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Update – Hidden Value in MLP & Midstream Credit

Sharam Honari | Partner
SHonari@BlackGoldCap.com
832 706 4873

Chris Jacobe | Director, Client Solutions
CJacobe@BlackGoldCap.com
832 871 4233

Shalin Patel | Director of Research
SPatel@BlackGoldCap.com
713 581 8884

Charles Marshall | Senior Analyst
CMarshall@BlackGoldCap.com
281 819 0980

BlackGold Office:

109 N Post Oak Lane, Suite 500
Houston, Texas 77024
+1 281 500 9981 | www.blackgoldcap.com

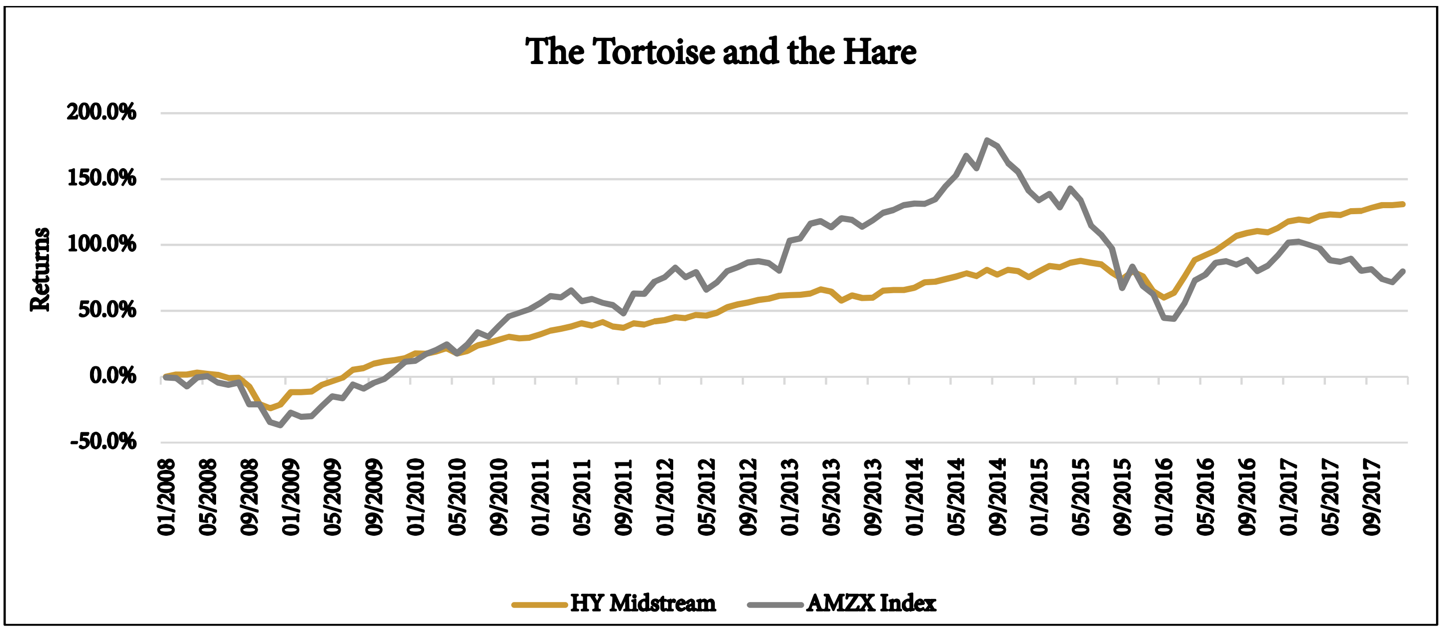
In our July 2017 White Paper on the "Hidden Value in MLP & Midstream Credit," we discussed how midstream credit investments outperformed MLP equities over the past 1, 3, 5 and 10-year periods while experiencing lower volatility and drawdowns due to their senior position in the capital structure. ***We anticipated further corporate structure simplification, industry consolidation, deleveraging and cost of capital improvements to offset the uncertainty associated with slower production growth and lower returns.*** These credit-positive trends persisted in the second half of 2017 and we expect they will continue for the foreseeable future. The midstream sector remains in a structurally uncertain and transitionary period as lower-than-expected production growth trajectories and contract re-pricings bring additional headwinds for generating cash flow. Most management teams recognize the need to increase coverage ratios, become less reliant on capital markets for funding, and reduce leverage at the senior debt level. As a result, companies continue to cut distributions, simplify corporate structures, sell assets and issue equity or hybrids to keep leverage from rising. ***These actions are positive for midstream credits and often a negative for common equity or units.***

Midstream Credit Outperforms MLP Equities

Midstream credits continue to provide solid total returns and more sustainable yields relative to MLP equities. Between July 1, 2017 and December 31, 2017, the BofA ML HY Midstream Index returned 3.7% while the Alerian MLP Index (AMZX) fell -4.0%, bringing their respective 2017 return to 8.4% and -6.5%.

HY Midstream Credit vs. MLP Equities Performance (Jan. 2008 – Dec. 2017)				
	2017	3 Year	5 Year	10 Year
BofA ML HY Midstream Index	8.4%	31.6%	43.1%	130.9%
Alerian MLP Index	-6.5%	-25.4%	-0.3%	79.9%

Source: Bloomberg, BlackGold. As of 12/31/17



Source: Bloomberg, BlackGold. As of 12/31/17

The Alerian MLP Index declined -13.2% into November 29, 2017 before bouncing back into year-end. This poor performance for much of the year restricted MLP access to capital markets through equity unit issuance. Retail investors historically supported the midstream sector but are fatigued by poor equity returns and are less willing to provide inexpensive equity capital for growth. Equity markets are effectively closed for many midstream companies and cost of capital has risen. Institutional investors are partially filling the void but, unlike retail investors, return on invested capital, less volatile returns, and better corporate governance are more important than distribution yield. Thus, the midstream sector is transitioning towards greater capital discipline and balance sheet improvement.

Midstream Credit Offers Better Downside Protection Than MLP Equities

Midstream credits have historically outperformed MLPs on both an absolute and risk-adjusted basis while experiencing dramatically less volatility and drawdowns. This trend continued in the latter half of 2017 as midstream credits benefited from the sectors focus on improving balance sheets and deleveraging. Per the data below, midstream credits are historically superior to MLP equities as they have a higher Sharpe and Sortino ratio along with a low correlation to oil prices and the broad market.

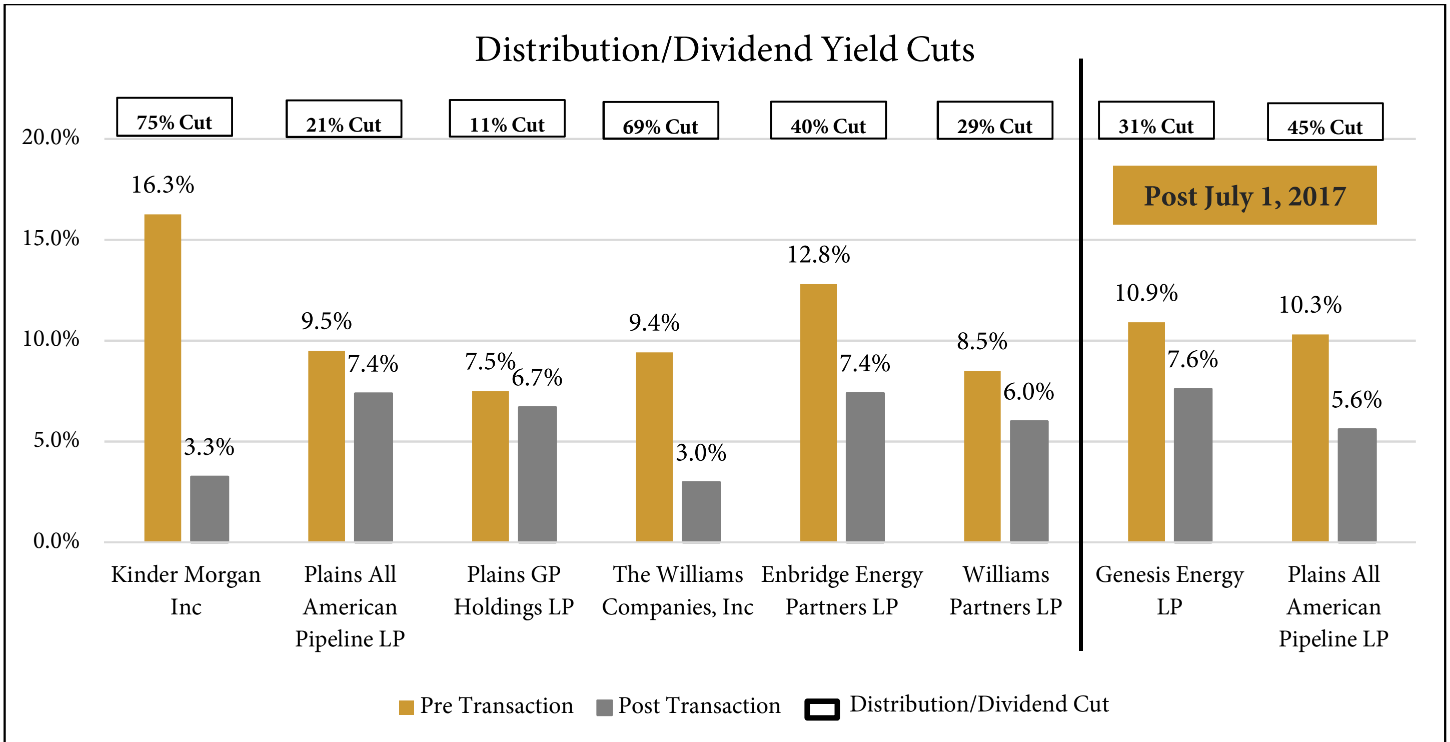
Index Statistics (January 31, 2008 – December 31, 2017)

Statistics	BofA ML HY Midstream	Alerian MLP Index	Oil	Natural Gas
Cumulative Return	130.9%	79.9%	-37.0%	-60.5%
Compounded Annual Growth Rate	8.7%	6.0%	-4.5%	-8.9%
Average Monthly Return (net)	0.7%	0.5%	-0.4%	-0.8%
Annualized Standard Deviation	9.6%	19.0%	32.3%	41.4%
Annualized Downside Deviation	9.5%	13.4%	22.4%	25.0%
Beta to S&P 500 Total Return	0.31	0.66	1.00	0.20
R-Squared to Oil	0.19	0.26	1.00	0.07
Sharpe Ratio (30-Day U.S. T-Bill)	0.61	0.25	-0.07	-0.10
Sortino Ratio (30-Day U.S. T-Bill)	0.62	0.35	-0.10	-0.16
Value of $1,000	$2,309	$1,799	$630	$395
% Positive Months	71.7%	55.8%	53.3%	48.3%
Max Drawdown	-26.3%	-48.5%	-76.0%	-87.2%

Source: Bloomberg, BlackGold. As of 12/31/17

Midstream Credit is Senior in the Capital Structure to MLP Equities

The primary structural advantage of investing in midstream credit is seniority in the capital structure which insulates credit investors from distribution/dividend cut risk in a prolonged low commodity environment. In fact, distribution/dividend cuts are almost always credit-positive events for bondholders as the company retains more cash flow, and minimizes balance sheet burden.



Source: Bloomberg, BlackGold. As of 12/31/17

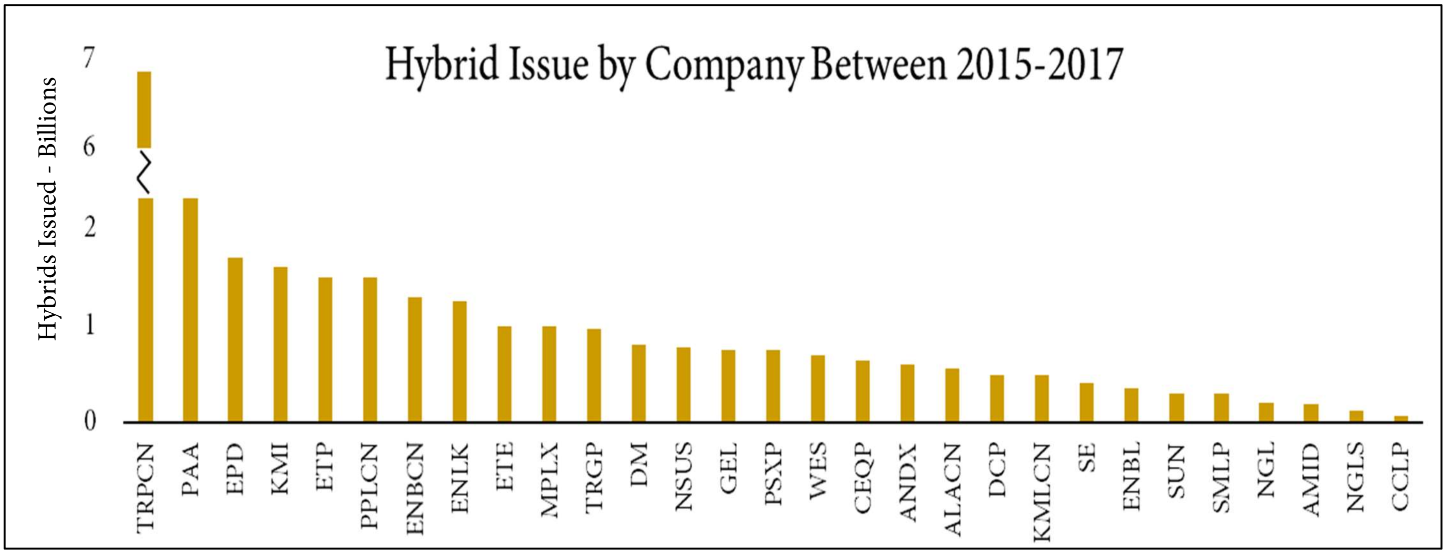
Midstream sector stress led to stretched balance sheets and tighter distribution coverage as earnings and cash flow eroded. As a result, companies continue to cut distributions or engage in stealth cuts through "simplification" transactions. The table above and chart below update "simplification" transactions since July 1, 2017.

Select IDR Restructuring & Consolidation Transactions Since July 1, 2017

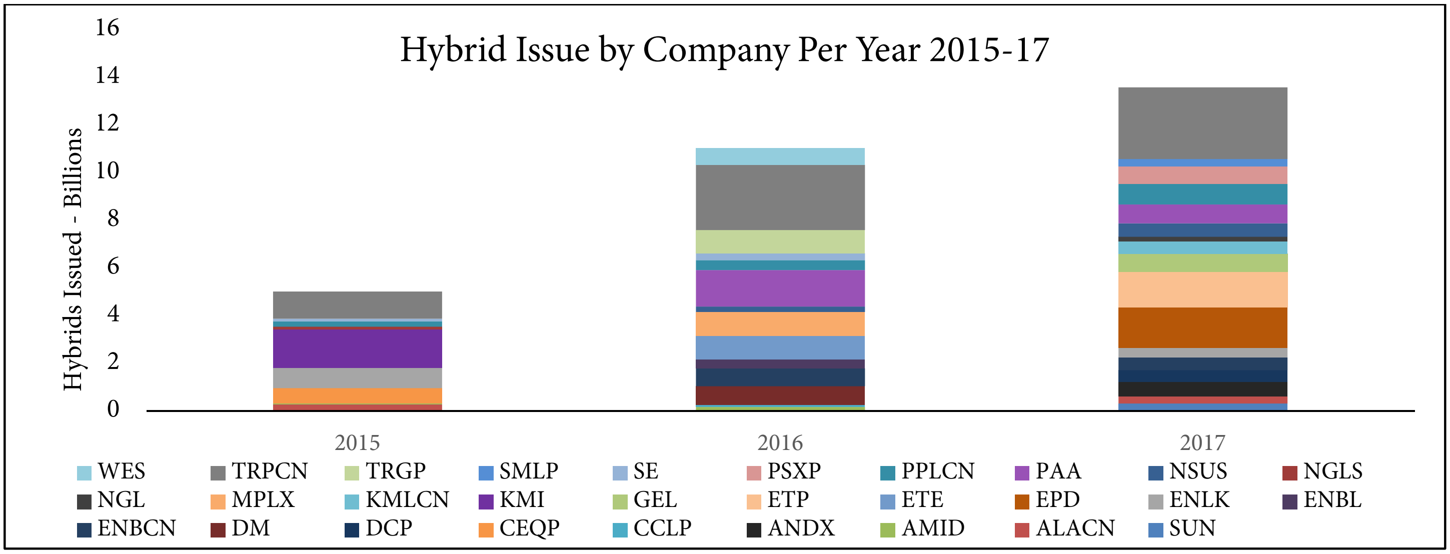
Announced	Acquirer	Target	Description	Stealth Cut
Aug-17	Andeavor Logistics LP (ANDX)	Andeavor Logistics GP, LLC (Owned by ANDV)	MLP units in exchange for removal of IDRs	No
Oct-17	Holly Energy Partners (HEP)	HEP Logistics Holdings LP (Owned by HFC)	MLP units in exchange for removal of IDRs	No
Dec-17	MPLX LP (MPLX)	MPLX GP LLC (Owned by MPC)	MLP units in exchange for removal of IDRs	No
Dec-17	Spectra Energy Partners (SEP)	Spectra Energy Partners GP (Owned by Enbridge)	MLP units in exchange for removal of IDRs	No
Jan-18	Archrock Inc (AROC)	APLP (Units not already owned by AROC)	GP acquires MLP	Yes (-40%)

Source: Bloomberg and Company Reports

Capital discipline and self-funding are becoming the norm as too many midstream companies are over-levered and can no longer rely on equity markets to fund growth. Poor equity returns, and high yields make equity expensive, while additional debt for a leveraged sector is not the solution. The issuance of preferred securities to close the midstream sector's funding gap has become popular as these securities are attractive to both management teams and lenders since rating agencies give companies partial equity treatment for preferred equity. Therefore, it is junior to debt and distributions are paid after debt service. ***This has enabled companies to issue debt-like securities without jeopardizing credit ratings, a positive for bonds and often a negative for common equity/units.***



Source: Bloomberg, BlackGold. As of 12/31/17



Source: Bloomberg, BlackGold. As of 12/31/17

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