MOODY'S
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Credit Opinion: OAO Novatek

Global Credit Research - 28 Sep 2012

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
Bkd Senior Unsecured	Baa3

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Key Indicators

[1]**OAO Novatek**

	6/30/2012(L)	12/31/2011	12/31/2010	12/31/2009	12/31/2008
Avg Daily Production (Mboe/d) (LTM) [2]	893	848	685	590	546
Proved Developed Reserves (Million boe)	3743	3743	4057	3707	3457
Total Proved Reserves (Million boe)	4874	4874	6227	6223	4512
Leveraged Full-Cycle Ratio	5.7x	6.0x	4.7x	5.6x	5.7x
E&P Debt / Average Daily Production	$3,292	$4,163	$4,581	$2,225	$1,667
E&P Debt / PD boe Reserves	$0.8	$0.9	$0.8	$0.4	$0.3
RCF / Total Debt	59.8%	52.5%	37.4%	62.5%	80.8%
EBITDA / Interest Expense	17.7x	16.7x	24.4x	20.9x	39.6x
E&P Unleveraged Cash Margin / BOE	$8.7	$9.6	$7.5	$6.1	$9.0

[1] All ratios are calculated using Moody's standard accounting adjustments. Source: Moody's Financial MetricsTM
[2] We apply the following conversion rates: 1 metric tonne (mt) =7.33 million boe and 1 billion cubic feet (bcf) =0.17 million boe.

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

Opinion

Rating Drivers

- Production growth to be supported by geographical, product and customer diversification

- Domestic market positions strengthening in 2012-13 due to acquisitions and new contracts

- Potentially lucrative Yamal LNG project bears execution risks

- Cash margin per boe lower than the peer group average due to regulated domestic gas prices

- F&D costs and leverage to remain low, profitability subject to a balance between gas price indexation and mineral extraction tax increases

- Liquidity to remain solid

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 stable) - with a total production of 327 million barrels (bbl) of oil equivalent (boe) in the last 12 months ended 30 June 2012.

In the last 12 months ended 30 June 2012, Novatek reported sales volumes (including purchases) of 57 billion cubic metres (bcm) of natural gas, all of which is sold domestically, and 4 million metric tonnes (mt) of liquid products, of which around 85% is attributable to the export volumes of stable gas condensate, liquefied petroleum gas (LPG) and crude oil. The company's total revenue in the last twelve months ended 30 June 2012 was RUB190 billion (approximately $6 billion), of which around 65% was generated from the sale of natural gas.

Novatek's key shareholders are as follows: Leonid Mikhelson (27% stake), who is also the CEO and Chairman of the Management Committee; Volga Resources (an investment vehicle of Gennady Timchenko), with a stake of approximately 21%; TOTAL S.A. (Aa1 negative), with a 15.2% stake, which it intends to increase to 19.4% by 2014; and Gazprom, with a 10% stake. Novatek's free float is estimated to be around 27%.

Rating Rationale

PRODUCTION GROWTH TO BE SUPPORTED BY GEOGRAPHICAL, PRODUCT AND CUSTOMER DIVERSIFICATION

In H1 2012, Novatek's natural gas production increased by more than 12% and liquids production increased by 2% compared with H1 2011. This was a result of the company's further development of its Yurkharovskoye field and crude oil deposits at its East-Tarkosalinskoye and Khancheyskoye fields. In the full year 2012, Novatek plans to increase its gas production volumes by 7-11% year on year (up to 57-59 bcm from 53 bcm in 2011, including its share of associates). Production of stable gas condensate and LPG will increase as Novatek expands its Purovsky Gas Condensate Stabilisation plant processing capacity to 11 mt by 2015 from the current 5 mt, which will allow the company to process additional volumes of the de-ethanised gas condensate expected to be produced from new fields.

For the transhipment and fractionation of stable gas condensate it produces at the Purovsky Plant, Novatek is constructing the Ust-Luga complex on the Baltic Sea, which has a fractionation capacity of 6 mt a year. The completion of the first phase (fractionation capacity of 3 mt) is expected in the fourth quarter of 2012 and the second phase (another 3 mt) in the fourth quarter of 2013. The project will allow Novatek to produce light and heavy naphtha, jet fuel, diesel fractions and heating oil and will help to further diversify the company's customer base (by increasing the number of potential off-takers for the new product mix) and export sales, thereby allowing it to realise profits by moving down the hydrocarbon value chain into higher margin products.

DOMESTIC MARKET POSITIONS STRENGTHENING IN 2012-13 DUE TO ACQUISITIONS AND NEW CONTRACTS

Novatek's sales to end-customers increased in 2012 thanks to acquisitions it made in 2011, namely OOO Yamalenergogaz, a Russian regional natural gas trader (Perm region), and OOO Gazprom Mezhregiongas Chelyabinsk, the largest gas distributor in the Chelyabinsk region. As a result of the latter acquisition, Novatek will supply 100% of the Chelyabinsk region's natural gas demand. We expect Novatek's domestic market positions to strengthen in 2012-13 as a result of (1) the new long-term energy contracts it recently signed with E.ON Russia, a subsidiary of German utility E.ON AG (A3 stable), and OAO Fortum, a subsidiary of Finnish utility Fortum Oyj (A2 stable); and (2) direct supplies to industrial consumers, such as the metallurgical company OAO Magnitogorsk Iron & Steel Works (MMK, Ba3 stable), with which Novatek signed a 10.5-year contract in June this year, and fertilisers producer UralChem (5-year contract), in addition to earlier signed contacts with OGK-1 and Inter RAO. Direct contacts will allow Novatek to lock in domestic market share, have greater security over longer term supplies and enhance the transparency of future cash flows.

YAMAL LNG PROJECT IS POTENTIALLY LUCRATIVE, BUT BEARS EXECUTION RISKS

Novatek is continuing preparatory works on its LNG project on the Yamal peninsula. In November 2011, TOTAL S.A. acquired a 20% equity stake in the Yamal LNG project. Novatek is seeking international partner(s) to take a stake of up to 29% in the project in order to share costs and execution risks. The company estimates that capital expenditure (capex) for field development and LNG and port facilities for the Yamal LNG project will reach approximately US$20 billion. The launch of the first train (out of three production trains of 5.0 mt per annum each) of the LNG plant is planned for the second half of the decade. If successfully executed, Yamal LNG will produce 1 mt per annum (mtpa) of gas condensate and 15 mtpa of LNG by 2019. Novatek already holds a long-term agency agreement with GazpromExport for the export of 100% of its prospective LNG output, a major step that addresses the issue of Novatek's access to LNG export markets.

Although potentially lucrative and enjoying favourable upstream economics and high liquefaction efficiency factor (due to low temperatures), the Yamal LNG project faces a number of challenges, namely (1) its remote location and the harsh climatic conditions; (2) the significant logistical constraints associated with navigating ships all year round; (3) competition from rival LNG projects for customers; and (4) the track record of sizeable cost overruns and project delays among similar international projects, which could lead to delays in its implementation or significantly heighten execution risks. Given the Yamal LNG project's development stage, its impact on Novatek's financial metrics remains uncertain; we will assess the project's potential effect on the company's business and financial profile and the ratings when the final structure and financial arrangements are in place.

CASH MARGIN PER BOE LOWER THAN THE PEER GROUP AVERAGE DUE TO REGULATED DOMESTIC GAS PRICES

An important measure in determining the underlying economic value of an oil and gas company's production is the unleveraged cash margin available on each boe of production. This is calculated as exploration and production (E&P) revenues per boe minus E&P production costs per boe minus E&P general and administrative costs per boe. It is also an indicator of the value of a company's overall reserves to the extent they are approximately aligned with its production profile. This measure captures both realised prices and the cost of production, including transportation costs, and is significantly influenced by the company's mix of production between oil, natural gas and natural gas liquids (NGL). Novatek's cash margin per boe of less than $10 maps to a Ca rating category, reflecting the regulated domestic gas tariffs in Russia.

F&D COSTS AND LEVERAGE TO REMAIN LOW, PROFITABILITY SUBJECT TO A BALANCE BETWEEN GAS PRICE INDEXATION AND SEVERANCE TAX INCREASES

Historically, Novatek's financial metrics have been consistently strong. According to its internal guidance, the company generally aims to adhere to 1.0x debt/EBITDA. However, in recent years this has fluctuated, driven by M&A activity, rising to 1.7x-1.2x in 2010-11, although nevertheless decreasing to 1.0x for the last 12 months ended 30 June 2012. If Novatek makes no material acquisitions, we expect that the company's FY 2012 debt/EBITDA ratio will remain at around 1.0x, and its debt/book capitalisation below 30% (31% in FY 2011).

Novatek is a very efficient operator, with one of the best results among global E&P players in terms of F&D costs per boe ($1.5 in FY2011), supported by efficient acquisitions, access to new licences and the favourable positioning and geology of its fields.

Novatek's overall operating efficiency should benefit from ongoing domestic gas price liberalisation reforms in Russia.. Under the current domestic gas price liberalisation programme, the Russian government intends to achieve "netback parity" with export sales by 2018-20, so that domestic gas will have the same price as gas exports to the EU, net of transportation costs and export duties. We anticipate that the Federal Tariff Service will raise domestic gas prices by a maximum 15% a year in 2013 and 2014.

The benefits of the domestic price increases will be partially offset by the planned increases in the severance tax (or mineral extraction tax - "MET") on natural gas. The government intends to gradually align the tax rates for the independents with the rate of Gazprom, which enjoys monopoly export rights, as domestic prices move towards netback parity with export prices. Currently independents' rate is approximately 50% of Gazprom's rate (RUB251 vs RUB509). According to the latest announced initiative of the Russian Ministry of Finance Gazprom's MET rate will grow by 55% to RUB788, and independent gas producers' rate will grow 2.2 times to RUB552, or 0.7 of Gazprom's rate, by 2015.

In the absence of other negative events and without taking into account the potential transformation of Novatek's financial profile as a result of its implementation of the Yamal LNG project, we would expect the company to remain within our guidance for the current rating category.

LIQUIDITY TO REMAIN SOLID

We expect Novatek's liquidity profile to remain strong during the period 1 July 2012 to 30 June 2013. Novatek expects to generate positive free cash flow (FCF), thereby fully funding its annual capex requirements from operating cash flow. In the next 12 months, Novatek's capex is set to reach around $1.7 billion, with the company's main focus being the development of existing and new fields and construction of the Ust-Luga complex, while Yamal LNG and the SeverEnergia projects will be financed on a project basis and are not included in the capex estimate. The company has a debt service requirement of around RUB19 billion (approximately $570 million) for the same period, including RUB10 billion of rouble-denominated bonds maturing in the second quarter of 2013, and plans to pay out dividend of around RUB9 billion (approximately $300 million) in the fourth quarter of 2012. Liquidity is supported by a cash balance of around RUB16 billion (approximately $500 million) as of 30 June 2012, and RUB30 billion (approximately $1 billion) of undrawn, uncommitted credit facilities.

Rating Outlook

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 to medium term, given (1) the company's modest scale, size and diversification of operations relative to similarly or higher rated peers in the Russian oil and gas sector; (2) a certain lack of transparency regarding the company's relationship with Gazprom; and (3) potential risks to Novatek's credit profile arising from its large-scaleYamal LNG project. However, the enhancement of Novatek's operating profile and scale of operations through production growth and diversification of sales and customer base, supported by benign regulatory regime, would positively affect the company's credit profile and the 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, measured by debt/EBITDA, increasing above 2.0x on a sustained basis; and/or (2) unfavourable trends in the company's logistical arrangements with Gazprom, as well as in Russia's regulation of the oil and gas sector, particularly the tax regime and domestic gas price indexation. We will consider Novatek's debt-financed investment projects and/or large-scale bolt-on acquisitions driving 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 [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Ca**
Factor 1: Reserves & Production Characteristics (40.0%)								
a) Avg Daily Production (Mboe/d) (LTM)			893					
b) Proved Developed Reserves (Million boe)			3743					
c) Total Proved Reserves (Million boe)			4874					
Factor 2: Operating & Capital Efficiency (20.0%)								
a) Leverage Full-Cycle Ratio	5.7x							
Factor 3: Leverage and Cash Flow Coverage (40.0%)								
a) E&P Debt / Average Daily Production	$3,292							
b) E&P Debt / PD boe Reserves	$0.8							
c) RCF / Total Debt				59.8%				
d) EBITDA / Interest Expense			17.7x					
Factor 4: Production Mix Overlay (Composite								

Score Adjustment)								
a) E&P Unleveraged Cash Margin / BOE								$8.7
Rating:								
a) Indicated Rating from Grid			A1					
b) Actual Rating Assigned				Baa3				

[1] All ratios are calculated using Moody's standard accounting adjustments. [2] As of 6/30/2012(L); Source: Moody's Financial Metrics