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Summary: OAO NOVATEK

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Credit Rating: BB-/Stable/--

Rationale

The ratings on OAO NOVATEK (Novatek), Russia's largest independent natural gas producer, reflect the company's operational dependence on the pipelines of Russian natural gas supply company OAO Gazprom (BB+/Positive/--) for the transportation of natural gas. The ratings also reflect the very low domestic natural gas prices compared with international benchmarks, Novatek's somewhat concentrated reserve base, and the company's short track record of consolidated financial reporting following the full consolidation of two core operating companies in December 2004. Although its operations have stayed unchanged, two of Novatek's key assets were only partially owned and had been accounted as equity investments before the consolidation of minority interests in 2005. The ratings also reflect the risks of operating in Russia, including tax and regulatory uncertainties.

Over the past decade Novatek has demonstrated its ability to manage these significant risks effectively and build a good working relationship with Gazprom. Potential risks associated with Gazprom's dominant and privileged position in the Russian natural gas market are further mitigated by Gazprom's fundamental interest in having independent producers like Novatek supplying the domestic market, where prices are low, thereby enabling Gazprom to boost its profitable exports. Novatek's credit quality benefits from the company's very low cost base, which results in high profitability and expected positive free cash flow generation over the medium term, despite low price realizations.

In 2005, Novatek produced 25.2 billion cubic meters (bcm) of natural gas. The company's reserve life is comfortable, at approximately 25 years. Novatek plans to increase production to 45 bcm by 2010, but this will depend on continued access to the Gazprom-owned transportation system. Novatek's realized weighted average prices are well below international levels, as only Gazprom is permitted to export Russian natural gas.

In 2005, the improvement in Novatek's credit ratios partly reflected the company's corporate restructuring, as non-core assets were sold, remaining stakes in core fields were acquired, and the owners' proceeds from an IPO were used to repay shareholder loans from Novatek as well as a portion of the company's own debt. In 2005, Novatek's natural gas sale volumes increased due mostly to the consolidation of production assets, and funds from operations reached about $422 million. FFO covered net debt by a high 195% and net debt to EBITDA were 0.3x. At Dec. 31, 2005, Novatek had reported total debt of about $322 million.

Liquidity

A high portion of Novatek's long-term debt matures in the short term. In total $290 million of total debt is due within one year. This exposure is to some extent mitigated by cash in hand of $105 million and by the company's positive free operating cash flow generation (about $173 million in 2005). Novatek also has access to about $300 million in uncommitted bank facilities. The uncommitted nature of bank lines granted to Novatek reflects market practice in Russia.

As is the case with other regional peers, Novatek's access to external financing is constrained by the weakness of the domestic financial system and by volatile demand of international investors for emerging-market debt. Novatek's management expects to refinance the company's short-term debt with longer dated debt. If refinancing were successful, the company's liquidity position would improve substantially.

Outlook

The stable outlook reflects our expectations that Novatek will maintain at least its current production level and will successfully refinance or repay its short-term debt. We also expect Novatek to continue to deliver positive free operating cash flow and to maintain net debt at less than its annual EBITDA. In 2005, Novatek reported net debt to EBITDA of 0.3x.

The ratings would likely benefit from a longer track record of successful financial performance. Adverse changes on the regulatory or competitive fronts, or evidence of heightened operational risk from Gazprom, could constrain or put downward pressure on the ratings.

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