Seeking Defensiveness in the Global Midstream Sector

Not All Midstream is Created Equal

By Stuart Blackadder - Managing Director & Head of the US Office at Prostar Capital

As the world grapples with the economic and social fallout of COVID-19, infrastructure investors are rightly examining their portfolios for red flags. For some assets the impacts are clear, and troubling. According to the International Air Transport Association (IATA), global air traffic is down 70% year on year[1]. Volumes through container terminals in major global ports are off at least 20%[2], and traffic on some of the major US highways is down by more than 50%[3]. Investors in airports, ports and toll roads, where revenues are primarily driven by the movement of goods and people, can expect to see significant deterioration in profitability. Moreover, many of these assets traded at high multiples over the last five years on the basis of stable growing traffic projections. Further valuation impairments can be expected as the full impact of this crisis unfolds over the coming months.

The energy sector too has felt its fair share of pain. Major producing countries have not as yet cut production to meet lower global demand, sending energy prices spiraling. WTI crude fell from $63 in late January to $20 during March. LNG spot prices have been more resilient, but have still fallen more than 10% since January[4]. Higher cost producers in the US shale basins are widely expected to cut production and capital investment, and many expect bankruptcies to follow.

Unsurprisingly, US midstream stocks have suffered. The Alerian MLP Index, which tracks the largest MLPs mostly invested in oil and gas gathering and transmission assets, has fallen by 56% since early January. The rout has led to speculation that midstream is a highly volatile asset class that, when compounded by ESG concerns, should be relegated to an investor's "too-hard basket."

This analysis ignores, however, that the global midstream sector is made up of several asset sub-classes, each with its own revenue model and risk profile, and that not all midstream is created equal.

The clearest example of defensiveness in the midstream sector is bulk liquid storage terminals. These collections of tanks, jetties, pipes and pumps are typically found at the crossroads of global energy supply chains. Singapore, for example, which sees more than 25% of daily global seaborne oil trade pass through the Malacca Straits[5], has more than 75 million barrels of storage capacity[6]. Fujairah, 25 years ago a sleepy fishing port outside the Straits of Hormuz on the Indian Ocean side of the UAE, is now a

[1] https://www.smh.com.au/business/companies/travel-meltdown-airlines-say-25-million-global-jobs-at-risk-can-t-afford-customer-refunds-20200408-p54i1t.html
[2] https://www.ft.com/content/1071ae50-6394-11ea-b3f3-fe4680ea68b5
[3] https://www.afr.com/companies/infrastructure/atlas-arteria-reveals-french-traffic-hit-from-covid-19-20200325-p54dmn
[4] https://www.reuters.com/article/global-lng/global-lng-asian-lng-prices-fall-to-2-70-mmbtu-amid-coronavirus-outbreak-idUSL4N2AE2BM
[5] https://www.businessinsider.com/maps-oil-trade-choke-points-person-gulf-and-east-asia-2017-4?IR=T
[6] Tankbank estimates

major global trading and bunkering hub with more than 65 million barrels of storage, increasing to 110 million barrels in the next two years[7].

Like all hubs, these locations benefit from a diversity of supply sources and multiple end markets which means that demand tends to be very robust.

The revenue model is akin to that of an office building. Leases are generally one to five years. Customers pay rent by capacity, not by usage, under arrangements known as take-or-pay. And rental rates are fixed, not linked to oil prices, and can include inflation indexation. Because maintaining access to oil product is critical to customers, incidences of non-payment are rare. When it does happen, the terminal is typically protected by a lien over the customer's product, which even at today's low oil price can be worth up to forty times the monthly rental fee.

Storage terminals can in fact act as a hedge against falling oil prices. In general, when oil prices are low, demand for storage, and therefore storage rates, is higher. This is due to both the physical need to store oil when there is an excess of supply over demand, and also to oil trader's strategy of buying at today's low price, storing, and selling at a higher future price – a market structure known as 'contango.' Much has been made recently of the global shortage of storage capacity (S&P Global Platts expects the world to exceed its full capacity of about 1.4 billion barrels during May) and storage rates are currently more than 40% above levels of only four months ago.

Contango markets, while a boon for storage owners, are unpredictable and do not underpin the storage terminal business model. Instead it is their low correlation with the economic cycle, robust contractual structures, and lack of commodity price exposure that make them a highly attractive and defensive part of the midstream sector.

A second asset class capable of delivering attractive risk-adjusted returns across the cycle is natural gas distribution. Like storage terminals, gas distributors are protected from commodity price risk. They typically operate as regulated monopolies that pass on the costs of operation (including the wholesale cost of buying the gas) and earn a pre-determined return on capital employed. This minimizes gas bills for consumers and incentivizes distributors to continually invest in network growth and upkeep. Natural gas consumption is historically not very sensitive to GDP. However, where sales volumes are lower than the estimates that went into determining the regulated price (as they are likely to be in 2020), typically the regulatory rules compensate the distributors in subsequent periods.

Key parts of the global LNG value chain offer similarly defensive characteristics. The global liquefied natural gas (LNG) model is shifting away from large, 20+ year supply contracts from a small number of massive liquefaction projects. The trend is increasingly towards sourcing spot cargoes from multiple

[7] https://www.spglobal.com/platts/en/market-insights/latest-news/oil/041619-interview-fujairah-port-expects-crude-storage-to-more-than-double-by-2022

sources, with less oil price linkage. This is creating defensive investment opportunities at the demand end of the chain in import and regasification terminals. These assets, chiefly in the end markets of Asia, provide long-term contracted cash flows based on capacity availability or tolling arrangements with no commodity price exposure. The asset is critical to its customer's operation and often physically integrated into it, cementing the long-term nature of the relationship.

COVID-19 has exposed the underlying risks of airports, ports and toll roads, just as the oil price crash has impacted commodity-linked midstream assets like pipelines and gathering systems. Investors must be careful not to assume all midstream assets are similarly at risk. Assets such as storage terminals, regulated distribution networks and regasification terminals can offer highly attractive, defensive investment opportunities, regardless of whether a barrel of oil costs $20 or $60.

Stuart Blackadder is a Managing Director and Head of the US Office at Prostar Capital, a private investment firm focused on midstream energy infrastructure assets.