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Research Update:

NOVATEK Upgraded To 'BBB-' On Strong Operating Performance; Outlook Stable

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Overview

- Russia-based gas producer OAO NOVATEK demonstrated continued strong operational performance and strong profitability in 2009 and the first quarter of 2010.
- We expect the company's capital spending to remain flexible, enabling positive free operating cash flow and its financial metrics to remain favorable.
- We are raising our long-term corporate credit rating on NOVATEK to 'BBB-' from 'BB+'.
- The outlook is stable and reflects our expectations that NOVATEK will continue to manage its operational dependence on Russian monopoly gas distributer OAO Gazprom and that the company's financial risk profile will remain 'intermediate'.

Rating Action

On June 23, 2010, Standard & Poor's Ratings Services raised its long-term corporate credit rating on OAO NOVATEK, Russia's largest independent natural gas producer, to 'BBB-' from 'BB+'. At the same time the Russian national scale rating was affirmed at 'ruAA+'. The outlook is stable.

At the same time we assigned a 'BBB-' issue rating and an 'ruAA+' Russian national scale rating to a proposed RUR10 billion bond issue by the company.

Rationale

The upgrade reflects NOVATEK's very healthy credit metrics--despite large growth-oriented capital spending and acquisitions in 2008 and 2009--and its high profitability, supported by the still-improving fundamentals of Russia's gas industry, a profitable condensate business, and efficient low-cost operations. The upgrade also reflects NOVATEK's positive record of co-operation with state-controlled Russian gas distribution monopoly OAO Gazprom (BBB/Negative/A-3). The company's total debt on March, 31, 2010 was Russian ruble (RUB) 33.6 billion.

NOVATEK's production continued to increase in 2009, thanks to new contracts with large domestic customers such as Inter RAO, despite the financial downturn that negatively affected many of its domestic peers and despite the fact that Gazprom had to cut its export sales and faced substantial production declines. In the first quarter of 2010 production stood at above 10 billion cubic meters, up 18% compared with the corresponding period of 2009. NOVATEK's

EBITDA was RUB13.6 billion, with a high 48.5% margin on sales. Recent strong performance was mostly thanks to increased production. Free operating cash flow was a high RUB7 billion and credit ratios remained very strong with FFO to debt and debt to EBITDA at above 100% and below 1x, respectively.

We now assess NOVATEK's business risk as satisfactory. In our view, NOVATEK still has operating exposure to Gazprom, which owns all of the country's gas pipelines, but the companies have a long record of co-operation. Gazprom also owns 19.4% of NOVATEK, and is represented on the board of directors. Gazprom is fundamentally interested in having smaller, independent companies such as NOVATEK satisfy growing domestic demand at low prices, so that Gazprom itself can use a higher share of its own stable production for lucrative exports. Moreover, we believe that the fact that NOVATEK is increasing its customer base and embarking on a major export-oriented project (OAO Yamal LNG) and the company's plans to co-operate with Gazprom, suggest implicit approval from the Russian government, which effectively controls the country's oil and gas industry. Gas industry risk in Russia includes low, but increasing, domestic prices. Although NOVATEK's prices are unregulated, they indirectly depend on Gazprom's prices. Prices have increased rapidly over the past few years as part of a government strategy to deregulate prices by 2011. NOVATEK's average netback price for end-customers increased, for example, to RUB1,205 per 1,000 cubic meters in the first quarter 2010. In 2009, however, NOVATEK's netback prices were negatively impacted by a heavy 24% increase in transportation costs, which was partly a result of longer transport routes. In addition, NOVATEK enjoys very profitable sales of exported condensate that provide important diversity from domestic gas sales due to higher market prices.

NOVATEK's financial risk profile remains 'intermediate' in our view. In 2010, we expect the company's funds from operations 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 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.

Liquidity

NOVATEK's liquidity is less than adequate for the moment, but we expect a near-term improvement. As at March 31, 2010, the company had a relatively high amount of debt due within one year (RUB18.4 billion). We understand that the company repaid RUB3.34 billion in line with its maturity schedule in April 2010.

The company has cash in hand of RUB11.5 billion and we expect it to continue to generate strong free operating cash flows. The company also 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.

If NOVATEK's proposed three-year bond issue is successful, we expect the company's debt maturity profile to improve. Even if NOVATEK fails to place the proposed bonds, we expect management to gradually improve the company's liquidity.

We expect NOVATEK to remain in line with its key covenants: net debt to EBITDA below 3x and EBITDA 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 free operating cash flow, 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 about $0.5 billion in acquisitions, most likely midstream assets, 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 to subsequently 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.

Related Criteria And Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Ratings List

Upgraded; Outlook Action

	To	From
OAO NOVATEK		
Corporate Credit Rating	BBB-/Stable/--	BB+/Positive/--

Ratings Affirmed

Russia National Scale Rating	ruAA+/--/--	

New Rating

Senior Unsecured	BBB-
	ruAA+

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