Quarterly Commentary
Q2 2018

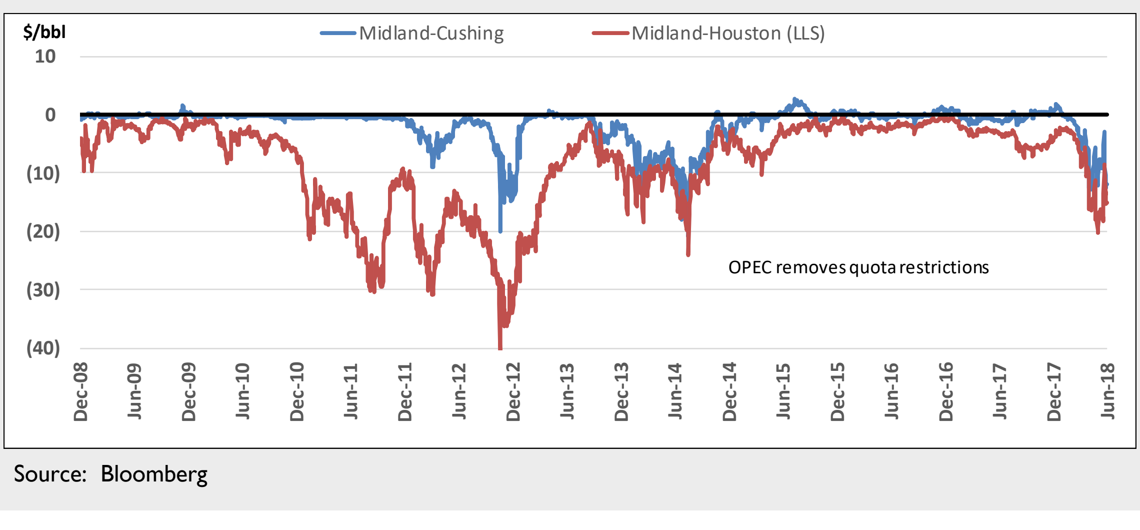
EGA Energy MLPs and Midstream Companies

GOOOOAAAAAALLLLLLL!!!!!!!!

A word that has been heard across offices and sports bars alike these last few weeks. The dynamic of sport, where the outcome can be difficult to accurately forecast, got us thinking about the midstream sector, which has not performed as expected these last several quarters. Our view, (we'll call it the Bull Case), was rooted in a forecast of improving commodity prices, improving asset utilization, and the development of price differentials while the market (Bear Case) remained focused on negative sentiment and uncertainty surrounding the MLP structure, capital market access, and the resulting sustainability of the current distribution. We thought that, over time, fundamentals would win over sentiment and these risks would be adequately addressed by management teams. While one quarter doesn't make a trend, it seems to us that the Bear Case is losing steam. We'll call it an Extra Time win.

Energy Price Differentials Are The Pulse Of The Midstream Business

We attended a general energy conference (non-midstream specific) in mid-June and were surprised to learn how focused energy investors were on Permian Basin basis differentials, specifically the difference in oil price between Midland (West Texas) and the storage tanks in Cushing, Oklahoma or the refining/export center in Houston, Texas. We had forecasted differentials to widen, but it was interesting to see producers and oil services worried about Permian capital expenditures in a world of lower spot netback prices. It has been some time since midstream was the Belle of the Ball, so we were happy to answer questions from all corners of the energy world: What is the max capacity of XYZ pipeline? When will ABC pipeline be in service? What other ways can midstream take oil away from the Permian? It seems suddenly the energy world rediscovered the value of midstream.



Source: Bloomberg

Basis Differentials Aren't A Problem, Until They Are…

The concept behind basis differentials is actually quite simple. When pipeline flows reach maximum capacity, the field price must decline until the difference between the field price and the demand center price matches the cost of the next available transportation method (usually rail or truck). As the Permian rig count increased dramatically over the last few years, production volumes started catching up to available pipeline capacity. Since pipelines take more time to build than wells take to drill, production can quickly surpass midstream's ability to build the necessary infrastructure. That's where we are for at least the next several quarters in the Permian Basin.

So what happens now? Based on past experiences, large basis differentials can have far reaching effects: pipeline expansion / new pipelines will be examined, E&P capital will flow to other basins, fees for storage will increase, midstream companies regain leverage during tariff negotiations, and marketing companies generate outsized (albeit temporary) profits. Based on events over the last several years, midstream management teams have become more risk averse, and are therefore more reluctant to build pipelines on speculation. As capacity limits are reached, producers become more willing to sign long-term contracts to support the construction of new pipelines. While there are multiple proposals for new pipelines out of the Permian Basin, the current environment could provide the incentive for producers to sign binding commitments.

With a typical build period of 1-2 years, signing up for a new pipeline doesn't help producers in the near-term. Therefore, existing pipelines with either existing spare capacity or contracts coming due gain some negotiating leverage. Any leverage is good as it allows midstream management to trade tariff for contract term, thereby securing long-term cash flows that ultimately support distributions.

One lever producers can pull is to simply slow development in the Permian Basin. Preliminary data suggests the Permian Basin rig count has peaked. With oil trading well above $70/barrel, we believe producers are still incentivized to grow production and will therefore divert capital to other fields that don't have takeaway capacity issues. Oil service companies are being asked about their equipment inventory outside the Permian, and how much time and capital it would take to move equipment to other fields like the Eagle Ford, Bakken, DJ Basin, and parts of Oklahoma.

	Drilling Rig Count			April 27 to	May 25 to
	April 27	May 25	June 29	May 25	June 29
Permian	452	478	474	26	(4)
Bakken	56	57	54	1	(3)
Cana Woodford	70	73	74	3	1
DJ-Niobrara	21	25	26	4	1
Eagle Ford	75	78	80	3	2
Granite Wash	11	14	16	3	2

Source: Baker Hughes

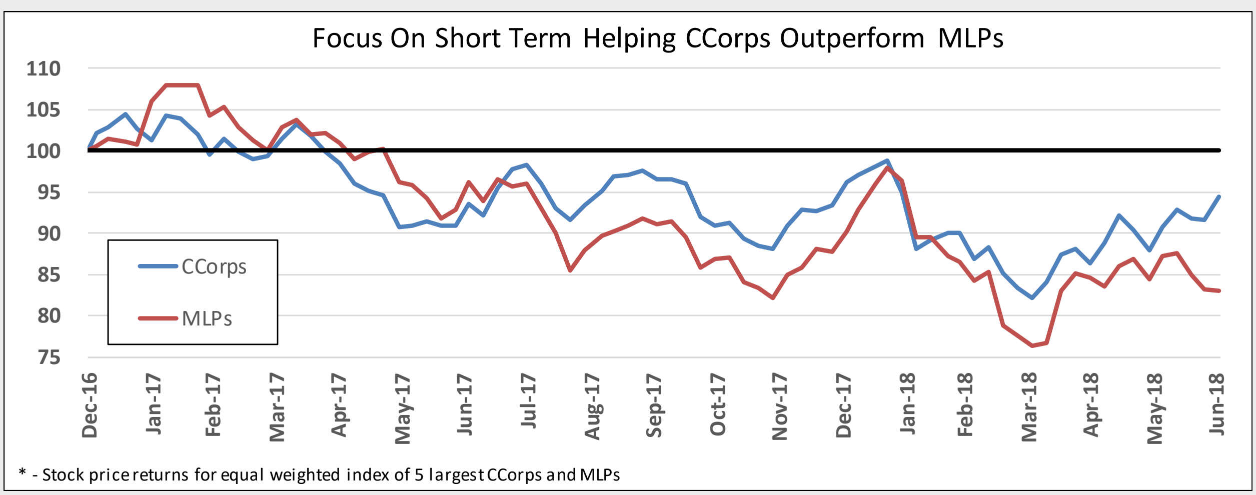
Midstream companies with oil storage should also benefit as producers must store the oil that can't be transported to demand centers. Perhaps inland storage investment will come on top of the significant coastal storage that's being developed today to support export markets. Where storage grows supporting infrastructure usually comes with it.

Finally, marketing companies should generate outsized profits until takeaway capacity catches up to production, a reversal of the trend of the last 3-4 years. It wasn't too long ago that marketing margins were essentially zero as producers who didn't have the volumes to meet their take-or-pay contracts bid down spreads in order to lose less money. We expect midstream management teams to utilize cash flows generated from marketing margins to help fund growth capital spending, accelerating the self-funding trend.

We view that a vast majority of the outcomes from basis differentials blow outs are positive for midstream. Combine this with MLP 2.0, where companies are financially stronger than they've been in a long time - distribution coverage ratios are higher, debt leverage is trending lower, and equity burdens are significantly lower than in recent years – and it's easy to see why we remain positive on the investment opportunity for midstream.

An Update on C-Corp Conversion and The Future Of MLPs

Some investors have questioned the long-term viability of the MLP structure but after talking to many management teams it seems its demise has been greatly exaggerated. Some management teams expressed the opinion that companies that are converting to C-Corps are doing so because of a short-term need for large amounts of capital. A quick look at stock price performance of C-Corps versus MLPs supports this theory (see exhibit below). For those who've already evolved into MLP 2.0, there is simply no near-term demand to convert and so they see no reason to rush any decision. Also repeated often was the implicit long-term advantage MLPs have over C-Corps, in that eventually C-Corps will pay tax and MLPs will never have to. We made this point in December, that tax reform lowered the tax advantage MLPs had over C-Corps though a 0% tax rate is still better than a 21% tax rate. We think it's entirely possible that down the road MLP and C-Corp valuations will normalize to account for the difference in future tax liability partially offset by a premium associated with a larger potential investor base.



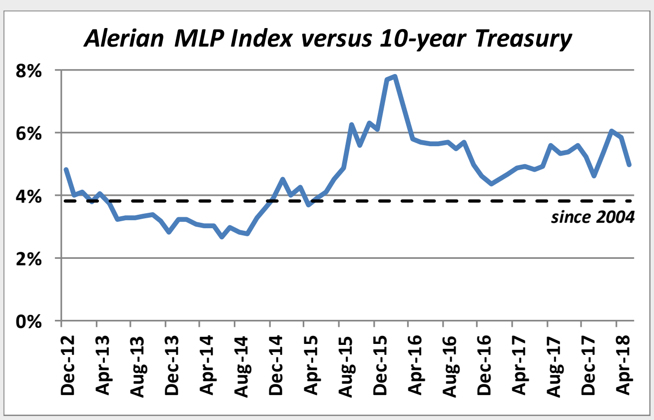
Source: Bloomberg

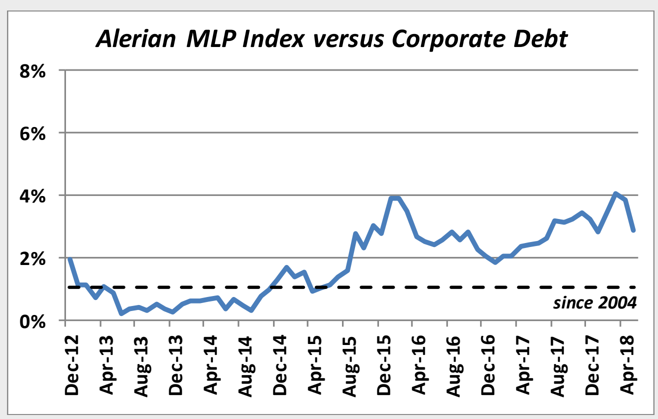
We should also be sure to distinguish the C-Corp conversion trend from the simplification trend. Simplification (i.e., the elimination of the Incentive Distribution Right payment to the General Partner) can go a long way toward solving cost of capital issues, and many MLPs have gone down this path to much success. While we haven't seen one yet, we think it is inevitable that a future MLP IPO will occur without the Incentive Distribution Rights (IDRs) structure. In our last Quarterly Commentary we wrote "we believe the MLP structure will remain a part of midstream, although we have always been structure agnostic and have consistently had midstream C-Corps as part of our investable universe", which some interpreted as Eagle Global lacking confidence in the structure. We'd like to clear the air and say that our faith in the MLP structure remains strong, and attribute any questioning of the structure as merely near-term forces overwhelming long-term logic.

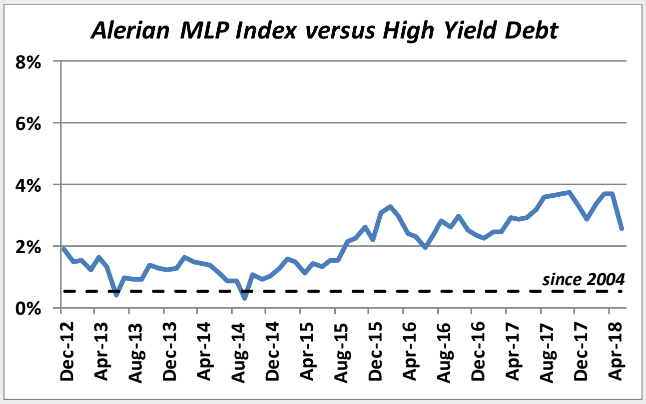
A Few Final Thoughts…

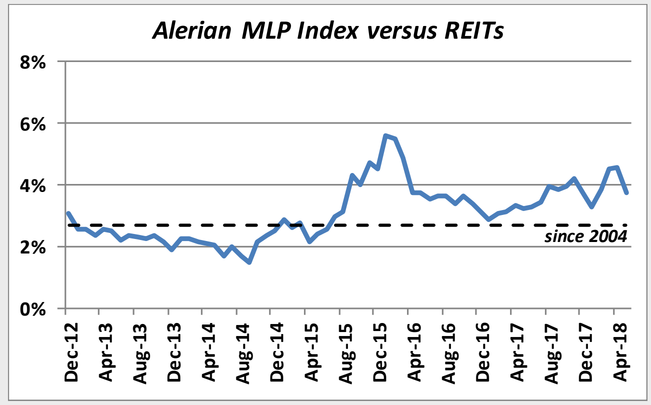
What brings investors back to the space? Last quarter we partially answered this question by saying that when investors' fears about potential "unknown unknowns" subside will be the point when investors come back to midstream. That view was expressed following the latest "unknown unknown", the FERC's policy reversal regarding income tax allowance. However, that concern did not last nearly as long as some expected as investor perception quickly (and accurately) identified the handful of companies that were most impacted. Also, management teams' unexpected quick response to the issue (Enbridge Inc. and Williams Companies simplification, for example) seemed to refocus the investor base back to individual company fundamentals.

One quarter does not make a trend, but MLP Yield spreads are converging. As shown in the exhibits below, the recent sector rally has made some progress in closing the gap in valuation spreads. If our earlier observation that market participants are recognizing strong fundamentals is accurate, equity valuations should continue to improve to levels more consistent with long-term spreads. Another set of graphs our readers will recognize is MLP yield spreads over comparable instruments.





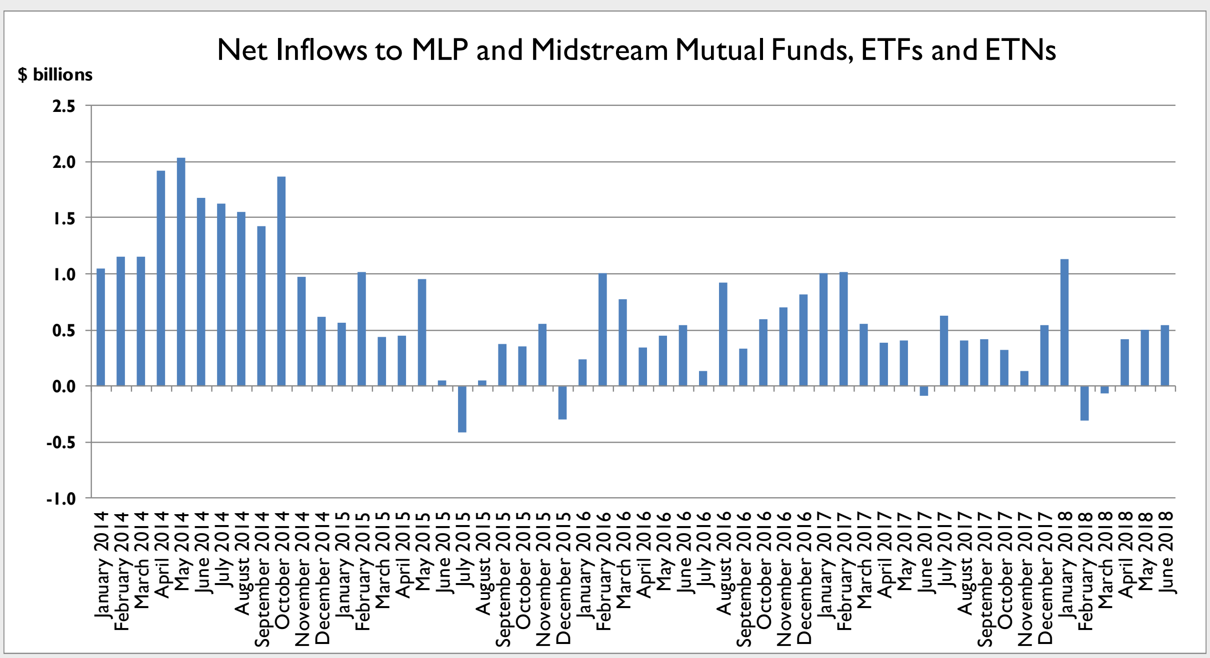




Source: Bloomberg

Access To Capital, Fundraising, and Cost of Capital

After a topsy-turvy first quarter for capital flows, the second quarter saw calmness return with net monthly inflows averaging just under $500 million. While not as high as the January inflow of $1.1 billion, the month-to-month consistency of the second quarter's inflows is promising. In addition, and as we detailed earlier, these inflows entered a market bereft of new common equity offerings. With common equity markets unburdened by new equity offerings, consistent month-to-month inflows applied consistent upside pressure to existing stocks and may have played a role in the quarter's stock price performance. That's not to say that MLPs no longer require equity, just that for the time being they're looking towards other means. For example, three MLPs (Energy Transfer Partners/DCP Midstream/NuStar Energy) leaned on the preferred equity market to the tune of roughly $1.2 billion to help finance growth and improve debt leverage. That said, midstream's equity burden is far lower than in recent years. Through the first half of 2018 capital raised from primary common and preferred equity offerings, and third party private placements was $4.9 billion, well below the average of $14.7 billion of the prior three years.



As of 6/29; Source: US 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've observed a positive change in investor sentiment over the course of the many conferences we attended in the second quarter, and are excited about the second quarter earnings season as our universe's management teams continue to execute strategic initiatives in a fundamentally sound market. We highlight our team's interactions with insiders beyond our midstream skill set that this quarter helped put the recent Permian Basin basis differential blowout into perspective.

We thank you for your continued patronage of Eagle Global Advisors. We believe the long-term return outlook for midstream 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

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