Oil, Energy Stocks, & Why Midstream/MLPs Could Rise Further

March 9, 2021

Author: Stacey Morris

Summary

- Oil prices have likely recovered more quickly than anticipated thanks to the disciplined cooperation of OPEC+.
- While midstream is unique from other energy sectors given its more defensive, fee-based business model, midstream MLPs and C-Corps have participated in energy's rally.
- Midstream's free cash flow and buyback potential, discounted valuations, and leverage to an ongoing macro recovery with potential tailwinds for the space could all contribute to continued positive momentum.

After years of underperformance relative to the broader market, the energy sector is finally enjoying a strong rally. The Energy Select Sector Index (IXE) is up 38.3% year-to-date through Friday, March 5, as West Texas Intermediate (WTI) oil prices have gained 36.2% YTD and closed north of $66 per barrel (bbl) last week. Despite its defensive, fee-based nature, midstream has participated in the broad improvement across energy. Today's note discusses the improvement in oil prices, midstream's participation in energy's rally, and discusses the reasons that midstream and MLPs could continue to see gains.

How did oil get to the mid-$60s per barrel?

Oil prices have likely recovered more quickly than anticipated thanks to the disciplined cooperation of OPEC+ since April 2020 that resulted in significant production cuts starting in May. After briefly going negative in April, WTI oil prices recovered through May and spent most of the summer of 2020 trading in a range of approximately $36 to $43/bbl. Prices began to climb more noticeably in November, gaining 26.7% for the month, following positive vaccine announcements that provided optimism for a demand recovery largely anticipated in 2H21. WTI ended 2020 at $48.52/bbl. Supply restraints driven by producer discipline have largely boosted oil prices in 2021, with temporary interruptions to US production in February due to cold weather also helping. On January 5, Saudi Arabia announced an incremental cut of 1 million barrels per day (MMBpd) for February and March, bringing total OPEC+ cuts to approximately 8 MMBpd. Last week, OPEC+ largely reaffirmed the cuts with Saudi Arabia maintaining its incremental 1 MMBpd reduction. The news pushed oil prices to highs not seen since 2019 and drove a strong rally in energy.

Midstream has participated in energy's rally.

Coinciding with the improvement in oil prices, energy stocks have rallied since November. Through March 5, the Energy Select Sector Index (IXE) has gained 83.1% since the end of October 2020 with WTI oil prices gaining 84.7% over that period. Aside from the improvement in oil, a rotation into value stocks and the reflation trade have helped boost energy. While midstream is unique from other energy sectors given its more defensive, fee-based business model, midstream MLPs and C-Corps have participated in energy's rally. The broad Alerian Midstream Energy Index (AMNA) and the Alerian MLP Infrastructure Index (AMZI) have gained 41.1% and 54.6%, respectively, since the end of October on a price-return basis. In the first week of March alone, the AMZI was up over 11%, even outpacing the 10.0% gain in the IXE as oil prices hit new relative highs. Alerian's MLP indexes, such as the AMZI, would be expected to have more upside to an oil price recovery for a few reasons – 1) MLPs were harder hit in 2020, 2) MLP indexes tend to have more exposure to companies focused on pipeline transportation of petroleum and less exposure to long-haul natural gas pipelines, and 3) MLP indexes tend to have smaller gathering and processing names that have greater indirect and sometimes direct exposure to commodity prices. That said, AMZI's outperformance relative to broader energy (IXE) last week was somewhat surprising.

Why can midstream/MLPs continue to gain?

While the gains since the end of October have been impressive, midstream and MLPs could continue to see positive performance due to potential macro tailwinds that have yet to materialize and company-level improvements.

Macro recovery still underway. Even though oil prices are back above pre-COVID-19 levels, many macro tailwinds have yet to materialize. The vaccine-driven demand recovery remains more of a summer 2020 or 2H20 story. Improving demand would benefit midstream companies with refined product assets. In terms of US production, oil prices have not been high enough for long enough to garner a production response. If oil markets can stabilize at these levels or even move higher, production is likely to respond, albeit at a more measured pace given a focus on capital discipline for US producers. Improvements in production would benefit midstream volumes. With 8 MMBpd of oil production currently curbed by OPEC+, a careful unwind of those cuts over time as demand improves will likely be key to keeping oil markets stable.

Free cash flow and buybacks represent company-level tailwinds. Independent of the commodity price environment, many midstream companies are positioned to generate meaningful free cash flow this year. While energy companies are broadly pursuing free cash flow, midstream is differentiated in its ability to generate free cash flow after robust dividends and its visibility to free cash flow regardless of the commodity price environment. Many midstream companies have buyback authorizations in place which could be an added tailwind in this recovery. As shown in the table below, constituents with buyback authorizations represent about half of Alerian's broader midstream indexes (MLPs and C-Corps) and upwards of 60% of the MLP index, AMZI.

Index Name	Ticker	Buyback Authorizations by Weighting
Alerian MLP Infrastructure Index	AMZI	62.3%
Alerian Midstream Energy Select Index	AMEI	53.5%
Alerian Midstream Energy Index	AMNA	52.4%
Alerian Midstream Energy Dividend Index	AEDW	49.5%

Source: Company reports, Alerian as of 2/26/21

Valuations remain discounted. Although oil prices are above pre-COVID levels, energy stocks remain well below where they started 2020 on a price-return basis. The IXE is down 12.1% relative to the first trading day of 2020, while AMNA and AMZI are down 16.0% and 24.4%, respectively. Furthermore, valuations for midstream remain discounted relative to history. Looking at forward EV/EBITDA multiples, the AMZI was trading about a turn below its three-year average and 1.5 turns below its five-year average as of February 26. The Alerian Midstream Energy Select Index (AMEI), an index with 25% MLPs and 75% US and Canadian C-Corps, was trading one turn below its three-year average and nearly two turns below its five-year average.

Bottom line

Setting aside the potential continuation of the reflation trade or value remaining in favor, midstream could continue to build on existing gains. Midstream's free cash flow and buyback potential, discounted valuations, and leverage to an ongoing macro recovery with potential tailwinds for the space could all contribute to continued positive momentum for midstream.

AMNA is the underlying index for the ETRACS Alerian Midstream Energy Index ETN (AMNA). AMZI is the underlying index for the Alerian MLP ETF (AMLP) and the ETRACS Alerian MLP Infrastructure Index ETN Series B (MLPB). AMEI is the underlying index for the Alerian Energy Infrastructure ETF (ENFR). AEDW is the underlying index for the Alerian Midstream Energy Dividend UCITS ETF (MMLP), and the ETRACS Alerian Midstream Energy High Dividend Index ETN (AMND).

// Disclaimers

This Document Is Impersonal and Not a Solicitation. In jurisdictions where Alerian, S-Network Global Indexes, or their affiliates do not have the necessary licenses, this document does not constitute an offering of any security, product, or service. Alerian and S-Network Global Indexes receive compensation in connection with licensing its indices to third parties. All information provided by Alerian and S-Network Global Indexes in this document is impersonal and not customized to the specific needs of any entity, person, or group of persons. Alerian, S-Network Global Indexes, and their affiliates do not endorse, manage, promote, sell, or sponsor any investment fund or other vehicle that is offered by third parties and that seeks to provide an investment return linked to or based on the returns of any Alerian or S-Network Global Indexes index.

No Advisory Relationship. Alerian and S-Network Global Indexes are not investment advisors, and Alerian, S-Network Global Indexes, and their affiliates make no representation regarding the advisability of investing in any investment fund or other vehicle. This document should not be construed to provide advice of any kind, including, but not limited to, tax and legal.

You Must Make Your Own Investment Decision. It is not possible to invest directly in an index. Index performance does not reflect the deduction of any fees or expenses. Past performance is not a guarantee of future returns. You should not make a decision to invest in any investment fund or other vehicle based on the statements set forth in this document, and are advised to make an investment in any investment fund or other vehicle only after carefully evaluating the risks associated with investment in the investment fund, as detailed in the offering memorandum or similar document prepared by or on behalf of the issuer. This document does not contain, and does not purport to contain, the level of detail necessary to give sufficient basis to an investment decision. The addition, removal, or inclusion of a security in any Alerian or S-Network Global Indexes index is not a recommendation to buy, sell, or hold that security, nor is it investment advice.

No Warranties. The accuracy and/or completeness of any Alerian or S-Network Global Indexes index, any data included therein, or any data from which it is based is not guaranteed by Alerian or S-Network Global Indexes, and it shall have no liability for any errors, omissions, or interruptions therein. Alerian and and S-Network Global Indexes make no warranties, express or implied, as to results to be obtained from use of information provided by Alerian and S-Network Global Indexes and used in this service, and Alerian and S-Network Global Indexes expressly disclaim all warranties of suitability with respect thereto.

Limitation of Liability. While Alerian and S-Network Global Indexes believe that the information provided in this document is reliable, Alerian and S-Network Global Indexes shall not be liable for any claims or losses of any nature in connection with the use of the information in this document, including but not limited to, lost profits or punitive or consequential damages, even if Alerian and S-Network Global Indexes have been advised of the possibility of same.

Research May Not Be Current. This document has been prepared solely for informational purposes based on information generally available to the public from sources believed to be reliable. Alerian and S-Network Global Indexes make no representation as to the accuracy or completeness of this document, the content of which may change without notice. Alerian and S-Network Global Indexes expressly disclaim any obligation to update the contents of this document to reflect developments in the energy Master Limited Partnership sector. The methodology involves rebalancings and maintenance of indices that are made periodically throughout the year and may not, therefore, reflect real-time information.

Linked Products. Alerian and S-Network Global Indexes licenses its indexes to third parties for the creation of investment funds or other vehicles. Alerian and S-Network Global Indexes are not responsible for the information on these websites or for anything that they provide.

Policies and Procedures. Analytic services and products provided by Alerian and S-Network Global Indexes are the result of separate activities designed to preserve the independence and objectivity of each analytic process. Alerian and S-Network Global Indexes have established policies and procedures to maintain the confidentiality of material non-public information received during each analytic process. Alerian, S-Network Global Indexes, and their affiliates provide a wide range of services to, or relating to, many organizations, and may receive fees or other economic benefits from these organizations.

Alerian
alerian.com
info@alerian.com // 972.957.7700
3625 N. Hall St., Suite 1200, Dallas, TX 75219

S-Network Global Indexes
snetworkglobalindexes.com
info@snetworkinc.com // 646.467.7928
267 Fifth Avenue, Suite 508, New York, NY, 10016