Tortoise QuickTake Energy Podcast

Dec. 19, 2018

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Rob Thummel: Welcome the final Tortoise podcast for 2018. I am Rob Thummel and I am joined by my fellow portfolio managers Brian Kessens, James Mick and Matt Sallee. Today, we are going to highlight what happened in the energy sector in 2018 and MLP sectors in 2018 and give you a sneak peek into 2019. So, let's get started. Matt, can you set the stage by reviewing year-to-date performance across the energy sector?

Matt Sallee: I sure can Rob. It hasn't been pretty! Oil started the year strong before frankly falling apart in the fourth quarter. This pulled E&Ps and oilfield services down with it which were both up through the year-to-date period starting the fourth quarter but have really gotten clobbered in the fourth quarter now down about 20% and 40%, respectively. Even the refiners weren't immune which should benefit from lower crude prices. And I'd say for me personally, what was particularly the most frustrating was midstream giving up its year-to-date gains in the fourth quarter after printing three straight quarters of phenomenal profits and they're now down mid-single digits for the year through last Friday.

Matt Sallee: I guess moving along Brian, I mentioned that oil prices have been on a bit of a roller coaster ride in 2018. Can you talk about what happened there and maybe at the same time hit why natural gas prices have recently surged?

Brian Kessens: Yes, thanks Matt. For the better part of 2018, OPEC's level of compliance with its production agreement was well over 100%. Global inventories reached their historical level and the U.S. indicated it would place sanctions on all Iranian crude oil exports that would start in early November. With supply and demand in balance and a view of reduced Iranian supply, the price for WTI reached a high of $76 per barrel in early October. In advance of the sanctions, Saudi Arabia ramped production to ensure supplies were not interrupted. This supply ramp and the decision by the U.S. to grant waivers to eight countries to continue importing Iranian crude oil resulted in a sharp correction in crude oil prices, to the point where WTI stands at $46 per barrel today. To achieve supply and demand balance again, then in early December, OPEC plus Russia agreed to reduce supplies by 1.2 million barrels per day. We think this sets up a balanced market in 2019.

Matt, you also mentioned natural gas prices which stayed fairly level for the better part of the year at prices above $3.00 per mmbtu. While production growth was strong at 8 Bcf/d, or about 10% higher, demand increased even more at 9 Bcf/d, led by more natural gas demand for power generation and exports. With demand ahead of supply, inventories entered the start of the heating season at low levels relative to recent history and with a cold snap in November, prices leaped to $4.90 per mmbtu. Prices have since moderated, they're now at about $3.75, yet if we see merely average temperatures this winter, inventories throughout 2019 are set to remain low.

Brian Kessens: And I guess looking back at the year, all of us have highlighted multiple times the strong fundamentals that are supporting the energy sector. James, removing fundamentals from the equation, what's been the biggest surprise in the midstream sector in 2018?

James Mick: I think for me, 2018 has really been the year of the transaction. Now we certainly anticipated coming into this year the continuation of the simplification theme for midstream MLPs in 2018, but I think it has definitely accelerated beyond our expectations. In particular in the back half of 2018. And just to be clear, what I mean by simplification primarily is eliminating the incentive distribution rights, or IDRs from the partnership. And just to give a little bit of context, in 2007 there were only about 4% of the names within the Tortoise MLP Index® that was IDR free. In 2012, that number had moved up to 28%. In 2017, it had jumped again, this time to 52%. But in 2018, we have accelerated with 75% IDR free, an almost 25% move in just one year. One final point on the magnitude of the change this year, we entered 2018 with 49 midstream MLPs in the Tortoise MLP Index®. That's not all MLPs, just the midstream side. Of those, seven had previously eliminated their IDRs.

So that left 42 companies. Of those remaining 42, over half, or 22 of them have been involved in a transaction in 2018. Just an amazing number when you think about it.

Brian Kessens: Thanks James. Rob maybe the same question for you only for the upstream sector.

Rob Thummel: Sure. In our opinion, companies in the energy sector are operating essential assets that are making a positive impact. You look at the energy sector there were numerous records set in 2018. For example, records levels of production of crude oil, natural gas and natural gas resulted in record levels of exports of all energy commodities in 2018. And we believe that record levels of oil and natural gas reserves set up the sector for continued record breaking activities in the years to come. In fact, the Department of Energy predicts that the U.S. will become a net energy exporter by 2022. But what surprised us? U.S oil production growth of 1.5 million barrels per day and total liquids growth of over 2 million barrels a day which was much higher than we forecast. We expect though the pace oil and gas production growth really to moderate in 2019.

James Mick: Well, we can't end the podcast without talking about valuation. Matt, can you highlight the one or two key valuation metrics that make the midstream sector compelling from a valuation perspective?

Matt Sallee: Sure James. Typically we talk about EV to EBTIDA, price-to-DCF and the discounts that midstreams are trading at. Frankly we've been talking this until we're blue in the face and nobody seems to care. So let's talk about good old fashioned price to earnings. If you go to your Bloomberg terminal and look up your favorite midstream index, you'll find it's about a 10 year average price-to-earnings ratio of about 23x. You may think this sounds a little bit elevated, but you have to keep in mind these companies have significant depreciation hitting earnings due to the asset intensive nature and fast investment that these companies have made over the last ten years. So that explains why that's higher than you would typically think. If you look at the price-to-earnings ratio today it stands at about 11x or about a 50% discount to where these names have traded over the last 10 years. On the other hand if you look at the S&P 500 for comparison, its 10 year average PE is 17x. Today it's at 17.4, so a small premium to its historical average. So said differently, midstreams have historically traded at a 35% premium to the S&P due to the defensive nature and strong growth outlook but today it's at an almost 40% discount to the S&P 500. So it certainly doesn't jibe with the record profits that these companies are producing. Maybe they need a better social media platform or they should talk about AI more often or something to get investors interested**.**

James Mick: Rob, do you have anything to add from outside of the midstream sector?

Rob Thummel: Surely we can talk about that James. In our opinion, the sector looks attractive based on historical EV/EBITDA multiples. But to Matt's point, one of the most intriguing things about the energy sector is the price-earnings ratio. But then when you factor in growth and turn it into a PEG ratio, we think it gets even more interesting. So, based on our calculations, the energy sector has the lowest PEG ratio amongst the sectors in the S&P 500 making it very compelling to investors that are looking at the sector. So to bring new investors to the energy sector, we believe that we need stable oil prices and capital discipline that will result in companies in the energy sector building a mountain of cash flow over the next five years. We expect OPEC plus Russia to do its part to keep oil prices stable in 2019. And as U.S. energy companies continue to build excess cash flow, we expect the pace of shareholder-friendly activities such as buybacks to accelerate.

Rob Thummel: Alright, so let's wrap up with a sneak peek into our outlook for 2019. Starting with James, can you start with our 2019 midstream outlook?

James Mick: Definitely. I think it can really be summarized in 3 main bullet points:

1) Structure
2) Return of Capital to Shareholders
3) Flows

So, on structure, I would highlight two things. 1) we believe simplifications continue, but are almost complete, giving us a lot more confidence moving forward on structure and 2) as part of the simplification, companies are self-funding the equity portion of our capex programs.

On return of capital, we think this is going to take several forms, including sequential growth in distributions, selling non-core assets to arbitrage the valuation gap between what private equity is willing to pay, which is pretty high, and what midstream is trading at, which is pretty low. And finally, we believe a select few midstreamers will institute buybacks that will help the sector as well.

And then, in regards to flows, we are involved in searches on the institutional side, we know of new closed end funds that are being launched, focused on energy and new entrants. And then insurance companies are coming into focus as a potential client. So we see upside coming on flows into the sector as well.

I think the bottom line, outside of fundamentals and valuation, we feel the steps are being taken by companies to attract capital and we'll be right there pushing them as needed!

Rob Thummel: And Brian, will you share our insights on our energy 2019 outlook?

Brian Kessens: Sure, we think the commodity backdrop is good with crude oil in balance and natural gas inventories low. With prices above $40 per barrel break-even prices in the U.S., we expect U.S. production growth for crude oil, natural gas and NGLs to meaningfully increase again. Producers are increasingly spending within cash flow and targeting returns to shareholders in the form of higher dividends and share buybacks. We do think service companies will continue to suffer from overcapacity. In downstream, global gasoline and finished product demand remains steady to the benefit of refiners. We believe U.S. refiners in particular will also benefit from lower local crude oil prices versus Brent prices in the first half of 2019 as pipeline takeaway capacity remains short. We expect petrochemical companies to take advantage of higher NGL supplies and utilities to find opportunities to include renewable infrastructure in their rate base. With higher global demand and changing sources of growing supply, energy is set-up well in 2019.

Rob Thummel: Okay thanks Matt, Brian and James. And thank for joining us today. We appreciate your interest in Tortoise. We look forward to continuing our weekly podcasts in 2019. Happy holidays everyone!

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.

The indices are the exclusive property of Tortoise Index Solutions, LLC, which has contracted with S&P Opco, LLC (a subsidiary of S&P Dow Jones Indices LLC) ("S&P Dow Jones Indices") to calculate and maintain the Tortoise MLP Index®, Tortoise North American Pipeline Index℠ and Tortoise North American Oil and Gas Producers Index℠ (each an "Index"). S&P® is a registered trademark of Standard & Poor's Financial Services LLC ("SPFS"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and, these trademarks have been licensed to S&P Dow Jones Indices. "Calculated by S&P Dow Jones Indices" and its related stylized mark(s) have been licensed for use by

Tortoise Index Solutions, LLC and its affiliates. Neither S&P Dow Jones Indices, SPFS, Dow Jones nor any of their affiliates sponsor and promote the Index and none shall be liable for any errors or omissions in calculating the Index.

Disclaimer: *Nothing contained in this communication constitutes tax, legal, or investment advice. Investors must consult their tax advisor or legal counsel for advice and information concerning their particular situation. This podcast contains certain statements that may include "forward-looking statements." All statements, other than statements of historical fact, included herein are "forward-looking statements." Although Tortoise believes that the expectations reflected in these forward-looking statements are reasonable, they do involve assumptions, risks and uncertainties, and these expectations may prove to be incorrect. Actual events could differ materially from those anticipated in these forward-looking statements as a result of a variety of factors. You should not place undue reliance on these forward-looking statements. This podcast reflects our views and opinions as of the date herein, which are subject to change at any time based on market and other conditions. We disclaim any responsibility to update these views. These views should not be relied on as investment advice or an indication of trading intention. Discussion or analysis of any specific company-related news or investment sectors are meant primarily as a result of recent newsworthy events surrounding those companies or by way of providing updates on certain sectors of the market. Tortoise, through its family of registered investment advisers, does provide investment advice to Tortoise related funds and others that includes investment into those sectors or companies discussed in these podcasts. As a result, Tortoise does stand to beneficially profit from any rise in value from many of the companies mentioned herein including companies within the investment sectors broadly discussed.*