Chickasaw Capital Management

AUGUST 19, 2024

MID-QUARTER UPDATE

In what may feel like a "copy/paste" from previous earnings report updates, Midstream securities continued to exhibit earnings results during Q2:24 in line with normal seasonality, with preliminarily lifted guidance in a few cases, and updated market participants on the strength of their businesses in an increasingly favorable macro outlook. Our main takeaway to investors: we have even more confidence in the capital returns through dividends/distributions and equity repurchases available through the end of the decade.

During the quarter, Model Portfolio companies beat Street expectations for earnings before interest, taxes, depreciation and amortization (EBITDA) by 1.0%, weighted average, with 10 beats and 8 misses. Q2 can always be difficult to estimate due to the seasonal declines from excess winter profits quarter over quarter (Q/Q) as exhibited by the (3.4%) Q/Q growth compared to the 12.3% year over year (Y/Y) growth, all weighted average. Distributable cash flow per unit (DCF/u) rose 6.6% Y/Y, weighted average, and these results are likely closer to a ~10% increase when adjusted for what we believe are more one-time items. Speaking to guidance increases, we saw updates from holdings Cheniere Energy Inc (LNG), Energy Transfer LP (ET), Kinetik Holdings Inc (KNTK), ONEOK Inc (OKE), Plains All American (PAA/PAGP), and Targa Resources Corp (TRGP)—all but 1 being alpha weight positions.

Distribution and dividend growth was essentially flat Q/Q and up 11.1% Y/Y, weighted average. This drives the Model Portfolio's cash return growth through distributions and dividends, based on consensus estimates, to 16.5% in 2024e, and 8.4% in 2025e. However, we would note our internal forecast is notably higher than the consensus estimated growth rate in 2025e, indicating, as mentioned in the opening paragraph, our increased confidence in the long-term capital return story. And for clarification, these are just cash return to investor figures, and don't include the synthetic return through buybacks, which we believe could add another ~2% to the Model Portfolio at a minimum.

We've been highlighting the potential for increased natural gas usage from data center demand for several quarters now, and how this trend has the potential to fuel an already strong natural gas forecast driven by increasing liquefied natural gas (LNG) exports and re-shoring of domestic manufacturing. Over the medium-term, gas delivery companies will still have to fit within the parameters of Utilities' long-term planning forecasts. But, as we suspected, company commentary confirmed in the near-term it's all about "speed to market" through creative solutions.

A recurring theme of our active allocation process is to be positioned with companies benefitting the most from tight capacity regardless of asset, hydrocarbon, supply or demand. In the gas pipeline world, reduced available capacity has a very high return threshold[1] given the lengthy nature of new construction.

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

[1] This is for non-regulated capacity. When regulated capacity is turned back to the marketed pool, it earns a similar return as the sanctioned rate-based return, but competes on duration. This can increase the duration of that capacity to multiple decades longer than the original term, typically 20 years, providing further terminal value support of the asset's valuation.

Anecdotally, Williams Cos Inc (WMB) indicated on their quarterly call they were previously only evaluating opportunities on spare capacity that generated a 6x EBITDA return on investment (~17% return). In just the past 4-6 months, though, the opportunity stack is so great, and the ability to evaluate all the requests is so demanding, WMB now says incremental capacity is only evaluated if it earns less than a 5x EBITDA return (20%+). As part of the speed to market theme, customers are lasered in on gas pipelines that have the ability to bypass Utilities' grid connections, and provide direct, behind-the-meter power.

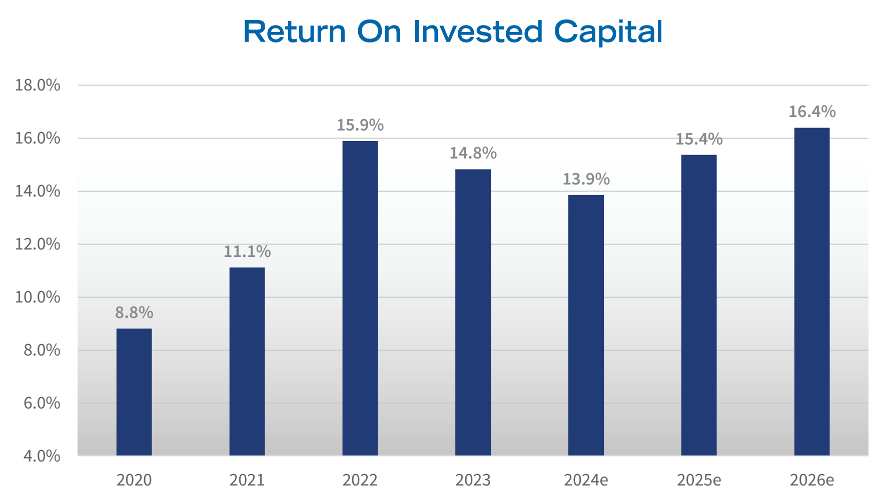
This emerging theme could provide incremental cash flow which is likely not accounted for in future consensus forecasts, nor have we begun to model that into our long-term return on invested capital (ROIC) forecasts (see next section). Compared to the 2010s, companies are now incredibly capital efficient, spending less while generating higher returns, and torquing free cash flow, which should increasingly find its way into investors' pockets.

Update to Annual ROIC Study

The key themes from our updated forecast are:

- Weighted average Model Portfolio ROIC continues to move higher
- Returns in 2023 were slightly better than our forecast
- Incremental Y/Y returns, post 2024e have gotten stronger
- As returns may increase through 2026e, companies need to remain focused on capital allocation decisions comparing risk adjusted returns on new capital expenditures versus additional cash returns to equity holders

The Midstream industry continues to exhibit strong ROIC due to higher profitability, lower capital expenditures, and higher rates of return on capital invested. Updating the long-term study of our Model Portfolio we are pleased to see our estimates are meeting or exceeding actuals, and that incremental ROIC in the out years continues to move higher. Taking those in reverse order, our forecast now includes 2026e estimates, which indicate additional Y/Y improvement.

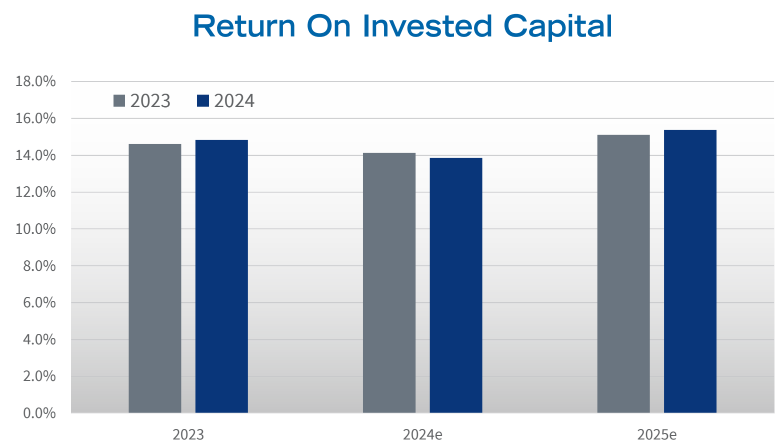


Source: CCM as of 7/31/24

Two items of note regarding this forecast. First, as indicated in last year's commentary 2022's outsized ROIC had tailwinds from the dislocation in domestic and international commodity prices due to Russia's invasion of Ukraine. Second, we were always expecting the modest step-down in 2024e ROIC due to higher capex, and, so far this year, it has held true to estimates. Of note, if the market is always looking forward, Midstream investors appear to be looking beyond 2024e as total return has delivered 18.4% through 7/31/24.

If market theory holds, investment dollars seek companies with higher ROICs, which are driving incremental ROIC improvement. In this case, 150 basis points (bps) in 2025e and 100 bps in 2026e of potential incremental improvement could portend strong total return prospects for our Model Portfolio.

We also believe it is practical to show how our estimates are performing year over year. The chart below shows our current ROIC estimates in blue and our 2023 measured estimates in gray.



Source: CCM as of 7/31/24

Actual results exceeded estimates in 2023, and our estimates are tracking higher for 2025e in the updated forecast. The estimates for 2024e show a consistent, slight decrease in expectations Y/Y. We believe investors should be more focused on the incremental increase in 2025e's ROIC, and the role that active management plays in future periods. As always, if you'd like to catch up on a deeper level please feel free to reach out to your Chickasaw representative.

Geoffrey Mavar Matt Mead Robert Walker Bryan Bulawa

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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.

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.

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. 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.

EBITDA is earnings before interest rates taxes depreciation and amortization.

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.

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).

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6075 POPLAR AVENUE, SUITE 720 • MEMPHIS, TN 38119 • p 901.537.1866/800.743.5410 f 901.537.1890 • www.chickasawcap.com