PJSC LUKOIL

1Q 2018 Financial Results Conference Call and Webcast Transcript

May 29, 2018

Speakers:

Alexander Matytsyn, CFO

Pavel Zhdanov, Head of Capital Markets and M&A

Alexander Palivoda, Head of IR

Alexander Palivoda

Slide 2. Forward Looking Statements

Good afternoon ladies and gentlemen and it's our pleasure to welcome you today on LUKOIL's first quarter 2018 financial results conference call and web-cast. Thank you for joining us. On today's call we have our Chief Financial Officer, Mr. Alexander Matytsyn; VP for Economics and Planning, Mr. Gennady Fedotov; Head of Capital Markets and M&A, Mr. Pavel Zhdanov; as well as our colleagues from the Accounting Team.

Mr. Matytsyn will start today's call with a general overview of the results followed by a more detailed discussion by Pavel Zhdanov and myself. We will then have a Q&A session.

I have to draw your attention to our cautionary statement. Some of our comments during this call constitute "forward looking statements" that involve risks, uncertainties and other factors which may cause our actual results to be materially different from what's expressed or implied by such forward looking statements.

Now, I would like to hand over to our Chief Financial Officer, Mr. Alexander Matytsyn.

Alexander Matytsyn

Slide 3. Operational results

Thank you, Alexander, and good afternoon ladies and gentlemen.

The first quarter was not only a great start of the year but also marked the beginning of diligent delivery on our new long-term strategy. Across most of the business lines we were either in line or ahead of our plans, which resulted in another strong set of quarterly numbers.

Despite external limitations of our liquids output in Russia, our daily hydrocarbon production increased by more than 3% year-on-year, which is almost double our production growth guidance for the year. This was achieved through faster gas production ramp-up in Uzbekistan. And even more important was the continued structural change of our production towards larger share of high-margin barrels.

In the downstream we efficiently optimized maintenance works at our refineries in anticipation of higher margins, while keeping the light product yield at above 70%. We also posted strong results in our premium marketing businesses.

Slide 4. Financial results

Our good operational indicators supported our financial results. We achieved 6% higher EBITDA year-on-year driven by strong performance of the upstream business on the back of higher oil prices, enhanced production mix and higher volumes. Our downstream business was weaker primarily because of lower benchmark refining margins in the first quarter of this year. Such balanced performance confirms the fundamental strength of our vertically-integrated business model, which enables us to generate strong results in practically any environment.

Quarter-on-quarter, our EBITDA was slightly higher in dollar terms, but a bit lower in rubles, which resulted from ruble appreciation. At the same time, we generated the same substantial amount of operating cash flow before changes in working capital. A material support to the first quarter results was from stringent cost control.

Slide 5. Growing free cash flow

We reduced our capital expenditures both year-on-year and quarter-on-quarter by investing less in the international upstream. As a result, another quarterly record was set for free cash flow generation before changes in working capital. It was more than 90 billion rubles, or 1.6 billion dollars.

I'd like to emphasize that such an outstanding performance is not only based on the positive macro trends, but predominantly on our strong business fundamentals, structural improvements, high cost discipline and very well balanced investment program.

Slide 6. Progressive dividend policy

Our strong results and positive outlook enable us to outperform on the minimum targets set in our progressive dividend policy. The most recent dividend recommendation by the Board of Directors represents four times faster dividend growth compared to the inflation rate.

Slide 7. Balanced distribution of additional cash flows to shareholders

We clearly explained our capital distribution policy at our Investor Day in March and we are moving ahead with preparing necessary corporate approvals for the share buyback program. We expect this incremental capital distribution mechanism to become fully operational already in the second half of this year.

With that I'd like to pass the word to Pavel, who will elaborate on the upstream results.

Pavel Zhdanov

Thank you Alexander, and good afternoon ladies and gentlemen.

Slide 9. Key operating results (upstream)

Our total daily hydrocarbon production excluding West Qurna-2 project increased by 3.3% year-on-year or more than 70,000 barrels of incremental daily output, largely driven by major progress at our gas projects in Uzbekistan.

Our liquids production in Russia remains flat since May 2017 because of the OPEC+ agreement. As we continue ramping-up our high-margin fields, we balance this growth by running our mature fields at lower rates. And I would like to reiterate our plans to decelerate production decline at our mature fields in the mid-term.

The share of high-margin barrels in our overall production mix reached 24% in the first quarter of 2018 as compared to 19% a year ago. So, we are well on track to reach 30% target by 2020.

We continue working on enhancing upstream technologies and efficiencies. Among the most noticeable developments were two horizontal wells of simplified design in West Siberia. The wells were 40% faster to drill and more than 20% cheaper than our average West Siberian horizontal well. We won't be able to completely switch to simplified horizontal well designs due to the geological factors, but we think they might become an efficient solution on a relatively wide scale. This is a good illustration of our tailored approach to the development of our mature fields in West Siberia which is the cornerstone of our new strategy.

Slide 10. Price and tax environment (upstream)

With 25% higher Urals price and only 3% stronger ruble the macroeconomic environment was quite supportive for the year-on-year dynamics of our financial results in the upstream. However, despite record high average crude oil prices in ruble terms in the first quarter of 2018 the quarter-on-quarter environment was less beneficial because of the lower positive export duty lag effect that resulted in lower net oil price in ruble terms.

Slide 11. Upstream EBITDA

As a result of better price environment, higher production volumes and better production mix, our EBITDA in the upstream was almost 35% higher year-on year. Most of the growth in absolute terms was from our operations in Russia. However, international upstream posted a much faster EBITDA growth of more than 70% year-on-year as it is generally more sensitive to oil price and also rapidly growing in terms of physical volumes of production.

The quarter-on-quarter dynamics was mixed as the Russian upstream was negatively impacted by lower net oil price. But still we were able to maintain our quarterly upstream EBITDA close to the record high level of the prior quarter thanks to the strong performance of the international part of the business.

Slide 12. Filanovsky field

Moving now to a more detailed discussion on our core projects.

In the first quarter of 2018 at our flagship Filanovsky field in the Caspian Sea we launched two wells from the field's second platform - one production well and one injector. We are currently finalizing another production well, which will allow us to ramp-up and stabilize production at the plateau.

We continue working on the field's third development stage, which is required to fully drill the reservoir. The substructure of the wellhead platform is close to completion at the yard, while the topside is 50% complete.

As for the second phase of the Korchagin field, we've installed the platform's topside and started drilling first well in May. Daily production at the field should start growing post completion of the well.

Slide 13. Hard-to-recover: heavy crude oil

Our heavy crude oil production increased by 45% year-on-year. Such an impressive growth was achieved thanks to the rapid development and use of advanced technologies at Yaregskoe and Usinskoye fields. A total of 45 wells were drilled at the fields in the first quarter. New steam generation facilities were launched at Yaregskoye field and we are currently finalizing construction of new facilities at Usinskoe field, which should trigger further production growth at this project.

To remind you, the production potential of these two fields is almost double the current daily production rate.

Slide 14. Hard-to-recover: low permeability

Our plans are even more ambitious for the production growth at our low permeability reservoirs, where doubling production is scheduled by 2020.

At the Imilorskoye field, where we recently moved to the commercial development stage, 16 production wells were launched as another step in production growth from the current 13 thousand barrels per day to the plateau level of approximately 50 thousand barrels per day.

The development of the Vinogradov field in the pilot mode goes as planned. Once moved to the commercial development stage, the field can add more than 30 thousand barrels per day to our overall production.

Slide 15. Gas projects in Uzbekistan

We are extremely pleased with the performance of our projects in Uzbekistan. Our gas production in this country doubled year-on-year as we launched new treatment facilities at the Gissar project and the first train of the Kandym gas processing complex. It was launched 6 months ahead of the original schedule enabling us to outperform our production ramp-up plans.

In the first quarter we were finalizing construction works at the second train of the complex and launched it in early April. This is eight months ahead of schedule and represents a great achievement for a project of such complexity and scale. The annual capacity of the complex is eight billion cubic meters of gas. It treats crude gas from the Kandym fields cluster to marketable gas, gas condensate and sulfur. With the launch of the second train of the complex we are now well on track to ramp-up production at Kandym to its plateau level in the third quarter of this year.

Few words on Iraq. We finalized negotiations on the next phases of the project. We will now be growing production from the current 400,000 barrels to the new plateau of 800,000 barrels by 2025. This expansion will be financed from the current production and we don’t expect our financial exposure to deviate materially from current level of approximately 0.5 billion dollars.

With that, I’ll pass the word to Alexander Palivoda.

<u>Alexander Palivoda</u>

Thank you, Pavel! I'll continue with our Downstream operations.

Slide 17. Price environment (downstream)

Benchmark European refining margins were lower both quarter-on-quarter and year-on-year. The dynamics of the margins within the first quarter was however positive as they were slowly recovering from the lows of January 2018 on the back of stronger demand for motor fuels and mid-distillates due to the cold winter.

The benchmark refining margin for the European part of Russia followed the trend of the international benchmarks. Among the additional negative drivers were higher excise tax rates and domestic prices lagging the international netbacks. On the positive side was higher export duty spread on crude oil and products driven by the higher export duty on crude oil.

Slide 18. Key operating results (downstream)

Amid relatively weak margins we decided to optimize schedules for maintenance works at our refineries to benefit most when margins get higher. We did quite a lot in the first quarter – five out of our eight refineries reduced throughputs due to maintenance. As a result, overall average daily throughput volumes were 5% lower quarter-on-quarter and 1% lower year-on-year.

We managed however to implement maintenance operations without material impact on the product slate. Light product yield at our Russian refineries even increased quarter-on-quarter to 71%, which is 6 p.p. higher year-on-year. The growth was achieved through more efficient utilization of hydrocracking unit at our Volgograd refinery and smooth operations of the delayed coking facility in Perm.

We also continued to proactively manage cross-supply volumes of semi-finished products in between our refineries to achieve better product slate and higher margins. Such cross-supplies increased by 24% quarter-on-quarter.

Slide 19. Premium Sales Channels

Now on marketing.

We delivered 2% year-on-year growth in retail sales volumes of our motor fuels on the back of stronger demand for our premium-quality diesel, which was to some extent underpinned by the cold weather in March. Our marketing efforts enabled us to continue delivering double-digit growth in high-tech ECTO branded motor fuel sales volume.

We achieved rapid growth in profits from non-fuel goods and services which increased year-on-year by 25% in Russia and 19% internationally. This is a great progress in our strategy aimed at increasing the coverage of operating expenses of our retail network by profits from non-fuel sales.

To reduce our cost base in the retail business in Russia we started optimizing the management structure with an idea to reduce the number of entities and achieve a more centralized control over the network. The efficiency of this initiative is backed by the available IT solutions.

We also grew sales volumes through other premium channels like aircraft refueling, ships bunkering and lubricants.

Slide 20. Efficient allocation of Russian oil

Our integrated margin from processing crude oil at the refineries in Russia and distributing the products through our marketing channels enhanced in the first quarter. This was driven by better performance of our marketing business amid lower refining margins. Such result is another illustration of the benefits of our vertically-integrated business model.

Slide 21. Downstream EBITDA

Our downstream business generated 47 billion rubles of EBITDA in the first quarter of 2018, which is just slightly lower quarter-on-quarter, but substantially lower year-on-year.

Our operations in Russia yielded EBITDA growth both quarter-on-quarter and year-on-year despite weaker benchmark refining margins. The growth was driven by better refinery product slate, better results of our marketing and petchem businesses. The quarter-on-quarter dynamics was also backed by seasonal EBITDA growth in the power generation.

In the European downstream, first quarter results were substantially weaker both quarter-on-quarter and year-on-year. This was driven by weak performance of our European refineries due to lower benchmark margins, as well as maintenance works and lower throughput volumes. Another negative factor was weaker performance of our trading business. The year-on-year dynamics was aggravated by one-off positive gains in the first quarter of 2017 driven by accounting specifics of our international trading operations.

Slide 22. Finance

Now briefly on our financial results.

First of all, I would like to draw your attention to the fact that we continue improving information disclosure and transparency of our statements. In particular, this reporting quarter we started to disclose the realized gas prices and volumes and introduced quarter-on-quarter analysis in the MD&A which we hope you will find useful.

So, I'll not spend a lot of your time now as many details are disclosed in the MD&A.

Slide 23. Revenue

The quarter-on-quarter decline in our revenue was volume driven. We reduced crude oil trading volumes, accumulated more than 1 million tonnes of crude oil in inventory. We also reduced sales of petroleum products by 0.7 million tonnes due to lower refinery throughput volumes. There was some rebalancing between domestic and international sales of petroleum products which was primarily driven by seasonality factor.

Slide 24. Operating expenses

We continue executing stringent control over our cost base. Our lifting costs in Russia remained flat year-on-year. This is a great starting point for delivering on our mid-term cost optimization targets.

Our lifting costs outside Russia declined quarter-on-quarter due to rapid gas production growth in Uzbekistan and seasonally high expenses in Kazakhstan in the fourth quarter of 2017.

In the refining business our per unit operating expenses declined substantially quarter-on-quarter in Russia as we did expensive maintenance works in the fourth quarter of last year. On the contrary, in Europe expenses increased due to maintenance in the first quarter.

Our refining expenses at third-party refineries halved quarter-on-quarter due to lower refining margins in North America, as what we pay as processing fee in Canada is directly linked to the refining margin.

Slide 25. EBITDA

Among other important factors which materially impacted the quarter-on-quarter EBITDA dynamics were lower SG&A driven by cost reduction in a number of areas including advertising and maintenance of nonproduction infrastructure, such as the office buildings.

Slide 26. Profit

One of the main factors affecting quarter-on-quarter profit dynamics was the increase in DD&A by 11 billion rubles driven by the start of depreciation accruals for the second stage of the Filanovsky field and gas treatment facilities in Uzbekistan, as well as DD&A adjustments in the fourth quarter of 2017 based on the new reserves audit report.

Another material factor was foreign exchange effect. I'd like to emphasize that post completion of intragroup capital structure optimization in the fourth quarter of last year our net monetary position in foreign currency more than halved, which is a very positive change for our financial statements as it substantially reduces the magnitude of the foreign exchange effect on our profits.

Another factor behind profit dynamics was net impairment loss in the fourth quarter which we didn't have in the first quarter.

Slide 27. Capital expenditures

We reduced our capital expenditures by 12% quarter-on-quarter and invested 121 billion rubles. Distribution of these investments was in line with our long-term strategy, as we spent the majority of capex in the Russian upstream.

Lower international upstream capex represents a natural decline post completion of key construction works at our projects in Uzbekistan. Lower capex in the Caspian Sea region is a seasonal change which you should not treat as a new sustainable level. We continue building up infrastructure in the region and in 2018 plan to spend approximately 50 billion rubles on our Caspian Sea projects.

Lower capex in the Russian downstream is primarily driven by seasonality in the retail business.

Slide 28. Cash flows

Lower quarter-on-quarter capex at flat operating cash flow before changes in working capital enabled us to further increase our adjusted free cash flow to a new record high level of 92 billion rubles.

This adjusted free cash flow volume was mostly spent on 61 bln RUB of interim dividends for 2017, approximately 20 billion rubles of payment effected under the long-term incentives plan for 2012-2017, as well as building up some incremental working capital in our core businesses on the back of higher oil prices and accumulation of inventory.

Slide 29. Financial position

Our balance sheet remains very strong with relatively flat quarter-on-quarter net debt position. In April we redeemed $1.5 billion of Eurobonds at maturity.

I would like to stop here and pass the word back to Pavel.

Pavel Zhdanov

Slide 30. Outlook

Thank you, Alexander.

Before opening the line for questions, I would like to reiterate our 2018 outlook.

We expect our hydrocarbon production to grow in the range of 1 to 2% driven by gas. We can slightly outperform this guidance depending on the production ramp-up pace in Uzbekistan.

In the refining business, we expect to maintain the performance at the 2017 level.

Our planned Capex for this year excluding service contracts is about $ 8 billion or 500 billion rubles.

We sincerely believe that LUKOIL is a unique investment story combining the best features of both Russian and international oil and gas companies. We have assets of outstanding quality, a massive resource base, a strong balance sheet and a very flexible strategy. We are focused on sustainable delivery of shareholder value. We believe our new strategy and capital distribution policy will inevitably result in re-rating of our stock.

Thank you for your attention!