Midstream: last month, we discussed underappreciated ways midstream (and midstream-adjacent) energy companies benefit from the commodity backdrop. With Q3 results now public, two themes stand out: 1) free cash flow (FCF) is inflecting higher as capex continues to fall in the face of record cash flow; 2) expanding FCF and low debt loads are finally translating into revamped allocation policies, including regular dividends, special dividends, and buybacks. In Q3 alone, Recurrent's midstream holdings saw 9% sequential dividend growth. As simplistic calls for "divestment" continue to discourage new projects, excess cash must go back to investors.

Natural Resources: "Christmas is on…I don't think we're going to have any problems on that scale." – PM Boris Johnson, Sep 2021, attempting to reassure the British that supply chains are sound for the holiday season. Fuel and natural gas price increases had elicited questions from the British press. Since the beginning of 3Q 2021, energy commodities, led by Asian and European LNG prices, have materially risen. While oil prices have risen by 14%, attracting media headlines, US natural gas prices have risen by nearly 50% and international LNG prices have nearly doubled. We look at the causes and the relationships between the oil, natural gas and LNG which cause shortages to spread to adjacent energy commodities.

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

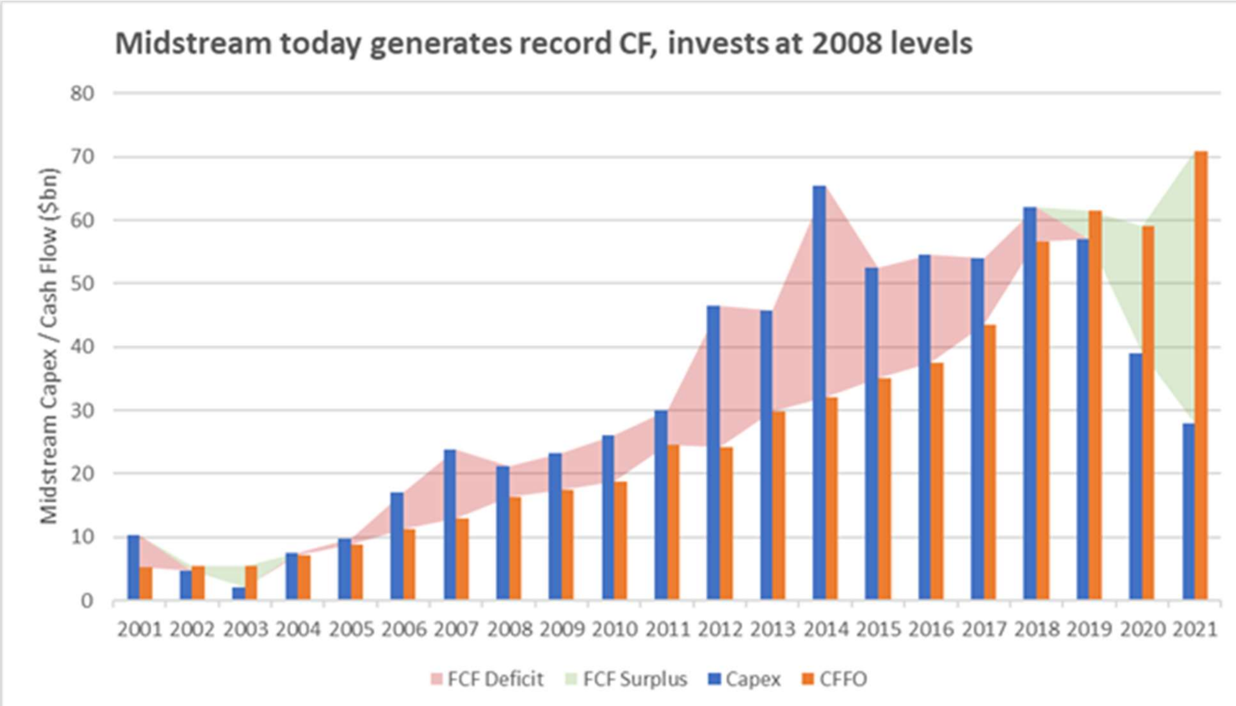
MLP & Infrastructure

Performance review

During the month of October 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +7.23%, outperforming the +4.98% gross return of the Alerian MLP Index (AMZ) by +2.25%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.52% (annualized, net of fees). Please see the performance section at bottom for more detail.

Q3 2021 saw our "lower capex, higher cash flow" midstream forecast become a reality

We spent a lot of time in 2019-2020 discussing the FCF "wedge" that would be created by falling capex and flattish cash flows. While this forecast of "expanding FCF" was met with a bit of (okay, a lot of) skepticism during the dark days of mid-2020, today we've seen that forecast realized. As of Q3 2021, full-year FCF (as shown in green below) is on pace to more than double vs. 2020 levels. Capex is expected to continue its decline in 2022, meaning that FCF yields are likely to expand again.

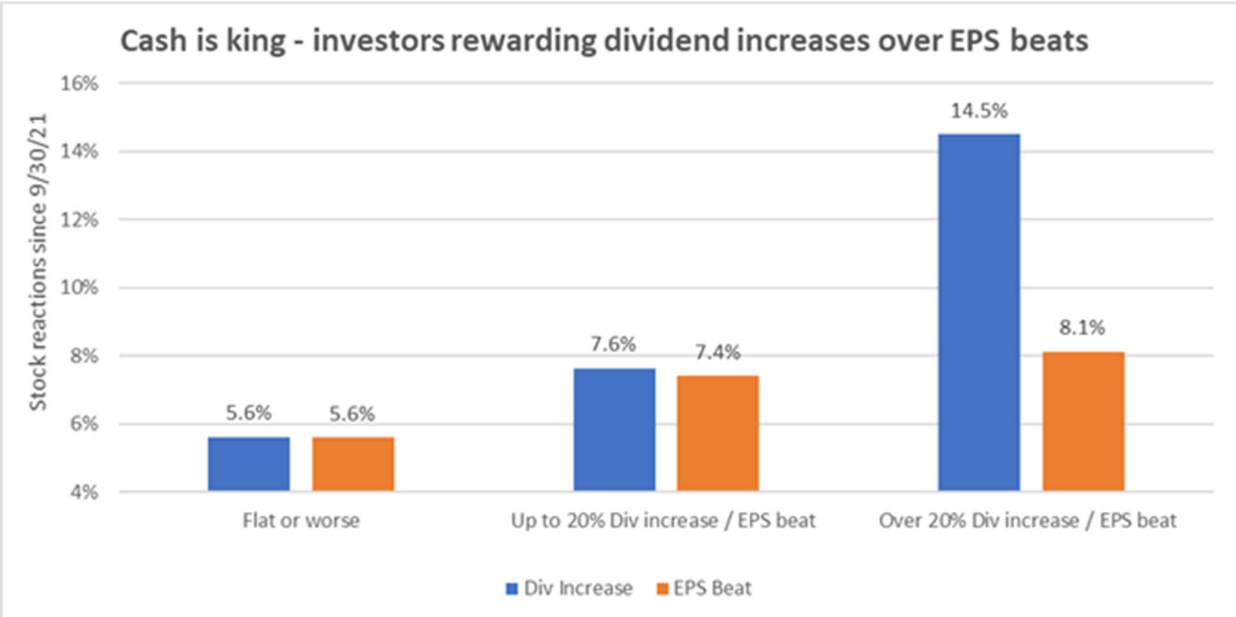


Source: Recurrent research, Bloomberg, SEC filings. Includes companies in Alerian Midstream Energy, Alerian MLP Index. Data retrieved as of 10/31/21.

With debt reduction largely complete, we seek companies positioned to translate FCF into cash back to shareholders

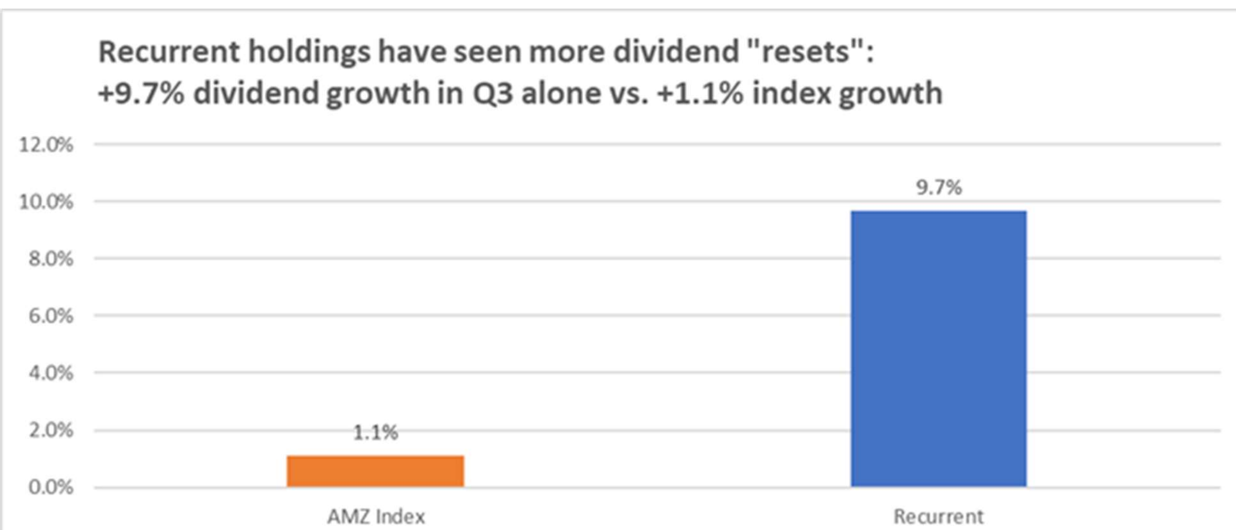
Last month, we discussed how certain midstream companies have an underappreciated ability to generate higher profits against the current commodity backdrop, which we believe is understated by Wall Street estimates. Our portfolio is generally overweight companies where we see this underappreciated earnings power.

Additionally, we are overweight companies who are closing in on debt reduction targets, as we believe companies with accelerating cash flow and below-target debt loads are more likely to announce dividend policy “resets” – i.e. dramatic step-ups in payout ratio – instead of single digit dividend increases. As we show below, in Q3 these “resets” received more recognition from the market than simple earnings and EBITDA beats.



Source: Bloomberg. Data retrieved as of 11/11/21.

In Q3 alone, we saw several dividend "resets" across our portfolio, including three companies with 100% quarter-over-quarter increases. It should be noted that in addition to dividend growth, companies across the midstream sector repurchased roughly 50 bps of aggregate market cap in Q3 – a 2% annual buyback yield that we believe is highly likely to increase in 2022.



Source: Public filings, Recurrent research. Data retrieved as of 11/11/21.

Natural Resources

Performance Review

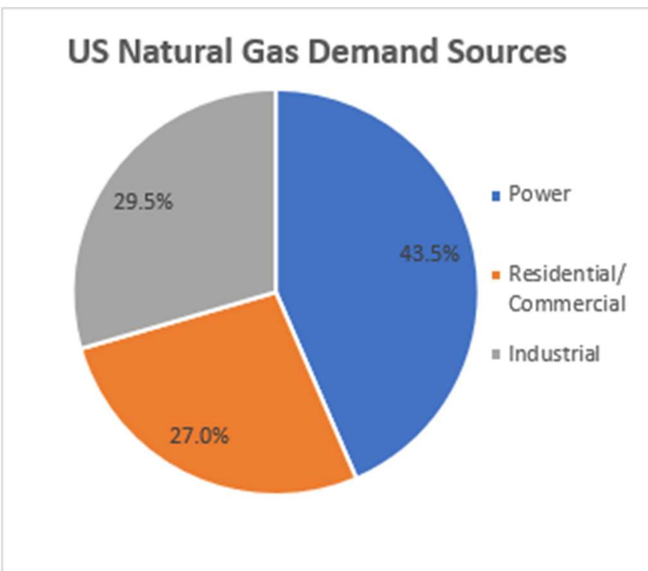
In the month of October 2021, the Recurrent Global Natural Resources Strategy rose +4.89% net of fees, outperforming the S&P Global Natural Resources Index's +4.79% return by 0.10%. In the month, Plug Power, a leading developer of hydrogen power technology, rose 50%, while Suncor Energy and Cenovus Energy, leading Canadian oil companies, rose 27% and 18% respectively. Portfolio performance was detracted by Alcoa, which fell 6% as Chinese real estate debt concerns caused speculation around weakening aluminum demand.

In October 2021, the Recurrent North American Natural Resources Strategy rose +7.49% net of fees, underperforming the S&P North American Natural Resources Index's +8.91% return. In the month, Renewable Energy Group, a leading refiner of biofuels, rose 27%, while Suncor Energy and Cenovus Energy benefitted the portfolio. Portfolio performance was again detracted by Alcoa, which fell 6%.

Natural gas, LNG, and oil – examining the interplay between key energy commodities

Natural Gas: As is the case with many commodities, since the 2nd quarter of 2021, the price of natural gas in the US has risen to multi-year highs, reaching $6/mmbtu in the fourth quarter, compared to the 5 year average of $2.87/MMbtu.

Natural Gas Demand
During COVID many commodities saw weakened demand. However, since natural gas is primarily used for heating, power and industrial purposes as opposed to supporting mobility, demand remained relatively constant. The rolling 12 month average for US natural gas consumption fell just 1% during COVID; well within the normal variability due to weather.



Source: Bloomberg, Recurrent Research

Natural Gas Supply
While demand for US natural gas was resilient during COVID, supply fell. Approximately 1/3 of US natural gas production is produced as a by-product from shale oil wells. As oil prices fell and were briefly negative in 1Q 2020, oil drilling activity fell. Associated natural gas production in higher cost oil producing Anadarko, Eagle Ford, and Bakken shale basins fell by 2.6 Bcf/day, approximately 3% of total US natural gas production.

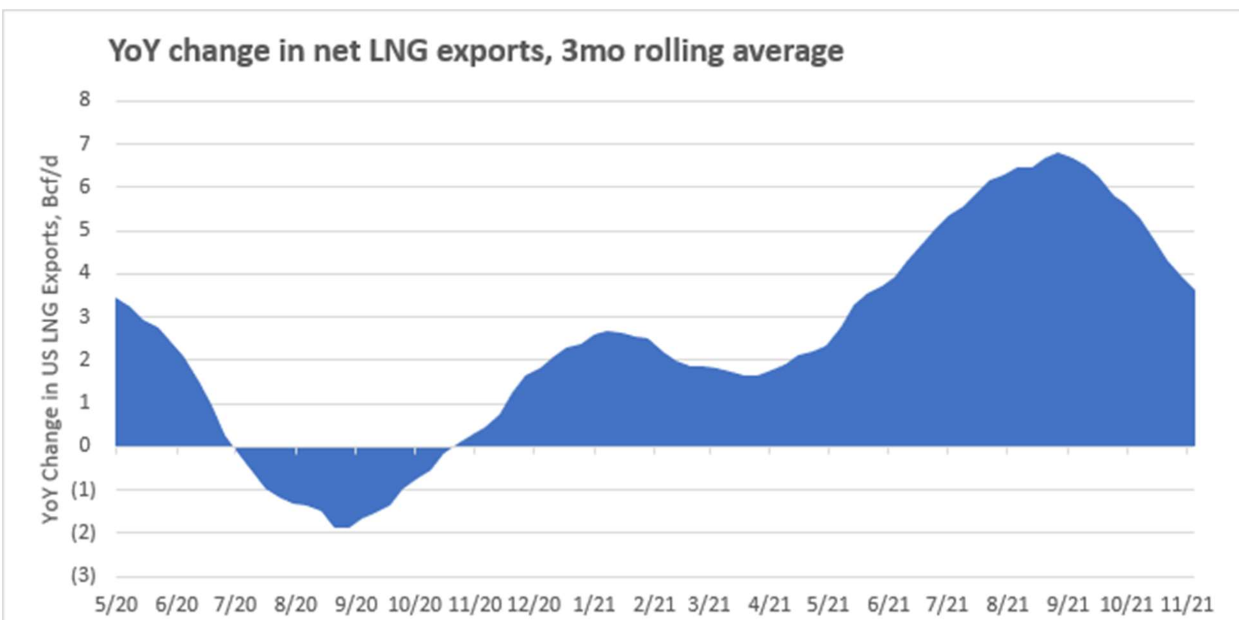
To summarize, within the US, demand fell by 1%, but supply fell by 3%.

LNG/Global Demand
While US natural gas supply/demand dynamics remained generally in balance, global inventories are far

below normal levels. Below is a chart outlining the percent of capacity utilization for one of the largest German natural gas storage facilities. The current 53% capacity is far below the normal 80% to 90% capacity levels seasonally seen over the last 7 years of recorded data.

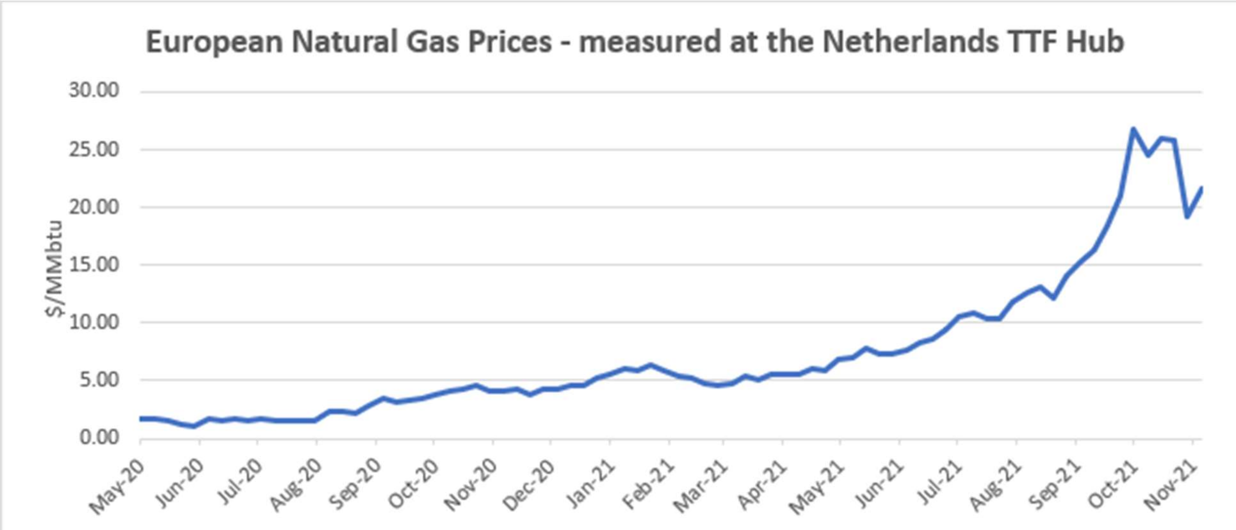
Source: Bloomberg, Recurrent Research

As a key supply source for additional natural gas to Europe, US LNG exports have notably increased in the second half of 2021. The below chart reflects the year-over-year change in LNG exports. LNG exports grew by roughly 7 bcf/d between September 2020 and September 2021 – effectively moving close to 10% of total US gas supply offshore in response to soaring global prices.



Source: Bloomberg, Recurrent Research

Understandably, European and Asian natural gas prices reflect the scarcity, as seen in the chart below.



Source: Bloomberg, Recurrent Research

Oil: Finally, turning to oil – how are high global natural gas prices increasing global oil demand?

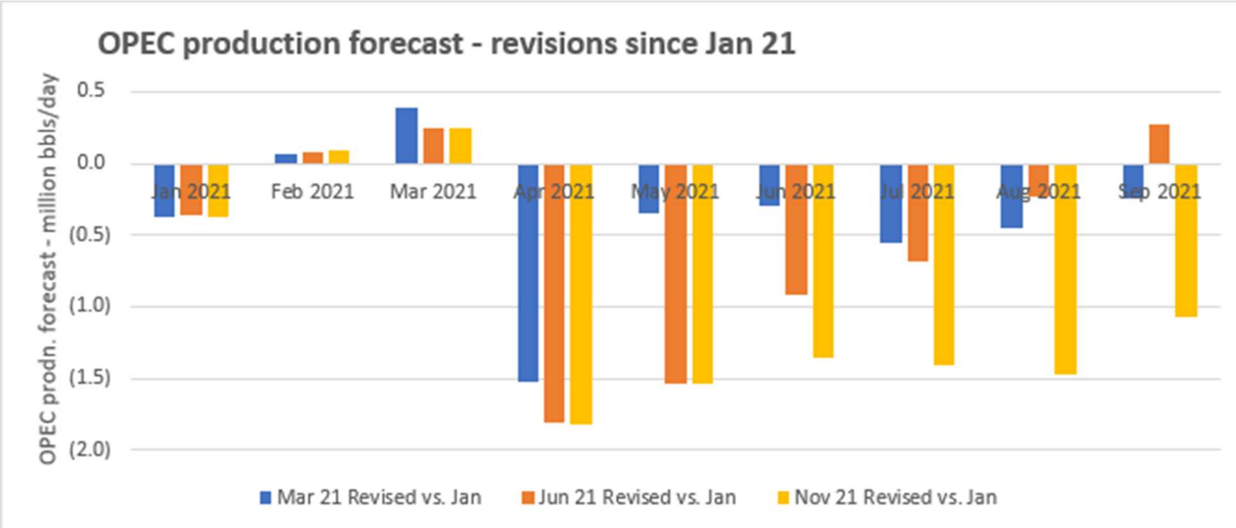
Oil Demand

After more than 18 months, global oil demand remains below pre-COVID levels, despite many mobility measures returning to pre-COVID levels. One idiosyncratic area of demand growth is in industries where natural gas and oil can be readily substituted. For example, many Asian power plants have the ability to switch between natural gas and oil, depending on the price per unit of energy.

As a rule of thumb, to determine the approximate btu equivalency between a barrel of oil and natural gas, multiplying the natural gas price by 6 is a rough estimate. As seen in the chart above, since the natural gas price in Europe and Asia is >$25/mmbtu, the btu equivalent oil price is $150 = 6 x $25/MMbtu. At that level, switching from natural gas to oil is the economically prudent decision, and as a result, current natural gas to oil switching estimates are as much as 1,000,000 barrels/day. Global jet fuel demand remains 15-20% below 2019 levels, and in 2019 accounted for 7% of global oil demand. The 1% of global demand weakness from jet fuel is largely offset by increased oil demand from natural gas to oil fuel switching.

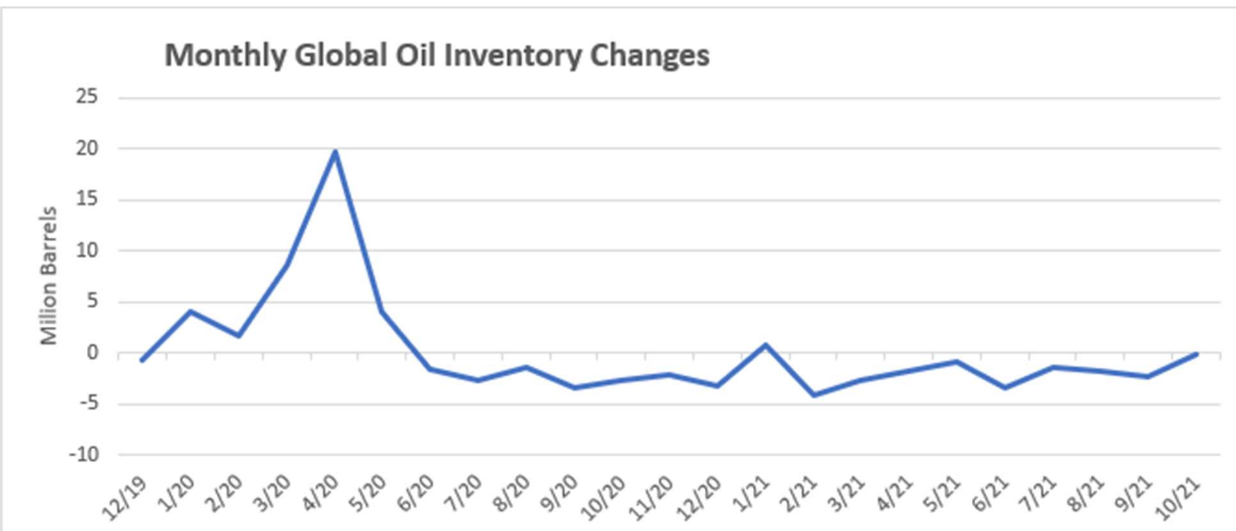
Oil Supply

In June 2021, OPEC announced its plan to increase monthly oil supply by 400,000 per day. However, OPEC production remains more than 2 million barrels/day below 2019 levels, while US oil production is a further 1.5 million barrels/day below 1Q 2020 levels. Moreover, OPEC is proving to have difficulty reaccelerating production. As shown below, OPEC's actual production has consistently missed the US Department of Energy (DOE) January 2021 expectations. OPEC has under-delivered vs. January expectations by 1 to 2 million barrels, despite OPEC's public July 2021 announcement to accelerate returning barrels into the market. Notably, the DOE's estimates were revised lower again in November, several months after OPEC's production increases should've started impacting the market.



Source: Bloomberg, Recurrent Research

Since the large inventory injections during the early stages of COVID, global inventories have persistently declined, returning to normalized levels, while demand remains above supply for quarters to come.



Source: Bloomberg, Recurrent Research

In summary, the interconnected nature of the natural gas, LNG and oil markets has acted as a tide which has lifted all boats. Price dislocations between commodities have incentivized switching, and increased prices for all three. As winter approaches, fossil fuel demand is likely to seasonally increase, while production increases lag. As a result, energy commodity prices should remain elevated for the short to intermediate term.

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