

Neptune Energy Q3 Results Announcement | Call Transcript Friday 30 November 2018

Sam Laidlaw – Executive Chairman

Good afternoon everybody, this is Sam Laidlaw here. Welcome to our earnings call for the third quarter of 2018. This covers the period from 15th February when we acquired the ENGIE E&P business up until the 30th September. I am pleased to say that we have continued to see strong performance across the Group both operationally and financially and remain on track to achieve the full year guidance we have previously stated.

Now some of you will have gone through the details of our results, but to summarise. Firstly we have driven further improvement in our HSSE metrics across the entire organisation reflecting our increased focus in this area through our safety culture project and this is really a key priority for the Group.

Secondly, operationally our performance has also been good with third quarter production at 151,500 barrels a day, slightly ahead of the acquired businesses results for the corresponding period last year and that is despite the fact that we had planned summer maintenance shutdowns in the programme.

We have also made significant progress with the integration of the companies we have acquired, including strengthening the management team and recruiting key people across the various functions.

Financially, cash flow generation continues to be strong and we are maintaining a disciplined approach to cost control.

Following our agreement to acquire VNG in Norway in June, we completed the acquisition on September 28th. The VNG portfolio is strongly complementary to our existing Norwegian business and will provide significant additional production from 2021.

Because the acquisition completed at the end of our reporting period, no revenue contribution is recognised in these results. The transaction to acquire two UK North Sea assets from Apache, remains on track for completion before the end of the year.

Our strong performance coupled with our strengthened management team and the integration of the ENGIE E&P and VNG Norge businesses and the introduction of enhanced systems and processes, positions us well to finish the first year strongly.

And with that, I am going to hand over to Jim who will take you through the operational highlights before handing over to Peter for the financial highlights.

Jim House – Chief Executive Officer

Thank you, Sam and good afternoon, or morning to those who have joined us today. As Sam mentioned, we continued our solid first half into the third quarter with strong operating cash flows for the year to date of \$740 million after tax. Operating costs per boe produced, stood at \$10 below last year's average for the acquired E&P business of \$11 per boe for the 9 months.

Our leverage remains modest at 40% and our net debt to EBITDAX stood at 0.61. After the VNG Norge acquisition, our liquidity stood at \$1.5 billion which provides plenty of headroom to further support our growth strategy and provides returns to our shareholders.

Production outlook for the year remains in line with previous guidance with average daily production for the full year 2018 anticipated to be around 160,000 barrels equivalent per day. As compared with EPI 2017 production of 154,000 barrels of equivalent per day.

Before acquisitions capex for the nine months on a cash basis, excluding exploration drilling was \$247 million. As we flagged at the first half results, we estimate full year capex to be slightly lower than our original outlook due to some re-phasing of spending on key projects into 2019.

Across our assets, we have taken a more rigorous approach to production management and internal reporting which is already having a positive performance impact across the portfolio. As a result of this sharper focus we have produced 160,500 barrels of oil equivalent per day for the period since completion of the acquisition of EPI on 15th February. This was in line with our expectations, given the planned annual programme of shutdowns in most countries during the third quarter.

On a proforma basis, production would have been 161,500 barrels of oil equivalent per day had EPI been consolidated from 1st January of this year. This represents an increase of 10,000 barrels of oil equivalent per day compared to the previous year. This increase was largely a result of higher production in Indonesia which reflects the start-up of last year's Jangkrik project and then with the UK with the Cygnus field which offset natural declines in Norway and the Netherlands.

Our financial performance benefited from strengthening in both markets for oil and gas with Brent crude averaging \$72 per barrel in the 9 months to September 30th. On a proforma basis, our average realised oil price before hedging was \$70 per barrel for the period compared with \$51 per barrel for the same period in 2017. After the hedging programme, much of which was implemented prior to close, our average oil realised price was \$64 per barrel.

It is important to remember that our portfolio is about 70% gas although closer to 50% of our overall production is sold on oil price linked contracts as a result of our LNG positions in Norway and Indonesia.

Coming on to projects, we continue to make good progress on our capital programme including both operated and non-operated projects. Construction of our joint venture operated Touat gas project in Algeria is now 93% mechanically complete. It remains on track for first gas exports during the first half of 2019.

We are working to combine the operated P1 and Cara projects in Norway that will be sub-sea tie backs to the Gjoa platform and aim to achieve sanction early next year with a target to deliver first production by the end of 2020. Also in Norway, the six well Fenja subsea development has been fully sanctioned and is in the execution phase, including a 36-kilometre tie back to the Njord A platform. This operated project which came to Neptune via the VNG acquisition continues on cost and on budget with anticipated first hydrocarbon date by the end of 2020.

Regarding non-operated Norwegian projects with the Njord redevelopment which is the host facility for Fenja, also remains on schedule and on budget for the restart expected by the end of 2020. The developments at Askeladd and Bauge also remain on track with first production from both expected also in 2020. At the Fram Field, three new multi-lateral development wells will be drilled early in 2019 providing additional production by the end of next year.

Turning to exploration, in Egypt the Bagha C-88 exploration well has been drilled and is currently being tested. During October the Silfari prospect which came to Neptune via the VNG acquisition is drilling in the Norwegian North Sea and it is designed to open up a new geological play type. As well as located at the operated Cygnus field, the Fault Block 9 well in the UK sector of the North Sea is being drilled to support the strategy of expanding the resource base with a view towards increasing export capacities.

Our cash spend on exploration in the period to 30th September was \$58 million of which \$12 was capex. The total spend was a result of higher than normal expenditure on seismic data which will support forthcoming exploration activity.

On that I will now hand over to Peter who will take you through the numbers.

Peter Thomas – Chief Financial Officer

Thanks Jim and good afternoon everyone. So first I should perhaps remind you of the period that the financial results cover. We completed the acquisition of the ENGIE E&P international business or EPI on 15th February 2018. So, our report consolidates the EPI results from that date rather than for the full nine months to 30th September. We have however provided some proforma data for the full nine months and for the same period last year. And we completed the acquisition of VNG Norge on 28th September this year, so the acquisition funding of that deal is reflected in the 30th September balance sheet and cash flow statement. But there are no operating results for the third quarter included in the Neptune Group figures for VNG Norge.

Today's report shows that net income stands at \$179 million for the period to 30th September, following Q3 net income of \$109 million. The operating results reflected \$71 per barrel of oil realisation and a gas price of \$7.8 per thousand cubic feet. So negative hedging results arising from the rising markets held back the net realisations by just over 10%.

Unit operating costs have been at a competitive level of \$10 per boe for the year to date. The book tax rate stands at 73% but that has been increased by non-taxable acquisition related expenses, so the underlying rates remain at 67%.

The report includes an update on our hedging position as at 30th September at which point of course, prices were stronger than they are today, especially for oil. The Group has continued to put in hedges to provide protection against low prices on a rolling 3-year outlook. Hedges provide approximately 50% cover for 2019 forecast sales on a post-tax basis and then declining proportions thereafter. There is a weighting of the percentage cover towards gas as available forward prices have been particularly strong for gas.

After the expiry of mostly swaps in the legacy ENGIE hedge book during the remainder of 2018, the majority of future hedges are through option collars and we have provided indications of the average floor and cap prices for those collars in the report. The recent decline in oil prices shows the value of the hedging programme which will provide some stability to cash flows. But the Neptune portfolio is well diversified between oil, gas and LNG anyway. Over 50% of our sales are price based on gas markets which continue to be strong.

Operating cash flow after tax was \$740 million to 30th September which includes \$62 million acquisition expenses. So, \$802 million on an adjusted basis. And that represents a post-tax operating margin of \$22 per boe produced or just over \$24 dollars per boe. if you do the calculations before working capital movements. And they arose primarily due to higher short-term receivables as a result of the schedule of liftings. The cash tax rate was 28% of pre-tax operating cash flow. So, there is some lag in the payment of taxes on those operating cash flows as a result of increased commodity prices.

So, it is still expected that the cash tax rate will be in the low to mid 30% as per our previous guidance on an annual basis.

Turning to capex. The acquisition costs of VNG Norge at closing was \$345 million before possible future contingent payments. And that's net of \$67 million of cash acquired in the business. This was a higher cash balance than we'd originally anticipated although partly offset by accruals for work done, not yet paid. But it means that the net cash acquisition costs were quite significantly lower than we had anticipated at the signing of the transaction for this reason. And also, because completion was a little earlier and 2018 capex a little lower up to that point.

And you may remember also that a significant part of the value of VNG Norge is attributed to tax balances. We will be merging an acquired business with tax losses with the tax paying Neptune Norwegian business which will result in a onetime tax saving in 2019 of about \$150 million which is based on this slightly lower capex incurred so far in VNG Norge and the latest estimate of the balance of tax losses. The acquisition was financed from existing cash and the drawdown under our bank facilities.

Our cash capex incurred, including exploration drilling was just \$150 million as reported for the period to 30th September and this reported figure is low partly for accounting presentation reasons. We account for interest in the Touat Project in Algeria under the equity accounting method because it is held in the joint venture company with ENGIE.

The joint venture was well funded at closing of the EPI deal in February and consequently we've had to invest new cash in the JV since then. But our underlying share of capex on Touat in the JV was around \$50 million for the year to date which is additional to that reported \$150 million investing cash flow since February. Looked at on a value of work done perspective and including Touat, the Group development capex for the full year is expected to be around \$430 million before acquisitions which is perhaps a better reflection of actual activity although reported cash spend will continue to be less than that.

Overall net cash flow since the EPI acquisition and related expenses was settled has been positive by a net \$277 million which is after funding the VNG Norge deal. As a result, at 30th September, our net debt was \$1.2 billion and this results in robust leverage at 40% of total balance sheet capital and 0.61 times a 12-month proforma EBITDAX result.

The borrowing base under our \$2 billion bank debt facility presently provides substantial backup liquidity with only \$749 million utilised for advances and letters of credit as at 30th September and we also had \$300 million of cash balances.

In terms of the production outlook, Jim has already reaffirmed that we are on track with the previous guidance subject to unforeseen events. We expect average production around the same level for the period to end of September for the full year. I remind you that that was 160.5 thousand boe per day.

And finally, we flagged in the Q3 statement that we expect to pay a dividend for the first year of operation of \$380 million. This reflects the Group's strong trading performance for 2018 and cash flows ahead of earlier expectations. Adjusting for this dividend, the financial metrics are still remaining robust.

I will now hand you back to Sam to make some summary comments.

Sam Laidlaw

Well, thank you Peter and I think as you have seen, we have continued to build during the quarter on our strong first half performance. The priorities we set out at the half year are strong performance this year is perhaps most notable given the absence of significant drilling activity last year. Our more rigorous approach to production management is already having an impact and this will continue to be a key area of focus.

We further strengthened the organisation with the appointment of a new managing directors for our Norwegian and Netherlands business along with a new CFO, Armand Lumens who is dialling in to this call and joins the team officially next week.

Cost control has also been good, and our costs remain low at around \$10 per barrel. We believe we have more to do across the portfolio to take out further costs without of course compromising on safety.

As we grow the business it's important we complete transactions quickly and efficiently and I was therefore very pleased that we were able to complete the VNG Norge transaction in less than three months after signing. Having completed the transaction, we have now almost completed the integration. Not only does it provide a strong portfolio, but also new colleagues who will complement the current team with high quality and diverse skillsets.

Finally, tighter allocation of our capital is also paying off with project progress continuing apace. Across our operated and non-operated portfolio, our projects remain on schedule. For the full year we expect low single digit production growth and continue strong cash flow generation as we build Neptune Energy into the leading independent international E&P company.

So, I think this brings our conference call remarks to a close. Thank you all for taking the time to listen and I will now hand over to the operator and hopefully address your questions. And I look forward to answering those with Peter and Jim.

Questions and Answers

Q1. Michael Boam, Sona Asset Management

Hi, a few questions around hedging and earnings sensitivity obviously given the recent volatility in the oil price. Your hedges for 2019, are they at higher prices than were realised in 2018 or similar or lower?

Answer: Peter Thomas

The hedges for 2019, if you look in the report we have given some average oil prices and some average gas prices where the floors and collars are sitting.

Further Answer: Sam Laidlaw

While we are just finding the precise figures, I would just make a general point Michael that obviously the thing that is unique about our portfolio is the diversity, the fact that we have a significant percentage of our production of course is gas, 70%. There is about 20% that is LNG and therefore that gas is oil price related so net:net it's sort of 50:50. But of course European gas markets and Asian gas markets have actually held up a lot better than oil markets and that I think shown some of the benefits of diversity. But coming to your specific question, Peter?

Further Answer: Peter Thomas

Yes, firstly for oil, the average floors are on page 13 of the Report. The average floor price is \$58 dollars per barrel in 2019 for hedges there and \$59 for 2020. So basically, we have put options on volumes at the \$58/\$59 range and if you turn the page you will see that is just under half our projected oil production on a post-tax basis because, we do adjust the different tax rates on hedges and physicals. And then that is down to 16% for 2020 so the bulk of those hedges are in 2019 covering about half our oil price exposure which will include some of the oil price inputs to LNG prices. And as part of the collar structure we then set a call option and that is in the \$75-\$77 range, so we give up upside above that so obviously today's prices sitting at around the floor, just above the floor, giving those oil hedges today some positive mark to market value, modest one.

Then for gas, the put options that we have in place are at an average price of just under \$6 per mmbtu for 2019 and 2020 with upsides put on at \$7.50 per mmbtu on average and they cover just over 50% at 2019 gas production and about 30% of 2020 gas production a little bit out to 2021.

Further question: Michael Boam

Okay, so given the hedge structure you have in place, what would you say the Group's sensitivity is to a \$10 move in the oil price in terms of EBITDAX?

Answer: Peter Thomas

If you first look pre-hedging, then general guidance we have given before is that a \$1 move in say the oil price is about a \$20 million EBITDA variant and if we hedged 50% then if that hedge is, if that movement in the oil price is going below the hedge floor then clearly for that 50% it won't apply.

Further answer: Sam Laidlaw

But these are post-tax hedging amounts - the post-tax amount will be obviously a lot less than the EBITDA amount, particularly as half our production remember comes from Norway and therefore 40% comes from Norway and that is a highly taxed environment.

Michael Boam

Okay, thank you very much and well done on the quarter.

Q2. Daniel Vaun, JP Morgan

Hi there. Just a quick question on the dividend. I think this was a bit more than we had been expecting. I mean obviously the cash flow has been better versus when you were

road showing the bond earlier this year. But I just think given the current commodity complex and the fact we were expecting a much lower dividend, could you just talk us to why you sort of deemed it necessary to go with the \$380 million dollars? I think there has been a couple of press reports I think a couple of weeks ago there was some assets in the North Sea as well which I think you have potentially been interested in. But I think Ineos Oil & Gas had sort of entered an agreement there. It seems like you have added sort of, 0.4 of return on leverage for something you didn't really have to do so could you give a bit of colour on that please?

Answer: Sam Laidlaw

I think if we go back to when we originally offered the bond we said clearly that in periods of, and we gave some guidance at that time, but we said that in periods of stronger trading conditions and stronger commodity prices we would be towards the higher end of that range and it has been a period of very strong cash flow generation. There is also an element here of first year adjustment to the opening capital structure to make sure it is a little bit more efficient because actually we were paying off debt at a pretty high rate which is how we were able to fund the VNG acquisition and the Apache acquisition and still end up with positive cash flow.

The other point is that in this first year, as we indicated in the Statement, our capital expenditure was actually occurring at a lower rate than we'd initially planned. And so that gave us I think a lot of headroom. We were paying off a lot of debt and we thought actually as a one-time payment we should pay the dividend at that level. But you shouldn't infer from that anything about future dividends which are dependent on circumstances at the time, including obviously operating cash flow performance investment opportunities and capex commitment. Nor should you infer that it was because we felt that there weren't any further investment opportunities organic or inorganic out there to do. You know we continue to look at sort of bolt-on acquisitions if they make really good sense. So that is the background to it; we are still within the guidance that we gave at the time.

Further question: Daniel Vaun

And the dividend policy was free cash flow post capex, was it 25-50%? Again, with the upper and lower limits?

Answer: Sam Laidlaw

It was guidance rather than a policy, but you know I think if you look at free cash flow for the year before acquisitions and working capital, then we are certainly within that.

Daniel Vaun

Perfect, thank you.

Q3. Diomidis Ntountounakis, Chenavari

Sam Laidlaw: Hi Dio

Congratulations for the great quarter. I wanted to ask again about the financial policies. I remember in the past you had kind of committed to stay within the 1.5x net debt to EDITDA. That is the first question whether that still stands? And b, whether if you had to fund a big acquisition like the one that was in the news the other day, whether there would be any equity component into that, equity injection into that from the shareholders?

Answer: Sam Laidlaw

Yeah, I think Dio we can't comment on specific opportunities, but I think the important point is, yes, we are still committed to the 1.5xEBITDA as basically that's something that we don't want to go beyond. If we did so we would only do it in exceptional circumstances and certainly the shareholders have got the appetite to put in more equity if the quality of the opportunity justifies it. So, you know I think the basic story is unchanged from what we told you six months ago.

Diomidis Ntountounakis

Okay, thank you very much.

Q4. Sebastian Kaufmann, BlackRock

Hi, thanks for taking my question. Just very quickly, in terms of ratings, have you recently talked to the ratings agencies with regarding your ratings and what do you expect, in the short-term, happening there?

Answer: Sam Laidlaw

I will let Peter answer that because he has had conversations with both agencies recently.

Answer: Peter Thomas

Yes, we obviously have a dialogue to keep them up to speed and for example on the VNG Norge transactions, speak to them on news like that. We have annual meetings which will typically be after the full year results, they get a fuller picture then. I think our understanding of our rating based on the original reports and subsequent conversations, it is there in the report for you to see is that the financial metrics are within the rating category with some comfort. The areas that they would need to have seen progress on and hopefully have seen progress on this year for any potential positive action on the rating are about filling the forward profile of production, adding new projects without obviously undue execution risk.

Things like the VNG Norge acquisition go directly to that in terms of adding production, adding capex, particularly where it is very tax efficient in Norway. I think as we look at our budgets for next year and our forward production plans and reserve replacement and so on, I am sure that the Company will have a pretty positive view to present to them in addressing exactly those perceived issues that they reported on in their rating reports about where was that build out of the future production profile going to come from.

Further question: Sebastian Kaufmann

So, I guess one has to wait until after the full year results to see if anything is happening?

Answer: Sam Laidlaw

I think at the full year results probably we will have more to say about the reserve picture and obviously you will have seen from the commentary from the rating agencies that one of their concerns was potentially a sort of shorter reserve life than some of the peers. But I think that they have recognised that we have addressed that, but we haven't actually put the numbers around it yet.

Further question: Sebastian Kaufmann

Right okay. Can you give us a bit of an idea in terms of production guidance for next year and the following year just broadly, is that possible?

Answer: Sam Laidlaw The short answer is not at this stage because we are actually still finalising the budget and plans for next year and obviously it is a function of how much capital we put in. I think we will come back to that.

Further answer: Peter Thomas

The only other comment we might just add to that is the key variable that we need to be more certain about which will drive whether production is flat, a little bit lower, a little bit higher and so on, the biggest variable in that, there are several, is the timing of the first gas from the Touat gas plant in Algeria. So, we will watch that closely driving for early but safe production from that and when we have more certainty perhaps that will be time to say a little bit more.

Further answer: Jim House

In general, we feel very good about our Portfolio and we have a pipeline of projects and part of this is timing. So, we are not concerned, we are actually looking for ways to compress schedules for this. Sam mentioned we are coming up for a meeting with the Board to approve a budget for 2019 but in general the outlook looks good.

Further answer: Sam Laidlaw

Certainly, there won't be any big surprises. As Peter says, the exact profile depends on how quickly we can get the Touat project up safely.

Further answer: Peter Thomas

And that is a big move, we have got some other smaller pieces too.

Sebastian Kaufmann

Okay, good, thanks very much.

Operator

We have no further questions. I would like to turn the conference back over to Sam Laidlaw for closing comments.

Sam Laidlaw

Well let me just thank everybody for sparing the time to dial in to the Results. Let me also take the opportunity to thank Peter as this is his last call, as Armand is going to be taking the calls going forward. Thank you, Peter, for all that you have done for Neptune and getting the bond going.

To all of you if I don't have a chance to speak to you before, have an enjoyable and restful Christmas and we will speak to you again during the first quarter of next year with the full year results where as I say, hopefully we will not only be able to tell you a little bit more about the reserve picture, but also what 2019 looks like.

End of conference call