Chickasaw Capital Management

NOVEMBER 18, 2024

MID-QUARTER UPDATE

"Macro Catalyst Rich"

Midstream securities have delivered strong total return results with the Alerian MLP Total Return Index (AMZX) rising 4.1% quarter-to-date (QTD). The macro themes of increased gas demand to support electricity consumption, positive sector read throughs regarding the upcoming change in political Administration and increasing exports of U.S. production have pushed equity prices higher. Of course, the incremental quarterly results continue to buoy the long-term themes haloing the sector, and this quarter was no different.

During the quarterly reporting period, Model Portfolio securities beat consensus earnings before interest, taxes, depreciation and amortization (EBITDA) estimates by 1.3%, weighted average, with 15 beats and 5 misses. EBITDA grew 3.2% quarter over quarter (Q/Q) and 10.1% year over year (Y/Y). Additionally, 13 companies, or 72% of the Model Portfolio's holdings, either increased 2024 EBITDA guidance or disclosed they will be at the "high-end" of previously delivered guidance indicating above trend growth outlooks.

Distribution growth remains strong and continues to surprise our internal expectations. For the quarter, the Model Portfolio's holdings saw growth of 2.5% Q/Q and 18.8% Y/Y. Distribution growth expectations for 2024 and/or 2025 were increased at Cheniere Energy Inc (LNG), MPLX LP (MPLX), and Targa Resources Corp (TRGP)[1].

Cash returns through share or unit repurchases of $1.5 billion remained strong across our coverage universe. We continue to believe even with slightly increasing sector growth capital expenditures capitalizing on high returning investments, the buyback theme remains key to understanding cash returns to equity holders. 2025 could represent an inflection point for several companies as the forecasted free cash flow wedge between cash flow from operation (CFFO) and capex widens more than previous years. As stated in last quarter's Mid-Quarter Update, we estimate the impact of a buyback "yield" could still be at least 2% per year across the Model Portfolio[2].

Looking ahead to 2025, the outlook for Midstream securities remains favorable as valuations have room to expand (see ***Long Term Value Inputs Improvement*** at the end), and the set up for total return is attractive. As of 11/15/2024, the Model Portfolio in 2025e is forecasted to yield 5.95% with 9.2% expected distribution/dividend growth, weighted average[3]. This is supported by weighted average EBITDA and distributable cash flow per unit (DCF/u) growth of 7.4% and 9.1%, respectively[4].

INVESTMENT TEAM

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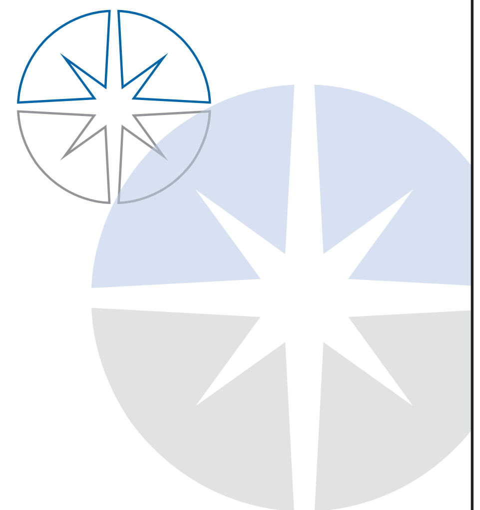


[1] Distribution/dividend growth is not a forecast of the portfolio's future performance and does not guarantee a corresponding increase in the market value of the holding or the portfolio.
[2] Actual share/unit repurchases may vary significantly.
[3] Distribution and dividend estimates sourced from Bloomberg, LP. Distribution/dividend growth is not a forecast of the portfolio's future performance and does not guarantee a corresponding increase in the market value of the holding or the portfolio.
[4] Weighted average distributable cash flow growth refers to the estimated 2025 weighted average Distributable Cash Flow (DCF) growth rate. DCF and EBITDA growth rates are not a forecast of the portfolio's future performance and do not guarantee a corresponding increase in the market value of the holding or the portfolio. DCF data is CCM-calculated consensus of Wall Street estimates.

Post-Election Themes

Undoubtedly, our readers are well aware of the post-election takeaway that a change in Administration can be viewed favorably for the Energy industry. We agree but remind investors what we have said for years: hard assets with long duration contracts have the ability to look through, potentially, several presidential election cycles. We believe this is an all-weather, long-term asset class. Our summary takeaways for the next four years are:

America First: The incoming Administration has a strong belief that low energy input costs improve the global competitive positioning of American companies. Many market pundits are focusing on the "Tax Cuts" portion of 2017's Tax Cuts and Jobs Act (TCJA), but the "Jobs" portion has been arguably just as important to American manufacturing and energy since it began the process of onshoring industries previously sent abroad to lower labor cost geographies. After some COVID delays, we believe the onshoring of manufacturing is just now hitting its stride, which is a strong tailwind to electricity, and thereby, natural gas consumption. Further support from the incoming Administration would be incrementally positive.

Call for energy unity: While some extreme points of view for de-carbonization reared their head in the early part of the previous Administration, we always believed pragmatism and industrial logic would prevail. The most recent 12 months has represented a more balanced atmosphere, which is constructive given our consistent messaging that it is going to take all energy sources (carbon through green) to accomplish the growth goals being forecasted. There are many promising clean and efficient applications for hydrocarbons which also deserve a place at the table and could help to accomplish environmental goals benefitting all. This has been echoed post-election by the leaders of both Exxon Mobil Corp (XOM) and Cheniere Energy Inc. (LNG), who have gone so far as to urge the new Administration to remain in the Paris Climate Accord[5].

Less onerous regulatory environment: The next step in achieving greater access to more forms of energy is eliminating the red tape associated with permitting and construction of energy assets. Remaining well-regulated but not over-regulated will be key to satisfying America's need for power.

Increased gas supplies to the global economy: The incoming Administration has emphasized America's energy exports as an arm of global policy making, in addition to making plentiful and economic use of energy inputs at home. The increased role U.S. natural gas can play through liquefied natural gas (LNG) exports could hasten export facility approvals and decrease domestic bottlenecks to delivery of the molecules to the facilities (i.e. pipelines).

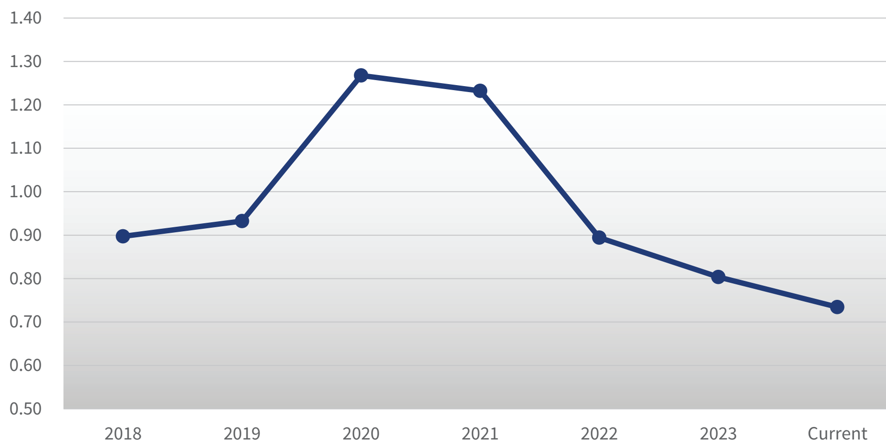
Bonus depreciation: At the individual security holding level, an extension of bonus depreciation beyond 2025 could be positive for both Midstream MLPs and C-Corps. For MLPs, this would add to the depreciation shield keeping some or all of distributions as return of capital. For C-Corps it could help shield them from higher taxes and could keep their cost of capital lower.

No matter how these themes play out, we remind investors the strong competitive positioning of many of these companies should support high returns on invested capital, well-maintained, long-duration assets, and excess free cash flow available to equity holders.

[5] Reuters, "Cheniere Energy wants US to remain in Paris climate agreement", November 13, 2024.

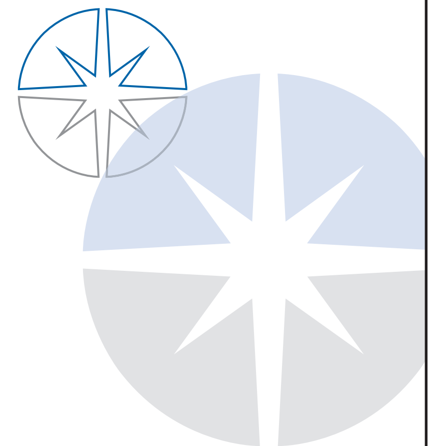
Long Term Value Inputs Improvement

Potentially going unnoticed by many market participants has been the decrease in factors affecting discounted cash flow valuation models, particularly around beta. The decrease in this ratio over time indicates market participants increasingly see the Midstream sector as less risky than the broader market. We show this here with the current Model Portfolio's weighted average beta over the previous 5 years through 11/15/24.



Source: Bloomberg LP calculated adjusted beta

The important takeaway is Midstream is not just reverting higher on valuation due to reversion to the mean on multiple valuation. We have always been forthright that multiples are an output of discounted cash flow valuations. As prices are moving higher it is likely because the sector is de-risking in investor's minds, and underlying expectations are moving higher affecting both the present value of the next 10 years cash flow (PV10) and the terminal values. As forecasted cash flow growth rates continue to increase and discounting factors improve favorably, we believe long term valuations remain supportive of potential total returns.



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Beta is the slope of the regression line. Beta measures the investment relative to the market. It describes the sensitivity of the investment to market movements. The market can be any index or investment specified.

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.

Cash Flow from Operations (CFFO) indicates the amount of money a company brings in from its ongoing, regular business activities, such as manufacturing and selling goods or providing a service to customers.

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.

Terminal Value is the value of an asset, business or project in perpetuity beyond a set forecast period for which future cash flows are estimated.

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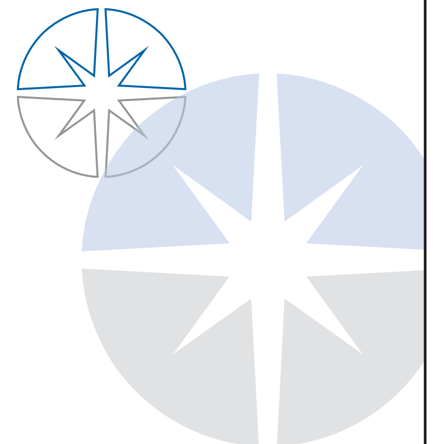

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