Chickasaw Capital Management

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MIDSTREAM UPDATE

INVESTMENT TEAM

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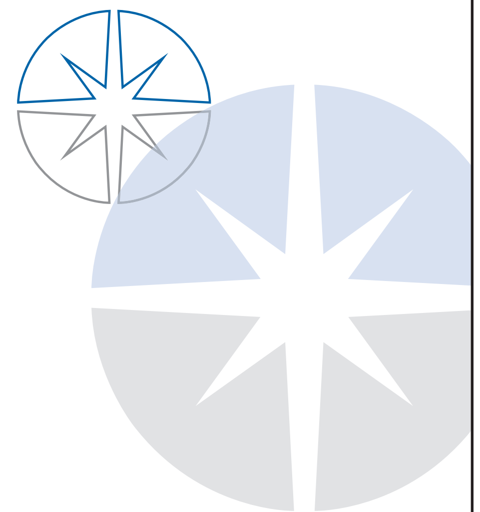
Midstream companies did what we expected them to do by showing the stability of the cash flow, despite the volatility in spot natural gas prices during the quarter. On the whole, companies:

- Reported consistent results,
- Offered conservative outlooks showing modest 2024 growth,
- Spoke to 2024 being a year of increased cash flow momentum towards 2025, and
- Continued to clearly state their capital return frameworks to help investors better model out the long-term value proposition.

We're happy to sound like a broken record: the Portfolio delivered another solid fundamental performance during the most recent earnings season. Earnings before interest taxes depreciation and amortization (EBITDA) results beat consensus estimates by 3.1%, weighted average, with 14 beats and 4 misses. EBITDA growth was also good increasing 9.2% quarter over quarter (Q/Q) and 9.3% year over year (Y/Y), both weighted averages. Distributable cash flow per unit (DCF/u) was up 2.7% Q/Q and 5.0% (adjusted) Y/Y, both weighted averages.

Turning to the outlook, the Portfolio's 2 year forward growth rate, based on consensus estimates, is 6.5%, up 70 basis points (bps) quarter to date (QTD)[1]. Importantly, we see Sellside estimates potentially embracing the 2025 outlooks as the wave of 11 billion cubic feet per day (Bcf/d) of new U.S. liquefied natural gas (LNG) capacity comes online through 2028, or ~85% growth over 2023 year-end capacity. This added capacity will most likely pull more than just dry gas volumes since such an increase in the current gas supply dynamic should force producers to target "wet" gas basins, and their incremental volumes of associated crude oil and natural gas liquids (NGLs). For our Portfolio, this is demonstrated by 4.5% DCF/u growth in 2024e increasing to 9.2% growth in 2025e. As market participants continue to buy-in to the current stability and increasing nature of 2024 through 2025 cash flows (and beyond!), they should also begin to perform some simple arithmetic to see the waterfall of cash available to be returned. Which leads to…

We were pleased, and in some cases darn right positively surprised, to see clear, increased delineations of return of capital plans for 2024, which focused on increases in distributions and equity buybacks. Based on capital return priorities outlined by companies, the Portfolio's estimated 2024 distribution/dividend yield is 6.5%, on the back of 12.1% growth, which is up 260 bps absolutely year to date (YTD). Potentially obvious, but worth pointing out, the increased outlook for dividend and distribution growth has outpaced the compression in yield from strong YTD total returns. Thus, we believe the market is still not fully embracing the increasing capital return outlook.



[1] Growth Rate refers to the estimated 2024 and 2025 weighted average Distributable Cash Flow (DCF) growth rate. This 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.

Equity repurchases ended the year at $3.7 billion, and we see potential growth to that figure in 2024+ between the combined effect of lower capex as major projects are completed this year (lower capex = more free cash flow), Debt/EBITDA leverage targets being achieved, and companies finding answers to the question they keep asking themselves: "what will we do with all this excess cash flow?"

Natural Gas Commentary

It's been an interesting quarter thus far for natural gas due to both, as mentioned, its price volatility to date, but also an increasingly strong macro set up. During the quarter Henry Hub spot prices dipped towards record inflation-adjusted lows of $1.50 per million British thermal units (mmbtu) due to stronger than expected production, and current over supply from warmer weather and some unplanned LNG maintenance. Prices have since begun to recover as public companies discussed near term well curtailment, and/or flat production to avoid over-supplying the market. Prices could remain somewhat volatile in the intermediate term as we head into the summer "shoulder" season. But we believe the natural gas futures curve has to move higher to incentivize new production when new LNG export capacity creates a step change in demand, potentially as early as the end of this year as companies seek to bring assets online earlier than expected.

Regardless of the macro-influenced price activity, gas pipelines remain very full. Several companies have indicated re-contracting negotiations of existing capacity are focused on longer terms and higher rates, even before new capacity comes online soon to feed the 11 Bcf/d growth. And we expect Midstream companies to remain capital efficient with low expense, high cash flow capacity additions through compression additions, looping, laterals and other measures.

Because it's topical, we'd be remiss without a few comments on the LNG export pause put in place by the current Administration. For context, the pause is for projects that have not yet received their licenses to export LNG to countries with which the U.S. does not have a current free trade agreement (FTA). This mostly affects capacity proposed to be online toward the end of this decade and early next decade, not yet sanctioned, and not impactful to the current wave of new capacity already referenced.

Economically, this is clearly bad business. Qatar has already stepped into this potential void in U.S. capacity by announcing a 16 million tons per annum (MTPA) expansion project proposed to enter service in 2030[2]. This is also a bad climate deal, ironic given reports the pause was an offering to the more progressive climate wing of the Democrat party. If a non-FTA country hoped to buy cleaner and more regulated U.S. gas, they're not now going to replace it with wind or solar. They're going to buy Qatari gas. As a reminder, these developing nations want what the Western world has, and they need molecules to achieve their societal goals.

This outcome is likely a benefit to U.S. LNG exporters and gas suppliers as they benefit from a tighter domestic supply scenario keeping gas prices low, though we haven't added any of that impact into our valuations given the fluid nature of the topic and longer horizon of the speculation. However, we'd rather the U.S. be open for business to supply our allies such as Germany[3] who face greater LNG supply uncertainty from projects they supported that are now paused, and Japan[4] which is increasingly in competition with China for Asian cargoes.

Utilities Follow-Up

As an update to our November 2023 Mid Quarter Newsletter's assessment of (1) the Utility industry's current and potentially forthcoming financing issues, (2) the impact of achieving adequate returns, and (3) the effect it could have on energy transition goals, we found Warren Buffett's honesty about Berkshire Hathaway Energy (BHE) utility operations in his 2023 Annual Report to be supportive to our cautious thesis. It's worth the full read; however the summary paragraph of the section should present a sober perspective:

"Whatever the case at Berkshire, the final result for the utility industry may be ominous: Certain utilities might no longer attract the savings of American citizens and will be forced to adopt the public-power model...Eventually, voters, taxpayers and users will decide which model they prefer."[5]

To Our Allocator Friends

We have enjoyed the recent uptick in conversations, particularly during in-person visits with many of you the past 5 weeks. A consistent theme is Midstream remains a suitable replacement of capital currently allocated to Utilities, REITs, Global Infrastructure, fixed income inflation-adjusted protection, private equity of all sorts (if you can find liquidity), and basically every Real Asset category that isn't Midstream.

Our conversations are increasingly focused on the role Midstream can play in one's portfolio, and our belief is one seldom comes across an asset class so well positioned as an

[2] Bloomberg, LP, "Qatar to Build New LNG Project as US Stalls on Export Push", 2/25/24.
[3] Bloomberg, LP, "Germany's SEFE May Divert Contentious Russian LNG to Europe", 2/20/24.
[4] Reuters, "Japan's Kyushu Electric to Wait for US LNG Policy Clarity on Lake Charles", 2/20/24.
[5] Berkshire Hathaway Inc, "Annual Letter to Shareholders, 2023", 2/24/24.

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alternative source of income, capital appreciation, income generation, and a potential offset to inflation. Institutional investors increasingly understand the sector offers income yields exceeding most other similarly positioned asset classes, supported by the stable underlying income of the companies, where inflationary pressures can be offset by regulated and/or contractual escalators. The past three consecutive years of returns prove this out. All this, in highly liquid, publicly traded equity securities.

As always, we welcome you reaching out to your Chickasaw representative if you'd like to discuss the specifics of these dynamic conversations in more detail.

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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.

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.

The Henry Hub is a distribution hub on the natural gas pipeline system in Erath, Louisiana, owned by Sabine Pipe Line LLC, a subsidiary of EnLink Midstream LLC, which purchased the asset from Chevron Corporation in 2014.

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.

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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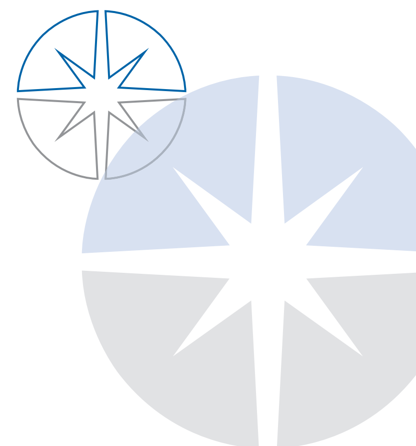

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