Building the resilient midstream company

The development of North America's unconventional oil and gas resources spurred the rapid growth of the region's midstream sector. However, the subsequent growth in hydrocarbon supply, coupled with shifts in OPEC policy[1], cut short the phase that one midstream company once referred to as 'a once in a lifetime super-cycle.' In fact, the degree of impact on what was thought of as a more cycle resistant portion of the energy chain surprised many industry observers.

As a first response, many players have further diversified their portfolios, increased their size, and taken steps to reduce costs and strengthen their balance sheets. While these steps are prudent, the challenge is to avoid potential side-effects such as dilution of focus, excess complexity, and barriers to operational excellence. As we enter the midstream sector's next phase of evolution, significant economic opportunities still exist, but they will be captured by those select participants that can establish a resilient growth strategy.

The re-birth of North America's midstream sector is well documented. To understand the future, it's helpful to highlight a few characteristics of that growth phase. First, increased drilling rates and production – especially in areas outside of historic producing basins – coupled with the development of new markets for gas and liquids (e.g., the NE US, gas power generation, chemicals feedstock) generated significant organic project growth for midstream companies. Second, the Master Limited Partnership structure, coupled with investors need to identify sources of yield in a low interest rate environment, provided significant amounts of low-cost capital to the midstream sector. Third, this high octane growth period overlaid and added to an industry born primarily of divested assets and a large number of relatively small midstream players – creating an industry structure ripe for consolidation. Importantly, many of these players did not possess particularly robust operational or commercial organizational capabilities.

The commodity price downturn triggered several cascading downturns: reduced drilling, production, transportation fees, and growth projects. As oil prices began their downward trend in the summer of 2014, the fortunes of the companies that drill wells, the exploration and production sector, and those companies that directly serve the drilling process, the oilfield service and equipment sector, waned. But the midstream sector remained relatively robust as investors sought out the presumably stable returns of the 'toll-road' like business model of midstream companies, which often accept a fee in exchange for transportation, without taking on commodity price exposure.

However, as oil and natural gas prices persistently set new lows throughout 2015 and into 2016, and exploration and production companies further curtailed their operations, a funny thing happened – there were fewer cars that needed to drive on the 'toll-road.' And the opportunity for new projects plummeted

[1] FORTUNE, *OPEC Members Are Shifting Toward Ending Oil Glut* (February 14, 2016)

significantly as well. Some midstream companies saw their cash flows decline to a level at which they were forced to reduce their quarterly distributions to shareholders. As investors second-guessed the stability of the sector and unit prices fell, midstream companies' cost of raising new capital increased significantly, placing further demands on cash from operations and curtailing the cash flow available to return to shareholders. Thus the viability of smaller and even several mid-sized and larger players became challenged. The price downturn had, albeit with some delay, shaken the underlying pillars of the midstream sector's growth phase, and the consistency of quarter over quarter distribution growth.

More sober views of production and project growth, and cost of capital lead us to conclude that the sector is entering its next phase of evolution – a phase characterized by a focus on more resilient growth. Current views on commodity prices suggest no earlier than a late 2017 recovery, and even then to settle in the $65 per barrel vs. $100 per[2] barrel range prior to the downturn. During this phase, the sector is likely to see considerable shifts in industry structure driven by portfolio diversification and increased scale, balance sheet restructuring, and an increased merger and acquisition activity. We expect to see at least three forms of inorganic activity accelerate over the next several months: consolidation, integration, and specialization.

Enbridge's proposed merger with Spectra Energy represents an example of *sector consolidation*, as well as portfolio diversification, and increased scale. Enbridge CEO and President Al Monaco described the deal by saying "scale mitigates exposure at industry downturns and the challenging project environment, and will generate new, large and more diverse opportunities for us."[3]

We view *integration-related M&A* activity as the tie-up of 'non-traditional' midstream participants with more focused midstream companies and assets, including through joint venture. So far, the industry has seen two forms of such integration: the first is the acquisition by leading refining and marketing participants of midstream assets as evidenced by Tesoro Logistic's acquisition of QEP Resources[4] and Marathon Petroleum's acquisition of MarkWest[5]. The second is moves by regional utility companies to secure gas-related midstream infrastructure (e.g., Southern's joint venture with Kinder Morgan[6]). Such integration moves capitalize on the non-traditional players' access to cash flow and capital and the potential medium term growth of midstream, which exceeds the projected structural growth of refining and utilities in North America.

The future of the midstream sector need not necessarily be solely controlled by a handful of large, diversified players; there are still niche areas of growth to be captured. It is these 'niches' that form the basis for potential *specialization deals*. For example, the recent lifting of the crude export ban significantly improves the outlook for certain strategically placed assets and smaller companies which control these assets. As another example, there is still continued growth in the North American petrochemical industry and the sector has a few successful players focusing on meeting the growth needs of this segment (e.g.,Phillips 66 Partners acquisition of natural gas liquids logistics assets from Chevron).[7]

However, inorganic moves do not, by themselves, represent a viable business strategy. While size and diversification are beneficial to weathering cyclical downturns, this must be weighed against excess complexity and inability to execute effectively. We believe those companies that achieve resilient growth will pursue a more thoughtful path that includes three specific actions and avoid the 'let's-do-a-deal' mentality.

First, successful companies will define a differentiated business model – the means by which the company will create value and compete for opportunities at an advantage vs. competition. There are multiple options: geographic or industry markets, or customer or operational excellence can be a focus of advantaged value creating capabilities. As illustrated below, there are at least four such 'pure-tone' business models. And while conceptual in nature, the point is that in a period which requires resiliency, a company will have to possess a tangible source of competitive differentiation and act on that advantage to profitably grow.

[2] WSJ Market Data Group http://www.wsj.com/articles/analysts-turn-bearish-on-oil-again-1470308004

[3] Enbridge Inc. *Enbridge and Spectra Energy to Combine to Create North America's Premier Energy Infrastructure Company* (September 6, 2016) Retrieve from http://www.enbridge.com/media-center/news/details?id=2083920&lang=en&year=2016

[4] Tesoro Logistics. (2014). *Tesoro Logistics Becomes Full-Service Logistics Company with Purchase of QEP Field Services* [Press Release] Retrieve from http://www.tesorologistics.com/phoenix.zhtml?c=242247&p=irol-newsArticle&ID=1979102

[5] Marathon Petroleum Corporation. (2015). *Marathon Petroleum Corporation Expands Midstream Footprint with MPLX/MarkWest Strategic Combination* [Press Release] Retrieved from http://ir.marathonpetroleum.com/phoenix.zhtml?c=246631&p=irol-newsArticle&ID=2067113

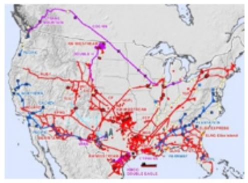
[6] Southern Company. (2016) *Southern Company, Kinder Morgan Finalize Southern Natural Gas Pipeline Strategic Venture* [Press Release] Retrieved from http://www.southerncompany.com/news/2016-09-01-kinder-morgan.cshtml

[7] Phillips 66 Partners to Acquire South Louisiana NGL Logistics Asset http://unitholder.phillips66partners.com/newsroom/news-release-details/2016/Phillips-66-Partners-to-Acquire-South-Louisiana-NGL-Logistics-Assets/default.aspx

Exhibit one – pure tone business models

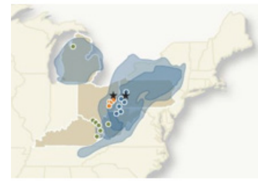
Scale and scope

- Leverage balance sheet and diversification to take on major projects/risks not accessible to smaller players
- Manage both large volumes and breadth of product/service offerings



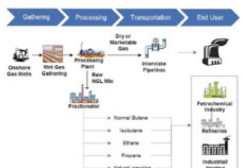
Basin consolidator

- Gain dominant position within a basin
- Access to 'all' deals in basin; position across local chain



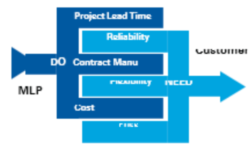
Value chain optimizer

- Driving specialization across particular value chains; e.g., liquids
- Providing integrated services from wellhead to end user



Customer service champion

- Work closely with customers to develop new opportunities and future project work
- Premium customer service



Second, resilient companies will proactively address their own internal cost base and re-invest savings in particular capabilities. Approaches to cost management range from short to long term, but they all share a focus on creating transparency into how spending supports organizational priorities as illustrated in the chart below.

Exhibit two – cost segmentation

Finally, those companies that actually take steps to prepare themselves for a period of substantial M&A activity will come out ahead. Exhibit three illustrates a number of best practices with respect to M&A preparedness.

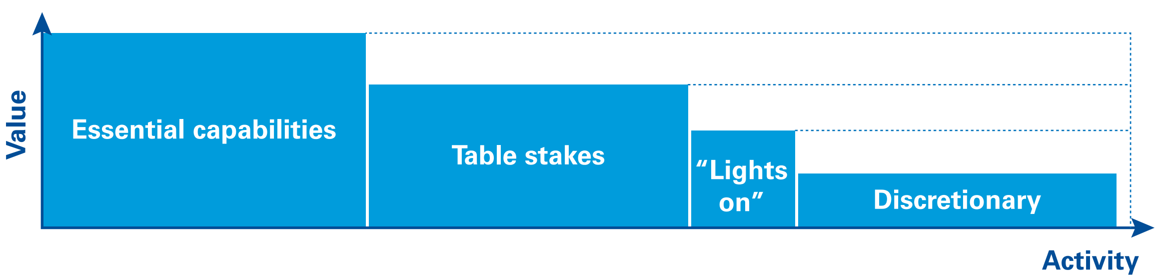


Exhibit three – M&A strategy best practices

1	Leadership across the organization needs to align and clearly define their growth ambitions, and how their approach is competitively advantaged – themeans by which the company will create greater value than their competition.
2	The company needs to define which markets and business models will help them to achieve their ambition and sources of advantage and then to identify which potential M&A targets align to those markets and models.
3	The company will need to evaluate which of the potential targets offer the best opportunity to achieve their strategy and maximize value.
4	The company will need to have the capability to execute the deal and do so quickly.
5	Finally, the effective integration of the acquired company is key to realizing the expected value.

The rapid growth phase characterizing the rebirth of the North American midstream sector is over. And while the longer-term fundamentals of the sector remain positive and there is still significant economic opportunity, we expect select few companies will transition successfully to the next phase of more resilient growth. Those companies that do will take pro-active action across a number of different fronts, both internal and external, and will do so in a coordinated approach to ensure the outcome of their efforts.

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