

Global Credit Portal

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Summary:

ОАО NOVATEK

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OAO NOVATEK

Credit Rating: BB+/Stable/--

Rationale

The rating on OAO NOVATEK, Russia's largest independent natural gas producer, reflects the company's very healthy credit metrics, despite ongoing large growth-oriented capital expenditures. It also reflects the company's high profitability, which is supported by the improving fundamentals of the Russian gas industry, profitable condensate business, and efficient low-cost operations.

In the first half of 2008, Novatek's EBITDA was Russian ruble (RUR) 21.5 billion (51% of sales). On June 30, 2008, Novatek's reported debt was RUR8.2 billion (RUR9.4 billion adjusted), compared with RUR5.2 billion in cash.

The key rating constraints are the risks inherent in the Russian gas industry. Domestic gas prices are several times lower than international benchmarks. Novatek is operationally dependent on the pipelines of state-controlled OAO Gazprom (BBB/Stable/--), the dominant player in the sector with 84% of the country's gas production, ownership of the pipelines, and a monopoly on exports. Although Novatek's prices are not regulated, they indirectly depend on Gazprom's regulated prices which are set very low by the government. Novatek remains a small player in comparison with Gazprom, with only 4% of Russia's gas production and a geographically concentrated reserve base. It has a massive growth-oriented investment program, which is expected to turn free cash flow negative and increase debt in 2008-2009. In the second quarter of 2008 Novatek arranged an \$800 million loan to fund investments, of which only \$189 million was drawn by the end of June. In August 2008, Novatek commissioned the second phase of the Yurkharovskoye field, but heavy investments continue as the company now focuses on upgrading its gas processing plant, which it expects to complete in the fourth quarter.

Novatek's exposure to these risks is offset by a number of factors. The company has a positive track record of cooperating with Gazprom. The larger company has a 19.4% stake in Novatek and can influence its strategy and growth plans. Gazprom is fundamentally interested in having small, independent companies like Novatek satisfy growing domestic demand at low prices, so that it can redirect a higher share of its stable production to its lucrative export markets. A government plan to increase regulated gas prices to about \$125/ thousand cubic meters by 2011 strongly suggests that Novatek's gas price will increase further. However, even at low prices, Novatek's gas business generates positive profits thanks to very low costs (2007: \$0.58/barrel of oil equivalent (boe) lifting cost, \$5.29/boe total production cost). Novatek's gas condensate business enjoys very high margins as a result of high unregulated prices and taxes that are lower than those paid by oil businesses.

Liquidity

Novatek's liquidity position is comfortable. On June 30, 2008, the company had RUR5.2 billion in cash and substantial availability under committed bank facilities, including \$611 million unused of its \$800 million loan, RUR7.6 billion under various short-term facilities, and RUR2.3 billion under a two-year line from CJSC Unicredit Bank (Russia) (BBB+/Stable/A-2), compared with only RUR8.2 billion on-balance-sheet debt . This comfortably

covers the RUR4.6 billion dividend announced on 2007 income and the RUR3.0 billion interim dividend announced for 2008. Even taking into account that high capital expenditures will turn free cash flow negative for the coming quarters, Novatek is not reliant on external financing for the near term. This is positive, because access to external financing can be very difficult in the current environment.

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, distributions to shareholders. Still, thanks to higher gas prices, operating cash flow is likely to increase and provide an important source of internal liquidity.

Outlook

The stable outlook reflects our expectation that Novatek's operating cash flow will benefit from increasing domestic gas realizations, high liquids prices, and competitive costs--despite ongoing ruble appreciation. Because of heavy growth-oriented investments, however, we expect the company's cash flow to turn negative in the next two or three years. Nevertheless, despite an expected increase in debt, Novatek's credit metrics should remain solid.

Ratings upside over the long term is likely to be driven by a continuing increase in domestic gas prices and implementation of the company's long-term strategy of strengthening its business profile while keeping a robust financial profile.

The current rating has some flexibility for about \$0.5 billion-\$1 billion in acquisitions if they strengthen and diversify the company's business. Even though such transactions could lead to a temporary debt buildup, we expect Novatek to subsequently return to its financial policy target of keeping its ratio of net debt to EBITDA below 1x, because higher gas and condensate prices should boost the company's future profits.

Adverse regulatory changes, heightened operational risk from Gazprom (which is not our base case scenario), or major debt-financed acquisitions could constrain ratings upside or even pressure the rating or outlook.

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