Energy Spotlight – Saudi Arabia and Russia Face Off

March 2020

Recent News

Leading into the weekend, the market expected the Organization of the Petroleum Exporting Countries (OPEC) to cut supply and support falling oil prices due to decreased demand as a result of COVID-19 (coronavirus).

In an unexpected turn, disagreements between Saudi Arabia and Russia led to the opposite outcome; both countries discussed increasing production to drive down energy prices hoping to rout out competitors. Fears of additional supply at a time of weak and uncertain demand led oil prices lower on Monday, March 9 in one of its largest single day moves since the Gulf War.

Impact on Midstream Assets

While midstream assets are mostly in the moving business, not discovery and extraction, they are impacted by such a material change in crude oil prices. Weaker demand and lower prices could lead to lower volumes, which may negatively impact the cash flows of midstream businesses. As a result of these developments, we believe there are four key areas investors should consider.

Distribution Coverage

- Distribution coverage speaks to how much cash a business has on hand to pay for a promised yield to investors. Distribution coverage ratios of 1.1x indicates companies have $1.10 for every promised $1.00 distribution
- Today, coverage on our recommended portfolios is 1.45x to 1.60x, near record high for the asset class
- Despite the material price drop in oil, prices would have to continue to fall into the low $30's and stay there for a multi-year period to materially erode this cushion
- Even in such a scenario of sustained low oil prices it is likely that future projects would be suspended offering additional support for investors

Upstream Impact

- Low energy prices over a sustained period of time would likely take a heavy toll on businesses that extract commodities from the ground and do not have a strong balance sheets. In a prolonged low oil price environment we would not be surprised to see a number of bankruptcies in this space
- However, should this occur the impact on the midstream segment would be fairly limited
- 80%+ of midstream counterparties are investment grade businesses and the vast majority are large integrated oil companies (e.g. Exxon Mobil) with multiyear contracts

Demand

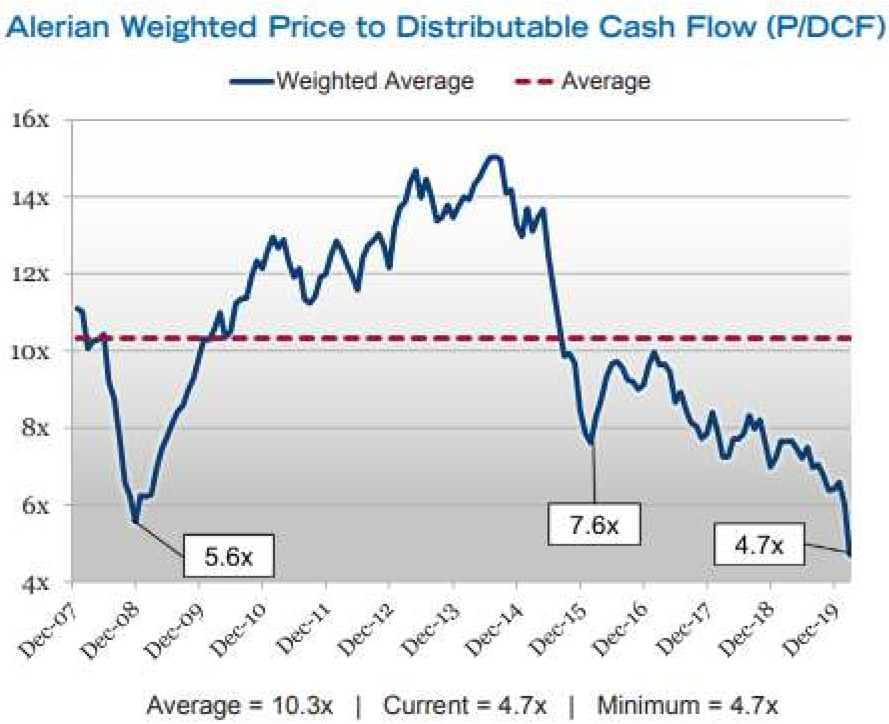
- COVID-19 is an unknown factor here influencing the demand for oil and related products. There is no question demand will fall, but by how much and for how long has yet to be seen
- However, oil price and volume do not move in tandem. In 2015/16 the price of oil dropped ~75%, but volumes over the same period only dropped ~10%. Midstream's cash flow is based on the volume moved at the contracted rate
- Additionally, many long-haul pipe contracts have minimum volume commitments which limits potential impact from decreeing volume/demand
- Lastly, pipelines are the low cost transporter relative to trucking and rail. In a cost cutting environment, pipelines are the preferred avenue of transport

Debt & Balance Sheets

- Midstream has gone through a substantial restructuring over the last few years providing much stronger balance sheets
- Today the majority of the asset class is investment grade and has far less leverage than 2016 when oil prices last had a similar pullback
- Midstream has become "self-funding" for new projects and less reliant on external financing. In 2019 midstream put $42 billion of capital expenditures to work which only $1.2 billion of that capital was raised externally. These businesses no long have to rely on "Wall Street" to fund projects.

Outlook

The standoff between Saudi Arabia and Russia and the demand impact from COVID-19 is likely to continue adding volatility among midstream businesses. Without perfect insight on how the country dispute or the epidemic will resolve we come back to fundamentals. The undisputable need for hydrocarbons in the economy, stronger balance sheets, considerable distribution coverage, more disciplined capital allocations and high current yields make midstream assets quite compelling. The weighted price to distributable cash flow, a measure of cheapness, now trades at valuations not seen since the financial crisis, a time period in which global demand was in free fall, capital markets were not lending and the quality of midstream businesses was not nearly as robust.



Bloomberg, Chickasaw, 3/6/20

That said, it is likely these assets will be volatile during this period of stress. Many investors are painting all energy businesses with the same broad brush and selling first only to ask questions later. This is often coupled with news coverage that conflates concerns in parts of the energy complex with all other segments.

Misinformation coupled with fear can be a hard scenario to overcome when allocating capital. However, we believe midstream assets can provide value to a thoughtfully diversified portfolio for investors who have a long-term investment horizon.

Please contact any of the professionals at The Trust Company with additional questions.