Dirty Little Secrets

The Naked Truth: Uncovering Opportunities in the Midstream Sector

***Dirty Little Secrets 2018*:**

- $7.2 billion (15%) in cash-flow growth from midstream companies in 2018 will be transformational for an industry beaten down in 2017.
- 17 of 28 companies covered in this report are expected to outperform market consensus, highlighting East Daley's positive outlook for midstream growth.
- Coverage and leverage are key metrics but they can mask insight into future company performance that is only uncovered from detailed asset-level analysis, such as the case with BWP and ETP.
- Gas and oil production is expected to surge across the country, boosting oil output by 1.3 MMB/d and gas extraction by 5.6 Bcf/d YoY…bolstering earnings across the sector.
- Supply growth has been underappreciated in basins like the Bakken, Powder River and Marcellus. Growth in those basins is contrary to market sentiment for rate and volume risk.
- The infrastructure of tomorrow could be in the ground today with old infrastructure finding new life in the Permian, Bakken and DJ.
- Tax cuts have raised return on equity for natural gas pipelines, oil, and NGL lines, increasing the risk of significant revenue cuts via rate cases or rate freezes.

1 Introduction

Dirty Little Secrets is the definitive guide to uncovering investment opportunities in the U.S. midstream oil and gas sector. The next 165 pages provide the most comprehensive review of upside and downside risk of 28 midstream companies. This report is used by investors, institutional banks, fund managers, private equity, midstream companies and E&Ps to understand how changing energy market dynamics will impact the midstream sector in 2018 and beyond. This report is made possible by East Daley's dedicated team of midstream analysts, leveraging the largest database of U.S. energy infrastructure that delivers unprecedented clarity into the vast network of midstream assets. ***New to Dirty Little Secrets 2018:*** *Distributable cash flow (DCF), coverage and leverage based on EDC's EBITDA forecasts and summary data files for all the companies that show earnings per asset, segment and commodity. If you have any questions about the information in this report, please contact East Daley!*

The midstream energy industry is complicated. From pipelines to storage to fractionation, the dynamics that impact the future value of assets a midstream company owns are intricate and can be tortuous to delineate. However, the naked truth is that each of these companies is no more than the sum of their parts which are, at their core, as simple as rate times volume. *Dirty Little Secrets* breaks down the complexity of the space to uncover the immense opportunity in 2018. 2017 was a brutal year for equity valuation in the energy industry which at times seemed to be indiscriminately beaten up. The Alerian MLP Index (AMZ), which is often used as a benchmark for the value of the midstream industry, fell 12.9% against the backdrop of a 19.4% rise in the S&P 500. Despite growing cash flows and an oil price recovery, the market keyed in on sluggish production growth and concerns about overextended capital structures. As a result, some companies used 2017 as a transition year to realign their capital structure. Others may be looking to the success of their operations to wash away the ashes of 2017, leveraging a 22.8% rise over the last year in the U.S. oil benchmark price West Texas Intermediate (WTI). At today's prices the industry is growing, which in general will lift all ships. However, deciphering between operational and capital structure challenges will be a key distinction to assessing those opportunities in 2018. *Dirty Little Secrets* dissects 28 prominent companies in the midstream space, laying out all their parts and rebuilding the company asset by asset, rate times volume. In doing so, the "Naked Truth" of financials and fundamentals are on the table to see and assess. After a brutal 2017, 2018 could be transformational, ripe with opportunities.

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1.1 2018 *Dirty Little Secrets* Highlights

In many ways, 2017 was Midstream-ers versus Wall Street-ers. The improving midstream company operational outlook was going head-to-head with Wall Street's deteriorating view of the industries capital structure. As a result, despite a 10% increase in cash flow from companies in this report, valuations were hammered. Of the 28 midstream companies discussed throughout this paper, the equity value of all but five fell in 2017. This included 11 companies that decreased by more than 20%, seven between 10%-20% and seven between 0%-10%. The downward pressure on valuation creates a great opportunity as the oil and gas market is indeed growing and the industry has and will continue to need infrastructure to move and process all the new supply. For the time being capital structure will still be a distinguishing factor. Based on growth expectations, some companies have held fast to structures that include future distribution growth and Incentive Distribution Rights (IDR), despite growing market consternation over both. Others have adjusted. Figure 1.1.1 shows East Daley Capital's (EDC) 2018 asset-by-asset outlook for each company's operations plotted in terms of coverage (distributable cash flow relative to total distributions) versus the leverage (net debt relative to LTM adjusted EBITDA). The matrix delineates the midstream market into four distinct zones: Danger Zone, Already Bit the Bullet Zone, Mixed Bag Zone, Gold Star Zone. The graphic highlights which companies have tight coverage and/or high leverage, helping to identify the companies that face the highest risk to restructuring capital to fix liquidity and leverage issues. The size of the marker for each company reflects the distribution yield as of January 23, 2018. In general, the higher the yield, the higher the market's perception of risk.

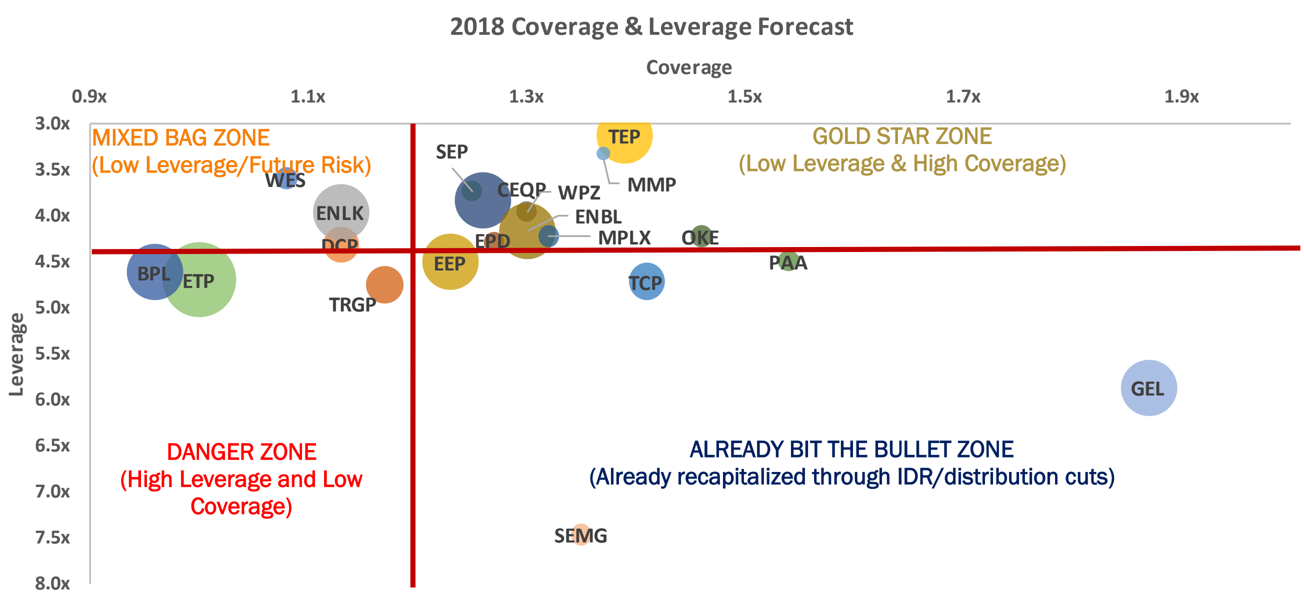

Figure 1.1.1: 2018 Coverage & Leverage Forecast
Source: East Daley Company Blueprints

A stark difference from the *2017 Dirty Little Secrets report* is that there is a positive skew to the 2018 expectations versus consensus on cash flow. Operationally, EDC estimates that 17 of the 28 company will have cash flows greater than consensus estimates with six expected to be more than 5% above while three will be more than 5% below consensus. Last year big names like EEP, PAA and TRGP were expected to heavily underperform. This year many of the bigger names like DCP, MPLX, OKE, SEP and ETP are expected to outperform consensus cash-flow expectations.

A big piece of the outperformance expectation is tied to U.S. production growth. In recent weeks, the U.S. oil benchmark price WTI surged close to $65 per barrel, a price not seen since 2014. Even before that, East Daley's models were showing substantial growth expectations across the country. Many market analysts have been, with good reason, focused on the Permian, which EDC expects to grow 32% YoY, leading the charge for 1.3 MMB/d growth in domestic oil supply across shale basins. However, the dirty little secret is that there is a quiet resurrection of other basins like the Bakken, which will set new records in 2018, up 18% YoY. This growth is expected to fill recently constructed pipeline space, changing the contract and rate risk paradigm many were anticipating for the region. Despite coming from a much smaller base, the Denver Julesburg (DJ) is expected to jump 23% and the Powder River will be up an astounding 70%. These shifts present opportunities and in some cases, change the risk outlook for midstream companies.

Natural gas production, often now an afterthought in the oil conversation, is also expected to rise. New pipeline projects out of the Northeast are expected to push an annual average of 5.5 Bcf/d more production into the market. At the same time, gas production in the Permian and DJ are also anticipated to grow, supported by new processing and a thirst for oil. Even the ArkLaTex (Haynesville and East Texas), which has struggled since 2012 due to low gas prices and a shifting focus to the Marcellus, is expected to grow 34% YoY. This onslaught of production will be difficult for the market to handle and is likely to depress both basis and outright prices but many midstream companies are sheltered by minimum volume commitments (MVC's).

Capital efficiency has been the latest buzzword around the industry as investors try to assess risk and returns. The focus on capital efficiency is not without merit given the intense competition and persistently low commodity prices that have resulted in impairments and led investors to question returns. The dirty little secret in understanding the risk and the return will be in accurately delineating between companies. As an example, companies like ENLK and ENBL, both with similar operational risk, have adopted different strategies to face low commodity prices and heightened competition. The result has been two very different financial risk profiles. While both companies are focused on growth in the Anadarko, ENLK is more leveraged to that growth and has a higher yield. Conversely, ENBL carries a lower yield but is less reliant on production growth expectations. Therefore, ENLK is a levered version of ENBL given its dependency on the STACK growth to earn its way out of low coverage and high leverage.

Companies are also getting creative about how they use their existing assets. While the 20% growth in crude production and 45% growth in gas production in 2018 would usually translate into a slew of greenfield expansion projects, this push for greater capital efficiency has companies getting more creative. The dirty little secret is that there is a vast network of pipeline infrastructure already in place, which creates opportunities for new, lower CAPEX midstream projects through reversals, conversions, and optimization. These projects could have a myriad of benefits for midstream companies, including mitigating the impact of contract cliffs, improving returns on existing assets, and allowing midstream companies to better compete with riskier and lower-return private equity-backed projects.

Tucked between the foundational mattress of operational fundamentals and the comforter of financial structure is a blanket of regulatory risk. Often a dark cloud on the space, the dirty little secret on the regulatory front is that the recent federal tax cuts have raised natural gas pipeline return on equity, increasing the risk of significant revenue cuts via upcoming rate cases. Companies with heavy pipeline exposure like Spectra Energy, Kinder Morgan, and TransCanada may now have assets where ROE has jumped into the high teens and even over 20%, when typically, the FERC targets around 10-14%. Oil and NGL pipelines are also expected to face increased regulatory scrutiny from over-earning and could face frozen rates starting this year.

2018 is lining up to be a great year for the midstream industry. However, deciphering between operational and capital structure challenges will be a key distinction between good and great. Laying all the assets out on the table to reengineer the financial metrics that define a company, uncovers the naked truth of risk and reward in 2018.

1.2 About East Daley

East Daley Capital is an energy asset research firm that exposes the complex risks in the midstream energy market. In addition to using top-level financial data to forecast a company's performance, East Daley delivers asset-level analysis that provides comprehensive, fact-based intelligence. Supported by a team of unbiased, experienced research analysts, East Daley provides its clients unparalleled insight into how midstream companies operate and generate cash flow. East Daley uses publicly available fundamental data and intersects that data with a company's reported financials to break midstream companies down to asset-level cash flows. The result allows for more informed portfolio decisions.

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The purpose of *Dirty Little Secrets* is to make a very complex sector easily digestible. This report is a must read for the seasoned veteran and for those who are looking to get into the midstream space. *Dirty Little Secrets* is a vital tool to help you assess midstream risk, by providing you with non-biased and data-driven analysis made possible from the largest database of U.S. energy infrastructure. At East Daley, we do the "heavy lifting" for you so that you can focus on strategy and execution. Whether you are an investor, institutional bank, fund manager, private equity, a midstream company or an E&P, this report will help you quickly understand how changing energy market dynamics will impact the midstream sector in 2018 and beyond.

The *Dirty Little Secrets* package includes:

- 165-page detailed analytical report covering 28 U.S. midstream companies – including:
    - Asset-level earnings forecasts for all companies
    - Capital structure risk, capex efficiency and return on equity (ROE) analysis
    - Distributable cash flow (DCF) and coverage and leverage based on EDC's EBITDA forecasts
    - Crude oil, natural gas and natural gas liquids outlook, including sections on the Permian, Bakken, Marcellus, Denver-Julesburg and the Powder River Basin
- Presentation from East Daley to your firm to review the report findings and answer questions
- Summary data files for all 28 companies covered that show earnings per asset, segment and commodity with earnings forecasts through 2019:

Boardwalk Pipeline Partners
Company Summary
($ in millions)

	B	G	L	M	N	O	P	Q	V
6	**EBITDA By Segment (Millions)**	**FY2016E**	**FY2017E**	Q1'18E	Q2'18E	Q3'18E	Q4'18E	**FY2018E**	**FY2019E**
7	**NG Pipelines and Storage**	**$726**	**$779**	$195	$145	$135	$177	**$652**	**$685**
8	**NG**	**726**	**779**	195	145	135	177	**652**	**685**
9	**NG Interstate Pipeline**	**726**	**779**	195	145	135	177	**652**	**685**
10	**Legacy**	**726**	**777**	192	139	129	169	**628**	**580**
11	Texas Gas_LEG	**293**	**325**	82	54	49	74	**259**	**271**
12	Gulf South_LEG	**236**	**252**	60	35	29	44	**168**	**156**
13	Gulf Crossing_LEG	**197**	**200**	49	51	51	51	**202**	**152**
14	**Expansions**		**3**	4	6	6	8	**23**	**105**
15	Texas Gas_EXP		**3**	3	3	3	3	**13**	**14**
16	Gulf South_EXP		**0**	0	2	2	5	**10**	**92**
17	Gulf Crossing_EXP		**0**	0	0	0	0	**0**	**0**
18	**Petrochemical/Other**	**65**	**73**	23	24	24	24	**95**	**97**
19	**PetChem**	**65**	**73**	23	24	24	24	**95**	**97**
20	**PetChem Pipeline**	**65**	**73**	23	24	24	24	**95**	**97**
21	**Legacy**	**65**	**68**	14	15	14	15	**59**	**59**
22	Louisiana Midstream_LEG	**59**	**62**	13	14	13	13	**53**	**53**
23	Boardwalk Petrochemical (Evangeline)_LEG	**6**	**6**	2	2	2	2	**6**	**6**
24	**Expansions**		**4**	8	8	10	10	**36**	**38**
25	Louisiana Midstream_EXP		**0**	0	0	1	1	**3**	**5**
26	Sasol (Evangeline)_EXP		**4**	8	8	8	8	**33**	**33**
27	Evangeline Expansion_EXP							**0**	**0**
28	Gas Treatment_EXP							**0**	**0**
29	**Gathering and Processing**	**-4**	**4**	1	1	1	1	**3**	**2**
30	**NG**	**-4**	**4**	1	1	1	1	**3**	**2**
31	**G&P**	**-4**	**4**	1	1	1	1	**3**	**2**
32	**Legacy**	**-4**	**4**	1	1	1	1	**3**	**2**
33	Marcellus/Utica	**3**	**3**	1	1	1	1	**3**	**3**
34	Eagle Ford	**-7**	**1**	0	0	0	0	**0**	**-1**
35	**Adjustments**	**19**	**3**	1	1	1	1	**3**	**3**
36	**Asset EBITDA**	**805**	**860**	219	169	159	202	**752**	**788**

38	**EDC v Consensus EBITDA ($ in Millions)**	**FY2016E**	**FY2017E**	Q1'18E	Q2'18E	Q3'18E	Q4'18E	**FY2018E**	**FY2019E**
39	Adj. EBITDA	$ 803	$ 856	$ 219	$ 169	$ 159	$ 202	$ 749	$ 784
40	Consensus		842	240	195	189	226	840	839
41	*Variance ($)*		$ 14.2	$ (20.6)	$ (25.9)	$ (29.2)	$ (23.7)	$ (91.3)	$ (55.0)
42	*Variance (%)*		1.69%	(8.60%)	(13.28%)	(15.51%)	(10.51%)	(10.86%)	(6.56%)
43	Distributable Cash Flow	$ 507	$ 677	$ 136	$ 96	$ 88	$ 123	$ 443	$ 484
44	Coverage		4.92x	5.33x	3.77x	3.44x	4.83x	4.34x	4.74x
45	Leverage			4.91x	4.91x	5.18x	5.35x	5.09x	4.89x

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