INVESTMENTS®

Energy

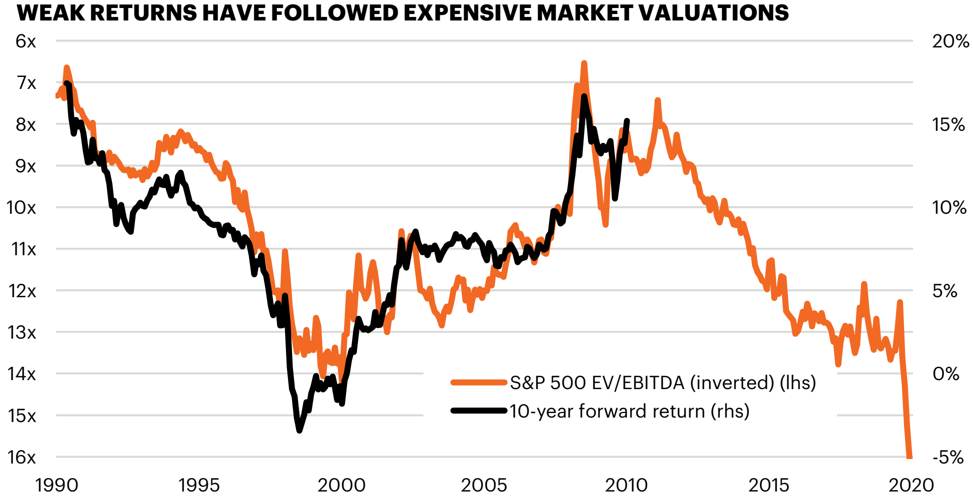
Energy infrastructure: A compelling opportunity in an expensive market

As the COVID-19 crisis has battered global energy demand and oil prices, the midstream energy sector is one area that has remained resilient, thanks in large part to its steady cash flow profile. Valuations in the space, however, remain extremely depressed. We look at those valuations, how they have decoupled from fundamentals, and why we believe midstream may be an attractive space in the current market.

Possibly the most confusing and essential question facing investors in 2020 is what to make of current equity market valuations. Some commentators have called the market a bubble akin to the one that burst in 2001, while others have cited deeply negative real interest rates, an acceleration of a tech-dominated future, and massive Fed liquidity as a justification for sky-high valuations. Whatever the reason, the reality remains that valuations are historically high, and long-term equity returns have consistently been negatively correlated with starting valuations.

The good news for investors is that there are areas of the stock market that continue to show attractive valuation relative to history and the market. While some sectors trade at low multiples for good reason, we believe there are areas of opportunity in today's market. One area that remains compelling in an otherwise expensive market is midstream energy, or energy infrastructure.

WEAK RETURNS HAVE FOLLOWED EXPENSIVE MARKET VALUATIONS



Source: Bloomberg Finance, L.P., as of August 31, 2020.

KEY TAKEAWAYS

- Investors are faced with extremely high public equity valuations, a reality that has historically resulted in lower long-term forward returns.
- In contrast, valuations in the energy infrastructure space are near record lows.
- Midstream fundamentals remain solid, with Q2 earnings results showing the resiliency of the sector.
- High current income could be supplemented by capital appreciation as valuation improves with greater free cash flow, reduced leverage, and increased shareholder returns.

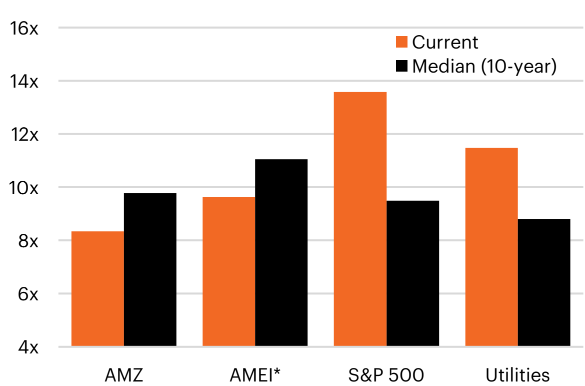
Digging for value

In a market where the enterprise value to earnings before interest, taxes, depreciation and amortization (or EV/EBITDA) ratio of the S&P 500 sits at a three-decade high, investors can look to diversify their portfolios by seeking out areas of the market that have become dislocated.[1] Coming into the year, we noted that valuations in the energy infrastructure space were at extremely low levels from a historical standpoint. On the other hand, utilities, which are commonly compared to midstream due to both sectors' stable cash flow profiles, saw valuations climb toward all-time highs.[1,2]

The COVID-19 pandemic has served only to exacerbate these dislocations. While most areas of the equity market experienced significant drawdowns in the early stages of the crisis, the broad market has rebounded sharply back to pre-pandemic levels, even taking into account the recent early-September volatility.[1] Conversely, energy infrastructure remains well below pre-COVID levels. The Alerian Midstream Energy Select Index (AMEI), which measures the performance of the broad midstream sector, sits 31.7% below its 2020 high, while the Alerian MLP Index (AMZ), which focuses on midstream MLPs, is still 42.1% below its yearly peak.[3] This has led to a widening gap between valuations in the energy infrastructure space and those in the broader market.

Using EV/EBITDA, we can see that midstream equities offer compelling value versus history and relative to the S&P 500 and utilities, which are both expensive versus history.[1,2]

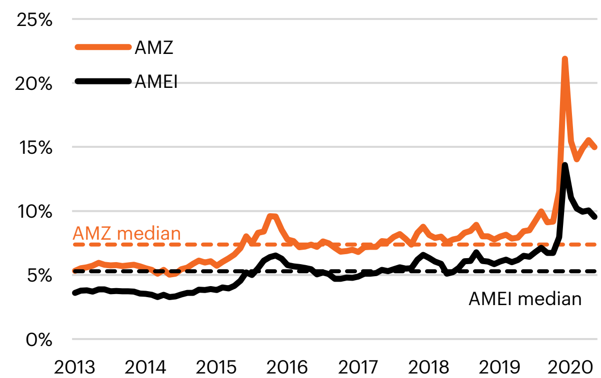
ENTERPRISE VALUE TO EBITDA



Source: Bloomberg Finance, L.P., as of September 4, 2020.
*AMEI history dates back to 2013.

Many investors in the sector are attracted by above-market current income offered by midstream energy firms. On a yield basis, the midstream sector again looks attractive versus history—the AMEI and AMZ yield 9.6% and 15.2%, respectively, both in the 95th percentile historically.[1]

MIDSTREAM DIVIDEND YIELDS



Source: Bloomberg Finance, L.P., as of September 4, 2020.

Fundamentally sound

Clearly these valuations look like an attractive entry point; however, valuations are just one piece of the puzzle. As energy prices have fluctuated, fundamentals have been challenged for sectors within energy where financial performance is tied more directly to commodity prices. Midstream fundamentals, on the other hand, have held up well throughout the COVID-19 crisis. Operating results have been generally resilient, raising the question of why the market has not rewarded the sector.

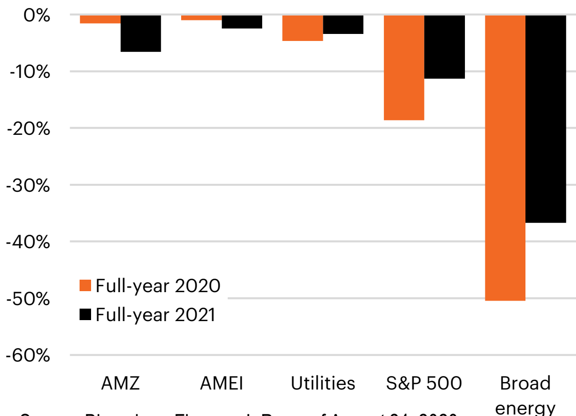
The ability of midstream firms to endure the crisis so far has been impressive. With the year more than halfway over, estimates for full-year 2020 EBITDA have declined only -1.0% and -1.6% for the AMEI and AMZ, respectively, compared to January pre-pandemic estimates. Contrasting this to the S&P 500 and utilities stocks, which have seen their 2020 estimated EBITDA fall by -18.6% and -4.6%, respectively, illustrates the resiliency of midstream cash flows.[1] Midstream companies tend to benefit from long-term, fixed rate contracts with energy producers and consumers, which can minimize the impact of commodity price fluctuations and reduce earnings volatility. Analyst projections for full-year 2021 show a similar story—that the crisis has not impacted midstream operating results as much as it has other sectors.[1]

1 Bloomberg Finance, L.P., as of September 4, 2020.
2 Utilities represented by the S&P 500 Utilities Index.

3 Bloomberg Finance, L.P., as of September 4, 2020. AMEI peaked on January 20, 2020, and AMZ peaked on January 16, 2020.

CHANGES IN PROJECTED EBITDA

Compared to pre-COVID consensus projections

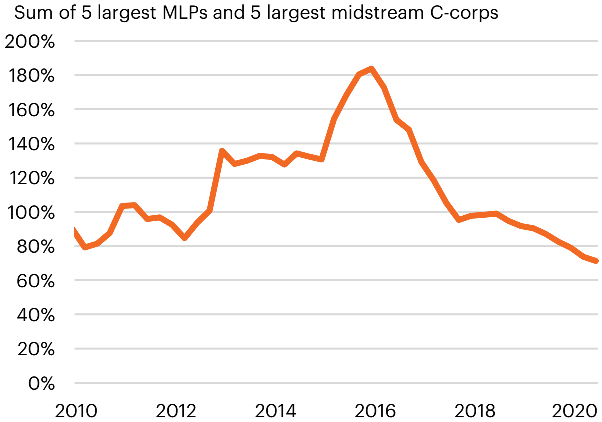


Source: Bloomberg Finance, L.P., as of August 24, 2020.
Note: Broad energy represented by the S&P 500 Energy Index.

As crude oil and natural gas production, driven by shale drilling, moderated in recent years, midstream capital expenditures also moderated, prompting a greater ability to generate free cash flow. The pandemic has accelerated this trend by reducing production growth expectations and therefore diminishing capital spending needs for midstream firms. When coupled with stable earnings discussed above, the outlook for free cash flow is impressive. The chart below shows capex as a percentage of operating cash flow for the largest firms in the space trending downward over the past five years. We expect this trend to accelerate in 2021 and subside only as excess pipeline capacity is utilized by growing production.[4]

CAPEX, % OF OPERATING CASH FLOW

Sum of 5 largest MLPs and 5 largest midstream C-corps

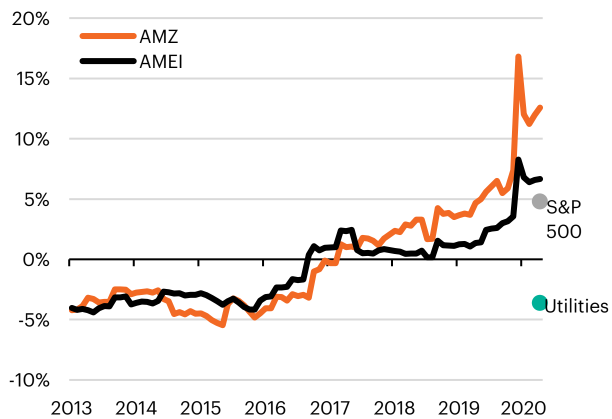


Source: Bloomberg Finance, L.P., Alerian, FS Investments, as of June 30, 2020 (Q2).

As discussed above, a combination of stable earnings and declining capital expenditures has led to steadily increasing levels of free cash flow (cash available for shareholders following capital expenditures) after years of being negative. This allows firms to focus on two things. The first is reducing debt loads. We believe midstream debt levels have historically been too high, leading to higher earnings volatility and lower equity and enterprise value multiples. Second, free cash flow can be used to grow shareholder returns via increased distributions or share buybacks.

While some midstream firms with higher commodity price exposure and greater financial leverage have chosen to cut distributions during the COVID-19 pandemic, most firms have been able to maintain payouts.[5] As energy demand and production stabilize and modest growth returns, we anticipate a resumption to distribution growth and potentially a new focus on share buybacks. The graph below shows midstream free cash flow yields near historic highs and above yields on the S&P 500 and utilities.

FREE CASH FLOW YIELDS



Source: Bloomberg Finance, L.P., as of July 31, 2020.

Gathering and processing the findings

We believe this data around valuations and fundamentals sheds light on a fairly simple and seemingly inconsistent reality: The equity market has broadly rebounded to reach new all-time highs despite estimates that total S&P 500 EBITDA could be 10%–20% lower compared to pre-COVID expectations for this year and next year. Meanwhile, midstream equity prices remain far below early-2020 levels even as analysts estimate a much smaller impact on earnings. This has resulted in midstream valuations that are detached from much of the rest of the market.

Why would the market apply such a low multiple to a sector that has shown impressive resiliency in the most difficult of environments? Part of it is likely the

4 Bloomberg Finance, L.P., Alerian, FS Investments, as of June 30, 2020.

5 Alerian, as of August 31, 2020.

simple fact that investors find the energy sector as a whole too volatile. However, while this certainly may apply to certain areas of the energy industry, midstream earnings during this crisis tell a much different story.

The other reservation may be that the era of rapid U.S. crude production growth driven by shale is over. We would generally agree that the next decade of U.S. oil production will not match the 9% annualized growth of the 2010s; growth will likely slow, the rapid 2020 COVID-induced decline notwithstanding.[6] However, slower industry growth actually allows companies to continue to moderate their capex spending without becoming overly concerned about being eclipsed by a rival firm growing at a faster rate. This may end up benefiting the midstream industry, allowing greater focus on balance sheet improvement and higher dividends or share buybacks for shareholders.

The midstream sector has transformed from a rapid growth, negative free cash flow sector into a more mature sector that is focused on steady earnings, lower capital spending, and free cash flow generation. As firms bring down leverage and increase returns to shareholders, we believe valuations could increase meaningfully. In a world where valuations in many areas of the equity market have reached extreme heights and income from most sectors is limited, we believe midstream offers a truly unique opportunity for income and capital appreciation.

6 EIA, as of July 31, 2020.

Robert Hoffman
Managing Director, Investment Research

As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

Andrew Korz
Associate

Andrew is an Associate on the Investment Research team at FS Investments, where he leads research efforts on the energy sector and the U.S. commercial real estate market. He also assists in the development of the firm's long-term views on the economy and the impacts on the investing environment. Andrew holds a BBA in Finance and Economics from Villanova University and has prior experience with structuring and pricing interest rate derivatives.

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