MOODY'S INVESTORS SERVICE

Credit Opinion: OAO Novatek

Global Credit Research - 29 Dec 2015

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Ba1
NSR Corporate Family Rating	Aa1.ru
Novatek Finance Limited	
Outlook	Stable
Senior Unsecured	Ba1/LGD4

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Key Indicators

[1]**OAO Novatek**

	30/09/2015(L)	31/12/2014	31/12/2013	31/12/2012	31/12/2011
Avg Daily Production (Mboe/d)	1090.6	1140.6	1094.5	1005.5	947.9
Proved Developed Reserves (Million boe)	4674.5	4674.5	4041.5	4174.2	4133.8
Total Proved Reserves (Million boe)	14035.0	14035.0	14192.5	14161.0	10299.8
Leveraged Full-Cycle Ratio	3.1x	2.8x	7.7x	6.3x	7.2x
E&P Debt / Average Daily Production	$4,152.3	$3,643.8	$4,655.4	$4,378.0	$3,713.9
E&P Debt / PD boe Reserves	$1.0	$0.9	$1.3	$1.1	$0.9
RCF / Total Debt	24.5%	27.8%	42.0%	43.0%	52.6%
EBITDA / Interest Expense	11.7x	15.2x	14.0x	17.7x	15.3x
E&P Unleveraged Cash Margin / BOE	$5.9	$7.6	$8.5	$8.0	$8.6

[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

- Russia's sovereign rating, outlook and country ceiling for foreign-currency debt

- Sizeable reserves are well monetised

- Sanctions limit financing options, but do not have material impact on business profile

- Reduced exposure to Yamal LNG financing

- Financial metrics will remain strong despite lower prices

Corporate Profile

Headquartered in Moscow, OAO Novatek (Novatek, Ba1 stable) is Russia's largest independent gas producer and second-largest gas company in Russia, after state-controlled OJSC Gazprom (Gazprom, Ba1 stable). For the last twelve months ended 30 September 2015, Novatek reported approximately $7.9 billion in revenue and its EBITDA amounted to approximately $2.8 billion (as adjusted by Moody's).

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, unrated), with a stake of approximately 23%; TOTAL S.A. (Aa1 stable), with a 18.9% stake, with a right to increase the stake to 19.4%; and Gazprom, with a 10% stake. Novatek's free float is estimated to represent approximately 23%.

SUMMARY RATING RATIONALE

Novatek's Ba1 corporate family rating reflects the following factors: (1) its vast conventional low cost reserves; (2) the company's integrated business model with a high share of processed value added products; (3) a track record of strong production growth in gas and liquids (gas condensate and oil); (4) its strong domestic market position in gas; (5) its strong financial metrics and fairly low leverage; (6) the execution and financing risks related to the development of Yamal LNG project, which has somewhat abated recently; and (7) the company's exposure to the credit profile of Russia.

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.

The final rating is constrained by the company's exposure to the credit profile of Russia, and is in line with Russia's sovereign rating and country ceiling for foreign-currency debt of Ba1 stable.

The company remains exposed to the Russian macroeconomic environment, despite its high volume of exports, given that most of the company's production facilities are located within Russia.

DETAILED RATING CONSIDERATIONS

SIZEABLE RESERVES ARE WELL MONETISED

Novatek has 31 licences for exploration and production, located mainly above the Polar circle of Russia in the West Siberian Yamalo-Nenets Autonomous District of Russia, with the total proved reserves of approximately 14 billion barrels of oil equivalent (boe) under the Petroleum Resources Management System reserve reporting methodology as of 31 December 2014. The company carries out the commercial production of natural gas, gas condensate and crude oil at 13 fields, including the company's flagship Yurkharovskoye and East-Tarkosalinskoye oil and gas condensate fields, with exploration and production licences valid until 2034 and 2043, respectively. These fields contributed 50% and 19% of the company's total gas and liquids production during the nine months 2015, respectively.

Production of gas and liquids at the company's joint ventures with Gazprom Neft (Ba1 stable), SeverEnergia, of which the company owns 53.3% (ownership will be reduced to parity during 2016) and Northgas, of which the company owns 50%, will continue contributing growing gas and liquids volumes in 2016. At SeverEnergia, the company is developing the Samburgskoye and Urengoyskoye fields launched in 2014 and the Yaro-Yakhinskoye field launched in 2015. The fields were ramped up to full capacity and allow a total production of approximately 28 billion cubic metres (bcm) of natural gas and more than 7.5 million tonnes (mmt) of gas condensate per year. At Northgas the company is developing the North-Urengoyskoye field with gas and condensate production of more than 10 bcm and 1.3 mmt, respectively. In December 2015, Novatek launched production at the Yarudeyskoye oil field, developed by its joint venture Yargeo, where Novatek owns 51%, where the company plans to ramp up production to about 3.5 mmt crude oil per year in the beginning of 2016. The company's share in Yamal LNG, which is a joint venture of Novatek, where it holds a 60% stake, and which develops the South-Tambeyskoye gas field, contributes about 16% to the company's total hydrocarbon reserves.

Novatek processes its unstable gas condensate at its Purovsky Gas Condensate Processing Plant, located in close proximity to its fields, where the company processes it into stable gas condensate and liquefied petroleum gas (LPG). Stable gas condensate is further processed at the company's Gas Condensate Fractionation and

Transshipment Complex located at the port of Ust-Luga on the Baltic Sea (Ust-Luga Complex) into higher-value refined oil products such as naphtha, jet fuel, gasoil and fuel oil. Increased liquids production allowed the company to fully utilise its Ust-Luga complex since Q1 2015. Both the Purovsky plant and Ust-Luga Complex are currently working at 15% higher than their name plate capacities of 11 million tonnes per annum (mmtpa) and 6 mmtpa, respectively, processing 13 mmtpa and 7 mmtpa, on an annual basis.

Novatek is not allowed to sell its natural gas in the export markets: according to the Russian law on gas exports, Gazprom has the exclusive right to export gas via its gas pipelines. Although Novatek can sell gas in the domestic market at any price, in practice it cannot deviate substantially from prices at which gas is sold by Gazprom at regulated tariffs ($45-$65/thousand cubic metres at the December 2015 exchange rate, depending on the region of sales, or about $8-$11/boe), which serve as benchmark prices. At the same time, the prices at which Novatek sells its liquids are market based and subject to fluctuations in underlying benchmark crude oil, naphtha and other gas condensate refined products prices, which are substantially higher on a boe basis compared with domestic gas sales, despite the recent fall in benchmark crude oil prices.

This integrated business model, with a growing share of liquids that are further processed into refined products at the Ust-Luga Complex, allows the company to shift to higher margin liquids sales (oil products, crude oil, LPG, stable gas condensate), which do not fluctuate seasonally and are largely sold in the export markets. As such the company has diversified away from gas, which is 100% sold in the domestic market in Russian roubles at regulated prices and exhibits seasonal volatility. The company sells almost 100% of its oil products, more than half of stable gas condensate and oil, in the export markets. Therefore, growing export sales of higher margin liquids provides the company with an increasing share of foreign-currency revenues, which is particularly beneficial in the view of the sharp depreciation of rouble since Q3 2014.

During the nine months ending 30 September 2015, natural gas sales fell by 7% to 44.7 bcm, compared with 48.2 bcm during the same period 2014, mainly as a result of warmer weather during the winter peak season. At the same time, liquids sales increased by 87% to 9.2 mmt compared with 4.9 mmt in the corresponding nine months of 2014, with oil products, stable gas condensate, LPG and crude oil comprising 55%, 19%, 18% and 8% of total sales volumes, respectively. As a result of the substantial increase in liquids production at SeverEnergia, the share of liquids in Novatek's overall hydrocarbon production increased to more than 15% in Q3 2015, from 10% in Q1 2014. The share of liquids in revenue and EBITDA during the nine months 2015 increased to 58% compared with 45% and 48% during the corresponding period of 2014, respectively. The share of liquids' sales in Novatek's total revenue and EBITDA will continue growing in 2016.

SANCTIONS LIMIT FINANCING OPTIONS BUT DO NOT HAVE MATERIAL IMPACT ON BUSINESS PROFILE

Novatek is subject to a US ban on the provision of financing for, and other dealings in, new debt with a maturity of longer than 90 days and all activities related to new debt, which does not impact the company's existing debt or equity instruments. We note that Novatek is not subject to the US technological sanctions, comprising a ban on the provision of goods, services and technology for certain deep-water (greater than 500 feet), Arctic offshore, or shale projects that have the potential to produce oil, encompassing also licence requirements for exports involving certain projects. For that reason Yamal LNG has not experienced meaningful difficulties, apart from some delays in closing external financing owing to these financial restrictions, while the project continues to receive equipment from foreign suppliers, including from the US.

Unlike the US financial sanctions, which target specific Russian companies, including Novatek, the EU ban on certain services necessary for deep-water oil exploration and production, arctic oil exploration or production and shale oil projects, apply to all such projects in Russia, which have the potential to produce crude oil. However, EU technological sanctions apply to unconventional oil projects and do not have an impact on the company's gas fields or joint ventures. The company's joint venture Yargeo, of which Novatek owns a 51% stake and which launched Yarudeyskoye oil field in December 2015 with an annual oil production from 2016 at approximately 3.5 million tonnes of crude oil, does not require import technologies or equipment, as estimated by the company. Novatek is a producer developing mainly conventional gas, oil and gas condensate deposits and therefore we do not expect that it will be affected by the EU technological restrictions.

REDUCED EXPOSURE TO YAMAL LNG FINANCING

On 24 November 2015, Yamal LNG issued RUB75 billion ($1.16 billion) of 15-year bonds. The bonds were issued as part of the withdrawal of the second tranche of the National Welfare Fund of Russia's (NWF) financing package for Yamal LNG, totaling RUB150 billion, which was approved by the Russian government in December 2014. The bonds have been purchased by the Ministry of Finance of the Russian Federation. The proceeds from the bonds issuance will be used to develop Yamal LNG.

The second tranche of the NWF withdrawal was preconditioned upon procurement of external creditors' approvals for Yamal LNG. Therefore, apart from being a vital financing source for funding Yamal LNG construction, the bonds issuance also serves as a confirmation that the Russian Government is satisfied that such approvals have been procured in due course. It also confirms that Yamal LNG continues to remain a high priority project for the Russian government, one of very few that managed to receive substantial support since oil prices collapsed and sanctions were introduced against a number of Russian corporates.

The successful issuance indicates that external creditors' approvals are in place and paves the way for external creditors to fully fund Yamal LNG on a project finance basis from 2016, reducing Novatek's exposure to this project as the key shareholder. As of 30 September 2015, Novatek had outstanding loans provided to Yamal LNG totalling approximately RUB125 billion, compared with RUB79 billion as of 31 December 2014. These loans will be repaid following the commencement of commercial production from the project's cash flows, available after servicing external debt. Yamal LNG's first phase will become operational in 2017 with 5.5 million tonnes LNG capacity and will further ramp up by 2020 with peak production at 16.5 million tonnes per year.

Yamal LNG has invested approximately $11 billion from $27 billion of total project investments. Yamal LNG is due to close $20 billion of project financing, out of which $12 billion will be provided by Chinese banks, with the rest covered by Export Credit Agencies and Russian financial institutions, of which $2.4 billion has already been received from NWF. Yamal LNG is progressing according to schedule, with the company estimating progress at 36% as of September 2015 (including 44% for the first train).

Novatek and China's Silk Road Fund (unrated) signed binding definitive agreements in December 2015 as part of a transaction for selling a 9.9% equity stake in the Yamal LNG project to the Silk Road Fund. The deal is not closed yet, and its closure is subject to certain amendments to the intergovernmental agreement between Russia and China coming into force. As part of the deal, the Silk Road Fund has already provided a EUR730 million loan to fund Yamal LNG development.

FINANCIAL METRICS WILL REMAIN STRONG DESPITE LOWER PRICES

Oil prices fell below $40/bbl in December 2015. We expect that oil prices will rise only gradually in 2016 and 2017 from late 2015 levels in a lower-for-longer environment, with Brent crude averaging $43/bbl in 2016, rising to $48/bbl in 2017. The average realised prices for the company's liquid products sold in the export markets correlate strongly with oil prices and fell accordingly. The weak rouble exchange rate, which depreciated by 42% in 2014 and further by about 14% in 2015 owing to falling oil prices, offsets to some extent the negative impact of lower oil prices. The company has 40%-50% of its revenue in foreign currency compared with less than 10% of its capex, while all of its operating expenses are in Russian roubles. Therefore, its lower US dollar revenues, owing to lower oil prices, will be somewhat offset by the positive impact of the weaker exchange rate on the company's costs and free cash flows, owing to the resultant lower operating expenses and capex. For the nine months ended 30 September 2015, Novatek generated free cash flows of $454 million (as adjusted by Moody's). We expect that the company will generate positive free cash flows in 2016.

Conventional reserves allow the company to be a low cost producer. The company estimates its average replacement costs over the last three to five years at $2.2-$2.4 per boe and its total all-in production costs (including depreciation, lifting costs, transportation and taxes) at approximately $6.2/boe during the first nine months of 2015, including lifting costs of $0.3/boe. Low costs and a substantial share of exports amid the rouble depreciation will allow the company to maintain strong profitability and operating cash flows despite lower prices.

The company's leverage as measured by Moody's-adjusted debt/EBITDA increased to 1.9x as of 30 September 2015, compared with 1.3x as of 31 December 2013, mainly owing to sizeable capex. This capex supported a substantial increase in the company's gas and liquids production, financing its share of Yamal LNG and rouble devaluation, as 82% of the company's debt is denominated in foreign currency.

The company has the capacity to reduce debt in 2016 following scheduled debt repayments, funding of Yamal LNG by external creditors rather than the company and substantially lower capex, which we estimate at RUB15-RUB30 billion during 2016. However, sizeable dividends at 30% of net profits and ad hoc share buy backs of up to $440 million until July 2016 could constrain the pace of deleveraging.

Liquidity Profile

Novatek has an adequate liquidity profile, which will further improve once external creditors have substituted

Yamal LNG's shareholders by providing funding for this project during its capital intensive development stage. As of 30 September 2015, Novatek had approximately RUB99 billion short-term debt, including $0.6 billion Eurobonds maturing in February 2016. We estimate that Novatek's (1) cash balances of RUB35 billion; (2) available long-term credit facilities of approximately RUB70 billion as of the same date; and (3) operating cash flows, which we estimate will amount to RUB120-RUB150 billion during 2016, will be sufficient to cover its capex programme and dividend payments as well as ad hoc share buy backs. We also expect Novatek to receive proceeds for the sale of the 9.9% stake in Yamal LNG when the deal with the Silk Road Fund is closed in 2016, which should further positively impact the company's liquidity profile.

Rating Outlook

The stable outlook is in line with the stable outlook for the sovereign rating and reflects our expectation that Novatek's specific credit factors, including its operating and financial performance, market position and liquidity, will remain commensurate with its ratings on a sustainable basis.

What Could Change the Rating - Up

We do not expect positive pressure to be exerted on the ratings in near term, owing to sovereign-related factors, and considering the stable outlook on the sovereign rating of Russia. However, positive pressure could be exerted on the ratings if we were to raise Russia's sovereign rating and the foreign-currency bond country ceiling, depending on the company's specific credit factors, including its operating and financial performance, market position and liquidity.

What Could Change the Rating - Down

The rating is likely to be downgraded if there is (1) a downgrade or a change of the outlook to negative on Russia's sovereign rating and/or a lowering of the foreign-currency bond country ceiling; or (2) a material deterioration in the company's operating and financial performance, business profile, market position or liquidity. In particular, a deterioration in the company's operating cash flows and leverage, such as retained cash flow/net debt falling below 30% and debt/EBITDA increasing above 2.0x on a sustained, forward-looking basis, would negatively affect the company's ratings.

Rating Factors

OAO Novatek

Independent Exploration & Production Industry Grid [1][2]	**Current LTM 30/09/2015**			[3]**Moody's 12-18 Month Forward ViewAs of December 2015**	
Factor 1: Reserves & Production Characteristics (40.0%)	**Measure**	**Score**		**Measure**	**Score**
a) Avg Daily Production (Mboe/d)	1090.6	A		1100 - 1200	Aa
b) Proved Developed Reserves (Million boe)	4674.5	Aa		4600 - 4800	Aa
c) Total Proved Reserves (Million boe)	14035.0	Aaa		14000 - 15000	Aaa
Factor 2: Operating & Capital Efficiency (20.0%)					
a) Leverage Full-Cycle Ratio	3.1x	A		2.8x - 3.3x	A
Factor 3: Leverage and Cash Flow Coverage (40.0%)					
a) E&P Debt / Average Daily Production	$4,152.3	Aaa		$3900 - $4200	Aaa
b) E&P Debt / PD boe Reserves	$1.0	Aaa		$0.9 - $1.1	Aa
c) RCF / Total Debt	24.5%	B		30% - 40%	Ba
d) EBITDA / Interest Expense	11.7x	Baa		12x - 15x	Baa
Factor 4: Production Mix Overlay (Composite Score Adjustment)					
a) E&P Unleveraged Cash Margin / BOE	$5.9	Ca		$5 - $7	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		A2		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 30/09/2015(L); 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.

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