Eagle Global Advisors

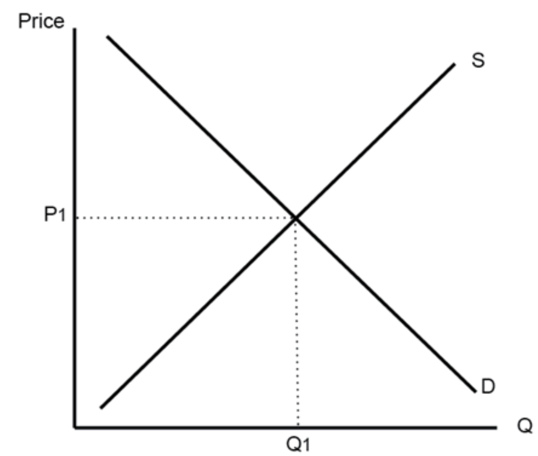
Quarterly Commentary 3Q 2021

EGA Energy Infrastructure

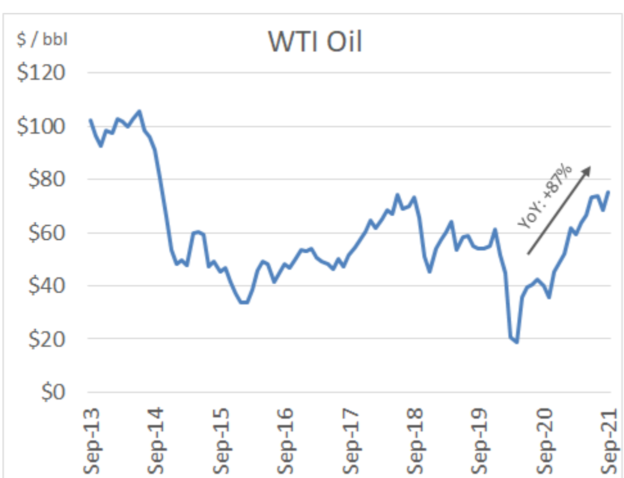
From the EGA Portfolio Management Team

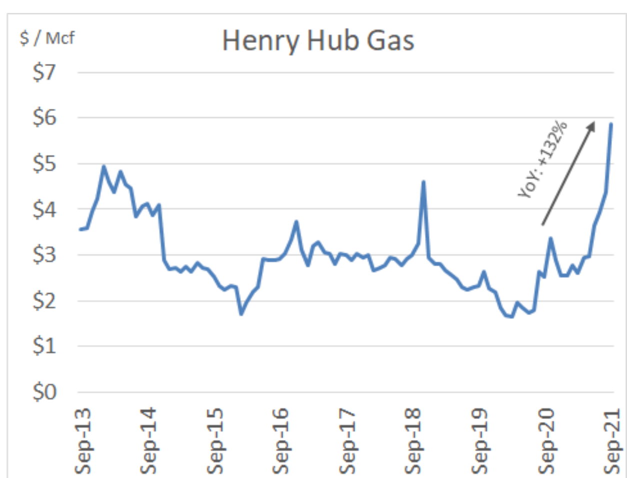
Economics 101: The Cure For High Prices, Is High Prices

Welcome to Economics 101. Today we will target the basics by analyzing our imaginary factory that produces widgets. If we flood the market with widgets and demand remains constant, the price of our widget will go down as people place less value on a product that is available everywhere. Conversely, if we underinvest in supply (and demand remains constant), then the price of our widget will go up because there is less of our product available. The market's main function is to find an equilibrium that results in stable prices that meets the needs of the general public. In a perfect world a free market results in stable prices, adequate supply, minimal inflation, and an absence of turmoil. Unless we're talking about oil and natural gas. In that case, buckle up.



Over the last several years we've experienced an abnormally large number of shocks to the energy market, both in supply and demand. Some of it, to be sure, has been self-inflicted. Twice over the last seven years OPEC has lost patience with U.S. producers and flooded the market with product in an effort to inflict financial pain. Meanwhile, demand has been afflicted by the unforeseen (Covid-19) and foreseen (increased renewables and energy conservation). What impresses us though is the resilience of long-term demand, which like a water level bounces back once pressure is released. By the end of the third quarter, energy demand had largely normalized as the world gained comfort with its ability to withstand the Covid-19 delta variant, while supply constraints emerged from a combination of OPEC discipline and severe underinvestment. Under these conditions, our friendly Economics 101 professor would not be surprised to see oil and natural gas prices end the third quarter at multi-year highs and with many predicting higher prices over the near- and medium-terms.

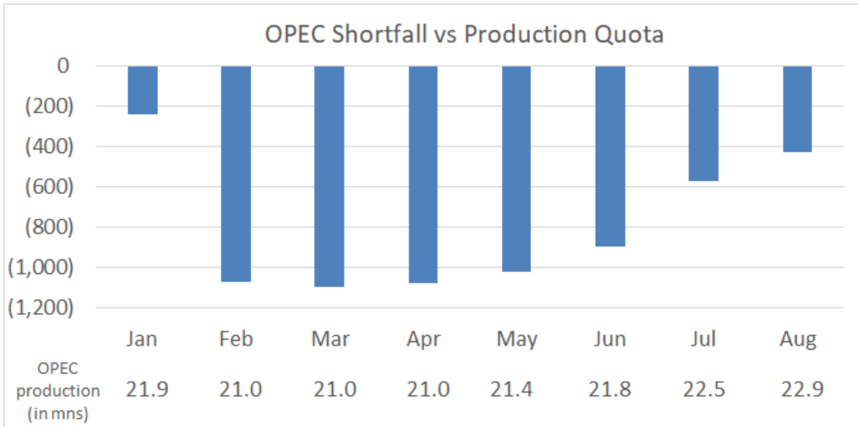




Source: Bloomberg

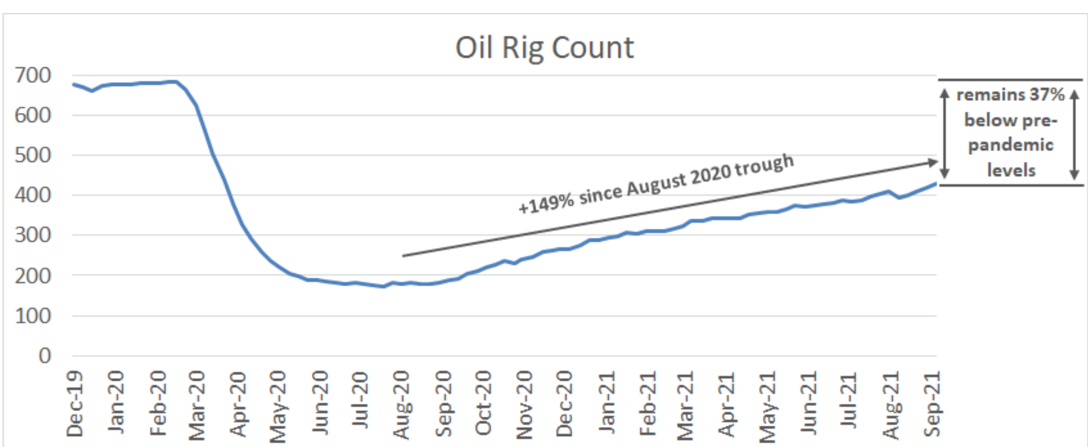
How To Solve High And Rising Energy Prices

The answer to the above is simple: raise production. What's interesting though is that while the answer is simple, the execution is apparently not. The world's primary supplier of oil (OPEC+) is struggling to meet its own production quotas, which raises questions about its ability to deliver steady increases to world supply that its agreement calls for through year-end 2022. Ever since the organization started raising member production quotas in December 2020 there has been a monthly shortfall. Interestingly, while the shortfall is led primarily by Angola, Kuwait, and Nigeria, concerns have been raised about Saudi Arabia and Russia's ability to increase production as well. Granted OPEC+ production is steadily increasing, but surging oil prices reflect the market view that they're unable to meet short-term demand.



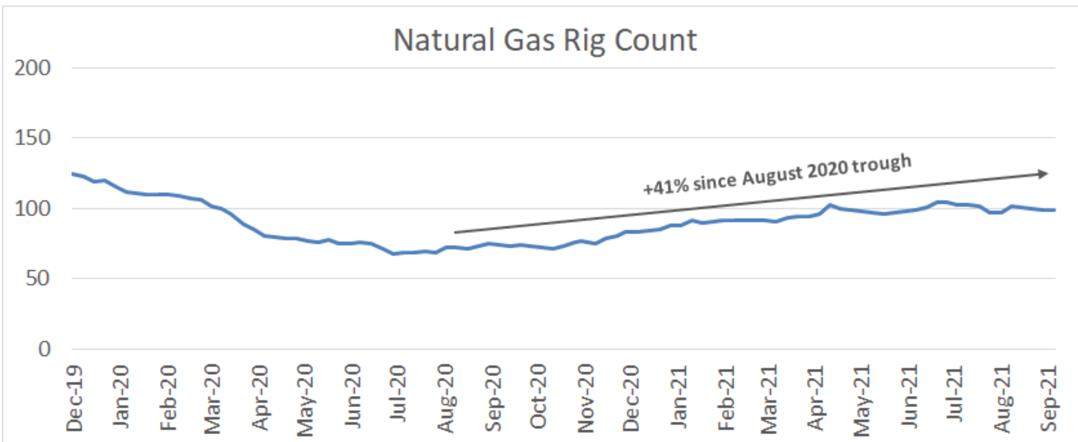
Source: OPEC, Rystad, Bloomberg

Since the shale revolution, the swing barrel has increasingly come from U.S. production because of its unique ability to cycle up over a short period of time. Producers reacted to price spikes by pouring capital into the wellhead. This time around it has been demonstrably different. U.S. producers, particularly those that are publicly traded, have been disciplined with capital. Investors are telling management teams to not invest, but rather harvest and distribute cash flow. While private producers have countered this trend to some degree, they're limited by the acreage they control. It's shocking to see how slowly the oil rig count has increased as oil prices continue to break through multi-year highs. There is little doubt that part of this is related to negative public sentiment that plagues fossil fuel production today. Financial institutions and investors are hyper aware of this negative sentiment and the political headwinds that come with it, and some believe U.S. producers would face higher costs of capital as a result that makes them even less likely to invest. That means we're left to rely on the slow-to-move national oil companies like those that make up OPEC to respond to rising prices. Unfortunately, OPEC's motivation is less about meeting global demand than it is controlling oil prices, which is to say they will act like the cartel they are and constrain production in order to maximize price. We therefore conclude that oil price risk is currently skewed to the upside.



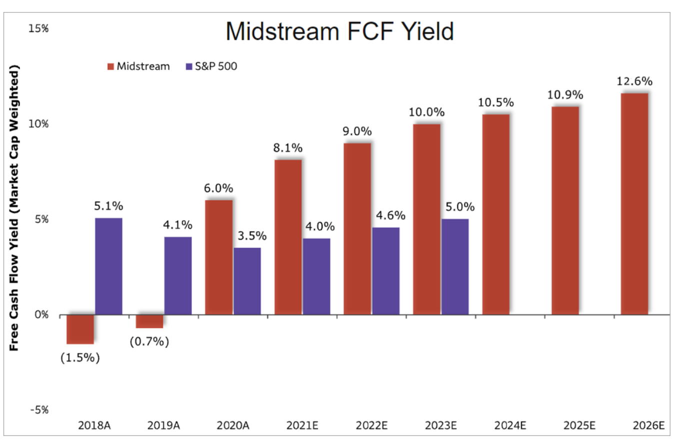
Source: Baker Hughes

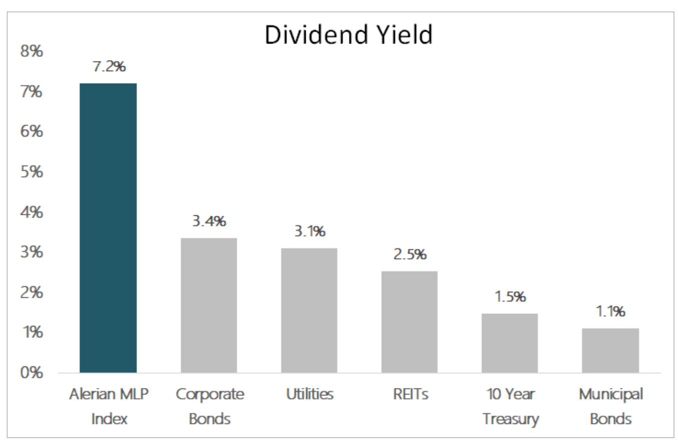
That brings us to natural gas supply, which within the U.S. depends a lot on oil production. Most of a well's economics are driven by oil prices and a meaningful chunk of natural gas supply comes as a byproduct of this oil production (a.k.a., associated gas). Since U.S. producers are not investing in new oil wells, associated gas production continues to underperform expectations. In fact, the (dedicated) natural gas rig count has not budged from pre-pandemic levels. While it can be viewed as good news the natural gas rig count showed resiliency during the pandemic, it's decidedly negative for prices that it has not responded at all to the recent surge. Once again, if U.S. producers aren't drilling enough wells, supply will not keep up with demand, and we conclude that natural gas price risk is also skewed to the upside.



Source: Baker Hughes

Where does this leave Midstream? Actually, in a good place. If we agree that oil and natural gas price risk is to the upside, then the reality is it's only a matter of time before U.S. producers respond. That means volumetric risks to forecasts are also to the upside. Furthermore, if inflation is not transitory, value stocks with minimal capital growth requirements and high yields should attract investors. That should sound familiar, as we've written extensively about declines in Midstream capital expenditures and regularly promote the sector's attractive free cash flow and dividend yields.





Source: Wells Fargo, Bloomberg

Midstream Can Play At This Game Too

Beyond the hoopla of rising oil and natural gas prices is a Midstream segment that is quietly playing the energy transition game. It may not generate the same buzz as offshore wind or the newest Tesla, but what were fuzzy long-term growth opportunity sets are starting to come more into focus. We don't expect Midstream will build wind farms or solar fields, but they could procure renewable energy to power their pumps and compressors. More exciting though is emerging opportunities in hydrogen, renewable natural gas, and carbon sequestration. Assuming the right incentives fall into place, Midstream is well positioned to capitalize on these opportunities and more.

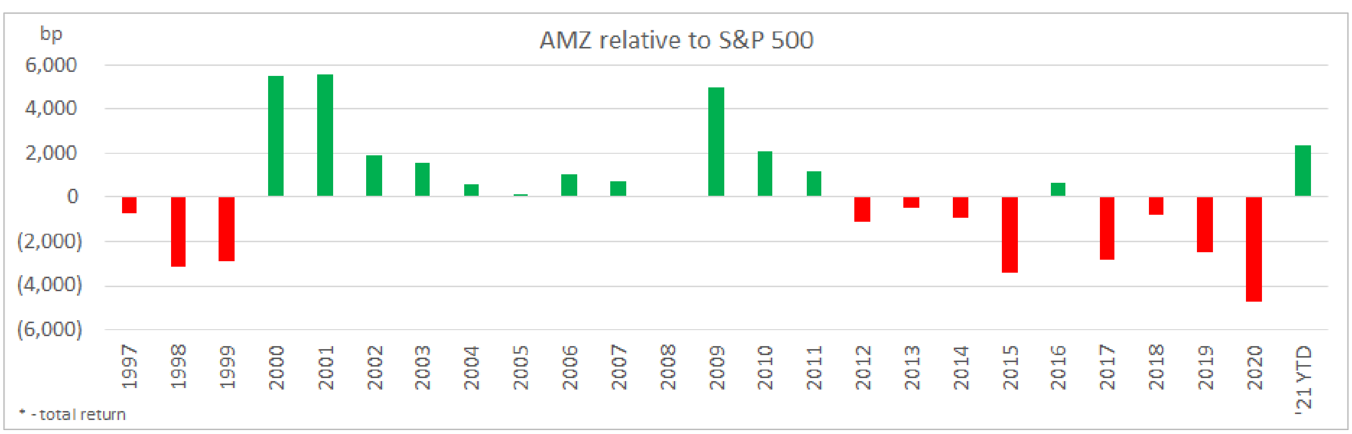
We highlight the following developments over the third quarter:

- Williams (WMB) and European renewables developer Ørsted will explore ways to leverage Ørsted's renewables and hydrogen expertise with Williams' natural gas infrastructure and processing experience to co-develop hydrogen or synthetic natural gas facilities.
- Enterprise (EPD) and Chevron will together evaluate opportunities for carbon capture, utilization, and storage (CCUS) from their respective business operations in the U.S. Midcontinent and Gulf Coast.
- Kinder Morgan (KMI) will partner with Neste to create a raw material storage and logistics hub that will support the increased production of renewable diesel, sustainable aviation fuel and renewable feedstock for polymers and chemicals.
- Energy Transfer (ET) signed a 15-year Power Purchase Agreement with SB Energy for 120 MW of electricity from its Eiffel Solar project in northeast Texas.

The above are only a few of the initiatives the Midstream sector announced in the third quarter as they seek their place in the energy transition world. We expect a higher frequency of these announcements in the future, helped along by a federal government that is likely to add incentives everywhere as part of their sustainability action plans. While we are excited about the emerging opportunities, they remain just that. We do not expect these initiatives to lead to anything material over the next five years (at least), and therefore expect the details and returns of such projects to be only slowly revealed over time. That said, we believe over the long-term these will develop into meaningful and material growth opportunities, extending the transparency and enhancing terminal values of Midstream cash flows for decades to come.

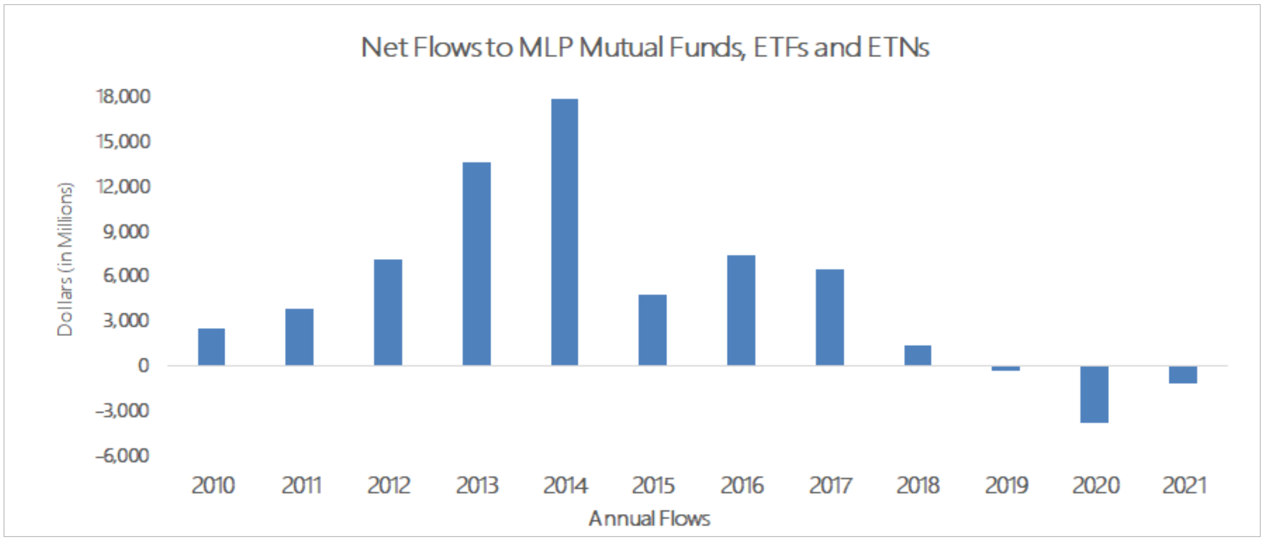
Midstream Delivering Outperformance In An Uncertain Market

The Alerian MLP Index remains on track to outperform the broader market in 2021. Through the end of the third quarter the Alerian is up 39% on a total return basis, outperforming the S&P 500 by 2,350 basis points. If maintained through year-end, this outperformance would represent the first time in five years and the second time in ten years the Alerian has outperformed the broader market.



Source: Bloomberg

What may be even more interesting is this outperformance is outweighing the technical impact of sector outflows. The technical tailwind required to push Midstream past these outflows into outperformance gives us confidence there are buyers out there. At the moment we believe it's a combination of generalist and quant funds that are supporting Midstream, though believe the retail investor is not far behind. It's no secret that retail investors are desperate for yield, and each quarter that passes pushes the unfortunate memory of Midstream dividend/ distribution cuts further out of view. Furthermore, we believe many retail investors take a long-term view of their investments, just like we at Eagle do. So, while we currently highlight the fundamentals of higher EBITDA, lower spending, and much higher free cash flow, we're equally excited about the long-term prospects (and viability) of Midstream as energy transition progresses. It is our view that Midstream's second act will be even better than its first.



Source: U.S. Capital Advisors

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 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

Disclosures

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