LUKOIL

PJSC "LUKOIL"

1Q 2020 Results

Conference Call and Webcast Transcript

June 4, 2020

Speakers:

Alexander Matytsyn, First Vice President (Economics and Finance)

Pavel Zhdanov, Vice President (Finance)

Alexander Palivoda, Head of IR

Alexander Palivoda

Slide 1 Title slide

Good afternoon, ladies and gentlemen. Thank you for joining us today for this conference call on LUKOIL's results for the first quarter of 2020. On today's call, we have Mr. Alexander Matytsyn, CFO; Mr. Pavel Zhdanov, Vice President for Finance; as well as colleagues from our Accounting Team.

Slide 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

Slide 3 “COVID-19: high responsibility”

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

Let me begin with the coronavirus pandemic, which prompted us acting fast.

The safety of employees and the continuity of our business processes have been at the heart of all our considerations amid the pandemic. We quickly set up a task force to protect the Company’s staff, contractors, and customers. We have been taking all the necessary measures, from regular testing to extended shift periods for our employees. As a result, we have been able to prevent any major outbreak at LUKOIL’s facilities while ensuring continuity of our business processes across the board. As one example, all of our filling stations continued operating with no disruptions whatsoever.

In line with its commitment to social responsibility, LUKOIL is working to contribute to the efforts against the COVID-19 pandemic in Russia and other countries of operation alike. We are supporting healthcare and research institutions and are aiding vulnerable families. The Company’s facilities are now producing sanitizers and personal protective equipment.

We hope that the joint efforts of governments, businesses and people will help to curb the pandemic and the implications it may have.

Slide 4 “COVID-19 impact on oil market”

The pandemic has caused demand for hydrocarbons to plunge on an unprecedented scale, leading to inventory build up and sending oil prices tumbling to their 20-year lows.

The timing of the OPEC+ agreement helped to prevent the situation from turning into a disaster for the industry. Today, we already see business activity gradually pick up across the world, with oil demand and prices following suit. We expect that the OPEC+ agreement will help to gradually bring the market back into balance along with destocking.

According to projections by the world's leading research agencies, oil demand is set to generally normalize as early as in the beginning of 2021, but full recovery will take longer. The key factors at play will be the evolution of the COVID-19 pandemic and how quickly lockdown measures are lifted. We realize that protracted mobility restrictions might undermine demand for energy resources in the long run. At the same time, the relatively low oil price is expected to act as strong growth driver.

Let me also say here that the subdued oil pricing environment is impacting production projects with the lowest efficiencies, which might have a profound influence over the supply and demand balance going forward.

In our expectations for oil price recovery, we are leaning towards the lower end of price ranges projected by analysts. This is primarily driven by our traditionally conservative approach to planning. We, however, see no fundamental reasons to review our strategic price target of 50 US dollars per barrel, and we expect oil price to exceed this level within the next 18 to 24 months.

Slide 5 "High resilience amid sharp decline in prices and demand"

This is by far not the first price cycle that the Company is going through. We have been consistently demonstrating our strong resilience and flexibility in a volatile and increasingly challenging market environment. The Company has always been able to keep free cash flow positive and continued its robust development.

The current downturn is certainly unprecedented in terms of the speed and magnitude of macro changes and the scale of market imbalances, which makes planning a challenge and potentially leads to considerable fluctuations in financial metrics. However, we believe that the advantages we have allow us to mitigate much of the negative impact that the external environment has on our current performance and targets while at the same time protecting our profit margins amid low prices.

These advantages include a high-quality asset portfolio and, a very robust balance sheet, low per unit costs, natural hedge in the form of a progressive tax scale and a currency exchange rate effect in Russia, flexibly adjustable investment program, and strong vertical integration, which includes Company-owned transportation facilities and trading operations. Finally, we have a great level of operational flexibility, helping us to minimize the impact of lower production on our financial performance.

Slide 6 "Maintaining efficiency leadership"

In the first quarter of 2020, we maintained a leadership standing in the industry in terms of per unit financial metrics and, unlike some of our peers, managed to keep our free cash flow in positive range. Our investment program in the quarter was also financed in full in line with the budget approved for the year.

Slide 7 "Financial results"

The existing market environment has had a marked negative impact on our financial performance. However, the decline that we currently see is to a large extent linked to one-off factors. This means that our normalized metrics look considerably better. On top of that, a lot of negative drivers are inherently temporary and will be supporting our performance going forward after market conditions start to improve.

As one example, one of the notable drivers of decline in our EBITDA in the Russian upstream segment was the tax lag effect. In the downstream segment, the key factor behind the declining EBITDA was the negative effect of inventories at refineries and product inventories write-down to net realizable value as at the end of the quarter. Our profit was under pressure from the considerable foreign exchange loss caused by sharp devaluation of the ruble, along with the impact of asset impairment, predominantly in the refining segment in Europe.

Controlled factors had an extremely positive impact on our financial results. I would like to note the reduction of costs, the improvement of the hydrocarbon production mix as well as the improvement of the trade basket in refining.

Still, our free cash flow was above the level of the first quarter of 2016, when the pricing environment was very similar to what we see now. The free cash flow was also supported by working capital release.

Slide 8 "Cost control"

Our traditionally low cost base is a major pillar that underpins our strong resilience in a weak market and helps us to maintain a positive EBITDA even with oil prices at extremely low levels. Successful cost optimization initiatives are additional contributors to our financial results.

In the first quarter, we continued to deliver a strong performance in cost optimization and control. Our conditionally controllable operating and administrative expenses per barrel went down by almost 4% compared to the 2019 average.

Slide 9 "Additional cost optimization"

In the current environment, we took additional steps to proceed with cost savings in order to support our financial results in 2020.

Our efforts cover all items of operating and administrative expenses as well as capital expenditures across the board.

Let me talk in greater detail about our investment program. Our base-case plan for 2020 assumed capital expenditures excluding the servicing project in Iraq of around 550 billion rubles. We carried out the work to optimize our investment program in line with the current market conditions and production limitations. The optimization mostly includes postponement of expenditures in exploration and early stage upstream and downstream projects. To lesser extent, we reduce our drilling and construction expenditures.

Our new target for investments in 2020 is flexible in the range of 450 to 500 billion rubles. It stems from the fact that we can quickly go back on track with our investments in some of the projects depending on the market environment.

Let me stress that the optimization efforts will neither prevent us from reaching our strategic targets nor affect any of the key aspects of industrial safety and environmental protection, including climate issues.

In the challenging market conditions, our paramount priority in cash flow management for 2020 is to deliver a positive free cash flow in any macro environment.

Slide 10 "Robust financial position"

We have taken well-timed action to increase the liquidity available to us. In May, we successfully placed 10-year 1.5 billion US dollars Eurobonds for an amount that covers our debt repayment obligations until the end of this year. The amount of committed credit lines grew to more than 3.5 billion US dollars.

We maintain a very strong financial position with the net financial debt close to zero. This is a major competitive edge in the current market conditions, enabling us to honor all our obligations to lenders and shareholders while continuing to develop the Company in line with our strategy, no matter how volatile prices are.

Slide 11 "Priorities with regard to COVID 19"

In conclusion, let me outline our priorities taking into account the coronavirus pandemic.

Above all, we focus on the safety of the employees and the continuity of our business processes.

Another priority for us is to maintain exceptional operational flexibility and ability to respond to macro changes as quickly as possible in order to maximize financial performance.

We will also be committed to cost optimization as a way to mitigate the market's impact on our free cash flow.

Our long-term strategy, including the policy for shareholder returns, remains unchanged.

On May 18, the Board of Directors recommended that the Meeting of Shareholders approve final dividends for 2019 in the amount determined in full compliance with the existing dividend policy.

We aim to deliver shareholder value in the long-term and view the current environment as an opportunity to enhance the efficiency of our operations.

Now, I would like to hand over to Pavel Zhdanov.

Pavel Zhdanov

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

Slide 13 "Price and tax environment"

I believe you are all well aware of the oil price developments that we have seen over the recent months.

With the average price of the Urals crude dropping by 23% quarter-on-quarter, the net price excluding MET and export duties suffered a stronger decline and went down by 30%. This was due to the considerable tax lag effect as oil prices plummeted in March. Excluding the tax lag effect, the net price drop would be 9% in US dollars and just 5% in ruble terms.

April proved to be the most challenging month for the Russian upstream segment, with the extremely strong negative impact of the tax lag effect causing the average net price to drop to 4 US dollars per barrel, which is below the operational break-even level. However, the situation recovered in May as oil prices partly bounced back and the lag effect reversed and started recovering the margins lost through the last two months.

As you may know, a progressive scale of MET and export duties helps to largely offset the negative impact that declining oil prices have on margins in the Russian upstream segment. Also, let me once again highlight our traditional low cost-base, which makes LUKOIL one of the world's most efficient oil producers in an environment of low prices. Another positive factor is the devaluation of the ruble that supports the Company's margins in the upstream segment due to costs denominated predominantly in rubles.

Slide 14 "Key operating results"

In the first quarter of 2020, average hydrocarbon production excluding the West Qurna-2 project totalled 2.3 million barrels per day, down 2.5% quarter-on-quarter. The decline is attributable exclusively to the reduced supplies from our Uzbekistan projects to China as demand weakened because of the coronavirus pandemic.

Since mid-February, we have cut our production in Uzbekistan to some 40% of the capacity and are currently in talks with the Uzbek side to resolve the situation. You may remember that gas is supplied to China under a contract between Uzbekistan and China, and that contract is beyond our control.

Excluding our projects in Uzbekistan, hydrocarbon production increased by 0.4% quarter-on-quarter. The share of high-margin barrels in the production structure also continued to grow – up by 2 percentage points year-on-year.

Slide 15 "OPEC+ production cut"

I would like to talk more specifically about the new OPEC+ agreement.

Based on that agreement, since May 1 we have cut our crude oil production in Russia by 19% or about 310 thousand barrels per day against average daily production in the first quarter. The production was reduced by shutting down the least profitable wells, predominantly at mature fields of West Siberia and the Komi Republic. The water cut in the shut-in wells exceeds 90%, which is above LUKOIL's average. This approach minimizes the adverse impact of the production cut on our financial performance.

When drafting the list of wells, we, besides the economics, factored in geological and technological risks to avoid a negative effect on the long-term production potential of our fields. Our experience from the previous OPEC+ agreement confirms that the production from shut-in wells can be restored without losing their potential. We are going to stay prepared to increase production as soon as appropriately instructed by the Russian Ministry of Energy.

In the current market environment, we decided to focus on maintaining our long-term production potential in order to be able to promptly restore the production back to normal and secure further sustainable growth. This is a perfectly justified approach as oil demand is expected to recover quite rapidly and our production is highly efficient even when the prices are low.

Given that most of the shut-in wells are mature, the number of wellworks with a relatively short-term impact on the output will be significantly reduced, including for instance hydraulic fracturing. At the same time, there will be a less considerable decline in production drilling, contributing to a better basic production profile by the time the restrictions are lifted. In addition, restoring the number of wellworks after the limitations are removed will create an extra production driver within a comparatively short period.

I would like to stress that the production cut due to OPEC+ agreement will not affect our high-margin priority projects. This means that we should expect an extra increase in the share of high-margin barrels in total output.

Besides our Russian projects, the OPEC+ agreement also affected some of our overseas assets. In particular, we had to cut production in Iraq and at our oil projects in Kazakhstan.

Slide 16 "Upstream EBITDA"

As oil prices went down, the upstream EBITDA fell by a half both quarter-on-quarter and year-on-year.

In Russia, EBITDA was significantly affected by the negative tax lag effect and inventory write down to net realizable value. Without these factors, the Russian upstream EBITDA decline would have been twice as low.

The adverse macroeconomic impact was partially offset by our efforts to cut costs and improve the production mix. In particular, our per unit production costs in the first quarter of 2020 went down by almost 2% compared to the 2019 average on the back of the operational efficiency improvement program.

In addition to the market environment, the overseas upstream EBITDA was adversely affected by lower gas production in Uzbekistan, which was partially offset by a greater share of attributable production in projects implemented under production sharing agreements due to lower hydrocarbon prices, as well as higher EBITDA of the West Qurna-2 project because of a higher amount of cost reimbursement.

Slide 17 "North Caspian"

Relatively robust cash flows amid low oil prices allow us to go ahead with our priority projects strictly in line with our plans.

In the first quarter of 2020, the Caspian drilling program helped us to keep production at the target level.

As part of Phase 3 development at the Vladimir Filanovsky field, one more high-rate horizontal well was drilled. Due to our continuous efforts to improve drilling efficiency in our offshore projects, we managed to increase drilling speed by 29% quarter-on-quarter, reducing the well drilling cost by more than 10%.

We have been successfully implementing the drilling program of Phase 2 at the Yuri Korchagin field. Since the launch of the program in the second quarter of 2018, the field's daily production rose by 50%.

As part of the Valery Grayfer field development, shipyards are building an ice-resistant stationary platform, an accommodation platform and a crossway connection. As at the end of the first quarter, the ice-resistant stationary platform was more than 40% complete, and the accommodation platform was almost 70% complete. In May, offshore jackets for the accommodation platform were installed in the Caspian Sea. In the second half of 2020, the Company is planning to install offshore jackets for the ice-resistant stationary platform and complete pipelines to the Vladimir Filanovsky field.

Slide 18 "Hard-to-recover: high-viscosity oil"

High-viscosity oil production in Timan-Pechora was up by 5% year-on-year.

In the first quarter of 2020, six SAGD production wells and 90 underground wells were commissioned at the Yaregskoye field. The Usinskoye field commissioned four production wells.

We continue to expand our field infrastructure and production facilities to support further production growth. By the end of this year, the Company plans to commission new steam-generating facilities and proceed with its drilling program.

We are consistently reducing our field development costs. For example, the drilling speed of SAGD wells increased by 25% compared to the average level of 2019. This led to 10% reduction of cost of drilling of such wells.

Slide 19 "Hard-to-recover: low permeability"

Our major low permeability fields in West Siberia increased production by more than 50% year-on-year. I would like to make a special mention of the Sredne-Nazymskoye field, which doubled its production.

In the first quarter of 2020, 37 production wells were commissioned at low permeability fields.

We continue our efforts to cut costs. For example, at the Sredne-Nazymskoye field we managed to increase drilling speed of directional wells by 20% compared to the average level of 2019 that resulted in 8% cut in cost of drilling of this type of wells. Now let me hand over to Alexander Palivoda, who will present our results in the downstream segment.

Alexander Palivoda

Slide 21 "Refining Profitability"

Thank you, Pavel!

In the first quarter of 2020, the economics of Europe's refining segment greatly improved quarter-on-quarter, despite a decline in demand for motor fuels and lower crack spreads for gasoline.

The benchmark margin was up more than 80% quarter-on-quarter on the back of lower feedstock costs coupled with a higher Urals discount vs Brent crude as well as relatively high crack spreads for diesel fuel and improved crack spreads for fuel oil. The same drivers contributed to further benchmark margin growth in April. In May, however, there was a drastic change as the refining margin fell to near zero amid oil price recovery and decline in crack spreads for diesel fuel.

The Russian benchmark refining margin also went up quarter-on-quarter, supported in part by the positive lag effect of the crude oil export duty. In April, the Russian margin was at the level of the first quarter, but in May it dropped to a negative value on the heels of the decline in the European margin. In April and May, the Russian refining margin was adversely affected by a decline in the net wholesale gasoline price on the domestic market with a negative damper payable to the government, well below the export netback. Another negative factor in May was the almost full erosion of the export duty differential due to the crude oil export duty being reduced to near zero during the month.

Slide 22 "Key operating results"

Travel restrictions due to the coronavirus pandemic resulted in a significant decline in demand for jet and motor fuels across our key sales markets. However, by leveraging our robust refining facilities and own trading operations we were largely able to mitigate the effect of this adverse factor on the refining throughput.

In fact, the first quarter of 2020 even saw an increase in the refining throughput quarter-on-quarter. In Russia, the growth of average daily throughput volumes exceeded 2%, mainly thanks to the Volgograd refinery. Our European plants also recorded growth of up to 1% mainly on the back of higher capacity utilization in Italy following the end of maintenance works in the fourth quarter of 2019. This offset the decrease in the Bulgarian refinery's throughput caused by disruptions of feedstock supply in February due to adverse weather conditions.

In April, the refinery in Nizhny Novgorod started scheduled repairs, while our other Russian plants continued operating at normal rates. To adjust to changes in the demand pattern, some optimizations were introduced at European refineries with capacity utilization there decreasing by 8% compared to the first quarter. Keeping a high level of refining throughput helped us to maximize our financial performance, which was supported by high margins.

In May, the Ukhta refinery was shut down for scheduled repairs, while our two high-margin Russian refineries in Volgograd and Perm continued operating at normal utilization rates. We optimized capacity utilization at our overseas refineries to factor in the refining margin pattern and commenced scheduled repairs at our plants in Bulgaria and the Netherlands. This resulted in refining throughput reduction in May by 40% and 20% to the level of the first quarter for our European and Russian refineries respectively that allowed us minimizing the negative impact from weak market environment.

I would like to stress that despite higher refining throughput in the first quarter of 2020, the fuel oil output across the Group was down by 10% quarter-on-quarter, while its share in our product slate decreased to a record-low 7%. This is 1 percentage point better than this year's target and more than 3 percentage points below the level of the first quarter of 2019.

Slide 23 "Premium sales channels"

The decline in demand for motor fuel adversely affected our filling station sales.

In the first quarter, our retail sales of gasolines and diesel fuel were down more than 10% quarter-on-quarter partly due to the seasonal factor. April saw the greatest decline in sales at filling stations, which were down some 40% year-on-year. In May, as some quarantine restrictions were lifted and economic activity started to pick up, we saw a certain upward trend in retail sales that significantly exceeded our expectations. The average daily sales volumes were up 26% compared to April 2020 and reached 80% of the level seen in May 2019.

The air travel industry was hit the hardest by the pandemic, which resulted in drastically reduced jet fuel consumption. In the first quarter of 2020, our aircraft fuelling sales decreased by 19% quarter-on-quarter. Apart from seasonal factor the sales dynamics was negatively affected by a decline of international flights of Russian airlines since mid-March due to pandemic. The peak in sales drop was in April when sales were down 75% year-on-year. Since May, we have been seeing a gradual sales recovery of aircraft fuelling sales at air hubs across our geographies. The month-on-month hike in May was 20%.

We expect demand for jet fuel to recover at a slower rate compared to other petroleum products, because it may take a long time for the domestic and international air passenger traffic to bounce back.

Slide 24 "Allocation of Russian oil"

In the first quarter, supplies to our refineries were traditionally the most efficient crude oil distribution channel. A higher refining throughput combined with improved petroleum product slate allowed us to maximize the positive effect of a better Russian benchmark refining margin on the downstream segment performance. More shipments of crude oil to LUKOIL's refineries resulted in lower export volumes.

Due to change in market environment, we markedly increased supplies of our equity crude oil to our European refineries.

Slide 25 "Downstream EBITDA"

Despite improved refining margins, increased volumes and better product slate, our downstream EBITDA went down by 51% quarter-on-quarter.

The key factors behind the decline were the inventory effect at refineries and products inventory write down to the net realizable value as at the end of the quarter.

Normalized EBITDA, which is adjusted for rolling over and one-off accounting items, remained almost unchanged quarter-on-quarter. This confirms the strong quality of our refining assets, the flexibility of our downstream segment, and its ability to operate in any market environment. The segment's performance was supported by reduced refining costs and improved results in power generation and petrochemicals.

Slide 26 "Selective projects at Russian refineries"

Despite the challenges caused by the coronavirus pandemic, selective projects at Russian refineries are being implemented fully in line with our plans.

As part of the delayed coker construction in Niznhy Novgorod, main long-lead items has already been installed. On-site pipeline installation and technological equipment strapping works are underway. The project is over 70% complete as at the end of the first quarter.

As part of the isomerization unit construction at the same refinery, all the main units of equipment excluding compressors have already been delivered to the site. The installation work is in progress on equipment, metal structures, and laying of technological pipelines. The project is 60% complete.

The bitumen production project at the Nizhny Novgorod refinery received a positive resolution of the main state environmental commission for its oxidation unit. The main equipment has been supplied for the polymer-bitumen binder production unit. We are now preparing to start construction.

The deasphaltizing unit construction project at the Volgograd refinery has seen the completion of foundation construction, with installation of tanks and pumping equipment currently at its final stage and existing pipe racks undergoing reinforcement. Installation of pipelines and electrical equipment continues underway. The project is 76% complete.

Slide 27 "Finance"

Now let me very briefly outline our financial performance compared to the fourth quarter of 2019.

Slide 28 "Revenue"

The key negative impact on revenue came from declining hydrocarbon prices, combined with reductions in oil product trading volumes and in international gas sales. Revenue was supported by higher volumes of oil trading. As a result, revenue was down by 13%.

Slide 29 “EBITDA”

EBITDA declined by 46% to 151 billion rubles.

In addition to prices, there were three major factors impacting our EBITDA performance.

The first one is the negative tax lag effect in Russia. The second factor is the inventory effect at our refineries, which traditionally plays a considerable role whenever prices fluctuate a lot within a quarter. And finally, the third factor is inventory write down to the net realizable value as of the end of the quarter, which was only partially offset by hedging gains since we hedge only trading operations. This factor is part of “Change in crude oil and petroleum products inventory” item included into “Cost of purchased crude oil, gas and products” line in the income statement. The aggregate write down amounts to 92 billion rubles including 58 billion rubles related to international trading offset with profit from hedging.

EBITDA in the first quarter was supported by stronger refining margins and volumes and improved product slate, along with a reduction in operating and administrative expenses.

In the first quarter, normalized EBITDA, adjusted for rolling over and one-off accounting items, totaled almost 240 billion rubles, which is more than 50% above the actual EBITDA for the period.

Slide 30 “Profit”

The Company posted a net loss for the quarter.

The key driver was the non-cash impact from asset impairment which includes several items. First, a loss on fixed asset impairment in amount of 36 billion rubles. Second, loss on impairment of other non-current assets totaling 8 billion rubles. These items are shown as part of “other expenses” line in the income statement. Third, write down of deferred income tax asset in amount of 13 billion rubles reflected in the amount of income tax. This non-cash effect in aggregate totaled 57 billion rubles including 49 billion rubles related to our ISAB refinery in Italy.

The impairment of ISAB stems from the model revision because the actual effect of MARPOL turned different compared to expectations.

The second net loss driver was non-cash FX loss due to sharp devaluation of ruble to US dollar and euro in March.

Profit was also under pressure from higher depreciation charge following the commissioning of Phase 3 of the Vladimir Filanovsky field in the Caspian Sea at the end of last year, along with an increase in cost recovery at the West Qurna-2 project in Iraq.

The normalized level of profit, net of one-off and rolling over factors, totals around 100 billion rubles.

Slide 31 "Cash flow"

Despite the unfavorable market environment and capital expenditures almost on par with the fourth quarter of 2019, our free cash flow exceeded 55 billion rubles. A driver behind the free cash flow performance was a reduction in the working capital associated mainly with lower oil prices. At the same time, inventories volume of crude oil and oil products increased by almost 2 million tons for the quarter, which is expected to support our performance in future periods.

Thank you.