Williams Companies, Inc.

On a More Sustainable Path with Attractive Dividend Yield

Key Takeaways:

- Between 2015-17, the company took several steps to shore up balance sheet, invest in accretive cash flow generative projects
- With balance sheet repaired, the company is well position to grow its cash flows and dividend
- Reasonably attractive dividend yield of 6.1%

Introduction:

After a difficult period involving financial and operational reorganization, the company has emerged financially stronger and set to grow its dividend. This article provides a background on the company, analyzes its recent past, dividend potential and finally concludes with our opinion on whether the company makes for a good income oriented investment.

Overview

Williams Companies Inc. is engaged in energy infrastructure business, primarily in the US. It owns and operates interstate natural gas pipelines and undertakes operations such as compression, processing, transmission. The Company's assets handle close to 30% of US' Natural Gas. It operates through three major reportable business segments:

Segment Name	Segment Description	% of Segment EBITDA
Northeast G&P	In this segment, the company undertakes natural gas gathering, compression, and processing, NGL fractionation in the north eastern part of US including Pennsylvania, West Virginia, New York, and Ohio.	23.5%
Atlantic Gulf	In this segment, the company carries out operations in the Gulf coast states by handling interstate natural gas pipelines along with various petrochemical and feedstock pipelines. It also undertakes crude oil transportation and production handling, NGL fractionation and gathering, processing etc. of natural gas.	41.6%
West	In this segment, the company operates a natural gas pipeline extending from New Mexico to Washington, covering western states like Colorado, Utah, Wyoming, Idaho, etc. Additionally, it is also engaged in natural gas gathering, processing, NGL fractionation and NGL, and natural gas marketing.	34.0%

Source: Williams Companies, Inc.

Stable cash flows driven by fee only contracts and minimal direct commodity price exposure

Close to 98% of the company's gross profit is driven by fee based revenue that is in turn tied to volumes rather than prices of commodities. It is then not surprising that despite oil and gas prices declining significantly during 2015, the company's EBITDA has actually increased over the last 4 years as gas demand in the US continues to inch higher requiring more transportation and gathering assets in the gas ecosystem.

"I would tell you there is lot of different definitions of fee-based in the space and we are talking about fee-based, we're talking about long-term contracts that we get paid a fee, a fixed fee to do it is not a matter of what's buying and selling commodities until we have long-term contracts in place where fixed fee or fee within inflators."

- *Alan Armstrong, CEO, The Williams Companies*

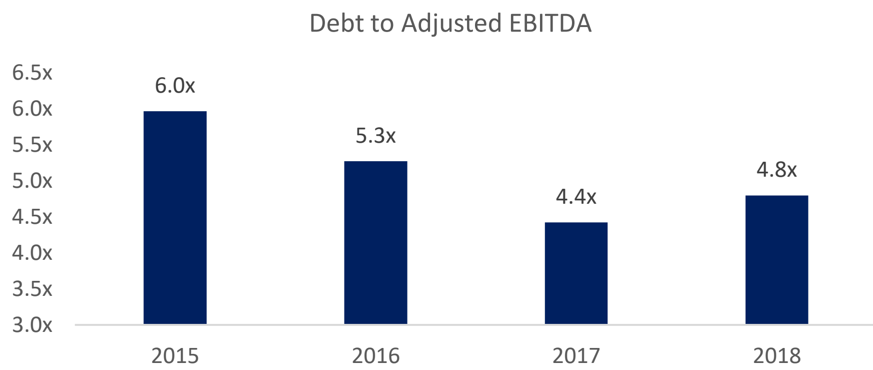
Revisiting a tumultuous period: 2015-16

The company would like to forget about 2015 but as investors it is important to recap what happened during the year as it explains the strategy over the last few years. After oil prices dropped from over $100 per barrel to mid-50s, WMB announced a merger agreement with its MLP called Williams Partners, LP to better position the two entities to raise capital in a difficult time for oil & gas companies. Energy Transfer, LP around the same time made an unsolicited bid to acquire WMB for $64 per share. ET's offer was contingent on cancellation of WMB's merger with its MLP. In June 2015, WMB rejected ET's offer claiming it to be inadequate. However, by September 2015, not only did WMB agree to the buyout by ET, it did so at $43.5, 32% lower than the initial offer possibly due to continued weakness in the oil and gas. Additionally, the company also cancelled its already announced merger with its MLP. In a tragic turn of events, in June 2016, ET backed away from the deal citing lack of clarity on certain tax issues. At the end, not only the deal with ET fell through, it also failed to merge with its MLP. Soon after that, six of the company's board of directors resigned after failing in their bid to get rid of the CEO. An activist driven proxy fight ensued which eventually led to a board rejig however CEO Alan Armstrong continues in his position till date.

Focus on getting its house in order: 2016-18

After the difficult two year period, the company focused on improving its balance sheet and growth prospects as a standalone, publicly listed company. It made the difficult decision to cut its quarterly dividend by 69% from $0.64 per share to $0.20 per share in 2017. The dividend cut was made primarily to invest in growth projects at its MLP, shore up the balance sheet and maintain a more sustainable dividend coverage ratio which was just under 1 in 2015. The dividend cut saved the company nearly $1.3 billion of much needed capital.

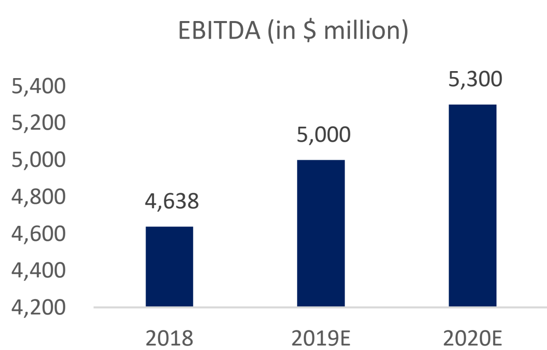
Additionally, the company put in place a process to get rid of non-core assets and generated roughly $4.4 billion in added cash flow between 2015-18. Despite asset sales, company's adjusted EBITDA increased 13% during the same period. As a result of the increased EBITDA, reduced net debt, the company's debt to EBITDA declined from 6x to 4.8x. In fact, the company's debt was upgraded to Baa3 in August 2018 after it was downgraded to junk status in January 2016. Additionally, the company finally acquired its MLP, Williams Partners in 2018 to improve the ability of the companies to raise capital and plan for the future.

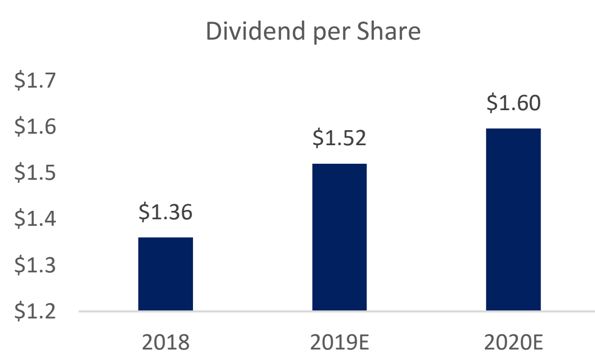


Source: Williams Companies, Inc.

Company is set to experience EBITDA and dividend growth as well as continued improvement in balance sheet

As a result of improving balance sheet and cash flow generation, the company resumed dividend growth in 2018. The company is targeting EBITDA growth of 5-7% annually over the medium to long term. Given adequate dividend coverage of around 1.7x, EBITDA growth should translate into higher dividends as well. Additionally, the above EBITDA growth will require around $2.5 billion of annual growth capex which can be funded by a mix of internal accruals and debt without raising overall leverage ratios due to increased earnings capacity.

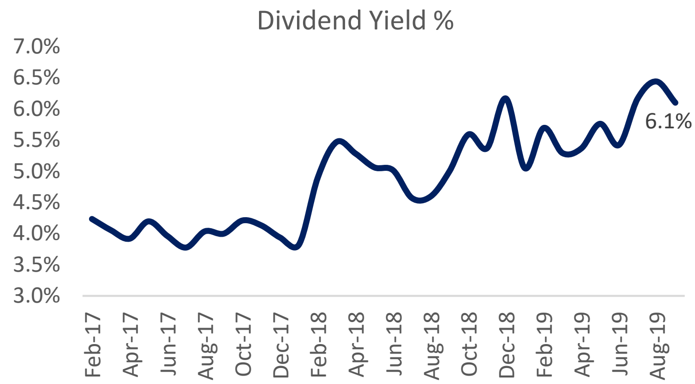




Source: Williams Companies, Inc and Blue Harbinger Research

Valuation getting more attractive despite improvements in the business

Curiously, the company's dividend yield has gone up from around 4% in 2017 to over 6% despite improvement in balance sheet and resumption of growth in dividends. Lower valuation is primarily on account of investor sentiment souring over the years due to commodity price volatility and that has opened up opportunities for income oriented investors even in areas of the sector that are much less volatile than the sector average.



Source: Yahoo Finance

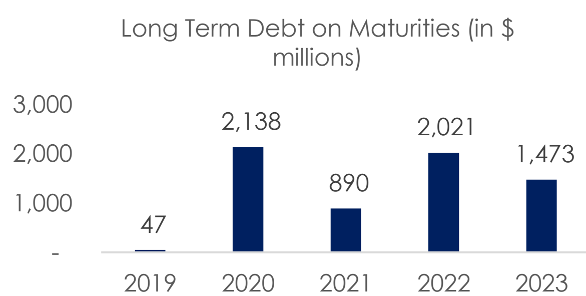
Risks

Lower oil and gas prices could impact long term dynamics

Even though oil and gas price swings in the near to medium term do not have a significant impact on WMB's cash flows, longer term sustained dislocation in the oil and gas market can have significant impact on demand for the company's gas gathering and transportation assets. If oil and gas prices stay at uneconomical price levels for a prolonged period, gas producers may cut down production which naturally reduces the need for distribution capacity. Having said that, in such a draconian scenario, demand and supply rebalancing should lead to increase in oil and gas prices and restoration of industry economics after the initial pain.

Freezing up of debt markets in event of a slowdown could have a negative impact

Despite an improved balance sheet, the company will need to continually tap the credit markets to refinance its debt. As can be seen in the chart, the company has on average over $1.5 billion of debt maturing per year. Given the growth capital needs as well as guidance of dividend growth, the company's maturing debt needs to be refinanced which will necessitate well-functioning credit markets.



Source: Yahoo Finance

Conclusion

The company has reengineered its business over the last few years to put itself on a more sustainable path. Going forward, the company is well positioned to grow its EBITDA, cash flows and dividend while maintaining its credit metrics. The company's dividend yield at 6.1% provides investors with an attractive, growing income source.