CRUDE OIL IMPACT ON MLPs AND ENERGY RENAISSANCE

EDGE is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

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Background:

The second half of 2014 has been marked by a period of sharply lower crude oil prices. In the five months from June 30, US crude oil spot prices have fallen 37% (see table below). This weakness has spilled over in varying degrees to gasoline, exploration and production (E&P) and oil service stocks, natural gas, and to a lesser extent, master limited partnerships (MLPs).

Benchmark/Commodity	June 30-Nov. 30	Sept. 30-Nov. 30
Gasoline (US)	-38.1%	-26.4%
Oil & Gas Exploration ETF (XOP)	-37.8%	-26.8%
Crude Oil (WTI)	-37.2%	-27.4%
Oil Services ETF (OIH)	-34.0%	-23.1%
Natural Gas (Henry Hub)	-8.4%	-0.8%
Alerian MLP Index	-4.5%	-7.1%

Source: Bloomberg

Theories explaining the fall in prices range from defense of market share by OPEC producers (namely Saudi Arabia), to geopolitical conspiracy theories, to old-fashioned supply-demand imbalances. What is known is that OPEC has elected not to cut production, even in the face of increasing US production and prices that are lower than what is needed to balance the national budgets of many of the cartel's members. While we are unable to offer definitive conclusions on the true drivers of the fall in prices- or moves in future prices- we do think it is helpful to provide an update on the fundamental outlook for midstream energy MLPs and companies within the energy value chain commonly referred to as the "Energy Renaissance".

Edge Implementation:

We identified these two investment opportunities as attractive relative to more traditional E&P or oil and gas service firms due to their lower sensitivity to underlying commodity prices and secular

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growth potential. Both sectors benefit from higher production and consumption volume, the continued build-out of infrastructure to support the US production boom, and the supply of abundant and affordable oil and gas in the US. While both MLPs and the Renaissance portfolio have declined since oil prices began their slide at the end of June, the magnitude of their decline has been far less than that of the commodity. From June 30- November 30, US crude oil spot prices fell 37%, but the Alerian MLP index fell just 4.5%. Our investments in the energy value chain fell 13.7% using the Cushing Energy Renaissance Fund as a proxy. Steep declines in oil and natural gas are not unprecedented (even excluding 2008, the average of the last 12 oil corrections was -29%), and it is common to see an over-reaction in the prices of related equities as portfolio managers often sell first and ask question later in the name of "risk management". Below we provide an update on the fundamentals and risks in our energy-related investments.

Fundamental Outlook- MLPs:

Midstream energy MLPs have fared relatively well over the last five months. These companies are the "toll roads" of the energy business. It is important to note that oil-related midstream energy MLPs are just one sector of a diverse MLP universe that also includes natural gas, natural gas liquids (NGLs), propane, refining, and other sub-sectors. Over the long-term, the price of a commodity is less important to midstream MLPs than the volume of oil, gas, etc that is moved through pipelines, stored in facilities, or distributed to retailers. Thus we expect changes in oil prices to have only a moderate impact on MLP fundamentals.

MLPs also benefit from an attractive distribution yield which adds to their defensive qualities. In recent years, the growth rate of distributions for the Alerian index has accelerated from 3-5% to 7-9% annually, supported by increased production and the need for more infrastructure to support US gas production. The growth rate of distributions is a function of both volume growth (driven by increased production, demand and new projects) and price increases (contractual increases that are negotiated in advance and often inflation-based). Investment and CAPEX decisions are made based on long-term price and demand projections, and companies rarely break ground on new projects until they receive commitments from customers. We believe that both oil and natural gas prices would have to fall further from current levels and remain depressed for a period of 1-2 years before there is a meaningful impact to distribution growth.

As a group, MLPs have done a good job of strengthening balance sheets, converting floating rate debt to fixed, and growing cash flows. The result is that their distributions are well-covered relative to history. Because distributions are well-covered, even a period of sustained lower commodity prices is unlikely to result in distribution cuts, outside of marginal firms.

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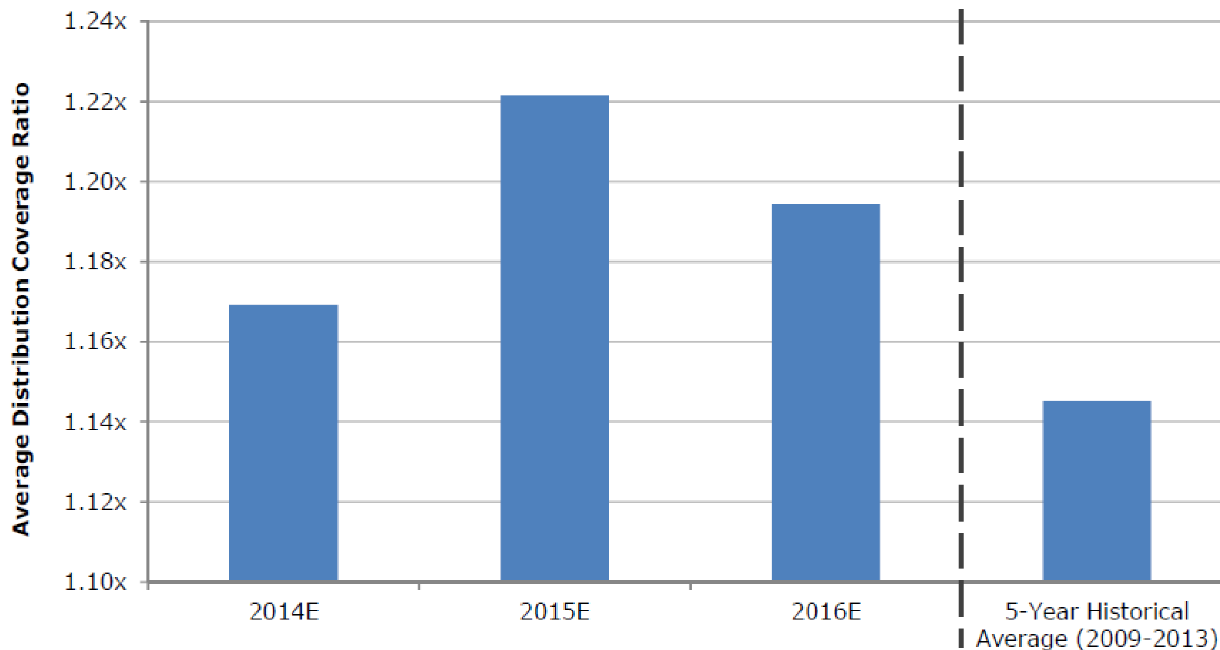

Outside of short-term price volatility, the primary risk that we identify is a re-rating of the valuation assigned to MLPs due to expectations of lower future growth. MLP valuations (similar to US equities) have traded up to or above the high end of historical ranges (depending on which valuation measure is used). Drivers of this increase in valuation include strong underlying fundamentals, investor desire for higher yield, and growing acceptance of the asset class.

Our preferred estimate of forward returns for MLPs is the current distribution yield plus the distribution growth rate. The index currently yields 5.8%, and distributions have grown 7% annually over the last 3 years. Even assuming a slowdown in growth, MLP total returns should average 8-10% over the next 3-5 years (5% yield, plus 3-5% distribution growth rate) which is inline or above our expectations for US equities. Note these are index figures. Our active managers tend to favor higher growing MLPs that are expected to have a higher total return than the broad index.

Fundamental Outlook- Energy Renaissance:

The fundamentals for companies involved in the energy Renaissance are more nuanced, due to the varied nature of their businesses. The energy Renaissance universe includes businesses that are as diverse as oil and gas E&P, oil and gas services, transportation, industrials, petrochemicals, specialty chemicals, manufacturing, and engineering and construction firms. Some of these industries, such as E&P and oil service companies are directly tied to the price of oil and gas. At the same time, other industries such as chemical and industrial companies benefit from abundant

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supply of US oil and natural gas at attractive prices because these commodities are among their largest cost inputs.

We believe that the appropriate way to view these companies in aggregate is as a portfolio of cyclical, US-based companies that are leveraged to US economic growth and which benefit from the increase in US oil & gas production. The 37% decline in oil makes the most commodity price-dependent industries less attractive, but even within this universe, opportunities remain for low-cost producers in the most attractive US onshore basins and specialty service companies who can take market share. At the same time, however, companies such as Dow Chemical- whose business has minimal sensitivity to oil prices- sold off 6% on November 28th as oil fell 10% and the S&P declined just 0.3%. There are multiple similar examples of indiscriminate selling that has resulted from falling oil prices. Based on current valuations relative to the S&P 500, the Renaissance portfolio trades at a 3% discount on trailing earnings and a 5% discount to the next 12 month earnings.

	Trailing 12 Months P/E Ratio	Next 12 Months P/E Ratio	Long-Term EPS Growth Est.	Dividend Yield
S&P 500	18.2	17.1	9.3%	1.9%
Cushing Energy Renaissance	17.6	16.2	12.6%	2.5%
Difference (Relative to S&P)	***-3.3%***	***-5.3%***	***35.5%***	***31.6%***

Source: Bloomberg, excludes negative earnings

These discounts are more meaningful when combined with a projected earnings growth rate that is 35% higher than the market. We would expect a portfolio of companies that is leveraged to US growth- currently the fastest growing developed economy in the world- to trade at a premium to the market, not a discount. The biggest risk to these names is a downward adjustment to the long-term growth rate caused by a multi-year period of low crude prices which would constrain output. Given strong overall fundamentals and the diversified profit drivers of the companies in this universe, we view a meaningful cut in growth as unlikely.

Conclusion:

To summarize, dramatic swings in the price of a high-profile, globally-traded commodity such as oil have had significant short-term impact on the prices of our favored investments in MLPs and the broad energy value chain. In the long-term, however, fundamentals win out.

- Over time, investors will look past commodity price volatility and evaluate companies on underlying fundamentals which have not materially changed
- The most attractive opportunities in energy are those which are less price sensitive and more demand/volume sensitive (MLPs and Energy Renaissance)

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- Not all companies are equally well-positioned: valuation, growth rates, assets, management teams, and product demand all matter
- We prefer active management to separate winners and losers

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