ClearBridge Investments

Energy MLP Strategy

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Key Takeaways

- Growing energy demand in a recovering global economy, supported by COVID-19 vaccine rollouts, government policy and higher commodity prices, helped midstream energy stocks rise 48% year to date.
- The futures curve for oil is already sending oil producers a signal that drilling activity needs to increase.
- With current free cash flow yields and high dividend/distribution coverage ratios, a revaluation to EV/EBITDA levels prior to the pandemic is not unrealistic.

Market Overview and Outlook

Growing energy demand in a recovering global economy, supported by COVID-19 vaccine rollouts, government policy and higher commodity prices, helped midstream energy to another strong quarter. The Alerian MLP Index rose 21%, returning to levels not seen since the pandemic began. Even with enthusiasm for energy and cyclical recovery stocks waning late in the quarter as the market rotated to growth stocks, the index has advanced 48% so far this year. Oil prices remained resilient, meanwhile, as vaccines and ongoing government stimulus enabled greater mobility and overall consumption and OPEC maintained its production cuts throughout the quarter. A barrel of WTI crude rose from $59.16 to $73.47 from April to June.

Expectations for inflation moderated, with U.S. 10-year Treasury yields declining from 1.75% at the end of March to finish June at 1.47%. Also helping to calm inflation fears, lumber futures dropped in June, falling 40% in the month after reaching an all-time high in May.

We expect U.S. energy production to recover from the COVID-19 related declines seen in 2020 over the next three to five years. The futures curve for oil is already sending oil producers a signal that drilling activity needs to increase, and already we have seen the number of rigs drilling for oil in the U.S. increase from an August 2020 low of 172 rigs to a current 475 rigs — an increase of over 175%. Yet, oil drilling remains well short of the pre-COVID-19 level of 683 rigs. Over the next three to five years, we expect global oil demand to not only recover to pre-COVID-19 levels, but also to continue modest growth on an annualized basis. Oil reservoirs are depleting resources. With limited drilling activity over the past year, global oil production capacity has declined.

Today, the group's multiple reflects a healthy recovery, though it is still not yet back at pre-pandemic levels.

With a recovery in global oil demand, the oil market could very well find itself short oil supply in the next 12–24 months. This is the key reason for the recent move higher in oil prices. Brent oil at $75 per barrel and WTI oil at $75 per barrel — as we have seen recently — are signaling a tightening market. Oil producers will eventually react to the improving economics of drilling for oil. Further, just like before the pandemic, it is likely that the incremental barrel of oil sold into the market will be a barrel from U.S. shale. This is simply because of the superior economics of U.S. shale oil and the short-cycle nature of shale drilling (wells can be drilled and brought online in two to three months versus an offshore oil field timeline of two to three years or longer).

The macro overlay should once again benefit U.S. midstream companies. Importantly, there will no longer need to be large capital expenditures to benefit from U.S. oil production recovering from 2020 levels. Broadly, U.S. energy infrastructure is today underutilized. Growing production levels will result in higher utilization levels, limited capital spending and high cash flow leverage to (again) rising production levels.

Partly related to this, and unlike before the pandemic, midstream companies are truly generating free cash flow. This transformed midstream business model of free cash flow after dividends/distributions with the resultant natural balance sheet deleveraging, share buybacks and/or dividend/distribution increases, has recently begun to resonate with investors. This, coupled with still-high current yields, could allow for the midstream sector to experience cash flow multiple expansion (relative to today's still 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 7.3%. This healthy current yield compares to 10-year U.S. Treasurys yielding 1.5%, U.S. stocks 1.4%, high-yield U.S. bonds 3.8%, U.S. utility stocks 3.4%, and U.S REIT stocks 2.9%. 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 with no need for perpetual access to the equity and debt capital markets. A looming wave of further dividend/distribution cuts is not on the horizon given free cash flow generation and high levels of dividend/distribution coverage.

In the absence of multiple revaluation, the right way to think about the total return proposition of owning U.S. midstream is the sum of its current yield plus sustainable distribution/dividend growth rate plus free cash flow yield. The Alerian MLP Index currently yields roughly 7.3%. The sustainable dividend/distribution growth rate is roughly 2% and free cash flow yield for the sector is estimated at 3%. This presents an expected annualized total return of roughly 12%. Again, this is

before any consideration of multiple revaluation. Immediately prior to COVID-19, midstream stocks traded at an average EV/EBITDA multiple of 9.7x. At the worst of the pandemic-related selloff, midstream stocks traded at 6.9x EV/EBITDA. Today, the group's multiple sits at 8.9x — a healthy recovery but still not yet back at pre-pandemic levels. Every 1.0x improvement in EV/EBITDA multiple represents roughly 25% appreciation in the value of midstream stocks. With current free cash flow yields and high dividend/distribution coverage ratios, a revaluation to EV/EBITDA levels prior to the pandemic is not unrealistic.

The key risk is that the global economy — and, with it, global oil demand — does not return to prior levels. Oil prices are clearly discounting a recovery in global demand. Without a demand recovery, there are clear downside risks. With a demand recovery, current oil prices and the outlook for U.S. energy production seem plausible, and a revaluation of midstream to pre-pandemic levels a real possibility.

Portfolio Highlights

The ClearBridge Energy MLP Strategy had a positive return for the second quarter, trailing its benchmark. In terms of absolute performance, all four subsectors in which the Strategy is invested made positive contributions, with the diversified energy infrastructure subsector 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. Stock selection in the diversified energy infrastructure and liquids transportation & storage subsectors and an overweight to the natural gas transportation & storage subsector detracted the most. Meanwhile, stock selection in the gathering/processing subsector was beneficial.

In terms of individual contributors, Targa Resources, Plains All American Pipeline LP, Energy Transfer LP, DCP Midstream LP and Enable Midstream Partners LP made the strongest absolute contributions, while there were no detractors. PBF Logistics LP, Equitrans Midstream, Rattler Midstream LP, Holly Energy Partners LP and Cheniere Energy Partners LP were the main laggards.