FitchRatings

Fitch Affirms Russia's Novatek at 'BBB-', Outlook Negative

Fitch Ratings-London-16 October 2015: Fitch Ratings has affirmed OAO Novatek's Long-term foreign currency Issuer Default Ratings (IDR) at 'BBB-' with a Negative Outlook. A full list of rating actions is available at the end of this commentary.

The rating reflects Novatek's strong business profile as Russia's second-largest natural gas producer and an exporter of refined liquids, its fairly low exposure to dollar oil prices and a manageable debt load. The rating also reflects Novatek's constrained access to international debt markets because of the US sanctions, and remaining completion risks associated with its Yamal LNG megaproject.

Novatek's ratings are capped by Russia's rating and Outlook (BBB-/Negative), due to the company's asset concentration in the country and the influence the state exercises on the oil and gas sector through taxes and regulation. On a standalone level and before the corporate governance and country risk discount, Novatek's rating would correspond to the high end of the 'BBB' category.

KEY RATING DRIVERS

Second-Largest Gas Producer in Russia

As Russia's second-largest gas producer after PJSC Gazprom (BBB-/Negative), Novatek plays an important role in domestic gas supplies. In 2014 the company produced 52.6 billion cubic metres (bcm) of natural gas, up 1% yoy, excluding joint ventures (JVs), which corresponds to 8% of the country's total production (10% including share in JV production); and sold 67bcm of gas, meeting 19% of total domestic gas consumption.

Since 2005 Novatek's production (excluding JVs) increased on average 9% per annum. We expect Novatek's gas production to stabilise in view of stagnant domestic gas consumption, intensified competition between Gazprom and independent gas producers, mainly Novatek and OJSC OC Rosneft, and limitations on the supply side.

Rising Exposure to Liquids

Over the past two years Novatek has substantially augmented its business and financial profile with rapidly increasing production of liquids, including gas condensate and crude oil. The company's liquids production amounted to around 198 thousand barrels of oil equivalent per day (mboepd) in 1H15, or 14% of overall production volumes (including JVs), which was 57% higher yoy. The share of liquids in Novatek's revenue after export duties and other sales taxes rose to 53% from 36% over the same period. We view the higher share of liquids in Novatek's production mix as positive because liquids sales generate higher margins. Although their dollar price is more volatile, this is mitigated by the flexibility of the rouble exchange rate.

Novatek's downstream facilities, including the recently expanded Purovsky condensate stabilisation plant and the Ust-Luga condensate refinery, should allow the company to further boost its EBITDA per barrel produced and benefit from a widening differential between export duties for stable gas condensate and light oil products.

Growing Output from JVs

Fitch expects Novatek to sustain the current natural gas production at a plateau level of 60-65 bcm (including JVs) over the medium term, with the share of production by JVs rising in 2015-19 as Novatek's own producing fields mature. Novatek's liquids growth strategy also depends on its JVs, mainly OAO Arcticgas (Novatek: 54.9%; JSC Gazprom Neft (BBB-/Negative): 45.1%) and ZAO Nortgas (Novatek: 50%; PJSC Gazprom: 50%). Since Novatek will need to purchase gas and condensate from its JVs before refining and/or reselling them to customers, we project its EBITDA margins to decline to around 36% in 2019 from 42% in 2014.

Yamal LNG on Track

Novatek occupies a strategic position in the gas-rich Yamal region, where it has been constructing a 16.5 mt LNG plant, with the first 5.5 mt train coming on stream in 2017. Currently, Novatek has a 60% stake in the project and its partners, China National Petroleum Corporation (CNPC, A+/Stable) and Total SA (AA-/Stable), hold 20% each. In September 2015, Novatek signed a framework agreement to sell a 9.9% interest in Yamal LNG to China's Silk Road Fund, a state-owned investment vehicle. We assume the deal will be finalised by end-2015. Novatek does not intend to reduce its stake in the Yamal LNG project below 50% in the future.

Novatek is subject to the US sectoral sanctions, limiting funding options for Yamal LNG. The company expects the USD27bn project to be financed by a combination of equity (USD10bn already provided by project partners) and project finance debt. The Russian National Welfare fund has already invested RUB75bn (around USD1.2bn) into the project and has committed to provide another RUB75bn after bank financing is approved. The largest portion is expected to be provided by a consortium of Chinese banks (USD12bn), with the remaining funding to be covered by Russian banks and European and Asian export credit agencies.

Fitch expects Novatek to provide completion guarantees to Yamal LNG's creditors for a maximum amount of USD9bn. We do not include these guarantees into Novatek's leverage since we assess the project's completion risks as manageable. This is also evidenced by the fact that the construction stage risks are largely insured by OJSC SOGAZ, the Russian leading insurance company, and re-insured with other insurers. The remaining risks associated with the project are taken into account in Novatek's standalone rating.

Yamal LNG should significantly enhance Novatek's business profile through diversification into the Asian LNG market. In comparison with other LNG projects constructed worldwide, Yamal's main advantage is its low cost of production and a competitive break-even LNG price, supported by tax holidays. According to Novatek, 96% of Yamal's LNG has been contracted for more than 20 years with contracted prices being higher than current spot prices due to price formulas.

Improving Customer Mix
Novatek has substantially improved its customer portfolio in Russia. In 2014 the share of end-customers (as opposed to traders) in its total sales further increased to 94%, compared with 45% in 2009 as the company has successfully signed long-term gas supply contracts with large industrial companies. Novatek has demonstrated the ability to re-allocate volumes of gas sold to new customers after PJSC INTER RAO (BBB-/Negative), Novatek's largest customer, in 2014 decided to switch to another supplier starting from 2016. We assess positively the prevalence of long-term contracts in Novatek's customer portfolio and believe that the company's volume risks will remain manageable over the medium term.

Low Price Risk
Novatek continues to enjoy a fairly low price risk atypical for the industry as Russia's domestic gas prices are effectively controlled by the state. Gazprom's regulated gas prices in Russia (which influence Novatek's selling prices) had increased 15% yoy for several consecutive years, until 2013 when the state decided to freeze the tariff for one year, and to limit tariff growth to inflation thereafter. In 2014, gas prices were increased by 7.5%. However, we do not expect tariffs to fall over the medium term, given their low current level. Even on the netback basis (deducting export duty and transportation), Russian domestic gas prices are about two times lower than Gazprom's average European export prices.

We also estimate that Novatek's income is broadly resilient to changes in oil prices. A drop in oil prices will result in Novatek's revenue and EBITDA being broadly stable in rouble terms due to flexibility in the rouble exchange rate.

Falling Capital Intensity
We expect Novatek's capital intensity to fall starting from 2016 as many of its field development and downstream project are approaching the production phase, and the company is not planning any new major projects, except for Yamal LNG, in the near future.

In 2013-14, Novatek's capital expenditures peaked at around 60% relative to funds from operations (FFO), compared with 50% in 2009-13. We expect Novatek's capex to moderate after 2015 to as low as 25%-30% of FFO, which should help the company accumulate funds to ensure timely debt repayment with no or minimal resort to external funding. As a result, the company's FFO adjusted net leverage should gradually decrease to below 1x by end-2017 from 1.9x at end-2014.

Sanctions
In July 2014 Novatek was 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 90 days to the company. 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 funds it generates, or resort to domestic borrowings in case of necessity.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- Broadly stable natural gas and liquids output with higher share coming from JVs;
- Russian domestic gas prices rising by single-digit numbers annually;
- Fitch's Brent price desk: USD55 in 2015, USD65 in 2016, USD75 in 2017, and USD80 thereafter;
- USD/RUB exchange rate: 60 in 2015, 55 in 2016, 50 in 2017, and 50 thereafter;
- Declining EBITDA margins due to higher share of production coming from JVs in 2015-19;
- Capex at around RUB60bn in 2015; moderating to RUB35bn p.a. afterwards;
- Dividend payout ratio: 30% in 2015-17 as per the company's dividend policy; increasing thereafter.

RATING SENSITIVITIES
Positive: Future developments that could lead to positive rating actions include:
- A positive rating action on Russia, which could result in Novatek's Outlook being revised to Stable, as Novatek's rating/Outlook is currently capped by that of the sovereign (for more details see 'Fitch Affirms Russia at 'BBB-' Outlook Negative', dated 3 July 2015 at www.fitchratings.com);
- A positive rating action on Russia together with an improved standalone profile, which could lead to an upgrade. An improved standalone profile would be manifested in FFO adjusted net leverage being consistently below 1.5x and/or further progress with Yamal LNG.

Negative: Future developments that could lead to negative rating action include:
- A negative ration action on Russia
- Intensification of western sanctions directly affecting Novatek
- FFO adjusted net adjusted leverage rising above 2.5x (end-2014: 1.9x) on a sustained basis.
- FFO adjusted interest cover falling below 8x (end-2014: 12.3x) on a sustained basis

LIQUIDITY

Significant Short-term Repayments
At end-June 2015, Novatek's short-term debt equalled RUB86bn, while its cash balance was RUB38bn. We assume Novatek will be able to repay the short-term debt mostly with its operating cash flows and cash reserves. In case of necessity Novatek also has access to domestic funding, including Russian state-controlled banks. Other sources of the company's liquidity include undrawn non-committed credit lines totalling more than RUB100bn, and, potentially, dividends and debt repayments from Novatek's JVs and consideration for the sale of the 9.9% equity stake in Yamal LNG.

FULL LIST OF RATING ACTIONS

OAO Novatek
Long-term IDR: affirmed at 'BBB-', Outlook Negative
Local currency long-term IDR: affirmed at 'BBB-', Outlook Negative
National long-term rating: affirmed at 'AA+(rus)', Outlook Stable
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)

Novatek Finance Limited
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)

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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 Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

Additional Disclosures
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