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Research Update:

OAO NOVATEK Outlook Revised To Positive On Continuing Output Volume Growth; 'BB+' Rating Affirmed

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Overview

- Russia-based gas producer OAO NOVATEK has demonstrated continued volume growth in 2009. Furthermore, we expect the company's capital spending to be more flexible, its financial metrics to remain favorable and its profitability strong.
- We have revised the outlook on the company to positive and affirmed the 'BB+' long-term credit rating.
- The positive outlook reflects the possibility that the rating could be raised if NOVATEK's high volumes prove sustainable.

Rating Action

On July 7, 2009, Standard & Poor's Ratings Services revised its outlook on OAO NOVATEK, Russia's largest independent natural gas producer, to positive from stable, following a review of the company's financial and operating performance. At the same time, the 'BB+' long-term corporate credit rating and the 'ruAA+' Russia national scale rating were affirmed.

Rationale

The outlook revision reflects the company's continued volume growth, long track record of operations alongside the dominant state-controlled OAO Gazprom (BBB/Negative/--), flexible capital spending program, and strong profitability. It also reflects our expectations that NOVATEK's financial metrics will remain favorable, as well as the gradually improving fundamentals of the Russian gas industry. The company's reported total debt as at March 31, 2009 stood at Russian ruble (RUR) 30.8 billion.

In the past few quarters we have been positively surprised by NOVATEK's continued year-on-year volume growth. Although these growth rates are lower than previously recorded, we notice a clear difference with most other Russian gas producers, which have been reporting shrinking volumes.

The outlook revision also reflects our expectations that NOVATEK's credit metrics will remain strong. Although the company plans capital spending of about RUR18 billion, after having completed two large projects in the fourth quarter of 2008 (the second phase of the Yurkharovskoye field and the second phase of the Purovsky plant) we take comfort from the fact that only a small part of the spending program is now committed. Although capital spending may still be high, we expect that management will act to ensure that net debt to EBITDA remains at about 1x over the cycle. No further major acquisition is expected following the recent acquisition of a 51% stake in oil and gas exploration and production company OAO Yamal LNG.

We view it as positive that NOVATEK continues to demonstrate its ability to manage domestic gas industry risk, including very low domestic gas prices (compared with international benchmarks) and its operational dependence on Gazprom. Although we continue to view these risks as key rating constraints, NOVATEK has a long track record without any operating setbacks. In addition, we view Gazprom's 19.4% ownership of NOVATEK as a strong mitigating factor. Gazprom is represented by two directors on NOVATEK's board and has approved key strategic moves, such as the OAO Yamal LNG stake acquisition.

NOVATEK's very low production costs ($0.66/barrel of oil equivalent in 2008), together with a degree of diversification between gas, stable gas condensate, and liquid petroleum gas, help to mitigate its exposure to low prices and enabled the company to generate a solid EBITDA margin of 41% in the first quarter of 2009 (47% in full year 2008). Although NOVATEK cannot export gas, the semiregulated nature of Russian domestic gas prices effectively limits the company's exposure to downside commodity price risk. Potential risks associated with Gazprom's dominant and privileged position in the Russian natural gas market--with 85% of the country's gas production, ownership of the pipelines and monopoly on gas exports--are essentially mitigated by Gazprom's economic interest in having independent producers such as NOVATEK satisfy growing domestic demand at low prices, thereby enabling Gazprom itself to boost its profitable exports. NOVATEK is set to benefit from gradually increasing domestic gas prices, even if gas transportation tariffs and gas production taxes also increase.

NOVATEK's large reserve base (4.96 billion barrels of oil equivalent at year-end 2008 under SEC standards.
) supports considerable opportunities for organic growth. In 2008, the company produced 30.88 billion cubic meters of gas, a 8.3% increase on 2007.

Liquidity

NOVATEK's liquidity position is adequate. Cash in hand stood at RUR14 billion at the end of March 2009. We understand that the company has access to committed credit facilities of $350 million until 2010. We further understand that the company is in the process of signing further committed facilities of about $300 million. Once this has been confirmed, we will factor it into our credit assessment. At March 31, 2009, short-term debt and the current portion of long-term debt stood at RUR11.6 billion. The company has to part finance the 51% acquisition of OAO Yamal LNG, in total $550 million during 2009. We understand that management plans to issue US$300 million Russian ruble notes in the second half of 2009. Longer-term finance would help underpin the credit profile when the issue takes place.

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

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Outlook

The positive outlook reflects our view that a one-notch upgrade may be warranted in the short to medium term provided NOVATEK's business model continues to enable the company to maintain its volumes. However, this would require NOVATEK to continue to demonstrate a prudent financial policy, keeping net debt below annual EBITDA and adjusting its capital expenditure accordingly. We would also look for successful placement of the planned US$300 million Russian ruble notes.

On the other hand, were volumes to decrease or profitability to decline for any reason we would probably revise the outlook to stable. Financial policy slippages, adverse regulatory changes, or evidence of operational risks such as adverse tariff or taxation moves, restrictions on access to gas or condensate transportation could put downward pressure on the outlook or ratings, although we do not consider this in our base-case scenario. We do not factor in significant acquisitions in 2009 and factor in only minor acquisitions in 2010.

Ratings List

Ratings Affirmed; Outlook Action

	To	From
OAO NOVATEK		
Corporate Credit Rating	BB+/Positive/--	BB+/Stable/--
Russia National Scale Rating	ruAA+/--/--	

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