PJSC LUKOIL

1Q 2019 Results Conference Call and Webcast Transcript

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Speakers:

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Alexander Palivoda

1. Title slide

Good afternoon, ladies and gentlemen. Thank you for joining us today on LUKOIL's first quarter of 2019 results conference call. On today's call, we have Mr. Alexander Matytsyn, First Vice President, CFO, Mr. Pavel Zhdanov, Vice President for Corporate Development and Investor Relations, Mr. Gennady Fedotov, Vice President for Economics and Planning, Mr. Viacheslav Verkhov, Chief Accountant, as well as our colleagues from the Accounting Team. In addition, as you already know, Alexander Kornilov joined our IR team in April. We are confident that his many years of experience as an investment analyst will help us further improve the quality of the IR service.

2. Forward looking statements

Before we start with presentation I have to draw your attention to the fact that 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.

More details you can find on the slide.

I would like to hand over to Mr. Alexander Matytsyn.

Alexander Matytsyn

3. Operating Results

Thank you, Alexander! Good afternoon, ladies and gentlemen!

The first quarter, with its strong operating and financial results, was an excellent start to the second year of our long-term strategy. LUKOIL's vertically integrated business model once again allowed smoothing out the volatility of the market environment and continuing to generate a sustainably high free cash flow.

Compared to the first quarter of 2018, our production increased by a record 4%, despite external restrictions. The production structure continued to improve. The share of high margin barrels rose to 31%. I want to note that in this indicator we are going ahead of our plans due to the success in the development of priority projects and the introduction of the tax on additional income.

Our refining throughput grew by more than 3%. Product slate continued to improve. The light products yield increased, the fuel oil production volume decreased by 19%. We continue to show a double-digit growth rate for most premium sales channels.

4. Macro environment

High price volatility persists in the oil market. In the first quarter oil price was growing, but was on average lower quarter-on-quarter and year-on-year. The refining margin decreased with significant decline in Russia due to, among other factors, the entry into force of a number of tax changes. Among the positive market environment factors are ruble depreciation year-on-year, as well as the export duty lag effect and the inventory effect as a result of higher oil prices during the quarter.

5. Financial results

Despite challenging market environment, EBITDA in the first quarter of 2019 amounted to RUB 298 billion, a 7% increase quarter-on-quarter and 36% increase year-on-year, also supported by strong operating results and our efforts to reduce expenses.

I am pleased to note that we are showing excellent results in increasing efficiency and controlled expenses dynamics. Our drilling costs per meter, per barrel lifting costs and per ton refining expenses decreased quarter-on-quarter. This is primarily the result of the implementation of targeted efficiency programs, which we described in detail at the previous call. The beginning of the IFRS 16 standard application also contributed to costs reduction. We will talk about the impact of this standard on our statements in more detail in the financial section of the presentation.

Our free cash flow before changes in working capital amounted to RUB 183 billion, or USD 2.8 billion in the reporting quarter. This is a 30% increase quarter-on-quarter and almost double increase year-on-year.

6. Leadership in efficiency

In terms of free cash flow per barrel of production for the quarter we surpassed not only Russian, but almost all international peers. LUKOIL also maintains its leadership among Russian companies in terms of EBITDA per barrel of production. We achieved this result due to the focus on production structure, a highly developed oil refining segment, access to premium marketing and sales channels, as well as continuous work on improving efficiency and cost optimization and high capital allocation discipline.

7. Growing distributions to shareholders

We are fulfilling and even exceeding our promises in the distributions to shareholders policy.

The gradual improvement in the fundamental quality of our business allows us to increase dividends at an accelerated pace, while being confident in our ability to deliver progressive dividend policy in the future under the conservative oil price scenario. In April, the Board of directors recommended to increase the dividend per share for 2018 by 16%. The recommended dividend growth is four times ahead of inflation.

In terms of share buyback, the program announced last year has already been executed by more than 90%. Compared to the original plans, we are moving at an accelerated pace, based on the actual additional free cash flow.

We also keep our promises to cancel purchased shares. The issue on reducing the Charter Capital of PJSC "LUKOIL" through acquisition of 35 million shares under public tender, in which all shareholders can participate, was submitted for the Shareholders meeting.

On the one hand, this procedure comes from the features of the Russian legislation. On the other hand, it seamlessly fits our policy of return of capital, as it provides us with an additional opportunity to purchase shares from the market and distribute additional capital to shareholders. From this point of view, a public tender for us is equivalent to the buyback program.

Taking into account that all shareholders have the right to participate in the tender, the amount of funds for the shares purchase from the market within the public tender may be significant. Therefore, we plan to determine the terms of the next buyback program and submit it for the Management Committee review after summing up the public tender in August 2019.

In conclusion, I want to once again emphasize our commitment to all previously stated strategic goals and policies, both in operating performance and capital allocation areas.

Thank you, now I would like to hand over to Pavel Zhdanov.

Pavel Zhdanov

8. Upstream

Thank you, Alexander. Good day, ladies and gentlemen! I will present you the results in the Upstream segment.

9. Price and tax environment

Despite the decline in international oil prices, the Urals net price, in ruble terms, increased by 11% quarter-on-quarter and by 18% year-on-year due to the positive export duty lag effect in the first quarter of 2019 and weaker ruble year-on-year. Such market environment was favorable for the financial results of the segment.

10. Key operating results

Average hydrocarbon production excluding the West Qurna-2 project reached 2.4 million barrels per day, which is 4.1% higher year-on-year and 0.3% higher quarter-on-quarter. The increase was mainly driven by gas production increase in our international projects.

The year-on-year production was record-high for the last 10 years and we achieved it despite oil production decline in Russia during the first quarter due to the OPEC+ external limitations. That is, in the absence of external limitations, the growth rate could be even higher.

We, as before, reduced production at the expense of mature fields, while continuing to increase production in high-margin projects.

As a result, new projects and hard-to-recover reserves production increased by 24 and 15% respectively year-on-year and the share of high-margin barrels reached 31%. This is 3 percentage points higher quarter-on-quarter and 7 percentage points higher year-on-year.

Implementation of tax on additional income or TAI also contributed to growing share of high-margin barrels.

I would like to remind that according to our strategy, we planned to achieve 30% by 2020. And in the first quarter we, in fact, already exceeded this level.

11. Upstream EBITDA

Upstream EBITDA increased by 37% year-on-year and 24% quarter-on-quarter and amounted to RUB 235 billion. In absolute terms, our projects in Russia were the main contributors to the EBITDA growth.

The growth was supported by an increase in net oil prices in ruble terms, an increase in production volumes and an improvement in its structure, as well as lower lifting costs.

At the previous call, we announced updated targets for the dynamics of controlled expenses. To achieve these goals, a program to enhance efficiency and reduce costs on our production assets in Russia is being implemented. At the corporate center level, a project office with branches in all Russian subsidiaries has been established. It organizes a continuous analyzing, developing and implementing initiatives aimed at reducing unit OPEX and CAPEX costs.

The first results were already visible in 2018, when lifting costs per boe decreased by 2% as compared to 2017. In the first quarter this trend continued. Lifting costs per boe of production in Russia in ruble terms decreased by 5% compared to the average 2018 level and by 6% quarter-on-quarter. One of the factors was the application of IFRS 16 standard, the effect of which was around half of this reduction. The second half is the result of our work to enhance efficiency.

The adoption of the tax on additional income at a number of license blocks also had a positive effect on the Upstream financial results.

12. Tax on additional income (TAI)

The list of pilot TAI projects currently includes 29 of our license blocks in groups 1, 3 and 4. Average daily production at these license blocks amounts to 93 thousand barrels or 5.4% of our total liquid hydrocarbon production in Russia.

The 3rd group plays a key role for us. These are mature fields in West Siberia. In the first quarter of 2019, the production at the fields of the third group was 56 thousand barrels of oil per day; and we plan to significantly increase production in the next 5 years which will require more than RUB 60 billion of additional investments. We plan to increase the drilling volumes at these license blocks by almost 30% already in 2019.

In addition to mature fields, we transferred 21 license blocks with greenfields located in Timan-Pechora and West Siberia to the TAI regime. We also transferred our large Pyakyakhinskoye field to the TAI regime.

According to our estimates, in the first quarter of 2019 the total effect on the Company's EBITDA from the transition to the TAI regime was about RUB 4 billion.

I would like to turn now to individual regions and projects.

13. West Siberia

In West Siberia we achieved significant improvement in production dynamics even under external limitations. Production in the region decreased only by 0.3% year-on-year, while the decrease at mature fields of the region was 1.3%.

The improvement in dynamics was achieved amid lower production drilling volumes and lower number of well stimulations; which indicates an increase in technological efficiency.

Financial efficiency is also increasing. In particular, the cost of production drilling per meter for directional wells and horizontal wells with a three-string design decreased by 3 and 12% respectively quarter-on-quarter.

Implementation of cost-cutting program, optimization of design solutions and achievements in improving drilling technologies allow for efficient acceleration of the pace at which current reserves are involved into production and involvement of additional reserves from our extensive resource base, which is the main source for achievement of priority strategic goal to improve the production profile at our mature fields.

14. Northern Caspian

As for marine projects:

In the North Caspian, we increased oil production by 19% compared to the first quarter of 2018 due to further development of the Filanovsky and Korchagin fields.

From the beginning of the year, two high-production wells were put into operation on the second production platform of the Filanovsky field, one of which is bilateral with a TAML-5 completion. Thus, we have successfully completed the main production drilling cycle in the framework of the second stage of field development. Now we are moving back to the first production platform for further drilling of the well stock in accordance with the project.

Within the third stage of the field development, preparations are being completed for the sea transportation of the upper structure of the wellhead platform, which we will begin in June. Drilling on the third platform is scheduled to begin this year.

As a result of the implementation of the drilling program at the second stage of the Korchagin field, oil production at the field increased by 27% compared to the first quarter of 2018.

As part of the development of the Rakushechnoye field, shipyards are carrying out hull works on the upper structures and supporting foundations of the platform of the living quarters platform and the ice-resistant fixed platform. Construction readiness at the end of May on ice-resistant fixed platform is 12%, on the living quarters platform - 26%.

A few words about our Baltic projects. We recently launched commercial operation of the D41 field. The field is operated from the onshore site by two horizontal wells over 7.5 thousand meters long each. Such a solution allowed a multifold reduction of the cost of field development and significantly speeding up its commissioning. The current daily production at the field is about 700 barrels.

For project D33, we have successfully completed tender procedures for the selection of a contractor for the development of project documentation for the field development.

15. Hard-to-recover: heavy crude oil

Production growth at high-viscosity oil projects in Timan-Pechora was 16% compared to the first quarter of 2018, including production at the Yaregskoye field that increased by 28%.

To ensure further growth in production at the fields, work is underway to expand infrastructure and production facilities. So, at the Yaregskoye field by the end of the year we plan to put into operation the second line of the pipeline, as well as to increase the capacity for oil treatment to 3 million tons per year. It is planned to introduce additional steam generation facilities and reservoir pressure maintenance systems at the Usinskoye field.

16. Hard-to-recover: low permeability

We are continuing to develop low permeability deposits according to approved plans. The total increase in production at the Imilorskoye and the Vinogradov fields compared to the first quarter of 2018 was 36%.

In the first quarter of this year, 17 production and 6 injection wells were put into operation at the Imilorskoye field. Production growth was 44% year-on-year. 7 production wells were put into operation at the Vinogradov field. Production growth was 21%.

17. Gas projects in Uzbekistan

Gas production in Uzbekistan in the first quarter of 2019 rose to 3.8 billion cubic meters in LUKOIL’s share, which is 33% higher than in the first quarter of 2018. The growth was achieved due to the launch of the second line of the Kandym gas processing complex in April 2018. Since September 2018, gas production in Uzbekistan has been on the projected level. Due to the end of the main investment stage of projects development since the third quarter of 2018, the projects reached a positive free cash flow in total.

Further tasks that we set for ourselves are to maintain the reached projected production level, optimize maintenance investments, as well as work on the study of geophysical data in order to assess the prospects for oil and gas potential of new investment blocks.

In conclusion, a few words about our projects in Iraq.

At the West Qurna-2 project the implementation of the second stage of the development of the field began to double the production volumes on the five years horizon. Capital expenditures will gradually increase, but their financing will come from current production without diverting additional capital from our side. From the statistics you can see a decrease in total production at the field in the first quarter of 2019. This is a temporary phenomenon associated with the conduct of scheduled repairs on technological units.

On the Block-10 project, in the first quarter, tests of the fifth well were successfully completed as part of the implementation of the evaluation stage at the Eridu field. The well confirmed the current geological model of the field.

Now let me pass the floor to Alexander Palivoda.

Alexander Palivoda

18. Downstream

Thank you, Pavel. I will talk about the results of the oil refining segment.

19. Refining Profitability

The dynamics of the refining margin in the first quarter of 2019 was determined by a number of factors.

In Europe, the benchmark margin has fallen to a minimum since the beginning of 2018 amid a record-low crack spreads for gasoline. The situation began to improve only towards the end of the quarter. Crack spreads for diesel have also decreased. The margin was supported by the improvement of crack spreads for fuel oil.

Benchmark refining margin in Russia after a record high in the fourth quarter dropped sharply, due to both the dynamics of the European margin and domestic market factors, namely, the increase in netbacks for oil and the increase in excise taxes on petroleum products amid falling wholesale prices for petroleum products in the domestic market. Negative effect on refining margins also had a negative gasoline damper, which was associated with low crack spreads on this product in the international market. A positive factor was the diesel fuel damper.

20. Key operating indicators

The average daily refining throughput in the first quarter of 2019 remained almost unchanged compared to the previous quarter. At the same time, in Russia it grew by 2.6% due to the planned works at the refinery in Nizhny Novgorod in the fourth quarter of last year. At the European refineries, refining throughput fell by 4.1% due to adverse weather conditions in the Black Sea ports and repairs at the refinery in Burgas.

Compared to the first quarter of 2018, the refining throughput increased by 3.4%, due to scheduled repairs at the refinery in Burgas, as well as an increase in the utilization of the Nizhny Novgorod refinery.

We continued to improve the product slate. The light products yield increased by about one percentage point both compared to the first and fourth quarters of 2018. The growth rate was achieved mainly due to foreign plants. The dynamics of the indicator was positively affected by the repairs of plants in Bulgaria and Romania in the first quarter of 2018 and the optimization of the feedstock basket at ISAB and Zeeland factories in the first quarter of 2019.

The growth in the light petroleum products yield and the optimization of the raw materials basket of foreign refineries made it possible to reduce the output of fuel oil to less than 10% or by 3 pp. year-on-year, which is equivalent to a decrease in the total volume of fuel oil output by 370 thousand tons.

21. Priority sales channels

We continue to increase sales of petroleum products through premium sales channels. In the first quarter, we showed a double-digit increase in sales of bitumen, into-plane refueling, as well as ship bunkering. Sales of premium engine lubricants and gross revenue from non-fuel goods and services continued to grow. The decline in retail sales of motor fuels in Russia was due to the normalization of volumes after their significant growth in 2018 due to increased consumer demand for petroleum products of vertically integrated companies, as well as a decrease in the average refueling volume at the filling station check. The decline was offset by an improvement in the economics of the retail business, which reached a positive zone compared with negative values in the fourth quarter of 2018.

22. Efficient allocation of Russian oil

Due to the high quality of refining facilities and a high level of vertical integration through access to end-users via developed premium sales channels, our total integrated margin in the Russian downstream shows much lower volatility compared to benchmark refining margin. This is one of the main competitive advantages of our business model and our asset portfolio.

Despite a significant deterioration in market conditions for the refining sector, we showed an increase in the integrated margin compared to the first quarter of 2018 and a moderate decrease compared to the fourth quarter. The allocation of oil at our refineries in Russia remained the most effective distribution channel.

23. Downstream EBITDA

EBITDA dynamics looks even better than the dynamics of the integrated margin. This is due to positive effect of oil and refined products inventories in the first quarter of 2019, in contrast to the negative effect in the previous quarter. This effect significantly smoothed the volatile dynamics of the refining margin.

In addition, such factors as improving the product mix at the refineries, improving the results in the retail business, bunkering, power, petrochemistry, international trading, had a positive impact on the dynamics of EBITDA.

There was also a reduction in the operating costs of refining, which is mainly due to the reduction in the purchase of additives from third-party suppliers after the completion of maintenance works on catalytic cracking and alkylation units in Nizhny Novgorod.

The impact of the revaluation of the hedge contracts at the reporting date had a negative effect. The negative impact of this effect in the first quarter of 2019 exceeded 10 billion rubles, compared with a positive effect of approximately the same magnitude in the fourth quarter of 2018.

As a result, despite a significant deterioration in the macroeconomic environment for oil refining, the total downstream EBITDA amounted to 80 billion rubles, almost unchanged quarter-on-quarter and increasing by 71% year-on-year.

24. Selective projects at Russian refineries

We continue to implement selective projects at our refineries, which will further improve the product mix structure and develop the bitumen business.

As for the delayed coker in Nizhny Novgorod, work is underway on the construction of reinforced concrete foundations, installation of steel structures and the pipelines laying. The completion rate for this project is 35%.

As for the isomerization unit, works on the reinforced concrete foundations are being carried out at the same plant. The project completion rate is 15%.

As for the project of modernization of bitumen production, project documentation has been developed to date and optimization of technical solutions has been carried out. Getting ready to start work.

At the Volgograd refinery, we are building a deasphaltizing complex. We carried out the construction of foundations and reinforced concrete structures, the installation of pipelines and metal structures, the installation of underground networks. The completion rate for this project is 15%.

25. Finance

Now I go to the financial section of our presentation.

26. IFRS 16 impact in 1Q19

I will begin with the innovation that has had a significant impact on many of the items of our reporting. From the beginning of this year, we began to apply the IFRS 16 standard, which essentially transforms operating leases, as well as a number of service contracts into financial leasing.

As a result of the application of the new standard, we have placed additional PP&E and additional debt on the balance sheet. Our net debt grew as a result by 150 billion rubles, to 197 billion rubles at the end of the quarter.

The transfer of operating lease expenses to depreciation and interest expenses led to a decrease in operating, transportation and administrative expenses, which added about 9 billion rubles to EBITDA in the first quarter.

The increase in PP&E on the balance sheet led to an increase in depreciation by 8 billion rubles, and an increase in debt increased interest expenses by 2 billion rubles.

The foreign currency component of the additional debt led to an additional effect of exchange differences in the amount of 5.5 billion rubles. As a result, the effect on net profit amounted to plus 4 billion rubles.

The new IFRS standard has also influenced the structure of our cash flow statement. Operating cash flow increased by 9 billion rubles as a result of the transfer of operating lease expenses to debt service costs. The effect on capital expenditures amounted to 3 billion rubles. As a result, the positive effect on free cash flow amounted to 12 billion rubles.

27. Revenue

Quarter-to-quarter revenue dynamics were equally affected by a decrease in hydrocarbon prices and a decrease in sales volumes as a result of a decrease in oil trading volumes.

28. OPEX

Once again, I'd like to note the excellent dynamics of operating expenses in upstream and downstream, which have significantly decreased in per unit terms, as a result of the application of IFRS 16 and as a result of the implementation of efficiency improvement programs.

All other categories of operating expenses are under control.

29. EBITDA

Despite challenging macro conditions, consolidated EBITDA grew quarter-no-quarter by 7%.

The main growth factors were a positive lag on export duty, an increase in the share of high margin volumes in the production structure, growth in gas production abroad, the inventory effect in refining, improved retail and trading margins, as well as a decrease in unit costs in upstream and douwnstream from IFRS 16.

The main negative impact on the dynamics of EBITDA had a reduction in refining margins and the specifics of accounting for hedging operations in the international trading.

30. Profit

Despite the increase in EBITDA, our net profit declined quarter-on-quarter mainly due to depreciation, which more than doubled. The main reason for this growth is the low level of depreciation in the fourth quarter of 2018 due to a one-time factor associated with its recalculation due to the growth of proved developed reserves. In addition, an extra 8 billion rubles of depreciation in the first quarter of 2019 were accrued as a result of applying IFRS 16.

31. CAPEX

Capital expenditures in the first quarter of 2019 amounted to 97 billion rubles, decreasing by 14% quarter-on-quarter and by 20% year-on-year.

The decrease is mainly due to the schedule of payments to suppliers and contractors, the seasonal factor, as well as the end of the next development stages at the Northern Caspian fields.

32. Cash flow

Free cash flow before changes in working capital increased by 33% to 183 billion rubles. The growth of working capital by 37 billion rubles was due to the refined products inventory build-up in the international trading, as well as oil inventory build-up at our international refineries.

In the first quarter of 2019, a total of 142 billion rubles was allocated to the distribution of capital to shareholders, which is a record for us in quarter terms. We distributed approximately equal amounts of dividends and share repurchases.

33. Financial position

As already noted, as a result of applying IFRS 16, our debt increased by 150 billion rubles to 642 billion. Our leverage at the end of the quarter was 0.2.

34. 2019 outlook

In conclusion, I’d like to once again note the strong operating and financial results of the reporting quarter and confirm all our targets and plans for the current year, which are presented in detail on the slide in the presentation.

Thank you for your attention!