

Research Update:

Russian Gas Producer OAO NOVATEK 'BBB-' Rating Affirmed Following Announced Acquisition; Off Watch; Outlook Negative

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Overview

- We expect OAO NOVATEK's financial metrics to weaken but remain in line with the rating after the announced acquisitions of interests in Sibneftegas and SeverEnergiya.
- The company plans to issue a bond of up to \$1.5 billion to finance the acquisitions. Notwithstanding the bond, we expect NOVATEK to have enough back-up facilities in place to bridge finance the acquisitions.
- We are affirming our 'BBB-' long-term issuer credit rating and 'ruAA+' Russia national scale rating on NOVATEK, and removing them from CreditWatch.
- The negative outlook reflects reduced flexibility within the rating category for further acquisitions or higher-than-expected capital expenditure.

Rating Action

On Nov. 19, 2010, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term issuer credit rating and 'ruAA+' Russia national scale rating on Russia-based OAO NOVATEK. At the same time, we removed the ratings from CreditWatch, where they were placed with negative implications on Oct. 28, 2010. The outlook is negative.

Rationale

The affirmation reflects our view that NOVATEK's financial profile will continue to be commensurate with our assessment of an "intermediate" financial risk profile despite the announced acquisitions (totaling \$1.5 billion). However, we expect the company's key credit metrics, such as the ratios of funds from operations (FFO) to debt and debt to EBITDA to weaken to about 55% and 1.3x-1.5x respectively in 2011, compared with 127% and 0.6x as of Sept. 30, 2010. Although the new levels remain acceptable for the rating, we expect flexibility within the rating to decline. An unexpected weakening of cash flow, higher-than-expected capital expenditure, or further acquisitions could, in our view, pressure the ratings.

We think the acquisitions will modestly strengthen NOVATEK's business risk profile: Its already large resource base will increase and its production will diversify further over time. Under the less conservative Russian reserve classification, a total of 4.7 billion barrels of oil equivalents will be

added. However, we continue to assess the company's business risk as "satisfactory". We anticipate FFO will continue to improve in 2011 to \$1.6 billion-\$1.8 billion, thanks to a recent 24% year-on-year production increase at the Yurkharovskoye field and the acquisition of Sibneftegas adding production of about 5 billion cubic meters. This should help the company maintain its financial profile in line with the rating. Despite our expectations of yearly capital expenditure of \$500 million-\$1,000 million, we expect the company to achieve positive free operating cash flow (FOCF) in 2010 and 2011.

On Oct. 27, 2010, NOVATEK's 50%-owned joint venture (OOO YAMAL Development) announced plans to acquire a 51% interest in SeverEnergi and later NOVATEK announced an acquisition of a 51% interest in Sibneftegas (for a combined consideration of about \$1.5 billion). We understand that NOVATEK will assume 51% of Sibneftegas' outstanding debt. We expect the acquisitions to be finalized in the next few months.

The rating on NOVATEK reflects the company's high profitability and its position as Russia's largest independent natural gas producer. The main weaknesses, in our view, are the company's exposure to Russian country risk, including uncertain enforcement of tax and regulations, as well as the volatile U.S. dollar/Russian ruble exchange rate.

In the first nine months of 2010, NOVATEK generated FFO of about Russian ruble (RUB) 32 billion (\$1 billion), which easily covered capital spending of RUB16 billion. We anticipate cash flow to increase in the near term following the recent production increase. The company's key credit ratios remain strong: Total adjusted debt stood at RUB34 billion, as of Sept. 30, 2010, with a ratio of annualized FFO to debt close to 150%. Following completion of the acquisitions, we foresee the debt level increasing to more than \$3.3 billion.

Liquidity

We continue to view NOVATEK's liquidity as "adequate" because we understand that the company is likely to place a bond of up to \$1.5 billion in the near future. We further understand that management recently signed several credit facilities that should enable bridge financing of the acquisitions, even if the bond is not placed.

As of Sept. 30, 2010, the company had cash in hand of about \$330 million and various long-term credit facilities totaling about \$1.3 billion (in this figure we do not include debt not yet issued or short-term credit facilities). Moreover, we expect the company to generate positive cash flow after capital expenditure in 2010 and 2011. This compares with short-term debt of about \$330 million and the financing required to fund the acquisitions.

We expect NOVATEK to remain in line with its key covenants following the acquisitions: a ratio of net debt to EBITDA of less than 3x and EBITDA interest coverage of more than 4x.

Outlook

The negative outlook reflects our expectation that, following the acquisitions, headroom under the rating category will be limited.

We think NOVATEK's implementation of financial policy has become less conservative than in the past: Consequently, further near-term acquisitions or substantially higher-than-expected capital spending could pressure the ratings. In addition, any adverse regulatory changes or larger-than-expected cost inflation could provide further pressure. Rating downside could also result if NOVATEK is unable to secure long-term financing, which we understand it plans to do with a new Eurobond. Although the company has limited committed capital spending after 2010, we believe actual levels could be substantially more, at about \$1 billion (this does not take into account the development spending related to the OAO Yamal LNG project, which we expect to start in the medium term).

We could revise the outlook to stable if, after the acquisitions, the company demonstrates an ability to deleverage more than we currently expect and generates discretionary cash flow, which should increase flexibility within the current rating. For the financial profile to remain in line with the 'BBB-' rating we expect the ratio of debt to EBITDA to remain at less than 1.5x and the ratio of FFO to debt to be about 60%.

Related Criteria And Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
OAO NOVATEK		
Corporate Credit Rating	BBB-/Negative/--	BBB-/Watch Neg/--
Russia National Scale	ruAA+/--	ruAA+/Watch Neg/--
Senior Unsecured (1 issue)	BBB-	BBB-/Watch Neg
Senior Unsecured (1 issue)	ruAA+	

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