Educated Investing

A Growth Story - Perspective on Natural Gas

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The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. In each issue of the Stern Opportunity, MPSIF will share a stock recommendation based on the recent work of a current MPSIF Analyst.

This edition features the research of MPSIF Small Cap Fund Analyst Karim Samra. He recommended the purchase of Regency Energy Partners shares (NASDAQ: RGNC) in mid-April. The MPSIF fund purchased 400 shares at an average price of $26.77, based on his 12-month target price for RGNC at $35.00. This represents upside potential of nearly 28% from the current price of $27.36 (as of 4/21/2008).

Natural Gas 101
Approximately 22% of energy consumption in the United States comes from natural gas. It is used in the generation of electric power, in industrial production, as well as in residential applications. More than 50% of US households use natural gas for heating.

The consumption of natural gas has been increasing steadily in the United States, and demand has far outstripped supply since the early 70's. Today, demand has quadrupled, and with energy prices expected to remain strong over the medium term, companies who have developed a head start in this sector are set to reap significant rewards.

RGNC: A focused Investment
RGNC's activities are focused on the gathering & processing, compression, transportation (pipelines), and marketing of natural gas in some of the largest producing areas of the United States -- primarily Texas, Louisiana, and Kansas. Their business model involves three revenue structures: charging transport fees based on amount of gas shipped, brokering sales from one end of the pipeline to the other, and collecting a percentage of the sale price in the form of processing bi-products. This efficient model shields the company from much of the volatility associated to owning reserves but allows it to benefit from the continuing increase in overall global demand in natural gas.

RGNC is an MLP (Master Limited Partnership), a legal structure enabled by the US government to encourage investment in the country's energy infrastructure,
and that provides an exemption from taxation at the corporate level. Such midstream energy businesses have generated superior historical returns (see table 1).

**The Investment Rationale: Growth and Inefficient Markets**

**Macro Trends**
Industry headwinds and tailwinds mean a global increase in the demand for natural gas, a general shortage of supply, and additional investment across developed and emerging markets with sustained price strength. RGNC stands to benefit from all of these trends.

**GE Capital (Energy) Investment**
An investment by GE Capital (Energy Financial Services), one of the largest global players in the energy business, sent the stock up $9.00 in the early summer of 2007 (see chart 1). GE's acquisition of a majority stake in the general partnership and the synergies it brings to the table, such as access to capital, industry and technical know-how, established government relationships, a solid track record, and an additional 20,000 mile portfolio of natural gas pipelines across the US, added an additional $640 million of market capitalization in RGNC.

**Market Ignoring GE’s Ability to Shield RGNC from Credit Woes**
RGNC's stock price has held a relative lead in performance compared to its competitors primarily due to the GE acquisition (see chart 2), but shares have been trading in synchronization with the industry, leading Samra to believe that RGNC is being penalized for general weakness in credit markets (widening spreads) that are less applicable given its association to and support from GE and its strong balance sheet. Samra believes there is an 'inefficient market moment' of opportunity, which eventually should be corrected.

**Significant Dividend Yield**
The company’s 6% annual dividend yield makes for an attractive cash reward in owning the share and the company has consistently increased its dividend payment over previous years. It has a stated strategy of providing significant dividend payments to investors, and given its stable cash flow and ability to maintain and/or increase its dividend, the additional yield gives investors a large margin of safety against idle stock movements.

**DCF Value Range: Upside**
According to Morningstar analysts, fair value currently stands at $28.00 per share, after having downgraded the entire industry for widening credit spreads and lowered the price by $ 3.00 on account of using a higher discount rate in the valuation. MPSIF analyst Samra ran a number of pessimistic and base case scenarios using a WACC of 8.74%, an EBITDA growth rate ranging between 10% and 20%, and treating the terminal value as a perpetuity with no growth.
With ‘conservative’ assumptions, his valuation analysis places RGNC at a midpoint of $28.50 given a range of $ 23.00 - $ 34.00 -- further evidence of upside potential

Asset Base: '50 cent dollar'
The company’s current assets and gross PP&E amount to almost $1.1 billion (market cap is currently close to $2 billion) of value, stated at cost. This does not include the time and effort of securing land rights on every parcel over the thousands of miles the pipeline runs on and the value of developing extensive relationships with natural gas purchasers. This is a significant barrier to entry and presents attractive organic growth opportunities in addition to the acquisition based expansion the company has been undertaking. Effectively, this represents an investment where 50% of the capital is backed by useful assets that would be much more costly to build today. In investment jargon, this is called a '50 cent dollar,' and this should provide further downside protection.

About MPSIF
The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. The fund, part of the overall NYU endowment, was established in 1999 through a generous gift from Michael Price, managing partner, MFP Investors, LLC and former chairman of Franklin Mutual Series funds. With roughly $1.9 million currently under management, MPSIF provides Stern MBA students interested in pursuing a career in asset management with hands on experience managing a real fund with significant assets. For more information, visit: http://pages.stern.nyu.edu/~mpsif/