

Research Update:

Russian Gas Producer OAO NOVATEK 'BBB-' Rating Placed On Watch Negative On Possible Acquisition Of SeverEnergia Stake

Primary Credit Analyst:

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

Secondary Contact:

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

Table Of Contents

Overview

Rating Action

Rationale

Credit Watch

Related Criteria And Research

Ratings List

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Overview

- We understand that Russia-based gas producer OAO NOVATEK intends to acquire a 51% stake in SeverEnergiya, a gas, oil, and condensate greenfield upstream asset, from OAO Gazprom.
- The company plans to acquire the asset through its 50/50 joint venture with JSC Gazprom Neft. We understand that OAO Gazprom recently paid \$1.6 billion for the 51% stake in the asset, so we expect NOVATEK's share of the acquisition cost to be at least \$800 million.
- We are placing our 'BBB-' long-term rating on NOVATEK on CreditWatch with negative implications.
- The CreditWatch placement reflects our view that the ratings on NOVATEK could be lowered if the transaction goes ahead.

Rating Action

On Oct. 28, 2010, Standard & Poor's Ratings Services placed its 'BBB-' long-term corporate credit rating on OAO NOVATEK, Russia's largest independent natural gas producer, on CreditWatch with negative implications.

Rationale

The CreditWatch placement reflects uncertainty about the potential implications of NOVATEK's intention to acquire a 51% interest in SeverEnergiya, a Russian gas, oil, and condensate greenfield upstream asset. We understand that OOO Yamal Development (not rated), a 50/50 joint venture between NOVATEK and Russia-based JSC Gazprom Neft (BBB-/Stable/--), will acquire the asset.

If the transaction materializes, we could affirm or lower the rating on NOVATEK, depending on the financing structure, SeverEnergiya's potential future investment needs, and NOVATEK's financial policy on liquidity, leverage, capital expenditure, and possible future acquisitions.

We understand that OAO Gazprom (BBB/Stable/A-2) acquired the stake in SeverEnergiya in 2009 for \$1.6 billion, leading us to conclude that NOVATEK's share of the acquisition cost would be at least \$800 million. In addition, we think NOVATEK's capital expenditure is likely to be higher in coming years because of the need to develop the asset. Although we think the acquisition could be positive for NOVATEK's business profile, and is likely to bring operational synergies, the acquisition size is relatively large compared with

the size of NOVATEK. The assumed acquisition price is more than 10% of the company's total assets and more than 50% of its annual EBITDA. Consequently, it could increase NOVATEK's leverage and strain its liquidity.

In first-half 2010, NOVATEK generated funds from operations (FFO) of about Russian ruble (RUB) 19.3 billion (about \$640 million), which covered capital spending of RUB10 billion. The company's key credit ratios are currently strong, in our view. Total adjusted debt stood at RUB36.6 billion, as of June 30, 2010, and the ratio of annualized FFO to debt was more than 100%. If the transaction goes ahead, however, we expect these ratios to materially weaken, potentially with the ratio of FFO to debt decreasing to about 50%-60%.

The current rating on NOVATEK reflects what we see as the company's high profitability, healthy credit metrics, and its position as Russia's largest independent natural gas producer. In addition, the company's long reserve base underpins the rating. The main weaknesses are NOVATEK's inherent exposure to the risks of the Russian gas industry, which include uncertain enforcement of tax and regulations, a volatile U.S. dollar/Russian ruble exchange rate, and exposure to Gazprom, the country's largest gas producer with a legal monopoly over gas transportation and export. Compared with other rated Russian oil and gas companies, NOVATEK's operations are smaller and more concentrated.

Liquidity

In light of the potential acquisition, we currently view NOVATEK's liquidity as "less than adequate". To our knowledge, the acquisition is not backed by any committed facilities at this stage, which forms the basis of our liquidity assessment. As of June 30, 2010, the company had a fairly high amount of debt maturing within one year (RUB21 billion) against cash balances of RUB18 billion. We understand that the company repaid RUB8.5 billion of short-term debt in July 2010, however. On a positive note, we expect positive free operating cash flow in 2010, which may help offset the financial impact of the acquisition.

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

CreditWatch

We expect to resolve the CreditWatch within the next three months, during which time we plan to obtain more information on NOVATEK's future policy regarding this and other potential acquisitions, as well as further information about its capital expenditure, liquidity, and leverage.

We could affirm or lower the ratings, depending on how the company's liquidity, debt, and credit metrics develop as a result of the acquisition. Any rating action will also be subject to clarification about the company's financial policy, including additional acquisitions, investment plans, and

target leverage levels. We expect rating downside to be limited to one notch.

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-/Watch Neg/--	BBB-/Stable/--
Russia National Scale	ruAA+/Watch Neg/--	ruAA+/--/--
Senior Unsecured (1 issue)	BBB-/Watch Neg	BBB-
Senior Unsecured (1 issue)	ruAA+	

Additional Contact:

Industrial Ratings Europe;CorporateFinanceEurope@standardandpoors.com

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