Alerian

Why Yesteryear's Valuation Metrics Aren't Sufficient for Today's MLP

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The MLP space has changed significantly in recent years with consolidations, distribution cuts, a shift away from raising equity, and a focus on positioning for sustainability instead of growth at all costs. The ripple effects of these changes have been widespread, but the focus of this piece is on the implications for valuation, particularly given a changing investor base.

MLPs have historically been known for their yield. Because yield was the focus, valuations for the space were also based on yield. Distributions and the growth of distributions were the hallmarks of the space for many years, which cultured a broad retail investor base. In the wake of the oil downturn, many MLPs cut their distributions and adjusted their business models to focus on more moderate distribution growth in favor of using retained cash flow for other purposes (debt reduction, self-funding equity). In other words, MLPs became more total-return focused than in the past. These changes not only made yield-focused metrics less meaningful, but they also contributed to a change in the investor base, with many retail investors exiting.

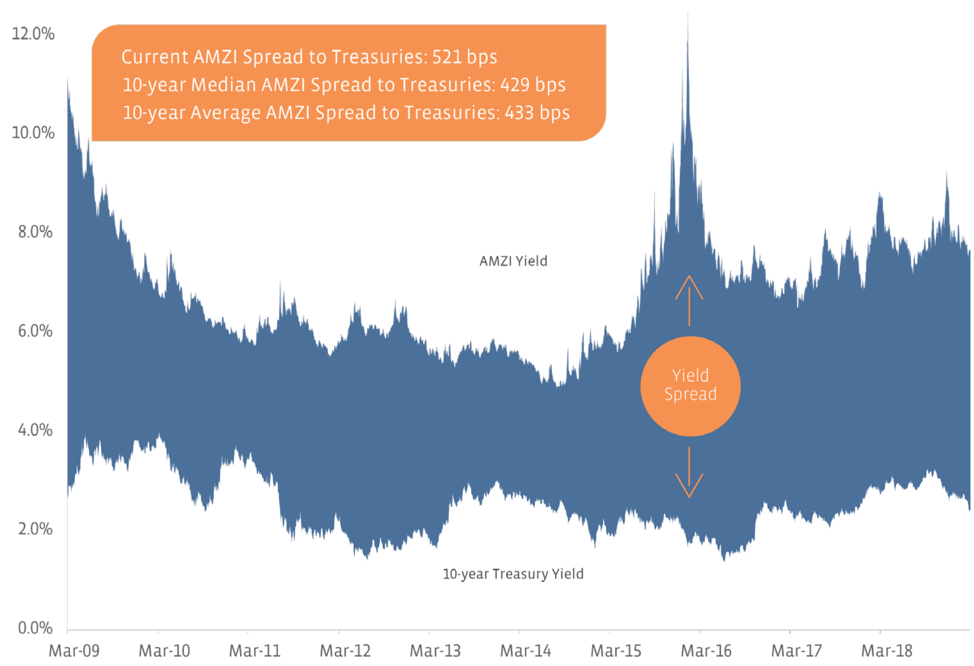
The evolution of MLP business models and the need to attract new investors to replace the retail contingent that left requires a fresh approach to MLP valuation metrics. Some distribution-based valuation methods still serve investors, particularly with distribution cuts largely behind the space. However, MLP-centric valuation methods using non-standardized measures that do not allow for broader comparison with other sectors are inadequate on their own, particularly for generalist investors. This piece explores historical valuation metrics and the valuation tools that are expected to become more prevalent going forward as MLPs increasingly compete with other sectors for generalist investor dollars. The Alerian MLP Infrastructure Index (AMZI) is used throughout to represent MLPs in valuation approaches.

Historically, MLP valuations focused on yield and distributable cash flow.

Despite offering other attractive characteristics such as real asset exposure and diversification, investors have historically focused on yield as the primary benefit of investing in MLPs. Accordingly, valuation metrics have been largely yield-focused, whether using yield alone, using yield and distribution growth as an estimate for total return, or comparing MLP yields to bonds or other equities. The ease of calculating yield also supported its widespread adoption. While yield is a useful metric for investors, it is somewhat limited as a valuation tool, particularly when it comes to comparability with other sectors. For example, looking at yield alone, MLPs will appear attractive relative to many other sectors, but that does not necessarily mean MLPs are a better value.

One of the most common ways that investors have historically valued MLPs is by comparing their yield to that of the 10-year Treasury. The greater the spread between the two relative to a historical mean or median, the more attractive the valuation for MLPs. This method completely ignores business fundamentals to solely focus on relative yield. The chart below compares the yield on the AMZI to that of the 10-year Treasury over the last ten years. Yield spread charts like this one are frankly an easy, but ineffective, means for valuing MLPs. In finance, a higher yield indicates higher risk, and in general, MLPs have made changes to their businesses to lower their risk profile, including reducing leverage, raising distribution coverage, improving corporate governance (eliminating IDRs), shifting to self-fund equity, and engaging in more joint ventures at the project level. If appreciated by the market, the result would be lower yields and higher equity prices. On the other hand, a dovish stance from the Fed has lessened expectations for rising rates this year, but the potential for rates to eventually increase would impact the relative comparison with MLP yields. Independent of changes to MLP yields, should an increase in the 10-year Treasury yield really determine the valuation of an MLP investment? Certainly not on a standalone basis.

Yield Spread Charts Are Becoming Less Relevant to MLP Valuations



Source: Bloomberg, Alerian as of 3/29/2019

The dividend discount model (DDM) is also commonly used to value individual MLPs. This model discounts all future expected distribution payments to their present value to calculate the MLP's intrinsic value (see formula below). Using the DDM requires incorporating distribution growth assumptions and the MLP's cost of equity. Small adjustments to the inputs in the equation, particularly the terminal growth rate assumption, can have large impacts to the resulting valuation. Because the DDM is best applied to companies paying steady (or growing) dividends, it would not have been a useful metric for MLPs that cut their distributions in recent years. Despite its limitations, the DDM can still be useful today, particularly with needed distribution cuts largely behind the MLP space and distribution growth likely becoming steadier but more modest than it was prior to 2014.

$$\text{Value of MLP} = \frac{\text{Expected distribution per unit}}{(\text{Cost of equity} - \text{Distribution growth rate})}$$

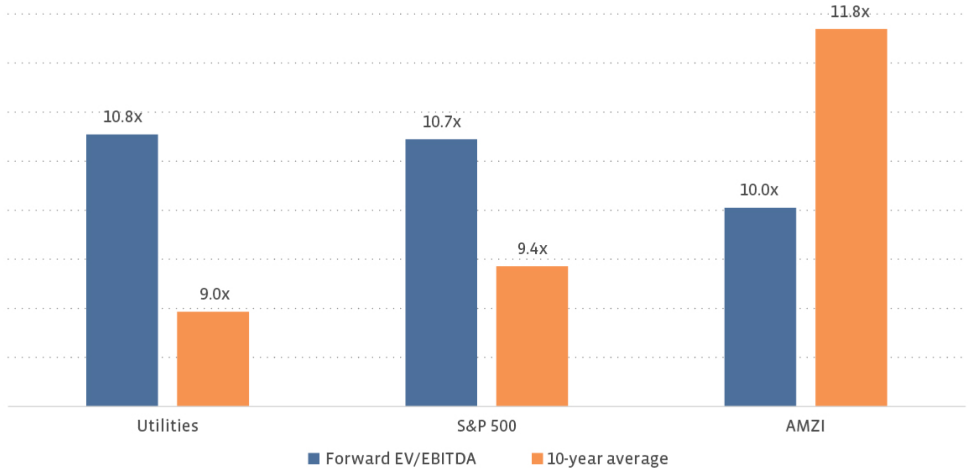
Finally, valuation metrics in the MLP space have often been based on distributable cash flow (DCF). DCF is a measurement of the cash that a partnership generates in a period that is available for distribution to unitholders. As a non-GAAP, MLP-specific metric, valuations based on DCF can create challenges. First, DCF is not readily comparable to other sectors, and moreover, DCF can be reported differently even among MLPs due to different treatment of certain items or company-specific nuances. To use DCF effectively to compare MLP valuations, one would have to standardize DCF among the companies, making assumptions as needed. Historically, Price-to-DCF and a multi-stage DCF discount model have been preferred ways to value MLPs. Certainly, DCF-based valuation metrics are helpful tools for sell-side analysts and MLP-dedicated asset managers. For generalists or new investors, the ability to compare MLPs with other sectors using a widely applicable valuation metric is important, and DCF-based metrics fall short in this regard.

Widely comparable valuation methods should gain traction going forward.

MLP valuations should evolve with the changes to the MLP business model and investor base. Yield and DCF-based metrics still have a place in the conversation, but more comparable valuation metrics should gain in prevalence over time. Why? MLPs need to attract new investors, including generalist institutional investors that are evaluating many sectors. To state the obvious, distribution cuts, weak performance in recent years, and heightened volatility have caused many retail investors to leave the space. Replacing those investors will require courting a wider investor base and competing against the broader market for investor dollars. New or generalist investors will likely prefer to value MLPs using familiar metrics.

Enterprise value to forward EBITDA (EV/EBITDA) has been used historically for MLPs and facilitates comparison with other sectors. Sum-of-the-parts[1] valuation approaches used to compare MLPs also rely on EV/EBITDA. Energy Transfer (ET) has incorporated a valuation slide with EV/EBITDA multiples in its investor presentation. Typically, investors compare current enterprise value to forward (or future year) expected EBITDA, which is more relevant than historical EBITDA. In the chart below, Bloomberg consensus 2020 EBITDA estimates are used as the denominator, and the weighted average EV/2020 EBITDA for the AMZI[2] is compared against Utilities, represented by the S&P 500 Utilities Index (S5UTIL), and the S&P 500. On a forward EV/EBITDA basis, MLPs (as represented by the AMZI) are currently trading at a discount relative to Utilities and the S&P 500. Notably, MLPs are also trading below their historical ten-year average forward EV/EBITDA while Utilities and the S&P 500 are trading at premiums relative to history.

AMZI Trading at a Discount to Utilities, the S&P 500, and its Historical Average Based on Forward EV/EBITDA



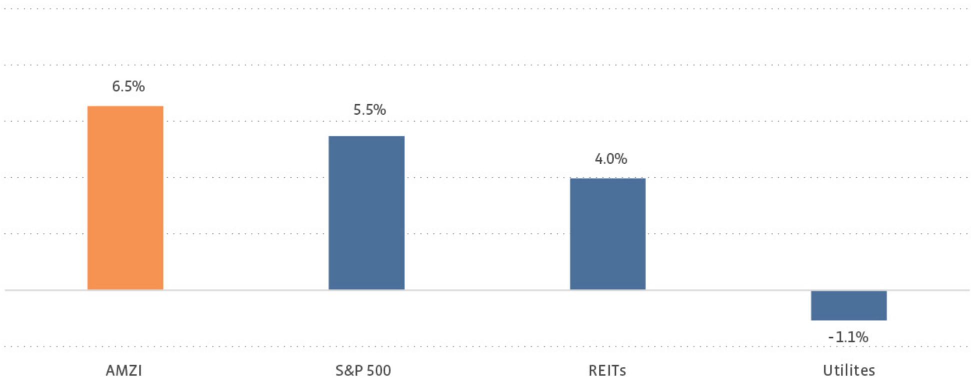
Forward EV/EBITDA based on Bloomberg 2020 EBITDA estimates.
Source: Bloomberg and Alerian as of 3/29/2019

Going forward, free cash flow (FCF) yield should become a more important metric for valuing MLPs, particularly as capital spending moderates from the hefty levels of recent years as long-lead projects come online. Enterprise Products Partners (EPD) included a slide in its analyst conference presentation highlighting its growth in FCF. FCF simply measures how much cash a company generates after paying for capital expenditures, or in other words, how much cash is available for paying down debt, investing in growth projects, or returning cash to stockholders/unitholders. FCF yield compares FCF to a company's market capitalization, allowing investors to evaluate FCF for companies using a standardized measure.

1 // In a sum-of-the-parts valuation, each MLP segment is assigned different EV/EBITDA multiples based on the profile of the business to calculate the total value of the MLP.
2 // The appendix includes EV/2020 EBITDA for the constituents of the AMZI used to calculate the weighted average included in the chart on the following page. The weights for the weighted average are based on the March 15, 2019 quarterly rebalancing.

The chart below shows current free cash flow yield based on estimated 2020 FCF per Bloomberg. REITs, as represented by the Real Estate 50 Index (FNR5), are included for additional comparison. Valuation methods for REITs tend to be sector-specific, but FCF yield is applicable. While the AMZI screens favorably relative to other sectors and the broader market, the 2020 FCF yield also represents a notable improvement relative to recent history. In 2016, for example, absolute FCF for the AMZI was negative. The improvement in FCF for MLPs reflects both growing cash flow from operations and improving capital discipline.

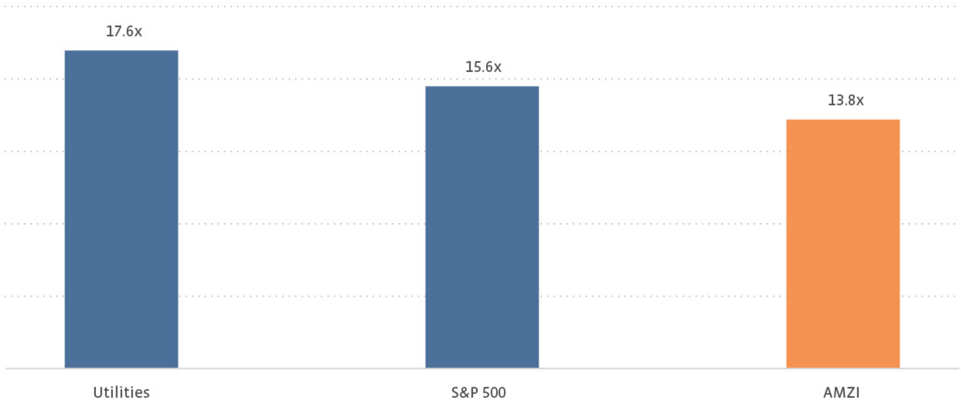
AMZI's 2020 Free Cash Flow Yield Compares Favorably to the Broader Market



Source: Bloomberg as of 3/29/2019

Price-to-earnings (P/E) is another metric frequently cited across sectors for valuation purposes. Setting aside relative weakness in net income compared to preferred cash flow-based metrics, earnings per share (unit) tends to be less meaningful for MLPs. Because of their prolific project building, MLPs tend to have high depreciation, which results in low earnings. For AMZI constituents, the range of forward P/E ratios was 6.4x to 34.5x (see appendix). While acknowledging the shortcomings of the P/E ratio for MLPs, we include below the weighted average P/E ratio for the AMZI relative to Utilities and the S&P 500 for context based on 2020 estimated earnings.

P/E Shortcomings for MLPS Limit Usefulness of Comparison



Source: Bloomberg and Alerian as of 3/29/2019

Investors may look at additional return-based metrics to compare MLPs or to compare MLPs with other sectors, including return on invested capital (ROIC) and return on equity (ROE). ROIC[3] is an indication of how well a company is using its debt and equity to generate profits. ROIC can be a useful gauge to measure value creation from acquisitions and as a check on whether company returns align with management's commentary on organic project returns. ROE, which compares net income to shareholder equity, will not be relevant for those MLPs with high depreciation and hence low income. EPD includes a chart of its historical unlevered ROIC[4] and ROE in its investor presentation to highlight its returns on capital. ROIC can further be compared to a company's weighted average cost of capital (WACC) to better understand the extent to which companies are creating value. Returns should exceed a company's cost of capital to if value is being generated. ROIC and ROE are useful as widely accepted and understood metrics, but each sector may have its own expected ranges, limiting broad comparisons.

Conclusion

The MLP business model and capital allocation strategy has changed significantly over the last five years, which has also led to an evolving investor base. Income remains a key tenet of MLP investing, but yield-based valuation metrics do not necessarily allow for a sufficient appreciation of the positive developments in the space (lower leverage, higher coverage, self-funding equity) or a useful comparison with other sectors. The new institutional and generalist investors that MLP management teams (and sell-side analysts) are targeting will want to compare MLPs with other sectors using familiar valuation metrics. As a result, MLP valuation metrics should increasingly shift from yield and DCF-based methods to more recognized approaches such as EV/EBITDA and FCF yield.

3 // The formula for ROIC is Net Operating Profit After Taxes divided by Invested Capital. Invested Capital represents a company's debt and equity.
4 // EPD calculates ROIC as gross operating margin divided by the average historical cost of the underlying assets (including fixed assets, investments in unconsolidated affiliates, intangible assets, and goodwill).

Appendix

AMZI Constituent Forward EV/EBITDA and P/E Ratios

Name	Ticker	EV/EBITDA	P/E
Andeavor Logistics LP	ANDX	9.2x	10.8x
Buckeye Partners LP	BPL	10.6x	11.0x
Crestwood Equity Partners LP	CEQP	9.4x	27.7x
Cheniere Energy Partners LP	CQP	12.7x	15.2x
DCP Midstream LP	DCP	7.6x	14.1x
Enable Midstream Partners LP	ENBL	9.3x	13.1x
EnLink Midstream LLC	ENLC	11.7x	34.5x
Enterprise Products Partners LP	EPD	11.0x	13.7x
EQM Midstream Partners LP	EQM	8.3x	8.0x
Energy Transfer LP	ET	8.9x	10.2x
Genesis Energy LP	GEL	9.6x	23.5x
Holly Energy Partners LP	HEP	11.7x	14.4x
Magellan Midstream Partners LP	MMP	11.5x	13.7x
MPLX LP	MPLX	9.6x	11.8x
Noble Midstream Partners LP	NBLX	7.7x	6.4x
NGL Energy Partners LP	NGL	8.8x	25.8x
NuStar Energy LP	NS	10.1x	19.2x
Plains All American Pipeline LP	PAA	10.4x	11.7x
Phillips 66 Partners LP	PSXP	7.4x	10.8x
Shell Midstream Partners LP	SHLX	7.5x	11.0x
TC PipeLines LP	TCP	10.8x	10.3x
Tallgrass Energy LP	TGE	11.1x	19.0x
Western Midstream Partners LP	WES	10.5x	10.7x
Weighted Average*		**10.0x**	**13.8x**

Based on Bloomberg estimates for 2020 EBITDA and Earnings per Unit
*Weighted average is based on index weightings as of the 3/15/2019 quarterly rebalancing
Source: Bloomberg and Alerian as of 03/29/19

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