ClearBridge Investments

A Better Path Forward for U.S. Midstream

Key Takeaways

- Total U.S. energy production in 2020 and 2021 will likely not be as negative as most investors fear, and there is potentially a looming oil market upcycle.
- With midstream companies expected to be free cash flow positive after dividends and distributions in 2021, management teams will be able to naturally deleverage balance sheets, buy back stock and/or increase dividends/distributions.
- A Biden win in November should not be as detrimental as some fear for midstream stocks and would not dramatically alter the sector's overall cash flow profile, which will drive a significant and increasingly important yield advantage relative to other sectors and other asset classes.

For all of us, in many different and individual ways, 2020 has proven to be a challenging year. The pandemic has ravaged the global economy, as well as our local communities. While U.S. equity market indexes recovered from the March lows to recapture all-time highs in early September, U.S. midstream stocks initially recovered, but have since languished.

From the March lows to early June, the Alerian MLP Index moved 148% higher on a total return basis. Between early June and the end of September, the index declined by 35% — leaving it up 62% from the March lows, but down 46% year to date (versus the S&P 500 Index, up roughly 6%).

Why has the recovery in midstream stocks faltered since early June? Growth stocks being in favor over value stocks has not helped. The energy sector broadly has also been out of favor with investors relative to other value-oriented sectors. More importantly, the narrative for why to own midstream stocks has changed this year and the market appears uncertain on how to value the "new" midstream landscape.

2020: The Changing Midstream Investment Narrative

After a lackluster 7% total return and compressing cash flow multiples in 2019, the investment narrative for midstream stocks heading into 2020 had several positives: growing U.S. energy production driving increasing volumes on midstream infrastructure systems, deleveraging balance sheets, potential stock buybacks and a likely acceleration

in merger and acquisition (M&A) activity. As a result of these positives, midstream stocks were accorded some expansion in cash flow multiples.

Then March hit. Saudi Arabia started a price war with Russia by raising production. COVID-19 impacts quickly reduced global oil demand by 20%–25%. With rising global oil production and collapsing demand, oil prices plummeted (and even went briefly negative on April 20). In past oil price cycles, it was argued that midstream companies were relatively immune to swings in oil prices from a cash flow perspective. This time was different. U.S. oil producers effectively shut down drilling activity, with the number of rigs drilling for oil declining by 76% from peak to trough.

M&A and consolidation in the sector has only been delayed.

After increasing from less than six million barrels per day after the Global Financial Crisis to more than 13 million barrels per day in February of this year, U.S. oil production fell sharply — down almost 20% from March through September. The U.S. oil production growth story was perceived as dead. Midstream stocks reacted accordingly.

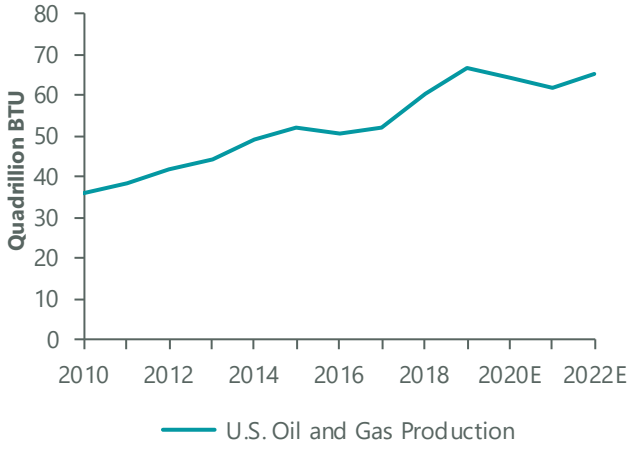
As the dust has settled, the investment narrative for owning midstream stocks has changed. It was about U.S. energy production growth and all the positives mentioned above. Now, it is about harvesting cash flow from existing investments, capturing current (and likely sustainable) yield and moving toward free cash flow generation (after capital spending and dividends/distributions). The move toward true free cash flow yield and the resultant organic deleveraging of balance sheets (with likely prospects for stock buybacks) is underappreciated, in our view. This presents the current investment opportunity.

U.S. Energy Production: More Than Just Oil

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 over the past three months. Looking forward, a flattish trajectory from current levels is likely through 2021 (Exhibit 1).

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%.

Exhibit 1: U.S. Oil and Gas Production



As of June 30, 2020. Source: Department of Energy, ClearBridge estimates.

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 most investors fear (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 ~6% decline in cash flows in 2020 and a ~1% decline in 2021 cash flows. Had midstream cash flow multiples remained flat during 2020, the Alerian MLP Index would be down roughly 15% year to date with cash flows down 6%. Yet, the index is down 46% year to date through September. Cash flow multiple contraction is the bigger culprit for this year's midstream stock performance. We believe some cash flow multiple reversion could occur in 2021 and 2022.

Looming Oil Market Upcycle

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 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 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

Up until four years ago, the midstream/MLP business model was to effectively pay out operating cash flows to investors in the form of dividends or distributions. Any growth projects — whether buying an existing asset or building one — required access to both the equity and debt capital markets. Cash flow from the acquired asset or the newly built asset supported roughly 10% annual growth in dividends or distributions for the sector.

This business model worked up until early 2016 when oil prices and midstream stocks collapsed. The decline in stock prices for midstream companies left them with effectively no access to the equity capital markets. To complete growth projects already in various stages of completion, many midstream companies were forced to finance existing growth projects with only debt capital. This resulted in midstream stocks becoming overleveraged. In an effort to improve balance sheet leverage ratios, many midstream companies reduced dividends and distributions.

This painful, but necessary, exercise moved most midstream management teams to limit dividend and distribution growth rates — allowing dividend/distribution coverage ratios to rise. Excess cash flow after dividends/distributions gave midstream companies the flexibility to limit the need to issue equity to finance growth projects. Yet, midstream companies in aggregate still did not truly generate free cash flow (defined as operating cash flow minus capital expenditures and dividends/distributions). The sector no longer needed access to equity capital markets but still required access to debt capital markets to finance growth.

> The narrative for why to own midstream stocks has changed this year and the market appears uncertain on how to value the "new" midstream landscape.

Following 2016, most midstream companies that were structured as MLPs announced transactions to eliminate incentive distribution rights (IDRs) paid to general partners. These transactions increased available cash flow to limited partners and reduced the cost of equity for these companies.

The COVID-19 pandemic has forced midstream to complete their business model transformation to generating free cash flow after dividends/distributions. Some midstream companies chose to reduce dividends/distributions. Others reduced capital spending. Again, while painful like in 2016, this final transformation leaves midstream companies in uncharted waters. The sector will be free cash flow positive after dividends and distributions in 2021 for the first time. This true free cash flow yield will likely widen in coming years. Midstream companies will need access to neither equity nor debt capital markets to finance capital projects. Importantly, they will also have excess cash flow after dividends and distributions. Midstream management teams will now be able to naturally deleverage balance sheets, buy back stock and/or increase dividends/distributions.

The importance of this final transformation should not be underestimated. In our view, it is greatly underappreciated. The midstream sector now yields 14.7%. Our expectation is midstream companies will have an average dividend/distribution coverage ratio of 2.1x in 2021. Thus, for every $100 that midstream companies pay out to investors they will have, on average, $210 of cash flow. As such, another wave of dividend or distribution cuts is unlikely for the sector as a whole. Debt reduction, share buybacks and/or increases in dividends or distributions will be part of the midstream management playbook in 2021 — a very different playbook than was used just a few years ago.

Midstream Yield Advantage in a Yield-Starved World

Midstream yield spreads to 10-Year Treasury yields and non-investment-grade bonds sit just off the all-time highs set during March — and remain far wider than any period prior to 2020 (Exhibit 2).

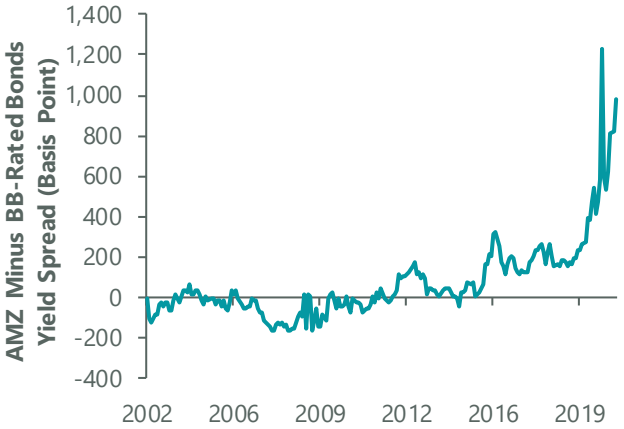
At the end of September, midstream stock yields were 1,405 basis points above 10-year Treasury yields. This compares to an average spread of 414 basis points over the past 20 years. Said differently, the spread of midstream equity yields relative to 10-Year Treasury yields sits nearly five standard deviations from the historical mean. Before this year, the prior peak yield spread between midstream equity yields and 10-Year Treasury yields was 983 basis points in December 2008.

The picture is similar if you compare midstream equity yields to higher-risk bond yields (Exhibit 3). At the end of September, the midstream equity yield spread to 10-year BB-rated bonds stood at 984 basis points — with midstream stocks yielding 14.73% and 10-Year BB-rated bonds yielding 4.89%. This was also almost five standard deviations from the historical average spread of 71 basis points.

Exhibit 2: Midstream/Treasury Yield Spreads Near Extreme

As of Sept. 30, 2020. Source: ClearBridge Investments, Bloomberg Finance.

Exhibit 3: Midstream/High-Yield Bond Spreads Also Near Extreme



As of Sept. 30, 2020. Source: ClearBridge Investments, Bloomberg Finance.

Further, midstream company bonds trade today at wide discounts to their own equity yields. The equity yield spread for investment grade midstream companies compared to their own debt stood at 236 basis points entering 2020 and at present sits at 610 basis points. In 2020, equity yields have risen and bond yields have fallen for midstream companies. At present, it appears that bond investors see meaningfully lower risk in midstream companies than equity investors do in the same companies.

A case in point is Enterprise Product Partners (EPD). At the beginning of 2020, Enterprise's 3.125% bonds maturing in 2029 were priced to yield 3.04%. Today, the same bonds are priced to yield 2.87%. In contrast, Enterprise's common equity began the year with a current yield of 6.32% and at the end of September it stood at 11.27%. For the same company, its stock price collapsed while its bond prices moved higher.

In our view, the disconnect between midstream equity yields relative to various fixed income yields is due for a reversion — particularly as equity investors begin to understand and embrace the transformed midstream business model.

C-Corp Vs. Partnership Midstream Stocks

C-Corp midstream stocks continue to deliver better relative performance and trade at higher cash flow multiples than partnership midstream stocks. Looking at a basket of the largest C-Corp stocks compared to a basket of MLP stocks, C-Corps outperformed the

MLPs by more than 30 percentage points in 2019 and are performing 12 percentage points better in 2020 year to date.

The key reason for relative performance and valuation disparities between these two baskets is the addressable investor universe. Large institutional investors such as mutual funds, pension funds and endowment funds have shied away from owning MLP stocks due to tax complications and governance issues. This has left MLP-structured stocks owned largely by retail investors — a group still scarred from the multiple downturns over the last five years. Converting from an MLP to a C-Corp is complicated. There are potential tax implications for current holders. Corporate income tax rates could increase, leaving MLP companies advantaged relative to C-Corps. Yet, C-Corp midstream stocks will likely continue to outperform MLP midstream stocks over the intermediate-to-long term, in our view — just given the larger potential investor base. On average, the five stocks in our illustrative MLP basket would need to increase by 50% to trade at the same average EV/EBITDA multiple as our illustrative C-Corp basket.

Investors should also keep an eye on the presidential election (see below). A Joe Biden administration could raise taxes on qualified dividend income — which could spur some renewed interest in MLP midstream stocks as income paid to investors comes in the form of distributions (tax deferred) instead of dividends (currently taxable).

M&A and Sector Consolidation

Entering 2020, we expected increasing M&A activity to be a theme for the midstream sector. The COVID-19 pandemic precluded such a wave of M&A activity from happening. However, we believe that M&A and consolidation in the sector has only been delayed.

In 2019, there was roughly $44 billion of M&A activity in the midstream sector — including two privatization transactions. The average EV/EBITDA multiple on these transactions was in excess of 11x. Beyond corporate restructuring mergers, the only M&A deal of any size in 2020 has been Berkshire Hathaway's approximately $9.7 billion acquisition of midstream assets from Dominion Energy for roughly 10x EV/EBITDA.

With the midstream sector trading at an average 2021 EV/EBITDA multiple of 8.0x and wide dispersion in multiples for the range of midstream companies, we think a renewed push for M&A in the sector will occur. In our view, such activity will accelerate once there is renewed visibility on the path of global economic recovery after the COVID-19 pandemic.

Presidential Election

There remains a lingering fear among investors that a Biden win in the November presidential election would be exceedingly negative for the energy sector broadly and midstream specifically. The issues relevant for energy and midstream are:

- **Regulation:** For midstream, the biggest risk of a Biden win is increased regulation. Federal permitting of new pipeline projects would certainly be more difficult. However, after a large wave of capital spending on new pipelines over the last five years, there is not a real need for incremental pipelines — particularly with U.S. oil production still well below its pre-COVID-19 level. Also, investors should keep in mind that, while a Biden White House will likely increase federal regulation, state regulation will not likely be meaningfully affected.
- **Corporate Income Tax:** Some expect a Biden win would ultimately result in higher corporate income tax rates. This will be a clear negative for C-Corp midstream stocks compared to MLP midstream stocks.
- **Capital Gains Taxes:** The Biden campaign has proposed raising the highest tax bracket for capital gains from 23.8% to 39.6% (equivalent to highest ordinary income tax rate). Somewhat oddly, this proposal may benefit energy and midstream stocks in the short term. With steep losses thus far in 2020, we would typically expect investors to harvest tax losses this year heading into year end. However, if investors come to believe that capital gains taxes are going to move meaningfully higher, they may

Exhibit 4: C-Corps are Outperforming MLPs

	2019 Performance	2020 Performance	Current Yield	EV/EBITDA	Debt/EBITDA
C-Corp	39.8%	-28.2%	8.6%	9.4	4.9
MLP	7.0%	-40.1%	14.3%	8.2	4.4

As of Sept. 30, 2020. Source: ClearBridge Investments, Bloomberg Finance. C-Corp basket: KMI, ENB, OKE, TRP and WMB. MLP basket: MPLX, EPD, ET, PAA and MMP.

choose to keep stocks with current losses as taking those losses in subsequent years would be more tax efficient. This dynamic could also result in investors actually selling stocks with gains into year end to limit future capital gains taxes.

- **Taxes on Qualified Dividends:** Presently, qualified dividend income is taxed at 20% for those filing with more than $425,801 in ordinary income. Biden will move to increase the qualified dividend tax to align with the ordinary income tax rate (39.6% for earners with more than $1 million in ordinary income). This would be a negative for income-oriented stocks such as midstream. However, with interest rates expected to remain near zero for the next few years, investors may just have to stomach the possibility of lower tax-adjusted income from equity investments. Further, most midstream stocks are structured as MLPs — which pay investors distributions as opposed to dividends.
- **Drilling on Federal Lands:** Biden has proposed to ban future oil and gas drilling on federal lands. This does not include shutting down existing production. Rather, it amounts to a ban on issuing permits for new wells. Roughly 10% of U.S. oil and gas production is on federal lands. This would not be a positive outcome for midstream (and certain companies in particular). However, it would not dramatically alter the sector's overall cash flow profile.
- **Fracking:** As the presidential campaigns have evolved over the past couple of years, the biggest risk to the energy and midstream sectors has been taken off the table. Elizabeth Warren and Bernie Sanders both wanted to ban outright fracking of oil and gas wells. This would have essentially ended shale drilling and resulted in steep declines in U.S. oil and gas production. Joe Biden has repeatedly stated a Biden administration would not move to ban fracking.

2021 Outlook

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 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 covered and there is 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.

About the Author

Chris Eades
Managing Director, Portfolio Manager
- 28 years of investment industry experience
- Joined ClearBridge in 2007
- BA from Vanderbilt University

ClearBridge Investments
620 Eighth Avenue, New York, NY 10018 | 800 691 6960
ClearBridge.com