Tortoise Special Energy Podcast

Tortoise

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

James: Hello and welcome to a special update podcast on the performance of midstream energy markets.

I'm James Mick, senior portfolio manager with Tortoise.

We wanted to hold a special podcast to address the volatility and generally poor performance that we've seen out of midstream stocks in the 4th quarter.

The Tortoise MLP Index fell approximately 11% at its low point during 4Q, but has since rebounded a bit.

That being said, it remains down about 9% for the 4th quarter to date and is down almost 13% since the end of 2Q.

To help explain what has happened, I have with me fellow portfolio team members Brian Kessens, Adam Peltzer and Braden Cielocha. This will be a round table of sorts, with questions posed and answered.

To explain what's transpired, we'll break down performance between macro, industry and finally company specific impacts.

I'm going to kick things off with the macro discussion.

It's clearly been a year of twists and turns from a macro perspective, most notably due to the seemingly never-ending news flow regarding the trade war with China.

The first real impact started in May when President Trump tweeted that China had essentially not lived up to their end of the bargain and a potential deal was off.

Midstream held in pretty well through that time period, thanks to a nice premium paid in an all cash offer for Buckeye Partners by a consortium of pension funds from Australia.

However, the MLP market peaked in mid-July and was driven lower by the inverted yield curve.

The inversion was caused by concerns about global growth.

In short, the trade war has led to caution by businesses to invest. That's led to an expected slowdown in global GDP. That in turn raised the concern of a potential recession. Which finally led to an inverted yield curve and a strong move down for all stock markets, energy included.

About this same time, the International Energy Agency, or the IEA, reduced demand for crude oil a couple of times in a few weeks. This fed into further energy weakness.

While the broad market recovered from the recession fears, helped by accommodative central bank policy, it has not helped out midstream nearly as much. Which is odd because lower rates help increase the desire and demand for yield oriented investments, which midstream clearly fits, arguably providing more compelling yields than just about any other asset class out there.

So needless to say, macro has played a massive role in performance for 2019. And it goes without saying, a potential agreement or settlement of the trade war with China would be a very strong positive for energy stocks in general.

With that, let's turn to our esteemed panel and dive into more detail.

I'd like to touch on industry specific items first. Brian, let's start with you.

We've discussed energy supply and demand being out of balance. What's going on there?

Brian: One misnomer is that demand has been weak. That's not the case. There is currently the strongest demand ever for crude oil, natural gas, and many natural gas liquids. The issue is that supply growth has just exceeded the growth in demand. For example, the EIA forecast in its 2017 five-year outlook, that crude oil production would reach 12 million barrels per day in 2023 and natural gas production would reach 93 billion cubic feet per day in 2023. Production is already at that level, four years ahead of schedule. Simply, U.S. production the past two years have been off the charts, two of the largest years of growth ever by a country in both liquids and natural gas.

Production growth now needs to slow while demand catches up. And on the demand side, with increased U.S. LNG capacity coming on-line in 2020 and with continued crude oil demand growth from developing countries, there is visibility to demand catching supply.

James: Ok great, if supply growth is slowing, but not really overall supply, what is the big implication for midstream?

Brian: In the interim, producers are being forced to live within cash flow which will result in lower production growth in 2020. On the midstream side, this has led to some concern about volumes. The context though is that we've seen tremendous growth recently and a more moderate pace is healthy. The moderate pace lessens the risk of a takeaway capacity overbuild and reduces the need for growth capital expenditures. Midstream can slow spending and focus on returning capital to shareholders through further debt pay-down, distribution growth, and/or share buybacks.

This thesis fits with our catalysts laid out at the beginning of this year. We indicated slowing capex in 2020 leading to a focus on free cash flow. Now we have visibility to a 5% free cash flow yield after dividends in 2020, increasing to 7% in 2021. Nothing to be scared of with that.

James: Definitely, concerns around the election seem to be one of the key issues holding midstream back. Braden, what's the latest on the political front?

Braden: Well, on September 6th we saw Elizabeth Warren tweet that she intended to institute a moratorium on new drilling leases on public lands as well as ban fracking everywhere. While the tweet initially got some headlines, it didn't have a notable impact on returns until weeks later when the Trump whistle blower news started to circulate and at that point we saw her begin to eclipse Biden in more of the national polls, making it appear more likely that we could see a Warren presidency in 2020.

James: Is a frack ban likely? What is it that Warren, or any candidate, would actually be able to achieve if they are elected?

Braden: In our opinion, a full national frack ban is unlikely. To fully ban fracking it would require coordination with the legislative branch that we don't expect to occur. There are however a number of smaller steps that a president Warren could take, through executive order, to slow down the drilling process and/or make it more costly. These mostly come through her direction of the EPA and regulation of air and water quality. She may also try to limit federal onshore and offshore drilling, but we would expect those actions to receive pushback from impacted states. For instance, New Mexico, which is a solidly blue state, receives ~40% of their annual state budget from oil and gas drilling.

James: There have been a few company specific things that could be attributed to weakened performance as well. Let's address those.

Adam, we just finished up earnings for 3Q, any big takeaways?
Adam: Third quarter earnings were, by and large, pretty good as midstream companies continue to report strong earnings and cash flow growth.

James: What about from an upstream perspective?

Adam: On the producer front, a major focus for the quarter continued to be on the northeast gas producers and their financial health as well as what 2020 production growth will look like. That has put some pressure on gathering and processing names within midstream, particularly those with assets in the northeast

Finally, one pushback from the quarter has been on capital discipline out of the midstream space. In particular, Enterprise and ONEOK, despite posting strong quarterly earnings, underperformed relative to the sector as investors reacted negatively toward both companies' capital allocation plans that focused more on growth capex instead of investor preference for share buybacks.

James: Braden turning back to you from a more technical standpoint, we had a couple of equity offerings, can you shed some light on those because we have stated quite a few times that we expected those to be done?

Braden: What we have been seeing lately has been secondary offerings. They are a fair bit different than the primary equity offerings we had been seeing prior to 2018.

James: Can you give us a little more detail on what a secondary offering is?

Braden: Absolutely, secondary offerings are sales of existing shares, similar to a block trade. They tend to come from large holders, often sponsors of a midstream company. Unlike in primary offerings where the company is issuing new units to the market and receiving proceeds to invest in the company, the company does not receive any of the proceeds in a secondary.

James: Do you expect any more of these soon?

Braden: No, at this point the selling holders have largely exited their positions. There were two notable sellers in 2019. First Occidental Petroleum Corporation (OXY) which fully exited their Plains All American (PAA) position in September and we have seen Warburg Pincus and Yorktown sell down their interests in AM in three separate sales during the year. Warburg has now fully exited their position and Yorktown is down to a modest position.

James: Adam, turning back to you, upstream producer Chesapeake Energy (CHK) certainly made some headlines, what happened?

Adam: In Chesapeake's 3Q 10-Q, the company disclosed a going concern risk, centered around leverage covenants in their Reserve Based Lending Facility that could be breached next year if commodity prices were to remain depressed.

James: What was the market reaction to that?

Adam: The market reaction was pretty severe with the equity off ~42% over the following two trading days after the 10-Q was filed; also the company's unsecured bonds traded down substantially, with the longest maturity debt trading off ~14 pts in two days and currently trade at yields above 20%.

James: What are the odds of a bankruptcy filing?

Adam: At this point we feel like there are a number of strategic actions the company can and likely will take to stave off a bankruptcy filing. For instance, even with the going concern language in the 10-Q, the company's RBL lending group re-affirmed the company's borrowing base meaning that there was no change to the amount of money the banks are willing to lend the company on the current facility. Second, the company has been looking to sell some non-core assets and may be getting into the later inning of negotiations on this front which would provide cash proceeds that can be used to pay down

debt. Lastly, if the company were to violate their leverage covenants, based on historical precedence, we think there is a high likelihood that they would be able to get waivers from the their banking group.

James: What would the impact be to midstream companies?

Adam: The risk to midstream companies primarily surrounds the ability of the bankrupt entity to reject contracts with their midstream service providers and in the event those contracts can be rejected, is the rate on those contract above the current market rate. Remember a bankruptcy filing in the case of Chapter 11, is a restructuring of the balance sheet, reducing debt and wiping out current equity holders but the entity itself continues to operate. This is important to note because the entity will still need their midstream service providers to get their product to market. So while there could be some movement in the rates charged for different services, the midstream service provider remains an integral part of the equation for the producer.

James: Brian, what's going on with Energy Transfer? What was all the buzz about their recent acquisition?

Brian: Management caught the market off guard by announcing the acquisition of SemGroup in September. Energy Transfer finds a lot of value in SemGroup's Houston Fuel Oil Terminal where there are 18 million barrels of liquids storage on the Houston Ship Channel. With it, the company is uniquely positioned to offer producer customers export options in Houston or further east at their Nederland terminal. Further, the transaction is immediately accretive and provides more opportunity for Energy Transfer to connect its existing assets. Yet while management's track record with acquisitions, that includes Southern Union and Sunoco is compelling, with current market sentiment, they are leaning into the wind. Investors are looking for more capital discipline and the SemGroup acquisition results in the threat of continued spending on M&A and organic capital expenditures.

James: They were also just recently in the news as part of an FBI investigation, can you provide some color on that?

Brian: For some background, the investigation involves Mariner East 2 and 2X, part of a series of pipelines that transport natural gas liquids from Ohio, West Virginia and Pennsylvania to Marcus Hook, Pennsylvania for domestic distribution and export to international markets. Energy Transfer is currently constructing Mariner East 2X, scheduled to be completed in mid-2020.

The AP reported, based on three anonymous sources, that the FBI is investigating Pennsylvania Governor Tom Wolf's administration related to construction permits issued for Energy Transfer's Mariner East pipeline. The report indicated the investigation is focused on whether the Wolf Administration forced staff of the Pennsylvania Department of Environmental Protection to approve pipeline construction permits for Mariner East 2 and 2X. Energy Transfer said it has not been contacted by the FBI, the FBI neither confirmed nor denied the investigation, and the Wolf Administration said it was surprised by the report of an FBI investigation. Governor Wolf, a Democrat, said, "I welcome anybody to look at what's going on in the administration, and if something's not right then people shall be held to account. Openness and transparency and integrity are absolutely important to me."

James: Any thoughts on potential implications?

We understand all of the permits for the project have already been litigated and upheld in court. Further, the AP report came forth on the same day Energy Transfer was scheduled to receive another permit for the pipeline. It seems that given the anonymity of the sources, surprise among the accused, the polarized political climate among Democrats in Pennsylvania with some in favor of the pipeline and others opposed, and the timing, that the legitimacy of any investigation is questionable.

Bottom line, we think the risk of the FBI investigation potentially results in further delays for Mariner East 2X.

James: Thank you. So to summarize the thoughts we laid out, the weakness has been a confluence of events. Starting with the macro trade war issues and potential slowdown in global GDP bleeding into industry concerns about end user

demand. Additionally, election rhetoric has been challenging, but very likely overstated. Finally, some company specific items, mostly technical in nature have not helped matters.

All that being said, are we still bullish on midstream? The answer is unequivocally yes. The valuations look even more compelling now than they did earlier in the year and they were pretty darn compelling at that point. Additionally, the free cash flow story that we laid out at the beginning of 2019 really starts to build in 2020 and we still see that not only materializing, but extending in 2021 and beyond.

Next major events will be OPEC's semi-annual meeting in early December, a couple of more conferences and then the flip of the calendar into 2020.

Thank you all for your continued interest in Tortoise 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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