

MASTER LIMITED PARTNERSHIPS

Introduction and Overview

It is not wrong that the village schoolmaster, or the country minister, or the dressmaker with her scanty earnings, wishes to have a share in the fabulous wealth which modern society is accumulating. They rightly think "it would be fine" if their bit of investment in the wonderful mine [or railroad] described in their denominational journal turns out as successfully as they hope. What they do not see is that they have no business to hope for this success; they do not know enough . . . (T)hese innocent people – a great host of them – are daily matching their ignorance against the loaded dice of those whom their credulity tempts to make a business of floating all kinds of plausible and worthless enterprises . . . We only make fools of ourselves in expecting great dividends, where we have not the least knowledge of the conditions of business.

– Charles F. Dole (1907)

It was the best of times and it was the worst of times for capitalism as railroads stitched their way across the North American continent in the late 19th and early 20th centuries. The businesses associated with this daunting enterprise provided jobs, enabled commerce, and returned a profit to many who had invested in them. On the other hand, as Charles Dole observed above in an article that appeared in *The Atlantic Monthly* titled “The Ethics of Speculation,” not all businesses – and not all businessmen – were created equal. Many ventures of that era lined the pockets of their creators at the expense of the average investor. As Dole eloquently pointed out (too late for most), the asymmetry of knowledge all but guaranteed an asymmetry of financial outcome for those who became involved in the more unscrupulous schemes. The lesson of history suggests that the words *caveat emptor* be taken seriously.

The railroads, of course, are long since built. But there is an industrial/commercial build-out going on today that bears some resemblance to that of the earlier era: the development of North American energy resources and related infrastructure.

Oil and gas (in all their many forms) are now being found in abundant supply thanks to modern retrieval technologies like multi-stage hydraulic fracturing (“fracking”), deep sea drilling offshore, and horizontal drilling on dry land. In the United States and Canada, potentially vast deposits are now being squeezed from shale, tar sands, and other geological strata previously considered inaccessible, not economically viable, or both.

But as in building a network of railroads, unearthing nature's riches comes at a cost. Today's large corporate energy extractors need infrastructure: sophisticated drilling equipment, transmission pipelines, access to refineries, and much, much more. And like the bygone railroad days, an enormous business structure has developed to build and sustain this enterprise – some with more scrupulous leaders than others.

One financial structure in particular has become very attractive to the modern-day village schoolmaster or dressmaker seeking “yield” in today's zero-interest-rate environment: the Master Limited Partnership, or MLP. There are now more than 100 energy-related MLPs in existence in the United States, with a total market capitalization of more than \$450 billion.

MLPs are publicly traded on securities exchanges and have recently become even more widely available to retail investors through ETFs and mutual funds. By federal law, MLPs are limited to enterprises that engage in certain businesses – primarily the extraction and transportation of natural resources like petroleum and natural gas.

In practice, MLPs pay their investors through regular distributions. Because the rate of those distributions is often more than triple what one would today expect from “safe harbor” alternatives like CDs, bank account interest, or even most short-term bonds, MLPs have grown rapidly in popularity. To emphasize that point, consider that as recently as 2000 there were only 18 energy-related MLPs in existence with a total market capitalization of just \$16 billion!

Investors typically think of their quarterly MLP distributions in much the same way they might think of stock dividends. No doubt there are capable and shareholder-friendly (technically, “unitholder”-friendly) MLPs in today's energy market. But in any “new investment idea” mania – whether a transcontinental railroad, a Klondike goldmine, or a North Dakota natural gas MLP – unsavory players inevitably emerge who present an attractive package of “dependable” returns, but stack the deck strongly in favor of those who organize and run the enterprise. Among those schemes, some of which exhibit Ponzi-like attributes and egregious conflicts of interest, there is a greater than normal likelihood of catastrophic collapse if adverse conditions arise.

As committed value investors, we at Martin Capital Management are always looking to buy businesses that are selling at prices far less than our analysis indicates they are actually worth. In that same process, however, we also come across businesses that are selling at far *higher* prices than they are actually worth. Typically, this disqualifies the business from further investment consideration. In times like the present, though, when we feel undervalued opportunities are in short supply, the enterprising investor can turn the value proposition on its head. We don't sell short, but we do access instruments that allow us to make small bets (with known and finite downside) that have the potential for asymmetrical payoffs. While carefully managing risk, an investor can profit from an *overvalued* asset that becomes fairly valued.

This is part of what Nassim Taleb has described as a “barbell” approach to building an “antifragile” investment portfolio. (For a more thorough discussion of this topic, see pages 21-23 of the 2013 MCM Annual Report). It's what we have described over the years as “winning by not losing”: First

protecting the bulk of one's capital in what we view as an overpriced equities environment on one side of the barbell, then committing a comparatively small portion of the portfolio to derivatives that profit asymmetrically if overvalued assets (like MLPs) regress to their mean valuations.

The following research paper examines MLPs from top to bottom and presents both the potential benefits and potential pitfalls that await investors. The study may indeed be viewed as one way for disciplined value investors to gain from their research acumen in a generally "value-unfriendly" market environment.

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The ABCs of MLPs

Master Limited Partnerships, more commonly known as MLPs, have been utilized since the 1980s. They operate under partnership tax law and typically trade on public exchanges. Legislation restricts the use of the structure to partnerships that generate at least 90% of their income from “qualifying” sources, primarily from energy-related activities.

As a partnership, an MLP pays no entity-level taxes and distributes “all available cash,” (generally operating cash flow adjusted for capital spending required to maintain the business) to its owners, called “unitholders.” This eliminates the double taxation unitholders would experience if the same assets were held in a corporate structure. It also reduces the entity’s cost of capital.

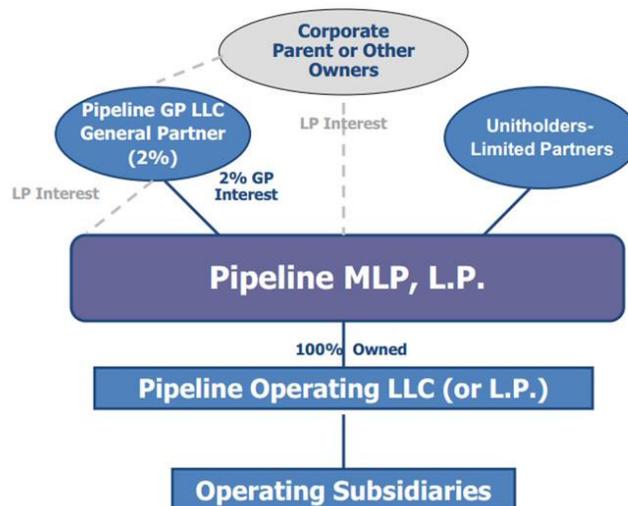
In addition to removing a layer of taxes, MLPs enable unitholders to defer paying taxes on most, typically 80%, of the distributions they receive. Only the portion of distributions attributed to reported income is taxable to unitholders as current income. Distributions exceeding the amount of reported income are considered a return of capital, reducing the cost basis and deferring taxation until the time of sale.

The tax advantages and focus on cash distributions attract yield-oriented investors and result in MLPs being valued on yield – specifically on distribution yield, which is analogous to a common stock’s dividend yield. Retail investors, in particular, have become enamored of MLPs. They account for about 65% of MLP ownership, by far the largest single group. As MLPs have become more popular and experienced an increase in trading volumes, institutional ownership (mutual funds, hedge funds, pensions, etc.) has grown and stands at roughly 30% today.

To understand the general organizational structure, it’s necessary to first know the various stakeholders in an MLP:

- The “sponsor,” or parent, is the entity that forms or creates the MLP.
- A general partner (GP) operates and manages the MLP’s assets.
- Limited partners (LP), also known as “unitholders,” simply provide capital.

These roles are not necessarily mutually exclusive. The sponsor, for example, frequently acts as the GP as well. Sponsors typically place certain assets (pipelines or oil drilling equipment, for example) in an MLP and then sell shares/units to investors



Source: © 2013 National Association of Publicly Traded Partnerships

through an initial public offering (IPO). The GP usually owns a 2% minority stake, essentially all the voting rights, and Incentive Distribution Rights (IDRs). IDRs warrant the GP to receive an incrementally larger share of the distributions paid to unitholders as the distribution grows. It is common for IDRs to split distributions 50/50 between the LP and GP at the highest level of the distribution schedule (or “tier”), a condition known as “high splits.”

In exchange for a claim on future distributions with preferential tax treatment, LPs provide capital, accept few (if any) voting rights, and participate in any growth at a diminishing rate over time. The sponsor, through the GP, is able to monetize assets and still retain effective control over them. They also receive distributions from the assets in an amount disproportionate to the 2% GP ownership interest as distributions grow.

As one digs deeper in the basic MLP structure, extraordinary conflicts of interest become apparent, as do attendant risks associated with the underlying businesses and capital markets. Investors are therefore well advised to develop a discriminating eye toward MLPs in light of all these factors. Certainly there are well-run MLPs... but not all MLPs are created equal. The age-old words of wisdom apply: “Let the buyer beware.” The following sections present a number of potential risks of which prospective MLP buyers (investors) should be aware:

1. Conflicts of Interest
2. Imbalance of Power
3. Accounting Practices
4. Reliance on Capital Markets
5. Valuation
6. Commodity Prices

Conflicts of Interest

“History shows that where ethics and economics come in conflict, victory is always with economics. Vested interests have never been known to have willingly divested themselves unless there was sufficient force to compel them.”

- B. R. Ambedkar

Fiduciary Duty

If one reads the risk disclosures in MLP prospectuses, conflicts of interest between the general partners (GP) and limited partners (LP) are nearly always listed first, yet most investors seem to gloss over this fundamental risk. The GP has fiduciary duty first and foremost to its own shareholders, not to the LPs. Because the GP has almost complete control of the MLP (more on balance of power later) in any decision making process, the GP can maximize its own benefits ahead of or even to the detriment of the LP. One might even observe that the natural state of conflicting interests between the GP and LP results in an ongoing risk that can be heightened at times.

Incentive Distribution Rights (IDRs) – Skewed Exposure to the Upside

Stock options and other forms of incentive compensation plans are frequent targets of criticism and complaint among corporate shareholders. They routinely attract media attention because of the absolute level of compensation received, and from investors seeking to understand whether their interests are aligned with those of the company's managers. Such scrutiny provides a way of getting a glimpse into management's true motives and incentives. IDRs are, in many ways, similar to corporate compensation plans; and yet many investors (let alone the media) disregard the even more egregious imbalances IDRs can make possible in the MLP structure.

According to proponents of MLPs, IDRs were created ostensibly to align the interests of the GP and LP by giving the GP some 'skin in the game.' IDRs give the GP the right to an increasing share of distributions as they grow. In our view, however, IDRs go beyond their original intention. They have exacerbated the conflict of interest problem by giving the GP the lion's share of upside potential without commensurate downside exposure.

Enticed by an increasing share of the pie, the GP is thus incentivized to raise distributions when possible. To do so, the GP must grow cash flows, either organically or through acquisitions. The GP may also access capital markets to fund distributions, though that seems far more volatile and likely unsustainable. Any owner of a business must weigh the potential risks, or downside, of a business transaction against the potential gains, or upside. Shareholders in a business typically share proportionately in the downside and upside, and thus their interests are aligned in both direction and magnitude. For general partners in an MLP structure, however, the calculation of risk versus reward is very different than for limited partners.

A general partner commonly owns a 2% stake in an MLP it manages. In a static scenario (i.e., one in which the distribution is not growing), the GP receives 2% of distributions, equal to its ownership stake. At worst, the GP's 2% stake could become worthless. On the other hand, IDRs allow the GP to take home an increasing share of incremental distributions, while LPs receive a declining share. An MLP said to be in "high splits" typically pays 50% of its incremental distributions to the GP. To illustrate how large a GP's share can grow, Kinder Morgan Energy Partners (KMP), which is well into the high splits, pays close to 45% of its *total* distributions to its GP.

Many sponsors, who frequently own the GP, ameliorate this imbalance by retaining a stake in the LP units to better align their interests with other LPs. The catch, however, is that the sponsor often obtains the position (or stake) at book value in exchange for the assets they initially "dropdown," or contribute, to the MLP. The buyers, the LPs, often pay a premium relative to book value because they are focused on distributions. By supplying the assets held by the MLP, the sponsor receives cash and/or units in return. In cases where the sponsor receives cash for a significant portion of the assets, it is possible for them to recoup a large portion of their cost and still retain effective control of the MLP through its GP interest. At that point, the cost of the units, or the real downside, is lower for the sponsor than for the other LPs. In the parlance of Las Vegas, behavior can change dramatically when gamblers play with "house money."

Furthermore, the way IDRs are calculated makes it possible for actions to be taken that are accretive to the GP but not necessarily to existing LPs. Distributions paid to the GP are based on the distribution per LP unit. So, for example, if the MLP simply issues shares, the GP is due a greater absolute amount of distributions. If the capital raised is used to make an acquisition, any growth in cash flows and distributions will be diluted somewhat for LPs. The GP, on the other hand, is able to increase its distribution per share. While this seems unfair to LP unitholders, the GP is simply acting within its rights under partnership law. LP unitholders may not notice because they continue to receive the same distribution on a per unit basis, but in reality their experience can be quite different from that of the GP. The simplified example below shows the inequality possible:

	<u>Current</u>	<u>Incremental Effect of Issuance*</u>	<u>Pro-forma</u>	<u>% Change</u>
Available Cash Flow	\$500	\$50	\$550	
Distribution to LPs	\$300		\$330	
LP Units	100	10	110	
LP Distribution per LP unit	\$3.00		\$3.00	0%
Distribution to GP	\$200		\$220	
GP Units	75		75	
GP Distribution per GP unit	\$2.67		\$2.93	10%

*Issuance assumes a current distribution yield of 6% and a 10% cash return on new capital.
Source: Martin Capital Management, LLC

This problem doesn't stop with issuing equity. In some situations, acquisitions are outright dilutive for existing LPs but accretive for the GP. Incentives are clearly not aligned in these scenarios. Even without the potential mismatch of an acquisition being accretive for one party but dilutive for another, the sponsor, through the GP, may have much more to gain and less to lose than the LP when faced with a risky business decision. An acquisition that carries a potentially large upside now but an equally large downside in the future may be attractive when, for example, you can take home 70% of the gains but suffer only 30% of the losses. The opposite view of that deal – little upside now but a potentially large downside later - doesn't quite have the same appeal! The GP may therefore be inclined to make risky decisions that are not in the LP's best long-term interests or necessarily fair to all parties involved.

Asset Dropdowns

Because of the relationship between GP and LP, there are ample opportunities where conflicts of interest could come into play. One is asset dropdowns.

A GP “drops down,” or sells, cash-generating assets to the MLP – usually with the intention of growing the MLP's asset base and/or distributions. These dropdowns are generally explained by management teams to be mutually beneficial to all parties:

- To the GP, the assets often achieve a premium valuation under the tax-advantageous partnership structure while the MLP's increasing cash flows disproportionately accrue to the general partner based on the IDRs;
- To the MLP, asset dropdowns are an important sign of support from the GP and a potential source of additional assets to steadily grow distributions.

However, GP dropdowns create a scenario in which both the buyer and seller of the asset are effectively one and the same: The management of the GP and the board of the LP – generally comprised of the same people – end up sitting on both sides of the transaction table. In other words, they are transactions not completed at arm's length – often a red light to an investor. Yet curiously, few people question the process by which valuations are determined. Keeping in mind the conflicts of interest inherent between the GP and LP, one may logically question whether a fair exchange occurs here. In these transactions, as opposed to those typically carried out at arm's length between unrelated buyers and sellers, one side stands a greater likelihood of getting the short end of the stick.

Competition and Connected Transactions Between the GP and LP (...and LP and LP)

It should come as no surprise that many GPs operate in the same lines of business as the MLPs, and thus they may potentially compete against one another. Although there are usually non-competitive agreements in some form, they tend to be limited in scope. This means that the MLP may face competition from the GP in attractive opportunities, such as the acquisitions of assets.

Alternatively, the GP may also decide to dropdown attractive assets to third party competitors instead of the MLP. In all cases, because the GP has a primary fiduciary duty to its owners, it likely will put those interests ahead of the LP's.

The situation becomes even murkier when a GP owns interests in multiple MLPs. One example is Energy Transfer Equity (ETE), the GP of both Regency Energy Partners (RGP) and Energy Transfer Partners (ETP), the latter of which is also GP of Sunoco Logistic Partners (SXL). Aside from competition, these entities may also have other connected transactions, such as service agreements and cost reimbursements. With such entangled relationships, the possibilities for conflicts of interest become mind boggling indeed.

Imbalance of Power

“Power corrupts, and absolute power corrupts absolutely”

- Lord John Dalberg-Acton

Lack of Voting Rights

Shareholder rights and corporate governance receive quite a bit of attention from investors, and rightfully so. In that light, however, it seems bizarre that the nearly complete lack of limited partner voting rights are generally taken for granted in MLP structures. Unlike shareholders of common

stocks, LP owners are severely restricted in voting and are not entitled to elect the MLP board of directors. They also have only limited ability to remove the GP. This means they have no recourse, as they would in any other corporate form, when the GP makes decisions that harm the LPs.

The lack of voting rights is problematic because it likely emboldens, rather than discourages, decisions to be made despite conflicts of interest that may be present between the GP and LP. Unlike shareholders who can exercise their voting rights, or bondholders who are protected by bond indentures in case of a default, LP owners are almost powerless to seek redress if they suffer losses because of the mismanagement by the GP. To look at this another way: What might a GP do when it can do almost anything it desires with only limited consequences?

Call Rights

Some MLPs carry a provision that gives the GP a limited “call right.” This is more or less a foreign concept to most of corporate America. Essentially the GP can take the MLP private by requiring LPs to sell their units, even at an undesirable time or price. This right, but not obligation, can be exercised at the GP’s discretion when it owns a significant majority – although technically the GP can also issue additional LP units so it can reach the threshold. There is no requirement that the price be fair, other than that it is not lower than the then-current market price. As a result, LPs may be forced to sell their units at severely depressed prices. To add insult to injury, the LPs may also be hit with a tax liability upon the sale.

Accounting Practices

Regardless of the asset being considered, investors typically focus on yield in some form or fashion: earnings yield, current yield, distribution or dividend yield, etc. In so doing, however, they are actually looking at cash flow whether they recognize it or not – because yield comes from dividing cash flow by the price paid. Accepting the quoted yield of an offering can thus pose significant danger if an investor doesn’t carefully review the underlying accounting components. Cash flows (and thus yields) may appear attractive when they are not, in fact, sustainable.

The best way to avoid this danger is to concentrate on the metric that most accurately reflects the economic reality of an asset. Equity analysts, for example, focus on earnings as a measure of a company’s profitability. Earnings are based on an accrual method of accounting and are subject to generally accepted accounting principles (GAAP). Analysts use these earnings calculations as a rough proxy for free cash flow.

Over time, accrual based earnings and cash flow should tell similar stories about a company’s financial performance and well-being. Any material divergence between cash flow and earnings should prompt an investor to “look through” the reported earnings to reconcile the difference. There may be a perfectly good explanation, or the discrepancy may prove to be a warning sign of aggressive accounting tactics or even outright manipulation.

In the case of MLPs, investors focus on distributable cash flow (or DCF – see basic calculation below), a figure not bound by generally accepted accounting principles, because earnings do not act as a reasonable proxy for cash flow as they do for most corporations. Taxable income often may represent only 20% of the cash flow available to unitholders. Part of the reason is the difference between depreciation expense and the amount spent to maintain the business (“maintenance capex”), which we discuss further below. Some is also a result of MLPs generally being required to pay out all available cash to unitholders as specified in their partnership agreements. The divergence is buoyed by the GP’s motivation to increase the distribution relative to taxable income. The greater the distribution relative to taxable income, the more the distribution is tax deferred. As a result, MLP investors do not pay much attention, if any at all, to reported earnings based on generally accepted accounting principles. They focus instead on distributable cash flow, a non-GAAP figure, which gives management greater leeway to change accounting definitions and use estimates of questionable origin.

Taxable Income
+ Depreciation and Amortization
Operating Cash Flow
- Maintenance Expenditures
Available Cash Flow
- GP Distribution
Distributable Cash Flow

It is no secret that management teams have a certain amount of discretion in determining many non-GAAP (and sometimes even GAAP) numbers, which introduces the possibility of using this discretion to serve management’s own agenda. While GAAP accounting has its flaws, it remains the conventional frame of reference when comparing companies and determining valuations. This is evident in the prevalent use of ratios such as P/E, P/B, or EPS among lay investors. MLPs are rare in that investors have a near total disregard for GAAP metrics, which invites greater risk of various massaging/maneuvering accounting techniques by management. Additionally, because investors don’t have a proxy like GAAP to use as a check, they are heavily reliant on the honesty of management.

The fact that management has the flexibility to change the definition of DCF or manipulate its components has an immediate and direct implication: GPs are able to influence, if not control to an extent, the distributions they receive. This point is especially salient for MLPs in high splits: For every extra \$100 million of (in this case, inflated) DCF, \$50 million goes into the GP’s pockets.

The incentives that drive MLPs to “manage” their DCF may be similar to companies that “manage” earnings – to meet goals and targets, to drive up the share price, to cover mistakes – but there is one crucial difference: Non-MLP companies are priced on a variety of inputs; MLPs are priced almost solely on yield. Thus, a 50% drop in GAAP net income or non-GAAP EBITDA for one quarter is unlikely to produce a commensurate decline in a stock’s price, but a 50% drop in DCF typically *does* lead to a commensurate decline in an MLP’s unit price. The pressure for an MLP to maintain a stable and growing DCF is much more intense than that of a normal company to maintain steady earnings. When an unexpected shock threatens to cut DCF, MLPs may have a strong incentive to maintain the appearance of a stable DCF to support cash distributions, despite deteriorating fundamentals. In the end, however, one cannot fudge a cash distribution, and when the cash runs

out (often sooner than expected) the truth ultimately emerges. For those interested in seeing what can happen when an MLP does cut its distribution, see the example of Boardwalk Pipeline Partners in the Commodity Prices section beginning on page 15.

For the technically inclined, some examples of dubious accounting practices to inflate DCF include:

- 1) Changing the DCF methodology
- 2) Understating maintenance capex
- 3) Improperly accounting for hedging income and costs
- 4) Excluding non-cash and non-recurrent expenses

Changing the DCF Methodology

Because DCF is a non-GAAP metric, management has discretion as to how it is defined. Red flags should go up when the definition is inconsistent or changed suddenly. Various components of DCF can be tweaked to support the desired level of cash distribution.

Understating Maintenance Capital Expenditures (Capex)

When calculating DCF, only “maintenance” capex – not “growth” capex – is deducted. Maintenance capex is a non-GAAP metric whose definition is entirely up to management’s discretion. Very few MLPs provide a definition of what exactly constitutes maintenance capex, often loosely interpreting it as the remainder after growth capex. If “maintenance” is the intent, then what is it meant to maintain? Revenues? Profit? Capacity? Throughput? Needless to say, this gives management a lot of leeway to determine the level of maintenance capex, and thus DCF.

Understating maintenance capex allows the company to inflate DCF, and thus distribute more cash than it could reasonably sustain. The gap is filled by cash raised from leverage or new equity issues. In other words, new capital is used not in investments that would grow distributions, but used to support distributions to existing unitholders, including the GP.

Improperly Accounting for Hedging Income and Costs

MLPs with exposure to commodity prices often use derivative instruments to hedge their exposure. These hedges may result in profits or losses depending on commodity price movements. It is up to management to determine whether such hedging activity counts as operating income. Certainly, when such hedges result in profits, inclusion will result in a more favorable DCF and thus higher distributions.

A problem arises if management includes profits from hedging activities in DCF, but excludes part or all of the corresponding hedging costs – an allegation, for example, that some have made against

LINN Energy (LINE).¹ The result may be an inflated DCF that does not reflect the actual economics of the hedging activity, leading the MLP to pay out more cash than may be sustainable.

Excluding Non-Cash or Non-Recurrent Expenses

While some non-cash and non-recurrent expenses can be legitimately excluded from DCF, some of these exclusions can produce consequences that may not be obvious at first glance. Non-cash expenses such as stock-based compensation or non-cash interest are real economic expenses that have a direct impact on the future cash distribution per share. And frequent non-recurrent expenses can be a consistent drain on cash despite being excluded from DCF. While excluding such expenses may be standard practice in calculating EBITDA, the implications are different for DCF, as cash needed to sustain operations is being distributed.

Reliance on Capital Markets

A House of Cards: All Cash Flow Paid Out; No Retained Earnings

MLPs typically pay out all “available cash” in the form of distributions to unitholders. Generally speaking, available cash is operating cash flow adjusted for capital spending required to maintain the business. The coverage ratio, i.e., the ratio of available cash to distributions paid, of midstream MLPs is just over 1.09x. This means for every dollar paid in distributions, there is a little more than one dollar of available cash to make the distribution. Contrast this with the more familiar dividend payout ratio – the ratio of dividends paid to reported earnings, typically associated with corporations. The aggregate payout ratio of S&P 500 companies is a bit over 32%. For MLPs, the comparable metric to the dividend payout ratio is the inverse of the coverage ratio. On that basis, one can see MLPs on average pay out nearly 92% of their cash flow in distributions. That leaves little room for error or declining profitability if the distribution is to be supported from operations.

Growth Dependent on Outside Sources

For MLPs and investors not looking for or expecting growth, access to capital markets isn't as big an issue as it is for those looking to grow. After all, the capital needed to maintain the business is *presumably* covered by internally generated cash flows. Those expecting an MLP to deliver yield *and* growth should carefully consider that very little (in some cases, barely any at all) of the cash flows are retained in the business. It means any capital spent to grow the business must come from external sources. Funding growth externally creates the risk that some entities will irresponsibly lever up the balance sheet or egregiously dilute existing unitholders. The irresponsible use of debt presents a host of other risks, such as restrictive financial covenants, financial leverage, etc. However, these risks are company specific and not unique to MLPs.

¹ See John Hempton of Bronte Capital: <http://brontecapital.blogspot.hk/2013/02/linn-energys-queen-gertrude-moment.html>. LINE circulated this press release in response to criticism of the company's hedging strategy: <http://www.sec.gov/Archives/edgar/data/1326428/000119312513062952/d488357dex991.htm>.

The deeper and more relevant concern is that without sacrificing the distribution, the ability to make accretive capital investments is largely dependent on others – a risky position that most competitive, strategic-thinking entities would rather not be in.

On an aggregate basis, MLPs have historically taken a balanced approach to raising external capital, raising roughly the same amount of debt as equity. Using debt and equity in equal proportion is not in and of itself cause for great concern if the underlying assets generate ample returns. In fact, the amount of leverage, as measured by debt to equity, in the capital structure of MLPs as a whole is comparable to companies found in the S&P 500. But considering S&P 500 companies are retaining equity in the business as mentioned above, MLPs carry relatively more risk because their growth is so dependent on external sources. And that presents the more far-reaching risk: Should the capital markets largely dry up or become more expensive to access, the sources and rates of MLP distribution growth could be greatly reduced.

Recent Example of the Effects of Relying on Capital Markets

2008 and 2009 provide an example of challenging capital markets. Investment-grade MLPs were able to access capital markets, but the cost to do so became more expensive. The average rate on debt issued increased more than 300bps during the course of 2008. At the other end of the spectrum, non-investment grade MLPs did not issue any credit market debt from the middle of 2008 through 2009. While weak commodity prices were certainly a factor as well, the higher cost of capital had a significant impact on the number of debt offerings and distribution growth. Sectors within the MLP space were affected differently, and roughly a quarter of all MLPs cut distributions. It is also telling, however, that the median distribution growth rate in 2007 was nearly 12% – but less than 4% in 2009.

As the cost of capital rises, especially debt, greater cash flows are required to service it. That reduces the amount of cash flow available to fund distributions. Beyond that, the cost of capital also affects capital decision making. 2008 saw MLP acquisition spending fall 65% and an additional 20% in 2009. MLPs covered by Wells Fargo reduced the amount spent on capital investments by 30% in 2009. Some acknowledgement is warranted that the uncertainty during those years reduced the willingness of companies to make capital investments. In the long run, however, lower return capital projects that can be justified when interest rates are low will be increasingly uneconomical if rates rise. That reduces the number of growth opportunities, all other factors remaining equal.

Because MLPs essentially pay out all available cash and do not retain earnings, the capital markets certainly affect the fundamental drivers of MLPs (i.e., cost of financing capital projects, cost of capital, and ultimately distribution growth). The more the growth of a given MLP is dependent on outside sources of capital, the more its growth becomes susceptible to decline or even collapse. Combining cyclical assets with leverage and the presumption of stable growth is a risky proposition, in our view. And this matters to the prices of MLPs. As Ben Graham famously said, “Price is what you pay; value is what you get.” If investors pay (up) for MLPs presuming steady and growing

distributions, and then realize the ability to grow has been reduced, the price of the MLP is likely to respond in a manner reflective of the reduced growth opportunities.

Valuation

It Makes Us Wonder...

Valuation is a frequently touted benefit of the MLP structure, at least from the GP's perspective. Assets within an MLP usually receive higher valuations than if they were to operate within a C-Corporation. MLPs with C-Corporation sponsors trade at an estimated median 2014 enterprise value-to-adjusted EBITDA multiple of 15.7x, versus 5.5x for the associated C-Corporation.²

Why such a significant difference in valuation? Some of the higher valuation is associated with the tax benefits and resulting higher cash flows MLP unitholders receive. Some is likely associated with the market appreciating the assets to be more stable than others that may remain in the C-Corp. Those may be valid reasons for relatively higher multiples, but we doubt they are entirely warranted for those reasons alone. The nature of the assets didn't change; the assets are still capital intensive and they produce rather low returns. The only thing that really changed is they are now held in an MLP instead of a C-Corp structure.

So why transfer assets from a C-Corp to an MLP? One MLP industry primer,³ authored by investment consulting firm NEPC, put it this way: "The parent C-Corp benefits from the sale of monetizing lower returning midstream assets to reinvest in higher returning projects." Think about what that one sentence implies: These assets are, at least in regard to midstream MLPs, monetized at relatively high valuation multiples *for the benefit of the sponsor*.

Inverting, what does that mean for the buyers, MLP unitholders? Are MLPs beneficial to both the GP and LP, or is the arrangement a zero-sum game? Are the MLP unitholders beneficiaries, or is the sponsor benefiting at LP investors' expense?

Priced for Yield, Not Assets: Cause for Concern?

Investors' focus on the distribution yield and the large difference between distributions and earnings results in MLPs appearing expensive on traditional earnings-based valuation metrics. The question that should be on the mind of yield-seeking investors is whether the distribution is sustainable. Can the asset's earnings or internally generated cash flows support the distribution?

² Wells Fargo Securities, MLP Primer Fifth Edition, October 31, 2013, p. 22.

³ NEPC, Investing in Master Limited Partnerships..., September 2012, p.3.

Average:	<u>EV/EBIT</u>	<u>P/E</u>	<u>P/B*</u>	Dividend (Distribution) <u>Yld</u>	Income to Book Value (ROE)	FCF** to Book Value	Dividends (Distributions) to Book Value	Debt to Equity
Energy MLPs	39.8	43.6	4.3	6.8%	8.8%	-12.0%	29.2%	162.0%
S&P 500	19.9	27.8	4.4	1.8%	17.4%	21.6%	7.9%	108.8%

Source: Bloomberg, Martin Capital Management, LLC

*Arguably, IDRs are off-balance liabilities that result in overstated book values for MLPs.

**As measured by cash flow from operating activities less total capital expenditures.

Some investors look to high-dividend-paying stocks to build a high-yield portfolio. Some may view MLPs as just another form of a yield-producing asset, presuming distributions are just another, rather safe form of traditional investment income. But there is a difference between the two. Here are a few things to consider:

- Corporations typically don't pay out all their cash flow in the form of dividends. Dividend payout ratios for publicly-traded companies averaged around 50% of GAAP earnings until the share buyback wave rolled in after 2000. That percentage affords businesses some cushion for earnings to fall before having to consider cutting dividends.
- Many MLPs pay out *all* their cash flow in the form of distributions, leaving them little margin for error if their goal is to grow and maintain a steady distribution. As explained elsewhere and for a variety of reasons, cash flow is not a certainty.
- Distributions can be funded by external sources, further propping up the amount of distributions. To the extent these sources of capital become no longer available, it is likely some portion of the distribution could not be supported.

If a distribution proves unsustainable and is cut, what is the likely effect? It depends on the magnitude as well as the reason for the cut. A temporary reduction resulting from the ebb and flow of the business cycle or a short-term change in commodity prices probably wouldn't produce a dramatic price response or a change in investors' attitudes toward MLPs. Regardless, if investors are still willing to value the MLP based on yield, the price of the MLP must fall by the same percentage as the distribution (*ceteris paribus*) to maintain the existing nominal yield.

In other cases, a distribution cut may be an outward symptom – and perhaps a leading indicator – of a much more serious ailment. An inability to service debt, to maintain financial covenants, or to respond to changing business fundamentals may result in dramatic distribution cuts or a change in investors' attitudes toward MLPs.

It may mean investors begin valuing the company similar to how a C-Corp structure is valued – based on a level of cash flows it can produce from internal resources on a sustainable basis. If that were to occur, the table above shows MLPs to be quite expensive. If the cut is for reasons that cause investors to question the viability of future distributions altogether, their focus may turn from the return *on* capital to the return *of* capital, resulting in a significant reassessment of the value for a given MLP's units. In that event, book value seems like a logical floor to the MLP's price.

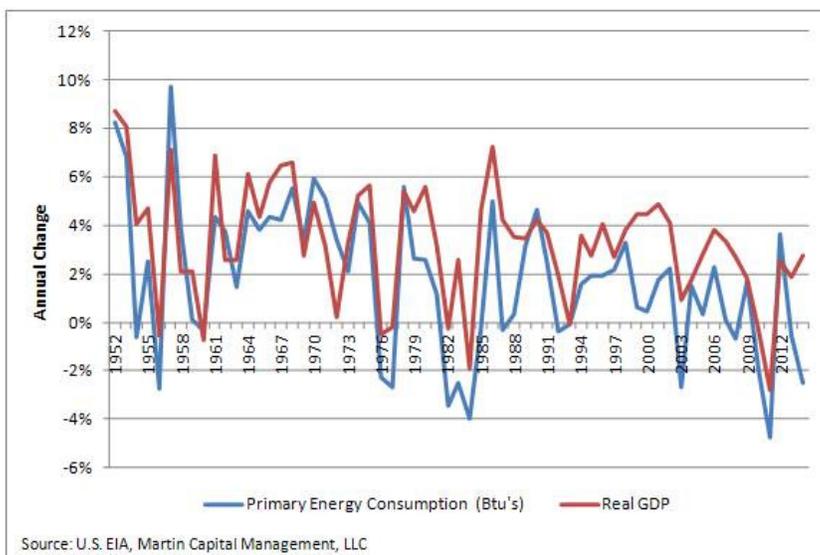
Furthermore, high yielding MLPs have become enormously attractive to retail investors suffering the financial repression of the Fed's low-interest-rate policy. As the old saying goes, what a wise man does in the beginning, the fool does in the end. Low interest rates and the popularity of MLPs, perhaps bolstered by the reported certainty regarding the future of our domestic energy landscape, have resulted in valuations that offer investors little to no margin of safety, in our opinion. Thus, distribution cuts that occur simultaneously with a change in investors' attitudes could result in investors fleeing, leaving significant price declines in their wake.

How can one know the difference between these wealth-threatening causes for distribution cuts and those that are more benign? That comes from studying and understanding the individual MLPs. Distribution cuts don't always portend big problems; but for MLPs operating close to the edge and in a highly leveraged manner, a cut may be followed by an outright collapse.

Commodity Prices

Commodities: The Uncertainty Principle

Oil and natural gas fuel many activities considered fundamental to modern life: travel, heating, cooking, and ubiquitous electronic gadgetry, to name a few. That leads to a seemingly stable demand for electricity, natural gas, and petroleum products. Energy consumption, however, does fluctuate with general economic activity. Such variability may be explained by recognizing that transportation accounts for 70% of our annual oil consumption and that roughly 65% of gas demand comes from power generation and industrial customers. As it relates to energy prices, an economic decline can lead to an increase in oil and gas inventories putting downward pressure on prices. Energy companies have varying degrees of exposure to declining prices, especially in the short run. In the event commodity prices remain low for an extended period of time, however, the impact would likely be more widespread. Lower prices could result in lower production and eventually lower volumes. That scenario would impact companies with exposure to commodity prices and those more sensitive to volumes alike. Companies can try to reduce this risk by increasing their operational and financial flexibility, and through hedging instruments to a degree. They cannot, however, control demand. Like many other businesses, energy companies are not immune to the effects of declining economic activity.



While demand may be outside an energy company's scope of control, supply is a variable over which companies can exert *some* control. They don't *have to* drill for oil and gas. That doesn't mean the supply side of the equation is simple or necessarily predictable. Geology, technology, and economics all play a part in the production and supply of energy. This results in differing resource estimates amongst experts and various opinions about the future and corresponding policy actions that should be taken today.

The EIA (U.S. Energy Information Administration) estimates there are 222.6 billion barrels of oil and 2,327 trillion cubic feet (tcf) of natural gas resources in the United States. At our country's current rate of consumption, those resources would last about 30 years and 100 years, respectively, holding all other factors constant. Of course, we do not live in a world where things remain the same. Furthermore, a little more than 10% of the resources are presented as "proved," meaning there is reasonable certainty they can be extracted given existing economic and operating conditions. The rest, about 90%, are considered "unproved," meaning they are available utilizing current technology, but no consideration has been given to the economic viability of extracting them.

These vast "unproved" resources present both great potential *and* great uncertainty. The EIA estimates we have close to 550 tcf of shale gas and 60 billion barrels of shale oil that could be produced with today's technology. These resources weren't considered technically recoverable as recently as 2006. The fact that they now are has generated great optimism regarding our country's energy outlook. Modern extraction systems like fracking and horizontal drilling (environmental concerns aside for the moment) are marvels of engineering. These technologies have created a spike in production and a corresponding reduction in energy prices. They have created both a technological and an economical way of tapping into what were once "unproved" resources, however that combination does not automatically mean that cheap energy abounds.

One uncertainty of "unproved" resources revolves around the fact that rates of production are not uniform from one well to the next, or from one "play" to another. Without great amounts of empirical evidence, geologists are left to make assumptions based on the experience of a few wells in an attempt to estimate what an entire play (or resource) is expected to produce over the long run. This methodology is obviously not perfect, and every estimate is prone to error. The EIA's 2012 estimate for the Marcellus shale gas play, for example, was revised downward to only one-third the prior estimate. The EIA's estimate for the entire country's shale gas resource was reduced by more than 40% that year as well. While such estimates provide a necessary basis for policy decision-making in the energy industry, one may legitimately question their accuracy.

Another uncertainty exists in the underlying economics of extracting and producing "unproved" resources. Producers look to generate economic returns for their shareholders, and economic theory would suggest they are only willing to produce oil and gas at prices high enough to justify the cost and earn satisfactory returns. Common practice is for producers to develop the "sweet spots" first. Many shale wells experience rapid declines in output, often leaving wells producing only 5-10% of what their initial production may have been by year five. Because the initial productivity of wells declines as producers drill outside the "sweet spots," it takes incremental wells and inputs to

maintain the level of output from existing wells. The need for greater and greater amounts of inputs to maintain a static level of output raises the cost of production, a condition adhering to what is known as the law of diminishing returns. To produce these resources and make it economical for producers, it is quite possible energy prices will need to rise. The caveat to higher prices could be the eventuality of renewable resources or other technological developments that further reduce the cost of energy. From our country's perspective, those would be positive outcomes.

There are a number of scenarios that could occur over a period of time that could cause energy prices to rise, production volumes to fall, or vice versa. If the resource base proved not to be as great as expected, that could impact volumes for many MLPs; however, the price impact could in some ways be influenced by the timing of such an occurrence and what technology may exist at that time. As explained later, it isn't even so much the supply and demand situation overall when one is considering an MLP but the various supply and demand curves pertaining to a specific company that are critical to its success. How all these factors play out, both on the demand side and the supply side, is uncertain. Commodity markets are cyclical and subject to change, and that's before considering world markets, geopolitics, and the influence of cartels like OPEC.

Drilling Down: Specific Company Considerations

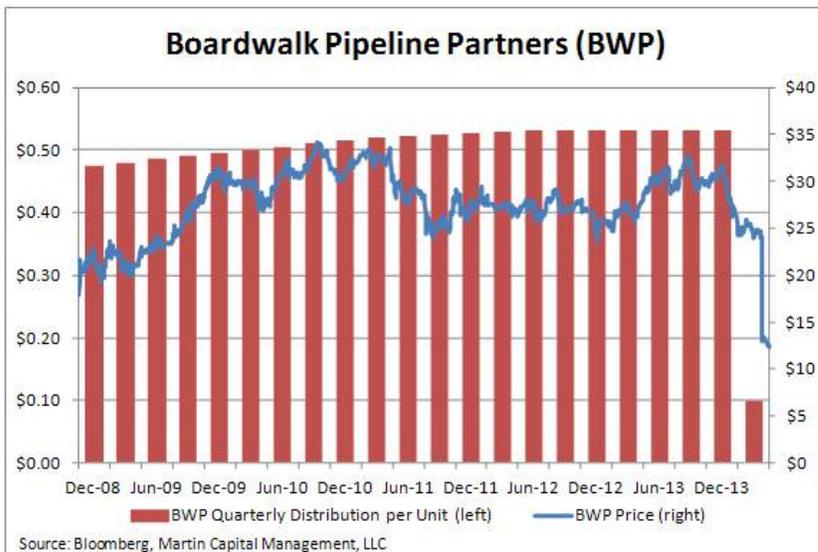
At the company level, direct commodity price exposure varies from one MLP to the next. Variation between companies can exist as a result of the business activities performed, the contractual arrangements under which an activity is carried out, hedging activities, and at a high level, the extent to which an MLP's energy assets are diversified.

"Midstream" MLPs represent the largest single segment (45%) of the MLP universe. They operate pipelines, storage facilities, and/or processing plants. These are predominately fixed-infrastructure assets designed to handle specific commodities and to provide transportation services in a specific direction. Many operate under relatively long-term contractual arrangements specifying various terms and guarantees. They charge toll-like fees to the producers for throughput on their infrastructure. Because they don't take title of the commodity, their exposure to prices is lower relative to other energy companies, such as those involved in exploration and production. However, to the extent prices impact volumes, their profitability and cash flows can be affected. One specific risk for such companies is that the economics present at the time contracts were originated may not be as favorable when the contracts expire and are renegotiated. Conventional wisdom suggests midstream MLPs are generally the most stable assets within the MLP landscape. However, as a recent example shows, these companies are not immune to changing fundamentals and their past record of stable and steady distributions is not guaranteed to continue in the future.

Boardwalk Pipeline Partners (BWP), for example, is a midstream MLP that provides natural gas and related liquid transportation, storage, and processing for its customers. It's a subsidiary of Loews Corp, which owns a conglomerate of businesses and is run by the Tisch family, a well-known name in the value investing world. BWP's pipelines transport gas from Texas to various parts of the country. At the time its long-haul transportation contracts were originally struck, natural gas

production was not as great as it is today in regions to which BWP was shipping. To meet demand in those areas, companies had to pay for natural gas to be shipped into the region of consumption. The cost of transportation raises the price of gas at the end point of consumption relative to where it came from.

Since that time, new natural gas sources have begun production. In BWP's case, production from the Marcellus and Utica plays affected areas to which they had been shipping gas. The new supply of gas and additional infrastructure built since BWP's existing contracts were originated has caused the basis differential (price between two different locations) to shrink. Said another way, the demand for



transportation fell, causing the price of transportation to fall as well. As BWP's legacy contracts have expired, they've been unable to renew them on as favorable terms as in the past.

Their storage business has also been facing headwinds. Seasonal spreads (difference between prices in the summer and winter months) have shrunk as natural gas consumption in summer months has increased – a phenomenon that can be explained at least in part by electrical plants converting from coal to gas. Additionally, increased production out of the Northeast has resulted in less need for storage there. These factors have caused natural gas price volatility to decline, reducing the value of storage.

This season's below normal winter temperatures have added yet one more factor to the mix. Frigid conditions increased demand for gas to heat homes in the United States, and that has caused the gas futures market to enter a state of "backwardation," meaning spot prices are higher than futures prices. When the market is in that state, a market participant cannot buy gas at the spot price, store it, and sell it forward at a profit using futures. That situation has further dampened the demand for storage. All of this paired with a debt-laden balance sheet culminated in BWP disclosing that cash flow and profitability would be negatively impacted and that the company was consequently cutting its distribution by about 80%. The market responded with the MLP's units falling by about 45% in a single day (see graph).

Beyond the midstream companies, upstream assets are the second largest sector utilizing the MLP structure. Upstream MLPs are involved in the exploration and production of natural resources, such as oil and gas. They are generally known to have more direct exposure to commodity prices than the midstream MLPs because they typically own the resources. Consequently, in periods when prices are weak, volumes are likely to be weak as well, unless the company has hedged a large

proportion of its production. Hedging production is one way of reducing the risk of falling prices, however the cost to do so is not static and the terms are subject to market forces. Furthermore, exploration and production companies must replace reserves if they are to sustain production over time. Upstream MLP failures would not be unprecedented. The energy price declines experienced in the 1980s exposed the risks underlying the upstream MLPs and led to their exit from the public market. They ceased to exist from the public equity markets until LINN Energy's successful IPO in 2006.

The Commodity Prices section has not identified all the risks carried by the different energy related companies and MLPs. The exposures carried by one company or one specific sector are not likely to be exactly the same as the next. The research does, however, highlight the uncertainty regarding the fundamentals given all the variables involved in producing energy resources. Changing fundamentals, not limited to the general level of supply and demand, can greatly affect the profitability and cash flow of companies. The cyclical nature and exposure to change can result in future economics being much different than what they currently are, even for businesses commonly considered stable and steady. Many companies work under the reality of an uncertain future. Nevertheless, conservatively financed companies with highly differentiated products, defensible market positions, and other forms of sustainable competitive advantages are likely to be able to withstand competitive and market forces. On the other hand, financial and operating leverage coupled with a cyclical, commodity-like business can create a volatile and potentially disastrous combination.

Conclusion

The research presents a number of risks MLPs and their unitholders face. Combined, the risks and the number of variables involved create fragility of which we believe many investors are unaware, or are choosing to ignore in the desperate search for return in today's low-interest-rate environment. New offerings of MLPs bear a resemblance, although maybe not in terms of scale, to the progressive degradation in quality of junk bond offerings ("covenant-lite" being one of the more recent compromises) or the pre-crisis, competition-driven deterioration in mortgages that comprised the securitization pools. For the many investors who don't understand or are not aware of the anti-unitholder structure of MLPs, it seems highly probable their experience will be quite similar to that of some 19th century railroad investors: *"...matching their ignorance against the loaded dice of those whom their credulity tempts to make a business of floating all kinds of plausible and worthless enterprises."*

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