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Midstream makeover: How a simplified structure has opened new opportunities for investors

Investor appetite for energy MLPs exploded after the financial crisis thanks to their attractive yields, tax-advantaged structure and strong performance that characterized 2009–2014. However, the subsequent drop in oil prices and commodity sell-off forced fundamental changes in the midstream space. This report delves into the consequences of sector restructuring, favorable aspects of energy infrastructure investing, and how investors may best access the sector's opportunity today.

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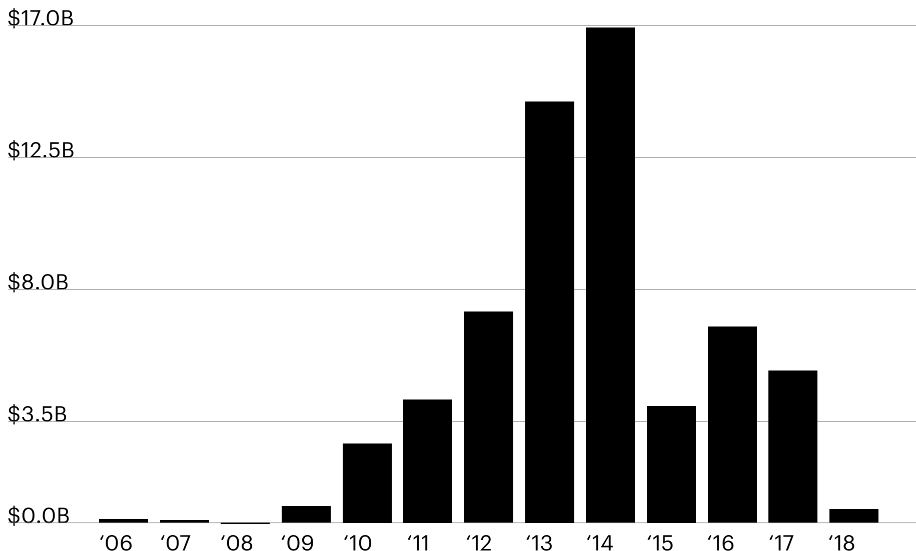
New kid on the stock (exchange)

While the modern master limited partnership (MLP) has been around since Congress passed the Tax Reform Act of 1986, investor interest in energy MLPs grew significantly following the 2008 financial crisis (see figure 1). They were rewarded as the 25% annualized return of the flagship Alerian MLP Index from 2009–2014 bested both the S&P 500 and the S&P 500 Energy Index.[1] Retail investors, some using MLP funds to efficiently access the sector, were drawn to the space due to 1) above-market dividend yields, 2) the tax-advantaged structure, and 3) the potential for growth driven by a rapidly expanding North American shale industry.

FIGURE 1: NET FLOWS INTO ENERGY LIMITED PARTNERSHIP MUTUAL FUNDS AND ETFs

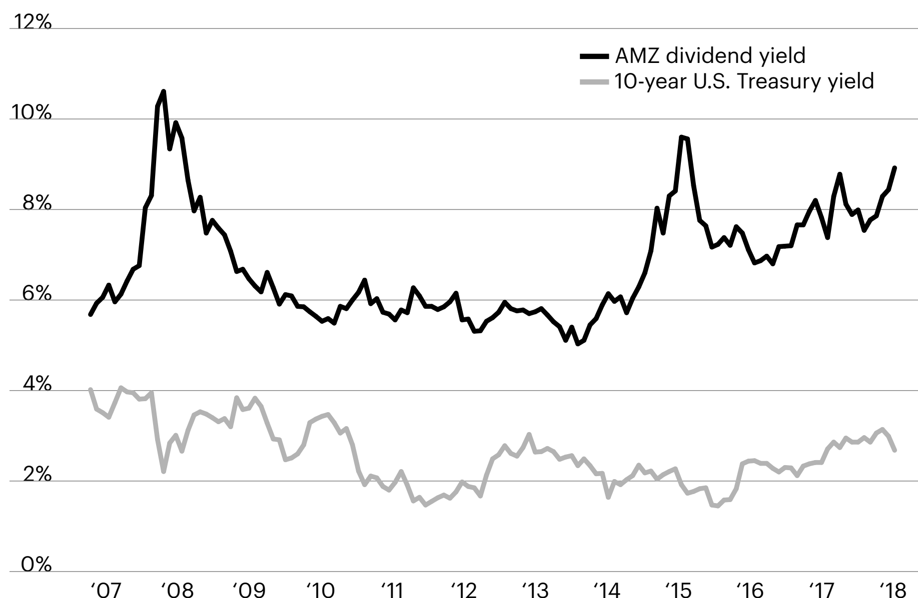


Source: Morningstar, as of December 31, 2018.

1 Bloomberg.

First, MLPs have offered relatively high yields for income-hungry investors. They are able to do so for two reasons. From an operational perspective, most MLPs are involved in midstream activities such as the transportation, processing and storage of oil and natural gas. These businesses generally involve firms signing long-term contracts with commodity producers, a business model that lends itself to a degree of cash flow certainty and, therefore, the ability to offer consistent distributions to investors. Additionally, as part of the partnership agreement, most MLPs must pay substantially all distributable cash flow (DCF) to unitholders. These factors have allowed MLPs to pay out high distributions in a post-crisis environment where yield has been hard to come by (see figure 2).

FIGURE 2: HISTORICAL YIELDS, 2007–2018



Source: Bloomberg, Alerian, as of December 31, 2018.

Second, MLPs offer a uniquely attractive tax structure. As partnerships, MLPs do not pay federal or state income tax at the firm level. They are considered a "pass-through entity," meaning each unitholder is taxed on the distributions received but the corporate entity pays no tax on its income. Typically, most of an MLP distribution is considered a return of capital to the unitholder, which serves to lower the investor's cost basis. Taxes on return of capital are deferred until the investor sells the units, making owning MLPs potentially tax-efficient.

Finally, the shale boom in North America has offered an appealing growth story for energy infrastructure firms. At the end of 2007, the U.S. was producing approximately 5 million barrels of crude oil per day; by 2018, that number had more than doubled to 11.7 million. The rapid growth in commodity production, driven by efficient new drilling techniques, necessitated a large increase in energy infrastructure investment, much of which was conducted by MLPs.

Adapt or die

While growing production in the U.S. and Canada supported the domestic energy industry, increasing supply eventually had a major effect on the global price of oil. As global production rose, OPEC, led by Saudi Arabia, decided not to cut production and attempted to price the flourishing North American shale industry out of the market. This, along with other factors, caused the precipitous fall of WTI crude prices from above $100/bbl in 2014 to a low of $26/bbl in early 2016.

The oil price crash had sweeping effects on the midstream sector. As performance suffered and valuations fell, MLPs' rising cost of capital started becoming a concern. MLPs had to choose between angering investors by cutting distribution rates or maintaining distribution rates that became unsustainably high as their share prices fell. The latter had a cascading effect for MLPs as well, in that it raised the required rate of return for new projects and limited the pool of available capital investments that had historically driven distribution growth.

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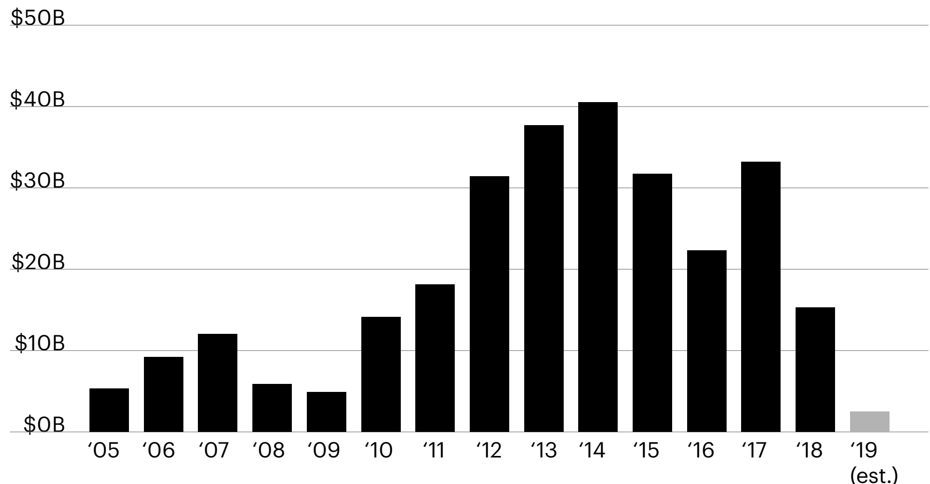
As performance waned, investors also started scrutinizing the corporate governance and incentive structure of MLPs. Most MLPs are structured with a general partner (GP), often a large energy company, owning a share of the MLP equity and limited partner (LP) unitholders holding the rest. These LP unitholders started to question certain aspects of the LP-GP relationship, such as incentive distribution rights (IDRs). IDRs essentially entitle the GP to a higher percentage of the gross distribution amount as distributions increase. Originally seen as aligning interests, this came to be seen as enticing the GP to make decisions aimed at aggressively increasing distributions, even at the expense of LPs. Additionally, MLP governance is weaker than that of traditional corporations in that LP unitholders have no voting rights and GPs technically have no fiduciary duties to the LPs.

This perfect storm of issues contributed to investors abandoning the space, even as oil prices recovered. Poor performance, perceived and actual governance issues, and a rising cost of capital significantly impacted MLPs' ability to access affordable capital, which is illustrated by the decrease in capital markets activity. In 2018, MLPs raised about $15 billion in equity, the lowest level since 2010, while the majority of these issuances were not available to the public (see figure 3).

FIGURE 3: MLP EQUITY ISSUANCE



Source: Wells Fargo Research, as of December 31, 2018.

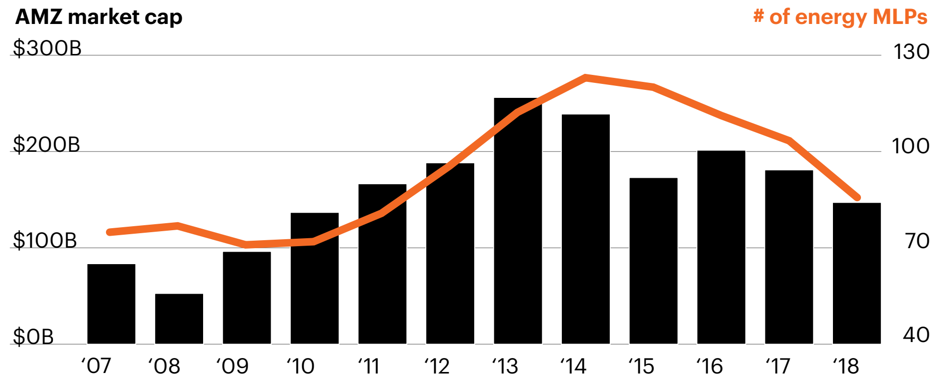
The issue of access to affordable capital has caused many firms to reassess whether the MLP structure is their best option going forward.

The simpler, the better

Together, the issues addressed above have culminated in a tectonic shift for the midstream sector. Many firms, including household names like ONEOK and Kinder Morgan, have decided to undergo "simplification" transactions. This is a broad term, but simplification generally involves an MLP converting to a C-corporation, commonly through the MLP being acquired by its GP. Of the 35 such transactions completed since 2007, more than two-thirds have come in the past four years.[2] These transactions have both consolidated the space and reduced MLPs' share of the midstream market.

2 Wells Fargo Research, as of February 1, 2019.

FIGURE 4: REDUCTION IN ENERGY MLPs

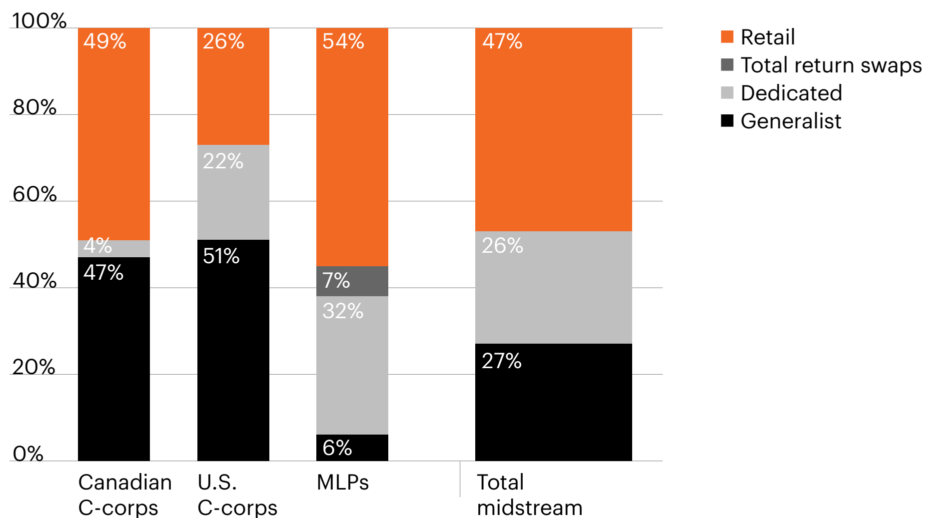


Source: Bloomberg, Alerian, as of December 31, 2018.

The wave of simplifications has created certain shorter-term challenges for investors including "back-door" distribution cuts, as the acquiring GPs often offer lower yields than the acquired LPs, and increased market volatility. Despite these issues, the long-term positives for the sector are numerous. Transparency, governance and investor alignment have generally been improved by these transactions. Many firms have eliminated IDRs, a meaningful improvement to the firms' go-forward cost of capital and their ability to grow distributions. Additionally, unitholders, now shareholders in a C-corporation, have shareholder voting rights, and firm management now has a fiduciary duty to these shareholders.

The ultimate hope is that these changes will spur interest from new sources of capital and, in turn, reduce the cost of equity as share prices rise. Potential investors may be better able to compare midstream corporations against other yield-based sectors like utilities and REITs, thereby attracting additional capital to the industry. As highlighted in figure 5, MLPs and midstream C-corps generally have different investor bases. MLPs tend to skew toward retail and "dedicated" MLP investors, while C-corps are much more weighted toward "generalist" institutional investors. As MLPs have struggled to attract capital, the possibility of drawing a broader investor pool by converting to a C-corp has proved appealing to many.

FIGURE 5: MIDSTREAM INVESTOR BASE



Source: Wells Fargo Research, as of February 1, 2019. Percentages may not total 100% due to rounding.

New look, new midstream

As the wave of simplifications enters its late stage, where does this leave midstream going forward? First, we believe the sector remains fundamentally attractive. Production is at an all-time high and is expected to continue growing, company financial performance has been stellar, and distribution rates are climbing at a healthy pace. Additionally, despite favorable fundamentals, valuations are well below historical averages.

EV TO EBITDA

	Current	5-year average	10-year average
MLPs	**9.6x**	12.2x	12.5x
Midstream C-corps	**10.5x**	15.1x	13.5x

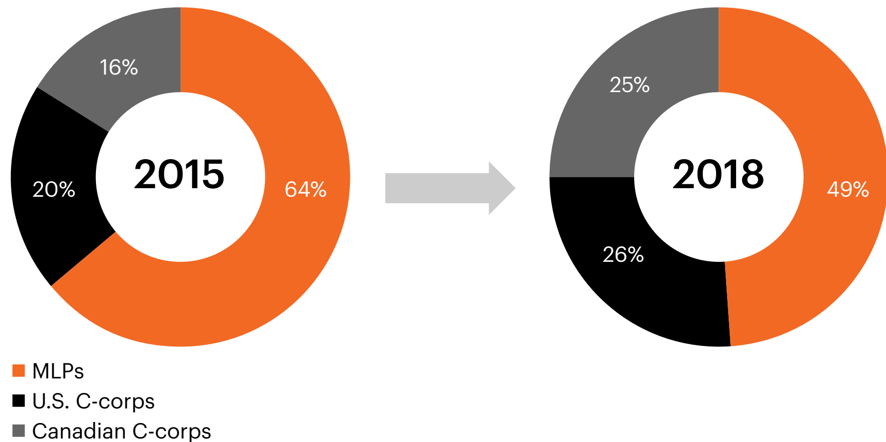
Source: Wells Fargo Research, FactSet, as of January 31, 2019.

We believe the fundamentally altered structure of the midstream sector calls for a fundamental change in how investors gain exposure.

What do these changes mean for how investors should access the opportunity in midstream? We believe the fundamentally altered structure of the midstream sector calls for a fundamental change in how investors gain exposure.

Many investors have historically utilized MLP funds to access the space in a diversified manner. Those investors must contend with two issues related to MLP funds' mandate of holding at least 80% of their assets in MLPs. First, any fund that holds more than 25% of its assets in MLPs does not qualify as a regulated investment company (RIC). The fund must pay taxes on income at the fund level and investors must also pay tax on the distributions they receive. Second, MLP funds' mandate limits potential diversification and flexibility to seek returns throughout the entire midstream sector. As figure 6 shows, just over half of the midstream sector in North America is structured as traditional C-corps, not partnerships. MLP funds' strict mandate ultimately constrains their opportunity set to a dwindling pool of assets.

FIGURE 6: MIDSTREAM COMPOSITION BY STRUCTURE TYPE, 2015 VS. 2018



- MLPs
- U.S. C-corps
- Canadian C-corps

Source: Alerian, as of December 31, 2018.

Summary

Energy infrastructure investments provide unique characteristics like above-market income and participation in a rapidly expanding North American energy industry. The question for investors is how they can most effectively access the benefits that midstream assets can offer a portfolio. We believe investing in an MLP fund is no longer an effective way to access this space. While MLPs themselves certainly remain an integral part of the midstream landscape, they represent less than half of the available investment universe. This new midstream landscape amounts to a "midstream 2.0" which is more structurally diverse, calling for fund structures with a more flexible mandate that matches the sector.

INDEX DEFINITIONS

Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs) and is a capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization.

S&P 500 Index (Standard & Poor's 500 Index) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value.

S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the Global Industry Classification Standard (GICS) energy sector.

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