ClearBridge

Energy MLP commentary

Key Takeaways

- A boost for cyclical sectors amid rising oil prices helped energy infrastructure stocks outperform equities in the first quarter.
- The trajectory of oil prices over the next year or so will likely be dictated by demand factors — not supply — and if global oil demand growth approaches roughly 1.0-1.5 million barrels per day in 2024, we see upside in oil prices.
- With no need for midstream companies to access capital markets for the foreseeable future, we increasingly expect excess cash flow (above and beyond capital spending and dividends/distributions) to be used for increasing share buybacks and further increasing dividends/distributions.

Market Overview and Outlook

A boost for cyclical sectors amid rising oil prices helped energy infrastructure stocks outperform equities in the first quarter. Winter storms dampening production across several U.S. oil fields, a weaker U.S. dollar and lower production levels by OPEC+ members conspired to help crude oil prices rise 16%, from $71.65 per barrel to $83.17, in the quarter. Prices were further supported by an improving economic outlook, as GDP growth remained strong and ISM Manufacturing PMI entered expansionary territory. The S&P 500 Index rose 10.56% for the quarter, while the Alerian MLP Index gained 13.91%.

At the same time, global economies continue to face multiple headwinds, led by a combination of stubbornly high (though recently moderating) inflation, elevated geopolitical uncertainty and lingering supply chain and policy impacts from the COVID-19 pandemic. In the U.S., we have begun to see the dampening effects on the economy of tighter monetary conditions. During 2022, equity markets began pricing in a reasonable chance of recession, both in the U.S. and abroad. In 2023, global equity markets generally recovered the losses incurred in 2022, and expectations are increasing that developed economies might avert a severe recession in 2024.

Crude oil prices fell from more than $120 per barrel in June 2022 to ~$70 per barrel at year-end 2023. Recession concerns left oil market traders fearful of global demand downdrafts for crude oil in 2023 much like those witnessed during the Global Financial Crisis (GFC). A stronger U.S. dollar and large-scale releases of crude oil from the U.S. Strategic Petroleum Reserve (SPR) further pressured oil prices. On the other hand, demand fear was partially offset by some optimism for a rebound in China demand with the lifting of COVID-19 restrictions. The surprise OPEC+ supply cut of 1.1 million barrels per day at the end of March 2023 and again in November 2023 have also likely put a near-term floor on oil prices.

The trajectory of oil prices over the next year or so will likely be dictated by demand factors — not supply. Most oil economists forecast a roughly 1.0-1.5 million barrel per day increase in global oil demand to ~103 million barrels per day in 2024. Essentially all of this oil demand growth is expected in developing nations, rather than OECD nations. We would argue that oil prices of roughly $70 per barrel at the end of December 2023 discounted that oil demand growth will not approach levels expected by oil economists in 2024. Said differently, oil traders seemed to expect a material contraction in global oil demand growth rates compared to oil economists. A final twist to oil demand analysis remains the timing of the U.S. refilling its vastly depleted Strategic Petroleum Reserve (SPR). After draining the SPR by roughly 275 million barrels (or ~45%) in the 18 months before in June 2023, the U.S. government has slowly begun refilling it. Thus, what has been a meaningful source of supply in the crude oil markets is becoming a source of demand. Since June 2023, SPR inventories have increased by 13 million barrels and are likely to continue increasing over the balance of 2024 and in 2025.

If global oil demand growth does approach roughly 1.0-1.5 million barrels per day in 2024, we see upside in oil prices. The supply side of the global oil market will meaningfully struggle to meet that kind of demand growth. We would also argue that the incremental barrel of oil supply in such a scenario will almost have to be a barrel of U.S. oil — continuing to drive visibility in continued growth in U.S. oil production to the benefit of U.S. midstream companies.

Looking at natural gas, the short-term outlook is decidedly negative while the intermediate- to long-term outlook remains robust. Fairly mild winter weather (demand) and increasing associated natural gas production from oil wells (supply) has resulted in spot natural gas prices falling from roughly $3 per mmbtu to $2 per mmbtu. The intermediate- to long-term outlook for natural gas prices remains positive — driven by continued increases in demand for natural gas in U.S. electricity generation and increasing U.S. liquefied natural gas (LNG) export capacity to international markets in 2024-2027.

Valuation for U.S. midstream companies remains well below the levels seen before the pandemic. Entering 2020, enterprise value to EBITDA (EV/EBITDA) multiples stood at roughly 10.5x. Despite the rebound the sector has experienced since the March 2020 lows, the sector today trades at 9.0x — despite what we view as a vastly better business model. Dividend/distribution coverage has moved from 1.1x to more than 2.0x. The sector has moved from being free cash flow negative to free cash flow positive (increasingly so in 2023) and balance sheet leverage (debt/EBITDA) has moved from more than 5.0x to below 3.5x. With no need for midstream companies to access capital markets for the foreseeable future, we increasingly expect excess cash flow (above and beyond capital spending and dividends/distributions) to be used for increasing share buybacks and further increasing dividends/distributions.

With improving financial metrics and continued low valuations, we still see solid upside potential for the U.S. midstream sector despite strong performance in 2022 and 2023..

Note: Any oil, gas and energy data referenced are sourced from the U.S. Department of Energy. Distributions and distribution growth rates are subject to change and are not guaranteed.

Investment risks

All investments are subject to risks, including the possible loss of principal. Investments in MLP securities are subject to unique risks.

MLP cash distributions are generally tax-deferred. Non-cash expenses, such as depreciation or depletion, usually offset income derived from an MLP's operations. To the extent that these expenses exceed income, cash distributions are considered return of capital under tax law. As such, they are not taxed when received. Instead, the distribution, in the form of return of capital, reduces a unit holder's cost basis. This adjusted cost basis, in turn, results in a higher capital gain or lower capital loss when the units are sold. Of course, there can be no assurances that distributions from an MLP will be tax-deferred. **Distributions are not guaranteed and are subject to change.**

Glossary

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

EV/EBITDA is the “enterprise value to earnings before interest, taxes, depreciation, and amortization ratio” which compares the value of a company—debt included—to the company's cash earnings less non-cash expenses.

Midstream involves the transportation (pipeline, rail, barge, oil tanker or truck), storage and wholesale marketing of crude or refined petroleum product.

The **Alerian MLP Index** is a composite of the 50 most prominent energy master limited partnerships, and it is calculated using a float-adjusted, capitalization-weighted methodology.

Metric Million British Thermal Unit is a unit used for measuring the energy value or the heat content. BTU stands for the British Thermal Unit. It is defined as the amount of heat required to raise the temperature by 1 degree Fahrenheit for one pound of water. Since heat is equivalent to energy, the Standard International unit of heat is Joule (Mathematically: 1 BTU = 1055 Joule). When one British Thermal Unit or 1 BTU is expressed in terms of millions, it is termed as a Metric million British thermal unit or MMBtu.