Midstream: FIMI May Lead to FOMO

We live in a strange world where FOMO ("Fear Of Missing Out") fever congregates almost entirely in the most speculative market sectors. The latest beneficiary of FOMO fever is artificial intelligence, where investors are pouring money in despite the terror inspired by ChatGPT. It's unclear how making lots of money in artificial intelligence will matter when the machines take over, but that's a debate for another day. We're okay with Midstream not benefiting from FOMO fever because usually it leads to the FOMO crash. However, we're not okay when the main question we get lately is "Did I miss the Midstream rally?" We would call this FIMI ("Fear I Missed It") if we were in charge of text abbreviations.

We considered writing again about how a large majority of industry experts forecast traditional energy demand will rise for several more decades, or how Midstream fundamentals are the healthiest we've ever seen. After all, it is this combination that has some convinced Midstream has entered a new Golden Age (we agree). However, we decided for this note we'd instead make a more practical argument. One that focuses on valuation and how Midstream continues to screen cheaply against itself and other sectors. For Midstream, we think investors asking FIMI may end up MO ("Missing Out").

Making Sense Of The Midstream Multiple, Or Lack Thereof

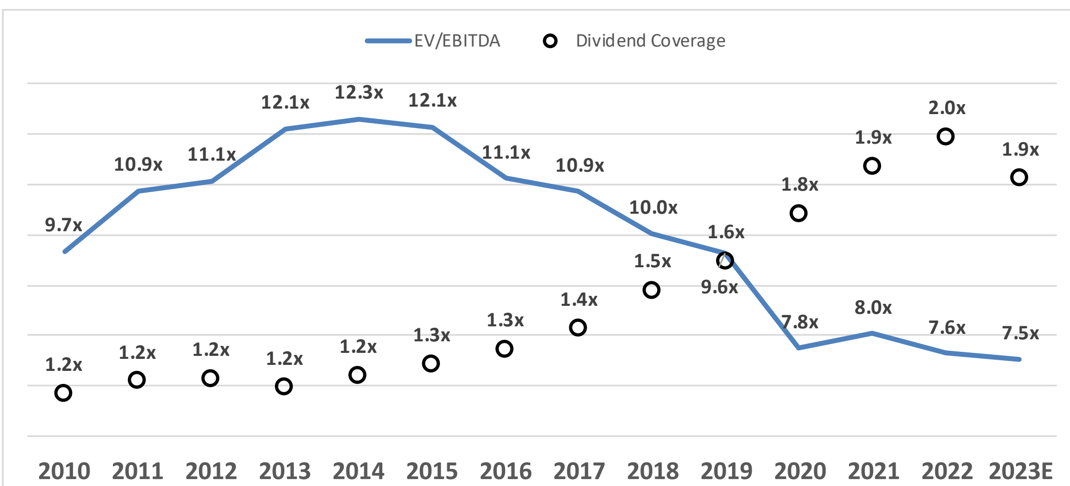
The Alerian MLP Index is currently trading at a 7.5x EV/EBITDA multiple that is well below its 10.1x average over the last ten years. It is barely above its 7.4x trough (4Q 2022), and nearly half its 13.0x peak (4Q 2013). This wide range between peak and trough is emblematic of a sector that experienced a paradigm shift over the last decade, something we've been highlighting for some time now. What may be lost in translation though is Midstream's paradigm shift has been unequivocally for the better, in our opinion. When you stop and think why a sector trades at a specific multiple, several reasons come to mind. To short list a few:

- *Growth expectations.* A company that is expected to have significant growth and/or has a track record signified by strong historical growth is typically rewarded with a high multiple.

- *Risk-return tradeoff.* Stable cash flows that have been proven over time require a lower risk premium, and investors are willing to pay a higher multiple for this stability.

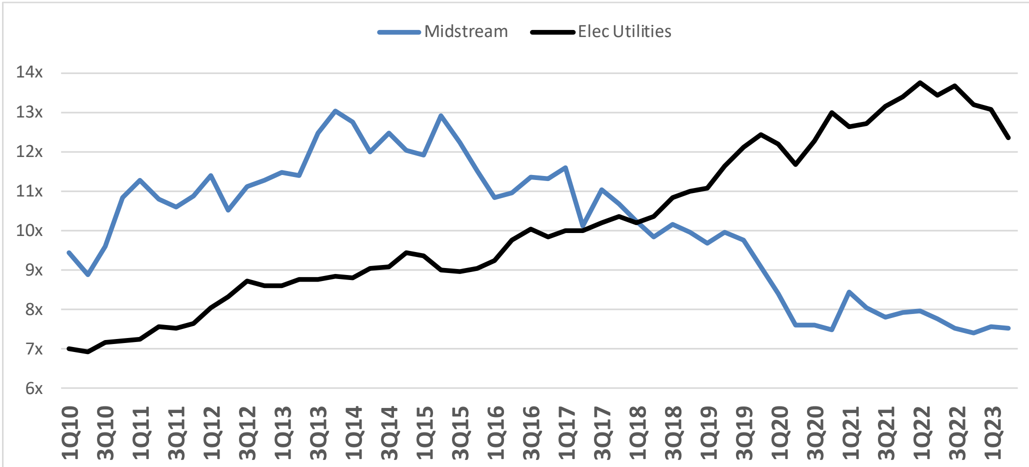
- *Market perception.* A sector perceived to have bright future prospects and a positive earnings outlook will be considered lower risk, and likely come with a higher multiple.

Several years ago we would have been hard pressed to justify a return to the peak multiples Midstream commanded in 2014. But today? It's actually super easy. The sector has improved its financial metrics dramatically while at the same time continuing to secure meaningful cash flow growth. The below chart shows the negative correlation between dividend coverage and multiples. It's not just dividend coverage as Debt-to-EBITDA metrics declined from 4.8x in 2017 to 3.6x today (2023E). We certainly recognize the painful dividend cuts investors experienced through 2020, though highlight that we're now in year three of sector-wide dividend growth. Some dividends that were cut have now been wholly restored (e.g., Energy Transfer). We know some wounds take longer to heal than others, though at some point healthy fundamentals should override what has been several years of Midstream multiples scraping bottom.



Source: Bloomberg, Wells Fargo

What about versus other similar sectors? Historically investors have preferred to compare Midstream to Electric Utilities because of their similar risk and cash flow profiles. However, Midstream trades at a substantial discount to Electric Utilities. There are certainly factors influencing each sector in either direction but given Midstream's financial strength it would make sense for this spread to converge.



Source: Bloomberg

What about other sectors and the broader market? Different question, same answer. Midstream and MLPs trade at a substantially higher discount to their 10-year average than Utilities, REITs, the S&P 500, and most of the other traditional energy sectors as well (Integrated Oil & Gas, Refiners, and Oilfield Services).

	EV-to-EBITDA Multiples	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
Midstream	**MLPs**	**7.6x**	**8.5x**	**(11%)**	**11.0x**	**(31%)**
	Midstream C-Corps.	**9.0x**	**10.1x**	**(11%)**	**12.4x**	**(28%)**
Energy	Exploration & Production	4.6x	5.8x	(22%)	6.7x	(32%)
	Refiners	4.9x	6.3x	(22%)	5.9x	(17%)
	Integrated Oil & Gas	4.7x	5.4x	(13%)	5.4x	(13%)
	Oilfield Services	7.0x	8.7x	(20%)	9.0x	(22%)
Yield	Utilities	10.2x	10.6x	(3%)	9.8x	4%
	REITs	16.0x	18.1x	(12%)	17.2x	(7%)
Market	S&P 500	12.1x	12.6x	(5%)	11.3x	7%

Source: Wells Fargo

Ironically and to circle back to the beginning, the only remaining argument for those staying on the sidelines is the fear that we've reached peak hydrocarbon demand. We'll take the over on that bet. It's not only the large majority of industry experts that don't see that happening, it's all those Net Zero countries signing long-term deals for more hydrocarbons (especially natural gas). It's because the vast majority of production around the world continues to be driven by oil economics. It's because traditional energy producers are actively working towards reducing or eliminating their own carbon emissions. It's because we do actually believe the world is energy transitioning.

So when investors ask us if they missed the Midstream rally, we say unequivocally no. Sure there may be some short-term recessionary headwinds, though beyond this noise we see financial stability, discipline, and accelerating growth prospects as all reasons that Midstream multiples should expand to historical averages (or higher). In summary, don't MO ("miss out") by thinking you already MI ("missed it"), or else at some point you may find yourself FOMO'ing your way into Midstream.

Another (BIG) One Bites The Dust

If you asked us at the beginning of the year which Midstream company was most likely to be acquired, Magellan would have been at or near the bottom of the list. Imagine our surprise when in mid-May ONEOK (OKE) announced it would pay a 22% premium to acquire Magellan (MMP) using a mix of cash and stock. Prior to the deal Magellan was trading at a 10.5x multiple, a substantial premium to the Alerian's 7.4x multiple and among the highest multiples in our group. We firmly believe Magellan deserves a premium valuation because of its sector-leading balance sheet, the demand-pull and inflation protected nature of its refined products infrastructure, and sharp focus on returns.

ONEOK detailed five reasons in its press release why acquiring Magellan is the right strategy. The shortened version of each are:

(1) Brings together two premier energy infrastructure businesses
(2) Expects to achieve immediate financial benefits, including cost, operational and tax synergies, supporting meaningful expected accretion
(3) Compelling long-term value proposition driven by consistent and disciplined capital allocation philosophy
(4) Complementary and diversified asset positions with potential for additional cost and commercial synergies over time
(5) Strong investment-grade credit ratings with enhanced scale and diversification

Most of these speak for themselves, though ONEOK specifically mentioned the step-up in tax basis from this acquisition will help ONEOK defer corporate taxes from 2024 to 2027. The company estimates the total value of this basis step-up is approximately $3 billion. The reason ONEOK is in this predicament of having to acquire a company to defer taxes is because the last few years the sector has been underinvesting in infrastructure, which is typically the primary avenue for companies to defer taxes. This is also a C-Corp problem since MLPs do not pay federal taxes (advantage: MLPs).

Separately, at a higher level this transaction also provides evidence of the importance of infrastructure and fiscal discipline. We've said multiple times that headwinds associated with building new infrastructure increases the scarcity value for those that own operational infrastructure. Think about what it says about Midstream that one company (ONEOK) was willing to pay a 22% premium for another company (Magellan) that was already among the highest premium stocks under coverage.

This Year's MVP Appears To Be … MVP

If not for ONEOK's takeout of Magellan, the surprise inclusion of Equitrans' (ETRN) Mountain Valley Pipeline (a.k.a., MVP) in the debt ceiling bill would have taken the trophy. We'll give them a trophy anyway though because it works with this section's title. To summarize, as part of the deal to raise the debt ceiling the political powers that be agreed to clear red tape holding up MVP, a mostly constructed natural gas pipeline from northwestern West Virginia and the Marcellus Shale to southern Virginia. One of the last remaining mega-projects from another era, MVP has seen costs rise and setbacks galore as legal challenges from environmental activists kept the project from crossing the finish line.

While certainly a win for ETRN, it seems like a one-off and not necessarily a win for Midstream. We're still patiently waiting for a grand bipartisan deal that will make it easier to build major infrastructure in our country, both for traditional energy and renewable energy. We continue to believe the pieces are in place for an agreement, though recognize the closer we get to the 2024 presidential election the more difficult it will get to complete a deal. The silver lining if nothing happened would be that nothing would happen! Midstream management teams will have few options other than continue being disciplined and returning capital to shareholders via share buybacks and dividend increases. If this scenario plays out, those that own infrastructure (like Midstream) will continue to see valuations rise as scarcity premiums rise.

Outlook & Positioning

We continue to focus on the research and portfolio execution effort and are in constant dialogue with industry experts and management teams. We continue to believe oil and natural gas will play a major and increasing role in the global economy, and owing to healthier balance sheets, higher coverage, and heightened discipline are optimistic about the long-term viability of Midstream as a sector for investors who prioritize income.

Economic conditions remain highly uncertain and there is no guarantee that these opinions or forecasts will come to pass.

Important Risk Disclosures:

Investors should carefully consider the investment objectives, risks, charges and expenses of the Eagle MLP Strategy Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 1-888-868-9501 or visiting www.eaglemlpfund.com. The prospectus should be read carefully before investing. The Eagle MLP Strategy Fund is distributed by Northern Lights Distributors, LLC member FINRA/SIPC. This is an actively managed dynamic portfolio. There is no guarantee that any investment (or this investment) will achieve its objectives, goals, generate positive returns, or avoid losses. The information provided should not be considered tax advice. Please consult your tax advisor for further information. Eagle Global Advisors, Princeton Fund Advisors, LLC and Northern Lights Distributors, LLC are not affiliated.

A master limited partnership (MLP) is a limited partnership that is publicly traded on a securities exchange. It combines the tax benefits of a limited partnership with the liquidity of publicly traded securities. To qualify for MLP status, a partnership must generate at least 90 percent of its income from what the Internal Revenue Service (IRS) deems "qualifying" sources, generally relating to the production, processing or transportation of natural resources, such as oil and natural gas.

The Alerian MLP Index is a composite of the 50 most prominent energy master limited partnerships calculated by Standard & Poor's using a float-adjusted market capitalization methodology.

The Alerian Midstream Energy Index is a broad-based composite of North American energy infrastructure companies.

The S&P 500 Index is a capitalization-weighted index that measures the performance of 500 U.S. large-capitalization domestic stocks representing all major industries.

The Barclays Capital U.S. Aggregate Index provides a measure of the performance of the U.S. investment grades bonds market.

Enterprise Value-to-EBITDA is a multiple used to determine the value of a company. It shows the value of a company based on a multiple of earnings before interest, taxes, depreciation and amortization (EBITDA).

Price-to-Distributable Cash Flow is a valuation ratio calculated by dividing a company's current stock price by its distributable cash flow per share.

Standard Deviation is a statistical measurement of volatility risk based on historical returns.

Risk Factors:

Credit Risk: There is a risk that note issuers will not make payments on securities held by the Fund, resulting in losses to the Fund. In addition, the credit quality of securities held by the Fund may be lowered if an issuer's financial condition changes.

Distribution Policy Risk: The Fund's distribution policy is not designed to guarantee distributions that equal a fixed percentage of the Fund's current net asset value per share. Shareholders receiving periodic payments from the Fund may be under the impression that they are receiving net profits. However, all or a portion of a distribution may consist of a return of capital (i.e. from your original investment). Shareholders should not assume that the source of a distribution from the Fund is net profit. Shareholders should note that return of capital will reduce the tax basis of their shares and potentially increase the taxable gain, if any, upon disposition of their shares.

ETN Risk: ETNs are subject to administrative and other expenses, which will be indirectly paid by the Fund. Each ETN is subject to specific risks, depending on the nature of the ETN. ETNs are subject to default risks. Foreign Investment Risk: Investing in notes of foreign issuers involves risks not typically associated with U.S. investments, including adverse political, social and economic developments, less liquidity, greater volatility, less developed or less efficient trading markets, political instability and differing auditing and legal standards.

Interest Rate Risk: Typically, a rise in interest rates can cause a decline in the value of notes and MLPs owned by the Fund.

Liquidity Risk: Liquidity risk exists when particular investments of the Fund would be difficult to purchase or sell, possibly preventing the Fund from selling such illiquid securities at an advantageous time or price, or possibly requiring the Fund to dispose of other investments at unfavorable times or prices in order to satisfy its obligations.

Management Risk: Eagle's judgments about the attractiveness, value and potential appreciation of particular asset classes and securities in which the Fund invests may prove to be incorrect and may not produce the desired results. Additionally, Princeton's judgments about the potential performance of the Fund's investment portfolio, within the Fund's investment policies and risk parameters, may prove incorrect and may not produce the desired results.

Market Risk: Overall securities market risks may affect the value of individual instruments in which the Fund invests. Factors such as domestic and foreign economic growth and market conditions, interest rate levels, and political events affect the securities markets.

MLP Risk: Investments in MLPs involve risks different from those of investing in common stock including risks related to limited control and limited rights to vote on matters affecting the MLP, risks related to potential conflicts of interest between the MLP and the MLP's general partner, cash flow risks, dilution risks and risks related to the general partner's limited call right. MLPs are generally considered interest-rate sensitive investments. During periods of interest rate volatility, these investments may not provide attractive returns. Depending on the state of interest rates in general, the use of MLPs could enhance or harm the overall performance of the Fund.

MLP Tax Risk: MLPs, typically, do not pay U.S. federal income tax at the partnership level. Instead, each partner is allocated a share of the partnership's income, gains, losses, deductions and expenses. A change in current tax law or in the underlying business mix of a given MLP could result in an MLP being treated as a corporation for U.S. federal income tax purposes, which would result in such MLP being required to pay U.S. federal income tax on its taxable income. The classification of an MLP as a corporation for U.S. federal income tax purposes would have the effect of reducing the amount of cash available for distribution by the MLP. Thus, if any of the MLPs owned by the Fund were treated as corporations for U.S. federal income tax purposes, it could result in a reduction of the value of your investment in the Fund and lower income, as compared to an MLP that is not taxed as a corporation.

Energy Related Risk: The Fund focuses its investments in the energy infrastructure sector, through MLP securities. Because of its focus in this sector, the performance of the Fund is tied closely to and affected by developments in the energy sector, such as the possibility that government regulation will negatively impact companies in this sector. Energy infrastructure entities are subject to the risks specific to the industry they serve including, but not limited to, the following: Fluctuations in commodity prices; Reduced volumes of natural gas or other energy commodities available for transporting, processing, storing or distributing; New construction risk and acquisition risk which can limit potential growth; A sustained reduced demand for crude oil, natural gas and refined petroleum products resulting from a recession or an increase in market price or higher taxes; Depletion of the natural gas reserves or other commodities if not replaced; Changes in the regulatory environment; Extreme weather; Rising interest rates which could result in a higher cost of capital and drive investors into other investment opportunities; and Threats of attack by terrorists.

Non-Diversification Risk: As a non-diversified fund, the Fund may invest more than 5% of its total assets in the securities of one or more issuers. Small and Medium Capitalization Company Risk: The value of a small or medium capitalization company securities may be subject to more abrupt or erratic market movements than those of larger, more established companies or the market averages in general. Structured Note Risk: MLP–related structured notes involve tracking risk, issuer default risk and may involve leverage risk. Mutual Funds involve risk including possible loss of principal.

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