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Research Update:

Russian Gas Extraction Group OAO NOVATEK 'BBB-' Ratings Affirmed Following Sanctions On Key Shareholder; Outlook Stable

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Overview

- On March 20, 2014, the U.S. Department of Treasury added a key shareholder and non-executive board member of Russian gas extraction group OAO Novatek (Novatek) to its U.S. sanctions list.
- However, we understand that Novatek itself has not been added to the list and we have therefore not materially changed our forecast base-case assumptions for the company. We believe that the company's credit metrics will remain within our guidelines for the current rating.
- We are therefore affirming our long-term 'BBB-' corporate credit rating and 'ruAA+' Russia national scale rating on Novatek.
- The stable outlook reflects our view that Novatek will continue to benefit from growing production and the group's competitive cost structure, and will minimize any further upward revisions in its investment program.

Rating Action

On March 27, 2014, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term corporate credit rating and 'ruAA+' Russia national scale rating on Russian gas extraction group OAO Novatek (Novatek). The outlook is stable.

Rationale

The rating affirmation follows the announcement on March 20, 2014, by the Office of Foreign Assets Control (OFAC) of the U.S. Department of Treasury, that it has added one of Novatek's key shareholders, Mr. Timchenko, to the list of "Specially Designated Nationals" (SDN) who are now subject to U.S. sanctions. We understand that these sanctions were brought about as a result of the current political crisis in Ukraine.

We understand from Novatek that Mr. Timchenko's direct and indirect ownership stake in Novatek totals 23.49%. Based on OFAC guidance, it is our understanding that a company in which an SDN owns 50% or more shares is also subject to U.S. sanctions. We understand that as Mr Timchenko's shareholding is significantly less than 50%, Novatek is not subject to U.S. sanctions. At present, we understand from management that operations have not been affected, and we have not materially changed the assumptions in our base-case forecasts for the company or our assessment of its liquidity position. For the current rating level, these forecasts include funds from operations (FFO) to debt of above 45% and debt to EBITDA of below 2x in 2014-2015.

Mr. Timchenko is currently a non-executive director on Novatek's board of directors and on the board's Strategy and Investments Committee and Audit Committee, although we understand from the Novatek that he is not involved in the day-to-day running of the company. Therefore, our assessment of Novatek's management and governance at "satisfactory" remains unchanged, but we could revise downward our assessment should events or information lead us to re-evaluate the effectiveness of Novatek's board.

Other downside risks to the rating on Novatek could develop if, due to reputational damage caused by recent events:

- Funding becomes more difficult for Novatek's major capital projects over the medium term; and/or
- Novatek's counterparties cease or restrict trading with Novatek.

However, we currently view the above risks as unlikely.

Liquidity

We view Novatek's liquidity as "adequate," as defined by our criteria, reflecting our view that liquidity sources will exceed uses by 1.2x over the next 12 months, as defined by our criteria.

As of Dec. 31, 2013, we view Novatek's key liquidity sources through to Dec. 31, 2014, as follows:

- Cash of Russian ruble (RUB) 7.9 billion.
- About RUB17.2 billion in credit line availability, including a syndicated term credit line facility of $430 million (now fully drawn down), which matures in 2018, and a $55 million UniCredit Bank facility available until August 2015.
- Our expectation of solid FFO of more than RUB100 billion in 2014.

In addition, in January 2014, Novatek closed the sale of a 20% stake in Yamal LNG to China National Oil and Gas Exploration and Development Corp., a subsidiary of China National Petroleum Corp., for $927 million (about RUB32 billion). Novatek now owns 60% of Yamal LNG.

For the same period, we forecast Novatek's key liquidity needs as follows:

- Large capital expenditure (capex) requirements. We understand however, that the company may have some flexibility to finance part of its capex on a joint venture basis (more than RUB60 billion).
- Debt maturities of about RUB24 billion.
- Dividends in line with the 30% payout policy (about RUB26 billion).

In addition, in January 2014, Yamal Development (a 50/50 joint venture between Novatek and GazpromNeft) completed a deal to acquire a 60% equity stake in Artic Russia B.V.--which owns a 49% equity stake in SeverEnergia--from Eni SpA for a total of $2.94 billion. The acquisition was loan-funded at the joint venture level, which Novatek issued a guarantee of $400 million to support.

We currently anticipate that Russian banks will continue to support Novatek, as the company's high-profile projects are very much part of Russia's plan to increase liquefied natural gas (LNG) production.

We project that Novatek will have ample headroom under key covenants, which require a consolidated leverage ratio of below 3.0x and EBITDA interest coverage of more than 4x.

Outlook

The stable outlook reflects our view that Novatek will continue to benefit from growing production and the group's competitive cost structure, and will minimize any further upward revisions in its investment program. In our view, after the acquisition of an additional stake in SeverEnergia and related capex, the company has used the headroom under the current rating. For the current rating level, we anticipate FFO to debt to remain above 45% and debt to EBITDA to be below 2x in 2014-2015. However, we project that free operating cash flow will weaken due to growing capex.

Downside scenario

The rating could come under pressure if FFO to debt falls to lower than 45% on a sustainable basis. The rating has limited headroom for additional increases in capex, debt-financed acquisitions, deteriorations in operating cash flow or liquidity due to adverse regulatory changes, operational risks, or cost inflation.

Novatek has a favorable track record of managing country-related risks, but in the future, we will view it in the context of the company's standing in Russia's developing political and institutional environment. Any change could lead us to reconsider the rating.

Upside scenario

We do not see any potential for a positive rating action in the near term, given Novatek's exposure to Russia and our expectation that the company will make increased investments.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/--

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

- Competitive position: Satisfactory

Financial risk: Intermediate
Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers, Jan. 2, 2014
- Key Credit Factors For The Oil And Gas Exploration And Production Industry , Dec. 12, 2013
- Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

OAO NOVATEK	
Corporate Credit Rating	BBB-/Stable/--
Russia National Scale	ruAA+/--/--
Senior Unsecured	ruAA+
Senior Unsecured	BBB-
Novatek Finance Ltd.	
Senior Unsecured	BBB-

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