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# EDITED TRANSCRIPT

HFC - Q2 2018 HollyFrontier Corp Earnings Call

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## OVERVIEW:

Co. reported 2Q18 net income attributable to HFC shareholders of \$345m or \$1.94 per diluted share.



## AUGUST 02, 2018 / 12:30PM, HFC - Q2 2018 HollyFrontier Corp Earnings Call

**CORPORATE PARTICIPANTS**

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**George J. Damiris** *HollyFrontier Corporation - CEO, President & Director*

**James M. Stump** *HollyFrontier Corporation - SVP of Refining*

**Richard Lawrence Voliva** *HollyFrontier Corporation - CFO & Executive VP*

**Thomas G. Creery** *HollyFrontier Corporation - SVP of Commercial and President of HollyFrontier Refining & Marketing*

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**Neil Singhvi Mehta** *Goldman Sachs Group Inc., Research Division - VP and Integrated Oil & Refining Analyst*

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**Roger David Read** *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

**PRESENTATION****Operator**

Welcome to the HollyFrontier Second Quarter 2018 Conference Call and Webcast. Hosting the call today from HollyFrontier is George Damiris, President and Chief Executive Officer. He is joined by Rich Voliva, Executive Vice President, Chief Financial Officer; Jim Stump, Senior Vice President of Refinery Operations; and Tom Creery, President, Refining and Marketing. (Operator Instructions) Please note that this conference is being recorded.

It is now my pleasure to turn the floor over to Craig Biery, Director, Investor Relations. Craig, you may begin.

**Craig Biery - HollyFrontier Corporation - Director of IR**

Thank you, Cathy. Good morning, everyone, and welcome to HollyFrontier Corporation's Second Quarter 2018 Earnings Call. I'm Craig Biery, Director of Investor Relations for HollyFrontier.

This morning, we issued a press release announcing results for the quarter ending June 30, 2018. If you would like a copy of the press release, you may find one on our website at [hollyfrontier.com](http://hollyfrontier.com).

Before we proceed with prepared remarks, please note the safe harbor disclosure statement in today's press release. In summary, it states statements made in regarding -- 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.

The call also may include discussion of non-GAAP measures, and please see the press release for reconciliations to GAAP financial measures.



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Also, please note that information presented on today's call speaks only as of today, August 2, 2018. Any time-sensitive information provided may no longer be accurate at the time of any webcast replay or rereading of the transcript.

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

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Thanks, Craig. Good morning, everyone. Today, we reported second quarter net income attributable to HFC shareholders of \$345 million or \$1.94 per diluted share. Certain items, detailed in our earnings release, increased net income by \$87 million on an after-tax basis. Excluding these items, net income for the current quarter was \$259 million or \$1.45 per diluted share versus adjusted net income of \$116 million or \$0.66 per diluted share for the same period last year.

Adjusted EBITDA was \$485 million, an increase of \$179 million compared to the second quarter of 2017. This increase in earnings was principally driven by our ability to capitalize on discounted crudes in our Refining segment.

Our Lubricants and Specialty Products business reported EBITDA of \$39 million, driven by a consistent Rack Forward sales volume and margins. Rack forward EBITDA was \$52 million, representing a 12% EBITDA margin. Rack Back EBITDA was driven by weakness in the base oil markets and planned maintenance at our Mississauga refinery. Rack Forward EBITDA is expected to be \$190 million to \$210 million this year, with an EBITDA margin of 10% to 15% of sales.

In the long run, we expect secular trends for its higher-performance engines, and Lubricants will drive higher margins for Group III base oils in our Rack Back and Rack Forward segments.

Yesterday, we closed the previously announced acquisition of Red Giant Oil Company. Founded in 1903, Red Giant Oil is one of the largest suppliers of locomotive engine oil in North America. Red Giant Oil brings great value to HollyFrontier, with its long-standing brand recognition in the railroad lubricants industry and the opportunity for supply synergies with our existing base oil business. The acquisition is expected to generate approximately \$7 million to \$8 million in annual EBITDA and is part of our strategy to grow the Rack Forward portion of our Lubricants business.

Holly Energy Partners reported EBITDA of \$82 million for the second quarter compared to \$75 million in the second quarter of last year. This growth was driven by higher volume in HEP's crude gathering system as well as the acquisition of the Salt Lake City and Frontier crude oil pipelines. We expect contractual tariff escalators and continued volume growth in our Permian crude oil system to improve -- to drive improvements in earnings in the second half of the year.

We remain committed to our capital allocation strategy of: first, maintaining our current assets and balance sheet strength; second, sustaining a competitive dividend; third, growing our business, both organically and through transactions; and fourth, returning excess cash to shareholders through share repurchases.

During the quarter, we repurchased \$29 million of HFC shares. HollyFrontier also today -- also announced today that its Board of Directors declared a regular dividend of \$0.33 per share. The dividend will be paid on September 20 to share -- to holders of record of common stock on August 23.

For the second half of the year, we expect the macroenvironment to remain very positive. Crude differentials have widened, especially in the Permian and WCS markets, and we expect them to remain wide due to logistical constraints. Crude spreads have been healthy and are supported by strong demand and relatively stable inventories, especially for diesel fuel, despite high industry utilization rates.

High PADD 2 turnaround activity in the second half of the year should also further support both frac spreads and crude differentials. With IMO 2020 on horizon, we believe our business is well positioned to benefit from both crude differentials and frac spreads for the next few years.

I'll now turn the call over to Jim for an update on our operations.



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**James M. Stump** - HollyFrontier Corporation - SVP of Refining

Thank you, George. For the second quarter, our crude throughput was 463,000 barrels per day, slightly above our guidance of 440,000 to 450,000 barrels per day. Overall throughput and sales of refined products were impacted by outages and downstream conversion units, some of which extended into July.

Our consolidated operating cost of \$5.89 per throughput barrel was 10% higher versus the \$5.35 per throughput barrel in the same period last year. The increase was primarily driven by comps associated with the Woods Cross outage that started this prior March. The repairs on the crude unit are mechanically complete, and we anticipate ramping production through August and reaching full run rates by September.

Cheyenne had a strong operating quarter, averaging 48,000 barrels per day of crude throughput and was able to take advantage of the favorable WCS crude discounts. Our Navajo plant ran approximately 112,000 barrels per day in the second quarter. OpEx per throughput barrel at \$5.25 was elevated due to 12 days of unplanned maintenance on our cat cracker or FCC. This plant is currently running at normal operating levels and continues to benefit from the widening crude discounts in the Permian Basin.

In the Mid-Con, our operating expense per throughput barrel was \$4.41, slightly higher than the \$4.18 in the second quarter of last year. The increase was driven by maintenance on our FCC at El Dorado that lasted 15 days. Our work is completed, and our Mid-Con refineries are operating at normal levels.

Our El Dorado plant is scheduled to start its planned turnaround in late September and is expected to last approximately 45 days. For the third quarter of 2018, we expect to run between 420,000 and 430,000 barrels per day of crude oil.

I will now turn the call over to Tom for an update on our commercial operations.

**Thomas G. Creery** - HollyFrontier Corporation - SVP of Commercial and President of HollyFrontier Refining & Marketing

Thank you, Jim, and good morning, everyone. As Jim just mentioned, in the second quarter of 2018, we ran 463,000 barrels of crude oil composed of 29% sour and 20% WCS and black wax crude oils. Our laid-in crude cost was under WTI by \$11.80 in the Rockies, \$1.60 in the Mid-Con and \$4.55 in the Southwest.

In the second quarter of 2018, we continued to see healthy economy, both domestically and internationally, which will support the demand for refined products and help to maintain levels of exports.

Gasoline inventories in the Magellan system ended the quarter at 8.1 million barrels, roughly 1.5 million barrels lower than March 31 levels. Diesel inventories ended the quarter at 6.5 million barrels, which compared similarly to the first quarter levels and approximately 0.5 million barrels lower than last year levels. Day supply of both gasoline and diesel in the group remained below 5-year averages despite high refinery utilization.

Second quarter 3-2-1 cracks in the Mid-Con were at \$18.15, \$30.23 in the Southwest and \$28.62 in the Rockies. Crude differentials remained wide across the heavy and sour slates in the second quarter. In the Canadian heavy market, second quarter differentials at Hardisty averaged over \$19.25 a barrel. Recently, however, we have seen this differential widen to more than \$25 per barrel as pipeline capacity limitations continue.

HFC continues to be able to purchase and deliver adequate volumes of price-advantaged heavy crudes from Canada to meet our refinery needs as well as being able to sell incremental barrels into the marketplace when economics dictate. Canadian heavy and sour runs averaged 78,000 barrels per day at our plants in the Mid-Con and Rockies regions.

We refined approximately 168,000 barrels a day of Permian crude in our Refining system, composed of 112,000 barrels per day at Navajo and 56,000 barrels per day by the Centurion pipeline on our El Dorado Refinery. The midline differential averaged the quarter at \$5.15. And once again, we see that same differential trading today at over \$16 per barrel.



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Second quarter consolidated gross margin was \$16.57 per produced barrels sold. This represented a 46% increase over the \$11.36 recorded in the second quarter of last year. The increase was driven by improved laid-in crude costs in the Southwest and Rockies and small refinery exemptions at our Woods Cross Refinery.

RINs expense for the quarter was \$56 million, which is net of the \$25 million cost reduction resulting from the Woods Cross small refinery exemption received in the quarter.

Looking forward, with widening Permian differentials and consistent discounts for WCS and black wax crudes, coupled with strong distillate demand, we anticipate continuous strong margins across our Refining system in the second half of 2018.

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

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### **Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Thank you, Tom. Our second quarter results included a few unusual items. Pretax earnings were positively impacted by a \$107 million lower cost to market benefit as well as a \$25 million reduction in RINs costs, resulting from the Woods Cross Refinery's 2017 small refinery exemption. These positives were partially offset by \$15 million in charges, net of incurred insurance claims related to the outage at our Woods Cross Refinery. The table detailing these items can be found in our press release.

For the second quarter of 2018, cash flow provided by operations was \$394 million, inclusive of turnaround spending of \$20 million. HollyFrontier's standalone capital expenditures totaled \$45 million for the quarter.

As of June 30, our total cash and marketable securities balance stood at \$980 million, a \$198 million increase over March 31. Working capital had a neutral impact on our cash position in the quarter, with an increase in accounts payable offsetting inventory builds.

During the second quarter, we returned a total of \$87 million of cash to shareholders, comprised of a \$0.33 per share regular dividend totaling \$59 million as well as the repurchase of approximately 467,000 shares of common stock, totaling \$29 million. As of June 30, we had \$123 million authorization remaining in our stock repurchase program.

As of June 30, we have \$1 billion of standalone debt outstanding and no drawings under our \$1.35 billion credit facility, putting our liquidity at \$2.3 billion and debt-to-capital at a modest 15%.

HEP distributions received by HollyFrontier during the second quarter totaled \$37 million, a 12% increase over the same period in 2017. HollyFrontier owns 59.6 million HEP limited partnering units, representing 57% of HEP's float with a market value of \$1.8 billion as of last night's close.

For the full year of 2018, we reiterate our expectation for \$380 million to \$440 million of both standalone capital and turnaround costs in HollyFrontier Refining and Marketing; \$70 million to \$90 million at HollyFrontier Lubes and Specialties, including the scheduled turnaround at our Mississauga base oil plant in the fourth quarter; and we have increased our expectation for HEP's CapEx to \$60 million to \$70 million, driven by new and potential projects in the Permian Basin.

With that, Cathy, we're ready to take questions.

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## QUESTIONS AND ANSWERS

### **Operator**

(Operator Instructions) Our first question comes from Brad Heffern, RBC Capital Markets.



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**Bradley Barrett Heffern** - RBC Capital Markets, LLC, Research Division - Associate

George or maybe Rich, I guess, can you talk a little bit about the repurchase program again? I mean, I know during this quarter, you would have known that you had the Red Giant acquisition close to the finish line. And so maybe that explains a relatively modest number, given the cash build this quarter. But you are sitting at close to \$1 billion of cash versus the \$500 million target you've talked about in the past. And I think probably good visibility on generating more. So any thoughts about how repurchases should trend over time?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Sure. I'll take this, then Rich could chime in. I think, Brad, we've been very open that we want to grow our company for the various reasons we shared previously. We're pleased with the deal flow we're seeing, both for our Refining and Lubricants businesses as evidenced by the Red Giant deal. But as we all know, a lot of factors have to line up to convert deal flow into actual deals like Red Giant. To the extent we can, we'll constantly make transactions that benefit our company. To the extent we can, we will return excess cash to shareholders through share repurchases as we laid out this capital allocation strategy.

**Bradley Barrett Heffern** - RBC Capital Markets, LLC, Research Division - Associate

Okay. And then I guess on the captures this quarter, they kind of work the opposite way I would have expected. In the Mid-Con, you guys had downtime last quarter. But it doesn't look like that was really reflected in a capture increase this quarter. And then in the Rockies, you obviously have had downtime for a couple of quarters. But the captures there have been much higher than they have been over the past couple of years. So any thoughts about -- anything special that happened in the second quarter? Or thoughts on the trajectory of those going forward?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Brad, it's Rich. So generally speaking, I think you mentioned we had several issues in downstream conversion units. And so the effect that's having, right, is on capture at the end of the day. So you're seeing high crude rates, but you're not seeing it flow all the way through. We don't anticipate these are going to be perpetual issues. So we view them as transitory, but they clearly hit kind of across the fleet this quarter.

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

I'll just chime in a little bit here, too. Remember in the first quarter, we had a turnaround in Tulsa. So we were liquidating inventories that we'd stored in advance of that. So in the second quarter, we're replenishing a little bit of inventory as well, coming out of that Tulsa turnaround. And as Rich said, some of these operating issues we've built in the intermediate, some of which we'll use in the fourth quarter at -- during the El Dorado turnaround. And it also kept us from making some higher value products like CBG and Phoenix and premium gasoline. So that will flow through the capture as well.

**Bradley Barrett Heffern** - RBC Capital Markets, LLC, Research Division - Associate

Okay, got it. And then Rich, just a couple of accounting questions. So you guys called out the \$15 million net charge related to the Woods Cross downtime. Can you walk through what exactly that is? And how it flows through with the numbers, where we would see it? And then secondly, there's this negative OpEx number in Rack Forward this quarter. Can you walk through what that is?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Sure. So on Woods Cross, Brad, where you're -- where this is flowing through is on operating expenses. We're anticipating total repair costs at \$30 million to \$40 million in the quarter. We expensed roughly \$25 million, and we went ahead and accrued a portion of what we expect. Insurance

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recoveries will be at roughly \$10 million. So that accrual offsets part of the spend, and that flows through in Rockies OpEx at the end of the day. On the Lubes question, what happened there was during the quarter, we realized we needed to reclassify some expenses to make sure we were treating all expenses appropriately. So some OpEx moved into cost of goods sold, and we had to recast a portion of that as well. So that's the impact you're seeing there. Importantly, there is no EBITDA or net income operating income affected at the end of the day. It's just a reclassification from one bucket of expense to the other, if you will, largely that was around transportation cost and how we were treating that.

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**Operator**

Your next question comes from the line of Paul Cheng with Barclays.

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

George, I'm looking at the Southwest, I understand you have the FCC and planned outage. But the margin capture seems really low. Is there anything other than the FCC outage that you can cite why the margin capture is so bad?

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

No. I think that's the majority of it, Paul. Again, I think it goes when you have your cat down, you have your LP down, we need [alcoholate] to make Pheonix CBG. And that's where you're seeing the most impact on the capture rates, especially on the gasoline side, obviously.

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

And doing -- is that only the 17-day or that before that, you're already having some issue of that unit? And how long it take after you come back there for you to run that through?

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Well, I think that's a...

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**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

That's a major issue, again, Paul.

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

The 17 days, I'll just add, is all the impact just on that, 17 day or -- that you need. It's down for 17 days, but the actual impact is larger than 17 days. That's what I'm trying to get out.

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**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Paul, this is Rich. I mean, so the unit down for 17 days. To George's point, we had some associated units down, which are impacting our ability to make the really higher-margin products, so it -- obviously it affects -- you feel the effect over the course of that month primarily. But it's pretty substantial, and it hit the quarter on average.



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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

There might be some transportation time to get products then from the Refinery to a market like Phoenix, Paul. It's typically 10 days. So -- but it is all tied to that specific event, again, at Navajo.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

Have you guys have any internal rough estimate? What was the opportunity cost loss related to that incident?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Yes. Paul, I don't think we're going to go there.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

Okay. That's fine. And which that -- you're saying that the total repair is going to be \$30 million, \$40 million. So we should assume that you have another \$15 million you're going to expend in the third quarter?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Yes. \$10 million to \$15 million, call it, Paul, but yes.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

And how about insurance?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

So we all make -- we incurred roughly \$10 million of claims. We're going to go ahead obviously and claim both property and business interruption. When timing of receipt of those is unclear to us. So we'll go ahead and follow that process.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

So we really don't know that. It probably may not be this year, I would imagine. By the time that you negotiate with the insurance company, the proceeds that are coming by is next year, right?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

We don't know that for sure, Paul. We've been working pretty closely with the insurance company. We think it won't be as protracted as maybe it typically is because that relationship we have with them. But timing is always difficult to call. The payments have started. It's just the exact timing for future payments is not something we can predict right now.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

Right. And which -- do you guys have business interruption insurance on this particular incident?





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**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Yes.

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**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

Are we going to see payment on that? Or that is still under the [deductible]?

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**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

No. We anticipate some recoveries under the BI policy.

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**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

Okay. So so far, what you booked is just on the property actual repair. You haven't booked any BI?

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**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Correct.

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**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

Okay. And that have you start the negotiation with the insurance company on the BI yet?

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**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Absolutely.

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**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

Any kind of time line that you may have in mind?

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**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Not at this point, Paul. No.

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**Operator**

Your next question comes from the line of Matthew Blair with Tudor, Pickering & Holt.

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**Matthew Robert Lovseth Blair** - Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - Executive Director of Refining and Chemicals Research

So Southwest product cracks have typically been some of the best in the U.S. We're now seeing a few projects though from various midstream companies to bring more gasoline and diesel into that market. HEP is also engaged in some of those activities as well. How big a threat is this to Navajo's margins? And what are you doing in response? Are you thinking about moving more product over to the Phoenix market?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

No. I think we'd plan to take our fair share of what's going on in the Permian. That's why we've announced, along with HEP, the oil truck rack project. The orders are about 80 miles south of Artesia. So we already service that market out of Artesia. We're going to expand that to Orla. And we're looking to expand that to other markets around both Artesia and Orla as far away as even Midland. So the closer we can get our diesel to the end user and to the specific well that uses it, the better off we're going to be, especially with a shortage of truck drivers in the area. So there's a lot of product that's being trucked and railed into the area currently. We think we have sound economics even if alternate supply is coming by pipeline from the Gulf Coast. It's almost \$0.10 a gallon to reach our markets from the Gulf Coast. That's a pretty good supporting structure for our margins and our product markets in our Artesia area.

**Matthew Robert Lovseth Blair** - Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - Executive Director of Refining and Chemicals Research

Sounds good. And then it looks like you ran a 46% sour and heavy crude slate in the quarter, but you only produced a 1% fuel oil yield, which seems pretty ideal from an IMO 2020 standpoint. It looks like you also produced the 4% asphalt yield. How do you expect to see asphalt trade in an IMO market? Is -- are you concerned that fuel oil might drift into the asphalt market? Or are those 2 pretty distinct products?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

No. I think directionally, that will occur. But there are quality constraints to how much of that number 6 fuel oil can get into the asphalt market. Making high-quality asphalt is not as easy as it may sound. And actually, we think the market right now is short of high-quality asphalt, which is what we make primarily from our refineries. And to the extent that the asphalt market is impacted by IMO 2020, we think that will be more than reflected in the crude price for the WCS and other similar crudes that contain a higher percentage of those heavy end of the barrel.

**Operator**

Your next question comes from Manav Gupta with Crédit Suisse.

**Manav Gupta** - Crédit Suisse AG, Research Division - Research Analyst

You've kind of mentioned a little bit about the weakness in the base oil market. I think BP also mentioned a few things about it. I'm just trying to understand what's causing this weakness in the base oil market, which is impacting your Rack Back margins? And how quickly can the market recover from it?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Manav, it's Rich. So basically, we're seeing solid demand for finished products, and base oil is consistent with strong macroeconomics. What's happened here is there's just a lot of base oil supply floating around globally at the moment, and it's compressing base oil cracks, if you will. We don't see a lot of supply additions coming, so we'd expect that market to strengthen in the next coming years.



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**Manav Gupta** - *Crédit Suisse AG, Research Division - Research Analyst*

That's fair. Second part is we are seeing a big Cushing draws, and Cushing inventory is now about 60% below last year. I'm trying to understand what's driving the dynamics of Cushing. Well, why are the draws happening? And the other part I'm struggling to reconcile is at the same time, people are announcing new pipelines out of Cushing. So why is the Cushing outbound capacity being raised when you're actually seeing depletions at Cushing? That's something I'm failing to reconcile, if you could help me out.

**Thomas G. Creery** - *HollyFrontier Corporation - SVP of Commercial and President of HollyFrontier Refining & Marketing*

Manav, this is Tom Creery. I'll take a shot at answering that. Yes, we are seeing big draws at Cushing. However, when you look at the forecast, people are still estimating by the first quarter of next year that Cushing is going to be false as additional crude comes on stream from Bakken, Niobrara, Saddlehorn and places like that. So we're sort of seeing a temporary situation. And it's also fueled by the fact that the markets are in backwardation. So it's one of those chicken and egg things. You don't build inventories in the backward-dated market. You tend to reduce it. So we've got a bunch of headwinds in trying to build inventories at Cushing at this point in time.

**Manav Gupta** - *Crédit Suisse AG, Research Division - Research Analyst*

That's fair, guys. And my last question is you announced a couple of very exciting projects. One was the Delaware diesel project last quarter, and then now your limited new refined product pipeline out of the Permian Basin. If you could just give us some color on those 2 projects.

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

I think, again, it's -- those -- all those projects are targeted towards the growing demand for distillate in the Permian, while the incremental sources of supply right now is coming in by rail and by truck, primarily from the Gulf Coast. We think we're well positioned, as I mentioned earlier, with our Orla project, which is connected by pipeline to Artesia, 80 miles south of Artesia. So we get into the southern end of the Delaware Basin. We're looking at other opportunities out of both Orla and Artesia to supply the Delaware Basin. And then looking at options to get from both Artesia and to Orla into the Eastern part of the Permian Basin.

**Operator**

(Operator Instructions) Your next question comes from the line of Neil Mehta with Goldman Sachs.

**Neil Singhvi Mehta** - *Goldman Sachs Group Inc., Research Division - VP and Integrated Oil & Refining Analyst*

George, I want to follow up on your comments around M&A. And I think you said there is a rich pipeline of potential opportunities that are out there, and that ultimately, you do want to grow the business and the capacity across business lines. Just can you talk about the scale of those opportunities? When we look at something like Red Giant, that's very different than something like PCLI. And so are we talking about smaller bolt-on transactions, things that could be more transformative to the business? Just help us frame the way you're thinking about capital allocation.

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

I think we're seeing deals along the entire spectrum of size. Our preference would be to do larger deals, think in the \$0.5 billion range. Small deals takes almost as much time and effort as the bigger deals. But at the end of the day, it all comes down to how attractive we feel the opportunity is. We're seeing a lot of deals as I mentioned in my previous response. So we're keeping a little more dry powder in reserve in the expectation that some of these deals that we're seeing and working on will come to fruition. But again, there's no guarantees that they will. And if they do, again, we'll use the cash on the deal. If they don't hit, we'll return it to shareholders.



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**Neil Singhvi Mehta** - *Goldman Sachs Group Inc., Research Division - VP and Integrated Oil & Refining Analyst*

And those are more Lubes and Midstream more so than Refining, George?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

No, we're also seeing opportunities in our Refining segment as well, Neil.

**Neil Singhvi Mehta** - *Goldman Sachs Group Inc., Research Division - VP and Integrated Oil & Refining Analyst*

Okay. And then you ran 78,000 barrels a day in Canada. You said 168,000 barrels a day, Midland. Is that a reasonable run rate to think about going forward, especially on the Canada side? And then how do you think about these Western Canadian differentials? They're certainly very healthy right now. But how do you see it playing out between now and the next couple of years, considering we have IMO 2020 and Enbridge line 3? You have a couple of competing factors that could move the differential.

**Thomas G. Creery** - *HollyFrontier Corporation - SVP of Commercial and President of HollyFrontier Refining & Marketing*

Right. It's Tom. I think those are pretty representative run rates. Definitely, our goal is to get more Permian crude back into the Mid-Continent and to our refineries there and take advantage of those differentials in the short term. And we're trying to do -- looking at several ways as well. But the Canadian, that's very consistent based on the premise that a portion (technical difficulty) on the Enbridge system that you referred to. Like everyone else, we understand the limitations on pipeline capacity is coming south. We expect some relief on that proportion number when the Sturgeon refinery comes on. But after that, you're correct in saying that the next tranche is Tier 3 on Enbridge, and then we're waiting for the big changes to come as a result of both XL and Trans Mountain. So -- and when you look at those, it's probably \$20, \$21, \$22, somewhere in there. So we expect differentials to hold at these levels. Going forward, that -- the \$20 to \$25 number.

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Let me just chime in a little bit, Neil, here. So remember, (technical difficulty) in a day is what we're capable of doing at Artesia with Permian crude. We have the pipeline capacity to Cushing that primarily goes to El Dorado. We comfortably do 50,000 barrels a day in that pipe and can get above that. And as Tom says, we're walking to run it at a higher level sustainably in the future. And then on the WCS side, El Dorado is capable of running 50 a day of WCS. And Cheyenne, 30, 35, and we'll run it to the extent that it's economical. If not, we're not afraid to sell the barrel at Cushing if it makes more sense to sell it there than to run it at El Dorado.

**Neil Singhvi Mehta** - *Goldman Sachs Group Inc., Research Division - VP and Integrated Oil & Refining Analyst*

One last question, if I can sneak one more in. At the Analyst Day, a year ago, you guys came out with a view that the stock was worth \$60. But a lot of things have changed since then. So I wanted to get your updated thoughts, maybe not a point number. But as we think about that representative valuation versus the market factors right now, you guys are making the decision to buy back at least some stock, so you must think it's undervalued. So just talk about something to help us frame the way you think about the value of the company.

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Neil, the big mover there to -- I think you kind of highlighted it right is in that Analyst Day valuation, right, we made a lot of assumptions around crack spreads, crude spreads. If we were wrong by a couple of bucks to the downside, it's worth a lot of money to the stock at the end of the day. And as we told you at the time, we thought those assumptions were pretty conservative. And certainly in today's market environment, they look very conservative. Now we do think the stock has room to go.



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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Yes. The differential, as Rich said, that we had at the Analyst Day presentation, were nowhere near the \$15 Permian dips we're seeing now and the \$29 WCS dips we're seeing now. And that we feel fairly confident they're going to extend through the next year, if not further.

**Operator**

Your next question comes from the line of Phil Gresh with JPMorgan.

**Philip Mulkey Gresh** - JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst

A couple of quick ones here. First, just on the Lubes, you talked about the Rack Forward versus Rack Back. Do you have a view on what part of Rack -- Rack Back or EBITDA we should be expecting on a go-forward basis? It's been a pretty big headwind for the past few quarters. And I know you mentioned the base oil...

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Yes, Phil, our expectation over the long term for Rack Back is it's going to be plus or minus 0. It's not going to be a large contributor to our profit. It is weaker currently than we expect for reasons that Rich laid out earlier. But again, we think it's important to be vertically integrated, minimize those transportation costs. It takes out some of the volatility. But our focus is on growing the Rack Forward part of the business.

**Philip Mulkey Gresh** - JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst

So specifically, for the second half, would you expect it to get closer to neutral? Or are there maintenance or other market headwinds that you think will continue through [second half]?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

No.

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Yes, Phil, this -- the base oil oversupply is certainly what I think is going to persist for the balance of the year. And then to your point, we've got a turnaround in the fourth quarter on the CDW there, so that's also going to affect the numbers.

**Philip Mulkey Gresh** - JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst

Okay. In the Southwest, I know people have already asked about the capture. I'll just ask in a slightly different way. Would you say that you've got the full benefit from the quarter-over-quarter improvement? And the Permian differentials, are there also any timing factors that influence the way that it hits your P&L?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

So I think on the crude side of the equation, we saw the benefits that we expected from the crude differentials in the market. Remember, it's a little bit lagged. But I think on that lag basis, we've got what we expected.



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**Philip Mulkey Gresh** - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

And for you guys, is the lag typically 1 month?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

That's about right.

**Philip Mulkey Gresh** - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Okay. And then last one just on the Southwest, the operating costs were high. Is that just the flow-through effects of the FCC issues and things like that? Or if 1Q is pretty low, 2Q is pretty high, so how do we think of a real normalized run right there on the OpEx?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Yes. Phil, you're right. You've kind of hit on it. So we had some maintenance issues in the second quarter, obviously, that ran through OpEx. First quarter was a little bit low, so we kind of think basically the middle is the run rate. So call it, roughly \$45 million to \$50 million a quarter.

**Operator**

Your next question comes from Doug Leggate with Bank of America Merrill Lynch.

**Douglas George Blyth Leggate** - *BofA Merrill Lynch, Research Division - MD and Head of US Oil and Gas Equity Research*

George, I guess, I'm sorry to go back to the M&A question, but I just wanted to see if I could push you a little bit on this. Do you have any line of sight right now on the possibility of getting something done in the kind of scale that you talked about or is it more aspirational? And I guess, while you're in that mood, should we just expect that you continue to carry an elevated level of cash? Or do you plan to reload the \$123 million remaining buyback that you have, in terms of authorization?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Yes, Doug. I don't think we want to get any more specific on where we are with any deal flow. Just leave it where -- what we said is that we're seeing good deal flow. And we're -- so we're pleased with the quality and the quantity of the deals we're seeing. But again, we're going to keep the dry powder. When we see a deal flow that we -- but again, it takes a lot of things to line up, as we all know, to actually turn a deal flow into actual deals. And that's what we can't predict, and we won't predict.

**Douglas George Blyth Leggate** - *BofA Merrill Lynch, Research Division - MD and Head of US Oil and Gas Equity Research*

Just to be clear, the elevated level of cash, should we expect that to continue until things play out one way or the other?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Yes. I think it's a fair statement. (technical difficulty) your question, we will reload the repurchase authorization when we need to. That would be how we'd approach that.



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**Douglas George Blyth Leggate** - *BofA Merrill Lynch, Research Division - MD and Head of US Oil and Gas Equity Research*

My follow-up is really more of a macro question. Look, obviously, there's a lot of debate or no question differentials are very wide right now. But at the end of the day, we're looking through the cycle. My question, I guess, Rich, is back to you and your comments about TI brand. There's a ton of pipelines coming on. And a year ago, Midland traded at a premium to WTI. So when you look beyond the windfall of the next year, what do you see the mid-cycle or Midland differential look like? And I'll leave it there.

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Yes. I think, over the long haul, the -- these differentials are going to be set by transportation costs. So whatever the transportation cost is, typically from the Permian to the Gulf Coast, \$2 or \$3, \$2 or \$3...

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

And then the incremental pipeline capacity we're seeing is \$4 to \$5. So I think, to your point, these look to be very volatile. And we'd expect that to continue. Pipes come along, you end up with more takeaway than you've got production. You're going to see it compress, and we have the opposite situation at the moment. But to George's point, over the long haul, you'd expect to think of the transportation economics.

**Douglas George Blyth Leggate** - *BofA Merrill Lynch, Research Division - MD and Head of US Oil and Gas Equity Research*

So just to be clear, I know you already talked about this, George, but the contract rates look wider coming in at 250, 275 from Midland to MEH. And obviously, that's cheaper than the Cushing to MEH. So when you think about the \$4 sustainable spread embedded in your -- what Neil was talking about earlier, we're not going to assume \$15 whatever. Are we going to assume less than \$4 at some point for a period of time or not?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

I mean, you could have a period of time that's why for sure. But again, over the long run, yes, you're seeing contract rates at 250 but walk-up rates, which are ultimately in (inaudible) economics, are still \$4 to \$5.

**Operator**

Your next question comes from the line of Roger Read with Wells Fargo.

**Roger David Read** - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Look, maybe to follow-up on Doug's last question there. If you think about longer term on WTI brand, I mean, most of these barrels are going to have to be exported outside of the U.S. In other words, it's not a Gulf Coast clearing price in the traditional sense. When you kind of factor that in, what are you kind of look at as maybe the longer term, that \$4 to \$5 walk-up plus another, I would think, \$2 a barrel of kind of shipping costs?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

I think that's right. I think the only other thing that you need to add in there is you're have to go through across a dock. That will cost another \$1 or \$2.



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**Roger David Read** - Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst

Okay. Right. Okay. And then changing back, and I'm sorry I missed part of the call earlier. But looking at PCLI, I caught the comments about the base oil market being oversupplied, a little bit of turnaround activity. When, as you look at PCLI, do you think we should see sort of a -- I don't know if I want to call it a clean run rate, but maybe a consistent run rate where there aren't too many turnarounds going on, there's not too much noise maybe in the numbers? And then what do you look at as the kind of the earnings or EBITDA power of this business now that you've run it for a little over a year then you've got a better feel for all the moving parts there?

**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

So yes, Roger, the -- for the turnarounds, we'll -- we have a clean run in 2019 on the base oil plan. And we did a guidance at the Analyst Day, and we believe that guidance is still pretty good. You're talking about a -- on the Rack Forward side, \$190 million, \$200 million, \$210 million type business, and we still think we've got room to grow. Obviously, Red Giant will be additive to that. And as George mentioned, over the long run, we're expecting our Rack Back business to be breakeven, maybe a little bit positive on an EBITDA basis.

**Roger David Read** - Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst

Okay. So no major uptakes here anyway?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Nothing that's really material.

**Operator**

You do have a follow-up question from Paul Cheng with Barclays.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

On El Dorado, the turnaround you said mostly in the third quarter or the fourth quarter?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Mostly in the fourth quarter, or it will start late third quarter.

**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

And then I have some difficulty to reconcile why third quarter, the throughput would be so low, that 420 to 430 on the crew? Do you have -- you don't have any other turnaround as I believe? So why that would be so low?

**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

I think it was -- part of what Jim was getting at in his prepared remarks, Paul, we had the El Dorado incident, the FCC outage in the second quarter. And it did spill over into the third quarter. That's what you're seeing primarily in the crude rate guidance for the upcoming quarter.





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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

Is that El Dorado? Or are you talking about Navajo, the FCC?

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

I'm talking about El Dorado.

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**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

We had some other activity -- so Paul, we also had some other downstream unit problems elsewhere that kind of -- those peaked in July, and it were not just El Dorado and Navajo. So that's what you're really seeing in that crew guidance for the third quarter.

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

So that means that July, you actually run pretty quite poorly in order for that to happen?

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**Richard Lawrence Voliva** - HollyFrontier Corporation - CFO & Executive VP

Yes.

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

For July.

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

All right. And George, I think, at one point at least that you believed your current capacity is actually slightly over 500,000-barrel per day in [Southwest] and (inaudible) that previous meeting is lower, and you think that you should be able to run on a rolling 12-month basis without any major incident, say, 450 to 470. Do you still believe, given your experience now here, that you actually would be able to achieve that?

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

Absolutely. So our expectation is to...

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**Paul Cheng** - Barclays Bank PLC, Research Division - MD & Senior Analyst

You're even far below that, right?

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**George J. Damiris** - HollyFrontier Corporation - CEO, President & Director

That's correct.

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**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Yes. And Paul, this is always going to be a tougher year, given the turnarounds at our 2 largest plants. So I think that's -- that colored like the full -- and it's always going to color the full year run rate. But to George's point, we fully expect that 450 to 470 through the cycle is a good number.

**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

So what higher benchmark or that from outside that we can track to see whether that you are on track of that to achieve that?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Well, I think, Paul, you can even look at the second quarter crude rate as an example. We've landed in the 460s with the Woods Cross plant being down. That's roughly a 30,000-barrel per day crude unit. So if we don't have the Woods Cross incident, we'll be in the 490-plus. We did have the issues with the downstream units that, again, Jim highlighted in his prepared remarks. We need to get those issues addressed and under control. But with all that falling in place, we still again are very confident that we can run this fleet at 450 to 470 as we guided during our Analyst Day presentation, even including the impact of the turnarounds.

**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

My final one, I think Centurion, the line you're using, the capacity should be about 60,000, 65,000 barrels per day. So what's the hurdle we need to overcome in order for you to get to that 65,000-barrel per day rate?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

There's no real hurdle, Paul. It's beyond our contract volume that we do have with Centurion. So -- and part of the issue that we have is getting trucks underneath crude oil in the Permian Basin. As you can well imagine, there's been a shortage of trucks with outflows back to the wellhead and getting that back into the system and then making sure that we can, as George mentioned before, sustainably move volume through that pipeline. So -- and you'll recall that in the first quarter, we -- I'm sorry?

**Paul Cheng** - *Barclays Bank PLC, Research Division - MD & Senior Analyst*

So you're saying there is a trucking issue?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Part of it is the trucking issue -- yes, a trucking issue and part of it is just a logistical issue of getting the barrels into Centurion and making sure that we can move them. As you will recall, in the first quarter, we had very much higher throughput through the Centurion pipeline because of the Navajo situation. So it is possible, but we have to make sure it's sustainable.

**Operator**

You do have a follow-up question from Phil Gresh with JPMorgan.



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**Philip Mulkey Gresh** - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Just one last question on these inventory factors in the Mid-Con that appeared to help the 1Q results and then hurt the 2Q results. Any way to kind of calibrate how we should think about that as we try to normalize our thinking for the back half?

**Richard Lawrence Voliva** - *HollyFrontier Corporation - CFO & Executive VP*

Phil, not (inaudible) on this. Historically, we run -- if we run 100, you can take crude rate. And we were typically in [3], 105%, 110% of (inaudible) Refined products at the end of the day. Over time, we'd expect to have -- to be representative. And clearly, we've had some noise up and down. The last couple of quarters we were managing our turnaround. I think that's probably the single best marker I can give you, if that helps.

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Just one other thought specific to the half that you asked Phil is we did build gas oil towards El Dorado as a result of the FCC outage. But also in anticipation of the crude unit outage we're going to have in El Dorado the fourth quarter. So we will run that gas oil a lot during the fourth quarter turnaround at El Dorado.

**Philip Mulkey Gresh** - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

So you're [building] -- overall, in the Mid-Con, you're building in third quarter, and you'll be drawing in the fourth quarter, kind of a reversal of the first half?

**George J. Damiris** - *HollyFrontier Corporation - CEO, President & Director*

Yes. We've built it already. That's correct.

**Operator**

At this time, there are no further questions. I will now turn the floor back over to Craig Biery for any closing remarks.

**Craig Biery** - *HollyFrontier Corporation - Director of IR*

Thank you, everyone. We appreciate you taking the time to join us on this call. If you have any follow-up questions, as always, reach out to Investor Relations. Otherwise, we look forward to sharing our third quarter results with you (technical difficulty).

**Operator**

Thank you. This does conclude today's teleconference. You may now disconnect your lines at this time, and have a wonderful day.

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