A Perspective on Murphy USA

By Dan Walker, CFA

Murphy USA is the largest stand-alone fuel retailer in the United States. The majority of its stores are located adjacent to a Wal-Mart, and they pursue a low-cost, high-volume model.

A Misunderstood Model

Over the last few decades, the convenience store industry has evolved from sellers of fuel to sellers of food. What began when an enterprising attendant sold his first pack of chewing gum has grown into stores with thousands of items, selling everything from lattes to pizza. As Americans increasingly purchase their calories in the most convenient setting, the industry has consistently grown non-fuel sales for decades. The attraction of this model is easy to understand, as margins on food are not only higher than fuel but also less volatile.

Murphy USA has a different model. They cater to a price-sensitive customer who values affordable fuel. By offering what is often the lowest price in the market, they sell four times as much fuel per location as a typical convenience store. Consequently, they turn their fuel more frequently, which allows them to exploit price changes faster than their peers. Because of Murphy's buying power (more than four billion gallons a year) and sourcing infrastructure (pipeline access, terminals and distribution), they have a low-cost advantage. They also keep costs low by operating primarily in 200 square foot kiosks, which allows them to underprice competition even further.

Many investors shun fuel earnings because they are volatile, and investors fear rapid improvements in fuel economy. Many will point to CAFE (Corporate Average Fuel Economy) standards which mandate 54.5 mpg by 2025. Whether automakers will be able to close the gap from today's 21 mpg remains to be seen, but because these regulations only apply to current year production (and the average car is 11.5 years old), we suspect fuel demand will last longer than many expect.

Another point of contention is Murphy's cooperation with Wal-Mart. Almost all of Murphy's stores are located on or adjacent to a Wal-Mart parking lot. While many view this customer concentration as a risk, we view it as a strategic advantage. If you want access to price-sensitive customers in large numbers, it's hard to imagine a better footprint. While the relationship with Wal-Mart has had its ups and downs, it's important to note that every other hyper-market (those who operate a low-cost, high-volume model, like Costco, Kroger and Safeway) is owned by its grocery parent. They use them strategically to drive traffic and incent purchases within the store. Thus, while the relationship with Wal-Mart isn't perfect, we do view it as strategically aligned.

Lastly, Murphy makes a sizeable portion of its earnings from selling environmental credits (called RINs or Renewable Identification Numbers) to refiners. Part of the EPA's Renewable Fuel Standard mandates increasing usage of renewable fuels. Because many engines aren't capable of handling ethanol blends greater than 10%, the mandate requires more renewable fuel than is currently possible (and is slated to increase). The result has been increased demand for these credits, driving up prices. While investors are right to question the sustainability of these earnings, management has been transparent about their impact and used the temporary windfall to repurchase shares at attractive prices. We believe investors shouldn't reward them for these one-time earnings, but neither should they punish them.

The Evolving Landscape

Many fuel retailers were once owned by integrated oil companies who also owned refineries. Historically, they saw their retail operations simply as a home for gallons. Because they made money producing the oil (upstream), moving the oil (midstream) and refining the oil (downstream), by the time it was gasoline, they were just happy to be rid of it. Consequently, fuel margins were somewhat an afterthought. Since then, not only have refineries split from oil companies, but fuel retailers have split from refiners. Thus, they are now incented to optimize volume, profit and traffic. We believe this has structurally increased fuel margins in the industry, which has disproportionately benefited Murphy USA.

Secondly, a host of rising costs are increasing the value of Murphy's franchise. Because competitors want to sell as much in-store merchandise as possible, they've begun building larger and larger stores, often in excess of 5,000 square feet. These larger stores have the effect of increasing the break-even price they must charge for their fuel, which provides a price umbrella for Murphy to undercut their big box peers while still earning attractive returns. Add higher credit card interchange fees, state minimum wages and overtime exemption changes, and Murphy's low-cost model becomes even more pronounced.

Lastly, low oil prices and deflation are a positive for Murphy. When oil began its descent from over $100 to $26, the price of gasoline fell too. There's a saying in the industry that gas prices go up like a rocket but down like a feather. Should prices rise, Murphy is quick to raise prices to not sell at a loss. When prices fall, they take their time, capturing high prices on lower-cost inventory. Low fuel costs have the added benefit of incenting more driving as well as freeing up wallet-share for more discretionary purchases in-store. While Murphy has the lowest merchandise contribution among its peers, a host of initiatives have allowed them to show rapid improvement in this metric.

Strong Capital Allocators

Murphy USA was spun out from an integrated oil company, Murphy Oil, in 2013. Since then, it has been led by Andrew Clyde, a 20-year industry veteran. As the only stand-alone hyper-market in the industry, the investing public was slow to grasp the attractiveness of the model. Since going public, Clyde has sold two ethanol plants and a pipeline at very attractive prices. He's refinanced debt and repurchased almost $500 million of stock. He's maintained a land-bank of both Wal-Mart and off-pad sites that allow for future store growth. And he's lowered fuel break-evens by tightly managing costs while expanding Murphy's merchandise sales.

But perhaps the least appreciated aspect of the model is its capital-light nature. While capital expenditures have been high in recent years due to a host of initiatives (investing in assets prior to sale, new store builds, stand-alone public company costs), 200 square foot kiosks require very little investment. This will free up even more capital for returns to shareholders, and we suspect a dividend may not be far behind. Management has retired 17% of its shares outstanding in its first three years as a public company while maintaining a conservatively leveraged balance sheet. We suspect they will continue to do so.

Lastly, strategic optionality could provide additional upside. There have been a host of mergers in the industry (Hess, Susser, Pantry) at very high multiples of EBITDA, perhaps none more pronounced than the recent acquisition of CST by Couche-Tard. While those are different models, focusing on in-store merchandise sales, Murphy USA trades at almost a 50% discount to CST, based on its forecast for 2016 EBITDA. We don't speculate on merger activity, but we feel this provides additional downside protection, especially for a company who is aggressively shrinking its share count.

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As of September 30, 2016: Murphy USA Inc. represented 3.2% and 1.2% of the Hickory and Balanced Funds' net assets, respectively. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

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