EGA Energy MLPs and Midstream Companies

From the EGA Portfolio Management Team

Out With The Old, In With The New

In March 1886 The Buckeye Pipe Line Company was incorporated as a subsidiary of the Standard Oil Company (yes, that Standard Oil). After 100 years of spinoffs, mergers, and expansions the company was reorganized as Buckeye Partners (BPL) in December 1986 as one of the first publicly-traded master limited partnerships following the passage of the "Tax Reform Act of 1986". It was Buckeye that others emulated early on as the MLP sector grew into the market force it is today. It was therefore notable when on May 10th Buckeye management announced an agreement with the IFM Global Infrastructure Fund to take the company private. The grandfather of MLPs was bowing out of the public market.

Only 12 days later on May 22nd Rattler Midstream (RTLR) priced its $765 million initial public offering, a deal that was upsized due to excess demand. Rattler was the first Midstream IPO since October 2017 (BPMP), ending an 18-month drought in Midstream IPOs. Notably, Rattler Midstream has no incentive distribution rights (IDRs) and will issue a 1099 (not a K-1). Midstream 2.0 had its first IPO and it was a resounding success.


Out With The Old ...

12,000,000 LP Units
Representing Limited Partnership Interests

1277

Buckeye Partners, L.P.

LP Units representing limited partnership interests in Buckeye Partners, L.P., a Delaware limited ...rtnership, are being offered hereby. The Partnership was recently formed to purchase substantially ... of The Penn Central Corporation's interests in Buckeye Pipe Line Company, L.P. and certain ...lated entities. The Partnership will use the net proceeds from the sale of the LP Units ...

... In With The New

Rattler Midstream LP

38,000,000 Common Units

Representing Limited Partner Interests

Source: Buckeye Partners, SEC

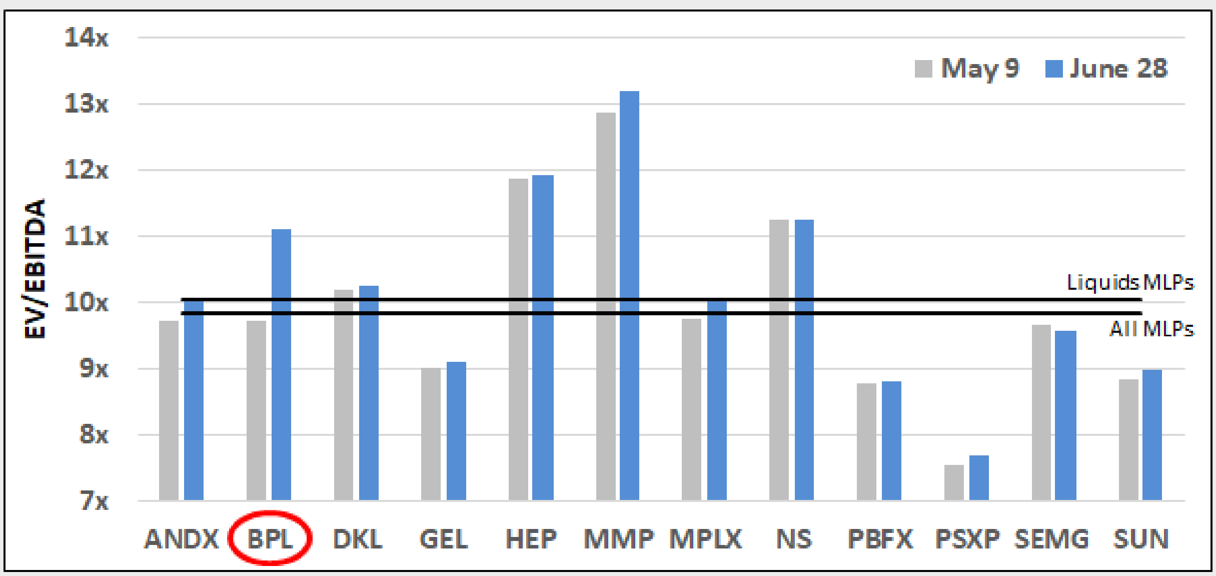
Buckeye: The Price Is Right!

It seems so straightforward. Company A offers a 27.5% premium to buy Company B, and Company B accepts. For Buckeye and MLPs these days, nothing is ever really that simple.

Six months prior to the privatization announcement, Buckeye completed an all-encompassing "strategic review" in which all options were on the table. Repeated often was the importance of maintaining its investment grade credit rating, and the outcome was a 41% distribution cut and $1.5 billion in assets sales. At the time, the strategic review resulted in an outcome that caused pain for equity investors to the benefit of credit investors. Nonetheless, management had taken the hard steps needed to right the ship and Buckeye was entering 2019 with a relatively clean slate and a brighter future.

Enter IFM, an asset manager backed by Australian pension funds. Aided by the availability of cheap capital, IFM offered a 27.5% premium to take out Buckeye. This time, equity investors rejoiced at the expense of investment grade credit investors that will see their holdings downgraded to high yield by the ratings agencies. Other high level takeaways from the deal include:

(1) The private market is valuing assets materially higher than the public market. At a 27.5% premium to its prior day close, IFM clearly valued BPL's cash flow stream higher than the public market. On EV/EBITDA Buckeye was trading at a slight discount to other Liquids MLPs and All MLPs just prior to the announcement, implying BPL was at or near fair value in the public market. Post-announcement, BPL's EV/EBITDA jumped into the top quartile. The Alerian MLP Index rose 3.9% (S&P 500: +0.4%) the day of BPL's announcement, likely driven by investor optimism that the IFM-BPL deal may become a catalyst to close the public-private valuation gap.

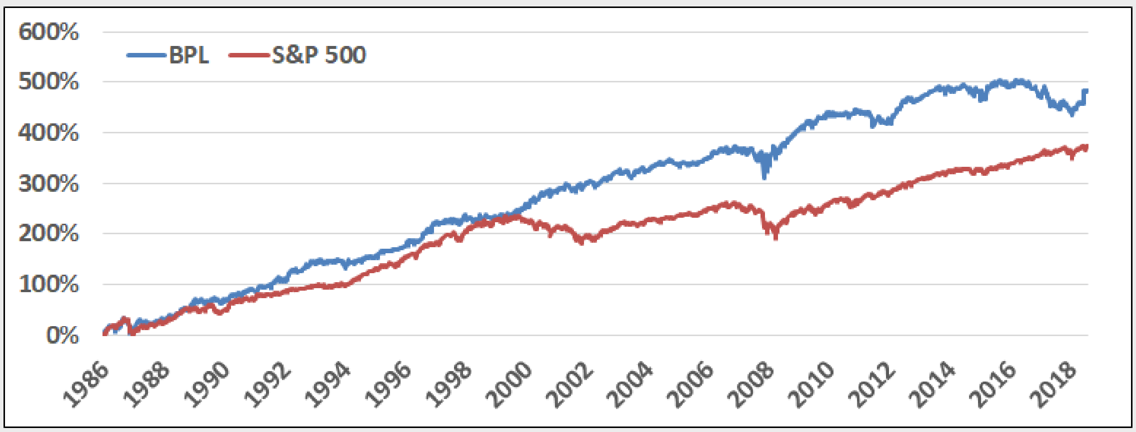


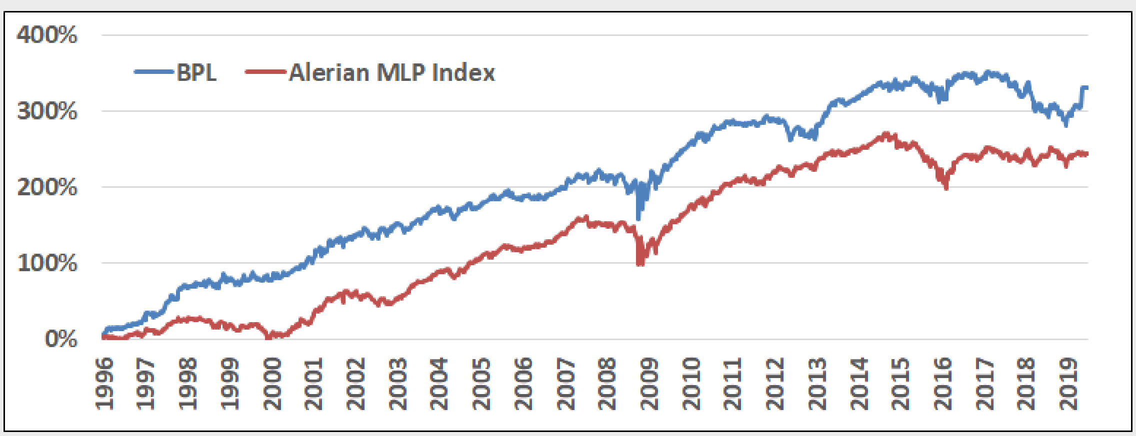
Source: Eagle Global Advisors, Company Data

(2) Foreign investors value hard assets and income, and are influencing domestic markets. It takes a company headquartered 9,000 miles away from Houston (in Melbourne Australia) to recognize the value in the cash flow streams of oil and natural gas infrastructure. Bear in mind this is a country that instituted and repealed a carbon tax not too long ago and has sizable natural gas deposits of its own. In a world of near-zero interest rates, income generating assets are king. We see a possibility that other investors will also appreciate the stable cash flow streams the Midstream sector affords. Perhaps they'll even be closer than Australia.

(3) Management is less patient to let the market work. Perhaps the most shocking part of BPL's sale to IFM was the small amount of time since the conclusion of its "strategic review". Perhaps BPL stock hadn't rebounded as much as management had expected, or perhaps management grew impatient telling its story to skeptical investors.

BPL outperformed both the S&P 500 Index and the Alerian MLP Index over its lengthy history. While BPL outperformed each index over its life span, they had more recently been an underperformer. So, it's not hard to see why privatization occurred, though what's frustrating is the company had taken the necessary steps to right the ship and public investors will not be able to fully participate in the recovery. These are interesting times.





Source: Bloomberg

Rattler: Midstream 2.0 Gives Birth To A Healthy IPO

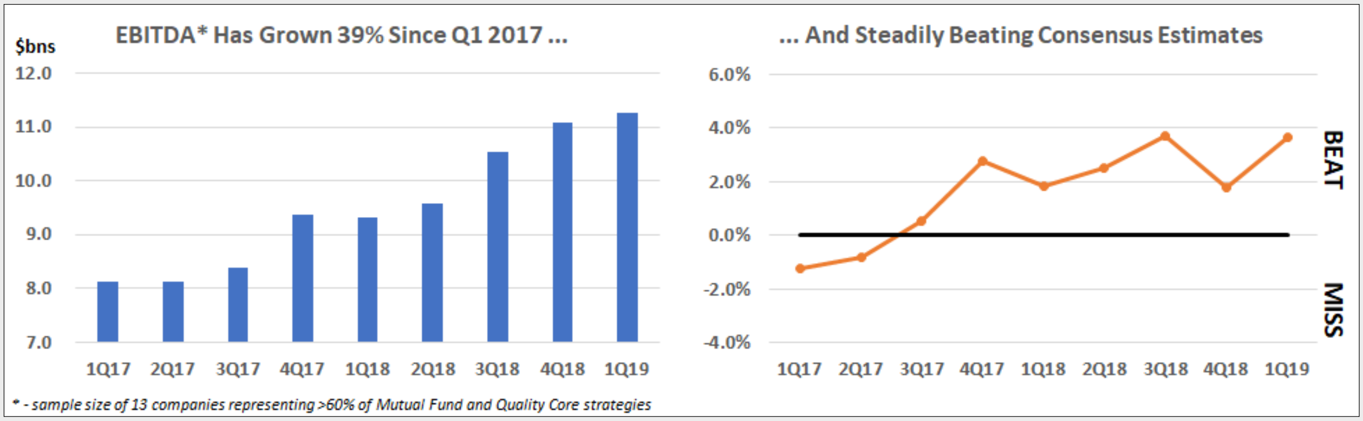
On May 22nd Rattler Midstream (RTLR) priced its initial public offering and became the first Midstream IPO since October 2017 (BPMP). We believe a major factor in the strong demand was Rattler's structure, specifically the absence of incentive distribution rights (IDRs) and a corporate structure that will have the company issue a 1099, not a K-1. In other words, the bankers gave investors what they wanted.

We believe Rattler's structure as a Corporation also resonates with today's investors. While Rattler is a limited partnership, they've elected to be treated as a corporation for U.S. federal income tax purposes and will therefore issue a more investor friendly 1099. Among the limitations to this setup as a hybrid partnership/corporation is they are not allowed to be included in major indices, which removes a significant potential technical tailwind. However, many of the tax benefits remain when compared to a MLP and, separately, its 1099 structure opens up Rattler to a wider pool of investors. We're less convinced of these arguments, partly due to the one-time nature of index inclusion and because over the long-term there seems to be minimal stock price performance benefit of a Corporation over a MLP. We also highlight at some point Corporations will begin paying federal income taxes, and a MLP will never have to (absent a change in law). This may not be a large consideration for many of the recently converted Corporations that have a large tax shield, but this shield will eventually disappear and then Corporations will find themselves at a cost of capital disadvantage to MLPs that can't be explained away by the higher liquidity of a Corporation's stock.

Finally, it's worth mentioning that in addition to crude oil and natural gas gathering assets Rattler generates substantial cash flow from water-related infrastructure, from both the delivery of freshwater that is used to fracture new wells and the disposal of saltwater from producing wells. While freshwater delivery is sensitive to drilling activity, saltwater disposal cash flow streams are cyclically consistent with oil and natural gas production. To put it in perspective, Rattler writes in their IPO prospectus "the average well produces 4 to 6 barrels of water for every one barrel of crude oil while the average Midland Basin well produces 1 to 2 barrels of water for every one barrel of crude oil." Put another way, the law requires a company safely dispose of saltwater if you want to produce oil and natural gas. So, the definition of what constitutes "Midstream infrastructure" is expanding, creating more opportunity for our companies.

A Few Final Thoughts...

Another quarter, another EBITDA beat. We reviewed 13 companies that represent a majority of our portfolio strategies to see how they're performing versus Wall Street expectations. Over the last nine quarters EBITDA has grown 39% while beating the Street's consensus estimates for seven consecutive quarters (see below charts). Despite analyst expectations that aggregate EBITDA among this sample would decline 2% sequentially, these companies actually posted 2% sequential growth. We are encouraged by the ability of management teams to deliver on EBITDA growth expectations, which goes a long way toward accomplishing de-leveraging strategies and rebuilding investor confidence in the sector.



Source: Bloomberg, Company Data

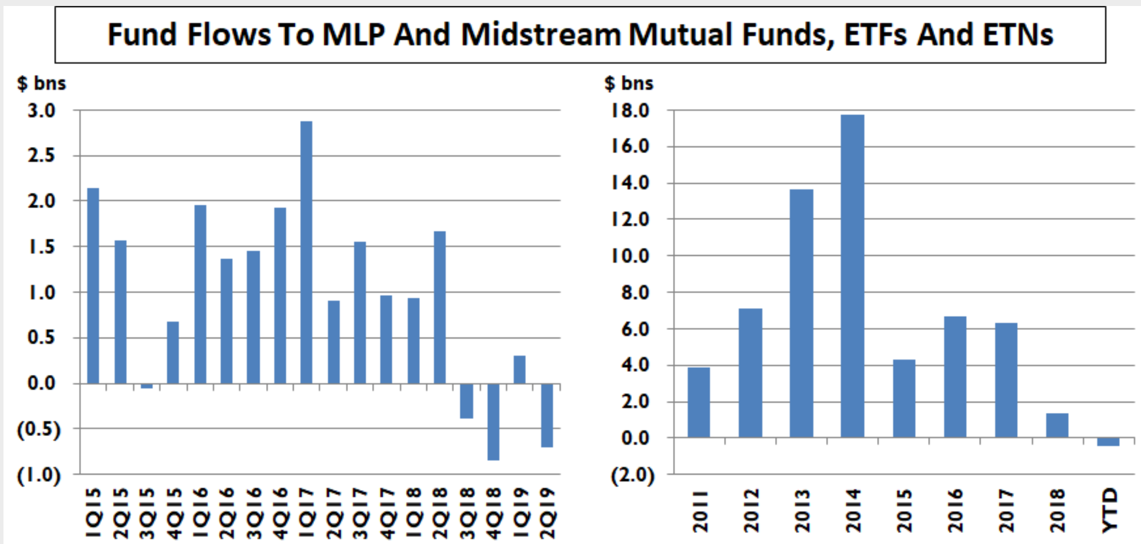
Overcoming the hurdle of relevance. While we primarily cover oil and natural gas infrastructure stocks, we also analyze and invest in green infrastructure stocks given similar characteristics and a desire to understand all forms of energy. Within that context (not just for the free lunch), we attended the Nextera Energy (NEE) analyst conference on June 20th. Nextera Energy is the world's largest producer of wind and solar energy. In our last Quarterly Commentary we discussed the misperception on Main Street about the relevance of oil and natural gas. With that in mind we thought CEO Jim Robo's comments during the Q&A on natural gas infrastructure is worth passing along.

Question: How are you thinking about natural gas in the context of everything else that you're doing?

Jim Robo (NEE CEO): "So the thing that mystifies me, like for example the opposition to the East Coast pipelines MVP and ACP, the piece of it that mystifies me, and this is coming from the largest owner of renewables in the world, the thing that mystifies me is these pipelines are enabling shutting coal plants down. Enabling 30%, 40%, 50% reductions in those states of CO2 emissions, and so it is a complete head scratcher for me. Natural gas is going to be an important part of the equation for a long time. This country has literally hundreds and hundreds and hundreds of years of natural gas. Remember there is still a ton of fuel oil that's burned in the Northeast that can be replaced by natural gas, that would be a huge CO2 improvement. You still need natural gas for heating in a lot of places. The opposition to it honestly mystifies me. I guess folks want to be cold in the winter and burn a lot of coal. I think it is really misguided. But it's real. It's real. Hopefully we're going to be able to start to have a more rational discussion about energy policy in this country. Energy policy has been very polarizing."

Capital Flows And Access To Capital

Capital flows remain weak. April, May, and June experienced capital outflows of $490 million, $124 million, and $61 million, which after adding the outflow from March means the sector has seen negative flows over four consecutive months. The silver lining is the Alerian Index was flat (+0.1%) in the second quarter and is still up 17% year-to-date, despite what has clearly been consistent downward pressure. We reiterate this is evidence that Midstream 2.0 and the self-funding model has a strong foothold in the sector, and is unlikely to go away. We also believe that even the slightest tailwind in capital flows could drive an outsized rally in the absence of any company-directed capital formation.



As of 6/30/2019 Source: US Capital Advisors

However, there were signs of life in capital markets as the RTLR IPO wasn't the only Midstream company to access capital markets during the quarter. PBF Logistics (PBFX) successfully placed a follow-on offering that despite the stock's low liquidity was discounted only 4% from the prior day's close. Meanwhile, there were a pair of secondary offerings that saw $600 million change hands (PAA/PAGP: $352 million, AM: $247 million) and $1.56 billion of preferred equity placements (CEQP: $235 million, ET: $700 million, ALTM: $625 million).

MLP Team Update

There were no significant team related news items to highlight this quarter. We continue to focus on the research and portfolio execution effort and are in constant dialogue with industry experts and management teams. We attended multiple major Midstream conferences over all three months of the second quarter, and saw sentiment deteriorate along with the recent 18% correction in oil prices. While Midstream fared materially better than more cyclical sectors (ie, E&Ps and Oil Services), there remains a dark cloud over sentiment that is encouraging both investors and management teams to emphasize a cautious approach. Not surprisingly, we reiterate our cautious optimism on 2019 as the sector's structural upgrades position it to benefit from the world's increasing appetite for energy infrastructure.

We thank you for your continued patronage of Eagle Global Advisors. We believe the long-term return outlook for Midstream remains attractive, and we look forward to communicating the results of your investment in an Eagle managed account next quarter.

- The Eagle MLP Team