EGA Energy MLPs and Midstream Companies

From the EGA Portfolio Management Team

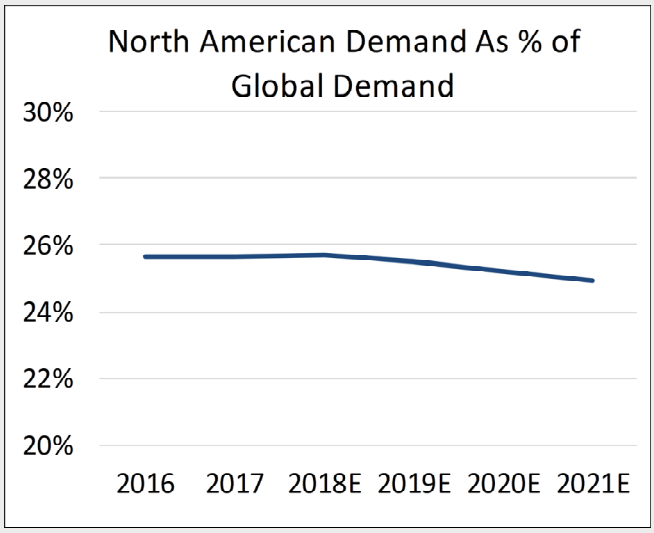
This Isn't Your Father's MLP

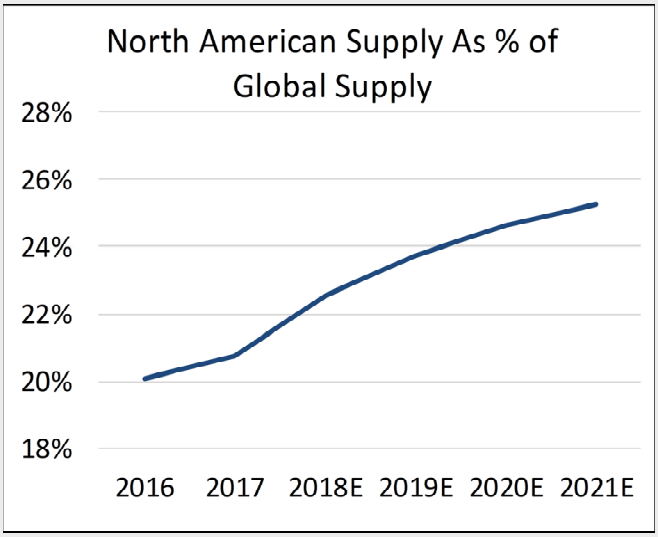
In the film "Back to the Future", Marty McFly inadvertently changes the past and nearly removes himself from existence. The succeeding adventure portrays Marty and Doc Brown rebirthing Marty's existence, though the events that transpire alter Marty's father's future into a better version of himself, one of leadership and strength versus the passivity and weakness shown in the film's beginning. No, Eagle Global hasn't invented a time machine (yet) that can alter the past to better the future. But if we had how would we change Midstream's past to invoke a better future? Our short list would be to have management finance organic growth capital spending with internally generated cash flow, have distributions covered by sustainable fee-based cash flows, and emphatically reject the creation of the incentive distribution rights (IDRs). While a time machine would have saved us a lot of volatility, we think Midstream has largely accomplished these goals and we look to 2019 for a fresh start.

Revisiting the Infrastructure Growth Story: The United States' Critical Role in Supporting Global Demand

The world continues to diversify its energy supply at the same time US production sets new records resulting in the need for more infrastructure. As a result, the sector provides a compelling total return proposition for investors as asset growth should be largely funded by internally generated cash flows resulting in better managed balance sheets. The US has an ample supply of oil and natural gas and constantly improving technology to extract these resources. Wells Fargo forecasts oil production will grow over 1 million barrels per day (10% annually) and natural gas production to increase 5% annually through 2022. What will consume all this new production?

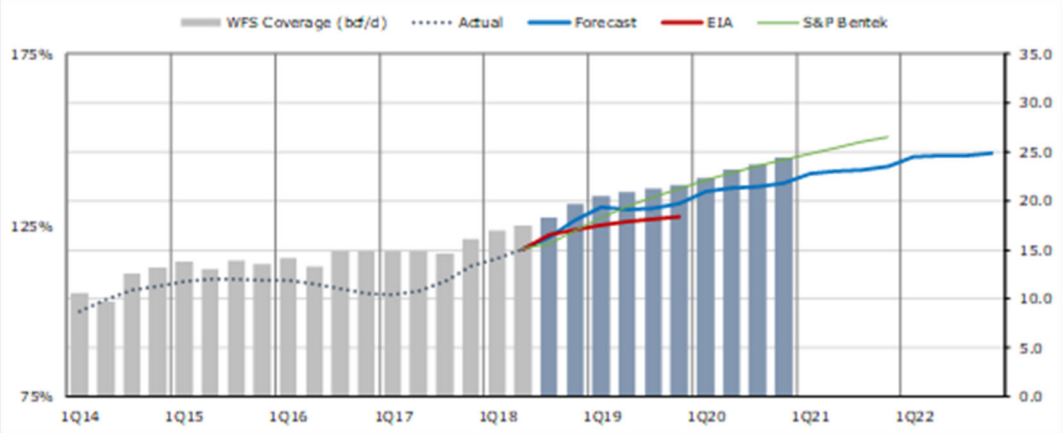
For oil, it's the Export Market. Conservation initiatives in the domestic market have kept demand flat, though globally demand continues to trend higher. As shown in the chart below, North America's market share of Global demand has stayed mostly flat and is projected to decline. However, Global demand is projected to grow 1.0-1.5% annually (Wells Fargo), and with sharp production declines in Venezuela and uncertainty in Russia and Iran the dependence on United States production as grown. North America's market share of Global supply is forecasted to materially increase from 20.1% in 2016 to 25.2% in 2021.



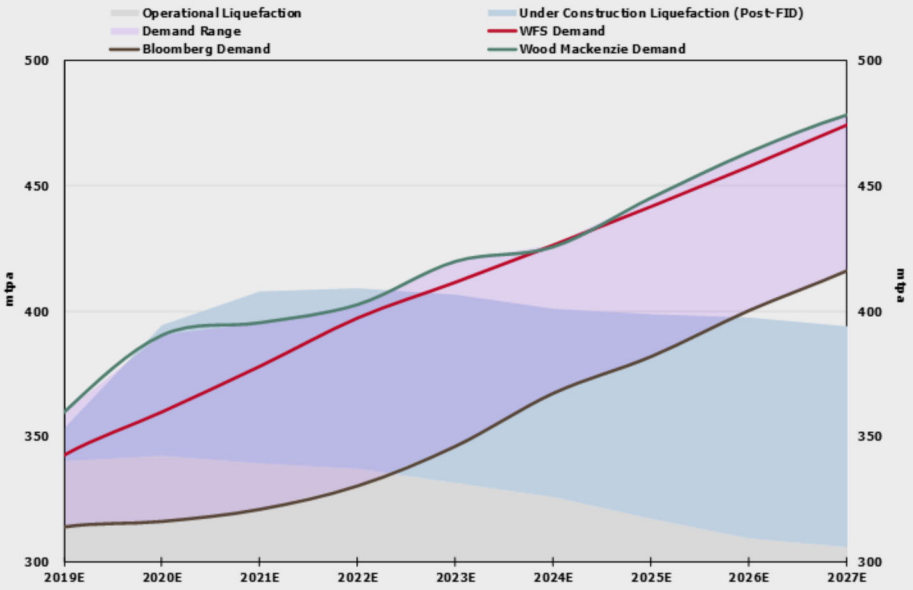


Sources: Wells Fargo Securities, LLC

For natural gas, it's the Domestic Market. The development of shale gas has led to a manufacturing resurgence, lower electricity prices, and large reductions in carbon emissions because of coal-to-gas switching. In addition, natural gas exports are climbing as new liquefaction facilities commence operations. We expect the secular natural gas growth story will continue for an extended time. There are a multitude of charts we could show to make our case but think the below two sums up our argument nicely. The first shows steady natural gas production growth, despite low prices and an export market still in its infancy. The second shows global demand for LNG, which we believe the US is best positioned to take advantage of.

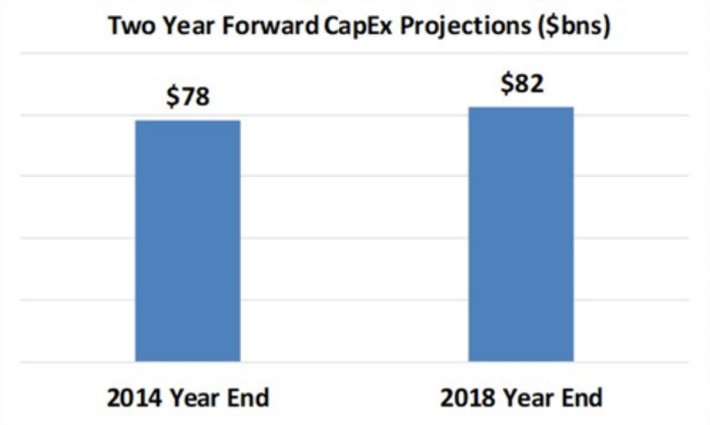


Sources: Wells Fargo Securities, LLC



Sources: Wells Fargo Securities, LLC

Maybe you're well versed in global energy supply/demand trends, though perhaps not how much infrastructure is still needed to drive this future. We estimate our Midstream companies (universe: 55) will invest $82 billion in capital expenditures in 2019-20 on infrastructure that range from deep in the producing basins all the way to demand centers that include coastal export facilities. While we prefer to look forward, we thought it'd be interesting to apply the same analysis to our models back in late-2014. Back in late-2014, right before oil prices corrected, we were forecasting our Midstream companies (universe: 62) would spend $78 billion in capital expenditures over the 2015-16 time frame. We admit additions/subtractions to our coverage universe (ie, Canadian stocks) between the two-time frames likely skews results to some extent, though even if we're somewhat off it speaks volumes that oil prices can correct as much as they have and the opportunity set for infrastructure companies has remained largely the same.



Sources: Eagle Global Advisors

Looking forward though there is a debate about whether the above is a positive or negative for Midstream. Some claim the era of massive Midstream spending is in its twilight, and this is a good thing because companies will apply harvested free cash flow to dividend increases and share buybacks. Others would say companies should take advantage of growth opportunities if the returns are attractive. The Bear case of each of these is straightforward. Fail to invest in attractive opportunities now and pay the price later, or fail to achieve expected returns on organic growth and pay the price now. It really all comes down to management teams and investors views on long-term expectations for energy infrastructure. We lean modestly bullish over the long-term, partly because there are still plenty of attractive growth projects under consideration but also because this capital spending is expected to be mostly financed internally.

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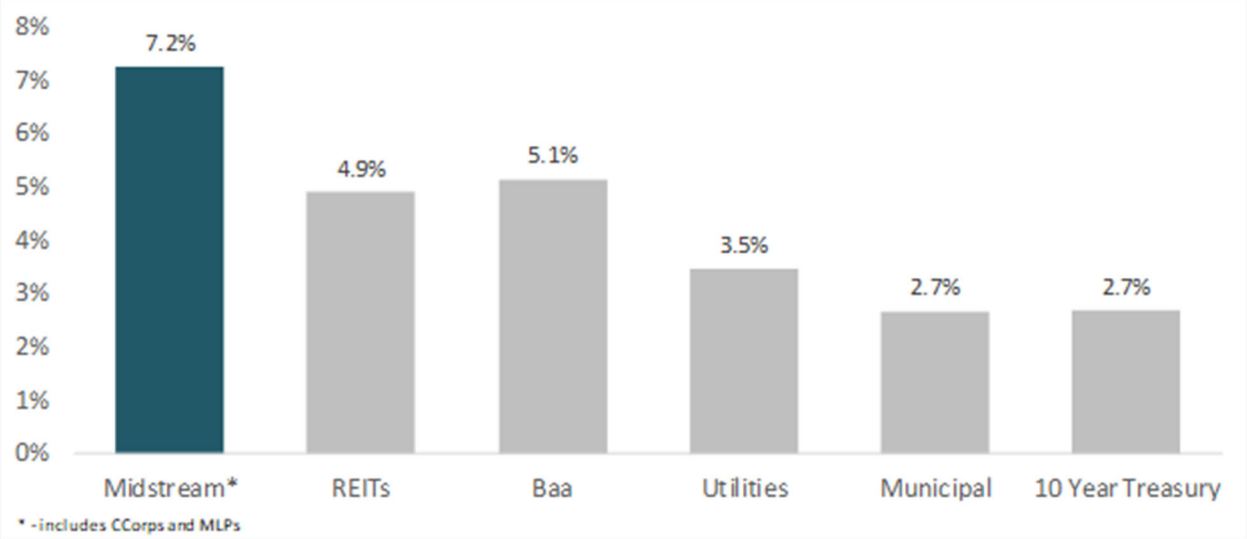
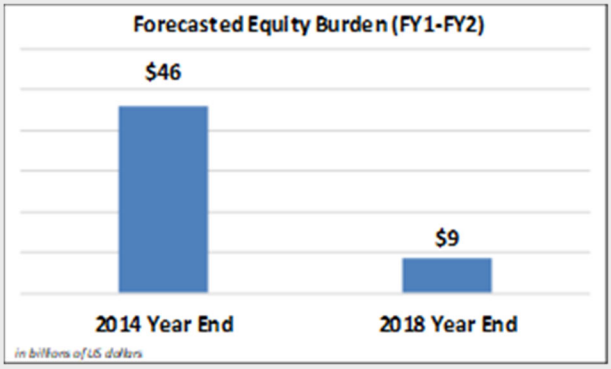
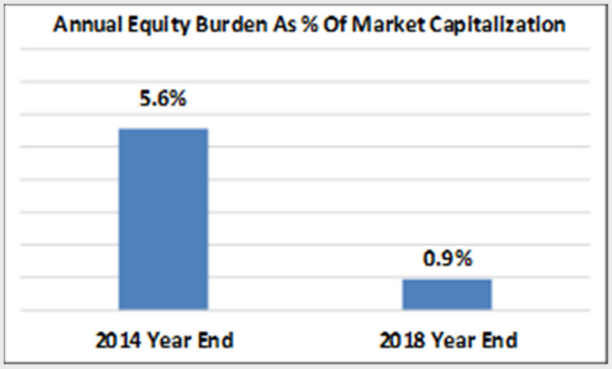
Investors Starved for Yield Will Come Around to Midstream 2.0, Eventually

We get it. It isn't that Midstream yields aren't interesting, it's that the last several years have shown they aren't believable. Many Midstream companies either reduced their distribution outright, or because of a GP/LP simplification. It's a classic case of "it isn't me, it's you!" At this point, we think distribution cuts have largely played out – all but 1 GP/LP paired has either completed or announced terms for a simplification and companies that cut distributions outright have transitioned to a self-funding model. While it could take investors some time to recognize the sustainability of the current yield, we believe this time is more likely to take quarters, not years. Therefore, we believe in the yield as depicted in the below chart, which shows the market cap adjusted yield of the MLPs and CCorps under coverage versus other yield-centric options.



Midstream companies have come a long way in their efforts to internally finance growth projects that allow them to exploit the attractive opportunities we touched on above. Once again looking at how much has changed over the last four years, we ran an analysis of all the companies we had financial models for at the end of 2014 and compared them to today. As shown in the below two charts, public equity burdens have fallen from an annualized $23 billion at the end of 2014 to $4 billion currently, a decrease of 81%! Relative to the sector's market cap, the burden at the end of 2014 was just over 5.6%, versus just 0.9% today. While we recognize the sector is not completely self funding – it will likely never be – the burden is tremendously lower today than it was four years ago. In addition, the modest consolidation we've seen within Midstream has the added benefit of increasing trading liquidity that should make even this small amount of equity digestible.

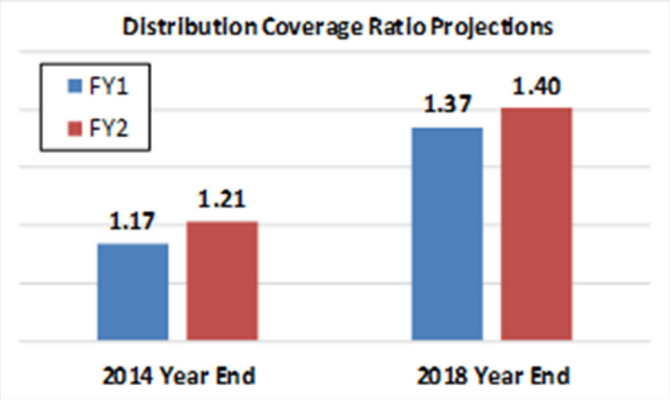




Sources: Eagle Global Advisors, Bloomberg

With momentum crushing equity offerings hopefully a thing of the past, we highlight coverage ratios today are also materially better than they were four years ago. As shown in the nearby chart, two year forward distribution/dividend coverage ratios averaged 1.19x at the end of 2014, compared to the 1.39x coverage ratio we expect over the next two years today. While balance sheets are still being repaired, this amount of excess cash flow allows management teams to finance growth internally (as depicted above) that will allow the denominator in leverage ratios (Debt/EBITDA) to repair balance sheets or simply do it directly via debt paydowns. The pushback we've received on this from investors is "is this enough?" What is the proper coverage for the sector? Meanwhile, management teams highlight the moving target that is credit agency and investor expectations. The idea that once a company reaches 4.0x leverage the market will require 3.5x, and so on down the line. We think this is pretty typical of a sector scarred by several years of terrible performance. These expectations will normalize only when investors believe management teams' claims of capital spending discipline and self funding.

Turning to general partner (GP) burdens, we highlight with several simplifications (aka IDR eliminations) under way that the scorecard shows 45% of coverage has no general partner burden. This compares to just 13% at the end of 2014. On a market cap basis, a whopping 88% of coverage has no GP burden, also comparing favorably to the end of 2014 where just 49% had no GP burden. The verdict is in, investors will penalize companies that have this archaic structure, a lesson not lost on those that still have the IDR structure in place. It may take a few more years, but we believe the IDR structure will find its rightful place in the dustbin of history.

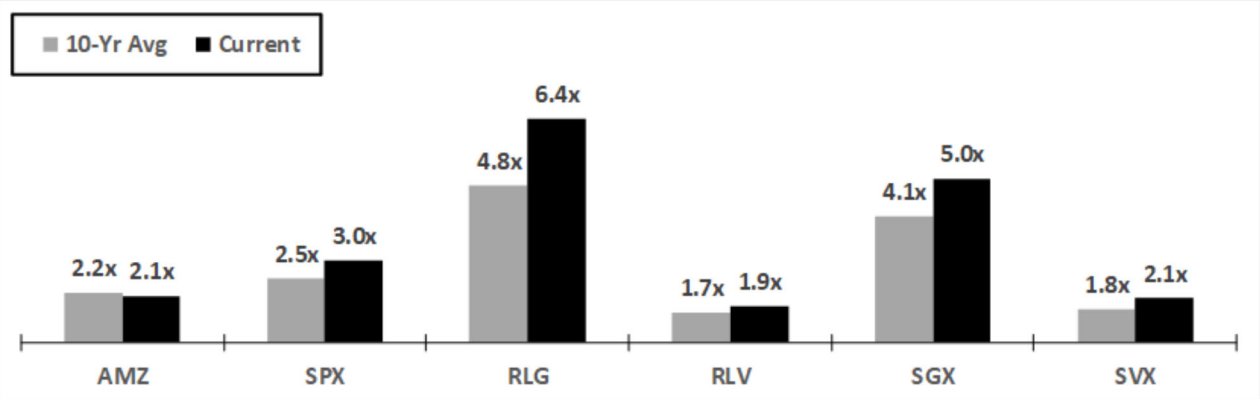


Sources: Eagle Global Advisors

Have Total Return and Value Stocks Come Back Into Vogue? Not Yet

Last quarter we wrote about the sharp dislocation between Value stocks and Growth stocks. We presented the case that history supports the mean reversion of Value to Growth, but also that Midstream screens well against the Value indices. An update of that analysis shows that despite recent volatility in the broader stock

market, Midstream continues to be underappreciated relative to the broader market, Growth indices, and Value indices. The chart below shows the current and 10-year average Price-to-Book for the Alerian MLP Index and a variety of other market indices. Growth indices continue to trade at an outsized premium (average: +28%) to their 10-year average, whereas Value is more fairly valued (average: +12%). Meanwhile, the Alerian trades at a discount (-3%) to its 10-year average, indicating the sector is inexpensive to both Value and Growth.



Sources: Bloomberg

What Does This All Mean?

Source: Bloomberg

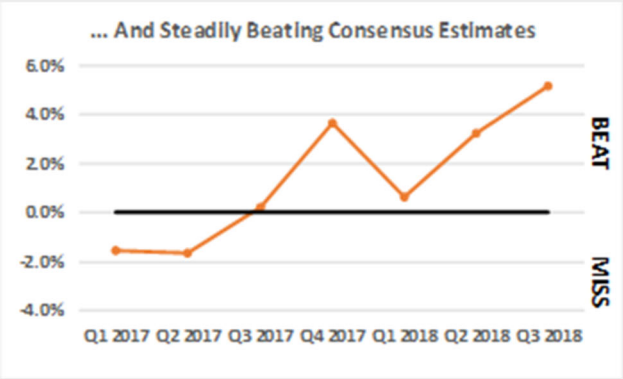
The theme of this Quarterly Commentary is to highlight to existing investors the strong long-term fundamentals of infrastructure and at a sector level all the positive changes incurred over the last several years. However, we understand why investors may be hard pressed to believe us since we've been bullish for a few years and it simply hasn't worked out. We understand because we're also nervous about 2019, not only because of the volatility in the broader market but also because of black swan events like what the FERC announced in March 2018. Also, there may still be dividend cuts (outright or via simplifications) or equity raised. Like a boxer that has taken too many punches, we're flinching at every fake punch.

We don't know what's going to get Midstream working again, we can only make our assumptions and continue to point out the positives and negatives of what's happening. Our hope is that Midstream will finally deliver on its promise of steady and stable cash flows, with organic growth financed internally and with healthy balance sheets. That Midstream will no longer be complicated by general partners and IDRs, while providing real defense against the fluctuations of oil prices. If this happens, we think both energy and generalist investors will find it hard to resist such a compelling total return proposition.

A Few Final Thoughts …

Lost in the noise is the solid EBITDA growth the Midstream sector is delivering. Most of the literature over the last several years has been dedicated to the structural shift occurring in Midstream that includes reforming the sector's financial management practices. While backwards looking, we highlight the sector is delivering on its EBITDA growth expectations. To show this we separated out 13 companies not impacted by the ongoing structural shifts (i.e., simplifications, etc.) that represent a majority of several of our portfolio strategies. Over the last seven quarters EBITDA has grown 30% while beating Street's consensus estimates for 5 consecutive

quarters (see below charts). It's one thing to say the fundamentals are great, it's another to verify they're great through actual earnings reports. It's possible the Street may catch company expectations and slow the "beat and raises" we saw in 2018, though we continue to forecast EBITDA growth as ongoing projects commence operations. The importance of this should not be understated, as the combination of debt paydowns and EBITDA growth will allow companies to de-lever faster.



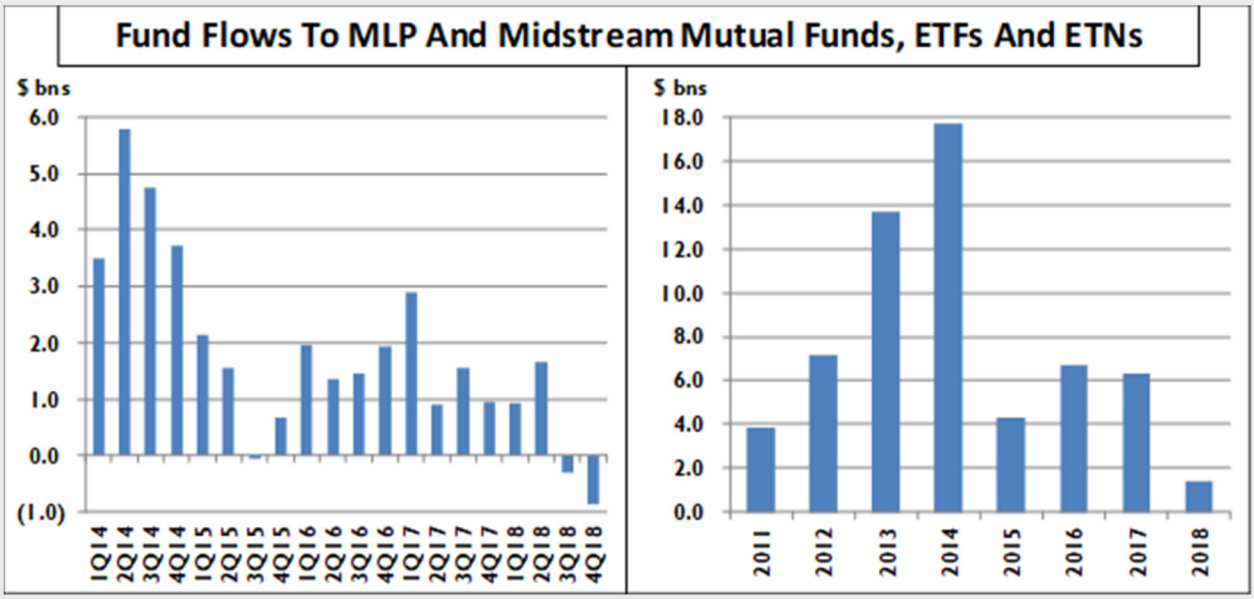
Sources: Bloomberg, Company Data

Stock buybacks coming? It seems likelier with every conference attended. In early December we met with nearly 20 companies at a major Midstream conference, and there were several management teams openly evaluating a stock buyback program. The thinking goes like this: Midstream companies have excess free cash flow that management is free to direct as they wish. Certainly, increasing organic growth is an option, but with competition still weighing on project returns management may see their own stock as providing the best value proposition. It's not lost on management that valuations for the same infrastructure are much higher in the private markets then they are in the public. To the extent management execute stock buyback programs could provide a tailwind to stocks that will feed itself and help investors feel comfortable re-entering Midstream.

Colorado Proposition 112 Update. The highly publicized Proposition 112 in Colorado failed by a vote of 57%-43%. As a reminder, Colorado Prop 112 proposed 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 have been a de facto ban on energy development in the state of Colorado. We have no opinion on the margin of victory but expect industry to work with the incoming Democratic Governor and Legislature to find a compromise in the hopes that this will not be an issue again in two years.

Capital Flows and Access to Capital

There is no way to sugarcoat how bad capital flows were in the fourth quarter and for 2018 as a whole. The fourth quarter saw a net capital outflow of roughly $850 million, though this paints only half a picture because November and December posted outflows of roughly $370 million and $905 million respectively. It is our view that while tax loss harvesting played a role, there were also real redemptions occurring as investors threw in the towel on Midstream and moved their capital elsewhere. For 2018, there was a net capital inflow of $1.4 billion, which is 77% below last year. The data set begins in 2011, which is how far back you have to go for the previous low of $3.9 billion.



As of 12/31; Source: US Capital Advisors

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 attended a major Midstream conference in early December and noticed management sentiment had worsened since last quarter, driven by concerns on oil prices, interest rates, and the broader economy. Investor sentiment continues to be weak, as ongoing sizable capital outflows weighs heavily. We highlight our team's interactions with insiders extends beyond our Midstream skill set and we continue to utilize our networks to better understand what's happening in the fields in order to better inform our Midstream investing decisions. For the reasons detailed above, we are cautiously optimistic on 2019 as the sector's structural upgrades position it to benefit from the world's increasing appetite for energy infrastructure.

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

- The Eagle MLP Team