MOODY'S
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CREDIT OPINION
13 February 2018

Update

Rate this Research

RATINGS

PAO Novatek

Domicile	Russia
Long Term Rating	Baa3
Type	LT Issuer Rating - Fgn Curr
Outlook	Positive

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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PAO Novatek

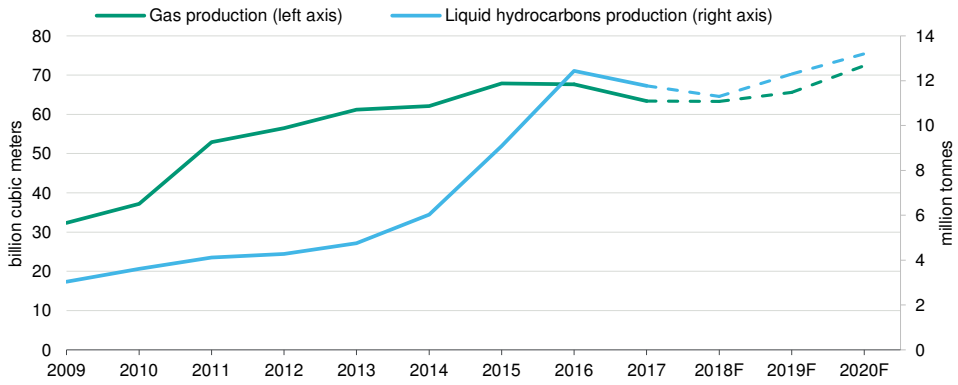
Update following upgrade to Baa3, outlook changed to positive

Summary

PAO Novatek's Baa3 issuer 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 both gas and liquids (gas condensate and oil); (4) strong domestic market position in gas; (5) strong financial metrics and liquidity profile with low leverage; and (6) substantially reduced execution and financing risks related to the development of Yamal LNG project.

The company remains exposed to the Russian macroeconomic environment, despite its high volume of exports, given that all of the company's production facilities are located in Russia. Novatek's long-term issuer rating (Baa3 positive) remains constrained by Russia's country ceilings for foreign currency debt (Baa3/P-3). The foreign currency country ceilings reflect the probability that a government would, in the event of a default, impose a moratorium on the foreign currency payments of domestic issuers. It determines the highest rating possible for debt instruments denominated in foreign currency by domiciled borrowers other than the national government.

Exhibit 1
Novatek's long-term production growth trend has moderated, but will resume in 2019



Source: Company data

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Credit strengths

» Substantial reserves at legacy fields and joint ventures

» Integrated business model with a high share of processed value added products

» The launch of the first train of Yamal LNG in Q4 2017 has turned the company into a global LNG player

» Financial metrics will remain strong despite lower prices owing to weak rouble and low costs

Credit challenges

» Falling gas and liquids production

» Elevated production drilling, acquisition of new licenses and planned Arctic LNG-2 project will keep investments at an elevated level

» Exposure to Russian operating environment

Rating outlook

The positive outlook on Novatek's rating is in line with the positive outlook for the sovereign rating and reflects the company's strong positioning within the current rating category, with a potential for an upgrade if we were to upgrade Russia's sovereign rating and raise the foreign-currency bond country ceiling.

Factors that could lead to an upgrade

» We could upgrade the rating if we were to upgrade Russia's sovereign rating and raise the foreign-currency bond country ceiling, provided there is no material deterioration in the company's specific credit factors, including its operating and financial performance, free cash flow generation, market position and liquidity

Factors that could lead to a downgrade

» We could downgrade the rating if we were to downgrade Russia's sovereign rating and/or lower Russia's foreign-currency bond country ceiling, or the company's operating and financial performance, market position or liquidity were to deteriorate materially

Key indicators

Exhibit 2
PAO Novatek

	Dec-13	Dec-14	Dec-15	Dec-16	LTM (Sep-17)	12-18 Month Forward View
Average Daily Production (Mboe / day)	1,202.7	1,251.2	1,429.0	1,467.2	1,372.5	1,350 - 1,380
Total Proved Developed Reserves (Mmboe)	4,041.5	4,674.5	4,670.8	4,306.8	4,306.8	4,300 - 4,500
Leveraged Full-Cycle Ratio	7.6x	3.3x	2.4x	3.4x	3.9x	3x - 4x
E&P Debt / Average Daily Production	$4,253	$3,543	$3,465	$2,472	$2,187	$2,000 - $2,100
RCF / Debt	42.0%	28.2%	25.4%	56.7%	71.2%	60% - 70%
EBITDA / Interest Expense	14.0x	12.3x	9.4x	18.0x	22.8x	23x - 25x
E&P Debt / Proved Developed Reserves	$1.3	$0.9	$1.1	$0.8	$0.7	$0.6 - $0.8

All figures and ratios are calculated using Moody's estimates and standard adjustments. Moody's Forecasts (f) or Projections (proj.) are Moody's opinion and do not represent the views of the issuer. Periods are Financial Year-End unless indicated. LTM = Last Twelve Months.
Source: Moody's Financial Metrics™

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 www.moodys.com for the most updated credit rating action information and rating history.

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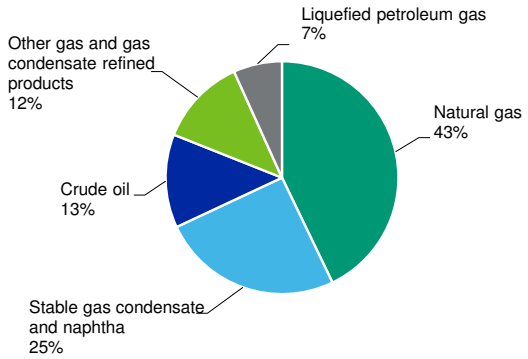
Profile

Headquartered in Moscow, PAO Novatek is Russia's second-largest independent gas producer and third-largest gas company in Russia, after state-controlled Gazprom, PJSC (Baa3 positive) and PJSC Oil Company Rosneft (Baa3 stable). For the last twelve months ended 30 September 2017, Novatek generated Moody's-adjusted EBITDA of RUB263 billion. In 2016, Novatek produced 67.7 billion cubic meters of gas and 12.4 million tonnes of liquid hydrocarbons.

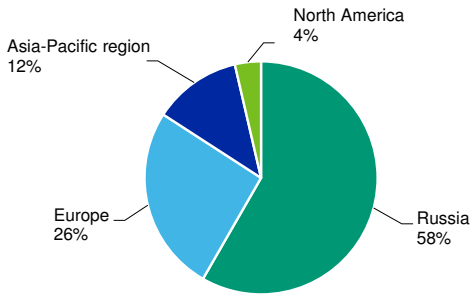
Novatek's key shareholders are as follows: Mr. Leonid Mikhelson (25% stake), who is also Chairman of the Management Board; Mr. Gennady Timchenko, with a stake of approximately 23%; TOTAL S.A. (Aa3 stable), with a 18.9% stake, with a right to increase the stake to 19.4%; and Gazprom, with a 10% stake. Novatek's free float is estimated to represent approximately 23%.

Exhibit 3
Revenue breakdown by product (9M 2017)



Source: Company data

Exhibit 4
Revenue breakdown by destination (9M 2017)



Source: Company data

Detailed credit considerations

Weaker production dynamics in 2017 offset by substantial reserves growth

Novatek holds 47 licences for exploration and production of hydrocarbon fields in Yamalo-Nenets Autonomous District. The company had total proved reserves (including its share in joint ventures) of approximately 15.1 billion barrels of oil equivalent (boe), including 2.1 trillion cubic meters of gas, under the Securities and Exchange Commission (SEC) classification as of 31 December 2017, which implies a proved reserve life of 29 years. The company managed to sizeably grow reserves in 2017 compared with 2016 (13.4 billion boe) due to acquisition of new licenses and exploration drilling activities. Novatek maintains robust reserve replacement, with organic reserve replacement ratio (excluding disposals) of 134% in 2017 (2016: 168%; 2015: 148%). We expect Novatek to grow its reserve base further, as the company continues to acquire new licences and carry out extensive exploration works at the Gydan peninsula and the Gulf of Ob.

The company carries out commercial production of natural gas, gas condensate and crude oil at 16 fields, including the company's core Yurkharovskoye and East-Tarkosalinskoye fields, which accounted for 48% and 12% of the company's total gas production and 12% and 11% of liquids production during three months ended 30 September 2017, respectively.

A significant share of Novatek's production is attributed to its joint ventures: Arcticgas and Nortgas, developed jointly with Gazprom Neft PJSC (Baa3 positive), where Novatek holds 53.3% and 50% stakes, respectively, and Terneftegas, a joint venture with TOTAL S.A., with Novatek's share amounting to 51%. Overall, joint ventures contributed 32% to Novatek's gas production and 42% to its liquids production in 2016.

At SeverEnergia, the company is developing the Samburgskoye and Urengoyskoye fields launched in 2012-14 and the Yaro-Yakhinskoye field launched in 2015. The fields have been 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 (mt) of gas condensate per year. At Nortgas, the company is developing the North-Urengoyskoye field with gas and gas condensate production of about 8.6 bcm and 0.8 mt per year, respectively.

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At Terneftegas, the Termokarstovoye field was launched and ramped up to its full capacity of 2.4 bcm of gas and 0.8 mt of gas condensate in mid-2015.

In the last three months ended 30 September 2017, the company's gas and liquids production fell by 7.5% and 4.5%, respectively, compared with the same period of 2016. While gas production at Novatek's largest brownfields (Yurkharovskoye, East-Tarkosalinskoye and Khancheyskoye) and Nortgas fields is currently falling mainly due to natural declines in the reservoir pressure at the current gas-producing horizons, this decrease was partially offset by improved efficiency of associated petroleum gas utilisation at Yarudeyskoye field, as well as the launch of compressing facilities to maintain the production levels at the Samburgskoye field of SeverEnergia. Novatek also aims to source future growth from North-Russkoye block of fields, which have a total production potential of 14 bcm of gas and 5 mt of liquids per year.

Yarudeyskoye oil field, developed by Novatek's 51%-owned subsidiary Yargeo, was launched in December 2015 and ramped up to full capacity of about 3.5 mt of crude oil per year in early 2016. Coupled with substantial increase in liquids production at SeverEnergia in 2015, the share of liquids in Novatek's overall hydrocarbon production increased to approximately 19% in 2016, up from 11% in 2014. The share of liquids in revenue increased to 57% in 2016 compared with 35% in 2014 and remained at about this level through Q3 2017. We expect that the share of natural gas in Novatek's total revenue and EBITDA will increase in the future following the launch of its Yamal LNG plant in Q4 2017.

In June and August of 2017, the company added roughly 20 billion boe to its resource base under Russian reserve classification standards by winning the auctions for four new licenses located at the Yamal and Gydan peninsulas.

Reserves are well monetised due to integrated business model

Novatek processes unstable gas condensate at its Purovsky Gas Condensate Processing Plant, located in 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, 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 and Purovsky plant since H1 2015. Both the Purovsky plant and Ust-Luga complex are currently producing more than their nameplate capacities of 11 million tonnes per annum (mtpa) and 6 mtpa, with the annualised throughput of 11.3 mtpa and 6.8 mtpa in Q3 2017.

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 somewhat 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 one third of crude oil in the export markets. Therefore, growing export sales of higher margin liquids provide the company with an increasing share of foreign-currency revenues, which contributes to fairly strong operating cash flows in rouble terms even when oil prices fall, owing to rouble depreciation.

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 regulated prices at which gas is sold by Gazprom (mostly in the range of $50-$60/thousand cubic metres, depending on the region of sales, or about $1.5-$1.7/mmbtu), which serve as benchmark prices. Novatek's gas monetisation rests on large medium- and long-term contracts with industrial end-customers (e.g. Russian steelmakers) and power generation companies.

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 per-boe basis compared with domestic gas sales, despite the recent fall in benchmark crude oil prices.

Yamal LNG launch in Q4 2017 improved the company's business profile

Novatek's flagship Yamal LNG project, which embraces the construction of a 17.4-mtpa liquefaction plant and the development of the South-Tambeyskoye field in the Yamal peninsula, will become the backbone of its medium-term growth. On 8 December 2017, the

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company loaded its first cargo of LNG following the launch of the first 5.5-mtpa train of Yamal LNG. The remaining two trains will be commissioned in 2018 and 2019. The company also intends to expand Yamal LNG by the fourth 0.9-mtpa train using the proprietary technology developed in-house. This fourth train will cost about $0.4-$0.5 billion (more than 2 times cheaper on a per tonne of capacity basis compared with the first three trains) and will be launched in Q4 2019. We positively note that long-term contracts cover more than 96% of the project's expected production volumes. As of 30 September 2017, overall project completion exceeded 89%.

Total capital spending requirements for Yamal LNG are estimated at $27 billion. Prior to obtaining external project financing, Yamal LNG was fully financed by the shareholders, who contributed approximately $13.1 billion to the project. In 2016, Yamal LNG signed 15-year syndicated credit line facilities in the amount of $4 billion equivalent with two major Russian state-owned banks and a $12 billion equivalent 15-year project financing facilities with Chinese banks. These and a number of other credit facilities of smaller size closed Yamal LNG's financing needs, which eliminated potential risks of this project funding out of Novatek's cash flows.

Yamal LNG is one of the lowest-cost liquefaction facilities worldwide owing to sizable conventional gas reserves near the plant and low temperatures in the Yamal peninsula (permafrost zone), which facilitate the liquefaction process. Novatek estimates that total cash cost at Yamal LNG, including feedstock, liquefaction and shipping, will total $3 per million British thermal units (mmbtu). We estimate that each train will contribute RUB30-RUB35 billion ($500-$600 million) to Novatek's EBITDA, or 12%-15% of reported 2016 EBITDA. The launch and subsequent ramp-up of Yamal LNG will positively contribute to the company's performance in 2018-20.

Novatek recently announced plans to expedite completion of the second train by three months and the third train by six months launching them in Q3 2018 and Q1 2019, respectively. Expedited completion would allow the project to reach its maximum LNG output one year ahead of schedule, allowing the earlier amortisation of shareholder loans (RUB172 billion as of 30 September 2017), the repayment schedule of which is linked to Yamal LNG's free cash flow. Novatek provided these loans, of size comparable to Novatek's own debt, to Yamal LNG to support the project's timely funding. The loans' repayment will enhance Novatek's cash position. Once all four trains are complete, Yamal LNG will be able to start paying dividends, and Novatek will be the key beneficiary. The launch of the fourth train and earlier completion of the first three trains will also allow the company to generate $1-$1.3 billion early revenue while lowering overall liquefaction costs by about 5%.

The company will continue increasing its LNG capacities after all four trains of Yamal LNG are completed. The next major LNG project of the company is a 19.8-mtpa Arctic LNG 2 plant, which envisages construction of three 6.6-mtpa trains at a total cost of more than $20 billion. The underlying resource base is the prolific Utrenneye field. The company plans to localise production of gravity based structures (GBSs), which shall reduce plant construction costs by 30% compared with Yamal LNG. GBSs will host the LNG and the accompanying facilities and will be anchored about 500 meters from the shoreline positioned on the river's soil. The company plans to make investment decision and select partners for this project in 2019.

The company also plans construction of the transhipment terminal at the Kamchatka peninsula, which will be launched in 2022-23 and will provide for $0.8/mmbtu LNG transportation cost savings compared with the current western (winter) route via Europe and the Suez Canal. This initiative shall give rise to the emergence of another global delivery basis (FOB Kamchatka) over the next several years, which will contribute to the globalisation of the LNG market and will give the company's LNG projects a competitive edge as key LNG consumers - Japan and South Korea - are only 3 days shipping from Kamchatka and the demand for LNG spot volumes can be satisfied at a fairly short notice.

Although 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 60 days and all activities related to new debt, the company 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.

Financial metrics will remain strong despite growth in capital spending

Prices for refined oil and gas condensate products sold by Novatek in the export markets correlate strongly with benchmark oil prices and fluctuate accordingly: Novatek's average realised contract prices for stable gas condensate and naphtha increased by 10.2% and 25.9% in Q3 2017 year on year, respectively, in USD terms. However, the stronger rouble exchange rate slightly offset the positive impact of higher oil prices. The company has approximately 50% of its revenue in foreign currency compared with only about 5% of its capital spending, while all of its operating expenses are in Russian roubles. Therefore, when oil prices fall, this positive foreign currency

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exposure has a cushioning impact on the company's metrics as 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 capital spending in US dollar terms.

Fairly weak rouble (despite recovery in oil prices) and largely conventional reserves allow the company to be a low-cost producer. We estimate that the company's total all-in production costs (including depreciation, lifting costs, transportation and taxes) at approximately $6-$7/boe, including lifting costs of $0.6-$0.8/boe.

The company's leverage, as measured by Moody's-adjusted debt/EBITDA, fell to 0.7x as of 30 September 2017, compared with 2.6x as of 31 December 2015. In the last twelve months ended 30 September 2017 the company generated strong free cash flows of RUB102 billion (as adjusted by Moody's), while Moody's-adjusted net debt fell to RUB100 billion as of 30 September 2017 compared with RUB172 billion as of end-2016. We expect that the company will break even on its free cash flows or generate slightly negative free cash flows after dividends in 2018, owing to sizeable investment programme aimed to counter the natural production decline at some of its mature fields. However, we expect the company to continue operating with fairly low level of leverage at below 1.0x.

Liquidity analysis

Novatek has strong liquidity profile. As of 30 September 2017, Novatek held a sizeable cash cushion of RUB74 billion, complemented with available credit facilities for a total of RUB164 billion. We estimate that Novatek's sizeable cash balances and robust operating cash flows, which we estimate will amount to approximately RUB130-RUB140 billion in 2018 will allow the company to make short-term debt repayments of RUB24 billion, to cover its increased capital spending programme of about RUB80-RUB90 billion and to continue making dividend payments of RUB60-RUB70 billion as well as ad hoc share buybacks. Novatek has no sizeable debt maturities in 2019-20.

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Rating methodology and scorecard factors

The application of our Independent Exploration and Production Industry rating methodology published in May 2017 to Novatek results in an A1 rating outcome. Novatek's current rating is below its grid assessment, reflecting the company's exposure to Russia's government credit profile, captured by the Ba1 sovereign rating with a positive outlook and the Baa3 foreign-currency bond country ceiling.

Exhibit 5

Rating Factors

PAO Novatek

Energy, Oil & Gas - Independent E & P Industry Grid [1][2]	Current LTM 30/09/2017		Moody's 12-18 Month Forward View As of February 2018 [3]	
Factor 1 : Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Average Daily Production (Mboe/d)	1,373	Aa	1,350 - 1,380	Aa
b) Proved Developed Reserves (MMboe)	4,307	Aa	4,300 - 4,500	Aa
Factor 2 : Business Profile (10%)				
a) Business Profile	A	A	A	A
Factor 3 : Profitability and Efficiency (25%)				
a) Leveraged Full-Cycle Ratio	3.9x	Aa	3x - 4x	Aa
Factor 4 : Leverage and Coverage (30%)				
a) E&P Debt / Average Daily Production	$2,186.9	Aaa	$2,000 - $2,100	Aaa
b) E&P Debt / PD Reserves boe	$0.7	Aaa	$0.6 - $0.8	Aaa
c) RCF / Debt	71.2%	A	60% - 70%	A
d) EBITDA / Interest Expense	22.8x	A	23x - 25x	A
Factor 5 : Financial Policy (15%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Rating:				
a) Indicated Rating from Grid		A1		A1
b) Actual Rating Assigned				Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 30/09/2017(L)
[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.
Source: Moody's Financial Metrics™

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Appendix

Exhibit 6
Peer comparison

	PAO Novatek			Apache Corporation			Anadarko Petroleum Corporation			ConocoPhillips		
	Baa3 Positive			Baa3 Stable			Ba1 Stable			Baa1 Stable		
(in $ millions)	FYE Dec-15	FYE Dec-16	LTM Sep-17	FYE Dec-15	FYE Dec-16	LTM Sep-17	FYE Dec-15	FYE Dec-16	LTM Sep-17	FYE Dec-15	FYE Dec-16	LTM Sep-17
Revenue	7,845	8,059	9,398	6,510	5,367	5,675	10,055	8,891	10,853	29,564	23,693	27,796
Average Daily Production (Mboe / day)	1,429	1,467	1,373	567	522	472	836	791	705	1,589	1,569	1,462
Total Proved Developed Reserves (Mmboe)	4,671	4,307	4,307	1,331	1,174	1,174	1,632	1,325	1,325	5,156	4,816	4,816
Leveraged Full-Cycle Ratio	2.4x	3.4x	3.9x	0.3x	0.0x	0.1x	0.5x	0.2x	0.4x	0.5x	-0.1x	-0.2x
EBITDA / Interest Expense	9.4x	18.0x	22.8x	7.1x	6.0x	7.4x	4.7x	3.2x	5.2x	7.4x	4.9x	7.4x
E&P Debt / Average Daily Production	$3,465	$2,472	$2,187	$16,103	$16,925	$18,662	$20,074	$21,000	$23,939	$19,851	$21,686	$18,979
E&P Debt / Proved Developed Reserves	$1.1	$0.8	$0.7	$6.9	$7.5	$7.5	$10.3	$12.5	$12.7	$6.1	$7.1	$5.8
RCF / Debt	25.4%	56.7%	71.2%	25.0%	18.2%	22.3%	15.6%	14.2%	19.8%	12.4%	10.9%	18.3%

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

Exhibit 7
Moody's-adjusted debt breakdown

(in RUB millions)	FYE Dec-12	FYE Dec-13	FYE Dec-14	FYE Dec-15	FYE Dec-16	LTM Ending Sep-17
As Reported Debt	**132,487**	**165,621**	**245,679**	**358,705**	**216,765**	**170,867**
Pensions	1,532	1,627	1,167	1,905	2,249	2,249
Operating Leases	452	188	2,532	236	1,028	1,028
Moody's-Adjusted Debt	**134,471**	**167,436**	**249,378**	**360,846**	**220,042**	**174,144**

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

Exhibit 8
Moody's-adjusted EBITDA breakdown

(in RUB millions)	FYE Dec-12	FYE Dec-13	FYE Dec-14	FYE Dec-15	FYE Dec-16	LTM Ending Sep-17
Unadjusted EBITDA	**101,275**	**158,591**	**75,737**	**121,713**	**354,365**	**254,282**
Pensions	662	222	104	152	201	201
Operating Leases	113	47	633	59	257	257
Interest Expense – Discounting	-232	0	0	0	-587	-837
Unusual	60	-33,971	43,463	19,023	-57,969	8,703
Moody's-Adjusted EBITDA	**101,878**	**124,889**	**119,937**	**140,947**	**296,267**	**262,606**

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

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Ratings

Exhibit 9

Category	Moody's Rating
PAO NOVATEK	
Outlook	Positive
Issuer Rating	Baa3
NOVATEK FINANCE LIMITED	
Outlook	Positive
Senior Unsecured	Baa3

Source: Moody's Investors Service

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