Tortoise QuickTake Energy Podcast

Sept. 26, 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.

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

Warren Buffett was quoted as saying, "The stock market is a device for transferring money from the impatient to the patient." No doubt energy investors have been very patient over the course of this downturn, yet the rewards are coming as the fundamentals are getting too tough to ignore.

We'll kick things off with market performance for the week that was:

- On the commodity front, crude oil was strong, rising 4%, while
- While natural gas was even better, closing the week almost 8% higher
- Shifting to equities, the broader S&P Energy Select Sector Index® increased 1.9%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠ tracked the commodities, gaining 3.3%
- And finally MLPs were slightly negative, as the Tortoise MLP Index® fell 51 basis points

It seems many of our questions right now revolve around two main topics. One, our outlook for crude oil prices and two, what the heck is wrong with midstream?

I'll tackle the crude oil price expectation first. Bottom line, it appears to us that the bias for crude oil prices at this point has to be higher. There are several reasons to be bullish, but here are a few:

Iranian exports have come off dramatically. Recall, U.S. sanctions are supposed to kick in starting in November, yet we have already seen sharp drops in exports to numerous countries as no waivers have been given by the U.S. so far. Notably, even China and India appear to be showing some level of tapering of purchases. In total, research firm Energy Aspects believes we could see 1.6 million barrels per day of Iranian exports removed from the market.

OPEC's Joint Ministerial Monitoring Committee met over the weekend and effectively led to nothing, as it simply reaffirmed the 100% compliance of the original 1.8 million bpd cut. Any increases will be strongly opposed by Iran, who would look to block. And while President Trump continues to put pressure on the Saudi's via tweets, OPEC's largest producer also noted it is comfortable with $80 oil prices.

Tensions continue to escalate in the Middle East with the latest a terrorist attack in Iran over the weekend.

Demand remains robust, despite concerns regarding emerging markets.

And finally, spare capacity to deal with all the world-wide potential supply disruptions remains at exceptionally low levels, with the Saudi's currently about 300,000 bpd below its previous peak of 10.8 million bpd. We don't know what Saudi's actual capacity truly is, but in terms of the ability to bring on supply quickly, it appears the two year ago number is the best estimate. In other words, supply risk far outweighs demand risk. In our view, providing upside to current oil prices.

The second big question we often get is, what is wrong with midstream and specifically MLPs? First some context. MLPs are currently up approximately 5.5% for the year-to-date period and about 6.5% for the last twelve months. Now consider that during that time, we have seen the impact of a major hurricane that hit the Gulf Coast, tax law changes that many feared would wreck the MLP structure, an initial negative outcome from the FERC on tax allowances in pipeline tariffs and then a reversal of that same news, and oh by the way a 10-year treasury rate that has risen 65 and 84 basis points from the beginning of the year and one year ago, respectively. Despite all that, as noted, MLPs are actually positive.

Yet we recognize they still remain undervalued based on historical metrics for valuation. This despite what we believe are some of the strongest fundamentals we have seen in midstream in the last 15 years.

So we did some brainstorming and after identifying a list of risks in our view, we came up with two predominant areas of focus, one is structure and two is allocation of capital.

Structure seemed to dominate our topics. We feel however that this is quickly becoming less and less of an issue for MLPs as companies put forward plans to simplify and eliminate incentive distribution rights and complicated structures, which will in turn improve governance. We aren't all the way there yet, but significant progress has been made and by the end of 2018, we will likely have over 70% of the Tortoise MLP Index® without IDRs. That extends to 85% by 2019 based on our estimates. The second area of focus was allocation of capital. Ultimately companies must be good stewards of capital and efficiently and effectively allocate it in the best manner possible.

While this is always playing out on a continual basis, what we can say about the current environment is that companies are working together more and more frequently to build projects as partners. What we hope this will do is help lower the risk of overcapacity and ensure utilization of assets remain at high levels.

Additionally, we have seen several MLPs sell assets at attractive multiples and then redeploy that capital into growth projects at better returns. Midstream companies are even discussing and contemplating buying back stock as well.

In general, we feel this is a key topic and one we are watching closely. Yet it feels like it is trending in the right direction and ultimately in favor of shareholders.

The bottom line is, the proof is in the numbers. Grow cash flow on a per unit basis and the topic is answered, which is exactly what we are seeing so far in 2018 and forecasting for 2019.

In summary, we absolutely recognize the frustration of midstream investors. We are right there with you. Yet the fundamentals are great and we see significant progress on many fronts for midstream companies continuing in 2018 and 2019.

Now we just need other investors to actually see it too!

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@tortoiseadvisors.com.

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