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The Midstream Energy Cycle Has Turned: Time to Buy

Tyler Rosenlicht, Senior Vice President and Portfolio Manager

Shares of MLPs and midstream energy companies remain well below their 2014 highs following the downturn in energy prices and, more recently, uncertainties around FERC rate changes for MLPs. However, we believe fundamentals for pipeline demand are improving and the MLP business model is changing for the better. In our view, this represents one of today's most compelling total-return opportunities in an otherwise richly valued market.

A Perfect Storm for Midstream Exacerbated the Down Cycle

Since 2014, MLPs and other midstream energy companies have substantially underperformed the S&P 500. Through the end of 1Q 2018, the MLP Index was still 56% below its 2014 high.

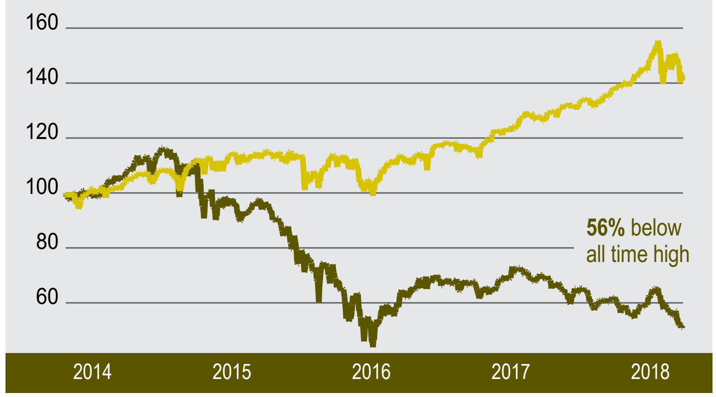
Beginning in late 2014, crude oil oversupply and an OPEC* policy shift towards market share contributed to falling energy prices, declining U.S. energy production volumes and falling pipeline utilization. The down cycle was amplified by a confluence of headwinds:

- Midstream companies entered the downturn trading at peak EBITDA multiples (~14x) with record-low distribution yields.
- Numerous pipeline projects were completed in 2015–2017, resulting in excess capacity for the midstream sector.
- Margins came under pressure as commodity prices declined and volumes fell.
- Many MLPs were highly levered and reliant on access to equity financing to fund capital expenditures.

These headwinds and subsequent balance sheet stress resulted in more than 45 distribution cuts and numerous "strategic restructurings" to improve cost of capital and reduce leverage ratios. Though the common narrative is that MLP distributions have been resilient throughout this downturn, distributions on a per-unit, market-cap-weighted basis have actually declined by an average of 4% per year over the past five years, alienating the yield-focused investor base.

*Organization of Petroleum Exporting Countries

Exhibit 1: MLPs vs. U.S. Stocks
2014 = 100



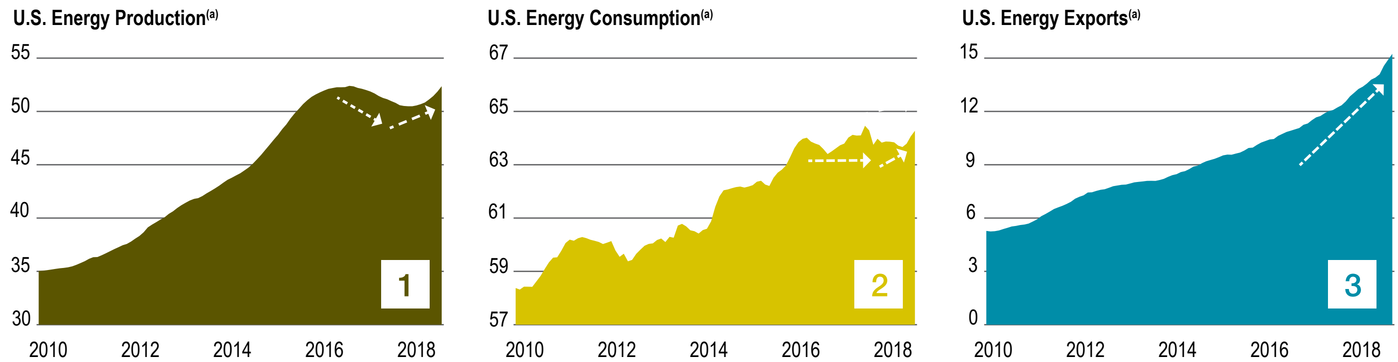
At March 31, 2018. Source: Bloomberg, Energy Information Administration (EIA), Wells Fargo and Cohen & Steers. **Data quoted represents past performance, which is no guarantee of future results.** See back page for additional disclosures.

Demand Fundamentals for Midstream Have Inflected Positively

There are three primary drivers for midstream asset demand: 1) domestic energy production, 2) domestic energy consumption, and 3) energy exports. For the first time since the energy down cycle began, all three are seeing strong growth.

- Energy Production: After declines in 2015 and 2016, the U.S. is expected to produce at record levels in 2018 and 2019. The U.S. is on track to produce more crude oil than Saudi Arabia this year.
- Domestic Consumption: The domestic economy remains strong and energy demand has increased after several years of flat consumption. Consumers and industrial users are taking advantage of low prices.
- Energy Exports: Exports have remained a bright spot throughout the down cycle. Crude oil exports have grown exponentially since the 2015 export ban was lifted. Liquefied natural gas (LNG) exports have also increased significantly.

Exhibit 2: Positive Inflection for Midstream Fundamentals



At March 31, 2018. Source: U.S. Energy Information Administration (EIA) and Cohen & Steers.

Data represents monthly U.S. crude oil, natural gas and liquefied petroleum gas energy production, consumption and exports, based on latest data available.
(a) Quadrillion British thermal units (Btu). See back page for additional disclosures.

These trends continue to push more energy production through pipelines and pull it into demand centers, which should help tighten capacity for midstream assets and drive cash flow growth.

MLP 2.0: The Shift to a Better Business Model

The traditional business model for MLPs was characterized by misaligned management incentives, weak corporate governance and a focus on maximizing cash distributions, using high leverage and a heavy reliance on equity markets to raise capital. While this model worked in an energy bull market, the energy downturn showed that this can be a dangerous strategy for companies that own assets linked to cyclical commodity prices.

In our view, the key problem with the old model centered on the incentive distribution rights (IDRs) that govern the relationship between the general partner (GP) and investors in the MLP. By funneling half of an MLP's cash distributions to the GP, IDRs created an incentive for GPs to maximize distributions and distribution growth and to accumulate assets without a strong focus on returns.

MLPs have increasingly transitioned towards what we believe to be a better model (MLP 2.0). This begins by eliminating the GP/LP/IDR structure, improving corporate governance and creating better alignment of interests. It changes the mindset for capital allocation, allowing companies to set sustainable distributions and fund growth projects internally. For the first time, management teams are able to sell assets or execute share buybacks, **putting the focus on generating attractive returns on invested capital, in our opinion.**

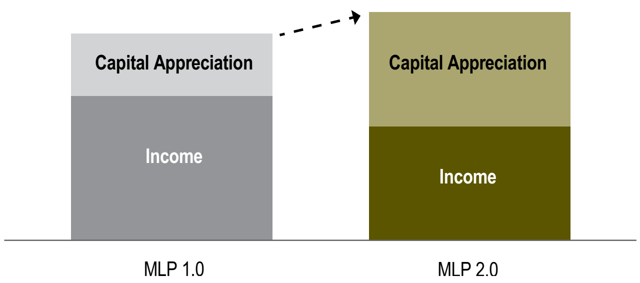
The 2.0 business model is likely to alter the return profile for midstream companies. Though the income potential may be modestly reduced, we believe the long-term return opportunity will improve due to less reliance on dilutive equity funding.

Exhibit 3: The New Business Model

MLP 1.0	MLP 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

At March 31, 2018. Source: Cohen & Steers. See back page for additional disclosures.

Exhibit 4: A Shifting Return Profile Focused on Total Return



At March 31, 2018. Source: Cohen & Steers. For illustrative purposes only. See back page for additional disclosures.

The MLP 2.0 story is beginning to resonate, in our view, and certain institutional investors are making meaningful allocations. For example, the State of Wyoming recently announced a $660 million MLP mandate (4.5% of its portfolio). In addition, asset managers are creating capabilities in midstream energy by acquiring independent MLP managers, such as Blackstone/Harvest, Brookfield/Center Coast and Lovell Minnick/Tortoise.

FERC Policy Change in March Has Further Pressured the MLP Market

On March 15, 2018, the Federal Energy Regulatory Commission (FERC) announced a proposal to disallow the recovery of income tax allowance on rates for certain pipelines owned by MLPs, igniting a broad selloff.

There is still some ambiguity surrounding the proposal, specifically regarding how it might affect pipelines owned in joint ventures between MLPs and corporations. However, we believe investors have overreacted to the news due to the uncertainty it created.

We estimate that the overall MLP market will see a -2.5% potential cumulative EBITDA headwind through 2021 from the proposed changes. Importantly, the impact will not be uniform, with many companies unaffected by the ruling and a few seeing meaningful EBITDA erosion of as much as -15%.

Cumulative EBITDA Exposed

	2018E	2019E	2020E	2021E	2022E
Cost of Service	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
Liquids Index				-1.3%	-1.3%
Total	-1.2%	-1.2%	-1.2%	-2.5%	-2.5%

At March 31, 2018. Source: Cohen & Steers estimates. See back page for additional disclosures.

Valuations

Our analysis indicates that MLPs are trading at meaningful discounts to their private-market values—a phenomenon rarely seen in this sector. Listed midstream companies currently trade at about 10x EBITDA multiples, while private equity investors are deploying capital at more than 13x EBITDA. We expect this discount to narrow as more private capital is deployed in the MLP space, or as midstream privatizations occur.

Summary

The downcycle in midstream energy has been prolonged and severe. However, fundamentals have inflected positively and we expect the industry to benefit from improving midstream asset demand, better corporate structures and more stable capital allocation policies. With listed companies trading at discounts to net asset values, we believe investors should be increasing their exposure to the asset class.

Exhibit 5: Private Investors Paying Higher Multiples Than Listed Implied Values
Recent Private Equity Transactions

Asset	Seller	Buyer	Date	Multiple
Elba Liquefaction	Kinder Morgan, Inc.	EIG Global Energy Partners	Feb-17	8.8x
EagleClaw Midstream Ventures	EnCap Flatrock Midstream	Blackstone	Apr-17	17.5x
Rover Pipeline	Energy Transfer Partners	Blackstone	Jul-17	10.7x
Kingfisher Midstream Assets	Alta Mesa/Kingfisher	Riverstone	Aug-17	11.9x
Arc Logistics Terminaling, Liquids Infrastructure	Arc Logistics Partners	Zenith Energy	Aug-17	10.4x
Midland Pipeline, Gathering, Transport Assets	EMG Group, Laredo Petroleum	Global Infrastructure Partners	Oct-17	17.9x
Grand Prix NGL Pipeline	Targa Resources Corp.	Blackstone	Oct-17	10.0x
Glass Mountain Pipeline	NGL Energy Partners L.P.	BlackRock Inc.	Nov-17	18.5x
Private Market Average				**13.2x**
Listed Midstream Energy Average				**10.3x**

At March 31, 2018. Source: Wells Fargo, company reports, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice. Private multiple represents the aggregate value of midstream acquisitions divided by total EBITDA acquired. Listed midstream energy average based on Cohen & Steers' investment universe and implied market values based on our estimates. See back page for index definitions and additional disclosures.

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This report was edited by Mark Blake.

Index Definitions

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

MLPs: Alerian MLP Index (Total Return), is a capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total MLP float-adjusted market capitalization.

Stocks: S&P 500 Index is an unmanaged index of 500 large-capitalization stocks that is frequently used as a general measure of U.S. stock market performance.

Important Disclosures

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Risks of Investing in MLP Securities

An investment in MLPs involves risks that differ from a similar investment in equity securities, such as common stock, of a corporation. Holders of equity securities issued by MLPs have the rights typically afforded to limited partners in a limited partnership. As compared to common shareholders of a corporation, holders of such equity securities have more limited control and limited rights to vote on matters affecting the partnership. There are certain tax risks associated with an investment in equity MLP units. Additionally, conflicts of interest may exist among common unit holders, subordinated unit holders and the general partner or managing member of an MLP; for example, a conflict may arise as a result of incentive distribution payments. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs may have additional expenses, as some MLPs pay incentive distribution fees to their general partners. The value of MLPs depends largely on the MLPs being treated as partnerships for U.S. federal income tax purposes. If MLPs were subject to U.S. federal income taxation, distributions generally would be taxed as dividend income. As a result, after-tax returns could be reduced, which could cause a decline in the value of MLPs. If MLPs are unable to maintain partnership status because of tax law changes, the MLPs would be taxed as corporations and there could be a decrease in the value of the MLP securities.

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Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure, commodities and natural resource equities, as well as preferred securities and other income solutions. Founded in 1986, the firm is headquartered in New York City, with offices in London, Hong Kong, Tokyo and Seattle.

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U.S. Advisors & Investors: +1 800 330 7348
U.S. Institutions & Consultants: +1 212 822 1620
Hong Kong: +852 3667 0080
Tokyo: +81 3 4530 4710
London: +44 207 460 6350

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