CHICKASAW CAPITAL MANAGEMENT

MAY 15, 2024

MID-QUARTER UPDATE

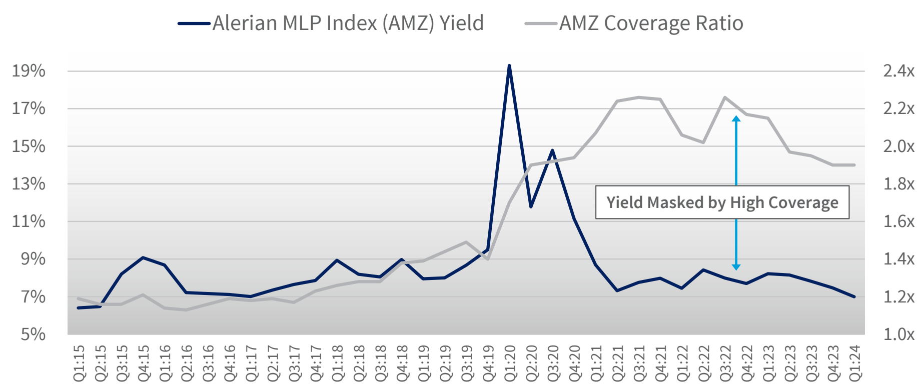
Midstream companies reported strong results during the Q2:24 reporting season, consistent with recent history. Despite typical seasonal headwinds for certain commodities, and some downtime related to extreme weather in January, the strength of contractual cash flows, inflation-adjusted rate increases for certain assets, and cash flow from new capital investment delivered earnings ahead of Street expectations.

Reviewing the quarterly results for the Model Portfolio, companies beat earnings before interest taxes depreciation and amortization (EBITDA) by 3.0%, weighted average, with 15 beats and 3 misses. Adjusted EBITDA grew 5.5% year over year (Y/Y), and adjusted distributable cash flow per unit (DCF/u) grew 3.5% Y/Y, both weighted average.

Importantly, capital returns remained strong. Distribution and dividend growth increased 13.0% quarter over quarter (Q/Q), and 20.9% Y/Y driven by companies such as Targa Resources Corp (TRGP) and Western Midstream Partners LP (WES) raising their dividend/distribution to levels commensurate with the long term, contracted nature of their cash flows. And the buyback theme remained strong as companies in the portfolio repurchased $2.6 billion during the quarter led by Cheniere Energy Inc (LNG) and Phillips 66 Corp (PSX). We should highlight LNG in particular as they were very active, while underperforming the market during the quarter, and ahead of strong expected cash flow growth in 2025—exactly what we encourage management teams to do.

Dividend and distribution growth remains a tangible theme for total return investors. Consensus weighted average distribution growth rate for the next 5 years across our holdings is 9.7% on a 6.3% estimated portfolio yield for 2024 as of 4/30/24.[1] Yield plus growth continues to matter in a world where uncertain interest rates, persistent inflation, and massive government debt create an uncertain broader investment outlook. The relative safety of Midstream cash flow, and the prudence of income statement management reflected in historically high coverage ratios[2] give us confidence the sector remains an "all weather" investment option through the remainder of the decade.

Distribution Coverage vs. Distribution Yield



Source: Bloomberg, LP

[1] Distribution and dividend estimates sourced from Bloomberg, LP.
[2] As of 3/31/24.

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Key Quarterly Themes

Natural Gas Supply Deficit

Right on the heels of our Q1 newsletter, the market and companies have rushed full steam into the potential imbalance between future demand and available supply of natural gas needed to support data center growth. This is *in addition to* the supply deficit we've been writing about for years due to demand from liquefied natural gas (LNG) terminals, and re-shoring of manufacturing demand back to the U.S.

More industry and Wall Street research analysts continue to rush forward gigawatt (Gw) demand estimates, and, as a sub-component of that analysis, seem to be converging around 5 to 10 billion cubic feet per day (Bcf/d) of incremental gas demand in 2030. Note the analysis from Wells Fargo Securities we cited in early April was 7 Bcf/d at the midpoint. This consensus appears to be eerily coincidental!

We are not being critical—we think there are real legs to the theme and a rising tide should lift all boats. But we also believe the demand uptake will likely not be linear. During the most recent reporting season, several public CEOs cited an electrical grid that is not prepared to necessarily handle the forecasted load growth. There remains a push & pull between local public utility commissions regarding the desire for renewables to be the source of generation, and the reality that anything timely and reliable will likely be gas and coal. Additionally, utilities aren't able to supply unlimited power (see grid issues; also utility balance sheet capacity issues referenced in previous newsletters). Lastly, when utility commissions are considering which entities should receive tax incentives, manufacturing businesses (whether re-shoring or not) create more jobs than data centers, which are employee-lite.

Understanding there needs to be a balance between enthusiasm and obstacles such as the ones above, we remain convinced Midstream companies are a great way to play any uptick in demand through latent system capacity (high returns), or capacity additions (also good returns), without making any heroic assumptions.

Underlevering

This is a topic we're previewing as part of a deeper Midstream education video in the works. Our opinion is several Midstream companies are at "risk" (small "r") of under-levering their businesses, and several management teams we have spoken to after earnings agree! Whether it was because of aggressive balance sheet actions taken during 2020, business outperformance since, improving fundamental outlooks or some combination of all three, the debt to EBITDA leverage ratio for several companies needs to go no lower than where it currently sits at approximately 3.0x D/EBITDA. If not, these companies end up restricting their financial flexibility and increasing their weighted average cost of capital (WACC) by not running leverage levels appropriate for long term, fee-based, contracted cash flows.

The industry's focus on generating positive free cash flow after distributions (FCFaD) has also played a key role in deleveraging the space, whether by actively retiring debt with the excess cash flow or by naturally de-leveraging with self-funded growth. But as leverage levels approach 3.0x, we believe the excess cash flow needs to be re-directed to equity holders. We have already seen several companies begin to address this issue with large step ups in their dividend or distribution (i.e. TRGP, WES, Plains All American Pipeline LP (PAA)). However, even if management teams were to increase their payout ratios to the point of FCFaD neutraility, this self-funding framework will continue to de-lever their businesses, albeit at a slower pace than prior to the step ups. Absent M&A, the only way to maintain appropriate leverage levels without sacrificing the self- funding FCFaD model is to repurchase equity.

Using the fungibility of leverage capacity within our long-advocated and analytically demonstrated position for repurchases, is another element we have been forecasting. Only now do we believe we're close to corporate actions, which could further illuminate this lever at Midstream management teams' disposal.

Expect forthcoming math and proofs to help explain this capital allocation logic since Midstream has not been in such a situation as this during past periods.

Client Communication Themes

During the quarter we produced a new document specifically designed for Allocators to help them consider Midstream in their decision-making framework. We believe it is helpful for both new entrants and long-term industry observers as we highlight key themes such as the macro energy investing climate, why Midstream is misunderstood, how the total return equation is supported (see previous comments), and why we believe an active approach is warranted. Finally, we frame the role Midstream can provide within the common allocation buckets of Total Return, Alternative Income, Real Assets, and Portfolio Offset so allocators understand the optionality they have when considering a Midstream allocation.

If you're interested in reviewing the document, or would like us to briefly take you through the information please reach out to your Chickasaw representative.

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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. DCF and adjusted DCF are non-GAAP accounting measures.

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.

EBITDA is earnings before interest rates taxes depreciation and amortization. EBITDA and adjusted EBITDA are non-GAAP accounting measures.

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.

Leverage is net debt divided by EBITDA.

Weighted average cost of capital (WACC) represents a company's average after-tax cost of capital from all sources, including common stock, preferred stock, bonds, and other forms of debt. As such, WACC is the average rate that a company expects to pay to finance its business.

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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