

**Energy Infrastructure:** in recent letters, we've highlighted how midstream infrastructure is one of the few yield-generating asset classes with low correlations to Fed policy. We've written about midstream discounts vs. REITs, utilities, and bonds... and how midstream should benefit from AI datacenters (while avoiding much of the capex required for the AI buildout). Still, many assume that the YTD rally bakes in much of the good news. Below, we see Wall Street's forecasted EBITDA growth implying that EV/EBITDA valuations are nearly flat YTD, despite nearly 20% YTD returns. Midstream offers comparable growth to Utilities, at a 30%+ EV/EBITDA valuation discount, before factoring in Wall Street's tendency to underestimate midstream EBITDA. [Click here for our new midstream white paper, which explores midstream's excess \(and growing\) yield vs. fixed income](#)

**Natural Resources:** Since the beginning of 2019, the US has grown oil production by 1.75 million barrels/day, to 12.7 million barrels/day as of June 2024. Whereas many investors assume production growth is dispersed across many oil producing areas of the country, our "dispatch curve" framework suggests that lower cost basins like the Permian are likely to remain the only drivers of production growth, at the expense of higher cost basins.

[Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG](#)

### September 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](mailto:info@recurrentadvisors.com).

## **MLP & Infrastructure**

### **Performance review**

During the month of September 2024, the Recurrent MLP & Infrastructure Strategy generated net returns of -1.70%, lagging the Alerian MLP Index's (AMZ) -0.29% return by -1.41%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +37.34% (+2.97% annualized), net of fees. On a gross basis, the Strategy has outperformed by +58.02% and +4.42% 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.

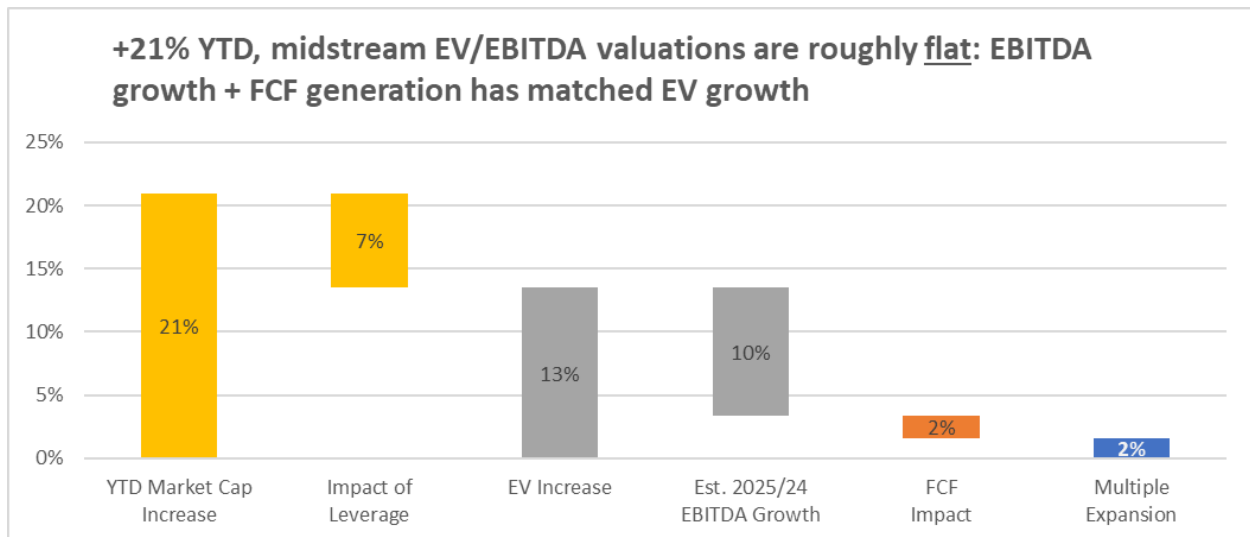
### **With the midstream sector up ~20% YTD, is it possible that valuations are only up 3%?**

Year to date, midstream stock performance is unambiguously positive. The Alerian MLP Index (AMZ) is +18.56% through September 30, 2024, while the AMNA Index - more heavily weighted to large-cap non-MLP pipeline companies - is up +27.29% over the same period.

Naturally, after an already-robust three-year performance period from 2021-23, investors are cautious given such strong performance YTD. But how does the increase in market valuations compare to business fundamentals? When we account for EBITDA growth, FCF generation (in reducing net debt, FCF effectively reduces EVs over time), and the reduction in leverage (as measured by debt/EBITDA), midstream valuations are roughly flat since December 31, 2023 – and maybe even cheaper than they were at the beginning of the year, given Wall Street’s tendency to underestimate midstream EBITDA.

How does this math add up? Let’s walk through the chart below:

- midstream sector market cap (including C-corps and MLPs) has increased by 21% YTD.
- With debt roughly flat over that time, enterprise values (EVs) have only increased by 13% YTD.
- In December 2023, Wall Street consensus estimates for next year (2024E) EBITDA was \$108bn. As of September 30, 2024, next year (2025E) EBITDA is expected to be \$119bn – a 10% increase.
- In the next 12 months, midstream stocks are expected to generate \$51bn in FCF to cover \$32bn of dividends. The remaining \$20bn of FCF modestly reduces EV by 2%.
- The result is an EV/EBITDA that is, at least based on Wall Street consensus – comparably valued as it was in late 2023.



Source: Recurrent research, SEC filings, Bloomberg.

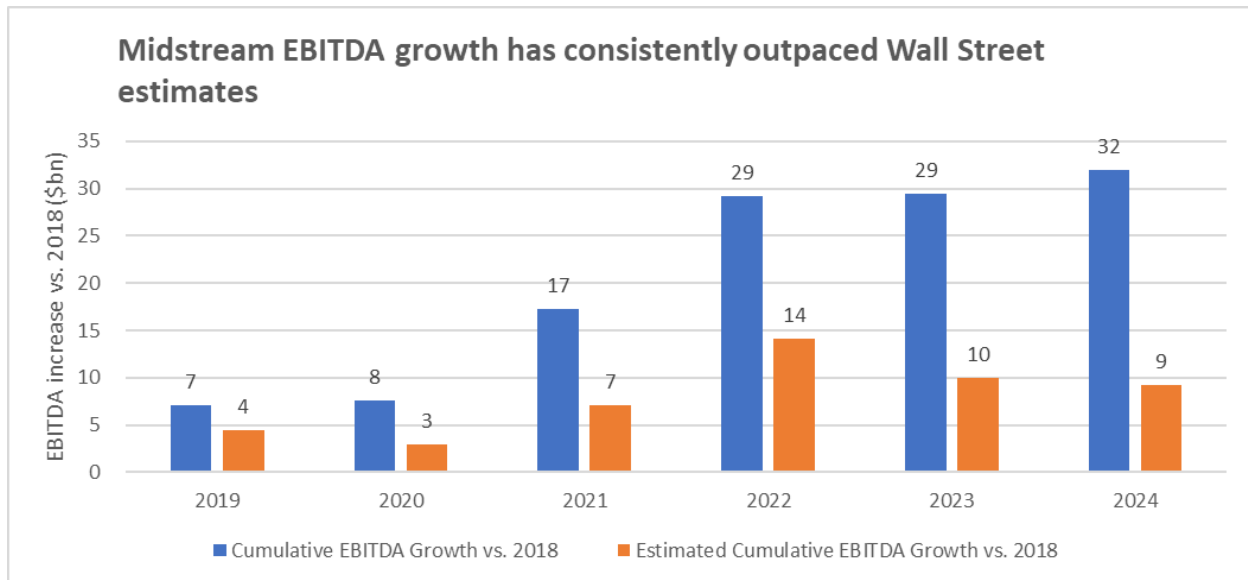
Notes: Compares public company EV as of 12/31/23 and 9/30/24, along with public EBITDA and FCF estimates for 2024 and 2025 as of those same dates.

Study contains the 28 largest publicly traded North American midstream companies by market cap, including KMI, ET, LNG, EPD, OKE, CEQP, WMB, TRGP, NS, MMP, WES, MPLX, PAA, DCP, ENLC, SUN, TRP CN, ENB CN, PPL CN, GEI CN, ALA CN, KEY CN, KNTK, HESM, DTM, ENBL, EQM, ETRN.

## Wall Street analysts have been slow to come around to the increased earnings power of the midstream sector... leaving more upside

So there’s good news – the midstream sector, by one measure at least – has gone from 8.8x EV/EBITDA to 9.0x EV/EBITDA. In other words, valuations based on forward EBITDA estimates have only increased by 2% even as investors have seen 20%+ appreciation. But then there’s better news – the same Wall Street analysis that makes midstream look attractively valued has systematically underestimated EBITDA over the last 5 years. If this trend continues, EBITDA growth

could exceed the 10% modeled above – implying an even cheaper EV/EBITDA valuation next year.



Source: Recurrent research, SEC filings, Bloomberg.

Notes: reflects Bloomberg estimates immediately prior to quarterly reporting vs. actual reported EBITDA.

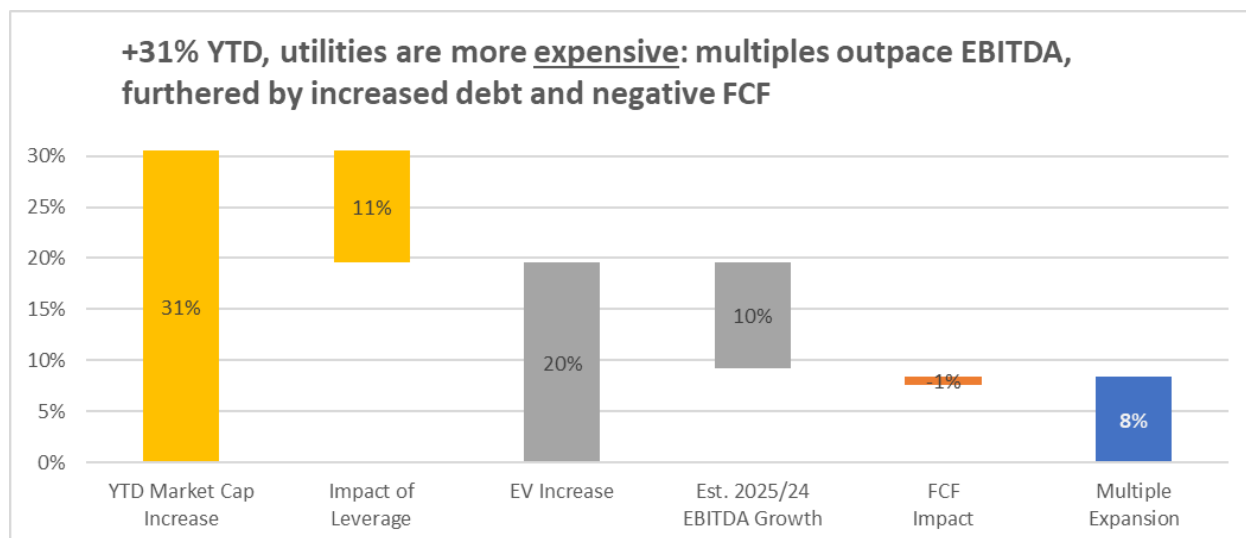
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### How has YTD stock performance impacted valuations in comparable sectors?

Like Midstream, the Utility sector has also enjoyed strong YTD stock performance (S&P 500 Utilities +30.63% through September 30), with the sector rebounding after negative absolute performance and weak relative performance in 2023. Performance has been particularly bolstered by unregulated IPP companies, which are much more exposed to rising spot electricity prices vs. traditional regulated utilities.

While the YTD total return is comparable to midstream, the composition of the return is notably different, as the sector has become more expensive on an EV/EBITDA basis. Let's walk through the chart below:

- Utility sector market cap has increased by 31% YTD.
- With debt increasing alongside market caps, enterprise values (EVs) have increased by 20% YTD.
- Comparable to midstream, Wall Street forecasts expect 2025E EBITDA to increase 10% over 2024 EBITDA levels.
- However, unlike midstream, utility growth is being funded by negative FCF – funded by debt which will further inflate EV – of nearly \$60bn after dividends, inflating EVs by 2%.
- The result is an EV/EBITDA that has increased from 11.0x to 12.2x (+11% increase in valuation) since December 2023.



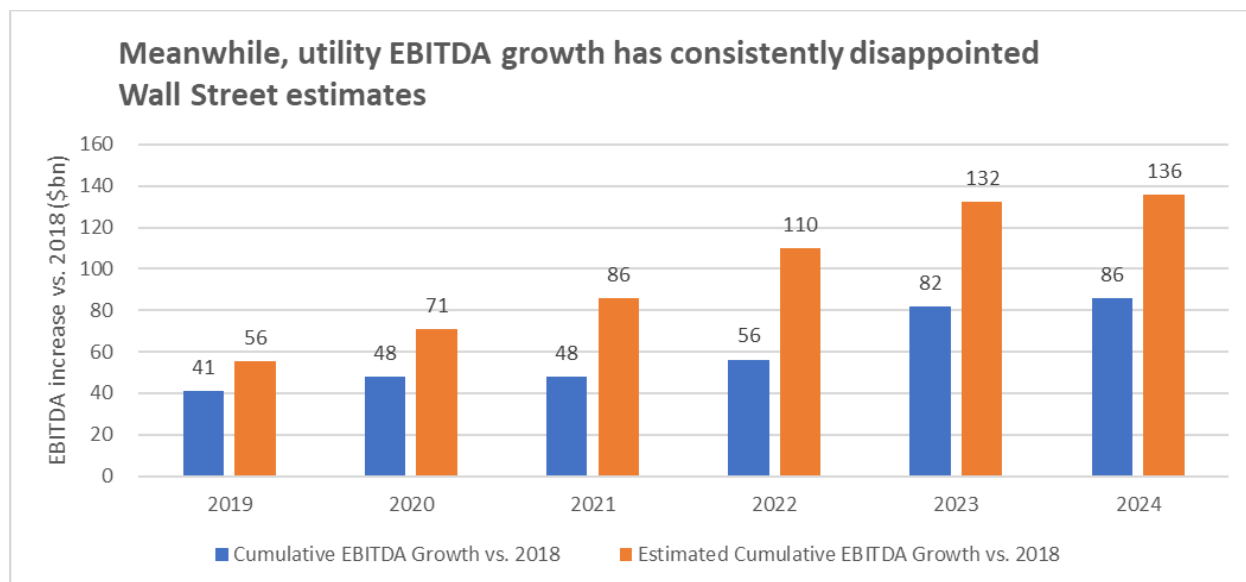
Source: Recurrent research, SEC filings, Bloomberg.

Notes: Compares public company EV as of 12/31/23 and 9/30/24, along with public EBITDA and FCF estimates for 2024 and 2025 as of those same dates.

Study contains the 29 largest members of the S&P Utilities Index by market cap, including NEE, SO, DUK, SRE, AEP, D, PEG, PCG, EXC, ED, XEL, EIX, WEC, ETR, DTE, FE, PPL, AEE, ES, ATO, CMS, CNP, LNT, NI, EVRG, AES, CEG, VST, NRG.

**Wall Street has systematically overestimated Utility EBITDA, primarily a result of unforeseen fires and freezes**

In a nearly mirror image of Wall Street’s underestimation of midstream, Wall Street has overestimated utility EBITDA. This is in large part due to weather events which have caused utilities to take charges against earnings, often without future recovery in regulated earnings. As a result, Wall Street has missed a cumulative \$50bn of utility earnings since 2018:



Source: Recurrent research, SEC filings, Bloomberg.

Notes: Compares public company EV as of 12/31/23 and 9/30/24, along with public EBITDA and FCF estimates for 2024 and 2025 as of those same dates.

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If Wall Street estimates prove correct, midstream investors have an opportunity to invest in the midstream sector at 8.97x EV/EBITDA (implying 2025 debt leverage of 3.60x debt/EBITDA). Those multiples screen attractive vs. other sectors (and midstream history). However, with Wall Street’s tendency to underestimate Midstream continues, those multiples may be biased lower. By comparison, today’s Utility investor has an opportunity to invest at 12.2x EV/2025 EBITDA after the YTD 2024 rally (embedding 5.41x debt/EBITDA leverage)... but if Wall Street’s overly optimistic forecasting continues, those already-high numbers could climb higher still.

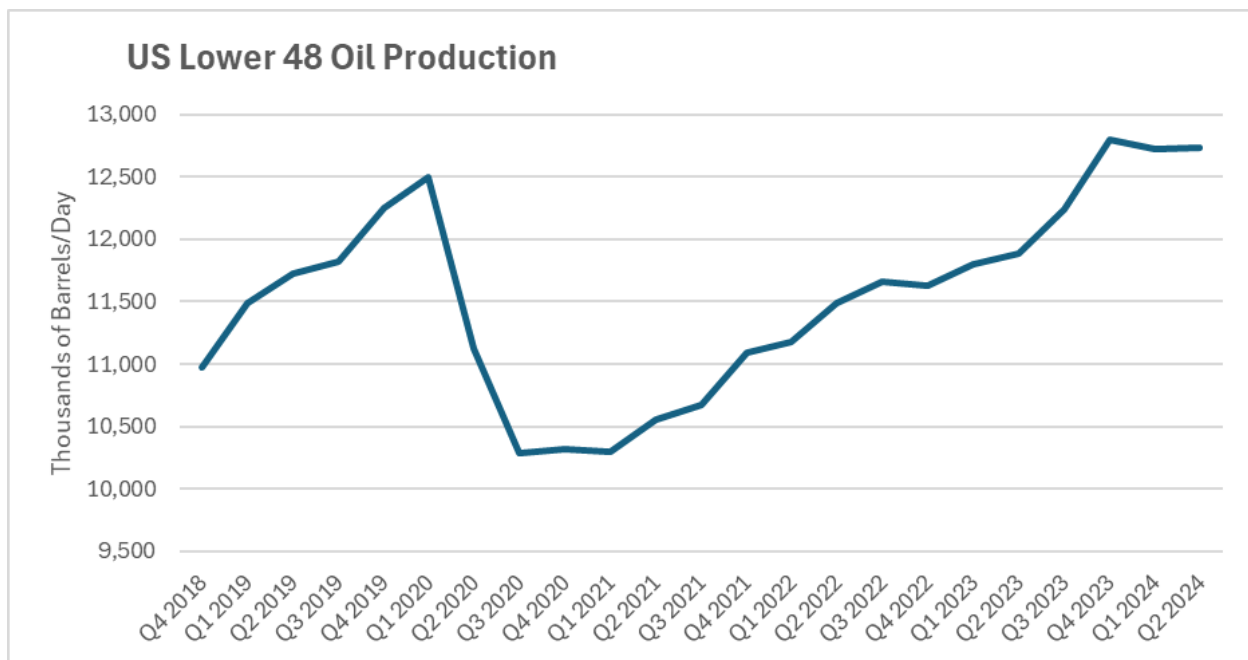
## Natural Resources

### Performance Review

During the month of September 2024, the Recurrent Global Natural Resources Fund rose 1.51%, underperforming the S&P Global Natural Resources Index’s 2.17% increase. Alcoa was the portfolio’s top performer after China announced financial stimulus, rising 20% in the month. On the other hand, the portfolio’s energy holdings generally fell after Saudi Arabia threatened to increase oil supplies in response to OPEC non-compliance.

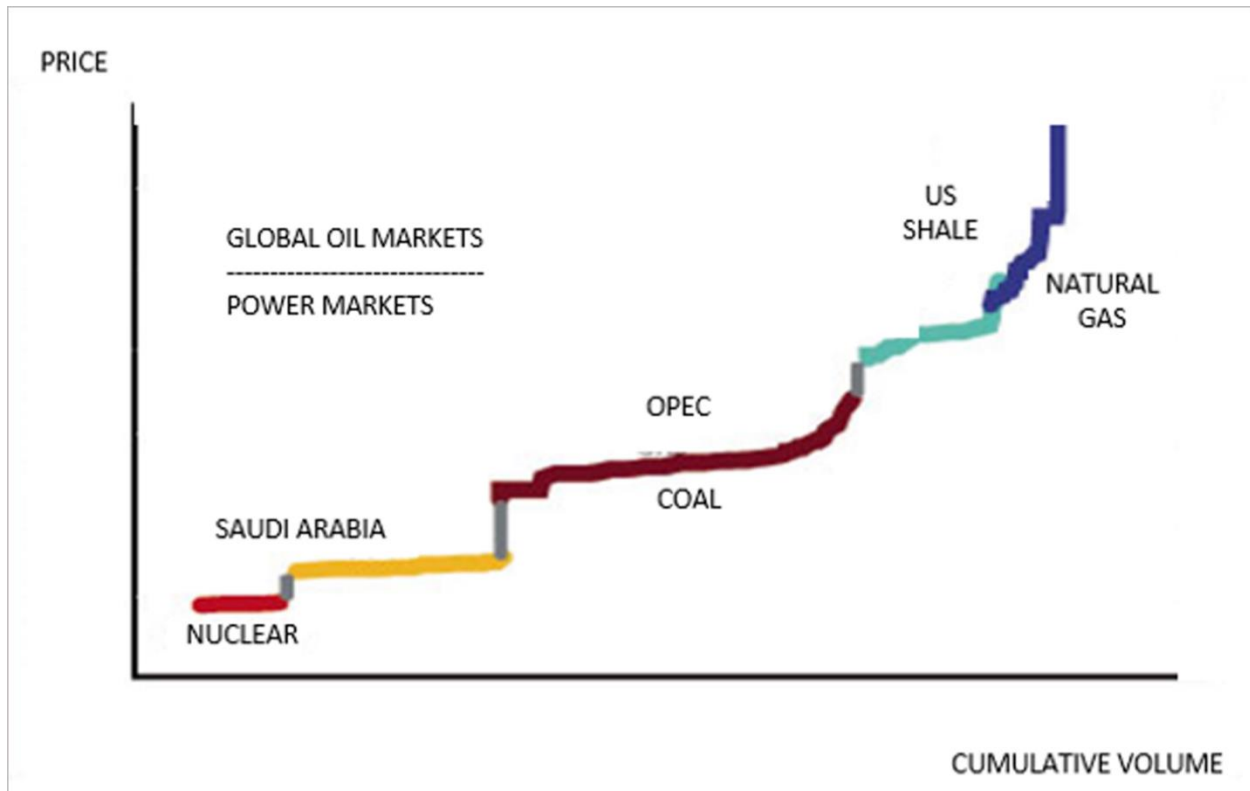
### Investment Discussion: Permian oil production growth vs the “rest of the US”

Since the end of 2018, the United States Lower 48 has seen oil production increase by 1.75 million barrels/day, or 16%.



Source: Recurrent research, SEC filings, Bloomberg.

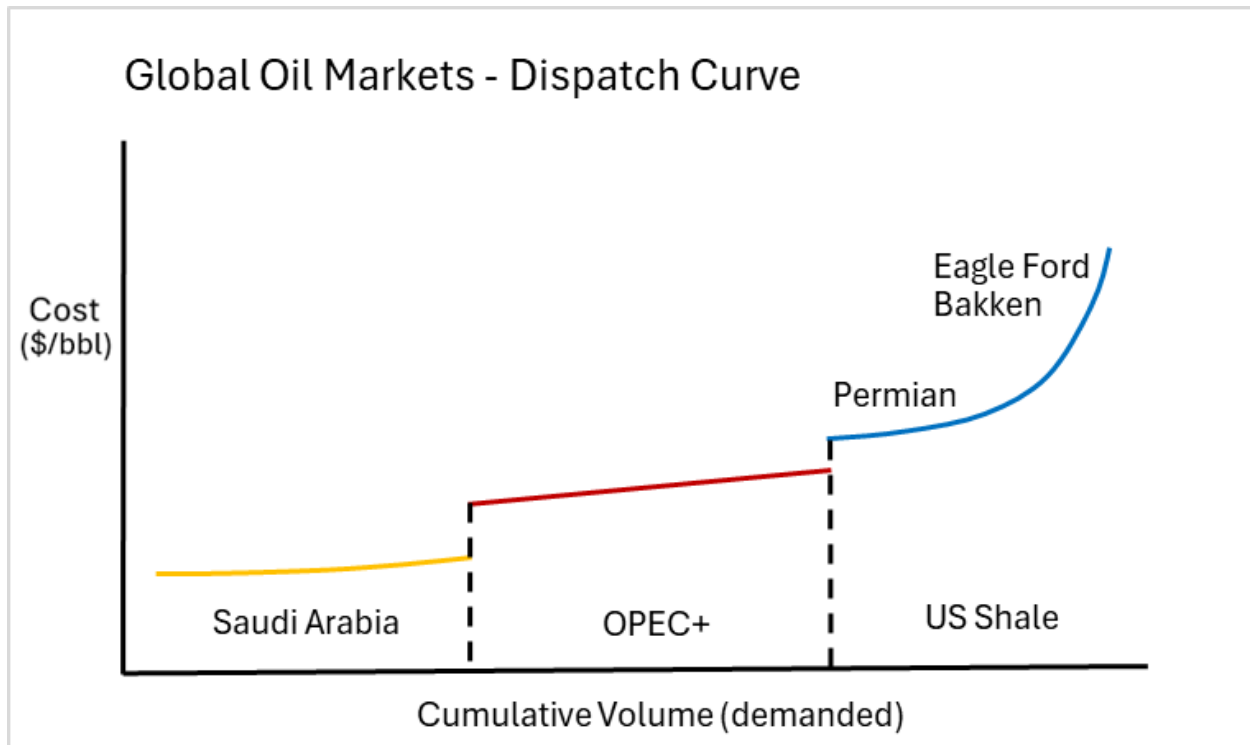
The natural inclination is to expect that oil production increased ratably in the country’s many oil producing areas. However, for many years, we have considered the structure of oil markets as being similar to power markets, which we have referred to as a “dispatch curve”. In essence, oil supplies would produce in order of their cost structure, as depicted in the chart below.



Source: Liza Moyer, University of Chicago, Recurrent research

While we have written about the aggregated oil market structure previously, the largest areas of change occur at the margin, reflecting the intersection between supply/demand. In the case of the oil market, this generally occurs in the “US Shale” portion of the cost curve.

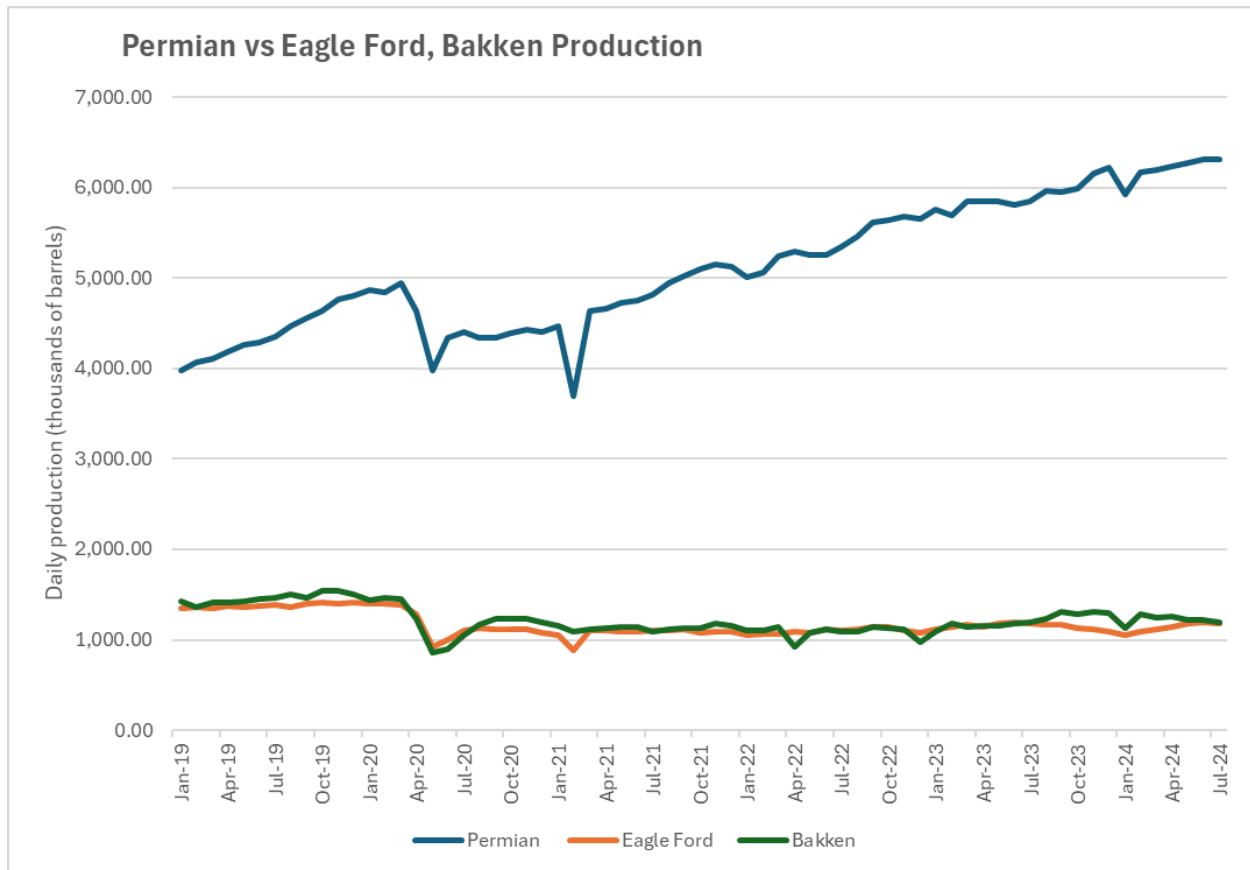
Within US shale, there are several distinct areas of oil production – the Permian Basin, Eagle Ford Shale, Anadarko Basin, Utica Shale, and Bakken Shale being some of the most prominent examples. While many view US Shale as a single monolith, the reality is that each basin has distinct differences and cost structures. Variables such as drilling depth, the percent of gas vs oil production, and transportation costs all combine to determine a basin’s aggregated production costs and economic value. If we consider these areas of production as a “mini dispatch curve”, we should be able to identify differentiation.



Source: Liza Moyer, University of Chicago, Recurrent research

Broadly speaking, we have charted the three largest oil producing areas onshore as the Permian Basin, Eagle Ford Shale and Bakken Shale. From a cost perspective, the Permian Basin is widely considered to be the lowest cost shale region, with the Eagle Ford and Bakken Shales maintaining similar cost structures.

If the “dispatch curve” framework were to hold, then production from the lower cost Permian Basin should be differentiated from the Eagle Ford and Bakken Shales. The chart below shows that since 2019, the production profiles between the shales are indeed different. As many investors know, the Permian Basin has continued to grow production, increasing by 2.3 million barrels/day (+57.6%) since the beginning of 2019. However, over the same time period, both the Eagle Ford (-14.6%) and Bakken (-14.7%) shales have experienced nearly identical falls in production.



Source: Bloomberg, Recurrent research

It is interesting to note that since the beginning of 2019, the Permian Basin has accounted for more than 100% of US oil production growth. So rather than ratable oil production growth across several basins, in accordance with the “dispatch curve” framework, lower cost basins such as the Permian Basin disproportionately grow at the expense of higher cost basins.

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