Northern Tier

Buy Pitch

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Western Investment Club

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Western Investment Club

MLP Primer

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MLP Primer

What is an MLP?

- MLP is a **master limited partnership**, which provides the tax benefits of a limited partnership and the liquidity of publicly traded security
  - Structure is fairly unique to natural resources, but comparable asset classes exist for other industries (REITs)
  - Classified as partnerships so they avoid income tax at the state and federal levels
  - Investors are paid through quarterly distributions, while the operators of the MLP are incentivized to maximize distribution
- MLP's typically trade at higher multiples because of their tax advantages, which increases the likelihood that acquisition of assets will be accretive to them

MLP Primer

Why are MLPs attractive right now?

- MLPs are currently becoming a more popular asset class, with the first MLP mutual find being launched only in 2010
  - MLPs are currently restricted only to the United States, but may gain international attention in the same trend that REITs had
  - MLPs are subject to impending regulations, which may have unpredictable outcomes for the asset class
- MLPs provide a steady yield of income, which is important for balancing a portfolio/fund
  - A well selected MLP can also provide capital gains

Business Overview

Western Investment Club

Business Overview

Company Description

Northern Tier Energy LP	
Ticker	NYSE:NTI
Stock Price	$24.83
IPO Date	Jul. 2012
Market Cap	$2.29B
P/E	9.1x
EV/EBITDA	8.8x

NORTHERN TIER

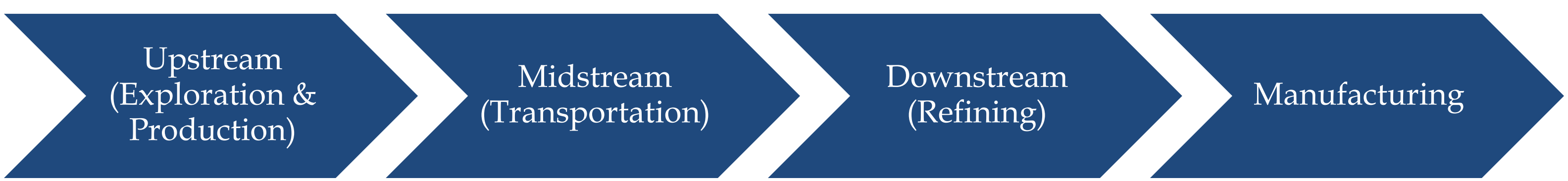
- Downstream energy company with refining, retail and pipeline operations
- Owns storage and transportation assets, which provide vertical integration
  - 17% interest in Minnesota Pipeline
  - Stored using light product terminals
- Marketed to resellers and consumers in PADD II region/Midwestern America through owned SuperAmerica gas stations

Business Overview

The Refining Business

Refining Business

- The oil and gas industry is divided into the **upstream, midstream**, and **downstream** sectors
- Refining (downstream) converts crude oil into more useful products such as gasoline, kerosene, diesel, which have multiple end users
  - Oil refiner profits are based on **volume processed** and **profit margin per barrel**
  - Refiners are concerned about the reliability of their inputs and their “crack spread”, which dictates profitability



Operating Segments

Refining

- NTI produces 89,500 barrels per calendar day (bpd)
  - Medium capacity out of 134 refineries in the US
  - Refinery capacity ranges from 14,000 bpd (smallest 10) to 300,000 bpd (largest 10)
- A refinery's complexity index refers to its ability to produce based on investment intensity and cost
  - A higher index is a sign of a higher quality refiner and its ability to process oil more profitably

Industry	NTI
10	11.5

Business Overview

Operating Segments

Supply Chain

Crude Oil from North Dakota/Canada → Refining at NTI → Sale to consumers through SuperAmerica

Retail

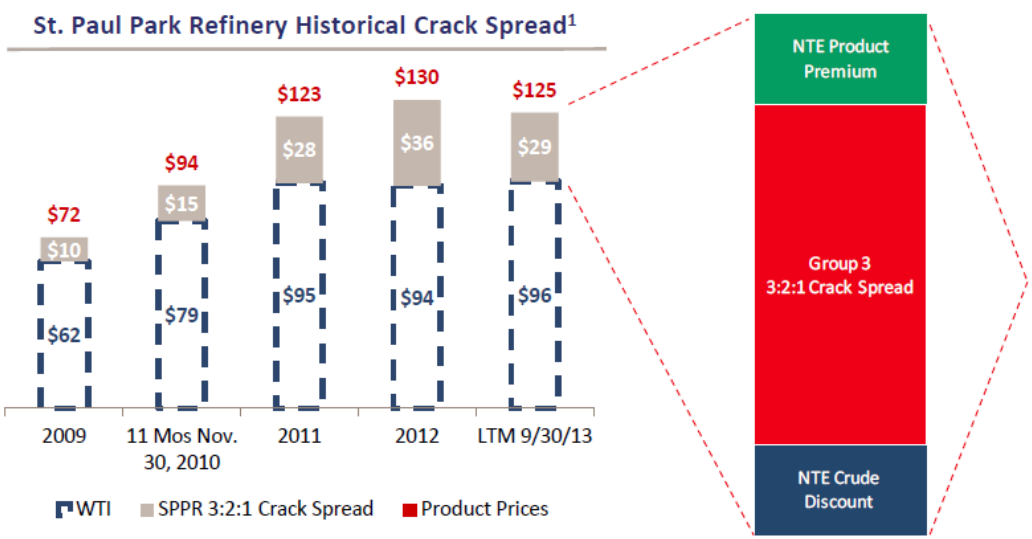
- NTI owns 163 convenience stores and 73 franchises under the SuperAmerica trademark
- 80% of these products are sold through convenience stores in Minnesota
- Tight integration between NTI's refining and retail operations reduces need for NTI to compete solely on price

External Analysis

Revenue Model

NTI's Favourable Crack Spread

- **3:2:1 Crack spread** is the difference between crude cost and refined products
- NTI has averaged a premium of $4.53/bbl relative to the benchmark crack spread over the past five years
- The refinery industry is primarily margin-based because both prices of feedstock and finished products fluctuate with the market

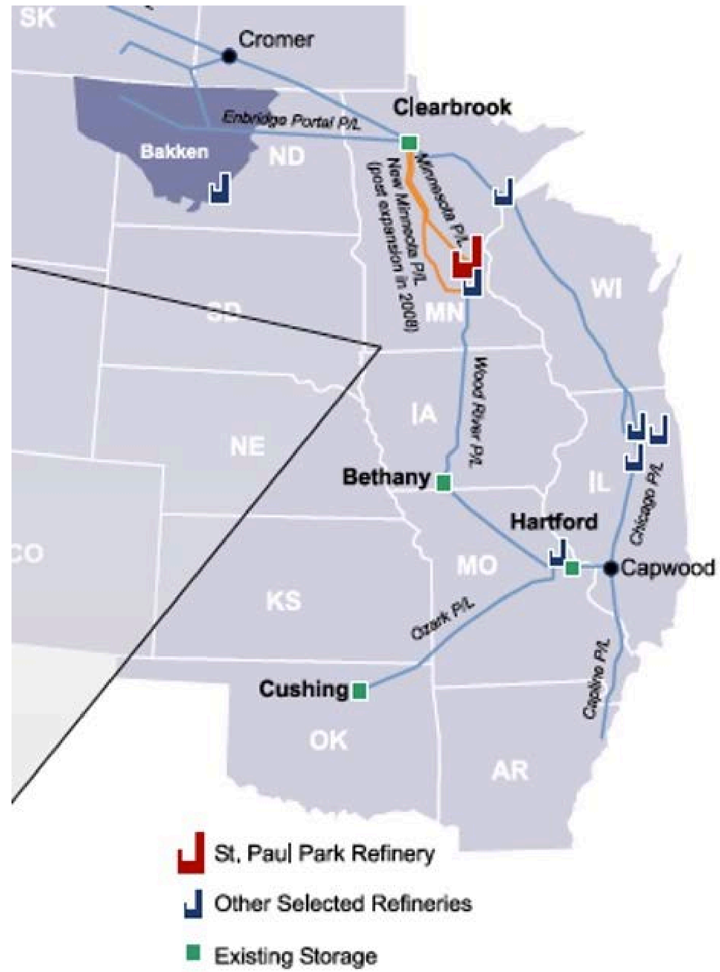


Business Overview

Geographic Advantage

NTI's Strategic Location

- NTI has one of the two refineries in Minnesota
- Direct access to Minnesota Pipeline that connects NTI to the oil hub in Bakken
  - Historically discounted crude compared to the WTI
- Direct supply to end consumers through company-owned convenience stores in Minnesota
- Importers from PADD 3 incur additional transportation costs compared with NTI
  - Higher "crack spread" and margin



Investment Thesis

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Investment Thesis

NTI's Competitive Advantage

Divergence in crude spread

- Advent of shale oil, shale gas and hydraulic fracturing has dramatically increased the volume of oil/gas in North America
- Uncertainty surrounding which E&P play will be successful, but U.S refiners stand to benefit regardless
- Increasing spread between WTI, Brent and WCS provide strong arbitrage opportunities for refiners

Favourable geographic location

- Location in Minnesota gives it access to the Bakken and Canadian oil sands, while it is able to sell at WTI
- One of few *PADD II* refiners makes this a rare opportunity

Investment Thesis

NTI's Competitive Advantage

Defensible, proven cost structure

- Robust vertical integration upstream:
  - Manages upstream intake through Minnesota pipeline stake (17.1%)
  - Controls downstream through SuperAmerica gas station stores
- WNR and NTI are the two most profitable refiners in North America by barrel

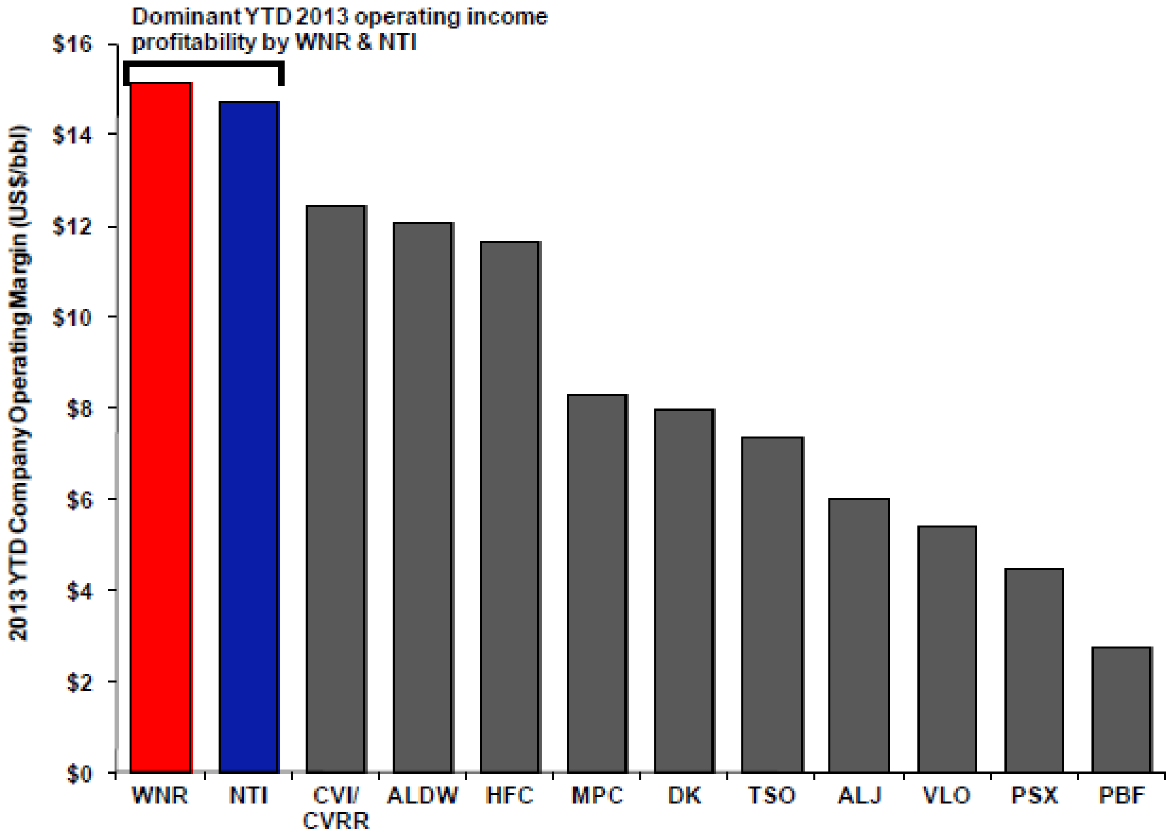
New ownership under WNR

- Recent investment from WNR (*a C-corporation*) lifts overhang of PE firms and creates strategic opportunities
- After WNR's investment, WNR's stock rallied, but NTI's stock remained untouched even though both parties will benefit from the partnership

Investment Thesis

NTI's Competitive Advantage

Defensible, proven cost structure evident in operating margin

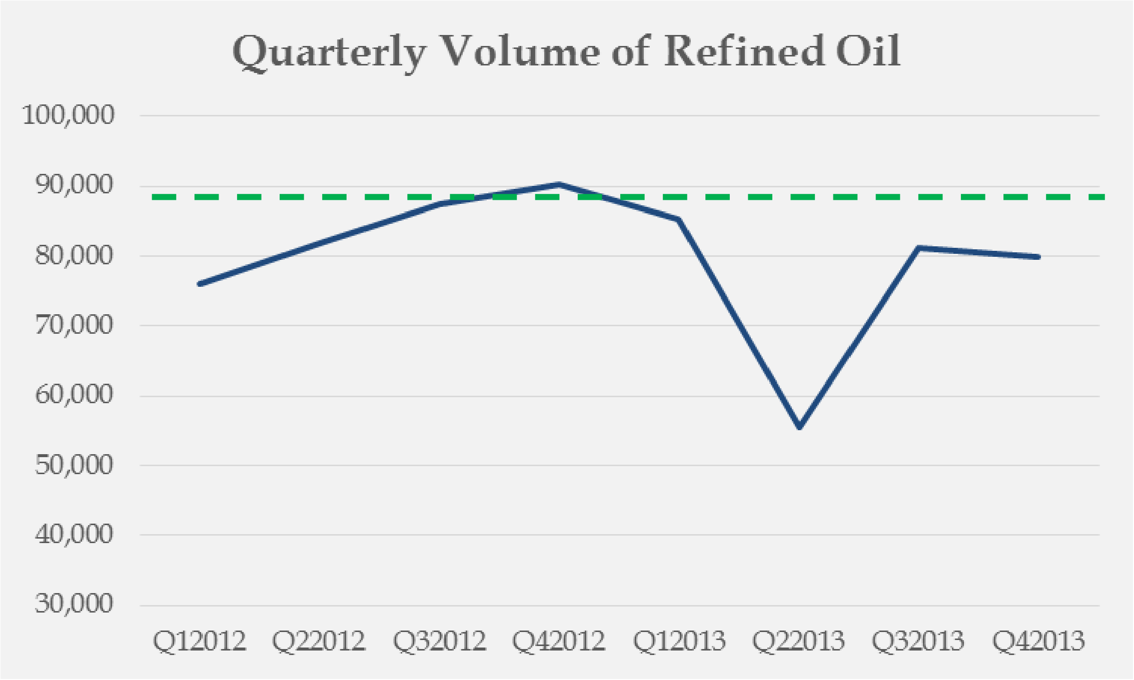


Investment Thesis

NTI's Unfair Valuation

Market Sentiment and NR Group's Views

- Market has unfairly punished NTI for a halt in its production during Q22013 because of a factory fire; average output since 2012 was 80,000 barrels



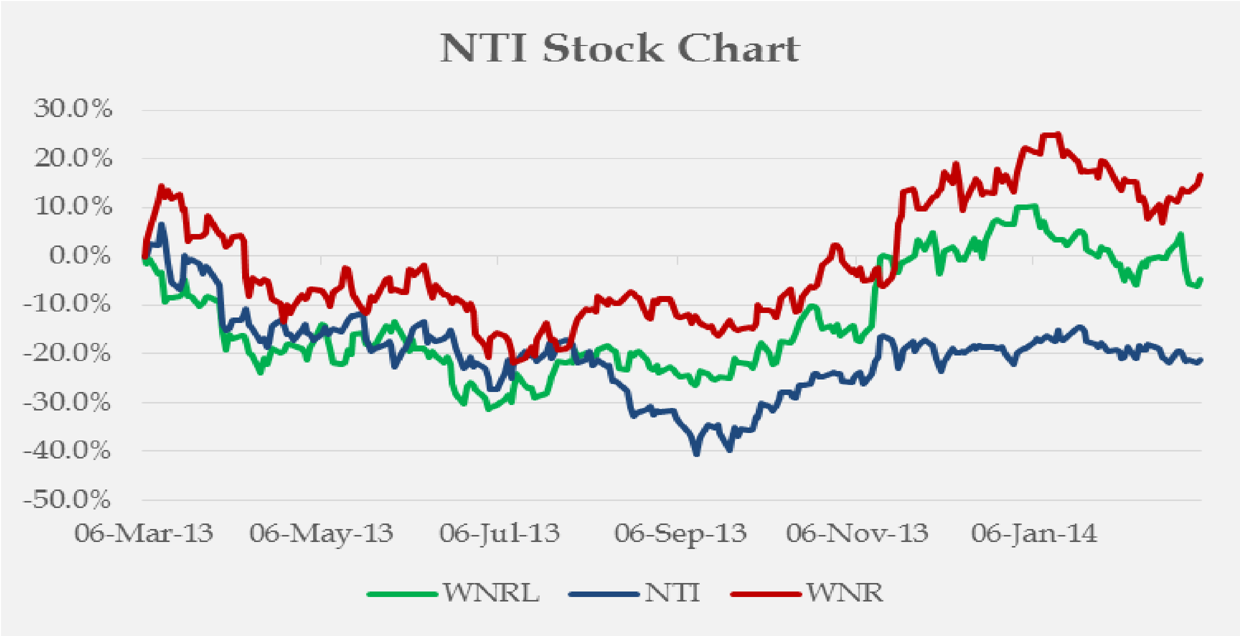
80,000 average output including fire (89% capacity util. of current capacity)

Investment Thesis

NTI's Unfair Valuation

Market Sentiment and NR Group's Views

- NTI's superior profitability and supporting crude barrel economics should make it trade at a premium, but it is trading at a P/E discount
- WNR and its other MLP appreciated in value when the acquisition was announced in Nov. 2013, but WNR has seen little movement



(WNR) +16.8%

(WNRL) -4.8%

(NTI) –21.4%

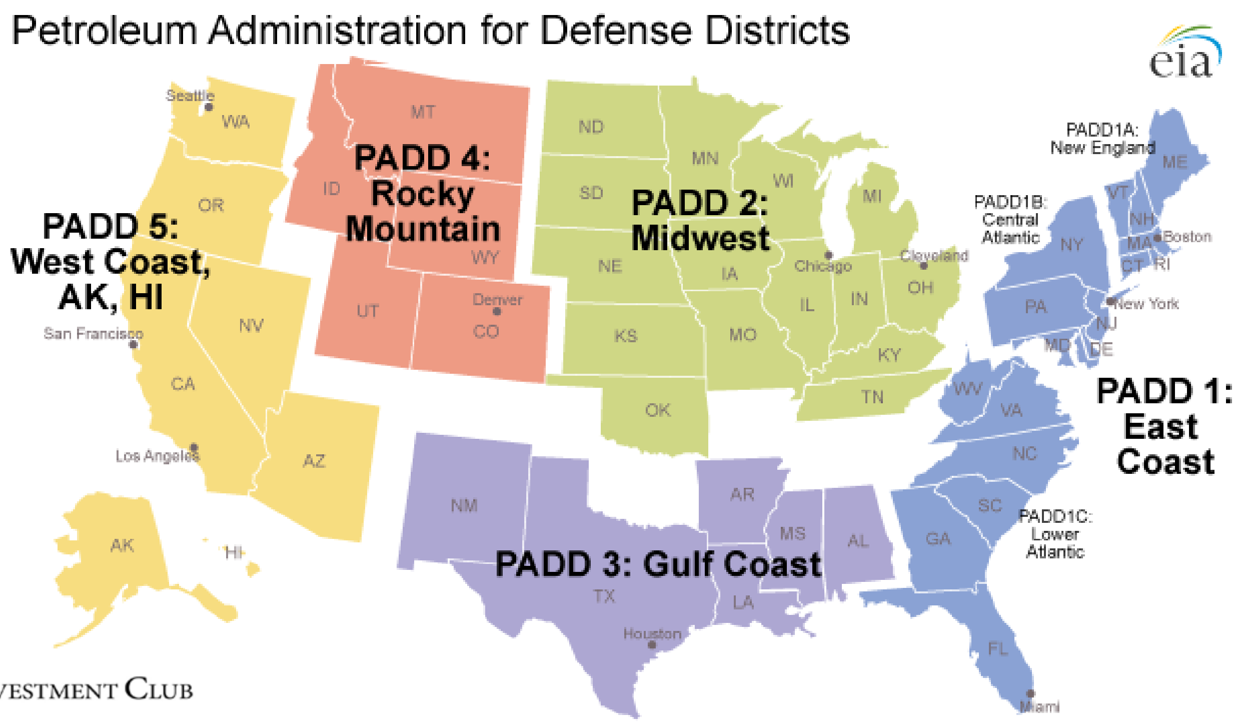
External Analysis

External Analysis

United States PADD System

Petroleum Administration for Defense Districts (PADD)

- The US is divided into five districts in terms of petroleum movements
- ¾ of petroleum movements is between PADD 3 to PADD2
  - Demand historically outstrips supply in PADD2 region



United States PADD System

Refining Capacity

- **Refinery capacity (EIA)** refers to the maximum amount of crude oil designed to flow into the distillation unit of a refinery, also known as the crude unit
- **Operable capacity (EIA)** refers to the sum of *actually utilized* capacity and the *idle* capacity
  - Operable capacity of Minnesota, Wisconsin, North & South Dakota is 453,000 bbl/d
  - Operable capacity of entire PADD II region is 3,769,000 bbl/d
- 27 operating refineries in PADD II, which has been the same since 2002

External Analysis

Tight Oil and Gasoline

Tight Oil

- The EIA predicts US tight oil production to increase from 2.3MMbbl/d in 2012 to 4.8MMbbl/d in 2021
- US tight oil production will rise from 35% of total oil produced to 51%
- OPEC predicts US tight oil supply to double from 2012 to 2020
- Daily oil production from the Bakken region is around 1,000,000bbl/d

Gasoline Prices ($USD)

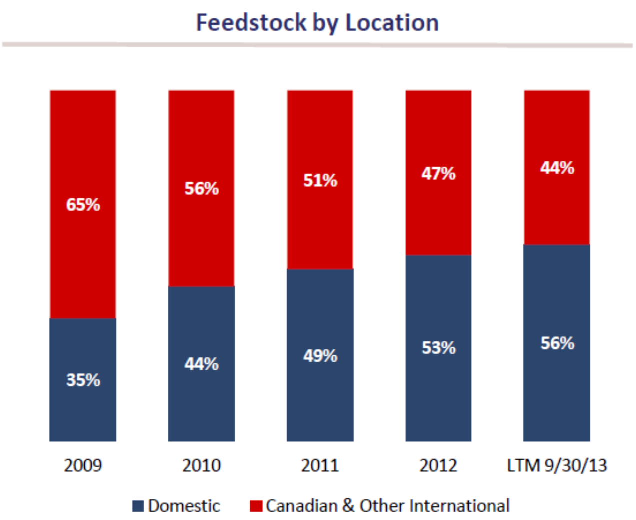
- Gasoline prices currently around $3.4/gallon
  Diesel prices currently around $4.0/gallon
- Gasoline prices are expected to remain relatively constant in the short term, before rising in the long term, according to the EIA

External Analysis

Crude Oil Prices

Benchmark Oil Prices

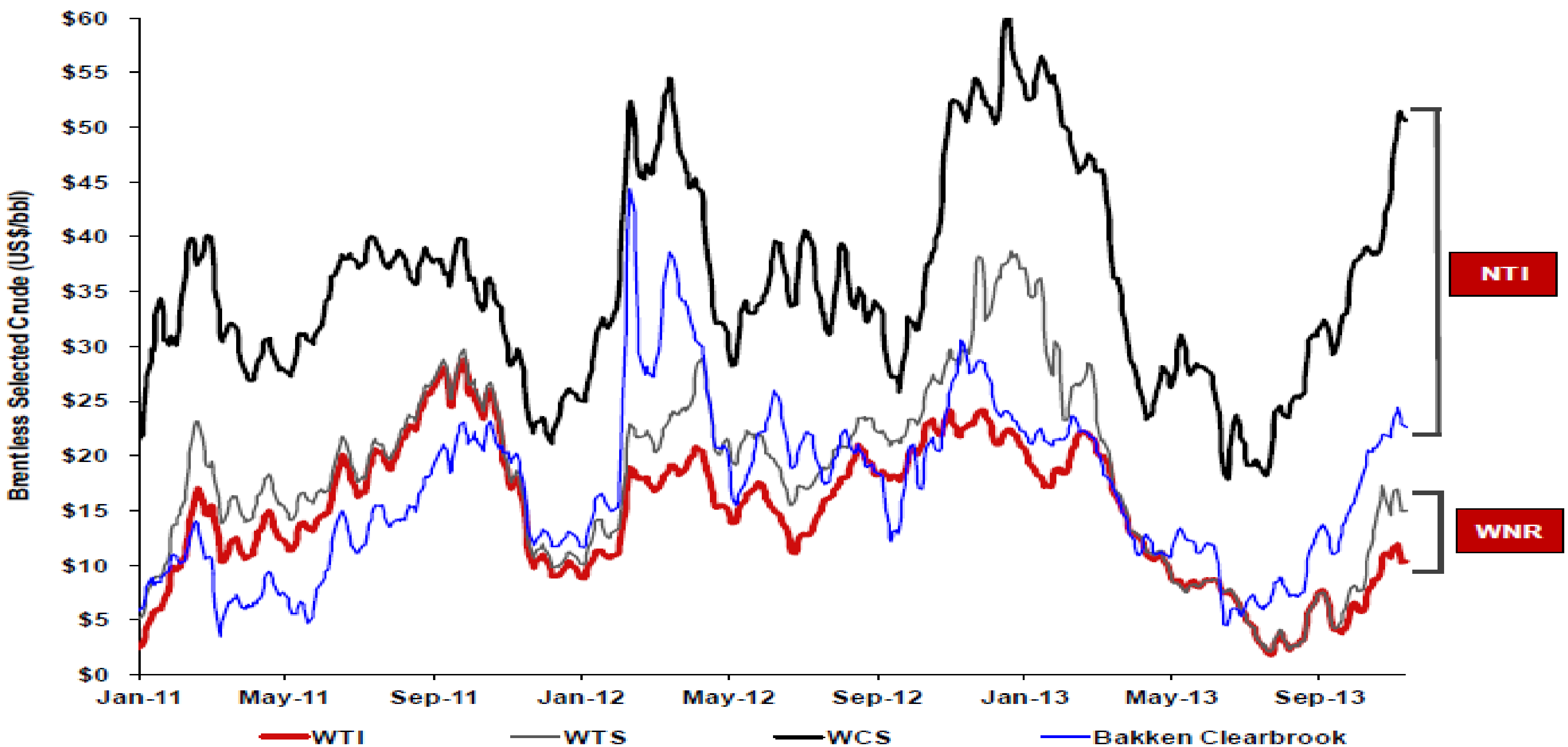
- **WTI:** Prices expected to maintain price discount to Brent because of increased hydraulic fracturing and increased tight oil
- **Brent:** Prices expected to increase in long-term because of Libya/global politics; Brent is independent of North American supply economics
- **Bakken:** Prices expected to remain depressed due to the massive increase in production and the lack of infrastructure to transport it
- **Canadian Oil (WCS):** Prices expected to remain depressed because of supply glut, may be slightly alleviated from improved pipelines



External Analysis

Crude Oil Prices

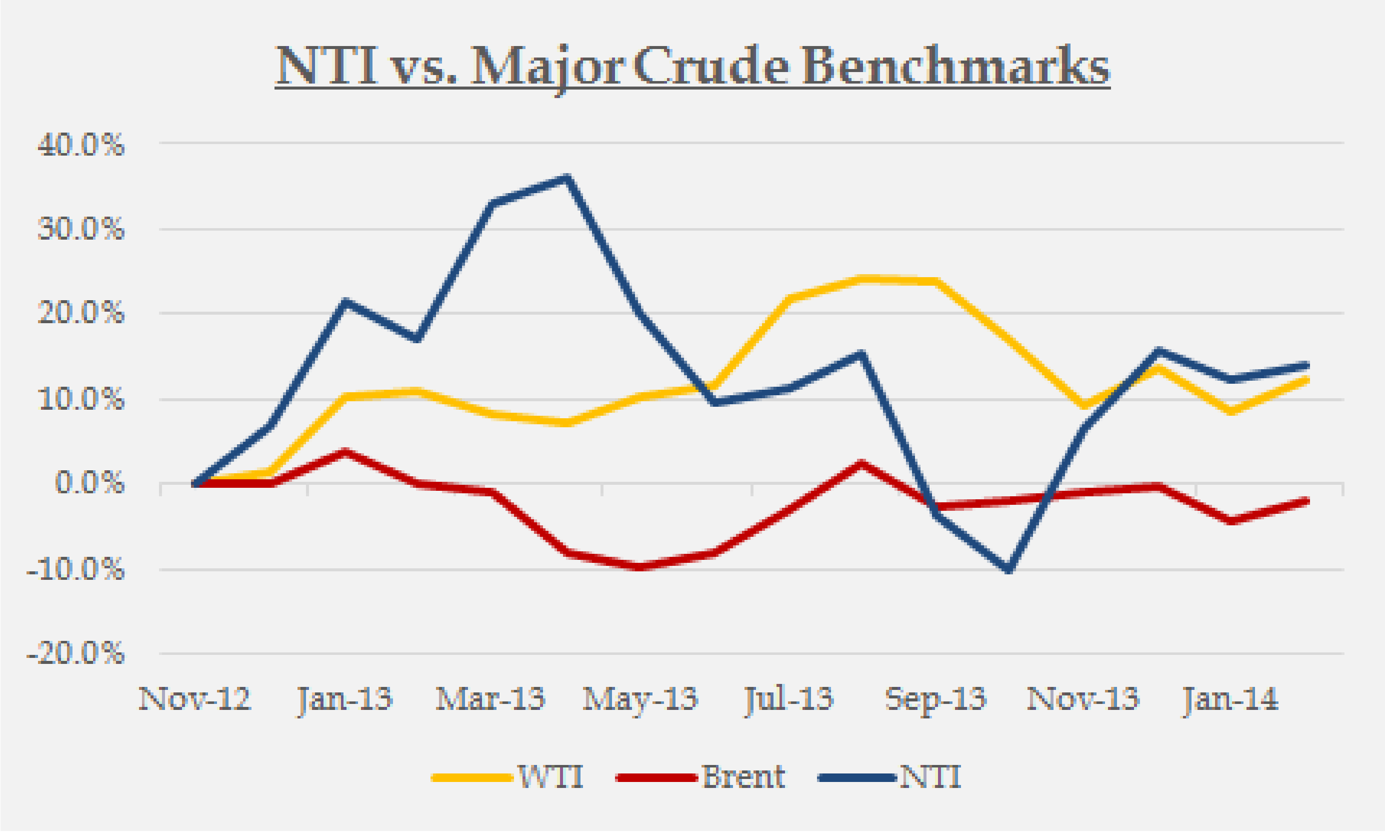
NTI's flexible refinery configuration allows it to take advantage of oil dynamics



External Analysis

Crude Oil Prices

NTI does not correlate with WTI or Brent benchmarks



Internal Analysis

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Internal Analysis

Management Overview

Incoming CEO

- David Lamp is becoming CEO of NTI in March 2014
  - Previous experience as Executive VP and COO of HollyFrontier (NYSE:HFC) makes him qualified candidate
  - 29+ years of industry experience and current Chairman of American Fuel & Petrochemical Manufacturers association
- Previous CEO, Hank Kuchta, retired from position with no political problems

Western Refining Investment

Western Refining

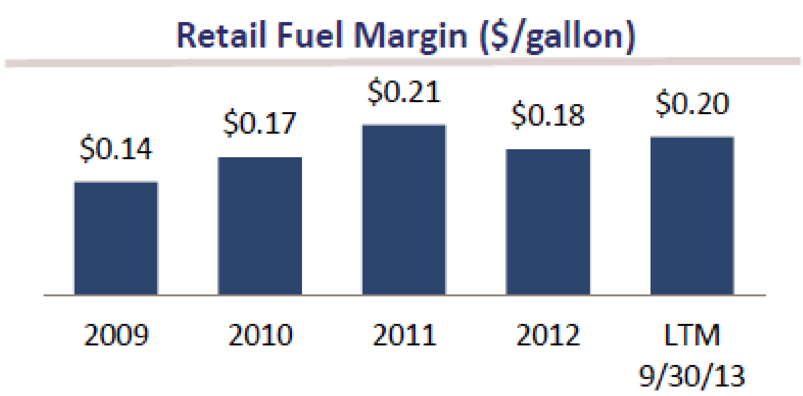
- WNR purchased 39% of NTI's LP units and 100% of GP in Q42013
- NTI was previously held by TPG and ACON Investments, which puts the company in the hands of a strategic buyer instead of financial buyer
- WNR has direct pipeline access to four North American crude oil producing regions: Permian, Bakken, San Juan and Western Canada
  - WNR is the most profitable refiner in the North America, with NTI being second
  - Partnership provides significant strategic options for NTI

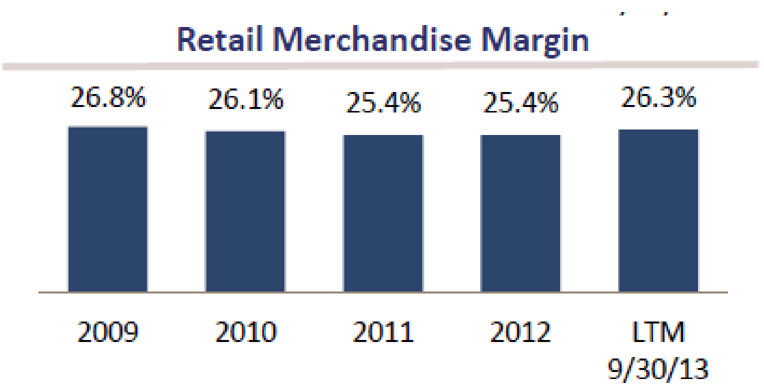
Internal Analysis

Profitability Breakdown

Profitability

- Refining revenue in fiscal 2012 made up around 70% of total revenue
  - Gasoline accounts for just over 50% of revenue for refining business, with distillates accounting for just over 30%
  - 24% of the retail segment's revenues were generated from non-fuel sales
- NTI's business model allows it to hand down costs to customers, which helps it guarantee a certain margin
  - When input costs increase, NTI can increase the end consumer price per barrel at its SuperAmerica stores

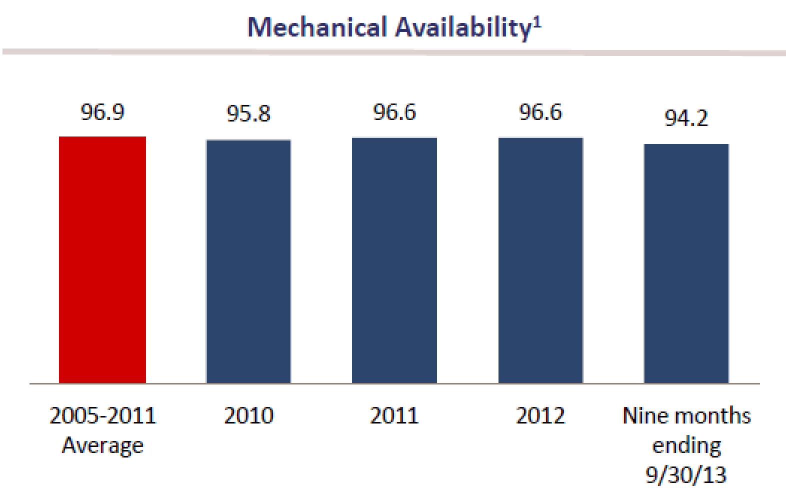


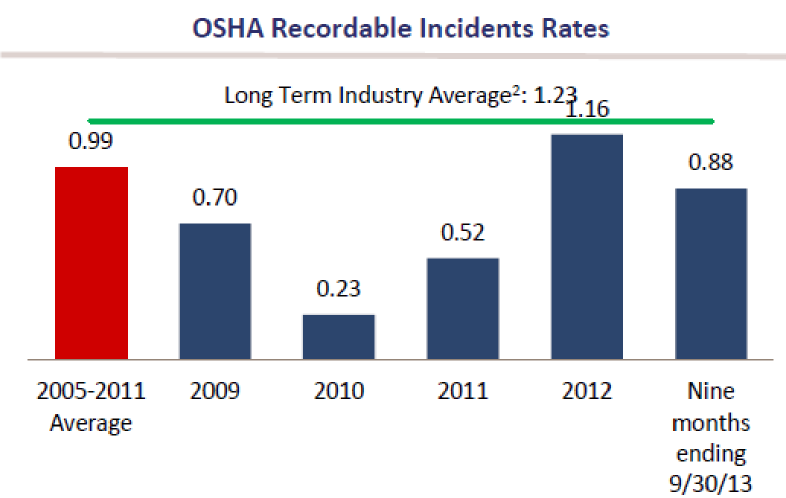


Internal Analysis

Capacity Utilization

- Midwest refining capacity utilization ranges from ~85% to ~95%
- NTI has had refinery utilization rates of 80% and 75% in fiscal years 2012 and 2011
- NTI upgraded St. Paul Park Refinery throughput in 2013, increasing its capacity by 10% to 84,500 bpd
- Consistent historical capacity utilization ensures consistent profitability; incident rates minimally offset by fire in Q32013





Valuation

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Valuation

Discounted Cash Flow Analysis

	2013	2014	2015	2016	Terminal 2017
Revenue Build					
Refining					
Refinery Capacity (b/d)	84,500	89,500	89,500	89,500	89,500
Refinery Throughput (b/d)	63,375	76,075	76,075	76,075	76,075
Annual Capacity (thousand b/year)	30,843	32,668	32,668	32,668	32,668
Capacity Utilization	75.0%	85.0%	85.0%	85.0%	85.0%
Barrels Refined (thousand b/year)	23,132	27,767	27,767	27,767	27,767
Product Prices	125	125	125	125	125
Implied Sales (thousands)	2,891,484	3,470,922	3,470,922	3,470,922	3,470,922
Gross Product Margin (/bbl)	20.26	20.26	20.26	20.26	20.26
Refining Gross Profit (thousands)	468,652	562,567	562,567	562,567	562,567
Retailing					
Number of Stores	236	237	238	239	240
Fuel Sold/Store/Month (thousand gallon)	157	157	157	157	157
Gallons sold per year (thousands)	444,624	446,508	448,392	450,276	452,160
Retail Fuel Margin (/gallon)	0.20	0.20	0.20	0.20	0.20
Retail Fuel Gross Profit (thousands)	88,925	89,302	89,678	90,055	90,432
Merchandise Sales (millions)	340	342	343	344	346
Merchandise Margin (%)	26.3%	26.3%	26.3%	26.3%	26.3%
Merchandising Gross Profit (thousands)	89,446	89,825	90,204	90,583	90,962
Total Gross Profit	647,023	741,694	742,450	743,206	743,961

Assumptions (as a % of gross profit)	
Direct Operating Expenses	37.4%
Turnaround and related expenses	7.0%
Depreciation and amortization	4.7%
Selling, general and adminitrative	11.3%
Other (income) expense, net	-1.7%
Income tax provision (as a % of pre-tax)	-5.0%

- NTI does not have a distribution schedule and issues dividends based on available cash flows
- Expenses based on % of gross profit because of lack of explicit sales information

Valuation

Discounted Cash Flow Analysis

WACC Calculation	
Target Capital Structure	
Debt Outstanding	282
Market capitalization	2772
Debt-to-total capitalization	9.2%
Equity-to-total capitalization	90.8%
Cost of Debt	
Cost of Debt	7.10%
Tax Rate	5%
After-tax Cost of Debt	6.75%
Cost of Equity (DDM)	
Net Income	231
Return on Equity	8.34%
LTM Dividends	3.49
Earnings Per Share	2.51
Dividend Payout Ratio	139.04%
Self Sustainable Growth	-3.26%
Current Price	24.44
Future Dividends	3.49
Cost of Equity	11.0%
WACC	10.63%

Output	Gordon	EM
Enterprise Value	3,197,595	3,018,008
Less: Debt	-282000	-282000
Less: Minority Interest	0	0
Less: Preferred Shares	0	0
Add: Cash	99000	99000
Equity Value	3,014,595	2,835,008
Units Outstanding	92100	92100
Implied Unit Price	32.73	30.78
Current Unit Price	24.44	24.44
Implied Upside	33.9%	25.9%

Sensitivity Table (Capacity Utilization vs. Refinery Margin)

		Capacity Utilization				
		75.00%	80.0%	85.0%	90.0%	95.00%
Refinery Margin	16.26	12.8%	13.2%	13.6%	13.9%	14.3%
	18.26	23.3%	23.8%	24.2%	24.7%	25.1%
	20.26	33.9%	34.4%	34.9%	35.4%	35.9%
	22.26	44.5%	45.0%	45.6%	46.1%	46.6%
	24.26	55.1%	55.7%	56.2%	56.8%	57.4%

Valuation

Comparables Analysis

Trading Companies

Company Name	Price	Market Cap	EV	Div %	Refining Capacity B/D	D/E	Debt/EBITDA	EV/EBITDA 2013A	EV/EBITDA 2014E	P/E 2013A	P/E 2014E
Northern Tier Energy	**24.24**	**2674 M**	**2857 M**	**19.61%**	**89,500**	**0.64x**	**0.87x**	**8.8x**	**6.1x**	**9.1x**	**6.2x**
Tesoro Logistics LP	50.82	3278 M	3255 M	1.99%	850,000	0.52x	9.39x	26.3x	11.2x	16.9x	8.9x
Calumet Specialty Products	27.24	1741 M	2491 M	9.74%	179,800	0.74x	4.16x	11.9x	6.8x	18.5x	17.0x
CVR Refining	39.72	3365 M	3845 M	7.97%	115,000	0.53x	0.85x	5.8x	4.3x	10.9x	9.9x
Delek US Holdings	29.79	1766 M	1891 M	2.04%	140,000	0.39x	1.09x	5.6x	5.2x	13.2x	12.3x
Western Logistics LP	28.09	1282 M	1282 M	3.24%	153,000	-	-	25.6x	18.6x	37.0x	24.2x
Average				5.00%	287,560	0.54x	3.87x	15.0x	9.2x	19.3x	14.5x
Median				3.24%	153,000	0.52x	2.63x	11.9x	6.8x	16.9x	12.3x

- Comparables selected based on U.S. refinery MLP's that operate in the PADD II region
- More MLP's expected to be created by integrated oil companies, which will broaden comparables set

Risks and Catalysts

Risks and Catalysts

Risks

- **Solvency:** High level of debt of $282M
  - Level of debt is manageable; D/E ratio of 0.64 is lower than industry average of 0.94. NTI also has an interest coverage ratio of 7.57x
- **Operations:** Fire in Q32013 may signal future difficulties
- **Regulations:** IRS may change MLP policies regarding taxation
  - MLP's are attractive because of their tax benefits, but regulation is unlikely to change because of large growth in asset class
- **Parent Company:** Western Refining filing for new MLP
  - Suggests that no new assets will be dropped directly into NTI, actual implications highly uncertain
- **Dilution:** Nature of MLP's would require future equity offerings

Risks and Catalysts

Catalysts

- **Refining Capacity:** St. Paul Park continuing to expand throughput, having installed wet gas compressor in Q42014
- **Dividend Increases:** NTI has propensity to increase dividends, having increased distribution from $1.48 in 2012 to $3.48 in 2013
- **Management Changes:** David Lamp joining as CEO in March 2014
  - Executive change-up along with increased WNR support creates opportunity to best realize strategic synergies
- **Brent Oil Prices Increasing:** El Sharara oilfield (340,000 bpd) in Libya expected to become completely inoperable during 2014
  - South Sudan also expected to close oil operations for political reasons
  - Price differential of crude benchmarks will widen further, increasing profit margin for NTI

NORTHERN TIER

Buy Pitch

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