Tortoise QuickTake Podcast

August 14, 2017

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.

Thanks for joining us today on the Tortoise QuickTake podcast. I'm James Mick, Managing Director and Portfolio Manager with Tortoise Capital Advisors.

What a difference a week makes. From a macro perspective, the VIX started the week below 10 and just off lows we haven't seen for over a decade. It ended the week up more than 50% at 15.5, primarily due to concerns around rising geopolitical tensions with North Korea. Equities fell, treasuries rallied and everything else became simply noise. Despite that, earnings chugged along for energy companies and are generally complete for the quarter.

Let's kick things off with a recap of market performance:

- On the commodity front, crude oil was down, falling 1.5%, while
- Natural gas was notably higher, up 7.5% on warmer forecasted weather and better than expected inventory numbers
- Shifting to equities, the broader S&P Energy Select Sector Index® declined 2.6%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠, were negative, down 2.7%
- And finally MLPs were also in the red, as the Tortoise MLP Index® fell 4.2%

Simply put, energy had a rough week. Here are some quick hit tidbits regarding the week that was:

- Crude inventories drew over 6 million barrels for the week, but sentiment was somewhat offset by a build in gasoline stocks
- Natural gas inventories built, but were smaller than expected and now stand a mere 2% above the 5-year average
- Venezuela continues to teeter on the verge of serious distress, including a host of U.S. sanctions against members of the government
- The weekly rig count declined by 5 in the U.S., but was mixed as crude oil was up 3 and natural gas was down 8

As it relates to earnings, the week was dominated by midstream company Plains All American and the management guidance they will likely reduce their distribution for a 2nd time in a little over a year.

Let's back up and see how we got here.

In May of 2016, we hosted a podcast that detailed our views regarding potential distribution cuts at Plains All American, Williams Companies and the Energy Transfer family. We felt there was a strong potential that all three would have to cut their distributions to shore up their balance sheets, move coverage back above 1.0x and preserve their investment grade rating. Williams and Plains announced cuts within the next several months and Energy Transfer merged with Sunoco Logistics, effectively lowering their payout.

At the time, our view, and the view of many on Wall Street, was that Plains would cut their distribution about 35%. Instead, Plains cut 21% and felt that was all that was needed. The stock traded better and was actually one of 2016's best performers, up 56%.

2017 has not been as kind. Leverage has remained elevated, above 5.0x and coverage has remained challenged, sub 1.0x.

On Monday, after market close, Plains released earnings, which were generally in-line with guidance, but moved their quarterly call from Tuesday morning to Monday evening. Rarely a good sign. The reason was the desire to inform the market information about a strategic review of the distribution policy, i.e. a likely second distribution cut.

Needless to say, this was a surprise to us. While we knew leverage and coverage were challenged, we felt the fee-based business growth PAA had been exhibiting would buy some time with the rating agencies as a "prove it" story. In particular, Plains had been guiding for increased EBITDA growth in 4Q due to ramping Permian drilling activity and step-ups in minimum volume commitments. Based on that, we felt the agencies would give management some more rope in terms of seeing how that played out.

However, along with earnings, management guided down forecasted EBITDA for 2017 and 2018, due to lower-than-anticipated supply and logistics profits. This segment essentially increases the utilization of the pipelines and terminals segments, but is subject to competition and influenced by basis spreads and the structure of the forward curve for crude oil.

What was once viewed as a $500 million per year business segment is now forecasted to earn $75 million in 2017. Quite a drop.

Exacerbating the issue for Plains has been a multitude of other factors:

1) Plains purchased the Alpha Crude Connector system in the Permian in early 2017 for over $1.2 billion dollars and issued equity for the entire amount

2) Plains pre-funded 2017's capex of approximately $900 million dollars with all equity via their at-the-market program in late 2016 and early 2017

3) Plains paid off the general partner line of credit of approximately $590 million dollars with equity raised via the at the market program

In total, over $2.5 billion of equity was raised and very little cash flow to show for it. This was due to an elevated leverage profile that did not allow for debt funding to be utilized.

But in doing so, coverage suffered and left little room for error on the operating side.

While the acquisition is likely to be a great purchase over time and the projects will eventually generate substantial EBITDA, that is simply not the case right this minute. Plains actually increased capex guidance for 2017 to $950 million dollars. In short, they have a ton of projects via their enviable Permian position, but difficulty funding them all.

Especially in light of the rating agencies, which are exerting serious pressure. Moody's is likely to downgrade the company to high yield and others may or may not follow. Obviously this is part of the reason for the distribution rethink.

Plains noted they are likely to lower the distribution after a 60 day review. An illustrative example was shown by the company, which coincidentally was for an approximately 18% cut and would put the total distribution cut almost right in line with our original 35% estimate.

In short, lowered guidance due to weak supply and logistics segment earnings, along with substantial equity issuance to fund an acquisition and growth capex has kept pressure on leverage and coverage and the agencies are unwilling to wait to see how the 4th quarter plays out.

Hence the likely cut.

We should note, in our view Plains remains a company with an outstanding asset footprint that touches over 50% of the crude oil that moves in the Permian basin on a daily basis. And the projects they have put into service and are building currently are driving growth in fee-based cash flows of over 18% based on management's guidance.

To wrap up, I wanted to touch on a likely misrepresentation of earnings season for 2Q. Obviously stocks have struggled in the energy sector, in particular within midstream. However, a look at earnings versus consensus estimates paints a different picture. For example, the Tortoise North American Pipeline Index℠ contains 86 total companies. Amongst the 86 securities, almost 55% beat expectations. If we take that down one more notch to just the midstream MLP level, 60% beat consensus. Additionally, average EBITDA growth on a year over year basis was 21% for midstream companies and also 21% for the narrower midstream MLP level. Probably not the takeaway you would have expected given the recent weak stock performance.

Oftentimes investors extrapolate one or two earnings to the entire group. Which reminds me of a great quote to end on, credited to the Hudson Institute.

"The old straight line extrapolation is just the shortest distance between two mistakes."

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@tortoiseinvest.com.

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The Tortoise MLP Index® 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.

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