

FITCH UPGRADES NOVATEK TO 'BBB', OUTLOOK STABLE

Fitch Ratings-London/Moscow-20 December 2017: Fitch Ratings has upgraded PAO Novatek's Long-Term Foreign-Currency Issuer Default Ratings (IDRs) to 'BBB' from 'BBB-'. The Outlook is Stable. A full list of rating actions is available at the end of this release.

The upgrade reflects Novatek's improved business profile following the start-up of the transformational Yamal LNG project, its strong free cash-flow generation capacity, and its currently low leverage. Novatek is considering another LNG project, Arctic LNG 2, and its leverage could come under some pressure in the medium term depending on the funding structure for this potential project, but we believe that the company should be able to maintain its leverage within our guidance for the current rating, namely, funds from operations (FFO) adjusted net leverage below 2.5x.

Novatek is rated above the 'BBB-' Country Ceiling for Russia (BBB-/Positive). This is in line with our 'Rating Non-Financial Corporates Above the Country Ceiling Rating Criteria' and takes into account the company's strong hard-currency external debt service ratio which is supported by significant operating cash flows from exports.

KEY RATING DRIVERS

Enhanced Business Profile: Yamal LNG has significantly enhanced Novatek's business profile and has propelled the company from being a niche Russian natural gas producer into a global LNG player. Novatek's financial profile remains conservative despite the project's large scale as Yamal LNG has been funded mostly through project finance debt. Although Novatek does not consolidate Yamal LNG, its financial profile should benefit from the repayment of shareholder loans (around USD3 billion, excluding interest) and later dividends.

Yamal LNG De-Risked: We view Yamal LNG's outstanding execution risks as limited. The price risk is low given that more than 95% of Yamal LNG volumes have been contracted. We assess Yamal LNG's break-even natural gas price at USD3/mmBtu, which we believe would support debt service even under USD40/bbl. Novatek has provided around USD10 billion of completion and other non-financial guarantees to Yamal LNG's creditors. We exclude these from Novatek's leverage, as the risk of cash outflows under these guarantees is remote and most of the guarantees will be released shortly after the project has become fully operational.

Piercing of Country Ceiling: Novatek is rated one notch above Russia's Country Ceiling of 'BBB-'. This factors in the company's strong hard-currency debt service ratio on the back of significant export cash flows which mitigates cash reserves predominantly deposited with Russian banks. We expect the ratio to be sustained within 1.0-1.5x over 2017-2020 and its weakening could result in a revision of our approach. We no longer cap the ratings of Russian oil and gas companies by the rating of the sovereign, to reflect the fact that the Russian state has been supportive of the sector, and our expectation that the tax regime in Russia will remain broadly stable.

Arctic LNG 2: Novatek is considering another LNG project, Arctic LNG 2. The management expects that the final investment decision could be taken in 2019, and the project could come on stream in 2022-23. While Arctic LNG 2 could further improve Novatek's business profile, it could put temporary pressure on its financial profile - especially if the company decides to provide shareholder loans to the project until the project finance and equity funding from other partners has been secured. However, we believe that Novatek should manage to maintain its FFO adjusted net leverage below 2.5x through the cycle, which is our guidance for the current rating.

Arctic LNG Funding Challenge: We believe that finding equity partners and obtaining funding could be the main challenges for the project, given that the LNG market is likely to be oversupplied for the next few years and given the US sanctions against Novatek. In mitigation, Novatek managed to secure funding for its Yamal LNG project primarily from Chinese banks, but also from the Japan Bank for International Cooperation and European banks. The company has signed framework agreements with potential Arctic LNG 2 partners, including the Chinese National Petroleum Company and China Development Bank. However, these arrangements are not legally binding.

Low Leverage: Novatek's funds from operations (FFO) adjusted net leverage peaked at 2.4x in 2015 on the back of investments in the Yamal LNG project and moderated at just above 1x in 2016. In our base case we expect Novatek's leverage to remain below 1x, a very conservative level by international standards, even assuming the company's rising capital investments in 2018-20 and intensified small-scale acquisitions. However, these forecasts do not include (i) potential investments in Arctic LNG 2 other than preliminary investments (Kola Yard and exploration capex) or (ii) potential loan repayments and dividends from associates, including Yamal LNG.

Stabilising Natural Gas Production: Novatek's natural gas production started declining in 2016 as some of its key producing fields became depleted. Development of new fields, including North Russkoye, as well as small-scale acquisitions, should help arrest the production decline. We expect Novatek's natural gas production, including share in associates but excluding Yamal LNG, to remain above 55 billion cubic meters (bcm) in the medium term, compared to the peak of 68 bcm in 2015 - this should be sufficient to meet Novatek's gas sales commitments.

Sanctions Manageable: Novatek has been included on the Sectoral Sanctions List by the US Office of Foreign Asset Control, which prohibits US companies and banks from providing new finance of longer than 60 days to the company and its subsidiaries. This has effectively barred Novatek from the US capital markets, and made access to other western markets difficult. We estimate the company will be able to repay its upcoming debt maturities largely from the internally generated funds, or resort to domestic borrowings in case of necessity. But its growth projects, such as Arctic LNG 2, may be dependent on the availability of external funding.

Global LNG Market Headwinds: The LNG market is likely to be oversupplied for the next few years on the back of additional LNG capacity being commissioned in the US, Australia and elsewhere, potentially resulting in depressed spot prices. Yamal LNG should be relatively immune, given most of its volumes have been contracted with prices mostly linked to oil. However, these are challenging times for launching greenfield LNG projects, given the reluctance of traditional customers to enter into long-term contracts. At the same time Arctic LNG 2 is likely to be competitive due to its potentially low operating costs and capex, especially compared to Australian projects coming online.

State Supportive Towards Arctic: Novatek's existing and potential projects, including Yamal LNG and Arctic LNG 2, are aligned with Russia's strategic aspirations, such as the diversification of energy exports through LNG and the development of the Arctic territories. The government has provided substantial tax breaks to Yamal LNG and helped to build infrastructure, as well as helped to fund the project from the National Welfare Fund. We believe that the state will continue support other Novatek projects in the Arctic through tax incentives and infrastructure investments.

DERIVATION SUMMARY

Novatek is Russia's major independent and natural gas producer. Its liquids business, mainly production and refining of gas condensate, as well as crude oil production, accounts for more than 60% of EBITDA. Novatek's business profile has significantly improved following the Yamal

LNG megaproject started in late 2017. In 2016 Novatek generated USD2.8 billion EBITDAX and produced 930 thousand barrels of oil equivalent per day (mbpd), excluding equity affiliates, comparable to that of Russia's Gazprom Neft (1,180mbpd, BBB-/Positive) and Tatneft (574mbpd, BBB-/Stable). Novatek's international peers include Apache Corporation (521 mbpd, BBB/Positive), Devon Energy (611mbpd, BBB+/Stable) and Marathon Oil Corporation (393mbpd, BBB/Stable).

Novatek's rating also takes into consideration higher-than-average systemic risks associated with the Russian business and jurisdictional environment. Its leverage is currently low but may rise on the back of the possible investments in Arctic LNG 2. However, we believe the Novatek should be able to maintain FFO adjusted net leverage at below 2.5x through-the-cycle, which is our guidance for the current rating.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- stabilisation in natural gas and liquids production by 2020 due to launch of North Russkoye field;
- domestic natural gas price inflation of slightly above 3% pa;
- Brent crude oil price of USD 55 in 2017, USD52.5 in 2018, USD55 in 2019, USD57.5 in 2020 and thereafter;
- average USD/RUB rate of 59.3 in 2017, 58 in 2018 and thereafter;
- capex rising to RUB80 billion, peaking at RUB115 billion in 2019 mainly amid spending on the North Russkoye field and gradually declining afterwards to RUB75 billion;
- dividend payout ratio of 30% of Net Income.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

-We believe that no further positive action is likely without a fundamental change in the company's business profile (including an improvement in scale and diversification), e.g. by bringing on stream another LNG project

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

-A downwards revision of the Country Ceiling below 'BBB-'

-FFO adjusted net adjusted leverage rising above 2.5x (end-2016: 1.1x) on a sustained basis

-Intensification of western sanctions directly affecting Novatek

LIQUIDITY

Strong Liquidity: At 30 September 2017 Novatek's short-term debt equalled RUB23.8 billion, being more than covered by the cash balance of RUB73.9 billion. We assume Novatek will be able to service its existing debt mostly with its operating cash flows and cash reserves. In case of necessity Novatek also has access to domestic funding, including Russia's largest banks. Other sources of the company's liquidity include undrawn available credit lines totalling almost RUB150 billion, and potentially, dividends and debt repayments from Novatek's JVs.

FULL LIST OF RATING ACTIONS

PAO Novatek

Long-Term IDR: upgraded to 'BBB' from 'BBB-', Outlook Stable

Local Currency Long-Term IDR: upgraded to 'BBB' from 'BBB-', Outlook Stable

Senior unsecured rating: upgraded to 'BBB' from 'BBB-' (the rating action applies to all debt issued prior to 1 August 2014)

Novatek Finance DAC
Senior unsecured rating: upgraded to 'BBB' from 'BBB-' (the rating action applies to all debt issued prior to 1 August 2014)

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Summary of Financial Statement Adjustments - Not applicable

The original committee decision was subject to an external appeal. This has resulted in a final rating outcome that is different from the original committee.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Corporate Rating Criteria (pub. 07 Aug 2017)

<https://www.fitchratings.com/site/re/901296>

Exposure Draft: Corporate Rating Criteria (pub. 14 Dec 2017)

<https://www.fitchratings.com/site/re/907387>

Exposure Draft: Sector Navigators (pub. 14 Dec 2017)

<https://www.fitchratings.com/site/re/10013332>

Rating Non-Financial Corporates Above the Country Ceiling Rating Criteria (pub. 15 Feb 2017)

<https://www.fitchratings.com/site/re/894126>

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