Tortoise QuickTake EnergyPodcast

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

Thanks for joining us today on the Tortoise Quick Take Podcast. I'm James Mick, Managing Director and Energy Portfolio Manager with Tortoise.

Let's just get this out of the way right now, last week was not fun. There's market volatility and then there's last week. As an example, the Dow Jones Industrial Average saw intra-day moves that averaged, yes averaged 4.5% last week. Monday had a sixteen hundred point gap between the high and low. While not to be outdone, Friday declined 500 points before reversing course mid-day to climb as much as 1000 points off those lows near the close of trading. According to most market pundits, the blame resides with a strong jobs report that showed wages finally starting to accelerate. Assuming wage inflation takes hold, interest rates will rise, bringing pain to the stock market, or so the narrative goes. In one of the more ironic twists of the week, the 10-year Treasury changed by a single basis point from Friday to Friday. Strange times indeed.

While I almost hate to do this, I'll recap the market performance:

- On the commodity front, crude oil was lower for the week, down approximately 9.6%, while
- Natural gas was also under pressure, falling 9.2%
- Shifting to equities, the broader S&P Energy Select Sector Index® decreased 8.2%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠ declined as well, down 9.6%
- And finally MLPs were better on a relative basis, but still negative, as the Tortoise MLP Index® moved lower by 4.7%

While there was a ton of news out last week, four things caught my eye in terms of materiality.

To start, NuStar Energy Partners announced it was reducing its distribution by 45% and simultaneously eliminating its incentive distribution rights, or IDRs. This in no way should have been a surprise, as virtually every Wall Street analyst had a distribution cut taking place in 2018 and the stock was trading as such. However, the guide down in terms of 2018 EBITDA estimates certainly was not as well forecasted, with the key driver being a non-performing contract with Venezuelan national oil company, PDVSA, for liquids storage.

Tallgrass Energy Partners also announced plans to eliminate its IDRs in 2018 as well as a drop-down of the remaining interest in Rockies Express Pipeline to its general partner, Tallgrass Energy GP. While details are still to come, this security was on our short-list of companies that were likely to do something with their IDRs in 2018 or 2019.

To recap, IDR elimination is a trend we fully expect to continue and believe the long-run ramifications are extremely positive as the elimination of the IDRs improves the cost of capital and corporate governance. It can be messy in the interim and neither of the Tallgrass entities traded well, yet we see this being a benefit to the story in the medium and long-term. Likewise, we should note, we certainly don't expect every restructure to result in a distribution cut, such as NuStar.

Targa Resources Corp announced a $1.1 billion dollar JV with Stonepeak Infrastructure Partners in the only deal of its kind for the week. Effectively, TRGP sold interests in some of their new projects to help with financing, but creatively structured the deal with the option to buy back the projects at a later date. The transaction significantly lowered the equity capital needs to TRGP for 2018, which was a nice catalyst for the stock, at least for a day or two.

The last item that stood out was the earnings call by Plains All American, the largest liquids pipeline MLP. Plains delivered an inline quarter, followed by slightly lower 2018 guidance. However, the guide down was primarily related to prospective asset sales in 2018.More importantly, Plains provided a preliminary look at 2019 EBITDA, which was approximately 15% higher than 2018, backed by strong growth in its core operating area, the Permian Basin. Plains actually traded up for the week and it was a further reminder that fundamentals actually do matter and cash flow will eventually win out in regards to stock performance.

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Finally, I would like to touch on the impact of rising rates on energy investments.

I covered this topic for MLPs on the podcast in December of 2016, but clearly it is relevant again given the macro concerns blamed for last week's abysmal market showings.

We most often get this question regarding MLPs, so I'll focus mainly on that.

From our view, we evaluate the impact of rising rates from both a direct and indirect basis on MLPs.

So first, from a direct standpoint, there is an impact to the extent that a company has floating rate leverage. The key mitigating factor is that midstream MLPs are approximately 80% fixed rate debt, so this impact is very minimal on cash flow.

Second, from an indirect standpoint, we look to assess the impact on the weighted average cost of capital and returns over and above that cost of capital.

While you could see some increases in the cost of debt and equity, there are several mitigating factors in our view that help lessen the impact of the higher rates and ultimately allow companies to continue growing their distributions.

A few of those mitigating factors are:

1. Excess coverage,
2. Internal versus external growth and
3. The ability to pass thru inflation via either higher rates or volumes
4. The next point simply looks at what history has shown us.

What we have seen historically is that when rates have increased by 50 bps or more, the return of MLPs has actually been quite positive and similar to what you see in the S&P 500®. In fact, MLPs have averaged a 6.8% return based on the 15 different time periods that we have noted since 2000. This compares favorably to the S&P 500 average return of 5.1% for the same time periods.

Finally, I would point out that one of the key factors to assess is WHY are rates moving higher?

In this case, it seems fair to say that indications point to a strong economy, driving lower unemployment, leading to rising wage pressure.

Assuming all of that is correct, we would fully expect it leads to higher consumption of energy, not lower. Higher consumption of energy means more molecules flowing through the pipelines and more revenue for pipeline companies.

In summary, while you may see some near term impact on MLPs from rate moves, we feel the data points to a more positive story and history has shown that to be the case as well.

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@tortoiseadvisors.com.

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