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The MLP Newsletter for Advisors • Fall 2016

As an investment advisor, you have been subscribed to the MLP Newsletter so that you and your clients can stay abreast of this powerful income-generating sector. Published quarterly, the MLP Newsletter includes valuable information and expert opinion about MLPs that you cannot get anywhere else.

The Master Limited Partnership Association (MLPA) is a trade association representing the publicly traded limited partnerships (PTPs) that are commonly known as master limited partnerships (MLPs), and those who work with them.

Today's newsletter features an interview with John Edwards, Director of Energy Logistics and Infrastructure MLPs/U.S. Equities Research with Credit Suisse, one of the world's most respected wealth creation institutions. Based in Switzerland and in operation since 1856, Credit Suisse has more than 1,214 billion in assets under management in CHF (Swiss francs).

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Advisor Access: ***It's been a difficult year for oil and gas markets, with commodity prices persistently depressed. Where do you see prices headed as we move into the winter season?***

John Edwards: The house view at Credit Suisse is that for Q3/16 and Q4/16, West Texas Intermediate (WTI) crude oil prices will be in the $45-50 per barrel range—pretty close to where they are currently. Brent will be modestly higher than WTI. There are expectations for growing natural gas demand, so we expect a continuing modest rally on the natural gas side.

AA: ***Where do you see the balance between oil stockpiles and domestic production headed?***

JE: The house view on oil stockpiles is that they're going to remain elevated, but they're going to be gradually trending down. We believe that the global oil market is roughly in balance currently. But obviously the stockpiles are way, way above the historical average. We will be watching how inventories play out over the next couple of quarters to get a better read-through on how supply-demand balances progress, since the reduction in inventories has taken longer than previously expected.

AA: ***What types of MLPs have been most resilient to commodity price fluctuations?***

JE: Interestingly, the most resilient are probably the propane retailers. They have been traditional laggards, but have been outperformers relative to the sector

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over the last year. Next up would be the MLPs involved in long-haul natural gas transportation. These would be the MLPs that dipped the least in the current downturn. They've come back less than others, but they also went down less than others.

AA: ***Why do you think those particular MLPs have been more resilient?***

JE: It has to do with the question posed above, which is if you have less commodity price exposure, you're likely to be more resilient. Ultimately, all these midstream companies have indirect commodity price risk because volumes are commodity price-dependent. When volumes are impacted, few companies are completely immune from commodity price risk.

". . . By and large, the majority of MLP distributions are secure."

That's why I mentioned the propane retailers. They're in broad secular decline, but oftentimes during these periods they do better because they acquire propane at wholesale prices. Because propane prices have been weaker, it has been good for the propane retailers because that's their cost of goods. Their demand for product is relatively immunized from fluctuations of the business cycle—demand for propane is more of a weather phenomenon.

AA: ***Can you discuss which sectors of the MLP industry are most secure in terms of their distributions?***

JE: The companies most immunized against commodity price fluctuations, like those we just talked about, generally have distributions that are more secure. That being said, some companies have a bit more commodity price exposure, but their balance sheet strength and distribution coverage is high enough that we consider their distributions secure as well. By and large, the majority of the MLPs' distributions are secure. We have only seen a few distribution reductions in this cycle. Within our coverage universe, it's a small number.

AA: ***Can you address the correlation between demand for oil and gas products and capital spending among MLPs, and how that has changed as the down cycle has progressed?***

JE: What we saw in terms of demand during the shale boom, when production was rising for natural gas, crude oil, and natural gas liquids, was accelerated spending by the midstream companies as they attempted to keep up. We saw a capital spending peak in 2014. And you'll recall that the collapse in commodity prices occurred around Q4/14.

". . . We think MLPs will grind sideways through the end of the year . . . And then, into 2017, we expect they will grind higher."

In 2015, we saw a continuation of projects that were partially built. Spending did come down, but the industry had to complete projects while simultaneously trying to delay or defer other projects, since it didn't look like there was sufficient demand to sustain them.

We've seen spending in 2016 come down pretty sharply from 2015. And our expectation is that spending in 2017 will come down below 2016. Spending will likely bottom out in 2018, before reversing to the upside.

AA: ***That said, how do you see the rest of the year playing out for MLPs, and for the oil and gas sector in general?***

JE: Specifically for MLPs, we understand the correlation between the valuations of MLPs compared to commodity prices. Looking at some of the broader benchmark indices, such as the Alerian MLP Index, MLPs are currently pricing in crude oil that's roughly in the low to mid-$50s per barrel range. Right now crude is trading in the mid- to high $40s per barrel. So there is the belief, looking out to 2017, that crude oil prices will continue appreciating and reach the mid-$50s range on a more consistent basis by the middle of next year.

But there are differing views on this. If you believe those prices will, in fact, materialize, you could say MLPs are just reflecting a forward view of the crude oil market, that it will continue to recover. But if you believe crude oil prices are going to be slow to recover, or will stay stagnant at the current level, then you could argue that MLPs are slightly overvalued. With that in mind, we think MLPs will mostly grind sideways between now and the end of the year. They could even pull back a bit. And then, into 2017, we expect they will grind higher, primarily in the second half, when expectations for crude price recovery are stronger.

AA: ***Is there anything else investors should be thinking about if they are looking at investing in MLPs at this point in time? Is this a good entry time?***

JE: I think it's an OK time to be entering MLPs, particularly if you take a longer-term horizon with respect to holding. We don't believe that crude oil prices are going to remain down at these levels forever. If investors have a little patience and are somewhat selective with the kind of MLPs they're going into, we think it's an OK time to get involved.

It's obviously not the kind of opportunity we saw back in February. MLPs have rallied somewhere around 60% off the bottom set in February, so clearly we don't have the same opportunity. But there are still high-quality MLPs in terms of balance sheet, asset footprint, distribution coverage, management quality, and so on. Investors can continue to be constructive on the space.

"... Investors can continue to be constructive on the MLP space."

There are a couple of issues with regard to risk that investors should look out for. Some overbuilding has gone on, particularly on the liquid side of the market, so it's going to take time for that to be worked out. Remember that MLPs were building back in 2014, before the sharp pullback, under the perception that production volumes were going to move up to around 10 million barrels a day (10 MMbbl/d). They peaked at around 9.6-9.7 MMbbl/d in 2015. We don't think we're going to get back to those levels until the 2019 time frame—maybe 2020. Given that crude production is around 8.5 MMbbl/d, and given the current price environment, it makes sense that the year-over-year growth is likely to be lower than the nearly 1 MMbbl/d year-over-year growth numbers we saw during the boom.

So investors are going to have to be patient. It's going to take a while to get back to levels where you'll actually see a shortage in capacity as opposed to overcapacity, particularly on the crude oil side. But there's still a shortage of capacity on the natural gas side. We believe a number of proposals are addressing that, and there will be adequate capacity for natural gas by the time we exit 2018.

The other broad trend that's a bit of a tailwind is in the natural gas liquids area. There's a massive steam cracker demand coming on line over the next few years. [Note: Steam crackers break bonds in feedstocks such as ethane to facilitate manufacture of petrochemical products such as ethylene.] The demand for ethane by the end of the decade, between steam cracker demand and exports, will be in the 900M to 1 MMbbl/d range, in what is currently an approximately 1.3 MMbbl/d market for ethane. We estimate that approximately 700,000 bbl/d of ethane is being rejected into the natural gas stream, but by the end of the decade we expect all of this ethane—and more—to be extracted, given the demand from the petrochemical industry and from expected exports. A lot of stocks have moved reflecting this, and we think it will be a pretty nice tailwind in the midstream area.

AA: ***John, thank you for your comments.***