Tortoise

Tortoise QuickTake Podcast

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

Ryan Holloman: Hello, I'm Ryan Holloman, Vice President at Tortoise. Thank you for joining us for this special QuickTake podcast. I'm joined today by Tortoise portfolio manager Brian Kessens and Institutional portfolio manager Greg Murphy. We're going to discuss short-term trends and our long-term energy outlook. Some of you may be wondering if this is a timely entry point for an energy investment. We'll cover our thoughts on that too. With that, let's begin.

Brian, pipeline returns are now roughly flat through the year-to-date period after starting the year higher. What do you think happened?

Brian Kessens: After starting the first six weeks of the year higher by 3.7%, the Tortoise North America Pipeline Index℠ (TNAP) has fallen about 1.0% since. While not in perfect lock-step, the selloff coincided with a downturn in the price of crude oil, which currently is the key driver of energy market sentiment. Energy investors continue to see inventories build in the U.S. despite OPEC's reduction in crude oil supplies.

Furthermore, Saudi Arabia's rhetoric is unclear about whether the OPEC cuts through the first half of the year are likely to be extended to the second half. We think the rhetoric is about maximizing OPEC member compliance, and expect the cuts to be extended. The previous OPEC strategy to maintain market share lasted two years. We do not think there is a willingness to give up on this one after just six months.

This more recent macro oil news overshadowed what we think was a good earnings season for pipeline companies to start the year. In our view, guidance for 2017 was constructive and new project announcements were healthy on the heels of the producer community outlining growth plans for the year.

Ryan Holloman: Greg, staying with those thoughts, do you think oil prices should drive the stock prices of pipeline companies?

Greg Murphy: We get this question or some version of it a lot. The first thing I'd say is that the question seems to presuppose that pipelines are somehow homogenous and that they all have some sort of exposure to crude oil. The fact is that currently the Tortoise North America Pipeline Index℠ (TNAP) has exposure to a variety of different kinds of pipelines; natural gas long-haul pipelines and local gas distribution pipelines actually represent about 58% of the constituents of that index. Gathering and processing companies, those are the smaller pipelines that run out to the wellheads throughout a production field and generally generate the bulk of their revenues and cash flows from processing natural gas, represents 16% of the TNAP. The bulk of the remaining 25% or so of the index is made up of crude oil pipelines. So arguably 75% of the index is more geared toward natural gas markets yet it has been years since I've been asked questions about correlations to natural gas prices.

Of that 25% of the index that are crude oil pipelines earn revenues based on throughput, that would be the volumes moving through the pipeline, not the price of the commodity. Over the intermediate and long term, the price of the commodity can have derivative effects on volumes, but the current narrative driving down oil prices is that the U.S. will be growing oil production too fast which is actually bullish near-term for pipelines volume and the midstream more generally.

I guess that's sort of a roundabout way of answering the question, but I think from a fundamental perspective, daily movements up or down in oil prices should not be driving pipeline returns.

Ryan Holloman: Thanks Greg. Brian, your team is focused on the long-term, yet energy headlines whether related to rhetoric out of OPEC or current inventory, dominate the headlines and daily stock price movement, even for pipeline companies as Greg just discussed. What do you think we should look for over the shorter term?

Brian Kessens: Well, seasonally, it is spring which is a period when refinery maintenance peaks. Basically, refineries reconfigure their operations to change over from producing a winter grade of gasoline (that includes more butane) to producing a summer grade. During this period, crude oil inventories increase as refineries just use less. Recently, the market's been trying to discern whether rising inventories are due to too high of supply globally or simply lower refinery utilization.

As we look into April, we expect refineries to come out of maintenance and to increase their demand for crude oil in the second half of the month. Inventories should then start to fall.

And looking forward to May, OPEC is set to meet on the 25th. We expect a lot of commentary between now and then from OPEC ministers threatening to end the production agreement, yet ultimately we expect the cut to be extended to the second half of the year because global inventories are not yet at historical levels which is one of the aims of the cut.

These items are likely to drive energy sentiment. For pipelines, we believe you should look for new project announcements, another good earning season that starts in mid-April, and the capital markets. We expect at least one MLP IPO to price in the second quarter.

Ryan Holloman: Greg, do you think the Trump administration will be good for oil and gas companies?

Greg Murphy: Putting aside politics and many of the common narratives, by almost any measure the eight years of the Obama administration were a great time for the oil and gas industries. Think about this, in 2008, the year Obama was elected, but hadn't yet taken office, domestic production of natural gas was about 55 Bcf/day and domestic crude oil production was about 5.0mm bpd. In 2016, obviously Obama's last year in office, domestic gas production was up to 72 Bcf/day, that's up 30% over the course of his administration, while oil production was 8.9mm bpd, up almost 80%. So it's really just an amazing success story for the industry!

So the question about "will the Trump administration be good for oil and gas companies?", I think it definitely will. As long as the regulatory environment does not get worse than what we saw under Obama, I think the oil and gas industries should continue to prosper. If the Trump administration can make some moves to intelligently lessen the regulatory burdens, I think that would just be gravy for the industry.

Ryan Holloman: Brian, in your view, how big a part of the energy story is natural gas, and are the dynamics for gas similar to oil?

Brian Kessens: We believe that natural gas is a huge part of the energy story. As Greg mentioned, in one shape or another, natural gas is 75% of the Tortoise North America Pipeline Index℠. Different from oil which is global, natural gas is largely a domestic market. The U.S. has had more natural gas than needed for the past couple of years, and 2016 in particular was notably poor from a demand perspective due to the warm winter of 2015-16. Consequently, there's been little production growth over the past two years. That's now changing as new sources of demand emerge.

Last year, the U.S. exported natural gas in the form of LNG for the first time. And with two LNG facilities coming on-line last year, three more are expected this year. We also anticipate more exports to Mexico, coal to natural gas switching to continue in the power generation sector and more industrial activity to drive demand for gas. By the end of the decade, we believe demand is likely to be about 15 Bcf/d or approximately 20% higher from current levels. This will require not only more production, but more pipeline takeaway capacity from areas like the Marcellus in the Northeast, and even the Permian basin in West Texas.

Ryan Holloman: Greg, if we stay focused on the long-term, what do you believe is the opportunity for energy pipelines beyond the next year?

Greg Murphy: We spoke a few minutes ago about the phenomenal successes of the industry in growing production of oil and gas over the last 8 years. I don't see the general trend in production growth ending anytime soon. Admittedly, I am not calling for another 30% & 80% growth in the next eight years, but neither is domestic production peaking at our current levels. The infrastructure build that accompanied that rapid rise in production is still on-going. We are effectively upgrading and re-plumbing many areas of the country to bring hydrocarbons from where we're finding them to where they need to go to be utilized. As production continues to grow, we continue to need to build and improve the pipes and tanks that move and store this production.

Back in January, the U.S. Energy Information Administration (EIA), published their Annual Energy Outlook for 2017. In reviewing that document, one of my key takeaways was that in the reference case, which is generally like their base case scenario, the U.S. moves from being a net importer of energy to a net exporter of energy by 2026. We've been a net importer of energy since 1953 and every President since at least Nixon has talked about "energy independence" and now it seems to exist, if only just over the horizon.

To bring that independence to reality, we are going to need more infrastructure; certainly more LNG export infrastructure, more refined product export infrastructure and more pipes and tanks that bring the hydrocarbons from the wellhead to the exporter or the consumer.

We are often asked if the pipeline system is overbuilt. Based on everything I am saying here, I'd say the answer is a resounding no. We see these strong drivers for increasing utilization and continued infrastructure investment for many years to come.

Ryan Holloman: Brian, the Fed continues to raise rates. How do you think MLPs and pipeline companies will perform in light of higher rates?

Brian Kessens: We looked at what history tells us, and there are 13 periods since 2000 when the 10-year Treasury increased by 50 basis points or more. In those periods, bond returns averaged a negative -1.4%, no surprise there. The S&P 500® Index is higher by an average of 6.5% and the performance of pipelines as measured by the Tortoise North American Pipeline Index℠ is similar, higher by an average of 5.6%.

We think there's a few reasons for this: (1) pipeline company dividend and distribution growth allows the stocks to grow through higher rates, (2) generally, higher interest rates are associated with better economic growth which means energy demand, and the volume moving through pipelines, is higher in better economic periods, and (3) higher interest rates also imply higher inflation. And many pipeline companies have an ability to pass along inflation in the form of higher tariffs pegged to the rate of inflation.

So to the extent the Fed increases rates two or three more times this year, we think that implies the economy is growing and expect pipeline companies to perform well in that scenario.

Ryan Holloman: Brian, what is your outlook for pipeline companies the rest of this year?

Brian Kessens: We expect total returns of low double digits for pipelines in 2017, with a mix of both current income where MLPs now yield about 7% and growth of 5%-7%. New project announcements have started after slowing in 2016 and we expect that trend to continue, especially in the Permian Basin related to gathering and processing, crude oil and even new natural gas pipelines. We're also seeing more activity in Oklahoma and the Haynesville shale. And certainly, the export infrastructure build continues as well.

We also expect more M&A activity this year as the bid-ask between buyers and sellers narrows. In front of that, potential buyers are simplifying their organizations through IDR buybacks to lower their overall cost of capital to be better positioned to make accretive acquisitions. We believe that companies are also taking the view that having a C-Corp and an MLP security is not a bad thing as it provides two options to raise capital.

Ryan Holloman: Greg, the last question goes to you. A lot of potential energy investors missed the outsized returns last year? In your view, is the recent pullback, a good buying opportunity?

Greg Murphy: Look, if a potential investor is waiting for an entry point that has valuations looking like they did in February 2016, I hope they have to wait a very, very long time, or honestly, I hope midstream valuations never go back there again. But really, that is a good thing. With the markets as disrupted as they were in early 2016, there was just a lot of fear if not outright panic in the energy market.

Warren Buffett famously wrote in an op-ed piece in the New York Times in October of 2008 that among other things to "be greedy when other are fearful." As you allude to in your question, investors who bought or at least did not succumb to the fears of the market in early 2016 have done very, very well.

We have covered a lot of ground on the conversation today. We have said that the near-term and longer-term fundamentals for the industry appear very strong. We have discussed that daily volatility in oil prices seems to be driving all pipeline stock returns, even if we believe there is no fundamental reason for them to be doing so. I guess what we have not talked about is current valuations. While the valuations may not be where they were in early 2016, to me, they still seem very attractive compared to historical averages, really on almost any measure.

I call myself thrifty, others might call me kind of a cheapskate. If I can, I like to buy things when they are on sale. To me it feels like the pipeline stocks are on sale. Could they go lower, sure. But over the next six, 12, or 24 months if the trends we have talked about today play out, I think we look back and see this was an attractive entry point in the market.

Ryan Holloman: Thank you Brian and Greg. That concludes our discussion. We hope this has been helpful. Thank you for joining us, 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.

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

The Tortoise North American Pipeline Index℠ is a float-adjusted, capitalization weighted index of pipeline companies headquartered in the United States and Canada. A pipeline company is defined as a company that either 1) has been assigned a standard industrial classification ("SIC") system code that indicates the company operates in the energy pipeline industry or 2) has at least 50% of its assets, cash flow or revenue associated with the operation or ownership of energy pipelines. Pipeline companies engage in the business of transporting natural gas, crude oil and refined products, storing, gathering and processing such as gas, crude oil and products and local gas distribution. The index includes pipeline companies structured as corporations, limited liability companies and master limited partnerships (MLPs)