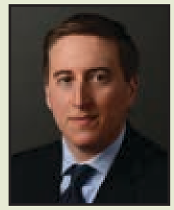
Cohen & Steers

Energy MLPs recovering from ‘perfect storm’

Recently, **Jonathan A. Schein,** senior vice president, managing director of global business development for Institutional Real Estate, Inc., spoke with **Tyler Rosenlicht,** senior vice president and a portfolio manager for Cohen & Steers’ infrastructure portfolios, with an emphasis on MLP and Midstream Energy strategies. The following is an excerpt of that conversation.



Tyler Rosenlicht is a senior vice president and portfolio manager for Cohen & Steers’ infrastructure portfolios, with an emphasis on MLP and Midstream Energy strategies. He has nine years of investment experience. Prior to joining the firm in 2012, Mr. Rosenlicht was an investment banking associate with Keefe, Bruyette & Woods and an investment banking analyst with Wachovia Securities.

MLPs have had a challenging several years. What happened?

MLPs have underperformed the broad market pretty dramatically since late 2014. To understand the sell-off, let’s go back to what the market looked like before the downturn. From 2010 to 2014, there were strong fundamentals for North American energy and midstream businesses, along with high, stable energy prices. The shale renaissance was in full force, driving production growth in North America. Pipeline capacity was tight, and midstream companies had unconstrained access to capital because these businesses were *en vogue*.

So what changed?

At the end of 2014, the crude oil market had become somewhat oversupplied with rising inventories, driving OPEC [Organization of the Petroleum Exporting Countries] to shift from a policy of maintaining stable prices to one of maximizing market share. In doing so, they flooded the global crude oil markets, driving steep declines and increasing volatility for the commodity. This had a secondary derivative impact on midstream companies.

For the most part, midstream energy businesses generate fee-based cash flows that are only marginally impacted by changes in commodity prices. Simplistically, if I own a pipeline and I charge $1 a barrel, I’m going to get $1 if oil prices are $80, and I am going to get $1 if oil prices are $30. But what many people missed is the importance of volumes in that equation, because if oil prices go down and less energy is produced, there will be less energy moving through pipeline systems, which will potentially impair cash flows. So in late 2014, the sell-off in oil caused a huge slowdown in energy production for North America. That came at a time when a lot of new pipeline projects were being completed, so you had a big increase in pipeline supply with a big decrease in pipeline demand. This quickly led to weak midstream asset utilization, rising spare capacity and pressured balance sheets and distribution payouts.

After that precipitous fall, are midstream fundamentals getting better? If so, what is behind that improvement?

Remember, these are fee-for-service businesses. They get fixed fees to move energy volumes through the pipeline system. That means there are only four things I really care about driving fundamentals: (1) **Domestic production.** How much energy is being produced in North America, which in turn pushes energy into the pipeline system. (2) **Domestic energy consumption.** If North America uses a lot of energy, that is going to pull energy commodities through the pipeline system. (3) **U.S. energy exports.** The more energy being exported, the more volume you get through the pipeline system as those energy molecules are sent to foreign markets.

If you add those up, in my opinion, the demand for pipelines is pretty simple: It’s domestic production, domestic consumption and exports. In 2015–2016, production declined, domestic consumption was flat, and exports were just beginning. But starting in late 2016 — and more so over the last 12 months as oil prices moved well above $50 per barrel — we’ve seen strong production growth that we think is going to continue. We have also seen strong domestic consumption — vehicle miles travelled are up, more people are flying, and billions are being invested in industrial and petrochemical facilities in the Gulf Coast. And U.S. energy exports remain a real bright spot as infrastructure is built.

You mentioned three things. What is the fourth?

Number four is the **supply of pipelines.** The industry has been building a lot of new midstream assets over the past five years, but we expect to see a slowdown in new projects in 2019. If you fast-forward two years from now, we expect to see strong demand for pipelines at a time when companies are not building as much new capacity. Filling up all of these midstream assets could drive improved cash flows. In my view, that could drive performance for the asset class. It has been a painful down cycle, but, when you look at the supply/demand drivers for the asset class, they are actually quite positive today, and we think it will remain that way for a while.

There seems to be confusion around the connection between MLPs and oil prices. Can you explain how they are correlated?

It is important to separate out what drives long-term asset returns and what drives shorter term correlations. Over the last 10 years, MLPs have had a 0.4 correlation to crude oil prices. But that misses the fact that correlations have been exceptionally low in some periods, and exceptionally high in other periods. In our view, the best explanation for this has to do with the linkage between MLP correlations to oil and oil volatility.

Can you elaborate?

When oil price volatility has been high, MLP correlations to oil have been high; when oil volatility has been low, MLP correlations to oil have been low. What drives midstream energy business is volume, so what I care about as a midstream investor is the ability to predict volumes, which helps predict cash flows. If you are in a high-oil-volatility regime — let’s say oil prices are averaging $50 but bouncing between $25 and $75 per barrel — your ability to accurately predict U.S. E&P activity, rig counts, U.S. energy volumes and MLP cash flows is going to be fairly low. You are going to constantly be revising your models, so you would expect to see MLPs trade with a higher correlation to energy prices. Now take the reverse scenario — oil prices are in a low-volatility regime where they bounce between $45 and $55. You can have a lot of confidence in your ability to predict energy volumes and pipeline demand. In 2016–2017, oil volatility was high, which meant high correlations for MLPs and oil prices in the short term. That has reversed over the last 12 months, and oil volatility is now relatively low. That could help reduce the MLP correlation to crude oil.

Are there any geopolitical risks involved, since we are talking about oil on the global stage?

When investing in midstream energy companies, you can't take a narrow view on just pipelines assets in the Permian, for example. You have to start with global energy markets, because I believe that's what drives energy prices, which dictates E&P activity, which drives volume — and volume drives pipelines' cash flows. If you go back 24 months, OPEC was focused on growing market share, oil prices were in freefall, and there was not a lot of confidence in the need for U.S. shale, so the macro picture was a little murky. Today, we think global oil supply and demand is fairly balanced. Supply declines in some of the higher cost regions like offshore are starting to accelerate. Global demand is strong, and we expect OPEC will generally remain disciplined and abide by their recent cuts. That should create a more stable oil price environment and require less shale growth. Given where we are in the global oil cycle, we believe there is more upside risk to oil prices from geopolitics than there is downside risk.

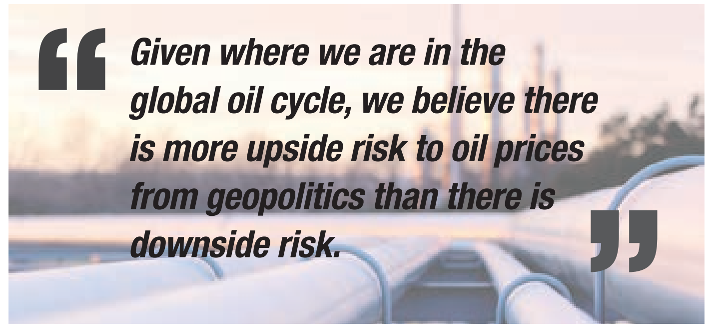
You recently published a paper on the shift to MLP 2.0. How are midstream business models changing?

The MLP business model has evolved quite a bit in the last 24 months because the market has required some significant changes. We think of the 1.0 MLP model as the types of companies in place from the early 2000s through 2015. This model had some unique features: two separate share classes, weak governance, and an incentive structure that encouraged empire building and distributing as much cash as possible. Most MLPs maximized distributions paid and distribution growth, minimized coverage, tolerated high leverage, and accumulated assets. That model was highly successful when companies had unconstrained access to capital markets. But when they lost the ability to fund activities via capital markets, it created a downward spiral.

Thankfully, in the course of this three-year down cycle, companies have started to adapt to what we call the MLP 2.0 model. This model starts with merging the limited partner and the general partner into one business, which removes the dual share classes and centralizes the board of directors around one set of investors. That often results in better corporate governance. You also remove incentive distribution rights — or IDRs — thereby changing the incentive structure from being focused solely on cash distributed, to an ability to think more about returns on invested capital. MLP 2.0 companies want to set sustainable distributions and grow those distributions prudently. They generally seek to retain more cash flow to fund their businesses. In MLP 2.0, management teams can sell assets, which was not really possible in the prior model. We believe they are going to be much more stable because they are less reliant on the capital markets. We think this is a healthy transition for the asset class, particularly because it comes with much better corporate governance.

What is your view of MLP valuations now?

MLP EBITDA [earnings before interest, taxes, depreciation, and amortization] multiples are close to all-time lows, and distribution yields are close to all-time highs. What we are more focused on, though, is the disconnect between the public and private markets. Private equity investors are generally buying U.S. midstream assets at 13 to 14 times cash flows, whereas publicly traded midstream companies are trading at 10 times cash flows. This means that we think listed midstream companies are trading at roughly 85 cents on the dollar, relative to what their assets would likely fetch in the private market. We don't see this type of discounted relationship in the MLP space very often — MLPs have typically traded at



premiums to their net asset values — but we are seeing it today. If these discounts continue, we could expect more private equity capital to migrate into the midstream universe on the asset level. Increasingly, we expect to see some privatizations of midstream businesses because there is lot of private equity capital sitting on the sidelines looking to get invested, and this is an asset class that appears disconnected from intrinsic values.

How does the recent FERC proposal affect your view of the MLP sector?

The ruling in March by the Federal Energy Regulatory Commission, or FERC, to remove the deferred tax allowance when calculating rates for cost-of-service pipeline assets took the entire industry by surprise. But while it presents a risk for some businesses, the impact should be negligible for most. The FERC announcement was definitely a big policy shift, as it changes 20 years of precedent policy and adds an element of regulatory uncertainty to the asset class. But when you look at the numbers, we think the potential headwind is manageable. We see a cumulative impact of about –2.5 percent EBITDA between now and 2021 for the average company. However, it's important to note the impact isn't uniform. Most MLPs are likely to face a headwind of a half a percent or less, while others may face 15 percent EBITDA degradation from the FERC ruling.

CORPORATE OVERVIEW

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