MOODY'S INVESTORS SERVICE

Credit Opinion: OAO Novatek

Global Credit Research - 16 Mar 2015

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Negative
Corporate Family Rating	Ba1
NSR Corporate Family Rating -Dom Curr	Aa1.ru
Novatek Finance Limited	
Outlook	Negative
Bkd Senior Unsecured	Ba1/LGD4

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Key Indicators

[1]**OAO Novatek**

	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Avg Daily Production (Mboe/d)	1141	1095	1005	948	685
Proved Developed Reserves (Million boe)	4675	4042	4174	4134	4479
Total Proved Reserves (Million boe)	14035	14193	14161	10300	8469
Leveraged Full-Cycle Ratio	2.8x	7.7x	6.3x	7.2x	4.6x
E&P Debt / Average Daily Production	$3,662	$4,658	$4,385	$3,723	$4,581
E&P Debt / PD boe Reserves	$0.9	$1.3	$1.1	$0.9	$0.7
RCF / Total Debt	28%	42%	43%	52%	37%
EBITDA / Interest Expense	15.0x	14.0x	17.6x	15.2x	24.7x
E&P Unleveraged Cash Margin / BOE	$7.6	$8.5	$8.0	$8.6	$7.5

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Sovereign rating of Russia and its outlook, country ceiling for foreign currency debt

- Revenue and EBITDA growth supported by growth in liquids sales

- Profitability remains strong thanks to favourable product mix

- Strong position in the domestic market

- US sanctions limit financing options to Chinese and Russian banks and the Russian state

- Leverage and coverage metrics to remain strong

Corporate Profile

Headquartered in Moscow, OAO Novatek (Novatek, Ba1 negative) is Russia's largest independent gas producer and second-largest gas company in Russia - after state-controlled OJSC Gazprom (Gazprom, Ba1 negative). In 2014, Novatek reported approximately $9.5 billion in revenue and its adjusted EBITDA amounted to approximately $3.9 billion.

Novatek's key shareholders are as follows: Leonid Mikhelson (25% stake), who is also the CEO and Chairman of the Management Committee; Volga Resources (an investment vehicle of Gennady Timchenko, not rated), with a stake of approximately 23%; TOTAL S.A. (Aa1 stable), with a 18.2% stake, with a right to increase the stake to 19.4%; and Gazprom, with a 10% stake. Novatek's free float is estimated to be around 24%.

SUMMARY RATING RATIONALE

Novatek's Ba1 corporate family rating (CFR) reflects the following factors: 1) a track record of growth; 2) strong domestic market position on the back of acquisitions and new contracts; 3) low finding and development (F&D) costs and 4) strong financial metrics.

The application of our rating methodology for the global independent exploration and production (E&P) industry published in December 2011 to Novatek results in the methodology-indicated outcome in the A rating category. We note however that the company remains exposed to the Russian macroeconomic environment, despite high volume of exports, given that most of the company's production facilities are located within Russia.

The rating is constrained by Novatek's exposure to the weakening of Russia's credit profile, as captured by our downgrade of the sovereign rating and country ceiling for foreign currency debt to Ba1 from Baa3 with negative outlook on 20 February 2015.

Novatek was included in the US sectoral sanctions identification list, a development that effectively undermined the company's access to external financing in US dollars greater than 90 days, at least in the western financial and capital markets.

DETAILED RATING CONSIDERATIONS

EXPOSURE TO THE WEAKENING CREDIT PROFILE OF RUSSIA

The company's rating reflects the weakening of Russia's macroeconomic and financial climate, as captured by Moody's downgrade of Russia's government bond rating to Ba1/Not Prime (NP) from Baa3/Prime-3 (P-3) and Russia's country ceilings for foreign currency debt to Ba1/NP from Baa3/P-3 on Friday 20 February, with negative outlook. The ratings levels for corporate issuers reflect our concerns about trends in the financial strength of the government of Russia, and potential that domestic companies could face challenges in meeting their external debt obligations in the event of a severe erosion in the government and central bank's financial flexibility which is a driver for why the foreign currency ceiling has been aligned with the rating of the sovereign. A country ceiling generally indicates the highest rating level that any issuer domiciled in that country can attain for instruments of that type and currency denomination. For additional information, please refer to the related announcement https://www.moodys.com/research/--PR_318857.

We believe that, even for corporates without material medium-term foreign currency refinancing needs, the likely continued severe deterioration of the operating environment might lead to a substantial weakening in their credit profiles.

The resilience of Russian non-financial corporates to the increased risk arising from the prevailing negative operating conditions in the domestic market is likely to be limited, as reflected by the alignment of the country ceiling for foreign currency debt with the sovereign rating.

REVENUE AND EBITDA GROWTH SUPPORTED BY GROWTH IN LIQUIDS SALES...

Novatek's revenue growth (20% in 2014 compared with 2013) in rouble terms has been largely driven by 1) the company's ability to secure 94% of its sales with end-customers in 2014, decreasing dependence on ex-field gas offtake by wholesalers; 2) a 35% increase in sales volumes of liquids and a 12% increase in sales volumes of gas, 3) material depreciation of Russian rouble versus US dollar in 2014.

In 2013-14 Novatek increased its share in the joint venture (JV) SeverEnergia (JV with with Gazprom Neft (Ba1 negative)) to 54.9% from 25.5%, and launched new production facilities at SeverEnergia and Nortgas (JV with Gazprom). In addition, it commissioned a gas fractionation and transshipment complex in Ust-Luga, and completed expansion of the Purovsky gas condensate stabilisation plant capacity to 11 million tonnes (mt) per annum. This resulted in a material increase in revenue generation and sales profitability as the share from sales of refined products derived from gas condensate more than doubled in the company's revenue (24% in 2014 compared with 11% in 2013). Liquids produced at joint ventures contributed 28% of the group's total liquids production (2013: 9%).

The Ust-Luga complex on the Baltic Sea is used for the transshipment and fractionation of stable gas condensate from the Purovsky plant. The first phase (fractionation capacity of 3 mt) was launched on 19 June 2013 and the second phase (another 3 mt) in October 2013. The project allows Novatek to replace stabilised gas condensate sales with higher added value light and heavy naphtha, jet fuel, gasoil and fuel oil and helps to further diversify the company's customer base (by increasing the number of potential off-takers for the new product mix) and export sales. It is also helping Novatek to save on transportation costs as Ust-Luga is located nearly 400 kilometres closer to Purovsky plant than the previously used port of Vitino.

...AND PROFITABILITY REMAINS STRONG THANKS TO FAVOURABLE PRODUCT MIX

Novatek's EBITDA margin (41% as adjusted by us) in 2014 was among the highest in the oil and gas sector in Russia due to its mix of domestic natural gas sales and export of hydrocarbon liquid refined products. Novatek is the second-largest condensate producer in Russia after Gazprom. Unstable gas condensate is processed into stable gas condensate and liquefied petroleum gas (LPG) at the Purovsky plant. LPG is sold domestically or exported. With the launch of Ust-Luga in June and October 2013, stable gas condensate is now processed into petroleum products, which are then exported. The new taxation regime enacted from 1 January 2015 assumes a 6.5x increase in the mineral extraction tax (MET) on condensate by 2017; however, a significant reduction in the export duty for refined products more than offsets the negative effect of the increased MET on the company's revenue. While contributing approximately 11% to production and slightly more than a third to Novatek's revenue, liquids as per our estimates will account for a significantly higher share (over 50%) of the company's EBITDA.

US SANCTIONS LIMIT FINANCING OPTIONS TO CHINESE AND RUSSIAN BANKS AND THE RUSSIAN STATE

Novatek among several other Russian corporates was placed on the US sectoral sanctions identification list, which undermines its ability to raise US dollar financing greater than 90 days in the international capital markets to develop certain projects, namely the Yamal LNG project, together with Western partners. Novatek is a conventional gas producer and therefore will not be affected by the ban on transfer of unconventional and offshore oil and gas production technology. The company has strong cash flow generation and benign debt maturity profile, with more than half of its maturities in 2015 represented by Russian rouble-denominated bonds.

We understand that following the introduction of sanctions, Novatek together with its partners will seek financing from Chinese and Russian banks and the Russian state for the Yamal LNG project. Government officials confirmed the willingness of the government to support the project and have allocated RUB150 billion (approximately $2.3-$2.4 billion) from the National Wealth Fund to the project. Yamal LNG has already received half of the amount (RUB75 billion) in February 2015, we expect the remainder to be granted in the second half of 2015.

LEVERAGE AND COVERAGE METRICS TO REMAIN STRONG

As a result of a sharp rouble devaluation in the fourth quarter of 2014 the company's adjusted leverage increased to 1.7x driven by a 50% growth in the rouble equivalent of debt as of end- 2014 as compared with end-2013, while revenue, largely denominated in US dollars, received a boost from the devaluation only in the fourth quarter of 2014. Novatek's cash flow coverage, as measured by retained cash flow (RCF)/debt, fell to below 30% in 2014. We expect leverage and coverage metrics to recover in 2015 as the company's profitability and cash flow generation benefits from largely US-dollar denominated revenue and rouble-denominated cost of production.

Novatek's cash flow generation remains robust and benefits from its cost advantage over global E&P peers thanks to its low F&D costs per boe ($2.8 in 2014 including acquisitions) and lifting costs ($0.5 per boe) supported by efficient acquisitions, access to new licences and the favourable positioning and geology of its fields.

Liquidity Profile

We expect Novatek's liquidity profile to remain strong over the next 24 months, given that debt maturities (repayments due in 2015 total $350 million and RUB20.0 billion, repayments in 2016 total $1.0 billion) as well as capex and dividend payout requirements are manageable relative to the company's robust cash flows. Liquidity is supported by a cash balance of around $689 million as of 31 December 2014 as well as available credit facilities of $555 million and RUB10 billion (ca. $166 million).

Rating Outlook

The negative outlook is in line with the negative outlook for the sovereign rating and reflects the fact that a potential further downgrade of Russia's sovereign rating may result in the further lowering of the country ceiling for foreign-currency debt and, as a result, lead to downgrade of the company's rating. In addition to considerations related to the sovereign rating, we will also be monitoring the company's ability to address increasing country and foreign exchange risks.

What Could Change the Rating - Up

An upward pressure on the ratings is unlikely over the next 12-18 months considering the macroeconomic outlook for Russia. Positive pressure could be exerted on the rating if we were to raise Russia's sovereign rating and/or country ceiling, provided there is no material deterioration in company-specific factors, including operating and financial performance and liquidity.

What Could Change the Rating - Down

The company's rating will be impacted by further developments at the sovereign level. The rating is likely to be downgraded if there is (1) a further downgrade of Russia's sovereign rating and/or a lowering of the country ceiling for foreign-currency debt, and/or (2) a substantial deterioration in the company's operating cash flow, with RCF/net debt falling below 30% and leverage, as measured by debt/EBITDA, increasing above 2.0 times on a sustained basis.

Rating Factors

OAO Novatek

Independent Exploration & Production Industry Grid [1][2]	**Current FY 12/31/2014**			[3]**Moody's 12-18 Month Forward ViewAs of 3/5/2015**	
Factor 1: Reserves & Production Characteristics (40.0%)	**Measure**	**Score**		**Measure**	**Score**
a) Avg Daily Production (Mboe/d)	1141	Aa		1100 - 1200	Aa
b) Proved Developed Reserves (Million boe)	4675	Aa		4600 - 4800	Aa
c) Total Proved Reserves (Million boe)	14035	Aaa		14000 - 15000	Aaa
Factor 2: Operating & Capital Efficiency (20.0%)					
a) Leverage Full-Cycle Ratio	2.8x	A		2.8x - 3.5x	A
Factor 3: Leverage and Cash Flow Coverage (40.0%)					
a) E&P Debt / Average Daily Production	$3,662	Aaa		$3500 - $4000	Aaa
b) E&P Debt / PD boe Reserves	$0.9	Aaa		$0.9 - $11	Baa
c) RCF / Total Debt	28%	B		30% - 40%	Ba
d) EBITDA / Interest Expense	15.0x	A		14x - 16x	A
Factor 4: Production Mix Overlay (Composite Score Adjustment)					
a) E&P Unleveraged Cash Margin / BOE	$7.6	Ca		$7 - $9	Ca
Rating:					

Indicated Rating from Grid Factors 1-3		A1		A1
Unleveraged Cash Margin: Composite Score Adjustment	-0.4	-0.4	-0.4	-0.4
a) Indicated Rating from Grid		A1		A1
b) Actual Rating Assigned				Ba1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.