Chickasaw Capital Management

# Weekly Midstream & Market Pulse

AUGUST 16, 2020

## Review of Second Quarter Portfolio Financial Performance

The Q2:20 financial results from our holdings met or exceeded our expectations. By the numbers:

- Earnings before interest, taxes, depreciation and amortization (EBITDA) beat consensus by ~1% (weighted average), was down 9.5% Q/Q, and down 5.7% Y/Y. The quarterly comparison reflected the difficult operating environment, normal seasonality (reflected in the Y/Y results), and the strong excess earnings last year from marketing and spread opportunities.
- Distributable Cash Flow (DCF) per unit beat our estimates by 5.0% (weighted average), and was down (11.3%) Y/Y.
- Distributions and dividends were flat (weighted average) Q/Q and down 11.7% Y/Y. The annual decrease reflects management decisions made in April and May to strengthen balance sheets through distribution and dividend reductions.

The key theme to highlight for earnings overall this quarter is stability. As we pointed out in our quarterly newsletter, second quarter earnings are typically the low point and reported results were generally better than the stress test estimates we have been providing since March.

Focusing on the sequential results for large holdings, Q/Q earnings for Shell Midstream Partners LP (SHLX, $11.85), Enterprise Products Partners LP (EPD, $18.85), and Williams Cos Inc. (WMB, $22.13) changed 0.3%, (0.9%), and (1.3%), respectively. These results were offset by Kinder Morgan Inc (KMI, $14.29), Magellan Midstream Partners LP (MMP, $41.39), and Plains All American Partners LP (PAA, $7.78) which were down (17.9%), (20.1%), and (24.0%), respectively. Even though these companies earnings results may initially indicate less stability, these results were impacted at KMI and MMP by the effect of COVID-19-influenced driving restrictions and normal, lower driving activity reflecting seasonality on refined products demand, as well as strong crude oil marketing opportunities for PAA and MMP that were present in 2019 and not 2020, thus making a difficult Y/Y comparison. It's important to note that the excess earnings from these companies last year were used towards debt reduction measures, and some of the similar marketing earnings expected in Q2:20 were said to have been booked during the quarter, but will be recognized in Q3 or Q4.

What surprised us the most was how well gathering and processing activities (G&P) held up, which either provided balance at diversified companies or provided strong earnings beats at others. Within the portfolio, we saw examples of beats relative to consensus by Western Midstream Partners LP (WES, $9.57), EnLink Midstream LLC (ENLC, $3.06), MPLX LP (MPLX, $19.78), and EPD of 16.3%, 8.9%, 5.8%, and 4.5%, respectively. Most companies with G&P activities indicated that

**INVESTMENT TEAM**

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

Paul R. Jacob – Vice President
Scott B. Warren, CFA – Senior Analyst
Luke B. Davis, CFA – Senior Analyst
Rahil Jiwan – Senior Analyst
Walter P. Frank – Associate Analyst

The information herein was prepared for informational purposes only and may not be copied, photocopied, duplicated or disseminated to any other party in any form without the express written consent of Chickasaw Capital Management, LLC.

This is not an offer or solicitation with respect to the purchase or sale of any security. Opinions expressed are our present opinions only. The material is based upon information which we consider reliable, but we do not represent that such information is accurate or complete, and it should not be relied upon as such. Opinions expressed are current opinions as of the date appearing in this material only. This information is current and is subject to change without prior notice. Any historical price(s) or value(s) is as of the date indicated. We, or persons involved in the preparation or issuance of this material, may from time to time, have long or short positions in, buy or sell (on a principal basis or otherwise) the securities or options of any companies mentioned herein.

**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.

**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.

**Distributable Cash Flow (DCF)** is calculated as net income plus depreciation and other noncash items, less maintenance capital expenditure requirements.

**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.

**FCF** is **Free Cash Flow** which represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets.

volumes experienced a sharp "V"-shaped recovery from April's lows, and that the overwhelming majority of curtailed production is back on line. Additionally, where EBITDA guidance had been previously given, it was reiterated or raised at companies such as WES, ENLC, and Targa Resources Inc (TRGP, $19.97), by 5.6%, 3.8%, and 3.3%, respectively.

## Outlook for the Second Half of 2020

As encouraged as we are by this quarter's results, we acknowledge that companies share our conservativism for the remainder of the year, primarily regarding what demand recovery will look like due to the persistent overhang of COVID-19. This is reflected by weighted average guidance across our portfolio remaining flat Q/Q.

The two biggest concerns remain the shape of the recovery in gasoline and diesel demand (with a recovery in jet fuel this year all but written off), and cautious optimism that new crude oil drilling rigs return at current oil price levels. MMP and KMI each extrapolated current (July) refined product demand levels through the remainder of 2H:20 for their guidance, which could be flat, higher or lower. Looking at production, we are encouraged to witness the return of volumes, and feel confident that drilled but uncompleted (DUCs) wells will support guidance for the remainder of the year. However, rigs need to return later this year to create more well inventory for volumetric stability and/or growth in 2021, as there is typically a 6 month lag from spud to sales. Company conversations this week reflect public comments from producers during earnings that they're still evaluating capital budgets for the remainder of 2020 and 2021 given the volatility and recovery seen since March.

Positive offsets not accounted for in company guidance include increased ethane recoveries, continued strength in natural gas liquids (NGLs) price per barrel (down 5% YTD versus WTI that is down 30% YTD), which could bring back rigs but shift drilling to wet gas from crude economics, and a stronger recovery in gasoline demand. The ethane demand increase is particularly worth highlighting because utilization at petrochemical facilities has remained at normalized levels due to higher demand for medical and personal protective equipment (PPE) goods that has been offset by lower demand for durables (auto, aviation, etc.). Ethane has been a missing component of NGL volumes for several years as low prices incentivized producers to leave it in the natural gas stream. As plastics demand has held consistent, and there is less available ethane due to lower associated gas volumes from lower crude production, this has led producers to choose to now recover ethane. Coincidentally this has allowed room for more natural gas in pipelines, thus improving the outlook for its price, too.

## Operating and Growth Capital Expense Control—Outlook for Free Cash Flow Growth Increasing

What was most encouraging to us during the calls was the discussion around continued operating expense (opex), selling, general & administration (SG&A) expense and growth capital expenditure (GCX) reductions to insulate cash flow margins and further protect balance sheets. This should generate higher levels of free cash flow (FCF), increasing the optionality for companies to enhance shareholder and unitholder value in the near future.

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

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.**

Companies indicated another ~$550mm of opex and SG&A reductions during the quarter which is a greater than 10% cumulative reduction since the end of 2019. Company commentary reflected continued movement towards additional cost savings and operational efficiencies so we expect the overall savings to continue to increase. We saw additional GCX reductions this quarter of $650mm collectively reducing overall guidance to $29.9bn from $35.1bn to begin the year (down ~15%). The majority of this capital has already been spent to complete projects from 2019, and 50% of the $29.9bn is from TC Energy Corp (TRP, $48.88) and Enbridge Inc (ENB, $32.87), which together represent ~3% of our portfolio allocation.

While 2021 GCX guidance has not been officially delivered by the majority of companies, we received several indicators by large capitalization companies that show 2021 and 2022 are coming down meaningfully.

- EPD indicated 2021 GCX could be $2.3bn and $1bn in 2022, down from $2.5bn and $1.5bn, respectively.
- Energy Transfer LP (ET, $6.62) indicated GCX could be $1.3bn in 2021, $500mm in 2022, and $700mm in 2023, versus previous indications of a <$2.5bn run rate.
- MMP indicated 2021 GCX may only be $40mm.
- PAA indicated 2021 GCX may only be $450mm and $300mm in 2022vs. $1.45bn in 2020.

As we rhetorically asked in the most recent quarterly newsletter, as this investment cycle that has been taking place for 12 years winds down, we wonder what companies will do with all this FCF?

## HY Midstream Issuance

Outside of financial reporting and guidance, we have seen strong debt issuance by Midstream companies during earnings season. Since 7/27/20, Midstream companies have issued $6.5bn at historically low rates.

Particularly worth noting was this week's offering on 8/11/20 by TRGP, a high yield issuer, of $1bn, 4.875%, 10.5-year bonds. This offering launched at $750mm and, according to market participants, at yields being discussed at a higher range. The final, upsized offering at a lower yield was discussed to have been substantially over-subscribed. Midstream credit investors continue to show confidence in issuance from both investment grade and non-investment grade companies. We believe there remains a wide disconnect between credit and equity investors particularly given the stability of quarterly results relative to current valuations.

Geoffrey Mavar Matt Mead Robert Walker Bryan Bulawa