

8-2018

EQM Investment Research Report

Kaitlyn Berg

Grand Valley State University, bergkai@mail.gvsu.edu

Follow this and additional works at: <https://scholarworks.gvsu.edu/honorsprojects>



Part of the [Finance and Financial Management Commons](#)

ScholarWorks Citation

Berg, Kaitlyn, "EQM Investment Research Report" (2018). *Honors Projects*. 698.
<https://scholarworks.gvsu.edu/honorsprojects/698>

This Open Access is brought to you for free and open access by the Undergraduate Research and Creative Practice at ScholarWorks@GVSU. It has been accepted for inclusion in Honors Projects by an authorized administrator of ScholarWorks@GVSU. For more information, please contact scholarworks@gvsu.edu.

Investment Rationale

We issue a buy recommendation for EQM with a target price of \$84.33 with an upside potential of 63%. The basis for the recommendation is based on the following factors:

- Over the past six months, EQM's price has declined due to the negative perception from a majority of the market based on substandard performance
- With fixed contracts, the expansion of the oil market, and further growth in programs through acquisitions, EQM is expected to grow at a larger rate than anticipated
- Since the start of 2018 the price has steadily declined offering an opportunity to purchase the company at a discounted price prior to growth
- EQM has the ability to generate sufficient cash flow and consistently reports strong cash flow trends
- The return on investment that the company generates through capital expenditures and acquisitions demonstrate a continuous pattern of strong growth

Update on Recent Results

On April 26th, EQM reported strong Q1 2018 earnings with a net income of \$177.2 million and an EBITDA of \$204.4 million. Revenue for the gathering sector was up 23% year over year due primarily to increased volume and capacity. Additionally, the transmission and storage side revenue was up 9%, driven by an increased contract capacity (*EQT Midstream Partners*).

In February of 2018, EQT announced plans to separate its upstream and midstream services in order to develop separate strategic organizations focused on one aspect of the service. The midstream operations will be separated into NewCo. Although there is not a direct impact on EQM, the new separation development further enforces EQT's dedication to driving individual value within the separate organizations.

Additionally, EQM, EQT, and RMP announced a streamlining transaction in which EQM will purchase EQT's midstream assets for \$1.15. The merger of EQM and RMP will allow EQM to further expand their gather services in multiple counties in Ohio. Finally, EQM announced a joint venture partnership between EQM and MVP Southgate. MVP Southgate is an interstate natural gas pipeline which will provide low-cost, reliable supply of natural gas in the Appalachian Basin to diversify EQM's pipeline services (*EQT Midstream Partners*).

Forward Guidance

EQM is set up to experience \$4.8 billion in organic growth due to the backlog from a variety of previously initiated projects, such as MVP Southgate, MVP JV, and the Hammerhead Pipeline. These contracts are authorized through fixed contracts which demonstrates a continuous revenue stream for the company. Specifically, EQM is pursuing organic growth opportunities within the Gulf Coast and the Southeast regions. EQM received a portion of EQT's midstream assets and Gulfport Energy's share of 25% ownership in Strike Force for \$1.69 million which will be completed in the second quarter. EQM maintained the future outlook for distribution growth of 15-20% annually (*EQT Midstream Partners*).

Recommendation: BUY

Industry: Energy

Sector: Oil & Gas

52 Week Range: 49.95-78.75

Average Volume: 599,709

Shares Outstanding: 86.48 B

EPS: 5.44

Market Capitalization: 4.49B

Dividend Yield: 3.62%

P/E: 10.01x

Beta: .91

Institutional Holdings: 68%

Insider Holdings: 32%

EQM Stock Price



Profit Margin: 50.56%

Operating Margin: 70.8%

ROE: 28.56%

ROA: 11.19%

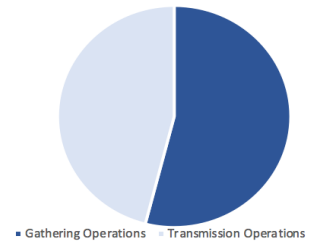
NGG16 - Natural Gas (NYMEX)



Business Description

EQM Midstream Partners is a growth focused limited partnership and provider of midstream services, focused on the expansion of strategic pipeline infrastructure in the Appalachian Basin. The limited partnership was formed by EQT in 2012. They offer natural gas gathering, transmission, and storage services through long term contracts with EQT, their parent company, and other third-party companies. Services are provided in Pennsylvania, West Virginia, and Ohio (*EQT Midstream Partners 10K*, 2018).

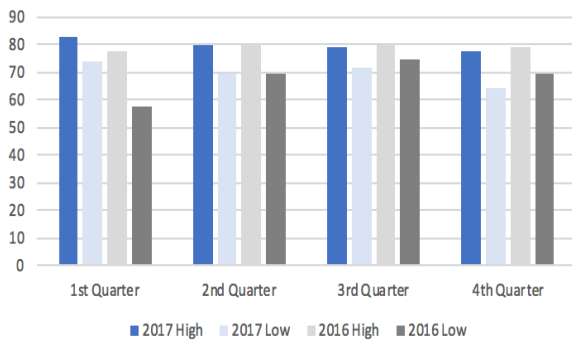
Revenue by Operation



Business Model

EQM acts as a provider of midstream services to third parties, with EQT accounting for 73% of the annual revenue. EQM derives around 91% of their revenue from long-term firm contracts, minimizing the exposure to risk from fluctuations in commodity prices. They provide two primary services, gathering which accounts for 54% of the revenue, and transmission which accounts for 46% of revenue. EQM does not have any employees and is managed solely by the directors and officers. EQM's daily operations are conducted by employees of EQT and their other subsidiaries (*EQT Midstream Partners 10K*, 2018).

Unit Price Range by Quarter



Competitive Strategy

EQM emphasizes the importance of organic growth through the expansion of current contracts and increasing the breadth of the delivery markets and operations. They are targeting geographically favorable industrial facilities and electric generation plants to expand into new markets with the rise in natural gas consumption. Additionally, EQM developed significant growth through acquisitions. With the large dependency on infrastructure for the industry, EQM maintains a competitive advantage in their three primary areas of operation. By placing significant level of emphasis on the relationship with third party customers, the company sees continuous growth and demand for expansion through stable fixed-fee contracts while minimizing exposure to commodity price risk (*EQT Midstream Partners 10K*, 2018).

Management Overview

Management Team

As a limited partnership, the NYSE does not require independent directors so the managers of EQT General Partnership Holdings (EQGP) currently manage EQM as well. The manager of EQGP are employees of EQT as well. Jerry Ashcroft currently serves as the president and CEO of EQM and EQGP since March 2018. Overall, EQM has a newer management team with the majority of the board appointed within the past five years, however, they have prior experience in other roles within the company (*EQT Midstream Partners*).

Shareholders

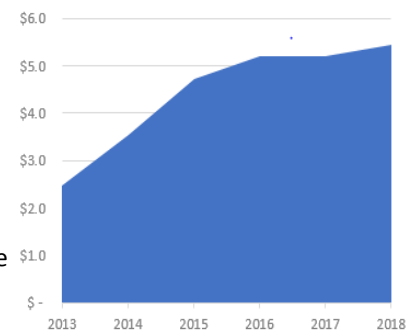
EQM has a large base of institutional ownership accounting for 72% of holders, with 28% of shares held by insiders (*EQT Midstream Partners 10K*, 2018).

Investment Thesis

Upside Potential

EQM's price has declined over the past few months due to investor's perception of substandard performance. However, EQM is expected to have an annual distribution growth of 15-20% for several upcoming years, demonstrating not just the expansion through organic growth within the company, but also the strength of the financials (Morris, 2018). EQM has the ability to generate sufficient cash flow and the return on investment. The capital expenditures and aggressive acquisition strategy demonstrate a continuous pattern of strong growth.

EPS Trend



Valuation

Target Price

The target price of \$84.33 is based on the EV/EBITDA, EV/Revenue, P/E, and P/CF multiples derived from peer competitors and a DCF model. Given EQM's consistent cash flow pattern, solid margins, EBITDA growth, and organic growth opportunities, the target price is an in-depth representation of the potential value. The multiple approach resulted in an intrinsic value of \$80.35. A Discounted Cash Flow analysis based on a WACC of 5.9% and a Long-Term Growth Rate of .84% derived an intrinsic share price of \$88.30.

Forecasting

Projected revenue for 2019 and 2020 are: \$949.9 million and \$1,015 million. The 2-year projections were based on annual growth rates of 9.58% and 6.58% derived from the average growth rate in revenue over the past three years. The 2-year outlook is higher than the previous guidance and analysis consensus, due to the undervalued potential for organic growth and strong cash flow stream.

Financial Analysis

Profitability

- The profitability of EQM have remained consistent over the past five years with increasing revenue and earnings per share, as one of the margin leaders in the industry
- EQM has strong revenue and gross margins in comparison to their peers and demonstrates a strong year over year revenue growth rate

Liquidity

- EQM has a relatively low quick and current ratio in comparison to peers in the industry, however, this most likely won't pose a significant problem since the industry in general tends to have lower liquidity ratios

Solvency

- Within a capital-intensive industry, high levels of debt can significantly influence the competitiveness of a company
- Overall, the EQM presents a slightly higher debt to equity ratio than prior years at 59.22%, but maintains a high coverage ratio of 13.4x representing the strength of the balance sheet among increasing debt levels
- Even though the short-term ability to meet financial liabilities is on the lower side, the company has strong long-term ratios demonstrating their ability to meet their liabilities

Capital Expenditure

- Capital expenditure industry wide is significant due to the need to purchase assets and high exploring costs
- EQM's capital expenditure as a percentage of revenue has fallen significantly over the past two years, however, with the new acquisitions and partnerships the company still maintains opportunities for expansion
- EQM maintains a strong EBIT/Interest ratio demonstrating their ability to cover their long-term liabilities

Ratios Analysis

EQM has strong ROE, ROA, and ROIC ratios, however, they display a downward trend over the past five years. In comparison to peer companies, EQM consistently ranks at the top with all three ratios.

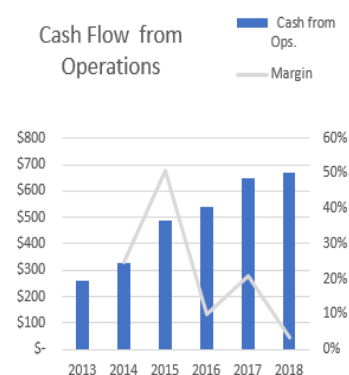
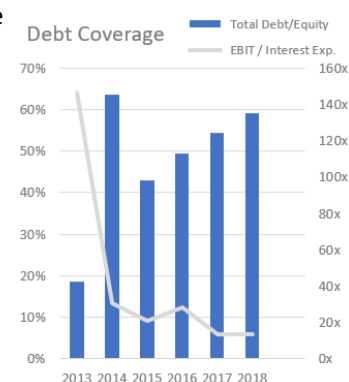
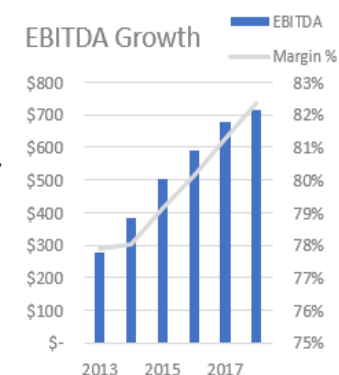
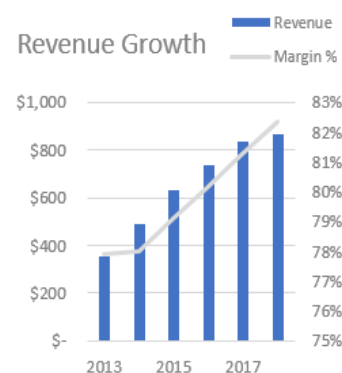
Cash Flow Patterns

EQM has consistently increased their cash flow from operations over the past five years, with consistently negative cash flow from investing and cash flow from financing. The general trends demonstrate that EQM is investing in growth for the company and returning money to shareholders.

Valuation Model

The target price is based on a combination of two models:

- **Discounted Cash Flow:** The DCF analysis resulted in an intrinsic stock price of \$84.33



- **Assumptions:**

- **Discount rate:** The CAPM model was used to calculate the cost of equity and resulted in a WACC of 5.9%
- **Terminal Value:** A long term growth rate of .84% was used
- **Market Multiple:** Based on the EV/EBITDA, EV/Revenue, P/E, and P/FCF multiples, EQM is fairly to undervalued in comparison to the median multiple of peer competitors.
- **Current Price:** At a current price of \$51.41, EQM is fairly valued to slightly undervalued compared to competitors within the industry and the intrinsic value of the stock based on the DCF analysis.

Free-Cash-Flow Model

FCF	\$	696	Million
Growth rate		0.8%	
ST-Investments	\$	685	
Total debt	\$	1,305	
Preferred stock	\$	-	
WACC		5.9%	
# shares outstanding		120	
V_{op}		13,963	
V_{total}		14,648	
Intrinsic equity		13,343	

Growth Drivers

The key growth driver for EQM is the expansion through acquisitions and joint partnerships leading to a broader revenue stream from fixed contracts and expansion of existing and third-party assets. EQM is expected to see significant organic growth due to their competitive advantage from the strategic location of their assets. Post initial public offering of EQM and EQGP, EQT announced the acquisition of Rice Energy in February 2017, adding significant strength to the three individual businesses. EQM demonstrates significant opportunities for organic growth, reinvestment of cash flows, and the consistent return of profits to shareholders (*EQT Midstream Partners 10K*, 2018).

	EV/Rev		EV/EBITDA		P/E		P/FCF
	2017	2018	2017	2018	2017	2018	2018
Max	11.2x	13.9x	20.5x	16.9x	37.0x	26.2x	0.2x
Median	7.8x	8.6x	11.3x	14.3x	25.1x	20.4x	-0.3x
Minimum	4.7x	5.2x	10.6x	12.0x	20.7x	16.9x	-0.5x
Average	7.9x	9.1x	13.4x	14.4x	27.0x	21.0x	-0.2x
EQM	8.5x	9.2x	10.4x	10.8x	14.1x	10.9x	0.1x

Catalysts

- Continuous strong earnings releases' in July 2018
- Implementation of MVP Southgate project
- Further growth with the implementation of the division of sectors with NewCo

Investment Risk Factors

Operational Risk:

- Large dependency on EQT for future revenue & growth
- In 2017, 73% revenue was driven by EQT
- Volatility in natural gas or lower commodity prices will have an adverse effect on EQM's drilling operations
- Changes in EQM's ability to borrow funds

Technology Risks

- Cyber security threats

Competition Risks

- Changes in rates and competition levels in the natural gas transmission & storage sector
- Alterations in customer commitment level will potentially pose a potential threat, but the long-term contract deals hedge against this potential risk
- The loss of third party revenue
- Expansion in the alternative fuel market

Government Risks

- Changes to stringent government regulations and tariffs by FERC
- Environmental regulation changes

	EV/Revenue	EV/EBITDA
EV	7476.5	11477.5
Debt	3019.5	3019.5
Shares Outstar	122.4	122.4
Equity Value	4456.9	8458.0
Price	\$ 36.40	\$ 69.08

	P/E
EPS	\$ 5.61
Price	\$ 117.74

	P/FCF
FCF	604.2
Price	\$ 98.19
Average Price	\$ 80.35

EQM Financial Statements

Income Statement	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	2019E	2020E
Total Revenue	354.0	489.2	632.9	735.6	834.1	866.9	949.9	1,015.0
Cost Of Goods Sold	42.7	56.4	70.1	73.2	84.7	86.1	94.3	100.8
SG & A	35.6	51.1	61.9	72.8	71.2	66.9	87.51	93.5
Depreciation	30.9	49.1	49.9	62.7	97.5	100.1	-	-
EBIT	244.8	332.6	451.0	526.9	580.7	613.7	768.1	820.7
Interest Expense	1.7	10.9	21.3	8.5	36.2	39.1	5.48	5.8
Unusual Items	85.0	68.9	66.5	2.2	(5.2)	(4.6)	75.56	80.7
EBT	158.1	252.8	363.3	516.3	549.7	579.2	687.0	734.1
Taxes	54.6	40.2	(16.7)	10.1	0	0	-	-
Tax Rate	34.51%	15.91%	-4.60%	1.97%	0.00%	0.00%	0.00%	0.00%
Net Income	103.6	212.6	380.0	506.1	549.7	579.2	687.0	734.1
Dividends	96.0	110.4	178.7	241.4	294.5	308.6	294.5	294.5
Add. To Retained Earnings	7.6	102.2	201.3	264.7	255.2	270.6	392.5	439.6

Balance Sheet	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	2019E	2020E
Assets								
Cash & ST Investments	18.4	126.2	361.0	64.4	6.6	9.0	9.0	9.0
A/R	32.1	71.6	99.2	104.8	137.3	121.1	132.74	141.8
Deferred Income Taxes	0.5	0.8	-	-	-	-	-	-
Other Current Assets	0.5	0.9	1.3	2.9	3.5	17.2	18.9	20.2
Current Assets	51.5	199.4	461.5	172.1	147.3	147.3	160.6	171.0
Net PPE	994.9	1,605.3	2,097.7	2,578.8	2,804.1	2,864.0	3,165.89	3,382.9
Long Term Investments	-	-	201.3	184.6	460.5	546.4	503.5	503.5
Other Non-Current Assets	17.6	18.1	274.2	324.9	597.4	681.9	639.67	639.7
Total Assets	1,064.0	1,822.8	2,833.4	3,075.8	3,548.8	3,693.3	4,469.6	4,697.0
Liabilities								
A/P	8.6	43.8	42.6	35.8	47.0	48.2	52.8	56.4
ST Borrowing	-	-	299.0	-	-	-	-	-
Accrued Expenses	2.4	11.6	15.6	20.7	27.8	26.5	32.0	33.7
Other Current Liabilities	146.8	39.1	47.6	30.5	137.4	89.6	98.1	104.9
Current Liabilities	157.9	94.5	404.8	87.0	212.2	164.2	183.0	195.0
Deferred Tax Liab	39.8	78.6	84.1	-	10.5	-	5.2	5.2
Long Term Debt	-	492.6	493.4	985.7	1,167.4	1,304.8	1,236.1	1,236.1
Other LT Liabilities	139.7	150.9	7.8	9.6	9.8	20.9	359.2	437.9
Total Liabilities	337.5	816.7	990.1	1,082.3	1,399.9	1,489.9	1,783.5	1,874.2
Equity								
Common Stock	724.8	1,033.6	1,874.2	2,008.5	2,147.7	2,198.1	2,198.1	2,198.1
Total Equity	724.8	1,033.6	1,874.2	2,008.5	2,147.7	2,198.1	2,682.6	2,819.1
Total Liab. & Equity	1,062.2	1,850.3	2,864.3	3,090.8	3,547.6	3,688.0	4,466.0	4,693.3
# Shares Outstanding	47.8	60.7	77.5	80.6	80.6	80.6	80.6	80.6

	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	2019E	2020E
Unlevered FCFE	-	(43.5)	(166.3)	(10.9)	49.7	318.0	604.2	605.3
EBIT	-	332.6	451.0	526.9	580.7	613.7	768.1	820.7
Tax	0.00%	15.91%	-4.60%	1.97%	0.00%	0.00%	0.00%	0.00%
Depreciation & Amortiz	-	30.9	49.1	49.9	62.7	97.5	-	-
Change in NWC	-	(2.2)	229.1	(7.4)	292.1	70.5	(138.0)	(1.6)
Capital Expenditure	-	356.2	458.1	584.8	301.6	322.7	301.8	217.0

Competitor Valuation & Analysis

	Competitor Analysis							EV/Rev		EV/EBITDA		P/E		P/FCF
	EQM	AM	EQGP	PSXP	WES	EQT		2017	2018	2017	2018	2017	2018	2018
TAT	0.25x	.3x	.3x	.2x	.3x	.2x	Max Median Minimum Average EQM	11.2x	13.9x	20.5x	16.9x	37.0x	26.2x	0.2x
ROE	28.6%	22.6%	28.4%	27.8%	15.8%	1.2%		7.8x	8.6x	11.3x	14.3x	25.1x	20.4x	-0.3x
ROA	11.2%	8.6%	11.1%	5.4%	4.9%	4.1%		4.7x	5.2x	10.6x	12.0x	20.7x	16.9x	-0.5x
ROIC	15.6%	21.0%	21.0%	8.0%	9.0%	0.0%		7.9x	9.1x	13.4x	14.4x	27.0x	21.0x	-0.2x
ART	7.73x	8.9x	7.7x	11.9x	12.3x	7.6x								
Quick	0.79x	1.5x	.8x	1.4x	1.5x	.8x								
EBIT/I	13.37x	9.8x	13.3x	3.9x	4.4x	6.2x								
D/E	59.2%	84.6%	59.2%	131.9%	107.8%	44.2%								
Gross Margin	90.1%	69.5%	90.1%	64.5%	48.0%	74.7%		8.5x	9.2x	10.4x	10.8x	14.1x	10.9x	0.1x

	Relative Valuation										
	Equity Value		Enterprise Value		EV/Revenue		EV/EBITDA		P/E		P/FCF
	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018	2018
AM	5,429	4,842	5,429	6,988	7.0x	8.4x	11.3x	12.4x	22.7x	19.0x	-0.1x
EQGP	7,160	6,143	7,160	12,021	8.6x	13.9x	10.6x	16.9x	27.4x	21.8x	0.2x
PSXP	6,364	5,818	10,469	8,420	11.2x	8.7x	20.5x	16.1x	20.7x	16.9x	-0.4x
WES	7,339	6,511	10,484	11,362	4.7x	5.2x	11.3x	12.0x	37.0x	26.2x	-0.5x

EQM Ratio Analysis

	Company Analysis					
	2013	2014	2015	2016	2017	2018
Revenue	354.0	489.2	632.9	735.6	834.1	866.9
Diluted EPS	\$2.46	\$3.52	\$4.70	\$5.21	\$5.19	\$5.44
Gross Profit	311.3	432.8	562.8	662.4	749.4	780.8
Operating Profit	244.8	332.6	451.0	526.9	580.7	613.7
ROA	16.8%	14.4%	12.1%	11.1%	11.0%	11.2%
ROE	14.8%	24.5%	26.8%	26.9%	27.6%	28.6%
Div Payout Ratio	95.4%	56.0%	54.5%	58.4%	70.4%	70.4%
D/E	18.6%	63.6%	43.0%	49.4%	54.3%	59.2%
TIE	146.4x	30.6x	21.1x	28.5x	13.5x	13.4x
EBITDA	275.7	381.7	500.9	589.6	678.2	740.6
EBITDA Margin	77.9%	78.0%	79.1%	80.2%	81.3%	85.4%
EV/EBITDA	10.61x	15.41x	12.60x	12.07x	10.40x	10.80x
EV/Revenue	8.26x	12.02x	9.97x	9.67x	8.45x	9.24x

DCF Model

Discounted Cash Flow Method						Capital Asset Pricing Model	
Perpetuity G rate	0.84%					Beta	0.91
WACC	5.87%					Risk-free rate	2.9%
						Market Risk Prem	3.8%
						Cost of equity	6.3%
Year		FCFF		Terminal Value	Total	PV	
0	2018	318	-	318	-		
1	2019	604	-	604	571	Market Value	\$ 7,110
2	2020	605	12,138	12,744	11,369		
				Firm Value	11,940	Cost of Debt	3.3%
				Debt Value	1,305	After-Tax	
				Equity Value	10,635	Cost of Debt	3.3%
				Intrinsic			
				Value per Share	\$ 88.30		