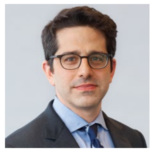
ClearBridge Investments

Energy MLP Strategy



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Key Takeaways

- U.S. energy production remains robust, with oil, natural gas and natural gas liquids production up double digits year over year.
- Infrastructure bottlenecks are beginning to clear as midstream projects are adding new takeaway capacity, primarily in the Permian Basin of West Texas.
- Despite higher cash flow growth and higher yields, MLP stocks trade at lower EV/EBITDA multiples than the broader U.S. equity market, utility stocks and REIT stocks.

Market Overview and Outlook

The U.S. equities market continued to generate solid returns in the second quarter, with the broad S&P 500 Index gaining 4.30%, led by the financials sector. Reflecting concerns that slowing global growth and trade tensions would curb energy demand, the energy sector was the only broad market sector in the red for the quarter. The Alerian MLP Index returned 0.12%, led by the refining and liquids transportation and storage subsectors.

Oil prices edged down from $60 per barrel of WTI crude at the end of March to $58.5 to finish the quarter, largely on rising U.S. crude oil inventories and worries escalations in the U.S.-China trade dispute would further slow sluggish global economic growth. Prices hit as low as $51 but rebounded in June, when tensions between the U.S. and Iran, an OPEC consensus on extended production cuts, and lower than expected U.S. inventories kept supply in check, while reported progress in U.S.-China trade talks helped improve the demand picture.

MLP stocks also paused after a very strong first quarter to register modest losses in April and May before rising again in June as investors were cheered by hints of a more accommodative policy turn by the Federal Reserve and trade optimism. They remain up almost 17% year to date. Slowing global growth remained a concern throughout the quarter, however, with China's GDP growth declining, the euro area economy losing momentum and trade tensions dampening business confidence. Reflecting a more pessimistic outlook, 10-year U.S. Treasury yields dropped to 2.0% and the yield curve inverted.

U.S. energy production growth remains robust. As of April 2019, oil production was up 16% year over year, natural gas production up 11%, and natural gas liquids production up 12%. Infrastructure bottlenecks are beginning to clear as midstream projects are adding new takeaway capacity, primarily in the Permian Basin of West Texas, where crude production is estimated to double, to 8 million barrels per day, over the next four years. We see continued evidence that growth opportunities to build new pipeline, storage and processing facilities will continue for at least the next several years. This continued growth in U.S. energy production and associated infrastructure buildout will drive increasing cash flows for energy infrastructure companies. Looking ahead, we expect 11% cash flow growth from the MLP sector compared to 3% for the S&P 500, 4% for utility stocks, and 3% for REIT stocks.

Oil prices are high enough to incent drilling necessary to ensure supply growth and low enough to ensure continued demand growth.

As of the end of the second quarter, the MLP index yields 7.8% compared to 1.9% for the S&P 500, 3.3% for utility stocks and 4.1% for REIT stocks. Yet, despite higher cash flow growth and higher yields, MLP stocks trade at lower EV/EBITDA multiples than the broader U.S. equity market, utility stocks and REIT stocks. We remain of the opinion that this disconnect is not sustainable in the long term.

In recent months we have also seen M&A activity and notable interest from private equity buyers. Typically, private market deals are transacted at lower multiples than public market valuations. For midstream, however, the opposite has been true. Public valuations are cheaper than private market assets, which has led to private equity buying select assets in the public midstream space. This is a clear indicator of how inexpensive public market midstream assets are.

Risks to the sector include protracted U.S.-China trade negotiations having a negative effect on global GDP and slowing U.S. corporate profit growth leading to a weakening U.S. equity market, which would likely present a headwind for midstream stock prices. Against these, we view the potential for multiple revaluation, increased M&A and private equity activity and more aggressive share buybacks as creating a positive outlook for MLPs and midstream energy companies. We expect WTI oil prices to trade in an intermediate to long-term range of $50 to $70 per barrel. In this price range, oil prices are high enough to incent drilling necessary to ensure supply growth and low enough to ensure continued demand growth.

Portfolio Highlights

On an absolute basis, the Strategy had a negative return for the second quarter, underperforming its benchmark. In terms of absolute performance, the Strategy had gains in three of the six subsectors in which it was invested. Of these, the liquids transportation & storage subsector had the strongest contributions. The diversified energy infrastructure subsector was the main laggard.

Leading individual contributors to Strategy performance included Buckeye Partners, LP, Magellan Midstream Partners, LP, Kinder Morgan, BP Midstream Partners LP and Andeavor Logistics LP. The top detractors during the quarter were Tallgrass Energy LP, EnLink Midstream, Energy Transfer, LP, Antero Midstream Corp. and Genesis Energy, LP.

During the quarter, we closed a position in EnLink Midstream LLC.