ADVISORY RESEARCH
INVESTMENT MANAGEMENT

FMO Commentary

First Quarter 2018

COMMENTARY

Master Limited Partnerships ("MLPs"), as represented by the Alerian MLP Index ("Index") returned -11.1% during the quarter ended March 31, 2018. For the one-year period, MLPs returned -20.1%. It is noteworthy that while many asset classes are near all-time highs, MLPs remain 42.8% off of their previous highs set in August 2014.

After a recovery in equity and bond prices in 2016, the market has not been supportive of MLPs and energy infrastructure equities. The group has traded in a downward trend consistently since the first quarter of 2017, with a few short-lived rallies.

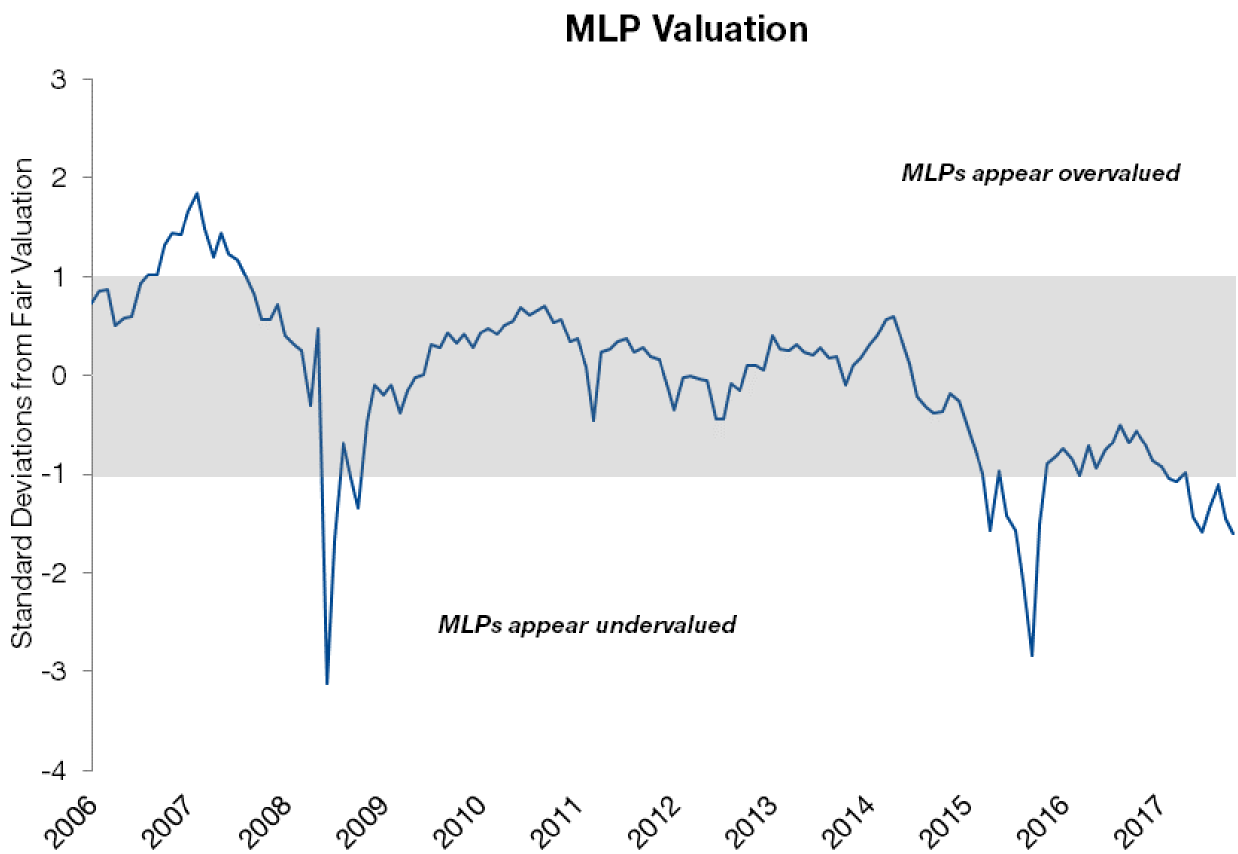
OUTLOOK

Our view is that investors seem more divided than ever on the outlook for the midstream sector. While some investors are fatigued by the persistent weakness in the space, there are indications that other investors are drawn to what they feel is great relative value. Our commentary will address the reasons we see for investor fatigue and negative sentiment, and lay out the fundamental backdrop that we believe is a reason for optimism over the long-term.

The only change from last quarter in our Key Issues table below was moving the political and regulatory environment from positive to neutral following the Federal Energy Regulatory Commission (FERC) decision, which we will discuss in more detail below. We feel current valuations continue to present a strong opportunity for investors as MLPs and energy infrastructure equities look exceedingly cheap relative to their history and comparable asset classes, despite strong and improving fundamentals for the underlying businesses.

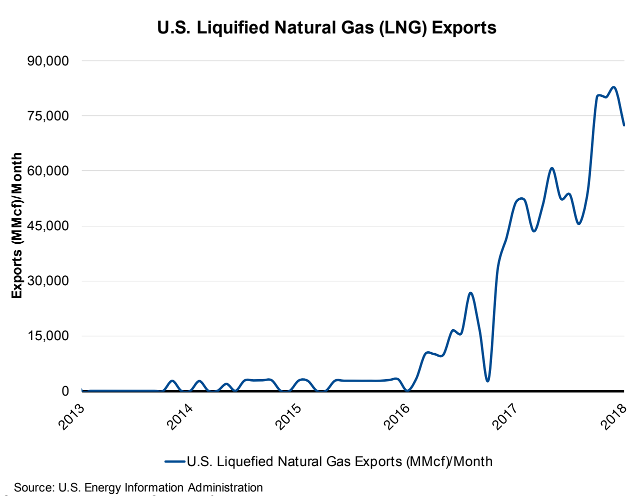
KEY ISSUES	Positive	Neutral	Negative	Comment
VALUATIONS	☑			MLPs remain cheap on an absolute and relative basis versus comparable asset classes
POLITICAL AND REGULATORY		☑		Tax initiatives were supportive of energy infrastructure but FERC's reversal of Income Tax Allowance was a negative
COMMODITY PRICES		☑		Extension of OPEC production cuts have moved commodity prices higher
INTEREST RATES			☑	Rising interest rates are expected to eventually impact higher yielding securities, including MLPs, but could trigger flows into MLPs from Utilities
DISTRIBUTION GROWTH		☑		Consensus estimates are lower but more realistic
ENERGY INFRASTRUCTURE BUILD-OUT	☑			Export opportunity should drive demand-oriented infrastructure spending but high cost of capital and limited access to capital markets may delay growth projects

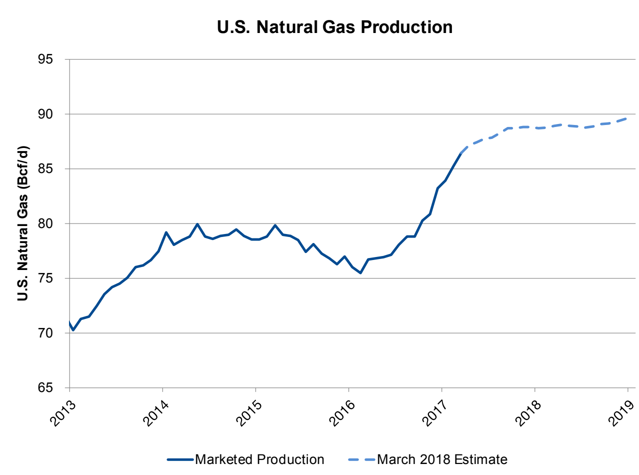
Our MLP valuation chart shows this is the cheapest MLPs have traded outside of crisis periods (Financial Crisis in 2008 and Energy Crisis in 2015-16). Thus our long-term return outlook remains for high single-digit to low double-digit returns and is at the higher end compared to recent years.



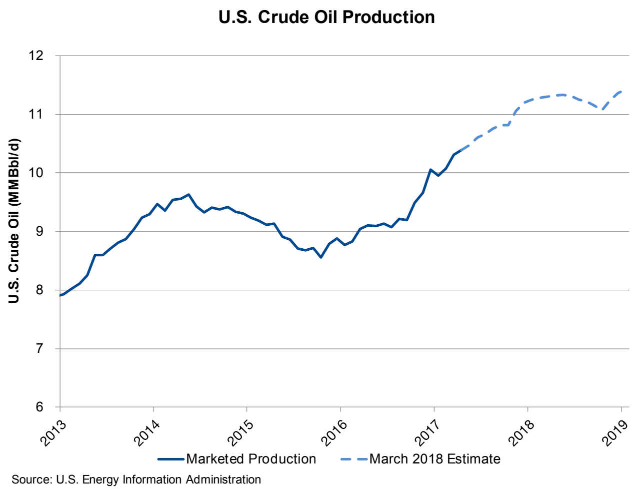
Period: 6/1/06 – 3/31/18
Source: FactSet Research Systems
Composite valuation based on both relative and absolute valuation metrics.

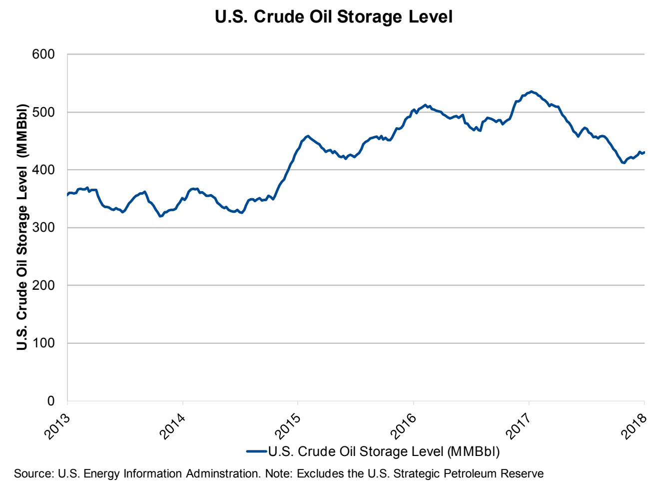
The actual business fundamentals for the energy industry are very strong. As shown below, liquefied natural gas exports continue to grow as our domestic natural gas production reaches all-time highs.



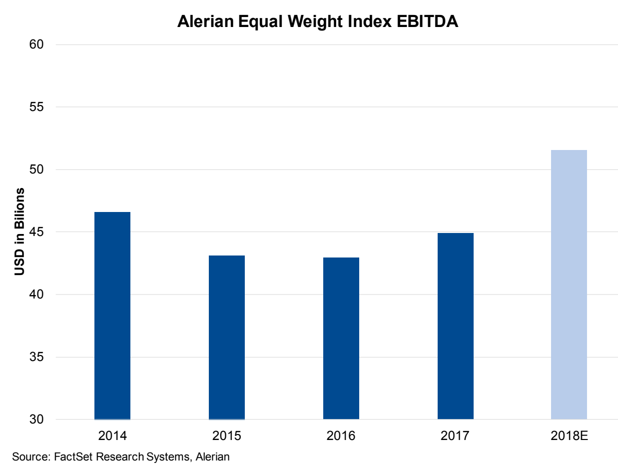


The two charts below show crude oil production in the United States at its highest level ever while inventories have dropped and demand continues to grow. This environment is supportive of crude oil pricing and incents producers to increase production.

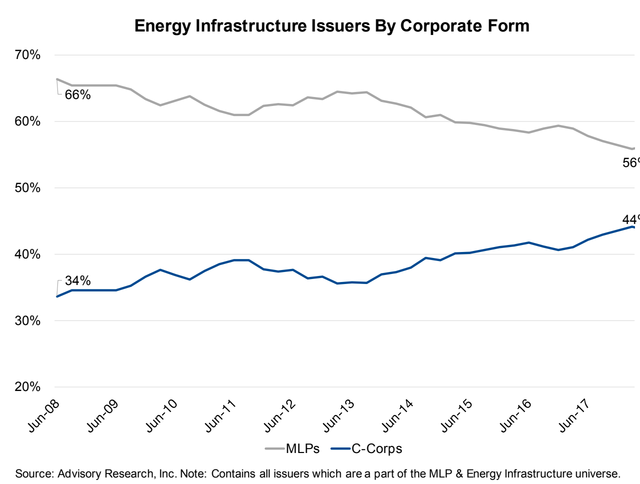




This activity supports high utilization of energy infrastructure assets and a need for increased investment. That is in fact what we see in company results. Earnings before interest, taxes, depreciation, and amortization (EBITDA), is a measure of a firm's cash flow. As noted in the chart to the right, EBITDA did contract somewhat at the bottom of the energy cycle but was very resilient given the scale of the drawdown in crude oil prices. Since those lows, the group's EBITDA has recovered quickly and is expected to make new highs going forward.

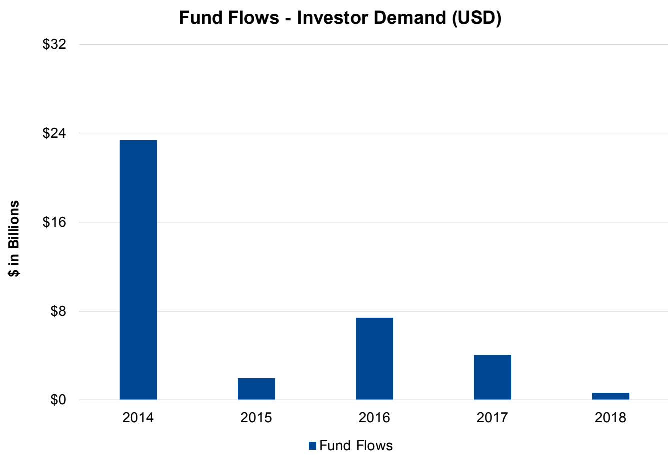


The recent poor performance of MLP equities has not been tied to a decline in business fundamentals but rather to a series of factors that have shaken investors' confidence in the MLP market. Many management teams created the perception that consistent and growing distributions, a hallmark of the group for decades, cannot be trusted by investors. Decisions to reduce distributions or distribution growth rates were viewed as death by a thousand cuts for many investors as they were often unexpected and usually poorly communicated. While most of the distribution cuts are likely behind us, investors are now pricing in very little growth to future distributions. Another reason for investor fatigue is that the recent tax law change has narrowed the tax advantage for MLPs versus corporations. This has already led some MLPs to reorganize or consolidate into corporate form. As illustrated in the chart to the right, MLPs are still the entity of choice for owners of energy infrastructure assets. However, the gap has slowly closed over the past decade and the recent tax law change will incent a few more owners to own assets via a corporation instead of an MLP. Some investors and market commentators are extrapolating this concern to the point where MLPs become irrelevant and the asset class no longer exists. While some further restructurings will undoubtedly occur, we think this narrative is

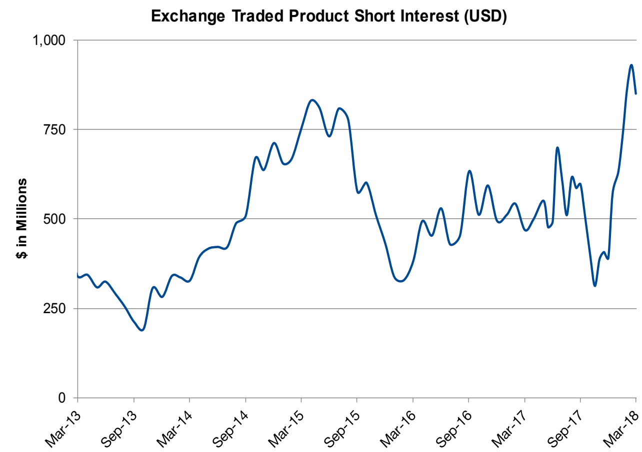


overstated. These entities own and operate essential infrastructure that is in high demand, but the market hates uncertainty, and the equities in our universe have reflected that.

The net effect of these activities is a very negative outlook by generalist investors. Per the charts below, there has been minimal net inflows into MLP-oriented products in the first quarter, and, in fact, record high short positions in MLP exchange traded funds. Midstream fixed income, which is exposed to the same fundamentals, has had very different results. Midstream fixed income returns were up in 2017 and were flat through the first quarter of 2018 suggesting fundamentals should support modest distribution growth going forward for midstream equities.



Period ending 3/31/18
Estimated flows are sourced from Bloomberg L.P., U.S. Capital, Financial Investment News.
Capital flows are incorporated from open-end funds, closed-end funds, exchange traded products and institutional mandates.



Period: 3/31/13 to 3/31/18
Source: Bloomberg L.P.

FERC TAX ALLOWANCE

In mid-March the FERC issued a news release ruling they were disallowing the Income Tax Allowance Cost Recovery in MLP pipeline rates. This was a reversal from the previous policy. The vast majority of MLP and energy infrastructure assets will not be directly impacted by the FERC's new guidance. Only those natural gas and liquids pipelines that cross state lines are regulated by the FERC. These pipelines are typically large and have little direct competition. To avoid these pipelines charging monopolistic prices to their shippers, the FERC sets tariff rates based upon their cost of service. Part of the cost of service is taxes incurred by the pipeline. Starting in 2005, an MLP-owned pipeline was allowed to incorporate a tax allowance into the rate of service it charged based upon the argument that the MLP unitholders paid taxes on the pipeline's earnings, even though the pipeline itself did not. The recent court ruling disallowed this policy and the FERC issued guidance disallowing the tax recovery portion of the rate-making process for MLP-owned pipelines. There are potentially other tax-related impacts that have yet to be decided upon by the FERC. Fearing the worst, the market sold off all MLPs and many energy infrastructure stocks.

In our view, the sell-off in late March was materially overdone. Not all MLPs are impacted, in fact, most new pipelines are still under their original contracts and operate under negotiated rates, not FERC set tariffs. Many pipelines face competition and therefore charge market-based rates. Further, only interstate pipelines charging the maximum allowable FERC tariff rate are impacted by the ruling. The majority of the assets owned by the companies we invest in are not impacted. Those assets include interstate pipelines charging negotiated or market rates, intrastate pipelines, gathering and processing, fractionation, compression, storage, and import/export facilities, to name a few.

For those pipelines affected by the recent policy shift, they will be required to go through a FERC rate case to reassess the allowable tariffs. There are several offsets to potentially lower tariff rates due to the policy change. For liquids pipelines, the rate cases will not occur until post 2020. The tariffs charged are based upon an allowed equity return on the pipeline's rate base. The rate base is the invested capital in the pipeline system. To the extent a pipeline has spent money on maintaining or expanding the system, the rate base will be higher. A potentially lower tariff rate applied to a larger rate base could mitigate any impact of the lower rate. We also believe it is highly likely that pipelines look to appeal the court ruling that predicated the FERC's policy change. It is important to note that this policy change does not impact pipelines owned by corporations, only pass-through entities like MLPs.

By our calculations, the impact on existing cash flows from these proposed policy changes could range from 0-10% for individual companies and between 0-5% for the group as a whole. It is worth noting that the FERC may issue further policy statements related to the new tax law and the use of tax allowances during the second quarter, and the result may push the eventual outcome into the courts. This process will likely be a long one, whether through rate cases or court cases, but new information is likely imminent.