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2 MLPs That Offer Risks but Plenty of Reward

By
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As crude oil has rebounded from February's lows, giving new life to energy shares, investors are wondering if the biggest losers in last year's oil price plunge, master limited partnerships, are poised for an equally dramatic bounce back. Some of the larger MLPs are showing signs of life, in spite of the fact they've cut the cash distributions that had made them appear so attractive.

In most cases, investors should be extremely wary and resist the temptation to snap up an apparent bargain in the MLP basement. MLPs were sold as investments that let you have your cake and eat it too, offering a high yield that was sustainable and could even grow. As a deep value investor with four decades of experience in the energy complex, a longtime member of the board of Panhandle Oil and Gas, Inc. **(PHX)**, itself a large mineral owner, and a major shareholder in the company, I can tell you that the truth for most MLPs is quite another story. Most master limited partnerships are structurally flawed. The best and most prudent opportunity in this space today can be found among the small group of limited partnerships that are structurally sound, mineral rights MLPs.

To appreciate the opportunity, it's important to examine the continuing problems and risks of most master limited partnerships. MLPs distribute the cash they generate to investors, while also claiming to have strong growth prospects. Yet growing or even maintaining most businesses requires capital, including, to varying degrees, all midstream energy assets, even pipelines, the sector where many MLPs are concentrated.

Furthermore, some MLPs overstated what they called their "distributable cash flow", a non-GAAP (Generally Accepted Accounting Principles) metric, by underestimating or mischaracterizing their maintenance capital expenditures. Managers were getting around these challenges in sustaining their business model by aggressively leveraging the balance sheet, borrowing at very low interest rates, and raising capital by issuing new equity that was attractive to investors in a yield-starved environment. Effectively, this was a MLP Ponzi scheme that had to collect money from new investors to pay distributions to existing unitholders. When the high tide of elevated oil prices went out to sea, the market saw many players were swimming naked, unable to cover their cash distributions, debt payments and expenses for running the business. The Fed-induced coma of free money facilitated this myth.

Cash flows remain strained, even with the rise in crude prices, so MLPs are reevaluating and revising their business models to try to survive. MLPs in the midstream and upstream business have slashed or eliminated their hefty dividends which were not sustainable. Even the largest energy infrastructure company in the nation, **Kinder Morgan (KMI)**, which is no longer an MLP but still an industry bellwether, chopped its payout by 75%.

Instead of paying distributions, MLPs now have to use cash to pay off debt. As they try to deleverage, midstream companies can't count on improvement in revenues because pipelines and other facilities are at least temporarily overbuilt. And, there's no cash coming from new debt or equity investors because the capital markets now recognize the risks facing these businesses.

The master limited partnerships still standing that do not face a cash squeeze are those requiring no substantial reinvestment in their operations, the model for mineral rights master limited partnerships, which own the rights to exploit the oil and gas beneath their territory. Unlike the capital intensive businesses that predominate in the oil patch, mineral rights MLPs are essentially tollbooth operators who collect fees by leasing their rights to explore, drill and extract oil and gas for a finite period of time. It's a cash flow generating business with minimal balance sheet debt, a structure well suited for the pass-through MLP model that distributes earnings to unitholders. The mineral rights companies didn't leverage themselves in the fat times, so there's no need to expend cash deleveraging today.

The largest of the mineral MLPs is **Black Stone Minerals, L.P. (BSM)**, which came public last May. The units paid an annual distribution of $1.05 over the past four quarters for a yield of 6.8%. Beginning this quarter, the annual distribution is scheduled to rise by 10 cents per unit each year for the next three years, as specified in the offering. Given the tollbooth nature of Black Stone's business and the fact that the company has minimal debt, the distribution and the underlying business appear secure. Technological improvements in fracking technology mean the company is sitting on an asset base which is primed to be developed and monetized over the next decade rather than depleted, again, at no required capital cost to the mineral company. And, if interest rates increase, even gradually, commodity prices, like oil, will likely move higher, which would also benefit Black Stone.

For long term investors willing to take advantage of the price discount that can come with limited liquidity, a small cap mineral resources Master Limited Partnership also worth considering is **Dorchester Minerals (DMLP)**, which carries no debt and yields 5.8%. More than 30 percent of its reserves and minerals are in the oil rich Permian Basin. Both Dorchester and Black Stone stand to benefit if the price of natural gas continues rebounding after hitting a multi-year low in early March.

Granted, the volatility in natural gas and crude oil can shake the price of mineral resources units, so these are best suited for those with a long-term horizon. But such investments are hard to find in today's market: bond-like instruments that offer a high yield, minimal debt, and a play on commodity prices that are still historically depressed.

It's important to consider another factor that distinguishes Black Stone and Dorchester Minerals from other master limited partnerships. In most MLPs, general partners who manage the partnership receive "incentive distribution rights" when an MLP is issued. This gives the general partners the right to a rising share of cash distributions as distribution benchmarks for the limited partners are reached. General partner distributions usually start at 2 percent of cash flow and rise to 50 percent, presenting a temptation for general partners to raise distributions by more than the underlying business can afford. Black Stone Minerals and Dorchester Minerals have no such incentive distribution rights, giving further assurance their managements will operate with prudence.

In our low interest rate world, investors can easily be attracted by high yields, as they are focused on getting a return on their money. But what's even more important, particularly when considering MLPs, is ensuring that they will receive a return *of* their money. With that in mind, mineral rights companies are by far the best alternative for investors seeking income from MLPs.

Robert Robotti is president of Robotti & Company Advisors, a money-management firm based in New York. Currently, he personally or his firm have positions in shares of Panhandle Oil and Gas, Inc., *Black Stone Minerals, and Dorchester Minerals.*

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