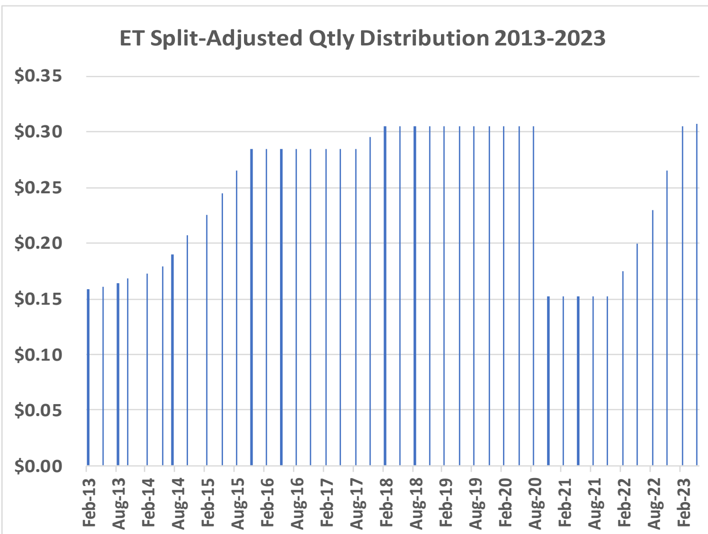
EAGLE GLOBAL ADVISORS

EGA Energy Infrastructure Quick Note - May 2023

From the EGA Energy Infrastructure Team

Energy Transfer (ET) Sets New Distribution Bar, Signaling New Phase For Midstream

On April 26th, Energy Transfer (ET) surprised the market with a quarterly distribution increase to $0.3075/unit, after previously suggesting they would only address distribution policy annually. The bigger story, though, is that the increase brings Energy Transfer's distribution above its previous high-water mark, eclipsing a 50% cut in the third quarter of 2020 to reach a new split-adjusted high.

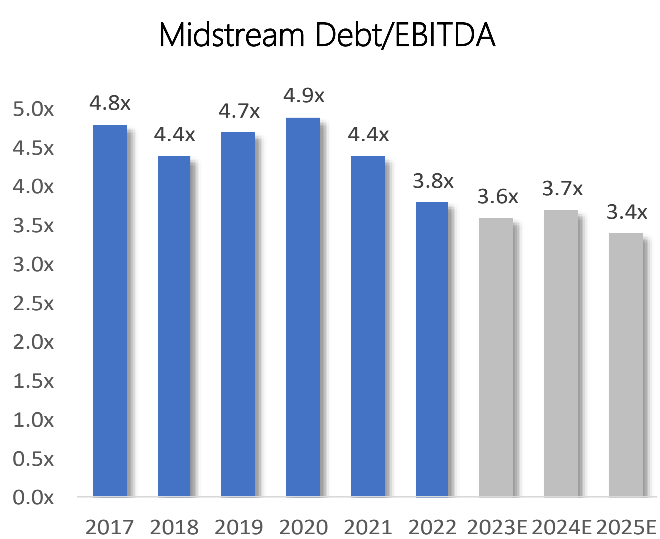


Source: Energy Transfer

After a cut in 2020, ET has raised distributions six times and now pays a record high dividend with a current payout yield of 9.6% based on the most recent payout.

At the same time Energy Transfer was upsizing its distribution, S&P was issuing a credit FAQ highlighting the company's leverage declining to 4.0X/3.75X in '23/'24, which should open the door to an upgrade further into investment grade territory. Between 2008-2022, the majority of Midstream's free cash flow was used for balance sheet repair - through debt reduction. In this regard, ET is part of a bigger movement.

Sector-wide debt/EBITDA has declined over one full turn since 2020. Now that debt has been addressed, it is equity holders' turn to benefit.



Source: Wells Fargo

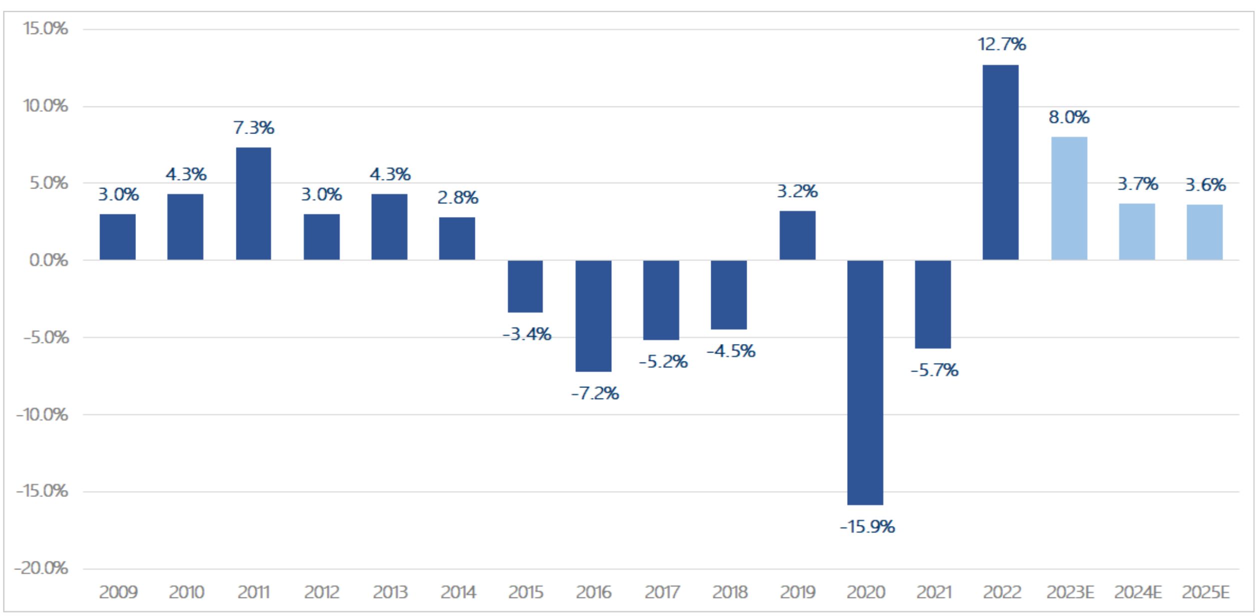
As each company in the sector hits its debt reduction targets, it then becomes the equity investors' turn to benefit from all this free cash flow generation. Over the last few years we were asked "When will dividend cuts end?", which slowly evolved to "When will Midstream start increasing dividends again?". With Energy Transfer's distribution now above the pre-cut level we can say with some confidence that these dividend questions are fully and completely in the rear-view mirror. This difficult task was accomplished by the focus and determination of Midstream management to right size capex and reduce debt (and yes, cut distributions). The result is today's record-setting free cash flow generation.

The Return of Distribution Growth

Midstream investors are first and foremost dividend yield investors. Decades of large and growing yields were interrupted twice in recent years. First in 2014 when OPEC+ sought to disrupt U.S. shale production growth by increasing its production, which drove down prices and made shale production less profitable. The second wave came on the heels of the 2020 Covid-led recession that cratered commodity demand and pushed Midstream companies to tighten their belts to starvation levels.

A visual of this journey is provided courtesy of Wells Fargo. The graph below shows the actual distributions received from a buy-and-hold portfolio of MLPs that was purchased in 2008. Using a static portfolio removes survivor bias (can't remove names after they cut) while also removing the benefits of active management. It shows a clear picture of the two periods of distribution cuts: the 2014-2015 OPEC+ output war (supply-side) and the 2020 Covid recession (demand-side). It also shows that in 2022 this same buy and hold portfolio experienced significant distribution increases. We are well on our way to what Wells Fargo forecasts as another good year of increases in 2023.

MLP Investors Portfolio Annual Income 2008-2026E



Source: Wells Fargo

Benefits of Dividends That Grow in Fighting Inflation

Despite eight consecutive rate hikes by the U.S. Federal Reserve, the core Consumer Price Index is still running a red-hot 5.5%, leaving investors searching for ways to maintain their after-inflation income. This role has long been filled by asset classes like Midstream which offer a combination of dividend yield and yield growth. While that track record was interrupted recently, it has re-emerged during the most recent bout of record-setting U.S. inflation as Midstream has provided healthy investor returns post Covid-dip.

Annual Changes to CPI, Alerian MLP Index, S&P 500

Period	Annual Change in CPI	Annual Change in AMZX	Annual Change in S&P
Average 1996-2022*	2.47%	13.36%	10.18%
Average During Low Inflation***	1.69%	10.04%	18.25%
Average During High Inflation**	3.75%	19.10%	0.09%

**2022 MLP & S&P performance annualized through 6/30/22; *CPI data annualized rate*
***Years when CPI was above the 26-year average*
****Years when CPI was below the 26-year average*

Midstream/MLP returns have increased during periods of high inflation while S&P returns have historically declined.

Is It Safe?

We believe Midstream/MLP yields have stayed stubbornly high in recent years because of trust issues. After two waves of cuts in five years, investors simply did not trust the yield. They expected more cuts. But armed with record free cash flow, reduced debt, and distribution coverage ratios of >2.0x, Midstream companies are fully into a new phase of repaying investor confidence with large and growing payouts once again.

Disclosures

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