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Midstream REITs face steep curve in becoming mainstream alternative to MLPs

By Allison Good **Nov. 26, 2019**

One pipeline company is circumventing the master limited partnership model's structural constraints by taking a page from the real estate industry's playbook, but midstream experts are not convinced it can be applied sectorwide.

The IRS in a private letter ruling earlier this year decided that CorEnergy Infrastructure Trust Inc.'s pipeline and storage assets qualified as rents from real property and could, therefore, be housed in a real estate investment trust structure. While the ruling cannot be applied to any other company or asset, Hunton Andrews Kurth LLP attorney Thomas Ford said in an interview that its utility as a precedent could indicate "a potential sea change for the midstream space."

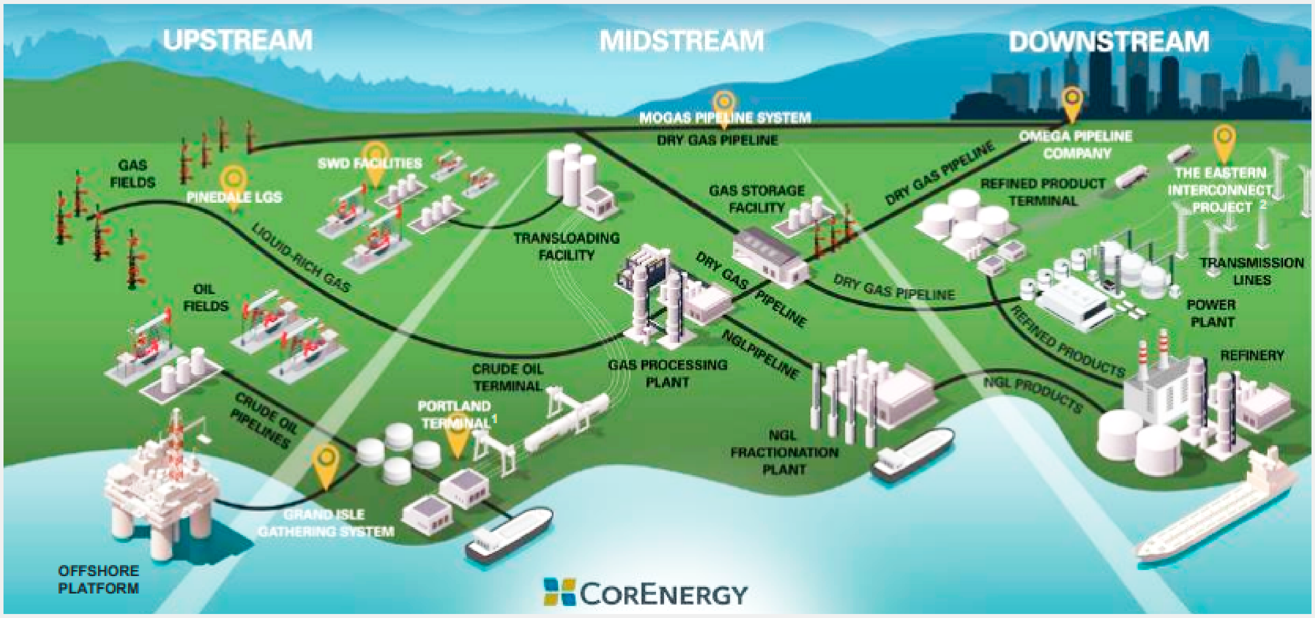
"It's more than a whole entity electing to be treated as REIT," he explained. "It can be used as a financing vehicle. It can be used as a way to create value for unit holders perhaps by getting an undervalued pipeline out as a public entity and it can be utilized as a joint venture structure."

CorEnergy President, Chairman and CEO David Schulte said that the REIT structure appeals to a much broader swath of shareholders, including foreign entities.

"We thought it was by far the most flexible structure to use to attract institutional capital," Schulte said in an interview. "Most foreign investors avoid investing in U.S. partnerships because it makes them subject to taxes in every state the enterprise does business in ... whereas REITs enjoy the same tax treatment as any other corporate investment in the U.S."

Like MLPs, publicly traded REITs do not pay federal income taxes and instead pass them on to individual shareholders who pay taxes on those dividends, but that is where the structural similarities end. REIT investors receive 1099-DIV forms, while MLP unit holders fill out and submit a Schedule K-1 form. REITs are also regular corporations with independent boards elected during proxy season, whereas MLPs do not hold annual meetings where unit holders can submit

CorEnergy's footprint



As of Nov. 11, 2019.
Yellow flags indicate assets currently or previously owned.
Source: CorEnergy Infrastructure Trust Inc.

matters for a vote. When it comes to delineating how businesses can choose their structure, REITs are not subject to the publicly traded partnership qualifying income test, which limits MLPs to enterprises generating 90% of gross income from sources including upstream and midstream natural resource assets. That means REITs can generate income from parts of the downstream value chain traditionally off-limits to MLPs, such as chemicals and refined products.

The primary operational difference between the two structures, however, is that MLPs can wholly own and manage all of their assets. REITs, on the other hand, are limited to ensuring their real property is safe and secure. Any use of the equipment to provide a service must be performed by a taxable REIT subsidiary, which does pay corporate income taxes.

Public vs. private

Whether a large and diversified midstream MLP such as Energy Transfer LP or Enterprise Products Partners LP could easily convert to a REIT, on the other hand, is more complicated than simply checking the box. Any of those companies' non-REIT-able assets, such as fractionation facilities and compressor stations, would have to be spun out as a taxable REIT subsidiary and could not "exceed 20% of the fair market value of the REIT's assets," according to Hunton Andrews Kurth's Ford. Additionally, a REIT cannot own 10% or more of one of its lessees in order for that income to be qualified REIT income, meaning that pipeline operators would have to significantly limit how much firm transportation capacity is awarded to affiliates and subsidiaries.

Midstream analysts at RBC Capital Markets wrote in an October note to clients that private midstream assets are more likely to be housed in REITs in the immediate term.

"As private equity infrastructure funds that have deployed capital will ultimately look for an exit, the REIT market may offer better liquidity points," they wrote. "Private REITs in real estate ... funds are used all the time. A private infrastructure fund could form a REIT subsidiary to hold individual pieces or portfolios, with the ultimate exit an IPO of the REIT rather than the specific assets."

The remaining pipeline MLPs could also elect to become C-corps, but the RBC analysts noted that structure "has yet to bring obvious [equity] valuation uplift." Even though midstream C-corp stocks outperform the Alerian MLP Index, that limited upside has not been enough to convince all partnerships to change their tax status ahead of federal elections in 2020, which could change the playing field yet again for pass-through businesses.

Energy Transfer, for one, has at least contemplated the REIT structure.

"It doesn't always work as well with operators, but we continue to look at it as possibly being a tool in our toolbox," Executive Vice President Brad Whitehurst said during a November conference call.

CorEnergy's Schulte also acknowledged that it would be difficult for integrated midstream MLPs to convert to REITs.

"You've got a lot of work to do to properly comply with even the new [private letter ruling]," he said.

No 'silver bullet'

The only reason for a midstream MLP to convert to a REIT would be exposure to passive investment, according to Simon Lack, a managing partner of energy-focused investment firm SL Advisors LLC — the same reason why many partnerships have become C-corps.

"If they get added into a REIT index, then that's a huge source of buyers that could drive the stock up," Lack said in an interview. "That's the argument in favor of making a change."

With a market capitalization of just under $600 million, CorEnergy is not big enough to be included in bellwethers such as the MSCI U.S. REIT Index, but it is part of the Financial Times Stock Exchange Nareit All REITs index. Schulte said the company's investor base is primarily non-energy-specific shareholders. Still, CBRE Clarion Securities portfolio manager and MLP expert Hinds Howard said in an email that it "doesn't solve the main problem, which is we need new investors" to bring in more fund flows.

REITs are not necessarily the right tools for bridging MLPs' corporate governance gap either, SL Advisors' Lack added. While Hunton Andrews Kurth said in a recent presentation that "the criticism to which MLPs are subjected on the governance front due to the inability to have any say on board composition is not present in public REITs," public partnerships could simply allow common unit holders to vote for members of the board like Magellan Midstream Partners LP and NuStar Energy LP, Lack said.

BMO Capital Markets midstream analyst Danilo Juvane agreed in an interview: "I don't think that this is going to be a silver bullet by any stretch."

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