MLP INVESTMENT REVIEW AND OUTLOOK

September 30, 2023

Index Total Returns

Source: NBW Capital

	Three Months Ended 9/30/2023	Nine Months Ended 9/30/2023
Alerian Total Return	9.90%	20.56%
S&P 500	-3.27%	13.07%
Russell 2000	-5.13%	2.54%
Bloomberg U.S. Aggregate Bond	-3.23%	-1.21%
Alerian U.S. Midstream Energy	6.75%	13.85%

*September 30, 2023 quarter end point in time data. The above returns are industry index benchmark returns, your actual portfolio return can be located on the "Performance Overview" page of your reporting package.

Yields

Source: Bloomberg

	Ended 9/30/2023
Alerian Total Return	8.08%
Ten-Year U.S. Treasury	4.57%
One-Year U.S. Treasury	5.46%
Bloomberg U.S. Aggregate Bond	5.39%
S&P 500	1.74%
Dow Jones REIT	4.68%

Market Summary

Master Limited Partnerships ("MLPs"), as measured by the Alerian Total Return Index ("MLP Index"), had a positive return of 9.90% during the third quarter of 2023. For the year-to-date period ending September 30, 2023, the total return was 20.56%. NBW Capital's MLP total returns performed in line with the MLP Index during the third quarter, but trailed the MLP Index year-to-date due in part to the underperformance of C-Corp midstream holdings, which significantly trailed their MLP peers. We view this as a transitory event and anticipate a return to index beating results in line with our historical record.

C-Corp midstream companies have become a bigger part of the MLP investment landscape over the last few years. Although the MLP Index remains the industry's standard market benchmark, the Alerian organization has developed a sub-index which includes C-Corps. The sub-index is called the Alerian U.S. Midstream Energy Index. We will include this index in our client reporting going forward for information purposes.

Review

MLPs have performed very well so far in 2023. This is especially true given the headwinds they faced in the form of lower natural gas prices, interest rate pressures and fears of economic weakness. The positive 20.56% year-to-date total return for MLPs compares favorably to both commodity and income-oriented equity peers, with the S&P 500 energy stocks up 5.99% and the S&P 500 utility stocks down 14.41%. This divergence does not surprise us as MLPs have important differentiators from both energy and utility stocks.

As we have written many times in the past, the MLP fee-based, long-term contracted revenue business model is volume based. Commodity prices have little direct impact on revenues. These long-term contracts also include inflation escalators that allow MLPs to recoup, with annual caps, a significant part of inflation. In a year like we have had so far in 2023, MLPs have flourished. Slow economic growth, sticky 4% plus inflation, and rising interest rates have not impeded MLPs from growing cash flows at a rate slightly better than was expected at the beginning of 2023.

Finally, higher interest rates have not exerted a meaningful negative impact on MLPs as the industry has been reducing balance sheet leverage for over three years. During this time, much of the remaining debt had been termed out to extend maturities and fix the interest rate, making the companies less vulnerable to the rising rate environment.

Outlook

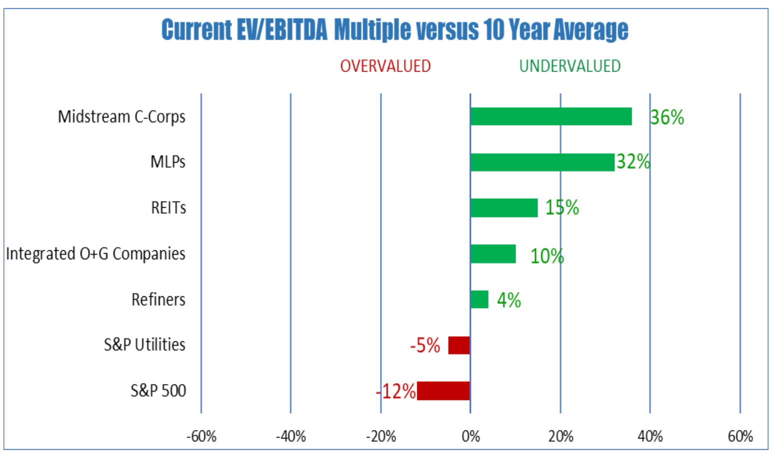
MLPs, as measured by the MLP Index, have quietly enjoyed a three and one-half year period of exceptional total return performance as the table below summarizes:

	3/31/2020 through 9/30/2023
Alerian Total Return Index (MLPs)	268.49%
S&P 500 Index (Stocks)	75.49%
Bloomberg U.S. Aggregate Index (Bonds)	-11.81%
Oil	343.31%
Natural Gas	78.60%

Has the opportunity in MLPs already occurred? Is the group now fairly valued? How can this historic bull run continue?

Fair questions for sure, but for numerous reasons discussed below, we continue to believe MLPs have compelling investment appeal from present levels.

MLP returns derive from three sources: dividend/distribution yield, dividend/distribution growth and valuation changes. At present, MLP distribution yields are 8.08% with a five-year forecasted distribution growth of 3.70%. These two factors alone lead to a very visible 11.78% annual rate of return expectation over the next few years. This nearly 12% annual total return expectation will be augmented in our opinion by some degree of valuation expansion whereby MLPs trade up to their historic median valuation of cash flow. As the chart below shows, MLPs presently exhibit a very distinct undervaluation versus their historic valuation norms. MLPs trade today at over a 30% discount to their historic median valuations. Key questions are how much of this valuation gap can be closed and over what time period. If we assume a ten-year linear recapture, MLP annual total returns of 11.78% mentioned above would increment to 15.38%. The closure of this valuation gap will, in all likelihood, not be linear nor close gradually. Our opinion is that the valuation gap closes at some point over the next three to five years. In sum, a five-year 15% annual return expectation for MLPs is very reasonable in our view.



Source: Wells Fargo Securities, LLC Data as of 9/5/2023

During the third quarter of 2023, bond yields, as measured by the 10-year U.S. Treasury, rose to 4.57% from their level of 3.84% three months ago. This generated much discussion around the negative impact on MLPs of higher interest rates. Interestingly, long-term historical MLP returns show essentially no correlation with interest rates. That was certainly true during the first nine months of 2023, and we expect it to continue should interest rates rise further in the future.

Why does this negative correlation between MLP price performance and interest rates exist? There are a number of reasons. MLPs have business models that generate contracted, fee for service revenues. These contracts usually have inflation escalators in fees charged. As inflation and interest rates rise, typically oil and natural gas prices rise as well. This does not directly benefit MLPs as their revenues generally are not based on commodity prices. However, higher oil and gas prices do stimulate energy production and volumes do matter to MLPs as their revenues benefit from volumes handled. Further, in general, MLPs over the last few years have extended the maturity structure of their debt and done so at low fixed rates of interest. Very little MLP debt is floating rate and subject to adverse rises in interest expense as interest rates increase.

Besides interest rates, another related topic of much discussion in the third quarter of 2023 was the idea that MLPs may now be closer to fair value given the historic relationship (i.e., spread) between 10-year U.S. Treasury yields and MLP distribution yields. MLP distribution yields have historically exceeded 10-year U.S. Treasury yields by about 3.60% on average. At bull market peaks (2008), this difference has shrunk to zero and at bear market troughs well over 12%. Today, the MLP yield is 8.08%, which is 3.51% over the 10-year U.S. Treasury yield of 4.57%. By this standard, MLPs may be considered fairly valued.

Further complicating the "spread" relationship between MLP yields and U.S. Treasury yields is the fact that MLPs and their dividend policies today are radically different versus the historical period, which much of the spread relationship is based upon. In short, MLPs today pay out about 50% of their distributable cash flow. Said differently, distributable cash flow covers distributions by 2.0 times. This hefty coverage of dividends compares very favorably to the "skinny" coverage of less than 1.2 times over much of the longer historical period. Dividend safety and dividend growth potential today have to be viewed much more favorably than 10 years ago. Inasmuch as potential dividends and dividend yield could be much higher, the old rules with regard to distribution yields versus treasury yields seem less relevant. So why are MLPs managing their distribution policy so conservatively? It is because they want to fund capital expenditures internally. Collectively, they are unwilling to finance capex externally at what they perceive as very low equity prices. To internally finance capex, you need to use your own cash flow.

A key part of the MLP outperformance of recent years has been the widespread adoption of "capital discipline." Over time, it has transformed the industry whereby today balance sheets have been strengthened through debt repayments, growing and well protected distributions, capital expenditures that are predominantly self-funded, and minimal reliance on capital markets.

Capital budgeting has also improved. Higher return and smaller investment "bolt on" capex is more the norm as it is typically faster to build and commence cash flows. Risk is dramatically reduced vis-a-vis big multi-year projects which have seen investment returns plummet as regulatory requirements have stifled planned completion dates. Numerous delays and large cost overruns have reduced investment returns on new build multi-year construction projects such as Mountain Valley Pipeline and Trans Mountain Pipeline. These two examples have cast a pall over future large scale energy infrastructure development. A corollary to this phenomenon is that existing and operating infrastructure has become more valuable.

Third quarter earnings for MLPs will begin to be announced in late October. Overall, we expect a continuation of the positive trends witnessed during the first six months of 2023. Economic activity and energy demand were both good during the third quarter. Continued growth in pipeline utilization is profit margin positive as is the industry's minimal exposure to the ongoing rise in interest rates. We expect capital budgets to continue to be restrained and focused more on "bolt on" spending that tends to be higher margin and have faster construction time.

During the quarter, three of our holdings were involved in significant acquisitions. Energy Transfer ("ET") acquired Crestwood ("CEQP") in an all-stock acquisition, whereby Energy Transfer issued equity in return for Crestwood stock. Energy Transfer expects the acquisition to be immediately accretive to cash flow on a per unit basis. The assets acquired are complementary to existing Energy Transfer assets in both the Bakken and Permian Basins. Inasmuch as this transaction will boost our already large Energy Transfer position, we have sold Crestwood and invested the proceeds in other attractive MLPs. We believe the net effect on our portfolios will be a further uptick in both expected distribution growth and financial strength.

The second major transaction the portfolio experienced in the third quarter was the acquisition of the private MLP, Meritage Midstream, by Western Midstream ("WES"). Western Midstream is a large portfolio holding which was able to acquire Meritage at the very attractive price of an estimated 5.5 times cash flow. Western Midstream paid cash. This acquisition will be immediately accretive to Western Midstream cash flow and improve its future growth prospects.

These acquisitions are anticipated to close during the fourth quarter.

Lastly, NBW Capital recently published a whitepaper on energy transition from carbon-based sources to greener ones—mainly wind and solar. The article can be accessed on our website or provided upon request. We are enthusiastic about the role MLPs will play in this transition and foresee multiple decades of opportunity for MLPs going forward.

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