MIDSTREAM ENERGY: A DISCONNECT BETWEEN FUNDAMENTALS AND PRICES

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Last week's "Behind the Markets" podcast focused on how fast we are going to reopen the economy and reasons to be optimistic about treatments for a potential second wave of the coronavirus. We also discussed disruption in the oil market and its impact on midstream energy companies with Brian Kessens, Senior Portfolio Manager at Tortoise Advisors, a firm that focuses on essential assets.

Kessens on the Oil Markets

The story I find particularly interesting is that pipeline fundamentals were supposed to be resilient when facing declines in oil prices, given their long-term futures contracts exposure and pricing that is not directly tied to spot prices.

Kessens believes we will see a rebound in oil in the third quarter and that the wells will not all come back online as quickly as they were shut down. For companies to ramp up production again, he believes we need higher prices to incentivize production.

He added that oil prices could very well go negative again in the next few weeks, referring to June futures contracts that expire later this month, as storage is still full.

Midstream Fundamentals Stronger than Expected

However, the fundamental case for midstream companies is that they are more insulated from oil prices than market prices have been implying.

Kessens estimates cash flows should be down anywhere from 5% to 20%, whereas by the end of March the whole sector was down 50%. There were some technical selling pressures in March that exacerbated the declines due to leverage components in the close-end fund space.

There have been some record spreads between midstream dividend levels and the 10-Year U.S. Treasury as well.

The average dividend yield in a number of master limited partnerships (MLPs) was over 10%, and Kessens believes the yi eld is stable but could actually grow another 2%. This dividend growth is lower than historical but still with a 10% average dividend yield likely pricing in the expectation of cuts. If we do see growth, this will be one of more interesting segments of the market.

This was a great discussion, and you can listen to it below:

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: Ed Stringham & Brian Kessens

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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DEFINITIONS

Futures/Futures Contract : Reflects the expected future value of a commodity, currency or Treasury security.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Closed-end fund : is a collective investment vehicle based on issuing a fixed number of shares which are not redeemable from the fund. New shares/units in a closed-end fund are not created by managers to meet demand from investors. Instead, the shares can be purchased (and sold) only in the market. Closed-end funds are usually listed on a recognized stock exchange and can be bought and sold on that exchange. The price per share is determined by the market and is usually different from the underlying value or net asset value (NAV) per share of the investments held by the fund.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Dividend : A portion of corporate profits paid out to shareholders.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Master limited partnership (MLP) : Investment structure where holdings typically must derive most of their cash flows from real estate, natural resources or commodities, combining the tax benefits of a partnership—taxes occur when holders receive distributions—with the liquidity of a publicly traded company.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.