

### Research Update:

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

#### Primary Credit Analyst:

Elena Anankina, Moscow (7) 495-783-4130;elena\_anankina@standardandpoors.com

#### Secondary Credit Analyst:

Per Karlsson, Stockholm (46) 8-440-5927;per\_karlsson@standardandpoors.com

### Table Of Contents

---

Rationale

Outlook

Ratings List

## Research Update:

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

## 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:

Industrial Ratings Europe;CorporateFinanceEurope@standardandpoors.com

Ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com). It can also be found on Standard &

Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com); under Ratings in the left navigation bar, select Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: [media\\_europe@standardandpoors.com](mailto:media_europe@standardandpoors.com).

Copyright © 2011 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P. The Content shall not be used for any unlawful or unauthorized purposes. S&P, its affiliates, and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).