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MLPs Are Poised for a Steep Recovery

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Over the past 18 months, Master Limited Partnerships (MLPs) focused on midstream infrastructure have suffered a severe selloff that we believe is unwarranted by the fundamentals. The roughly 45% price decline since the 2014 peak presents investors with an opportunity to gain exposure to an attractive asset class at deeply discounted levels.

The steep decline in the commodity complex dominated both equity and credit markets during 2015, with heightened investor focus carrying into this year. The price of oil on a per barrel basis plummeted from ~$96 in August 2014 to below $27 in mid-February, rendering few new drilling projects sufficiently profitable to merit capital. Despite their more insulated cash flow dynamics and toll-road-like qualities, MLPs have not been spared from the energy drawdown. Investors have been blindsided by significant losses in their MLP portfolios and confused by the sector's heightened correlation to oil prices, prompting them to ask some key questions:

- How could an industry that led the U.S. recovery since 2009 and holds the promise of energy independence fall so far and so fast?
- Was this all a capital-markets, bubble-driven investment cycle run amok?
- Will Saudi Arabia simply crush the "high-cost" U.S. shale producers and drive them all out of business?
- I thought I owned a toll road … what happened? Is the MLP business model broken?

While all of those questions are legitimate and debate-worthy, we believe we can cut through the noise and pinpoint the overarching drivers of the MLP selloff. These have been relatively straightforward, and by analyzing each one specifically, we can create a roadmap to a recovery. We postulate that the bulk of the dislocation has been driven by industry-specific technical factors and a point-in-time correlation to oil prices. This caused a historical disconnect between the durability of underlying MLP cash flows/asset values and current security prices. Importantly, however, these factors appear to be reversing course, and the green shoots of a rebound are sprouting. Although we

Key Highlights

1. The energy dislocation has created a historical disconnect between the durability of underlying MLP cash flows/asset values and current security prices.
2. We believe the oil market is in the later innings of this down cycle and could rebalance at some point in the second half of 2016.
3. MLP capital requirements are decreasing and capital flows are returning.
4. In our view, the midstream MLP sector offers a compelling way for investors to play a recovery in the broader energy markets.

expect continued uncertainty and know that bottoming processes tend to be volatile, we believe the stage has been set for outsized risk-adjusted returns. We further posit that the near-to-mid term opportunity set for energy infrastructure presents the best and most asymmetric way to exploit the dislocation in energy more broadly.

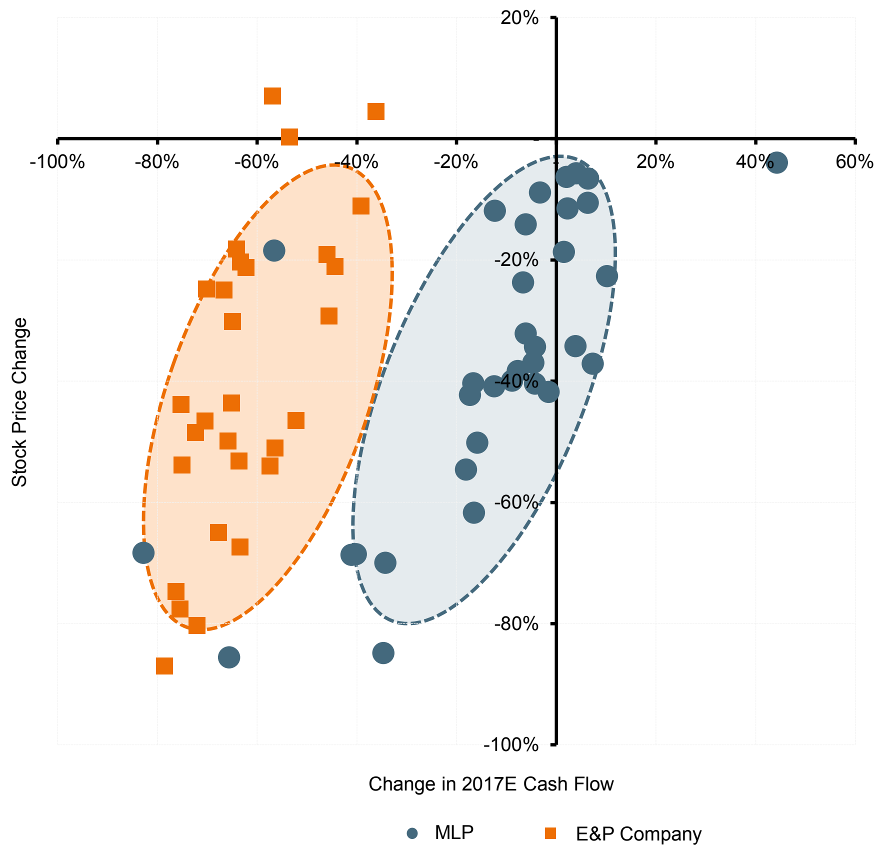
Technical Factors Have Overwhelmed Fundamentals

Illustrating our point that the market has overshot in its devaluation of midstream cash flows, Exhibit 1 shows that the sector has been discounted (unfairly in our view) as if it were entirely correlated to the underlying commodity. MLPs are essentially trading as if they were producers.

Alerian vs. XOP

- MLPs Down ~45% Despite Only ~7% Reduction in '17E Dividend Projection
- E&Ps Down ~55% But '17E EBITDA Projection Reduced ~62%

Exhibit 1: Fundamentals vs. Price Performance - MLPs vs. E&P Companies*



Source: Bloomberg, as of April 29, 2016. Stock price change from August 29, 2014 to April 29, 2016. Change in 2017E cash flow equals the change in Bloomberg consensus estimated 2017 Distribution per share (for MLPs) and EBITDA (for E&Ps) from August 29, 2014 to April 29, 2016. *As represented by the Alerian MLP Index (AMZ) and the S&P Oil & Gas Exploration & Production ETF (XOP).

As the graph highlights, the core cash flow for the vast majority of midstream MLPs (and their underlying assets) has remained remarkably stable in the face of historic corrections in commodity prices and producer activity levels. While cash flow growth has slowed and capacity utilization of certain discrete assets has fallen or failed to ramp, we believe this is a point-in-time issue. As oil and natural gas markets normalize, we

expect U.S. production growth to resume and the real assets owned by midstream MLPs to experience increased utilization, driving cash flow back on track relative to original expectations. Undoubtedly, that trajectory will not be uniform across all geographies and assets, creating an additional opportunity set for active security selection.

Our confidence that fundamentals will ultimately reassert themselves is driven by our view that a rebalancing of three core factors is both inevitable and well on its way. These are: (1) oil supply vs. demand, (2) capital sources and uses, and (3) MLP cash flow allocation.

1. Oil supply vs. demand is rapidly rebalancing.

We attribute the majority of the oil price dislocation to a readily identifiable oil-specific supply glut that has nothing to do with deflation or a slowdown in global demand. This “supply shock” has been self-inflicted largely by Saudi Arabia and other large producers that have simultaneously ramped volumes to all-time highs in a battle for market share and control. Excess capacity levels, however, from OPEC and Russia are now extremely tight in the face of robust global demand growth and declining non-OPEC production (mostly from U.S. shale). As a result, we believe the oil market is in the later innings of this down cycle and could rebalance at some point in the second half of 2016 (see Exhibit 2). Assuming a static demand picture, a drawdown in global inventories could follow in relatively short order.

Call on future production from U.S. (the world’s new swing capacity)

Exhibit 2: How Much U.S. Production Growth Will the World Need Over the Next Five Years?

Global Oil Supply & Demand

	Average 2009-2013	2014A	2015A	2016E	2017E	2018E	2019E	2020E
Demand (millions barrels/day)								
Global Demand Growth (y/y)	**1.1**	**0.6**	**1.8**	**1.2**	**1.3**	**1.2**	**1.2**	**1.3**
Supply (millions barrels/day)								
Global Supply Growth (y/y)	**1.0**	**2.3**	**2.7**	**(0.1)**	**(0.1)**	**0.0**	**(0.0)**	**(0.0)**
Saudi Arabia	0.1	0.1	0.6	0.2	-	-	-	-
Iran	(0.2)	0.1	0.0	0.6	0.3	0.1	-	-
Rest of World (ex-U.S.)	0.5	0.4	1.1	(0.4)	(0.4)	(0.1)	(0.0)	(0.0)
U.S. (No growth scenario)	0.6	1.6	0.9	(0.5)	(0.1)	-	-	-
Balance								
Market Imbalance				1.8	0.6	(0.0)	(1.2)	(2.5)
Add: Excess Inventory (EOY 2016E)*					0.8			
Change in (Supply - Demand)				(1.2)	(1.4)	(1.2)	(1.3)	(1.3)
Global Supply Shortfall				**0.6**	**(0.0)**	**(1.2)**	**(2.5)**	**(3.8)**

Source: Wolfe Research, Citi Research, TBCAM Analysis. *2016E Excess Inventory represents millions barrels/day of projected surplus inventory at the end of the year.

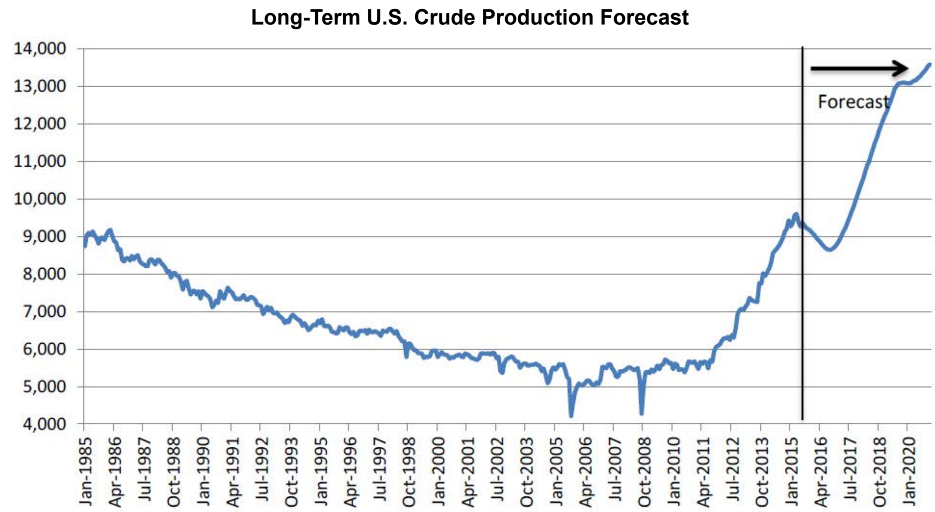
Irrespective of intent, Saudi Arabia’s actions have served to inflate the cost of capital for future oil production and have injected material uncertainty into the market. In addition to sharp reductions in current rig counts and capital spending, the global E&P sector has announced almost $1 trillion of project cancellations or deferrals that will meaningfully alter the future supply curve to the downside. Simply put, high-cost and large-scale

projects will not see the light of day as both return hurdles and price deck assumptions have been fundamentally altered. We believe many years may pass before long-term projects that require $80-$100 per barrel oil prices to garner decent returns are greenlit.

Ironically, the “call” on future U.S. shale production may become as strong after 2017 as it was in the years leading up to this dislocation. U.S. shale has become the *de facto* swing barrel of oil for the market. Shale production is modular and scalable, and the spigot can be turned on faster than it can in other regions. Importantly, these projects have predictable returns and short payback periods, and the assets are almost entirely privately owned (i.e. not government-controlled). While it is difficult to handicap an ultimate price of oil, we believe shale producers will be the first destination for capital investment when the need for future production becomes less opaque.

Although U.S. production growth has clearly shifted a few years to the right and the corporate entities that own and manage the assets might change around the margins due to bankruptcy and M&A, we believe this growth will resume at a similar, albeit lagged pace to what was previously modeled. The prospective ramp, as shown in Exhibit 3, is still significant, and those volumes bode well for the midstream sector.

Exhibit 3: U.S. Oil Growth Potential Still Staggering



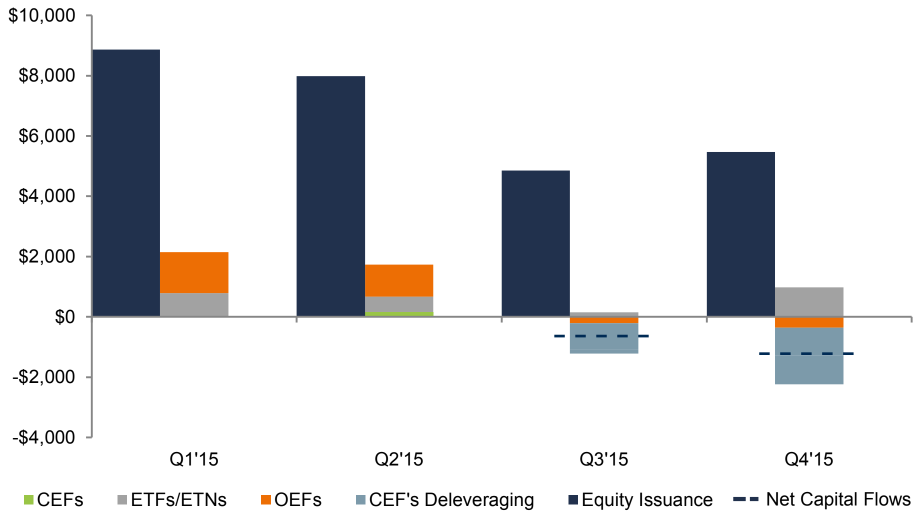
Source: HPDI, EIA, Raymond James Research.

2. The capital markets overhang has lifted.

The second rebalance relates to sources and uses of capital. Designing, contracting and building large-scale infrastructure projects is a complicated and long-lead-time business. To borrow an oft-used analogy, meaningful changes to investment programs can be equated to turning around an aircraft carrier. During 2015, the lag effect between the construction of new organic capital projects and the capital raises to finance them created a large overhang. Despite obvious signs of slowing market demand and tightening capital markets, MLPs pressed ahead to complete existing projects and, in many cases, pursued aggressive growth agendas for new opportunities. To fund that activity, they raised more than $10 billion of equity in the second half of 2015 despite net outflows from the sector.

That dynamic was compounded by aggressive short-selling and forced selling by closed-end mutual funds required to de-lever their balance sheets as prices dropped. In the third and fourth quarters, we estimate that closed-end funds alone accounted for more than $2.5 billion worth of selling pressure to stay within their leverage limits. Simply put, we witnessed lots of supply in the form of equity issuance and sharply lower demand as investors decreased allocations to energy more broadly and the MLP sector specifically (see Exhibit 4).

Exhibit 4: MLP Sector - Capital Supply vs. Demand



Source: US Capital/Bloomberg, TBCAM analysis, as of December 31, 2015.

Fortunately, the severity of the correction (and sharp increase in capital costs) has led to a dramatic change in management behavior. Companies have meaningfully tightened their capital spending plans and eliminated or reduced their dependence on public equity markets. Threshold return hurdles have been raised, and MLPs are working collaboratively with their customers to re-scope or defer projects. In some cases, external capital in the form of parent sponsor support or private equity has been secured to lower leverage and/or eliminate public-markets financing risk. Management teams do not want to issue equity at these prices, and unlike 2015, few will be forced to do so. During the first quarter of 2016, dedicated MLP mutual funds and ETFs had $1.75 billion of inflows, representing a significant upswing from the prior few quarters. As sector capital flows continue to stabilize/reverse, we see a real possibility that the imbalance could swing in the other direction.

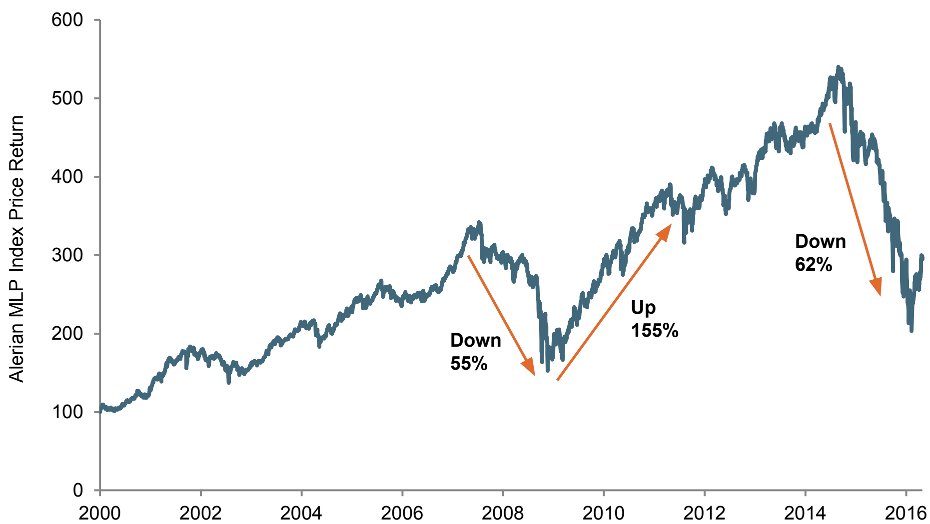
3. More conservative financial policies help restore confidence.

Lastly, we are in the midst of a rebalance in MLP cash flow allocation. Over the past several years, many MLPs used aggressive capital structures and financial policy to drive shareholder value. Companies generally focused on maximizing dividend growth, maintained limited excess dividend coverage, and operated with high levels of debt. They also relied heavily on public markets to finance organic growth capital and M&A activity. While much of this strategy was rational at the time, the market has clearly changed. Investors (and ratings agencies) are focused on balance sheet health, the sanctity of dividends, and the ability to finance growth plans with limited capital markets exposure. In a few isolated cases, this has resulted in outright dividend cuts, but for the most part, it has mostly manifested itself in the form of reduced or no dividend growth, higher dividend coverage, and lower leverage targets. We view these changes as necessary, given the current market environment, and crucial to restoring investor confidence in the sector's operational and financial stability.

With Adversity Comes Opportunity

For the 10 years prior to September 2014, the MLP sector delivered robust results, compounding at 17.1% per year vs. the Standard & Poor's 500 Index at 8.4% (see Exhibit 5). The assets owned by MLPs were perceived to be highly desirable, long-lived and mission-critical with predictable and recurring cash flows. Similar to real estate investment trusts ("REITs"), MLPs do not pay corporate-level taxes, and they distribute the vast majority of their cash flow back to investors in a tax-advantaged manner. We believe that as the dust settles and the aforementioned imbalances are resolved, these same economic attributes will once again prove attractive to investors.

Exhibit 5: Alerian MLP Index



Source: FactSet, Index values for January 3, 2000 - April 30, 2016.

We believe the midstream MLP sector offers the best way for investors to play a recovery in the broader energy markets. MLPs' operating cash flows have proven to be quite durable, unlike those of producers or oilfield-service companies. The vast majority of MLP cash flow is fixed fee in nature and not tied to actual commodity prices. As the global oil market returns to equilibrium, we believe a clear necessity will arise for renewed growth in U.S. shale production that will in turn directly benefit the midstream sector. Importantly, midstream operators have deployed meaningful capital over the past two years in anticipation of higher production levels. The earnings power of the industry without incremental capital investment is therefore higher than the current run rate. Additionally, while the market myopically tends to focus exclusively on oil when

volatility spikes, midstream MLPs are also exposed to bullish trends in the natural gas and liquids segments tied to ramping exports and domestic expansion by the utility and petrochemical sectors.

The Alerian MLP Index (AMZ) is currently yielding approximately 7.9% versus a five-year average of 6.4%, and trades at a spread to the 10-year U.S. Treasury of approximately 600 bps vs. long term average of ~360 basis points.[1] Clearly, the energy crisis has created uncertainty about core business fundamentals, the sanctity of dividends and appropriate valuation metrics for the sector. Sentiment has been hampered by high-profile dividend reductions, misguided acquisitions and concerns about counterparty risk.

When we dig beneath the headlines, though, we find a sector that is remarkably resilient. Even in the current environment, the AMZ is projected to grow dividends by more than 5% in 2016.[2] As discussed earlier, we believe oil supply/demand will soon rebalance, pushing prices toward the higher levels needed to justify new investments in production. As this transpires, investors should lower the odds ascribed to their worst-case scenarios and push valuations toward historical norms. Importantly, we believe the current price of that "optionality" is extremely cheap relative to the attractive return potential in even a slow recovery.

To illustrate hypothetical total returns, Exhibit 6 presents a simple matrix showing the two-year impact of changes to the dividend yield and distribution growth assumptions for the sector (represented by the AMZ).

Current AMZ yield equals ~7.9% with expected dividend growth of >5%

Exhibit 6: Alerian MLP Index – Two Year Total Return Potential

	Alerian Distribution Growth Per Year (2015 to 2017)					
Alerian Yield	-3.0%	-1.0%	1.0%	3.0%	5.0%	7.0%
11.0%	-17.2%	-14.2%	-11.2%	-8.1%	-5.0%	-1.8%
10.0%	-10.4%	-7.2%	-3.9%	-0.5%	2.9%	6.4%
9.0%	-2.2%	1.4%	5.0%	8.7%	12.5%	16.4%
8.0%	8.1%	12.1%	16.2%	20.3%	24.6%	28.9%
7.0%	21.3%	25.9%	30.5%	35.3%	40.1%	45.0%
6.0%	38.9%	44.2%	49.6%	55.1%	60.7%	66.5%

As of April 29, 2016; Bloomberg Alerian component consensus estimates. For illustrative purposes only, not a projection.

It is worth highlighting a few takeaways from the above. First, investors are getting paid to wait, as the sector is projected to yield approximately 7.9% during 2016. Second, a revaluation for the sector toward the historical norm of 6.4% would provide notable

valuation upside while retaining a sizable spread to the 10-year U.S. Treasury. Third, even in a scenario with no dividend growth, the strong current yield provides some cushion for investors, with a breakeven yield over the time period of approximately 9.4%.[3]

Conclusion

The past year has been arduous for most energy investors and has forced a re-examination of key assumptions. Fundamentally, MLPs are much better insulated from commodity volatility than other energy subsectors, but have not been spared from the selloff. A confluence of negative drivers caused stock prices to sharply overshoot even the most pessimistic scenarios.

While it is difficult to call an absolute floor, the MLP market appears to be deep into its bottoming process. We believe the framework for investors is very similar to what we saw in the high-yield market in 2009, an attractive multiyear total return opportunity underpinned by significant current yield and the potential for valuation re-rating as markets normalize.

The Boston Company's Energy Infrastructure MLP strategy is a dedicated alternative strategy targeting companies operating primarily in the midstream segment of the energy infrastructure value chain. The strategy invests in both MLPs and related corporations that own or control midstream assets. Our acute focus on total return and event-driven framework differentiate us from typical yield-oriented investors in the sector. The strategy has an inception date of April 1, 2013, and is available in separate account and commingled vehicles.

End Notes

1. Bloomberg Finance L.P., US Capital Advisors, as of April 29, 2016.
2. Based on Bloomberg Finance L.P., consensus as of April 29, 2016.
3. Bloomberg Finance L.P., as of April 29, 2016

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Bob is a senior portfolio manager on The Boston Company's Energy Infrastructure MLP strategy and Event-Driven strategy. He primarily focuses on event-driven opportunities across a range of industries, particularly among small- and mid-cap U.S. companies, and he has specialized expertise investing in Master Limited Partnerships, specifically in the midstream energy infrastructure segment. Before joining The Boston Company, Bob was a managing partner and co-founder of Pine Cobble Capital, LLC. Before that, he served as a managing director and general partner at Spectrum Equity Investors, a $4 billion private equity firm focused on media, communications, business and consumer services, and technology. Previously, he was a consultant at Bain & Company. Bob received a B.A. with honors in economics from Williams College and an M.B.A. with High Distinction from Harvard Business School, where he was a Baker Scholar.

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