Tortoise Special Podcast

Tortoise

April 8, 2020

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

Narrator: 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.

Brian Kessens: Hello. I am Tortoise Managing Director and Portfolio Manager Brian Kessens with a special podcast on Stressing Midstream Companies. Full warning there are a lot of numbers we are going to walk through. If helpful the transcript is posted on our webpage at www.tortoiseadvisors.com.

The biggest question we've received from investors over the past several weeks as the energy complex adjusts to the abrupt change in demand from COVID-19, is if and how midstream companies are going to hold up.

To make that determination, we performed a stress test on our companies' cash flows using our financial models. Based on changes in energy volumes and prices, what is the impact to distribution coverage and leverage? Based on the market's indiscriminate and acute reaction over the past month, surely every company needs to reduce its distribution and pay down leverage. Our analysis indicates that's just not near the case.

We stressed the cash flows of our companies in several ways. First, we know demand for gasoline and jet fuel, or refined products, are going to be down for a period of time as employees work from home and schools are closed. We assumed refined product demand is down 10% in the first quarter of this year from fourth quarter levels, 25% down in the full second quarter, and 15% down in the full third quarter beginning in July, before returning to flat for the remainder of the year.

Next, for crude oil we assumed volume declines in the second half of 2020 of 5%, a further decline of 15% in 2021, and another 10% decline in 2022. That implies that at the beginning of 2021, the US is down to 10.4 million bpd of production, or off 2.6 million bpd from current levels, a significant drop in just the next nine months. For commodity prices, we assume $30 per barrel for WTI and $2 per mmbtu for natural gas through 2022.

What are the results in the portfolios? Distribution coverage, which is a measure of the margin of safety in a company's current dividend where a reading below 1.0x means a company would struggle to maintain its distribution, moves down from 1.5x in 2019 to 1.3x in 2021 and leverage measured by debt / EBITDA moves from 4.1x in 2019 to 4.3x in 2021. Leverage around 5x or lower is generally considered to be worthy of investment grade ratings. Both coverage and leverage remain steady from there in the outer years. We feel good that the portfolios are quite durable. Distribution and dividend cuts are not required as companies cover payouts with cash flow and leverage is not elevated.

Metric	2019	2020E	2021E	2022E	2023E
Coverage	1.5x	1.3x	1.3x	1.3x	1.3x
Leverage	4.1x	4.2x	4.3x	4.3x	4.2x

Yet, let's take a deeper look at the numbers by sector given that most of our portfolios are tied to natural gas. What performs best and worst? In fact, as expected, natural gas focused companies hold up well. Excluding Cheniere because the stock pays no dividend, coverage in 2021 comes in at 1.7x with leverage steady at 4.6x.

For refined products companies, no surprise that coverage is lowest in 2020 given demand drops most acutely in the 2Q. Here, coverage moves from 1.4x in 2019 to 1.2x in 2020 before increasing to 1.3x in 2021. Leverage is healthy at 3.3x.

With crude oil pipelines, coverage moves from 1.5x in 2019 to 1.2x in 2021, though because these companies entered the downturn with modest leverage, leverage remains manageable in 2021 at 3.9x. Notably, we expected if any distribution

reductions would take place pre-emptively for pipelines, it would be in this sector. In fact, the first company did so today, Plains All American reduced its distribution to shore up its balance sheet and ensure leverage does not exceed a level our stress tests indicated was possible, that of 5.0x in 2021. We believe this was the prudent step and would note the stock is trading up on the news as it was generally already priced in that a distribution reduction was forthcoming.

In gathering and processing where cash flows are tied closer to the well, no surprise that leverage becomes elevated and distribution cuts are likely. Note, this represents a tiny portion of our portfolios.

Finally, there are some diversified midstream companies that are worth watching. As a group, coverage is fine at 1.3x in 2021 yet debt levels elevate to 4.9x, at the warning track of 5.0x. We think the diversified nature of the business models help, where we don't give any credit to other parts of the business that might benefit from the energy dislocation. This bears continued watching. And that's exactly why we have a large investment team to stay on top of all the supply and demand fundamentals across the whole energy value chain. It is times like this where we believe our team thrives.

One note on the stress test, it's merely a tool and not a crystal ball. For example, it doesn't fully take into account counterparty risks where because 85% of the cash flows in our portfolios are tied to investment grade counterparties, we don't have an outsized concern. The stress tests also don't account for a force majeure, or companies claiming they don't need to honor contracts because of the pandemic. Our work here suggests that midstream contracts hold up well in a pandemic, yet they've never been tested. Maybe what's more realistic are pipelines working with producers to renegotiate some contracts, offering a lower fee in exchange for a longer-term. The stress test also does not take into account further reductions in capex and gives no credit for what is likely a more balanced natural gas supply and demand environment as reduced crude oil production results in less associated natural gas supply. Further, we don't give any credit to companies with liquids storage. We understand storage rates have more than doubled during the downturn.

Given the portfolios didn't break in our stress test, we ran another case where we took a harder swipe at the fundamentals, assuming crude oil volumes are down 40% in the third quarter 2020, natural gas are down the same on a relative basis and crude oil prices are $10 per barrel with natural gas prices at $2 per mmbtu for the duration of our forecast. In this case, distribution coverage moves down from 1.5x in 2019 to 1.1x in 2021 and leverage measured by debt / EBITDA moves from 4.1x in 2019 to 4.9x in 2021.

Metric	2019	2020E	2021E	2022E	2023E
Coverage	1.5x	1.2x	1.1x	1.1x	1.2x
Leverage	4.1x	4.6x	4.9x	4.9x	4.9x

I'd characterize this stress as where the portfolios start to break, where distribution cuts in some cases become necessary to reduce leverage. Yet that's also the world in a sustained 2Q 2020 or a great depression like scenario for well over one year. With the amount of monetary and fiscal stimulus already unleashed, we think that's unlikely, yet this is the scenario that we think stock prices are implying today. After all, in 2016, when crude oil last touched $27 per barrel, midstream stock prices were nearly double where we find ourselves today.

So what gets the market to change, to differentiate between those companies who have steadier cash flows from those that don't. What are the catalysts? During the financial crisis in 2008-9 and during the last energy downturn when crude oil touched $27 per barrel in 2016, catalysts were as simple as companies announcing distributions and reporting results that proved better than stock prices implied. We think the same can happen during this downturn. In fact, Energy Transfer, with a yield above 20%, announced its holding the distribution flat this quarter. Since, the stock is up over 20%, outperforming the index by 17%. We'll see how this plays out soon as more companies announce distributions over the coming weeks.

On earnings, Kinder Morgan will be the first company to report on or about April 15th with others following through the first weeks of May. What are companies likely to report? We expect first quarter results to be solid given that the economic

downturn did not begin until the end of March. Companies will also have a good sense of how their business is holding up during the lockdown period. They'll emphasize take or pay contracts, minimum volume commitments, fee-based cash flows, investment grade counterparties, higher storage rates, and strong relative natural gas demand. Frankly, the reasons all of these pipeline protections exist is for a period like we're currently enduring. We expect the guidance to be relatively favorable relative to expectations. Of course, having some certainty on the true length of the lockdown will be helpful too, which by the end of April, we ideally have a much better sense of the progress made in controlling the spread of the virus.

In summary, we're confident in our portfolios during the downturn. Midstream companies operate essential assets with cash flows that hold up well in distressed environments. We believe distribution cuts to delever are going to be the exception, rather than the rule which seems to be implied by the market. We're going to find out shortly as distributions are announced over the next couple of weeks, followed thereafter by earnings and more certainty on the duration of the economic pause due to the coronavirus. Needless to say, we expect midstream will far exceed the market's low expectations.

Thanks for listening.

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.

The S&P 500® Index is a market-value weighted index of equity securities.

The **PCE inflation rate** is the Personal Consumption Expenditures Price Index. It measures price changes for household goods and services. Increases in the PCEPI warn of inflation while decreases indicate deflation.

Broad Energy = 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.

Producers = Tortoise North American Oil & Gas Producers Index℠
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 United States royalty trusts.

MLPs = 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.