LUKOIL

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2Q 2020 Results

Conference Call and Webcast Transcript

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Alexander Palivoda

Slide 1

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 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

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 "Financial results"

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

The second quarter turned out to be one of the most challenging in the history of the oil and gas industry. The coronavirus pandemic led to an unprecedented slump in demand and hydrocarbon prices, as well as to imbalance of key macro parameters.

We had to significantly cut production following the OPEC+ agreement and weaker demand for gas from China, and optimize the refining throughput due to tighter crack spreads and a sharp drop in demand for jet and motor fuels.

Our management team showed efficiency and flexibility despite limitations introduced because of the COVID-19 pandemic. Therefore in this extremely challenging and volatile environment, we were able to perform well in the second quarter and once again confirm the resilience of our business.

Despite an increase in the working capital, we managed to keep free cash flow positive as opposed to most of our peers. And though the Company's investment program was downsized as part of our optimization efforts it remained sufficient to implement our key projects as planned.

While revenues declined by more than 40% quarter-on-quarter, EBITDA slid only 4%. Moreover, the decrease in upstream EBITDA was completely offset by its growth in the downstream segment.

The results were supported by both carrying over factors and our efforts to cut costs, smartly reduce production by shutting in the least profitable wells and quickly optimize the refining capacity utilization, coupled with strong trading performance.

Net profit was significantly affected by the impairment of assets on the back of a weaker market environment.

Slide 4 "Leadership in resilience to external shocks"

Thanks to a highly efficient business model, in the second quarter of 2020 LUKOIL maintained a strong leadership standing in the industry in terms of per unit financial metrics among our competitors, many of which posted operating losses and negative free cash flow.

I would like to note a significantly lower gap between LUKOIL's EBITDA per barrel and that of international majors, which was largely attributable to the natural hedging of our Russian assets.

Slide 5 "Oil market recovery"

As mobility restrictions are lifted, we see the demand for hydrocarbons recovers. However, the recovery speed varies greatly depending on the type of oil products and the region. For example, our retail sales of motor fuels are only 5% lower year-on-year. At the same time, our into-plane fueling sales decreased by 50%.

Oil demand is forecasted to reach 95% of the pre-crisis level as early as at the beginning of 2021, but a full recovery will take longer. It will depend on the dynamics of the COVID-19 spread and the pace of lifting the restrictions.

The recovery in demand against the backdrop of production cuts by both OPEC+ and other players has already put the oil market in deficit. As a result, we see a gradual reduction in accumulated inventories, which supports oil prices.

At the same time, price forecasts have improved compared to early June, when we presented our results for the first quarter. This is primarily due to the forecasted drop on the supply side.

The current market trends and forecasts demonstrate the effectiveness of our strategy aimed at maintaining free production capacity.

Slide 6 "Well positioned for market recovery"

I would like to note that today LUKOIL is perfectly positioned to derive full benefit from an improving market environment.

We are prepared to increase oil production and get back to sustainable growth at any time. High-margin barrels, whose profitability has been significantly affected by lower prices, are now an important driver of the financial results recovery. And it is important that we keep steadily increasing our high-margin production even in times of crisis.

LUKOIL's downstream can adjust promptly to changes thanks to a good access to markets, including through our own trading operations. The low base of the second quarter in terms of both refining margins and throughput allows us to significantly improve our financial results in the downstream as crack spreads recover. Next year's planned growth of the light oil product yield following the launch of new conversion facilities will provide the downstream with additional benefits from improved market conditions.

In the current situation, the Company has put an even greater focus on the optimization of all expense items. I would also like to remind you of our efficient dividend policy, according to which the entire free cash flow generated in better market conditions will be paid out as dividends.

Slide 7 "Robust financial position"

LUKOIL's robust financial position has traditionally been our additional competitive edge. Our net financial debt was close to zero at the end of the reporting period. This enables us to honor all our obligations while continuing to develop the Company in line with our strategy, no matter how volatile prices are.

In a highly volatile market environment, we have been working to increase the liquidity available to us. In particular, in the second quarter we successfully placed 10-year Eurobonds for 1.5 billion US dollars, and significantly increased the amount of committed credit lines, which now stands at some 3 billion US dollars.

In July, we paid final dividends for 2019 in the amount of over 240 billion rubles without compromising the financial stability of the Company. As a reminder, the dividends were paid out from the actual free cash flow generated in the second half of 2019.

Slide 8 "CAPEX optimization"

During the previous call, we announced the optimization of this year's investment program. At the end of the second quarter, the actual savings amounted to some 25 billion rubles. We expect the savings to be even greater as we move further into the second half of the year.

You may remember that the optimization mostly includes the postponement of expenditures in exploration and early-stage upstream and downstream projects. To a lesser extent, we reduce our drilling and construction expenditures. In other words, lower capital expenditures do not affect the implementation of key projects or the achievement of the Company's strategic goals.

We reiterate our target for investments in 2020 in the range of 450 – 500 billion rubles excluding the servicing project in Iraq. With this amount, we can quickly boost our investments in some of the projects depending on the market environment.

Let me remind you that our base-case plan for 2020 assumed capital expenditures of around 550 billion rubles. This means that following the optimization, our cost savings will amount to 20% in ruble terms and up to 25% in US dollar terms.

Slide 9 "Cost control"

In addition to optimizing our investment program, we also stepped up the efforts to cut all the Company's expenses. At the end of the second quarter, almost all conditionally controllable expenses decreased in absolute terms quarter-on-quarter. Though per unit costs went up, this increase is attributable to a certain share of fixed costs amid a forced reduction in production volumes. This means that as production and refining volumes recover, the indicators will normalize.

Slide 10 "Managing risks in permafrost"

Let me stress that our cost reduction efforts do not affect any aspects of industrial safety and environmental protection, including climate change management.

Following a major diesel fuel spill in the Far North attributed to Russian metallurgical industry, permafrost risk management has stepped into the limelight.

Importantly, LUKOIL has been operating in the Arctic Zone for many years. We leverage the most advanced technologies and take maximum responsibility for industrial safety and environmental protection. The Company built its entire infrastructure in the permafrost area using specially designed technical solutions and in compliance with special standards. We regularly monitor and control the condition of soils and production facilities. LUKOIL's costs of maintaining infrastructure in the North are substantially higher than in permafrost-free regions. All this allows us to effectively manage permafrost risks in order to prevent environmental incidents.

Finally, a few words on managing the direct risks of the coronavirus pandemic. The safety of our employees and the continuity of our business processes have been at the heart of all our considerations amid the pandemic. The steps we took enabled us to prevent any major outbreak at LUKOIL's facilities while ensuring the continuity of our business processes across the board.

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

Pavel Zhdanov (Upstream)

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

Slide 12 "Price and tax environment"

In the second quarter of 2020, we faced an unprecedented volatility of oil prices. Having plunged to a 20-year low of 13 US dollars per barrel, Brent crude traded above 40 US dollars per barrel as early as in the beginning of June. This was facilitated by the new OPEC+ agreement. At the same time, due to the sharp decline of Russian oil supplies to Europe, Urals crude traded at a premium to Brent.

The average Urals crude price went down 39% quarter-on-quarter. In parallel, the Urals net ruble price added 15% due to the tax lag effect and ruble devaluation.

July and August saw further improvement in the market environment, with the Urals net ruble price reaching its 2019 average.

Slide 13 "Key operating results"

In the first half of 2020, average hydrocarbon production excluding the West Qurna-2 project totalled 2.2 million barrels per day, down 8.4% year-on-year.

In the second quarter, we significantly cut production following the new OPEC+ agreement and lower gas supplies from Uzbekistan to China, which was attributable to the coronavirus pandemic aftermath.

However, the production of high-margin barrels continued to grow fully in line with our plans, with their share in total output in Russia rising by 3 percentage points year-on-year.

Gas production in Russia also grew after the second stage of the booster compressor station was launched at the Nakhodkinskoye field late last year.

Slide 14 "Production cut due to OPEC+"

I would like to talk more specifically about oil production developments driven by the OPEC+ agreement.

Since May 1, we have cut our oil production in Russia by 19% or about 310 thousand barrels per day against average daily production in the first quarter. We did so by shutting in the least profitable high water-cut wells, predominantly at mature fields of West Siberia, Urals, and the Komi Republic.

Let me remind you that, when drafting the list of wells to be shut in, we factored in both the economics and geological and technological factors to avoid a negative effect on the long-term production potential of our fields.

Based on our experience from the previous OPEC+ agreement and the results of the last two months, we know that the production from shut-in wells can be quickly restored without losing their potential.

In particular, we have increased output by 20 thousand barrels per day since July 1 and by another 60 thousand barrels since August. Remarkably, most shut-in wells managed to restore production within a single day.

We restore production based on the economics and focus on restarting the most profitable wells.

We continue to maintain our production potential at about 230 thousand barrels per day of free production capacity in Russia currently, so we are able to promptly restore the production back to normal and secure further sustainable growth.

Slide 15 "Upstream EBITDA"

As the market environment deteriorated and production declined, the upstream EBITDA fell by 34% quarter-on-quarter and 61% in the first half of 2020.

The much lower quarter-on-quarter decline was attributable to the tax lag effect in Russia which was deeply negative in the first quarter before turning positive in the second quarter on the back of recovering oil prices.

In addition to lower gas prices and output, our international assets also suffered from lower demand for gas from China forcing the Uzbekistan projects to redirect their exports to the domestic market. That was why the second quarter results were also adversely affected by gas price adjustments in Uzbekistan in the first quarter.

Slide 16 “North Caspian”

Notwithstanding the unfavourable market environment and external limitations on production, we continued to aggressively develop our priority projects.

The drilling program in Caspian Sea helped us to keep production at the Yuri Korchagin and Vladimir Filanovsky fields at the target level. In the first half of 2020, their combined oil and gas condensate production reached 3.7 million tons, generally flat year-on-year. From the outset, we have successfully drilled 48 production wells, with another three wells to be commissioned by the end of this year.

As part of the Valery Grayfer field development, shipyards continued to build platforms. As at the end of June, the ice-resistant stationary platform was 48% complete, and the accommodation platform was 74% complete. In May, offshore jackets for the accommodation platform were installed in the Caspian Sea. The plan for September is to install offshore jackets for the ice-resistant stationary platform. As a reminder, oil production is set to commence as early as in 2022.

As for the Baltic Sea shelf, we are finalising the FEED work on the D33 field, with the final investment decision expected at the end of this year.

Slide 17 “Hard-to-recover: high-viscosity oil”

High-viscosity oil production in Timan-Pechora was up by 4.5% year-on-year.

In the first half of 2020, 16 SAGD production wells and 157 underground wells were commissioned at the Yaregskoye field. The Usinskoye field commissioned 11 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.

We actively strive to reduce our high viscosity oil field development costs. For instance, given the large number of wells required for the Usinskoye field to reach its production target, we focused on optimizing drilling operations. Currently, we are testing the technology for drilling small-diameter wells which is likely to result in significant cost savings. The preliminary results already speak for its great potential at the Usinskoye field.

As a reminder, this technology is now being successfully rolled out in the Urals and the Volga Region. In the first half of 2020, we launched 61 small-diameter wells, a more than twofold increase year-on-year.

Slide 18 "Hard-to-recover: low permeability"

Our major low permeability fields in West Siberia increased production one and a half times 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, 93 production wells were commissioned at low permeability fields. We continue our efforts to cut field development costs.

In particular, we increased the horizontal drilling speed at the Vladimir Vinogradov field by 9% year-on-year, reducing the per unit drilling costs by 5%.

At the Imilorskoye field, we managed to increase the directional drilling speed which was already high enough. The speed rose by another 10% year-on-year, further reducing the per unit drilling costs.

At the Sredne-Nazymskoye field, we optimized the well design to increase the horizontal drilling speed by more than 25% and reduce the per unit directional drilling costs by more than 20%.

Given the large number of new wells at low permeability fields, even small costs savings translate into significant capex cuts in absolute terms.

Slide 19 "Gas projects in Uzbekistan"

In conclusion, I want to update you on situation with our projects in Uzbekistan.

In addition to a short-term decline in gas demand from China, pipeline gas turned out to be more expensive than LNG in the coronavirus pandemic aftermath, which made China scale back its gas purchases in Uzbekistan.

As a result, we had to gradually cut production there. Currently, our daily output amounts to 20% of the designed capacity, with production at Gissar project completely suspended.

Also, we could not export the bulk of gas produced in 2020, sending it to the local market. Though China gradually ramps up gas purchases in Uzbekistan, our projects are yet to resume exports.

Following our negotiations with Uzbekistan, we have achieved a preliminary agreement for the sale of gas on the local market in 2020. We also continue negotiations to resume exports.

The changes in gas supply terms resulted in revenue adjustments in the first quarter by 5.5 billion rubles, also translating into further revenue reduction in the second quarter.

In view of a dramatic decline in production, we also ran another impairment test. The financial model of these projects relied on conservative assumptions, with impairment amounting to 36 billion rubles.

Now let me hand over to Alexander Palivoda, who will present our results in the downstream segment.

Alexander Palivoda (Downstream)

Slide 21 “Refining profitability”

Thank you, Pavel.

The market environment for European refineries changed sharply for the worse in the second quarter of 2020. The average benchmark margin decreased more than twofold quarter-on-quarter and even hit negative numbers at the end of the second quarter. The drivers behind the margin decline were lower crack spreads for diesel and gasoline on the back of the coronavirus pandemic aftermath, as well as faster growth of Urals prices as compared to Brent prices. In July–August, the margin returned to positive territory but remained extremely low.

The economics of our Russian refineries was under pressure from the decrease of European margins and also from the lower export duty differential and larger negative damper. As a result, the benchmark margin in Russia went to negative territory in the second quarter. I would like to note that optimized capacity utilization and high quality of our product slate helped our refineries achieved positive results for the second quarter. In July and August, margins in Russia returned to positive territory on the back of recovery in European margins, growing export duty differential and lower negative damper.

Slide 22 “Key operating results”

As the refining margin decreased and the demand for jet and motor fuels declined sharply, we swiftly optimized capacity utilization at our production facilities to minimize negative effects of the market environment on financial performance. Furthermore, extensive scheduled repairs were completed at some of our refineries.

As a result, our refining throughput in the second quarter decreased by 21% quarter-on-quarter.

The decrease in the throughput at Russian refineries was first of all due to scheduled repairs at the Nizhny Novgorod and Ukhta refineries, which coincided with poorer market environment and falling demand. These were the large-scale maintenance works which are conducted once in 4 years.

At the same time, our two best Russian refineries in Volgograd and Perm did not reduce their throughput volumes in the second quarter.

In other countries, scheduled repairs were carried out at the refineries in Bulgaria and the Netherlands. Furthermore, capacity utilization at the ISAB refining facility in Italy was reduced by 20% quarter-on-quarter as part of our optimization efforts in the current market environment.

As the environment improved and scheduled repairs were completed in July, we began recovering the throughput at our facilities. In August, the throughput increased to reach 87% of the August 2019 level.

We continued improving our product slate. The fuel oil yield across the Group dropped in the second quarter to a record low of 6%, 2 pp. better than our target for the current year and two times lower in absolute volume terms than in the second quarter of 2019.

Slide 23 "Premium sales channels"

And now a couple of words about our premium sales channels. Lower demand for motor fuels affected sales at our filling stations in the second quarter. Sales hit the bottom in April when they were down more than 30% year-on-year. In May, retail sales began to recover gradually as economic activity picked up in Russia and Europe. The recovery of sales continued in July–August, so the difference from the last year's figure has shrunk to about 5% for now. Recovery in Russia is going faster compared to the European chain of filling stations.

The coronavirus pandemic had the most dramatic impact on the consumption of jet fuel. In April, our daily average aircraft fueling sales were down 75% to the level seen in April 2019. They are gradually recovering, but at a much slower pace than motor fuel sales. For instance, by August sales at the air hubs across our geographies revived to only 50% of the level seen last August. Further growth of sales will be supported by an increase in flight numbers.

Slide 24 "Allocation of Russian oil"

In the second quarter, the difference between netback for oil refining at Russian facilities and export netback decreased to a historic low due to a sharp decline in the refining margin.

Oil supplies to refineries declined in the second quarter on the back of lower throughput. At the same time, we increased deliveries of our oil to LUKOIL's

facilities in Europe and thus reduced purchases of third-party feedstock in order to guaranteed placement of own crude oil amid collapsed demand.

Oil exports declined in the second quarter mostly due to production cuts in accordance with the new OPEC+ agreement. By contrast, exports of oil subject to a lower-rate export duty increased because our high-margin projects did not cut oil production.

Slide 25 “Downstream EBITDA”

Despite the decline in margins and throughput, Downstream EBITDA grew almost twofold quarter-on-quarter.

The growth was driven by strong performance in the downstream segment outside Russia, mostly due to the carrying-over effects from the first quarter. In particular, the inventories unsold in the first quarter were revalued on the back of falling prices for oil and oil products, with a negative impact on financial performance. In the second quarter, most of this impact was recovered with a positive effect on EBITDA. As a result, revaluation of inventories had almost no impact on our performance in the first half of the year.

Similarly, EBITDA in the segment was affected by the factor of incoming inventories at the refineries. They were negative in the first quarter and close to zero in the second quarter.

Our trading operations demonstrated record-high financial result in the second quarter by capitalizing on access to markets and high volatility. I would like to stress that the third-party trading volumes were reduced in order to distribute our own volumes.

It is also important to mention timely optimization of the output mix and capacity utilization at our refining facilities as it minimized the negative impact of market conditions on our financial performance.

However, hedge accounting in our international trading operations and seasonal performance deterioration in power generation did affect Downstream EBITDA.

In the first half of the year, Downstream EBITDA decreased by almost one third year-on-year, mostly due to a negative effect from incoming inventories at the refineries and lower refining margins. Performance was supported by the product slate optimization and strong performance of international trading operations.

Slide 26 "Selective projects at Russian refineries"

Challenges posed by the coronavirus pandemic did not affect our selective projects at the refining facilities in Russia.

In the delayed coker construction project in Niznhy Novgorod, main long-lead items have been installed. The work is now underway to install on-site pipelines and complete technological equipment strapping. The project was 75% complete as at the end of the quarter. Scheduled for commissioning in 2021, the delayed coker unit will significantly improve the output mix of the Nizhny Novgorod refinery.

Construction of the isomerization unit is ongoing at the same site. All major units have been delivered and are being installed. The work is underway to install metal structures, cable supports and technological pipelines. The project was 77% complete as at the end of the quarter.

As for the deasphaltizing unit construction project at the Volgograd refinery, we are finishing the installation of core technological equipment and are installing

Slide 27 "Finance"

Now let me briefly outline our financial performance compared to the first quarter of 2020.

Slide 28 "Revenue"

Revenue dropped by 41% quarter-on-quarter. In addition to the key factor of prices, the negative impact on revenue came from lower volumes of hydrocarbon production, a decline in trading volumes in oil and petroleum products, and also lower retail sales of petroleum products. On the other hand, our revenue was supported by the ruble devaluation.

Slide 29 "EBITDA"

Despite a significant drop in revenue, EBITDA was down just by 4%, to 144 billion rubles, which was due to the factors carrying-over from the first quarter.

The reversal of the unhedged inventory write down was the first driver here. Let me remind you that in the first quarter this write down amounted to 34 billion rubles. In the second quarter, the write down was reversed for an amount of 30 billion rubles. Hence the effect of this driver in the first half of the year was just 3 billion rubles.

Another driver was the positive tax lag effect in the Russian upstream segment after the negative tax lag effect in the first quarter.

And yet another one is the inventory effect at our refineries, which I have already spoken about.

The second quarter EBITDA was also supported by record-high trading performance, a higher share of high-margin barrels in the Russian output, and the ruble devaluation.

Slide 30 "Profit"

The Company posted a net loss for the quarter, while its profit from operating activities was positive. The loss was due to the impairment of assets totaling 39 billion rubles, 36 billion rubles of which are attributable to the projects in Uzbekistan.

A positive impact on the profit came from our FX gains on the back of the ruble appreciation versus the loss in the first quarter and lower depreciation associated with lower production volumes and lower expenditures at the servicing project in Iraq.

The normalized level of profit, net of one-off and carrying-over factors, totaled about 10 billion rubles in the second quarter and more than 110 billion rubles in the first half of the year.

Slide 31 “Cash flow”

Despite the challenging environment, our free cash flow was about 26 billion rubles. As part of our contango strategy, we additionally increased our unsold oil inventory in the second quarter, which resulted in working capital growth. The free cash flow before changes in the working capital amounted to 38 billion rubles versus 10 billion rubles in the first quarter. A positive impact on the cash flow was made by a 13 billion ruble reduction in capital expenditures quarter-on-quarter and increase in the operating cash flow before changes in working capital.

Thank you.