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Summary: OAO NOVATEK

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Summary:

OAO NOVATEK

Credit Rating: BB+/Positive/--

Rationale

The rating on Russia-based independent gas producer OAO NOVATEK reflects the company's dependence on the pipelines of state-controlled OAO Gazprom (BBB/Negative/A-3), the dominant player in the sector with 84% of the country's gas production, ownership of the gas distribution system in Russia, and a monopoly on exports. Further rating constraints are the geographic concentration of its operations and low domestic gas prices. In our view NOVATEK is also exposed to the risk of operating in Russia, including uncertain enforcement of tax and regulatory rules and the volatile U.S. dollar/Russian ruble exchange rate.

These weaknesses are offset by healthy credit metrics and the company's high profitability. NOVATEK's position as Russia's largest independent natural gas producer and its long reserve base underpin the rating. OAO Gazprom owns 19.4% of NOVATEK, which in our view reduces pipeline infrastructure risk.

Key business and profitability developments

In the first half of 2009, total natural gas production stood at 15.7 billion cubic meters, up 5% compared with the same period of 2008. Although growth rates are lower than previously recorded, we notice a clear difference with most other Russian gas producers which have been reporting shrinking volumes due to a significant decline in domestic and EU gas demand.

In 2009 NOVATEK has continued to demonstrate its ability to manage domestic gas industry risk, including very low domestic gas prices and its operational dependence on Gazprom. Although we continue to view these risks as key rating constraints, NOVATEK has a long track record without any operating setbacks. In addition, we view Gazprom's 19.4% ownership of NOVATEK as a strong mitigating factor. Gazprom is represented by two directors on NOVATEK's board and has approved key strategic moves, such as the acquisition of a stake in OAO Yamal LNG in May 2009.

Low domestic gas prices, which are significantly lower than international benchmarks, greatly affect NOVATEK's profitability. Although NOVATEK's prices are not regulated, they indirectly depend on Gazprom's regulated prices, which the government sets at very low levels. Nevertheless, Gazprom's prices increased by about 20% in 2008 in Russian ruble terms and a further 15% increase in regulated gas prices in 2009. We therefore expect NOVATEK's gas price realization to increase further. In the first half of 2009, about 65% of revenues came from domestic natural gas sales, with the remainder coming chiefly from other oil products such as crude oil and stable gas condensate (35%). Even at low prices, NOVATEK's gas business generates positive profits; the company had an EBITDA margin of 40% in the same period, chiefly thanks to very low costs. NOVATEK's reliance upon the regulated domestic gas price is partly mitigated by sales of crude and condensate at market prices.

Key cash flow and capital-structure developments

In the first half of 2009, NOVATEK generated funds from operations (FFO) of Russian ruble (RUR) of nearly 14 billion ($450 million). Changes in working capital were small, and cash flow from operations therefore easily covered both capital expenditures of RUR7.7 billion and dividend payments of RUR1.5 billion. The company's key credit ratios remained strong. Total debt stood at RUR41.5 billion on June 30, 2009, with annualized FFO to debt of about 87%. We note that the company is exposed to foreign exchange risk: about 62% of its revenues are denominated in Russian rubles and about 70% of its long-term debt in U.S. dollars.

Although the company plans capital spending of about RUR18 billion in 2009, after having completed two large projects in the fourth quarter of 2008 (the second phase of the Yurkharovskoye field and the second phase of the Purovsky plant), we take comfort from the fact that only a small part of the spending program is now committed. Although capital spending may still be high, we expect that management will act to ensure that net debt to EBITDA remains at about 1x over the cycle. We don't expect any further major acquisitions following the acquisition of a 51% stake in oil and gas exploration and production company OAO Yamal LNG in May 2009.

Of the total $650 million consideration to be paid for the acquisition, we understand that $550 million will be paid through a combination of cash and new debt (already issued).

Liquidity

We consider NOVATEK's liquidity position to be somewhat weak. Cash in hand stood at RUR8 billion ($255 million) on June 30, 2009. We understand that the company has access to committed credit facilities of about $350 million, but those credit lines have short maturity terms (within one year). We further understand that the company is in the process of signing further facilities of about $300 million. Once this has been confirmed, we will factor it into our credit assessment if they are committed. On June 30, 2009, short-term debt and the current portion of long-term debt stood at RUR22.7 billion ($734 million), but we understand that the company refinanced about one-half of this amount in August. A longer-term financing would help underpin the credit profile.

We expect the company to remain in line with its key covenants: net debt to EBITDA below 3x and EBITDA interest coverage above 4x.

Outlook

The positive outlook reflects our view that a one-notch upgrade may be warranted in the short to medium term, provided NOVATEK's business model continues to enable the company to maintain its sales volumes. However, this would require NOVATEK to continue to demonstrate a prudent financial policy, keeping net debt below annual EBITDA and adjusting its capital expenditure accordingly.

On the other hand, were volumes to decrease or profitability to decline for any reason, we would probably revise the outlook to stable. Financial policy slippages, adverse regulatory changes, or evidence of operational risks such as adverse tariff or taxation moves, or restrictions on access to gas or condensate transportation could put downward pressure on the outlook or ratings, although we do not consider this in our base-case scenario. We do not factor in further significant acquisitions in 2009 and factor in only minor acquisitions in 2010.

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