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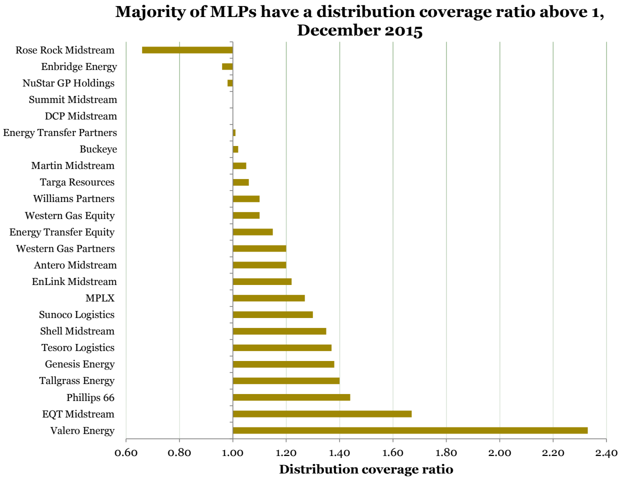
ETF Securities Equity Research:

Midstream MLPs: The Master of Yields interrupted by negative sentiment

Summary

- Master limited partnership (MLP) distributions continued to grow in Q4 2015.
- MLP valuations are attractive when assessed by appropriate valuation metrics.
- Midstream MLPs' revenues are more resilient to oil price fluctuations than upstream oil companies' revenues…
- …yet they are trading more like upstream oil companies. We believe there is potential for an upward correction as MLP resilience becomes apparent.



Source: Bloomberg, ETF Securities, company websites

The MLP structure remains intact

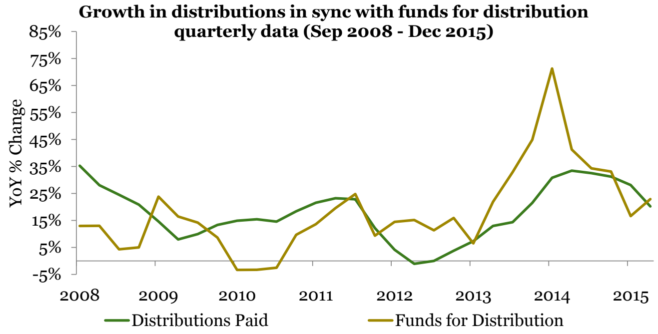
Master limited partnerships (MLPs) are tax exempt limited partnerships that are required to pass through majority of their earnings as distributions to investors. A confluence of factors from restrained capital market access, declining oil prices and fears of rising interest rates have seen the price of MLPs fall by more than 46%. We believe that this price reaction has been overdone. Negative sentiment over single MLPs such as Kinder Morgan, which became overleveraged after the additional purchase of 30% of Natural Gas Pipeline Company of America LLC, appear to have affected the sector at large. However, we see sustainable distributions and low valuations opening an attractive entry point to this sector.

For the purpose of this report MLPs refer to the 24 constituents (as on 12 Feb 2016) of the Solactive US energy infrastructure total return index.

Sustainable distributions

In their latest fourth quarter 2015 results MLPs have reported a 15% growth in quarterly distributions over the prior year allaying widespread concerns of distribution cuts.

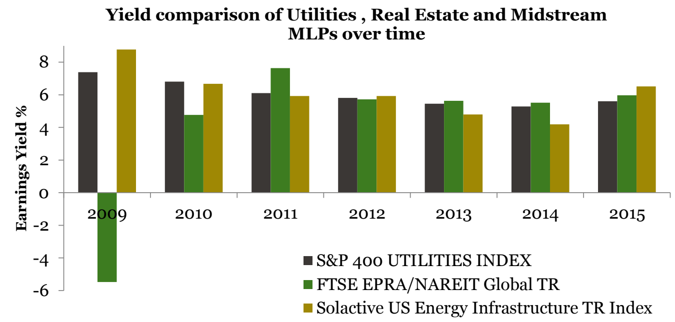
Although funds available for distribution have been on the decline since their peak in 2014, MLPs have been prudent in adjusting their capital budget by keeping distributable cash flow in sync with distributions paid as outlined by the weighted average coverage ratio of 1.27x.



Source: Bloomberg, ETF Securities

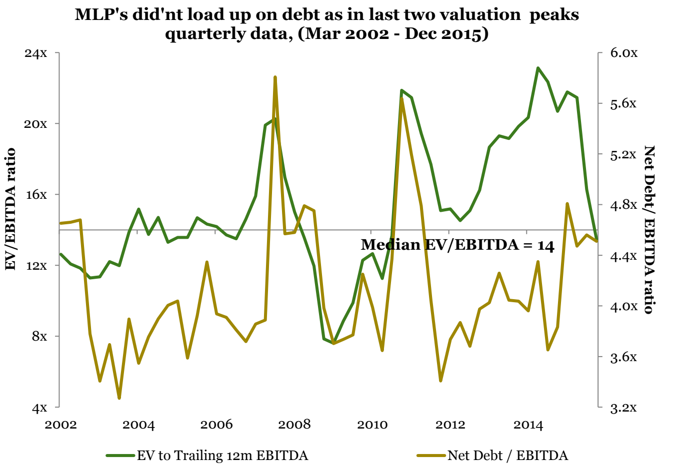
Attractive valuations

When analysing distribution yields, we believe it's vital not to view MLPs in isolation. We can draw a comparison to both utilities and real estate investment trusts (REITs). Utilities and MLPs are known to derive their primary source of earnings from services indelible to society that have high barriers to entry. In fact utilities were the original owners of many of the assets from which today's MLPs are formed. Real estate investment trusts (REITs) and MLPs can be linked by their ownership of tangible, long lived assets ruled by underlying contracts that provide a stable income stream. MLPs also have a similar structure to REITs that escape being taxed at a corporate level. Midstream MLPs currently offer a 6% distribution yield, attractive relative to history of earnings yields of similar assets. The current low interest rate environment has investors searching for yield from non traditional sources, supporting the case for MLPs.



Source: Bloomberg, ETF Securities

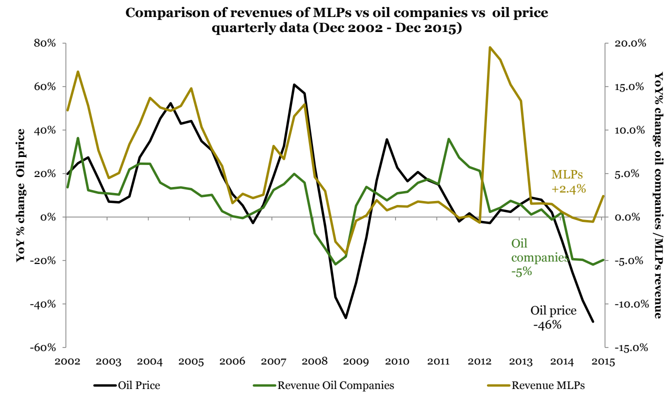
Given that MLPs pay a vast percentage of their income in distributions and rely on debt and equity capital markets to fund capital growth, we use valuation metrics such as enterprise value (EV) to earnings before interest tax depreciation and amortisation (EBITDA) multiples, in tandem with net debt to EBITDA rather than traditional price to earnings and price to book ratios. Since the latter half of 2014, MLPs were cautious not to raise debt in large proportions as they did in the prior valuation peaks. In the last valuation peak, MLPs did not leverage as high as in previous peaks because funding costs were higher and they had less capex need. While it has not yet reached the trough of 7x last seen in the financial crisis, EV/EBITDA is currently at 13.5x below its median of 14x. The price to cash flow from operations multiple for MLPs at 7.8x is trading at a discount to the 10-year average of 12x, also highlighting MLP's attractive valuation.



Source: Bloomberg, ETF Securities

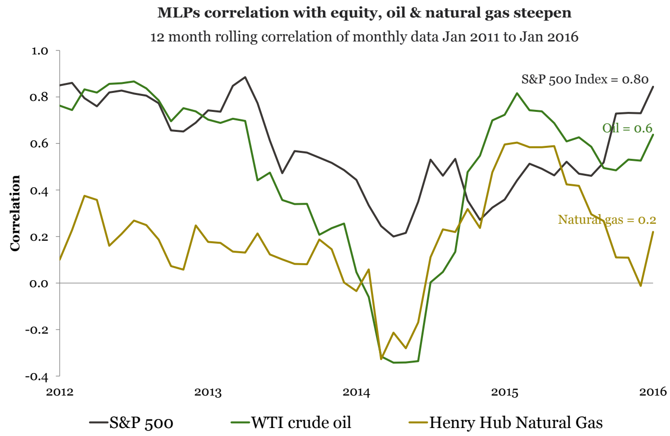
Midstream MLPs derive their revenues from the volume and not price of the product being transported. MLP revenues are far less correlated to oil prices than oil companies. MLP revenues rose by 2.4% in 2015 while revenues for the top 30 oil companies (by market capitalisation) fell by 5%.

Despite MLPs' greater revenue resilience to oil price, they have been trading more like upstream oil companies and we believe that there is potential for an upward correction in their price when this becomes more apparent to the market.



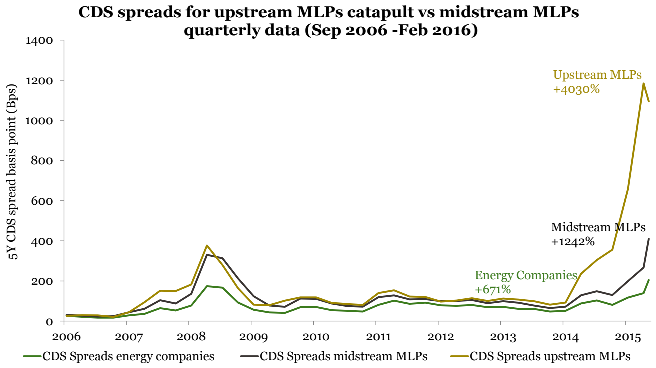
Source: Bloomberg, ETF Securities

Correlation of MLPs with oil, natural gas and the US benchmark S&P 500 index have been rising this year. The correlation of MLPs with the S&P 500 index has risen to 0.8. This underscores the effect of negative sentiment emanating from the global equity market rout on MLPs and not just weak oil prices. MLPs are likely to remain correlated to the oil price and a potential rebound in oil prices could play in MLP's favour.



Source: Bloomberg, ETF Securities

Credit default swap (CDS) spreads that measure the cost of protecting MLPs from default have risen astronomically compared with energy companies and have surpassed levels last seen in the 2008 financial crisis. What stands out from the historical data for CDS spreads is that upstream MLPs (compiled from the weighted average of the top 20 upstream MLPs) are at a greater risk of default and are denting sentiment among midstream MLPs. It's imperative to distinguish between the energy silos as they carry different cash flow dynamics. While upstream MLPs are directly involved in exploration and production of oil and natural gas products, midstream MLPs differ from them as they generate a significant amount of fee based revenue tied to storage and transportation. In fact the vast majority of distribution cuts that occurred in Q4 2015 were from upstream MLPs and we have seen no distribution cuts from our current midstream MLP universe. Valuations are treating upstream and midstream MLPs similarly, while in reality their default risks, are inherently different, a result of their different business models.



Source: Bloomberg, ETF Securities

Conclusion

In light of the above discussion we believe midstream MLPs are trading at levels that reflect the distress in the energy sector. By virtue of the resilience of their revenue streams, current valuations on EV/EBITDA basis and managed debt levels, midstream MLPs are well positioned to appreciate given a turnaround in stressed capital markets and sentiment.

Important Information

General

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