

## Gazprom Neft

### Financial Results in Q2 2017 10 August 2017

#### Anna Sidorkina, Head of Investor Relations

Good afternoon, ladies and gentlemen! Allow me to open this conference call to present the Company's financial results in the second quarter and first half of 2017. I would also like to introduce our managers who will be taking part in today's conference call. Alexey Yankevich, CFO and Management Board member, will provide opening remarks and comment on financial aspects. Alexey Urusov, Head of the Economics and Corporate Planning Directorate, will tell you about developments in upstream during the reporting period. And developments in downstream will be covered by Vladimir Konstantinov, Head of the Downstream Economics and Investment Department. We will also be joined for the Q&A session by the Head of the Strategy Department, Sergey Vakulenko, and our colleagues from other relevant departments.

Before we start our presentation, which you can all see online on our website, I would like to remind you that the presentation and all comments to the presentation, and all the statements during today's conference call can contain and will contain forward-looking statements that relate to the financial position, performance and business of Gazprom Neft. All statements, other than assertions about past facts, are or should be treated as forward-looking statements. Such statements express expectations about the future based on the current situation and assumptions made by Company managers, and involve both known and unknown risks and uncertainties that may cause actual results, performance or events to differ materially from those, which are contained in or implied by the conference call today.

Thanks for your attention. I will now hand over to Alexey Yankevich.

#### Alexey Yankevich, Chief Financial Officer

Good afternoon, ladies and gentlemen. It is my pleasure to present the business results of Gazprom Neft in the first half of the year. We are pleased with the results: our operating profit increased by 21% y-o-y and net profit was 23% higher, which is very good performance. Certainly, there was some positive effect from the oil price rebound this year compared with last year, but most of the positive contribution was due to management action, as you will see from the slides analyzing operating profit.

The main points in the results are successful launch of new upstream projects and growth of production at those fields, and optimization of the sales structure and increase in the share of retail sales in downstream. Retail sales grew by 4.4% and hydrocarbon production increased by 5.3%, despite restrictions. We carried out a large repair programme at our refineries in the first half of the year, which held back profit growth to some extent. Without the repair programme this year, operating profit could have grown by almost 30%. But repairs are a scheduled event. We tried as far as possible to make them coincide with the period when demand slackens in order to minimize losses for the market and for us. Taking that into account, we view the y-o-y results as very good.

Looking at quarterly dynamics, conditions were tough, the second quarter was slightly worse than the first in price terms and there were the OPEC production restrictions, but we still managed to increase operating profit (by almost 9% q-o-q). The net profit trend is not indicative, because it is not determined by operating results, but by exchange rate differences, which worked in different directions in the two quarters. There was a positive difference in the first quarter and a negative one in the second, and the effect of the minus after plus was so strong that the operating result couldn't make up for it. In general, though, the half-year net profit figure suits us and it represents an advance on the previous year.

I will now hand over to my colleagues. The first speaker will be Alexey Urusov, Head of Economics at the Company, who will talk about results in upstream. And then, as usual, you will hear a presentation from Vladimir Konstantinov on downstream. Here is Alexey.

## **Alexey Urusov, Head of Economics and Corporate Planning**

A lot happened in upstream in the first half of 2017. Firstly, on 29 June 2017, our Company acquired a 25% stake in Evrotek-Yugra and the right to increase the stake to 50%. Our company and Repsol are joint operators of the company on parity basis. Evrotek-Yugra will carry out geological exploration in Kondinsky district, which is in the south-western part of Khanty-Mansi Autonomous Okrug. In the Kuyumba project we completed engineering work for connection to the Transneft system and signed an act on technical connection, and commercial oil shipments started on 1 July 2017. In the Badra project, the first section of the gas plant was launched and an export gas pipeline was put into operation in June. Pumping of saleable dry gas from Badra began at the end of June (on 29 June), and the Iraqi power plant at Al-Zubaidiyah started taking Badra gas on 2 July. The gas production complex is the most modern in Iraq; it will boost electricity generating and play an important role in providing power supply to several provinces of Iraq. Commercial shipments of oil are going ahead according to the schedule, which was agreed with the other party. In the Kurdistan project drilling of the Sarkala-2 well started at the end of June and we plan to complete drilling in early 2018. And in April this year, a Russian Ministry of Energy working group signed a protocol, which gives the status of a "national project" to Gazprom Neft's study work on the Bazhenov suite.

Oil production rose by 5.6% q-o-q, and you can see that Novoport, which is our new, super-large project, made the biggest contribution along with the Prirazlomnoye and Messoyakha projects. The negative oil production trends at mature fields in West Siberia is due to two factors: natural depletion of the fields, and implementation of the recommendations from the Ministry of Energy to limit production.

Let's move on to operating expenses. Zero change of operating expenses is down to two factors: firstly, it is caused by growth of unit costs at our mature fields, as a result of production decline, and secondly, it is the scale effect from growth of production at our new large projects.

Things that happened on April 20 had major impact on our resource base: we obtained a license for geological study, exploration and production of hydrocarbons at the Samburgskiy subsoil area from Gazprom-Dobycha Yamburg and, on the same day, we obtained a license for the same activities at the Severo-Samburgskiy area from Gazprom-Dobycha Urengoy. Also, as you know, on January 16 this year we obtained a license for geological exploration, exploration and production of hydrocarbons at the Ayashskiy area (part of the Sakhalin project) and we started construction of the first prospecting and evaluation well at that area on June 17. We plan to finish the work this autumn.

We have two major projects for maximizing use of existing infrastructure at our mature fields. First, there is a remote group of fields, the OGM project, with potential of 40 million tons, which our subsidiary Gazpromneft-Noyabrskneftegaz is handling, and, as you can see on slide 10, drilling and seismic work have been successfully completed. The second major project, Southern Hub, with potential of 51 million tons, belongs to our SPD joint venture. Exploration wells have been drilled and gave daily flows of 556 tons.

We are also working on future projects for development of the Bazhenov suite. As I said, on 26 April this year the Russian Ministry of Energy approved the application and gave it national-project status under the title "Creation of a domestic technology and high-tech equipment complex for developing reserves in the Bazhenov suite". As part of this national project, we will design and apply technologies for prospecting oil- and gas-bearing Bazhenov deposits using Russian-made seismic, magnetic and gravity prospecting methods, specialized core studies, and geological and hydrodynamic reservoir modelling.

I'll now hand you over to Vladimir Konstantinov.

## **Vladimir Konstantinov, Head of Economics and Investment (Downstream)**

Good evening, ladies and gentlemen! As usual, I will update you on downstream, starting with price trends and their impact on the economic efficiency of refining. The price of oil in the second quarter fell from USD 52.6 per barrel in April to USD 46.5 in June. Given our production and sales structure, this was bound to impact positively on refining efficiency. The price factor was compounded by change in the sales structure, and as a result refining netback in the second quarter of 2017 was substantially higher than in the first quarter. The netback trend was also affected by the ratio of repair and non-repair periods. In the first quarter large-scale repairs continued through almost the whole period from January to March, while in the second quarter

they only lasted about one and a half months. So we reached refining margin of USD 8-10 per barrel in June, and the average margin for the quarter fluctuated at USD 5-6 per barrel.

Looking at our use of crude, you can see two major changes compared with the first half of 2016. Crude sales increased by 80%, but there was a 10% reduction in volume supplied for refining. These changes are related. Of course, part of the increase in export sales is a consequence of the refining reduction, but the main factor was an increase in oil production, mainly due to Arctic projects. The total increase in crude supply was about 2 million tons, while oil exports rose by about 4.4 million tons.

The next slide shows refining volumes. As I just said, volumes were down by almost 10% y-o-y. The decline was mainly caused by large-scale repair and modernization work at the Moscow Refinery. Refining in Moscow in the first half of this year was almost 30% lower than in the first half of 2016. A slight decrease in refining at Omsk was also due to the difference in repair schedules. YANOS showed a slight volume increase.

As regards technical efficiency, refining depth increased by 0.5%. This is the result of many factors, including repair periods and changes in the ratio of dark product output (due to change in the methodology for ratio calculation). For example, refining reduction at Omsk and YANOS was a result of the overall structure of petroleum product production, but significant increase in refining depth at Moscow was due to change in the structure of dark products. The fall in production of light products at the Moscow Refinery calls for explanation. It is due to two factors, which are the quality of crude (reduction of light crude inputs) and the repair work that I already described.

Going on to sales. As usual in the past few years we compare trends in retail sales of petrol and diesel fuel in Russia as a whole and retail sales by Gazprom Neft. In the first quarter, as in past years, we were ahead of the market by these indicators. Retail sales of gasoline in Russia as a whole increased by 0.6%, while the increase for our Company was 5%, and the respective figures for diesel were 1% and 13%. The figures reflect work we have carried out to improve our filling station network, and unit sales per station are still growing. They increased by 4% in the first half of 2017 compared to the first half of 2016 to reach about 19 tons per day per filling station.

The trend in sales of other premium products (kerosene, bunker fuel, lubricants and bitumen) was also positive. Premium sales of kerosene increased by 7%, of lubricants by 16% and of bitumen by 5%. Some decline in premium bunkering sales is due to lack of logistical advantages on the bunkering market in the Far East. But overall decrease of sales in that region was largely offset by increase of sales in the Northwest. Our networks and the base infrastructure of our premium sales are improving, customer numbers are increasing, we are expanding the scale of our operations.

To conclude, let me tell you about a major event in our downstream business related to our efficiency programme. Our Efficiency Management Centre for Refining and Marketing started work in May 2017. The Centre uses advanced analytics tools to improve operating efficiency. The tools include predictive analytics and situation management throughout the value chain, construction of a single digital platform to manage value chain efficiency from crude supplies to refineries and sales of petroleum products to end-users. Main projects of the Centre include creating a daily integrated planning system for 60 days from receipt of raw materials to completion of the product, predictive management of asset quality, production and energy efficiency based on predictive modelling, and monitoring of product shipments to the consumer.

That's about it. We think that downstream performed well in the second quarter and in the first half of 2017. Thank you.

#### **Alexey Yankevich, Chief Financial Officer**

Colleagues, I will finish off our presentation as usual with a section on finance. I won't go into the half-year and quarterly financial trends again - I already talked about them earlier. Let's look at slide 20 which shows factors that influenced our financial results in this half-year and in the second quarter. Here you can see what I was talking about. Despite some positive contribution from the external environment and the recovery of oil prices, the role of internal factors and actions by management is much greater, and, as I said, it was held back by a one-off event – the repair programme, which we don't expect to be repeated next year. But for this factor, EBITDA would be much bigger and would have grown by almost 30%. As things are, we think that growth of 21% is very good.

The next slide shows quarter-on-quarter dynamics. Despite negative trends in the external environment (decline in oil prices, OPEC restrictions, the second quarter was more difficult from all points of view), we still managed to increase operating profit q-o-q thanks to qualitative improvement in the structure of upstream

production, increasing the share of output from greenfields, as well as steps to optimize the sales and production structure in downstream.

Look particularly at the slide with cash flows. There was a lot of discussion about when we will reach positive free cash flow and I promised you, our investors and analysts, that it would happen this year. This came true in the first half of the year – we already have quite solid positive free cash flow. In the first quarter it was positive, though small, close to zero, but for the half year it was already 27 billion rubles. We expect positive free cash flow for the whole year too.

Our investment trends are logical enough. Total investments fell because the most intensive stage of infrastructure construction at new fields was completed – the main reduction was in greenfield investment. But we also optimized drilling volumes at brownfields; drilling was reduced, so investments there declined too. The only growth was of investments in refining, which is logical, since, as I said, we started implementation of the second stage of modernization, in which we will increase refining depth. So refining projects are moving into a more active phase.

Finally, a few words about our financial policy and management of the debt portfolio. I would say that, despite the decline in prices since 2012 and 2013, we have been able to significantly reduce the debt ratio in our business, the ratio of debt to EBITDA, thanks to increase in operating results: we have brought the financial stability indicator back to what it was before the decline in oil prices. The debt /EBITDA ratio has been substantially reduced and has returned to the level, which we targeted when prices were high. If you remember, we said that we would aim for net debt to EBITDA no greater than 1.5x, and we have returned to this level – the figure in the the first half of the year was 1.37x. As regards structure of the debt portfolio, the ruble portion has increased, and so our portfolio has become more balanced, given that the market has become more volatile and a certain share of ruble liabilities makes the portfolio more stable. Unfortunately, the link to the sovereign rating puts a ceiling on our credit ratings, but I think that with our net debt to EBITDA level, we can certainly claim Investment Grade. At the moment, we only have Investment Grade from one international agency: the other two keep us tied to the sovereign ceiling. But, again, from the point of view of our country indicator, we are certainly already at Investment Grade. This is confirmed by the fact that we get new ratings from new agencies and they are very high. Specifically, we were among the first in the industry to get a credit rating from the Russian analytical agency, ACRA, The rating was AAA and we immediately put it to good use. You know that companies, which want to issue public instruments in rubles on the Russian stock exchange, now have to have appropriate credit ratings from Russian analytical agencies. We were among the first to get a credit rating, we took advantage of a good market window and placed ruble bonds in August to the value of 15 billion for seven years at a very low rate of 8.25. That is the lowest rates for a corporate issue since 2013. We made some good issues before that too, which shows that we are a good borrower. Generally, this gives us confidence that we will remain financially stable

I'll end our presentation there. Thanks for listening. We are ready to answer your questions.

## Q&A session

### Question №1

#### **Olga Danilenko, Prosperity**

Hello, and thanks very much for the presentation. I have three questions. The first question is: what caused the positive trend in working capital in the second quarter and do you expect the opposite trend in the third and fourth quarters of 2017? The second question is about capital investments: on slide 23 in the presentation you show a decrease of capex in the first half of 2017 relative to the previous year and, if I remember right, the whole-year forecast was USD 5.8 billion, if I'm not mistaken. Tell me, were the forecasts changed based on the trend in the first half of the year, the possibility of an agreement with OPEC, and what is to be expected in the second half of the year? And the third question is about oil production at the Prirazlomnoye field: there was a quite major drop in July. Could you explain the reasons for it and tell us something about what to expect in the future? Thank you!

#### **Alexey Yankevich, Chief Financial Officer**

Thanks for the questions.

I'll start with the working capital trend. Indeed, there are some one-off factors related to the fact that we had accumulated inventories due to repairs and they were spent in the second quarter as the high season began. We also carried out various optimization measures to reduce working capital, some of them in the second quarter, but I expect that we will be doing some things in the third and fourth quarters, respectively. I hope that the effect will not be one-off. Working capital is hard to predict, but I don't expect a sharp reverse of the trend. As for one-time events, it's probably important to note the accumulation of inventories. But, on the other hand, it's now the high season and we are unlikely to accumulate inventories in the third quarter; it's more likely that the level will remain stable. Probably, you can expect a reverse trend in the fourth quarter.

Going on to the next question about the capital investment forecast. You are probably used to the fact that, at many companies, particularly in our sector, first-half capex is often slightly lower than in the second half of the year. Weather conditions are harsh in the first quarter, and that was particularly true this year, so various works couldn't be carried out, but contracting is usually arranged so that most of the costs fall in the second half of the year. There will probably be a certain upward adjustment, but I wouldn't offer predictions yet that differ from our business plan – we are still focused on the business plan. I think it will be possible to give a more exact capex forecast after nine months, when we have results for the third quarter.

Alexey Urusov can answer the third question about the Prirazlomnoye field.

#### **Alexey Urusov, Head of the Economics and Corporate Planning Directorate**

As regards production at Prirazlomnoye, you have to realize that we have started a 90-day repair cycle, which will end in October this year. Such major repairs are carried out once every five years, and they have impact on the production trend.

#### **Question №2**

#### **Andrey Polishchuk, Raiffeisen**

Good afternoon! I have two questions. First on dividends: you expect positive free cash flow already this year, so are you considering a return to the practice of interim dividends, perhaps you are already discussing that? And the second question is about downstream capex: should we expect growth of capex at the start of the second stage of modernization to increase refining depth? Can you give any forecast? Thank you!

#### **Alexey Yankevich, Chief Financial Officer**

Andrey, thanks for the questions. We would like to take a conscious decision about interim dividends, without switching back afterwards. So our main focus is on stabilization of the oil market, we need to be sure that there won't be more price fluctuations like the one we saw last year in particular. As soon as we are sure that the market has stabilized (there are already promising signs, signs of stabilization, but we don't yet have a sufficiently long period of observation), as soon as we are convinced of this, we will make a final decision on interim dividends. No decision has been taken yet. Yes, options are being considered, but it will depend, I repeat again, on the degree of stabilization that we see in the oil market.

I will answer the question about downstream capex. Yes, refining capex this year will be higher than last year. I can't give a forecast for next year, because we haven't prepared the business plan yet. We are doing a lot of work at present on the portfolio for next year.

I'll add something on dividends: what is most important for us is the level of dividends per share and, of course, dividend yield. We see potential for increasing the level of dividends per share, we want to increase dividends per share. We announced very good dividends (10.68 rubles per share) for last year,. If you take dividends per share (10.68) and divide by the current share price, you get dividend yield above 5%. We view that as a good result. We look very good in comparison with our competitors, and we will stay focused on these indicators in order to be among the leaders. Thank you.

#### **Question №3**

#### **Pavel Kushnir, Deutsche Bank**

Good afternoon, thank you for the presentation. About sales costs: the company has shown excellent trends in the last two quarters, particularly in the first quarter when you cut costs by 25%; they were almost unchanged in the second quarter. Could you give a forecast of how sales costs will change to the end of the year? For example, can we expect bonus payments to management, which, as I understand, are included in

these costs. Perhaps you could mention some other factors that are part of this line in the accounts. Thank you.

**Alexey Yankevich, Chief Financial Officer**

Pavel, thanks for the question. This is work to optimize, to contain SGA: it's a task that was set for this year in the business plan. But you have to remember that our foreign company expenses made a positive contribution – these costs decreased in rubles because of strengthening of the ruble compared with last year. So, if there's no serious weakening of the ruble in the third and fourth quarters, this effect will continue.

As for bonuses, the principle is that bonuses for 2017 are paid next year. We have already paid everything for 2016, and we will determine remuneration for 2017 next year. So it's hard to say how much better the trend will be compared with last year. Certainly, we will set the reserve for bonuses at the end of the year, and that is done taking account of expected annual results, but I don't expect any major fluctuations. As for the SAR, we have some room for manoeuvre. If the share price doesn't grow drastically, we won't accrue additional costs this year. In general, I don't expect any sudden jumps.

**Question №4**

**Ron Smith, Citi**

I would like to come back to dividends. As far as I understand, you are saying that you plan to raise them and concentrate on yield. But can you be specific about how you decide on policy and what the future dividend policy will be, can you specify, say, the percentage increase? Some of your competitors do that – they set a specific level for yield per share or raise the overall level of percentage payments. You currently have 25%. Can we expect this level to be raised in the future? Thank you.

**Alexey Yankevich, Chief Financial Officer**

Thanks, Ron, for your question. I will say straight away that, for sure, there is only upside and no downside as regards paying a percentage of IFRS profits. The percentage certainly won't decline, and it will most likely grow. But, still, that is a matter for the shareholder; it is an important and meaningful decision, and it is in the competence of the board of directors. How fast we increase payments as a percentage of IFRS profit is for the shareholder to decide. I suppose that the percentage will increase in the medium term. That is what I expect, but it's a decision for the shareholder. What we as managers can have impact on is growth of dividends per share and we work for growth of net profit, which boosts the size of dividends.

**Question №5**

**Alexander Donskoy, VTB Capital**

Good afternoon! Thank you very much for the presentation. I have two questions. First, it was said during the presentation that the quality of crude inputs at the Moscow Refinery deteriorated, and my question is whether this is a local event or is there a fundamental reason, so that we can expect lower crude quality at the Refinery in the future? And the second question: other operating expenses almost doubled (from 2.6 billion to 5.3 billion rubles) in the second quarter of 2017 compared with the first quarter. I didn't see a breakdown in the accounts. Could you explain the reason. Thank you.

**Alexey Yankevich, Chief Financial Officer**

Thanks for the question, Alexander. Do I understand rightly that you mean other expenses as part of operating expenses?

**Alexander Donskoy, VTB Capital**

Yes, that's right .

**Alexey Yankevich, Chief Financial Officer**

The explanation is this (we will send you the breakdown): firstly, there was a change in work-in-progress (plus in the second quarter after minus in the first quarter), then also there was growth in cost of other sales, due to the fact that we provide certain services to our joint ventures, which aren't consolidated (they are accounted as equity investments). When we provide services to our joint ventures (equity investments), they are

accounted as external sales. They are mainly transport and warehousing services, which we provide to Megionneftegaz and Slavneft.

Vladimir Konstantinov will answer the second part of your question about deterioration of crude quality.

**Vladimir Konstantinov, Head of Economics and Investment (Downstream)**

Crude quality is difficult to predict, so it is hard to say whether it will remain at the same level or worsen or improve in coming quarters. We believe that worsening of crude quality at the Moscow Refinery is due to proportions of different oils from various fields fed into the Transneft system in the second quarter. We don't expect the drop in quality to be systematic. Thank you.

**Question №6**

**Ekaterina Smyk, Bank of America Merrill Lynch**

Good evening, thank you for the presentation. I have a question about the Bazhenov suite. A year ago you held a meeting, most of which was devoted to development of the Bazhenov suite, and you described some targets. Today's presentation is the first time you have mentioned the Bazhenov suite since then. Could you tell us what progress has been made in the year, whether you have changed your forecast production figures? As far as I remember, you talked about 2.5 million tons by 2025 and the most important condition was reduction in unit cost of drilling by almost half from 9-10,000 rubles per ton to 5000 rubles. Have you managed to achieve any of that reduction over the year. Thank you.

**Alexey Urusov, Head of Economics and Corporate Planning**

As we said earlier, development of the Bazhenov suite is a national project. The key focus is research work as part of the national project up to 2021, which calls for the creation of Russian technologies for the construction of horizontal wells with multi-stage fracturing, optimized for the extractive and geological conditions of the Bazhenov suite. We also need, as part of the research work, to find a cost-effective way of bringing light oil in shale rocks into development. So the goal we announced (production of about 2.5 million tons of oil by 2025), remains, but for the moment and until 2021 we will be carrying out research work together with our partners, which are listed on slide 11 in the presentation.

**Ekaterina Smyk, Bank of America Merrill Lynch**

Thanks a lot. I'll ask one more question on upstream, if I may. Under the OPEC + agreement, you are keeping production at levels lower than October, and, so far as I understand, this reduction has been obtained through lower production at your mature fields. If, say, this agreement ceases to operate after the first quarter of 2018, to what extent will it be economically expedient to return the production level at mature fields to the levels of October last year. And, if it is economically impractical, then what output do you forecast for next year if output at brownfields remains at current levels. Thank you.

**Alexey Yankevich, Chief Financial Officer**

Ekaterina, thank you very much for your question. I will answer briefly. Yes, it will be economically expedient to restore production levels, because now, since we acted with a short horizon and had data on the agreement in a fairly short period, we adjusted production without changing our capacities. So we have the capacities and we still have fixed costs there, so reinstating this production will make economic sense. But the business plan with exact figures is still in preparation, as I said earlier, so we will be able to give some data later on, closer to the end of the year.

**Ekaterina Smyk, Bank of America Merrill Lynch**

Thanks you very much.

**Question №7**

**Pavel Kushnir, Deutsche Bank**

I would like to ask about the current production level. In July production by Gazprom Neft grew by 6.7%, so far as I understand. The figures was largely the result of repairs to the platform (GPN Shelf), while production by NNG and Zapolyarneft increased quite strongly, and that growth covered the decline in production by GPN Shelf. I understand that there will be high levels of production in August-September, while the platform at the

Prirazlomnoye field is under repair. My question is, what will happen to the volumes at NNG and Zapolyarneft, when the platform at the Prirazlomnoye field comes back into operation? Thank you so much.

**Alexey Yankevich, Chief Financial Officer**

Pavel, thanks for the question. We are guided by a daily production quota, so, certainly, as I have already noted several times in our discussions, we try to maximize output at greenfields and, basically, use brownfields to ensure that we hit the production quota, since production at greenfields is economically more efficient for a number of reasons. But in this case, the opposite happened: a greenfield was under repair and it was a planned event, so we were able to lift the restriction for brownfields. When the repair is over, it is logical to suppose that brownfield production will decrease, because we will maximize production at greenfields, and the overall production level will remain steady within the limitations that we set ourselves. Thank you.

**Anna Sidorkina, Head of Investor Relations**

Ladies and gentlemen, this is Anna Sidorkina, Investor Relations. Thank you very much for joining our conference call. Many thanks to the managers who took part and answered all of your questions. If there are any further questions, we are happy to answer them online, so please send them in or call us. Thank you very much. All the best until next time.