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Fair-haired orphans

The United States is poised to overtake Saudi Arabia in energy production this year, though you wouldn't know it by the slump in the prices of American pipeline stocks. The pipeline companies are the toll-takers of the steel energy highways, and they ought to shine in a season of resurgent domestic output. Now in progress is a reappraisal of the investment merits of a trio of such businesses (see the issue of *Grant's* dated July 14, 2017). They are Antero Midstream Partners, L.P. (AM), SemGroup Corp. (SEMG) and Delek Logistics Partners, L.P. (DKL; all on the New York Stock Exchange). We remain bullish on them.

Two of our three picks to click are organized as master limited partnerships (SemGroup is the exception). It's a problematical corporate status. MLPs avoid the double taxation that ravages corporate dividends but at the cost of tax-time inconvenience; the investor must file an irksome Schedule K-1. Owing to tax rules, most endowments and pension funds keep their distance from these companies, so the MLP investor base is necessarily limited. There is a kind of ETF work-around in the shape of, for instance, the Alerian MLP ETF (AMLP on NYSE Arca), but Alerian and ETFs like it are taxed in such a way that investors get only 79% of the dividends that the underlying MLPs pay.

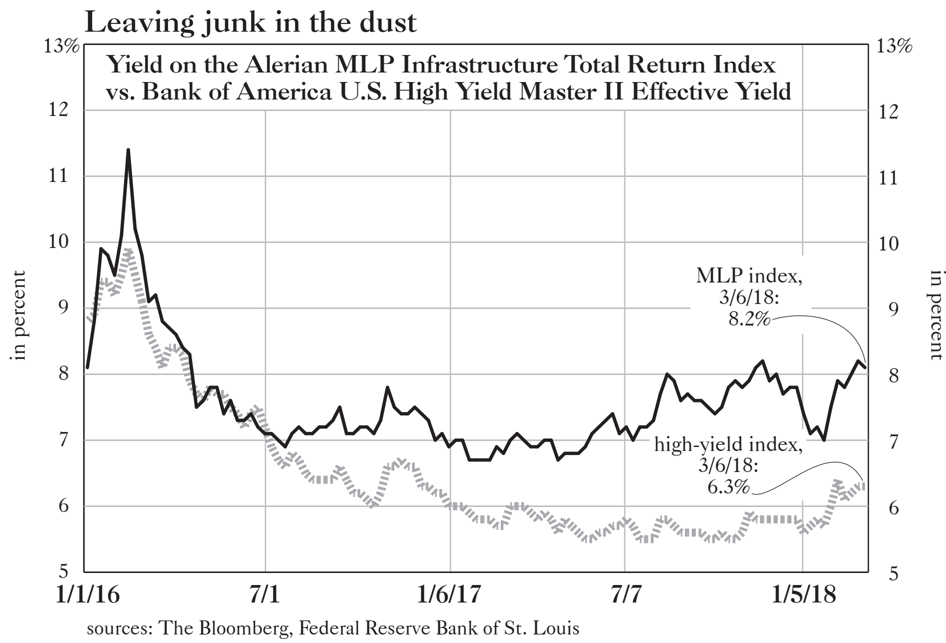
As a group, our trio of pipeline companies reported decent fourth-quarter results (SEMG did better than that). Still and all, shares of Antero, SemGroup and Delek have declined by 18.9%, 19.3% and 12.5% since our July review. So discounted, they offer dividend yields of 5.4%, 8.0% and 10%, respectively.

Rising interest rates and the arc of the oil price are two sources of worry. The pipeline CEOs themselves make a third. We generalize—if the shoe fits, wear it—but the executives seem to favor asset growth, whereas the investors, in whose interest the executives go to work in the morning, seem to prefer steady and predictable cash distributions.

With the rapid growth in shale production came the need for oil-related infrastructure, and the pipeline CEOs leapt to fill it. To broaden the potential field of investors, many pipeline companies have resorted to switching to corporate structures from partnerships (Kinder Morgan, Inc. was the first to do so in 2014; see *Grant's* June 29, 2012). Some, in addition, have retained earnings to finance growth, rather than paying them out as dividends.

The most recent instance of pursuing growth at the expense of shareholder distributions is Macquarie Infrastructure Corp. (MIC on the Big Board), which slashed its quarterly payout to $1.00 for 2018 from $1.44 in the fourth quarter of 2017. Could Macquarie have maintained the higher distribution? "Our payout ratio would have increased . . . but maintaining our dividend policy would likely have made either foregoing our investment-grade credit rating at some point or foregoing some portion of our growth agenda." So said CEO Christopher Frost on the Feb. 22 earnings call. Investors fled, and the stock is down a tidy 39% since the CEO expounded his capital-allocation strategy.

A measure of the disenchantment of the investor base is the spike in pipe-



line dividend yields, one that has outrun the overall rise in interest rates. Since year-end 2016, the yield on the Alerian MLP Infrastructure Total Return Index has increased by 107 basis points, to 8.16%, more than double the 0.44% rise in the yield on the 10-year Treasury. Over the same period, the Bank of America Merrill Lynch High Yield Master II Effective Yield Index has grown by only 0.06% to 6.25% as junk spreads have contracted.

It does nothing to boost investor morale when it is possible to find (as in Tuesday's *Wall Street Journal*) a cacophony of energy authorities asserting (a) shale production is set to swamp the world oil markets and (b) shale production will prove nothing so disruptive as the energy bears contend. Year to date, the energy component of the S&P 500 is down by 6.8% amid a 2% rise in the overall index. While shale production is increasing, the world needs more American oil as global exploration has reached lows last seen in the 1950s (*Grant's*, March 10, 2017).

Anyway, the hot and heavy announcements of share buybacks by domestic drillers would seem to signal some production restraint. "These are companies that don't exactly have a lot of cash to buy back their stock with," an energy investor, who asks to go nameless, tells colleague Phil Grant. "Gulfport is one. Laredo Petroleum announced a stock buyback. Anadarko has one in place. Noble Energy has one in place. The mantra is all capital discipline: 'We are not going to drill our brains out. We are not going to lever ourselves up in order to grow production. We're going to try to grow within cash flow.'"

Then, too, while shale production is rising, it is doing so perhaps at a slower rate than some breathless prognosticators thought. "For instance," says Adam A. Rozencwajg, the managing director and one-half the eponym of Goehring & Rozencwajg Associates, "the U.S. Department of Energy releases both total state data and then data by shale play. All of the big surge in production that we've seen recently has come from Texas and New Mexico, but if you add up all of the Texas and New Mexico shales, it doesn't show a huge surge in production. . . . I think there is a reason to think those numbers need to be adjusted and come down."

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Taking one thing with another, the pipeline toll-takers ought to be flourishing. "We are over the hump in big growth projects," Simon Lack, the managing partner at SL Advisors, a management company that runs MLP-focused mutual funds, tells deputy editor Evan Lorenz. "Those are going into production and some are already in production. The thing about a big infrastructure project is you spend loads of money before you get any cash flow back. And so, we are coming through all of that. Distributions are growing. It's much more that the traditional investor base has concluded that they have been abandoned by management teams because of all of the past distribution cuts."

As you may remember, Antero Midstream is the proliferating MLP that serves Antero Resources Corp. (AR on the Big Board), itself a bustling natural-gas exploration and development business in the Marcellus and Utica shales. AR forehandedly hedged its natural gas through 2023 at rates well above today's spot prices. Given this price surety, AR plans on expanding production at an 18% compound annual rate through 2022, which should underwrite strong growth for AM.

AM boosted its earnings before interest, taxes, depreciation and amortization (EBITDA) by 13% and its distributions by 30% year-over-year in the fourth quarter. Despite the dividend hike, AM's distributable cash flow covers the payout by 1.3 times and its debt-to-EBITDA ratio is a moderate 2.3 times. Owing to weak share performance and pressure from an activist, Antero Resources and Antero Midstream's independent directors have each formed special committees to pursue measures to enhance shareholder value.

While SemGroup's fourth-quarter results hit the mark with a 68% and 5% year-over-year rise in EBITDA and dividends, the company's guidance of EBITDA of $385 million to $415 million for 2018 fell far short of Street expectations of $434 million. The source of disappointment arises from the SemGroup supply and logistics (S&L) division, which purchases oil in the spot market and sells it to refiners and other users. This division had generated operating profit of $30.9 million in 2015. For 2018, management projects it will lose $10 million to $15 million. The slump in S&L profits is an industry-wide phenomenon. Plains GP Holdings, L.P.'s EBITDA from S&L activities collapsed to $60 million in 2017 from $822 million in 2013.

"The margins on supply and logistics have been creamed as basis differentials have gone away and as quality differentials have gone against legacy players," Henry Hoffman, a partner at SL Advisors, which owns SemGroup on behalf of clients, advises Lorenz. "This goes in cycles. Most people, however, were expecting zero as the downside scenario." Importantly, if the problems facing the S&L business turn out to be secular rather than cyclical, management could shut it down.

SemGroup, which operates gathering, transport, storage, distribution and marketing assets in the United States and Canada, bought the Houston Fuel Oil Terminal Company for $1.5 billion in a cash and stock transaction last year. As a result of the deal, leverage is elevated at 5.1 times EBITDA but adjusted earnings covered the fourth-quarter dividend by 1.7 times. Weak S&L results mean that SemGroup is targeting 5% dividend growth this year vs. previous guidance of around 10%.

Delek Logistics operates supply and marketing assets for oil, intermediate and refined products in Texas, Louisiana, Arkansas and Tennessee, primarily serving Delek U.S. Holdings, Inc. (DK on the NYSE). In the fourth quarter, Delek increased its EBITDA and distributions by 28% and 21% year-over-year, respectively. At year end, Delek's net debt to EBITDA amounted to 3.8 times EBITDA. Distributable cash flow fell 4% short of covering dividends in the fourth quarter. However, Delek is rapidly expanding its underlying earnings and, post the close of the fourth quarter, signed two deals that will add $40 million to EBITDA, a material amount compared to full-year 2017 EBITDA of $115 million.

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