Cohen & Steers

Secular, cyclical tailwinds rising in midstream

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, *Institutional Investing in Infrastructure*, recently spoke with **Tyler Rosenlicht,** senior vice president and a portfolio manager for Cohen & Steers' Infrastructure portfolios and head of midstream-energy and MLP strategies. The following is an excerpt of that conversation.

It seems like a lot of smart private-equity funds have been investing in midstream recently, and we had our first privatization with IFM's acquisition of Buckeye Partners in May. What is your take on this activity?

There's an interesting tension these days between what listed investors want and what private-equity investors are willing to accept. Listed investors are focused on deleveraging, distribution sustainability, fixing balance sheets, improving governance and resetting business models for the long run, which is commendable. That being said, there may still be opportunities for midstream companies to invest capital at attractive returns, as North America completes a major wave of energy infrastructure projects. So, you have management teams that want to continue to grow, and listed investors who want them to shrink. That tension is weighing down the stock prices of a lot of midstream companies. Private-equity funds have a generally low cost of capital and less need for current distributions, which has catalyzed a lot of activity.

What is driving PE funds to privatize midstream? Will we be seeing more deals?

I do think there is a high probability we will see more privatizations in midstream. A lot of companies in listed markets are trading at 70 cents on the dollar, which means private-equity investors can pay premiums of 25 percent or 30 percent and still acquire these assets at a discount. That can put them in a position to achieve low-double-digit IRRs. Private investors don't have to pay distributions, so they can redirect cash flows to fund capital spending and improve balance sheets organically. Fundamentals are attractive, yet capital remains fairly constrained in the listed markets, and private-equity investors are sitting on a war chest of dry powder they want to deploy. We think that's a recipe for continued private-equity transactions in the space.

If more midstream companies go private, how will that affect the listed market?

We think the fact that some listed companies are going into private hands is a good outcome, because it demonstrates to the markets that these companies are trading below their intrinsic value. We see listed companies continuing on a clear path to strengthening their balance sheets and repositioning their businesses, which we believe may help them outperform the broad equity market over the next couple of years. In this next phase, the name of the game is going to be consolidation. This is because, even though there is huge demand for energy infrastructure, it's becoming harder to permit and build new pipelines, particularly large pipelines that cross state and national borders. We expect some listed companies will look for merger opportunities, which can help them gain scale to improve asset utilization and potentially drive better returns on invested capital.

For investors who have historically focused on the private markets, why would they want to consider listed midstream right now?

We believe there is a great case right now for allocating to midstream through listed markets. Start with the fundamentals, because what matters is the supply and demand of energy infrastructure assets. Today, the United States is producing more, consuming more and exporting more energy than ever, which we expect to drive strong pipeline demand in the coming years. In addition, we believe important factors like compensation, governance and distribution sustainability have turned a corner. So you have the potential secular tailwind of strong pipeline supply/demand coinciding with an improving cyclical outlook — in our view, those two factors make for a very powerful investment case.

It has been a volatile asset class, which may have kept investors on the sidelines. Do you see volatility improving?

In the past, midstream has typically exhibited a positive correlation to commodity prices and interest rates. But look what happened in the second quarter of 2019: Crude oil prices declined more than 15 percent; natural gas and natural gas liquid prices set multi-year lows; there was a lot of market volatility from tariff news; and midstream mutual funds had net outflows. If I had painted that picture a few years ago, midstream would likely have been down materially because, historically, those factors contributed to performance. But midstream had a flat return in the second quarter. I think it's because investors are starting to appreciate that balance sheets are improving, these companies had strong earnings results in first quarter, and they offer very high distribution yields that look more sustainable than they were a few years ago. Investors shouldn't extrapolate one quarter and assume it's the new normal, but I do feel that the investment merits of midstream are beginning to shine through.

CORPORATE OVERVIEW & CONTACT

Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure and natural resource equities, as well as preferred securities and other income solutions. Cohen & Steers is headquartered in New York, with offices in London, Hong Kong and Tokyo.

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