October 1, 2015

Energy and MLP Turmoil – What Should Investors Do?

Russ Allen, CIO

Our bottom line: quality midstream assets are now more attractive, and investors without exposure should consider them in light of their overall objectives. We are buyers or holders, not sellers.

In August, we wrote to you about falling oil prices and the consequent impact on MLPs / energy infrastructure. Since the time of our writing, oil has remained quite volatile but is actually about flat point to point. MLPs, on the other hand, have lately come under even more pressure, falling over 8% September 28-29 alone. Given that MLPs are generally considered safer than their associated commodities, investors want to know, “what is going on?”

Clearly, great fear has set in regarding the industry, and some of the claims being repeated are way off-base. Yet there are grains of truth in these charges, which we will address below. We are certainly taking industry events with gravity, but feel assured on our thesis. A big part of the dislocation is likely mutual fund selling ahead of their reporting deadline (window dressing) and hedge funds giving up on previously high-momentum stocks.

Source: Alerian

The market's largest concern right now is global recession, driven by worries over a "hard landing" in China. On one hand, there are clear signs of a slowdown in China, and the opaqueness of information on China's economy worsens market fears during downturns. Most emerging markets have sold off in sympathy with the Chinese market. Despite these fears, the data shows oil demand continues to grow slowly on a global basis. There is no easy substitute for oil, and oil use is not going away – especially as it is much cheaper than last year.

Oil prices have also been pressured by strong oil and gas supply growth, which has only slowed slightly despite many rigs being taken out of service. Yet again, this is not a negative for the midstream MLP industry, which is in the business of gathering, processing and transporting this production. Infrastructure MLPs, where our investors are focused, operate under long-term, take or pay contracts. They provide a necessary, quasi-monopolistic service to the local fields.

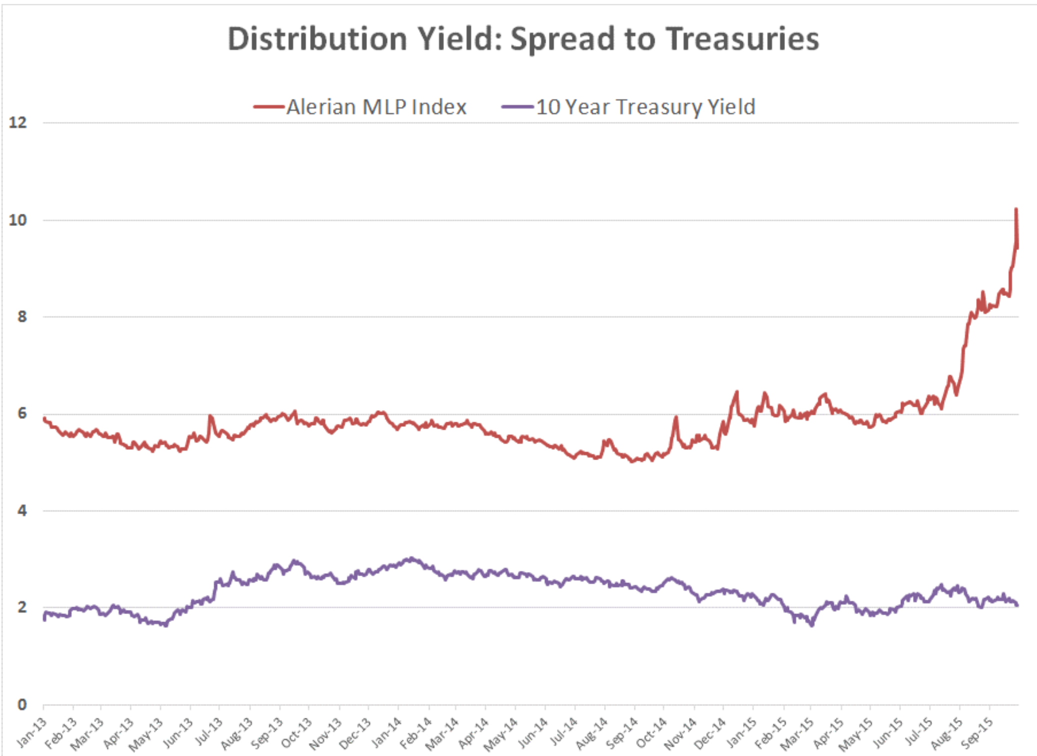
Concerns and Answers

Cost of capital will make new projects prohibitive: Capital markets do sometimes close (e.g. for REITs in 2008), and currently new equity is prohibitively expensive for MLPs. Debt is also more expensive than it was six months ago. Yet capital markets do not close forever when fundamentals are strong. MLPs, like offices and shopping malls, are not going out of business. They own real, valuable assets, supported by long-term contracts. Most MLPs are still able to meet their investment hurdle rates, even in the present environment. This means they can still find projects and grow distributions, even if more slowly than before.

Energy companies will go bankrupt and be unable to pay their contracts: The majority of the eleven companies that have filed for bankruptcy this year have been E&Ps (companies exploring for and producing oil). Their assets are picked up by stronger companies, and renegotiation with MLPs, if any, is usually in exchange for a longer contract and volume guarantees. Midstream MLPs themselves have been under pressure due to fears over yield growth, not bad balance sheets or cash flow shortfalls.

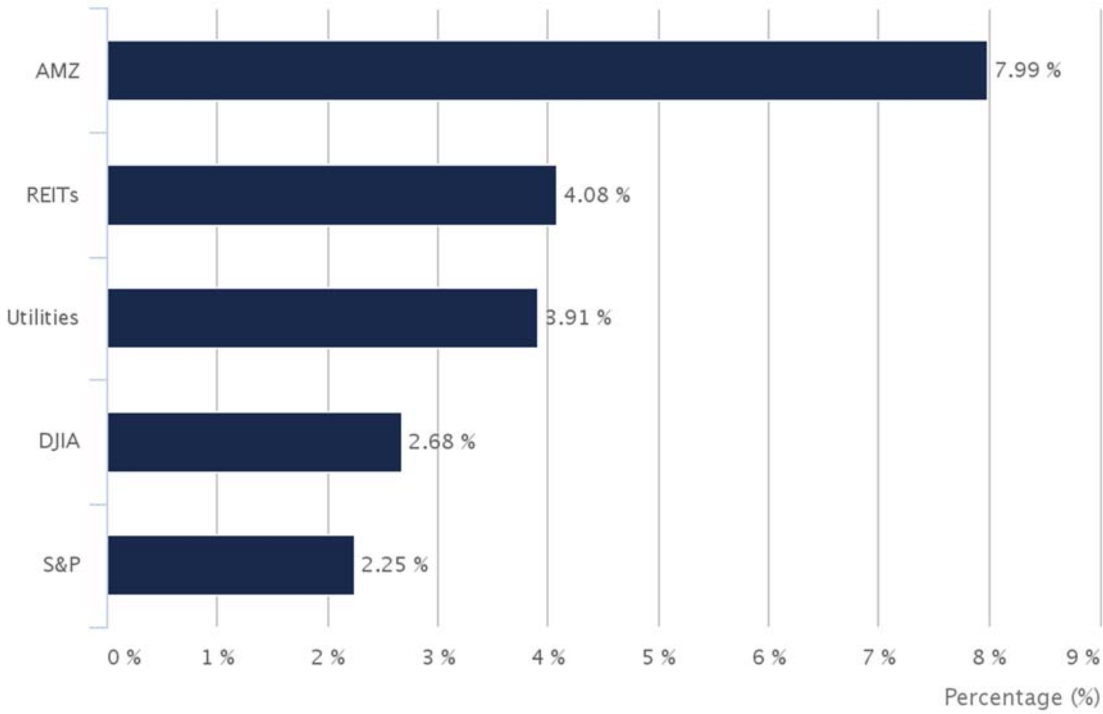
The upcoming quarter will be disastrous for earnings: Companies are indeed lowering expectations, but are still forecasting growth in earnings. Consensus estimates for 2015 and 2016 show continued growth in distributions for midstream energy companies. Slower growth is likely temporary, and is far from a disaster. A shift back toward attention to fundamentals, which may be triggered by the upcoming reporting season, could actually be a good thing for the industry. In short, fear is likely far outpacing reality.

The Industry can't cover the distribution yields it now pays:
As the chart below shows, yield spreads for MLPs versus treasuries have widened significantly. The index yield as of September 30 was 8%, while the 10 year Treasury bond pays just over 2%. This sounds too good to be true – and our stance is that the only reason it is true is because of market panic.



CBRE Clarion estimates that the current coverage ratio of dividends across the midstream MLP universe is 1.18 times. That means the current distribution is covered by cash flow after payments to the GP and maintenance capital expenditures. Capital spending for growth projects is optional and companies can choose not to spend for uneconomic projects. Even under that scenario, MLPs would still cover their current distributions which are now considerable.

MLP Yields compared to other market sectors as of 9/30/2015



AMZ = Alerian MLP Index
Source: Alerian

Midstream MLPs versus Non-Infrastructure MLPs

A last note - as we noted in August, pipeline companies are inherently different from the commodity-exposed energy exploration MLPs (which probably shouldn't be in a MLP structure to begin with). Predictably, high debt has also been a problem in the current downturn. Yet we believe the selloff has wrongly depressed many high quality, appropriately levered pipeline companies as well.

We think the best way to approach MLP investing is through an active manager who can focus on MLPs with low capital costs and strong balance sheets. The sharp selloff in recent weeks has given investors the opportunity to buy blue chip MLPs at discount prices.

We can't predict when fears might dissipate, and they could even worsen first. Yet our opinion is favorable for the industry as a whole, and could provide opportunities for yield-focused investors.

Important Disclosures:

This information is for discussion purposes only and is being furnished on October 1, 2015. This information is not to be re-transmitted in whole or in part without the prior consent of Berman Capital Advisors (BCA).

While all the information prepared in this presentation is believed to be accurate, BCA makes no express warranty as to its completeness or accuracy nor can it accept responsibility for errors appearing in the presentation.

No information provided herein shall constitute, or be construed as, an offer to sell or a solicitation of an offer to acquire any security, investment product or service, nor shall any such security, product or service be offered or sold in any jurisdiction where such an offer or solicitation is prohibited by law or registration.

Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product will be profitable or be suitable for your portfolio or individual situation. Please contact BCA to discuss your individual situation.