EGA Energy Infrastructure

From the EGA Portfolio Management Team

"Most Human Beings Have An Almost Infinite Capacity For Taking Things For Granted"

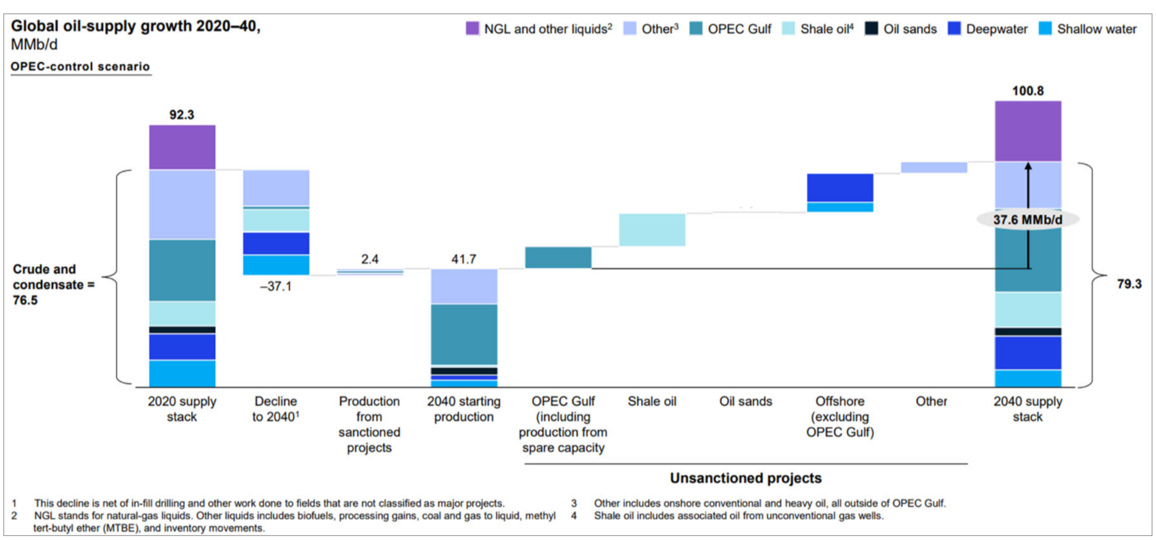
Published in 1932, "Brave New World" by Aldous Huxley follows the stories of Bernard and John as they challenge the ideals of a dystopian society. Among many things, the book explains that a dystopian society must eliminate individuality so its people can be molded into "useful" cogs in a machine. These types of books are designed to make people think about the societal nudges that push conformance, though these awakenings tend to be quickly forgotten. Perhaps part of this amnesia is because as Huxley put it, "Most Human Beings Have an Almost Infinite Capacity for Taking Things for Granted".

These are exciting times for energy and the United States, and we think a comprehensive energy policy is imperative to future success. We must not take what we have for granted. Main Street supports energy transition, though if implemented too quickly will impact our quality of life, erode public support, and endanger the environmental movement. Rhetoric can be dangerous. The de-carbonization movement will have you believe fossil fuels can be eliminated tomorrow while the hydrocarbon industry will flat out ignore advances renewable energy has made. To avoid energy chaos, we need to work together.

Short-Term Optimism Meets Long-Term Reality

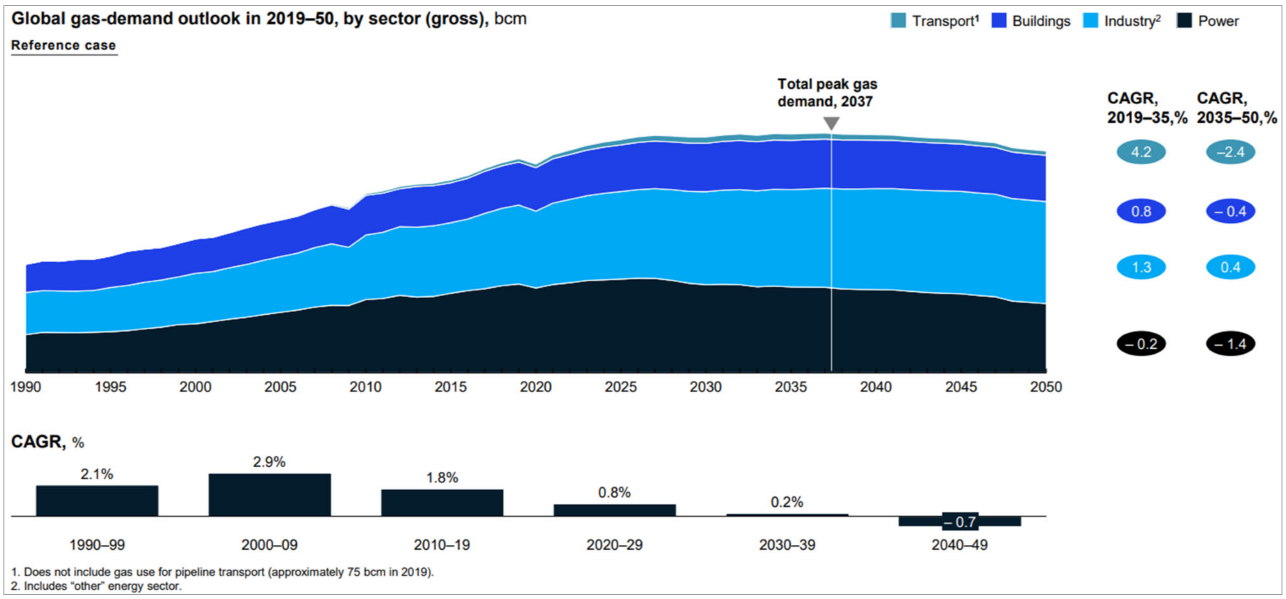
Main Street's optimism is grounded in good intentions, though the reality is that global society depends on hydrocarbons to a degree that is not easily replaced (aka "taken for granted"). It goes well beyond simply converting to an electric vehicle. In fact, a quick look around a generic household or workplace will reveal the bulk of any person's material possessions are created directly or indirectly with oil and natural gas.

Recently McKinsey updated forecasts for oil and natural gas, and their reference case (see below exhibit) presumes global oil supply will continue to grow through 2040. Assuming supply matches demand suggests a CAGR (2020-40) of roughly 0.5% that while slower than the steady 1.0% CAGR experienced over multiple prior decades, still represents growth. Even in McKinsey's "accelerated energy transition" scenario oil demand increases meaningfully through 2025 and then remains roughly flat through 2040.



Source: McKinsey, Rystad Energy

Meanwhile, McKinsey forecasts natural gas demand will peak in 2035 before steadily declining in the 2040's. Since we think most of the natural gas supply will be consumed by electric generation or home heating, the implication is forecasted declines will be offset by energy storage (i.e., batteries). There is much riding on society's ability to solve reliability issues while at the same time keeping pace with what will be enormous increases in electricity demand. Keep in mind natural gas is far cleaner than coal, and material emission reductions can be had simply by converting coal generation to natural gas. A big reason why United States' carbon emissions have declined 15% since 2008 is because cheap natural gas has out-competed coal power plants.

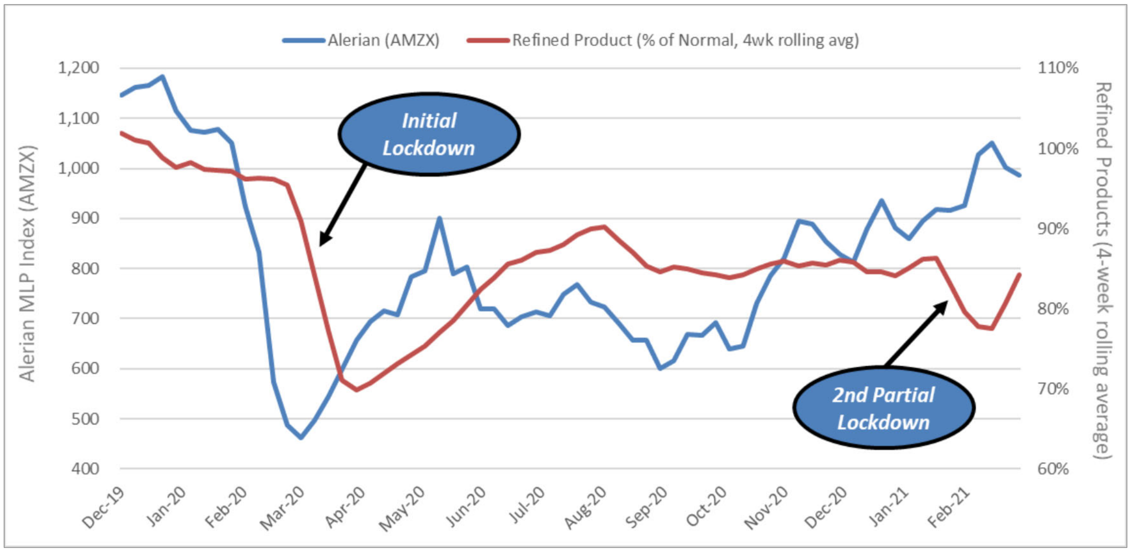


Source: McKinsey

We may also find it difficult to raise up the welfare of global citizens while at the same time achieving climate goals. Hydrocarbons are the cheapest, most reliable, and transportable form of energy in existence, and is the most effective way of helping achieve basic goals like access to clean water, food, or shelter. We don't know if peak oil supply or demand is right around the corner, but we do know a comprehensive energy policy that benefits the most people is best, and this requires more of all kinds of infrastructure.

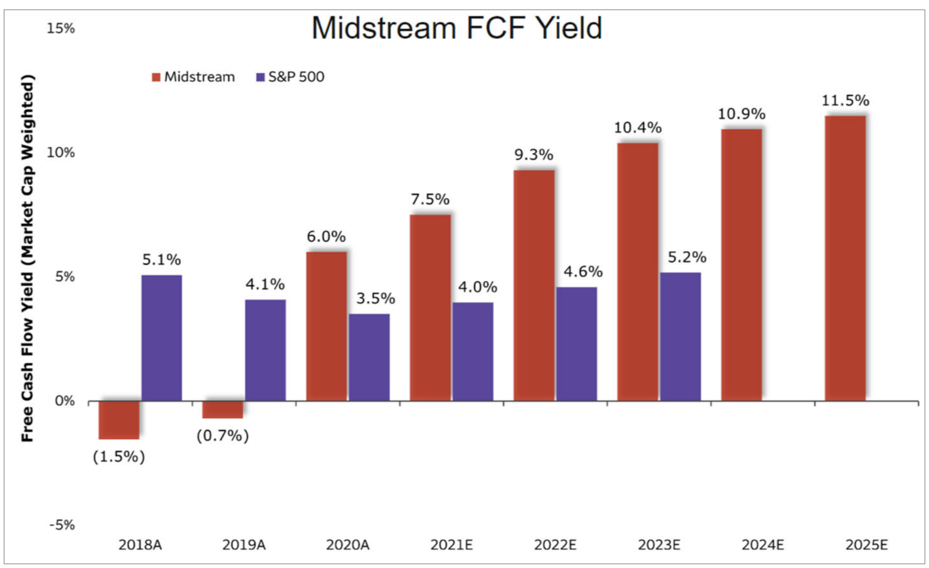
In the Meantime, The Great Re-Opening Continues And Investors Are Noticing

While we debate the long-term outlook the stock and energy markets are being looked at through a short-term lens. The trauma experienced from Covid-19 remains embedded in our fabric, as evidenced by refined product demand that still tracks below pre-pandemic levels. We believe there are two compelling stories to tell as it relates to Midstream. The first is the re-opening of trade, which as vaccine penetration continues to expand should help refined product demand make that final push back to normal. The market appears to have begun to price in normalization as the partial lockdowns in January-February 2021 were largely met with indifference. As shown below, the initial lockdown in February-March 2020 crashed the Alerian Index, whereas the second lockdown did not appear to slow the Alerian's recovery. We recognize the second lockdown was partial and not total, though price performance suggests investors did not panic. It is increasingly clear investors are confident in both the improvements in Covid-19 treatment and vaccine distribution. Either way, Covid-19 isn't the market killer it was in early-2020.



Source: Bloomberg, Department of Energy (DOE)

The second highly compelling story predates the pandemic. The market is gaining confidence in Midstream's ability to generate large amounts of free cash flow. This free cash flow provides visibility on de-leveraging and share buybacks, and that is attracting generalist interest. It goes beyond this though. Management teams are more disciplined, and there is less fear that a company will make an ill-advised acquisition or pursue an unnecessary growth project. This is helping calm fears the energy infrastructure overbuild will weigh on the sector for years to come. It's true that volumes are slated to decline in some instances and contract renegotiations will be difficult, but analyst models are still generating massive free cash flow in spite of these negative catalysts.



Source: Wells Fargo

These positive trends are also coinciding with rising interest rates. To be clear, rising interest rates are rarely good for investors, though they seem to be less bad for those with stable cash flows and limited growth. With very low growth expectations, Midstream is in a place where it may benefit from a rise in interest rates (to some degree). Looking around at the rest of the market there are whole sectors where stock valuations have far exceeded their ability to grow. As interest rates rise, the present value of future cash flows declines quickly and a reckoning (or at least a correction) is occurring for the 2020 high-flyers. We believe this is another reason why our companies are gaining momentum, as long as rising interest rates don't spiral out of control.

Source: Bloomberg

At the same time, we don't want to paint too optimistic a picture. Regulatory and activist pushback continues to be high and rising. They are well funded and willing to challenge each and every detail of the process. Enbridge's (ENB) Line 3 Replacement project is slated to be completed in 4Q21 after spending years in regulatory purgatory and assembling numerous Environmental Impact Statements (EIS). This is for a replacement, not even a new pipe. Equitrans' (ETRN) Mountain Valley Pipeline project continues to be held up to the point that completion is truly in doubt despite being >90% complete. Energy Transfer's (ET) Dakota Access Pipeline is at risk of being shut down over a process issue, despite having operated safely since 2017. Each of these examples are disconcerting and emblematic of a society that is perhaps rushing too fast towards de-carbonization, and risking energy chaos. The silver lining is Midstream assets that continue to operate in the future will become extremely valuable given the perception that new infrastructure will be nearly impossible to build.

We continue to believe Midstream is walking a tightrope. Main Street does not believe oil and natural gas will be around forever, and so we're focused on how Midstream will participate in the energy transition. On paper they're well positioned to benefit given their experience and expertise in managing complex permitting processes and building large infrastructure.

As we head further 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