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The reports of my death have been greatly exaggerated - MARK TWAIN

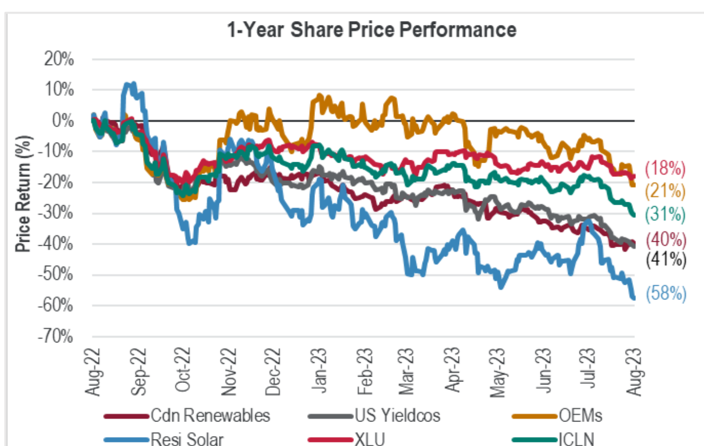
Written by: Sean Fitzgibbon and Ben Niedermeyer

Executive Summary

- **The push towards new energy sources has created stock bubbles as reality has caught up with hyped expectations.**
- **Regulations subsidies and the changing rate environment have created an ebb and flow environment on behaviors and uncertainty on new investment projects as well as the take up of new energy offerings.**
- **Despite the big push towards clean energy, solar and wind are not keeping pace with the overall demand for energy globally and still only account for a small percentage of overall energy supply.**
- **Despite the obvious bubbles and corrections evidenced in the marketplace, one constant within the energy sector continues; U.S. midstream (MLPs) benefit from their toll pricing models, fixed and highly regulated infrastructure, and a newfound fiscal discipline which provides increased tax advantaged dividends to meet the income needs of investors.**

The role of hydrocarbons within energy transition

A frequent misquote from Mark Twain, but it seems appropriate about the sentiment around hydrocarbons today. While we are believers in the transition to clean energy, we have been cautious about the market's enthusiasm around this theme. In particular, stock prices for companies associated with green initiatives, which rose dramatically after Joe Biden was elected President, as anticipated given his platform on energy transition. This was even more exaggerated for ETFs focused on green energy as they rose as much as 300%, even though many companies held by these funds were not showing meaningful increases in business fundamentals. Not surprisingly, this group of stocks has been underperforming, as the pace of adoption on green initiatives has been disappointing.



Source: CIBC

The transition to greener energy is a long and winding road

Reality has started to set in that hydrocarbon consumption will be around for longer than many had hoped. Wind, solar and other sources of clean energy continue to grow at an impressive rate, but this growth is barely enough to offset the expanding demand for energy that occurs year-over-year. Global coal consumption, one of the dirtiest hydrocarbons, grew by 3.3% in 2022 making it clear that energy transition goals need to include ways to use hydrocarbons cleaner. Near term, the biggest impact to global CO2 reduction will likely come within the hydrocarbon spectrum, e.g., switching coal usage to natural gas – a small step that can allow us to make a greater impact in near terms.

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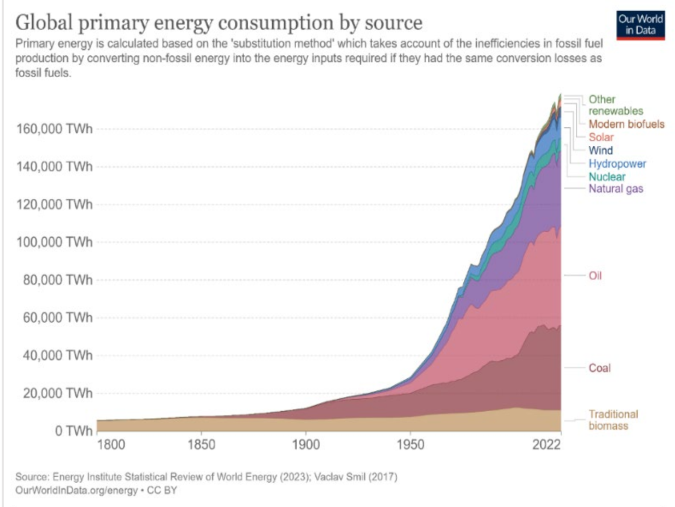
As seen in the chart on the right, wind, solar and other renewables still represent a relatively small portion of global energy consumption. While that group has grown over 12% annually for the last five years, compared to total energy growth of 1.3% in that same period, it has only made a small dent in displacing traditional hydrocarbons in terms of the overall mix. In general, both companies and consumers would like to move to cleaner sources of energy, however, barriers including cost and availability of parts and labor are resulting in a slower pace of adoption in many areas.



Within the U.S., the most recent quarter saw many solar companies reduce guidance for the adoption of residential solar. A change in the California tax incentive from the very generous NEM2 policy to a more balanced NEM3 was an expected headwind for that state's adoption of solar. Beyond this, there was a more broad-based slowdown in the adoption of solar across the country. One element slowing adoption is that higher interest rates are impacting the financing for companies that previously offered free solar installation in exchange for future electricity payments. Enthusiasm for solar adoption in the U.S. has ebbed and flowed considerably over the past few decades, with long stretches of disappointment in the past. Significant cost reductions for solar that bring costs near parity with traditional electricity costs means the growth trend will continue, just not at the bullish pace some investors assumed.

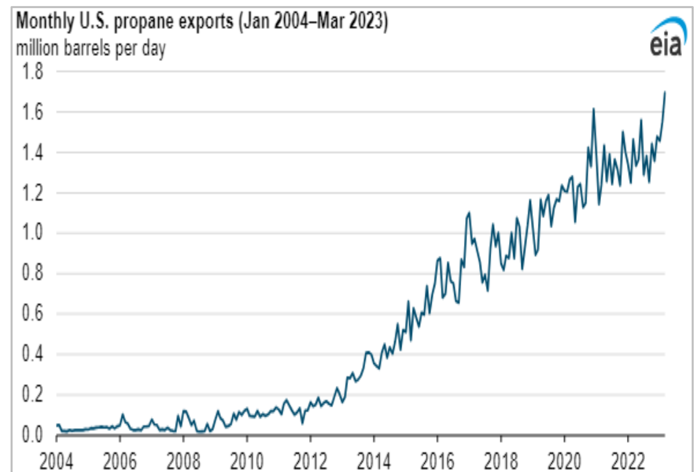
Anecdotally, our home state of Massachusetts has experienced significant delays in the New England Clean Energy Connect (NECEC) project, which is a 1,200-Megawatt project to bring clean energy from Hydro-Québec to New England, due to increase in risk on the investment. The project was launched in 2017, permitted in 2018, and construction began in 2021. However, after nearly $1 billion was spent on starting to clear land for power lines to run from Canada to Boston, Maine residents decided they didn't like the look of power lines running through the picturesque mountain landscape. A referendum in Maine passed in 2022 to put that project on hold for a year, introducing significant risk on that investment. We believe similar hurdles will be faced with other large scale energy projects as enthusiasm builds around a resurgence of nuclear energy.

Would you want this in your backyard?

A big opportunity for U.S. exports

Globally, over 2 billion people are living in energy poverty with a lack of access to basic energy needs that many of us take for granted. Many developing countries are aspiring to build out their energy infrastructure in a green fashion, but the reality is energy demands are so great that traditional sources continue to be necessary to provide basic energy needs. The result is many of the dirtiest hydrocarbons are consumed at a growing pace.

Case and point, India, the world's most populated country, continues to dramatically increase coal consumption, yet many citizens still don't have basic energy needs. A project launched in 2014 provided a significant subsidy for propane tanks for every household. This project was designed in part to help citizens move from burning cow dung to cook their food. Overall, the project has been a success, and not only improves the sanitary conditions for Indians but also helps the environment, despite still using a traditional hydrocarbon. Much of the propane for this initiative comes from the U.S., highlighting the opportunity for continued growth in the export of natural gas and other NGLs (ethane, propane, butane) to the rest of the world as a cleaner source of energy.



Words of caution

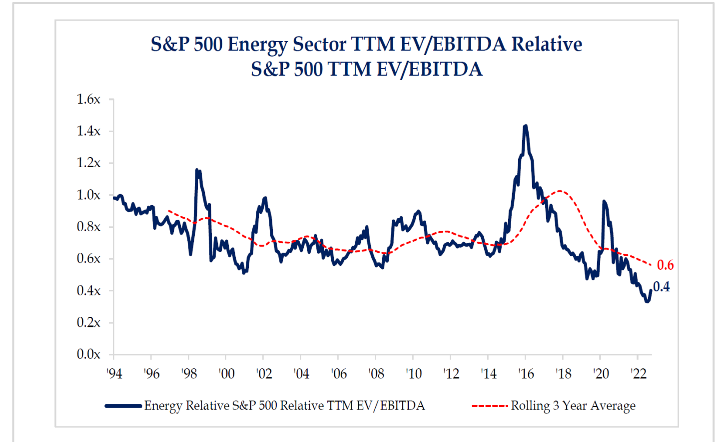
From an investment perspective, we understand the enticement around green energy investments since there has been more growth opportunities in wind, solar and other renewables than in the traditional hydrocarbon space. Additionally, the world is moving towards ESG (Environmental, Social and Governance) initiatives. However, this dichotomy has resulted in much more capital flowing to companies in the green space. More broadly, we are worried that the market may be in a phase where too much capital is chasing a good idea.

Eventually, winners and losers will be sorted out and capital markets will adjust the flow of new capital to allow for reasonable returns to be generated from this group. Certain pockets, such as electric vehicles, have seen big winners in the form of the likes of Tesla. But that success has attracted a lot of capital to the space with companies like Rivian and Lucid launching compelling products. Additionally, the traditional automakers are scrambling and launching their own versions of fully electric vehicles. Valuations within the auto group will someday need to be reconciled, as the market capitalization of the fully electric vehicle companies dwarf that of the traditional auto makers. Historically, the auto industry has always been competitive and it's hard to justify the market capitalization for the EV group.

Where we see opportunity

At the other end of the spectrum, 'capital discipline' has become the buzzword for traditional hydrocarbon companies. Despite a strong rebound in the price of oil post Covid-19, capital expenditure budgets remain constrained and well below the peak in 2016. Even with oil topping $100 in 2022, companies stayed conservative knowing that institutional investors would punish any stock if the company announced a meaningful increase to their capex guidance.

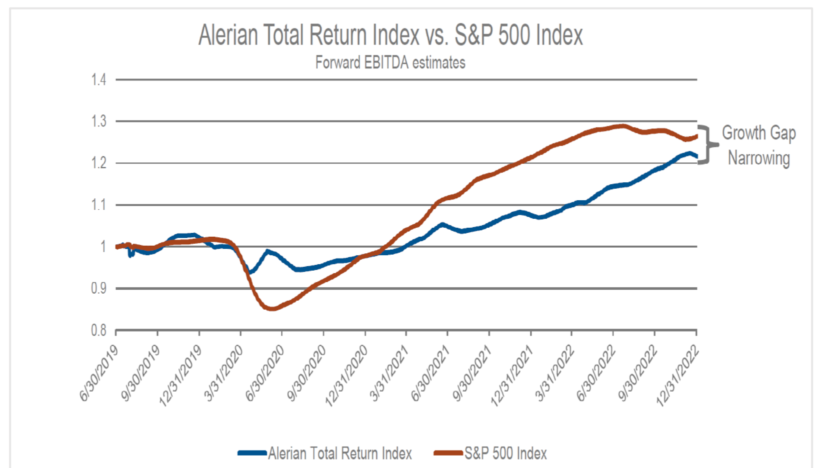
Despite this newly found religion, valuations within the energy space remain very attractive. In general, companies have dramatically reduced their debt levels as the new capital discipline and strong oil price has resulted in high levels of free cash flow. Cash flow is now being diverted more towards share buybacks and increased dividends. The market has appreciated this trend, as the energy sector has performed well over the past few years, but relative valuation levels remain at 30-year lows.



U.S. Midstreams

An area we find particularly attractive is the U.S. midstream space. These companies have much lower exposure to oil and gas prices as the bulk of their revenues is contracted on a take or pay basis. In many ways, they operate like a toll road to move the oil and gas this country needs to operate. While there was a period of overbuilding pipes in some basins, the industry has come back into balance and incremental capital expenditure is done mostly just to meet increased demand. As U.S. exports of natural gas and NGLs grow over the next decade, there will be continued attractive opportunities for this group.

The midstream industry, along with most companies around the world, faced significant challenges during the Covid-19 era. As the global economy ground to a halt, demand for oil and gas declined. At one point in April 2020, oil prices went negative as storage capacity became full. Despite this challenging environment, cash flows for the midstream industry remained relatively stable. As seen in the chart on the right, the peak drawdown on cash flows for the midstream industry was about 5%, while for the S&P 500 the decline was closer to 15%.



Outlook

Sentiment around the use of hydrocarbons may remain challenging as the world tries to address the impact of climate change. But it's very difficult to see a world where we move away from this traditional source of energy any time soon. In the meantime, the biggest impact to the environment can come from more responsible production and consumption of hydrocarbons. New initiatives around Carbon Capture and Sequestration (CCS), which appears to have bipartisan support, can potentially have a much greater impact on the environment than the next wind farm or solar field.

As investors, we can't help but be attracted to an area of the market that has the highest free cash flow yield, and management teams that are behaving much better in terms of capital discipline. With a 7-8% tax advantaged yield, that is more than two times covered by cash flow, we continue to see an attractive investment opportunity in the midstream energy space. After three years of dramatic outperformance for these companies, we like to take a clean sheet of paper and make sure our biases aren't clouding our view. After thoughtful analysis of the fundamental trends and hearing from both the clean energy companies and the traditional hydrocarbon companies, we believe the market is underappreciating the growth potential and longevity of U.S. midstream assets. Time will tell whether our view is correct, but we are very encouraged from the recent discussions with midstream companies about their business prospects and opportunities to favorably impact the environment. To us, it is starting to feel more and more likely that we are in the early innings of a revaluation cycle for this industry.

For more information on CCS, please refer to our June 2023 publication entitled The Greening of Energy Midstream Infrastructure.

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