Tortoise

Tortoise QuickTake Podcast

June 26, 2017

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

Hello. I am Tortoise Managing Director and Portfolio Manager Brian Kessens with this week's QuickTake podcast.

Energy sentiment remained negative last week, though the summer solstice brought an end to the length of the red, as both Thursday and Friday were solidly in the green. Net for the week, commodities (both crude oil and natural gas) were down 3.7%, the fifth straight week oil's been lower. Broad energy followed with a decline of 2.9%. Producers were off 2.6%, with MLPs falling 1.1%.

To the fundamentals – U.S. crude oil stocks fell 2.5 million barrels last week, ahead of the five-year average of 180,000 barrels and consensus of 2 million barrels. That would seem to be mildly bullish for prices, yet lower prices after Wednesday's announcement show how touchy positioning is with oil. The market quickly returned its focus to rising U.S. production, higher production from Nigeria and Libya that are seen offsetting the impact of OPEC's production curtailment, and a stubborn rig count that moved higher for the 23rd straight week.

To turn the market, we think that rig count increases need to stop and/or a decline in inventory levels needs to accelerate before crude oil prices stabilize and move higher. So far, U.S. producers are not blinking in the face of lower prices given 2017 capex budgets are set and deep hedging offsets the impact of lower spot prices. If prices do persist, we think the second quarter earnings calls will offer an opportunity to float the idea of lower production growth in 2018. Until then, stronger balance sheets are likely to be rewarded. As for OPEC, deliberately reduced exports should start to take affect in July, and there is an opportunity for further action given Saudi Arabia's pledge to do "whatever it takes" to defend prices.

To the news – Tropical Storm Cindy interrupted Gulf of Mexico production and ship traffic in Houston and New Orleans last week. We understand logistics returned to normal, yet expect some noise in the inventory data that is released over the next couple of weeks.

There was one new midstream project announcement: ONEOK announced it will expand its Mid-Continent footprint by accommodating volume growth from the STACK play in Western Oklahoma. The project is backed by a long-term contract with an expected capital need of $130 million.

In regulatory items, as expected, FERC issued a final Environmental Impact Statement for the Mountain Valley Pipeline (a 305 mile natural gas pipeline, taking gas from the Marcellus through the Virginias). The pipeline, operated by EQT Midstream, is expected to come on-line in late 2018 in time to meet heavy winter demand.

The largest energy transaction last week was EQT Corporation's announced acquisition of Rice Energy for $6.7 billion, or at a 37% premium. Post deal, EQT will be the largest U.S. natural gas producer, slightly ahead of ExxonMobil and Chesapeake Energy. Rice's acreage in Pennsylvania and Ohio fits well with EQT's in the Marcellus, allowing the company to enhance drilling efficiencies with longer laterals. As a complement, EQT Midstream will be the fourth largest natural gas gatherer in the U.S. – the transaction only enhances its growth profile.

In midstream, there was one dropdown transaction. Noble Midstream Partners acquired additional interests from its parent, Noble Energy, for a Permian and DJ gathering system. In conjunction with the dropdown, the company announced it will grow its distribution 8.5% next quarter and resume 20% annualized growth thereafter. Total consideration was $270 million, with part of the financing from a $143 million PIPE. For the midstream sector in particular, we think the PIPE demonstrates the value of an alternative access to capital, providing confidence in the ability to attain equity financing when traditional means remain fickle.

Speaking of capital markets, in the largest private offering last week, NextEra Energy Partners raised $550 million through a convertible preferred issuance. Terms were a 4.5% coupon with a 15% conversion premium. Proceeds will be used to acquire assets and keep the company out of the equity market through 2020.

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We had one question last week from a podcast listener related to distribution expectations in midstream in light of recent volatility. Relative to the volatility in 2016, today midstream companies have healthier balance sheets, improved distribution coverage and a tailwind of volume growth across crude oil, natural gas and natural gas liquids. We continue to believe growth will be 5% - 7% over the next 12 months.

A few members of our team attended an energy conference last week. Four takeaways were (1) drilling remains economic at current commodity prices, and no producers indicated a willingness to reduce activity levels unless the lower commodity price environment is sustained for four to six months, (2) big data is the next big thing driving efficiency improvement, with one management team indicating we're not even in the early innings on this trend (just stepping in the batter's box), (3) so far, no cost pressure is surfacing from services, and (4) midstream would be a winner with continued volume increases.

This week marks the end of the second quarter and first half of the year, with news this past week only emphasizing what we've witnessed in the second quarter – new midstream projects and dropdowns continue even when energy sentiment is poor, and U.S. shale breakeven economics continue to decline due to greater efficiencies without a correspondent material increase in service costs. We expect this last point to drive U.S. production growth in the second half of this year and into 2018. We expect oil prices to only dictate the magnitude of this growth, something we'll continue to monitor and comment on. Thanks for listening.

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.

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