TRANSCRIPT
2Q 2019 EARNINGS CALL

PHILLIPS 66 PARTNERS (NYSE: PSXP)
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PHILLIPS 66 PARTNERS PARTICIPANTS

Jeff Dietert, *Vice President, Investor Relations*

Kevin J. Mitchell, *Director, Vice President and Chief Financial Officer*

Rosy Zuklic, *Vice President and Chief Operating Officer*

Tim Roberts, *Director and Vice President, Operations*

MEETING PARTICIPANTS

Elvira Scotto, *RBC Capital Markets*

Spiro Dounis, *Credit Suisse*

Justin Jenkins, *Raymond James & Associates, Inc.*

Barrett Blaschke, *MUFG Securities*

Christine Cho, *Barclays*

Jeremy Tonet, *JP Morgan*

Ryan Levine, *Citigroup*

Christopher Sighinolfi, *Jefferies*

TRANSCRIPT

Operator:

Welcome to the Second Quarter 2019 Phillips 66 Partners Earnings Conference Call. My name is Julie, and I will be your Operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.

I will now turn the call over to Jeff Dietert, Vice President, Investor Relations. Jeff, you may begin.

Jeff Dietert:

Good afternoon, and welcome to the Phillips 66 Partners Second Quarter Earnings Conference Call. Participants on today's call will include Kevin Mitchell, Vice President and CFO; Tim Roberts, Vice President, Operations; and Rosy Zuklic, Vice President and Chief Operating Officer. The presentation materials we will be using during the call can be found on the Events section of the Phillips 66 Partners website, along with supplemental financial and operating information.

Slide 2 contains our Safe Harbor statement. It is a reminder that we will be making forward-looking statements during the presentation and our Q&A session. Actual results may differ materially from what we present today. Factors that could cause actual results to differ are included here, as well as in our SEC filings.

With that, I'll turn it over to Kevin Mitchell.

Kevin J. Mitchell:

Thank you, Jeff. Good afternoon, everyone. This morning we announced an agreement to eliminate our general partners incentive distribution rights. This transaction further reinforces PSXP as a premier MLP with a lower cost of capital and a simplified structure. PSXP is well-positioned with a strong balance sheet and a robust portfolio of growth opportunities. I will cover this transaction in more detail later in the presentation.

Our Board of Directors recently approved a second quarter distribution of $0.855 per common unit, an increase of $0.01 from the previous quarter and 14% higher than the second quarter 2018 cash distribution. We have increased the distribution every quarter since the July 2013 IPO. We remain committed to delivering a competitive and growing distribution while maintaining strong coverage and leverage ratios.

Moving on to Slide 4 to discuss financial results, the Partnership reported second quarter earnings of $233 million. Adjusted EBITDA during the quarter was a record $319 million, an increase of $38 million from the first quarter. The improvement reflects higher volumes on the Explorer, Bakken, and Bayou Bridge joint venture pipelines. In addition, volumes on our wholly owned pipelines and terminals increased due to higher utilization at refineries operated by Phillips 66.

Second quarter distributable cash flow was $254 million, an increase of $28 million from the prior quarter, primarily due to higher earnings.

Slide 5 highlights our financial flexibility and liquidity. We ended the second quarter with $130 million of cash and $749 million available under our revolving credit facility. The debt-to-EBITDA ratio on a revolver covenant basis was 2.8x. Our distribution coverage ratio was 1.44x. Long-term, we're targeting leverage of up to 3.5x and distribution coverage over 1.2x.

The partnership continues to advance its major projects. In the second quarter, organic growth capital was $102 million. This included spend for the Clemens Caverns expansion, the new isomerization unit at the Phillips 66 Lake Charles Refinery, and the Clemens to Gregory ethane pipeline.

During the quarter, the Gray Oak JV secured $1.3 billion of project financing for the pipeline construction. Starting with the second quarter, capital spend for this project will be largely funded through this secured financing.

Switching topics now to discuss the IDR elimination transaction which starts on Slide 6, the elimination of IDRs improves our cost of capital and simplifies our structure. The transaction further aligns the LP and Phillips 66 economic interests. Given the Partnerships' robust growth profile, high distribution coverage, and solid financial position, we believe the transaction is attractive for both our LP unitholders and our general partner. The lower cost of capital enhances PSXP's ability to grow through organic projects, dropdowns, and third party acquisitions.

Looking ahead, the Partnership maintains strong fundamentals and our commitment to unitholders is unchanged.

Slide 7 provides the details of the IDR transaction. When the transaction closes, PSXP will issue 101 million common units to Phillips 66 in exchange for the elimination of the IDRs and the GP economic interest. Phillips 66 will own approximately 75% of PSXP's expanding common units.

The transaction value is approximately $5.4 billion. This is based on a July 25 closing price and represents a 16.7x multiple on forecasted 2020 GP distributions. The transaction is accretive to DCF on a per unit basis by the fourth quarter of 2020. The transaction is expected to close on August 1, 2019.

I'll now turn it over to Rosy to provide an update on our growth projects.

Rosy Zuklic:

Thanks, Kevin, and hello, everyone. Slide 8 lists the projects we have ongoing. I'll only touch on a few updates. We continue to construct the Gray Oak Pipeline. We have received all major permits and acquired 100% of right of way. Approximately 80% of the pipe has been installed and all 17 tanks are at sell height. The project remains on track to start up in the fourth quarter of this year.

New to the slide this quarter is the C2G Pipeline. This is a 16-inch ethane pipeline that will run from the Clemens Caverns in Sweeny, Texas, to Gregory, Texas. The C2G Pipeline will serve petrochemical customers in the Corpus Christi area. The pipeline will have 240,000 barrels per day of capacity and is expected to be completed in mid-2021.

During the quarter we completed construction of the Lake Charles products pipeline that connects storage at the Phillips 66 Lake Charles Refinery to the Clifton Ridge Marine Terminal. The connection to the terminal will provide the refinery an outlet to competitively place its products in the market. The terminal will have up to 50,000 barrels per day of product export capacity. Just last week Phillips 66 exported its first high sulphur diesel cargo from this facility. We have a long-term agreement with Phillips 66 that includes minimum volume commitments for the pipeline and marine dock.

Earlier this month, the Lake Charles isomerization unit reached mechanical completion and is expected to ramp up to full production in the third quarter. The project was completed on schedule and below budget.

This concludes our prepared remarks. We will now open the line for questions.

Operator:

Thank you. We will now begin the question-and-answer session. If you have a question, please press star, then one on your touchtone phone. If you wish to be removed from the queue, please press the pound key. If you're using a speakerphone, you may need to pick up the handset first before pressing the numbers. Once again, if you have a question, please press star, then one on your touchtone phone.

Elvira Scotto from RBC Capital Markets, please go ahead. Your line is open.

Elvira Scotto:

Hey, good afternoon everyone. I bet you're glad this is probably the last quarter you'll get the IDR questions. Just starting with that, can you walk through the rationale for the structure of the IDR elimination? Specifically, given the multiple paid on the GP cash flows, absent a dropdown, we can't get to accretive in 4Q 2020 or, really, any time kind of beyond that, so my question is really why not do a dropdown acquisition in conjunction with the IDR elimination?

Kevin J. Mitchell:

Yes. Elvira, this is Kevin. As we modeled this transaction, we did consider doing a dropdown in conjunction with it. And actually, on our math, we couldn't get to the sort of big bang combination transaction as really providing any incremental benefit over the simplicity and transparency of doing a straight up IDR conversion the way we have done it.

Now, what's important to remember is the MLP continues to have a significant growth profile ahead of it in terms of the organic projects that are underway, so there's a pretty clear line-of-sight to EBITDA growth through 2020 and into 2021. Then, in addition, you think about what's going on at the PSX level in the Midstream business with the assets that are there today and the ongoing investment and projects that are taking place at the PSX level, there's still a long runway of potential growth beyond just the organic projects. That's a significant growth coming, but layer on what's going on at the PSX level, there's a lot of line-of-sight to potential growth that will come to PSXP.

Elvira Scotto:

Can you just maybe walk us through how you get to accretive 4Q 2020? Just what are the different things we need to consider to get to that?

Kevin J. Mitchell:

Yes. As you think about what's going to drive some of that, as we look at through 2020—so you've got the underlying growth in the MLP, right, so just in simple EBITDA terms, taking this quarter annualized, you're at $1.3 billion EBITDA rate. We've got new projects coming on this quarter, third quarter, fourth quarter, and then more in 2020 and right through into 2021 with the just newly announced C2G Pipeline. You've got significant growth in aggregate at the MLP level. Then you think about the different drivers as you look at that calculation in terms of distribution growth; issuance of units, which can come in many forms, so dropdown assumptions can drive unit issuance, ATM, the potential for equity market issuance, not that we really had any plans to go do anything like that; but all of those will impact the calculation as you walk through that.

Elvira Scotto:

Okay. Thank you. Then just the last one for me is, now that you've eliminated the IDRs here at PSXP, just what's the strategic views on developing Midstream projects at the PSX level versus the PSXP level, like Red Oak and Liberty, for instance?

Kevin J. Mitchell:

Yes. I think that our views on that have not changed. As you step back and think about, at the MLP, we've sort of consistently been doing really as much as we can reasonably absorb at the MLP from an organic capital standpoint while keeping the balance sheet in a comfortable place the way we like it and not being dependent on having to go to equity markets that really aren't available, not over levering the balance sheet. There's no reason to assume that that will change. While it's a decision of the sponsor whether when projects like Red Oak and Liberty come into the MLP, the sort of decision criteria around that will be just the same as they were previously.

Elvira Scotto:

Okay. Sorry. Just one last one for me and then I'll hop off, but now that post-IDR elimination, PSX is going to own 75% of PSXP units outstanding, if you were to do a dropdown and if the MLP equity markets just aren't amendable, I mean, would you issue even more units to PSX and theoretically, push that ownership up even higher?

Kevin J. Mitchell:

Yes. I mean, in theory you could. The nice thing is there's still plenty of debt capacity available at the MLP. Typically, in a dropdown transaction there's always going to be a minimum number of units that are issued back to PSX, but because you're impacting, any unit issuance is impacting the numerator and the denominator. When you're at 75%, you actually have to do a lot to really move that percentage by much, right, so it's not something we're concerned with at this point.

Elvira Scotto:

Great. Thanks a lot, everyone.

Operator:

Spiro Dounis from Credit Suisse, please go ahead. Your line is open.

Spiro Dounis:

Hi, everyone. Good afternoon. Sticking with the IDRs here, with them basically behind you at this point, just curious where you stand on the potential to check the box at some point and go 1099 and potentially open up the investor pool here, especially if you're going into a stronger position here where you could maybe grow a little bit faster and get more enhanced returns. Is that something that's of interest to you now?

Kevin J. Mitchell:

Yes, Spiro; it's Kevin again. It's something we would consider, but for the time being, as we've looked at it to date, there hasn't been a compelling reason for us to go down that path. The nice thing is for as long as we—as having not done it, it's an option that's out there for us. It's something we can consider, but hasn't been a priority so far.

Spiro Dounis:

Okay. That's fair. Then just thinking about financing some of this growth going forward and maybe forgetting about equity issuances and things like that, obviously there's public/private ARB is still pretty wide here and you guys have a pretty interesting project slate, most of which you still wholly own. Just curious if there's any appetite or interest you're seeing to maybe joint venture some of these projects that you got there, like C2G.

Kevin J. Mitchell:

You could, but it really depends on what the joint venture partner would bring to the table on a project like that. What we don't want to do is just give up economic value and just for the sake of selling down our ownership interest. There needs to be more to it than that, so you've got to think there's an overall win for PSXP in a transaction like that.

Spiro Dounis:

Okay. Fair enough. Last one is a clean up one. I know you're not providing any sort of specific distribution guidance here, but just following the IDR removal, any reason to expect maybe a change in the quarterly increase pace or slowdown or speed up for the remainder of 2019?

Kevin J. Mitchell:

Well, you're right; we're not giving distribution guidance other than we expect to remain competitive, top quartile level. But the one comment I would make is with IDRs out of the way, once you get to sort of mid-to late-2020, PSXP has the ability to increase the distribution at a faster pace than it could with IDRs in place. Once you get past a year or so, you have the potential to do that. Now, whether we choose to do that or not is another matter and there'll be a lot of factors that go into that, but we're very well-positioned for continued distribution growth.

Spiro Dounis:

Got it. That's great color. Thanks, everyone.

Operator:

Justin Jenkins from Raymond James, please go ahead. Your line is open.

Justin Jenkins:

Thanks. Good afternoon, everyone. I guess just a couple of quick operational ones for me. Thinking through here with the Lake Charles isom being in completion here in July, any ramp in terms of the contracted nature of the cash flow there or is that all pretty much coming in day one for PSXP?

Rosy Zuklic:

Hi, Justin. This is Rosy. I would say that from a modeling perspective you probably don't see anything until the fourth quarter for isom.

Justin Jenkins:

Same type of question here, I guess, on Bayou Bridge; thinking through probably only a month or two of earnings flowing through in 2Q, should we think of same type of ramp profile for Bayou Bridge expansion?

Rosy Zuklic:

Right. The Phase 2 Bayou Bridge, we only saw two months in the second quarter. That's right; so you would see an improvement in the third quarter.

Justin Jenkins:

That's all I've got. Thanks, everyone.

Operator:

Barrett Blaschke from MUFG Securities, please go ahead. Your line is open.

Barrett Blaschke:

Is there a comfort level that PSX has in terms of the percentage of the LP common it's willing to hold at this point? I mean, 75% seems relatively high; any plans there?

Kevin J. Mitchell:

Barrett, it's Kevin. That question, it really is a PSX question and it came up this morning on the PSX call. The answer is, really, our decision-making is not driven around a targeted ownership percentage. It's really about as PSX sort of executes on its growth strategy in Midstream, and PSXP is an integral part of that, and there'll be various factors. We'll determine where that unit percentage ownership sits, but there's no target level specifically around that.

Barrett Blaschke:

Okay. Then just one other thing as I'm looking at the multiple on the elimination. It was 15.8 and a $5.2 billion value, so that gets me to about $330 million as an assumed cash flow to the GP in 2020. Would that imply that you would have a faster rate of distribution growth in that year based on those numbers, sort of pre-transaction?

Kevin J. Mitchell:

Well, what I would is, yes, taking you back to those comments I made a little earlier that there are several factors in the IDR structure that will determine what the IDR distribution would be. The distribution growth is one of them and that's a very important one and a significant one, but you also think about other things that can be happening around the LP units; ATM program, any dropdown with takeback units, or any other form of unit issuance will also impact that. Then the other one is the preferreds that are outstanding, and a conversion of the preferreds would impact that as well. Several moving parts will get you to that final number.

Barrett Blaschke:

Okay. That's fair. I think that does it for me. Thank you.

Operator:

Christine Cho from Barclays, please go ahead. Your line is open.

Christine Cho:

If we're to look at PSXP, if we were to assume the IDRs weren't restructured, and then we look at this new PSXP, are you assuming this new PSXP could do more projects and spend more money than if you weren't to have done this transaction now that your cost of capital is lower?

Kevin J. Mitchell:

I think that's a reasonable assumption, Christine. One of the key advantages of having the IDRs out of the picture is that your cost of equity no longer has that drag from an LP holder's standpoint, so that does make the MLP better positioned to execute on projects.

Christine Cho:

Okay. Then if we are to look at the assumptions for this, the timing of this accretion math as well, it sounds like if the growth assumptions are different, then the equity assumptions could theoretically also be different in the two scenarios.

Kevin J. Mitchell:

Yes, in theory.

Christine Cho:

Is that fair? Okay.

Kevin J. Mitchell:

Yes.

Operator:

Jeremy Tonet from JP Morgan, please go ahead. Your line is open.

Jeremy Tonet:

Hi. Good afternoon. Just wanted to go to the results here were better than we expected. On the JV one, equity earnings line came in pretty strong. I was wondering if you could talk to some of the drivers there, as well as kind of if this is a good run rate or there's kind of more capacity that could be squeezed out, or how should we think about this, particularly, I guess, DAPL, given that we knew Bayou Bridge was going to be coming online?

Rosy Zuklic:

Sure. Jeremy, this is Rosy. We had three JVs that really contributed to the earnings this quarter; probably the strongest contributor actually came from Explorer. Seasonally, the second quarter and the third quarter tend to be stronger quarters for Explorer as you think about product moving up to the Midwest. During the second quarter specifically, there was more pull on Explorer as more products got pulled up due to some refinery outages in the area. Bayou Bridge was actually probably the second most, just simply from the fact that you saw Phase 2 coming online and then I'm thinking about it just kind of relative compared to the first quarter. Bayou Bridge had Phase 2 come online and so that was the improvement there. The Bakken pipeline had stronger performance relative to the first quarter, but not anything that was astronomical changes; 559,000 barrels per day compared to 543,000 barrels per day, I think, it was in the first quarter.

All three of those pipelines ran really well. I think from a ratability perspective, again, Explorer second quarter, third quarter stronger quarters for that pipeline; Bayou Bridge, you could see that improving in the third quarter because Phase 2 being full production; and then Bakken just continues to operate well, its capacity now at 570,000 barrels per day. Probably running somewhere in 540,000 to 550,000 barrels is my assumption.Bbut Energy Transfer would probably be the best one to answer that one.

Jeremy Tonet:

That's helpful. Thanks. Just thinking about how you guys sit with your balance sheet now and all the projects that you have on hand, you have good organic slate there; you're retaining a good amount of DCF. Just

wondering thoughts on the need for equity or ATM at this point and did that factor into the IDR elimination process?

Kevin J. Mitchell:

Yes. Jeremy, you're right; the balance sheet is in great shape; we have debt capacity. I think as you look forward with IDRs behind us, would we issue under the ATM, would we issue equity? We may if the markets are there. The nice thing is we're not in a position where we have to issue and take hefty discount on any issuance, so it just gives more flexibility to the MLP's funding structure going forward.

Jeremy Tonet:

Got you. Just a quick housekeeping one; Gray Oak, did you say that line fill had started there or not yet because it's not all—or when do you expect it to start if it's 80% complete at this point?

Rosy Zuklic:

No. It has not started. We just have about 700 miles of the pipeline installed at this point. Line fill wouldn't start until sometime probably in the fourth quarter, with the line being completed at that point.

Jeremy Tonet:

Great. Just one last one if I could. Clearly there's been a lot of investor requests to have IDRs eliminated and kind of a big part of the MLP evolution here. Just wondering if you had thought about other steps, I guess, that investors had talked about with regards to how management was compensated moving from PSX to PSXP compensation or any other thoughts there, I guess, as far as MLP 2.0 evolution here.

Kevin J. Mitchell:

Yes, Jeremy. With PSXP, we acknowledge that we are a sponsored vehicle and so some of those other governance matters that you've seen some changes on MLPs, that's going to be more challenging and probably less likely to see in a sponsored structure like we are, so you still have that. That overall sort of sponsored nature of PSXP is not going to change.

Jeremy Tonet:

Okay. Thanks for the color there. That's helpful.

Operator:

Ryan Levine from Citi, please go ahead. Your line is open.

Ryan Levine:

Can you comment on your appetite for strategic third party acquisitions in light of the IDR restructuring and pro forma financial outlook?

Kevin J. Mitchell:

Yes. As we've talked about, we have a lot of growth ahead of us, both organic at the MLP and there's a lot of activity going on at the PSX level as well, and so there's no need for us to go down a third party M&A path. However, with IDRs behind us, we do have more flexibility, and if the right opportunities were to come along, it's certainly something we could consider. But, as always, the third party opportunities have to compete with the organic as well and so we look at them from the standpoint of the overall sort of

competitive nature of those opportunities, where they are from a returns standpoint, how that fits into the overall portfolio, obviously, the strategic fit because what we've been building out to date has been very strategic in alignment, both within the PSXP portfolio and when you look across the greater PSX portfolio. It has to be the right sort of industrial logic around as well around that.

I think the reality is it probably gives us a bit more flexibility to consider third party acquisitions than we had before, but it's not something we are compelled to do.

Ryan Levine:

Are there any specific characterizations of assets that fit the description around strategically rational over the next few years that it's a priority for the portfolio?

Kevin J. Mitchell:

Really not that we've worked through at this point.

Ryan Levine:

Okay. Thank you.

Operator:

Chris Sighinolfi from Jefferies, please go ahead. Your line is open.

Christopher Sighinolfi:

Hey. Good afternoon. Thanks again for the added color here. Kevin, I wanted to circle back to the earlier questions about that accretion characterization. I don't mean to belabor the point, but it's helpful to understand your baseline thought process, particularly because we've seen so many of these transactions and every one of them claims accretion, but often there's different assumptions being used in there. You had mentioned a number of different items that drive IDR cash flow—the coverage, the growth rate, the unit issuance, pref conversion. If I think about what you guided us on the last quarter call with regard to 1.2x coverage; leverage under 3.5—3.5 is your target, but you're running well south of that—there was no immediate plan for dropdown; we've seen one penny per quarter distribution growth; and then Slide 7, I see you still have an assumed pref equity conversion.

If I use all of that, I guess I share in my colleagues' struggle to get the accretion. I'm just wondering if there's any one of those assumptions that was meaningfully different than we understood it that could help address or get us to the same place.

Kevin J. Mitchell:

No, not really. All of those items will drive the IDR cash flows next year in that structure. Bear in mind that when we've given guidance on both coverage and leverage, we're giving sort of minimums; we're not giving guidance to a number. For coverage of 1.2, we would expect to be north of that, so I wouldn't necessarily hardwire that into your calculations. We've been in the ATM market. We're in blackout periods each quarter for a few weeks, but we have been in the ATM markets. Then we have our own assumptions around what we're going to do on dropdowns, for example. We've never given guidance on any of those kinds of transactions, so I think part of what you're probably struggling with is we've never given a lot of specific guidance other than the previous guidance around distribution growth and EBITDA target by the end of 2017. I think those moving parts are in there and they're in our calculation, but you don't have clear line-of-sight to what our assumptions are.

But those are all the factors that will drive it.

Christopher Sighinolfi:

Okay. Maybe if I could just follow up on one thing. We saw, for example, when Marathon eradicated their IDRs, they were guiding at 1.3x coverage ratio, but when they went and calculated it for purposes of IDR eradication, they went to a 1.0x full payout. Did you guys do something similar in this approach?

Kevin J. Mitchell:

No. No, definitely not.

Christopher Sighinolfi:

Okay. Thank you for the time.

Kevin J. Mitchell:

All right. Thanks.

Operator:

We have no further questions at this time. I will now turn the call back over to Jeff.

Jeff Dietert:

Thank you, Julie. I would give you a reminder again of the November 6 Analyst and Investor Day and hope to see you there. In the meantime, Brent and I will be available for any follow-up questions. Thank you.

Operator:

Thank you. Ladies and gentlemen, this concludes today's conference. You may now disconnect.