Rocaton

INSIGHTS

Energy Market Opportunities

March 2016

203.621.1700 | **rocaton.com**

EXECUTIVE SUMMARY

* Falling energy prices have created significant dislocation in the North American energy industry. Previous capital investments which helped increased domestic production will likely realize low returns or are impaired. As a result, new capital will be required over the short- and long-term to maintain production at current levels. Given the uncertain energy price outlook, we would suggest investors avoid investments that require energy price recoveries in the short- and medium-term. However, even with flat energy prices going forward, we believe there are compelling investment opportunities available.
* We would avoid investment strategies that require energy prices to recover in the short-term, such as commodity futures investments. We are cautious on high yield energy bonds and energy-related public equities.
* Investors who can utilize illiquid partnerships should consider various long-term approaches to private equity and debt in the energy industry. We believe there are and will continue to be opportunities to provide capital to surviving businesses that are engaged in the exploration and production of oil and natural gas, companies that service these industries and companies engaged in the transportation and movement of these commodities and refined products.
* Parts of the domestic energy industry have stable and contractual cash flows that may be protected from commodity price volatility. Midstream master limited partnerships ("MLPs") may exhibit these characteristics. However, MLP equity prices are driven by retail investor sentiment and may be too volatile for many investors' appetites. We believe that the debt instruments issued by MLPs currently offer attractive risk-adjusted returns for both investment grade and below investment grade bonds.
* Importantly, we do not need energy prices to recover for these investments to perform well over the medium- and long-term. We do not know how to predict energy prices and we would suggest that the finance industry has a poor record of predicting future energy prices. However, whether energy prices rise, stay flat or decline further, we would expect the investing opportunity set to evolve through time.

Introduction

The decline in energy markets over the past 18 months has been dramatic with crude oil prices falling 70% and natural gas prices falling 60%. When a market experiences a severe correction, we believe it is appropriate to look for attractive investing opportunities in that market. We think investors should be selective in regard to how they gain exposure to the energy complex as some strategies require a recovery in energy prices which, in our view, is highly uncertain. We would prefer to invest assuming that there is no recovery in energy prices over the investment horizon and to find strategies with downside protection. For example, we still recommend that investors avoid traditional commodities futures investments as this exposure requires an increase in spot prices to generate attractive returns. Some of the areas which we believe present attractive opportunities today include private energy investments and midstream energy debt. To be clear, these opportunities do not rely on a significant rise in energy spot prices to generate attractive returns. In fact, we believe there is the potential for further declines in energy prices as little progress has been made to correct the supply/demand imbalance that exists in many energy markets. The balance of this paper details our views on each of the energy investment opportunities outlined in Figure 1.

Figure 1: Spectrum of Energy-Related Investments

Investment Opportunity	Liquidity	Investment Management Fees	Rocaton View
Long-Biased Energy Futures	Liquid	Low to moderate	Bearish
Energy Public Debt	Relatively Liquid	Low	Neutral
Energy Public Equities	Liquid	Low	Neutral
Master Limited Partnership Equity	Liquid	Low	Neutral
Master Limited Partnership Debt	Relatively Liquid	Low to moderate	Bullish[1]
Private Energy Partnerships	Illiquid	Moderate to high	Bullish

Rocaton views are made in isolation and do not consider any specific portfolio. Any allocation decisions should be made in the context of the overall portfolio objectives and other asset class considerations.

Energy Futures[2]

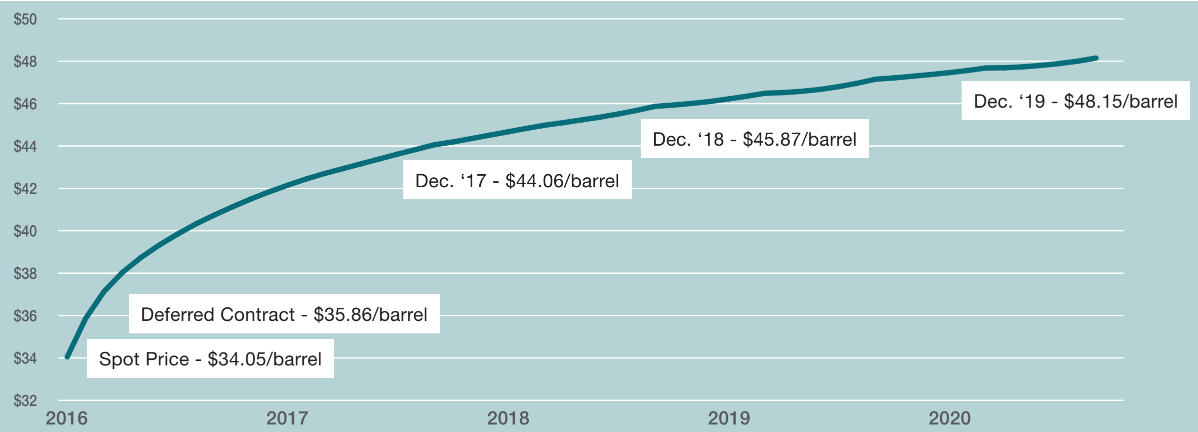
Despite recent price declines, we are still cautious about making new investments in commodity futures. Although spot prices certainly have the potential to rise from here, negative roll yields could potentially erode most of that return. Currently, in many commodities futures markets, the forward curve is in a state of contango in which the price of a given commodity future increases with time. Assuming no change in spot prices, as contracts "roll-down the

1 We are primarily bullish on the midstream sector of the MLP market. See additional detail in the section below labeled "Master Limited Partnerships"

2 Please see *Rocaton Insights – End of the Super Cycle? August 2013* which provides the original thesis for our view on commodity futures.

curve", negative returns will be generated[3]. For example, the spot price for West Texas Intermediate crude oil as of March 1st was $34.05/barrel while the deferred contract was trading at $35.86/barrel (see Figure 2). If the futures curve is unchanged, rolling down the curve will generate a negative 5% return. A similar situation occurred in 2009 after energy prices had fallen significantly during the global financial crisis. Despite crude oil spot prices rising 81% in 2009, the S&P GSCI Energy Index was up only 11% due to significant detraction from contango. We are concerned that, should oil prices rebound, the returns realized by investors in energy futures will be underwhelming. Admittedly, it is difficult to forecast the impact roll yield will have on performance, but this component has historically detracted value.

Figure 2:
WTI Crude Oil
Futures Curve



Source: Bloomberg.
Futures curve as of 3/1/2016.

As we highlighted in the introduction, from a fundamental standpoint, we expect continued price volatility and do not attach a high probability to a meaningful rise in spot prices. First, many Organization of the Petroleum Exporting Countries ("OPEC") continue to produce record amounts of oil. Additionally, inventories have reached very high levels, which will take time to draw down at the current rate of demand. Finally, North American producers (the marginal producers) have been able to reallocate capital to their most productive assets and have proven that they can continue to produce more hydrocarbons with less capital, despite a sharp drop in active rigs. Our fundamental outlook combined with the potential for negative returns from rolling contracts has led to our bearish outlook for commodity futures. In our opinion, the primary argument for retaining or creating an exposure to commodity futures at this point remains the ability of that exposure to act as a geopolitical or inflation hedge.

Energy Public Equity and Debt

After oil's 70% decline, price expectations are lower today and energy-related public securities are likely discounting a significantly lower oil price than prior to mid-2014 levels. While the lower oil price suggests a good entry point in the space, we remain cautious about public energy equities because the market appears to be facing a number of headwinds that could

3 Of the 21 most active commodity futures markets, 86% (18 contracts) are in contango. All 5 of the energy futures markets in the Bloomberg Commodity Index were in contango as of March 1, 2016. In this example, we define the shape of the curve as the difference between the active contract and the deferred contract.

potentially delay rebalancing beyond current expectations[4]. That said, we do acknowledge there is likely to be opportunity for active managers to add value due to performance dispersion between companies that have low cost, attractive assets or stable cash flows and those that have production or balance sheet risk. In our view, security selection is going to be an important component of any active manager's ability to generate alpha in the energy sector, even in an uncertain commodity price environment.

On the debt side, as of March 1st, the energy high yield bond sector was yielding 16.4%. While this may seem like an attractive investment opportunity, we believe high defaults and low recoveries will meaningfully impact the return realized by investors. According to one estimate, since the start of 2015, nearly 60 producers have filed for bankruptcy, with another 150 on rating agency watch lists currently. Even if energy companies are able to avoid default, there are likely to be distressed exchanges and downgrades to any outstanding debt. This could potentially increase the cost of capital for energy companies and could send bond prices lower.

Master Limited Partnerships

Master Limited Partnerships (as well as other midstream companies structured as C-Corps), own, maintain and operate the majority of energy infrastructure in North America. Midstream companies are involved in the transportation, storage and processing of crude oil and natural gas. The recent dislocation in energy has created a unique opportunity to invest in both investment grade and high yield debt securities, primarily in the midstream space. Midstream MLPs and C-Corps own real assets such as pipelines, gathering and processing facilities, and storage facilities. Such assets tend to produce relatively strong, predictable cash flows, and have more stable earnings and higher barriers to entry than upstream-related energy equities. Importantly, there is less commodity price risk in the midstream sector as most of these companies tend to rely on commodity volume-based fees to generate revenue. While energy spot prices have fallen, demand for commodities has improved in recent months, particularly for gasoline as drivers take advantage of low gas prices. In the event that demand softens, midstream MLPs have a partial safeguard against falling demand. Some midstream MLP contracts with oil and gas producers are structured as "take-or-pay" contracts with minimum volume commitments, meaning that the MLPs collect a baseline level of income even if producers slow or stop production[5]. As a result of the resilience in cash flows, high debt service coverage ratios and high asset coverage ratios relative to stressed liquidation values, we believe default risk among midstream companies is relatively low, especially for investment grade borrowers. These companies are currently offering yields between 6-9% which we view as adequate compensation given the investment opportunity we have described. While there have been several

4 Global oil supply has proven to be much more resilient than anticipated and in fact, global supply is arguably still growing thanks to elevated output from OPEC producers and the likely onset of Iranian production during 2016. Additionally, there are an increasing number of data points that suggest that global demand for oil may be slowing, including a potential deterioration in demand from China

5 Take-or-pay contracts do not guarantee against falling revenues. In the event that an E&P company stops production and has no resources to pay, the midstream energy company will not receive its revenues.

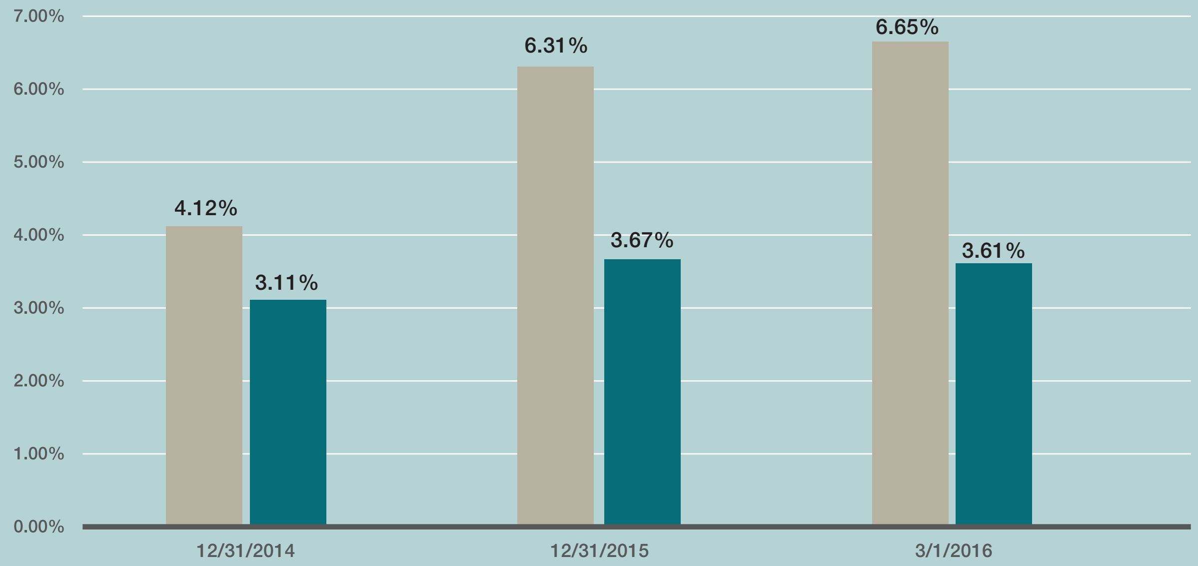
downgrades to midstream debt offerings by ratings agencies, and we are likely to see more downgrades if the environment remains unchanged, we believe that much of the negative sentiment has already been priced into these securities and skilled investment managers in the midstream space should be able to generate attractive risk-adjusted returns.

Figure 3:
Corporate Bond Yields – Broad Market and Midstream Energy Sector

Legend:

Investment Grade Midstream Energy Corporate Bonds

Broad Investment Grade Corporate Bonds



Source: Barclays Capital. Data as of March 1, 2016.

While we are excited about the debt of midstream MLP companies, we are more neutral on the midstream MLP equity market opportunity, despite attractive valuations which imply strong potential upside[6]. For starters, the potential volatility for MLP equity is much higher than MLP debt and it is unclear whether midstream companies will ever trade at levels similar to those experienced at prior peaks. We also believe that investors can earn equity-like returns with less risk by investing in midstream MLP debt. Further, interest payments are contractual obligations of debt issuers while equity distributions, which make up a portion of MLP equity expected total returns, are discretionary. There have been several instances of MLP companies slashing their equity distributions in an effort to protect free cash flow. Additional cuts to equity distributions could still occur as midstream companies look to protect their credit ratings or decide to allocate more capital to development projects rather than continue to issue large distributions. It is somewhat unclear what impact further distribution cuts would have on equity prices, but in most cases, distribution cuts should be a benefit for MLP debt investors as companies would have further cash to service their debt. We believe investors should first consider midstream MLP debt which can be used as a replacement for traditional high yield or other credit fixed income. Total-return oriented investors with a knowledge of the MLP industry and who can withstand significant volatility may then want to consider investments in MLP equity. We would recommend that investors who are inclined to add to positions in the MLP equity space do so cautiously and invest over time.

6 MLP equities are trading at roughly 8x distributable cash flow (relative to 20x at the peak and 7.3x at the prior trough in 2009) and roughly 10.5x EV/EBITDA (relative to 18.4x at the peak and 10.0x at the prior trough).

Private Energy Partnerships

Beyond midstream MLP debt, we are very interested in the return prospects for private partnership strategies investing in energy-related equity and debt. There are a number of compelling reasons for investing in such private strategies including the fact that private lenders or equity investors can typically negotiate more stringent terms. Secondly, there is a broad opportunity set for investors to access as many shale producers may not be of scale to access public markets and there is a wide array of deal types unique to private strategies. For example, private energy strategies may include direct lending, corporate carve outs and stressed/distressed credit. Many private strategies typically have wide flexibility to invest in the most attractive segments of the energy market and have some propensity to hedge their positions over the near term. Public debt or equity strategies are often confined to a smaller universe of investments. We also believe that strategies focusing on private assets will have access to more detailed company specific information whereas investors in the public markets often work with a much smaller data set pertaining to company assets and financials. In a capital constrained environment for all public energy companies, we believe large pools of dedicated equity capital should be able to earn competitive returns by providing capital solutions to upstream and midstream energy companies that either need to sell assets or receive a capital infusion.

Return and risk objectives for private energy strategies vary, but many seek to deliver 10-15%+ returns, net of fees, which often include management fees of 1.5-2% and incentive fees of 20% over a preferred rate of return. The lock up period for these strategies typically ranges from 5-10 years, although some may have longer terms. Investors should also be aware that some private strategies may focus on sectors outside of energy including metals, mining and agriculture. We believe that performance for private strategies will be less impacted by the daily fluctuation in energy prices, although a “low for longer” scenario for oil or other energy markets may negatively impact performance.

Considerations

There are a number of considerations which investors should be aware of before making any dedicated energy investments. We have already outlined our fundamental view on oil prices and noted that the potential for a low for longer scenario exists. It is important to recognize that falling prices have been driven by over-supply as opposed to a demand slowdown. A recessionary environment has the potential to significantly impair demand which could negatively impact all of the ideas we have outlined, including midstream debt and private equity strategies. Even without a recession, increased efficiency, such as more fuel-efficient cars, have the potential to slow hydrocarbon demand over the long-term. Substitutions and switching to clean fuels is another negative impact which may harm long-term performance in the energy sector. Finally, nearly all of the strategies we have presented rely on active management to varying degrees. As with any actively managed strategy, misjudgments or poor underwriting by the investment manager could undermine performance.

Conclusion

Significant market declines, while painful, often present attractive opportunities for investors. The recent decline in the energy market is no exception. We would prefer to be selective when accessing the energy market. Midstream debt offers compelling yields and, in our view, resides in a defensive part of the capital structure. Further, this opportunity is relatively liquid and available to many investors. We remain neutral on MLP equity investments at this time. For investors who are able to take advantage of illiquid opportunities, private energy investments appear to offer attractive returns. We continue to suggest that investors avoid commodity futures investments and are cautious on energy-focused public equity or debt strategies at this time.

Rocaton

Energy Market Opportunities

Disclosures

Rocaton is registered as an investment adviser with the U.S. Securities and Exchange Commission. Rocaton's Form ADV, Part 2 is available upon request. The information included in this publication has been taken from sources considered reliable. No representations or warranties are made as to the accuracy or completeness of this information and no responsibility or liability (including liability for consequential or incidental damages) is assumed for any error, omission or inaccuracy in this information. This information is subject to change over time. This publication is not intended as investment or actuarial advice. Before acting on any information contained in this material you should consider whether it is suitable for your particular circumstance and consult with your actuary. Any opinions expressed in this publication reflect our judgment at this date and are subject to change. No part of this publication may be reproduced or redistributed in any manner without the prior written permission of Rocaton Investment Advisors, LLC.

Performance Information and Return Expectations

The analysis contained in this document may include projections of long-term return and risk expectations. There is no guarantee that the projected returns or risk will be realized. The projections are based in part on historical performance of various asset classes, and past performance is no guarantee of future performance. The projections include assumptions, including those regarding risk and return. These assumptions are used for modeling purposes only and may not be realized. Because the analysis is based on assumptions and projections, there can be no warranties or guarantees.

203.621.1700 | **rocaton.com**