Long Tail ASSET MANAGEMENT PTY LTD AFSL 341 474

Semgroup (31/12/2011)

The fund holds a 4.5% position in Semgroup. We acquired this position from mid-July 2011 to mid-August 2011 at an average price of $22.58 per share. On 24th October 2011 Semgroup became the target of a takeover bid by Plains All American at $24.00.

Semgroup is currently trading around $26 per share and its enterprise value is around $1.3 billion. In 2011 we expect the business to generate a pre tax ungeared cash coupon of approximately $105 million (before growth capital expenditure) - we perceive this coupon can grow considerably with incremental development capital expenditure and increased utilisation of existing assets.

The key insight we feel we held regarding Semgroup following its bankruptcy was the fundamental change in their business model away from being a volatile marketing / trading business towards a fee based revenue model. We had regarded the business as owning reasonable quality assets and felt a fee based model was more appropriate and sustainable - rather than using the assets to facilitate marketing / trading activities. We believed we had confirmation of this change from the results the business delivered following its relisting in October 2010.

When we acquired the investment we thought about the numbers as summarised in the table below.

	2011
Shares on issue (1)	44.3m
Our average buy price	$22.58 per share
Implied market capitalisation	$1,000m
Estimated net debt (2)	$180m
Estimated enterprise value	$1,180
Estimated pre tax cash ungeared coupon (3)	$105m
Estimated pre tax ungeared yield	8.9%

Notes: The estimates are pre the sale of SemStream, the Rose Rock IPO and debt refinancing. Totals, ratios, etc may not add due to rounding. (1) Includes dilution for warrants and unvested restricted shares. (2) Reflects gross debt plus some other liabilities less cash held, estimated cash from warrants and SemStream inventory allowance. (3) Reflects EBITDA / operating cashflow pre interest and tax less maintenance capex and some additional expenses not otherwise captured.

Semgroup is a US based company with an event filled last few years, culminating with its bankruptcy in 2008 (in 2008 Semgroup came unstuck as it seems to have been on the wrong side of the strong rally in the oil price. This resulted in significant losses and a bankruptcy filing in July 2008. Creditors took losses overall in the vicinity of 50%).

We have some familiarity with a number of the trends occurring in the US energy sector, including the rise of shale gas supply, increase in natural gas liquid extraction and processing, increase / change in North American oil supply, and others. We are interested in how these dynamics will create opportunities for new infrastructure (pipelines, processing facilities, storage, etc) and leave other infrastructure stranded.

Ideally we want to find companies that own quality assets that are well located given the trends referred to above and have the opportunity to invest in / around these assets to generate favourable incremental returns. We also want to buy cheaply based on existing (not future) earnings, reasonable management and a good balance sheet.

Our research led us to Semgroup. Semgroup's assets consist of an eclectic range of oil storage and pipeline assets in and around Cushing, and gas processing assets in Canada and the Texas / Oklahoma area. They also have a petroleum storage facility in the United Kingdom and a small Mexican asphalt business. Some of the assets are new or recently refurbished.

Semgroup emerged from bankruptcy and relisted on the NYSE during October 2010, owned by its creditors. Importantly, it emerged with:

- new management headed by a CEO with a long track record and reputation for good operational expertise;
- new tolling based business model focused on providing fee based oil and gas pipeline, storage and processing services to third parties; and
- new balance sheet, with a low level of debt.

Below we have provided considerable detail regarding the major assets owned by Semgroup. We felt this background enabled us to build confidence in the earnings power of the individual assets and the business as a whole, and was necessary for us to gain confidence in our valuation of the business. The detail outlines how Semgroup has been able to extract incremental returns to date and the opportunities for the future. We also felt this detail provides greater insight to our research process.

White Cliffs Pipeline

Our initial interest in White Cliffs was sparked a few years ago as it was being developed by the pre-bankruptcy version of Semgroup. What attracted us was the genuine need for the pipeline (it seemed to relieve a key constraint of producers in the Denver-Julesberg (DJ) Basin seeking a market for their oil) and the economics looked attractive.

White Cliffs is a 12 inch 525 mile pipeline that provides the only pipeline link between the rapidly developing DJ Basin in Colorado and the oil market hub at Cushing, Oklahoma. Prior to White Cliffs producers were restricted to the two local refiners or trucking oil to other regions.

White Cliffs commenced construction prior to bankruptcy and came into operation in mid-2009 with a capital cost of approximately $235 million. As a result of the agreement entered into with foundation customers and the bankruptcy process, Semgroup's interest in White Cliffs was reduced to 51% in 2010.

Given its monopoly position, White Cliffs obtained FERC (Federal Energy Regulatory Commission) approval for its throughput rate of $5.20/bbl for foundation customers and $5.70/bbl for subsequent customers. The rate base for the asset was set at around $250 million and the corresponding return around 14% on an ungeared pre tax basis. Assuming gearing of 50%, this translates in a pre tax equity return of around 20%. We believe this is very attractive given the underlying risk profile.

White Cliffs had an initial capacity of approximately 30,000 bbl/ day and the foundation customers contracted two-thirds of this capacity for around 5 years on a take or pay basis.

Strong demand for capacity on White Cliffs saw its utilisation reach capacity in early 2011. We thought the economics at this point looked attractive – the pipeline was generating revenue of around $55 million with operating expenses of $14 million and depreciation another $10 million. In other words, an ungeared pre tax cash coupon of $40m+ and EBIT of $30m+. Relative to the capital cost of $235 million, this implies an ungeared pre tax return of 17% or 13% respectively.

Demand for capacity on White Cliffs has continued to rise and it has been able to easily expand capacity with pump stations (which increase pipeline flow rate) - initially one pump was installed to expand capacity to around 50,000 bbl/ day. Semgroup already owned the pump and the cost of installation was very small. During the September 2011 quarter, use of the pipeline grew to nearly 42,000 bbl/ day.

Given the relatively fixed cost nature of the pipeline, a large part of the incremental revenue falls to the bottom line / shareholders. Demand permitting, management expect that with small additional capital expenditure, capacity can be increased to 70,000 bbl/ per day.

Cushing Storage

Cushing is a major oil hub in the US and the price settlement point for West Texas Intermediate on the New York Mercantile Exchange.

The oil flow dynamics around Cushing have changed in recent years as the increased flow from the north (e.g. Canada, Bakken, DJ Basin, etc) has congregated at Cushing and there has been insufficient take away capacity from Cushing. We believe it is only a matter of time before new pipeline capacity is added with the Keystone XL pipeline (to be developed by TransCanada as an extension of the existing Keystone pipeline from Canada to Cushing) probably the leading contender.

During October 2011 we met with most of the companies that have storage capacity at Cushing and visited the oil storage tanks. The tanks are primarily owned by 5 or 6 companies with Plains All American being the largest with around 18.5 million bbl of capacity. The tanks are located on farm land a few minutes out of Cushing and one hour by car from Tulsa.

In 2008 Semgroup had just over 1 million bbl of oil storage capacity at Cushing. This has grown to 5.05 million bbl currently and will reach 7.0 million bbl in 2012. Semgroup has contracted all of its capacity (it does not build and hope the demand comes) on a take or pay basis for approximately 5 years. They also own enough land to expand their capacity to around 13 million bbl.

The economics of storage capacity is broadly as follows. Tanks have a new construction cost of around $25 per bbl (give or take). Revenue is derived mainly from a take or pay storage fee which is currently around 40 cents per bbl per month (give or take), EBITDA margins are very high (the tanks are operated remotely and opex is a bit of labour and electricity) and there is minimal ongoing capital expenditure requirements (particularly given Semgroup's assets have all been built in the last 3 or so years). We expect this provides an ungeared pre tax cash yield somewhere in the low to mid teens.

Given the increase in oil flow into Cushing there has been significant storage build in recent times and this may (probably) result in too much storage capacity at some point in the future. This was one of the issues we addressed in our US company meetings. Semgroup seems to be reasonably placed as it has fully contracted its storage for the next 4-5 years. We probably regard the economics of oil storage less highly than we perceive the market does. We suspect generally these earnings are viewed as a longer term stable to growing coupon. Given that there seems to be no limit to building additional storage capacity, we have tended to think of the initial 5 year contracted period as enabling the storage owner to recover most of their construction cost, and then what they receive in the out years as return on this investment. In essence, we think they are net present value positive investments but the earnings profile will likely be more volatile and may be lower than the market is currently anticipating.

Gas Processing

Semgroup has gas processing facilities in the US and Canada.

Semgroup owns three gas processing facilities in Texas and Oklahoma. These facilities take in raw natural gas and strip it of its liquids content. The processed natural gas is then sold for domestic or industrial use (e.g. heating) and the natural gas liquids are sold for further refining and then used in manufacturing products such as plastic, fibre, paint, etc.

Semgroup receives a percentage of the liquids / natural gas revenue as its fee for processing the raw gas. Semgroup's assets are in liquids rich regions which significantly improves the processing economics. Semgroup also receives a fee for some of its 800 miles of gas gathering pipeline assets. Semgroup takes volume risk (raw gas inflow) and price risk on the gas / liquids it sells.

Semgroup has recently completed a new cryogenic plant (the Hopeton facility) which will enable it to take a deeper cut of the raw gas stream and extract a higher amount of liquids. It appears that this facility made a very meaningful contribution in the September 2011 quarter and should significantly lift the US gas assets contribution to group earnings in 2012 and onwards.

Going forward we would expect to see meaningful expansion opportunities around Semgroup's US gas processing assets.

In Canada, Semgroup has interests in four gas processing plants (near Edson, Alberta) which are mainly used to sweeten gas (remove high sulphur content). The plants have an operational capacity of 730 million cubic feet per day. The assets also include 600 miles of gathering and transmission pipelines.

Semgroup owns a 60-70% interest in the facilities with a gas producer holding the balance (e.g. BP / Chevron).

The economics of the facilities are a tolling business model where the facilities are reimbursed their operating expenditure plus a margin plus a capital return. Volumes are at risk, however, a sizeable portion of current throughput is from producers that are tied in to the facility for the life of field /acreage. The assets do not take ownership of the gas while processing or take direct commodity price risk (in contrast to the US gas assets).

Over the past 12 months operational issues have held back the performance of the Canadian gas assets with utilisation dropping from around 90% to 75%. Some of these issues are outside their control (e.g. weather) and the others should be able to be addressed / remedied.

The opportunity for these assets is to expand into and capture increased processing volume from the developing Montney and Douvernay shale formations.

UK Petroleum Storage

This asset is the largest independent petroleum products storage facility in the UK. It is located in Milford Haven, Wales. It has 50+ tanks with capacity of nearly 9 million bbl and two deep water jetties. The facility is able to handle a wide range of petroleum products including gasoline, gasoline blend stocks, naptha, jet fuel, gas oil, crude oil, etc.

Semgroup bought the facility in 2006 and since then invested significantly in the tanks to refurbish and upgrade.

The facility is unregulated and historically has contracted its capacity for terms of up to 5 years on a take or pay basis. In recent years it has been able to achieve reasonable fee increases - the facility has little competition in the UK – the main competition comes from the European northern range ports such as Antwerp, Rotterdam and Amsterdam. Moreover, demand has been strong with utilisation in recent years over 90%.

However, the financial performance of this asset changed materially in 2011 with utilisation falling from 99% in 2010 to just 42% in the September quarter 2011. Not surprisingly EBITDA has also halved.

The key customers for the facility are producers (logistical), European strategic storage (requirement to hold minimum reserve levels) and traders (forward curve or directional bets). Customers are taking a wait and see attitude to re-contracting which seems to be influenced by the relative Brent crude oil price, flattening out of the oil forward curve and disruptions in the Middle East / North Africa. The situation has been made worse as it appears that a large number of contracts were re-negotiated as part of the bankruptcy process with terms expiring around 2011.

While it is still early days, there may be light at the end of the tunnel - at the end of November 2011 utilisation had improved to 52%. Nevertheless, we are not assuming utilisation will return to the previous 90%+ levels.

Longer term it would not surprise us to see this asset sold.

Other assets

Semgroup also owns a few other assets (some of which are relatively small) which we have listed below:

- Oklahoma and Kansas pipeline system – 600 miles of gathering and transmission oil pipeline with throughput growing to over 37,000 bbl/ day during the September 2011 quarter. There should be further operational improvement from these assets as the stigma associated with the bankruptcy dissipates;
- NGL Partners - Nearly 9 million limited partner units and 7.5% interest in the general partner. These interests arose as a result of the sale during 2011 of the SemStream terminals and marketing business;
- Bakken and Platteville - truck unloading and storage facilities; and
- Mexican asphalt business - 13 terminals, 20% market share and sold over 350,000 short tons over the past 12 months. We regard this as a fairly low quality business and longer term would not surprise us if it was sold.

Management have recently disclosed group wide growth capital expenditure opportunities amounting to $350-500 million for the next couple of years. While we would not expect all these projects to proceed, it remains a large amount relative to the current enterprise value of around $1.3 billion. Management's ability to deploy capital wisely and successfully execute will be critical to Semgroup achieving its potential.

Finally, Semgroup is not the only infrastructure company in our portfolio which has emerged from bankruptcy – there are two others which exited, albeit earlier than Semgroup (around 4 years ago). While former bankrupt companies is not an area we set out seeking opportunities, to date it has shown to be prospective and rewarding.

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