Andeavor Second Quarter 2018 Webcast Transcript

Date: August 6, 2018
Presenters: Greg Goff, Chairman and CEO
Steven Sterin, Executive Vice President and CFO
Brad Troutman, Vice President, Investor Relations

Brad Troutman:

This is Brad Troutman, Vice President of Investor Relations, and I would like to thank you for joining our webcast covering progress of our strategic plans and our second quarter 2018 earnings.

This pre-recorded webcast will be presented by Greg Goff, Chairman and CEO and Steven Sterin, Executive Vice President and CFO.

The earnings release, which can be found on our website at andeavor.com, includes financial disclosure and reconciliations for non-GAAP financial measures that should help you analyze our results. A transcript of this webcast will also be available on our website.

Our comments during this webcast will include forward-looking statements that refer to management's expectations or future predictions. These statements are made as of the date of this webcast and we are under no obligation to update these forward-looking statements in the future.

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 webcast over to Greg.

Greg Goff:

Thanks, Brad.

We had an excellent quarter. Our integrated business had very strong earnings, and Andeavor Logistics reported its best quarter ever.

Now, let me cover a few of our highlights during the quarter.

- First, we completed two acquisitions and further extended our footprint into Mexico.
- Second, our refining operations ran at high utilization rates and all planned maintenance was successfully completed on time.

- Third, we went live with our new advanced Enterprise Resource Planning system that had been in development for over two years.
- Fourth, we completed a $1.6 billion drop down to Andeavor Logistics and now expect our Permian Basin crude oil gathering, transportation and storage business to exit 2018 with a run rate of $90 million of annual net earnings and $150 million of EBITDA.
- Fifth, we continued to deliver on our Western Refining synergies as expected.
- And sixth, we continue to expect to meet or exceed all of our previously communicated goals for 2018.

We are making significant progress on the proposed strategic combination with Marathon, and I'm pleased to announce that we have scheduled a shareholder meeting to approve the proposed transaction on September 24, 2018, and pending shareholder approvals and other customary closing conditions, we expect to close on October 1, 2018. We have already received regulatory approvals in the United States and Canada.

We have been working diligently on integration and synergy planning and continue to expect to deliver at least $1 billion of annual run rate synergies within the first three years and are well prepared for a seamless transition at close. As I have said previously, I am very excited about the significant shareholder value and long-term growth opportunities this powerful combination is expected to create.

Turning to the quarter,

Our integrated business model allowed us to deliver excellent results this quarter. The refining margin environment in the second quarter improved significantly, primarily due to strong demand, declining product inventory levels across the industry, strong demand for logistics infrastructure and favorable crude oil fundamentals. We continue to see a strong refining environment and improving marketing margins in the third quarter. Our integrated business model is performing very well and overall is exceeding our expectations for 2018.

We continue to make excellent progress with the execution of our strategic growth plans in Mexico. On June 6, we announced our intention to invest $100 million over the next two years in a new refined products terminal with marine capability at Rosarito, Baja California. Additionally, we recently won new open season awards for additional Pemex Logística storage and throughput capacity in the states of Baja California Sur, Sinaloa and Chihuahua. These efforts will increase our refined product logistics capabilities, reduce costs, extend our value chains further into Mexico and support our ARCO® brand growth plans.

We also announced a project to convert the Dickinson Refinery in North Dakota into a 12,000 barrel per day renewable diesel facility. Although we are currently co-processing about 5% soybean oil, this project will enable the refinery to process up to 100% soybean oil and other feedstocks, like distillers corn oil, into renewable diesel. The project is expected to be completed in late 2020 and is subject to permitting and regulatory approval. This project is part of our strategy to reduce regulatory compliance costs through the implementation of renewable technologies.

Our integration of Western Refining and Western Refining Logistics is progressing well, and our delivery of synergies is on schedule. We continue to have a successful integration and are moving forward towards full integration and synergy capture.

We exited the second quarter at a run rate of $280 million in synergies, and we expect to deliver a synergy run rate of $350 to $425 million by mid-2019. The synergy run rate achieved by the second quarter consists of approximately $140 million of corporate efficiencies and approximately $140 million in value chain optimization, marketing and other improvements.

Now, turning to our business segments,

First, within our Marketing business,

We remain committed to driving growth in our Marketing business by adding new retail sites to the network, placing product into the highest-value branded distribution channels and growing our non-fuels convenience business.

We are continuing to make excellent progress executing our organic growth plan, adding 30 net branded stations in the second quarter. And, to date, we have successfully converted over 100 stations from multi-site operator to company-operated. These conversions allow us to capture additional non-fuel margins, higher fuel sales and enhance overall station profitability.

We are also now supplying fuel to approximately 128 stations in Northwest Mexico. We expect to increase our marketing presence across the entire northern part of Mexico with an estimated 250 to 300 stores planned through 2020 and believe there is substantial growth beyond that. As I mentioned, our recent supply agreements and planned terminal support these targets.

Moving to our Logistics business,

We are very pleased to announce the completion of the $1.6 billion drop down of assets to Andeavor Logistics this month, which includes high-growth Permian Basin crude oil logistics assets as well as the majority of Andeavor's refining logistics assets.

The drop down also included the transfer of the Conan Crude Oil Gathering System and the Los Angeles Refinery Interconnect Pipeline. The drop down is expected to generate 2019 annual net earnings of $105 to $115 million and EBITDA of $195 to $205 million. This represents an EBITDA multiple of approximately 8.4 times in 2019, when including additional capital investments of approximately $150 million that Andeavor Logistics will spend in 2018 and 2019 in relation to dropped projects that are still under construction.

In the Permian Basin, we were awarded an additional crude oil gathering project. The project is supported by an acreage dedication of 4,000 acres, bringing our total Permian Basin acreage commitments to 76,000 acres. We expect to invest $75 to $85 million on awarded gathering projects in the Permian Basin through early 2019 at attractive organic project multiples that average 6 to 7 times EBITDA.

Including the assets in the recent drop down and continued execution of our growth projects, we expect to exit 2018 with a run rate of $90 million of annual net earnings and $150 million of annual EBITDA in the Permian Basin.

We continue to see strong fundamentals for logistics infrastructure and customer demand. As such, today we announced that Andeavor Logistics expects to invest $150 million additional growth capital in 2018, in relation to projects included in the drop down and to accelerate Permian Basin crude oil gathering projects.

The Conan Crude Oil Gathering System is approximately two-thirds complete and already exceeding our expectations. We continue to expect full operations to begin later this year.

Construction is progressing on the North Dakota NGL Logistics Hub and the project is expected to start partial operations late in the fourth quarter of 2018.

The growth in our Logistics business continues to bring more stable, fee-based earnings and cash flow to Andeavor. Following the drop down just completed, our ownership in Andeavor Logistics is now 64%, allowing Andeavor investors to participate in third-party organic growth across the business, and in particular, the Permian Basin at very attractive multiples. Our focus on high return investments, customer excellence and project execution positions us for further growth as a leading customer focused, full-service logistics company. We are very excited about the growth in logistics and the value it creates for the owners of Andeavor and Andeavor Logistics.

Shifting to our Refining business,

Our refining system ran very well this quarter. Total refinery throughput for the quarter was 1.1 million barrels per day, which was in-line with our guidance. Refining margin was $1.4 billion, or $14.26 per barrel and utilization was 96%, which was impacted modestly by planned maintenance. These figures are all significant improvements over the prior year.

We successfully completed the planned maintenance at our Anacortes and Kenai refineries in the second quarter and have no material planned work scheduled for the third quarter. As previously discussed, we will continue to take advantage of our planned downtime to optimize our system and fully prepare for IMO 2020, from which we expect to see the benefits beginning in 2019.

The Los Angeles Refinery Interconnect and Compliance Project (LARIC) is progressing well with primary projects on target for completion by the end of the year. The project will significantly reduce emissions as well as enhance our flexibility to make 30 to 40 thousand barrels a day more of diesel or jet fuel instead of gasoline, dependent upon demand. This flexibility will deliver significant benefits, with the potential for upside with the upcoming IMO specification changes. The project is expected to deliver annually $75 million of net earnings and $125 million of EBITDA growth. This earnings improvement and timing is consistent with the targets discussed at our Investor Day and does not include any incremental benefits related to IMO.

The Isomerization Project at our Anacortes refinery, which increases octane production capability, meets Tier III sulfur requirements and reduces operating costs, was mechanically complete in the second quarter 2018 and full operations are expected to start in the third quarter. This project will deliver approximately $20 million in annual net earnings and $40 million in EBITDA, which is consistent with our commitments.

I would like to take a moment to thank our employees for all of their tremendous efforts to transform Andeavor into the company it is today. I am proud and personally grateful for their excellent work and all they have accomplished for our company, our customers, our shareholders, our communities and all of our other stakeholders. Without great people collaborating and working hard together, we could not have achieved this success. I look forward to the proposed strategic combination with Marathon and have confidence that our combined teams will continue to lead the industry as we move forward.

With that, I'll turn it over to Steven to provide more detail of the second quarter financial and operational results.

Steven Sterin:

Thanks, Greg.

Andeavor reported second quarter 2018 net earnings attributable to Andeavor of $515 million, or $3.38 per diluted share, compared to $40 million, or $0.31 per diluted share a year ago.

Consolidated net earnings were $582 million for the second quarter compared to $87 million for the same period last year and EBITDA was $1.2 billion compared to $479 million a year ago.

Please keep in mind that our 2018 second quarter results include $30 million of integration costs related to the Western Refining integration and transaction costs primarily related to the strategic combination with Marathon.

Turning to our business segments,

In our Marketing business, for the quarter,

Segment operating income was $209 million and segment EBITDA was $227 million compared to segment operating income of $240 million and segment EBITDA of $255 million a year ago.

We continued to grow our network of retail and branded stations, growing station count by 257, or 8% year-over-year, to 3,330 stations. This was primarily driven by the additional stations from the Northern California Retail acquisitions and the continued execution of our organic growth plan, including rebranding and expansion into Mexico.

Total fuel margins for the second quarter were 11.6 cents per gallon versus fuel margins of 13.2 cents per gallon last year. Retail and Branded fuel margins were 21.1 cents per gallon compared to 23.2 cents per gallon in 2017. We saw a lag in street prices relative to spot prices in the first two months of the quarter, which resulted in lower than typical fuel margins. As we head into peak summer driving season, we are seeing improvements in fuel margins and continue to see strong demand for our products across the business. We continue to expect to average between 11 and 14 cents per gallon for 2018 as outlined at our 2017 Investor and Analyst Day.

Our merchandise margin continues to improve, increasing to $58 million from $20 million in 2017, primarily due to the Western Refining acquisition but also from the successful conversion of multi-site operator stations to company operated. As Greg mentioned, we have converted over 100 stations to company operated, so we are just now beginning to see the benefits of our efforts.

Shifting to our Logistics business, for the quarter,

Our Logistics segment reported record results, with segment operating income increasing to $193 million from $163 million a year ago and segment EBITDA growing to $282 million versus $236 million last year. While we are proud of this accomplishment, we are more excited about partnering with our customers to help them achieve their growth plans, and growing our businesses together.

Andeavor's total distributions received from Andeavor Logistics were $115 million during the second quarter, an increase of $44 million or 62% from a year ago.

Turning to the drop down,

As Greg described, we are pleased to announce that we completed the $1.6 billion drop down.

This drop down provides several key benefits that further strengthen our integrated business:

- First, substantially all of our Permian Basin assets are now owned by Andeavor Logistics, which positions it to more efficiently optimize, connect and capture growth.
- Second, nearly all of the traditional refining logistics assets and pipelines are now owned by Andeavor Logistics, creating opportunities for operational synergies and asset optimization as well as the potential for bringing more third-party business into the systems.
- Third, the 5 asphalt terminals coupled with the 4 terminals already in Andeavor Logistics' business position it well to optimize trucking, distribution and operating costs. Also, the outlook for volumes in this business is constructive, especially with the upcoming changes related to low sulfur marine diesel fuel standards and the ability to partner with our refining and commercial operations to create value.

To fund the drop down and the additional growth projects of $150 million announced today, Andeavor elected to receive $1.25 billion in Andeavor Logistics common units and $300 million in cash. Following this drop down, Andeavor's ownership in and future cash distributions from this high-growth business goes from 59% to 64%. And, it is expected to reduce Andeavor Logistics' overall leverage to approximately 4 times and support coverage of approximately 1.1 times by the end of the year.

All of these factors should enhance the value of Andeavor Logistics and the significant number of units held by Andeavor.

Moving to our Refining business,

Our segment operating income for the second quarter was $607 million compared to $45 million a year ago and segment EBITDA was $782 million versus $206 million last year.

Refining margin for the second quarter was $1.4 billion, or $14.26 per barrel. This compares to a refining margin of $768 million, or $9.45 per barrel last year. Total Refining crude oil throughput for the second quarter was 1.1 million barrels per day, or 96% utilization, which was in-line with our guidance.

Our business continues to benefit from the widening of crude differentials, particularly in our inland operations. In the quarter, Midland traded at an average differential of $8 per barrel to

WTI and at a $14 per barrel differential to Brent, enabling our El Paso and Gallup refineries to capture significant value. Although Canadian differentials tightened compared to the first quarter, they remain very attractively priced, primarily benefiting our St. Paul Park and Anacortes refineries.

Consolidated manufacturing costs in the second quarter decreased 60 cents per barrel over the same period last year to $5.07. The year-over-year decrease is due to our continued focus on driving productivity to offset inflation, Western Refining synergy execution and improved operational reliability. We expect there will be a modest increase in manufacturing costs in the third quarter due to planned maintenance and higher energy prices, and we have included that in our guidance.

Our corporate and unallocated costs for the second quarter 2018 were $162 million. This includes $30 million of transaction and integration costs. We continue to achieve our planned corporate synergies and remain disciplined with our spending. We remain committed to delivering on the Western Refining synergies and the continued productivity we are demonstrating in our corporate functions.

Now, let me take a moment to discuss our balance sheet, cash flow and our strategic priorities for creating long-term shareholder value.

Total debt, net of unamortized issuance costs, was $8.7 billion at the end of the quarter. Excluding Andeavor Logistics, debt was $4.4 billion. I would like to point out that Andeavor paid down debt of approximately $230 million in the quarter and invested $75 million plus working capital for the Asphalt Terminal Acquisition.

Turning to cash flow,

Andeavor generated cash flow from operating activities of $847 million in the second quarter. Please keep in mind that we incurred $69 million in turnaround expenses and $14 million in marketing branding expenditures that are included in the presentation of our operating cash flows.

In the second quarter, we invested $258 million in high-return, growth capital projects at Andeavor and Andeavor Logistics, primarily driven by our Permian Basin growth investments, LARIC and the Isomerization project Greg mentioned a moment ago.

Andeavor paid dividends of $89 million and Andeavor Logistics distributed $90 million to its public unitholders during the quarter. Due to the proposed strategic combination with Marathon, we were unable to repurchase shares this quarter.

We also announced that the Andeavor board of directors declared a quarterly cash dividend of $0.59 per share, payable on September 14, 2018 to all holders of record as of August 31, 2018.

Our continued commitment to capital allocation discipline, a strong balance sheet and consistent execution of our growth plans positions us to continue to create significant shareholder value.

Looking ahead, you can find details of our planned throughput, manufacturing costs per barrel and other elements related to our third quarter outlook in our earnings release.

This concludes our webcast. Thank you.