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Research Update:

NOVATEK Rating Raised To 'BB' After Strong First-Half 2007 Performance; Outlook Positive

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Table Of Contents

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Rationale

On Sept. 26, 2007, Standard & Poor's Ratings Services raised its long-term corporate credit rating on OAO NOVATEK (Novatek), Russia's largest independent gas producer, to 'BB' from 'BB-', following a review of the company's first-half 2007 performance. The outlook is positive.

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

The rating action reflects Novatek's strong financial metrics, with no net debt and strong profitability, and the gradually improving fundamentals of the Russian gas industry.

In the first half of 2007, Novatek's EBITDA margin was a strong 47%, as gradually increasing domestic gas prices more than offset growth in transportation costs and taxes other than income. Free operating cash flow was positive (Russian ruble {RUR} 4.2 billion), despite an increase in capital expenditure to RUR6.4 billion as the company proceeds with its plan to invest in future production growth. At June 30, 2007, Novatek had RUR1.7 billion in debt (RUR2.0 billion if pension-adjusted), versus RUR7.7 billion cash.

Russian gas industry risks (notably very low domestic gas prices and operational dependence on the pipelines of government-controlled OAO Gazprom; BBB/Stable/--), remain the key constraints on the rating on Novatek. Nevertheless, the company's very low cost position and a degree of diversification between natural gas, gas condensate, and crude oil help to offset those risks. Novatek's prices are not regulated, but indirectly pegged to Gazprom's, which are set very low by the regulator. Although Novatek cannot export gas, its exposure to downside price fluctuations is effectively limited by the semiregulated nature of the industry. The government's plan to more than double regulated gas prices to $125 per thousand cubic meters by 2011 provides a good benchmark for Novatek to increase its price realizations.

Novatek has a good working relationship with Gazprom, the dominant player in the Russian gas industry with 85% of the country's gas production, ownership of the pipelines, and a monopoly on export. The risks related to Gazprom's privileged position are mitigated by Gazprom's fundamental interest in having smaller independent players like Novatek satisfy growing domestic demand at low prices, so that Gazprom can use a higher share of its stable production for profitable export. Gazprom's 19% stake in Novatek gives it some influence on the company's strategy. Novatek's purchase of a 25% interest in several gas fields in the third quarter of 2007 for RUR1.2 billion, demonstrates the company's ability to make smaller acquisitions to support its growth prospects. Still, Novatek remains a relatively small player, with only 4% of Russia's gas production and a geographically concentrated reserve base.

Liquidity

The company's liquidity position is comfortable. At June 30, 2007, Novatek had RUR7.7 billion in cash and RUR6.3 billion of unused committed credit facilities, versus RUR1.7 billion of total debt on the balance sheet (of which RUR1.25 billion was repaid in the third quarter). Liquidity will remain solid after dividend payments of RUR2.5 billion on first-half 2007 income (subject to directors' and shareholders' approval). 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 presented by 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--even if Novatek's access to external financing, like that of its regional peers, is susceptible to volatility because of fluctuating demand from international investors for emerging market debt.

Outlook

The positive outlook reflects our expectation that the rating on Novatek could be raised by one notch in the next 12 months, as Novatek continues to benefit from the fundamental improvements in the Russian gas industry. In particular, we will focus on how the government's plan to raise domestic gas prices is implemented in 2007-2008. The rating upside also factors in our expectation that Novatek will retain its competitive cost position, successfully manage its capital expenditure program, continue its mutually beneficial cooperation with Gazprom, and stick to its prudent financial policy to keep net debt below annual EBITDA, despite an expected increase in capital expenditures and the recent increase in dividends to about 31% of net income (compared with a 15% minimum target level). Because capital expenditures are mainly growth oriented, we expect Novatek to adjust them in line with market demand and pipeline infrastructure availability. We also expect that Novatek's capital expenditures will be targeted first at infrastructure, so that 2007 production volumes should be broadly flat, with the bulk of the resulting production growth occurring after 2008. Adverse changes in regulations or evidence of heightened operational risk from Gazprom (although we don't consider this to be a base case scenario) could constrain the rating upside or even pressure the rating or outlook.

Ratings List

	To	From
OAO Novatek		
Corporate credit rating	BB/Positive/--	BB-/Positive/--
Russia national scale rating	ruAA	ruAA-

Additional Contact:
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