FitchRatings

09 Jul 2020 | Affirmation

Fitch Affirms Novatek at 'BBB', Outlook Stable

Fitch Ratings-Moscow-09 July 2020:

Fitch Ratings has affirmed PAO Novatek's Long-Term Foreign-Currency Issuer Default Rating (IDRs) at 'BBB' with a Stable Outlook. Fitch has also affirmed Novatek Finance Designated Activity Company's senior unsecured rating at 'BBB'. The affirmation applies to the ratings of all debt issued by Novatek Finance Designated Activity Company prior to 12 September 2014. A full list of rating actions is at the end of this commentary.

The affirmation reflects Novatek's strong integrated business profile, enhanced operations after the full ramp-up of the company's transformational Yamal LNG (YLNG) project, strong cash-flow generation and large low-cost reserve base. Novatek managed to keep low leverage through the cycle, despite substantial capex for the completion of its large scale YLNG project. We expect leverage metrics will increase but remain within the rating guidance in the next four years, as investments in Arctic LNG 2 will be financed from proceeds from the sale of a 40% stake in the project, which has already taken place, an equity injection from partners as well as project finance.

Novatek is the largest independent gas producer in Russia with 820 thousand barrels of oil equivalent per day of total hydrocarbon production (excluding joint ventures - kboe/d) with assets concentrated within the Russian Arctic Circle. The company's rating also takes into account its exposure to the operating environment in Russia.

Key Rating Drivers

LNG to Drive Growth: Novatek's YLNG mega project has enhanced its business profile and propelled the company from a niche Russian natural gas producer into a global LNG player with a 5% share of the global LNG market. Novatek has an ambitious target to increase its LNG production from the current 19 million tonnes (mt) to 40mt in 2026 with the start-up of all Arctic LNG 2 trains and further to 57mt-70mt by 2030 with future LNG projects. In our view, Novatek's vast reserve base with 1P reserve life of 27.5 years, low lifting costs, expertise with launching YLNG and strategy towards LNG infrastructure should support this target.

Arctic LNG-2 Progress: The final investment decision (FID) on Novatek's second LNG mega project with 19.8mt capacity was taken in September 2019. Novatek's stake stands at 60%. Total

(AA-/Stable), Novatek's minority shareholder, China National Petroleum Corporation (A+/Stable), China National Offshore Oil Corporation and the consortium of Mitsui & Co and Japan Oil, Gas and Metals National Corporation each acquired a 10% stake.

The launch of the three LNG trains is scheduled throughout late 2023-2026. Capex is estimated at USD21.3 billion, which is more than 30% cheaper than Yamal LNG on a per-tonne basis, achieved through placing the plant on gravity-based structures, and a higher degree of localisation. The project is estimated to be 19% complete to date.

Arctic LNG-2 Financing: Management views a 50%/50% debt/equity as the most likely financing structure, which translates into up to around USD11 billion of project finance debt. As the final funding scheme is yet to be agreed, we conservatively assume a higher share of equity in our forecast. We anticipate that Novatek's share of investments in the project will be predominantly covered by proceeds from the sale of 40% equity stakes to its partners. These proceeds include a cash consideration of around USD5.2 billion and have a contingent part that relates to train launches. Each project partner provides a long-term LNG offtake in proportion to their respective ownership interest.

Future LNG Ventures: The next LNG project is a smaller scale Obskiy LNG with two trains of 2.5mt capacity, which will be based on Novatek's in-house liquefaction technology similar to the fourth train of YLNG. Due to an anticipated supply glut on the global gas market, Novatek is considering delaying the FID and commissioning of Obskiy LNG by one year to 2024. However this should not impact its long-term target. The company's future LNG projects will benefit from efforts to optimise logistics across the Northern Sea Route, as construction of LNG hubs in Kamchatka and Murmansk will reduce transportation expenses.

Uncertainty in Financial Profile: We expect that funds from operations (FFO) net leverage will remain comfortably below our guidance for negative rating action over 2020-2023. The company's internal policy targets a net debt/EBITDA ratio of 1.0x on a through-the-cycle basis.

The pipeline of new LNG projects adds some uncertainty to the company's credit profile due to their potentially large scale, not yet finalised financial arrangements and mid-term pressure on the global gas market. Novatek has historically financed its projects capex through the sale of stakes to partners. However, if the company decides to provide shareholder loans as bridge funding for future projects, this could have a temporary negative impact on its credit metrics. Novatek's intensified capex programme and elevated dividend pay-out will lead to negative free cash flow (FCF) in the medium term.

Elevated Capex: Since 2019, Novatek has significantly intensified investments in LNG-related projects and infrastructure, as well as in exploration and drilling aimed at stabilising its domestic production. In 2020, the initial capex guidance was indicating a further spike. However, pandemic-related challenges drove the decision to cut it by 20% from its initial figure to RUB200 billion. The updated capex is still higher than a year ago, primarily stemming from a large budget for LNG projects, while investments in oil production were curtailed. We anticipate that capex will remain relatively high by historical standards at least for the next three to four years.

Yamal LNG Resilient to Volatility: Despite low spot gas prices and subdued gas demand, we believe that the project's performance will be resilient due to pricing mechanism in offtake contracts that cover 95% of sales and low-cost base. We assess YLNG's operational break-even natural gas price at around USD3/million british thermal units (MMBtu). This is above the current spot price but oil-linkage in offtake contracts provides for higher average sales price.

Therefore, we expect that YLNG will be able to service its bank debt with no support from Novatek, although cash flows to shareholders are likely to be lower than previously projected. The start-up of the fourth train, which will be purely priced on a spot based, was delayed until end-2020.

Although Novatek does not consolidate YLNG on its balance sheet and we also treat it on a deconsolidated basis, its financial profile will benefit from the repayment of shareholder loans and later on, dividends. We expect that under normal market conditions annual cash flows from YLNG to Novatek will exceed USD600 million. In a hypothetical scenario when YLNG is proportionally consolidated into Novatek's financials, which is not our rating case, its FFO net leverage would have been around 3x in the next three years, above the guidance for a negative rating action.

Natural Gas Production Stabilising: Novatek's natural gas production started declining in 2016 as some of its key producing fields were depleting. The commissioning of North Russkoye cluster, which at plateau will produce 14 billion cubic metres (bcm) gas, as well as small-scale acquisitions, should help mitigate the production decline. We expect Novatek's natural gas production, including a share in associates but excluding YLNG, to remain above 60bcm in the medium term, compared with a peak of 68bcm in 2015. This should be sufficient to meet Novatek's domestic gas sales commitments.

Domestic sales of gas have historically provided lower profitability than liquids business, but stable revenue and cash flows.

LNG Challenges: The ramp-up of new LNG facilities, slowing Chinese demand growth and the warm winter of 2019-2020 in the northern hemisphere put LNG prices under pressure even before the coronavirus crisis started. The COVID-19 related lockdowns deepened the imbalance between

LNG supply and demand. Despite near-term challenges, we expect that LNG demand will grow considerably in the long term and its role in the global energy mix will continue to increase, particularly in the context of the low-carbon transition.

Moreover, many final investment decisions for new projects are being postponed in the current low price environment, potentially resulting in the market switching to a deficit after 2022-2023.

Sanctions Manageable: Novatek has been included on the Sectoral Sanctions List by the US Office of Foreign Asset Control, which prohibits US companies and banks from providing new finance of longer than 60 days to the company and its subsidiaries. This has effectively barred Novatek from the US capital markets, and we believe may make access to other western markets difficult. We estimate the company should be able to repay its upcoming debt maturities largely from internally generated funds, or resort to domestic borrowings in case of necessity.

State Supportive Towards Arctic: Novatek's existing and potential projects, including Yamal LNG and Arctic LNG 2, are aligned with Russia's strategic aspirations, such as the diversification of energy exports through LNG and the development of the Arctic territories. The government has provided substantial tax breaks to Yamal LNG, helped build infrastructure, and partially funded the project from the National Welfare Fund. The state will also fund infrastructure construction for Arctic LNG 2, which justifies our expectation that the state will continue supporting other Novatek's projects in the Arctic through tax incentives and infrastructure investments.

Fitch has chosen to affirm and withdraw the senior unsecured rating of PAO Novatek, because it is no longer considered relevant for the agency's coverage.

Derivation Summary

Novatek is Russia's major LNG and domestic natural gas producer with sizable exposure to liquids. Novatek's upstream production volumes in 2019 was 820kbpd by subsidiaries and 1,556kbpd including equity affiliates and joint ventures. Its EBITDA in 2019 was USD2.3 billion.

This compares with Russian oil majors production in 2019 (all excluding equity affiliates): 1,359 kbpd by PJSC Gazprom Neft (BBB/Stable), 2,318 kbpd by PJSC Lukoil (BBB+/Stable), 598kbpd by Tatneft (BBB-/Stable) and 10,248 kbpd by PJSC Gazprom (BBB/Stable, 'a-' Standalone Credit Profile). Novatek compares favourably with US peers Marathon Oil Corporation (BBB/Negative), Devon Energy (BBB/Stable) and Noble Energy Inc. (BBB/Negative), which are twice smaller in production volumes.

However, Novatek has much lower EBITDA than its Russian peers: Gazprom Neft - USD8.2 billion, Tatneft - USD4.1 billion and Lukoil - USD14 billion and lower profitability on a per barrel oil equivalent basis compared with both domestic and foreign peers. This is because it primarily focuses on domestic sale of natural gas (on a subsidiary level), which is less profitable than liquids.

Novatek has one of the highest reserve life metrics domestically of 27.5 years based on 1P reserves, which is a very strong reserve estimate compared with the US peers median of 11 years in this rating category. All Novatek's reserves are concentrated in Yamal region of Russia, hence the company is subject to the higher-than-average risks pertaining to the Russian operating environment.

Novatek's leverage is low compared to Russian and international peers, with only Lukoil and Tatneft being less levered and we believe that the company will be able to maintain its conservative leverage profile in the next three-four years.

Key Assumptions

- Brent crude oil price: USD35/bbl in 2020, USD45/bbl in 2021, USD53/bbl in 2022 and USD55/bbl thereafter.
- USD/RUB: 70.4 in 2020, 68.9 in 2021, 68.0 in 2022 and 67.0 thereafter.
- Broadly stable tax environment in Russia.
- Stabilisation in natural gas and condensate production from consolidated subsidiaries in 2020 due to the launch of the North Russkoye cluster.
- Oil production declines due to OPEC+ agreement restrictions and reduction in oil-related capex.
- Capex peaking at RUB200 billion in 2020 and moderating towards RUB110 billion in 2022 and thereafter.
- Novatek's investments into Arctic LNG 2 to be broadly covered by proceeds from equity stake sales to other partners.
- Dividend pay-outs in line with dividend policy of above 30% of adjusted net income.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Enhancement in the company's business profile evidenced by accomplishment of funding arrangements and visible progress with implementation of Arctic LNG 2 along with improvement in Russia's operating environment, provided that credit metrics remain conservative.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO net leverage rising above 2.5x on a sustained basis

- Intensification of western sanctions directly affecting Novatek and/or its LNG projects

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Comfortable Liquidity: At end-March 2020, Novatek's short-term debt equalled around RUB56 billion and was fully covered by cash balances and short-term bank deposits of around RUB217 billion. Other sources of liquidity include undrawn long-term committed credit lines totalling RUB163 billion. We assume that Novatek will tap the capital market to partially fund its FCF deficit in 2021-2023. The company has strong access to domestic funding, including Russia's largest banks, but is barred from the US dollar debt market due to sanctions.

Guarantees Excluded: Novatek has provided around USD10 billion of completion and other non-financial guarantees to Yamal LNG's creditors. We exclude these from Novatek's leverage, as we view the risk of cash outflows under these guarantees as diminishing since the project was launched, reached full capacity and passed commercial and production tests in April 2020. Most guarantees will be released shortly or replaced by other guarantees, more specific and lower in size. We will assess our view on Artic LNG 2's guarantees once the terms and conditions are finalised.

Summary of Financial Adjustments

Fitch added around RUB84 billion of short-term bank deposits to cash and cash equivalents, increasing Fitch-calculated readily available cash to about RUB137 billion.

Fitch reclassified around RUB2.5 billion of depreciation of right-of-use assets and around RUB544 million of interest on lease liabilities as lease expenses, reducing Fitch-calculated EBITDA by around RUB3 billion in 2019.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

PAO Novatek; Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Local Currency Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
----senior unsecured; Long Term Rating; Affirmed; BBB
----senior unsecured; Long Term Rating; Withdrawn; WD
Novatek Finance Designated Activity Company
----senior unsecured; Long Term Rating; Affirmed; BBB

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Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)
Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).
Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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