Timely thematic topic:

Energy Outlook 2021

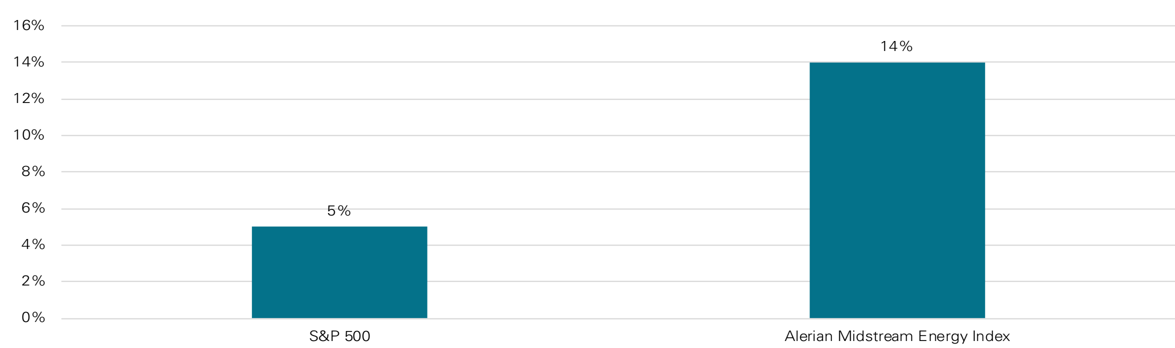
Summary

- Today, a vast majority of the midstream infrastructure network in North America is in place.
- With less capital expenditure needs combined with durable earnings, midstream companies can now focus on free cash flow (FCF). For the first time in recent memory, the energy market is more demand-focused than supply focused.
- As the world continues to demand “more energy and less carbon” midstream companies are viewing the global energy transition opportunistically.
- In a rotation towards value-oriented stocks, energy should benefit.

Today, a vast majority of the midstream infrastructure network in North America is in place. With less capital expenditure needs combined with durable earnings, midstream companies can now focus on free cash flow.

- Nearly every midstream company is expected to generate free cash flow after dividends in 2021.
- The FCF yield for midstream in 2021 is expected to be 14%, almost 3x that of the S&P 500.

Free cash flow yield (2021)



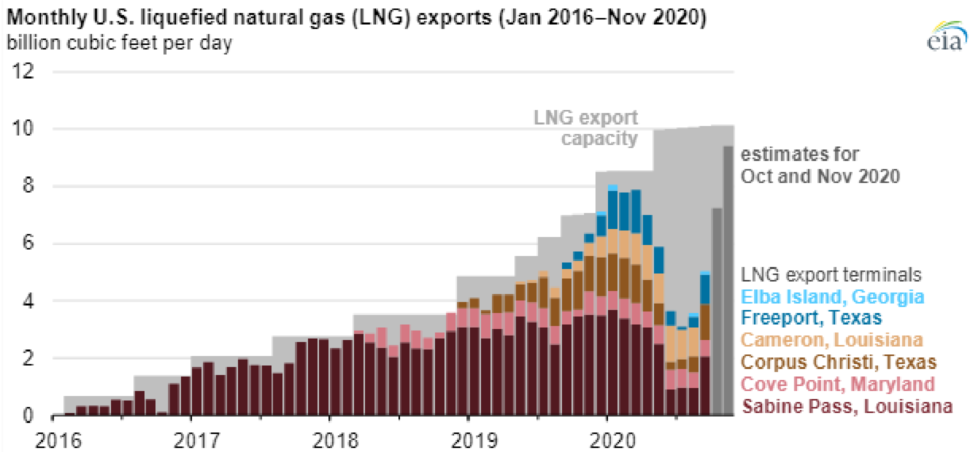
Source: Bloomberg

- We believe the significant FCF will lead to sustainable outperformance. FCF is used for dividends, debt pay-down and share buybacks. In fact, 14 midstream companies now have an active share buyback program.

For the first time in recent memory, the energy market is more demand-focused than supply focused.

- We believe a vaccine rollout will lead to increased energy demand activity as economic output returns to more normalized levels.
- Exports are more important than ever – natural gas liquids (NGLs) and natural gas production far exceed domestic consumption requirements.

The chart below shows expected U.S. LNG exports rising to their highest ever levels in November 2020.



Source: Energy Information Administration

- Infrastructure in the Permian Basin is well positioned to benefit from global demand for cheap American energy. According to Baker Hughes, since the rig count bottomed in August, more than 60% of new rigs added have been in the Permian Basin. Natural gas and natural gas liquids offer improved ESG profiles for companies. Both fuels provide a net improvement to air quality and emissions, particularly in key Asian markets relative to the status quo (coal or wood-fire).

As the world continues to demand "more energy and less carbon" midstream companies are viewing Energy Transition opportunistically.

- With the EU moving further towards renewables and 7 of the 10 largest economies pledging to have net-zero emissions by 2050 pipeline companies are turning to what role they can play in the energy transition.
- Pipeline companies are well positioned in emerging energy technologies such as hydrogen and carbon capture that can assist in energy transition. Green hydrogen can be particularly relevant from an environmental perspective, as it uses renewable power to split hydrogen from water, further increasing the use of renewable energy.
- Examples of midstream investment around ESG include:
  - Enbridge Inc. (ENB) is focusing on renewables and European offshore wind, and hydrogen pilot projects
  - TC Energy Corporation (TRP) is focusing on renewables and hydrogen opportunities
  - The Williams Companies, Inc. (WMB) is planning to spend on solar across its footprint

In a rotation towards value-oriented stocks, energy should benefit.

- Increased fiscal and monetary stimulus could lead to higher taxes and interest rates, which could potentially compress P/E multiples of growth sectors.
- Stronger inflation could result from the significant injection of liquidity. Besides hard assets, cyclical sectors like energy should exhibit correlation to inflationary pressures. According to a Morgan Stanley study, using monthly data looking back 30 years, the correlation between U.S. inflation and energy sector valuations is strongly positive, with an R squared of 0.77. Liquids pipelines directly pass along inflation in form of tariff escalators at PPI +0.78%.