**Have These High-Reward Oil Plays Become Too Risky?**

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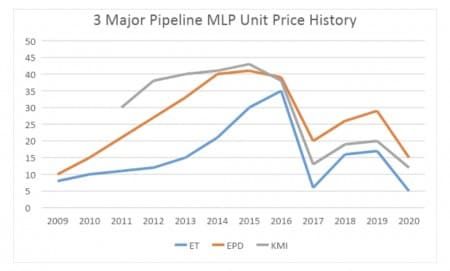
Pipeline Master Limited Partnerships, (MLPs) were once the darlings of the energy industry. The CEO’s of companies like Kinder Morgan, (NYSE:KMI), Energy Transfer, (NYSE:ET), and Enterprise Products Partners, (NYSE: EPD) and a host of others were on the business channel morning shows regularly. Circa 2009 was a great time to be CEO of an MLP. Worth noting is that the CEOs of all the MLPs mentioned became billionaires over the last couple of decades, counting the time before they went public.

And, why not? They had a “can’t lose” business model. Pitching themselves as “Energy Toll Roads,” they didn’t have capital tied up in the hydrocarbons being pumped through their line, or direct commodity pricing risk. They skipped the exploration and production risks and expenses that burdened upstream operators, and just collected tolls. Accordingly, customers lined up to pay their money to move their products to market and signed long-term multi-year contracts to secure take away space in pipelines forecast to be built. Thus, providing a long term stream of cash flow for the MLPs. The investing case for MLPs got better for investors. MLPs were obligated to pay most of their profits in the form of “Distributions” to them, leading to fat checks per unit if an investor was willing to do a little extra paperwork for the I.R.S. Growth and yield rarely come together in such a neat package.

(Note-MLPs have complicated tax structures that shift some tax liability to unitholders and often involve the need for sophisticated tax assistance!)

With a license to essentially “print money,” starting in 2009 the share prices of these company ‘units’- *in an MLP you are buying units*, took off. What is a little curious is why the stocks of these two companies didn’t go even higher. With dividend yields often approaching double digits for most of their history, who wouldn’t want on this gravy train? Why indeed. A lot of investors wondered about this and passed on the handsome returns offered by ET, and EPD. Something just wasn’t right, they reasoned. Double-digit returns are often a sign of risk in equity. That’s investing 101. But, for a number of years, the lure of easy money seemed to outweigh any risk, and many investors jumped in.

Those who held off might be congratulating themselves right now as ET’s dividend (after a 50% cut a year or so ago), hit 18% the other day. This is the result of their share price hitting 10-year lows, lower than it entered the decade for a total return for the period of about 4% including those distributions. If you only go back five years the total return is[-17.53%.](https://www.morningstar.com/stocks/xnys/et/trailing-returns)



Source: Yahoo Financials, chart by author

In fairness as regards stock price movement in the last couple of weeks, it is driven more by the tiff between Russia and Saudi Arabia, than their own fundamentals. As you likely well know virtually all energy-related stocks have been decimated following the decision [March 6th,](https://www.forbes.com/sites/arielcohen/2020/03/06/opec-talks-collapse-sending-crude-prices-to-2017-lows/#6b5d4901431d) by two of the world’s largest energy producers to go for market share and flood the market with oil.

In this article, we take a look at the resource fundamentals that drive the MLP business. Then we will narrowly focus in on a couple of metrics that might give investors pause as they decide whether or not to go “bottom-fishing,” in the MLP space, at all. And what companies might have the best prospects to rebound.

**Oil and Gas fundamentals**

It is putting it fairly mildly to say the hydrocarbon industry is in a state of flux right now. The core problem is that the market is drastically over-supplied with each commodity, and has been for some time. This point has been well covered in recent articles so I am not going to develop this point extensively in this article.

[**Related: OPEC+ Scraps Meeting As Oil War Heats Up**](https://oilprice.com/Energy/Crude-Oil/OPEC-Scraps-Meeting-As-Oil-War-Heats-Up.html)

What is worth mentioning is that the business case (supportive commodity prices) for a huge amount of energy development upon which the MLPs have based their investment decisions, has deteriorated seriously in the last few weeks. This can be seen in the most recent release by the Energy Information Agency, (EIA) of its Short Term Energy Outlook, STEO.



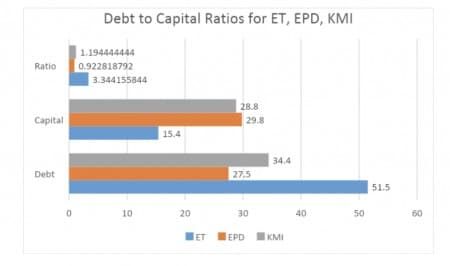
Prices for oil and gas have just collapsed over the last year, as storage volumes for each has risen. Simply put there just isn’t a spare “tea kettle” or “crock pot” to put another liter in and companies are resorting to [floating storage](https://gcaptain.com/shell-eyes-tankers-for-floating-storage/) to cope.

What is alarming and germane to this article is that many of the customers of the MLPs being discussed are [largely financially distressed](https://www.marketwatch.com/story/why-weak-energy-companies-wont-likely-get-a-lifeline-from-higher-oil-prices-2020-01-22) and are [cutting back their development plans](https://www.washingtonpost.com/business/2020/03/13/us-oil-companies-prepare-slash-spending/). If you extend this thinking out a year or so production could fall off, and lessen demand for pipeline transport.

“Tolls” will decline in that scenario and that might create cash flow problems for the pipeline MLPs.

**Debt**

It can be instructive to look at the debt to capital ratios of the [pipeline MLPs](https://oilprice.com/Energy/Crude-Oil/This-Oil-Niche-Is-Performing-Well-Even-With-Low-Prices.html). This metric is a combination of a company’s capitalization and its total debt. Optimal or acceptable ratios of debt to capital vary somewhat according to the industry, but good ratios are in the 1:1 to 1:1.5 range. Generally, [experts agree that this ratio](https://www.investopedia.com/ask/answers/040915/what-considered-good-net-debttoequity-ratio.asp) should not exceed 1:2.0.



Yahoo Financials, Chart by author

Of the three companies we have been discussing, only Energy Transfer is seriously out of step with the debt to capital guidelines. So indebtedness doesn’t explain the market’s disdain for these entities over the past few years. What might?

**Public Perception**

One thing these companies simply can’t get away from is a negative public perception of their presence. Put aside for a moment that they carry the hydrocarbon “stain,” that [inspires avoidance](https://www.washingtonpost.com/business/2020/01/14/blackrock-letter-climate-change/) in the investing circles today.

Pipeline companies by necessity must secure permits and rights of way to build out their networks. This fact brings them into and under the purview of the various local, state, and federal regulatory agencies who must decide for the public at large if its interest is being met. Any one or several of these regulators can stop work on the project without concern for the financial impact it will have on the commercial enterprise. All the companies we are focusing on today have had project delays or cost overruns from regulatory intervention.

[**Related: Saudi Arabia’s Oil War Could Bankrupt The Kingdom**](https://oilprice.com/Energy/Energy-General/Saudi-Arabias-Oil-War-Could-Bankrupt-The-Kingdom.html)

Another vector for potential problems is that much of the routes that these pipelines must travel cross or come close to the boundaries of reservations set aside for American aboriginal tribes. Fierce resistance, often aided by the court’s system, has been encountered in recent years as the tribes have sought to delay or deny forward access to pipelines. A good example of this would be the [tribal protests](https://www.wsj.com/articles/fight-over-dakota-access-pipeline-intensifies-1476234035) around the Dakota Access Pipeline, DAPL. Many of the other pipeline projects undertaken in the last few years have run into similar push back to the DAPL.



[WSJ](https://www.wsj.com/articles/fight-over-dakota-access-pipeline-intensifies-1476234035)

It is worth noting that most of these projects are ultimately completed and go into service, albeit somewhat behind schedule.

What investors should note is that this risk really can’t be mitigated and could and has had adverse impacts on the stocks of the [MLP companies](https://oilprice.com/Finance/investing-and-trading-reports/Get-in-on-Energy-Infrastructure-MLPs-Now.html) in the past. The past impact has been to insulate the stock from upward trends in the industry, and exacerbate downward trends. In the investing game, this is called “Dead Money,” and represents a real risk to capital.

**Insider buys**

Open Market “Buys” by senior executives in a company are often a way of telegraphing confidence in a company’s prospects. These are acquisitions where real money is exchanged for common stock, as opposed to planned buys or planned dispositions. Open Market Buys are bullish indicators, Dispositions less so. It should be noted that this is not a perfect indicator of management's thinking as there are all kinds of reasons to sell stock.

Insiders at Energy Transfer have been scooping up their stock over the last three at a hectic place, with broad participation by the company’s officers and directors. Not the least of which was a nearly $3.8 mm buy from Kelcy Warren (ET’s Founder and CEO) on Feb-28th.

Insiders have been busy at Enterprise Products Partners as well, but not on the same scale as the execs at ET.

At Kinder Morgan, Richard Kinder (Founder and CEO) has been a busy little bee scooping up 1.4 mm shares since the 26th of February for an average cost of ~$16.00/share. Mostly on his own save for a small purchase by one of the firm’s officers.

I wouldn’t go overboard here, but I read this is a bullish sign broadly.

**Your takeaway**

On the bullish side of things, these companies have the real cash flow to cover capex and dividends, at least for now. My point about the possibility of these cash flows diminishing down the road, is not a problem for today. It could be one 6-months from now though.

On the bearish side, which I’ve already tipped my hand on, the industry fundamentals are still weakening day by day. The turmoil is relentless and trillions of dollars of market capitalization across the upstream and downstream industry have been lost in the last 2-3 weeks. I doubt that it is entirely over.

What this means, although the external signs like yesterday’s Monthly Drilling Productivity Report from the [EIA](https://www.eia.gov/petroleum/drilling/#tabs-summary-2) shows shale production still rising incrementally to over 9-mm BOEPD, there is no relief in sight for oil prices. Companies are starting to implement drastic cuts that will over time act to bring some relief to oil prices. ExxonMobil, (NYSE:XOM) just [announced a major cost-cutting](https://corporate.exxonmobil.com/News/Newsroom/News-releases/2020/0316_ExxonMobil-evaluating-significant-near-term-capital-and-operating-expense-reductions) move in light of the reduced demand from the Corona-virus impact. The easiest place for it to cut in its portfolio is in the Permian, so although there were no specifics, that’s where I am looking for big cuts.

You will see more of this in the days ahead. The growth phase of shale production is behind us, and I will detail in a future article how I see that playing out over the next couple of years.

Bottom-line, I am not ready to tie-up capital in a pipeline MLP. You have a fair amount of information now to guide your own investment decisions, and if your investing temperament includes high risk, high reward companies, you might well want to consider one of the companies discussed herein.

By David Messler