January 24, 2020

2019 Fourth Quarter Midstream Energy Market Review

Dear Investors,

There were a mix of positive signs in the market during the fourth quarter (e.g., continued strong earnings growth, free cash flow ("FCF") generation, and near completion of corporate structure simplification) and negative actions (e.g. commodity price weakness, tax-loss harvesting, and midstream-focused closed-end fund deleveraging). This led to an increase in year-end volatility and negative returns for the quarter.

Calendar 2019 was another year in the midstream sector where, in general, EBITDA grew, cash flows were more robust than anticipated, capital expenditures came in lower than expectations, and free cash flow generally surprised to the upside. However, poor capital allocation track records and questionable structural simplification transactions, corporate governance concerns, and a critical view of the master limited partnership ("MLP") structure tampered the positive fundamental developments for many companies.

Review of Fourth Quarter 2019

From a fundamental perspective, the fourth quarter continued to show the impressive resiliency and operational leverage of midstream companies with continued earnings growth. All of this was further supported by continued execution on a wide range of investor initiatives from leverage reduction, free cash flow generation, increased capital discipline (including the high grading of project backlogs and reduced capital expenditures), simplification of corporate structures and return of cash to investors.

From an equity performance perspective however, the positive dynamics above were overshadowed by commodity price weakness and elevated concerns regarding the health of U.S. producers and U.S. production growing at a slower pace.

Technical selling, largely due to tax-loss harvesting and midstream-focused closed-end fund deleveraging, led to a volatile conclusion to the year. The AMZ fell as much as -13.2% during the quarter, only to rebound +10.5% in the final month, and concluded the period at -4.08%. Persistent relative underperformance versus other domestic equities and negative absolute performance for several names led to pronounced year-end tax-loss harvesting in the midstream sector.

While uncertainties persist, many midstream insiders remain steadfast buyers of their own stocks. Significant insider buying occurred throughout the quarter and throughout the year.

For the quarter, wellhead-exposed gatherers and processors were most impacted by upstream commentary regarding reduced production growth outlooks and the reigning in of producer capital expenditure programs. While reduced capital expenditure may seem negative at the surface level, we believe this shift will allow midstream operators to also reduce spending, ultimately resulting in many midstream companies growing free cash flow significantly.

A Review of 2019

The midstream energy sector posted a gain for 2019, with the AMZ up 6.56%. However, the sector trailed the strong 31.49% gains of the broader equity market, as measured by the performance of the S&P 500 Index. As of the end of the year, energy weight as a percent of the S&P 500 was at 4.2%, an absolute low since S&P began tracking the data in 1989, and down substantially from the long-term average of approximately 9%.[1]

Many shale exploration and production (E&P) companies have been victims of their own success. Absolute production growth in the U.S. has been staggering, but the significant amount of undisciplined capital required to facilitate this growth, combined with a weak commodity price environment (largely a direct result of production growth) has led to poor return metrics across the board for the upstream space. The S&P Oil & Gas Exploration and Production Select Industry Index (SPSIOP) traded to a new 15-year low on December 3rd. [2]

Midstream energy has traditionally outperformed other energy subsectors and has long believed to be a steady, "safe haven" within the overall energy complex. While this has been the case over the last three years, the performance of midstream energy has still trailed the S&P 500 significantly. Despite the stable and growing earnings provided by midstream companies, the fact remained that public-market funded capital programs, elevated debt levels, tight distribution coverage and complex corporate structures proved to be an unsustainable model. Many companies cut their dividend in order to reduce leverage or fund capital growth projects, and others executed de facto cuts from "structural simplifications". With poor capital allocation track records and questionable structural simplification transactions, corporate governance concerns and a critical view of the MLP structure overshadowed continued positive fundamental developments.

Looking back on 2019, it's important to realize that it was another year where, in general, midstream sector EBITDA grew, midstream cash flows were more robust than anticipated, capital expenditures came in lower than expectations and free cash flow generally surprised to the upside.

Our 2020 Outlook

Heading into 2020, we believe that not only are most headwinds and known risks priced in at current equity valuation levels, but the attractive underlying fundamentals are mispriced as well. We remain of the view that the risk/reward for midstream energy is tilted to the upside for investors with longer-term perspectives. We view the current stock volatility as largely disconnected from the improving fiscal health of the midstream sector.

U.S. production growth, although still positive, is slowing – and we believe this is not necessarily a bad sign. Many producers are targeting positive free cash flow, with production almost as a byproduct, not the driver. During the past year, E&P management teams generally became more disciplined with their capital spending and slowing their rate of production growth in order to improve corporate returns, generate positive FCF and attract a broader investor base. We reiterate that we are firm believers that a slower growth, but more financially stable and higher return E&P sector should be positive for the overall energy sector, especially midstream energy equities.

The broader energy sector efforts appear to be working, with the S&P 500 Oil & Gas Exploration and Production Index and Philadelphia Stock Exchange Oil Service Sector Index both up significantly from the lows. We believe better equity performance from key midstream customers should help to alleviate counterparty concerns in the midstream space. We are not particularly bullish on crude oil prices, but believe E&Ps will be more hesitant to increase activity despite near-term improvements in the commodity environment (note: WTI Crude oil prices ended the year above $60/bbl). This could help the global supply-demand balance, as well as their FCF generation. OPEC remains supportive and appears determined to eliminate excess storage inventory and stabilize oil prices.

[1] Source: Cushing analysis of Bloomberg data.
[2] Source: Cushing analysis of Bloomberg data.

U.S. energy infrastructure spending, although still positive, is slowing – and we believe this is also not necessarily a bad sign. For the first time ever, the midstream energy sector appears to have reached a positive FCF inflection. Many midstream management teams are following a similar playbook to their upstream counterparts, by high-grading capital project backlogs, eliminating external financing needs and generating positive FCF. In general, we expect midstream management teams to continue to spend less, seek to generate more FCF and explore alternative means of returning excess cash to investors, possibly including share/unit buybacks.

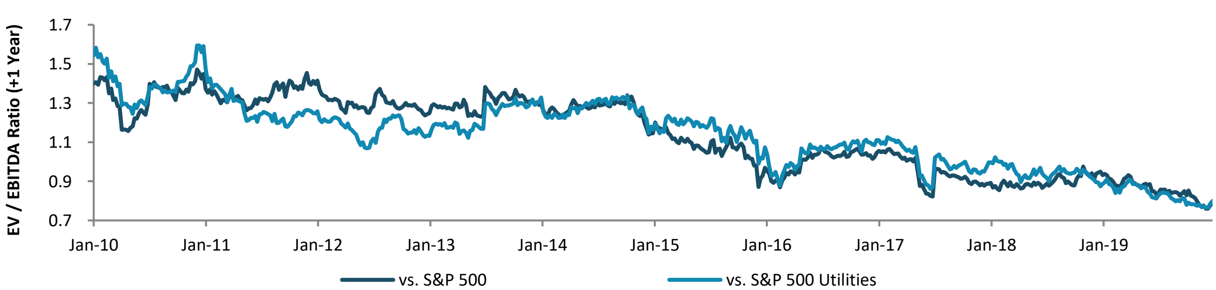
In conjunction with slowing production growth, most basins have adequate or surplus takeaway capacity, especially as current large-scale projects enter service. We believe this will help to drive lower capital spend levels, increase FCF and improve credit metrics. Regulatory issues – acting a blessing in disguise – could further help keep capital expenditure backlogs low. Accordingly, we believe capital expenditure budgets will decline in 2020 and beyond. There are still select areas of attractive growth opportunities (especially in natural gas liquids ("NGL") infrastructure and multi-commodity exports), but with a backdrop of slowing production growth, large-scale infrastructure already in service, and higher hurdle rates for capital spending.

Distributions for the sector, as measured by the distributions for passive products (e.g. ETNs and ETFs) that track the AMZ, stabilized at the end of 2018, began to move higher in 2019, and we project will to continue to do so in the coming years, even including expected distribution cuts from select companies (ENLC, EQM, etc.). This comes after nearly four years of declining income for investors in the midstream energy sector due to the previously mentioned consolidations, simplifications, and capital reallocations. We believe this stabilization of income and resumption of growth to be critical in attracting flows from income investors in a yield-starved world.

Importantly, the disruptive midstream company restructuring process appears to be essentially complete. Overall, the sector is significantly healthier with reduced leverage, increased distribution coverage, reduced and/or eliminated equity financing needs, improved corporate governance with a renewed focus on return on invested capital ("ROIC") and a virtual elimination of incentive distribution rights (over 90% of the sector is simplified and IDR-free).

We believe depressed valuations offer compelling total return opportunities. Absolute valuations for the midstream energy sector are well below average, and relative valuations are at decade lows.

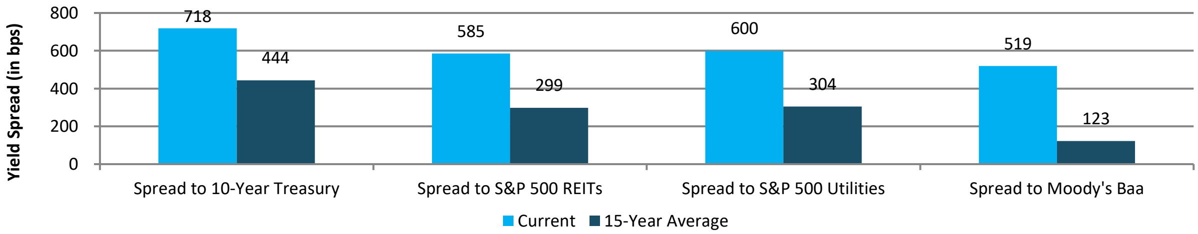
Relative EV/EBITDA Valuation of AMZ



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 December 31, 2019. Source: Bloomberg. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS**.

We believe this contradicts current fundamentals and attractive financial metrics for the sector. Yields have been reset and are, in our view, more secure between 5%-9% or greater. The yield spread of midstream energy to other yield alternatives has rarely been higher over the last 15 years, and the support of that yield has arguably never been stronger during that time. Cash flow coverage of the distribution/dividend is at 15-year highs. Most of these cash flows are no longer burdened by IDRs, and capital expenditures are largely being self-funded.

AMZ Relative Yield Spreads



Note: S&P 500 Utilities is the S&P 500 Utilities Sector Index, S&P 500 REITs is the S&P 500 Real Estate Investment Trusts REITS Industry Index, Moody's BAA is the Moody's Bond Indices Corporate BAA Index. Data shown for the period January 1, 2006 through December 31, 2019. Source: Bloomberg. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS**.

Large, sophisticated institutional and private equity investors continue to allocate capital to critical energy infrastructure assets. Numerous private transactions have been announced recently at higher multiples than those at which many publicly traded midstream companies are valued. We do not believe the dislocation between private market assets and public valuations can continue indefinitely.

To round out the positivity, there has been a healthy amount of insider buying. We believe we have seen the recent conclusion of technical extremes that were impairing valuations (fund flow pressure, index rebalancing and massive tax-loss selling). If it wasn't apparent, we will remind you now that all the above has occurred since the last time the AMZ index was at these levels. Considering this, current equity prices of midstream energy seem even more mispriced.

Conclusion

These were periods of continued transformation in the midstream energy sector that we have witnessed over the past few years. While we view the transformation as a positive in the long-run, it no doubt caused volatility in the space and angst among investors. As a result, positive midstream operating results seemed to go unnoticed by investors during the period, who appeared to remain acutely focused on macro headlines (e.g., Fed, China, impeachment inquiry) and energy commodity price volatility.

Moving forward, we believe that the structural transformation which has taken place in the midstream energy sector, and is now nearly complete, is helping to refocus investor attention to the attractive fundamentals in an asset class trading at significantly discounted valuations. To summarize our outlook:

- We believe that the risk/reward for midstream energy is tilted to the upside for investors with longer-term perspectives. Such depressed valuations offer compelling total return opportunities. Absolute valuations for the midstream energy sector are well below average, and relative valuations are at decade lows.
- Yields have reset and are more secure between 5%-9% or greater, despite the many cuts in distribution. The yield spread of midstream energy to other yield alternatives has rarely been higher over the last 15 years, and the support of that yield has arguably never been stronger during that time.
- Cash flow coverage of the distribution/dividend is at 15-year highs. These cash flows are no longer burdened by IDRs and capital expenditures are largely being self-funded.
- E&P management teams have become more disciplined with their capital spending and have slower their rates of production growth in order to improve corporate returns and generate positive FCF.
- Midstream management teams are also targeting positive FCF. This, in conjunction with lower leverage, high distribution coverage and less reliance on equity markets than at any point in the sector's history, provides optimism that midstream equities will attract incremental fund flows, supporting better valuations.

- Finally, there has been a healthy amount of insider buying as well as large, sophisticated institutional and private equity investors allocating capital to critical energy infrastructure assets. Numerous private transactions have been announced recently at higher multiples than those at which many publicly traded midstream companies are valued, a dislocation that cannot continue indefinitely.

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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