Chickasaw Capital Management

NOVEMBER 14, 2023

MIDSTREAM UPDATE

Midstream securities experienced a healthy reporting season for the period ending 9/30/23. What were expected to be "boring" updates on corporate health, though, turned out to be catalytic for several companies as they leaned heavier into their plans for returning capital to their investors. And those companies which outperformed during the reporting period were those acting with purpose through consistent quarterly repurchase activity, and/or that outlined specific plans to increase the amount of buyback activity based on certain measures or ratios.

Speaking to results, the Model Portfolio beat earnings before interest, taxes, depreciation and amortization (EBITDA) estimates by 3.1% with 15 beats[1] and 4 misses, and EBITDA grew 5.6% quarter-over-quarter (Q/Q) and 3.9% year-over-year (Y/Y), all weighted average. Distributable cash flow per unit (DCF/u) grew 3.0% Q/Q and 3.7% Y/Y on a weighted average basis. The Y/Y results are impressive given the high level of base comparison to 2022's excess profits arising from global energy security dislocations, and the active nature of the portfolio.

It also bears mentioning that Midstream performance continues to de-couple from the price of WTI crude oil, which is down -15.0% quarter-to-date (QTD) through 11/10/23, and down -6.8% since 10/6/23, the last trading date before renewed Middle Eastern conflict. Conversely, the Alerian MLP Total Return Index (AMZX) has returned +1.4% QTD, and +4.1% since 10/6/23. Oil prices still appear to be more technically than fundamentally driven, defying past periods of elevated prices that accompanied heightened regional uncertainty. Looking at the annual data, the typical relationship between crude prices and inventory levels has become inverted, with oil prices declining -14% despite inventories falling -7%[2]. To wit, when asked about the price of crude being weak, Prince Abdulaziz bin Salman, Saudi's oil minister, recently replied, "It's not weak. People are pretending it's weak. It's all a ploy."[3] Fundamental equity investors appear to be taking the short-term volatility in stride as well potentially realizing that differences between the physical (healthy demand) and financial (lower *financial* demand) markets remain dislocated.

Early 2024 Outlook

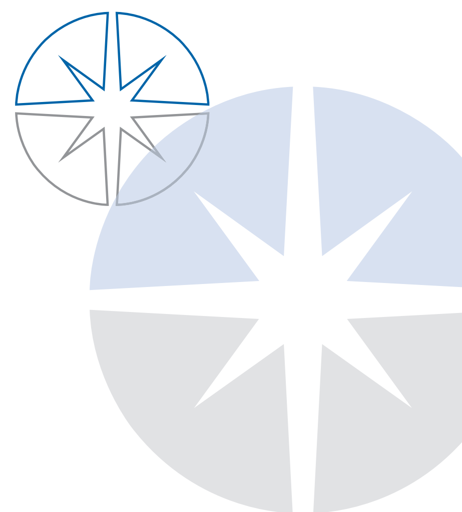
With much of the year completed, and allocators increasingly focused on the forward 12 months, we'll share some general expectations for Midstream in 2024. We expect healthy supply and demand fundamentals, which will keep EBITDA growth consistent with 2023 in the mid-single digits. However, we have the potential to see the second half of the year look more capacity constrained than the first half of the year, which could witness increasing tailwinds to profits through the year.

Not to be too, too early, but 2024 is going to increasingly gear us towards what we believe will be even stronger 2025 EBITDA growth. New liquefied natural gas (LNG) plants will begin to be placed in service at the end of 2024 and 2025 creating a giant

INVESTMENT TEAM

Geoffrey P. Mavar – Principal
Matthew G. Mead – Principal
Robert M.T. Walker – Principal
Bryan F. Bulawa – Principal

Scott B. Warren, CFA – Senior Analyst
Luke B. Davis, CFA – Senior Analyst



[1] This includes Crestwood Energy Partners LP (CEQP), which, due to its pending merger, was synthetically tied to Energy Transfer LP (ET) at the time of ET's announcement. This transaction has now closed.
[2] Wells Fargo Securities, LLC "Well(s) Refined", 11/10/23.
[3] Bloomberg LP, "Saudi Energy Minister Blames Speculators for Oil Price Drop", 11/9/23.

sucking sound for natural gas needing to leave the U.S. Gulf Coast, which will affect both domestic and international markets. Imbalances in the global natural gas liquids (NGL) market likely will persist in 2025 increasing the utilization of processing plants, pipelines, fractionators and export docks. Lastly, under-investment in global crude oil production also has the potential to rear its head even more strongly in 2025 according to our model, creating pricing incentivization to transport higher volumes seeking global markets.

We expect capital discipline, by and large, to remain consistent in 2024 as companies continue to realize they can create more cash flow with fewer investment dollars due to the fundamental support mentioned above, and the natural cycle of upward revisions to return on invested capital (ROIC) that is a present tailwind. Continued discipline could lead to incrementally higher growth in total return of capital from dividends/distributions and equity repurchases, which, similar to this year, would outpace base business cash flow growth, thus potentially supporting equity prices further.

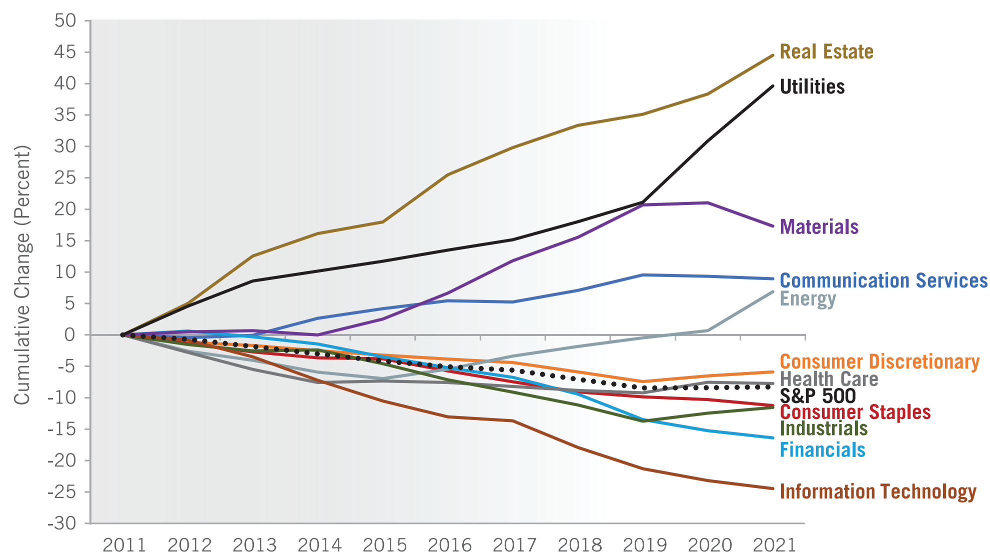
One final point: institutional investors continue to be under-allocated to energy/Midstream, or flat out "not in the trade". Based on our current activity with institutions, we are optimistic this may finally begin to reverse in 2024, which could help create value recognition for a persistently undervalued sector.

To Our Utility Investor Friends

Sorry, what you are about to read is not positive regarding the Utility sector. For those not paying as close attention as others, as of 11/10/23, the S&P 500 Utilities Sector GICS Level 1 Index (S500Util) is having a pretty terrible year decreasing -14.7% on a total return basis versus the AMZX increase of +22.9%. The earnings reports, by and large, remain "fine" due to the regulated nature of the assets and the pre-determined returns on equity (ROEs) earned. Whether the sector valuation trades above, below, close to the average or within a standard deviation range is also less interesting in terms of calling the future direction of the sector. However, we believe we are early in witnessing an unwind of the sector, sentiment broadly fading, and the potential for less funding going forward. Some of the lessons learned from the most recent 7-8 years of investing in Midstream point to more trouble ahead.

Pundits and Utility analysts will point to much of this year's decrease being attributable to the increase in interest rates, as the sector benefitted from positive correlation to rates during the low-rate period, and is now seeing the opposite effect. But what is most striking to us are the capital allocation and funding plans in the future. The Utility sector has already been the largest issuer of new shares (at higher valuations) to fund their rate-based asset additions over the past 10 years, particularly around wind and solar, as seen below[4].

Exhibit 8: Cumulative Change in Shares Outstanding by S&P 500 Sectors, 2011-2021



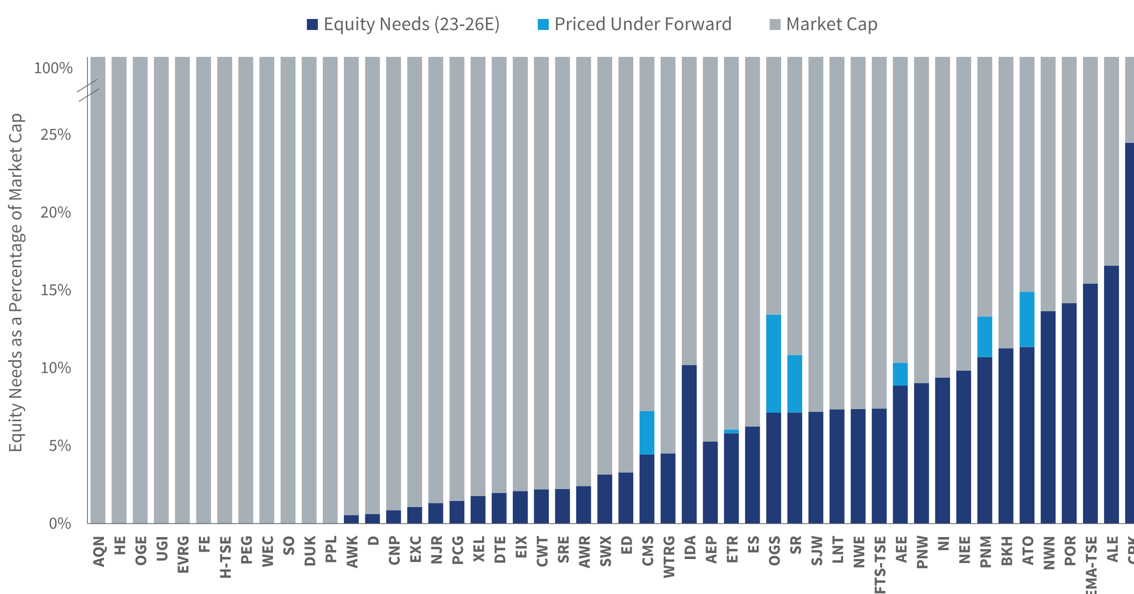
Source: Counterpoint Global Insights. Source notes, "FactSet and Counterpoint Global. Note: S&P 500 constituents, as of 8/31/23, that had data every year from 2011-2022; Reflects common shares used to calculate basic earnings per share".

[4] Counterpoint Global Insights, "Total Shareholder Return", 10/24/23.

However, management teams have only been able to manage spending in one direction—growth subsidized by low interest rates. Now they enter the rest of the 2020s at high leverage levels, higher financing rates, and a need to keep spending to keep pace with demand trends. Wells Fargo recently estimated their coverage universe needs to issue $38 billion of equity over the next 3 years just to fund equity requirements for future projects, not to reduce debt[5]. On a percentage basis, this only represents 4% of their coverage group's total market capitalization (not float adjusted), though results vary widely between companies. We think, more logically, that $38 billion represents 3x the net assets of the Utilities Select Sector SPDR Fund (XLU), the largest ETF that tracks the sector, and we're less sure more fundamental investors are willing to finance low to no growth given the challenges the sector faces.

Equity Market Risk Exposure 2023–2026E

$38B New Equity Needed, in our View



Source: Wells Fargo Securities, LLC. Source notes, "Company filings/disclosures and Wells Fargo Securities, LLC estimates. Notes: PNM is based on standalone plan - AGR merger offsets the need; AGR is excluded as asset sales are contemplated to mitigate external equity needs; 'D' is subject to strategic review".

We have a few takeaways from Utilities' present condition. If one takes "the under" on this sector raising substantial equity, or, worse, if investors demand lower leverage levels like what the market did to Midstream in recent years, and we're hearing early rumblings of, the inevitable implication is we could see business financial model repositioning for certain companies. The first logical area to be cut will be growth capital investments, which will likely decrease energy transition investments, thus also slowing down alternative energy adoption as a second order effect. Lower cash flow growth due to fewer asset investments placed in service would then likely slow dividend growth rates, a negative to valuations for investors expecting continued dividend growth.

Second, we expect to see asset sales to help fund equity needs, hopefully that are leverage accretive, though the first few we've witnessed leave that topic up for debate. The early sales have been mostly Midstream or Midstream-adjacent businesses, and more sales could be favorable for Midstream companies seeking to bolster their franchises. As an example, on November 6th, Kinder Morgan Inc. (KMI) purchased STX Midstream from NextEra Energy Partners LP (NEP) for $1.8 billion, and an attractive 8.6x enterprise value to EBITDA (EV/EBITDA). The positioning of this asset within KMI's overall asset profile led them to disclose they believe the multiple could work down to 7.0-7.5x in future years.

[5] Wells Fargo Securities, "Figure of the Week: Assessing Equity Needs", 10/20/23.

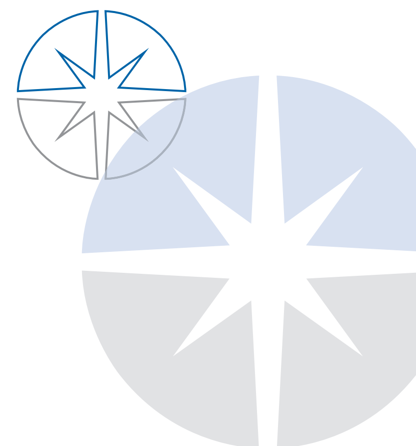
Last (and we'll figuratively whisper this one), beyond dividend growth being eliminated you could see some dividends reposition lower as companies seek equity in any form. This is a low odds scenario at the moment. But past history shows us all it takes are a few cracks to move sentiment further out to sea, and force Utilities to disprove a negative for longer than they have time incrementally pulling levers they didn't intend to pull including sacrosanct, current dividend payouts. The longer they are at lower valuations, it becomes a vicious negative feedback loop of taking de-leveraging measures other than selling unattractively priced equity. This typically takes years.

Thankfully, Midstream is on the other side of this outlook after many years. Below is a quick compare and contrast for those investors still holding on to Utility ETFs, SMAs, or companies, and who might need to take a closer look at the Midstream sector.

	AMZX	**S5Util**
2024e Yield*	8.3%	4.0%
2024e FCF Yield*	12.0%	-1.1%
Balance sheet leverage	Below normal	Above normal
Equity Status	Buyback	Issuance
Assets for Sale	Advantaged buyer	Potential price taker

*Bloomberg, LP as of 11/10/23.

Geoffrey Mavar   Matt Mead   Robert Walker   Bryan Bulawa



Chickasaw Capital Management, LLC gives no guarantees with respect to the success of its investment management services and has not authorized any person to represent or guarantee any particular investment results. Any historical data provided herein are solely for the purpose of illustrating past performance and not as a representation or prediction that such performance could or will be achieved in the future. Securities are subject to numerous risks, including market, currency, economic, political and business risks. Investments in securities will not always be profitable, and investors may lose money, including principal. Past performance is no guarantee of future results. This is not an offer or solicitation with respect to the purchase or sale of any security.

Chickasaw Capital Management, LLC does not provide legal, tax or accounting advice. Any statement contained in this communication concerning U.S. tax matters is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties imposed on the relevant taxpayer. Clients of Chickasaw Capital Management, LLC should obtain their own independent tax advice based on their particular circumstances. Opinions expressed are current opinions as of the date appearing in this material only. No part of this material may be copied, photocopied or duplicated in any form, by any means, or redistributed without the prior written consent of Chickasaw Capital Management, LLC.

References to market or composite indices, benchmarks or other measures of relative market performance over a specified period of time (each, an "index") are provided for your information only. Reference to this index does not imply that the portfolio will achieve returns, volatility or other results similar to the index. The composition of the index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which are subject to change over time. Indices are unmanaged. The figures for the indices do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices.

The Alerian MLP Index is a composite of the most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis (NYSE: AMZ), and the corresponding total-return index is disseminated daily (NYSE: AMZX). Relevant data points such as dividend yield are also published daily. For index values, constituents, and announcements regarding constituent changes, please visit www.alerian.com.

"Alerian MLP Index", **"AlerianMLP Total Return Index"**, **"AMZ"** and **"AMZX"** are service marks of GKD Index Partners, LLC d/b/a Alerian ("Alerian") and their use is granted under a license from Alerian. Alerian does not guarantee the accuracy and/or completeness of the Alerian MLP Index or any data included therein and Alerian shall have no liability for any errors, omissions, interruptions or defects therein. Alerian makes no warranty, express or implied, representations or promises, as to results to be obtained by Licensee, or any other person or entity from the use of the Alerian MLP Index or any data included therein. Alerian makes no express or implied warranties, representations or promises, regarding the originality, merchantability, suitability, non-infringement, or fitness for a particular purpose or use with respect to the Alerian MLP Index or any data included therein. Without limiting any of the foregoing, in no event shall Alerian have any liability for any indirect, special, incidental, or consequential damages (including lost profits), arising out of the Alerian MLP Index or any data included therein, even if notified of the possibility of such damages.

The Energy MLP Classification Standard ("EMCS") was developed by and is the exclusive property (and a service mark) of GKD Index Partners, LLC d/b/a Alerian ("Alerian") and its use is granted under a license from Alerian. Alerian makes no warranties, express or implied, or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and hereby expressly disclaims all warranties of originality, accuracy, completeness, merchantability, suitability, non-infringement, or fitness for a particular purpose with respect to any such standard or classification. No warranty is given that the standard or classification will conform to any description thereof or be free of omissions, errors, interruptions, or defects. Without limiting any of the foregoing, in no event shall Alerian have any liability for any indirect, special, incidental, or consequential damages (including lost profits), arising out of any such standard or classification, even if notified of the possibility of such damages.

S&P 500 Utilities comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

Utilities Select Sector SPDR® Fund seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the Utilities Select Sector Index.

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.

Correlation measures the extent of linear association of two variables.

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.

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.

Return on Equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE is considered the return on net assets.

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.

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

This material is provided for informational and educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell any security, product or service.

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.