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BTN Thursday Thoughts

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Contents

We begin this issue with a couple of potential ideas we stumbled across while reviewing various conference calls. Starwood (STWD) and Energy Transfer (ETP) are both stocks that have been flat to down for some time, despite offing above-average yields. We think some catalysts are well underway that could unlock some value and investors are getting paid well while they wait.

Starwoods's (STWD) Improvements

We mentioned Starwood Property Trust (STWD) as a company that is misunderstood because it is classified as a Mortgage REIT and is the #3 holding in ETFs holding Mortgage REITs, where the bulk of peers have vastly different business models. The top players in the ETFs play in fixed residential mortgages backed by the government and leverage their balance sheet 5x-8x equity. Rising interest rates raise their cost of funding, but their assets produce flat income, so the profit spread is squeezed. On top of that, the life of their assets stretches out as fewer people refinance mortgages, so the value of the assets declines which hurts book value. Plus, the Fed has spent years buying residential mortgage bonds competing with those mortgage REITs which bids up the price of assets and shrinks the spread the REITs could earn.

Starwood, by comparison, buys almost exclusively floating rate assets and has fixed its cost of funding. So, higher interest rates drive its spread up and they produce greater income. They are not leveraged as highly at only 1.5x equity and 2.0x including off-balance sheet leverage. Starwood is also not competing with the FED or even banks in many cases buying commercial mortgages and properties. It is larger than many of its peers enabling it to find more value-priced opportunities to buy. The yield is currently 8.8% and we think it should be very attractive, as results are getting stronger due to three reasons:

1. Core EPS is rising vs. the dividend and it appears to be accelerating
2. EPS will be helped further by rising rates and rent increases
3. Depreciation on property assets understates book value and shields more cash flow from distribution and thus can be recycled without equity funding

We are going to refer back to this basic table throughout this note when talking about some points to keep in mind here:

	1Q18	4Q17	3Q17	2Q17	1Q17
Core EPS	$0.58*	$0.55	$0.65*	$0.52	$0.51
Dividend	$0.48	$0.48	$0.48	$0.48	$0.48
Payout %	83%	87%	74%*	92%	94%
Book Value	$16.88	$16.93	$17.01	$17.05	$17.00
Accum Depr	$0.78	$0.65	$0.57	$0.48	$0.39
Convert Note Spread	$0.08	$0.13	$0.15	$0.21	$0.21
Adj. Book Value	$17.74	$17.71	$17.73	$17.74	$17.60
Diluted units	267.7	262.5	261.9	261.6	260.1

Core EPS is an attempt to add back some non-cash charges to earnings: GAAP earnings + real estate depreciation + non-cash compensation and management incentive fees along with recurring gains and losses. Three things in the last five quarters have impacted core EPS. First, more capital was raised at the end of 2016 bringing the share count to 244.6 million in 4Q16. The cash came in so late in the quarter that it did not fully get put to work in 1Q17 and cash earning little sitting in the bank was a drag on results. A new portfolio of affordable housing was purchased in 4Q17 and 1Q18 known as Woodstar – these deals were settled with cash and issuance of stock and some contingent rights to acquire more equity. That raised the number of shares again in the last two quarters.

Second, the company has issued and has been paying off convertible debt. Convertible debt that is in the money over and above the face value of the debt represents a spread that would be value delivered to bondholders. It is a reduction to book value and is accreted through interest expense. In 3Q17 and 1Q18, STWD retired some of its convertible notes. In 3Q17, there was a drag on earnings like in 1Q17 of holding excess cash to retire the notes. In 1Q18, retiring the convertible debt with cash resulted in $10 million of accreted interest cost related to possible conversion to be reversed which added 4-cents back to EPS. Because, STWD has been refinancing and retiring convertible debt, the accreted spread that negatively impacts interest expense and book value has been reduced significantly. Finally, in 3Q17 STWD sold an unconsolidated venture called Ten-X and realized a 13-cent per share gain.

Core EPS is Rising

The reason we say things are improving is quarterly Core EPS was running about 50-cents per share in 2016 on 238 million shares. Now, it is running about 54-55 cents per share on 268 million shares. The company is also replacing convertible debt to remove that potential dilution and has started to buy back some shares. Because the economy is improving STWD has also been more willing to increase the portfolio, even though it is now only 1.5x leveraged to equity vs. 1.4x for most of 2016. Here is what the company was envisioning in 2Q17:

> Barry Sternlicht STWD CEO – *"Trump has five stimulus packages, none of which, as you know, have passed, any one of which will accelerate the U.S. economy, we believe from its lagged pace now that we are lagging both Asia and Europe in growth. And what's good for the economy is good for wages, it creates inflation, increased replacement cost for real estate assets and I think our LTV at 63% would drop to 58% 55% and it will be more compelling for the shareholders as the risk-reward basis. And we would love to see that because LIBOR would go up and our earnings would go up with LIBOR."*

What the company was battling in prior years of falling interest rates was it couldn't keep money deployed. It was coming back as fast as it could put it out and with interest rates falling it was tougher to maintain spreads. The company still has considerable liquidity to invest now. It always has loans that mature and capital that returns, but compare the 2016 and early 2017 view of the world with May 2018:

First, they reduced their funding costs to help spreads:

> Jeff DeModica – STWD President - *"we articulated our strategy to diversify and lower our borrowing cost to allow us to continue to grow our loan portfolio notwithstanding the tighter spread environment we see today. We issued $500 million of unsecured notes in Q1 with a 3.625% coupon swapped to LIBOR plus 128, the tightest spread*

for a high-yield bond issuance since the financial crisis and more in line with where investment-grade name trade.

Our diversified model has created a funding advantage that enabled to us to once again more than offset loan spread tightening and still achieve an optimal 12.3% IRR and $1.2 billion in loan originations on 12 assets this quarter. In the aggregate, we deployed $2 billion this quarter across our multi-cylinder platform despite having one $375 million ***loan*** *we expected to close in Q1 slipped into very early Q2."*

Second, the stronger demand for money in a better economy and higher rates, is allowing them to place capital coming back out at higher spreads:

Jeff DeModica - *"Surprisingly, at this point in the cycle, our loan portfolio is rolling off at lower yield than we are replacing it with. Despite tighter loan spreads and without increasing leverage, we're expanding our credit criteria, our optimal origination IRR this quarter with 12.3% consistent with our historical averages and 90 basis point above the optimal IRR on the loans that repaid in the quarter. In addition to tighter lending spreads, this increase has been partially driven by higher LIBOR. Additionally, tighter lending spreads have the benefit of increasing the duration of our loans by providing borrowers with lower coupons that are less likely to refinance."*

So, the funding costs are lower, the investments are going out at higher returns, and the duration is longer. On top of that, the company is reducing dilution from financing and has considerable liquidity to deploy without issuing capital. The LTV (Loan to Value) has dropped too from 64% in 4Q16 to 62% in 1Q18. Here are the stats for the lending portfolio for returns:

	1Q18	4Q17	3Q17	2Q17	1Q17
% in First Mortgage	85%	83%	82%	79%	78%
Unleveraged Return	7.40%	7.20%	7.20%	7.30%	7.20%
Leveraged Return	11.30%	11.10%	11.00%	11.10%	11.00%

Keep in mind STWD does not leverage investments in subordinated loans, which are only 3% of the portfolio or in mezzanine loans, which are only 9% of the portfolio. Both those categories historically yield more than the first mortgages with leverage. So, this isn't a case of STWD boosting leverage or taking on greater risks to see improved returns. In fact, the risk level is falling with first mortgages becoming a larger part of the portfolio with a lower LTV ratio.

Higher Rates and Rents are Driving Income

We talked before of how rising interest rates can squeeze many of the residential mortgage REITs on spread because they are often dealing with fixed rate loans that stretch out in duration and the REIT borrows on shorter term basis. That is not the case with STWD where 93% of the mortgages it buys are floating-rate tied to LIBOR.

Rates are increasing – not at a break-neck speed like many have feared since 2012 – but enough to start returning some normalcy to the markets. STWD updated its forecast that increases in LIBOR will boost its EPS:

LIBOR Increase	Annual EPS change
100bp	6-cents
200bp	13-cents
300bp	20-cents

So again, Quarterly Core EPS is now about 55-cents vs. 50-cents. Yields are increasing and further increases in interest rates could add another 1.5-5.0 cents to Core EPS.

It's more than that too. Only recently has STWD begun to buy property directly rather than just mortgages. It has focused on areas with strong demand in good locations and has seen solid growth in earnings in this area after several acquisitions:

Prop Income

	1Q18	4Q17	3Q17	2Q17	1Q17
Op Income	$43.80	$40.10	$29.40	$28.70	$29.10
Debt/Value	68%	65%	64%	69%	68%

STWD financed this property with long-term fixed-rate debt and is earning a double-digit cash return. With occupancies high at basically 98% on residential and 95% on US Medical Office, STWD can also boost rents due to demand and rising property values. Jeff DeModica also noted this in 1Q18's call:

> *"With the bulk of the Woodstar II multifamily assets now closed, we are buoyed by continued strong performance in this 99%-plus leased portfolio. The portfolio was all based in strong markets in Florida with growth in medium – the growth in median income levels that will allow us to increase rents faster than we originally modeled."*

Barry Sternlicht noted that rents are growing faster than they forecast and the improving economy for wages is going to be a tailwind for them.

> *"So we've taken the long-term approach consistent with stable and consisting growing revenue stream and we have kind of windfalls in the multi space, Jeff mentioned this but we're under like 2% growth in rents because that's what we figured inflation cost of living would be and let's say in the Orlando sub market and they just increased rents 4%, plus everything in the town up 4%, so which is better than the actual market and apartment closed at the moment. And we remain totally full. And there's no issue of affordability since were affordable."*

The Property Side Offers Some Other Potentials

Right now, property is only about 12% of the total asset base at STWD. However, this gives it a third way to differentiate itself from the more commonly discussed mortgage REITs that focus on fixed-rate residential mortgage bonds. STWD already was focused on commercial and floating-rate debt, but now owning property outright gives it an opportunity to benefit from appreciation of the investment as well. It removes the prepayment risk too.

Owning property also gives the company an earnings shield via depreciation. As a REIT, STWD must pay out the bulk of its earnings as a dividend. When it essentially bought mortgage bonds for all its business – earnings and cash flow were roughly equal. Thus, STWD was also paying out the bulk of its cash flow as dividends. The company would need to raise more capital or boost leverage to expand the portfolio in most cases.

With property on the balance sheet, it is depreciated over time and that reduces earnings. That is a non-cash expense, so cash flow remains high but the dividend requirements for a REIT are based on earnings. Thus, STWD has the ability to retain more capital for growth without raising new capital. It becomes more self-funding. Looking back to the first table, there is 78-cents per share of accumulated depreciation at STWD now vs. about 54-55 cents in quarterly Core EPS. That is capital that can be retained.

Increased valuations for property are not recorded unless STWD sells the asset. Their assets are getting rising rents amid higher demand which should mean asset values are increasing. However, GAAP does not allow the property to be marked up and it penalizes book value via depreciation reducing income. Thus, STWD's results are increasingly set up for positive surprises. If they paid $50 million for something and it is now on their books at

$42 million after depreciation, but they sell it for $60 million because of appreciation due to rising rents – they see a gain and increase in book value of $18 million not $10 million. Moreover, the gain comes in as cash income. Jeff DeModica summed this whole thought very well in the last conference call:

> *"Financed conservatively with long-term fixed rate debt, our diversified Property segment provides us with double-digit cash return. We retain the potential equity upside, extend our duration, and benefit from the depreciation shield, which lowers our required payout ratios. This portfolio continues to perform extremely well.*
>
> *As we have previously mentioned, we believe that in the aggregate, our investment portfolio has over $1 per share in unrealized gains that are available for us to harvest in the future, but we view the bulk of this book as long-term core hold that we will continue to add earning for years to come."*

In addition, adding physical real estate allows STWD to look at construction lending from an ownership perspective not as a lender. Let's be clear, STWD has always been very aware of risk in how it lends money and always focuses on the underlying property value and future potential. It regularly culls individual loans out of securitizations to improve the quality based on this analysis. Thus, construction lending is not something they are jumping in with both feet. It remains about 7% of the total portfolio.

The focus on getting into this market is to be in an area with fewer competitors, make loans for only 50-60% of value that are typically short-term, and look for projects that appear to have solid fundamentals behind them in terms of inherent value and demand. Thus, they get paid well on the lending side for financing this project and generate a solid return over a short period. Or, if it runs into problems, they would be happy to take ownership of a new building for half the price it cost to build and have already done their homework to envision its value increasing. Barry Sternlicht pointed this out too on the last call:

> *"And, of course, because we're equity players from the start, not lenders, we clearly get this beautiful property at $0.60 – $0.50 to the $1, we'd be delighted. So they fail, we win. They pay us back, we also win. So it's okay, I mean, at this point of the cycle, we're very picky about what we do and where we do it. And sometimes, we pass, we think we've seen some crazy deals by the way."*

Conclusion:

People are still searching for yield – STWD pays about 9% per year in cash trading for only 1.2x book value and only leveraged 1.5x equity. That compares to Wells Fargo at 2.8% yield, for 1.5x book and leveraged over 4x equity.

STWD is positively correlated to higher interest rates and inflation. It is already seeing rising income in these areas giving it more cushions on the dividend and they are not taking on more risk to produce these higher returns in our view.

There is more positive surprise potential here from continued growth in returns and rents as well as realizing cash gains on appreciated real estate positions and recovering depreciation expense.

Energy Transfer – Going C-Corp?

Another area that has had some big discussion during presentations and earnings season is the pipeline sector. This has been an area of the market that has been very unloved in recent years even with a big rebound in oil prices and activity. That is surprising because there are people jumping into it. Most of them have a history of being fairly bright or conservative and must see a need for more energy infrastructure and decent returns. Here are some recent examples from the Energy Transfer complex, which we will use as an example throughout this report:

> Dakota Access Pipeline to move oil out of North Dakota has Phillips 66 as a 25% partner. Another 36.75% was sold to a venture of Marathon Petroleum and Enbridge. Those partners also ship oil on the pipeline.
>
> Rover Pipeline – Blackstone acquired 32.44% of this gas pipeline that will soon be fully operational. This line will take natural gas out of the Marcellus field.
>
> People buying preferred stock have paid about $2 billion in late 2017 and early 2018 to take on shares with a yield of 6-1/4% to 7-3/8%.

People buying bonds bought $1.0 billion 4.5% notes due in 2023, $750 million 4.0% notes due in 2024 and $1.5 billion of 5.4% notes due in 2047.

Meanwhile – people buying the common units are being paid 11.7% on Energy Transfer Partners (ETP) – AFTER the stock has rallied a bit.

The first can control costs by investing, the second can benefit from asset appreciation. Third and fourth get paid a set rate of return. The fifth is last to get paid, but is making a high cash return and the potential for more capital appreciation. But, should it be getting nearly twice the cash rate of return and still have all the upside potential? This seems to be the mark of a very unloved investment. We think investors should be focusing on several catalysts – many of which are already happening:

1. The MLPs are simplifying their structures by eliminating General Partners, IDRs (Incentive Distribution Rights), and even looking to become C-Corporations.
2. Changing structures could make it easier and cheaper for these companies to finance their growth. There is almost no representation in the S&P either and some of the structure changes require acquisitions for some Limited Partners.
3. The growth potential for cash flow also appears huge. Projects that take years to complete are now well along in that process and new ones are turning on almost every quarter.
4. The new tax law creates several possibilities. The pipeline assets could be marked up in an acquisition, creating a huge depreciation shield for earnings.

Some MLPs Are Already Simplifying

The new tax law, the need for new capital, and the growth story are all driving these changes. Many MLPs have already eliminated the prior deals with General Partners that led to payments via IDRs (Incentive Distribution Rights). We will explain this in more detail below – but one of the largest MLPs – Enterprise Products Partners did this years ago, and others such as Williams, MPLX (Associated with Marathon Petroleum, NuStar Energy are doing this too. Just last week, Enbridge announced its intention to roll up its MLP associates and Williams Partners LP has an offer to be acquired by Williams.

Stacy Morris at Alerian.com noted recently that 60% of the Alerian MLP Infrastructure Index no longer has IDRs. Several more are looking at changing to a taxable C-Corporation as Kinder Morgan has already done.

Incentive Distribution Rights are paid to the General Partner. It is essentially a distribution of some of the Limited Partner's cash flow to encourage the General Partner to actively work to expand the operation and produce growing cash flow that will benefit the Limited Partner owners as well as the General Partner. Here is a simplified example of how cash distributions are made when there are Limited Partners, IDRs and a General Partner. It is allocated in a series of buckets. Let's assume - $1000 to distribute to 100 shares of Limited Partnership, IDRs, and GP

Step 1:	$20 to GP	Pay 2% to GP for basic annual management
Step 2:	$100 to LP	Pay all LP Unit holders up to $1.00 per Unit
Step 3:	$50 to IDR and $50 to LP	Pay IDRs 5% of cash and all LP Units up to $0.50
Step 4:	$80 to IDR and $200 to LP	Pay IDRs 5% of cash and all LP Units up to $2.00
Step 5:	$150 to IDR and $200 to LP	Pay IDRs 15% of cash and all LP Units up to $2.00
Step 6:	$50 to IDR and $100 to LP	Pay IDRs 5% of cash and all LP Units up to $2.00

This type of structure can go on and on, and it keeps moving to the next bucket if the prior one is filled. As you can see, the cash ran out in Step 6. There was only $150 left coming into Step 6, which required 5% to the IDRs and that took $50, then the LP unit holders could get paid up to $2.00 per unit. With 100 units outstanding, that's $200, but only $100 was left so they are paid $1.00 per unit.

In this example, MLP paid out $1000 and the investors in the LP received $650 of it. The GP and IDRs were paid $350. One of the reasons investors frown on this type of structure is it becomes expensive to pay an increase in the distribution to the LP holders because it also means more cash also goes to the IDRs. Another reason is, the LP holders and creditors view the IDR deals as becoming excessive and often become a larger and larger percentage in later buckets. Thus, instead of retaining some of the cash flow internally to fund growth projects, there is monetary rationale for the GP to boost the distribution level so that the GP gets more of the cash flow. That means the MLP pays for more of its growth by raising external capital.

Enterprise Products Partners LP (EPD) is one of the largest MLPs and it has already simplified on the GP and IDR side. They see themselves as largely self-funding their growth and still paying an attractive yield of over 6%. That is a lower yield than many other MLPs who still have the complex structures so to some degree; EPD had been rewarded for making this change. Its last potential change would be to convert to a C-Corporation, but on its 4Q17 conference call did not see the reason to do it:

> Ted Durbin - question, “And then just I think I heard the quick comments on tax reform, but I know one of your -- one of the questions we've got and you've thought about over the years is, the ultimate corporate structure for Enterprise and one of the uncertainties there was what happened with tax reform. So you have that behind us now. Just love your thoughts on whether you -- do you think you're in the right corporate structure as you think about access to capital, M&A rather other strategic ideas?”
>
> Randy Burkhalter of EPD, “Ted, this is Randy. I think where we are I think we still feel like the MLP structure works for us as far as access to capital is concerned. Access to equity capital at a reasonable price, we'll continue to monitor, frankly, how the capital values midstream C Corps versus midstream MLPs. Frankly, we haven't seen a lot of difference over the last couple of years, but frankly there was a lot of noise in the space whether you're a C Corp or MLP over the last three years. So, I think we will continue to monitor that and see what develops on the front. But that’s forever election, so it/s not to be taken lightly and we will continue to come and evaluate. But we think we got good access to capital now.”

Going the other way is another of the largest weightings in the Alerian index - Energy Transfer Partners. This has always been one of the more complex structures in the group with multiple partnerships some having general partner status to one, while being a limited partner to another or investing jointly in projects. In recent years, there has been reorganization at Energy Transfer to merge some limited partners and consolidate general partnerships. The company believes there is a big need to simplify much more and is looking at ways to have a C-Corporation as part of the family for investors. This conversation happens on almost every conference call and management continually says that they are digesting the needs to accomplish it, but that it will happen. Here is a comment from the 4Q17 conference call:

> Question from Ross Payne at Wells Fargo – “putting the ETE and ETP together has been a discussed matter here. You talked about doing it in 2019. Could this be potentially accelerated? And second of all we saw EQT spin off their midstream into a C-Corp with the MLPs remaining below at least for now. Is that a structure that perhaps Kelcy you might examine in the future? Thanks.”
>
> Kelcy Warren Chairman, “Yeah. Ross, absolutely. If we're allowed to accelerate a consolidation of ETE and ETP, we will do that. It's just fundamentally simple as in – Ross you know the numbers about as well as anybody in the industry. We just can't risk any kind of negative view by rating agencies and until we get our financial health

improved and the family, we will not be doing any kind of consolidation. But as soon as we can, we will.

We are interested in a C-Corp structure. As you know we almost did one with the Williams transaction. We have many quality assets that are already in a corporate structure and they're quality assets. So we're exploring having a publicly traded C-Corp in the family of Energy Transfer that will allow us to better access the capital markets and hopefully there'll be more to follow on that."

This talk continued in 1Q18 and Energy Transfer noted that it will very likely convert to a C-Corp sooner rather than later and are studying the issue very heavily:

Question from Jeremy Tonet at JPMorgan:

"And then maybe just the last one as far as the structure and anything new you could say there or refresh us for your thoughts as far as how you see eventual family simplification down the future? And I guess most importantly, do you see a C-Corp as something that could really be additive to the family and open up kind of the shareholder base there?"

Kelcy Warren –Chairman:

"I'll start with the second part of that question. We are evaluating a C-Corp structure within our partnership. We are very, very carefully evaluating that. We do not want to do something that is irreversible and something that we would regret. So that is something we are studying.

As far as the simplification that you refer to, it would most certainly be a structure whereby ETE acquires ETP. There's – we've looked at every scenario possible to us. And we don't see any mathematical scenario that makes any sense other than that one."

Darren Horowitz at Raymond James:

"Kelcy, just back on simplification for a minute. Was it ever in the thought process of consideration, when you're thinking about evaluating a C-Corp structure in the family of companies, that you would look at ETP's depreciated asset basis. And from a taxable perspective obviously any sort of step up with ETP would create a significant amount of tax depreciation that could be amortized for many years? Or is

it simply more of a partnership equity-to-equity swap with ETE? And there is no taxable liability coming from that simplification?"

Kelcy L. Warren:

"Both. You are correct. We have looked at – we've just every way we know to look at a C-Corp type solution for us. And we've not just said that we will not be doing that. It's just at this time, that does not appear to be the superior solution for us. So we have looked at that, to answer your first part of the question.

And of course in the next part of your question, taxes influence our decisions here. They're a very big component for our unitholders to deal with. So that is a reason that we've ended up where we've ended up. I say ended up, that's not fair. Today, if we had to make a decision today, we believe a simple purchase by ETE of ETP would be the structure. That could change by the time the rating agencies give us the green light to go forward.

So not every company has this catalyst, but many are pursuing it. A company with the most complex structure like Energy Transfer may have the most upside to doing something here.

The Tax Code Changes May Spur Faster Changes

A big reason companies are structured as MLPs in the first place is to reduce taxes. The companies do not pay federal income taxes and part of the distribution to shareholders is considered income with a larger portion return of capital. Let's say the distribution is $1.00; 30-cents may be income and 70-cents return on capital. The company isn't paying taxes and the shareholder is only paying taxes on 30-cents. The shareholder treats the return of capital as a reduction in is cost basis and pays tax capital gains taxes when he sells. So, let's keep this simple, he buys the MLP for $20, collects 30 and 70 cents as described for 5 years and then sells the MLP for $20. He paid taxes on 30-cents every year or $1.50. His cost basis falls by $3.50 (5 years of 70-cent return of capital) so when he sells at $20 less his cost of now $16.50 – he pays capital gains on $3.50.

The rationale has been to avoid the 35% corporate tax rate for the company and then having less cash to distribute so the shareholder gets a smaller dividend and pays tax on those earnings after the company already did.

At a 21% corporate rate, the burden may not be as bad. Yes, there is double taxation, but it comes at lower rates. In addition, if the LP is acquired by the GP as Energy Transfer envisions, it can mark-up the pipeline assets to fair market value. There is about $70 billion in plant and equipment at Energy Transfer and about $10 billion has been depreciated. We'll talk about growth in demand more below, but the value of those assets is likely increasing. There is more demand, higher interest rates boost the replacement cost, and the environmental attacks create delays and lawsuits to deal with which also adds to costs to build new ones. So instead of having $60 billion in assets to depreciate and lower taxable income, what if these are marked to $80-$100 billion? Now, the deprecation level increases and cuts the taxable income and effectively lowers the corporate tax rate further. Using a more accelerated deprecation life could reduce the tax bill again.

There is a limit on tax deductibility on interest expense at 30% of EBITDA under the new tax law, but Energy Transfer is about half that level and unlikely to have problems there. The interest expense thus creates another tax shield before paying the new 21% rate.

Where it may create the greatest opportunity is allowing the former MLPs greater access to bigger pools of money. Right now, retirement accounts have a difficult time owning MLPs and individuals and CPAs do not like the tax procedures either. They are also not in the various stock indices. The S&P 500 has just over 6% of its exposure in energy but only 0.2% exposure to energy infrastructure after Kinder Morgan and Williams converted to C-Corp. The infrastructure side is huge at several hundred billion in assets. What if the passive index funds had to add 1%-2% to pipeline companies? The stocks could see strong appreciation.

A higher stock price for MLPs due to increasing the size of the pool for potential investors is a big deal. For the last 3-4 years, they have fought a funding battle. They need capital to pay for growth projects. However, they have to protect their balance sheets and thus raise equity capital along with debt. When the stock is $15 instead of $45, they have to issue 3x the number of new shares. Each share adds to the total being paid out via dividends and investor perception requires a high dividend. Thus, new cash flow from completed projects is getting consumed in dividends and the capital raising starts all over again.

The new tax rules give these companies a reason to simplify their structures and cut the outflow to IDRs – which preserves capital to pay for growth. They may get a higher stock price by appealing to more investors and thus new funding needs come by issuing less stock. So this catalyst looks fairly solid and is driving changes already in the sector.

Growth in the Pipeline Sector has been Significant in Recent Years

With the ability to export oil and natural gas, the US has plenty of supply and the production companies have seen sizeable recoveries in their stocks. Yet, all are pointing out a severe shortage of infrastructure in places like the Marcellus Shale (Pennsylvania, West Virginia, Ohio) and the Permian Basin (West Texas). As a result, oil, gas, and NGLs (Natural Gas Liquids) are being stranded in those areas and often trading at a discount because it is difficult to get them to market. That sounds like a great growth story – a big need for pipelines, producers willing to invest which ought to guarantee business, an ROI that gets a boost by eliminating a price discount that exists without the pipeline. Look at how much capital spending has been going on in the industry by focusing on some of the bigger participants:

	2015	2016	2017	2018e
Energy Transfer (ETP/ETE)	$9,947	$8,836	$9,147	$5,000
Enterprise Products (EPD)	$5,031	$4,123	$3,351	$2,700
Magellan Midstream (MMP)	$694	$874	$691	$900
Plains All American (PAA)	$2,437	$1,917	$2,720	$1,615

This is very broad-based, pipelines are being built to carry crude oil, refined gasoline and diesel fuel, natural gas, and various natural gas liquids. We have talked in previous reports (1/25/18 issue) about the huge demand for cheap chemical feed-stocks transforming the US chemical industry into a growth sector with as well. This is all inter-related and is helped by rising oil prices being over $40 to also result in substantial supplies of natural gas and NGLs being produced as byproducts.

The reason all this capital spending is a current catalyst is that pipelines consume huge amounts of capital and produce no cash flow until construction is complete. After that, cash flow starts as commodities start to flow and cash flow grows as the volume builds. At that time, spending is almost nil. The industry is now at the point where much of the spending shown above is starting to result in projects going active. This can be seen in the EBITDA growth at ETP and its rising coverage ratio on distribution payout:

	2014	2015	2016	2017	1Q18
EBITDA	$4,564	$4,527	$4,601	$5,649	$1,576
Growth Rate	28%	-1%	2%	23%	27%
Distributable cash/payout	1.03x	0.99x	0.87x	1.20x	1.15x

It appears that investors have already experienced the worst of it. The coverage ratio is above 1x again and the cash flow growth has been driven by turning on the Dakota Access Pipeline and recently part of the Rover.

Look at the schedule of new projects turning on over the next 5-6 quarters:

2Q18	Rebel II Processing Plan
2Q18	Old Ocean Pipeline
2Q18-2019	Red Bluff Pipeline
2Q18	Rover Pipeline Phase II
2Q18	Revolution System
3Q18	Lonestar Frac V
3Q18	Mariner East 2
4Q18	Arrowhead II
Q418	Bayou Bridge Extension
Q418	NTP Pipeline Expansion with Old Ocean
2Q19	Mariner East 2X
Q219	Lone Star Frac VI

Construction on many of these projects is already over 90% complete. A project like Revolution will feed into Rover and Mariner East 2, so as phase II of Rover and ME2 turn on, Revolution turns on as well. It is basically complete. The other key with some of these projects is they do not require as much spending. For example, the Old Ocean Pipeline already exists and is being reactivated to carry gas out of the Permian Basin. It will require an expansion in 3Q and 4Q of 2018, but the level of work will be quicker to complete. Bayou Bridge is another pipeline that is already in operation and ETP is adding an extension to it. That also involves less pipe and perhaps less time to complete.

It is also important to remember that many of the projects take a few quarters to fully ramp up. Thus, once they turn on, there is a growth phase for EBITDA and again the capital needs essentially vanish from these projects as their cash flow appears.

Conclusion:

No one likes to hear the letters MLP – it's practically the law anymore to play sinister music when one is mentioned. However, we think the worst of the time lag when huge capital outlays are made before there is a dollar of cash flow coming in for these companies is past.

The growth in cash flow is rising and the coverage on the distribution has improved. A company like ETP has become smarter and issued more preferred stock at almost half the dividend cost as common stock as well as bringing in partners as project investors that also will be customers for the pipeline being built. The lack of bad news is already a catalyst

There are new projects turning on rapidly over the next year, which will drive cash flow growth and there is much less spending needed to complete those projects at this point. So that picture will look even better going forward as another catalyst.

Finally, the MLP structure and its tax complexities are changing rapidly in this industry. Simplified structures without IDRs would allow more capital to be retained for future growth projects – that is another catalyst. More of the MLPs are talking about converting to C-Corporations, which would increase the pool of investors who can buy and some may be mandated to buy if more are added to the indices. That is still another catalyst. Plus, the new tax laws would encourage this change as well as acquisitions to allow assets to be marked up and create a larger tax-shield from depreciation – there's another catalyst. In the meantime, the yield is almost 12% and the coverage on that yield is remarkably strongly now than even 2 years ago. Investors are getting paid to wait for these multiple changes to play out over the next year.

Merck (MRK) 3/18 Quarter Review

Merck (MRK) reported adjusted EPS of $1.06 versus the consensus estimate of $0.99. However, there were several one-time benefits at work in the quarter:

- Adjusted EPS included a $0.06 per share swing in other income.

- R&D expense fell after adjustment for one-time charges largely due to timing of licensing payments. If R&D had remained a constant percentage of sales, it would have shaved about $0.04 per share off adjusted EPS in the quarter. R&D expense has been lumpy, but new drug development will keep it elevated in the next several quarters with difficult comparisons coming in the next two periods.

- Accruals for discounts fell as a percentage of gross sales. This could have added about $0.05 per share to EPS.

- MRK launched a strategic collaboration with Eisai to co-develop Lenvima both as a monotherapy and in combination with MRK's *Keytruda*. The company recognized $1.4 billion in expense in research and development to account for upfront and future payments to Eisai but added these expenses back in the calculation of adjusted non-GAAP earnings. While this is typical among drug companies, we believe ignoring these costs going forward overstates future reported profitability from the agreement.

Other Income Jumps (But Not Excluded from Non-GAAP Adjustments)

MRK's other income line item jumped in the quarter from $71 million last year to $291 million. The company disclosed in its 10-Q that $115 million of the increase was due to a gain on settlement of patent litigation. Management referenced the litigation gain in the conference call and quantified it at $0.03 per share. However, even after factoring out the litigation gain, other income still displayed a significant jump over last year. Management gave no color on the balance of the increase. The total increase in other income amounted to $0.06 per share and accounted for all of the EPS upside in the quarter. We also find it interesting that given all of the adjustments the company makes in its non-GAAP presentation that it elected not to exclude at least the litigation gain from adjusted results.

R&D Expense Adjusted for One-Time Charges Falls

The following table shows a common size income statement for the last eight quarters. Note that all expense amounts are adjusted for restructuring charges, acquisition-related items including amortization of intangibles, and other one-time items.

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Sales	$10,037	$10,433	$10,325	$9,930
Adjusted Gross Margin	75.7%	74.9%	76.0%	77.6%
Adjusted Marketing & Admin % of Sales	24.9%	24.1%	23.1%	24.4%
Adjusted R&D % of Sales	17.9%	19.4%	17.0%	17.5%
Operating Margin (pre-amortization)	32.9%	31.4%	35.8%	35.8%

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Sales	$9,434	$10,115	$10,536	$9,844
Adjusted Gross Margin	77.4%	74.8%	75.3%	75.7%
Adjusted Marketing & Admin % of Sales	26.0%	25.4%	22.4%	23.9%
Adjusted R&D % of Sales	19.3%	17.2%	15.5%	19.1%
Operating Margin (pre-amortization)	32.1%	32.2%	37.4%	32.7%

The decline in gross margin in the 3/18 quarter was due to "unfavorable FX as well as amortization of unfavorable manufacturing variances." However, this was more than compensated for by lower marketing and admin expenses and lower R&D expense. Management attributed the decline in R&D to the timing of licensing costs. In addition, R&D as a percentage of sales has been lumpy, the 3/18 quarter faced an easy comparison. However, MRK is undergoing extensive clinical trials with several key drugs at the moment and management has indicated that this will keep R&D spending elevated for the next several quarters. With the next two quarters representing more difficult comps, increased R&D will likely be a headwind to profit growth in the upcoming quarters.

We also note that the company cited lower selling and promotional costs in the 10-Q as being key drivers in profit growth in the pharmaceutical segment. Given the activity surrounding new drugs, we doubt the company can enjoy lower selling and promotional costs for long.

Discounts Continue Lagging Sales

We noted in our original review of MRK that the company's 2017 results benefitted from lower accruals for rebates and chargebacks. MRK does not provide disclosure showing the full development of the discount accrual reserve on a quarterly basis so we cannot track actual payments and writebacks of the reserve. However, it does mention in a footnote how much the impact of current period accruals reduced reported net sales. The following table shows the quarterly discount accruals and their percentage of gross sales.

	3/31/2018	12/31/2017	09/30/2017	6/30/2017
Net Sales	$10,037	$10,433	$10,325	$9,930
Discount Accruals	$2,400	$2,700	$2,900	$2,800
Gross Sales	$12,437	$13,133	$13,225	$12,730
Accruals % of Gross Sales	19.3%	20.6%	21.9%	22.0%

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Net Sales	$9,434	$10,115	$10,536	$9,844
Discount Accruals	$2,500	$2,700	$2,600	$2,300
Gross Sales	$11,934	$12,815	$13,136	$12,144
Accruals % of Gross Sales	20.9%	21.1%	19.8%	18.9%

We can see that despite a 4% increase in gross sales, the discount accrual fell by 4%, causing the 3/18 discount accrual to decline by 160 bps as a percentage of sales versus the comparable year-ago number. If the discount accrual had remained a constant percentage of gross sales, it would have reduced net sales by about $200 million. This would have filtered straight down to profits, implying the decline in the accrual could have added another $0.05 to EPS in the period.

Eisai Payments Adjusted Away

During the quarter, MRK established a collaborative agreement with Eisai Company to co-develop and co-commercialize Lenvima. Under the agreement, the two companies will develop Lenvima jointly, both as a monotherapy and in combination with MRK's *Keytruda* and essentially split the profits. In the quarter, MRK made $750 million in upfront payments to Eisai and will make another $650 million in payment through 2021 for option rights. MRK reported the full $1.4 billion in R&D expense in the quarter and then adjusted them all out in the presentation of non-GAAP adjusted earnings. Therefore, future earnings will not reflect these costs as offsets to revenues recognized under the agreement. We realize that this accounting treatment is commonplace in the pharmaceutical industry, but we still can't help but point out the degree to which this is overstating future reported revenue. A more realistic approach would be to capitalize these payments and amortize them over the period that the resulting therapy produces revenue. Interestingly, during the quarter, Lynparza, a drug being co-developed with AstraZeneca, received a specific approval in the US which triggered a milestone payment to AstraZeneca of $70 million. This payment was capitalized and will be amortized over the remaining life of Lynparza. This is a much more realistic treatment of such amounts.

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