Chickasaw Capital Management

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MIDSTREAM UPDATE

MARCH 2023

A Strong Total Return Setup for 2023

The recently completed quarterly earnings period showed that 4Q:22 continued to meet investor expectations, proved that 2022 was a solid fundamental year for Midstream, and highlight that the 2023 outlook remains quite favorable. For Q4:22, our Model Portfolio beat consensus earnings before interest, taxes, depreciation and amortization (EBITDA) by 2.2%, weighted average (adjusted), and increased distributions 5.3% quarter over quarter (Q/Q), weighted average. Year over year (Y/Y), the Model Portfolio grew EBITDA 20.0%, distributable cash flow per unit (DCF/u) 19.9%, and distributions 22.2%, all weighted average. Highlighting our championing of the buyback theme, we estimate our universe repurchased over $2 billion of equity in the quarter and $6 billion during 2022, a phenomenal figure by itself and one we expect to remain consistent in 2023.

Looking forward, the Model Portfolio is well positioned for 2023e based on consensus estimates. Due to recent and expected dividend and distribution increases, the forecasted yield is 7.1%[1], coverage remains strong at 2.95x[2], and DCF/u growth of 7.6%[3] remains favorable. We will remind readers that at this time in 2022, the DCF/u growth rate was expected to be 6.3% and ended up increasing 26.7%. Midstream 2023e cash flows have re-based higher due to 2022's outperformance, and while some of the excess tailwinds from 2022 are not expected to continue, we believe there remains upside to per unit/per share growth metrics. Our analysis of sell-side models continues to see them understate the effect of contracts repricing higher due to inflation mechanisms embedded in agreements, volumetric growth expectations which do not necessarily match the timing of what corporates are communicating, and the effect of lower share and unit counts in the denominator.

Midstream and the Energy Transition Takes Further Shape

The Model Portfolio remains well-aligned with management teams who embrace our prescribed methods for capital returns to unit holders, primarily in high returning, quick payback growth capital expenditures, and share repurchases to take advantage of historically low valuations.

For those of you reading beyond just our newsletters, you've probably seen either sell-side research or national publications discussing Midstream's increased growth capital expenditures as being a sign of losing discipline. For some numerical context, Wells Fargo estimates that growth capital expenditures for 2023 have increased to $33 billion from $20 billion this time last year, and collective corporate guidance versus consensus for 2023 came in 14% higher than the estimates prior to the earnings releases[4]. Even at $33 billion, this remains well below peak spending of $47 billion in 2019.

(1) Distribution and dividend estimates sourced from Bloomberg, LP. (2) Calculated as: Distributable Cash Flow (DCF) / Distributions and Dividends. Distribution and dividend estimates sourced from Bloomberg, LP. DCF data is CCM-calculated consensus of Wall Street estimates. (3) Weighted average distributable cash flow growth refers to the estimated 2023 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. DCF data is CCM-calculated consensus of Wall Street estimates. (4) Wells Fargo, "Weekender: Is Midstream Losing Discipline?", March 3, 2023.

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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.

Distribution Coverage Ratio is calculated as cash available to limited partners divided by cash distributed to limited partners. It gives an indication of an MLP's ability to make dividend payments to limited partner investors from operating cash flows. MLPs with a coverage ratio of in excess of 1.0 times are able to meet their dividend payments without external financing.

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.

Let us shed some light. First of all, most of the analysis compares Midstream to their Exploration & Production (E&P) customers who are seemingly more disciplined. As a reminder, this has predominantly been a demand-led recovery post-pandemic, and much of the capital and excess returns have come from demand-facing Midstream assets. Capital spent has also come from enhancing assets within the full value chain that may face production, but also play a role in the global deliveries of hydrocarbons. U.S. production entered the pandemic over-supplied and, after falling off precipitously to rebalance, is now better aligned with U.S. and global demand estimates. By touching both supply and demand, Midstream assets have dual optionality to deliver growth.

Second, the extent to which capital spending reflects waning discipline ultimately depends on what the returns on the capital being spent are. Our preliminary estimate is that the return on invested capital (ROIC) across our portfolio holdings increased last year and is forecasted to increase this year (more to come in future newsletters). That's more economic profits being recycled into the business to sustain the economic "moat" over time. Such a strategy is also self-fulfilling long term as companies have to solve for ways to grow the business or return capital in such a way that maintains or grows ROIC.

Sorting through a discussion on capital spending, hopefully, shines another light as to why active management is so important in this sector. Discipline is not measuring the gross amount of dollars being spent; it's analyzing how those dollars compete against other uses of capital, and then, as a portfolio management company, assessing that in the portfolio risk/reward analysis. Much of the capital being spent by our companies in 2023 is expected to return +/- 20% (or a 5x EBITDA multiple) according to management commentary on earnings calls. Where we have lower equity exposure, either absolutely or relatively, is to companies who have large projects subjected to cost overruns (a good chunk of the Y/Y increase in the Wells data), or companies who lack a fulsome appreciation of how projects compete against equity repurchases.

Lastly, to emphasize our portfolio management approach to buybacks, 89% of the Model Portfolio by weight is allocated towards companies with active repurchase programs, signifying our alignment with management teams who force capital to compete—that is the discipline we're looking for. We believe companies will continue to surprise to the upside on equity reduction in 2023, while also delivering strong ROICs, and the Model is weighted to names which we believe will outperform on this metric.

The Case for Active Allocation and Active Management Remains Strong

An additional point to the above discussion which segues to a broader discussion of sentiment is, anecdotally, we have heard there was a high amount of capital that was raised/allocated at the beginning of the year. However, our sources indicate the majority was to long/short funds, and multi-strategy pods. A lot of the headlines you may read we believe are written to this short-term trading cohort allowing them to create inefficiencies for them to trade on – the discussion of growth capital expenditures being one such topic. But don't get confused regarding the long-term opportunity. The sell-side may just be writing to all of their respective bank's trading clients.

We believe the opportunity for active allocation alpha remains as strong as we outlined in our January newsletter, when we outlined our expectation for more attention to be shown to the asset class as allocators and advisors "got back to work" assessing Midstream allocations in their go forward plans. Our cumulative level of activity for in-person visits, conference calls and virtual meetings is back at 2019 levels, and that doesn't even include the strong number of investors who have engaged in our Midstream Education video series.

There's also an indication that momentum is increasing beyond our own activity. We found the most recent commentary from BlackRock's Investment Institute to sum up observations of what other strategists are saying: "For sectors, we see energy as a fusion of value and quality. We find value in the sector after being unloved and undisciplined with capital in the past. We think its stronger balance sheets, better investor payouts and improved return on equity give it more of a quality tilt."[5]

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(5) BlackRock Investment Institute, "Weekly Commentary", February 27, 2023.

EBITDA is earnings before interest rates taxes depreciation and amortization.

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 a calculation used to assess a company's efficiency in allocating capital to profitable investments. ROIC equals net operating profit after tax divided by invested capital. ROIC gives a sense of how well a company is using its capital to generate profits.

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

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.