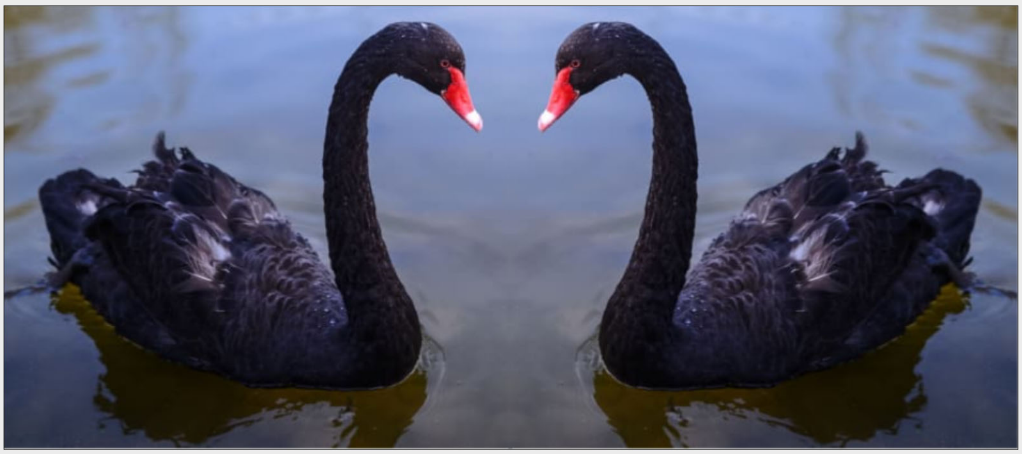
Quarterly Commentary
Q1 2020

EGA Energy MLPs and Midstream Companies

From the EGA Portfolio Management Team

The Pessimist Complains About The Wind; The Optimist Expects It To Change; The Realist Adjusts The Sails – William A. Ward

While we did not forecast either the emergence of COVID-19 or the breakdown of OPEC+ (a double black swan), we entered 2020 by constructing our portfolios with a defensive tilt. There was a lot we liked and still like about Midstream in the long-term, but our issues with the short-term led us to implement the most defensive portfolio we've had in years. We know this is small solace for investors that have endured much pain, with the Alerian MLP Total Return Index (AMZX) down 57% year-to-date and 74% from its peak on September 30, 2014. At quarter end, the index was trading just above the level it fell to during the financial crisis, which if we ignore this blip will take us back to levels unseen since 2005.



The first black swan that needs to fly away is the one that brought COVID-19 and destroyed demand for energy. This pandemic will subside, as it reportedly has in several Asian countries that were first impacted. We are under no expectation that demand will snap back to previous levels as some of the damage is permanent. It is safe to say there will be a sharp increase in demand based on where we are today, and when this happens it will provide a level of support to energy prices.

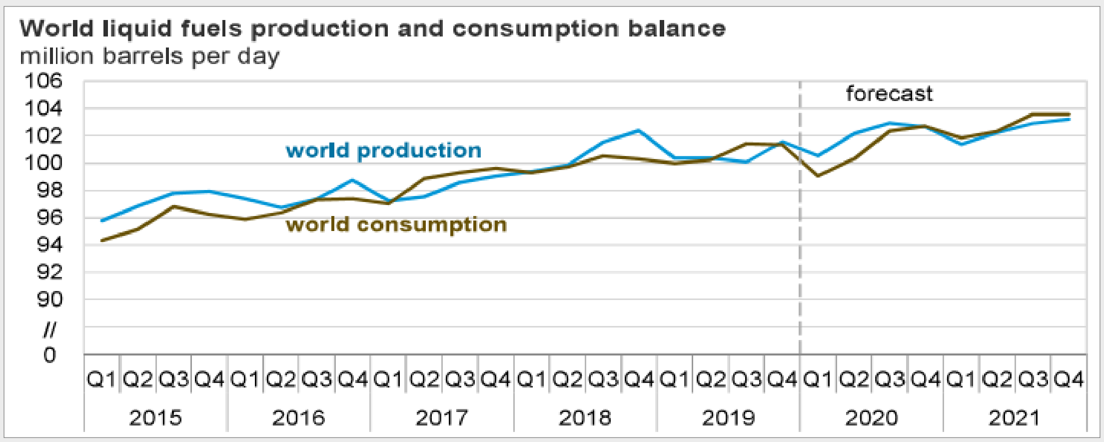
The second black swan that needs to fly away is the one that encouraged OPEC and Russia (OPEC+) to ignore the market reality and set a course towards energy market chaos. Even the recent deal coordinating a production cut of just under 10 million barrels per day is unlikely to stop storage tanks from filling in May or June, thereby pushing some U.S. producers into bankruptcy. All worldwide producers ultimately want to see higher sustained prices on the other side of COVID-19. So the question here is who blinks first when demand finally recovers? The last time we went through this in 2014 the shale revolution remained intact and OPEC+ eventually capitulated. Does history repeat itself? And how long does it take to play out? It is our view this will not be resolved in 2020.

To end at the beginning, the pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails. The market needs to deal with these two black swans first. As this plays out, we have worked hard to understand the rapidly changing producer dynamics and the impact on Midstream economics. We have positioned the portfolios with Midstream companies that have the assets and balance sheets to increase market share. Our focus is identifying the survivors and owning selectively, because when this passes it will be these companies that will most benefit from a recovery off what we believe are grossly oversold levels.

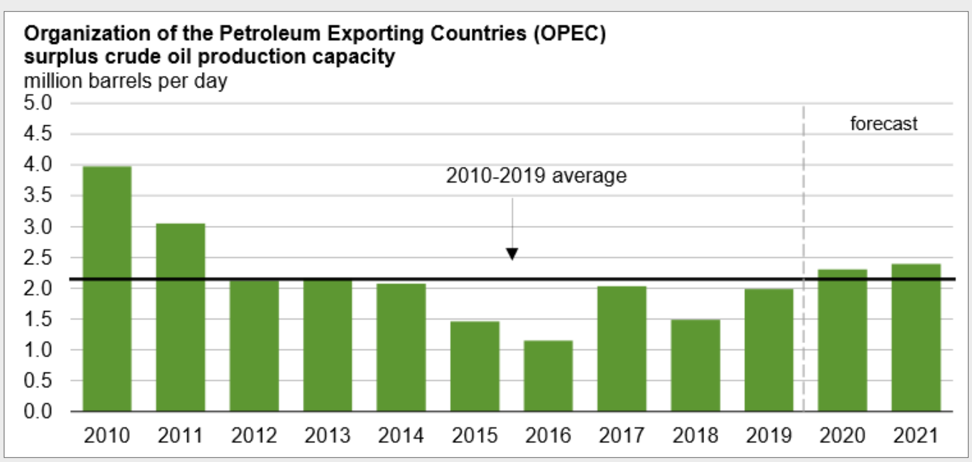
We like companies that have: (1) integrated networks, (2) exposure to the most economic parts of the most economic fields, (3) the healthiest balance sheets, and (4) operate in areas with low competition (ie, Canada). Conversely, we're avoiding companies that are: (1) closer to the wellhead, (2) lack diversification of energy products, geography, and assets, (3) operate in areas of high competition. Prudence, deep dive research, and discipline is what you've come to expect and should continue to expect from Eagle Global Advisors.

Painting An Unpleasant Picture

Prior to COVID-19 there was a delicate balance where global demand for hydrocarbons was being met by an equivalent increase in the production of hydrocarbons. OPEC maintained historically normal spare capacity of 1-2 million barrels per day to match steady increases in demand, though the ever-increasing efficiency of North American shale was threatening to widen this buffer. Prices started to weaken and you began to see a reaction in North American activity to the point many forecasters believed production would flatten in 2020, and then COVID-19 struck. This black swan created a significant mismatch as demand fell off a cliff, leaving spare capacity at a shocking 15-20 million barrels per day and the reality that storage tanks would be full in a matter of months.



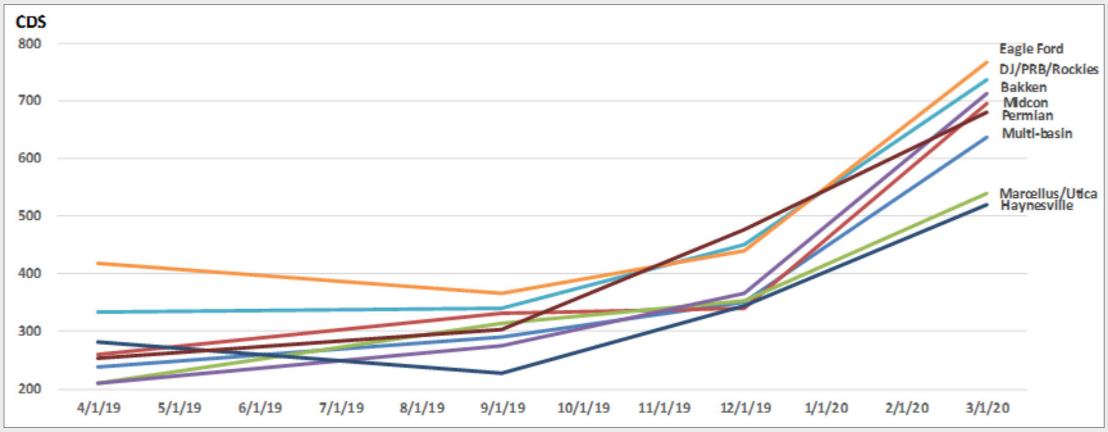
Source: Energy Information Administration (EIA)



Note: Black line represents 2010-2019 average (2.1 million barrels per day)

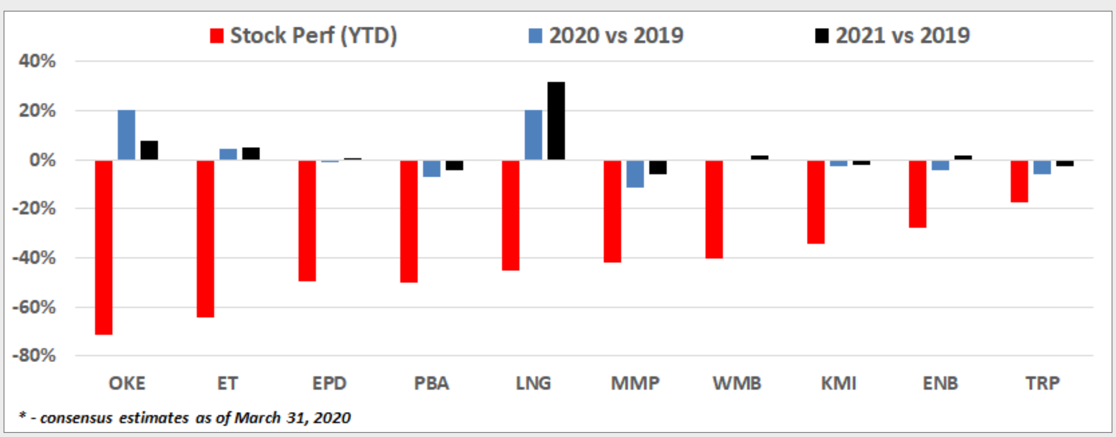
Source: Energy Information Administration (EIA)

Several U.S. producers were struggling financially even before COVID-19, and we've since seen CDS spreads blow out further. U.S. production is now expecting to fall even more than what forecasters were previously expecting, and demand for existing infrastructure will fall along with it. For some Midstream companies this means contracts may need to be re-negotiated and this, in turn, will put unexpected stress on balance sheets. Several Midstream companies have pre-emptively cut their dividends (by significant amounts), and we believe there will be more down the road. We believe these proactive moves should be viewed positively and provide confidence that the large majority of Midstream companies will make it through these uncertain times.



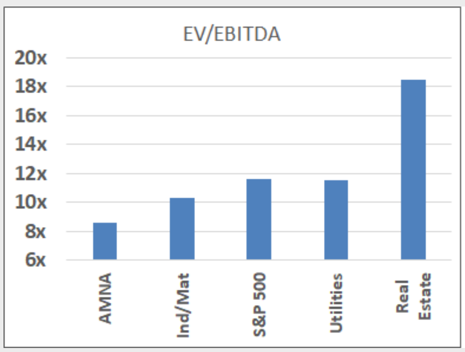
Source: Bloomberg

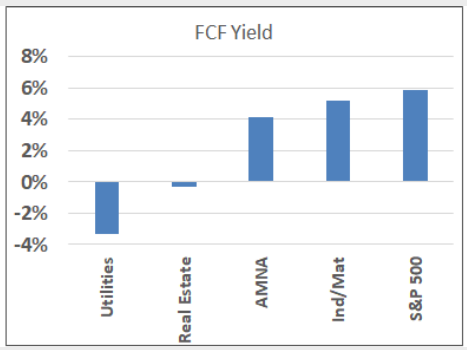
The median of Sell-Side consensus estimates for the Top 10 stocks in the AMNA guides to a 1%-2% YoY decline for 2020 and a 1%-2% increase in 2021 versus 2019. These estimates relative to where they were on January 1, 2020 are down on average 3%-4% and 6%-7% for 2020 and 2021, respectively. Within Eagle Global and relative to Sell-Side consensus we've imposed a more bearish near-term view into our "Base case" for modeling and valuation purposes and continue to stress test more dire conditions in our "Low case" scenarios. We expect Midstream balance sheets will be strained and therefore the sector's stock prices deserved a stock price correction, but with the same Top Ten AMNA stocks trading down 45% on average (YTD) something seems off.

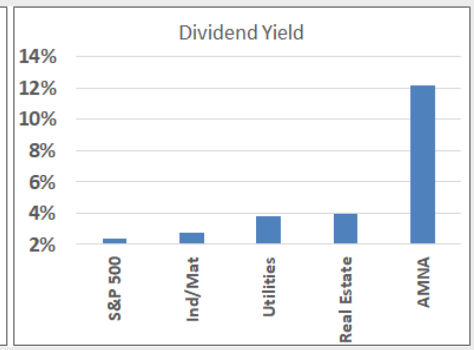


Source: Bloomberg

The fundamental reality is our analysis of EV/EBITDA and free cash flow suggests the sector has never been more attractive from a historical perspective. However, the paradigm has shifted making historical comparisons more difficult. We're left with comparing Midstream to other subsectors, which is likely how an outside investor would approach a new investment. Fortunately for us Midstream screens well on a variety of metrics when compared against other S&P subsectors. On EV/EBITDA Midstream trades at 8.4x, comparing favorably against the S&P 500 and its closest S&P subsectors (Utilities, Real Estate, and Industrials/Materials). Meanwhile, Midstream's 4.3% free cash flow yield is currently in the middle of the pack, though will likely surge higher as the Street lowers 2020 growth capital spending that should result in higher free cash flow (albeit on a lower EBITDA base). In addition, Midstream companies have hinted at another step down in capital spending in 2021, which further increases an already attractive 2021 free cash flow yield. Finally, and admittedly the least likely to convince investors is Midstream's attractive dividend yield. Keep in mind the AMNA is contrived of the largest, safest Midstream C-corps and MLPs publicly traded. We see minimal probability of a dividend cut from the Top Five AMNA constituents, which comprise 55%-60% of the index.





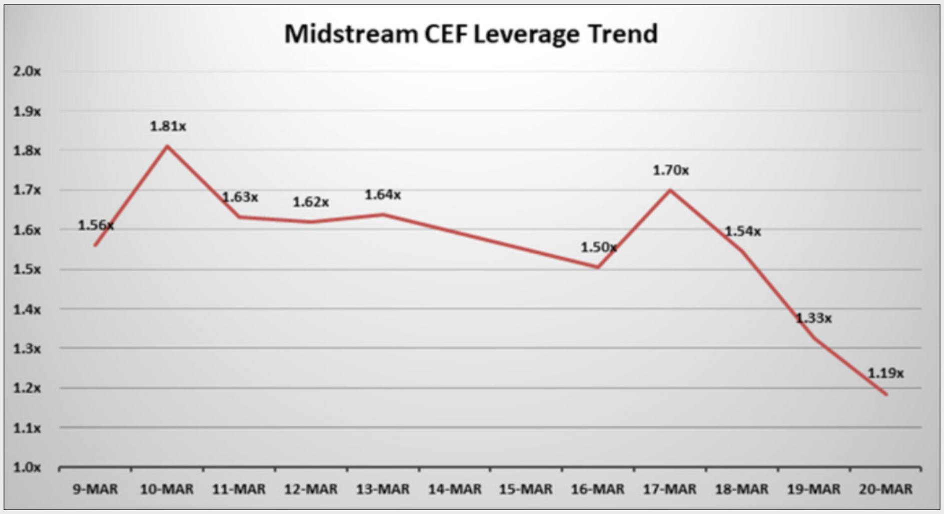


Source: Bloomberg

We want to be clear the above doesn't suggest a new wave of capital is about to surge into the sector. However, we do believe these comps may finally raise eyebrows among the generalist, "smart money" community, assuming they believe oil and natural gas energy will continue to make up a significant and growing part of energy consumption.

The Near-Term Technical Implications of the CEF Selloff, And The Medium-Term Fundamental Reality

A stealth overhang on the market has been the deleveraging of a large number of closed end funds (CEF). The sharp selloff in Midstream stocks has blown out leverage metrics for these funds, which drove a run of blind selling within the sector. On March 24, US Capital Advisors published an analysis of this technical trend, and concluded that CEF leverage has come down by $2.2 billion since late February. This technical pressure is likely a major contributor to the oversold nature of Midstream, and it's possible this overhang will continue to exist in the short-term. This technical event will run its course though, after which we expect a short-term technical rally will drive stocks higher. While we will look to capitalize on this trend, our firm's strength has always been medium and long-term investing.



Source: US Capital Advisors

MLP / Midstream 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 several major Midstream conferences before the Covid-19 shutdown and sentiment was poor, though we reiterate our long-term constructive view on the sector as we believe oil and natural gas will continue to play a major and increasing role in the global economy. We look forward to communicating the results of your investment next quarter.

We thank you for your continued patronage and confidence in Eagle Global Advisors, and we truly hope you and those close to you remain safe and healthy during these trying times

- The Eagle MLP Team