PJSC LUKOIL

2Q 2019 Results Conference Call and Webcast Transcript

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Speakers:

Alexander Matytsyn, First Vice President, CFO

Pavel Zhdanov, Vice President, Corporate Development and Investor Relations

Alexander Palivoda, Head of Investor Relations

Alexander Palivoda

1. Title slide

Good afternoon, ladies and gentlemen. Thank you for joining us today for this conference call on LUKOIL's results for the second quarter and the first half of 2019. On today's call, we have Mr. Alexander Matytsyn, CFO; Mr. Pavel Zhdanov, Vice President for Corporate Development and Investor Relations; Mr. Gennady Fedotov, Vice President for Economics and Planning; Mr. Vyacheslav Verkhov, Chief Accountant; as well as our colleagues from the Accounting Team.

2. Forward-looking statements

Before we move onto the presentation, I would like to draw your attention to the fact that some of the comments during this call constitute "forward-looking statements" involving risks, uncertainties and other factors that may cause our actual results to be materially different from what is expressed or implied by these forward-looking statements.

More detailed information is presented on the slide.

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

Alexander Matytsyn

3. Operating results

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

The second quarter and the first half of 2019 proved to be very successful for LUKOIL.

Despite external limitations, we continued to outperform in terms of hydrocarbon production, which increased by nearly 3% year-on-year. The product slate is also improving, with the share of high-margin barrels exceeding 31%. This puts us ahead of the target due to the advancement of priority projects and introduction of the tax on additional income (TAI) at some fields.

Our refining throughput grew by 2% compared to the first half of 2018. Our product slate also continued to improve. In particular, our European refineries improved the light product yield by 6 percentage points. Sales through premium channels continued to grow at a double-digit rate.

4. Macro environment

After a rapid recovery in the first quarter of 2019, crude oil prices have been declining since late May on the back of growing risks of global economic slowdown. As a result, average international prices were rising quarter-on-quarter, but the net price in rubles was sliding due to the tax lag effect and US dollar depreciation. Although international prices were lower than in the first half of 2018, the net price in rubles surged on the weaker ruble.

Refining margins greatly improved quarter-on-quarter both in Russia and Europe, mainly driven by higher crack spreads for gasoline. As compared to the first half of 2018, refining margins decreased by about 20% in Europe due to the deterioration of crack spreads for gasoline and diesel fuel.

5. Financial results

I am pleased to announce that our quarterly EBITDA hit a new record high of over 330 billion rubles, thanks in no small part to increased downstream profitability. As a result, even despite lower oil prices, the half-year EBITDA rose by 22% year-on-year to 630 billion rubles, which was mainly driven by effective business development and efficiency improvements.

We continue to implement our efficiency improvement programs. Our costs per meter drilled, barrel lifted and ton refined decreased year-on-year. Our selling, general and administrative expenses (excluding incentive program) remained flat year-on-year. Introducing IFRS 16 also contributed to cost reduction.

Despite growing capital expenditures, our free cash flow in the second quarter increased by 11% quarter-on-quarter, amounting to 308 billion rubles, or 4.7 billion US dollars, for the first half of 2019. This is 50% higher than in the first half of 2018. The upstream segment was the key growth driver.

Although crude oil prices remain relatively sluggish, LUKOIL is still generating strong free cash flow by leveraging its vertically integrated business model, which is proving to be highly efficient and sustainable.

6. Leadership in efficiency

It is worth mentioning that LUKOIL is not only maintaining its long-standing leadership among Russian oil companies, but also surpassing some global peers in terms of EBITDA and free cash flow per barrel produced. Our EBITDA per barrel produced stood at 23 US dollars in the first half of 2019 and hit a record high of 25 US dollars in the second quarter. This is the best evidence that our focus on a better production mix, selective downstream projects, premium sales channels and continuous OPEX and CAPEX control is paying off.

7. Growing distributions to shareholders

As for shareholder returns, we completed our buyback program – worth 3 billion US dollars – in August, having purchased over 37 million shares in the open market, or about 5% of the charter capital. Based on our strong free cash flow, we managed to complete the program much faster than initially planned.

Yesterday, we cancelled 35 million shares following the decision made by the Shareholders' Meeting in June, which is just below the number of shares repurchased so far. We also spent another 1.6 billion US dollars on repurchasing 19.5 million shares from minority shareholders under our public tender offer.

Thus, since 2018, we have spent a total of 4.6 billion US dollars purchasing shares, which is 50% more than the size of the recently completed buyback program and some 10% more than half of the incremental free cash flow we generated between January 2018 and June 2019. So, we are ahead of the announced policy targets to return capital to our shareholders.

We are now in the process of finalizing a new buyback program through 2022 that will be in line with our three-year business plan. An official announcement on this will be coming soon.

We are committed to pursuing this policy further in view of its paramount importance for LUKOIL's investment case.

8. Better corporate governance

In conclusion, I would like to emphasize the ongoing improvements to LUKOIL's corporate governance. In particular, our Board of Directors was reshuffled in June at the Annual General Meeting of Shareholders. Six out of 11 directors are now independent, with their share exceeding 50%. This is what makes us different from the majority of Russian public companies, including those in the oil and gas industry.

Thank you. Now I would like to hand over to Pavel Zhdanov.

Pavel Zhdanov

9. Upstream

Thank you, Alexander. Good afternoon, ladies and gentlemen. I will now present our results in the upstream segment.

10. Price and tax environment

The segment showed mixed results in the reporting periods due to a highly volatile price environment.

The average Urals crude price rose by 8% quarter-on-quarter, but the tax lag effect coupled with a 2% ruble appreciation made the ruble-denominated net price drop by 4%, negatively affecting our financial performance in the segment.

The average Urals crude price in the first half of the year went down by 4% year-on-year, but the ruble lost 10% of its value, driving up the net price in rubles and positively affecting our financial performance.

11. Key operating highlights

The average hydrocarbon production, excluding the West Qurna-2 project, reached 2.4 million barrels per day in the first half of 2019, which is 2.8% higher than in the first half of 2018. The increase was mainly driven by international gas projects and oil production ramp-up in Russia following amendments to the OPEC+ agreement in 2018.

But for external limitations, the growth rate could have been even higher. This is obviously the case with the second quarter when hydrocarbon production dropped by 2.3% quarter-on-quarter mainly due to a number of external factors, specifically amendments to the OPEC+ agreement in late 2018 and lower gas output in Uzbekistan, also driven by external technical constraints.

We are continuing to focus on a better production mix as well as on increase in the share of high-margin barrels. Compared to the first half of 2019, production from new projects and hard-to-recover reserves increased by 15% and 21%, respectively. The share of high-margin barrels reached 31%, which is 6 percentage points higher than in the first half of 2018. I would like to emphasize that we are ahead of our original target of 30% in 2020. This is thanks to the acceleration of priority projects and introduction of the TAI effective as of the beginning of 2019.

12. Upstream EBITDA

Upstream EBITDA rose by 14% year-on-year to 470 billion rubles. The growth was supported by a better production mix coupled with higher volumes, TAI introduction at some fields, and reduction in per-barrel lifting costs. As I mentioned earlier, the net price in roubles surged on the back of a weaker rouble, also improving results.

EBITDA from our international operations grew by more than 30%, greatly boosting financial results in the segment. This impressive growth was primarily driven by higher gas production in Uzbekistan and Azerbaijan, as well as by rising gas prices.

Upstream EBITDA stayed more or less the same quarter-on-quarter. However, production volumes shrank and the net rouble price on oil dropped. Russian operations were supported by a better product slate and the introduction of TAI. Outside Russia, the negative effect from lower gas output in Uzbekistan was partly offset by higher EBITDA of the West Qurna-2 project in Iraq as a result of the growing CAPEX.

13. Tax on additional income (TAI)

Now, I would like to touch on the TAI. In the first half of 2019, our 29 TAI projects produced a total of 2.43 million tons of oil -- equal to 6% of our total liquid hydrocarbon output in Russia.

The third group plays a key role for us. These are the mature fields in West Siberia which are now yielding quick wins. In the first half of 2019, we increased productiondrilling operations there by 30%, while oil production grew by 8% year-on-year. Evidently, the upstream segment benefited from introducing TAI.

Now I shall move onto specific regions and projects.

14. West Siberia

Subject to the external limitations, we are continuing to manage production volumes at mature fields in West Siberia efficiently. In the first quarter, we scaled back drilling operations and well interventions to reduce our oil production in Russia as required. In the second quarter, we brought drilling operations back to normal in order to maintain the current levels of production.

As a result, over the first six months of 2019, production in the region decreased by no more than 0.4% year-on-year, including by 1.8% at mature fields. I would like to remind you that we originally planned to reduce the production decline rate to 2–3% at mature fields, so we are ahead of our targets. We also see huge potential in further improving the production profile, which we are willing to unlock should the external limitations be removed.

We are pushing on with implementing our cost optimization program, streamlining project approaches and improving drilling technologies. Our drilling costs per meter decreased by 8% year-on-year at multi-bore and basic horizontal wells. This is key to delivering on our strategic priority to improve the production profile at mature fields through the development of additional reserves from our extensive resource base.

15. North Caspian

We are continuing to develop our priority projects in the North Caspian. In the first half of 2019, we increased oil production by 14% year-on-year in the region.

We successfully completed the main production drilling cycle under Phase 2 of the V. Filanovsky field development, with three high-flow-rate production wells commissioned during the first six months of 2019. Now that construction and installation operations are mostly over at Phase 3 of the field’s development, we have started drilling the first production well. The first production platform have embarked on further drilling of the well stock as per the field development plan.

I would like to emphasize the progress at the Yu. Korchagin field, where oil production has increased by 30% year-on-year as a result of the Phase 2 drilling programme.

As part of the Rakushechnoye field development, shipyards are building an ice-resistant stationary platform, a living quarters platform and a crossway connection. As of the end of the second quarter, the ice-resistant stationary platform is 14% complete, and the living quarters platform is 36% complete. Also, tender procedures are underway to conduct offshore operations and lay subsea pipelines.

16. Hard-to-recover: heavy crude oil

Now I would like to move onto heavy crude oil in Timan-Pechora.

The development of the Yaregskoye field and the Permian-Carboniferous reservoir at the Usinskoye field has helped us to increase high-viscosity oil production by 18% year-on-year to 2.4 million tonnes.

We are continuing to expand infrastructure and production facilities.

At the Yaregskoye field, we plan to put the second line of the oil pipeline into operation by the end of this year, and to expand its oil treatment capacity to 3 million tons per year.

Over the six months of 2019, the Usinskoye field commissioned 18 production wells along with a facility which generates 20 tonnes of steam per hour. We are also optimising our drilling costs.

17. Hard-to-recover: low permeability

We are continuing to develop low-permeability reservoirs in West Siberia.

Over the six months of 2019, the total increase in production at the Imilorskoye and the V. Vinogradov fields reached 38% year-on-year.

In the first half of 2019, 45 production wells and 13 injection wells were put into operation at the Imilorskoye field. Production growth there was 42% year-on-year.

Over the same period, we commissioned 14 production wells at the V. Vinogradov field, where oil production grew by 29%. As part of our ongoing cost-cutting efforts, we successfully piloted the batch drilling, a technique which has helped us to reduce drilling time by up to 10%.

18. Gas projects in Uzbekistan

In the first half of 2019, LUKOIL’s share of gas production in Uzbekistan rose by 18% year-on-year to 7 billion cubic meters. This growth was thanks to the second train of the Kandym gas processing plant launched in April 2018.

The second quarter saw a decline in production, caused by scheduled maintenance at the Kandym plant as well as limitations in gas intake from the Gissar project by the Shurtan gas processing plant as a result of repairs. The Shurtan plant owned by Uzbekneftegaz is engaged to process our gas from the Gissar project into marketable gas. According to our Uzbekistan partners, the plant will remain dormant for repairs for quite a while. As of now, we are keeping our production at Gissar nearly 5 million cubic meters a day below the target level, and we expect it to recover over time as repairs progress. At the same time, our production at Kandym is ahead of targets, which is largely offsetting production losses at Gissar.

19. Acquisition of a stake in Marine XII project in the Republic of Congo

We expect to close our deal with New Age to acquire a 25% interest in Marine XII project in the Republic of Congo at some point soon.

This project is in line with our M&A strategy. The project boasts explored reserves, substantial production growth potential, and access to well-developed infrastructure. It is also a good fit for our technological expertise. The project is already generating positive free cash flow, sufficient to finance output expansion going forward. The project operator is ENI, our strategic partner.

Now I will give the floor to Alexander Palivoda.

Alexander Palivoda

20. Downstream

Thank you, Pavel. I will now present the results in the downstream segment.

21. Refining profitability

The second quarter saw a better price environment for the downstream segment.

In Europe, the benchmark margin rose by 19% quarter-on-quarter as crack spreads for gasoline were recovering after a trough in the winter. This was largely due to seasonal maintenance at European refineries and the seasonal rise in demand for gasoline in the USA during spring and summer. This effect was partly offset by tighter crack spreads for diesel fuel, naphtha and fuel oil.

In Russia, the benchmark margin in US dollar terms more than doubled following a slump in the first quarter of 2019. This growth was driven by lower feedstock costs, higher wholesale prices in the domestic market as well as rising crack spreads for gasoline in the international market, causing export netbacks and the corresponding damper for gasoline to rise. I would like to point out that the damper was negative in January through February 2019 as crack spreads for gasoline remained low, also keeping gasoline prices relatively low.

22. Key operating highlights

In the second quarter, our average daily refining throughput remained virtually flat quarter-on-quarter. At the same time, the refining throughput in Russia dropped by 3%, mainly as a result of scheduled maintenance at our Perm refinery. Our European refineries increased throughput by more than 5%, thereby offsetting the decline in Russia. The growth was mainly attributable to higher capacity utilization in Bulgaria following refinery maintenance in Q1 2019 as well as disruptions to feedstock supplies in the first quarter which were caused by adverse weather conditions in the Black Sea ports.

Both Russian and European refineries increased their throughput by 2% in the first half of 2019, driven by higher capacity utilization at the Nizhny Novgorod refinery in Russia and our refinery in Bulgaria.

Despite the scheduled maintenance at our Perm refinery, the light product yield in Russia generally remained flat quarter-on-quarter at 69% after we improved the hydrocracking process at the Volgograd refinery.

Our overseas refineries significantly enhanced their light product yield in the second quarter from 75% to 79% thanks to a better feedstock mix,and also processing lighter oil blends.

Despite higher refining throughput, the first half of 2019 saw a decline in total fuel oil output by 129 thousand tons, down to 11% in terms of yield.

23. Priority sales channels

The sales growth through premium channels is key to our downstream strategy. In the first half of 2019, our sales of bitumen, into-plane refueling and ship bunkering were growing at double-digit rates. Sales of our premium lubricants for motor engines and industrial uses also continued to grow.

Retail sales of motor fuels fell by 4% year-on-year due to a high base effect of 2018 when vertically-integrated companies enjoyed a surge in consumer demand for motor fuels. Critically, the decline in sales was offset by better economics in our retail business, including higher revenue from non-fuel goods.

24. Efficient allocation of Russian oil

Oil supplies to our Russian refineries remained the most efficient distribution channel. The second quarter saw a better price environment for the Russian downstream segment, thus enhancing our integrated margin on oil supplies to Russian refineries and further sales through our channels, including the premium channel. Oil supplies to our Russian refineries decreased in the second quarter entirely due to scheduled maintenance. The decline gave a boost to exports, with incremental volumes being largely processed by our European refineries.

25. Downstream EBITDA

Notwithstanding the favourable market environment, downstream EBITDA in Russia dropped by 8% quarter-on-quarter. This was due to the negative effect of carried-over inventories of oil and refined products in the second quarter of 2019 as opposed to their positive material effect in the first quarter. In addition, the refining throughput shrank as a result of scheduled maintenance, coupled with a seasonal decline in revenue from power generation. These negative factors were partly offset by higher refining margins and better results in the retail business and petrochemicals.

In contrast, downstream EBITDA outside of Russia showed strong growth, mainly due to the impact of hedge accounting as part of our international trading business. In the first quarter of 2019, higher oil prices resulted in a loss recognized as of the reporting date in relation to our hedging of unsold crude oil and refined products, dragging down on our Q1 EBITDA performance. In the second quarter, however, profit from the sale of these oil and product volumes contributed to EBITDA growth, driving the impact's quarter-on-quarter variance above RUB 25 billion. I would like to note, though, that the overall impact of hedge accounting on EBITDA in the first half of 2019 was close to zero.

The positive quarter-on-quarter impact of hedge accounting was partly offset by the effect of carried-over inventories at refineries, which was positive in the first quarter and negative in the second quarter.

Downstream EBITDA grew in the first half of 2019 both in Russia and abroad. It rose by half in Russia on the back of higher margins and processing volumes, a better product slate, and robust results in the retail business. It went up by more than 30% outside of Russia due to higher processing volumes, a better product slate, and stronger profitability in trading operations. Lower refining margins in Europe constrained the EBITDA growth.

26. New projects

We are working to implement selective downstream projects in Russia with a view to enhancing the light product yield and promoting bitumen production as a premium business.

As for the delayed coker in Nizhny Novgorod, work is underway on installation of steel structures, with shipments of plant and equipment started by water. The project is 42% complete.

As for the isomerization unit, also in Nizhny Novgorod, work is underway on reinforced concrete foundations together with furnace installation. The project is 25% complete.

As for the bitumen expansion plans, we are getting ready to submit project documentation for environmental review and the main state expert review. Getting ready to start construction.

We are building a deasphaltizing unit at our Volgograd refinery. Work is underway on underground utilities, process pipelines, furnace foundation, with the existing racks used to lay pipelines. We have also started receiving shipments of plant and equipment. The project is currently 25% complete.

<u>Alexander Palivoda</u>

27. Financial highlights

Let me present the financial section of our presentation.

28. Revenue

The quarter-on-quarter revenue growth was primarily due to higher trading volumes in oil and petroleum products as well as the sale of inventories accumulated during the first quarter, while the price factor was far less pronounced. Inventories were an important driver behind this quarter-on-quarter growth: in the second quarter, we sold 1.3 million tons of oil and petroleum products accumulated in the first quarter.

29. OPEX

Our operating costs show excellent dynamics in both upstream and downstream segments.

Our per unit costs decreased year-on-year, reflecting the adoption of IFRS 16, which we discussed in more detail at the previous call, and the implementation of our efficiency improvement programs. In the first half of 2019, our lifting costs were down by 4% year-on-year in Russia and by 7% across our overseas assets. Excluding the effect of IFRS 16, per unit costs decreased by 1% and 2% year-on-year, respectively, on the back of our success in improving efficiency and optimizing controllable costs. Our per unit refining costs in Russia declined by 1% year-on-year, while those of our European refineries dropped by 5% year-on-year. The effect of IFRS 16 in the downstream segment was not significant, that is the costs decrease was driven by real business factors.

30. EBITDA

Our EBITDA grew by 11% quarter-on-quarter to 332 billion rubles, hitting a whole new record.

The key growth drivers were higher refining margins in Russia, positive accounting effects of hedging for global trading operations, and sale of oil and petroleum product inventories accumulated during the first quarter. The last factor is reflected in the Elimination line of the EBITDA breakdown by operating segments. Please note that the inventories and hedging factors are recurring.

Second quarter's additional EBITDA that came from sold inventories and hedging offset the EBITDA we lost in the first quarter, meaning that in the six months we broke even.

31. Net profit

The net profit rose by 21% quarter-on-quarter on the back of EBITDA growth. Another driver of net profit growth was the decrease in the effective income tax rate (19% vs 22% in the first quarter) due to the one-off effect of the revision of regional income tax benefits.

32. CAPEX

Our capital expenditures amounted to 108 billion rubles in the second quarter of 2019, up by 10% quarter-on-quarter. The increase in upstream is due to the schedule of payments to suppliers and contractors, as well as the start of the second development phase of the West Qurna-2 project.

In the first half of 2019, our capital expenditures decreased by 10% year-on-year as we scaled down our investments in Uzbekistan given the completion of the main construction works and the respective development phases at two Caspian fields.

As usual, we expect increased capital expenditures in the second half of the year.

33. Cash flow

Despite rising CAPEX, our free cash flow before changes in working capital increased by 3% quarter-on-quarter to 189 billion rubles. The 27 billion ruble growth in working capital was due to the increase in trade receivables on the back of higher trading volumes.

Our free cash flow before changes in working capital reached 373 billion rubles in the first half of 2019, which is a 50% increase year-on-year.

In the first half of 2019, we distributed more than 200 billion rubles to shareholders, with about two thirds of the funds spent on the share buyback. We spent over 56 billion rubles on debt repayment and servicing.

34. Financial position

Our balance sheet remains very strong. Total debt stands at 620 billion rubles as at the end of the first half of 2019, including 142 billion rubles attributable to the adoption of IFRS 16. Our leverage is 0.1 as at the end of the reporting period.

35. Plans for 2019

Before we proceed with a Q&A session, I would like to speak on our 2019 plans.

Initially, we planned for our hydrocarbon production to grow by 1%, assuming that the external limitations would be removed in mid-2019, which was expected to boost our daily liquid hydrocarbon output in the second half of 2019. Though the external limitations are still in place, we believe that our plan is feasible and we expect our production to grow by 0.5% to 1.0% in 2019 on the back of incremental gas volumes.

We also expected our capital expenditures, excluding the West Qurna-2 project in Iraq, to reach 500 billion rubles. Since the production limits remain in effect, we expect lower capital expenditures somewhere in the range of 470–490 billion rubles.

Thank you for your attention.