Master Limited Partnership Simplifications on the Rise

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With the announcement of three separate master limited partnership simplification transactions on May 17 alone, we must revisit our thesis that the business structure may not be in it for the long haul.

By Kris Rosemann

At Valuentum, we continue to believe the master limited partnership (MLP) business model is at risk over the long haul, and recent news from the space only seems to support the notion that the MLP model we once knew may be fading more quickly than some had expected. If there is nothing inherently wrong with the structure of MLPs, then the rate at which simplification transactions are occurring would certainly be an alarming development, but we continue to point to factors such as the need for robust levels of outside capital financing for growth and an industry-wide preference for selective cash flow measures that do not properly account for capital needed for growth but prop up lofty yields and distribution-based valuation as key causes for concern.

The detachment of fundamentals and analysis in the space may finally be coming to an end, but the acceleration of simplification transactions, which we had originally highlighted as a long-term concern, is due in part to the FERC ruling that MLPs are no longer allowed to receive credit for income taxes they do not pay. Nevertheless, the core of our thesis is based on the idea that MLPs should not be treated, valued, or analyzed differently than typical corporates, which is supported by the FERC's ruling to eliminate the MLP tax allowance, in our opinion.

Three different simplification transactions were announced May 17, which we will address later in this note, but they are only a fraction of the restructuring activity we have seen thus far in 2018. Let's take a quick look at some of those deals.

Terra Nitrogen was swallowed by its general partner, Terra Nitrogen GP, which is a subsidiary of CF Industries (CF).

Legacy Reserves (LGCY) announced that it is working to transition to a C-Corp with the goals of attaining a less complicated balance sheet and enhanced ability to raise capital.

NuStar (NS) announced its merger plans with general partner NuStar GP Holdings (NSH), along with the elimination of its incentive distribution rights and a cut in its quarterly distribution.

Tallgrass Energy Partners (TEP) will be acquired by its general partner Tallgrass Energy GP (TEGP) and eliminated its incentive distribution rights, which is aimed at reducing its cost of capital.

Archrock (AROC) will acquire the remaining units it does not already own in Archrock Partners LP (APLP) in a deal designed to increase dividend coverage, improve its credit profile, simplify its capital structure, and lower its cost of capital.

Alliance Resource Partners (ARLP) and Alliance Holdings GP (AHGP) announced a series of simplification transactions intended to simplify the organization's structure and increase investor transparency while attracting a broader investor base.

EQT Midstream Partners (EQM), EQT GP Holdings (EQGP), and Rice Midstream Partners LP (RMP) announced a midstream streamlining transaction that includes the purchase of Rice Midstream's incentive distribution rights by EQT GP Holdings and efficiency gains that should offset the need for a not immaterial amount of incremental capital.

Though no official announcement has been made, Boardwalk Pipeline Partners (BWP) CEO Stanley Horton has suggested general partner Loews (L) may take the MLP private.

We are not here to dissect the strategic rationale of these transactions.

We continue to be of the opinion that the majority of the businesses underlying master limited partnerships are sound and core to our economy (US energy production is strong and organic growth projects are prevalent), but their complex organization structures and industry-specific manner of operating and valuation are not sustainable over the long haul, in our view. The proliferation of simplification transactions across the MLP space seems to support this notion as organizations continue to work to reduce their cost of capital, a factor that is extremely important to entities that are dependent on outside funding.

With that in mind, let's dig in to the three freshest simplification announcements. A little more than a year after the Williams family's double equity raise and distribution cut, "MLPs: Williams' Double Equity Raise," general partner Williams Companies (WMB) has agreed to acquire the remaining units of Williams Partners (WPZ) it does not already own, which is ~26% of the limited partner, for a premium of just over 6% of Williams Partners' May 16 close price.

Williams Companies will issue 382.5 million shares in the proposed transaction, and Williams Partners unithodlers will receive 1.494 shares of the general partner for each unit owned, assuming the deal closes before Williams Companies' third quarter dividend record date. If the transaction closes as scheduled, Williams Partners' unithodlers will receive five payouts in calendar 2018, which management estimates equates to a ~15% increase over its previously expected distributions in the year. The 2018 payout projection was near the top of a list of highlights for Williams Partners unitholders provided by management, but the team made no effort in explaining what the dividend will look like in 2019 and beyond compared to the limited partner's current distribution.

Williams Companies' current annualized dividend of $1.36 per share implies an annual payout of ~$2.03 for Williams Partners unitholders after considering the exchange ratio (1.494 x 1.36). It appears as though there will be a meaningful reset of the payout for the MLP's unitholders following the unique case of 2018. A 15% increase (management expects 10%-15% annual dividend growth in 2019 after the ~13% increase in 2018) from $1.36 reveals an annualized dividend of ~$1.56 per share for 2019. Assuming the proposed transaction closes as scheduled, this implies a payout of ~$2.34 per share for Williams Partners' unitholders in 2019, which compares unfavorably to its current distribution of $2.46 per unit.

Enbridge (ENB), the largest energy infrastructure company in North America, announced that it will acquire all of the outstanding equity securities of Spectra Energy Partners (SEP), Enbridge Energy Partners (EEP), Enbridge Energy Management (EEQ) and Enbridge Income Fund Holdings (TSX: ENF). Enbridge announced in December 2017 that it was assessing a potential streamlining and simplification of its organizational structure, and management points to the recent reversal in FERC policy as a cause of its decision as the ruling would weakened Enbridge Energy Partners' and Enbridge Energy Management's credit profiles and viability as financing vehicles for Enbridge's growth. Direct ownership in Enbridge and an enhanced dividend growth profile were also offered as key rationales for the simplification from the point of view of the to-be-acquired entities.

Enbridge also notes that in order for Enbridge Energy Partners to retain its investment grade credit ratings, the MLP would have to raise a significant amount of equity at an unattractive cost of capital and materially cut its distribution in early 2019, which would come on top of its previous distribution cut in 2017. However, the announced simplification transaction includes an implied dividend cut for unitholders. Enbridge Energy Partners will receive 0.3083 share of Enbridge for each unit owned, and the two entities' most recent quarterly payouts were $0.35 (EEP) and $0.671 (ENB). The exchange ratio implies a reset of its quarterly payout to ~$0.21 (0.3083 x 0.671), which is not immaterial even if dividend growth prospects are enhanced as a result of the transaction.

The third simplification transaction announced May 17 comes from Cheniere Energy (LNG) and Cheniere Energy Partners (CQH). Cheniere Energy is offering 0.45 of its share per share of Cheniere Energy Partners in a tax-free exchange. The proposal offered no guidance regarding future dividend payments, but Cheniere Energy does not currently pay a dividend. Shares of Cheniere Energy Partners currently yield more than 7%. Cheniere Energy already owns ~92% of Cheniere Energy Partners.

Recent actions taken by master limited partnerships only seem to reaffirm our thesis that the complex business structure is not sustainable over the long haul. The need for access to outside capital may never totally go away, but if the typical structure of MLPs is an attractive one, then why must so many simplification transactions be pursued?

This will not be the end of the simplification movement either, and while some who prefer to champion the business model over objective analysis may point to smaller operators simplifying as not representative of the attractiveness of the structure, Williams and Enbridge will not be the last of the high-profile names to consolidate. For example, the Energy Transfer (ETE, ETP) family is evaluating its organizational structure and points to late 2019 as a potential timeline for an internal restructuring transaction.

Valuentum members should not be surprised by any of the recent developments in the MLP space, and the recent regulatory change (FERC ruling) has only accelerated what we had originally pointed to as a long-term concern.

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