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Research Update:

Ratings On Russian Independent Gas Producer OAO NOVATEK Raised To 'BB+/ruAA+'; Outlook Stable

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Rationale

On July 11, 2008, Standard & Poor's Ratings Services raised its long-term corporate credit rating on OAO NOVATEK, Russia's largest independent natural gas producer, to 'BB+' from 'BB'. The outlook is stable.

At the same time, the Russia national scale rating on NOVATEK was raised to 'ruAA+' from 'ruAA'.

The upgrade reflects NOVATEK's very healthy credit metrics--despite ongoing large growth-oriented capital expenditures--and its high profitability, supported by the improving fundamentals of Russia's gas industry, a profitable condensate business, and efficient low-cost operations. The upgrade also acknowledges NOVATEK's positive track record of cooperation with state-controlled Russian gas giant OAO Gazprom (BBB/Stable/--).

In 2007, NOVATEK's EBITDA was Russian ruble (RUR) 29.96 billion, a high 47% margin on sales (RUR11.1 billion and 52% in first-quarter 2008). Despite a capital-expenditure increase to RUR19.7 billion in 2007 (RUR6.8 billion in first-quarter 2008), free operating cash flow remained positive. As at March 31, 2008, NOVATEK's reported debt was RUR5.1 billion (RUR6.4 billion adjusted), compared with RUR5.2 billion in cash. However, in the second quarter NOVATEK arranged an $800 million loan to fund capital expenditures.

Gas industry risk in Russia includes low domestic prices (NOVATEK's average realizations were $44.3 per thousand cubic meters in 2007 and about $60 in first-quarter 2008) and operational dependence on monopoly gas exporter Gazprom, which produces 84% of Russia's gas and owns all of the country's gas pipelines. Although NOVATEK's prices are unregulated, they indirectly depend on Gazprom's prices, which the government sets very low.

Compared with Gazprom, NOVATEK remains a relatively small player, with only 4% of Russia's gas production and a geographically concentrated reserve base. It has a massive growth-oriented investment program, which is expected to result in negative free cash flow and increased debt in 2008-2009.

However, NOVATEK's exposure to these risks is offset by a number of factors:

- Gazprom is fundamentally interested in having smaller independent companies such as NOVATEK satisfy growing domestic demand at low prices, so that Gazprom can use a higher share of its stable production for lucrative exports.
- Gazprom owns 19.4% of NOVATEK and has some influence on NOVATEK's strategy and growth plans.
- NOVATEK enjoys a very low cost position (2007: $0.58 per barrel of oil equivalent lifting cost and $5.29 per barrel of oil equivalent total production cost).

- Diversification into the gas condensate business boosts NOVATEK's profits thanks to high prices and relatively low taxes. Although liquids represent only 9% of production, we estimate their contribution to EBITDA at about 60% in 2007.
- The government's plan to increase regulated gas prices to about $125 per thousand cubic meters by 2011 provides a good benchmark for NOVATEK's price to increase further. NOVATEK's gas business has virtually no downside price risks.

Liquidity

NOVATEK's liquidity position is comfortable. On March 31, 2008, NOVATEK had RUR5.2 billion in cash and RUR7.5 billion in unused committed credit facilities, compared with RUR5.1 billion in total on-balance-sheet debt. Liquidity will remain solid after dividend payments of about RUR4.6 billion on 2007 income. The company's financial policy aims to maintain an unrestricted balance-sheet cash position of $100 million-$150 million and available bank lines of about $300 million-$500 million.

The key calls on liquidity are NOVATEK's growing capital expenditures and, potentially, dividends. Still, thanks to higher gas prices, operating cash flow will also increase and provide an important source of internal liquidity. NOVATEK's access to external financing, like that of its regional peers, can depend on fluctuating demand from international investors for emerging market debt.

Outlook

The stable outlook reflects our expectation that NOVATEK's operating cash flow should benefit from increasing domestic gas realizations, high liquids prices, and competitive costs--despite ongoing ruble appreciation. Because of heavy growth-oriented investments, however, we expect NOVATEK's cash flow to turn negative in the next two or three years, while the resulting production growth should only come in late 2008 or in 2009. Nevertheless, despite an expected increase in debt, NOVATEK's credit metrics should remain solid.

Ratings upside over the long-term will be driven by the continuing increase in domestic gas prices and the implementation of the company's long-term strategy of strengthening its business profile while keeping a robust financial profile.

The current rating has some flexibility for about $0.5 billion-$1 billion in acquisitions if they strengthen and diversify the group's business. Even though such transactions could lead to a temporary debt buildup, we expect NOVATEK to subsequently return to its financial policy target of keeping the ratio of net debt to EBITDA below 1x, because higher gas and condensate prices should boost the company's future profits.

Adverse regulatory changes, heightened operational risk from Gazprom (which is not our base case scenario), or major debt-financed acquisitions could constrain ratings upside or even pressure the rating or outlook.

Ratings List

	To	From
Corporate credit rating		
	BB+/Stable/--	BB/Positive/--
Russia national scale rating		
	ruAA+	ruAA

Additional Contact:
Industrial Ratings Europe;CorporateFinanceEurope@standardandpoors.com

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