Chickasaw Capital Management

AUGUST 15, 2023

MIDSTREAM UPDATE

AUGUST 2023

Midstream companies performed admirably in the 2Q23 earnings reporting season, despite the headwinds we forecasted in our July newsletter including normal business seasonality, and a tough year over year (Y/Y) comparison versus last year's incredibly strong Q2 which was driven by the energy security theme induced by Russia's aggression towards Ukraine. The most important takeaway from earnings season, though, is not the actual results, but the positive performance quarter-to-date (QTD) of the sector and our conviction that Midstream equities are set up for potentially strong total returns going forward.

Reviewing the numbers for our Model Portfolio, its holdings beat earnings before interest, taxes, depreciation and amortization (EBITDA) by 0.9%, weighted average, comprised of 11 beats and 9 misses. EBITDA grew 2.9% Y/Y, and distributable cash flow per unit (DCF/u) grew 3.4% Y/Y, both on a weighted average basis. Midstream management teams generally did a good job framing that Q2:23 was likely the trough for earnings and cash flow, and the set up for the remainder of 2023 and potentially into 2024 is favorable. This likely helped to balance out a quarter that ultimately proved to have low expectations.

Highlighting the sector's QTD performance through August 11, 2023, the Alerian MLP Total Return Index (AMZX) is up 5.7% versus the S&P 500 Total Return (SPXT) of 0.5%. A good portion of this outperformance can be attributed to a positive commodity performance which has seen WTI crude oil regain much of its year-to-date (YTD) underperformance by rising 17.7% QTD, to now be down 0.6% for the year. In keeping with our stance from July's newsletter that Midstream equities are decoupling from WTI, it's important to note what we think has really happened YTD is Midstream has limited its downside exposure to crude, while retaining upside exposure. Bringing YTD performance back around to the broad market, we believe most would be surprised to see the AMZX's 15.9% return has kept pace with the SPXT at 17.4%.

Model Portfolio – Updated Return on Invested Capital (ROIC) Analysis

Our team has recently completed the hard work of updating our return on invested capital (ROIC) metrics across our coverage universe. Not to overstate the process but this required full model updates to actual and forecasted years, and then compiling them in a way we believe represents comparable analysis to any other S&P 500 company. We're happy to discuss the process in more depth if that is of interest to you, but what we know you really care about are the results and the takeaways.

But not yet! One of the long-held tenets of our research and investment process is to find securities mis-priced on fundamental factors, and measuring incremental ROIC changes is a key input. In our current universe where companies continue to be grouped around relative metrics, in particular enterprise value to EBITDA (EV/EBITDA), diving into how incremental profits will be generated and then, ultimately, distributed to investors should help us differentiate our investment approach over a longer investment horizon.

INVESTMENT TEAM

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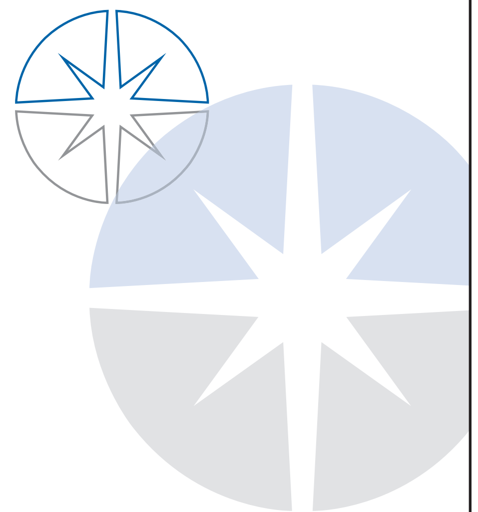
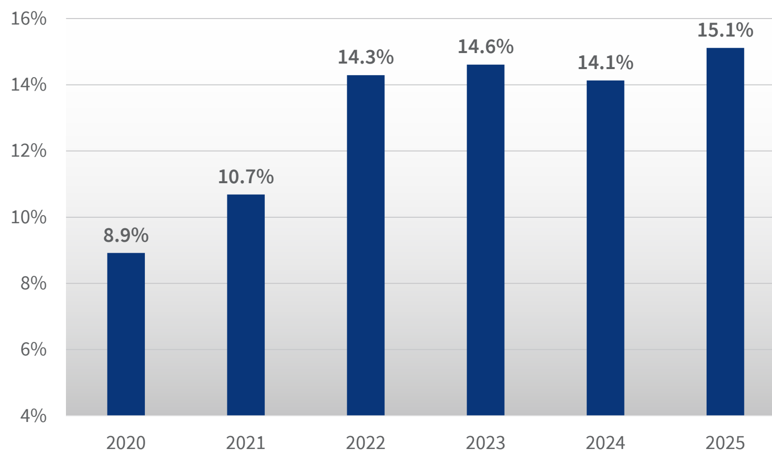
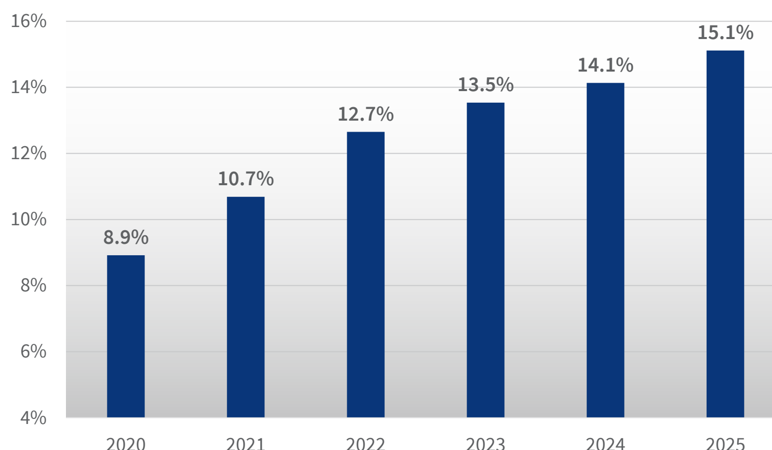


We estimate our Model Holdings generated a weighted-average ROIC of 14.3% at year-end 2022 versus 10.7% the year before in 2021. This is a “software sector-like” incremental improvement, and helps to explain 2022’s very strong performance as well as the solid returns we’re seeing this year. There were some excess regional spread and commodity volume-linked profits in 2022, and if we normalize certain companies where that took place to our long-term forecasts for those companies, we still would’ve seen a 12.7% weighted average ROIC in 2022. Even using this approach, a 200 basis points (bps) improvement is tremendous, and is a good demonstration of the cash flow generation occurring as Midstream companies come off the elevated growth capital spending period of 2015-2020.

Looking forward we show continued improvement over the long term. Our actual Model Portfolio forecast shows another year of improvement in 2023, a slight decrease in, but still healthy, 2024, and then an even higher ROIC in 2025.



If we adjust 2022 and 2023 ROICs lower for certain companies that were the biggest beneficiaries of dislocations in 2022 to their long-term ROIC forecasts, you can see a more stair-step pattern consistent with the process of capital discipline, and high incremental ROIC on a primarily fee-based underlying stream of cash flow.

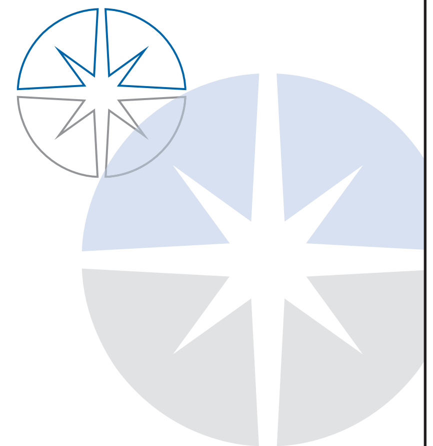


As it relates to allocation within the portfolio, we have strong over-weightings in names where we believe the incremental ROIC improvement is underappreciated, the company is expected to generate excess free cash flow (FCF) stemming from strong fundamentals coupled with effective capital discipline, and the company possesses the good fortune of fitting into our long-running question: “what else are they going to do with all this excess cash flow?”

Conclusion

We hope you have been enjoying your summer! As your planning begins to look ahead to the remainder of 2023, please feel free to reach out to your Chickasaw representative to discuss these or any other topics.

Geoffrey Mavar   Matt Mead   Robert Walker   Bryan Bulawa



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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.

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. The estimated consensus weighted average distributable cash flow (DCF) per unit growth rate for the AMZ and our Model Portfolio incorporates market expectations by using the average annual growth rate using rolling-forward 24-month data. 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.

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.

Enterprise Value (EV) measures a company's total value, often used as a more comprehensive alternative to market capitalization. EV includes in its calculation the market capitalization of a company but also short-term and long-term debt and any cash or cash equivalents on the company's balance sheet.

EV/EBITDA is a ratio used to determine the value of a company. The enterprise multiple looks at a firm as a potential acquirer would, because it takes debt into account – an item which other multiples like the P/E ratio do not include. Enterprise multiple is calculated as: Enterprise multiple = EV/EBITDA.

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.

Return on Invested Capital (ROIC) is the amount of money a company makes that is above the average cost it pays for its debt and equity capital. ROIC is used to assess a company's efficiency at allocating the capital under its control to profitable investments. ROIC = EBIT (1 - Tax rate) / (Total Assets – Total Liabilities).

West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.

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