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OAO NOVATEK

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OAO NOVATEK

*(**Editor's Note:** In the original report published earlier today, the ratings on Yamal-Nenets Autonomous Okrug and the Russian Federation were misstated. A corrected version follows.)*

Major Rating Factors

Corporate Credit Rating
BBB-/Stable/--
Russia National Scale Rating *ruAA+/--/--*

Strengths:

- Robust financial metrics.
- Low-cost production.
- Large reserves of natural gas.
- Diversification between gas and liquids.

Weaknesses:

- Low domestic gas prices.
- Exposure to pipeline infrastructure of Russian monopoly gas distributor.
- Geographically concentrated operations.
- Russian country risk, including uncertain enforcement of tax and regulations.

Rationale

The rating on OAO NOVATEK reflects the company's high profitability and healthy credit metrics and its position as Russia's largest independent natural gas producer. Its long reserve base underpins the ratings.

The main weaknesses are the group's inherent exposure to Russian country risk, including uncertain enforcement of tax and regulations, as well as the volatile U.S. dollar/Russian ruble exchange rate. Further rating constraints are NOVATEK's exposure to OAO Gazprom (BBB/Negative/A-3), the owner of the gas distribution system in Russia and a monopoly gas exporter, and geographic concentration of the company's operations.

Key business and profitability developments

In the first quarter of 2010, NOVATEK's total natural gas production stood at about 10 billion cubic meters, up 20.5% compared with the corresponding period in 2009. In 2009, NOVATEK continued to demonstrate its ability to manage domestic gas industry risk, including low domestic gas prices and its operational dependence on Gazprom. NOVATEK has a long record without any operating setbacks. In addition, we view Gazprom's 19.4% ownership of NOVATEK as a strong mitigating factor. Gazprom, represented by two directors on NOVATEK's board, has approved key strategic moves, such as the company's acquisition of a stake in oil and gas exploration and production company OAO Yamal LNG (not rated) in May 2009. We understand that Gazprom may consider decreasing its stake in NOVATEK to about 10%, but do not expect any change in the relationship between the two companies at this stage. Moreover, we believe that the fact that NOVATEK is increasing its customer base, embarking on a major export-oriented project (OAO Yamal LNG), and planning to export gas from that project with Gazprom acting as an agent, suggests implicit approval from the Russian government, which, in our view, tightly controls the country's oil and gas industry.

Although NOVATEK's prices are not regulated, they indirectly depend on Gazprom's regulated prices. Regulated prices increased by about 15.9% in 2009, in Russian ruble terms, and by a further 15% in January 2010. Although we understand that gas price liberalization may happen later than in 2011 as initially planned, we believe that the Russian government aims to further increase domestic gas prices, at least in ruble terms. In 2009, about 60% of NOVATEK's revenues came from sales of domestic natural gas, with the remainder coming chiefly from other liquid hydrocarbon products such as stable gas condensate and liquefied petroleum gas. Even with low gas prices, NOVATEK's gas business generates strong profits; this is a result of efficient, low cost onshore operations from a few key fields. In addition, NOVATEK enjoys very profitable sales of exported condensate that provide important diversity from domestic gas sales due to higher international market prices and relatively modest taxation.

Key cash flow and capital-structure developments

In the first quarter of 2010, NOVATEK generated funds from operations (FFO) of about Russian ruble (RUB) 10.5 billion ($350 million). Cash flow from operations easily covered capital spending of RUB5 billion, allowing funds to be used for debt reduction. The company's key credit ratios remained strong. Total adjusted debt stood at RUB35 billion as of March 31, 2010, with annualized FFO to debt of more than 100%.

In 2010, we expect the company's FFO to cover capital spending (about $1 billion), supported by continued high production, a favorable cost structure, and increasing prices. This should enable NOVATEK to achieve positive free operating cash flow (FOCF) under our credit scenario of about $200 million-$500 million in 2010. We understand that capital spending beyond 2010 is largely uncommitted and can be postponed if necessary. At this stage we expect small or midsize acquisitions only. We expect that management will act to ensure that net debt to EBITDA remains at about 1x over the cycle.

Liquidity

Following NOVATEK's issuance of a three-year RUB10 billion bond in June 25, 2010 we assess the company's liquidity as adequate.

As of March 31, 2010, the company had a relatively high amount of debt due within one year (RUB18.4 billion). We expect the company's second quarter results to show a strong improvement in its liquidity position as a result of the three-year bond issue and a RUB3.34 billion repayment in April 2010. As of March 31, 2010 the company had cash in hand of RUB11.5 billion. We expect NOVATEK to continue to generate strong FOCF, covering capital spending and dividends. The company has access to some credit facilities, but as they are not fully committed according to our methodology we do not include them in our liquidity analysis.

We expect NOVATEK to remain in line with its key covenants: net debt to EBITDA below 3x and EBITDA net interest coverage above 4x.

Outlook

The stable outlook reflects our expectation that NOVATEK's operating cash flow should continue to benefit from increasing domestic gas realizations, high liquid petrol product prices, and a competitive cost structure. We understand that after 2010 very little capital spending is committed. We believe that heavy spending related to the OAO Yamal LNG project will start only after several years. Thanks to production growth in recent years and higher prices we expect NOVATEK to continue to achieve strong positive FOCF, despite expected annual capital spending of $0.6 billion-$1 billion. Accordingly, NOVATEK's credit metrics are likely to remain solid. The current rating has some flexibility for bolt on acquisitions, if such acquisitions strengthen and diversify the company's business. We expect NOVATEK to exercise an option to acquire a further 23.9% stake in OAO Yamal LNG for $450 million in 2012. Even though such transactions could lead to a temporary debt buildup, we expect NOVATEK subsequently to return to its financial policy target of keeping its ratio of net debt to EBITDA below 1x.

Adverse regulatory changes, operational risk related to Gazprom (which is not our base-case scenario), or major debt-financed acquisitions could pressure the rating or outlook.

Business Description

NOVATEK is the largest independent gas producer in Russia. In 2009, the company produced 32.4 billion cubic meters of natural gas and three million tons of liquid petroleum products. NOVATEK's production is mostly concentrated at three 100%-controlled fields in Yamal-Nenets Autonomous Okrug (BBB-/Stable/--; Russia national scale 'ruAAA'), the main gas-producing province in the Russian Federation (Local currency BBB/Stable/A-3; foreign currency BBB+/Stable/A-2; Russia national scale 'ruAAA'). NOVATEK's shareholding structure is as follows: Volga Resources holds 20.77%, Gazprom 19.4%, with the remainder free floating or held by management.

Business Risk Profile: Satisfactory On Low Cost Profile And Long Reserve Replacement, Partly Offset By Inherent Russian Gas Risk

The major supports for the company's "satisfactory" business risk profile are:

- NOVATEK's long, positive record of cooperation with Gazprom. Unlike some other independent gas producers in Russia, the company has never experienced substantial distribution interruptions. We believe that Gazprom's 19.4% ownership interest in NOVATEK helps to mitigate the risk of disruption to pipeline access. Accordingly, Gazprom can exercise a degree of control over NOVATEK's investment and growth plans. In our view, close coordination with Gazprom's own plans is beneficial for NOVATEK's credit profile. We believe that Gazprom has a strong interest in having independent suppliers such as NOVATEK sell natural gas on the domestic market. Gazprom holds the Russian gas export monopoly, but still has to ensure the domestic market is served. Independent suppliers need to invest in developing their smaller fields to satisfy an increasing share of domestic demand at low prices. In our opinion, this allows Gazprom to free up volume for lucrative exports, inure domestic customers to higher gas prices, provide an alternative to relatively costly gas imports from Central Asia, and effectively "outsource" part of its capital spending to independent producers. In our view, this creates a niche for independent players such as NOVATEK. We believe that independent producers will meet an increasing share of Russia's domestic gas demand.
- Increasing gas prices. Although Russian domestic gas prices remain below those of Western Europe, we believe that there is political and regulatory support for progressive gas price increases. The most recent was in January 2010 (15%). Politicians appear committed to the liberalization program. We view downside gas price risk as low and are of the opinion that this limits NOVATEK's exposure to commodity price volatility.
- NOVATEK's status as Russia's largest independent gas producer. The company contributes about 30% of total independent production. It is also the main gas supplier to large industrial regions. In 2009, despite the fact that Gazprom's exports declined, NOVATEK did not reduce its gas shipments and was even able to sign new contracts with large industrial customers.
- NOVATEK's long reserve life of about 29 years, plus potential upside from probable and possible reserves (see table 1). At year-end 2009, the company's proven reserves totaled 6.9 billion barrels of oil equivalent (boe) (91%

gas) excluding non controlling interest shares. In 2009, the share of developed reserves stood at 50% for gas and 46% for liquids. The reserve replacement rate has been very healthy in recent years, with a reserve replacement of 898% in 2009 and a three-year average of about 600%. Although Gazprom has priority access to new reserves, NOVATEK has been able to acquire smaller assets, which are of limited interest to Gazprom, and has a positive record of replacing reserves through successful exploration in its core area. The acquisition of 51% of the outstanding shares of OAO Yamal LNG in May 2009, which added net proven reserves of 1.3 billion boe, i.e. about 20% of NOVATEK's existing proven reserves, but much more in terms of probable and possible reserves. OAO Yamal LNG holds the license for the South-Tambeyskoye field. As of Jan. 1, 2010, the field's fully consolidated natural gas reserves under Russian reserve C1 + C2 classifications amounted to 1.3 trillion cubic meters. This provides a basis for continued long-term growth and has further boosted probable reserves. We view the OAO Yamal LNG acquisition as an indicator that the Russian government and OAO Gazprom approve and support a greater role in the gas sector for independent producers such as NOVATEK.

- High profitability. This is chiefly a result of very low production costs and diversification into liquids. Low taxes on gas and condensate production offset very low gas prices. In 2009, NOVATEK's lifting costs were only $0.5 per boe and total production costs $5.3 per boe net of depreciation, depletion, and amortization (see table 2), which highlights the company's operating efficiency. In addition, NOVATEK's gas and condensate wells have virtually zero watercut compared with about 80% at some Russian oil and gas wells, and, unlike oil wells, do not need frequent and costly workovers due to wax accumulation. NOVATEK's costs are gradually increasing, with the key drivers—-including ruble appreciation and regulated transportation costs-—beyond the company's control. Nevertheless, the company has a very substantial margin of safety.

Table 1

OAO NOVATEK Proven Reserves*

	2005	2006	2007	2008	2009**
Proven reserves (mil. boe)	4,573	4,665	4,677	4,965	8,130
of which gas (bil. cubic meters)	641	651	653	690	1,153
of which liquids (mil. barrels)	381	407	406	452	589
Proven developed (%)	57	76	82	75	50
Proven developed gas (%)	59	78	84	78	51
Proven developed liquids (%)	35	52	65	60	46

boe--Barrels of oil equivalent. *As calculated by S&P with a conversion factor of 6.54. **Includes boe 1.267 billion of controling interest shares.

Table 2

OAO NOVATEK Costs And Revenues

$/boe	2005	2006	2007	2008	2009
USD/RUB exchange rate	28.3	27.2	25.6	24.8	31.7
Revenues/boe*	6.7	8.0	10.5	12.4	11.3
Production cost/boe	0.5	0.5	0.6	0.7	0.5
Transportation/boe	1.1	1.9	2.5	3.0	3.8
Taxes/boe	0.9	1.1	1.2	1.3	1.1
Depreciation, depletion, and amortization/boe	0.6	0.6	0.7	0.8	0.7
Operating profit/boe	3.6	3.9	5.6	6.7	5.3

boe--Barrel of oil equivalent. *As calculated by S&P with a conversion factor of 6.54.

These supports are partly offset by:

- A relatively high share of production from the Yurkharovskoye field. We view the company's production and reserves as concentrated. In 2009, its three largest fields (East Tarkosalinskoye, Khancheyskoye, and Yurkharovskoye) accounted for 99% of its production. This concentration enables economies of scale and reflects the geological features of NOVATEK's core operating region, but highlights the company's exposure to the logistic risks of a single region.
- Operational dependence on Gazprom's pipelines. Although NOVATEK has never experienced any difficulty gaining access to pipelines, we view this is an operating exposure. We note that the company's growth plans depend on access to Gazprom's pipeline capacity. Although Russian legislation requires Gazprom to grant pipeline access to independent producers, some independent gas players have had difficulty accessing Gazprom's infrastructure in the past.
- The risk of lower gas demand during economic downturns. Although NOVATEK's business model proved to be resilient in the recent economic downturn (in contrast with the models of many other operators) we do not exclude the possibility that a deeper, longer downturn could affect the company's volumes.
- Low domestic gas prices (see table 3). NOVATEK's prices are not regulated, but its gas prices depend indirectly on the still low prices set by the Russian government for Gazprom. Historically, regulated prices for end customers have been well below European benchmarks.

Table 3

OAO NOVATEK Gas Prices

RUB/thousand cubic meters	Q1 2010	2009	2008	2007	2006
Gas, end customers	2,304	1,933	1,818	1,505	1,253
Gas transportation expense	1,099	809	718	631	516
Netback	1,205	1124	1,100	874	737
Gas ex-field (wholesalers)	1,211	1049	979	779	664
Novatek's netback differential (end customers minus ex-field price)	(6)	75	121	95	73
Regulated gas price in Novatek's regions	2,292	1,776	1,563	1,274	1,110

RUB--Russian ruble.

Financial Risk Profile: Intermediate On Strong Credit Metrics And Low Debt Levels

The main strengths of the company's "intermediate" financial risk profile are:

- Strong credit metrics and a relatively small debt burden. On March 31, 2010, rolling 12-month debt to EBITDA and FFO to debt stood at 0.8x and 113%, respectively. We expect these credit metrics to remain strong.
- Despite aggressive capital spending in the past, FOCF has been at worst neutral, but mostly positive. Although we expect NOVATEK to continue to spend aggressively from time to time to increase production, there is no large ongoing project. We expect the company to reduce capital spending, if needed, to meet financial targets. Other than some ongoing projects to be completed in 2010, future capital spending is mostly related to development drilling, which can be easily delayed if necessary. Accordingly, we expect capital spending to be broadly financed and adjusted according to operating cash flow, and do not expect major negative FOCF for a number of years. The development of OAO Yamal LNG will likely require extensive investment in the medium to long term, but we believe it will have only very limited impact on cash flows in the near term.
- Acquisition risk is relatively low. Following the $650 million acquisition of OAO Yamal LNG in May 2009, we

now expect small to midsize acquisitions (including the option to acquire a further 23.9% in OAO Yamal LNG). In the event of an acquisition, we expect NOVATEK to continue to honor its financial polices.

- Conservative financial targets and polices. NOVATEK aims to keep net debt below annual EBITDA, although we understand that this threshold may be temporarily breached. The company plans a dividend payout of 30%, which is less than payments by some of its peers.

These strengths are mitigated by:

- High debt due in the short term as of March 31, 2010. We expect this to change, however, following the recent bond issue.
- Some commodity price risk. Sales values of crude oil, stable gas condensate, and liquefied petroleum gas exports are volatile and depend on global demand. Liquefied petroleum gas contributed about 9.5% of sales in 2009, somewhat up from 2008, mainly due to a decline in crude oil prices.

Financial Statistics/Adjustments

The company reports quarterly under International Financial Reporting Standards. Annual reports are audited, and, until Dec. 31, 2009, the auditor issued unqualified opinions. Annual and quarterly reports are issued on a timely basis and are comparable with those of the company's international peers with respect to timing and detail. Standard analytical adjustments to the company's 2009 financials are relatively minor and are summarized in table 4.

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUB)*

	--Fiscal year ended Dec. 31, 2009--					
OAO NOVATEK reported amounts						
	Debt	**Operating income (before D&A)**	**Operating income (after D&A)**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**
Reported	37,703.0	39,271.0	33,533.0	819.0	36,454.0	36,454.0
Standard & Poor's adjustments						
Postretirement benefit obligations	620.0	125.0	125.0	30.0	(72.0)	(72.0)
Capitalized interest	--	--	--	1,481.0	--	--
Share-based compensation expense	--	176.0	--	--	--	--
Asset retirement obligations	988.0	--	--	--	--	--
Exploration costs	--	566.0	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	325.0	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	(1,569.0)	(1,569.0)
Reclassification of working-capital cash flow changes	--	--	--	--	--	(752.0)
Minority interests	--	--	--	--	--	--
Other	--	--	(52.0)	--	--	--

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUB)* (cont.)						
Total adjustments	1,608.0	867.0	398.0	1,511.0	(1,641.0)	(2,393.0)
Standard & Poor's adjusted amounts						
	Debt	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**
Adjusted	39,311.0	40,138.0	33,931.0	2,330.0	34,813.0	34,061.0

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 5

OAO NOVATEK -- Peer Comparison*				
	OAO NOVATEK§	**OAO Gazprom**	**OJSC Oil Company Rosneft¶**	**LUKoil OAO**
Rating as of July 16, 2010	BBB-/Stable/--	BBB/Negative/A-3	BBB-/Stable/--	BBB-/Stable/--
	--Fiscal year ended Dec. 31, 2009--			
(Mil. $)				
Revenues	2,978.2	99,345.1	34,695.0	68,025.0
Net income from cont. oper.	865.0	25,893.9	6,514.0	7,011.0
Funds from operations (FFO)	1,131.3	33,312.9	10,572.8	11,282.3
Capital expenditures	539.3	26,427.2	6,898.0	6,523.0
Debt	1,305.7	51,716.3	21,531.6	13,344.5
Equity	4,426.2	186,809.7	45,537.0	56,379.0
Adjusted ratios				
Oper. income (bef. D&A)/revenues (%)	43.9	37.8	39.1	21.4
EBIT interest coverage (x)	14.6	8.1	9.1	13.3
EBITDA interest coverage (x)	17.2	9.5	13.3	17.9
Return on capital (%)	21.8	14.2	13.5	15.8
FFO/debt (%)	86.6	64.4	49.1	84.5
Debt/EBITDA (x)	1.0	1.4	1.6	0.9

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. §Excess cash and investments not netted against debt. ¶Fully adjusted.

Table 6

OAO NOVATEK -- Financial Summary*						
		--Fiscal year ended Dec. 31--				
	LTM ended Q1 2010	**2009**	**2008**	**2007**	**2006**	**2005**
Rating history	BB+/Positive/--	BB+/Positive/--	BB+/Stable/--	BB/Positive/--	BB-/Stable/--	--/--/--
(Mil. RUB)						
Revenues	100,419.0	89,663.0	79,272.0	62,321.0	49,373.0	38,477.0
Net income from continuing operations	35,091.0	26,043.0	22,899.0	18,736.0	14,079.0	13,697.0
Funds from operations (FFO)	39,806.0	34,061.0	28,712.9	23,156.7	17,416.0	12,682.0
Capital expenditures	17,019.0	16,238.0	31,596.0	19,666.0	4,770.0	4,433.0
Debt	35,221.0	39,311.0	27,988.4	7,907.1	3,708.6	9,094.0
Equity	146,694.6	133,257.6	96,434.4	81,609.2	68,676.0	57,549.0

Table 6

OAO NOVATEK -- Financial Summary* (cont.)

Adjusted ratios						
Oper. income (bef. D&A)/revenues (%)	45.8	43.9	46.6	47.0	46.8	49.4
EBIT interest coverage (x)	15.1	14.6	37.5	62.1	24.4	17.9
EBITDA interest coverage (x)	17.7	17.2	44.1	71.3	29.6	17.4
Return on capital (%)	24.4	21.8	28.5	29.3	25.1	26.2
FFO/debt (%)	113.0	86.6	102.6	292.9	469.6	139.5
Debt/EBITDA (x)	0.8	1.0	0.7	0.3	0.2	0.5

*Fully adjusted (including postretirement obligations). LTM--Last 12 months. RUB--Russian ruble.

Ratings Detail (As Of July 16, 2010)*

OAO NOVATEK		
Corporate Credit Rating		BBB-/Stable/--
Russia National Scale Rating		ruAA+/--/--
Senior Unsecured (1 Issue)		BBB-
Russia National Scale Rating (1 Issue)		ruAA+
Corporate Credit Ratings History		
23-Jun-2010		BBB-/Stable/--
07-Jul-2009		BB+/Positive/--
11-Jul-2008		BB+/Stable/--
26-Sep-2007		BB/Positive/--
28-Jun-2007		BB-/Positive/--
17-Mar-2006		BB-/Stable/--
11-Jul-2008	*Russia National Scale Rating*	ruAA+/--/--
26-Sep-2007		ruAA/--/--
17-Mar-2006		ruAA-/--/--
Business Risk Profile		Satisfactory
Financial Risk Profile		Intermediate

Debt Maturities

(As of March 31, 2010)
March 31, 2010–March 31, 2011: RUB18.4 bil.
April 1, 2011-March 31, 2012: RUB6.6 bil.
Thereafter: RUB8.7 bil.

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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