U.S. MLPs

COMMENTARY Q3 2016
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MARKET OVERVIEW

For the third quarter of 2016, master limited partnerships (MLPs), as measured by the Alerian MLP Index (AMZ), were down 0.8% on a price basis but up 1.1% on a total return basis, or including the impact of distributions. As measured by the Alerian MLP Infrastructure Index (AMZI), a more concentrated measure of midstream MLPs, the sector increased 0.0% on a price basis and 1.9% on a total return basis. For context, the broader market, as measured by the S&P 500, gained 3.3% on a price basis and 3.9% on a total return basis.

Though few macro events appeared to exert meaningful influence on the sector over the period, midstream regulatory oversight garnered headlines late in the quarter due to unprecedented Federal intervention in established permitting procedures. On September 9, 2016 a federal judge rejected a request by the Standing Rock Sioux Tribe to block construction on a 40 mile segment (or 3%) of the Dakota Access Pipeline ("DAPL") project that straddles the Missouri River, near Lake Oahe, and reaffirmed the U.S. Army Corps of Engineers' previous decision to permit construction. Despite the judge's ruling, the Department of Justice, Department of the Army, and Department of Interior later directed the U.S. Army Corps of Engineers to determine "whether it will need to reconsider any of its previous decisions" and called on Energy Transfer to voluntarily halt construction. While this "headline risk" did weigh on Energy Transfer Partners' (ETP) unit price in late September, the matter also led some market participants to reevaluate in-service dates for other longer-lead time, multi-state infrastructure projects. While any long-term implications are difficult to gauge at this point, increased regulatory inconsistency and uncertainty would likely ultimately benefit existing infrastructure.

Second quarter operating performance was reported during the period and was, on average, better than expectations with EBITDA, or Earnings Before Interest, Taxes, Depreciation and Amortization, coming in 4.9% above consensus estimates and 2.4% lower than the prior quarter's results. Further, 83 midstream entities announced distributions for the quarter, including 32 distribution increases, 49 distributions that were unchanged from the first quarter, and two distribution reductions.

Approximately $2.3 billion of new MLP equity was issued over the quarter via marketed transactions, including the first midstream initial public offering since June 2015. We estimate an additional $1.5 to $2.5 billion was issued through "at-the-market" programs in which primary units trade into the market anonymously throughout the normal trading day. An additional $5.5 billion of capital was raised via the debt capital markets. We estimate MLP-focused investment vehicles, including closed-end funds, open-end funds and index-linked products, experienced approximately $1.5 billion of inflows over the quarter.

MLP capital investment over the quarter included approximately $2 billion of announced asset acquisitions and we estimate $4 to $5 billion of organic capital spending. MLP capital spending plans continue to benefit from a robust slate of growth projects needed to accommodate localized capacity constraints, demand-pull from new industrial projects, and export opportunities. While growth rates have moderated, we continue to expect infrastructure investment to endure as energy infrastructure demand remains significant, particularly in premier basins such as the Permian, Midcontinent, and Appalachia.

West Texas Intermediate (WTI) crude oil priced at the Cushing hub ended the quarter at $48.24 per barrel, flat from the end of the second quarter but 7% higher than the year-ago period. Domestically, most regional and quality crude pricing differentials were little changed. The differential between crude oil priced in Clearbrook, MN (a proxy for Bakken barrels) and WTI reverted to a discount after exhibiting a rare premium during the second quarter but remained at tighter than normal levels. The spread between Brent crude, a proxy for international crude prices, and WTI ended the quarter near the $1 per barrel range, continuing a spread trend extant over much of the past year but much tighter than the $3 to $8 per barrel average of 2013 to 2015.

Henry Hub natural gas spot prices ended the quarter at $2.84 per million British thermal units (MMbtu), a decline of 2% from the end of the second quarter but 15% higher than the year ago period. Natural gas priced in certain areas of Appalachia weakened further relative to benchmark pricing over the period as incremental capacity from new pipelines has yet to sufficiently debottleneck the region and regional storage levels were approaching limits. For example, natural gas pricing near Leidy, PA exited the quarter at approximately $0.41 per MMbtu, an 86% discount compared to Henry Hub.

Natural gas liquids (NGL) priced at Mont Belvieu ended the quarter at $22.49 per barrel, up 6% from the end of the second quarter and 15% higher than the year-ago period. Frac spreads, a measure of natural gas processing economics, improved over the quarter to settle at $0.28 per gallon, up 15% from the end of the second quarter and approximately 16% higher than the year-ago period. Generally, the greater the frac spread, the greater the incentive for producers to seek natural gas processing capacity.

Notably the crude oil and natural gas futures curves remained mostly contango in structure (in which future prices are higher than near-term prices). Generally, for any commodity, a contango futures market is supportive of storage providers as traders are able to enter into futures contracts to sell volumes in the future at the higher price while hedging this commitment with volumes held in storage.

Please note, though we routinely review the pricing environments for the major energy commodities in our commentaries, we do so primarily to provide investors a more nuanced understanding of the broader energy markets. However, we choose to seek to exploit the logistical needs surrounding these products primarily through energy infrastructure MLPs that we believe are not overly exposed to changes in these prices.

Over the quarter, the ten-year Treasury yield rose 12 basis points to end at 1.60%. The MLP yield spread at quarter-end, as measured by the implied yield of the AMZ index relative to the 10-year Treasury bond, narrowed by 19 basis points to 5.57%. The long-term average (2000-3Q2016, ex-financial crisis) spread is 3.30%, which continues to suggest that 10-year treasury rates could increase materially before this spread approached its historical average. At period-end, the AMZ's indicated yield was 7.16%.

Over the third quarter of 2016, REITs and utilities posted total return losses of -1.4% and -6.0%, respectively, versus the AMZ's 1.1% gain. Price weakness for these yield-oriented sectors likely reflects the modest negative movements in interest rates over the period. Although MLPs are often associated with interest rates, given the yield-oriented return component, the energy markets continued to exert a stronger influence on midstream equities over the period.

We believe U.S.-sourced hydrocarbons will play a critical role in meeting incremental global demand going forward and will provide for a sustained period of rising U.S. production that could equal or exceed the production growth achieved over the past five years. Since the beginning of the energy renaissance, North American producers have meaningfully improved their drilling efficiencies and economics through oil field service cost rationalization and technological gains. We believe the resumption of U.S.-sourced production growth will enable midstream business, and distribution growth, prospects to regain greater visibility over time which could help lift sector valuation metrics to historical levels. As a result, we believe the midstream asset class offers attractive total return potential comprised of the potential for price appreciation as well as a stable or growing distribution stream. .

SECTOR COMMENTARY

During a volatile quarter for crude, the Alerian MLP Index (AMZ) traded largely flat, returning 0.8% during the period. Similarly, most sub-sectors were flat as well, with Natural Gas and Petroleum Pipelines both returning 1.0%. However non-core groups saw more varied performance, with Coal up 74% and Propane down 13.2% during the quarter; both driven by dramatic performance of a few individual constituents.

OUTPERFORMERS

Coal partnerships lead the broader group as higher coal prices helped to mitigate business risk fears. Coal pricing was in part aided by improved natural gas pricing which could encourage gas-to-coal switching for power generation.

Diversified partnerships again produced strong performance during the quarter, with the majority of partnerships in the green. The group was led again primarily by Williams and Energy Transfer as the respective entities executed on standalone business objectives following the dissolution of the merger agreement.

UNDERPERFORMERS

Propane partnerships produced negative returns during the quarter, with the group down 13.2%. The group was led lower by Ferrellgas, who announced a potential distribution cut. The group generally has been under pressure as investors appeared to rotate out of the subsector in favor of more traditional midstream names and as rising propane prices could result in some margin pressure in future quarters

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CONTRIBUTORS

Targa Resources Corp (TRGP)

- TRGP shares outperformed as improved energy market sentiment appeared to calm investor anxiety surrounding the volume outlook for the partnership's gathering and processing areas of operation. Positive Permian basin producer commentary during the period appeared to further buoy investor interest in midstream entities with significant exposure to the basin.
- Consistent with guidance for 2016, volumes across TRGP's extensive gathering and processing footprint have been flat or better compared to 2015.

EnLink Midstream Partners, LP (NYSE: ENLK)

- ENLK shares outperformed over the quarter as improved energy market sentiment appeared to calm investor anxiety surrounding the volume outlook for the partnership's gathering and processing areas of operation.
- Further, ENLK announced a strategic joint venture with Natural Gas Partners, an energy-focused private equity firm, to jointly expand the partnership's Lobo system in the Delaware basin, a project anchored by long-term producer commitments.

Enbridge Energy Partners, LP (NYSE: EEP)

- EEP outperformed over the quarter due to a better than expected operating performance report and as energy market sentiment generally improved. In addition, EEP's sponsor, Enbridge Inc. (ENB), announced plans to acquire Spectra Energy Corp. (NYSE: SE), which may further strengthen its sponsor's financial and strategic position.
- EEP benefits from a large network of crude oil pipelines in the U.S. and Canada, most of which benefit from strong contractual cash flow regardless of commodity prices or throughput volumes. Further, ENB remains a supportive sponsor and continues to reaffirm its intent to provide financial assistance and strategic backing.

DETRACTORS

Enterprise Products Partners, LP (EPD)

- EPD underperformed during the quarter as improved market sentiment appeared to result in some investment rotation from lower-risk entities into higher risk entities. EPD units experienced some additional volatility following disclosure that EPD had expressed interest in exploring an acquisition of The Williams Companies (WMB). EPD has subsequently indicated that it has withdrawn its indication of interest in acquiring WMB.

- EPD has over $5 billion of mostly fee-based projects currently under construction that are expected to be placed into service over the next three years. The partnership benefits from a solid balance sheet, largely fee-based cash flows, and strong distribution coverage.

Magellan Midstream Partners (MMP)

- MMP units underperformed over the quarter as improved market sentiment appeared to result in some investment rotation from lower-risk entities into higher risk entities. MMP units have performed well over the energy cycle due to the partnership's fee-based assets that include Permian crude pipelines with long-term contracts and one of the largest refined product pipeline systems in the country.
- During the period, MMP announced a significant new marine terminal project to handle refined products for a customer under a long-term contract.

Martin Midstrean Partners (MMLP)

- MMLP units underperformed over the period after reported operational results missed expectations increasing investor anxiety over distribution sustainability.
- Despite the potential for a distribution adjustment, the partnership's set of diverse business segments with a focus on demand-based customers bodes well for long-term operating resiliency.

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