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Market Trends 2019/20: Master Limited Partnerships

A Lexis Practice Advisor® Practice Note by Eric Johnson, Michael Blankenship, Ben Smolij, and John Niedzwiecki, Winston & Strawn LLP

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This practice note will examine the recent trends regarding master limited partnerships (MLPs) beginning with the continuing consolidation occurring in the industry and presenting an overview of notable transactions. It will then discuss other recent trends including the continuation of Incentive Distribution Rights (IDR)-related transactions, legislative developments as well as distribution activity and conclude by offering an outlook for 2020. Continuing to face strong headwinds from commodity prices, MLPs had a defining 2019. Many upheld capital discipline and successfully generated sufficient cash flow to maintain or even grow distributions. Others have continued to struggle in the current environment, especially those focused on gas gathering and processing.

For additional information on MLPs, see Top 10 Practice Tips: Master Limited Partnerships, Market Trends 2018/19: Oil and Gas Transactions, and Oil and Gas Industry Guide for Capital Markets.

Notable Transactions

Below is a list of selected notable transactions announced in the past year. As is evident from the parties involved, there is increased interest from private equity investors.

Date of Announcement	Target	Acquirer
3/18/19	American Midstream Partners, LP	ArcLight Energy Partners LP
5/8/2019	Andeavor Logistics LP	MPLX LP
5/10/2019	Buckeye Partners, L.P.	IFM Investors Pty Ltd.
8/28/2019	Tallgrass Energy, LP	Blackstone Group Inc., Blackstone Infrastructure Partners L.P.
9/16/2019	Semgroup Corp	Energy Transfer LP
11/15/2019	Noble Energy Inc.	Noble Midstream Partners LP

Consolidation and Private Equity Participation

The past year witnessed additional consolidation in the MLP space. This trend largely began in 2015 and since that time MLPs represent approximately 19% less of the midstream universe than before. The share of MLPs versus U.S. and Canadian midstream entities in a more traditional C-Corp structure has also decreased. The mix of MLP and C-corps in the energy space will be closely watched and reflect the attractiveness of the MLP structure going forward. Interestingly, the sole MLP IPO of 2019, Rattler Midstream LP, went public in the MLP form but elected to be taxed as a corporation.

Consolidations in the MLP segment have typically involved a parent sponsor's outright acquisition of the MLP or an offer by the parent to purchase the outstanding LP units. The motivation for such roll up or consolidation transactions varies but are clearly driven by the belief that the resulting structure will derive greater value. This may be due to a simplification of the capital structure or other tax/regulatory motivations as discussed below. Other consolidations involve the merger of two unrelated MLPs such as the MPLX LP and Andeavor Logistics transaction this past year.

An interesting new trend that accelerated in 2019 is the participation of private equity firms either in the form of joint ventures with or acquisitions of entire MLPs. The most notable of such transactions occurring in 2019 has been the buyout of Buckeye Partners, L.P. by IFM Investors Pty Ltd. in an all cash deal valued at $6.48 billion. Similarly, Blackstone Infrastructure Partners closed on the purchase of Tallgrass Energy, LP's general partner and a 44% interest in Tallgrass Energy, LP for $3.2 billion.

A diverging valuation of MLP assets by private and public markets is credited with the increased interest in MLPs from private equity investment. Private investors tend to value midstream assets at a premium to public market valuations. Such transactions have validated claims by MLP management teams that the stock market unjustly undervalues MLP equity.

IDR Simplification and ESG

Typically, the general partner of an MLP owns a noneconomic general partner interest in the partnership, IDRs, and common and subordinated limited partner units. Historically, IDR simplification transactions have been employed by both strong performing and struggling MLPs. For the more successful MLPs with high levels of cash distributions, IDRs burden such entities by increasing the cost of capital relative to peers, which may hinder acquisitions. Alternatively, IDRs in weaker performing MLPs are considerably "out of the money" if even meeting minimum quarterly distributions is difficult. IDR simplification transactions can take many different forms including IDR resets under the limited partner agreements, elimination of IDRs in exchange for common units, or M&A transactions with the general partner. While these transactions are not new to MLPs, they have witnessed a resurgence during recent times. The current driver for such transactions has been in response to weakening unit performance and a desire to improve MLPs' cost of equity. IDRs may be eliminated either by a direct offer to purchase the General Partner interest and associated IDRs, or by consolidating the General Partner and the MLP.

Over the past few years, most MLPs have eliminated IDRs through IDR simplification transactions. This past year witnessed additional such transactions for some remaining MLPs that still had IDRs. These include Hess Midstream Partners, DCP Midstream, and Noble Midstream Partners. Rattler Midstream LP, a new MLP going public last year, launched without any IDRs on its balance sheet. The move away from IDRs is favorably viewed from the investment community as reflective of better corporate governance and aligning the interests of the General Partner and Limited Partners.

The elimination of IDRs timely corresponds to the increased prevalence of environmental, social, and governance (ESG) considerations for investors. MLPs have been steadily increasing their engagement of such topics. In 2019, several MLPs filed their first sustainability reports disclosing ESG related plans and goals. Such reports provide an opportunity for MLPs to communicate the extensive efforts undertaken to maintain safe and environmentally conscious operations. Outside of sustainability reports, MLPs have also shown increased engagement with the investment community on ESG topics and improved disclosure of ESG data.

Other Key Trends

Dividend Growth and Self-Funding

A noteworthy trend that continued in 2019 was the dearth of MLP equity issuances. Largely as a result of continued pricing pressure on MLP equity securities, issuers struggled to raise the necessary cash to fund growth projects through unit issuances. Many have turned to self-funding by relying on free cash flow to fund projects. This trend is also reflective of a maturing industry. While the management of most MLP issuers have not ruled out equity issuances if appropriate to fund strategic acquisitions or drop downdrop-down transactions, few have pursued this route.

As a result of more disciplined cash management strategies and simpler balance sheets, many MLPs have generated improved cash flow. Several have announced increases in distributions including Hess Midstream Partners, Noble Midstream Partners, and Plains All American Pipeline all of which enjoyed dividend growth of over 10% in 2019. Other MLPs have struggled to achieve sufficient cash flow in the current commodity price environment to maintain distribution levels and have been forced to cut distributions over the past year.

Buybacks

Following the trend of improved cash flow, there is increasing discussion among MLP management of buyback programs. These programs provide issuers with a means to generate returns for unitholders apart from distribution hikes. Most recently, Magellan Midstream Partners and Enterprise Products Partners announced plans for unit buybacks in 2020. Many expect increasing dividends and buybacks next year given the low demand for capital growth spending

Regulatory Developments – Proposed Legislation Impacting Renewables

Interesting legislation has recently emerged that hopes to expand the MLP universe by allowing companies in the renewable energy space to take on the MLP form. In June of 2019, Senator Chris Coons of Delaware introduced The Financing Our Energy Future Act that expands the definition of Qualifying Income to include power generation operations deriving energy from solar, wind, hydropower, hydrokinetic, biomass, and geothermal sources. The bill has enjoyed bi-partisan support and may attract a wider investor base for such companies.

Market Outlook

Throughout the remainder of 2020, many of the existing trends related to MLPs are expected to continue. MLPs ability to respond to challenging commodity pricing environments will largely influence decisions in the coming year. Those focused on gas gathering and processing may be particularly challenged depending on their exposure to certain basins and geographic diversification. For example, some gas pipelines supply gas to utilities or LNG export facilities and are less impacted by demand fluctuations. Those MLPs that continue to have IDRs will likely seek transactions that involve their elimination. Many commentators believe that we have already passed the peak of consolidation and simplification transactions. With respect to continuing consolidation transactions, many will closely watch whether surviving entities continue on in the MLP form or convert to C-corps.

The industry fundamentals remain strong. Much of the strength is driven by industrial demand and coal to gas power generation conversions. Forecasters expect domestic crude oil and natural gas production to continue to increase through 2020. The pace of growth is likely to slow partly in response to weaker pricing. Many MLPs will likely continue to focus on cost reductions and capital discipline in response. Even in the face of price volatility, the midstream business model of depending on volume over commodity prices coupled with improved balance sheets and governance keeps MLPs attractive for many investors.

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Eric Johnson has extensive experience representing private and public energy companies, including master limited partnerships, in a broad range of corporate and securities matters. Eric has represented both publicly-traded and privately-held companies in numerous mergers, stock purchases, asset purchases, and acquisition and disposition transactions. He has represented issuers, underwriters, and selling stockholders in registered and private offerings of equity and debt securities, tender offers, and exchange offers. Eric assists his publicly-traded clients on corporate governance matters. He also assists clients in connection with general commercial and contractual matters.

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