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 year-end 2017 Outlook Quick Take Podcast. I'm joined today by Tortoise portfolio managers Brian Kessens, James Mick, Matt Sallee and Rob Thummel. We're going to discuss key topics of interest and provide our energy sector outlook for 2018. Let's get started. Matt, we'll start with you. OPEC announced an extension of their production cuts. Can you walk us through some of those decisions?

Matt Sallee: You bet. So as widely expected, leading up to the late November meeting, the production cap was extended to the end of 2018. I guess some key highlights I'd hit, this was a joint agreement, including both OPEC and Russia who want to see significant inventory reductions. Saudi Arabia thinks this is likely to take all of 2018, after which an exit discussion can begin. We expect a strategy to ensure that they'll put in a strategy to ensure we don't go right back to a market share strategy. Related to this, post 2018, we wouldn't be surprised to see continued cooperation between Russia and Saudi Arabia.

One outcome from the meeting that caused the market some pause was the June review clause for the agreement which we think is extremely unlikely to change mid-year, but it did spook the market a bit. We really think this language was just included to bring Russia along in agreeing to the 2018 extension.

Ed Russell: Thank you, Matt. Brian, given that backdrop, where do we stand in terms of the status oil prices, production and inventory levels?

Brian Kessens: Sure. To set the stage, let's quickly hit on the current production levels. OPEC produces about 40% of all liquids, which would include crude oil and natural gas liquids, such as propane and butane. The U.S. produces about 13% of the world total; Russia produces about 11%, and the remaining 35% is produced by all other countries, notably Canada, China and Brazil. Total production then is approximately 98 million barrels per day. We are constructive on the crude oil price of 2018, expecting the price to marginally move higher, exceeding 2017 levels. That's due to, one, as Matt just touched on, the willingness of OPEC and Russia to cooperate and continue to hold production at 32.5 million barrels per day through the course of 2018 as inventory levels remain above the five year average. Two, strong global demand, again reaching 1.5 million barrels per day as demand grows led by emerging markets like India and other countries such as China where populations are buying cars as they move from lower to middle class income levels. Then three, increased capital discipline from larger oil companies. They are indicating 2018 capital expenditure levels no higher than 2017 levels and in many cases lower. Many have pledged to spend within their cash flow including the payment of dividends.

Ed Russell: So, James, over to you. As we turn to 2018 and beyond, what are the forecasts for growth in the oil sector?

James Mick: Yes, great question. As Brian alluded to with the different groups that we'll talk about, in terms of growth for 2018, we anticipate OPEC to be up about 550,000 barrels per day. That's primarily because Libya and Nigeria increased production throughout 2017. So assuming they hold production at current levels, it would result in an increase for 2018 of about 400,000 barrels per day for those two countries. In general, we feel this is conservative and doesn't account for any supply disruptions. Let's come back to the U.S. in a moment, but for Russia we anticipate it will be about flat for 2018. Of course the remaining 35% of production that Brian alluded to from various countries across the world will be mixed, with some higher such as Canada and Brazil, and some lower such as China and Mexico. In total, we anticipate about 350,000 barrels per day of growth from this group. So if you're following along on your spreadsheet, so far we have OPEC growing 550,000 barrels per day, Russia flat and the rest of the world ex-U.S. growing 350,000 barrels per day. Let's shift gears now to the U.S. This is probably one of the biggest areas of concern for oil markets in 2018, i.e., will the U.S. flood the market with crude and drive up inventories putting a damper on the price recovery? Aggregating a variety of independent third party sources, we come up with growth in U.S. production of about 800,000 barrels per day in crude oil. Additionally, we anticipate 400,000 barrels per day of growth in natural gas liquids or NGL's during 2018 for a total U.S. production growth of about 1.2 million barrels per day. Of course this would be an outstanding number and represent very strong growth. The range of estimates is pretty diverse; some showing as low as

700,000 barrels per day and some as high as 950,000 barrels per day just on the crude side. Our view is that we will likely come in on the lower side of those numbers. A couple factors that could impact the U.S. growth numbers from a positive perspective, increased access to capital for producers; better hedge positions; and then overall higher crude oil price due to disruptions elsewhere in the world. Some factors that could impact from a negative perspective, oil field service bottlenecks, notably lack of personnel; shift in focus to returns as opposed to pure production growth; and then producers spending within cash flow. In summary, we're bullish on U.S. production for 2018, but probably a bit below consensus and not fearful that it exceeds a number so high that it impairs the global recover for crude oil inventories. And from a worldwide perspective, all the numbers in total lead to a draw of approximately 400,000 barrels per day for 2018. And assuming that happens, we will hit the five year average for inventories in 2018.

Ed Russell: Thanks James. Rob, as evidenced by your frequency CNBC interviews, the natural gas story is always being overshadowed by the oil market. Why should investors be paying attention to the natural gas space?

Rob Thummel: So natural gas prices are low and have remained low for much of 2017. We don't see any significant increase in natural gas prices, which actually we think is a good thing. Low natural gas prices keep consumer prices low for things like heating our homes. Industrial and manufacturing plants are also more competitive globally due to low energy costs. So, the biggest impact, though, of low natural gas prices comes from the ability to export low cost natural gas to other countries from the U.S. So low cost U.S. natural gas just makes export economics work. It is simply cheaper to produce, liquefy and ship U.S. natural gas to places like Europe and Asia. Now, 2017 was a stellar year for US natural gas exports. First, according to the EIA, natural gas exports to Mexico were 12% higher than in 2017 compared to 2016. But the biggest beneficiary of natural gas exports is expected to come from liquefied natural gas or LNG. In 2017, LNG exports from the U.S. have averaged almost 2 Bcf a day. In fact, the U.S. has exported over 210 cargoes of LNG to 25 different countries and we're just getting started. We estimate that LNG exports over the next ten years will be five times higher than today's levels. This creates a significant growth opportunity for many U.S. companies along the energy value chain, including U.S. natural gas producers, natural gas pipeline operators, as well as LNG facilities operators.

Ed Russell: Thanks. So, Matt, investor's sentiment for the MLP sectors played a part in how the sectors' underperformed in 2017. What's changing the MLP landscape and what might investors be missing?

Matt Sallee: Well, the market has certainly been evolving. The change is happening because we've had three years of a depressed oil price, plus public equity markets have been more or less closed during this period. At the same time, there's been an increased focus on governance generally and in the IDR structure in particular. MLPs that entered this downturn with tight distribution coverage and elevated leverage were forced to hit the reset button that reduced payouts and strengthened the balance sheet. Furthermore, buying out IDRs is nearly always a dilutive transaction, and companies taking this step have had another headwind to deal with. But that's where we've been. Looking forward, with just a couple of exceptions, the space has dealt with the needed financial and structural improvements and is on solid footing to capitalize on tailwinds of strong production growth balanced against yet another year of above trend demand growth.

Ed Russell: So, Brian, to you, given the backdrop that Matt highlighted, how is the capital markets evolving from midstream energy and what's your outlook for 2018?

Brian Kessens: Though the equity markets MLPs have been closed, companies continue to invest capital and new projects to facilitate the strong levels of production growth. And the appetite to finance these projects in the debt and preferred markets has been strong. In debt, issuance topped $36 billion through the third quarter and midstream yields remained competitive with the broader market. For example, as of November 30th, midstream had a 3.9% yield to worst with an average rating of BAA3 versus the broader corporate credit market with a yield to worst of 3.3% and a higher average rating of BAA1. We've also seen the preferred market issuance emerge for a number of reasons. Issuers like it because they received some equity credit with the security, and the overall cost of capital is lower than that of equity partly due to the fact there are no associated IDR payments. Investors like being higher in the capital structure and the more certainty of the dividend payment given some common payments have been reduced as companies move to a more self-funding model, preferred issuances over $3 billion from midstream preferred in the fourth quarter alone. I'd also add that demand for structured securities like convertible preferreds remains high. Private equity capital looking at energy deals is robust. And where there's more certainty over the near-term with a preferential payment, with longer term upside in the form of equity inversion, there's PE interest. In 2018, we expect debt markets to remain open and for equity needs to be funded with pipes, the convertible preferreds I mentioned and through excess cash flow.

Ed Russell: Thank you. James, a frequent question I get from investors is, "What do you think of the traditional MLP model and does it still work?"

James Mick: Yes, historically investors have utilized the model of taking the current yield and adding the distribution growth to get to their projected total return. While simplistic, this intuitively makes sense and it had explained about 90% of MLP total returns prior to the most recent downturn. Now as the space has moved more institutional over the years, the tools have expanded to focus a bit more on cash flow metrics such as enterprise value to EBITDA and price to distributable cash flow. We also employ a standard dividend discount model incorporating three stages of growth. Additional valuation methodologies involve spreads to various fixed income securities such as the 10-year Treasury, and spreads to other income-oriented equities such as REIT's and utilities. Then finally, we can also evaluate the market based on multiples paid by private equity for companies and/or asset packages. A couple points on valuation, we've always utilized a variety of tools to determine valuation in the market, including cash flow multiples, which is the preferred choice of institutional investors. Many of the tools are obviously similar and contain components of the other. For instance, the yield plus growth model has a third component, change in the market multiple, that is exactly the same as EV to EBITDA or price to DCF concept. Then finally, and I think most importantly to investors, no matter which valuation metric one utilizes, MLPs look cheap. On a go forward basis, we believe you will continue to see a variety of tools utilized, but the market may take a further step towards cash flow multiples. Either way, we're comfortable with all the methods. We continue to utilize multiple approaches to triangulate value as opposed to just one single method. Then finally, we would actually argue that the market multiples require extensive further information to determine the validity of what you're observing. And as such, it really makes the case for active management as a multiple by itself isn't incredibly useful without context.

Ed Russell: Thank you. Rob, can you touch on the role natural gas plays in our evolution towards clean energy?

Rob Thummel: Sure, Ed. Before I do that, I think it's important for investors to step back and just look at the overall energy sector and where it's going. First and foremost, at Tortoise all year we've been saying in general that investors have underappreciated the energy sector in 2017. There are really few sectors that can say that demand growth has grown 32 out of the last 33 years. We see that trend of rising energy consumption extending into the future. So if you look forward over the next couple of decades, the future of the energy will likely be more natural gas and renewables. But petroleum, including oil, will also play a critical role as well. In our opinion, natural gas is the most practical solution to reducing emissions. Natural gas is cheap, it's clean and it's abundant. And in the U.S., natural gas has been effective at reducing carbon dioxide emissions in the electric generation sector. Two of the largest energy consumers in the world, China and India, are looking to follow the U.S. lead in displacing coal with natural gas to generate electricity. This shift in the energy mix could aid in reducing global emissions as well. One final point. As the global energy landscape changes, we believe that the U.S. becomes a critical supplier of low cost energy, both domestically and to the rest of the world.

Ed Russell: Thanks, Rob. So, Matt, you drew the short straw here. We're going to move to taxes. What's your take on how tax reform will impact the energy space? What regulatory matters should we be watching for in 2018?

Matt Sallee: Thanks a lot, Ed. I appreciate that one! Well, it's always dangerous for me to opine on tax issues, but I did sleep at a Holiday Inn last night. So here's what we know at this point. First and foremost, as expected, the MLP tax exempt status is unchanged, but there have been a lot of discussion around rates for income from pass-through entities. So, here's how the math works. Based off of a top marginal rate of 37% with a 20% deduction, income from MLPs would be taxed at a net rate of about 30%. This is a nice improvement for pass-through investors, but what often gets overlooked is that most distributions are return of capital anyway due to accelerated depreciation. In fact, this will likely move more in this direction because of my next point, which is that the plan also allows for companies to get five years of 100% expensing of capital, which will create a huge income shield for midstream companies. For corporations, we'll have a 21% tax rate. That's a clear win for our MLP funds, since they are structured as C-Corps and have a deferred tax liability. And it's also good for our underlying C-Corp energy investments held in the RIC Funds, though most are not current cash taxpayers. Interest expense limitations are set at 30% of EBITDA for the first five years and then reduced to 30% of EBIT thereafter. We don't have any investments that would have over 30% of interest relative to EBITDA, so they would all pass that test, but there could be a couple that are impacted when the test switches to measure against EBIT.

Ed Russell: Thanks, Matt. Brian, can you talk to us a little bit about our outlook for 2018 as far as total return expectations for the MLP sector?

Brian Kessens: Certainly. We're optimistic returns will be compelling for MLPs and across thee energy value chain in 2018. As we've discussed, supply and demand fundamentals in the U.S. remain favorable and commodity prices are at levels supportive of further production growth. Further, there is an acute management focus on returns for every incremental dollar of capital invested. Despite that backdrop, valuations remain below historical averages. For midstream, we expect total returns in the low double-digits supported by an 8% yield and 5% to 7% distribution growth. At some point, we also expect midstream to trade back to historical levels, generating 15% to 20% of additional upside. For the broader value chain, we believe returns will be in the high teens following compelling production growth and constructive commodity prices in upstream and competitive input costs relative to global levels and strong demand in the downstream. We think there's real reason for optimism in the New Year.

Ed Russell: Great. Thank you, Brian. I think we'll wrap up 2017 with our thanks to Matt, Brian, James and Rob for contributing to our weekly podcast program. That concludes our discussion. Thank you for joining us and for your support. This will be our last podcast for 2017, so we wish you a Happy Holiday season and we'll speak to you again in 2018.

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.