Equity Outlook

VOLATILITY WILL CONTINUE UNTIL MORALE IMPROVES

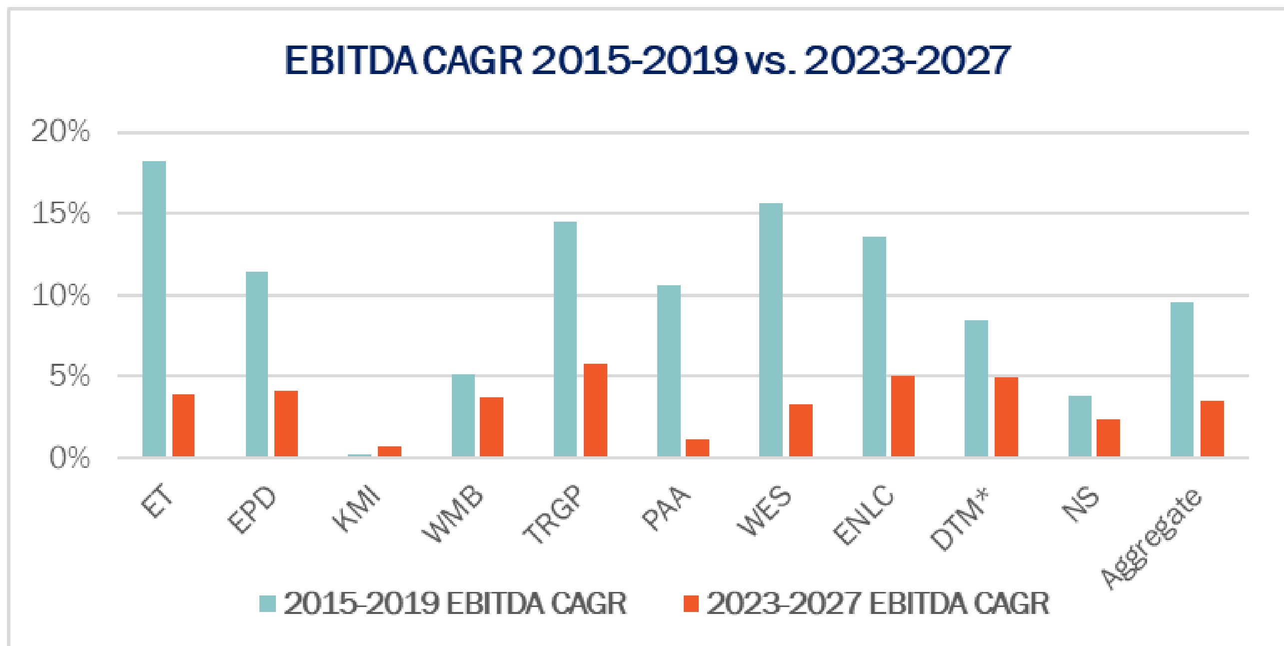
Midstream Company Financial Key Takeaways:

- Midstream is ripe for consolidation. The industry is generating positive free cash flow (FCF) after dividends, and companies have dramatically reduced leverage ratios. Combining healthier balance sheets with fewer organic growth opportunities and lower valuations, and M&A looks especially attractive for capital allocation.
- M&A strategies with three targets: scale, growth, and long-term value. Companies need M&A if they want to compete effectively in a lower-growth environment. Recent deals reflect this reality, and we expect them to continue.
- Expect more public company consolidation. We expect M&A between public companies to dominate the headlines as G&P-focused SMID-caps become limited by short-term growth dynamics, while large-caps look to backfill vertically integrated strategies. [AW1]Can we include a few deal values in this section, for OKE-MMP and maybe ET-ENBL

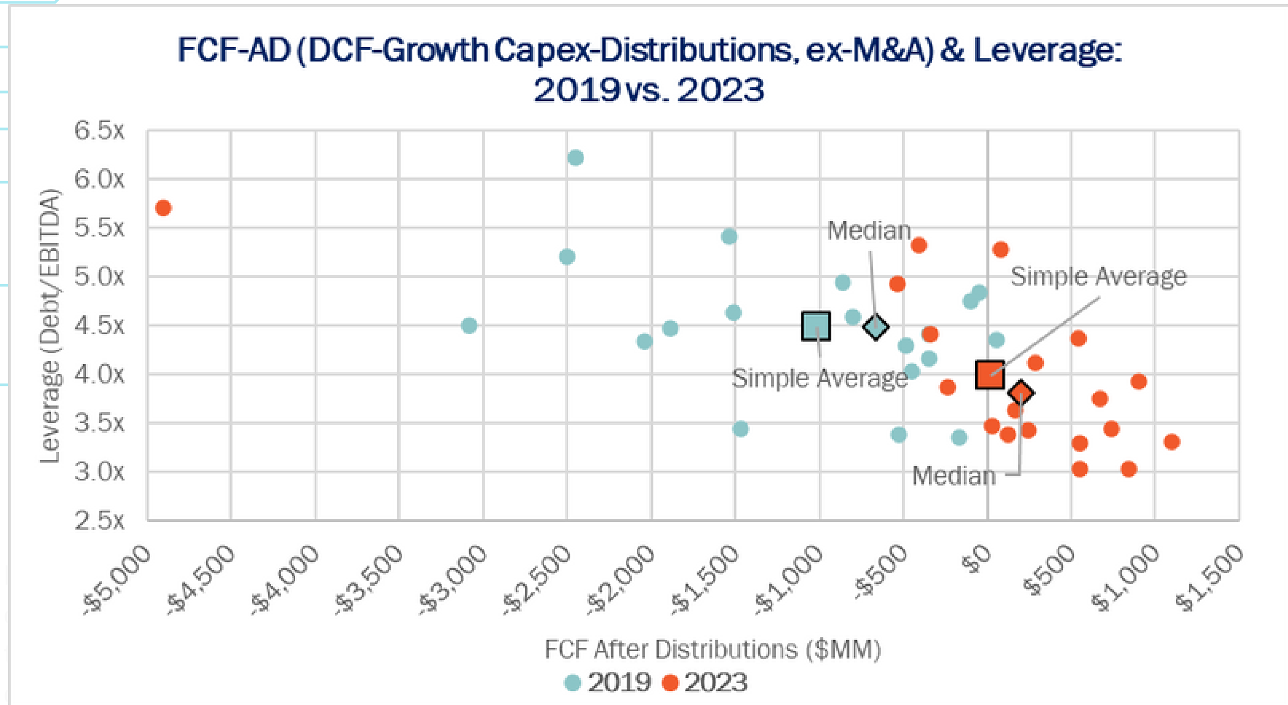
Executive Summary

Midstream is Ripe for Consolidation

The era of consistent double-digit growth is over for Midstream. Production forecasts have re-rated post-2020, and environmental regulations have become more stringent. Even in areas where development is needed, such as the Northeast, onerous permitting makes development unfeasible. The impact to midstream is lower demand for new greenfield projects. If the industry was still in growth mode, Matterhorn would not be the only natural gas pipeline under construction out of the Permian Basin right now, and investors would actually show interest in pursuing crude pipelines.



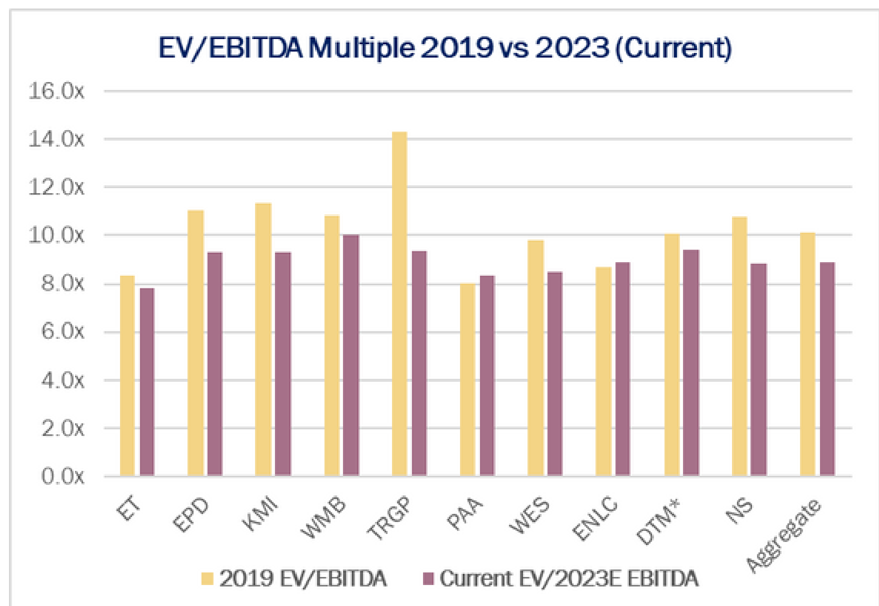
However, slowing growth does not mean the industry is in poor financial health. In fact, midstream is generating significant free cash flow. Most companies are on track to generate positive FCF after distributions for FY23, with the median at $205MM vs -$663MM in 2019 (see figure below).



EDA highlighted this wave of cash flows in the 2022 edition of Dirty Little Secrets. We noted the sector had fewer opportunities to spend capital, allowing more FCF to go to debt reduction and shareholder returns. Since then, leverage ratios in our coverage group have declined to 3.8x in 2023 (see figure above). Balance sheets are healthier than ever in Midstream. At the same time, distributions have increased 17% since 2021 to $35.6B (+9% Y-o-Y in 2023 alone) and are well above 2019 distributions of ~$31.8B.

In line with lower growth expectations and concerns over terminal value following the 2020 market crash, EV/EBITDA multiples for the companies in our focus are a full turn below 2019 levels (see figure below).

However, with limited new development, pipes in the ground become more valuable as production grows (just not as fast) along with demand. Given improved balanced sheets, more stable production growth vs 2019, and lower multiples, the sector is ready to move its capital allocation focus from debt reduction and dividends to M&A.



M&A Strategies Focus on Scale, Growth, and Longer-Term Value

In a lower-growth environment with increasing regulations, Midstream will need to look to M&A to drive growth and leverage existing assets in the ground.

Scale is of utmost importance as the focus shifts from taking a slice of a growing pie to poaching market share from other companies. Vertical integration is one strategy to achieve this scale. The NGL subsector has already seen this transformation, as major NGL players like EPD, ET and TRGP have spent $22.5B acquiring G&P-focused companies. The wave of M&A shifts the strategy from the 2015-2020 period when Midstream focused on reducing price and volumetric risk and invested more in contracted, long-haul infrastructure. Owning G&P assets is one way to secure flows through the rest of the asset base.

Date Announced	Target	Acquirer	Purchase Price ($MM)	Payment Type	Forward Yr. EBITDA	Est. EV/EBITDA
Aug-23	Crestwood	ET	$7,100	Equity	$890	7.98x
Mar-23	Lotus	ET	$1,450	Cash	$195	7.44x
Jul-22	Lucid	TRGP	$3,550	Cash	$473	7.50x
Jan-22	Navitas	EPD	$3,250	Cash	$489	6.65x
Feb-21	Enable	ET	$7,200	Equity	$960	7.50x
	Aggregate		$22,550		$3,007	7.50x

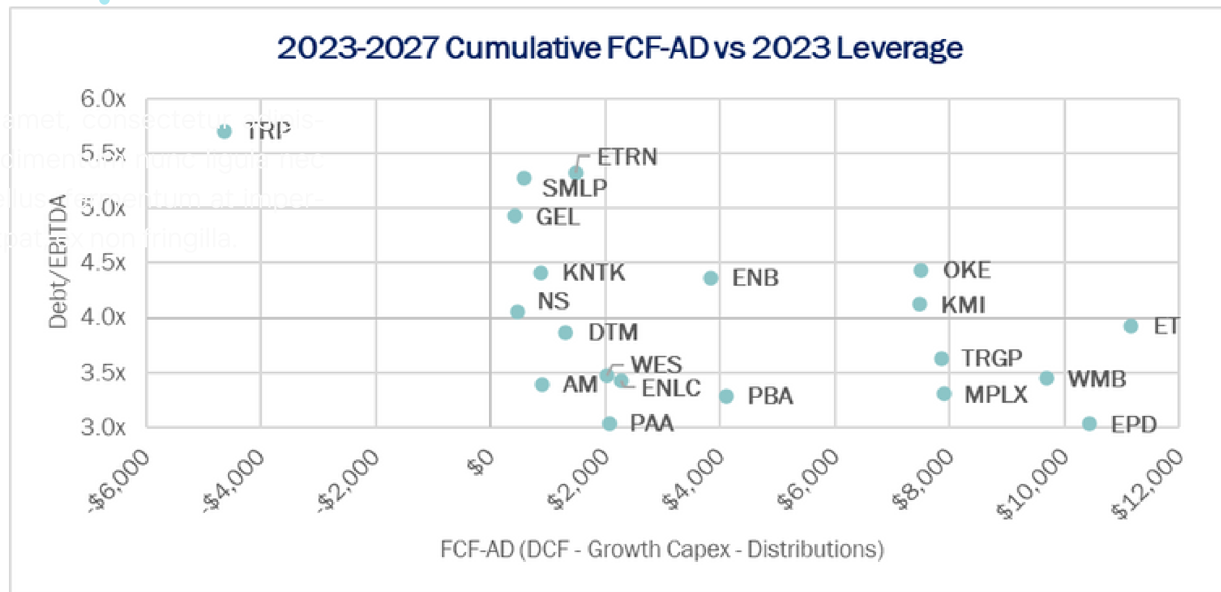
Lower growth does not mean no growth. Exports is one area growing across crude, natural gas and NGLs. Midstreamers need to align their strategies and businesses around export growth, and M&A will be key as greenfield projects become increasingly difficult to build. Midstreamers have already started to use M&A to boost their exposure to the exports tailwind, such as Williams' (WMB) acquisition of Trace Midstream and ET's acquisition of ENBL.

The Permian and Haynesville are also key areas of growth but are (relatively) fully valued. Companies should look to Tier 2 basins as a cost-effective and longer-term bet on demand growth in natural gas. As LNG exports increase, EDA expects a call on production from these basins, and Midstreamers can stay ahead of the curve by building positions in those regions now. WMB and KMI are early-movers with their recent acquisitions of Cureton and South Texas pipelines from NextEra Energy Partners.

Date Announced	Target	Acquirer	Purchase Price ($MM)	Payment Type	Forward Yr. EBITDA	Est. EV/EBITDA
Nov-23	NextEra STX Pipelines	KMI	$1,815	Cash	$211	8.60x
Nov-23	Cureton	WMB	$560	Cash	$81	6.91x
Nov-23	Rocky Mtn. Midstream (50%)	WMB	$714	Cash	$101	7.07x
Feb-21	Enable Midstream	ET	$7,200	Equity	$960	7.50x
Dec-22	MountainWest	WMB	$1,500	Cash	$188	8.00x
	Aggregate		$11,789		$1,541	7.65x

Public Company Consolidation

To evaluate which midstreamers could be acquirers vs sellers, East Daley focuses on companies with positive free cash flow and low leverage. These companies are highlighted in the bottom-right quadrant of the chart below.



ET, EPD, TRGP and WMB screen as the most likely acquirers, given their large asset bases that could benefit from bolt-on transactions. KMI is an outlier with leverage just above 4.0x, but KMI lacks the same EBITDA growth profile, so we expect it could also be an acquirer. Plains All American (PAA) stands out as a potential acquirer as well, especially given the limited growth capex opportunities. EDA's estimated 2023 growth capex is only 15% of our 2023 EBITDA estimate for PAA.

Ranking Matrix (1 = Low, 3 = High)						
Acquirer	Target	Scale	Exports	Tier-2 Exposure	Diversification	Total
PAA	NS	3	3	2	2	10
TRGP	ENLC	3	2	3	1	9
EPD	WES	3	1	2	1	7
KMI	DTM	2	3	1	1	7
ET	PAA	3	2	1	1	7

To screen for potential M&A, East Daley focuses on combinations with asset overlap that can add scale, align volume growth with export demand growth, or increase exposure to Tier 2 basins. We also consider increased diversification, though most combinations rated relatively low given that commercial synergies would be the main driver of these tie-ups. The table above includes some potential combinations that caught our eye. In Dirty Little Secrets, EDA explores how these tie-ups might look using our integrated asset and commodity models.