PJSC “LUKOIL”

3Q 2019 Results

Conference Call and Webcast Transcript

November 27, 2019

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 third quarter and first nine months of 2019. On today’s call, we have Mr. Alexander Matytsyn, CFO; Mr. Pavel Zhdanov, Vice President for Corporate Development and Investor Relations; as well as colleagues from our Accounting Team.

2. Forward-looking statements

Before we move on to 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.

Despite the decrease in oil prices, our performance remained strong. This was especially evident in the third quarter, which saw our EBITDA and free cash flow before changes in working capital stay flat amid a 17% drop in oil prices and a slightly appreciating ruble as compared to 3Q 2018. We achieved this mostly thanks to our vertically-integrated business model, prudent approach to capital management, and our continued efforts to improve efficiency and promote further growth.

Despite external limitations on oil production in Russia, hydrocarbon production continued to expand with some 2% growth versus the 9 months of 2018 driven by the development of gas projects. Our production mix is ahead of the target, with the share of high-margin barrels reaching 31% thanks to the successful development of our growth projects coupled with the tax on additional income introduced early this year.

Compared to the corresponding period in 2018, our refining throughput rose by 3% on the back of, among other things, a quarter-on-quarter growth, which exceeded 7%, allowing us to amplify gains amidst higher refining margins. Our product slate also saw improvements. We are pleased to report a higher light-product yield and a record low in fuel oil yield. We also continued to develop our premium sales channels.

4. Macro environment

Oil quotes remained volatile as spiralling rhetoric on trade wars and the increased risk of lower demand for oil were placing significant pressure on prices.

Compared to the corresponding period in 2018, the decline in oil prices was more than half offset by the ruble devaluation; however, from a quarter-on-quarter perspective, the exchange rate remained almost flat, resulting in a less impressive performance.

Growing crack spreads for medium distillates drove up refining margins quarter-on-quarter. At this point, I would like to note that uncertainty is still high with regards to the potential impact of MARPOL on price spreads. In particular, we are witnessing worsening spreads for high sulfur fuel oil with no rise in the spreads for medium distillates. We are monitoring the situation very closely and taking necessary actions to manage the product slate and further reduce the output of high sulfur fuel oil.

5. Financial results

Despite the quarter-on-quarter decline in oil prices, our EBITDA remained virtually flat. The lower upstream profitability was largely offset by an increase in downstream EBITDA.

Year-on-year, the downstream segment was shown to be the main driver behind EBITDA growth which was also due to the high quality of our refining facilities. At the same time, upstream EBITDA was largely resilient to oil price decline thanks to higher production volumes, improved production mix and a reduction in per barrel lifting costs.

The latter came in the wake of our successful implementation of initiatives to improve efficiency. In addition to lifting costs, the third quarter saw a decrease in drilling and refining costs, as well as in administrative expenses. Nearly all of the expense items under our control are now at or below 2016 levels, which speaks to the effectiveness of our initiatives.

I would like to make a special mention of the free cash flow, which is the main high-level KPI in LUKOIL linked to management remuneration. It increased 1.5 times in 9 months against the corresponding period in 2018, amounting to 517 billion rubles, or 8 billion dollars. Quarter-on-quarter, it also performed strongly, seeing growth of almost 30%.

6. Leadership in efficiency

We maintained strong leadership in efficiency compared not only to Russian oil companies, but also staying well ahead of some of our global peers.

In the third quarter, our free cash flow per barrel reached 15 US dollars, a record high for the Company.

7. *New principles of capital distribution*

We are not only committed to improving our operating and financial performance but also seek to maintain our corporate governance standards in line with market best practices.

In mid-October, the Board of Directors introduced a major improvement by approving new principles of capital distribution. I would like to remind that new principles represent a shift to opportunistic share buybacks and paying dividends equal to at least 100% of adjusted free cash flow. This approach allows substantially increasing shareholder returns without limiting our investment capacity.

Yesterday, the Strategy, Investment and Sustainability Committee reviewed a new version of the Regulations on the Dividend Policy based on these new principles. This issue is included in the agenda of the meeting of the Board of Directors that will take place on December 12^{th}.

As a reminder, we already used the new principles to calculate our recommended interim dividends for 2019, which are subject to approval at the upcoming shareholder meeting.

The new principles suggest strong advantage - the complete transparency of calculations. Once a quarter is in the books, everybody will be able to calculate the corresponding dividends. In the third quarter of this year, for example, they stood at 120 rubles per share, bringing the nine-month total to 312 rubles.

In fact, this is close to the current market consensus forecast of the dividend amount for the full year. And we expect to stay free cash flow positive in the fourth quarter.

Please also note that 2019 is a transition year, as we have bought back shares for a total of 244 billion rubles during the year. Under the new principles, dividends shall be reduced by this amount, meaning that they would have been much larger if not for the buyback – by over 350 rubles per share, to be precise. Over 9 months in 2019, we offered an adjusted for buyback dividend yield of 11%, far higher than many of our peers. And this is without the fourth quarter.

Furthermore, our business is growing steadily, complementing these high dividends with higher cash flows for shareholders in the future. Total returns are, therefore, even higher, leading us to believe that LUKOIL's shares are significantly undervalued. We hope that investors will appreciate our efforts, including recent changes to our capital distribution policy.

LUKOIL will continue to pursue its long-term strategy aimed at boosting its shareholder value.

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

Pavel Zhdanov

8. Upstream

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

9. Price and tax environment

In the third quarter, the segment's performance was adversely affected by worsened market conditions.

The average Urals crude price declined by 11% quarter-on-quarter, while the ruble remained flat on average and the negative tax lag effect grew bigger. As a result, the average ruble-denominated net oil price fell by 9% quarter-on-quarter.

The market fared slightly better than in the corresponding 9 months of 2018 as the 9% price drop was largely offset by a weaker ruble. As a result, the reduction in the ruble-denominated net oil price was limited to 4%.

10. Key operating highlights

The average hydrocarbon production, excluding the West Qurna-2 project, reached 2.3 million barrels per day in the first 9 months of 2019 – 1.6% higher than in the corresponding period of 2018. This increase was mainly driven by international gas projects and a minor ramp-up in oil production in Russia following amendments to the OPEC+ agreement in 2018.

As you may remember, the same agreement forced us to cut oil production in Russia in early 2019, slowing down overall production growth.

These external limitations served to validate our continued focus on improving the product slate. Compared to the 9 months of 2018, production from new projects and hard-to-recover reserves increased by 10% and 30%, respectively. As a result, the share of high-margin barrels in total hydrocarbon production rose by 5 percentage points to more than 31%. The introduction of the tax on additional income, or TAI, in the beginning of this year made an additional contribution into this increase.

11. Upstream EBITDA

Upstream EBITDA delivered a mixed performance.

Its year-on-year and quarter-on-quarter decline in Russia reflected the deteriorating macro conditions. However, this decline was quite moderate compared to the first 9 months of 2018 and slightly exceeded 2%. This impressive performance relative to oil price dynamics was supported by the higher production volumes and improved production mix.

Outside of Russia, higher production volumes and gas prices substantially outweighed the adverse impact of lower oil prices. As a result, EBITDA from foreign operations rose by 13% versus the first 9 months of 2018 and by 2% quarter-on-quarter. A constraint came from the lower EBITDA seen at the West Qurna-2 project in Iraq as a result of lower capital expenditures.

12. Tax on additional income (TAI)

We continue to operate our assets under the TAI regime.

In the first 9 months of 2019, our 29 TAI projects produced a total of 3.5 million tons of oil, which is equal to 6% of our total liquid hydrocarbon output in Russia. Capital expenditures on these assets for the same period exceeded 24 billion rubles. The intensity of capital expenditures, or costs per barrel lifted, is 2 times higher than the Company's average. We are taking active steps to develop reserves that were previously deemed non-commercial.

Specifically, we increased drilling operations by 33% at the mature fields in West Siberia, which belong to the third group of TAI projects and play a key role for us, leading to a 7% production growth year-on-year in 9 months 2019. I would like to emphasise here that we are far ahead of the initial production target with the third group.

The TAI scheme gives new life to mature fields, transforming them into growth drivers and offering the additional opportunity to reinvest capital.

Now I shall move onto specific regions and projects.

13. West Siberia

Subject to the external limitations within the OPEC+ agreement, we are continuing to take an efficient approach to managing production volumes in West Siberia.

In the first quarter, we scaled back drilling operations and well workover operations to reduce our oil production in Russia as required. From the second quarter, we have been bringing the production drilling operations back to normal in order to maintain the current levels of production at mature fields and to develop our new TAI projects and assets.

We are continuing our work on enhancing efficiency across our operations as well as introducing innovative technology. For example, we are launching horizontal wells within the three-string well program and have doubled their number since 2018.

14. North Caspian

In the North Caspian, we have increased oil production by 9% year-on-year through our continuing development efforts at the Yu. Korchagin and V. Filanovsky fields.

The third quarter saw a slight decrease in production due to simultaneous scheduled maintenance at the fields and Stavrolen plant.

In July, as part of the Phase 3 development at the V. Filanovsky field, the topside for the wellhead platform was installed onto the substructure. In August, we started drilling the first well using a jack-up floating drilling rig. In November, the production from the new well began. This is a two-bore well with smart completion and an initial flow rate of over 1,800 tons of oil per day. The wellhead platform enables us to develop the western part of the field and to sustain production at the designed level of 6 million tons of oil per year.

We also carried on with the drilling program of Phase 2 at the Yu. Korchagin field. In the third quarter, a new horizontal well was launched at the wellhead platform. In the first 9 months of 2019, we increased oil production at the field by 22% year-on-year.

As part of the Valery Grayfer (formerly Rakushechnoye) field development, shipyards are building an ice-resistant stationary platform, a platform for living quarters and a crossway connection. As of the end of the third quarter, the ice-resistant stationary platform was about 25% complete, and the platform for living quarters was almost 50% complete. In addition, agreements to conduct offshore operations and to lay subsea pipelines were signed in the third quarter. Let me remind you at this point that the field will be utilising the infrastructure of the V. Filanovsky field.

15. Hard-to-recover: heavy crude oil

Now I would like to move on to high-viscosity oil in Timan-Pechora.

The development of the Yaregskoye field and the Permian-Carboniferous reservoir at the Usinskoye field helped us increase production in the first 9 months of 2019 by 18% year-on-year.

We are continuing to expand our infrastructure and production facilities to ensure further production growth. In the first 9 months of 2019, we launched new steam-generating facilities and we also completed construction and installation operations at the second line of the Yaregskoye field oil pipeline.

16. Hard-to-recover: low permeability

Our success in production growth at West Siberia low permeability fields is worth special mention.

At the Imilorskoye field, we have launched 78 oil and 18 injection wells since the beginning of the year. Production growth here amounted to 46% year-on-year.

At the V. Vinogradov field, production grew 30% year-on-year, with 21 wells launched at the field year-to-date. All in all, the plan for the year is to launch 34 production wells.

17. Gas projects in Uzbekistan

As for natural gas production abroad, in the first 9 months of 2019 LUKOIL's share of gas production in Uzbekistan rose by 9% year-on-year to reach 10 billion cubic meters.

In the third quarter, we continued to see some limitations in gas intake from the Gissar project by the Shurtan gas processing plant, which belongs to Uzbekneftegaz and is engaged to process gas from the project into a marketable form. The scheduled maintenance at the plant enabled it to bring Gissar's production back to normal levels in October. In the third quarter the daily gas production at Gissar had grown by 7% quarter-on-quarter. Production at Kandym also returned to its designed levels in October after a slight maintenance-related decrease. Overall, we expect our share in the Uzbekistan production to reach over 14 billion cubic meters in 2019.

Now I will give the floor to Alexander Palivoda.

Alexander Palivoda

18. Downstream

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

19. Refining economics

The market environment continued to improve in the third quarter following the slump seen in the first quarter.

In Europe, the benchmark margin rose by 24% quarter-on-quarter on the back of much higher crack spreads for medium distillates and diesel fuel, in particular, while Russia followed suit.

20. Key operating highlights

In the third quarter, our refineries greatly increased their throughput compared to the second quarter. The growth amounted to 7%, while some of our refineries were under scheduled maintenance in the second quarter and the market environment favoured higher capacity utilization.

Compared to 9 months 2018, our refining throughput rose by 3%, with Russian refineries being the key contributors, mainly driven by the higher capacity utilization at the Nizhny Novgorod refinery. Our overseas refineries increased their throughput by 2% year-on-year as the Bulgarian refinery picked up momentum following maintenance in 2018.

In the third quarter, our Russian refineries enhanced their light product yield by 2 percentage points quarter-on-quarter. This growth is attributable to maintenance at the Perm refinery in the second quarter and improved processes at the Nizhny Novgorod refinery. The light product yield remained virtually flat across our Russian refineries over these nine months, which is in line with our annual plans.

In the third quarter, our overseas refineries reduced the light product yield by 2 percentage points following a much stronger second quarter, and driven by the higher refining throughput of heavy crude oil in Bulgaria and Italy. However, our overseas refineries managed to increase their light product yield by 5 percentage points over the nine-month period. The key contributors were the Burgas refinery (due to a 23% increase in throughput year-on-year) and ISAB refining plant (on the back of a better feedstock mix).

Despite higher refining throughput, the nine months saw a decline in fuel oil output by more than 300 thousand tons, down to 10% in terms of yield. The third quarter even saw a record-low fuel oil output at 9%, down by 3 percentage points quarter-on-quarter, reflecting our preparedness for MARPOL 2020.

21. Priority sales channels

We continue to build on sales of oil products through premium channels, which is key to our long-term downstream strategy. In the first 9 months of 2019, our into-plane refuelling saw double-digit growth rates. Sales of our premium lubricants for motor engines and industrial uses also continued to grow, as did ship bunkering.

A decrease in retail sales of motor fuels in the domestic market can be attributed to the high base effect of 2018, when vertically integrated companies enjoyed a surge in consumer demand for motor fuels. At that point, the decline in retail sales was offset by better economics, including higher revenue from non-fuel goods and services.

22. Efficient allocation of Russian oil

Oil supplies to our Russian refineries remained the most efficient distribution channel in the third quarter. A better market environment for the refining segment resulted in a higher integrated margin on oil supplies to Russian refineries and further sales through our channels, including premium ones. The third quarter saw a significantly wider gap between the margins of oil supplies to our own refinery facilities and those of exports. Higher refining throughput along with an improved product slate strengthened the positive market effect on our downstream performance. Higher supply volumes to our own Russian refineries resulted in a slight decrease in oil exports.

23. Downstream EBITDA

The favourable market environment and continuing improvement of operating performance boosted our downstream EBITDA by 25% quarter-on-quarter.

Russian downstream EBITDA grew by almost 30%, supported by a considerable increase in refining throughput and enhanced light product yield. However, the growth here was constrained by the deteriorated performance in the petrochemicals and retail business, as well as a seasonal decline in revenue from power generation.

Downstream EBITDA outside of Russia was up 14% quarter-on-quarter, driven by higher refining margins and the stronger profitability of global trading operations, as well as improved results in the retail business. In the meantime, the segment’s financial performance saw some negative accounting effects of hedging in global trading operations.

In the first 9 months of 2019, downstream EBITDA showed a marked increase both in and outside of Russia. In Russia, the growth of 1.5x year-on-year can be attributed to higher refining margins and throughput, and better retail business performance.

Outside of Russia, the growth of almost 30% can be attributed to the higher margins of global trading operations, higher refining throughput and the improved product slate. These drivers taken together were stronger than the impact of lower refining margins in Europe.

24. Selective projects at Russian refineries

We keep working to implement selective downstream projects in Russia with a view to enhancing our light product yield and promoting bitumen production.

With respect to the delayed coker in Nizhny Novgorod, work is underway on reinforced concrete construction and installation of steel structures and equipment, with large-capacity plant and equipment being shipped and installed. The project is over 50% complete.

Turning to the isomerization unit, also at the same refinery, site preparation is complete and installation work on equipment and steel structures is ongoing. Currently, all the required equipment is fully contracted. The project is 33% complete.

As for the bitumen expansion plans, we have submitted our project documentation for a state environmental review. The polymer-bitumen binder production unit will soon be ready. We are now preparing to start construction.

With the deasphaltizing unit at our Volgograd refinery, we have completed underground utilities and foundations. The installation work on steel structures is nearing completion. Installation work continues on equipment, steel racks, and process pipelines, with the bulk of equipment ready for installation. The project is 31% complete.

25. Financial highlights

Now a couple of words on the major drivers behind our financial performance.

26. Revenue

In the third quarter, the effect on revenue brought about by the price and by the volumes was almost equally negative, with revenue falling by 8% quarter-on-quarter. The decrease in sales volumes was due to lower trading volumes and a build-up of inventories abroad. These factors were partially offset by a seasonal growth in sales of oil products in the Russian market.

27. OPEX

We continue to show robust results for various expense items.

Specifically, lifting costs decreased year-on-year, reflecting the implementation of our efficiency improvement initiatives and the adoption of IFRS 16 *Leases* standard. In the first 9 months of 2019, our lifting costs were down 2% year-on-year in Russia and 2% in US dollars for our overseas assets. With respect to the optimisation of lifting costs under our control, we have made significant progress. For example, in Russia our per unit costs in nominal terms are now back to 2016 levels, despite higher power tariffs and other negative factors.

In the downstream segment, the results are even more impressive. In the first 9 months of 2019, we were able to reduce per unit refining costs at our Russian refineries by 8%, and as much as 13% in US dollars for those in Europe.

28. EBITDA

Despite the deteriorating macroeconomic conditions, EBITDA saw a decrease of just 1% quarter-on-quarter, down to 328 billion rubles.

Downstream EBITDA grew by 23 billion rubles, or 25% quarter-on-quarter, fully offsetting the decline in upstream EBITDA. This is both a perfect example of how a business can benefit from vertical integration and also further testament to the resilience of our financial performance in the face of price volatility.

It is important to note that EBITDA was positively affected by the change in selling, general and administrative expenses, which decreased by 2% against the corresponding period in 2018 and are now 10% lower than in 2016, excluding non-cash long-term compensation program expenses.

29. Net profit

Despite the marginal drop in EBITDA, net profit saw an increase of 5% quarter-on-quarter in the wake of the change to the effective income tax rate, which was lower due to a revision of historic data. Another driver here was profits from the sale of predominantly non-core assets as part of our efforts to streamline our international operations.

30. CAPEX

Capital expenditures were almost flat compared to the second quarter at 109 billion rubles. Quarter-on-quarter changes in this area are mostly linked to the schedule for payments to our contractors and suppliers.

In the first 9 months of 2019, capital expenditures decreased by 7% year-on-year as we scaled back our investments in gas projects in Uzbekistan, given the completion of the main construction works and the respective development phases at two of our Caspian fields.

As usual, we expect increased capital expenditures in the fourth quarter.

31. Cash flow

Free cash flow grew by 29% quarter-on-quarter to 209 billion rubles mostly driven by the change in working capital, which decreased by 13 billion rubles in the third quarter following a drop in oil prices, and after expanding by 27 billion rubles in the second quarter. Net of this change, free cash flow rose by 3.5% quarter-on-quarter as operating flow increased slightly.

32. Financial position

Our balance sheet remains very strong, with total debt standing at 621 billion rubles as of the end of the third quarter, including 135 billion rubles attributable to the adoption of IFRS 16 accounting standard. The leverage as of the end of the reporting period remains traditionally low at 0.1.

33. 2019 outlook

Before we move onto the Q&A session, I would like to draw your attention to some changes in our guidance for 2019.

With respect to hydrocarbon production, we expect growth to reach the top of the initial guidance range of 0.5–1.0%. I would like to emphasize here that, despite external limitations on production, we are set to fully achieve the initial target.

During our August call on results for the second quarter, our capital expenditure guidance, excluding the West Qurna-2 service project in Iraq, was revised downwards from 500 billion rubles to 470-490 billion rubles. It is highly likely that the actual expenditures will be even lower than the bottom end of this range.

One more thing I would like to mention is that we are continuing to work on improving our disclosure practice. As such, we have added a breakdown of revenue by the type of oil products to our MD&A for the third quarter.

Thank you for your attention.