Midstream: 1 year ago, we forecasted: accelerating inflation (check), higher rates (mixed), record buybacks (check, but below forecast) – all supportive of midstream returns in 2021. With AMZ +40%, it's easy to say it was a "good year" – but we feel like Nick Saban at a postgame press conference. Why? 1) Multi-year underperformance remains massive, 2) midstream equity vs. bond spreads are wide, 3) and all key valuation metrics remain <2019 levels. A large share of 2021 returns were driven by debt reduction! You wouldn't call it a housing bubble just because people paid down their mortgages. Accordingly, we don't see this market as overheated, and we expect further improvement in the 3 factors listed above.

Natural Resources: in recent months, we've talked about the macroeconomic character of accelerating global inflation; this month, we review some recent microeconomic developments in Europe, where policymakers are accelerating power plant shutdowns in the face of rising energy prices. Accordingly, industry is responding in kind with industrial capacity closures. Ironically, closures are in markets like steel and aluminum, where demand is surging and prices are rising. The reduction of reliable "baseload" power in major western economies is an inflationary pressure that is likely to prove stubbornly resistant to higher interest rates.

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 December 2021, the Recurrent MLP & Infrastructure Strategy generated net returns of +3.63%, outperforming the +3.56% gross return of the Alerian MLP Index (AMZ) by +0.07. 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.

+40% midstream returns in 2021, +11% vs. S&P 500 +18% vs. NASDAQ… why do we sound as grumpy as Nick Saban at a press conference?

Yes, 2021 returns offered the first year of relative and absolute outperformance since 2016 (it really had been that long). But to us, 2021 was less of a rebound, and more of a reminder of how much more things can improve for midstream in 2022. Let's take a look at 3 metrics we expect to improve further this year:

Markets are inherently uncertain, and the below predictions are for research purposes only, and do not constitute a recommendation.

1. **Prediction 1: Relative performance vs. S&P/NASDAQ should continue to improve:** even after 2021, 5-year underperformance vs. major equity indices remain massive. Given improving

fundamentals and reduced debt, we expect midstream to continue to reduce trailing underperformance this year.

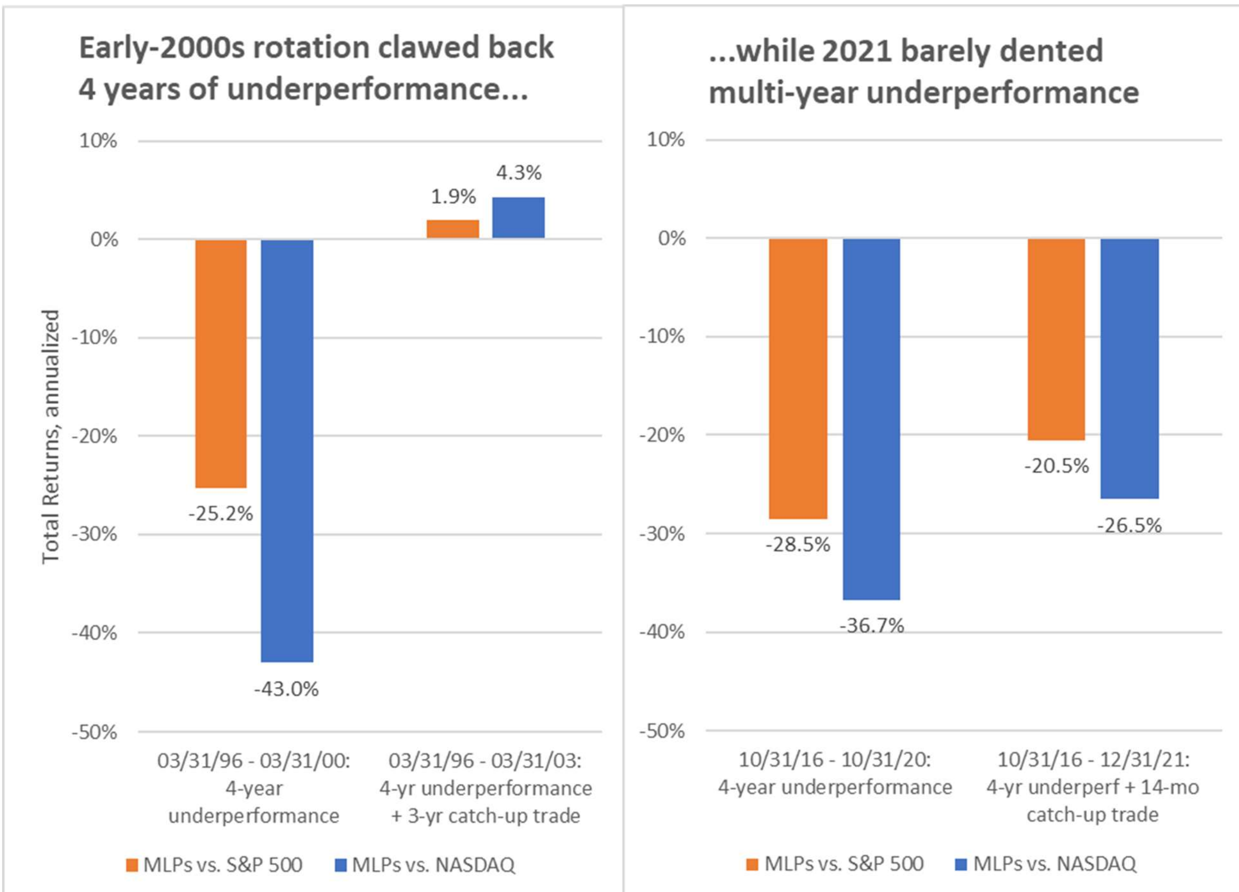
2. <u>Prediction 2:</u> **Midstream equity yields tighten meaningfully vs. midstream bonds:** after years prioritizing debt reduction, midstream bond yields are near record lows, while equity yields remain extended. This spread should tighten meaningfully as debt retirements slow and buybacks accelerate.
3. <u>Prediction 3:</u> **With fundamental improvements and increasing returns to shareholders, midstream valuations return to 2019 levels:** midstream EV/EBITDA valuation multiples have declined by 10% since 2019 on an absolute basis, but compared to the multiple <u>expansion</u> of the S&P 500, the relative picture is even worse! We expect that fundamental improvements and more supportive fund flows will push midstream valuations back to 2019 levels.

Prediction 1: Time for midstream to claw back some underperformance, driven by improved money flows

Given that we're midstream managers, we're often asked, "has this rally run its course?" While nobody can predict future returns, we would note that today strikes us a strange time to call for the end of the current midstream rally. After a historically bad 4-year run from late 2016 through late 2020, the AMZ trailed the S&P 500 by 114% on a total return basis – 28.5% annualized underperformance. If we extend that period from 2016 through 12/31/21, cumulative midstream underperformance reaches 154%, or -20.5% on an annualized basis.

By historical standards, it appears we haven't yet seen a "catch up" trade yet at all. And if the rotation of the early 2000s is any indication, negative absolute performance in equity indices can be a powerful catalyst for outperformance in a subsector like energy.

Exhibit 1: including 2021 performance, midstream has underperformed major equity indices by 20%+ annually, for 5+ years



Source: Bloomberg, Recurrent research

As we discussed last month, 2022 money flows into midstream are almost certain to improve in 2022, driven by the midstream companies themselves. Investor sentiment and money flows remained broadly negative on midstream in 1H 2021. The midstream/MLP-dedicated fund complex saw $3bn of outflows in 2021. This trailed only the record annual outflows of 2019 and 2020. Consultants and endowments generally finished divesting from midstream positions in 1H 2021, as opposed to adding to positions. Encouragingly, outflows were weighted to 1H 2021, offering a positive fund flow trajectory into early 2022 (see last month's note for more).

Prediction 2: With midstream companies less likely to buyback more debt (and more likely to buyback stock) equity-debt yield spreads should compress

Many midstream equity valuation metrics look cheap, but one of the most striking is the spread of midstream equity yields vs. bond yields on 10-year midstream notes. Two reasons why this is so striking:

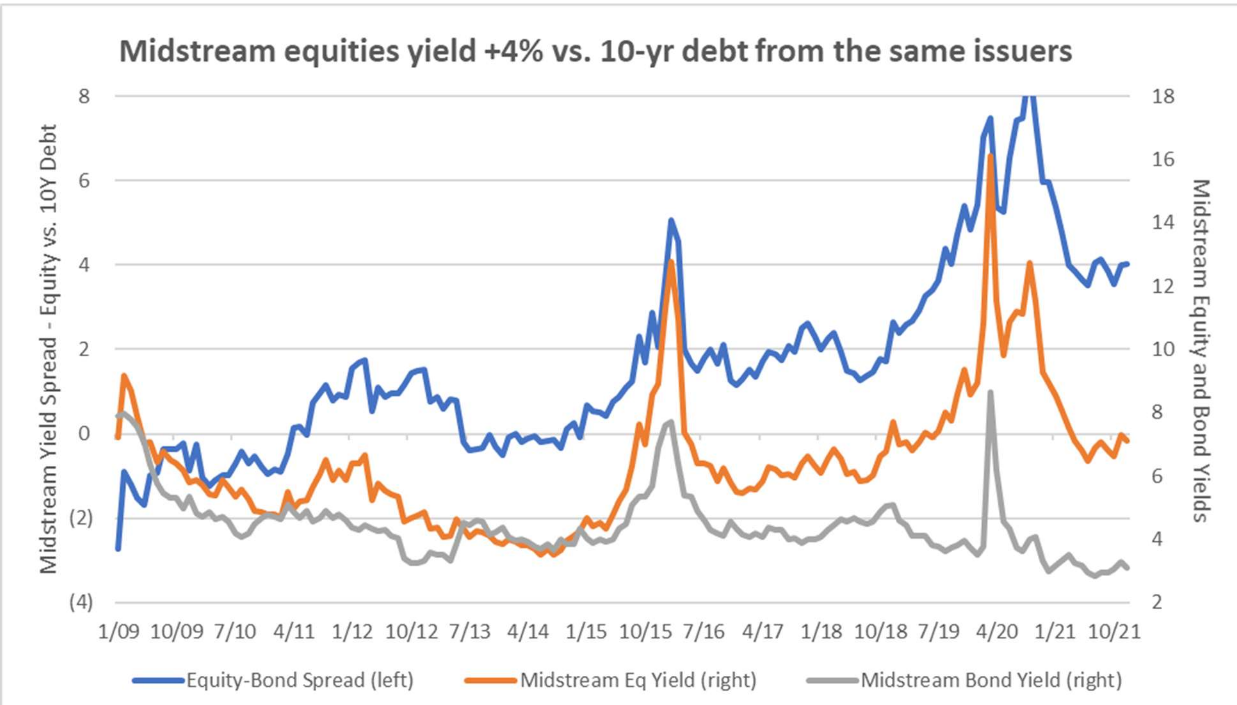
1. The "energy transition" is often cited as a bear case for midstream businesses. However, exhibit 3 seems to show that bond investors – often regarded as being highly sensitive to downside risks – are sanguine about long-term solvency risks. Interestingly, we've heard anecdotes from large institutional investors that ESG policies are applied aggressively to equity holdings, while

ESG is hardly a factor in fixed income portfolios – potentially creating the market inefficiency shown below.

2. Dividend yields have been reduced by ~30% as a result of dividend cuts. So while cuts have reduced yields and arguably made go-forward equity yields safer over the past 6 years, markets have responded by counterintuitively applying a greater discount rate to the surviving dividends.

After the midstream credit crunch of 2015-19, debt reduction was absolutely necessary – however, today, with bonds trading above par and yields below 3% in many cases, it is hard to make an argument for further debt reduction when equity dividends are generally >5%. Accordingly, we expect financial policies to move away from debt reduction, towards addressing equity undervaluation in 2022.

Exhibit 2: equity yields remain stubbornly high despite record-low payout ratios, credit improvements

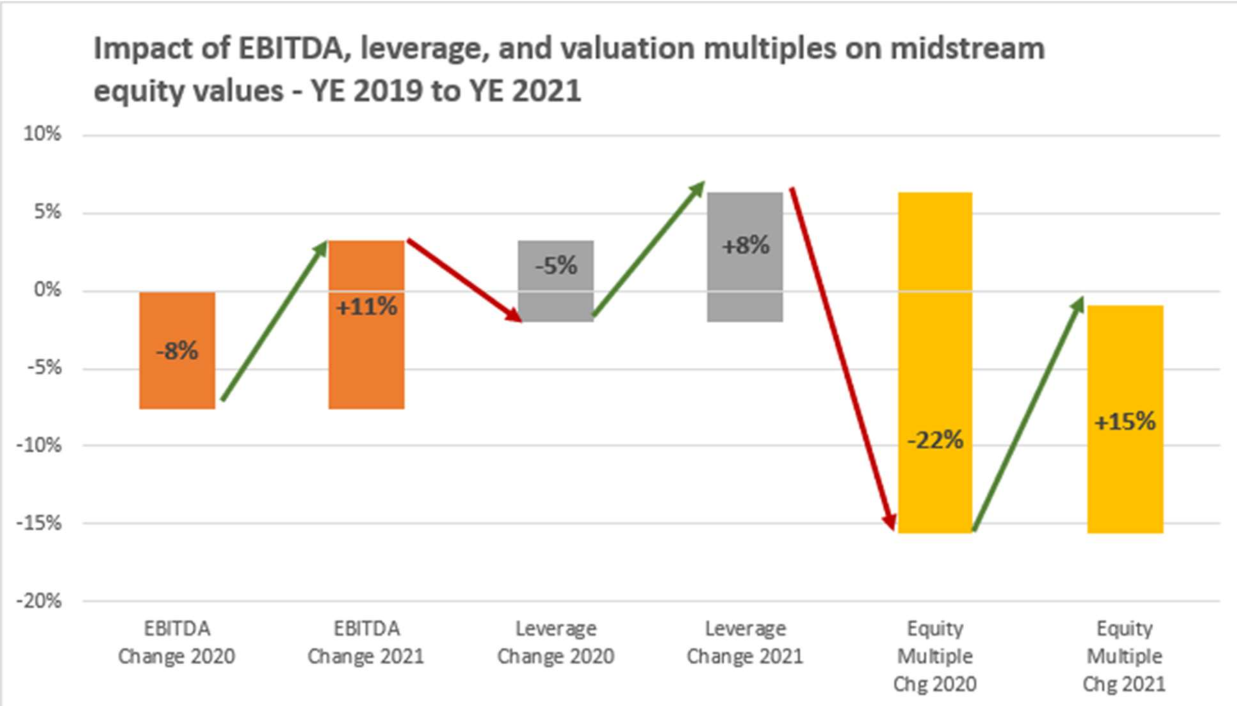


Source: Bloomberg, Recurrent research

Prediction 3: absolute and relative midstream valuation metrics will return to 2019 levels

Since the pre-COVID era (YE 2019), despite negative oil prices, reductions in drilling activity, and an ongoing pandemic, midstream EBITDA projections have risen, capex projections have fallen, and debt leverage has declined. One thing that hasn't gone midstream's way: market perception!

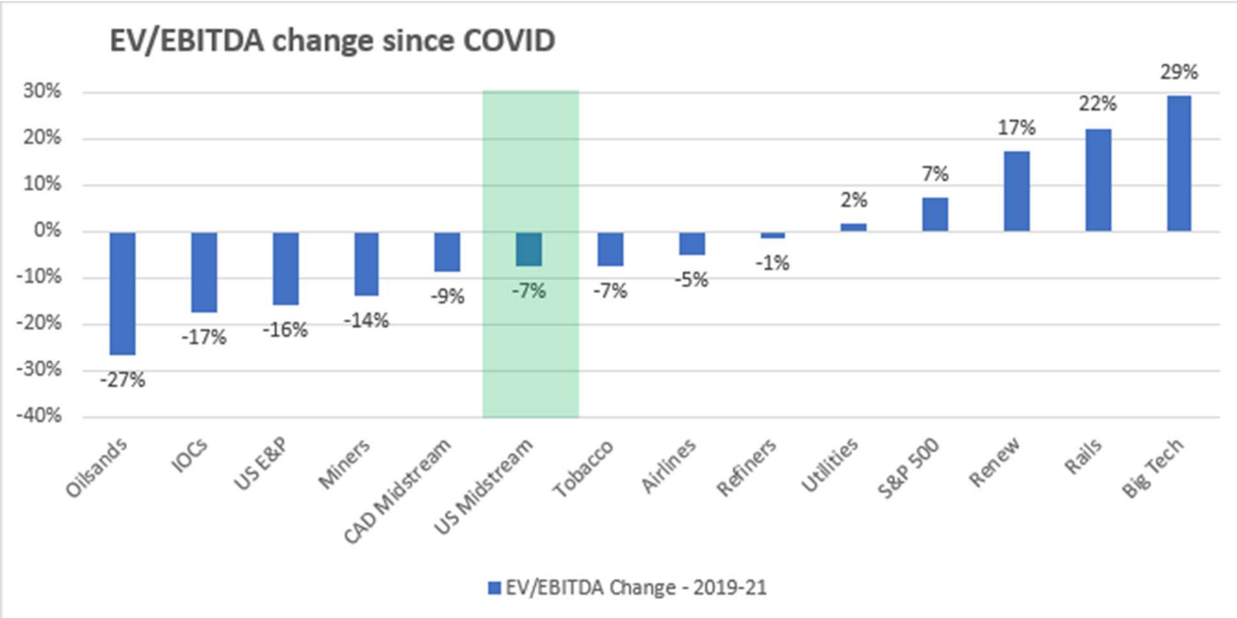
Exhibit 3: the net impact of COVID has pushed EBITDA higher and debt lower… yet multiples have fallen since 2019



Source: Bloomberg, Public filings, Recurrent research

Despite meaningful fundamental improvement on multiple fronts, midstream equity valuations fell by -22% in 2020, and increased by +15% in 2021, leaving multiples below 2019 levels, against a broad market backdrop that has generally seen expanding multiples over that same period, as shown below. Importantly for 2022, continued reduction in debt leverage means that equity appreciation is possible even if EBITDA growth moderates.

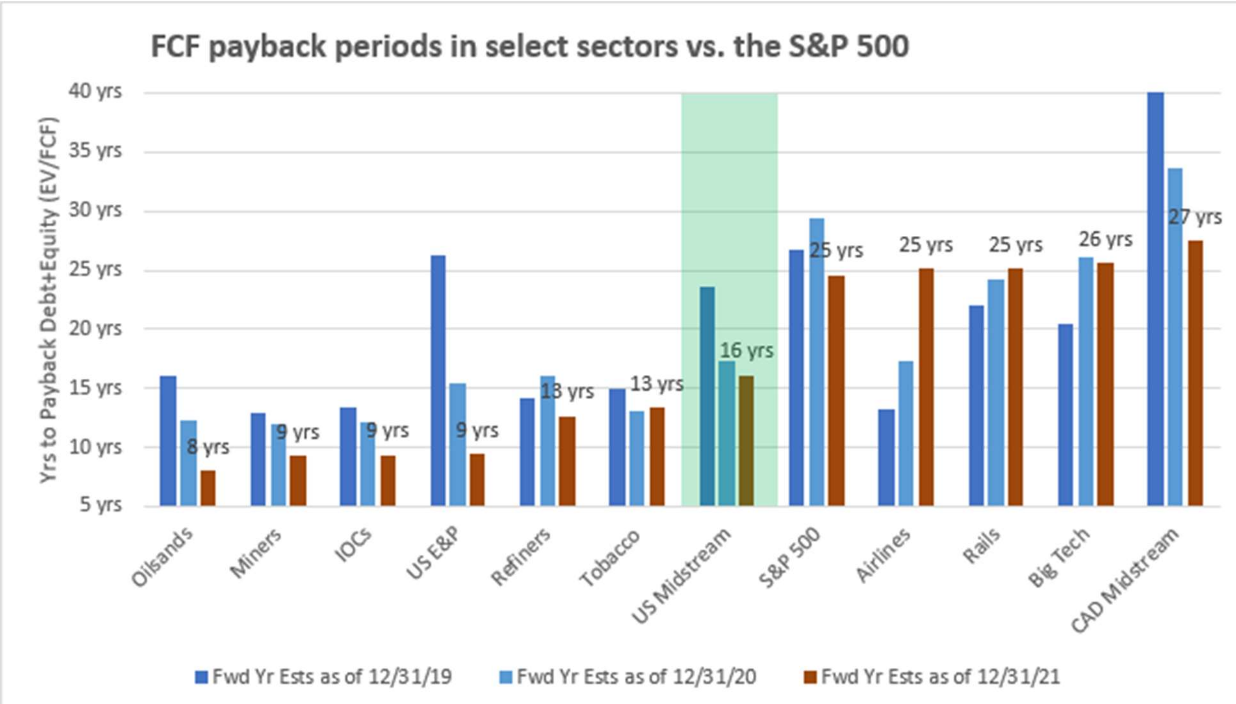
Exhibit 4: since 2019, midstream EV multiples are down -7 to -9%, while S&P 500 have expanded +7%



Source: Bloomberg, Public filings, Recurrent research

While a return to 2019 EV/EBITDA multiples would imply a fairly pedestrian 20% equity return (and 30% returns relative to the S&P 500), FCF-based valuations imply even more upside. On the basis of EV/FCF, midstream is 30% cheaper vs. 2019 levels (and 35% cheaper vs. S&P 500 FCF yields). A return to midstream's 2019 EV/FCF multiple (vs. 16 years today) would imply equity returns of closer to 40%. For the sake of our prediction, we think somewhere north of the 20% implied by 10x EV/EBITDA multiples is a reasonable bogey for 2022. ***Importantly, the massive FCF generation implies that equities should continue to appreciate even in the absence of business growth – as debt leverage continues to fall.***

Exhibit 5: Thanks to low capex, midstream FCF paybacks are quicker than during COVID… currently 30% cheaper vs. S&P 500



Source: Bloomberg, Public filings, Recurrent research

Natural Resources

Performance Review

During the month of December, the Alma Recurrent Global Natural Resources Fund rose +7.68% net of fees, outpacing the S&P Global Natural Resources Index's +7.14% return. For the year ending 2021, the Alma Recurrent Global Natural Resources Fund rose +32.15% net of fees, outperforming the S&P Global Natural Resources Index's +24.40% return. Since the Fund's 6/29/2018 inception, the Alma Recurrent Global Natural Resources Fund has risen +7.53% on an annualized basis, outperforming the S&P Global Natural Resources +5.75% annualized return.

Investment discussion – ***Shutdown -*** */ˈSHət͵doun/ - noun - A closure of a factory or system, defined by the minimum price at which companies prefer shutting down their operation instead of continuing to operate.*

Economic theory would suggest that shutdowns generally occur in falling demand environments, where prices are falling. In those environments, high-cost, marginal producers are unable to generate profits and are forced to shut down in order to eliminate losses. In the month of December 2021, two high profile European shut down announcements underscored the unconventional economic climate. One announcement was caused by inflation, while the other is likely to cause further inflation.

Exhibit 1:


Alcoa to Curtail San Ciprian Smelter, With Commitment to Restart

Alcoa announced that it would close its San Ciprian smelter in Spain through 2024, and agreed to pay labor costs through the entirety of the idled period. Importantly, contrary to most shut down scenarios, global aluminum prices remain near multi year highs.

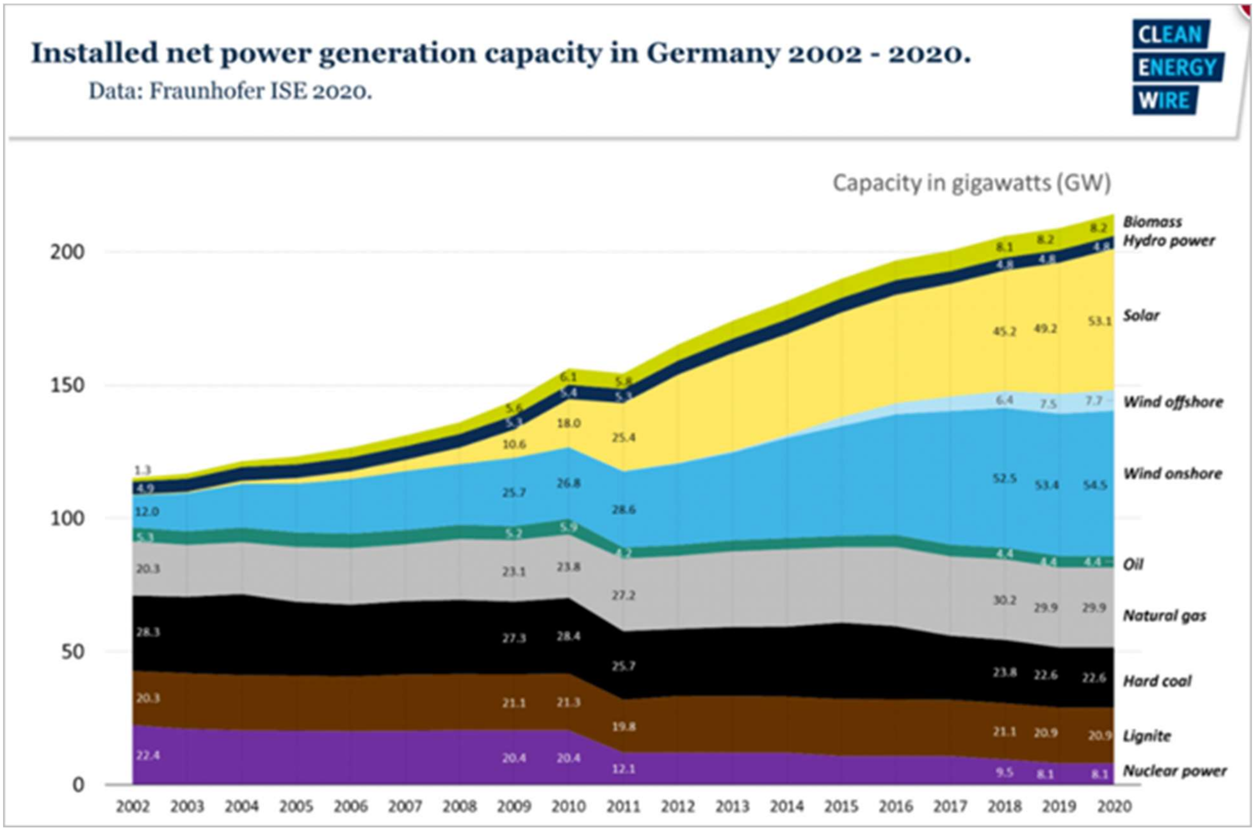
The answer as to why the San Ciprian smelter was closed reverts us to the subject of our October 2021 monthly commentary – the price of natural gas (and power) in Europe, especially relative to other global markets. At the close of 2021, the price was $21/mmbtu, after peaking at $43/mmbtu during December. Importantly, the price of natural gas in the US is <$4/mmbtu. In the specific case of aluminum smelting, power comprises 30-35% of costs. In the current environment, the significant difference in the largest single cost makes high cost European aluminum smelters globally uncompetitive, despite the historically robust environment.

Exhibit 2:

Belgium to shut down all seven of its nuclear reactors by 2025

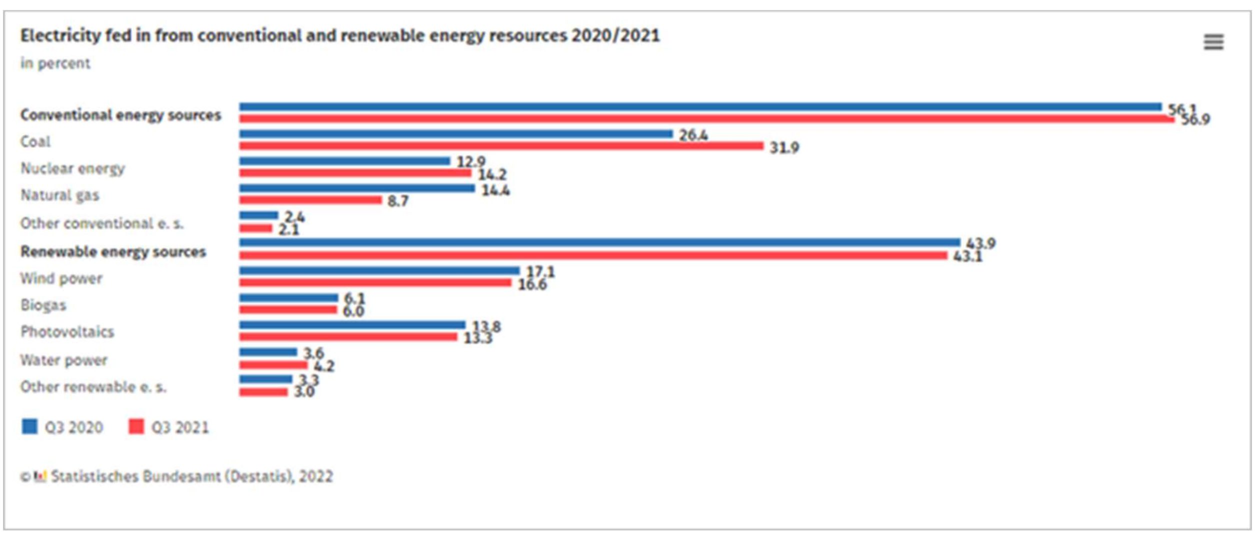
A second noteworthy shut down announcement was from Belgium. To highlight the impact of the announcement, nuclear power comprised more than 50% of Belgium's power production in 2021. In its place, Belgium primarily intends to increase renewable power production. As a point of reference, in 2021, <19% of power was renewable, so renewable power capacity must be more than tripled in relatively short order.

The decision is particularly interesting in light of another European country making a similar decision years ago. Germany, in the aftermath of the 2011 Fukushima disaster, decided to shutter their nuclear plants, which will be completed at the end of 2022. In place of nuclear power, wind and solar power capacity have grown, as seen in the chart below.



Source: Clean Energy Wire

While the capacity of renewable production has grown, the intermittent nature of renewable production means that actual production may not correlate to capacity. In fact, in 2021, both wind and solar power have not produced as much electricity as expected. To fill the gap, coal power generation has risen the most, from 26 to 32% in the last 12 months. This is despite Germany's efforts to retire coal capacity due to environmental concerns.



Source: German Federal Statistical Office

Furthermore, natural gas prices have risen, and as the marginal power source, the price of power in Germany has risen dramatically, as seen in the chart below. Germany shut down low-cost nuclear power plants in order to build intermittent renewable power capacity, and the country unwittingly became more exposed to high-emission power sources and higher power prices. With Germany's experience as a potential analog for Belgium, nuclear power plant shutdowns entail the risk of pan-European inflationary pressures until sufficient and reliable alternative power sources are developed.

Source: Bloomberg

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