Fort Washington
Investment Advisors, Inc.

Midstream Energy/MLP Market Outlook

June 2016

With natural gas prices rebounding, a refocus could be on midstream equities

Fort Washington believes the time has returned for investors with patience and a long-term investment horizon to consider gaining or increasing exposure to midstream energy.

Our view is predicated on our risk/reward outlook for midstream securities, which are pricing in minimal or negative growth despite contracted volumes that provide visible growth opportunities. The broad-based and, in many cases, irrational selloff of midstream securities is overdone. Lastly, and critical to our outlook is that we see green shoots emerging within subsectors of midstream energy.

Opportunities that we want to highlight include, but are not limited to: capital market access, stronger pricing for natural gas liquids, and LNG (liquefied natural gas) exports.

- **Capital Markets Access:**
  Traditional capital markets are open for high-quality midstream companies, but remain tight for higher-levered and/or more commodity exposed names. Talk of a closure is premature. Many companies have reduced or deferred capital spending and implemented non-traditional partnerships and financing strategies to protect balance sheets and reduce or eliminate the need for capital market funding. This includes joint ventures and asset sales, issuance of preferred equity, distribution cuts to fund organic growth, and the slowing of the distribution growth rate.
- **Stronger prices for natural gas liquids:**
  Excess ethane supply has resulted in ethane rejection, thus creating a price floor for ethane. Growth in exports and steam cracker demand (almost doubling by 2018) should support a strengthening of ethane prices and volume growth. Exports compete with oil based naphtha demand at refineries and chemical plants in Europe, Asia, and the Middle East. While low crude prices in Europe can be a headwind for exports, we believe prices will strengthen towards the end of the year and into 2017. This, and domestic demand, support our bullish outlook on midstream companies with exposure to transporting ethane.
- **LNG Exports:**
  U.S. supplies are competing with existing international exports of LNG, including Qatar and Australia. The first U.S. exports, excluding Alaska, started in early 2016 with commercial cargoes expected in June 2016. This will take exports to approximately 1.5-1.6 million tons (MT) per month. Those volumes are contracted under long-term take-or-pay capacity agreements which differ from the current, pre-commercial volumes which are sold on the spot market. This is where we see many analysts and investors missing the boat, pun intended, as they view the cargoes in the context of global gas prices (primarily oil-indexed and thus at near-term lows) as marginally economic, or uneconomic depending on minor adjustments to assumptions. We believe this approach is terribly wrong. For shippers with take-or-pay capacity commitments in place, as is common along the Gulf Coast, the price of international oil-index natural gas is irrelevant as are concerns pertaining to a surplus of liquefaction capacity from 2017-2024.

  The surplus becomes relevant when contracts are up for renewal, but we see a tightening of the supply-demand balance. Most of our midstream company investments are currently insulated from direct exposure to volatile commodity prices. Nonetheless there can be a lagged effect as producer volumes suffer first. Midstream companies would feel the impact later as upstream volumes decline overtime. However our view is that the midstream equity market is irrational, and this is largely confirmed to us by the movement of non-commodity exposed equities with movements in the price of oil. With this in mind, our view is not without caveats.

Near-term headwinds:

We believe the most significant headwind facing the industry is continued weakness in crude oil prices, which has been driven by an oversupply. The conditions supporting the oversupply must be resolved prior to any normalization in prices. We anticipate the market will be well on its way to a resolution come late 2016 with equity volatility normalizing in the middle of the second half of 2016.

- Under "normal" conditions we would expect market forces to bring about an equilibrium. However, some OPEC members are engaged in a price war as they seek to increase or at least maintain market share. The price war needs to come to an end. While we see a glimmer of hope, internal politics within OPEC could push back any resolution until late 2016, despite ongoing talks of a production freeze.

- While U.S. oil production is down 5.3% from its peak (as of February 2016), or 515 mbpd (thousand barrels per day), it has only put a dent in the expected 0.5-1.5 mbpd oversupply situation (excluding inventories). Complicating the analysis are plans by Iran to restore production to pre-sanction levels, or add over 1,000 mbpd to the global market as soon as possible. This dueling dynamic between lower U.S. volumes and the risk of increasing Iranian barrels weighs on the market and could more than offset the positive near-term impacts from any OPEC freeze.
- Near-term headwinds could turn into a bearish hurricane if U.S. producers take on significant hedges with oil above $40 and if drilled and uncompleted wells come online. These well completions could more than offset recent production declines.

Subsector exposure:

We are seeking to outperform the Alerian MLP Index (AMZ) while seeking attractive total returns. To this end we are wary of companies with significant exposure to coal, retail propane, or companies engaged in risky exploration or production activities. In contrast, we have been actively increasing our exposure in the refinery logistics space. In addition, we are moving more aggressively into marine transportation, seeking to capitalize on greater export opportunities. We are avoiding oversupplied crude tankers while focusing on exporters of LNGs and NGLs (natural gas liquids). Finally, we have been increasing our exposure to natural gas transportation companies with long-haul pipelines that link prolific supply basins with end markets. We are indifferent to corporate structure and are willing to invest across all the structures of midstream equities.

Summary:

In summary, it is our view that the market appears to be testing a floor in midstream valuations. While there remains a significant risk of macro disruptions from OPEC, our view is that the risk-reward profile over the coming months favors owning midstream equities. Particularly given the ongoing OPEC negotiations for a production freeze, we believe market forces will have pushed supply and demand closer to an equilibrium by the end of the year. In our opinion, allocations should be made prior to an equilibrium being achieved and investors with a long-term horizon and ability to withstand market volatility on a long-term call should be prepared to make an allocation by year-end.

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