Amid the slowdown of production of natural gas, crude oil and natural gas liquids (NGLs) in many parts of the world, North America has become the growth engine of global energy markets. Midstream energy companies, which provide the transportation infrastructure through pipelines and processing facilities, have enjoyed impressive returns over the past five years, benefiting from rising volumes, consistently high energy commodity prices and a powerful industry investment cycle. However, the steep price declines of many energy commodities have altered this investment landscape. Now that rig counts are declining, some basins are becoming less economic to drill and production growth appears likely to slow, it is more important than ever to understand the fundamentals and distribution growth potential for master limited partnerships (MLPs).

Despite these challenges, we see near-term opportunities arising out of market dislocations in a volatile sorting out period. Over the long term, the imperative of U.S. energy independence continues to present a powerful investment opportunity across the midstream energy value chain.
The past five years have been characterized by consistently high oil prices and significant advancements in drilling technology. This environment has propelled a massive investment cycle for companies throughout the North American energy value chain. While global natural gas, crude oil and natural gas liquids production has slowed in many parts of the world, the U.S. and Canada have emerged as growth engines for global energy markets.

These shifts have fueled strong investment returns for midstream energy companies that focus on energy infrastructure; however, the severe downturn in prices for virtually all energy commodities has altered the fundamental landscape. We expect distribution growth rates for many MLPs to slow, as capital deployment opportunities are reduced, volume growth decelerates in some resource basins and lower commodity prices weigh on returns.

Even more so than in 2014, we expect 2015 to be characterized by continued energy market volatility and a widening dispersion of returns for midstream energy companies and MLPs. Factors impacting performance include asset location (basin exposure), balance sheet strength, contract structure, commodity exposure and sponsor relationships.

Despite growing challenges, we continue to believe that the imperative of U.S. energy independence presents a powerful long-term investment opportunity in the midstream energy asset class—with near-term opportunities arising from the dislocations that will occur during the current volatile sorting out period in the global energy markets.
$50 Oil: A Game Changer for the Midstream Energy & MLP Markets

Which Themes Can Continue Into 2015?

In the final quarter of 2014—which was characterized by sharply higher volatility—units of MLPs with strong sponsors, midstream assets in attractive basins and embedded competitive advantages were rewarded. Companies that outperformed were often characterized by strong balance sheets, fee-based income with little or no exposure to commodity prices, volumetric protection and/or solid prospects for distribution growth. Those with assets not directly exposed to crude oil prices, such as diversified midstream utilities, were further insulated from commodity price declines.

In our view, many of these same themes will dominate the market in 2015. We believe that MLP market performance will become increasingly differentiated by asset location, commodity exposure, balance sheet strength/distribution coverage, contract structure and sponsor relationships. We also believe that 2015 will see a continuation of consolidation, which accelerated in the second half of last year. For these reasons and given the growth of investment choices in the MLP universe, understanding the underlying risks of each individual company has become even more important. A rising tide will no longer lift all boats.

Setting the Stage:

The Diverging Paths of Two Secular Tailwinds

Throughout the current investment cycle, midstream energy investors had benefited from two powerful tailwinds in the energy markets: the “Supply Push” of rising production, and the “Demand Pull” of increasing consumption. In the current “lower for longer” oil environment in which prices languish, these tailwinds have changed course.

A Deceleration of the Supply Push. North America currently produces more crude oil, natural gas and NGLs than it has in decades. Although we expect production growth to continue, we believe the growth trajectory will decelerate in this price environment. With crude oil priced below $50, some shale plays are no longer economic to drill, and we have already seen many exploration and production (E&P) companies cut capital expenditure budgets, some by up to 70%. The U.S. rig count has decreased by about 6% since its September 2014 peak, and is expected to keep declining. This will have a direct effect on the Supply Push, deferring some growth into the future.

The Changing Composition of Demand Pull. Investments in new sources of demand—such as petrochemical crackers, liquefied natural gas (LNG) liquefaction and industrial facilities—should continue to provide opportunities for midstream energy companies to build new infrastructure. With average gasoline prices below $2.00 per gallon, we are already starting to see changing consumer habits such as increasing SUV sales, which bodes well for the energy sector. On the other hand, some longer-dated projects in the export infrastructure of LNG, liquefied petroleum gas and ethane—a major driver of expected growth in the current investment cycle—are losing steam. The reason is that North America has lost some of its cost competitiveness relative to foreign markets in this price environment.

Considering the shifts in energy supply and demand and the length of this energy investment cycle, it will take time for current imbalances in the energy markets to be reconciled. We expect this to drive continued volatility in the near term.
The Key Drivers of Near-Term and Long-Term Oil Prices

Though oil prices are influenced by a myriad of factors, we view three factors as the key drivers of supply and demand in the market:

**Non-OPEC (North American) Supply Growth.**(1) North America has been one of the only drivers of oil production growth globally for the last few years. Yet, North America's supply growth is likely to continue, albeit at a slower pace.

**Global Demand.** While we do believe that lower oil prices will drive a positive demand response, this trend will develop gradually, and with a lag. Anecdotally, car sales are up in the U.S., as are the number of miles driven, and heating oil purchases are also above seasonal norms. But the shift in demand is likely to take several quarters or longer before it filters through the market and affects oil prices.

**OPEC’s stance on supply.** In our view, the most significant game changer in recent markets has been OPEC, which historically has been the primary price supporter of global oil markets. At its November meeting, OPEC announced its decision not to cut production quotas in order to maintain market share as the world’s oil production leader. The oil price decline that followed has been significant. These lower prices are meaningful to midstream energy investors as they impact upstream energy production and the growth profile of MLPs with both direct and indirect commodity exposure.

As these factors play out, understanding the distinct risks and opportunities of individual midstream energy holdings will take on a new level of importance. These considerations are addressed in the next section. Although it is difficult to forecast the impact these three powerful factors may have on the energy markets over the near term, we believe that oversupply will continue to lead to low and volatile oil prices for at least the rest of 2015. Yet, we see a path to oil price stabilization beyond that as trends evolve over time.

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*(1) Organization of the Petroleum Exporting Countries (OPEC).*
Considerations for Midstream Energy Investing

It is important to look at MLPs’ past history of distribution growth at different stages of the energy price cycle. As seen in Exhibit 1, MLP distribution growth has been positive in every year since 2000. Although we expect growth to decelerate over the next three years due to reduced capital investment opportunities, potentially lower volumes and commodity price headwinds, many MLPs are still positioned for solid growth in the coming years.

Our research suggests that annual distribution growth over the next year across the entire MLP universe stands at 6.5%, which is down approximately 250 basis points from our previous expectations of 9%. It is important to note that although the average MLP will see a deceleration of distribution growth, we believe the pain will not be shared equally. Some companies—such as certain “drop-down” MLPs—may still grow distributions by over 20% annually over the next two years, while others with commodity exposure or recontracting risk could be forced to cut distributions.

Risk Characteristics

Some of the primary risks when investing in midstream energy companies in this environment include commodity exposure, counterparty risk and individual balance-sheet considerations. Low prices and volatility, particularly for crude oil and NGLs, heightens the importance of commodity exposure when evaluating investments. In addition, volumetric exposure varies dramatically within the midstream universe, and companies with “take-or-pay” contracts should garner a premium.

As lower oil prices pressure E&P companies’ balance sheets and weaken the credit of pipeline shippers, evaluating counterparty risk also takes on increasing importance. Also, access to capital, a balance sheet positioned for volatile markets, management teams with a history of adding value and firms able to execute M&A transactions as the “shake out” unfolds are key factors in evaluating each company.

Understanding Midstream Energy Pipeline Contracts

Midstream energy companies utilize a variety of contract structures with upstream and downstream customers. Contract types and terms vary dramatically, but most fall broadly in the four categories below:

**Regulated Return:** Regulatory entities such as the Federal Energy Regulatory Commission (FERC) allow pipeline owners a fixed return, typically calculated as an “allowed return on equity.” These contracts are bond-like in nature.

**“Take-or-Pay”:** The customer is obligated to pay a fixed fee and has stipulated a minimum volume of throughput, regardless of whether the customer utilizes the asset. These are stable contracts with limited downside as they provide for rate and volumetric protection. However, when renewal contracts are negotiated, terms will reflect the then-current market environment, which can be more or less favorable for the midstream energy company.

**Fee-based:** Customers agree to pay a fixed fee for all volumes on a pipeline system. Though there is no direct commodity exposure, these contracts do expose pipeline operators to volumetric risk if customer’s shipments come in below expectations.

**Commodity Exposed (such as Percent of Proceeds):** These contracts are often found in gathering & processing. Typically, the midstream company gathers and processes natural gas on behalf of producers. The MLP sells the resulting residue gas (dry, pipeline quality gas) and NGLs at market prices and remits to the producer an agreed upon percentage of the proceeds based on an index price. These contracts have both volumetric and commodity exposure as revenues fluctuate based on the prevailing commodity prices.
Investment Return Considerations

Over time, MLPs have demonstrated a consistent track record of distribution growth over multiple commodity cycles. With the expectation for continued volatility in 2015, we believe that the dispersion of returns and bifurcation of performance will be wider than ever. In this environment, some companies may curtail distribution growth in favor of maintaining higher distribution coverage, while others with embedded growth opportunities, such as dropdown MLPs, will continue to execute on their stated business plans.

MLP Valuations Near 10-Year Averages

As of year-end 2014, distribution rates across the MLP universe averaged approximately 6.6%, which represents an increase from roughly 5.9% in mid-2014. As highlighted in Exhibit 2 below, MLP valuations have recalibrated towards their 10-year historical averages. Similarly, MLP yield spreads to U.S. Treasury securities and high-yield bonds remain significantly above historical averages, helping to solidify the appeal of MLPs to the income oriented investor. With interest rates and Treasury yields at historically low levels, investments in MLPs and midstream energy have been an attractive solution explored by many yield seeking investors. Moreover, investors are also likely to find the distribution rates on investments in MLPs and midstream energy relatively attractive as long as interest rates stay low.

Exhibit 2: Income and Valuation Metrics

|                      | 12/31/14 | 10-Year Average |
|----------------------|----------|----------------
| MLP Distribution Rates | 6.6%     | 7.3%           |
| Price-to-Discounted Cash Flow(1) | 12.1x   | 11.9x          |
| Enterprise Value to EBITDA(2) | 12.1x   | 11.2x          |
| MLP Yield Spread vs. U.S. Treasuries | 507 basis points | 379 basis points |
| MLP Yield Spread vs. High-Yield Bonds | 109 basis points | -88 basis points |


Performance data quoted represents past performance. Past performance is no guarantee of future results. MLPs represented by index data based on Wells Fargo Securities LLC's research coverage list of 50-80 midstream energy MLP securities, selected as a representative benchmark for the investable universe. High-yield bonds are represented by the BofA Merrill Lynch High-Yield B-BB Index, a sub-index derived from the BofA Merrill Lynch High-Yield Master Index. See the back cover for index definitions and other disclosure.

(1) Price-to-Discounted Cash Flow is based on 2015 estimates, multiple is determined by the ratio of the per-unit price of an MLP-to-Discounted Cash Flow (i.e., an estimate of the inflows and outflows of cash that may be experienced by a company in the future).

(2) Enterprise Value to EBITDA is adjusted to reflect the percent of the partnership’s cash flow payable to the general partner. Multiple is determined by the ratio of enterprise value to EBITDA, a ratio of Enterprise Value (i.e., the market value of a company’s debt, common equity, and preferred equity minus the value of cash) to EBITDA (i.e., a company’s earnings before interest, taxes, depreciation and amortization).

The relatively high spreads of MLP distribution rates to high-yield fixed income signals an attractive relative valuation of MLPs, in our view.(1)

Exhibit 3 on the following page provides a history of the valuation multiple for MLPs relative to broad equity markets.(2) Prior to 2009 (labeled as “Pre-Shale,” which is before the massive ramp up in shale-related midstream energy investments), the average relative premium was about 1.24x. This implies that the average multiple for MLPs was 24% higher than the average multiple for the S&P 500 Index, and, in our view, is reasonable considering relative growth rates and the pass-through tax structure of MLPs. In the period labeled “Shale Renaissance,” from 2010 through the end of 2014, this ratio rose sharply to 1.58x, which represents a 60% premium over equities. However, after the significant late-2014 price decline in midstream energy share prices, this ratio stood at 1.26x, well below the 10-year average and in line with the “pre-shale” premium.


(2) Multiple is determined by the ratio of enterprise value to EBITDA, a ratio of Enterprise Value (i.e., the market value of a company’s debt, common equity, and preferred equity minus the value of cash) to EBITDA (i.e., a company’s earnings before interest, taxes, depreciation and amortization).
With valuations now well below long-term averages, we believe that MLPs no longer embed a “shale premium.”

We think these metrics signal attractive valuation for MLPs relative to other asset classes. Although dispersion among MLP returns is likely to be elevated in the near term, the overall MLP market is trading closer to its long-term averages. For investors with a long time horizon, this means that the current period of volatility may reveal attractive opportunities in the MLP market.

### Our Closing Perspective

In our view, “lower for longer” is how we would characterize the crude oil markets; however, it is important to remember that these challenging conditions will also create opportunities for active managers positioned to capitalize on uncertainty, turning points and inefficiencies. We have always emphasized the importance of focusing on high-quality businesses, firmly entrenched in the midstream segment of the energy value chain. We continue to believe in the merits of investing in companies with fee-based revenue streams, as well as those with little or no direct commodity exposure and adequate volumetric protection.

We also believe that the opportunity set for investing in midstream energy goes beyond traditional pipelines. In addition to MLPs, we believe that investments in companies structured as corporations offer some of the best opportunities in midstream energy, as many are beneficiaries of the substantial buildout of domestic energy infrastructure.

Ultimately, we believe that the balance of energy supply and demand will be restored—as capital and expansion get shut off and global growth continues—and the long-term, secular opportunities driven by the continued evolution of global energy markets will provide substantial investment opportunities across the midstream energy universe.
Index Definitions
An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.

10-Year U.S. Treasury is a debt obligation issued by the U.S. Treasury that has a term of approximately 10 years.
The BofA Merrill Lynch High-Yield Master Bond Index monitors the performance of below investment grade USD-denominated corporate bonds publicly issued in the U.S. domestic market.
The S&P 500 Index is an unmanaged index of 500 large-capitalization, publicly traded stocks representing a variety of industries.

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Risks of investing in MLP Securities
An investment in MLPs involves risks that differ from a similar investment in equity securities, such as common stock, of a corporation. Holders of equity securities issued by MLPs have the rights typically afforded to limited partners in a limited partnership. As compared to common shareholders of a corporation, holders of such equity securities have more limited control and limited rights to vote on matters affecting the partnership. There are certain tax risks associated with an investment in equity MLP units. Additionally, conflicts of interest may exist among common unit holders, subordinated unit holders and the general partner or managing member of an MLP; for example a conflict may arise as a result of incentive distribution payments.

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