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Summary:

OAO NOVATEK

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Summary:

OAO NOVATEK

Corporate Credit Rating	BBB-/Stable/--

Profile Assessments

BUSINESS RISK	SATISFACTORY	Vulnerable – Excellent
FINANCIAL RISK	INTERMEDIATE	Highly leveraged – Minimal

Initial Analytical Outcome ("Anchor") And Rating Result

Our 'BBB-' rating on Russia-based gas extraction group OAO NOVATEK (Novatek) is derived from:

- Our anchor of 'bbb-', based on our assessments of the company's business risk profile as "satisfactory" and financial risk profile as "intermediate".
- No other modifiers have any impact on the rating.

Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
• Position as Russia's largest independent gas producer, with a solid reserve base and strong potential for production growth. • Profitability benefits from low production costs and large, high-quality onshore reserves. • Uncertainty about developments in the Russian gas industry, given that competition is growing and that domestic price increases are expected to slow in 2014. • Exposure to Russian country risk, including taxes, regulations, and volatile U.S. dollar/Russian ruble (RUB) exchange rate.	• Good track record of containing costs and capital expenditures. • Our expectation of growing capital expenditures following the final investment decision on the Yamal LNG project. • Our expectation of weakening credit metrics after the acquisition of an additional stake in Severenergia.

Outlook: Stable

The stable outlook reflects Standard & Poor's Ratings Services' view that Novatek will continue to benefit from growing production and the group's competitive cost structure, and will avoid any further upward revisions in its investment program. In our view, after the acquisition of an additional stake in Severenergia and factoring in Novatek's part of capital expenditures on Yamal LNG, the company has used the headroom under the current rating. For the current rating level, we expect funds from operations (FFO) to debt to remain above 45% and debt to EBITDA to be below 2x in 2014-2015. However, we expect free operating cash flow (FOCF) to weaken due to growing capital expenditures.

Downside scenario

The rating could come under pressure if FFO to debt falls to lower than 45% on a sustainable basis. The rating has limited headroom for additional increases in capital expenditures, debt-financed acquisitions, or deteriorations in operating cash flow due to adverse regulatory changes, operational risks, or cost inflation.

Novatek has a favorable track record of managing country risk, 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 near-term upside for the rating, given Novatek's exposure to Russia and our expectation of increased investments.

Standard & Poor's Base-Case Scenario

Assumptions	Key Metrics

Assumptions

- We expect a healthy production increase in both gas and liquids.
- We assume a strong link between stable condensate price and crude oil prices.
- We expect Russian domestic gas price to remain broadly flat in 2014, in line with regulatory trends, and then to grow broadly with inflation.
- We assume that Novatek will keep a 60% stake in Yamal LNG, following the sale of 20% interest in the project to China National Petroleum Corporation (CNPC).
- Capital expenditures factor in Novatek's share in Yamal LNG, based on the recently announced $26.9 billion project budget but assuming that a significant part of it will be financed by partners or on a non-recourse basis to Novatek. Novatek is currently in the process of arranging project financing, which we expect to be successful. The group plans to issue a completion guarantee as a precondition of the project financing.
- Novatek's joint venture with GazpromNeft, Yamal Development, will finalize the purchase of an additional stake in Severenergia for $2.94 billion.

Key Metrics

	2012A	2013E	2014E
FFO/Debt	57%	50%-60%	50%-60%
Debt/EBITDA	1.4x	1.3-1.7x	1.3-1.7x

A--Actual. E--Estimated.

Business Risk : Satisfactory

We view Novatek's business risk profile as "intermediate," reflecting the following key factors:

- 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 profitable sales to end-customers.
- Solid profitability supported by low production costs, high quality of its large onshore reserves, and by the fact that Novatek's gas and condensate activities in Russia are subject to lower taxes compared to crude oil.
- Favorable track record of managing country risk, with strong production growth in recent years, access to attractive gas assets, tax holidays for sizable reserves, including the Yamal region, and recent liberalization of LNG exports.

These strengths are partly offset by the following constraining factors:

- Growing capital expenditure needs to support the group's ambitious growth plans. We expect that Severenergia and Yamal LNG will finance a major part of their capital expenditures without recourse to Novatek.
- Heavy exposure to Russia, which we view as a high-risk country. Novatek could be exposed to potential changes in taxes and regulations, as well as cost inflation and foreign exchange changes. 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. After several years of ongoing increases, we expect regulated domestic gas prices to stay flat in 2014 and increase only gradually in subsequent years.
- The risk of demand fluctuations and growing competition on the domestic gas market. 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 going forward, slower economic growth and increasing independent gas production in Russia could affect Novatek's volumes.
- We view Novatek as smaller, less diversified, and less exporting than most of its domestic peers, which drives our anchor of 'bbb-'.

Financial Risk : Intermediate

We view Novatek's financial risk profile as "intermediate," with FFO to debt above 45% and weakening FOCF.

We expect capital expenditures to increase following the final investment decision on the $26.9 billion Yamal LNG project. We expect leverage to increase after Novatek's 50:50 joint venture with Gazprom Neft has acquired an additional $2.94 billion stake in Severenergia (bringing Novatek's share to $1.47 billion). We understand, however, that Yamal LNG and Severenergia will remain equity investments for Novatek, with most capital expenditures financed on a non-recourse basis. Currently, our base-case scenario assumes that Novatek will keep a 60% stake in the Yamal LNG project following the sale of 20% interest in the project to CNPC. The proceeds from selling the stake could ease the pressure on the credit metrics, in our view, but are unlikely to change our overall assessment of financial risk.

Liquidity: Adequate

We view Novatek's liquidity as "adequate" reflecting our view that liquidity sources will exceed uses by 1.2x, as defined by our criteria.

Principal Liquidity Sources	Principal Liquidity Uses
As of Sept. 30, 2013, Novatek's key liquidity sources included: • Cash of RUB10.3 billion; and • Our expectation of solid FFO generation.	As of Sept. 30, 2013, Novatek's key liquidity needs included: • Large capital expenditure needs. We understand however, that the company may have some flexibility to finance part of its capital expenditures on a joint venture basis; • Relatively limited short-term debt of RUB0.97 billion; and • Dividends in line with the 30% payout policy.

We understand that the acquisition of an additional stake in Severenergia is financed at the joint venture level and creates only contingent liabilities for Novatek.

We expect Novatek to have ample headroom under key covenants, which require a consolidated leverage ratio of below 3.0x and EBITDA interest coverage of more than 4x.

Other Modifiers

Novatek has undertaken several sizable acquisitions in recent years, which have led to a material increase in debt. Still, the company has been able to sell stakes in Yamal LNG to partners and arrange non-recourse financing for its joint ventures, which helps to limit the pressure on credit metrics. We therefore view the financial policy as moderate, albeit borderline aggressive.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/--

Business risk: Satisfactory

- Country risk: High
- Industry risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Intermediate

Cash flow/Leverage: Intermediate

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria And Research

Related Criteria

- Corporate Methodology, Nov. 19, 2013
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

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