Tortoise QuickTake Special Year-End Podcast

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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.

Ed Russell: Hello, I'm Ed Russell, Senior Managing Director at Tortoise. Thank you for joining us for our 2016 year-end/2017 outlook QuickTake podcast. I'm joined today by Tortoise portfolio managers Brian Kessens, James Mick and Rob Thummel. We're going to discuss key topics of interest and provide our energy sector outlook for 2017. With that, let's begin. Rob, what's the broad energy outlook for 2017?

Rob Thummel: You know, 2016 has really been a great year for the energy sector. When you look back at the U.S. energy sector in 2016, it was really a milestone year with 2016 being the first year that the U.S. exported U.S.-produced crude oil, natural gas and ethane, which is a natural gas liquid.

If you look at investor sentiment, investor sentiment towards the sector has flipped and is now positive. We're entering a new era with the recently announced production cuts by OPEC and non-OPEC producers. This means oil prices are expected to remain stable and to eventually move higher, which is a positive catalyst for the entire sector.

Additionally, President-elect Trump has talked about achieving American energy independence and eliminating excessive regulatory burdens on the industry. So in summary, the table is set for the U.S. energy sector as we move into 2017.

Ed Russell: James, what's your MLP outlook for next year?

James Mick: Sure. I think given the backdrop that Rob just highlighted, we have a positive view for the MLP outlook in 2017.

Just a quick background, we would expect returns to be in the neighborhood of 12% to 15% with potential upside from there. That return breaks down as follows: The yield on the Tortoise MLP Index® is currently about 7.5%. We anticipate distribution growth for the index of 5% to 7% for 2017, so that in total generates the 12% to 15% return noted.

Additionally, though, we could definitely see a compression of the yield, meaning that the market multiple trades higher if energy sentiment continues to improve. Just as an example, the three, five and ten-year median yields on the index are 6.0%, 6.1% and 6.5%. So, if we simply move back closer to those averages, the total market return will exceed the 15% that I mentioned.

Now, some of the factors that could cause us to move back closer to those yields: 1) an uptick in growth expectations; supply growth in commodities resumes, increasing volumes, and of course leading to new projects; 2) an increase in investor appetite for yield-oriented products such as MLPs; and 3) relative value of MLPs to other yield-oriented asset classes such as REITs and utilities. Of course, that's just a couple of factors, but it does give you an idea of what could happen to cause the higher returns.

And then on the flipside, higher interest rates may pose a near-term headwind, and of course OPEC compliance is clearly something that would be seen. But in general, we are positive on the space and see the potential for higher production to help bring back some of the supply-push projects that have been waning during the commodity price downturn and will help support distribution growth along with the current slate of demand-pull projects.

Ed Russell: Brian, what's the C-Corp pipeline outlook?

Brian Kessens: Sure. We're largely agnostic of MLP versus C-Corp for corporate pipeline structure. What James discussed largely holds for C-Corp pipelines as well. We think pipelines in the ground are increasingly even more strategic assets essential to support increasing oil and gas production. For C-Corps, cash flow multiples are in-line with historical averages, and with an index yield of around 4% and dividend growth of 5% to 7%, we expect total returns to be in the low double digits. An added benefit could be if the corporate tax rate is reduced.

Ed Russell: Rob, since you spent so much time this year on CNBC talking about crude oil prices, can you tell us what we think about the upstream sector in 2017?

Rob Thummel: Sure. I'm going to focus on the North American oil and gas producers as well as oilfield service operators. So, $50 really seems to be the line of demarcation. If oil prices stay above $50 per barrel, we expect to see oil producers increasing capital expenditures, which ultimately results in production growth. U.S. producer response to lower oil prices has been remarkable as some oil producers, particularly in the Permian Basin, have lowered their production costs to levels that allow U.S. producers to compete in the global oil markets. In fact, some U.S. producers produce oil at cheaper costs than some OPEC countries.

But there is more to the U.S. energy story than oil. Natural gas producers, specifically in the Marcellus Shale, are expected to grow production volumes and to respond to rising domestic as well as international demand for cheap U.S. natural gas.

From an oilfield services perspective, offshore drillers will remain challenged in 2017 as commodity prices remain too low to encourage significant deep water type of drilling. Onshore drillers will likely be able to boost revenues as they raise prices for the first time in several years. Additionally, demand for sand is forecasted to accelerate as increased sand concentration tied to the fracking process has been one of the ways that oil and gas producers have been successful in increasing the volume of oil and gas recovered from each well drilled.

Ed Russell: Brian, can you share your thoughts on the downstream sector?

Brian Kessens: Sure. Given our expectation for higher crude oil prices next year, refiners had a headwind from higher input costs that could be offset somewhat by wider differentials to the extent bottlenecks occur from greater production. The biggest item for refiners to watch for next year might be reform in renewable fuel standards that mandate a certain amount of ethanol blending. Today, the biggest cost after crude oil for merchant refiners is the compliance cost of supplying renewable identification numbers, or RINs.

For utilities, we expect continued generation investment in cleaner energy like natural gas, wind and solar to drive growth. Yet, given their historical correlation with interest rates, higher rates next year may weigh on the stock performance.

Ed Russell: Brian, we're getting a lot of questions from advisers about the President-elect. What specifically about a Trump administration leads you to have more confidence in oil and gas?

Brian Kessens: Yes, Trump has publicly made energy a central part of his agenda, supporting oil and gas and reviving the coal industry. Several of his appointments are to oil and gas supporters, and none of those is bigger than Exxon's CEO, Rex Tillerson, to the role of Secretary of State. He also picked former Texas Governor, Rick Perry, to head the Department of Energy and the Attorney General of Oklahoma, Scott Pruitt, to lead the EPA. Further, he's already indicated support for the Dakota Access Pipeline and in restarting the Keystone XL pipeline project to bring more crude oil from Canada to the U.S.

We think energy companies can invest more confidently over the next four years with less concern over federal delays.

There is one potential negative with this backdrop that we've already mentioned, which is an increase in interest rates following Trump's plan for a fiscal stimulus.

Ed Russell: James, let's stick with that issue. Interest rates are expected to increase next year. How will that impact MLPs?

James Mick: Well, it's a great question, and it's one that we're getting frequently from investors just given the recent rise of roughly 75 basis points in the ten-year treasury since the election. From our view, we evaluate the impact of rising rates from both a direct and an indirect basis on MLPs.

First, just from a direct standpoint, there's an impact to the extent that a company has floating-rate leverage. The key mitigating factor is that midstream MLPs are approximately 80% fixed-rate debt, so this impact is very minimal on their cash flow.

Second, from an indirect standpoint, we look to assess the impact on the weighted average cost of capital and returns over and above that cost of capital. While you should see some increases in the cost of debt and equity, there are several mitigating factors in our view that help lessen the impact of the higher rates and ultimately allow companies to continue growing their distributions. A few of those mitigating factors are 1) excess coverage; 2) internal versus external growth; and then 3) the ability to pass through inflation via either higher rates or volumes.

Next, we simply look at what history has shown us. What we've seen historically is that when rates have increased by 50 basis points or more, the return of MLPs has actually been quite positive and similar to what you see in the S&P 500® Index. In fact, MLPs have averaged a 6.4% return based on the 12 different time periods that we have noted previously. This compares favorably to the S&P 500® Index average return of about 6.7% for the same time periods.

Finally, I point out two more important data points. First, we evaluated the spread of the MLPs to the ten-year treasury for two different scenarios. The first is when the ten-year is above 4%, and in those instances, the average spread to MLPs is roughly 256 basis points. The second is when the ten-year is below 4%, and in those instances, the average spread to MLPs is roughly 450 basis points. The key takeaway is that as the ten-year moves higher, the spread is historically not a linear function, but rather will compress; hence, MLPs don't have to trade off simply because the ten-year is moving higher.

And then second, we ran correlation data for the ten-year treasury to MLPs and confirmed that traditionally over essentially all time periods, including one, three, five and ten-year, the correlation is exceptionally low and actually is lower with more recent time periods, one more indication of our view that MLPs trade more as equities as opposed to fixed income due to the growth component.

In summary, while you may see some near-term impacts on MLPs from rate moves, we feel that the data points to a more positive story, and history has shown that to be the case as well.

Ed Russell: Thank you, James. Let's switch to commodities. Rob, crude oil prices are in the news daily with the tug-of-war between OPEC and shale. What do you expect to happen in 2017?

Rob Thummel: Our expectation is that both OPEC and non-OPEC producers carry out the commitments agreed to in early December. What happens next is the global oil supply begins to fall while global oil demand continues to increase. As a result of that, concerns regarding excessively high global oil inventories will subside as global oil inventories continue to fall and ultimately return to historical or more normal levels. From there, oil prices will likely remain range-bound between $50 and $60 a barrel in 2017, but this is a real sweet spot as certain U.S. producers can still earn adequate rates of return at these prices, but just as important, global consumer demand remains high as well.

Ed Russell: Brian, what about natural gas prices?

Brian Kessens: Well, it's been cold, and inventories are below where we were last year at this time. Supply has been relatively flat this year, and next year expect continued increased demand, notably for more coal to natural gas switching in power generation, greater exports in the form of LNG as additional facilities come online, exports increased to Mexico and industrial activity increases along the Gulf Coast.

From those sources alone, demand could be at least 4% higher. If the winter is even moderately cold, supply is going to need to get going. For that reason, we think natural gas prices remain stronger next year, north of $3 per MMBTU.

Ed Russell: Okay, I'm going to open this up to all three of you. What are any surprises you think could happen in 2017? Brian, can you start.

Brian Kessens: While there has been a fair amount of M&A activity in 2016, particularly in the Permian Basin, we think 2017 could result in even more activity for several reasons. Capital markets are open for energy issuance. Stock prices have rebounded from lows where sellers now feel that they aren't crawling on a bottom. The Trump administration, as we've already discussed, provides a better oil and gas investment climate. And bond prices for high-yield energy companies are closer to par; buyers no longer have to pay a significant bond premium to the sellers' debt holders.

Specifically, MLPs share this same rationale, including the desire to lower their cost of capital through simplification. Look for that too.

Ed Russell: Thanks, Brian. Rob, what about you?

Rob Thummel: You know, the export theme that we highlighted is expected to accelerate and could be a surprise. The U.S. possesses a lot of low-cost oil and natural gas, and we haven't been able to say that for very long. As global demand for oil and natural gas continues to rise, the U.S. will be a critical supplier. Even with OPEC cutting back on production, OPEC spare capacity is relatively low. What this means is that U.S. oil and gas producers will likely continue to increase production volumes. In addition, additional energy infrastructure will need to be constructed to support increased exports of U.S.-produced oil and natural gas.

Ed Russell: Thank you, Rob. James?

James Mick: Yes, I think just given the interest rate backdrop, we think that you could see a larger rotation out of bonds and into equities. This could frankly be a pretty big factor in helping drive the market higher. Of course, a lot of investors are still likely to be focused on finding yield, especially to replace those fixed income investments. We think MLPs can benefit from this.

We've looked at performance of a couple different asset classes since the election, and it's interesting to see how things have responded. Just generally, REITs are flat. Utilities are down about 2%. The ten-year treasury is down a little over 6%. Meanwhile, MLPs are up 6%. We think that the positive energy backdrop bodes well for capital to flow into not just MLPs, but energy broadly.

Ed Russell: Okay, great. Well, thank you, Brian, James and Rob. That concludes our discussion. Thank you for joining us and for your support. This will be our last podcast for 2016, so we wish you a happy holiday season, and we'll speak to you again in 2017.

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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