THE SHIPPING MASTER LIMITED PARTNERSHIP (MLP) – A BLESSING WITHOUT A CURSE?

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Quality of company and distribution strategy are key
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PRIMARILY ESTABLISHED FOR THE ENERGY SECTOR

An MLP is a relatively ‘modern’ specific type of US corporate structure which was established in the 1980s with the intention to encourage primarily US energy infrastructure investments in the transportation (mainly pipelines), storage, processing, refining, marketing, exploration, production, and mining of minerals or other natural resources. The majority of MLPs own and operate assets across the whole energy supply chain and are listed on the NYSE and NASDAQ.

A PARTNERSHIP IS NOT AN ENTITY

MLPs are partnerships and differ from corporations because they are considered to be the aggregate of their partners rather than separate entities. Partners in an MLP own individual fractions of the partnership (‘units’; partners are called ‘unit-holders’). Because the partnership is not an entity, it pays no corporate taxes on its profits. The tax liabilities are passed on to the individual unit-holders who pay tax on their share of MLP profits at their individual tax rates. The MLP resembles a German ‘Kommanditgesellschaft’. Unit-holders typically receive quarterly cash distributions from their MLP but are also allocated a share of depreciation on the MLP. This means that one part of the distributions represents a repayment of the initial investment (‘Einlagenrückgewähr’).

CLEAR DIFFERENTIATION BETWEEN GENERAL PARTNERS AND LIMITED PARTNERS

There are two classes of MLP owners: general partners (GPs) and limited partners (LPs). GPs manage the day-to-day operations of the partnership. An MLP technically has no employees, so all services from business development, manage-

MANIFOLD BENEFITS FOR INVESTORS

1 CONSISTENT DISTRIBUTIONS OVER TIME | Companies that use the MLP format often operate in very stable, slow-growing industries such as pipelines. Many MLPs generate secure, steady income by having shippers sign long-term ‘ship-or-pay’ contracts meaning that the MLPs would receive fees regardless of whether the shippers or the commodity owners were actually using the pipeline. These long-term contracts make the cash distributions of MLP units very predictable (‘toll-road’ analogy). Cash distributions to owners often exceed the partnership’s profit. The difference is counted as a return of capital to the LP and subject to the capital gains tax when the unit-holder sells its units.

2 BELOW-AVERAGE RISK | There is little prospect for unit price appreciation. However, the stability of the businesses that use the MLP format means below-average risk for investors. The relatively even cash distributions cause MLP units to trade somewhat like bonds, rising when interest rates fall and vice versa.

3 HIGH YIELD | Most MLPs offer attractive cash yields, generally in the 6-7% range.

4 LOWER COST OF CAPITAL | The absence of taxes at company level gives MLPs a lower cost of capital, allowing them or their sponsors to pursue projects that might not be feasible for a taxable entity.

5 NO COMMODITY EXPOSURE | Unlike typical energy companies, MLPs – at least in theory – tend not to take on commodity exposures, thereby reducing the risk and the cash flow volatility.

6 GPS’ COMPENSATION ALIGNED WITH LPS’ INTEREST | Most GPs are paid a greater share of each dollar of cash flow as the LPs’ cash distributions rise, giving the GP an incentive to increase LP distributions as well.

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CONSIDERABLE DOWNSIDES TO MLPs

1 PERSONAL TAX LIABILITY | Each unit holder is responsible for paying his or her share of the partnership’s income taxes which can make filing taxes more complicated.

2 LIMITED POOL OF INVESTORS | MLPs face a smaller pool of potential investors than traditional equities because large institutional investors such as pension funds usually do not pay taxes and are not allowed to hold MLPs.

GP’S AND LP’S INTERESTS NOT ALWAYS ALIGNED

Most MLPs leave up to 98% of the LP units available for sale to the public. However, apart from their 2% stake in the MLP, GPs often retain special ‘Incentive Distribution Rights’ (IDRs). These give the GP an increasing share in the distributable cash flow the MLP generates. With growing distributable cash flow, a relatively larger portion of that cash is distributed to the GP, meaning that the additional cash is more and more split in favor of the GP. When what is known as the ‘high splits’ level is reached, for every additional dollar distributed to the LP units, one dollar is also distributed to the GP (50/50 split). This will occur despite the fact that the investment producing each incremental dollar of distributable cash flow is funded in proportion to the ownership interest: the LP funds 98% of the capital required and the GP 2%, yet each receives 50% of the cash flow produced by that investment once the high splits threshold is met. The result is a much higher return for the GP even if the underlying investments only generate modest returns for the LP. This could place the LP at a disadvantage relative to the GP as such structures may incentivize the GP – as the manager of the MLP – to propose investments which only generate very modest returns for the LP while they could be extremely profitable for the GP.

A SUCCESS STORY?

The expansion of the US shale energy production has been one of the most important economic events in recent US economic history and resulted in a boom that has significantly boosted US onshore energy production. MLPs have considerably benefited from the increased capital needs to finance the shale energy infrastructure. Another driver was the increased demand for higher yield instruments in a low interest rate environment. As a result, the Alerian MLP Index (leading measure of energy MLPs whose components represent approximately 85% of total public float-adjusted market capitalization) increased 286% from 189 at the beginning of January 2009 to a high point of 540 at the end of August 2014. However, the index has declined by 299 points to reach 241 points as of February 17, a reduction of 55%.

A BITTER AFTERTASTE

The five years win-win for investors and midstream energy companies created the financial platform for the US shale boom - as long as high commodity prices provided the incentive for producers to keep drilling to recover more oil and gas for MLPs to process and transport. Falling prices have slowed down the growth in US shale oil and gas output as producers cut back capital expenditure and drilling rig contracts. Although US production has remained remarkably strong because of improved productivity, the aforementioned toll-road analogy only works if those paying the toll stay in business, and if they continue to have an increasing need to use that toll-road. The several years of high returns experienced by investors...
created a belief that this was the norm. However, some of those shippers may not survive the current downturn at worst or seek to renegotiate terms at best, thereby reducing contracted MLP revenues.

WEAL AND WOE
The ‘good’ MLPs have a strong balance sheet with the ability to cover debt payments and distributions from cash flow easily. The ‘bad’ MLPs are the ones with higher debt and less ability to maintain distributions. MLPs are not immune to their underlying markets, for example commodity prices in the case of energy MLPs or charter contracts and vessel values in the case of marine & shipping MLPs. Eventually, prolonged weaknesses in commodity prices and charter revenues will undermine the shippers’ ability and willingness to pay the toll fee and the charter rate, respectively.

MARINE MLPS
ONLY A SMALL FRACTION
As of February 2016, there were about 120 MLPs with a total market capitalization of USD 253bn. Of this, the share of marine transportation MLPs is just 1.6% or USD 4bn. The reasons for this are that the marine transportation is a new asset class to the MLP sector as it was established only in the mid-2000s. Secondly, the average market capitalization for shipping MLPs of about USD 400m is relatively small compared to the MLPs established for investments in the US energy infrastructure.

PERCEIVED RISKS REFLECTED
BY WIDENING MARGINS
The strong performance of shipping MLPs from 2009 to 2015 is reflected in the increase from 90 to 250 points of the Notos Marine MLP Index. However, the ongoing collapse in energy and commodity prices with its negative impact on the oil & gas MLPs have also dragged down shipping MLPs. In the wake of the falling sentiment, investors started selling even ‘good’ MLPs with sound financials and profitable long-term time charters.

MARINE MLP MATRIX

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>MARKET CAP</th>
<th>CURRENT YIELD</th>
<th>AVERAGE CONTRACT COVERAGE</th>
<th>FLEET NO. OF VESSELS</th>
<th>AVERAGE FLEET AGE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OFFSHORE</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>TEEKAY OFFSHORE PARTNERS L.P.</td>
<td>384m</td>
<td>15.5%</td>
<td>4.2 years</td>
<td>57</td>
<td>13.3 years</td>
</tr>
<tr>
<td>SEADRILL PARTNERS LLC</td>
<td>259m</td>
<td>38.5%</td>
<td>2.7 years</td>
<td>11</td>
<td>3.2 years</td>
</tr>
<tr>
<td>TRANSOCEAN PARTNERS LLC</td>
<td>601m</td>
<td>17.0%</td>
<td>2.6 years</td>
<td>3</td>
<td>4.6 years</td>
</tr>
<tr>
<td>KNOT OFFSHORE PARTNERS L.P.</td>
<td>485m</td>
<td>13.1%</td>
<td>5.6 years</td>
<td>10</td>
<td>3.9 years</td>
</tr>
<tr>
<td><strong>LNG</strong></td>
<td></td>
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<tr>
<td>TEEKAY LNG PARTNERS L.P.</td>
<td>885m</td>
<td>5.5%</td>
<td>7.4 years</td>
<td>81</td>
<td>3.3 years</td>
</tr>
<tr>
<td>GOLAR LNG PARTNERS L.P.</td>
<td>925m</td>
<td>15.8%</td>
<td>5.1 years</td>
<td>10</td>
<td>7.3 years</td>
</tr>
<tr>
<td>GASLOG PARTNERS L.P.</td>
<td>509m</td>
<td>12.5%</td>
<td>8.1 years</td>
<td>8</td>
<td>5.0 years</td>
</tr>
<tr>
<td><strong>BULK</strong></td>
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<tr>
<td>CAPITAL PRODUCT PARTNERS L.P.</td>
<td>413m</td>
<td>28.5%</td>
<td>6.8 years</td>
<td>34</td>
<td>7.0 years</td>
</tr>
<tr>
<td>NAVIOS MARITIME PARTNERS L.P.</td>
<td>97m</td>
<td>0.0%</td>
<td>3.1 years</td>
<td>32</td>
<td>7.5 years</td>
</tr>
<tr>
<td>NAVIOS MARITIME MIDSTREAM PARTNERS L.P.</td>
<td>181m</td>
<td>18.4%</td>
<td>5.5 years</td>
<td>6</td>
<td>9 years</td>
</tr>
</tbody>
</table>

Source: Notos Group, 03/2016
Investors’ confidence in MLPs was betrayed by some MLPs’ decision to reduce or even completely cut dividends. As steady dividends have been the primary reason to invest in these MLPs, investors ‘fled’ when distributions were gone. Furthermore, high leverage in times of practically closed capital markets as well as much increased roll-over risks of charters for dry bulk vessels and containerships also have increased the risk profile of MLPs and forced them to cut their distributions. This triggered a sell-off of shipping MLPs which is mirrored in the Notos MLP Index’s decline of 150 points or 60%. The perceived increase in the risk of shipping MLPs is reflected in an average yield of currently 17%.

**TO PAY OR NOT TO PAY DIVIDENDS**

While some of the shipping MLPs have a more speculative business model, for example a high leverage requiring a broad recovery of markets, especially in the dry bulk and container shipping, most shipping MLPs are financially sound with a good cash flow visibility of more than five years. Nevertheless, the market is discounting all perceived risks without differentiating between ‘good’ and ‘bad’ structures. It remains to be seen whether there will be more distribution cuts from MLPs less willing to carry on with expensive dividend programs or whether MLPs will stick to their consistent dividend policy in order to maintain credibility with their investors.

**CUTTING DISTRIBUTIONS COMES AT A PRICE**

The negative impact of distribution cuts on investors’ confidence is best illustrated by Teekay Group’s December 2015 decision to cut the dividend of Teekay Corp (TK) by 90% and the distributions of its MLP subsidiaries Teekay Offshore (TOO) and Teekay LNG (TGP) by 80%. TK Group explained the cuts with preserving cash at the MLP subsidiaries to fund committed projects at the MLP level during times of capital markets being too expensive. Following such announcement, the share prices of TK, TOO and TGP dropped by 50-60%. This sell-off may be regarded as exaggerated given the long contract coverage and good cash flow visibility of TOO (4.3 years on average) and TGP (7.7 years on average) and their strong intrinsic valuations based on fleet value and long-term charters.

Teekay Group was not only ‘downgraded’ by investors but also by the rating agencies: Moody’s reduced the stand-alone rating of the MLPs’ parent company TK because TK as GP and LP shareholder of TOO and TGP will receive significant lower cash distributions from its subsidiaries in the future which affects its ability to reduce debt and fund new projects. Due to less liquid equity capital markets, the MLPs, too, will have to

**KEY FACTORS FOR 2016**

We believe that MLPs with one or more of the following characteristics are more likely to cut distributions in 2016:

1. **HIGH LEVERAGE** | If cash flows are reduced due to weak fundamentals, for example lower charter income, the companies may choose to cut dividends and use the resulting cash savings to reduce leverage.

2. **NEAR-TERM CHARTER ROLL-OVER RISK** | A large number of an MLP’s charters expiring in the current extremely soft dry and container market could pose a need for a distribution cut.

3. **FUNDING GAP** | Companies with committed capital requirements facing a funding gap may have to reduce dividends to help finance the projects, especially if access to external capital is difficult.

4. **STRATEGICALLY ACCRETIVE PROJECTS** | When investors do not honor dividend payments and continue to disengage themselves even from ‘good’ MLPs, any cash saved from a cut could be used for more value-creating projects. In such a case, it would make sense for the company from a strategic point of view to cut dividends and invest that cash into accretive projects.
PAINFUL IMPACT OF TEEKAY’S DIVIDEND CUTS

Source: Notos Group, 03/2016

rely on a larger portion of self-funding in the years to come.

For TK this is a dramatic setback in its corporate financial strategy which for more than 10 years has focused via the establishment of MLPs on ‘low cost of capital’. But TK may also have realized that the good times of shipping MLPs may not come back very soon.

WHAT TO EXPECT IN THE FUTURE

In the coming years, it will be much more difficult for GPs to ‘drop down’ assets or projects at comparatively lower cost of capital into MLPs and create accretive transactions for themselves. The continuation of important cash distributions from GP positions and IDR arrangements are a strong motivation for parent GPs to maintain scheduled or even growing distribution levels of their affiliate MLPs. A good example is GasLog Partners LP (GLOP) which operates a large fleet of LNG carriers with an average contract coverage of 8.1 years. However, GLOP is not yet given the credit for that as its current share price of USD 16.98 is well below its NAV based valuation of USD 21 per share.

BENEFITS OF MLPs WILL PREVAIL

MLPs are in a better position to pay scheduled distributions if they maintain conservative capital structures such as low leverage and use of long-term low cost bank debt. Recent experience has also shown that MLPs in the shipping “commodity” markets (dry bulk, container and tanker) are more exposed to market cycles than MLPs in the technically more demanding industrial shipping markets (LNG).

All in all, we believe that shipping MLPs could be attractive investments provided that stable long-term cash flows are secured by long-term charter contracts with high quality industrial shippers.
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