

# OAO Novatek

## Update

### Ratings

<b>Foreign Currency</b>	
Long-Term IDR	BBB-
Senior unsecured <sup>a</sup>	BBB-
<b>Local Currency</b>	
Long-Term IDR	BBB-
Senior unsecured <sup>a</sup>	BBB-
<b>National</b>	
Long-Term Rating	AA+(rus)
Senior unsecured <sup>a</sup>	AA+(rus)

<b>Novatek Finance Limited</b>	
Senior unsecured rating <sup>a</sup>	BBB-

<sup>a</sup> The affirmation applies to all debt issued prior to 1 August 2014.

### Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable
National Long-Term Rating	Stable

### Financial Data

OAO Novatek	31 Dec 2013	31 Dec 2012
Net revenue (RUBm)	278,539	196,140
Operating EBITDA (RUBm)	121,511	97,022
Operating EBITDA Margin (%)	43.6	49.5
Funds From Operations (RUBm)	100,523	77,994
Cash Flow From Operations (RUBm)	81,324	72,837
Free Cash Flow (RUBm)	-35,696	17,087
FFO Interest Coverage (x)	13.7	16.1
FFO Adj. Net Leverage (x)	1.5	1.6

Based on OAO Novatek's consolidated financials.

### Related Research

- [Rating Oil and Gas Production Companies \(August 2012\)](#)
- [Russian Sanctions Negative, But Ratings Unaffected For Now \(July 2014\)](#)
- [Russian Oil & Gas Dashboard 2H14 \(August 2014\)](#)
- [Russian Oil and Gas Industry \(August 2013\)](#)

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### Key Rating Drivers

**Second-Largest Russian Producer:** As Russia's second-largest gas producer (after Gazprom), OAO Novatek plays an important role in domestic gas supplies. In 2013, it produced 52.2 billion cubic metres (bcm) of natural gas, up 3.4% yoy (excluding joint ventures), which corresponds to 8% of the country's total production, and sold 64bcm, accounting for 18% of total domestic gas consumption. Since 2005, Novatek's production has increased at a CAGR of 10%, though Fitch Ratings expects growth rates to decelerate.

**Sanctions Neutral for Now:** In July 2014, Novatek was included on the Sanctions Sectorial List by the US Office of Foreign Asset Control, which prohibits US entities from providing new finance of longer than 90 days to the company. This has effectively barred Novatek from the US capital markets for the time being, and made access to other western markets complicated. It has no credit implications at this stage given Novatek's sound liquidity.

The US and EU sanctions on oil and gas equipment and technology transfer into Russia enacted in July 2014 should not affect either Novatek or its Yamal LNG project, as they apply specifically to the Arctic, deep offshore and non-conventional oil and gas production. However, the risk of further sanctions remains.

**Yamal LNG Megaproject:** Novatek occupies a strategic position in the gas-rich Yamal region, where it has plans to construct a 16.5 million tons (mt) LNG plant due to come on-stream in 2017. The project, in which Novatek holds a 60% stake and Total SA (AA/Negative) and China National Petroleum Corporation (CNPC; A+/Stable) have 20% each, could enhance Novatek's business profile through diversification into the lucrative Asian LNG market. However, the Ukrainian crisis and sanctions imposed on Russia may result in the project being delayed.

Novatek expects most of the USD27bn project to be funded through non-recourse debt. Western investors are less likely to participate in the deal because of the sanctions, which limits the available financing. We believe Novatek and its partners could rely on Russian state support, which would possibly be available, given the project's importance for Russia's LNG strategy, and on Chinese banks.

### Rating Sensitivities

**Sanctions, Leverage, Liquidity:** New sanctions targeted at Novatek or more general sanctions, weaker financial metrics making the issuer's funds from operations (FFO) net leverage rise above 2.5x, or a lack of progress with regard to attracting an alternative source of finance by end-1Q15 might result in negative rating action.

**Sovereign Rating:** Negative rating action on Russia (BBB/Negative) might also be negative, as Novatek's rating would become capped by the sovereign rating if this were lower than Novatek's standalone rating. However, a potential downgrade of Russia to 'BBB-' with a Stable Outlook would have no direct implications as Russia and Novatek would be rated at the same level.

### Liquidity and Debt Structure

**Sound Liquidity:** We believe Novatek can afford not to attract new debt at least until the end of 2015, supported by a considerable cash balance of RUB46bn as of 30 June 2014 and an undrawn credit line of RUB10bn due June 2015. On the same date, Novatek's short-term debt was negligible at RUB5bn.

Peer Group

Issuer	Country
<b>A-</b>	
BG Energy Holdings Ltd	United Kingdom
OMV AG	Austria
<b>BBB+</b>	
Apache Corporation	United States
Marathon Oil Corporation	United States
<b>BBB</b>	
Devon Energy Corporation	United States
Hess Corporation	United States
OAO Gazprom	Russian Federation
OAO LUKOIL	Russian Federation
Repsol, S.A.	Spain
<b>BBB-</b>	
Anadarko Petroleum Corp.	United States
OAO Novatek	Russian Federation
OAO Tatneft	Russian Federation
Pioneer Natural Resources Co.	United States
<b>BB+</b>	
Newfield Exploration Company	United States
<b>BB</b>	
Joint Stock Oil Company Bashneft	Russian Federation

Issuer Rating History

Date	LT IDR (FC)	Outlook/ Watch
8 Sep 14	BBB-	Stable
17 Dec 13	BBB-	Stable
20 Sep 13	BBB-	Stable
13 Mar 13	BBB-	Stable
7 Nov 12	BBB-	Stable
30 Oct 12	BBB-	Stable
27 Sep 12	BBB-	Stable
27 Oct 11	BBB-	Stable
10 Nov 10	BBB-	Negative
5 Oct 10	BBB-	Stable
19 Oct 09	BBB-	Stable
9 Oct 09	BBB-	Stable

Related Criteria

[Corporate Rating Methodology \(May 2014\)](#)

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

In 2013 Russian oil production edged up by 1% to 10.5mmbpd, and we expect it to stabilise at this level in 2014-2015. Most major Russian oil companies have a high proved reserve life of around 20 years, which should support their production profile in the medium term. Further growth, though, will be limited as many fields in Western Siberia are now highly depleted and the Arctic shelf exploration is unlikely to yield any significant amount of oil in the next ten years.

Financial Risks

The Russian oil and gas sector remained highly capital intensive in 2013, which we expect to continue in the medium term. High oil prices should support companies' ability to fund their capex needs. The existing industry-specific tax regime in Russia and relative flexibility of the exchange rate should support the companies' cash-flow generation ability if oil prices decline. The substantial influence the state exerts on the sector and its profitability is though negative given the opacity of decision-making in the country.

2013	LUKOIL BBB/Neg.	GPN BBB/Neg.	Novatek BBB-/Stable	Bashneft BB/RWN
Hydrocarbon production (mmbpd)	2.21	1.02	0.94	0.32
Proved reserve life (years)	21	16	19	18
EBITDA (USDm)	18,564	9,385	3,815	3,190
Mid-point FFO net leverage (x)	1.0x	1.7x	1.5x	2.1x
Mid-point FFO interest coverage (x)	23x	12x	12x	8x

Key Credit Characteristics

The creditworthiness of Russian integrated oil and gas companies is supported by their moderate leverage, high proved reserve life and low cost position, on the one hand, and lack of international diversification and country-specific risks, on the other. The agency believes that 2014 should be favourable for the industry and expects Russian oil and gas companies to generate healthy cash flow from operations, primarily due to the anticipated high oil prices.

Overview of Companies

**OAO LUKOIL** (BBB/Negative) – is the largest Russian private oil company. It accounts for 16% of crude production and 16% of oil refining in the country. LUKOIL's low leverage and good maturity profile make it less vulnerable under the Western sanctions. The Outlook is constrained by the Outlook on Russia.

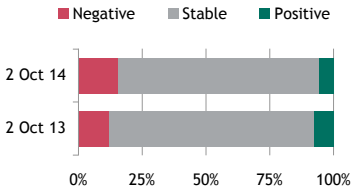
**JSC Gazprom Neft** (GPN, BBB/Negative) – Russian major oil company controlled by OAO Gazprom (BBB/Negative). Gazprom Neft accounts for 6% of crude production and 12% of oil refining in the country (excluding joint ventures). We expect the company's leverage to edge up but to remain sound on the back of its upstream greenfield development programme. The Outlook is constrained by the Outlook on Russia and its parent OAO Gazprom.

**OAO Novatek** (BBB-/Stable) – is the second-largest Russian natural gas producer after Gazprom. Novatek sells its gas in Russia at regulated low prices but capitalises on sales of gas condensate. The company is developing a 16.5mt LNG plant in the Yamal region, and the lack of clarity on the project's financing constrains Novatek's credit profile in the low 'BBB' category.

**Joint Stock Oil Company Bashneft** (BB/ Rating Watch Negative) – a second-tier Russian oil producer that accounts for 3% of oil production and 8% of oil refining output in the country, with producing assets located mainly in the Republic of Bashkiria. Bashneft and its largest shareholder Sistema Joint Stock Financial Corporation (Sistema, BB-/RWN) were placed on RWN following the charges levied against Vladimir Yevtushenkov, Sistema's majority shareholder, in connection with the legalisation of shares of BashTEK group.

### Distribution of Sector Outlooks

Directional Outlooks and Rating Watches



Fitch's expectations are based on the agency's internally produced, conservative rating case forecasts.

They do not represent the forecasts of rated issuers individually or in aggregate. Key Fitch forecast assumptions include:

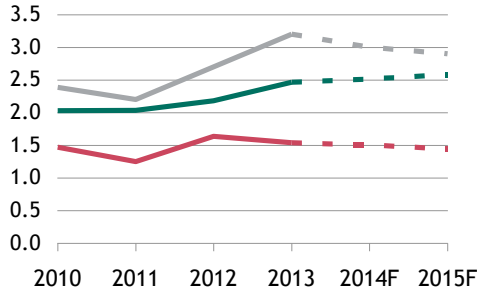
- strong operating cash flows based on stable output, stable domestic gas prices and declining oil prices in line with Fitch's price deck;
- moderating capex in 2015 onwards;
- dividend payout ratio in line with the company's policy of 30% to net profits.

### Definitions

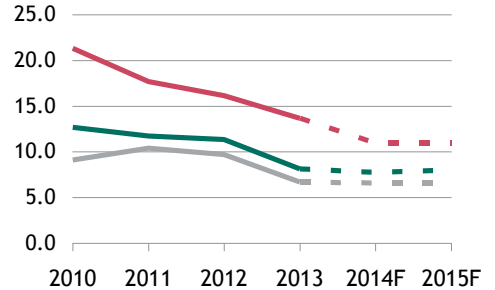
- Leverage: Gross debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus gross interest paid minus interest received plus preferred dividends plus rental expense.
- Interest cover: FFO plus gross interest paid minus interest received plus preferred dividends divided by gross interest paid plus preferred dividends.
- FCF/revenue: FCF after dividends divided by revenue.
- FFO profitability: FFO divided by revenue.
- For further discussion of the interpretation of the tables and graphs in this report see Fitch's "[Interpreting the New EMEA and Asia-Pacific Corporates Credit Update Format](#)" Special Report, dated 25 November 2009 and available at [www.fitchratings.com](http://www.fitchratings.com).

Legend: OAO Novatek (red line), Energy (Oil & Gas) Median (orange line), Emerging BBB Cat Median (green line). Source: Company data; Fitch.

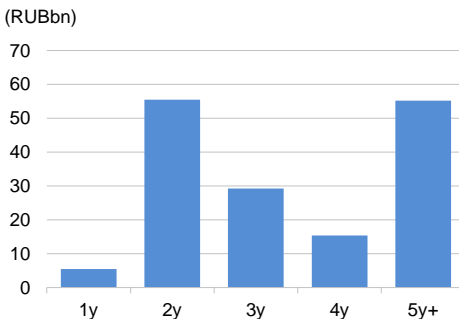
### Leverage including Fitch expectations



### Interest Cover including Fitch expectations

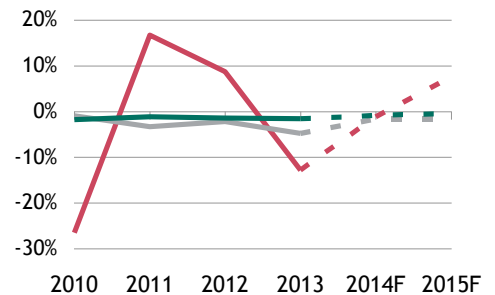


### Debt Maturity Profile at 1 Jul 2014

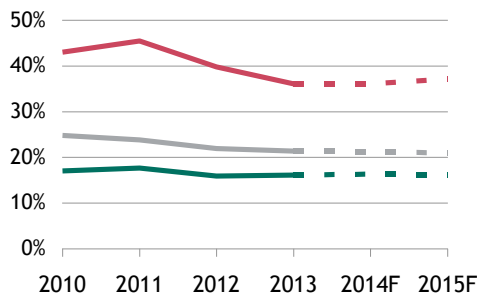


Source: Novatek

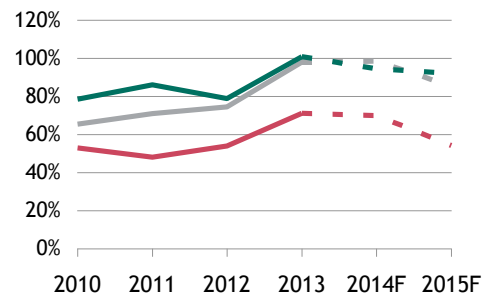
### FCF/Revenues including Fitch expectations



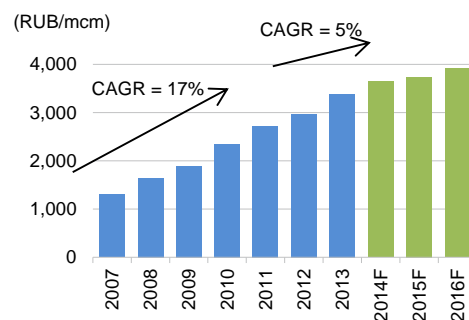
### FFO Profitability including Fitch expectations



### Capex/CFO including Fitch expectations

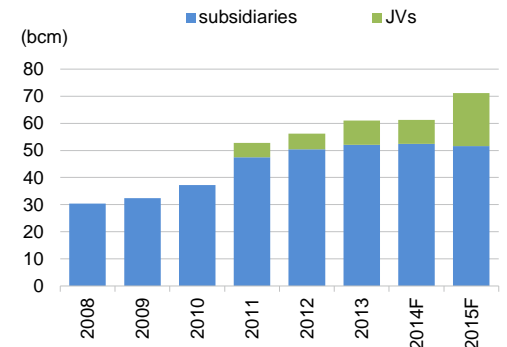


### Average Domestic Gas Prices



Source: Fitch's interpretation of Gazprom's data

### Novatek's Natural Gas Output



Source: Novatek, Fitch's forecasts

**OAO Novatek  
FINANCIAL SUMMARY**

	31 Dec 2013 RUBm Year End	31 Dec 2012 RUBm Year End	31 Dec 2011 RUBm Year End	31 Dec 2010 RUBm Year End	31 Dec 2009 RUBm Year End
<b>Profitability</b>					
Revenue	278,539	196,140	160,750	109,163	83,255
Revenue Growth (%)	42.01	22.02	47.26	31.90	14.29
Operating EBIT	108,008	85,523	79,235	49,047	33,949
Operating EBITDA	121,511	97,022	88,710	55,804	39,687
Operating EBITDA Margin (%)	43.62	49.47	55.19	51.12	47.67
FFO Return on Adjusted Capital (%)	20.13	19.59	22.95	20.52	21.03
Free Cash Flow Margin (%)	(12.82)	8.71	16.67	(26.51)	10.89
<b>Coverages (x)</b>					
FFO Gross Interest Coverage	13.65	16.14	17.67	21.31	19.16
Operating EBITDA/Gross Interest Expense	15.40	19.34	20.51	24.23	21.30
FFO Fixed Charge Coverage (inc. Rents)	13.65	16.14	17.67	21.31	19.16
FCF Debt-Service Coverage	(0.87)	0.56	1.26	(0.97)	0.70
Cash Flow from Operations/Capital Expenditures	1.41	1.85	2.08	1.89	2.05
<b>Debt Leverage of Cash Flow (x)</b>					
Total Debt with Equity Credit/Operating EBITDA	1.36	1.37	1.08	1.29	0.95
Total Debt Less Unrestricted Cash/Operating EBITDA	1.30	1.18	0.81	1.11	0.68
<b>Debt Leverage Including Rentals (x)</b>					
Gross Lease Adjusted Debt/Operating EBITDAR	1.36	1.37	1.08	1.29	0.95
Gross Lease Adjusted Debt /FFO+Int+Rentals	1.54	1.64	1.25	1.47	1.06
FFO Adjusted Net Leverage	1.46	1.41	0.94	1.26	0.76
FCF/Lease Adjusted Debt (%)	(21.55)	12.90	28.07	(40.07)	24.05
<b>Debt Leverage Including Leases and Pension Adjustment (x)</b>					
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	1.36	1.37	1.08	1.29	0.95
<b>Balance Sheet Summary</b>					
Readily Available Cash	7,925	18,430	23,848	10,238	10,643
Restricted/Not Readily Available Cash	0	1,959	n.a.	n.a.	n.a.
Short-Term Debt	24,026	34,682	20,298	25,152	13,827
Long-Term Senior Debt	141,595	97,805	75,180	47,074	23,876
Total Debt with Equity Credit	165,621	132,487	95,478	72,226	37,703
Lease-Adjusted Debt	165,621	132,487	95,478	72,226	37,703
Pension Adjusted Debt	165,621	132,487	95,478	72,226	37,703
<b>Cash Flow Summary</b>					
Operating EBITDA	121,511	97,022	88,710	55,804	39,687
Gross Cash Interest Expense	(7,890)	(5,018)	(4,326)	(2,303)	(1,863)
Cash Tax	(14,677)	(17,607)	(13,933)	(8,575)	(4,264)
Associate Dividends	n.a.	n.a.	n.a.	n.a.	n.a.
Other Items before FFO (incl. interest receivable)	1,579	3,597	2,607	2,028	574
<b>Funds from Operations</b>	<b>100,523</b>	<b>77,994</b>	<b>73,058</b>	<b>46,954</b>	<b>34,134</b>
Change in Working Capital	(19,199)	(5,157)	(4,548)	(4,210)	(855)
<b>Cash Flow from Operations</b>	<b>81,324</b>	<b>72,837</b>	<b>68,510</b>	<b>42,744</b>	<b>33,279</b>
Total Non-Operating/Non-Recurring Cash Flow	(37,237)	3,284	6,437	(39,183)	(347)
Capital Expenditures	(57,781)	(39,316)	(32,978)	(22,636)	(16,238)
Dividends Paid	(22,002)	(19,718)	(15,166)	(9,868)	(7,628)
<b>Free Cash Flow</b>	<b>(35,696)</b>	<b>17,087</b>	<b>26,803</b>	<b>(28,943)</b>	<b>9,066</b>
Net (Acquisitions)/Divestitures	(2,883)	(47,424)	(17,523)	(5,205)	(18,615)
Net Equity Proceeds/(Buyback)	(188)	194	354	678	1,767
Other Cash Flow Items	(4,872)	(12,284)	(19,276)	(1,458)	(3,993)
Total Change in Net Debt	(43,639)	(42,427)	(9,642)	(34,928)	(11,775)
<b>Working Capital</b>					
Accounts Receivable Days	29	27	25	23	18
Inventory Days	11	10	11	15	19
Accounts Payable Days	31	32	22	19	42

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