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Valero Rolls Up Logistics MLP as Funding Market Changes

Drop-down growth is no longer attracting investors.

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Repurchase Best Exit

Less than five years after it was created as a master limited partnership in December 2013, San Antonio-based logistics company Valero Energy Partners (VLP) is merging with its parent, refiner Valero Energy (VLO) this month. Valero decided the MLP structure no longer works to its advantage and a repurchase is the best way to exit the strategy. This note discusses the changing value of MLPs to the U.S. refining sector.

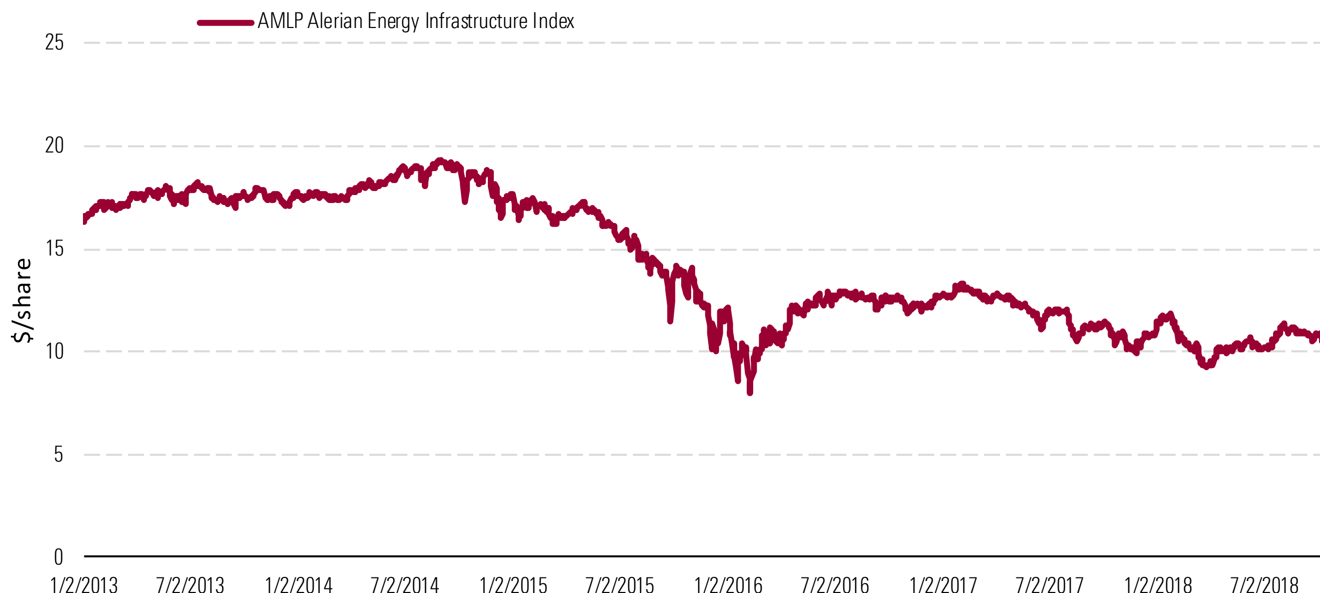
Partners in Energy

MLPs are U.S. corporate structures established by federal tax reform legislation in 1986 to encourage investment in energy infrastructure. They are typically businesses where income is derived from the volume of traffic using an asset such as a pipeline or terminal rather than owning the commodity that flows through. The toll road analogy is used to describe such fee-based businesses that are not directly exposed to commodity price risk.

MLPs are publicly traded. Instead of individual stockholders owning stock, the partners in an MLP own distinct pieces of the partnership called units. Because a partnership is not an entity, it pays no corporate taxes on its profits. Tax liabilities are instead "passed through" to individual unitholders who pay tax on their share of MLP profits. Unitholders typically receive cash distributions from their MLP every quarter based on earnings but are also allocated a share of depreciation on MLP assets that offsets the tax liability on cash distributions.

During the shale era, a boom in U.S. energy industry infrastructure needs and very low interest rates on alternative "safe" investments like bonds combined to make MLPs attractive to retail investors. MLPs also appealed to midstream companies looking for ways to finance infrastructure required to get shale resources to market. Enthusiasm for MLPs came to a halt when oil prices crashed at the end of 2014, scaring away investors and reducing demand for new infrastructure. Since then unit prices for MLPs have not recovered to levels seen in 2014. The industry benchmark Alerian MLP Infrastructure Index ETF fund AMLP settled at $9.96 per share on Oct. 24, 2018, down 48% from its high of $19.28 in September 2014 (Exhibit 1).

Exhibit 1 Alerian Energy Infrastructure Index



Source: Morningstar

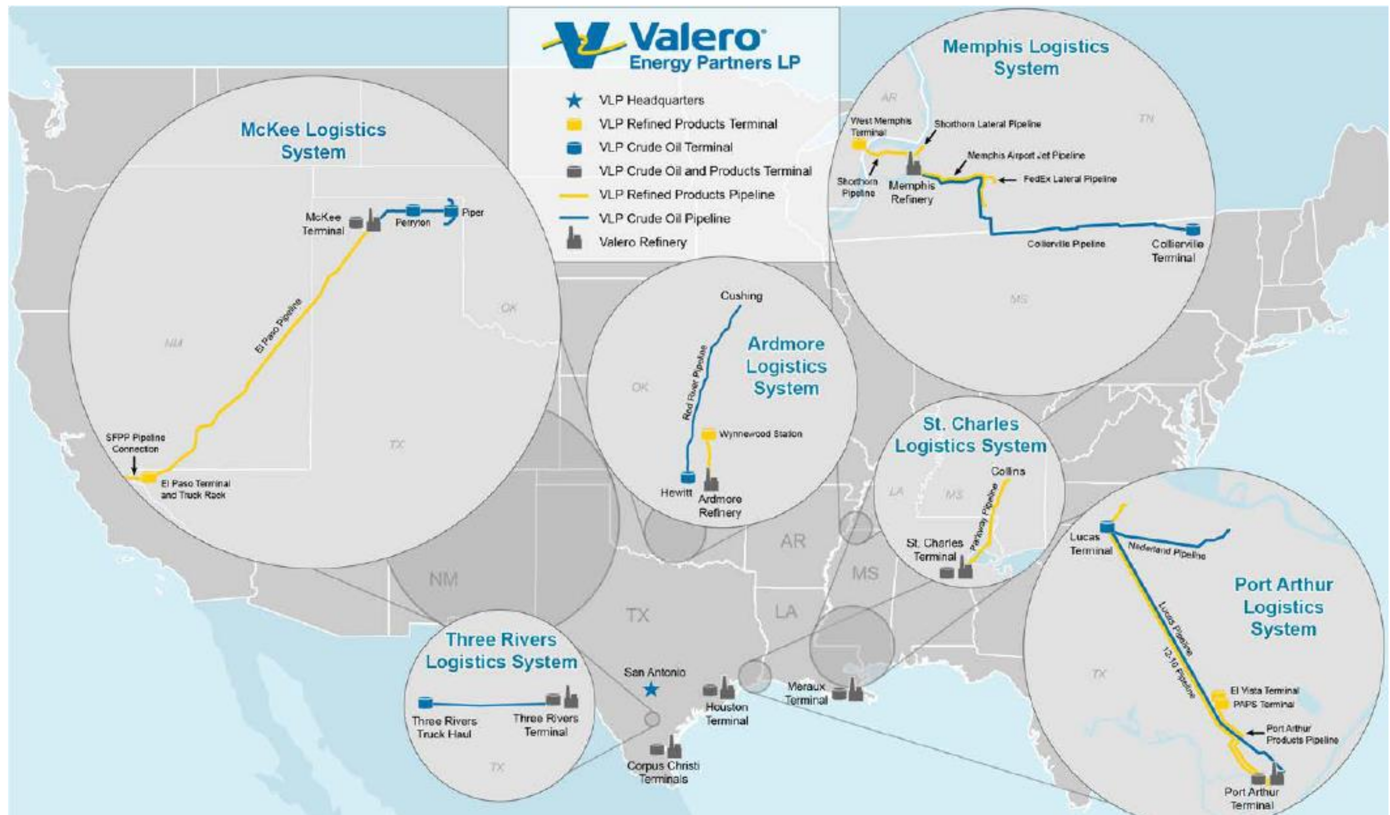
Valero and Partner

As we described in a May note, Valero is the second-largest U.S. independent refiner behind Marathon following the latter's acquisition of Tesoro (see "Has Marathon's Refining Empire Hit a Wall?").

Valero's assets include 15 refineries in the United States, Canada, and the United Kingdom with a combined total throughput capacity of approximately 3.1 million barrels per day and 11 ethanol plants in the U.S. midcontinent region with combined production capacity of approximately 1.45 billion gallons per year. Valero is a true independent refiner. It has no upstream exploration and production assets and spun off its downstream retail fuel business as an independent public company, CST Brands, in 2013. Valero inherited pipeline and storage MLP Shamrock Logistics when it acquired Diamond Shamrock in 2001 but subsequently renamed the partnership NuStar and divested it after an initial public offering in 2006.

Following the industry trend in the shale era, Valero created VLP in December 2013. The initial MLP consisted of pipeline and terminal assets around the company's Port Arthur and McKee, Texas, and Memphis refineries. These assets—already being used by Valero—were sold to VLP and effectively leased back to the parent via multiyear minimum volume throughput commitments. Over the subsequent five-year period, Valero continued to drop down additional logistic assets from its U.S. refinery network on a regular basis, mostly crude and refined product pipelines and distribution terminals (Exhibit 2). VLP generated revenue from the throughput agreements and used the cash to pay down debt from acquiring the assets and to pay distributions to unitholders.

Exhibit 2 Valero Energy Partners Assets



Source: Company presentations, Morningstar

MLPs Lose Favor

The crude price crash in 2014 and 2015 caused MLP unit prices to fall and made retail investors wary. Meanwhile, partnerships were obliged to continue making quarterly distributions for fear of further upsetting unitholders. This made expanding MLPs difficult since it was hard to attract new investor capital, meaning that new infrastructure had to be paid for with borrowing. Increasing borrowing instead of selling new units reduced the cash available to pay distributions, squeezing investor returns. Adding to the pain was a gradual increase in interest rates by the Federal Reserve over the past two years, increasing the cost of servicing debt. So, in the absence of rapid asset growth and easy access to investor capital, MLPs became self-funded slower-growth vehicles with a burden of cash distributions.

As a result of the downturn in MLP investment, some partnerships like Kinder Morgan changed back to a regular C-Corporation structure. Others changed their structure to remove a class of general partner units with incentive distribution rights that received preferential distributions when the partnership exceeded target cash payouts. Removing IDRs meant more of the cash flowed to regular unitholders, making the MLP more attractive.

Private Equity

In the meantime, the shale sector has recovered since the start of 2017 to reach record production of natural gas, gas liquids, and crude oil this year. That revival necessitated a fresh round of infrastructure build-out. This time around, most new investment has come from private equity instead of MLPs. The largest midstream MLPs survive, such as Enterprise Product Partners, Plains All American, and Magellan Midstream, but they are more cautious in their investments and self-fund new growth.

Rollup

After reviewing alternatives this year, Valero decided the best option for VLP unitholders and the company was to buy out unitholders at $42.25 per unit and roll the partnership up into the parent. The company explained on an Oct. 25 investor call that it no longer believes VLP is the most efficient structure to finance growth. Valero continues to invest in new infrastructure, including a new coker for its Port Arthur refinery, expected online in 2022, that will cost nearly $1 billion, and alkylation units at its Houston and St. Charles, Louisiana, refineries.

Other Refiners

Other U.S. refiners retain their MLPs. Marathon, the largest U.S. refiner, operates its original logistics partnership MPLX as well as the inherited Tesoro Logistics, which came with the Andeavor acquisition. Both these MLPs fared better in the post-price-crash era from revenue growth in expanding shale assets in the Permian and Williston basins. The same is true of Phillips 66 Energy Partners, which has similar upstream interests. Smaller U.S. refiners Delek and HollyFrontier have most of their assets tied to the booming Permian region, where they benefit from advantaged crude pricing (see our September note "Sweethearts of the Permian–Refinery Jackpot"). Majors Shell and BP still operate midstream MLPs; indeed, BP only brought its logistics partnership public a year ago, in October 2017. They benefit from investor confidence that the parents have deep pockets and a huge inventory of potential drop-down assets available for growth. PBF Energy's logistics subsidiary invested in the company's refineries as well as pipelines and terminals, increasing investor risk but providing upside for investors in an era of high margins and advantaged crude.

For now, the MLP structure appears less attractive for new infrastructure investment and could be further threatened in an era of high interest rates. The good news for refiners and midstream companies is that there's no lack of private equity willing to fill the gap. M

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