Phillips 66 (PSX): Initiate 1.25% Position **May 2021**

Phillips 66 engages in the processing, transportation, storage, and marketing of fuels and other related products. The company operates through the following segments: Midstream, Chemicals, Refining and Marketing & Specialties

- **Midstream:** Midstream provides crude oil and refined petroleum product transportation, terminaling (temporary storage of refined petroleum prior to transport) and processing services as well as natural gas and natural gas liquids transportation, storage, fractionation, processing and marketing services mainly in the U.S. Segment. It includes Phillip's publicly traded master limited partnership, Phillips 66 Partners LP (PSPX), as well as the company's 50% equity investment in publicly trade DCP Midstream, LLC (DCP).
- **Chemicals:** The Chemicals segment is composed of a 50% equity investment in Chevron Phillips Chemical Company which manufactures and markets petrochemicals and plastics worldwide.
- **Refining:** Refining refines crude oil and other feedstocks into petroleum products such as gasoline, distillates and aviation fuels at 13 refineries in the US and Europe.
- **Marketing/Specialties:** Marketing and Specialties purchases for resale and markets refined petroleum products, mainly in the US and Europe. The segment includes manufacturing and marketing of specialty products such as base oil and lubricants.

Investment Thesis

Phillips 66 is a well- diversified midstream and downstream energy company. We believe there is a continuum of catalysts that make this an interesting company to own.

The reopening of the economy should provide a short-term catalyst for the company. We suspect that individuals will be ready to escape from the confines of their Covid-induced lockdowns, providing a catalyst for an increased consumption of refined products, particularly gasoline. This should provide boosts to the moribund refining portion of the company, as well as the marketing (gas stations) and the lubricants businesses.

A more mid-term catalyst is the company's capital allocation strategy of using the free cash flow from the Refining and Marketing businesses to invest in the profitable and generally less volatile Midstream and Chemical segments. This should help to further diversify PSX's business with less volatile earnings and cash flow generation.

The longer-term transitional catalyst is the creation of the Emerging Energy group. It is focused on commercializing and implementing emerging energy technology within the company's operations and portfolio of assets, ultimately establishing a low carbon, sustainable business platform. PSX expects renewable diesel (a biofuel) to have the largest impact on the emerging energy portfolio. Management believes it is conceivable it could be a business nearing $1 billion in EBITDA before mid- decade. Other projects include powering facilities with on-site solar energy, participating with the UK's Gigastack Consortium to produce hydrogen using a combination of offshore wind power and water, as well as working on battery technology, solid oxide fuel cells and organic photovoltaics. It also has initiated a program building stations for hydrogen fueling in Switzerland.

Positives

- Diversified portfolio of midstream and downstream assets. Focus on growing the high margin and less volatile segments of the fuel.
- Roll-off of major Midstream project spending with the accompanying increase in cash flow from the completed projects.
- Well positioned for demand recovery in refined products. Lower exposure to aviation and jet fuels could increase the speed of the refining segment's recovery. The company expects some reduction in refining capacity due to closing of smaller financially weak refineries and the delay/cancellation of development projects.
- Emerging Energy segment shows commitment to the development of renewable energy that could provide a significant new source of cash flow in the future.

Negatives/Risks

- Refining is still a significant portion of the business portfolio. While refining can be quite profitable, it introduces a potential source of volatility into the company's cash flows.
- The future of the Dakota Access Pipeline is in question under the current administration. Its closure could be a significant headwind for Phillips 66 Partners LP that would either result in higher debt and/or a significantly lower distribution. The distribution reduction would directly impact Phillips 66's cash flows.
- Various aspects of PSX's business can be negatively impacted by extreme price fluctuation in crude and natural gas prices creating pressure on margins.
- The profitability of the midstream assets is dependent on significant US oil and gas production. Any disruption in US production could negatively impact the cash flow and ROI on these assets.
- A slowdown in the U.S. and/or global economies could reduce demand for Phillips 66's products.

Valuation Summary

Valuation Measurement	Current	Trailing 5 Year High, Low & Average		
		High	Low	Avg
Price	86.93	123.34	46.66	87.42
*P/E Last 12 Months	n/a	n/a	46.66	18.90
Forward PE	22.6	25.2	5.3	14.6
P/BV (Price to Book Value)	2.1	9.85	2.44	3.94
Dividend Yield	9.87%	11.01%	6.13%	6.68%

Valuation Note: Energy companies are very cyclical and consequently, traditional valuations approaches are not very helpful regarding the future of the company. For the last several months PSX trailing PE is not available given earnings have been negative. We expect earnings to significantly rebound over the next year. The 2016 and 2017 calendar years are the most recent example that is somewhat representative of today. In 2016, oil prices dropped into the mid $30/barrel range which put pressure on earnings. PSX earnings for Q4-2016 came in at $.31/share. Oil prices rebounded back to the mid $60/barrel range in 2017 which in turn allowed the company to post $6.29/share of earnings for Q4-2017.

Note:

The securities identified and described do not represent all the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. All material of opinion reflects the judgement of Morgan Dempsey Capital Management at this time and are subject to change. This material is not intended as an offer or solicitation to buy, hold or sell any financial instrument or investment advisory services.