ClearBridge Investments

Energy MLP Strategy

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Key Takeaways

- The combination of Saudi Arabia increasing oil production in March and global oil demand plummeting at roughly the same time due to the COVID-19 pandemic left the oil market grossly oversupplied, with prices plunging and global inventories rapidly building.
- Investor focus is seemingly only on oil, but U.S. energy production is more than just oil. The steep decline seen in U.S. oil production has not occurred with natural gas or natural gas liquids.
- The transformed midstream business model, including free cash flow after dividends/distributions with the resultant natural balance sheet deleveraging, share buybacks, and/or dividend/distribution increases, should begin to resonate with investors.

Market Overview and Outlook: New Midstream Business Model Could Start to Resonate

The persistence of new global coronavirus infections and related travel restrictions raised concerns about fuel demand recovery and pressured oil prices and the energy sector. The Alerian MLP Index returned -16.3% for the quarter.

With reduced drilling activity and natural declines, U.S. oil production has predictably moved lower. Production levels stood at 13.1 million barrels per day in early March. It has since declined roughly 20%. Outside Gulf of Mexico storm shut-ins, U.S. oil production has been fairly steady over the past three months. Looking forward, a flattish trajectory from current levels is likely through 2021.

Investor focus is seemingly only on oil, but U.S. energy production is more than just oil. Excluding coal production, natural gas constitutes 52% of total U.S. energy production. Natural gas liquids (NGLs) makes up 10% of the total, while crude oil represents 38%.

The steep decline seen in U.S. oil production has not occurred with natural gas or NGLs. Second-quarter U.S. natural gas production was down 5% compared to first-quarter production and was down only 1% year over year. Second-quarter NGL production was up 2% compared to the first quarter and up 9% year over year.

As a result, total U.S. energy production in 2020 and 2021 will likely not be as negative as many investors expect (typically based just on oil production headlines). We estimate total U.S. energy production will be down 4% in 2020 and down another 3% in 2021. These fairly modest overall declines in U.S. production will drive a roughly 6% decline in cash flows in 2020 and a roughly 1% decline in cash flows in 2021.

The combination of Saudi Arabia increasing oil production in March and global oil demand plummeting at roughly the same time due to the COVID-19 pandemic left the oil market grossly oversupplied, with prices plunging and global inventories rapidly building. Yet, there are always cyclical forces at play that arrest the downcycle and present a new upcycle. The reversal from downcycle to upcycle usually consists of five related events:

1. Oil prices decline — either because of oversupply issues, demand destruction due to higher prices, or a demand shock (such as the COVID-19 pandemic).
2. Drilling activity declines as oil prices move below cash breakeven levels.
3. Production capacity declines due to reduced drilling activity and natural declines of existing fields.
4. Inventories begin to decline.
5. Demand responds positively to lower oil prices.

Looking down this list, the first two events have occurred. The last three have begun to occur but the full effects have yet to impact the global oil market.

In the U.S., the average shale oil field needs roughly $40 per barrel for the producer to break even on drilling a new well. Cash operating costs of existing wells are roughly $20–$25 per barrel. As oil prices moved below both thresholds in the spring, drilling activity for new wells declined and some existing production was shut in with oil prices below cash operating costs.

Since March, the number of rigs drilling for oil in the U.S. has fallen by roughly 75%. International drilling activity has declined by 32% since the pandemic began. This underinvestment in drilling activity is having, and will continue to have, an impact on global oil production capacity.

After surging through the spring and the first part of the summer, preliminary data indicate that global oil inventories began decreasing in August — on a combination of reduced supply and recovering demand.

Global oil demand has begun to recover but remains far from its pre-COVID-19 levels. The biggest wildcard in the oil market, moving into an upcycle, is clearly demand recovery. We simply do not have visibility on the timing or magnitude of the recovery. Yet, if global oil demand recovers to levels anywhere near

pre-pandemic levels, global oil supply will likely be caught flat footed and unable to quickly respond to rising demand. At that point, the downcycle will have been reversed and the next upcycle will be upon us.

The transformed midstream business model, including free cash flow after dividends/distributions with the resultant natural balance sheet deleveraging, share buybacks, and/or dividend/distribution increases, should begin to resonate with investors. This, coupled with high current yields, could allow for the midstream sector to experience cash flow multiple expansion (relative to today's depressed multiples). M&A activity could provide a catalyst for investors to embrace the new midstream business model. However, until that occurs, midstream investors will get paid to wait, with a current yield of roughly 13%. In our view, this high level of both absolute and relative yield is sustainable for the sector, with dividends/distributions that on average are more than 2x coverage and do not require for perpetual access to the equity and debt capital markets.

Midstream stocks could likely become attractive to both value and growth investors.

Cash flows will decline modestly in 2021 compared to 2020. However, with what we believe to be a looming oil market upcycle, cash flows could resume growing in 2022. If that occurs, midstream stocks would likely become attractive to both value and growth investors — setting the stage for a more lasting share price rebound.

Portfolio Highlights

The ClearBridge Energy MLP Strategy had a negative return for the third quarter yet outperformed its benchmark. In terms of absolute performance, all four subsectors in which the Strategy is invested made negative contributions, with the liquids transportation & storage and diversified energy infrastructure subsectors detracting the most. The gathering/processing subsector led in terms of absolute contribution to returns, with a largely neutral contribution.

On a relative basis, the Strategy outperformed due to stock selection and sector allocation effects. In particular, stock selection in the diversified energy infrastructure, liquids transportation & storage and gathering/processing subsectors contributed to relative results.

In terms of individual contributors, Brookfield Infrastructure Partners LP / Brookfield Infrastructure Corporation, CNX Midstream Partners LP, Delek Logistics Partners LP, Williams Companies and Antero Midstream contributed the most to absolute performance. Energy Transfer LP, Plains All American Pipeline LP, Magellan Midstream Partners LP, ONEOK and Enterprise Products Partners LP were the main detractors.

During the quarter, CNX Resources Corp. (CNX) completed the acquisition of all outstanding common units of portfolio holding CNX Midstream Partners LP (CNXM); common shares of CNX Resources were received and retained in the portfolio.