flow / Distribution Payout (Distribution Coverage)
AA	n/a	n/a
AA	3.0x	1.5x
BBB	4.0x	1.1x
BB	5.0x	0.8x
B	6.0x	0.6x
CCC	>6.0x	<0.6x

Source: FitchRatings

Gauging an appropriate MLP valuation impact from lower credit quality

In the context of fixed income analysis, we find that a hypothetical downgrade from BBB to BB would cause the yield of a typical corporate issuer to increase roughly 160 bps, on average, over the past 15 years.

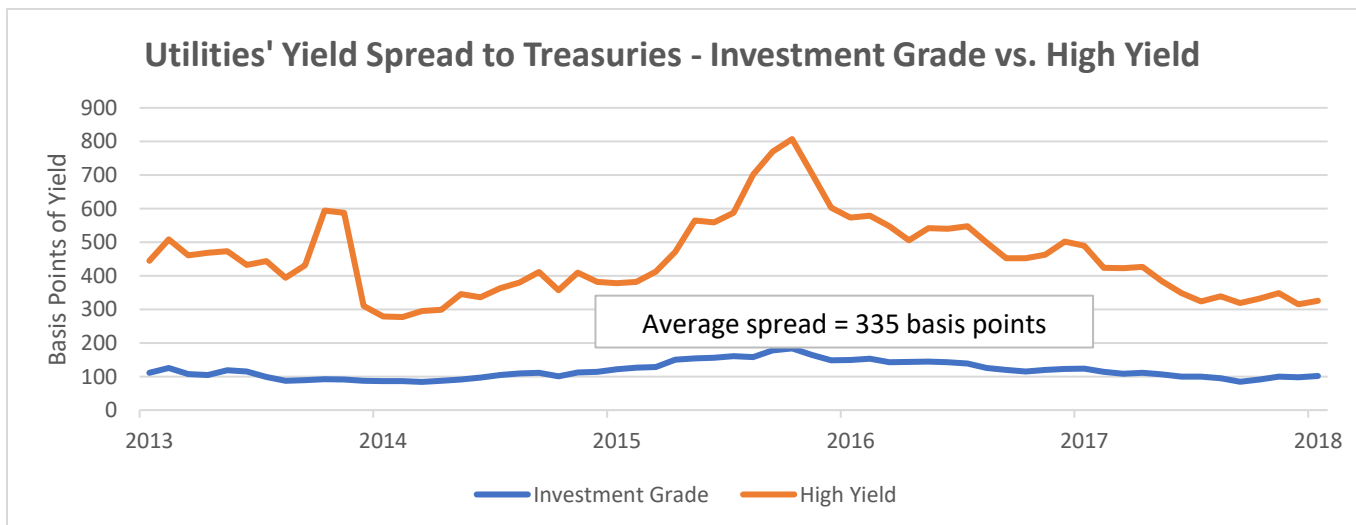


Source: Bloomberg, Recurrent research

As a result of utility and broader corporate bond analysis, we would expect that the MLP sector's yield spread would reflect a hypothetical a 1- to 2-notch downgrade as the creditworthiness of the MLP sector has deteriorated in the face of a decade-long increase in leverage (as measured by debt/EBITDA). The effect of this hypothetical "MLP sector credit downgrade" would be a **widening of spreads by 160 to 300 bps.**

Once the sector's fundamentals incrementally worsened as US Shale oil production peaked and started to fall in June 2015, MLPs' yield spreads to the 10 year have widened and have not materially improved, even though US Shale oil production resumed growth and is now at multi decade highs.

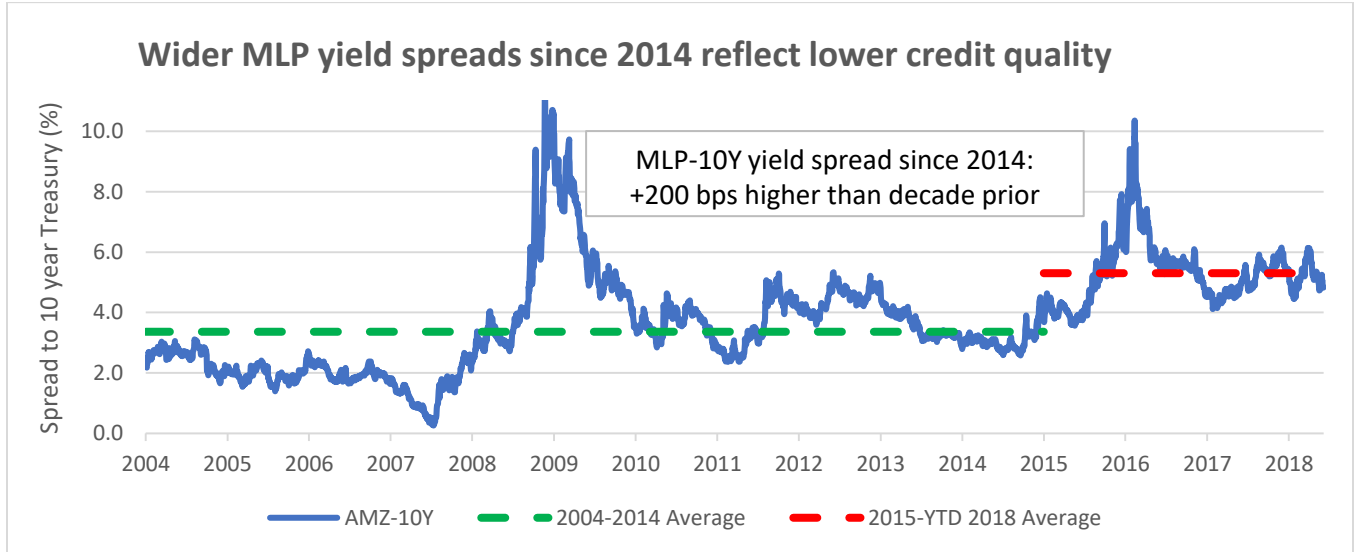
A relevant example can be found in the spread between investment grade and high yield utility issuers. Below, we see that for regulated utilities, the roughly one- to three-notch difference in creditworthiness costs the issuer an average of **335 basis points.**



Source: Bloomberg, Recurrent research

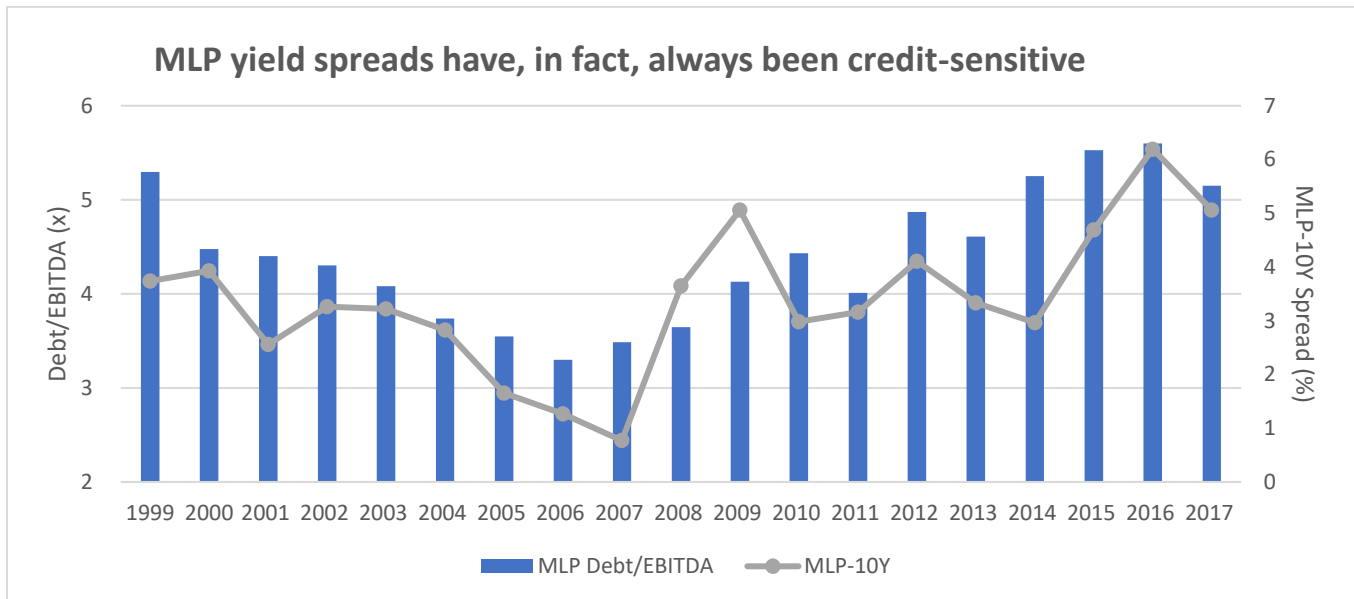
Since the 1990s, MLP yield spreads have shown sensitivity to debt loads

With an expected range of widening between 160 bps or 335 bps, it is unsurprising that we find the broad MLP sector has experienced a “yield spread” widening of roughly 200 bps since the deterioration in MLP credit quality.



Source: Bloomberg, Recurrent research

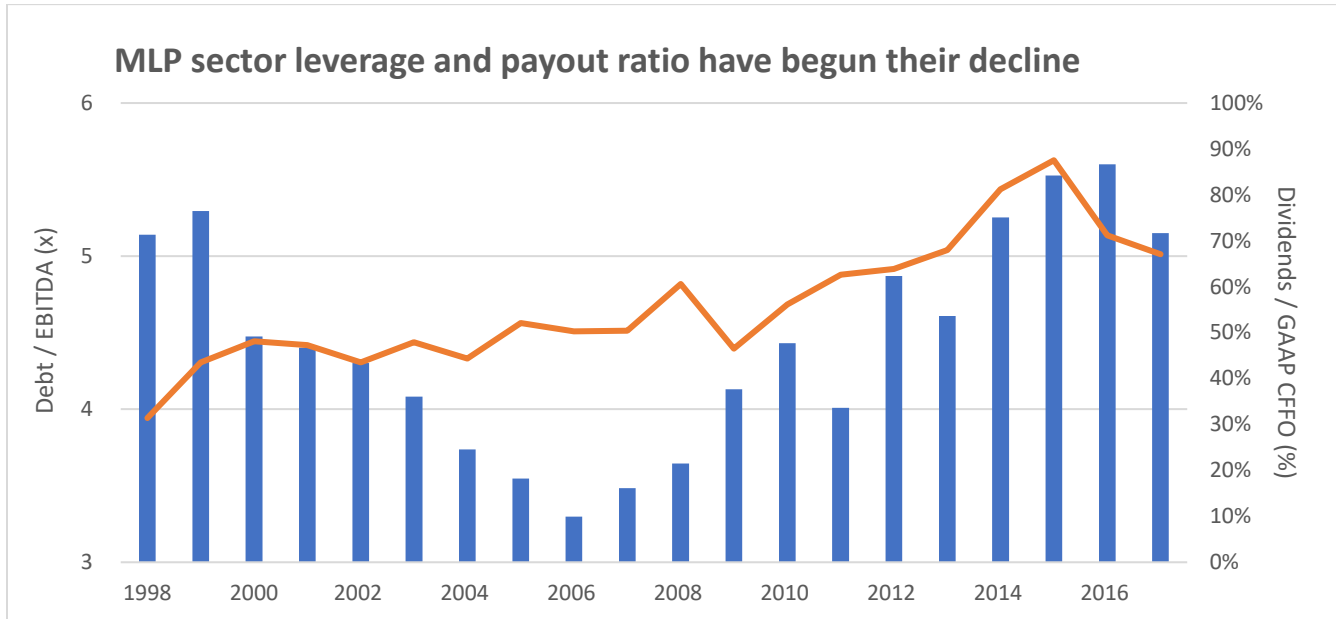
So with a heightened credit risk profile since 2H 2015, midstream equity yields, relative to history, have moved to be priced more than 200 basis points more than investment grade rated bonds. **Far from being “irrational,”** the market has, with a high degree of precision, priced in the added risk of MLP investing, reflective of a deteriorated credit profile.



Source: Bloomberg, Recurrent research

Debt is the cause of the MLP malaise; deleveraging will drive recovery

The opportunity currently resides in the reversal of this exact trend. As noted above, the industry's dividend payout ratio has already fallen to approximately 65% from nearly 90%, and leverage has fallen to just above 5x Debt/EBITDA by the end of 2017.



Source: Bloomberg, Recurrent research

As of mid-2018, the sector-wide leverage reduction continues, and by the end of 2018, should sit well below 5x. The overall credit profile of the sector will again approach investment grade status, and we expect a return to the low- to mid-4x range by mid-2019.

So what does that mean for the investment opportunity today?

As of mid-2018, the midstream MLP dividend yield is approximately 8%, as measured by the Alerian MLP Index. As the industry returns to investment grade metrics, the warranted “yield spread to Treasury” should revert to investment grade levels, or 200-300 basis points tighter than today’s “non-investment grade” yield spreads.

In the event the MLP sector’s 8% yield tightens by 200-300 bps, as our thesis suggests, this implies MLP upside of 30% to 45% from current levels, exclusive of dividend income received.

The misdiagnosis of the cause of the MLP collapse, and resulting wide MLP yield spreads, have contributed to a slow pace of recovery

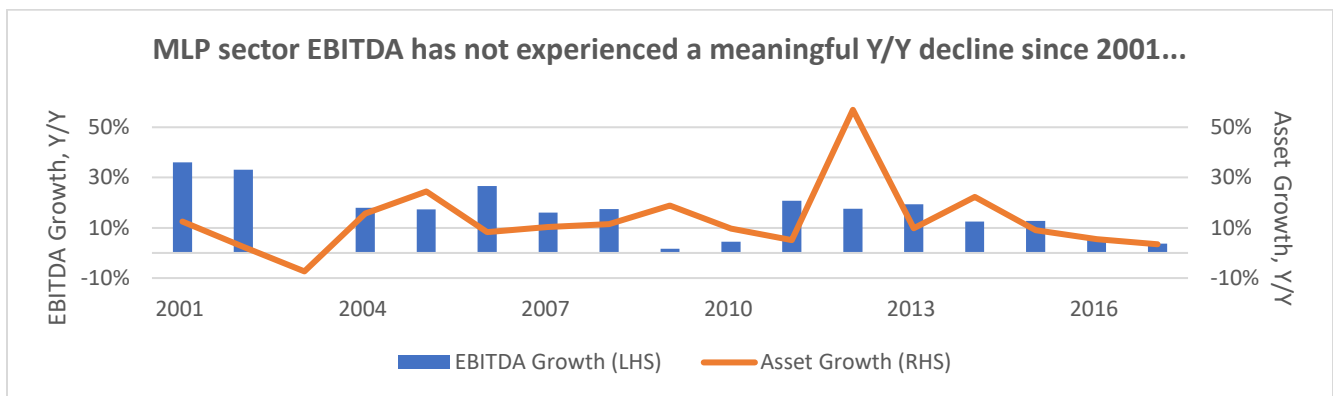
Sell side analysts and MLP managers have employed a variety of explanations for this new paradigm:

- MLP cash flows are fundamentally more volatile than before. **Our view: FALSE**
- Low gas and oil prices pose an unprecedented threat to MLP cash flows. **Our view: FALSE**
- Exogenous issues – FERC, contracts, customer issues have hurt MLPs. **Our view: FALSE**

We find these to either be overly complex yet insufficient explanations of a much simpler phenomenon.

First claim for wider spreads: MLPs are fundamentally riskier today – FALSE

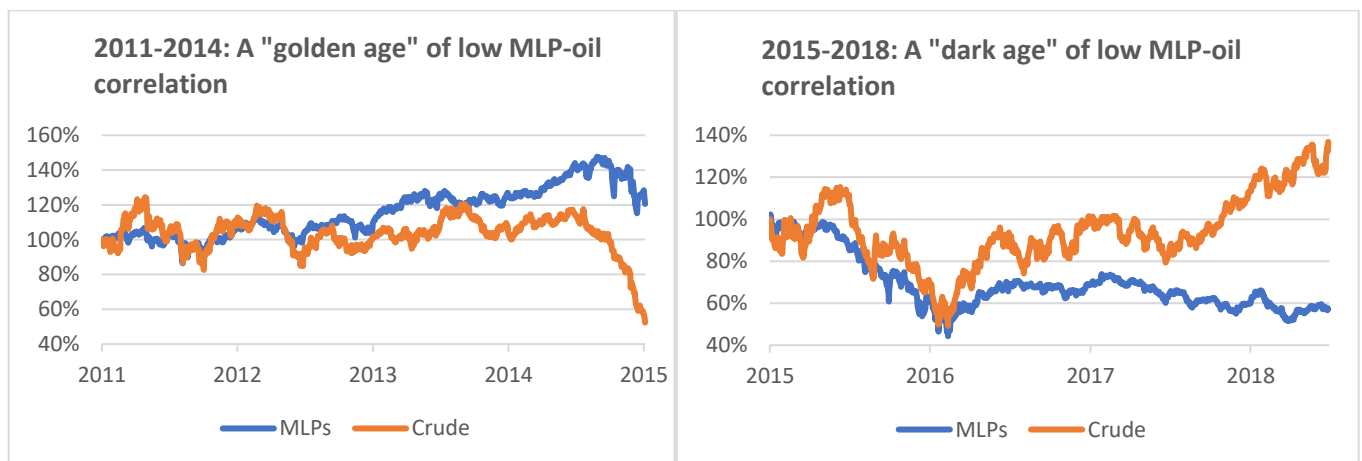
As shown below, the notion that MLP and midstream businesses have taken on greater risk over time is not supported by the evidence. During the recent energy downturn, MLP sector-wide EBITDA (*blue bars*) continued to grow at single-digit percentages, generally reflecting levels of investment (*orange line*).



Source: Bloomberg, Recurrent research

Second claim for wider spreads: MLPs are more oil-sensitive since 2014– FALSE

The late 2014 oil price “shock” awakened the MLP market to MLPs different financial profile (high debt, high payout ratios), the idea that MLPs went from “non-commodity-sensitive” to “highly commodity-sensitive” is a case of selective memory.



Source: Bloomberg, Recurrent research

*Third claim: MLPs struck by exogenous factors – **FALSE***

Investors and MLP managers alike have pointed the finger at a variety of external factors – the FERC, E&P bankruptcies, changes in contract terms or the broader energy environment – and while these various arguments have been used to “explain away” different MLP dividend cuts, debt has been the one common dominator in all dividend cut scenarios.

By late 2017, the actual tally of E&P bankruptcies (majority of filings were small, private companies) had impacted well under 1% of MLP cash flows.

It is true that long-haul gas pipelines experienced a construction boom during 2006-10. This late 2000s boom was underpinned by 7- to 10-year contracts, which expired in the late 2010s, and have now been replaced by less-profitable arrangements. These contract roll-offs impacted a few midstream companies, and therefore fail to explain a sector-wide malaise.

Most recently, the Federal Energy Regulatory Commission (FERC) has been cited as a cause of “unpredictable” MLP payout cuts. We’ve written extensively about the FERC elsewhere, but we’ll recap briefly: in March 2018, the FERC concluded a proceeding initiated 20 years ago (which should have limited the surprise). The decision, in our worst-case view, will impact less than 3% of MLP revenues.

The FERC decision indicated that certain regulated interstate pipelines owned by MLPs could face a decline in regulated revenues, as MLP-owned pipes will be disallowed from charging customers a “cost of service” surcharge to recover corporate income taxes (since MLPs themselves pay no income tax). Additionally, the decision only impacts non-contracted, interstate pipelines owned by MLPs – a small portion of total MLP assets. The final outcome of the FERC decision remains years away, once all affected pipelines have assessed its impact and in turn, filed for new tariffs in response.

Several companies announced “restructurings” or dividend cuts in response to the FERC announcement. Importantly, all companies had seen debt loads meaningfully increase in the past 5 years and were facing record-high equity yields as a result.

Company	Cut or MLP		Debt cited in announcement?
	Buyout?	Year	
KMI	Buyout	2014	Yes
BWP	Cut	2014	Yes
TRGP	Buyout	2015	Yes
KMI	Cut	2015	Yes
TGP	Cut	2015	Yes
TOO	Cut	2015	Yes
GLP	Cut	2016	Yes
APLP	Cut	2016	Yes
RRMS	Buyout	2016	Yes
NGL	Cut	2016	Yes
AMID	Cut	2016	Yes
CEQP	Cut	2016	Yes
PAA (1)	Cut+Buyout	2016	Yes
MMLP	Cut	2016	Yes
WMB	Cut	2016	Yes
SXL	Buyout	2016	Yes
EEP	Cut	2017	Yes
OKS	Buyout	2017	No
CCLP	Cut	2017	Yes
PAA (2)	Cut	2017	Yes
GEL	Cut	2017	Yes
BKEP	Cut	2017	Yes
APLP	Buyout	2018	Yes
NS	Cut+Buyout	2018	Yes
TCP	Cut	2018	Yes
EEP	Buyout	2018	Yes
SEP	Buyout	2018	Yes
WPZ	Buyout	2018	Yes
DLNG	Cut	2018	Yes
SXCP	Cut	2018	Yes

Source: Public filings, Recurrent research

Conclusion: The MLP market recovery will be driven by debt reduction

The argument that we've presented in this white paper – namely, that the midstream/MLP downturn is primarily a result of over-extended balance sheets, and not a result of increased commodity sensitivity or a fundamental change in the MLP business model – has several powerful implications.

First and foremost, MLP sector cash flows have NOT declined in the face of a vicious commodity downturn. Since cash flow weakness from low oil prices was NOT the primary cause of the downturn, the recovery will NOT depend on commodity prices moving higher.

Said another way: the MLP recovery will occur as debt loads are reduced – even if commodity prices move lower from here.

Since debt reduction does not significantly depend on commodity prices, let's consider the two primary drivers of MLP debt reduction:

- 1) **free cash flow (i.e. cash flow after dividends and capex)**
- 2) **asset sales**

While the pace of asset sales is inherently unpredictable, we expect that the 30-40% total reduction in midstream/MLP payouts combined with a drastic reduction in net capex spending from 2015 to 2020 will drive MLPs' debt profiles back to within the historical range of 3.5x to 4.5x debt/EBITDA in 2019.

The hardest and most meaningful decision to reduce debt – cutting the dividend payout – has already been taken by 90% of the MLPs who need to do so. As a result, the path to lower debt has already been paved. Asset sales will only accelerate this pace.

While we do not know when exactly the market will reward the improved MLP financial profile, the trajectory over the next 12 to 24 months is clear – toward a financial position much more similar to MLPs of the 1990s and early 2000s – when MLPs delivered solid, stable returns thanks to capital discipline and strong balance sheets.

As balance sheets improve, the return to historical average MLP yield spreads could imply a 35% to 40% appreciation in MLP equities.