Tortoise QuickTake Energy Podcast

Tortoise

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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.

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

October is close to a perfect storm for sports fans. Playoff baseball, the NFL and college football are in full swing, and the NBA is just getting started. The major league soccer playoffs are also on the doorstep. For investors, October has not always been a panacea. Of course it's primarily remembered for the two major crashes of 1929 and 1987. In reality, October is not a bad month at all for stocks, and for MLPs the 10^{th} month of the year is actually the 5^{th} best month by average return. Additionally, December is the third best month, so the 4^{th} quarter has historically been pretty good. Time will tell, but with earnings starting to pick up, hopefully we end the year on a high note.

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

- On the commodity front, crude oil was weak, falling 3.1%, while
- Natural gas was higher, closing the week up 2.8%
- Shifting to equities, the broader S&P Energy Select Sector Index® fell 1.9%
- Exploration and production companies, as measured by the Tortoise North American Oil & Gas Producers Index℠ also had a tough week, losing 2.8%
- And finally MLPs were slightly positive, as the Tortoise MLP Index® rose 10 bps

I wanted to focus on two main themes from the past week: 1) earnings kicked off for energy companies with two bellwethers reporting and 2) MLPs had some more transaction activity simplifying structures.

On Wednesday, midstream heavyweight Kinder Morgan was the first energy company to report earnings. It was a solid start to the 3Q season with an inline quarter and guidance for a full-year beat. A couple of other highlights to note:

KMI noted a new, lower leverage target of 4.5 times and stated they exited 3Q at 4.6 times. This is significant as it will allow any excess cash flow after capex spend to be distributed back to shareholders via continued dividend increases and/or share buybacks. Management noted an ability to source \$2-\$3 billion dollars of growth projects annually. Natural gas pipelines delivered strong volumes, up 14% year over year, while natural gas gathering volumes were up 20%. Finally, all three ratings agencies stated they have KMI on positive watch for an upgrade, with S&P likely to raise in January.

Overall, a pretty good start for midstream.

On the services side, the largest oil field services company, Schlumberger, announced earnings on Friday. It was also an inline print, with positive results internationally, offsetting some slowdown in North America.

A couple of highlights from the call:

- The North American slowdown is mostly expected due to the takeaway constraints in various basins, notably the Permian;
- SLB repurchased approximately \$100 million dollars of stock during the quarter; and
- Management has confidence that international margins will continue to improve.

Oil field services is a subsector that has underperformed, so a relatively positive start is an improvement.

Let's turn our attention now to simplification with midstream MLPs. We have talked before about the benefits of eliminating incentive distribution rights, or IDRs, and how it not only improves the cost of capital, but also aligns unitholder interests. And during the past week, Energy Transfer Equity completed its rollup of Energy Transfer Partners with an affirmative vote from unitholders, while Valero Energy Partners received an offer to be acquired from parent company Valero Inc.

But where do we stand in this process for the sector as a whole?

First a bit of background. With the energy downturn that commenced in mid-2014, MLPs have morphed from version 1.0 to version 2.0. That change has been highlighted by several characteristics, including higher distribution coverage, lower leverage, less reliance on equity capital markets and improving cost of capital by eliminating IDRs.

To put some context around this, in 2007, approximately 4% of the Tortoise MLP Index® by weight did not have IDRs. In 2012, that number had moved higher, up to 28%. In 2017, again a nice improvement, this time ending at 52%.

However, the trend to eliminate IDRs has accelerated quickly in the last year. In fact, we project 2018 to end with 74% of the index without IDRs and 2019 to end with 85%. Further, if we look at just the top 20 MLPs by market cap, 95% of the weight of the index of the top 20 companies will not have IDRs by year-end 2019 per our estimates.

What a change.

One other item to point out, while there may be 15% of the total index still with IDRs by year-end '19, one interesting detail is that the average general partner cash flow take of those companies will be a mere 7.5%. Recall, we feel the GP burden becomes too great when it goes over 30%, so even though 15% of the index may still have IDRs, the cash flow burden will be minimal.

All that is to say, we aren't there yet in relation to the simplification of the sector, but we are making great progress.

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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