Tortoise QuickTake Special Edition Podcast with Ed Russell, Brian Kessens and Matt Sallee

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Ed Russell: Hello, This is Ed Russell Managing Director at Tortoise Capital. I am joined by Portfolio Managers and Managing Directors Brian Kessens and Matt Sallee for this week's edition of our QuickTake Podcast. Today we're going to use a special format where I'll ask some questions to Brian and Matt and hopefully people will find that helpful. Matt, I'll start with you. And before we get into specifics about the MLP space, can you take us through market conditions in 2015?

Matt Sallee: You bet, Ed. The downturn started with the price of oil falling significantly which has resulted in lower drilling activity, stalled production growth and is now leading to production declines. As this environment has persisted over the last year and a half, sentiment on the energy patch has become remarkably negative. To be clear, the outlook for pipelines is not as strong as it was at $100 oil, but cash flow per unit is still up in our portfolios year over year and we believe this sell off is clearly overdone. Compared to a year ago, open-end fund products have seen big declines in the inflows and in some months actually witnessed net redemptions. Add to this, short interest that's up over $1 billion this year, closed end fund selling, along with tax loss selling, and the result is pipeline valuations we haven't seen since 2008!

Ed Russell: Thank you. Brian, this next question's for you. Last week we saw some closed end funds reduce their distributions Can you talk about the distribution outlook for our funds.

Brian Kessens: Sure thing, Ed. We are subject to the same market dynamics as all MLP closed end funds, yet we don't think near to the same degree. Notably, we entered the downturn this year with less leverage and higher distribution coverage, and haven't been subject to the same level of distribution cuts from individual holdings. Expenses for several items, including: advisory, administrative and interest, declined due to lower asset values in the fund. Partly for these reasons, distribution coverage is not materially different than it was a year ago.

Currently, the MLP market is witnessing technical pressure, some of which we expect will diminish at year-end as the desire to sell to realize tax losses diminishes. We continue to think MLPs in our portfolios will grow their distributions next year. Our board meets quarterly to determine the distribution and will decide to do what it believes are in the best interest of shareholders, aiming for a distribution that it believes sustainable over the long-term. Expect our next distribution declaration the first half of February. For these reasons, we currently don't see a reason to change our distribution policy.

Ed Russell: People are asking me about the leverage of our closed end funds. Can you talk about whether we're in compliance with our covenant requirements?

Brian Kessens: Yes, as last posted on our website, we were in compliance with all of our funds. We update our leverage metrics or asset coverage ratios weekly.

Ed Russell: Matt, the next question's for you. Brian mentioned the growing distributions of the MLP sector. Now I am getting questions from investors asking 'Hey can MLPs sustain their distributions?' Could you comment further about your distribution outlook?

Matt Sallee: While some MLPs are pressured by low commodity prices and elevated leverage, and it's only prudent that they evaluate their best use of capital, that being paying current distributions or otherwise, those companies are the exception, not the norm. Our MLP portfolios maintain a weighted average debt to EBITDA ratio of about 3.5x with distribution coverage north of 1.1x on average. Don't forget, low oil prices are helpful for refined production pipelines due to higher gasoline demand and it's necessarily harmful to natural gas pipelines. On top of this, the hyper-growth, drop-down sponsored MLPs that we met with in person recently just reiterated that they are not changing their growth strategy. The bottom line is that Tortoise has always maintained a high quality investment strategy and markets like this are exactly why!

Ed Russell: Brian, Rising interest rates are in the news again. Can you talk about how those will impact MLPs?

Brian Kessens: Sure. We don't think a rising rate environment negatively impacts MLPs. We looked at returns across twelve periods since 2000 when the 10 year Treasury rose by 50 bps or more. During those periods, MLPs returned 6.4% on average, very comparable to the S&P 500 return of 6.7%. In a rising rate environment, the economy is generally healthy with modest inflation – both good for pipeline companies.

I'd also note the historic spread between the 10 year Treasury and the MLP yield is about 300 bps. Currently the spread is over 750 bps. That's a lot of rate rise necessary to impact valuation.

Ed Russell: Brian, Specifically on the MLPS. Can they access debt to fund growth projects?

Brian Kessens: Bond rates across the board have sharply risen the past month, particularly for energy. Spreads on investment grade energy are now at 300 bps and for high yield energy, above 1300 bps.

That being said, we believe the maturity schedule for our portfolios is very manageable, along with most MLPs. In our portfolios, the weighted average tenor is 10 years, and the average next maturity is 2018.

We don't expect much difficulty with refinancing for investment grade pipelines and our portfolios are consistently around 80% investment grade. Even for high yield midstream companies, spreads are much tighter than for exploration and production companies, with the average spread at around 550 bps.

Ed Russell: Matt to you. A lot of current investors in the MLP space are asking for outlook for MLPs in 2016?

Matt Sallee: You know it's hard to focus on the positive right now during these current market conditions but basically distribution cuts across the board are being priced into MLPs right now. So while things are likely to be volatile for the near term, we think they can only get better, especially if you have a 12+ month time horizon. The current MLP index yield is north of 10% and we still expect distributions to grow on a weighted average basis. Our proprietary financial models forecast cash flow growth that would allow at least 5% distribution growth but we recognize that at current yields the market isn't paying for growth, it prefers stability. So let's assume management teams take the more conservative route and choose to grow coverage rather than distributions. Even in our low case we see distributions growing about 2% at the index level (and even higher in our funds). This would result in a cash on cash return of that 10% yield + 2% growth or low double digit total returns. However, assuming the market stabilizes at some point and valuations return to longer-term averages, returns could become multiples of this rate.

Ed Russell: Thanks Matt. Brian, I'm basically going to ask you the same question in a different way. We've heard a lot of comment the MLP party being over? Can you react to that?

Brian Kessens: Sure. In our view, the U.S. energy revolution is not over. In fact, breakeven economics for oil and gas production continues to decline and the U.S. is producing more natural gas and more natural gas liquids than ever before. Natural gas liquids exports continue to grow and early next year the U.S. will begin exporting natural gas in the form of LNG. And the U.S. is now able to economically recover more crude oil than ever before.

For MLPs and pipeline companies, I think investors are missing the fact that the underlying cash flows of these companies has still been growing. There was nearly $100 billion invested by MLPs over the past three years on projects that continue to ramp, resulting in growing cash flow. The reason commodity prices are low is because supply, or that amount being transported by pipelines that earn a fee to do so, is higher than ever before.

There are a couple key risks to be clear on. If commodity prices continue to stay depressed, there is a risk that producers are unable to fund existing and /or new production.

And, secondly, MLPs do need access to capital to fund growth projects over the next year. We think other forms of capital are available versus traditional equity, such as parent support, Private Investments in Public Equity, and we've recently seen private equity capital enter the sector.

Ed Russell: And Brian, just finally, last week was really volatile for the MLP space. Is there anything we missed that you'd want to talk about?

Brian Kessens: Interestingly, the U.S. government, including Congress and the President, have improved the regulatory environment for all forms of energy, except coal. There is broad agreement to lift the crude oil export ban while also extending production tax credits for wind energy and investment tax credits for solar energy. And the Clean Power Plan announced earlier this year followed by the global climate discussions in Paris just two weeks ago result in a big win for natural gas due to its better CO2 footprint.

A few months ago there was a sense in the industry that nothing would get done in Washington. Yet it has. This provides energy companies much needed clarity and certainty with the regulatory environment going forward, improving their ability to plan and allocate capital appropriately. A holiday gift if you will.

Ed Russell: Thank you Brian. Due to the holiday season, this will be our last podcast for 2015, so we look forward to speaking with everyone in 2016 and hopefully we'll see better market conditions.

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