

Global Credit Portal

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Summary:

OAO NOVATEK

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Table Of Contents

Rationale

Outlook

Summary:

OAO NOVATEK

Credit Rating: BB+/Stable/--

Rationale

The ratings on Russia-based independent gas producer OAO NOVATEK reflect the company's dependence on the pipelines of state-controlled OAO Gazprom (BBB/Stable/--), the dominant player in the sector with 84% of the country's gas production, ownership of all pipelines, and a monopoly on exports. Further rating constraints are the geographic concentration of its operations and very low domestic gas prices. NOVATEK is exposed to the risk of operating in Russia, including uncertain enforcement of tax and regulatory rules and the volatile U.S. dollar/Russian ruble exchange rate.

These weaknesses are offset by healthy credit metrics and the company's high profitability. NOVATEK's position as Russia's largest independent natural gas producer and its long reserve base underpin the rating.

Key business and profitability developments

In the first quarter of 2009, total natural gas sales stood at 8.5 billion cubic meters, slightly up from the levels of previous quarters and up 7% from the first quarter of 2008. There were no material changes in production volumes, despite a significant decline in domestic and EU gas demand as a result of the global economic slowdown and a considerable decline in Gazprom's production volumes. We believe that NOVATEK's gas sales volumes may come under pressure later in 2009, if Gazprom decides to redirect some of its export flows to the domestic market. This risk is mitigated by NOVATEK's positive track record of cooperating with Gazprom. The larger company has a 19.4% stake in NOVATEK and can influence its strategy and growth plans.

NOVATEK's profitability is highly affected by low domestic gas prices which are significantly lower than international benchmarks. Although NOVATEK's prices are not regulated, they indirectly depend on Gazprom's regulated prices which are set at very low levels by the government. Gazprom's prices, nevertheless, increased by about 20% in 2008 in Russian ruble terms and a further 15% increase in regulated gas prices is likely in 2009. Accordingly, we expect NOVATEK's gas price realization to increase further. In the first quarter of 2009, about 75% of revenue came from domestic gas sales, with the remainder coming chiefly from other products such as crude oil and stable gas condensate. Even at low prices, NOVATEK's gas business generates positive profits; the company had an EBITDA margin of 40% in the first quarter of 2009 thanks to very low costs (2008: \$0.64/barrel of oil equivalent (boe) lifting cost, \$5.62/boe total production cost).

Key cash flow and capital-structure developments

In the first quarter of 2009, NOVATEK generated funds from operations of Russian ruble (RUR) 4.7 billion, which covered capital expenditure of RUR3.8 billion. Although this was lower than in previous months, the company's key credit ratios remained strong. Total debt stood at RUR32.5 billion at the end of March 2009, while funds from operations/debt was about 60%. We note that the company is exposed to foreign exchange risk with about 80% of its revenues denominated in Russian ruble and 100% of its long-term debt in U.S. dollars.

The company has a major growth-oriented investment program and could post negative free operating cash flow in

2009. Taking into account payment for the acquisition of 51% of OAO Yamal, announced May 26, 2009, we nevertheless do not expect net debt to EBITDA to substantially diverge from below 1x. Of the total \$650 million consideration to be paid for the acquisition, we understand that \$550 million will be paid this year with current cash and \$300 million in promissory notes that the company plans to issue. We further understand that the company does not plan substantial capital expenditures on new fields in 2009-2010.

Liquidity

NOVATEK's position is relatively weak as the company is exposed to some financing risk in 2009. While cash in hand of RUR14 billion as at March 31, 2009 covered short-term debt of RUR11.5 billion, the company needs to finance \$550 million of the OAO Yamal transaction during 2009. It plans to do so with a mix of cash and new promissory notes. Other key calls on liquidity may result from NOVATEK's growing capital expenditure, expected in the range of RUR14 billion-RUR24 billion in 2009 and, potentially, distributions to shareholders.

An \$800 million unsecured credit line was fully drawn at the end of March 2009. Although access to external financing can be difficult in the current environment we expect NOVATEK to be able to arrange the financing of the acquisition well in advance.

The company's financial policy is to maintain an unrestricted balance-sheet cash position of \$100 million-\$150 million and available bank lines of \$300 million-\$500 million.

Outlook

The stable outlook reflects our expectation that NOVATEK's operating cash flow will be supported by gradually increasing domestic gas realizations and competitive costs. Because of heavy growth-oriented investments, however, the company's cash flow could turn negative in 2009 and 2010.

A drop in gas volumes sold, heightened operational risk from Gazprom (which is not our base case scenario), or adverse regulatory changes could pressure the ratings or outlook. With the recently announced \$650 million OAO Yamal acquisition, there is now limited headroom for further acquisitions. We expect NOVATEK to continue to meet its financial policy target of net debt to EBITDA below 1x over time.

Ratings upside over the long term is likely to be driven by a continuing increase in domestic gas prices and implementation of the company's long-term strategy of strengthening its business profile while keeping a robust financial profile.

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