EAGLE GLOBAL ADVISORS

Quarterly Commentary
Q1 2018

EGA Energy MLPs and Midstream Companies

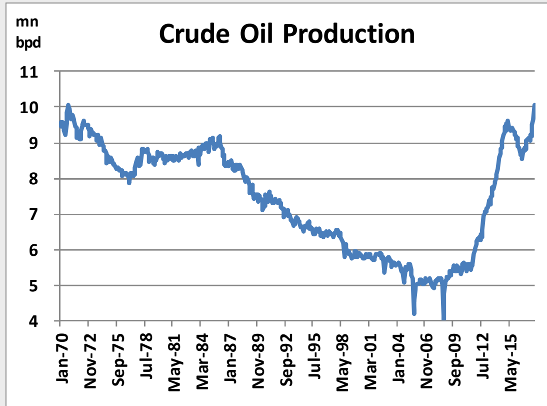
From the EGA Portfolio Management Team

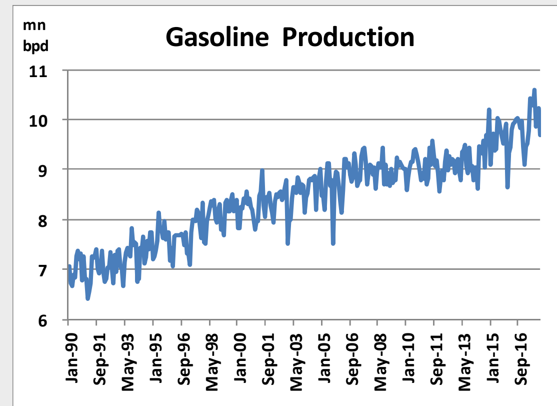
With Friends Like FERC, Who Needs Enemies?

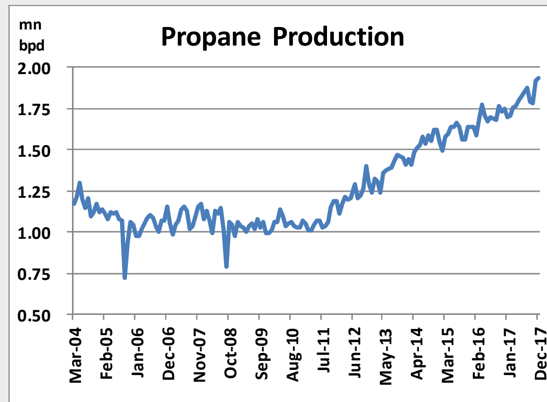
In the late 19th century Auguste Rodin first conceived the idea for his famous "The Thinker" sculpture, where it's believed to depict Dante in "The Divine Comedy" pondering heaven, hell, and the fate of humankind. Recent decisions by the Federal Energy Regulatory Commission (FERC) have many pondering the fate of Midstream companies, though we believe these existential questions are more a product of severely depressed investor sentiment than rational thinking. Don't get us wrong, we believe the FERC's decision to exclude a long allowed income tax allowance in setting maximum cost of service tariffs for some pipelines seriously calls into question this administration's "pro-business" and "pro-infrastructure" claims. It's just that we believe it is better to look forward and re-position our portfolios for success in this new regulatory environment.

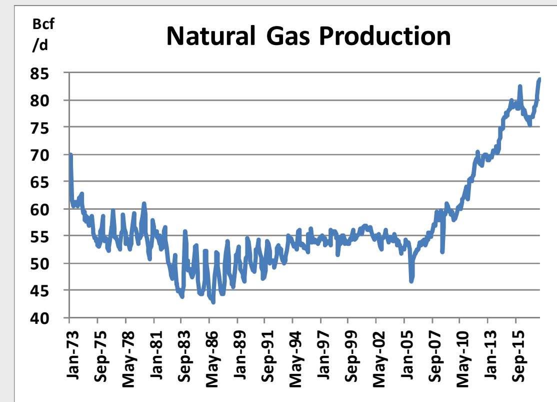
Is Midstream Finished?

Of course not. The United States has seen a remarkable surge in crude oil and natural gas volumes over the past decade, setting records for just about all commodities we produce (see exhibits on next page). It was this volumetric recovery that caused OPEC to initiate a supply-driven bear market in energy that began in late 2014, though OPEC has long since waved the white flag. Yet, despite the ongoing volume/price recovery and management initiatives that have dramatically improved company financials over the last two years, Midstream stocks continue to struggle.









Source: EIA

It has been increasingly frustrating for fundamental investors like us who expect macro and micro indicators to drive stock valuations. We are convinced market valuations must ultimately reflect fundamentals, which bodes well for Midstream. Current distributions are supported by existing cash flows, while the ongoing surge in energy volumes supports construction of infrastructure projects that will drive future cash flow growth.

What Is To Become Of The MLP Structure?

Another question is whether the MLP structure's days are numbered. The irony is thick. We are only a few months past December's tax reform bill, which appeared to spell relief for investors worried that MLP's tax status would change. Then FERC delivered an unexpected policy reversal that blindsided the market. We continue to see advantages in the MLP structure. However, the potential exclusion of income tax allowance into setting maximum cost of service tariffs may encourage some management teams to elect to convert (or consolidate) to the C-Corp structure. The recent elimination of the GP IDR structures for some large, diversified MLPs, coupled with the trend towards self-funding, has blurred the distinction between traditional C-Corps and MLPs. Additionally management teams, spurred on by a lack of investor sponsorship for the partnership structure, may elect to formally change their structure. In some cases, conversation can create access to a larger investor base by eliminating some institutional investor concerns. (No K-1s, improved corporate governance). This can be done without materially changing the way they operate or manage their cash flow (leverage, capital spending funding, distribution policy, etc.).

So who is most likely to convert? In the below exhibit we offer our perspective on which companies are most likely to convert, many through consolidation with a related party. It's worth noting that on a float capitalization basis, roughly 55% of the Midstream sector has already converted or is a 1099-paying entity. However, on an absolute basis MLPs still greatly outnumber C-Corps, with roughly 70% of the same sample structured as MLPs. At the moment, we see a greater than 50% chance that nine companies will undertake this conversion, and see another ten companies with a roughly 20% to 50% chance of conversion.

	Probability of Conversion (next 12-18 months)			
	Minimal (0%-20%)	Moderate (20%-50%)	Likely (>50%)	Existing C-Corps
	ANDX, BPL, BPMP, BWP CEQP, ENBL, EPD, GEL HEP, MMP, NBLX, NGL NS, PSXP, VLP	DCP, ETE, ETP, MPLX PAA, SEP, SHLX, SUN WES, WGP	AM, CQP, EEP, ENLK EQM, RMP, TCP, TEP WPZ	AMGP, CQH, ENB, ENLC GMLP, KMI, LNG, OKE PAGP, PBA, SEMG, TEGP TGP, TRGP, TRP, WMB
Float Cap*	*$73,433*	*$63,560*	*$24,957*	*$207,622*
Absolute	*15*	*10*	*9*	*16*

* -float capitalization in millions of dollars

Source: Eagle Global Advisors, Bloomberg

So that begs the question, how will it happen and how long will it take? The "how" is fairly straightforward. An MLP can convert outright, consolidate with a related party, or be acquired by a third party. We've long believed the Midstream space needs to consolidate, and now expect that it happens sooner rather than later. For Eagle, we believe the MLP structure will remain a part of the Midstream space, although we have always been structure agnostic and have consistently had Midstream C-Corps as part of our investable universe.

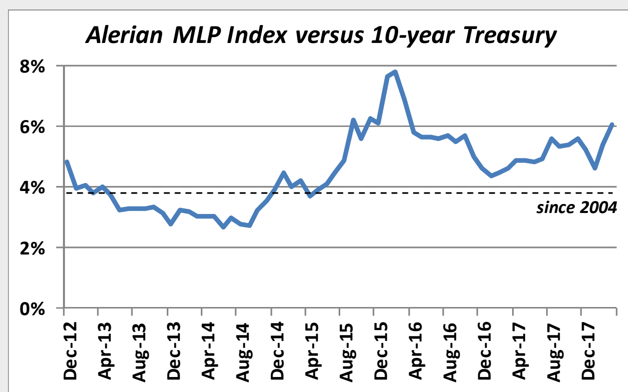
How Impactful Will FERC Proposed Policy Be On MLPs?

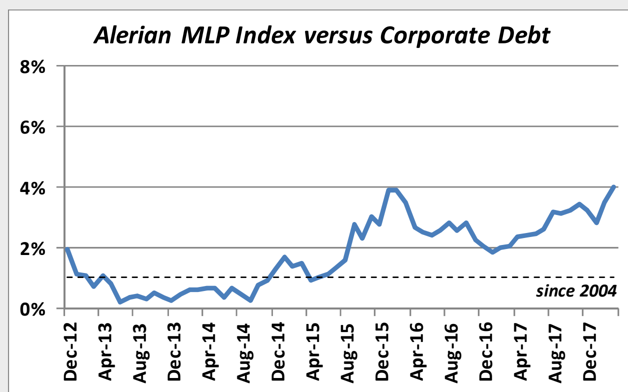
Our main grievance with FERC is that their recent actions show an underappreciation of why precedent was set in the first place, and an absence of resolve to minimize the impact such a change would have on the market. These regulatory issues may overhang the sector for some time, countering the notion that this administration is "pro-business" and "pro-infrastructure." At a sector level the change impacts MLPs with exposure to cost of service pipeline systems, some near-term (i.e., EEP), others over the next 12 months (i.e., natural gas), and some not for several years (i.e, oil, refined products, natural gas liquids focused companies). More specifically, Wells Fargo Research indicates the companies most impacted were EEP (16% of EBITDA), TCP (13%), DM (11%), SEP (6%), and WPZ (4%). With these numbers adding context, it's worth mentioning that the FERC only regulates interstate assets and there are a large number of Midstream companies that were unaffected by their actions. Even among those with interstate assets there are varying levels of exposure, with most indicating it was minimal. Furthermore, sentiment on the Street is that FERC's actions are unlikely to impact the way state regulatory agencies think in the near-term, as states are up to the task of evaluating issues independently and we would hope recognize the negative ramifications of creating long-term overhang on what is a healthy, functioning market.

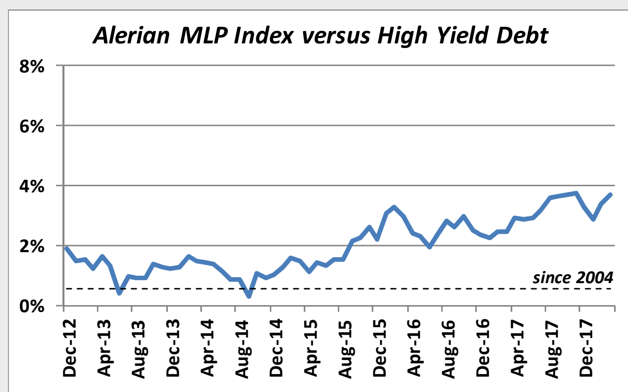
In the end, Midstream and every other sector in the market faces some level of regulatory risk. The potential for regulatory oversight of some previously unregulated technology stocks has recently caused significant waves in those sectors, where for Midstream this is much less a problem since the sector has successfully operated under regulatory scrutiny for many decades.

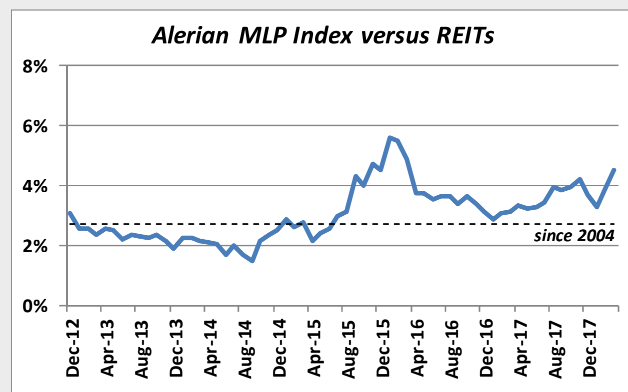
Why Buy Now? What Brings Investors Back To The Space?

A question we've been asked for the better part of three years. We believe current valuations are attractive, with both relative (EV/EBITDA) and yield-based methodologies suggesting stock prices do not reflect future cash flow growth expectations. For some time we've highlighted that Midstream fundamentals are favorable, certainly not a bubble market and well beyond the bear market that severely impacted the sector in 2015. Crude oil and natural gas volumes are setting records, commodity prices have recovered, and growth opportunities are out there. Also, the sector has made great leaps in its transition to independence and self-funding, with some now more attractively positioned than they've ever been.









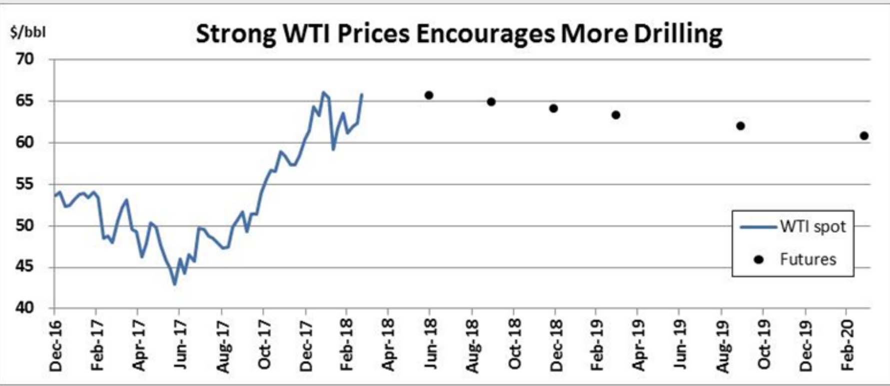
Source: Alerian, Barclays, Bloomberg, NAREIT

However, investor support for Midstream remains fleeting still well below what was experienced during the 2009-2014 bull market. So what brings investors back? It is our view that investors understand "known unknowns" and only fear "unknown unknowns". If investors believe a sector is full of "unknown unknowns" they will stay away until that fear subsides. Over the last several years the Midstream space

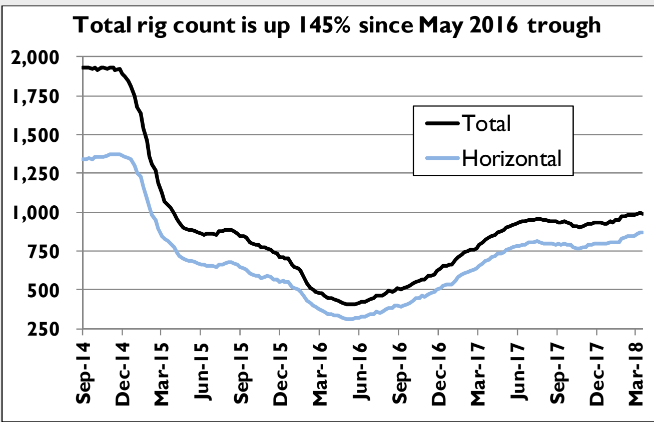
has been dominated by "unknown unknowns", with the latest example being the FERC's actions. Each time an "unknown unknown" occurs the sector is put back in the penalty box. It's a big reason why we believe some MLPs will gravitate towards C-Corps, because the idea is this change in structure may eliminate many of the "unknown unknowns". It is interesting to us that several years ago the private market became comfortable with Midstream's risk profile in such force that there still exists a sharp divergence between where the public and private markets are valuing similar assets. Like the private market has, we believe the public market is not far away from recognizing the solid fundamental value in the Midstream sector and that fundamentals will drive future value if in the near-term "unknown unknowns" are addressed.

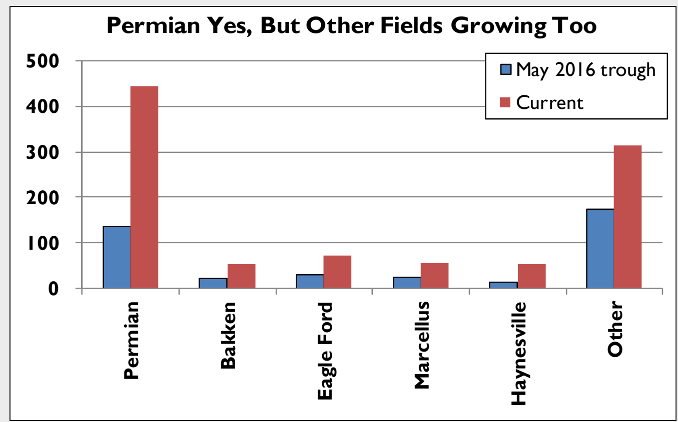
A Few Final Thoughts...

No surprise, the rig count continues its rise. With oil prices steadily increasing it is no surprise that the U.S. rig count continues its drive upward. In fact, early in January and again at the end of March Brent oil prices were above $70/barrel, a level not seen since December 2014. As a result, the U.S. rig count has risen a remarkable 145% since its May 2016 trough, and while the Permian Basin has enjoyed the bulk of this growth there is optimism in all the other major U.S. fields (see below exhibits). With oil prices in backwardation, producers are motivated to deliver volumes to the market today versus storing for later. While different parts of the Midstream chain have varying levels of exposure to these energy market nuances, in its most basic sense energy stocks typically rise when oil prices rise. While this cycle has seen historical correlations break down, we believe that over the long-term market fundamentals and sector valuations will converge.



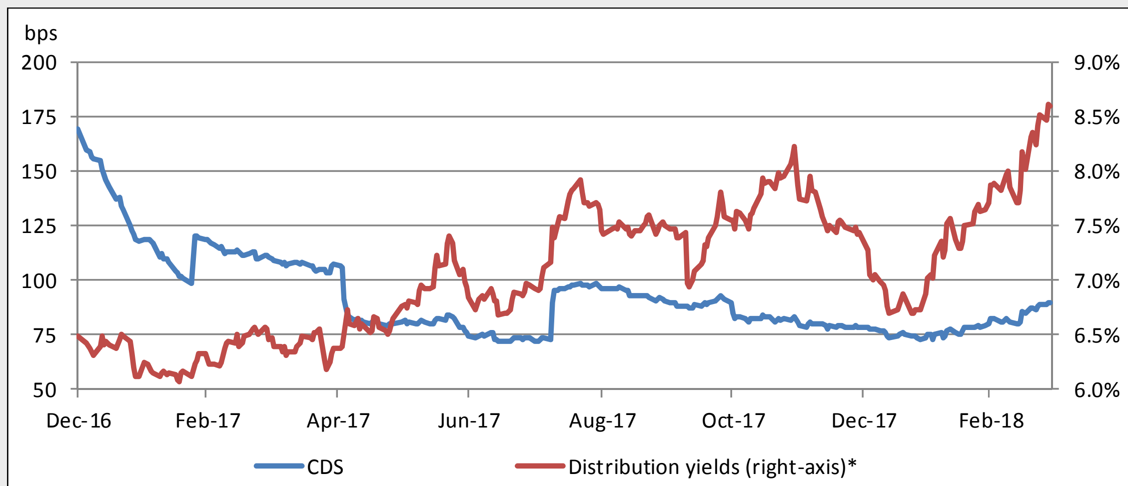
Source: Bloomberg





Source: Baker-Hughes

Equity / Debt risk continues to be uneven, though recently correlated. As shown in the below exhibit, equity yields continue to assume the sector is materially more risky than the credit markets. Since mid-January, equity yields have moved higher at a much faster rate than credit spreads have, once again signaling a disconnect between equity and credit markets. We continue to believe that as "unknown unknowns" dissipate stock prices will rally and bring equity yields back to their historical norms.

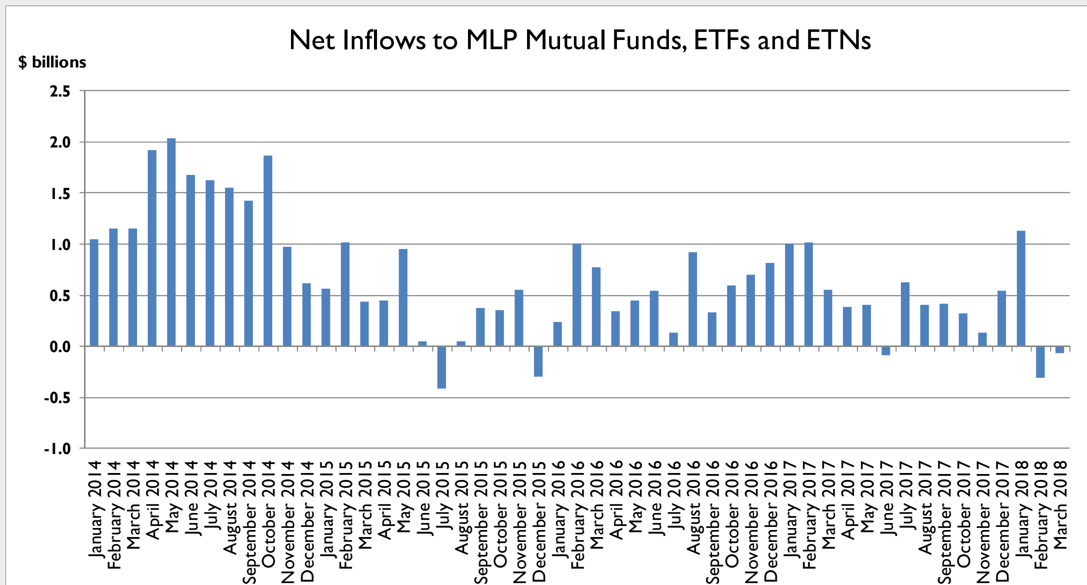


Source: Bloomberg

Access To Capital, Fundraising, And Cost Of Capital

Like the old saying about March, the first quarter came "In like a lion, and went out like a lamb". January experienced net inflows to public Midstream focused funds of roughly $1.1 billion, the highest level since October 2014. This helped support several successful secondary equity offerings including ONEOK's (OKE) $1.0 billion deal. We believe inflows were a snapback from the sector being oversold on tax reform fears and the technical tailwind of tax loss harvesting reversals. Fund inflows, however, turned out to be short lived as inflation/interest rate fears in February and the FERC action in March took over. In fact, February's $305 million of outflows were the largest since July 2015, followed by outflows of $68 million in March.

Looking forward, we believe capital markets and sector inflows will remain constrained until investors regain confidence in the sector. We are optimistic in the potential of sector inflows with the multi-year high monthly January inflow a sign that there is massive pent up demand just waiting for the right time to reinvest in the Midstream sector. With access to capital becoming less important, increasing clarity on recent FERC actions, and the rising probability of MLP-to-C-Corp conversions, the number of "unknown unknowns" is declining. We believe there will be a tipping point, when reward meaningfully exceeds risk and investors buy into a sector that on its core fundamentals is strong and healthy.



As of 3/29/2018; Source: U.S. Capital Advisors

MLP 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 attended several Midstream conferences and company analyst days in the first quarter and have a busy conference and analyst day schedule in the current quarter as well. We continue to have interactions with insiders beyond our Midstream skill set; prudent given our view that we are in the early stages of an energy upcycle and see data points collected outside of Midstream necessary in helping us evaluate our Midstream investments.

We thank you for your continued patronage of Eagle Global Advisors. We believe the long-term return outlook for MLPs remains attractive, and we look forward to communicating the results of your investment in an Eagle managed MLP account next quarter.

- The Eagle MLP Team