Inside MLPs: Our Mid-Year Review Part I

By Elliott H. Gue and Roger S. Conrad

As we write this issue, the yield on 10-year US government bonds is just 2.12%, down from north of 3.2% as recently as November 2018.

Against that pay-nothing interest rate backdrop, you’d think MLPs with an average yield closer to 8% would be attracting attention from yield-hungry investors.

However, returns from MLPs have been mixed at best over the past year as investor fret about several issues including potential exposure to energy commodity prices, rising cost of capital, and MLP-to-corporation conversions.

In June each year, we conduct a detailed deep-dive analysis of the MLP industry timed to coincide with the conclusion of the annual MLP Association Conference. And we reveal the results of this analysis in the pages of Energy & Income Advisor.

This week, in Part I, we present our discussions surrounding 6 crucial, hot button “talking points” that are receiving the most attention from MLP investors these days and offer some of our top recommendations in the industry.

Around the middle of the month, we’ll be back with Part II of our Inside MLPs Mid-Year Review.

In This Issue

1  Feature. Part one of our “Inside MLPs” analysis, following first quarter earnings releases and guidance calls from our 76-member coverage universe, as well as this year’s annual MLP Association conference.

2  Portfolios. We’re adding two picks to our High Yield Energy List: Oasis Midstream Partners LP (NYSE: OMP) and Suburban Propane Partners (NYSE: SPH).

3  Endangered Dividends List. There were no distribution cuts in our coverage universe since the previous issue of Energy and Income Advisor. Our EDL members, however, remain at elevated risk to reductions by the time of their next distribution declarations.
High Yield Energy Target List, Active Portfolio, Endangered Dividends List

The Actively Managed Portfolio puts our top recommendations into a $100,000 hypothetical model portfolio, including specific position sizes. We also continue to wind up the three legacy portfolios posted on the Energy and Income Advisor website: Model, MLPs and International.

Criteria for inclusion to the High Yield Energy list include: (1) Yield of 7 percent or higher, (2) Strong and rising distribution coverage, (3) Consistent progress stabilizing and preferably reducing leverage, as measured by the debt-to-EBITDA ratio, (4) Manageable needs to raise new capital over the next 24 months, for CAPEX as well as refinancing existing debt, (5) Ownership structure that discourages changes in structure.

This issue, we’re adding two new members to our High Yield Energy list, bringing the number of current recommendations to 8: Oasis Midstream Partners (NYSE: OMP) and Suburban Propane Partners (NYSE: SPH).

Oasis was the only member of our previous “Focus List” that was not also in our Actively Managed Portfolio. We’re adding to the High Yield Energy list now because the unit price has dropped below our buy target of 20.

Oasis at its current price yields just south of 10 percent, after management increased the quarterly payout by 2 cents per unit in mid-May. The boost is well supported by distributable cash flow, with the first quarter coverage ratio of 1.6 times topping earlier guidance of 1.5 times. The company during its first quarter guidance call also raised its expected fourth quarter coverage guidance to 1.9 to 2 times, after a planned 20 percent full year 2019 distribution growth rate.

Oasis has grown rapidly since its September 2017 IPO. But it’s consistently held debt leverage at a low level. First quarter debt to EBITDA came in at 3 times and management is guiding to 2.5 times by the end of the year. High coverage has also enabled the partnership to consistently self-finance a hefty portion of capital expenditures without having to access capital markets, especially for new equity.

Oasis Midstream is 45.27 percent owned by general partner Oasis Petroleum (NYSE: OAS). Third party business, however, is increasingly fueling growth in the partnership’s key regions like the Bakken and Permian. And earnings performance has exceeded projections made at the time of the IPO by 150 percent according to management. Those are strong reasons for the parent to support the current structure. And insiders are buying, lifting holdings by 15.87 percent over the last 12 months.

The upshot is Oasis is a rare high yield, high growth MLP with a long runway for future growth in the top shale producing regions of the US. **Buy up to 20.**

Suburban Propane Partners’ fiscal first and second quarter results (end March 31) were primarily impressive for their stability, at a time when volatile weather produced disappointing results even at industry leader Amerigas Partners (NYSE: APU).

Distribution growth is unlikely this year as the partnership focuses on reducing its debt to EBITDA ratio to “less than four times,” from a current rolling 12-month rate of 4.32 times. But with modest capital spending and strong rolling 12-months coverage of 1.3 times, management has plenty of room to make that happen.

The “simplification” merger of UGI Corp (NYSE: UGI) and Amerigas has left Suburban as the largest remaining independent propane distributor in the US, and a takeover target. But there’s no general partner and no incentive distribution rights to pay out on, so any deal will have to offer a high enough premium to
The economics of propane distribution is for greater consolidation of what's still a quite fragmented industry across North America. Larger entities can better absorb volatile wholesale fuel/propane costs as well as weather fluctuations by utilizing larger asset bases. Suburban’s solid results this winter are proof it’s accomplishing that. **And the well-covered distribution is attractive below our buy up to price of 24.**

As for the rest of the High Yield Energy list, all are trading a bit below where they were when we launched the list on May 22. That’s well in line with the action in the broader MLP universe, which has seen elevated volatility along with the overall stock market.

More important, the dips are also wholly unrelated to any developments at the underlying businesses. Consequently, the lower prices simply mark better buying opportunities. See the Feature article for more on our outlook for MLPs.

### High Yield Energy Target List

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Date</th>
<th>Recent Pr</th>
<th>Yield</th>
<th>12-Mo Dist Gr</th>
<th>Proj Dist Gr</th>
<th>Coverage</th>
<th>Debt/ EBITDA</th>
<th>Total Return</th>
<th>Advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antero Midstream Corp (NYSE: AM)</td>
<td>5/22/19</td>
<td>12.40</td>
<td>9.76</td>
<td>280.0</td>
<td>10.0</td>
<td>1.10</td>
<td>3.1</td>
<td>-7.7</td>
<td>Buy&lt;14</td>
</tr>
<tr>
<td>Enable Midstream LP (NYSE: ENBL)</td>
<td>5/22/19</td>
<td>12.78</td>
<td>9.95</td>
<td>0.0</td>
<td>0.0</td>
<td>1.51</td>
<td>4.0</td>
<td>-6.5</td>
<td>Buy&lt;17</td>
</tr>
<tr>
<td>Energy Transfer LP (NYSE: ET)</td>
<td>5/22/19</td>
<td>14.04</td>
<td>8.69</td>
<td>0.0</td>
<td>5.0</td>
<td>2.07</td>
<td>3.8</td>
<td>-5.9</td>
<td>Buy&lt;17</td>
</tr>
<tr>
<td>EnLink Midstream LLC (NYSE: ENLC)</td>
<td>5/22/19</td>
<td>10.53</td>
<td>10.14</td>
<td>6.1</td>
<td>6.0</td>
<td>1.35</td>
<td>3.7</td>
<td>-8.0</td>
<td>Buy&lt;13</td>
</tr>
<tr>
<td>Hess Midstream Part (NYSE: HESM)</td>
<td>5/22/19</td>
<td>19.39</td>
<td>7.91</td>
<td>15.0</td>
<td>15.0</td>
<td>1.13</td>
<td>0.5</td>
<td>-5.9</td>
<td>Buy&lt;24</td>
</tr>
<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>5/22/19</td>
<td>30.97</td>
<td>8.49</td>
<td>6.5</td>
<td>6.0</td>
<td>1.41</td>
<td>3.9</td>
<td>-3.4</td>
<td>Buy&lt;37</td>
</tr>
<tr>
<td>Oasis Midstream Part (NYSE: OMP)</td>
<td>6/3/19</td>
<td>19.70</td>
<td>9.54</td>
<td>19.7</td>
<td>20.0</td>
<td>1.60</td>
<td>3.0</td>
<td>NEW</td>
<td>Buy&lt;20</td>
</tr>
<tr>
<td>Suburban Propane Part (NYSE: SPH)</td>
<td>6/3/19</td>
<td>23.04</td>
<td>10.44</td>
<td>0.0</td>
<td>0.0</td>
<td>1.30</td>
<td>4.3</td>
<td>NEW</td>
<td>Buy&lt;24</td>
</tr>
</tbody>
</table>

Prices and yields as of June 3, 2019 close. Projected distribution growth is based on company guidance and Energy & Income Advisor analysis. Coverage is distributable cash flow divided by current distribution rate. All prices, returns and buy targets in US dollars. Source: Bloomberg, Energy & Income Advisor
## Energy & Income Advisor: Actively Managed Portfolio

<table>
<thead>
<tr>
<th>Company (Exchange: Ticker)</th>
<th>Date Added</th>
<th>Position Size</th>
<th>Price</th>
<th>Indicated Yield</th>
<th>Total Return</th>
<th>Profit/Loss</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Halliburton (NYSE: HAL)</td>
<td>12/04/17</td>
<td>200</td>
<td>$21.19</td>
<td>3.40</td>
<td>-49.93</td>
<td>-2115.91</td>
<td>Buy&lt;60</td>
</tr>
<tr>
<td>MPLX LP (NYSE: MPLX)</td>
<td>05/04/17</td>
<td>150</td>
<td>31.05</td>
<td>8.47</td>
<td>7.38</td>
<td>343.56</td>
<td>Buy&lt;37</td>
</tr>
<tr>
<td>Texas Instruments (NSDQ: TXN)</td>
<td>05/01/18</td>
<td>50</td>
<td>109.48</td>
<td>2.81</td>
<td>9.52</td>
<td>520.94</td>
<td>Buy&lt;112</td>
</tr>
<tr>
<td>Concho Resources (NYSE: CXO)</td>
<td>10/26/17</td>
<td>30</td>
<td>98.40</td>
<td>N/A</td>
<td>-24.21</td>
<td>-714.57</td>
<td>Buy&lt;165</td>
</tr>
<tr>
<td>Core Laboratories (NYSE: CLB)</td>
<td>06/30/18</td>
<td>35</td>
<td>49.04</td>
<td>4.49</td>
<td>-55.28</td>
<td>-948.87</td>
<td>Buy&lt;$133</td>
</tr>
<tr>
<td>Enterprise Products Partners LP (NYSE: EPD)</td>
<td>01/09/17</td>
<td>150</td>
<td>28.10</td>
<td>6.23</td>
<td>18.90</td>
<td>796.81</td>
<td>Buy&lt;33</td>
</tr>
<tr>
<td>Hess Midstream Partners LP (NYSE: HESM)</td>
<td>03/28/18</td>
<td>200</td>
<td>19.00</td>
<td>8.07</td>
<td>11.29</td>
<td>429.16</td>
<td>Buy&lt;24</td>
</tr>
<tr>
<td>Occidental Petroleum Corp (NYSE: OXY)</td>
<td>09/29/17</td>
<td>45</td>
<td>47.43</td>
<td>6.58</td>
<td>-21.06</td>
<td>-449.56</td>
<td>Buy&lt;75</td>
</tr>
<tr>
<td>Crestwood Equity Partners LP (NSDQ: CEQP)</td>
<td>11/06/17</td>
<td>120</td>
<td>35.91</td>
<td>6.68</td>
<td>65.08</td>
<td>2804.62</td>
<td>Buy&lt;40</td>
</tr>
<tr>
<td>Northland Power (TSX: NPI; OTC: NPIFF)</td>
<td>11/27/17</td>
<td>150</td>
<td>18.75</td>
<td>4.78</td>
<td>8.15</td>
<td>229.36</td>
<td>Buy&lt;20</td>
</tr>
<tr>
<td>WPX Energy (NYSE: WPX)</td>
<td>12/28/17</td>
<td>150</td>
<td>10.66</td>
<td>N/A</td>
<td>-24.93</td>
<td>-396.62</td>
<td>Buy&lt;19</td>
</tr>
<tr>
<td>Marathon Oil (NYSE: MRO)</td>
<td>06/01/18</td>
<td>320</td>
<td>13.19</td>
<td>1.52</td>
<td>-37.98</td>
<td>-1603.25</td>
<td>Buy&lt;23</td>
</tr>
<tr>
<td>Plains GP Holdings (NYSE: PAGP)</td>
<td>06/14/18</td>
<td>328</td>
<td>23.14</td>
<td>6.22</td>
<td>-5.00</td>
<td>-379.32</td>
<td>Buy&lt;26.50</td>
</tr>
<tr>
<td>Antero Midstream GP (NYSE: AM)</td>
<td>12/28/18</td>
<td>70</td>
<td>12.71</td>
<td>9.52</td>
<td>3.76</td>
<td>33.42</td>
<td>Buy&lt;14</td>
</tr>
<tr>
<td>Magellan Midstream Partners LP (NYSE: MMP)</td>
<td>01/02/18</td>
<td>30</td>
<td>62.36</td>
<td>6.45</td>
<td>-3.99</td>
<td>-74.60</td>
<td>Buy&lt;75</td>
</tr>
<tr>
<td>TechnipFMC (NYSE: FTI)</td>
<td>08/07/18</td>
<td>100</td>
<td>21.46</td>
<td>2.42</td>
<td>-29.84</td>
<td>-640.34</td>
<td>Buy&lt;$33</td>
</tr>
<tr>
<td>Schlumberger (NYSE: SLB)</td>
<td>08/15/18</td>
<td>80</td>
<td>34.94</td>
<td>5.73</td>
<td>-41.36</td>
<td>-1155.97</td>
<td>Buy&lt;65</td>
</tr>
<tr>
<td>Kinder Morgan (NYSE: KMI)</td>
<td>02/19/19</td>
<td>200</td>
<td>20.47</td>
<td>4.89</td>
<td>8.24</td>
<td>337.29</td>
<td>Buy&lt;$22</td>
</tr>
<tr>
<td>Pembina Pipeline Corp (NYSE: PBA)</td>
<td>09/16/13</td>
<td>75</td>
<td>36.04</td>
<td>4.94</td>
<td>51.67</td>
<td>1396.61</td>
<td>Buy&lt;35</td>
</tr>
<tr>
<td>TransCanada Corp (NYSE: TRP)</td>
<td>11/15/13</td>
<td>30</td>
<td>49.27</td>
<td>4.55</td>
<td>36.66</td>
<td>541.83</td>
<td>Buy&lt;50</td>
</tr>
<tr>
<td>Brookfield Renewable Energy Partners LP (NYSE: BEP)</td>
<td>09/16/13</td>
<td>40</td>
<td>32.87</td>
<td>6.27</td>
<td>76.90</td>
<td>1011.11</td>
<td>Buy&lt;35</td>
</tr>
</tbody>
</table>

As of 06/05/19, close. Source: Bloomberg, Energy & Income Advisor
Endangered Dividends List

Endangered Dividends List companies are vulnerable for one or more of the following reasons:

- Cash flow coverage of distributions is inadequate.
- Elevated debt levels with imminent refinancing needs.
- Revenue pressure triggered by weakness for at least one key asset.
- Inability to access the equity market on favorable terms to fund capital spending, forcing management to utilize more internally generated cash flow.
- Exposure to volatility in commodity margins from either rising or falling prices of raw materials.
- Aggressive general partners anxious to buy in limited partners’ cash flows at discounted prices.
- Regulatory reversals.
- Expiring contracts with little hope for renewals at comparable rates.

There have been no distribution cuts since the previous issue of *Energy and Income Advisor*, which posted on May 22. That’s largely because companies are now in between declaration dates.

Unfortunately, we continue to see elevated risk for a number of companies, and particularly for the 13 currently on our Endangered Dividends List.

For more on where the risk lies at individual midstream energy companies and MLPs, see the comments column in our now updated MLP Ratings table, including analysis of first quarter results, distribution coverage and debt-to-EBITDA figures and prospects for potential roll-up mergers. It’s posted on the *Energy and Income Advisor* website under the “Portfolios” tab.

### Endangered Dividends List

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Potential Cut</th>
<th>Risk Level</th>
<th>Last Increase</th>
<th>Rating</th>
<th>Declaration Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>CrossAmerica Partners (NYSE: CAPL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-17</td>
<td>Sell</td>
<td>8/8/19</td>
</tr>
<tr>
<td>Cypress Energy Part (NYSE: CELP)</td>
<td>-100.0</td>
<td>Elevated</td>
<td>Nov-14</td>
<td>Sell</td>
<td>7/26/19</td>
</tr>
<tr>
<td>EQM Midstream Partners (NYSE: EQM)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>Feb-19</td>
<td>Sell</td>
<td>7/25/19</td>
</tr>
<tr>
<td>Gaslog Partners LP (NYSE: GLOP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Jan-19</td>
<td>Hold</td>
<td>7/25/19</td>
</tr>
<tr>
<td>Golar LNG Partners (NSDQ: GMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-15</td>
<td>Sell</td>
<td>7/29/19</td>
</tr>
<tr>
<td>Green Plains Partners (NYSE: GPP)</td>
<td>-33.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Sell</td>
<td>7/19/19</td>
</tr>
<tr>
<td>Martin Midstream Part (NSDQ: MMLP)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-14</td>
<td>Sell</td>
<td>7/23/19</td>
</tr>
<tr>
<td>Navios Maritime Acquisition (NYSE: NNA)</td>
<td>-33.3</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Hold</td>
<td>8/5/19</td>
</tr>
<tr>
<td>NGL Energy Partners (NYSE: NGL)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Sell</td>
<td>7/23/19</td>
</tr>
<tr>
<td>Sanchez Midstream Partners LP (NYSE: SNMP)</td>
<td>-100.0</td>
<td>Elevated</td>
<td>Nov-17</td>
<td>Sell</td>
<td>8/6/19</td>
</tr>
<tr>
<td>Sprague Resources LP (NYSE: SRLP)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>May-18</td>
<td>Sell</td>
<td>7/26/19</td>
</tr>
<tr>
<td>Sunoco LP (NYSE: SUN)</td>
<td>-25.0</td>
<td>Elevated</td>
<td>Aug-16</td>
<td>Hold</td>
<td>7/25/19</td>
</tr>
<tr>
<td>USA Compression Part (NYSE: USAC)</td>
<td>-10.0</td>
<td>Elevated</td>
<td>Aug-15</td>
<td>Hold</td>
<td>7/18/19</td>
</tr>
</tbody>
</table>

Source: *Energy and Income Advisor*. 
Talking Point #1: It’s been a little over a year since FERC shocked the MLP industry with its decision to disallow a significant tax-related item in cost-of-service rates for interstate pipelines. That ruling, coupled with the big drop in oil prices last fall sent the industry benchmark Alerian MLP Index tumbling to its lowest levels in a decade. Is the MLP industry dead? What are your thoughts on the general outlook for MLPs and their investment prospects over the next few years?

Roger Conrad (RC): The short answer is the demise of MLPs has been greatly exaggerated. I’ll never forget the gloom at the MLPA conference last year in the wake of that FERC decision. It wasn’t so much that some pipeline companies were going to have to cut rates. In fact, as you and I pointed out at the time, the actual decision really didn’t affect more than a tiny handful of MLPs that operated interstate pipelines at cost of service rates.

Of those, Dominion Midstream Partners is now part of Dominion Energy (NYSE: D). Spectra Energy Partners is part of Enbridge Inc (TSX: ENB, NYSE: ENB). TC Pipelines (NYSE: TCP) is back on track after immediately cutting its payout by 35 percent. As for the rest of the 76 names in our MLP Midstream coverage universe, I just finished going through first quarter results for all of them and more than a year later there’s been no real revenue impact on any of them.

What was really getting people down was also something you and I commented on last year. Mainly, the FERC decision was simply the last straw for many individual investors as well as institutions regarding MLPs. And when energy prices retreated again, it was all the excuse they needed to exit. That drove down prices for MLPs yet again and so doing made it impossible for them to issue equity on economic terms. And that in turn made it more difficult to issue debt, even for refinancing.

Probably the most asked question at that MLPA conference was about potential corporate conversions and simplification mergers. And the Wall Street guys there were pushing both, just like a few years ago they were selling management teams in the energy business on the benefits of going MLP.

The biggest mistake I’ve made over the past year with MLPs is underestimating how deep and powerful investors’ pessimism has been in this sector. In some cases, I think that sentiment alone has been strong enough to cause casualties, by convincing boards and management teams that the MLP model has permanently lost its appeal.

As we’ve written here, the M&A hasn’t been all bad. In fact, I think Buckeye Partners’ (NYSE: BPL) lousy first quarter results are a pretty clear warning that it could easily be a sub-$30 stock, if Australian infrastructure firm IFM ever walked away from its $41.50 cash offer. And I would definitely take the money and run at this point.

But even the idea of a simplification or roll-up merger being a possibility is definitely depressing the prices of MLPs. For example, the first question during Noble Midstream Partners’ (NYSE: NBLX) first quarter call concerned an ongoing strategic review they previously announced—and CEO Terry Gerhart refused to comment. Talking about fanning the flames!

Anyway, the irony here is that if you look at the first quarter results and guidance for the 76 midstream companies we track in EIA, you see two things. First, there’s been no real difference in performance between midstream MLPs that converted to corporations and those that have stayed MLPs over the past year.

I think there are great buys right now in both groups. But the only real winners from the actual transactions—the
corporate conversions, simplification mergers et al—at least so far are the banks and Wall Street firms that successfully sold them to management teams and MLP boards.

Converting thus far has been anything but a panacea for midstream businesses’ ability to raise capital. I had to laugh when I found out Hi-Crush Partners (NYSE: HCR) converted to a corporation June 3. Sorry guys. Your problem is the really awful economics of selling frac sand. No one is going to love you more as a corporation that can’t pay a dividend than they did when you were an MLP that also couldn’t afford a dividend.

My other point is there are definitely haves and have nots among both midstream corporations and MLPs. But it’s crystal clear the best of both groups have turned a corner now as businesses. They’ve cut away their non-performing assets, slashed debt and raised distribution coverage, and as a result are self-funding at least the equity portion of their capital spending.

I still think self-funding is a ridiculously conservative strategy for financing assets that will measure their useful life in decades. It’s like banks requiring homebuyers to put up all cash. But the fact that these MLPs are doing it means they don’t have to issue equity. That means they can keep raising distributions even when they yield 8, 9 or even 10 percent. And I’m talking about the midstream companies organized as corporations as well as those that are still MLPs.

I really have a hard time believing this state of affairs is going to last much longer. But while it does, this is really an historic opportunity to buy the best in class MLPs and midstreams. There’s plenty to avoid, as anyone can see from a look at the coverage universe or the Endangered Dividends List. But then you have Enterprise Products Partners (NYSE: EPD) yielding one of the safest 6 percent pluses you’ll ever see. And the companies on our High Yield Energy list are even more attractive at their current prices.

Elliott Gue (EG): Yes, at last year’s MLP Association Conference I think we both pointed out just how bad investor sentiment was on the sector—it was the most negative I’ve seen in nearly 20 years of covering the industry.

And I agree with all the factors Roger mentioned. I also think that MLPs suffer from a similar malaise to the rest of the energy sector. In short, oil and commodity prices have endured breakneck volatility over the past 3 years and that’s turned a lot of investors off the group.

Think about it: Oil prices soared from under $30/bbl in early 2016 to over $55/bbl a year later, then oil collapsed to the low $40s in the summer of 2017, then jumped to nearly $77/bbl last fall. Since then, of course, WTI plummeted to around $42/bbl on Christmas Eve 2018 before jumping close to 60% to recent highs near $67/bbl.

That’s a $60/bbl round-trip move in 8 months!

Most MLPs have limited direct exposure to commodity prices and many, like Enterprise Products Partners that Roger mentioned, also have limited indirect exposure or volumetric risk. That said, commodity prices do impact sentiment on the group just as they do for other energy related groups.

And when you have wild swings like that in commodity prices as well as the media and Wall Street narratives being peddled regarding energy, some investors are put off or discouraged from investing in the group. No one wants to buy into an MLP that seems to be on the upswing only to get hit by 30% or 40% 3 months later because oil prices plunged.

However, I see a few pieces of good news out there that suggest this vicious cycle of commodity-driven pessimism is drawing to a close.
First up, there’s the old saw that it’s always “darkest before the dawn,” meaning that the news and sentiment is always at maximum negativity right before there’s a major turn in a group. I think that’s at least partly true with MLPs over the past year.

Simply put, since the end of June 2018, the S&P 500 is up a little less than 5% and energy was the worst performing sector in the index down 18.2%.

However, the Alerian MLP Index is actually up 2.4%...

And let’s look at the list of MLPs we have recommended in the Actively Managed Portfolio: Plains GP (NSDQ: PAGP) is up about 3% including distributions, Enterprise Products Partners (NYSE: EPD) is up 8.6%, Hess Midstream (NSDQ: HESM) is up about 6.2% and Crestwood Equity Partners (NSDQ: CEQP) up 23.8%.

Even our “losers” like MPLX (NSDQ: MPLX) and Magellan Midstream Partners (NYSE: MMP) are only down marginally – about 1.2% and 4.2% respectively.

My point is that, contrary to all the headlines about the death of MLPs and the end of the business structure following tax reform, the group has performed pretty well, especially when compared to the outright rout in energy shares over the same time period.

In part, this reflects the fact that MLPs are regaining some of their defensive characteristics. Since many of the more commodity-sensitive MLPs are no longer with us following the post 2014 bear market in oil, most of the surviving MLPs are high quality stocks with, as Roger mentioned, the potential to self-fund their capital spending plans over the next few years and pay a distribution. So, it could be that once again MLPs become the lower volatility and lower beta play on the energy sector.

Second, a few years ago you had hedge funds and institutional investors of all stripes jammed into MLPs looking for yields in a pay-nothing interest rate world. Following a collapse in the group, a lot of this hot money has exited the sector; in other words, I believe that last year's spring panic selling in the group washed out most of the weak hands.

I think that represents an opportunity for those of us willing to look beyond the sentiment and headlines about oil to actual business conditions, solid yields and the potential for distribution growth over time.

Talking Point #2: Over the past 5 years, crude oil prices have come down sharply and MLPs have generally followed oil prices lower. How much commodity exposure and price risk do the MLPs have?

RC: There are still a handful of companies in our coverage universe with direct commodity price exposure. Viper Energy Partners LP (NSDQ: VNOM), for example, is an affiliate of Diamondback Energy (NSDQ: FANG) that owns producing properties in the Permian Basin. It’s quite healthy and growing rapidly by making acquisitions, though the quarterly distribution varies from quarter to quarter with energy prices. I think that will be a good thing going forward but this is not a pipeline company.

We also still track a couple of coal royalty MLPs, as well as Dorchester Minerals LP (NSDQ: DMLP). And their earnings also move in virtual lockstep with what they sell, though they moderate the quarterly volatility somewhat with hedging. Sometimes these are buys and sometimes holds or sells.

In contrast, the midstream MLPs and corporations in our coverage universe have been systematically trying to reduce even their indirect exposure to commodity prices. You used to have a number that suffered huge fluctuations in cash flow when natural gas liquids price spreads shifted. Today, the list of the truly
exposed is basically Targa Resources Corp (NYSE: TRGP), which is actually the product of the one of the first simplification mergers—long before the FERC made that pipelines decision.

The other exception in midstream I guess would be Kinder Morgan Inc (NYSE: KMI), which still has that CO2 division that produces oil. First quarter results, however, show pretty clearly that this company is focusing squarely on natural gas pipelines. CO2’s ability to affect earnings is shrinking by the day. In fact, right now the enhanced oil recovery part is only about 6 percent of revenue and that’s also hedged to a large degree.

Of course, the best thing for Kinder’s share price would be an outright sale of that whole division. But owning it isn’t crippling the company and they have every incentive to wait for a good selling price. Management by the way spent a lot of time on the subject of a CO2 sale at a recent Bernstein conference. **We still like Kinder under 22.**

As for the rest of the midstream companies in our coverage universe, most are still affected by changes in volumes on their systems, particularly the gathering and processing businesses, which are especially close to the well head. We are once again, however, seeing a large number of “take or pay” contracts getting signed particularly for large pipelines, which pay the midstream company no matter how much is getting shipped. Also a number of midstreams are drawing larger percentages of revenue from straight fees that aren’t affected by volume swings either.

This all goes with the risk reduction efforts that have been underway now for several years. And some of it has to do with focusing on what have emerged as the better performing reserve basins like the Permian in west Texas and the Bakken in the upper Midwest. But the upshot is despite a great deal of volatility in the oil price starting the past two quarters, the best in class midstreams had very steady results, bringing new assets on stream and keeping older ones full.

No doubt there will come a time when management teams throw caution to the winds again in search of growth. But this is definitely not such a time. And as a result, investors can feel really good about these very high dividends, at least for the better run MLPs and other midstreams.

**EG:** As I said a little earlier on, I think the main impact of commodity prices on the higher quality midstream MLPs has been on investor sentiment rather than actual distributable cash flow and results.

In a sense, it’s more psychological than fundamental.

That said, some of our best-performing MLP recommendations in recent years have been names that did have significant commodity exposure and were hurt by that back in 2014-2017 but have since refocused on more fee-based revenue streams.

A perfect example is Plains All-American (NYSE: PAA) and Plains GP Holdings (NYSE: PAGP). Since PAGP’s only asset is units of PAA, these two companies are the same fundamentally except that PAGP is organized as a corporation and PAA as an MLP.

Back in 2013-2014 Plains was considered one the blue-chip names in the sector with a track record of strong and consistent distribution growth over time. However, if you dig a bit below the surface, you’d see that a good chunk of the company’s cash flows back in 2013-14 were from its Supply & Logistics (S&L) business:
A large piece of the S&L business consists of buying oil from one place and then immediately selling the same crude delivered to a second location.

So, for example, Plains might buy crude oil from producers near Midland (West Texas) and sell it immediately in Cushing, Oklahoma at a higher price, using the company’s own pipelines to move that crude from Midland to Cushing. When the basis differentials are wide – when oil, in Midland is priced much differently than in Cushing or Houston – PAA has more opportunities to profit.

The S&L business is NOT really leveraged to the absolute price of various commodities like oil but to volatility and regional pricing differentials.

Back in 2013-14 these regional differentials were high as were regional pricing differentials in natural gas liquids like propane, ethane and butane. So, Plains’ S&L business made a ton of money – some $900 million in 2012, $900 million in 2013 and $700 million in 2014.

That’s huge when you consider the company’s total Earnings Before Interest, Taxation, Depreciation and Amortization (EBITDA) was around $2.2 to $2.3 billion annualized over this time period.

The problem was that when oil prices collapsed in 2014, all these regional pricing differentials did too – the broader oversupply sank the prices of crude and many NGLs across the board and by 2017 the S&L business only generated around $100 million in EBITDA, a near 90% decline from 2013.

Well, PAA was counting on these earnings to support its payout and, when earnings collapsed, so did their distribution – the company was forced to cut it quarterly payout from $0.70 per quarter to $0.55 and then again to $0.30. The stock collapsed something close to 80% between late 2014 and early 2016.

Source: Plains All-American May Investor Presentation
Today, PAA is still in the S&L business. In fact, they’re making around $450 million per year due, in large part, to near record price differentials for oil between West Texas, Cushing and the US Gulf Coast. The difference is that they are NOT relying on those cash flows to make their quarterly distribution payment—instead they’re mainly using these windfall cash flows to pay down debt.

So, for example, in 2018 PAA reported around $2.40 in distributable cash flow per unit and they paid out a total of $1.20, which means they had a near 2-to-1 coverage ratio, considered sky-high for any MLP. However, they did make about $462 million from their commodity-sensitive S&L unit last year and that margin may well disappear entirely by next year as new pipeline capacity reduces regional pricing differentials. In fact, their own guidance shows S&L EBITDA at roughly the same level for 2018 and 2019, then “meaningfully below 2019” in 2020.

However, even if I back out their entire S&L EBITDA, I calculate Plains’ coverage at close to 1.4-to-1 for 2018 and, based on their updated guidance from May, at about the same level for 2019.

And, here’s the real kicker – in April, Plains announced a 20% increase in their quarterly distribution from $0.30 to $0.36 per unit. I am calculating this coverage ratio based on the company’s now higher distributions and excluding the impact of elevated S&L EBITDA this year due to regional pricing differentials.

And, the company is also deploying those excess S&L cash flows towards paying down debt. Total debt to EBITDA is down to 3.1 times, half of what it was just a few quarters ago. And Plains has a long-term target of 3.0 times EBITDA, putting debt metrics near the low end of its MLP peer group.

Put another way, back in the 2014-17 period, Plains faced a massive decline in EBITDA from its S&L division and was forced to slash its distributions by more than half to retain enough cash to survive. In 2020, the company expects S&L margins to collapse again.

The difference between 2020 and 2015?

Now, Plains’ fee-based businesses – basically contracted “take or pay” payments from shippers on its pipelines – account for around $2.2 billion in annualized EBITDA, growing to $2.4 billion in 2020. Thus, the firm can weather the inherent volatility in the S&L business without threatening its payout.

Plains is a great example of an MLP that did have real, underappreciated commodity price exposure back in 2014-15 but has since taken steps to reduce its commodity sensitivity and resume distribution growth. I don’t believe these positive fundamentals are fully reflected in the price of Plains’ units, which now yield around 6.3%.

We rate PAGP a buy under $26.50.

Talking Point #3: There’s a growing list of MLPs that have converted into C-Corporations. Will this trend continue? If so, who’s next?

RC: We’ve said pretty consistently since that MLP conference that there would be more simplification mergers and outright conversions—but that the action would be confined to the weaklings. I guess the big exception this year is Amerigas Partners, which was covering all of its capital spending and distributions with internally generated cash flow. Parent UGI decided it wanted a bigger take of those cash flows and the result was an offer at a decent premium, but that will result in a big distribution reduction for those that hold on past the close.
Last year, it was Antero that made the move, though that transaction was a little different—as they merged the general partner and limited partner that were both MLPs, and then converted the combination to a C-Corp. I still like Antero, and it’s worth pointing out that their deal actually resulted in a big distribution increase. But as I said answering question one, I’d be surprised if management isn’t now scratching its collective head about why the shares haven’t received more benefit from the move. I think they might have done better by staying an MLP.

What we haven’t seen yet, however, is any of the major MLPs convert into C-Corps. Instead, they’ve eliminated IDRs either by outright merging or by eliminating them in exchange for common equity. **Energy Transfer LP** (NYSE: ET) is still an MLP. So are Enterprise, **Magellan Midstream Partners** (NYSE: MMP) and **Plains All-American Pipeline** (NYSE: PAA). And together they’re roughly 40 percent of the Alerian MLP Infrastructure Index.

**NuStar Energy LP** (NYSE: NS) also eliminated IDRs by merging with its general partner. **Crestwood Equity Partners LP** (NYSE: CEQP) did the same by merging in its MLP unit. So did **EQM Midstream Partners LP** (NYSE: EQM) by swapping IDRs for equity shares issued to general partner Equitrans (NYSE: ETRN), after the latter bought up all the units of EQM’s publicly traded GP. **Western Midstream Partners LP** (NYSE: WES), **EnLink Midstream LLC** (NYSE: ENLC) and **Tallgrass Energy LP** (NYSE: TGE) also kept the MLP structure while eliminating the drag of IDRs with simplification mergers.

That kind of deal doesn’t get the press that the straight up roll-ups have. But the resulting entities are arguably much stronger and they’re still MLPs.

Will more of the 76 midstream companies in our coverage universe convert from MLPs to corporations in the next 12 to 18 months? Almost certainly they will. But a lot more MLPs are going to decide they can strengthen their capital structure without triggering a major and alienating taxable event for especially their long-term investors.

And let’s not forget the possibility that corporate taxes are actually increased again sometime in the next five years. That would make management teams look quite prescient for resisting the pressure to convert to C-corps.

As for the question of who’s likely to be next to convert, I think any MLP talking about a “strategic review” right now is highly suspect. That would include Noble Midstream Partners. But the MLPs at greatest risk to a conversion on disadvantageous terms are those that are floundering now as businesses, and they should be avoided no matter what structure they have.

**EG:** I think that’s correct. The more important point isn’t which MLPs will convert from an MLP to a corporation, but which names may be in line to do a simplification transaction. Sometimes these simplifications involve converting into a corporation though, for many of the best, these simplifications proceed without abandoning the MLP structure.

So, you might be wondering, what’s a simplification and why do MLPs perform these transactions?

Traditionally, MLPs consist of two basic entities, a limited partner (LP) and a general partner (GP). When you buy an MLP, what you’re really buying in most cases is LP units, which entitle you to a share of the cash flows generated by the partnership. The GP is often controlled by a parent or sponsor company that handles the actual management of the MLP’s assets.

Again, traditionally, the GP receives a quarterly payment known as an incentive distribution right (IDR) from the MLP as compensation for managing the assets. Historically, these IDRs are calculated based on a tier
system based on the level of LP distributions paid – the idea is that the GP gets rewarded as payments to LP unitholders rise.

So, let me give you a specific example: **Shell Midstream** (NSDQ: SHLX).

Shell Midstream pays quarterly incentive distribution rights (IDRs) to its general partner, ultimately controlled by parent **Royal Dutch Shell** (NYSE: RDS/A). These IDRs are paid according to the following tier structure:

- **Minimum Quarterly Distribution**: LP unitholders must be paid the MQD of $0.162500 each quarter. Holders of SHLX receive 98% of the total distribution and the GP gets 2%.

- **Tier 1**: When the LP’s quarterly payout is between $0.162500 and $0.186875, holders of the common units receive 98% of the payout with the GP receiving 2%.

- **Tier 2**: When the LP’s quarterly payout is between $0.186875 per unit and $0.203125 per unit, holders of the common units receive 85 percent of the total distribution within this interval. IDR holders collect 15 percent.

- **Tier 3**: When the LP’s quarterly payout is between $0.203125 per unit and $0.243750 per unit, holders of the common units receive 75 percent of the total distribution within this interval. IDR holders collect 25 percent.

- **Tier 4**: When the LP’s quarterly payout exceeds $0.243750 per unit, holders of the common units receive 50 percent of the total distribution above this threshold. IDR holders collect 50 percent.

So, SHLX paid a quarterly distribution of $0.415 in May, covering its Q1 2019 payout. In other words, the MLP is above the Tier 4 threshold in what is known as the “high splits.”

Let’s calculate what that means for SHLX:

<table>
<thead>
<tr>
<th>Low range</th>
<th>High range</th>
<th>LP</th>
<th>GP</th>
<th>Total Payout</th>
<th>Amount Paid to GP</th>
<th>Amount Paid to LP</th>
</tr>
</thead>
<tbody>
<tr>
<td>MQD</td>
<td>$0.162500</td>
<td>98%</td>
<td>2%</td>
<td>$0.165816</td>
<td>$0.0033163</td>
<td>$0.1625000</td>
</tr>
<tr>
<td>Tier 1:</td>
<td>$0.162500</td>
<td>$0.186875</td>
<td>98%</td>
<td>2%</td>
<td>$0.024872</td>
<td>$0.0004974</td>
</tr>
<tr>
<td>Tier 2:</td>
<td>$0.186875</td>
<td>$0.203125</td>
<td>85%</td>
<td>15%</td>
<td>$0.019118</td>
<td>$0.0028676</td>
</tr>
<tr>
<td>Tier 3:</td>
<td>$0.203125</td>
<td>$0.243750</td>
<td>75%</td>
<td>25%</td>
<td>$0.054167</td>
<td>$0.0135417</td>
</tr>
<tr>
<td>Thereafter</td>
<td>$0.243750</td>
<td>$0.415000</td>
<td>50%</td>
<td>50%</td>
<td>$0.342500</td>
<td>$0.1712500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$0.606473</td>
<td>$0.1914731</td>
</tr>
</tbody>
</table>

Source: Energy & Income Advisor, 2018 10-K Shell Midstream Partners

This table sets out the actual IDR payment SHLX is supposed to pay based on its current distribution of $0.415 per unit. The important thing to remember is that these Tiers are based on the amount paid to LP unitholders. As you can see:

- The minimum quarterly distribution of $0.162500 represents 98% of the total paid. That means the total distribution is equal to $0.1625 divided by 0.98 or $0.1658163265 with the $0.1625 paid to holders of SHLX and the remainder about one-third of a cent, paid to the GP.
• **Tier 1:** This tier consists of the $0.024375 in quarterly distributions of between $0.1625 and $0.186875. The total distributions paid here are $0.024872 (0.024375 divided by 0.98).

• **Tier 2:** This tier consists of the $0.01625 in quarterly distributions of between $0.186875 and $0.203125. The total distributions paid here are $0.019118 (0.01625 divided by 0.85 at this tier level).

• **Tier 3:** This tier consists of the $0.040625 in quarterly distributions between $0.243750 and $0.203125 per quarter. Since 75% of that amount is paid the LP, the total distribution is a little over 5.4 cents per quarter.

• **Tier 4:** This tier consists of $0.17125 in quarterly distributions paid to the LP – that’s the difference between the current quarterly payout of $0.415 per unit and the Tier 4 threshold of $0.243750. Since the LP portion only accounts for 50% of the total distributions paid, the total distribution is twice the LP portion or $0.3425 per unit.

The point is that if we sum up what this actually means for the MLP in the most recent quarter, the LP unitholders received the $0.415 per unit but the MLP actually had to pay out $0.606473 per unit because the IDR structure called for the GP to be paid an additional sum of more than 19 cents in the quarter.

Just consider: SHLX currently yields over 8%. Should the MLP want to go out and raise capital by issuing additional units of the MLP (equity capital) that carries a cost of 8% per year as it will need to make distributions on any units issued.

However, while 8% is bad enough, it massively understates the MLP’s true cost of equity capital.

You see, SHLX is really paying out $0.606473 per unit per quarter at the current distribution rate, equivalent to $2.426 per year or a yield of 11.8%!

In effect, for SHLX to raise capital by issuing units is an expensive proposition and it’s pretty tough to identify projects that can earn an acceptable return on investment with a cost of capital that high.

It also makes it tougher for SHLX to grow its payout. Just consider that over the past few years, SHLX has been increasing its payout at a roughly 20% annualized pace. If that pace were to continue, the MLP would grow its payout to around $0.50 per quarter in a year’s time, up 8.5 cents from the current level. But, because of the 50/50 LP/GP split at this tier, SHLX would really be raising its payout by $0.17 per unit to generate that level of growth.

That’s likely one reason that management’s guidance is for mid-teens distribution growth in 2019 – SHLX just can’t support the 20% plus annualized growth rates it achieved earlier in its lifecycle when distributions were in lower IDR tiers.

To be fair to Shell, the GP has agreed to waive its IDRs by a total of $50 million in the first 3 quarters of 2019, consisting of $17.0 million in Q1, $17.0 million in Q2 and $16 million in Q3 2019. Thus, based on the Q1 distribution of $0.415 and the 223.8 million units outstanding, the company’s total payout to LP unitholders was $92.88 million (223.8 multiplied by $0.415) and IDRs would have been about $43.58 million (223.8 multiplied by the above-calculated $0.1914731) for a total of $136.5 million. Subtracting the $17.0 million waiver, SHLX’s actual payout was closer to $119 million in total LP distributions and IDRs.

Taking this analysis one step further, SHLX generated total distributable cash flow of $140 million so coverage of the $119 million in total distributions was about 1.2 times, considered healthy for an MLP.

However, had the GP not granted that IDR waiver, the coverage of $136.50 in total distributions with just $140 million in distributable cash flows looks ultra-tight at about 1.03 times.
So, a few points to note here. First, it’s a huge mistake to say that the IDR structure is inherently “bad,” “unfair” to LP unitholders or “wrong” – after all, by basing IDR payments on LP distributions, the structure aligns the incentives of both LP and GP unitholders toward distribution growth.

However, particularly in a weak energy market backdrop such as we’ve seen over the past few years, when an MLP starts to get into the “high-splits” the partnership often sees an untenable increase in its cost of raising equity capital to grow its asset base. Even an MLP like SHLX, with its attractive base of reasonably priced drop-down acquisitions from its parent has struggled to generate returns high enough to offset the rising cost of capital.

Meanwhile, waivers clearly help reduce the cost of capital for SHLX and Shell is a supportive parent for SHLX. Of course, that’s not entirely altruistic on Shell’s part because the parent also owns LP units and the MLP’s assets are mission-critical for Shell’s large US operations. However, ultimately there is no guarantee that they’ll continue to extend IDR waivers indefinitely or at anything close to the current level.

Ultimately, I believe the solution will be some sort of a simplification transaction that involves a one-off payment or share issue to Shell in exchange for either the outright elimination of the IDRs or a permanent change in the tier structure, which lowers SHLX’s cost of capital.

That would provide the level of certainty and predictability that investors crave. I think you will see more MLPs like SHLX that are in their high-splits today either do simplification transactions to eliminate IDRs or do some sort of a conversion with the same effect.

Talking Point #4: The Alerian MLP Index has a net debt to EBITDA ratio of more than 4 times compared to about 1.85 times for the S&P 500. Heavily leveraged companies tend to underperform in the latter stages of an economic expansion. How big of a problem is debt for the MLPs?

RC: I have two points. First, regulated utilities also carry very high levels of debt but are at this stage of the cycle quite popular. NextEra Energy (NYSE: NEE), for example, trades at an historically high mid-20s earnings multiple, but also has a debt to EBITDA ratio of 4.48 times. Investors are willing to accord such a high price to its shares despite high debt because there’s an understanding revenues are either earned by regulated monopolies or by long-term contracts measured in decades. Debt is high on an absolute basis but revenue is reliable enough to handle it.

As we’ve seen over the past five years or so since oil last traded north of $100 a barrel, midstream energy cash flow isn’t as reliable on the whole. But neither is revenue from a pipeline contract with, for example, ExxonMobil (NYSE: XOM) ever truly at risk.

Again, I’m not saying investors should cut MLPs as much slack for high debt as they do utilities. But neither do the best in class midstreamers and MLPs carry the same risks as the majority of S&P 500 companies. They can comfortably handle a higher level of debt.

Second, MLPs have been cutting debt for several years. A lucky few have been able to do so by simply growing their business. Most have made sacrifices such as slowing distribution growth, cutting or eliminating payouts and/or selling assets. But we have seen debt to EBITDA ratios come down a point or more for most over the past couple years. And most MLPs plan to do a lot more over the next year, even if it means freezing distribution growth.

The bottom line is debt was a huge emerging problem for MLPs in 2014. It nearly crushed several companies in 2015, including Kinder Morgan. It forced big dividend cuts in 2016-18, including to household
names. And it’s even caused MLP bankruptcies, including this year to Southcross Energy Partners (OTC: SXEEQ). That company in fact plans to liquidate in an auction next month.

But debt is not the problem right now for the best in class MLPs that it was only a couple years ago. Just check out the data in the “comments” column in the MLP Ratings table.

EG: That’s exactly right. I think excess debt is really yesterday’s headline for many of the MLPs in our coverage universe given efforts in recent years to bring down excess debt loads.

Actually, the situation is similar to what’s going on in the rest of the energy business – investors are clearly rewarding energy companies that are spending free cash flow on reducing leverage and then performing other shareholder-friendly moves such as buying back stock or boosting dividends.

A week or so ago, I put together a quick chart covering more than 30 MLPs in the Alerian MLP Index that compares the change in each MLP’s net debt to EBITDA ratio between the end of 2017 and today to the each MLP’s total return – distributions and price change—over the same time frame:

![Change in Net Debt to EBITDA and Returns](image)

While the relationship is by no means perfect, there is an obvious correlation evident on the chart. Simply put, the more a particular MLP has reduced debt over the past 18 months, the higher the total return in its stock has tended to be.

So, I think that just underlines the fact that it pays to look for and identify MLPs with stable cash flows and limited commodity price exposure that can both reduce their debt burden and pay out distributions comfortably.

As I mentioned earlier, names like Plains GP Holdings clearly fit the bill.
Talking Point #5: The Alerian yields a little under 7%; however, there are several MLPs with yields much higher than that – 8%, 9% even 10% and higher. Are there any opportunities or pitfalls among these higher yield names?

■ RC: I think there’s still danger in this group. But there’s also compelling value, provided the MLPs in question can self fund at least the equity portion of their growth. If they can do that consistently, they won’t have to issue equity and that means they can keep raising distributions despite high yields.

Identifying and highlighting these MLPs, as well as other high yielding stocks in our Energy and Income Advisor coverage universes, is what we’re doing with the High Yield Energy list. We feature it along with the Actively Managed Portfolio in the front of every issue.

We currently have 8 names, including the two we added this issue Oasis Midstream Partners (NYSE: OMP) and Suburban Propane Partners (NYSE: SPH). And we intend to add more over the coming weeks. Some of the hallmarks of each of them are strong, consistent and sustainable distribution coverage, manageable and falling debt and some level of protection against a wealth-destroying merger.

I do think over the next several quarters we’ll see more companies in our coverage universes meet these criteria and become buys. But I don’t see any advantage now to buying anything that doesn’t meet our criteria. Many if not most super high yielding companies have those lofty payouts because there’s commensurately high risk alongside. And where dividend cuts have occurred historically, they’ve triggered massive losses of capital, no matter how far stocks have fallen already.

■ EG: I agree entirely that higher yields usually do mean higher risk. However, as Roger pointed out, there are opportunities in names like those on our High Yield Energy list that are simply too cheap (therefore offering too high a yield) given their underlying business risks.

One more area I have mentioned in past years that I think continues to merit attention is one of the more commodity sensitive areas within the MLP universe.

Long-term subscribers will remember that we once recommended several upstream MLPs including Linn Energy and Vanguard Natural Resources – these companies were oil and gas producers that made extensive use of hedging instruments to reduce their exposure to commodity prices. And that strategy was solid as long as oil prices held up well.

In fact, the reason we recommended selling out of all our upstream exposure back in 2014 was our bearish call on crude oil and our view that we were entering a “lower for longer” commodity price environment. Ultimately, hedges do run out and falling commodity prices would hit the upstream names hard. That proved to be a good move as most of the upstream MLP names have long since gone bankrupt – they simply couldn’t survive in this era of lower energy prices.

However, I do think the “royalty” model followed by names like Black Stone Minerals (NYSE: BSM) is a great deal more suitable to the partnership model than the old school upstream MLPs. That’s because BSM does NOT actually produce oil and gas; instead, the company owns and leases out mineral rights to oil and gas producers (mainly the well-known exploration and production companies).

Typically, a royalty contract with BSM will be structured in two parts – an up-front cash payment known as a “lease bonus” followed by an ongoing stream of royalties equal to 20% to 25% of revenues generated from oil and gas produced.

So, BSM still has commodity price exposure because lower oil and gas prices spell lower royalty payments.
However, it has a huge advantage over the old upstream MLPs because it is not exposed to the costs associated with the oil and gas business.

In other words, if well costs overrun expectations due to service cost inflation or increases in rig day-rates – all issues that plagued the old upstream MLPs – that does not directly impact BSM. If a particular play doesn’t pan out – wells just aren’t economic – BSM still benefits from the upfront lease bonus and isn’t exposed to the outright losses the E&Ps testing the new play have.

Don’t get me wrong: When oil prices come down, BSM is going to fall as well as it did late last year and again more recently.

However, as I explained in the May 7, 2019 issue “Oil: It’s Not October 2018,” the recent sell-off in oil prices does not look sustainable based on the supply and demand indicators we follow. In particular, the last 4 oil inventory reports released by the Energy Information Administration have included unprecedented “adjustment” factors of more than 800,000 bbl/day. I explained exactly what that means in a recent video posted on YouTube but suffice it to say that a large adjustment factor means that the reported inventory builds are probably much larger than actual inventory builds.

For investors looking for high yields – and BSM currently yields around 9% -- and a play on a recovery in oil prices, a royalty MLP could be an interesting more aggressive choice.

Talking Point #6: Drop-Down transactions, where an MLP’s general partner sells assets to the MLP were an attractive growth driver for the group for many years. Lately, though, they seem to have fallen out of favor. Is the drop-down growth angle exhausted? Are there any attractive names?

RC: I still think monetizing midstream assets with spinoffs can be quite rewarding for some owners. For one thing, it’s literally the only way they can generate immediate cash, while keeping control of the assets and cash flows. And that cash can be used to grow those assets to generate more income, or just to cut debt.

Monetizing with a spinoff is also a way management can let its investors know what its core business is. That in turn can unlock value, since pure plays on a sector are usually more highly valued than conglomerates.

Drop down MLPs have fallen out of favor primarily because investors have come to question their ability to finance these transactions by issuing new debt and equity. As a result, they’ve driven down the prices of these MLPs despite their robust growth rates, thereby making it effectively impossible to issue new equity on economic terms.

Some MLPs are still financing a steady stream of drop downs with innovative financing, in hopes that investors will eventually come back to the sector and reward them with higher valuations. If that happens, they’ll be able to resume some equity issuance, which in turn will allow them to fire up growth. If it doesn’t, however, they’re eventually going to have to slow their capital spending, which in turn means dividend growth will stall as well.

I’m encouraged by the action in Shell Midstream Partners LP (NYSE: SHLX), which we’ve rated a buy below 20 for most of this year. Management has continued to grow assets and cash flow with acquisitions and to raise distributions at almost 20 percent a year. And shares have responded with a rise into the low 20s at the same time other MLPs have slumped.
We still don’t know for certain what Royal Dutch Shell’s (NYSE: RDS/A) plans are long-term for the MLP, which is why I’m not willing to chase it over 20. But it looks like the parent and general partner will continue to be supportive for a while at least. And the same thing appears to be happening at several other drop down entities.

My personal favorite in the group is Oasis Midstream Partners, which we’ve just picked up on our High Yield Energy list. It’s still closely attached to its parent Oasis Petroleum. But it’s also largely self-funding its capital spending, which means it’s not dependent on investors’ feelings about drop down entities for growth.

It still looks really cheap to me, which I think is due in large part to that lingering negative sentiment about drop down MLPs. But so long as Oasis can grow a dividend that’s over 9.5 percent at a rate of almost 20 percent a year, I’m willing to be patient.

■ **EG:** I think the answer to this question is directly related to the earlier question regarding simplification transactions.

Simply put, most “drop down” MLPs were originally created with IDR Tier structures that offered an incentive for the parent to drop down assets over time to the MLP. However, as more assets were dropped down to the MLP and distributions rose, the resulting IDR splits have pushed up the cost of capital for the MLP.

In a more sanguine market for energy stocks, the effect would probably be manageable. But, with investors in a sell-first-and-ask-questions-later mood these days, the cost of capital for some drop-down MLPs like SHLX has risen to levels that just wouldn’t have been contemplated a few years ago when these MLPs were created by companies like Shell.

I still think there’s value in drop downs and, just as investors got too enamored with these stories a few years ago, they’ve now turned too pessimistic.

I think you’ll eventually see a re-rating driven by two factors:

1. Ongoing high distribution growth rates and yields are pretty tough to ignore in an environment where yields on most assets are low and/or falling.

2. I do think you’ll eventually see companies like Shell permanently address their IDR-related cost of capital issues on a more permanent basis as I discussed earlier.

In the meantime, I think there’s value in names like SHLX but, as Roger indicated, you’ll definitely want to stick to our buy targets so that you don’t overpay.