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The Global Value strategy had a performance of -10.35% gross of fees and -10.61% net for Q3 2015 (YTD: 2.80% gross, 2.06% net). This was a difficult quarter for global equity markets with US small-cap value stocks particularly hard hit (Russell 2000 Value index: -11.21% for Q3). Periods of poor performance are unavoidable in a value investing strategy and make the implementation of this strategy difficult for impatient investors. It is these difficult periods which allow patient investors to compound their wealth over the long term with portfolios of good businesses acquired at bargain prices.

One investment that we bought into last year is Star Gas Partners LP (SGU). Star Gas has experienced a total return (capital appreciation plus dividends) of 43.66% in the first 9 months of the year which makes it the best-performing US oil & gas midstream stock for 2015. In this letter, I will explain our investment thesis in the company and why Star Gas is performing well in this challenging environment.

Summary of Investment Thesis in Star Gas

Star Gas is the largest residential heating oil distributor in the US. The company grows mainly through acquisitions, and the current management has been doing a good job of allocating capital in a disciplined manner. The business is trading at a cheap valuation relative to other energy distributors. Due to noncash amortization charges, Star Gas has generated more free cash flow than net income over the past 7 years.

Overview of Star Gas's business

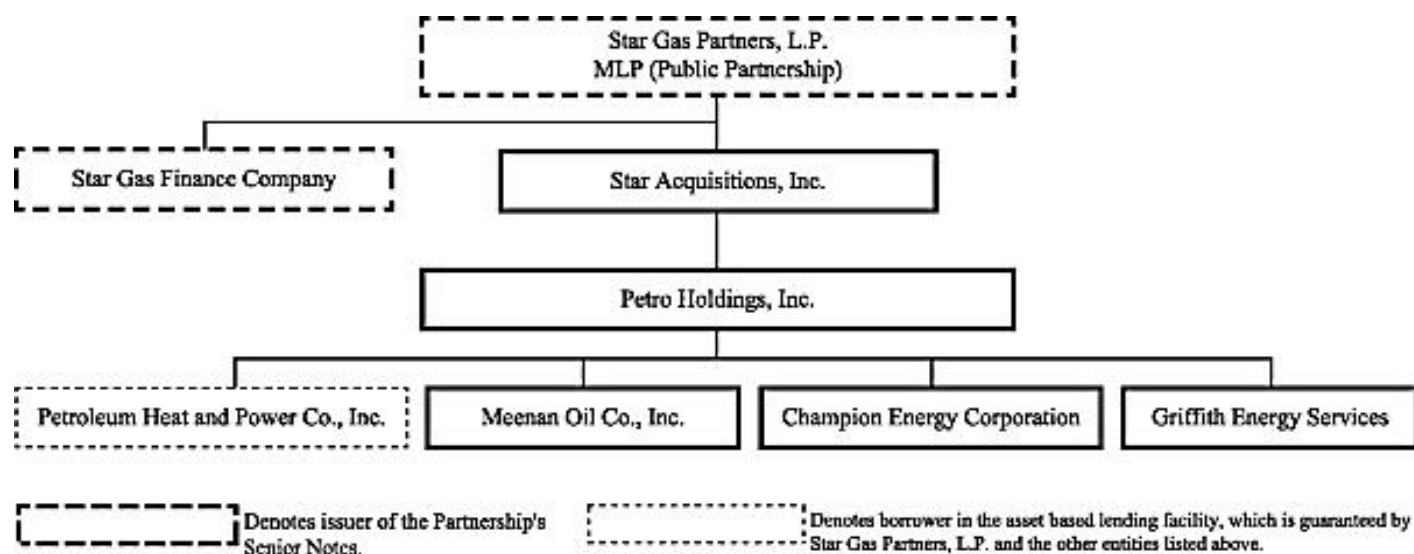
Star Gas is a distributor of heating oil (and to a lesser extent propane) to residential and commercial customers in the northeastern United States. This is a seasonal business as customers only need heating oil during the winter. In the past most of these contracts with residential customers are fixed price contracts negotiated prior to the heating season, but the company has been trying to move customers to floating rate plans. The exposure of the company to the liability of providing heating oil at a fixed price is hedged by purchasing call options on heating oil on commodity markets. Since the company cannot know with perfect accuracy how much heating oil customers will require, it is not able to perfectly hedge their commodity exposure. At the same time, over-hedging their commodity exposure can add an unnecessary expense and reduce the operating margins of the company.

This business model makes the company one of the few oil & gas midstream companies whose fortunes are inversely related to the price of oil (albeit with the small risk that falling oil prices may upset their fixed-price customers). As oil prices decrease, the incentive for

customers to pay the switching costs from heating oil furnaces to natural gas powered ones is decreased. For this reason, a rational observer would have expected the value of Star Gas units to increase during the global oil price collapse in the second half of 2014. Instead, Star Gas was flat for the second half of 2014. It seems possible that some naïve investors were selling or shorting Star Gas along with the rest of energy MLPs without considering the fundamentals of the business.

Unusual Corporate Structure

Star Gas, like many oil and gas midstream companies, uses a master limited partnership (MLP) structure. In order to use an MLP structure in the United States, an entity must derive over 90% of its income from real estate, natural resources and commodities. In this structure, all available cash must be distributed with the allowance that a reserve can be made for operations, capital expenditures, and the next four quarters of distributions. Shares of an MLP are called units, and shareholders are called unitholders. The MLP is not taxed on the income it produces and unitholders pay taxes on distributions which avoids the double taxation issues usually associated with corporations. In the case of Star Gas, the MLP sits above a taxable C-corporation (Star Acquisitions) which must pay state and federal income taxes. This convolutes the tax situation since the unitholders still pay taxes on the dividends paid by the C-corporation to the parent MLP. This excess tax is offset by a negative return of capital which adjusts the cost basis of the units up if the cash distribution to the unitholders is less than the amount paid to the parent (which happens if the parent retires debt or buys back units). This corporate structure results in an unnecessary headache for unitholders and the usual tax advantages of having an MLP structure are lost. Management has said that they are considering doing away with the MLP structure and moving to a more typical C-corporation structure in the future. This corporate structure issue may be depressing the price of the company, and eliminating it could be a catalyst to an increased valuation.



Overview of corporate structure

Source: Star Gas Partners 2014 10-K filing

History of Management

In its recent past, Star Gas had a history of mismanagement culminating in a famous February 2005 open letter from Dan Loeb of Third Point LLC harshly criticizing the mismanagement of the company and a -91.9% loss (total return) to unitholders in the two year period of 2004-2005. This loss was largely due to a large number of nonhedged fixed contracts for heating oil delivery written by Star Gas during a period of rising heating oil prices. In 2005, new management took over the company as Kestrel Heat LLC replaced Star Gas LLC as the general partner of the partnership. Kestrel Heat LLC is a wholly-owned subsidiary of Kestrel Energy Partners LLC which is a private equity investment firm formed by Yorktown Energy Partners VI, L.P., Paul A. Vermylen, Jr. and other investors. Yorktown Energy Partners VI, L.P. is a New York-based private equity investment partnership which makes investments in companies engaged in the energy industry. The general partner under the current agreement receives 10% on any distributed cash over \$.0675 (per quarter) up to \$.1125 (per quarter) and 20% above \$.1125.

This new management has proven far more adept at capital allocation and commodity hedging. Revenue has grown from \$16.72/unit in FY2007 (the first full year with the new management) to \$34.13/unit in FY2014; an annualized increase of 10.7%/year. Capital has been returned to investors during this period through unit buybacks and cash distributions.

Growth through acquisitions

While Star Gas is a small cap stock with a market capitalization at quarter end of \$486 million, it is still the largest distributor in the highly fragmented US retail heating oil distribution industry. This provides an attractive runway for the company's management to grow using a rollup strategy of their smaller competitors. The company's new management has taken advantage of this with their recent acquisitions at attractive valuations of several companies. This recently includes Griffith Energy on March 2014 at 5.1 times EBIDTA plus working capital (\$97.7 million). Griffith in 2013 sold 78.4 million gallons of petroleum products to 50,000 customers in the mid-Atlantic region.

Pricing Power

Compared to most of the investments in our portfolio, Star Gas does not operate in an industry with great pricing power. Switching costs are not terribly high for customers to go from one distributor to another. Star Gas has relied upon superior maintenance and customer service in order to command a premium price. After the damage from Hurricane Sandy, the company was able to repair damages and make service calls with better responsiveness than most of their competitors which earned them goodwill from customers and may allow them an ability to charge premium prices and still gain market share.

As the largest player in their industry, Star Gas has scale that their competitors lack. This allows them to have increased efficiency from hedging and service operations. These efficiencies are further reinforced and realized in the accretive acquisitions that the company makes.

Net income weighed down by amortization

Star Gas has grown their business through strategic acquisition at attractive valuations. They have then allocated a large amount of the purchase price to acquisition-related intangibles which are amortized on a straight-line basis over seven to twenty years. For the Griffith acquisition, the majority of the purchase price was allocated to these intangibles.¹

The effect of this greatly reduces reported net income and reduces the tax obligations of the company. As a result, the free cash flow that the company has been generating over the past 7 years has been approximately 142% of the earnings of the company. The accumulated amortizable intangibles of the company will provide a tax shield to earnings for years to come.

Valuation

The most attractive thing about investing in Star Gas is the valuation. It is difficult to estimate a fair value for Star Gas for three reasons. The first reason is that there are no other public heating oil distributors in order to do a valuation comparison. We can make an imperfect comparison by looking at the valuation of Star Gas against public propane and natural gas distributors. Heating is moving more towards natural gas, so it makes sense that these companies may trade at a slightly higher valuation due to their future growth opportunities. Secondly, one must also take into consideration that Star Gas is likely trading at a slight discount due to its corporate structure. Thirdly, due to the varying amounts of financial leverage employed by these companies, we should use enterprise value (EV) instead of market capitalization. Enterprise value is calculated as the market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents. One way of thinking about enterprise value is that it is the amount of money you would have to pay to acquire the entire business. The aforementioned intangibles amortization issue means that looking at net income may not be as informative as looking at earnings before interest, taxes, depreciation, and amortization (EBITDA).

EV/EBITDA of Star Gas and Nine Selected Propane and Natural Gas Distributors

	SGU	GAS	CPK	DPM	FGP	NGL	SPH	NGLS	UGI	APU
EV/EBITDA	3.49	9.21	9.56	8.85	17.17	14.84	9.84	10.35	8.71	10.77

As of 9/30/2015

The justifiable valuation for Star Gas is broadly open to interpretation considering these issues. However, if Star Gas were to trade at the same average EV/EBITDA as these companies (11.03) while holding all else constant, that would translate to a price of \$26.92/share for SGU. Star Gas closed at \$8.49 at the end of September, so there is still potential upside from the current price despite the recent increase.

¹ - Star Gas Partners, L.P. 2014 10-K Filing, page 10

Risks

Obsolescence: The home heating oil distribution industry is shrinking due to consumers switching to natural gas heating and few newly constructed homes using heating oil as their source of heat. So far, this customer attrition has been dealt with by gaining customers from competitors and making acquisitions.

Heating Oil Prices: An increase in the price of heating oil would reduce the amount of oil consumed by customers. It would also make customers perceive switching to natural gas as a more attractive alternative increasing customer attrition.

Hedging: If the company poorly hedges their commodity exposure, there could be a significant loss from fixed contracts. I believe that the current management has been diligent in this regard to prevent another disaster like 2004-2005.

I hope this letter has communicated the diligence we take with our investors' capital when investigating opportunities. Please contact us if you have any questions.

Sincerely,

Andrew Oskoui, CFA
Portfolio Manager

Disclaimer: This commentary does not represent a recommendation to trade any particular security, but is intended to illustrate Blue Tower's investment approach. These opinions are current as of the date of this commentary but are subject to change. The information contained herein has been obtained from sources believed to be reliable but the accuracy of the information cannot be guaranteed. Past performance is no guarantee of future results.