

MLP Investing:

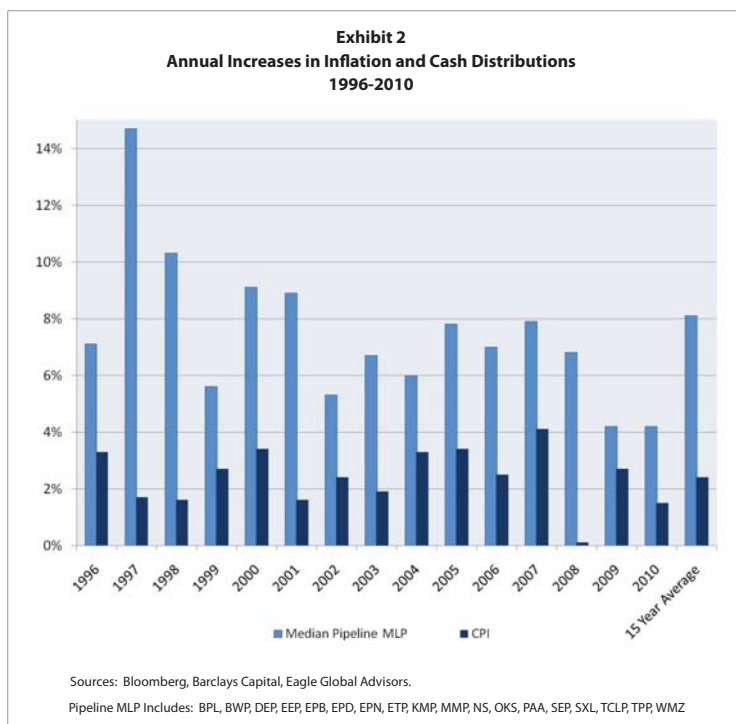
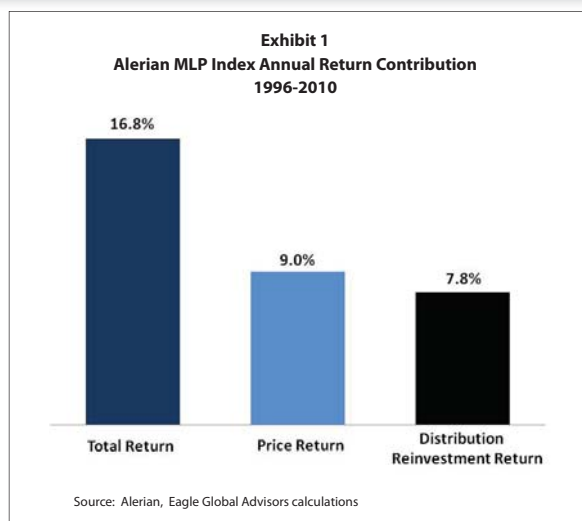
Distribution Cuts Tie to Specific Business Risks

Malcom Day, Partner

Curt Pabst, Managing Director

Energy Infrastructure Master Limited Partnerships (MLPs) engage in businesses that provide robust, stable and predictable cash flows and typically pay a substantial portion of that cash flow to investors. As shown in Exhibit 1, since 1996, nearly half of the 16.8% annual return of the Alerian MLP index has come from reinvesting distributions.

MLPs offer both high current income and growth. Because distributions drive almost half of the total return, it is important for investors to understand the effect that distribution cuts can have on individual MLP returns, and some risk factors that are associated with higher risk of distribution cuts and eliminations.

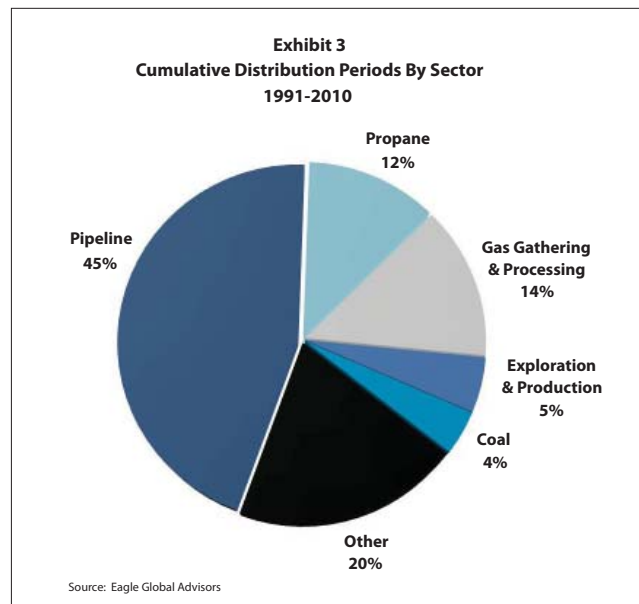


Unfixed Income

MLPs are sometimes referred to as providing “unfixed income”, meaning the payments are not fixed, but can grow or shrink over time. The median pipeline MLP has increased its annual distribution by over 8% per year since 1996. This steady distribution growth has come from a combination of accretive asset acquisitions, a steady diet of organic growth as the sources of energy supply in the U.S. continue to shift and evolve, and some built-in inflation adjusted pricing. As seen in Exhibit 2, average MLP distribution growth has materially outpaced inflation.

However, there is a potential downside to owning unfixed income. While many MLPs engage in “toll road” businesses, collecting fees for services provided without taking ownership of the physical commodity, others accept commodity price risk as part of their business. Exhibit 3 illustrates different types of MLPs. Not all MLPs are “toll roads”.

Exploration and Production (E&P) MLPs in particular have revenues that are sensitive to the changing prices of commodities. Coal mining MLPs also have revenues tied to commodity prices, although contract terms are typically longer, while MLPs that gather and process natural gas have varying degrees of exposure to the price of the liquids that are removed from the natural gas.



Corporate Bond Analogy

Overall, MLPs aim to pay distributions that attempt to rival bonds in reliability, stability, and yield. Typically, when a bond defaults, its investors suffer a serious loss of value. For MLPs, the most similar event is a significant cut or elimination in the quarterly distribution. Just as bonds with different credit ratings tend to experience different levels of default (i.e. a bond rated Ba has historically been much more likely to default than a bond rated Aaa), MLPs with different business models have experienced different distribution failure rates. For this reason it is worthwhile to determine which MLPs offer stable cash flow with the potential to grow, and which ones pose a higher risk of distribution cuts or possibly even elimination of distributions altogether.

Study Methodology

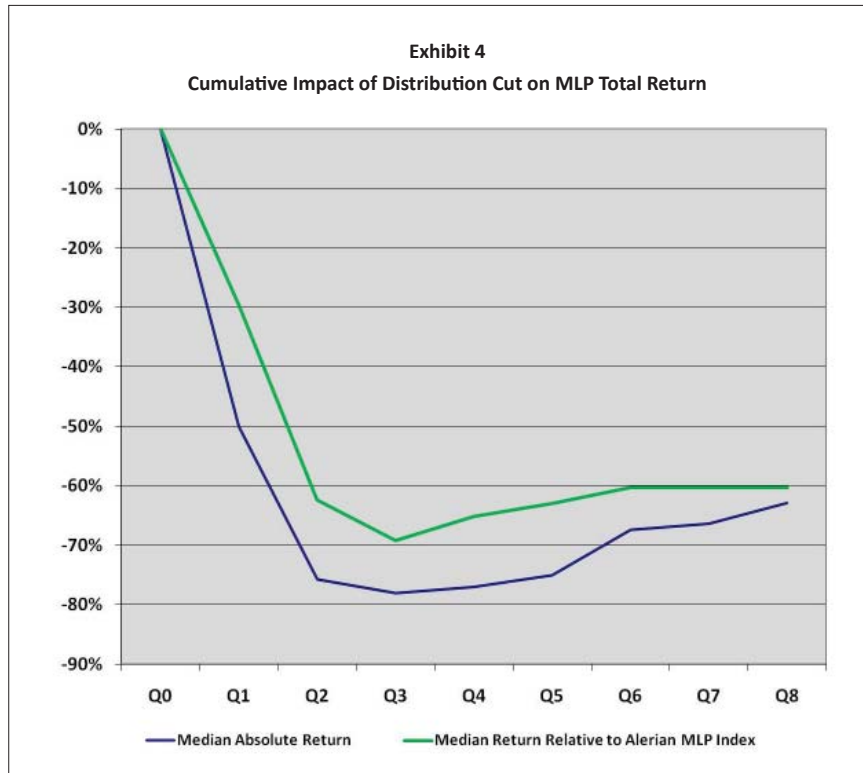
To study the frequency of distribution cuts and eliminations Eagle Global Advisors analyzed all distribution payments and omissions by MLPs from 1991 through 2010. The universe of MLPs chosen for the study includes MLPs that seek to pay a stable distribution, and excludes those who seek to make variable distributions (as do some E&P MLPs). It includes those that have been publicly traded and have made a distribution payment during the evaluation period of 1991-2010. There are 74 MLPs that meet the criteria.

Small distribution cuts, though important, are overshadowed by distribution cuts of 40% or more from the highest declared value. Therefore in the study, cuts of 40% or more have been identified as “distribution failures.” Distributions that were increased, held steady, or cut less than 40% are defined as “successes”.

The distribution failure rate is the number of failures divided by the number of failures plus the number of successes. A Numerical Example: MLP “A” made three distributions after inception and then eliminated its distribution for the fourth quarter. MLP “B” made six distributions after inception, and has never cut its distribution by 40% or more. These two MLPs as a group would have a failure rate of 10% (one quarter with a failure and nine quarters without failure; $1/(1+9)=10\%$).

The Impact of Distribution Failures

During the examination period, there were a total of 33 distribution failures, and 2085 distribution successes (increase or no change in the distribution). Although the incidence of failure is small, the results were catastrophic for investors, as seen in Exhibit 4. The median MLP that cut its distribution declined by close to 80% on an absolute basis and over 60% relative to the benchmark Alerian MLP Index during the two quarters following the last distribution. The absolute and relative loss of value after eight quarters remained stubbornly high at -65% and -60%, respectively.



Causes of MLP Distribution Failures

Bond investors can utilize a credit rating from a rating agency to help identify higher risk securities. Although no panacea, there is no doubt that lower rated corporate bonds have a higher incidence of default than those with higher ratings from the agencies. MLP equity investors have no such ratings to rely upon.

Eagle has identified three criteria that highlight those MLPs with the lowest risk of distribution failures:

- Stable, fee-based revenues
- Minimal commodity price exposure
- Investment grade debt ratings

Stable, Fee-Based Businesses

As noted earlier, many MLPs have stable, fee-based businesses. These include natural gas pipelines, natural gas storage facilities, and refined products pipelines, among others. Since 1991, the incidence of non fee-based businesses cutting or eliminating distributions is roughly eight times higher than for stable, fee based businesses.

Business Model	Failure Rate
Stable, Fee-Based Businesses	0.2%
Non Fee-Based Businesses	1.6%

Minimal Commodity Price Exposure

MLPs with commodity price exposure, even when hedged, still experienced six times the distribution failure rate as those with no commodity price exposure. Additionally, numerous E&P MLP distribution failures occurred in the 1980's prior to the study period.

Business Model	Failure Rate
Minimal or No Commodity Price Exposure	0.5%
Commodity Price Exposure (inc. hedged)	2.9%

Investment Grade Debt Ratings

No MLP with investment grade debt ratings cut or eliminated its distribution during the examination period, versus a 1.5% incidence for MLPs with below investment grade or unrated debt.

Business Model	Failure Rate
Investment Grade Rated Debt	0.0%
Non-Investment Grade (including unrated)	1.5%

Summary

MLPs have offered investors outstanding total return for over twenty years with the potential for more to come through a combination of high current income and growth. Owning cash flows that grow over time has proved a winning investment formula. However, not all MLPs offer the same level of stability and predictably of current income or growth, and the impact when distributions are materially cut are catastrophic to investment values. Investors who are attracted to the core value proposition of MLPs—income and stability-- will most likely benefit from taking a high quality investment approach to building a portfolio.

For more information on Master Limited Partnerships, please contact:

Curt Pabst, Managing Director, Eagle Global Advisors, LLC
713-952-3550 or cpabst@eagleglobal.com