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Research Update:

Russian Oil And Gas Producer NOVATEK Rating Raised To 'BBB'; Outlook Stable

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Overview

- Novatek's large Yamal liquefied natural gas project is well ahead of schedule--it recently launched the third facility (known as a train), which should further boost its cash flows in 2019.
- We forecast that credit metrics will remain robust and that funds from operations (FFO) to debt will be well above 60%, even with our assumption of a material increase in capex in 2019-2020.
- We are therefore raising our rating on Novatek to 'BBB' from 'BBB-'.
- The stable outlook indicates that we expect the balance sheet to remain very strong, with ample headroom for additional capex and potential dividend increases.

Rating Action

On Nov. 29, 2018, S&P Global Ratings raised its issuer credit rating on Russian oil and gas producer NOVATEK PJSC to 'BBB' from 'BBB-'. The outlook is stable.

We also raised our issue ratings on Novatek's bonds to 'BBB', in line with the issuer credit rating.

Rationale

The upgrade reflects the increased headroom in Novatek's credit metrics, which should allow it to absorb very high capital expenditure (capex) and potential dividend increases. Novatek has maintained a strong balance sheet--its funds from operations (FFO) to debt has been above 60% for several years and will likely strengthen further because Novatek has started to receive proceeds from its large-scale Yamal liquefied natural gas (LNG) project well ahead of schedule. The project is expected to produce 16.5 million tonnes of LNG a year, or 5% of global LNG market.

Novatek already received some proceeds from the early sales in 2018 and will receive much more in 2019, which will boost its cash flows, which have already been supported by oil prices and the weak Russian ruble. We believe the increased cash flow will fully cover the very high capex related to other growth projects in 2019-2020, and will support maintenance of a very conservative balance sheet.

Novatek's key risks stem from its ambitious growth projects and sizable joint ventures. Many of these projects are already factored into our base case; for example, work done on the Arctic LNG 2 project before the final investment decision and construction of facilities that will produce LNG modules in Murmansk. However, we understand that Novatek could also be investing in the infrastructure required for its ambitious LNG projects partially on a joint venture basis. Such infrastructure could include terminals, railroads, shipbuilding, and, more generally, projects related to the Northern Sea Route. Because these investments are difficult to predict, we do not include them in our base-case forecasts. However, the risks involved cause us to take a more conservative view of Novatek's underlying creditworthiness than its current credit metrics suggest.

The company also has stakes in joint ventures with other Russian oil and gas companies, such as Arcticgas or Nortgas. The funding for the joint ventures was arranged at a joint venture level, without immediate recourse to Novatek, but we consider Novatek highly likely to step in to provide support in case of need. That said, our base-case scenario does not assume that Novatek's joint ventures will need any material cash support. Instead, we expect them to start gradually repaying debt and distributing dividends, which could further support Novatek's cash flows in the longer run.

The LNG projects themselves do not carry material risk for the company's credit profile, once the funding is set up. Typically, they do not require financial support once the huge initial investments are complete. Arranging the funding for Yamal LNG took longer than initially planned as an indirect consequence of U.S. sanctions against Novatek. However, it did not affect the timeline of the project, which is not itself subject to sanctions.

We understand that Novatek aims to significantly increase the equity component of the financing package for its next LNG project, Arctic LNG 2. Given the success of Yamal LNG, several companies have publicly expressed interest in investing in Arctic LNG 2. So far, only Total S.A. has acquired a 10% stake, with an option to increase it by another 5%.

Without the current geopolitical tensions between Russia and the U.S./Western Europe, we think Arctic LNG 2 would easily fill its equity order book, as the project boasts attractive economics similar to those the Yamal project demonstrated. The sanctions and other limitations might result in Novatek seeking to achieve a different capital structure for Arctic LNG 2. But unless Russian LNG exports are completely banned, a hypothetical scenario we see as very low probability, Novatek's credit profile is unlikely to be materially impaired by Arctic LNG 2.

The sanctions had a dual impact on our rating on Novatek: they both constrained the company's financing options and created a strong incentive to reduce leverage. We see the reduced leverage as positive, but consider that Novatek could implement a different capital structure if the sanctions against the company were lifted. In practice, the likelihood of such a scenario is low, in our view, and the company has built meaningful headroom. The company's financial policy stipulates that the capital structure be conservative, and that debt to EBITDA be at 1x through the cycle, which supports our assessment.

In our base-case scenario for Novatek we assume:

- A Brent oil price of $70/bbl for the end of 2018, $65/bbl in 2019, $60/bbl in 2020, and $55/bbl in 2021 and thereafter, in line with our price assumptions.
- Minor 2%-3% annual growth in gas prices and gas transportation tariffs on the domestic market, where Novatek sells 100% of its gas, excluding LNG.
- Liquids production growth by 3%-4% in 2018, with further growth in 2019-2020 up to 8% coming from newly acquired assets and the ramp up of the North-Russkoye field.
- Additional cash flow from joint ventures of Russian ruble (RUB) 50 billion-RUB70 billion in 2019, primarily the proceeds from early launch sales of LNG.
- Cash capex of RUB100 billion-RUB120 billion in 2018, increasing to RUB160 billion-RUB200 billion in 2019, then reducing to RUB100 billion-RUB120 billion in 2020-2021.
- Dividend of RUB60 billion-RUB70 billion in 2018, up to RUB80 billion in 2019. We assume dividend growth, taking into account Novatek's strong balance sheet, but the company has not given any guidance on expected dividends.

Based on these assumptions, we arrive at the following credit metrics:

- Operating cash flow of FFO to debt of more than 100% in all periods; and
- Positive discretionary cash flow (DCF), meaning that positive free operating cash flow should cover dividends.

We see the 'BBB' rating as well-positioned within the category. In terms of capital structure, Novatek's has the lowest leverage among peers, which is a key supporting factor for the rating. Even though Novatek is smaller than Russia's oil giants--Gazprom, Rosneft, and Lukoil--it is still comparable in size with large international oil companies, especially in terms of reserves. Novatek's Securities and Exchange Commission (SEC) reserves exceed 15 billion barrels of oil equivalent--comparable with those of Shell and BP and almost twice as higher number using Petroleum Resources Management System (PRMS) proven and probable reporting. Novatek also ranks among the Top 3 companies globally in terms of gas reserves. Importantly, about half of these reserves could potentially be used for LNG.

Novatek's annual production of 1.4 thousand barrels oil equivalent per day (mboed) compares well with Conoco Phillips (1.2 mboed) and ENI SpA (1.6 mboed). However, these two companies generate material higher cash flows from the same production. For example, Novatek's 2017 adjusted FFO was less than $3 billion, while Conoco generated more than $6 billion and Eni more than $8 billion. This primarily reflects two key weaknesses:

- As a Russian company, Novatek pays very high taxes; and
- Because Gazprom has a monopoly on gas exports, Novatek has to sell all its gas domestically at a price significantly below the international one. As 81% of Novatek's production in terms of barrels of oil equivalent is gas, this results in much weaker cash generation.

Liquidity

We view Novatek's liquidity as adequate. Its ratio of sources to uses is about 1.4x-1.5x for the 12 months from Sept. 30, 2018. Our assessment is supported by the company's strong DCF generation, limited debt maturities, and potential support from Russian banks. In our view, these factors partly offset Novatek's constrained capital market access due to sanctions. Novatek has very solid headroom under its financial covenants, which exist in only some of its credit facilities.

Principal liquidity sources as of Sept. 30, 2018, include:

- Cash and short-term investments totaling RUB82.8 billion; and
- Solid FFO generation of above RUB250 billion-RUB290 billion.

Principal liquidity uses as of Sept. 30, 2018, include:

- No debt maturities in next 12 months;
- Large capex of about RUB150 billion-RUB180 billion; and
- Dividends of about RUB50 billion-RUB80 billion.

Outlook

The stable outlook reflects our expectation of very strong balance sheet, with solid headroom for additional capex and potential dividend increases. We expect FFO to debt to remain consistently above 60% and free cash flow to remain positive, even as capex peaks in 2019-2020. We also assume that financing for Arctic LNG will not represent an actual or contingent obligation for Novatek, beyond its equity contribution.

Downside scenario

We could lower the rating on Novatek if the geopolitical situation deteriorates further, for example, if Novatek could not raise equity and debt for Arctic LNG 2. This would require the company to use its own funds to finance this and similar LNG projects. However, we currently view the likelihood of such a scenario as relatively low.

Other than that, we could lower the rating if the company undertakes even larger capex or acquisitions, especially at a time when oil prices are low, or in case of large unexpected dividend distributions that cause FFO to debt to fall below 60%.

A negative rating action on the sovereign would not automatically trigger a similar action on Novatek, as the company can be rated above the transfer and convertibility assessment on Russia, given its high share of exports and low debt.

Upside scenario

We see limited upside in the rating in the next 18-24 months. An upgrade would require structural and fundamental improvements to country risk in Russia. We do not anticipate that this will occur in the near term.

An upgrade would be also depend on a more clearly articulated dividend distribution policy. We generally expect dividends to increase in absolute terms as cash flows grow, but the company's current policy does not cap the maximum payment. We see this as a potential constraint for a higher rating. We note, however, that the company has a track record of distributing close to 30% of net income for the past seven years.

Issue Ratings - Subordination Risk Analysis

Capital structure

Novatek's capital structure primarily consists of two bonds ($1 billion maturing in 2022 and $650 million maturing in 2021), issued by an orphan special-purpose vehicle. The company also has smaller bilateral loans that total less than $1 billion.

Analytical conclusions

We rate the two bonds at 'BBB', in line with the issuer credit rating. We believe there are no material subordination risks in Novatek's capital structure because all large debt instruments rank pari passu.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Satisfactory
- Country risk: High
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Minimal
- Cash flow/Leverage: Minimal

Anchor: a-

Modifiers
- Diversification: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-1 notch)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded

	To	From
NOVATEK PJSC		
Issuer Credit Rating	BBB/Stable/--	BBB-/Stable/--
Senior Unsecured	BBB	BBB-

Novatek Finance Ltd.		
Senior Unsecured	BBB	BBB-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.