Master Limited Partnerships: 2018 Outlook

Investor sentiment for MLPs and midstream energy companies is turning positive. While 2017 was a difficult year for MLP prices, the outlook has rarely looked better. Crude oil production is closing in on 10 million barrels/day, natural gas production is booming, and new pipeline projects are being developed. The Alerian MLP index bottomed in early December as the sector was the victim of significant tax loss selling, but since the bottom they have bounced back nearly 15% and are poised for further gains. Crude, natural gas, and NGL volume increases will result in "free" cash flow growth for midstream companies with available pipeline capacity. MLPs remain an attractive investment for many reasons including; improving underlying energy fundamentals, valuation metrics towards historical lows, cash flow that is rising, and volume growth in the coming years. MLPs with assets in the low-cost basins such as the Permian and Marcellus will benefit from rapid volume, and cash flow growth as producers focus on those locations. Another tailwind for MLPs is the expected completion of up to seven world-class petrochemical facilities that will significantly boost demand for ethane and propane. After a difficult three years for energy markets, it is a welcome development to have multiple tailwinds at the back of MLPs once again.

	DCM MLP (Net)	Alerian MLP Index	S&P 500
Q1	4.1%	4.0%	6.1%
Q2	-8.7%	-6.4%	3.1%
Q3	-1.6%	-3.0%	4.5%
Q4	0.2%	-0.9%	6.6%
2017	-6.28%	-6.52%	21.83%

What Happened in 2017?

MLPs peaked in late January 2017 and then entered a downtrend until they broke above the trendline in mid-December. The negative performance was driven by too much new MLP equity coming to market, concerns about oil prices, tax-loss selling and uncertainty surrounding the MLP business model. Historically the MLP business model was to fund growth capital expenditures with 50% equity and 50% debt. The market has soured on this model so the MLP companies are adjusting to a new normal. Enterprise Product Partners (EPD) addressed this new normal in the 4th quarter when they announced they were cutting their distribution growth rate from 5% to 2.5% and using the excess capital to develop new growth projects. They have the goal of being self-funded on the equity side of the equation by 2019. We view this as a very positive development for the midstream world as it demonstrates better capital discipline and will increase per/unit earnings in the years to come. This move to the self-funding model and a focus on return on invested capital should attract more institutional capital to the sector.

Another theme that continued to play out in 2017 was the elimination of incentive distributions rights (IDRs). IDRs are rights held by the general partner that entitle the GP to an increasing percentage of excess cash flow as the MLP raises its distribution. By eliminating IDRs, MLPs have a lower cost of capital which makes growth projects more profitable. We expect to see this trend continue in 2018. As the sector waned, some management teams lowered their cost of capital by cutting distributions. Five years ago, the thought of cutting the distribution was a death wish, but as the sector moves towards self-funding, some MLPs that cut distributions have traded up on the news. We believe we are moving out of the phase of distribution cuts and look forward to growth in 2018.

2018 Outlook

We are very excited for 2018. Underlying energy fundamentals are rapidly improving as the oil markets tighten, the global LNG trade is accelerating faster than analysts predicted and U.S energy production will be at all time highs. We believe we are currently seeing a sector rotation into energy as investors look for sectors that have underperformed. Technological advancements in drilling have enabled producers to significantly increase efficiency and decrease break-even costs which gives midstream companies further confidence that volumes will be there even in oil prices stall. We expect to see more consolidation in 2018 as larger MLPs use M&A as a tool to pursue growth. As many of the major pipeline projects from previous years are completed and placed into service, we will see a significant boost in cash flows and a decrease in growth capital expenditures.

Demand for ethane is expected to increase by nearly 700,000 barrels/day in the next three years. This demand is driven by seven new world-class ethane steam crackers coming online in the coming years. This petrochemical boom is driven by low-cost feedstock that U.S shales produce. They are now competitive or superior to Middle East petrochemical facilities.

U.S crude production has increased by over 15% since the lows of 2016. According to Goldman Sachs, crude is expected to grow a further 6% in 2018. Natural gas production is also expected to grow by 6%. Natural gas liquids supply is expected to grow by 40% by 2040. Consensus analysts estimates expect the Alerian MLP Index EBITDA to increase by a remarkable 18.5% in 2018. All this growth flows through pipelines and associated infrastructure to demand centers.

Tax Plan

The recently passed tax bill is a positive for midstream infrastructure companies. According to Wells Fargo and Latham Watkins LLP, pass-through income could be taxed at an effective max rate of 29.6%. The bill provides for a 20% deduction (or a lower max income tax rate of 29.6% vs 39.6% currently) for income earned from pass through entities for tax years through 12/31/25. For C-corp midstream companies, the corporate income tax has been permanently lowered to 21% from 35%. This is a positive and will likely be recognized as a longer-term benefit as many of the midstream C-corps don't pay full cash taxes. One potential negative in the bill was the limitations on deduction of business interest. The bill limits the amount allowed as a deduction to 30% of annual EBITDA for tax years through 12/31/2021 and 30% of EBIT thereafter. Wells Fargo estimates that only 5 midstream companies under coverage would incur an interest expense in excess of 30% of EBITDA. Another feature of the bill is accelerated depreciation. Businesses are able to fully and immediately expense 100% of the cost of qualified property acquired and placed into service between 9/27/17 and 1/1/23. The percentages decrease in 20% increments over the following 5yr period. However, the bill excludes natural gas pipelines, which would not be able to fully expense depreciation in year one.

	Existing	New	Net Benefit
CORPORATION Example			
Income	$100	$100	
Corporate tax rate	*35%*	*21%*	
Income after taxes	$65	$79	
Qualified dividend rate	*20%*	*20%*	
Income after taxes and qualified dividend rate	$52	$63	
Corporation - effective tax rate	**48.0%**	**36.8%**	**11.2%**

	Existing	New	Net Benefit
PASSTHROUGH Example			
Income	$100	$100	
Deduction	*NA*	*20%*	
Income after deduction	$100	$80	
Tax rate	*39.6%*	*37.0%*	
Income after taxes	$60	$70	
PASSTHROUGH - effective tax rate	**39.6%**	**29.6%**	**10.0%**
Passthrough vs Corporation advantage	**8.4%**	**7.2%**	

Source: Wells Fargo, Latham Watkins LLP

As most MLPs are diversified, there will be assets that certainly benefit from this deduction. Another likely benefit of accelerated depreciation is that it will increase the tax shield for MLP income, so less of your distributions will be taxable.

Conclusion

We are very optimistic that midstream energy infrastructure will have a strong 2018. Most of the question marks surrounding MLPs during the downturn have been answered. MLPs are primed to benefit from improving operational economics, growing volumes and a supportive regulatory environment. Several major projects that are coming on-line in the coming months will enhance cash-flows and drive earnings growth. Management teams shifting towards the self-funding model will create a healthier sector over the long term. The United States has emerged as an energy super-power, and the buildout of infrastructure is vital to the success of shale. With a 7.5% yield, and valuations at significant discounts to historical metrics, we view the asset class as one of the few great values in the market. It's been a tumultuous road for MLPs since 2014, but the future remains bright as we return to growth in the energy sector. DeWitt Capital Management strives to put its clients in the MLPs participating in the growth areas and provide index-beating returns to its investors.