MLPs: How Perceived Market Foe May be Fundamental Investment

Summary:

- Master Limited Partnerships (MLPs) continue to trade at significant discounts relative to the historical averages if you use cashflow metrics
- With simplification transactions having resulted in some distribution cuts and casting investor doubt, things may look different going forward. Some MLPs may have these same simplification transactions sans the distribution cuts, while others may change the way they manage their distribution, focusing more on keeping cashflow to develop organic growth projects and, in turn, increasing their distribution coverage ratios and improving the stability of that distribution
- Future returns are believed to be significantly better than many other parts of investors' options today.

Joined by Ed Russell, Managing Director — Tortoise and James Cunnane, Managing Director and Chief Investment Officer of the Advisory Research MLP & Energy Infrastructure team, we discuss one of the more curious performances of the market this year.

James Cunnane

Ed Russell

Libby Hastert

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on April 20, 2018.

LH: **For those who frequent our monthly podcast, I'm Libby Hastert of the Closed-End Fund Association. This week, I'm returning to discuss the energy sector and master limited partnerships. Despite MLPs having a challenging start to the new year, we're going to consider the potential for improvement over the remainder of 2018. Here to provide insight are a couple of the industry's experts, addressing some concerns around product valuation and also identifying the outlook for income-seeking investors. Kicking things off today is Tortoise's senior managing director, Ed Russell. Ed, I've had the pleasure of working with you before at some of our CEFA Advisor Summits all over the country, but there's also a new voice on the mic today. That said, I'd like to extend a big welcome to you, Jim. Jim, who some of you may know as James Cunnane, is Managing Director and Chief Investment Officer of the Advisory Research MLP & Energy Infrastructure team. Jim and Ed, thanks for joining us today.**

Ed, turning things over to you, as the Managing Director of Tortoise, can you kick us off touching on the fundamentals of MLPs? Specifically, how are they positioned with regard to cashflows and the potential to bolster distributions? Ed?

ER: Thanks, Libby. With the exception of the last few days, it's been a rough start for MLPs in 2018, but if you look at the last, these numbers are, as of quarter end, the valuations are very attractive. **MLPs continue to trade at significant discounts relative to the historical averages if you use cashflow metrics.** MLPs will normally historically trade at about 11.5 times enterprise value to EBIDTA and about 10 times price to discounted cashflows. Today they're trading at about nine times 2019's estimated EV to EBIDTA and about five and a half times price to discounted cashflow. Very attractive multiples.

If you look at the average yield right now for the sector, at the quarter end it was almost 9%. We still expect throughout the sector to see distribution growth at about 5% to 7% for the next 12 months. That's a very attractive total return potential. I would, however, state that I think that you need to look at the individual companies, as well. Do not subscribe 5% to 7% across the entire sector. **Our suggestion would be to look at companies with lower yields and higher growth expectations because, to be frank, there are companies out there, MLPs in particular, that are trading at yield levels that are there because there's going to be very little implied distribution growth in 2019.** Again, if you look at the entire sector, distribution growth expectations are in a range that are the historical average. I really don't think the valuations today reflect that distribution growth. **Then if you compare them to REITs and utilities, MLPs are about 11% cheaper than utilities and about 43% cheaper than REITs, respectively.** Again, I think relative valuation if you look at yield-oriented stocks, MLPs are very attractive today.

LH: **Then if we could zero in on the energy segment of that, we have an environment that's had pretty stable energy prices and continued strength in the US production. Can you address what seems to be the disconnect between this backdrop and the recent performance that you spoke to?**

ER: That's obviously been the question on investors' minds, and rightfully so they're very frustrated because it seems as if we were only correlated to commodity prices on the way down. As they started to improve, we did not see the improvement in the midstream sector. Clearly investors have been frustrated by that. I would have to say that there's really no fundamental reasons that you can point to on why we have not seen more improvement in the midstream sector with the exception of the last few trading days. We believe the outlook though is very positive for the MLP sector. **We have, unfortunately, gone through some transactions, simplification transactions, that did result in distribution cuts, which I think really put a lot of doubt in retail investors' minds on the stability of the distribution of these underlying securities.** That kept them on the sidelines when you would normally see them as buyers when you get attractive yield rates like the 9% average.

If you look going forward, we think the continuation of these simplification transactions that will take place without those backdoor distribution cuts will make this sector more attractive to the retail market. You also have seen MLPs change the way they manage their distribution where they're focusing more on keeping cashflow to develop organic growth projects, increasing their distribution coverage ratios, which again, I think improves the stability of that distribution. We believe that will also help bolster the attractiveness to the sector. I'll let Jim touch a little bit more on the FERC issue. I think what's going to need to take place over the next couple of quarters is good quarterly announcements, which we expect very few surprises, so no surprise distribution cuts that were not expected, and then more clarity on the FERC issue that recently happened because we think that has very little material effect on the sector, but we think the market really overreacted to that.

LH: **Yeah, thanks, Ed. Obviously there's been some specific things that we can point to like FERC. Jim, with that in mind, we had the federal tax reform bill and then a ruling in mid-March by the Federal Energy Regulatory Commission, FERC, regarding certain tax allowances for the MLPs. Can you touch on how these have impacted MLPs and how the market properly reflected these impacts?**

JC: Sure, Libby. I think it's been a mixed bag from a standpoint of taxes and FERC, and as Ed already referenced, it's created some uncertainty and a lack of confidence among investors that's going to need to be sorted out over a period of time. But there are some real positives here. If you look at the tax bill, for example, the tax bill was a benefit for both corporations and for MLPs. On the margin, you can argue that corporations benefited more, but MLPs benefited significantly as well.

A lot of energy infrastructure, including energy infrastructure that we own in our portfolios, are both MLPs and corps. Overall, we feel that was an advantage for MLP investors and energy infrastructure investors in general.

On March 15, as you referenced, we had a ruling out of FERC that while the announcement itself was not a surprise, the content of the announcement, I think, caught the market, including ourselves, off guard. The issue at hand was an income tax allowance issue that's been debated between pipeline operators and their customers, between the courts and the FERC for 20 years. It's gone back and forth. **The ruling that came out of the FERC on March 15 was certainly not an advantageous one for MLPs.** Without getting into great detail on it, I think the bottom line was that the market's immediate reaction was to assume a worst case scenarios. When we break down the impacts, **we believe that the longer-time impact is going to be fairly minimal for most of the MLP group.** There will be a handful of securities that maybe are more impacted. As Ed already referenced, maybe the bigger issue behind both of these items is that it's infused some uncertainty that's going to take time to sort itself out. That has come at a time where MLPs are at the tail end of a fairly long period of underperformance. That's created, I think, some selling pressure among fatigued investors.

LH: Jim, obviously you spoke to this, and I don't want to dwell too much on the difficult start they've had in 2018, but really what's your view on the current valuations in the sector? Are you finding any interesting opportunities with specific types of MLPs, or have valuations gotten to the point where these opportunities are across the board?

JC: Ed already laid out the valuation case, and I completely agree. Valuations are very attractive at this time in a variety of metrics. We look at absolute metrics, cashflow metrics, for example, we look at relative metrics to other asset classes in the market. Without repeating those, they all look attractive at this time. **I don't think valuations today are certainly as attractive as at the bottom of the energy crisis or back in the financial crisis in '08. Other than that, this is as attractive as we've been since probably the 1999, 2000 window where you actually had some similarities to today's market.** Technology stocks were hot. Dividends weren't of much interest. Energy companies were somewhat out of favor. But there certainly were some differences. Oil prices were much lower at that time.

Today, I think the fundamental outlook is much better. We've talked about before here when you look at the EBITDA of these companies, it's sound. I think that that is what makes us confident that eventually this undervaluation will be corrected. We also can look to the debt markets. The debt markets have been strong for these companies. **Again, I feel like the issue we're running into here is not a lack of confidence around current earnings but confidence around MLP equities and some of the uncertainty that's been infused.**

When we look at opportunities, we're thinking about looking for quality as this period of uncertainty works its way out. When we talk about quality, I'm talking about things like friendly management teams; great assets; and companies with distribution coverage and with reasonable leverage entities that are able to sustain their distributions and hopefully grow. **We share Ed's view that there will be growth in distributions as we move forward from here.**

LH: **It's certainly great to hear that. Jim and Ed, just to wrap things up, if you could give me your quick take on the biggest thing that investors could take away from this discussion in relation to recent volatility in the markets and these MLP fundamentals and value. Jim, do you want to start that off?**

JC: Sure, Libby. **MLPs have been a poor performing asset class for the last five years, but when you look at the underlying fundamentals, the fundamentals are improving.** The story around MLPs should continue to improve. You should see sentiment pick up as we move through this year. **We believe future returns will be significantly better than many other parts of investors' options today.**

LH: Ed, is there anything that you'd like to add?

ER: Sure. I'll just echo what Jim said in that the issue that's causing a lot of frustration with advisors is when you see a period, which is now quite a long period, of poor performance, advisors want to know why. What is fundamentally wrong that is causing these stocks to trade down? Their frustration more recently seems to get sometimes magnified when we say, "Look, we can't point to a fundamental reason why these stocks are trading down." What I try to express is that there are some opportunities here for investors is that if you ask me what needs to happen to be a catalyst for the midstream space to perform better from the stock price, I don't need a change in commodity prices. I don't need the economics of drilling activity in the United States to change. I don't need the demand for these commodities or refined products to increase or change.

Fundamentally we're in a very good space in the US in the energy. We can drill at attractive returns for both crude oil and natural gas in a number of basins. The demand for those products continues to improve. **We don't talk about natural gas a lot in this country, but we're starting to export that at very high levels.** I would expect that to continue to grow. Natural gas is continuing to grow in terms of the percentage of electrical generation that is done by natural gas. There's a lot of tailwind helping push the energy sector. We think that eventually midstream will continue to catch up with that and start to improve along with that. We definitely think it's a very unique opportunity where I don't need to point to specific things to drive the fundamental increase in these stock prices. We just need market sentiment to improve, I think, relatively through no negative headlines and just a couple of quarters of essentially demonstrating the earnings growth that Jim and I have both mentioned throughout this call.

LH: Ed, Jim, I think you gave investors a lot to think about today. I really am excited to see where we go with MLPs because, as you both touched on, we've got a really interesting backdrop right now, lots of opportunities and many considerations. Thank you both for calling in today. We'll touch base soon. Thanks.

Speaker: Thank you for joining us. We hope you will stop by again for news on this ever changing space. Until next time, connect with us on Twitter at @CEFAssociation or by searching for the Closed End Fund Association on LinkedIn and YouTube.