Chickasaw Capital Management

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MIDSTREAM UPDATE

MAY 2022

Beat & Raise

As we emphasized in our Q1 newsletter, we believe Midstream is fundamentally a growth sector while also positioned well within a defensive asset allocation framework. We also believe these companies have the potential to capture increased market attention as this was one of the strongest "Beat & Raise" financial reporting quarters we can remember. Even though market volatility has reared its head again for all asset classes quarter-to-date, allow us to shed a little light on the solid prospects for Midstream companies and their publicly traded securities.

Assessing this quarter's results, the portfolio beat 1Q22 EBITDA estimates by 5.2% (weighted average), and showed quarter-over-quarter (Q/Q) growth of 8.7%. This compares to the Alerian MLP Index TR (AMZX), which also beat estimates by 5.2% and grew 7.5% Q/Q. The drivers of the beats were more volume-related, specifically demand pull-related, not price driven. Companies indicated higher demand from utilities, petrochemical companies, and U.S. and global consumers of fuels. Also, we should point out most of the commodity price increases which occurred during the quarter were in the last 1/3 after Russia's hostile invasion of Ukraine, thus supporting the volumetric argument further.

In addition to the strong quarter of beats, the guidance raises from companies were impressive, too. For those who provide guidance, the remainder-of-2022 outlooks led them to raise guidance by 4.7% on average (11 of 14 holdings). In fact, questions on several of the company conference calls were leading in the sense of (sic) "why haven't you increased guidance *more*?" We just finished meeting with 16 companies, and they emphasized they normally wouldn't provide a guidance update this early in the year, but rest of the year outlook is favorable in such a way they were compelled to update forecasts. Also, companies say they're keeping inflation costs mostly under control, and the positive net effects of higher contractual rates will begin to show up the remainder of the year as contracts roll. Thus, we believe "Beat & Raise" could be a theme of the next few earnings reporting seasons, particularly given we don't typically see guidance raises this early in the year.

Capital returns to equity holders remained strong during the quarter, and the majority of management teams indicated continued flexibility to return free cash flow after distributions/dividends in a balanced way between share/unit repurchases, dividend/distribution increases and special distributions. Management teams showed a slight preference towards income returns over equity repurchases during the quarter, and we tracked that our portfolio distributions/dividends increased 10.0% (weighted average) sequentially. We'll have a better sense of the total level of buyback activity when all the 10-Qs are filed, and will update that figure in our Q2 newsletter. We can anecdotally describe it as consistent with previous quarters.

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

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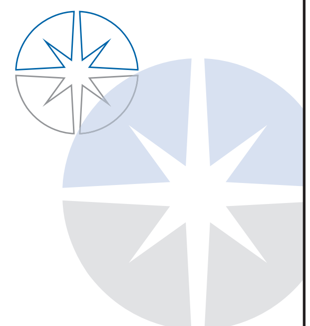

Lastly, Midstream analysts are starting the process of "price target creep". Price targets are increasing in some cases due to the fundamental improvements discussed above, but in others they are rising due to higher multiples, changes in discounted cash flow assumptions, growth rates or whatever tweaks they need to make to not dilute the momentum the market is telling them is at hand. Contrast this with the broader market where analysts are "slashing price targets for S&P 500 firms at the fastest pace since the pandemic crash in 2020. Altogether, their projected price level for the index fell 11 weeks in a row, the longest stretch of declines in a decade, data compiled by Bloomberg show."[1]

Market Sentiment

As we referenced above, market volatility has returned as investors digest higher interest rates, inflation data, Chinese COVID lockdowns, Russia's aggression, and other factors. Whether you were paying attention to Midstream earnings or are catching up through our comments above, it would appear the market has resumed its place as a voting machine rather than a weighing machine as the companies stand in a strong position, and a sell-off based on fundamentals would be illogical in our opinion. The most overwhelming factor cited for Energy sector weakness has been China's COVID restrictions, and our position is this is most likely a short-term phenomenon.

So, what's going on under the surface? During the worst part of the volatility between May 4–11, there was greater than $100 million invested into Midstream open-end ETFs and other products, and trading desk commentary indicated retail, institutional, and long/short investors were all net positive buyers during the pullback. Overall, total open-end flows to the space have been net positive $750 million year-to-date, which marks the first quarterly inflow period since 2017.

If we were going to draw conclusions on who's selling, the macro funds we've referenced in previous communications as the marginal buyer the past 12-18 months are probably going through a period of equity de-risking, and energy has been caught up in broader selling programs. We've also heard anecdotally investors are using gains across energy equities to offset losses in other, high-growth allocations in their portfolio.

Update on Global Energy Security

For our initial thoughts on this subject, we would refer you to our website www.chickasawcap.com >> Library >> Newsletters >> Midstream & Global Energy Security – March 2022. Since this time, and as the conflict has not shown itself to be quickly resolved, European Union and other global nations have increased their efforts to wean themselves from Russian energy supply.

As of the time of this writing, certain EU members have agreed to eliminate Russian gas supplies in the coming years, but support for a broad ban remains fluid. There is strong support for banning all Russian oil imports, but a small minority of member countries including Hungary and Moldova are still seeking assurances of flow, rather than unilaterally agreeing to an import ban with wide ranging economic implications. It's generally agreed the next few years will be tumultuous for EU energy supply, as they are compelled to economically cut themselves off from Russia without any clear paths for substitution. We reiterate Midstream infrastructure remains mission critical to the delivery of increased supplies of natural gas, crude oil and refined products such

(1) Bloomberg, LP "Wall Street Is Trying Desperately to Catch Up with Stock Rout", May 11, 2022.

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as gasoline, diesel and jet fuel to the EU and the world. The unfortunate reality for U.S. consumers though is, through policy, they are now subject to global market pricing, most recently and particularly in natural gas through LNG exports and diesel shortages on the East Coast.

Probably unnoticed by the general headline reader on May 10th was Saudi Oil Minister Prince Abdulaziz bin Salman saying, "The world needs to wake up to an existing reality. The world is running out of energy capacity at all levels."[2] This succinctly sums up the current macro situation where we find ourselves. Consumers may not like it, but the global constraints placed on development of infrastructure and resources in a dashed rush towards alternative energy such as wind and solar may be the greatest policy error facing global economies for the next decade.

Zooming in on the U.S., we have the gas reserves to supply our domestic needs and the needs of global consumers, which could potentially keep natural gas prices in a lower range. However, producers lack confidence to materially increase deliveries due to legal challenges delaying new pipeline capacity, and the absence of a clear signal from the current administration that it supports the role domestically-produced natural gas can provide. The U.S. has added crude capacity to the market through the six month, 1 million barrel per day Strategic Petroleum Reserve (SPR) release[3], but, keeping with the theme above, there is not enough aggregate refining capacity in the U.S. to absorb the release and give relief for pump prices. Instead, these reserves have been mostly exported to global refiners, and are being used by other economies. Whether the Administration knew what they were doing or not is still subject to debate, and we see little reason to think consumer energy price inflation will significantly moderate this year.

Conclusion

We hope you enjoy your upcoming Memorial Day holiday. The set up for positive global energy fundamentals and the role Midstream can play is, we think, increasingly being recognized by the market. In addition, we believe the financial health of Midstream companies has never been better, which may provide tailwinds for increased returns to equity holders over the coming years.

Geoffrey Mavar Matt Mead Robert Walker Bryan Bulawa

S&P 500 Total Return Index tracks the total return of the S&P 500 Index, an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. Dividends are reinvested. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

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.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures.

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PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

(2) Bloomberg, LP "OPEC Kingpins Warn About World's Dwindling Energy Capacity", May 10, 2022.

(3) DOE, "U.S. and Allies Agree to Largest Oil Release in History to Combat Putin's War", April 7, 2020.