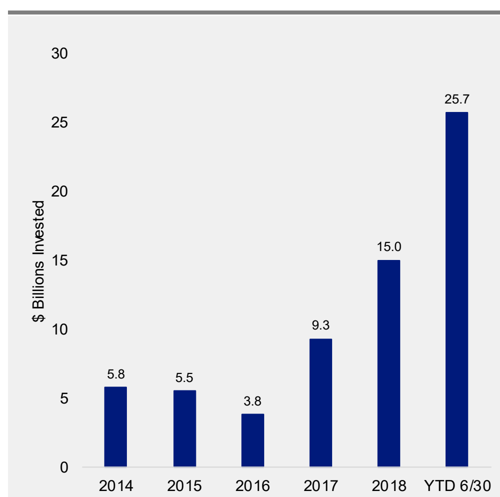
Private Equity Believes in Midstream Infrastructure

Public equity buyers have been slow to return to midstream, but private equity has been buying

Since the start of the year, private equity funds have invested nearly $26 billion in energy infrastructure, or midstream. Specifically, $3.3 billion was invested in a partial equity stake in Tallgrass Energy LP (NYSE: TGE) and $1.6 billion was invested in a partial equity stake of Bakken midstream assets owned by Targa Resources Corp (NYSE: TRGP). In fact, private equity has invested more than $40 billion since the beginning of 2018 in midstream assets in the public space over the last twelve months at cash flow multiples of 12x-15x according to RBC Capital Markets. Meanwhile, current valuations for public MLP and midstream companies average just 8.0x.

Private equity ramping up invest in midstream



We believe these private equity transactions represent another constructive data point for public investment in midstream equities.

Private capital's attraction to midstream

While the current depressed valuations of public midstream equities reflect tepid interest from public investors, large recent investment by private capital suggests these long term-focused investors are encouraged by the outlook for midstream. Domestic midstream assets are generally underpinned by fee-based cash flows and poised to benefit from visible production growth in the near and long-term. U.S. resource basins appear likely to grow production for the foreseeable future which should support midstream fundamentals.

Private capital's recent ability to successfully execute on midstream investment also reflects a new-found willingness of midstream companies to sell assets at the right price. Because public midstream trading multiples remain low, and below private market multiples, most midstream companies have been working to fund their growth capital plans internally as opposed to issuing new shares at a cheap price. To this end, most midstream companies now retain a significant level of cash flow after paying distributions or dividends which can then go to new investments. In fact, the sector's average distribution coverage ratio now approximates 1.4x versus the 1.1x historical level. In addition, midstream companies can supplement their capital investment funding plans by selling non-core assets to private equity at reasonable multiples or by partnering with private equity through joint ventures.

Public versus private valuation divergence

Current valuations for public MLP and midstream companies average 10.5x, according to RBC Capital Markets, versus the 12x to 15x cash flow multiples private capital is paying for midstream assets. For example, Buckeye Pipeline (NYSE: BPL) sold a $450 million package of assets at a 13x multiple to a private equity buyer while the partnership was trading at approximately 10x. Blue Racer Midstream, a private midstream operator, was sold to private equity at an estimated 14-16x multiple versus the 9x -11x trading multiple range of comparable public companies. Notably, illiquid or individual asset sales multiples historically are below, not above, the trading multiple of integrated and public midstream companies.

Individual assets simply cannot offer the advantages of scale, managerial expertise, customer relationships and vertical integration of a large public midstream operator. In fact, the majority of large-scale infrastructure investment today and over the past decade has been spearheaded by public operators because of these advantages. Therefore, public, integrated midstream companies typically offer lower risk, through size and diversification, than individual assets as well as greater growth prospects through an ability to capture new, high return investment opportunities.

Obviously, midstream investment within private equity portfolios is competing against investment in other forms of infrastructure and the resultant 12x to 15x multiples paid reflects a real-world market valuation. So, why do the public equities of many midstream companies trade at a discount to these multiples? In our view, the disconnect between public and private valuations can largely be attributed to a combination of (i) the public markets' short-term orientation and (ii) a continued lack of rotation into the broader energy sector more broadly.

Until public midstream multiples recover to more normalized levels, we believe public midstream companies will continue to sell non-core assets to help finance higher returning new investment opportunities. It also appears that private equity remains ready to continue to take advantage of the sector's cyclical weakness. With an estimated $193 billion of infrastructure-focused private capital still to be invested and more than 200 infrastructure-focused funds currently in the market looking to raise an additional $200 billion there appears to be ample potential demand for such assets[1].

Conclusion

We continue to emphasize the quality of U.S. natural resources – technology, geology, and entrepreneurial spirit underpin the U.S. shale renaissance. U.S. shale resource is competitive globally, exemplified by supermajors now devoting an increasing share of their drilling budgets to U.S. resources in lieu of other international opportunities. Similarly, private capital's large investment into U.S. midstream infrastructure is congruent with the competitiveness and long-term growth outlook for domestic resources. Although we welcome private capital's investment in the midstream space, especially as an important source of liquidity, we believe retail investors are missing the opportunity that private capital recognizes in the public midstream space.

DISCLOSURES

1. Q4 2018 Preqin Private Capital Fundraising Update (January 2019)

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