Chickasaw Capital Management

Weekly Midstream & Market Pulse

JULY 26, 2020

Which Half?

Is the glass half empty or half full? Either way, 50% of the glass contains water, and 50% does not. It is merely perspective that determines if the 50% containing water is more important than the 50% that is absent water. Perspective is unique, however, in that it is most often derived from past personal experience.

How did we get here?

While many investors in general entered 2020 expecting this to be quite a different year, it seems that feeling is particularly universal to Midstream investors. After a strong start to January, the broader Energy patch felt the international effects on demand from COVID-19 before the rest of the markets and pulled the Midstream space down in concert. This COVID-induced weakness was then exacerbated by infighting between the Organization of the Petroleum Exporting Countries (OPEC) and Russia. As Midstream security prices tumbled and liquidity dried up, there were forced liquidations from levered financial products holding these securities as well as other levered strategies. While fund flow data confirms the liquidations spanned across a multitude of financial products, these forced security sales were most notable from closed-end funds carrying leverage. What began as demand and supply uncertainty (COVID-19 & OPEC infighting, respectively) and was furthered by technical pressure from the forced liquidations, eventually culminated with a year-to-date low of -66.8% on 3/18/2020 for the Alerian MLP Total Return Index (AMZX).

What was the response?

In response, the Energy sector jumped to action. The expectations for future demand, at that time, led many in the upstream community, including OPEC and Russia, to quickly reduce production volumes. The need to reduce production or comply with production quotas was reinforced as the world averted a crisis of running out of storage tank capacity, which forced the generic front-month contract of WTI into unprecedented, negative territory. This crashing of physical and financial markets was jaw-dropping, but stems from a simple problem: supply and demand for storage capacity. Speculators and market participants had no place to put contracted deliveries, and as such they were forced to pay other market participants to take over their contracts.

Midstream operators similarly acted swiftly in the face of uncertainty and were able to flexibly adjust their financial response due to the benefits of Midstream 2.0. The characteristics of Midstream 2.0 companies include the hallmarks of: 1) No incentive distribution rights (IDRs); 2) Higher coverage ratios; 3) Higher excess cash retention for capital flexibility; and 4) Lower balance sheet leverage. The vast majority of Midstream companies had already initiated and completed a transition to Midstream 2.0, which involved several years of carefully monitoring cash flow growth, distribution policies, capital expenditures, and leverage.

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PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

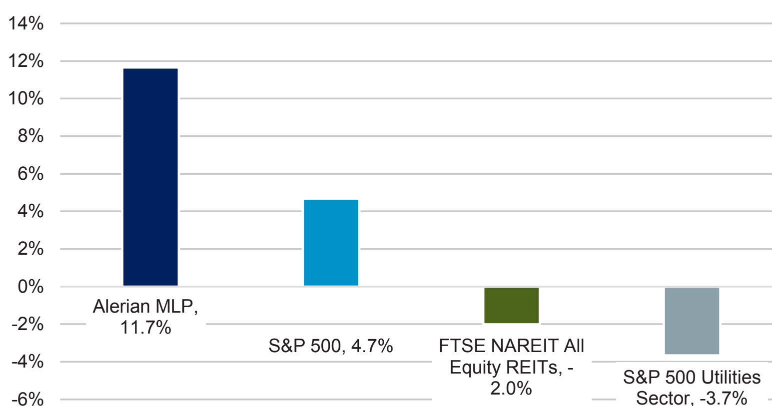
A minority of Midstream companies were just exiting the reformation stage in their transition to Midstream 2.0 when the current period arrived. This group of operators "hasn't let a good crisis go to waste" and has prudently shifted their capital allocation policy to lower the current yields, some of which had climbed well above 60%, in order to favor cash retention and leverage reduction. In addition to selective distribution policy changes, Midstream operators, almost universally, enhanced their cash retention as they chose to lower capital expenditures by approximately 38% year-over-year. In effect, current market volatility has expedited the Midstream 2.0 transition for some companies that had just recently reformed, and it has reinforced the key tenets of Midstream 2.0 for almost all management teams.

What about the fundamentals?

Amid the technical pressure in the Midstream space, it was easy to forget about the fundamentals. The fundamentals, however, arguably constitute one of the most amazing elements of this downturn. The demand impacts were, and remain, somewhat uncertain, though we have received more clarity throughout this cycle and the EIA is currently projecting demand declines of less than 10% for 2020, year-over-year. Meanwhile, the producer supply responses were material and have, so far, outweighed the degradation in demand. In fact, by the end of Q1 earnings calls, Midstream operators were already discussing producers turning back on previously curtailed production volumes. This is also evidenced in EIA data that is published monthly. Prices are expected to stay lower in the near term, though, as the global market continues working through inventories that accumulated when demand began its precipitous fall.

In Midstream, it's true that companies derive the majority of their cash flows from fee-based, multi-year contracts, which often carry minimum volume commitments. This contracting structure helps provide security to the cash flows a Midstream operator will earn for outlaying the capital to transport/process/store hydrocarbons for a counterparty. These contracts were built with environments like these in mind, they were tested during this downturn, and they yet again proved their durability. As a result, the AMZX is projected to see cash flow degradation of only 10% in 2020 and is expected to remain essentially flat in 2021. Obviously, those metrics are a far cry from the 66.8% market price decline that the AMZX experienced earlier in the year. This cash flow profile is supporting a yield of nearly 12.1% in 2020 for the index, and that distribution yield enjoys a 1.8x coverage ratio for 2020, which is an all-time high for the index.

The excess, undistributed cash flow would typically be earmarked for capital expenditures and leverage reduction, but the CapEx reductions have allowed much more of the "free cash flow" to be used for leverage reduction. Eventually, leverage should reach a point at which a company can switch from targeting reduction to targeting leverage maintenance, and it is at this point that the company can then focus on one of the ultimate benefits of Midstream 2.0: driving shareholder total returns. And, there is now additional flexibility to achieve this, as companies can not only embrace the prior method of increasing distributions, but now, and very importantly, can also engage in share and unit repurchases.

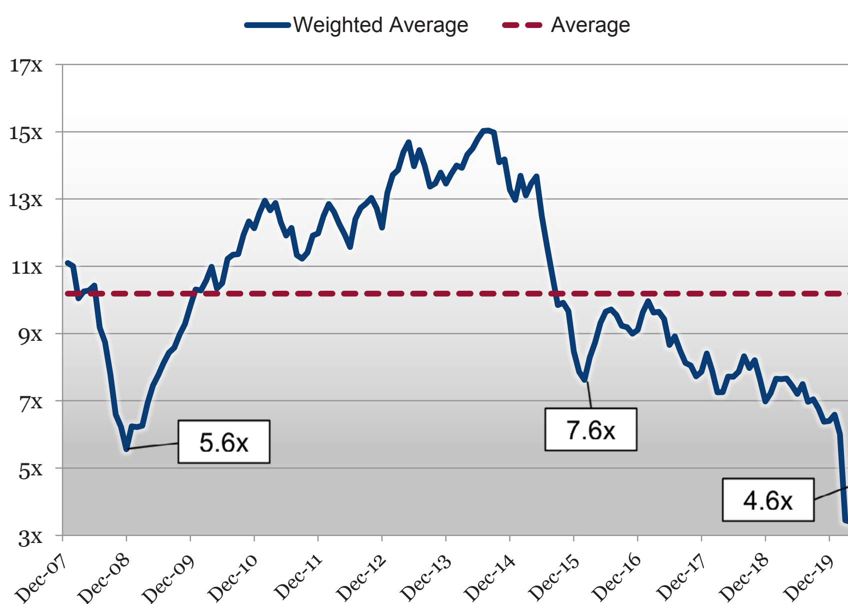


Source: Bloomberg, LP

Have I missed it?

Although Midstream companies generally bottomed in early April and have rebounded higher thereafter, the space, as measured by the AMZX, still remains down 37.4% for the year, which does not comport with the previously discussed supply-demand dynamics or Midstream fundamentals. As of the end of June, the Alerian price-to-distributable cash flow remained 22% below the 2008 market low, 122% below the long-term average (January 2008 to June 2020), and 226% below the all-time high set in September, 2014. While we believe these metrics indicate a drastically undervalued asset class, it is also important to keep in mind that most of this time series was generated using a Midstream 1.0 operating framework and it is possible the efficiencies gained from a transition to Midstream 2.0 may command a premium to prior market multiples.

Alerian Weighted P/DCF (Dec '07 – Jun '20)



Average = 10.2x | Current = 4.6x | Minimum = 3.4x

Bloomberg, Chickasaw

To that end, Warren Buffett seemed to recognize the value, as he recently made his second large investment in Midstream energy infrastructure, and first since 2002. The Buffett-backed Berkshire Hathaway Energy deployed approximately $10 billion of capital to purchase natural gas infrastructure assets from Dominion Energy, and assume a portion of Dominion's debt to aid in the utility's efforts to clean up its balance sheet. Importantly, this acquisition makes Berkshire Hathaway Energy a formidable player in the natural gas infrastructure world, bringing its footprint up to transporting roughly 18% of domestic natural gas, from 8% previously. Buffett, who is widely known for purchasing assets at a discount to market multiples, may have actually paid a higher-than-current-market multiple for these assets, when considering the excess debt he assumed in the deal. We estimate this transaction implies 6.0x debt to earnings before interest, taxes, depreciation and amortization (debt/EBITDA) leverage versus similarly positioned public Midstream companies that typically employ 4.25-4.50x leverage.

Where to from here?

We have long stated, *we believe it would be hard for these companies to continue to go unnoticed by the broader marketplace, given their attractive cash flow generation profiles.* For new Midstream investors evaluating their own capital allocation decisions, we usually find they bring a perspective of optimism. Similar to Warren Buffett, they tend to look favorably at the underlying fundamentals, especially in the context of how well the recent downturn was navigated by Midstream operators. For them, the glass is half full with currently low valuations and a potentially bright future ahead. Conversely, some of the investors with existing Midstream allocations share a different perspective, focusing more on the half empty portion of the glass. Unlike Warren Buffett, the fundamentals are not the focal point for many of these investors; it tends to be the price performance of the space, which as we illustrated above and in many publications before, we believe has not aligned with the underlying fundamentals. We think this is by definition market inefficiency, which is, according to many, rarely seen and one of only a handful of ways to generate above-market returns. While we are not foolhardy enough to pretend we can project when the broader market will recognize the value and strength in this asset class, we do feel confident and comfortable that both exist.

Geoffrey Mavar Matt Mead Robert Walker Bryan Bulawa

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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.

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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.

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.

EBITDA is earnings before interest rates, taxes, depreciation and amortization.

Growth Capital Expenditures or Growth CapEx or GCX refers to the aggregate of all capital expenditures undertaken to further growth prospects and/or expand operations and excludes any maintenance and regulatory capital expenditures.

Incentive Distributions Rights (IDRs) allow the holder (typically the general partner) to receive an increasing percentage of quarterly distributions after the MQD and target distribution thresholds have been achieved. In most partnerships, IDRs can reach a tier wherein the GP is receiving 50% of every incremental dollar paid to the LP unitholders. This is known as the 50/50 or "high splits" tier.

Leverage is net debt divided by EBITDA.

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 unit price at a particular point in time.