Tortoise QuickTake Special Edition Podcast with Brian Kessens

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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 a special QuickTake podcast.

The energy sector was dealt a heavy blow yesterday, following last Friday's OPEC meeting and negative news related to a recent acquisition by Kinder Morgan. Here's our responses to questions we're hearing from the investment community.

What happened yesterday in energy markets, particularly for MLPs?

Yesterday, West Texas Intermediate crude oil fell 5.8% as investors fully digest OPEC's decision to stay the current course. With that, producers, as measured by the Tortoise North American Oil and Gas Producers index slipped 6%. Leading the selloff, the Tortoise MLP Index dropped 6.7%. That index is now down 40% for the year.

Technical selling in MLPs continued yesterday from three main things (1) tax loss selling, (2) fund redemptions and deleveraging and (3) hedge fund shorting into these technical issues, only exacerbating this negative feedback loop.

On the fundamental side, fears are that lower commodity prices will significantly impact production volumes. So lower prices are driving a concern that is resulting in a higher cost of capital for the sector, resulting in concerns with whether the sector will be able to finance growth in an accretive manner. This is a fundamental negative feedback loop.

We think concerns about significant production declines are overstated. In 2008 when crude oil dropped ~50% (and near 80% peak to trough), crude oil production declined less than 5%. Similarly, the EIA expects a 4% decline in production in the 2015-2016 timeframe.

We also think crude oil prices can improve once supply and demand are in better balance. With expected demand growth of 1.2 mmbpd in 2016 according to the IEA, and non-OPEC production declines, we estimate this happens in mid-2016.

What's this I hear about Kinder Morgan cutting its dividend?

Last week Kinder Morgan made an acquisition of an additional interest in the Natural Gas Pipeline Company of America for $136 million. The purchase resulted in an increase in Kinder's leverage and following, Moody's put the company on Negative outlook, or a single step away from losing its investment grade rating.

Last Friday, Kinder responded indicating a commitment to an investment grade rating. Further the company reiterated 2016 cash flow expectations of $5 billion and an ability to grow the dividend 6-10%, yet stated they are evaluating the dividend policy in light of the need to reduce leverage and finance growth projects. The company believes the dividend may be the best lever to use, or said differently, a full payout is the least effective use of cash. Expect a more detailed plan from Kinder sometime this week.

After suggesting on its third quarter call that the 2016 dividend would be 6-10% higher than 2015's, the change and uncertainty of the announcement gave the market pause and concern.

Another question we're getting…should I expect other MLPs and pipeline companies to make similar announcements?

Contrary to some of the recently published articles, in our view, Kinder's announcement doesn't suggest the rest of the pipeline sector will cut distributions and dividends though it is possible because it is prudent that companies evaluate what is their best use of capital. Kinder's leverage at 5.8x EBITDA is significantly higher than peers and others' equity needs are not as great. Furthermore, many pipeline MLPs have parent or sponsors that are able to be supportive in times of capital market dislocation. Indeed, we've seen several sponsor companies step up in the past two months and demonstrate support, either through accretive dropdown multiples, self-financing, share buybacks, or a combination of all of the above.

And as a reminder, earnings for our midstream holdings in 3Q resulted in: average annualized distribution growth over 10% and average distribution coverage of 1.1x, with average leverage around 3.7x EBITDA. Those aren't metrics of distress.

I've heard capital markets for MLPs and pipeline companies are closed.

Overnight equity capital market access is challenged right now. However there are other means to access equity capital and we are seeing companies use other levers.

These other levers include: Private Investments in Public Equity or PIPEs, parent / sponsor support as mentioned previously, using excess cash flow for funding needs, and accessing the $100 billion in private equity money dedicated to the energy sector.

Looking at actual issuance inclusive of the past two weeks, last week, Columbia Pipeline Group raised $1.25 billion in an equity offering, in a deal that was upsized and that traded higher the following day.

Just yesterday, EnLink Midstream announced an acquisition with committed financing of $750 million from the private equity firm TPG and Goldman Sachs Merchant Banking. And the private equity firm First Reserve committed to buying $100 million in Crestwood Equity Partners units in a move of "continued confidence in CEQP's long-term outlook."

Private equity buying straight common units is an indication of the opportunity in the sector currently.

So that's a good lead-in, so where do we go from here?

2008 was the last time there was both a fundamental and technical negative feedback loop in the MLP sector. In that year, MLPs were down 38%. In the following year, 2009, MLPs rebounded 78%.

I'm not suggesting there will be a rebound of this magnitude, only providing some historical context. Every period is different and while history doesn't perfectly repeat itself, history does tend to rhyme as Mark Twain quipped.

In the short term, there is no catalyst in sight other than the simple turn of the calendar to 2016. The sector may continue to move lower. Yet over the medium and longer-term, we believe there is opportunity.

Finally, another question we're hearing, can you characterize the current investment opportunity?

We think a no growth yield for MLPs is 9-10%. The yield on the Tortoise MLP Index is now 10.3%, implying no or even negative growth in the sector. We don't think that's the case. We think growth in 2016 will be in the mid-single digits as cash flow from ongoing and recently completed internal projects are put into service. We calculate nearly $160 billion in MLP and C-Corp pipeline projects between 2015 and 2017.

While investor sentiment in the near term may be determined by the direction of crude oil prices, our long-term conviction in the cash flow growth from additional pipeline infrastructure needs and existing assets remains. When investors appreciate this, we think market participants will look back on the existing period of capitulation and recognize the opportunity that was at hand. Warren Buffett's quote to "be greedy when others are fearful," seems very apt.

That's it for today, talk to you 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