Issuer Comment: Moody's comments on Novatek's two recent acquisitions

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Moody's Investors Service has today affirmed the Baa3 rating of OAO Novatek ("Novatek") with the stable outlook.

"Moody's affirmation of Novatek's Baa3 issuer rating follows the company's announcement of its acquisitions of a 25.5% stake in OOO SeverEnergiya and a 51% stake in OAO Sibneftegas for the total consideration of USD1.8 billion," says Victoria Maisuradze, a Moody's Vice President-Senior Credit Officer and lead analyst for Novatek. "Under the acquisitions, which are expected to be completed by the end of 2010, Novatek will pay around USD1.2 billion in Q4 2010, with the remaining portion due at the end of Q4 2011. The company will finance the first instalment with a USD600 million one-year bridge loan, three-year bank facilities worth USD400 million and USD200 million in cash. The company intends to secure a longer-term funding for refinance the bridge, as well as to settle the remainder of the acquisition price for the assets, at a later stage," adds Ms Maisuradze.

Moody's considers the above acquisitions to be in line with Novatek's financial strategy, which is already factored into the rating. Novatek has been clear about the fact that its general leverage target of 1.0x could fluctuate in the medium term as a result of possible M&A activity, potentially rising to 1.5-2.0x to allow for greater financial flexibility. Factoring in the acquisitions, for 2010-2011 the rating agency expects Novatek's: (i) debt/book capitalisation ratio to remain below 30%; (ii) debt/EBITDA ratio to not exceed 1.5x; and (iii) retained cash flow (RCF)/net debt ratio to be above 40%, which is fully consistent with Moody's rating guidance.

Novatek's current operations have benefited from the acquisitions. Furthermore, given the close proximity of the acquired assets to Novatek's existing fields and processing and transportation infrastructure, Moody's expects these assets to be accretive to the company's business profile and longer term growth. While SeverEnergiya is a green-field project with first visible production not expected in the short to medium term, Sibneftegas will begin contributing more than 10% to Novatek's gas production in 2011.

Novatek's Baa3 issuer rating is also supported by the company's historically robust operational and financial performance. Novatek demonstrated significant resilience to negative market and economic developments during the major crisis on the gas market. In 2009 and the first nine months of 2010, Novatek managed to: (i) substantially ramp-up its production capacity, driven by the development of its Yurkharovskoye field; (ii) successfully market gas sales and extend its end-customer base; (iii) broaden its liquids sales channels; (iv) maintain strong profitability and cash flow generation; and (iv) sustain healthy financial metrics, with an adjusted last-12-months (LTM) Q3 2010 (RCF - sustaining capex)/total adjusted debt ratio of over 70% and a debt/book capitalisation ratio of below 20%.

Moody's also notes good liquidity position of the company, supported by strong cash flow generation and high capex flexibility. In 2010, Novatek has completed the major part of its investment programme aimed at building up its production capacity and removing bottlenecks in gas condensate operations. This will allow Novatek to cut future development capex spending if necessary, while maintaining the currently strong production level. Moody's also takes comfort from Novatek's historically strong relationships with Russian banks.

To maintain the stable outlook on the rating, Moody's expects Novatek to continue to produce sufficiently strong operating cash flow to support its 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. The rating agency has factored some flexibility into the ratings and would expect RCF after maintenance capex/total debt to remain above 30% and leverage (Debt/Ebitda) not to exceed 2.0x at any given point in time (to reflect short-term hikes driven by M&A activity), while trending towards 1.0x as a general guidance, consistent with the company's financial policy. Moody's would also expect the percentage of secured debt in the company's total debt structure to remain below 15%.

Given Novatek's very strong performance with regard to 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. 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.

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 substantial weakening of Novatek's operating cash flow (with RCF/net debt trending towards 30%), leading to pressure being exerted on its ratings, could also result from (i) a change in the company's financial policies, with an adverse impact on key cash flow and leverage parameters; or (ii) a reversal of the government gas price liberalisation reform (including a delay or substantial slowdown in its implementation). However, the ratings allow for limited 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. In addition, should the company fail to secure a long-term funding in order to finance the second instalment under the acquisitions of SeverEnergiya and Sibneftegas and to refinance the USD600 million bridge loan, a potential liquidity pressure may cause the downward pressure on the rating. However, Moody's believes Novatek is comfortably positioned to timely address the liquidity issues taking into account its significant capex flexibility as well as strong relationship with the Russian state-owned banks.

OAO Novatek ("Novatek"), rated Baa3 with a stable outlook, is the largest global independent gas producer and Russia's second-largest gas company after state-controlled OJSC Gazprom ("Gazprom", Baa1/stable), with total 2009 annual production of 215 million barrel of oil equivalent (boe). In 2009 the company generated total revenues of USD 2.8 billion.

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