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Agency problems aggravate credit woes of Ferrellgas Partners

by Victor Liu

Ferrellgas Partners, the second largest US propane distributor, has sunk in a downward spiral following the acquisition of Bridger Logistics in June 2015, which resulted in a whopping USD 650mn asset impairment on the company's bottom line in 2016.

In the US, while most propane distributors only serve their own states and areas, Amerigas Partners (Amerigas), Ferrellgas Partners (Ferrellgas) and Suburban Propane Partners (Suburban), the largest three firms in the industry, provide nationwide propane distribution services. As propane distribution has long been a stable and mature business, all the three behemoths have been fairly active in M&As to seek business growth and maintain market share in the downstream propane industry. However, when a downstream propane company ventured into a non-core business by leveraging to acquire a midstream energy company, the disaster came along. On Sep 28, 2016, Ferrellgas reported an annual net loss of USD 659mn versus a USD 29.3mn net profit in 2015, dragged down by over USD 650mn in asset impairment of the newly acquired midstream business. Along with the earnings results, Ferrellgas also announced a CEO change to its founder and Executive Chairman James Ferrell.

Unlike the other main competitors, which did not diversify away from their core business, Ferrellgas has seen its market cap shrink by nearly 50% since June 2015, in tandem with the RMI-CRI 1-year Probability of Default (PD) hitting an all-time high since 1995, the inception of its PD history. By contrast, Amerigas and Suburban maintained benign credit profiles in terms of the RMI-CRI 1-year PDs, as shown in Figure 1.

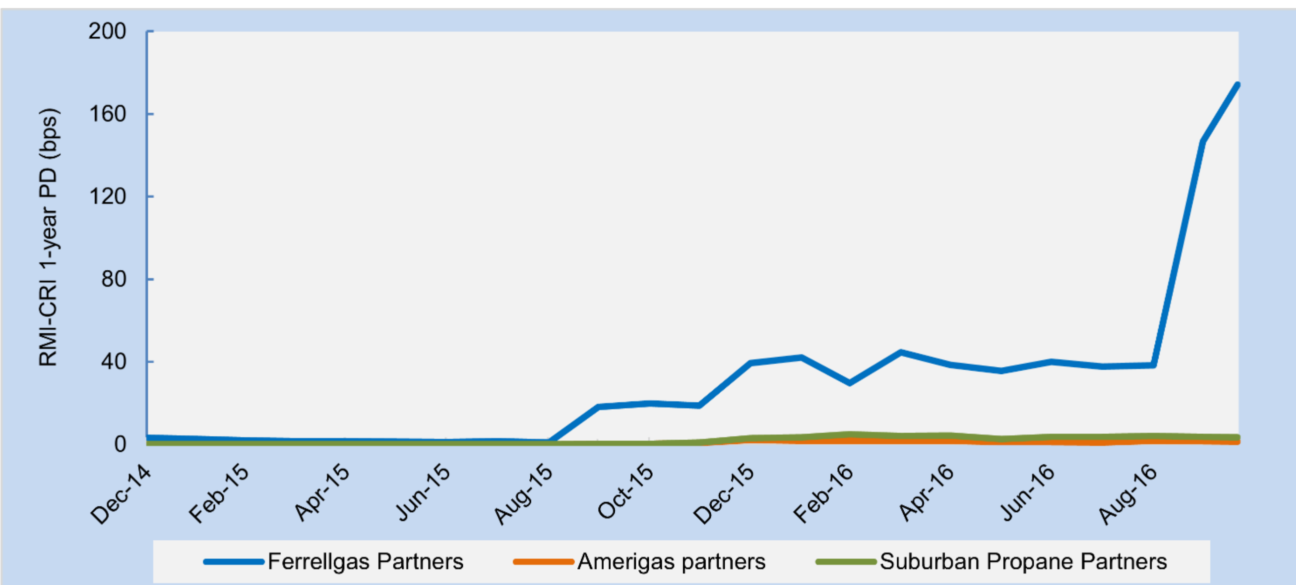

Figure 1: RMI-CRI 1-year PDs for Top 3 US propane distributors. *Source: RMI-CRI, Bloomberg*

Although the management of Ferrellgas attributed the dismal earnings result to decreased propane sales and the newly acquired money-losing midstream business, the misfortune could be better explained by the emergence of two agency problems behind Ferrellgas' business strategies.

The first agency problem relates to the conflict of interests between Ferrellgas' shareholders and debtholders under its unique business structure. In fact, Ferrellgas is not a company but a master limited partnership (MLP) where the limited partners (LP) provide capital for the MLP to receive periodic dividend income, while the general partners (GP) manage daily operations and receive management fees and performance bonus after dividend payout. Since the management fee to the GP is typically linked with the dividend payout to the LP, both GP and LP have incentives to increase the dividend payout under the MLP structure.

As shown in Table 1, Ferrellgas had proven the profitability of core propane business by delivering stable operating margin for six years despite a volatile revenue stream. Nevertheless, the net profit margin always ended up slim or negative due to high interest expense as a percentage of the operating profit. Ferrelgas consistently distributed cash dividend of USD 2 per share, which is considered aggressive with payout ratios ranging from 283% to 564%. In fact, the company even paid dividend on a net loss. It manifests that Ferrellgas had been aggressively raising debt to maintain its constant dividend payout policy and ended up with a huge interest expense as a drag on its net profit for many years, a business strategy that benefits the GPs and LPs but increases the probability of default for debtholders. As this agency problem was caused by the nature of the MLP structure, it was also observed in Ferrellgas' main peers and affected their bottom lines and leverage ratios, albeit at a manageable level.

	2011	2012	2013	2014	2015	2016
Propane revenue YoY growth	16%	-2%	-20%	23%	-11%	-26%
Operating margin	5.0%	3.8%	8.0%	6.5%	6.5%	7.6%
Net income margin	-1.8%	-0.5%	2.8%	1.4%	1.4%	-32.3%
Interest expense/ EBIT	84%	105%	56%	55%	76%	89%
Dividend/ share (USD)	2.0	2.0	2.0	2.0	2.01	2.05
Payout ratio	NM	NM	283.0%	484.6%	564.2%	NM

Table 1: Profitability and dividends for Ferrellgas Partners. *Source: Bloomberg, Capital IQ*
Note: NM denotes situations in which dividend was paid even when net income was negative

The second agency problem arose from the conflict of interests between the GP and the group of LP and debtholders. The objective of the MLP should be to run the business and distribute stable income to the LPs rather than to seek higher rate of return by taking additional risk. However, the GPs have the incentive to engage in risky business projects to generate a high performance bonus after income distribution. As shown in Table 2, the free cash flow for Ferrellgas failed to cover either cash interest expense or dividend payout, a fact that required Ferrellgas to keep increasing leverage to sustain the interest and dividend payment, and that left the GP with little performance bonus. Since Ferrellgas had higher debt to capital ratios and dividend to FCF ratios than the other two competitors, it faced a more serious agency problem which may have provided an incentive for the GP to venture into a risky non-core midstream business, unfortunately leading to a severe asset impairment loss and a surge in the leverage ratio in 2016.

(USD mn)	Ferrellgas			Amerigas			Suburban		
	2014	2015	2016	2014	2015	2016*	2014	2015	2016*
Free cash flow (FCF)	73.1	130.6	76.8	366.2	421.9	363.6	195.5	283.0	151.2
Cash dividend paid	159.3	165.4	202.1	319.4	334.4	343.8	211.0	213.1	215.3
Cash interest paid	90.8	91.8	133.6	161.5	158.8	158.8	91.8	75.6	75.6
Dividend/ FCF (multiple)	2.2	1.3	2.6	0.9	0.8	0.9	1.1	0.8	1.4
Debt/ capital	108.3%	90.3%	144.6%	63.8%	66.2%	69.4%	54.9%	58.0%	60.1%

Table 2: Cash flow and leverage comparison between Top 3 US propane distributors. *Source: Bloomberg, Capital IQ*
*Note: * denotes last 12 months*

As the surge in the leverage ratio of Ferrellgas had made it approach the ceiling required in some of the loan covenants, the company recently obtained an amendment to increase the maximum leverage ratio over the next six quarters. As promised to creditors, it plans to cut down on the future periodic dividend payout to strengthen cash flow. Ferrellgas currently has nearly USD 394mn revolving credit and USD 1.7bn senior bonds and notes, most of which mature in more than four years. Despite no urgency to repay debts, the estimated annual cash interest payment (nearly USD 130mn) is higher than its current free cash flows, translating into the fact that Ferrellgas will have to raise more debt to fulfill the old debt's interest payments, even if it does not pay a penny in cash dividend in the near future. Because Ferrellgas remains capable of generating stable profits from its core propane business, it is likely to go through the difficult period as long as it effectively communicates with creditors and shareholders to reduce its cash dividend payout and gain further financial support.

Ferrellgas' high interest expense and failure of business diversification highlighted the agency problems behind the MLP structure and GP's business decisions. Also Ferrellgas' financial distress reminded all the major propane distributors that the time is really ripe to review their MLP structures and moderate their leverage and dividend payout policies.

Credit News

Rising debt of small businesses adds to South Korea woes

Oct 25. Swelling debt among small businesses in South Korea is posing more challenges for an economy already burdened by record household borrowing. The debt levels of small firms have surged to an all-time high of SGD 315bn, rising 9% in the past 12 months. South Korea's policymakers are worried that 70% of small businesses can hardly last more than five years, and most entrepreneurs lack essential business skills. Economists forecast that South Korea's economy will grow 2.6% this year and 2.7% next year, lower than projected by the central bank and the government. (Straits Times)

Canada's record household debt is threatening its financial stability

Oct 24. Canada's debt has increased to almost triple the size of its economy as a result of a decade-long housing boom. Market observers are concerned that the heightened debt level will threaten future economic growth and financial stability. The combined debt of the Canadian government, companies and households reached USD 4.4tn in the first quarter, equivalent to 288% of GDP. The economy is struggling to find growth drivers in the wake of an oil-price slump with falling exports and declining business investments. The country's government has also been actively trying to get households to reduce debt, mostly by implementing new measures to cool the country's housing market. (Straits Times)

AT&T Time Warner deal could disrupt USD 8tn debt market

Oct 23. AT&T is officially acquiring entertainment-media giant Time Warner, at a price of USD 108.7bn. Although it now owns Time Warner's HBO, CNN, and TBS, AT&T's debt may balloon to levels that would put it at risk of a downgrade. Prior to the acquisition, the wireless carrier already had more than USD 120bn debt outstanding. AT&T is borrowing billions of dollars in additional debt to finance the acquisition. As net debt to EBITDA might surge to nearly three times post acquisition, AT&T is at risk of losing its investment-grade rating. With Sprint already downgraded to junk status, the loss of AT&T's investment grade rating could trigger more disruption in the bond market. (Financial Express)

Saudi official says country is doomed for bankruptcy unless changes are made

Oct 23. Saudi Arabia, previously thought to be impervious to any prolonged downturn in oil prices, has run a record high budget deficit of USD 98bn last year with an estimated USD 87bn deficit forecasted for this year. The slumping oil prices has weighed on Riyadh's state coffers as it made its first international bond sale, worth USD 17.5bn, to bring in much needed cash. In a broadcasted official discussion of Saudi Arabia's economy, Saudi deputy economy minister Mohamed Al Tuwaijri mentioned "If we (Saudi Arabia) didn't take any reform measures and if the global economy stays the same, then we're doomed for bankruptcy in three to four years." Furthermore, Saudi Finance Minister Ibrahim AlAssaf said that oil prices will not return as in the past, adding to the already dismal disclosure. (Forbes)

Fitch cuts Italy outlook on political uncertainty, weak growth

Oct 22. Fitch Ratings has cut the outlook for Italy, warning that an uncertain outcome of a planned referendum, high sovereign debt and weak economic growth could undermine the country's fiscal management. Italy will be holding a referendum on Dec 4 to decide if Prime Minister Renzi remains in power. The polls suggest that the Prime Minister could lose by a slight margin as voters are leaning towards the populist and Euro-skeptic parties ahead of the upcoming elections. Fitch says Italy's EUR 200bn of bad loans also poses a risk to the sovereign issuer as the rescue outcome for Banca Monte dei Paschi si Siena, Italy's third largest bank, is uncertain. (CNBC)

Australian mortgage arrears will continue to rise from three year high (Moody's)

Basel modeling proposals will broadly impact risk-weighted assets for large banks (Moody's)

Stone Energy's stock plunges as RSA agreement contemplates bankruptcy (Marketwatch)

Regulatory Updates

CBRC tells lenders to improve risk management of property loans

Oct 22. China's banking regulator has asked lenders to step up risk management of property loans amid record gains in house prices that have raised concerns of price bubbles and ballooning debts. According to National Bureau of Statistics, the price of new home is rising at the fastest pace on record. Outstanding mortgage loans to individuals also rose 33.4% YoY in September. In addition to property, the regulator also reminded banks to effectively manage credit risks in industries troubled by excess capacity. (SCMP)

EBA recommends only GSIIs and OSIIs be subject to the full CRD/CRR requirements

Oct 20. The European Banking Authority (EBA) has answered the European Commission's request for technical advice on the criteria to identify the class of investment firms for which the prudential regime laid down in the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) is applicable. The EBA recommends that only investment firms that are currently identified as Globally Systemically Important Institutions (GSIIs) and Other Systemically Important Institutions (OSIIs) remain subject to the full CRD/CRR regime. The criteria for being identified as GSIIs and OSIIs include systemic importance, interconnectedness with the financial system, complexity, and bank-like activities. (EBA)

BCBS publishes progress report on adoption of Basel III standards

Oct 19. The Basel Committee on Banking Supervision (BCBS) has published a report on the adoption status of the risk based capital requirements for 27 jurisdictions. The BCBS has been monitoring the implementation of capital rules of its members since 2011. According to the Basel Committee, all 27 members have finalized rules for risk-based capital, liquidity coverage ratios and capital conservation buffers. While many jurisdictions have drafted regulations for leverage and net stable funding ratios, some member countries reported difficulties in meeting the implementation deadlines for some standards. Mexico and Russia for example have yet to draft Pillar 3 disclosure requirements ahead of the December 2016 deadline. (BIS)

ECB publishes October 2016 bank lending survey (ECB)

Philippines regulator looks for ways to cap interest rates by informal lenders (Business World)

SEC preparing large scale review of exchange traded fund industry (FT)

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