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Summary:
OAO NOVATEK

Primary Credit Analyst:
Elena Anankina, London (44) 20-7176-3802; elena_anankina@standardandpoors.com

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

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Credit Rating: BB/Positive/--

Rationale

The ratings on OAO NOVATEK (Novatek), Russia's largest independent natural gas producer, reflect the risks of the Russian gas industry, offset by the company's operating efficiency and high financial metrics.

Novatek is exposed to the risks of the Russian gas industry, notably very low domestic natural gas prices compared with international benchmarks (Novatek's realization in third-quarter 2007 were about $60 per thousand cubic meters) and operational dependence on the pipelines of government-controlled OAO Gazprom (BBB/Stable/--). Novatek's prices are not regulated, but are indirectly affected by Gazprom's prices, which are subject to government regulation and set very low.

Nevertheless, the company's very low cost position and a degree of diversification between natural gas, gas condensate, and crude oil help to offset these risks. 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 realization.

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. Still, Novatek remains a relatively small player, with only 4% of Russia's gas production and a geographically concentrated reserve base.

The rating on Novatek benefits from low debt and high profitability. Although in 2007 gas production growth was somewhat constrained by warm weather, in the 12 months ended September 2007, Novatek generated Russian ruble (RUR) 26.9 billion ($1.0 billion) EBITDA, which corresponds to a strong 46% margin on sales, thanks to operational efficiencies, increasing gas prices and higher share of more profitable exports of liquid hydrocarbons and gas sales to end-customers. Despite an increase in capital expenditures to RUR14 billion as the company proceeds with its investment program, FOCF was positive at RUR7.1 billion over that period. At Sept. 30, 2007, its reported debt was RUR2.9 billion (RUR3.2 billion if pension-adjusted), versus RUR7.7 billion in cash.

Liquidity

Novatek's liquidity position is comfortable. At Sept. 30, 2007, Novatek had RUR7.7 billion in cash and RUR6.2 billion of unused committed credit facilities, versus RUR2.9 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. 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, Standard & Poor's Ratings Services 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). As capital expenditures are mainly growth oriented, Standard & Poor's expects 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. In the unlikely event of adverse changes in regulations or evidence of heightened operational risk from Gazprom, this could constrain the rating upside or even pressure the rating or outlook.

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com