PJSC LUKOIL

2Q 2018 Financial Results Conference Call and Webcast Transcript

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Speakers:

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Pavel Zhdanov, VP for Corporate Development and Investor Relations

Alexander Palivoda, Head of IR

<u>Alexander Palivoda</u>

Slide 2. Forward looking statements

Good afternoon ladies and gentlemen and it's our pleasure to welcome you today on LUKOIL's second quarter and first half 2018 financial results conference call and web-cast. Thank you for joining us. On today's call we have our Chief Financial Officer, Mr. Alexander Matytsyn; VP for Corporate Development and Investor Relations, Mr. Pavel Zhdanov; VP for Economics and Planning, Mr. Gennady Fedotov; Chief Accountant, Mr. Viacheslav Verkhov; as well as our colleagues from the Accounting Team.

Mr. Matytsyn will start today's call with a general overview of the results followed by a more detailed discussion by Pavel Zhdanov and myself. We will then have a Q&A session.

I have to draw your attention to our cautionary statement. Some of our comments during this call constitute "forward looking statements" that involve risks, uncertainties and other factors which may cause our actual results to be materially different from what's expressed or implied by such forward looking statements.

Now, I would like to hand over to our Chief Financial Officer, Mr. Alexander Matytsyn.

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Alexander Matytsyn

Slide 3. Operating results

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

I'm very pleased to report that we continue to deliver strong operational results.

Our total hydrocarbon production increased by more than 3% year-on-year. This is well above our initial expectations due to outperformance at our international gas projects. The share of high margins barrels continued to grow and exceeded 25% of our total production. This was driven by the excellent execution of our upstream projects both onshore and offshore.

Following the easing of OPEC+ production limitations starting in July, we've managed to rapidly increase our crude oil production in Russia to the new level. This development further increases our expectations on our year-on-year production dynamics.

Our European refineries drove operational performance of our refining business in the second quarter of this year as we did our best to capture the benefits of rising European refining margins. At the same time in Russia we were managing our throughput volumes to address less favorable macro conditions for domestic downstream business. Overall for the Company, we delivered over 70% light product yield for the second quarter of 2018 which is in line with our expectations.

Slide 4. Macro environment

Operational excellence was reinforced by favorable macro environment that enabled us to deliver outstanding financial results.

Slide 5. Financial results

We achieved more than half a trillion rubles EBITDA in the first half of 2018. This is one third higher than in the corresponding period of last year. Almost 300 billion rubles of EBITDA was generated in the second quarter alone. This is an all-time high. Such a performance was mainly driven by our upstream business in Russia on the back of growing oil prices, weakening ruble and improved production structure.

Our downstream business also generated solid EBITDA despite domestic prices were lagging international netbacks. The key growth factor was the inventory effect driven by rising oil prices.

Our free cash flow generation remains very strong. We've more than doubled the free cash flow to 183 billion rubles in the first half of this year, or to over 3 billion US dollars. Before changes in working capital the number was even higher at 244 billion rubles, or over 4 billion US dollars.

Slide 6. Growing free cash flow

In the second quarter alone we generated more than 150 billion rubles of adjusted free cash flow. This is again an all-time high. Free cash flow generation of all of the business segments was strong, but Russian upstream was the main contributor.

As mentioned, oil price growth and weaker ruble during the quarter were the main support for such a performance. And this impact was amplified by our diligent project execution of high-margin projects that are inherently more sensitive to the oil price growth. Our cost control both on capex and opex side also supported such results.

Slide 7. Progressive dividend policy

We continue delivering on our unique progressive dividend policy. At the recent AGM the total dividend for 2017 was approved in the amount of 215 rubles per share. The year-on-year DPS growth is 10%, which is four times higher than the inflation rate. This is our twentieth year in a row when we deliver growing dividend. We maintain our leadership among the industry peers based on the 2017 dividend yield.

Slide 8. Balanced distribution of additional cash flows to shareholders

Now about implementation of our strategic initiatives which we announced earlier this year.

First of all, as you know last week the EGM supported the cancellation of 100 million shares or almost 12% of issued share capital. The plan is for LUKOIL Securities, which currently holds those 100 million treasury shares, to offer them as part of this process. Given the timeline prescribed by applicable legislation, the cancellation will be finalized in early November this year. Following the cancellation, the share capital of LUKOIL will be reduced to 750 million shares.

We also reported today that we start our 3 billion US dollar share buyback program in line with our capital allocation principles, whereby a half of the incremental free cash flow above $50 oil price is reinvested and the other half is distributed to shareholders in the form of share buybacks. We've set-up all the necessary infrastructure, selected the brokers and now are ready to start the purchases.

Our progressive dividend policy coupled with the share buyback program offer one of the best shareholder capital distribution policies in the industry, which should definitely be reflected in LUKOIL's valuation.

Before passing the word to Pavel, I'd like to mention several important decisions recently made by the Russian government in relation to the oil and gas tax system.

The first decision is to gradually complete the tax maneuver. The changes were designed with the neutral impact on our business and to keep all the incentives for the upstream and downstream. But there are still some open questions regarding the domestic market pricing, which we expect to be resolved in the nearest future. The decision on the tax maneuver and the way it will be implemented evidence the stability of tax regime in Russia and support our confidence in delivery of our projects both in the upstream and downstream.

In addition to the decision on the tax maneuver, the profit based tax regime was introduced. It represents a major fundamental step in the evolution of the Russian tax system and will be implemented in a pilot mode starting 2019. For us this opens up new reinvestment opportunities at our brownfields that will further support our long-term production profile.

With that, I would like to pass the word to Pavel.

Pavel Zhdanov

Thank you Alexander, and good afternoon ladies and gentlemen.

Slide 10. Key operating results

Our total daily hydrocarbon production for the first half of 2018 excluding West Qurna-2 project increased by more than 3% year-on-year or more than 70,000 barrels of incremental daily output largely driven by major progress at our gas projects in Uzbekistan. The growth is clearly well ahead of our initial 1-2% guidance for the year.

Our daily crude oil production in Russia was flat since May 2017 because of the OPEC+ agreement and we managed to rapidly increase production by approximately 2% or more than 30,000 barrels per day since July 1, 2018, fully in line with the higher limits agreed by OPEC+ earlier in June. Most of the ramp up occurred in July, much faster than we initially expected due to the preparatory works conducted in the second quarter, as well as favorable summer weather conditions.

This production increase is another factor, which enables us to increase our full year production growth guidance to 3%.

Importantly, because the recent ramp up of our crude oil production in Russia was coming mainly from the brownfields, it means deceleration of production decline rates at those fields. Our production at the brownfields in August was even flat year-on-year compared to more than 4% decline in the first half of last year.

In line with our strategy, production from high-margin projects in the first half of this year increased by impressive 30% year-on-year to 25% of total hydrocarbon production, which is 6 percentage points higher compared to the first half of 2017. We continue to be right on track to reach our strategic targets in this respect.

As for our initiatives on improving efficiency and reducing costs, we delivered very good results in line with our mid-term and strategic targets. Among the most important achievements was a year-on-year decline in our lifting costs in Russia in real terms. We also posted a 9% reduction in nominal terms in a per-meter drilling costs for horizontal onshore wells, which was achieved through higher drilling speeds. Our average per-meter drilling costs in Russia were reduced by 3% year-on-year on a comparable drilling structure. We continued to drill in a test mode the horizontal wells with the simplified design, which we think may become a substantial factor for further efficiency gains. One of the most recent wells was drilled in less than 9 days, 2.5 times faster than standard horizontal well on average.

As the Russian government approved the profit based tax pilot project, we moved on with accelerating works at our mature fields that will be subject to this new tax regime. Its estimated impact is quite substantial. It will enable us to rejuvenate the brownfields as we expect to double the production profile from these fields on a 10 year horizon compared to the production profile under the current tax regime. This is a great new reinvestment opportunity for us, which broadens our portfolio of growth projects. We will accelerate investments into these fields.

Slide 11. Price and tax environment

Moving now to the macro environment.

In the first half of 2018 it was very supportive for the results of our upstream business with 37% higher Urals price year-on-year and 2% weaker ruble.

Net oil price in ruble terms hit a historical record of 17 hundred rubles per barrel in the second quarter driven by a combination of ruble devaluation and a significant export duty lag effect on the back of growing oil prices.

Slide 12. Upstream EBITDA

Supportive macro, production growth, bigger share of high-margin barrels and stringent costs control resulted in record EBITDA in our upstream business, which increased by more than 70% year-on-year to 412 billion rubles for the first six months of 2018 with 240 billion rubles generated in the second quarter alone. In absolute terms most of EBITDA growth was driven by our upstream assets in Russia. The contribution of our international upstream was also substantial driven by the growing oil and gas prices and production ramp-up in Uzbekistan.

Slide 13. Filanovsky field

Let me now move to the detailed project discussion.

At Filanosky field we launched the third well at the field's second development stage, and it is the eleventh well drilled at the field since the start of its development. The new well has a bilateral horizontal smart design and completion. Its initial daily flow rate exceeds 3.2 thousand tonnes or 25 thousand barrels of oil.

Upon the launch of the well we reached sustainable daily plateau production level at the field equivalent to 6 million tons on annualized basis. It took us less than 2 years to ramp up the field to full capacity, which is a great achievement assuming the high complexity of the project. Further development of the field aims at sustaining the production plateau. We utilize an integrated model to achieve the most efficient field management.

We progressed on schedule with the third field development stage. Construction works were completed on the substructure of the wellhead platform. We towed the substructure to the installation point and are now finalizing the installation works in the sea. The top side construction completion rate is more than 65% and we plan to proceed with its towing and installation next year.

At Korchagin field in July we launched the first well from the second platform. The length of the horizontal well exceeds 5 kilometers. It is equipped with high-tech multi-position inflow control valves, which enable to maximize the well's production potential. The initial flow rate of the well is 500 tons or almost 4 thousand barrels per day.

We also completed a production well and a sidetrack as part of additional drilling program at the field's first development stage. All this will help to achieve a gradual production growth at the field.

Slide 14. Rakushechnoe field

We took Final Investment Decision on Rakushechnoye field. This is an offshore field located in the close proximity to Filanovsky field in the Caspian Sea. Commercial production at the field is scheduled to start in 2023. The field's production plateau level is estimated at 1.2 million tonnes per year.

The field will be developed by approximately 20 wells including 13 production wells from the fixed ice-resistant platform and it will use the existing infrastructure of Filanovsky field for treatment and transportation of crude oil. This will result in significant synergies and cost savings on field development.

Capital expenditures before the start of commercial production are estimated at approximately 1 billion US dollars. The field is subject to the same tax regime as the Filanovsky field, thus it represents another source of high margin barrels for our production profile.

Before moving to the onshore fields a few words on the Baltic Sea. In 2017 we took final investment decision on D41 field discovered in 2015. As the field is located in the close proximity to the coast, it will be developed by extended reach horizontal wells using the onshore drilling rig. In August we started drilling the first well with the target depth of more than 8 kilometers.

Slide 15. Hard-to-recover: heavy crude oil

Now moving onshore.

Our heavy crude oil production in Timan-Pechora for six months of this year increased by 35% year-on-year. The growth at Yaregskoye field was even more impressive – the field produced 77% more heavy crude oil year-on-year. New steam generation facilities were launched both at Yaregskoe and Usinskoye fields, which will facilitate further production growth.

As a part of our drilling cost optimization program we have drilled the first production well of simplified design at Usinskoe field, which enabled us to achieve approximately 20% cost reduction compared to standard wells. This is a remarkable result of implementing new technological solutions in order to unlock the full potential of the Company’s extensive hard-to-recover resource base.

Slide 16. Hard-to-recover: low permeability

Our crude oil production from reservoirs with low permeability continues to grow. At Vinogradov field during the first half of 2018 we successfully drilled and commissioned 6 horizontal wells, which resulted in production growth of 11% year-on-year. We utilize the most advanced drilling and completion techniques at the field. As an example, 2 wells were completed with 16 multistage frac ports on 15 hundred meters length horizontal sections. The development of the field continues in the pilot mode, but once moved to the commercial development stage, the field can add more than 30 thousand barrels per day to our overall production.

We also continue with production drilling at Imilorskoe field in order to ramp-up production to a plateau level of approximately 50 thousand barrels per day. We launched 32 oil production wells at the field since the beginning of the year. And we are well on track to deliver on that target, as already in the second quarter of 2018 we achieved a significant 12% quarter-on-quarter production growth.

Slide 17. Gas projects in Uzbekistan

We continue a rapid ramp up of our gas projects in Uzbekistan. Our production from the region doubled year-on-year driven by the launch of all of the gas treatment and processing facilities at Kandym and Gissar.

The final second train of the Kandym gas processing complex was launched in April, eight months ahead of schedule. As of now the Gas Processing Complex is running at around 75% of its designed capacity or an equivalent of around 6 billion cubic meters per year. We are finalizing the commissioning works on gas gathering systems on Kandym field and expect achieving full utilization of Gas Processing Complex in the third quarter of this year, well ahead of initial schedule.

With the launch of the second train of the Kandym gas processing complex we completed the intensive capital investment phase. Going forward our investments in Kandym and Gissar will be limited mainly to maintenance capex. So, I’m very glad to state that the second quarter of 2018 was the first quarter of positive free cash flow for us in Uzbekistan.

On the international gas production side, I would also like to say a couple of words about the Shah Deniz project in Azerbaijan, where we own a 10% stake. As was announced in the beginning of July by the operator of the project, Shah Deniz phase 2 was launched and is expected to produce at plateau 16 billion cubic meters of gas per year incrementally to current Shah Deniz production. This will bring it up to 26 billion cubic meters of gas per year and up to 120,000 barrels of condensate a day. This is another addition to our international hydrocarbon production profile.

In West Qurna-2 project in Iraq we made a lot of progress with preparing for further production growth at the field. In April we signed new field development plan which provides for increasing production to a plateau of 800 thousand barrels per day by 2025, which means doubling production from current level. The expansion will be financed from the current production and we don’t expect our financial exposure to deviate materially from approximately half a billion dollars. As you can clearly see in our MD&A in the second quarter of 2018 our financial exposure fell below 400 million US dollars.

With that, I would like to pass the floor to Alexander Palivoda.

Alexander Palivoda

Thank you, Pavel! I'll continue with our Downstream operations.

Slide 19. Price environment

Benchmark European refining margins continued to recover in the second quarter post the lows of January 2018 driven by seasonally higher demand for motor fuels and especially for diesel.

In Russia on the opposite, the benchmark refining margins in dollar terms were lower quarter-on-quarter because domestic prices were lagging the export netbacks. This negative impact was less pronounced in ruble terms because of ruble devaluation. The retail margins were also under pressure because retail prices were lagging wholesale benchmarks. From this perspective the decision to decrease excise taxes made by the Russian government in June was very timely as it partially muted the effect of prevailing macro conditions.

In general, the macro environment for our downstream business in Russia was not supportive in the second quarter of 2018 apart from positive inventory effect which was a result of growing price trend. However we benefited from the high quality output structure at our refineries, which to a big extent offset the negative impact of lower benchmark margins, in other words, our margins declined less significantly than the benchmark margins.

Slide 20. Key operating results

In Russia, our daily refinery throughput volumes were slightly down quarter-on-quarter as we optimized the workload of the Ukhta and Nizhniy Novgorod refineries to maximize their financial performance amid weak refining margins. This was partially offset by higher utilization rates at our refinery in Volgograd.

The year-on-year growth of refinery throughput volumes in Russia by approximately 2% was mainly driven by maintenance works in the first half of last year.

We continued to increase the volume of cross supplies of semi-finished products between refineries, which is an efficient mechanism to incrementally enhance our consolidated product basket. Such volumes increased by 3% quarter-on-quarter and 9% year-on-year.

Slight reduction in light product yield quarter-on-quarter was a result of maintenance works at the hydrocracking facility in Volgograd and hydrotreatment unit in Nizhny Novgorod. The resulting negative impact was partially offset by higher utilization of the delayed coker and catalytic cracking units in Perm.

On a year-on-year basis our light product yield increased on the back of higher utilization of the conversion facilities built as part of the recently completed major refinery upgrade program.

In Europe, throughput volumes and light product yield increased quarter-on-quarter following the completion of maintenance works in the first quarter of 2018 that allowed us to maximize the benefits of recovering refining margins. The year-on-year decline in throughput volumes and light product yield was also a result of maintenance works in the first quarter of 2018.

Regarding our new projects in the downstream - we rapidly progress with the delayed coker complex at Nizhniy Novgorod refinery, a project that will be the main contributor to a reduction in fuel oil output and an increase in light product yield in 2021. We finalized the contracting process, placed orders for all of the long-lead items such as furnace, coke drum, columns and reactors for hydrotreatment process etc. We are currently finalizing on-site preparations to start the construction works as soon as next month.

We also progress in line with our plans on the delivery of the isomerization unit at Nizhniy Novgorod refinery. We are currently at the stage of tender procedures to select the contractors. The unit is scheduled for launch in 2021 and will enable us to increase production of high-quality gasoline.

Slide 21. Premium sales channels

Our priority marketing channels continue to expand driven not only by the seasonal factors but also by our premium-quality product offering. We delivered 5% growth in retail sales volumes of our motor fuels year-on-year and achieved a much faster growth in profits from non-fuel goods and services, which increased year-on-year by 23% in Russia and 19% internationally. The latter represents a great progress in our strategy aimed at increasing the coverage of operating expenses of our retail network by profits from non-fuel sales.

As we've mentioned on a last call, in order to reduce our cost base in the retail business in Russia we started optimizing the management structure with an idea to reduce the number of entities from 8 to 4 and achieve a more centralized control over the network. We already finalized personnel transfers and progress with the migration of IT systems. We plan to complete the process by the end of this year and estimate a positive impact from this initiative on our cost base already in 2019.

We continue growing in the premium sales channels such as bunkering and aircraft refueling. Our bunker fuel sales volumes grew by 6% year-on-year. And we are also pleased to announce that early July the construction of a new aircraft refueling facility at Sheremetyevo airport in Moscow was complete. Its annual capacity is 1.2 million tonnes and it will enable us to maximize our margin by increasing the share of end-customer sales.

Slide 22. Efficient allocation of Russian oil

Our integrated margin from processing crude oil at the refineries in Russia and distributing the products through our marketing channels contracted just slightly quarter-on-quarter despite the unsupportive macro environment. If not the strong performance in our premium sales channels, the decline would be more pronounced. Such a result is another illustration of the benefits of our vertically-integrated business model.

Slide 23. Downstream EBITDA

Our EBITDA in the downstream segment increased quarter-on-quarter by 1.5 times to 72 billion rubles. The biggest contributing factor to such an impressive growth was inventory effect on the back of growing hydrocarbon prices with additional support from better refining margins in Europe.

Our operations in Russia yielded EBITDA growth quarter-on-quarter despite weaker benchmark refining margins. Apart from the inventory effect EBITDA was supported by our high quality product slate, which makes us less sensitive to the volatility of the benchmark refining margins, as well as excellent performance of our petrochemical business and premium marketing channels apart from retail. In the retail, results were weaker because the prices at the pump were lagging the wholesale benchmarks. Seasonal contraction in power generation was another constraining factor.

Internationally, higher benchmark refining and retail margins, as well as higher throughput volumes supported EBITDA growth.

In the first six months of 2018 our downstream EBITDA decreased by 11% to 118 billion rubles. Such a dynamics was driven by the international part of the business primarily due to accounting specifics of hedging as part of our international trading operations, which resulted in substantial gains in the first half of 2017. Trading margin was also weaker than last year.

In Russia downstream EBITDA was relatively flat year-on-year as the impact of lower benchmark refining margin was fully offset by positive inventory effect and our better relative to benchmark product slate.

Slide 24. Finance

Now briefly on the quarter-on-quarter dynamics of our financial results.

Slide 25. Revenue

The increase in our revenue was driven by both price and volume. We increased crude oil trading volumes and released more than 1 million tonnes of crude oil from inventory. While petroleum products sales volume decreased by approximately 1 million tonnes due to inventory accumulation versus release in the first quarter.

There was some rebalancing between domestic and international sales of petroleum products, which was primarily driven by seasonality factor.

Slide 26. OPEX

We continue delivering on our mid-term cost optimization targets and executing stringent control over our cost base. Our lifting costs in Russia remained flat both quarter-on-quarter and year-on-year in nominal terms which means they declined in real terms.

Our lifting costs outside Russia naturally increased quarter-on-quarter driven by ruble depreciation and a decrease in our share in profit crude oil at the PSA projects due to higher hydrocarbon prices.

In the refining business our per unit operating expenses in Russia increased by 15% quarter-on-quarter due to seasonally higher consumption of additives for gasoline production. In Europe our per unit refining expenses remained flat in Euro terms, but increased in rubles due to ruble devaluation.

Slide 27. EBITDA

Among other substantial factors which impacted the quarter-on-quarter EBITDA dynamics were export duty lag effect in the upstream and substantial inventory effect in the downstream.

On the cost side, a moderate increase in transportation expenses was mainly due to ruble devaluation, while higher SG&A was primarily driven by salaries indexation and bonuses.

Slide 28. Profit

One of the main factors affecting quarter-on-quarter profit dynamics was the increase in foreign exchange gain by 24 billion rubles driven by ruble depreciation. This is a result of our positive net monetary position in foreign currency due to intragroup loans.

Our effective income tax rate increased from 17% in the first quarter to 21% in the second quarter mainly due to reassessment of deferred taxes related to our project in Uzbekistan. Excluding this factor, the effective tax rate would be around 19% in both quarters.

Our DD&A increased by 10 billion rubles. This increase was due to launching new production facilities in Uzbekistan, ruble devaluation, as well as inventory effect. Excluding the inventory effect DD&A growth would be approximately 40% lower in absolute terms.

Another factor behind profit dynamics was net impairment loss in the second quarter of 5 billion rubles related to our East Taimyr exploration project in East Siberia.

Slide 29. CAPEX

Our capital expenditures, that we disclose on a cash basis, decreased by 13% quarter-on-quarter to 106 billion rubles. The decrease was primarily due to payment schedule to our contractors and suppliers and natural decline of investments in Uzbekistan. On the accrued basis our capital expenditures increased quarter-on-quarter.

Distribution of the investments was in line with our long-term strategy, as we spent the majority of capex in the Russian upstream.

We continue investing in the Caspian Sea region into the new stages of Filanovsky and Korchagin fields. As Pavel mentioned earlier, we also started working on the development of the Rakushechnoye field. This resulted in higher quarter-on-quarter investments.

Slide 30. Cash flows

Lower quarter-on-quarter capex and high operating cash flow before changes in working capital enabled us to further increase our adjusted free cash flow to a new record level of 152 billion rubles, which is 65% higher quarter-on-quarter.

This free cash flow was mostly spent on 137 bln RUB of debt reduction and 20 bln RUB of building up incremental working capital in our core businesses on the back of higher oil prices.

Slide 31. Financial position

Our balance sheet remains very strong with total debt reduced by 11% quarter-on-quarter and net debt to EBITDA of 0.2 as at the end of quarter. In the second quarter we redeemed $1.5 billion of Eurobonds at maturity.

I would like to stop here and pass the word back to Pavel.

Pavel Zhdanov

Slide 32. 2018 Outlook

Thank you, Alexander.

Before opening the line for questions, I would like to update our 2018 outlook.

We now expect our hydrocarbon production to grow in the range of 3% driven by exceptional delivery on our gas projects in Uzbekistan, as well as higher liquids production in Russia.

Despite ruble devaluation we keep our planned investment program excluding service contracts at approximately 500 billion rubles. This is a result of implementing cost optimization measures.

We continue being focused on sustainable delivery of shareholder value through diligent execution of our projects and our long-term strategy. A combination of high-quality asset base, sustainable business model and shareholder friendly capital allocation policy make LUKOIL a unique investment proposition among our peers. We also believe that our most recent decisions and progress with cancelling the treasury shares and starting the buyback program should contribute to higher valuation of the Company.

Thank you for your attention!