A Tale of Two Cities is Coming to the MLP Space . . .

Developing parallels between the MLP and REIT markets

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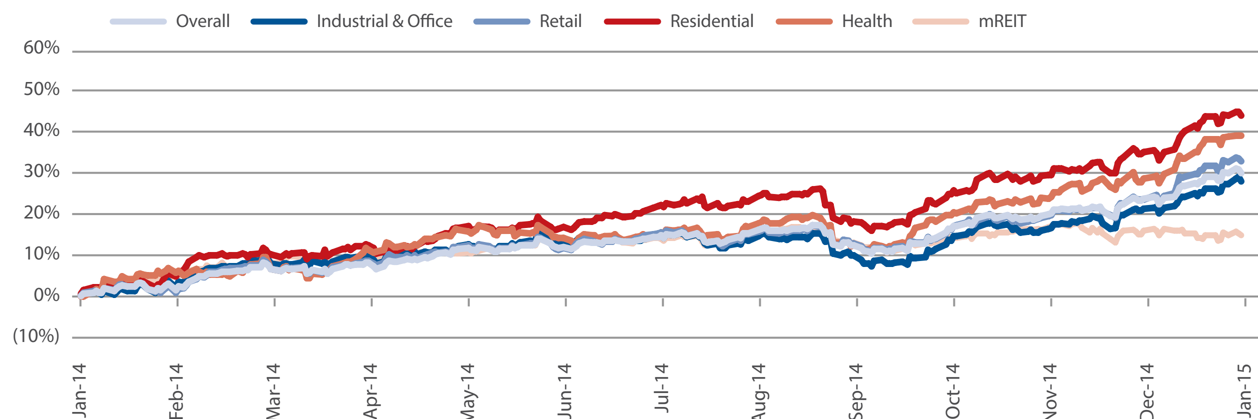
It is the best of times for the REIT Index as it hits new highs. However, belying that strength, the performance of non-traditional REITs (e.g., those investing in mortgages and mortgage servicing rights (MSRs), often classified as mREITs) has generally lagged that of other sectors by a substantial amount. Since the market correction in October, the overall NAREIT Index has returned 21%, but the mREIT sector has only provided a 4% return. We believe that we may be at the beginning of the market making the same distinction between MLP sectors.

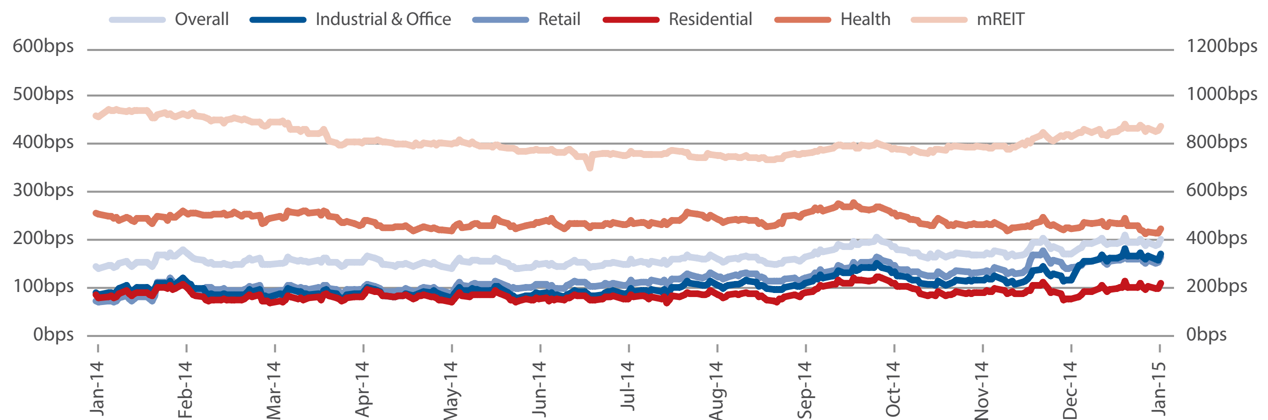
The divergence in REIT performance is the result of investors differentiating between the cash flow characteristics of the respective assets. mREITs offer an attractive current yield (average of about 10%), but the managers' desire to protect book values in a potentially rising rate environment (often effectuated by entering into interest rate swaps that leave the funds over hedged when rates actually fall) and the nature of their assets (MSRs and mortgages that have increased prepayment risk in a declining rate environment) introduce a degree of uncertainty and complexity that investors shun. On the other hand, the other REIT sectors are generally exhibiting stable and growing cash flow characteristics, and investors are gravitating towards those assets as interest rates decline and they seek additional sources of income. A substantial portion of REIT performance since October is the result of the movement in interest rates, and with the exception of mREITs, spreads have generally remained flat.

Figure 1: NAREIT Indices—Total Returns



Source: Bloomberg

Figure 2: NAREIT Indices—Yield Spreads to 10-yr UST



Source: Bloomberg

The REIT market has obviously not experienced the turmoil that has engulfed MLPs, but we believe there are some parallels that could develop as the market begins to differentiate between the specific MLP sectors. The recent collapse in oil prices has caught many investors off guard, resulting in an extraordinary amount of volatility, as evidenced by the performance of various energy indices versus WTI.

As crude has moved lower, MLPs have traded off with the broader energy sector. However, not all MLPs are created equal. Within the MLP universe, upstream MLPs have been hit the hardest and rightfully so. These companies might be structured as partnerships but they do not have the same stable and growing fee-based cash flows as the bulk of the midstream MLP space. Upstream MLPs are actually E&P companies with large exposure to commodity prices. If crude prices remain near $50, we estimate that most if not all of the upstream MLPs will be forced to cut their distributions.

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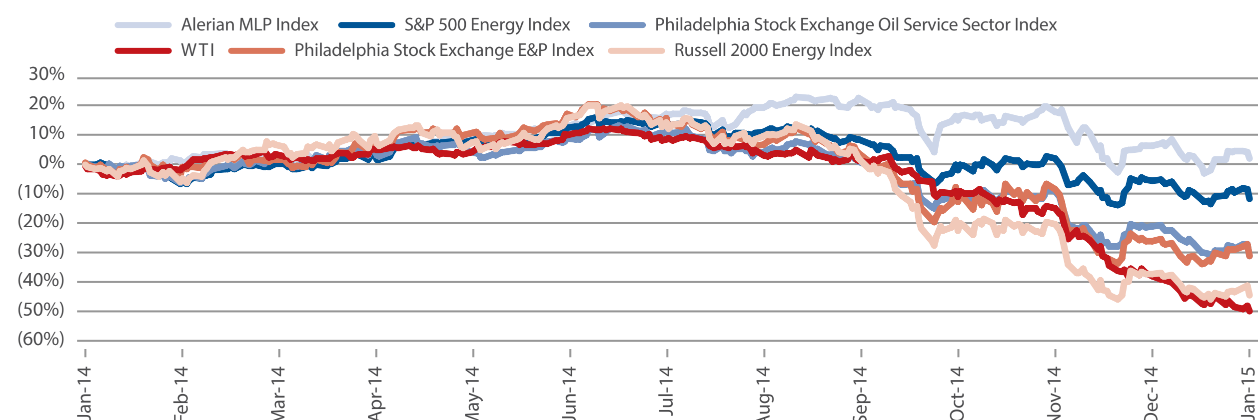
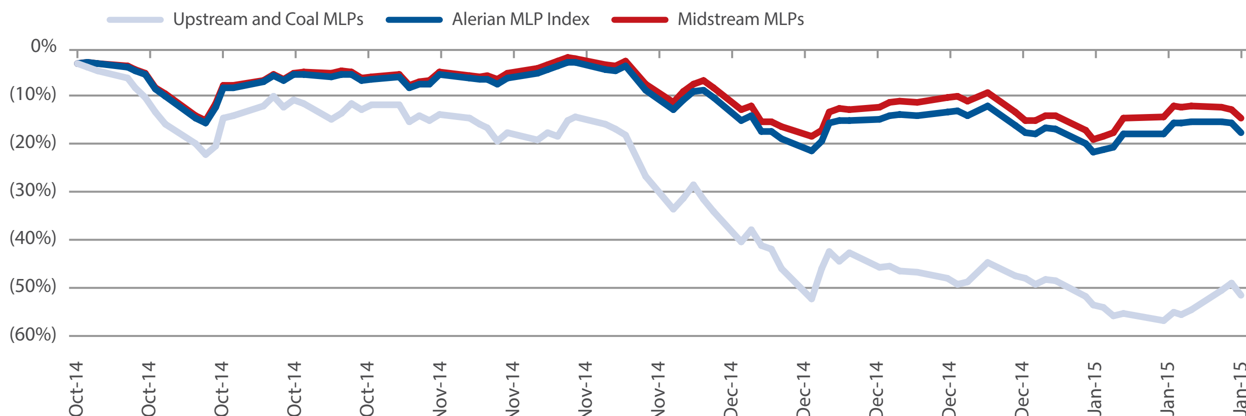
Midstream MLPs have also been impacted by the recent decline in crude but have exhibited much less downside volatility. These types of MLPs have largely long-term contracts that are fee-based or take-or-pay, often with

Figure 3: Energy Index Performance



Source: Bloomberg

Figure 4: MLP Performance



Source: Bloomberg and Alerian

built-in inflation adjustments, which makes them more commodity and inflation-insensitive. These companies produce stable cash-flows under long-term contracts, and operate critical infrastructure for the functioning of our economy. Nevertheless, their performance is being dragged down by the negative sentiment that is currently pervasive throughout the energy space.

MLPs for Sale

We view the recent decline in the midstream MLP space as technical and unwarranted as investors panic and sell all energy-related names regardless of commodity sensitivity. While we personally believe that current oil prices are at unsustainably low levels — as capex budgets are cut and production growth slows, eventually the market will need new production and thus higher prices to incentivize it — we believe we don't have to make a call on commodity prices to recognize the attractiveness of the current investment opportunity in midstream MLPs given their defensive characteristics.

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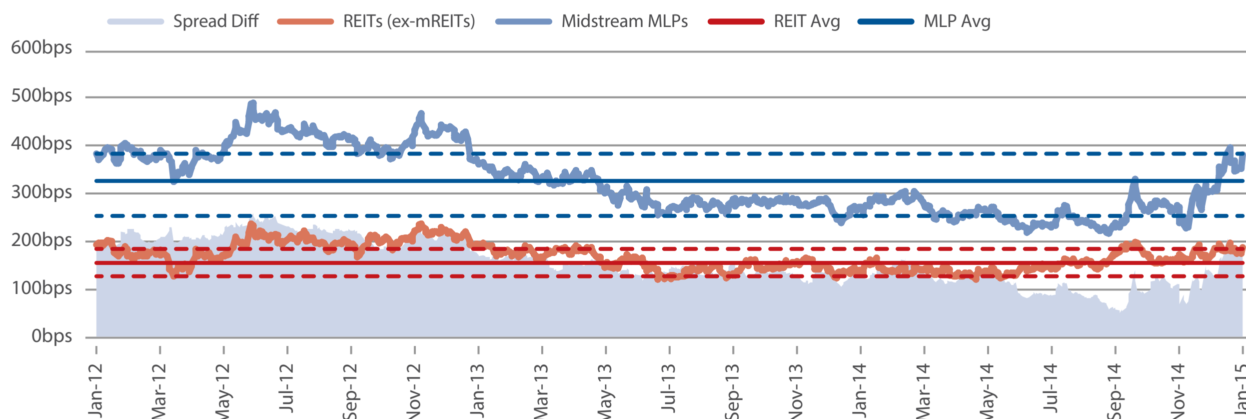
Spreads have widened to one standard deviation from their three year average and are currently around 385bps for the midstream sector, which is over 30% higher than where

Figure 5: Yield Spread Comparison — Midstream MLPs vs REITs



Source: Bloomberg and Alerian

they traded during the beginning of 2014 (see Figure 5). This widening becomes even more dramatic when one compares them to where the non-mREIT sectors currently trade (about 190bps on average, with some specific sectors 10-80bps even tighter). A mere tightening of midstream MLP spreads back to 3-year average levels could provide a 12% return (a figure that increases to 28% using the 2014 average). However, against the market backdrop of deflation concerns (as China's growth slows, Europe faces issues in both its core and periphery, and capital expenditure growth remains uncertain due to energy-related spending), one could argue that the stable, defensible, and growing cash flow characteristics of the midstream MLP sector are more appropriately valued at an even tighter spread, like some of the REIT sectors that share some of the same attributes. The midstream MLPs converging with the average spread of the non-mREIT sectors could provide a return of over 60%, all while the investor receives a quarterly distribution equating to about a 5% annualized yield.

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A Case for Active Management

We are seeing evidence that industry insiders realize this dislocation as a buying opportunity as M&A activity heats up and activist investors start to make noise. If industry insiders recognize this as a buying opportunity, shouldn't savvy retail investors also take advantage?

- Large transactions, such as Kinder Morgan's reorganization and the recently announced Regency Gas Partners (RGP)/Energy Transfer Partners (ETP) transaction positions Kinder Morgan and Energy Transfer as continued consolidators in the space
- SemGroup's CEO was quoted by an activist investor that "the sharks were circling"

There are two takeaways from these events:

- M&A activity is picking up and likely to remain a key theme in 2015
- While we think the RGP/ETP transaction is positive for both MLPs, the biggest winner is the General Partnership (GP), as the transaction will be 15-20% accretive to its distributable cash flow and creates a larger currency to pursue acquisitions (it is important to note that management teams' personal stakes are often more concentrated in the GP portion of the corporate structure)

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We believe recent commodity price volatility and M&A activity illustrate the value of our consistent approach of:

1) Focusing on midstream assets
2) Overweighting GPs that are inherently levered to the performance of their underlying MLPs, and
3) Emphasizing companies with greater than average likelihood of participating in M&A.

We acknowledge that the short term performance of MLPs is likely to be impacted by the direction of crude prices. If prices should weaken further or remain depressed for an extended period of time, the price performance of MLPs may be negatively impacted as well. Therefore, when viewing all of these factors together with today's environment of extraordinary commodity price volatility, we believe active investment management is more important than ever.

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