OAO Novatek

Full Rating Report

Ratings

Foreign Currency

Long-Term IDR	BBB-
Senior unsecured	BBB-

Local Currency

Long-Term IDR	BBB-

National

Long-Term Rating	AA+(rus)
Senior unsecured	AA+(rus)

Novatek Finance Limited

Senior unsecured	BBB-

Outlooks

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

Financial Data

OAO Novatek

Based on consolidated IFRS report	31 Dec 12	31 Dec 11
Revenue (RUBm)	196,140	160,750
Operating EBITDA (RUBm)	97,022	88,710
Operating EBITDA margin (%)	49.5	55.2
Funds from operations (RUBm)	77,958	73,058
Cash flow from operations (RUBm)	72,837	68,510
Free cash flow (RUBm)	17,087	26,803
FFO gross interest coverage (x)	16.1	17.7
Total debt with equity credit (RUBm)	132,487	95,478
FFO adjusted gross leverage (x)	1.64	1.25
FFO adjusted net leverage (x)	1.41	0.94

Related Research

Russian Oil and Gas Industry: Rising State Ownership, Less Volatility, Higher Country Risks (August 2013)

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Key Rating Drivers

Second-Largest Gas Producer: OAO Novatek plays an important role in domestic gas supplies, being Russia's second-largest gas producer after OAO Gazprom (BBB/Stable). In 2012 the company produced 50.5 billion cubic meters (bcm) of natural gas, excluding joint ventures (JVs), up 6.3% yoy, which corresponds to 8% of the country's total production.

Increasing Competition: Since 2005 Novatek's production has increased by a CAGR of 11%, but Fitch Ratings expects growth to slow in the medium term as the competition between Gazprom and other gas producers intensifies.

Yamal Financing a Concern: Novatek expects to fund development of its USD20bn Yamal liquefied natural gas (LNG) megaproject primarily through project-finance debt, which we expect will be non-recourse. However, until the financing is finalised, there remains the risk that some form of recourse to Novatek (eg, guarantees) will be needed, which could dramatically increase Fitch-calculated financial leverage. This is a constraint on the rating.

Over the medium term, the Yamal project could transform Novatek's operational profile, although financial upside may be limited until any project finance debt is paid down.

Low Price Risk: There is still some uncertainty over the growth of regulated domestic gas prices in Russia. Regulated gas prices have been rising by 15% yoy over the past few years, and we conservatively assume that there will be no growth in 2014 and then that growth will be limited to the general inflation level – this proposal is now being considered by the government. However, even these assumptions still imply low price risks for the company.

Concentrated Reserve Base: We assess the company's reserve base as concentrated, though we expect some improvement in this respect in the medium term. In 2012 the Yurkharovskoye field accounted for 67% of the company's total output, which means that maintaining the field's production will be particularly important to Novatek's meeting its contractual obligations.

Rating Sensitivities

Improved Business Profile: Rising output and diversification of the resource base while maintaining strong credit metrics could trigger a positive rating action. Progress with Yamal LNG could also be positive for the rating, including more clarity on how the project will be financed and the amount of completion or performance guarantees granted, if any, as well as securing export rights for the project. Novatek's rating, though, would be capped by that of the sovereign, so under Russia's current rating of 'BBB' only a one-notch upgrade is possible.

Deteriorating Financial Profile: Novatek could be downgraded if its financial metrics undergo a sustained deterioration, possibly from additional acquisitions, performance or financial guarantees granted in relation to Yamal LNG, making the issuer's FFO net adjusted leverage rise to above 2.5x and FFO interest cover to fall below 10x on a sustained basis.

Liquidity and Debt Structure

Balanced Debt Portfolio: Debt is well balanced by maturities, currencies and instruments. Debt is predominantly raised at the level of OAO Novatek and is not secured, hence no subordination issues arise. At 30 June 2013 the company had negligible short-term debt.

Key Contents

- This document focuses on the key credit issues relating to the issuer, and assumes background knowledge of both Novatek and its industry.

Novatek's rating of 'BBB−' reflects its strong business profile as Russia's second-largest natural gas producer and exporter of stable gas condensate and liquefied petroleum gas, its low price risks, and manageable debt load. The ratings are limited by Novatek's moderate scale, concentrated reserve base and uncertainties over how its Yamal LNG megaproject will be financed. Novatek's rating is also discounted by two notches due to its high exposure to Russia, which is our usual practice for Russian oil and gas companies due to corporate governance and country risks considerations. In 2012 Novatek's hydrocarbon production amounted to 909,000 barrels of oil equivalent (mboe) per day, of which 11% was liquids.

Key Rating Issues

Favourable Business Environment but Competition May Intensify

- Novatek enjoys favourable business environment, including low price risk due to regulated domestic gas prices.

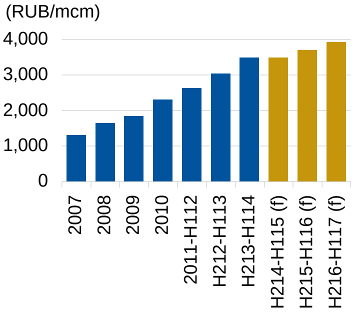
The business environment remains favourable for Russian natural gas producers. The industry is still dominated by OAO Gazprom (BBB/Stable), though the share of other emerging gas producers, primarily Novatek and OJSC OC Rosneft (BBB/Rating Watch Negative), is on the rise. In 2012 Novatek accounted for 8% of the country's total natural gas output, and for 16% of domestic consumption – making it the second-largest gas producer in Russia.

Price Growth May Decelerate but Earnings Volatility will Remain Low

Novatek continues to sell all its natural gas domestically as Gazprom's export monopoly is legally secured. Novatek's selling prices are not legally regulated but are influenced by state-approved Gazprom's domestic selling prices, which in 2012 were on average two times lower than the export netback, which is Gazprom's export price in Europe less export taxes and transport costs. In several instances the state has announced it will liberalise the domestic gas market over time, and it has been increasing regulated domestic gas prices by 15% p.a. in order to equalise them with the export netback equivalent. This policy is now being questioned as it contributes to inflation and reduces the competitive advantage of Russian businesses. The government is now considering slowing down the growth of all tariffs, including gas, in 2014 and limiting them to the level of inflation in 2015-2016 – this is our base case.

Figure 1

Average Domestic Gas Prices



Source: Fitch

Even with this possible deceleration, Novatek's price risks will remain fairly low – which distinguishes it from other Russian and international oil and gas peers. We assess the possibility of the state decreasing gas prices as extremely low, even if crude prices collapse as happened in 2009.

Novatek also has some exposure to oil prices as a substantial part of its revenue comes from sales of liquids – gas condensate and refined products. However, the sensitivity analysis shows that if oil prices decrease by 25% (say, from USD110/bbl to USD82.5bbl) Novatek's EBITDA will only decrease by 10%. Taking this into account we assess Novatek's earnings volatility as low.

New Tax Formula – no Surprises Expected

Russian natural gas and condensate producers are subject to the industry-specific mineral extraction tax, the rates for which are currently set in the tax code and are not directly tied to selling prices. This will change with the introduction of the tax formula, which will be based on

Related Criteria

Corporate Rating Methodology (August 2013) natural gas and gas condensate selling prices, as well as the transportation tariffs and geological factors.

The new tax rules will not significantly affect the credit position of Russian natural gas producers as their resulting tax burden will remain broadly in line with the tax rates set for 2014 and 2015 by the current legislation, and hence will trigger no rating actions. At the same time, this move will have some positive long-lasting effects. First, it reduces the risk that the tax rates may increase much faster than regulated domestic gas prices, which will probably be frozen in 2014. Second, independent gas producers, including Novatek, will be hedged against rising state-regulated gas transportation fees, which are received by Gazprom – the monopoly owner of the gas transport infrastructure in Russia. These effects contribute to the agency's view that the earnings of Russian oil and gas companies are less volatile than those of their international peers.

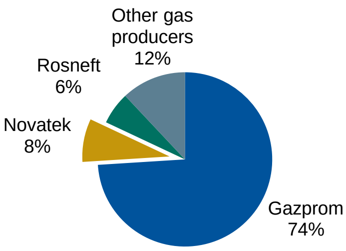
- Although Novatek's solid customer portfolio secures limited volume risks in the medium term, this may change in the long term as competition will intensify.

Rosneft – Three is not A Crowd

Rosneft's acquisition of TNK-BP and Itera in 2013 resulted in the appearance of a new third-largest market player with an ambitious target to increase its annual production to 100bcm by 2020. It means that the competition between Gazprom, Novatek and Rosneft for domestic customers, primarily the largest industrial, chemical and power generating companies, will intensify. Evidence of this has already been seen. JSC INTER RAO (BB+/Stable), Novatek's largest customer, has decided to switch to Rosneft from 2016 when its contract with Novatek expires. Though higher competition may have a negative impact on the company in the long term, especially taking into account that there may be some political, not only economic considerations behind long-term gas agreements, we believe that Novatek's balanced customer portfolio with a high share of long-term contracts implies limited volume risks for the company, at least in the medium term (see Figure 3).

Figure 2

Largest Russia's Natural Gas Producers in 2012



Source: Fitch

Figure 3

Novatek's Largest Contracts Portfolio

Customer/rating	Volumes	Duration	Estimated annual volumes
JSC INTER RAO (BB+/Stable)	65bcm	6 years (2010-2015)	10.8bcm
OJSC Mosenergo (BB+/Stable)	27bcm	3 years (2013-2015)	9bcm
Fortum Corporation (A-/Negative) E.ON SE (A-/Stable)	180bcm	15 years (2013-2027)	12bcm
OJSC Magnitogorsk Iron & Steel Works (MMK) (BB+/Negative)	50bcm	10.5 years (H212-2022)	4.8bcm
OAO Severstal (BB/Stable)	12bcm	5 years (2013-2017)	2.4bcm
Mechel (n/r)	17bcm	11.5 years (H112-2023)	1.5bcm
Total			**40.5bcm**

Source: Fitch

Healthy Operational Metrics, Still Concentrated Reserve Base

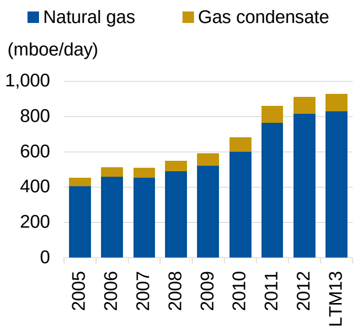
Novatek has healthy operational metrics. The company has managed to increase its total hydrocarbon output by a CAGR of 11% since 2005 (excluding JVs). At end-2012 its proved gas reserve life increased to 22 years, up from 16 years at end-2011, using the first reserve estimation of the Salmanovskoye (Utrenneye) and Geofizicheskoye fields. Novatek's share of developed reserves stayed at 52%, close to the 60%-80% considered by Fitch as appropriate for higher-rated oil and gas companies.

- Novatek has healthy operational metrics and has managed to increase its production by a CAGR of 11% since 2005.
- The company's reserve base remains concentrated, though we expect this to improve in the medium term.

We currently view Novatek's reserve base as concentrated, but expect this to improve once the company launches a number of new production fields in 2013-2015. The Yurkharovskoye field remains the main producing asset of the company, accounting for 67% of Novatek's natural gas output (but only for 40% of its natural gas proved reserves). The future performance of the field, which at end-2012 had an average proved reserve life of 13 years, will be important to maintain and increase Novatek's production levels. Following the launch of the fourth stage of Phase Two development of the field in H212 its production plateau increased to 38bcm, compared to the actual output of 34bcm in 2012.

Figure 4

Novatek's Gas and Condensate Output

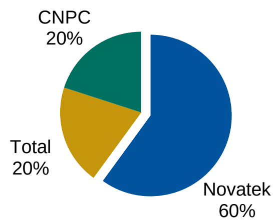


Source: Novatek

- Novatek intends to launch its Yamal LNG megaproject by 2017.
- This will enhance the company's operational profile.

Figure 5

Yamal LNG Envisaged Participants



Source: Fitch

In 2013-2015 Novatek intends to put on stream several new fields, including those operated by its JVs, with a total peak production of 15bcm (this includes only Novatek's share). The successful launch would offset the possible decline of the Yurkharovskoye field, which may begin in the medium term. In 2015 Novatek also intends to step into oil production and launch the Yarudeyskoye oil field which will allow it to produce around 70,000 barrels of crude, close to the current production of Alliance Oil Company Ltd's (B/Stable) upstream output.

Yamal LNG Could Transform the Company – but Its Financing is A Concern

Novatek currently holds an 80% stake in a JV to develop LNG production in the Yamal region, which was created to construct a pilot LNG plant based on the resources of the currently undeveloped South Tambeyskoye field. After the deal with China National Petroleum Corporation (CNPC, A+/Stable) closes, Novatek's share will decrease to 60%, and its two partners, CNPC and Total SA (AA/Stable), will hold 20% each. We believe that even if more co-investors join the project Novatek's share will remain at least at 50%.

At end-2012 Novatek's stake in the field's proved reserves amounted to 385bcm. This will fall to 289bcm when the deal with CNPC has been completed, adding 27% to the company's proved consolidated reserve base of 1,089bcm (excluding equity stakes). The reserves of the field should be enough to produce up to 16.5 million tons of LNG per annum – which is the planned total capacity of the project. The development of the Yamal LNG project will enhance Novatek's business profile by diversifying production geographically and providing potential new marketing channels. It would also give Novatek a toe-hold in the global LNG market and position the company at the centre of one of Russia's key energy development projects. Novatek assesses total investments in the project, which is expected to be launched by 2017, at USD20bn. The company has not made a final decision about how the Yamal LNG project will be financed. We believe that the company's exposure to the project will be limited, assuming the major part of it will be project financed. In September 2013 Novatek announced that Chinese banks are considering participating in financing the project, but prospective terms and conditions have not yet been made available to Fitch. Our base-case scenario is that there will be no recourse to Novatek.

However, until the financing is finalised, there remains the risk that some form of recourse to Novatek (eg, guarantees) will be needed, which could dramatically increase Fitch-calculated financial leverage. This is a constraint on the rating. We expect more clarity on financing plans only after the final investment decision has been taken later this year.

The project may be less attractive without evidence of government support, a stable tax regime and additional economic investment in infrastructure. We believe that the government's decision to exempt Yamal-based LNG producers from the mineral extraction tax, export duty and property tax enacted in 2012 will significantly enhance the feasibility of the project. We also expect the state to continue providing support to the project, including the Sabetta port construction. One key decision that still has to be taken by the state is whether to abolish Gazprom's monopoly on LNG exports.

Rating Issues Register

Issue	Fitch view	Likelihood, timescale, rating impact
Second-largest gas producer in Russia Novatek is Russia's largest gas producer after Gazprom, accounting for 8% of domestic production.	Novatek plays an important role as incremental gas producer in Russia. It has a solid customer base with a prevalence of long-term contracts which limits its volume risks. However, the company's scale remains limited compared to Russian and international O&G peers – this could change when the Yamal LNG project becomes operational.	Likelihood: Probable Timescale: Medium term Rating impact: Positive (included in the current ratings)
Intensifying competition Rosneft has intends to increase its production to 100bcm in the long term.	Competition between Gazprom, Rosneft and Novatek for domestic consumers will intensify. This may affect Novatek's volumes in the long term.	Likelihood: Possible Timescale: Long term Rating impact: Negative
Low price risks Domestic gas prices in Russia are regulated. Novatek's exposure to oil prices is limited.	Novatek's earnings volatility is significantly less than that of other O&G peers. We expect this to continue in the medium term as domestic gas prices will remain regulated. In addition, the expected switch to the formula-based mineral extraction tax will make the company's profits even more predictable.	Likelihood: Highly probable Timescale: Medium term Rating impact: Positive (included in the current ratings)
Concentrated reserve base Novatek's Yurkharovskoye field yields around two-thirds of its natural gas output.	This factor puts a constraint on Novatek's rating – though we expect some improvement here as several new fields will be put on stream in the medium term.	Likelihood: Will probably improve Timescale: Medium term Rating impact: Positive
Yamal could be transformative Novatek expects to launch its USD20bn Yamal LNG project by 2017.	Once launched the project will significantly improve Novatek's business profile. It would also give Novatek a toe-hold in the global LNG market and position the company at the centre of one of Russia's key energy development projects.	Likelihood: Possible Timescale: Medium term Rating impact: Positive
Manageable debt burden – but Yamal financing a concern. We expect Novatek's leverage to come close to 2x in 2014-2015 on the back of the extensive capex programme, and expect it to fall thereafter.	This debt burden is commensurate with the current rating category. However, until the financing for the USD20bn Yamal LNG megaproject is finalised, there remains the risk that some form of recourse to Novatek (eg, guarantees) will be needed, which could dramatically increase Fitch-calculated financial leverage. This is a constraint on the rating.	Likelihood: Probable Timescale: Long term Rating impact: Neutral Negative (if Novatek's higher-than-expected exposure to the project results material deterioration of credit metrics)
Corporate governance and country risks. Novatek's rating is discounted by two notches due the higher corporate governance and country risks in Russia.	This is our usual approach for all Russian oil and gas names and is mainly governed by the general environment, not individual issuer's characteristics. In addition, the company's rating is capped by that of the sovereign.	Likelihood: Will probably remain Timescale: Long term Rating impact: Negative

Source: Fitch

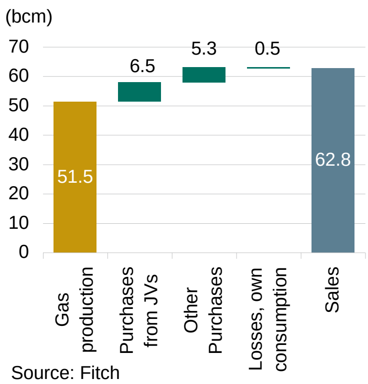
Sector Performance and Expectations

(RUBm)	2011	2012	LTM13	Expectation
Revenue	**160,750**	**196,140**	**235,061**	Novatek has only one business segment for reporting purposes – Exploration, Production and Marketing. We expect the company's revenue and EBITDA margin to remain stable based on moderately rising production, marginally rising gas prices, a stable tax regime and limited exposure to oil prices.
yoy (%)	47	22	20	
Transportation expenses	-48,329	-60,848	-83,523	
Purchases of gas and liquids	-5,994	-17,483	-26,031	
G&A	-8,218	-8,218	-8,052	
Material and services	-5,947	-7,216	-6,437	
Exploration expenses	-1,819	-2,022	-2,097	
Other	-1,733	-3,331	-2,924	
EBITDA	**88,710**	**97,022**	**105,997**	
EBITDA margin (%)	55	49	45	
Natural gas production (mmcm)	47,521	50,507	51,453	
EBITDA to gas production (RUB/mcm)	1,867	1,921	2,060	
Total hydrocarbon production (mboe/d)	861	909	926	
EBITDA to hydrocarbon produced (USD/boe)	9.6	9.4	10.0	

Source: Company/Fitch

Figure 6

Novatek's Gas Balance in LTM13



Source: Fitch

Stable FFO, Rising Capex

Novatek continues to enjoy a healthy financial profile, with a relatively low debt level, stable operating cash flows and manageable capital expenditure. In 2012 and in the last twelve months to end-June 2013, its funds from operations (FFO) remained solid at RUB78bn and RUB91bn, respectively. In 2009-2012 the company's pre-acquisition FCF (excluding acquisition expenditures and loans granted to JVs) on average amounted to RUB14bn p.a., or 10% of consolidated net revenue.

We expect Novatek to intensify its upstream and downstream capex in 2013-2014, including the third-stage development of the Purovsky gas condensate plant, the transhipment complex complex at Ust-Luga, the development of the Yurkharovskoye field, and bringing new production gas and oil fields on stream. This will put downward pressure on Novatek's FCF, but in 2015 capex will return to more moderate levels and we expect FCF will turn positive again.

Manageable Debt Burden

At end-2012 Novatek's total debt increased to RUB132bn from RUB95bn at end-2011 on its acquisition of a 49% stake in Nortgaz, as a result of which the company's FFO-adjusted net leverage increased to 1.6x from 1.25x at end-2011. We expect that the company's leverage will continue to rise due to its intensified capex programme and its equity injections into the Yamal LNG project in 2013-2014. Leverage will rise to close to 2x, but will fall thereafter if no other M&A deals come in. These projections do not consider the possibility that Novatek could provide guarantees to secure finance for the Yamal project. If this were the case we might treat such guarantees as the company's off-balance sheet obligations – and hence the projected leverage will be higher. We expect that the company's FFO interest cover will not fall below 10x in the medium term.

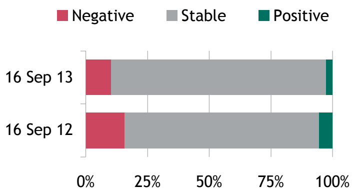
Balanced Debt Structure

Novatek's debt portfolio is well balanced in terms of maturities, instruments and currencies. The company continues to enjoy ready access to the international debt capital markets and has available lines of credit for around RUB51bn.

At end-H113 less than 10% of Novatek's debt was due within two years and slightly more than a half within four years, limiting medium-term refinancing risks. At end-H113 68% of the debt was denominated in US dollars, and 32% was denominated in roubles. Most of the debt – 65% – was represented by Eurobonds.

OAO Novatek Energy (Oil & Gas) Median Emerging BBB Cat Median
Source: Company data; Fitch

Distribution of Sector Outlooks
Directional Outlooks and Rating Watches



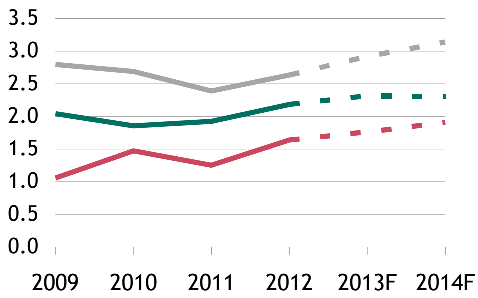
Fitch's expectations are based on the agency's internally produced, conservative rating case forecasts. They do not represent the forecasts of rated issuers individually or in aggregate. Key Fitch forecast assumptions include:

- strong operating cash flows based on marginally rising output, stable domestic gas prices and declining oil prices in line with Fitch's price deck;
- rising capex and equity injections in Yamal LNG in 2013-2014;
- dividend payout ratio in line with the company's policy of 30% (based on the standalone Russian statutory accounts).

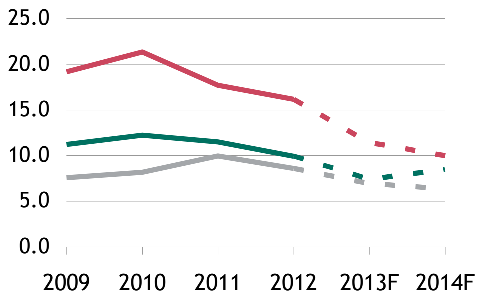
Definitions

- Leverage: Gross debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus gross interest paid plus preferred dividends plus rental expense.
- Interest cover: FFO plus gross interest paid 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.

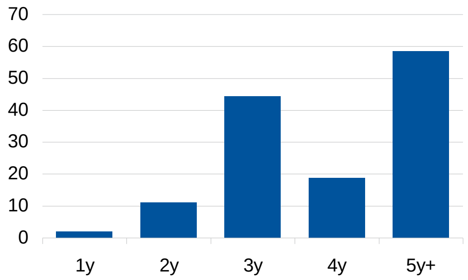
Leverage
including Fitch expectations



Interest Cover
including Fitch expectations

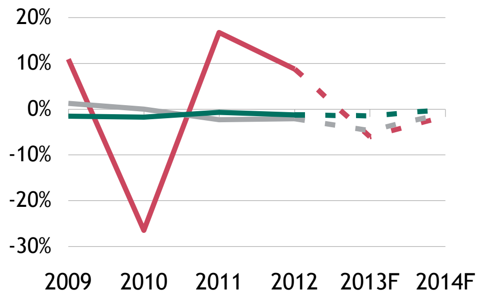


Debt Maturity Profile at 1 Jul 2013
(RUBbn)

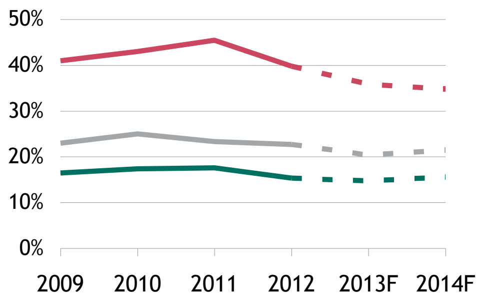


Source: Novatek

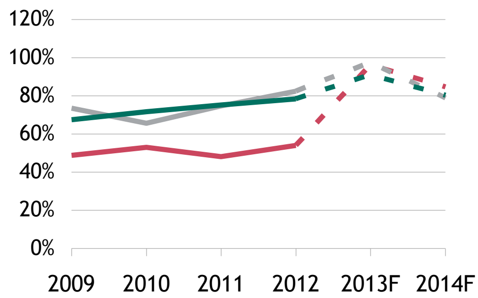
FCF/Revenues
including Fitch expectations



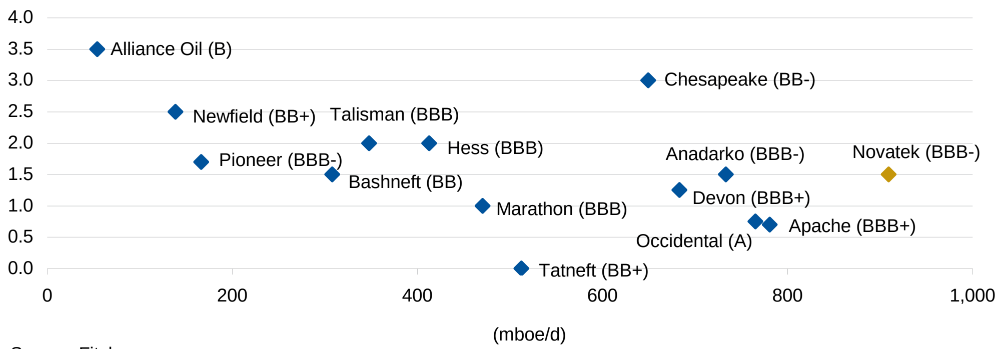
FFO Profitability
including Fitch expectations



Capex/CFO
including Fitch expectations



Rating Mapping: Leverage vs. Hydrocarbon Output
(Projected mid-point FFO adj. leverage)



Source: Fitch

Building Blocks - Oil & Gas Production Sector - OAO Novatek (BBB-/Stable)

Rating	Sector Risk Profile	Sub-Sector (Company-Specific Traits)	Reserves	Cost of production	Production size	FFO adj. net leverage (x)	FFO fixed charge cover (x)	Adj. debt/ Proved reserves ($/boe)	Cycle ratio: (CFO/boe)/ (FD&A/boe) (x)	Capex/ CFO (%)	Size (Annual) FFO (USDm)
AAA						0.5		3.0	>2.0	50	50,000
AA	Integrated	Integrated players: • Benefit from diversity and spread of projects that smooth out volatility • Ratings limited by scale of operations	• Large • 60%-80% developed • FD&A Costs: <USD15/boe	• <USD10/boe	• Large	1.0		4.0	2.0	67	30,000
A	Exploration and production	Upstream E&P companies: • More diverse projects, less vulnerable to price volatility, but still subject to cost overruns and production delays	• Medium • 60% - 80% developed • FD&A costs: >USD15 - <USD25/boe	• >USD10 - <20/boe	• Medium	2.0	10	5.0	1.5	<100	10,000
BBB			• Medium • <60% or >80% developed • FD&A costs: >USD15 - <USD25/boe	• >USD10 - <20/boe	• Medium to Small	2.5	8	6.0	>1.0	100	5,000
BB		Upstream E&P companies: • Fewer projects, vulnerable to price volatility, cost overruns, production delays	• Small • <60% developed • FD&A costs: >USD25/boe	• >USD20/boe	• Small	3.5	6	7.0	<1.0	>100	2,000
B				• >USD20/boe	• Very Small	4.5	4	8.0	<1.0	>100	<1,000

Financial Profile (historical where relevant and forecast, mid-points)

General
- Essential global commodity
- Depleting resource
- Natural hedge to commodity price fluctuations from diversity across fuel types
- Commodity price exposure
- Significant cost focus due to commodity nature of industry
- Cyclical industry

Current Forecast

Indicative factors observed or extrapolated for rated issuers in developed markets. Ratio levels refer to the mid-point of a through-the-cycle range; actual observations are likely to vary from these. Certain sub-sectors may contain a small number of observations; where no observations currently exist, guidelines for a category are extrapolated based on Fitch judgement. The factors give a high-level overview and are neither exhaustive in scope nor uniformly applicable. Additional factors will influence ratings, particularly in emerging markets and where group relationships constrain or enhance a rating level.

Peer Group

Issuer	Country
A	
Occidental Petroleum Corp.	United States
BBB+	
Apache Corporation	United States
Devon Energy Corporation	United States
BBB	
Hess Corporation	United States
Marathon Oil Corporation	United States
OAO Gazprom	Russian Federation
OAO LUKOIL	Russian Federation
OJSC OC Rosneft	Russian Federation
Talisman Energy Inc.	United States
BBB-	
Anadarko Petroleum Corp.	United States
OAO Novatek	Russian Federation
Pioneer Natural Resources Co.	United States
BB+	
Newfield Exploration Company	United States
OAO Tatneft	Russian Federation
BB	
Joint Stock Oil Company Bashneft	Russian Federation
B	
Alliance Oil Company Ltd	Russian Federation

Issuer Rating History

Date	FC LT IDR	Outlook/ Watch
19 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

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

Key challenges facing the oil and gas industry in 2013 include sustaining production growth and continuing with the capex programmes necessary to maintain existing reserve and production profiles. Gas markets remain primarily regional, and specific regional demand and supply fundamentals and domestic policies continue to affect prices. The prospects for European and Asian gas demand will determine the production plans of the Russian companies and development schedules for gas fields. At the same time, Fitch does not anticipate that the success of shale gas development in the US, which put downward pressure on US gas prices, will be replicated in Europe on a similar scale in the short to medium term.

Financial Risks

The Russian oil and gas sector remained highly capital intensive in 2012, which Fitch expects to continue in the foreseeable future. High oil prices along with gas market liberalisation in Russia should support companies’ ability to fund their capex needs. In July 2013 the agency revised up its base-case oil price deck. Given the highly capital-intensive nature and long lead times of the oil and gas projects, companies in the sector are exposed to potential delays and/or cost overruns. Russian hydrocarbons producers will also face general industry inflation in 2013, which may put some pressure on their cost positions.

Peer Group Analysis

	Apache BBB+/Stable	Devon BBB+/Stable	Novatek BBB-/Stable	Tatneft BB+/Stable	Bashneft BB/Positive
Hydrocarbon production (mboe/d)	781	683	909	512	308
Share of liquids (%)	51	37	11	100	100
Proved reserve life (years)	10.0	11.9	20.9	34.2	17.9
EBITDA to boe produced (USD/bbl)	43.1	21.1	9.4	21.0	28.3
Projected mid-point FFO net leverage (x)	1	1.25	1.5	<0.5	1.5
Projected mid-point FFO interest coverage (x)	20	12	12	>20	9.0

Source: Fitch, companies

Key Credit Characteristics

The creditworthiness of Russian integrated oil and gas companies is supported by their healthy balance sheets and relatively low leverage. The agency believes that 2013 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

Apache Corporation (BBB+/Stable) – a medium-scale US oil and gas producer with a diversified portfolio of upstream properties. The company was downgraded in November 2012 as its leverage was increased by acquisitions.

Devon Energy Corporation (BBB+/Stable) – medium-scale North American natural gas and liquids producer.

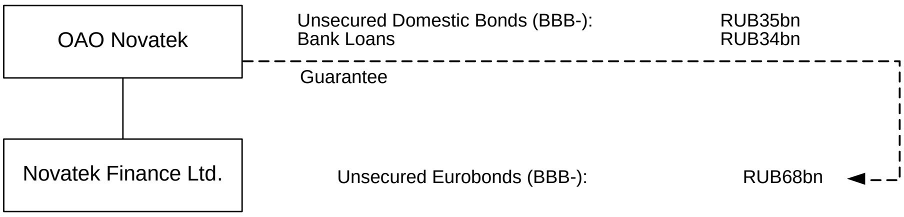
OAO Tatneft (BB+/Stable) – the sole crude oil producer in the Republic of Tatarstan (BBB−/Stable) and the closest Russian peer for Bashneft. At end-2011 Tatneft launched the TANECO refinery, which helped the company to vertically diversify its operations. Fitch expects Tatneft to maintain low leverage.

Joint Stock Oil Company Bashneft (BB/Positive) – a second-tier oil company with a large downstream segment. We revised the Outlook for Bashneft’s long-term ratings to Positive in May 2013 due to the company’s recent success in increasing its upstream production.

Group Structure Diagram

Figure 7

Debt Diagram At End-2012



Source: Company

This diagram is a stylised summary of Fitch's understanding of the key features of the issuer group's legal structure at the date of publication. It cannot include all relevant details, or all subsidiaries, and may change over time.

OAO Novatek
FINANCIAL SUMMARY

	31 Dec 2012 RUBm Year End	31 Dec 2011 RUBm Year End	31 Dec 2010 RUBm Year End	31 Dec 2009 RUBm Year End
Profitability				
Revenue	196,140	160,750	109,163	83,255
Revenue Growth (%)	22.02	47.26	31.90	14.29
Operating EBIT	85,523	79,235	49,047	33,949
Operating EBITDA	97,022	88,710	55,804	39,687
Operating EBITDA Margin (%)	49.47	55.19	51.12	47.67
FFO Return on Adjusted Capital (%)	19.58	22.95	20.52	21.03
Free Cash Flow Margin (%)	8.71	16.67	(26.51)	10.89
Coverages (x)				
FFO Gross Interest Coverage	16.13	17.67	21.31	19.16
Operating EBITDA/Gross Interest Expense	19.34	20.51	24.23	21.30
FFO Fixed Charge Coverage (inc. Rents)	16.13	17.67	21.31	19.16
FCF Debt-Service Coverage	0.56	1.26	(0.97)	0.70
Cash Flow from Operations/Capital Expenditures	1.85	2.08	1.89	2.05
Debt Leverage of Cash Flow (x)				
Total Debt with Equity Credit/Operating EBITDA	1.37	1.08	1.29	0.95
Total Debt Less Unrestricted Cash/Operating EBITDA	1.18	0.81	1.11	0.68
Debt Leverage Including Rentals (x)				
Annual hire lease rent costs for long-term assets (reported and/or estimate)	n.a.	n.a.	n.a.	n.a.
Gross Lease Adjusted Debt/Operating EBITDAR	1.37	1.08	1.29	0.95
Gross Lease Adjusted Debt /FFO+Int+Rentals	1.64	1.25	1.47	1.06
FFO Adjusted Net Leverage	1.41	0.94	1.26	0.76
FCF/Lease Adjusted Debt (%)	12.90	28.07	(40.07)	24.05
Debt Leverage Including Leases and Pension Adjustment (x)				
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	1.37	1.08	1.29	0.95
Balance Sheet Summary				
Cash and Equivalents (Unrestricted)	18,430	23,848	10,238	10,643
Restricted Cash and Equivalents	1,959	n.a.	n.a.	n.a.
Short-Term Debt	34,682	20,298	25,152	13,827
Long-Term Senior Debt	97,805	75,180	47,074	23,876
Subordinated debt	n.a.	n.a.	n.a.	n.a.
Equity Credit	n.a.	n.a.	n.a.	n.a.
Total Debt with Equity Credit	132,487	95,478	72,226	37,703
Off-Balance-Sheet Debt	n.a.	n.a.	n.a.	0
Lease-Adjusted Debt	132,487	95,478	72,226	37,703
Fitch- identified Pension Deficit	n.a.	n.a.	n.a.	n.a.
Pension Adjusted Debt	132,487	95,478	72,226	37,703
Cash Flow Summary				
Operating EBITDA	97,022	88,710	55,804	39,687
Gross Cash Interest Expense	(5,018)	(4,326)	(2,303)	(1,863)
Cash Tax	(17,607)	(13,933)	(8,575)	(4,264)
Associate Dividends	n.a.	n.a.	n.a.	n.a.
Other Items before FFO (incl. interest receivable)	3,561	2,607	2,028	574
Funds from Operations	**77,958**	**73,058**	**46,954**	**34,134**
Change in Working Capital	(5,121)	(4,548)	(4,210)	(855)
Cash Flow from Operations	**72,837**	**68,510**	**42,744**	**33,279**
Total Non-Operating/Non-Recurring Cash Flow	3,284	6,437	(39,183)	(347)
Capital Expenditures	(39,316)	(32,978)	(22,636)	(16,238)
Dividends Paid	(19,718)	(15,166)	(9,868)	(7,628)
Free Cash Flow	**17,087**	**26,803**	**(28,943)**	**9,066**
Net (Acquisitions)/Divestitures	(47,424)	(17,523)	(5,205)	(18,615)
Net Equity Proceeds/(Buyback)	194	354	678	1,767
Other Cash Flow Items	(12,284)	(19,276)	(1,458)	(3,993)
Total Change in Net Debt	(42,427)	(9,642)	(34,928)	(11,775)
Working Capital				
Accounts Receivable Days	27	25	23	18
Inventory Days	10	11	15	19
Accounts Payable Days	32	22	19	42

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.