Midstream: as 2023 comes to a close, it's natural to look to the year ahead. Instead of a traditional forecast, we find ourselves asking: given 2023's macro worries, why did midstream do so well? 2023 saw falling oil and gas prices, bank failures, and a widely-predicted recession. So why did midstream outperform almost every other equity sector (ex-tech)? 2 years ago, midstream was viewed as "fragile" after a multi-year downturn. It seems that lower leverage, capital efficient growth, and still-reasonable valuations supported midstream during a year many expected to get ugly for energy-related sectors. The good news is that these variables remain intact as we move into 2024.
Click here for our new midstream white paper, which explores midstream's near-record excess earnings yields vs. fixed income.

Natural Resources: In the course of the last month, expected global copper supply was impacted by announcements from two different companies in three different countries. In Panama, Chile, and Peru, future production will be less than expected for the next few years, tightening global supply/demand balances. In today's weak global demand environment, the announcements had little impact on current or future copper prices. However, should copper demand accelerate, the impacts of these announcements will loom larger.
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

November 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

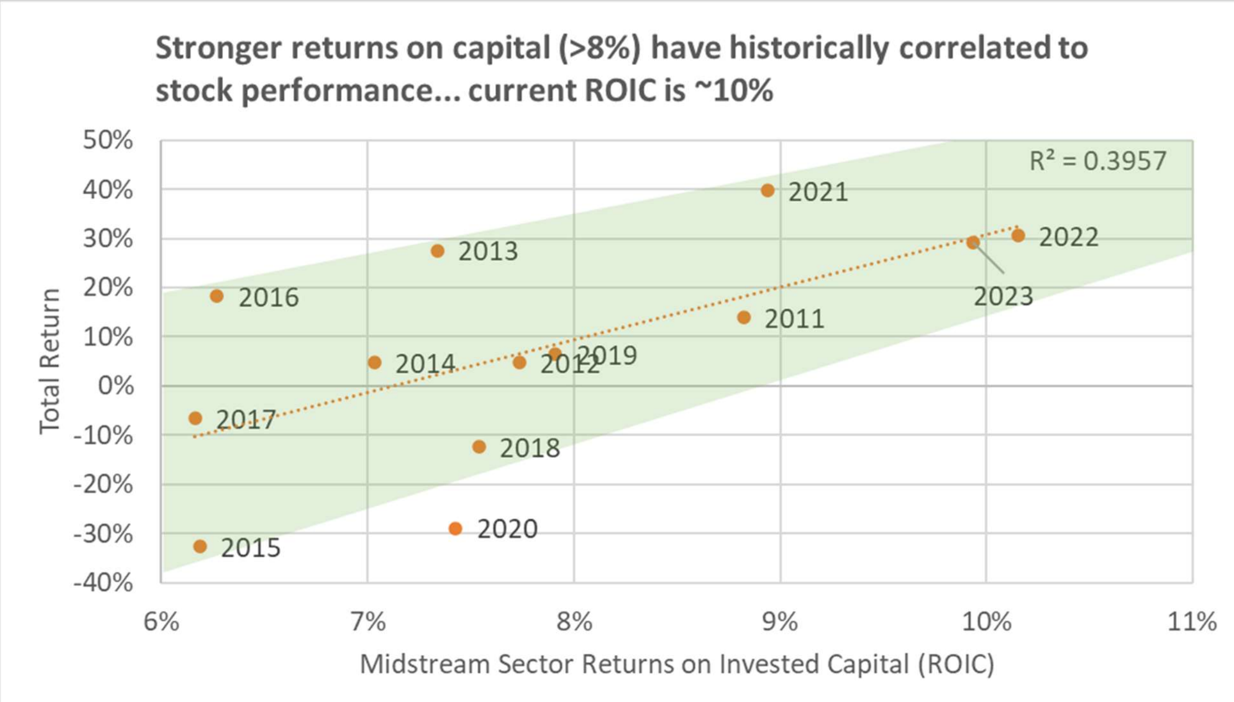
During the month of November 2023, the Recurrent MLP & Infrastructure Strategy generated net returns of +5.51%, lagging the Alerian MLP Index's (AMZ) +6.86% return by -1.35%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +21.16% (+2.24% annualized), net of fees. Please see the performance section at bottom for more detail.

What has supported the midstream sector performance in a tumultuous year for commodity prices and non-tech stocks?

During a year of bank failures and falling commodity prices, midstream stocks have performed well on a relative and absolute basis. Only a few years ago, midstream was seen as a "fragile" sector, likely to asymmetrically underperform in times of macro turmoil. So what explains midstream's newfound resilience? There appear to be several factors involved.

First, higher capital efficiency appears to support better stock price performance

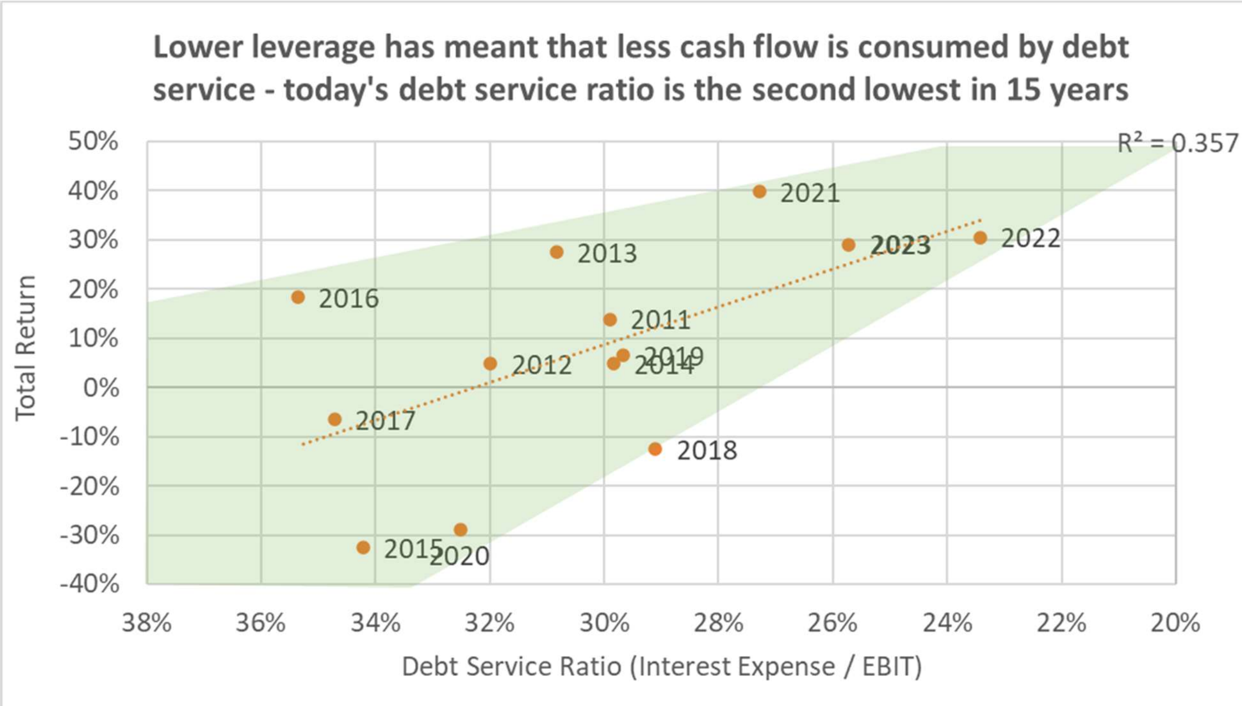
Over the last dozen years, returns on capital have steadily improved for the sector, as midstream has transitioned from a state of constant expansion to a model less focused on expansion and more focused on capital efficiency. In a state of constant growth, much of midstream's invested capital lies "fallow," effectively stuck in a "work in progress" state, not generating cash flow. As the rate of asset growth has slowed, midstream companies are generating cash flow from the vast majority of assets, driving returns higher.



Source: Recurrent Advisors' research, Bloomberg, public filings.

Second, lower leverage has driven structurally higher cash flow and greater financial flexibility

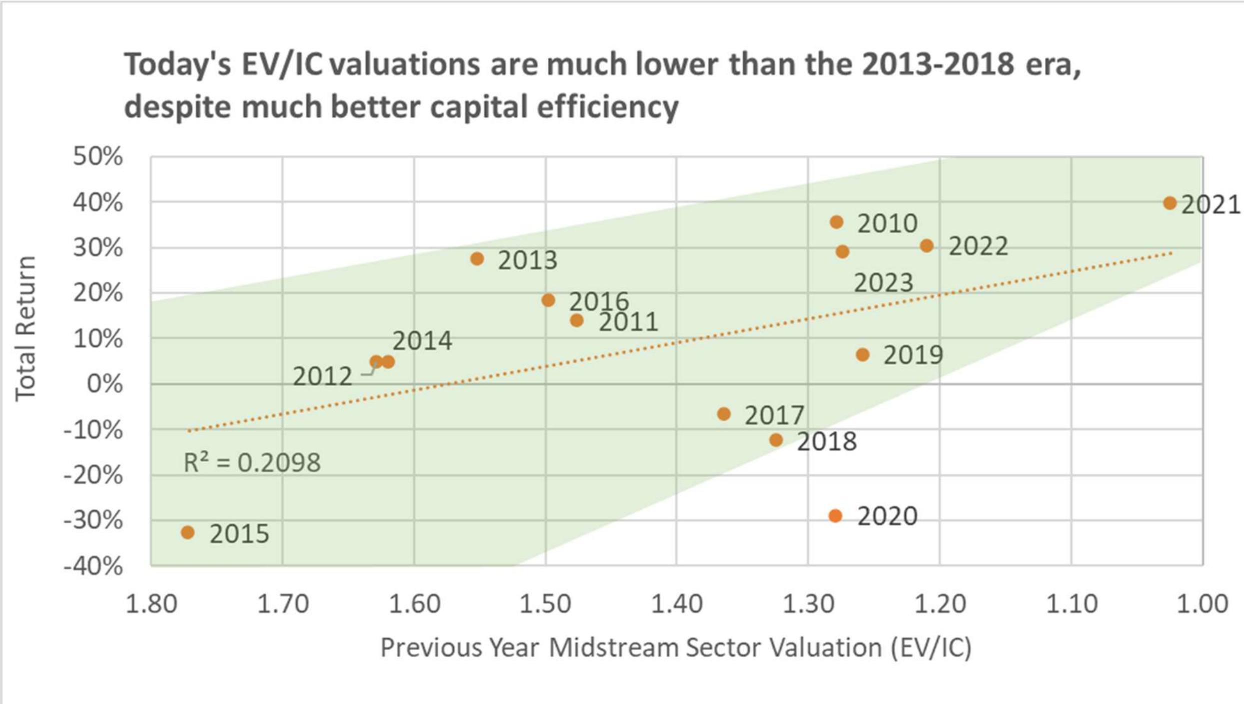
It will not come as a surprise to our longer-term readers that one key reason for strong midstream stock performance appears to be lower leverage. While leverage ratios (debt/EBITDA) are often used as key indicators of balance sheet health, the reality is that midstream's lower leverage ratios, along with generally long-dated debt maturities and locked-in low interest rates mean that while returns on invested capital (ROICs) shown in the previous chart are near historic highs, the percentage of EBIT being consumed by interest payments is near historic lows. Notably, in a low-capex industry like midstream, EBIT tends to approximate free cash flow as D&A is roughly in-line with capex for most midstream companies, a topic covered in last month's monthly.



Source: Recurrent Advisors' research, Bloomberg, public filings.

Third, reasonable valuations support midstream's case, but valuation is best when paired with strong and improving fundamentals

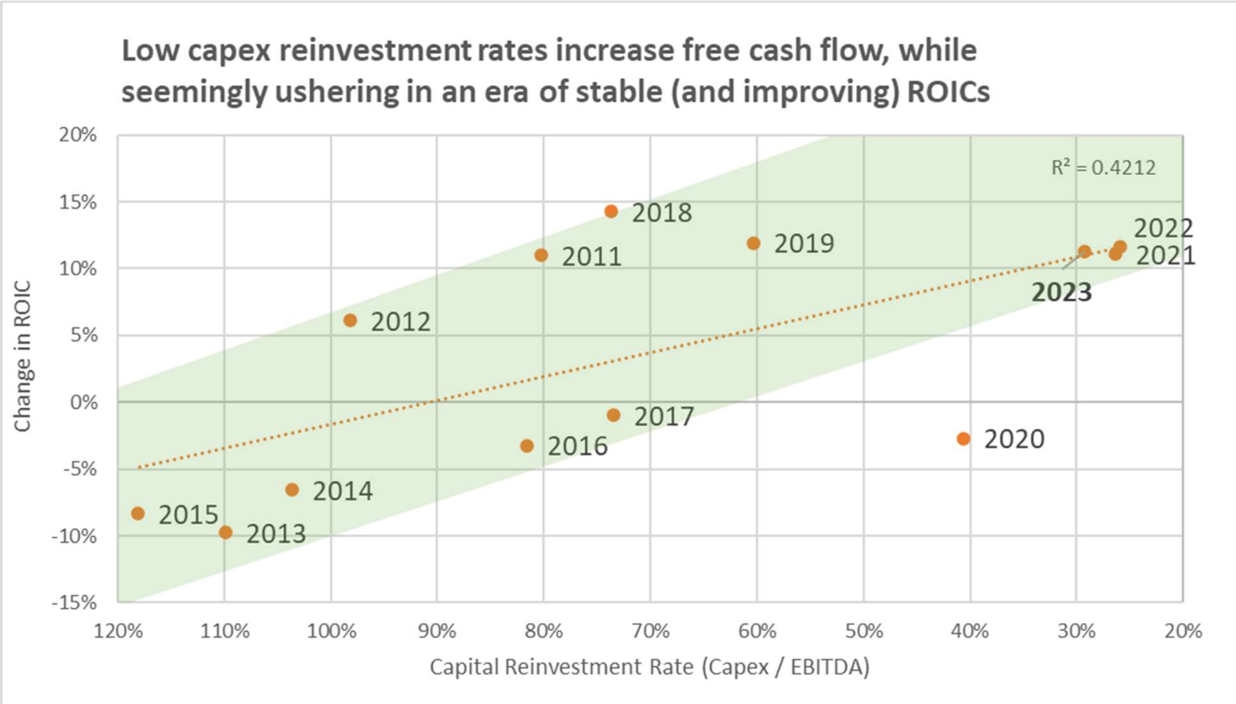
Below, we see that EV/IC valuations are also relatively supportive of midstream. While well off the 2020 lows, midstream valuations remain inline or below any year between 2011-2019, and roughly in-line with 2021 and 2023, as IC per share has grown at pace with valuations over the last 12 months.



Source: Recurrent Advisors' research, Bloomberg, public filings.

All improvements listed above are underpinned by judicious capital spending, as low capex appears strongly related to higher ROICs

We noted last month how midstream capital expenditures had approximated 1.2-1.3x depreciation levels in recent years, which had supported modest single-digit earnings growth, but importantly had led to increased returns on invested capital, as shown below. Since 2020, a 7.4% industry ROIC has increased by roughly 10% each year, with ROICs now approximating 9.9% in 2023. As noted in the first graph above, higher ROICs appear to be a key component of stronger midstream shareholder returns. Encouragingly, the graph below indicates that ROICs seemingly improve at a sustainable rate in a low capex reinvestment environment. Even if 2024's rate of improvement falls short of the levels seen post-COVID and during the Russian invasion of Ukraine, midstream's low-growth model should support ROIC improvement as smaller projects tend to generate higher returns while avoiding the painful experience of invested capital lying "fallow," waiting for construction to complete and cash flow to commence.



Source: Recurrent Advisors' research, Bloomberg, public filings.

So as we look into 2024, rather than make a prediction of future returns (our lawyers hate that), we would instead suggest another way of looking at the future. 2023 turned out significantly better than feared for several key related reasons: first, higher capital efficiency is allowing midstream companies to grow their book value per share, supporting stock price performance; second, lower debt puts midstream companies in a better position to weather macro turmoil; third, returns are improving and free cash flow is structurally higher thanks to capital spending levels which are low enough to avoid putting strain on midstream companies' capital employed. For now, the outlook in 2024 is for these key trends to continue, as ROIC should rise as select megaprojects are expected to be completed in 2024, and remaining capex will be spent on smaller, capital efficient projects, all while debt leverage continues to fall.

Natural Resources

Performance Review

In November 2023, the Recurrent Global Natural Resources Strategy rose +5.68% net of fees, outpacing the S&P Global Natural Resources Index's +4.91% increase. During the month, stock selection in the copper sector added value, as did portfolio overweights in the refining, and oil and gas storage, and transportation sectors. Portfolio underweighting in the paper packaging sector incrementally detracted from performance.

Investment Discussion

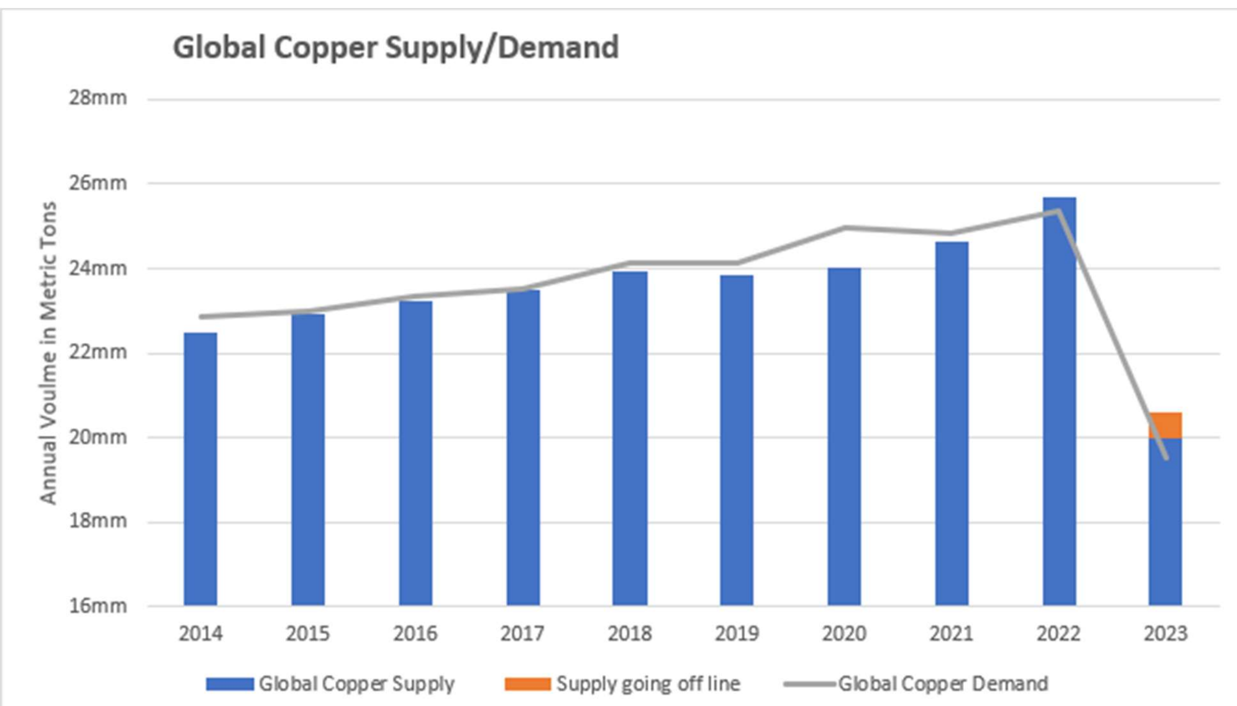
In an attempt to understand the movements of commodity markets, most analysis focuses on supply/demand dynamics. More specifically, supply estimates are generally fixed going into a given calendar year, and as the year progresses deviations in demand vs expectations serve to alter price and volume expectations through the year. 2023 has been very typical in this regard, since continued

Chinese demand weakness post-COVID caused global copper market expectations to remain oversupplied for the next few years, until demand accelerates.

While changes in demand occupy many investors' attention, the fragility of supply regularly provides greater surprises relative to market expectations. Major supply disruptions can occur for a variety of reasons – political unrest, transportation disruptions, and geological challenges. In the last few weeks, copper supply prospects materially changed, moving expected supply/demand balances from oversupplied to undersupplied.

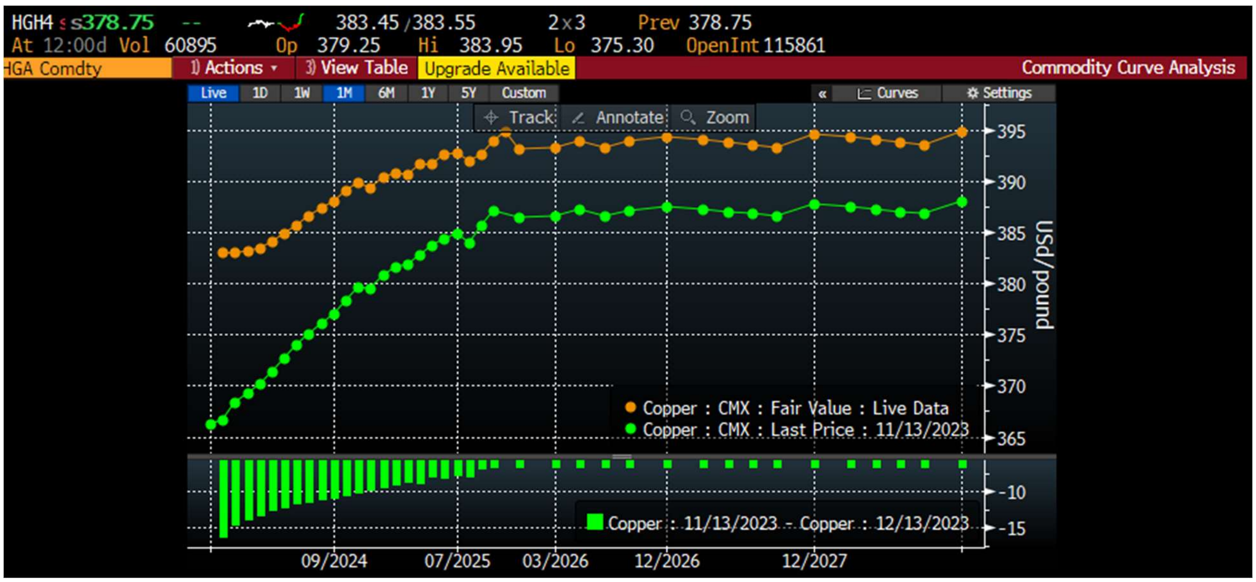
In Panama, the government ordered production to be halted at the Cobre Panama copper mine, which has productive capacity of 400,000 tons/year. The country's Supreme Court ruled that the operating license was invalid, placing operations under legal review for the foreseeable future. While not the largest copper mine, at approximately 2% of global supply, it remains a material component of expected global supplies.

Compounding the impact of the Cobre Panama shutdown was last week's announcement by Anglo American, a global mining company and portfolio holding. Due to both above ground and below ground reasons, Anglo American announced production reductions in Chile, totaling nearly 200,000 tons of annual production. Compared to previous estimates, copper production is expected to fall nearly 10% in 2024 vs 2023, and an additional 10% in 2025. At the 156-year-old Los Bronces facility, Anglo American is having difficulty with the ore quality and will mothball one of the two processing facilities for at least 2 years. Since costs at the Los Bronces facility were stated to be toward the high end of the cost curve, Anglo American management chose to reduce production. At the Quellaveco mine, geologic issues will slow production until at least 2027, with production growth expected 2028 and beyond.



Source: Bloomberg, Recurrent analysis

The combination of these two announcements significantly impacts copper's global supply/demand balance for the next few years. In round figures, 2023 global refined copper supply is approximately 20,000,000 metric tons, according to Bloomberg. By most estimates, the global copper market was expected to be oversupplied by 300,000-1,000,000 metric tons in 2024-2026, depending on the analysis. In the last two weeks, the Cobre Panama and Anglo American announcement reduced expected global supply by 600,000 metric tons annually. This approximately 2-3% reduction to global supply will tighten the global supply/demand market significantly, if not bring the supply/demand balance into deficit.



Source: Bloomberg, Recurrent analysis

In terms of the copper price, the reaction to the supply announcements was relatively muted. Compared to the pre-announcement price curve, copper prices generally rose by 2-3% over different time horizons as seen on the curve below. Given the transition from an oversupplied market to an in balance or even slightly undersupplied market, the change in prices appears to be small. Continued concerns regarding Chinese demand tamper ebullience, but should demand recover, the weakened supply situation could cause further positive commodity price revisions.

Recurrent Investment Advisors LLC
3801 Kirby Dr, Ste 654
Houston, Texas 77098
d: 832.241.6400