

Midstream: after years spent paying down debt to prepare for the worst, midstream companies are now reaping the benefits of rising commodity prices. In the short-term, post-COVID destocking has exacerbated shortages, but longer-term, new supplies continue to be constrained by the premature divestment from technologies that currently supply 85% of humanity's energy. Inadequate energy supplies increase the value of reliable energy infrastructure, but how else do midstream companies benefit from the current environment? We examine specific examples below.

Natural Resources: nowhere is the impact of the "everything shortage" clearer than in the aluminum market. Aluminum makes machinery and infrastructure lighter and stronger, so it is essential for increasing fuel efficiency and decarbonizing electricity and transportation. However, producing aluminum is one of the most energy-intensive processes in the global industrial value chain. As underinvestment continues to reduce energy supplies worldwide, aluminum prices are spiking to accommodate higher energy prices – ironically ESG-driven underinvestment is stunting the process of decarbonization and electrification.

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 September 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +6.25%, outperforming the +3.02% gross return of the Alerian MLP Index (AMZ) by +3.22%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +4.05% (annualized, net of fees). Please see the performance section at bottom for more detail.

Midstream companies have gotten their financial houses in order – could higher EBITDA forecasts be the next catalyst?

Over the last several years, we have detailed how midstream companies have been focused on transforming into "all-weather" investments. Midstream companies have paid down debt, dividend payout ratios are at 20-year lows, and capital spending has been cut to the bone. During this time, midstream companies have generally gone unrewarded, with total returns roughly flat since late 2019.

Despite the fundamental improvements and surging FCF, midstream EBITDA estimates have been flattish – could expectations of increased EBITDA drive midstream valuations higher? With commodity shortages making front page news, investor focus has shifted to potential upside scenarios in the event of sustained high commodity prices.

We walk through various midstream business lines, with upside analysis below.

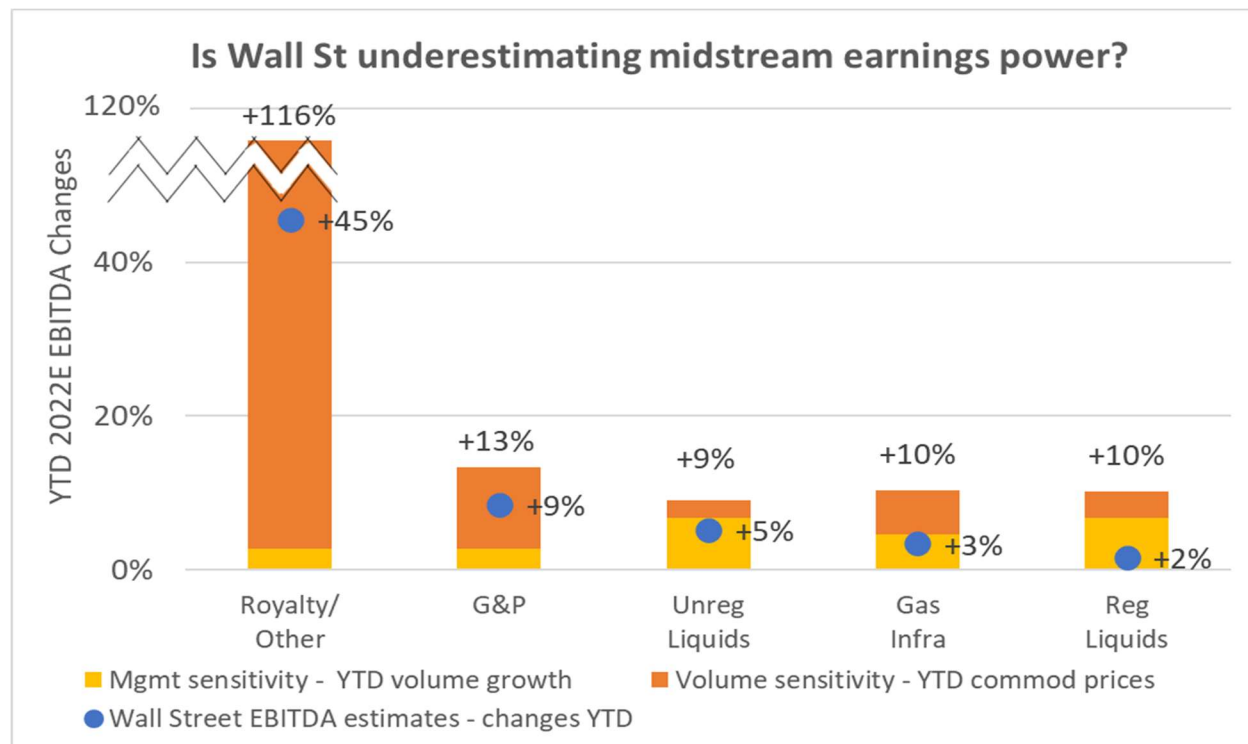
- **Royalty/Other** – we identify these businesses as having minimal/low reinvestment requirements, and significant exposure to commodity price movements.

- **G&P** – these businesses gather and process wellheads into consumable dry gas and NGLs, with customers paying for services with fixed fees + sharing commodity exposure with the G&P operator.
- **Unregulated Liquids** – these diversified midstream businesses typically handle some combination of oil, NGLs, and gas, providing storage and transport services.
- **Gas Infrastructure** – from dry gas pipelines to storage assets to LNG export facilities, these assets move gas, with some ability to capture upside from moving low-value domestic gas to higher-value international gas and petrochemical markets.
- **Regulated Liquids** – these assets typically enjoy automatic revenue step-ups that track PPI. If PPI stopped increasing today, these pipes would be allowed to increase revenues +9% beginning in mid-2022 without any capex.

Is Wall Street underestimating midstream exposure to higher prices and higher volumes?

Cyclical stocks generally appreciate and depreciate with a high correlation to changes in forward-year Wall Street EBITDA forecasts. As some large institutions have exited energy in recent years, many midstream research analysts have moved onto renewables and utilities. Accordingly, given this “brain drain” dynamic, the quality of investment analysis has perhaps declined as well. As a result, public Wall Street research seems to be overlooking significant upside drivers in the midstream sector.

Below, we compared the change in YTD Wall Street EBITDA expectations to 1) the publicly-available commodity sensitivities provided by midstream companies and 2) YTD volume growth for a variety of US energy products, including oil, motor fuels, NGLs, and natural gas. What we found was that Wall Street seems to be reluctant to give midstream companies credit for the upside levers that many companies provide in public filings.



Source: Bloomberg, SEC company filings, Recurrent research.

Notes: “Wall Street EBITDA estimates” reflect the increase in aggregate EBITDA estimates between 12/31/20 and 9/30/21;

“Direct exposure to YTD commodity prices” reflects published company-level commodity sensitivities;

“Direct exposure to YTD volume growth” reflects average YTD oil+gas production growth for “G&P”, oil/NGL/motor fuel growth for “Unregulated Liquids”, gas production growth for “Gas Infrastructure,” and motor fuel volume growth for regulated liquids.

While understandable that certain businesses more exposed to “leading edge” commodity pricing would experience a lag in estimates (such as Royalties and G&Ps), it is noteworthy that even more diversified volumetric businesses are seeing EBITDA estimates lag fairly pedestrian low- and mid-single-digit post-COVID volume growth rates.

Recurrent Midstream vs. AMZ Benchmark – at a glance

Subsector	RMLPX	AMZ	O/U Weight	Attribution
G&P	13.7	37.3	(23.6)	1.3
Gas Infra	25.2	13.6	11.5	(1.6)
Unreg Liq	33.4	36.5	(3.1)	(1.1)
Reg Liq	6.4	12.6	(6.2)	0.8
Royalty/Other	20.8	0.0	20.8	(0.4)
Cash	0.7	0.0	0.6	(3.0)
Total	100.0	100.0	(0.0)	(3.9)

Note: Q3 2021. Totals may not foot due to rounding

As shown above, our current portfolio positioning reflects some of the discrepancies we’ve noted above. Our strategy is significantly overweight in “Royalty/Other,” where we see Wall Street estimates dramatically lagging what commodity prices should imply. G&P businesses, while generally well-positioned to benefit from higher commodity prices, are getting more credit for this upside from Wall Street than, say, Gas Infrastructure, where consensus estimates have hardly budged YTD, despite a near-doubling in gas prices (and even more dramatic dispersion between North American and global gas pricing).

Natural Resources

Performance Review

In the month of September 2021, the Recurrent Global Natural Resources Strategy fell -0.07% net of fees, outperforming the S&P Global Natural Resources Index’s -1.07% return. During the month, stock selection in the aluminum and gold sectors added relative value, while an underweight sector weighting in the integrated oil sector detracted relative value. Since inception, our Global Natural Resources Strategy has outperformed the benchmark by +7.43%, or 2.04% annualized.

In the month of September 2021, the Recurrent North American Natural Resources Strategy rose +4.50% net of fees, outperforming the S&P North American Natural Resources Index’s +3.93% return. During the month, stock selection in the integrated oil and aluminum and sectors added relative value, while an overweight sector weighting in the steel sector detracted relative value.

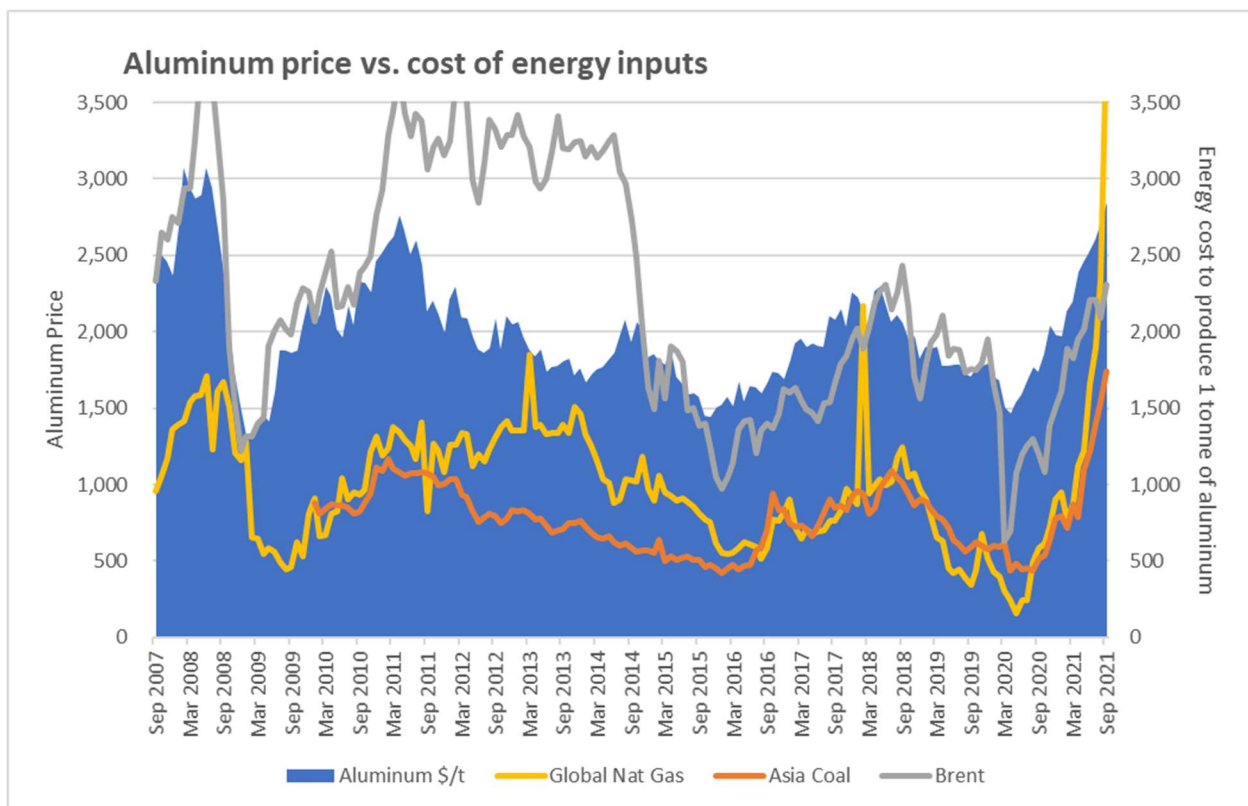
The state of the aluminum market + the demand impact of energy transition

Over the last few months, we have reviewed key industrial commodities to assess supply/demand and the impact on commodity prices, key to stock performance. While we recently looked at copper, this

month we examine aluminum, an important lightweight material used in a variety of forms supporting the energy transition.

The aluminum market is undergoing dramatic changes relative to the recent past. Demand is unsurprisingly growing at an accelerated pace as the impacts of COVID subside; Goldman Sachs estimates 2021 global demand to grow 6.6% YoY, outpacing global supply and reducing inventories.

The short-term global aluminum supply situation is particularly noteworthy, because one of the largest costs to produce aluminum is energy – primarily power. Historically, there is a strong relationship between aluminum and Brent crude oil, global LNG and coal prices, reflecting marginal global power plant economics. With oil, natural gas, and coal prices rising in tandem, particularly since the beginning of 2021, aluminum prices have risen in lockstep.



Source: Bloomberg, Recurrent research

Export constraints insulate US natural gas and power prices from global price spikes

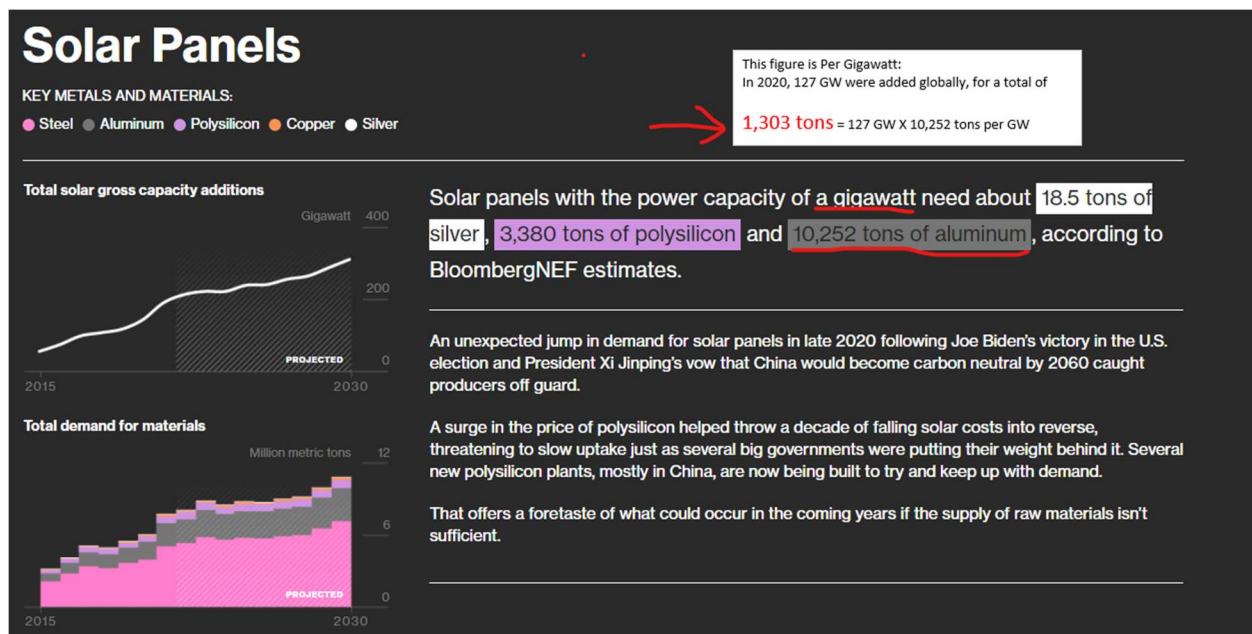
Additionally, power input costs have risen, but with material differences between regions. For example, in 2021 the US benchmark Henry Hub natural gas price has risen 132%. However, in 2021 Europe's benchmark TTF natural gas price has risen 372% through the end of September, mirrored by Asian LNG prices, which have shot to \$25/mmbtu after beginning the year near \$8/mmbtu. Power prices have risen more in Europe and Asia than in the US. China, which accounted for 57% of global aluminum production in 2020, has suffered from the combination of low coal supplies, power outages and environmental concerns. At a time when aluminum prices should be incentivizing more production, marginal supply is

being priced out, production is being cut, and inventories are falling. This is illustrated above as global gas and coal prices have risen faster than aluminum prices.

Long-term aluminum consumption is driven by solar installations, electrification of transport

The global aluminum supply/demand balance is tighter than it has been in years and is expected to tighten further for the next few years, as supply remains constrained as demand recovers from COVID levels.

While the short to intermediate term outlook is supportive for higher aluminum prices, long term aluminum demand is bolstered by the energy transition. Many key elements of the energy transition – from electric vehicles, to solar power, and improvements to the electric grid – require aluminum. In fact, recent Bloomberg analysis showed that in 2020 aluminum demand from solar panels comprised 2% of total global aluminum demand, with additional demand coming from wind turbines and electric vehicles.



As a result, future demand growth rates are likely to remain strong, while supply will take time to inflect meaningfully higher. In fact, with high energy prices, many non-US aluminum smelters are shutting capacity due to high costs, instead of increasing capacity. As the energy transition continues, the forecast for above average demand will persist; with high energy prices causing higher costs, additional supply will be slow to follow, meaning the current tight supply/demand dynamics will continue for the foreseeable future.

Recurrent Investment Advisors LLC
3801 Kirby Dr, Ste 654
Houston, Texas 77098
d: 832.241.6400

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