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Credit Opinion: OAO Novatek

Global Credit Research - 26 Jun 2013

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3
NSR LT Issuer Rating -Dom Curr	Aaa.ru
Novatek Finance Limited	
Outlook	Stable
Senior Unsecured	Baa3

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Key Indicators

[1]**OAO Novatek**

	3/31/2013(L)	12/31/2012	12/31/2011	12/31/2010	12/31/2009
Avg Daily Production (Mboe/d) (LTM) [2]	1013.6	906.9	847.8	684.9	590.0
Proved Developed Reserves (Million boe) [2]	3611.2	3611.2	3742.5	4056.5	3707.3
Total Proved Reserves (Million boe) [2]	6913.3	6913.3	4873.5	6227.3	6222.7
Leveraged Full-Cycle Ratio	4.7x	4.4x	6.0x	4.7x	5.6x
E&P Debt / Average Daily Production	$5,023.9	$5,436.8	$4,162.8	$4,580.8	$2,225.1
E&P Debt / PD boe Reserves	$1.1	$1.2	$0.9	$0.8	$0.4
RCF / Total Debt	51.7%	42.9%	52.5%	37.4%	62.5%
EBITDA / Interest Expense	16.0x	17.2x	16.6x	24.4x	20.9x
E&P Unleveraged Cash Margin / BOE	$10.5	$10.0	$9.6	$7.5	$6.1

[1] All ratios are calculated using Moody's standard accounting adjustments. Source: Moody's Financial MetricsTM [2] Without Novatek's share in joint ventures

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Revenue growth supported by higher gas prices, shift to end-customer sales and growth in sales volumes

- Market positions strengthening as end-customer sales reach nearly 90% of total sales

- Cash margin per barrel of oil equivalent (boe) supported by increased export of natural gas liquids

- Profitability benefits from gas price indexation, but is impaired by rising taxes

-Leverage and coverage metrics to remain strong

- Liquidity to remain solid

Corporate Profile

Headquartered in Moscow, OAO Novatek (Novatek, Baa3 stable) is Russia's largest independent gas producer and second-largest gas company in Russia - after state-controlled OJSC Gazprom (Gazprom, Baa1 stable). In 2012, Novatek reported RUB211 billion (approximately $6.8 billion) in revenue with adjusted EBITDA of RUB107.7 billion (approximately $3.5 billion).

Novatek's key shareholders are as follows: Leonid Mikhelson (25% stake), who is also the CEO and Chairman of the Management Committee; Volga Resources (an investment vehicle of Gennady Timchenko), with a stake of approximately 23%; TOTAL S.A. (Aa1 negative), with a 15.7% stake, which it intends to increase to 19.4% by 2014; and Gazprom, with a 10% stake. Novatek's free float is estimated to be around 26%.

SUMMARY RATING RATIONALE

Novatek's Baa3 issuer rating reflects the following factors: 1) a track record of growth; 2) a strengthening domestic market position on the back of acquisitions and new contracts; and 3) low finding and development (F&D) costs and strong financial metrics.

To position Novatek on the global rating scale, we apply our rating methodology for the global independent exploration and production (E&P) industry published in December 2011. The difference between the assigned ratings and the methodology-indicated outcome, which is in the upper A rating category, reflects the execution risks associated with the development of new projects. As Novatek operates in Russia (Baa1 stable), its ratings are constrained by the country's weak institutional and economic framework compared with those of more developed markets.

DETAILED RATING CONSIDERATIONS

REVENUE GROWTH SUPPORTED BY HIGHER GAS PRICES, SHIFT TO END-CUSTOMER SALES AND GROWTH IN SALES VOLUMES

Novatek's revenue growth (20.4% year on year in 2012, 37% in the first quarter of 2013 compared with the fourth quarter of 2012) has been largely driven by 1) gas price growth - the Federal Tariff System increases domestic gas prices by 15% per annum for Gazprom, and independent producers such as Novatek move in lockstep; 2) the company's ability to secure nearly 90% of its sales with end-customers, decreasing dependence on ex-field gas offtake by wholesalers, in particular Gazprom; and 3) an increase in sales volumes of gas and export volumes of liquids.

Novatek's gas sales in 2012 and the first three months of 2013 were driven by the company's further development of its Yurkharovskoye field and crude oil deposits at its East-Tarkosalinskoye and Khancheyskoye fields. In the full year 2012, Novatek increased its gas production volumes by more than 6% year on year (to 56.5 billion cubic meters (bcm) from 53 bcm in 2011, including its share of associates). Own production of liquids increased insignificantly, as higher oil production was largely offset by a decline in gas condensate production. Novatek's liquid sales, however, grew by more than 70% year on year thanks to purchases of unstable gas condensate from joint ventures SeverEnergia and Nortgas, and a decrease in inventories. Novatek exports over 80% of its liquids.

Novatek's Purovsky Gas Condensate Stabilisation plant, which processes own and purchased gas condensate for further domestic and export sales, increased its throughput by 19.5% year on year in the first three months of 2013. Novatek aims to expand the plant's processing capacity to 11 million tonnes (mt) by 2014 from 5 mt initially.

For the transshipment and fractionation of stable gas condensate from the Purovsky plant, Novatek is constructing the Ust-Luga complex on the Baltic Sea, which has a fractionation capacity of 6 mt a year. The completion of the first phase (fractionation capacity of 3 mt) was launched on 19 June and the second phase (another 3 mt) will be completed in the fourth quarter of 2013. The project will allow Novatek to produce light and heavy naphtha, jet fuel, diesel fractions and heating oil and will help to further diversify the company's customer base (by increasing the number of potential off-takers for the new product mix) and export sales, thereby allowing it to realise profits by moving down the hydrocarbon value chain into higher margin products. It will also help

Novatek to save on transportation costs as Ust-Luga is located nearly 400 kilometres closer to Purovsky plant than the currently used port of Vitino.

MARKET POSITIONS STRENGTHENING AS END-CUSTOMER SALES REACH NEARLY 90% OF TOTAL SALES

A leap in Novatek's end-customer sales to nearly 70% by the end of 2012 and to 90% in the first quarter of 2013 from a little over 50% at the beginning of 2011 was driven by 1) the acquisitions of regional gas trader Gazprom Mezhregiongas Chelyabinsk (NOVATEK-Chelyabinsk) in November 2011 and Gazprom Mezhregiongas Kostroma in December 2012 (renamed NOVATEK-Kostroma in February 2013); and 2) signing of contracts with Mosenergo (unrated) and Severstal OAO (Ba1 stable).

Earlier in 2012, Novatek signed long-term energy contracts with E.ON Russia, a subsidiary of German utility E.ON AG (A3 stable), OAO Fortum, a subsidiary of Finnish utility Fortum Oyj (A2 stable), and OAO Mosenergo, a subsidiary of Gazprom; as well as industrial consumers, such as the metallurgical company OAO Magnitogorsk Iron & Steel Works (MMK, Ba3 stable), and fertilisers producers UralChem (unrated) and OJSC Uralkali (Baa3 stable). Novatek also has contracts with OGK-1 and Inter RAO UES JSC (Ba1 stable).

In 2012, end-customer sales provided a 3%-4% premium over ex-field sales. However, as a result of 1) 7% growth in transportation tariffs from 1 July 2012, 2) longer transportation distances, and 3) switch to other than Gazprom ex-field offtakers, Novatek's ex-field and end-customer netback prices nearly converged in the first quarter of 2013. We note that sales channels economics and relative competitiveness of the gas market players will continue to evolve as the Russian gas market develops, i.e 1) transportation tariffs rise in accordance with the currently envisaged by the Ministry of Economic Development indexation plan by 5.4%, 5.0% and 4.8% from 1 July in 2013-15, respectively; 2) independent producers are granted indiscriminate access to the pipeline transportation system, and 3) downward revisions to the annual domestic gas price indexation programme for Gazprom (currently envisaged at 15% in 2013-15, and 10% in 2016), if any, are approved by the government.

CASH MARGIN PER BOE SUPPORTED BY INCREASED EXPORT OF GAS LIQUIDS

An important measure in determining the underlying economic value of an oil and gas company's production is the unleveraged cash margin available on each boe of production. This is calculated as E&P revenues per boe minus E&P production costs per boe minus E&P general and administrative costs per boe. It is also an indicator of the value of a company's overall reserves to the extent they are approximately aligned with its production profile. This measure captures both realised prices and the cost of production, including transportation costs, and is significantly influenced by the company's mix of production between oil, natural gas and natural gas liquids (NGL). Novatek's cash margin per boe crossed over $10 in Q1 2013 and migrated into the Caa category from Ca on the back of higher realised domestic gas prices, as well as an increased share of natural gas liquids, in particular stable gas condensate, in the company's revenue (Q4 2012:19%, Q1 2013:24%).

Novatek is second-largest condensate producer in Russia after Gazprom. Stabilized gas condensate and liquid petroleum gas (LPG), processed from unstable gas condensate, can be sold domestically or, unlike natural gas, which can only be exported by Gazprom, can be exported by independent producers for further processing into fuels and chemicals. The taxation regime for condensate is more beneficial than for crude oil and gas. For example, the mineral extraction tax (MET) constitutes 4%-5% of the export netback price of condensate versus 15% of the domestic net gas price. Export duty on condensate is linked to the export duty on oil, but condensate sells at up to a 20% premium to oil on the export markets. This taxation regime provides for healthier netbacks on condensate export sales compared to oil and better profitability than domestic gas sales, which helps to improve Novatek's average cash margin per boe of production. While contributing only a quarter to Novatek's revenue, we estimate that gas condensate accounts for a significantly higher share (up to 40%-50%) of the company's EBITDA.

RISING TRANSPORTATION COSTS AND INCREASING MET PRESSURE PROFITABILITY

Historically, Novatek's financial metrics have been consistently strong, with an EBITDA margin (as adjusted by us) in the high 40s (2011: 52.2%, 2012: 47.2%). In Q1 2013, however, the company's profitability (as measured by its EBITDA margin (42%)) was negatively affected by a 60% increase in operating expenses, driven primarily by 2.5 times growth in purchases of gas and liquids from third parties and joint ventures, as well as transportation costs and the MET. Transportation expense grew by nearly 80% year on year, with one third of the increase attributable to higher tariffs and longer distances for gas transportation, and the rest to growth in volumes.

The MET rose to RUB265 (equivalent to $8.55 when introduced) /thousand cubic meters (mcm) from 1 January

2013 from RUB251 ($8) previously and accounted for 60% of non-income tax growth in Q1 2013 year on year. The effect of the tax rise has been somewhat offset by the company receiving a MET benefit for its Yamal Nenets Autonomous district oil production. It applied a zero MET rate from 1 January 2012 in accordance with the Russian Tax code provision for oil and gas condensate fields located north of the 65th parallel north.

We note that the Russian government is currently working on shifting from a flat rate of MET on gas to a calculation that will take into account such factors as the actual realized price of gas and transportation costs. This recalculation should alleviate the potential negative squeeze resulting from the application of a higher MET alongside potentially lower-than-expected domestic price indexation.

LEVERAGE AND COVERAGE METRICS TO REMAIN STRONG

According to its internal guidance, the company generally aims to adhere to a 1.0 times debt/EBITDA ratio. As a result of the Nortgas acquisition, however, Novatek's leverage, measured by debt/EBITDA, increased to 1.4 times as of end-2012. Based on the figured for the 12-month period ending 31 March 2013, however, the company's leverage decreased to 1.2 times due to both the growth in absolute EBITDA and decreased debt. Cash flow coverage, as measured by retained cash flow (RCF)/debt, returned to its 2011 level of above 52%. We expect the company to deleverage to pre-transaction levels in the next 18-24 months.

Novatek's robust cash flow generation benefits from its cost advantage over global E&P peers thanks to its low F&D costs per boe ($1.1 in FY2012 including acquisitions) and lifting costs ($0.57 per boe) supported by efficient acquisitions, access to new licences and the favourable positioning and geology of its fields.

LIQUIDITY TO REMAIN SOLID

We expect Novatek's liquidity profile to remain strong over the next 12 months, given relatively modest debt maturities (total repayments due in Q2 2013-Q1 2015 total approximately $700 million) as well as capex and dividend payout requirements relative to the company's robust cash flows. Liquidity is supported by a cash balance of around RUB16.9 billion (approximately $528 million) as of 31 March 2013, a committed $1.5 billion credit line from a consortium of banks, and over $500 million of undrawn, uncommitted credit facilities.

Rating Outlook

Novatek is adequately positioned in its rating category.

What Could Change the Rating - Up

We consider the potential for an upgrade of Novatek's rating to be limited over the near term, given 1) the company's scale, size and diversification of operations relative to Baa2 rated peers in the Russian oil and gas sector; and 2) certain concerns over the company's long-term positioning on the Russian gas market, given the political and administrative liaisons of its beneficiaries and historic linkages with Gazprom. The structuring of the ambitious and large-scale Yamal LNG project will have an effect on our assessment of Novatek's business risks and financial flexibility. However, the further enhancement of Novatek's operating profile and its scale of operations through production growth, the diversification of its sales and customer base, and the support provided by a benign regulatory regime, will exert positive pressure on the company's credit profile and its ratings.

What Could Change the Rating - Down

Downward pressure could be exerted on Novatek's rating as a result of 1) a substantial deterioration in the company's operating cash flow, with RCF/net debt falling below 30% and leverage, as measured by debt/EBITDA, increasing above 2.0 times on a sustained basis; and/or 2) unfavourable trends in the company's logistical arrangements, as well as in Russia's regulation of the oil and gas sector. We will consider Novatek's debt-financed investment projects and/or large-scale bolt-on acquisitions, which are fuelling an increase in leverage, in the context of their cash conversion cycle and whether they complement the company's business profile.

Rating Factors

OAO Novatek

Independent Exploration & Production Industry [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Ca**
Factor 1: Reserves & Production Characteristics (40.0%)								

a) Avg Daily Production (Mboe/d) (LTM)			1014					
b) Proved Developed Reserves (Million boe)			3611					
c) Total Proved Reserves (Million boe)		6913						
Factor 2: Operating & Capital Efficiency (20.0%)								
a) Leverage Full-Cycle Ratio		4.7x						
Factor 3: Leverage and Cash Flow Coverage (40.0%)								
a) E&P Debt / Average Daily Production		$5,024						
b) E&P Debt / PD boe Reserves		$1.1						
c) RCF / Total Debt				51.7%				
d) EBITDA / Interest Expense			16.0x					
Factor 4: Production Mix Overlay (Composite Score Adjustment)								
a) E&P Unleveraged Cash Margin / BOE							$10.5	
Rating:								
a) Indicated Rating from Grid			A1					
b) Actual Rating Assigned				Baa3				

[1] All ratios are calculated using Moody's standard accounting adjustments. [2] As of 3/31/2013(L); Source: Moody's Financial Metrics

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