



Fitch Affirms Russia's Novatek at 'BBB-', Outlook Stable Ratings Endorsement Policy

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Fitch Ratings-London/Moscow-20 September 2013: Fitch Ratings has affirmed OAO Novatek's Long-term foreign currency Issuer Default Ratings (IDR) at 'BBB-', Outlook Stable. A full list of rating actions is at the end of this release.

Novatek's rating of 'BBB-' reflects its strong business profile as Russia's second largest natural gas producer and exporter of stable gas condensate and liquefied petroleum gas, its low price risks and manageable debt load. The ratings are limited by Novatek's moderate scale, concentrated reserve base and uncertainties over how its Yamal LNG megaproject will be financed. Novatek's rating is also discounted by two notches due to its high exposure to Russia, which is our usual practice for Russian oil and gas companies due to corporate governance and country risks considerations. In 2012 Novatek's hydrocarbon production amounted to 909 thousands of barrels of oil equivalent per day (mboe/d), of which 11% was liquids.

KEY RATING DRIVERS

Second Largest Gas Producer

Being Russia's second largest gas producer (after Gazprom) Novatek plays an important role in domestic gas supplies. In 2012 the company produced 50.5 billion cubic meters (bcm) of natural gas, up 6.3% yoy (excluding joint ventures), which corresponds to 8% of the country's total production; and sold 59bcm, accounting for 14% of total domestic gas consumption. Since 2005 Novatek's production increased by a CAGR of 11%, and we expect growth rates to decelerate in the medium term as the competition between Gazprom and other gas producers, primarily Novatek and state-owned OAO Rosneft ('BBB'/Rating Watch Negative), will intensify.

Yamal Financing a Concern

Novatek expects to fund development of its USD20bn Yamal liquefied natural gas (LNG) megaproject primarily through project finance debt, which we expect will be non-recourse. However, until the financing is finalised, there remains the risk that some form of recourse to Novatek (e.g. guarantees) will be needed, which could dramatically increase Fitch-calculated financial leverage. This is a constraint on the rating. We expect more clarity on financing plans only after the final investment decision has been taken later this year.

In the medium term, the Yamal project could transform Novatek's operational profile, although financial upside may be limited until any project finance debt is paid down. Novatek occupies a strategic position in the gas-rich Yamal region, where it has plans to launch LNG production by 2017. After the deal with China National Petroleum Corporation (CNPC, 'A+'/Stable) closes, Novatek will hold a 60% stake in the project and its partners, CNPC and Total SA ('AA'/Stable), will hold 20% each.

Improving Customer Mix

Novatek has substantially improved its customer portfolio. In 2012 the share of end-customers (as opposed to traders) in its total sales increased to 69%, compared to 45% in 2009 as the company has been successful in signing long-term gas supply contracts with large industrial companies and also acquired Gazprom's regional trading arms in the regions of Chelyabinsk and Kostroma. We positively assess the prevalence of long-term contracts in Novatek's customer portfolio and believe that the company's volume risks will remain limited in the medium term.

Low Price Risk

There is still some uncertainty over the growth of regulated domestic gas prices in Russia. Regulated gas prices have been rising by 15% yoy over the past several years, and we conservatively assume that there will be no growth in 2014 and then the growth will be limited to the general inflation level - this proposal is now being considered by the government. However, even these assumptions still imply low price risks for the company which is untypical for the industry. The company also has some exposure to oil prices as it generates around a third of its revenues through liquids sales - however, such exposure remains limited. We estimate that a Brent price drop by 25% will result in Novatek's EBITDA declining by only around 10%.

Long-Awaited Tax Formula

Our base-case scenario is that in 2014 natural gas and gas condensate producers will see a transition to a formula-based production tax, resembling that applied on oil production. The formula, which will capture the price of gas and gas condensate, geological factors and gas transportation tariffs, has been agreed on between state authorities and gas producers in all material aspects, and is awaiting final approvals. We view the formula introduction as rating

neutral as the effective tax rates will be in line with the rates previously set for 2014 and 2015. However, it will bring more predictability to the sector, which is overall a positive factor.

Concentrated Reserve Base

We still assess the company's reserve base as concentrated though expect some improvement in this respect in the medium term. In 2012 the Yurkharovskoye field accounted for 67% of the company's total output, which means that maintaining the field's production will be particularly important to Novatek meeting its contractual obligations. The weighting of the field in total production will decrease over time as Novatek expects to launch several new fields next year, most importantly, Urengoykoye and Yaro-Yakhinskoye.

Opportunistic M&A, Rising Capex

In 2009 - 2012 Novatek's capex level remained at around 50% of its funds from operations (FFO), and we expect it to increase in 2013 and 2014 to 90% on the back of intensified investments in upstream and downstream assets, including the third stage development of the Purovsky gas condensate plant. In 2015 we expect the capex to return to its historic level. In the past the company was also involved in several M&A deals. In 2010 Novatek acquired a 51% stake in Sibneftegas for USD850m and in 2012 a 49% stake in Nortgaz (later increasing its stake to 50%) for USD1.4bn. Though Novatek does not consolidate those entities they positively affect its cashflows as Novatek processes liquids produced by the JVs at its own downstream facilities and re-sells its share in gas produced. We assume no new acquisitions in our forecast and if there are any will assess their impact on a case-by-case basis.

RATING SENSITIVITIES

Positive: Future developments that could lead to positive rating actions include:

Rising output and diversification of the resource base while maintaining strong credit metrics could trigger a positive rating action. Progress with Yamal LNG could also be positive for the rating, including more clarity on how the project will be financed and the amount of completion or performance guarantees granted, if any, as well as securing export rights for the project. Novatek's rating, though, would be capped by that of the sovereign, so given Russia's current rating of 'BBB' only a one-notch upgrade is possible.

Negative: Future developments that could lead to negative rating action include:

Novatek could be downgraded if its financial metrics undergo a sustained deterioration, possibly from additional acquisitions, performance or financial guarantees granted in relation to Yamal LNG, making the issuer's FFO net adjusted leverage rise above 2.5x and FFO interest cover falling below 10x on a sustained basis.

LIQUIDITY AND DEBT STRUCTURE

Balanced Debt Portfolio: Novatek's debt portfolio is well-balanced per maturities, currencies and instruments. Debt is predominantly raised at the level of OAO Novatek and is not secured, hence no subordination issues arise. At 30 June 2013 the company had negligible short-term debt.

Manageable Debt Burden: We expect Novatek's leverage to rise in 2013-2014 due to the intensified capex programme and injections in Yamal LNG project getting close to 2x, but will go down thereafter if no M&A deals come in. We also expect that the company's FFO interest cover will not fall below 10x in the medium term.

The rating actions are as follows:

OAO Novatek

Long-Term foreign currency Issuer Default Rating: affirmed at 'BBB-', Outlook Stable

Long Term local currency Issuer Default Rating: affirmed at 'BBB-', Outlook Stable

National Long Term Rating: affirmed at 'AA+(rus)', Outlook Stable

Senior unsecured rating: affirmed at 'BBB-'

National senior unsecured rating: affirmed at 'AA+(rus)'

Novatek Finance Limited

Senior unsecured rating: affirmed at 'BBB-'

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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', dated 5 August 2013, are available at www.fitchratings.com.

Applicable Criteria and Related Research:

Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage

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