



AN OVERVIEW OF THE GENERAL PARTNERS OF MASTER LIMITED PARTNERSHIPS

MLPs AND GPs

Master Limited Partnerships, or MLPs, are tax pass-through entities that derive 90 percent of their income from the exploration, development, mining or production, processing, refining, transportation, or the marketing of minerals and natural resources. Their ownership consists of one or more General Partners (GPs), which have managerial and administrative control over an MLP, and many Limited Partners (LPs), which provide capital to an MLP and are entitled to periodic distributions, but have no control over operations. The GPs typically hold an initial stake of 2% in an MLP, while LPs hold the other 98%. Investors can access an MLP by buying LP 'common units' on an exchange or by purchasing shares of publicly traded General Partners.

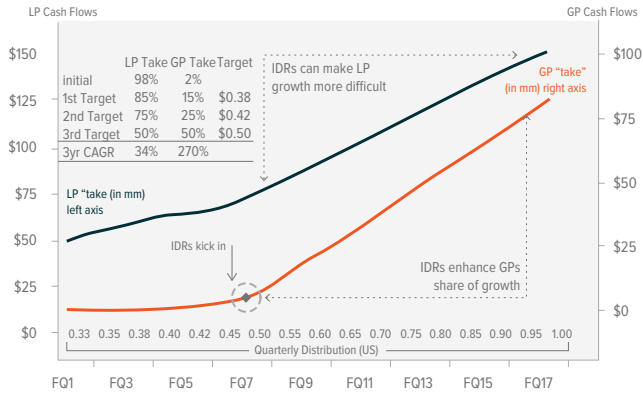
GENERAL PARTNER CARRIED INTEREST¹

A General Partner is compensated for its management efforts through incentive distribution rights (IDRs), which are a form of carried interest. The structure of IDRs incentivizes a GP to increase the MLP's distributions to its common unit holders. As the General Partner raises the nominal amount of distributions made by the MLP to predetermined thresholds, the GP receives an increasing percentage of the distribution. The IDR schedule occurs in a staggered manner and as the distribution target at each stage is reached, the cash flow available to the GP increases up to 50%. This tiered system aligns the GP's interests with the LP unit holders as they both reap the benefits of increasing distributions.



Figure 1: Role of IDRs in GP Earnings Growth

Source: Midstream Energy MLPs Primer 3.0, Morgan Stanley, April 2013
(Hypothetical example. For illustrative purposes only.)



IDRs can be explained by analyzing a typical compensation structure for a General Partner:

- Tier 1: When an MLP’s quarterly distribution is \$0.275 per unit or less, the GP receives 2% of the payout through its ownership stake, but no additional income from IDRs. The Limited Partners receive the remaining 98% of the distribution.
- Tier 2: When the quarterly distribution is between \$0.275 per unit and \$0.3175 per unit, IDRs entitle the GP to 13% of the payout within this interval, in addition to the GP’s 2% payout through its ownership stake (for a total of 15%). The LP unit holders receive the remaining 85% of the total distribution.
- Tier 3: When the quarterly distribution is between \$0.3175 per unit and \$0.4125 per unit, GPs receive a total of 25% of the payout within this interval (23% from IDRs, 2% from ownership stake). The LP unit holders receive 75%.
- Tier 4: When the quarterly distribution exceeds \$0.4125 per unit, GPs collect a total of 50% of the payout in this interval (48% from IDRs, 2% from ownership stake), while the LP unit holders receive 50%.

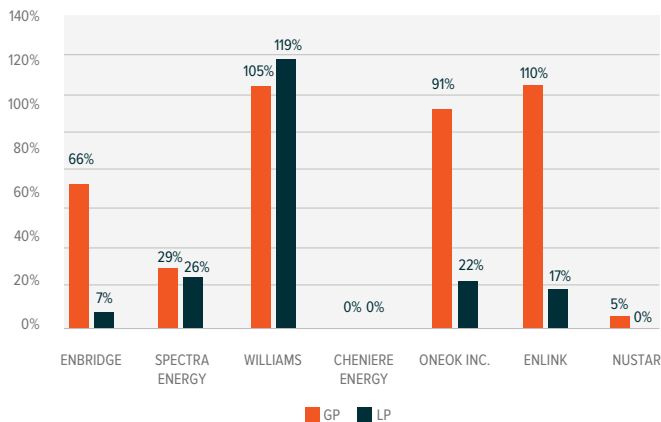
As the MLP’s distribution increases and reaches higher IDR tiers, the GP’s earnings will grow disproportionately faster than the LP’s.

Role of IDR’s in GP Earnings Growth (Fig. 1)

As a GP increases an MLP’s distributions and reaches higher IDR tiers, the GP’s earnings will grow disproportionately faster than the LP unit holders’ ‘take’. Figure 1, to the left, illustrates the relative earnings growth of a GP versus the cash flow available to LP unit holders.

Figure 2: Distribution Growth From 2012-2015 of The Largest GPs and Their Associated LPs

Source: Bloomberg 2016



Distribution Growth of The Largest GPs and Their Associated LPs (Fig. 2)

If a GP elects to return a portion of its earnings to shareholders, having a higher earnings growth rate than its corresponding LPs will often translate into having a higher distribution growth rate. A security with a high distribution growth rate can be attractive to investors as rising distributions often leads to stock price appreciation². Despite the fact that GPs often have lower yields than their related LPs, increasing distributions and the resulting price appreciation can result in higher total returns (yield + price appreciation) for investors. These higher distribution growth rates can be a major driver for the total return outperformance GPs might experience in bull markets as distributions grow.

¹Source: MLP Basics: Incentive Distribution Rights Explained, Energy & Income Advisor, Master Limited Partnerships – 101, Latham & Watkins LLP

²When a security increases its distributions, its yield (distribution amount divided by price) will initially increase. Since the yield is now higher than before, investors are more attracted to the security. They will theoretically buy shares until the security’s price rises to a level where its yield is no longer attracting additional investment.



Potential For Mergers & Acquisitions^{4,5,6,7}

In a growing number of instances, MLPs have merged with their General Partners in order to reduce their cost of capital³. The cost of capital for an MLP is the weighted average of cost of limited partner equity, cost of general partner equity and cost of debt. The cost of general partner equity increases with increasing distributions (due to the presence of IDRs), therefore making it an expensive component of some MLPs' capital structures. Merging LPs with their GPs eliminates the IDRs, giving the resulting entity greater flexibility with its cash flows, which can be used for growing distributions, paying down debt, or fueling growth through acquisitions. Examples of MLPs which have taken over their GPs include Magellan Midstream Partners, Enterprise Product Partners, PVR Resources, Buckeye Partners, Crestwood Partners, and Targa Resources. Additional GP acquisitions can come from private equity firms looking to invest in midstream energy infrastructure.

High Institutional Ownership

ETFs, Mutual Funds, and Closed End Funds are taxed at the fund level when more than 25% of their portfolio includes LP units of an MLP. Additionally, tax deferred accounts like individual retirement accounts may lose tax advantages when investing in LPs, as they can owe an unrelated business taxable income, or UBTI. These factors often restrict institutional investment in LP units. GPs are favored by institutional investors because they provide leveraged, highly correlated exposure to LPs, while avoiding the potential tax obligations related to owning the LP units.

GPs in The Current Environment

While the General Partners benefitted greatly from the 5-year MLP bull run from 2009 to mid-2014, 2015 proved to be a challenging year for GPs as well as the broader energy industry. Energy prices fell dramatically due to the global oil glut, which cut into the revenues of upstream oil and natural gas producers. While energy infrastructure tends to have lower correlation to oil prices because of their toll-road business models, the market began to fear that potential upstream bankruptcies and cuts in output could hurt entities in the midstream infrastructure space.

Unlike an LP, which typically distributes all of its available cash flows, a GP has much greater flexibility in its distribution policy. This allows a GP to much more easily limit its distribution growth or cut its distributions if management believes the cash can be more effectively used. In 2015, some GPs did cut their distributions and used the additional retained cash to pay down debt or organically fund growth opportunities. As the oil glut brought additional risk in the energy sector, many GPs found cutting their distribution to be a desirable option as issuing debt became more expensive and raising capital through equity markets became undesirable because of lower valuations.

There has also been a recent increase in instances of GPs buying their LPs, with many citing the need to simplify their ownership structure and reduce costs. Other reasons cited for this surge in M&A activity include 1) lower valuations for LPs than GPs incentivizes a GP to buy its LP at a discount 2) acquisitions can allow a step up in basis for the acquired assets, resulting in greater tax efficiencies 3) the acquisition of the LP by its GP brings more cash flows to the GP, which it can use to either grow future distributions, reduce its debt, or fund future acquisitions.

Conclusion

Despite having lower distributions yields than LPs, the General Partners of MLPs have exhibited in certain environments higher distribution growth rates than their LP counterparts due to the compensation structure established by IDRs. These higher distribution growth rates can be a major driver for the total return outperformance GPs might experience in bull markets as distributions grow. There are additional factors that make GPs appealing including their M&A activity and significant institutional investment. While some GPs have recently cut their distributions, their greater cash flow flexibility could make GPs asset buyers in a low valuation market, potentially positioning them for a strong rebound when energy prices climb.



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³ Cost of Capital represents the expenses associated with a firm's financing methods. Two common financing methods are issuing debt and selling equity. The cost of debt is the rate a firm pays to service its debt. The cost of equity is the returns required by shareholders.

⁴ Source: Current GP/IDR Market Trends, Platts Conference. October 11, 2011.

⁵ Source: A Trio of MLP Takeover Targets, The Money Show. October 2, 2013.

⁶ Source: Crestwood Equity Partners Completes Merger with Crestwood Midstream, Business Wire. September 30, 2015.

⁷ Targa Resources Corp. Announces Closing of Acquisition of Targa Resources Partners LP, Targa Resources. February 17, 2016.



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