ClearBridge Investments

Energy MLP Strategy

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Key Takeaways

- The beginning of the distribution of vaccines for the coronavirus and a resultant brighter outlook for economic growth and energy demand in 2021 helped energy midstream stocks.
- There are always cyclical forces at play that arrest an oil downcycle and present a new upcycle; stirrings of the next upcycle are underway but have yet to impact the global oil market.
- Once cash flows resume in an oil market upcycle, midstream stocks would likely become attractive to both value and growth investors.

Market Overview and Outlook: Energy Demand Outlook Brightens

The beginning of the distribution of vaccines for the coronavirus and a resultant brighter outlook for economic growth and energy demand in 2021 helped midstream energy stocks to a robust quarter. The Alerian MLP Index advanced 32.45%, well ahead of the S&P 500 Index's 12.15% gain. Oil prices also continued to rise as the energy demand outlook improved for 2021 and as OPEC and its partners agreed to only a modest increase of production beginning in January. A barrel of WTI crude rose just over $8 to finish the quarter at $48.52.

Within the benchmark index, the gathering/processing subsector (+45.82%) led the advance, followed by liquids transportation & storage (+34.92%) and diversified energy infrastructure (+27.03%). The natural gas transportation & storage subsector (+12.94%) was the main laggard.

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. They have since declined roughly 20%. Outside Gulf of Mexico storm shut-ins, U.S. oil production has been fairly steady since August. 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. Third-quarter U.S. natural gas production was up 1% compared to first-quarter production and was flat year over year (YoY). Third-quarter NGL production was flat compared to the first quarter of 2020 and up 9% YoY.

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. As we noted in last quarter's commentary, 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 breakeven 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 have a continued impact on global oil production capacity.

If global oil demand recovers to levels anywhere near pre-pandemic levels, global oil supply will likely be caught flat footed.

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. With government approvals and beginning phases of distribution of vaccines imminent, we are beginning to gain some visibility on the timing 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.

In such an environment, 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 sector current yield of roughly 10%. 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 covered and have no need for perpetual access to the equity and debt capital markets.

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 rebound in midstream stock prices.

Portfolio Highlights

The ClearBridge Energy MLP Strategy had a positive return for the fourth quarter, trailing its benchmark as energy infrastructure rebounded strongly. In terms of absolute performance, all four subsectors in which the Strategy is invested made positive contributions, with the diversified energy infrastructure and liquids transportation & storage subsectors contributing the most. The natural gas transportation & storage subsector was the main laggard.

On a relative basis, the Strategy underperformed due to stock selection and sector allocation effects. In particular, stock selection in the liquids transportation & storage and gathering/processing subsectors detracted from relative results, while stock selection in the diversified energy infrastructure subsector was positive. A cash drag weighed on relative performance.

In terms of individual contributors, ONEOK, Enterprise Products Partners LP, MPLX LP, Targa Resources and Western Midstream Partners LP made the strongest absolute contributions, while Equitrans Midstream was the only detractor.

During the quarter, we exited a position in CNX Resources.