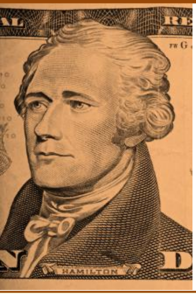


5 MLPs to Generate High Yield Income

A Special Research Report from **The Dividend Hunter**

Investors Alley

By Tim Plaehn

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 on LP units 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.

Should You Put MLPs in Your Retirement Account?

This section of the report was inspired by a subscriber to The Dividend Hunter asking about putting MLPs in his retirement account. Considering that many of my readers are using the dividend stocks in the portfolio to generate retirement related income and some have the option to trade within their retirement account I thought it only natural to include a discussion on this issue.

We'll start with his original question:

> "*Given that IRA investors tend to avoid the headaches that accompany MLPs and their dreaded K-1s, do you feel that ETFs that include MLPs, plus 1099 forms, might provide an alternative path with a lower yield? Just curious to learn if you favor individual equities only and do not favor ETFs in your publication.*"

The question brings up two important topics you'll want to understand about master limited partnerships (MLPs) and taxes.

K-1 Reporting Investments and Individual Retirement Accounts

There are not rules that prevent you from owning MLP units in an IRA. However, buying units with IRA money could result in your IRA earning what the IRS calls the unrelated business taxable income (UBTI). If an IRA account earns more than $1,000 in UBTI, the account becomes liable for income tax on the UBTI earnings over the $1,000 threshold. The account itself must file a tax return, which is handled by the IRA custodian. The custodian may charge up to several hundred dollars to file the return, plus the account will be debited for the UBTI tax owed.

MLPs report the amount of UBTI earned on the Schedules K-1 sent to investors holding units in an IRA. Just so you know, UBTI is not reported on a K-1 for MLPs in a regular brokerage account. Typically, an MLP owned in an IRA will report very little, if any, UBTI in the early years after units are purchased, and a growth focused MLP will not produce much UBTI for many years. My discussions with MLP investor relations departments and investors owning MLPs in their retirement accounts have shown that it is rare for an MLP owning IRA to hit the $1,000 UBTI trigger for a tax return.

The other time that UBTI can become an issue is when MLPs owned in an IRA are sold. The distributions earned over the holding period will be reported and classified as UBTI. As a result, owning a high-yield MLP in an IRA for more than a few years can trigger the UBTI tax if the units are sold.

My general opinion is to not own individual MLP units in an IRA. How much UBTI you will earn is unknown until the units are actually in your IRA and you receive a K-1. I think that a packaged investment product (fund) is the better way to get MLP sector exposure in a retirement account. The answer to which type of fund gets a little complicated, and that topic gets covered next. One last point, not all K-1 issuing companies are the same as MLPs. The finance related publicly traded partnerships may or may not generate UBTI. The investor relations managers at our portfolio holding Oaktree Capital (NYSE: OAK) have told me that OAK units will not generate UBTI in an IRA.

More Fun Tax Rules in Funds Such as ETFs, Mutual, and Closed-End Funds

Funds that focus on MLPs also must deal with negative tax issues. If an MLP focused fund has more than 25% of its assets in partnership units, the fund cannot qualify as a non-taxable, regulated investment company. The tax rules force a fund with a higher percentage of MLP assets to be organized as a corporation and to pay corporate taxes on its profits.

In practice an MLP fund tracks the accrued income taxes on the gains in its portfolio and subtracts the future tax liability from the fund's net asset value (NAV). As a result of the 35% to 40% corporate income tax bill, the NAV of a fund will lag the gains of its investments by the tax rate. For example, the Alerian MLP Infrastructure index is one of the most widely followed indicator of MLP sector returns. The index is mirrored by the **ALPS Alerian MLP ETF (NYSE: AMLP)**. Over the three years that ended on June 30, 2014 the index had recorded an average annual return of 20.83%. For the same period, the AMLP ETF produced average returns of 12.90% per year, a 38% per year under-performance compared to the index. The bottom line is that MLP index tracking ETFs are not a good investment choice.

Some MLP Focused Package Products for Your IRA Ideas

To get MLP exposure in your IRA without the potential UBTI hassles and costs, or the corporate tax hit suffered by ETFs, you have a couple of options. There exists an even dozen MLP exchange traded notes (ETNs). An ETN tracks a specified index, but does not actually own the investments tracked by the index. Instead an ETN is a debt obligation of the financial services company that issues the ETN shares. The returns of an ETN will match the selected index minus management fees of 0.80% to 0.95%, depending on the fund. Since ETN shares are not backed by any assets, there is a very small but real possibility of losses if the fund sponsor runs into financial problems or goes bankrupt.

My personal preferences for MLP packaged investments come out of the 27 closed-end funds (CEFs) covering MLPs. While a CEF faces the same corporate income tax as an ETF, there are several features of this type of fund that allows them to put up superior returns compared to the ETF indexes. Closed-end funds can use leverage, up to about 30% for stock funds. This means an MLP CEF with $100 million of assets can own $130 million of MLP units or stock shares. Also, CEF shares often trade at a discount to NAV, allowing you to own even more assets for your invested dollar.

Finally, and most important, CEFs are actively managed and the MLP space is a great hunting ground for good investment managers. The CEF advantages show up in the numbers: Through August 26 year-to-date, 10 of the MLP CEFs have outperformed the Alerian MLP index. These returns are after all fees and accrued taxes. 19 of the funds have done better than the AMLP ETF. Of course, when picking actively managed funds you need to know how to find the top performers.

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 rate 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 and spent on new production assets 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, distributions paid by an MLP are not taxable income. 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.

Memorial Production Partners (Nasdaq: MEMP)

The earlier section of this report titled, "The Upstream Master Limited Partnership Game" 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 distribution hikes.

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.

Legacy Reserves LP (Nasdaq: LGCY)

As with Memorial we'll stay focused on upstream MLPs for the moment – 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 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 earlier, 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.

Salient Midstream and MLP Fund (NYSE: SMM)

Here at The Dividend Hunter, our focus is on high yield stocks providing attractive combinations of current yield, dividend growth potential, and safety of future dividend payments. The individual stocks that meet our investment criteria will provide a steady and growing cash flow into your brokerage account.

In general, this type of return potential – especially the focus on high current yield – cannot be matched by packaged investment products such as mutual funds and ETFs. Closed-end funds (CEFs) are one packaged asset class that does offer attractive high-yield income potential. Many CEFs are managed for high and steady dividend yields. CEFs also provide more focused investment coverage into smaller or specialized sectors of the stock and bond markets. As the name clearly states, the **Salient Midstream and MLP Fund (NYSE: SMM)** is a closed-end fund that owns Master Limited Partnership units and MLP related companies.

Currently the MLP space offers a wide choice of income opportunities ranging from high-yields with steady distributions primarily from oil and gas upstream companies, variable distributions from the downstream and specialty partnerships, and attractive yields combined with growing distributions from the energy midstream focused MLPs. There are also related companies such as pure-play general partner MLPs and corporations that offer growth investment prospects based on the distribution growth from the controlled partnerships.

Over time, the best MLPs that I find which fit The Dividend Hunter criteria will be added to the newsletters portfolio recommendations. However, there are circumstances when certain issues make direct MLP unit ownership an unacceptable investment option. These circumstances usually involve the tax consequences and reporting requirements with MLPs and their K-1s. In this month's article on funds, taxes, and IRAs I cover the specific case of not wanting to own MLP units in an IRA.

For me, MLP focused CEFs bring together the best investment traits of both types of assets. Owning a CEF eliminates the tax challenges of investing in MLPs. And the CEF structure helps bypass the tax issues funds face when they invest in the MLP sector. As noted in the other article this month, a CEF that has more than 25% of its assets in MLP units must be set up as a corporation and pay the 35% federal corporate income tax on earnings generated from the fund's assets.

Salient Midstream and MLP Investment Focus

Three factors determine the investment results of SMM: management's investment philosophy, the investment in MLPs or affiliated companies with different structures, and the use of leverage.

The holdings selected by the SMM portfolio managers focus on distribution growth over current yield. The fund's portfolio is populated by the larger MLPs and affiliated companies which have established track records of above average distribution growth. Of the Top 10 holdings shown here, Williams Companies, Energy Transfer Equity, Targa Resources Corp, and Plains GP Holdings are high distribution growth companies, with dividend or distributions forecast to increase by 15% to 25% per year. The fund charter also allows management to sell covered call options to enhance income and to use puts and futures contracts to hedge against a market decline.

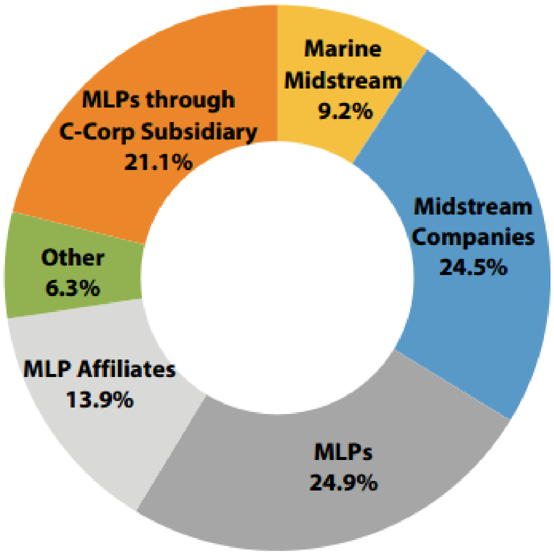
TOP 10 HOLDINGS[2] **AS OF 6/30/2014**

COMPANY NAME	SECTOR	% OF GROSS ASSETS
Enterprise Products Partners, LP*	MLP	9.2%
Williams Companies, Inc	MIDSTREAM COMPANY	7.9%
Kinder Morgan Management, LLC	MLP AFFILIATE	6.3%
Energy Transfer Equity, LP*	MLP	5.9%
Plains All American Pipeline, LP*	MLP	5.8%
Enbridge Energy Management, LLC	MLP AFFILIATE	5.0%
Targa Resources Corp	MIDSTREAM COMPANY	4.1%
NGL Energy Partners, LP	MLP	3.8%
Plains GP Holdings, LP	MIDSTREAM COMPANY	3.2%
Targa Resources Partners, LP	MLP	3.0%
Total		**54.4%**

The investment strategy has worked out well, on a net asset value per share basis, the average annual return has been 36% since the fund was launched in May 2012. It has been a great two-year run for MLPs, but even going forward the fund's focus on distribution growth should produce 15% to 20% average annual returns.

Notice from the pie chart below that the SMM holdings are spread among different types of MLP and other business structures.

One reason for this is that some of the high-growth affiliated companies are set up as corporations. Another reason is that a fund that has more than 25% of its assets in MLPs must be set up as a corporation and pay corporate income tax at a 35% rate on gains. Salient has set up the fund to own less than 25% MLPs directly. The fund also has a



subsidiary organized as a corporation that is another 24% of the fund and also owns MLPs. That portion is the blue wedge on the pie chart. As a result of this setup, 50% of the holdings consist of MLPs but only one-quarter of the fund's assets are subject to corporate income tax.

The final piece of the investment return puzzle is the use of leverage. Closed-end funds are allowed to use a limited amount of leverage to boost returns. The Salient Midstream and MLP Fund can use up to 33% leverage. From the semi-annual report as of May 31, 2014, the fund had total assets of $273.3 million. However, with the leverage it owned securities valued at $406.7 million. The use of leverage by SMM adds to the total return and also offsets some of the corporate income taxes and fund operating expenses.

SMM Nuts and Bolts

Closed-end fund shares trade on the stock exchanges and you invest using your brokerage account, just like with stock shares. The commissions will be the same as buying or selling any stock. There are two different share prices with a CEF. The net asset value (NAV) is the value of the assets behind each share. Once a day after the market closes, the fund company calculates the NAV by dividing the total fund assets by number of shares outstanding. The market price is what the fund shares are selling for on the stock exchanges. CEF market values are affected by supply and demand conditions as well as the NAV value. CEF shares often trade at a discount or premium to NAV. Over the last year, SMM on the stock exchange has traded at discounts of 0.5% to 11.7% less than the NAV.

According to the fund's prospectus, investors who buy shares of SMM will have dividends automatically reinvested into more shares. If you prefer to get the dividends in cash you need to contact your broker and inform them that you do not want to participate in the dividend reinvestment plan, sometimes called a DRIP. When dividends are reinvested, if the shares are trading at a discount, reinvestment shares are purchased at the lower market price. If the shares are trading at a premium, reinvestment shares will be purchases at the higher of NAV or 95% of the market price.

Dividends paid by SMM will be a combination of ordinary income or non-taxable return of capital. The breakdown changes each quarter, depending on investment results. For 2013, the dividends were classified as 37% return of capital and 63% ordinary income. For the first half of 2014, ordinary income made up about 44% of the distributions.

Note: Salient has filed to merge the Salient Midstream and MLP Fund with its sister, the Salient MLP and Energy Infrastructure Fund (NYSE: SMF). The two funds are very similar, with 9 of top 10 holdings the same. The larger size of the combined funds should benefit investors. This type of merger typically results in a narrower share price discount to NAV.

The Investment Basics

On October 1, SMM was trading at a 10.13% discount to NAV. The fund yields 5.0% based on market share price and most recent quarterly distribution. Remember that the dividend has been increased every quarter, so your yield-on-investment will grow over time.

Recommendation: SMM shares can be purchases any time the discount to NAV is greater than 5%.

Arc Logistics Partners LP (NYSE: ARCX)

Arc Logistics Partners LP (NYSE: ARCX) was one of the first MLPs 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.

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 as we talked about earlier and presented a couple of investing options for your consideration. 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.

Tallgrass Energy Partners (NYSE: TEP)

Tallgrass Energy Partners LP (NYSE: TEP) is another midstream master limited partnership that provides interstate natural gas pipeline transport and processing. The partnership launched with a late July 2013 IPO and has a market cap of $1.64 billion.

We've plucked TEP from our sister publication, 30 Day Dividends, because if fits neatly with ARCX and is complementary to our upstream plays. (You can find out more about 30 Day Dividends at the end of this report or online here).

The sponsor and general partner of Tallgrass Energy Partners is privately-held Tallgrass Development LP. The sponsor bears the cost of developing new midstream assets so that when they drop down to TEP, the MLP will generate almost immediate, accretive cash flow.

Currently, TEP is quite undervalued compared to its peers. In spite of an expected 30% rate of annual distribution growth over the next three years, TEP yields 3.84%. The other 20% plus growth MLPs I track have an average yield at 2.1%. To be in line with its peers, growth wise, TEP would need to increase in value by about 75%.

Of even more value, Tallgrass Energy Partners just announced a drop down acquisition of a 33.3% interest in a newly developed pipeline that will move crude from the Bakken in Wyoming to Cushing, Oklahoma. The $600 million purchases from Tallgrass Development will add about 50% to TEP's distributable cash flow, and increase distributable cash flow per unit by about 40%.

As a result of this drop down alone (remember, Tallgrass Development still owns 67.7% that could be transferred) I forecast that the TEP distribution will increase by 40% by the end of next year. When the market sees the distribution growth I expect the unit price to increase to bring the yield under 3%. The combination of these two factors produces a target price of $70, compared to the current $39 and change.

A word of warning: due to a one-time, non-cash charge, when TEP reports second quarter earnings on August 6, the earnings numbers will be down significantly compared to the first quarter results. I am uncertain which will win the unit price battle, details of the drop down for a higher value or the one-time bad news for a temporarily lower unit price.

Recommendation: Buy up to $40, with a target of $70 by the end of 2015. Total return: 75%.

As you're investing in dividend stocks and seeking steady, consistent income then Congratulations, you're already head and shoulders above most investors.

But what if I told you there's a way to COMPOUND that income?

That there's a tool that takes what you're going to pull in with the dividend stocks you're already holding and will pile on even MORE income. By adding this to your existing strategies, you're in essence **DOUBLING your income potential** again. What I'm talking about here is called:

30 Day Dividends

This is another one of my powerful tools that is made to not replace in any way what my regular income service, The Dividend Hunter, provides, but to complement and supplement the results you're already getting.

30 Day Dividends uses short holding periods for maximum profits and minimal risk.

You see, the focus of 30 Day Dividends will be to recommend stocks that will provide opportunities for relatively fast, attractive profits around potential dividend payouts. (And no, this is not another dividend capture strategy.)

The information you'll get from this newsletter will let you be nimble.

It will let you move fast.

It will let you bounce in and out of the market, making quick hits that pull in big profits.

How does it work?

Let me tell you how it operates.

First off it looks for investments that are considered **Special Dividends**. It finds those companies that will pay large, one-time dividends as a bonus to investors. Some stocks do this fairly regularly and there are other ways to ferret out stocks that have a high probability of paying a special dividend. There is seriously strong profit potential within these special dividend type stocks, and you can expect to earn up to 10% or more in a VERY short period of time.

The next tactic in this newsletter involves **International Stocks trading as ADRs**. You'll find that dividend-paying companies outside of the U.S. often do not follow the U.S. practice of steady quarterly dividends.

30 Day Dividends gets around that by finding and recommending companies that pay large dividends at odd times of the year. The recommendations will be to buy shares, earn the dividend and get out. The timing of the buy and sell dates will help you further maximize the profits of these trades.

The next trick up my sleeve: **Variable Dividend Payers**.

There exists a group of U.S. companies with full profit payout policies and operate in industries where profits can vary a lot from quarter to quarter and year to year. I understand the underlying factors that cause profits to swing and will recommend when to buy shares on the cheap to profit when the dividends swing again to the high side. This strategy aims to produce long term holdings where the dividend earnings are well above what you'd expect from typical dividend stocks.

Income Stock IPOs: When new REIT and MLP stocks hit the market the share prices follow a different trajectory than widely followed "hot new stock" IPOs.

What else do I show you in this newsletter? How about stocks with **Large Dividend Increases**?

I'm an expert in finding companies that are projected to significantly increase the regular dividend rate due to cash flow increases and past history of how those increases have been paid to investors.

Much of the benefit of this approach will be to pick the buy and sell timing points to maximize the returns from the upcoming or predicted dividend events. Again, not a dividend capture strategy, rather taking advantage of market actions.

For example, it may be more profitable to buy before a dividend announcement and sell on the news and price increase, rather than buying to earn the dividend itself. Much of the analysis will be price pattern recognition around dividend events.

–> Recommended stock holding periods will be a few weeks to several months, except for those that we are trying to accumulate on the cheap. This means you're money isn't tied up in and exposed to the market any longer than it has to be.

I know about a couple of dozen stocks right now that can fit into these categories. Other opportunities will arise as I research stocks for the regular stock income newsletter. With the base letter the focus is on higher yielding stocks that provide a stable and predictable income along with dividend and share price increases. Special situations offer higher returns obtained by trading in and out of the selected income stocks.

That's the thinking behind what I have built into my 30 Day Dividends service.

This portfolio changing information will be delivered via email and online every week… like clockwork.

You'll hear from me often enough that you won't ever miss any big moves.

<u>We locked in our first double digit gain in the first month, and more are on the way</u>.

So if you consider yourself an investor who's looking for income from stocks and willing to accept some additional risk to time the profits from increasing dividend payouts or capital appreciation from general market interest in those special payouts then this service is perfect for you.

So the question is:

Are you OK with just making just a tiny amount every month?

Or losing every month?

Or are you ready to start investing in safe income stocks that will produce quick dividend payouts and share price gains, all with the click of a button?

Delivered to your inbox like clockwork.

If you're ready to multiply your income streams, then press "add cart button" now.

Fly, Land, or Die,

Tim Plaehn
Editor
The Dividend Hunter
30 Day Dividends

Investors Alley