Midstream: year-to-date, we've focused on long-term themes like tech taking energy's throne as the world's highest capex sector; the increasingly persistent nature of "services" inflation; and the fact that investors continue to sell energy and buy tech. This month, we return to the shorter-term: Q3 earnings. Despite rising recessionary fears and a broad commodity pullback in Q3, Recurrent's midstream portfolio generated near-record FCF. Even after the YTD rally, our FCF yield (based on 10/31 NAV) is >3x that of the S&P 500 – with a lower payout ratio and comparable debt leverage.

Natural Resources: As an economically sensitive industry, commodity prices generally fluctuate as determined by changes in global demand. Recently, despite demand weakness, inventory levels have fallen to multi-decade lows, as production has fallen due to sustained CAPEX underinvestment. In 2H 2022, as the economy weakened, commodity prices fell, in line with previous cycles. However, with both inventories and production low, signs of potentially renewed Chinese demand pointed to market imbalances which drove prices and equities sharply higher.

Click here for the latest white paper on the long-term relationship between inflation and capex

MLP & Infrastructure

Performance review

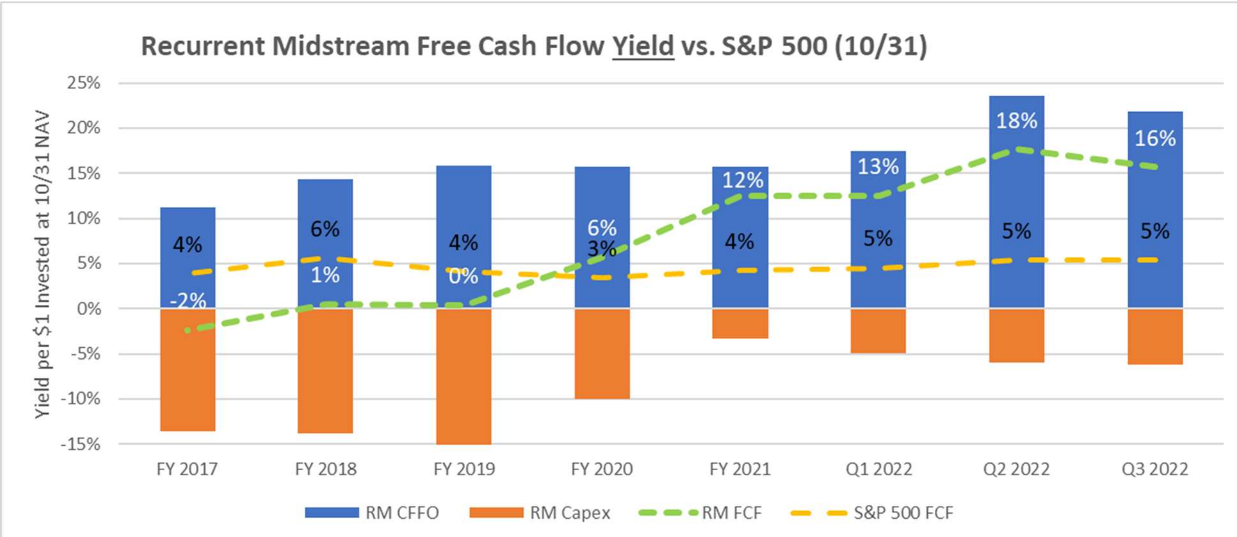
During the month of September 2022, the Recurrent MLP & Infrastructure Strategy generated net returns of 14.50%, slightly outperforming the Alerian MLP Index's (AMZ) +14.32% return by +0.18%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.45% (annualized, net of fees). Please see the performance section at bottom for more detail.

Given the popularity of our Q2 earnings update in early August, we're providing a Q3 earnings portfolio update

After a record Q2, Q3 cash flows generally held serve across the Recurrent Midstream (RM) portfolio. The RM portfolio experienced a +3% value increase since our Q2 update, and the S&P fell -6%. Despite divergent performance, RM's FCF yield remains more than 3x that of the S&P 500, when we annualize recently-reported Q3 results.

In absolute dollar terms, free cash flow (FCF) for Recurrent's portfolio and for the S&P 500 moderated in Q3, down roughly ~7% across RM and the S&P. Encouragingly, slightly lower FCF generation was caused by something managements cannot control: a pullback from Q2's record commodity margins (primarily driven by moderating European export opportunities). In terms of what managements can control, capex reinvestment rates remains very low, with organic capex (excluding M&A) broadly flat from Q2, and well below 2020 levels.

FCF yields (even accounting for portfolio appreciation) have remained near record highs. FCF metrics are based on the actual financial results from the period shown below, and net asset value (NAV) for the RM portfolio and the S&P 500 reflects the approximate earnings season, or one month following calendar quarter end.

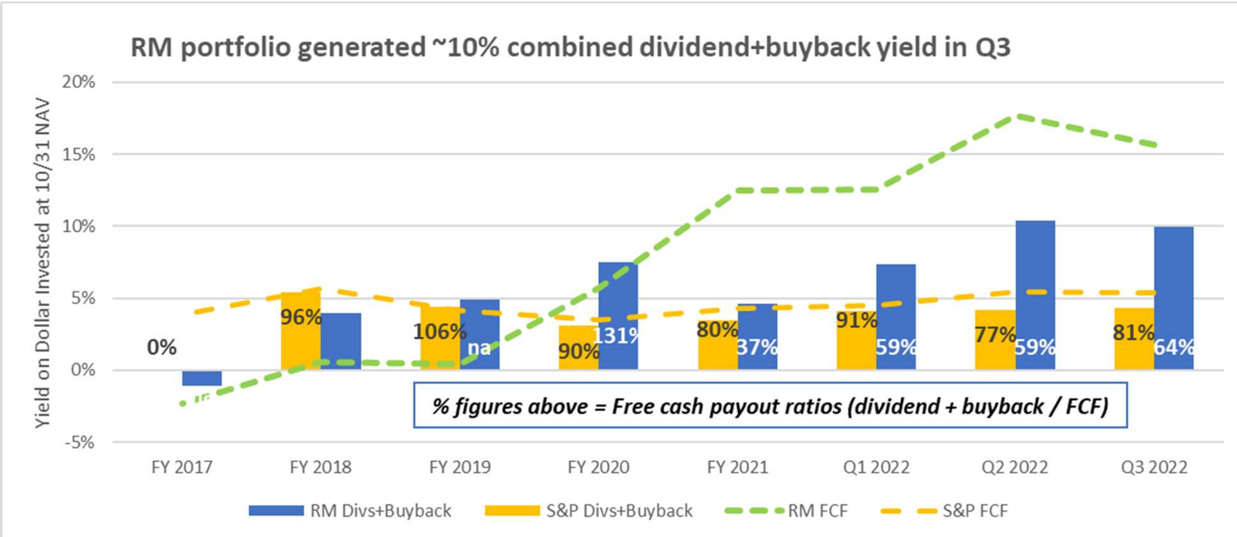


Note: "RM" is Recurrent Midstream portfolio. "Q3 2022" reflects Q3 results and NAV as of 10/31/22. "Q2 2022" reflects Q2 results and NAV as of 7/31/22, "Q1 2022" reflects Q1 results and NAV as of 4/30/2022, "FY 2021" = 2021 reporting and NAV as of 1/31/22, and so on. This document uses the S&P 500 index for comparison purposes only. The comparisons should not be understood to mean there will necessarily be a correlation between a strategy's returns and any index, and further do not suggest that the strategy will, or is likely to achieve returns, volatility or other results similar to such indices]
Source: Recurrent research, Bloomberg data

Portfolio dividends increased slightly in Q3 vs. Q2, with a total cash return yield of 10% (as of 10/31)

Total cash returned to shareholders (buybacks + dividends) was roughly flat Q/Q, with dividends increasing slightly (just over 1%) and buybacks pulling back by roughly the same amount. On a yield basis, total cash return declined from 10.4% in Q2 to 10.0% in Q3 (see blue bars below). The total payout ratio (buybacks + dividends) was 64%, up slightly from Q2's 59% payout ratio. Dividends represent slightly more than half of RM's cash return, so the "fixed dividend" payout ratio remains a very conservative 33%. We expect fixed dividends to increase across our portfolio going forward given low payout ratios, although this remains subject to significant uncertainty and does not represent a recommendation.

By contrast, the S&P 500 continues, on average, to distribute the vast majority of its FCF in the form of buybacks, and to a lesser extent, dividends. S&P 500's Q3 total payout ratio was 81%, up from 77% in Q2. While the typical S&P company pays out almost all of its cash flow to shareholders, the majority of S&P cash returns are in the form of buybacks. The S&P's "fixed dividend" payout ratio was comparable to the RM portfolio at 34%.



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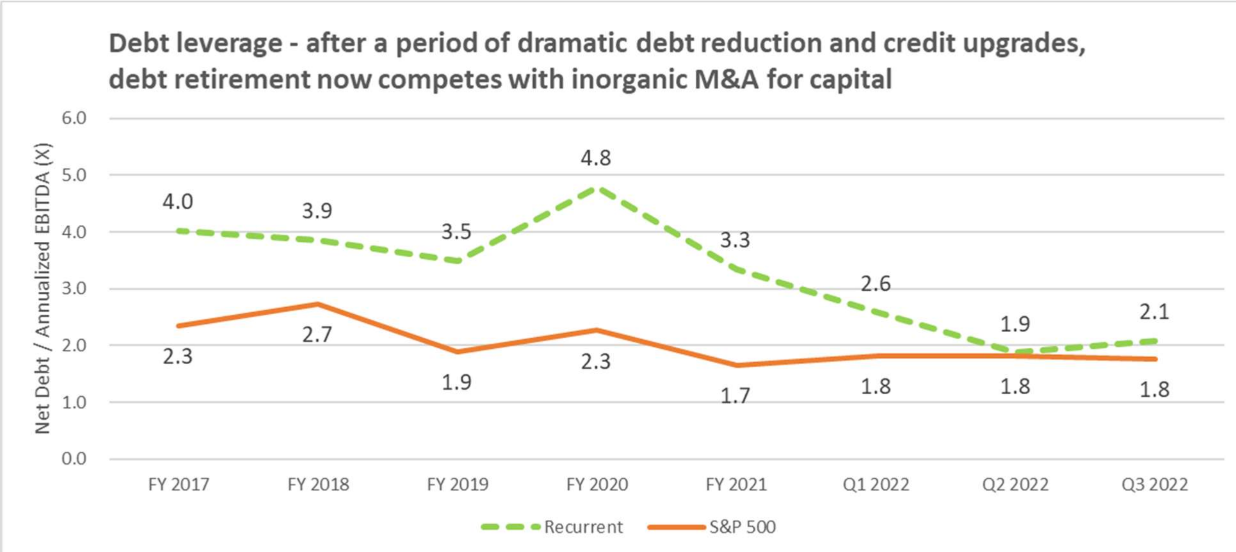
Source: Recurrent research, Bloomberg data

Debt leverage remains dramatically improved from previous years, but consolidation-focused M&A has ticked up

With a total cash payout ratio of 64%, roughly 36% of FCF remains available for debt reduction and inorganic growth opportunities. While excess FCF has gone disproportionately to reduce debt since 2019, in Q3 we saw leverage tick up slightly as absolute debt increased due to M&A executed by our portfolio companies. The most significant transactions completed were the Targa acquisition of Lucid (an all-cash deal) and Phillips 66's buy-in of Enbridge's JV stake in DCP Midstream (which led to DCP's debt being consolidated by Phillips). Both deals struck us as reasonable on valuation, with Phillips' deal appearing highly strategic, in our view. Most importantly, both deals represent the consolidation of already-existing assets, and therefore do not increase midstream capacity or introduce new competition to the market.



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Source: Recurrent research, Bloomberg data

Natural Resources

Performance Review

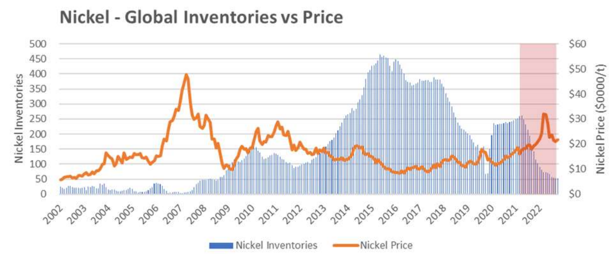
During the month of October 2022, the Alma Recurrent Global Natural Resources Fund rose +11.97%, outpacing the S&P Global Natural Resources Index's +10.07% increase. After weak performance in September, portfolio holdings Cenovus Energy, Suncor Energy, ExxonMobil, Archer-Daniels-Midland, ConocoPhillips, Nucor, and Phillips 66 all rose by more than 20% in the month, adding to both absolute and relative performance.

Investment Discussion

In many commodities, there is a clear relationship between a commodity's supply/demand dynamics and price. In most economic cycles, demand changes more quickly than supply reacts, so demand weakness usually portends higher inventories and falling commodity prices. As an example, during the Great Financial Crisis in 2008/2009, many commodities' inventories rose and prices fell rapidly.

In the aftermath of COVID, weakening global demand caused commodity prices to fall initially. However, due to production declines, inventories fell and commodity prices quickly recovered. In the nearly two years since the beginning of COVID, sustained low CAPEX levels and high natural gas prices in Europe/Asia have reduced production, as we have identified in previous monthly commentaries.

Today the situation has evolved to noteworthy levels. As seen the charts below, copper, zinc, aluminum, and nickel prices have all fallen in the last few months despite inventories simultaneously falling to multi-decade lows.



Source: Bloomberg, Recurrent research

Monthly Investment Commentary
October 2022

Falling commodity prices in a period of low inventories and below average production due to low CAPEX imply expectations of sustained weak demand. In the last weeks, the prospect of China emerging from COVID lockdowns have improved global market demand outlooks. As a large consumer of commodities, if China returns to normal demand levels instead of remaining low, the positive impact to global prices would be significant. Since the beginning of November, all four commodities have increased by >10%. Should Chinese re-emergence from COVID progress further, we would expect both commodity prices and the related equities to perform well, despite broad global economic concerns.

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