

Fitch Affirms Novatek at 'BBB', Outlook Stable

Fitch Ratings-Moscow-27 February 2019: Fitch Ratings has affirmed PAO Novatek's Long-Term Foreign-Currency Issuer Default Ratings (IDRs) at 'BBB' with a Stable Outlook. A full list of rating actions is available at the end of this commentary.

The rating of PAO Novatek reflects its improved business profile following the start-up and full ramp-up of its transformational Yamal LNG project, a strong cash-flow generation capacity, a large low-cost reserve base and solid credit metrics. Novatek is working towards another LNG project, Arctic LNG 2, and its leverage could increase in the medium term depending on funding arrangements for this project. However, we believe that the company should be able to maintain its leverage comfortably within our sensitivity for the current rating since we expect the project will be predominantly funded by equity injections from other partners and project finance.

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

Yamal Improves Business Profile: Novatek's Yamal LNG mega project has significantly enhanced the company's business profile and has propelled the company from being a niche Russian natural gas producer into a global LNG player with a 5% share on the global market. Although Novatek does not consolidate Yamal LNG on its balance sheet, its financial profile will benefit from the repayment of shareholder loans and, later, dividends. We expect that in the next four years annual cash flows from Yamal LNG to Novatek will exceed USD600 million annually.

New LNG Venture: Novatek is progressing with another large project with a 19.8mtpa LNG capacity, Arctic LNG 2, with the final investment decision (FID) expected in 2H19. The project should be more than 30% cheaper to construct than Yamal LNG on a per-tonne basis. Novatek is planning to reduce costs through new engineering solutions, such as placing the plant on gravity-based structures, and a higher degree of localisation. Novatek expects the first train could come on stream in late 2023.

Arctic LNG Funding: It is not completely clear how the project will be funded. Total SA (AA-/Stable),

Novatek's partner in Yamal LNG and Novatek's minority shareholder, has committed to acquire a 10% stake in Arctic LNG 2, and Novatek has mentioned several companies from Japan, Korea, China and Saudi Arabia as other potential partners. We understand from Novatek that the project should be predominantly funded by equity from partners (70%) and project finance (30%), but the exact structure is yet to be agreed. The new project adds some uncertainty to the company's credit profile due to its large scale and still unknown financial arrangements, but at the same time it will enhance Novatek's business profile over the longer term.

We believe it is possible that Novatek may decide to provide shareholder loans as bridge funding for the project, which could have a temporarily negative impact on its credit metrics; however, we expect that the company will be able to maintain leverage within our sensitivity. Our base case is that Novatek's investments in the project will be broadly covered by proceeds from sale of equity stakes to partners.

Low Breakeven LNG Price: We assess Yamal LNG's operational break-even natural gas price at around USD3/mmBtu, which makes it a very low-risk project in terms of price. In general US LNG projects would broadly break-even at the price of USD5-USD6/mmBtu for Europe and Asia (excluding capex/tolling fees). The future LNG projects of Novatek, including Arctic LNG 2, would have even lower operating costs due to on-going efforts to optimise logistics across the Northern Sea Route.

Piercing of Country Ceiling: Novatek is rated one notch above Russia's Country Ceiling of 'BBB-', in line with Fitch's Rating Non-Financial Corporates above the Country Ceiling Rating Criteria. This factors in the company's strong hard-currency debt service ratio, which is a function of strong hard-currency cash flows from exports. At the same time, Novatek's cash reserves are predominantly deposited with Russian banks.

Higher Capex Funded Internally: We expect that starting from 2019 and beyond Novatek will significantly intensify investments in LNG-related projects and infrastructure, including transshipment hubs, as well as in exploration and drilling aimed at stabilising its domestic production. In 2019, Novatek's capex will almost double on the 2018 level, and will remain high by historical standards at least in the next three to four years. However, we still expect Novatek's free cash flow (FCF after repayment of loans from JVs) to remain broadly neutral to positive given the company's strong operating cash flows and contribution from JVs, including Yamal LNG.

Low Leverage: Novatek's funds from operations (FFO) adjusted net leverage has been very low in the last three years (end-2018: 0.6x) as the company has switched to funding its growth projects mainly from internally generated funds. In our base case, which yet excludes the Arctic LNG 2

project, we expect Novatek's leverage to remain well below 1x, a very conservative level by both international and Russian standards. Leverage may end up higher depending on the funding arrangements for the new project; however, we expect that the project will be predominantly funded by equity injections from other partners and project finance.

Stabilising Natural Gas Production: Novatek's natural gas production started declining in 2016 as some of its key producing fields are depleting. Development of new fields, including North Russkoye cluster, 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 60 billion cubic meters (bcm) in the medium term, compared with the peak of 68 bcm in 2015. This should be sufficient to meet Novatek's domestic gas sales commitments.

Positive Outlook For LNG: Our long-term outlook for the LNG market is positive. We believe that surplus in the market, if any, will be temporary, as rising demand in Asia and elsewhere is likely to absorb new LNG volumes coming from the US and other regions. Moreover, there is a risk that the market may shift into deficit in the next two to three years as global investments in LNG have subsided following a drop in oil prices. Meanwhile, prices may remain volatile, but Novatek's LNG projects should remain profitable even under reasonable stress-case price assumptions, given the company's very low operating costs.

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 we believe made access to other western markets difficult. We estimate the company should be able to repay its upcoming debt maturities largely from internally generated funds, or resort to domestic borrowings in case of necessity.

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 and partially funded the project from the National Welfare Fund. We believe that the state will continue supporting other Novatek projects in the Arctic through tax incentives and infrastructure investments.

Derivation Summary

Novatek is Russia's major LNG and domestic natural gas producer with large exposure to liquids. Novatek's business profile has significantly improved after the Yamal LNG mega project started

operations and ramped up to full capacity in late 2018. The company has an abundant low-cost reserve base with very strong proved reserve life of 31 years (including shares in associates). Reserves are concentrated in the Yamal region of Russia.

In 2018 Novatek generated USD4.1 billion in EBITDAX and produced 874 mboepd (thousand barrels of oil equivalent per day), excluding equity affiliates, comparable to that of Russia's PAO Gazprom Neft (1,308 mboepd, BBB-/Positive) and PJSC Tatneft (596 mboepd, BBB-/Stable). Novatek's international peers include Anadarko Petroleum Corp. (663 mboepd, BBB/Stable), Apache Corporation (476 mboepd in 3Q18, BBB/Positive), and Marathon Oil Corporation (419 mboepd, BBB/Stable).

Novatek's leverage is low by Russian and international standards. We believe that Novatek should be able to maintain its leverage within our sensitivity for the current rating even assuming its potential investments into Arctic LNG 2, since the project will be predominantly funded through equity injections from partners and project finance. The company's rating also takes into consideration higher-than-average systemic risks associated with the Russian business and jurisdictional environment.

Key Assumptions

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

- Brent crude oil price: USD65/bbl in 2019, USD62.5/bbl in 2020, USD60/bbl in 2021 and USD57.5/bbl thereafter
- USD/RUB: 67.5 in 2019 and thereafter
- Broadly stable tax environment in Russia
- Stabilisation in natural gas and liquids production from consolidated subsidiaries in 2020 due to launch of North Russkoye cluster
- Capex peaking at RUB185 billion in 2019 and moderating to RUB160 billion in 2020 and thereafter
- Novatek's investments into Arctic LNG 2 to be broadly covered by proceeds from equity stake sales to other partners, hence we currently include in our base case only investments in exploration activities and development of LNG construction centre
- Dividend pay-outs in line with dividend policy (30% of net income)
- Small bolt-in acquisitions in the upstream segment

RATING SENSITIVITIES

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

- Improvement in the company's business profile evidenced by accomplishment of funding

arrangements and visible progress with implementation of Arctic LNG 2, provided that credit metrics remain conservative. We do not expect an upgrade in the next two years.

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

- A downwards revision of the Country Ceiling below 'BBB-' and deterioration in hard-currency debt service cover ratio consistently below 1x (2018: 0.6x)
- FFO adjusted net leverage rising above 2.5x on a sustained basis
- Intensification of western sanctions directly affecting Novatek and/or its LNG projects

Liquidity and Debt Structure

Comfortable Liquidity: At 31 December 2018, Novatek's short-term debt equalled RUB4.4 billion and was fully covered by a cash balance of RUB69.3 billion. We assume Novatek will be able to service its existing debt mostly from internally generated funds and available cash. In case of necessity Novatek also has access to domestic funding, including that from Russia's largest banks. Other sources of liquidity include undrawn long-term committed credit lines totalling almost RUB100 billion. Besides, redemption of shareholder loans and dividends from Yamal LNG and Arcticgas will provide additional liquidity.

Guarantees Excluded: 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 we view the risk of cash outflows under these guarantees as diminishing after the project was launched and reached full capacity. Most guarantees will be released shortly after the project passes commercial, production and other tests within this year.

PAO Novatek; Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Local Currency Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
----senior unsecured; Long Term Rating; Affirmed; BBB
Novatek Finance Designated Activity Company
----senior unsecured; Long Term Rating; Affirmed; BBB

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Applicable Criteria

[Corporate Rating Criteria \(pub. 19 Feb 2019\)](#)

[Non-Financial Corporates Exceeding the Country Ceiling Criteria \(pub. 17 Jan 2019\)](#)

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