

Energy Transfer, LP

Solid Income Potential with Improving Fundamentals

Introduction:

Energy Transfer, LP (ET) is a stable, cash flow generative Master Limited Partnership (MLP) that operates energy oriented transportation, storage and midstream assets in major production basins in the United States. This article provides a background on the company, analyzes its cash flow generation, balance sheet, dividend potential and finally concludes with our opinion on whether investors should take advantage of the company's high dividend yield.

Overview:

Energy Transfer, LP is engaged in providing energy related services like natural gas interstate, intrastate, midstream transmission & storage, crude oil and refined products transportation, various other fractionation and terminalling services. It operates through the following key segments:

Segment Name	Segment Description	% of Segment EBITDA
Intrastate transportation and storage	In this segment, the company provides energy logistics with an operational capacity of 9,400 miles of natural gas pipelines and storage facilities to trading hubs and industrial consumption areas in the US	10%
Interstate transportation and storage	In this segment, the company owns and operates 12,200 miles of interstate natural gas pipelines and 6,750 miles of transportation capacity through joint venture interests.	18%
Midstream	In the midstream segment, the company is engaged in natural gas gathering, compression, treating, processing, transportation and storage.	17%
NGL and refined products transportation and services	In this segment, the company provides services pertaining to NGL operations and other refined products like transport (with approx 4,769 miles pipelines), storage,	21%

Key Takeaways:

- Stable cash flows driven by volume rather than price driven energy contracts
- Capex and debt levels expected to fall after peaking in 2017
- Solid Distribution coverage of 2x
- Appealing 8.8% dividend given the stability in cash flows

	fractionation & blending facilities, and acquisition and marketing activities.	
Crude oil transportation and services	The company undertakes various crude oil operations like transportation, terminalling, acquisition and marketing to crude oil markets. It owns and operates approximately 9,524 miles of crude oil pipelines.	25%
Investment in Sunoco LP	Sunoco LP undertakes the distribution of motor fuel and other petroleum products to independent dealers, commercial customers, end-user customers through commission agents, distributors.	7%
Investment in USAC	USAC provides compression services which aids in production, processing and transportation of natural gas and crude oil.	3%

Source: Energy Transfer, LP

What is a Master Limited Partnership (MLP)?

Master Limited Partnerships are publicly traded limited partnerships with a hybrid legal structure incorporating elements of both partnership and a corporation. They issue units instead of shares and the units trade on stock exchanges. MLPs are primarily engaged in energy and natural resources related activities with a focus on midstream assets.

What Are the Advantages of Investing via a MLP?

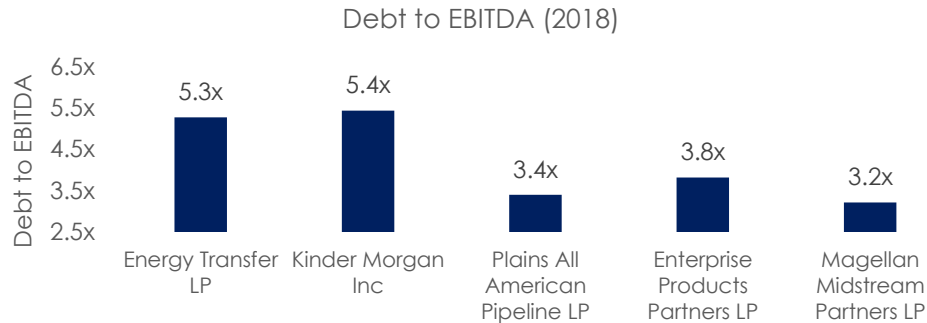
- MLPs offer combination of a partnership's tax advantages and a corporation's stock liquidity.
- Distributions received by unitholders become taxable only when the units held are sold and unlike dividends are not taxed as and when received.
- They offer steady cash flows and consistent distributions out of the generally stable income from long term service contracts.
- Offer lower risks as a result of the limited direct commodity price exposure and stable long term, inflation adjusted contracts.

Pipeline operators offer lower risk exposure to energy

The majority of Energy Transfer's EBITDA is derived from long term contracts that earn a fees dependent on volumes and not price of oil or gas transported through the company's infrastructure. Oil & Gas volumes tend to see muted volatility as compared to prices of the commodities. In fact, over the last five years, US gas consumption has grown 1.1% with 2018 seeing lowest growth at -0.1%. Meanwhile, during this period, crude oil price touched a high of nearly \$100 a barrel and a low of around \$36 in January 2016 and is currently trading near \$56.

However, ET's elevated capex spending and debt raised risks

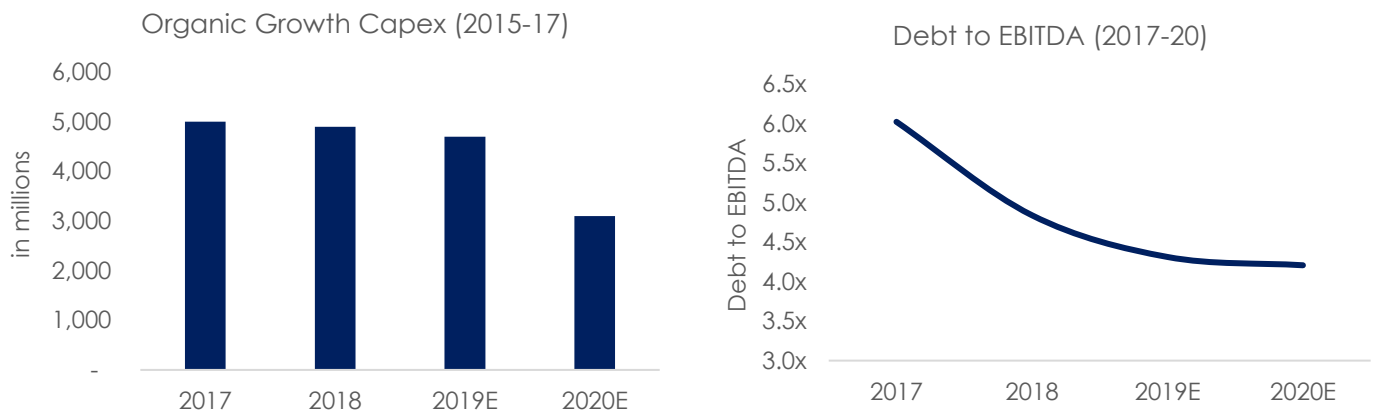
Over the last few years, Energy Transfer has seen elevated levels of capital spending. The outsized spending led to the company frequently tapping debt markets to plug the funding gap. The majority of the capital expenditure has been on discretionary, growth projects and while the investments have led to EBITDA growth, leverage ratios have been above the company's desired range.



Source: Energy Transfer, LP, Yahoo Finance

Recently, capex and debt levels have begun to normalize

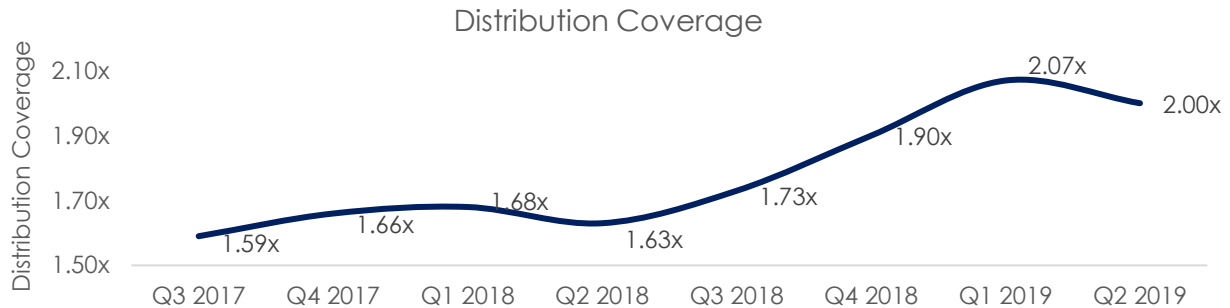
Energy Transfer's capex levels are set to normalize as a major spending cycle comes to an end. The company lowered its annual growth capex target from \$5 billion to around \$4.7 billion in the latest announced quarter and 2020 growth capex spending could go down to as low as \$3-\$3.5 billion. Additionally, the company has publicly guided to reducing its debt to EBITDA to 4-4.5 times and it is expected to achieve this range by the end of the current year or mid next year.



Source: Energy Transfer, LP

Meanwhile, EBITDA and Distribution coverage are improving

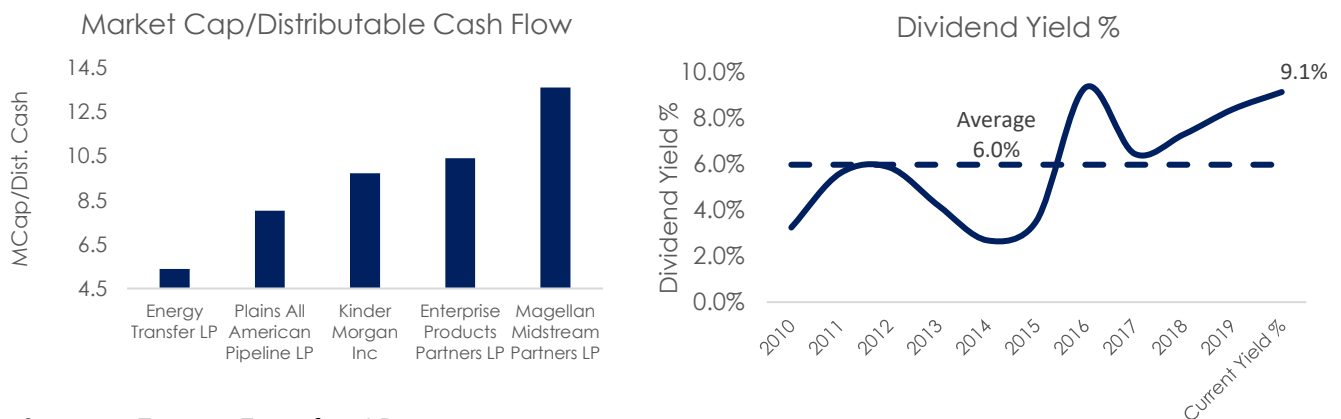
Energy Transfer's EBITDA has increased at a CAGR of 17% over the last four years to \$10.9 billion based on company's guidance for 2019 as new growth projects start contributing to cash flow. As a result, ET's distributable cash flow coverage has improved from 1.59 times in Q3 2017 to 2 times in Q2 2019. The company's long term distribution coverage target is between 1.7x-1.9x which implies **potential for buybacks and/or dividend increases in the medium term.**



Source: Energy Transfer, LP

Valuation Trails Peers and Dividend Yield at its Highs

ET trades at a deep discount to peers with its market cap to distributable cash flow at 5 times as compared to 9.5 times average for the peer group. Additionally, given the improving fundamentals with respect to the company's cash flow generation, leverage as well as distribution coverage, **the company's dividend yield of 8.8% is highly appealing.** The company yields higher than the 8.4% dividend yield of the Global X MLP ETF, a midstream MLP focused ETF. Clearly, the market has chosen to focus more on the lower oil and gas prices which has impacted valuations across the industry. However, it is important to reiterate here that **ET's EBITDA is largely insulated from near term swings in oil and gas prices.**



Source: Energy Transfer, LP

Risks

Lower oil and gas prices could impact long term dynamics

Even though oil and gas price swings in the near to medium term do not have any noticeable impact on ET's cash flows, longer term sustained dislocation in the oil and gas market can have significant impact on midstream MLPs such as ET. If oil and gas prices stay at uneconomical price levels for a prolonged period, the company's oil and gas producer customers may face financial distress and choose not to renew certain contracts. Having said that, in such a draconian scenario, demand and supply rebalancing should lead to an increase in oil prices and restoration of industry economics after initial pain.

Freezing up of debt markets in event of a slowdown could negatively impact growth MLPs

As a growing MLP, the company will invest in growth projects beyond the minimum maintenance capex the business needs. Additionally, \$20 billion of the company's \$46 billion debt is coming due over the next 5 years and the company will need to refinance this debt. A well-functioning credit market with reasonable cost of debt will be needed to successfully achieve refinancing. In case of a deep recession refinancing needs may create uncertainty among investors.

Conclusion

Energy Transfer offers investors an attractive, stable income vehicle in the energy sector. As a midstream MLP, the majority of the company's cash flows are based on fee and tariffs tied to volumes rather than prices which leads to cash flow stability despite swings in oil and gas prices. The company is set to improve its balance sheet and cash flows which will help reduce the company's valuation gap relative to its peers. **ET's 8.8% dividend yield is highly appealing given improving fundamentals and defensive nature of its cash flows.**