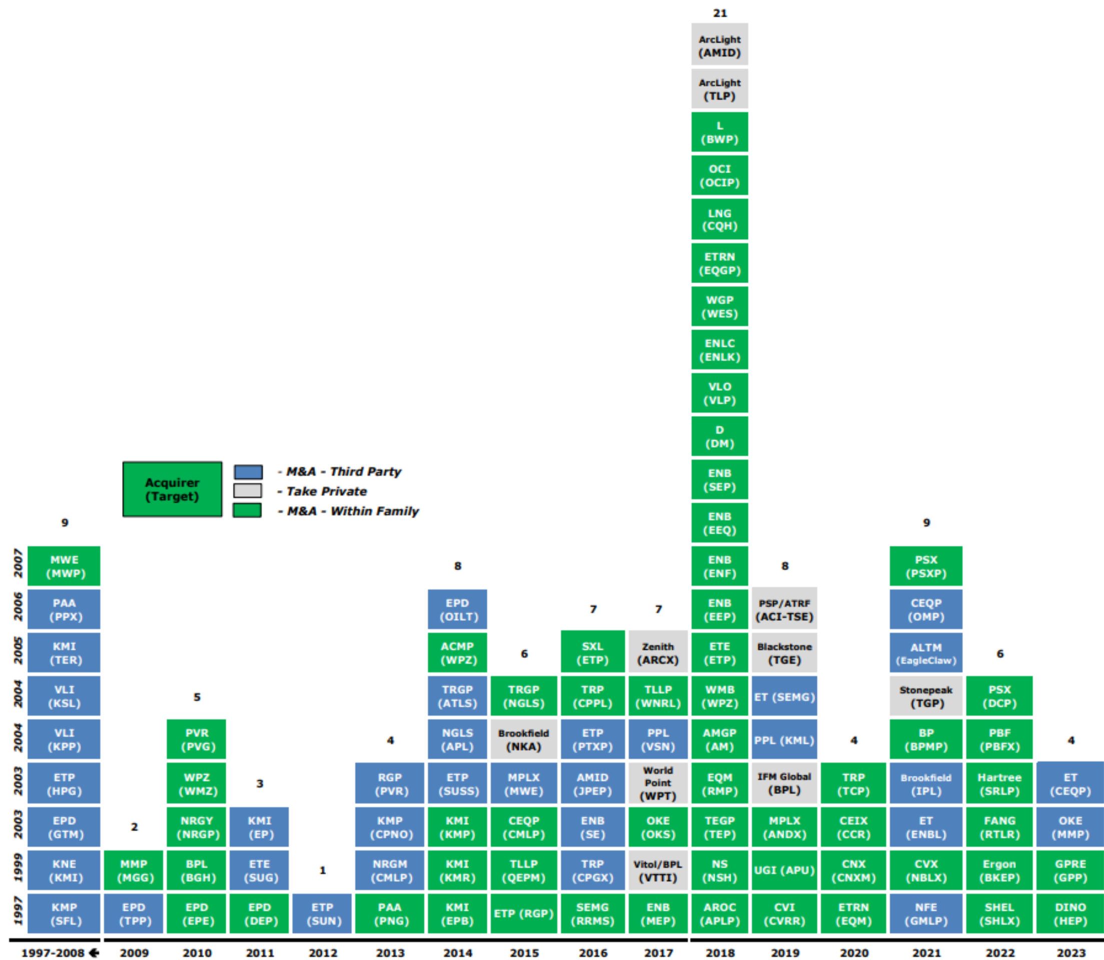
Midstream: Three (Or More) Makes A Trend

Three times make a trend. There's not really any science behind this proverb. Years ago, British novelist Ian Fleming (James Bond creator) said "Once is happenstance. Twice is coincidence. Three times is enemy action." What we're discussing today isn't quite as bold as enemy action, though we're well above three Midstream corporate actions this year and therefore a trend is well underway. We never thought much of sponsor roll-up acquisitions, which are still happening (DINO/GPRE rolling up HEP/GPP, respectively). What's noteworthy this time around are both the third-party nature and the scale of recent deals; ONEOK (OKE) taking out Magellan (MMP), Energy Transfer (ET) buying Crestwood (CEQP), and Enbridge (ENB) buying Dominion's (D) gas utility businesses to name a few. We're talking tens of billions of dollars of acquired value, and we see the potential for more deals to be announced over the next twelve months.

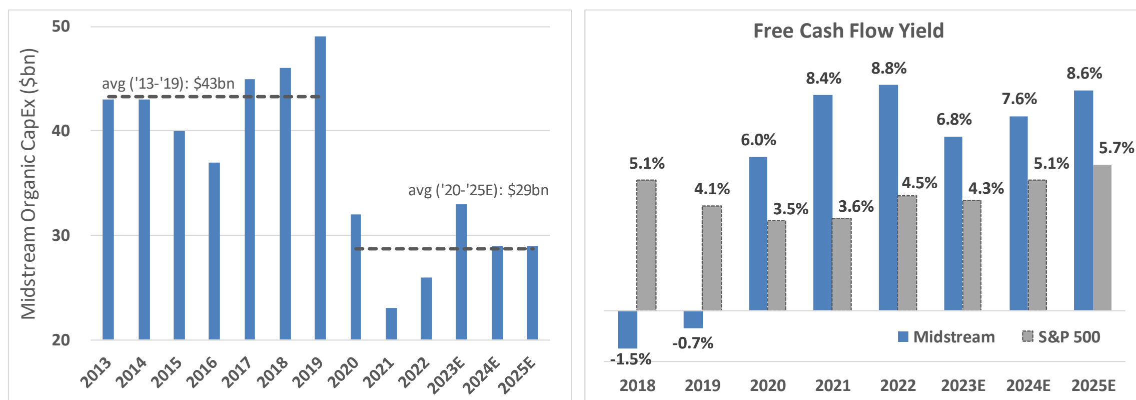


Source: Bloomberg, Wells Fargo

Consolidation: Why Now?

Put simply, companies generating material free cash flow can allocate it in a number of ways. As an example: (1) invest organically, (2) improve their balance sheet, (3) hand out goodies via return of capital, or (4) execute acquisitions. In a perfect world companies would acquire assets only when organic opportunities are limited, resulting in an almost inverse relationship between organic growth and acquisitions. We know the world isn't perfect and you will find organic growth in a market that doesn't need it and acquisitions in other markets where organic opportunities abound. We're all human!

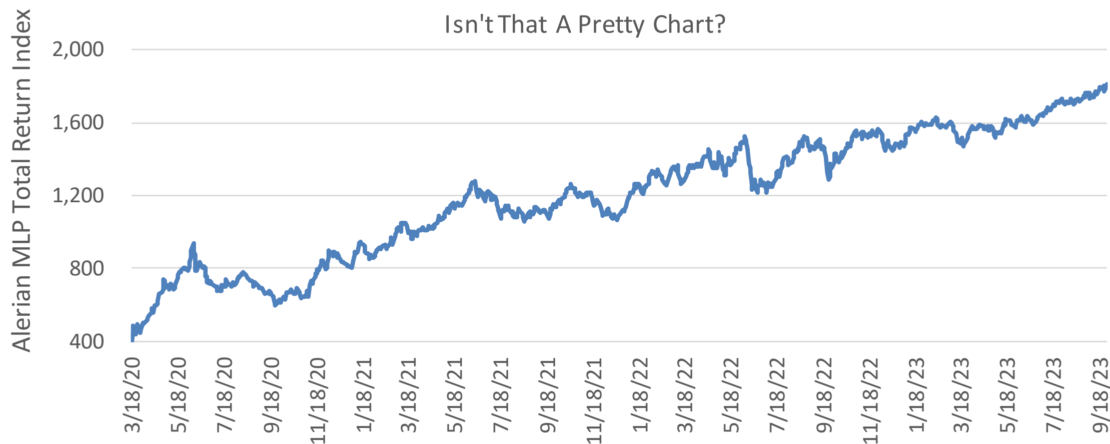
Why now? For the past several years Midstream capital spending has been well below previous highs; the average annual capex spend since 2020 is running about 33% below the 2013-2019 average. Meanwhile, free cash flow yields are at all-time highs, tracking between 6%-9% since 2020, and well above the average of the S&P 500. The sector's balance sheets are healthy, and raising dividends is somewhat limited by a desire to maintain hardy dividend coverage ratios and also the fact that dividend yields are already compelling. What does that leave? Share buybacks and acquisitions. Share buybacks have been well received, especially because equity valuations trade at a discount to the broader market and a variety of similar asset classes. Management has to do something with the money! Therefore, acquisitions. Since many of these transactions involve a large equity component the balance sheet impact is limited, and management's core job remains positioning the company for long-term success. Therefore, on paper (or at least academically) the time is ripe for consolidation.



Source: Wells Fargo

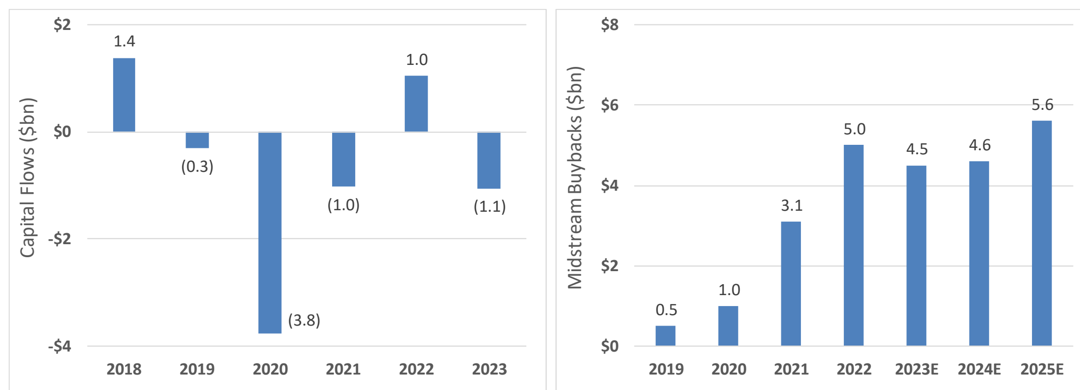
Consolidation: What Does It All Mean?

The sector is cheap. We once again encourage our readers to take a look at last quarter's note that focused on Midstream valuations. Furthermore, (1) the Midstream sector remains out of favor with the broader investor base, and (2) the current regulatory and legal framework makes it difficult to see how the operating environment can shift back to one that favors organic growth. In a sense "it is what it is" and we're not unhappy about these issues. If for nothing else the two will work together keeping Midstream the best kept secret in the market, and it lowers the probability that management teams will make silly decisions and alter what is a fantastic technical chart.



Source: Bloomberg

Despite the attractiveness of the above chart, you may be surprised to learn the Midstream sector has experienced $1.5 billion of outflows over the last three years (YTD: $1.05 billion). This is despite outperforming the S&P 500 by 10,700 basis points over the same time frame (YTD: 750 basis points), and sentiment remaining as positive as we've ever seen it. How is this possible? We believe the major offset to outflows has been share buybacks, which have overwhelmed negative capital flows.



Source: US Capital Advisors, Wells Fargo

We also see little chance of organic growth ramping up any time soon. Even if capital wasn't constrained there have been too many nightmare experiences with growth projects for a management team to go out on a limb. The risk is not worth the reward. We don't see this improving as regulatory and environmental activism cracks down on everything traditional energy undertakes. The most obvious example is the Mountain Valley Pipeline (MVP), where activism has led to cost increases and construction delays. In fact, MVP required a special act of Congress to complete! If that's the new bar for Midstream we see little chance of organic growth accelerating anytime soon. However, what may be bad for Main Street (less infrastructure) is undoubtedly good for Midstream. The U.S. economy still depends almost entirely on fossil fuels, and most industry experts expect demand will continue to increase. Infrastructure limitations greatly increases the value of the assets that are already operating. Oh, and don't forget that Midstream assets typically deliver steady, inflation-protected cash flows over long periods of time.

Annual Changes to CPI, Alerian MLP Index, S&P 500

Period	Annual Change in CPI	Annual Change in AMZX	Annual Change in S&P
Average 1996-2022*	2.47%	13.36%	10.18%
Average During Low Inflation***	1.69%	10.04%	18.25%
Average During High Inflation**	3.75%	19.10%	0.09%

Source: Bloomberg, Alerian

Meanwhile, management teams still have businesses to run, and as such they will make strategic decisions with their asset portfolios. With organic growth limited that means companies are instead turning to acquisitions. In our view, acquisitions check many boxes (e.g., higher float, larger scale, diversification, etc.) and generate far less headaches than today's organic growth projects.

In conclusion, we believe the Midstream sector will continue to consolidate. Our hope as capitalists is society will recognize and reward infrastructure developers for the critically important role they play in the economy. Only then will the incentives and process be streamlined to allow our companies to do what they do best, build and operate infrastructure that powers the economy. We believe most people understand infrastructure's importance, though we're not convinced enough appreciate how difficult it is to build anything in this country. Since we don't believe peak oil or natural gas will occur this decade we're left with a country (and world) that will become critically short on infrastructure. Until the risk and reward dynamic changes we see no reason for Midstream to extend itself into a large-scale growth project, especially if there are alternatives like debt reduction, dividend growth, and share buybacks. Eventually a lack of infrastructure will cause major economic problems and regulators will move mountains to fix the issue. "Never let a good water crisis go to waste" is unfortunately how the world works. Until then every chance we get we stress to Midstream management to stay the course on return of capital initiatives. And if they continue to consolidate? Do so strategically and at a rational price and the transaction will get rewarded.

	EV-to-EBITDA Multiples	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
Midstream	**MLPs**	**8.2x**	**8.5x**	**(3%)**	**11.0x**	**(25%)**
	Midstream C-Corps.	**8.9x**	**10.1x**	**(12%)**	**12.4x**	**(29%)**
Energy	Exploration & Production	5.3x	5.8x	(9%)	6.7x	(21%)
	Refiners	5.6x	6.3x	(11%)	5.9x	(5%)
	Integrated Oil & Gas	5.0x	5.4x	(7%)	5.4x	(7%)
	Oilfield Services	9.2x	8.7x	6%	9.0x	2%
Yield	Utilities	10.0x	10.6x	(5%)	9.8x	2%
	REITs	14.3x	18.1x	(21%)	17.2x	(17%)
Market	S&P 500	12.2x	12.6x	(4%)	11.3x	8%

Source: Wells Fargo

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.

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. Eagle Global Advisors, Princeton Fund Advisors, LLC and Northern Lights Distributors, LLC are not affiliated.

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. Past performance does not guarantee future results.

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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