July 15, 2019

2019 Second Quarter Midstream Energy Market Review

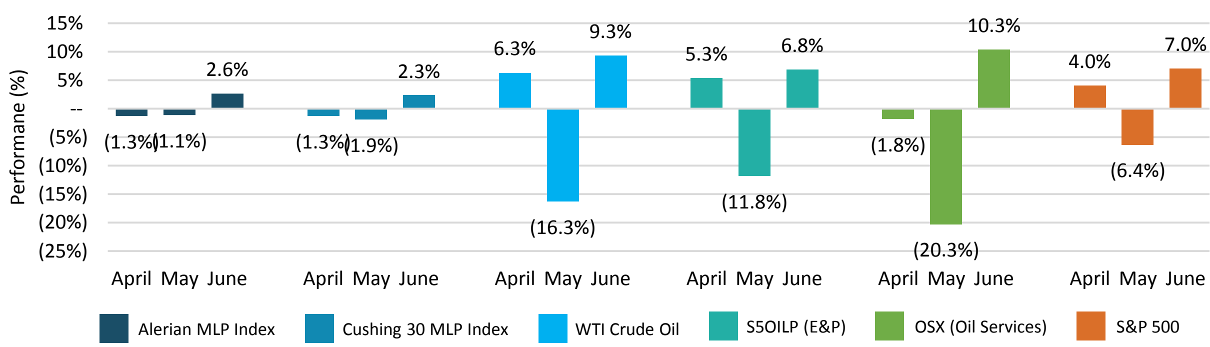
Dear Investors,

Similar to the first quarter of 2019 (although excluding a significant “take private” transaction of one of the oldest MLPs in existence discussed below), it was another relatively quiet quarter for the midstream energy sector. This further supports our belief that the complicated, disruptive era of structural simplifications and shifting capital funding strategies is nearing an end. This, we believe, should allow for investors to refocus their attention on the sector’s many positive underlying fundamentals.

As we stated in our first quarter 2019 letter, “***we believe the message that management teams must be better stewards of capital and prioritize returns over growth is resonating across the energy sector with positive long-term implications.***” In the second quarter, midstream companies continued to execute on their plans for asset-optimization, improved capital efficiency, debt reduction and increased distribution coverage – all while delivering another fundamentally strong earnings season. As a partial offset to these positives, select midstream systems were negatively impacted by the further tightening of exploration and production (E&P) company capital budgets, as E&P companies also continued the shift towards “living within cash flows” and improved shareholder returns.

Although it is a short-term observation, we were encouraged by the more defensive performance attributes and lower volatility of the midstream energy sector during a quarter of heightened volatility for other commodities, the energy sector as well as the broader market, as shown in the chart below.

Second Quarter 2019 Performance By Month for Select Benchmarks



Source: Bloomberg. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Index data is provided for comparison purposes only. It is not possible to invest directly in an index. The Cushing 30 MLP Index provides a benchmark to measure the performance of the more stable and widely held energy infrastructure master limited partnerships (MLPs). It is an equal weighted index that uses an objective, formula based, proprietary valuation methodology to rank the MLPs for inclusion in the index. The Standard and Poor's 500 Oil & Gas Exploration & Production Index (S5OILP) is a capitalization-weighted index comprised of those companies included in the S&P 500 that are classified as members of the GICS Oil & Gas Exploration & Production sector. The Philadelphia Oil Service Sector Index (OSX) is 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® Index (S&P 500) includes 500 leading companies and captures approximately 80% coverage of available market capitalization.**

Macro in the Driver Seat

In our opinion, equity price performance for the quarter was driven more by macro factors, which unfortunately were quite volatile. Trade disputes continued to dominate the macroeconomic narrative, as apparent progress in talks between the U.S. and China throughout April gave way in early May to a breakdown in negotiations, paired with tariff escalations from both sides and threats from President Trump of additional tariffs in the near future. In addition, Trump demonstrated his willingness to use trade policy to influence unrelated foreign policy by threatening to impose tariffs on Mexican imports in order to extract enhanced cooperation in stemming Central American migration into the U.S.

Economic growth concerns – exacerbated by trade pressures – and persistently low inflation led central bankers to rethink their tightening trajectory and begin preparing for possible stimulus should conditions worsen. Federal Reserve Chairman Jerome Powell stated in his June 19th post-FOMC press conference that the case for accommodation in U.S. monetary policy had strengthened. In accordance, the U.S. 10-year Treasury note yield fell to ~2% by period end, which was the lowest level since November 2016.

Commodity Price Volatility

Most important from an energy investor's perspective, is what effects these trade wars, geopolitical tensions and potential for a slowing economy are having on worldwide hydrocarbon demand. Unfortunately, investors contended with several adverse data points during the quarter, leading to heightened commodity price volatility.

As an example, in June the International Energy Agency (IEA) formally reduced its estimate of 2019 oil demand growth to 1.2mmbbls/d from 1.4mmbbls/d, while estimating non-OPEC 2019 oil supply growth of 1.9mmbbls/d.[1] In other words, the IEA projects the implied call on OPEC production to continue to decline, with more than enough non-OPEC supply growth, mainly from the U.S., to meet declining demand growth expectations.

On the other hand, escalating tensions in the Middle East may put expectations of "plentiful oil supply" at risk. During the period, six crude oil tankers and a U.S. spy drone were attacked near the Strait of Hormuz, a key chokepoint for seaborne crude oil. Additionally, armed drones reportedly attacked Saudi Aramco's East-West pipeline in Saudi Arabia. Given the series of events, intra-quarter crude oil price volatility was to be expected.

Other energy commodities fared generally worse than crude oil. Increased natural gas liquid (NGL) production and elevated inventories led to a collapse in NGL prices for the quarter, with the price of ethane falling by -26.6% (down by -42.1% YTD) and the price of propane falling by -24.4%.

This was particularly painful for natural gas producers who have become more dependent on associated NGL economics to support their drilling operations, as the price of natural gas fell by -15.8% and remained stubbornly under $2.75 for the entirety of the period, as measured by the Henry Hub Natural Gas Spot Price. In select regions, natural gas economics were even worse, with West Texas natural gas (as measured by the Waha Hub Spot Price) averaging $0.00/mmbtu for the quarter (that is not a typo). However, we'll note that an average price of "zero" was quite the improvement from the -$4.63/mmbtu spot price on April 3rd.

Free Cash Flow Inflection Within Sight

Despite the increased commodity volatility, the upstream sector continued its focus on capital discipline, dialing back growth in order to "live more within their cash flow." Given this sector's long history of outspending cash flow and arguably destroying shareholder returns and capital, there is understandably investor skepticism.

However, it does appear that E&P companies are so far sticking to the new mantra under the weight of intense scrutiny from a more demanding investor base. With E&P valuations close to multi-year lows, investors have

[1] International Energy Agency. "Oil Market Report." June 14, 2019.

focused on increasing returns and actual free cash flow ("FCF") generation, providing the ability to return cash to shareholders via dividends and/or share repurchases. To accomplish this, producers have in many instances set (and held to) budgets with conservative price decks, slowed production growth, sold non-core assets, and reduced debt. While early results have been positive, new investors will likely want to see several quarters (or longer) of performance throughout the cycle before allocating to the space.

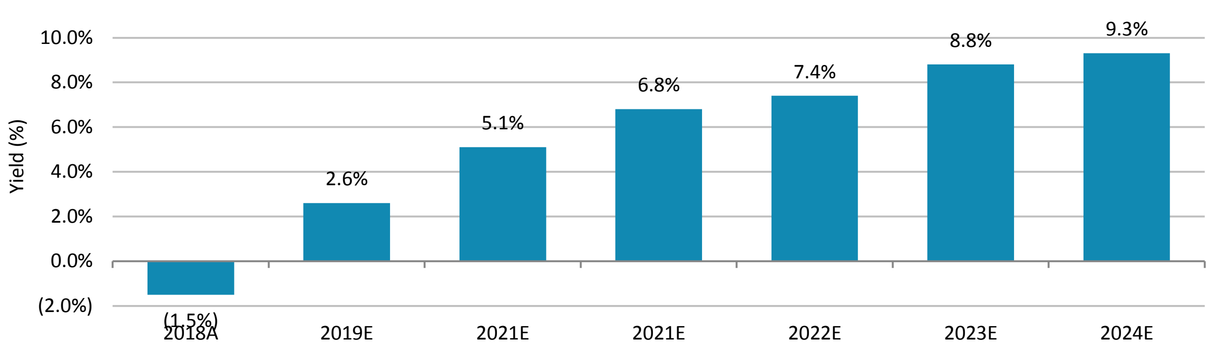
For the midstream sector, we have also written before about how this same idea of capital discipline, self-funding, improved balance sheets, better distribution/dividend coverage, and free cash flow generation has reshaped the sector. Again, the objective is to improve shareholder returns and ultimately attract incremental capital investment.

Of course, given this ongoing and significant evolution for the energy industry, we continue to be mindful of changing E&P activity levels and how they manifest in midstream business outlooks. For example, as announced with first quarter 2019 earnings results, EnLink Midstream , LLC (NYSE: ENLC) slowed its Oklahoma (or "STACK") volume growth outlook for 2019 to 10-15% from 25% (mid-point), and Williams Companies, Inc. (NYSE: WMB) reduced its Northeast gathering and processing (G&P) capex and gathered volume outlook to a 10-15% CAGR vs 15% previously due to lower expected producer activity.

Among other reasons, this dynamic supports our preference in the current environment for larger, diverse, integrated midstream companies that can withstand changing producer activity (and less so for single sponsor/customer G&P businesses). Additionally, we think energy investors prefer a slower, but more sustainable production growth backdrop versus the more "boom and bust" historical trend.

Given all the above, we concur with Wells Fargo and other who believe capital investment for the midstream sector is set to decline following a heavy capex budget for 2019, positioning these companies to generate meaningful (and increasing) free cash flow in the coming years, as shown in the chart below.

Midstream Median Free Cash Flow Yield Forecast



Source: Wells Fargo Securities. "Midstream Monthly Outlook: June 2019." June 5, 2019.

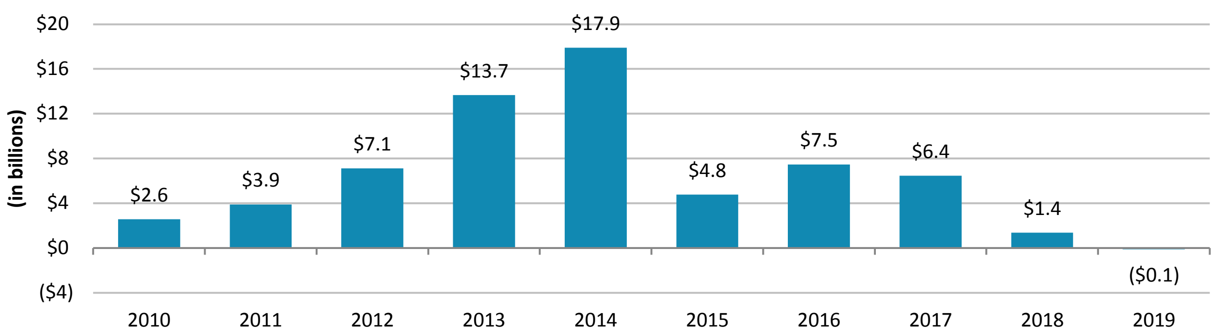
However, like the skepticism of E&P investors, many midstream sector investors will want to see "proof" given the industry's historical reputation for overbuilding and seemingly chasing growth with sub-par returns. It should be noted that some ~$10 billion of projects have achieved final investment decision ("FID") status in the past 6 months, but this does not change our thesis that we are approaching the tail of existing backlogs and the peak for industry spending.

The debate within the midstream sector continues as to what is the "ideal" capital allocation strategy. There seems to be some consensus forming among investors and management teams that, first, leverage needs to be near 4x or even lower, then the equity portion for attractive organic projects (with returns sufficiently above the cost of capital) should be largely self-funded, coverage should be at least 1.2-1.3x on a modestly growing distribution/dividend, and finally share buy-backs can be considered.

Midstream Sentiment

Understandably, skepticism surrounding the shift toward "living within cash flow" and positive FCF generation combined with macro uncertainty and commodity price volatility was not conducive to fund flows into the midstream sector during the period. Fund flows into midstream-focused products are at the worst levels in a decade, as shown in the chart below.

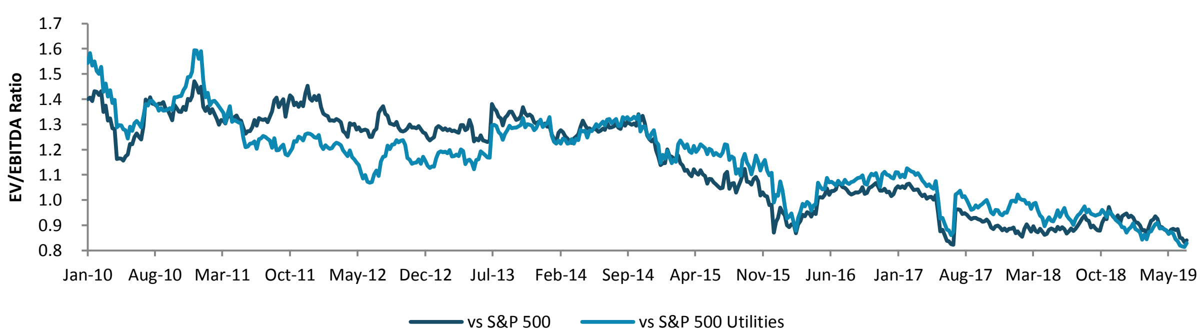
Capital Raised via Public MLP Funds



Source: U.S. Capital Advisors. "USCA Friday Midstream Recap." June 28, 2019.

We would argue these flows are contradictory and do not reflect the significant progress that has been made in the sector over the last several years. The vast majority of corporate restructurings are now complete, and the sector is perhaps better positioned from a structural, leverage, funding, and dividend coverage perspective than at any point historically – all while relative valuations are at decade lows.

Relative EV/EBITDA Valuation of AMZ



Note: Comparison of enterprise value / EBITDA for constituents of the Alerian MLP Index, S&P 500 Index and S&P 500 Utilities Index for the period from January 1, 2010 through June 30, 2019. Source: Bloomberg. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS**.

However, as stated earlier, we are cognizant that investors will want proof that energy companies will adhere to their newfound capital discipline and returns-focused spending, while generating free cash flow in excess of market averages. The bigger picture, in our opinion, is the fact that energy, as represented by its weight in the S&P 500, was at a new 30-year low at just 4.9% as of the end of the period. Accordingly, the incremental "generalist" investor simply does not seem to care, which is admittedly not conducive to fund flows. Regardless, we do believe the risk/reward to be skewed positively for patient investors.

Private Equity

We dedicated a substantial part of last quarter's letter to the increasing scale and involvement of private equity within the midstream energy sector and the opportunities and threats it poses. On the positive side, we believe it is an attractively priced and efficient source of capital for publicly traded midstream companies, allowing these companies to continue executing on their plans for asset-optimization and improved capital efficiency. On the negative side, we expressed our concerns regarding the competitive threats arising from a large private equity base armed with relatively cheap capital and an interest in energy infrastructure, specifically at the project level. Regardless, we emphasized how ***the sector continues to attract significant flows from large, sophisticated institutional and private equity investors who are typically paying higher cash flow multiples than those at which many publicly traded midstream companies are valued***.

This trend accelerated in the second quarter, with the announcement of one of the largest private equity transactions in the sector's history. On May 10th, IFM Investors, a Melbourne, Australia-based investor-owned fund manager, announced that it had entered into an agreement to acquire Buckeye Pipeline Partners, LP (NYSE: BPL) for a 27.5% premium in a $10.3 billion transaction.

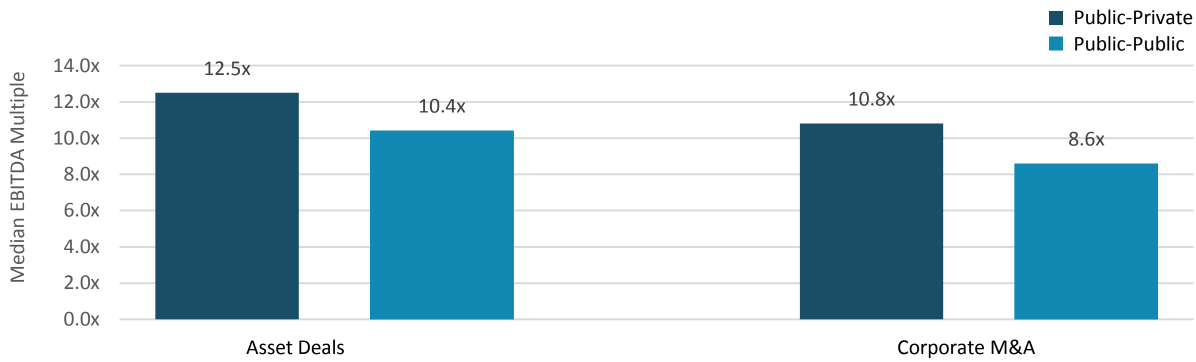
From BPL's earnings call immediately following the transaction announcement, Clark Smith, Chairman, President and CEO of BPL stated, "*The dislocation between private market assets and public valuations continues to grow in the midstream space, and the transaction with IFM will allow our unitholders to take advantage of that disconnect… We believe this offer more appropriately reflects the value of our underlying assets, compared to our public market valuation.*"[2]

In addition to the BPL "take private" transaction, there were numerous other transactions announced in the period, including 1) private equity funds acquiring private assets from other private equity funds; 2) private equity funds acquiring non-core assets from public midstream companies; and 3) private equity funds acquiring direct interests in assets owned by public midstream companies.

Regardless of the form, there continues to be a disconnect in public-private valuations relative to public-public valuations, as shown in the chart below. We believe this ought to give support for publicly traded midstream equities to trade higher, and more in line with the values private equity investors are ascribing to the sector. Perhaps the BPL transaction may help to serve as a catalyst in this regard.

[2] Buckeye Pipeline Partners, LP. "Q1 2019 Earnings Call." May 10, 2019.

Median EBITDA Multiples (2017-2019)



Note: Median transaction multiples from 51 Public-Public deals and 82 Public-Private deals announced from 2017 through 2019 YTD.
Source: Raymond James Research. "Should Investors Start Looking More Closely at Sum-of-the-Parts Valuation?" June 26, 2019.

Conclusion

For the period, positive midstream business results were largely overshadowed by macro headlines (Fed, China, Mexico), commodity volatility (which did negatively impact select G&P stocks), and weak fund flows. Unfortunately, we think the macro uncertainty could continue for some time, specifically related to how Fed policy and the yet to be resolved trade war with China impacts economic growth, which obviously has consequences for commodity demand/prices and energy equities.

Nonetheless, most midstream companies have fixed their larger structural and/or leverage issues, helping to refocus investor attention to attractive fundamentals. With the tail end for existing project backlogs in sight, reduced capital spending should free up more cash that can be returned to shareholders via dividends/distributions and/or buybacks or to reduce leverage even further.

We are of the view that the risk/reward for midstream energy in general is tilted to the upside for investors with longer-term perspectives. With projected FCF in conjunction with lower leverage, the highest distribution coverage and less reliance on equity markets than at any point in the sector's history, we are optimistic that midstream equities will attract incremental fund flows, supporting better valuations. In the meantime, we believe private-equity transactions continue to highlight the value proposition of midstream assets.

Our preference in the current environment is for larger, more diverse, integrated midstream companies that are positioned to take advantage of (and self fund) high-return growth opportunities spanning the entire value chain across multiple geographies and products (in general all funneling to export markets), as well as better withstand changing/slowing activity levels of E&P customers. We will also seek to rotate into other opportunistic names as the environment changes.

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.

Kind regards,

Cushing Investment Team

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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 of oil & gas exploration & production companies within the S&P 500 Index. 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. Indices are included for comparative purposes only.

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