GRANT'S
INTEREST RATE OBSERVER®

Vol. 35, No. 14c Two Wall Street, New York, New York 10005 • www.grantspub.com JULY 14, 2017

Viscous black yields

The trouble with oil-related securities is the price of oil, of course. The appeal of oil or gas pipeline shares, or master limited partnership interests, is that the price of energy does not control the investment outcome. Following is a survey in two parts: energy in general and pipeline securities in particular. As to the latter, we are bullish.

The issue of *Grant's* dated March 10 laid out the upbeat case for oil. We mentioned the collapse in exploration activity and the prospect for stronger oil demand. The preponderance of bullish positioning was the principal offsetting bearish risk.

For your investment consideration, we served up a laddered oil play, highlighting stocks that, so to speak, would go into the money at various oil-price attachment points. Oasis Petroleum, Inc. (OAS on the New York Stock Exchange) was one of these candidates: It would achieve profitability at a mid-$50s crude price, we posited. With West Texas Intermediate at a $40-handle today, the stock is decidedly out of the money. It's plunged by 40%.

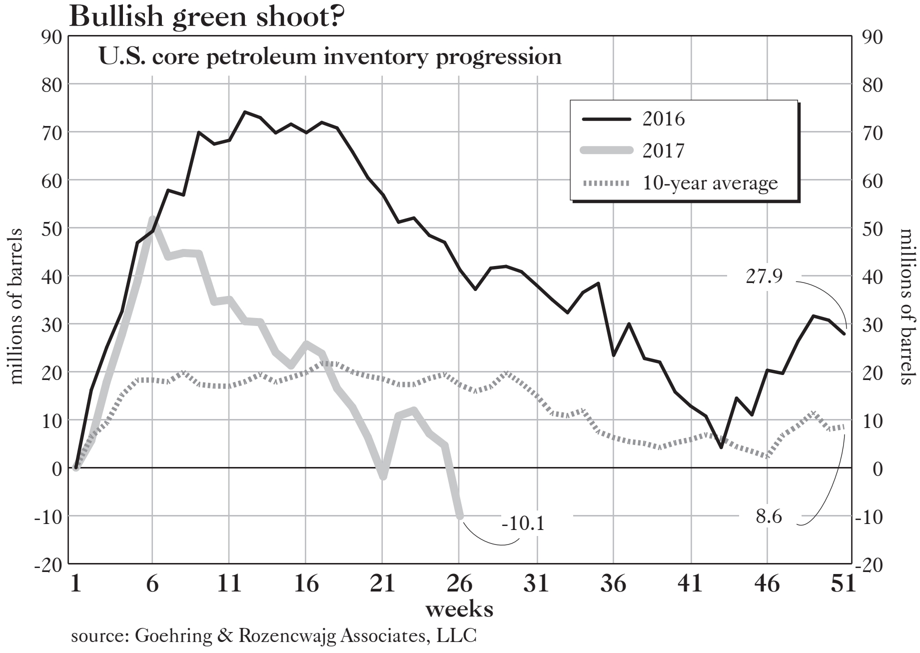
The honor of calling the bottom in crude we shall therefore leave to others. In the week ended June 30, for what it might be worth, commercial petroleum inventories (crude, gas, distillates and other oils) fell by 13.4 million barrels, the third-largest weekly draw in the past five years. This is "during a week that normally sees inventories build by 2.8 million barrels," Adam Rozencwajg, a managing partner at and one-half the eponym of Goehring & Rozencwajg Associates, LLC, a boutique investment-management firm that focuses on natural resources, advises colleague Evan Lorenz. "This implies a market that was undersupplied by 2.3 million barrels per day (mbpd)."

U.S. inventory tends to exhibit a seasonal pattern, with builds in the first half of the year and draws in the summer driving season. Adjusting for these patterns, "inventories have drawn down in something like 10 of the last 12 weeks," Leigh Goehring, Rozencwajg's partner, chimes in. "We are going in the right direction. It's just that everyone has been overwhelmed with these fears, whether they be that the shales are growing, the fact that Libyan production is up, Nigerian production is up, the electric car will take over the world in the next three years and all of these types of things. We are in a tightening process in global oil markets."

Maybe, the partners speculate, the world is setting up for a repeat of the 2006–08 oil-price swing. In 2006, the International Energy Agency (IEA) estimated that the market was oversupplied by 1.7 mbpd. In response, OPEC agreed to cut production by 1.2 mbpd, beginning in November. Subsequently, IEA revisions to supply and demand showed that 2006 was in deficit, not surplus, before OPEC's cut. In consequence, world inventories contracted by more than 300,000 barrels per day throughout 2007 and early 2008, leading to the anomalous oil-price surge to $145.29 per barrel on July 3 of that otherwise unprosperous year.

"Looking into the end of 2016, the oil markets according to the IEA were in surplus last year by 0.7 mbpd at that time," Rozencwajg relates. "OPEC

Bullish green shoot?



source: Goehring & Rozencwajg Associates, LLC looked at those figures, got very nervous and decided to curtail production at the end of last year. Within 60 days, the IEA had come back out and revised away all of that surplus in 2016 and instead said it was a deficit year. The implication being that OPEC had again cut into an already tight market." From its initial estimates, the IEA has revised upward its demand estimates by 1.4 mbpd and 0.6 mbpd for 2016 and 2017. Upward revisions to demand have, in fact, been the norm for the IEA over the past six years.

Well, *Grant's* is in no position to point fingers. But we're safe, we think, in observing that oil doesn't drill itself. A friend with a connection to a private E&P company active in the Permian Basin says there's a six-month wait to get a fracking crew.

"We believe that the industry's active fleet of pumping equipment is fully utilized," Jeffrey Allen Miller, CEO of Halliburton Co., said on the company's April 24 earnings call. "And we know from our own experience, as we get near the bottom of the stacked equipment pile, [that] it will be progressively harder and more expensive for the industry to reactivate equipment . . . but [we] will not consider responding to this demand until the economics make sense."

Nor is it cheap to deploy equipment that has long lain fallow. "From a land-rig standpoint, the cost can run anywhere from $2 million to $10 million to activate a rig, depending on what the requirement is of that rig in the field," Kurt Hallead, the co-head of global energy research for RBC Capital Markets, tells Lorenz. A new frac spread costs around $45 million, and a rebuild can cost 75% of that amount. Hallead estimates that prices for oil-field services need to rise another 25%–30% before the Halliburtons of the world begin to build new equipment or refurbish old equipment. A higher services cost, of course, will raise the marginal cost of extraction.

And this is just in from Bloomberg: "The tussle for supremacy between OPEC and U.S. shale drillers is killing off older oil fields [from China to North America] at the fastest pace in almost a quarter century."

. . .

What matters most to a pipeline operator is the volume of flow through its pipes. The price that that flowing oil or gas commands in the market is of secondary interest. It follows that continued growth in American energy production is what the pipeline bulls root for.

Most pipelines are organized as master limited partnerships (MLPs), i.e., publicly traded limited partnerships. MLPs pay out most of their income. The catch is that you, the recipient of this income, must record the fact (along with other IRS-relevant data) on the dreaded K-1 tax form. K-1s can be late to arrive in your mailbox. They can likewise be costly to file. This has historically limited the investor base for MLPs to K-1-tolerant, high-net-worth individuals.

"Index funds present another source of worry," Lorenz points out. "Clever sponsors found out they could broaden the investor base for MLPs by wrapping the stocks in ETFs and mutual funds that do away with K-1s. Of course, this comes at a cost: The funds are taxed so they remit to investors only 65% of the dividends they receive. Less amply rewarded than the K-1 type of holder, the ETF cohort is quick to sell. Thus, on July 5, the $10 billion Alerian MLP ETF (AMLP on the NYSE Arca), the largest MLP index fund, suffered a 12.4 million-share redemption, the biggest single daily exodus in the fund's seven-year life.

"It leaves opportunity in its wake," Lorenz proceeds. "An Alerian-sponsored index of such pipeline MLPs is priced to yield 7.2% today, or 142 basis points more than high-yield bonds. Over the past decade, the MLPs that stock the Alerian index have yielded on average 1.1% less than junk. Then, too, the coupon on the vast majority of high-yield bonds is fixed. Most MLPs today are investing in projects that might increase payouts over time."

SemGroup Corp. (SEMG on the NYSE) is a midstream energy operator without the K-1 hassle. True, it is no longer a limited partnership with the attendant tax advantages of that legal status. But it does—by virtue of its 2016 purchase of Rose Rock Midstream, L.P.—provide a compensating advantage: a large depreciation-expense-to-shield earnings, as the acquired assets were written to fair value post-acquisition.

SemGroup operates gathering, transport, storage, distribution and marketing assets in the United States and Canada for petroleum and natural gas, as well as a petroleum-storage business in the U.K. and an asphalt business in Mexico. In the first quarter, operations in the 50 states contributed 68.9% of earnings before interest, taxes, depreciation and amortization (EBITDA), with the balance attributable to Canada (21%), the UK (7.3%) and Mexico (2.8%). Rated middling junk—single-B-plus—by S&P, SemGroup earned adjusted EBITDA to cover interest expense by 4.4 times in the first quarter; net debt is equal to four times trailing 12-month adjusted EBITDA.

With shares priced to yield 7%, the company says it's striving to boost the dividend by 8% a year through 2020. Growth is driven by acquisitions and internally generated projects, which in 2017 include the Maurepas Pipeline in Louisiana (slated for early completion) and two pipelines in Oklahoma. Capital outlays are projected to reach $500 million this year, well above the company's estimated $60 million in maintenance capex. Based on the investments expected to come to fruition in the second half of this year, SemGroup is on track to end 2017 at an annualized EBITDA run rate of $325–$340 million versus $282.8 million in 2016.

On June 6, management announced the acquisition of Houston Fuel Oil Terminal Company (HOFCO) for $1.5 billion in a cash and stock transaction that, if all goes according to plan, will close in the third quarter. HOFCO will allow SemGroup to tie its mid-continental crude assets to the Gulf Coast. It appears that the deal will raise total leverage to around 5.3 times. Perhaps growth will lighten that burden. Management says it anticipates that the Terminal Company's EBITDA will increase to $180–$190 million in 2019 from $135–$145 million in 2018 based on projects currently under construction and backed by long-term customer contracts.

"We recently added a little bit to our SemGroup position," Simon Lack, the managing partner of SL Advisors, LLC, a management company that runs MLP-focused mutual funds, tells Lorenz, "because they invested in some assets in the Houston ship channel that we think are attractive."

Over the past year, insiders have purchased a net 19,854 shares at a cost of $608,371. The company has a (pre-deal) market capitalization of $1.7 billion and trades an average of $19.5 million per day.

. . .

Delek Logistics Partners, L.P. (DKL on the NYSE) is an MLP—complete with a K-1 reporting requirement—that operates logistics and marketing assets for oil, intermediate and refined products in Texas, Louisiana, Arkansas and Tennessee. Delek Logistics mainly serves Delek U.S. Holdings, Inc. (DK on the Big Board), which owns 62.9% of DKL and which continues to buy more—a problem for competing investors, as we shall see. The parent is a holding company with refining, transportation and convenience-store operations in the Southeast and Texas. On July 3, DK acquired Alon USA Energy, Inc., a Texas-based company also in refining, transportation and convenience retailing.

The Alon acquisition forms the bull case for Delek Logistics. Alon owned a number of assets—asphalt terminals, pipelines—that fit well in an MLP. DK, the parent, intends to drop-down (i.e., "sell" in industry jargon) the terminals and pipelines into its MLP over time. Such assets, DKL estimates, can boost EBITDA to $190 million in two or three years from an expected $112 million in 2017. "The assets that came along with the Alon acquisition make sense and fit inside of an MLP structure," Jason Hill, a portfolio manager at Addie Capital, an investment manager that specializes in MLPs, tells Lorenz. "So, the growth opportunities are there. In my opinion they can grow the distribution at least 8% per year for a five-year period and meanwhile you have a stock that yields almost 9%." Hill's clients are long Delek Logistics.

Rated single-B-plus, Delek Logistics covered interest expense with EBITDA by 5.8 times in the first quarter. As of March 31, net debt footed to four times trailing EBITDA. Distributable cash flows did not quite rise to the level of the first-quarter dividend distribution (just 98% of it), though it seems reasonable to expect better coverage if management achieves the higher tariff rates it expects to earn on the 195-mile Paline Pipeline in Texas.

Delek Logistics is priced to yield 8.6%. The company's small float and market cap of $780.9 million result in an average daily value trading of $1.6 million, a state of illiquidity which is partly chargeable to the parent; in the three months ending June 2, Delek U.S. Holdings purchased 216,554 shares of DKL worth $6.7 million.

. . .

With a 3.7% dividend yield, Antero Midstream Partners, L.P. (AM on the NYSE) is not so cheap as SEMG or DKL, but it is much less leveraged and has been rapidly raising its dividend. The MLP—hence, prepare for the K-1 filing—operates gathering pipelines, compressor stations, processing and fractionation plants and water-handling and -treatment assets in West Virginia and Ohio. Antero Midstream exists to operate and develop the midstream assets with which to serve Antero Resources Corp. (AR on the NYSE), an E&P company active in the gas-rich Marcellus and Utica shales.

The price of natural gas bottomed at $1.64 per thousand cubic feet (mcf) in March 2016; it's quoted today at $2.87. This does not impact Antero Resources, which produced 505 billion cubic feet of gas last year, as the company forehandedly hedged its production for the next five years. As of Dec. 31, the E&P's hedge book footed to 3.3 trillion cubic feet of gas through 2022 at an average price of $3.66 per mcf.

With little exposure to the spot price of gas, Antero Resources was able to boost its production by 59% in the two years ended 2016. As a result, Antero Midstream has been able to grow rapidly by building out the infrastructure that facilitates Antero Resources' growth. In the first quarter, adjusted EBITDA and dividends jumped by 49% and 28%, respectively, year over year.

"That has allowed them a lot of freedom and ability to grow production," Hill, whose clients are long AM, tells Lorenz. "That's a great setup for an MLP—having a sponsor with a GP like that because you can have a lot of confidence in their ability to grow at a high level for a longer period of time than everybody else. It's not a drop-down story to get there, which is what makes it even more unique. It's all organic growth." The company says it wants to boost its dividend by 28% to 30% per year through 2020.

While rated only double-B, Antero Midstream is conservatively financed with net debt footing to 2.1 times EBITDA and EBITDA covered interest expense by 12.4 times in the first quarter. In the same three months, distributable cash flow covered dividends by 1.4 times. In the past 12 months, insiders have sold 18,883 shares for net proceeds of $510,685.

•