EGA Energy Infrastructure

From the EGA Portfolio Management Team

Midstream: FIMI May Lead To FOMO

We live in a strange world where FOMO ("Fear Of Missing Out") fever congregates almost entirely in the most speculative market sectors. The latest beneficiary of FOMO fever is artificial intelligence, where investors are pouring money in despite the terror inspired by ChatGPT. It's unclear how making lots of money in artificial intelligence will matter when the machines take over, but that's a debate for another day. We're okay with Midstream not benefiting from FOMO fever because usually it leads to the FOMO crash. However, we're not okay when the main question we get lately is "Did I miss the Midstream rally?" We would call this FIMI ("Fear I Missed It") if we were in charge of text abbreviations.

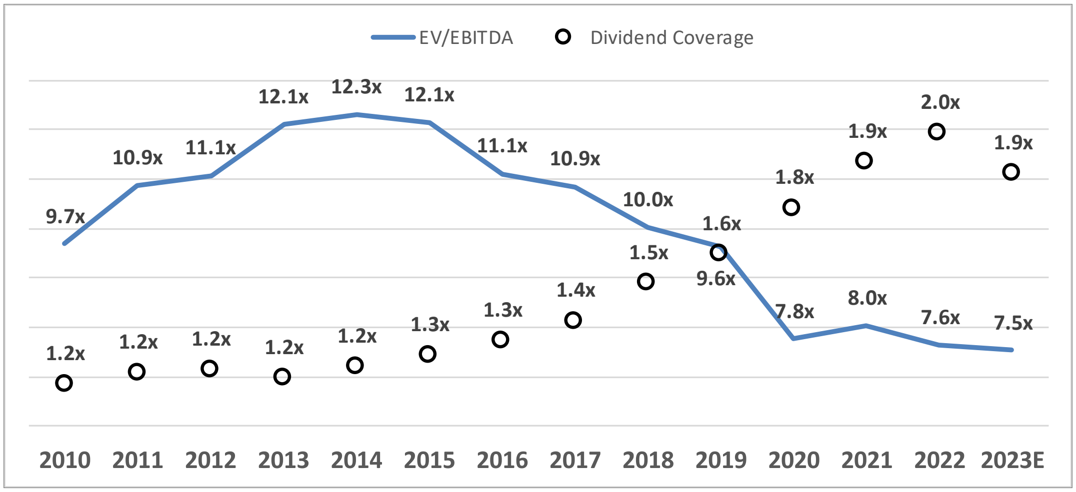
We considered writing again about how a large majority of industry experts forecast traditional energy demand will rise for several more decades, or how Midstream fundamentals are the healthiest we've ever seen. After all, it is this combination that has some convinced Midstream has entered a new Golden Age (we agree). However, we decided for this note we'd instead make a more practical argument. One that focuses on valuation and how Midstream continues to screen cheaply against itself and other sectors. For Midstream, we think investors asking FIMI may end up MO ("Missing Out").

Making Sense Of The Midstream Multiple, Or Lack Thereof

The Alerian MLP Index is currently trading at a 7.5x EV/EBITDA multiple that is well below its 10.1x average over the last ten years. It is barely above its 7.4x trough (4Q 2022), and nearly half its 13.0x peak (4Q 2013). This wide range between peak and trough is emblematic of a sector that experienced a paradigm shift over the last decade, something we've been highlighting for some time now. What may be lost in translation though is Midstream's paradigm shift has been unequivocally for the better, in our opinion. When you stop and think why a sector trades at a specific multiple, several reasons come to mind. To short list a few:

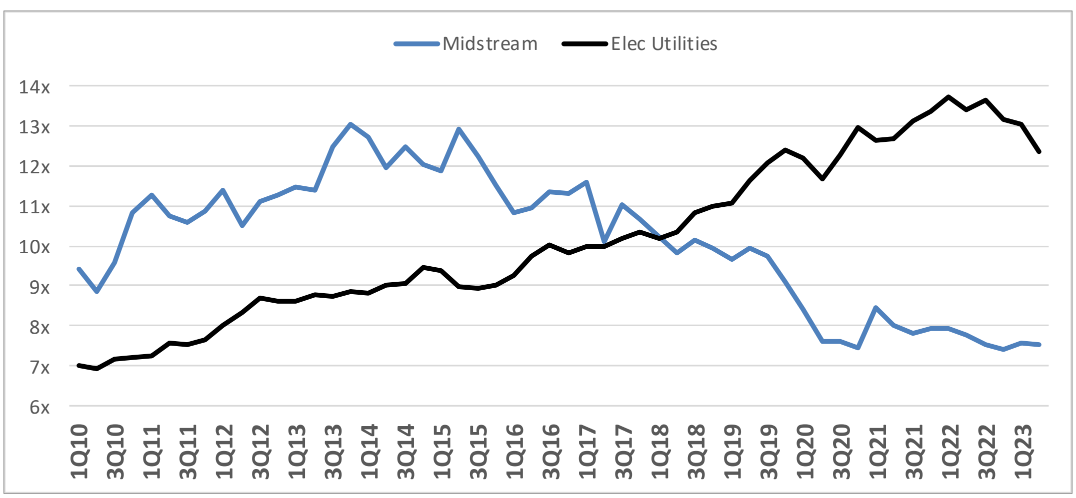
- *Growth Expectations.* A company that is expected to have significant growth and/or has a track record signified by strong historical growth is typically rewarded with a high multiple.
- *Risk-return tradeoff.* Stable cash flows that have been proven over time require a lower risk premium, and investors are willing to pay a higher multiple for this peace of mind.
- *Market perception.* A sector perceived to have bright future prospects and a positive earnings outlook will be considered lower risk, and likely come with a higher multiple.

Several years ago we would have been hard pressed to justify a return to the peak multiples Midstream commanded in 2014. But today? It's actually super easy. The sector has improved its financial metrics dramatically while at the same time continuing to secure meaningful cash flow growth. The below chart shows the negative correlation between dividend coverage and multiples. It's not just dividend coverage as Debt-to-EBITDA metrics declined from 4.8x in 2017 to 3.6x today (2023E). We certainly recognize the painful dividend cuts investors experienced through 2020, though highlight that we're now in year three of sector-wide dividend growth. Some dividends that were cut have now been wholly restored (e.g., Energy Transfer). We know some wounds take longer to heal than others, though at some point healthy fundamentals should override what has been several years of Midstream multiples scraping bottom.



Source: Bloomberg, Wells Fargo

What about versus other similar sectors? Historically investors have preferred to compare Midstream to Electric Utilities because of their similar risk and cash flow profiles. However, Midstream trades at a substantial discount to Electric Utilities. There are certainly factors influencing each sector in either direction but given Midstream's financial strength it would make sense for this spread to converge.



Source: Bloomberg

What about other sectors and the broader market? Different question, same answer. Midstream and MLPs trade at a substantially higher discount to their 10-year average than Utilities, REITs, the S&P 500, and most of the other traditional energy sectors as well (Integrated Oil & Gas, Refiners, and Oilfield Services).

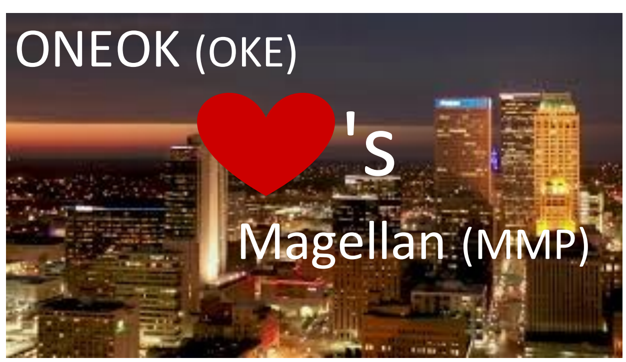
	EV-to-EBITDA Multiples	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
Midstream	**MLPs**	**7.6x**	**8.5x**	**(11%)**	**11.0x**	**(31%)**
Midstream	**Midstream C-Corps.**	**9.0x**	**10.1x**	**(11%)**	**12.4x**	**(28%)**
Energy	Exploration & Production	4.6x	5.8x	(22%)	6.7x	(32%)
Energy	Refiners	4.9x	6.3x	(22%)	5.9x	(17%)
Energy	Integrated Oil & Gas	4.7x	5.4x	(13%)	5.4x	(13%)
Energy	Oilfield Services	7.0x	8.7x	(20%)	9.0x	(22%)
Yield	Utilities	10.2x	10.6x	(3%)	9.8x	4%
Yield	REITs	16.0x	18.1x	(12%)	17.2x	(7%)
Market	S&P 500	12.1x	12.6x	(5%)	11.3x	7%

Source: Wells Fargo

Ironically and to circle back to the beginning, the only remaining argument for those staying on the sidelines is the fear that we've reached peak hydrocarbon demand. We'll take the over on that bet. It's not only the large majority of industry experts that don't see that happening, it's all those Net Zero countries signing long-term deals for more hydrocarbons (especially natural gas). It's because the vast majority of production around the world continues to be driven by oil economics. It's because traditional energy producers are actively working towards reducing or eliminating their own carbon emissions. It's because we do actually believe the world is energy transitioning.

So when investors ask us if they missed the Midstream rally, we say unequivocally no. Sure there may be some short-term recessionary headwinds, though beyond this noise we see financial stability, discipline, and accelerating growth prospects as all reasons that Midstream multiples should expand to historical averages (or higher). In summary, don't MO ("miss out") by thinking you already MI ("missed it"), or else at some point you may find yourself FOMO'ing your way into Midstream.

Another (BIG) One Bites The Dust



If you asked us at the beginning of the year which Midstream company was most likely to be acquired, Magellan would have been at or near the bottom of the list. Imagine our surprise when in mid-May ONEOK (OKE) announced it would pay a 22% premium to acquire Magellan (MMP) using a mix of cash and stock. Prior to the deal Magellan was trading at a 10.5x multiple, a substantial premium to the Alerian's 7.4x multiple and among the highest multiples in our group. We firmly believe Magellan deserves a premium valuation because of its sector-leading balance sheet, the demand-pull and inflation protected nature of its refined products infrastructure, and sharp focus on returns.

ONEOK detailed five reasons in its press release why acquiring Magellan is the right strategy. The shortened version of each are:

1) Brings together two premier energy infrastructure businesses
2) Expects to achieve immediate financial benefits, including cost, operational and tax synergies, supporting meaningful expected accretion
3) Compelling long-term value proposition driven by consistent and disciplined capital allocation philosophy
4) Complementary and diversified asset positions with potential for additional cost and commercial synergies over time
5) Strong investment-grade credit ratings with enhanced scale and diversification

Most of these speak for themselves, though ONEOK specifically mentioned the step-up in tax basis from this acquisition will help ONEOK defer corporate taxes from 2024 to 2027. The company estimates the total value of this basis step-up is approximately $3 billion. The reason ONEOK is in this predicament of having to acquire a company to defer taxes is because the last few years the sector has been underinvesting in infrastructure, which is typically the primary avenue for companies to defer taxes. This is also a C-Corp problem since MLPs do not pay federal taxes (advantage: MLPs).

Separately, at a higher level this transaction also provides evidence of the importance of infrastructure and fiscal discipline. We've said multiple times that headwinds associated with building new infrastructure increases the scarcity value for those that own operational infrastructure. Think about what it says about Midstream that one company (ONEOK) was willing to pay a 22% premium for another company (Magellan) that was already among the highest premium stocks under coverage.

This Year's MVP Appears To Be…MVP

If not for ONEOK's takeout of Magellan, the surprise inclusion of Equitrans' (ETRN) Mountain Valley Pipeline (a.k.a., MVP) in the debt ceiling bill would have taken the trophy. We'll give them a trophy anyway though because it works with this section's title. To summarize, as part of the deal to raise the debt ceiling the political powers that be agreed to clear red tape holding up MVP, a mostly constructed natural gas pipeline from northwestern West Virginia and the Marcellus Shale to southern Virginia. One of the last remaining mega-projects from another era, MVP has seen costs rise and setbacks galore as legal challenges from environmental activists kept the project from crossing the finish line.

While certainly a win for ETRN, it seems like a one-off and not necessarily a win for Midstream. We're still patiently waiting for a grand bipartisan deal that will make it easier to build major infrastructure in our country, both for traditional energy and renewable energy. We continue to believe the pieces are in place for an agreement, though recognize the closer we get to the 2024 presidential election the more difficult it will get to complete a deal. The silver lining if nothing happened would be that nothing would happen! Midstream management teams will have few options other than continue being disciplined and returning capital to shareholders via share buybacks and dividend increases. If this scenario plays out, those that own infrastructure (like Midstream) will continue to see valuations rise as scarcity premiums rise.

Energy Infrastructure Team Update

There were no significant team related news items to highlight this quarter. We continue to focus on the research and portfolio execution effort and are in constant dialogue with industry experts and management teams. We continue to believe oil and natural gas will play a major and increasing role in the global economy, and owing to healthier balance sheets, higher coverage, and heightened discipline are optimistic about the long-term viability of Midstream as a sector for investors who prioritize income.

We look forward to communicating the results of your investment next quarter and thank you for your continued patronage and confidence in Eagle Global Advisors.

- The Eagle Energy Infrastructure Team

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