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Research Update:

Russian Natural Gas Producer NOVATEK Outlook Now Stable On Strong Operating Performance; Affirmed At 'BBB-/ruAA+'

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Overview

- Russian independent natural gas producer NOVATEK's recent operating performance has been stronger than we anticipated, thanks to increased production and higher price realization.
- In our view, the headroom under the rating has been restored.
- We are revising our outlook on NOVATEK to stable from negative and affirming the 'BBB-/ruAA+' ratings.
- The stable outlook reflects our expectation that NOVATEK's operating cash flow should continue be strong and that the financial profile will remain in line with the ratings.

Rating Action

On July 6, 2011, Standard & Poor's Ratings Services revised its outlook on OAO NOVATEK, Russia's largest independent natural gas producer, to stable from negative. At the same time, the 'BBB-' long-term issuer credit and 'ruAA+' Russia national scale ratings were affirmed.

Rationale

The outlook revision reflects our view that NOVATEK's financial profile has been able to absorb late-2010 acquisitions--combined totaling $1.7 billion--quicker than we anticipated, thanks to strong operational cash flows. Cash flows have been strong due to strong production growth, increased regulated gas prices, and high price realization on exported condensate. These factors together have led to stronger-than-anticipated operating cash flows and credit ratios. For the 12 months ended March 31, 2011, funds from operations (FFO) to debt stood at 65% and debt to EBITDA stood at 1.3x, which we view as in line with the ratings.

In first-quarter 2011, the Russian government increased regulated gas prices 15% and we believe that it plans further increases in domestic gas prices, at least in ruble terms, until the expected deregulation in 2015. Although NOVATEK's prices are unregulated, the regulated prices for OAO Gazprom (BBB/Stable/A-2), the largest domestic gas producer, significantly influence NOVATEK's prices.

In 2011, we expect NOVATEK's production to continue to increase to more than 50 billion cubic meters (based on recent quarters' production), from about 37 billion cubic meters in 2010. The company should be able to achieve such an impressive improvement, thanks to added production from acquired Sibneftegas and recently increased production at the Yurkharovskoye field.

While price realization of domestic sold gas remains fairly low, NOVATEK enjoys very profitable sales of exported condensate that provide important diversity from domestic gas sales because of higher international market prices and relatively modest taxation on exports. EBITDA for the 12 months ended March 31, 2011, stood at about Russian ruble (RUB) 68 billion, ($2.3 billion) compared with RUB40 million for the same period in 2010. We expect NOVATEK's profitability measured as a return on capital to remain strong in 2011, at 30% or above.

In 2011, we foresee the company's FFO vastly improving to about RUB70 billion-RUB75 billion ($2.3 billion-$2.5 billion) from about RUB46 billion in 2010, thanks to higher production and increased prices. Better FFO should enable NOVATEK to achieve positive free operating cash flow (FOCF) under our credit scenario of about $800 million-$1 billion in 2011, assuming capital expenditures in the range of $1.2 billion-$1.3 billion. Part of FOCF is likely to be consumed by increasing dividends, which we expect will grow in line with increased income. Also after 2011, we expect NOVATEK to continue to post material FOCF, which we view as a ratings strength.

On March 31, 2011, adjusted debt stood at RUB86 billion. We now we see NOVATEK's strategy as more acquisitive than in the past, following large acquisition both in 2009 and 2010. Even though NOVATEK's recent acquisitions add to business diversification and growth prospects, they result in higher leverage. In the mean time the shareholder structure of NOVATEK has also changed, whereby Gennady Timchenko, a Russian businessmen reported to have strong political connections, acquired an approximate 21% stake and became a member of the board. While we foresee some ratings headroom for further acquisitions, if management undertook extensive acquisitions, pressure on the ratings could return.

The ratings on NOVATEK reflect the company's high profitability and still healthy credit metrics and its position as Russia's largest independent natural gas producer. 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, which is partly mitigated by NOVATEK's dollar-denominated export revenues.
As seen in the past, the Russian tax and political systems are unpredictable, and weak institutions can result in overdependence on key personalities. While we still view institutional factors as a key risk for NOVATEK and other Russian companies, significant negative changes are not our base case for NOVATEK.

We believe that NOVATEK has demonstrated a favorable track record in managing country risks, as seen in strong production growth in recent years, in demonstrated access to attractive gas assets, in the tax holidays for NOVATEK's greenfield OAO Yamal LNG project, and in NOVATEK's agreement to export future gas production from Yamal LNG with Gazprom acting as an intermediary for a small commission. This arrangement effectively bypasses Gazprom's legal monopoly on gas exports. We view this favorable track record as a ratings support, but in future will see it in the context of NOVATEK's standing in Russia's developing political and institutional environment.

Liquidity

We believe NOVATEK has adequate liquidity sources to cover its needs in the near term, even in the event of unforeseen EBITDA declines. We think the company's debt maturities over the medium term should be manageable, but we note the relatively large debt maturity in 2013 of RUR30 billion. Our assessment of NOVATEK's liquidity profile incorporates the following expectations and assumptions:

- We expect the company's sources of liquidity, including cash and positive FOCF, to exceed its uses by 1.2x or more over the next 12-18 months.
- We expect net sources to remain positive, even if EBITDA declines more than 15%.
- Compliance with financial covenants could survive a 15% drop in EBITDA, in our view.

Liquidity sources include our expectation of $200 million to $300 million of discretionary cash flow in 2011-2012, and nominal cash balances. NOVATEK's credit facilities are uncommitted, so we do not include them in the resources. The company currently has about $650 million available of uncommitted facilities and all major facilities are due before August 2012. Uses of liquidity in 2011-2012 include roughly $1.2 billion-$1.5 billion in capital expenditures, and some debt amortization.

As of Sept. 30, 2010, the company had an ample EBITDA cushion against the consolidated leverage ratio covenant of 3.0x and EBITDA interest coverage of more than 4x.

Outlook

The stable outlook reflects our expectation that NOVATEK's operating cash flow should continue to benefit from increasing production and domestic gas realizations as well as from its competitive cost structure. We also expect the company will continue to manage its liquidity prudently.

While the current ratings have some headroom for further acquisitions in the $750 million-$1 billion range, we might take negative rating actions if debt to EBITDA was above 1.5x and FFO to debt was below 60% for a prolonged time.

We understand that little capital spending is committed beyond 2012, but nevertheless anticipate that spending will remain in the $1 billion-$1.5 billion range per year in line with the company's strategic growth focus. This does not take into account any major capital expenditures to develop the Yamal LNG project. If NOVATEK takes the final investment decision for Yamal LNG, in line with management's guidance, we expect the development to be carried out largely by international partners (to date, only one partner, Total S.A. [AA-/Stable/A-1+], has been announced). It is also our base case that NOVATEK will pass on to these partners the cost for two options (both due in 2012) to acquire the remaining 49% stake in Yamal LNG, if the options are triggered.

Adverse regulatory changes, operational risk related to Gazprom (which is not our base case), or larger-than-expected cost or capital-expenditure inflation could also lead to negative rating actions or a revision of the outlook to negative.

Ratings upside is unlikely, given the already high rating for a company with such large Russian exposure.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
OAO NOVATEK		
Corporate Credit Rating	BBB-/Stable/--	BBB-/Negative/--
Russia National Scale Rating	ruAA+	
Senior Unsecured	BBB-	
Senior Unsecured	ruAA+	
Novatek Finance Ltd.		
Senior Unsecured	BBB-	

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