Midstream: Positive FCF Drives Solid '23, Likely "More In '24"

For the third straight year the Alerian MLP Index outperformed the S&P 500 on a total return basis (AMZ: +26.6%, SPX: +26.3%), and it's all thanks to positive free cash flow. It opens so many doors. It allows companies to self-finance growth, reduce debt, buy back shares, and raise dividends. Despite these positive intangibles, Midstream continues to live in relative obscurity as data from U.S. Capital Advisors shows a net $934 million flowed out of Midstream ETFs, ETNs and mutual funds in 2023, extending the sector's net outflow streak that started in 2020. Said differently, this is the rally for which no one appears to be taking credit.

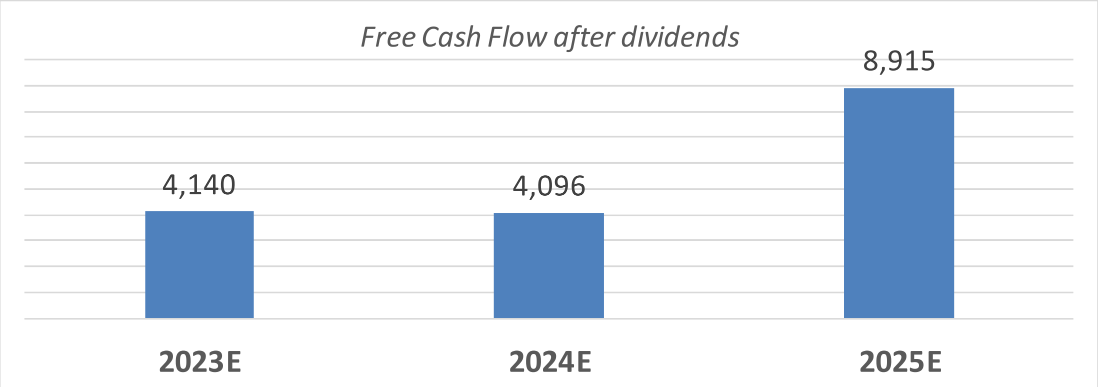
We believe Midstream obscurity also led to one of the more surprising trends of 2023: sector consolidation. Strategically most of these combinations made sense. However, we can't deny that "sellers" may also be running out of patience when it comes to their stock price, while "buyers" are looking at acquisitions as simply something else to do with their free cash flow. We believe one of two things will happen in 2024: (1) Wall Street will recognize the scarcity value of energy infrastructure and stocks will re-rate higher, or (2) stocks won't re-rate higher and sector consolidation will continue.

Either way the outcome should be positive as long as Midstream continues to generate positive free cash flow. "More in '24!"

Midstream … Income

After a turbulent 2015-20, Midstream has regained its status as a sector with high income. And yet, we often wonder how much time our investors spend thinking about Midstream? Given the turmoil elsewhere in the world, we guess they spend little, if any, time on Midstream. We hope this is the case. It means you're happy with your Midstream investments. We don't see any of this changing in 2024 following yet another year of solid positive free cash flow.

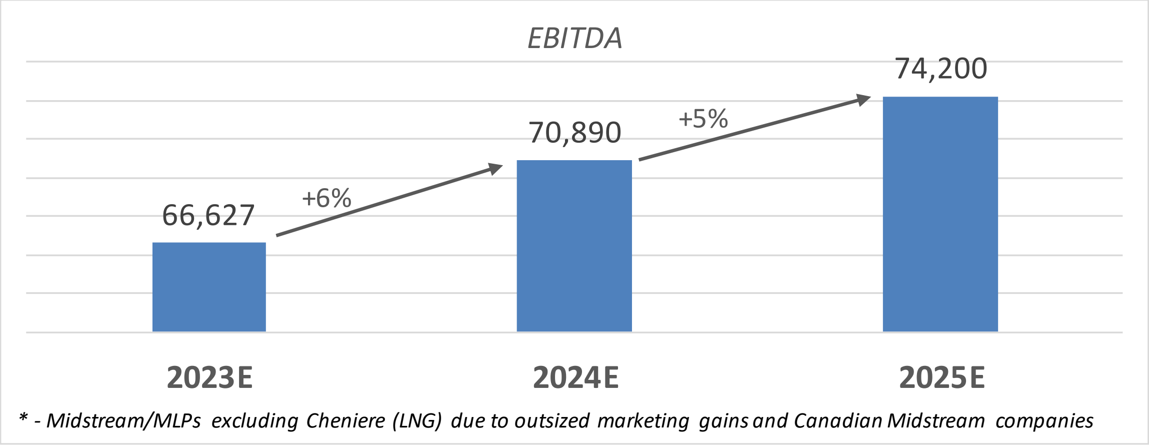
Wells Fargo forecasts greater-than $4 billion of free cash flow after dividends in 2024, largely in line with the amount generated in 2023. This is Midstream's foundation and why we believe the sector will spend another year returning capital to investors. It's also worth highlighting this figure is projected to more than double to just under $9 billion in 2025 thanks to investments that fly under the radar, like the building or expansion of processors, fractionators, pipeline and storage networks and the development of carbon capture/sequestration (CCUS). However, these projects don't come close to alleviating the country's shortage of energy infrastructure.



** - Midstream/MLPs excluding Cheniere (LNG) due to outsized marketing gains and Canadian Midstream companies*

Source: Wells Fargo

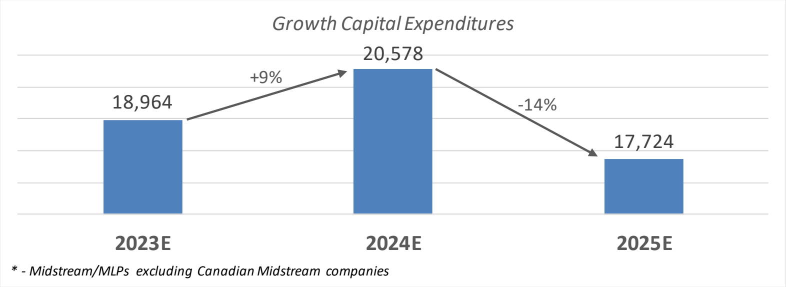
So investors can be forgiven for not noticing Midstream's growth, though make no mistake Midstream is growing. Wells Fargo forecasts EBITDA (earnings before interest, taxes, depreciation and amortization – used as an indicator of the overall profitability of a business) will grow 6% in 2024 and another 5% in 2025. While a small portion of this is driven by inflation escalators, most of it comes from organic growth financed internally.



* - Midstream/MLPs excluding Cheniere (LNG) due to outsized marketing gains and Canadian Midstream companies

Source: Wells Fargo

While we are unabashedly excited about EBITDA and distribution growth, we are slightly less enthusiastic about forecasted growth in capital expenditures. Capex is forecasted to increase 9% in 2024 before declining 14% in 2025, though we recognize both estimates are likely to be revised higher as new projects are announced and/or costs rise. We were disappointed by the rise in growth capex projections in 2023 and expect something similar in 2024. However, capital being spent relative to enterprise value in 2024 (3.5%) remains proportionate to 2023. It's also far below the 5.5%-6.0% level pre-pandemic (2018-19) and even further below the blowout spending years prior to that. The point is that Midstream capital spending is stable, digestible, and only partially cuts into the sector's ability to return capital to shareholders.



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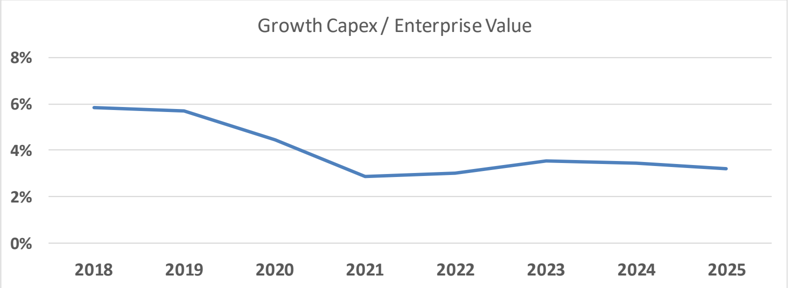
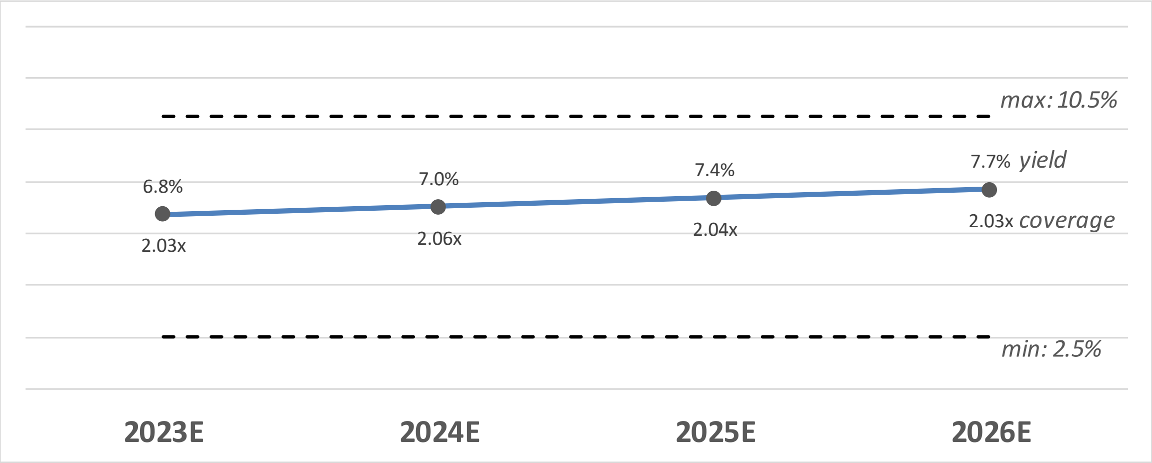


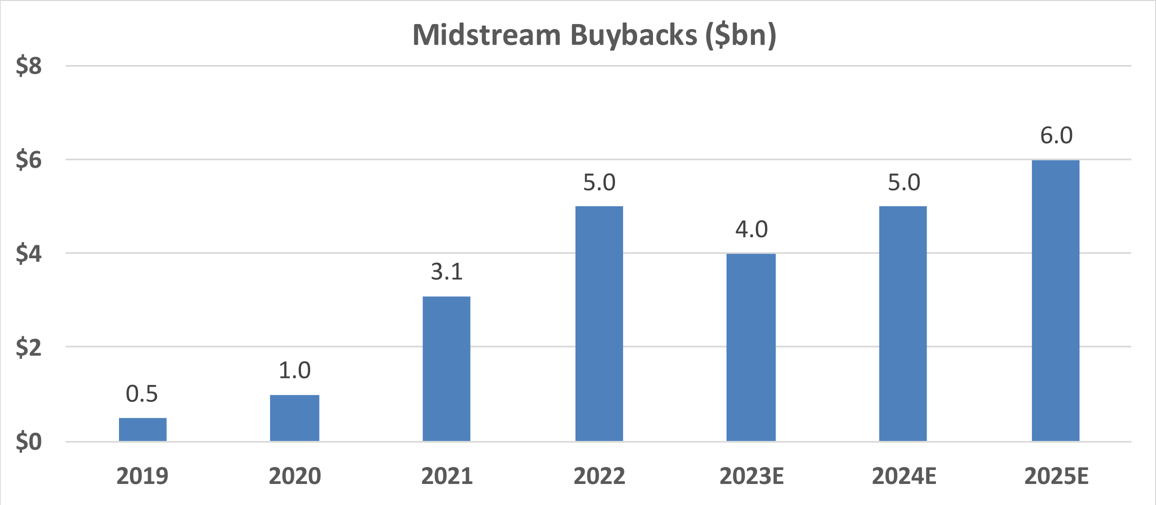
Source: Wells Fargo

It all comes down to "return of capital". Midstream has it, most other sectors don't. Dividends are growing, debt is low and going lower, shares are being bought back, and growth is self-financed. How long does this last? We think awhile, and that's why we don't see any reason the multi-year Midstream rally slows. Let's start with dividends. We forecast dividends will increase 5.5% in each of 2024 and 2025, which follows 7.5% growth in 2023. We've often asked management teams why they're raising dividends when Midstream's dividend yield is comfortably above 6.5% (12/31: 6.9%), and they (more or less) point out that coverage ratios are holding steady. In other words, they're raising dividends in line with free cash flow growth. To not raise dividends would result in higher coverage, which is not an efficient use of capital.



Source: Eagle Global

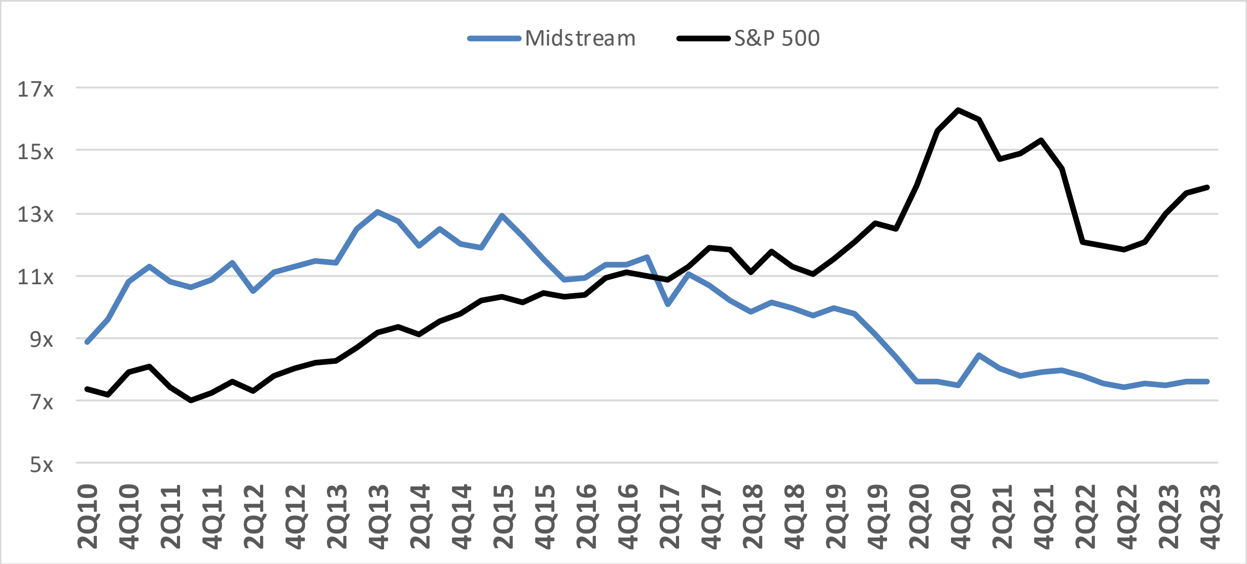
Management teams also highlight their healthy balance sheets and share buyback programs. For this we tip our cap. Balance sheets are healthy to the point that some companies have lowered their long-term targets for debt/EBITDA to reflect the new paradigm. Meanwhile, share buybacks are expected to again be in the billions of dollars in 2024, and meaningfully increase in 2025.



Source: Wells Fargo

Free cash flow gives us confidence that whatever direction the economy travels, Midstream is set up to succeed. If the stock market continues to rally we would expect Midstream to participate, delivering solid absolute total return based on 6%-8% dividend growth and a 6.9% yield. Should the economy and stock market falter the value/defense attributes of Midstream should prove valuable.

Midstream is also relatively inexpensive. Despite the tremendous rally over the past three years the sector's EV/EBITDA multiple has stayed flat. EBITDA has grown (and will continue to), while enterprise value has seen debt reduced and share price increase. These forces offset, keep the multiple flat, and should give investors' confidence. After all, Midstream has traded at a material discount to the S&P 500 since mid-2017. Even narrowing this discount implies the opportunity for outperformance.



Sources: Bloomberg

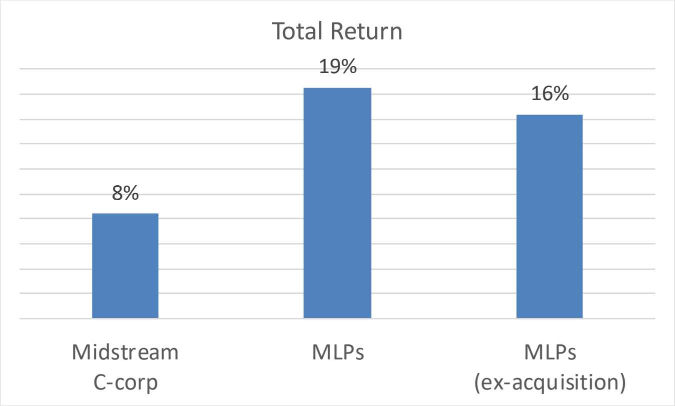
And if valuation doesn't re-rate higher? In that case we'd expect more sector consolidation, similar to what we saw in 2023. Whether it be Exxon buying Pioneer, ONEOK buying Magellan, or anywhere else on the energy chain. We wrote above that most of these combinations make sense, whether strategically, because "sellers" are running out of patience, or "buyers" are simply looking at acquisitions as something else to do with their free cash flow. Consolidation won't stop until the "bid-ask spread" widens, because management believes the market is more likely to deliver a higher share price than what another company will pay. In other words, if the stocks re-rate higher consolidation likely slows. To date the consolidation trend has not led to a re-rating of the sector. Yet.

From 2000 through 2011 the Alerian MLP Index outperformed the S&P 500. Back then the sector was driven by the need to expand infrastructure to support the shale revolution. Today the importance of traditional energy has never been more obvious, yet it's nearly impossible to build energy infrastructure. This constraint on development adds to an already high scarcity premium, at the same time management discipline has led to unprecedented returns of capital. The result has been 3-years of relative outperformance.

2023 Recap: Midstream Quietly Delivers Another Solid Year

MLPs Outperformed C-Corps

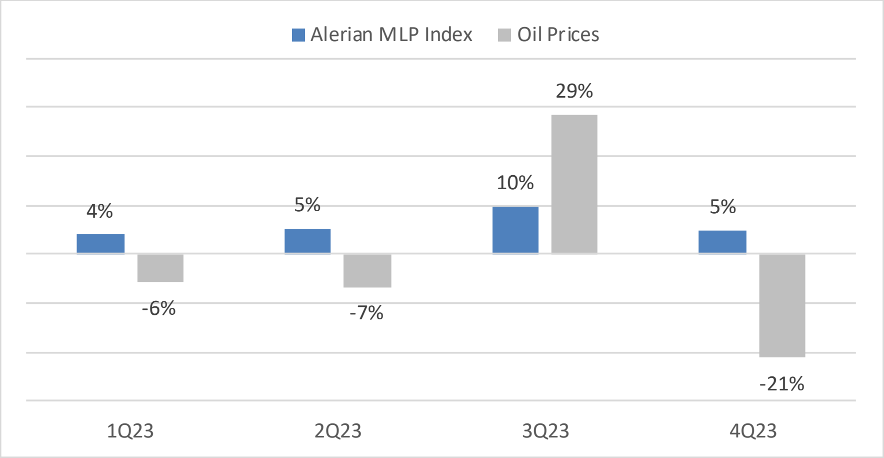
Master Limited Partnerships, or MLPs, are back. In 2023 MLPs outperformed C-corps by 9% (MLPs: +19%, C-corps: +8%). Companies that were acquired were exclusively MLPs and added only about 2.2% to outperformance. We've long expressed the view that MLPs offer tax advantages over C-corps that make their existence worthwhile. In fact, the significant decline in capital spending has weakened the ability for Midstream C-corps to defer taxes and was identified as a significant factor in ONEOK's acquisition of Magellan Midstream. MLPs don't have to worry about taxes and so the decline in capital spending isn't as much an issue. The problem these days for MLPs is the quality differential between those that remain. The "haves" like ET and EPD are positioned well, while the "have nots" like CSI Compressco and Martin Midstream may struggle to compete. Despite these advantages we see little appetite for MLP IPOs. For at least a little while though it was nice to not have to answer existential questions about MLPs.



Sources: Bloomberg

Midstream's Negative Correlation To Oil

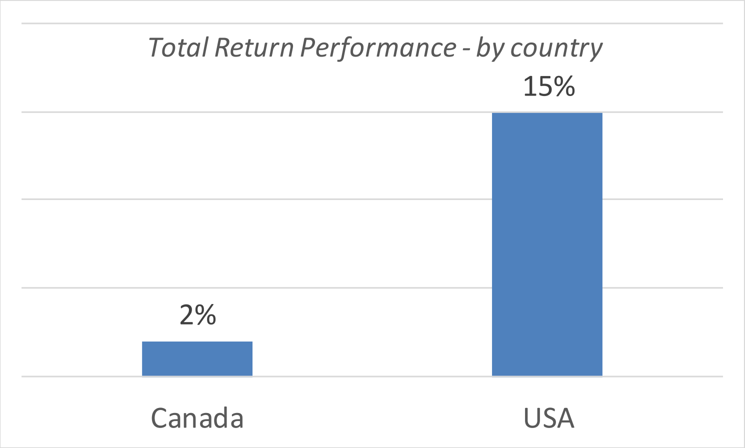
The Alerian MLP Index delivered steady total return performance through the four quarters of 2023, while oil prices fell in three of the four quarters (1Q, 2Q, 4Q). We've made note of this negative correlation at various points over the last few years though 2023 was eye-opening. All the corrective action that saw balance sheets improved, dividends restored and increased, buybacks, self-financed capital programs, and Midstream's role as an inflation hedge culminated in this remarkable transformation. We believe over the long-term that oil and Midstream performance should have some positive correlation, though for several years after 2014 it seemed Midstream stocks didn't go up when oil went up and fell much harder when oil prices fell. We prefer today's correlation over yesterdays.



Sources: Bloomberg

Canada Underperforms The USA

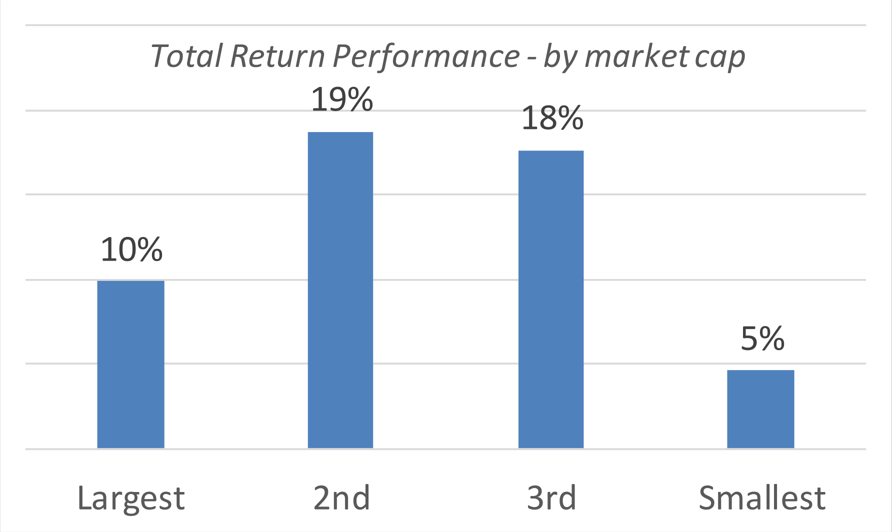
It paid to be south of the Canadian border in 2023 as U.S. Midstream stocks generated total return of 15% versus only 2% for Canadian Midstream stocks. We attribute a large part of U.S. outperformance to their focus on return of capital, which is to say the Canadians (especially ENB and TRP) seem to care little about debt reduction and share buybacks. In fact, we continue to be surprised how Canadian companies maintain such strong investment grade ratings despite any lack of discipline when it comes to capital. We don't see this changing any time soon and therefore expect us to be selective when it comes to investing in Canada.



Sources: Bloomberg

Midstream In The Middle

Midstream companies in the middle of the pack (2nd/3rd quartile) outperformed the largest and smallest companies, based on market cap. The average total return in the middle was roughly +18%, versus +10% for the largest companies and +5% for the smallest. While interesting, we believe the major takeaway here is that it doesn't matter how large the company is, but whether the company is delivering the wants of the market. In this case, the largest and smallest companies largely failed to return capital to shareholders.



Sources: Bloomberg

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. 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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