Chilton Investment Services

Weekly Update

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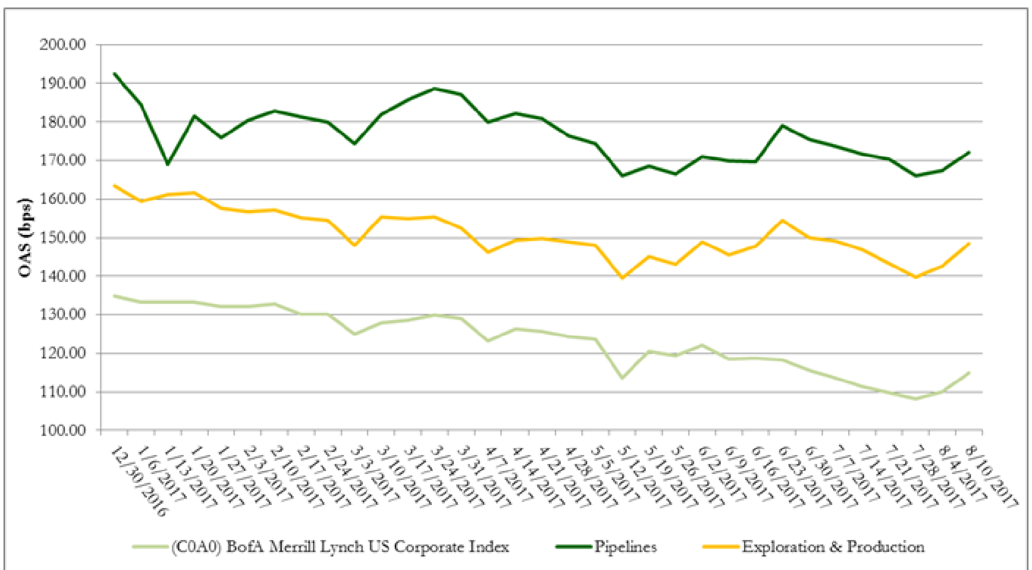
Retain Positive Outlook Despite Weaker Commodity Prices

Our long term positive view on midstream energy companies is predicated on the active, robust North American onshore drilling industry and the strong pricing power enjoyed by large midstream companies which control essential pipelines to key market centers and derive a majority of their revenue from fee-based, minimum volume contracts. Like any industry there are cycles and midstream energy stocks have recently come under pressure in line with lower oil and gas prices. However, credit spreads have remained relatively stable and midstream companies in particular offer attractive yields relative to oil & gas producers and the broader investment grade corporate bond market (Chart 1).

Chart 1: Midstream Offers Attractive Spread

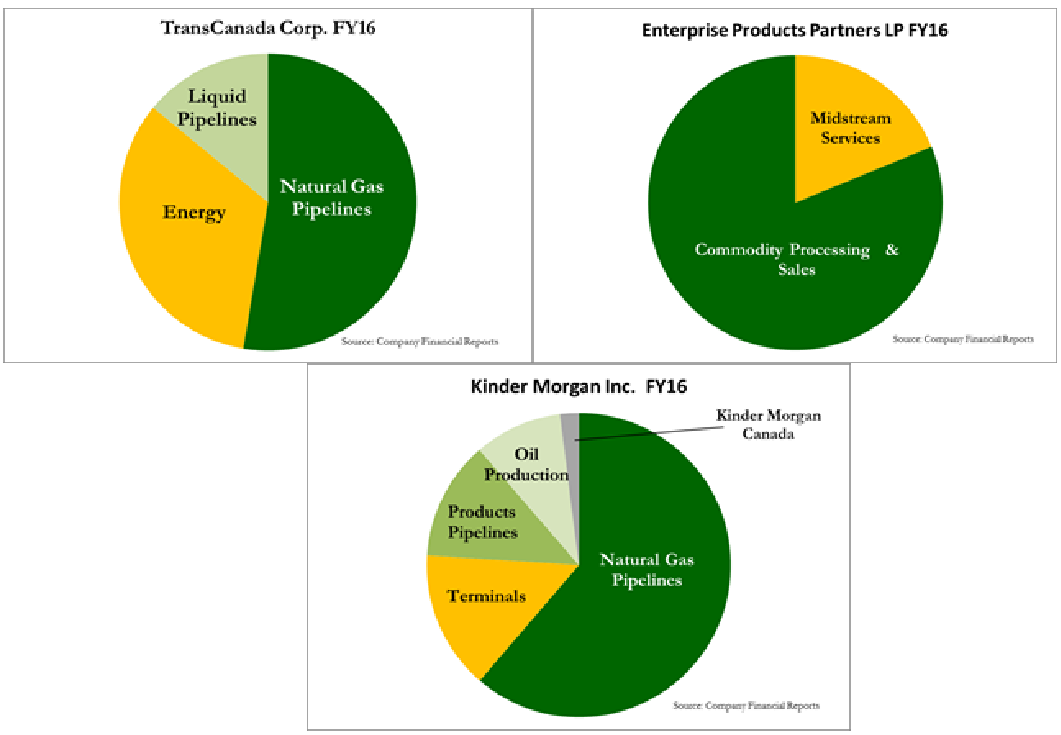


Source: Bank of America Merrill Lynch US Corporate Index

Not All Midstream Companies Are Created Equal

Our three midstream companies – Enterprise Products Partners (EPD), Kinder Morgan Inc. (KMI) and TransCanada Corp. (TRP) - all boast extensive North American footprints with assets positioned in proximity to almost every major oil and gas field on the continent. **A key factor in differentiating credit quality is what proportion of sales are derived from contractually-based agreements versus market pricing.** From this perspective, EPD has the riskiest operating profile with roughly 81% of revenue derived from natural gas processing as opposed to just 19% from traditional midstream services such as transportation. EPD offsets this risk by carrying relatively lower leverage and hedging about 90% of gross margin. Nonetheless, the company remains relatively more vulnerable to the pricing and profitability of producing natural gas products like ethane, butane and propone. Conversely, TRP derives virtually all of its revenue from lower-risk transportation services as well as a power generation subsidiary which sells the vast majority of its output under long term contracts. KMI has a modest level of market risk with a small oil production subsidiary (9% of revenues) and about a quarter of volumes which are not contractually based (Chart 2).

Chart 2: Enterprise Products Partners Has Greater Commodity Price Risk



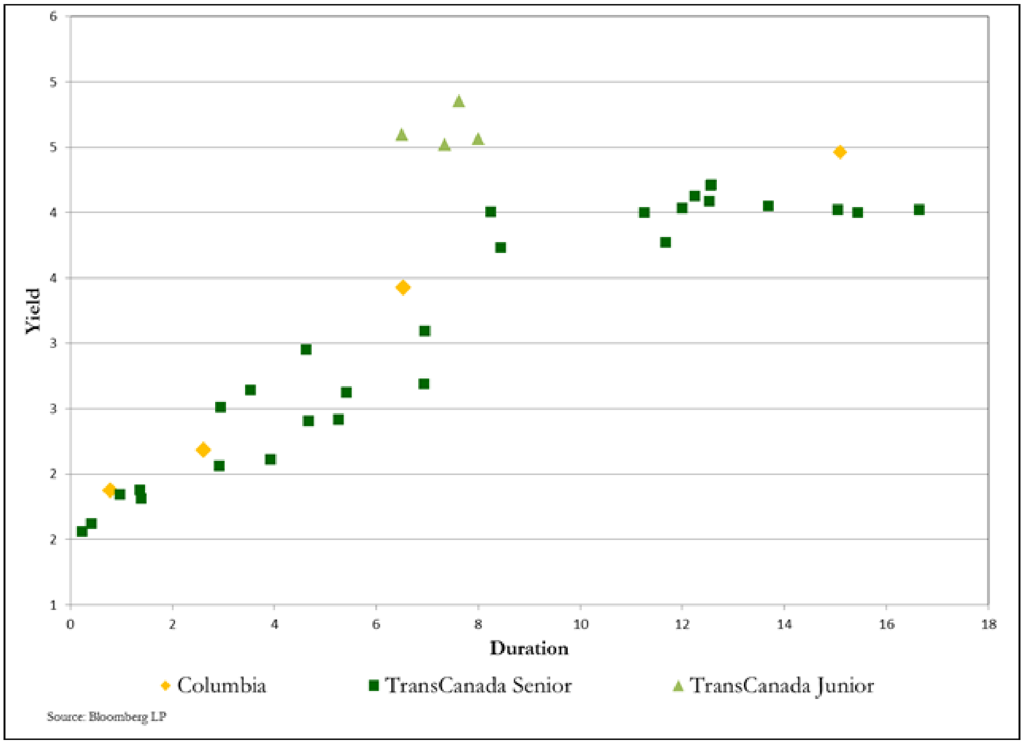
Shareholder-Friendly Financial Policies Cap Credit Quality

Midstream companies generally carry above-average leverage, reflecting the legacy of a sector intended by law to minimize taxes and incentivize shareholder returns. This resulted in the increased use of a Master Limited Partnership (MLP), a corporate tax-exempt, high dividend structure. While 2 of our 3 covered companies are no longer organized as MLP's, the ingrained tendency to prioritize shareholders appears ever present with uninterrupted growth of shareholder cash distributions considered sacrosanct. During the energy downturn, TRP and EPD were successfully able to maintain their dividend rate. However, KMI – burdened by a relatively higher debt burden – was forced to slash its dividend 75% in the 1st quarter of 2016 to preserve cash flow. However this period of creditor-friendly behavior by KMI was brief. In the most recent quarter (2Q17), KMI reversed course, announcing it was boosting its dividend 60% in 2018 and instituting a $2 billion share buyback. **As credit investors, we typically dislike such behavior but understand the importance for midstream operators to maintain competitive returns for all capital providers**. We are comfortable with the resumption of KMI's dividend growth given our projections showing good post-dividend surplus cash flow.

Successful Asset Development In The Right Geographies Is Critical

The industry is extremely capital intensive and midstream companies must maintain access to a variety of capital sources including debt and equity capital markets. TRP currently has the most ambitious capital program in our coverage as they are ~40% of the way through a massive $24 billion spending plan. Spending could rise further if TRP wins approval of the Keystone XL pipeline with the State of Nebraska expected to make its decision by November 2017. However, we believe TRP will maintain the ability to access capital markets or raise cash via asset sales or dropdowns. With a number of key projects expected to enter service in the next several years, the company is on a path to reduce leverage from current above-average levels. Within the TRP family, we prefer bonds issued by the company's Columbia subsidiary which enjoy a priority claim on cash flows from the capacity-constrained Marcellus shale region. Columbia debt was not explicitly guaranteed by TRP post-acquisition but the Marcellus assets are unquestionably strategically important to TRP. **A number of major projects are expected to be brought on-line in the next year and a half, strengthening Columbia's cash flows and potentially improving the credit profile relative to the rest of TRP. Therefore while Columbia bonds currently trade roughly in-line with TRP debt, we believe they offer a relatively stronger value proposition (Chart 3)**. We are also bullish on EPD's near term growth potential given the expected initiation of service on a new pipeline from the Permian basin to the Gulf of Mexico. Compared to TRP & EPD, we do not expect similarly rapid deleveraging in the near term from KMI given that its major new project – the Trans-Mountain Expansion Project – is facing heightened legal opposition following the election of a new, more anti-pipeline government in British Columbia.

Chart 3: Columbia Bonds are Preferred TransCanada Investment



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