The Power of the MLP GP

Kinder Morgan Partners (KMP) announced a secondary offering of 6.9 million shares last night at $78.32, raising $540 million. KMP is predictably weaker this morning as is usually the case when an MLP sells stock unexpectedly. For Kinder Morgan Inc., (KMI), the math is somewhat different. KMI owns the General Partner (GP) of KMP, and as such is entitled to 50% of the distributable cashflow generated by KMP. Simplistically, without considering any additional debt that KMP might raise, KMI will earn the return on 50% of the equity capital KMP has raised. In effect, the value of the assets on which KMI earns a return has gone up by $270 million, without KMI having to put up any money. KMI investors should thank the KMP investors for making this possible.

CFA Institute Reviews "Bonds Are Not Forever; The Crisis Facing Fixed Income Investors"

A very nice review, which you can find here.
Unlisted, Registered REITs; an Investment Designed for Brokers

Unlisted, registered REITs (Real Estate Investment Trusts) deserve a worse reputation than they apparently have. Yield-seeking investors continue to plow cash into them, and the brokers that market them clearly won’t let a bad idea get in the way of a commission. This is a curious animal; registered, meaning the security has to meet all the disclosure, reporting and other requirements of public securities, but not listed meaning there’s limited or no liquidity. The registration feature no doubt gives comfort to the retail investor, but the absence of liquidity represents a substantial drawback.

You’d think that if you’ve gone to all the trouble of registering a security you’d want it to be publicly traded. However, these unlisted securities can charge underwriting fees of up to 15%, leading to an immediate 15% loss of value for the client. A public market quote that reveals this loss would be quite an inconvenience for the underwriter and issuer. Furthermore, the absence of a public market dissuades any sell-side research from covering the company, because there are no commissions to be earned on secondary trading activity. Inland American Realty is one such security, and in September Massachusetts [announced](#) a settlement with five brokers over improper sales of unlisted registered REITs including Inland American Realty. I wrote about this in [June](#). Five firms, including Ameriprise, had been stuffing unwitting clients with a bad investment because of the high fees it generated. At least regulators are on the case. The Federal securities regulator, FINRA, also has a [website](#) that warns investors about this type of security. The warnings are out there. Why would any firm that truly puts its clients’ interests first continue to push such poor investments?
Yesterday, I was at a conference and I picked up a brochure from one firm titled, “The Case For Investing in Non-Traded REITs”. Among the supposed advantages are, “Illiquidity that favors the long term investor.” Are they serious? How does illiquidity favor any kind of investor, short term or long term?? It favors the issuer, because there’s no public market to expose how poorly their securities are valued. Another related benefit is that they are, “Not subject to public market volatility.” But again, public markets allow you to exit your investment. It’s your choice, you can always decide to ignore the information public markets give you, but as with most information it’s better to have it than not.

If your broker markets unlisted, registered REITs, they’re not wholly focused on investment products that are designed with your best interests in mind. You should draw the appropriate conclusion.

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**Kinder Morgan Lawsuit Highlights Who's In Control**

Last week an investor in Kinder Morgan Partners (KMP) filed a lawsuit against its general partner, Kinder Morgan Inc. (KMI), alleging that KMI (which runs KMP) had directed excessive cash distributions to itself to the detriment of investors in KMP. The suit (filed by Jon Slotoroff) highlights a seldom noted feature of MLPs, which is that investors have far less power than conventional equity investors in a corporation. MLP GPs are extremely hard to displace, enjoy preferential rights with respect to distributable cashflow (DCF) and can organize the capital structure of their MLP in such a way as to benefit the GP at the expense of the MLP unit holders (by, for example,
causing the MLP to issue dilutive equity that increases distributions to the GP).

These features are disclosed to those who read the documents. KMP’s 2013 10-K for example notes in its Risk Factors that, “The general partner can protect itself against dilution”, that conflicts of interest of the GP may be resolved in ways that are unfavorable to LP unitholders and various other issues of control. Removing KMI as the GP takes a two thirds vote of the LPs but no one holder may vote more than 20% of the units even if they own more.

Simply put, the value proposition for an MLP is for its GP to manage its distribution yield and capital structure such that it’s just sufficient to maintain demand for new units as they’re sold but not overly generous. Too much abuse of LPs will drive up the required yield to sell additional equity, impeding the GPs ability to continue growing the MLP and the DCF it receives. But there’s little point in running an MLP to be overly generous to its unitholders, unless the GP also owns healthy percentage of the MLP’s units (and some do).

Suing KMI under such circumstances seems to be a waste of time, although America is a litigious country and any lawyer will tell you that in court anything can happen. But the fact of the lawsuit highlights the stronger position of GPs versus LPs in the MLP structure. The sensible move would seem to be to invest in GPs and therefore avoid the need to sue as a disgruntled LP. Evidently, not everybody reads the SEC filings before they invest.
Kinder Morgan's Analyst Day, Part 2

The meeting concluded with a financial review and Q&A. Overall the impression is one of numerous projects to grow and add to their energy infrastructure assets. Many seemingly attractive opportunities are available. The shadow of Kevin Kaiser, the HedgeEye analyst who criticized their accounting last year, was present even though Kaiser himself did not ask any questions (he was actively tweeting though). The maintenance capex figure for Kinder Morgan Partners (KMP) received some scrutiny, up as it was from $327MM last year to $438MM this year. The series of presentations also offered a lot of detail, and although today’s market vote was a negative (KMI is -4%) we are comfortable with our investment. We are long KMI, but also short a substantially smaller amount of KMP as a hedge in one particular strategy.

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Kinder Morgan's Analyst Day, Part 1

So far we’re half way through Kinder Morgan’s analyst day. It opened with a summary by Rich Kinder who repeated his oft-stated thoughts that the stock price of all four Kinder entities is too low. We agree with him at least in the case of Kinder Morgan Inc (KMI) which we own. We much prefer the position of General Partner over Limited Partner, although so far the presentations haven’t been able to draw in too many new buyers of the stock, with KMI currently -3.4%. Everything we’ve heard is consistent with a solid long term growth story
in U.S. energy infrastructure. Kinder Morgan (KM) is involved in numerous ways, and the development of shale resources is causing many new opportunities and incongruous developments that the company is involved in. These include:

1) Increased capability to export coal, since domestic demand is being displaced by natural gas. In spite of the developed world’s focus on clean energy, coal use is forecast to exceed crude oil in consumption by 2020, on an energy-equivalent basis.

2) Regulatory uncertainty over the Keystone pipeline as well as the increasing variability of liquids produced is increasing the need for flexible supply systems. Crude by rail has grown enormously, to the benefit of firms like Burlington Northern (owned by Berkshire Hathaway, BRK, another holding of ours). KM is investing in infrastructure to support more movement of crude oil by rail.

3) Distillate is being transported from the Marcellus shale in Pennsylvania to the Canadian tar sands in Alberta, where it is used as a diluent mixed in with the heavy crude produced there to ease its subsequent transportation.

There were many projects aimed at increasing existing pipeline capacity, reversing pipelines and creating additional infrastructure to move product from where it’s produced to refiners and end users.

So far a very interesting session, with no doubt more to come.
Why DirecTV Is Redirecting The Weather Channel

An obscure dispute between DirecTV and The Weather Channel (TWC) highlights the shifting landscape of the economics behind what you see on TV. DirecTV dropped TWC from its lineup because they wanted to reduce the current 13 cents per subscriber per month that they pay to carry the service; TWC wanted an increase to 14 cents. Unable to agree on terms, the service was dropped. It’s a big deal for TWC because it’s possible other cable companies will see an opportunity to negotiate better terms. In fact, it’s not clear to me that DirecTV should be paying much, if anything, to TWC because they already carry advertising. Charging viewers to watch TWC and also inflicting advertising on them seems a bit much to me. But then, I rarely get my weather information from TV, but instead like millions of others favor the far more precise access offered by the internet.

And that is really the point. In so many ways, TV channels are an increasingly inflexible way to deliver content. You get what they want to deliver when they want to, across several hundred channels, compared with the internet which in effect offers limitless choices of content. The important exception is anything live, most notably sports, for which providers will be able to charge a premium price for the foreseeable future.

News delivery on TV has long struggled to compete with the far more customized content available online. As for shows and movies, Netflix must be one of the best deals around. The quality of online video on a laptop even over a wireless network is quite acceptable in most cases. On a recent trip south for warmer weather, my wife and I didn’t even turn on the TV in our room, instead using Netflix to choose our evening’s viewing.
Like so many developments in technology, it is empowering for the consumer. As I compare my cable bill with my Netflix subscription and ponder how little I watch on live TV beyond the English Premier League, it seems clear that many traditional business models in the fields of entertainment and broadcasting are at risk.

The Freedom to Write Without Having to be Right

This morning I perused the front page of the Financial Times the old-fashioned way (i.e. by physically holding the newspaper in my hands rather than visiting the website) over breakfast in a NY hotel following a client dinner last night. I was struck by the juxtaposition of two articles. One was: “‘Fragile Five’ Fall Short of Taper Threat” discussed the exposure some BRIC countries and others have to a too rapid tapering of the Fed’s policy of QE. We all remember how last Summer’s mere mention of tapering by Ben Bernanke was felt disproportionately in the Emerging Markets.

Incongruously facing this article was: “Christine Lagarde warns of growing threat of deflation.” Clearly, deflation and too-rapid tapering are unlikely to occur at the same time, which just goes to show that even the FT sometimes practices that well used journalistic trick of warning of every danger (including the possibility of no danger) so as to be able to claim foresight when one of the forecasts takes place. The FT’s website, with its far more mobile layout, doesn’t position these stories side by side, but it did highlight for me the many concerns that still confront equity markets.
On a related topic, we’ve noted recently some persistent underperformance of low volatility stocks versus the S&P500. Over the past couple of months Consumer Staples stocks (as reflected by the ETF XLP, for example) are flat while the market itself is up 5%. It’s been a similar story for SPLV. The logical corollary is that high beta, more volatile stocks have been outperforming the averages, in a sign that active managers are increasing their market risk. I’ll stop short of making the obvious prediction that the market must, therefore, be vulnerable to a sell-off, because the data doesn’t necessarily say that. Such outperformance of one sector versus another can persist for quite some time, although ultimately mean reversion occurs and the process reverses itself. We just haven’t identified any reliable tool with which to predict the timing of a reversal. However, if we were journalists this story would be titled, “Outperformance of High Beta Stocks Signals Market Reversal” and, unburdened by the need to deploy capital in response to our opinions, we would eventually be proven right.

MoneyLife Interview

Nice piece with Chuck Jaffe of MoneyLife. Here’s the link – go to the December 24th show, starts at the 17 minute mark.

http://www.moneylifeshow.com/archives.asp
Why Flying is Getting More Expensive

I was struck today by an article in the New York Times (“On Jammed Jets, Sardines Turn on One Another”). As airlines pack more people onto planes, the flying experience (as least in Economy Class) becomes ever worse. This was hardly news to anyone who has flown domestically in the U.S. in recent years. Airlines have generally found that, in a market where tickets are bought online and the cheapest fare wins, charging more for better quality is not a winning strategy. Everybody knows that flying commercially in the U.S. has become worse. Seats are smaller with less legroom; food quality has fallen; needed security has trapped us all in terminals that are shopping malls such is the extra time needed to be processed. In short, the quality of flying has gone down.

The statisticians at the Bureau of Labor Statistics (BLS) would not agree. Why should we care what they think? Because this is where the Consumer Price Index (CPI) is calculated. Because products and services are routinely offered in different shapes and formats, simple month-to-month price comparisons don’t capture the complete picture. A jar of peanuts formerly 16 oz but now 18 oz has, if sold at the same price clearly experienced a price drop. So has a new, faster ipad if sold for the price of last year’s. Generally quality improves, and where it does the BLS registers a price decrease which is part of their methodology. But as I discovered when researching my recent book, Bonds Are Not Forever; The Crisis Facing Fixed Income Investors, airfares have mysteriously not registered a quality decrease, although there’s little doubt that’s what happened. Since 2000 the only change the BLS has recorded to the quality of flying is an improvement, due to easier cancellation terms.

In effect, the BLS has miscounted airline fare inflation, in
that (for example) an unchanged price with lower quality is just as much of a price increase as if quality was unchanged but the price raised. The problem is that it’s hard to objectively measure how much the quality of flying has deteriorated.

Now it’s not hard to find conspiracy theorists who are convinced the government is deliberately understating inflation so as to curb its spending on all kinds of inflation-linked programs starting with Social Security. Clearly, the Federal government benefits from understated inflation. I am not among those who believe there is intentional manipulation of the statistics going on. It would be impossible to keep secret. But I do think that the inflation statistics produced do not measure what people think they are measuring. Growing your savings pot, or your income, at inflation (after taxes, naturally) isn’t going to maintain your standard of living, as this one simple example shows. Inflation figures have their place, but they’re not that helpful to the average saver.