Eagle Global Advisors

Quarterly Commentary
Q4 2020

EGA Energy Infrastructure

From the EGA Portfolio Management Team

Turning The Page On A Difficult Year

Small businesses make up:
- 99.7 percent of U.S. employer firms,
- 64 percent of net new private-sector jobs,
- 49.2 percent of private-sector employment,
- 42.9 percent of private-sector payroll,
- 46 percent of private-sector output,
- 43 percent of high-tech employment,
- 98 percent of firms exporting goods, and
- 33 percent of exporting value.

Source: Small Business Administration

The year 2020 will be remembered as one of the most eventful and challenging years in history. There were silver linings, like short commutes, more family time, and an overall greater appreciation for the things we have. However, these pale in comparison to the loss of life, the many who have personally suffered or those who have been economically devastated as a result of Covid-19. A casual observer may not understand the disconnect between the new records being set by the S&P 500 and the magnitude of small businesses that have broken or are about to break as a result of the pandemic. Keep in mind that small business makes up roughly 50% of private sector employment and represent what many economists believe to be the true backbone of the United States. It is therefore our view the fate of Midstream in 2021 depends on the successful delivery of an effective vaccine, which drives societal normalization, a recovery in small business, and a rebound for traditional energy.

We think it's also important to give credit to old-fashioned human intelligence, innovation, and perseverance. The rate at which multiple vaccines were developed and tested exceeded both the expectations of experts and any historical precedent. In some ways, it is reminiscent of how entrepreneurism solved the U.S.' energy dependency issues in the early-2000s. Then it was a handful of super smart petroleum engineers that launched the shale revolution that positively impacted international geopolitics, global economics, and yes, even the environment.

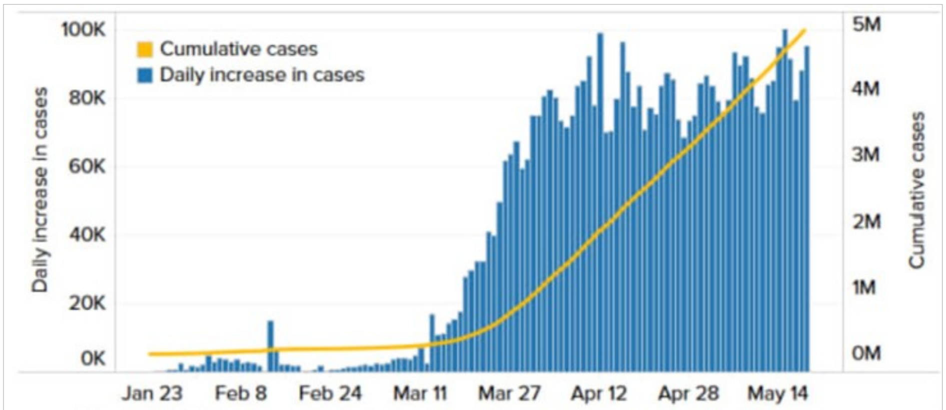
Autopsying 2020

Midstream investors can be excused for experiencing a serious bout of fatigue in 2020. How else would an investor react when a demand-driven crash overlaps a supply side correction? The latter weighed on the sector by way 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" (Source: EGA 4Q19 Quarterly Commentary) and has been an unfortunate recurring theme for the past several years. The former, driven by Covid-19, came fast and hit hard.

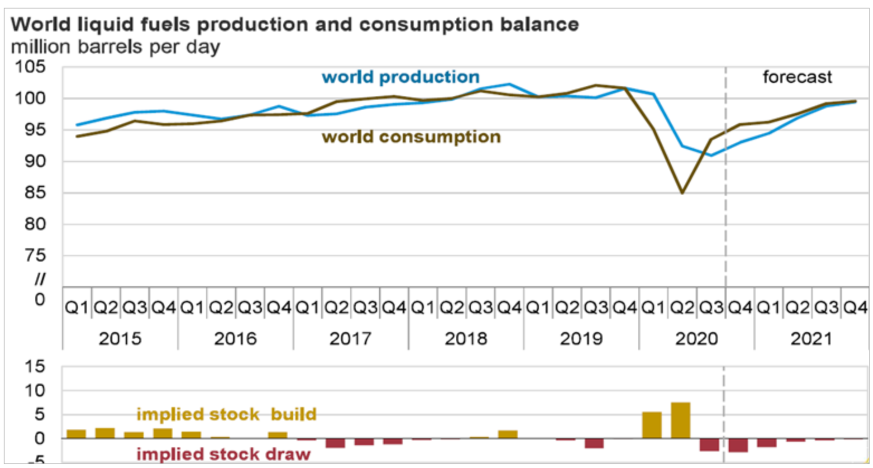
Life was put on hold as virus fears spread quickly across the U.S. Naturally, this fear caused businesses to close and the vast majority of energy consumers were left stranded at home. Regular trips to the gas station stretched from one, to two, and then three or more weeks apart. The global economy is not built to withstand an "emergency stop" situation, and the cogs of global business gummed up quickly as a result. Anyone can paint a theoretical picture of this type of scenario in a lab, but watching it happen over the course of just a few months was scary.

The following is an abridged timeline of events in pictures, as per John Hopkins University (Covid-19 case count chart) and the U.S. Department of Energy (others):

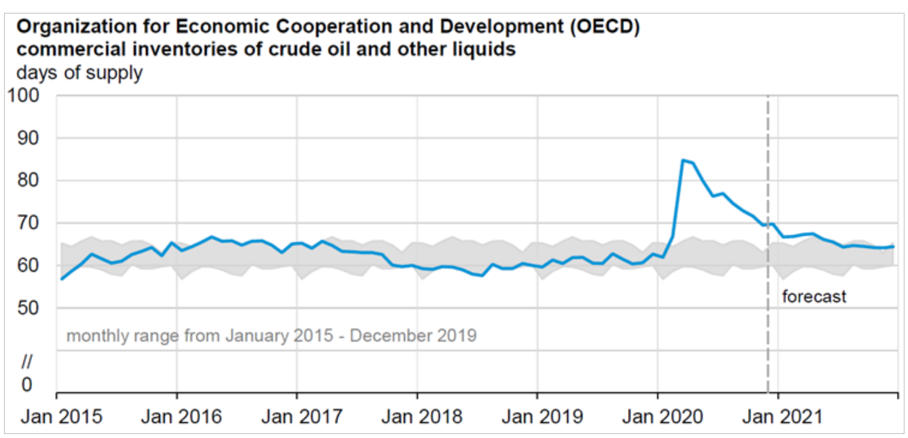
Covid-19 cases begin to "officially" skyrocket in early-March…



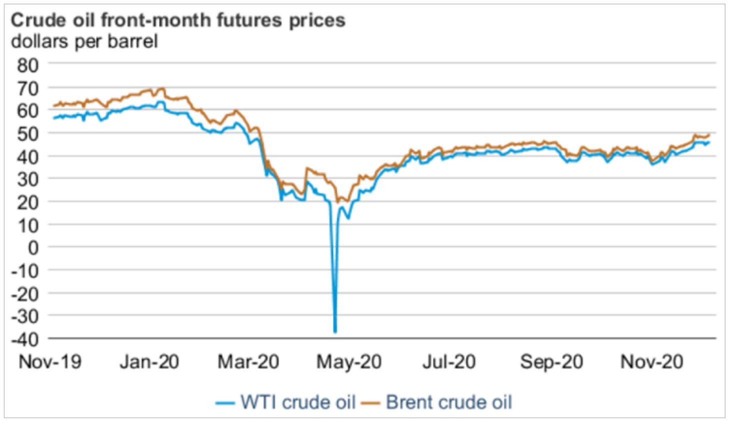
…Global oil consumption fell roughly 17 million barrels per day in just a few months…



…Since production can't be turned off so quickly, global inventories skyrocketed…



...Oil prices collapsed, epitomized by WTI crude oil's April 20th closing price of -$37.63 (minus!)...

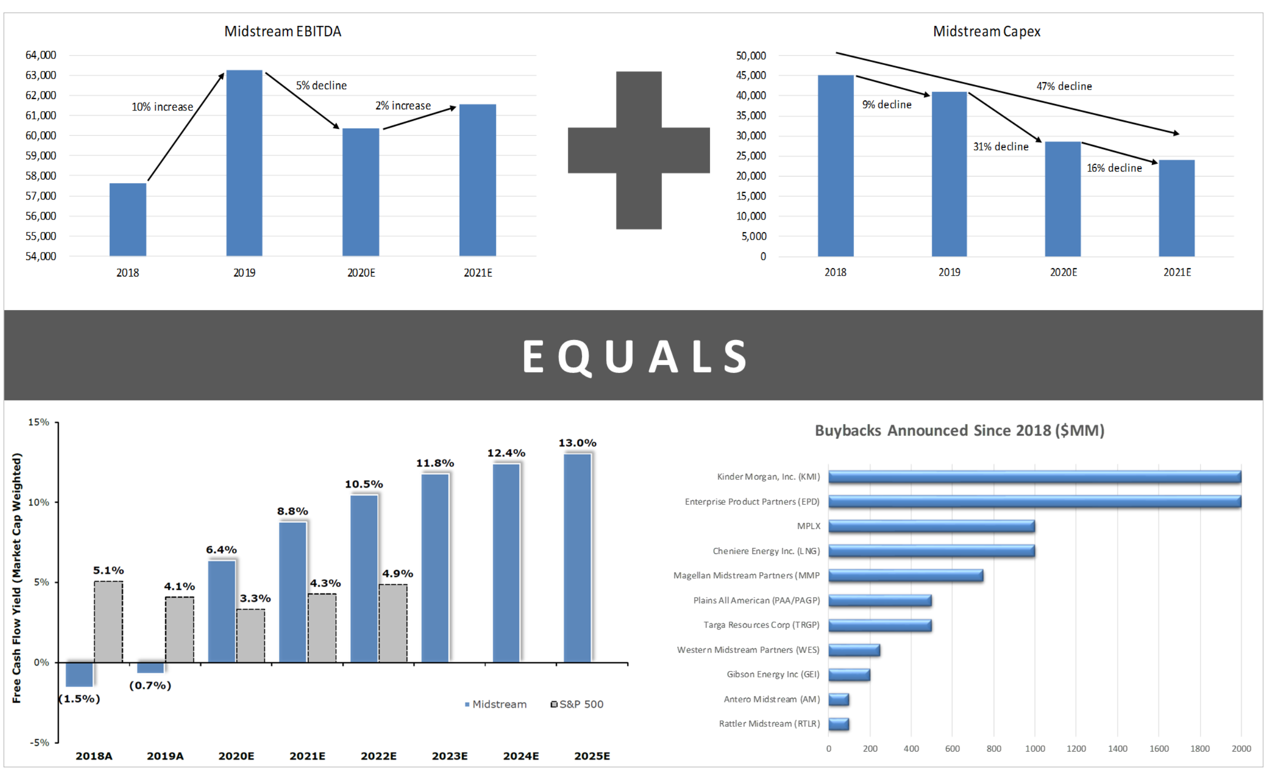


Source: EIA

By early-April traditional energy was experiencing a disaster scenario of epic proportions. U.S. oil producers reacted quickly by shutting in production where they could. The resulting battle to balance the global oil markets came at considerable damage to their financial position and possibly the geological makeup of the wells themselves (time will tell). What limited access to capital was available prior to the pandemic disappeared and many small producers were forced into bankruptcy. Midstream companies reacted swiftly by once again cutting dividends, trimming operating costs and capital expenditures. Keep in mind this was all in the context of a bitter presidential election that was adding jitters to an already nervous and increasingly capitulating base of traditional energy investors.

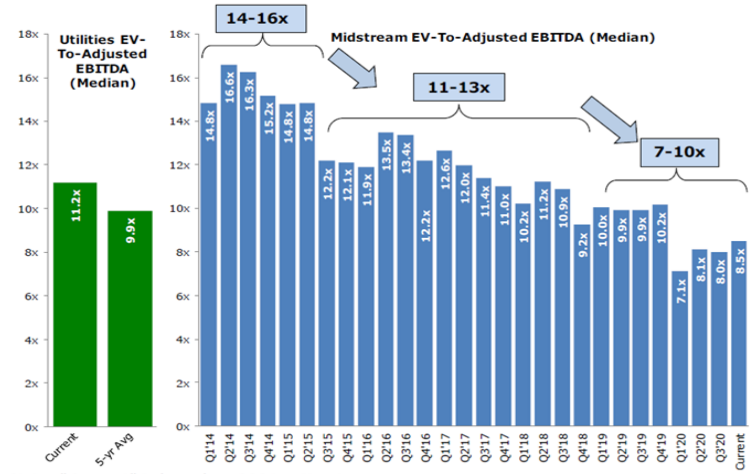
However, by mid-summer the virus case count was declining and as a result we began to see a partial recovery in liquids demand. There were also multiple consolidations among the larger producers that many believed was overdue, which in the short-term improves confidence for Midstream companies by way of lowering counterparty risks. Market turbulence also drove Midstream companies to re-examine existing as well as future projects, and the market warmly received news of project cancellations or project combinations.

The other thing the market noticed was the resilience of Midstream cash flows as the year progressed. When you combine resilient EBITDA with lower financial (capex/dividends) obligations the result is an avalanche of free cash flow. Management teams have no incentive to increase dividends for a variety of reasons, and there is more than enough cash to both continue reducing debt and finance share buybacks. To date there have been 10 share buyback programs totaling $8.4 billion announced, and we have reason to believe others will join the trend in 2021.



Source: Eagle Global Advisors, Wells Fargo

This brings us to November 9th, a date signified by Pfizer and BioNTech's announcement that their vaccine could prevent 90% of people from contracting Covid-19. This was followed soon after by other vaccines with similar results and the market the world over caught a tailwind, but Midstream in particular. From November 9th through year-end the Alerian MLP Index is +15% versus the S&P 500 +6%. We believe Midstream has compelling upside assuming a full normalization of the market, and valuation metrics (see chart to the right) suggest meaningful upside beyond this normalization trade.



Note: "Current" is based on 2021 estimates.

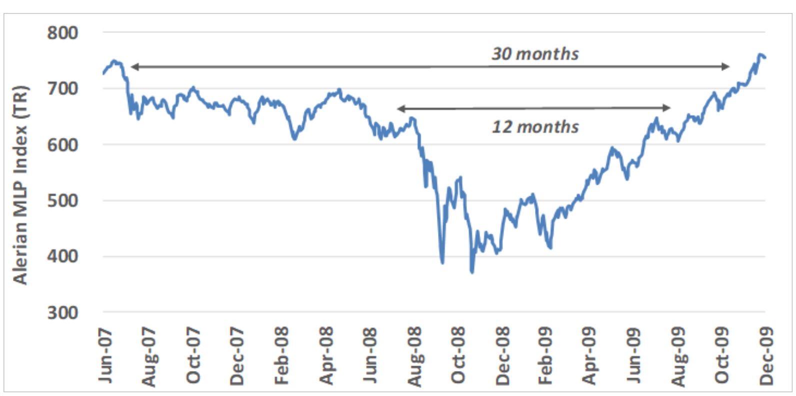
Source: Wells Fargo

Previewing 2021

Last year at this time we wrote "The Top Ten Signs That Midstream Is NOT Dead". We believe the vast majority of our investment thesis remains intact, and view 2020 as more of an interruption in what is a compelling fundamental outlook. We reiterate:

- declining capital expenditures
- management teams have a great problem, how to allocate excess cash
- technological improvements at all points of the energy chain are lowering costs
- the private sector values Midstream assets materially higher than the public market
- energy demand is growing and with it the need for fossil fuels
- dividend yields are attractive, sustainable, and poised to grow
- self-funding reduces capital markets risk and should reduce share price volatility
- tax advantages, especially for MLPs, are intact

We wrote above how Midstream companies are in a far stronger position to execute on their initiatives given how they rightsized themselves to a pandemic economy that will hopefully be a distant memory by mid-2021. There is evidence that demand-driven crashes have V-shaped recoveries, at least that was the Midstream experience during the 2008 financial crisis (see below). However, a critical difference between then and now is that management didn't really do much in 2008. They just waited out the return of demand and when it happened, they continued business as usual. Their 2020 response was very different. Management teams have done a lot over the last several years, and even despite a supply-side correction were authorizing share repurchase programs. As we enter 2021 their financial position is even stronger, which in our view doesn't necessarily assume demand normalization. Perhaps the post-vaccine rally we've experienced is the start of a long overdue V-shaped recovery.



Source: Bloomberg

There are two lingering questions/doubts we encounter. First, which investors have and will buy Midstream stocks? It's basic knowledge that stocks (or anything) do not increase in value if no one is buying. Second, what about the existential threat of renewable energy? Taken in order:

We have anecdotal evidence that much of the post-vaccine rally was driven early on by dedicated energy investors adding leverage and more recently a rotational trade out of Electric Utilities. We believe the rotational trade will continue until energy recovery momentum stalls, which should be easy to ascertain given the large amount of data tracked by the energy industry. Beyond the recovery trade it will be the passage of time that builds investor confidence in Midstream dividends that may lure retail and generalist investors back to a sector that recently betrayed them. We don't believe Midstream will attract a meaningful ESG investor base anytime soon, though this is not meant to discourage the efforts by the industry to present themselves as ESG-friendly. It's critical to answer these questions because ignoring them will inevitably drive existing investors away. Midstream must do everything it can to retain its existing investor base while allowing the free cash flow theme to attract new investors.

Something else that shouldn't be ignored is the existential threat of renewable energy, which we believe is increasingly an argument of "when, not if". Technological innovation is occurring so rapidly that we believe it is naïve to ignore the potential impact from renewable energy. We do believe questions over how long this transition will take to occur are reasonable. There is widespread misunderstanding by the general public of how instrumental hydrocarbons are to modern society, and how much of the world still needs cheap, reliable energy to progress to a modern economy. We believe oil demand will continue to grow over the foreseeable future, and to the extent it gets displaced it is more likely to be replaced by natural gas than wind and solar. Along the way, a conversion to natural gas has a positive environmental impact and is one reason why domestic carbon emissions have declined over the last decade. The natural gas megatrend is very much alive, as is the outlook for oil and natural gas liquids (NGLs) growth.

However, we reiterate our view that renewable transition is a question of "when, not if". It's the reason why we have been investing in renewable energy for nearly seven years in our broader infrastructure products and have a dedicated renewable infrastructure product. Since we cannot see the future our best hope is to closely analyze the present and adjust portfolios quickly to the situation on the ground. It's why we allocated a meaningful portion of our 2020 portfolio to renewable infrastructure, and why after the vaccine announcement we lowered this weight in favor of Midstream exposure. Stock selection is key, always has been, but effectively investing in energy infrastructure also requires understanding and balancing the many themes at play at any given time.

As we head deeper into 2021, our portfolio priorities are:

- own stable, predictable cash flows capable of *benefitting from improving economic activity*
- focus on *free cash flow generation*
- *strong contractual counter party exposure*, with emphasis on investment grade debt ratings
- own *vertically integrated assets* that touch the molecule from the well head to the consumer
- *select higher beta exposures* (e.g. PAA, TRGP, WES, NS)
- continue to participate in the *growing demand for renewable power*

Energy Infrastructure 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 Energy Infrastructure Team

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