Expect Q3 Results to Confirm Sector Values

By Elliott H. Gue and Roger S. Conrad

Earnings season in the energy sector is about to get under way. And wherever companies reside on the value chain, we expect to hear a lot about investment discipline.

Halliburton Co (NYSE: HAL) will be one of the first to release numbers and update guidance on October 21. But management of the energy services giant has already signaled there will likely be a more cautious tenor to its comments, after announcing the layoff of 650 workers across the Rockies region this week.

A little belt-tightening is never a bad thing. That’s especially true in the current long-term environment, where global supply and demand dynamics favor oil and gas prices staying in the neighborhood of where they are now for quite a while.

But we do think the energy bears have it wrong in one very critical respect: Mainly, slogging through a bear market of five years plus, the survivors are actually pretty well adjusted to what we’ve called a “lower for longer” price environment. That’s even true of US shale companies, which are now the target of heavy bearish bets.

There are a number of what we’d call “zombie” companies still going through the motions. That includes almost all members of our enlarged Endangered Dividends List, as well as the sells in our coverage universes. And a handful of companies appear headed for a date with bankruptcy court in the next 12 months.

But many of the companies now coming under selling pressure and seeing elevated short interest are likely to report just as solid third quarter results as their first half 2019 numbers. On the guidance calls, they’ll talk a lot more about improving efficiency than they have in the past. And only a handful of producers will report the kind of explosive output increases we’ve seen in previous years.

Neither, however, are we likely to see the meltdown of activity that appears priced shares into midstream giants like Energy Transfer LP (NYSE: ET), which yields nearly 10 percent. In short, there’s a lot of value in this sector. We expect to see it confirmed in company results the next few weeks. And it’s there for the taking now.
Feature: MLP C-Corp Conversions. Our Q&A looks at the state of MLP conversions and roll-up mergers following Hess Midstream Partners' (NYSE: HESM) big move, and Elliott Management’s latest attempt to break up Marathon Petroleum (NYSE: MPC).

Portfolios. We highlight key developments since the previous issue for Actively Managed Portfolio and High Yield Energy List companies, and when to expect third quarter earnings.

Endangered Dividends List. This earnings reporting season has claimed its first distribution cut, with Dynagas LNG Partners LP (NYSE: DLNG) eliminating its payout to comply with the conditions of its new loan. We’re also adding three challenged companies to the EDL this issue ahead of results: Alliance Resource Partners (NSDQ: ARLP), Blueknight Energy Partners (NSDQ: BKEP) and Ensign Energy Services (TSX: ESI, OTC: ESIVF).

High Yield Energy Target List, Active Portfolio, Endangered Dividends List

The Actively Managed Portfolio holds our top recommendations in a $100,000 hypothetical model, including specific position sizes.

Our High Yield Energy List focuses on big distribution stocks that meet five criteria: (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 that aren’t favorable to current shareholders.

The big event for our recommendations is upcoming earnings reporting season. Here are the expected dates for announcement and guidance calls. We’ll be updating our advice based on what we see in the coming weeks:

- Antero Midstream Corp (NYSE: AM)—October 30 (expected)
- Brookfield Renewable Partners (NYSE: BEP)—November 14
- Concho Resources (NYSE: CXO)—October 29
- Core Laboratories (NYSE: CLB)—October 23
- Crestwood Equity Partners (NSDQ: CEQP)—October 29 (expected)
- Enable Midstream (NYSE: ENBL)—October 31
- Energy Transfer LP (NYSE: ET)—November 6 (expected)
- EnLink Midstream (NYSE: ENLC)—November 7
- Enterprise Products Partners (NYSE: EPD)—October 28
- Halliburton Co (NYSE: HAL)—October 21
- Hess Midstream Partners (NYSE: HESM)—October 23 (expected)
Occidental Petroleum (NYSE: OXY) has delayed the sale of a portion of its general partner interest and 55.45 percent common equity stake in Western Midstream Partners (NYSE: WES). Management’s goal was apparently to keep control of the MLP while unloading enough to shed $7.5 billion in debt off its books.

The decision to put off is reportedly due to belief Western is worth much more than its current price. That’s a good sign Occidental will continue to manage its ownership interest to maximize value, either as a future asset sales candidate or to facilitate low cost production growth in the Permian Basin of West Texas.

This clarity removes considerable uncertainty from both companies. Occidental remains a deep value buy in the low 40s. Western Midstream is a solid bet for income investors up to 30.

Plains GP Holdings’ (NYSE: PAGP) 34.64 percent owned affiliate Plains All-American Pipeline (NYSE: PAA) will build and operate a new 160,000-barrel per day common carrier crude oil pipeline and terminal system. The assets will connect the Cushing, Oklahoma hub to a Tulsa, Oklahoma refining complex owned by a unit of Holly Frontier Corp (NYSE: HFC).

The $130 million estimated cost is to be shared with Holly Energy Partners (NYSE: HEP). The terminal is expected to be in service in the second quarter of 2020, with the pipeline the first quarter of 2021. Capacity is fully contracted under long-term arrangements.

The project continues Plains’ focus on low risk growth opportunities that are conservatively financed with operating cash flow after distributions. We expect another sizeable payout boost this coming spring. Plains GP Holdings is a buy up to 26.50.
### 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>
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<tr>
<td>Antero Midstream Corp (NYSE: AM)</td>
<td>5/22/19</td>
<td>7.19</td>
<td>17.12</td>
<td>146.0</td>
<td>5.0</td>
<td>1.00</td>
<td>3.2</td>
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<td>10.94</td>
<td>12.08</td>
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<td>4.2</td>
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<td>Buy&lt;30</td>
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</table>

Prices and yields as of October 10, 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>
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<td>50</td>
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<td>30.57</td>
<td>1983.14</td>
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<td>Concho Resources (NYSE: CXO)</td>
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<td>30</td>
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<td>N/A</td>
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<td>-972.03</td>
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<td>Core Laboratories (NYSE: CLB)</td>
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<td>35</td>
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<td>15.31</td>
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<td>TransCanada Corp (NYSE: TRP)</td>
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<td>51.14</td>
<td>4.42</td>
<td>45.07</td>
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<td>41.68</td>
<td>4.94</td>
<td>127.39</td>
<td>2,123.82</td>
<td>Buy &lt;35</td>
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</tbody>
</table>

As of 10/16/19, 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.

Dynagas LNG Partners (NYSE: DLNG) has arranged a new $675 million credit facility with lenders to refinance a $470 million term loan and $250 million in senior notes maturing in November. The new debt deal should enable the company to continue its recovery, with six LNG tankers operating under multi-year charters. The average length of lease is a comfortable 9.1 years, with 100 percent of the fleet contracted through 2020 and 92 percent through 2021.

Unfortunately, under the terms of the new loan, Dynagas will not be able to make distributions until the money is paid off in full. This will be in 20 consecutive quarterly payments, followed by a balloon payment in year 5. That’s a long time to go with no payout. In addition, interest on the loan is calculated at 300 basis points plus the ICE LIBOR rate, meaning the cost would rise if short-term interest rates move higher before payoff.

It’s possible that with a market capitalization of just $60.7 million, Dynagas will attract a takeover offer long before those five years are up. That could be a roll-up by general partner Dynagas Holding Ltd, which already owns 43.94 percent of the common shares. But income investors should clearly look elsewhere.

Equitrans Midstream Corp (NYSE: ETRN) and its 58.49 percent-owned affiliate EQM Midstream Partners (NYSE: EQM) caught a potentially huge break last week. The US Supreme Court agreed to hear the appeal of a lower court ruling that halted work on the Atlantic Coast Pipeline by overturning permits granted by US Forest Service.

The Court will hear arguments in the case early next year and is expected to issue a decision by early July. If it does rule in favor of the developers, the way would then be clear for work to resume on the also-stalled Mountain Valley Pipeline, providing a big lift to lead developer EQM and Equitrans.

The companies will still face a significant challenge from EQT Corp’s (NYSE: EQT) ongoing retrenchment and cost cutting, including a potential negotiation to reduce fees paid for use of EQM’s midstream assets. EQT last month slashed 23 percent of its work force amid a major management shakeup, as the Rice brothers moved aggressively to take control after a successful Board of Directors battle against the previous management.

EQT’s biggest worry is continued weakness in Appalachian natural gas prices, which is currently priced $1 per thousand cubic foot below the Henry Hub benchmark. With Henry Hub itself currently at a depressed $2.29, that doesn’t leave much room to make money.
The situation would likely improve if and when ACP and MVP enter service. But risk is still very high that won’t happen soon enough to prevent EQT cutbacks from triggering distribution cuts at EQM and Equitrans. **Conservative investors should continue to avoid both.**

We’re also adding **Alliance Resource Partners** (NSDQ: ARLP), **Blueknight Energy Partners** (NSDQ: BKEP) and **Ensign Energy Services** (TSX: ESI, OTC: ESIVF) to the Endangered Dividends List in advance of third quarter earnings reporting season.

Fresh off a half cent per share quarterly dividend increase in July, Alliance is more likely to raise its payout later this month than cut. But with fellow coal producers **Foresight Energy LP** (NYSE: FELP) and privately held Murray Energy Corp both missing interest payments this fall, the handwriting is on the wall for its sector as more US utilities shut coal power plants and prices overseas drop. That’s eventually going to be too much even for this well run company. **Sell Alliance Resource Partners.**

Blueknight has already cut its payout twice since spring 2018. But with major holder Ergon (6.73 percent ownership) walking away from its takeover offer, the spotlight is once again on the $257 million drawn on the company’s $400 million credit line maturing in 2022. That’s nearly six times current market capitalization for a company that depends heavily on the low margin and highly cyclical asphalt business. **Sell Blueknight if you haven’t already.**

Finally, extreme competitive pressures in the land-based drilling and well servicing contractor space are dragging down Ensign. The acquisition of Trinidad Drilling earlier this year has been a plus. But no one should expect much other good news in third quarter results due out November 5. **Sell.**

<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>
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<tbody>
<tr>
<td>Alliance Resource Partners (NSDQ: ARLP)</td>
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<td>Moderate</td>
<td>Jul-19</td>
<td>Sell</td>
<td>10/28/19</td>
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<td>Aug-19</td>
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<td>10/15/19</td>
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<td>Blueknight Energy Partners (NSDQ: BKEP)</td>
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<td>Nov-15</td>
<td>Sell</td>
<td>10/16/19</td>
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<tr>
<td>Ensign Energy Svc (TSX: ESI, OTC: ESIVF)</td>
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<td>Elevated</td>
<td>Jan-15</td>
<td>Sell</td>
<td>11/1/19</td>
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<td>Moderate</td>
<td>May-19</td>
<td>Sell</td>
<td>11/5/19</td>
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<td>10/22/19</td>
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<td>Sell</td>
<td>10/24/19</td>
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<td>Golar LNG Partners (NSDQ: GMLP)</td>
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<td>May-15</td>
<td>Sell</td>
<td>10/23/19</td>
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<tr>
<td>Green Plains Partners (NYSE: GPP)</td>
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<td>May-18</td>
<td>Sell</td>
<td>10/18/19</td>
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<td>Martin Midstream Part (NSDQ: MMLP)</td>
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<td>Moderate</td>
<td>Nov-14</td>
<td>Sell</td>
<td>10/17/19</td>
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<tr>
<td>Navios Maritime Acquisition (NYSE: NNA)</td>
<td>-33.3</td>
<td>Moderate</td>
<td>Nov-15</td>
<td>Hold</td>
<td>11/5/19</td>
</tr>
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<td>NGL Energy Partners (NYSE: NGL)</td>
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<td>Nov-15</td>
<td>Sell</td>
<td>10/22/19</td>
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<td>Peyto Expli &amp; Dev (TSX: PEY, OTC: PEYUF)</td>
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<td>Summit Midstream Partners (NYSE: SMLP)</td>
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<td>Sell</td>
<td>10/24/19</td>
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<td>Vermillion Energy (TSX: VET, NYSE: VET)</td>
<td>-25.0</td>
<td>Moderate</td>
<td>May-18</td>
<td>Hold</td>
<td>10/15/19</td>
</tr>
</tbody>
</table>

**Source: Energy and Income Advisor.**
MLP Conversions and Rollup Q&A

Q. Is the Hess Midstream Partners (NYSE: HESM) transaction a good deal for unitholders, or should we take this opportunity to cut and run before there’s real damage?

A. We think the positives outweigh the negatives of this deal. With Hess Midstream converting to a corporation, those who hold it outside of an IRA will probably pay higher taxes on distributions going forward. There will be no K-1 to file at tax time, however. Most importantly, management is sticking to its current dividend policy of 15 percent annual increases, which remains very attractive off a current yield of nearly 8 percent.

It’s pretty clear that converting to a C-corp is no panacea for a struggling MLP. Nor does it necessarily “widen the investor base,” as conversion proponents proclaim. In fact, you could make a pretty good case that most former MLPs actually alienated and lost a sizeable portion of their investor bases by changing structure.

Wary prospective shareholders almost certainly partly explain why shares of Kinder Morgan Inc (NYSE: KMI) are still trading around $20. That’s despite the company posting quite stellar operating results and doubling the dividend since spring 2018, with a lot more to come.

Converting to a corporation, however, is only one aspect of the proposed Hess transaction. More important is the company’s effective merger with Hess Infrastructure Partners (HIP), a 50-50 joint venture between Hess Corp (NYSE: HES) and privately held Global Infrastructure Partners.

HIP currently holds an 80 percent stake in Hess Midstream’s oil and gas midstream business. It also controls a rapidly growing water services operation and the general partner interest in Hess Midstream, along with the attached incentive distribution rights.

Adding HIP’s assets significantly scales up post-transaction Hess Midstream. It eliminates any overhang from concerns about financing potential drop downs. And scrapping IDRs should be immediately accretive to distributable cash flow.

Post transaction, Hess Corp will own 47 percent of Hess Midstream. Global Investment Partners will hold 47 percent and the public 6 percent. Such large holdings of parents may pressure Hess Midstream’s share price, should either elect to sell. Neither has given any indication it plans to do anything more than hold on and collect dividends.

But even if there were a temporary negative overhang or dilution from a sale, the post-transaction company has the wherewithal to self-finance capital spending. That means it won’t depend on access to equity markets to execute growth plans, a big plus in a capital market that remains hostile to midstream, whether organized as C-Corps or MLPs.

There’s also plenty of reason for both Hess and GIP to hang onto their investment. Anticipated 15 percent annual distribution growth at least through 2021 has backing from an expected increase in distribution coverage to 1.2 times from previous guidance of 1.1 times. Debt-to-EBITDA starts at a very modest 3 times.

Without this deal, general partner IDRs will consume 23 percent of distributable cash flow by 2021. The transaction essentially swaps those for what appears to be a fair price of stock and cash at a multiple of about 10.3 times expected 2020 EBITDA.

Another aspect of this deal that’s positive is management has structured the corporate conversion to be
non-taxable to current unitholders. That’s a huge difference from every other conversion transaction we’ve seen so far, where some long-time investors have been socked with massive tax bills.

It’s unclear if this can be a model for other conversions. But if so, it certainly would eliminate a lot of potential pain for MLP investors from simplification deals.

One last point: As much as we like the tax advantages of the MLP model and generally scorn managements that slavishly follow trends, we make Energy and Income Advisor recommendations on business quality, not just because we like a particular corporate structure.

And whether it’s organized as an MLP or a C-Corp, Hess Midstream operates highly profitable midstream assets with tremendous upside, as parent Hess Corp ramps up its oil and natural gas production in the Bakken. The addition of water services assets set to grow gathering volumes 50 percent the next 12 months is an added bonus. And the company has no plans to issue additional equity in coming years either.

All of that is solid support for the dividend and the extremely robust projected growth rate. There’s also a potential credit rating boost after the close expected at year-end, as Moody’s has elevated the outlook for the Ba2 rated company to “positive.” Hess remains a buy up to 24 in the Actively Managed Portfolio and we’re keeping it on the High Yield Energy List as well.

Q. What’s your outlook for MPLX LP (NYSE: MPLX) now that Elliott Management is trying to break up its parent Marathon Petroleum (NYSE: MPC)?

A. Last issue, we wrote that the most likely outcome of Elliott Management boss Paul Singer’s latest run at Marathon would be asset sales. That’s basically what went down the last time his activist investment firm tried to push changes at the company. And one result of that effort was the merger of MPLX with the former Andeavor that closed July 30.

Elliott’s demands this time around include sacking Marathon CEO Gary Heminger and splitting the company into three: (1) A pure play refiner that presumably would keep the Marathon name, (2) Convenience store and fuels distribution operator Speedway, and (3) MPLX as a standalone midstream energy company. The plan also calls for MPLX to convert to a C-Corp at the spinoff.

Elliott Management held 0.7 percent of Marathon shares as of the end of June and is now purported to own a 2.5 percent “economic interest” in the company. Singer has reportedly been joined in his quest to oust Heminger by two other large investors who have combined ownership of 1.7 percent.

That’s obviously not enough to take down Marathon’s board or current management. And we doubt that’s the ultimate aim in any case. But it is enough to force management into action, if for no other reason than to ensure Elliott and allies don’t acquire the needed support to mount a real corporate raid.

Last week, Heminger told workers that management has been conducting its own strategic review for several months. He also said he agreed with Elliott’s view that Marathon’s current share price doesn’t reflect the underlying value of the company’s assets.

Other than stating “confidence we can achieve our target of $600 million of gross annual run-rate synergies by the end of this year,” however, Heminger offered few details of what’s really being contemplated. Meanwhile, management executed another transaction that likely won’t make those in favor of “simplification” very happy.

That was merging its ownership interests in four ethanol facilities with those of The Andersons (NSDQ: ANDE) in a partnership Marathon will own 50.1 percent of. The goal is to establish greater scale in the...
market with the goal of hardening operations against the US/China trade war-triggered supply glut.

Marathon will report its third quarter earnings on October 31 and questions about its plans are certain to dominate the conversation on the guidance call. At this point, however, we believe it’s unlikely management or the board will agree to a full spinoff of MPLX.

The primary reason is its 63 percent ownership stake in the newly merged entity is its surest source of income. Management could, however, decide MPLX would command a higher valuation as a C-Corp than it currently does as an MLP.

Were it to go in that direction, we can reasonably assume they’d follow the Hess model, i.e. try to structure a transaction as tax neutral as possible and with no change to the current dividend policy. That’s in large part because MPLX distributions are Marathon’s sole source of cash flow from that company. And it’s hard to see how cutting the payout or even curtailing the growth rate wouldn’t have a sharply negative impact on parent shareholder value.

There’s also absolutely no operational or financial pressure for a more restrictive dividend policy at MPLX. The balance sheet is blessed with some of the highest credit ratings in the MLP and energy midstream space at Baa2, BBB and BBB from Moody’s, Fitch and S&P, respectively. And all three raters assign the company stable outlooks.

Distribution coverage post the Andeavor transaction is expected at 1.36 times this year, with 6 to 8 percent annual distributable cash flow growth fueling commensurate increases. That growth is backed by the start up of two major contracted projects in the Permian Basin by early next year.

Even risk to MPLX results from softer gas gathering operations in the Marcellus and the Utica looks very manageable. For one thing, post the Andeavor merger, these operations contribute just 20 percent of EBITDA. And that share will continue to drop as the company sells assets there and builds more in Texas.

MPLX’s third quarter results will include just two months post the Andeavor merger. So it won’t be until the fourth quarter that we start to see the full positive impact on the bottom line of promised deal synergies. Based on what we’ve heard, however, we expect the operating numbers to be in line with previous guidance.

The one outcome we would not expect from the ongoing strategic review and negotiations with Elliott would be for Marathon to make an offer for the 37 percent of MPLX it doesn’t currently own. Three reasons: Such a plan is precisely the opposite of what the dissident shareholders are asking for and is sure to provoke considerably more hostility, if not a wider call for management’s ouster.

Second, a cash offer would be extremely burdensome given Marathon already has a $34 billion plus debt load. And third, despite its high yield, MPLX commands a far better valuation, trading with enterprise value 12.5 times EBITDA versus just 7.8 times for Marathon.

But whatever is decided, the purpose of any move would be to enhance shareholder value, not to destroy it. That’s no doubt a major reason why 15 of 17 major research houses covering MPLX and tracked by Bloomberg rate the shares buy, versus 2 holds and no sells. Insiders have also stepped up purchases recently, boosting overall holdings by nearly 30 percent over the past six months.

Those are some very good reasons to stay with MPLX despite the uncertainty caused by current activist investor pressure on Marathon. **The MLP is a buy up to 37 and we’ll stick with it in both the Portfolio and the High Yield Energy Target List.**
Q. Do you expect any other MLPs to announce C-Corp conversions or roll-up mergers this year?

A. Absolutely. We’ve said pretty consistently the past few years that we expect to see more simplification mergers among MLPs, both corporate conversions and roll-ups into general partners.

We continue to believe there are too many midstream energy companies in the US.

It was easy to forget during the boom times when money and champagne were flowing that this is a capital intensive business where establishing scale is absolutely critical to weathering ups and downs in oil and gas production. And few investors paid any heed to whether or not companies had diversified revenue streams, or instead depended on a single asset, business line or customer.

It’s been more than five years since oil prices were over $100 a barrel. Most of the JPEPs, Sanchezes and Southcrosses of the world have either been taken under by parents, gone bankrupt or liquidated. Many of our “MLPs and Midstream” coverage universe companies, however, still aren’t big enough for anyone to assume they’ll still be around in five years.

We’re not saying some of the small C-corps and MLPs aren’t attractive. In fact, the best will deliver much fatter returns than blue chips like Enterprise Products Partners (NYSE: EPD), which have become as close to recession proof as it gets in midstream.

But with so many MLPs and midstreams still lacking sufficient scale, sector consolidation is far from over. Just look at Canada, with 8 midstream companies operating of consequence.

Three of them actually do most of their business now in the US: Altagas Ltd (TSX: ALA, OTC: ATGFF), Enbridge Inc (TSX: ENB, NYSE: ENB) and TC Energy Corp (TSX: TRP, NYSE: TRP). One is the operator of a Pacific coast terminal for metallurgical coal exports, WestShore Terminals (TSX: WTE, OTC: WTSHF), so it really doesn’t count.

That leaves four pure Canadian midstream companies: Gibson Energy Inc (TSX: GEI, OTC: GBNXF), Inter Pipeline Corp (TSX: IPL, OTC: IPPLF), Keyera Corp (TSX: KEY, OTC: KEYUF) and Pembina Pipeline (TSX: PPL, NYSE: PBA).

As we’ve written here, Canada’s energy patch is currently in its worst depression in decades. And odds are the situation isn’t improving any time soon, as oil sands and shale drilling have continued to ramp up while pipelines to carry oil and gas out of the region remain stalled.

But despite crashing energy prices and producer bankruptcies, not one of these four has cut its dividend even once this cycle. In fact, they’ve been raising payouts consistently, even while growing cash flows by finding new projects and funding them at a low cost.

It’s not likely the much larger US midstream business will contract to so few names. But the point of the Canadian example is there’s tremendous room and incentive for consolidation. Mainly, the bigger companies get, the more resilient and sustainable they’ll become.

The big question is whether consolidation will enhance shareholder wealth or destroy it. It’s true that much of the current wave of M&A in MLP-land more resembles vulture investing than a real bidding war.

Blackstone’s take private proposal for Tallgrass Energy (NYSE: TGE) in late August, for example, is a massive premium to where the Rockies midstream MLP traded immediately beforehand. But it’s an equally wide discount to where shares had traded only weeks earlier. And it was preceded by a side deal with management that ensured it would receive any offer as friendly.

Tallgrass does face unique challenges renewing contracts at a time when investors have been bailing on midstream and MLPs in particular. And despite recent comments from Blackstone to the contrary, there’s
still the chance of a higher number than the initial salvo of $19.50 per unit, once the conflicts committee deliberates. Nonetheless, this deal still feels a lot like the way Enbridge Inc waited for maximum price weakness to swoop in on its US MLPs last year, the former Enbridge Energy Partners and Spectra Energy Partners.

The recent drop in MLP and energy midstream share prices across the board is likely to tempt other general partners to make low ball offers for their holdings, which will be at big premiums to current prices, but huge discounts to previous trading ranges. That risk is another reason we’ve generally shied away from struggling smaller names, as the most likely to be taken under.

There is of course another way to look at this. Mainly, if a company is in position to be taken under, shareholders have already taken heavy losses. The transaction itself won’t recoup all losses long-term investors have suffered. But it will restore some value and in that case deals will be wealth enhancing rather than wealth destroying.

Q. **Will we see more equity-for-IDRs exchanges? Are these positive or negative for MLPs?**

**A.** We think the trend to eliminate or at least severely curtail incentive distribution rights will continue and will be positive for MLP investors. Investors clearly want simplification and better alignment of general partner interests with their own. And getting rid of IDRs cuts cost of capital in an environment where raising new equity has been problematic for quite a while.

The big question is what MLPs have to sacrifice to get the job done. Back in December 2017, MPLX LP paid its general partner Marathon Petroleum 275 newly minted common units to cancel IDRs obligations (see our 12/15/17 Alert “Goodbye IDRs.”)

MPLX paid a multiple of about 16.7 times expected operating cash flow. That was within the previously announced guidance range of 15 to 20 times but was also considered somewhat rich at the time. And the result was MPLX units gave up about 5 percent of their value following the announcement.

In contrast, Hess Midstream Partners will effectively pay $6.2 billion or 10.3 times adjusted EBITDA to bring Hess Infrastructure inside. That multiple isn’t directly comparable, as it includes cancelling the IDRs and adding the water assets. But it does imply the cost of these transactions has come down. So does Hess’ rising unit price since the deal was announced in an otherwise weak market for midstream energy.

Given IDRs’ toxic reputation now, it’s hard to believe MLPs that carried them were ever popular. But IDRs were in fact considered at one time to be a major incentive for general partners to support the growth of their affiliates, and therefore distribution growth.

What changed was the cost of capital in the energy sector, along with successful growth that quickly maximized GPs’ splits, significantly decreasing unitholders’ share of incremental cash flow. Eliminating IDRs isn’t a panacea for cutting cost of capital anymore than C-Corp conversions are. But provided the price paid is fair and the underlying business is sound, it can be a significant step in that direction, and without the disruption simplification mergers cause.

In any case, our exposure to IDR splits and potential swaps for equity is limited in the Actively Managed Portfolio as well as the High Yield Energy List.

**Enterprise Products Partners** (NYSE: EPD), **Magellan Midstream Partners** (NYSE: MMP), **NuStar Energy LP** (NYSE: NS) and **Suburban Propane Partners** (NYSE: SPH) have all subsumed their general partners, thereby eliminating IDRs entirely. So did **Crestwood Equity Partners** (NYSE: CEQP) and (NYSE:
ENLC) and Western Midstream Partners (NYSE: WES) with the opposite transaction by acquiring limited partners. And Antero Midstream Corp (NYSE: AM) and EnLink Midstream LLC (NYSE: ENLC) did the same by merging GPs with MLPs and converting to corporations.


That leaves only Enable Midstream Partners (NYSE: ENBL) and Oasis Midstream Partners (NYSE: OMP) as Portfolio MLPs still carrying IDRs. Enable is currently not paying IDRs under agreement with co-general partners Centerpoint Energy (NYSE: CNP) and OG&E Energy (NYSE: OGE).

Management has said it would revisit the issue with the board, should IDRs eventually become an impediment to being able to raise capital economically. But the major issue for shares now is the selling pressure resulting from some of the comments made about drilling activity in Oklahoma. We think Enable will answer them when it reports results early next month. In the meantime, the shares look very undervalued at around $11.

As for Oasis Midstream, it’s still a young MLP so its current IDR split with general partner Oasis Petroleum (NYSE: OAS) is only 5 percent this year. That would rise to 13 percent in 2020 and 17 percent in 2021, which management says is still supportive of its planned 20 percent annual distribution growth rate and a superior coverage rate of 1.9 times.

Questions about Oasis Petroleum’s ability to follow through on drilling plans in the Bakken have recently dogged Oasis Midstream shares. The MLP is reducing this risk by expanding business with third parties, which management expects to contribute between 15 and 20 percent of Q4 EBITDA.

We anticipate Q3 results expected November 4 to calm investor fears a bit, if for no other reason than simply not being as bad as Oasis’ falling share price would suggest. Until then, it will be difficult for Oasis Midstream shares to make significant headway. But the shares nonetheless present considerable value and are still a buy up to 20 for those who don’t already own them.

It is possible Oasis Petroleum will eventually buy Oasis Midstream Partners back in. The 45.27 percent of common shares it owns are a fair head start, especially combined with a swap of IDRs even at the current low split rate. Partners’ current market capitalization is $532 million. So assuming cashing the IDRs takes the common equity stake to around 50 percent, the most the parent would have to come up with would be $250 to $300 million.

The main impediment to a deal would be what currency Oasis Petroleum would offer, given its share price has nearly fallen in half year-to-date. Midstream’s enterprise value is currently depressed at 5.8 times EBITDA. But that still tops the parent’s 4.1 times. Also the GP is carrying nearly $3 billion in debt. That’s nearly three times its current market capitalization, and roughly $2.6 billion comes due by the end of 2023.

Bottom line is a simplification merger is possible. But a realignment of IDRs seems more likely at this point in time.

For an explanation of IDRs in general, check out our November 15, 2012 article on the subject “MLP Basics: Incentive Distribution Rights Explained.” Some of the players have changed since then. But the basics of this once popular structure have not. Note that Diamondback Energy’s (NSDQ: FANG) recently launched Rattler Midstream LP (NSDQ: RTL) has no IDR splits. That’s also likely to become a trend.
Q. Do you see the MLP model as doomed? Is there any hope it will regain its former popularity with investors?

A. Not doomed and yes, we believe the MLP model will have another day in the sun.

The longer you hang around the financial services and investment industry, the more you notice just how easy is it to not look beyond prevailing trends. And we’re talking about everyone, from the biggest investors to investment banks and company managements.

MLPs are a great example. Back on December 11, 2013, we posted “Rating the Master Limited Partnerships IPOs of 2013.” That year and the first half of 2014 were the height of MLPs’ popularity this cycle. Oil was north of $100 a barrel and even natural gas was reliably trading for more than $3 per thousand cubic feet. Investors were after income, and were still more attracted by MLPs’ tax advantages than put off by filing K-1s.

So not surprisingly, Wall Street did its usual thing and sold to meet the demand. And the result was a baker’s dozen of fresh MLP IPOs in 2013, followed by 15 more in 2014.

What’s truly astounding is to how few of them are still around. Of the class of 2013, only Dynagas LNG Partners (NSDQ: DLNG) and Phillips 66 Partners LP (NYSE: PSXP) are still around in their current form. Phillips has returned roughly 12 percent a year including distributions. Dynagas on the other hand has lost more than 90 percent of its value and eliminated its distribution last month. That group also included a trio of bankruptcies.

Of the 8 we highlighted as “Forthcoming MLP IPOs” in late July 2014, only three are still around. General partners reabsorbed the rest at a cost below IPO prices, some well below. And the same was true for the group of 7 that went public in the first half of 2014.

We’re happy to say we were able to warn investors away from the majority of the new IPOs, either immediately or within the first year. But the larger point is the big investment houses saw a golden opportunity to rake in a bonanza in fees. They pushed as hard as they could for US energy companies create their own MLPs. And when they ran out of targets they packaged assets together on their own.

Now the big fee opportunity is to re-merge midstream energy assets back into general partners and sponsors. And the investment banks are at it again, this time trying to convince energy company management that MLPs are a bust as a model.

A good many of the simplification deals we’ve seen so far actually do make sense, mostly because the initial MLP IPOs did not as standalone companies. But the argument that all MLPs should be converted to corporations as soon as possible is as off base as the push to convert all energy assets to MLPs was earlier in the decade.

The primary factors driving down MLPs’ popularity now (1) Concerns that North American energy prices will weaken further this year and drive down production, (2) The perception they’re too complex for investors to get a fair shake and (3) The perception the 2018 tax cuts have eliminated their advantages.

What all three of these factors have in common is they weren’t concerns five years ago. And they could just as easily be irrelevant five years from now or more likely much sooner.

Energy prices will always be volatile. But as we’ve pointed out, the supply and demand balance in this ever-more globally connected market argues for oil and gas prices to remain in the current range for some time in North America. The best MLPs have already simplified by taking steps like eliminating IDR’s. And the worst run companies have no choice but to follow or else leave the field.
As for the impact of tax cuts, we’ve pointed out MLPs still retain considerable tax advantages for high-income investors even now. But it’s also worth remembering how much today’s lower rates depend on politics. And it’s not hard to imagine a new Washington consensus emerging in either 2021 or 2025 that tax rates should be much higher.

That would certainly send investors scrambling to find shelter. And it would almost certainly make a further narrowed field of MLPs suddenly popular again. No doubt we’d then see another 180 degree shift by the investment banks, accompanies by a new wave of IPOs for tax advantaged income producing vehicles.

In the meantime, the best MLPs and midstream companies will continue their conservatively funded asset expansion and distribution growth—building wealth for us as they wait for their strengths to once again be recognized by a fickle investment public, and move to share prices more in line with their real value.