Chickasaw Capital Management

Weekly Midstream & Market Pulse

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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
Rahil Jiwan – Senior Analyst
Walter P. Frank – Associate Analyst

Weekly Volatility

The Alerian MLP TR Index (AMZX) had a poor showing this week, declining (12.3%). Through Monday the AMZX was up 18.1% month-to-date for June. The cumulative (6.8%) pullback on Tuesday and Wednesday was attributed to profit-taking and "cooling off", according to market 'pundits'. However, the outsized (10.1%) decline experienced Thursday was partially wrapped up in broader market declines – the S&P 500 was down (5.9%) – which placed blame on Fed comments that the economic recovery could take longer and we should expect a second wave of viral resurgence. This excuse feels convenient and masks technical factors, which in our opinion were setting the stage for some time.

We believe the more extreme sell-off in Midstream on Thursday can be attributed to an outsized equity offering by ONEOK Inc (OKE, $34.09). The action by OKE caused sales in other securities to create cash to participate in the offering, and market conversations indicated there are also concerns that more offerings could be in the works. We don't believe this is the case, or, if there are others, they'll be discrete.

Equity Offerings

It seems as though any time a single event occurs, particularly from a large capitalization or well-known company, investors tend not to treat the news idiosyncratically, but rather "who's next". This appears to be particularly prevalent in periods of market dislocation or uncertainty, and is akin to the question that began this newsletter series, "what am I missing". Such was the case this week with OKE's $832 million equity offering which priced June 11th at a 24% discount to the prior day's close.

It's been previously discussed in these newsletters that Midstream companies have several levers to pull to protect their cash flow and balance sheets as a result of the Midstream 2.0 actions taken post-2016. These include: reducing capital expenditures, reducing selling general and administrative (SG&A) and operating expenses, improving asset efficiency and utilization, discounted debt re-purchases, dividend reductions, and other levers, of which we placed equity offerings into "other" because we did not think companies would choose to issue equity at historically low prices. The recent sector rally has improved that potential option for certain companies and our opinion is OKE chose to take advantage of current conditions.

Since early March, we estimate Midstream companies have reduced 2020e growth capital expenditures by at least $7 billion, total annualized expenses at least $4.4 billion, and annualized distributions and dividends by $4.8 billion. As indicated in our lead sentence for this section, we think the OKE offering is unique to their profile. They were one of the few, remaining companies that needed additional balance sheet protection to manage leverage below 5.0x, which the offering accomplishes. Observing sell-side research reports, analysts had been estimating a dividend reduction to shore-up the balance sheet, so instead choosing to add a very high cost of capital equity offering that we estimate is 6-7% dilutive caught the market off-guard, which unfortunately spilled into other Midstream securities broadly.

Reiterating comments made in prior newsletters, during and since the end of 2019 we have continued high-grading our portfolio holdings and weights to have an even stronger balance sheet focus, diversity of assets, and increased cash flow stability, which we believe has it appropriately positioned within our conservative expectations.

Recent Debt Capital Markets Activity

While the market was not ready for an equity offering, the debt markets showed strong receptivity to Plains All American Pipeline LP's (PAA, $9.73) offering on Monday, June 8th. The company launched 10-year notes at $500 million, which was upsized to $750 million, and the final coupon was 3.8%. From a market perspective, the spread to the 10-year Treasury was 2.92%[1], which was in line with other recent offerings from Magellan Midstream Partners LP (MMP, $43.56) and Williams Cos Inc (WMB, $18.23), and well inside the 5.71% spread-to-treasury OKE priced its 10-year debt at on May 4th.

Where Do We Go from Here?

Referencing Monday's AMZX level of 938.88 as a near term high, the price to distributable cash flow (P/DCF) valuation was still only 5.2x versus the 2008 historical low of 5.6x. As of Friday, June 12th, the P/DCF was lower at 4.5x. Our bear case scenario is that we're already there given we are below data-set lows (end of 2007 to present). Our base case assumes we have 24.4% upside to 5.6x, which excludes the receipt of dividends and distributions (~10% at current). Our bull case assumes an 8.0x multiple implying 77.8% upside, also excluding receipt of income, and which is still 27.5% below the long-term average since 2007 of 10.2x.

It would be short-sighted to assume volatility, such as was seen this week, has disappeared. However, we believe both the fundamental and technical worries remain over-emphasized relative to current valuation levels.

Geoffrey Mavar Matt Mead Robert Walker Bryan Bulawa

(1) Bloomberg, LP

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