EAGLE GLOBAL ADVISORS

Quarterly Commentary
Q4 2017

EGA Master Limited Partnerships

From the EGA Portfolio Management Team

Necessity Is The Mother Of Invention

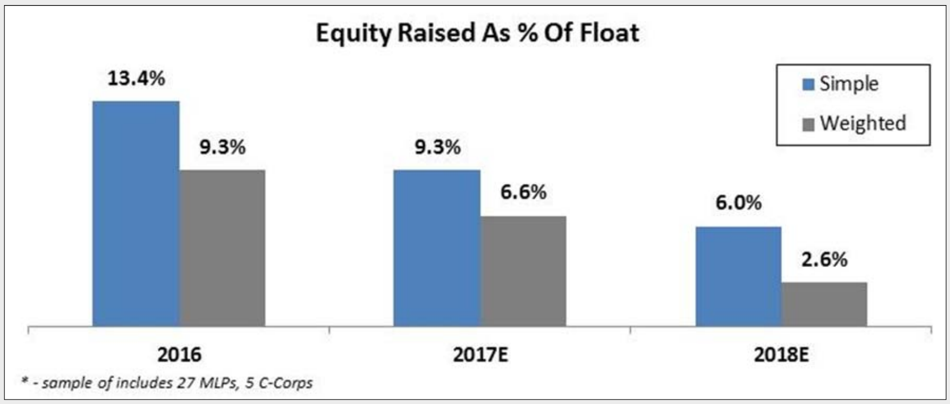
We predicted a return to MLP normalcy at the beginning of 2017 as regulatory and fundamental headwinds within our sector subsided amidst a broader market that was powering higher. Energy producers had right-sized operations to account for weaker commodity prices leading to an environment of slowly rising volumes in core fields and green shoots in others. It was within this context we saw Energy Infrastructure benefitting as operating leverage pushed cash flows higher creating a cure-all for already improving balance sheets and coverage ratios. But the Alerian MLP Index declined 6.5% in 2017. Historically MLP's had been frozen out of equity capital markets for only limited, short time periods and they typically dealt with this limitation by waiting for the equity market to thaw. In the current cycle that began in late 2014, the freeze has lasted significantly longer as equity investors have focused on debt leverage and distribution coverage at the expense of distribution growth. With reduced access to capital, necessity is driving invention in Energy Infrastructure.

The result is a new Energy Infrastructure company, characterized by simplicity and substantially less reliance on the equity capital market. Distribution growth will remain subdued near-term, though we forecast long-term growth will return Energy Infrastructure to its lead position among income generating sectors. We see immense value at current levels as the market has yet to appreciate just how far along the paradigm shift is, and for that reason we are optimistic about 2018.

We've Come A Long Way, Baby!

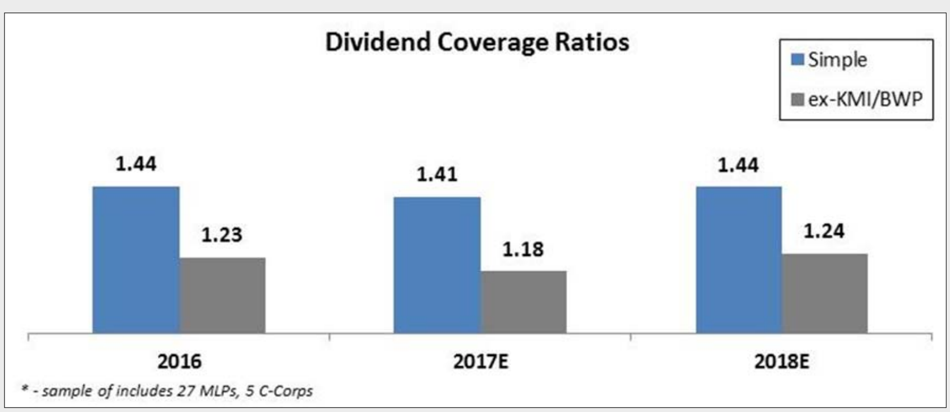
The last time the Energy Infrastructure paradigm shifted this meaningfully was when Congress passed the American Jobs Creation Act of 2004, which added MLP income to the list of acceptable sources of income for mutual funds (with some conditions). This rule change created an influx of capital that allowed MLP management teams to finance increasingly larger growth projects with equity and debt offerings, further justifying the dedication of almost all existing cash flows to distributions. This major shift was well timed as it began a virtuous cycle of fund raising and cash flow growth at the beginning of a decade of strong oil prices and investor enthusiasm. The model broke down in 2014 as a supply-driven oil price recession caused producers to reduce drilling activity and greatly lowered U.S. volume growth expectations. With the cost of equity capital on the rise, the prior virtuous cycle was replaced with a negative investor feedback loop. With no visibility on when MLP's access to capital will return, management teams were presented with a "Sophie's Choice" with most choosing (some forced by debt rating agencies) to transition to a self-funding strategy. Our analysis suggests the paradigm shift is further along than current market valuations imply.

The declining equity burden. While downturns typically hit the entire vertical, there are some businesses that inherently take longer to belt tighten than others. Energy Infrastructure fits into this category as infrastructure projects are very difficult to scale back once started, and the sector is forced to raise capital in an unenthusiastic market. The good news is the equity burden for Energy Infrastructure declined significantly in 2017 and we expect it to take another leg down in 2018. Using a sample of 32 of the largest midstream MLPs and corporations, equity raised in 2016 was 13.4% of float capitalization. In 2017 this declined to 9.3% and we forecast in 2018 it will fall further to 6.0%. On a weight-adjusted basis the decline is more impressive, suggesting the largest Energy Infrastructure companies have almost no required equity burden in 2018. Also, in 2016-17 there were 8 companies on our list that had no equity burden, and in 2018 we expect this to jump to 14 companies.



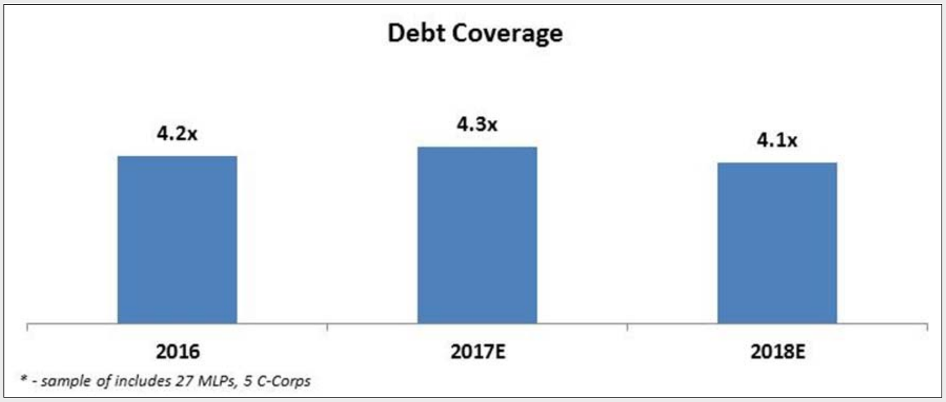
Source: Company data, Eagle Global Advisors

Corporate actions created noise in 2017, though sets up 2018 quite well. Distribution coverage slipped in 2017 versus 2016, though are still meaningfully higher than 2014 (1.30x) and we expect them to rise again in 2018. We believe capital market access and pressure from rating agencies were the major drags on 2017, which in turn pushed management teams to proactively address issues. Distribution cuts, simplifications, and other corporate actions confirmed fears but at the same time put the sector on more solid footing for 2018. With the noise out of the way, coverage ratios are set to move higher in 2018 and beyond. We predict the number of companies with coverage below 1.1x will be only 6 in 2018, down from 10 in 2016 and 7 in 2017.



Source: Company data, Eagle Global Advisors

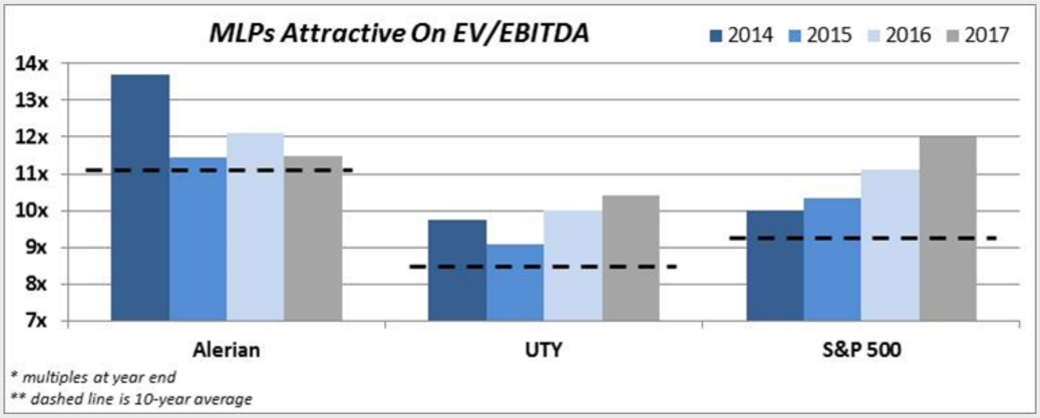
Similar to distribution coverage, we are seeing a similar trend in debt coverage. Once again, corporate actions freed up cash while new assets are starting to deliver cash flows, which together should have a marked improvement on 2018 debt coverage. These positive trends are occurring in a market where equity burdens and overall dependence on external capital markets are falling. We expect leverage to continue decreasing in 2019 and beyond, thanks largely to the new Energy Infrastructure paradigm.



Source: Company data, Eagle Global Advisors

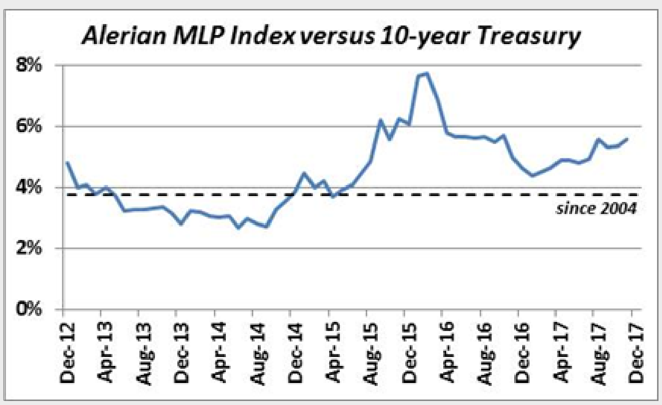
Simplification is nearing the halfway point, a potential boon for Energy Infrastructure investors when the cycle turns. Among the 32 Energy Infrastructure companies in our survey, 14 have eliminated or announced they will do away with the burden of the general partners' Incentive Distribution Rights (IDRs). In the fourth quarter, MPLX (MPLX) followed through on an earlier announcement by releasing terms of its simplification agreement while Spectra Energy Partners (SEP) indicated plans to buy its IDRs from its sponsor Enbridge Inc. (ENB). At this point, of the top 10 largest companies in our survey (roughly $177 billion of float cap), only Energy Transfer Partners (ETP) has yet to eliminate its general partner. This large-cap skew is not a surprise as the IDR burden on the largest companies is greater than on smaller companies. However, we believe the writing is on the wall for this component of the MLP structure and expect more companies to follow suit in 2018. We are strongly in favor of this trend, as we believe the simpler structure and the elimination of the GP burden is more investor friendly, while enhancing growth and competitiveness at the limited partner level.

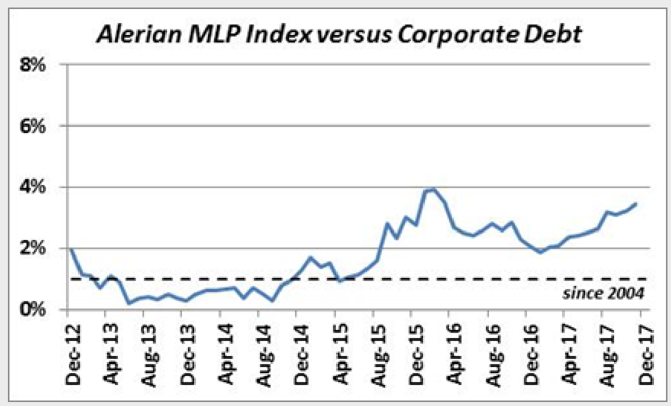
Valuation attractive on EV/EBITDA and yield. Using the Alerian MLP Index as a proxy, the sector screens attractive on both EV/EBITDA and yield relative to the S&P 500 and the UTY (a market cap-weighted index composed of geographically diverse public utility stocks). The MLP Index is trading near its 10-year average multiple of 11.1x, while the S&P 500 and UTY are trading at a 22% and 29% premium, respectively. In addition, the MLP Index is trading at an only 10% premium to the UTY, versus its historical 31% premium. We understand the paradigm has shifted for Energy Infrastructure, though we highlight it is the financial construct and proposition that has changed, not its long-term cash flow growth prospects.

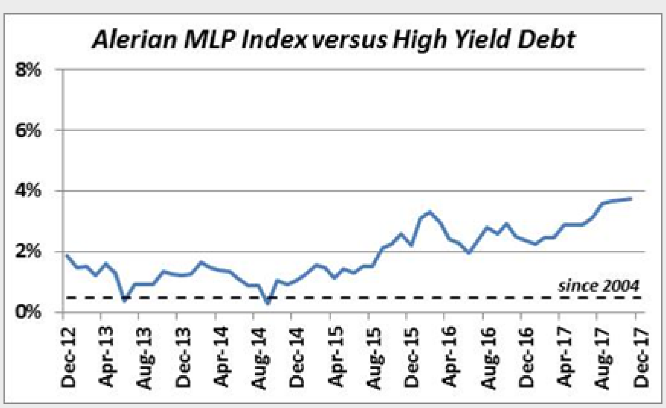


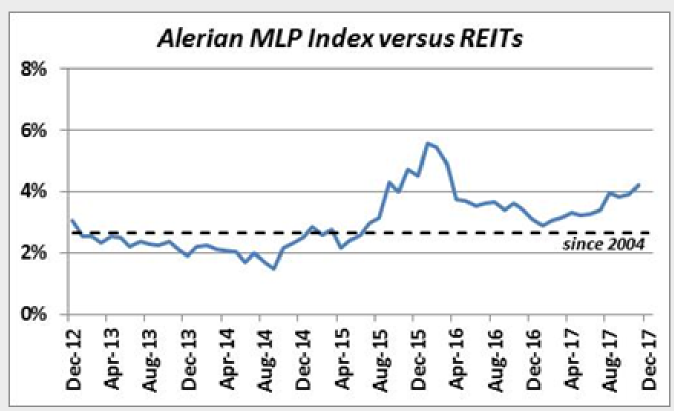
Source: Bloomberg

On a yield basis, the MLP Index's spreads over comparable securities also implies inexpensive valuation. Over the course of 2017, the relative attraction of MLPs has only continued to get more compelling. We believe yield comparisons continue to be highly relevant as many investors focus on income generation, and we believe that once confidence is restored income-oriented investors will be compelled to buy.









Sources: Alerian, Barclays, Bloomberg, NAREIT

A Few Final Thoughts...

Tax Reform Happened, Positive Outcome to MLP Investors. The Tax Cuts and Jobs Act was passed in December, paving the way for the first major tax overhaul in more than 30 years. We believe tax reform was a significant overhang on Energy Infrastructure in the second half of 2017, though we view the final bill as being very positive to MLP investors and neutral to the sector itself. While there are many components of the legislation, we highlight our main takeaways:

- No change to the tax treatment of partnerships, in that a MLP does not pay corporate level federal income taxes. (Positive)
- Pass through income earned from pass through entities (i.e., MLPs) could be taxed at an effective max rate of 29.6%, down 20% from current max income tax rate of 39.6%, through December 31, 2025. (Positive)
- The corporate tax rate is lowered to 21% from 35%. While positive for the increasing number of midstream companies organized as corporations, MLP's tax advantage relative to corporation decreases by 1-2%, negligible in our view. (Neutral)
- Businesses will now be able to fully and immediately expense 100% of the cost of qualified property acquired and placed into service through 2022. As Energy Infrastructure is very capital intensive, this should allow for a greater tax shield. (Positive)

We expect the exact impact of tax reform will take some time to completely flesh out. Our initial take is the bill will have a negligible impact on the Energy Infrastructure sector but is positive for investors due to lower tax rates on pass through income and a greater tax shield.

There are also benefits associated with subsiding tax reform fears, which can be seen in sector statistics and recent stock price performance. In early-to-mid December it became apparent that tax reform was not going to have a negative effect on Energy Infrastructure. While hard to prove causation, we wanted to highlight that from December 12th to year-end the sector has benefited from an impressive $620 million of net inflows. In addition, the Alerian MLP Index rose 5% in December 2017, notching its best monthly return since June 2016. As fundamental investors, we think a combination of the negligible impact of tax reform, ongoing positive trends in energy, the conclusion of tax loss harvesting, and attractive relative valuation all played a role in the recent strength in stock prices.

Access To Capital, Fundraising, and Cost of Capital

The fourth quarter was noisy and tumultuous as several issues came to a head. A fitting final chapter in a year that actually began quite promisingly. Our optimism regarding 2017 was rewarded in January with the index up almost 5%. However, Enbridge Energy Partners' (EEP) unexpected distribution cut led to renewed investor consternation on debt leverage and equity capital market access, compounded later in the year by another major distribution cut by Plains All American Pipeline (PAA). For the second time in three years, investors felt betrayed by the implied promise of distribution payment / growth by the Energy Infrastructure sector, further impacting access to equity capital markets and accelerating the paradigm shift. In a sour mood, the market rejected the initial price range of the BP Midstream Partners (BPMP) IPO and forced other small-cap MLPs to pull back entirely from equity financing plans.

Meaningful events in the fourth quarter include the aforementioned IPO of BPMP in late October, which priced 10% below the midpoint of the initial range ($19-$21) and closed below deal price on its first day of trading. Separately, TransMontaigne Partners (TLP) attempted to raise $100 million of equity in early November to help finance the purchase of two terminals, though had to pull the deal saying "equity market conditions are not conducive for an offering on terms that would be in the best interests of the Partnership's unitholders." Finally, management teams in need of equity had to engage the preferred markets, as they searched for liquidity and recognized the impact common equity offerings would have on their cost of capital. In the fourth quarter, just over $4 billion of preferred equity (versus $800 million in the first three quarters) was raised by a wide range of companies including Plains All American Pipeline (PAA), Energy Transfer Partners (ETP), DCP Midstream (DCP), NuStar Energy (NS), Andeavor Logistics (ANDX), Golar LNG (GMLP), and Summit Midstream (SMLP).

Looking forward, we believe MLP equity capital markets will remain constrained until investors perceive debt leverage and distribution coverage improving to levels that allow self-funding. Despite the progress most companies have made, we still see a few companies at risk of distribution cuts, either outright or through GP / LP simplification. However, for the most part these stocks have already priced in a cut, so we do not anticipate these negative events will be a contagion for the rest of the Energy Infrastructure universe.

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 remain in constant dialogue with industry experts and management teams. We attended multiple Energy Infrastructure conferences in the fourth quarter, expect to attend several others in the first quarter, and continue to have interactions with analysts and managements teams both within the Energy Infrastructure space and with those around it. We believe this is prudent given our view that we are in the early stages of an energy upcycle, and see data points collected outside of the Energy Infrastructure sector as necessary in helping us evaluate our 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