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Credit Opinion: OAO Novatek

Global Credit Research - 05 Jul 2010

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3
NSR LT Issuer Rating -Dom Curr	Aaa.ru

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Key Indicators

OAO Novatek

	2009	2008	2007	2006
Total Production (MBOE) [1]	215,333	199,833	185,167	186,000
Total Adjusted Debt / Proved Developed Reserves [1]	$0.36	$0.28	$0.09	$0.05
(Retained Cash Flow - Sustaining Capex) / Total Adjusted Debt	44%	53%	161%	246%
EBIT / Interest Expense	14.10x	34.30x	53.79x	23.31x
Adjusted RCF / Net Adjusted Debt [2]	84%	134%	408%	-770%

[1] Moody's conversion rates are applied: 1 mt =7.33 million boe and 1 bcf =0.17 million boe [2] Negative amount indicates Net Cash position

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

Opinion

Company Profile

OAO NOVATEK ("NOVATEK" or the Company), based in Moscow, is the largest global independent gas producer and Russia's second-largest gas company after state-controlled OJSC Gazprom ("Gazprom", Baa1/stable), with total annual production of 215 million barrel of oil equivalent (boe). In 2009, NOVATEK reported sales volume (including purchases) of 33 billion cubic metres (bcm) of natural gas, all of which is sold domestically, and 3.1 million tonnes (mt) of liquid products (including stable gas condensates, LPG and crude oil), of which around 70% is attributable to the production of stable gas condensate, which the Company exports. Total revenue was RUB90 billion (US$2.8 billion) in 2009, of which around 60% was generated from the sale of natural gas and 37% from the sale of liquid products.

Recent Developments

In May 2009, NOVATEK acquired a 51% interest in Yamal LNG, the company holding the licence for one of Russia's biggest gas fields (South-Tambeyskoye in the Yamal Peninsula), from companies related to Volga Resources for US$650 million. The company also signed a call option for an additional 23.9% of shares in the company for US$450 million, with an option period of three years. Volga Resources is a vehicle of Gennady Timchenko, the founder of the third-largest oil trading company in the world (Gunvor). During 2009/2010, Mr. Timchenko acquired a 20.8% stake in the Company and became the second-largest shareholder after Management and ahead of Gazprom. In addition, Mr. Timchenko received approval from The Federal Antimonopoly Service to further increase his shareholding in NOVATEK to 23.49% by 2012. He has one seat on NOVATEK's Board.

The acquisition of Yamal LNG is accretive to NOVATEK's reserves metrics. In the long term it could benefit the company's production and financial profile, however at this point Moody's does not factor this into its current rating assessments, in view of the acquisition's early stage and the high uncertainty attached to the timing and costs associated with the field's development. Given the size of the project, its remote location and lack of infrastructure, NOVATEK is currently involved in negotiations with several global majors to jointly develop the field. The negotiations are expected to be finalised within the next 18-20 months.

In June 2010, NOVATEK signed a cooperation agreement with Gazprom providing for the joint development of the Tambey group of fields (Gazprom holds licences for the adjacent North- and West-Tambeyskoye fields), which involves a joint construction of the LNG plant and infrastructure. NOVATEK has also signed a long-term agency agreement with Gazprom for LNG exports from the South-Tambeyskoye field - a major step which would address the issue of the company's access to LNG export markets given Gazprom's monopoly position on LNG exports.

Rating Rationale

NOVATEK's Baa3 long-term local and foreign currency ratings are based on the Global Rating Methodology for the Independent Exploration and Production Oil & Gas Industry, which defines four key rating factors that determine credit quality in the sector. Accordingly, NOVATEK's ratings reflect the significant scale associated with the Company's reserve and production base, its high operating and capital efficiency (due to its low cost base and strong leverage) and its cash flow metrics. However, the ratings are constrained by both fundamental risk factors, such as field concentration and geopolitical risk, and NOVATEK's high dependence on Gazprom, which holds a monopoly on gas transportation, pipeline access and export sales of natural gas. We also factor in the Company's ambitious growth plans and the execution risks associated with the development of South-Tambeyskoye field. These factors currently keep NOVATEK's ratings several notches below its fundamentally Aa credit profile.

FACTOR 1: RESERVES & PRODUCTION CHARACTERISTICS. NOVATEK scores a Aa/A by size of production and reserves, with proved reserves of 6.03 billion boe based on conservative SEC-LOL (Life of Licence classification), according to which reserves are measured until the expiration date o the licence, and 2009 production levels of around 215 million boe. The major step-up in proved reserves in 2009 (38% y-o-y) moved it one rating category up to Aa on this sub-factor. The reserves growth was mainly driven by the strategic acquisition of the large South-Tambeyskoye field, and to a lesser extent, by its E&P activity mainly related to the Yurkharovskoye field development. In 2009, NOVATEK discovered a new Severo-Yubileynoye field and nine new gas condensate deposits at existing fields.

NOVATEK's reserves are concentrated in Russia, with production coming from three large fields in the Yamal-Nenets region. Moody's positively acknowledges the Company's efforts to diversify its reserve base in the longer term including: (i) its progress on the JV project in Egypt; and (ii) the recent acquisition of Yamal LNG. In the medium term, NOVATEK will continue focusing on further development of the Yurkharovskoye field as the main driver of production and reserves growth. It also plans to jointly develop the Termokarstovoye field with Total.

In 2009, despite the overall downturn of the domestic gas market, NOVATEK's hydrocarbon production increased by around 8% to around 215 million boe (gas production grew by 6.3% from 30 bcm to 32 bcm), all of which was organic and driven by the launch of the first stage of the second phase of development at the Yurkharovskoye field in September 2008. The commissioning of the second stage of the second phase in October 2009 allowed the Company to further increase its hydrocarbon production in 1Q 2010 by 5% q-o-q as well as to boost total daily gas production capacity to about 120 million cubic meters (mcm) (or 879,000 boepd). As part of the Yurkharovskoye field's development, the Company also built an 87 km natural gas pipeline linking the field to the Unified Gas Supply System (UGSS), which increased NOVATEK's annual transport capacity from the field to 34 bcm of gas. In 2010, the Company plans to further grow its gas production to around 36-37 bcm.

FACTOR 2: RE-INVESTMENT RISK

NOVATEK is very strongly positioned within the Aaa category for reinvestment risk. It benefits from its three core fields' close proximity to each other, their advantageous geology and the cost-conscious management philosophy that is practiced throughout the organisation. On a three-year average, NOVATEK reported all-sources F&D costs and drill bit F&D costs (excluding acquisitions) of around US$1.2/bbl, one of the best results for global E&P players and well below the US$9/bbl threshold set for three-year average all-sources F&D costs in the Aaa category. Moody's expects the Company's F&D costs to gradually rise as it develops new fields.

FACTOR 3: OPERATING & CAPITAL EFFICIENCY

NOVATEK scores Aaa in this category, as its young and streamlined operations give it one of the most efficient cost structures in the industry and provide it with a high level of operating and capital efficiency. NOVATEK's high operating and capital efficiency enables it to produce solid margins, despite the fact that Russia's domestic gas prices are significantly below the international average, albeit have been improving over the past several years as Russia progresses with the domestic gas price liberalisation programme. Consequently, Moody's believes that NOVATEK will continue benefitting from gradually rising domestic prices as well as the liberalisation of the domestic gas market, which should partly compensate for any cost inflation (particularly transportation costs, which are beyond the Company's control and represent the main driver for operating costs growth).

The Company's operating efficiency should benefit in the short term from: (i) the devaluation of the rouble; (ii) easing inflationary pressure on oil field services; (iii) stable natural gas Mineral Extraction Tax (MET) on gas; and (iii) discounts for the railroad tariff for LPG and gas condensate exports. The completed capacity expansion at the Purovsky stable gas condensate and LPG plant in November 2008, which resulted in liquids now playing a bigger role in the Company's overall revenue base, has boosted NOVATEK's revenue-generation capacity, as well as optimised its product mix and marketing channels. In addition, the completion of the de-ethanisation plant at the Yurkharovskoye field and the gas condensate pipeline from the field to the Purovsky plant scheduled for Q3 2010 should further support operating efficiencies.

FACTOR 4: LEVERAGE AND CASH FLOW COVERAGE

NOVATEK scores Aaa on three of the four sub-factors in this category due its relatively low level of debt, substantial reserves and production base.

In 2009, NOVATEK's net debt increased to US$964 million, compared with US$573 million at the end of 2008, on the back of the debt financed acquisition of the equity stake in Yamal LNG. Its cash flow metrics and leverage profile remained strong in 2009, despite some weakening since 2008, with RCF/net adjusted debt of over 80% (134% in 2008) and (RCF - sustaining capex)/total adjusted debt of 44% (53% in 2008). In 2009, the Company's leverage (debt/book capitalisation) marginally increased to 22% (21% in 2008), and reduced marginally to 18% as of Q1 2010.

The Company's policy is to attract financing on an unsecured basis. As per its internal guidance, it aims to adhere to 1.0x debt/EBITDA and to maintain a healthy cash balance well in excess of its minimum working cash requirements. At the same time, Moody's notes that the current leverage threshold of 1.0x could fluctuate in the medium term given possible future M&A activity, potentially rising to 1.5-2.0x, to allow for greater financial flexibility. Factoring in a potential acquisition of up to US$500 million (in case NOVATEK decides to exercise its put on the additional 24% share in Yamal LNG), Moody's expects NOVATEK's debt/book capitalisation ratio to stay within 20%-25% in 2010-2011, with debt/EBITDA not exceeding 1.2x. Without factoring in any significant acquisitions, the ratio is anticipated to stay below 1.0x.

Liquidity

Moody's expects NOVATEK's liquidity profile to remain healthy during 2010/2011. NOVATEK expects to generate positive free cash flow (FCF), fully funding its annual capex requirements from operating cash flow. Capex is set to reach around RUB29 billion (US$1.0 billion (at a RUB/USD exchange rate of 30z) in 2010 and will be mainly directed at further development of the Yurkharovskoye field. Capex for 2011 is estimated at RUB27 billion (US$0.9 billion), with the main focus gradually shifting to the Ust-Luga project and new development fields and license areas. The actual capex magnitude will depend on market dynamics. In 2009, NOVATEK demonstrated significant financial flexibility, when it reduced its capex spending by 48% as a response to the market downturn.

NOVATEK has significant debt service requirements with around US$630 million repayable during Q2 2010-Q1 2011, around half of which is expected to be serviced out of internally generated cash. In April 2010, the Company repaid US$114 million from internal cash flows. In addition, in June 2010, NOVATEK issued a three-year RUB10 billion (over US$300 million) bonds under the existing RUB30 billion programme with the proceeds directed to refinancing of the current debt obligations.

The liquidity is also supported by US$390 million cash balance as of the end of Q1 2010 and around US$130 million of undrawn committed credit facility with Gazprombank and US$300 million of short-term undrawn uncommitted credit facilities.

Other Considerations

According to the Methodology outcome, NOVATEK resembles an Aa-rated company on the global scale, but there are a number of specific risks that are likely to keep it at its current level.

The dominant presence of Gazprom in the Russian gas sector and NOVATEK's direct dependence on Gazprom's pipeline network continues to be one of the key constraining factors for the rating, despite the positive track record of the relationship between the two entities.

This risk factor became increasingly pronounced during 2009/beginning of 2010, when the gas market experienced a severe downturn with most independent Russian gas producers facing reduced output and a squeeze of purchase volumes by domestic market monopolist Gazprom. So far NOVATEK proved to have a strong position in the market: (i) it increased and successfully marketed its gas production during 2009 with no interruptions in access to UGSS; (ii) it maintained its contracted off-take gas volumes with Gazprom during 2009 and increased them in 2010; and (iii) the company managed to attract two large end-customers which were previously serviced by Gazprom and secure transportation for these volumes. NOVATEK's beneficial relationship with Gazprom allows NOVATEK to demonstrate substantial resilience to political and domestic gas market risks at this point in time.

Moody's is positive about the Company's plans to co-operate with Gazprom on expanding the UGSS pipeline network, where it has reached its full capacity, as well as the joint development of the Tambey group of fields, including construction of the LNG plant. In the longer term, given the projected increase in gas demand globally, independent Russian gas producers are expected to play an important role in supplying the domestic gas market, enabling Gazprom to focus its attention on exports (which currently provides the bulk of its profitability).

At the same time Moody's notes that the recent changes in the global supply-demand equilibrium, coupled with the reduced demand for gas in Europe as a result of the global economic slowdown, make NOVATEK's position more vulnerable in the medium term in view of its high dependence on Gazprom in the event domestic gas output and exports to Europe were to suffer a prolonged decline.

As a company active in the Russian oil & gas sector, NOVATEK is subject to greater geopolitical volatility than companies operating under more developed frameworks. However, from a political risk standpoint, the Company's exposure to the government's negative interference is currently mitigated by the nature of its shareholding structure, which has recently been enhanced by strong political connections of the Company's new shareholder, Mr Timchenko. A further mitigant is its more pronounced proximity to the state, illustrated by the government's heavy involvement in, and support for, the deal with Total, NOVATEK's purchase of a 51% interest in the Yamal LNG project and the prospects of deepening collaboration with Gazprom.

Rating Outlook

To maintain the stable outlook on the rating, Moody's expects the Company to continue to produce sufficiently strong operating cash flow to support capital investments and dividends, while maintaining a prudent leverage profile and healthy liquidity. Moody's also assumes that NOVATEK will continue to maintain its productive and stable working relationship with Gazprom. We have factored some flexibility into the ratings and would expect retained cash flow after maintenance capex/total debt to remain above 40%. We also expect NOVATEK to maintain secured debt as a percentage of total debt at no more than 15%, with the majority of debt to be raised centrally.

What Could Change the Rating - Up

Given the Company's very strong performance on re-investment, operating and capital efficiency and cash flow metrics, the key factors constraining its rating are related to the low diversification of the reserve base, its dependence on, and the risk of intervention by, Gazprom (exacerbated by a lack of transparency in Gazprom's relationship with independent gas producers) and the Russian political/regulatory environment, which affects all oil and gas companies in Russia. Significant improvements to these factors could generate some upward pressure on the rating. Moody's would also require evidence of continued unimpeded operations under more attractive pricing conditions before we could upgrade NOVATEK's ratings closer to its fundamental credit quality. In addition, we would expect the Company to deliver on its production and financial targets, and to stay on track in implementing its capex programme.

What Could Change the Rating - Down

Ratings could come under pressure if NOVATEK experiences: (i) any difficulty or suffers interruptions in accessing Gazprom's pipeline; and/or (ii) production reductions as a result of unfavourable treatment by Gazprom, to the extent that it causes material deterioration to its operational and financial performance. A change in the Company's financial policies, with an adverse impact on key cash flow and leverage parameters, or a reversal of the government gas price liberalisation reform (including a delay or substantial slow down of its implementation) would result in a substantial weakening of operating cash flow (RCF/net debt trending towards 30%) and would also put pressure on the rating. However, the ratings allow for some flexibility to increase investments or for higher shareholder returns, provided that they are adopted in the context of the above-mentioned financial parameters set by Moody's.

Rating Factors

OAO Novatek

Independent Exploration & Production Industry	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Reserves & Production Characteristics (36%)							
a) Average Daily Production (Mboe/day) [1]			590				
b) Proved Developed Reserves (Million boe) [1][2]			3,650				
c) Total Proved Reserves (Million boe) [1][2]		6026					
Factor 2: Re-Investment Risk (16%)							
a) 3-Year All-Sources F&D ($/boe)	$1.21						
b) 3-Year Drillbit F&D Costs incl. Revisions ($/boe)	$1.26						
Factor 3: Operating & Capital Efficiency (18%)							
b) Leveraged Full-Cycle Ratio	5.39x						
Factor 4: Leverage & Cash Flow Coverage (30%)							
a) Debt / PD BOE Reserves [1]	$0.36						
b) (Debt + Future Development Capex) / Total Reserves [1][3]	x						
c) Debt / Average Daily Production [1]	$2,230						
c) (Retained Cash Flow - Sustaining Capex) / Debt				44%			
Rating:							
a) Indicated Rating from Methodology		Aa2					
b) Actual Rating Assigned				Baa2			

[1] Moody's conversion rates are applied: 1 mt =7.33 million boe and 1 bcf =0.17 million boe [2] Under SEC - Life of the license standards [3] Moody's estimation due to the absence of information

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