Midstream/MLPs: Summer Sell-Off Feels Overdone

August 31, 2021

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Summary

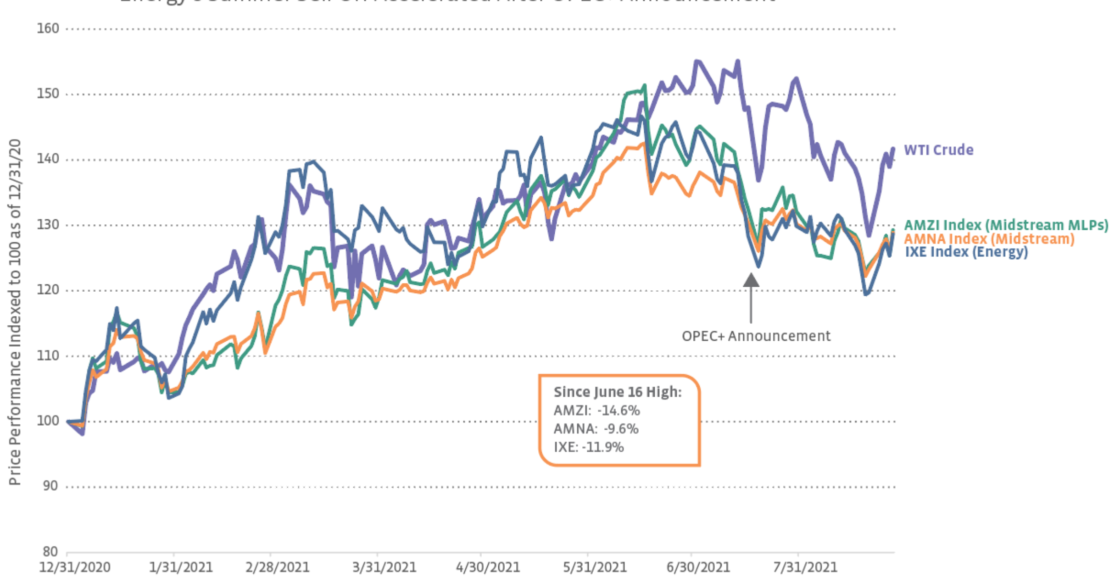
- Energy equities retreated from their relative highs in June as the Delta variant spread, the value trade sputtered, and oil prices weakened following the OPEC+ announcement in July.
- While midstream sold off with oil and energy stocks, the fundamental picture for midstream improved in many respects as reflected by positive estimate revisions coming out of 2Q21 earnings season.
- The outlook for midstream remains constructive with a compelling investment case driven by attractive yields, discounted valuations, growing free cash flow, and buyback potential. That said, some challenges persist for energy equities broadly.

Energy stocks, including midstream, remain well off their mid-June highs, even after last week's rebound driven by oil price gains and strength in broader equity markets. West Texas Intermediate (WTI) oil prices closed at $68 per barrel (bbl) on August 27, which is down from the July high of $75/bbl but still a significant improvement from the pre-pandemic $61/bbl seen at the start of 2020. Natural gas prices have strengthened through the summer from barely $3/MMBtu to over $4.30/MMBtu currently. Commodity prices have more than recovered, but energy stocks and midstream MLPs are still down almost 20% from the levels seen at the start of 2020. Today's note discusses midstream in the context of broader energy, why the summer sell-off in midstream may have been overdone, and the challenges that persist for energy broadly.

Noisy macro leads to summertime sadness for energy stocks.

Energy and midstream saw a strong start to the year on the back of improving oil prices, reflation expectations, and a value rotation. Energy and midstream equities hit a relative high in mid-June, with the Alerian Midstream Energy Index (AMNA) reaching levels not seen since the start of 2020 even as broader energy and MLPs were still trading below pre-pandemic levels. The upward trend in energy stocks then stalled as sentiment seemed to turn (discussed more below) even though oil prices continued to move higher through mid-July. For the last several weeks, the oil supply and demand narrative has been dominated by OPEC+ policy and the demand impact related to the resurgence in COVID-19 cases as the Delta variant spreads. Oil prices tumbled by more than 7% on July 19 following the OPEC+ agreement to increase production by 400,000 barrels per day each month starting in August. Since then, the AMNA Index, the Alerian MLP Infrastructure Index (AMZI) and the Energy Select Sector Index (IXE) have traded relatively in line shadowing the volatility in oil as shown below. From June 16 to August 27, the AMZI and AMNA are down 14.6% and 9.6% on a price-return basis, respectively.

Energy's Summer Sell-Off Accelerated After OPEC+ Announcement



Source: Bloomberg as of August 27, 2021

Outside of oil price movements, other factors have contributed to energy weakness over the summer. The value trade began to sputter as the Delta variant spread, and the yield on the 10-year Treasury generally moderated, with growth stocks getting a boost. Energy investors may have done some profit taking as well. To that end, the largest broad energy ETF saw outflows in July after notching positive inflows for five of the first six months of 2021. While oil prices and broader market trends contributed to weakness in energy stocks, including midstream, fundamental trends were likely more supportive than equity performance would suggest.

Has the fundamental picture changed for midstream?

Oil prices today are lower than in July, but has much really changed for midstream? It seems like the answer is no. Of course, a higher oil price helps sentiment, but from a midstream perspective, fundamentals continue trending in the right direction. For example, the oil rig count has continued to move higher, with 38 rigs added since the end of June contributing to a total year-to-date increase of 143 rigs (+53.5%) per Baker Hughes as of August 27. Increasing upstream activity can only be positive for midstream. Meanwhile, since June, the Energy Information Administration has maintained its US oil production estimates for 2021 and 2022 at 11.1 and 11.8 million barrels per day, respectively, while modestly increasing its 2022 natural gas production forecast. If US producers maintain spending discipline, the near-term production outlook is probably not much different at $68/bbl WTI than at $75/bbl WTI.

Setting aside the decline in oil prices, fundamentals for midstream seem no worse than they were several weeks ago and better in several ways. Second quarter earnings results were largely positive, with many names raising their 2021 guidance or anticipating full-year results at the high-end of provided guidance ranges (read more). Forward estimates have generally moved higher for the midstream space from the start of June to August 25. Eight of the top ten names in the AMNA Index saw positive 2021 EBITDA revisions over that timeframe, and seven saw 2022 estimates move higher. Of the top ten constituents of the AMZI Index, nine names saw positive 2021 EBITDA estimate revisions, and eight saw positive 2022 EBITDA revisions. The two AMZI constituents with downward revisions announced asset sales over the summer, and 2022 estimates moved lower by less than 3%.

With midstream equities down from their relative high and EBITDA estimates increasing, valuations have only improved and remain compelling as other pockets of the market sit at or near record highs (read more). Income continues to be attractive with the AMZI and AMNA yielding 8.2% and 6.4% as of August 20, which is up from 6.9% and 5.6% in mid-June, respectively. Importantly, midstream payouts have been largely steady in recent quarters (read more) adding confidence to the income opportunity. The midstream space remains poised to generate significant free cash flow, often in excess of dividend payments, with buybacks potentially enhancing the return profile (read more). For midstream, the outlook remains largely constructive, but there are still challenges for the energy complex.

What are the challenges?

While fundamentals remain attractive for midstream, there are challenges facing energy equities broadly. The potential for continued volatility in oil prices could weigh on energy stocks, even though oil price levels have improved noticeably from pre-pandemic levels. The low weighting of energy in broad market indexes (2.5% of the S&P 500 as of August 27) requires the sector to fight for investor attention and interest. Volatility and underperformance in years past has likely moved some investors to the sidelines, and it will take strong execution of shareholder-friendly initiatives, capital discipline, and solid operational performance to bring investors back. An oil price spike could also reignite interest, but in the meantime, execution and buybacks could help lift equities. The political and regulatory framework may also be giving investors pause, but the resumption of federal oil and gas leasing is one example of a former political headwind that has subsided.

As the investment community increasingly focuses on ESG-related initiatives, energy companies must continue to respond to investor demands for improved ESG reporting and tangible actions to curb emissions and participate in developing solutions for a cleaner energy future. For its part, the midstream space has made significant strides in ESG reporting, and companies are pursuing alternative energy opportunities, including for example Kinder Morgan's (KMI) recent purchase of renewable natural gas producer Kinetrex Energy and Williams' (WMB) $285 million investment in 16 solar projects to power their facilities. A handful of companies are also targeting net-zero emissions by 2050, including WMB, Enbridge (ENB), DCP Midstream (DCP), DT Midstream (DTM), and EnLink Midstream (ENLC).

Bottom Line

Looking past the recent noise from oil prices, the investment case for midstream remains compelling when considering the improving macro backdrop, positive estimate revisions, discounted valuations, generous yields, ESG progress, free cash flow generation, and buyback potential. With continued execution, these positives may start to be appreciated instead of being overshadowed by the noise from oil prices and broad equity market trends.

AMZI is the underlying index for the Alerian MLP ETF (AMLP) and the ETRACS Alerian MLP Infrastructure Index ETN Series B (MLPB). AMNA is the underlying index for the ETRACS Alerian Midstream Energy Index ETN (AMNA) and the ETRACS Alerian Midstream Energy Total Return Index ETN (AMTR).

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