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2020 Marked a Key Inflection Point for the Midstream Energy Sector

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In late 2019, the midstream energy sector was nearing the completion of a multi-year restructuring process. Simplification transactions across the sector had effectively eradicated complex corporate structures and costly incentive distribution rights. Equity capital needs had nearly all been eliminated, which was a first for a heavily capital-intensive growth sector. Midstream companies shifted to self-funded capital programs. The arguably disruptive structural transformation positioned the sector on stronger footing with increased distribution coverage and a renewed focus on capital returns and positive free cash flow (FCF) generation. For these reasons and more, we were optimistic on the future total return potential for the asset class.

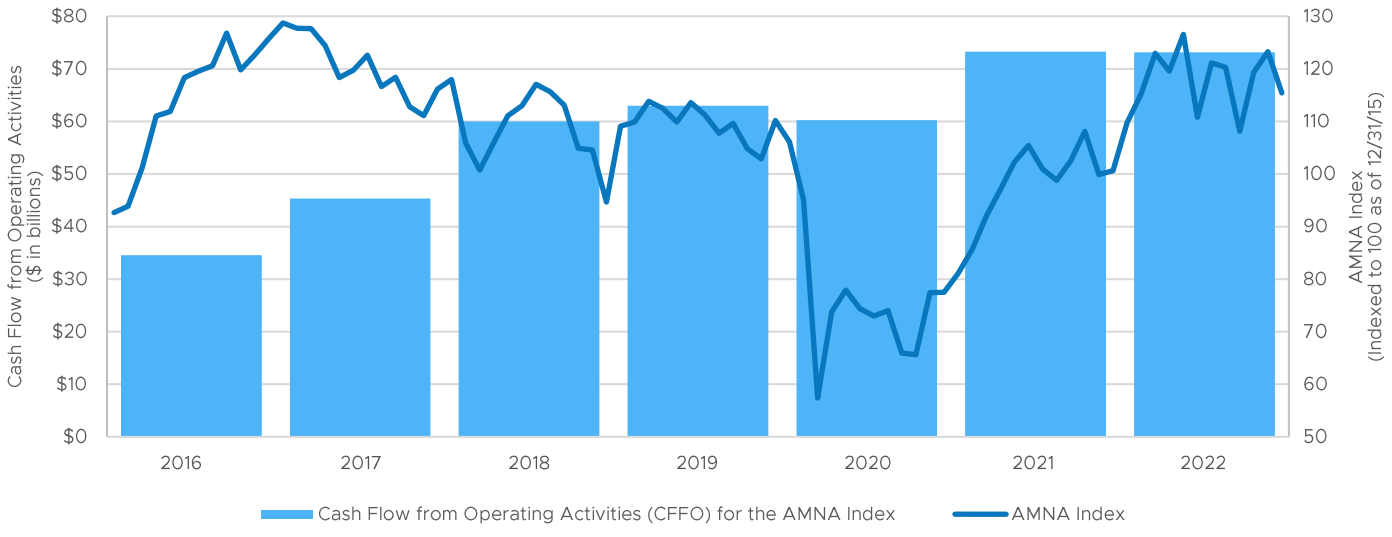
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The unprecedented events of 2020 upended this optimism. Concurrent oil supply (e.g. OPEC+ agreement dissolution) and oil demand (e.g. COVID-19 pandemic) shocks materially altered the outlook for the energy markets. The weakness in midstream energy equities was further exacerbated by technical selling pressure from forced deleveraging by midstream dedicated closed-end funds (CEFs). These events led to the largest correction in midstream history.

2020 served as a stress test for midstream cash flows. Despite an incredibly difficult operating environment with numerous "market shock" events (e.g., failed OPEC+ agreement, pandemic, forced production curtailments, negative crude oil prices, etc.), hydrocarbon volumes and cash flows were either more resilient than expected or recovered faster than expected. As a result, 2020 company outlooks stabilized and rebounded into 2021, as shown in the chart below. We believe the major equity drawdown in early 2020 did not match the stability of cash flows.

AMNA Price Performance to Annual Cash Flows



Source: Bloomberg. CFFO includes all companies in the Alerian Midstream Energy Index (AMNA) as of December 31, 2022.

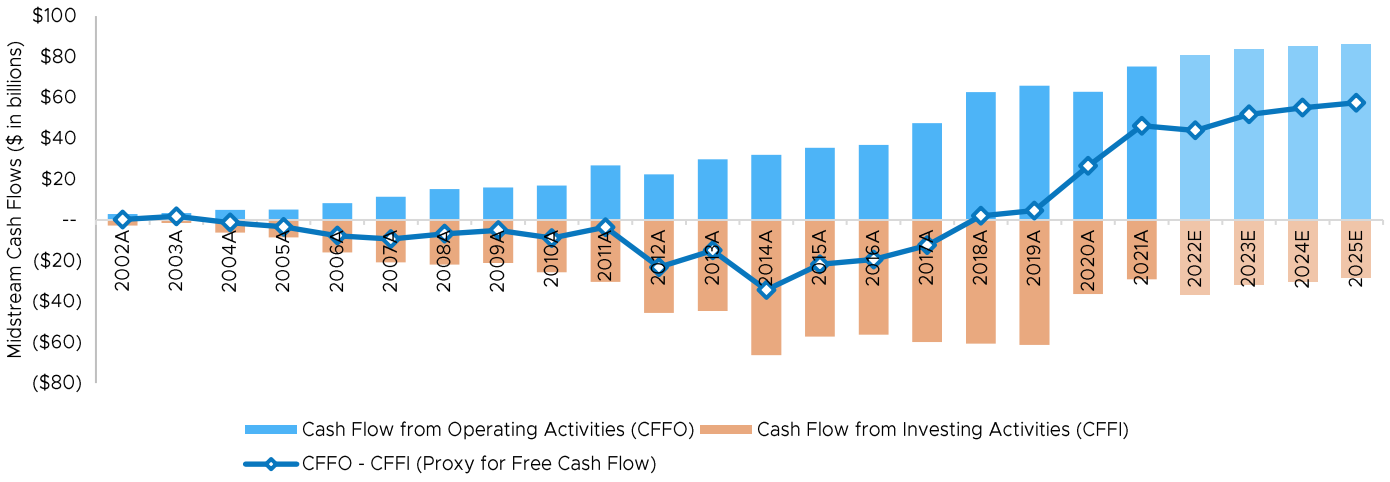
Free Cash Flow Generation

We believe the events and actions of 2020 catalyzed and accelerated needed change. The past decade was largely focused on aggressive growth, both in upstream and midstream. Energy investors were left with too much production, low commodity prices, overbuilt infrastructure, and poor returns.

What likely would have taken several years to accomplish under ordinary circumstances was compressed into a single year. Investors made it clear that aggressive growth, capital spend exceeding cash flows and poor returns on invested capital would no longer be tolerated. Midstream company management teams were given a clear mandate: reduce risk (e.g. capital spending, leverage, etc.), generate FCF and increase shareholder returns.

The events and actions of 2020 have resulted in several billion dollars of capital savings and even higher positive FCF than we initially projected at the end of 2019. FCF generation is projected to continue to increase in coming years (see chart below).

Midstream Cash Flows: Historical and Projected



Source: Bloomberg, Visible Alpha and Company Filings. Includes all companies in the Alerian Midstream Energy Index (AMNA) as of December 31, 2022.

This positive FCF generation allowed midstream management teams to rapidly reduce debt and become more aggressive in shareholder return alternatives. Many implemented buyback authorizations to take advantage of dislocated stock prices. This philosophy shift is in stark contrast to years ago where nearly every midstream company had an active at-the-market (ATM) offering to constantly issue new shares in public markets.

It strikes us as most impressive that a growing number of companies are starting to report free cash flow after dividends / distributions ("FCFaD"), which measures excess free cash flow after all capital expenditures and all dividend payments. We believe this is no small feat for a traditionally capital-intensive sector currently paying high single-digit dividend yields. We believe this dynamic is not widely recognized nor appropriately valued by investors.

In summary, management teams have remained committed to executing their pledge to investors to generate positive FCF, remain ultra-disciplined on capital spending, lower debt leverage and redeploy excess cash flows towards shareholder return initiatives.

These transformative changes appear to be working. For the first time in over ten years, the AMNA has outperformed the S&P 500 for two consecutive years (2021 and 2022) as the recovery in value-, cyclical- and commodity-oriented assets continues.

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