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Research Update:

Gas Producer OAO NOVATEK Outlook To Positive On Improving Performance; 'BB-' Rating Affirmed

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Rationale

On June 28, 2007, 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 and 'ruAA-' Russia national scale ratings on Novatek were affirmed.

The outlook revision reflects the positive trends visible in Novatek's favorable financial metrics, with no net debt and strong profitability; impressive organic production growth that is set to continue; and the gradually improving fundamentals of the Russian gas industry.

In recent years, Novatek has demonstrated its ability to manage Russian gas industry risks, including very low domestic gas prices (compared with international benchmarks) and operational dependence on the dominant government-owned OAO Gazprom (BBB/Stable/--). Although these risks continue to be the key constraints on the ratings, Novatek's very low costs ($0.45/barrel of oil equivalent {boe} in 2006, $56.4/cubic meter in the first quarter of 2007), together with a degree of diversification between gas, condensate, and liquids, help to mitigate low prices and enabled the company to generate a solid EBITDA margin of 47% in 2006 (44% in the first quarter of 2007). Also, although Novatek cannot export gas, the semiregulated nature of domestic gas prices effectively limits the company's exposure to downside commodity price risk.

The company has built a good working relationship with Gazprom, further supported by Gazprom's purchase of a 19% stake in Novatek in 2006 and the presence of two Gazprom representatives on Novatek's board of directors. 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 like Novatek satisfying growing domestic demand at low prices, thereby enabling Gazprom 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 (4.7 billion boe at year-end 2006) supports considerable opportunities for organic growth. In 2006, the company produced 28.7 billion cubic meters of gas, a 14% increase on 2005 (12.2% in total hydrocarbon terms). This, coupled with better pricing conditions, resulted in a 27% increase in revenue and a 21% increase in EBITDA (to Russian ruble {RUR} 48.8 billion and RUR23.6 billion, respectively). Due to strong cash flow generation, Novatek moved to a net cash position. At March 31, 2007, the company's total debt of RUR3.7 billion was more than offset by available cash of RUR9.2 billion.

Liquidity

Novatek's liquidity position is strong. At March 31, 2007, short-term debt was RUR3.2 billion, which was comfortably covered by RUR9.2 billion of cash and equivalents and about RUR5.6 billion of unused bank facilities. The company's growing operating cash flow is another important source of internal liquidity, even though, as is the case with other regional peers, Novatek's access to external financing can be volatile because of international investors' fluctuating demand for emerging-market debt. 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.

Outlook

The positive outlook reflects that the ratings could be raised, potentially by one notch, if Novatek continues to demonstrate a prudent financial policy, in line with its target of keeping net debt below annual EBITDA. This is despite an expected increase in capital expenditures that will result in broadly neutral free cash flows in 2007-2008 (compared with strongly positive free cash flows in 2006). Progress in the company's capital expenditure program and the continuation of favorable relations with Gazprom would also be positive for Novatek's credit quality. In coming years, the company is likely to benefit from improvements in Russian gas industry fundamentals, as we expect that an increase in domestic gas prices will not be fully offset by growing taxes and transportation costs.

Financial policy slippages, adverse regulatory changes, or evidence of heightened operational risk from Gazprom could put downward pressure on the outlook or ratings, although we don't consider this to be a base-case scenario. No substantial acquisitions are factored into the ratings, as we expect Novatek to focus on investing in its core business.

Ratings List

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

Additional Contact:
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