BERMAN CAPITAL ADVISORS

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Energy and MLP Turmoil – Follow-Up

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2015 has been the *annus horribilis* for MLP investors, with the principal Alerian MLP Index down just over 40% through November. Price drops like this certainly prompt a reassessment of the thesis – is the market in an unjustified panic, or did our analysis take a very wrong turn? Compared to the recent past, fundamentals have turned more negative for MLPs – yet we believe the market reaction is far in excess of the facts on the ground.

The principal problems for MLPs are the following:

1. Energy prices have declined so massively that the market fears energy companies will significantly cut capital expenditures to store and transport fuels. There is a related fear that customers' financial stress will be so severe that take-or-pay contracts with MLPs will be renegotiated. To date such negotiations have resulted in longer contracts in exchange for modified terms, not a bad result for the MLP.
2. The sharp MLP price drop has made issuing equity to fund growth unattractive or impossible. In other words, the cost of capital for MLP funding has risen significantly, creating a negative feedback loop.
3. Some MLPs should have never been MLPs to begin with – those tied directly to energy prices which are not "toll-road" businesses such as the pipeline and storage partnerships typically are. Their financial distress from commodity prices is dragging down the entire complex, despite the significant differences between them.
4. There is a massive round of technical selling driven by tax loss selling and mutual fund outflows currently underway, which may not abate until next year. Many MLP investors were relatively new and were shocked by the downward volatility of the asset class, and are capitulating.

Let's try to take these in turn. The most important point is that the fundamental need for energy infrastructure is real and remains a significant opportunity. The latent potential to export cheap U.S. natural gas overseas is coming closer to fruition, and requires further investment. Coal plants are being retired and utilities need gas supply, another important source of demand. Eventually, financial markets will open to fund projects with fundamentally sound prospects and attractive returns.

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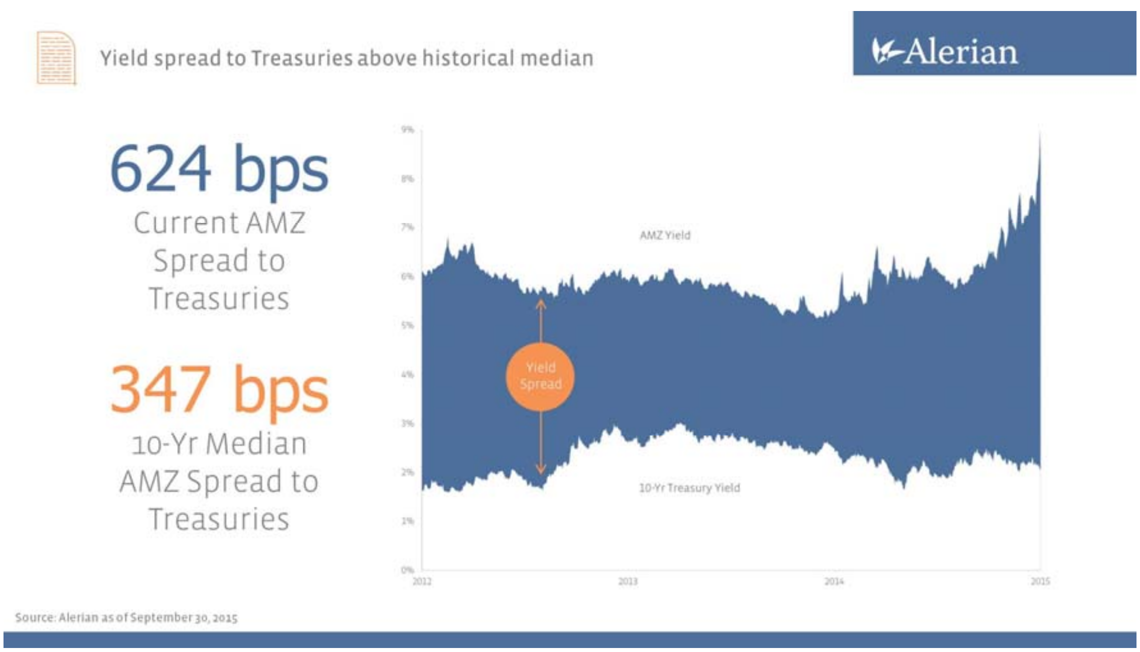
Historically, MLPs do not have a high correlation with crude oil prices. Yet the massive downturn in commodity prices has changed that, pushing correlations toward one (1.0) as fears have cascaded over. The higher quality MLPs have only marginal direct exposure to commodities. Worries that demand will decline, and thus will the need to transport oil and gas, would be more plausible, but demand has not fallen off. Actual financial results at midstream MLPs have been O.K. with a few exceptions.

On the other hand, investors are afraid and the capital markets are restrictive. Due to their favorable tax treatment, MLPs must distribute a large portion of cash flow, and turn to the capital markets to fund most expansion projects. As MLPs have gotten the memo on high debt levels and investor fears, companies will indeed shelve some projects and slow their distribution growth in 2016. Historically distribution growth has been about 6.5%, while industry experts expect about half that in 2016 as MLPs batten down the hatches.

One of our key contentions is that valuations have gotten so low, that even if there was no growth ever again (which we don't think is realistic) many MLPs would be attractive on their yield alone. The Alerian Index now yields 8.5%, even higher than junk bonds, many of which are issues from actual energy producers. As the chart below shows, yield spreads over treasuries have reached very high levels, indicating significant distress.



Spreads over treasuries historically have ranged about 4%, versus over 6% presently. Valuations have now reached levels last seen in the financial crisis, the last major downturn for MLPs. Historically MLPs have seen large rallies after selling pressure abated, including in 2000 and 2008.

At BCA, we have focused on active management in the MLP space, given the tricky environment and the need to own the highest quality companies. In a meeting last week with the portfolio management team from Rachlin, they reiterated that the thesis for investing in MLPs has not changed. In their meetings with industry management teams, they are hearing demand dynamics are fundamentally strong. There is a crucial difference between pipeline and storage MLPs with strong balance sheets and minimal commodity exposure on one hand, and commodity exposed energy producers on the other. The current market panic is obscuring this difference, which should be a source of opportunity for investors.

Important Disclosures: