MLP and Energy Infrastructure Market

March 17, 2020 Commentary

The energy markets were brutal last week, sparing no one. What started off as a surprise move last weekend by Saudi Arabia to pump more oil supply into a market already facing demand challenges due to the coronavirus, was amplified by fears of the impact the coronavirus will have, short and long-term, across global economies. On the week, broad energy, crude oil and midstream energy were down between 23% and 29%.

We called all our company management teams last week to understand impacts. We have been calling for more capital discipline, were starting to see it through lower capital expenditures (capex), and now we expect to see lower capex accelerate further. There were already some announcements last week. ONEOK is a good example. The company announced a $500 million or 20% reduction in 2020 capex, while maintaining 2020 financial guidance. Management teams indicated any volume declines are likely to emerge in the second half of the year as it takes six to nine months for lower producer activity to show up in supply. On dividends and distributions, the general feeling is no need to reduce and a willingness to see how the market plays out, after all, distribution coverage is healthy. Buying back shares or reducing debt may be better options. That said, there will likely be a few meaningful distribution cuts to achieve lower leverage if the current OPEC and COVID-19 impacts are extended.

We also confirmed that liquidity issues are fine, something different than we faced during the 2008/9 financial crisis. Other differences from that period are that leverage is lower, distribution coverage is higher, and midstream companies are self-funding.

We also ran an extreme stress test where crude oil volumes fall by 20% next year. In that scenario, distribution coverage moves to 1.3x from 1.4x and leverage moves from 4.1x to 4.2x. And what about counterparty risk? We estimate midstream counterparty risk is 85% investment grade and 15% high yield. That is based on knowing 60% of counterparties are investment grade, 10% is high yield, and splitting the remaining 30% unpublished number between the two credits. Every aspect of the midstream universe is essential to proper economic functioning, these assets and business are and will remain viable.

As we sift through the downturn for opportunities, specific to crude oil price, there are some midstream assets that become more valuable in a lower price environment. For example, the crude oil price curve was formerly in backwardation (with future prices lower than spot). That quickly reversed and now are in steep contango, with the spot price over $4 lower than the 12-month forward price. Crude oil storage is now more valuable. Following, President Trump even announced that the U.S. government will take advantage of the low oil prices and fill the strategic petroleum reserve (SPR) “right to the top”. We estimate the SPR currently has 92 million barrels of additional capacity.

Also, natural gas was in oversupply in 2020 which was weighing on the price. In an environment with lower crude oil drilling, less associated natural gas will be produced which will bring natural gas supply back into balance with demand faster. In fact, natural gas prices moved higher by 9% last week. That is helpful to northeast gas producers and pipeline companies that transport gas.

Management teams have been buying shares in droves. We calculate 36 midstream insiders bought back $20 million in stock from 14 different companies just last week. YTD, the total is 92 insiders buying over $190 million.

We are confident the coronavirus fears and its impact on overall demand will pass. China is now going back to work. It will be messy in the U.S. for a period, yet that will pass, and demand will bounce back. When that occurs, refined product pipelines, in particular, will benefit from the tailwind of lower oil prices and the positive impact on end user demand.

Finally, midstream valuations stand at about 7 times next year's EBITDA. The Index is well below arguably even tougher periods, like during the financial crisis of 2008/9 and the 2016 oil price collapse when oil was $27 per barrel. Midstream companies generate primarily fee-based cash flows from moving energy products. Cash flows really remain resilient through crude oil price swings. When companies proved this, and investors realized it following those periods, midstream prices surged higher. 76% higher from March 2009 lows to year-end 2009 and by coincidence, 76% higher from February 2016 lows to year-end 2016.

Data is as of 3.17.2020 and is subject to change on a daily basis. ONEOK Inc. is not a current holding in the Fiduciary/Claymore Energy Infrastructure Fund (FMO) as of 3.17.2020.

Broad Energy = The S&P Energy Select Sector® Index is a capitalization-weighted index of S&P 500® Index companies in the energy sector involved in the development or production of energy products.

Crude Oil = West Texas Intermediate (WTI): Light, sweet crude oil commonly referred to as "oil" in the Western world. West Texas Intermediate is the underlying commodity of the New York Mercantile Exchange's oil futures contracts.

Midstream Energy = The Tortoise MLP Index® is a float-adjusted, capitalization weighted index of energy master limited partnerships (MLPs). The index is comprised of publicly traded companies organized in the form of limited partnerships or limited liability companies engaged in transportation, production, processing and/or storage of energy commodities. This index is the exclusive property of Tortoise Index Solutions, LLC, which has contracted with S&P Opco, LLC (a subsidiary of S&P Dow Jones Indices LLC) ("S&P Dow Jones Indices") to calculate and maintain the Tortoise MLP Index®, Tortoise North American Pipeline Index℠ and Tortoise North American Oil and Gas Producers Index℠ (each an "Index"). S&P® is a registered trademark of Standard & Poor's Financial Services LLC ("SPFS"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and, these trademarks have been licensed to S&P Dow Jones Indices. "Calculated by S&P Dow Jones Indices" and its related stylized mark(s) have been licensed for use by Tortoise Index Solutions, LLC and its affiliates. Neither S&P Dow Jones Indices, SPFS, Dow Jones nor any of their affiliates sponsor and promote the Index and none shall be liable for any errors or omissions in calculating the Index.

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