ClearBridge Investments

Energy MLP Strategy

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Key Takeaways

- As a result of three quick and unexpected blows, the outlook for midstream has gone from bright to cloudy.
- Should global demand recover sufficiently later in 2020, midstream cash flows could be moderately lower than expected before the recent downturn; this is manageable at the midstream company level.
- Private transactions at higher multiples than publicly traded midstream 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.

Market Overview and Outlook

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. 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 in early February to a decline of 1.0 million barrels per day 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. 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%) and oilfield service stocks (-17.7%).

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 barrel per day 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%.

Any decline in midstream cash flows will be mitigated by long-term contracts.

The third (and by far the most painful) punch came when Saudi Arabia 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. A renewed OPEC+ agreement reached in early April will reduce global oil supplies by roughly 10 million barrels per day (bpd). However, global oil demand has collapsed by over 20 million bpd due to coronavirus shutdowns. The question as the second quarter unfolds will be whether demand will return before global inventories are completely full. If demand recovers in time, oil prices will likely hover between cash operating costs ($15–$20 per barrel) and the price where new oil drilling is economical ($35–$40 per barrel). If demand does not recover before inventories fill, oil prices will have to fall below $15 per barrel to incentivize producers to shut-in existing production. If the latter becomes reality, it will likely be short lived. Yet, it would bring into question midstream cash flows in 2020 as U.S. oil production would likely move sharply lower.

Should global demand recover sufficiently in the third quarter, midstream cash flows could be moderately lower than expected before the recent downturn. This is manageable at the midstream company level as distribution/dividend coverage ratios for the group stood at 1.5x in February. Further, midstream companies on average could weather a subsequent decline in U.S. oil production in 2021 given improved balance sheets and coverage ratios relative to the last oil market downturn in 2015.

What does this mean for midstream stocks? It will remain unclear until the market gains clarity on how long global oil demand will remain depressed. That said, the 47% decline midstream stocks posted in March likely discounts among the most bearish outcomes. We regained confidence in midstream cash flows over the balance of 2020 and, more importantly, into 2021, midstream stocks could be poised for a material rebound. However, in the absence of such clarity, it remains difficult to predict the very short-term direction for midstream stocks.

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.

Portfolio Highlights

On an absolute basis, the Strategy had a negative return for the first quarter, outperforming its benchmark. In terms of absolute performance, the Strategy had losses in all four subsectors in which it was invested. The natural gas transportation & storage subsector delivered the least negative contribution. The diversified energy infrastructure subsector was the main detractor.

On a relative basis, the Strategy outperformed due to sector allocation and stock selection effects. In particular, an overweight to the diversified energy infrastructure subsector, an underweight to the gathering/processor subsector and stock selection in the gathering/processing and liquids transportation & storage subsectors contributed to relative results. Conversely, stock selection in the diversified energy infrastructure subsector and an underweight to the natural gas transportation & storage subsector weighed on relative returns.

Least negative contributors to Strategy performance included Brookfield Infrastructure, Noble Midstream Partners LP, Holly Energy Partners LP, Plains GP Holdings LP and EQM Midstream Partners LP. The top detractors during the quarter were ONEOK, Energy Transfer LP, Enterprise Products Partners LP, Plains All American Pipeline LP and Targa Resources.

During the quarter, we initiated a position in Brookfield Infrastructure and closed a position in Noble Midstream Partners LP.