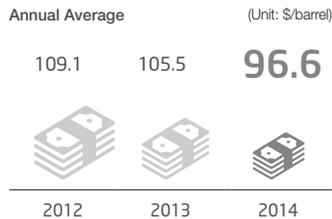


# Management's Discussion and Analysis

## Fluctuations in the Dubai Crude Oil Prices



\* Based on Platts for disclosing prices.

## International Crude Oil Market

In 2014, the international crude oil market continued to experience excess supply due to the slowdown of economic recovery around the world and the increase in the production volume of non-OPEC countries, including the US. In the case of global crude oil supply, OPEC countries maintained the same level of production as the previous year, but the non-OPEC countries' supply increased 1.9 barrels per day (2.1 percent) from the previous year to record 93.3 million barrels per day. On the other hand, the non-OECD countries achieved the highest economic growth rate for global crude oil demand, but the oil demand decreased for the OECD countries because of the economic downturn in Europe and Japan, to record 92.4 million barrels per day with an increase of 0.6 million barrels per day (0.7 percent) from the previous year. In 2014, the annual average Dubai crude oil price dropped from the previous year's \$105.5 per barrel to record \$96.6 per barrel. Also, the violent fluctuations of oil prices due to increased geopolitical uncertainties like the Iraq crisis resulted in a forecast ranging from the highest price of \$111.23 per barrel to the lowest price of \$53.60 per barrel.

## Market Conditions by Industry

### Petroleum Industry

Crude oil prices are crucial to petroleum product prices. As Korea depends entirely on imported crude oil, its market is sensitive to the effects of exchange rates and the export policies of oil-producing nations in the Middle East and elsewhere. Since the petroleum industry value chain includes importing crude oil and refining the oil into petroleum products, transporting and storing the product and finally selling it, the crude oil shipped in oil tankers from oil-producing countries is sent to the places where refinery plants are located and discharged to storage tanks near the refinery plants to be imported into Korea. Also, the products are sold differently according to the wholesale prices sold at direct sales places, gas stations and intermediate seller and the retail prices sold at gas stations (or charging stations) for the general consumers. In 2014, the year-to-date petroleum product consumption fell by 4.3 percent from the previous year. With a steady growth in the number of vehicles registered to authorities and an increase in the aerial demands, the domestic demand for gasoline, diesel and aviation fuel increased from the previous year. However, in the case of other types of products, the LPG consumption decreased due to a decrease in the number of LPG-fueled vehicles, the kerosene consumption for heating purpose decreased because of changing to other fuel sources due to the waning need for kerosene-fueled boilers and the distribution of city gas, and the demand for non-transportation use like heavy oil fell compared to the previous year.

### Consumption Trends by Type

(Unit: thousand barrels, %)

Classification	Total	Petroleum	Kerosene	Diesel	Heavy oil	Naphtha	LPG	Others
2014 (accumulated)	822,092	73,475	15,414	144,755	31,094	396,979	89,674	70,701
	(100.0)	(8.9)	(1.9)	(17.6)	(3.8)	(48.3)	(10.9)	(8.6)

\* Source: Korea National Oil Corporation Petronet (as of December 2014) / Consumption ratio indicated inside the bracket.

### Petrochemical Industry

**Basic Chemical Industry I** Basic chemical industry refers to a business of basic materials that use naphtha to produce olefin products like ethylene and propylene and aromatic products like ethylene and propylene, so that chemicals like synthetic resins, synthetic rubbers and synthetic fibers are produced. It is a process industry that requires a huge initial investment in plant and equipment where the economy of scale applies because of a high entry barrier and the effect of technological preoccupation. On the other hand, due to the industrial characteristics of producing basic materials by using naphtha that is produced from crude oil, the basic chemical business is sensitive to oil price fluctuations with repetition of downturn and boom according to the global economic and supply-demand conditions.

**Chemical Material Industry I** Chemical material industry uses basic distillates like ethylene, propylene, benzene and xylene to produce chemical products like synthetic resins, synthetic rubbers and 1,4 BDO (Butanediol). It is one of the key industries for supplying raw materials to core industries like automobile, electronic, construction, pharmaceutical and apparel material. Due to the industrial characteristics, the chemical material industry is sensitive to changes in profitability resulting from oil price fluctuations and business fluctuations of related industries.

## Management's Discussion and Analysis

### Lubricant Industry

Lubricant industry is an industry that produces finished products by using base oil as its major raw materials. Since the lube base oil is produced through an additional process (vacuum distillation, catalyst) for unconverted oil (UCO) that are made from a high value-added equipment called Hydrocracker during the oil refining process, it is very difficult to enter into the lubricant market other than the oil refiners with large-scale facility investments. The market for lube base oil can be divided into Group I, Group II and Group III according to the quality and function, with different growth rates shown for each market. In the case of the lube base oil (Group I) with lower function and life expectancy of the products, the growth rates have slowed down and it is expected that the demand will decrease in the future. However, the premium base oil (Group II/ III etc.) market is forecasted to maintain high growth rates due to the changes in environmental regulations and demands. The domestic lube base oil market has four oil refiners with refining facilities and high value-added facilities participating in it. Since the domestic demand has exceeded the supply, most of the products are being exported to Asia, the Americas and Europe. Korea's lube base oil market has more than 200 companies competing with one another, including 19 companies registered as full members at the Korea Lubricating Oil Industry Association and other non-registered companies. Major companies include SK Lubricants, GS Caltex, Kukdong Oil & Chemicals, Michang Oil Industry, Dongnam Petroleum Industry, Valvoline, Cals Corporation, S-OIL Total Lubricants and Hyundai Oilbank. In the case of foreign lubricant completed products, there are major oil refiners like Shell, Exxon Mobil, BP, Chevron, Total, Petro China, Sinopec, Fuchs, and Ashland (Valvoline). Since there are many lubricant companies already in place at each region, it is not easy for domestic companies to tap into new markets abroad.

### Business Performance by Business Segment

Due to the difficult business environment in 2014 like inventory losses resulting from falling oil prices and continuous weakness in refining margin and PX market, SK Innovation posted KRW 65,865.3 billion in sales on a consolidated basis, which is a decrease of KRW 174 billion from the previous year, with an operating profit dropping KRW 1,637.7 billion from the previous year to record KRW 231.3 billion. The international oil prices that fluctuated around \$107 per barrel at the beginning of the year in 2014 rapidly dropped by about 50 percent to \$54 per barrel at the end of the year due to the global oversupply of oil production such as increased shale oil production in North America and the same level of production from OPEC countries. As a result, there were huge inventory losses in the petroleum business, which also aggravated the oil development business. In the future, SK Innovation is forecasted to be greatly affected by the international oil fluctuations. Most of the experts in the industry predicted weak demands and a rise in interest rates due to the surplus of crude oil supply. Therefore, it is highly likely that the low oil prices will continue for a medium-and short-term basis until there is a sign of improvement in excess supply or there is a full recovery of demands.

#### Business Performance by Business Segment

(Unit: KRW million)

Classification	Sales			Operating Profit and Loss		
	2012	2013	2014	2012	2013	2014
Petroleum Business	56,588,893	49,896,814	49,056,300	279,070	59,662	(999,031)
Chemical Business	11,835,945	12,111,982	12,635,174	770,567	866,967	359,189
Lubricant Business	2,901,055	2,786,124	2,981,801	313,224	155,365	289,851
Oil Development and Other Businesses	1,268,572	1,244,385	1,191,994	355,424	324,424	118,714
Total	72,594,465	66,039,305	65,865,269	1,718,285	1,406,418	(231,277)

### Petroleum Business

The company's petroleum business sales fell by approximately 1.7 percent from KRW 49,896.8 billion in 2013 to reach KRW 49,056.3 billion in 2014, with the operating profit dropping approximately KRW 1,58.7 billion from the previous year to record KRW 999 billion to show deficits. In 2014, the petroleum business recorded a huge loss due to the continued weakness in refining margin resulting from decreased demands of major importing countries in the region and the inventory losses from oil price fluctuations. In 2015, it is forecasted that the pressure of falling oil prices around the world will continue due to high supply volume compared to the crude oil demands. However, SK Innovation plans to maintain our number one position in the Korean refining industry by maximizing synergies with the largest refinery in operation and running our facilities efficiently with differentiated technologies. Also, we strive to take a step forward to become a global energy company by improving our business structure and reinforcing our expertise, such as strengthening the trading business and setting up a hub for the global market.

### Chemical Business

The company's chemical business sales fell by approximately 4.3 percent from KRW 12,112 billion in 2013 to KRW 12,635.2 billion in 2014, with the operating profit dropping approximately 58.6 percent to record KRW 359.2 billion. In 2014, our chemical business showed improvement in olefins, but the market condition of PX products, a representative product of aromatic business, got worse to post a huge fall in operating profit from the previous year. Due to the downstream of market conditions like PTA and the expansion of large-sized facilities in the region like China, the PX spread fell substantially from the previous year. In 2015, it is forecasted that the PX market condition will turn around somewhat as a result of the number of facilities being expanded decreasing. In order to overcome the limits of domestic market and achieve continuous growth, SK Innovation will establish sales channels in China, Southeast Asia, the Middle East and Latin America to enhance our global competencies and diversify our business areas. Also, we plan to achieve qualitative and quantitative growths by producing diverse solvent products and high value-added polymer products.

### Lubricant Business

The company's lubricant business sales increased by approximately 7.0 percent from the previous year to record KRW 2,981.8 billion in 2014, with the operating profit dropping approximately 86.5 percent to record KRW 289.9 billion in 2014 compared to KRW 155.4 billion in 2013. Due to the decrease in the raw material costs resulting from falling oil prices, the base oil spread increased and showed an improved performance from the previous year. In 2015, it is forecasted that there will be a small improvement or it may remain at the same level as the previous year because of limited expansion of facilities. SK Innovation set up a joint venture company together with a multilateral company Repsol in April 2014, and it also set up a Group III lube base oil plant in Spain with full commercial operation in September 2014. Currently, SK Innovation's Group III lube base oil market share is estimated to be around 35 percent. We will strive to become a market leader in the base oil market by making active investments and acquiring capacity.

### Petroleum Development and Other Businesses

The company's petroleum development and other business sales fell by approximately 4.2 percent to reach KRW 1,192 billion from the previous year, with the operating profit dropping approximately 63.4 percent, falling from KRW 324.4 billion to KRW 118.7 billion. The biggest reason behind the poor performance is because of decreased sales and profits in petroleum development business resulting from international oil price fluctuations. In 2015, it is forecasted that the performances will fall from the previous year because of falling oil prices and low oil prices even though the production volumes from the blocks in Vietnam and North America increased.