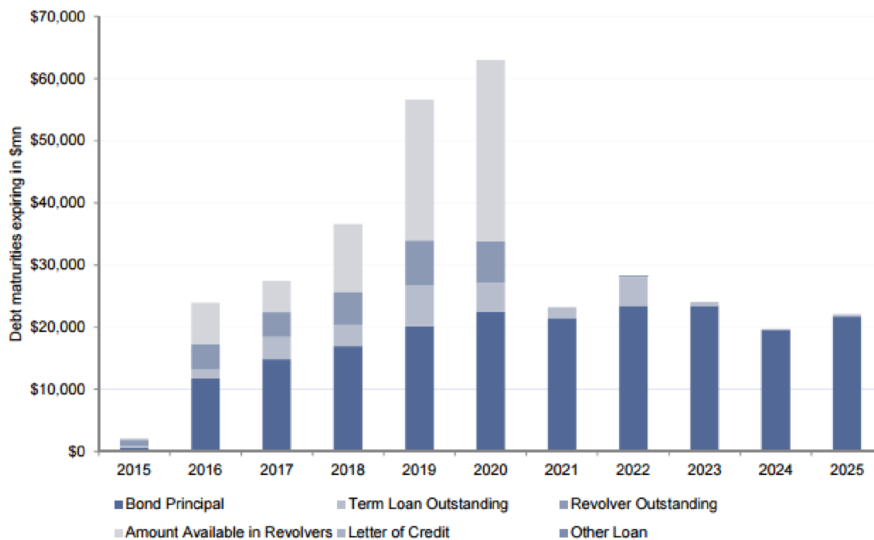
**Master Limited Partnerships: A Prediction for Their Recovery**

Energy master limited partnerships (MLPs) took it on the chin in 2015 as the underlying commodity, crude oil, experienced yet another year of abysmal performance. For the calendar year, crude oil lost 37% amidst the current and now second longest peak to trough market cycle in recent history (as of year-end it was a 530 day old cycle), while the average MLP index lost approximately 32%. Those with the weakest performance for the year were exploration and development MLPs, while variable pay and refining focused MLPs posted stronger relative results. Obviously the biggest beneficiary of the energy market meltdown has been the U.S. consumer, but despite today's market sentiment for limited partnerships, for many in the midstream space, the underlying fundamentals are not as dire as they appear, while their debt maturity timeline seems manageable for the next few years (chart 1). Moving into 2016, we are of the opinion that if, at the least, the price of oil stabilizes in the mid/high-$30s, likely during the second half of the year, high quality midstream MLPs ought to produce positive performance given that they tend to act as a levered play on the price of oil at certain price points.

Chart 1

**Exhibit 6: Debt maturities look reasonable for the sector over the next 12-18 months**
Debt maturities coming due by year and type of debt, 2015-2025



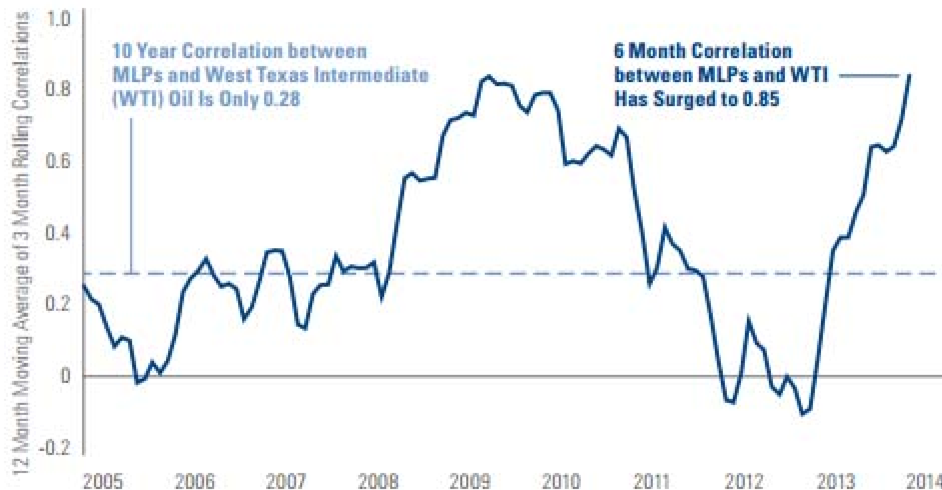

*Source: Goldman Sachs Global Investment Research, Bloomberg.*

To begin, we'd like to clarify what we mean by an MLP's relationship to oil at certain price levels. As is standard, MLPs employ leverage or in other words resort to borrowing in order to fund current and future projects. In a normal trading environment, the MLP "toll-road" business model has little commodity price exposure and historically has acted independently of oil prices, but in highly stressed environments, their correlation to the price of oil tends to increase as the two move in tandem (chart 2). At today's oil prices it's clear investors have grouped the two together, which we interpret to mean that once the market

believes the price of oil has stabilized, MLPs should experience a performance reversal given their slightly riskier investment profile due to the aforementioned leverage levels.

Chart 2

**Correlation of MLPs v. The Price of Oil**



Source: Bloomberg and GSAM.

Another point and argument for a strengthening MLP market relates to their cash flow levels. In general, the cash flow for many MLPs remained undisturbed over the last year and additionally, over the last three years approximately $100 billion has been invested in projects that continue to ramp up, resulting in cash flow growth. As we know, oil prices are low today due to oversupply, which in general should not affect its involvement with MLP pipelines. Yes, it is the case that MLP operators traditionally pay out most of their operating cash flow in the form of distributions, while, as mentioned above, project funding comes from debt and equity issuance. Therefore, if MLPs are no longer able to access funding to support project growth, they may be forced to either slow their growth trajectory or bring down investor distributions, in turn reducing their investment appeal. It is our belief that though some lower quality MLPs may in fact run into such problems, for those higher quality securities, we believe aside from the traditional options, funding from counterparts such an associated GP, a PIPE (private investment in public equity) or even a private equity relationship is available. Thus, for well-managed, midstream MLPs, cash flows should remain intact and inline, as should their debt levels and distribution coverage ratios. Additionally, for those pipelines transporting refined product, lower oil prices and subsequently lower gas prices is a benefit as consumer demand strengthens.

In terms of interest rates, in theory a Fed rate rise should negatively affect an MLP's cost to borrow and in turn its share price. That said as a result of where midstream yields and credit spreads currently stand, rising rates present less of a risk to stock performance and debt costs given how much rates would need to increase in order to impact valuations (chart 3). Tortoise Investments conducted a study on MLP returns over twelve different time periods during which the 10-year rose by 50 bps or more since 2000.

What they found was that during these periods MLPs posted 6.4% annually, while the S&P500 returned 6.7% on average.

Chart 3

**Exhibit 11: MLPs vs. 10-Year Treasury & BBB Corporate Bond Yield**

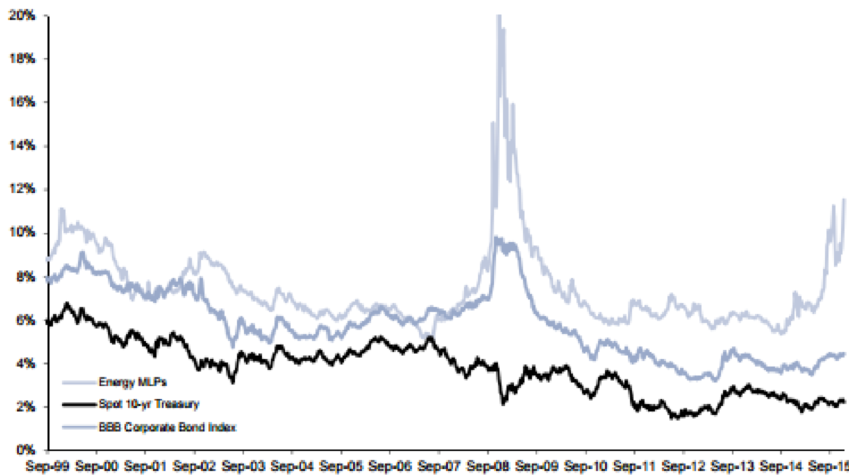
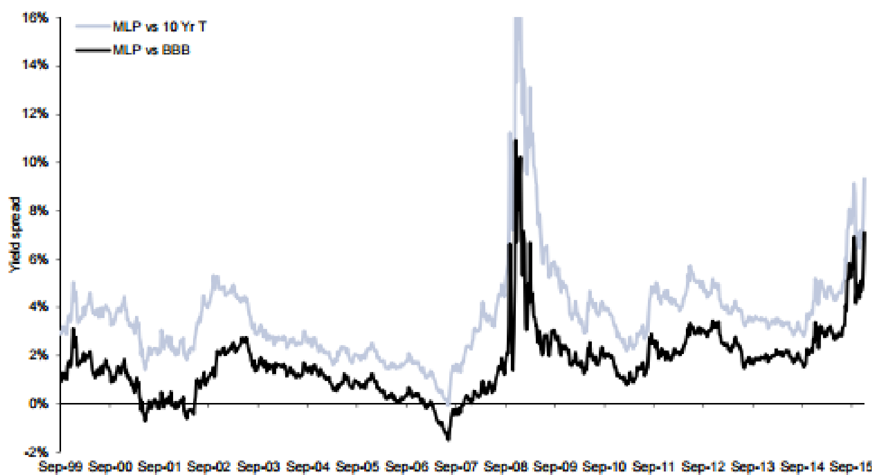



**Exhibit 12: MLPs vs. 10-Year Treasury & BBB Corporate Bond Spreads**




Conversely, though in the above paragraphs we've laid out reasons for why we believe midstream MLPs are better positioned than market consensus and when a buying opportunity may occur, we do have concerns. We remain concerned about the possibility that a further and sustained drop in oil prices could facilitate a scenario in which oil producers are unable to continue to honor their contracts with MLPs. The

possibility that an oil producer reaches a point at which it can no longer meet its agreements, has to renegotiate, or potentially file for bankruptcy is very real.

In conclusion, though we are in the midst of a colossal energy market upheaval supported by the over supplied raw commodity, the strong U.S. dollar and considerable geopolitical influences, we maintain a constructive outlook on high quality, midstream energy MLPs in the second half of 2016. At today's 10% yields across the MLP complex, the indiscriminate valuations lead us to believe that not enough credit is being given to those well managed and positioned MLPs. Once the crude oil market finds its footing and is able to stabilize in the mid-$30s and above, those MLPs with both organic, as well as distribution growth, should see the stabilizing effect translate into higher stock prices and total returns.

Lynx Investment Advisory, LLC 1100 Connecticut Ave., NW Suite 300 Washington, DC 20036