Midstream Valuation Discounts Shouldn't Last:

A Q&A with Chris Eades

Key Takeaways

- Simplifications are allowing energy infrastructure companies to use internally generated cash flows to fund capital growth projects, rather than issuing equity in the public markets, which is typically dilutive to the share price.
- The combination of lower valuations, better growth and higher yields positions the sector well over the balance of 2019.
- Growing U.S. energy production is increasing cash flows for the companies we invest in and allowing them to raise their distributions.

How would you characterize recent midstream and MLP performance?

The surge in stocks that we've seen in the first quarter of 2019 really comes on the heels of how weak things were in the fourth quarter of 2018. The U.S. equity market was extremely weak in the fourth quarter, and midstream or MLP stocks were not immune to that. They traded down about 15%. We've rebounded in 2019; the sector's up almost 20% since its Christmas Eve low, but keep in mind we're only back to the levels we were at late in October 2018. These stocks are still at very cheap valuations and still exhibiting double-digit cash flow growth. We had record cash flows in 2018, we should have record cash flows again in 2019. So, while we've rebounded, the rebound could certainly have some legs as we look out over the balance of 2019.

How have recent simplifications and the elimination of incentive distribution rights changed your expectations for the sector?

Cleaner corporate structures and fewer incentive distribution rights (IDRs) should be a boon for midstream and MLP companies. IDRs were part of the original structure of the master limited partnership: a general partner receives cash flows from a limited partner. Over time, however, the general partner gets a higher and higher cut, and at some point it becomes prohibitive from a cost perspective, and it forces the limited partnership to have a higher cost of equity capital. We've seen a collapsing of these structures in 2017 and 2018, where the general and limited partners have merged together. Sometimes the

resulting entity remains a partnership, sometimes it becomes a C-corporation, but certainly the companies that have undertaken those simplification transactions have a lower cost of capital and higher distribution or dividend coverage ratios. The simplification typically allows the company to fund itself, i.e., by using internally generated cash flows to fund capital growth projects instead of perpetually coming out and issuing equity in the public markets, which is typically dilutive to the share price.

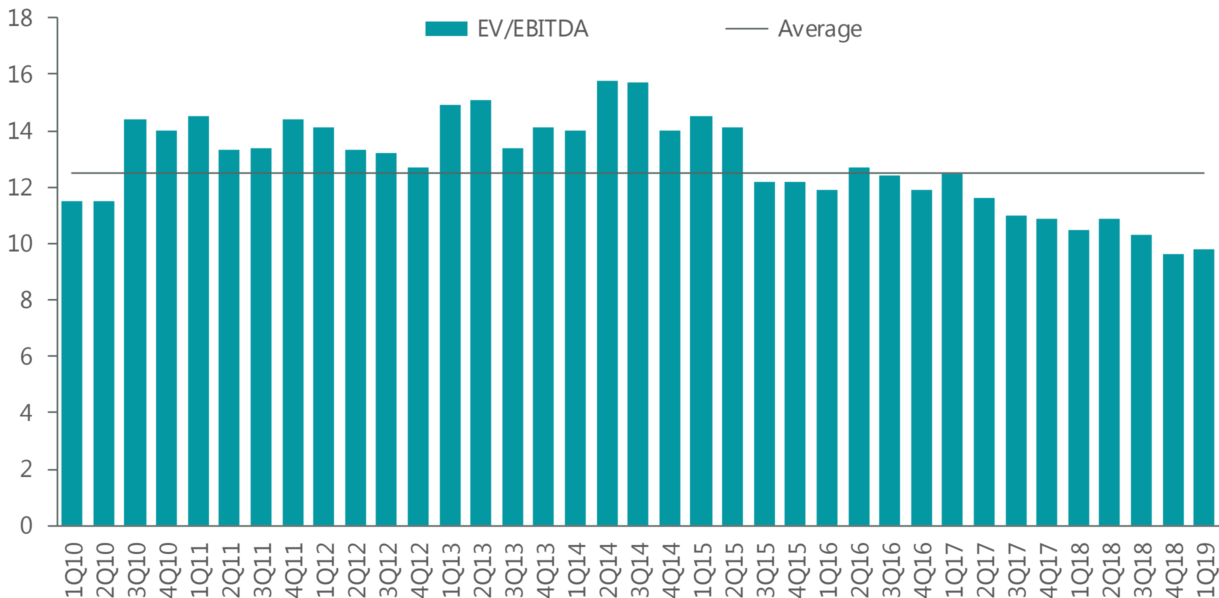
What are midstream and MLP valuations telling you at the moment?

On a relative basis, midstream companies are exceedingly attractive. The yield of the midstream sector is just over 6%, compared to REITs around 4% and utilities around 3%. And you look at cash flow growth rates for 2019: midstream companies should have double-digit cash flow growth, compared to REITs, which should be about flat, and utilities, which should be around 4%. So you have higher yields, faster growth and, very importantly, lower valuations. In terms of cash flow multiples for midstream companies, right now they are trading at about a 22% discount to where they've traded historically, and that would compare to REITs and utilities, which are both trading at 15%–20% premiums to where they've traded historically. I think the combination of lower valuations, better growth and higher yields certainly positions the sector well over the balance of 2019.

What is your outlook for midstream and MLP companies?

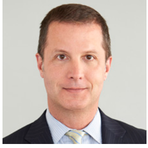
We remain very constructive in 2019 for MLP or midstream companies, and that positive bias toward the sector is a function of growing U.S. energy production, which is increasing cash flows for the companies we invest in and allowing them to raise their distributions, albeit at a slower rate than four or five years ago. Even with the fundamental landscape as positive as it is, valuations are at a 22% discount. Balance sheets are deleveraging, distribution or dividend coverage ratios are rising — these are characteristics of a sector that should be trading at parity, or at a premium, to its historical multiples. In our view, if the cash flows come in as we expect, and they have so far, that disconnect between cash flow growth and the lack of share price appreciation is bound to get bridged. We're not quite sure if it happens in a week, a month or six months, but certainly that disconnect between cash flows and stock prices is unsustainable if the cash flows come in as we expect they will.

Exhibit 1: MLP EV/EBITDA Multiples Two Points Lower than Average



As of March 31, 2019. Source: Partnership reports, FactSet, and Wells Fargo Securities estimates.

About the Author



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