PJSC “LUKOIL”

1Q 2021 Results

Conference Call and Webcast Transcript

May 27, 2021

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Alexander Palivoda

Good afternoon, ladies and gentlemen. Thank you for joining us today for this conference call on LUKOIL’s results for the first quarter of 2021. On today’s call, we have Mr. Alexander Matytsyn, CFO; Mr. Pavel Zhdanov, Vice President for Finance; as well as our colleagues from 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

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

Slide 3. Macro environment and operating results

On the back of the first quarter's strong financial performance, we jumped off to a good start in 2021. LUKOIL's business model has once again proved effective not only in weak but also in recovering market environments.

Oil prices were rising in the first quarter thanks to gradually recovering demand and concerted efforts by OPEC+ countries. At the same time, the tax lag effect translated into an all-time high Urals net ruble price.

Hydrocarbon production was up 4% quarter-on-quarter as external limitations on oil production were eased and gas production recovered in Uzbekistan.

Refining margins continued to rebound in the first quarter, though still below pre-COVID-19 levels. Effectively following the market trends, we increased capacity utilization at our refineries by 12% quarter-on-quarter. We also continued to carry out our projects aimed at improvement of our product slate as planned.

Slide 4. Financial results

In a recovering market environment, LUKOIL demonstrated impressive financial performance, with its key metrics returning back to 2019 levels.

Our high-quality assets and ability to ramp up production volumes promptly and efficiently helped LUKOIL financials capitalize the most on the market recovery tailwinds.

As a result, EBITDA rose by 66% quarter-on-quarter to 314 billion rubles and by more than 100% as compared to 1Q 2020.

Free cash flow in the reporting period stood at 164 billion rubles and virtually doubled quarter-on-quarter, driven by the market recovery and lower capex.

Slide 5. Leadership in efficiency

In terms of per unit financial metrics, LUKOIL maintains its strong leadership among Russian oil and gas companies while with free cash flow we continue to outperform even many international majors.

Slide 6. Financial position

Our balance sheet remains very strong. As at the end of the first quarter, our financial debt was slightly above 460 billion rubles, with financial leverage close to zero. LUKOIL's credit ratings and outlook remain stable.

Slide 7. Cost control

Despite the impressive results already achieved on the cost optimization side, as we discussed during our previous calls, LUKOIL continues its efforts in this area.

At the end of the first quarter, almost all conditionally controllable expenses decreased in absolute terms quarter-on-quarter. Both Upstream and Downstream segments reduced their per unit costs quarter-on-quarter. I would like to note that we managed to keep operating costs per barrel in the Russian upstream segment on par with 2019, despite significant production cuts.

Finally, we still maintain strong potential for production volumes recovery. Furthermore, we also may expect refining margins to keep recovering on the heels of mobility restrictions easing up. That is why we are so optimistic about our operating and financial performance in the quarters ahead.

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 now present our results in the upstream segment.

Slide 9. Price and tax environment

Let me begin with the price environment. The average Urals oil price in US dollars went up by 35% quarter-on-quarter. However, the Urals net ruble price rose by a less impressive 19% quarter-on-quarter due to the ruble appreciation and the progressive taxation scale in Russia. In the first quarter, it averaged at almost 1,850 rubles per barrel, which is a new all-time high. This is largely a result of the tax lag effect.

The favorable market environment continued into the second quarter, with the Urals net ruble price in May even beating the first quarter's high.

Slide 10. Key operating results

In the first quarter, the Group's hydrocarbon production, excluding West Qurna-2, totaled just slightly below 2.2 million barrels of oil equivalent per day, up 4.2% quarter-on-quarter, as external limitations on oil production were eased up following amendments to the OPEC+ agreement and gas production in Uzbekistan recovered back to the project capacity. Nonetheless, the OPEC+ deal resulted in a decline of hydrocarbon production by 7.6% year-on-year.

Despite the external limitations, we continue to develop our priority projects in Russia. As a result, their share rose by 5 percentage points year-on-year to 28% of total liquid hydrocarbon output, excluding West Qurna-2.

Slide 11. Effective production management within OPEC+ limitations

We continue to efficiently manage production volumes amid external limitations. Our oil production in Russia currently exceeds the level achieved in May last year by 170 thousand barrels per day, meaning that the production is already 55% recovered. Along with the instructions of the Russian Ministry of Energy, we recover the output as quickly as possible and with minimal cost.

Currently, our spare capacity in Russia is about 130 thousand barrels per day. As discussed during the previous call, we optimized our drilling program in the beginning of 2021, and hence have been using our spare capacity to offset the naturally declining production at our wells in operation. Given a favorable market environment, we decided to adjust our drilling plans upwards with a view to cut usage of spare capacity to offset natural decline at our operating wells.

Slide 12. Upstream EBITDA

In the first quarter, the upstream segment delivered very strong financial results on the back of rising oil prices and higher production volumes. Its EBITDA added 34% quarter-on-quarter, which was supported by the tax lag effect and lower per unit lifting costs. The further support was provided by negative one-off factors in the fourth quarter. The growth was however constrained by negative effects from tax incentives being cancelled for high-viscosity oil projects. Abroad the EBITDA was also positively affected by higher capital expenditures at the West Qurna-2 project in Iraq.

Despite external production limitations and the cancellation of tax incentives for high-viscosity oil projects, the Russian upstream EBITDA grew by 2.5 times year-on-year, driven by rising oil prices, ruble depreciation and the positive tax lag effect.

Slide 13. North Caspian

Now let us move on to our priority projects.

We commissioned two horizontal production wells with high oil flow rates in January, which helped us keep production at the Vladimir Filanovsky and Yuri Korchagin fields in the Caspian Sea at the project level in the first quarter. Their combined oil and condensate production reached 1.9 million tonnes, up 1.6% year-on-year.

As part of the Valery Grayfer field development, shipyards continue to build platforms. As at the end of the first quarter, the fixed ice-resistant platform was 73% complete, and the living platform was 84% complete.

We continue exploration in the Caspian region. In the first quarter, we successfully drilled an exploration well at the Titonskaya structure, with a hydrocarbon flow produced and work underway to appraise well testing results. In the fourth quarter of 2021, we plan to start drilling the second well to more precisely estimate reserves discovered so far.

As for the Baltic Sea shelf, we made our final investment decision on the D33 field in April. I would like to emphasize that we streamlined our development systems to increase the field's design capacity from 1.5 to 1.8 million tonnes of oil per year. Currently, we are finalizing tender procedures to select suppliers and contractors for the field construction facilities and drilling operations. The field is scheduled for commissioning already in 2024.

Slide 14. Hard-to-recover: high-viscosity oil

Thanks to investments made in 2020, the average daily output of high-viscosity oil in Timan-Pechora increased by 5.4% year-on-year reaching 1.3 million tonnes in absolute terms.

We now focus on completing the current phases of development. Before we invest in further production ramp-up from these fields, we need decisions on tax incentives going forward. As a reminder, the former tax incentives were cancelled from 1 January 2021.

Slide 15. Hard-to-recover: low permeability

Our major low permeability fields in West Siberia increased average daily production by 18% year-on-year. In the first quarter, we commissioned 30 production wells at these fields.

We are working to improve technologies and cut costs. In particular, we managed to increase the drilling speed for horizontal wells at the Imilorskoye field by 20% year-on-year, further reducing the per unit drilling costs by 4%.

Slide 16. Gas projects in Uzbekistan

As we discussed earlier, we fully recovered gas production in Uzbekistan by late 2020, even exceeding the designed capacity in the first quarter. The average daily output went up by 31% year-on-year.

Production is expected to decline in the second quarter due to maintenance works. Provided the market environment is stable, in 2021 our production at the Uzbek fields is expected to reach up to 14 billion cubic meters of gas (based on a 100% share).

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

Alexander Palivoda (Downstream)

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

Slide 18. Refining profitability

In the first quarter, the refining market environment improved dramatically compared to the previous quarter. In Europe, the benchmark margin rose by almost 70% quarter-on-quarter, driven by an increase in the crack spreads of light products, primarily gasoline, as a result of declining global inventories and US refining volumes. Growing margins also reflected a wider Brent/Urals spread, which can be attributed to weaker demand for heavy crude oils amid better economics of light products. Nevertheless, benchmark margins in Europe are still far below pre-pandemic levels, as crack spreads for mid-distillates remain at multi-year lows due to weak demand for jet fuel.

The Russian benchmark refining margin not only climbed from zero mark demonstrated in the fourth quarter of 2020 into positive territory, but also exceeded the level of the first quarter of 2020. Other growth drivers alongside the increase in benchmark margins in Europe are higher export duty differentials and the damper for motor fuels which returned to positive figures in the first quarter.

I would like to highlight that in the second quarter we see further recovery of refining margins in both Europe and Russia.

Slide 19. Key operating results

Both domestic and overseas refineries increased their throughput by 12% quarter-on-quarter on the back of a better market environment and scheduled maintenance in the fourth quarter of last year. Russian refineries saw a 6% quarter-on-quarter increase in utilization primarily due to the completion of the scheduled maintenance at the Perm Refinery in the fourth quarter of 2020, as well as owing to additional utilization of Nizhny Novgorod and Ukhta refineries. At European refineries, utilization grew more significantly – by 30% quarter-on-quarter, mainly on the back of the scheduled maintenance at the ISAB plant in Italy in the fourth quarter.

In the second quarter of 2021, refinery utilization continued an upward trend.

The increase was coupled with improvements in product slate. Compared to the fourth quarter of 2020, light product yield increased, while the yield of high sulfur fuel oil declined.

Slide 20. Priority sales channels

Priority sales channels, which serve as a good litmus test for demand, also demonstrated growth.

Motor fuel sales at our filling stations continued to recover. In the first quarter, sales volumes were a mere 2% down year-on-year, and in the second quarter, they keep going up.

Jet fuel sales in April and May have also been on the rise compared to the first quarter. At the same time, the demand for jet fuel remains low, with April and May sales approximately 40% below the level of 2019.

Slide 21. Allocation of Russian oil

Higher refining margins seen in Russia in the first quarter made oil supplies to refineries much more attractive, which resulted in a more than 8% drop in crude oil exports quarter-on-quarter. A decrease in the exports of oil subject to a lower-rate export duty was due to cancelled tax incentives for high-viscosity oil.

Slide 22. Downstream EBITDA

Downstream EBITDA grew several fold both quarter-on-quarter and year-on-year.

The biggest contributor was the downstream segment outside of Russia where growth was supported mostly by the accounting specifics of hedging operations in international trading. This impact was further strengthened by the closure of the most of positions opened as part of our contango strategy in 2020. Other growth drivers of downstream EBITDA outside of Russia included a positive inventory effect and stronger refining margins and volumes at our European refineries. As a reminder, the first quarter of 2020 saw a negative downstream EBITDA outside of Russia mainly due to a negative inventory effect at European refineries and negative inventory revaluation on the back of plummeting hydrocarbon prices.

Downstream EBITDA in Russia rose by more than 1.5-fold quarter-on-quarter to 67 billion rubles driven mostly by stronger refining margins and volumes, a positive inventory effect at refineries, improved results of the petrochemical segment, and a seasonally stronger performance in power generation. The retail segment's weaker results were a headwind.

Downstream EBITDA in Russia grew by 8% year-on-year primarily as a result of a positive inventory effect at refineries, which, as you remember, was negative in the first quarter of 2020, as well as due to the petrochemical segment's stronger results. A decrease in refining margins and throughput volumes along with weaker retail sales of motor fuels offset the bulk of this growth.

Slide 23. Selective projects at Russian refineries

We keep implementing selective projects at our Russian refineries.

With respect to the delayed coker in Nizhny Novgorod, we are finishing the installation of core process equipment, while the installation of pipelines, equipment piping, cabling and wiring, and equipment insulation are underway. The project was more than 90% complete as at the end of the first quarter. The facility launch is planned for the autumn of this year.

I would also like to note that in March 2021 we signed an agreement with the Russian Ministry of Energy in regards to this project. Effective until 2030, the agreement provides for an investment increment to reverse excise tax on petroleum feedstock, which helps materially improve the project economics.

The Nizhny Novgorod refinery is also completing the construction of the izomerization unit scheduled for launch already next month. Start-up operations are now ongoing.

Let me also remind you that following the launch of the de-asphalting unit at the Volgograd refinery in January 2021, we increased the output of lubricants with improved features.

Alexander Palivoda (Finance)

Now let me briefly outline our financial performance in the first quarter.

Slide 25. Revenue

Higher oil prices were the key factor driving revenue up by 23% quarter-on-quarter. Other factors contributing to the revenue growth included higher hydrocarbon production and petroleum product output, and increased oil trading volumes. Revenue was also supported by a decrease in commercial inventories of crude oil by about 900 thousand tonnes in the first quarter as we closed a large portion of positions as part of the contango strategy.

Negative factors included lower trading volumes of petroleum products, a seasonal decline in retail sales, and the ruble appreciation.

Slide 26. EBITDA

EBITDA was up by 66% quarter-on-quarter to 314 billion rubles, exceeding the level of the last pre-pandemic fourth quarter of 2019 featured with higher production and refining volumes.

The key driver of EBITDA growth quarter-on-quarter was the Downstream segment, which saw its EBITDA rise by more than 2.5 times.

We have already spoken in detail on EBITDA drivers for each segment. I would also like to note that amid the improving price environment, a significant positive impact of EBITDA came from carrying over drivers, including the positive inventory effect and the accounting specifics of hedging operations in international trading.

Slide 27. Profit

In the first quarter of 2021, the Company posted net profit of 157 billion rubles. The quarter-on-quarter growth was supported primarily by stronger EBITDA. It was also driven by one-off factors observed in the fourth quarter of 2020, which included low depreciation due to the effect of an increase in proved reserves at some fields, as well as an impairment loss.

Slide 28. Cash flow

Free cash flow in the first quarter almost doubled quarter-on-quarter to 164 billion rubles. In addition to a higher operating cash flow driven by improvements in the market environment, free cash flow was also supported by a decrease in capital expenditures.

I would like to underline that capital expenditures in the first quarter are not representative because of a number of carrying over factors, such as seasonality and the schedule of payments to suppliers and contractors. In addition, investment activities in the first quarter were in line with the 2021 budget, which is based on a conservative oil price at about 40 US dollars per barrel.

Slide 29. 2021 outlook

At the end of our presentation today, let me talk briefly about our plans for 2021.

We expect our hydrocarbon production to grow by around 2% excluding the West Qurna-2 project assuming that the current limitations on oil production remain unchanged.

Refining volumes may vary depending on the market environment and we will stay flexible in managing our refining fleet utilization. In 2021, we intend to launch two new units at the Nizhny Novgorod refinery in addition to the facility commissioned at our Volgograd refinery in January.

As I mentioned earlier, capital expenditures in the first quarter are not representative. During the previous call, we said that our annual investment plan could be adjusted upwards assuming a favorable market environment. We made such a decision and now expect the investments in the current year, excluding the West Qurna-2 project, to be in the range of 460–490 billion rubles.

Slide 30. LUKOIL – a unique investment proposition in Oil&Gas

I would like to once again highlight the strength of LUKOIL's investment story.

The Company is equipped with a range of competitive advantages and is able to build shareholder value in any market environment. At the same time, we have witnessed some underperformance of LUKOIL stock in the recent past and we believe that the Company is largely undervalued. This is further evidenced by our strong first quarter results, which exceeded market expectations.

Thank you.