MOODY'S INVESTORS SERVICE

Credit Opinion: OAO Novatek

Global Credit Research - 07 Nov 2014

Moscow, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3
NSR LT Issuer Rating -Dom Curr	Aaa.ru
Novatek Finance Limited	
Outlook	Stable
Senior Unsecured	Baa3

Contacts

Analyst	Phone
Julia Pribytkova/Moscow	7.495.228.6060
Thomas S. Coleman/London	44.20.7772.5454
David G. Staples/DIFC - Dubai	971.42.37.9536

Key Indicators

[1]**OAO Novatek**

	9/30/2014(L)	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Avg Daily Production (Mboe/d)	1107	1095	1005	948	685
Proved Developed Reserves (Million boe)	4042	4042	4174	4134	4479
Total Proved Reserves (Million boe)	14193	14193	14161	10300	8469
Leveraged Full-Cycle Ratio	9.2x	7.7x	6.3x	7.2x	4.6x
E&P Debt / Average Daily Production	$4,202.9	$4,650.2	$4,385.4	$3,723.1	$4,580.8
E&P Debt / PD boe Reserves	$1.2	$1.3	$1.1	$0.9	$0.7
RCF / Total Debt	47%	42%	43%	52%	37%
EBITDA / Interest Expense	15.0x	13.6x	17.6x	15.2x	24.7x
E&P Unleveraged Cash Margin / BOE	$9.3	$8.5	$8.0	$8.6	$7.5

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Revenue and EBITDA growth supported by higher gas prices and growth in liquids sales

- Profitability remains strong thanks to favourable production mix

- Strong position in the domestic market

- EU and US sanctions limit financing option to Chinese banks and the Russian state

- Leverage and coverage metrics to remain strong

Corporate Profile

Headquartered in Moscow, OAO Novatek (Novatek, Baa3 stable) is Russia's largest independent gas producer and second-largest gas company in Russia - after state-controlled OJSC Gazprom (Gazprom, Baa1 negative). In the last 12 months ended 30 September 2014, Novatek reported approximately $10 billion in revenue and its adjusted EBITDA amounted to approximately $4.0 billion).

Novatek's key shareholders are as follows: Leonid Mikhelson (25% stake), who is also the CEO and Chairman of the Management Committee; Volga Resources (an investment vehicle of Gennady Timchenko, not rated), with a stake of approximately 23%; TOTAL S.A. ((P)Aa1 negative), with a 18.0% stake, with a right to increase the stake to 19.4%; and Gazprom, with a 10% stake. Novatek's free float is estimated to be around 24%.

SUMMARY RATING RATIONALE

Novatek's Baa3 issuer rating reflects the following factors: 1) a track record of growth; 2) strong domestic market position on the back of acquisitions and new contracts; and 3) low finding and development (F&D) costs and 4) strong financial metrics.

To position Novatek on the global rating scale, we apply our rating methodology for the global independent exploration and production (E&P) industry published in December 2011. The difference between the assigned ratings and the methodology-indicated outcome, which is in the lower Aa rating category, reflects the risks associated with operating in Russia (Baa2 negative), where institutional and economic framework compared with those of more developed markets is more weak.

DETAILED RATING CONSIDERATIONS

REVENUE AND EBITDA GROWTH SUPPORTED BY HIGHER GAS PRICES AND GROWTH IN LIQUIDS PRODUCTION...

Novatek's revenue growth (41% year on year in 2013, 22% in the first 9 months of 2014 in rouble terms compared with the same period of 2013) has been largely driven by 1) gas price growth - the Federal Tariff Service increased domestic gas prices by 15% on 1 July 2013 and 3% on 1 August for Gazprom, and independent producers such as Novatek move in lockstep; 2) the company's ability to secure 94% of its sales with end-customers in 2014, decreasing dependence on ex-field gas offtake by wholesalers, in particular Gazprom; 3) a 30% increase in sales volumes of liquids, 4) improvement in the product mix (commencement of gas condensate refined products sales) following commissioning of the Ust-Luga gas condensate fractionation and transshipment complex from mid-2013, and 5) rouble depreciation in 2014.

Novatek's gas sales in 2013 and the first nine months of 2014 were driven by the company's further development of its Yurkharovskoye field, acquisition of a stake in Nortgas Joint Venture and increase in volumes of gas procured from Sibur. Further growth in production in 2015 will be driven by the launch of several fields of SeverEnergia which the company expects to run at 80% of capacity already in 2015 and other fields. In the first 9 months 2014 revenue generation and sales profitability further increased thanks to commissioning of the third stage of Purovsky gas condensate stabilization plant (expansion to 11 million tonnes (mt)) and the gas fractionation and transshipment complex in Ust-Luga.

The Ust-Luga complex on the Baltic Sea is used for the transshipment and fractionation of stable gas condensate from the Purovsky plant. The first phase (fractionation capacity of 3 mt) was launched on 19 June 2013 and the second phase (another 3 mt) in October 2013. The project allows Novatek to replace stabilised gas condensate sales with higher added value light and heavy naphtha, jet fuel, gasoil and fuel oil and helps to further diversify the company's customer base (by increasing the number of potential off-takers for the new product mix) and export sales. It is also helping Novatek to save on transportation costs as Ust-Luga is located nearly 400 kilometres closer to Purovsky plant than the previously used port of Vitino.

...AND PROFITABILITY REMAINS STRONG DUE TO FAVOURABLE PRODUCT MIX

Novatek's EBITDA margin (40% as adjusted by us) in the 9 months ended 30 September 2014 is among the highest in the sector in Russia due to its mix of domestic natural gas sales and export of hydrocarbon liquid refined products. Novatek is second-largest condensate producer in Russia after Gazprom. Unstable gas condensate is processed into stable gas condensate and liquefied petroleum gas (LPG) at the Purovsky plant. LPG is sold domestically or exported . Stable gas condensate since launch of Ust-Luga is processed into petroleum products, which are then exported. The taxation regime for condensate and its products is more beneficial than for crude oil and gas. For example, the mineral extraction tax (MET) for condensate constitutes 4%-5% of the export netback price of condensate versus 15% of the domestic net gas price. Export duty on condensate and its products is linked to the export duty on oil, but condensate sells at up to a 20% premium (on a per ton basis) to oil on the export markets. This taxation regime provides for healthier netbacks on condensate and condensate product export sales compared to oil and better profitability than domestic gas sales, which helps to improve Novatek's average cash margin per boe of production. While contributing less than 10% to production and only a quarter to Novatek's revenue, we estimate that liquids account for a significantly higher share (up to 50%) of the company's EBITDA. The positive effect was partially offset by an increase in the transportation tariffs.

US SANCTIONS LIMIT FINANCING OPTIONS TO CHINESE BANKS AND THE RUSSIAN STATE

Novatek among several other Russian names, was placed on the US sectoral sanctions lists, which undermines its ability to raise financing in the West to develop certain projects, such as its Yamal LNG project, together with Western partners. Novatek is a conventional gas producer and therefore will not be affected by the ban on transfer of unconventional and offshore oil and gas production technology. The company has strong cash flow generation and benign debt maturity profile, with more than half of its maturities in 2015 represented by rouble-denominated bonds.

We understand that following the introduction of sanctions, NOVATEK together with partners will seek financing from Chinese banks and the Russian state for the Yamal LNG project. Government officials confirmed the willingness of the government to support the project.

LEVERAGE AND COVERAGE METRICS REMAIN STRONG

According to its internal guidance, the company generally aims to adhere to a 1.0x debt/EBITDA ratio. As a result of the Nortgas acquisition, however, Novatek's leverage, measured by debt/EBITDA, increased and stood at 1.3 times as of end-2013. In the latest twelve months ended 30 September 2014, the company's adjusted leverage decreased to 1.2 x due to growth in EBITDA. Novatek's adjusted debt peaked at $5.1 billion as of end-2013 but then decreased to $4.7 billion as of 30 September 2014. Cash flow coverage, as measured by retained cash flow (RCF)/debt, returned to its 2011 level of above 50%. The acquisition by Yamal Razvitie, the JV of Novatek and Gazprom Neft (Baa2 negative), of the stake of ENI S.P.A in SeverEnergia) in December 2013, had a limited effect on Novatek's financials because the acquisition financing (approximately $2.94 billion) remained at the joint venture level, and had no recourse to either Novatek or Gazprom Neft.The transaction assumes that, Novatek will retain control over 50% of SeverEnergia and consolidate the respective share of its reserves and growing production. However, the increased debt service will most probably reduce or even delay payouts of dividends by Yamal Razvitie to Novatek for several years.

Novatek's robust cash flow generation benefits from its cost advantage over global E&P peers thanks to its low F&D costs per boe ($4.6 in FY2013 including acquisitions) and lifting costs ($0.7 per boe) supported by efficient acquisitions, access to new licences and the favourable positioning and geology of its fields.

Liquidity Profile

We expect Novatek's liquidity profile to remain strong over the next 18 months, given that debt maturities (repayments due in 2015 total $350 million and rouble 20 billion) as well as capex and dividend payout requirements are modest relative to the company's robust cash flows. Liquidity is supported by a cash balance of around $880 million as of 30 September 2014.

Rating Outlook

Stable outlook reflects our view that Novatek is adequately positioned in its rating category.

What Could Change the Rating - Up

We consider the potential for an upgrade of Novatek's rating to be limited over the near term, given 1) the company's scale, size and diversification of operations relative to Baa2 rated peers in the Russian oil and gas sector;. The structuring of the ambitious and large-scale Yamal LNG project will have an effect on our assessment of Novatek's business risks and financial flexibility. However, the further enhancement of Novatek's operating profile and its scale of operations through production growth, the diversification of its sales and customer base, and the support provided by a benign regulatory regime, will exert positive pressure on the company's credit profile and its ratings.

What Could Change the Rating - Down

Downward pressure could be exerted on Novatek's rating as a result of 1) a substantial deterioration in the company's operating cash flow, with RCF/net debt falling below 30% and leverage, as measured by debt/EBITDA, increasing above 2.0 times on a sustained basis; and/or 2) unfavourable trends in the company's logistical arrangements, as well as in Russia's regulation of the oil and gas sector. We will consider Novatek's debt-financed investment projects and/or large-scale bolt-on acquisitions, which are fuelling an increase in leverage, in the context of their cash conversion cycle and whether they complement the company's business profile.

Rating Factors

OAO Novatek

Independent Exploration & Production Industry Grid [1][2]	**Current LTM 9/30/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 11/7/2014**	
Factor 1: Reserves & Production Characteristics (40.0%)	**Measure**	**Score**	**Measure**	**Score**
a) Avg Daily Production (Mboe/d)	1107	Aa	1100 - 1200	Aa
b) Proved Developed Reserves (Million boe)	4042	Aa	4000 - 4200	Aa
c) Total Proved Reserves (Million boe)	14193	Aaa	14000 - 14500	Aaa
Factor 2: Operating & Capital Efficiency (20.0%)				
a) Leverage Full-Cycle Ratio	9.2x	Aaa	9x - 10x	Aaa
Factor 3: Leverage and Cash Flow Coverage (40.0%)				
a) E&P Debt / Average Daily Production	$4,202.9	Aaa	$3500 - $4000	Aaa
b) E&P Debt / PD boe Reserves	$1.2	Aa	$0.9 - $1.1	Aa
c) RCF / Total Debt	47%	Ba	44% - 55%	Ba
d) EBITDA / Interest Expense	15.0x	A	14x - 16x	A
Factor 4: Production Mix Overlay (Composite Score Adjustment)				
a) E&P Unleveraged Cash Margin / BOE	$9.3	Ca	$9 - $10	Ca
Rating:				
Indicated Rating from Grid Factors 1-3		Aa2		Aa2
Unleveraged Cash Margin: Composite Score Adjustment	-0.4	-0.4	-0.4	-0.4
a) Indicated Rating from Grid		Aa3		Aa3
b) Actual Rating Assigned				Baa3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 9/30/2014(L); Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.