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HollyFrontier Corp. (HFC)

Q1 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to HollyFrontier Corporation's First Quarter 2015 Conference Call and Webcast. Hosting the call today from HollyFrontier is Mike Jennings, President and Chief Executive Officer. He is joined by George Damiris, Executive Vice President and Chief Operating Officer; and Doug Aron, Executive Vice President and Chief Financial Officer.

At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation. [Operator Instructions] Please note that this conference is being recorded.

It is now my pleasure to turn the floor over to Julia Heidenreich, Vice President-Investor Relations. Julia, you may begin.

Julia Heidenreich
Vice President-Investor Relations

Good morning, everyone, and welcome to HollyFrontier Corporation's first quarter 2015 earnings call. This morning, we issued a press release announcing results for the quarter ending March 31, 2015. If you'd like a copy of today's press release, you can find one on our website, www.hollyfrontier.com.

Before Mike, George and Doug proceed with their prepared remarks, please note the Safe Harbor disclosure statement in today's press release. In summary, it says statements made regarding management expectations,

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judgments or predictions are forward-looking statements. These statements are intended to be covered in the Safe Harbor provisions of federal securities laws. There are many factors that could cause results to differ from expectations, including those noted in our filings. Today's statements are not guarantees of future outcomes.

Today's call may also include discussion of non-GAAP measures. Please see the press release for reconciliations. Also, please note that information presented as of today's call speaks only as of today, May 6, 2015. Any time-sensitive information provided may no longer be accurate at the time of a webcast replay or re-reading of the transcript.

And with that, I'll turn the call over to Mike Jennings.

Michael C. Jennings

Chairman, President & Chief Executive Officer

Thank you, Julia. Good morning. Thanks for joining us on HollyFrontier's first quarter earnings call. Today, we reported first quarter net income attributable to HFC shareholders of $227 million, or $1.16 per diluted share. First quarter EBITDA was $445 million, 34% above the comparable quarter last year. Realized margin improvement combined with lower costs drove more than a 50% increase in earnings per share year-on-year. This improvement came despite significantly compressed crude differentials and lower benchmark product margins across all our regions. On a per barrel basis, consolidated refinery gross margin was $16.69, a 13% increase versus the $14.75 per barrel reported in Q1 of 2014.

Our refineries are operating safely and reliably. First quarter 2015 utilization rate was 94% of nameplate capacity, 4% above our five-year average level. Adjusted for planned turnaround activity, crude throughput was 104% of nameplate capacity.

March performance was particularly strong averaging 465,000 barrels per day of refined product make. Given low planned maintenance, I expect continued high refinery utilization rate for the balance of 2015. We continue to target increase in crude access and flexibility benefiting both product yield and crude acquisition costs.

For example, in the Southwest, Navajo's access to higher gravity crudes through HEP's Malaga system is driving light product yields higher. Additionally, in Mid-Con, processing a greater amount of Bakken and Rocky Mountain sweet crudes, now accessible via pipeline, has contributed to the 4% increase in distillate yields during the quarter versus the comparable quarter last year. Our ongoing progress in accessing higher value crudes will allow us to continue optimizing feedstocks and generate higher realized margins per barrel.

Through 2015, we expect to spend between $600 million and $650 million in capital. Half of this will be focused on executing growth projects, which will contribute more than $175 million in annual EBITDA beginning in 2016, with expected growth from that level in subsequent years.

In addition to the larger capital projects, which include the Woods Cross Phase 1 expansion, El Dorado Naphtha Fractionation project and Cheyenne hydrogen plant, we have several small-dollar high-return projects underway.

Our gas oil optimization strategy in the Mid-Con is driving results. Tulsa intermediate feedstock optimization improved liquid yields and relaxed previous crude rate constraints caused by gas oil containment. Other investments that will further diminish gas oil driven constraints at Tulsa include the Tulsa FCC modernization which is due to complete in early 2016.

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Investments targeting liquid yield improvement are currently underway, including the El Dorado Naphtha Fractionation unit which is due to complete mid-year. Other smaller-dollar high-return projects include improvements to the El Dorado reformer, the Tulsa PVA unit and a Navajo vacuum unit enhancement project.

In addition to the liquid yield improvements, there are several debottlenecking opportunities we can take advantage of across our refining system, which are low-cost, high return projects. We received a permit granting us the ability to utilize Tulsa's existing 170,000 barrel per day crude distillation capacity, which will allow us to modify and upgrade several downstream units to improve conversion and expand throughput. Beyond 2015, we have planned upgrades at several units of the Cheyenne Refinery, which will increase light product yield and enable us to run at a higher crude utilization rate.

Over the last four years, we've completed turnarounds at all of our plants and run the combined system through a variety of commodity price environments. This has enabled us to identify several quick hit projects. These projects require relatively small upfront investments and yield high returns, which will drive EBITDA growth over the next few years.

Upon startup of the El Dorado naphtha fractionator, we intend to drop the unit into Holly Energy Partners. Under this structure, we expect HEP to operate the unit using a tolling arrangement with a minimum volume commitment. Holly Energy Partners will remain a fee-based organization underpinned by long-term minimum volume commitments.

Upon completion of the El Dorado naphtha fractionator transaction, we will evaluate other opportunities for dropdown to the MLP, including improved logistics related to the Woods Cross Phase 1 expansion. We're also working to increase HEP third-party business through organic projects and acquisitions.

Our 2015 goals target safe and reliable operational execution. Completion of the growth projects currently underway, identification of additional growth investments, and improvement of our balance sheet efficiency.

So with that let me turn it over to George Damiris, our Chief Operating Officer.

George J. Damiris
Chief Operating Officer & Executive Vice President

Thanks, Mike. First quarter throughput was approximately 417,000 barrels per day versus our guidance of 400,000 barrels per day. Our average laid-in crude cost was $2.62 per barrel under WTI. Total refinery operating costs for the quarter were $236 million, a 6% reduction compared to the same period last year.

Cheaper natural gas prices and lower maintenance expenses contributed to our operating expense improvement in the quarter. Rockies crude throughput was 67,000 barrels per day. Average laid-in crude cost was $6.94 per barrel under WTI. Refinery operating costs were $9.13 per throughput barrel.

I expect Rockies OpEx to revert back to the $6 to $7 per barrel range upon startup of the Woods Cross expansion with continued reliability improvement of the Cheyenne Refinery. Recently completed upgrades to the Cheyenne Boiler and Plant Air Systems have improved reliability and will continue to drive utilization rates higher and per barrel operating expenses lower going forward.

Mid-Con throughput was 258,000 barrels per day. Average laid-in crude cost was $1.68 per barrel under WTI. Refinery operating costs were $4.67 per throughput barrel. Improvement initiatives at our Tulsa Refinery are

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starting to become apparent. Tulsa hit new production and processing unit rate records contributing to the 99% Mid-Con utilization rate achieved in the first quarter.

First quarter Mid-Con margin capture was exceptionally strong at 100% of the Group III benchmark reflecting the benefit of crude-slate optimization in the quarter and liquid yield focused investments being made across our systems.

Light product yield was 90%, well above historic average levels. Drivers of this improvement include upgrades made to the El Dorado FCC unit during the fourth quarter turnaround, which increased conversion rates by 2.4% and optimizing intermediate streams between various units at Tulsa, El Dorado, and third-party sales.

These improvements have allowed us to more consistently run the Tulsa crude unit at or above 125,000 barrels per day historical constraint and the El Dorado FCC at its 42,000 barrel per day capacity. Southwest crude throughput was 91,000 barrels per day. We ran 100% Permian crude, of which 42% was higher gravity crude available to Navajo through HEP's Southwest New Mexico Gathering system.

Average laid-in crude cost was $2.08 per barrel under WTI. Refinery operating costs were $5.56 per throughput barrel. We successfully completed the planned turnaround in the 35,000 barrel per day Artesia crude unit during the first quarter. Navajo has since run at record rates averaging over 105,000 barrels per day of crude throughput in March and April.

Our refining system is running exceptionally well as reflected in our first quarter operating results. In recent weeks, we have seen record throughputs at our Tulsa and Navajo refineries and are hitting new record rates at several of our downstream processing units. Going forward, I expect we will continue to see the benefit of our ongoing efforts to improve reliability, including better optimization of our units and operating costs. Given the low maintenance levels in 2015, I expect the mid to high 90% utilization rate to be achievable.

For the second quarter, we expect to run 420,000 barrels per day of crude with 29% of it being sour and 19% WCS and black wax crude. We have a 30-day crude unit turnaround at the Woods Cross Refinery in the second quarter.

With that, I'll turn it over to Doug for some closing remarks.

Douglas S. Aron

Chief Financial Officer & Executive Vice President

Thank you, George. For the first quarter of 2015, cash flow provided by operations totaled $247 million. First quarter capital expenditures totaled $134 million, which excludes HEP's $38 million capital spend. Turnaround spending in the quarter totaled $29 million. In 2015, we expect to spend between $600 million and $650 million in capital, and additionally we expect to spend about $70 million on tanks and turnaround.

During the first quarter, we repurchased approximately 1.4 million shares at an average price just below $40. As of March 31, we have $462 million remaining on our current share repurchase authorization.

This morning, in conjunction with our results, we announced a new $1 billion share repurchase program. We remain committed to our regular dividend, which currently stands at $0.32 per share per quarter, putting our yield at 3.3% as of last night's close, towards the top-end of the peer group range. We intend to maintain both a competitive dividend yield and total cash yield relative to our peer group.

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We returned approximately $120 million in cash to our shareholders through buybacks and dividends in the first quarter over 50% of first quarter reported net income. As of March 31, 2015 HollyFrontier debt, totaled $187 million, excluding non-recourse HEP debt of $891 million. Our total cash and marketable securities balance stood at $1 billion. This year we expect to add leverage to our balance sheet and make significant progress reducing our cash balance by executing on our share repurchase program and taking advantage of internal investment opportunities.

HollyFrontier owns 39% of Holly Energy Partners, 22.4 million common units, plus the 2% general partner interest. The current market value of our LP units is approximately $722 million as of last night's close. First quarter general partner incentive distributions were $10.2 million, a 21% increase over the same quarter last year. First quarter results were not significantly impacted by unusual items. The $6.5 million pre-tax benefit from inventory valuation was more than offset by the $8.5 million pre-tax charge relating to the write-off of our Sabine Biofuels investment.

Lastly, a reminder that you can find our monthly WTI-based 3-2-1 indicators for our Mid-Con, Rockies and Southwest regions posted on HollyFrontier's Investor page. These regional indicators do not reflect actual sales that are not – and are rather meant to show monthly trends. Realized gross margin per barrel may differ from indicators for a variety of reasons. You may find the data on our Investor page at hollyfrontier.com.

And now, Sharon with that I believe we're ready to open the floor to questions.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question comes from the line of Paul Sankey from Wolfe Research. Your line is open.

Paul B. Sankey
Wolfe Research LLC
Q

Hi. Good morning, everyone.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Hello, Paul.

Paul B. Sankey
Wolfe Research LLC
Q

Mike, the throughputs are impressive and the outlook is impressive. I was wondering is there a risk that we oversupplied the market? I know one of the great advantages of you guys has been that you're in a fundamentally product short market. I'm just wondering whether if everyone choose the kind of performance that you've been achieving and say that you're likely to achieve for the rest of the year, we may get to a situation of oversupply. And further to that, I was wondering how do you anticipate that the market would clear and I guess I'm thinking of product exports and how that sort of flows through to your markets? Thanks.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

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Sure. For starters, Paul, I think the demand side of the equation has to be considered when we talk about oversupply. Year-over-year demand figures for gasoline, in particular, are looking strong in terms of the comparisons if you look at individual store sales for those with refining or with retail exposure. We're anticipating 3%, 4% demand growth, we're seeing that in the vehicle fleet profile in terms of new purchases.

So we believe that the wind is at our back right now with respect to demand. Yeah, there is a risk, obviously that a lot of this crude surplus ends up as product in tanks, but our job is to run these plants and find good markets in which to place them. As you say, our markets are fundamentally short product, which means that the incremental barrel is coming up from the Gulf Coast and that the margin being produced with sweet crude on the Gulf Coast. So we have an inherent crude advantage relative to that barrel. We intend to run these plants reliably and strong through the summer and capture as much of that market as we can.

Paul B. Sankey
Wolfe Research LLC — Q

Thank you. And then the follow-up, Mike, is that you led the market in special dividends and somewhat changed strategy, could you just – given the free cash flow update us on your cash return thoughts? Thank you very much.

Michael C. Jennings
Chairman, President & Chief Executive Officer — A

Absolutely. As we know, we discontinued the special dividend [ph] spending (17:31) strategy at the end of last year. We felt as though we weren't being compensated for that strategy at our share price, but we're now going to dedicate free cash flow plus a considerable amount of our balance sheet to share repurchase. We feel like the stock at this level represents a wonderful value and we're going to try to take advantage of that on behalf of our shareholders.

Paul B. Sankey
Wolfe Research LLC — Q

Thank you. That's clear. Thank you.

Operator: Your next question comes from Brad Heffern from RBC Capital Markets. Your line is open.

Brad Heffern
RBC Capital Markets LLC — Q

Morning, everyone. Just on the same buyback theme, I'm curious why the authorization for the $1 billion buyback when there is so much left on the old one? And if you could talk through maybe the pace and what your target cash level is?

Douglas S. Aron
Chief Financial Officer & Executive Vice President — A

Sure. Brad, this is Doug. And I would tell you why the increased authorization is, I think we've got really a renewed focus here, not that we ever didn't have a focus, but as Mike took you through a host of different small capital projects that we have going on, really it's sort of the conclusion of a lot of maintenance work that we've had through our system. We've had a chance to look internally and externally at what might be available and we've come to the conclusion that the assets we own, we think are the best opportunity for investment. And that's why we're going to ramp up our share repurchase program.

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In terms of a target cash balance, I would tell you that we probably like to keep at least – well let's call it $500 million or so on hand of liquidity on a go-forward basis. Now, as you look at our balance sheet today with $185 million of debt outstanding, that is by far the lowest in the refining peer group. So I don't think we're limited to just necessarily the $1 billion that we had authorized this morning, but no point in really talking about anything beyond that until we get through that amount and we would hope to try to execute that in the next 12 months to 18 months.

Brad Heffern
RBC Capital Markets LLC
Q

Okay. Thank you for that. And Mike, obviously, you spoke about M&A last quarter, can you give your updated thoughts there and I suspect that the repurchase would indicate that you're finding your own assets more attractive than those on the market at the moment?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yeah. I think Doug just answered that question pretty well. We have a lot of attractiveness internally and we feel like that our shares and our internal organic projects are the best use of our capital in terms of driving return going forward.

Brad Heffern
RBC Capital Markets LLC
Q

Okay. Thank you.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yep.

Operator: Your next question comes from Neil Mehta from Goldman Sachs. Your line is open.

Neil S. Mehta
Goldman Sachs & Co.
Q

Good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Hi.

Neil S. Mehta
Goldman Sachs & Co.
Q

So, I wanted to give you guys an opportunity to talk a little bit about Holly Energy Partners, one of the pushbacks investors often cite about HFC is the lack of growth at the HEP business given the maturity. So what can be done to grow that business? And then, in particular, the thoughts on dropping down some of the refining margins into HEP seems interesting. Can you dig that out for us a little bit?

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Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Certainly. I think we have to start at a very high level. And that is that all of these refinery dropdowns across the industry are digging into refinery gross margin, whether it's a truck rack, or a marine dock, or whatever asset, gross margin per barrel is being transferred into the MLP structure. So as we look at our refining system, we realize we have one of the highest per barrel generators of gross margin across the industry. We've got a lot of room to push earnings into the MLP. The question is which assets best qualify.

And as we look at those, we're trying to get the most tax efficient assets, meaning new iron that we don't have a gains tax to pay upon the dropdown, because that dilutes the impact of the dropdown by about 35%. Okay. So as we dig into some of these refining assets, à la El Dorado naphtha fractionator, we understand that that's perhaps not traditional, that people have become accustomed to seeing logistics assets. But the fact is it's a very efficient transaction from a tax perspective.

It's also a growth project that's going to generate a very durable cash flow stream, because it's effectively a gas to liquids project. So the underlying cash flow that we're generating and dropping a portion of is very predictable in the same manner that a crude pipeline might generate such predictable cash flows.

So that's sort of the thinking behind what we're doing. We feel like Holly Energy Partners has certainly internal drops of the sort that I'm identifying, as well as external growth based upon their crude gathering system and potential for non-organic growth outside the system in terms of the acquisitions that we're pursuing with HEP, most likely that would be synergistic with our crude gathering and transportation operations.

Neil S. Mehta
Goldman Sachs & Co.
Q

Thanks, Mike. And then, the follow-up here is on Brent/WTI. Last quarter you had some comments and your thoughts on where it could go, I think you cited high single digits for the balance of the year. Just curious on updated thoughts in light of production and then also what we're seeing here in Cushing, and how it could play out from here?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Certainly. Look Cushing is operationally slower right now. We've seen a draw here in the last week and I think most of the consensus sees small draws continuing through the second quarter. But a lot of that crude is still moving to the Gulf Coast. So, if you look at total U.S. balances, have had three balances and the Cushing Houston transportation differential, I think what we find is a lot of the crude remains in tanks. And so the country has still long crude volumes, crude inventory. I think based on that you're going to see a pretty significant Brent/WTI differential through the balance of the year until aggregate crude inventories draw and I don't see that happening in a material way until the third or even the fourth quarter.

Neil S. Mehta
Goldman Sachs & Co.
Q

Thanks, Mike.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yep.

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Operator: Your next question comes from Faisel Khan from Citigroup. Your line is open.

Faisel H. Khan
Citigroup Global Markets, Inc. (Broker)

Q

Yes, thanks. Just a quick follow-up question on the naphtha fractionator, just how large of a dropdown could that be? Could you put a little bit more color around the dropdown and also timing?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Certainly. The as build cost of that project is approximately $100 million. I've emphasized the desire to be tax efficient in these dropdowns. So, therefore, we would likely dropdown the cost basis. The typical metric around these dropdowns in refining companies seems to be in the 9 times, 10 times EBITDA range. So I think you can take it from there. But what I would say is that's sort of first step and we're continuing to seek out other such opportunities be they logistical or otherwise that might be good internal candidates for dropdown.

Faisel H. Khan
Citigroup Global Markets, Inc. (Broker)

Q

Okay. And the last question, you mentioned that the share repurchase program you want to maximize the use of your balance sheet, does that mean that including the cash that you have on hand right now, would you borrow to buyback your stock?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Certainly. I mean these balance sheets can be leveraged. I think a normal debt quotient might be one times debt to EBITDA, call it 20% debt to cap. We have some stepping to do between here and there in terms of the quantum of share repurchase. So as a starter, the balance sheet cash available is approximately $1 billion and our intention is to get after that and retire approximately that amount of shares.

Faisel H. Khan
Citigroup Global Markets, Inc. (Broker)

Q

Okay. Great. Thanks for the time. Appreciate it.

Operator: Your next question comes from Doug Leggate from Bank of America. Your line is open.

Doug Leggate
Bank of America – Merrill Lynch

Q

Thanks, everybody. Good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Hi, Doug.

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Doug Leggate
Bank of America – Merrill Lynch

Mike, terrific operating result obviously after a couple of years ago you'll remember had the tough time you had, so great turnaround there. I guess my question is really on the capture rate. I'm guessing this has something to do with the increase in the light sweet crude run, so the improvement we saw this quarter, is that something you see as sustainable or what is the extent to which you think you still have upside to shift your, I guess, your yields and your throughput towards more light sweet crude? And I've got a follow-up please.

Michael C. Jennings
Chairman, President & Chief Executive Officer

Further shifts to light sweet crude, I think we've taken that as far as it will go in the near term, but that's why we highlight the yield improvement projects and then the debottlenecks because as we do some of these small capital quick hit projects, we would be able to take it further. But for today, we gained – what is it – about 15 percentage points in capture rate in Mid-Con versus the historical average, of which contango contributed about 4% of those 15 percentage points. So the other really was the old-fashioned way in terms of crude substitutions, better refining efficiency, better marketing efficiency around bottoms to price realizations, and we think that all those are sustainable.

Doug Leggate
Bank of America – Merrill Lynch

I appreciate that. My follow-up is more, I guess, philosophical on the MLP strategy. How do you think about prioritizing organic growth out of the refining business versus the acquisition model for the MLP, in other words, third-party opportunities? What I'm really getting at is the cannibalization, if you like, to the EBITDA on the refining business, how far are you prepared to take that? And can you quantify any implied from the [indiscernible] (27:50)?

Michael C. Jennings
Chairman, President & Chief Executive Officer

Okay. So, to start with, the naphtha fractionator project, as an example, represents incremental EBITDA to our company of $50 million to $65 million per year. It's a very high returning investment. Of that, we may propose to carve off, pick a number between $10 million and $15 million of EBITDA as it dropped to the MLP. Incrementally, we're still gaining, call it, $40 million of EBITDA at the refining company.

So we really don't see this as diluting refining capture. It actually is a very efficient transaction. And if those funds are used to repurchase stock, that being the dropdown proceeds, we should see a penny or two a share of actual EPS gain by the refining company as a result of the dropdown. So I think it's a virtuous transaction.

In terms of how far are we willing to add fixed charges to our refining company, we've been probably more conservative than most, Doug, in stewarding refining company cash flow statements and gross margin per barrel. So I don't really see a risk in our shop of overdoing it. But we do recognize we've got a very high gross margin per barrel generation machine, and a certain portion of that logically should reside in the MLP due to cost of capital advantages.

Doug Leggate
Bank of America – Merrill Lynch

That's terrific quarter. Thanks, Mike.

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Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Thank you.

Operator: You next question comes from Jeff Dietert from Simmons. Your line is open.

Jeffery Alan Dietert
Simmons & Company International
Q

Good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Hi, Jeff.

Jeffery Alan Dietert
Simmons & Company International
Q

So you talked about early on a number of quick hit low capital, high return projects. Do you have an estimate as to what kind of EBITDA enhancements you could receive in aggregate from these projects as you look out 2015, 2016?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yeah. I do Jeff. We've highlighted the 2016 effect already. But we're looking to spend capital incrementally that might be $250 million with incremental EBITDA in the $200 million to $225 million range, and that would be things that are commissioned to be constructive in 2016, probably start realizing EBITDA in 2017. But we're going to lay this out in a much more visible fashion such that it can be easily digested by the analyst community in the market.

Jeffery Alan Dietert
Simmons & Company International
Q

Got you. And similarly would you look at identifying those EBITDA streams that are MLP qualifying and what's your expectations for MLP dropdowns would look like going forward?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yes. As a quantum, I would say, something like 20% of the incremental EBITDA being generated by these growth projects will probably find its way into the MLP. That's a level at which we're very comfortable.

Jeffery Alan Dietert
Simmons & Company International
Q

Great. So it sounds like an increase in effort in both the low-cost, high return asset investments and an increase in opportunity for MLP dropdowns relative to perhaps what you've done historically.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

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Yes. Let me be kind of clear on that. We've spent about the last 9 months to 12 months working principally on refiner reliability and operational execution. Moving the needle on those fronts takes time and effort. George and his team have dug in deep. We've added people, we've added capability, and until we get to or have gotten to a more solid foundation, the notion of growth, even quick hit growth, was something that we pushed off just because of the sheer importance of getting capacity utilization up on the existing system. We feel like we've achieved a lot of that now, obviously we're never done, but we now have an opportunity to think more about growth and about greater investments given just the better performance at our refinery system.

Jeffery Alan Dietert
Simmons & Company International
Q

Thanks for your comments.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

You bet.

Operator: Your next question comes from Roger Read from Wells Fargo. Your line is open.

Roger D. Read
Wells Fargo Securities LLC
Q

Hey, good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Good morning.

Roger D. Read
Wells Fargo Securities LLC
Q

Glad to see the adjustment on the strategy. I was wondering, as you look overall though and I think on the last call we talked about – I say, we talked about, you mentioned that you had an acquisition target that didn't work out. As you look at this opportunity relative to future acquisitions, how are you evaluating that? I think it's pretty clear the return on relatively modest CapEx for a nice EBITDA hit here, but in terms of growth of the company outside your current footprint, how did you evaluate that comparison?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yeah. Look our strategy is about per unit, per barrel, per share. And it's really going to be focused toward high return projects and reducing share count. The tilting at windmill strategy of hoping for a large and accretive acquisition is just not high enough probability for us to spend a lot of time on. And obviously, we're going to keep our eyes open and our ears up, but these are things that are within our wheelhouse, we know we can execute them and they'll be delivered to shareholder value within a year to two years' time, so that's the priority. Would we love to help consolidate this industry a bit and get bigger and more efficient? Absolutely, but not at the expense of realizing the value of our existing system.

Roger D. Read
Wells Fargo Securities LLC
Q

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Okay. I appreciate that. And then two kind of operational questions together. What are you seeing in terms of product demand, I think the question was sort of asked earlier, but I was wondering if you had any specifics on what you were seeing for either gasoline or diesel? And then what was the RINs impact during the quarter?

George J. Damiris
Chief Operating Officer & Executive Vice President A

For the first one, I think as Mike outlined earlier, we see demand still very strong, especially on the gasoline side. Diesel demand is weaker than we would like, but still relatively strong. And I think you can see that reflected in the crack spreads. We have high-teens gasoline cracks in all our regions, and we have distillate cracks that are in the low-$20s. And I think again the diesel cracks' probably lower than it has been in the mid-$20s instead of low-$20s and the gas crack has been maybe in the mid-teens rather than high teens. So a little bit higher on gas at the end of the day and a little bit lower on diesel than we'd like. And as far as RINs -

Douglas S. Aron
Chief Financial Officer & Executive Vice President A

I got it, George. It's a little over $40 million for the quarter, or $0.13 a share.

Roger D. Read
Wells Fargo Securities LLC Q

Okay. And just a follow-up on the gasoline demand, diesel demand. I mean no percentages, I know you-all don't have a retail outlet, but I mean any other granularity other than the commentaries to the crack spreads?

George J. Damiris
Chief Operating Officer & Executive Vice President A

Well, I don't think we have any more to share than what Mike already laid out there, Roger.

Roger D. Read
Wells Fargo Securities LLC Q

Okay. Appreciate it. Thank you.

Operator: Your next question comes from Phil Gresh from JPMorgan. Your line is open.

Philip M. Gresh
JPMorgan Securities LLC Q

Hi, good morning. First question, just on the CapEx, the $600 million to $650 million for this year, you talked about the potential incremental spend opportunities you see moving forward. How should we generally think about run rate CapEx as we look out to 2016 with certain projects rolling off and the others rolling on? Trying to get a sense of how you think about core CapEx.

Douglas S. Aron
Chief Financial Officer & Executive Vice President A

Yeah. We were, until last quarter, pointing toward a runoff of growth-oriented CapEx, which would've left us at maintenance levels of approximately $150 million plus compliance really into the next two or three years of $100 million to $125 million, so looking at that $300 million. I think what you can conclude is that we're going to be spending probably another $150 million a year on these smaller quick-hit projects. More than a self-funding strategy for sure in that the payouts are so quick, but CapEx will be higher to accommodate these projects.

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Philip M. Gresh
JPMorgan Securities LLC
Q

Okay. And with any of the major projects that you're doing this year, is there any carryover into next year, or is that factored into the $450 million-ish type of number you're talking about?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

That's factored in. The Woods Cross Phase 1 project is due to start up in the month of November approximately, the Cheyenne hydrogen plant year-end, and the El Dorado Naphtha Frac project middle of the year. So those are really the chunky investments that have caused this year's CapEx to be so high.

Philip M. Gresh
JPMorgan Securities LLC
Q

Got it. And then the $175 million of related EBITDA that when you said realized in 2016, you are thinking the full run rate of that EBITDA should actually be realized as opposed to maybe just a portion of it?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

That's right. All these projects should be started up and on stream for the full 12 months.

Philip M. Gresh
JPMorgan Securities LLC
Q

Okay. And if I were to just kind of roll that in. I think in the past you've talked about how you're thinking about normalized EBITDA maybe through a cycle. Any new thoughts in terms of take this market environment, the projects what you're laying out beyond 2016?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

We don't give guidance is what I would tell you. Everybody is looking at each other in this room. It's so hard with a very fluid gasoline and diesel crack, a Brent WTI spread that can move around a couple bucks in a month. We've had a very wide range. If you look across the last three or four years, it ranges between probably $1.4 billion and $3.5 billion, normalize is sort of a setting on your washing machine, I think. I don't know that we have that [indiscernible] (39:01).

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

The other side of that, though, is that we'll spend plus $175 million for the growth projects this year and plus $200 million to $250 million for quick-hit projects that will be executed across the next couple of years. So add that to whatever your prior definition of normal was which, as Doug suggests, is kind of a point in time estimate. But that's how we would look at it.

George J. Damiris
Chief Operating Officer & Executive Vice President
A

And I'll probably fill in, maybe 5% improvement in reliability to 20,000 barrels a day refining throughput to that earnings as well.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Earnings last year?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Right.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Yeah.

Philip M. Gresh
JPMorgan Securities LLC

Q

Okay. Thanks. I'll turn it over. Thank you.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thanks.

Operator: Your next question comes from the line of Evan Calio from Morgan Stanley. Your line is open.

Evan Calio
Morgan Stanley & Co. LLC

Q

Hey. Good morning, guys. Good results.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thanks.

Evan Calio
Morgan Stanley & Co. LLC

Q

Just a brief follow-up on the [indiscernible] (39:51) higher MLP-able potential here, 20% of growth project EBITDA potentially your cost basis. I presume is it timing following the startup or after some period of performance, and given this new iron and it's a toll, I presume the accounting wouldn't be a hold-up here as you think about timing or conversion of that capital into the MLP?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Right. So the way that we look at it is, we don't need to rent capital from the MLP during the construction phase. We have access to plenty of cheap capital. Our objective is to try to grow the MLP with real earnings and that happens after startup. There isn't an accounting hitch, but really the drop-down of approximately the as-built cost is going to be the target. It's very tax efficient. And depending on the return of the underlying asset, you're talking about it might be 20%, 25%, 30% of the overall EBITDA from that project is dedicated to paying the tariff and the residual sits with the refining company.

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Evan Calio
Morgan Stanley & Co. LLC
Q

Good. Very clear. In the first quarter, a smaller question, you will have completed an acquisition of existing tank farm adjacent to your El Dorado refinery. What's EBITDA potential there, maybe small, and is there any strategic value there to give you flexibility for your refinery asset?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

I'll explain the EBITDA potential and I'm going to ask George to speak to the benefits of our owning that inside the family versus outside. The EBITDA to HEP is in the $3 million to $5 million per year range. And effectively that's bringing in a tank farm that holds the crude storage for the El Dorado refinery that's been owned by third parties for many years. Progressively there are some opportunities to improve earnings and crude flexibility.

George J. Damiris
Chief Operating Officer & Executive Vice President
A

We have tankage in Cushing and in El Dorado now, but by owning both we believe we can optimize the use of that tankage. Then the other significant improvement is being able to optimize our blend more efficiently at both Cushing and El Dorado to feed the refinery in El Dorado, the tank utilization and blending.

Evan Calio
Morgan Stanley & Co. LLC
Q

Great. That makes sense. Maybe just one last one for me, macro, I know you had thoughts on differential – constructive use and differentials in storage at Cushing. But with a heavy fall Pad 2 turnaround planned industry-wide in the fall, do you expect this debate returns to the market later in the year, and any thoughts there and I'll leave it at that?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

The debate you're talking about relates to crude differentials and theoretically overfilling the Cushing tanks?

Evan Calio
Morgan Stanley & Co. LLC
Q

You got it, yeah contango what are the differentials that relate of-approximating both tank tops here?

Michael C. Jennings
Chairman, President & Chief Executive Officer
A

Yes, I think we're going to have to wait and see what happens with production decline practically speaking. Yes, heavy turnaround season, yes we hope to benefit from it, but production at some point is going to follow rig count and we're going to keep our eyes open. With that said, the productivity of individual wells seems to be improving while rig count is falling. So it's a pretty circular debate and it's one that I don't think we have unique insights on.

Evan Calio
Morgan Stanley & Co. LLC
Q

Wonderful. Thanks, guys.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thanks.

Operator: [Operator Instruction] Your next question comes from Ed Westlake from Credit Suisse. Your line is open.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Yes, thank you, and very good call so far. Just on the EBITDA improvements from the quick-hits. Appreciate you're going to try and give us some extra color, but how much of that, as you've looked at the assets, is coming from say volume expansion? You mentioned Tulsa. How much is it light product yield shifts? How much is taking the swell of gas into liquids given the large differences in natural gas versus liquids prices? Just trying to get a sense of the durability of these types of EBITDA uplifts that you're talking about. Thank you.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

That's right. Understand the question, and what I'm going to tell you is that we're going to have to be more explicit at upcoming Analyst Day, which is not yet on the calendar, but we do want to give comfort and characterization around these projects. What I would say is liquid yield improvement is core to refinery profitability. Yes, that does have the effect of bringing more light product to market, but if you're bringing light product out of what is otherwise heavy oil discounted sales from profitability perspective, it's a must-do transaction.

The crude slate substitution in those kinds of projects tend to be very high return projects. So what we will do and plan to do is to get this group together and demonstrate what the projects consist of and how they respond profit-wise in different crack spread environments. But I want to leave you with the thought that we're not talking about large refined product expansions in terms of making a whole lot more gasoline and diesel. What we're doing is improving the operating efficiency and the yield efficiency of existing plants at largely existing crude rates.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

That's helpful. And then on the turnarounds, obviously, you don't have planned turnaround, so you get a reliability boost there. But unplanned downtime has been something that you've been working very hard on. Can you give us a sense of why you're more confident that the unplanned downtime will be less going forward across the plant?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Yes, I would say it's a couple things. We've invested a lot of money in a lot of our utility systems. As we mentioned at Cheyenne we've invested a lot of money in our steam boiler system, in our plant air system. Those have caused us more than their fair share of headaches in the past. We feel we've rectified those systems and won't see those contribute to our unreliability in the future. I think we also have increased focus. We have increased staff and capability, as Mike mentioned earlier. We've moved a couple of people around and got a guy from Navajo named Mike McKee to Dallas to help us with our reliability efforts, so there's a huge human resource component to our improvement as well.

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Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

And then the final question. This could be a bit cheeky, so I don't want you to take it in the wrong way. But you've invested a lot to improve reliability and that's been the focus as you've laid out. Today you've chosen to obviously announce the share buyback, announced that you might have an Analyst Day, that you'd be more aggressive in the MLP and also additional EBITDA. Is anything going on in the background that we should be aware of in terms of why today is the day that you chose to put this out?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

No. We've got a good story to tell. We've got our refineries running well now. We've got a balance sheet that affords a significant amount of share repurchase and we're very constructive about the future prospects of the company. So I think that it's important that market understands what we have going on internally. And we look forward to producing that plus some.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Well, thanks very much for all the color today.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thank you.

Operator: [Operator Instructions] We do not have any questions at this time. Ms. Heidenreich, I will turn the call over to you.

Julia Heidenreich
Vice President-Investor Relations

Thanks, everyone. Thank you for joining us today. Give a call to Investor Relations, we'll be here to answer any and all questions and otherwise we look forward to sharing our next quarter results in August. Have a great day.

Operator: Thank you. This does conclude today's teleconference. Please disconnect your lines at this time, and have a wonderful day.

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