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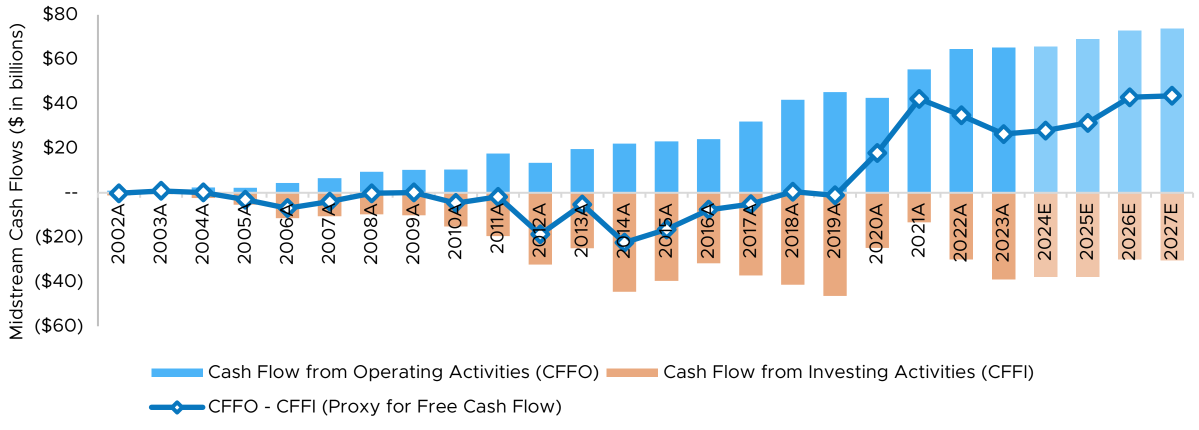
Midstream Energy 2024: In the Driver's Seat for Uncorrelated Returns

We'll say it plainly: we believe the midstream energy sector's significant transformation in recent years, alongside its positive free cash flow (FCF) attributes, remains unrecognized and mispriced.

Previously, this capital-intensive sector was marked by precariously high leverage and capital spending that far exceeded the cash flow-generative capabilities of the assets. This condition led to an unsustainable business model, heavily reliant on external capital financing that, among other factors, drove low capital returns. We contend that this operating model contributed to a level of volatility that far exceeded what was justified by the stability of the sector's underlying fundamentals and earnings potential.

With the transformation to a regime of capital discipline and internal funding complete, the midstream sector has evolved into a robust generator of FCF (see below). Midstream management teams are now well-positioned to direct these cash flows to drive positive uncorrelated returns for shareholders – with less dependence on macroeconomic forces, commodity prices or multiple expansion (i.e. higher valuations).

Midstream Cash Flows: Historical and Projected



Source: Bloomberg, Visible Alpha and Company Filings. Includes all companies in the Alerian US Midstream Energy Index (AMUS) as of December 31, 2023.

Macro Energy Outlook Less Clear

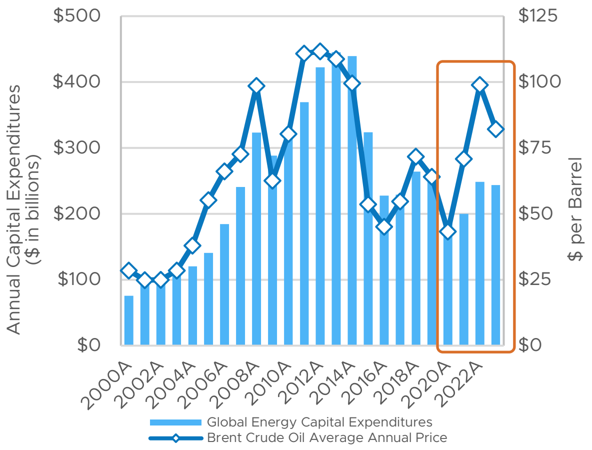
The midstream energy sector's potential for unique returns stands out, especially against a backdrop where broader energy tailwinds may moderate in 2024.

Recently, the energy sector has benefited from a range of supportive macroeconomic factors such as recovering hydrocarbon demand post-pandemic, impacts of Russia's conflict in Ukraine, a heightened focus on energy security, and ongoing underinvestment in oil and gas reserves. These elements have significantly boosted commodity prices and energy equities since the lows of 2020.

While our outlook for hydrocarbon energy has been strongly bullish in recent years, we anticipate a temporary shift in these tailwinds for 2024. The next twelve months could serve as a transitional phase – a 'bridge' to a potentially more robust 2025, particularly as new sources of hydrocarbon demand (notably, considerable liquefied natural gas (LNG) demand) come online.

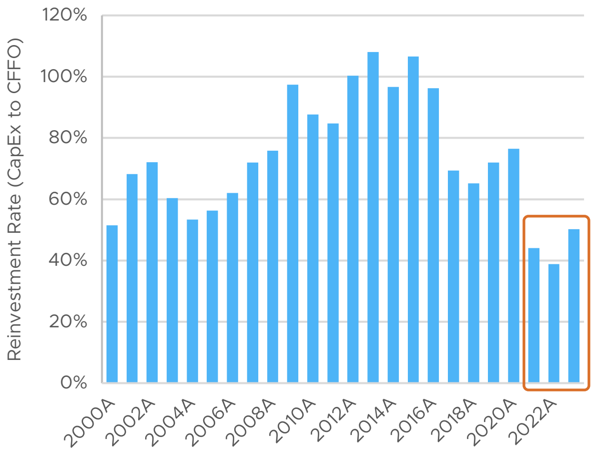
It’s important to clarify that our more 'neutral' energy macro stance in the short term should not be mistaken for bearishness. **We remain resolute in our view that the ongoing theme of persistent underinvestment in the oil and gas sector will lead to a prolonged period of higher commodity prices and higher capital returns for the energy sector** (see right)**.**

Global Integrated Oils and E&Ps Capex



Source: Bloomberg. Represents total capital expenditures of the Bloomberg energy universe of global integrated oils and independent E&Ps. Brent crude oil is the average closing price for the year. Data through December 31, 2023.

Capex as a % of Cash Flow from Operations



Source: Bloomberg. Represents total capital expenditures of the Bloomberg energy universe of global integrated oils and independent E&Ps. Brent crude oil is the average closing price for the year. Data through December 31, 2023.

Nevertheless, we acknowledge a mix of factors shaping our near-term outlook. On the downside, the crude oil market seems adequately supplied, with rising inventories and potential demand challenges from tight monetary policy. OPEC+ is managing market prices by cutting production quotas, though spare capacity has increased and will likely re-enter the market later as higher prices support increased production. Moreover, China's demand is below expectations, though global demand ex-China seems to have fully returned to normalized levels post-pandemic.

Positively, the critical need to replenish global oil reserves remains, with geopolitical tensions likely to keep the risk premium high. Despite the highest average commodity prices in a decade, capital investment in the energy sector remains at decade lows (top right). While producers are spending less and rig counts continue to decline, productivity has been increasing, which should lead to more ratable domestic volume growth with less capital intensity.

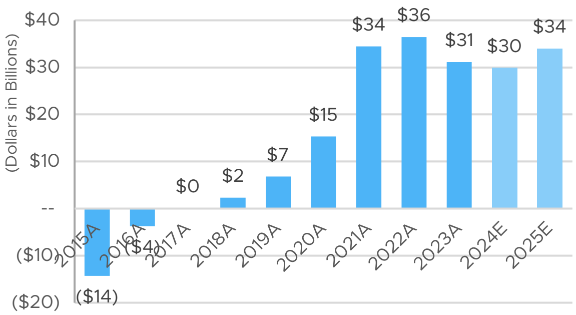
Nonetheless, we see midstream energy as well-positioned to leverage multiple strategies to drive positive shareholder returns, irrespective of short-term uncertainties in the broader economic environment.

The Benefits of FCF: A Case Study

For the following case study, we used the ten largest US midstream companies as measured by market capitalization.

We have continually emphasized our conviction that FCF can drive idiosyncratic total returns for shareholders, with less correlation to macroeconomic forces, commodity prices and/or multiple expansion. With midstream energy having produced at least three years of substantial positive FCF generation (shown right), we can now evaluate and quantify the positive impacts this newfound financial flexibility has had on equityholder returns – trends that we believe are likely to continue in the years ahead.

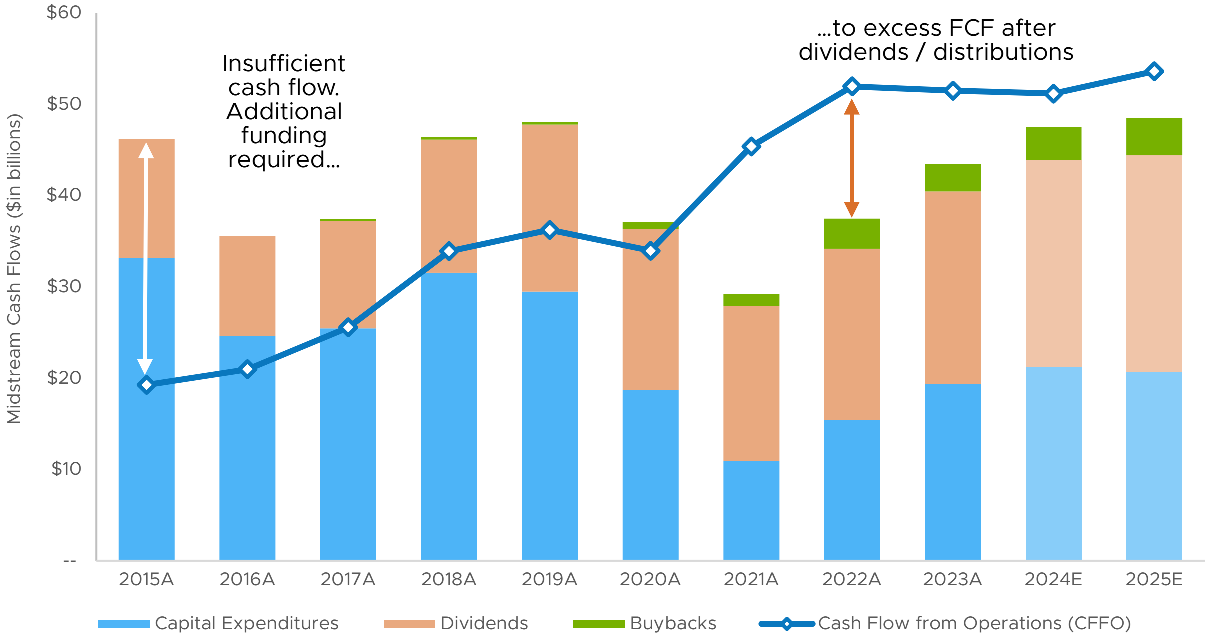
Free Cash Flow



Source: Bloomberg, Visible Alpha and Company Filings. For the companies: EPD, ET, KMI, LNG, MPLX, OKE, PAA, TRGP, WES and WMB.

Historically, these midstream companies' cash flows from operations (CFFO) were insufficient to cover the primary uses of capital, including both capital expenditures and distributions. To bridge this gap, these companies relied on multiple external funding sources, such as debt offerings and equity issuances, in addition to CFFO.

How Is Capital Being Spent and Funded?

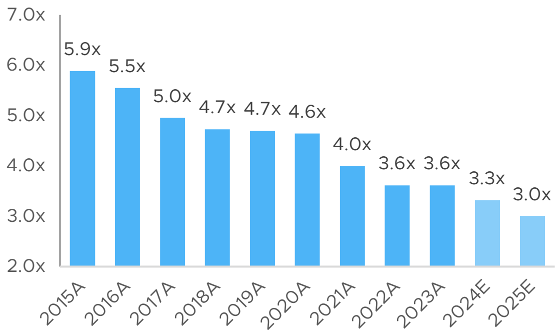


Source: Bloomberg, Visible Alpha and Company Filings. For the companies: EPD, ET, KMI, LNG, MPLX, OKE, PAA, TRGP, WES and WMB.

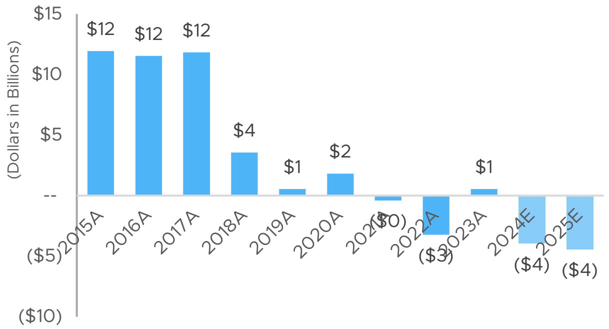
However, the recent shift to positive FCF marked a significant transformation for this traditionally capital-intensive growth sector. This shift has dramatically altered the conventional funding model, almost eliminating the previous dependence on continuous debt and equity financings, which often contributed to lower equityholder returns through interest burden and earnings dilution.

As a result, CFFO has emerged as the primary, if not the exclusive, source of capital. **In a notable shift, debt and equity, once primary *sources of capital*, have transitioned to being *uses of capital*. Management teams are now strategically directing excess cash flow towards reducing debt and implementing equity buyback programs.** We believe the midstream sector stands alone in financial metrics for a highly cash generative, mature and stable – but still capital-intensive – industry.

Net Debt / EBITDA



Net Equity Issuance / (Repurchase)



Source: Bloomberg, Visible Alpha and Company Filings. For the companies: EPD, ET, KMI, LNG, MPLX, OKE, PAA, TRGP, WES and WMB.

Uncorrelated Driver of Returns

This multifaceted return of capital initiates a 'flywheel effect': as the companies reduce their leverage, there is a corresponding decrease in the interest expense burden, freeing up earnings available for capital investment or to return to equityholders. Similarly, reducing the number of shares or units outstanding naturally boosts earnings per share/unit (all else equal). These actions collectively strengthen the company's overall financial position, enabling management teams to further allocate capital to additional equityholder return initiatives – notably dividend and distribution increases.

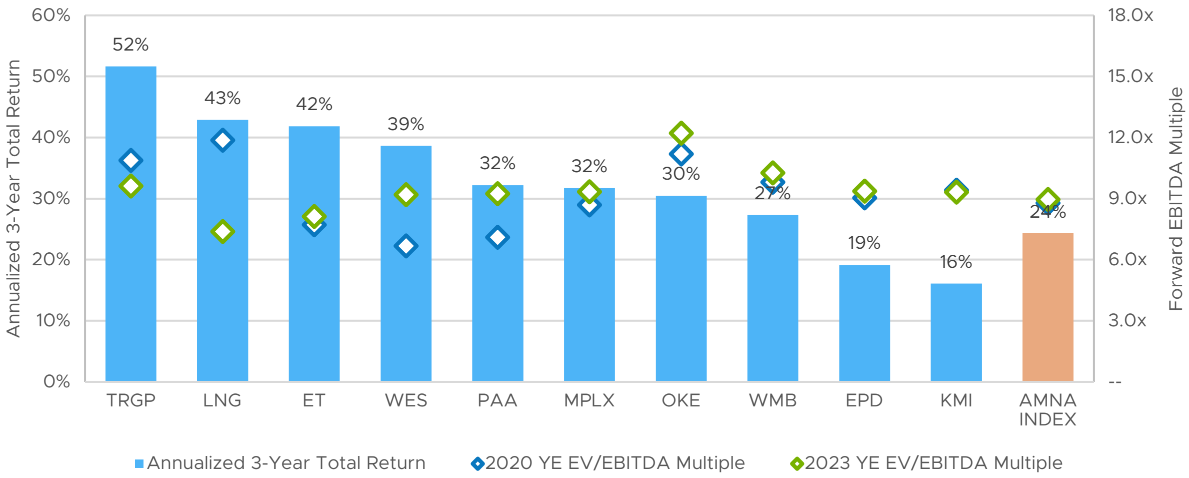
All of these factors, combined with strong underlying sector fundamentals and resilient cash flows, have helped to drive positive returns for equityholders uncorrelated with the broader market. This result is achieved with less dependence on macroeconomic forces, commodity prices, or multiple expansion (i.e., reliance on higher valuations).

As shown at the top of the next page, these ten midstream energy companies have averaged a 3-year annualized total return of more than 32%. Interestingly, the valuation multiples of these companies, as measured by enterprise value (EV)-to-EBITDA ratios, have remained relatively unchanged over that period, and in some cases, have declined.

To put it differently, the price performance over the last several years in the midstream energy sector has been almost completely driven by earnings growth, deleveraging, equity buybacks, and cash distributions to equityholders. This conclusion reinforces our perspective that midstream management teams are effectively utilizing their improved financial metrics – such as positive free cash flow after dividends/distributions (FCFaD), strengthened balance sheets, and stable earnings – to drive equity returns.

Considering this scenario, an intriguing question arises: what would be the impact if investor sentiment (and therefore investor flows) towards midstream energy were to improve and the sector experienced long-overdue multiple expansion?

3-Year Annualized Total Returns vs. Change in Valuation Multiple



Source: Bloomberg, Visible Alpha and Company Filings. For the companies: EPD, ET, KMI, LNG, MPLX, OKE, PAA, TRGP, WES and WMB. The AMNA index is the Alerian Midstream Energy Index (AMNA).

We Remain Positive on Midstream for 2024

After three years of solid performance, both in absolute terms and relative to the market, the question arises: can this trend continue? Although we don't expect the same level of energy macro tailwinds that have supported the sector in recent years, our outlook for 2024 remains optimistic. This optimism is based on the durable FCF generation capabilities characteristic of midstream companies, which we believe will continue to drive idiosyncratic and uncorrelated total returns for equityholders.

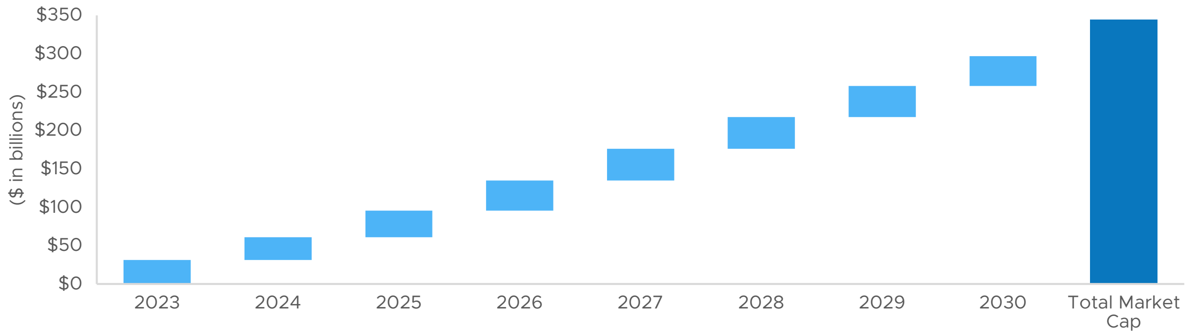
We anticipate EBITDA and earnings to continue their consistent growth trajectory. Coupled with stable EBITDA growth and a decline in capital expenditure spending, especially heading into 2025, the sector is well-positioned for solid FCF generation. Consequently, returns to equityholders are expected to increase in 2024 and 2025, even in the absence of energy macro tailwinds or multiple expansion.

The current strength of the sector's balance sheets is unparalleled compared to any other period in recent history. With a reduced need for FCF to be allocated towards reducing leverage, the prospects for increased cash returns to equityholders through dividend/distribution growth and buybacks are evident, providing investors with potential downside volatility protection against future market fluctuations.

Valuations remain attractive, with the EV/EBITDA ratio still trading at a more than 30% discount to the S&P 500. Furthermore, we believe the midstream energy sector's FCF characteristics, as highlighted here, are still underappreciated and mispriced. The 2024 FCF yield is projected at almost 10%, approximately double that of the S&P 500 and significantly higher than all major sector yields. Notably, these elevated midstream FCF yields have proven to be resilient over economic and commodity price downturns, underpinned as they are by non-cyclical cash flows.

The significance of this FCF is noteworthy. Based on street estimates, we forecast that the FCF generation of these ten largest midstream companies could equal nearly 90% of their total current market capitalization within 8 years, offering a path for disconnected valuations to converge with underlying fundamentals.

Annual Free Cash Flow to Current Market Capitalization



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Please let us know if you'd like to have an in-depth conversation of these topics. As always, we appreciate your support and continued confidence in us.

Regards,

John Musgrave

Chief Investment Officer
Portfolio Manager

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