Investors Alley

August 2014 Vol. 1 Issue 3

The Dividend Hunter

Must Be in the Game to Make the Money

Fellow Investor,

Over that last several weeks I have put in a lot of study and research time looking for signs that the stock market is due for a correction of 10% or more to the downside. The main reason to expect a correction is timing.

There was a correction every year – 2010, 2011, and 2012 – each year following the 2008-2009 bear market, but the market has not corrected since the spring of 2012. However, I believe that at least three other factors that indicate the market is not poised to correct in the near, or foreseeable, future. Here is the short list:

- Corporate America remains strongly profitable as shown by the second quarter earnings reports that have come out over the last two weeks. There has been no bad news from any major company earnings that could trigger a sell-off and subsequent correction.
- The market continues to ignore serious geo-political events. Ukraine, Gaza, Iran and what used to be Iraq are all issues for the people who live in those parts of the world, and to the U.S. political class, but they do not affect business conditions in the rest of the world and the market values rightfully have not been effected.
- The investing public has no alternative investment option besides the stock market. Dumping cash into an S&P 500 ETF looks much better than earning 2.4% from a Treasury bond, 1% from a bank CD, or precious metals that pay no income and are on a 3-year losing streak. Currently the stock market is the only game in town if you want to earn a reasonable return on your investment assets.

In This Issue

A Strategy for All Market Conditions

The stock selection strategy for The Dividend Hunter recommendations focuses on earning a high current yield. This criterion may be most important to investors who want to draw that income and use it to cover living expenses. However, even investors whose current goal is wealth accumulation will do well with these stock recommendations. The high rate of cash flow can be reinvested into the stocks that currently offer the best investment potential. Also, when companies increase the dividend rate over time, the share price must eventually follow. With the investment strategy used here, short-term market declines can be ignored or used to pick up more shares on the cheap. As long as dividends are not reduced, the cash flow that is the core of the strategy will continue.

The Dividend Hunter

You probably have noted the "Land, Fly or Die" catch phrase at the end of my email updates. I picked up the phrase during my first real assignment, flying OV-10 Broncos in South Korea. Land, fly or die was a response from one squadron pilot to another who was whining over the radio about flying conditions. I quickly learned that flying in South Korea was subject to extremely variable weather conditions mixed with a ruggedly mountainous terrain. Every day, the mission included dealing with those conditions to complete the mission. It was not an option to tell the squadron commander that I did not feel like flying that day.

The stock market works the same. To fly is to be invested in the market. You cannot earn a 6% and growing income stream in another asset class. To land is to accept 1% to 3% from government bonds. Avoiding the equivalent of crashing an airplane involves investing smart, understanding what you are buying, not being emotional, and looking far enough ahead to see the mountains that you need to fly around or over. As I work through each month between newsletter publications, I am staying very excited about the opportunities to find stocks that meet the yield, growth, and safety goals established for The Dividend Hunter recommendations.

Land, fly or die,

Tim Plaehn
Editor
The Dividend Hunter

P.S. In the following pages you'll find detailed research on two new investments for our portfolio as well as a great education article on master limited partnerships and finally our current portfolio holdings. If you ever have a question about anything I've written here please feel free to drop me a line at tim.plaehn@investorsalley.com.

Arc Logistics Partners LP NYSE: ARCX

For this month **Arc Logistics Partners LP (NYSE: ARCX)** has been selected as the first master limited partnership (MLP) to be added to The Dividend Hunter's recommendations portfolio. With a 6% yield and our forecast 10% per year distribution growth, the new midstream logistics MLP will bring a stellar combination of yield and growth to the income investor's portfolio.

MLP Jargon disclosure: *Instead of shares and paying dividends, you buy MLP limited partner units and receive distributions. From this moment forward to the end of the article, if I say shares or dividends, you know what I mean.*

Furthermore, MLP distributions are not taxable income, but instead reduce your cost basis in the units. With MLP investments you receive a partnership Schedule K-1 that you use to complete your taxes. In most cases, you will have little or no taxable income from an MLP investment for the first several years, and possibly longer.

MLPs offer both tax advantages and tax challenges. Distributions received from MLP units are classified as tax-free return of capital and will reduce your cost basis. Investors receive an IRS Schedule K-1, reporting your share of partnership profits or losses.

In most cases, you will have little or no reportable income for the first several years of an MLP investment. Tax preparation software will take K-1 information and complete the required tax reporting for your MLP holdings.

Providing the Energy Industry Infrastructure

The drilling for and collecting of oil and gas at the well is referred to as the upstream part of the energy business. Refining and distributing to end users of energy is the downstream sector. In the midstream middle there are companies providing a wide range of natural gas and oil collection, transport, processing and storage services.

Individual MLPs tend to focus on one smaller part of the larger midstream services sector. Many of the services offered by midstream companies are fee based, with customers signed up to long-term, take-or-pay contracts. As a result many MLPs have very visible, longer term revenue streams, which allow them to pay regular and often increasing distributions to LP unit investors.

Arc Logistics Partners listed on the NYSE with a November 2013 IPO. In the prospectus, the company listed the following assets owned when the company went public:

- 14 terminals in nine states located in the East Coast, Gulf Coast, and Midwest regions of the United States with approximately 5.0 million barrels of crude oil and petroleum product storage capacity.
- Two rail transloading facilities near Mobile, Alabama with approximately 23,000 bpd of throughput capacity, 17,000 bpd of which is currently dedicated to crude oil throughput.; and
- The LNG interest in connection with the LNG Facility, which has 320,000 cubic meters of LNG storage, 1.5 bcf/d natural gas sendout.

Terminals and storage provide an important link between both crude and petroleum products producers and their customers. Even the large integrated energy companies are turning to third-party providers of these services rather than owning and maintaining their own facilities. The LNG interest is a 10.3% stake in the Gulf LNG facility, 50% owned and managed by Kinder Morgan.

Sticking to the MLP Growth Model

An MLP produces both revenue, and more importantly, distribution growth by the development or acquisition of additional revenue producing assets. These purchases are financed by a combination of the issuance of additional LP units (equity) and debt funding. As long as the return on the new assets exceed the combined financing costs (roughly LP unit yield plus debt interest rate) the added assets will produce accretive cash flows. The most reliable source of add-on assets is for an MLP to have an asset rich parent or sponsor company that owns the general partner interest and manages the MLP. New assets for the MLP are owned or developed by the sponsor and then transferred (called a drop down) to the MLP at a cost that ensures the new asset will allow the MLP to grow the distribution rate to investors.

Privately held Lightfoot Capital Partners GP LLC focuses on investments in the energy sector through a range of funds, publicly and privately managed companies. According to the IPO prospectus, Lightfoot plans to use Arc Logistics Partners "as a growth vehicle for its energy logistics business to facilitate future organic expansion and acquisitions." The MLP business structure provides an efficient and financially rewarding outlet for a company like Lightfoot to increase its presence in the midstream energy infrastructure. At the IPO, Lightfoot retained 43% of the ARCX limited partner units, the general partner interest and the partnership incentive distribution rights, which result in increasing cash payments to the general partner as the distributions to limited partners grow.

Crunching the Numbers

The core to our MLP investment approach is to first ferret out those partnerships that have the sponsorship resources to allow the companies to grow via drop downs and regularly increase the distributions to investors. This research first identifies that the MLP currently has enough cash flow – distributable cash flow, or DCF in MLP jargon – to support the current dividend.

For Arc Logistics Partners, the 2014 first quarter DCF of $5.4 million provided 1.15 times coverage of the $4.7 million needed to pay the current distribution rate. Next, a review of available information allows us to put together an estimate of how fast an MLP can grow the distribution rate. A range of resources and expert opinions results in a 10% annual distribution growth estimate for the next three years.

A final check is to compare the smaller MLPs in our database with the large-cap MLPs with market values in excess of $10 billion. These large partnerships have the financial resources to develop internal growth projects to support their distribution growth plans. Currently seven MLPs fall into this large-cap group. These are MLPs that will maintain distributions in almost any financial or economic condition. Investors could buy units in these MLPs and receive a steady and safe income.

The goal here at The Dividend Hunter is to find smaller MLPs with better yield and growth metrics, while maintaining a high degree of safety. For comparison purposes, the current average yield of the seven is 5.75% and distributions are projected to grow by an average of 5.8% per year. Average DCF to distribution coverage is 1.02 times.

In comparison, Arc Logistics Partners currently yields 6.13% to go along with the 10% forecast growth rate and solid DCF coverage. The yield is slightly higher than the big boys and the extra 4% of annual distribution growth will put the distributions on ARCX 20% higher than the large cap yields after just three years. And Arc Logistics comes with a distinct probability that growth will exceed the 10% projection. The large-cap MLPs will hit their growth targets, but have little chance to produce much higher growth.

Recommendation: Arc Logistics Partners is a Buy up to $28, which would produce a 6% current yield.

Why Should MLPs Be in Your Portfolio?

A master limited partnership (MLP) is a company organized as a partnership with shares – called limited partner units – that trade on the stock exchanges. The attributes of many MLPs make them natural choices to be included among The Dividend Hunter recommendations. No other type of investment offers the combination of yield and dividend – called LP distributions – growth potential that can be found in the lists of MLPs and related companies.

First a word about taxes and MLPs

As the owner of MLP units, you are treated as a partner for tax purposes. The distributions you receive will be non-taxable, return of capital. You do not declare this income for taxes, but they do reduce your cost basis in the MLP units. As a partner you must declare a proportional share of the MLPs profits or losses on your tax return. You receive an IRS Schedule K-1 from the MLP which lists your partner share results. In many cases, due to write-offs the MLP can claim, you will have little or no taxable income from an MLP investment. Almost always, any amount of taxable income will be less than the distributions you received during the year. K-1s will add some extra work to your tax reporting, but all of the tax software packages can handle them without any fuss.

An Almost Guaranteed Growth Business Model

Legal restrictions limit the use of the MLP business structure to companies involved in energy or minerals production and processing. As a result, MLPs operate and/or own oil and gas wells, coal mines, pipelines, storage and processing terminals, refineries and support operations or supplies for these businesses. Each MLP tends to focus on a certain sector of energy production or infrastructure services. Historically, MLPs have grown by either developing or purchasing assets that fit into their businesses. Growth is funded by a combination of equity from new unit issuance and debt. As long as the added assets generate returns greater than the blended cost of equity and debt capital an MLP can regularly increase the distribution rate. The better MLP companies increase their distributions every quarter, with annual distribution growth rates ranging from 5% to well over 20%.

Over the last several years, corporations, such as Phillips 66, and private energy companies that own significant amounts of infrastructure assets have started to use the MLP structure as a way to monetize those assets and produce a growing income stream back to the sponsor company. A new MLP is spun-off or set up privately then listed with an IPO.

The new MLP receives enough assets to generate free cash flow to cover the initial minimum distribution rate. Then, over a period of years, the sponsor sells – called drop downs – assets on a periodic basis from itself to the MLP. The drop downs are structured and priced to guarantee that the MLP can continue to grow the distribution rate it pays to LP unit holders. The sponsor keeps a large portion of the LP units for itself and the partnership agreement also includes incentive payments to the general partner/sponsor that increase as the MLP grows and the distribution rate increases.

As a result the sponsor has a very large financial incentive to manage the MLP so that the distributions to LP grow steadily. Individual investors get to go along for the ride as the sponsor enriches itself. With this model, all of the assets to grow the MLP exist or will be developed by the sponsor. The MLP receives assets that are already generating cash flow, typically on guaranteed fee structure contracts.

For The Dividend Hunter MLP recommendations, I work through the business models of MLPs with strong sponsor companies to find those with the best combination of current yield and growth prospects. You will start to see MLPs added to the recommendations list on a regular basis, starting with this issue.

New Residential Investment Corporation NYSE: NRZ

Evolving out of an interesting and profitable investment story, New Residential Investment Corp. (NYSE: NRZ) offers a combination of a current 11% yield and exposure to niches of the residential mortgage financing system that will do better and better if mortgage interest rates increase. New Residential will provide a higher level of income safety to The Dividend Hunter portfolio than the double-digit yield indicates. This is a relatively new company that is not understood by the investing public, and that lack of knowledge benefits subscribers here to the tune of an 11% plus bonus dividends return.

The Back Story

Mortgage REIT Newcastle Investment Corp. (NYSE: NCT) was the predecessor company to New Residential Investment. With a portfolio of toxic CMOs and CDOs (collateralized mortgage and debt obligations), the company basically blew up when this type of security triggered the 2007-2008 financial crisis. The NCT management spent several years cleaning up the portfolio and positioning Newcastle to take advantage of post-crisis mis-pricing of mortgage backed assets. From the time the dividend was reinstated in early 2011 until the spin-off of New Residential Investment in May 2013, Newcastle generated a 300% total return for investors.

By early 2013, Newcastle was managing three distinctly different businesses: the legacy CDOs, some senior housing investments, and the company's newer moves into excess mortgage servicing rights (MSRs) and non-agency mortgage backed securities (MBS).

With the spin-off, the MSRs and MBS went into New Residential Investment. As I reviewed the holdings of the two resulting companies at the time of the spin-off, it was clear that New Residential had taken the more interesting and potentially more profitable types of assets. Since the spin-off, the New Residential management team has improved the portfolio holdings and set NRZ up to be able to pay a high and continuing dividend to investors.

Current Investment Strategies and Holdings

New Residential has a close, management relationship with Fortress Investment Group (NYSE: FIG), which controls Nationstar Mortgage company, one of the largest mortgage servicing companies. These relationships have helped New Residential find and invest in niche type of mortgage related investments that can produce 15% or better returns. The company currently holds the following types of investments:

- **Mortgage servicing related assets**: 56% of portfolio. Mortgage servicing companies receive a portion (usually 0.25%) of the interest paid on residential mortgages. It costs less than the servicing rights to actually handle the mortgage paperwork, producing excess mortgage servicing rights. New Residential buys the right to receive future excess MSRs covering pools of mortgages at a discount. Servicing rights are expected to produce a 15% to 20% annual return. Since starting with these investments in 2012, returns have been right in the middle of the expected range.
- **Residential securities and loans** make up 28% of the portfolio. The company invests in non-performing loans, re-performing loans, and non-agency qualified mortgages. Expected returns on invested capital are 12% to 20%.
- **Other investments** account for 16% of holdings. Currently this category consists of an investment in a pool of consumer loans. Expected annual return on is 33%.

A large portion of the New Residential portfolio will perform above expectations if interest rates rise and/or housing prices continue to improve. The management team uses its expertise to buy assets from cash needy sellers at deep discounts to provide a high probability of hitting the company's 15% target investment return. In its short one-year life, actual portfolio returns have been closer to 20% annually.

Great Dividends Matched With Tums Inducing Share Price

For each of the four complete quarters since the spin-off, New Residential has paid a $0.175 dividend, resulting in the current 11.5% yield. The company has also paid two bonus dividends of $0.075 when the quarterly profits warranted the higher payout.

Along the way, the NRZ share price has been extremely volatile, swinging every few months between about $6.00 and $6.75. (I included an extra large chart this time so you can see exactly what I mean.) The reasons for the price fluctuations appear to be due to the one month spreads between the earnings dates, ex-dividend dates and dividend payment dates. The dividend capture crowd seems to be attempting to catch those 3.5% dividends with short-term trades. As a result, it is best to buy shares of NRZ between the ex-dividend date and the next earnings announcement, closer to the latter. The stock went ex-dividend on June 25 and earnings will come out around August 7, so now is a good time to get in. Do not buy shares just before the ex-dividend date, with the next occurring on about September 25.

Recommendation: Buy up to $6.25 per share.

Portfolio Update

The most interesting news of the last month was the announcement by portfolio recommendation Macquarie Infrastructure Company LLC (NYSE :MIC) that it had agreed to purchase the remaining 50% it did not own of International-Matex Tank Terminals for about $1 billion from the founding family. The market liked the news, and MIC is now valued at about 15% above our May 30 entry price. **Currently MIC is rated as a HOLD.** Subscribers who got in at the lower entry should hang on to their shares. I want to review the upcoming quarterly earnings results before deciding whether buying in at the current share value is actually a good value.

The remainder of the portfolio holdings changed very little during July. With summer winding down, August will be the month for earnings release information and dividend declarations. For the types of stocks recommended here, quarterly earnings reports and conference calls provide accurate snapshots of how each company is performing. With a current 6.7% yield at the most recent dividend rates, The Dividend Hunter portfolio continues to function as expected.

I do not expect any big news or dividend increases with the second quarter earnings. Primarily I will be watching to make sure all of the holdings are successfully implementing their individual business plans and cash flow remains sufficient to support the dividend rates.

I personally am very excited to add the first MLP to the portfolio. In a few years, investors who get into MLPs like ARCX now will be very happy with those investments. And it doesn't hurt to be earning a 6% yield right out of the gate.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Annual Div	Proj. Yield	Total Returns
New Residential Investment (NRZ)	07/30/14	$6.08	$6.08	$6.25	$0.70	11.00%	N/A
Arc Logistics Partners (ARCX)	07/30/14	$25.10	$25.10	$28.00	$1.55	8.00%	N/A
Main Street Capital (MAIN)	06/27/14	$32.51	$31.35	$32.50	$1.98	6.00%	-3.0%
Starwood Property Trust (STWD)	05/30/14	$24.39	$23.74	$25.00	$1.92	7.80%	-0.7%
Ship Finance International (SFL)	05/30/14	$18.46	$18.48	$19.00	$1.64	8.50%	2.0%
Oaktree Capital Group (OAK)	05/30/14	$50.66	$50.10	$56.00	$3.92	6.50%	0.2%
Macquarie Infras. Company (MIC)	05/30/14	$61.48	$70.09	$63.50	$3.75	6.00%	14.0%
Ventas (VTR)	05/30/14	$64.94	$63.86	$65.00	$2.90	4.50%	-3.3%

Notes:

Entry price is determined by the last "Ask" price at the closing of the market on the day before publication.

Recent price is determined by the last "Ask" price at the closing of the market on the day before publication.

Annual Div is the dividend payment as declared by the company and made publicly available. It is as of the closing of the market on the day before publication.

Total Returns include share price appreciation and dividend payments to provide a more accurate assessment of returns in that investment.

We make no guarantee that any company in the portfolio will continue dividend payments.

Announcements

Whitelist our address subs@investorsalley.com with your email provider to ensure you never miss an issue of The Dividend Hunter or any urgent alerts. Several subscribers have reported not receiving their issue and upon investigation found their issues were blocked by their email provider. The best way to prevent this is whitelisting. Your email provider should have instructions on how to do this.