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Summary:
OAO NOVATEK

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Summary:

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Credit Rating: BB-/Positive/--

Rationale

The ratings on OAO NOVATEK (Novatek; BB-/Stable/--; all ratings herein are issuer credit ratings), Russia's largest independent natural gas producer, reflect the risk in the Russian gas industry, including very low domestic natural gas prices (compared with international benchmarks) and operational dependence on the pipelines of government-controlled OAO Gazprom (BBB/Stable/--). Although Novatek's prices are not regulated, they are indirectly affected by Gazprom's prices, which are subject to government regulation and set very low.

Nevertheless, Novatek has demonstrated its ability to effectively manage Russian gas-industry risks. Novatek's very low costs ($0.45/barrel of oil equivalent (boe) in 2006) and a degree of diversification in gas, condensate, and crude oil help the company to mitigate the effects of low gas prices and to generate solid EBITDA margins (47% in 2006 and 44% in first-quarter 2007) even when prices are low ($7.3/boe in 2007). Although Novatek cannot export gas, the semiregulated nature of domestic gas prices effectively limits Novatek's exposure to downside commodity price risk. Novatek is set to benefit from gradually increasing domestic gas prices, even if gas transportation tariffs and gas production taxes also increase.

Novatek has built a good working relationship with Gazprom, further supported by Gazprom's purchase of a 19% stake in Novatek in 2006. Potential risk 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 a monopoly on gas exports—are mitigated by Gazprom's economic interest in having independent producers like Novatek satisfy growing domestic demand at low prices, enabling Gazprom to boost its profitable exports.

Novatek's large reserve base (4.7 billion boe at year-end 2006) supports considerable opportunities for organic growth. In 2006, Novatek produced 28.7 billion cubic meters of gas, a 14% increase from 2005 (12.2% in total hydrocarbon terms). Growth in production, 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). Strong cash flow generation moved Novatek 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

The company's liquidity position is strong. At March 31, 2007, short-term debt was RUR3.2 billion, covered comfortably by RUR9.2 billion in cash and equivalents and about RUR5.6 billion in unused bank facilities. The company's growing operating cash flow is another important source of internal liquidity—even if Novatek's access to external financing is, like that of its regional peers, susceptible to volatility because of fluctuating demand from international investors for emerging-market debt. The company's financial policy aims at maintaining 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 the potential for the ratings to be raised 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 the coming years, the company is likely to benefit from improvements in Russian gas industry fundamentals; we expect that growing taxes and transportation costs will not fully offset the ongoing gradual increase in domestic gas prices.

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

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