

Focus Research

Master Limited Partnerships

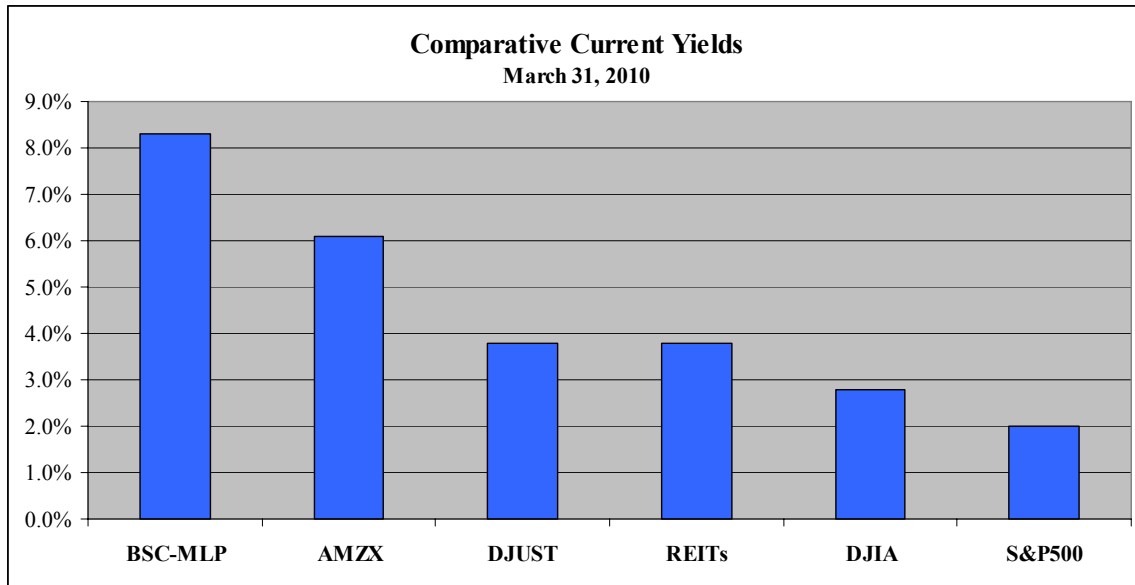
Publicly traded Master Limited Partnerships (MLPs) provide a high level of current income to investors that in many cases are significantly higher than equity alternatives such as REITs and Utilities. In addition, MLPs provide tax advantages that can make the after-tax yields of these investments more attractive relative to other alternatives.*

* Beacon Street Capital, LLC and its principals are not experts in the area of taxation. Income is reported on a Schedule K-1 like other partnerships. You should seek the expertise of your personal tax advisor as to the specific tax features and potential benefits from these types of investment products.

Master Limited Partnership

A master limited partnership (MLP) is a business entity that passes through its income to unit holders (shareholders). The benefit of the MLP structure to the entity is that it avoids paying taxes at the entity level which reduces the cost of capital, but to qualify the MLP has to generate at least 90% of its income through activities that produce or transport natural resources and/or commodities, or in some cases by having an interest in real estate. A business best suited for this type of structure is one with steady and predictable cash flows, such as energy infrastructure, since cash distributions are based on the distributable cash flow generated rather than the reported income of the entity.

Most energy MLPs are involved in the “midstream” portion of the energy business. This includes processes which occur between the source of a commodity (natural gas or oil) and its endpoint, such as transportation (pipelines), storage and processing. Because these operations are in the middle portion of the commodity chain, unlike regulated utilities they are less impacted by commodity price fluctuations, weather and plant outages. Consequently, the distribution yield paid by energy MLPs is typically higher than stock dividend yields.



Indexes

BSC-MLP: Beacon Street Capital's MLP-Oil & Gas strategy
 AMZX: Alerian MLP Index
 DJUST: Dow Jones Utility Sector Index Fund iShares ETF
 REITs: Dow Jones U.S. Real Estate Index Fund iShares ETF
 DJIA: Dow Jones Industrial Average Index
 S&P500: Standard & Poor's 500 Index

Yield

8.3%
 6.1%
 3.8%
 3.8%
 2.8%
 2.0%

General Partner

An MLP consists of a general partner, which runs the operations and may receive incentive distribution rights (IDRs), and limited partners, or shareholders, who invest the majority of the capital in the MLP. The IDRs generally increase the better the performance of the MLP, which gives the general partner an incentive to increase the distributions to the limited partner shareholders. The general partner's share normally starts at 2% and increases as the distribution to limited partners increase, and is capped at 50% of incremental cash flow or less. The smaller the cap the better for limited partners since more cash flow is returned to them.

Limited Partner/Shareholder

Tax advantages also accrue to the shareholder and investors should seek tax guidance before investing to understand the tax implications. In general, 80-90% of the distributions from MLPs are tax deferred since they are classified as "return of capital", and are reported on a Schedule K-1. A "return of capital" distribution reduces the shareholder's original cost basis and the tax liability comes into play only when the MLP is sold. The decline in basis due to return of capital distributions is taxed at ordinary income rates, while any gain above the original basis would be taxed at long-term capital gain rates. While MLPs can be held in IRAs and other non-taxable accounts they are typically not efficient because if, in the aggregate, they generate over \$1,000 in unrelated business taxable income (UBTI), the amount above \$1,000 is subject to tax. Once again, you should speak to your tax advisor for any tax-related questions.

Cash Flow vs Income Earned

With natural resource producers, income is reduced by non-cash expenses such as the depletion of natural resources, and the depreciation associated with the cost of a long-term asset, such as a pipeline, over its useful life. However, these types of assets require little maintenance and do not deteriorate rapidly; therefore an MLP can distribute a very high level of its cash flow to shareholders without diminishing the long-term basic earning power of the business. This makes MLPs unique from traditional corporations which must grow by replacing short-lived assets and improving technology which leaves little cash flow left over for distribution to shareholders. For this reason MLPs are valued based on their distributable cash flow and not on the accounting calculation of earnings.

Fundamental Analysis

Since distributable cash flow is the key to valuing an MLP it is essential to determine the coverage ratio, or the amount available to be paid relative to the amount that could potentially be paid out. MLPs with higher coverage ratios can grow their businesses without adding more debt and these typically are energy related companies as opposed to companies with higher fee-based businesses such as real estate. Also, debt-to-operating

income is another metric that is important to watch. If the level is too high, debt default will be more likely and future expansion less likely.

Other metrics we use in our bottom up analysis include the leverage ratio, cost of equity, and enterprise value relative to operating income. In addition to analyzing the quarterly and annual financial reports, we monitor the intra-quarter news releases and third-party sources of information to ensure the high quality MLPs we select for investment maintain their advantages and payout structures.

Investment Management Process

As investors in this sector, we look for a visible cash flow stream, lower IDRs and strong distribution coverage with reasonable leverage. An advantage to energy MLPs is that fluctuating oil prices have little impact on most entities, thus we have our highest-confidence investments in the “midstream” portion of the energy business which includes pipelines, gathering and processing, production and transportation. These tend to have stable cash flows and stronger balance sheets. From a universe of 50+ candidates we select only those we consider best-of-breed in the various categories for our clients and for ourselves. We utilize a separately managed account for each client that is maintained by an independent custodian and distributions are either paid to the client when received from the MLP or reinvested to compound the return. We monitor the holdings and sell or trade when the fundamentals change.

Risks to Shareholders

MLPs are regulated by the SEC and also must comply with Sarbanes Oxley. They are traded on the major stock exchanges making them relatively liquid investments and like stocks and bonds are not insured and may lose value.

The two major risks to shareholders are a change in the tax structure of MLPs and the level of interest rates. Since these are yield-based investments they carry interest rate risk and most likely will underperform in a rising interest rate environment. On the other hand, energy MLPs are often less exposed to fluctuations in commodity prices than traditional income-oriented equities and have more visibility in their cash flow leading to more consistent and potentially growing payouts. However, distributions for each MLP may vary over time and may fall to zero in an extreme situation.

Alternative Income Investments

1. REITs: Real estate investment trusts are subject to periodic over-building, discretionary consumer spending, and default risk and thus their cash flows are less stable. Also, much of the future returns are based on expected capital gains from higher property values and lower capitalization rates.

2. Utilities: Utilities were the go-to investments for income oriented conservative investors, but the fundamentals of electric utilities have changed. Their capital spending has not kept pace with infrastructure needs and is expected to grow rapidly in the future. This will significantly reduce the free cash flow of the industry which will have an impact on their dividends to shareholders. In addition, more than half of the electricity generated in the US comes from coal, which, due to its low cost, will be the dominant fuel used in electric power production for the foreseeable future. However, environmental concerns will cause these operators to invest heavily in technology to eliminate the associated pollutants.

Growth of the MLP Sector

The MLP sector market cap doubled to \$75 billion in the past two years and is expected to double again before the end of this decade. The MLP sector could be on a similar trajectory to REITs in late 1980's due to strong need for energy infrastructure investment and the migration of existing assets into the MLP structure. Currently less than 10% of institutions own MLP assets giving them plenty of room to grow.

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