Investors Alley

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The Dividend Hunter

The Dividend Hunter Approach Lets You Rest Easy When Fear Shakes Up the Market

Fellow Investor,

Greetings, and welcome to the October issue of The Dividend Hunter. With the way the stock market agitated last week, I have several important topics to cover, so let's dive right in.

First and of primary importance, the income stock selection strategies I use to choose stock recommendations that will weather volatility in the stock market and come out the other side of whatever is making investors fearful with both stock values and dividend earning power intact.

There will be times when the market drops as a whole, and so will the share prices of The Dividend Hunter portfolio holdings. <u>Those drops will not affect the longer term viability of the investment thesis</u>, and most importantly the yields you earn on the investments you make in these stocks. Every Dividend Hunter recommendation has the primary attribute of paying an attractive dividend that I expect to grow over time. <u>The dividend rate on each will go up at least once a year</u>, and many will grow their payouts every quarter.

In This Issue

In the meantime, there will be several times a year when share prices, including those of high yield stocks will drop by 3%, 5% or even 10%. If you follow and believe in the longer term benefit of buying stocks with rising dividends, these temporary – by which I mean week or possibly couple of months – drops in share values are good times to pick up more shares, or buy some of the recommendations you didn't have a chance follow when the stock selection was first published.

Now let's discuss what I see happening in the market and some of the underlying reasons, fears, and realities.

This last week market volatility jumped up with big moves daily, in both the up and down directions. After this last week, it is almost hard to believe that the Dow Jones Industrial Average and the S&P 500 both set new record highs just a little over a week ago on September 19. Over this past week the DJIA changed by more than 100 points each and every day, with three down days and two up. From the September 19 record high, the Dow was down as much as 334 points on

Thursday, September 25. Yet in percentage terms, what felt like a big drop was really just short of a 2% decline, and much of that drop was recaptured with Friday's gains.

More of a factor to investors in higher yielding stocks is the fear of higher interest rates. Short term rates have not changed at all and long term rates are moving by 1/100ths of a percent, but suddenly a lot of investors are worried that higher interest rates will hurt the financial stocks and the higher yielding MLPs. I say Rubbish!

First, it is likely that the Fed will not start to increase short rates until well into 2015. And then maybe by 0.25%. From the present time, foreseeable interest rate increases will be quite small. Of more importance is what will really happen when rates start to increase. The Fed has not actually implemented a rate increase since 2006 – over 8 years ago. A large portion of the current investing public and money managers have no reference frame concerning rising rates. This week, I watched a Bloomberg interview with legendarily successful investors Leon Cooperman and Howard Marks. Cooperman made the point that historically, Fed rate increases help the stock market continue to move higher and that on average, the bull market continues 29 months after the Fed started to increase rates. Higher rates by the Fed are a reaction to a stronger economy, which is good for companies and stock prices. We who understand that a moderate increase in interest rates will be good for stocks will take advantage of those who don't and sell on the fear of higher rates, allowing smart investors like us to pick up dividend paying stocks on the cheap.

A specific factor affecting our high yield recommendations is the effect of a stock going ex-dividend. On the ex-date the share price drops by the amount of the dividend and it is common for the share price to then trend downward for a few weeks to a month after the ex-dividend date. So if you have a stock with an 8% yield, at ex-dividend it will drop by 2% (one-quarter of 8%), the usual ex-dividend effect gives another 1% to 2% decline and then when a down market pushes stock prices in general 2% to 3% lower and you have a share price that goes down by up to 8% in the short term.

In the upcoming two months, our high-yield stocks will announce third quarter earnings results and declare the next dividend date and amount. These events will most likely pull share prices back up, and when the stock market again moves higher, these recent short term losses will be more than recovered. As I mentioned, these temporary market pull-backs to the downside are a good time to buy shares to boost your future yield from these stocks.

I encourage new subscribers to take a look at recommendations from past issues and consider taking positions in stocks that were added to the portfolio at higher prices. I will briefly cover what is going on with all the portfolio stocks later in this issue.

Finally, I think you will find the combination of this month's discussion about upstream, high-yield MLPs very informative, and I have selected two of these partnerships stocks as new additions to the recommended investment list this month. There is a lot to like about 8% plus yields with growing distributions backed by stable oil and gas well production.

Land, fly or die,

Tim Plaehn
Editor
The Dividend Hunter

Memorial Production Partners (Nasdaq: MEMP)

The article titled, "The Upstream Master Limited Partnership Game" in this month's issue of The Dividend Hunter gives an overview of how the high-yield upstream MLPs function. This group provides high-yield investment potential with cash flow generated from the production out of oil and gas wells. My challenge to find recommendations out of the 20 or so upstream MLPs for The Dividend Hunter has been to dig out one or more with distribution growth potential as well as a current high yield. **Memorial Production Partners LP (Nasdaq: MEMP)** combines a very attractive yield with the possibility of a distribution hike as early as later this month.

Company Overview

Memorial Production Partners came into the market through a December 2011 IPO. Through a dozen asset acquisitions, the company now owns energy production assets in California, the Rockies, the Permian Basin in West Texas, East Texas and South Texas. As a result of the growth through acquisitions, average daily production in the second quarter of 195.7 million cubic feet of gas equivalent was 23% higher than a year earlier and up 18% compared to the first quarter of 2014 results. The company is nicely profitable, producing $43 million of distributable cash flow out of adjusted EBITDA of $98.5 million in the first half of 2014.

On July 1, 2014 Memorial Production closed on a $915 million acquisition of oil producing properties in Wyoming. The size of the acquisition almost doubled the market value of the partnership. As I explain in the upstream MLP article, the purchase was funded with a combination of debt and the issuance of new LP units – those are what you own as an investor in MEMP. With its previous acquisitions, the company has done a very good job in managing the new assets to increase production, EBITDA and, most importantly, distributable cash flow per unit. The big purchase should allow the company to significantly grow the payments to investors over the next year.

The Sponsored MLP Difference

While in the midstream MLP sector it is common for a partnership to have a sponsor company that acts as general partner, most of the upstream MLPs stand on their own. In contrast to most of its peers, Memorial Midstream Partners does have a sponsor: energy focused private equity firm Natural Gas Partners funds. Other holdings of NGP funds own or develop the type of oil and gas production assets that Memorial Production would someday want to own. The sponsor relationship was instrumental in 7 of the 12 acquisitions the company has made since its IPO.

With a sponsor, both parties benefit from the sale or transfer of assets (called a drop down in MLP jargon) from the sponsor to the MLP. The sponsor gets cash for its assets and its holdings in the MLP will generate an increased level of cash flow. The MLP gets to purchase those assets at a lower cost having to compete for them. The lower initial cost allows the partnership to grow distributions to both LP unit holders and the GP interests at a faster rate.

Over the last two to three years, the upstream MLPs without some sort of sponsor arrangement have had trouble making purchases at prices low enough to allow the distributions to be increased from the production of the new assets. Memorial's relationship with NGP funds and other companies it controls gives better opportunities to purchase distribution growth accretive properties.

Yield and Distribution Growth Prospects

With its most recent $0.55 quarterly distribution and a $22.12 unit price, MEMP currently yields 9.95%. Since its IPO, the distribution rate has been increased four times from an initial $0.48 quarterly rate. That equates to 15% distribution growth in about 2 1/2 years. The current rate has been in effect for the last four quarters.

The big July acquisition should provide additional cash flow growth to fund the next distribution increase. I expect a higher rate announcement with either the next or following distribution announcement. Since the third quarter payout will be announced on or about October 22, now is a good time to establish a position in MEMP.

Recommendation: Buy MEMP up to $23 to generate a minimum 9.5% yield. We will stay with MEMP as long as the distribution is bumped up in the next two quarters then at least once a year.

The Upstream Master Limited Partnership Game

There exists a broad range of activities undertaken by energy companies along the path from finding crude oil and natural gas underground to selling fuels at your corner store or using natural gas to generate electricity. The upstream energy sector is the part of the energy spectrum involved with the drilling of wells to find oil and gas and then selling those energy commodities. Upstream operations can be just one part of the business of a large integrated energy company such as ExxonMobil or Chevron. There are also pure play exploration and production companies – E&P, another term comparable to upstream – which are focused on drilling holes to find and grow their oil and gas production.

There are distinct differences between the upstream E&P companies organized as corporations and those set up as publicly traded partnerships. The corporations are most interested and operate on the "E" side. These companies measure success by how many successful wells they drill during the year. Corporate E&P companies reinvest most of their profits into drilling more new wells and rarely pay dividends.

The publicly traded master limited partnerships – MLPs – primarily stick to the "P" side, buying and owning producing wells to generate free cash flow that can be paid out as distributions to investors. The upstream MLPs currently sport yields in the 8% to 10% range making them very attractive to income focused investors. The corporate and MLP sides of the E&P business have a symbiotic relationship. The MLPs need the corporate E&P companies to cover the high costs of drilling wells, which the partnerships can then purchase to generate immediate cash flow. The corporations sell older production properties to the MLPs to raise cash to help fund their exploration and drilling operations.

At the most basic level of operations, an upstream MLP owns and operates oil and/or natural gas wells. The oil and gas is sold, expenses are paid and the remaining free cash flow is paid to investors as income distributions. The partnership structure allows these companies to pay the majority of free cash flow as tax-advantaged distributions. To stabilize the distribution rates, these MLPs use hedges such as energy futures and put options to lock in the prices received for the projected oil and gas production for the next several years. Everything about how an upstream MLP is managed focuses on the goal of maintaining those steady distribution payments. To achieve that goal each of the MLPs in the sector faces several challenges:

The rate that oil and gas comes out of a well naturally declines over time. The decline is faster in the early months after a well starts to produce and the decline rate slows as a well ages. Upstream MLPs like to invest in slow decline wells, but there will be some level of decline and to maintain enough distributable cash flow the companies must reinvest some revenue into projects that will sustain production. The cash used for sustaining or maintenance capex (capital expenditures) comes out of what will be the reported earnings before interest, tax, depletion and amortization (EBITDA).

Sustaining capex can be spent on drilling new wells, reworking old wells with new techniques to increase the production, or with the purchase of additional production assets.

An upstream MLP will regularly make acquisitions of energy production properties. The purpose of these purchases is to both replace declining production from current wells and to grow the total amount of oil and/or natural gas produced by the company.

Acquisitions will be funded with a combination of new debt and the issuance of new limited partner units. The additional EBITDA generated from the new assets must be enough to cover the interest on the debt, the distributions that will be paid on the new LP units and the sustaining capex needed for the assets. The money raised from debt and equity issuance is referred to as growth capex.

If an upstream MLP does a good job with what it pays for production assets, the acquisitions made over the course of a year will produce an increasing amount of distributable cash flow per unit, allowing the MLP management to grow the distributions paid to LP unit investors. However in recent years, a combination of low natural gas prices and the realization by the corporate E&P companies that the MLPs can be desperate to add production assets, has made it tough for upstream MLPs to do more than end up with enough distributable cash flow to maintain a level distribution rate. What you will find with this type of MLP are partnerships that are growing assets, market cap, enterprise value and oil and gas production, but the distributions paid to investors have remained flat. To a certain extent, the upstream MLP business model developed in the 2005-2008 era of higher natural gas prices has become stale and the old ways currently are not working well to generate growing distributions for investors.

Finally a word on taxes: under the tax rules, <u>distributions paid by an MLP are not taxable income</u>. Instead the distributions will be classified as return of capital and reduce your cost basis in the units you own. Investors receive an IRS Schedule K-1 that lists the investor's proportionate share of income or losses for the year. If the K-1 shows income, that will be included in your taxable income for the year and you will owe taxes. Since the upstream MLPs can claim depletion of energy assets and are always buying new assets to grow production, an investment in the units of an upstream MLP is unlikely to generate any meaningful amount of taxable income. Basically, these MLPs will be a tax free investment until you sell units and recapture the basis write down from distributions earned, or your have earned distributions in excess of your original unit cost. If you reach the point that you have earned more in distributions than you paid for the units, distributions will start to count as taxable income.

This month's portfolio recommendations are two newer, smaller upstream MLPs using growth strategies that set them apart from their old-school, no-growth peers. With these two, the yields are still very attractive and you can count on a growth distribution stream.

Legacy Reserves LP (Nasdaq: LGCY)

This issue of The Dividend Hunter has focused on upstream MLPs – high-yield investments that generate cash flow from owning and operating oil and gas wells. To stay with the theme and, more importantly, because they are really attractive income investments, both recommendations this month come from the upstream MLP sector. **Legacy Reserves LP (Nasdaq: LGCY)** provides a nice balance to Memorial Midstream Partners.

Company Overview

Among upstream MLPs, Legacy Reserves is actually one of the oldest, operating as a public company since 2007. The company currently owns oil and gas production assets in the Permian Basin of West Texas, the Mid-Continent in Oklahoma, and in the Rocky Mountains. Production is close to evenly split between crude oil and natural gas. Legacy Reserves has generated growth through a practice of many smaller asset acquisitions. With a current market cap of $1.7 billion, the company has made an impressive 131 acquisitions over the last 7 years.

If you have read up on upstream MLPs, you know these companies like to focus on the amounts of reserves they have in the ground and how much they have grown production and EBITDA as a company. While these numbers are somewhat important, since these MLPs partially fund their growth by issuing additional LP units, all of the upstream partnerships will show similarly impressive numbers for these data points. I focus on what drops to the investor level as distributable cash flow and distributions per unit. Top line growth means little if the investors do not participate in the form of regular increases in the distribution rate. Legacy Reserves has done well in this respect. The distribution has been increased every quarter for 15 consecutive quarters. The overall rate of increase works out to about 3.5% per year, which is not "leader of the pack" growth, but combining the steady increases with the high yield makes LGCY an attractive income generating investment.

Originating a Different E&P Company Relationship

As I have discussed elsewhere in this issue of The Dividend Hunter, the upstream MLP business model has stalled for many of the companies in this sector. In spite of large asset acquisitions, distribution growth has stalled out for these companies and the next step from a continuously level dividend may be a reduction – the fate we most want to avoid as income investors. My personal theory is that the requirements to buy more assets just to stay level with production has allowed the sellers of those assets to ask for higher prices, which the MLPs must accept just to stay in business. Going forward, the standouts in the upstream MLP group will find new ways to be able to acquire production assets at more favorable pricing. Legacy Reserves has done just that.

In May of this year, Legacy entered into a new kind of asset purchase agreement with WPX Energy (NYSE:WPX), a corporate E&P company. As part of the purchase value, Legacy issued incentive distribution rights (IDRs) units to WPX. These units will pay WPX a portion of the distributable cash flow when the LGCY quarterly distribution exceeds $0.6785 per unit. The latest, second quarter payout was $0.61 per unit. WPX can earn more IDRs by selling additional assets to Legacy. These agreement ties a very large ongoing benefit to WPX if Legacy Reserves can raise its distribution to above the IDR threshold. WPX has vesting rights for up to 30% of the IDRs Legacy has created. The remaining 70% can be used for similar agreements with other E&P energy companies.

Distributions to Grow Every Quarter

The Legacy Reserves management has committed to maintaining its history of a 1/2 cent distribution increase every quarter. I think that the WPX deal will allow the company to grow the distribution even faster, since I am sure that WPX does not want to wait three years for the IDR payments to kick in. Do not be surprised to see the distribution grow by a penny or more each quarter. However, with the current 8.4% yield, and dividend increases every quarter, LGCY makes a nice addition to The Dividend Hunter portfolio even at the current growth rate.

Recommendation: Buy up to $30 per unit. Hold as long as the distribution is increased by at least$ 0.005 each quarter.

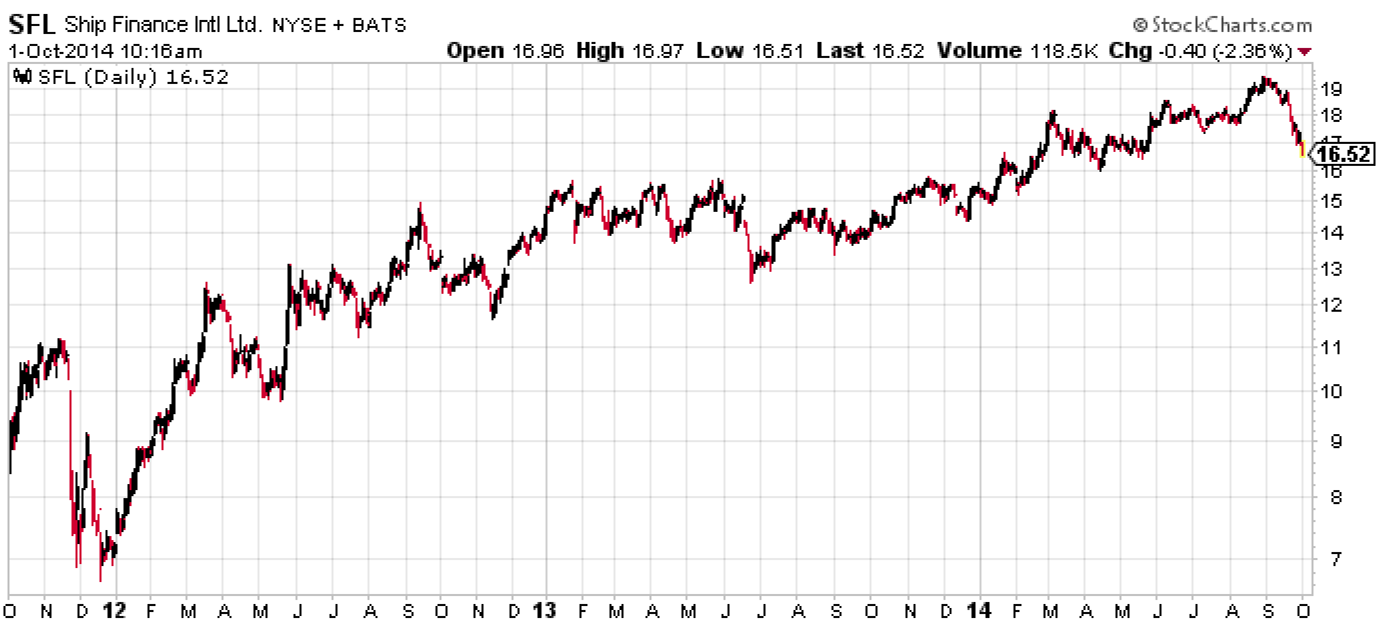
Portfolio Update

Five of The Dividend Hunter recommended income stocks went ex-dividend in September, with three of those occurring during the last full week of the month. Here is the list and the ex-dividend dates and when the dividends will actually be paid:

- Starwood Property Trust (NYSE: STWD): 9/26, 10/15
- Ship Finance International (NYSE: SFL): 9/10, 9/30
- Ventas, Inc. (NYSE: VTR): 9/10, 9/30
- New Residential Investment (NYSE: NRZ): 9/25, 10/31
- Harmon Armstrong Sustainable Infrastructure Capital (NYSE: HASI): 9/24, 10/9

The share prices of several of these have been hit by the factors discussed in the beginning of this month's issue, but the cash dividend benefits have not yet been realized in your brokerage account.

I was asked by a subscriber specifically about **Ship Finance International (NYSE: SFL)**. I have watched this stock for years and there are two factors about SFL to understand. First, the company pays very stable dividends that will increase moderately from year to year. Second, the share price moves up and down significantly, sometimes with what seems to be for little or no reason. One month ago, I was worried that SFL was approaching an overvalued level when the share price climbed to $19.90. Now, one month later, nothing has changed concerning the company's prospects and the share price is down to $17.37. A review of the one and three-year price chart below shows that share price pullbacks are good times to buy into SFL. I expect similar price cycles in the future.



The Dividend Hunter

One of last month's recommendations, **Salient Midstream & MLP Fund (NYSE: SMM)** picked the last 30 days to pull back by 5.7%. Ouch! SMM is a closed-end fund that owns MLP and related companies. MLPs as a sector dropped by about 3% in September and the market share price to NAV discount for SMM has widened by almost 3% to 10.35%. This means with SMM you would currently buy $1.00 of MLP assets for 90 cents. The quality MLPs are well set up to build out badly needed energy infrastructure over the next decade and at the same time produce attractive yields and distribution growth. The one-year chart for SMM shows how the recent decline is just a blip in the trend.

There will be almost nothing during October in the way of real news, like quarterly earnings reports, which is probably one reason why the month is often one of the worst for the stock market. Investors do not have actual good news to hang onto, so fears can result in selling and lower prices. Hang tight, collect your dividends and we will enjoy the positive earnings reports from the portfolio holdings when we get into November.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Buy Up To	Annual Div	Proj. Yield	Total Returns
Memorial Production (MEMP)	09/30/14	$22.02	$22.02	$23.00	$2.20	9.50%	N/A
Legacy Reserves (LGCY)	09/30/14	$29.68	$29.68	$30.00	$2.44	8.00%	N/A
Salient Midstream & MLP Fund (SMM)	08/28/14	$31.23	$29.23	See 09/14 issue	N/A	4.70%	-6.4%
Hannon Armstrong Sustainable Infrastructure Capital (HASI)	08/28/14	$14.49	$13.82	$15.00	$0.88	6.00%	-3.11%
New Residential Investment (NRZ)	07/30/14	$6.08	$5.84	$6.25	$0.70	11.00%	-1.07%
Arc Logistics Partners (ARCX)	07/30/14	$25.10	$25.15	$28.00	$1.55	8.00%	1.79%
Main Street Capital (MAIN)	06/27/14	$32.51	$30.61	$32.50	$1.98	6.00%	-4.31%
Starwood Property Trust (STWD)	05/30/14	$24.39	$21.96	$25.00	$1.92	7.80%	-6.03%
Ship Finance International (SFL)	05/30/14	$18.46	$16.96	$19.00	$1.64	8.50%	-4.00%
Oaktree Capital Group (OAK)	05/30/14	$50.66	$51.11	$56.00	$3.92	6.50%	3.36%
Macquarie Infras. Company (MIC)	05/30/14	$61.48	$66.74	$63.50	$3.75	6.00%	10.10%
Ventas (VTR)	05/30/14	$64.94	$62.12	$65.00	$2.90	4.50%	-4.84%

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. For a more detailed look at the portfolio, log on at www.investorsalley.com.