Tortoise QuickTake Energy Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Rob Thummel: Welcome to our final Tortoise podcast for 2019. I am Rob Thummel and I am joined today by my fellow portfolio managers Quinn Kiley, Brian Kessens and James Mick. Today, we are going to highlight what happened in the energy sector in 2019 and look ahead to 2020. So, let's get started. Brian, 2019 was an eventful year in energy, arguably one of transition. Can you recap the year for us, and particularly comment on fourth quarter weakness?

Brian Kessens: Sure Rob. It was a year of transition as we saw consolidation accelerate and management teams start to shift from putting more capital in the ground to putting more in shareholders' hands.

Helping buyers and sellers see more eye to eye, crude oil prices were relatively stable post January. We witnessed range-bound prices for WTI between $50 and $60 per barrel most of the year. This stability resulted from OPEC staying united in their effort to manage supply and partly due to U.S. producers reducing capital expenditures and consequently crude oil production growth expectations.

Upstream transactions included large cap Occidental Petroleum buying Anadarko, and small cap stock for stock mergers including Callon buying Carrizo, PDC Energy purchasing SRC Energy and Parsley acquiring Jagged Peak. Equity capital market access was limited in 2020as capital was scarce, 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 made an offer for Tallgrass Energy and private equity acquired multiple non-core pipeline assets from the publics. 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.

Specific to the fourth quarter weakness, on the heels of lower natural gas prices, Chesapeake Energy included "ability to continue as a going concern" language in its third quarter 10-Q filing. The inclusion is due to relatively high debt levels that includes a leverage covenant becoming increasingly tighter through 2021. That cautioned upstream and midstream investors alike. Further, on 3Q earnings calls midstream companies lacked full transparency on 2020 capital allocation, and investors became concerned that 2020 capex may not fall enough. This negativity fed upon itself through tax loss selling as MLPs trailed off in the fourth quarter.

Since the end of November, Chesapeake announced some balance sheet restructuring including covenant relief and buyers returned to the market, potentially anticipating a strong January once tax loss selling ends.

Rob Thummel: James, are there any broad categories for what worked and what didn't work in energy in 2019?

James Mick: Well I know it didn't feel like anything worked in energy, but in reality that's not the case. Utilities have really led the pack of subsectors, with a return approaching that of the S&P 500, up over 20% year-to-date. Refiners, who generate a lot of free cash flow, followed the utilities in positive territory. Majors were in the green as well. Midstream has been a mixed bag. MLPs have provided a total return in the low single digits, depending on the benchmark, but price action was negative as the distributions made the difference pushing to the positive side. On the contrary, C-corp pipelines have done quite well, generating returns similar to utilities.

Finally, on the upstream side of the ledger, it's been much less positive. Anything with natural gas exposure or higher leverage with less ability to get to free cash flow generation, has been hit and hit hard. In particular northeast natural gas

exposure and small caps with more marginal acreage have fared the worst. 2019 was generally a risk-off environment and outside of defensive utilities, those companies that can generate free cash flow really outperformed.

We would expect 2020 to be more constructive, but that focus on free cash flow is certainly not going away.

Rob Thummel: Brian, shifting gears, oil and natural gas prices can drive energy sentiment. So what are our expectations for 2020?

Brian Kessens: Crude oil is a tough one is 2020, seemingly with more variables than ever at play. On the supply side, we're confident U.S. shale producers are reducing capex levels. The days of adding 2 million bpd per year are behind us. We think U.S. supply increases between 400 mbpd and 1 mmbpd in 2020. We also know that new supply from Brazil, Guyana and Norway will come on-line, adding up to 800 mbpd there. The wildcard is OPEC. Yet with Saudi Arabia focused on the success of the IPO of Saudi Aramco, we're confident the Saudis and OPEC will restrain production enough to maintain Brent prices north of $60 per barrel. Oil demand is also hard to gauge. With trade tensions easing and the global economy not showing any signs of a true slowdown, we think demand growth eclipses 1 million bpd. All in all, we expect supply and demand to be in balance and WTI prices to range between $55 and $65 per barrel.

On gas, weather is a big driver as evidenced by last year's cold winter that left inventories low entering the spring. Yet weather aside, the natural gas market is currently oversupplied after supply grew 10% in 2019 over 2018 average levels. Demand set records from more coal-to-gas switching and exports, yet simply has not kept up with supply. Gas producers are consequently taking action and slowing production. We expect U.S. supply to flat-line in 2020 while demand continues to improve, in large part from more LNG export infrastructure coming on-line. As production slows we expect prices to improve off of the current $2.30 per mmbtu level, yet not sustainably eclipse $3.00 per mmbtu, as producers are sure to add production as prices approach a three handle.

Rob Thummel: James, natural gas demand is a big focus. I understand LNG exports are a large part of it. Given weaker global LNG prices this year, the trade tensions with China and a new natural gas pipeline from Russia to China, is there still a place for U.S. LNG exports?

James Mick: Absolutely. We firmly believe that U.S. LNG will play a big role on a go-forward basis serving worldwide LNG demand. That being said, we are undergoing a similar transition right now with LNG as we did in crude oil and liquefied petroleum gas a few years ago. What I mean by that we're now exporting more of our low cost hydrocarbons, this time in the form of LNG to the rest of the world, effectively exporting deflation in the form of energy prices.

The U.S. built up from basically zero LNG exports in 2015 to projections for almost 5 bcf/d in 2019, on average. In fact, we've had days of just over 7 bcf/d exported recently. Combined with a warm winter in Asia, this incremental supply from the U.S. produced a surplus in Europe, which serves as a bit of a dumping ground for excess LNG given storage availability. Hence, we've seen a pretty significant decline in prices in both Asia and Europe, to the tune of about 40% from 2018 levels. It's likely that LNG prices will stay somewhat depressed in 2020, unless we get a cold winter across the pond and in the Far East.

But all of that is temporary, demand is on the way from emerging markets looking to replace dirtier coal fired generation with natural gas. The pipeline from Russia to China is another example of that. And while that pipeline is a nice source of supply, it is estimated by Chinese oil and gas giant Sinopec that at peak capacity it will only account for about 15% of China's import needs for natural gas in 2025, let alone beyond.

So we believe China, after the trade war ends, as well as other nations, will sign up for U.S. LNG due to diversification of supply. The U.S. offers surety of supply, excellent court systems with contractual confidence and most importantly a very competitive price.

Rob Thummel: Quinn, focusing on midstream, where are we at in the evolution process and what does that mean for 2020?

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Quinn Kiley: As our listeners know, midstream energy companies have been changing their financing models and corporate structures over the last few years to address investor's concerns about reliance on the capital markets to fund growth capital expenditures and corporate governance. Midstream MLPs are well down the path to completing this transformation; we've seen improved distribution coverage, reduced leverage and the elimination of misaligned general partner payouts. However, not every MLP has addressed these issues and that tarnishes the market's view of the group, even for those MLPs that have long ago completed the transition. As we look to 2020, we expect the laggards to finally conform. While this is a positive development, the required steps to fully evolve into a midstream 2.0 company creates noise around the space and could introduce some volatility into the group. All in all, midstream is a much cleaner story and a healthier sector than it was just a few short years ago.

Rob Thummel: Midstream valuations have looked cheap for some time. Is that still the case and if so, what is the magnitude, Quinn?

Quinn Kiley: Despite a welcome strong start to December, midstream continues to trade at stubbornly low valuations. If you look at EBITDA to enterprise value metric, the median midstream MLP is trading two turns lower than its long-term average. On a relative basis, median MLP spreads to the high-yield indicies are near all-time highs. In fact, spreads are wider today than they were in early 2016 when crude oil briefly touched $27 per barrel. As a reminder, crude oil today as measured by the WTI price points is currently trading at approximately double those 2016 lows. Current valuations are attractive for investors looking to establish or add to positions in midstream equities.

Rob Thummel: And Quinn, how concerned should we be with midstream counterparty risk with E&Ps?

Quinn Kiley: To be sure, oil and gas producers are going through their own evolution, in many ways it is similar to what midstream companies embarked on a few years ago. While there are clearly some distressed entities out there, the majority of oil production is profitable at today's oil price levels. Natural gas producers as you mentioned earlier are more challenged, and you have seen some natural gas gatherers, especially if they are exposed to acreage in the northeast, sell off amid these concerns. We think the risk to these gatherers is more about contract renegotiations, and potential lower revenues, and less about recovery in a bankruptcy situation. Remember, once a well is connected or acreage is dedicated to a gatherer, the midstream provider becomes the producers only route to market for their commodities. We have seen some renegotiations already where the midstream provider lowers fees but the producer either commits to longer contract terms, higher volume guarantees or increased acreage dedications. In most cases, these are NPV neutral changes to the value of the contract. So yes, there is reason for some concern, but we view the sell-off in gathering & processing names to be overblown and would expect this group to lead a recovery in the near term.

Rob Thummel: Brian, given the backdrop of all of our discussion, what are the total return expectations in 2020 across the energy sector?

Brian Kessens: We're optimistic across energy in 2020. Supply and demand should find better balance and companies will shine a brighter light on their cash flow when they return it to shareholders in more transparent ways like dividend growth and share buybacks.

We expect midstream returns in the low double digits based on current income or yields of 7%-10% and cash flow growth per share of 4%-6%. As investors gain greater confidence in the sustainability of that growth and capital allocation becomes more transparent, we think midstream multiples can expand back toward their historical averages that Quinn noted. That, potentially adds very meaningfully to returns.

With a relatively stable commodity price backdrop and upstream companies focused only on their highest return plays, we expect producer returns of 15%-20%, yet with a lot of volatility.

Downstream valuations look more in-line with historical averages, if not above for utilities due partly to their improved growth profile from renewables. Yield and growth generate our expectations for high single digit to low double digit returns there.

Rob Thummel: James, as we wrap up the podcast, broadly, what is our longer-term outlook? We've talked before about the electrification of energy and some of the actions utilities are taking toward renewables.

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James Mick: sure, well our long-term outlook is built around demand. We believe that the world will continue to electrify, with demand for electricity worldwide to double by 2050. In turn, that will require power generation, driven by both renewables and natural gas. In our view, natural gas and renewables need to replace coal in the generation stack. Simply put, this is the fastest and most economical way to lower carbon emissions across the globe.

Additionally, while we see continued efficiencies across the developed world, the demand for energy is highly likely to grow based on the developing world continuing to increase living standards. Case in point, the United Nations notes that about 80% of the world's population lives in countries where the average energy consumption is less than 100 gigajoules per head. The 100 number is what the UN associates with a minimum level for substantial human development and well-being.

At the forefront of the electrification movement are utilities, which are transitioning the generation stack away from coal in developed markets, with developing markets to follow. Additionally, U.S. midstream energy is playing a big role, exporting cheap and lower carbon energy to the rest of the world by building the necessary infrastructure to support these exports.

In summary, not only is energy still important, it's absolutely critical for the functioning of the economy and to help deliver populations out of poverty. It's not hyperbole to say that getting people to understand this is simply one of the most important topics that we face today as an industry and a story that we will continue to tell to anyone and everyone that will listen.

Rob Thummel: Okay thanks Quinn, Brian and James. And thank for joining us today. We appreciate your interest in Tortoise. We look forward to continuing our weekly podcasts in 2020. Happy holidays everyone!

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.

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