NXG INVESTMENT MANAGEMENT
The Next Generation of Investment Management

CUSHING

Is Energy's Outperformance Sustainable? Part 1

February 2023

Investors have been questioning whether the two-year trend of outperformance in the energy sector is nearing its end. Despite the highest average commodity price environment in a decade, capital investment remains at decade lows as the typical response to the supply 'price signal' breaks down.

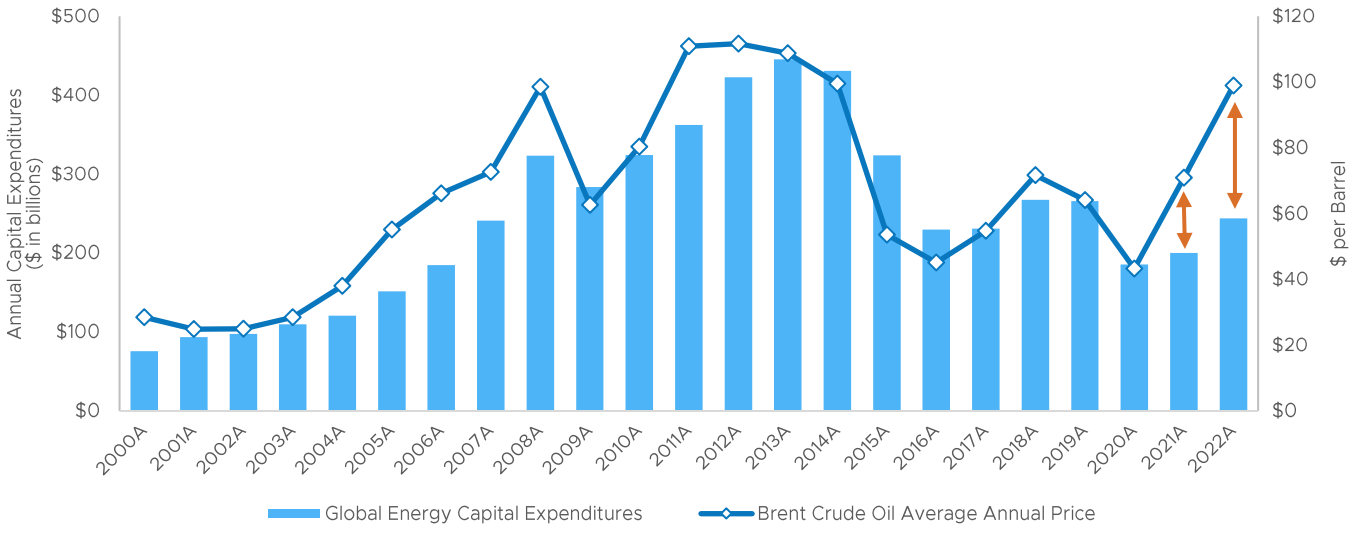
A variety of factors are inhibiting the sector's ability and/or willingness to respond to commodity price strength with higher levels of capital investment – a decade of low returns, lack of capital availability, low company valuations and correspondingly restructured management incentives (see chart below).

NXG Investment Management is dedicated to providing Next Generation investment strategies to investors seeking long-term growth in companies focused on a clean and sustainable future, as well as traditional and transformational infrastructure companies.

www.nxgim.com

In this three-part series, we will explain why **we believe this underinvestment could lead to a more structural shortage of commodity supply growth, potentially providing for a prolonged period of commodity price strength, higher company returns on invested capital and ultimately, sustained energy outperformance.**

Global Integrated Oils and Independent E&Ps Capex



Source: Bloomberg. Represents total capital expenditures of the Bloomberg energy universe of global integrated oils and independent E&Ps. Brent crude oil is the average closing price for the year.

Part 1: Reduced Incentives to Invest

The past decade has largely been defined by what proved to be aggressive overspending on capital-intensive growth, both in upstream and midstream. As a result, energy investors were often left with too much production and overbuilt infrastructure, resulting in low commodity prices and poor returns. The destruction of capital, particularly from upstream companies, was significant. Tired of low returns, investors understandably took their capital elsewhere.

The capital flight was exacerbated by the "decarbonization" theme and ESG sensitivity. Whether investors were actively anti-carbon in their ESG process or simply looking to avoid the debate, ignoring an underperforming energy asset class was rationally viewed as a logical outcome.

The energy sector avoidance was substantial and has led to depressed valuation multiples even as profitability is approaching all-time highs**. At the end of 2022, energy comprised just 5% of the S&P 500, despite contributing 15% of the index's cash flows.** We believe low index weightings only further disincentivized generalist investors to allocate resources and time to the sector.

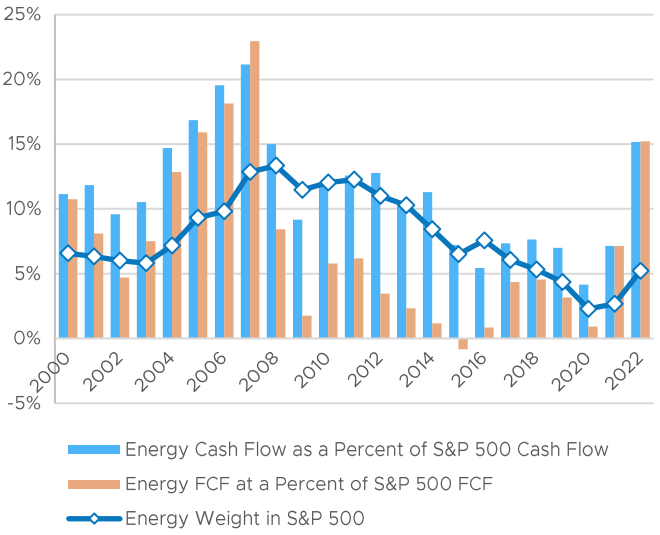
With a lack of new capital availability and depressed valuations, management teams have little economic incentive to risk this expensive capital on growth projects. Capital investment return hurdles have increased across the sector. Further complicating investment decisions have been increased regulatory hurdles and punitive policy measures (e.g. threat of windfall profit tax, export bans, price ceilings, etc.).

Finally, why put the capital to risk at all if investors are not attractively rewarding the future returns of that capital? **Management teams have rationally decided the best use for their cash flow, the highest return for the lowest risk, is to simply return it to investors in the form of share repurchases and dividends.**

These actions are reinforced by the recent restructurings of management incentive structures to focus on shareholder returns rather than production growth. This has led to renewed prioritization of capital returns and free cash flow (FCF) generation ahead of production growth.

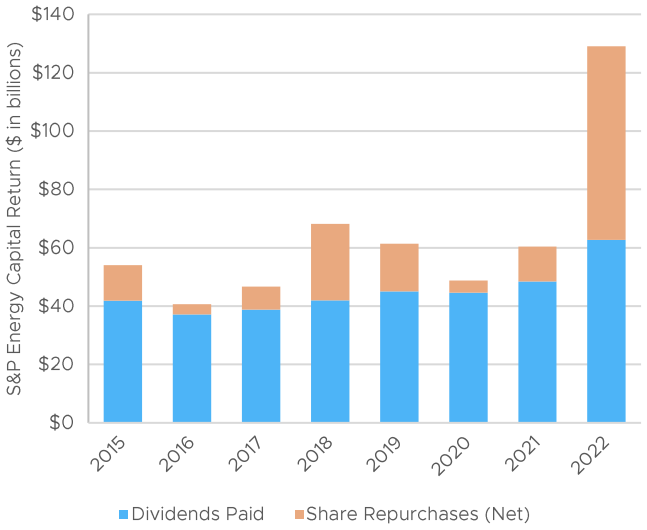
In part 2, we will discuss how this underinvestment could lead to a more structural shortage of commodity supply growth.

S&P Energy Contribution to S&P 500



Source: Bloomberg. Represents the S&P Energy Sector GICS Level 1 Index contribution of cash flow from operations and free cash flow to the S&P 500.

S&P Energy Capital Return



Source: Visible Alpha. Represents equity repurchases net of issuance and total dividends paid for the S&P Energy Sector GICS Level 1 Index.

Important Information
Investment advisory services offered through Cushing Asset Management, LP ("Cushing"), an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Registration with the SEC does not imply a certain level of skill or training. NXG Investment Management is the trade name for the Clean and NextGen strategies offered by Cushing. This information does not constitute an offer of any securities or investment advisory services, which may be made only by means of materials which contain a description of material terms and risks of an investment.

The information in this report was prepared by Cushing and is current as of the date of this report. Opinions represent Cushing's opinion as of the date of this report and are for general informational purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. Such opinions are subject to change at any time, are not guaranteed and should not be considered investment advice. Securities mentioned in this report may or may not be held in the portfolio and there is no guarantee that securities held in the portfolio will continue to be held. The mention of a specific security is not a recommendation or solicitation to buy or hold that security and should not be relied upon as investment advice. Cushing does not undertake to advise you of any changes in its opinions or the information contained in this report.

Certain information contained herein may constitute "forward-looking" statements, which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "estimate," or "believe" or other variations thereof. Such statements reflect various assumptions by Cushing concerning anticipated trends or events, which may or may not occur. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements.

The S&P 500 Energy Sector GICS Level 1 Index (S5ENRS) Is a capitalization-weighted index of all companies in the S&P 500 that are classified as members of the GICS energy sector. The S&P 500 Index is widely regarded as a gauge of performance of large cap equities. Indices shown are provided for comparison purposes only. The indices are unmanaged, and returns do not reflect the impact of the advisory fees. It is not possible to invest directly in an index.