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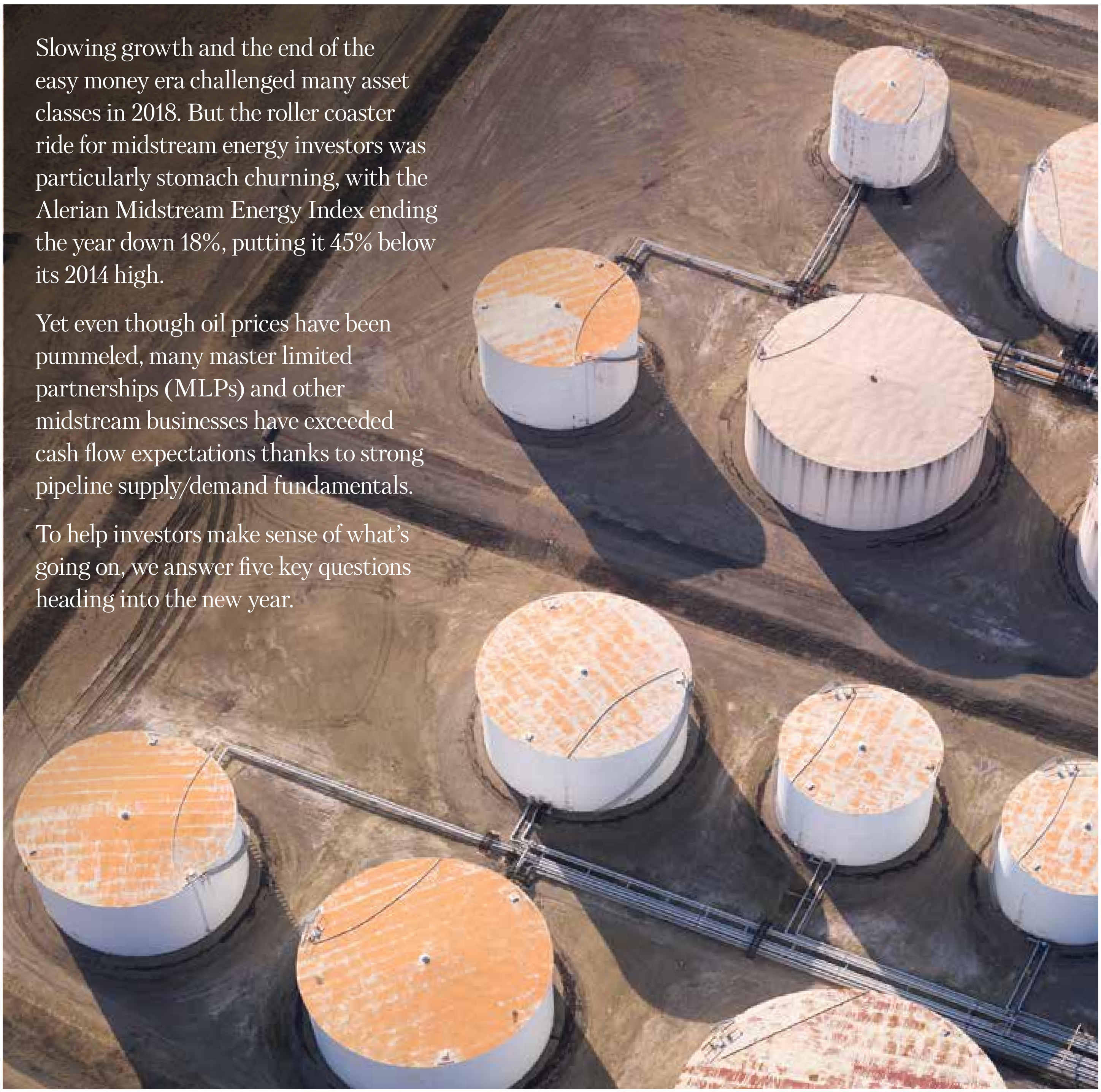
5 Key Questions for Midstream Energy in 2019

Tyler Rosenlicht, Head of Midstream Energy & MLPs, Portfolio Manager

Slowing growth and the end of the easy money era challenged many asset classes in 2018. But the roller coaster ride for midstream energy investors was particularly stomach churning, with the Alerian Midstream Energy Index ending the year down 18%, putting it 45% below its 2014 high.

Yet even though oil prices have been pummeled, many master limited partnerships (MLPs) and other midstream businesses have exceeded cash flow expectations thanks to strong pipeline supply/demand fundamentals.

To help investors make sense of what's going on, we answer five key questions heading into the new year.



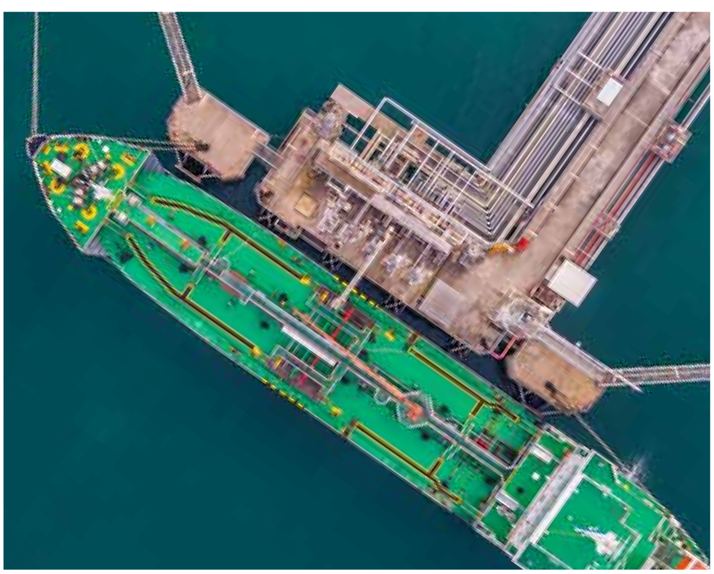
1

Why was 2018 so challenging, and why should 2019 be different?

It seemed the past year was a game of 'Whack-a-Mole' for the midstream sector. Every time it began to rise, a sentiment killer surfaced: rising interest rates, the Federal Energy Regulatory Commission's ruling on the tax treatment of MLPs, some poorly received mergers and distribution cuts, a Colorado ballot initiative aimed at curtailing drilling activity, declining crude prices, and finally tax-loss selling. These headlines overshadowed an otherwise strong fundamental environment.

In 2018, the U.S. became the world's largest producer of crude oil for the first time since 1973, while the Energy Information Administration (EIA) projected that U.S. production of crude oil, natural gas and natural gas liquids (NGLs) could rise between 20% and 30% through 2022. In addition, significant pricing differentials—which signal constraints in pipeline capacity—materialized across North America, representing another positive driver for midstream cash flows.

This combination of poor stock-price performance and strong underlying earnings trends has left cash flow multiples at near-crisis levels, roughly 20% below our estimate of intrinsic fair-market value.[1] It may take time for investors to realize that value, but we believe this kind of upside potential, along with strengthening fundamentals and a history of low equity correlations, should be attractive.



2

What does it mean to be "energy independent," and how is that good for midstream?

Contrary to popular opinion, U.S. energy independence does not mean America will produce enough to shut its borders and retreat from global trade. The U.S. will likely produce more than it consumes, but not necessarily the right mix of products. That creates opportunities for U.S. energy exports, which we are already seeing in liquefied natural gas (LNG). North America's abundant excess natural gas production is currently being exported to Europe and Asia as a replacement for coal-fired electric generators. We believe these exports represent an important opportunity for midstream companies that develop and own the infrastructure assets that facilitate this trade. Beyond LNG, the U.S. continues to set records for exports of crude oil and other energy commodities.

3

What do price differentials tell us about tomorrow's infrastructure needs?

Commodity price differences between two locations—called price differentials—are often a meaningful sign of how energy flows are evolving and where there are bottlenecks in infrastructure. The past year has seen wide and often volatile differentials. For instance, in September, when crude oil was trading at $75 on the Gulf Coast, producers selling in the Permian Basin (West Texas) were receiving only $51. Only 500 miles separates these two locations, and pipeline tariffs are typically $2—so this $24 difference was a clear sign that existing pipelines were full, and that a lot of crude oil had to be shipped at higher costs by rail and truck.

Wide differentials are generally good for midstream companies. In these situations, pipelines tend to operate at full capacity, and firms that operate logistics assets such as trucks and rail loading facilities can earn outsized profits in the short term. In the long run, midstream companies may build new pipelines with long-term contracts offering attractive returns on investment, which is how the sector has historically created value over time.

(1) Current valuation of 9.1x EBITDA for the Wells Fargo MLP Index at 12/31/2018, compared with our fair value estimate of 12–13x based on multiples of recent private equity transactions.

4

How far are we on the path to Midstream 2.0?

We've published several papers over the past year about how midstream companies are simplifying their business models. This trend was catalyzed by the collapse in energy prices in 2014–15, which exposed the old MLP models as having misaligned management incentives, weak corporate governance and a heavy reliance on access to capital.

Having learned their lesson, most midstream companies have taken steps to become more self-sustaining—removing dual share class structures, eliminating burdensome incentive distribution rights (IDRs) that give general partners (GPs) an increasing share of cash flows, and aligning boards of directors around one set of investors. The result has been improved corporate governance, with a focus on return on invested capital. We call this new era for the industry "Midstream 2.0."

We are almost complete with the announcement phase of these changes and are now moving to the execution phase. We believe investors will eventually wake up to the improvements that come with Midstream 2.0—namely better managed, more stable business models that are less dependent on capital markets. We believe these changes should produce better outcomes for investors over the long run.

5

Will midstream continue to trade with oil prices and credit spreads?

What we saw in 2018, like before in 2015, is that when energy prices and capital markets become volatile, midstream correlations to both crude oil prices and credit spreads tend to rise in the short term. Though this can be frustrating for investors, there are good reasons for it.

Changes in commodity prices generally have minimal direct bearing on the long-term contracts between pipeline operators and upstream and downstream companies. However, as commodity prices become more volatile, energy throughput volumes become less predictable, increasing uncertainty in midstream revenue forecasts. Furthermore, movements in credit spreads can make customer credit risk a larger factor for investors.

We believe correlations to these factors should subside over time. The energy exploration and production industry is much better capitalized than it was in 2015, and advancements in shale extraction have improved drilling prospects, potentially reducing both counterparty and volume risks. And as more midstream companies simplify their business models, it should lead to stronger balance sheets and substantially less need for outside capital to fund projects. We believe this will eventually alleviate the midstream industry's dependence on credit markets.

The New Business Model

Midstream 1.0	Midstream 2.0
Complex structure (GP/LP with IDRs)	Simplified structure (no IDRs)
Weak alignment of shareholder interests	Greater shareholder alignment
High leverage	Lower leverage
Maximized distribution growth / greater risk of distribution cuts	Higher distribution coverage / lower risk of distribution cuts
Asset buying to drive IDR payouts	Focus on core assets and return on invested capital
Frequent, dilutive equity issuance	Stock buybacks

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For further analysis of the shift to Midstream 2.0 and other market trends, visit our **MLP insights page**.

Index Definitions

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. The Alerian Midstream Energy Index is a capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities. The Wells Fargo MLP Index is a capitalization-weighted index of energy MLPs with market capitalizations of at least $200mn at the time of inclusion.

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