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HEP - Q1 2018 Holly Energy Partners LP Earnings Call

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CORPORATE PARTICIPANTS

George J. Damiris *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

Jared Harding

Richard Lawrence Voliva *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

CONFERENCE CALL PARTICIPANTS

Jeremy Bryan Tonet *JP Morgan Chase & Co, Research Division - Senior Analyst*

Justin Scott Jenkins *Raymond James & Associates, Inc., Research Division - Research Analyst*

Theresa Chen *Barclays Bank PLC, Research Division - Research Analyst*

PRESENTATION

Operator

Welcome to the Holly Energy Partners First Quarter 2018 Conference Call and Webcast. (Operator Instructions) Please note that this conference is being recorded. It is now my pleasure to turn the floor over to Jared Harding. Jared, you may begin.

Jared Harding

Thanks, Jason. Thank you all for joining our first quarter 2018 earnings call. I'm Jared Harding with Investor Relations for Holly Energy Partners. Joining us today are George Damiris, President and CEO; and Rich Voliva, Executive Vice President and CFO. This morning, we issued a press release announcing results for the quarter ending March 31, 2018. If you would like a copy of today's press release, you may find it on our website at hollyenergy.com.

Before George and Rich proceed with their remarks, please note the safe harbor disclosure statement in today's press release. In summary, it says statements made regarding management expectations, judgments or predictions are forward-looking statements. These statements are intended to be covered under 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 SEC filings. Today's statements are not guarantees of future outcomes.

Also please note that information presented on today's call speaks only as of today, May 1, 2018. Any time-sensitive information provided may no longer be accurate at the time of any webcast replay or reading of the transcript. Finally, today's call may include discussion of non-GAAP measures. Please see today's press release for reconciliations to GAAP financial measures.

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

George J. Damiris - *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

Thanks, Jared. And thanks to each of you for joining the call this afternoon. We are very pleased with our first quarter results, which enables us to announce our 54th consecutive distribution increase since our IPO in 2004. HEP's fee-based business model, supported by long-term minimum volume commitments, continues to provide a strong foundation for distribution growth.

Pipeline volumes increased 47% compared to the same period last year, primarily due to the acquisition of the remaining interest in the Salt Lake City and Frontier pipelines completed in October of 2017. HEP also had higher refined product shipments, largely driven by the turnaround that occurred in HollyFrontier's Navajo refinery in the first quarter of last year.

As many of you know, the FERC announced a policy revision in March that would no longer allow MLPs to include the income tax allowance in the calculation of cost of service tariffs. We do not anticipate this ruling will have a material impact on HEP as we have very limited cost of service tariffs. Looking forward, our focus is to leverage our existing footprint to grow organically, especially in the Permian.

This morning, we announced our intention to construct a new rack in Orla, Texas connected to our refined product systems in Texas and New Mexico. This asset will serve growing diesel demand associated with oil patch activity in and around the Delaware Basin. We also have an upcoming debottleneck project for the Malaga crude oil pipeline system and plan to expand the Salt Lake City and Frontier pipelines this year.

With that, I'll turn the call over to Rich.

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Thank you, George. On April 19, Holly Energy Partners announced a quarterly distribution of $0.655 per unit, which represents a 5.6% increase over the distribution for the first quarter of 2017. This distribution is scheduled to be paid on May 10 to unitholders on record as of April 30.

During the period, HEP generated distributable cash flow of $69 million, $12 million higher than the same period last year. Our distribution coverage ratio for the quarter was 1.04x. We continue to expect seasonal factors will drive coverage under 1x in the second quarter, followed by a much stronger second half of 2018 with a coverage ratio of 1x or higher for the full year.

Operating expenditures totaled $36.2 million versus $32.5 million in the same period last year. The increase is attributable to operating costs and expenses related to the acquisition of the remaining interest in the SLC and Frontier pipelines. Our CapEx for the quarter was $11.9 million, including approximately $300,000 of maintenance capital and $600,000 of capital reimbursed by HollyFrontier.

For the first quarter of 2018, we recognized $2.2 million of deferred revenue from prior shortfalls billed to shippers. And as of March 31, HEP carried $2.5 million in deferred revenue on our balance sheet. In the second quarter of 2018, we anticipate recognizing approximately $400,000 of deferred revenue.

Interest expense increased $4 million compared to the first quarter of 2017 due to the tack-on offering of an additional $100 million of our 6% senior notes completed during the third quarter of 2017 as well as our decision to temporarily finance all the SLC and Frontier acquisitions via our revolving credit facility.

In February of 2018, we issued $110 million of limited partner equity through a private placement. We also raised an additional $4.6 million during the period from the sale of LP units through our at-the-market or ATM program. These proceeds were used to repay a portion of the debt associated with the Frontier and SLC acquisitions.

And as of the end of the first quarter, our leverage was roughly 4.25x debt to trailing 12-month EBITDA. And we expect leverage to reach roughly 4x by the end of 2018. Including cash and revolver availability, our current liquidity is over $500 million. We are confident that our strong liquidity and ability to access the capital markets will enable us to achieve future growth, both organically and through M&A.

And with that, I'll turn the call over to Jason for the Q&A period.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from Theresa Chen from Barclays.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

My first question has to do with the guidance for second quarter of being below 1x. What is the cause of the seasonal factors?

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Theresa, it's primarily UNEV-related. As you'll recall, UNEV volumes run significantly lower in the second and the third quarter typically. So that's the big driver there.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Got it. And related to your terminalling segment, what was the revenue recognition change there?

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Specific to terminalling?

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Yes, there's a sentence that says, "These increases are primarily due to higher volumes in several of our terminals," yes.

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

It was between $1 million and $2 million.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. But what's the rationale behind the revenue recognition change? And how should we think about that going forward?

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Yes, sure. So that will be pretty standard going forward. This is the accounting that relates to the rev rec standard that came into enforcement earlier this year. And we have a couple of contracts that have a minimum tariff escalation that's greater than 0%. And the way that accounting works is you need to essentially recognize that over the life of that minimum, over the life of the contract.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. And previously recognized...

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Importantly, it would be recognized as that tariff increase. So it has a somewhat perverse effect of essentially making EBITDA -- the revenue look a little higher in the early years of a contract and a little lower than the actual billings in the later year of a contract. Importantly, we adjusted the distributable cash flow for this. So really the cash flow metrics are what the billings look like at the end of the day.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Understood. In terms of your diesel project, can you talk about the returns on the $10 million to $20 million of expected spend? How much EBITDA do you expect to generate from this?

George J. Damiris - *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

Yes, I don't think we want to get too specific there, Theresa. I mean, I think we disclosed what we think the capital cost is going to be and what EBITDA multiples are for the projects in the midstream space. So you can kind of impute a number from that.

Theresa Chen - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. What about the capital costs for the debottlenecking project at Malaga and the expansion of SLC and Frontier?

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

So those are in the kind of single-digit million dollars range, Theresa, and they're embedded in our capital guidance already. So there's nothing incremental for those.

Operator

Your next question comes from the line of Justin Jenkins from Raymond James.

Justin Scott Jenkins - *Raymond James & Associates, Inc., Research Division - Research Analyst*

I guess following up maybe on Theresa's question on the Permian, obviously a lot of focus here on the supply growth and basis differentials, and maybe it's a better question for HFC's call tomorrow. But George, you kind of referenced this in your prepared remarks. Just curious if there's any new opportunities down the road here on the crude side, whether it's gathering or longer-haul pipelines to get even more Permian barrels into the HFC refining system.

George J. Damiris - *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

I think we're going to continue to work on getting more gathering build on our existing HEP systems. In addition to that, as you know, we run 100% Permian crude at Navajo. And then on top of that, we also have leased capacity on a pipeline out of the Permian to Cushing. And we'll get into some of the volumes there on the HFC level tomorrow.

Justin Scott Jenkins - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Perfect. And Rich, forgive me if I missed it. But did we get a new CapEx number with the addition of the diesel supply project?

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

Yes. So we're basically raising capital guidance to a range of about $10 million, so $50 million to $60 million in total.

Justin Scott Jenkins - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. And then last one for me, with Woods Cross being down for a bit towards the end of the quarter and start of 2Q here, any issue in 1Q for HEP related to that and maybe potential impacts into 2Q?

George J. Damiris - *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

We don't really expect anything. UNEV typically runs slack in the -- or certainly lower in the second quarter. So there's really not going to be any change from that. We may see some lower volumes on the SLC and Frontier lines, but they were in and out of proration to begin with. So I'm not really sure it's going to have a huge impact at the end of the day.

Operator

(Operator Instructions) Your next question comes from Jeremy Tonet from JPMorgan.

Jeremy Bryan Tonet - *JP Morgan Chase & Co, Research Division - Senior Analyst*

I just want to go back to the Permian a little bit here and see if you might be able to expand a little bit more as far as how the gathering volumes trended -- trending over the quarter here.

Richard Lawrence Voliva - *Holly Energy Partners, L.P. - Executive VP & CFO of Holly Logistic Services LLC*

I'm not sure there was much of a trend over the course of the quarter. Navajo ran well, which is the base for the gathering system. And then with differential being fairly healthy, we're able to move a decent number of barrels up to Cushing as well.

Jeremy Bryan Tonet - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then I guess just turning to M&A out there, I was wondering if you might build or provide any updated thoughts. I think in the past, you commented some of the valuations were strong out there. But I guess, is there any opportunities kind of in the smaller size or anything that might be unique to your footprint that you could execute on that others might not see the same value that you do?

George J. Damiris - *Holly Energy Partners, L.P. - President, CEO & Director of Holly Logistic Services LLC*

Yes, I don't think there's much change in the overall M&A market from what we discussed earlier. We think it's still a pretty hot market especially in the Permian. And as far as smaller opportunities, there really aren't a whole lot of smaller opportunities in the Permian, in that most of the smaller systems are full already and most of the activities (inaudible) around new construction with the new volumes that are coming out in the area.

Operator

If there are no further questions, I will turn the floor back over to Jared for any closing remarks.

Jared Harding

Thanks again for joining the call today. If you any follow-ups, please reach out to Investor Relations.

Operator

This concludes today's conference call. You may now disconnect. Thank you for joining, and have a great day.