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Gas-fired income

Irrepressible yields may not be available until the Federal Open Market Committee disbands, but Boardwalk Pipeline Partners (BWP on the New York Stock Exchange), a master limited partnership in the business of transporting and storing natural gas, perhaps comes as close as any public security to delivering Fed-resistant income. The shares—not to be confused with Treasury bills, by any means—are priced to yield 7.7%.

Boardwalk is the principal topic under discussion, gas is a secondary topic and Westshore Terminals (WTE.UN on the Toronto Exchange), a Canadian income play, is a tertiary topic. We like Boardwalk as an income vehicle, gas as a commodity (though our bullish view is wholly derived from expert testimony and personal hunch) and Westshore as a foil to Boardwalk.

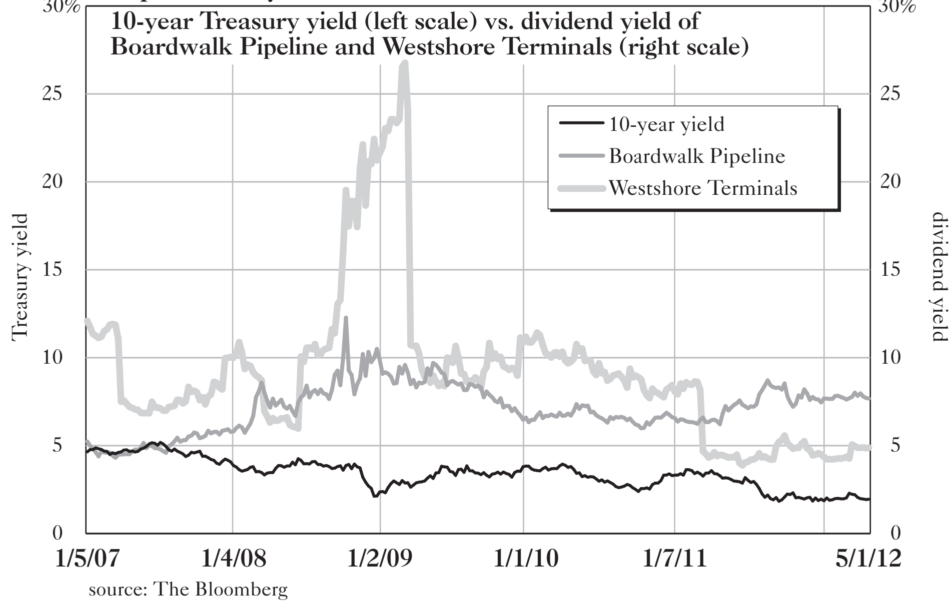
Boardwalk is the owner of three interstate natural gas pipeline systems that transport 7.3 billion cubic feet of gas a day, or 11% of American daily gas consumption. The trio includes Gulf Crossing Pipeline, Gulf South Pipeline and Texas Gas Transmission, and they reach 14,300 miles and can store 185.6 billion cubic feet of gas. The longest of the three, Gulf South Pipeline, spans 7,600 miles through Texas, Louisiana, Mississippi, Alabama and Florida.

In most of its operations, Boardwalk is a regulated utility. The Federal Energy Regulatory Commission tells it how much it can charge for transmission and storage. Some pockets of the business are unregulated—notably Boardwalk Field Services, a new subsidiary involved in gas gathering and processing. Field Services is building assets in the Pennsylvania-centered Marcellus shale formation. But 96% of Boardwalk's income is derived from long-term contracts in its mainly regulated business lines. As of the end of 2011, the average remaining life of such contracts was six years.

Boardwalk is a production of Loews Corp. (L on the Big Board), the Tisch-managed conglomerate. Loews bought Texas Gas Transmission in May 2003 and Gulf South Pipeline in December 2004. From those assets, it fashioned Boardwalk Pipeline Partners, taking the company public in November 2005. Today, Loews owns 59% of Boardwalk's shares through a limited partnership interest and 2% through a general partnership interest. The Loews presence gives Boardwalk—the senior debt of which is rated triple-B—a financially stable, A-plus-rated, shareholder-friendly long-term partner.

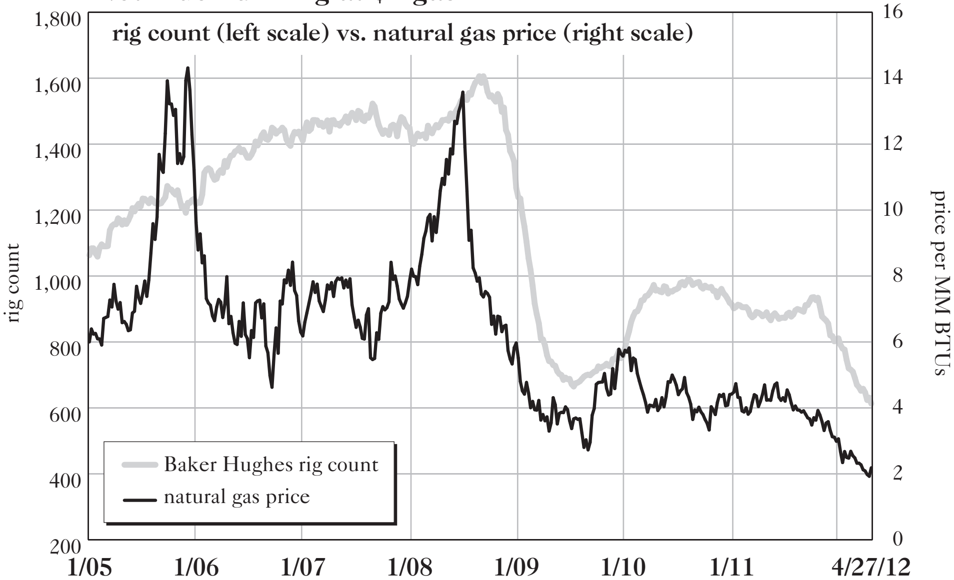
Stability is a good thing in the gas business these days, what with the price of the commodity recently scraping $2 per thousand cubic feet. It is an especially good thing for Boardwalk, which has $3.4 billion in net debt as against roughly the same amount in stockholders' equity and earnings before interest, taxes, depreciation and amortization of $652 million. Boardwalk's debt is fixed

Irrepressible yields?



source: The Bloomberg

Not much drilling at $2 gas



source: The Bloomberg

rate (all except $684 million from one bond and a revolving credit line), and it carried an average interest rate in 2011 of 5.78%.

Under the terms of its debt covenants, Boardwalk may show a ratio of net debt to EBITDA no higher than 5.0 times. At year-end, in fact, it showed 5.2, a permissible stretch, according to management. Allowances are made for future contractual income to be produced from new investments, it says. The company warrants that all was shipshape, covenant-wise, at year-end.

"Boardwalk increased its assets at a compound annual rate of 18.3% between year-end 2005 and year-end 2011," colleague Evan Lorenz relates, "as the partnership was able to capitalize on ever greater demand for transport and storage assets on the back of growing shale-gas production. Between 2006, the first full year the company paid distributions to limited partners, and 2011, distributions and revenues have increased by 9.7% and 13.4% a year, respectively. 'The Interstate Natural Gas Association of America anticipates that U.S. natural gas consumption in the power sector will increase to 14.8 [trillion cubic feet] in 2020 vs. 7.4 tcf in 2010,' JPMorgan analysts Jeremy Tonet, Tim Fisher and Alistair J. Meadows write in a Dec. 12 note. 'We expect that the significant ramp-up in shale-based production will overwhelm existing infrastructure, thereby providing attractive expansion opportunities for natgas [transportation and storage] MLPs.'" Of the three-dozen or so energy MLPs known to Bloomberg, Boardwalk ranks high in yield and middling in leverage.

Because all but 4% of Boardwalk's revenue is delivered via long-term contracts, short- and even medium-term fluctuations in the gas price are not so important to its ability to generate income. For the long term, Boardwalk would no doubt prefer a price high enough to keep its producers solvent, yet a price not so high as to induce electric utilities to burn coal instead of gas. As to the current shale-gas-powered bear market in gas, this too shall pass, according to Zev Abraham, managing partner at Resource Equity Insights. One of the troubles with shale—or, more particularly, the over-hyped version of shale now popular on Wall Street—is that there are not enough facts on which to base a solid judgment.

Much of the value in a well lies in so-called tail production, the gas extracted toward the end of the well's productive life. But, in the case of the shale plays, it is exactly this end-of-life yield about which little is known.

"There are some basins where evidence suggests wells are flattening out slightly below expectations and there is not enough history to know whether the production remains flat for as long as advertised," Abraham says. "The problem is that a slightly lower flattening or a continued, albeit very slight, decline can change the IRR on a well a lot. It can go from a good return to a lousy one pretty easily, and we just don't know what production is going to be and will not for a while."

In other words, Abraham suggests, talk of a permanent low plateau in the price of natural gas is likely to be no more helpful than talk was, along about 1929, of a permanent high plateau in common stocks.

Lorenz asked Kenneth I. Siegel, chairman of Boardwalk and a senior vice president at Loews, what he worries about. Not much, Siegel replied. "We have a very significant portion of business locked in under long-term contracts. We've got good pipelines, we're well located, we've got growth opportunities, we've got a very strong management team. We have the financial flexibility to do interesting things when they present themselves. I'm pretty comfortable with where we are strategically."

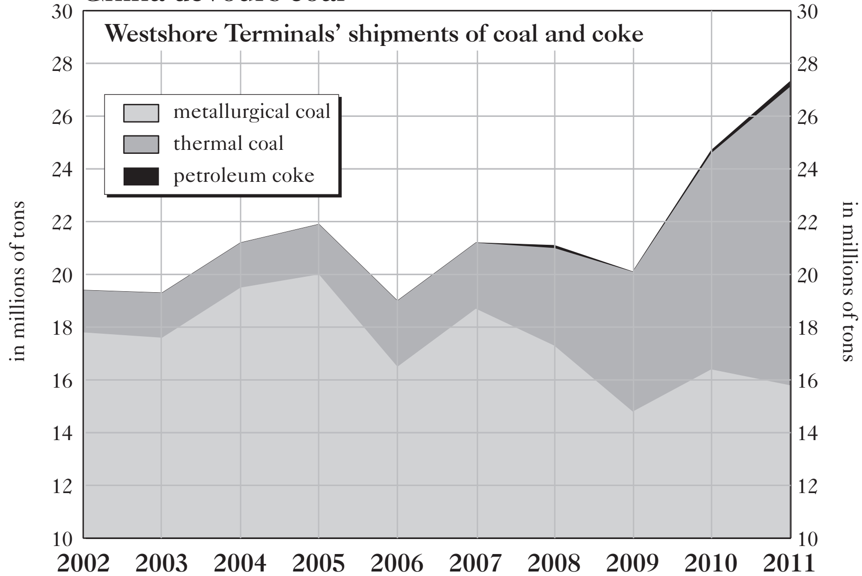
Westshore Terminals operates the largest coal-loading facility on the west coast of the Americas on a man-made island at Roberts Bank, British Columbia. Like Boardwalk, Westshore has made hay from the shale-gas boom. Thermal coal, once the mainstay fuel for Canadian and American electric utilities, but increasingly displaced by cheap gas nowadays, still finds an eager market in Asia, especially in China.

As Boardwalk has a major shareholder in Loews, so Westshore has a principal investor in Jim Pattison, the third-richest man in Canada. Pattison and the stockholders see eye to eye on the subject of taxes: They are united in seeking to pay as little as possible. Pattison and the public are, however, perhaps a little less closely aligned in the matter of disclosure. If you are the kind of investor who needs to listen to a conference call, Westshore won't be for you. The company—or, rather, Westar, the company's external manager—holds none. As for income, Westshore is priced to yield 4.9%, a yield not so different from Boardwalk's when you consider that Westshore shows C$0.88 of net cash per share.

Westshore's business is through the roof—or the gunwales. There isn't enough capacity to handle the explosive Asian demand for coal. Westshore is, therefore, investing to increase its annual export capacity to 33 million tons at the end of this year from the 27.3 million tons it shipped in 2011. Nor is Westshore alone. Ridley Terminals, a Canadian state-owned facility in Prince Rupert, is planning to double its 12 million-ton capacity by the end of 2014. Neptune Bulk Terminals, a three-berth operation handling coal, potash and fertilizer, shipped 5.2 million tons of coal in 2011 and plans to bulk up in order to be able to ship 12.5 million tons of coal in 2013.

Coal prices are up, volumes are up, margins are up. Walter Spracklin, an RBC analyst who follows Westshore, says that all systems are go. "I'm very comforted by the minimum volume requirements that the company has gotten," Spracklin tells Lorenz. "I like the significant supply-demand imbalance that exists right now to Westshore's favor for port access and loading capacity on the West Coast. Even in the event of a tempering in [metallurgical] coal demand, they know there is plenty of thermal coal to fill in that capacity, and it provides them very good economics. The dividend—we have it going up 25% this year and 25% again next year. The cash-flow generation that this company is putting out—very low capex program on a sustaining basis—means that, in our view, investors will be rewarded with significantly increasing dividends over the next few years."

China devours coal



source: company reports

If, however, you are as bearish on China as we are, you will not be so quick to jump in. Quoted at 14.3 times enterprise value to projected 2012 EBITDA, Westshore is valued for the Asian boom, not a Chinese bust. Our conclusion: Better a stroll on Boardwalk.

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