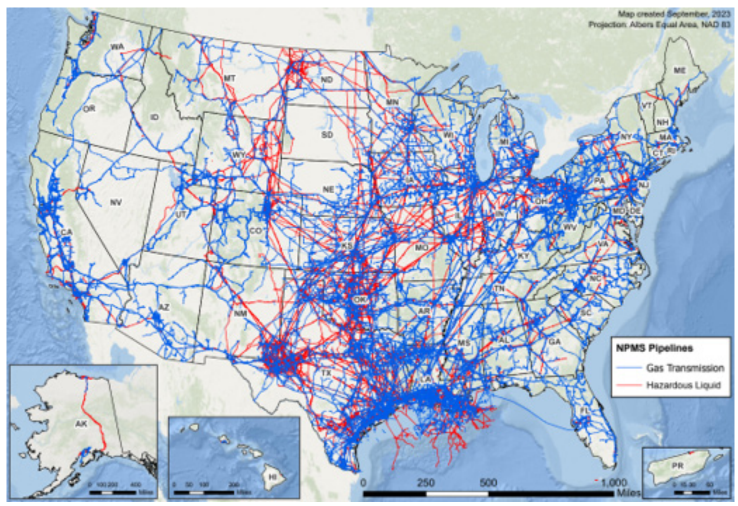
EAGLE GLOBAL ADVISORS

Eagle Energy Infrastructure

Midstream: What Sector Consolidators See That Others Don't

Three months ago we wrote in our year-end Quarterly Commentary that "one of two things will happen in 2024: (1) Wall Street will recognize the scarcity value of energy infrastructure and stocks will re-rate higher, or (2) stocks won't re-rate higher and sector consolidation will continue."

The sector hasn't yet re-rated higher, and so sector consolidation continues. We can't say for certain why investors haven't gravitated towards Midstream to drive what we believe is a long overdue re-rate, though we can analyze why consolidators are doing what they're doing. They see companies that transport a product (fossil fuels) that will remain critical to the world for decades to come, increasingly higher barriers to entry for those that transport this product, at a valuation that doesn't come close to appreciating this dynamic.



Source: U.S. Department of Transportation

DEMAND FOR FOSSIL FUELS UNLIKELY TO SLOW ANYTIME SOON

We've heard that a swift shift to renewable energy (a.k.a., energy transition) heralds the demise of fossil fuels in the near future. This is often supported by anecdotes about the expansion of renewable energy in Europe – German renewable energy accounts for >50% of power generation – or market share gains of electric vehicles (EVs) in China and Norway, the latter of which has achieved greater than 80% auto market penetration. In a way we believe the above is selectively presented and doesn't show the whole picture. As an example, while the above is true what's not said is the currently in political power German Green Party is pushing to postpone climate neutrality goals by five years and to outright scrap parts of their fossil fuels phase-out policies. China continues to see coal consumption increase and is years away from peak emissions, while a critical component of Norway's government revenue is oil production that they project will increase over the next several years.

The point is that even in areas where progress is most apparent there is data supporting not only the continued importance of fossil fuels, but the need to increase the production of it to support technological advances like artificial intelligence in the First World and step change increases in the quality of life for the rest of the world. Therefore, it's no surprise the Energy Information Administration's (EIA) reference case forecasts global energy consumption to increase annually through 2050 for liquids (+0.7%), natural gas (+0.9%), and even coal (+0.1%).

ABOUT US

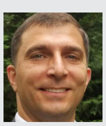
- Located in Houston, TX
- Founded in 1996
- $2.2B in AUM, $613MM in Energy Infrastructure*
- 22 employees including 10 investment professionals
- 100% employee owned

INVESTMENT HIGHLIGHTS

- *Essential Infrastructure:* Energy Infrastructure companies build and operate pipelines and storage facilities for the transmission of vital domestic energy supplies
- *Distributions:* Majority of cash flows are distributed to unit holders
- *Tax Efficiency:* Distributions are largely a return of capital
- *Inflation Protection:* Energy Distributions have grown over time, providing an effective inflation hedge

PORTFOLIO MANAGEMENT

Alex Meier
Portfolio Manager
23 Years of Experience



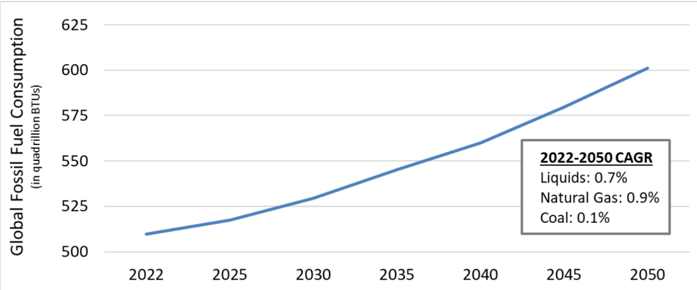
Michael Cerasoli, CFA
Portfolio Manager
24 Years of Experience

CONTACT US

Steven Russo
713.952.3550
srusso@eagleglobal.com

**AUM data is inclusive of both discretionary and non-discretionary client assets.*

Eagle Energy Infrastructure



Source: Energy Information Administration (EIA)

Another critically underappreciated aspect of the energy market and energy transition is the enormous need for more infrastructure. More liquids infrastructure to move product internationally, more natural gas infrastructure to move product both domestically and internationally, and more electrical infrastructure to support the energy transition that we agree is happening. One of the more confusing questions of our time is why the world and the United States is so complacent when it comes to energy infrastructure and traditional energy production? We live in a world where energy supply chain disruptions occur on a regular basis (see war in Ukraine and travel restrictions in the Red Sea) and ample evidence that traditional energy producers are not investing enough in the field to meet the demand growth that is coming.

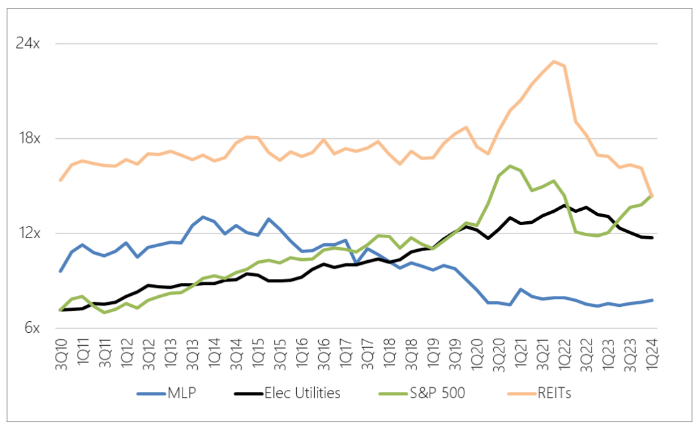
INCREASINGLY HIGHER BARRIERS TO ENTRY

The unfortunate reality is society tends not to notice issues until a crisis occurs. In the meantime, domestic energy policy grows more in complexity and the path to bring hydrocarbons to market more difficult. This is especially true for the Midstream sector where crossing state lines and jurisdictions almost always results in delays and cost overruns. Take the Mountain Valley Pipeline (MVP) and the TransMountain Pipeline expansion. MVP was expected to be completed in 2018 for $3.7 billion, though in 2024 it remains under construction at a cost that has risen to $7.6 billion. Meanwhile north of the border in Canada the construction cost for the TransMountain Pipeline expansion was originally expected to be C$5.3 billion though its most recent cost estimate is over C$34 billion (wow!). On the demand side cities like Berkeley (CA) and Brookline (MA) have banned natural gas, while a de facto ban is in place in southern New York due to inadequate natural gas infrastructure. At the federal level the current administration announced a temporary pause on all permit approvals for new LNG export projects pending further analysis of economic and environmental impacts by the Department of Energy.

It's true that higher barriers to entry dulls growth for the Midstream sector, though assuming fossil fuel demand will grow as the EIA suggests above does two things: (1) raises the probability for an energy crisis in areas where infrastructure is scarce, and (2) greatly increases the value of operational infrastructure due to its scarcity. We call the latter a "scarcity premium", driven by red tape and ignorance of what powers our society.

VALUATION NOT CLOSE TO RECOGNIZING MIDSTREAM'S TRUE VALUE

With demand/consumption rising and high barriers to entry you'd think Midstream valuations would have re-rated after three consecutive years of outperforming the S&P 500. Well, you're wrong. Equity appreciation has matched EBITDA growth, resulting in a multiple that has traded relatively flat over the last several years. So Midstream has not yet re-rated, trades at a substantial discount to the market and comparable sectors like Utilities and REITS, and a 20% discount to its 10-year average. The latter of which ranks among the widest discounts among the traditional energy sectors, and almost a full sign (+/-) change versus the broader market (Midstream: 20% *discount*, S&P 500: 13% *premium*).

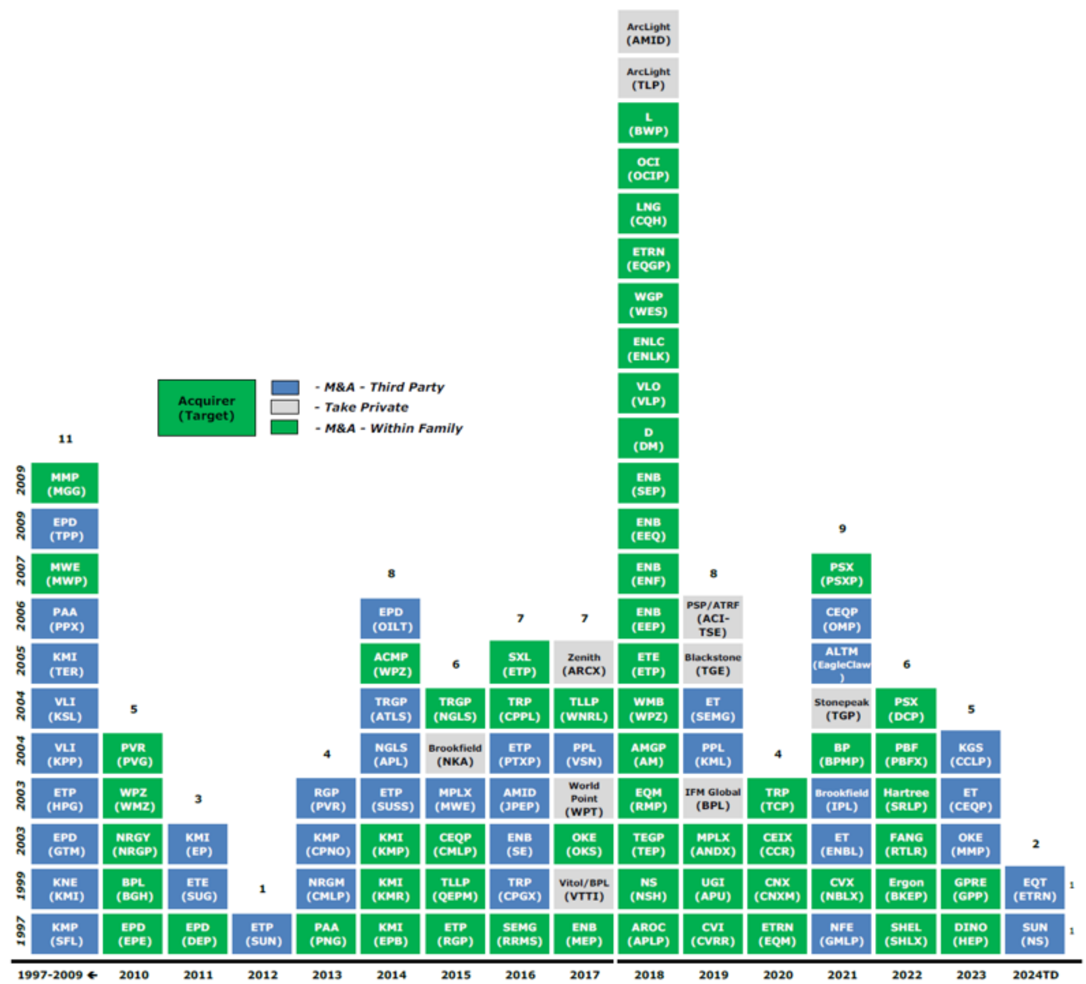


Source: Bloomberg

	EV-to-EBITDA Multiples	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
Midstream	**MLPs**	**8.3x**	**8.0x**	**4%**	**10.4x**	**(20%)**
	Midstream C-Corps.	**9.5x**	**9.7x**	**(2%)**	**11.7x**	**(20%)**
Energy	Exploration & Production	5.3x	5.4x	(2%)	6.8x	(21%)
	Refiners	6.6x	6.3x	5%	5.9x	12%
	Integrated Oil & Gas	5.0x	5.4x	(7%)	5.4x	(7%)
	Oilfield Services	7.6x	8.7x	(13%)	9.0x	(16%)
Yield	Utilities	9.6x	10.5x	(9%)	10.0x	(4%)
	REITs	14.4x	17.9x	(20%)	17.1x	(16%)
Market	S&P 500	13.2x	12.9x	3%	11.7x	13%

Source: Wells Fargo

Our confidence in the ability of the Midstream rally to continue goes beyond increases in global fossil fuel consumption. It also has to do with the sector's healthy balance sheets, strong dividend coverage ratios, manageable capital expenditure programs, and related EBITDA growth that has resulted in sizeable free cash flow after dividends. This in turn has led to a plethora of return of capital initiatives including incremental debt reduction, dividend increases, share buybacks, and the latest trend of sector consolidation. In the eyes of management there is tremendous value in energy infrastructure assets in the current environment, and it's only a matter of time before the market sees what we and all of our clients see. So management teams are going long the "scarcity premium" and filling gaps in their asset portfolios. The sector consolidation headline of the first quarter was Sunoco LP's (SUN) proposed acquisition of NuStar Energy (NS). It's also worth noting a recent Wells Fargo report indicating there are roughly $40 billion of Midstream assets for sale.



Though perhaps some companies are trying unorthodox ways to enhance the value of their stocks and, perhaps, take the target off their backs. With this in mind we wanted to highlight a corporate action taken by Western Midstream (WES). The events unfolded like this: (1) WES' largest holder Occidental Petroleum (OXY) announces in December 2023 a $12 billion acquisition of CrownRock and a desire to partially fund the deal with asset divestitures, (2) media coverage in February 2024 that WES is working towards a sales process, (3) a WES press release later the same day indicating they have not launched a sales process, and (4) the next day WES announcing they will increase their base distribution by 52% starting in the first quarter and asset sales totaling $790 million. WES' stock meaningfully jumped on the news, which while still far from a re-rate did help improve its valuation relative to the sector.

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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