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Summary:
OAO NOVATEK

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Summary:

OAO NOVATEK

Credit Rating:	BBB-/Stable/--

Rationale

The rating on OAO NOVATEK reflects the company's high profitability and healthy credit metrics and its position as Russia's largest independent natural gas producer. Its long reserve base underpins the ratings.

The main weaknesses are the group's inherent exposure to Russian country risk, including uncertain enforcement of tax and regulations, as well as the volatile U.S. dollar/Russian ruble exchange rate. Further rating constraints are NOVATEK's exposure to OAO Gazprom (BBB/Negative/A-3), the owner of the gas distribution system in Russia and a monopoly gas exporter, and geographic concentration of the company's operations.

Key business and profitability developments

In the first quarter of 2010, NOVATEK's total natural gas production stood at about 10 billion cubic meters, up 20.5% compared with the corresponding period in 2009. In 2009, NOVATEK continued to demonstrate its ability to manage domestic gas industry risk, including low domestic gas prices and its operational dependence on Gazprom. NOVATEK has a long record without any operating setbacks. In addition, we view Gazprom's 19.4% ownership of NOVATEK as a strong mitigating factor. Gazprom, represented by two directors on NOVATEK's board, has approved key strategic moves, such as the company's acquisition of a stake in oil and gas exploration and production company OAO Yamal LNG (not rated) in May 2009. We understand that Gazprom may consider decreasing its stake in NOVATEK to about 10%, but do not expect any change in the relationship between the two companies at this stage. Moreover, we believe that the fact that NOVATEK is increasing its customer base, embarking on a major export-oriented project (OAO Yamal LNG), and planning to export gas from that project with Gazprom acting as an agent, suggests implicit approval from the Russian government, which, in our view, tightly controls the country's oil and gas industry.

Although NOVATEK's prices are not regulated, they indirectly depend on Gazprom's regulated prices. Regulated prices increased by about 15.9% in 2009, in Russian ruble terms, and by a further 15% in January 2010. Although we understand that gas price liberalization may happen later than in 2011 as initially planned, we believe that the Russian government aims to further increase domestic gas prices, at least in ruble terms. In 2009, about 60% of NOVATEK's revenues came from sales of domestic natural gas, with the remainder coming chiefly from other liquid hydrocarbon products such as stable gas condensate and liquefied petroleum gas. Even with low gas prices, NOVATEK's gas business generates strong profits; this is a result of efficient, low cost onshore operations from a few key fields. In addition, NOVATEK enjoys very profitable sales of exported condensate that provide important diversity from domestic gas sales due to higher international market prices and relatively modest taxation.

Key cash flow and capital-structure developments

In the first quarter of 2010, NOVATEK generated funds from operations (FFO) of about Russian ruble (RUB) 10.5 billion ($350 million). Cash flow from operations easily covered capital spending of RUB5 billion, allowing funds to be used for debt reduction. The company's key credit ratios remained strong. Total adjusted debt stood at RUB35 billion as of March 31, 2010, with annualized FFO to debt of more than 100%.

In 2010, we expect the company's FFO to cover capital spending (about $1 billion), supported by continued high production, a favorable cost structure, and increasing prices. This should enable NOVATEK to achieve positive free operating cash flow (FOCF) under our credit scenario of about $200 million-$500 million in 2010. We understand that capital spending beyond 2010 is largely uncommitted and can be postponed if necessary. At this stage we expect small or midsize acquisitions only. We expect that management will act to ensure that net debt to EBITDA remains at about 1x over the cycle.

Liquidity

Following NOVATEK's issuance of a three-year RUB10 billion bond in June 25, 2010 we assess the company's liquidity as adequate.

As at March 31, 2010, the company had a relatively high amount of debt due within one year (RUB18.4 billion). We expect the company's second quarter results to show a strong improvement in its liquidity position as a result of the three-year bond issue and a RUB3.34 billion repayment in April 2010. As of March 31, 2010 the company had cash in hand of RUB11.5 billion. We expect NOVATEK to continue to generate strong FOCF, covering capital spending and dividends. The company has access to some credit facilities, but as they are not fully committed according to our methodology we do not include them in our liquidity analysis.

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

Outlook

The stable outlook reflects our expectation that NOVATEK's operating cash flow should continue to benefit from increasing domestic gas realizations, high liquid petrol product prices, and a competitive cost structure. We understand that after 2010 very little capital spending is committed. We believe that heavy spending related to the OAO Yamal LNG project will start only after several years. Thanks to production growth in recent years and higher prices we expect NOVATEK to continue to achieve strong positive FOCF, despite expected annual capital spending of $0.6 billion-$1 billion. Accordingly, NOVATEK's credit metrics are likely to remain solid. The current rating has some flexibility for bolt on acquisitions, if such acquisitions strengthen and diversify the company's business. We expect NOVATEK to exercise an option to acquire a further 23.9% stake in OAO Yamal LNG for $450 million in 2012. Even though such transactions could lead to a temporary debt buildup, we expect NOVATEK subsequently to return to its financial policy target of keeping its ratio of net debt to EBITDA below 1x.

Adverse regulatory changes, operational risk related to Gazprom (which is not our base-case scenario), or major debt-financed acquisitions could pressure the rating or outlook.

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