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INSIGHTS

The Case for Midstream Energy Equities

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EXECUTIVE SUMMARY

- Midstream energy equities, including Master Limited Partnership ("MLPs"), have produced dismal total returns over the past three years despite high distribution yields and relatively healthy fundamentals.
- Absolute valuation levels for midstream energy equities and the underperformance of this sector relative to broad public equity markets has created a compelling investment opportunity from our perspective.
- While MLPs are primarily focused on the energy sector, we believe the best opportunity lies within the midstream energy space as this sub-sector has exhibited relatively stable and contractual cash flows that may be protected from commodity price volatility. Further, the midstream energy sector goes beyond MLPs and includes companies structured as C-Corporations ("C-Corps").
- In 2015-2016, we felt that the debt instruments issued by midstream energy companies offered attractive risk-adjusted returns. Despite recent volatility in the sector, we do not currently find the debt of midstream companies to be particularly attractive as credit spread levels remain tight.
- At times, MLP prices can be driven by changes in retail investor sentiment which may result in an investment that is too volatile for some investors' appetites. We believe investors should size any allocation to midstream equities appropriately and should view this type of investment alongside their more traditional public equity exposures.
- Investors should pay careful attention to implementation choices in the MLP space as there are potential tax considerations[1]. For non-taxable investors, we believe that insurance company-sponsored vehicles have the potential to be an effective way of gaining exposure to the asset class while also blocking unrelated business taxable income ("UBTI"). For taxable investors, we support qualified investors owning MLPs through open-ended private limited partnership ("LP") funds.

Introduction

MLPs (as well as other midstream companies structured as C-Corps), own, maintain and operate most of the energy infrastructure in North America. As oil prices declined sharply between late 2014 and early 2016, MLP and midstream equity prices also fell meaningfully. Despite a recent recovery in oil prices, the midstream energy sector has continued to fall. Importantly, from our perspective, midstream energy companies should be less sensitive to changes in commodity prices as revenues are generally tied directly to commodity volumes as opposed to commodity prices. Immediately after oil prices fell in 2015, we suggested that investors make an allocation to midstream energy debt as yields for both investment grade and below investment grade bonds had risen significantly. During 2016, the midstream energy high yield index returned 27.3% while the midstream energy BBB long duration index returned 34.1%, both of which outpaced returns for traditional high yield (+17.1% in 2016). Currently, we feel that midstream equity is a far more attractive opportunity as credit spreads on midstream debt have largely returned to long-term normal levels. The balance of this paper will provide an overview of the midstream energy space, present the case for making a near-term allocation, discuss potential risks and, finally, cover the potential implementation options for different investor types.

[1] Rocaton does not provide to any client legal or tax advice.

Definition of Midstream Energy Sector and the MLP Structure

Investors have historically used the term "MLPs" to describe opportunities in the energy sector. From our perspective MLPs are a legal structure that represent a subset of the midstream energy opportunity set. More recently, there have been a number of companies moving from the MLP legal structure to more traditional C-Corps. Part of the rationale for companies to shift to C-Corps (and away from MLPs) is to eliminate incentive distribution rights ("IDR") which entitle the General Partner to a higher proportion of an MLP's quarterly distribution. From our perspective, removing the IDR mechanism and the need to pay an ever-greater share of distributions to general partners better aligns the interests of all shareholders and gives companies more flexibility in how they allocate capital.

There are several other reasons why we find the C-Corp structure attractive. Namely, the legal structure is simpler and may encourage more institutional capital to invest in the asset class given that investors do not need to deal with various tax consequences, some of which we outline later in this paper. Further, C-Corps are available for inclusion in traditional indexes (such as the S&P 500 or Russell 3000) whereas MLPs have historically been excluded from these popular indexes. Inclusion in broader equity indexes may lead to a more stable profile for midstream companies over time. We are not suggesting that the MLP structure will go away entirely or that investors should ignore this segment of the market. However we suggest that investors consider the broadest opportunity set when investing in midstream energy, including MLPs and C-Corps.

Overview of Midstream Equity Opportunity

As mentioned above, midstream energy companies are involved in the transportation, storage and processing of crude oil and natural gas. Midstream MLPs and C-Corps also 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 MLPs or C-Corps. There is also 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 remain well below highs experienced a few years ago, demand and production for crude oil, natural gas and related products continues to increase (see Figure 1). In the event that demand softens, midstream energy companies have a partial safeguard against falling demand. Some midstream contracts with oil and gas producers are structured as "take-or-pay" contracts with minimum volume commitments, meaning that the midstream companies collect a baseline level of income even if producers slow or stop production[2]. A resilience in cash flows, high debt service coverage ratios and high asset coverage ratios relative to stressed liquidation values are just a few of the key fundamental features which we believe are attractive for midstream companies. Below are additional fundamental observations which we find compelling.

- Innovation, capital formation and positive geology should keep the U.S. as one of the most important world locations for sourcing hydrocarbons for a long time to come. Various market pundits expect the U.S. to become the world's largest oil producer in

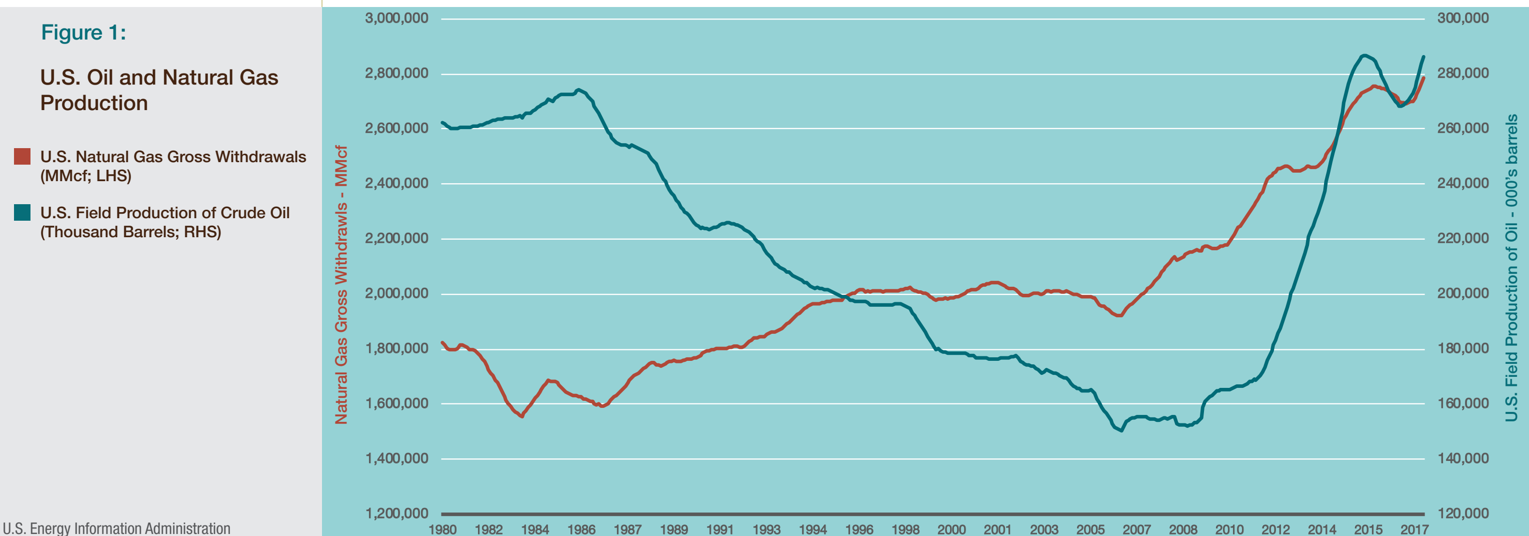
[2] Take-or-pay contracts do not guarantee against falling revenues. In the event that an exploration and production company stops production and has no resources to pay, the midstream energy company will not receive its revenues.

the next several years. Further, U.S. exports of crude oil are soaring since the U.S. lifted its oil export ban in late-2015 and the U.S. Energy Information Administration expects the U.S. to become a net exporter by 2022. Pipelines are essential for moving the hydrocarbons from where they are extracted to their final locations.

- Production costs are declining due to technology enhancements in drilling efficiencies and production performance. Production volumes (which continue to rise in the U.S.; see Figure 1) are a significant driver of midstream company revenues and should correlate with returns over time.
- Approximately 50% of the companies in the midstream sector are focused on natural gas (not crude oil)[3]. Cheap natural gas is leading to greater usage in electricity, greater exports and a resurgence in chemical industry investment, all of which requires new investment in pipeline and storage infrastructure.
- A significant trend over the past 18 months has been that MLPs are generally seeking to become self-financing over time (sometimes referred to as "MLPs 2.0"). As cash flows from new projects increase and CAPEX spending decreases, MLPs attempt to improve distribution coverage ratios and de-lever their balance sheets, thus becoming increasingly self-financing. The ultimate goal is for MLPs to become less dependent on equity issuance to fund projects.

Figure 1:

U.S. Oil and Natural Gas Production



Source: U.S. Energy Information Administration

Current Midstream Valuations and Earnings

Beyond the attractive fundamentals we outlined, we believe valuations for midstream equities are attractive. To start, the yield on MLPs is far superior to the yield on traditional public equities as well as many fixed income asset classes (see Figure 2). As of April 9, 2018, the Alerian MLP Index (a common proxy for the MLP asset class) was yielding 8.3%. This is well above the dividend yield for the S&P 500 (1.9%) as well as the yield on U.S. Treasuries (2.8%) and broad U.S. investment grade corporate bonds (3.8%). Even the yield on below investment grade bonds (6.2%) is below that of MLP yields. Additional valuation metrics, such as EV/EBITDA and spreads to other asset classes (such as U.S. Treasuries), also suggest that MLPs are attractive. For example, at the start of 2018, EV/EBITDA for the broad MLP asset class was 11.0x. This compares favorably to both the trailing 5-year average of 13.7x and the trailing 10-year average of 12.8x, both of which included periods of weakness for the energy sector as oil prices fell

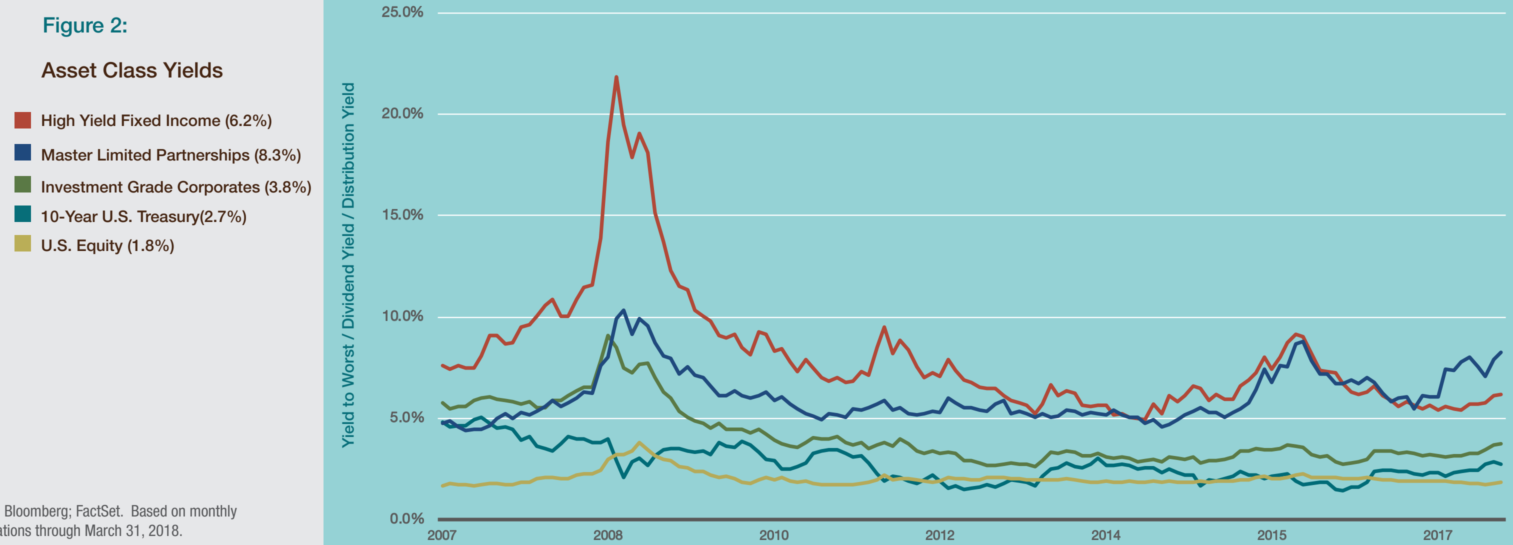
[3] As defined by the sector allocations within the Alerian MLP Index as of March 31, 2018.

sharply in 2008-2009 and 2014-2016. Further, at the start of the year, EV/EBITDA was trading at a discount to the S&P 500 for the first time since the financial crisis in 2008.

From an earnings perspective, MLP earnings per share have recovered to the levels seen prior to the decline in oil prices which began in 2014. In the most recently completed quarter where earnings are available (4Q 2017), MLPs achieved medium EBITDA growth of 12.3% year-over-year. Strong earnings in 2017 allowed midstream MLPs to increase distributions 6.1% year-over-year, leading to the aforementioned 8.3% yield on the Alerian Index.

Figure 2:

Asset Class Yields



Source: Bloomberg; FactSet. Based on monthly observations through March 31, 2018.

Potential Investment Considerations

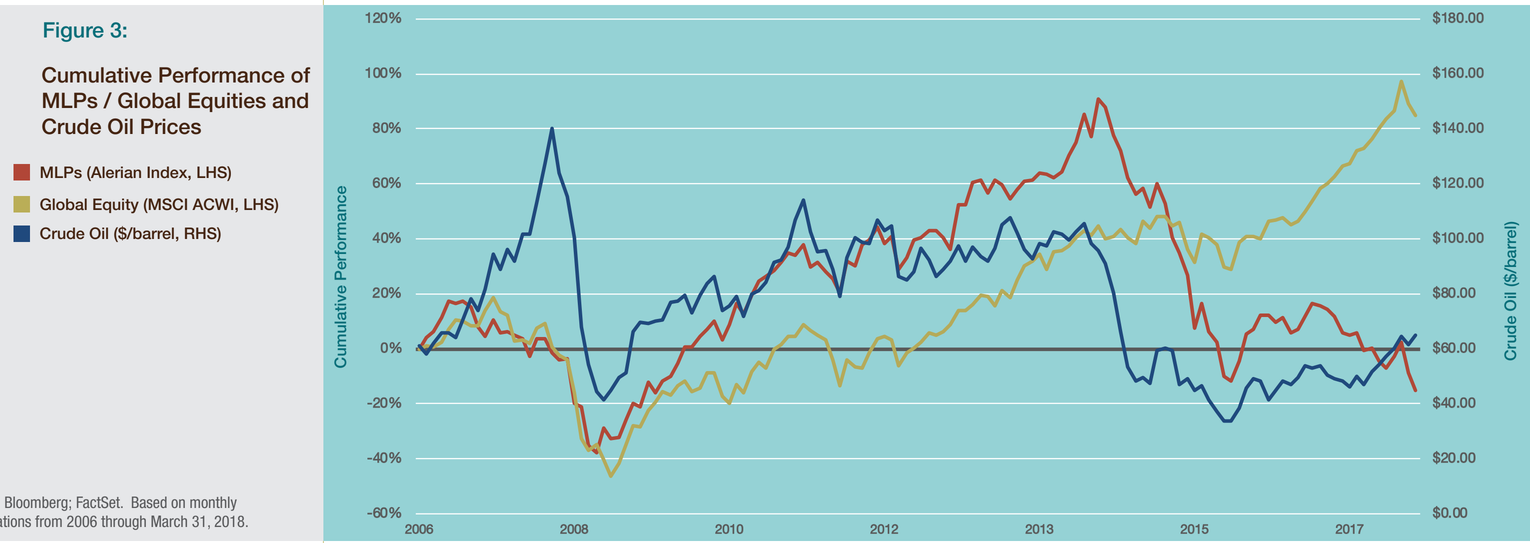
While we have presented what we believe to be a compelling case for midstream energy, we also acknowledge that there are certain risks investors should understand before making an investment. The following is a list of the primary risks that we believe exist in the midstream energy space.

- The potential volatility for midstream equity is higher than both developed and emerging market equities. Over the trailing 10-year period ending March 31, 2018, the Alerian MLP Index had a volatility (as measured by standard deviation) of 19.2% versus 16.7% for the MSCI ACWI Index (in USD terms).
- Despite sound fundamentals, there is the potential for valuations to remain depressed for an extended period of time.
- 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 should be noted that cuts in equity distributions may be beneficial over the long-term as midstream companies are able to reinvest in the business rather than distribute income to shareholders.
- Midstream equities may exhibit high correlations with oil price movements despite oil prices having less direct ties to midstream revenues or earnings than the investor community seems to believe (see Figure 3).

- The midstream equity asset class can be driven by changes in retail investor sentiment which can lead to increased volatility or extended periods of divergence between prices and fundamentals.
- High debt loads increase financing risk and may make the asset class more sensitive to rising rates.
- A need to continue to raise debt and equity capital has the potential to cause the asset class to sell off each time market volatility shuts down new issue activity.
- MLPs are subject to regulation by the Federal Energy Regulatory Commission ("FERC") and other government regulatory bodies which may impact revenue/earnings or create volatility in the asset class as new regulations are introduced.

Figure 3:

Cumulative Performance of MLPs / Global Equities and Crude Oil Prices



Source: Bloomberg; FactSet. Based on monthly observations from 2006 through March 31, 2018.

Implementation

While midstream equities present a compelling case for investment, there are challenges associated with owning the asset class. Notably, the tax treatment for MLPs can be complex. Direct investors will generally receive a K-1 instead of a 1099 (although some vehicle structures, such as mutual funds, will provide investors with a 1099). Further, investors may have state tax filing requirements in the states in which the MLPs do business or owns assets. Practically speaking, many individual investors are not burdened by these requirements because the income allocated among the states will be relatively small and is often below state filing thresholds. Tax-exempt entities (such as pensions and endowments) will typically incur UBTI. This will necessitate the need to file tax returns and generate a tax liability if the UBTI exceeds $1,000 per year.

Perhaps most importantly, there are limitations to mutual funds, closed end funds, exchange traded funds ("ETFs") or other regulated investment companies ("RICs"). Since the passage of the American Jobs Creation Act of 2004, mutual funds (and RICs) are permitted to own MLPs, but MLPs in aggregate cannot exceed 25% of the fund's assets nor can the fund own more than 10% of any one MLP security. Some funds that are sold as "MLP mutual funds" (or ETFs) have complied with this rule by purchasing the 25% maximum alongside midstream C-Corps, energy equities or other similar allowable securities.

Our preference is for taxable investors to own midstream equities through long-only private LP funds, as these funds offer "pure" MLP exposure (and thus higher yields), a single consolidated K-1 (which preserves the tax benefits of the sector and reduces complexity), and the lowest overall fee drag. For tax-exempt investors, we believe that vehicles structured as variable annuities by insurance companies have the potential to be an effective way of gaining exposure to MLPs while blocking UBTI with an acceptable degree of counterparty risk. There are also emerging strategies that only invest in C-Corps in the midstream space which could offer a UBTI-free option to tax-exempt entities.

Conclusion

From our perspective, both valuations and fundamentals are compelling for midstream energy equities. As many other asset classes, including U.S. equities, have significantly elevated valuations, we find midstream equities to be one of the few attractive asset classes at this time. Total-return oriented investors who can withstand significant volatility may want to consider investments in midstream energy equity. We would recommend that investors who are inclined to add to positions in the midstream equity space do so over time. Investors should also be mindful of sizing this type of investment appropriately. An allocation of 3-5% at the total portfolio level is generally appropriate for many investors with the understanding that individual investor situations and risk tolerances can vary greatly.

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