Midstream: The market is discounting a dramatically different future for Midstream than it did 9 (or 4!) months ago, with EV valuations 20-30% lower, even adjusting for post-COVID earnings. In late 2019, the S&P 500 and Midstream both implied 4% FCF/EV yields – implying 25-year paybacks of all debt and equity. Today, midstream paybacks are 15 years – a level typically saved for businesses with short asset lives or revenues in rapid decline (neither present in midstream). Meanwhile, midstream credit markets remain healthy. Equity valuations imply that COVID transformed a "slower growth" midstream sector into a tobacco-like sector in terminal decline, a thesis that we believe is unsupported by credit markets and fundamental analysis.

Natural Resources: Across sectors, economic impacts of COVID have pressured volumes and margins to differing degrees. The market has looked beyond the short-term implications in many industries, while pricing in much more lasting impacts in others. Using historical industry betas as a proxy for the implied risk vs. the broader market, we note that for many economically-sensitive industries, the market-implied risk remained relatively constant during COVID. However, perceived risk in Energy increased dramatically, and, interestingly, the subsectors which saw the largest increases in implied risk were subsectors with the most consistent profit streams – integrated oils and pipelines. Given the increase in implied economic sensitivity during COVID, we would expect that improving economic conditions would disproportionately benefit these market sub-sectors.

Recent Recurrent Publications

1. **Download new 2020 white paper here: Recurrent's 2020 Midstream/MLP White Paper.**
2. Download our 2019 white paper here: Recurrent's 2019 Midstream/MLP White Paper.
3. Recurrent's MLP white paper – "From Balance Sheet Recession to Balance Sheet Recovery" is available here.
4. Recurrent's white paper on the "dispatch curve" that now governs the oil market is here.

September 2020 Performance Summary and Market Commentary

Please find below performance and market commentary for our two 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 September 2020, the MLP & Infrastructure Strategy generated net returns of -12.82%, 0.80% better than the -13.62% return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +5.60% (annualized, net of fees). Please see the performance section below for more detail.

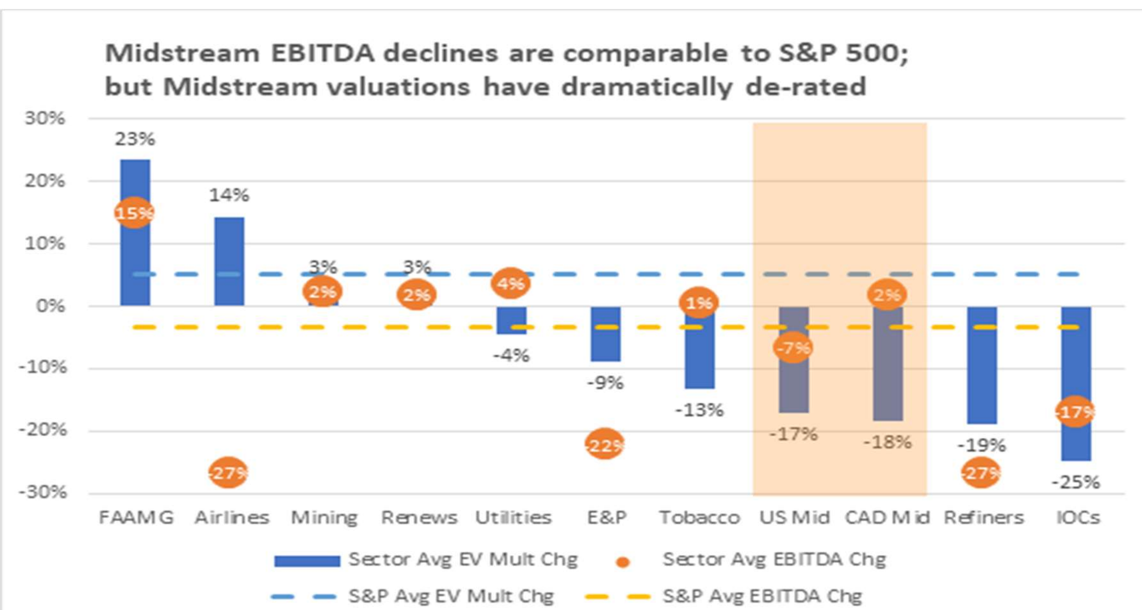
After a violent selloff since June, midstream valuations now reflect the transition from a growth to a mature industry, and imply a "remaining useful life" of 15 years or less – comparable to trough tobacco valuations

Since June, midstream valuations have fallen to an implied 15 year free cash flow (FCF) payback period, similar to that of the trough tobacco valuations seen today. Surprisingly, current implied midstream valuations are also approximating the reserve lives of extraction assets, which typically have depreciable or reserve lives of +/-10 years, but also require significant capex to maintain. Especially as midstream capex is poised to fall -60 to -80% from peak levels of 2015-16, driving significant FCF *increases*, we ask if the 20-30% multiple decline that has occurred during COVID is reasonable for midstream assets?

Wall Street estimates for midstream earnings have fallen only modestly, while midstream valuations have cratered – multiples have gone from slightly discounted vs. the broad stock market, and fallen into the realm of tobacco and other "short life" assets

Since the emergence of COVID, expectations of future midstream earnings have fallen modestly, and in some cases not at all. Canadian midstream companies' (mostly large cap, less commodity-exposed) forward-year EBITDA estimates are +2% higher on 9/30/20 than they were on 12/31/19; US midstream companies (large and small caps, with some commodity exposure) have seen EBITDA estimates fall -7%. This compares decently well with the S&P 500, which has seen forward-year EBITDA estimates fall -4% over this same time period.

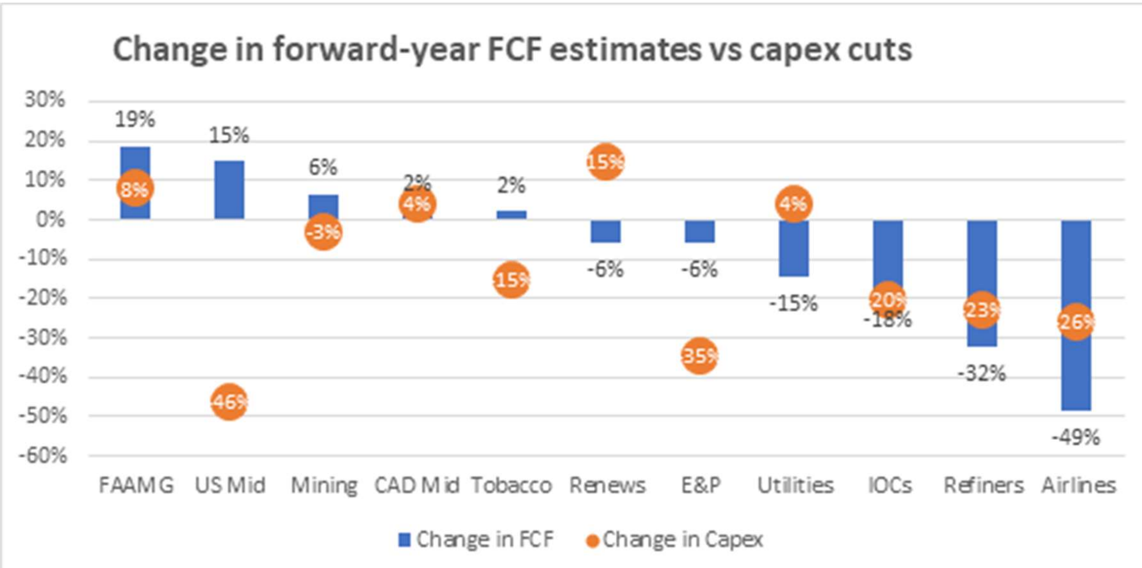
That is where the similarity ends, however. While the S&P 500 has seen EV/EBITDA multiples increase by +5%, from 11.7x to 12.2x, based on forward-year estimates, midstream has seen a dramatic negative re-rating, with EV/EBITDA valuations falling -17% and -18% for US and Canadian midstream, respectively.



Source: Bloomberg estimates, Recurrent research

With aggressive capex cuts, midstream free cash flow (FCF) should improve more than almost any other sector in the market, making the sharp valuation decline even harder to justify

As we've discussed in previous monthlies, midstream EBITDA has been impacted by COVID, but midstream enjoys significant capital flexibility, since next year's earnings do not depend heavily on maintaining high levels of current year capital investment. Accordingly, midstream has demonstrated the ability to slash forward-year capex forecasts to increase FCF (CFFO less capex), even during a downturn. In the case of Canadian midstream, overall capex forecasts have ticked slightly higher due to the approval of the Keystone XL pipeline during 2020.

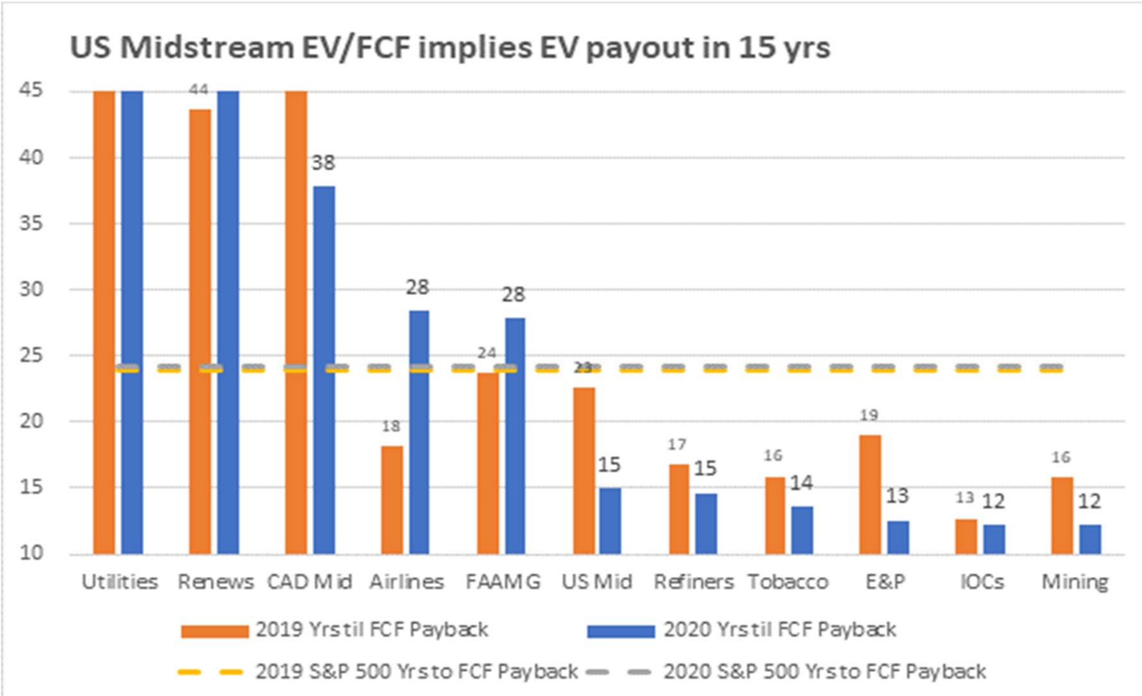


Source: Bloomberg estimates, Recurrent research

Midstream now implies a "full FCF payback" of debt and equity in 15 years, comparable to industries with shorter asset lives and declining revenues, such as tobacco, in almost half the time of the S&P 500 payback period

While debates around the speed of the "energy transition" towards renewable power have been a part of the energy backdrop for years, valuations since COVID seem to reflect a belief that the pace of the transition is accelerating, at almost impossible speeds. As shown below, US Midstream de-rating has been even more dramatic in EV/FCF terms than in EV/EBITDA terms. declining from a 23-year payback in YE 2019, in-line with YE 2019 S&P 500 average of 24 years, to a 15-year payback, in-line with E&Ps/mining (much shorter asset lives), tobacco (declining revenue), integrated oils and refining (high capital intensity), despite exhibiting none of these attributes which typically reduce valuation multiples.

Additionally, the implied payback is materially shorter than even the aggressive forecasts of the transition away from oil and gas (which typically range from 30-100 years). Lastly, the 15-year valuations also seem to imply zero ability for these asset-rich midstream companies with sophisticated project development teams to participate in low-carbon or green energy development (several large midstream companies have already announced renewable projects and are beginning to explore hydrogen infrastructure opportunities). While Canadian midstream paybacks are elevated due to the inclusion of KXL capex, without this major cross-border project (which may still be canceled), paybacks would be a more reasonable ~25 years.

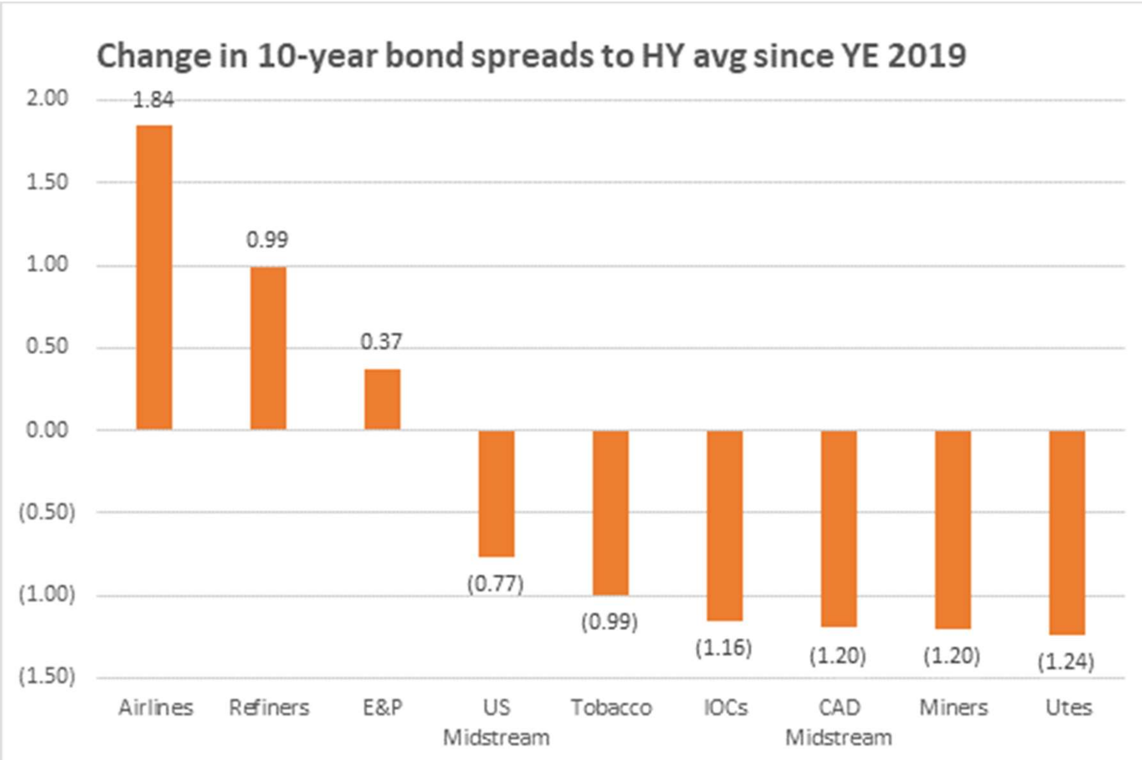


Source: Bloomberg estimates, Recurrent research

So midstream debt leverage remains higher than S&P 500 – are short "useful lives" implied by equity markets reflective of credit risk?

Now, a skeptic might rightly say – S&P 500 leverage is roughly 2x debt/EBITDA – midstream leverage is in the mid-4x on forward-year EBITDA estimates. Could midstream credit risk be the explanatory variable for extremely low FCF and EBITDA-based valuations?

The credit markets themselves make this explanation hard to swallow. As of writing this monthly, the Bloomberg/Barclays BBB bond index is yielding 2.4%, while the Bloomberg/Barclays High Yield Index yields 5.8%. As shown below, cap-weighted 10-year average yields across a variety of sectors show that midstream bond yields have tightened compared to high yield (HY) averages since the arrival of COVID, and today yield 3.2% on average, 77 bps **tighter** than the spread between midstream bonds and HY averages in late 2019 - reflective of the bond market pricing in an industry which is becoming financially *healthier*, rather than experiencing the turbulence and uncertainty that would justify a 30% negative valuation re-rating.



Source: Bloomberg estimates, Recurrent research. Renewables and FAAMG companies are excluded due to insufficient 10-year bonds outstanding.

Midstream equity markets imply a future for midstream that is hard to square with fundamentals, or credit markets

Today's equity valuations, after punishing YTD performance, seem to imply that COVID's impacts are especially negative for the midstream industry. Meanwhile, forward-year earnings, and credit markets, reflect little or none of this concern. These valuations are comparable to trough valuations in tobacco. So the questions remain:

1. Is midstream's current valuation justified, given comparable trough valuations in industries facing much more rapid declines?
2. Is this valuation justified, given that it is out of sync with other areas of capital markets, including the much larger oil and gas bond market?

We struggle to see how the answer could be yes. Even as COVID has reduced society's energy consumption (temporarily), midstream earnings have remained robust and cash flows have expanded – totally out of step with midstream's valuation de-rating, which has been among the worst in the capital markets.

Natural Resources

Performance Review

For the month of September, the Recurrent North American Natural Resources Strategy fell by -9.83%, underperforming the S&P North American Index's -9.57% decline. During the month, stock selection in the commodity chemicals and paper industries added value relative to the index, while overweight portfolio allocations in the refining and aluminum sectors detracted from relative performance..

Portfolio Discussion – the changing nature of energy sector betas, before and during COVID

Prior to the widespread development of shale, the energy industry was considered a defensive sector, relative to the broader market. In fact, for many consecutive rolling 5-year periods prior to 2000, the Energy sector's beta relative to the market was well below 1.0, with many 5 year periods ranging from 0.5 - 0.6!

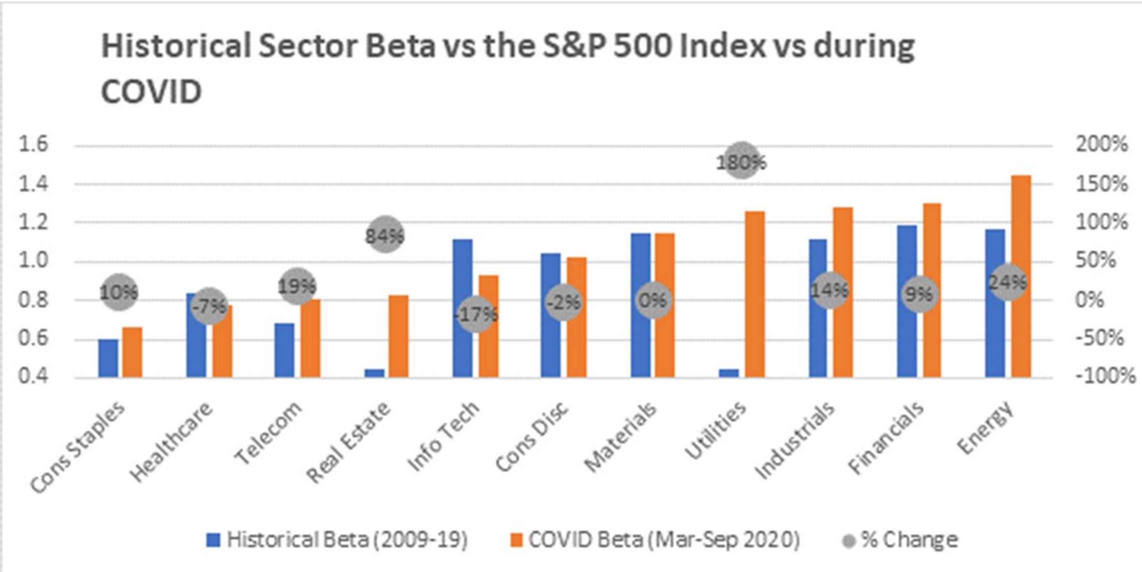
The onset of shale has increased the energy sector's correlation with the market, such that energy has more recently shown more market sensitivity than the broader market. In the 10-year period ending 12/31/2019, energy's beta to the S&P 500 was 1.17, broadly consistent during the shale era starting in 2005.

Compared to other traditionally economically sensitive sectors, the energy sector exhibited similar or below-average market sensitivity. In particular, two market sectors warrant further attention, given their operational leverage to economic changes. The materials sector showed similar characteristics, with a 10-year measured beta < 1 prior to 2000, which rose to the 1.1 – 1.2 range post 2000. The 10-year beta of the industrial sector was more consistent, ranging from 1.0 - 1.1 during the entire period, reflecting the industry's inherent economic sensitivity.

Sector betas structurally shift as COVID impacts are felt across the broad economy

Although comparatively short in duration, during the COVID era, some sectors exhibited markedly different correlations to the broader market. Interestingly, the technology sector saw its beta fall below 1.0, far from its historical >1.0 levels. Interestingly, on the other hand, the utilities and real estate sectors saw significantly higher Beta during the period. COVID-related economic weakness caused interest rates to fall, and given those industries' interest rate sensitivity, the sectors' beta increased.

Most noteworthy (and directly related) to us was the movement in the economically sensitive market sectors. Historically, sectors such as energy, materials and industrials all exhibited appropriately higher volatility than the market. While materials and industrials and showed similar levels of volatility, it was noteworthy to us that energy exhibited beta nearly 25% higher since the end of February, as seen in the chart below.



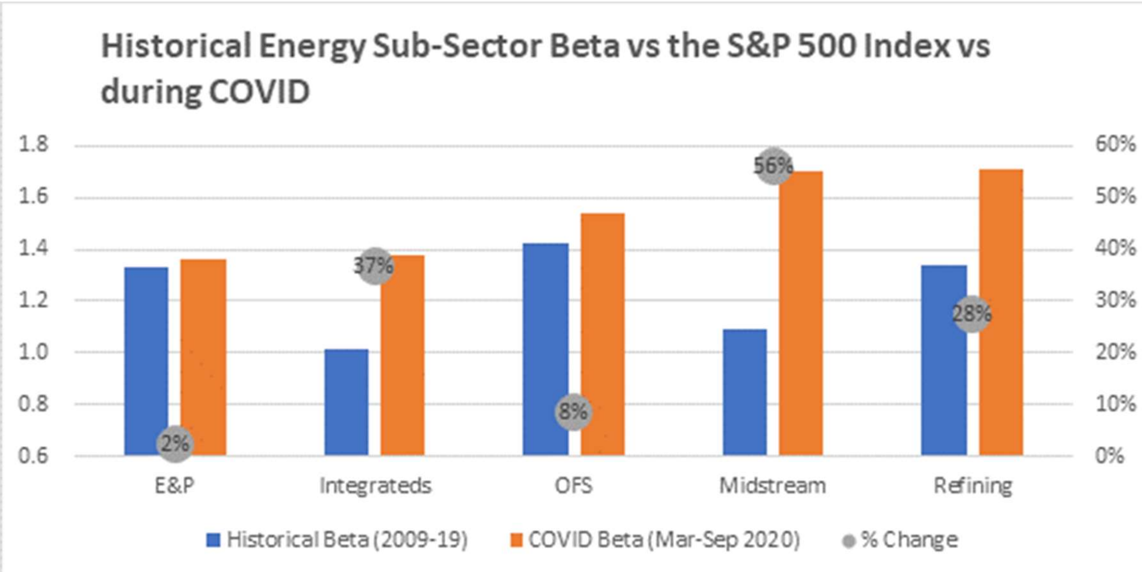
Note: Historical Sector Beta is measured from 12/31/2009-12/31/2019; COVID is from 02/28/2020-09/30/2020
Source: Bloomberg, Recurrent research

While steadily improving from 2Q trough levels, the energy industry is clearly facing unique demand challenges due to COVID, as driving miles remain at least 8-10% below normal levels in many parts of the world. Aviation remains approximately 50% below normal levels, leaving total oil demand approximately 10% below a year ago. However, the energy industry is not alone in its exposure to COVID. According to Bloomberg estimates, the industrials sector is estimated to see 2020 EBITDA fall by roughly 33% compared to 2019, yet its market sensitivity as measured by beta has only incrementally risen.

Within energy, COVID has had an outsized impact on subsectors previously viewed as "defensive," such as integrated and midstream

Within the energy sector, some industry betas during COVID diverged greatly from historical experience. Surprisingly, the industry betas of the Exploration and Production (E&P) and Oil Services Industries remained in-line with historical experience. Given the operational leverage of both industries, the fall in oil price and US oil production would have historically been reflected in market leveraged equity performance.

In contrast, the more stable operations of the integrated oil and pipeline industries have been historically been reflected in market betas approximating 1.0. However, during COVID, the beta of these sectors rose significantly, even exceeding the betas of the more operationally volatile E&P and oil services segments. While COVID has impacted operations, the extent to which the beta has increased in the integrated oil and pipeline industries far exceeds the operational leverage.



Note: Historical Sector Beta is measured from 12/31/2009-12/31/2019; COVID is from 02/28/2020-09/30/2020
Source: Bloomberg, Recurrent research

In sum, while it is undoubtedly the case that COVID has impacted near term demand for energy, with further potential to change consumption habits over the longer term. However, if the recent past is any indication for the future, increased stock volatility relative to the broader market serves as an expression that with improved economic recovery and consumption habits, energy should experience positive stock leverage relative to the broader market. Furthermore, a period of improved shareholder returns and returns on capital, comparable to historical norms, for integrated and midstream subsectors, should create outsized positive outcomes given the recent uncharacteristically high volatility in these subsectors.
