Reaves Asset Management

Review and Outlook

Second Quarter 2017

OVERVIEW

The positive total returns from utilities, cable and telecommunications infrastructure REITs[1] were not enough to overcome the price declines of oil service and oil and gas equities held in our ERISA Composite.[2] Within the energy sector the mid-stream service providers and the sole refiner produced positive internal rates of return. The decline in the average quarterly price of West Texas Intermediate (WTI)[3] from $51.81 in the first quarter to $48.19, combined with a rise in production from U.S. shale producers, resulted in stock price declines for equities with commodity exposure to the price of oil. If shale production can continue to grow with oil in the $40 to $50 per-barrel range it is likely the per-barrel price will be lower than expected when supply and demand are roughly in balance. The decline in the yield on the 10-year U.S. Treasury,[4] post the Federal Reserve's March 15, 2017 rate increase, was supportive for utility valuation. While one more increase is anticipated in 2017, the outlook remains for gradual rates of increase in the future.

UTILITIES

The utilities holdings generated a return of 4.5% during the quarter which outpaced the 2.2% return of the S&P 500 Utilities Index.[5] The largest contributors to the sector's performance were utilities with significant renewables assets. Their rising stock prices suggested a reduction of uncertainty around renewables which arose following the 2016 Presidential election.

We have a more positive outlook on electric transmission because of developments at the Federal Energy Regulatory Commission (FERC) and recent court cases. On April 14th, a federal appeals court vacated the FERC's 2014 decision on the calculation of allowed returns on equity for electric transmission assets in New England, remanding it back to the FERC for re-consideration. The New England case was the first in a long series of dockets, of which many are still open. While the decision is a short-term setback for transmission owners, as it increases uncertainty, we are more optimistic about the ramifications for the longer term, as it will allow a platform for new incoming Republican commissioners to establish a more favorable policy. That appointment process did make some progress during the second quarter as the Trump Administration brought forward a slate of four candidates: Neil Chatterjee, senior energy advisor to Senator Mitch McConnell; Robert Powelson from the Pennsylvania Public Utility Commission; Richard Glick, a Democrat and well-regarded energy lawyer with a long record in Washington; and, more recently, Kevin Mcintyre, who will be the new Chairman, an attorney and co-head of Jones Day's global energy practice. Chatterjee and Powelson have made it through the Senate Energy Committee and await final confirmation before the full Senate. Final confirmation will break an important log jam at the FERC as the commission lacks a quorum and is unable to rule on all significant outstanding dockets including approval of significant new energy infrastructure projects.

COMMUNICATIONS

Our investments in communications outperformed the S&P 500 Telecommunications Services Index[6] by 1,003 basis points during the quarter. The outperformance relative to the benchmark was driven by a combination of our materially underweight position in domestic large-cap telecom and strength in our concentrated holdings of both wireless tower and cable securities.

Towers performed especially well during the quarter as a number of significantly positive catalysts unfolded for these stocks. For starters, the supply of spectrum controlled by wireless carriers materially increased. The quarter began with AT&T being awarded the government's FirstNet contract (a network to be built for communications among emergency first responders, but utilized by AT&T absent crises) and completion of the Broadcast Incentive Auction. Both events were many years in the making – and thus the significant increase in deployable spectrum, poised as it is to drive up rental revenues for towers, was heavily anticipated – though the timing had long been unclear. The conclusion of both processes helped generate support for positive revisions to estimates for tower stocks. In the case of AT&T, in particular, expectations that the company would time the deployment of other owned but fallow spectrum coincident with its FirstNet build were especially supportive. Additionally, rumors of partnerships and consolidation were generally constructive for towers. Speculation that Amazon might help DISH Network begin the deployment of its vast spectrum resources, and rumors that cable was in discussions with Sprint about either a takeout or an assist building its network, pointed to the potential for improved tenant quality for towers and partially offset some of the concerns investors had surrounding customer concentration due to consolidation.

Cable stocks performed well as they are the principal beneficiaries of new Federal Communications Commission (FCC) Chairman Ajit Pai's decision to distribute a notice of proposed rulemaking that aimed at reversing the prior regime's reclassification of broadband as a Title II communications service. The move would limit the FCC's ability to regulate broadband. From a practical perspective, we hadn't expected that the current FCC had any intention of enforcing existing Title II rules. Nonetheless, changing the classification (or, reclassifying the reclassification, if you prefer) eliminated an overhang, at least in the near term. Additionally, an announced collaborative effort by Comcast and Charter to launch wireless services over Verizon's network suggested a measured, prudent capital deployment strategy in wireless that was warmly received by investors.

Returns from integrated telecom companies were mixed. U.S. wireless stocks were hurt by an exceedingly aggressive promotional environment and reduced hope for market repair via consolidation. The latter dynamic resulted from the rumored potential relationship between cable and Sprint. Partially offsetting this weakness within our portfolio was a healthy contribution from Canadian telecom, which operates in a more benign competitive environment.

ENERGY

Our energy holdings declined by over 8.0% during the quarter and lagged the -6.4% return of the S&P 500 Energy Index.[7] The average price of West Texas Intermediate (WTI) grade oil fell, motivating sales of energy equities with commodity exposure. OPEC's November 2016 pledge to curtail production by 1.5 million barrels per day was renewed in May, but this was not enough to offset rising supply from North America and Libya, and poor weather-related winter heating demand. In North America, the rig count pivoted from contraction to expansion in mid-2016 as domestic oil prices rose above $48.00 per barrel and showed no sign of slowing when the oil price began to decline in late May. Significantly, the rigs that continue to be added are far more capable than those of even three years ago. Each rig can drill bigger wells faster than those of previous generations. The result is fear that U.S. production will grow at an accelerating rate in 2017 after declining for much of 2016. The growth could conceivably fully offset OPEC rebalancing efforts and lead to inventories rising in 2018 rather than falling as many had hoped.

Such an environment will most likely lead to further consolidation as companies seek to gain scale and reduce costs. While there has been a lot of asset level M&A activity, we saw the first corporate deal with EQT Corp.'s announced purchase of adjacent competitor, Rice Energy. We expect that this will be the first of many deals to come as the industry will need to find ways to further reduce costs and ultimately control productive capacity growth.

OUTLOOK

Our outlook on utilities remains largely unchanged from last quarter. While short-term interest rates are likely to rise, the recent flattening of the yield curve due to a decline in the yield on the 10-year U.S. Treasury is signaling a possible economic slowdown in the coming months. Historically, in a slow-growth low-inflation economy, the predictable revenue and dividends of selected utilities have increased appeal to many investors. We expect continued support in selected states for renewable investment and multi-year investment in generation and transmission infrastructure. We anticipate a more accommodative FERC will adopt a less contentious approval process, resulting in greater transparency around allowed rates of return.

In communications, we expect the competitive pricing structure within the wireless industry will continue to pressure the share prices of the large integrated players. We see better opportunities at cable, tower and fiber companies where cash-flow growth is driven by increasing demand for broadband accessible from mobile and fixed devices.

Our energy outlook is less sanguine than it was last quarter. The degree to which North American producers have been able to drive costs down means that the outlook for near-term commodity price recovery is less clear. There are several international development projects that have come online in 2017, for which capital was deployed before prices fell. These projects will limit the degree to which natural field declines manifest into lower global supply. Thus, it may be later in 2018 before the effect of global reduction in capital spending produces natural production declines meaningful enough to offset increased North American productivity.

For further information contact:
Rowland O. Wilhelm, Jr.
Vice President, Director of Sales and Marketing
Reaves Asset Management
10 Exchange Place, Jersey City, New Jersey 07302
Telephone 201.793.2383
Fax 201.332.8593
rwilhelm@whreaves.com
www.reavesassetmanagement.com

[1] R*eal Estate Investment Trusts*

[2] *The Reaves ERISA Composite reflects the dollar-weighted return of all corporate ERISA pension accounts with assets of at least $1,000,000 under management. All references to performance and holdings reflect the Reaves ERISA Composite. This quarterly commentary covers the period 03/31/17 through 06/30/17.*

[3] *West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing.*

[4] *The 10-year U.S. Treasury note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

[5] *The S&P 500 Utilities Index is a capitalization-weighted index containing 28 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities. This equity index does not currently have telecommunications or energy equities that are contained in the Reaves ERISA Composite.*

[6] *The S&P 500 Telecommunications Services Index comprises those companies included in the S&P 500 that are classified as members of the telecommunication services sector.*

[7] *The S&P 500 Energy Index comprises those companies included in the S&P 500 Index that are classified as members of the GICS energy sector. This equity index does not have telecommunications or utilities equities that are contained in the Reaves ERISA Composite.*