CEF Insight:
Energy Infrastructure and MLPs – are we turning the corner?

Jeff Jorgensen, Portfolio Manager and Director of Research with the Energy Infrastructure Securities team at Brookfield Public Securities Group and the Closed-End Fund Association discuss the fundamentals and opportunity in the energy infrastructure and MLP space after a difficult period for the sector as part of CEFA's CEF Insights podcast series. The podcast audio can be heard here.


Jeff Jorgensen

CEFA: **Welcome to CEF INSIGHTS, your source for closed end fund information and education brought to you by the Closed-End Fund Association. My name is Diane Merritt. Today we are joined by Jeff Jorgensen, Portfolio Manager and Director of Research with the Energy Infrastructure Securities Team for Brookfield Public Securities Group. We're happy to have you.**

JJ: Thanks Diane. Happy to be here.

CEFA: **Jeff, MLPs and energy infrastructure have traded at almost all-time lows in recent months. Why do you believe this sector remains so out of favor?**

JJ: Yeah, it's unfortunate to have to answer that question. I certainly don't like seeing good companies trade at around all-time lows, and certainly didn't anticipate being here at this time of year, given what we're seeing at the operating level for many of these companies. But energy remains out of favor, and sentiment is very negative across energy public securities. I'd say private equity continues to be excited about energy, the credit markets continue to be supportive of energy, but the public equity markets are... the sentiment is incredibly low on energy stocks. And I think MLPs get pulled into that, despite having a lot of infrastructure and real asset type quality.

But I also think within the MLP space specifically, you've had a series of missteps by smaller companies, in some instances, that have impacted the broader asset class. And one of the things you've seen happen over the last four or five years is a reduction in distributions for the entirety of the asset class. And you have to keep in mind that MLPs were sold to financial advisors in a largely retail community, on the strength and the underlying stability of the distribution and that yield. And over the last four years for a few reasons, not many of which are fundamental, the distribution payouts from MLPs have been reduced. So the stability of that yield has been called into question, and therefore the original intent, or the original sales pitch around MLPs has been called into question.

And that's an unfortunate read through, because as I mentioned at the beginning, the fundamentals underpinning most of the MLPs, and particularly the best in breed ones where we focus our efforts, have not changed and have actually improved. And so you see some corporate finance, some missteps, some small mid-cap names impacting the entirety of the sector, and probably overshooting as a result of some of those missteps.

CEFA: **Do you see a return to growth from companies in this sector as having a positive impact?**

JJ: I do. And that's a good segue from my last answer. So with four years in a row of distribution reductions, we're actually finally seeing that turn the corner. So we're seeing distributions now, 2019 over 2018 should be positive for the first time since 2014 over 2013. And once the confidence in that distribution stream returns, we expect fund flows to follow. So that the end of the distribution cut era should be close, and I think that could be a catalyst for slow and steady rerating of the space, back to historical norms.

CEFA: Do you think that the regulatory and political backdrop has contributed to weakness in the sector?

JJ: Yeah, that's a great point, Diane. I think so. I mean it can't be ignored. It's an important part of the research we do at Brookfield, is looking at the regulatory and political backdrop and how it might impact the fundamentals of companies in particular. Obviously that has contributed to the broader negative energy sentiment with a good focus on climate initiatives, global warming and what have you. But there are a lot of positive stories and green shoots that we could point to, in the infrastructure space, and how our companies are actually positively impacting things for the better, even when addressed with those. So I do think it's a headwind, it's something you've got to manage around, and on a pipeline specific basis or on a company specific basis, that's something we must do diligence on, so that we can avoid any regulatory pitfalls, any project specific risks. It's a big area of focus for what we do over here.

CEFA: What impacts could you see resulting from the upcoming elections in 2020?

JJ: Well, obviously it depends on the outcome of those elections, but certainly as the election heats up, we would expect more discussion around what the Democrat candidates might do to regulate and to increase regulation for U.S. oil and gas. We've heard everything from outright fracking ban, to returning to the export ban that was reversed in the Obama administration in 2015. And we think some of that dialogue will continue. What actually happens if one of those Democrats is elected, I think is a little bit more difficult in talking about what they say from the podium. And I do think a lot of jobs have been created by the energy industry. A lot of GDP growth has been contributed from the energy industry and the resulting low prices of commodities, because of the supply that we've created. And I do think the export market is important for the rest of the world in reducing carbon emissions, and becoming less dependent on producer States which might not be so friendly, and might not be free market oriented.

So, I think it's a complicated question. I do think that there will be... If a Democrat were to win, there would be some additional regulation almost immediately on federal land. Now the flip side of that, I think that's the easiest thing that we can say is probably going to happen, and I think that would impact about 10% of activity. The current rig count or the current well completions, it's about 10% on federal land. Most of the activity is being done on state private land, and for that reason we see continued growth regardless of what may happen at the ballot box in 2020. But expect more conversations, expect more debate, expect more discussion around potential regulation.

CEFA: So, Brookfield is an active investment manager within the energy infrastructure space. How do you approach portfolio construction, and what advantages do you see for an active manager, with respect to managing risk and adding to performance?

JJ: Yeah, this is a, obviously we've talked a little bit about the regulatory and political backdrop, and I think that's one very easy area where it's incredibly important for an active manager to do work, to avoid some of these pitfalls that obviously passive investing, takes no effort at looking at. So I think that's an important area of active management. Our focus is on quality. Our focus is long-term. We're investors, not traders. And whether it's C-corps or MLPs, we're investing in midstream energy infrastructure companies with solid fundamentals that can work through commodity cycles, and we're trying to do so at the best relative valuation for our asset class.

So, in the past, the products in this space, you're often limited to just partnerships. We do not limit ourselves in just partnerships or just C-corps. There are other structures that are more C-corp oriented. We are really, truly focused on the best assets run by the best management teams, and really at what we think are the most compelling relative valuations in any given moment. Also, while doing an incredible amount of diligence on those potential project level issues or regulatory issues, things that we can keep our eyes on to manage risk accordingly.

CEFA: Brookfield manages a closed-end MLP and energy infrastructure fund with the ticker symbol CEN. Do you find the closed-end fund structure to be advantageous in managing a portfolio of energy infrastructure securities?

JJ: We do. Yeah, absolutely. We can... In our closed-end fund, we're doing that core investing that we do across all of our strategies and products, and that is providing investors with our best ideas. But in addition, because of the closed nature of a closed-end fund, we are able to do private investments in our closed-end fund, CEN. We can manage more illiquid securities, and so we can do co-invest private equity, to complement our public exposure. Currently we have a $40 million investment for example, in a co-invest private equity joint venture, with a very well-known private equity company, operated in a very attractive base, and that's created quite a bit of alpha for us and excitement in what has been a difficult environment.

CEFA: Jeff, the energy related sectors are always subject to market and domestic issues as well as global events. And the mid-September attack on Saudi Arabia's oil supply was the first time in a while that we have seen geopolitical supply disruption. How do you think this could impact U.S. energy and midstream energy infrastructure?

JJ: It's a great question. That was a surprising attack, and an unfortunate attack. The Abqaiq facility, which was attacked, is really... If the oil market had a heartbeat, it was really the Abqaiq facility in Saudi Arabia. And we think that the market shrugged off that event pretty quickly, crude oil prices returned to normal and came back down fairly quickly. And a lot of that was because they were able to be repaired quite quickly. But what I think it points to, is that there is a large amount of supply subject to geopolitical risk, and we have not been reminded of that in quite some time. And that's a good thing. You want to be reminded of that. But in the U S we have no comparable geopolitical risk or beating heart, that could be attacked and could disrupt crude oil supply in such a large magnitude.

So, I think it's important and should be recognized, that the U.S. provides light sweet crude that is less susceptible to large supply shocks, comes from a free market, and is one in which should provide overall stability to the commodity market. The presence of the U.S. in the crude oil market I think is a good one for those reasons. So I think it points to what I think should be a premium placed on what we're doing. And if that premium continues to exist, or that premium... And if people believe that narrative, then I think you should continue to see flows through the pipelines, and through the export facilities that we're investing in over at Brookfield.

CEFA: **Natural gas pricing has added to volatility in the energy sector generally. What is the root cause of this volatility, and what is the impact on the midstream equities?**

JJ: Yeah, natural gas is a really important part of what we do. We spend a lot of our time talking about crude oil, because it dominates the headlines. It tends to be the focus of most people when they think about energy stocks. The natural gas is as important, if not more important, to the infrastructure that we're investing in at Brookfield. And so natural gas... The cause of the most recent volatility is actually the success of the U.S. oil and gas industry. And I say success, not in terms of stock success, because we have not seen that unfortunately. Talking success in terms of production success, in terms of volume success, in terms of volume growth. The U.S. has gone from a nobody on the global stage, to the leading producer of crude oil, natural gas, and natural gas liquids.

And on natural gas specific to this question, a lot of the natural gas comes out of crude oil wells as an associated byproduct. And I think that's very important for investors to keep in mind. So, in the Permian oil fields, as primarily an oil field in West Texas, producers like Exxon and Chevron are producing crude oil and about 30 to 35% of the well that comes out, comes out with natural gas. But they are there for the crude oil economics.

So, the success of the Permian has created a lot of associated gas. And that associated gas is very cheap, because those producers don't necessarily want it, and it comes out in large quantity. And so you're seeing an absolute flood of natural gas due to our own success in creating new production and creating volume. And lots of supply is not necessarily a good thing for price. And so that's what has happened. That does create an opportunity on the demand side, which is why you've seen a lot of coal switching, displacing coal fired power plants for natural gas fired power plants, which has a better carbon footprint. And you've seen a lot of LNG facilities constructed and built. But unfortunately the demand response to the supply signals we see this summer doesn't happen overnight. It takes time to get that demand, to build that demand, and to create the infrastructure to let the world access those cheap markets. And so that's what we're in the process of doing now and investing in here at Brookfield.

CEFA: **Midstream and energy infrastructure as C-corporations have outperformed MLPs by a wide margin this year. Do you think this will lead to further conversions of the C-corporation structure, and how does this impact the investor base in the space?**

JJ: Yeah, I think this has been a big trend. Historically, most midstream companies were housed in partnerships or MLPs. There is a tax advantage to being a partnership. Everyone knows that partnerships are not subject to double taxation like the C-corps. And so what you've seen is many entities, and I'll name a few like Kinder Morgan or Williams Companies or Oneok Inc., had C-corps that were publicly traded, and used those C-corps to buy out their partnerships. So what you've seen is less of a conversion to C-corps, and more of an aggregation within C-corps, and an elimination of some of the publicly traded partnerships.

Now the fact pattern for each company is quite specific. But there has been continued outperformance of those C-corps this year. I personally don't believe that the conversions will necessarily pick up steam or that the large-cap partnerships will necessarily convert to a C-corp for a few reasons. One, I think the verdict's still out as to whether the outperformance seen by the C-corps is something permanent. Currently those C-corps are not paying taxes, and currently the tax rate is 21%. If a Democrat will win, the corporate tax rate would probably go up, and when those C-corporations start paying taxes, the MLP advantage would obviously be wider than it is today. So there's a real fundamental reason, a real cash tax reason, that someone might want to stay a partnership.

Second, the performance along C-corp versus partnership lines has mostly been focused on capitalization. So it's been large-cap companies that have outperformed as opposed to just being a C-corp. It does not appear to be a cure all. And then finally, C-corps, the conversion process. If you're a large-cap partnership that is looking at conversion, that can be a very unfavorable tax event for legacy unit holders, and I don't think it's something that companies enter into lightly.

So, I don't see wholesale conversions happening. I do think there's been some technical tailwinds for the C-corps over the partnership size this year specifically, and some of that could reverse going forward. I think it's silly to look at companies from a structural perspective, and not spend all your time focusing on the best assets and the best management teams, which is what we do.

CEFA: **Jeff, we have seen some M&A activity this year. Can you discuss how this has impacted the sector?**

JJ: Well, I think what you've seen is a healthy M&A market. An M&A market that's disconnected from a valuation perspective, from the public market. And I'll give you a few examples. Recently you saw SIM Group bought out at a 65% premium. And you've seen Tallgrass, which these are mid-cap C-corps in partnership. Tallgrass bought out in a leveraged buyout by Blackstone, and you saw a large Australian infrastructure fund do a leverage buyout of a terminal and storage company called Buckeye Partners. Actually the oldest midstream MLP going back to 1986.

So, you've seen quite a bit of private equity appetite to buy midstream assets. And they do that because of the stability, the cashflow, all of those things that tick the box of a good LBO candidate. And then you're seeing... And they're doing some evaluations of 11, 12, 13 times on average, regardless of it being an asset deal, leverage buyout, or corporate transaction. And yet the public still trades at nine to 10 times. So I think what you're seeing is a continued valuation disconnect between the private markets and the public market. And one that highlights I think an opportunity in the public markets once they're allowed to heal and investors feel comfortable underwriting the stability of the distribution and the stability of the company.

CEFA: **Jeff, with interest rates at current levels, how do you believe an allocation to energy infrastructure is best positioned in the portfolio of an incoming seeking investor?**

JJ: Yeah, I think it's a great question. I think that's a lot of the opportunity here. I think after four years of distribution reductions, we finally are at a point where distributions should stabilize if not grow.

I think with a little bit of time, investors will learn that this is an under-writable dividend, particularly in the large-caps, the partnerships, the C-corps that have fixed their balance sheets, remain investment grade, and are trading at all-time lows, that have all-time high coverage ratios. And they are nearing the end of a large build-out cycle that should accrue a lot of free cashflow to the benefit of equity investors.

CEFA: **And how would you see an allocation to energy infrastructure best positioned in the diversified portfolio of an investor that is less focused on current income?**

JJ: Yeah, I think less focus on current income still provides an attractive story. And without even talking about the option value of mean reversion on value, you can just look at the underlying cashflow growth of these companies. Some of that may be, which we see still as a stable 9% to 12% on average over the next few years. Add on to that, some of that may be paid out as a dividend, some may be in dividend growth, some may go to reduce debt, some may be done now in stock buy backs or share buy backs. All providing a lot of free cashflow to investors that should accrue to the benefit of equity in the form of total return. And on top of all that, you have very discounted valuations, providing the option or the opportunity for mean reversion over time, as healing takes place.

CEFA: Jeff, thank you so much for joining us today. We appreciate it.

JJ: You got it. Thanks Diane.

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