Chickasaw Capital Management

MAY 17, 2023

MIDSTREAM UPDATE

MAY 2023

During the Q1:23 earnings period, Midstream reported another great fundamental quarter. However, the current market continues to lack capital flow, and the renters (hedge funds, "pods", trend following strategies, and others) are using this to their advantage thus obscuring the near-term and long-term opportunity potentially staring us all in the face.

The Model Portfolio reported strong results. Sixteen of twenty names beat consensus earnings before interest, taxes, depreciation and amortization (EBITDA) expectations by 5.6% on a weighted average basis, one had no estimates[1], and the three that missed, missed by an average of (~1%). EBITDA increased 2.4% quarter over quarter (Q/Q) and 15.9% year over year (Y/Y), weighted average. Distributable cash flow per unit (DCF/u) increased 8.1% Q/Q and 14.5% Y/Y, weighted average.

We'll highlight here a few holdings which reported strong results, yet still underperformed during the earnings season. On May 4th, Targa Resources Corp (TRGP) reported $875 million of EBITDA, which beat consensus by 7.5%, and was up 12% Q/Q and 50% Y/Y. They repurchased $52 million of stock during the quarter, which was commensurate with the quarterly increase in dividend, and approved a new $1.0 billion repurchase program. The "knock" on TRGP post call was that their 2023 forecasted growth capital expenditures increased by $250 million to $2.1 billion at the midpoint. We will re-hash our broader growth capital expenditure thoughts later in the newsletter, but will only retort, specific to Targa, that they have generated a 26% return on invested capital (ROIC) on $6 billion of capital spent since 2018.

Another name to highlight is Cheniere Energy Inc (LNG), which, on May 2nd, reported $3.6 billion of EBITDA, beating consensus by 45%. Open capacity dynamics propelled LNG's earnings last year, allowing it to capture the spread between U.S. and European gas prices. These dynamics persisted beyond expectations into Q1; however, we still expect earnings to moderate in 2023 given the absence of those conditions at present. LNG retains a large cash position and low balance sheet leverage, which could allow them to repurchase $1.5 billion or more on top of the $450 million repurchased in Q1 ($2 billion guidance). Yet investors were less than ecstatic about stable, 20+ year contracted cash flow with a strong return of capital corporate mindset, and, instead, appear to be waiting for marketing spreads to become favorable again. Again, a potential long-term opportunity obscured by the myopia of current incremental investment dollars.

We believe the public market continues to undervalue Midstream assets. On May 14th, ONEOK Inc (OKE) announced an agreement to purchase Magellan Midstream Partners LP (MMP) for an implied valuation of 12.0x 2024e EBITDA, which represented a 22.5% premium to MMP's previous trading price. Additionally, the Alerian MLP Index (AMZ) trades at ~7.5x EV/EBITDA, which, even though MMP was valued more highly than its constituents in the AMZ, highlights the broad difference between where private bidders value Midstream companies versus where the public markets value them.

(1) DCP Midstream LP (DCP) is in a pending merger with Phillips 66 Corp (PSX).

INVESTMENT TEAM

Geoffrey P. Mavar – Principal
Matthew G. Mead – Principal
Robert M.T. Walker – Principal
Bryan F. Bulawa – Principal

Scott B. Warren, CFA – Senior Analyst
Luke B. Davis, CFA – Senior Analyst

Active Allocation as it Relates to the Q1:23 Reporting Season

Continuing the theme of active allocation we've discussed the past few newsletters, we believe the potential opportunity for Midstream investors remains firmly in place. Let's logically discuss the narrative headwinds during this reporting period and rebut them with a forward view of the rest of the year.

First narrative: "sure companies beat this quarter's estimate, but they did not meaningfully increase full year guidance". Our response is the size of the beats were impressive in and of themselves, and deserve attention driven by the growth and consistency of cash flow, particularly with lower commodity price tailwinds year over year. Second, corporate management teams leave themselves less room for error if you increase guidance with eight months remaining in the year. While we believe recessionary impacts would be mild to unnoticed for the majority of Midstream companies, it remains a lingering unknown in the market's eyes, so, in essence, they are saving that bullet. Producer health remains stronger than the past as drilling budgets are being financed with cash flow and not debt. Demand continues to remain strong due to domestic contracts and increasing demand for U.S. exports, which also supports U.S. production forecasts. This could be a tailwind for the remainder of the year.

Second narrative: "all increases in growth capital expenditures are bad". This argument principally revolves around gross free cash flow available to shareholders, statically implying there is less excess cash flow to return if capital spending is increasing. We feel we thoroughly rebutted this in March's mid-quarter Midstream Update, but we can hit the high points again. Our observation and analysis is incremental announcements to previously disclosed budgets generally (a) are competitive with all forms of capital allocation (including buybacks); (b) are not large in scale and have generally resulted in < 5% increases to budgets; (c) typically have a less than 12 month investment period with strong upfront returns due to the continuing theme we express as "capacity short" across upstream, midstream and downstream assets; and (d) may in part be a pull forward from 2024 plans due to timing that is commercial not calendar related.

The other rebuttal to this short-term narrative is a reminder that when you have debt outstanding, "cash" is fungible between timing and receipt of cash flow and a company's leverage level. With an increasing number of Midstream companies reporting leverage levels less than 3.5x debt to EBITDA ratios, well below policy thresholds of 4.0x, companies have ample flexibility between cash and balance sheets to achieve capital allocation policies that potentially create equanimity in the capital allocation discussion regarding distributions, repurchases, and capital expenditures.

Third narrative: "a recession is imminent, this impacts the crude oil price, and therefore a positive commodity backdrop is necessary for Midstream 'to work'". Stating the obvious, if an investor is waiting on the catalyst to hit them in the face, they're likely to miss the opportunity. We discussed in our April newsletter the price signals from oil are not being driven by fundamentals. To further support this, we pass along a comment cited in a recent piece from RBC Capital Markets discussing the lack of liquidity in oil markets: "A quant fund recently shared: 'The absence of fundamental investor activity means that the price signals we look for are being created by ourselves and other systematic funds.'"[2]

There are also other market forces at play to help keep a floor under oil prices including the Organization of the Petroleum Exporting Countries plus Russia (OPEC+) supply cuts announced in April but effective starting in May[3], and the recent news the U.S. intends to take advantage of current prices to begin refilling the Strategic Petroleum Reserve (SPR)[4] after draining it last summer. Our internal forecast is oil demand begins to overtake supply in the second half of 2023 due to growth in international markets, and if that happens it could be supportive for all energy.

Lastly, Midstream fundamentals remain much more insulated to the price movements of oil than other Energy sectors. Year to date through May 10th the Alerian MLP Total Return (AMZX) has returned +3.7% versus the Energy Select Sector SPDR Fund's return of -8.4%, which may help to show how investors have discerned that commodity price risk is less for Midstream than other Energy sectors.

Yes, the macro remains uncertain, and we continue to acknowledge the market hates uncertainty. But uncertainty doesn't last forever, and we hope you agree with our near-term outlook that looks beyond the current, short-term noise taking advantage of the vacuum of fundamental investment flow. Based on our comments, we believe the market is giving investors an open lane to take advantage of a sector with solid fundamentals and low valuation.

Geoffrey Mavar   Matt Mead   Robert Walker   Bryan Bulawa

(2) RBC Capital Markets, "Oil Market in 60 Seconds: Mixed Physical Signals", 4/23/23. (3) John Kemp, Reuters, "OPEC+ Surprise Squeezed Oil Shorts", 4/11/23. (4) Reuters, "US Could Start Buying Oil for Reserve after June Sale, Energy Secretary Says", 5/11/23.

Chickasaw Capital Management, LLC gives no guarantees with respect to the success of its investment management services and has not authorized any person to represent or guarantee any particular investment results. Any historical data provided herein are solely for the purpose of illustrating past performance and not as a representation or prediction that such performance could or will be achieved in the future. Securities are subject to numerous risks, including market, currency, economic, political and business risks. Investments in securities will not always be profitable, and investors may lose money, including principal. Past performance is no guarantee of future results. This is not an offer or solicitation with respect to the purchase or sale of any security.

Chickasaw Capital Management, LLC does not provide legal, tax or accounting advice. Any statement contained in this communication concerning U.S. tax matters is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties imposed on the relevant taxpayer. Clients of Chickasaw Capital Management, LLC should obtain their own independent tax advice based on their particular circumstances. Opinions expressed are current opinions as of the date appearing in this material only. No part of this material may be copied, photocopied or duplicated in any form, by any means, or redistributed without the prior written consent of Chickasaw Capital Management, LLC.

References to market or composite indices, benchmarks or other measures of relative market performance over a specified period of time (each, an "index") are provided for your information only. Reference to this index does not imply that the portfolio will achieve returns, volatility or other results similar to the index. The composition of the index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which are subject to change over time. Indices are unmanaged. The figures for the indices do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices.

The Alerian MLP Index is a composite of the most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis (NYSE: AMZ), and the corresponding total-return index is disseminated daily (NYSE: AMZX). Relevant data points such as dividend yield are also published daily. For index values, constituents, and announcements regarding constituent changes, please visit www.alerian.com.

"Alerian MLP Index", **"AlerianMLP Total Return Index"**, **"AMZ"** and **"AMZX"** are service marks of GKD Index Partners, LLC d/b/a Alerian ("Alerian") and their use is granted under a license from Alerian. Alerian does not guarantee the accuracy and/or completeness of the Alerian MLP Index or any data included therein and Alerian shall have no liability for any errors, omissions, interruptions or defects therein. Alerian makes no warranty, express or implied, representations or promises, as to results to be obtained by Licensee, or any other person or entity from the use of the Alerian MLP Index or any data included therein. Alerian makes no express or implied warranties, representations or promises, regarding the originality, merchantability, suitability, non-infringement, or fitness for a particular purpose or use with respect to the Alerian MLP Index or any data included therein. Without limiting any of the foregoing, in no event shall Alerian have any liability for any indirect, special, incidental, or consequential damages (including lost profits), arising out of the Alerian MLP Index or any data included therein, even if notified of the possibility of such damages.

The Energy MLP Classification Standard ("EMCS") was developed by and is the exclusive property (and a service mark) of GKD Index Partners, LLC d/b/a Alerian ("Alerian") and its use is granted under a license from Alerian. Alerian makes no warranties, express or implied, or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and hereby expressly disclaims all warranties of originality, accuracy, completeness, merchantability, suitability, non-infringement, or fitness for a particular purpose with respect to any such standard or classification. No warranty is given that the standard or classification will conform to any description thereof or be free of omissions, errors, interruptions, or defects. Without limiting any of the foregoing, in no event shall Alerian have any liability for any indirect, special, incidental, or consequential damages (including lost profits), arising out of any such standard or classification, even if notified of the possibility of such damages.

Cash Flow is a revenue or expense stream that changes a cash account over a given period. Cash inflows usually arise from one of three activities - financing, operations or investing – although this also occurs as a result of donations or gifts in the case of personal finance. Cash outflows result from expenses or investments. This holds true for both business and personal finance. Cash flow can be attributed to a specific project, or to a business as a whole. Cash flow can be used as an indication of a company's financial strength.

Distributable Cash Flow (DCF) is calculated as net income plus depreciation and other noncash items, less maintenance capital expenditure requirements. Distributable cash flow (DCF) data is CCM calculated consensus of Wall Street estimates. The estimated consensus weighted average distributable cash flow (DCF) per unit growth rate for the AMZ and our Model Portfolio incorporates market expectations by using the average annual growth rate using rolling-forward 24-month data. DCF growth rate is not a forecast of the portfolio's future performance. DCF growth rate for the portfolio's holdings does not guarantee a corresponding increase in the market value of the holding or the portfolio.

Distributions are quarterly payments, similar to dividends, made to Limited Partner (LP) and General Partner (GP) investors. These amounts are set by the GP and are supported by an MLP's operating cash flows.

EBITDA is earnings before interest rates taxes depreciation and amortization.

EV/EBITDA is a ratio used to determine the value of a company. The enterprise multiple looks at a firm as a potential acquirer would, because it takes debt into account – an item which other multiples like the P/E ratio do not include. Enterprise multiple is calculated as: Enterprise multiple = EV/EBITDA.

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.

Net Debt to EBITDA Ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. The net debt to EBITDA ratio is a debt ratio that shows how many years it would take for a company to pay back its debt if net debt and EBITDA are held constant. If a company has more cash than debt, the ratio can be negative.

OPEC+ is a loosely affiliated entity consisting of the countries that are members of the Organization of the Petroleum Exporting Countries (OPEC), plus several of the world's major non-OPEC oil-exporting nations, most notably Russia, with the goal of exerting a degree of control over the price of crude oil.

Return on Invested Capital (ROIC) is the amount of money a company makes that is above the average cost it pays for its debt and equity capital. ROIC is used to assess a company's efficiency at allocating the capital under its control to profitable investments. ROIC = EBIT (1 - Tax rate) / (Total Assets – Total Liabilities).

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

This material is provided for informational and educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell any security, product or service.

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.