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Tagging Info

Fitch Affirms Russia's Novatek at 'BBB-', Outlook Stable

Ratings Endorsement Policy

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Fitch Ratings-Moscow/London-08 September 2014: Fitch Ratings has affirmed OAO Novatek's Long-term foreign currency Issuer Default Ratings (IDR) at 'BBB-' with a Stable Outlook. A full list of rating actions is at the end of this release.

Novatek's 'BBB-' rating reflects its strong business profile as Russia's second-largest natural gas producer and exporter of stable gas condensate and other liquids, its relatively low price risks untypical for the industry, and manageable debt load. The ratings also reflect Novatek's medium operational scale, country risks due to its concentration in Russia and uncertainties about how its Yamal LNG megaproject will be financed.

Sanctions imposed on Novatek by the US in July 2014 have not yet triggered any negative rating actions, in view of Novatek's sound liquidity. They have not affected the company's day-to-day operations. However, already enacted and possible future sanctions may be negative in the long term and could delay the Yamal LNG project.

KEY RATING DRIVERS

Second-Largest Gas Producer in Russia

As Russia's second-largest gas producer (after Gazprom), Novatek plays an important role in domestic gas supplies. In 2013 the company 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 increased by a compound annual growth rate of 10%. We expect growth rates to decelerate in view of the stagnant domestic gas consumption, intensified competition between Gazprom and independent gas producers, mainly Novatek and Rosneft, and limitations on the supply side.

In 2013 Novatek's hydrocarbon production amounted to 940 thousand barrels of oil equivalent per day (mboepd, excluding joint ventures), of which 10% was liquids.

Sanctions

In July 2014 Novatek was included on the Sanctions Sectorial List by the US Office of Foreign Asset Control, which prohibits US companies and banks 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, in our view. It has no credit implications at this stage given Novatek's sound liquidity. Even under our conservative assumptions we believe the company can afford not to attract new debt until at least the end of 2015. However, if the western capital markets remain closed for Novatek, we would expect the company to make progress in attracting finance from alternative sources by end-1Q15 to cover its debt repayments.

Separately, Novatek will need to secure financing for its USD27bn Yamal LNG project, and the number of available options has now considerably reduced. 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. Inability to secure financing by the end of 2014 may result in the project being delayed.

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 Yamal LNG, as they apply specifically to the Arctic, deep offshore and non-conventional oil and gas production. However, there is a risk of further sanctions as the crisis over Ukraine is far from being resolved.

Yamal May Be Transformative, But Delays Possible
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. Novatek has a 60% stake in the project and its partners, China National Petroleum Corporation (CNPC, A+/Stable) and Total SA (AA/Negative), hold 20% each. The project could significantly enhance Novatek's business profile through diversification into the lucrative Asian LNG market. In comparison with other LNG projects constructed worldwide, Yamal's main advantage is a relatively low cost of production and a competitive break-even LNG price, supported by tax holidays. However, the Ukrainian political crisis and sanctions imposed on Russia may result in the project being delayed.

Novatek expects most of the USD27bn project will be funded through non-recourse debt. It seems that Western investors are less likely to participate in the deal because of the sanctions, which limits the available financing option. Possible delays should not alone result in negative rating action unless they also lead to higher than expected cash outflows (e.g. due to Novatek's higher capital injections into the project).

However, further possible sanctions may potentially delay the project even if the finance is secured.

Improving Customer Mix
Novatek has substantially improved its customer portfolio in Russia. In 2013 the share of end-customers (as opposed to traders) in its total sales increased to 89%, compared with 45% in 2009 as the company has successfully signed long-term gas supply contracts with large industrial companies and also acquired Gazprom's regional trading arms in the regions of Chelyabinsk and Kostroma. We assess positively the prevalence of long-term contracts in Novatek's customer portfolio and believe that the company's volume risks will remain limited in the medium term.

Low Price Risk
Novatek continues to enjoy a relatively low price risk untypical for the industry as Russia's domestic gas prices are effectively controlled by the state. Until recently, regulated gas prices in Russia (which influence Novatek's selling prices) increased by 15% yoy for several consecutive years, but in 2013 the state decided to freeze the tariff for one year, and to limit tariff growth by the level of inflation onwards. We believe that the tariffs are unlikely to go down in the medium term, given their relatively low current level. Even on the netback basis (deducting export duty and transportation), Russian domestic gas prices are now two times lower than Gazprom's average European export prices.

Novatek has limited exposure to oil prices as it generates around one-third of its revenues through liquids sales. We estimate that a Brent price drop by 25% will result in Novatek's EBITDA declining by only around 10% in rouble terms.

Moderating Capital Intensity
In 2013-2014 Novatek's capital expenditures significantly increased compared with previous periods, on the back of intensified investments in upstream and downstream assets, including the third stage development of the Purovsky gas condensate plant and the Ust-Luga complex. For example, in 2009-2012 capital intensity measured as capex to funds from operations (FFO) averaged 50% and in 2013 it increased to almost 60%. We expect Novatek's capex to moderate in 2015 onwards. Even taking into account equity injections into Yamal LNG, we expect Novatek's FFO adjusted net leverage to gradually decrease from 1.5x in 2013 to 1x in 2016.

The company has also previously been involved in several M&A deals. We expect no new significant acquisitions in the medium term, taking into account the company's blocked access to international debt markets.

RATING SENSITIVITIES
Negative: Future developments that could lead to negative rating action include:
- Negative rating action on Russia (BBB/Negative), as Novatek's rating and Outlook are capped by the sovereign's. However, Russia's possible downgrade to 'BBB-' with a Stable Outlook would have no direct

implications as Russia and Novatek would be rated at the same level. Negative rating action on Russia may stem from an intensification of sanctions, a further deterioration in growth prospects, or large-scale stimulus measures that would endanger macroeconomic stability or the sustainability of public finances (for more details see 'Fitch Affirms Russia at 'BBB' Outlook Negative', dated 25 July 2014 at www.fitchratings.com);
- New sanctions targeted at Novatek or more general sanctions;
- Worsened financial metrics, possibly from additional acquisitions, or equity injections or guarantees granted in relation to Yamal LNG, making the issuer's FFO net adjusted leverage rise above 2.5x (Fitch's expectations for 2014: 1.4x) and FFO interest cover falling below 10x (Fitch's expectations for 2014: 11x) on a sustained basis
- No progress with regard to attracting an alternative source of finance (Russian banks, state support, Chinese banks etc) by end-1Q15 should international financial markets remain closed.

Positive: Future developments that could lead to positive rating actions include:
- Progress with Yamal LNG, including more clarity on how the project will be financed and the amount of completion or performance guarantees granted, if any.

LIQUIDITY AND DEBT STRUCTURE
Sound Liquidity: We believe Novatek will afford not to attract new debt at least until the end of 2015, supported by a considerable cash balance of RUB46bn built as at 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.

The rating actions are as follows:

OAO Novatek
Long-Term IDR: affirmed at 'BBB-', Outlook Stable
Local currency long-term IDR: affirmed at 'BBB-', Outlook Stable
National Long-Term Rating: affirmed at 'AA+(rus)', Outlook Stable
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)
National senior unsecured rating: affirmed at 'AA+(rus)' (the affirmation applies to all debt issued prior to 1 August 2014)

Novatek Finance Limited
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology', dated 28 May 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage

Additional Disclosure
Solicitation Status