Tailwinds and Supportive Policy Reassure Midstream Outlook

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Summary

- Led by G&Ps and natural gas pipeline operators, midstream names delivered strong 2Q21 results that largely beat expectations and led to improving outlooks in 2021 and 2022.
- Strong free cash flows drove higher buyback activity for a combined $302 million spent on repurchases in 2Q21. Buybacks are likely to remain a potential tailwind given continued excess cash flow generation in 2H21.
- On the ESG front, the outlook is shaping more and more favorably as midstream names continue to evaluate and set forth clean-energy initiatives, while efforts around carbon capture and hydrogen could potentially accelerate amid recent legislative developments that fare well for midstream and energy broadly.

The midstream space delivered solid quarterly results as tailwinds from the recovering macro backdrop continued apace during 2Q21. Stronger trends across the commodity landscape led to a wave of "beat and raises" among midstream names, solidifying the near-term outlook as numerous management teams increased or maintained their guidance to incorporate stable or higher volume activity. Additionally, a string of new ESG-related initiatives announced by midstream names in July and August, coupled with recent favorable legislative developments, paved the way for continued progression on the ESG front, reassuring the secular outlook for midstream.

G&Ps and natural gas pipeline operators deliver a strong 2Q21, see near-term improvement ahead.

Names that derive most revenues from the gathering, processing, and transporting natural gas and/or natural gas liquids (NGL) accounted for the bulk of upward guidance revisions in 2Q21. Kinder Morgan (KMI), Targa Resources (TRGP), Equitrans Midstream (ETRN), Hess Midstream (HESM), and Crestwood Equity Partners (CEQP) all delivered results above expectations while increasing their 2021 guidance to incorporate forecasts for higher commodity volumes and prices, and in some cases, to also reflect expansion projects or bolt-on acquisitions. Others with similar exposure, including gathering and processing (G&P) names DCP Midstream (DCP), Western Midstream Partners (WES), EnLink Midstream (ENLC), and Williams (WMB), as well as natural gas pipeline operator ONEOK (OKE), reported in-line or higher than expected results and pointed to the high-end of their guidance ranges. Cheniere Energy (LNG), the lone liquification name, slightly missed 2Q21 estimates but raised its 2021 EBITDA guidance for the third consecutive time to incorporate higher LNG margins and production.

Notably, stronger momentum in 2021 is expected to continue through next year. WES, for example, sees higher commodity prices sustaining increased producer activity and expects the higher throughput to materialize in 2022. On their conference calls, OKE mentioned its outlook for growth in 2022 continued to strengthen, providing a tailwind into next year, while WMB noted expectations to see EBITDA growth in 2022.

2021 momentum steadies for petroleum MLPs, 2022 seen as inflection point.

Crude and refined product midstream names delivered solid results stemming from favorable trends while remaining largely positive on their outlooks. Plains All American (PAA), and smaller names like PBFX Logistics (PBFX), and Delek Logistics Partners (DKL) were among those that beat estimates and simultaneously increased their guidance. However, the stabilization of crude and refined product trends through the second half of 2021 was the overreaching theme across conference calls, with 2022 seen as the inflection point for an uptick in crude production. Magellan Midstream Partners (MMP), for example, beat 2Q21 EBITDA estimates and reported record throughput during the quarter but maintained its 2021 guidance, mentioning during the conference call that the volume forecast for the second half of the year hasn't changed much since 1Q21. On its 2Q21 earnings call, PAA alluded to stable oil production through the remainder of 2021 and mentioned expectations for production growth to resume in 2022, adding that it believes to be well positioned for a "multi-year" period of Permian growth.

Strong free cash flows drive higher buyback activity in 2Q21

Buyback activity picked up in 2Q21 and saw a combined $302 million in capital deployed following moderated activity in 1Q21. MPLX (MPLX), PAA, and MMP accounted for the majority of the buyback spend ($ 287 million) but were also joined by smaller names like ENLC and RTLR that also capitalized on their buyback programs to enhance return-of-capital. In addition, HESM announced a $750 million unit repurchase from its sponsors, and while the dynamics of the buybacks differ from open-market buyback programs, the repurchases increase common ownership and deliver accretive benefits to common-unit holders.

With the midstream space generating significant free cash flow, and in some cases excess free cash flow after distributions, buyback activity is likely to continue as some names execute buybacks more systematically while others continue to approach them opportunistically. For example, Enterprise Product Partners (EPD) stated it plans to opportunistically buy back common units in 2H21 and alluded to a $200 million spend on its 2Q21 conference call, while CEQP, who has met its objective to strengthen its balance sheet, mentioned on its call that returning capital through its repurchase program has become the nearest term priority. And while ample availability among existing repurchase programs remains a potential tailwind, the possibility for new buyback programs is also on the table. WMB stated that its board is in the process of detailing the framework around a potential buyback program during its 2Q21 conference call and alluded to likely buying back shares opportunistically in light of the levels of excess free cash flow the company generates.

ESG initiatives move forward, legislative developments shape constructive long-term outlook

A handful of new clean-energy initiatives were announced along with 2Q21 earnings releases. Midstream names also provided a deeper look into clean-energy initiatives that were recently announced throughout July and August since our last research piece on July 6th (read more here). KMI provided additional color on its acquisition of renewable natural gas producer Kinetrex energy, which was announced July 16th and marked the first official project led by KMI's Energy Transitions Ventures group formed back in March. And while the magnitude of the purchase is relatively small, it represents a step in the right direction. On their 2Q21 conference call, KMI management mentioned the purchase provided a good head-start to work on hundreds, if not thousands, of potential RNG projects with attractive returns and long-term value. Other names involved or exposed to other types of renewable fuel also made steady headway. MMP confirmed during its 2Q21 conference call that it is already adding biodiesel blending at some facilities and is targeting to start blending at hub locations to then transport renewable fuel via pipeline. NS, who already handles about 30 percent of California's renewable diesel volumes, announced through its 2Q21 earnings release that it's exploring additional renewable fuels opportunities, particularly around ammonia.

LNG made progress on its intent to monitor, track, and reduce greenhouse gas emissions (GHG) and announced on August 5th the publication of a peer-reviewed LNG life cycle assessment to be used as an analytical tool and be included in Cheniere's Cargo Emissions Tags. On July 28th, the day before reporting 2Q21 results, TC Energy (TRP) announced its agreement to develop a 1,000-megawatt—and Ontario's largest—clean energy storage, which is projected to reduce 490,000 tons of GHG emissions. TRP's Canadian peer, Enbridge (ENB), announced through its earnings release the development of its Ridgeline Expansion Project to provide natural gas power generation to displace coal generation. ENB also confirmed continued progression of the construction and development of its offshore wind and solar self-power program projects.

Before diving into any updates regarding midstream initiatives around hydrogen and carbon capture, it should be noted that political uncertainty and lack of legislative support has been a major detractor impeding hydrogen and carbon capture initiatives to move beyond exploratory phases. That said, recent developments have seen supportive policy beginning to take shape, reinforcing a positive outlook for midstream and its role to play through the energy transition. The Infrastructure Investment & Jobs Act passed by the Senate earlier this month, which would become the largest infusion of federal investment into infrastructure projects in more than a decade, allocates more than $10 billion in funding for carbon capture, usage and sequestration (CCUS), and roughly $8 billion for hydrogen. Without going into too much detail, the bill would essentially lay down a roadmap to engineer a regional infrastructure backbone for both hydrogen and CCUS and reduce costs associated with hydrogen production/innovation and CCUS projects.

For context, the recurring energy-transition theme for midstream has been leveraging existing assets and capabilities–including the potential repurposing of midstream assets to move and store hydrogen and carbon dioxide (CO2)—to pursue secular growth opportunities. Hydrogen remains longer dated as most midstream companies have only begun to focus on blending hydrogen into existing natural gas pipelines, which has been set forth, explored, and/or discussed by names like ENB, TRP, KMI, and WMB. In addition, TRP and EPD have also discussed evaluating leveraging existing nuclear and petrochemical plants for hydrogen production. Relative to hydrogen, CCUS appears to be the most immediate clean-energy technology to be adopted. And while natural gas pipelines have the potential to be repurposed for CO2, there are also names that already have established CO2 capabilities and infrastructure on the ground that could be leveraged for CCUS expansion. KMI, for example, is the largest transporter of CO2 in the US.

That said, discussions around carbon capture and hydrogen continued to be a focal point during 2Q21 earnings calls. ENLC, who announced early June the formation of the Carbon Solutions Group, alluded to the carbon capture opportunity being vast during its 2Q21 conference call and emphasized its ability to repurpose existing assets to move CO2 efficiently. On August 2nd, Energy Transfer (ET) announced it had joined The Environmental Partnership and mentioned its pursuit of several carbon capture projects. On their 2Q21 conference call, ET provided additional color around its carbon capture initiatives and added that its Marcus Hook carbon capture project continues to look promising based on preliminary cost estimates and design feasibility studies, though they also mentioned the magnitude of the projects is small in regard to capital spend. DCP mentioned in its 2Q21 conference call that carbon capture and sequestration will be adjacent to its core and alluded to already doing a significant amount of carbon capture and sequestration today, with additional opportunities present in New Mexico, Colorado, and Michigan.

Though few midstream names have announced large-scale CCUS or hydrogen ventures, as initiatives remain largely in exploratory phases, accommodative policies that favor the clean-energy technologies could potentially accelerate efforts and enable long-term growth opportunities for midstream.

Bottom Line:

Supportive trends from a stable macro backdrop present a positive setup for the midstream space, and potential tailwinds such as buybacks and higher oil and gas production add confidence to the near-term outlook. On the ESG front, legislative developments are paving the way for continued progression, reinforcing the secular outlook for midstream and its role to play through the energy transition.

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