Midstream: we examine the prospect for midstream payout growth, which seems incongruous with today's cheap valuations. We see payouts growing in 2022 at the fastest rate in almost a decade. This trend was highlighted by recent multi-billion-dollar announcements from WMB and LNG. We see potential payout growth of 15% in 2022, spread across dividends and buybacks. With midstream bonds yielding 3%, and midstream equities yielding 7% (and rising), the market is seemingly daring midstream companies to buy back stock.

Natural Resources: 2021 shale drilling activity has remained restrained despite higher commodity prices. Per-well CAPEX has also been further reduced in 2021 as producers are now completing wells previously drilled during COVID. As uncompleted inventories are exhausted in 2022, per-well CAPEX will increase. With shale E&Ps facing built-in cost inflation in 2022, production is unlikely to accelerate. Given a robust commodity outlook paired with service cost inflation, we continue to prefer energy companies with lower reinvestment requirements.

Check out Recurrent's video series, "Research in 99 Seconds," as well as our research white papers, here.

MLP & Infrastructure

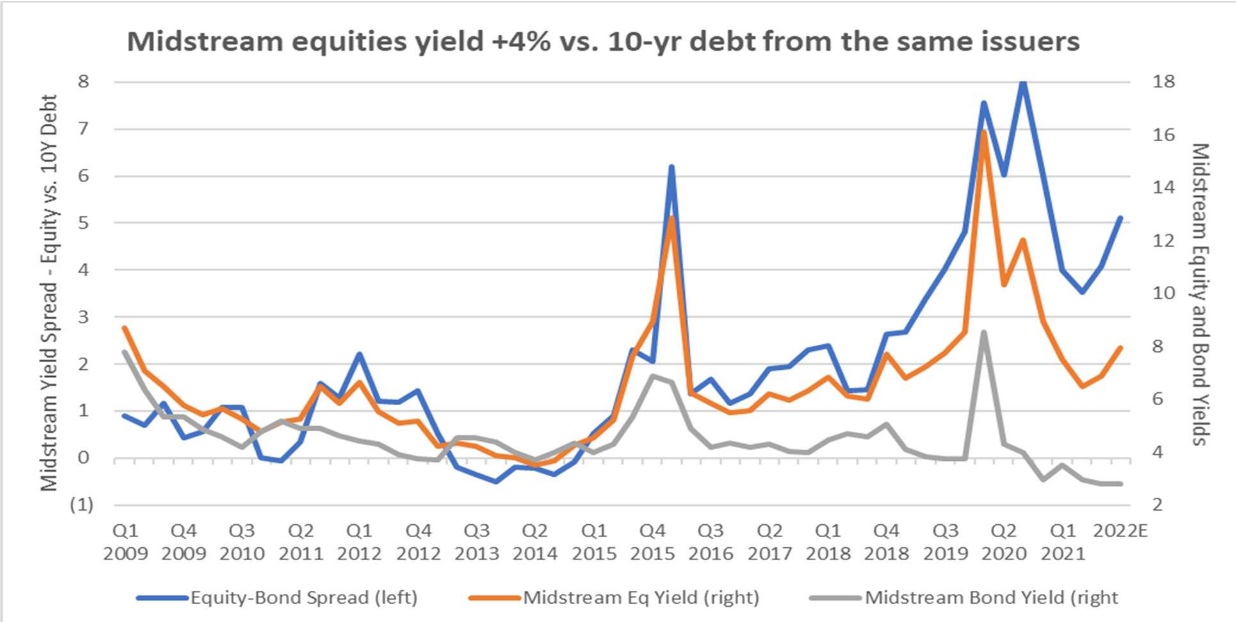
Performance review

During the month of August 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of -1.10%, outperforming the -2.31% return of the Alerian MLP Index (AMZ) by +1.11%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +3.34% (annualized, net of fees). Please see the performance section at bottom for more detail.

Debt paydown has pushed midstream bonds to the lowest yields ever… equities pay 3x as much

Last month, we discussed the fundamental improvement in midstream debt leverage levels – now back to 4.1x, down from nearly 6.0x in 2016. The credit market clearly agrees with our analysis, as midstream bond yields have tightened vs. credit benchmarks and are now hovering near 3% for 10-year, midstream unsecured senior notes.

By comparison, midstream equity markets remain totally dislocated – equities offer nearly 4% more yield than bonds today. In other words, the market is underwriting significantly different outcomes for equities and bonds in the same companies.



Source: Bloomberg, Recurrent research.

Midstream yields reflect angst, but the midstream sector is poised for payout growth in 2022

Of course, with elevated yields, it is natural to ask about the sustainability of midstream payouts. However, with free cash flow surging, midstream payout growth is set to grow in 2022, in a combination of increased dividends and share buybacks. The figures below incorporate Recurrent projections as well as company announcements – as always, the below should not be used as an investment recommendation, and investors should do their own due diligence.

Source: Bloomberg, SEC filings, Recurrent research. 2022E reflects company announcements and Recurrent projections.

As portfolio managers, it is our objective to find companies whose ability to grow faster than the sector average. We believe the growth in payout ratios, as well as the pace of buybacks ($3bn to $5bn of midstream buybacks expected in 2021-2022 per company announcements) will keep midstream valuations well-supported going forward.

Natural Resources

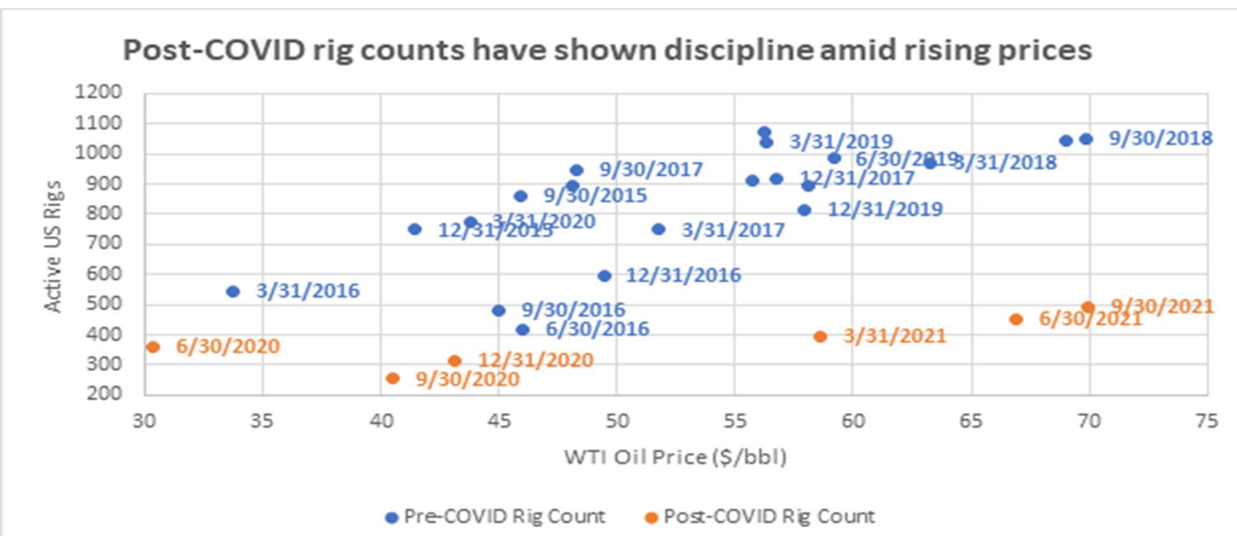
Performance Review

In the month of August, the Recurrent Natural Resources Strategy fell by 0.66% net of fees, outperforming the S&P North American Natural Resources Index's -0.98% return. Stock selection in the integrated oil sector added to performance. Overweight allocations as well as stock selection in the steel and aluminum sectors further added to portfolio performance. Stock selection in the fertilizer and oil storage sectors detracted from performance.

E&P newfound drilling discipline drives supply restraint, low CAPEX in 2021

Within the energy industry, one of the most encouraging developments since the outset of the COVID-19 pandemic has been the capital discipline shown by the Exploration and Production (E&P) companies. Since March 1st, the WTI oil price has averaged nearly $67/barrel. Traditionally, oil prices this high would incentivize additional capital expenditures (CAPEX) from US shale producers, and any operating cash flow would generally be reinvested in drilling new wells in order to grow.

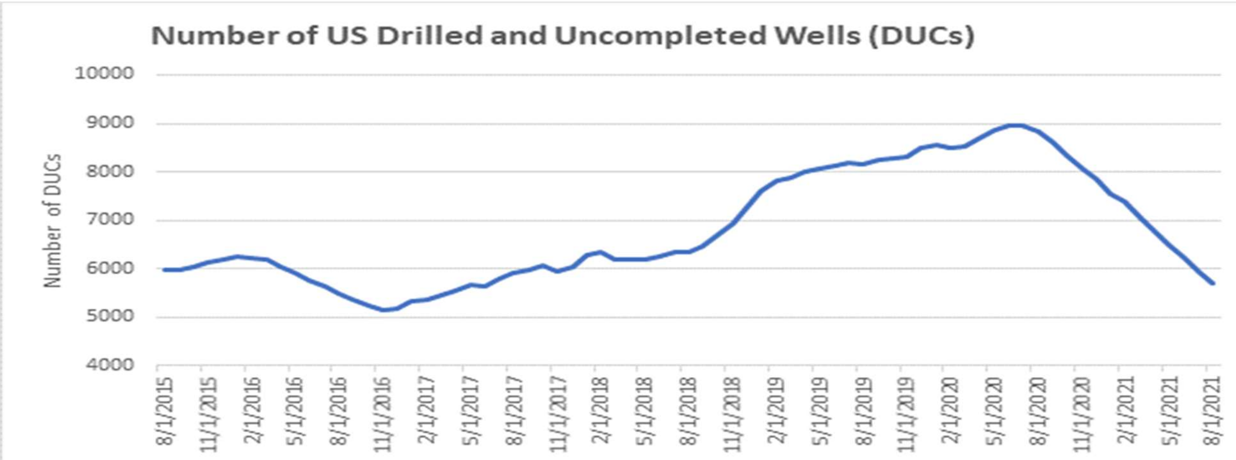
Many market observers are encouraged because this time seems different. With elevated oil prices, E&P companies are generating more cash flow than in recent years, and using the proceeds to pay down debt instead of increasing CAPEX.



Source: Bloomberg, Recurrent research

DUC inventory helps suppress E&P spending, but benefit is unlikely to last beyond 2021

However, there is one element of the capital discipline conversation worth following. In order to produce oil/natural gas, wells need to be first drilled, and then completed. In shale, there is a statistic which tracks the number of wells which have been "drilled and uncompleted", known as DUCs. Since the beginning of COVID, the number of DUCs in the US has fallen by nearly 1/3, as shown in Chart 1.

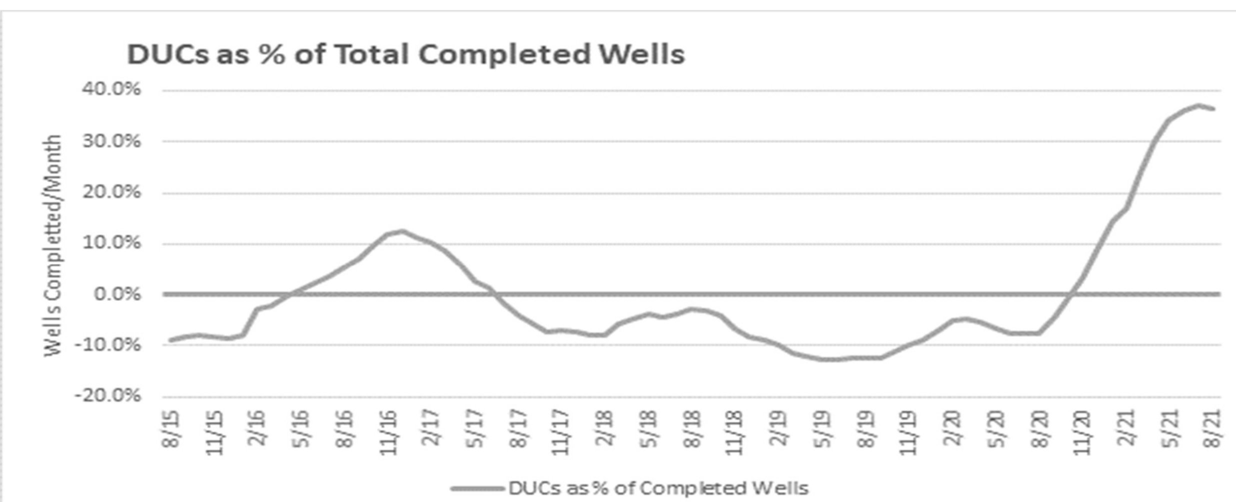


Source: Bloomberg, Recurrent research

While there may be alternate ways to interpret the data, at the core, the number of completed wells is exceeding the drilled wells. In doing so, the cost of turning wells into production during the COVID era is less because the full cost of drilling wells is not incurred – only the completion costs are.

How is this relevant to the capital discipline discussion for E&P companies? In contrast to earlier periods of the shale era, E&P companies are meeting production expectations while keeping CAPEX under control. The decline in DUCs (akin to clearing inventory off of the shelf) signifies a cost-effective method of producing oil and natural gas, but is not sustainable in the long term. Instead, the capital discipline E&P companies are currently being complimented for may actually be a short-term benefit which may not offer a true representation of the capital expenditures needed to produce at the desired levels.

To further quantify the CAPEX savings, we look at the number of DUCs compared to the total wells completed in the US in recent months. As the gray line in Chart 2 shows, in 2021 approximately 35% of completed wells have been from DUC inventory, requiring less-than-full CAPEX cost. Depending on the well, drilling costs comprise up to 50% of the total cost of producing a well. With 35% of wells excluding drilling costs in 2021, CAPEX costs have been as much as 18% lower than a "normal" drilled-and-completed well.



Source: Bloomberg, Recurrent research

Exhaustion of DUCs will likely drive higher per-well CAPEX in 2022+, supporting discipline

E&P companies' profits have significantly benefited from elevated oil and natural gas prices. Additionally, in exhausting DUC inventories, companies have further depressed per-well CAPEX and enhanced free cash flow, at least on a temporary basis. Going forward, we expect that this benefit to be short term in nature, and **CAPEX will increase by as much as 18% simply to maintain the current rate of well completions, assuming no service cost inflation**.

There are 2 likely outcomes from the trend above: first, shale E&Ps are unlikely to aggressively increase activity, given that they will be running 18% faster just to stay still. Second, we expect greater margin expansion in energy companies outside of shale, given shale's higher CAPEX reinvestment requirements.

During this commodity upturn, we have strived to identify and invest in companies with long-term visibility on maintenance CAPEX requirements, such as Canadian oil sands and pipelines. These businesses enjoy the fruits of the commodity upcycle, with limited exposure to the CAPEX inflation that is likely accompany the exhaustion of shale producers' DUC inventories.

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