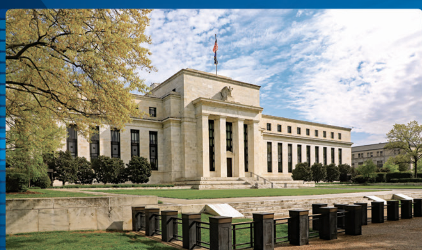
Chickasaw Capital Management

WHITE PAPER SERIES

You Say Inflation, I Say Midstream

OCTOBER 2021



Investors can see and feel the current inflationary pressures without needing to search too far. While there is plenty of debating as to how sticky or transitory this bout with inflation could be, we will succinctly say our work indicates go-forward inflation may be more pronounced than markets have experienced for quite some time. As it relates to Midstream, we regularly hear the broad question, *'How do you think about inflation within the Midstream asset class?'* Thankfully, we believe Midstream has proven itself as a natural inflation hedge. And, it appears as though this is still a little-known feature, as the Midstream space is still trading at attractive valuations.

We reminded our investors about the effects of inflation in our 2Q21 newsletter, Midstream Update: The Story is Only Beginning, for which we suggest a quick look back to page 5.

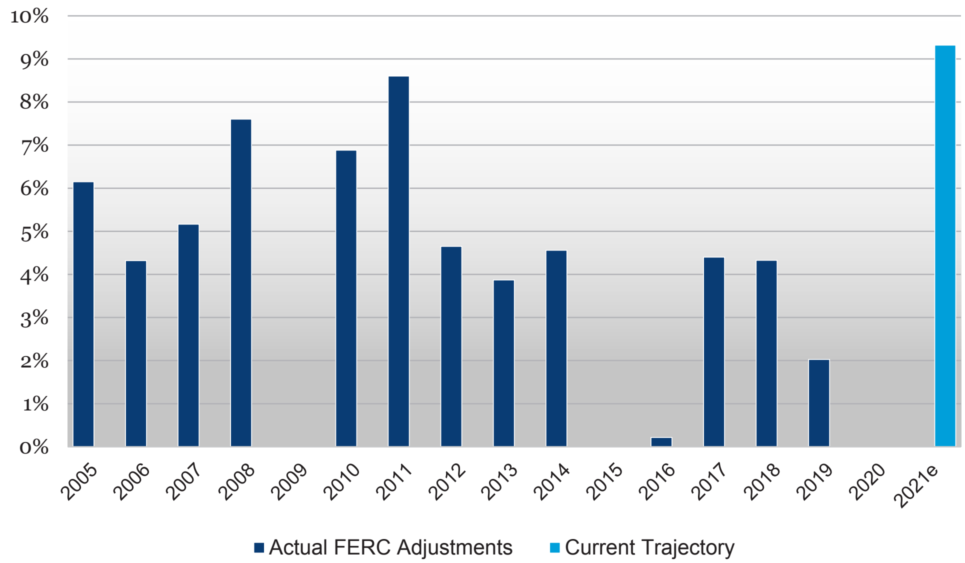
Let's Discuss Contracts

Investors allocated to Midstream naturally benefit from certain features during inflationary time periods. Fundamentally speaking, Midstream benefits from:

- **Real Assets/Hard Assets:** Midstream owns contracted, hard assets that should increase in value alongside increasing replacement costs and increasing scarcity.
- **Inflation Indexed Contracts:** Contract structures typically carry inflation escalators tied to either the Producer Price Index (PPI) or the Consumer Price Index (CPI).
- **Commodity Price Sensitivity:** Although we estimate ~90% of Midstream cash flows are fee-based and contracted, the remaining 10% sensitivity to commodity price and/or volumes ought to help during periods of rising commodity prices.

As an example, referring to the second bullet point, and updating the numbers used in the 2Q21 newsletter, refined products pipeline regulated rates increase at the producer price finished goods index (PPI-FG) plus 0.78%. Using the methodology described in the newsletter for carrying forward the September month-end PPI-FG index level of 227 through the end of 2021, we estimate PPI-FG would end 2021 at 8.5%, which would result in a rate increase of 9.3%. Many of the companies within the Midstream asset class should benefit from this increase in the PPI-FG Index, which we expect to show up during a rate reset in July 2022.

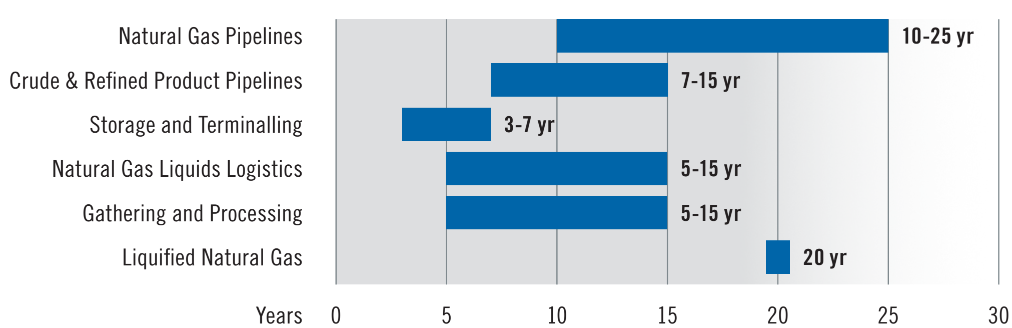
Exhibit 1: FERC Tariff Adjustments



Source: FERC, CCM as of 9/30/2021

Longer-dated contract tenures and built-in fee escalation help to ensure Midstream operators have reliable multi-year cash flows to underpin their asset footprints without subjecting the space to long-term inflationary pressures. And, to potentially state the obvious, if/when inflation abates the rate increases should remain "sticky" over the remaining contract life.

Exhibit 2: Contract Length by Subgroup



Source: Companies' information, CCM as of 9/30/2021

Historical Out-Performance

The business fundamentals of Midstream help to protect investors against the harm of inflation, and we correspondingly find that Midstream, measured using the Alerian MLP TR Index (AMZX), has typically performed well during inflationary environments. We have examined the two time periods over the last 20 years where inflation expectations have crested above 2% for a sustained, multi-year period. The performance of the AMZX during the two sustained inflationary time periods and the current inflationary regime is compared to that of the S&P 500 Total Return Index (SPX) below:

Time Period	AMZX Period Return	AMZX Avg. Daily Return	AMZX Excess Return Over SPX	Avg. Exp. Inflation
12/31/20 – 9/30/21	39.4%	0.21%	+23.26%	2.29%
10/30/09 – 8/29/14	184.7%	0.15%	+69.83%	2.22%
7/31/03 – 8/29/08	92.7%	0.07%	+56.13%	2.41%

Source: Bloomberg LP, CCM as of 9/30/2021

When looking at Midstream performance over the last 20 years, we find the AMZX has an average daily return of +0.04%. During periods of sustained inflation expectations above 2%, the AMZX's average daily return climbs an additional 10 bps to +0.14% per day. However, excluding the periods of sustained higher inflation expectations, the average daily return of the AMZX falls 5 bps to -0.01% per day. Moreover, compared to the broad-market S&P 500 Total Return Index, Midstream has handily outperformed during these sustained periods of inflation.

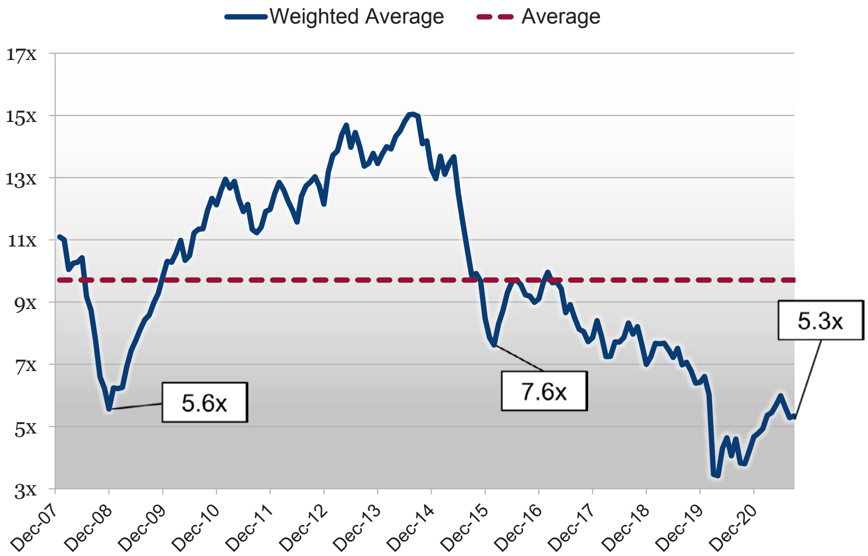
AMZX Avg. Daily Performance	
20-Year Avg.	0.04%
Inflationary Avg.	0.14%
Non-Inflationary Avg.	-0.01%

Source: Bloomberg LP, CCM as of 9/30/2021

Risks

The benefits of allocating to Midstream in inflationary environments should be clear. While there are always risks associated with an investment, we believe the risks are well-contained for Midstream investors. As an example, there is the possibility that the Federal Energy Regulatory Commission (FERC) changes its rate-making framework. However, this would involve several steps, input from all interested parties, and a lengthy hearing process before any changes could potentially be made. There is also a potential that construction materials experience inflationary price increases and erode returns for newly built assets. We also believe this risk is muted, given Midstream companies are often able to pass costs on to their clients, and capital expenditures are projected to remain low for the foreseeable future. Similarly, we find the debt of Midstream companies continues to be priced at attractive spreads to commensurate maturity Treasuries, implying financing risks also appear to be at bay. Lastly, there is the risk that inflation is more transitory than we expect; although, our work indicates otherwise and the chant from the 'sticky' inflation camp seems to grow stronger by the day. Whether any of these risks materialize, or not, the Midstream asset class is trading at historically-low valuations with historically-high free cash flow yields, both of which are attractive in their own right and should help insulate investors against the risks we have identified.

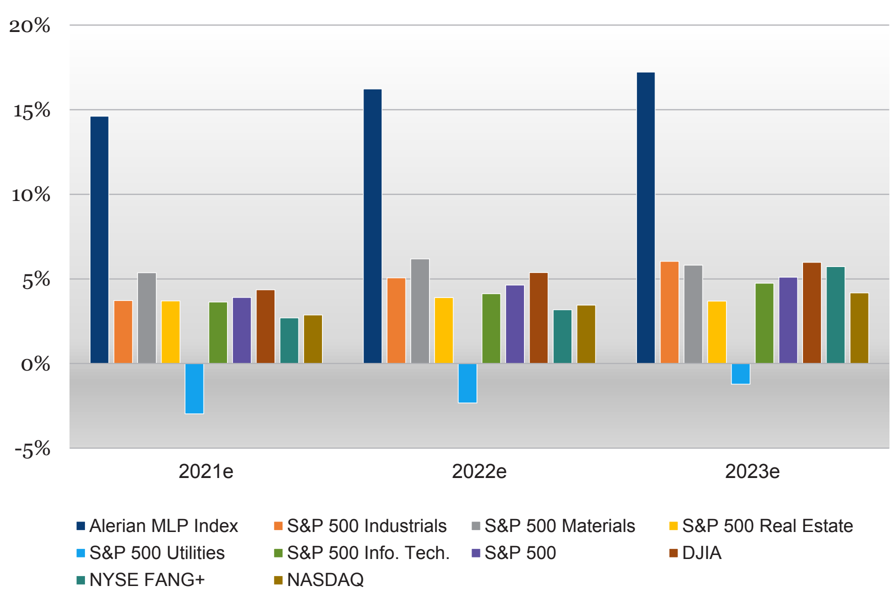
Exhibit 3: Alerian Weighted P/DCF



Average = 9.7x | Current = 5.3x | Minimum = 3.4x

Source: Bloomberg LP, CCM as of 9/30/2021

Exhibit 4: Estimated Free Cash Flow Yield



Source: Bloomberg, LP. at 9/30/2021. Using Bloomberg definition of Free Cash Flow to Equity of cash flow from operations (CFFO) less capex. BPMP has no consensus estimate; therefore we use CCM's estimate.

Conclusion

Inflation is here, whether policy-makers are willing to acknowledge it, or not. It could easily be argued policy-makers have helped to fuel the inflation we all see and feel. With some forecasting a prolonged battle with inflation, we believe Midstream is uniquely positioned with natural inflationary hedges, a track record of outperformance during inflationary environments, and, as of the end of September, the Midstream asset class was still trading at a relative valuation multiple beneath the low from 4Q08 with a free cash flow yield north of 15% for 2022. These represent powerful potential drivers for the asset class in our opinion.

Please reach out to your Chickasaw representative with any questions, or if you would like to set up a phone call with a member of the Investment Team.

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S&P 500 Total Return Index: Tracks the total return of the S&P 500 Index, an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. Dividends are reinvested. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

S&P 500 Industrials Index: The S&P 500® Industrials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® industrials sector.

S&P 500 Materials Index: The S&P 500® Materials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® materials sector.

S&P 500 Real Estate Index: The S&P 500® Real Estate Index comprises those companies included in the S&P 500 that are classified as members of the GICS® real estate sector.

S&P 500 Utilities Index: The S&P 500® Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

S&P 500 Information Technology Index: The S&P 500® Information Technology Index comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

DJIA Total Return Index: Tracks the total return of The Dow Jones Industrial Average, a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. Dividends are reinvested. The DJIA was invented by Charles Dow back in 1896.

NYSE FANG+ Index: The NYSE FANG+ Index is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded growth stocks of technology and tech-enabled companies such as Facebook, Apple, Amazon, Netflix, and Alphabet's Google.

NASDAQ: A market-capitalization weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks. The index includes all Nasdaq listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debentures.

CPI (Consumer Price Index) is a measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rates represent the inflation rate.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures.

Growth Capital Expenditures or Growth CapEx or GCX refers to the aggregate of all capital expenditures undertake to further growth prospects and/or expand operations and excludes any maintenance and regulatory capital expenditures.

PPI (Producer Price Index) is a measure of the change in the price of goods as they leave their place of production.

Yield refers to the cash dividend or distribution divided by the share or unit price at a particular point in time.

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Chickasaw Capital Management

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