Sean T. Wheeler
Latham & Watkins MLP Practice

Issues and Complexities: Evaluating an MLP at 4 Key Points in the IPO Process

Understanding what and when decisions need to be made can help companies ensure a smooth MLP IPO process.

The number of master limited partnerships (MLPs) has grown significantly over the past five years, increasing from 59 in 2009 to over 100 in 2013. Currently, more than 30 MLPs are in the planning stages with numerous other companies considering the structure. Companies should evaluate several issues and complexities at four key points during the IPO process.

Generally companies face potential issues and complexities in clusters, which correspond to the various time periods in the initial public offering (IPO) process.

1. Evaluating the Pros and Cons of an MLP

Pros

- Substantial cash proceeds from the initial public offering
- Additional source of lower cost capital
- Strong pricing environment for MLPs
- Continued control of strategic assets
- Possible valuation uplift for Sponsor
- A vehicle to acquire third party assets on more competitive terms
- Potential future value through incentive distribution rights (IDR) distributions

Cons

- Subordination of retained equity interest
- Requirement to distribute all available cash on a quarterly basis
- Significant retail investor base
- Managing conflicts of interest
- Additional costs from running another public company (approximately $3 million per year)
- Increased complexity in the organization
- Risk of value loss during a period of rising interest rates
- Possible taxable gain on transfers of assets from Sponsor to MLP
- Difficulties in managing two shareholder constituencies (Sponsor and MLP)
- Post-IPO indemnification obligations for environmental, title, tax and other matters

2. Considerations Prior to Initial Filing of Form F-1/S-1

General Business

- Finalize business plan, including strengths, strategies and “IPO story”
- Determine MLP accounting predecessor and prepare financial statements
- Identify consents and/or amendments to loan agreements and other financing arrangements (existing Sponsor debt/new MLP debt)
- Evaluate benefits of public vs. confidential filing (if an emerging growth company)

IPO Structure, Forecast and Asset Selection
- Develop five year financial model
- Evaluate structure of MLP (OPCO vs. traditional)
- Evaluate structure of offering (primary and/or secondary; directed share program)
- Develop preliminary determination of IPO size, target level of earnings before interest, taxes, depreciation and amortization (EBITDA) and forecasted available cash
- Calculate estimated maintenance and replacement capital expenditures
- Determine the tax shield
- Identify assets and assess asset conveyance issues (consents, permits, etc.)

Sponsor/MLP Relations
- Determine business contracts necessary between MLP and Sponsor with respect to contributed assets
- Identify employees to service MLP assets and necessary services agreements for dedicated and shared employees
- Establish the general terms of "omnibus" agreement that will govern relationship between the MLP and Sponsor
    - Indemnification obligations (title, tax, environmental, other)
    - Right of first offer, right of first refusal or option on Sponsor assets
    - Scope of noncompete between MLP and Sponsor, if any
    - Rights to use Sponsor's marks and other intellectual property
- Determine future dropdown opportunities from Sponsor to MLP

Governance

While no decisions need to be made prior to first filing, Sponsor should start considering:
- Overall board size and board committees
- Independence analysis for directors
- Non-independent director candidates – minimum of three
    - One independent director required at pricing, another independent director required within 90 days of pricing and another independent director required within one year of pricing

Communications
- Develop internal and external communications plan
- Adhere to gun-jumping rules

Diligence

The overall diligence process falls into four main categories:
- Financial diligence
- Accounting diligence
- Management diligence
- Legal diligence

The diligence process can be made more efficient by using an electronic data room for key documents

Compensation Matters
- Assess preliminary contours of equity incentive plan, including types of awards to be available under the plan, outside director annual awards and executive officer awards at IPO, if any

Other
- Evaluate Sponsor "backstop" indemnity in underwriting agreement
- Select underwriters and recommend underwriters' counsel
- Select stock exchange
- Select financial printer
- Update directors and officers (D&O) insurance coverage

3. Considerations Prior to Marketing the IPO
- Determine Board size
- Identify independent directors
- Select non-independent directors
- Assign committees and chairpersons
    - Conflicts committee (required)
    - Audit committee (required)

    - Compensation committee (optional)
    - Governance committee (optional)
- Determine Director annual retainers and meeting fees
- Finalize forecast of cash available for distribution
- Determine common unit/subordinated unit split
- Set minimum quarterly distribution (MQD) and IDR target levels
- Quantify IPO equity awards to officers and directors
- Determine other IPO economics
    - Number of units to be sold
    - Primary/secondary sale split
    - Initial quarterly distribution level
    - Anticipated distribution coverage ratio

4. Considerations For Dropping Down Assets

- Identify assets and prepare proposal
- Appoint Conflicts Committee (consisting of two or more independent directors)
- Engage legal and financial advisors to the Conflicts Committee
- Assess restrictions on asset transfers under existing contractual arrangements, including loan agreements
- Analyze tax considerations, including implications for the tax shield
- Negotiate transaction agreements, including a contribution agreement and potential amendments to the omnibus agreement
- Determine financing plan
- Assess whether the acquisition will require filing acquisition financial statements with the Securities and Exchange Commission (SEC) and, if so, whether those financial statements must be filed prior to launching an SEC-registered debt or equity offering

This article is one of a series that examines the unique characteristics of MLPs. For further information on MLPs, visit the MLP Portal at www.lathammlp.com.

CONTACTS

Sean T. Wheeler
Houston
sean.wheeler@lw.com
+1.713.546.7418

Sean T. Wheeler is a partner in Latham & Watkins' Houston office and Co-chair of the Oil & Gas Industry Team. His practice focuses on corporate transactions in the oil and gas industry including substantial experience representing master limited partnerships.