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TLLP - Q2 2016 Tesoro Logistics LP Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Tesoro Logistics second quarter 2016 earnings conference call. At this time all participants are in a listen only mode. Later we will conduct a question and answer session and instructions will follow at that time.

(Operator Instructions)

As a reminder, this call is being recorded. I would now like to introduce your host for today's conference, Mr. Evan Barbosa, Investor Relations Manager. You may begin, sir.

Evan Barbosa - *Tesoro Logistics LP - IR*

Good morning and welcome to today's conference call to discuss our second quarter 2016 earnings. Joining me are Greg Goff, Chairman and CEO; Phil Anderson, President; and Steven Sterin CFO. The earnings release which includes financial disclosures and reconciliations for non-GAAP financial measures should help you in analyzing our results and can be found on our website at TesoroLogistics.com.

I would like to point out that starting this quarter, TLLP will no longer be reporting adjusted EBITDA and adjusted distributable cash flow, but will continue to highlight significant items impacting quarterly results to help you analyze our performance. Further explanation can be found in the earnings release issued yesterday. Please refer to the forward-looking statements in the earning release, which says statements made during this call that refer to management's expectations, and/or future predictions are forward-looking statements, intended to be covered by the Safe Harbor provisions of the securities net as there are many factors that could cause results to differ from our expectations.

Now I will turn the call over to Phil.

Phillip Anderson - *Tesoro Logistics LP - President*

Thanks, Evan. Good morning and thank you for joining us today. I will review our second quarter performance and then the turn the call over to Greg.

Yesterday, we reported second quarter net earnings with $83 million, an increase of 24% from a year ago, and EBITDA of $172 million, an increase of 15% from a year ago.

For the second quarter, net cash from operating activities was $91 million, an increase of 40% from a year ago, and distributable cash flow was $126 million, an increase of 42% from a year ago. The improvements in our financial results reflect the progress on our strategy to grow the business through optimization, organic investments, and strategic acquisitions, which I will cover in a moment.

On July 20, we announced our second quarter distribution of $0.842 per limited partner unit, or $3.368 cents per unit on an annualized basis, which was our 21st consecutive quarterly distribution increase of approximately 4% or more and represents the 17% year over year increase.

With this distribution, our distribution coverage ratio was 1.02 times for the second quarter and 1.18 times on a trailing 12 months. Also during the quarter, we successfully accessed capital markets through new offerings of debt and equity, raising approximately $1 billion to fund the growth of the business. I would like to point out that our distribution coverage ratio was impacted with the successful issuance of 6 million new public units in June and the issuance of units to Tesoro on July 1 as part of the acquisition of the Alaska assets.

Now turning to our operations for the second quarter. In our gathering segment, operating income declined by $9 million to $36 million, and segment EBITDA declined $10 million to $53 million, compared to the second quarter of last year. Most of the year on year variance reflects the de-consolidation of our RGS joint venture and the recognition of historical minimum volume commitment revenues during last year's quarter.

Crude oil gathering volumes grew year over year on our North Dakota system with throughput of approximately 208,000 barrels per day. Volumes increased approximately 11% year on year, primarily due to customer demand for deliveries to regional takeaway pipelines.

Later this quarter, we expect to complete one new inbound pipeline interconnect with two more in the fourth quarter, including an interconnect with Tesoro's BakkenLink pipeline.

We expect these projects to bring increased volumes, expand the capability of our system, and capture the continued demand to move barrels towards regional takeaway pipelines. Moving to crude oil trucking, the segment has performed in line with our guidance. We expect to grow volumes in the third quarter as Tesoro's acquisition of the Dickinson, North Dakota, refinery provides incremental demand for truck barrels.

Shifting to natural gas gathering, throughput in the second quarter was 854,000 MMBTU per day, compared to just over 1 million MMBTU per day in 2015. But the 2015 throughput includes 146,000 MMBTU per day, related to third-party RGS volumes that are no longer consolidated in our results.

In line with our expectations during the second quarter, we saw producers defer completion of the wells drilled over the winter months as natural gas values continued to decline. We expect volumes to increase over the next few months as we now see producers bringing those wells online.

We're also making progress with compression projects in all three of the drilling areas within our Rockies footprint, which we believe will support volumes going into 2017. In the processing segment, we grew operating income by $3 million to $27 million, and segment EBITDA by $4 million to $39 million, compared to second quarter of last year.

Revenues improved slightly as minimum volume commitments more than offset volume declines, and segment EBITDA benefited from reduced operating and maintenance expenses. Consistent with natural gas gathering, we anticipate volumes in our processing segment will increase during the third quarter.

Moving to terminaling and transportation, segment operating income grew 50% year over year from $50 million to $75 million. Segment EBITDA grew 41% from $66 million to $93 million. This significant growth in earnings can be attributed to organic growth projects, performance from the LA storage assets acquired from Tesoro, and higher volumes at our terminals and pipelines driven by higher refinery throughputs at Tesoro compared to a year ago.

We reported terminaling throughput of approximately 994,000 barrels per day and pipeline transportation throughput of approximately 867,000 barrels per day for the second quarter. Year over year, the California and Salt Lake City regions saw significant pipeline and terminaling volume increases, primarily due to Tesoro's refineries returning for maintenance.

Volume growth was also driven by optimization of the Northwest product system, as well as the benefits of organic projects to expand the Anacortes product terminal and the Salt Lake City crude oil terminal.

In the third quarter, we expect volumes in the terminaling and transportation segment to remain strong, supported by high summer demand and the addition of our new Alaska terminals. We expect to close on the Anchorage and Fairbanks terminals late in the quarter, which should typically provide between 15,000 and 20,000 barrels per day of throughput.

We also are receiving a substantial increase in our storage revenues with the closing of the Kenai storage portion of the transaction, effective July 1.

Shifting to capital expenditures, in the second quarter, we spent $35 million net of reimbursements. This includes $31 million of gross capital, and $4 million of maintenance capital. During the quarter, we made progress on projects to add capacity on our High Plains pipeline, increased gas compression in the Uintah Basin, and expand capacity at our Mandan, North Dakota, and Stockton, California, terminals.

Looking ahead, you can find details of our volume expectations and other elements related to our third quarter outlook in the earnings release issued yesterday. With that, I will turn the call over to Greg.

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Thank you, Phil, and good morning. Let me start by pointing to the success of our strategy to grow the business. We delivered strong year over year net earnings and EBITDA growth, which drove our 21st consecutive quarter of distribution growth for our unit holders. Our largest business segment, terminaling and transportation, showed growth in both operating income and volumes year over year.

The successful quarter in this business was driven by solid execution of each phase of our strategy. Throughputs in the terminaling and pipeline transportation grew 9% and 8% respectively on a year over year basis. We continue to see strong refined product demand in our West Coast markets, with PADD 5 gasoline demand up 2% year over year through May. We expect this to remain a key driver of results in this segment of our business.

Within our gathering and processing segment, the combined earnings contributions including our non-consolidated remains resilient. With a challenging commodity environment, we continue to focus on capturing existing crude oil production in the Bakken region, integration synergies with Tesoro's new Dickinson refinery, and managing our Rockies gas business to drive optimization and efficiency in our operations.

While we continue to pursue improvements in the existing business, we remain committed to our strategy of growing Tesoro Logistics through acquisitions. Supporting that strategy, we accessed the capital markets during the quarter with very successful debt and equity offerings. The debt offering of new senior notes raised approximately $700 million, which was used to pay amounts outstanding on our credit facilities, as well as provide us an incremental cash to fund our growth plans for the year.

The equity offering of over 6 million new units raised nearly $300 million and positions us to execute our growth plans while maintaining a strong balance sheet.

Now, let me highlight a few items related to our outlook. During the quarter, we began expansion projects at our product terminals in Mandan, North Dakota; Nikiski, Alaska; and Stockton, California. We continue to see strong demand that supports our ability to capture incremental throughput as well as consolidate Tesoro's volume into our terminals.

These projects also provide us new capabilities to support renewable fuels, which are increasingly important in our markets. These projects are expected to be in service later this year or early 2017. On July 1, we closed the first phase of the Alaska storage and terminaling acquisition from Tesoro, consisting of feedstock and product storage assets in Kenai, Alaska, with a combined capacity of approximately 3.5 million barrels.

These assets have connectivity to Tesoro Logistics' Alaska pipeline, it's Nikiski product terminal, and Tesoro's Kenai refinery. We expect to close the second phase of the acquisition later this quarter. This will include refined product terminals in Anchorage and Fairbanks, with combined storage capacity of 600,000 barrels, and throughput capacity of over 10,000 barrels per day.

The assets also enable us to offer rail access to our customers in the interior of Alaska, with the throughput of approximately 7,000 barrels per day.

We are very pleased with the addition of these assets to our Alaska portfolio, as they allow us to better serve our customers in the interior of the state and simultaneously contribute stable fee-based cash flows for our investors.

Now, regarding future dropdowns, we expect that Tesoro will offer crude oil and refined products, storage, and terminaling assets in Martinez, California, in the second half of 2016. We expect to add an estimated $16 million to $36 million of annual net earnings, and $40 million to $60 million of annual EBITDA. Consequently, TLLP expects that Tesoro will offer the previously announced Great Northern Midstream assets for acquisition at a later time.

Turning to our overall goals, we now expect the base business adjusted for the full year impact of the RGS de-consolidation that Phil mentioned, to deliver $370 million to $395 million net earnings, and $720 million to $745 million of EBITDA in 2016, before any completed or future acquisition opportunities from Tesoro.

Our target of 17% annual distribution growth in 2016 remains unchanged, and we are committed to maintaining an annual distribution coverage ratio of at least 1.1 times in achieving a debt to EBITDA ratio of four times or less by the end of the year. We continue to drive towards our strategic target to grow TLLP's net earnings to $650 million and its EBITDA to $1 billion by the end of 2017.

We also believe we're well positioned to achieve an investment grade credit rating. Guided by our strategic priorities, we strive to grow a sustainable, stable, full-service logistics business, while maintaining the financial flexibility to pursue strategic opportunities. This represents a strong value proposition for investors and backed by the strength of Tesoro, we believe TLLP is well positioned to deliver on its strategy. Now, we're pleased to take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Gabe Moreen from Bank of America.

Gabriel Moreen - *BofA Merrill Lynch - Analyst*

Hey, everyone. Just a quick question concerning Great Northern, if I could, just in terms of I guess the decision to delay the dropdown there. Can you just talk about some of the reasons there? Obviously, I would assume some of that has to do with the commodity price environment, and I guess, kind of related to that, is the primary customer there going to be Tesoro Corp., or is it really going to be mostly third-party producers? And when and if the dropdown happens, would you consider I guess splitting it up, the assets up, into different parts basically?

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

That's a long first question, but I'll be glad to answer it. We, Tesoro, acquired Great Northern earlier this year. At the time, we recognized we wanted to do some restructuring of the system to provide advantages to the producers and to fit our requirements for crude supply in North Dakota.

And we've been working on that and that's going to take a little bit longer than we expected. And as a result, we elected to just move that dropdown out of this year and bring forward what we plan to do early in 2017, which has been stated as the assets at the Martinez Terminal.

That is really the primary change there with the asset, the business from a Tesoro perspective is performing extremely well. So it's meeting all of our expectations. It is just going to take us a little bit longer than we expected to do some restructuring of the system.

The customers are on the system are both producers and Tesoro because of the rail facility that's on the base, on the southern portion of the system. So it's a mix of both companies and Tesoro will be using the rail facility to supply its needs on the West Coast, starting next year.

Gabriel Moreen - *BofA Merrill Lynch - Analyst*

And does the rail facility there at all make a difference in terms of whether Vancouver happens or not, or is that just going to happen regardless at Greater Northern?

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Well, Gabe, we already have our requirements and a course that we need to continue to supply on that. When the Vancouver Energy Project comes forward, that would just be additional volume that the company and potentially other people will supply their needs to the West Coast.

Gabriel Moreen - *BofA Merrill Lynch - Analyst*

Got it. And just shifting gears, a minor question promise, in terms of just providing adjusted EBITDA and DCF. The decision there I don't think other MLPs have really adopted that, per se, and then are you still just going to be keeping line items like maintenance Capex, which I know is non-GAAP, but pretty important to tax leading DCF?

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Let me ask Steven to comment on our position.

Steven Sterin - *Tesoro Logistics LP - CFO*

We haven't traditionally made many adjustments to our GAAP earnings. And as we look at the continued growth and the quality of the company, and the quality of the earnings, we just think it's better now to provide GAAP earnings and continue to provide full transparency of all the things going on with the company, things we're doing well, things we're not, and allow you to fully analyze the business and be able to calculate whatever metrics you'd like to off of that.

Gabriel Moreen - *BofA Merrill Lynch - Analyst*

Okay. Will do. Thanks guys.

Steven Sterin - *Tesoro Logistics LP - CFO*

Thank you.

Operator

And our next question comes from the line of Kristina Kazarian, Deutsche Bank. Your line is now open.

Kristina Kazarian - *Deutsche Bank - Analyst*

Hey guys.

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Hi, Kristina.

Kristina Kazarian - *Deutsche Bank - Analyst*

Quick question. You guys talked a little bit on the gas side about some of the deferred completions and what that meant from shifting some stuff from second quarter into third quarter. Can you just talk a little bit regionally about what you're seeing and how you are still comfortable with what you were thinking for year end?

Phillip Anderson - *Tesoro Logistics LP - President*

Sure. Kristina, this is Phil. Relative to the Rockies right now, there is really one rig operating within our footprint, and that's up in Pinedale. And that is a reduction from what we originally thought coming into the year.

As we discussed on last quarter, we also saw the key Pinedale producer defer the completion of the winter wells into the summer, which impacted our second quarter volumes to the extent that they came down about 50,000 MMBTU per day.

In the third quarter, if you look at our guidance, we are roughly going up backed by that same amount, and that is, we are looking at those wells now. And we are seeing that volume come back onto the system. We think that, combined with the one rig continuing to work and assuming that completions happen rateably for the rest of the year, we think we will be approximately flat to 3Q throughout the rest of the year.

And then we do have some compression projects in each of the Vermillion Pinedale and that will come on between the end of this year and early next year, that should help offset declines that would happen at a continued assumed growing pace of one rig.

Kristina Kazarian - *Deutsche Bank - Analyst*

And then question on the crude side, too. Phil, you guys mentioned three new interconnects in the back half of the year. Can you help me think about the magnitude of volume increases I could see from that, and then also, is there a longer term opportunity here for you guys to capture volume from shippers who are looking to meet commitments on the DAPL line, especially if we see that line being upsized?

Phillip Anderson - *Tesoro Logistics LP - President*

You are absolutely focused in the right area, Kristina. The inbound connections that we are seeing have existing crude moving on them, hopefully our interconnects provide a better way for them, shippers to get to these regional takeaway pipelines.

I would say the available amount of volume is somewhere in the 20,000 to 70,000 barrel markets. It's really ultimately, how much do they choose to ship to these takeaway points? The Dakota Access Pipeline, we expect to be done about year end. We will have to interconnects. One in the north and one in the south at the two major junction points.

And we absolutely have been focused on working with producers as well as other shippers coming up into the Bakken through the DAPL commitments, seeking to access a lot of Bakken crude oil. We do believe we are well positioned to be able to offer them a lot of flexibility and optionality to meet their demands.

Kristina Kazarian - *Deutsche Bank - Analyst*

Perfect, thanks guys, and good luck capturing that business.

Phillip Anderson - *Tesoro Logistics LP - President*

Thanks.

Operator

And our next question comes from the line of Sharon Lui from Wells Fargo.

Sharon Lui - *Wells Fargo Securities, LLC - Analyst*

Hi, good morning. So a quick question on the Martinez plan dropdown. In terms of the range of the projected EBITDA, maybe just talk about some of the factors that would drive it up or down, towards the lower end or high end of the range. And also, if you can speak to potential organic opportunities tied to those assets?

Phillip Anderson - *Tesoro Logistics LP - President*

So Sharon, this is Phil. As we begin these processes, we have yet to negotiate really the commercial rates around those assets. These assets have been historically operated as a cost center inside Tesoro, and so we always give ourselves a pretty wide range until we complete those negotiations.

Relative to organic growth, the significant opportunity around this footprint is to add additional tankage that Tesoro presently uses at a third-party terminal in the area, that would allow us to capture revenues that right now Tesoro is paying to somebody else. And that's probably a little bit down the line, but that's certainly part of our consideration as we evaluate these assets.

Sharon Lui - *Wells Fargo Securities, LLC - Analyst*

Okay, that's helpful. And in terms of just Great Northern, is it safe to assume that that would be the next dropdown after Martinez? Or how should we think about the timing of that?

Phillip Anderson - *Tesoro Logistics LP - President*

Sharon, this is Phil. I think from our standpoint, we've got a lot of optionality going into next year, and while we keep a lot of different things in front of us, we will make that decision probably much later this year, and really begin to work earnestly at that time.

Sharon Lui - *Wells Fargo Securities, LLC - Analyst*

Okay, great, thank you.

Operator

(Operator Instructions)

And our next question comes from Jeremy Tonet from JPMorgan.

Jeremy Tonet - *JPMorgan - Analyst*

Good morning, it's Jeremy Tonet here. I just wanted to go back to the crude oil gathering in the Bakken. I was just wondering, over the back half of the quarter there, just wondering what unfolded that drove volumes below your guidance as of the last earnings call? If you could expand a bit more there.

Phillip Anderson - *Tesoro Logistics LP - President*

Sure Jeremy, this is Phil. What we saw during the quarter was the completion rate in the Bakken dropped to about half of what it had run the prior quarter. And we've heard everything from, I mean, obviously deferrals, there was some pretty rough weather in April that kept trucks off the road for much of the month.

But nonetheless, what we saw was a significant decline in rail volumes going to rail terminals during the quarter. And that's really the significant difference. Our other destinations being Tesoro and regional pipelines, picked up a little bit and actually offset some of the decline on the rail side.

Jeremy Tonet - *JPMorgan - Analyst*

Great, thanks. And you guys have had a number of expansion projects in that area, and I'm just wondering, do you think that you've kind of hit the full run rate for your expansions in Bakken crude gathering or is there more ramp that could occur there over time?

Phillip Anderson - *Tesoro Logistics LP - President*

We can absolutely add additional capacity within our whole system. It's really the combination of origins and multiple destinations that give us the ability to drive volumes higher on the system.

And so we look at the opportunities in front of us to get these additional shippers on the line later this year, the DAPL interconnects that start up around the end of the year as sort of the next significant opportunity for us to drive volumes on the system.

Jeremy Tonet - *JPMorgan - Analyst*

Great, thanks. And then, just one last question, kind of a high-level philosophical question. Just wondering how you guys think about the interplay between the IDRs and the dropdown multiples going forward, if the GP's taking about somewhere around 30% of cash being paid out now, effectively that portion is still coming back to TSO. How do you think about that in terms of the relationship with dropdown multiples?

Steven Sterin - *Tesoro Logistics LP - CFO*

Jeremy, it is Steven. Like we said before, when we contemplate dropdowns, we want to make sure that they have healthy accretion for our LP unit holders, that's very important to us. As we look at the overall transaction and the value on the transaction and taking into account the IDRs, we look very carefully at that.

And when you look at the different -- one of the things that you hear us talk a lot about is our growth plans really are balanced between organic growth, acquisition and dropdown, and when you look at those three options, the most accretive to LP unit holders are acquisition and organic growth, given that many of the dropdowns that we could do from Tesoro do not have as much growth.

And so, however, when we do those, we do make sure that the overall equation is balanced and the accretion is there, and we have many different ways to do that, and so we will keep an eye on that and make sure that that remains a core commitment from us to make those drops accretive.

Jeremy Tonet - *JPMorgan - Analyst*

Great, so would it make sense to think that as the GP take increases over time, multiples would go down just to incorporate that, if an asset is of similar quality and whatnot?

Steven Sterin - *Tesoro Logistics LP - CFO*

I think that would probably be an oversimplification. I think we would first always sell the asset at its fair value, taking into account everything from the tax efficiency, the transaction, to the comparable multiples that are out there, and typically, based on the quality of the assets, and the fairness of the multiple it's allowed for, even with, we've been at the high splits for coming up on two years, they're still accretive.

And so, physically you find yourself in a position where you are struggling to make the drop accretive even at the high splits, then maybe it's not a high quality drop, and so we would look at other things. And so, we would prioritize more around making sure that the investment for growth, whether it be drop, organic, or M&A is inherently accretive.

Jeremy Tonet - *JPMorgan - Analyst*

That's helpful. That's it for me, thank you.

Operator

Our next question comes from Justin Jenkins from Raymond James.

Justin Jenkins - *Raymond James - Analyst*

Great, thanks guys. We covered most of what I had, but Greg, you spent a minute on the TSO call talking about the synergy potential at the Dickinson plant for the refining level. I was just curious on your views maybe on how TLLP might be able to play a role in really integrating that plant into the Tesoro system.

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Yes, probably the primary benefit will be in crude supply, how we supply crude into the refinery through our tracking system, and that will fit because of the local nature where Dickinson is located relative to production. That is the primary synergy from a Tesoro Logistics standpoint.

Justin Jenkins - *Raymond James - Analyst*

Is there any optionality in the medium term maybe of interconnecting the Dickinson and the Mandan plants, or is that not really being considered?

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Probably, I mean, we would look at it all types of possibilities, but the Mandan refinery is very, very balanced from -- into the crude unit and then through all of the upgrading units, there probably is very limited potential with the exception of when we are doing maintenance. And we would expect to gain some benefits.

So when we do our major maintenance, we may have units down, especially at Mandan, then the Dickinson refinery can play a role in that in helping to basically get higher run levels than we normally would've been able to achieve without that refinery.

Justin Jenkins - *Raymond James - Analyst*

Okay, great, that's really helpful. And then I guess I will wrap it up here on the financing side. Steven, on the TSO call, you mentioned that you expect a bit more cash from dropdowns now in 2016 with the capital raise. Is it right to think that much of the cash for dropdowns has really been raised in Q2 and there's not a whole lot left to go here in the second half of the year for the Martinez drop?

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Yes, I mean, everything else being equal, as we've said, we continue to look at other investment opportunities, organic growth opportunities, but in general, your statements are absolutely correct. So anything we would likely do, if there's no other change, would be very modest.

Justin Jenkins - *Raymond James - Analyst*

Perfect. I will leave it there, guys, thanks again.

Greg Goff - *Tesoro Logistics LP - CEO and Chairman*

Thank you.

Operator

That does conclude the question and answer session for today's call. Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a wonderful day.