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TLLP - Q4 2016 Tesoro Logistics LP Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Tesoro Logistics LP fourth-quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder, today's program is being recorded. I would now like to introduce your host for today's program, Evan Barbosa, Investor Relations manager. Please go ahead, sir.

Evan Barbosa - *Tesoro Logistics LP - IR Manager*

Good morning, and welcome to today's conference call to discuss our fourth-quarter and full-year 2016 earnings. Joining me are Greg Goff, Chairman and CEO; Phil Anderson, President; and Steven Sterin, CFO.

The earnings release, which can make on our website at TesoroLogistics.com, includes financial disclosures and reconciliations for non-GAAP financial measures that should help you analyze our results. Our comments and answers to questions during this call will include forward-looking statements that refer to management's expectations or future predictions. They are subject to risks and uncertainties that could cause actual results to differ from our expectations. Please refer to the earnings release for additional information on forward-looking statements. Now, I will turn the call over to Greg.

Greg Goff - *Tesoro Logistics LP - CEO*

Thanks, Evan. Good morning, and thank you, everyone, for joining us today.

We are pleased with TLLP's performance in 2016, as we continued to successfully grow the business through all phases of our strategic priorities, including the following: optimization of our existing asset base; organic growth to enhance our portfolio; and strategic investments to expand and diversify our portfolio, including third-party acquisitions and drop downs from Tesoro. This delivered year-over-year growth in net earnings of 27%, and growth in distributions to our unit holders of 17%, despite a challenging market environment, characterized by lower crude oil and natural gas prices.

First, let me take a minute to discuss our optimization and our organic growth efforts in 2016. During the year, we completed several organic growth projects to expand our base business. We expanded our project terminals in Mandan, North Dakota and Kenai, Alaska, which allows us to capture additional volumes and support Tesoro's refined products business.

We completed several interconnections on the High Plains Pipeline in North Dakota, including the connection at Johnson's Corner in the fourth quarter. These interconnections enhance producer's optionality to move crude volumes to the different exit points in the basin.

We enhanced and optimized our Northwest product system, allowing us to capture higher throughput during the year. And we completed a new natural gas gathering pipeline compression project in the Uinta Basin in the Rockies, which should enable us to capture higher volumes on our systems, starting in 2017. Also, we started several growth projects during 2016, including a new compression project in the Vermillion basin, a new crude oil gathering interconnection on our High Plains pipeline, and two interconnections to the Dakota Access Pipeline.

Shifting to strategic investments, we completed two acquisitions from Tesoro in 2016. We acquired the Alaska storage and terminalling assets in the third quarter, which will add annual net earnings of $36 million and annual EBITDA of $51 million, and increases our capability in the state of Alaska.

In the fourth quarter, we acquired the Northern California terminalling and storage assets from Tesoro, which will add estimated annual net earnings of $28 million to $33 million, and annual EBITDA of $45 million to $50 million. We expect to generate even higher revenues on the Northern California terminalling and storage assets over the next several years, by improving our asset utilization by 10% to 15%.

We also announced a third-party acquisition of crude oil, natural gas, and produced water gathering systems and two natural gas processing facilities in North Dakota, in 2016. The assets are located in core Bakken producing zones, that are supported by long-term acreage dedications from ten different producers, and are economic at current commodity price levels.

Substantially all of the volume we have forecasted in 2017 is based on current well production. There are presently four rigs working in the dedicated acreage, and a significant inventory of drilled uncompleted wells.

The North Dakota gathering and processing assets should add an estimated $80 million to $90 million of annual net earnings and $100 million to $110 million of annual EBITDA in 2017. To give you an update on this acquisition, we closed on January 1, 2017. We successfully completed the day one transition, and integration work is underway. The assets are operating well, and based on conversations with our customers, we are excited about the future organic growth prospects this business brings to TLLP.

Looking ahead to 2017, we expect 50% to 55% of our EBITDA to be generated from our terminalling and transportation business with the remainder from gathering and processing. We have several new projects in the downstream-facing portion of our business, including the Los Angeles Refinery Interconnect Pipeline System project, crude oil storage in Los Angeles, and several terminal expansions across our system that should position us for future growth.

Shifting to gathering and processing, for our crude oil gathering, we expect slight growth in volumes on our legacy assets in 2017, driven by the new inbound gathering interconnection we completed during the fourth quarter, and planned well completions in our Bakken footprint. The newly acquired assets in the Bakken are expected to bring an incremental 25,000 to 30,000 barrels per day of crude oil and water volume to our system.

For natural gas, we expect our 2017 volumes in our Rockies footprint to remain flat versus 2016, as our compression improvements and potential new drilling in our basin are offset by production declines. We expect the North Dakota natural gas gathering assets to deliver an incremental 125 million to 135 million cubic feet per day this year.

Over the last several months, crude oil prices have stabilized in the $45 to $55 per barrel range, and natural gas prices increased to about $3 per MMBtu. With this improving outlook, we are having more conversations with our customers about securing organic growth projects that could provide additional volume on our systems.

With the acquisitions of the North Dakota gathering and processing, and the Northern California terminalling and storage assets announced in November, Tesoro agreed to waive $100 million of general partner incentive distributions over 2017 and 2018, improving our cost of capital, and allowing for more balanced distribution growth between our general partner and our limited partners. We continue to evaluate our IDR structure relative to our long-term strategy, and believe there are potential options that will continue to position TLLP to be very competitive, and provide strong growth potential for all unitholders.

We expect 12% to 15% distribution growth for our unitholders in 2017, which will help us maintain the financial flexibility required to pursue future opportunities. Additionally, during the quarter, Tesoro announced the proposed acquisition of Western Refining. The growth of Tesoro as a geographically-diversified and highly integrated parent company should provide additional strategic and organic growth opportunities for TLLP.

With our current organic growth plans and the acquisitions we completed in 2016 and early 2017, we believe we are well-positioned to achieve our target of $550 million of net earnings and $1 billion of EBITDA by the end of the year. With that, I turn the call over to Phil.

Phil Anderson - *Tesoro Logistics LP - President*

Thanks Greg, and good morning, everyone. We are proud of the financial results we delivered in 2016, despite a challenging market environment. This performance reflected executing our strategic priorities to grow the business both organically, and through strategic investments.

Yesterday, we reported fourth-quarter net earnings of $73 million compared to $59 million a year ago, and EBITDA increased to $177 million from $146 million from last year. Net earnings and EBITDA for the fourth quarter of 2016 included charges of $12 million and $11 million, respectively, related to loss attributable to predecessors, transaction costs for the acquisitions announced in the quarter, and environmental accruals.

For the full year, net earnings were $315 million, compared to $249 million a year ago, and EBITDA increased to $696 million from $587 million last year. Full year net earnings and EBITDA included $24 million and $17 million respectively, of charges related to losses attributable to predecessors.

Now, I'll review our business segments. The gathering segment operating income was $25 million in the fourth quarter, compared to $21 million a year ago, and segment EBITDA was $45 million versus $39 million last year. Segment operating income and segment EBITDA included $7 million in 2016 and $24 million in 2015 of environmental charges, primarily related to the expected remediation cost for the 2013 crude oil pipeline release at Tioga, North Dakota.

In crude oil gathering, throughput was 218,000 barrels per day, which was above our expectations, and an increase of 6% year over year. During the quarter we completed a new inbound connection on the High Plains pipeline system at Johnson's Corner, and saw continued demand to move barrels to regional takeaway pipelines.

In January, 2017, we completed our northern connection to the Dakota Access Pipeline. We have plans for two more connections to DAPL and construction of our southern connection is underway.

Natural gas gathering throughput declined to 871,000 MMBtus per day in the fourth quarter, from 1.1 million MMBtus per day last year. A reminder that our volumes last year included 132,000 MMBtus per day from our RGS system, which is no longer consolidated in our results. We did not connect any new wells during the quarter, which is typical given winter operating conditions.

Also during the quarter, we completed the compression project in the Red Wash area of the Uinta Basin, an area of significant potential growth within our footprint. We expect this project to enable us to capture higher volumes on our system, starting in 2017.

We have seen additional producer interest within our Utah footprint, and the improving commodity prices, including a return to our Rockies pricing premium, have improved and improved liquids values. We have begun construction on a compression project to support new drilling in the Vermilion basin in Wyoming, which we expect to complete later this year.

For the full year, our total gathering segment operating income was $132 million compared to $142 million last year. Segment EBITDA was $213 million, compared to $216 million a year ago.

Moving to processing, segment operating income was $26 million and segment EBITDA was $37 million for the fourth quarter of 2016. This compares to $28 million and $39 million respectively for the year-ago period. Keep-whole processing volumes in the quarter were 6,800 barrels per day compared to 7,800 barrels per day last year.

Fee-based processing volumes were 611,000 MMBtus per day, compared to 748,000 a year ago. For the full year, processing segment operating income grew 6% year on year, from $105 million to $111 million. Segment EBITDA grew 5%, from $149 million to $156 million. The lower volumes were mostly offset by higher minimum volume commitment revenues, and the continued benefits from the optimization of the system.

Shifting to terminalling and transportation, segment operating income increased from $88 million from $59 million a year ago, and segment EBITDA grew to $111 million from $79 million last year. Terminalling throughput increased to 992,000 barrels per day in the fourth quarter, from 949,000 barrels per day last year, and benefited from strong demand for waterborne crude oils at our marine terminals serving West Coast refineries, as well as contributions from our new Alaska terminals. Volumes in our transportation business increased year over year to 874,000 barrels per day from 841,000 barrels per day last year, as we saw higher demand from refineries on our Southern California pipeline system.

During the quarter, we acquired the Northern California terminalling and storage assets from Tesoro. These assets include 5.8 million barrels of crude oil feedstock and refined product storage, as well as an adjacent marine terminal with feedstock and refined product capabilities, and throughput capacity of up to 80,000 barrels per day. For the full year, terminalling and transportation segment operating income grew to $297 million from $200 million in 2015, and segment EBITDA increased to $380 million trend from $276 million last year.

Moving now to our balance sheet cash flow and capital expenditures, and other financial metrics. We ended the year with $688 million of cash, which was used to fund the closing of the North Dakota gathering and processing assets acquisition on January 1 this year. We also have approximately $1.3 billion of availability under our revolving credit facilities.

Net cash from operating activities for 2016 increased to $498 million from $436 million last year, and distributable cash flow grew to $532 million from $422 million in 2015. We made significant progress towards our goal of obtaining an investment grade credit rating for TLLP.

We were pleased to announce yesterday, Fitch ratings assigned our first-time long-term issuer default rating of BBB minus to TLLP, marking the Company's inaugural investment-grade credit rating. Fitch indicated that the BBB minus rating reflects the size, scale and stable cash flow profile of TLLP; benefits provided by the relationship with our sponsor, Tesoro; visibility on growth opportunities, which should offset any potential weakness in the existing operations; and adequate liquidity, given low CapEx requirements and minimal projected cash flow volatility.

Also during the quarter, S&P upgraded TLLP's credit rating to BB-plus with a stable outlook, from the previous rating of BB. This new rating is now the same of that of Tesoro and one notch below investment grade. Additionally, shortly after Tesoro's announcement in November to acquire Western Refining, Moody's changed TLLP's rating outlook to positive. We are actively engaged with the rating agencies, and look forward to updating you on our continued progress towards an investment-grade credit rating.

As for our distribution growth, on January 18, we announced our fourth-quarter distribution of $0.91 per limited partner unit, or $3.64 per unit on an annualized basis, which was our 23rd consecutive quarterly distribution increase of approximately 4% or more, and represents a 17% year-over-year increase. Our distribution coverage for 2016 was 1.06 times. This is lower than our target of 1.1 times coverage, but also reflects the significant cash balance we carried in the second half of the year from our equity and debt offerings earlier in 2016.

Additionally, we have funded portions of the two acquisitions from Tesoro with new units. This cash balance was used to fund the North Dakota gathering and processing acquisition at the beginning of 2017, and we expect our distribution coverage to return to our target going forward.

Turning to capital spending, we invested $239 million in 2016, including $197 million of growth capital, and $42 million of net maintenance capital. Full-year capital spend included $64 million of predecessor spending on the Northern California terminalling and storage assets, prior to our acquisition. Looking at our capital expenditure plans for 2017, we expect total CapEx to be $295 million, including $230 million of growth capital, and $65 million of net maintenance capital.

Looking ahead, you can find details of our volume expectations and other elements related to our first-quarter outlook in our earnings release, issued yesterday. With that, we'll take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jeremy Tonet, JPMorgan.

Jeremy Tonet - *JPMorgan - Analyst*

I was just curious, with regards to the accruals that popped up in the earnings related to the environmental release in 2013, just wondering if that is the last we've seen of that, or if it is possible that could creep up again? Or any more color you could provide there?

Phil Anderson - *Tesoro Logistics LP - President*

Jeremy, that reflects the ongoing remediation happening at the site. We hope to wrap that up in the next year or so. We can't say definitively that's the end and we'll just learn more as we continue to round up the job up there.

Jeremy Tonet - *JPMorgan - Analyst*

Okay, thanks. And looking at the Bakken, looks like activities have increased a bit here, and you have expanded your position nicely. Just wondering if you could provide a bit more detail as far as what the upside opportunity is for you, if activity improves? And also how do you think about your ability to win new business, given your bigger position now?

Phil Anderson - *Tesoro Logistics LP - President*

Sure. So the newly acquired assets are really well-positioned, relative to the overall basin. The Robinson Lake processing facility, and the gathering system that supports that is in the Parshall area of the field. Additionally, the Sanish area sits just north of that facility.

There are additional very high-quality producers in that area, that we believe we can bring into that facility, based on the long-term prospects for that area. And those discussions have already begun.

This is based on relationships that we've had, based on in some cases our Rockies business. And really positioning us well to capture the full-service capabilities that we can present now in the Bakken. So we like that opportunity very much.

Jeremy Tonet - *JPMorgan - Analyst*

Great, thanks. And just last one, thinking about the cost of capital for Tesoro, just it seems like there's a few different avenues you could take going forward, as far as looking to improve it. It could be periodic IDR relief associated with acquisitions or other things, as recently done. Could be an

IDR reset, or could be buying out the IDRs, the three main avenues that come to mind. Greg, I'm just wondering if you're in a position to share with us any thoughts philosophically as far as how you see gives and takes between those different options?

Greg Goff - *Tesoro Logistics LP - CEO*

Yes, Jeremy, it's a good question. And as you recognize from Tesoro's standpoint, we are right in the middle of doing a major transaction, and so we're doing all the evaluation work on the things we want to do. And as we progress through completion of the Western acquisition, then we'll be better positioned in a few months to then disclose exactly how we plan to go forward with the IDRs and that.

Jeremy Tonet - *JPMorgan - Analyst*

Okay, thanks, and maybe just one last one. Just wondering as far as the assets upstairs if you could provide any thoughts as far as which ones might make sense as far as dropping down next? Any thoughts on sequencing of assets would be helpful?

Greg Goff - *Tesoro Logistics LP - CEO*

Jeremy, we keep an ongoing process that usually has several different options available to us. That team continues to look at the portfolio, and as we make progress and make decisions, as we move through the year, we'll provide further updates around that. But at this point, I wouldn't expect it to be anything radically different than anything we've done in the past.

Jeremy Tonet - *JPMorgan - Analyst*

That's it for me. Thank you.

Operator

Brian Zarahn, Mizuho.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

On the crude gathering business, how should we assess the impact of DAPL? Is that included in your forecast for volumes this year?

Phil Anderson - *Tesoro Logistics LP - President*

We've got a number of scenarios for DAPL. We obviously don't have any unique insight into when that system will actually start up. From an overall customer standpoint, both whether it's producers or other shippers, refiners if you will, that will be on that system, we'll have multiple connections, and able to serve crude into the system at various different points. So what that looks like eventually, in terms of timing and how it impacts our full year, obviously remains to be seen, given the uncertain timing around the start up.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

But within your outlook for ending the year roughly at $1 billion of EBITDA, are volumes from DAPL included in your forecast?

Phil Anderson - *Tesoro Logistics LP - President*

We don't have any significant upside in our forecast related to DAPL volumes, required to hit our $1 billion target.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

Okay and then turning to your Fitch rating, I'm sure you're very pleased with the announcement yesterday. When you expect an update from the other agencies potentially?

Steven Sterin - *Tesoro Logistics LP - CFO*

Brian, it's Steven. So S&P, both the other rating agencies updated their outlook when we announced the Western transaction. S&P put Tesoro on credit watch positive, and reaffirmed as Phil mentioned, a positive outlook and BB-plus on TLLP. So, they haven't indicated what they would do at the close, but it is on a positive trajectory.

Moody's reaffirmed the current rating, so there's not a clear trigger that would require them, or that we would expect them to move forward on that, but we think we are ready operating at investment grade levels. The leverage targets that we've committed to, and the approach that we used to running the Company, we believe are already there. So hopefully we're on a pretty quick trajectory.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

Okay, and then turning to potential IDR restructuring, understanding that you're evaluating your options during the Western Refining integration. But I guess longer-term after this year, is there a distribution growth target that you're looking at for TLLP?

Phil Anderson - *Tesoro Logistics LP - President*

Brian, this is Phil. I think we start with, our fundamental strategy, we think serves up plenty of opportunities to grow the Business. To that extent, we think efficient access to capital is essential to our strategy going forward.

From that, we look at distribution growth rates, coverage, leverage, all of those factors come into our thinking. And I think as we move forward through the year, and make any potential changes around any of that, it all moves hand in hand, I think, in our view.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

Thanks, Phil.

Operator

(Operator Instructions)

Richard Roberts, Howard Weil.

Richard Roberts - *Howard Weil Incorporated - Analyst*

2017 growth CapEx, $230 million. Is this a level you think you can sustain over the next few years? And as you look at the opportunity set, do you see more in the G&P business or more in the terminalling and transportation side?

Greg Goff - *Tesoro Logistics LP - CEO*

Well I think from an appetite standpoint, we would like to actually run a significantly stronger portfolio of organic growth going forward. The $230 million we have on slate for this year is about two-thirds related to terminalling and transportation projects, the largest of which is the Los Angeles interconnection pipeline project. Ultimately, we would like to have a stronger mix of gathering and processing projects built around, not only the Bakken and Rockies, but increasingly around the Permian basin as well.

We think the organic growth always delivers the best returns. It allows us to capture a lot of the integration value that both TLLP and Tesoro bring to those types of situations. So all in all, I think longer term, we'd like to have a larger number than the $230 million we've got out there presently.

Richard Roberts - *Howard Weil Incorporated - Analyst*

Okay, great. Thanks for that. Maybe a switch to the drop-down side. I think the last update you gave was around $500 million of EBITDA is still up at TSO available for drop-down. I'm curious, does that only include assets that are currently operational? And if it does, would you be able to provide an estimate on what the EBITDA could be when you include everything under development?

Greg Goff - *Tesoro Logistics LP - CEO*

So, Richard, that at least $500 million does include estimates of some projects under development, and we don't really break out which is which. But the vast majority of the $500 million relates to existing assets. All of that, the stuff that's under development, we've got some fairly broad ranges around the EBITDA potential for those projects, and we tend to use the low end of those projections when we add all that up.

Richard Roberts - *Howard Weil Incorporated - Analyst*

Okay, got it, thanks. And one last one for me. Just on the Great Northern assets, can you comment? Has Tesoro been able to move all of its rail loading from COLT onto Fryburg? And then also, is there anything else that Tesoro is looking to do with those assets before they would offer them for drop-down to the TLLP? Thanks.

Greg Goff - *Tesoro Logistics LP - CEO*

So, Tesoro has transitioned all of its North Dakota rail loading over to that facility. The facility is running very well, set a volume record here in the last full month of operations, and Tesoro is very satisfied with that asset.

Longer-term, between the rail facility and the pipeline, I think we'd like to see the Bakken return to growth mode, especially in the central part of the basin, where that pipeline tends to be the catchment area for that area. And I think as we see that system stabilize going forward, we'll look at it at that point as a potential candidate to move into TLLP.

Richard Roberts - *Howard Weil Incorporated - Analyst*

Thank you very much.

Operator

TJ Schultz, RBC Capital Markets.

TJ Schultz - *RBC Capital Markets - Analyst*

Phil, you just mentioned G&P and the Permian. Are you actively looking at assets there?

Phil Anderson - *Tesoro Logistics LP - President*

TJ, yes. We've actually been active in the Permian, going back well into last year. And that involves working with the producers, where we already have very good relationships, and what their plans are for new drilling, as well as a number of opportunities that we see on the radar for potential acquisition going forward. So we've been active, we think. With the activities going on at Tesoro, it's tough to say it will make us more active, but I think it increases the odds of our ability to be successful.

TJ Schultz - *RBC Capital Markets - Analyst*

Okay, thanks. And just as it relates to gas gathering in 2017, what declines are you assuming, or how much if this is offset by the compression at Red Wash and Permian, or are there additional compression projects that you can target to offset?

Phil Anderson - *Tesoro Logistics LP - President*

Absent any significant new drilling in the Rockies, I don't think we have any additional material compression that we would be looking to put on the system at this point, unless the customers came to us and asked us for it. Overall for the basin, this year, based on the number of rigs in place right now, which is sort of 2.25, combined with the compression, we would expect volumes to be reasonably flat. We are actually seeing some increased dialogue with producers in that area, which gives us a little ray of optimism there, but at this point we would not call volumes higher there or significantly lower at this point.

TJ Schultz - *RBC Capital Markets - Analyst*

Okay, thanks.

Operator

Corey Goldman, Jefferies.

Corey Goldman - *Jefferies & Co. - Analyst*

I'm sorry if I missed this earlier, but given that some of the noise surrounding year-end, and when ultimately the acquisition for the Bakken assets closed, can you guys provide us a compliance adjusted debt to EBITDA to start the year, where you are shaking out?

Greg Goff - *Tesoro Logistics LP - CEO*

I don't have that at hand. Evan Barbosa, our IR Manager, will be in touch, but suffice it to say, I believe it's in the low 4 area.

Corey Goldman - *Jefferies & Co. - Analyst*

Okay, yes, I will circle back with Evan off-line. And just one final one for me. Given the improvements that you had realized in 2016, relative to the operating income and EBITDA growth that you also realized over that year, and this was echoed in your release last night just given some commodity headwinds, and the volumetric curtailments there. Is a reversal of that included in the 2017 EBITDA projection of the $1 billion, or is that, if it comes it's great, but we don't need it to reach that $1 billion?

Greg Goff - *Tesoro Logistics LP - CEO*

No. We don't have any reversal like that in our estimate. The business ran very well for us in the fourth quarter. Crude throughput was actually a record for us. We see those businesses both on the gas and on the crude side, the base business performing well.

The new assets in the Bakken we're very happy with, they're off to a good start. There's four rigs in that footprint right now, which is ahead of what we had estimated for the year. Good discussions going on with customers. So as far as the base business goes this year, we don't have any reason to have any concerns around that, at this point.

Corey Goldman - *Jefferies & Co. - Analyst*

Awesome, Maybe just one final one of I could squeeze it in there, sorry. The Bakken assets that were closed upon January 1, that was I think you had said that was on current production, that gets you hat roughly $500 million EBITDA midpoint. Is there a -- we shouldn't expect a ramp on that? That should be relatively stable for the year, just given where 1Q EBITDA is? Just trying to calibrate that?

Greg Goff - *Tesoro Logistics LP - CEO*

We did not plan on a ramp in that business. And we did have 1.5 rigs in our estimate for this year which was based on some JV commitments from one of the producers, as well as stated plans from another producer. So we did -- that would have kept things roughly even for the year. But at four rigs, if we see that carry through the balance of the year, we think volumes would improve as we get into the year.

Corey Goldman - *Jefferies & Co. - Analyst*

All right. That's really helpful. Thanks.

Operator

Thank you. This does conclude the question-and-answer session, as well as today's program. We thank you for your participation. You may now disconnect. Good day.
