

# GRANT'S

INTEREST RATE OBSERVER®

Vol. 38, No. 2c

233 Broadway, New York, New York 10279 • www.grantspub.com

JANUARY 24, 2020

## Energetic income

Fabiano Santin writes:

Larry Fink, CEO and ethicist-in-chief of BlackRock, Inc., last week announced steps to begin weeding fossil-fuel companies from actively managed BlackRock investment portfolios and to lend the firm's moral authority (assets under management: \$7 trillion) to the instruction of American boards of directors in the urgency of progressive, Fink-compliant, "stakeholder" capitalism. "In the near future—and sooner than most anticipate—there will be a significant reallocation of capital," wrote Fink, driving home the point in bold type.

Whether or not the angels concur with Fink's coal-gas-oil divestment drive, the gods of contrary opinion are massing on the other side of the trade. The S&P 500 equity segment constitutes a scant 4.2% of the blue-chip index, down from 13.3% in 2008; it pays a dividend yield of 4.15%, compared with 1.90% for the index as a whole. We write to call attention to opportunities in income-producing stocks that occupy the energy wing of the investment dog house.

Since the subject is income, oil and gas bonds may spring to mind first, but the rock-bottom recovery rates recorded in recent energy-related bankruptcies will give pause to prudent creditors.

Better, we think, are high-yielding stocks of companies engaged in the transportation and processing of natural gas. It's a business inherently more stable than the volatile work of fossil-fuel exploration and production, in which an enterprising capitalist can

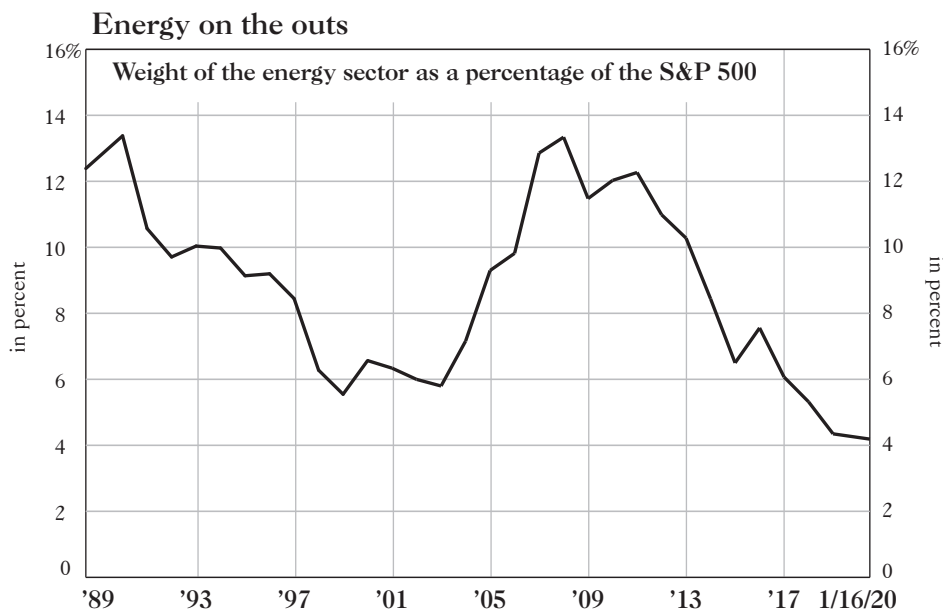
know everything there is to know about his investment except the return he will make for building it. Skipping down to the bottom line, we're bullish on the shares of The Williams Companies, Inc., Enbridge, Inc. and Oneok, Inc. (WMB, ENB and OKE, each on the Big Board).

If it's confidence you need, you'll hardly find it in the futures price curve of West Texas Intermediate crude. In relation to the \$58-a-barrel spot price, the contract for delivery in December 2021 trades at \$53, the one in December 2023 at less than \$52. The backwardated price array describes a process of "pulling oil from the ground" by selling it forward. It's a measure of the producers' bearishness, or resignation, that they are willing to accept a lower

price tomorrow than the one they could earn today.

The tea leaves may, after all, foretell lower hydrocarbon prices, perhaps brought about by a collapse in worldwide oil demand or a postponement of the expected downshift in American shale production or a diplomatic triumph with Iran that transforms the roiled Strait of Hormuz into a sea of tranquility.

Or it could be that the backwardated curve is no more prophetic than the people who try to interpret it. "Supply was tighter than futures prices might have suggested," recently said Russell Hardy, chief executive officer of the Vitol Group, the world's largest independent oil trader, to the *Financial Times* about the 2019 market. Vitol,



source: S&P Global, Inc.

which netted more than \$1 billion during the first half of 2019 by correctly anticipating the bearish implications for European natural-gas prices from a bulge in LNG supply, is now projecting a “marked slowdown in the pace of growth in the U.S. shale sector.”

Be that as it may, renewable alternatives will not soon displace fossil fuel as the world's mainstay power source. Especially in the case of natural gas, we believe, such dependence offers the prospect of sustainable relief from the ongoing income famine.

...

Two weeks ago, on the back of the short-lived, geopolitically driven oil rally, investors took up \$6 billion of new, energy-industry junk bonds, the most in a week since September 2014. Among the borrowers were a pair of Permian explorers, Laredo Petroleum, Inc. and WPX Energy, Inc., neither of which has generated a penny of free cash flow since their 2011 initial public offering.

WPX's 10-year, 4½% senior unsecured notes (B1/BB-; \$900 million) and Laredo's 8-year, 10.125% senior unsecured notes (B3/B+; \$400 million) both came at par. Observant investors scratched their heads at the not-dissimilar ratings and tenors, on the one hand, and the curiously disparate coupons, on the other. Why the four-handle on one profitless, “B”-ish oil explorer, and the 10-handle on the other?

At a glance, the 10.125% coupon is

appealing enough. It looks considerably less fetching in the light of the previously mentioned plunge in values that bondholders recovered in recent energy-company bankruptcies. Thus, in the past three years, senior unsecured creditors of fossil-fuel concerns have salvaged an average of just 19% of par value, less than half of the 40% average from 1987 to 2019, according to Moody's Investors Service. On Jan. 13, EP Energy Corp. disclosed an agreement in Chapter 11 bankruptcy that would give its unsecured creditors a 3.46% recovery rate—something of a victory compared with the 0.6% recovery mooted in a previous plan.

Even so, creditors continue to hope, as Benjamin Banwart, a partner at Keewatin Asset Management, LLC, tells me: “We have dealt with many distressed E&Ps, and the belief that they can drill their way out is still quite prevalent. [It] has not been uncommon to see unfunded annual capex budgets being a multiple of market cap in some small publics. In general, the risks outweigh the returns given that loans are unsecured and managers have a penchant for burning money until and after they are in Chapter 11.”

At another time or on another planet, income seekers might have earned a relatively safe premium by venturing into the least favored segments of the debt markets. But today's earthlings, contending with the double-barreled disinhibiting factors of QE4 and the boom in passive bond investing, find few such

opportunities. Junk bonds (excluding energy issues), priced to yield an average scarcely higher than 5%, constitute as eloquent a commentary as any on the paucity of pickings (and the profusion of risk) in today's bond market.

“Midstream” companies, the apples of our eye, own such critical assets as interstate oil and gas pipelines. They operate under long-term, fee-based regulated contracts, independent of the price of the gas or oil they transport. It happens that the very stability of the business model poses risks for the unwary lender.

Thus, the Energy Transfer Partners 6¼% preferred shares, callable in 2023, trade at 95½ to yield 7.9%. Too good to be true? The 3.3% yield attached to that company's triple-B-minus-rated 4% senior notes of Oct. 1, 2027 attest to the debt market's confidence in the solidity of the ETP balance sheet.

But solidity alone avails the holder little when an M&A transaction turns his world upside-down. Just ask the holders of the Buckeye Partners, L.P. 6¾% preferreds, which changed hands above 90 cents last May before an Australian private-equity firm swooped in to take Buckeye private in a leveraged buyout. “Leveraged” was the word: New senior buyout debt kicked the preferred down the capital structure and knocked its price to 70 before recovering to the consolation-prize level of 78¼.

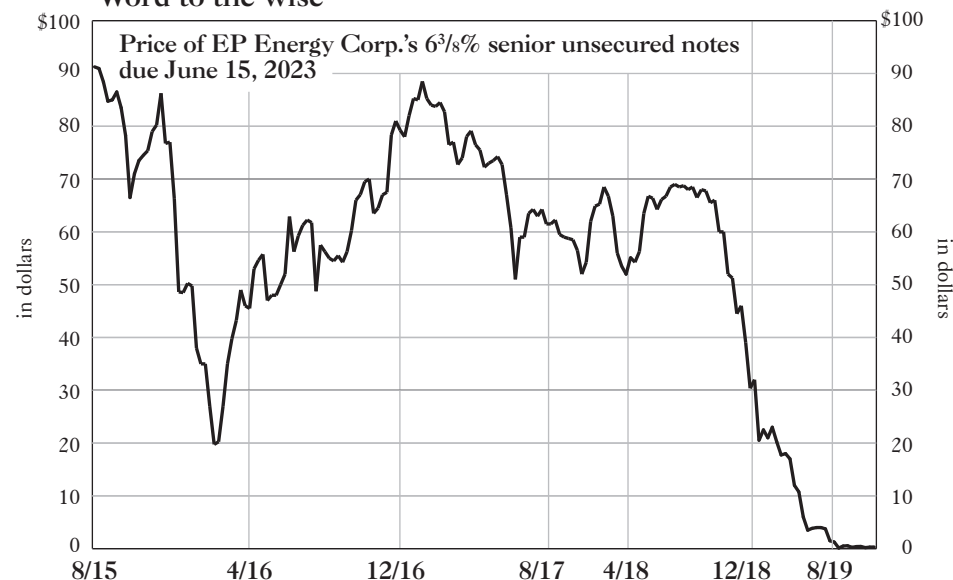
Given the non-negligible risks of M&A activity in energy, and particularly in the midstream segment (fragmented and relatively stable as it is), perhaps it's better to take one's chances with equity rather than with the senior portions of the capital structure that offer limited upside and considerable downside.

Because the billions invested in recent years to move shale-sourced natural gas to refiners and end-users are finally bearing fruit, capital expenditures are at last declining—and free cash flow and dividends are poised to begin rising.

If the stock market refuses to believe the bullish implications of these facts, you can hardly blame it. A 6% dividend yield paid by an investment-grade company that services its senior debt at yields of 4% or less naturally arouses curiosity if not suspicion.

Then, too, holders of such master limited partnerships as Boardwalk Pipeline Partners, L.P. won't soon forget

## Word to the wise



source: The Bloomberg

how a regulated hauler of natural gas that operated interstate pipeline networks under long-term contracts—the very business model on which this publication is now waxing bullish—wound up slashing its dividend to invest in (as management styled it six years ago) “growth.” *Grant's* was among the credulous losers in that transaction. What your editor failed to appreciate, among other things, was the precariousness of Boardwalk's capital structure and the vulnerability of MLPs as a class to tweaks in the federal tax law. Suffice it to say that the February 2014 kneecapping of the Boardwalk quarterly payout, to \$0.10 a share from \$0.5325 a share, did the stock price no good (*Grant's*, March 7, 2014).

The pipeline companies that this publication favors now are C corporations—entities taxed separately from their owners—as opposed to MLPs, which pass through their tax liabilities to the partners. It's on account of this wrinkle that an MLP investor must annually file a so-called K-1 form with the Internal Revenue Service. It's a bother that some want no part of, which helps to explain the discount at which the MLP pipeline group trades in relation to the C-corporation pipeline companies.

Needless to say, the MLPs have their champions—the partnership pipeline stocks are cheaper than the corporate kind, and they pay higher nominal dividends, although the corporate dividends, enjoying “qualified” income-tax treatment, are taxed at the long-term capital-gains rate, as distinct from the usually higher ordinary income rate. Besides, most institutional investors are prohibited from investing in MLPs, a detail that will take on added importance in the next bear market, when bids for anything will, by definition, be scarce.

...

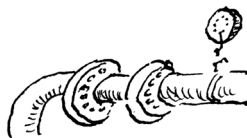
Williams Cos., our first pick to click, owns and operates more than 30,000 miles of natural-gas pipelines nationwide and conducts a natural-gas “gathering and processing” business in the country's main shale regions and along the Gulf Coast.

“For the large, diversified and integrated midstream companies, there is not really a lot of competition at that scale,” Henry Hoffman, portfolio manager of the SL Advisors MLP & In-

frastructure SMA strategies, tells me. Transco, the nation's largest and fastest-growing pipeline, which runs from the Gulf of Mexico to New York City, typifies that scale.

“You know they're going to be the same players in 10 years as they are today,” Hoffman goes on. “New pipeline growth is going to slow. That's why, I think, if you own these fully integrated ones with franchise positions, that touch all the basins or the best basins and have a lot of financial flexibility, meaning their leverage is low, they can throw off cash flow, they can self-finance their capex budget. I think that's a great place to be in infrastructure.”

Baa3/BBB-rated Williams shows net leverage of 4.5 times adjusted earnings before interest, taxes, depreciation and amortization, which, while it may not look low, Hoffman points out, is nonetheless manageable given the company's long-dated contracts with investment-grade counterparties providing visibility of cash flows.



If the analytical consensus is on the money, an expanded Transco pipeline and higher (regulated) rates will generate \$5 billion in adjusted Ebitda in 2019, compared with \$4.6 billion in 2018. And if so, reduced capital spending attendant on the completion of major projects will produce a jump in free cash flow to \$1.8 billion in 2020, from \$1.4 billion in 2019 and \$30 million in 2018.

Miller and David Williams founded the legacy Williams Brothers firm in Fort Smith, Ark., in 1908, but the better known Williams historical detail is the bankruptcy of the pipeline company's fiber-optics communications subsidiary in 2002. This miscalculation, a classic dotcom-era overreach, cost the stockholders such valuable assets as the Mid-America Pipeline Company, LLC, a transporter of natural-gas liquids, as well as the 34% interest cost on an emergency \$2 billion loan that Warren Buffett selflessly advanced (though the Sage of Omaha left a king's ransom on the table by not buying the common instead).

Having long since returned to its

pipeline knitting, Williams today targets net leverage of 4.2 times adjusted Ebitda and cash-flow growth of 5%–7% a year. Dividend coverage, as defined by adjusted Ebitda minus maintenance capital expenditures, cash interest, dividends paid to noncontrolling interests and cash income taxes, stood at 1.8 times dividends paid in the first nine months of 2019.

Is this the kind of business you want to own? Compare WMB's 6.5% dividend yield to Chevron Corp.'s 4.2% yield or Exxon Mobil Corp.'s 5.1% yield. And compare Williams's declining capex and its near indifference to the price of gas with the two majors' growing capex on uncertain oil-development projects and their heavy dependence on fossil-fuel prices. The majors' stronger financial positions feature on the other side of the argument.

...

Enbridge, of Calgary, our second pick, transports 20% of the natural gas consumed in the United States and 25% of North America's crude oil through the world's longest oil and liquids transportation system. Enbridge's pipelines connect America's key basins to refining centers in the Midwest, the Gulf Coast and eastern Canada.

An admiring investor tells me he likes the Enbridge front office because, for one thing, it is so quintessentially Canadian. “They are disciplined,” he says. “The Canadians are very by the book. They have a lot of capital discipline.”

Enbridge is expected to end 2019 with C\$13.3 billion in adjusted Ebitda, up from C\$12.8 billion in 2018 and climbing to C\$13.7 billion this year. Greater demand for Canadian crude oil from the U.S. Gulf Coast and stronger throughput from the Bakken pipeline, as well as higher regulated tariffs, are the leading sources of this forecast growth. That 98% of Enbridge's 2019 estimated Ebitda is derived from regulated take-or-pay contracts provides a welcome margin of safety.

Free cash flow is expected to reach C\$5.3 billion in 2019, from C\$3.7 billion in 2018. A C\$400 bump in capital spending in 2020 (along with associated delays and cost overruns) will cap free cash flow at levels only marginally above last year's, analysts expect. Such outlays are slated to peak this year at

C\$6.2 billion before dropping to C\$4.8 billion in 2021, when free cash flow is tipped to soar to C\$7.1 billion.

At last report, Enbridge showed net leverage of 4.6:1 (it targets a ratio of between 4.5 and 5 times adjusted Ebitda). Management says it aims to increase free cash flow by 5% to 7% every year. The common yields 6.1%, the market cap stands at \$82 billion and the ratings agencies appraise the debt Baa2/BBB-plus. Dividend coverage stood at 1.6 times for the first nine months of 2019.

Supplemental note to Larry Fink: Enbridge, an early mover in renewable energy, was selected for admission to Michael Bloomberg's 2020 Gender-Equality Index.

...

Pick No. 3, Oneok of Tulsa, Okla.—you say it “One-Oak”—is, like Williams Cos., a centenarian. Founded in 1906 as the Oklahoma Natural Gas Co., Oneok owns and operates processing plants that separate natural gas from natural-gas liquids as well as NGL “fractionators,” plants that split the molecules into ethane, propane, isobutane, normal butane and natural gasoline. Oneok likewise owns interstate natural-gas and

NGL pipelines and storage facilities.

More highly valued than the others, Oneok is, to its fans, a unique story. “Return on invested capital has been really good,” an investor tells me. “The company’s been very, very disciplined investing around their business. When the returns aren’t there, they pass. It’s a very good management team.”

Oneok is expected to generate \$3.2 billion in adjusted Ebitda this year, up from a projected \$2.6 billion in 2019 and \$2.4 billion in 2018. For this handsome improvement, credit larger gas-processing volumes in the Rockies and the Permian and faster flows through the corporate pipelines.

Free cash flow is expected to touch \$680 million this year, against a cash burn of \$1.6 billion in 2019; positive \$1.8 billion is forecast for 2021. The anticipated jump is owing to several projects coming online through early 2021 (which will add to processing and transporting capacity) whose backlog totaled \$6.3 billion. They are expected to add more than \$1 billion in annual adjusted Ebitda once completed, according to Bloomberg Intelligence.

Oneok pays a 4.9% dividend, commands a \$31.5 billion market cap and is rated Baa3/BBB. Several projects now

nearing completion are expected to lift the current 4.9% dividend rate, boosting distributions by 9% to 11% a year through at least 2021. Net leverage stands at 4.5 times adjusted Ebitda, dividend coverage at 1.4 times over the first nine months of 2019. Management aims to lower net leverage to 4 times Ebitda by the end of this year and then 3.5 times (or lower if it cannot find growth projects) “going forward,” said Walter S. Hulse III, CFO and Vice President of Strategic Planning and Corporate Affairs at Oneok, during the Barclays CEO Energy-Power conference in September.

Final word goes to Henry Hoffman: “If you’re Williams and you have a long-haul natural-gas pipeline, that asset actually appreciates over time. You have steel in the ground, and you have to repair your compression stations, but it is very hard to replicate or rebuild these large pipeline projects. That’s different than, say, with coal plants that at the end of their 30-year useful life, you’re actually left with a liability, because you have to decommission it.”

Having high-quality, long-haul pipelines, Hoffman winds up, “is like owning commercial real estate in downtown Manhattan.”

•

*Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.  
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.  
Copyright ©2020 Grant's Financial Publishing Inc. All rights reserved.*