Fitch Ratings

Fitch Affirms Russia's Novatek at 'BBB-', Outlook Negative

Fitch Ratings-London/Moscow-28 September 2016: Fitch Ratings has affirmed OAO Novatek's Long-Term Foreign-Currency Issuer Default Ratings (IDRs) at 'BBB-' with a Negative Outlook. A full list of rating actions is available at the end of this release.

The rating reflects Novatek's strong business profile as a large Russian natural gas producer and exporter of refined and crude liquids, its moderate debt load, which we expect to decline in the short term, and projected positive free cash flow (FCF). The rating also takes into account Novatek's constrained access to international debt markets because of the US sanctions, and diminishing though still present completion risks associated with its Yamal LNG megaproject.

Novatek's ratings are capped by Russia's rating and Outlook (BBB-/Negative), due to the company's asset concentration in the country and the influence the state exercises on the oil and gas sector through taxes and regulation. On a standalone basis and before taking into account regulatory and country risks, Novatek's rating would correspond to the high end of the 'BBB' rating category.

KEY RATING DRIVERS

Large Gas Producer

Novatek is Russia's second-largest natural gas producer by sales and third-largest by production volumes (excluding joint ventures, JVs). The company plays an important role in domestic gas supplies. In 2015 Novatek produced 49.2 billion cubic metres (bcm) of natural gas, excluding JVs, which corresponds to 8% of the country's total production (11% including share in JV output,; and sold 62bcm of gas, accounting for 20% of total domestic gas consumption.

Novatek's market position is secured by its long-term contracts with key customers. However, we expect competition in the domestic market to remain high, driven by Rosneft's ambitious gas strategy, as well as a falling premium of export gas sales relative to domestic supplies, which may prompt Gazprom to more actively defend its domestic market share. This should not harm Novatek as the company is not planning to increase its domestic gas market presence.

Falling Capex, Positive FCF

Novatek's capital intensity started to fall in 2016 as many of its field development and downstream projects have switched to the production phase, with the exception of Yamal LNG which is financed at the JV level and should not require any further contributions from partners. Novatek is considering a second LNG plant in the Arctic, but given the current market situation we believe this is unlikely to be sanctioned in the next two years. Quicker progress with the second LNG plant in the Arctic could reduce Novatek's financial flexibility and may negatively affect its immediate credit position.

In 2015 Novatek's capital intensity measured as capex to funds from operations (FFO) started to fall, reaching 36% compared to 59% in 2013-14, both on lower capex and stronger FFO generation mainly driven by rising liquids production. We expect Novatek's capex to moderate further in 2016-18 at around 35% of FFO, which should result in positive FCF after dividends and should help the company accumulate funds to ensure timely debt repayment with minimal resort to external funding.

Tax Risks Remain

Novatek was marginally affected by the tax hike announced in October 2015 as an oil producer and exporter of refined liquids. In 2016 the continued pressure on the Russian federal budget due to low oil prices triggered discussions on additional oil and gas taxes for 2017. According to press reports, raising taxes on independent gas producers, such as Novatek, was considered for some period of time, but is off the table at the moment. Our base case is that taxes for Novatek will remain broadly at the same level as in 2016. A very significant tax increase, which in our view is unlikely for Novatek at the moment, could result in a downgrade, though.

Declining Gas Production

Novatek's gas production (ex-JVs) started to decline in 2015 after a decade of steady growth due to a natural depletion in its key producing fields. In 1H16 Novatek's gas production (ex-JVs) amounted to 24bcm, down from 25bcm in 1H15, and this is likely to decline further in the future. At the same time, Novatek's share of gas production from JVs increased from 8bcm in 1H15 to 10bcm in 1H16.

This projected decline does not weaken Novatek's business profile, in view of its still very high proved reserves and rising exposure to liquids. In 2015 Novatek's proved reserve life (excluding JVs) amounted to 21 years. In a longer term, it should be able to sustain production profile through development of North-Russkoye field and other assets.

Rising Exposure to Liquids
Over the past two years Novatek has substantially augmented its business and financial profile with rapidly increasing production of liquids. The company's liquids production averaged 283 thousand barrels of oil equivalent per day (mboe/d) in 2Q16, or 19% of overall production volumes (including JVs), which was 37% higher yoy mainly due to the launch of Yarudeyskoye oil field. The share of liquids in Novatek's revenue after export duties and other sales taxes rose to 57% in 1H16 from 36% in 1H14. We view a higher share of liquids in Novatek's production mix as positive because liquids sales generate higher margins.

Yamal LNG on Track
Novatek is leading the Yamal LNG project, potentially a 16.5 mt LNG plant in Yamal, with the first 5.5 mt train coming on stream in 2H17. Yamal LNG should significantly enhance Novatek's business profile through diversification into the global LNG market. In comparison with other projects constructed worldwide, Yamal's main advantage is its low cost of production and a competitive break-even LNG price, supported by tax holidays.

Novatek agreed the long-awaited funding package for the project in April 2016. OAO Yamal LNG signed two euro- and renminbi-denominated 15-year credit lines equivalent to around USD12bn with the Export-Import Bank of China (Exim, A+/Stable) and China Development Bank Corporation (CDB, A+/Stable). Together with USD12.8bn already invested by the partners, and the previously announced deals, including euro-denominated credit lines signed with the Russian state-affiliated banks (USD4.0bn) and the Russian Welfare Fund (USD2.4bn), we expect the lines to be more than enough to cover the project's USD27bn capex needs.

Fitch expects Novatek to provide completion guarantees to Yamal LNG's creditors for around USD12bn to be released once the project is fully operational in 2019 and meets certain completion tests by 2020. We do not include these guarantees in Novatek's leverage since we assess the project's completion risks as manageable. This is also evidenced by the fact that the construction is undertaken by reputable contractors, and construction stage risks are largely insured. The remaining risks associated with the project are taken into account in Novatek's standalone rating.

Sanctions
In July 2014 Novatek was included on the Sectoral Sanctions List by the US Office of Foreign Asset Control, which prohibits US companies and banks from providing new finance of longer than 90 days to the company. This has effectively barred Novatek from the US capital markets, and made access to other western markets difficult. We estimate the company will be able to repay its upcoming debt maturities largely from the funds it generates, or resort to domestic borrowings in case of necessity.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:

- Russian domestic gas prices rising by on average 3% p.a. in the medium term;
- Fitch's Brent price desk: USD42 in 2016, USD45 in 2017, USD55 in 2018, and USD65 thereafter;
- USD/RUB exchange rate: 69 in 2016, 68 in 2017, 62 in 2018, 58 in 2019 and 59 thereafter;
- Gradually declining natural gas and condensate produced by Novatek and its JVs (excluding Yamal LNG);
- Declining EBITDA margins due to higher share of production coming from JVs in 2016-19;
- Capex moderating to around 35% of FFO in 2016-2018;
- Dividends averaging RUB35bn in 2016-2019;
- Industry taxes broadly at the 2016 level;
- Readily available cash balance is maintained at around RUB25bn; surplus cash flows (RUB115bn in 2018-2020) are considered to be either re-invested or paid out as additional dividends.

RATING SENSITIVITIES
Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- A positive rating action on Russia, which could result in Novatek's Outlook being revised to Stable, as Novatek's rating/Outlook is currently capped by that of the sovereign (for more details see Fitch Affirms Russia at 'BBB-' Outlook Negative, dated 15 April 2016 at www.fitchratings.com);
- A positive rating action on Russia together with an improved standalone profile, which could lead to an upgrade. An improved standalone profile would be manifested in FFO adjusted net leverage being consistently below 1.5x and/or further progress with Yamal LNG (eg, successful launch of the first train).
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- A negative ration action on Russia;
- Intensification of western sanctions directly affecting Novatek;

- FFO adjusted net adjusted leverage rising above 2.5x (end-2015: 2.5x) on a sustained basis;
- FFO adjusted interest cover falling below 8x (end-2015: 10x) on a sustained basis.

LIQUIDITY
Short Term Repayments Manageable
At end-June 2016, Novatek's short-term debt equalled RUB48bn, while its cash balance was RUB26bn. We assume Novatek will be able to repay the short-term debt mostly with its operating cash flows and cash reserves. In case of necessity Novatek also has access to domestic funding, including Russia's largest banks. Other sources of the company's liquidity include undrawn available credit lines totalling almost RUB150bn, and, potentially, dividends and debt repayments from Novatek's JVs.

Novatek continues to be exposed to limited FX risks. Further rouble depreciation could reduce its US dollar-denominated EBITDA, while Novatek's debt is predominantly in dollars, resulting in higher leverage. This would be partially mitigated by lower capex, which is mainly rouble-linked.

FULL LIST OF RATING ACTIONS

OAO Novatek
Long-term IDR: affirmed at 'BBB-', Outlook Negative
Local currency long-term IDR: affirmed at 'BBB-', Outlook Negative
National long-term rating: affirmed at 'AA+(rus)', Outlook Stable
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)
Novatek Finance Limited
Senior unsecured rating: affirmed at 'BBB-' (the affirmation applies to all debt issued prior to 1 August 2014)

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Summary of Financial Statement Adjustments
Not readily available cash: Fitch estimates that Novatek will need to keep RUB5bn of cash on balance sheet for various corporate needs such as working-capital funding and excludes this amount from Novatek's readily available cash.
Mineral extraction tax: Fitch has subtracted RUB33.7bn of mineral extraction tax expense from Novatek's 2015 revenue and operating costs to facilitate revenue comparability among Russian oil and gas producers and international peers.
EBITDA(R) metrics: Novatek's EBITDA(R) metrics were unadjusted for dividends received from associates or paid to minority shareholders.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016) (https://www.fitchratings.com/site/re/885629)
National Scale Ratings Criteria (pub. 30 Oct 2013) (https://www.fitchratings.com/site/re/720082)

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