UPDATE ON MLPs AND THE CURRENT DISLOCATION

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:

Since the inception of Edge we have been investors in infrastructure, including energy infrastructure master limited partnerships (MLPs) with a specific focus on midstream. The weakness in crude oil spot prices since the second half of 2014 first impacted energy exploration and production (E&P) and oil service stocks, then natural gas, and more recently MLPs. As of August 10, MLPs (as measured by the Alerian MLP Index) are down 20% for the year and 30% from their peak nearly 12 months ago. In just the first 10 trading days of August, MLPs are already down 6%, representing 30% of the total return loss this year and are close to matching the 8% decline in June. The selloff has been wide-spread across all types of MLP business models, including midstream and infrastructure, the subsector of the MLP market we have been recommending since inception.

After the 2014 broad decline in energy prices, we recommended that investors maintain their midstream MLP exposure. The attractive fee-based revenue model, combined with high yield and distribution growth presented what we believed to be stable exposure to the US energy renaissance story. In addition, we also recommended that investors look to energy high-yield credit as another investment to generate cash flow from a cheapened asset class. While our energy credit recommendations continue to be profitable, midstream MLPs – broadly speaking – have not held up and have been more sensitive to commodity prices than history would suggest. While we are unable to offer definitive conclusions on the future moves in commodity prices, we want to provide an update on MLP valuations, fundamentals, and our view of current risks.

FUNDAMENTALS:

Because Edge has specifically recommended midstream MLPs we will focus our analysis on fee-based, recurring revenue companies that own and operate energy pipelines. It is important to understand that mid-stream MLPs are the "toll roads" of the energy business, often located in monopolistic footprints. 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. Revenue for midstream MLPs is tied to inelastic energy demand and offers inflation escalators through mandated tariff increases. Because they are capital-intensive businesses with physical, long-lived assets, a core risk to their business model is the fact they require continuous capital infusions through debt and equity. In summary, growth of their fee-based business model is dependent on rising volumes, tariff increases, stable financing,

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new projects, and secure long-term contracts with reliable counterparties. It is these dependencies that the market is currently re-evaluating.

Let's first focus on the fundamentals and future guidance communicated during second-quarter earnings announcements. Thus far in 2015, not a single midstream MLP has reduced its distribution in this environment (and only 5% of midstream MLPs reduced or suspended their distribution during the financial crisis) - highlighting the durability of the model. Despite the challenging environment, the median MLP distribution to date has increased 5%. Although a 5% increase in distribution is attractive relative to a utility company, it is lower than what investors have come to expect from MLPs. The shift in growth expectations partly explains the recent MLP selloff. As an example of the market's sensitivity, one of the largest midstream MLPs, Plains All American, announced that the company's 2016 distribution could be flat with 2015 if the current commodity environment continues. The stock price declined 11% on the day that announcement was made. We believe the future growth rate will be lower; however, we expect high-quality midstream MLPs will continue to support distributions at or above current levels. Providing one additional example, Enterprise Products Partners (the largest MLP by marketcap) announced a 5.6% increase in its most recent distribution, increasing the yield to just under 6%. Despite the yield and growth rate, the stock continues to be weak and is down nearly 30% year to date. In short, many quality midstream companies are performing well but clearly not up to the expectations of many investors.

Supply conditions also appear to be supportive of MLP midstream fundamentals. Again, it is critical for investors to make the distinction between primarily fee-based MLPs and other types of MLPs. Volumes for midstream MLPs remain steady and have increased for most. Larger midstream MLPs, such as Plains All American, Enterprise Products Partners, and Magellan Midstream, are all reporting supply growth, whether it be crude oil, refined product, or natural gas liquids – even in the current commodity environment. Despite the decline in crude prices, quality, well-financed, upstream producers continue to benefit from declining costs and improving rig efficiencies, both lowering the cost to drill and improving rig economics. The relationship between pipeline operator and driller introduces the concept of counter-party risk. We expect sustained commodity weakness to financially stress the exploration and production community, especially as forward hedges expire, but remind investors that the quality midstream MLPs are aligned with well-funded operators such as Occidental, Exxon, and Anadarko.

As a group, midstream MLPs have done a great job strengthening balance sheets especially with the conversion of floating-rate debt to fixed-rate debt. On average, 80% of debt is now fixed. While higher interest rates will impact margins, especially for new projects, and therefore future distribution growth, we argue that MLP balance sheets are in sound shape and protected from higher interest rates because of the debt extension that has occurred. Investors should also take comfort that at current yield levels, the average midstream MLP with a yield of 7% has a 4.4% spread versus the US 10-year Treasury.

RISKS AND OUTLOOK:

Despite reported results suggesting that supply growth remains sound and that distributions will be at or above recent levels for many midstream MLPs, the current energy environment including MLPs remains fragile. Crude volatility remains elevated and is likely to drive near-term performance for most if not all, energy-related investments including MLPs. For many companies, fundamentals and financial markets are likely to remain detached through the second half of 2015.

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As markets seek equilibrium, investors (including Edge) are anxious to identify opportunities to generate attractive risk-adjusted returns. As we continue to evaluate energy opportunities, we want to highlight a few risk factors that we are monitoring:

- Valuations

  Investors incorporate yield (both relative and absolute), price to distributable cash flow, and EV to adjusted EBITDA to evaluate MLP valuations. Yield-based metrics suggest that MLPs are valued at or near 2009 levels; however, other metrics such as EV / adjusted EBITDA suggest valuations are at 2012 levels. While we believe the valuation correction has been significant, we cannot dismiss the potential for additional valuation contraction – largely driven by oil prices breaching current levels ($43 WTI at time of print). This is not our base case but MLP prices remain sensitive to commodity price swings in the near-term.

- Declining production

  We are surprised at the resilience of US energy producers in the face of a 50% collapse in prices since last summer. We contend that energy service costs have also fallen significantly, thereby improving well economics, however, we believe many smaller producers are operating at levels that are not sustainable. Lower for longer is a meaningful threat to these producers and could dampen supply and MLP throughput volumes for some midstream operators. Timeliness of current hedges will also impact operations. We do not know the price at which producers will be forced to curtail crude output. For these reasons, we continue to stand-by our recommendation of high-quality, midstream MLPs with strong counter-party relationships.

- Credit conditions

  As we mentioned earlier, access to attractively priced credit is essential for producers and the broad MLP universe that relies on future growth to support higher distributions. Lower rates and frothy liquidity have benefited all segments of the energy complex. MLPs with lower return-on-capital metrics will be most exposed to higher interest rates which we assume will materialize later this year as the Fed lifts short-term rates.

- Correlations

  While massive commodity price declines over the past year are commonly cited as the culprit of MLP weakness, we continue to believe this is more headline risk than a longer term shift in fundamentals. In analyzing the relationship between crude oil and natural gas prices and MLPs (as measured by the Alerian MLP Index) over time, we note that while the correlation between the price of natural gas and the index has almost doubled over the last year (to a 0.20 coefficient), it still does not represent a significantly strong relationship, and that the correlation between the price of crude oil and MLPs has remained effectively unchanged (at 0.45) over different intervals during the last five years. Taking a step further to examine if the relationship has strengthened during various energy commodity sell-offs over this time period, the data again reveals that the link between crude oil and MLPs has remained fairly unchanged. The change in correlation between natural gas and the index has been quite variable (from 0 in the large price drop last year to modestly positive in the decline this year). This analysis supports our belief that crude and natural gas price swings

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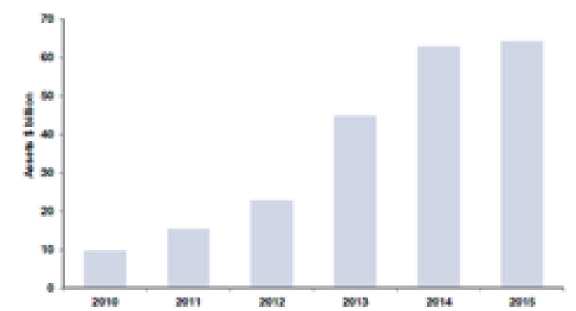
have only a minor impact to long-term fundamentals of midstream MLPs. Over shorter timeframes, this relationship can be stronger.

- Flows

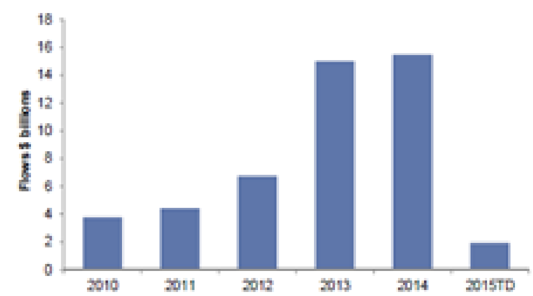
  Since the MLP universe is small relative to other markets, the impact of fund flows through index products as well as mutual funds is an important driver of short term liquidity and performance. On a year-to-date basis, outflows have certainly increased as the performance of MLP's deteriorated; however, it cannot be blamed as a primary contributor of recent negative performance. July and August have seen negative mutual fund flows while the full year 2015 still has net inflows. Likewise, trading volumes and institutional sized block trades have escalated through the summer. However, trading volume is still 30% below 4Q2014 levels and block trades in July are nearly one-third of the number seen last December. Based on the current data, technical trading risks remain that could further impact prices if the heightened levels of selling last seen at the end of 2014 resurface. The charts below summarize annual asset data and annual fund flows for MLP funds over a longer period of time to put in context the impact of capital flows to the sector.

Exhibit 10: Annual Assets
Asset Data in Billions $US



Source: Simfund

Exhibit 13: Annual Flows - 2010 - May 2015



Source: Simfund

Maximum pessimism is near. Even considering the risk of another 1-2 years of persistent weak energy prices, midstream MLP's have priced in a significant dose of negativity. Downside risks remain; but we encourage investors to consider the following:

- With the selloff, midstream MLPs have a blended yield approaching 7% which is at or near 2009 levels. The list of 2015 available investment opportunities priced at or near 2009 level is rare. We also remind taxable investors that MLP distributions (for some investors) could be tax-deferred.

- Despite a lowered distribution growth outlook, we still expect positive distribution growth in 2015 and 2016 for midstream MLPs.

- Midstream MLPs offer investor access to assets that we would deem "irreplaceable". When we consider the asset base of Magellan Midstream or Enterprise Products Partners, we are reminded that these companies are supplying energy to the country and in the case of exported NGLs, providing energy to the world. These assets are long-lived, are vital to the US economy, and can't be replicated.

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- The long-term US energy renaissance opportunity remains sound. The US continues to serve an increasingly important role in exporting cheap fuel sources such as Ethane and Propane to other parts of the world. Given the development of new efficiencies enabling even cheaper extraction, and the stability of US producers relative to our foreign counterparts, we believe this trend will continue.