Midstream Energy MLPs

We would like to share with you our review and outlook for the master limited partnership (MLP) and midstream energy market as of February 28, 2015. For the month, the Alerian MLP Index had a total return of +2.1%. Year to date, the index returned −1.0%.

Investment Review

MLPs and midstream-energy-focused equities advanced in February, outperforming fixed income markets but trailing most equity indexes. A modest rebound in crude oil prices off their January lows broadly supported investor sentiment toward the asset class. Those MLPs with a higher sensitivity to oil prices, such as exploration and production companies, certain commodity-exposed gathering and processing (G&P) businesses, and some offshore marine shipping firms, tended to outperform in tandem with rising energy prices. Companies with more defensive characteristics and fee-based cash flows underperformed.

Observations from Fourth-Quarter Earnings

Management teams highlighted near-term headwinds related to West Texas Intermediate crude oil as inventories continue to build and domestic oversupply persists. This has driven many companies to base their 2015 budgets on $50 crude oil for the full year. With fourth-quarter earnings mostly complete, 2015 expectations have been reset and the average MLP management team has guided to 3% lower earnings before interest, taxes, depreciation and amortization (EBITDA) than prior guidance, an 8% decrease in capital expenditures and a 1% pare back in distribution growth. Some G&P businesses, particularly those with natural gas liquids (NGLs) (e.g., ethane, propane and butane) exposure, significantly reduced guidance due to greater volume sensitivity and counterparty risk. Seven out of 11 upstream MLPs cut their distributions by an average of approximately 53%. Overall, guidance revisions were in line with expectations and companies are still finding projects to develop even in the current market environment.

Regarding subsector performance, the G&P sector (+6.4% total return in the index)1 led the Alerian Energy Infrastructure Index. MarkWest Energy Partners stood out. Unit prices rose 11.9% amid fourth-quarter earnings results that revealed strong growth in the Marcellus and Utica regions and the partnership provided distribution growth guidance through 2020.

The crude/refined products group (+6.2%) similarly gained. Steep contango in the crude oil futures market provided crude/refined products storage businesses with opportunities to re-contract at more favorable and/or extended terms. Firms with marketing and logistics businesses, such as Sunoco Logistics Partners, also performed well amid the rise in crude oil prices. Out-of-index Plains All American Partners lagged the rest of the sector as a large equity offering put downward pressure on unit prices.

Returns in the diversified (+3.1%) group tended to be driven by company-specific factors. Enterprise Products Partners reported solid fourth-quarter earnings but investors remained concerned about the firm’s longer-term outlook in a lower crude oil, natural gas and NGL price environment. NGL Energy Partners was a standout; fourth-quarter results revealed better than expected EBITDA and distributable cash flow growth. Diversified midstream utilities (−5.6%) fell, largely due to a rise in Treasury yields and expectations for higher interest rates; we remain underweight the group.

Out-of-index marine shipping companies performed well. Companies with substantial offshore crude oil and liquefied natural gas (LNG) businesses, often perceived as more sensitive to energy prices, outperformed. We continue to believe that companies with exposure to LNG shipping, liquefaction and regasification, such as Teekay, are well positioned to benefit from the globalization of energy markets.

Consolidation Theme Continued

Companies and management teams that were able to unlock value via more efficient balance sheets and corporate restructurings generally performed well, particularly those structured as general partners. Last year, there were over

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1 Performance data quoted represents past performance. Past performance does not guarantee future results.

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Periods greater than one year are annualized.
$174 billion in mergers and acquisitions (M&A) transactions announced. Year to date, deals valued at $25.6 billion were announced. Noteworthy events in February included Phillips 66 Partners' announcement of a $1 billion dropdown from its parent.

Investment Outlook

We have reduced our medium-term distribution growth estimates in the wake of materially lower crude oil, natural gas and NGL prices. We anticipate a widening dispersion of returns as companies with strong balance sheets, quality assets and attractive contract structures should outperform while more challenged businesses may see severely reduced cash flows and growth expectations. Additionally, we expect the theme of consolidation to continue, helping drive increased dispersion among winners and losers.

We believe the longer-term growth prospects of midstream energy businesses remain compelling given the imperative to continue to invest which is supported by North America’s drive towards energy independence. MLP valuations have moved in line with historical averages in terms of enterprise-value-to adjusted EBITDA, price-to-distributable cash flow and yield/growth—and in our view, some companies are beginning to appropriately reflect the changing fundamental outlook.

Evolving flow dynamics and demand drivers will continue to further the need to redesign the North American energy grid—driving the development of new and repurposed pipelines, processing plants and storage facilities. Additionally, we remain cognizant of these changing flow patterns as legacy pipeline contracts expire—with some pipelines at risk of being rendered obsolete in their current form. We believe the asset class offers a unique combination of attractive income and visible medium-term growth, and expect these characteristics to support performance.

Rising North American energy production will be a critical factor shaping MLP performance going forward. Whereas the past several years have been focused on investments to respond to the massive infrastructure needs to accommodate the “supply push” created by shale production, future “demand pulls” should add a meaningful next leg to the investment case. During periods where domestic prices for natural gas and NGLs trade substantially below global prices, we would expect export infrastructure projects to remain a tailwind for midstream energy companies. Furthermore, U.S. industrial demand is expected to rise, particularly in the chemicals industry, as shale-sourced ethane, propane and natural gas are now a low-cost feedstock for energy-intensive industrial processes. And while we view it as unlikely that U.S. restrictions on crude oil exports will be overturned in the near term, we do expect the political atmosphere in Washington to become more accommodative over time.

Overall, recent declines in crude oil, natural gas and NGL prices will have a material impact on the medium-term growth rate for the midstream energy sector. However, we remain firm believers in the long-term investment imperative, and expect to be able to take advantage of attractive investment opportunities that will arise during the currently volatile “sorting out” period for midstream energy equities.

(1) Sector returns are in local currencies. Sector classification of securities in the index are determined by investment advisor.

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The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships ("MLPs") that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index is calculated using a float-adjusted, capitalization-weighted methodology, total return basis. The index is included to provide a detailed basis for comparison and a representative measure for the Cohen & Steers MLP style.

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