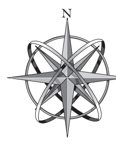

UTILITY FORECASTER

High Yield Without High Risk

3 Stocks Every Income Investor Must Own

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By Ari Charney

Never buy the highest yield in any group: That's advice we've been giving investors for years in this yield-hungry market.

Some have ignored us, and they may do well for a while. But, ultimately, the highest yield means the highest risk in a sector. And unless one is very lucky, reality will eventually intrude with the inevitable dividend cut followed by a steep share-price decline.

Avoiding unnecessary risks is a strategy based on taking a lot of hard knocks in the market over the years. But it's made us appreciate a high yield that's backed by an absolutely essential element: a solid underlying business.

Strong businesses are what keep the dividend flows going. And as a good operation increases its payout over time, its share price typically follows suit.

By contrast, a bad business will always be in danger of being unable to pay the tab. And when it comes to dividend cuts, the stock market has a very unforgiving history.

Below, we highlight three dividend payers that combine a high yield with a good business. These three picks have an average yield of 7.1%, which is nearly 4 times higher than the S&P 500's current yield of 1.9%.

One important thing to note is that all three of these companies are structured as master limited partnerships (MLPs). While you should always consult your tax advisor, our Tax Guide details some of the general implications of these investments.

High-Yield Pick #1: Magellan Midstream Partners LP (NYSE: MMP)

Magellan Midstream Partners LP is one of the trio of conservatively managed MLPs that did a superior job of weathering the energy sector's downturn.

A key part of Magellan's financial strength is its lack of incentive distribution rights (IDRs). Management

had the foresight to eliminate the IDRs and acquire the general partner in a simplification transaction back in 2009.

While IDRs can help spur distribution growth for young MLPs, they become a cash drain for more mature operators. That's because as an MLP's distribution hits certain thresholds over time, its general partner becomes entitled to an increasing share of its distributable cash flow.

Without IDRs, Magellan has been able to maintain a comfortable 1.3 times coverage of its quarterly distribution, while growing its payout 14% annually over the past three years.

Magellan also has one of the strongest balance sheets in the industry.

Net debt to EBITDA (earnings before interest, taxation, depreciation, and amortization) for many MLPs averages around 4.5 times. By contrast, Magellan sees 4.0 times as an absolute ceiling. Recently, its leverage has averaged around 3.6 times.

In addition to prudent financial management, Magellan also benefited from having a largely demand-facing business amid a supply-induced crash. The MLP owns the longest system of gasoline and diesel pipelines in the U.S., with 9,700 miles of pipelines complemented by 53 storage terminals and 42 million barrels of storage.

This infrastructure is concentrated in the middle third of the U.S., giving Magellan a commanding market share throughout much of the Midwest.

In recent years, management has been diversifying into newer areas for the partnership, including crude oil pipelines and marine terminal storage. While such moves could create execution risk, these are core areas for midstream operators, and we trust management to get it right.

Magellan yields 5.6% on a forward basis.

High-Yield Pick #2: Enterprise Products Partners LP (NYSE: EPD)

Enterprise Products Partners LP, the largest publicly traded MLP in the U.S., enjoys a reputation for conservatism that helped it weather the energy sector's downturn far better than most midstream players.

Unlike its more profligate peers, who got into trouble by pursuing distribution growth at all costs, EPD typically retains a portion of distributable cash flow (DCF) to reinvest in its business.

In late 2017, EPD went a step further, and in doing so may have set the new standard for the midstream space.

Management decided to slow the pace of distribution growth to retain even more cash flow than it does already. The midstream giant's goal is to fully self-fund the equity portion of its growth spending by 2019.

This strategic shift is a big change from how MLPs typically operate. Growth projects are usually funded with an even mix of debt and equity, which means that midstream players regularly issue new equity, thereby diluting existing unitholders.

That was fine during the energy boom, but it hasn't worked out so well as the sector recovers from the crash. So EPD is wisely taking a different tack.

The other key to EPD's financial strength is that it doesn't have to shoulder the burden of incentive distribution rights (IDRs), which give a general partner (GP) first claim to a significant portion of an MLP's cash flow.

That's courtesy of management's foresight to engineer a deal in 2010, whereby the MLP subsidiary acquired its GP and eliminated the IDRs. Though IDRs can help spur distribution growth, over time this obligation can undermine distribution coverage, while leading to a high cost of capital.

While many MLPs struggled to sustain their payouts amid the energy crash, EPD has continued to cover its distribution by a comfortable margin, recently around 1.2 times.

At the heart of EPD's story is an asset base that spans the full midstream value chain, with a focus on natural gas liquids (NGL) and petrochemicals.

That affords some flexibility in this environment since EPD's demand-facing businesses, such as the ones that serve the resurgent petrochemicals industry, can help offset weakness from the supply side.

In addition to its domestic business, EPD is increasingly becoming export-oriented, with the 2015 acquisition of Oiltanking Partners providing access to waterborne markets.

EPD yields 7.1% on a forward basis.

High-Yield Pick #3: AmeriGas Partners LP (NYSE: APU)

AmeriGas Partners LP is the largest retail propane distributor in the U.S.

And with a 15% market share, the MLP has room to further consolidate its highly fragmented industry.

Despite what its high yield may suggest, AmeriGas is actually a pretty conservative operator. It recycles assets to raise capital, keeps a lid on debt, and generates enough cash flows to comfortably cover its quarterly distribution.

Right now, seasonality is the company's biggest near-term operating risk, especially given the recent warmer-than-average winters.

Because propane is mainly used for heating, distribution of the fuel is a highly seasonal business that generates the vast majority of cash flows during fall and winter.

But the effect of seasonality should smooth out over longer-term periods, thanks to AmeriGas' increasing geographic diversification within the U.S.

Even so, AmeriGas recently took an important step to mitigate this potential overhang. In late 2017, the MLP and its sponsor, UGI Corp., announced an agreement to create a $225 million standby equity commitment.

If necessary, the facility will provide AmeriGas with equity financing in $50 million increments, so that it can continue making strategic growth investments even if the next two winters end up being warmer than normal.

In exchange for this financing, UGI would receive equity units that would pay it 1.3 percentage points more than the yield on APU's common units. But the new units would not include incentive distribution rights, which can ultimately be a bigger drain on cash flows.

As it stands, AmeriGas currently has no plans to tap the facility. But it's encouraging to have the support of a strong sponsor if it needs to do so.

Further, earlier this year, the MLP completed the refinancing of all long-term debt. This move lowered the average interest rate on these obligations by a full percentage point and pushed out the next maturity to 2024.

AmeriGas yields 8.6% on a forward basis.

IMPORTANT NOTES:

Guidance concerning the stocks highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any stock in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the stock still earns a buy rating. Furthermore, confirm that the stock trades below our current buy limit. Do not buy any stocks above our recommended buy limits. If a stock's price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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