October 18, 2018

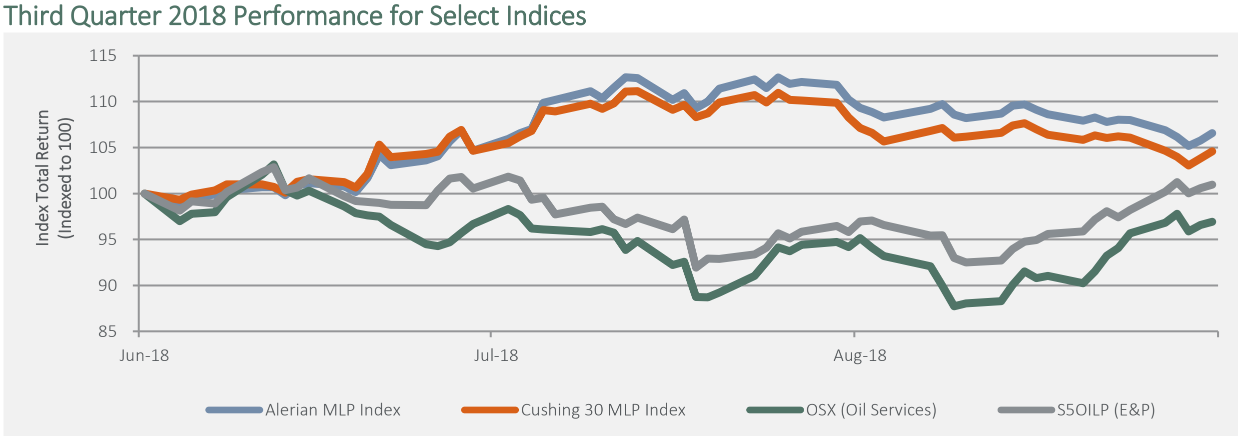
2018 Third Quarter Midstream Energy Market Review

Dear Investors,

We are pleased to report that the midstream energy sector continued its positive performance for the third quarter of 2018. For the period, the market cap-weighted Alerian MLP Index (AMZ) produced a +6.6% total return, while the equal-weighted Cushing® 30 MLP Index (MLPX) produced a +4.6% total return. This marks the first time since the first quarter of 2017 that these two midstream indexes each posted consecutive positive quarterly returns.

For the third quarter, West Texas Intermediate crude oil prices decreased by -1.2%. Energy equity indices offered mixed results for the period as the S&P 500 Oil & Gas Exploration and Production Index (S5OILP) increased by +1.0%, while the Philadelphia Oil Service Sector Index (OSX) decreased by -3.1%.

Third Quarter 2018 Performance for Select Indices



Note: Represents relative total return performance from June 30, 2018 through September 30, 2018. Indexed to 100.
Source: Bloomberg. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

The positive price performance in midstream indices during the quarter occurred despite the negative fund flows from midstream-focused products (mutual funds, ETFs and exchange-traded notes). In fact, this quarter's flows ranked as the absolute worst, and only negative quarter, in midstream product flows in the 39 quarters we have tracked. In a positive way, this data point does not seem to match the positive midstream energy sector price performance for the quarter. It is further important to note that a majority of the outflows were mainly realized in one specific ETF. While the subtleties of ETF creation and redemption can be nuanced, we believe that it was a testament to the strength of the underlying company fundamentals to be able to withstand the significant selling pressure from midstream-focused products experienced during the quarter.

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Energy Fundamentals Accelerate

Energy sector fundamentals continued to move from "good" to "better" during the third quarter.

Starting with commodity prices, the international spot crude oil price (Brent) was up by +6% for the quarter to $82.95 per barrel (+24% year-to-date), the highest price realized since November 2014 when OPEC embarked upon their global market share battle with U.S. producers. U.S. crude oil prices (WTI) ended the quarter at $73.25 per barrel, slightly lower than end of second quarter pricing; however, this is up by +21% year-to-date and at levels not realized since November 2014.[1]

Global crude oil demand remained robust and increased to all-time highs as OPEC spare capacity continued to decline. [2] We further believe that geopolitical risks are increasing (i.e. Iran sanctions) while several distressed countries experienced supply outages (i.e. Venezuela, Libya). Furthermore, domestic infrastructure constraints are limiting the U.S.' ability to fill the void in the near term. In summary, ***we believe the near-term macro backdrop for crude oil prices remains strong, yet well below levels which would warrant concerns on demand destruction.***

Similar price strength exists for other hydrocarbons as well. Ethane prices ended the quarter at 58 cents per gallon, the highest level since 2012 and an astounding +66% and +148% increase for the quarter and year-to-date periods, respectively. Propane prices also increased by +15% for the quarter. This natural gas liquid (NGL) strength, concurrent with stable natural gas pricing, led to a ***+25% increase in the fractionation spread during the third quarter, a key driver for processing plant utilization and profitability for select midstream companies***. [3]

American Energy Emergence on the Global Stage

On the domestic front, the emergence of the U.S. as a dominant global energy producer continues. In October's Short-Term Energy Outlook produced by the U.S. Energy Information Administration (EIA), average production levels of crude oil, natural gas and NGLs all set new record highs for the month of September as well as for the quarter.[4]

In this same report, the EIA estimated that U.S. crude oil production will average 11.8mmbbls/d in 2019. If true, this would lead to the U.S. overtaking Russia as the largest producer of crude oil in the world. This would be an astounding feat considering that average production in the U.S. was just 5.0mmbbls/d ten years ago. The same holds true for natural gas and NGLs, where the U.S. is increasingly establishing itself as a low-cost producer and supplier to the global markets.

As expected, hydrocarbon exports also set new records for the quarter, with liquefied natural gas (LNG) exports averaging 3.0 Bcf/d (+82% yoy) and NGL exports averaging 1.6mmbbls/d (+35% yoy).

For midstream companies, ***international demand for U.S. hydrocarbons is leading to significant export opportunities, with numerous projects announced during the quarter*** such as Enterprise Products Partners, LP (NYSE: EPD) announcing its intention to develop an offshore crude oil export terminal in the Texas Gulf Coast capable of loading/exporting 2mmbbls/d, among others.

With Pipelines Full, Bottlenecks Increase

Across most major producing basins in the U.S., the ***surge of production volumes, including crude oil, natural gas and natural gas liquids, has simply overwhelmed the existing pipeline infrastructure*** that facilitates the

[1] Source: Pricing data from Bloomberg.
[2] Source: U.S. Energy Information Administration. "Short-Term Energy Outlook (STEO)." October 2018.
[3] Source: Pricing data from Bloomberg.
[4] Source: U.S. Energy Information Administration. "Short-Term Energy Outlook (STEO)." October 2018.

movement of these volumes out of the basins. As a result, regional basis differentials, or the difference in price between two locations, continued to widen *significantly* during the quarter. This dynamic can not only directly and positively impact midstream companies with marketing businesses but is also an indication of (and drives commitments to) new infrastructure needs.

For a point of reference, the difference in the price of crude oil in Midland versus the Gulf Coast (Magellan East Houston to West Texas Intermediate Midland) averaged over $18/bbl during the quarter, versus an average of ~$12/bbl for the previous quarter and ~$3/bbl for the third quarter of 2017. [5] A similar dynamic exists for natural gas and NGLs as well, with pricing between multiple hubs widening out as the midstream sector struggles to build pipelines fast enough to keep up with the pace of production.

During the quarter, the sector also saw bottlenecks move further downstream, most notably with NGL fractionation capacity. RBN Energy stated, "*there is no doubt that the U.S. NGL market has entered a period of disruption unlike anything seen in recent memory. Mont Belvieu fractionation capacity is, for all intents and purposes, maxed out. Production of purity NGL products is constrained to what can be fractionated, and with ethane demand ramping up alongside new petchem plants coming online, ethane prices are soaring.*" [6]

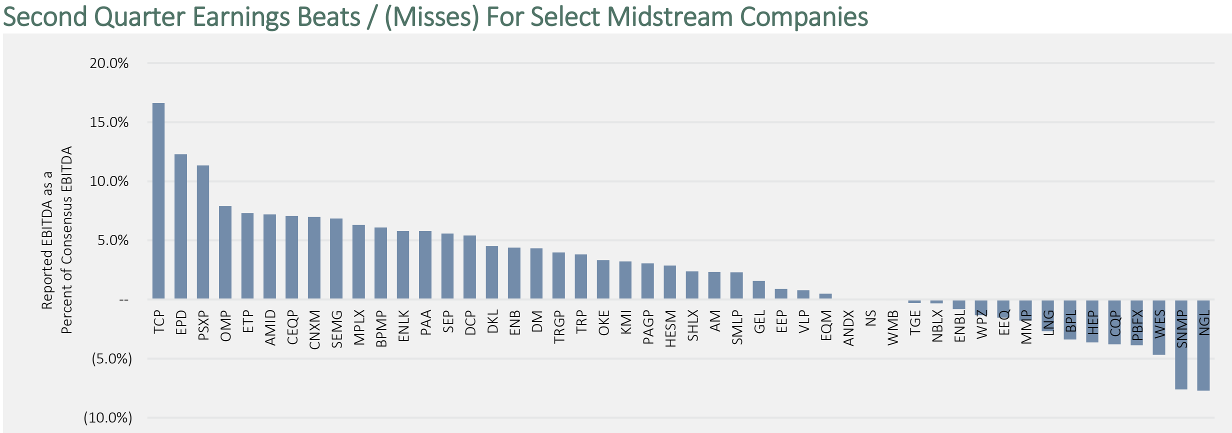
From a midstream perspective, we believe these dynamics are undoubtedly positive for the sector. ***The bottleneck theme – a cornerstone of our investment thesis – should help drive in full utilization of existing midstream assets while increasing demand for new projects.***

Midstream Earnings Deliver

For the past couple of quarterly market reviews, we have frequently discussed the improving fundamentals of the midstream energy sector at length. But are these fundamentals showing up in earnings? Recent earnings announcements indicated the answer is "yes," as earnings continued to show operational leverage to accelerating production volumes, higher commodity prices, higher asset utilization and rising exports during the quarter.

In our judgement, the second quarter earnings season was one of the more impressive overall quarters we have experienced as long-time investors in the space. The chart below illustrates the widespread beats relative to consensus expectations for the second quarter.

Second Quarter Earnings Beats / (Misses) For Select Midstream Companies



Note: Represents relative beat / (miss) per street consensus estimates for EBITDA.
Source: Bloomberg.

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[5] Source: Pricing data from Bloomberg.
[6] "Hotel Fractionation - Far-Reaching Impact Of The Unprecedented Shortfall In NGL Fractionation Capacity." RBN Energy, LLC. September 16, 2018.

Interestingly, ***most of the significant drivers of second quarter earnings beats have only accelerated into the third quarter*** (as discussed earlier). We continue to scratch our heads regarding the growing disconnect between fundamentals, earnings trends and equity performance (we discuss our theory further below). We believe energy sector tailwinds, continued distributable cash flow (DCF) per unit growth estimates, and an attractive yield combine to offer quite a compelling total return story from these levels.

IDR Extinction

Significant progress on the "simplification" trend was made during the quarter. Williams Companies, Inc. (NYSE: WMB) completed their merger with Williams Partners, LP (NYSE: WPZ). Enbridge Inc. (NYSE: ENB) revised the terms for their consolidation (including NYSE: SEP, EEP, EEQ and ENF), and is now awaiting formal approval for the transaction to close (expected fourth quarter). Dominion Energy Inc. (NYSE: D) announced it would acquire its MLP, Dominion Energy Midstream Partners LP (NYSE: DM). And just after quarter end, the Antero complex announced the long-awaited conclusion of its "Special Committee" process to simplify the structure with the announcement that Antero Midstream GP, LP (NYSE: AMGP) intends to acquire Antero Midstream Partners, LP (NYSE: AM).

But overshadowing the above (in our opinion) was perhaps the most significant event of the quarter, the announcement by the Energy Transfer complex to simplify its company structure. Consensus expectations were for this event to be announced next year. We think the fact it was announced on August 1, 2018 is an indication of the company's bullish view of the midstream business and management's desire to remove this hurdle quickly. ***With this simplification, the last of the major midstream names is headed towards a simplified, more "corporate" structure with lower leverage and a focus on self-funding and per share returns.***

We believe complex partnership structures are becoming a relic of the past as investors desire a single, simplified entity that has a lower cost of capital and is more aligned with investor interests. As such, we would expect any MLP in the high splits of their incentive distribution rights (IDRs) to arrive at a simplification solution sooner rather than later. Thankfully, we believe the era of unsustainable, financially engineered growth is sunsetting.

As we are approaching what we believe to be a near full extinction of the IDR era, we note there were two midstream IPO filings during the quarter, neither of which incorporate IDRs into their structures. Let's hope this trend continues.

The Private vs. Public Disconnect

Private equity continues to be heavily involved in midstream transactions, mainly as the acquirer. We continue to find it fascinating to see that many of these transactions are occurring ***at higher multiples than public valuations***. We believe this is at least partially reflective of the abundance and relatively cheaper cost of capital available in the private markets.

A recent Bloomberg article, entitled "Private Equity Is Increasing Bets of Risky Permian Pipelines," stated that "*operations in the Permian that gather oil and gas, and process fuel into propane and other liquids, have drawn almost $14 billion in investment since the start of 2017, with $9.2 billion of that coming from private companies."*[7] How this dynamic ultimately plays out is anyone's guess, but we suspect some of these asset packages may come up for sale again and at potentially lower valuations.

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7 Adams-Heard, Rachel. "Private Equity Is Increasing Bets on Risky Permian Pipelines." Bloomberg. September 17, 2018.

While we admit so-called risky capital allocation like this does concern us, we also are encouraged that public companies appear to be more disciplined in their capital allocation and are slowing down, if not completely ceasing, to chase expensive M&A opportunities for growth. Regardless, the plethora of private equity capital is allowing public companies to sell non-core assets in order to alleviate equity needs, with multiple transactions announced during the quarter.

Regulatory Gives and Takes

During the quarter, the Federal Energy Regulatory Commission (FERC) issued its long-awaited final notice of proposed rule making (NOPR) related to its March 15th decision to change the treatment of income taxes for cost of service pipelines. Regardless of the details*, we believe further clarity on FERC concerns helped to remove a key uncertainty for the sector.*

Perhaps the most impactful outcome of the NOPR was that accumulated deferred income tax (ADIT) balances could be written to zero and negotiated rates would not be affected. Ultimately, we believe the final impact will be better than initially feared for those select MLPs most affected. However, we'll also note that those select MLPs most affected have already been or have agreed to be acquired by their corporate sponsors.

Unfortunately, and unrelated to the above, multiple projects have been delayed or temporarily stopped due to an increase in regulatory and environmental issues as of late. Most notably, the FERC ordered Mountain Valley Pipeline (predominately owned by EQT Midstream Partners, LP (NYSE: EQM)) to stop all construction activity, granting the Sierra Club's request given questions surrounding multiple permits.

As a result, EQM announced a 12-month delay to in-service timing as well as an increase in costs of ~$900mm, which unfortunately worsened project economics from ~7x to ~10x estimated EBITDA. Since this development, the project has had other permits vacated as well, potentially adding further pressure to timing and economics.

It is becoming more challenging and costlier to build interstate pipelines, especially in the Northeast. Going forward, we believe large-scale projects will face significant legal challenges, which could put project timetables in jeopardy.

Lastly, the energy industry (including both E&P and midstream) found itself in the crosshairs of proposed legislation designed to severely limit future drilling in Colorado's DJ Basin. This isn't the first time Colorado environmentalists have proposed "anti-frac" rules (and probably not the last); however, we do not expect Proposition 112 to pass this November due to the well-funded opposition, voter polling trends, and the projected disastrous economic consequences to the state. Nonetheless, it warrants investor attention given the material potential downside for those entities with Colorado exposure if approved and enacted as written. We expect this issue to continue to weigh on the related equities until the binary outcome on November 6th.

Questions and Concerns

Investor apathy is our main question at the moment. We believe the midstream sector is grossly underinvested, underappreciated and undervalued.

The fundamental drivers are flashing green nearly across the board: crude oil prices are up, NGL prices are up even more so, production is setting new records, regional basis spreads are blowing out, exports are booming, companies are staying disciplined, leverage is moving down, credit ratings are moving up, equity issuance has materially declined, corporate structures have been "simplified," corporate governance has improved, private equity is paying up for assets and nearly every midstream company beat earnings estimates for the quarter.

If everything is so good, why are investors not buying into the story? Is a push into ESG (Environmental, Social and Governance) measurements a factor? Is there a lack of belief that the rate of change in fundamentals can continue to improve from here? Notwithstanding the recent broader market selloff in the first two weeks of October, we believe one key reason is that investors simply remain focused on other equities that have been "working" more as anticipated, such as high-growth tech stocks.

Another worry is the potential escalation of tariffs on U.S. exports of oil, natural gas and/or NGLs, which could dampen overall demand. However, recent export data (and recent long-term export contract announcements) do not corroborate this fear.

Economic generalists have been lowering crude oil price forecasts for 2019, which may be misconstrued as a reason to remain underweight the energy sector broadly. We believe that a dampening of demand fears and/or continued commodity price strength could assuage such concerns. ***Regardless, we don't think lofty crude oil price assumptions are necessary for midstream businesses (and their stocks prices) to do well.***

With moderately rising interest rates in the U.S., borrowing costs could become a concern. However, as midstream companies continue to migrate towards a self-funding model, we do not see this as a major issue as long as there are no extreme rate spikes.

Conclusion

We believe that the fundamental backdrop for investing in the midstream energy space remains positive. The tailwinds we mentioned in our prior quarterly letter remain, and in some cases, are growing even stronger.

To summarize:

- The U.S. is re-emerging as a global leader in hydrocarbon production and export.
- Regional basis differentials remain elevated and commodity price trends are bullish, supporting volume growth and new project opportunities.
- With positive fundamental drivers, midstream companies have posted strong financial results for three consecutive quarters, confirming the trend.
- Structural simplification, as punctuated by Energy Transfer's consolidation announcement, and the extinction of IDRs are moves towards a healthier overall structure.
- Self-funding and per share earnings growth will be a key driver of value creation.
- Private equity is enabling public companies to shed non-core assets, and they're willing to pay a premium for it in a reversal that shows public companies are being more financially prudent.
- Regulatory and environmental concerns remain.

We believe we are almost through this phase of midstream company structural repair. Next is the phase of investor sentiment repair, which we believe can only be won through long-term discipline by midstream company management teams. We believe long-term investors will be rewarded for their patience. At current valuations, we would be no less than an equal weighting in midstream as we believe the setup for investing is as good as it has been for quite a long time.

Please let us know if you'd like to have an in-depth conversation of these topics. As always, we appreciate your support and continued confidence in us.

Best regards,

Cushing Investment Team

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Investments in MLPs are subject to price changes in crude oil and natural gas, as well as regulatory and interest rate risks, among others.

Glossary of Indices: The Alerian MLP Index (AMZ) is a composite of the most prominent energy master limited partnerships. The Cushing® 30 MLP Index (MLPX) is an equal weighted index that tracks the performance of 30 publicly traded MLP securities that hold midstream energy infrastructure assets in North America. The S&P 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The S&P 500 Oil & Gas E&P Sub Industry Index (S5OILP) is a capitalization-weighted index. This is a GICS Level 4 Sub-Industry group. The Philadelphia Stock Exchange Oil Service Sector Index (OSX) is a price-weighted index composed of 15 companies that provide oil drilling and production services, oil field equipment, support services and geophysical / reservoir services. The S&P 500 Utilities Index is comprised of those companies included in the S&P 500 that are classified as members of the GICS utilities sector. Indices are included for comparative purposes only.

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