Energy Infrastructure: "It was the best of times…" in 2023's More than just Dividend Yield, we noted how 5 years of (underappreciated) cash flow growth in excess of dividends meant that midstream dividends were unsustainably low. "The sector has ample capacity to increase dividends from current levels… dividends could rise by roughly 50% and still sit near historical average [cash flow] payout ratios." With balance sheets already investment grade, and a variety of factors discouraging capex, dividends seemed an obvious outlet. This month, we saw our thesis validated as one of our holdings announced a 52% dividend increase. Future increases are impossible to predict, but our analysis shows that higher dividends would be supported by midstream's significant unspent free cash flow (FCF).
Click here for our new midstream white paper, which explores midstream's excess (and growing) yield vs. fixed income.
Click here for our white paper on the long-term relationship between inflation and capex

Natural Resources: "…it was the worst of times," utility investors might well groan today. Like midstream 10 years ago, today's utilities, under the inertia of COVID-era demands for endless "green" growth capex, remain committed to borrowing to fund massive capex and dividends, even as the market signals trouble ahead. In the same month that midstream investors cheered higher dividends, utility investors were reminded of deep and unresolved problems facing their sector. After $20bn of dilutive asset sales to reduce debt, Dominion (D) indicated operating cash flows necessary to sustain dividends remain 4+ years away. A week later, in an echo of midstream's "bad old days", Avangrid's (AGR) parent gave up on growth ambitions and proposed a buyout 40% below AGR's peak, rather than borrowing to sustain AGR's dividend. Midstream's recovery required years of big dividend cuts along with a full repudiation of externally-financed growth. Utilities have been unwilling to cut dividends or give up on growth ambitions, meaning that doubling down on debt-fueled growth is the only path forward… for now.
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

February 2023 Performance Summary and Market Commentaries
Please find below performance and commentary for our strategies – MLP & Infrastructure and Natural Resources. Performance follows at the bottom of the commentary. For additional information, please contact us at (832) 241-6400 or info@recurrentadvisors.com.

MLP & Infrastructure

Performance review

During the month of February 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +4.62%, leading the Alerian MLP Index's (AMZ) +4.33% return by +0.29%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +20.97% (+2.03% annualized), net of fees. On a gross basis, the Strategy has outperformed by +37.20% and +3.46% respectively. Please note that we have also added the Energy Infrastructure Strategy, which seeks to emulate much of our MLP & Infrastructure Strategy while excluding MLP exposure, which has

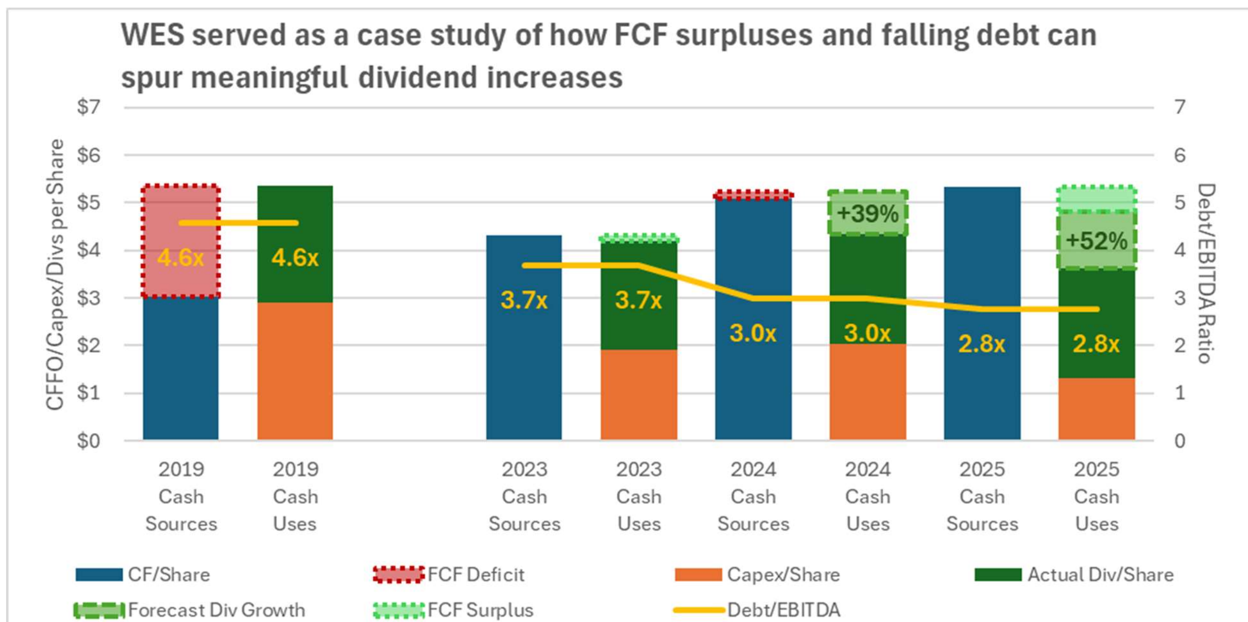
historically represented 20-25% of our core strategy. See performance section at bottom for more detail.

Our 2023 analysis indicated that ~50% dividend increases were possible… in February, WES announced a +52% bump

As recently as 2019 (on the eve of the COVID shock), despite attempts to slow growth spending, WES was reinvesting 100% of its operating cash flow (CF/share, dark blue in the below chart) into capex (orange). Even with elevated leverage of 4.6x debt/EBITDA, the decision to grow at all costs meant that WES's 2019 dividend was effectively 100% externally financed with additional debt (the 2019 deficit indicated in red below).

By 2023, thanks to dramatic cost and capex cuts, the combined dividend (green) and capex (orange) were fully covered by significantly higher cash flow (blue), even with 2023 capex representing the highest rate of investment since 2019. With an aggressive capex program fully funded by cash flow in 2023, the stage was set for significantly higher dividends in 2024 (announced +39% vs. 2023 levels) and 2025 (announced +52% vs. 2023 levels) as cash flow grows and capex moderates, as shown below.

Based on management commentary pointing to additional modest cash flow growth and declining capex, 2025 will once again see a free cash flow (FCF) surplus after funding a 52% higher dividend, as shown in the illustration below.



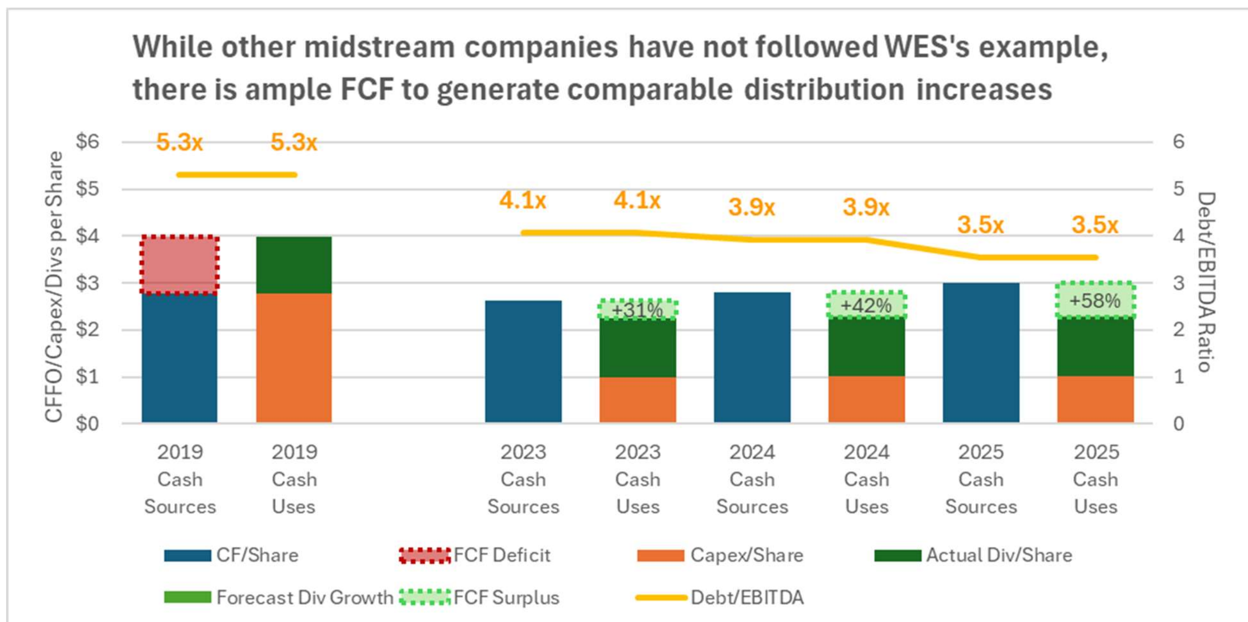
Source: Recurrent research, company press releases, SEC public filings.

WES's announcement may have been an outlier, but other midstream guides indicate similar levels of untapped FCF

As the debt reduction cycle has now largely played out, the question remains how to maximize the impact of the excess free cash flow being generated by the midstream sector. Some companies may follow WES's approach, opting for a splashy dividend "resets" back to more normalized payout ratios (WES's dividend announcement implied a shift from ~50% to ~65% payout of cash flow), while other management teams may prefer smaller increases to retain more flexibility, while continuing to naturally whittle down debt leverage. While we don't aim to predict or forecast which company could be next, we

would simply offer another well-known midstream company to illustrate that WES's financial position is not an outlier.

Below, we offer a comparable illustration of Energy Transfer (ET), another FCF-rich midstream company (and the midstream company most often asked about in client and investor conversations). Like WES, ET spent years slowing down an ambitious growth program, but by 2019, remained highly levered (>5x debt/EBITDA) and was reliant on asset sales and debt for its combined dividend and capex. By 2023, debt leverage had improved meaningfully, but cash flow per share was largely flat. Capex had declined by nearly 65%, creating significant FCF. Based on 2024, per-share cash flow should continue to expand beyond dividends, further expanding FCF in excess of the dividend as debt continues to fall.



Source: Recurrent research, company press releases, SEC public filings.

Natural Resources

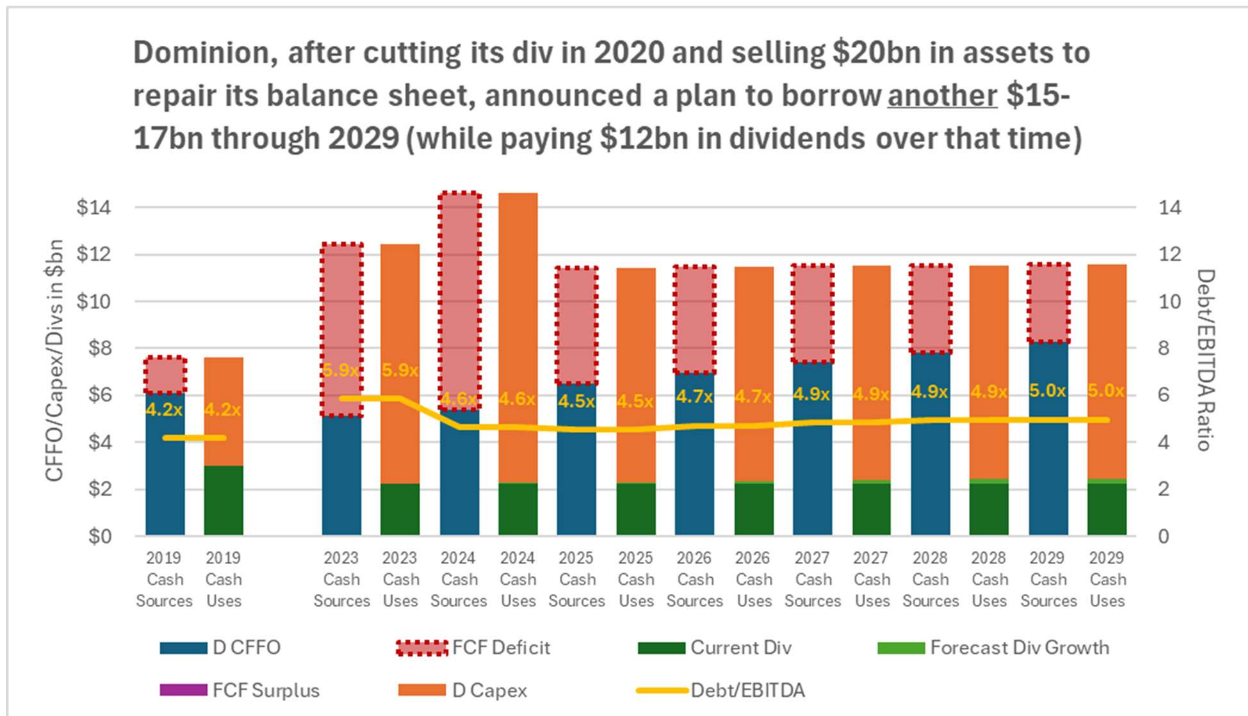
Performance Review

During the month of February 2024, the Alma Recurrent Global Natural Resources Fund fell by -1.30% net of fees, lagging the S&P Global Natural Resources Index's -0.45% return. Since the Strategy's June 2018 inception, the Alma Recurrent Global Natural Resources Strategy has outperformed the S&P Global Natural Resources by +2.82% annually, and +21.12% cumulatively.

A world away from midstream's recovery, utilities sink further with few answers in sight

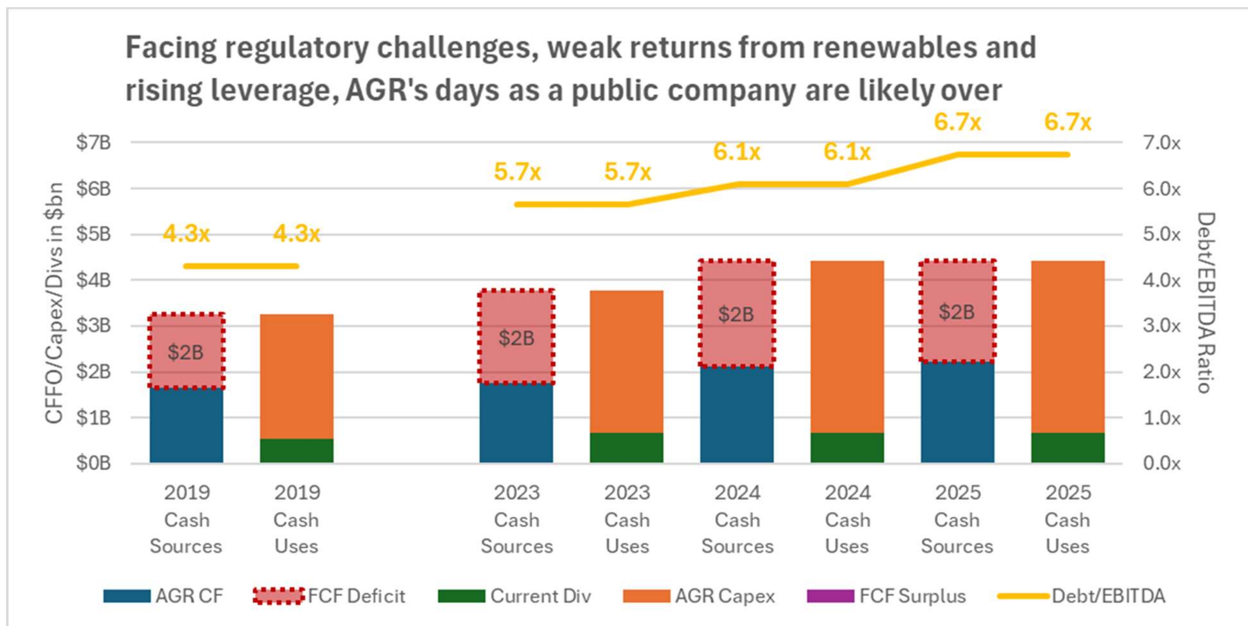
With the utility sector meaningfully underperforming the market since COVID, we are often asked, "aren't utilities increasingly compelling?" Given our experience living through and chronicling the debt-fueled midstream downturn, we feel especially well-positioned to answer. In contrast to midstream's robust health, utilities have offered up a steady stream of case studies of what it looks like when companies are unable, or unwilling, to change track as debt accumulates and returns deteriorate. We have talked about the challenging dynamics of today's utility sector in previous monthlies, but recent business updates from Dominion (D) and Avangrid (AGR) put a finer point on our sector-wide observations.

Dominion, after an aggressive pivot to becoming a "green" utility prior to COVID, reduced its dividend in 2020 and doubled down on aggressive low-carbon growth. Recent asset sales (including a large sale to ENB we wrote about last Aug) staved off disaster by bringing leverage down from ~6x debt/EBITDA in 2023 to ~4.6x this year, but the loss of earnings power has put additional pressure on the dividend and required more future financings. While asset sales satisfy the massive 2024 FCF deficit, meeting the deficits in 2025-29 will entail $15-17bn of debt and mezzanine issuance, and even then it is unlikely debt/EBITDA ever gets significantly below 5x. For the next 5 years, almost everything must go right simply to <u>maintain</u> the dividend - growth is almost out of the question. With 5x debt/EBITDA, interest rates are also a factor in D's dividend policy.



Source: Recurrent research, company press releases, SEC public filings.

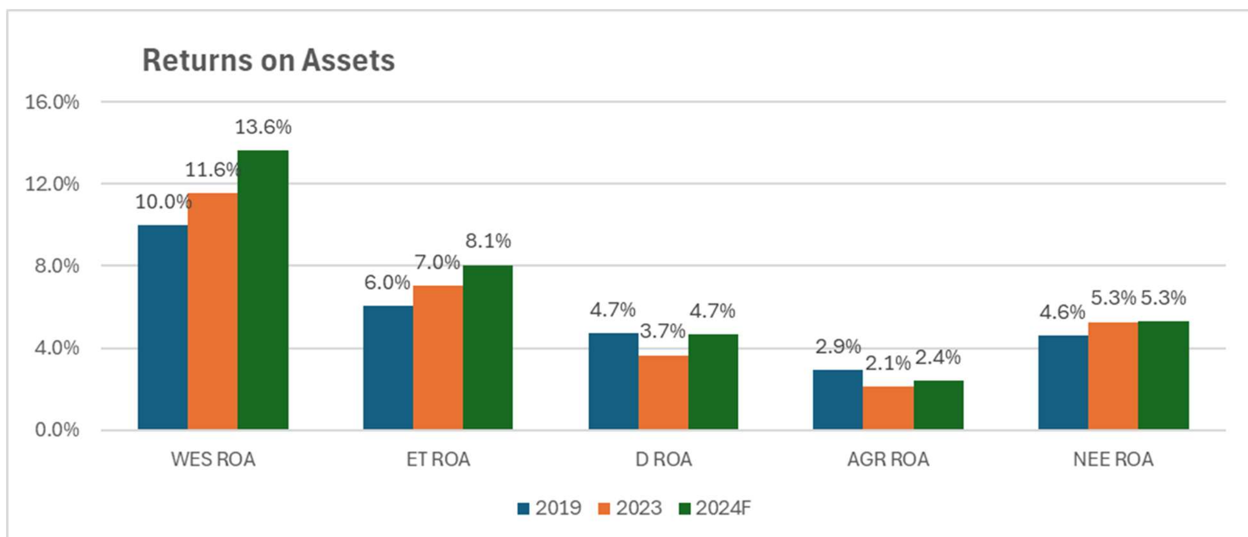
Just as WES is one example of a broader trend of excess FCF generation in midstream, D is similarly one example of a broader trend of low returns, high debt and dividend challenges in the utilities space, even if D has been a negative outlier in certain regards. Iberdrola's US subsidiary, Avangrid (AGR), was supposed to create a renewable-heavy growth engine for its Spanish parent. Instead, AGR (like D) has struggled with offshore wind project delays, regulatory headaches, mistimed equity issuance and low returns on capital. Facing the possibility of spiraling leverage and a financing overhang, Iberdrola has decided to deploy cash to take the 20% publicly traded stake in AGR private.



Source: Recurrent research, company press releases, SEC public filings.

What got utilities here? How could utilities emulate the midstream recovery?

How could two "real assets" sectors that are often compared against one another look so different? How could it be that the outlook for utilities – even management expectations - appears so challenged? As midstream investors remember, managements hate cutting dividends, especially during times when a yield is one of the few silver linings on a challenging investment. But even if dividends were cut, utilities' would remain challenged by low returns on capital. Returns have tanked due to misguided bets on unregulated renewable investments (now facing the same regulatory challenges as pipeline megaprojects) and undiscerning investments in projects whose returns appear to target only a shade higher than the then-prevailing cost of debt. Even Nextera (NEE) – a higher-growth and generally well-regarded utility management team – has been unable to avoid the temptation of deploying massive amounts of debt-financed capital while generating returns that appear to be tracking nothing more than the falling cost of capital over the past decade.



The simple fact is, after a period of austerity, midstream returns on assets are improving; after a period of bullish excess, utility returns are low and are likely to remain stagnant until the approach to capital allocation changes. When you find yourself in a hole, stop digging. Midstream took years to abandon a strategy of aggressive debt-fueled growth; today, utilities still seem unable or unwilling to put down the shovel.

This email may contain forward-looking statements. These statements are not guarantees of future performance and undue reliance should not be placed on them. This email also may contain references to indices. Such references are for comparison purposes only and should not be understood to mean that there will be a correlation between the Strategy's returns and any index. All investing involves risk.

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