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Summary:
OAO NOVATEK

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Table Of Contents

Summary:

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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), which is the dominant player in the sector with 84% of the country's gas production; it also reflects Gazprom's ownership of the gas distribution system in Russia and its monopoly on exports. A further rating constraint is the geographic concentration of the company's operations. In Standard & Poor's Ratings Services' view, NOVATEK is exposed to the risk of operating in Russia, including uncertain enforcement of tax and regulatory rules, as well as the volatile U.S. dollar/Russian ruble exchange rate.

Standard & Poor's considers these weaknesses to be 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. Gazprom owns 19.4% of NOVATEK, which, in our view, reduces risks associated with the pipeline infrastructure.

Key business and profitability developments

In 2009, total natural gas production stood at 32.35 billion cubic meters, up 6.3% compared with 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 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, represented by two directors on NOVATEK's board, has approved key strategic moves, such as NOVATEK's acquisition of a stake in oil and gas exploration and production company OAO Yamal LNG (not rated) in May 2009. However, we understand that Gazprom may consider decreasing its stake to about 10% in the future.

Low domestic gas prices 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 low levels. Nevertheless, regulated prices increased by about 15.9% in 2009, in Russian ruble terms, and a further 15% in January 2010. However, we note that Novatek's realized price increase in 2009 was only about 5.2%, and that average price realization after transportation costs decreased by 2%. In 2009, about 60% of revenues came from sales of domestic natural gas, with the remainder coming chiefly from other oil products, such as crude oil and stable gas condensate (37%). Even with low prices, NOVATEK's gas business generates profits: The company had an EBITDA margin of 44% in the same period, mainly as a result of very low costs. NOVATEK's reliance on the regulated domestic gas price is partly offset by sales of crude and condensate at market prices, in our view.

Key cash flow and capital-structure developments

In 2009, NOVATEK generated funds from operations (FFO) of about Russian ruble (RUB) 34 billion ($1.08 billion). Changes in working capital were small, and cash flow from operations easily covered both capital expenditures of RUB16.2 billion and dividend payments of RUB7.6 billion. The company's key credit ratios remained strong. Total adjusted debt stood at RUB39.3 billion as of Dec. 31, 2009, with FFO to debt of about 87%.

We take some comfort from the fact that only a small part of the company's 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 OAO Yamal LNG. Although the level of capital spending may be higher than in 2009, we still expect internally-generated funds to cover it.

Liquidity

We consider NOVATEK's liquidity position to be less than adequate. Cash in hand stood at RUB10.5 billion ($350 million), as of Dec. 31, 2009. During the past year, we understand that the company's main credit lines were fully utilized. At the same time, short-term debt and the current portion of long-term debt stood at RUB13.8 billion ($460 million). We believe a longer-term financing would help support the credit profile.

We expect NOVATEK 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 the business model continues to enable NOVATEK to maintain its sales volumes. However, this would require the company to continue to demonstrate a prudent financial policy, keeping net debt below annual EBITDA and adjusting its capital expenditure accordingly. Any positive rating action would also depend on an improvement in liquidity.

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, lack of progress in the company's liquidity position, adverse regulatory changes, or evidence of operational risks, such as adverse tariff or taxation moves, could put downward pressure on the outlook or rating. In addition, restrictions on access to gas or condensate transportation could provide further pressure, but we do not consider this in our base-case scenario. We will also closely monitor the possible changes in Novatek's shareholding structure, should they arise. We factor in only minor acquisitions in 2010.

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