Pipeline companies can persevere in a rising interest rate environment

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While pipeline companies have typically fared better than bonds and other yield-oriented securities such as real estate investment trusts (REITs) and utilities during a rising interest rate environment, it is important to remember that they are not immune. The low interest rates that were in place after the 2008 recession helped midstream MLPs (master limited partnerships) and other pipeline companies raise capital economically, enabling returns that are significantly higher than their cost of capital. That in turn supported cash distribution growth. With the strengthening U.S. economy and higher rates, investors are wondering what that could mean for their midstream energy investments, given their attractive distribution rates. Let's take a look at both the potential direct and indirect effects of rising rates on pipeline companies.

Direct effects

The direct relationship is fairly simple as it reflects how increasing interest expenses can affect variable or floating rate debt held by companies. The key mitigating factor is that pipeline companies have historically been very conservative in terms of their debt structure. Midstream companies, including long-haul crude oil, refined product and natural gas pipeline companies generally utilize 70 to 100% fixed-rate debt, making their cash flow growth and longer-term performance less sensitive to higher rates. In short, we believe the direct impact of rising rates on pipeline companies is minimal and in our view will not significantly hinder growth.

Indirect effects

The indirect effect of higher interest rates on midstream energy relates to their impact on total return. There are three main factors that can provide a buffer to rising rates: excess coverage can allow for slightly lower returns on invested capital; focus on internal growth versus external growth; and ability to pass through inflation in tariff rates or benefit from increased demand.

First, it's important to distinguish the catalyst for rising rates – typically either rising inflation or an improving economy. Both have potential benefits for midstream energy.

- A strengthening economy helps pipeline companies transporting energy because aggregate demand increases, likely driving increased volumes transported.
- If inflation is the catalyst, though in our view this is the less likely scenario at this time, some pipeline companies can pass through the rate as it relates to liquids pipelines, which receive tariff escalators tied to the producer price index (PPI) that would push up the rate side of the equation.

We believe both catalysts for rising rates could drive improved cash flow, which could offset an increase in rising equity and debt.

History as teacher

MLPs, like all distribution-paying entities, can experience some short-term volatility during periods of rising rates. However, MLP distribution growth has historically provided positive returns over the long term during these periods. Pipeline companies' combination of attractive yield and growth potential distinguishes them from other income-oriented investments. Unlike bonds and REITs, MLPs can grow their distributions, which can help drive total return. Historically, midstream energy companies have experienced short-term volatility when interest rates increased, followed by a rebound and solid long-term performance. The following table reflects our analysis of the past 16 periods of one or more consecutive months with a 50 basis point or more increase in the 10-year Treasury since 2000. During those periods, the 10 year treasury yield change has averaged 0.8%, MLPs returned 6.1% and pipeline companies returned 5.1%, compared to -1.4% for bonds and 5.4% for U.S. equities. MLPs and pipelines companies outperformed bond returns in 13 of 16 periods of rising rates since 2000 by an average margin of 7.5% and 6.5%, respectively.

Impact of rising interest rates on pipeline companies

MLPs and pipeline companies outperformed bond returns in 13 of 16 periods* of rising rates since 2000 by an average margin of 7.5% and 6.5%, respectively.

Time period	10-year Treasury yield change	MLP returns	Pipeline returns	Bond returns	Equity returns
3/2001 - 6/2001	0.5%	11.0%	-1.4%	1.1%	-0.9%
11/2001 - 12/2001	0.8%	-0.7%	0.4%	-2.0%	8.6%
3/2002	0.5%	7.8%	10.1%	-1.7%	3.8%
10/2002 - 11/2002	0.6%	0.2%	2.7%	-0.5%	15.2%
6/2003 - 8/2003	1.1%	7.3%	2.6%	-2.9%	5.1%
4/2004 - 5/2004	0.8%	-8.6%	-2.8%	-3.0%	-0.2%
9/2005 - 10/2005	0.5%	-2.3%	-1.4%	-1.8%	-0.9%
1/2006 - 6/2006	0.7%	9.0%	7.5%	-0.7%	2.7%
4/2008 - 5/2008	0.6%	8.3%	11.5%	-0.9%	6.2%
1/2009 - 2/2009	0.8%	11.1%	-8.2%	-1.3%	-18.2%
4/2009 - 6/2009	0.9%	19.3%	18.9%	1.8%	15.9%
12/2009	0.6%	6.9%	7.0%	-1.6%	1.9%
9/2010 - 3/2011	1.0%	24.6%	32.1%	-0.8%	27.8%
5/2013 - 8/2013	1.1%	-0.9%	-2.6%	-3.7%	3.0%
8/2016 - 1/2017	1.0%	9.4%	10.6%	-3.0%	6.0%
9/2017 - 2/2018	0.7%	-4.7%	-6.1%	-2.2%	10.8%
Averages	**0.8%**	**6.1%**	**5.1%**	**-1.4%**	**5.4%**

As of 6/30/2018 *Time periods are determined using end of month yields and returns. Periods shown are those where the 10-year Treasury yield increased by at least 50 basis points over one or more consecutive months. Returns are period-specific and are not annualized. 10-year Treasury yield change source = Bloomberg. MLP returns source = Tortoise MLP Index® (as of 1/1/2000). Pipeline returns source = Tortoise North American Pipeline Index℠ (as of 1/1/2000). Bond returns source = Bloomberg Barclays U.S. Aggregate Bond Index. Equity returns source = S&P 500® Index. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

Looking ahead

We believe that although these assets are not immune to rising interest rates, they remain attractive long-term investments in both periods of economic growth and uncertainty. While higher rates are inevitable, we believe that over the long term, quality growth will prevail.

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The Tortoise MLP Index® is a float-adjusted, capitalization-weighted index of energy master limited partnerships (MLPs). The Tortoise North American Pipeline Index℠ is a float-adjusted, capitalization-weighted index of pipeline companies domiciled in the U.S. and Canada The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable rate mortgage pass-through securities), commercial mortgage-backed securities (agency and non-agency) and asset-backed securities. The S&P 500® Index is an unmanaged, market-value weighted index of stocks that is widely regarded as the standard for measuring large-cap U.S. stock market performance. It is not possible to invest directly in an index.

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