

The Midstream Balance Sheet Recovery: The Journey back from “Junk”

MIDSTREAM COMPANIES ARE PURSUING THEIR MOST CONSERVATIVE FINANCIAL POLICIES IN 15 YEARS – AND DEBT IS FALLING RAPIDLY

WE ARE REACHING A “CROSSOVER POINT” AS MIDSTREAM BALANCE SHEETS ARE ONCE AGAIN WORTHY OF INVESTMENT GRADE RATINGS, AND WE BELIEVE VALUATIONS ARE SOON TO FOLLOW SUIT

Recurrent Investment Advisors – Research Material Disclaimer

This material is for informational purposes only and is an overview of the midstream MLP and energy infrastructure markets and provides a description of potential future outcomes in the MLP market, and is intended for educational and illustrative purposes only.

It is not designed to cover every aspect of the relevant markets, and is not intended to be used as a general guide to investing or as a source of any specific investment recommendation.

It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, investment product or service. This material does not constitute investment advice, nor is it a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. In preparing this material we have relied upon data supplied to us by third parties.

The information has been compiled from sources believed to be reliable, but no representation or warranty, express or implied, is made by Recurrent Investment Advisors, LLC as to its accuracy, completeness or correctness. Recurrent Investment Advisors, LLC does not guarantee that the information supplied is accurate, complete, or timely, or make any warranties with regard to the results obtained from its use.

Recurrent Investment Advisors, LLC has no obligations to update any such information.

In 2018’s white paper, we identified the key causal factor for the multi-year downturn in midstream, which began in 2015: **DEBT**.

While many other midstream players pointed to fundamentally unsupported causes for weak performance: oil prices, contract renegotiations, the FERC, or production growth risks, our last paper found those explanations lacking in material evidence.

Below, we measure progress in balance sheet repair and identify the “crossover point” – specifically, when midstream companies are once again valued as “investment grade” entities after several years of being treated as “junk.”

IN REVEALING THAT DEBT, NOT OPERATIONAL RISKS, WAS THE MAIN CAUSE OF THE DOWNTURN, WE ALSO IDENTIFIED A KEY COROLLARY TO OUR THESIS: THE RECOVERY IS FAR MORE DEPENDENT ON FINANCIAL POLICIES THAN OIL PRICE OR MACRO VARIABLES.

IN THIS UPDATED ANALYSIS, WE SEE THAT MIDSTREAM FINANCIAL POLICIES AND EQUITY PERFORMANCE DIVIDE INTO **3 DISTINCT PERIODS**: 1) THE “NORMAL ERA” FROM 1996-2010, A PERIOD OF REASONABLE LEVERAGE, PRUDENT PAYOUT RATIOS, AND LOW CORRELATIONS TO OIL; 2) THE “SHALE ERA” OF HIGH PAYOUTS, DEBT ACCUMULATION AND HIGH OIL CORRELATION DURING 2011-2017; 3) AND TODAY’S EMERGING “BACK-TO-NORMAL ERA,” MARKING A RETURN TO THE CONSERVATIVE FINANCIAL POLICIES AND LOWER DEBT LEVELS THAT SERVED COMPANIES SO WELL BEFORE 2010.

WE ARE IN THE EARLY DAYS OF THE “BACK-TO-NORMAL ERA”. CORRELATIONS TO OIL PRICE AND BROAD EQUITY SELL-OFFS SEEM TO BE DECLINING, AS MIDSTREAM RECOVERS SOME OF ITS “UNCORRELATED” ATTRIBUTES. ACCORDINGLY, WE EXPECT TIGHTER SPREADS AND STRONG RELATIVE PERFORMANCE AS MIDSTREAM CREDIT QUALITY IMPROVES.

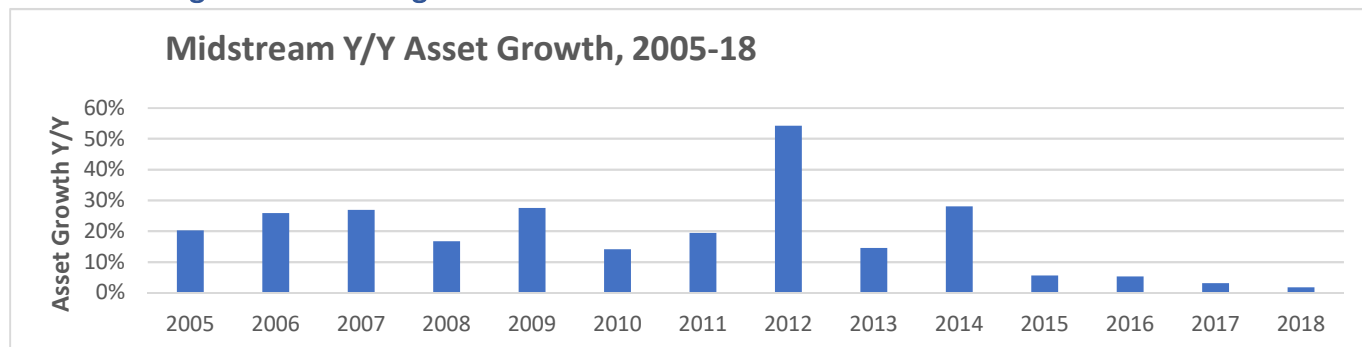
VALUATIONS – FOR BOTH MLPs AND CORPORATIONS - REMAIN DEPRESSED COMPARED TO OTHER ASSETS. WE SEE A POTENTIALLY COMPELLING SITUATION: CREDIT DETERIORATION IS LARGELY REVERSED, BUT ALERIAN MLP TOTAL RETURN INDEX (AMZX) HAS NOT MOVED IN 7 YEARS. THE ALERIAN MIDSTREAM ENERGY TOTAL RETURN INDEX (AMEIX, MLPs AND CORPS) HAS NOT MOVED IN 5 YEARS.

IN THE FACE OF SUSTAINED BALANCE SHEET IMPROVEMENT, EQUITIES ARE YET TO APPRECIATE. WE DO NOT BELIEVE THIS DISCONNECT IS SUSTAINABLE AND BELIEVE THE “CROSSOVER POINT” FOR MIDSTREAM VALUATION IS RAPIDLY APPROACHING.

Elevated debt levels have driven tighter financial policies in midstream, frustrating investors but laying the foundation for recovery

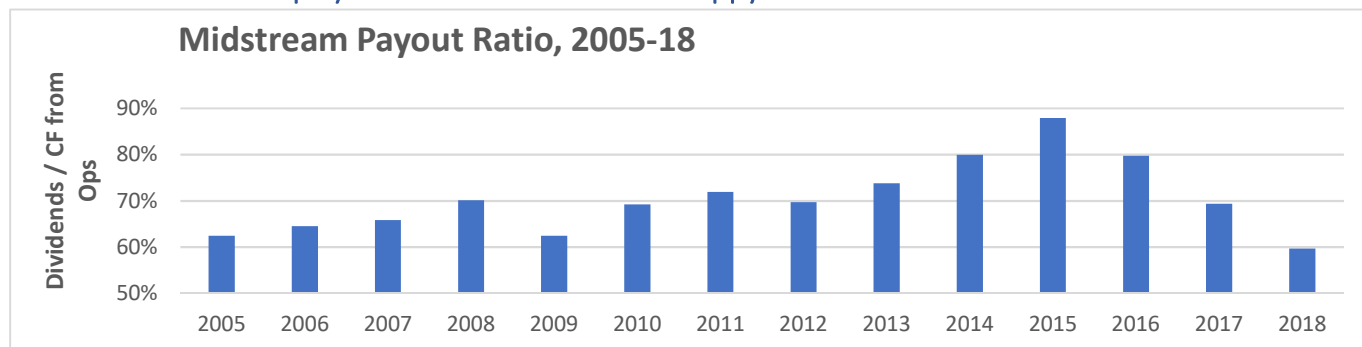
As a refresher, in our previous white paper we outlined how the excitement of the “shale boom” drove huge midstream asset growth, which translated into ballooning debt loads and soaring payouts from 2011 through 2017. During this period, midstream corporations and MLPs sought to satisfy an unofficial dual mandate of generous dividend payouts to investors while simultaneously growing assets to participate in opportunities afforded by the North American shale boom.

A decade-long boom in asset growth from 2005-2015...



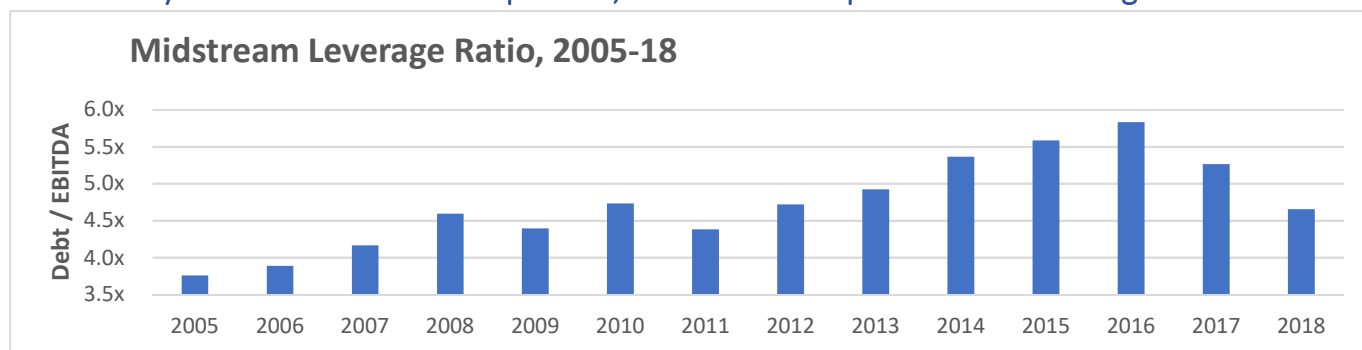
Source: Bloomberg, Public Filings, Recurrent research

...and a desire to keep “yield-oriented” investors happy...



Source: Bloomberg, Public Filings, Recurrent research

...led to 10 years of balance sheet expansion, which is now in process of unwinding.



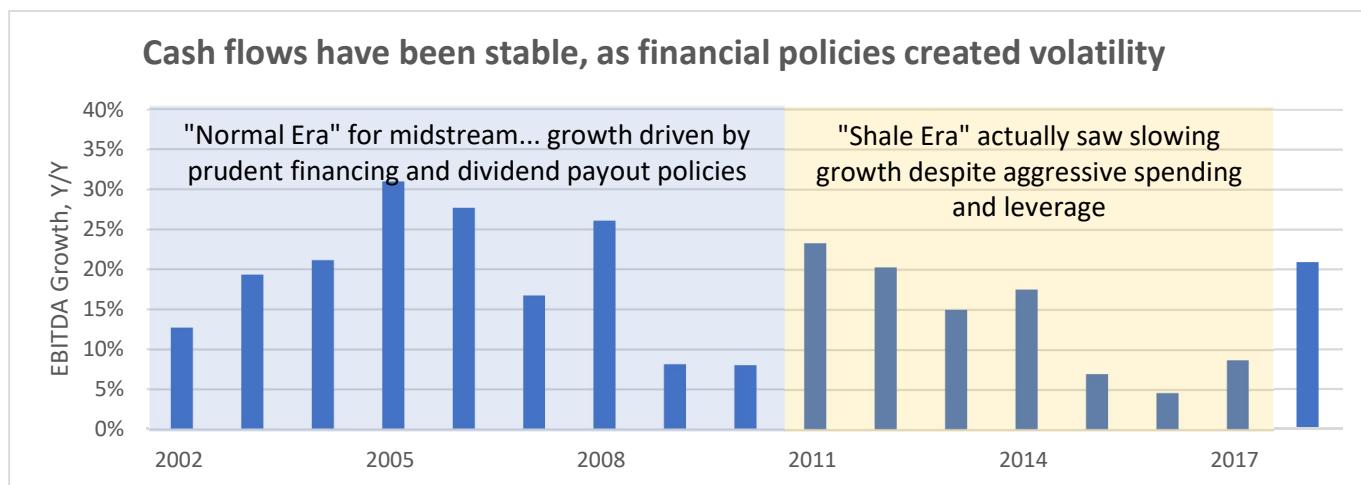
Source: Bloomberg, Public Filings, Recurrent research

In this sequel to our original midstream MLP white paper, we will explore the following topics –

1. Progress on deleveraging – **sector average now on the verge of “BBB” leverage metrics**
2. Rating agency response – **“upgrade cycle,” 4 years after agencies catalyzed the downturn**
3. Dividend progress – **cuts largely complete – dividends back to 2015 levels with lower payouts**
4. Debt vs. equity outlook – **debt markets offer approval, but equity yields remain blown out**
5. Comparison vs. other assets - **Midstream spreads to utilities and REITs also remain dislocated**
6. Other benefits of deleveraging - **De-leveraged midstream regaining “uncorrelated” attributes**

Topic 1: Cash flow growth, ongoing debt reduction underpins recovery

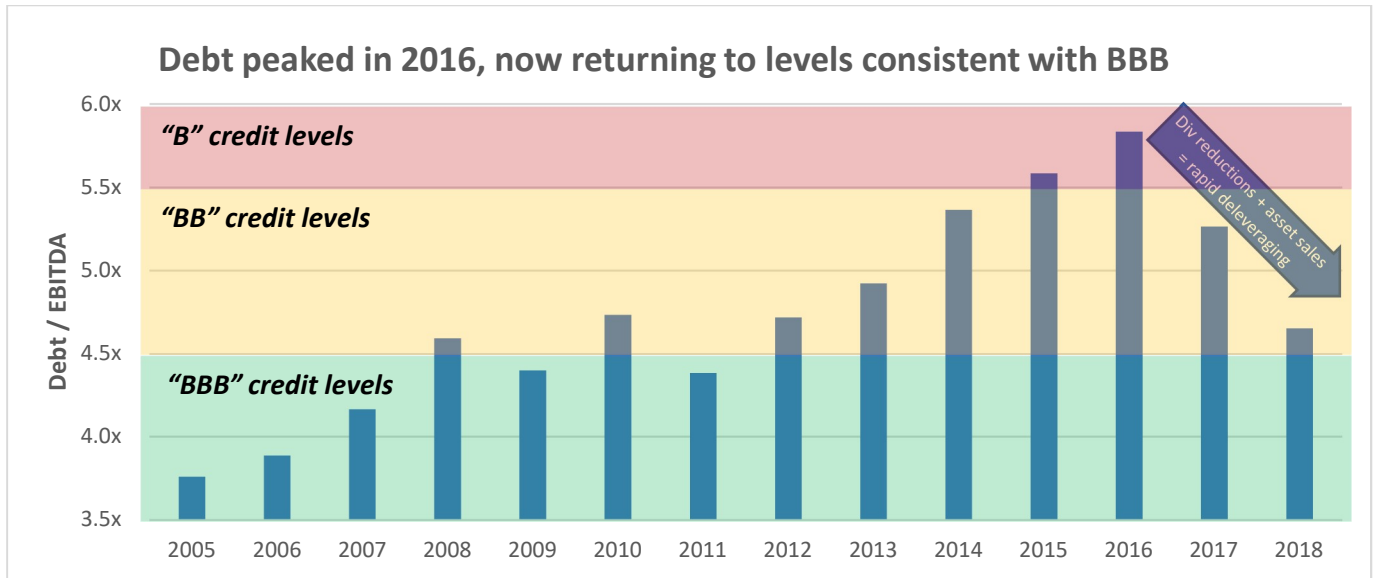
First and foremost, we are encouraged to see that the industry’s health continues to improve. Operationally, cash flows and EBITDA remain strong. In fact, despite narratives highlighting concerns about profitability due to falling oil production in 2016, industry-wide EBITDA has grown every year since 2001, as shown in the chart below.



Source: Bloomberg, Public Filings, Recurrent research; universe based on Alerian Indices’ AMEI index

As cash flows have remained robust, then balance sheet repair has come from reducing cash outflows. Capex levels and net asset growth have moderated since 2014, with the final ingredient in deleveraging coming from reduced payouts to shareholders. This has come in 2 forms. The most straightforward means to reduce payouts to equity shareholders is via dividend cuts, which we identified in last year’s white paper. Additionally, equity payouts have been reduced by “backdoor dividend cuts” via the acquisition of higher-yield subsidiary MLPs by lower-yield parent companies (whether C-Corp or MLP).

In considering the state of the industry as of 2Q 2019, it is clear that efforts to reduce indebtedness have borne fruit. Since industry-wide Debt/EBITDA peaked at nearly 6x in 2016, dividend reductions, corporate restructurings and moderating capital expenditures combined to reduce industry Debt/EBITDA to 4.7x by end 2018. In the chart below, we illustrate leverage against the backdrop of Fitch Ratings’ published criteria used in evaluating the creditworthiness of a given midstream company.

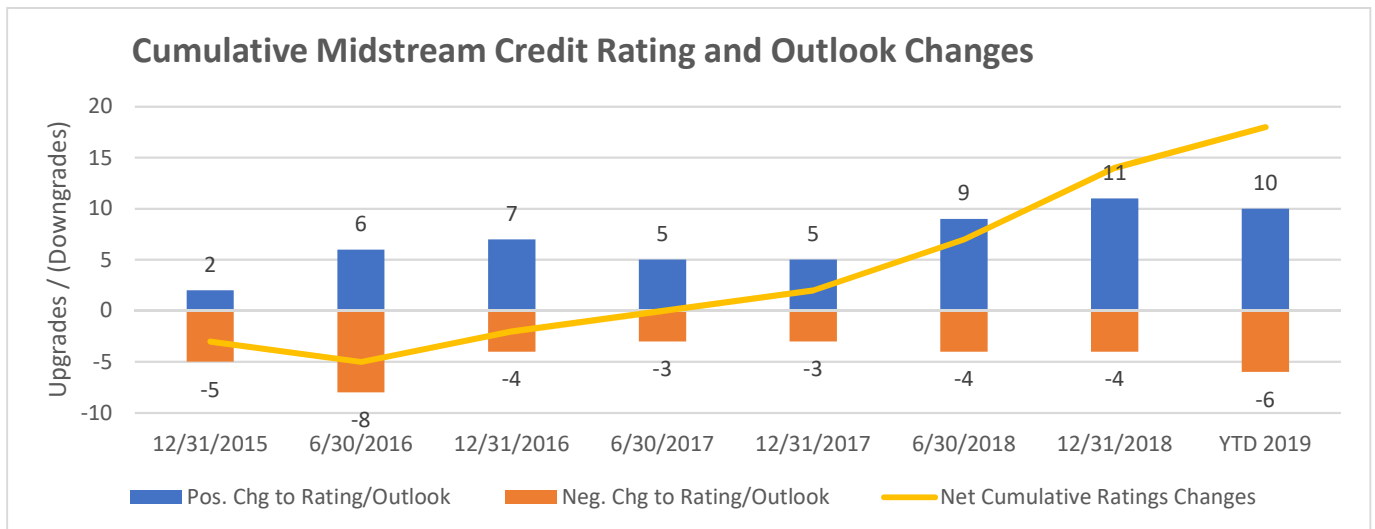


Source: Bloomberg, FitchRatings, Recurrent research

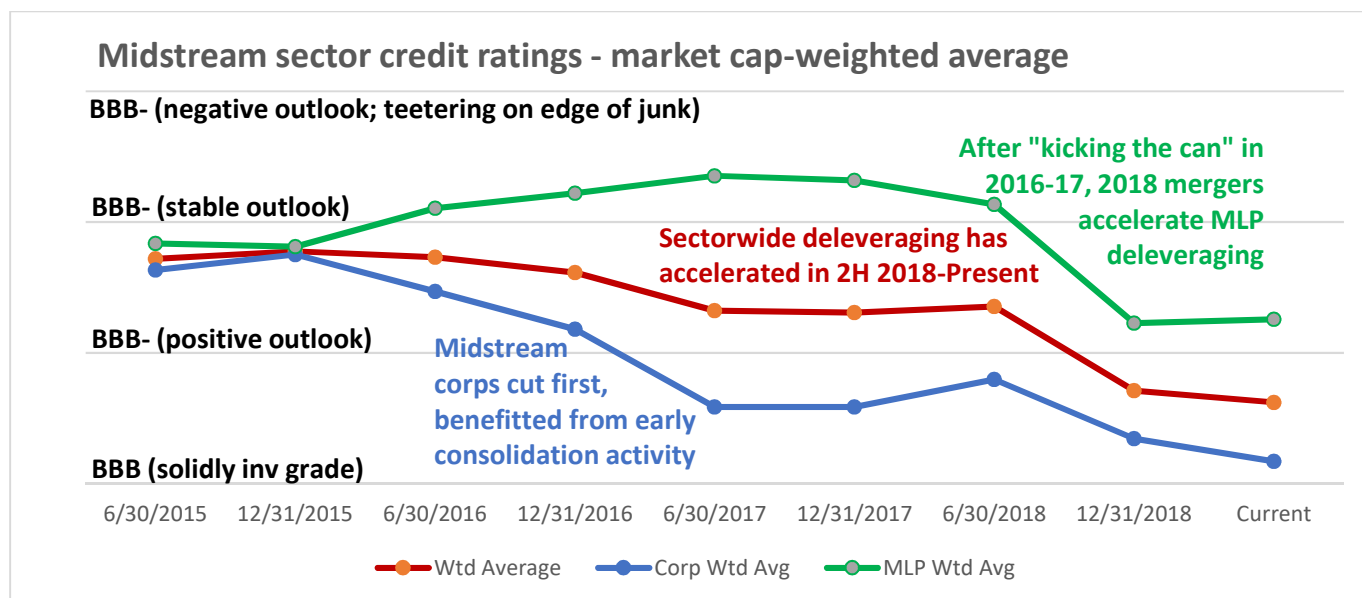
Topic 2: Credit agencies who scorned midstream in 2015, are now issuing upgrades to companies across the sector

Since steps toward capital preservation were initiated in 2015, aggregate Debt/EBITDA has fallen by approximately 0.5x annually. Should this trend continue, we expect the industry to return to a credit profile consistent with Fitch’s BBB rating during 2019, for the first time since 2009. We would note that leverage is not the sole determinant of published credit ratings, but is a key quantitative input.

While our analysis reflects the progress made in this key metric, we see the ratings agencies’ holistic view of the sector is also improving – recent quarters have seen a wave of credit upgrades, with **more net rating improvements in the past year than were seen cumulatively since 2014.**



Source: Bloomberg, S&P Ratings, Recurrent research, as of June 2019. Note: Covers all companies in AMEI/AMNA (MLPs + C-corps) and AMZ (MLPs only) as of 9/30/14 and subsequent additions (to avoid survivorship bias).



Source: Bloomberg, S&P Ratings, Recurrent research, as of June 2019.

It is hard to overstate the importance of this development, given the fact that most dividend cuts initiated since 2014 – most notably Kinder Morgan’s December 2015 dividend cut, which was the first major midstream company to cut and began a violent cascade downward in equity values – have occurred under threat of ratings downgrades.

Accordingly, with the overhang of negative credit agency actions lifted from the midstream sector, we expect the incremental dollar of cash flow growth to be allocated to shareholder returns – in the form of dividends and share buybacks funded by free cash flow – rather than increased debt paydown.

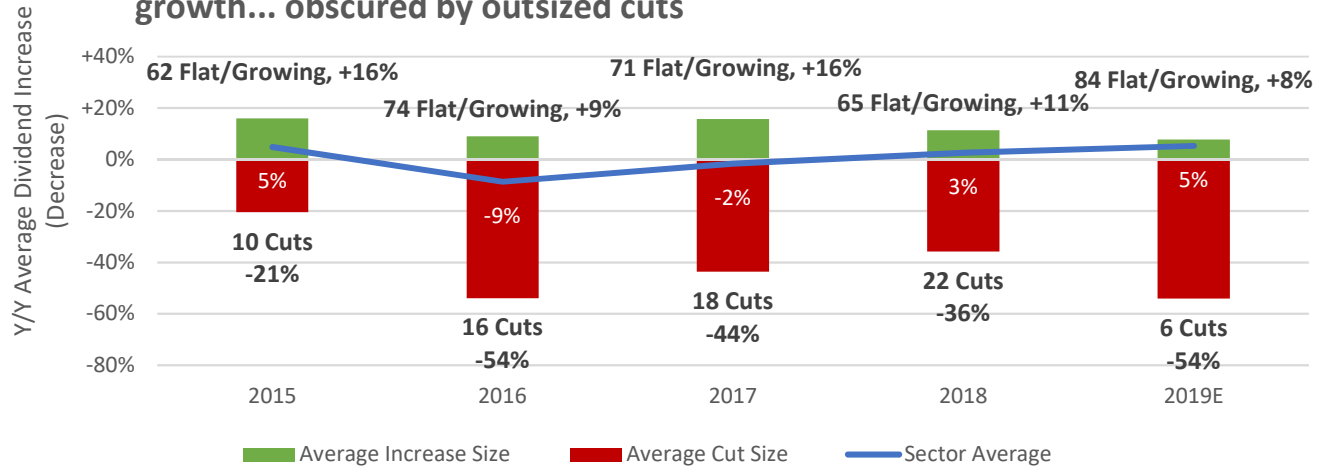
Topic 3: The dividend cut cycle that inflicted so much pain on midstream investors has concluded, with payouts back at 2015 levels (and growing)

With the threat of ratings agencies downgrades lifted, the financial flexibility afforded to midstream companies is much greater, which means cash returns to shareholders are likely to increase in the coming years at a rate well above that of the recent past.

As the average midstream investor faced falling payouts during 2015-18 (with a higher rate of cuts for MLP-structured investments, as MLP dividends took the brunt of “simplification” transactions and mergers), it’s understandable that sentiment around the midstream sector soured as investor confusion grew and payouts fell in a flurry of complex transactions.

Many sources of midstream sector research (managers and sellside analysts alike) spent much of 2015-18 continuing to publish “dividend growth rates” for midstream stocks, not acknowledging that 2015-18 was a period of actual dividend reduction for the sector, after 2014’s stretched payouts and high leverage. As we disaggregate dividend increases and cuts below, we see a tale of a sector with single-digit dividend increases (when dividend cutting stocks are excluded), but this growth trend was obscured by outsized cuts from a smaller number of dividend-cutting companies. This income reduction process has peaked and is now reverting to net income growth, as shown below.

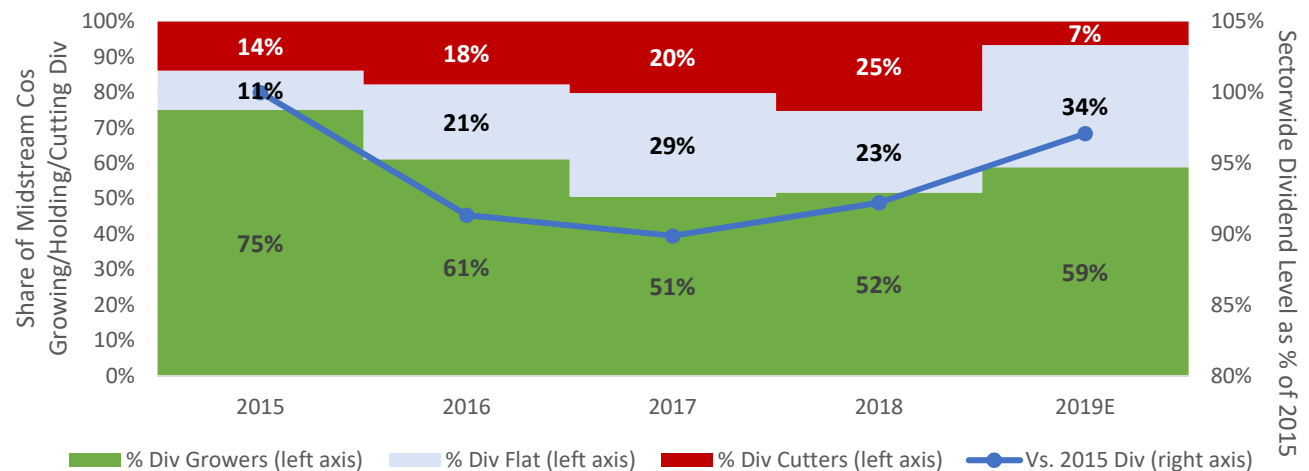
Simple average of Y/Y dividend changes reveals healthy average growth... obscured by outsized cuts



Source: Bloomberg, Alerian, Recurrent research, as of June 2019. Note: 2019E based on Bloomberg consensus. Covers all companies in AMEI/AMNA (MLPs + C-corps) and AMZ (MLPs only) since 9/30/14 and subsequent additions (avoiding survivorship).

Below, we illustrate that this process is largely complete and the loss of income from cuts, mergers and conversions is well on its way to being reversed as income has almost returned to 2019 levels. Today's broad midstream sector offers comparable apples-to-apples income levels vs. 2015, while currently generating significant excess cash flow for continued debt reduction.

Midstream (MLP+Corps) payouts have nearly returned to 2015 levels



Source: Bloomberg, Alerian, Recurrent research, as of June 2019.

Note: Covers all companies in AMNA (MLPs + C-corps) and AMZ (MLPs only) as of 9/30/14, merged and defunct companies and subsequent additions (to avoid survivorship bias). For companies acquired in mergers, the pro forma dividend consists of the acquiror's dividend assuming an all-equity exchange ratio. For companies acquired by affiliates in all-cash “take unders” (acquired below 3-year average price or below IPO price), dividend is treated as canceled. For companies acquired in all-cash acquisitions, dividend is treated as “held flat”.

Topic 4: Are MLP spreads to fixed income reflecting the midstream sector’s recent past, or its near-term future?

For many years, MLP investors analyzed the sector using valuation methodologies analogous to those found in the fixed income markets: yield spread-based analysis. US shale production accelerated, and midstream debt surged with growth capex, as the industry raced to capture shale-derived opportunities. Despite straining balance sheets, investors continued to use fixed income valuations more suited to highly-stable cash flows derived from debt securities.

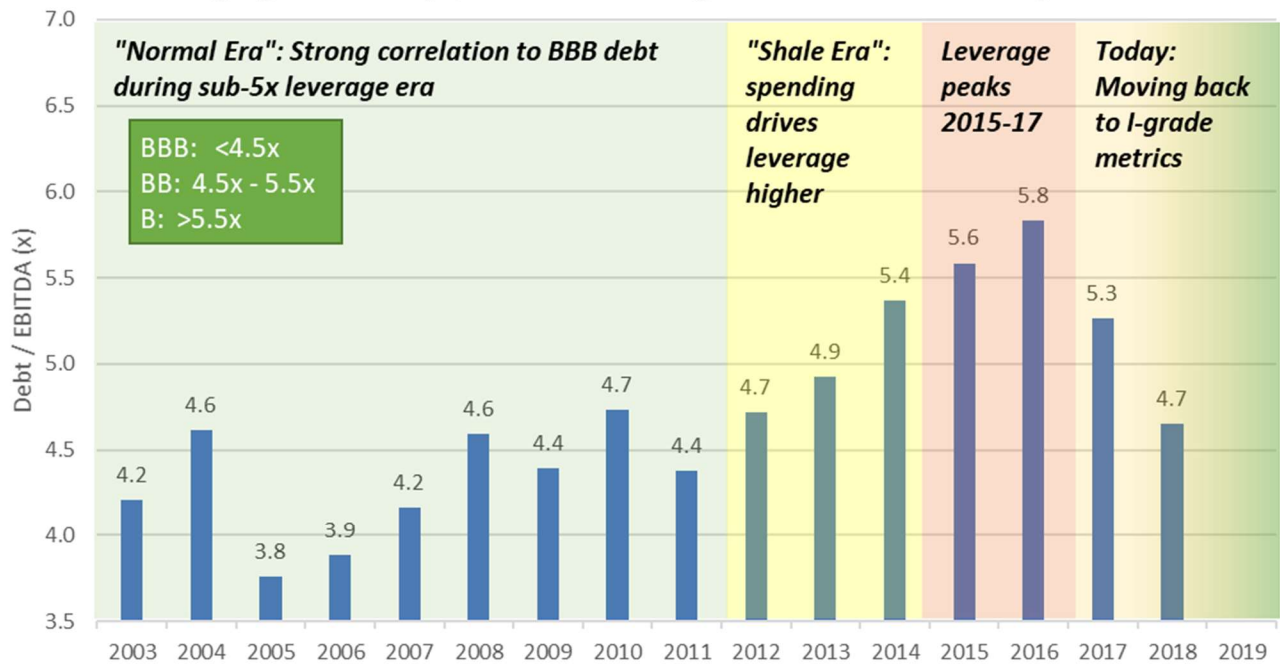
As we examine midstream yield spreads today, we see that yield spreads to fixed income remain relatively unimpressed by the deleveraging achieved to date, and seemingly unaware that the pace of deleveraging is set to continue or accelerate going forward.

The “Normal Era” prior to the Great Financial Crisis (GFC) and several years in its wake: MLP equity yields approximated BBB (investment grade) bond yields, reflecting investor confidence in these payouts. As the “Shale Era” began in earnest in 2011, MLP yields widened beyond BB bonds (high yield). MLPs continued to take on debt to finance projects, and the industry’s credit profile weakened from investment grade (BBB) to non-investment grade (BB) ratings. Ratings agencies demanded dividend cuts in exchange for forbearance - even though actual debt metrics justified downgrades to junk in 2015-16.

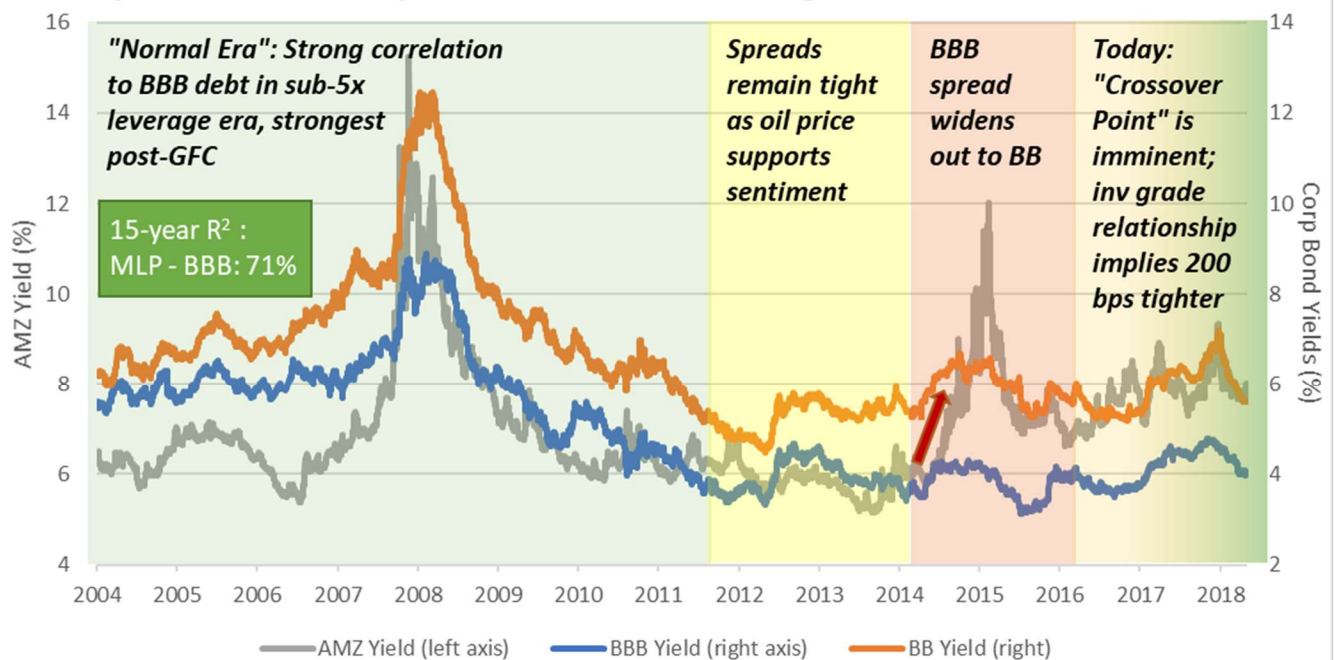
With the early signs of trouble in the oil market in 2014: oil and economic volatility caused bond yields to widen, MLP yield spreads still remained relatively flat, reflecting the perceived stability in energy infrastructure as US oil production prices continued to grow as oil prices remained above \$80/barrel.

Midstream spreads definitively cracked with ratings actions in 2015: US oil production peaked and then fell, credit agencies’ focus turned to energy infrastructure companies. At the same time, industry-wide debt leverage rose to nearly 6x Debt/EBITDA, and MLP dividend yields reflected that leverage, definitively exceeding even BB bond yields.

As rating agencies slept, markets downgraded midstream to "junk"

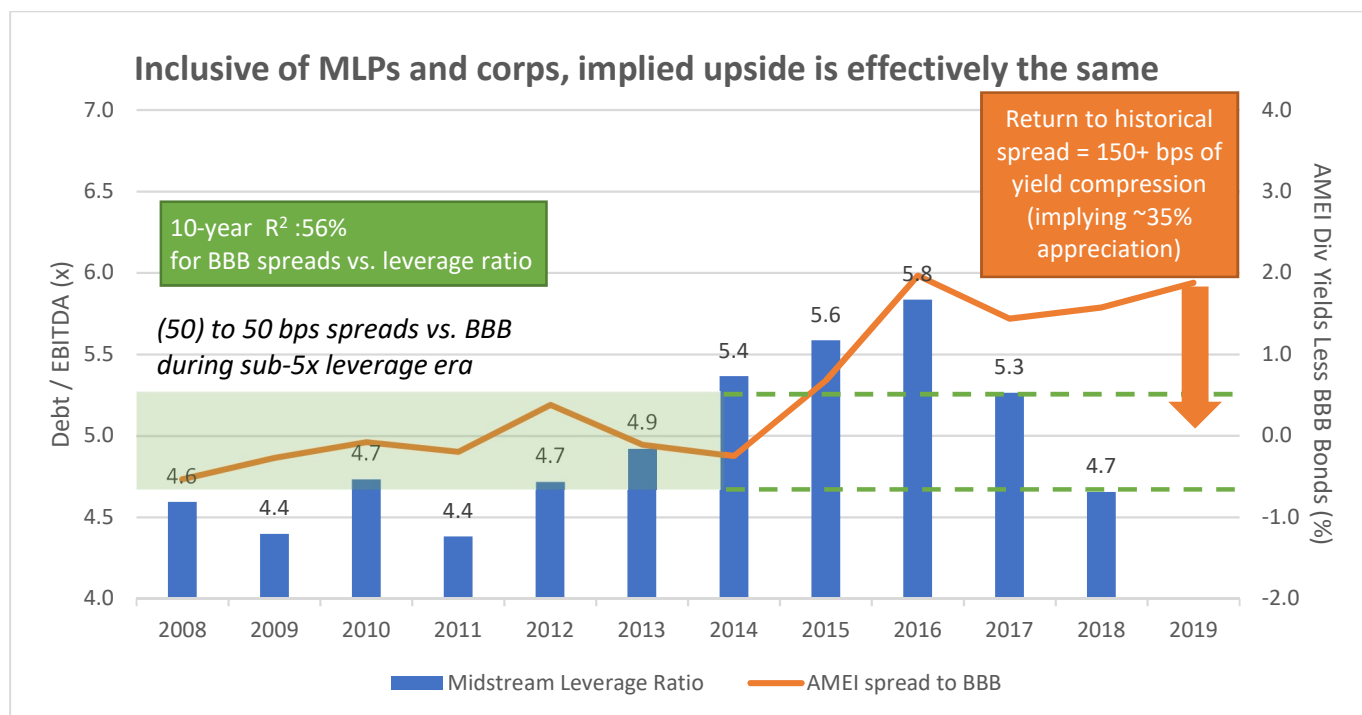


Spreads widened equal to a "one-notch downgrade" in 2015-16



Sources: Recurrent research, Bloomberg, Alerian

While ratings agencies were slow to scrutinize MLP credit prior to the 2015 equity downturn, MLP equity yields reflected higher leverage after 2014. During the peak of the 2011-17 “Shale Era,” yields continued to widen, contrary to strong high yield markets and favorable “dividend growth outlooks” for the sector. Since 2015, we have seen MLP spreads vs. BBB bonds expand 200 to 400 bps vs. pre-2014.



Sources: Recurrent research, Bloomberg, Alerian

The question today is “If the most influential valuation driver for midstream companies is debt leverage, is the market continuing to accurately price the sector given its credit profile?” In short, the answer today may still be “yes”, but, given the rapidly improving credit profile of midstream, this is unlikely to persist. As we outline in debt-to-EBITDA chart on page 4, by the end of 2018, the sector’s 4.7x Debt/EBITDA was only slightly higher than the 4.5x Debt/EBITDA threshold consistent with investment grade levels. If a restoration of midstream creditworthiness is likely to occur in the near term, as we believe, then we expect the sector’s dividend yield should tighten meaningfully – recapturing some portion of the 200 to 400 bps referenced above.

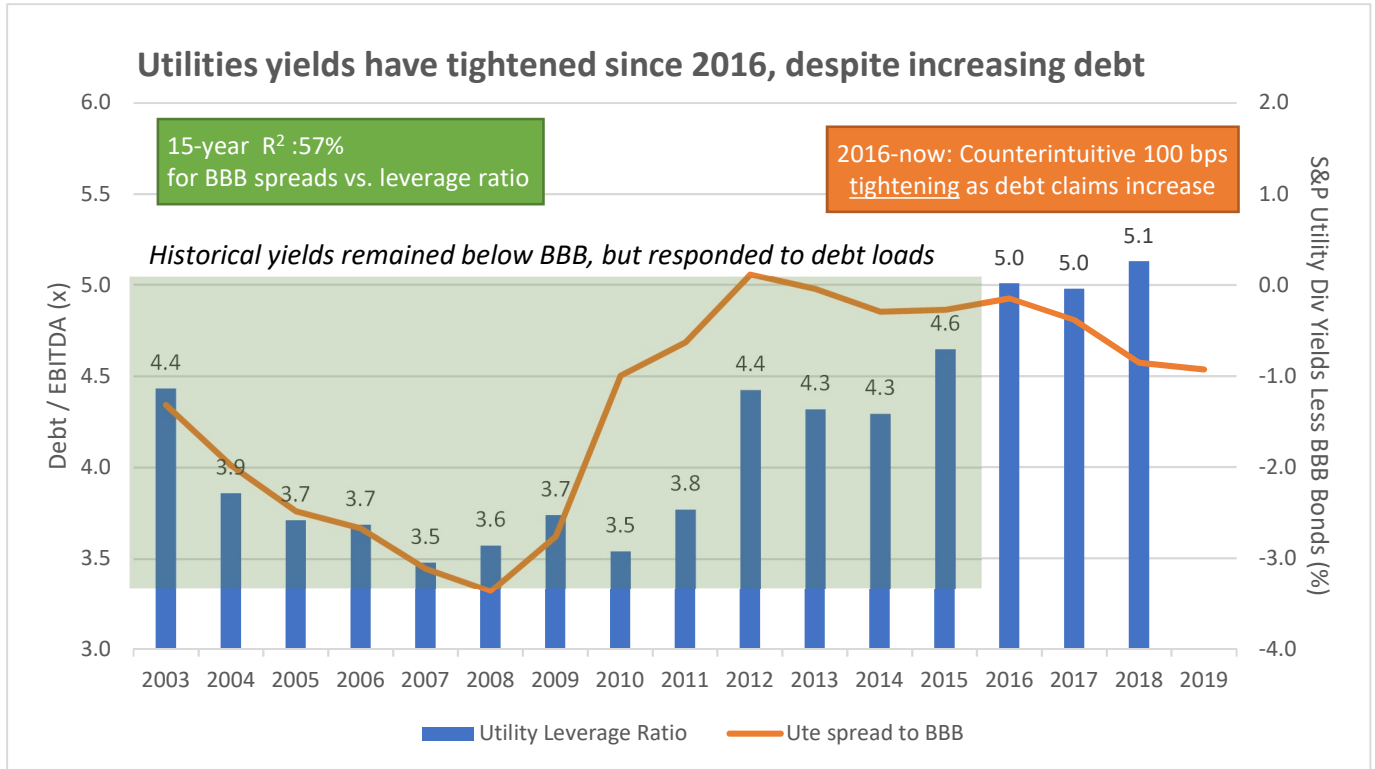
Even 200 bps of MLP yield tightening – the low end of the range – would move the sector back to a non-investment grade yield, offering 30%+ appreciation from here.

To return to BB-like yields, midstream equities would need to rise 30%. When we examine midstream corporations, the overall sector yield is lower (6.0% instead of 7.5% as of early June 2019), but the AMEI, which includes midstream corporations and MLPs, has seen the same magnitude of spread widening since 2013 (AMEI’s inception) as the MLP-only AMZ. As shown above, MLPs have widened roughly 200 bps vs. their historical relationship, while a broader midstream index like AMEI (inclusive of MLPs and C-corps) have widened by 150 bps. In both cases, even the conservative end of historical yield-vs-debt relationship indicate valuations implying 35% appreciation from current levels.

As we look the universe inclusive of midstream corporations, a 150-200 bps spread tightening – returning only to spreads of 2013 – would similarly offer 30-40% upside from current valuations.

Topic 5: How is energy infrastructure priced relative to other yield-generative equities, like utilities and REITs?

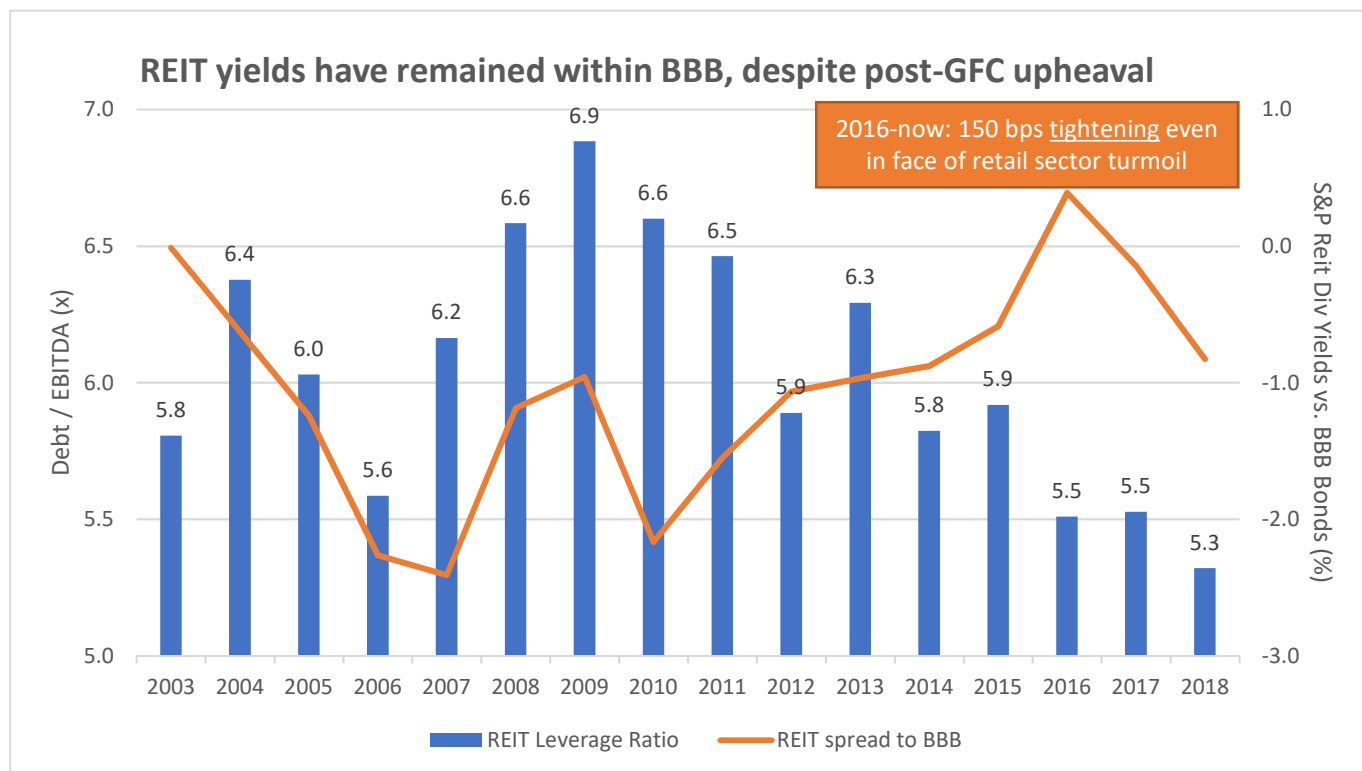
Given the persistently low interest rate environment, investors are searching for opportunities to generate income. Utility and real estate sectors generally provide similar attributes to the perception of energy infrastructure prior to 2015 – stable cash flow businesses which return income to shareholders. In contrast to the last 3 years of weak MLP performance, these sectors have continued to perform strongly, and their dividend yields have remained in-line with or below BBB yields. Rightly or wrongly, the perception of these sectors’ cash flows and business health is strong, and is priced accordingly.



Sources: Recurrent research, Bloomberg

Interestingly, low utility equity yields and tight spreads to investment grade (BBB) bonds have persisted even as the underlying balance sheets of utilities have grown in the low-rate environment that also helped spur the midstream spending boom of 2011-17. Below we can see that the utility sector remains below the >5.5x peak leverage achieved by midstream, but there has been a clear and sustained increase in debt since the GFC.

While midstream companies are in the process of reducing debt, we can see below that utility sector debt loads continue to rise. Suffice to say, we believe it is an interesting juxtaposition that utility investors seem unconcerned by the accumulation of leverage on their underlying businesses, while investors seem unimpressed by midstream’s rapidly declining leverage profile.



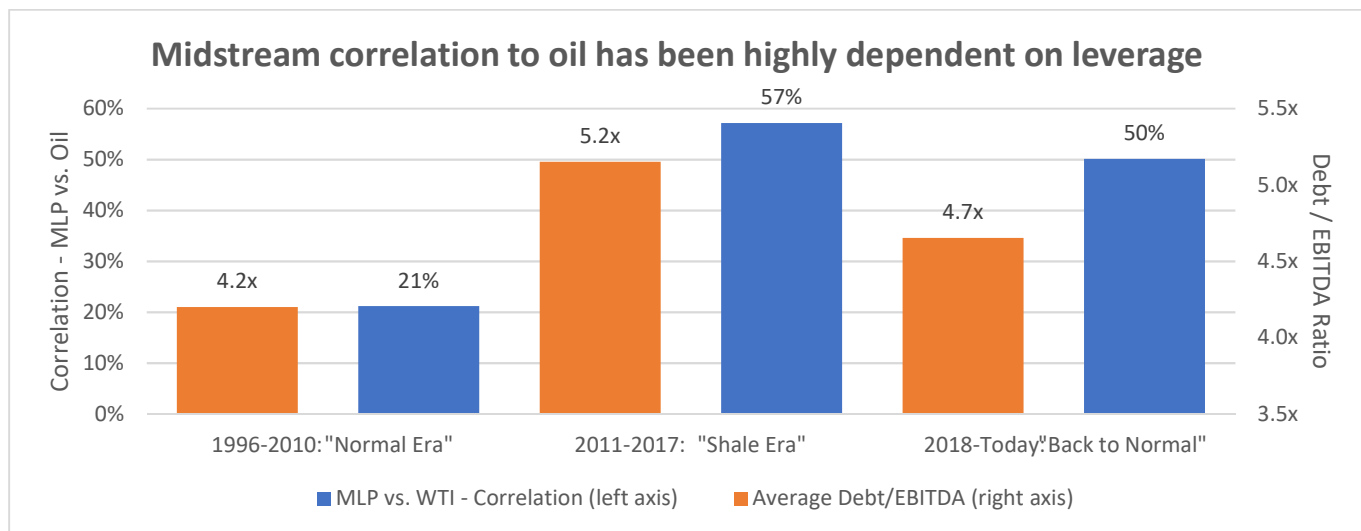
Sources: Recurrent research, Bloomberg

Whereas utilities have continued to see falling yields in the face of increased indebtedness, REIT yields have remained between BBB and 200 bps below BBB yields over the past 15 years, as a restrained growth outlook has been balanced by a slow deleveraging process that began after the GFC.

In contrast, midstream yields remain priced in line with the BB bond market. Importantly, while MLPs currently have a BB credit profile, the sector as a whole will be reducing debt leverage to migrate to an investment grade profile, and as such, offers significant total return opportunities which the already more expensively priced utility and real estate sectors do not offer.

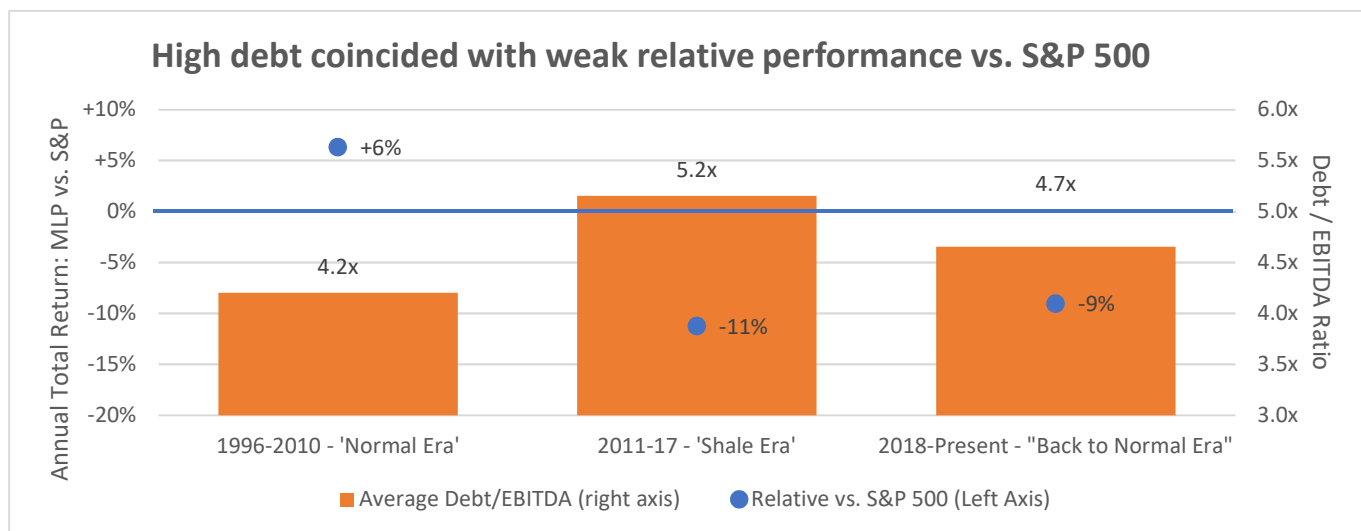
Topic 6: What performance impacts should we expect from lower debt levels?

A skeptical reader might reasonably say that, despite the fundamental improvement in midstream credit, the market has rendered its verdict: reduced debt has delivered very little in midstream equity performance. And to date, that is right – but this perspective ignores subtle shifts in midstream equity behavior during the last 18 months that send positive signals.



Source: Bloomberg, Public Filings, Recurrent research

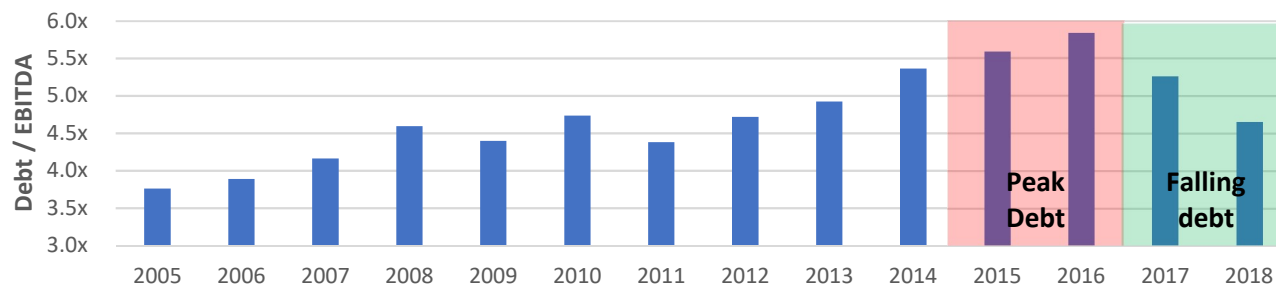
The performance impact of elevated debt levels during 2011-17 is clear upon examination of the above and below. During a period of aggressive financial policies, midstream resilience in the face of oil price volatility, as well as midstream relative performance vs. broad equities was meaningfully compromised. But since 2017, we’ve seen falling debt, and a modest reduction in oil correlation from 0.57 to 0.50 – still a far cry from the 0.21 correlation of the “Normal Era” – and S&P underperformance has continued in 2018 and YTD 2019, but relative performance has improved from the 2011-17 high-debt “Shale Era.”



Source: Bloomberg, Public Filings, Recurrent research

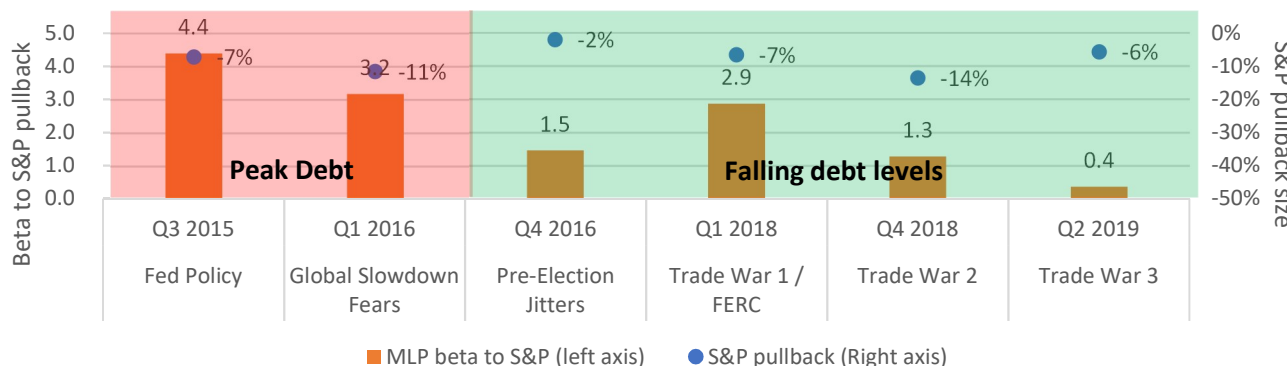
On a much more recent (and accordingly, less well-established) basis, it appears the sensitivity of midstream stocks to pullbacks in oil price or S&P 500 performance is declining as well, a likely result of increased creditworthiness in the midstream sector. The April-May 2019 “Trade War”-associated pullback in oil and the S&P 500 has actually been the first pullback since 2015 where MLPs did not exhibit greater downside than WTI or the S&P 500 – an immature but still encouraging sign.

Midstream Leverage Ratio, 2005-18



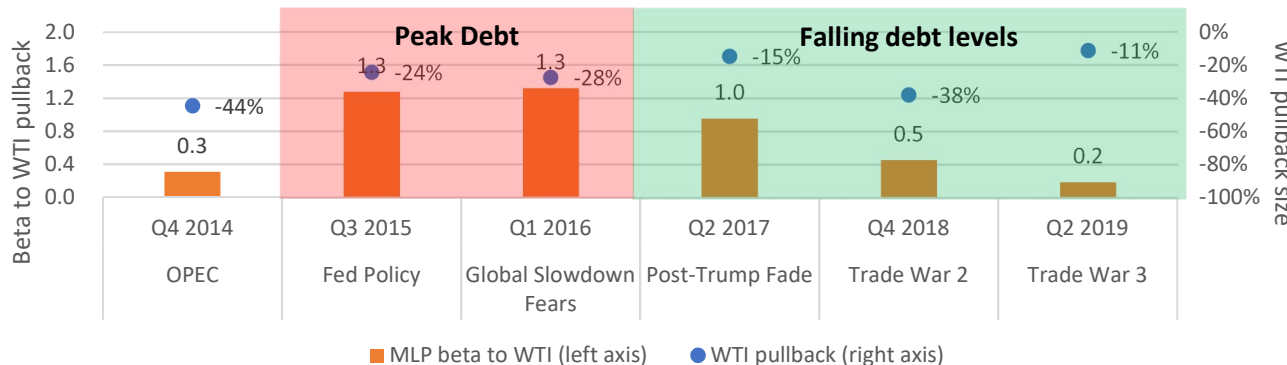
Source: Bloomberg, Public Filings, Recurrent research

Midstream beta to S&P pullbacks appears to be waning



Source: Bloomberg, Public Filings, Recurrent research

Midstream beta to oil pullbacks appears to be declining



Source: Bloomberg, Public Filings, Recurrent research

Conclusion – a midstream outlook unlike the past 5 years

For the midstream sector, the journey back from non-investment grade, or “junk” credit profiles, to balance sheets worthy of the investment grade designation, has been almost 5 years in the making. Even though aggressive dividend cuts and capex reductions averted the wave of credit rating downgrades that threatened the midstream sector back in 2015, the collateral damage of these dividend cuts included a large-scale shareholder rotation and an equity recovery that has meaningfully lagged the solid fundamental outlook for energy infrastructure.

However, today marks a categorically different outlook for the midstream sector compared to the last several years: investment grade metrics will be achieved across the midstream sector by late 2019, the midstream sector is now riding a wave of credit rating upgrades, and dividend levels have returned to levels not seen since the downturn began. At the same time, almost none of these improvements have been reflected in equity valuations. As the midstream sector reaches the “crossover point” back to solidly investment grade footing by the end of 2019, we expect the incremental dollar of cash flow to be unencumbered by further deleveraging. Accordingly, this cash flow will be increasingly available to reward midstream equityholders in the forms of buybacks and increased dividend payouts. As corporate debt balloons across the American economy in the 10th year of a mature economic expansion, we believe these midstream infrastructure businesses – which are actively reducing leverage while increasing payouts to equityholders - will not remain undervalued for much longer.