Midstream: in recent months, we've highlighted how midstream's underappreciated earnings growth has driven higher free cash flow (FCF) and lower debt, leaving room for future dividend increases. Last month, we highlighted how *utilities* have chosen a different path: high capex and negative FCF are pushing debt leverage to record levels. Since then, we've seen a real-world case study as Enbridge, a large-cap midstreamer, suspended its buyback, issued equity and announced its intent to buy $14bn of FCF-negative utilities. The market's negative reaction seems to confirm our preference for capital-efficient midstream vs. capital-intensive utilities in today's high-interest rate environment.
Click here for our new midstream white paper, which explores midstream's near-record excess earnings yields vs. fixed income.

Natural Resources: Over the last decade, divestment from fossil fuels is one of the most profound developments in the institutional investment community. This month, our research looks at the more than 1500 global divestment announcements to look at the vintage of the announcements, which appears to be slowing in the last 2 years. Furthermore, our analysis looked at the energy sector's relative performance to broader markets to see if a correlation existed with the number of announcements….(HINT – it certainly seems so!) With the seemingly strong relationship between sector performance and the number of divestment announcements, we hypothesize about whether institutional divestment from energy has reached a relative ebb, meaning new investments will have a disproportionately positive impact on sector performance.
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)

August 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.

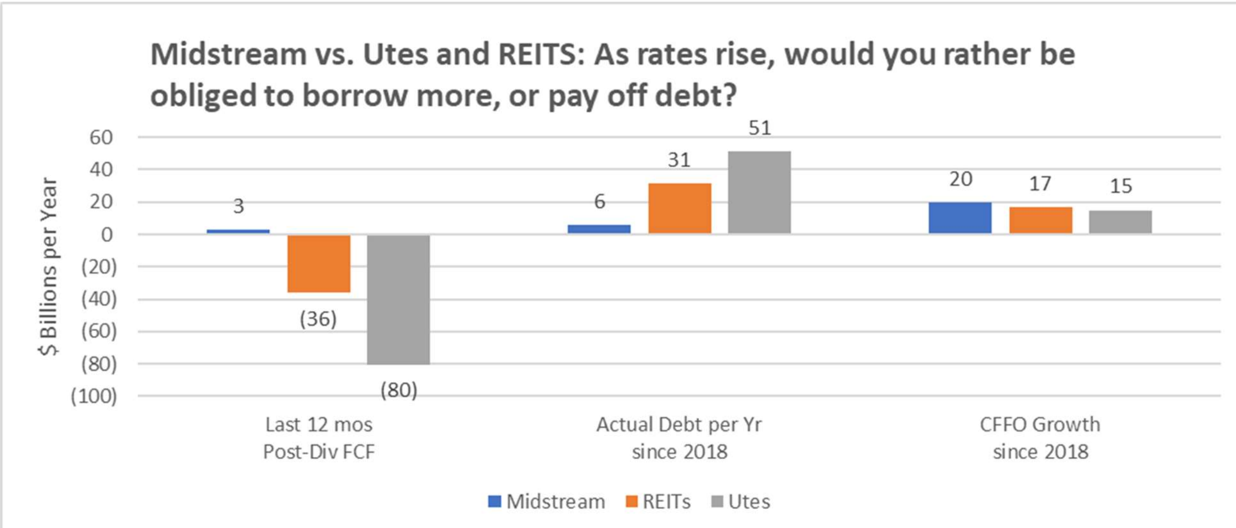
MLP & Infrastructure

Performance review

During the month of August 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +1.70%, outpacing the Alerian MLP Index's (AMZ) +0.47% return by +1.23%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +40.54% (+3.29% annualized), net of fees. Please see the performance section at bottom for more detail.

Midstream fundamentals are different than many other "real asset" and "infrastructure" asset classes

Last month, we discussed in detail how midstream valuations remain historically discounted vs. REITs and utilities, despite the fact that midstream balance sheets and FCF profiles are the strongest they've been in 25+ years. Meanwhile, utility debt leverage is at an all-time high, and regulatory challenges and low-return renewable projects have stunted cash flow growth even as debt has soared. While broadly less indebted than utilities, some REITs are struggling with adapting to post-COVID realities, in addition to the squeeze between low cap rates and high interest rates.



Source: Recurrent research, Bloomberg, SEC filings

Since COVID, investors have clearly preferred FCF-positive midstream infrastructure vs. utilities… with apparent good reason

Current market valuations clearly put a premium valuation on utility assets (>20x P/E) vs. midstream assets (~10x P/E), despite the divergent capex, debt and FCF profiles highlighted above. But that valuation disparity – which peaked during the height of the "electrification bubble" during COVID – is changing. Midstream performance has been much stronger than utilities since 2020, and given midstream's superior FCF profiles and lack of dependence on the debt markets, we see a path for midstream's outperformance to continue in the coming years.

Recent transaction announcements highlight how investor perceptions around midstream and utility sectors are changing.

In recent months, ENB and TRP have made moves to grow regulated assets while diluting their midstream businesses – these have been poorly received by investors

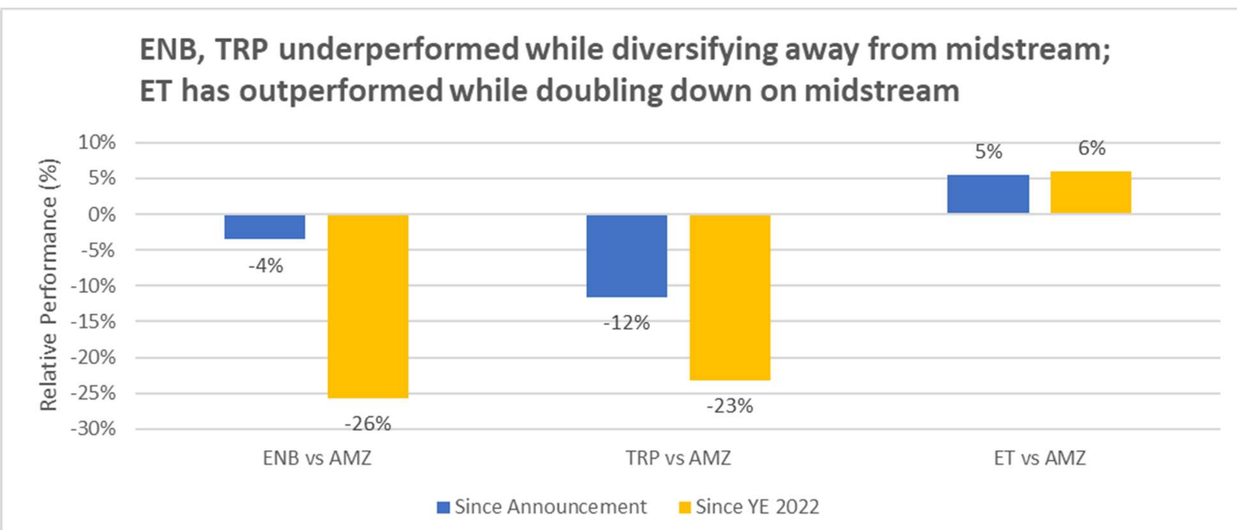
First, in July 2023, TC Energy (TRP), a midstream company whose utility-style corporate strategy has relied on negative FCF funded by significant debt, reached an impasse. In a situation very familiar to midstream investors active during 2014-2018, debt incurrence accelerated in advance of project cash flows, leading to a situation where TRP was obliged to sell assets to plug the funding gap. Instead of selling the potentially highest-value regulated assets in its portfolio, TRP took aggressive steps to sell a large stake in its US gas pipelines business and spin its oil pipelines business. Both businesses have limited ongoing capex needs and meaningful FCF generation.

Despite relieving an acute financing situation, the market has generally been unimpressed with TRP's steps to shrink its high-FCF midstream asset base in order to grow its more regulated, lower-FCF assets. Given the lack of meaningful reduction of debt/EBITDA resulting from these moves suggests that TRP's long-term strategy is to maintain a higher "regulated" debt load, similar to the utility group, rather than pursue an aggressive multi-year deleveraging campaign as has already been accomplished by many "unregulated" midstream companies.

Then, in September 2023, fellow large-cap Canadian midstreamer Enbridge (ENB) announced the acquisition of $14bn of US-based gas utilities, instantly doubling the size of its utility asset base. While gas utilities trade at a discount to electric utilities due to their perceived higher fossil fuel risk, the acquisition at 16-17x P/E was roughly +60% higher than broad midstream valuations. Despite attractive earnings growth, these assets are expected to be meaningfully FCF negative for the foreseeable future.

In contrast to TRP, ENB had in recent years completed significant capex projects, begun to generate meaningful FCF, and had initiated a buyback program to return FCF to shareholders. The acquisition was funded in part with $4.6bn of newly issued shares. The assets came with 5.3x of asset-level debt/EBITDA, although the transaction is currently capitalized in excess of 8x debt/EBITDA, so more equity issuance is possible. Ironically, the aggressively leveraged transaction was only made possible by the enormous FCF of ENB's midstream assets.

We would note, in the chart below, that both ENB and TRP were significant underperformers YTD, and that underperformance has not abated since their respective transactions were announced. Even if we were to use the more comparable Canadian-heavy AMNA Index (instead of AMZ used below), the YTD underperformance has been 15-20% for both names.



Source: Recurrent research, Bloomberg, SEC filings. ENB's utility acquisition was announced on 9/5/23; ET's acquisition of CEQP was announced on 8/16/23; TRP's strategic divestiture and spinoff were announced on 7/24/23 and 7/25/23.

Energy Transfer (ET) offers an interesting counterpoint vs. ENB and TRP

ET has been comparably active on the M&A front, but has not seen the same underperformance. Why? Interestingly, despite a market that has rewarded companies for FCF generation and debt reduction (as we discussed in a previous monthly), investors do not seem opposed to all M&A activity. We have seen ET continue to execute on a multi-billion acquisition program, with $0.5bn for Woodford Express (wellhead gathering), $1.5bn for Lotus Midstream (crude infrastructure) and most recently the $7.1bn Crestwood Midstream (mostly wellhead gathering) merger announcement. Despite a focus on growth via acquisition (and an increase to ET's share count), these acquisitions have not prevented ET from outperforming. We would posit that ET is attempting to grow exposures that investors are already seeking: all 3 acquisitions have been at accretive valuations, have not increased ET's leverage, and will generate meaningful FCF in the coming years.

Some investors will reasonably ask, "why can't utilities stage a catch-up trade vs. midstream?" While anything is possible in the markets, this question obscures midstream's dramatic long-term underperformance vs. utilities (>100% since 2009), ignores the current valuation disparity covered last month, and finally, does not address utilities' continued reliance on massive debt issuance. While utilities could perhaps manage to escape midstream's fate, we would remind readers of the nearly decade-long journey for midstream, which began as excessive debt issuance, and led to a wholesale restructuring of the midstream business model, which was undoubtedly painful but has delivered the low leverage, high-FCF asset class that we see today.

Natural Resources

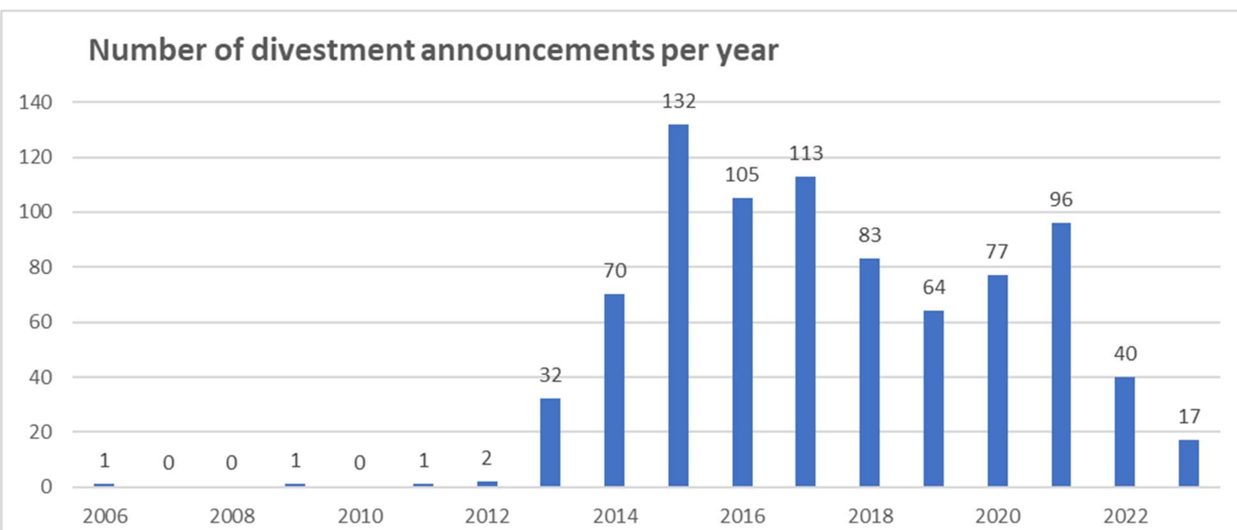
Performance Review

During the month of August, the Recurrent Global Natural Resources portfolio fell by -3.02% net of fees, outperforming the S&P Global Natural Resources Index's -3.44% return. During the month, the portfolio's refining holdings rose nearly 5%, reflecting strong stock selection. The portfolio's overweight position in aluminum detracted from relative performance, falling more than 16% during the month, more than the broader portfolio's 3% decline. Since the its June 2018 inception, the Recurrent Global Natural Resources Strategy has outperformed its benchmark by +3.00% (annualized, net of fees). Please see the performance section at bottom for more detail.

Investment Discussion

Since Recurrent's inception in 2017, the topic of institutional investors divesting from fossil fuels has been a constant. Over the last 24 months, however, our conversations with institutional investors have not included ESG or divestment commentary as readily. In order to get a better sense of the "intensity" of the divestment conversation, we analyzed more than 1500 global divestment announcements from institutions since 2006.

As seen in the chart below, the percentage of divestment announcements was highest between 2013-2021, where nearly 95% of the announcements occurred. While in most cases the institutions' divestment were scheduled to occur over the course of years, from an "impact" perspective, the peak seems to have passed.

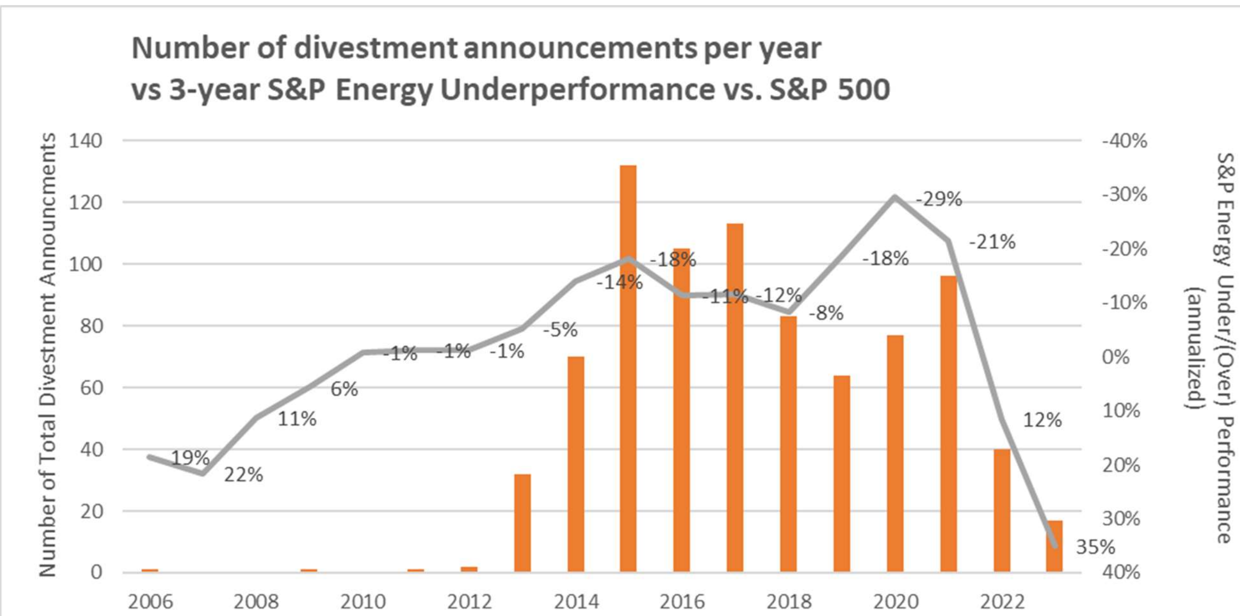


Source: https://divestmentdatabase.org/, Recurrent Research

As we considered the timing of the many global announcements, we wanted to better understand the role of sector performance, both as a variable input into the divestment decision, as well as the impact after the decision.

In the chart below we look at the relationship between the divestment announcements and the 3 year rolling annualized performance between the S&P 500 Energy Sector and the broader S&P 500 Index. The thesis behind this analysis is that in many cases, institutions have the qualitative rationale to divest from fossil fuels. However, if relative performance is weak, institutions are more inclined to extrapolate past performance to the future as an additional reason to divest. For every year during the period from 2011-2022, the annualized rolling 3 year performance of the energy sector underperformed the S&P 500. Institutions not only were able to achieve qualitative objectives, but experienced improved investment results from portfolio exclusions. The combination of the 2 variables proved to be a strong incentive, and divestment announcements continued throughout the 2011-2022 period.

Understandably, the heightened level of divestment announcements had an impact on subsequent performance as well. As companies announced and executed divestment from the industry, relative performance weakened, in particular the relative 3 year returns ending in period from 2020-2022. To summarize, the divestment decision was made easier by the relative underperformance in advance of the decision. As more companies chose to divest, performance continued to weaken through COVID.



Source: https://divestmentdatabase.org/, Recurrent Research

Given the historical relationship between relative performance and divestment announcements, the 2022-2023 period may prove to be a turning point for divestment announcements, and therefore future performance. In the calendar year 2022, the S&P Energy Sector rose 65.66%, while the S&P 500 fell 18.17%. After years of relative performance benefiting from energy divestments, the strong relative energy performance dramatically impacted many institutions' relative performance. Therefore, allocators were faced with a decision that they hadn't been forced to consider – for many years, fossil fuel divestment offered both qualitative and performance benefits, making the decision easier.

However, in 2022, the qualitative decision caused many institutions to underperform stated benchmarks, meaning the qualitative benefits negatively impacted relative performance. For fiduciaries, the decision to divest became less clear and the virtuous cycle of poor performance influencing further divestments may have been slowed for some time. The bottoming of divestment should provide a strong foundation for future performance, on both a relative and absolute basis.

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