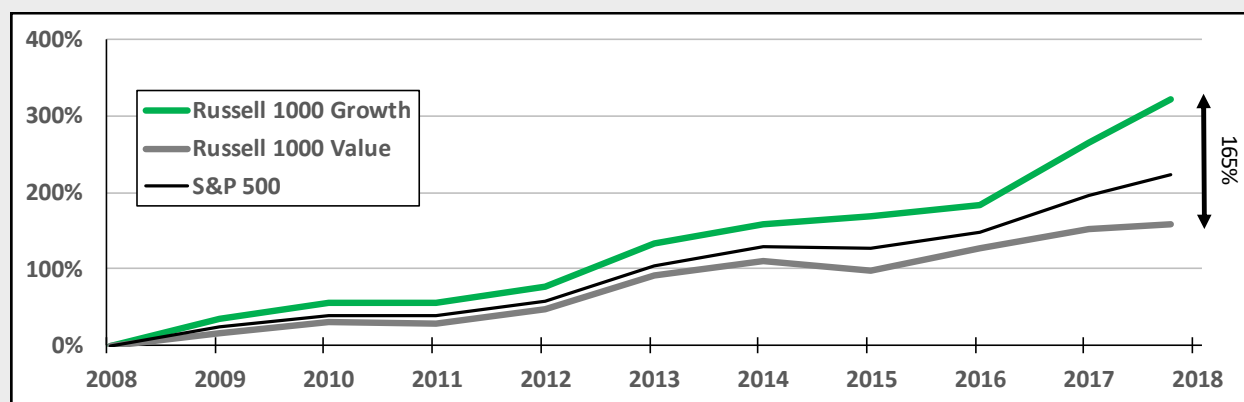


EGA Energy MLPs and Midstream Companies

“It’s Only When The Tide Goes Out That You Discover Who’s Been Swimming Naked”

- Warren Buffet

It was ten years ago on September 15, 2008 that Lehman Brothers filed for bankruptcy protection, an event that ranked among the more noteworthy low points during what became known as the Financial Crisis. Painful as that period was, only a few months after that began one of the longest bull markets in U.S. history, a rally that continues to this day. In recognition of that rally, the Wall Street Journal recently published several articles highlighting the material outperformance of Growth Investing over Value Investing over the same time frame.



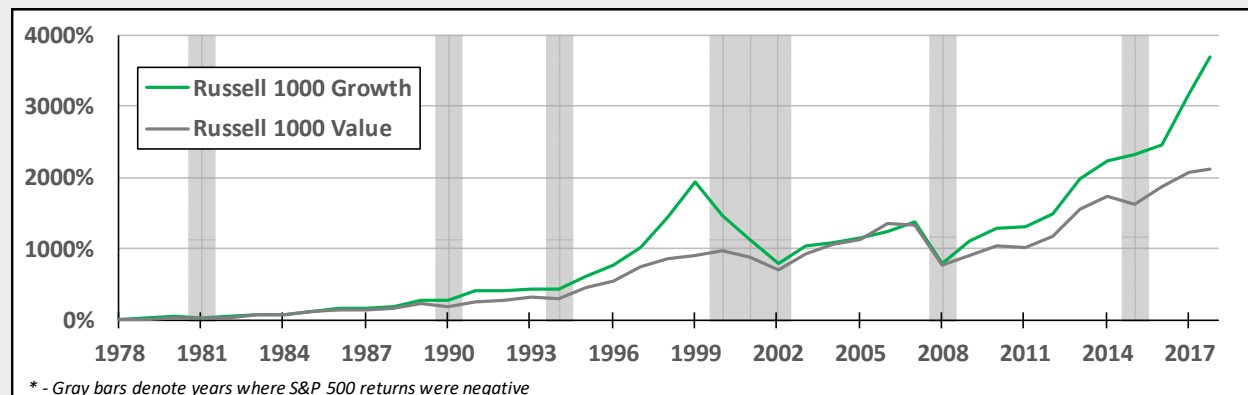
Source: Bloomberg

The key question raised in the WSJ articles is whether Value Investing is a relic of the past. We have great respect for history, and believe legendary value investor John Templeton put it best when he said “The four most dangerous words in investing are ‘This time it’s different.’” On the next page we analyze this recent trend of Growth outperforming Value and provide our views on how this may be impacting Midstream Energy investing. To summarize our conclusion, we’ve long believed that slow and steady wins the race and that value and fundamentals will win the day. In other words, while the tortoise has been caged over the last several years, we think it’s on the verge of breaking out.



The Divergence Of Growth From Value Is Not Without Historical Precedence

Consistent among all the WSJ articles is the preconceived notion that Value outperforms Growth over the long-term, though our analysis of the data implies the truth is much closer to the “Chicken-Egg” conundrum in that results are inconsistent. During most periods the results appear rational, like Growth outperforming Value during market rallies (i.e., 1998-99) and Value outperforming Growth during market corrections (i.e., 2000-2003). However, there are also examples of the opposite occurring, where Value outperforms Growth during market rallies (i.e., 2006) and Growth outperforms Value during market corrections (i.e., 1994, 2008). This doesn't take away from the fact that Growth has materially outperformed Value since 2008.

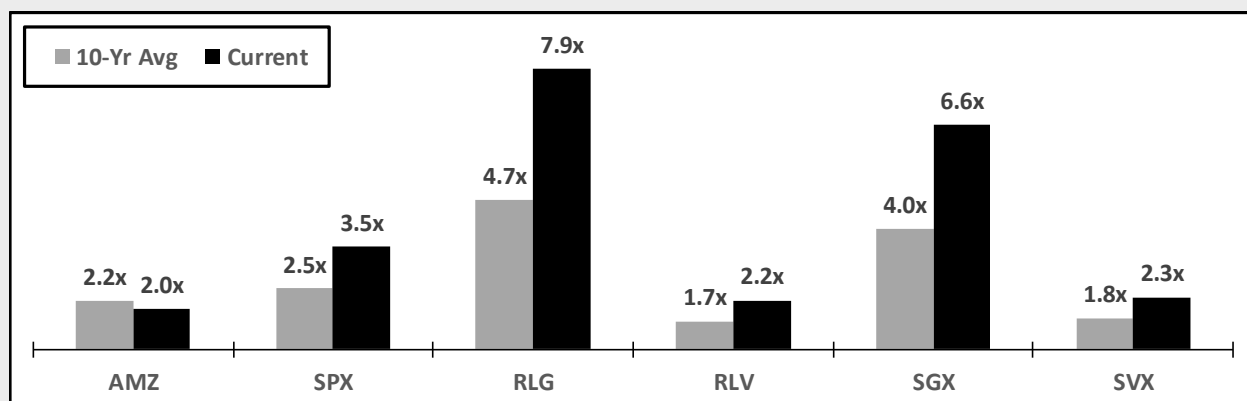


Source: Bloomberg

The articles defended this Growth-Value divergence by positing that the value of soft assets in the “new economy” of FANG stocks outweigh long-held views of how Value investors evaluate stocks. Aside from the obvious reference to John Templeton's quote, we believe there are a long list of issues with this argument. However, we're not here to argue the legitimacy of these articles but rather the relevance of this trend to the Midstream sector.

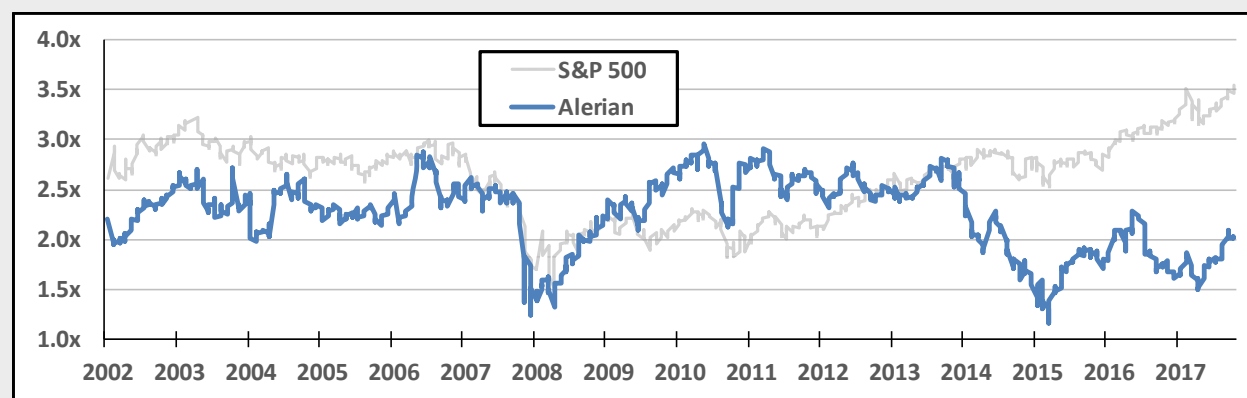
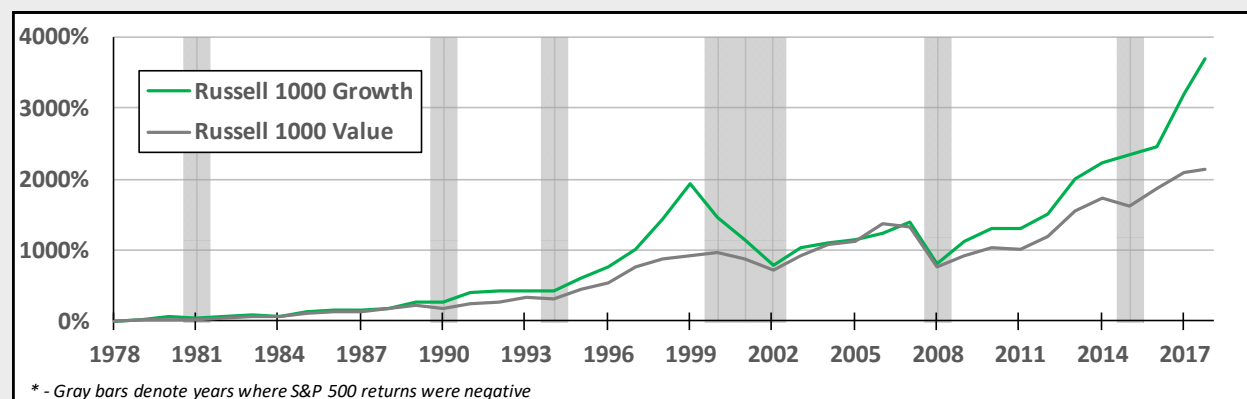
How “Growth Over Value” Pertains To Midstream

The two indices we looked at (S&P 500 Value Index / Russell 1000 Value Index) use some form of growth expectations and hard asset relative valuation as a universe filter, the latter typically Price-to-Book ratios. The chart on the next page shows the current and 10-year average Price-to-Book for the Alerian MLP Index and a variety of other market indices. There are two key points we'd like to make: first, the Alerian MLP Index has been in line with the Value indices on average over the last 10 years, which to us makes sense because Midstream companies embody the asset heavy and slower growing nature of most Value companies; second, the Alerian is the only index that is trading at a discount to its 10-year average. The other Value indices are trading at a roughly 30% premium to their 10-year average, while the Alerian is trading at an 8% discount.



Source: Bloomberg

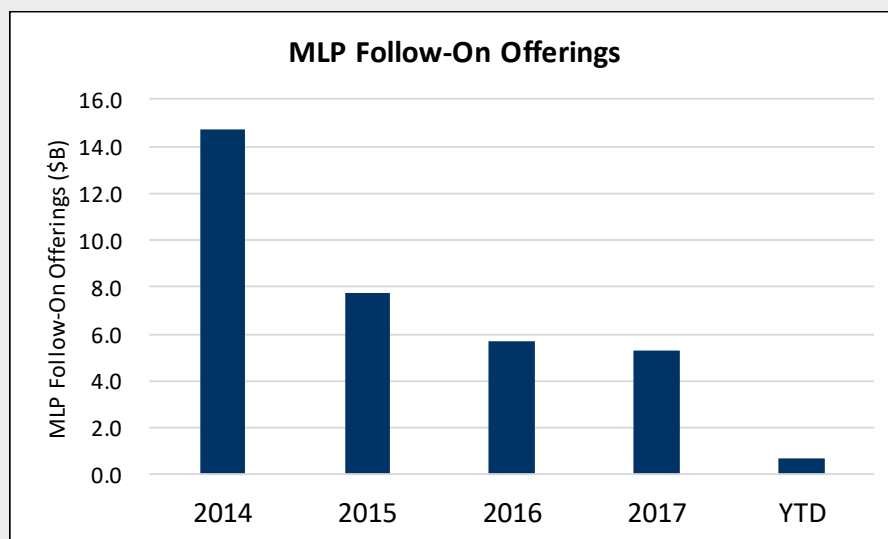
The next two graphs show just how far Value has diverged from Growth and similarly how far the Alerian has diverged from the broader market. On the former Growth has outperformed Value by 165% since the 2008 Financial crisis, with the divergence becoming more exaggerated over the last few years. Meanwhile on the latter, the Alerian's Price-to-Book sharply diverged from the S&P 500 beginning in late-2014, something that will come as no surprise to our long-term investors. Diving deeper into the details, it was Price (-47%) and not Book Value Per Share (-28%) that drove the majority of this decline, which to us implies the market has overshot fair valuation. For those of us who believe in mean reversion theory, history would suggest the right action is to sell Growth and buy Value (easier said than done!).



Source: Bloomberg

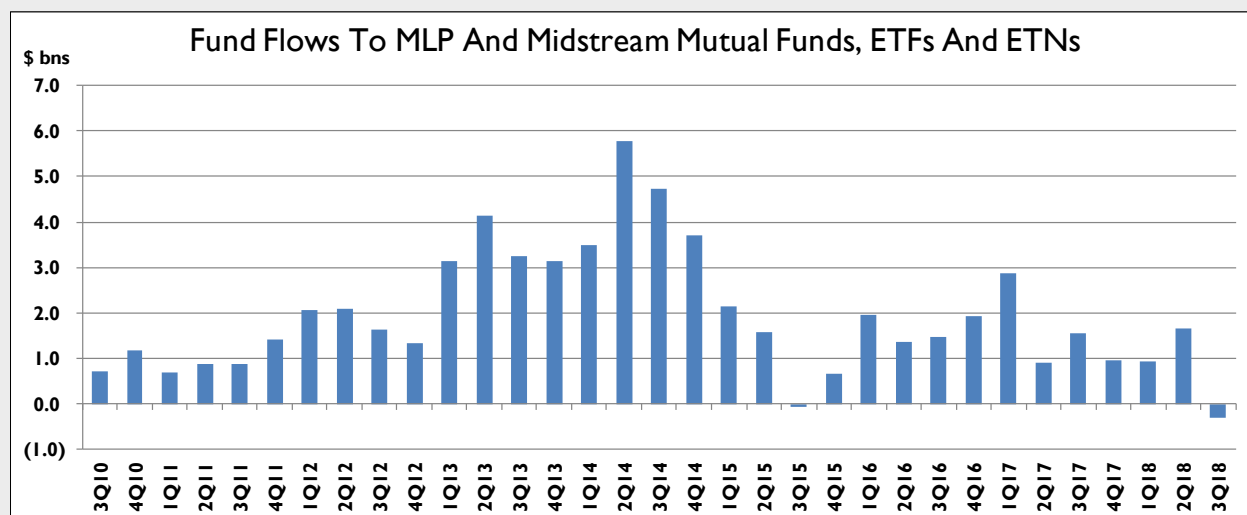
The Stars Seem Aligned, So Why Isn't Midstream Working?

For the last several years we've written about Midstream's inherent fundamental value, particularly as WTI Oil has steadily moved higher and now sits comfortably above \$70/bbl. We never thought such an oil price rally could occur without a subsequent increase in energy stock prices. We recognize the structural trials Midstream in particular has gone through over the last several years, but the majority of the Universe has eliminated the GP/LP complexities and is now self-funding. The below chart shows that equity capital raises have dropped to extremely low levels relative to history. For us, it's clearly not an equity supply issue that continues to weigh on Midstream valuation, and so we look to equity demand.



Source: Company Data

Stocks do not rise in a vacuum and therefore investor demand is necessary for stocks to go up. As shown in our Fund Flows chart below, demand for Midstream equities is simply not there. Of the nine months completed in 2018 a remarkable five of those months had fund flows that were either negative or essentially zero. While this data only includes fund flows to Midstream mutual funds, ETFs, and ETNs, we believe it is representative of a broader trend. Midstream equity demand is low relative to any measured period since these vehicles became available in 2010.



As of 9/28; Source: U.S. Capital Advisors

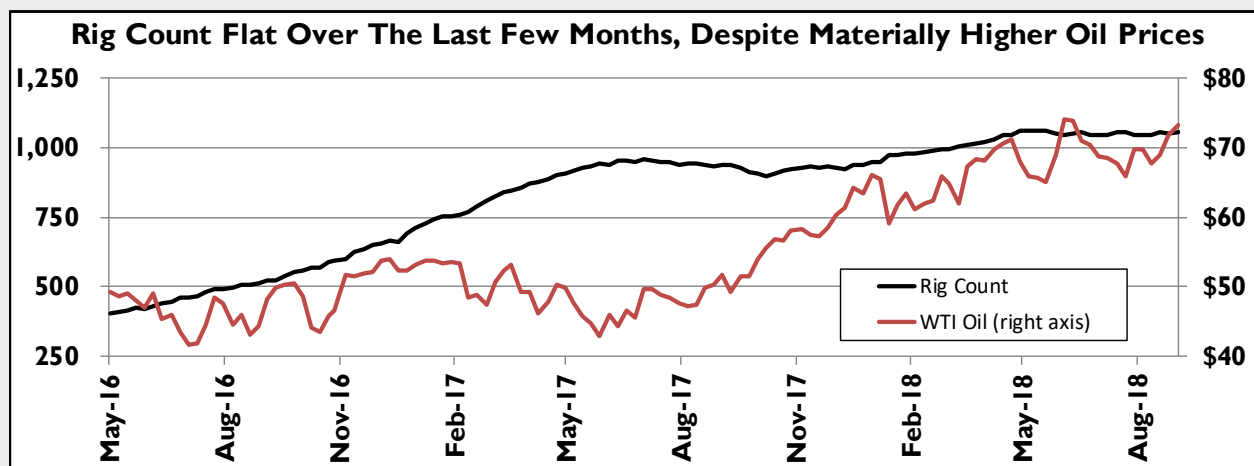
To summarize, it seems clear that Midstream – even at currently discounted levels – is simply not what broader market investors are interested in at this time. Among dedicated energy investors there is still a hesitance towards Midstream given the structural upheaval over the last several years, and we continue to hear feedback from Midstream management and our buy-side colleagues that the sector remains in the penalty box (“show me” mode).

Of course we’re optimists by nature and believe the market runs in cycles. Euphoria around the FANG stocks will ebb, appreciation of hard assets and core operations will flow, management teams will emerge from the penalty box as they continue quietly executing, and Midstream will once again catch a bid.

A Few Final Thoughts..

Colorado Proposition 112. In late-August, environmental activist group Colorado Rising succeeded in moving onto the November 6th ballot its proposition to make mandatory a minimum 2,500-foot setback from “occupied buildings” within the state, an increase from the current setback of 500 feet for homes and 1,000 feet for schools. While pitched as a safety measure, the proposed setback as policy would be a de facto ban on energy development in the state of Colorado. The Colorado Oil & Gas Association has said the impact would be crippling, leading to mass job losses and a material drop in tax revenue. Therefore, the energy industry is allocating substantial resources into educating voters of the potentially severe negative ramifications of approval. At this time with limited polling information available we have no informed opinion on the outcome, although our models suggest the most affected stocks would be NBLX, NGL, SEMG, WES/WGP, SMLP, and DCP. At the end of the third quarter our portfolio in aggregate has limited exposure to these stocks. As a separate consideration, we highlight Colorado production accounts for 4%-5% of total U.S. oil production. If Proposition 112 passed a significant amount of future oil and gas supply would be removed from the market and (in theory) have a favorable impact on oil prices and investment in other domestic fields.

Production and oil prices. While attending a major energy conference in early-September, we had the opportunity to sit down with the CEO of one of the largest oil service companies in the world. When we asked why energy sector stock prices are not reflecting the strong rally in oil prices he pointed at us and said investors were the reason. He explained that producers are vigorously sticking to the idea of capital discipline as they promised investors during the energy bear market. It’s only when investors start badgering producers to prioritize growth over capital discipline will growth prospects across the energy chain increase. In the meantime, with energy investment lagging historical trends both domestically and internationally, the expectation is that front month oil prices will continue to rally.



Source: Baker Hughes, Bloomberg

Regulatory and tax issues. In mid-July, the Federal Energy Regulatory Authority (FERC) issued a final rule and updated their guidance on the tax treatment of pipelines owned by MLPs, which greatly needed clarifying after the agency's confusing and conflicting proposed rule announced in mid-March. For this iteration the news in aggregate was positive, specifically in three areas: (1) natural gas pipeline MLPs with C-Corp parents will be allowed to include an income tax allowance in rates, (2) accumulated deferred income taxes (ADIT) will be eliminated for pipeline MLPs, and (3) any pipeline that acts pre-emptively to adjust rates to account for the earlier changes will receive beneficial treatment on several fronts. This was a welcome reprieve from a FERC that many had questioned was not as "business friendly" as originally expected.

Separately, we attended the MLPA's Annual Conference in Washington DC and were surprised how politics seemed to engulf everything. As a point of reference, the Annual Conference is typically focused on Midstream technical and policy/operational minutiae that the vast majority of investors would find boring (no other way to describe it). As we've attended this conference for well over a decade it was noticeable, and a sign that regulatory headwinds underpinned by environmental activism is unlikely to subside anytime soon.

Access To Capital

Capital fundraising in the third quarter was quieter than what has already been a very quiet year, with no common equity follow-ons and just under \$500mn of preferred equity placed. One noteworthy transaction was Apache Corp (APA) and Kayne Anderson Acquisition Corp (KAAC) agreed to form Altus Midstream LP, an entity that will be structured as a C-Corp and house Apache's midstream assets in the Alpine High; Alpine High is an unconventional resource play in the Delaware Basin (Permian). Unique among precedent Midstream IPOs, KAAC was formed as an acquisition vehicle and priced its IPO in late-March with the expressed intention of using proceeds to effect "a merger, capital stock exchange, asset acquisition, stock purchase, reorganization or similar business combination with one or more businesses." In addition to the accessibility of the preferred equity market, we highlight this deal as evidence that capital markets are open.

MLP Team Update

There were no significant team related news items to highlight this quarter. We continue to focus on the research and portfolio execution effort and are in constant dialogue with industry experts and management teams. We observed a slight reduction from the positive sentiment we wrote about in the second quarter, which we believe was largely driven by the third quarter's sizable capital outflows. Management teams continue to be bullish on their positioning, earnings growth, and the overall fundamental outlook, particularly following a strong second quarter earnings season and what is expected to be a similarly solid third quarter earnings season. We expect these positive execution trends to continue for the rest of 2018. We highlight our team's interactions with insiders beyond our midstream skill set, emphasized by the previously mentioned conversation with the CEO of one of the largest oil service companies. We believe the rise of oil prices and reluctance of producers to fully invest in growth will drive oil prices even higher, and supports our view that we remain in the early stages of an energy upcycle.

We thank you for your continued patronage of Eagle Global Advisors. We believe the long-term return outlook for MLPs remains attractive, and we look forward to communicating the results of your investment in an Eagle managed MLP account next quarter.

- The Eagle MLP Team