Midstream: Our recently published midstream white paper highlighted the benefits of the transition to a "tobacco-style business model" as free cash flow (FCF) generation is set to expand in 2020 and beyond, even as the broader energy industry slows. As Q2 earnings have concluded, we were unsurprised to hear midstream management teams highlighting FCF margins, even as oil and gas demand remains stuck at 90% of pre-COVID levels pending a broader economic normalization, and find the current valuation levels (20 year lows vs. book values) to be overly punitive vs. COVID's largely one-time, 5-10% impact on sector cash flow.

Natural resources: The prospect of global economic recovery and inexpensive valuations bolstered returns in early cycle industries, while energy equities underperformed broader markets. Second quarter corporate earnings reflected many trends seen in July equity performance. Energy company earnings were impacted by weak oil prices and refined product margins, while other natural resources companies benefited from stronger commodity prices and aggressive cost cutting programs.

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.

July 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 July 2020, the MLP & Infrastructure Strategy generated net returns of -1.15%, 2.40% better than the -3.55% return of the Alerian MLP Index (AMZ). Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +5.52% (annualized, net of fees). Please see the performance section below for more detail.

Today's midstream sector is a crossroads of miserable sentiment, compelling fundamental setup

While YTD midstream results have largely confirmed our initial March 2020 outlook (5-10% decline in 2020 cash flows vs. 2019 results, and comparable declines vs. pre-COVID Wall Street analyst expectations), the sector's equity valuations have remained stuck closer to March 2020 lows than January 2020 highs, and have meaningfully lagged the broad equity recovery. Sentiment remains very poor, driven by frustration with underperformance over the last 3 years, and evidenced by significant 2020 YTD midstream fund outflows, which thankfully Recurrent has largely avoided.

On the other hand, the fundamental setup for midstream remains attractive, with valuations (on an enterprise value vs. invested capital value, or EV/IC basis) near 20-year lows. Furthermore, with a ~10% negative cash flow impact from COVID in 2020, much of which will reverse in 2021+, the sector's enterprise value (total value of debt and equity) remains roughly 20% below January 2020 levels. In other words, midstream stocks appear to discount an ongoing impact of COVID for years to come.

We continue to believe that midstream public equities provide an attractive, differentiated way to prepare for a post-COVID economic normalization. Cash flow stability is reflected by midstream debt trading near all-time highs, while midstream leverage to commodity prices provides some measure of inflation protection following significant liquidity injections conducted by global central banks YTD.

Midstream management teams offer confirmatory datapoints of Recurrent's latest "tobacco model" white paper

Over the last several weeks, the midstream industry has reported Q2 results, representing the first fulsome update since WTI prices turned negative and COVID "shelter in place" orders gave way to an uneven reopening of the US economy.

Prominent midstream executives offered comments strongly supporting our "lower growth, higher shareholder returns" framework. And we would also note that significant cash returns are not a distant prospect – they are a capital allocation decision being weighed right now, as almost every other sector has been forced to curtail cash returns to shareholders by the pandemic.

- ***Rich Kinder, Kinder Morgan:*** "Looking beyond 2020, we believe, we are operating in a maturing business segment, and there are opportunities for viable expansion projects will likely be significantly less than we have experienced over the last several years. If that expectation proves accurate, it will probably reduce our growth potential, but allow us to husband significant cash flow that we can use to increase our dividend, pay down debt and/or buy back shares under the right conditions."
- ***Randy Fowler, Enterprise Products:*** "For 2021 and 2022, we currently anticipate growth capital investments to be approximately $2.3 billion and $1 billion respectively. This is an aggregate $700 million reduction from guidance we provided for 2021 and 2022 at the end of the first quarter… We'll look for opportunities for the remainder of the year to see how we would want to come in and if we're going to return more capital to investors where that'd be in the form of distributions or buyback."
- ***Alan Armstrong, Williams Companies:*** "Intentional capital discipline and the shifting of some project spending continues to drive capital spending down and as a result, [drive] our free cash flow up… expansion capital spending for the quarter and year-to-date is about half of what it was last year. With expansion capital spending now expected to come in the $1 billion to $1.2 billion range and looking at our EBITDA and distribute cash flow forecasts, we still predict that we'll produce excess free cash flow this year above all dividends and capital expenditures."
- ***Mike Mears, Magellan Midstream:*** "if we cannot find [accretive projects] for 2021, then, we will definitely look at unit buybacks or distribution increases. And those decisions will be made really at a point in time in the future when it's abundant that we need to make that decision that we'll have that excess cash. And that it'll really be driven by what the current valuation is on our units and whether we think that's the best place to put the cash versus distribution."

- ***Al Swanson, Plains All American:*** "Absent short term changes in working capital associated with hedged inventory storage, we expect our cash generation combined with lower capital investment to benefit free cash flow for the balance of the year and into 2021 and beyond."

To reiterate: our prediction is that FCF growth will occur as capex/costs decline, with or without meaningful revenue growth. In Q2, industrywide year-over-year cash flow only dipped slightly, despite an unprecedented synchronized shutdown of the US economy. Midstream companies have already engaged in aggressive cost-cutting to drive industrywide "free cash flow" (cash flow in excess of reinvestment) ***higher*** in 2020 vs. 2019 levels. In addition to the progress seen above, expectations for capital spending in 2021+ have been slashed even more dramatically, all but ensuring that FCF per share will continue to increase going forward.

Natural Resources

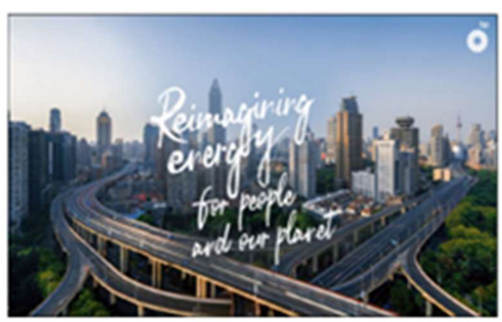
Performance Review

During the month of July 2020, the Recurrent North American Natural Resources Strategy fell by 0.30%, underperforming the S&P North American Natural Resources Index's 1.19% gain. Sector overweights in early cyclical resources holdings added value, as aluminum and copper were among the top performing industry sectors. The gold sector continued its impressive run of performance, with the commodity rising more than 10% in July alone. The portfolio's underweight weighting in gold equities negatively impacted relative performance.

Portfolio Discussion

In what has been an eventful decade for natural resources industries, the story of BP has been particularly noteworthy. A little more than 10 years ago – April 20, 2010 – the BP Horizon disaster caused approximately 4 million barrels of oil to spill into the Gulf of Mexico, with regional environmental impacts which last to this day.

BP's decade since the Deepwater Horizon Incident: from lemons… to lemonade



Last week, at its 2nd quarter 2020 conference call, BP outlined its strategy transformation, with a primary goal to reach net zero carbon operations by 2050. This ambitious plan leads peer integrated oil companies, and presents quite a transformation from 2010, when its profoundly negative environmental impact attracted global contempt.

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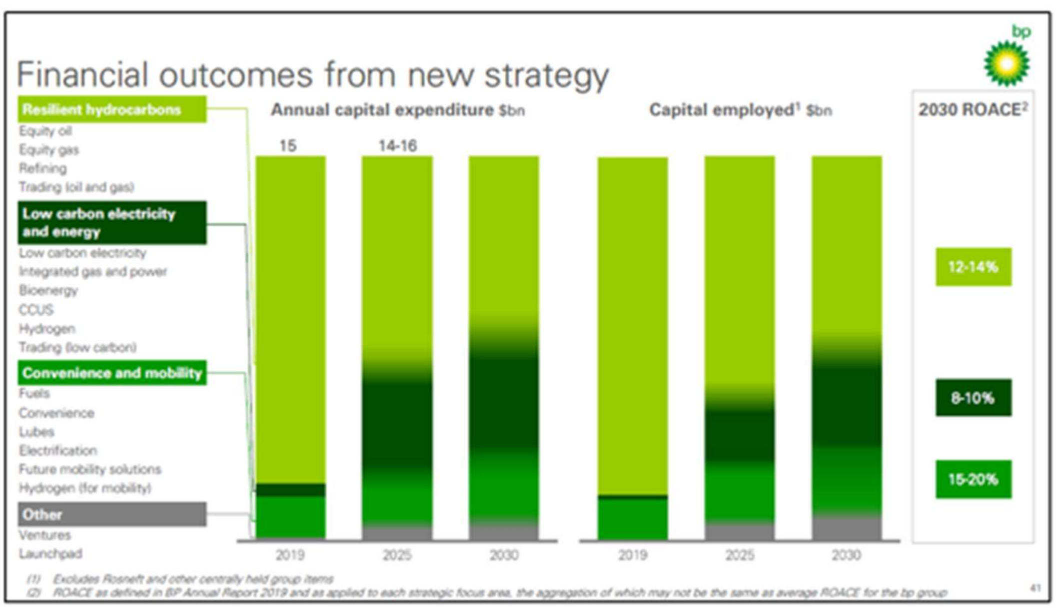
Making the best of challenging situation

In the aftermath of the Horizon disaster, BP faced significant challenges to its core business – drilling for oil and natural gas. From a financial standpoint, BP was forced to pay significant fines, which have totaled approximately *$65 Billion* through the end of 2Q 2020. In order to pay for the fines, BP eliminated its dividend and divested valuable assets including the Permian Basin and Egypt. To put that figure into perspective, the over the last decade, annual capital expenditures averaged $19.1 Billion, approximately 3.4 years' worth of total CAPEX! Additionally, safety concerns impacted key strategic operations and new investments in the Gulf of Mexico and other deepwater locations were stunted.

The shift to "new energy"

The multi-year period immediately following the Deepwater Horizon disaster proved to be the peak of the energy cycle, with oil prices peaking at $147/barrel. As oil prices rose, competition increased for valuable assets and in its relatively weakened financial state, BP looked to other areas to invest capital. Two years prior to the Deepwater Horizon disaster, the company announced its "BP – Beyond Petroleum" strategy, and the company increased its investment in areas beyond the traditional oil and natural gas drilling.



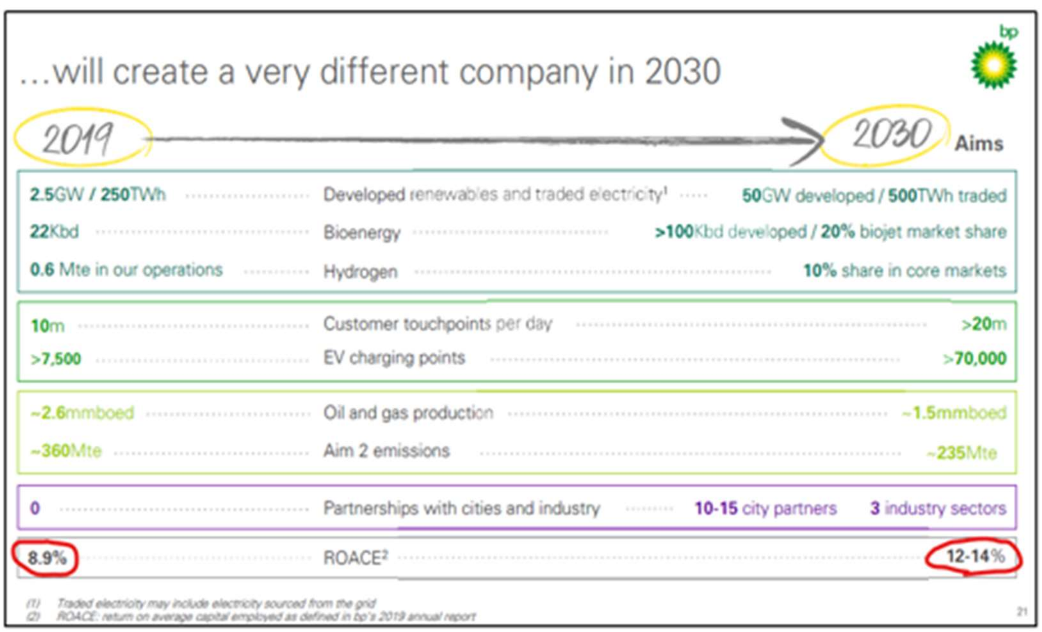
Source: BP company presentation

Last week's strategic announcement to move from and "Integrated Oil Company" to an "Integrated Energy Company" is the natural evolution of the period immediately following the Deepwater Horizon disaster. In 2019, BP spent about 15% of CAPEX on "new energy" and growth initiatives, which is expected to grow to 40% by 2030. Two of the most prominent "new energy" growth investments will be in electric vehicle (EV) charging stations and low carbon power generation. In the case of EV charging stations, the company intends to grow its current base of 7,000 stations to 70,000 stations by 2030. BP also announced plans to double the number of convenience stores to 3000 stores by 2030.

What does the strategic shift mean for future company returns?

The company intends to divest of $25 Billion of traditional hydrocarbon assets, and retain "resilient hydrocarbons", intended to generate 12-14% returns, consistent with historical divisional returns as reported by the company. Looking at the convenience and mobility division, the company expects to generate 15-20% returns. In this area, the returns appear to be fairly optimistic, given that mature US pureplay peers generate 10-12% returns; a company undergoing a growth phase generally generates lower returns as investments accelerate. Lastly, the low carbon investments are expected to generate 8-10% returns. While possible, the gestation period for early low carbon investments will likely determine the 2030 return profile. Many businesses, while in their formative growth phase, have difficulty generating returns approximating the cost of capital, and many do not generate positive returns at all.

As seen in the chart below, BP generated returns of 8.9% in 2019, and as a result of the strategic changes, the company is expected to grow returns to 12-14%. While the company's initiatives harken a bold strategic direction focused on a new energy future, history tells us that mature businesses (higher cash returns, lower valuation multiples) can face significant challenges entering into more competitive, higher-growth businesses (lower cash returns, higher valuation multiples) as this transition deprives the existing investor base of cash returns, while transitioning to a structurally higher growth business is a process measured in years, not quarters.



Source: BP company presentation

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