Energy Infrastructure: we have been asked if Trump's energy policies will lead to a sharp increase in pipeline capex, potentially outstripping midstream cash flows. Our simple answer is no. Today's midstream companies face capital markets realities that make large-scale pipeline construction unappealing. Example: before 2015, valuations implied ~$3mm/mile vs. new construction costs of $3-5mm/mile. Newer assets often enjoy higher fees and longer-term contracts, so construction was accretive. Since 2015, per-mile valuations are down, while construction costs outside of Texas have ballooned to >$20mm/mile. This makes pipeline newbuilds unappealing, unless permitting reform makes construction cheaper or public valuations increase significantly.

Natural Resources: In June 2024, presumptive Treasury Secretary Scott Bessent outlined his "3-3-3" plan to strengthen the US economy. One of the three components outlined the need to grow daily oil-equivalent production by 3 million barrels. Is this an outlandish goal? The short answer is "no," since recent oil-equivalent production has grown at that pace over the last five years. However, after years of apathy, investor focus on the energy patch is re-emerging.
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

November 2024 Performance Summary and Market Commentaries
Please find below performance and commentary for our strategies – MLP & Infrastructure and Natural Resources. See performance tables 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 2024, the Recurrent MLP & Infrastructure Strategy generated net returns of +11.37%, lagging the Alerian MLP Index's (AMZ) +14.60% return by -3.22%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +42.91% (+2.99% annualized), net of fees. On a gross basis, the Strategy has outperformed by +66.89% and +4.46% respectively. See performance section at bottom for more detail, plus performance detail on the Recurrent Energy Infrastructure Strategy, which seeks to track the MLP & Infrastructure Strategy while excluding MLPs.

Pipeline megaprojects were once viewed as accretive trophies – since 2015, they have been costly albatrosses… what happened?

Prior to 2015, multi-billion-dollar long-haul pipeline megaprojects were considered "crown jewels" in the midstream industry. With permitting and construction risks perceived as minimal, highly-contracted interstate pipes were seen as accretive to both equity valuations and credit quality, thanks to long-term contracts with higher tariffs than existing assets. With companies trading well above 10x EBITDA and $3mm/mile, new construction implied 5x-7x EBITDA and <$5mm/mile. Furthermore, successful newbuild projects could open up future growth avenues along the newly-built route, enhancing a company's long-term growth outlook.

Typical pre-2015 megaproject assumptions

	Standalone Company	Interstate "Megaproject"	Pro Forma Company	Valuation Uplift
EV	50.0	6.0	56.0	63.6
Debt	22.0	6.0	28.0	28.0
Mkt Cap	28.0			35.6
EBITDA	4.0	1.1	5.1	5.1
EV/EBITDA	12.5x	5.5x	11.0x	12.5x
Debt/EBITDA	5.5x	5.5x	5.5x	5.5x

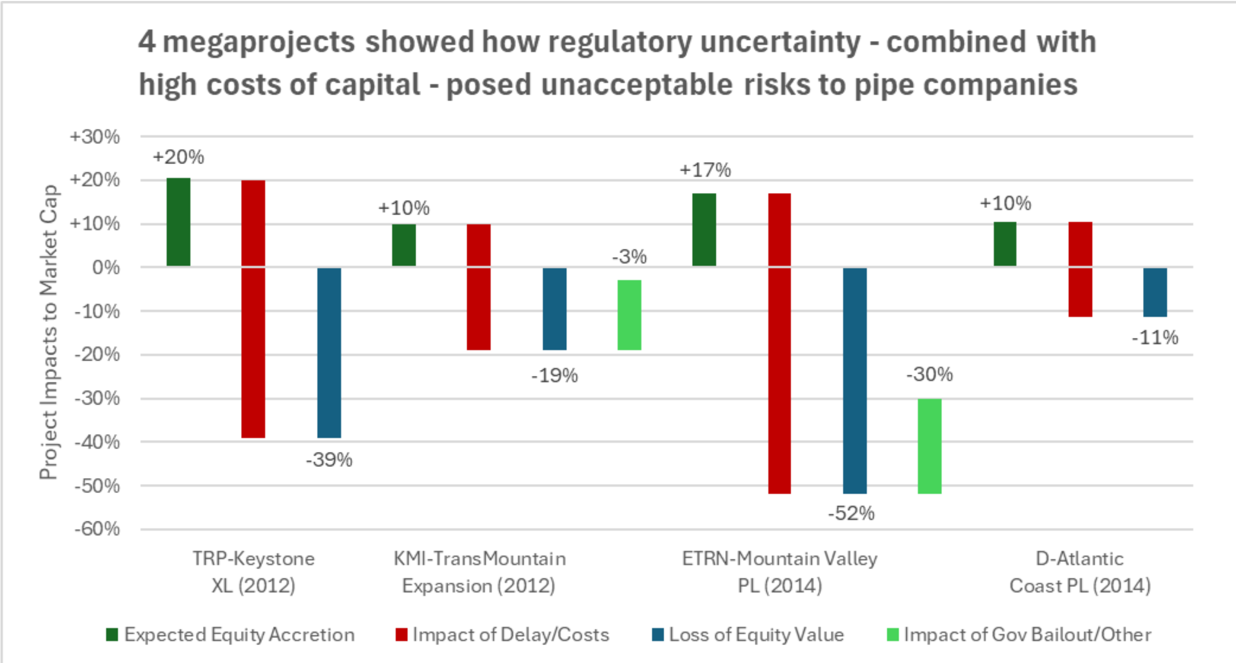
Source: Recurrent research, FERC filings, public SEC filings

As shown in the hypothetical above, a typical megaproject, featuring economics roughly 50% below public market valuations (as measured by EV/EBITDA multiples). In other words, with early 2010s public valuations of 12x EBITDA or higher, megaprojects were being pursued at 5x to 7x multiples. Put simply, a project that would cost 10% of EV could in turn increase EBITDA by more than 20%. This could hypothetically expand equity valuations by 20%, assuming largely debt project financing.

The 4 ill-fated megaprojects shown below – TC Energy's Keystone XL (KXL), Kinder Morgan's Transmountain Expansion (TMX), EQT/Equitrans's Mountain Valley Pipeline (MVP), and Dominion/Duke's Atlantic Coast Pipeline (ACP) – changed the calculus of newbuild pipeline construction forever – at least outside of producing states like Texas.

In the cases of KXL and ACP, the projects' regulatory challenges led the developers to abandon partially-completed pipelines, impairing $9bn and $3.4bn of work in progress, respectively. In the case of TMX and MVP, the projects were completed thanks to unprecedented government sponsorship - direct ownership by the Canadian government in TMX's case, and Joe Manchin's threat to vote against Biden's signature Inflation Reduction Act in the case of MVP.

Below, we attempt to isolate the financial impact of each pipeline to its primary owner, while understanding that the exact market cap impacts and factors such as decline in valuation multiples due to foregone cash flows and increased debt cannot be estimated precisely. What is clear is that these megaprojects offered their developers EBITDA growth of 10% to 25%, with the hope that these projects would offer commensurate equity accretion.

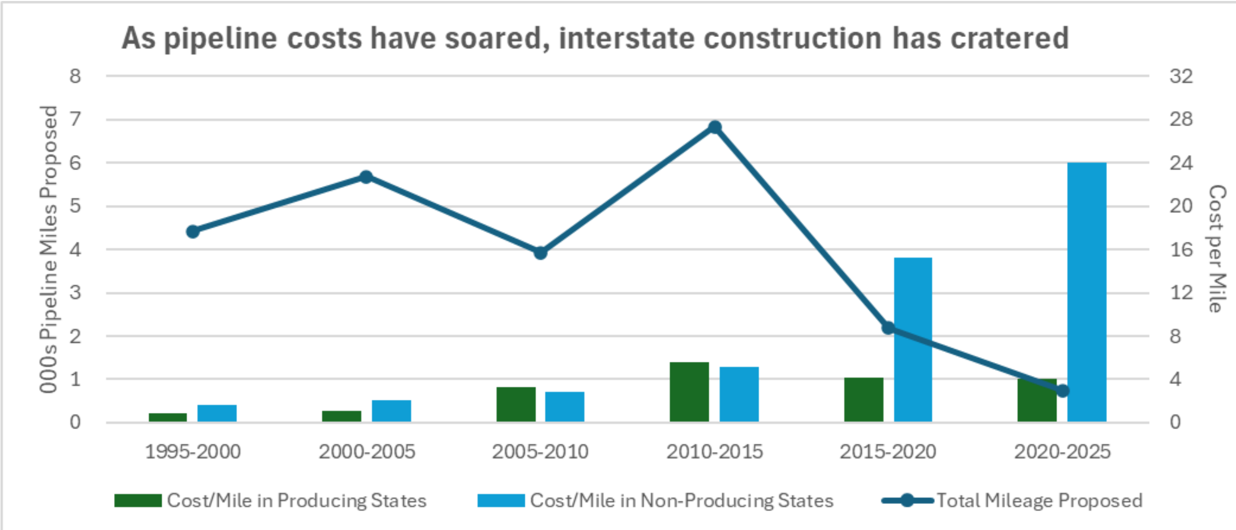


Source: Recurrent research, FERC filings, public SEC filings

- In the case of KXL, the hoped-for 20% equity valuation uplift from KXL turned into a $9bn impairment, representing almost 40% of TRP's pre-KXL market cap.
- The TMX project's $20bn cost overrun ($26bn total) would have led to a loss of ~30% of KMI's pre-project market cap. TMX's ability to charge higher tolls to recoup overruns mitigated some economic damage, but it was KMI's timely exit, selling to the Canadian government in 2018 at ~cost, that saved KMI from the massive overruns to come. TMX was completed >20x EBITDA, a multiple that would be deeply dilutive for any public pipeline company.
- MVP required the intervention of Sen. Joe Manchin to receive final approvals. MVP was completed for $30mm/mile and an implied build multiple of 20x EBITDA, making it massively dilutive to developer ETRN. The company experienced a 75% decline in share price during MVP's development. Unprecedented Congressional intervention the sale of ETRN recovered some value loss, but MVP's victory was pyrrhic and illustrated how hopelessly costly pipeline construction had become.
- Finally, the ACP project, announced with a similar timeline and economic rationale as MVP, began as a $4.5bn project sponsored by Dominion and Duke, before seeing cost estimates double in 3 years. The partially completed pipeline was abandoned in 2020 with $3.4bn in losses. After spending 70% of the original budget, ACP was only slightly more than 10% complete upon its abandonment.

Could a new POTUS force a faster pace of energy growth? We are skeptical, especially for pipe development

In light of the economic carnage highlighted above, proposed long-haul pipeline construction has fallen dramatically in the US. While in oil and gas producing states like Texas, Oklahoma, Louisiana and North Dakota, costs remain roughly in-line with pre-2015 levels, costs anywhere outside of these producing states have become prohibitively expensive (as shown in blue bars below).



Source: Recurrent research, FERC filings, public SEC filings

Could changes in Washington, DC dramatically alter the pace of pipeline construction? We are skeptical. Yes, cost increases are the result of an increasingly hostile permitting environment. But this increased hostility has not been due to any new law written in the past 10 or 15 years. The law defining the permitting process for all interstate infrastructure in the US (the National Environmental Policy Act, or NEPA) has been in place since 1970. Rather than any government action, it has been a combination of growing public hostility to <u>all</u> types of infrastructure, (as we discussed in [our letter one year ago](#)) as oil and gas projects have dwindled, opposition to clean energy projects has surged, and judicial appointees who have established a clear precedent of incorporating broad climate change analyses into what once was a narrowly-defined environmental assessment process. Neither the public hostility that has driven project costs higher nor the judicial precedents that have steadily expanded the scope of environmental reviews are trends that can easily be reversed by the Federal government, and a wholesale replacement of NEPA is likely to be met with more aggressive state-level enforcement in the states where building costs are already the highest.

Does this mean that pipeline earnings growth is sputtering out?

This does not mean that pipeline companies will be unable to grow. However, it does suggest that the vast majority of growth will come from a set of opportunities defined within Texas (and to a lesser extent, neighboring states of Louisiana, Oklahoma, and New Mexico) and to nearby LNG export facilities. In the back half of the 2020s, there will be brownfield projects (existing asset expansions) to serve increasing numbers of datacenters supporting the AI boom. Growth-hungry investors will be increasingly focused on Texas and LNG opportunities, considering that pipeline mileage outside of Texas will be hard-pressed to grow without much higher valuations, or herculean permitting reform.

Natural Resources

Performance Review

During the month of November 2024, the Recurrent Global Natural Resources Strategy rose +1.32% net of fees, outperforming the S&P Global Natural Resources Index's -0.75% return. From a portfolio perspective, the US election outcome had a significant impact on performance. Energy and aluminum sectors increased more than 10% during the month, strongly benefiting relative performance. Non-US levered industrial companies performed relatively poorly as a result of the potential impacts of tariffs on the global economy. Diversified metals, gold, chemicals and paper products all fell significantly during the month.

Investment Discussion: Could the incoming administration create a “step-change” in US energy production?

Since the November election results, investors have regularly asked us about how the “drill, baby, drill” mantra would impact energy markets. Furthermore, the designation of Scott Bessent as the presumptive Treasury Secretary further elicited inquiries as a result of his “3-3-3” plan, announced in a Manhattan Institute speech before the election.

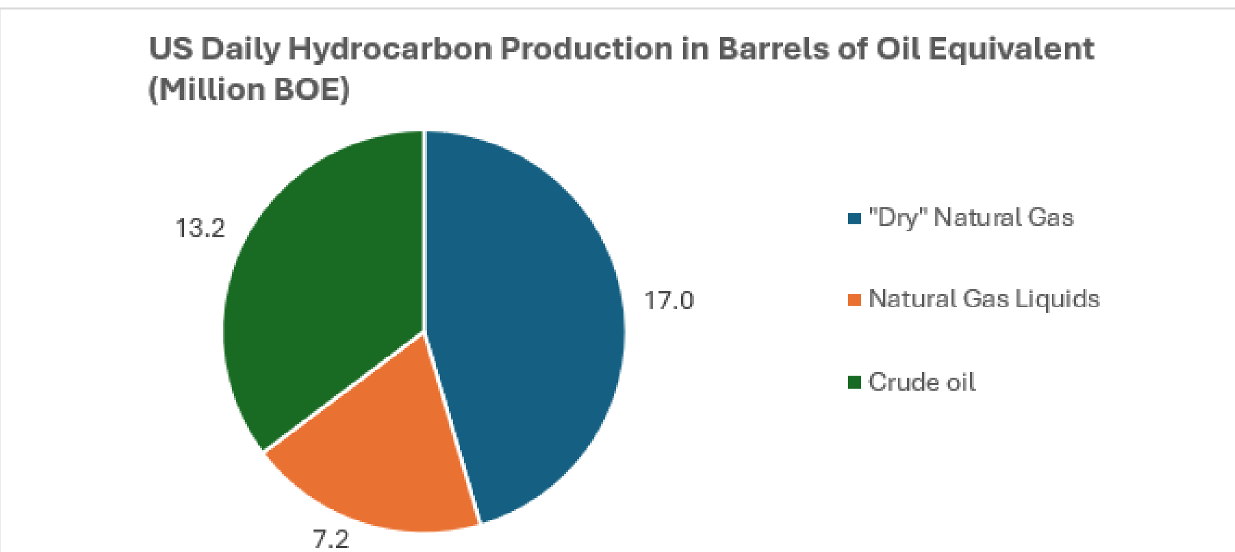
<u>What is the 3-3-3 plan?</u>
As a baseline economic plan, the goal is to:
3 - Reduce the annual federal deficit to 3% of GDP, down from the current 6-7% level
3 – Maintain an economic growth target of 3%
3 – Increase oil-equivalent production by 3 million barrels per day

While the first two conditions are worthy of discussion and debate, we receive regular inquiries about the third. When considered in conjunction with the commonly used “drill baby drill” mantra, there is a sense that oil production will grow rapidly. With significant growth, energy related prices would fall, reducing inflation across the economy.
There are quite a few points to highlight regarding this seemingly simple statement.

“Oil-equivalent”

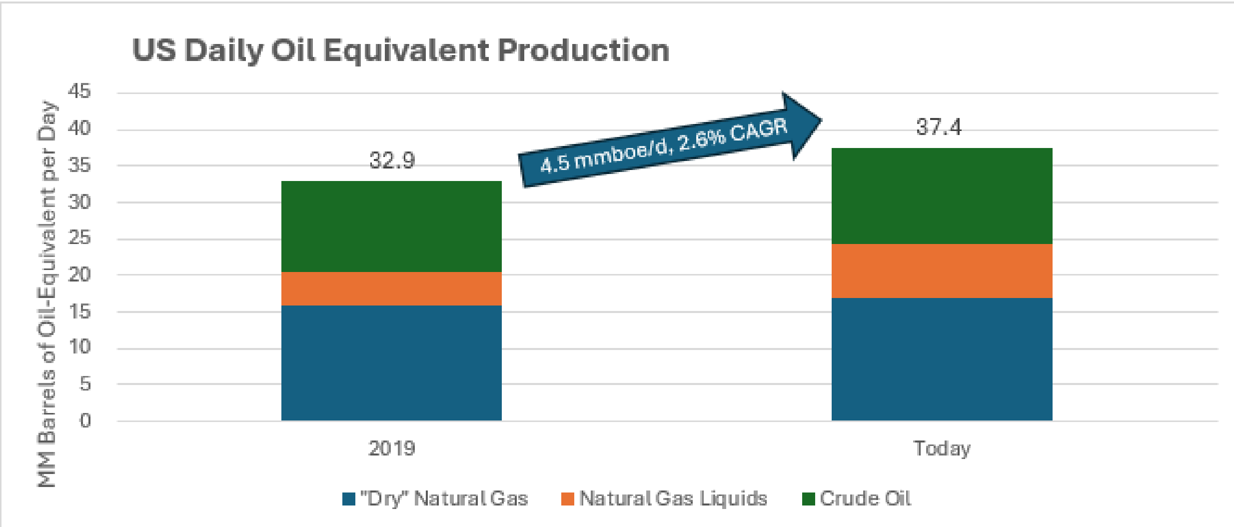
In many reports of the speech, the growth in production referred to only oil production, instead of oil-equivalent production. Oil production in the United States is +/- 13 million barrels daily, according to the EIA. However, Bessent specifically used the term “oil-equivalent” production, to include natural gas liquids such as ethane and propane, as well as “dry gas” production, all converted to barrel of oil equivalent terms on an energy equivalent (BTU) basis.

The addition of that production materially changes the math to **37.4 Million barrels of oil equivalent per day**, as seen in the chart below.



Source: EIA, Recurrent research

So when the goal is adding 3 million barrels of oil equivalent per day, 3 million barrels of production increases changes from 3/13 = 23% increase to 3/37.4 = 8% increase. A much more achievable goal, especially over a 4-year period. Interestingly, since 2019, US oil equivalent production growth has been 2.6% annually, 50% higher than the 3-3-3 plan - which many believe represents an acceleration of oil and natural gas production!



Source: EIA, Recurrent research

One of the commonly stated means to explain how oil/natural gas production would increase is to reduce regulations, most notably by opening more federal lands for drilling. However, according to the EIA, in 2023 only 12% of oil and 11% of natural gas onshore production was in federal lands, with an additional 15%/2% oil/natural gas from offshore production. These percentages fall much further when accounting for which areas have generated the most production growth in recent years. Easing restrictions would certainly expand opportunity, but is unlikely to provide meaningfully greater drilling opportunities.

One of the most important elements helping to make the US energy market unique is the idea that most drilling for oil and natural gas occurs on private lands, meaning that economics and project returns are the main variables determining whether or not companies will drill for oil and natural gas. While the government's goal of increased drilling for oil/gas is noteworthy, at the end of the day, companies make investment decisions on behalf of their investors.

Post-election data points not showing significant commitment to production growth

Interestingly, since the November election, Chevron and ExxonMobil announced their 2025 capital spending budgets. Chevron, from its company's website…"the company's 2025 capex and affiliate capex budget represent a $2 Bln year-over-year reduction….Permian Basin spend is lower than the 2024 budget….as production growth is reduced in favor of free cash flow". ExxonMobil announced a CAPEX increase on the surface, but after adding the CAPEX of recently acquired Pioneer, the increase was less than 10%. As industry standard bearers, the generally flat CAPEX between the companies does not reflect a strong growth initiative.

What about the impact of energy production on inflation?

While only two companies, the Chevron and Exxon statements are interesting because they highlight the importance of drilling economics instead of national policy. Furthermore, many leading (presumptive) government officials like Howard Lutnick have stated that if energy prices fall, then inflation would fall also – in line with our white paper titled "The Great Inflation Misdiagnosis". However, since shale drilling is short cycle, companies will only drill if there is an ability to earn sufficient returns over a relatively short period of time. Similarly, if commodity prices are too low, then drilling will slow and supply will be restrained until prices rise.

The stated goal of lower commodity prices sounds good on paper, but in reality natural gas prices remain toward the low end of historical experience. Would there be an expectation of accelerating natural gas production growth to then supply LNG export facilities, which deregulation would support? While that is all a reasonable expectation over time, commodity prices would probably be maintained, rather than fall.

In sum, when considering the energy related elements of the 3-3-3 plan, the goals are in line with recent history. Despite talking points which convey exceptional efforts to achieve, recent oil-equivalent production has been growing at a similar pace to the growth outlined in the 3-3-3 plan. While federal deregulation could incrementally augment production growth, companies' core tenant of investor returns has a much higher impact on production than does federal policy.

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