Tortoise QuickTake Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Thanks for joining us today on the Tortoise QuickTake Podcast. I'm James Mick, Managing Director and Portfolio Manager with Tortoise Capital Advisors.

It was a relatively quiet week for energy from a news flow perspective as earnings are over and market activity was light, but the upcoming week will no doubt make up for that. We are finally here, the OPEC meeting takes place on Thursday the 25th and all energy markets will be on pins and needles to see what is announced. The key questions are: 1) will OPEC extend the current production cut? 2) will they extend beyond six months, possibly going into 2018 and 3) will they deepen the level of the existing cuts? We believe they extend the production cuts at the current level through at least the fourth quarter and possibly into the first quarter of 2018, essentially what Saudi and Russia leaked to the market. Needless to say, this will be the key driver of energy markets from a macro perspective over the next several weeks.

Let's kick things off with a recap of market performance:

- On the commodity front, crude oil was strong, increasing 5.2%, while
- Natural gas was weak, down almost 5% on weather
- Shifting to equities, the broader S&P Energy Select Sector Index® finished a tick higher, up 40 basis points
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠, were also up, rising 78 bps
- And finally MLPs were marginally higher, as the Tortoise MLP Index® rose 20 bps

Given the light news flow, I thought it would be a good opportunity to discuss a key topic that drives virtually every company decision in some way… cost of capital.

Very simply, the definition of cost of capital is the cost of a company's funds. Or said another way, the return investors require to incent them to invest in the company.

Cost of capital, as well as pressure from rating agencies, has been a key driver in many recent moves to either cut the distribution or simplify the structure of MLPs.

To unpack that a bit, let's evaluate how we calculate cost of capital, in particular for MLPs, where we have seen the most activity regarding moves to improve cost of capital.

Of course, there are multiple ways to get to an answer, this just happens to be the methodology we use.

To start, we evaluate both the cost of debt and the cost of equity capital.

For the cost of debt capital, we keep it pretty simple and utilize what the company issues 10 year paper for on a normalized basis. We also evaluate the current cost of debt as that is a key component in evaluating new projects, assuming it is different than the normalized cost of debt.

In terms of the cost of equity, for MLPs specifically, we start with the yield of the security. Next, we gross up the yield for the incentive distribution right percentage take of the general partner. This is a critical step and is one of the reasons we have seen so many simplification transactions recently. More on this in a minute. Finally, we incorporate at least two years of distribution growth into the cost of equity to ensure we capture what we think it will be, not what it is currently. To the extent we have visibility beyond that, we will incorporate more growth.

This ensures we capture the true cost of issuing new equity to fund a growth project or acquisition.

Back to the general partner's take for a minute, because this is a key factor.

Incentive distribution rights, or IDRs, allow the general partner, or GP to take an increasing percentage of the distributions over time as the distribution is increased at the limited partner, or LP level. The rationale is to align the incentives of the LP and GP unitholders for growth.

When starting with the limited partner's yield, we have to incorporate how much the general partner takes of the overall distribution of the company. As you'll hear in a moment, it's also why companies with no IDRs, are at a significant advantage versus their peers with IDRs from a cost of capital standpoint.

After starting with the LP's yield, we gross it up for the GP take. For example, if you have a 6% LP yield and the general partner is taking 40% of the total distributions, the true grossed-up yield for cost of capital purposes is actually 10%, or 6% divided by 1- the GP portion. We then layer on growth to this new, GP-loaded yield.

Consider two MLPs both yielding 6% at the LP level, one with no IDRs and one with 40% of cash flow going to a GP due to IDRs. That 4% cost of capital difference we just calculated, prior to baking in the growth rate, can have a material effect on the ability of the company to win a bid for a new project.

Additionally, the spread over and above the cost of capital is clearly hindered in that case as well. The same bid will certainly not yield the same accretion to both companies.

A competitive cost of capital has been the key factor in simplification transactions and to a large extent the distribution cuts witnessed in the MLP space.

Companies want to grow their cash flow and increase distributions to unitholders, something they can only do if they are competitive in the marketplace.

That will do it for today…have a great week and we look forward to speaking with you again soon.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

The **S&P Energy Select Sector® Index** is a capitalization-weighted index of S&P® 500 Index companies in the energy sector involved in the development or production of energy products.

The **Tortoise North American Oil & Gas Producers Index℠** is a float-adjusted, capitalization-weighted index of North American energy companies primarily engaged in the production of crude oil, condensate, natural gas or natural gas liquids (NGLs). The index includes exploration and production companies structured as corporations, limited liability companies and master limited partnerships, but excludes U.S. royalty trusts.

The **Tortoise MLP Index®** is a float-adjusted, capitalization-weighted index of energy master limited partnerships (MLPs). The index is comprised of publicly traded companies organized in the form of limited partnerships or limited liability companies engaged in transportation, production, processing and/or storage of energy commodities.