Energy MLPs: Looking Beyond the Headlines

There have been a lot of news-making headlines in the energy space over the past year. Michael Hedstrom, director of the Closed-End Fund Association (CEFA), sat down with Chris Eades, managing director and portfolio manager at ClearBridge Investments, an independent affiliate of Legg Mason, to discuss investing in energy Master Limited Partnerships (MLPs), the outlook and trends in the energy market, and the Trump presidency and other factors influencing the MLP space.


Chris Eades


Michael Hedstrom

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on February 15, 2017, which can be heard at CEFA.com.

MH: MLP closed-end funds offer access to what is often talked about as a true American success story. That is, North America's energy renaissance and the growing demand for U.S. energy sources and supporting infrastructure. Chris, as a backdrop, what are your thoughts on how the story has played out so far?

CE: Well, it has been a very volatile ride for MLP investors over the past couple years. Now, despite the volatility that we've seen in oil prices and in MLP stock prices, for that matter, most MLP business models have held up as we would've expected during the cyclical downturn and now the cyclical recovery in oil prices. Now, most of the assets owned by MLP companies generate cash flows not based on the price of oil or the price of natural gas, but rather on the volume of oil and the volume of natural gas. So, while oil and natural gas prices have been exceedingly volatile over the past couple of years, MLP cash flows actually remained quite resilient and, in fact, grew in 2015 and in 2016 despite oil prices having fallen from more than $100 a barrel to $26 a barrel.

Despite those resilient cash flows, MLP stock did trade off by more than 55% from an August 2014 high to the February 2016 low. Essentially, what we saw in that period was that MLP stocks traded as if their cash flows were dependent on the price of oil and the price of natural gas, much like an oil and gas production company for a period of time. Now in fairness, the severity of the downturn in MLP stocks was worse than we envisioned going into the cyclical downturn for oil and natural gas prices. But, while over the short term stocks can disconnect from their underlying cash flow fundamentals, we knew that ultimately stocks would begin to again discount cash flow fundamentals. This did take a while to occur, but the rebound that we have seen in MLP stock prices since February of 2016 reflects a market being much more rational in value and the cash flow capabilities of these MLP companies and their assets.

MH: **As you mentioned, we've seen a lot of volatility as well as news making headlines in the energy space. Oil prices hitting a low in February last year before rebounding. OPEC recently announced production cuts. President Trump signed multiple executive orders in late January that were designed to expedite current and future midstream projects. Chris, let's talk a little bit about your outlook. What potential implications does a Trump presidency have for MLP companies?**

CE: A Trump presidency potentially has positive implications for MLP stocks, at least over the next four years, and perhaps beyond that. I guess I would highlight four different things. First, during the Obama administration, we did see delays in permits for new pipeline projects. That should become less of an issue in the Trump administration. And, obviously, as you mentioned before, within days of being inaugurated, President Trump signed executive orders easing the regulatory or permitting burdens on two very large pipeline projects: Energy Transfer Partners' Dakota Access Pipeline or DAPL, as well as TransCanada's Keystone XL pipeline. Now, these are all the executive orders signaling an administration that seeks to foster development of energy resources in the United States, and also an administration that will seek to limit the regulatory delays, which is to the benefit of MLP companies. I think you also could see lead times needed to receive drilling permits on United States federal land decrease. We certainly saw an increase in the lead times required during the Obama administration, but a Trump presidency should see a more streamlined process for well permits, which could allow for more development of federal lands across the US.; eventually leading to an increase in production and the resulted need for incremental infrastructure to transport those volumes to the marketplace.

I think it's also important to note, that Trump did campaign rather heavily on a vision of U.S. energy independence. He advocated increased drilling activity as a means to achieve this policy goal, and an administration that encourages drilling activity will very much benefit the MLP companies from the resulted need for the transportation infrastructure. The last thing I would mention, as it pertains to Trump, is that don't forget that President Trump has populated his cabinet with individuals with energy backgrounds or individuals from energy producing states. Namely, Secretary of State Rex Tillerson, who was the CEO of ExxonMobil before joining the Trump administration. Secretary of Energy nominee Rick Perry was the governor of Texas prior. Lastly, the Environmental Protection Agency had nominee Scott Pruitt, who was Attorney General for Oklahoma. This is obviously an administration that is knowledgeable about energy, is probably in favor of energy, and all of these things bode well for energy companies broadly, but also MLP stocks specifically.

MH: **With that said, after rebounding so strongly in 2016 and into this year, are you concerned about a correction at all and what is your broader outlook for MLPs in 2017?**

CE: Well, I mean stocks are always going to be volatile, and we've had a very big rebound, as you mentioned, off the lows that we saw in February. In fact, MLP stocks are up over 75% since the February 2016 lows. That being said, we're actually still very constructive on MLP stocks. If you look at how we started the year off, we've gotten off to a very solid start here in early 2017, with the O'Leary and MLP index up roughly 5% in January. That would compare to the S&P 500 up 2%, Utility stocks up 1% and REIT stocks which were actually flat. Now the performance in MLP stocks in the early part of this year reflects renewed investor confidence that oil and natural gas prices have bottomed and are poised to further recover.

On the oil side, that's obviously a function on OPEC agreeing to production cuts, which I think has probably put a pretty firm floor on how low oil prices can go from here forward. Then you look at MLP company fundamentals specifically, and I think we'll see MLP distribution growth in 2017 that will likely accelerate somewhat relative to the 3% distribution growth we saw in 2016. Very important, as far as fundamentals for MLPs are concerned, after a modest decline in 2016 we do expect U.S. oil and natural gas production to begin increasing again in 2017. We actually think we'll likely see the recent peaks in the second half of 2017 and from that point forward, any incremental production gains in the United States will drive the need for incremental infrastructure to process, transport, and store that increase in production. This in turn will likely lead to accelerating cash flow growth for MLP companies which should, very importantly, lead to accelerating distribution growth for the MLP companies that we invest in, as we head into the back half of 2017. Certainly, as we see it heading into the early parts of 2018.

Now, on average for the MLP sector, I think it's also very important to note, as you think about outlooks, the balance sheets for these companies are in very healthy conditions right now, and these companies have ready access to both the debt and the equity capital markets. This, in our opinion, leaves MLP companies extremely well positioned to not only execute these growth projects, but equally as important, to finance those growth projects — Again, as we look over the balance of '17 and into the first parts of 2018. Now, though MLP stocks have stationed an impressive rebound as I mentioned before, I think it's also important to note that valuation for MLP stocks actually still remains below typical levels for this sector. Now, following the extreme lows of a year ago, we continue to expect MLP valuations to return to their historical average level. This continued normalization of stock valuations, combined with what should be accelerating cash flow growth, leaves us positive on MLP stocks looking out over the rest of this year and into 2018.

The last thing I'll just add in terms of outlook, even though MLP cash flows are not really driven by the price of oil, we do actually remain constructive on oil prices looking forward. Entering 2017, our expectation was that oil demand would eventually begin to exceed available supply, and this would likely necessitate inventory draw downs and, ultimately, stronger oil prices. We've mentioned OPEC a couple times already, but OPEC's decision to curb output is likely going to accelerate the inventory draw downs and more quickly result in firmer oil prices looking forward. In addition, we also expect U.S. oil drilling activity to continue to increase through 2017, as U.S. oil production very likely will be needed in the global market to ensure that the market does not move to an undersupplied position. Again, this increase in U.S. oil, as well as natural gas production is likely going to drive the need for new growth projects and higher cash flows for the MLP companies that we're invested in.

MH: Chris, you talked about MLP distribution growth. What impacts could rising interest rates have on MLP investments and distributions?

CE: I think it really depends on what kind of rising interest rate we find ourselves in. You know, if we find ourselves in a situation where we have rapidly and very quickly spiking interest rates, that is obviously going to be problematic for MLP companies and, for that matter, it'd be problematic for most asset classes across the capital market spectrum. There is the risk of spiking interest rates if Trump does follow through with his potentially inflationary fiscal spending measures that he discussed during the campaign. We still don't know exactly how that's going to play out, but it's certainly something to keep in mind and to monitor. However, more likely, a gradual increase in interest rates, I don't think, is going to be an issue for MLP stocks as we look forward.

Keep in mind there have been, and I think a lot of people have forgotten this, there have been three periods over the last 10 years where we did see 10 year treasury rates increase by more than 100 basis points, or by 1%. In all three of those periods, MLP stocks were up in terms of total return, and they actually posted better returns than other income oriented stocks like utility stocks and REIT stocks. I would also note that the absolute level of interest rates in those three most recent periods of rising rates were actually much higher than the current rates that we've seen in the market here of late.

I'll just very quickly highlight these three periods because I think it's important to see how these stocks behaved in recent periods of rising rates. So, from the end of 2008 to middle of 2009, 10 year treasury rates increased by 189 basis points to 3.95%, and over this period MLP stocks were up 39%. Utility stocks were down 4.6%, and REIT stocks were down 4.2%. Second period was from October 2010 to February 2011, and 10 year rates increased by 136 basis points to 3.73%. And over that period MLP stocks were up 9.7%. Utility stocks were up 2%, and REIT stocks were up 9.2%. The final period was July 2012 to December 2013, 10 year treasury rates increased by 160 basis points to a little more than 3%. Over that period, MLP stocks were up 19.7%. Utility stocks were up only 4.6%, and REIT stocks were up 8.7%.

So that kind of brings us forward to where we are today. Obviously interest rates bottomed in the U.S. in July of last year in 2016, and they've since increased by 110 basis points at the end of January to a still relatively low 2.45%, looking at the 10 year treasury interest rate. But over this period, importantly, MLP stocks were up 9%. Utility stocks were down 4.3%, and REIT stocks were down 5.6%. So, why do MLP stocks typically trade well relative to, certainly, fixed income securities in a rising interest rate environment? The easiest way to sum that up is, these are not fixed income securities. I mean, MLP stocks increased their income to investors over time, which has left the stocks less likely to trade like bonds or other income oriented stocks like utilities or REITs over the full interest rate cycle.

MH: Given your outlook, how are you trying to position your MLP portfolios? And looking long-term, what trends do you anticipate in the MLP space in the next few years?

CE: First, we focus on assets. Now there are many kinds of assets that are owned by MLP companies. We do not invest in oil and gas production companies. We do not invest in oil field service or drilling rig companies, and we also do not invest in downstream refining or petrochemical companies. Why? Because the cash flows of these kinds of assets are definitely dependent on the price of oil and the price of natural gas. What we do invest in are those companies whose assets are primarily focused on the transportation, processing, and storage of natural gas, natural gas liquids, crude oil, and refined products. These asset cash flows are not based on the price of the commodity, but as I said before, rather the volume of the commodity moving through that infrastructure system. These are often fee based businesses backed up with long term contracts, and these are also typically assets that are government regulated.

Next we focus on the geography of these assets. Where are they located within the United States? In our view, the near term production growth that we're expecting to see in the United States is going to be focused on the Permian Basin in west Texas, what is called the SCOOP and STACK play in western Oklahoma, and the Marcellus Shale play in Pennsylvania. Our portfolios are constructed to gain exposure to those three regions. We also believe that the Eagle Ford Shale play in south Texas could reemerge as another driver of production growth in the second half of 2017, and maybe that slips into the first part of 2018.

The next thing we certainly focus on, in terms of our portfolios, are the balance sheets. This is a very capital intensive business, and as such, we spend a lot of time focusing on the balance sheets of our portfolio companies. Obviously we focus on how balance sheets look today, but more importantly, how those balance sheets are going to look moving forward, as these companies attempt to finance their growth opportunities that they have in back log, typically with a mix of both debt as well as equity. Now this process leaves us with a group of stocks that we consider investible from an asset perspective, a geographical perspective, and a financial perspective.

Next comes in valuation. That's the final part of our process to ensure these portfolios, in terms of position sizes, are correctly sized relative to the risk and reward.

And I'll just add a couple more things as far as trends over the next few years. We do expect continued growth in crude oil production, driven by the need in the global market, for more U.S. oil barrels. We also expect more natural gas production growth. That's going to be driven by the need to export natural gas via LNG, or liquefied natural gas, as well as growing demand from power generation companies for natural gas. And I think kind of forgotten is natural gas liquids, where we're going to see increased demand for natural gas liquids from petrochemical plants coming into service beginning this year over the next couple years, as well as for exports. And very importantly, and perhaps simplistically, but it's the right way to think of it I think: This production growth for all three of those commodities is going to drive the need for more energy infrastructure, and the companies we invest in are well positioned to deliver the required infrastructure needs to transport, process, and store increasing U.S. energy production.

MH: I also want to ask you about closed-end funds. What are some of the benefits of using the closed-end fund structure to invest in MLPs?

CE: I think there's several actually. The first and foremost would simply be yield. The current yield of investing in any of the four MLP closed-end funds that we manage here at ClearBridge is between 7 to 9%, and that's in a world where the 10 year treasury is current yielding roughly 2.5%. High yield bonds are yielding a little bit more than 5%. So you're getting a significant yield uplift for a cash flow stream that we think is relatively secure over a full investment cycle, given the types of assets that we're invested in. The other thing I would note is the income that these funds generate is typically tax advantaged income. This is typically 75 to 80% of the income that these funds pay out is a return of capital, which is a tax deferred income stream until you actually sell the fund itself.

Next I would mention diversification. Instead of owning one or two MLP stocks in your portfolio, if you buy one of our MLP closed-end funds, our funds typically have between 30 and 45 names. Obviously that brings an immense amount of diversification relative to an investor who's simply trying to own a couple names in their portfolio. The other thing I'd mention, as far as diversification goes, is keep in mind that MLPs and MLP funds as well, including the ones that we manage at ClearBridge, have a low correlation to the broader equity market. They also have low correlation to commodities, and they're inversely correlated to 10 year treasury rates. Those are all benefits that investors can achieve in terms of diversification beyond the number of names. The fact that these are stocks and portfolios that are lowly correlated to other asset classes that investors may have exposure to, certainly brings benefit to those investors who own them.

Then I guess the last thing I would mention, as it pertains to owning MLP stocks in a closed-end fund versus owning individual MLP stocks, is you're not going to generate a K-1. You're not going to have to file a K-1 with the US government for owning an MLP closed-end fund, which you would have to do if you owned individual MLP stocks. So, it's a more simple way to own these from a tax reporting perspective as well.

You can learn more about ClearBridge Investments and their closed-end funds on the Legg Mason website at leggmason.com. Information is also available on CEFA.com – your comprehensive resource for education, data, and timely insight on closed-end funds.

Disclosure

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