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OAO NOVATEK

Primary Credit Analyst:
Per Karlsson, Stockholm (46) 8-440-5927; per_karlsson@standardandpoors.com

Secondary Contact:
Elena Anankina, CFA, Moscow (7) 495-783-4130; elena_anankina@standardandpoors.com

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OAO NOVATEK

Major Rating Factors

Corporate Credit Rating
BBB-/Stable/--
Russia National Scale ruAA+/--/--

Strengths:

- Strong production growth, which we expect to continue.
- Low-cost production.
- Large reserves of natural gas.
- Diversification between gas and liquids.

Weaknesses:

- Low domestic gas prices.
- Exposure to pipeline infrastructure of Russian monopoly gas distributor.
- Geographically concentrated operations.
- Relatively short debt maturity profile
- Exposure to Russia's uncertain political and institutional environment, including uncertain enforcement of tax and regulations.

Rationale

The rating on Russia-based gas extraction group OAO NOVATEK reflects what Standard & Poor's Ratings Services views as the group's "satisfactory" business risk profile and "intermediate" financial risk profile.

NOVATEK's key strengths include its position as Russia's largest independent natural gas producer, with a long reserve life, high profitability, and robust free operating cash flow (FOCF) generation in recent years. NOVATEK's profitability benefits from low production costs, the high quality of its large onshore reserves, where both gas and liquids are present, and management efficiency gains. Russian gas industry regulation limits the downside to domestic gas prices, in our view. Even though NOVATEK's gas prices are not regulated, we believe they depend indirectly on the regulated gas price for Russia's largest gas producer OAO Gazprom (BBB/Stable/A-2) and are set to gradually increase. The rating is also supported by NOVATEK's currently robust credit metrics.

We believe that NOVATEK has a favorable track record of managing country risk, with strong production growth in recent years, access to attractive gas assets, tax holidays for subsidiary OAO Yamal LNG, and an agreement with Gazprom to act as intermediary for a small commission in NOVATEK'S future exports of Yamal LNG's gas production. Like other independent Russian gas producers, NOVATEK faces lower mineral extraction tax than the country's industry champion Gazprom. Most of the liquids NOVATEK produce are condensates, which are taxed at a lower rate than crude oil in Russia.

NOVATEK's favorable track record of managing country risk is a ratings support for now, but in the future we will view it in the context of NOVATEK's standing in Russia's developing political and institutional environment. NOVATEK's shareholding structure provides some comfort, in our view. Gazprom controls 10%; Total S.A. (AA-/Stable/A-1+) controls 12%; and businessman Gennady Timchenko, reported to have strong political connections, controls about

21%.

On the negative side, we view NOVATEK's financial policies as moderate and borderline aggressive, reflecting the group's large acquisitions in recent years that have led to heavy debt increases, as well as the group's likely heavy increase in capital spending in coming years. In our view, this may result in negative, or at best neutral, FOCF. Another relative weakness in our view is the group's inherent exposure to Russian country risk. Currently, NOVATEK does not export gas and faces relatively low, but stable, domestic gas prices. Other important country risk factors include uncertain enforcement of taxes and regulations, as well as exposure to the volatile U.S. dollar/Russian ruble exchange rate, and dependency on a third party, Gazprom, which owns the gas distribution system in Russia, for transporting the bulk of its products. Gazprom is required by Russian law to transport natural gas for independent producers.

S&P base-case operating scenario

We forecast that EBITDA will improve to about RUB100 billion-RUB105 billion in 2012 ($3.1 billion-$3.3 billion assuming a U.S. dollar/Russian ruble exchange rate of about 32), up from RUB90 billion in 2011. We base this forecast on continued healthy production that we anticipate will increase to about 58 billion-60 billion cubic meters in 2012, from about 53.7 billion cubic meters in 2011. We also anticipate that NOVATEK will benefit indirectly from a 15% increase in the regulated domestic gas price for the country's biggest gas producer, Gazprom, effective from July 1, 2012.

We note Gazprom's recent decision to temporarily stop buying gas from independent gas producers like NOVATEK. According to management, the risk of this ban for NOVATEK is limited. If anything, we expect the ban to be temporary and have no bearing on sales to end customers via Gazprom's transportation network (67% of NOVATEK's gas shipments in the second quarter of 2012). We also see NOVATEK's increase in sales to other parties as a mitigating factor. Nevertheless, we continue to view exposure to Gazprom as a fundamental risk for the Russian gas industry.

We anticipate that NOVATEK's return on capital will remain solid in 2012, supported by low-cost onshore operations from a few key gas fields.

S&P base-case cash flow and capital-structure scenario

In 2012, we forecast that NOVATEK's funds from operations (FFO) will increase to $2.4 billion-$2.5 billion from about $2.5 billion in 2011. We believe that cash flow generation should continue to benefit from increased production and prices.

While we envisage that NOVATEK's credit ratios will remain robust, with FFO to debt of about 70% and debt to EBITDA about 1x, we now foresee negative, or at best neutral, FOCF because of the group's more aggressive capital spending plans. NOVATEK has not yet taken a final investment decision, but we anticipate that Yamal LNG and two of its partners will undertake the construction of a liquefied natural gas (LNG) plant in the Yamal peninsula for a total estimated cost of at least $18 billion.

Liquidity

We assess NOVATEK's liquidity as "adequate" under our criteria. We anticipate that liquidity sources will cover uses by more than1.2x in the near term, even in the event of an unforeseen EBITDA decline. We think that the group's debt maturities should be manageable. Nevertheless, we note relatively large debt maturities of about RUB27 billion in total until December 2013.

Our assessment of NOVATEK's liquidity profile incorporates the following forecasts and assumptions:

- Estimated sources of about $4.0 billion-$4.5 billion. These include cash (of which we assume RUB10 billion is tied to operations); our estimate of FFO; and an undrawn long-term RUB40 billion committed credit facility from Russian bank BPS-Sberbank (B-/Stable/C) due in December 2014.
- Estimated uses of about $2.7 billion-$3 billion, including capital spending, short-term debt, and dividends.
- Our expectation that net sources will remain positive, even if EBITDA declines by more than 15%.
- Our view that compliance with financial covenants could survive a 15% drop in EBITDA.

As of June 30, 2012, the group had an ample EBITDA cushion against a consolidated leverage ratio covenant of 3x and EBITDA interest coverage of more than 4x.

Outlook

The stable outlook reflects our view that NOVATEK's operating cash flow will continue to benefit from increasing production and domestic gas price realizations, as well as the group's competitive cost structure. We anticipate that the group will continue to manage its liquidity.

While there is some headroom at the current rating for further small to midsize acquisitions, we could take negative rating actions if debt to EBITDA were to rise to more than 1.5x and FFO to debt were to remain less than 60% for a lengthy period.

The rating could come under pressure if management undertook large debt-financed acquisitions, or if it managed capital spending in such a way that FFO to debt was lower than 60% for a prolonged time. Negative rating actions could also follow adverse regulatory changes, operational risk related to Gazprom, an escalation of costs or capital expenditure (capex) inflation, or increased mineral taxes.

If NOVATEK decides to develop the LNG project in the Yamal peninsula, we anticipate that it will pass on a large share of the development costs to international partners, in line with its guidance. To date, only one partner, Total, has been announced.

Ratings upside is unlikely, because the rating is already high for a group with such large exposure to Russia.

Business Description

NOVATEK is the largest independent gas producer in Russia. In line with the group's guidance, we anticipate production of about 58 billion-60 billion cubic meters of gas in 2012 and about 4.5 million tons of liquids. NOVATEK's production is mostly concentrated at three 100%-controlled fields in Yamal-Nenets Autonomous Okrug, the main gas-producing province in the Russian Federation (foreign currency BBB/Stable/A-2; local currency BBB+/Stable/A-2; Russia national scale 'ruAAA').

Business Risk Profile: "Satisfactory;" Low Costs And Long Reserve Replacement Partly Offset By Inherent Country Risk

The major supports for the group's "satisfactory" business risk profile are:

- NOVATEK's long, positive record of managing the risks of operating in the Russian gas industry, notably its favorable record of cooperation with Gazprom and access to assets. Unlike some other independent gas producers in Russia, the group has never experienced substantial distribution interruptions. In our view, close coordination with Gazprom's own plans is beneficial for NOVATEK's credit profile. We believe that Gazprom has a strong interest in having independent suppliers such as NOVATEK sell natural gas on the domestic market.
- NOVATEK's status as Russia's largest independent gas producer. The group generates about 30% of total independent production, and is the main gas supplier to large industrial regions (for example, Chelyabinsk). In 2009, the worst year of the global economic downturn, despite the fact that Gazprom's exports declined, NOVATEK did not reduce its gas shipments and was even able to sign new contracts with large industrial customers. We view the Yamal LNG acquisition as an indication that the Russian government and Gazprom approve and support a greater role in the gas sector for independent producers such as NOVATEK.
- NOVATEK's robust reserves. The group has robust reserves, including potential upside from probable and possible reserves (see table 1). This has been boosted by acquisitions in recent years. At the end of 2011, the group's reserves, including its share in equity companies, stood at more than 9.4 billion barrels of oil equivalent (boe), predominantly gas.
- High profitability. This is chiefly a result of very low production costs and diversification into gas condensate which is exported and very profitable for NOVATEK. In 2011, NOVATEK's lifting costs were only $0.5 per boe and total production costs $6 per boe net of depreciation, depletion, and amortization (see table 2), which highlights the group's operating efficiency. In addition, NOVATEK's gas and condensate wells have virtually zero watercut compared with about 80% at some Russian oil and gas wells, and, unlike oil wells, do not need frequent and costly workovers due to wax accumulation. Although NOVATEK's costs are gradually increasing, with the key drivers--including ruble appreciation and regulated transportation costs--beyond the group's control, the group's cost position should remain under control, in our view. Another factor supporting profitability is lower taxes. NOVATEK pays lower mineral extraction tax than Gazprom. In Russia, the marginal tax rate on crude exports is close to 90% of anything more than $25 per barrel. Condensate is taxed at a much lower rate.
- Diversification into profitable liquid products. In 2011, about 35% of NOVATEK's revenues came from liquid hydrocarbon products such as stable gas condensate and liquefied petroleum gas that was largely exported. Prices of liquids are linked to international benchmarks and are not regulated, and their sales are subject to very low taxation, compared with crude oil sales. Accordingly, they provide a relatively large share of EBITDA (we estimate about 40%) and enable NOVATEK to benefit significantly from currently high international hydrocarbon prices.
- Gradual increases in domestic gas prices. Although NOVATEK's prices are not formally regulated, Gazprom's are. Russian domestic gas prices remain below those of Western Europe, but we believe that there is political and regulatory support for progressive increases of about 15% a year. The most recent was in July 2012 (15%). Although deregulation has been postponed several times, politicians appear committed to further gradual price increases and potentially full price liberalization over the medium term. We view downside gas price risk as low and are of the opinion that this limits NOVATEK's exposure to commodity price volatility.

Table 1

OAO NOVATEK Proven Reserves*						
	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Proven reserves (mil. boe)	4665	4677	4965	8130	9491	9434
of which gas (bil. cubic meters)	651	653	690	1153	1349	1325
of which liquids (mil. barrels)	407	406	452	589	566	78
Proven developed (%)	76	82	75	50	52	48
Production (mil. barrels)	208	202	220	237	274	380
Production ('000 boe per day)	571	555	604	651	753	1044
Reserve life	22	23	23	29	35	25

boe--Barrels of oil equivalent. *As calculated by S&P with a conversion factor of 6.54.

Table 2

OAO NOVATEK Costs And Revenues						
$/boe	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
$/RUB exchange rate	27.2	25.6	24.8	31.7	30.4	29.4
Production (Mil. boe)	208.0	202.1	220.0	237.0	274.0	380.0
Revenues/boe*	8.0	10.5	12.4	11.6	13.8	14.7
Production cost/boe	0.5	0.6	0.7	0.5	0.6	0.5
Transportation/boe	1.9	2.5	3.0	3.8	4.5	4.1
Taxes/boe	1.1	1.2	1.3	1.1	1.1	1.5
Depreciation, depletion, and amortization/boe	0.6	0.7	0.8	0.7	1.0	1.0
Operating profit/boe	3.9	5.6	6.7	5.5	6.7	7.6

boe--Barrels of oil equivalent. *As calculated by Standard & Poor's with a conversion factor of 6.54. RUB--Russian ruble.

These supports are partly offset by:

- Still low domestic gas prices (see table 3). NOVATEK's prices are not regulated, but depend indirectly on the still low prices set by the Russian government for Gazprom. Historically, regulated prices for end customers have been well below European benchmarks and are likely to remain so despite ongoing gradual increases.
- Growing capex needs to support the group's ambitious growth plans and develop recently acquired assets. We expect that partners will carry part of these investments.
- High cost inflation in Russia. We expect that annual percentage inflation will remain in the high single digits over the medium term due to rising pipeline transportation tariffs.
- Operational dependence on Gazprom's pipelines. Although NOVATEK has never experienced any difficulty gaining access to pipelines, we view this as an operating exposure. We note that the group's growth plans depend on access to Gazprom's pipeline capacity. Although Russian legislation requires Gazprom to grant pipeline access to independent producers, some have had difficulty accessing the company's infrastructure in the past due to capacity constraints in their areas of operations. One mitigating factor for NOVATEK is the fact that its fields are located in areas where capacity exists in the pipeline system.
- The risk of lower gas demand during economic downturns. Although NOVATEK's business model proved resilient in the recent economic downturn (in contrast with the models of many other operators) we do not exclude the possibility that a deeper, longer downturn could affect the group's volumes.

Table 3

OAO NOVATEK Gas Prices

RUB/thousand cubic meters	2012*	2011	2010	2009	2008	2007	2006
Gas, end customers	2,652	2,627	2,310	1,933	1,818	1,505	1,253
Gas transportation expense	1,175	1,207	1,119	809	718	631	516
Netback	1,477	1,420	1,191	1124	1,100	874	737
Gas ex-field (wholesalers)	1,399	1,392	1,211	1049	979	779	664
NOVATEK's netback differential (end customers minus ex-field price)	78	28	-20	75	121	95	73
Regulated gas price in NOVATEK's regions	2,619	2,619	2,299	1,776	1,563	1,274	1,110

RUB--Russian ruble. *First six months.

Financial Risk Profile: "Intermediate;" Strong Credit Metrics And Low Debt

The main strengths of the group's "intermediate" financial risk profile are:

- Strong cash flow generation abilities. Despite aggressive capital spending in the past, FOCF has been at worst neutral, but mostly strongly positive. We expect the group to reduce capital spending, if needed, to meet financial targets. The development of Yamal LNG is a multi-billion dollar project and we expect the group to undertake such projects with international partners. Accordingly, we expect capital spending to be broadly financed and adjusted according to operating cash flow, and do not expect major negative FOCF.
- The group's target of keeping net debt below annual EBITDA, although we understand that this threshold may be temporarily breached. The group plans an annual dividend payout of 30%.

These strengths are mitigated by:

- Increasing debt. Following large acquisitions, debt has more than doubled since year-end 2009.
- We cannot exclude the possibility of further acquisitions following several large acquisitions in 2009-2011. NOVATEK has publicly confirmed its interest in Russian gas producer Nortgas.
- Some commodity price risk. Sales values of crude oil, stable gas condensate, and liquefied petroleum gas exports are volatile and depend on global demand.

Financial Statistics/Adjustments

The group reports quarterly under International Financial Reporting Standards. Annual reports are audited, and, until Dec. 31, 2011, the auditor issued unqualified opinions. Annual and quarterly reports are issued on a timely basis and are comparable with those of the group's international peers with respect to timing and detail. Standard analytical adjustments to the group's 2011 financials are relatively minor and are summarized in table 4.

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts

--Fiscal year ended Dec. 31, 2011--

OAO NOVATEK reported amounts

(Mil. RUB)	Debt	Shareholders' equity	Revenues	EBITDA	Operating income	Interest expense	Cash flow from operations	Cash flow from operations	Dividends paid	Capital expenditures
Reported	95,478.0	241,013.0	239,273.0	151,865.0	141,608.0	1,713.0	71,907.0	71,907.0	15,166.0	32,978.0
Standard & Poor's adjustments										
Postretirement benefit obligations	810.0	(116.8)	--	32.0	32.0	48.0	(98.4)	(98.4)	--	--
Capitalized interest	--	--	--	--	--	3,709.0	--	--	--	--
Asset retirement obligations	1,292.0	--	--	--	--	--	--	--	--	--
Exploration costs	--	--	--	1,819.0	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	--	(697.0)	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	--	(3,397.0)	(3,397.0)	--	--
Reverse changes in working-capital	--	--	--	--	--	--	--	4,548.0	--	--
Minority interests	--	669.0	--	--	--	--	--	--	--	--
EBITDA--Gain/(loss) on disposals of PP&E	--	--	--	(62,948.0)	(62,948.0)	--	--	--	--	--
Total adjustments	2,102.0	552.2	0.0	(61,097.0)	(63,613.0)	3,757.0	(3,495.4)	1,052.6	0.0	0.0

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Adjusted	97,580.0	241,565.2	239,273.0	90,768.0	77,995.0	5,470.0	68,411.6	72,959.6	15,166.0	32,978.0

Table 5

OAO NOVATEK Peer Comparison

	OAO NOVATEK	LUKoil OAO	OAO Gazprom	OJSC Oil Co. Rosneft	TNK-BP International Ltd.
Rating as of Sept. 27, 2012	BBB-/Stable/--	BBB-/Positive/--	BBB/Stable/A-2	BBB-/Watch Neg/--	BBB-/Stable/A-3
(Mil. $)	--Fiscal year ended Dec. 31, 2011--				
Revenues	7,457.9	133,650.0	144,620.4	91,975.0	43,248.0
EBITDA	2,829.1	21,058.2	65,831.7	22,507.5	14,256.0
Net income from continuing operations	3,729.5	10,357.0	40,738.4	12,452.0	8,981.0
Funds from operations (FFO)	2,274.1	16,942.5	53,969.5	17,201.2	12,058.6
Capital expenditures	1,027.9	8,274.0	48,409.1	12,828.4	4,493.0
Free operating cash flow	1,104.4	7,139.5	4,553.7	2,256.8	5,800.6
Discretionary cash flow	631.7	5,309.5	1,624.5	1,303.8	(2,061.4)
Cash and short-term investments	742.8	1,157.0	1,870.1	1,000.0	500.0

Table 5

OAO NOVATEK Peer Comparison (cont.)					
Debt	3,041.5	9,570.6	44,131.5	17,015.8	7,793.2
Equity	7,529.3	67,466.0	239,344.4	66,802.0	20,755.0
Adjusted ratios					
EBITDA margin (%)	37.9	15.8	45.5	24.5	33.0
EBITDA interest coverage (x)	16.6	23.3	23.3	23.8	30.5
EBIT interest coverage (x)	14.3	17.7	19.8	18.3	26.2
Return on capital (%)	25.9	20.8	20.5	21.0	41.6
FFO/debt (%)	74.8	177.0	122.3	101.1	154.7
Free operating cash flow/debt (%)	36.3	74.6	10.3	13.3	74.4
Debt/EBITDA (x)	1.1	0.5	0.7	0.8	0.5
Total debt/debt plus equity (%)	28.8	12.4	15.6	20.3	27.3

Table 6

OAO NOVATEK Financial Summary					
	--Fiscal year ended Dec. 31--				
(Mil. RUB)	**2011**	**2010**	**2009**	**2008**	**2007**
Rating history	BBB-/Stable/--	BBB-/Negative/--	BB+/Positive/--	BB+/Stable/--	BB/Positive/--
Revenues	239,273.0	117,420.0	89,663.0	79,272.0	62,321.0
EBITDA	90,768.0	57,430.0	40,138.0	38,264.0	29,960.0
Net income from continuing operations	119,655.0	40,533.0	26,043.0	22,899.0	18,736.0
Funds from operations (FFO)	72,959.6	46,865.0	34,049.0	28,695.0	23,136.0
Capital expenditures	32,978.0	22,636.0	16,238.0	31,596.0	19,666.0
Free operating cash flow	35,433.6	20,019.0	16,956.0	(386.0)	1,771.0
Discretionary cash flow	20,267.6	10,151.0	9,328.0	(8,038.0)	(4,089.0)
Cash and short-term investments	23,831.0	10,238.0	10,532.0	11,000.0	4,018.0
Debt	97,580.0	73,929.0	39,411.0	27,988.4	7,907.1
Equity	241,565.2	167,586.0	133,212.0	96,384.0	81,536.0
Adjusted ratios					
EBITDA margin (%)	37.9	48.9	44.8	48.3	48.1
EBITDA interest coverage (x)	16.6	25.8	18.9	44.1	71.3
EBIT interest coverage (x)	14.3	22.1	15.9	37.5	62.1
Return on capital (%)	25.9	22.8	21.8	28.5	29.3
FFO/debt (%)	74.8	63.4	86.4	102.5	292.6
Free operating cash flow/debt (%)	36.3	27.1	43.0	(1.4)	22.4
Debt/EBITDA (x)	1.1	1.3	1.0	0.7	0.3
Debt/debt and equity (%)	28.8	30.6	22.8	22.5	8.8

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Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Key Credit Factors: Global Criteria For Rating The Oil And Gas Exploration And Production Industry, Jan. 20, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings Detail (As Of September 27, 2012)		
OAO NOVATEK		
Corporate Credit Rating		BBB-/Stable/--
Russia National Scale		ruAA+/--/--
Senior Unsecured *Russia National Scale*		ruAA+
Senior Unsecured		BBB-
Corporate Credit Ratings History		
06-Jul-2011		BBB-/Stable/--
19-Nov-2010		BBB-/Negative/--
28-Oct-2010		BBB-/Watch Neg/--
23-Jun-2010		BBB-/Stable/--
07-Jul-2009		BB+/Positive/--
11-Jul-2008		BB+/Stable/--
19-Nov-2010	*Russia National Scale*	ruAA+/--/--
28-Oct-2010		ruAA+/Watch Neg/--
11-Jul-2008		ruAA+/--/--
Business Risk Profile		Satisfactory
Financial Risk Profile		Intermediate
Debt Maturities		
As of June 30, 2012: Within 1 year: RUB19.8 bil. July 1, 2013–June 30, 2014: RUB25.2 bil. July 1, 2014–June 30, 2019: RUB29.7 bil. Thereafter: RUB21.3 bil.		
Related Entities		
Novatek Finance Ltd.		
Senior Unsecured		BBB-

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com