Chickasaw Capital Management

The Evolution of Midstream Energy Infrastructure: Poised for the Transition

EPISODE 11

Midstream Capital Structure

JUNE 2024

CONFIDENTIAL

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Capital Allocation

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As management teams consider the future evolution of capital allocation in the space, we believe they can create value by:

Executing on accretive projects and *disclosing* the accretion to investors

Increasing dividends and distributions back to the point of *Free Cash Flow, or* ***"F C F"***, neutrality

Using balance sheet flexibility to repurchase equity

The Capital Allocation Hierarchy

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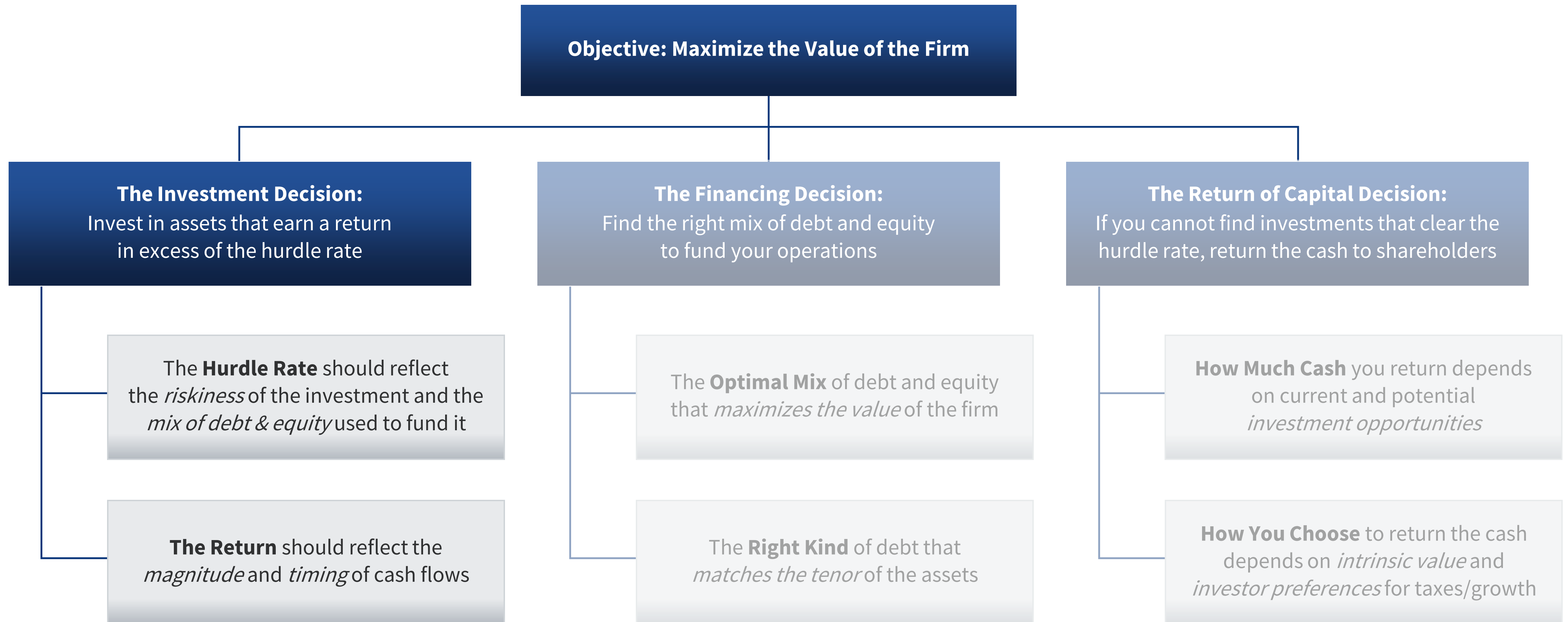

Adopted from Aswath Damodaran, Musings on the Market “Data Update 7 for 2023: Dividends, Buybacks, and Cash Flows”; March 8th, 2023

Midstream EVA Spread (2023)

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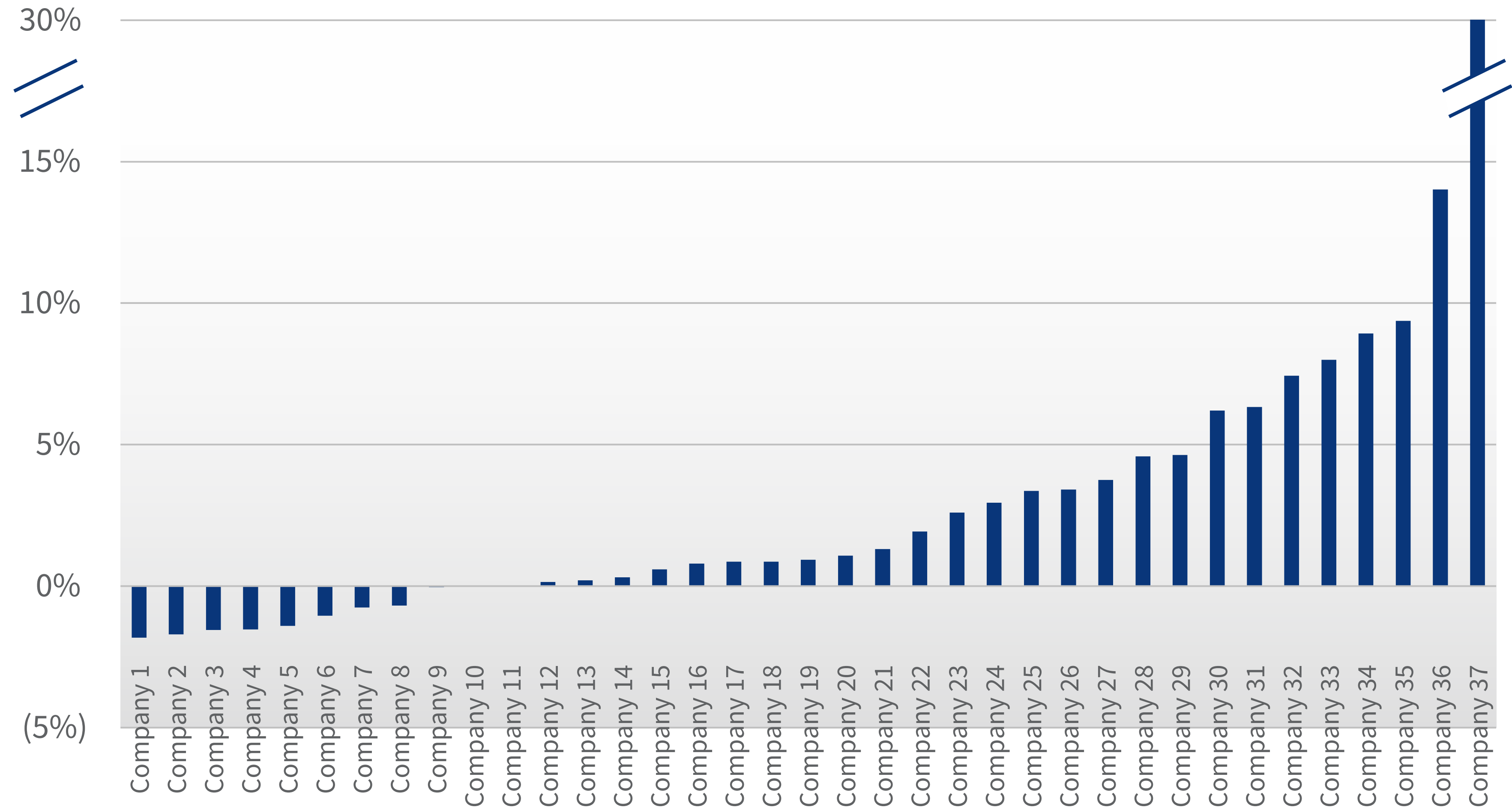
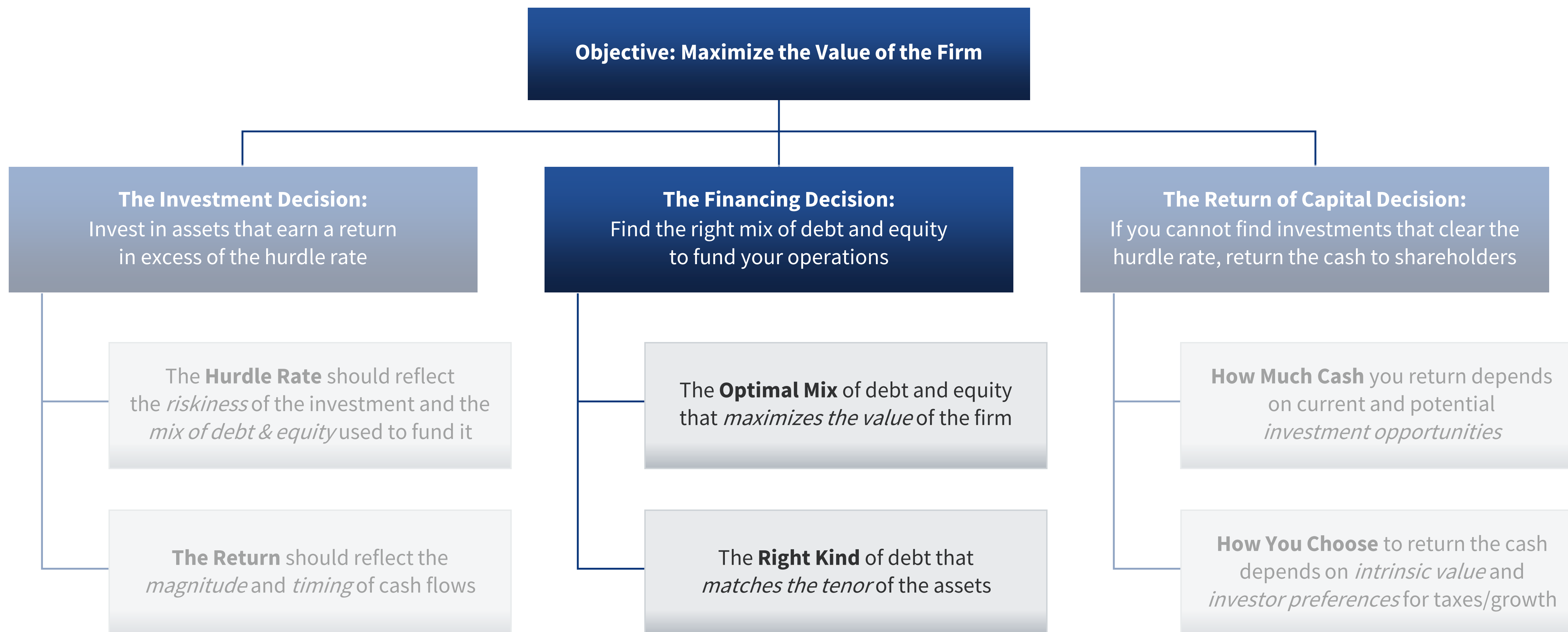
Nearly 90% of Midstream companies created positive Economic Value Add "EVA" in 2023 with 54% more than 200 bps.



Source: SEC filings, Bloomberg L.P., CCM

The Capital Allocation Hierarchy



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Weighted Avg. Cost of Capital vs Leverage

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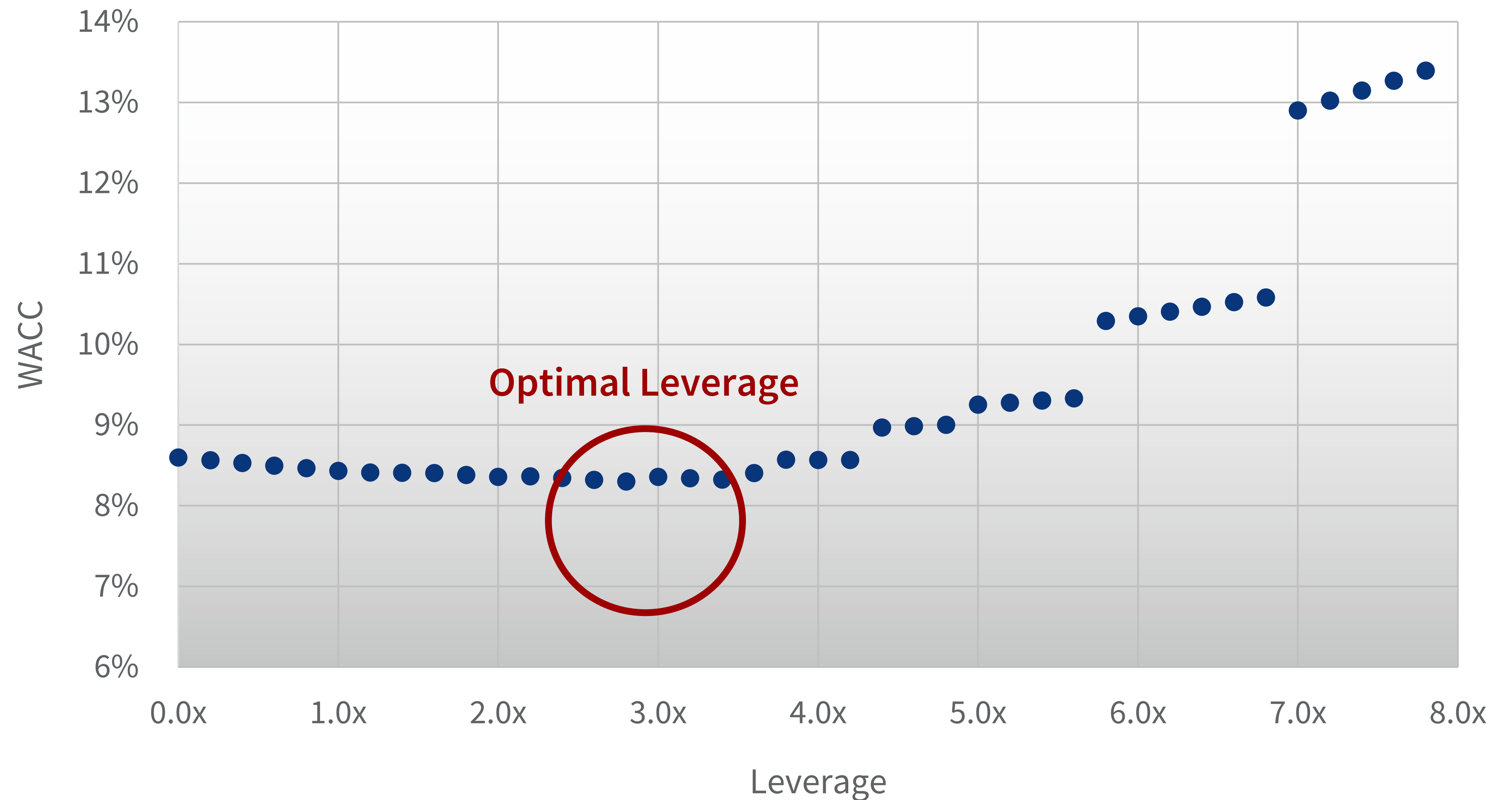
The optimal capital structure can be found at the point where the tax savings from debt are maximized relative to the increasing cost of bankruptcy from issuing more debt.

Increasing/ Decreasing leverage above/below the optimal level will increase the WACC.



Example provided for illustrative purposes only.

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Free Cash Flow After Distributions “FCFaD”

Cash Flow from Operations

(-) Capital Expenditures

Free Cash Flow

(-) Distributions

Free Cash Flow After Distributions

(-) FCFaD = Capital Raise

(0) FCFaD = Natural Leverage Reduction

(+) FCFaD = Accelerated Leverage Reduction and/or Share Repurchases

Consensus Leverage (Year of Estimate)

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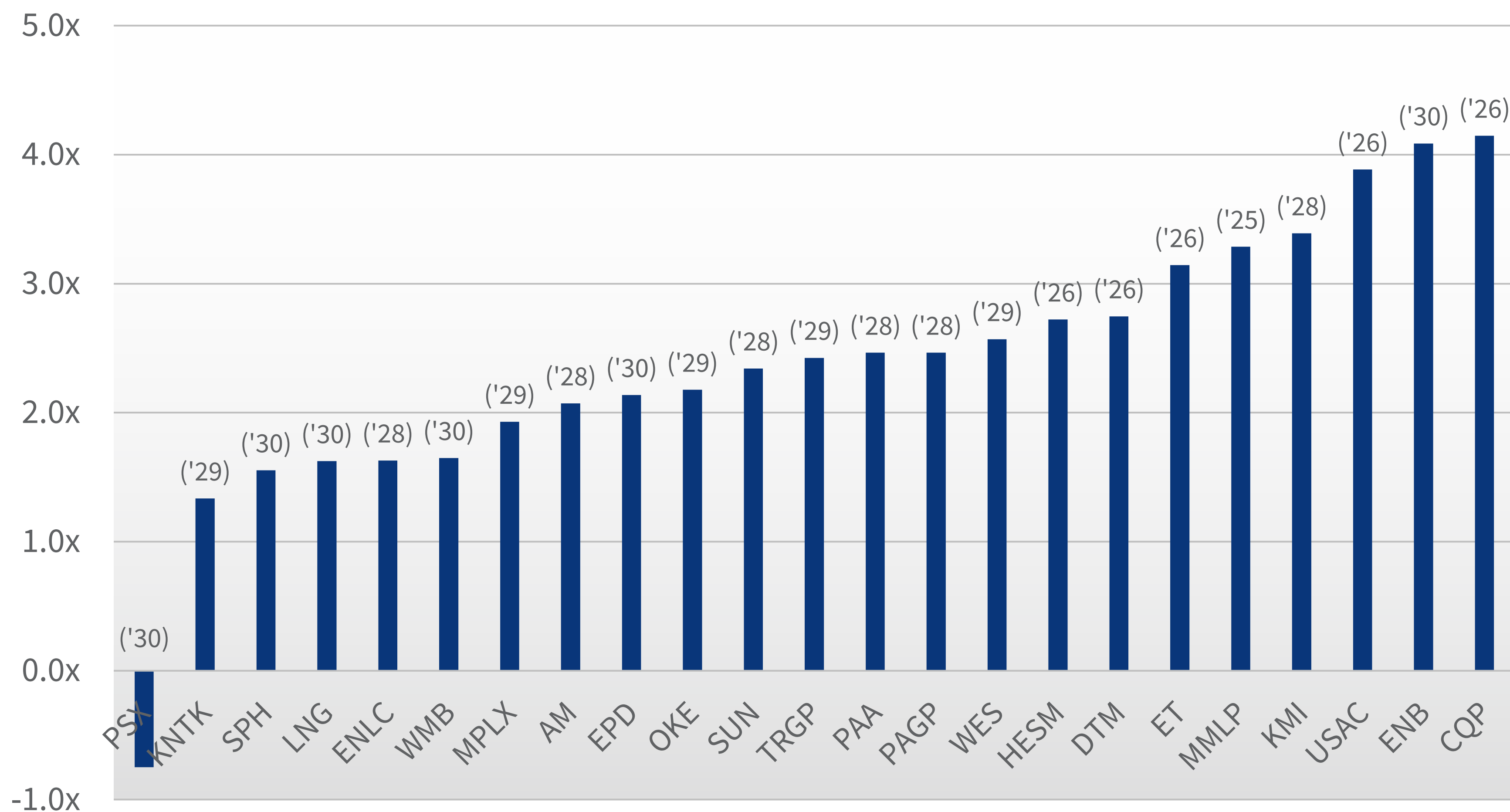
Continued estimates call for continued de-leveraging through the end of the decade.

~74% of the names with estimates at least two years out have leverage below 3.0x, which is the low end of many companies' long term guidance ranges.



Source: SEC filings, Bloomberg L.P., CCM

Increasing Capex to Optimize Leverage

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The larger a firm becomes, the harder it can be to increase leverage to optimal levels given the issue of scale.

For example, an $8.0bn company earning a 14% return on investment would need to spend an equivalent amount per year in capex to maintain leverage.

Beginning EBITDA	8,000
Capex	8,000
Return	14%
New EBITDA	**$9,143**

Beginning EBITDA	8,000
Dividends and Interest	(4,000)
Capex	(8,000)
FCFaD	**(4,000)**

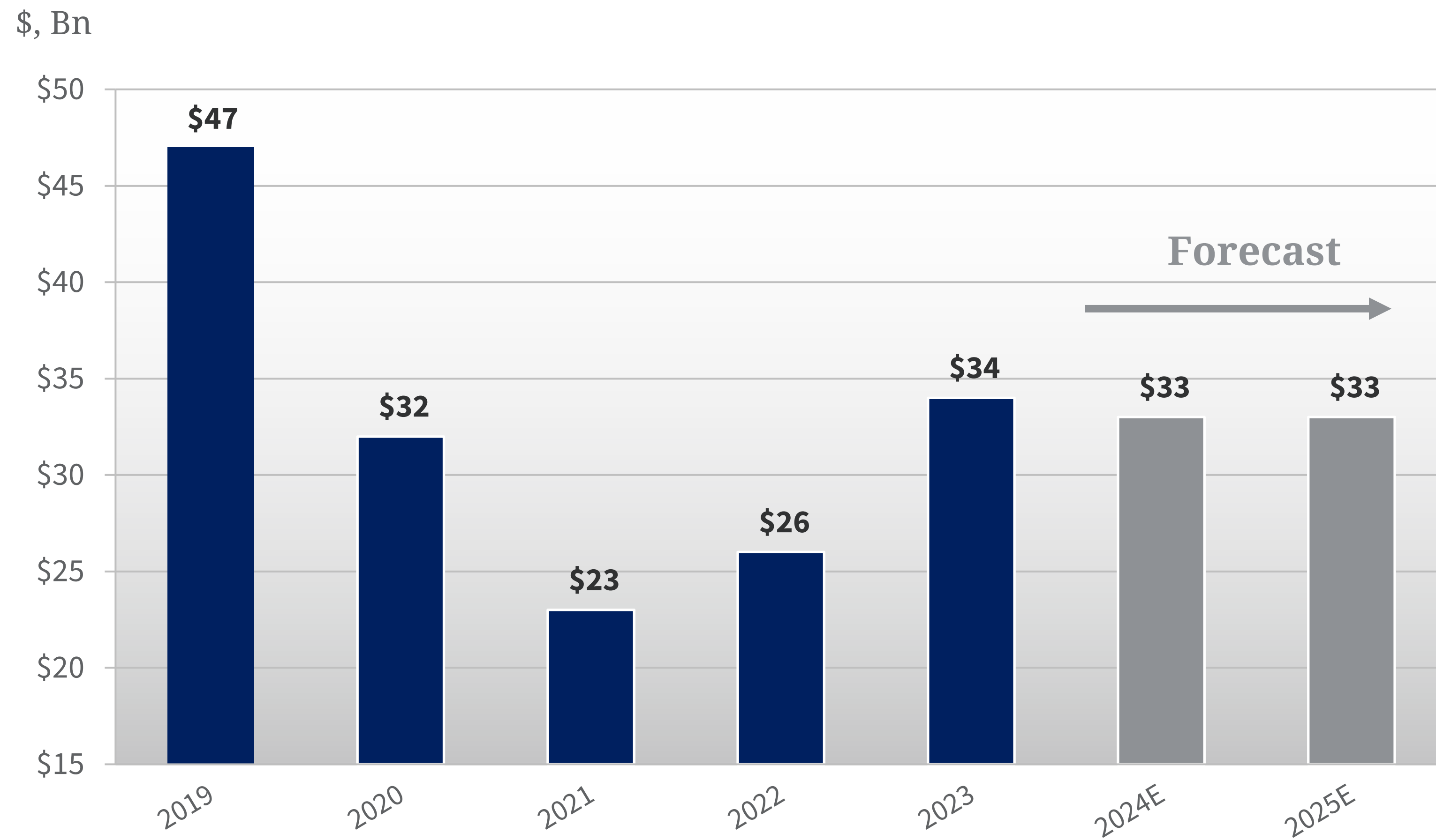
Beginning Debt	28,000
Debt Raise	4,000
Ending Debt	**32,000**

Beginning Leverage	3.5x
Ending Leverage	**3.5x**

Example provided for illustrative purposes only.

Midstream CapEx Forecast

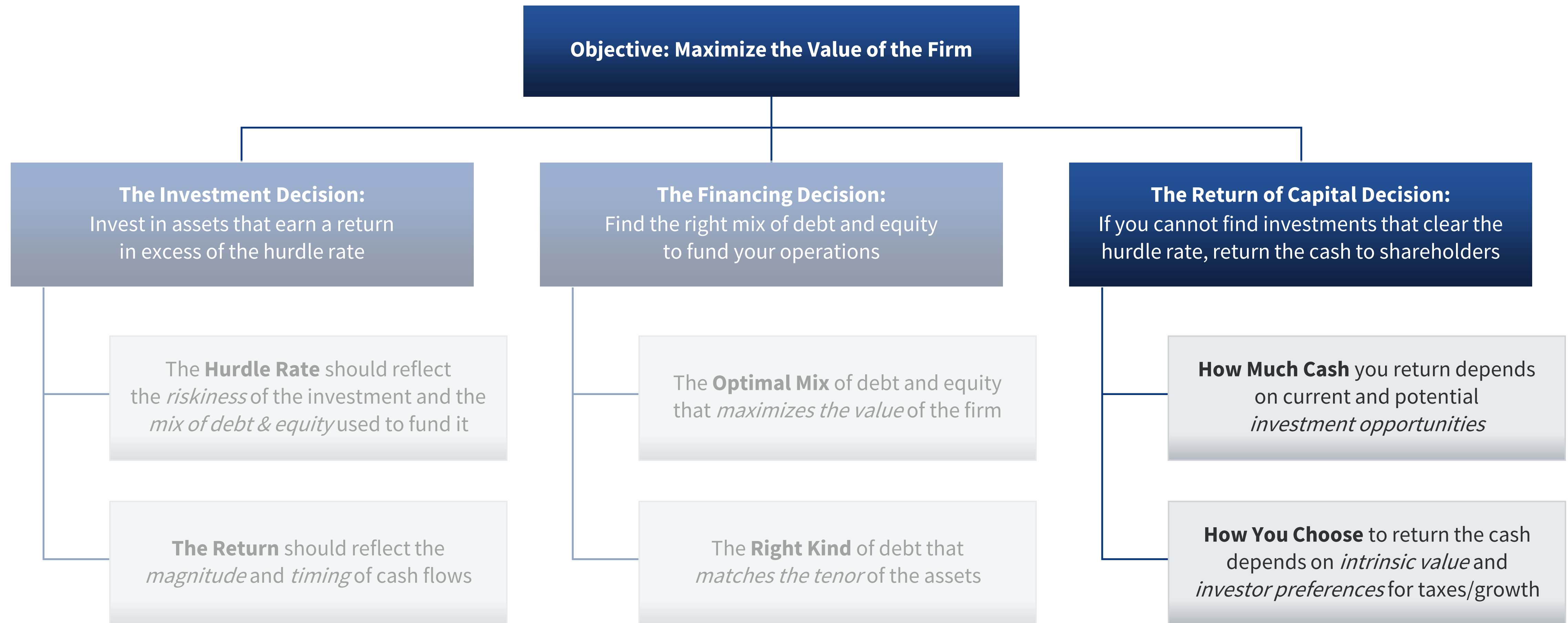
$8bn in capex from a single firm would represent ~25% of the entire industry’s annual capex budget.



Source: Wells Fargo Securities Equity Research, April 3, 2024.

Data for periods is presented as an estimate where indicated as companies have not reported financial results for the period.

The Capital Allocation Hierarchy



Adopted from Aswath Damodaran, Musings on the Market "Data Update 7 for 2023: Dividends, Buybacks, and Cash Flows"; March 8th, 2023

The Return of Capital Decision

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Buybacks can have an impact on each of the 3 capital allocation decisions, which in turn influence valuation.

- **Investment decision** → returning cash back to shareholders in the form of a repurchase is a better alternative than investing in projects that do not add EVA
- **Allocation decision** → buybacks can help maintain optimal leverage of the firm while not sacrificing financial flexibility
- **Return of capital decision** → buybacks can act as a transfer of value from selling shareholders to remaining shareholders when executed at a price below intrinsic value

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Additional Information

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.

Cash Flow from Operations (CFFO) indicates the amount of money a company brings in from its ongoing, regular business activities, such as manufacturing and selling goods or providing a service to customers.

Distributions are quarterly dividend payments 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, 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. *FCFaD* is free cash flow after distributions.

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.

Intrinsic Value is a measure of what an asset is worth. This measure is arrived at by means of an objective calculation or complex financial model. Intrinsic value is different from the current market price of an asset. However, comparing it to that current price can give investors an idea of whether the asset is undervalued or overvalued.

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 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).

Weighted average cost of capital (WACC) represents a company's average after-tax cost of capital from all sources, including common stock, preferred stock, bonds, and other forms of debt. As such, WACC is the average rate that a company expects to pay to finance its business.

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