

Gazprom Neft

Financial Results in Q3 2017 15 November 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 and operating results for the third quarter and nine months of 2017 under IFRS. Allow me also to introduce the participants of today's conference call. Alexey Yankevich, CFO and member of the Management Board, will give a presentation and comment on financial aspects. Alexey Urusov, Head of the Economics and Corporate Planning Directorate, will tell you about the work of the Upstream Division in the third quarter and nine months, and then Vladimir Konstantinov, Head of Economics and Investment in the Downstream Division, will talk about events during the reporting period in our refining and marketing unit. We will be joined by the Head of the Strategic Development Department, Sergey Vakulenko, and colleagues from relevant departments for the Q&A session.

Before starting the 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 made 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 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

Welcome, ladies and gentlemen! Today we bring you the results of work by Gazprom Neft in nine months of 2017. It would be no exaggeration to say that our results in the period set a new record. You will remember that we announced record results for the whole of 2016, when the Company showed net profit of 200 billion rubles. Now we are reporting net profit of about 190 billion rubles in nine months of 2017. That means that we will surpass the 200 billion record set last year. The headline trends show how impressive the results are: EBITDA in rubles increased by 23%, net profit increased by 28%. And the growth is even greater when we look at the same figures in dollars: EBITDA rose by 44% in dollars and net income in dollars was 1.5 times higher (growth of 50%). The external environment played a role, but in many respects the progress was due to the launch of major projects, growth of overall production and increase in the share of new assets in total production. Refining volumes were down, but that was planned, and we saw further growth of sales in the premium and retail segments. Our sales grew year-on-year, even though the market was roughly static. Throughput at our filling stations also increased. It was already among the best in the industry, and we managed to improve it – the growth was 4.5%. Certainly, the main factor was increase in production, by 6% compared to last year, but downstream also made a contribution.

Quarterly dynamics also look very positive: EBITDA grew by 20% and net profit increased by 58% (of course net profit includes foreign exchange differences, but most of the growth was due to improved operating results). Production volume increased by 4.3% and refining also increased, mainly due to the end of repair cycles. I would note that the growth of indicators year-on-year was constrained by scheduled factors, which we took into account for this year in advance, namely major repairs at our refineries as part of the four-year cycle and a suspension of work at Prirazlomnaya for repairs and reconstruction. Without those factors the growth rate could have been even greater. I will say something about that a bit later.

We are pleased with the results overall. Let's think back to what the Company was in 2005, when we declared that we wanted to double in size – increase production and grow by a factor of two. A lot of people didn't believe in us, a lot of investors said that the plans were too ambitious. Let me remind you that in 2005 EBITDA of the Company was USD 4.1 billion at approximately the same level of oil prices, and this year we came close to USD 9 billion. So we grew by more than two times in dollars and the growth in rubles is certainly much larger.

On that positive note, I'll hand over to my colleague Alexey Urusov, who will tell you about results in our Upstream Division.

Alexey Urusov, Head of the Economics and Corporate Planning Directorate

Good afternoon, colleagues. Let's start with the sixth slide. The title might be "Growth continues". We can see a 6% increase in 3Q 2017 to 3Q 2017. The main source of growth is our flagship Novoport project, where production increase was driven by launch of new production wells, commissioning of surface infrastructure and improvement of sea shipping logistics. Our second flagship is the Messoyakha project, where the average number of wells in operation increased to 18. The project was brought into full development in September 2016, so in 2017 we could see the effect of a whole year's work at full strength, and the growth trend was impressive. Growth at Prirazlomnoye was more modest, partly due to a scheduled three-month shutdown of the platform, but Prirazlomnoye still showed an increase of production. There was some decline in production at our mature fields, due firstly to OPEC quotas for reducing production, which we had to meet, and secondly to steps we took to obtain the best possible economic result in the framework of the OPEC requirements.

The seventh slide, for operating expenses, shows change of 0% in unit terms, but the structure of operating expenses is actually more complex. Firstly, we have an effect of scale from launch of our new fields, Novoport and Messoyakha, which reduces unit costs. We get the same economy effect in international projects, mainly Badra where we have 50% increase in production in 9M 2017 to 9M 2016. Growth of costs in joint ventures is due, firstly, to changeover to a lease scheme for pumps, which means a redistribution between investment and operating costs, and secondly, we have increased the total number of wells, which raises repair costs in unit terms. We also see an increase in unit costs at mature fields. As discussed before, this is a consequence of changes in hydrocarbon production volumes.

The next slide shows a major event for our company – the discovery of a new field, the Neptune field, on the shelf of the Sea of Okhotsk. Geological reserves are more than 255 million tons of oil equivalent and we have used an innovative riserless drilling technology at the Ayashsky area at the field. We are considering alternatives to bring in partners for further development of this large field.

Moving on to the Badra project, we marked a very important date at the start of the third quarter, on July 2, when Iraq's Al-Zubaidiyah power plant started receiving gas delivered by pipeline. Our company has created a gas production complex, which is the most modern in Iraq and will enable that country to significantly increase electricity generation, playing a very important role in ensuring reliable electricity supply in several of the country's provinces.

It has been decided how associated gas at the Eastern license area in the Messoyakha project will be used: it will be injected into strata at the Western license area. The relevant license was obtained in April. We are continuing work on construction of facilities for associated gas utilization at Novoport and we expect to have a compression station and gas processing complex ready for launch in the fourth quarter of this year, so that we can start injection of gas into strata.

That's all from me, here is Vladimir Konstantinov.

Vladimir Konstantinov, Head of Economics and Investment (Downstream)

Good evening, ladies and gentlemen. The oil price rose in the third quarter of 2017 compared to the second quarter, which led to some reduction in refining margins. But the decline was not large and refining margin remained at a fairly comfortable level, fluctuating between USD 3 and USD 7 per barrel depending on the month and the refinery. As regards crude oil supplies, our total supply volume in the first nine months of 2017 (to the market and to refineries) was 50 million tons. The growth was mainly from export oil sales, and the biggest contribution to overall sales came from Arctic projects, which represented about 43% of total crude exports. Crude deliveries to refineries in nine months of 2017 were 4.4% below their level in the same period of 2016, but we had scheduled an even bigger decline due to repair work, which we have talked about several times already. The decline was smaller thanks to efficiency achievements, which enabled us to increase the refining volume for nine months by about 1.3 million tons compared with initial plans. I emphasize that these volumes were cost effective. The increase compared to plans was mainly at the Omsk Refinery.

As usual, the next slide shows refining volumes. As I have already said, the overall decline was 4.4%. There was a rise in volumes at YANOS, where no significant repairs were carried out, and there was also a positive

trend at the NIS Refinery. The negative trends were at Moscow and Omsk. The decline at the Omsk Refinery was insignificant compared to 2016 (about 1%), but it was large at the Moscow Refinery, due to large-scale repairs carried out there. We believe that trends in technical efficiency indicators (refining depth and light product yield) make sense and are quite positive. For YANOS, refining depth was unchanged, even though refining volume increased by 4%. An increase of 5% at the Moscow Refinery is also explainable: it reflects a decrease in output of straight-run gasoline due to lower refining volumes. Refining depth at the Omsk Refinery stayed at the same level as in nine months of 2016. As for light product yield, we see growth at Omsk and understandable decrease at YANOS and Moscow, due to large-scale repairs at the Moscow Refinery and due to changes in the structure of petroleum product output and increase in refining volumes at YANOS.

We are traditionally ahead of the market by sales of motor fuels. Looking at retail sales of gasoline, the market grew by 0.8% in 2017, while our retail sales grew by 4.5%. The gap for retail sales of diesel is even greater: the market grew by 1.2%, and we increased sales by 14.2%. This is achieved mainly through superior sales efficiency and cost optimization. In particular, our indicator for sales per filling station in Russia continues to grow: the improvement in nine months of 2017 was about 4.5% to 19.7 tons per day, which is the best result in the country. We are implementing large-scale projects that use advanced IT technologies at our refineries, we have designed a system for control of fuel quality in the Gazprom Neft filling station network, which has won a consumer safety award, and brand awareness and levels of consumer confidence in our Company are on the increase.

I would also like to mention positive trends in premium sales compared with 2016. Sales of aircraft fuel grew by 8%, lubricants by almost 10% and premium bitumen sales by about 15%. The only decrease (we discussed this at our previous meetings) was for bunker fuel, associated with our Company's lack of logistical advantages in the Far East.

One other important event in the third quarter: we completed and launched innovative facilities for multistage water purification as part of the large-scale Biosphere project. The facilities increase our wastewater treatment rate to almost 100%, reduce use of river water by 2.5 times, and ensure that the wastewater treatment process is hermetic, avoiding atmospheric evaporation. More than 70% of treated waste water is re-used in production. That briefly summarizes everything I had to say. Thank you.

Alexey Yankevich, Chief Financial Officer

Ladies and gentlemen, let me say something more about financials. I already commented on financial indicator trends, so it will probably be more interesting to look at factor analysis in the following slides to see what explains the trends. I'll start with the annual trend for operating profit. As I already said, EBITDA growth wasn't due so much to external factors, although, of course, recovery of prices for crude and petroleum products had positive impact, but internal factors also counted for a lot: growth of volumes, measures to increase efficiency, increase of retail sales and sales in premium segments. Growth from internal factors alone was over 16% in comparable terms, and if we exclude the factor of repairs, which were all scheduled and non-recurring, then growth from internal factors would be about 19-20%.

The next slide shows quarterly dynamics. Here too you can see that the Company's own efforts made a major positive contribution: growth of volumes, growth of scale, efficiency gains. The impact of external and internal factors was probably 50/50, but we also added about 10% solely from internal factors in comparable terms.

The cash flow slide is probably the one that will interest you most. You remember our long discussions as to when the company will achieve positive cash flow and our assurances that we are making every effort for that purpose. The investment peak has passed, the fall in prices naturally played a role, but we have continued to implement our projects, because all of them were profitable, they offer a good return on invested capital. These efforts are now bearing fruit and, as you can see, we hope to pleasantly surprise you with our level of free cash flow this year. It was almost 86 billion rubles in the first nine months of 2017, which is a sizeable amount. If we take the difference between operating cash flow and CAPEX we get 83 billion rubles, and there was also a small but positive cash flow from our joint projects, in which we previously invested loan money and now these loans have been partly repaid, which, in principle, is also our cash flow, so it is right to name a sum of about 86 billion rubles. As a result we reached a fairly good level for dividends on last year's results – 10.68 rubles per share. That looked like a record, but, looking ahead, I can say that we have more good news for you: dividends this year will also grow significantly, as you can already see from the level of interim dividends, which we proposed and which was approved by our BoD, at 10 rubles per share. This is already open information and you all already know it, but I'm just reminding you. What it means is that you can

assume that dividends for the full year will be more than 10.68 rubles per share, i.e. more than 50 billion rubles. And, so we get total positive cash flow in the amount of 36 billion rubles.

The next slide takes a brief look at investment trends. As I said, we are getting past the investment peak, one way and another, and this is reflected in the fact that our capital investments declined year on year. This can be seen in both the greenfield and brownfield segments. It mainly concerns the exploration and production division, since that is where we have implemented our largest projects in recent years. So basic infrastructure is mostly already completed. Drilling work and creation of additional infrastructure is still ongoing, but those aren't such big investments, so investments in greenfields have been reduced. There is a certain correction for investments in brownfields, due to the fact that we are working within production constraints and need to optimize production at various fields. Investment in refining has grown and you will see us implementing several quite large projects in the near future. That shouldn't frighten you, because all these projects offer very good returns on invested capital, especially in current price and tax conditions. They will significantly increase our refining margin (more than 20-30%) and, to give you an idea, I will tell you that after completion of modernization our average Nelson Index will exceed 10, which will not only make us the absolute leaders in Russia by refinery complexity, but also put us ahead of some refineries in Europe. This will also ensure strong profits. So there will be some growth of capex in refining, but the rationale is clear – these projects have a high level of commercial viability.

I will round off as I usually do with a few words about financial stability and financial policy. We are glad to be returning to a financially stable level of net debt/EBITDA under 1.5. We have already reached very comfortable levels of financial stability, even though we are still carrying out quite large-scale investments – the investment level has decreased, but is still fairly high. Net debt/EBITDA as of 30 September 2017 was 1.27. The figure will be slightly higher by the end of the year, but it will still be less than 1.5, and that gives us confidence. Unfortunately, we can't go above a certain political level of the credit rating ceiling for the Russian Federation, so we can't reach investment grade. By stand-alone metrics, we are now at investment grade, so if there was no ceiling in the form of the sovereign rating, we would have been raised to investment grade a long time ago, but I hope that this situation will be resolved. In principle, the financial situation of the Russian Federation has improved significantly and continues to improve, and that gives us hope for a change in credit and sovereign ratings and for return of our credit rating to investment grade. There are already signals from the rating agencies, which suggest that. Fitch has revised its outlook from stable to positive (BBB), which is an indirect confirmation of what I said. Debt investors understand this: we place bonds at very good rates and make very successful issues. That can be seen from the 25 billion ruble issue we carried out in October 2017: we placed five-year bonds at 7.85% per annum, which is a very good rate, matching the rates we achieved before the fall in oil prices. So we are getting back to very good and comfortable ruble rates. I already mentioned dividends – we expect growth of dividends on 2017 results beyond the level of 10.86 rubles per share for 2016, which is sure to please our investors.

Thank you for having confidence in us. We are doing our best to show good results and I think that the figures for nine months of 2017 are good confirmation that the company is developing successfully and carrying out all of its announced plans. That was first visible in growth of our production volumes, and now it can be clearly seen in growth of our financial indicators. That's everything I had to say. We are ready to answer your questions.

Q&A session

Question №1

Ekaterina Rodina, VTB Capital

Good evening and thank you very much for the presentation. Congratulations on the excellent results and thanks for the chance to ask a question. I have two. Could you comment on production trends at GPN-Noyabrskneftegaz in the third quarter compared to the second. What happened there to cause such strong growth? And the second question: could you please say something about your possible changes in production plans, if the agreement with OPEC to limit production next year will be extended to the end of the year. Will that somehow change your strategy, your investments for next year? Thank you very much.

Alexey Yankevich, Chief Financial Officer

Ekaterina, thank you for the questions.

The first question was about production trends at GPN-Noyabrskneftegaz. As Alexey Urusov already said, we are living within OPEC limitations, within quota limits, so, of course, we are optimizing production between our various assets, and assets that are the worst performers in economic terms get a large quota for reduction, and vice-versa, if growth at a certain field is limited, some other asset makes up for its growth potential. In this case, when Prirazlomnaya had a scheduled suspension for reconstruction, a quota became available for other fields and it became possible to increase production there, including at fields of GPN-Noyabrskneftegaz. As we have said, production is regulated in various ways. We can regulate amounts of drilling and the number of new wells, and we can control production at existing wells. Naturally, in cases where we have limited production at existing wells, when it becomes possible to increase output, we do it, because it is profitable. This explains this trend. Let's translate and then I'll answer the second part.

The second question was about production plans under the OPEC conditions, and if I understand correctly, you are interested in plans for 2018??

Ekaterina Rodina, VTB Capital

Yes, of course.

Alexey Yankevich, Chief Financial Officer

As regards plans for 2018, different scenarios are being considered. Even in a tough scenario, where the agreement with OPEC is extended, we still plan a modest increase. It will be less than the 3.7%, which we expect this year, but there will still be a modest increase. The most important thing is that we will increase production at greenfields in any case, as a matter of principle. If you look, you can see that upstream profitability will grow next year even with a slight increase in production, and even if the OPEC agreement is extended to the whole of 2018, thanks to improvement of production structure, i.e. by increasing the share of production at new fields, which are less depleted, and which are therefore better performing in economic terms with lower unit costs.

Question №2

Alexander Kornilov, Aton

Good evening, colleagues. Allow me to add my congratulations on the excellent results! Thank you very much for the opportunity to ask questions. I have two.

The first question is about reporting: one of the reasons for the growth of free cash flow in the third quarter and nine months is a large-scale release of working capital. In the third quarter, by my estimation, it amounted to 38 billion rubles and 54 billion rubles for nine months. Could you give us some guidance on what to expect in the fourth quarter? Do you expect this strong performance to be toned down by the end of the year or not? And the second question is a follow-up to the previous question about the OPEC deal: do I understand correctly that, even if the agreement is extended, you won't revise your plans for production volumes at greenfields? If so, could you remind us of your expectations for production in 2018 at the Novoport and Prirazlomnoye fields and in the Messoyakha project? Thank you.

Alexey Yankevich, Chief Financial Officer

Thank you very much for your questions, Alexander. I'll start with working capital. You are right that working capital has declined. Generally speaking, this is the result of consistent work by us. We have taken the task of optimizing working capital quite seriously; in particular, this year we did a lot of work on rapid, timely and automatic preparation of documents for VAT confirmation, which has done a lot to speed up our VAT refunds. We sorted out cases where we were incurring certain losses because not all of the necessary documents were being brought together well enough and quickly enough. We also worked with accounts receivable, optimizing payment terms, and with accounts payable: we carried out benchmarking and identified opportunities for reviewing payment terms. Release of working capital was also driven by several "one-off" factors, one of which was return of the advance payment of the security deposit, which we paid to take part in the auction for the Erginskoye field. You know that we took part, but we weren't successful, so the advance was returned. There was also a reduction of advances paid, which had been quite large when we had to buy petroleum products to meet our needs during the repair cycle. Additional petroleum products aren't bought on a pay-later basis, but either day-by-day or in advance. This effect has ceased, production has returned to normal, so accounts payable have declined. To summarize: the greater part of this effect comes from our systematic work to optimize working capital, so we don't expect a reverse in the fourth quarter. However,

there are also one-off factors. The fourth quarter makes more demands for working capital, so there could be some reverse effect, but I don't expect it to be very significant.

The next question was about OPEC and greenfields, and I can confirm that production at greenfields won't be limited. We can reach the volumes that we had planned at these fields even with the OPEC limits. I would ask Ivan Razdobudko, who heads the financial service for our new projects, to comment on volumes at the fields, which you named.

Ivan Razdobudko, Deputy CEO for Economics and Finance

Good evening, ladies and gentlemen. Planned production in 2018 in the Novoport project will be about 6.8 million tons, about 4.3 million tons in the Messoyakha project and about 3.6 million tons at Prirazlomnoye.

Question №3

Pavel Kushnir, Deutsche Bank

Good afternoon and thank you very much. You said in the presentation that net debt to EBITDA will be higher by the end of the year than at the end of the third quarter of 2017. The forecast seems a little strange. Could you tell me what assumptions you used for this calculation? And the second question is about dividends. It is clear that your results for the year will show growth of net profit, so there will be an increase of dividends per share, even with an unchanged payout, which raises the question of why the Company is still not prepared to increase the payout, as all other Russian companies (including those with state participation) are doing. Thank you.

Alexey Yankevich, Chief Financial Officer

Thank for the questions, Pavel. Yes, net debt to EBITDA is about 1.3 after nine months, and I think it will grow a little, but only a little, maybe up to 1.4. Why? Because, as we see, the ruble exchange rate is weakening slightly towards the end of the year, and we build in this weakening, since more than 70% of our loan portfolio is in foreign currency. So the debt to EBITDA ratio may be slightly adjusted due to this revaluation, but not very significantly.

As for dividends, what matters to investors? Growth of dividends per share and dividend yield is what matters to investors. How much is paid in percentage terms is not so important, because, as you know, net profit is subject to the influence of a large number of unpredictable factors. In particular, the exchange rate difference has recently had very strong impact on net profit. Therefore, we are looking at dividends per share growth. Growth of this indicator will be ensured: we can promise investors that dividends per share will grow. We hope that dividend yield will also grow, the share price has increased. Current dividend yield has adjusted, but is still at a good level. As regards your implied reproach, that other companies are increasing their payout, let's look at companies with state participation and ask which company with state participation has growth of dividends? Last year our dividends per share doubled, now they will grow by a further 20%. I don't know companies with state participation, where dividends per share are growing at that rate. There are some, but it's certainly far from the case that they can all make that boast. What is important, I think, is growth of absolute dividends per share, not of payout. Payout may also grow if we see that, for some reason, net profit will not grow as much as we would like. At that time, accordingly, we will be able to adjust payout. But when our profit increased significantly thanks to foreign exchange earnings (it grew by 40%), we can't increase payout as well. Growth shouldn't be in sudden leaps, it has to be gradual. We are geared to major increase of our dividends per share, but I believe in moving forward smoothly, and not in jumps with sharp increases and then downward adjustments. And remember, when we went on the field trip, we said at Novoport that dividends could reach 15 rubles per share in the near future from 10, that this would be very good growth, and now we can see that this is quite realistic, we are moving towards that goal, we will get to 15 rubles in a few years' time, and maybe even higher. So, again, dividends per share will grow, they will grow at a good pace, well above inflation, and dividend yield will be market-based, we will make sure of that, We want to be among the top three comparable companies by this indicator. That's my answer, thank you.

Anna Sidorkina, Head of Investor Relations

Ladies and gentlemen, thank you very much for taking part in our regular conference call. If you have any further questions, please get in touch. We are always happy to give additional explanations if you have any outstanding questions. Thank you very much, all the best and goodbye.