NBW CAPITAL LLC

Departing Chaos, Destination Normal

MLPs, as represented by the Alerian Total Return Index, appear to have recently exited an extended bear market. Total return from June 30, 2014 through February 10, 2016 suffered a decline of over 54%. After almost 20 months of declining market values, MLPs finally reached their low point in mid-February of this year. Since February 11, 2016, MLPs have rocketed upward and have generated a jaw dropping return of over 53%. Still, and as a result of compound return dynamics, MLP total returns are cumulatively down almost 30% from their levels in June 2014.*

In trying to understand the bear market that from our perspective ended in mid-February, it is clear that worries about a myriad of risks galvanized selling across the group. This selling pressure ended in mid-February. The magnitude of the advance since then has mitigated the self-reinforcing selling or negative feedback loop that we and others have written about over the course of the bear market decline.

In short, anxious retail investor psychology motivated redemptions from exchange-traded notes, mutual funds, and other co-mingled MLP investment vehicles. The ensuing price weakness from these redemptions created margin calls on leveraged portfolios and attracted short selling pressure from price momentum oriented investment strategies. This in turn reverberated back to retail investors creating even more incremental selling pressure. This "wash, rinse, repeat" cycle was self-perpetuating until the dramatic price reversal of mid-February decisively ended it.

Some of the more prominent worries over the course of the bear market included:

- Lower oil prices negatively impacting customers (i.e. energy companies). Will they be financially able to honor their contracts?
- Contract sanctity questions. Will contracts be renegotiated in bankruptcy proceedings?
- Would lower U.S energy production portend a shortfall in volume transported/processed?
- Would MLP distribution growth slow dramatically or be cut outright?
- Would MLPs be able to finance their growth?

All of these concerns in our view proved to be exaggerated. Lower energy prices did not result in widespread customer bankruptcies. MLP cash flow performance throughout the downturn proved to be resilient and not directly affected by energy prices. Distributions on balance grew over the course of the bear market. To that point, NBW Capital portfolios had median distribution growth rates of over 23% and 21%, respectively, in calendar year 2015 and the first quarter of 2016. Contracts proved to be durable on balance and in rare cases renegotiations providing customer relief in return for lengthier terms and/or increased acreage dedications proved to be revenue and net present value neutral or positive. The "stress test" conditions of this down cycle in energy were severe and mid-stream MLP businesses performed admirably.

*Source: Alerian Total Return Index

As we leave chaotic conditions behind, what does normal look like? Our perspective is that it engenders a return over the next few years to median historic valuation levels. The next few years we feel are likely to be similar to the recovery from the 2008 downturn. We don't anticipate a repeat of the explosive 2009 through 2011 MLP performance that resulted in a cumulative total return of 173%, but we do envision dynamic returns nonetheless over the course of 2016 through 2018 and beyond. MLP distribution growth will likely slow as it did during the early years of the last up cycle. Balance sheets and distribution coverage will be bolstered and capital expenditures will take a back seat to this. Nevertheless, 4% annual growth in distributions for the Alerian Total Return Index seems achievable over the next three years. The table below describes appreciation potential from May 20, 2016 price levels assuming median valuations.

	Current	10 Year Average	% Upside
MLP Yield Spread to 10 Year Treasury*	5.69%	3.36%	44.80%
Price to Distributable Cash Flow	10.5x	11.8x	12.4%
EV to EBITDA	12.4x	11.6x	-6.9%
Average			16.8%
Annualized Over 3 Years			5.3%

*7.53% less 1.84%

Based upon this approach, we feel the next three years and beyond will be rewarding to MLP investors. Annual total returns for MLPs will be driven by their yield, growth of distribution, and an uplift to normal valuation levels. This framework suggests total annualized returns of:

- Yield: 7.5%
- Growth of Distributions: 4.0%
- Valuation Uplift: 5.3%
- Total Potential Annual Return: 16.8%

Normal also means less drama. Contract terms will likely be stronger. Capex plans will likely be more conservative and be made at higher return levels. Cash flow coverage of distributions will be stronger. Balance sheet leverage will lessen with longer maturity structures and less floating rate debt. Finally, the percentage of fee-based revenues will grow with commodity at risk revenue percentages likely to decline. These healthy trends emerged in 2009 and strengthened the industry for the 2015 "chaos." We anticipate they will forcefully continue over the next three years.

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