GLOBAL X
by Mirae Asset

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Topic: Income

Related ETFs

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MLPA – Global X MLP ETF

MLPX – Global X MLP & Energy Infrastructure ETF

GLOBAL X ETFs RESEARCH

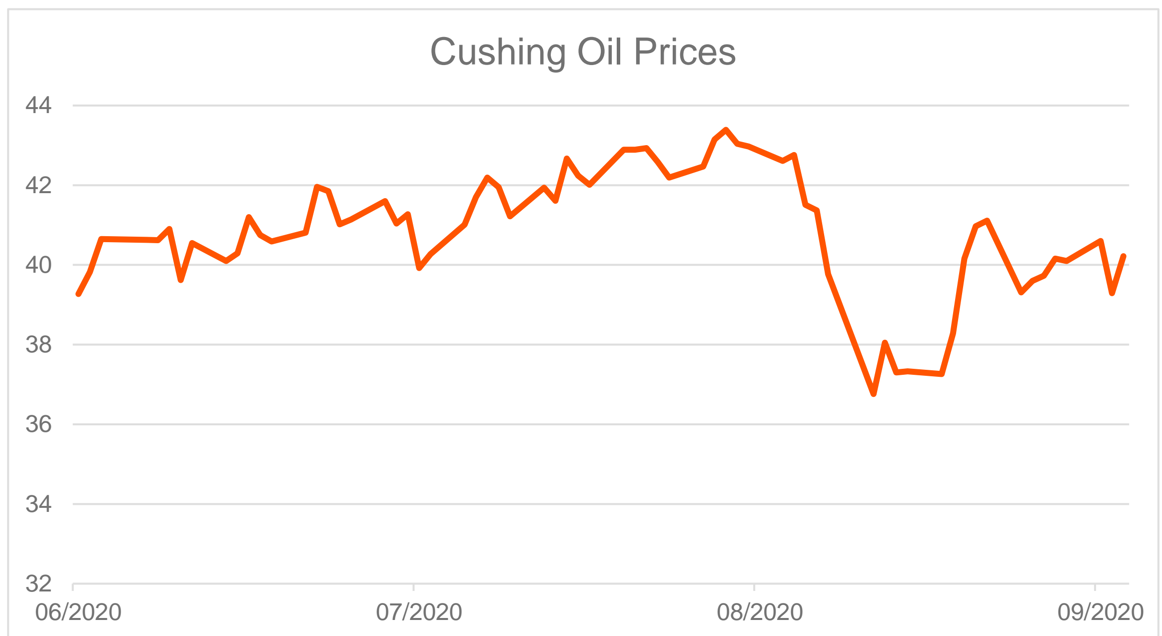
MLP Insights: Q3 2020

2020 is proving to be another challenging year for the midstream space, as MLPs and energy infrastructure companies seek to weather the storm of low oil prices, slowing US production, and election uncertainty that has weighed on the broader Energy sector. Looking forward, strong fundamentals and improving global growth could present opportunities within the midstream complex. In this quarter's MLP Insights, we discuss key topics for this space, including:

- Range bound oil prices are pressuring US output
- Long term trends challenge the energy sector
- Midstream fundamentals remaining robust through tough macro environment
- An optimistic case for midstream

Range Bound Oil Prices Are Pressuring US Output

Amid a slow global economic recovery, oil demand has failed to return to pre-COVID-19 levels. Global oil & liquids demand in August stood at 94.3 million bp/d according to the Energy Information Administration (EIA). This represented an increase from the 85.1 million bp/d average in Q2, but still a full 8.2 million bp/d below last year's August 2019 level. With demand only recovering about half of what it lost during worldwide shutdowns, there's been few catalysts to push prices higher. The result is range-bound oil prices, zeroing in around the $40/barrel level.



Source: Bloomberg. Data from 6/30/20 to 9/30/20.

Looking forward, prices could remain in this range well into 2021. Forecasts expect demand to increase by another 6.5 million bp/d next year, but much of this could be absorbed by the phasing-out of OPEC supply cuts.[1] The Organization of Petroleum Exporting Countries (OPEC) and its allies cut output by 7.7 million bp/d beginning in August and is expected to keep the curbs in place through year end. Beginning in 2021, cuts are scheduled to taper down to 5.8 million bp/d to offset increases in demand. OPEC+ has recently been flexible on extending output cuts when needed, though.

The prolonged low oil price environment has forced US shale producers to reconsider their capital budgets and output targets. Oil production at its core is tied to the price of oil itself. Producers collect the difference between the market price for oil and the cost to extract it, hedging aside. With oil at $40/barrel, many US energy producers cannot profitability extract the commodity. The result is that US energy production declined from a peak of 13 million bp/d to under 10 million a day in August.

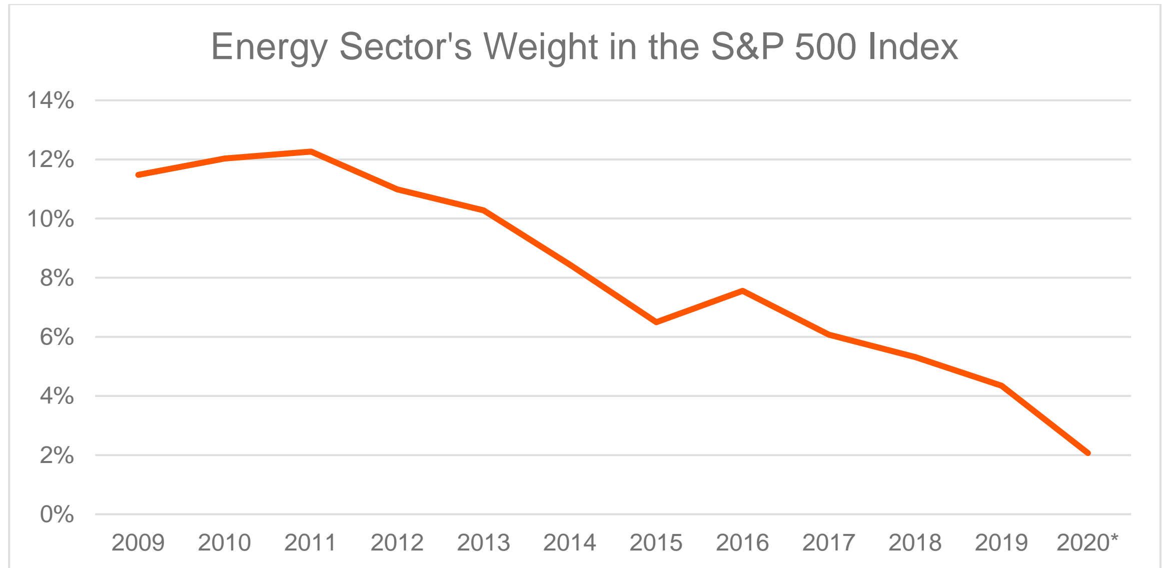
Midstream MLPs and energy infrastructure companies, which primarily benefit from the volume of oil and natural gas they transport and store, suffered amid fears that energy production would continue to decline. Midstream equities were down -9.4% in Q3 versus a -18.8% decline in the Exploration & Production segment. For the year, midstream is outperforming the E&P space by nearly 19% as less direct ties to commodity prices has helped somewhat insulate energy infrastructure.[2] Midstream's value proposition hinges in part on strong US energy production levels. The COVID-19 pandemic and consequent capital expenditure reduction by E&Ps reduced output as oil prices remained depressed.

Long Term Trends Challenge the Energy Sector

The broader Energy sector continues to suffer from short-term issues, like reduced demand from COVID-19, and long-term concerns, like peak oil and ESG divestiture. In addition to the COVID-19-related demand shock discussed above, major oil producers BP and Total suggested that oil demand may have peaked in 2019. With policies around the world to reduce carbon emissions, as well as advancements in alternative energy sources like batteries, total global output could be in a structural decline indefinitely.

Additional pressure on the Energy sector stems from changing preferences and considerations in investment criteria – namely the increased incorporation of ESG data into investment processes. Many ESG funds don't explicitly divest from the Energy sector, but there is a growing microscope on the 'E' within ESG amid the climate change discussion. Estimated ESG investments hit $40 trillion in 2020, nearly doubling in the past four years, which has likely put further selling pressure on the Energy sector.[3]

Another technical challenge includes the Energy sector's shrinking weight in major benchmark indexes. Energy became the smallest weighted sector in the S&P 500 this summer, representing just 2% of the index.[4] This means less direct investment from passive investors as well as from benchmark-aware active investors who can avoid the entire sector without risking major tracking error. Additionally, Utilities eclipsed Energy's weight in the S&P 500 for the first time in history earlier this year. Further, ExxonMobil was removed from the Dow Jones Industrial Average Index this summer after 92 years of inclusion. These changes present a significant headwind for Energy investors due to the significant amount of assets either invested in or benchmarked to those major indexes. There are $11.2 trillion invested in or benchmarked to the S&P 500, for example, with $4.6 trillion directly tracking the index.[5] Therefore, the falling relevance of the Energy sector has become a self-reinforcing cycle as investors can increasingly ignore the shrinking industry.



*Source: S&P. *Data as of year end, except 2020 which is as of 9/30/20.*

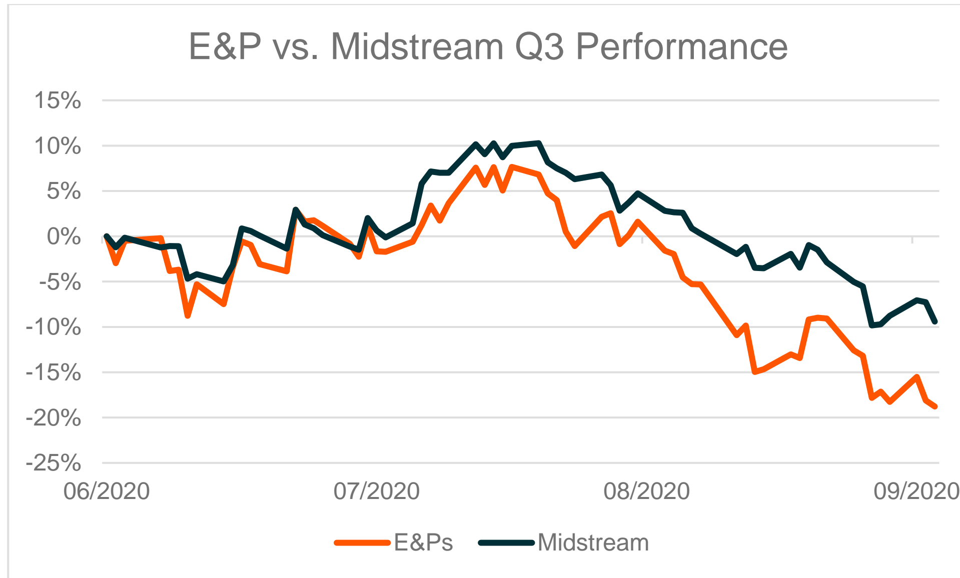
One method upstream exploration and production (E&P) companies are using to adapt to this challenging environment is through consolidation. M&A transactions can increase scale and reduce overhead, which can reduce breakeven prices for mega-producers. The low commodity prices are accelerating this trend. Chevron, for example, announced in July that they are buying Noble Energy, a mid-size shale operator, for a transaction value of $13 billion. In September, WPX Energy & Devon Energy announced they were combining their two entities in a $6 billion transaction. And in October, Pioneer Natural Resources announced it was acquiring Parsley Energy for $4.5 billion.

We believe consolidation will be the norm as E&Ps adapt to this new environment for several reasons. First, if oil demand is generally on the decline then the lowest cost producers globally will be the best positioned to profit. Mega-firms can trim redundant costs and wield greater negotiating power with partners. Second, while the Energy sector may remain much smaller in the aggregate, high concentration in a few names will likely garner more attention from investors. Third, consolidation helps energy producers mitigate certain risks by achieving greater geographic diversity.

Consolidation could have a modestly positive impact on midstream. Lower breakeven oil prices for mega-producers should be a positive for oil output and therefore help midstream volumes. In addition, mega producers have had better credit ratings and risk mitigation, improving counterparty risk for midstream. And while greater negotiating power from mega E&P firms might hurt in contract re-negotiations, midstream's own consolidation efforts could counteract this force.

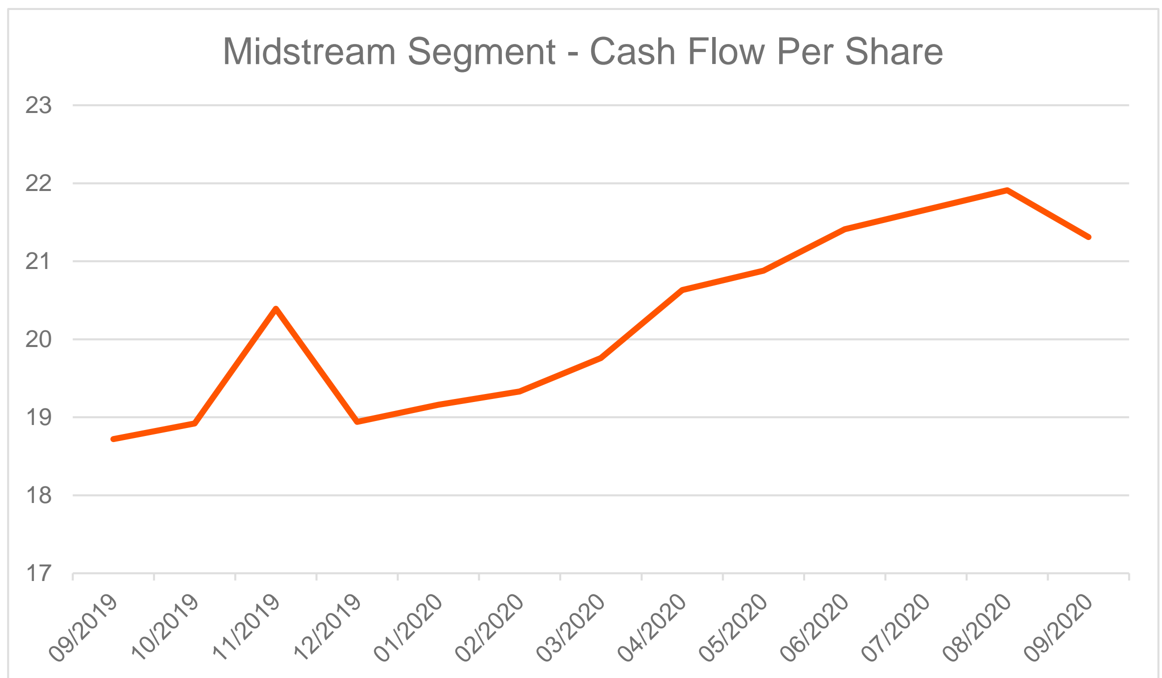
Midstream Fundamentals Remaining Robust Through Tough Macro Environment

The challenges facing the Energy sector have not left the midstream sub-segment unscathed, but overall the infrastructure segment has fared better than its Exploration & Production (E&P) counterparts. Despite low oil prices, the toll-road nature of the midstream business model insulated these companies against some of the downside in commodity prices, resulting in meaningful relative outperformance.



Source: Bloomberg. E&Ps represented by the S&P Oil & Gas E&P Index. Midstream represented by the Solactive MLP & Energy Infrastructure Index. Data from 6/30/20 to 9/30/20.

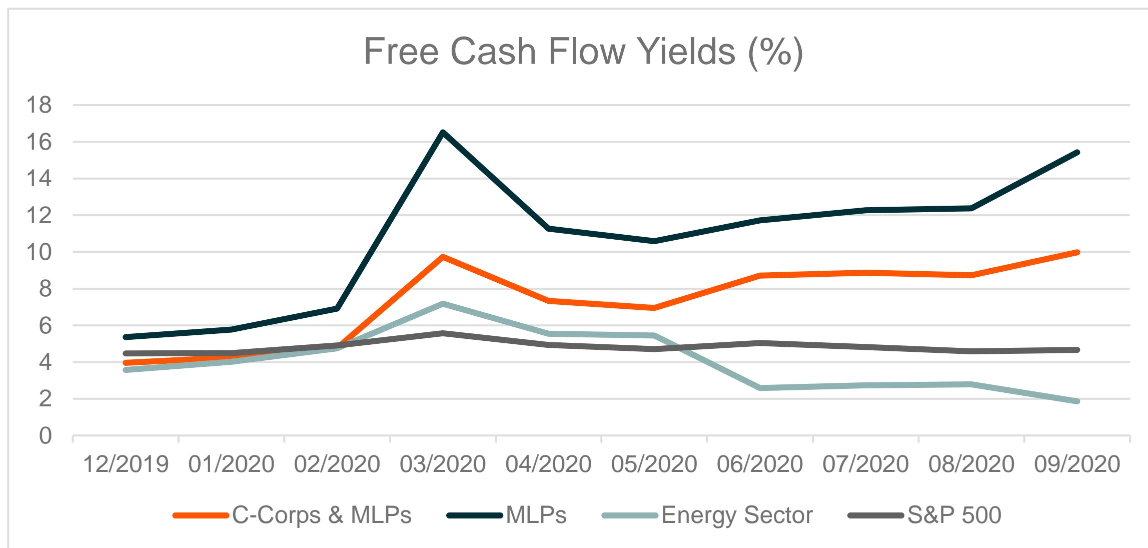
A bright spot among midstream entities was cash flow strength. Despite midstream equity prices falling amid weak Energy sector conditions, the long term nature of midstream companies' contracts helped to protect the asset class's cash flows. Midstream long-haul pipeline contracts tend to be protected by 5-10 year fee based commitments. It still gets paid for volumes transported, so midstream is not immune to all the challenges in the sector, but it tends to have more insulation than E&Ps to oil prices. We can see in the chart below that the midstream segment's cash flows have proven to be fairly robust despite falling oil output.



Source: Bloomberg. Represented by Solactive MLP & Energy Infrastructure Index. Data from 9/30/19 to 9/30/20.

In the past, many investors used distribution yields to value MLPs given that the structure distributed most cash flow to investors. Yet major portions of the MLP space have converted to the corporate structure and are retaining a much greater portion of their cash flow. Therefore, we believe cash flow yield may be more appropriate to value midstream equities today.

Free cash flow yields in midstream started the year at 3.96%, but rose to 9.98% at the end of Q3.[6] Higher cash flow yields can indicate lower valuations and/or greater business model strength.



Source: Bloomberg. Data from 12/31/19 to 9/30/20. C-Corps & MLPs represented by Solactive MLP & Energy Infrastructure Index, MLPs represented by Solactive MLP Infrastructure Index, Energy sector represented by S&P Energy Sector GICS Level 1 Index.

We can also evaluate midstream's strength based on the market's assessment of the segment's debt versus the other Energy sub-sectors. Equity prices are closely scrutinized, but the credit markets may tell more about the stability of the overall business. With midstream focused on stable cash flows and de-leveraging their balance sheets, the segment's debt has performed relatively well year to date, down just 3% while E&P debt is down almost 20%.

Debt Performance by Energy Segment - YTD			
Midstream	Refining	E&P	Oilfield Services
-2.97%	-10.39%	-19.65%	-44.40%

Source: ICE BofA, Bloomberg. Represented by ICE BofA High Yield indexes. Data through 9/30/20.

Another area to evaluate is the coverage ratios for midstream, or the ratio of cash flows to distributions. The higher the coverage ratio, the more insulated distributions will be from short term changes in the macro environment. With midstream retaining more cash flows (via aggressive distribution cuts) and cash flows remaining robust year to date, distribution coverage remains high.[7]

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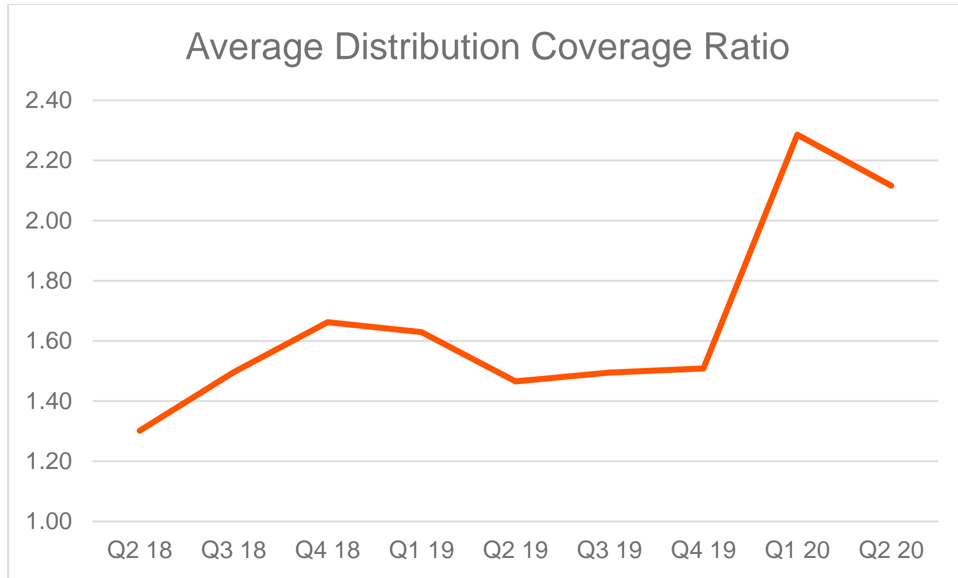
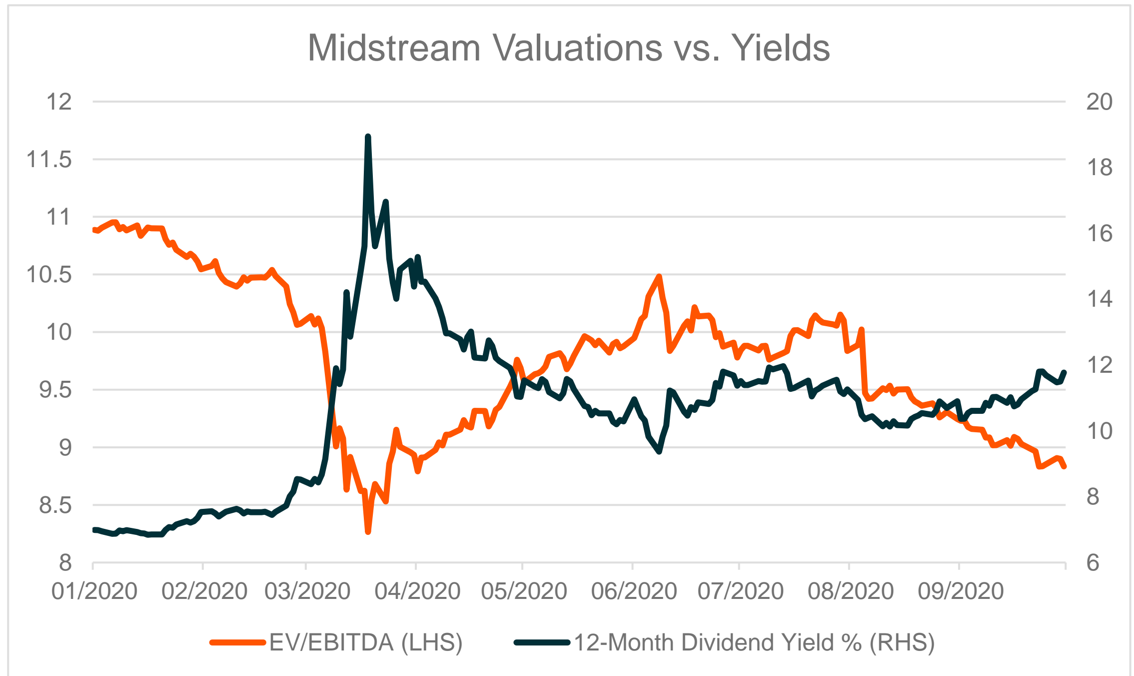


Source: Company reports. Data represents average of constituents in Solactive MLP & Energy Infrastructure Index.

Despite fundamentals appearing relatively strong, midstream distribution yields are hovering well above 10% as equity performance has suffered.



Source: Bloomberg. Data YTD from 1/1/20 to 9/30/20. Represented by the Solactive MLP & Energy Infrastructure Index.

An Optimistic Case for Midstream

Midstream's low valuations and underperformance versus the broader markets this year reflects the negative headwinds and sentiment the segment faces. Yet there are cases for market enthusiasm towards the space to improve. First, institutional interest in the space remains meaningful as midstream's long term

assets and high yields are attractive characteristics amid a low yield environment. Should institutional investors acquire more midstream assets, it could provide a tailwind for prices across the space. Second, a lower for longer interest rate environment has multiple positive implications for the space including greater demand for high yield assets, lower borrowing costs for midstream entities to pursue capex or refinance, and cheaper financing for M&A deals. Last, the better than expected fundamentals show midstream's business model robustness amid a challenging commodity price environment. Should oil price remain flat or improve, due to OPEC+'s continuation of output curbs or strengthening demand, the market may exhibit growing confidence in the business structure. Taken together, these optimistic views of the midstream space could reward investors with income in the near term and a rebound in valuations over the medium term.

1. EIA. Short Term Energy Outlook. Data as of 9/7/20.
2. Data measured using the Solactive MLP & Energy Infrastructure Index & the S&P Oil & Gas Exploration Select Index. YTD data through 9/30/20.
3. Pensions & Investments. "Global ESG-data driven assets hit $40.5 trillion". 7/2/20.
4. S&P 500 Index. Data as of 9/30/20.
5. S&P. Data as of 9/30/20.
6. Represented by Solactive MLP & Energy Infrastructure Index.
7. Represented by constituents in the Solactive MLP & Energy Infrastructure Index.

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complex tax structure than traditional ETFs and investors should consider carefully the significant tax implications of an investment in the Fund. The Funds are non-diversified. Current and future holdings are subject to risk.

MLPA is taxed as a regular corporation for federal income tax purposes, which differs from most investment companies. Due to its investment in MLPs, the fund will be obligated to pay applicable federal and state corporate income taxes on its taxable income as opposed to most other investment companies. The fund expects that a portion of the distributions it receives from MLPs may be treated as tax-deferred return of capital. The amount of taxes currently paid by the fund will vary depending on the amount of income and gains derived from MLP interests and such taxes will reduce an investor's return from an investment in the fund. The fund will accrue deferred income taxes for any future tax liability associated certain MLP interests. Upon the sale of an MLP security, the fund may be liable for previously deferred taxes which may increase expenses and lower the fund's NAV.

The potential tax benefits from investing in MLPs depend on them being treated as partnerships for federal income tax purposes. If the MLP is deemed to be a corporation then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value.

Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. In addition to the normal risks associated with investing, real estate and REIT investments are subject to changes in economic conditions, credit risk and interest rate fluctuations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Preferred stock is subject to many of the risks associated with debt securities, including interest rate risk. In addition, preferred stock may not pay a dividend, an issuer may suspend payment of dividends on preferred stock at any time, and in certain situations an issuer may call or redeem its preferred stock or convert it to common stock. U.S. Treasury securities are considered to be of high credit quality and are backed by the full faith and credit of the U.S. government. U.S. Treasury securities, if held to maturity, guarantee a return of principal while no other securities mentioned in this material offer such a guarantee.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

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