Master Limited Partnerships (MLPs):

Frequently Asked Questions

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Master Limited Partnerships (MLPs) - Structure

What are Master Limited Partnerships (MLPs)?

MLPs are equities that trade on the New York Stock Exchange. They are structured as partnerships versus corporations for U.S. tax purposes. MLPs are operating companies that invest primarily in U.S. energy infrastructure. They offer all the benefits of investing in infrastructure (uncorrelated returns and higher yields) with the liquidity of investing in publicly traded equities.

What types of companies qualify as MLPs?

MLPs were created by an Act of Congress in 1986 to encourage private investment in U.S. energy infrastructure. In order to qualify for MLP status, 90% of revenues must come from energy related activities.

How are MLPs structured?

MLPs are structured as partnerships. Partnerships do not pay corporate income taxes of 35%. Profits and losses flow through to the underlying partners. This pass-through structure status is similar to a REIT and gives MLPs a cost of capital advantage over regular corporations. All partnerships, whether private or public, have the same pass through structure and capital advantage.

Growth Drivers of MLPs

What are the growth drivers of MLPs?

Unconventional shale plays will drive the growth of MLPs for the foreseeable future. New technologies have unlocked vast new energy reserves in the U.S. The country is the fastest growing energy producing nation in the world and is rapidly becoming the new Middle East based on reserves. It is forecast that the United States will become energy independent by as early as 2020.

How will MLPs benefit from unconventional shale plays?

MLPs provide the essential infrastructure (i.e. pipelines) required to transport oil and natural gas from the wellhead to the end user. Yorkville forecasts between $250 - $300 billion dollars will be invested in energy infrastructure in order to develop the U.S.'s unconventional shale reserves. These infrastructure investments will be the fundamental driver of MLP distributions for the next 10-20 years.

What do lower energy costs mean for the United States?

Low energy costs will power U.S. GDP growth. This energy advantage is the primary reason the U.S. is experiencing a manufacturing renaissance. A $30bn investment blitz is underway in the U.S. petrochemical industry. This investment has dual benefits: (i) the original capital investment in property, plant and equipment; and (ii) longer-term from high paying manufacturing jobs.

Investment Case for MLPs

What are the benefits of investing in MLPs?

MLPs are an alternative asset class uncorrelated to equities, commodities or fixed income. The underlying assets of the public partnerships are primarily U.S. energy infrastructure. MLPs are a hybrid between fixed income, offering high current yields, and equities, offering capital appreciation and an inflation hedge through growing distributions.

How have MLPs historically performed?

MLPs have consistently outperformed broader equity markets. Yorkville's Liquid MLP Index has outperformed the S&P 500 in ten of the past twelve years. This outperformance is consistent across economic, interest rate, and commodity price cycles. The index has delivered annualized total returns of 19.7% since 2000 versus 1.6% for the S&P 500 generating positive annual alpha of 18.1%.

How are MLPs correlated to other asset classes?

MLPs have a very low correlation to other asset classes. MLPs have an average correlation of 0.5 to equities, 0.4 to REITs, and 0.5 to global infrastructure. Their correlation to commodities is even lower dropping to 0.1 to natural gas and 0.3 to oil. Their correlation to bonds is flat, slightly negative, and slightly positive depending on the fixed income category. In short, MLPs when added to a portfolio increase diversification, lower the risk profile, and enhance returns – greatly pushing out the efficient frontier.

How stable are the cash flows from MLPs?

MLPs generate stable income streams with limited exposure to commodity prices. Pipeline operators generally enter into long-term contracts that charge rental fees based on leased capacity ("ship-or-pay"). These contracts are typically access based and not volume based. Furthermore, long-term contracts usually have some type of step-up in pricing providing a hedge against inflation.

Why did MLPs underperform equities in 2008?

The underperformance in 2008 was due to technical not fundamental reasons. Credit hedge funds were forced to liquidate their MLP holdings in 2008 to meet margin calls when they were unable to sell their collateralized debt obligations. Strong underlying fundamentals, 74% of all MLPs maintained or increased their distributions during the credit crisis, resulted in an 82% rebound in the Yorkville Liquid MLP Index in 2009.

Master Limited Partnerships – Risks

What is the possibility that MLPs will lose their partnership structure?

It is not very likely that MLPs will lose their partnership structure for two primary reasons: (i) any change would raise very little in tax revenues; and (ii) the government is voting on expanding qualifying income for MLPs to included renewal energy projects. (i) MLPs generate distributable cash flow of approximately $18B per year. 80% of that distributable cash flow is shielded by depreciation leaving $3.6B of taxable income. $3.6B multiplied by a 35% corporate tax rate would raise a nominal $1.3B of tax revenue. (ii) There is a bill in congress that would expand the sources of qualifying income to include renewable energy projects. This bill represents governmental approval of the partnership structure if passed. Furthermore, MLPs have proven to be an excellent way to fund energy infrastructure projects with private investment.

What will happen to MLPs if interest rates rise?

MLPs are not correlated to interest rate movements. The equity like growth of distributions offer a hedge against inflation and interest rate increases. MLPs had total returns of over 40% during the last Federal Reserve tightening cycle between 2004 and 2006.

What would happen to MLPs if U.S. tax rates increase?

MLPs will benefit from an increase in tax rates. Approximately 80% of MLP income is tax deferred. This tax deferral shields income from tax increases. The following is an example: $1MM of dividend income is taxed at 15%, this leaves the investor with $850,000 after taxes, if the tax rate on dividends increases to 40% after-tax income decreases to $600,000. $1MM of MLP income 80% is tax deferred that leaves $200,000 of taxable income leaving investors with $930,000 after taxes, if tax rates rise to 40% after-tax income only decreases to $920,000. MLPs are an excellent way for U.S. investors to shield income from the pending fiscal cliff. The prospect of rising taxes may increase investment demand for MLPs.

How dependent are MLPs on capital markets?

MLPs are highly dependent on capital markets. They rely on the equity and credit markets to fund new projects or acquisitions. This reliance is due to the pass through nature of MLPs i.e. they distribute the majority of their cash flow to investors. This means that any sustained disruption in capital markets would pose a headwind to future distribution growth; however, MLPs issued over $12B of new equity during the credit crisis of 2008 and 2009.

What is the risk of competition driving down pricing?

There is an economic disincentive for other firms to build competing pipelines in a region. The primary reason is the incumbent pipeline operator generally has long-term contracts with the energy companies producing in the area. The secondary reason is pipeline operators need to go to the capital markets to obtain financing for new projects and only projects that have contracts in place are financed.

Evaluating MLPs

How are MLPs valued?

MLPs are valued based on cash flows like all infrastructure investments. Investors focus on distributable cash flow (DCF), distribution coverage and yield when analyzing MLPs. DCF equals *EBITDA less Maintenance Capex less Interest Expense.* Distribution coverage is the *DCF divided by cash distribution*. Yield is calculated by *dividing annualized distribution by current share price*. Investors award premium valuations to MLPs with the highest quality and fastest growing distributions.

Are MLPs expensive?

MLPs are not expensive. Yorkville's Liquid MLP Index has a yield spread of approximately 500 bps over treasuries well above the historical MLP average of 330 bps. Similarly, the Yorkville Liquid MLP Index has a current spread of 200 bps to BBB bonds, compared to a 10-year average of 70 bps. The index also offers 330 bps spread over REITs with higher quality income. REITs cut their dividends by almost 50% in 2009 and have yet to return 2008 distribution levels. The Liquid MLP Index distributions ticked down slightly in 2009 and have since reached new highs. The current yield on the strategy of 6.7% is further proof that fundamental have kept pace with total returns.

What drives MLP fundamentals?

Strong and consistent distribution growth is the cornerstone of the MLP investment thesis. Price returns are tied to strong fundamentals across market and economic cycles. Future distribution growth will be fueled by the $250 - $300B of infrastructure investment needed to develop unconventional shale reserves. This distribution growth will be the driver of further capital appreciation.

How can investors estimate total returns of MLPs?

Total returns are estimated by adding current yield and distribution growth rates. Yorkville estimates that MLPs may deliver 6% current yields with 6% distribution growth rates for an estimated total return of approximately 12%. Growth will be driven by the development of unconventional shale reserves.

Investing in MLPs

How does the Yorkville Liquid MLP Index work?

Yorkville's Liquid MLP Index is designed to provide investors with smart exposure to the largest and most liquid MLPs. Yorkville's portfolio management and research team monitors the fundamentals of portfolio constituents daily so that we can act proactively to preserve capital if a special event is triggered. The portfolio is rebalanced quarterly. The index is liquidity weighted to facilitate institutional trading volumes.

How can investors access the Yorkville Liquid MLP Index?

Investors may gain exposure to the Yorkville Liquid MLP Index through various access products, including, but not limited to certificates and swaps. Yorkville may also assist in finding access solutions for non US investors who would face regulatory or tax constraints if they invested directly into MLPs.

Can Yorkville create a bespoke MLP investment solution?

Yes. Yorkville's investment team has been actively managing MLP portfolios for over twenty years. Yorkville will work with institutional investors to understand their unique investment objectives. We will leverage our industry leading knowledge to construct a bespoke MLP investment solution to meet these objectives.

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