EAGLE GLOBAL ADVISORS

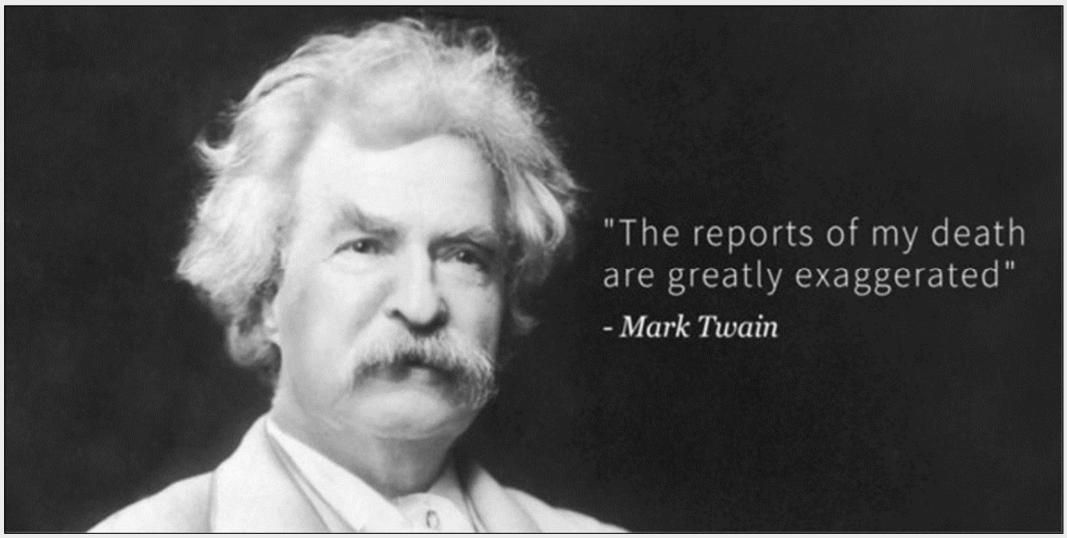
# Quarterly Commentary Q4 2019

## EGA Energy MLPs and Midstream Companies

From the EGA Portfolio Management Team

### The Reports Of Midstream's Death Are Greatly Exaggerated

In May 1897, while Mark Twain was undertaking a speaking tour in London, it became known that a major American newspaper had reported Twain as dead and printed an obituary. When asked to comment by a reporter, Mark Twain famously quipped "the reports of my death are greatly exaggerated." The truth is this interaction never happened, and one of Twain's most famous quotes was nothing more than fake news. This quote came to mind as we were walking around a major conference in December, observing the ghostly figures of Midstream investors contrasting sharply with Midstream management teams. One could visualize the reporter (investors) asking Mark Twain (management) to comment on the death of Midstream, at which point a mash-up of voices sounding like Rich Kinder, Jim Teague, Kelcy Warren, Mike Mears, and others replied "the reports of Midstream's death are greatly exaggerated."



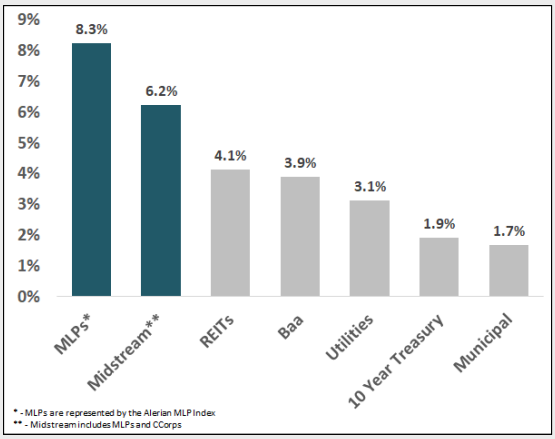

It's easy to understand why Midstream investors are so downtrodden given another year of underperformance. However, we continue to believe the signs are inevitable for recovery, and therefore we've compiled a David Letterman-esque list of the "Top Ten Signs That Midstream Is NOT Dead":

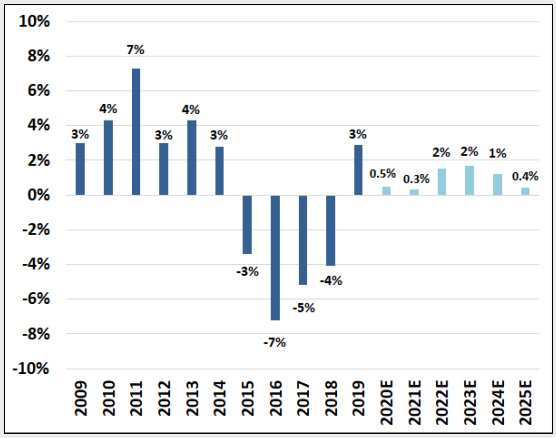
1) Dividend yields are attractive, sustainable, and poised to grow
2) Companies are consistently beating Street expectations
3) Declining capital expenditures
4) Management teams have a great problem, how to allocate excess cash
5) Energy demand is growing and with it the need for fossil fuels
6) Technological improvements at all points of the energy chain are lowering costs
7) Tax advantages, especially for MLPs, are intact
8) Growth extends its lead on Value, deepening Midstream's value proposition
9) The private sector values Midstream assets materially higher than the public market
10) Self-funding reduces capital markets risk and should reduce share price volatility

Please know our intention is to not deflect away from what was yet another difficult year for Midstream. We fully acknowledge yet another year has passed without the realization of our seemingly annual prediction of a recovery. We are also intensely frustrated the market has not appreciated the tremendous transformation our sector has undertaken to fix itself, though at the same time recognize why capital has not re-engaged Midstream and that the sector is not perfect. On the latter, there is evidence of an infrastructure overbuild, issues with contract expirations, potential E&P bankruptcies, and further rightsizing (i.e., dividend cuts), all in a presidential election year. That said, we believe our companies are uniquely positioned to provide stable, income generating cash flows tied to the infrastructure of the world's largest and most dynamic energy center (the United States).

## "Top Ten Signs That Midstream Is NOT Dead"

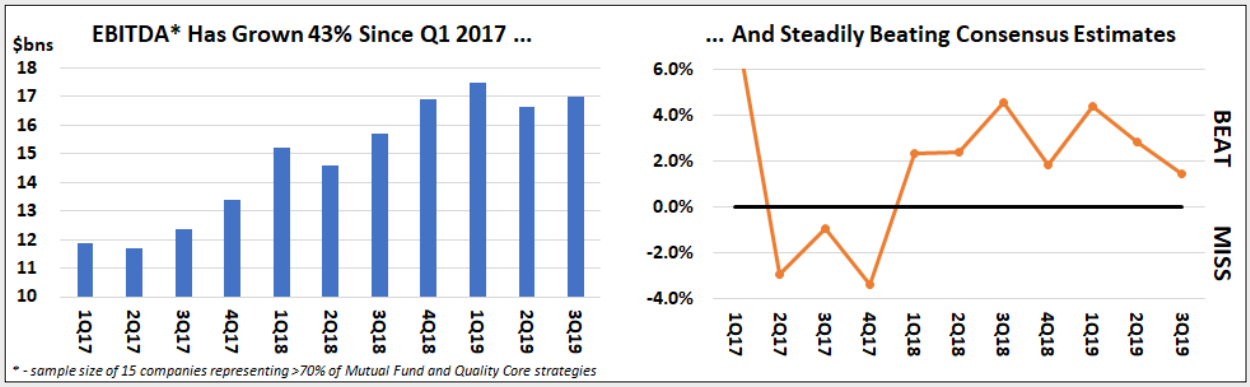
(1) *Dividend yields are attractive, sustainable, and poised to grow.* Over the past several years the most common response to our yield chart (below left) was the yield was compelling, but was it real? The reason why this was the most common response is summed up by the other chart (below right), as seemingly endless dividend cuts made the sector's attractive yield anything but believable. In our view, the number one sign Midstream is not dead is dividend growth returned in 2019. After four years of dividend cuts, dividends grew 3% in 2019. The Street also expects positive dividend growth over the long-term, and we think it's worthwhile to mention the reason why the forward growth rate isn't more attractive is because management teams are exploring other ways to enhance shareholder value (see Sign #4).



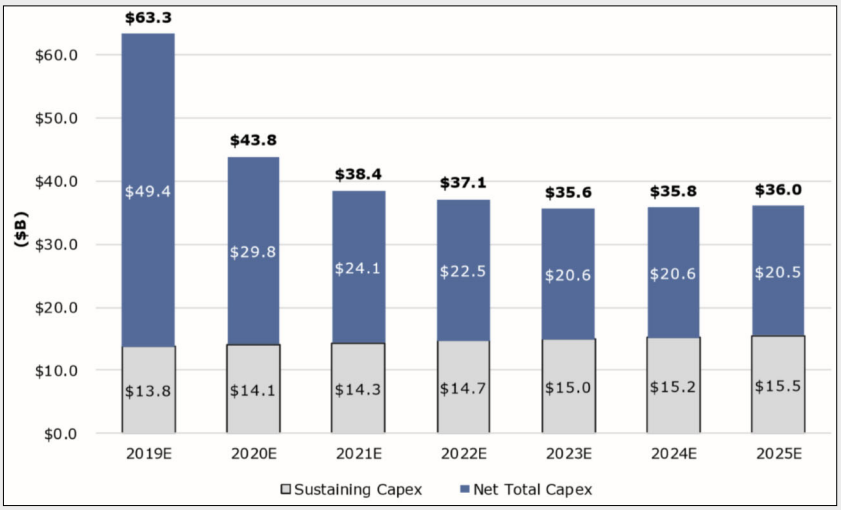

*Source: Bloomberg, Wells Fargo Research*

(2) *Companies are consistently beating Street expectations.* We analyzed 15 stocks that represent roughly 70% of our portfolio's exposure and found EBITDA has grown a remarkable 43% since 1Q17. In addition, these quarterly reports have beat Street expectations seven consecutive quarters and counting.




*Source: Bloomberg, Company Data*

(3) *Declining capital expenditures.* Consistent with what we're seeing internally, Wells Fargo Research estimates a 40% reduction in growth capital spending for 2020, and an additional 20% in 2021. We believe this is a sign management teams are increasingly focused on harvesting cash flow, and therefore are either walking away from projects with lower return hurdles or are more willing to join other projects in the form of joint ventures. This should quell some concerns over the magnitude of what many believe is an infrastructure overbuild situation.

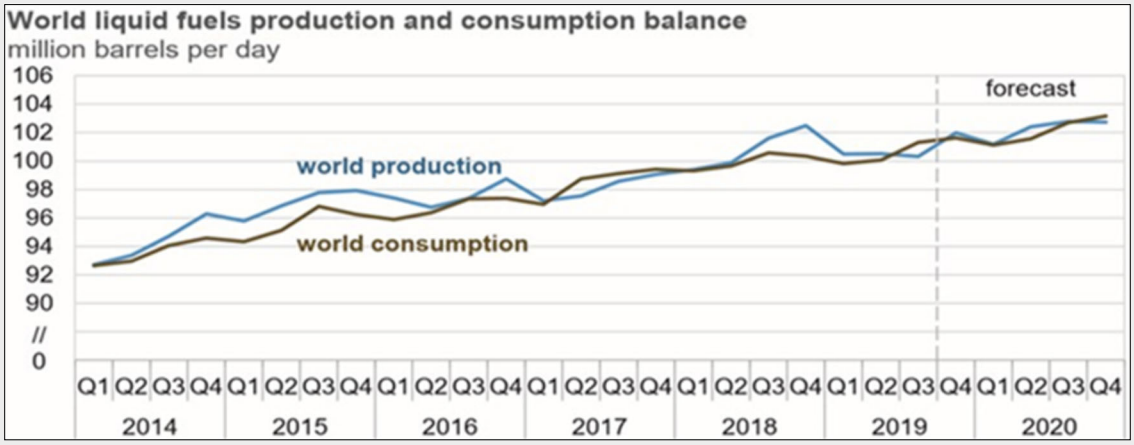



*Source: Wells Fargo Research*

(4) *Management teams have a great problem, how to allocate excess cash.* Historically excess cash flow was directed into dividend increases, a major cog of the pre-oil price cash virtuous cycle. Today the overwhelming view among management is that dividend growth is unrewarded. As companies close in on leverage targets, they're left with the choice of de-levering below their target (unlikely), raising dividends (unrewarded), or share buybacks. Some companies like Magellan Midstream (MMP) are polling investors on a policy of irregular special dividends. We believe we're going to see a wide array of shareholder enhancing initiatives, which when taken in aggregate may finally attract external capital back to Midstream.

(5) *Energy demand is growing and with it the need for fossil fuels.* The regular drumbeat of energy demand growth will continue its upward march, supported by a global market that desires modernization. For those who question traditional energy's role in an increasingly "woke" society, I revive a quote from Jim Robo, the CEO of prolific renewable energy developer NextEra Energy:

"So the thing that mystifies me, like for example the opposition to the East Coast pipelines MVP and ACP, the piece of it that mystifies me, and this is coming from the largest owner of renewables in the world, the thing that mystifies me is these pipelines are enabling shutting coal plants down. Enabling 30%, 40%, 50% reductions in those states of CO2 emissions, and so it is a complete head scratcher for me. Natural gas is going to be an important part of the equation for a long time. This country has literally hundreds and hundreds and hundreds of years of natural gas. Remember there is still a ton of fuel oil that's burned in the Northeast that can be replaced by natural gas, that would be a huge CO2 improvement. You still need natural gas for heating in a lot of places. The opposition to it honestly mystifies me. I guess folks want to be cold in the winter and burn a lot of coal. I think it is really misguided. But it's real. It's real. Hopefully we're going to be able to start to have a more rational discussion about energy policy in this country. Energy policy has been very polarizing."




*Source: Energy Information Administration (EIA)*

(6) *Technological improvements at all points of the energy chain are lowering costs.* Only a few Midstream companies are highlighting cost cutting initiatives, and even less are willing to quantify what it could mean for their business. However, it seems clear that for management to earn its keep in the face of a reduced growth program it will need to control (and cut) costs to enhance margins. Already doing this for some time, DCP Midstream's "DCP 2.0" initiative has been working toward a goal of increasing centralization via automation and stronger pipeline control. While there is a limit to how much this can achieve, margin enhancement can meaningfully move the needle and to the extent this is communicated properly can drive stock price outperformance.

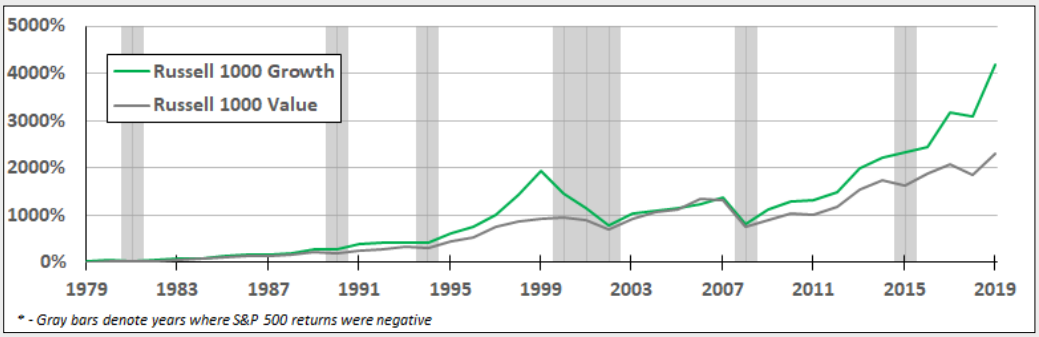
Beyond Midstream we believe technological improvements will continue up and down the energy chain. What this all does is help the United States (already the #1 producer) compete more effectively against international competitors, potentially smoothing out the production growth curve into a more predictable future that our Midstream companies can then use to limit infrastructure overbuild risk.

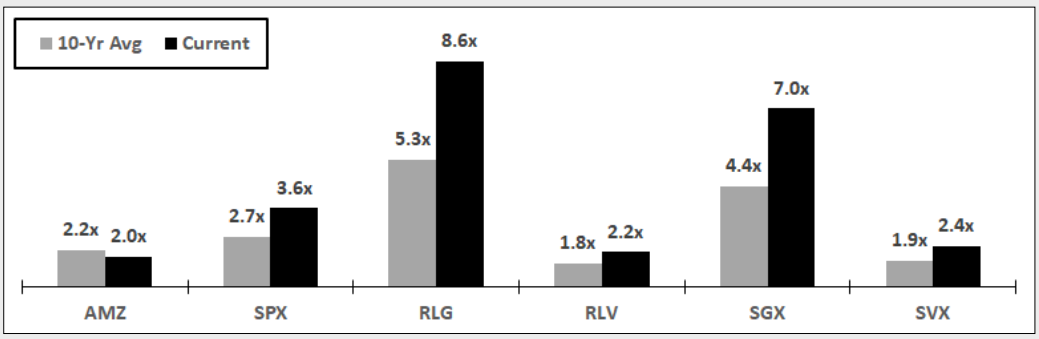
| Country | Million barrels per day | Share Of World Total |
|---|---|---|
| United States | 17.9 | 18% |
| Saudi Arabia | 12.4 | 12% |
| Russia | 11.4 | 11% |
| Canada | 5.4 | 5% |
| China | 4.8 | 5% |
| Iraq | 4.6 | 5% |
| Iran | 4.5 | 4% |
| United Arab Emirates | 3.8 | 4% |
| Brazil | 3.4 | 3% |
| Kuwait | 2.9 | 3% |
| **Total Top 10** | **71.2** | **71%** |
| **World Total** | **100.9** | |

*Source: Energy Information Administration (EIA)*

(7) *Tax advantages, especially for MLPs, are intact.* Lost in the noise over the last several years is that Midstream remains tax advantaged relative to other sectors. It's a hard argument to make these days that it wasn't the MLP vehicle itself that drove stocks lower, but rather management malpractice on how to properly run a capital-intensive business. The attractive attributes that drew investors to the sector in the first place are still there. In addition, Midstream C-Corps have tax shields for multiple years that protect them from corporate level taxation. While not necessarily an explicit sign we can point to, we merely highlight that an increase in corporate tax rates would have a positive effect on Midstream and MLPs.

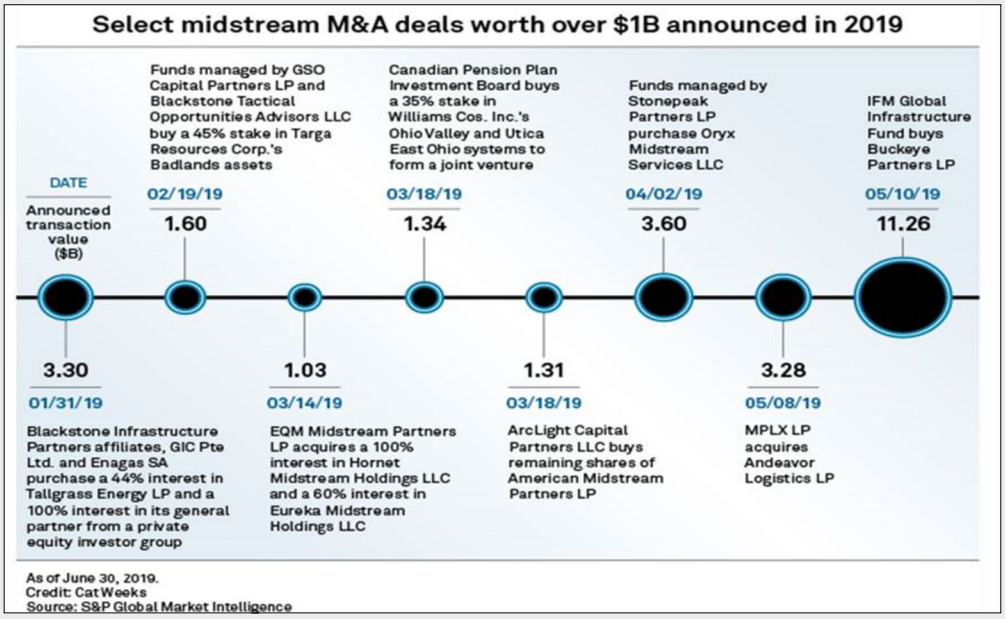
(8) *Growth extends its lead on Value, deepening Midstream's value proposition.* In yet another sign ignored by the general public, the increasing valuation gap between Growth and Value stocks is due for mean reversion if history is any precedent. We make two points, shown in the charts below: (1) Growth stocks extended their lead on Value stocks in the fourth quarter, and (2) Midstream stocks continue to be one of the only sectors that trades at a discount to its 10-year average.



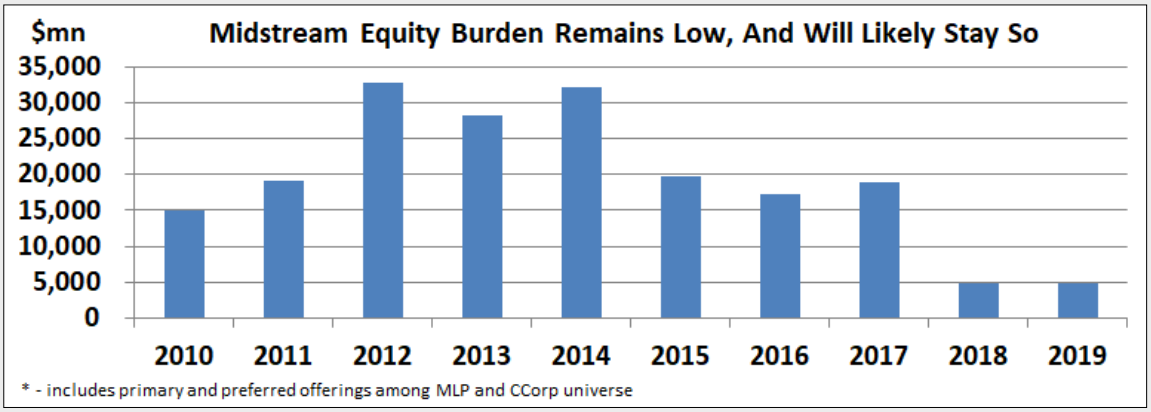




*Source: Bloomberg*

(9) *The private sector values Midstream assets materially higher than the public market.* We believe this is likely the result of a yield starved investor community. Midstream assets generate stable cash flows, typically at yields above other hard assets and certainly stocks in the market. Like the mean reversion we expect in Growth versus Value investing, we believe the signs are there for public valuations to be valued in line with what the market will pay for them.



(10) *Self-funding reduces capital markets risk and should reduce share price volatility.* In 2019 the market raised $4.8 billion of conventional equity capital, matching 2018. However, this does not include at-the-market (ATM) equity capital raises, where we estimate there was roughly $2 billion raised in 2018 and de minimus in 2019. It's all connected of course, given EBITDA has grown significantly at a time when capital expenditures are declining. However, lost in the mix is the defensive impact this self-funding trend should have on Midstream stock price volatility. We realize one data point doesn't make a trend, but we're optimistic the outperformance Midstream stocks had relative to E&P and Oil Services stocks during the recent cyclical weakness isn't in isolation, perhaps allowing Midstream to finally deliver on the promise to be a more defensive vehicle to invest in traditional energy.

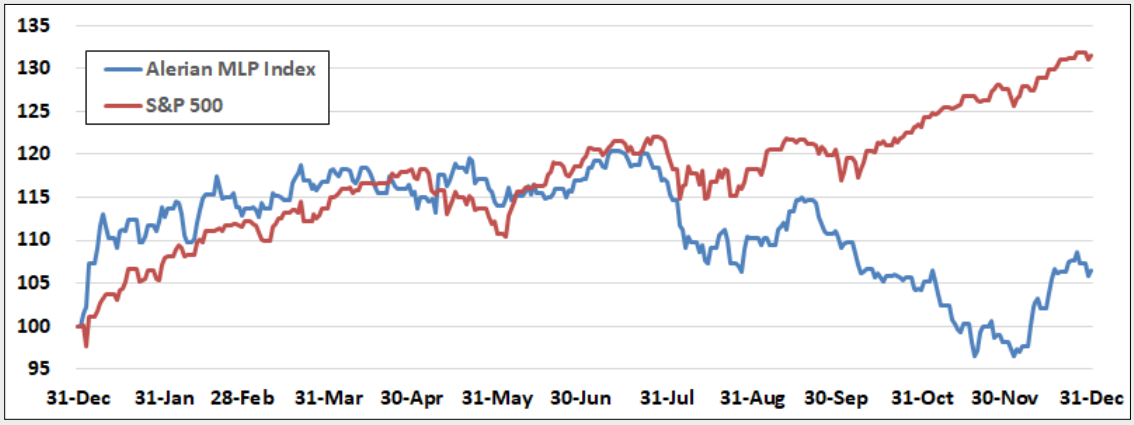



*Source: Company Data*

As a quick conclusion to this Top 10 list, the inevitable question we will receive is what will get these stocks working again. While many are willing to give their opinions on exactly what needs to be done, the truth is these people (us included) don't know. Issues remain in the form of infrastructure overbuild, contract expirations, E&P bankruptcies, and further rightsizing (i.e., dividend cuts), all in a presidential election year. What we do know is the setup remains excellent. The sector's corporate structure and strategy have never been better positioned to take advantage of when the recovery does happen. With multiple valuation metrics further supporting our thesis, we maintain our long-term constructive view on Midstream.

## 2019: Another Year, Another Dashed Dream For Midstream Recovery

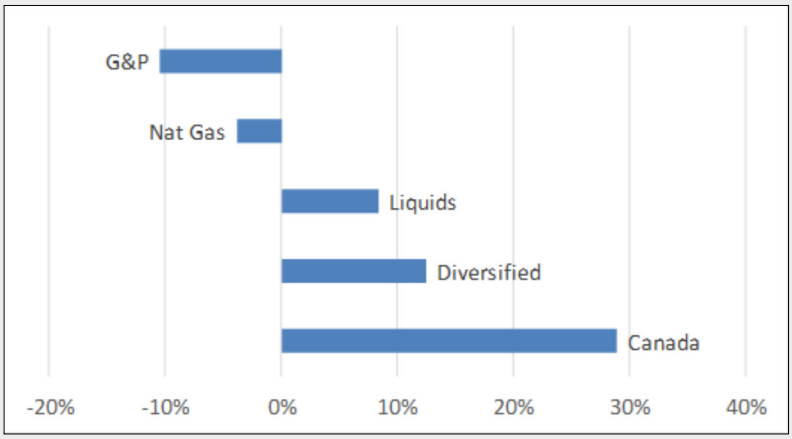
After an astonishingly strong start to the year we were hopeful 2019 would finally deliver the long-awaited recovery. Alas, this was not the case. To put it as straightforward as we can, Midstream's checkered past and strategic missteps have alienated investors, causing them to sell on strength and say "I told you so" on weakness. The sector remains in the penalty box, and will be there until, well, basically until it's not.




*Source: Bloomberg*

Among the sector winners were Canadian stocks and Diversified Midstream, which likely benefited from the market's view of their defensive attributes. Canadian stocks by virtue of their separation from the hyper-competitive U.S. market, and Diversified Midstream by owning integrated chains, being exposed to multiple types of energy, or the "utility like" nature of what they do own.

Among the sector losers were Natural Gas Gatherers & Processors (G&Ps), where close proximity to the more volatile well head caused investors to bail on these stocks as conditions deteriorated in the producer market. This was especially apparent for G&Ps exposed to natural gas and natural gas liquids (NGLs), which seemed to deteriorate more than those exposed to oil.




*Source: Bloomberg*

## MLP / Midstream Team Update

In December 2019, Eagle Global promoted Alex Meier and Michael Cerasoli to Co-Portfolio Managers for the firm's MLP/Midstream strategies. Both Alex and Michael have served in the PM/Analyst role for the past three years and have a combined 39 years of industry experience. They have extensive knowledge in the Midstream sector and have also demonstrated a strong competency in the management of the firm's MLP/Midstream portfolios. The firm is highly confident in Alex and Michael's ability to manage the strategies as they have been top alpha generators to strategy performance during their tenure with Eagle. Malcom Day, Senior Strategist, Curt Pabst, Managing Director and Senior Analysts, Will Shen and Steve Sherowski will remain in their current roles.

We thank you for your continued patronage and confidence in Eagle Global Advisors. We look forward to communicating the results of your investment next quarter.

- The Eagle MLP Team