MLP and Energy Infrastructure Market

First Quarter 2020 Commentary

OVERVIEW

Master Limited Partnerships (MLPs), as represented by the Alerian MLP Index ("Index") returned -57.19% for the quarter and -60.95% for the one-year period ending March 31, 2020. In comparison, the S&P 500® Index returned -19.60% and -6.98% for the quarter and one-year, respectively.

OUTLOOK

During the first quarter, the S&P dropped 20%, the 10-year approached 50 basis points, the VIX touched over 80, oil dropped under $20 and the list goes on. To top it all off, the Alerian MLP Index closed the quarter at 91. To put this in perspective, that is over 40% lower than the 152 low point the Index hit in November 2008. Pipelines are going to see volumes decline, but in our estimation these companies are going to be able to service their debt and have adequate cashflow to support their operations. Many companies are trading at yields that suggest financial distress. While we think security prices are well below the financial reality of the underlying operations, management teams may take this opportunity to reduce distributions and dividends to preserve cash and liquidity in these unusual times.

We stress tested the investment universe for commodity prices, crude oil production declines, refined product demand shock and lack of access to capital markets among a host of other company specific factors. We are testing 25% cuts in refined product demand, a 30%-40% decline in U.S. crude output, and we assume the crude oil production drops will never come back. Here is the punchline. With 25% near term refined product decline and permanent $30 crude leading to a cumulative 30% production decline, we think the vast majority of our portfolio companies not only have sufficient liquidity, can maintain investment grade ratings but can even sustain distributions. This is a far different outcome than what we believe is priced in the market today.

There has been a lot of debate about how low oil prices will go and speculation it will hit zero or even go negative. Mid-last week, prices in West Texas were around $10 and in North Dakota and Canada, prices got down to $3 and $4 per barrel, respectively. This is due to the vast oil oversupply in the market with refinery runs down from the freefall in product demand. This is already leading to the logistics system clogging up and we estimate storage, theoretically, will approach full in the U.S. in the next 30-60 days at the current pace. To avoid this seizing of physical markets we expect to see high cost wells shut in permanently along with curtailments across the rest of the U.S. While this is painful in the short term, as the economy returns to normal at some point in the future, the E&P industry will be healthier as weaker competitors shut in, merge or otherwise go away leading to reserves being held in the hands of better capitalized, stronger and more disciplined operators. In combination with the recently announced OPEC+ production cuts, these U.S. reductions will be met by cuts from oil producers across the globe. The market reaction has been swift and painful, but ultimately, we believe that current valuations discount a worse outcome than is likely. It is worth noting that our portfolios are more heavily exposed to trends in natural gas, which has suffered less reduction in demand and prices than oil due to the corona virus.

Acknowledging the challenging volume outlook ahead we believe some upcoming developments might give the midstream industry a boost. Virtually every midstream entity is pricing a distribution/dividend cut. Outcomes will vary, but we think we are at a point where any firm news will be well received. Energy Transfer announced a flat dividend on March 31st and subsequently outperformed the Index by 20% over the next 3 trading days. Enterprise also declared a flat dividend on March 18th and is up 17%, but that is less than the nearly 30% return for the Index since then, but better than the almost 8% for the S&P 500. After the end of the quarter, on April 7th Plains All American announced a distribution cut of 50% and outperformed the Index into the Easter weekend. The tenure of the economic shut down will determine when and how the economy rebounds, but it will rebound at some point and energy infrastructure companies will be required to fuel that rebound.

Thank you for your continued trust and support. As always, we welcome any questions you may have.

Sincerely,

The Tortoise St. Louis investment team

One basis point equals 0.01%

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