ClearBridge Investments

Unexpected Punches Hurt, but Midstream Looks Oversold

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Key Takeaways

- Entering 2020, ongoing balance sheet deleveraging, rising dividend/distribution coverage and robust expected M&A activity gave midstream investors good reason to be optimistic.
- As a result of three quick and unexpected blows, the outlook for midstream has gone from bright to cloudy.
- Yet with lower leverage and higher dividend/distribution coverage than in the past, the midstream sector is not nearly as badly beaten as current stock prices would suggest, and cash flows should remain resilient.

Improved Fundamentals Should Keep Midstream Sector Resilient

Entering 2020, midstream investors had a good reason to be optimistic. U.S. energy production growth would likely continue to drive midstream cash flows. Balance sheet deleveraging had reached a level where share buybacks were likely to be in play during the second half of the year. Dividend/distribution coverage was estimated to approach 1.5x. M&A activity was expected to be robust with publicly traded midstream stocks trading substantially below cash flow multiples seen in private market transactions. In short, the outlook was positive heading into the year.

Then three unexpected punches arrived — each new punch compounding the pain of the previous one.

First, the coronavirus began to spread in Wuhan in January. As recently as a month ago, this was still such an unknown that Corona beer virus was trending on Google. In just a few weeks, this went from a threat to China to a threat to the global economy. Expectations for global oil demand in 2020 went from growth of 1.0–1.2 million barrels per day (BPD) in early February to a decline of 1.0 million BPD in March. The speed at which the virus impacted global oil demand was breathtaking. Midstream stocks weakened during this period, declining -9.8% in February.[1] However, they traded more or less in line with the broader U.S. equity market, which fell -8.2% as measured by the S&P 500 Index, and fared much better than oil production (-19.5%)[2] and oilfield service stocks (-17.7%).[3]

Second, the OPEC+ coalition broke down on March 6. Commentary out of OPEC+ countries indicated a high likelihood that OPEC+ would react to the quickly deteriorating oil demand by reducing oil output. On March 4, OPEC indicated it intended to push through a 1.5 million BPD oil production cut with its members and Russia. On March 6, Russia (unexpectedly) refused to participate. Oil prices and energy stocks (including midstream) traded off around 10%.

[1] Alerian Midstream Energy Index
[2] S&P Oil & Gas Exploration & Production ETF
[3] S&P Oil & Gas Equipment & Services ETF

The third (and by far the most painful) punch came over the weekend. Saudi announced that, not only would it not reduce production, it would instead raise it, since Russia chose not to participate in the previously discussed oil production cut. This Saudi action was completely unexpected. Rising Saudi oil production in the face of declining oil demand due to the coronavirus immediately sent oil prices down by almost 30% on March 9. Energy stocks traded off roughly a similar amount. Global equity markets plunged with the U.S. stock market enduring its seventh-worst selloff since 1940.

As a result of these three quick and unexpected blows, the outlook for midstream has gone from bright to cloudy. With Saudi raising production and demand weakening, the global demand for more U.S. oil has declined. In the absence of a new agreement with OPEC+, U.S. oil production needs to decline to help balance the market (until demand likely rebounds as coronavirus fears fade). Oil prices fell to levels that will ensure reduced U.S. drilling activity. Depending on the field, U.S. oil shale plays need oil prices around $35–$40 per barrel to break even. With oil prices below this, oil producers will reduce drilling activity. In just two days since the Saudi action, many U.S. oil producers have announced revised capital spending plans for 2020.

U.S. oil production will not suddenly shift lower. However, it is reasonable to expect a gradual decline over the course of 2020 after a gradual incline over the course of 2019. As such, oil production will now likely be flat year-over-year in 2020 and will likely see a year-over-year decline in 2021.

What does this mean for midstream stocks? It is not as dire as the more than 30% decline in midstream stock prices following the March OPEC+ disintegration. Unlike an oil production company whose cash flows are directly tied to the price of oil, midstream cash flows are tied to the volume of oil moving through infrastructure systems. We believe it is reasonable to expect roughly flat year-over-year cash flows in 2020 given recent developments. With likely lower oil production in 2021, midstream cash flows could modestly decline in 2021, though declines will be mitigated by long-term contracts.

Much like in 2015–2016, the oil price downturn will likely drive a wave of bankruptcy filings from oil production companies. In 2015–2016, a handful of contracts between midstream companies and producers were reworked. There was not a widespread cancellation of existing transportation contracts. The reason for this is simple: in a bankruptcy the oil producer must maximize cash and the way to generate any cash flow for an oil producer is to have its oil production transported to market.

In many ways, the only similarity from the current environment to the downdraft in 2015 into early 2016 is low oil prices. In 2015–2016, midstream companies needed access to equity capital to fund committed capital spending projects. Today, midstream companies rely on internally generated cash flows to fund capital projects. In 2015–2016, dividend/distribution coverage for the sector sat around 1.1x. Today, dividend/distribution coverage for midstream is around 1.5x. As such, we would not expect a wave of dividend/distribution cuts. Finally, the midstream sector on a whole was overleveraged heading into the 2015–2016 downturn. That is not the case today. In fact, leverage levels have reached a point where many midstream companies expect to exercise stock buybacks. A very different financial environment today than in 2015–2016.

At current valuation levels, we expect a meaningful pickup in M&A activity over the balance of 2020 and into 2021. This trend began in 2019 with two publicly traded midstream companies taken private and will likely continue in 2020. Private transactions at higher multiples than stocks are trading at highlights how wide the valuation disconnect is between current market cash flow multiples and what private buyers are willing to pay. This gap cannot remain indefinitely.

In summary, the rapid 1-2-3 punches endured over the past few weeks has left midstream stocks badly beaten. However, we feel the sector is not nearly as badly beaten as current stock prices would suggest. As in previous oil price cycles, cash flows will likely be resilient. Dividend/distribution coverage suggests midstream companies will not have to reduce payouts to investors. Share buybacks will likely accelerate over the balance of 2020, providing support for midstream stock prices.

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