MLP and Energy Infrastructure Market

Fourth Quarter 2019 Commentary

OVERVIEW

Master Limited Partnerships (MLPs), as represented by the Alerian MLP Index returned -4.08% for the quarter and 6.56% for the one-year period ending December 31, 2019. In comparison, the S&P 500® Index returned 9.07% and 31.49% for the quarter and one-year, respectively.

OUTLOOK

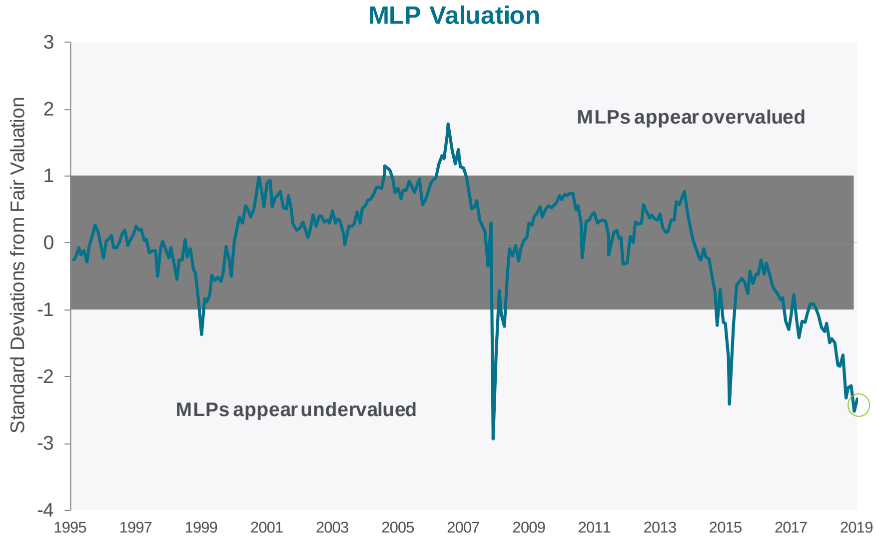
MLPs had weak performance during the fourth quarter but turned positive for the year on a strong December return of 8.53%. Pundits and market commentators pointed to fears of a global economic slowdown and expectations for weak global oil demand as the culprit for weak energy returns during the quarter. It is more likely to us that the recent weakness reflects the expectation that growing U.S. production will keep the market oversupplied. As a result, we believe any introduced geopolitical risk like the Iranian attack on Saudi Arabia will have limited long-term impacts on prices. This outlook is offset by some certainties we know will occur in the U.S. midstream industry in 2020. Multiple previously announced projects came on-line around year-end 2019 and will be cash-flowing in 2020 and beyond. The subdued outlook for commodity prices has caused oil & gas producers to lower capital spending plans in 2020 and midstream operators are responding in kind. These higher cash flows and lower spending plans will push midstream companies into a near-term free cash flow growth environment. This should get noticed by investors. Dividend and distribution expectations are solidifying as well, and we think yield-oriented investors who had avoided energy recently, might return as interest rates and yields in other equity market sectors remain low.

Our long-term outlook is bullish as we believe the industry is much healthier than investor sentiment indicates, and energy securities should benefit if value investing begins to outperform. Our Key Issues table below remains weighted to the positive. Attractive valuation levels and the resumption of distribution growth are important catalysts while the challenging political and regulatory environment remains an impediment to future returns. Given the current outlook, we are confident that long-term returns will be strong.

KEY ISSUES	Positive	Neutral	Negative	Comment
VALUATIONS	☑			We believe MLPs remain undervalued on an absolute and relative basis versus comparable asset classes
POLITICAL AND REGULATORY			☑	Infrastructure regulation is increasingly local, making for a more complicated operating environment. Domestic political risk could cause volatility in 2020.
COMMODITY PRICES		☑		Despite recent volatility, commodity prices are at the low end of our expected range
INTEREST RATES	☑			Interest rates remain low and are expected to stay around current levels
DISTRIBUTION GROWTH	☑			After 4 years of decline, distributions are inflecting and showing signs of growth
ENERGY INFRASTRUCTURE BUILD-OUT	☑			Multiple projects coming online is positive for cash flow but increased capital discipline by E&Ps may delay demand for new infrastructure for midstream companies

Valuations remain attractive, and strategic and financial buyers were active in 2019. Upstream transactions included large cap Occidental Petroleum buying Anadarko and multiple smaller cap stock-for-stock mergers. Equity capital market access was limited in 2019 as capital was scarce and, as a result, efficiency with the capital you have becomes ever important. Part of the rationale for the M&A was the enhanced drilling efficiencies along with reduced levels of SG&A.

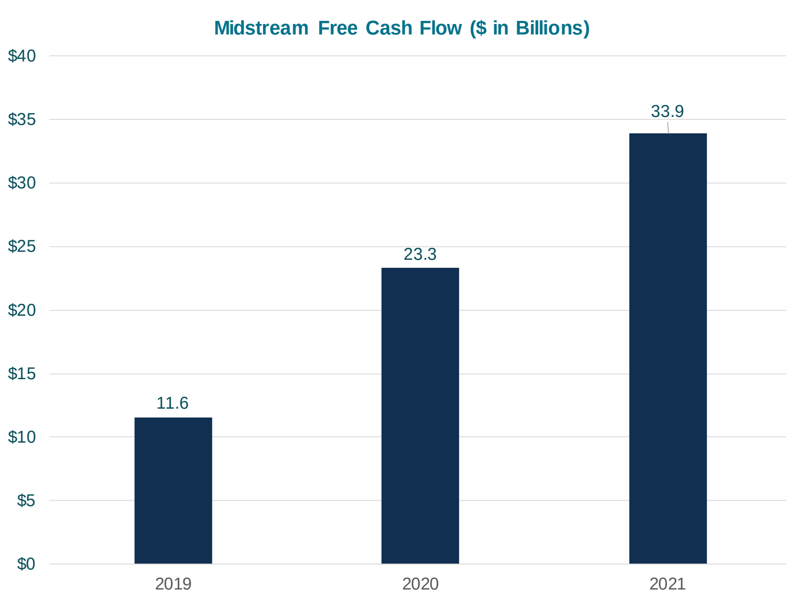
Midstream saw private equity interest continue to be high. IFM Global Infrastructure purchased Buckeye Partners for over $10 billion, Blackstone raised its offer for Tallgrass Energy and private equity acquired multiple non-core pipeline assets from public companies. Midstream companies are using the proceeds from these sales to strengthen balance sheets, fund the build out of more strategic assets and are considering share buybacks.



Period: 12/31/1995 – 12/31/2019
Data Source: FactSet Research Systems
Composite valuation based on both relative and absolute valuation metrics. Standard deviation is a measure of volatility, which shows how much variation exists from the average return.

A theme in our portfolios is a preference for natural gas infrastructure compared to oil infrastructure. We have long held the view that natural gas was the fuel to bridge the world economy from one reliant on coal and oil to a more renewable energy focused one. We have seen this play out over the last year and decade. Natural gas production in the U.S. has grown from 70.9 billion cubic feet per day (Bcf/d) at the end of the last decade to approximately 115 Bcf/d at the end of 2019.[1] The transition to natural gas makes sense from a practical, political, regulatory, and economic point of view. The data suggests that the landscape has already changed dramatically. As a percent of fuels consumed for electricity generation, natural gas has more than doubled over the last decade growing from 20% of the total to 42% of the total today.[1] During 2019, a tough year for energy capital markets, natural gas production still grew 8.8%. While much has changed, we expect the trend and pace of change to accelerate in the decades to come. This leaves us bullish on natural gas midstream infrastructure going forward.

As we look into 2020, geopolitical risk will be a market driver, but we expect individual incidents to have short-term impacts on commodity prices, not a phase shift higher. Crude oil prices, which are high relative to natural gas, are driving the production of associated natural gas, the gas that is produced out of a well drilled on crude oil economics. This natural gas production should keep natural gas prices low. We think this price environment is good for global demand and LNG exports should continue to grow. Historically, midstream equity returns are seasonally front-loaded into the first half of the year, but domestic political risk could cause volatility in an election year. The election of a moderate Democrat or the incumbent Republican could be a positive for energy and midstream in the second half of the year. Overall, energy infrastructure companies look cheap, on average, and the business models have been significantly de-risked in recent years. The advent of a free cash flow ramp could push valuations higher as companies return more cash to shareholders in 2020 and beyond.



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

Sincerely,

The Tortoise St. Louis investment team

Source:
1. U.S. Energy Information Administration

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