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MLPs – A New Dawn

The positive fundamentals around MLPs are clearly evident: significant leverage to growing North American oil and gas production, valuation multiples that are well below historical averages and stock prices that are still more than 30% below 2014 highs. Even with all this, however, investors may be missing something even more important and that is the significant number of company restructurings that have taken place. As a result, this is a very different sector than it was five years ago.

The downturn that began in late 2014 with the collapse in oil prices exposed many of the sector's flaws. Early restructurings were driven by the need for MLPs to fix their balance sheets and eliminate incentive distribution rights (IDRs) which had grown to a point where general partners (GPs) were receiving upwards of 40% of their MLPs distributable cash flow. Historically, MLPs always had a finite life cycle because, at a certain point, the IDR split became too draconian. Nevertheless, compressed valuations and closed equity markets accelerated the pressure on MLPs to act.

The restructurings that occurred were generally painful for investors. MLPs had a tendency to trade poorly into the restructurings, and if the restructuring involved a general partner structured as a corporation and its MLP, the merger often was treated as a taxable transaction, triggering significant tax recapture for long-term holders. Nevertheless, once the restructurings were completed, the new companies started to trade much better. ONEOK was one of the first companies to restructure, and its success quickly set the bar for the rest of the industry.

As the broader MLP structure continued to struggle and the investor base began to turn over, more investors started pushing companies to undertake restructurings. Investors became increasingly less tolerant of the traditional MLP structure, especially for companies with a meaningful IDR overhang; they wanted to see pure-play GPs and MLPs folded into a single company where they could ensure better corporate governance and aligned management incentives. The restructuring snowball started to take off. Following the March 2018 FERC decision on income tax allowances, Williams and Enbridge both announced the buy-ins of their MLPs on the same day in May, and in August, Energy Transfer became the last of the large cap MLPs to merge its GP and MLP in effort to reduce its cost of capital. Five more entities announced restructurings in the fourth quarter of 2018, making it 18 restructurings for the year.

So where does the sector stand? At this point, a lot of the company restructurings have happened. There are only roughly a dozen meaningful MLPs that still need to restructure. The three most important are Phillips 66 Partners (PSXP), Shell Midstream Partners (SHLX), and DCP Midstream (DCP). All three have acknowledged that they are looking at a restructuring, but each has been slow to act. MPLX and Andeavor Logistics (ANDX) are a little different; both have shed their IDRs, but both have the same GP, Marathon Petroleum (MPC). The two need to merge, but parent MPC has shown a lack of urgency in making the deal happen. There are number of growth MLPs (BP Midstream (BPMP), CNX Midstream (CNXM), Cheniere Energy Partners (CQP), Hess Midstream (HESM) and Noble Midstream (NBLX)) that are earlier in their growth cycles. Because these companies are still low in their IDR splits, their GPs are hesitant to undertake a restructuring now. Finally, there are some older, lower growth MLPs that still have IDRs, but their splits are fairly minimal so the GPs have been slow to eliminate them.

As an investor, we think the writing is on the wall for all of these companies. While the GPs can drag their heels and wait to restructure, we think they will continue to be penalized by the market. Investors are simply unwilling to commit significant capital to companies with IDRs as investors do not like the structure and they fear how the MLPs will trade if a restructuring gets announced. Our portfolios are heavily skewed towards companies that have already gone through the restructurings. These companies have better balance sheets, better funding models, and real corporate governance. Many of them are regular c-corporations. Ultimately, we believe we are seeing the institutionalization of the midstream and MLP asset class, and these company restructurings are essential to that process. The faster it all happens, the better off investors will be, and we are urging all of these companies to move forward and get it over with.

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David D. Grumhaus, Jr., Executive Managing Director, is the Head of the Infrastructure Group and a Senior Portfolio Manager leading the firm's master limited partnership effort. Prior to joining Duff & Phelps in February, 2014, Mr. Grumhaus served as a portfolio manager and director of research for Copia Capital, LLC; and earlier worked as an investment banker for Goldman, Sachs & Co. and William Blair & Company, LLC. He holds a BA in History, cum laude, from Princeton University and a MBA from Harvard Graduate School of Business Administration, where he was a George F. Baker scholar.