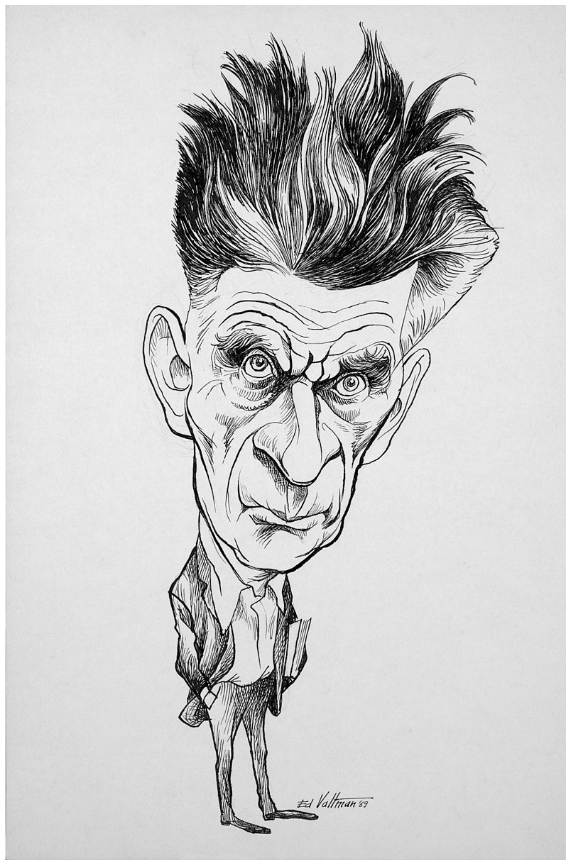
Convexity Maven

A Commentary by Harley Bassman

October 22, 2019

"Fail Better"



Samuel Beckett- "Westward Ho" - 1984

"Ever tried; Ever failed, No matter;
Try again; Fail again; Fail better"

Those who did not major in the humanities likely only know Samuel Beckett from his play *"Waiting for Godot",* which premiered in Paris in 1953. I saw the more recent and well-acclaimed version on Broadway in 2013 with Patrick Stewart and Ian McKellen. That said, I find the notion of "fail better" to be more poignant as it so well aligns with the Bassman family motto – Never panic, never give up. Today, I seek to merge the play and the poem with respect to oil/gas MLP's.

I stopped collecting a W-2 in 2017, and as consistent with my demographic cohort, I began looking for investments that might produce a reasonable income despite the efforts of the G-7 Central Banks to pressure interest rates to zero.

At the suggestion of a trusted colleague, I started sniffing at mid-stream oil and gas Master Limited Partnerships (MLPs). I had avoided these in the past as it was unclear that the toil and treasure involved in filing a fistful of K-1 tax forms was worth the meager extra few hundred basis points of yield.

Skipping over the how and why, I will just say that any significant asset class that tumbles nearly 60% in a year without someone going to jail deserves a second look.

At 30,000 feet, I fundamentally like the mid-stream business since they earn their income from transporting carbon-based energy (oil and gas) from point A to point B. In theory they are insulated from the exploration and marketing business, and are thus are less impacted by price. This is well within my wheelhouse since it dovetails nicely with the old notion that Wall Street is in the "moving business, not the storage business". [Program Note: Merrill went bust when our CEO decided to store (own) $45bn of CDOs instead of selling them.]

While not quite a Ponzi scheme, MLPs collapsed in late 2014 as their financial structure was often governed by the mis-aligned interests between the General Partner (GP) and the Limited Partner (LP). Soon enough, Adam Smith's Invisible Hand pressured structural change in this sector that has now mostly aligned the interests of management and shareholders, as well as reducrd the financial (cash flow) uncertainty between capital expenses and dividend payouts.

Using the Alerian MLP Index (AMZ) and its eponymous ETF (AMLP) for reference and eventual trade execution, it seemed that a December 2017 value of down 50% from the late 2014 high would be a fine entry point. All I have to say is that those who liked MLPs down 50%, must love them down a further 20%.

While there are many ways to value this asset class, I suppose the most salient might be the size and security of the dividend since this sector is primarily an income vehicle. AMLP peaked in 2014 at $19.35 to yield about 6.00% or 360bps cheap to the UST10yr rate; and about flat to the High Yield (HY) Index.

AMLP's quarterly payout topped at $0.299 in early 2015; and was clipped 31% to $0.2052 by late 2017. It closed that year at $10.79 to yield 7.61%, 520bp cheap to the UST10yr. The most recent dividend of $0.19 was announced in August. Versus a current price of $8.74, this ETF yields 8.70% for a pick-up of nearly 700bps to the UST10yr and 350bp to HY. Either $8.74 is the wrong price, or this dividend will soon be cut to $0.13. In preview, I think it's the former.

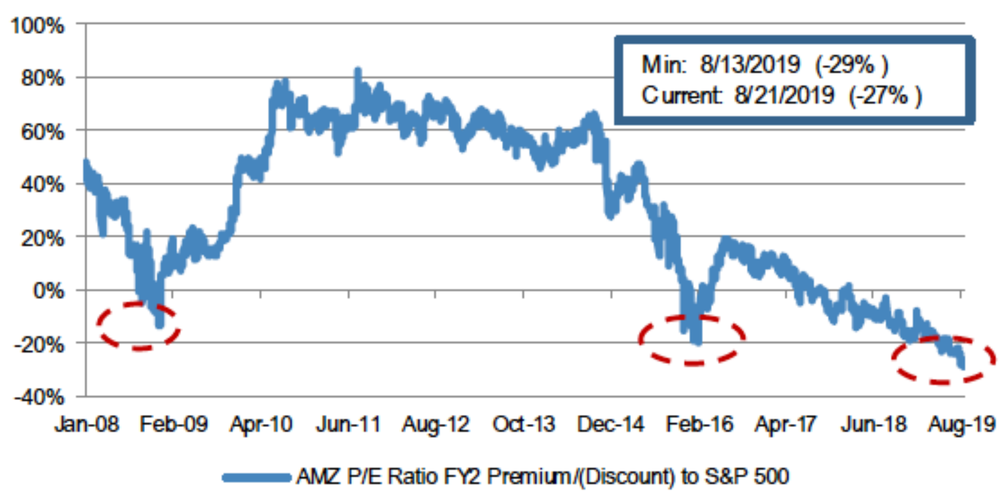
At core, the problem with MLPs was their structure and cash management. A significant portion of earnings were paid to the General Partner in the form of Incentive Distribution Rights (IDRs). Additionally, capital expenditures were often funded via secondary Equity offerings or increased Debt. It was the swift collapse of oil prices in late 2014 that finally brought focus to these issues.

I will defer to the experts to explain the embedded conflicts for the Limited Partners, but once the music stopped and payout reductions closed the window for new capital, the market forced management to alter business practices. The period prior to 2015 is often known as the MLP 1.0 model, and post 2018 is now called the MLP 2.0 model.

Presently, only a weighted 14% of AMLP still have IDRs in place. Earnings now cover distributions by a weighted 140%; an excess that allows capital expenditures to often be funded internally. These changes have not been painless, thus the reduction in dividends; but on the flip side, payouts should be more secure and efficiency should lead to dividend growth. In fact, Bloomberg estimates (BDVD) a November dividend for AMLP at $0.21.

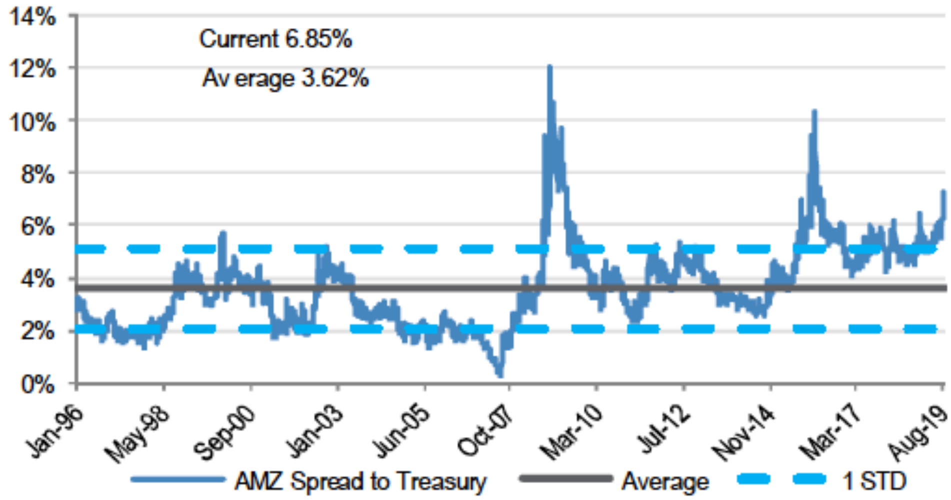
Of course, after five years of almost consecutively lower dividends, the market is no longer accepting management's good word.

The -majorelle line- below is the relative P/E of the AMZ Index versus the SPX. While it is not clear that the tech-heavy S&P should map directly to what is basically a utility, at some point earnings per share do matter. And I would note an updated chart would sport an even larger discount since AMZ has dipped another 5% since August.



Source: JPMorgan / Bloomberg

More instructive might be the relationship between the dividend payout of this 20-stock diversified ETF and some benchmark rate. The -phthalo line- is the spread between the yield of AMLP and the UST10yr rate. While I do not think the narrow spread before the Great Financial Crisis (GFC) should be a standard; I do think the current gap of 700bps is a signal of unfounded distress.



Source: JPMorgan / Bloomberg

Let's stipulate that my reach for that falling knife at the end of 2017 was a failure. I will also confess that I have added to this trade with no better result. So, it's time to try a bit harder….

While clipping this 8.70% coupon (or closer to 7.00% at my cost basis) is nice, the money trade is to anticipate the staunching of dividend cuts, and the "power-windows up" re-rating that will occur once the MLP 2.0 model is fully valued. But, while most analysts propose the time is nigh, the market is channeling Jerry Maguire: "Show me the Money".

The issue here is not my belief this will occur, but rather the timing. A five-year bear market does not turn on a dime; it may take a year's worth of flat to rising dividends. Thus, the need to construct a position that offers both time and leverage. It would also be helpful to have a cushioned downside to reduce the possibility of a "stop-out".

Before you read any further, let me reprise my disclosure that I am not an investment advisor, nor is this a solicitation. You should not rely upon this Commentary for accuracy and you should seek additional advice from a professional. Finally, <u>I may personally own positions in this asset class</u>.

My prior Commentary, *"The Opposite of Bad is Worse"*, September 24, 2019, focused on how negative interest rates create silly forward prices. This sparked the thought that the combination of the AMLP dividend and the Fed's new $60bn/month QE-lite might create an opportunity:

AMLP:
Spot price - $8.74
Dividend - $0.20 (between most recent and projection)
Repo rate – 1.78% (borrow/lend rate @ Tsy +20bp)
Forward price to January 21, 2022 = $7.32

The Trade:

AMLP listed options; Spot = $8.74
Buy 100 January 21, 2022 expiry call, K = $9.0, Ivol = 18%, @ $0.40
Sell 100 January 21, 2022 expiry put, K = $7.0, Ivol = 19%, @ $0.65
Net Credit = $0.25

Note: Using the same parameters, <u>this trade is costless at $9.06</u>

Comments:

<u>Owning AMLP via options is safer than owning it outright</u>. There will be nine dividends paid between now and expiry; using a current dividend of $0.19, that totals $1.71. Ignoring taxes, this reduces your cost basis to $7.03, slightly above the put strike. A further decline in AMLP should only occur if the dividend is cut again, and this would raise your total cost basis well above the strike.

The all-time low on AMLP is $7.77 set on February 12, 2016. This was certainly coincident with the February 9, 2016 announced dividend cut from $0.299 to $0.24 (-20%). However, AMLP bounced hard to closed 2016 at $12.60.

Unless one executes this trade above $9.06, there is no cash outlay to own all the upside above the call strike.

These are listed options; thus, one can implicitly borrow at the market-maker's institutional cost of 1.78%. Compare that to much higher standard margin rates.

Despite a low terminal breakeven, **there is significant mark-to-market risk** since the net 'delta' (exposure) is 75%. This means that (all else equal) a $1.00 decline in AMLP will result in a $0.75 unrealized mark-to-market loss on this option package. While the delta will migrate over time, initially, options on 1,000 shares will behave like 750 shares of stock.

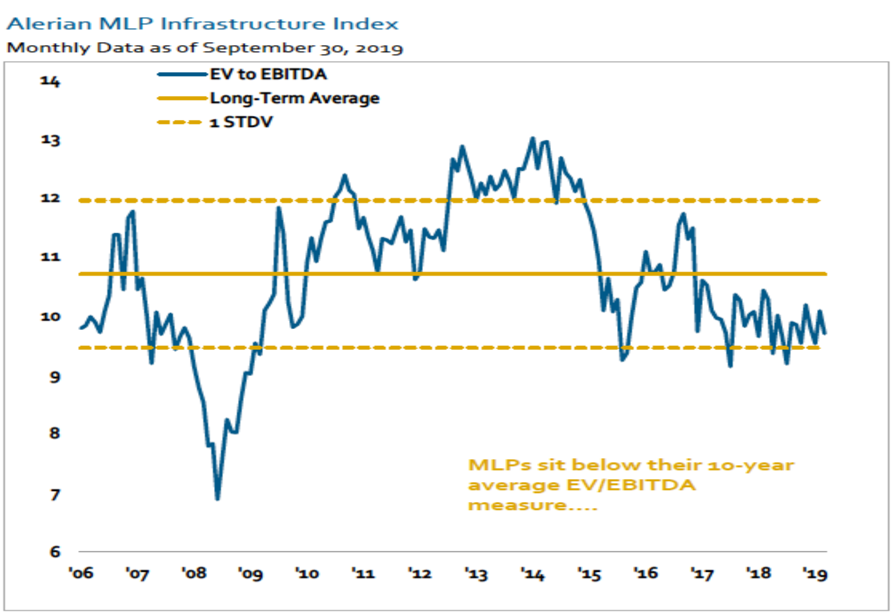
What is the Upside ? …and repeating my prior disclaimers.

The bulge bracket firm that holds my account has five analysts looking at the Energy Infrastructure / MLP space. They offer projections on five (55% by weight) of the twenty assets in AMLP. If I only change the current price of those five to their YE-2020 projections, and leave the other 15 unchanged, AMLP would have a NAV of $10.39.

Let's assume the quarterly dividend of $0.19 is unchanged until expiry. At that point, investors should feel confident in the cashflow, and reduce the discount rate (yield). Let's assume the UST10yr backs up to 2.50% (it's ten-year average), and the HY (Junk) Index widens to 375bp (it's ten-year average), for a total HY yield of 6.25%. At that yield, AMLP would price at $12.16. A more conservative target might add some cushion, so 75bp over the HY Index would create a yield of 7.0% and offer a price of $10.85.

Presently, there is significant upside leverage to AMLP. If the dividend increases by a penny from $0.19 to $0.20, the stock price will increase by $0.47 with an unchanged yield. And if dividend remains constant but the yield tightens by 50bps, the price of stock will rise by $0.53.

Another metric is the -savoy line- ratio of Enterprise Value (EV) (the sum of all Debt plus Equity) versus EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization). I am not a lover of EBITDA since interest and taxes must be paid eventually, but it is a nice macro vector for cross asset comparisons. An increase of 1 turn from 9.75 to its long-term average of 10.75x would jump the AMLP NAV by 18%. By comparison, the S&P 500 Utilities sector is well over 12x.



Source: Morgan Stanley / Bloomberg

What is the Downside ?

The only rational explanation for why AMLP is trading at this price, away from seasonal tax loss selling, is that the market believes the dividend will be cut substantially. Since the price of carbon energy is not the main input for mid-stream firms, it must be the expectation that there will be a huge reduction in volume.

I prefer to avoid politics, but perhaps the market is smelling a Green New Deal on the horizon that could massively reduce the demand for carbon-based energy. Pencil to paper, an 8.75% dividend might make sense if carbon-based fuels will be mostly eliminated over the next thirty years and a MLP is valued as a self-liquidating asset.

The other related source of price pressure may be the popularity of Environmental, Social & Corporate Governance (ESG) investing where reducing carbon emissions is a priority. While I fully support ESG as a public policy concept, one should be reminded that similar socially-minded investment styles missed the terrific out-performance of tobacco / alcohol stocks.
[Note: I recommend *"Thank you for Smoking"* by Christopher Buckley]

Let's be clear, this is not a financial arbitrage, this is pure risk; the difference here is the structure of the exposure via options which allows one to obtain all of the upside with a deeply cushioned downside. The cost is that if AMLP meanders near this level, you have tied up a portion of your risk budget for the next 27 months and received nothing in return.

As always, **sizing is more important than entry level.** Well-intended Central Bank policies have created some delicious investment opportunities; but by their nature they will be volatile on a mark-to-market basis. Barbell your risk profile, keep some assets in the low volatility bucket, but also make sure you allocate enough to the 'elephant hunter' trades to move the 'needle' on your portfolio.

Your comments are always welcome at: harley@bassman.net
If you would like to be added to my distribution, just ping me.

Harley S. Bassman
October 22, 2019

For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

http://www.convexitymaven.com/themavensclassroom.html

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net