Phillips 66 Credit Primer

BI Refining & Marketing, North America Dashboard

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1. BI Credit: Buybacks Hurt Phillips 66 Profile as Much as Margins

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(Bloomberg Intelligence) -- Aggressive share-repurchase and dividend strategies at Phillips 66 are affecting its credit profile just as much as business fundamentals, such as refining crack spreads and olefin and polyolefin margins. While the company enjoys strong liquidity and cash flow, the use of debt to partly fund shareholder returns will hurt its credit profile. Phillips spent an additional $379 million on buybacks in 2Q, bringing the total over the prior 12 months to more than $1 billion.

Citing concerns specifically about the company's debt-funded share buybacks potentially raising leverage, Moody's lowered its rating outlook to negative from stable in October 2016. (10/18/17)

Credit Considerations

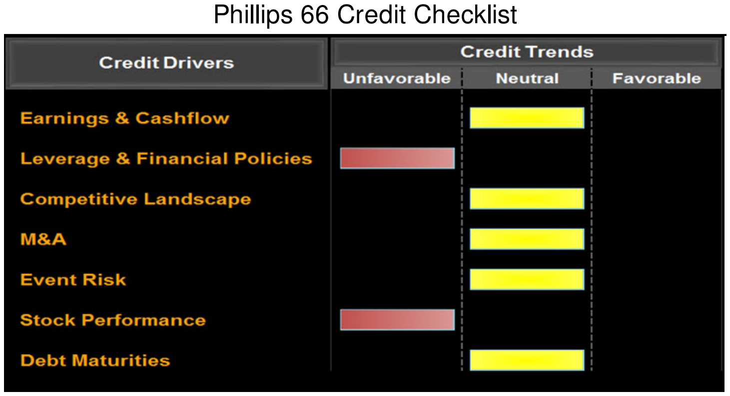
PSX Credit Check List

2. Midstream to Marketing, Phillips 66 Covers the Petroleum Chain

Phillips 66 is an independent energy company organized into four segments: midstream, chemicals, refining and marketing. The company's midstream operations are housed partly at its affiliates Phillips 66 Partners and DCP Midstream, while its chemicals business is mostly run out of Chevron Phillips Chemical Co. Phillips 66 also has a significant international presence, particularly in the U.K. and Germany.

Chevron Phillips Chemical Co. (CPChem) is a joint venture owned by Phillips 66 and Chevron. DCP Midstream is also a joint venture that is owned by Phillips 66 and Spectra Energy. Phillips 66 is the general partner of -- and owns 59% of the limited partner interest in -- Phillips 66 Partners. (10/18/17)

Phillips 66 Credit Checklist



PSX Key Drivers

Aggressive Return of Capital Leaves Phillips 66 More Exposed

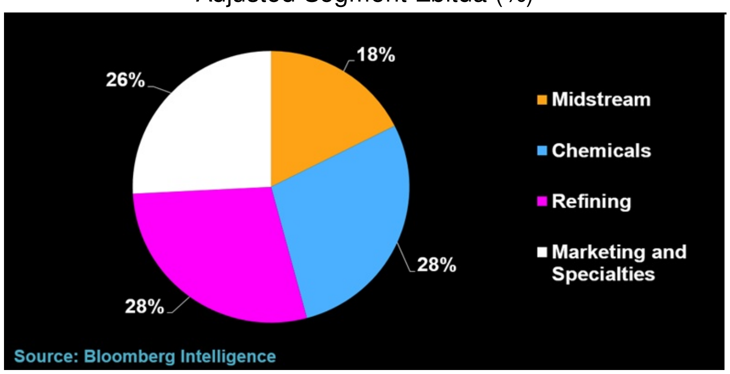
While substantial contributions to earnings from Phillips 66's nonrefining and international businesses markedly soften its exposure to volatile crack spreads, aggressive share buybacks and dividend-growth programs weaken the company's credit profile and leave it more vulnerable to declining margins. (10/17/17)

3. Refining Is Now a Minority Contributor to Phillips 66 Earnings

Phillips 66's credit profile gains from a higher level of product diversification than sector peers. For the 12 months through June 30, the company's midstream, chemicals and marketing and specialties businesses contributed a substantial 72% of segment-adjusted Ebitda. While this proportion will likely decline as the company transfers midstream assets to Phillips 66 Partners and refining margins recover, S&P expects these segments to continue to contribute the majority of its proportionately consolidated Ebitda.

Peer Comparison: While integrated oil companies such as Exxon Mobil and Chevron have substantial refining operations, Phillips 66 is more comparable to independent refiners such as Marathon Petroleum, Andeavor, Valero Energy, HollyFrontier and PBF Energy. (10/17/17)

Adjusted Segment Ebitda (%)

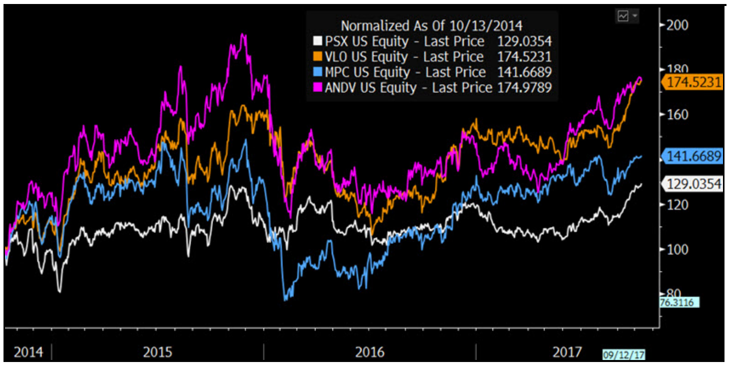


4. Rising Dividends, Share Buybacks May Pressure Phillips 66 Credit

Phillips 66's commitment to maintain sizable stock repurchases and increase shareholder dividends will constrain any improvement in the company's credit profile, especially without a sustained recovery in refining, NGL and ethylene margins. While the company's share price has underperformed vs. its independent refiner peers over the last three years, it has displayed markedly less volatility -- largely due to the limited correlation in earnings between its various segments.

Peer Comparison: Issuance of new equity at Phillips 66 Partners to fund asset transfers only partly compensates for share repurchases at Phillips 66. Parent debt is effectively subordinated to partnership debt and equity. (10/17/17)

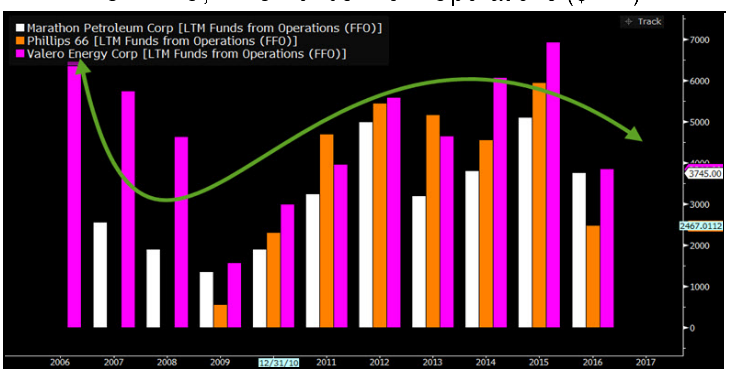
Phillips 66 vs. Peers Share Prices



5. Diverse Operating Base Gives Phillips 66 an Edge Over Peers

Phillips 66's diverse operating base better prepares it, relative to peers, to face a sustained refining-industry downturn. This gives the company somewhat more leeway to carry higher leverage -- something that an aggressive share buyback and dividend growth program could well entail. Still, given the volatility of earnings across the energy spectrum, Phillips 66's credit profile could quite easily be stressed if more than one segment were to face significant headwinds. (10/17/17)

PSX. VLO, MPC Funds From Operations ($MM)

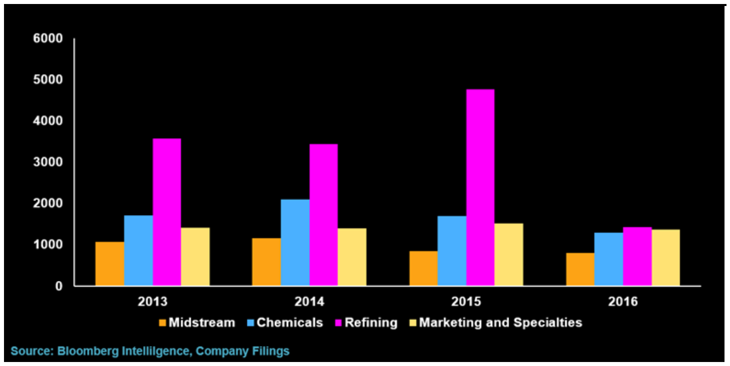


6. Phillips 66: Not Quite the Ideal Path to a Balanced Earnings Mix

Refining, chemicals and marketing sectors each accounted for about 28% of Phillips 66's segment Ebitda in 2016, with midstream making up 16%. While such a relatively balanced mix of earnings is generally desirable, Phillips 66 has been able to achieve this only because of a huge decline in refining profit rather than sustained improvements in other sectors. Earnings declined in every segment in 2013-16.

Peer Comparison: Increasing scale at DCP Midstream, which houses a significant portion of Phillips 66's midstream operations will better enable the company to compete with peers such as Energy Transfer Partners, Kinder Morgan, Plains All American Pipeline, Enbridge Energy Partners and Enterprise Products Partners. (10/17/17)

Phillips 66 Sector-Adjusted Ebitda ($ Million)

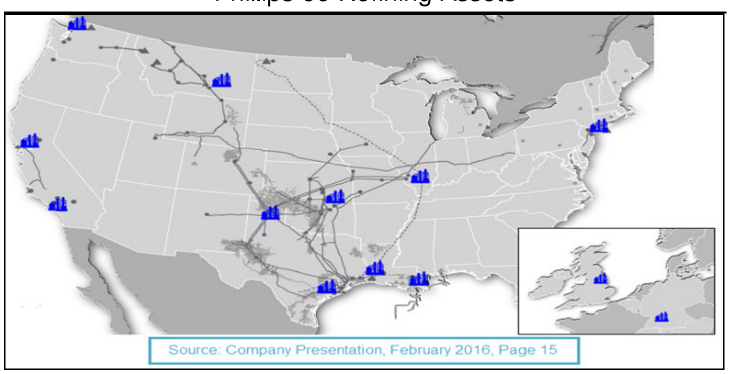


7. Phillips 66 Refineries Can Capitalize on Crude Price Variations

Geographic diversity across the U.S. allows refining companies to take advantage of price differences among various grades of crude oil. The four Phillips 66 mid-continent refineries are especially well placed to gain from discounted Canadian and domestic crude prices. Its three Gulf Coast refineries are well situated to capitalize when export markets are strong, as well as to take advantage of variations in light and heavy crude prices.

Peer Comparison: Almost all major refiners operating in the U.S. have a Gulf Coast presence, including Exxon Mobil, Royal Dutch Shell, Chevron, BP, Marathon Petroleum, Citgo Petroleum and Valero Energy. (10/17/17)

Phillips 66 Refining Assets



PSX Valuation

Energy Universe Beyond Refiners May Offer Better Comparables

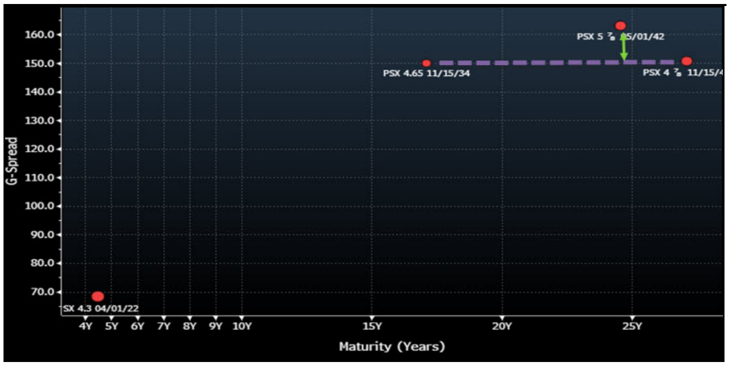
Relative-value assessments in the refining sector are difficult, with just six investment grade participants, not all of which have comparable maturity bonds outstanding. Investors may find better comparisons across the broader energy sector, as well as among non-U.S. issuers. (10/18/17)

8. Longer-Term Concerns May Justify Switching to Off-the-Run Bonds

Switching from Phillips 66's 4.875% bonds due in 2044 to the shorter-dated off-the-run 4.65% bonds due in 2034, which trade at a similar price and an almost equivalent spread, makes sense if the longer-term impact on the refining sector from the growth in market share of electric vehicles is a primary concern. Switching out of the 5.875% bonds due in 2042 may also make sense, despite their higher spread, given the significant price premium these bonds trade at.

Peer Comparison: Companies that will gain at the expense of refiners if electric vehicles begin to replace traditional gasoline and diesel vehicles in a significant way include Tesla, Renault-Nissan, General Motors, Geely, Toyota and Ford. (10/18/17)

Phillips 66 Bond Spreads

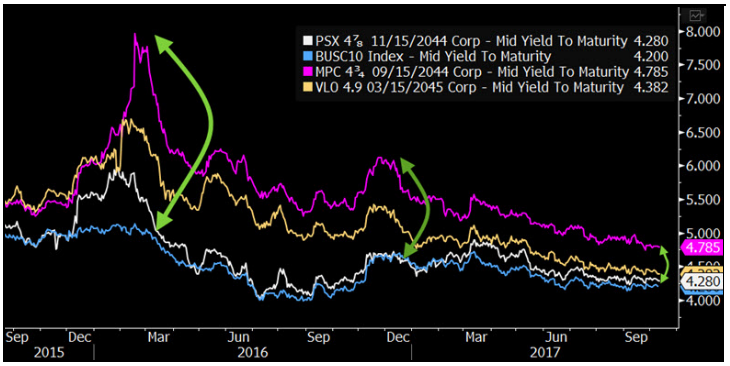


9. Yields on Less Volatile Phillips 66 Approach Tightest vs. Peers

Phillips 66 yields are lower and less volatile across the curve than those of peer investment grade refiners Valero Energy and Marathon Petroleum, partly due to the company's more diversified operating base. When the broader market's yields surged in 1Q16 and 4Q16, the Phillips 66 4.875% bonds due in 2044 widened by a lesser amount than peer issues. The yield on the Phillips 66 bonds due in 2044 is now close to its tightest levels relative to similar maturity Valero and Marathon bonds in two years.

Companies Impacted: Andeavor doesn't have any long-maturity bonds. Its 5.125% notes due in 2024 trade 120 bps wider than similar-maturity Marathon Petroleum bonds. (10/18/17)

Phillips 66, Peers Long-Maturity Bond Yields



Topics

Ratings

10. Phillips 66 Has to Deliver Earnings Growth to Offset Buybacks

The risk of higher leverage due to debt-funded share buybacks and aggressive dividend targets in a weak refining environment largely drove Moody's change in Phillips 66' outlook to negative from stable in October 2016. Though crack spreads have recovered since then, Phillips 66 will have to deliver on Ebitda growth targets for projects that will come online in 2018 to prevent additional asset transfers and share repurchases leading to a deterioration in its credit profile.

Peer Comparison: Phillips 66 bonds are rated A3 at Moody's and BBB+ at S&P, higher than any other refining and marketing sector bonds in the U.S. At the other end of the spectrum are Delek Logistics, Citgo Holding, Sunoco and Calumet Specialty Products with B/CCC tier ratings. (10/18/17)

U.S. Refining Sector Bond Ratings

Iss Name	S&P	Moody's
Phillips 66	BBB+	A3
Motiva Enterprises LLC	BBB	Baa1
Marathon Petroleum Corp	BBB	Baa2
Valero Energy Corp	BBB	Baa2
Andeavor	BBB-	Baa3
HollyFrontier Corp	BBB-	Baa3
CVR Refining LLC / Coffey...	BB-	B1
PBF Holding Co LLC / PBF ...	BB	B1
Sunoco LP / Sunoco Finan...	B+	B1
CITGO Petroleum Corp	B+	B3
Delek Logistics Partners LP	B	B3
Citgo Holding Inc	B-	Caa1
Calumet Specialty Product...	CCC+	Caa2

PSX Earnings, Projections

Phillips 66 Business Offsets Should Be Evident in 3Q Earnings

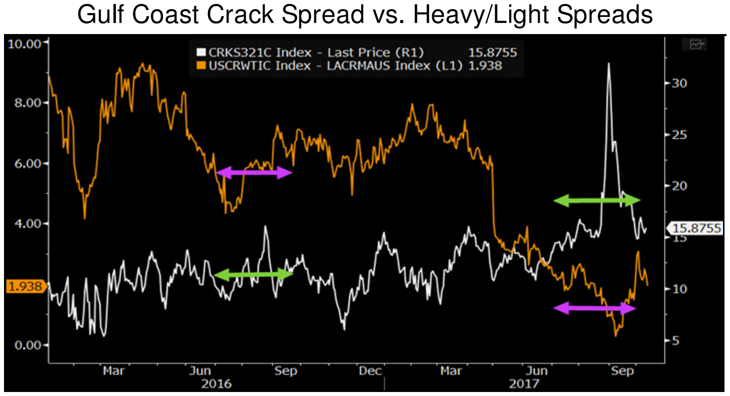
The ability of strength in one segment of Phillips 66's business to offset potential weakness in another should be evident when 3Q earnings are released. Stronger fractionation spreads in the midstream sector should help to allay any softness that weaker light/heavy spreads cause in the refining segment. (10/16/17)

11. Tighter Light-Heavy Spread Will Limit Refining Earnings Recovery

A tighter spread between domestic light and imported heavy crudes will have partly offset higher 3Q crack spreads relative to 3Q16 to limit the improvement in Phillips 66's refining segment 3Q earnings. The average Gulf Coast spot crack spread marked a recovery to $17.65 a barrel in 3Q from $11.28 in 3Q16. The spread between domestic light and imported heavy crudes, which can also affect refining earnings, declined to $1.72 a barrel in 3Q from $5.83 in 3Q16.

Companies Impacted: Refiners that will be affected by improving crack spreads include Phillips 66, Marathon Petroleum and Valero Energy. Those with substantial E&P operations, including Exxon Mobil, Royal Dutch Shell, Chevron and BP, will lose some of this benefit, due to lower oil prices. (10/16/17)

Gulf Coast Crack Spread vs. Heavy/Light Spreads



12. Higher Natural Gas Liquids Margins Should Support 3Q Earnings

Higher 3Q natural gas liquid fractionation spreads relative to 3Q16 should support a notable improvement in Phillips 66's midstream segment earnings. After almost regaining its a two-year high of $22.28 a barrel, the average Henry Hub Mont Belvieu LDH Fractionation Spread was substantially higher at $16.35 in 3Q compared with just $8.85 in 3Q16. Recent investments should also have resulted in improved transportation revenue for the midstream segment.

Peer Comparison: DCP Midstream's peers Enterprise Products Partners, Energy Transfer Partners, Oneok Partners and Targa Resources should also have benefited from higher natural gas liquid fractionation spreads in 3Q. (10/16/17)

Henry Hub Mont Belvieu LDH Fractionation Spread

PSX Tax Reform

13. Refiners Poised to Be Major Beneficiaries of Lower Tax Rate

U.S. refining and marketing companies have traditionally been high cash taxpayers and could be among the primary beneficiaries of a corporate tax cut. A 15% reduction in the corporate tax rate could add as much as $240 million to Phillips 66's bottom line in 2018 and $300 million in 2019. Yet a failure of Congress to pass a meaningful reduction in tax rates could see a sharp decline in the Phillips 66 share price and drive the company to pursue buybacks even more aggressively to support its share price.

Peer Comparison: While a repatriation tax break wouldn't benefit Phillips 66 as much as some companies with more substantial overseas earnings such as Apple, Cisco Systems, Amgen and Microsoft, the company stands to gain more from this than its independent refining peers. (10/16/17)

Phillips 66 Consensus Projections

12 Months Ending	12/31/2018	12/31/2019
EBIT	4.690B	5.502B
EBITDA	6.431B	6.803B
Pre-Tax Profit	4.731B ↑	5.273B ↑
Net Income Adj+	3.124B ↑	3.292B ↑
Net Income, GAAP	3.124B ↑	3.292B ↑
Net Debt	7.492B ↓	4.098B
Return on Equity %	14.217 ↑	13.520 ↑

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