RECURRENT
INVESTMENT ADVISORS

Monthly Investment Commentary
June 2023

Midstream: in 2019's Journey Back from Junk, we detailed how midstream companies took on excessive debt during the MLP boom (2010-15), causing equity valuations to fall and dividend yield spreads vs. bonds to blow out. In 2019, we predicted midstream debt reduction would tighten these dividend yield spreads, just as "junk" bond yields tighten when they move back to investment grade. Despite a COVID-related detour, debt reduction has indeed improved valuations and tightened midstream yield spreads.

As dividend yield spreads return to 20-year averages, some are asking if the midstream "catch-up trade" has run its course. As investors fixate on stagnant dividends, they are ignoring the fact that midstream sector cash flow has grown +55% since 2018 (vs. dividend growth of +6% over the same period). As a result, payout ratios are historically low, and midstream cash flow yields remain historically high compared to fixed income yields, despite broad increases in interest rates since COVID. If midstream cash flow yields return to long-term norms, yields could compress another 300-500 bps before reaching long-term historical averages.

Natural Resources: Last month, we discussed how PDC Energy's decision to sell out to Chevron – at a relatively inexpensive valuation of $28k per barrel of production and below book asset value – reflected the difficult choices facing Shale E&Ps. As discussed last month, moderating oil prices, steep well declines, and capex inflation have squeezed FCF for Shale companies. This month saw a contrasting example – Exxon announced the proposed acquisition of Denbury for $100k per barrel of production. 3 variables explain this valuation disparity: 1) DEN has low-decline oil production that can be sustained with less capex than typical "shale" assets (so DEN is less impacted by oilfield cost inflation); 2) DEN owns a significant pipeline system on the Gulf Coast; 3) DEN is expected to participate in the Energy Transition via its carbon capture/storage system, which should generate significant tax credits (and EBITDA) later this decade. We believe these 3 themes – resistance to inflation, operational integration, and energy transition "option value" – offer a good synopsis of why our NR portfolio seeks energy exposure primarily outside of Shale E&Ps.

Click here for the latest white paper on the long-term relationship between inflation and capex
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG
(noteworthy in light of CVX-PDC deal)

June 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.

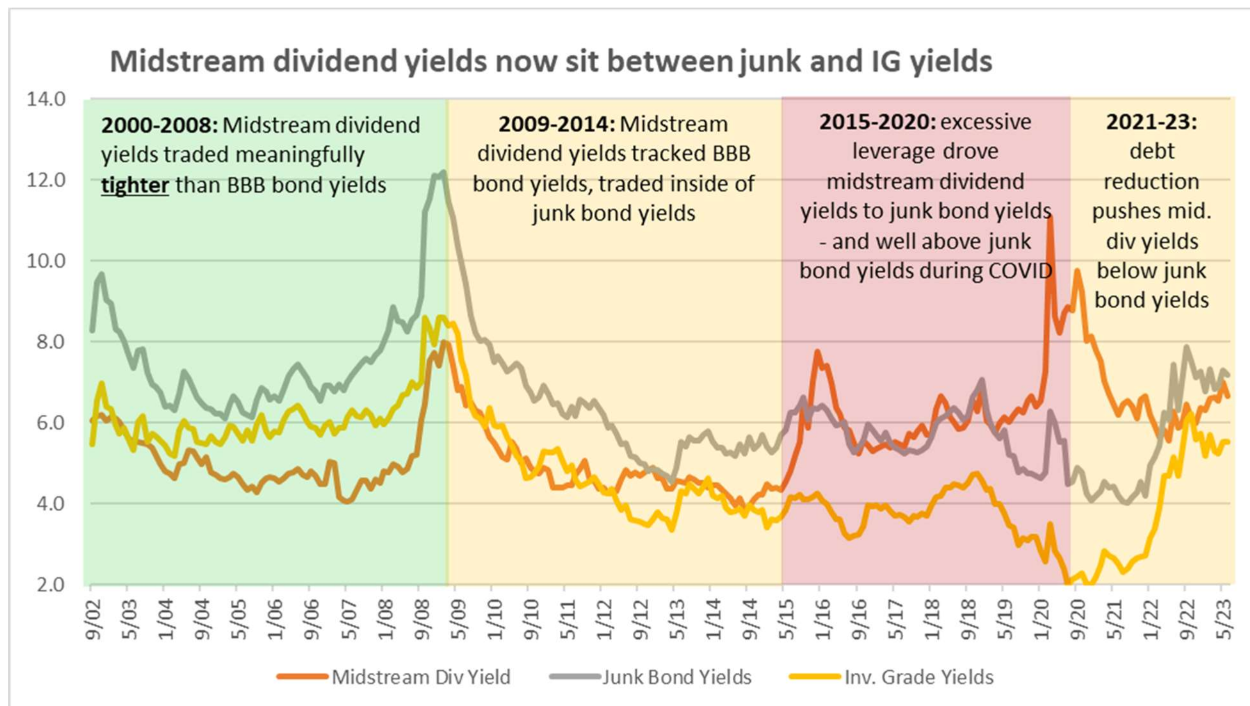
MLP & Infrastructure

Performance review

During the month of June 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +6.82%, outpacing the Alerian MLP Index's (AMZ) +4.14% return by +2.68%. Last month, we noted how the OKE-MMP merger announcement boosted the performance of small-cap MLPs (where we are underweight). This trend partially reversed in June. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +2.99% (annualized, net of fees). Please see the performance section at bottom for more detail.

After the surge of 2021-2022, where do we stand in midstream's "journey back from junk"?

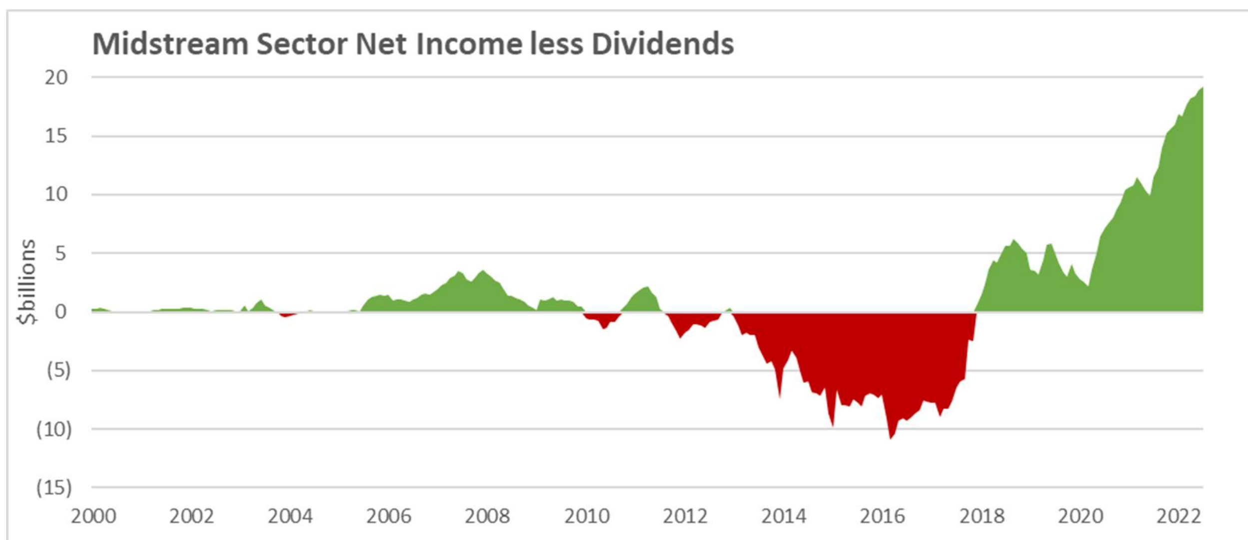
Below, we revisit a chart from our 2019 "Journey Back from Junk" white paper, which detailed the 2015-2020 deterioration in midstream credit and the impact of this deterioration on midstream dividend yields. Despite the impact of COVID, we have seen our 2019 prediction of debt reduction come to pass. We have seen midstream dividend yields fall once again below "junk" bond yields, although they have remained well above BBB "investment grade" yields, suggesting the market is not giving "full credit" for fundamental improvements made to date.



Source: Recurrent research, Bloomberg, SEC filings

Dividend yield spreads overlook the massive credit improvement and cash flow growth that has taken place in midstream

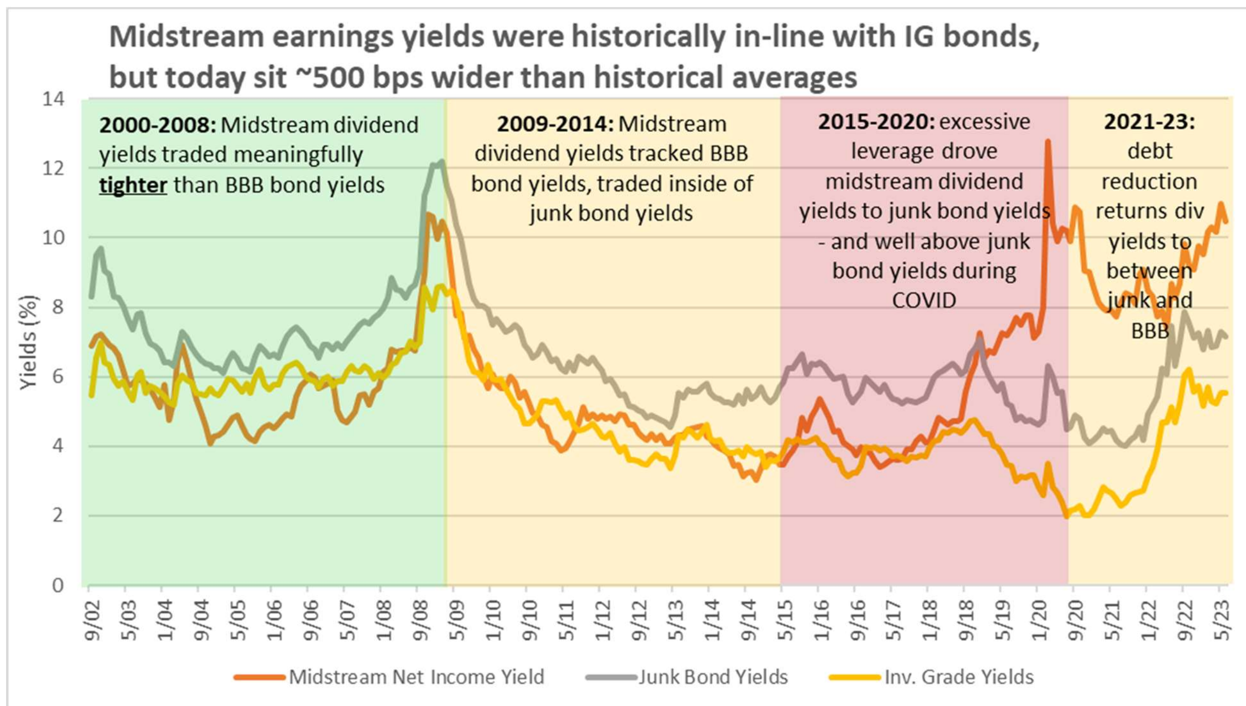
While midstream dividend yield spreads have fallen below junk bond yields, they remain above investment grade bond yields. This suggests that the market is giving "partial credit" for midstream's dramatic credit improvements. It is also causing some dividend-centric investors to ask if the "journey back from junk" is already complete. This dividend-centric analysis ignores 2 key factors: first, midstream credit metrics are the best they've been in 20 years. This suggests that midstream yields could once again trade below investment grade bonds, as they did frequently from 2002 to 2014. Second, dividend payout ratios are at record lows, after a massive surge in cash flow and net income that has FAR outpaced dividend growth, as shown below.



Source: Recurrent research, Bloomberg, SEC filings

Looking at rapidly-growing earnings, instead of dividends paid, suggests that yield compression still has a ways to go

Below, we update the chart above to reflect net income growth instead of dividend growth. For the 2002-2018 time period, midstream cash flow yields almost exactly tracked investment grade bond yields In light of significant dividend cuts and credit deterioration in the 2015-2020 period – which undermined investor confidence even as earnings positively inflected – earnings yields blew out significantly. On an earnings yield basis, there is >400 bps of yield compression required simply to reach 20-year average yield spreads. Even to get back to the bottom 20th percentile of valuations, there is 275 bps of yield compression required, implying 30%+ appreciation. Making this comparison even more striking is that midstream companies are currently spending less than depreciation on capex (in other words, current free cash flow is actually larger than the net income figures shown below due to the low rate of reinvestment).



Source: Recurrent research, Bloomberg, SEC filings

There are several ways out of the current midstream yield dislocation, and most involve significantly higher valuations

Given the dramatic undervaluation of earnings compared to historical yield spreads, there are several ways this situation could resolve itself. First, earnings yields could be translated into dividend yields, as payout ratios rise from their current low levels, to more normalized historical payouts of ~65%. This would imply 50% dividend growth from here, which would likely drive equity valuations higher. Second, earnings yields could compress by ~400 bps, to reach historical long-term averages. This would imply a valuation increase of 60%+ across the midstream sector. Finally, bond yields could rise until midstream yield spreads normalize – but this would likely involve value loss across an array of fixed income and yield-oriented vehicles, such as REITs and utilities. Plus, given the current trajectory of Fed policy, a significant additional increase in interest rates seem unlikely. So we believe that there is a strong possibility, if not probability, that the current anomalous yields in the midstream space are resolved with some combinations of higher dividend rates and higher valuations.

Natural Resources

Performance Review

In the month of June 2023, the Alma Recurrent Global Natural Resources Strategy generated returns of +7.02% net of fees, slightly more than the S&P Global Natural Resources Index's +6.46% return. Since the its June 2018 inception, the Recurrent Global Natural Resources Strategy has outperformed its benchmark by 2.72% (annualized, net of fees). Please see the performance section at bottom for more detail.

The Exxon-Denbury deal suggests there are "two markets" for energy assets today

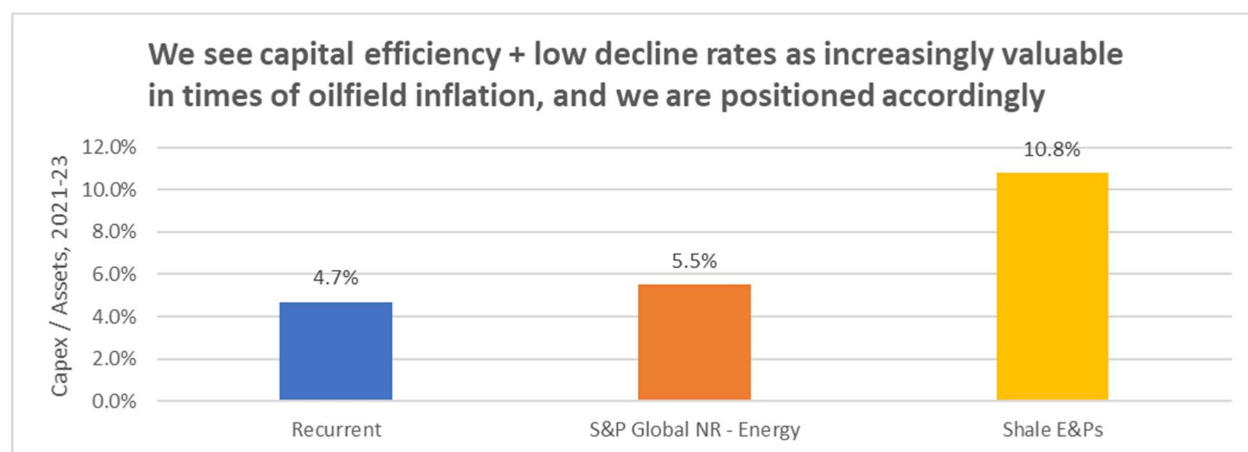
On a pure valuation basis, the proposed acquisition of DEN by XOM appears out of line with recent transactions. While recent private-to-public deals (and the proposed acquisition of PDCE by CVX) have

traded near $30k per "flowing BOE" of production, DEN is being valued near $100k – in other words, a total value of $5bn, despite a production base that is <50k barrels per day. Although DEN is a highly oil-weighted producer, its tertiary recovery "CO2 flood" production technique means that the barrels are relatively high cost, and generate comparable cash flows per BOE as a gassier producer, like PDCE. On a free cash flow (FCF) basis, the deals are similarly disparate – CVX suggested that its acquisition of PDCE would generate a ~15% FCF yield, while DEN will not generate FCF when including "carbon capture" (CCUS) capex – and generates only a 4% FCF yield when excluding CCUS spend.

What about the XOM-DEN deal makes for a valuation that is 3x pricier than similar E&P deals in 2023?

Given XOM's absence from the M&A market for the last several years, the $5bn acquisition of DEN is a major industry event. So what explains the excess value attributed to DEN by XOM?

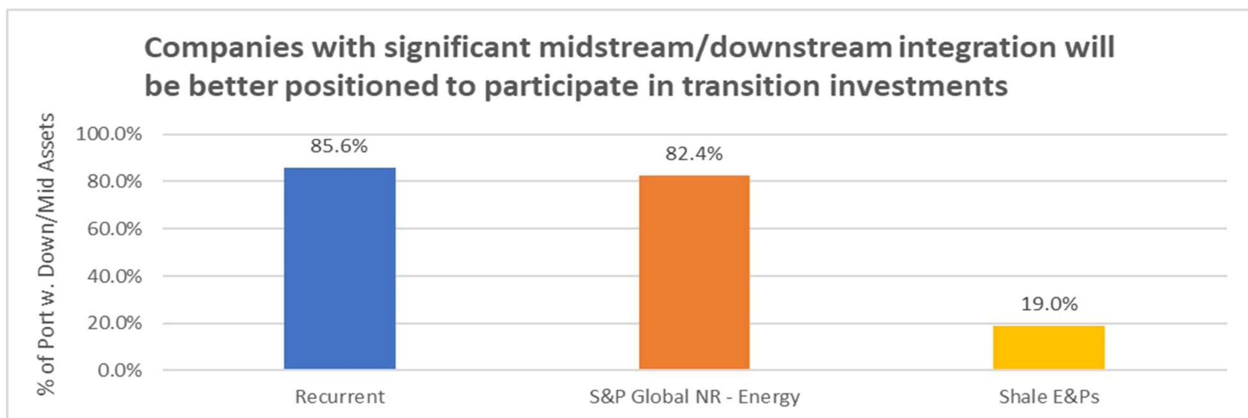
First value-additive attribute is DEN's base business's capital efficiency. DEN's low-decline assets, which are naturally capex-efficient. DEN's E&P business is a tertiary recovery oil business, and although high-cost, it has a very low decline rate compared to typical shale E&Ps (such as PDCE). As a result, DEN should be able to keep production ~flat without extensive use of the oilfield services that have caused Shale capex/barrel to nearly double in the last 18 months, as detailed in our previous monthly. Even with an expected 9% production growth rate this year, DEN's capex per barrel was up modestly vs. 2022 levels. That is a far cry from Shale producers, facing 50% capex inflation on a per-barrel basis. With inflation still raging in the oil industry (even as CPI cools), we see low-capex assets, with options to defer or minimize capex during inflationary periods, as increasingly valuable. Excluding the impact of COVID-era writedowns, DEN's capex/asset ratio is roughly 5.5%, in line with the energy holdings in our GNR benchmark, as shown below. However, the Recurrent GNR portfolio is even more capital efficient than the GNR benchmark, and drastically more capital efficient than Shale E&Ps which populate most competitor portfolios.



Source: Recurrent research, Bloomberg, SEC filings

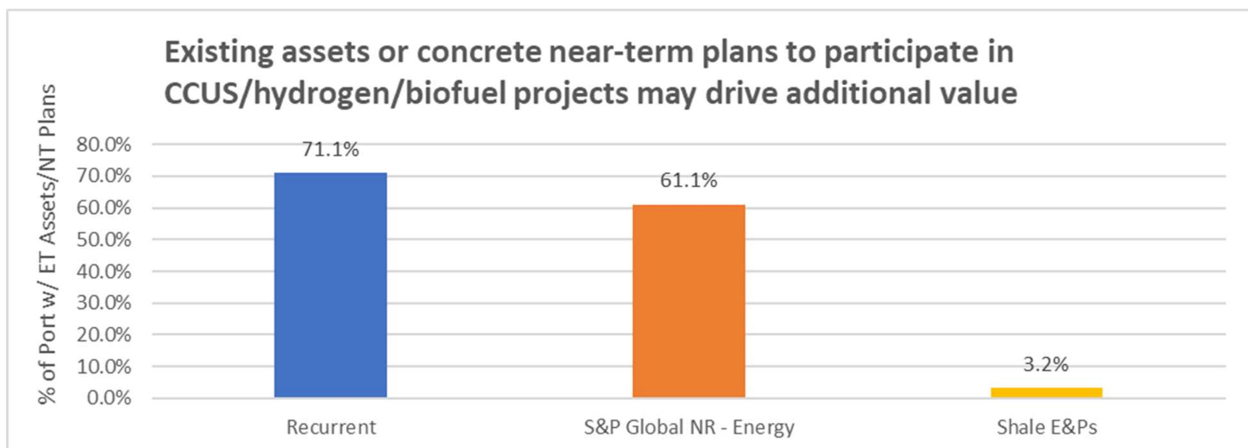
Second value-additive attribute is DEN's portfolio of midstream/downstream assets. While oil wells and associated acreage have one clear purpose – oil and gas production –midstream and downstream energy assets have already shown a high level of optionality for potential repurposing in the last several years. Decades ago, WW2-era oil pipelines were repurposed to accommodate growing natural gas demand and provide fiber optic rights-of-way, and we've seen more recently as oil and gas assets have

been repurposed to produce and transport biofuels, ammonia, hydrogen, and carbon. Even before the Inflation Reduction Act (IRA) massively increased economic incentives to produce and transport these new types of energy, we have seen midstream and downstream companies take an active role in repurposing "steel in the ground" assets in a way that simply is not possible for "E&P-only" businesses. In DEN's case, a 1300-mile carbon pipeline asset, which to date has simply been an accessory to DEN's E&P business, is a clear driver of XOM's deal value, as DEN has forecasted this long-ignored asset could provide the backbone for an emergent carbon capture business with $600mm (or more) in potential annual EBITDA – potentially a $6bn+ business, ignoring the potential "ESG" benefits of making DEN (or XOM) a lower-carbon energy producer.



Source: Recurrent research, Bloomberg, SEC filings

Third value-additive attribute is DEN's concrete plan to participate in the IRA. One reason that the DEN deal was both 1) significantly more expensively valued vs. other E&P deals but 2) did not involve a significant announcement premium (although as an all-stock deal it is a tax-efficient participation in future XOM value-creation), is because DEN had concrete plans to invest in the IRA-qualifying activities and had promoted those plans heavily to Wall Street, driving a significant "low carbon" premium and offering significant details on how much EBITDA could be generated from potentially capturing the carbon-capture "45Q" credits detailed in the IRA. So asset value is nice, but value is more likely to accrue to 1) in-service assets generating cash flow or 2) very concrete plans to generate energy transition-related cash flows in the future.



Source: Recurrent research, Bloomberg, SEC filings

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