STANDARD & POOR'S RATINGS SERVICES

MY CREDIT PROFILE

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Summary: OAO NOVATEK

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Rationale

Business Risk

- Position as Russia's largest independent gas producer, with a large resource base and strong potential for production growth.
- Profitability benefits from low production costs and large, high-quality onshore reserves.
- Exposure to Russian country risk, including uncertain enforcement of taxes and regulations, as well as exposure to the volatile U.S. dollar/Russian ruble (RUB) exchange rate
- Dependence on third party for gas transportation.

Financial Risk

- Good track record of containing operating costs and capital expenditures.
- Moderate, borderline aggressive financial policies, reflecting the group's large acquisitions in recent years.
- Likely heavy increase in capital spending in coming years, notable if NOVATEK develops YAMAL LNG.
- Credit ratios currently weak for the rating.

Outlook

The stable outlook reflects Standard & Poor's Ratings Services' view that Russia-based gas extraction group OAO NOVATEK's operating cash flow will continue to benefit from growing production and increasing domestic gas prices, as well as the group's competitive cost structure. We anticipate that the group will continue to manage its liquidity. In 2013, we expect gradual improvement in EBITDA and cash flow, following increased gas prices and continued production increases, albeit more moderate than in previous years. We expect this to lead to moderately improved credit ratios in 2013 and funds from operations (FFO) to debt to return above 60% in 2013.

Downside scenario

The rating could come under pressure if management undertakes large debt-financed acquisitions, or if it manages capital spending in such a way that FFO to debt falls lower than 60% for a prolonged time. Negative rating actions could also follow adverse regulatory changes, operational risk, an escalation of costs or capital expenditure inflation, or increased mineral taxes.

Rating pressure could also emerge if NOVATEK decided to develop the liquefied natural gas (LNG) project on the Yamal peninsula without passing on a large share of the development costs to international partners. To date, only one partner, Total, has been announced. We expect the final investment decision to be taken in the second half of 2013.

NOVATEK's favorable track record of managing country risk is a ratings support for now, but in the future we will view it in the context of NOVATEK's standing in Russia's developing political and institutional environment and any change could lead to rating pressure.

Upside scenario

We don't see any upside scenario, given that the rating is already high for a group with such large exposure to Russia.

Standard & Poor's Base-Case Scenario

Assumptions

- We expect a healthy gas production increase in 2013 of around 7%-8% and liquids of about 9%
- 15% annual increase in domestic gas prices in both 2013 and 2014, influenced by regulated prices that are set to increase.
- Price increases, to some extent offset by growing taxes and general cost inflation.
- We have assumed a strong link between stable condensate prices and crude oil prices, corresponding to a Brent price of $95/barrel in 2013 and $90/barrel in 2014, and applied our long-term prices. We assume no further acquisitions at this stage.
- We assume capital expenditures of about RUB50 billion-RUB60 billion, which excludes any investments in YAMAL LNG.
- Dividends of 30% of net income.

Key Metrics

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	2012A	2013E	2014E
EBITDA (mil. RUB)	99,649.0	105,000-120,000	125,000-135,000
Adj. debt to EBITDA	1.4x	1.4x-1.0x	0.9x-1.2x
Adj. FFO/debt (%)	57%	60%-65%	65-75%
FOCF/Debt (%)	24%	10-20%	17-25%

*Fully Standard & Poor's-adjusted. A--Actual. E--Estimated. RUB--Russian ruble.

Business Risk

NOVATEK's business risk profile reflects:

- A large proven reserve base of 12.4 billion barrels of oil equivalent, and a comforting reserve life of 31 years.
- Strong production growth in recent years and likely continued healthy production growth, supported with growing sales to end customers.
- Benefits to profitability from low production costs and the high quality of its large onshore reserves, where both gas and liquids are present. NOVATEK's profitability benefits from the fact that its gas and condensate activities are subject to lower taxes in Russia than for crude oil. Diversification into profitable liquid products is another supporting factor. Russian gas industry regulation that limits the downside to domestic gas prices, in our view. Even though NOVATEK's gas prices are not regulated, we believe they depend indirectly on the regulated gas price for Russia's largest gas producer Gazprom (BBB/Stable/A-2) and are set to gradually increase. In 2013, Gazprom's gas price has increased by 15%, and we expect further increases in subsequent years.
- Favorable track record of managing country risk, with strong production growth in recent years, access to attractive gas assets, tax holidays for YAMAL LNG (the ownership is accounted for as equity interest), and an agreement with Gazprom to act as intermediary for a small commission in NOVATEK'S future exports of YAMAL LNG's gas production.

These strengths are partly offset by the following constraining factors:

- The key constraint on NOVATEK's business risk is its heavy exposure to Russia. The Russian government is considering certain changes to gas industry regulation, such as potentially slower increases in domestic gas prices and a new formula for mineral extraction tax, although we understand that no final decisions have been made yet. The balance between a slower price increase and a lower mineral extraction tax might impact NOVATEK's future profits. Also, the weak institutional environment results in uncertain implementation of legislation and regulations. Government-related entities have preferred access to strategic reserves. Operationally, NOVATEK depends on Gazprom's pipelines and the transportation price is set by the regulator, even though so far, NOVATEK has not experienced any difficulty gaining access to the pipelines and the transportation tariff is manageable.

- From a peer perspective, we view NOVATEK as less diversified and less exporting than most of its domestic peers.
- Growing capital expenditure needs to support the group's ambitious growth plans and develop recently acquired assets. We expect that partners will carry part of these investments.
- High cost inflation in Russia. We expect that the percent of annual inflation will remain in the high single digits over the medium term due to rising pipeline transportation tariffs.
- The risk of lower gas demand during economic downturns. Although NOVATEK's business model proved resilient in the recent economic downturn (in contrast with the models of many other operators), we do not exclude the possibility that a deeper, longer downturn could affect the group's volumes.

Financial Risk

In 2013, we expect a gradual improvement in credit ratios, with fully adjusted FFO to debt to improve above 60% under our base-case scenario. We believe that cash flow generation should continue to benefit from increased production and prices.

At the end of 2012, the ratio of adjusted debt to EBITDA was 1.4x, which we consider relatively high for the rating.

NOVATEK has undertaken several sizable acquisitions in recent years, which have led to a material increase in debt. We therefore view the financial policy as moderately, borderline aggressive. We estimate capital expenditures for 2013 in the RUB50 billion-RUB60 billion which should allow the company to post positive free operating cash flow under our oil price scenario. We note that very few capital expenditures beyond 2013 are committed. The largest uncertainty regarding capital expenditures is the potential construction of an LNG plant on the Yamal peninsula--YAMAL LNG. NOVATEK has not yet taken the final investment decision, but we anticipate that YAMAL LNG and two partners will undertake the construction of anLNG plant on the Yamal peninsula for a total estimated cost of at least $18 billion over several years.

Liquidity

We view NOVATEK's liquidity as "adequate", despite its ratio of liquidity sources to liquidity needs falling just below 1.2x at the end of the first quarter 2013. However, we expect management to very quickly address this, and bring the ratio well above 1.2x.

Principal Liquidity Sources

At the end of March 2013, key liquidity sources for 2013 included:

- Cash balances of Russian ruble (RUB) 16.9 billion; and
- Our expectation of about RUB93 billion-RUB100 billion in FFO under our oil-price scenario.

Principal Liquidity Uses

Key liquidity needs for the coming 12 months include:

- Debt maturities of about RUB12.7 billion;
- Capital expenditures of RUB55 billion; and
- Cash dividends of about RUB20 billion- RUB25 billion.

Ample headroom

We expect the company to keep ample of headroom under the key covenants,which require a consolidated leverage ratio of 3x and EBITDA interest coverage of more than 4x.

Related Criteria And Research

- Standard & Poor's Revises Its Oil And Natural Gas Liquids Price Assumptions; Natural Gas Price Assumptions Remain Unchanged, Feb. 11, 2013

- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Key Credit Factors: Global Criteria For Rating The Oil And Gas Exploration And Production Industry, Jan. 20, 2012
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

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