Quarterly Commentary Q2 2020

EGA Energy Infrastructure

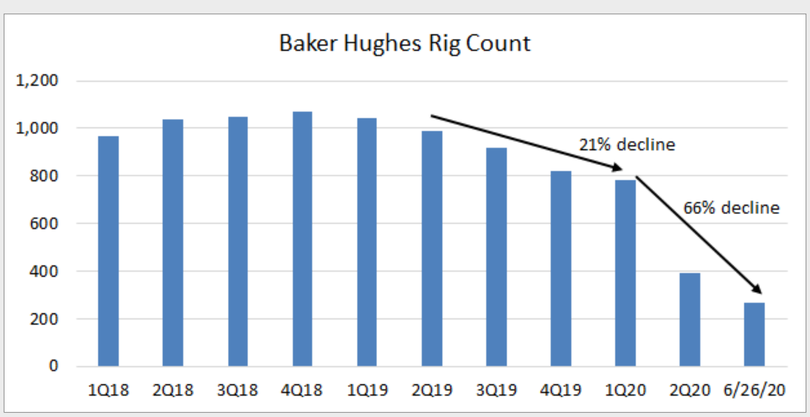
From the EGA Portfolio Management Team

"There is no way this winter is ever going to end as long as this groundhog keeps seeing his shadow" – Phil Connors ("Groundhog Day")

In the 1993 comedy "Groundhog Day", Phil Connors (Bill Murray) keeps repeating Groundhog Day over and over until he transforms into a better person, performing good deeds and putting others above himself. It's only at this point that his time loop ends and he's allowed to advance his life as a positive force on society. The Midstream asset class has gone through a similar metamorphosis. Since 2014, Midstream companies have eliminated Incentive Distribution Rights, become equity self-funding, reduced leverage & built distribution/ dividend coverage. Even after making these changes, the market has been skeptical of the Midstream business model, instead choosing to focus on the regulatory & commodity headwinds facing the asset class. It's hard to dispute this. Building a pipeline today is more challenging than 10 years ago (e.g. – Mountain Valley Pipeline, Atlantic Coast Pipeline, Dakota Access Pipeline). However, it's important to put things in perspective. Shale has matured and Midstream companies have built the necessary infrastructure for U.S. hydrocarbon production to continue to grow with minimal additional investment. Pipe in the ground is now more valuable than ever since the cost to replicate that infrastructure has only increased due to regulatory headwinds. We believe Midstream companies are now at an inflection point, where they can generate substantial free cash flow with compelling free cash flow yields that screen attractively relative to other asset classes.

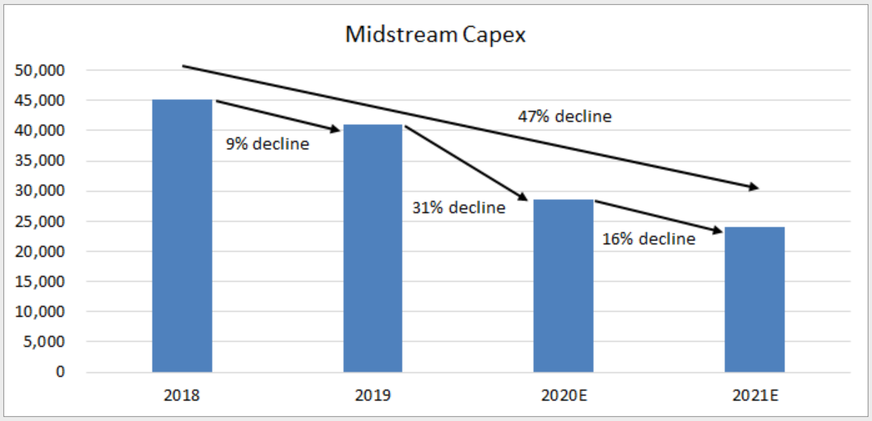
Market Forces Drive A Reduction In Capex Spending, Underpinning Attractive Free Cash Flow Yields

The last step in Midstream's transformation began in 3Q19, before the double black swan event of the OPEC+ supply surge and the demand-crushing Covid-19 pandemic. The rig count had been reduced 21% from 3Q19 through 1Q20 on the heels of wavering energy prices, as Midstream curtailed capital expenditures. That trend accelerated dramatically with the double black swan event in March, which drove the rig count down an additional 66% to the 265 rigs working at the end of June.



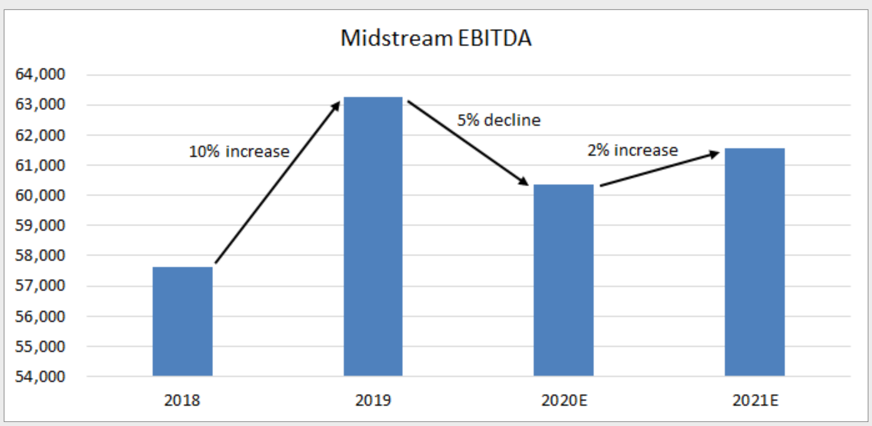
Source: Baker Hughes

In other words, what started as a modest rethink of Midstream capital spending became a full-blown reckoning. As shown below, we forecast Midstream capital spending will decline 31% to $28.5 billion in 2020 relative to 2019 ($41.1 billion), and another 16% to $24.0 billion in 2021. Again, this is a trend that had been slowly developing for several years, and when compared to 2018 our forecast for 2021 Midstream capital expenditures represents a nearly 50% decline. These cuts represent a substantial change in philosophy for an asset class that not too long ago celebrated infrastructure spending & massive investment capital spending backlogs.



Source: Company data, Eagle Global Advisors

Meanwhile, EBITDA has grown modestly as a result of prior capital investment. Even after accounting for the double black swan event we expect only a modest decline in EBITDA cash flow in 2020. Excluding a few positive outliers (LNG & MPLX) we forecast EBITDA will drop 5% to $60.3 billion in 2020 and increase 2% to $61.5 billion in 2021.



Source: Company data, Eagle Global Advisors

This combination of materially lower Midstream capital spending and more resilient EBITDA underpins what we believe is an opportunity for investors to harvest the benefits of free cash flow generation over the next several years.

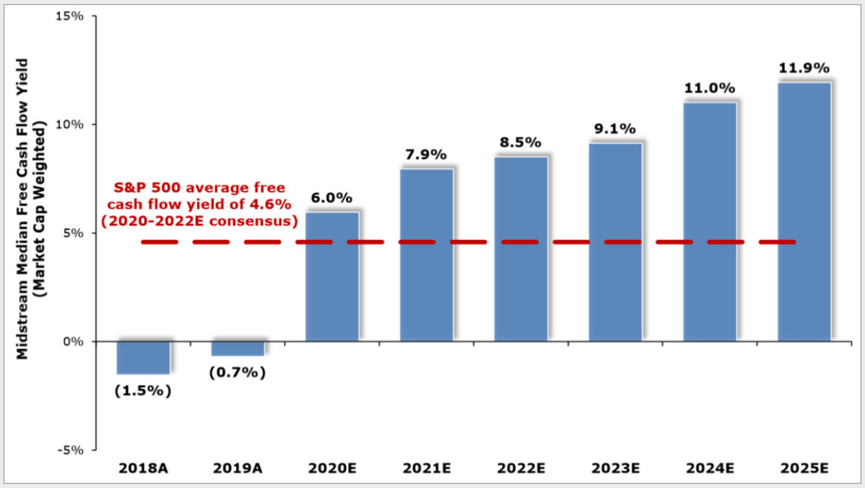
Top Eagle Holdings		FCF Yield	
		2020	2021
BP Midstream	BPMP	14.2%	11.5%
Enbridge Inc	ENB	6.3%	7.6%
Enterprise	EPD	9.6%	10.3%
Energy Transfer	ET	10.5%	22.0%
Equitrans	ETRN	-2.9%	0.4%
Gibson	GEI	6.1%	3.4%
Keyera	KEY	5.5%	6.2%
Kinder Morgan	KMI	8.2%	9.7%
Cheniere Energy	LNG	-8.7%	1.1%
Magellan	MMP	6.1%	8.8%
MPLX	MPLX	15.6%	16.0%
Nustar	NS	15.2%	15.0%
Plains All Amer.	PAA	12.1%	19.3%
Pembina	PPL	3.9%	9.4%
TC Pipelines	TCP	11.0%	1.0%
Targa	**TRGP**	**7.7%**	**11.2%**
TC Energy	TRP	4.7%	2.3%
Williams	**WMB**	**9.3%**	**9.2%**

Source: Bloomberg,, Eagle Global Advisors

At this point it's important to stress two things: (1) excess free cash flow provides optionality for Midstream companies, (2) healthy free cash flow yields are important to many investors.

On the first point, it is our view Midstream companies will direct free cash flow to continue deleveraging balance sheets and, down the road, execute share buybacks. We do not believe Midstream will prioritize dividend growth in the near-to-medium-term because it does not come with the flexibility that the other options provide. It's quite clear to management companies that dividend stability is being rewarded only if it comes with conviction in cash flow stability and healthy balance sheets.

On the second point, we believe there are markers many generalist investors use when deciding what sectors to analyze, and for those who focus on hard assets we think free cash flow yield is an important marker. According to Wells Fargo, the average free cash flow yield of the S&P 500 is 4.6% (as of June 2020), while anticipating Midstream free cash flow yields of 6.0% in 2020 and 7.9% in 2021. We are cautiously optimistic these markers are being noticed by non-dedicated investors.

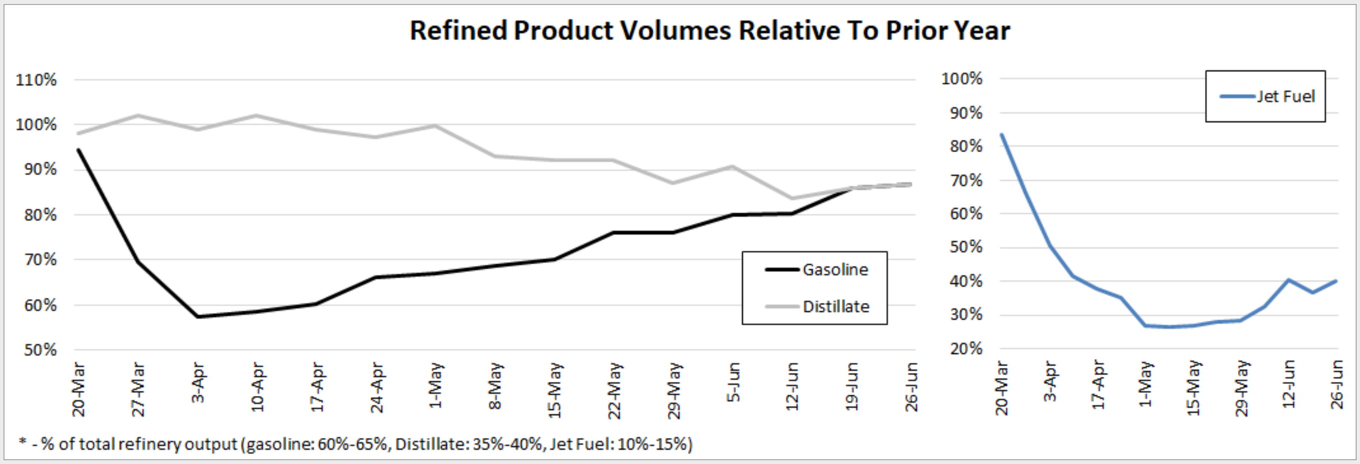


Source: Wells Fargo

We have seen a few direct examples of generalist investors focused on free cash flow reaching out to us and have separately heard indirect anecdotes about this as well from our contacts across the industry. These investors are patient and waiting for "all clear" signs before initiating investments. We think there are three key milestones that need to be achieved: (1) the dividend cut trend needs to end, (2) investors need to believe management teams will do the right thing and that balance sheets are safe, and (3) Midstream companies need to generate free cash flow yields better than other mature cyclical asset classes.

As Covid-19 Resurgence Fears Rise, So Does The Potential For A Slowdown In Volume Recovery

The economic reopening of the United States has caused an inevitable increase in Covid-19 positives, and with it some broader market fears that another lockdown is coming. Many industry insiders (us included) have been surprised by the recovery in refined products, particularly gasoline. As shown below, gasoline volumes at the end of June have recovered to roughly 85% of what they were at this time last year, up materially from the early-April trough of 58%. Distillate volumes held up during the crisis as the supply chain was required to continue, though has come in slightly since then as the broader market adjusted to a new, lower economic normal and energy demand in the field subsided as the rig count fell. Jet fuel was by far the most impacted by the pandemic, reaching a low of 27% of prior year volumes in early-May and having only recovered to roughly 40% at the end of June. In our view the most relevant product is gasoline though, as its usage by U.S. consumers can be a useful measure of economic activity.



Source: Department of Energy

Like a lot of things these days, we're cautiously optimistic about the economic recovery and believe its fragility is intertwined with the country's ability to safely push us past this pandemic. It's for this reason we continue to focus on quality for our Midstream strategies, though still dedicate a small portion of our portfolio to "survivor beta". We continue to avoid all low quality, high beta, concentrated Midstream stocks. Separately, some may have noticed a decline in income received from your EGA Midstream investment. We took steps in the first quarter before the pandemic to upgrade the quality of our portfolios, and typically higher quality companies pay lower dividends.

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 continue to believe oil and natural gas will play a major and increasing role in the global economy, and owing to healthier balance sheets, higher coverage, and heightened discipline are optimistic about the long-term viability of Midstream as a sector for investors who prioritize income.

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

- The Eagle Midstream Team