S&P Global
Ratings

Research

Research Update:

Russian Independent Hydrocarbon Producer Novatek Upgraded To 'BBB-' On Projected Strong Credit Metrics; Outlook Stable

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Overview

- Russian independent oil and gas producer Novatek's credit metrics continue to strengthen on the back of robust free operating cash flow and completion of asset disposals.
- In our opinion, Novatek could withstand a hypothetical sovereign default and be rated higher than Russia, thanks to increasing export revenues, moderating debt maturity profile and arrangement of financing for Yamal LNG project.
- We are therefore raising our ratings on Novatek to 'BBB-/ruAAA' from 'BB+/ruAA+'.
- The stable outlook balances our view of the weak industry conditions against Novatek's moderate and declining debt leverage and reducing investments.

Rating Action

On Nov. 2, 2016, S&P Global Ratings raised its corporate credit rating on Russia's independent oil and gas producer OAO NOVATEK (Novatek) to 'BBB-' from 'BB+'. The outlook on the rating is stable.

At the same time, we raised our ratings on Novatek's loan participation notes (LPNs) to 'BBB-' from 'BB+'. We also raised the Russia national scale rating on Novatek to 'ruAAA' from 'ruAA+'.

All these ratings were removed from CreditWatch with positive implications, where we had placed them on Sept. 20, 2016.

Rationale

The upgrade reflects our view that Novatek's low debt leverage and solid operating performance could allow it to sustain a hypothetical sovereign default and therefore be rated one notch above the foreign currency sovereign rating and the transfer and convertibility (T&C) assessment on Russia. Our view is primarily supported by the following considerations:

- Novatek's leverage has declined, with adjusted debt to EBITDA reducing to 1.5x from 2.0x, and should continue to decline further with positive free cash flow after capital expenditures (capex) and dividends, which we expect the company to generate in 2016-2018. On top of that, earlier in

2016 Novatek completed the disposal of a 9.9% stake in the Yamal liquid natural gas (LNG) project for €1.1 billion, further supporting the improvement in credit metrics. As Novatek continues to repay debt, its debt maturity profile similarly improves. The company's annual debt service has already reduced to about Russian ruble (RUB) 44 billion (about US$700 million) per year and is set to reduce further as the company gradually repays the maturing debt with free cash flow. We believe it is particularly important that the company has reduced its exposure to external factors, such as refinancing risk, as Novatek is under U.S. sanctions and therefore has meaningful limitations in accessing capital markets.
- The share of liquid hydrocarbons in Novatek's total production continues to increase, reaching approximately 60% of revenues and consolidated EBITDA in the first half of 2016. This is important as, unlike gas, where Gazprom holds an export monopoly, Novatek can export its oil and condensate. Therefore access to these export revenues, which in the current stress environment could be more stable in terms of volumes and prices than domestically sold gas, should allow Novatek to maintain sufficient liquidity in hard currency to service its US$ debt maturities.
- The financing package for Novatek's US$27 billion Yamal LNG joint project with Total, China National Petroleum Company and China's Silk Road Fund, the signing of which was postponed a number of times because of the sanctions against Novatek, has now been fully arranged. We view this development as important, as it materially reduces the risk of potential cash outlays for Novatek related to the project, even if Novatek does not provide any formal guarantees.

In our base-case scenario for Novatek we assume:
- A Brent oil price at US$42.5 per barrel (/bbl) for the rest of 2016, US$45/bbl in 2017, US$50/bbl in 2018, and US$55/bbl thereafter. We also assume that stable condensate prices will strongly correlate to oil prices.
- We expect limited increase in domestic gas prices in 2016-2018, but we do not expect any material increase in gas transportation tariffs.
- Broadly stable production profile with moderate decline in production of own gas compensated with growth of production at joint ventures.
- No material changes to the Russian tax regime.
- US$/RUB exchange rate of close to 68 in 2016-2018.
- Capex of RUB45 billion in 2016-2018.
- Dividends of about 30% of net profit under International Financial Reporting Standards.
- No material acquisitions.

Based on these assumptions, we arrive at the following credit metrics:
- Funds from operations (FFO) to debt of about 50% in 2016, and higher than 60% in 2017-2018.
- Positive discretionary cash flow in 2016-2018.

Our assessment of Novatek's business risk profile recognizes the company's solid competitive position, resulting from large and high-quality reserves and

profitable low-cost production. Our assessment is primarily constrained by Russian country risk, including the high sensitivity of profits to potential changes in the tax system. Russian government revenues are significantly dependent on the oil and gas sector. We believe there are risks to the stability of the current tax system, although in our base-case scenario, we do not anticipate significant changes in 2016-2017.

Our assessment of Novatek's financial risk profile reflects our forecast of strong and improving credit metrics, with FFO to debt of above 60% in 2017 and thereafter. Novatek's capex is set to moderate because all major investment projects, including those related to its joint ventures, have been completed. This should result in solid free operating cash flow (FOCF) generation and, starting from 2018-2019, more meaningful cash inflows from the joint ventures. Given the above, the key risks to Novatek's financial profile will lie in with strategic decisions on growth and higher shareholder returns. We also note as an area of risk Novatek's sizable unconsolidated joint ventures, at various stages of their development, which could require additional cash outlays for Novatek.

Liquidity

We view Novatek's liquidity as adequate, with a ratio of sources to uses exceeding 1.2x for the 12 months started Sept. 30, 2016.

Principal liquidity sources as of Sept. 30, 2016, include:
- Cash and short-term investments totaling RUB27 billion.
- Expected FFO of about RUB120 billion.

Principal liquidity uses as of Sept. 30, 2016, include:
- Short-term debt of about RUB44 billion due in next 12 months.
- Capex of about RUB40 billion-RUB45 billion.
- Negative working capital outflow of not more than RUB10 billion.
- We consider dividends to be generally discretionary for Novatek; however, in our base-case scenario we project they will be RUB20 billion-RUB30 billion.

Novatek has very solid headroom under its financial covenants.

Outlook

The stable outlook on Novatek reflects our expectation that its debt will gradually decline on the back of positive FOCF generation. We assume that Novatek's FFO-to-debt ratio will improve to above 60% in 2017 and that it should strengthen further from this level, absent any increase in dividends.

Downside scenario

We would likely lower the rating on Novatek if its FFO-to-debt ratio were to drop to consistently below 45% without near-term prospects of improvement.

This could likely happen in case the management took a more aggressive stance on growth, with higher investments and mergers and acquisitions, or if it significantly raised shareholder distributions.

The outlook on our long-term Russian sovereign rating is currently stable, suggesting limited likelihood of a sovereign downgrade in the next 12 months. However, if a downgrade scenario were to materialize, it would result in a similar rating action on Novatek, as the rating on Novatek can exceed that on the sovereign by no more than one notch.

Upside scenario

Upside ratings potential is currently constrained by Novatek's exposure to Russia. We do not expect to rate Novatek by more than one notch above the sovereign rating on Russia.

Ratings Score Snapshot

Corporate credit rating: BBB-/Stable/--

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

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-1 notch)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry - December 12, 2013
- General Criteria: Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns - November 19, 2013
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity

Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013

Related Research

- Various Rating Actions Taken On Russian Corporations Following The Sovereign Outlook Revision, Sept. 20, 2016

Ratings List

Upgraded; CreditWatch Action

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

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings'

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