Overview

It’s been a Dickens-like tale for Master Limited Partnerships, or MLPs. If we rewind the clock to the end of the third quarter of 2014, it was the best of times for over five years as the space had enjoyed seemingly uninterrupted and outsized gains. MLPs delivered returns well in excess of their yield component as they capitalized on the growth opportunities presented to them by the oil and gas supply boom. However, the pendulum has now swung in the other direction as MLP’s Gilded Age has been upended on the heels of a -23.4% year-over-year move for the asset class. What was then a five-year annualized return (through September 30, 2014) of +22.7% has been hollowed out and now stands at +8.5% through July 20, 2015. The precipitous decline in crude oil and natural gas has been exacting and MLPs now squarely reside in textbook correction territory. This correction has bred anxiety and confusion, as the space has long been marketed as a “toll taker” that should be rather impervious to moves in the spot pricing of oil and gas. Was that a false narrative? That’s a fair question given MLP’s increasing sensitivity to oil and gas prices. MLPs are a widely held position across Abbot Downing and given the gravity of the drawdown, we wanted to proactively share our findings on what, if anything, has changed and how we suggest moving forward.

Market Introspection

Technical

There is little doubt that MLPs have been subject to some technical damage this year. Why? MLPs are active in the capital markets and issue equity on a recurring basis, and by their very nature have very little in retained earnings. This has a dilutive effect unless absorbed by investors.²³ We don’t have perfect visibility on fund flows, but, as best we can tell, they have been positive for the duration of 2015. Yet, the rate of change has been negative and sits at roughly one-third of 2014 levels. While it appears capitulation has not set in, this rate of change in flows has proven pivotal and helped to exacerbate price movements. MLPs, perhaps more so than other asset classes, need strong investor flows or share prices come under pressure due to the laws of supply and demand.

The typical MLP balance sheet is roughly half debt and half equity, but it seems like MLPs have at some level attempted to rein in the dilutive and self-feeding impact equity issuance can have on the broader asset class. Debt has been the preferred currency as compared to equity. Yet, this at best is an incremental positive, and the overall technical story won’t change until fund flows alter their trajectory. Yet, with energy infrastructure assets at more favorable valuations, that may have been set into motion already with a masterful deal maker leading the way. Richard Kinder, of Kinder Morgan fame, purchased $3.5 million of Kinder stock this week.⁴⁵ More value investors will need to follow to help the space find a price floor, which has proven rather elusive.

Lastly, justly or unjustly, MLPs have been trading more closely to the pricing of oil and gas. There has been an overpowering negative sentiment hovering over oil and gas due to a few factors, such as the potential impact of Iran re-entering the energy market. This dynamic may elicit more odd behavior for the MLP space. They are, after all, a risk asset—caveat emptor.

Fundamentals

Yields alone don’t dictate the script for MLP performance. In many respects, the lifeblood for returns is their distribution growth. How they achieve this depends on the respective business model of the MLP, but infrastructure build-out is an overarching theme. In simple terms, more pipelines or rigs create more throughput and revenue, which ultimately drives distribution growth. Fortunately, there exists a substantial backlog of these projects. However, the plunge in oil and gas pricing has recast them with more uncertainty. We don’t expect a large swath of cancellations, but there is a higher risk they will be delayed, as the economics of these capital intensive initiatives have been diminished. Margins just aren’t what they were after the correction in oil and gas and any delays will have the effect of diluting MLP economics and a corresponding reduction in their respective distribution growth.

The largest constituents of the MLP space are the natural gas and petroleum transportation sectors at 68% of the Alerian index. These are the “toll takers”
that have their fortunes based more on commodity demand as compared to spot pricing. But there is more to the story. In particular, there is a bevy of more commodity price sensitive names in the index and their economics have been rattled. This year there have been six or seven MLPs that have cut their distribution, including a coal MLP in late July, which sends their respective price plummeting (see Exhibit A).

Exhibit A: Boardwalk Pipeline Partners

The fundamental story does have its share of positives. In particular, the price-demand continuum for commodities suggests more aggregate consumption for oil and gas will be an outcome of lower prices. This should help distribution growth and recent demand numbers already reflect this changing dynamic. Further, there is the strong likelihood that the United States will start exporting natural gas in the near future. Not to mention, there is a rather benign credit environment and MLP-specific legislative risk seems to be muted. All this bodes well for the space, but may take time to be appreciated by investors.

Conclusion

In December 2014, after MLPs had experienced the brunt of the oil and gas price declines, Abbot Downing had published a memo with a stance of “hold/incremental buy.” We had our concerns, such as shrinking distribution coverage ratios for E&P names and a negative spillover effect. Yet, the position was ultimately probabilistic in nature as the odds of another substantial decline seemed limited as MLPs lost -12.4% in the fourth quarter. Not to mention, the yield alone seemed magnetic and a sufficient enough return when compared to the prospects of other richly priced asset classes. That train of thought has been proven incorrect, at least temporarily, and we need to take accountability. Yet, as Keynes once said, “When my information changes, I alter my conclusions. What do you do, sir?” The basis for our call has not materially changed, but MLP valuations certainly have. As such, it would be hard for us to do anything but reaffirm our prior stance.

One parting note is that this correction may present tax loss harvesting opportunities, and perhaps ones with little execution risk. The approved MLP ETNs (tickers AMU and MLPI) are fairly interchangeable and any variance in returns will be limited during the wash sale period. A sensitivity to consider is the difference in x-dates (AMU was May 27, 2015, and MLPI was July 10, 2015) as yields now are in excess of 6% and too valuable to needlessly forego.
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