Tortoise Energy Podcast

Tortoise

April 27, 2020

Welcome to the Tortoise podcast. Thank you for joining us. Today, Tortoise provides 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.

I would like to start off with a huge thank you to all those on the front lines battling COVID-19 on a daily basis.

On a lighter note, we finally had a "live" sporting event. I used air quotes around live since I'm referring to the NFL draft. It was just good to have a respite from the crazy pace of news coverage regarding the virus and amazing to see so many kids realizing their dream. For the Chiefs, they drafted another weapon to pair with the world's best quarterback, Patrick Mahomes. I'm sure Andy Reid will find creative ways to utilize his newest running back. On a programming note, if you are a basketball fan, I would highly recommend the The Last Dance, the documentary about the 1997-98 Chicago Bulls. I grew up in the '80s and '90s, so Michael Jordan was my favorite athlete and this has been like a trip down memory lane. I've even been able to share it with my two boys, explaining the feeling I had watching Jordan play live in Chicago Stadium as a kid.

Back to reality, let's start things off with market performance for the week that was:

- On the commodity front, crude oil declined approximately 12% for spot pricing, while
- Natural gas was positive with spot up 6.5%,
- Shifting to equities, the broader S&P Energy Select Sector Index® was in the green, up 1.7%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠ shook off oil's volatility, moving higher by almost 9%
- Utilities, per the Dow Jones Utility Index, faltered, lower by 3.5%, similar, but slightly more than the S&P 500's decline
- And finally MLPs had an excellent week, as the Tortoise MLP Index® improved by 9.8%

I basically just brushed over the crude oil price moves for the week, but it was genuinely one of the biggest stories for all markets. So what happened? Well, the price of the front month contract dropped almost $56 in a single day, volatility spiked to 1,400% and we saw our first ever negative price settle for crude oil. Overall, pretty boring week.

But seriously, the movement was unprecedented. On Friday, the 17th of April, the front-month contract settled at $18.27. By end of day Monday, the 20th, it was down to negative $37.63. How could this happen? Well, a confluence of events, starting with the fact the May contract, which was the front-month, was expiring on Tuesday. That meant that any traders that were still long the contract would have to take delivery of crude oil at Cushing, Oklahoma at some point in the month of May if held until expiry.

Think back now to a couple of our last podcasts, where we have talked about crude oil storage filling up, and rather quickly. This presents a big problem. In effect we had a combination of both physical and paper market issues at the same time.

- First, as noted, the May contract was set to expire on Tuesday, so volume was already thin
- Second, the paper market is multiples larger than the physical market, with many pundits pinning the differential at 20x or greater
    - As an example, the amount traded in the paper markets is quite often larger than the entire storage capacity at Cushing, where the oil would theoretically need to be delivered
- Third, on the physical front, we are running out of storage, so taking delivery could be difficult, if not impossible

So what happens, traders get caught in a bind. They simply can't afford to take delivery of a product they have no ability to store. Hence, they are willing to pay someone to take the contract off their hands and we end up with an anomaly, negative prices.

Alas, it was short-lived as prices snapped back on Tuesday and then the front-month contract rolled to the June expiry, with crude settling the week on the futures market at just under $17. I would point out as well, Jim mentioned the contango market last week and it continues to be compelling for storage, with a 12 month differential of $14, half of which is in the first two months.

On the earnings front, the largest utility, Nextera Energy was first out of the gates to report earnings, with a stellar release fit for the industry bellwether. Nextera beat for the quarter, reiterated full year EPS guidance, reiterated 10% dividend growth through 2022 and CEO Jim Robo stated he would be disappointed if they didn't achieve results at or near the top end of their guidance range for the next three years.

That's impressive. Results continue to be driven by steady utility earnings and an industry leading renewables build out.

On the midstream front, Wednesday afternoon, Kinder Morgan became the first pipeline company to report 1Q earnings. Essentially 1Q is a non-event, with almost all focus on outlooks. That said, Kinder was generally a bit shy on 1Q numbers, coming in about 3% below our estimates. They provided what is incredibly difficult, however, guidance for the remaining 9 months.

In total, KMI expects to be approximately 8% below their previously budgeted 2020 EBITDA estimates. The main drivers are within the refined product pipelines segment and the gathering and processing segment. KMI expects refined product volumes to be down ~40-45% in the second quarter, down ~10-12% in the third quarter and ~5-6% in the fourth quarter. We believe given the coastal systems KMI operates, it's likely this is worse than what we anticipate those more centrally located will report, but time will tell. On the gathering and processing front, while a small part of the business, KMI expects a 12% reduction in volumes, with a pretty big variance based on which basin it applies to. I would note, natural gas pipelines with take or pay contracts are not expected to feel any impact. One other perspective, as it relates to counterparty risk, management noted in 2016 they only had $10M related to defaults from customer bankruptcies. Hopefully this go-round will be equally immaterial.

Kinder also increased their dividend by 5%, versus the expectation of 25%, simply due to market uncertainty and wanting to be prudent with capital, which we agree. In what we believe will be maybe the most relevant point for all midstream companies, KMI also reduced capex spending by $700M, or almost 30%. Importantly, this $700M decrease in capital spending was <u>more</u> than the decline in earnings anticipated by the headwinds for the market, i.e. the reduction in guidance, meaning the free cash flow for Kinder is projected to actually be HIGHER than budgeted.

This should not be lost on the market and in most of our discussions with clients and prospective clients, we have tried to highlight the silver lining of the COVID-19 led downturn as a faster reduction in capital spending and hence, a potential for higher free cash flow.

I'll wrap up with just a few quick hit items for the week:

- The rig count continues to plummet, with US rigs lower by 64 week over week and 526 year over year, dropping from 991 to 465
- President Trump tweeted the desire to help the oil and gas industry, but given the partisanship in D.C. to fossil fuels, we aren't holding our breath on this one
- And finally, the government did sign a stimulus bill measure for $484 billion dollars, mostly aimed at small businesses

Earnings pick up extensively this week and some states are attempting to re-open portions of their economies. Needless to say, we will be watching closely.

Have a great week, stay safe, 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.

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

The Alerian Midstream Energy Index is a broad-based composite of North American energy infrastructure companies. The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMNA) and on a total-return basis (AMNAX).

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