MACRO OPS
TRADE - LEARN - EVOLVE

Saturday, April 09, 2022

An Equity Note

Brandon Beylo

brandon@macro-ops.com

What's Inside:

- ➢ Hess Midstream LP (HESM) Deep Dive

Companies Mentioned:

- ➢ Hess Midstream LP (HESM)
- ➢ Hess, Inc. (HES)

Equity Note: Hess Midstream (HESM) Is A Good Business & Trades For 2x Free Cash Flow

I'm spending too much time with Alex. Here's how I know. Usually, I spend each weekend unearthing fantastic, software-based companies or fast-growing consumer retail/tech businesses.

These businesses are generally in the earlier stages of their growth cycle and offer longer duration cash flows.

And nothing's hurt more in this market environment than estimates (read: hopes) of long-duration cash flows.

I couldn't have pivoted farther from the above research this weekend. This week's Equity Note highlights a midstream O&G player trading for *2x current free cash flow*.

That company is **Hess Midstream (HESM).**

The value proposition is clear. You can buy HESM today and get 1.25x your money in three years. After year three, you have all your initial cash (and then some), an ownership stake in the business, and a right to all future cash flows, buybacks, and dividends ... for free.

HESM is a good business. The company generates 30%+ ROC with 75%+ (and growing) EBITDA margins. Most of their revenue is guaranteed through minimum volume contracts (MVCs -- which we'll discuss later), and they boast unilateral rights to extend customer relationships into 2034.

There are a few reasons why this opportunity exists:

- ➢ **It's an oil and gas play**
- ➢ **It's a forgotten asset compared to larger Hess Corporation**
- ➢ **Generates 90%+ of its revenues from one customer (Hess)**
- ➢ **See HESM only as a dividend play; not as a growing business with excellent economics/ROCs**
- ➢ **Underestimate HESMs long-term earnings power by bucketing it with upstream/downstream comparables**

Who knew you could still buy great companies trading at sub-5x FCF in today's market!

Our investment case rests on three pillars:

- The **financial health/survivability** of Hess, Inc (HES) as HESM's core customer.
- The **probability** that unitholders receive HESM's future cash flows via distributions.
- The **strength** of HESM's future earnings power.

We'll answer each of the above points below. Let's get after it.

The Oil & Gas Value Chain

Hess Midstream LP (HESM) acquires, develops, and owns/operates midstream assets. These assets enable HESM to gather, store, terminal/export, and transport commodities like crude oil and natural gas to various downstream customers (think industrial manufacturers, etc.).

Before we go any further, let's quickly explain *where* HESM sits in the commodity value chain.

There are three main business segments in O&G: **Upstream, Midstream,** and **Downstream**.

Upstream is commonly called "E&P." These guys drill, recover, and produce the actual crude oil and natural gas from the ground.

Examples of upstream businesses include Hess, ExxonMobile, and Royal Dutch Shell.

Midstream businesses collect the oil or gas from the wells and send it to processing plants and transportation systems (rails or pipelines) for distribution to downstream companies. In other words, the creme filling in the O&G cookie.

Finally, Downstream companies refine, sell, and/or use the oil or gas in production. Think of businesses like Valero Energy, Sunoco, or any other gas station.

As we'll see below, midstream operators possess the best business models out of the group.

How HESM Makes Money

HESM generates revenue by charging fees for

- Processing and fractionating NGLs
- Terminaling and loading crude oil and NGLs
- Transporting crude oil by rail car
- Storing and terminaling propane

Fees are structured as part of long-term (10YR) contracts with Hess, Inc. These contracts carry with them attractive contingencies like Minimum Volume Contracts (or MVCs). MVCs basically set a floor for how much revenue HESM makes in any given agreement, whether gas or oil.

Revenues are a function of **volumes of crude oil, natural gas, and NGLs** that HESM handles at their processing, terminaling, and storage facilities.

The more volume they pass through, the more money they make.

Volumes are affected by the supply of and demand for crude oil, NG, and NGLs in the markets served directly or indirectly by HESM assets.

HESM's Two Business Segments: Crude Oil & Natural Gas

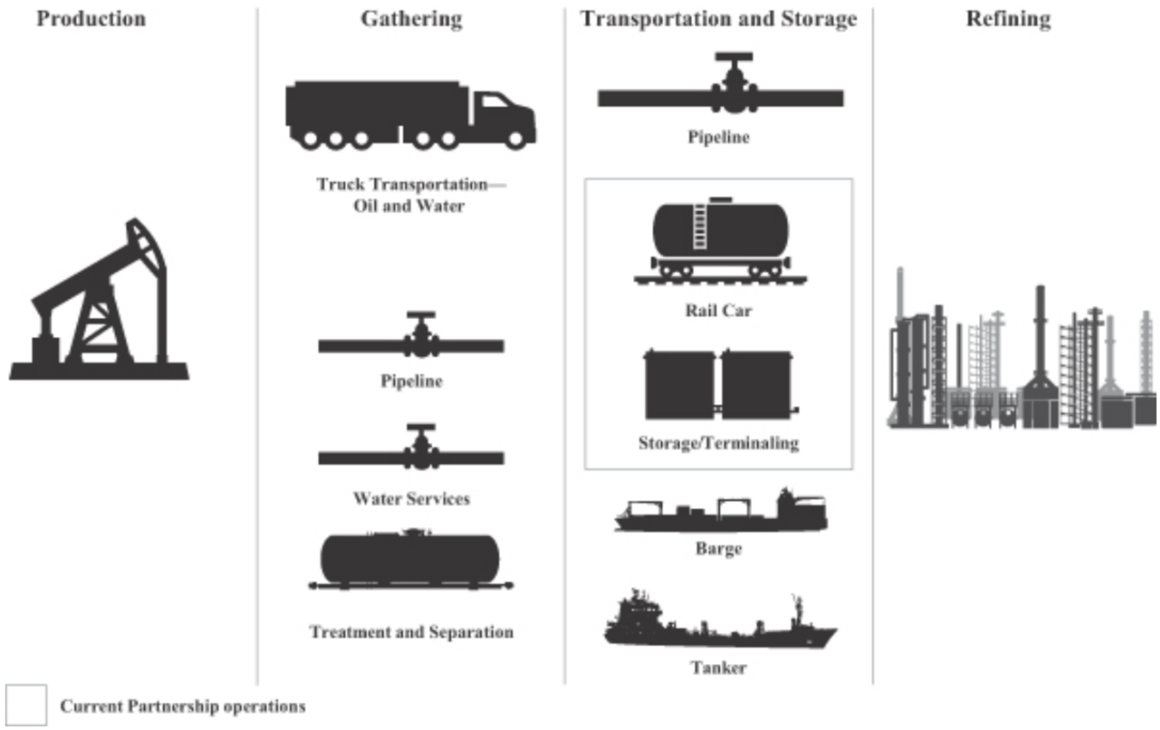
HESM bifurcates its business into two segments: crude oil and natural gas.

On the crude oil side, HESM provides three primary services:

- Gathering
- Stabilization
- Terminaling, Transportation, and Storage

The company offers ~385 MBbl/d of Crude Oil Terminaling Capacity and ~240 MBbl/d of Crude Oil Gathering Capacity.

You can see below where HESM fits in the oil value chain.



Then, there's the natural gas segment. HESM is the link between the exploration and production of NG from the wellhead or lease and the delivery of that nG to end-use markets like generators, industrial consumers, or local distribution companies.

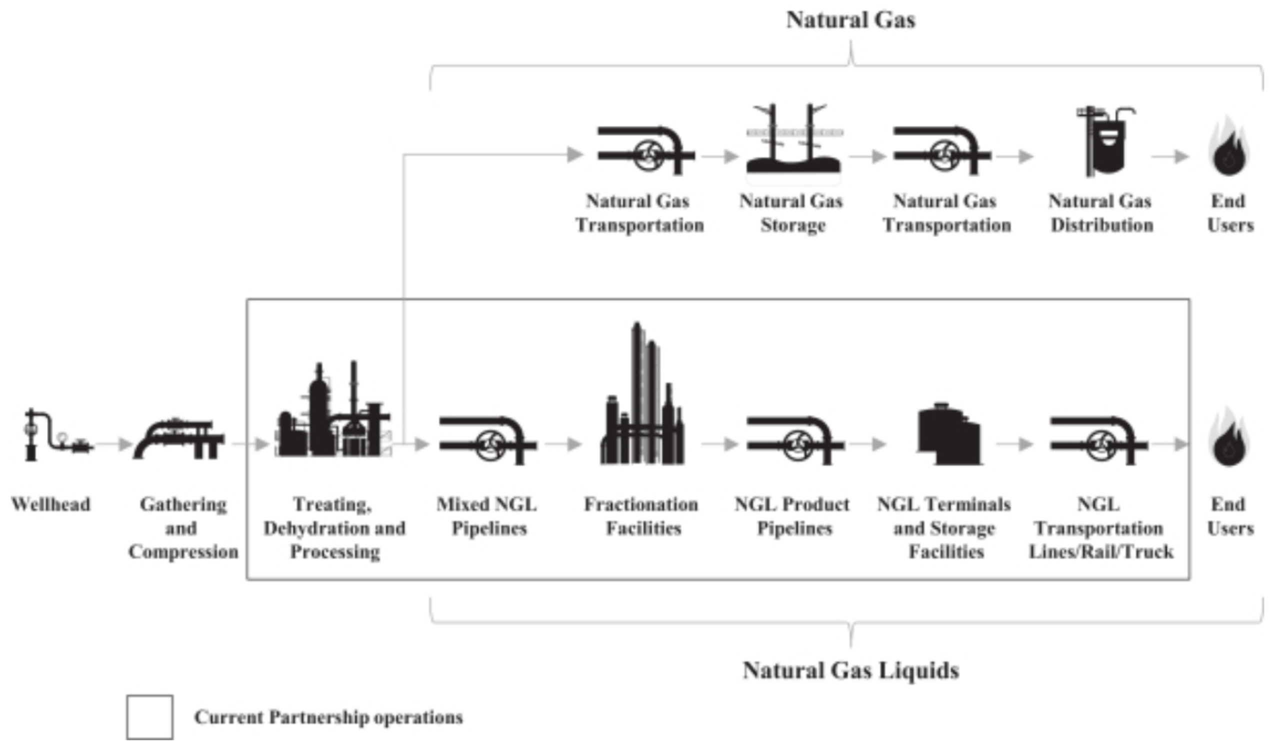
The company's primary services include

- Gathering
- Compression
- Treating/Dehydration
- Processing
- Fractionation
- Transmission

HESM sports a 500 MMcf/d **processing capacity**, including 400 MMcf/d at the Tioga Gas Plant and 100 MMcf/d (net) at the Little Missouri 4 plant. It also has ~325 MMcf/d of compression capacity.

That's the power of ~1,350 miles of natural gas pipelines.

Again, you can see below where HESM fits in the natural gas value chain.



What Makes Midstream (and HESM) A Good Business?

The midstream business is a lower-risk model because it sits between upstream drilling/discovery and downstream demand (from corporations and residential).

This insulates midstream operators from the usual commodity-based gyrations in cash flows and earnings.

HESM generates roughly all its revenues and cash flow from long-term fee-based services with MVCs.

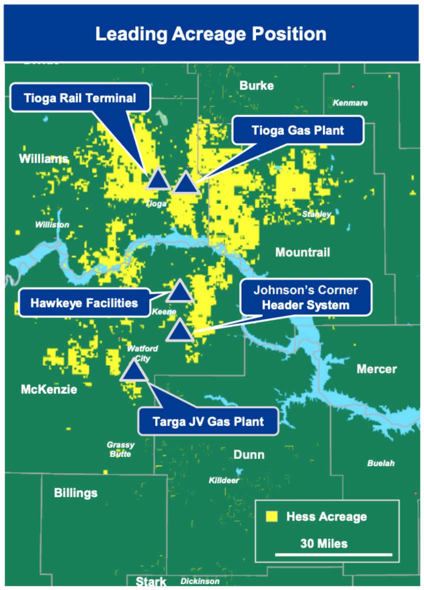
Finally, the company spends little in maintenance capex as most of its infrastructure/assets are already built. Remember, you only need to lay 1,000+ miles of pipe in the ground once.

Low maintenance capex allows companies like HESM to expand operating margins (which we'll see later) and generate incrementally higher FCF.

HESM boasts all of these great qualities *and more.*

For instance, its biggest customer, Hess, is one of the most prominent players in the Bakken region. This means HESM has first rights to all of Hess's future production growth before any other third-party midstream player.

Assessing HES's Financial Stability



HES is practically HESM's only customer. As such, it's critical that HES remains financially stable and can drill new wells over the next few years.

Currently, HES is in decent financial shape. The company sports an unassuming Net Debt to EBITDA ratio of 1.66x.

Additionally, Funds From Operations (FFO) cover interest payments 6x over.

In fact, HES added a third operating rig in September 2021, highlighting the company's strength and willingness to explore more of its 460K acre position in the Bakken.

Next, let's discuss HESM's current revenue and earnings and the potential durability of those future cash streams.

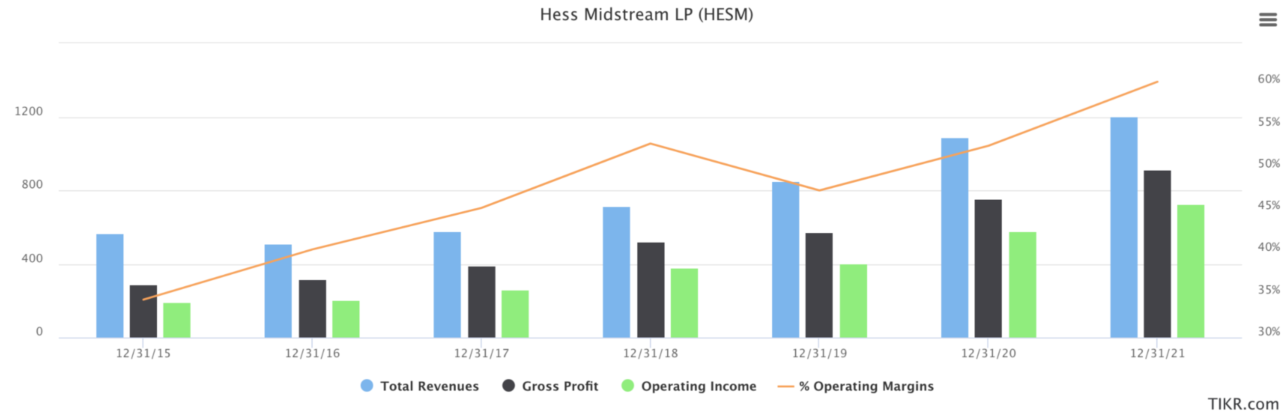
Does HESM Generate High-Quality Cash Flows?

HESM has demonstrated an ability to grow cash flows during multiple oil price corrections. For example, the company's grown EBITDA by a 22% CAGR since 2015 and should eclipse $1B in EBITDA this year.

It's important to note that HESM has grown since 2015 with an average rig count of ~4.35 per year and roughly 134Mboe/d production volumes.

Moreover, HESM has expanded EBITDA margins 900bps since 2017 (65% to 74%). In fact, the company's estimating further EBITDA margin expansion (to ~80%+) by 2026.

We're talking about high-quality cash flows here. Check out the graphic below.



Those revenues, cash flows, and margins *look* like an Enterprise SaaS company, not a midstream LP.

But that's all in the rearview mirror. What's ahead?

What About Future Cash Flows?

The last piece in our "high quality" puzzle is the durability of the above cash flows. Remember, HESM secures fee-based long-term contracts with MVCs. HESM's MVCs look great over the next three years giving us high visibility into sustained revenue and cash flow.

Agreement	2022	2023	2024
Gas Gathering (MMcf/d)	**363**	**317**	**351**
Oil Gathering (MBbl/d)	**117**	**100**	**100**
Gas Processing (MMcf/d)	**345**	**302**	**340**
Crude Terminaling (MBbl/d)	**145**	**113**	**114**
Water Gathering (MBbl/d)	**67**	**70**	**85**

What about after 2024? HESM sees three potential scenarios assuming different oil prices:

- ➢ **$40/barrel:** 27 rig years and 800 future locations
- ➢ **$50/barrel:** 53 rig years and 1,600 future locations
- ➢ **$60/barrel:** 70 rig years and 2,100 future locations

Even assuming a 50% decline in oil from here (which is possible, remember negative oil?), Hess still sees 27 rig years and 800 future locations to expand.

Given HESM's MVCs over the next few years, we can reasonably assume the company can generate at least **~$600M in annual free cash flow.**

Finally, HESM has the unilateral right to extend each commercial agreement for one additional 10-year term.

That means **HESM could potentially generate stable revenues and cash flow well into 2034.**

Valuing HESM's Future Cash Flows

HESM currently trades at a $1.3B market cap. The company will likely generate $600M in FCF per year over *at least* three years.

Unitholders will receive 90% of available FCF in quarterly distributions (~$540M) before any buybacks or special dividends.

By the end of year 3, HESM will have returned $1.62B (or 1.25x its current market cap) in cash back to unitholders.

So at the current price, you get all your money back in three years, keep your ownership in the LP, and enjoy future distributions/dividends/buybacks for free.

Speaking of buybacks, HESM bought back ~$750M in units last year. We believe they'll continue this pattern of lumpy buybacks into 2026.

Over the next few years, we can realistically estimate 8-10% revenue growth, 75%+ EBITDA margins, and 90% cash returned to owners. So how much would those future cash flows be worth to a private buyer?

Let's assume they'd pay 4-6x 2025 cash flows. That gets us to a $3B market cap ($70/share) or 133% higher than the current share price.

Concluding Thoughts

It's easy to find businesses trading at 2x cash flow in today's quantitative-driven world. The problem is most of them are just shitty Chinese EV scams.

HESM bucks that trend in an authentic way. Sure there are the obvious risks associated with an O&G company like

- Oil goes below $40 (or negative), reducing HES's ability to drill new wells
- Take-under offer from a private buyer at a lower-than-market price
- HES chooses to partner with another midstream player, which reduces HESM's revenues

However, you're paying 2x cash flow for the business. The above risks are already embedded in the stock price.

The company sports software-like margin profiles with 8-10% top-line growth. Like software businesses, most of HESM's revenues are locked in due to MVCs, providing strong look-through guidance over the next few years.

In sum, HESM is a reasonably low-risk opportunity to more than double your money in a few years just from cash distributions alone. A potential share re-rating (assuming a modest 5x multiple on 2025 FCF) to $70 would be icing on the cake.

Portfolio Updates

Buys

- **BUY** Breakout in Sugar Futures (SBK2022)
- **BUY** Breakout in Corn Futures (ZCM2022)
- **BUY** Second Leg position in Ethereum (ETHUSD)
- **BUY** Dollar Futures (DXM2022)

Sells

- **SHORT** Dax Futures (FDXM2022)
- **SOLD** Half Telefonica Brazil (VIV)
- **SOLD** Half Corteva (CTVA)
- **SOLD** Half Square, Inc. (SQ)
- **SOLD** Half Twitter (TWTR)
- **SOLD** Half Sprott Uranium (U.UN)
- **SOLD** Half Vista Energy (VIST)
- **SOLD** Full Nintendo (NTDOY)
- **SOLD** Full Ammo, Inc. (POWW)
- **SOLD** Full Bitcoin (BTCUSD)