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CJSC SSMO LenSpecSMU

Primary Credit Analyst:
Izabela Listowska, Frankfurt (49) 69-33-999-127; izabela_listowska@standardandpoors.com

Secondary Credit Analyst:
Varvara Nikanorava, Frankfurt (49) 69-33-999-135; varvara_nikanorava@standardandpoors.com

Table Of Contents

CJSC SSMO LenSpecSMU

Major Rating Factors

Corporate Credit Rating
B/Stable/B
Russia National Scale Rating
ruA/--/--

Strengths:

- A leading market position in St. Petersburg and environs, combined with an established track record and brand recognition
- Considerable vertical integration, with enhanced process and cost control
- Commitment to prudent development, marketing, and financial-risk policies

Weaknesses:

- Very weak liquidity profile
- Severe cyclical downturn in Russia's property markets
- Uncertainty associated with the country's evolving political and business climate
- Risky industry profile, owing to high competition and volume and price volatility
- Lack of administrative transparency and predictability
- Limited business scope and diversity

Rationale

The ratings on Russia-based property development group CJSC SSMO LenSpecSMU (LSS) are constrained by the company's very weak liquidity profile; a severe cyclical downturn in the property markets in the Russian Federation (foreign currency BBB/Negative/A-3; local currency BBB+/Negative/A-2), which is likely to continue until at least the end of 2009; and the country's lack of administrative transparency and predictability. Other negative rating factors are what Standard & Poor's Ratings Services' considers to be a risky property development industry profile, owing to high competition and volume and price volatility; the company's dependence on property development in a single region of Russia; and still-aggressive financial leverage, although it has decreased somewhat over the recent past.

Conversely, the company's leading position in its core market, St. Petersburg and the surrounding region, an established track record of completing projects, and brand recognition moderate these risks. Based on information provided by the company, we believe that LSS' control of all the stages of a project's evolution should allow it to manage quality and costs adequately. The company is also able to effectively address key administrative and legal risks.

Key business and profitability developments

After benefiting from a favorable trading environment over the past few years, LSS' operating performance has been challenged by weakened lending and economic conditions in Russia that severely hamper local housing markets. Despite tougher market conditions, we believe the impact on LSS' performance could be mitigated by presold units, due for completion in 2009, and its ability to scale back its development pipeline. Presold units are currently suffering still-modest cancellation and default rates, which could rise because of falling disposable incomes and consumer confidence. In our view, LSS' operations remain fairly resilient to tighter access to mortgage financing because mortgages fund only a small share of customer contracts. On the negative side, further depreciation of the Russian ruble against the dollar poses a risk for the company. This is because of the mismatch between dollar-denominated debt and largely ruble-denominated cash flows, although the company links housing contract prices to the dollar as far as possible. Following a positive profitability trend, EBITDA margins are likely to contract from about 20% in the 12 months to June 30, 2008, owing to declining property prices and slowing demand.

Key cash flow and capital-structure developments

LSS entered the housing downturn with an aggressively leveraged balance sheet, owing to its ambitious growth strategy over recent years and a need to close the gap between investment requirements on the one hand and available internal cash resources and customer advances on the other. As of Dec. 31, 2008, LSS' total reported debt was about Russian ruble (RUR) 7.4 billion ($247 million), some of which has since been partly repaid from internal cash resources. Based on preliminary 2008 financials received from the company, we estimate that LSS was able to maintain credit ratios at levels consistent with the ratings, with pro forma debt to EBITDA at about 3.5x. Management's financial discipline and prudent approach to a new development schedule in light of difficult markets will be essential factors in maintaining credit measures commensurate with the ratings.

Liquidity

We regard LSS' liquidity as very weak, according to our rating criteria, because we consider the company dependent on external financing from currently distressed credit markets.

We understand that LSS was successful in restructuring its credit-linked note (CLN) obligations at the beginning of March 2009, which lengthened and better distributed its debt maturity profile. Nevertheless, further short-term maturities remain outstanding. Management information indicates that, as of March 1, 2009, LSS had about $54 million available under credit lines and unrestricted cash balances of about $17 million. In our opinion, LSS' current liquidity sources are not sufficient to meet sizable debt maturities in the second half of this year.

We anticipate that new customer deposits and advances may only partly bridge the funding gap, so the company will probably need to roll over a substantial portion of its upcoming debt maturities or obtain additional funding from other sources. We believe these refinancing needs are likely to be manageable, owing to management's proactive treasury management, established borrowing relationships, and historically good access to the Russian loan market. Company data suggests that LSS is the largest house builder in St. Petersburg and environs, which should also facilitate access to funding.

We understand that LSS is in advanced discussions with potential lenders on several funding options, any of which, if closed, should be sufficient to cover most or all its short-term maturities.

The recent successful restructuring of CLN obligations eliminated maintenance covenants and left the company subject only to incurrence financial covenants. We understand that there are currently no financial covenants in LSS' other bank and bond documentation.

Recovery analysis

The senior unsecured debt issued by Golden Ring Finance S.A. and guaranteed by LSS is rated 'B' in line with the corporate credit rating on LSS. This debt has a recovery rating of '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default. In addition, as of Dec. 31, 2008, LSS had RUR580 million outstanding under a RUR1.5 billion unsecured bond issue, which has an 'ruA' Russia national scale rating, and about $229 million in unrated bank debt.

For further information see the article "CJSC SSMO LenSpecSMU's Recovery Rating Profile," published on July 30, 2008, on RatingsDirect. For more information on the way we classify the world's legal jurisdictions with regard to creditor friendliness and our review of Russia's insolvency procedures, please see "Update: Jurisdiction-Specific Adjustments To Recovery And Issue Ratings," published on June 20, 2008, and "Debt Recovery For Creditors And The Law Of Insolvency In Russia," published on May 7, 2007.

Outlook

The stable outlook reflects our view that despite currently difficult credit markets, LSS will be able to refinance its short-term debt maturities. Furthermore, we believe the group will be able to achieve adjusted debt to EBITDA of about 3.5x, which is consistent with the 'B' rating, by prudently managing its operating costs and leverage position.

We would consider lowering the rating, possibly by more than one notch, if LSS fails to adequately address the challenge posed by its short-term debt maturities over the next few months or if its operating cash flows, which are susceptible to order cancellations and customer defaults, deteriorate significantly. Adverse developments in Russia's transitional regulatory and administrative environment could also trigger negative rating actions.

Ratings upside is unlikely in the near term, owing to tough market conditions and increased uncertainty about the company's business prospects.

Business Description

Based in St. Petersburg, Russia, LSS specializes primarily in the development and construction of residential (85% of developments) and commercial real estate projects (15%). With more than 20 years' experience, the company is one of the leaders in a highly fragmented St. Petersburg market and had a market share of about 13% in 2008. The company generated revenues of about RUR11.8 billion in 2008.

LSS is privately owned. Its principal shareholder is the Zarenkov family, with minority stakes held by Russian private-equity fund Baring Vostok (15%) and members of the group's management.

Business Risk Profile: Leading Market Positions In Cyclical, Competitive, And Risky Markets

The major risks for LSS' vulnerable business profile are:

- High risks in the property development industry, owing to fierce competition and limited barriers to entry; heavy working-capital needs; exposure to subcontractors' credit quality; and persistent exposure to speculative construction and cyclical fluctuations in selling prices and volumes. Specifically, we consider Russia's property market to be sensitive to the economic and political environment, which--albeit evolving--is far from mature;
- A complex, still-developing regulatory framework and lack of administrative transparency and predictability. The generally very lengthy process of obtaining approvals for projects from inception to final completion certification requires the establishment and maintenance of relationships with local authorities and deep-rooted knowledge of local administrative procedures;
- Limited business scope and diversity and the company's dependence on property development in a single region of Russia. Furthermore, market specifics, such as the need to establish effective working relationships with

respective local officials, make it very difficult to diversify and expand across different markets; and

- Profitability is highly exposed to movements in selling prices and input costs. Following adequate profitability on the back of favorable housing markets in the recent past, EBITDA margins are likely to contract in the near future because of a cyclical downturn.

These risks are mitigated by:

- A proven business model and established management track record. Over its more than 20 years in business, LSS has managed to build a successful business model;
- Leading positions, reinforced by its vertically integrated business model, which provides enhanced cost and quality control of projects at almost every stage. Exposure to subcontractors' credit quality is limited because the majority of them are entities of the LSS group and are fully controlled by LSS;
- LSS' larger size compared with peers, its long-standing track record, brand recognition, and established administrative resources provide a number of competitive advantages. These include cost synergies, greater purchasing power, and frequently, the first pick of government deals--usually federal housing programs--because authorities favor well-established counterparties; and
- Ability to effectively address key administrative and legal risks.

Financial Risk Profile: Aggressive Financial Policy And High Working-Capital Needs Burden Operating Cash Flows

The main weaknesses of LSS' highly leveraged financial risk profile are its:

- Aggressive financial policy. LSS has pursued an ambitious growth strategy over recent years, resulting in an aggressively leveraged balance sheet;
- Foreign currency exposure. Devaluation of the ruble against the dollar is a risk for the company because of the mismatch between dollar-denominated debt and largely ruble-denominated cash flows;
- Operating cash flows are burdened by considerable working-capital requirements because receipts from clients typically trail cash outflows for development costs and land acquisition;
- Short-dated debt maturities. The need to raise additional funding and continually refinance short-term debt heightens financial risk, in particular, amid currently difficult financial markets; and
- Very weak liquidity, according to our rating criteria. We consider LSS to be dependent on external financing.

These weaknesses are partly mitigated by:

- Management's demonstrated commitment to fairly prudent cost control and its balanced financial risk appetite, which somewhat moderates the risks associated with its aggressive financial policy. The group's internal financial policy is to maintain debt to EBITDA at 3.5x or lower. As far as possible, the company links housing contract prices to the dollar to moderate foreign currency exposure;

- Proactive treasury management, established borrowing relationships, and good access to the Russian loan market in the past. Company data indicates that LSS is the largest house builder in St. Petersburg and the region, which should also facilitate access to funding; and
- Credit measures commensurate with the current ratings. Based on preliminary financials, debt to EBITDA was about 3.5x and the asset-coverage ratio at about 5.0x in 2008.

Financial Statistics/Adjustments

LSS provides audited reports in accordance with Russian Accounting Standards and International Financial Reporting Standards. We did not make any material adjustments to its reported financial statistics. Off-balance-sheet liabilities include guarantees for leased equipment and industry-specific project-completion or performance bonds, which we considered in our analysis, but did not include in any of our financial ratios.

We note that customer advances were not added to the company's total debt burden because they lacked the backing of committed financing guarantees and were offset by inventories and accounts receivables. Nevertheless, this represents an alternative form of financing that should not be completely disregarded as a balance-sheet constraint.

LSS recognizes sales and profit after construction is completed and units are sold, which is a more conservative approach than that of the "percentage-of-completion" accounting method. The completion method typically generates a delay between the time the company receives cash from customers as a project progresses and the time it books the related revenue and margin. Current cash inflows and outflows therefore relate to developments for which revenues and margins will only be booked a few years in the future.

In our analysis, we consider operating cash flows to be a better indicator of LSS' actual cash generation. The use of funds from operations--the most frequently used credit measure in industrial ratings--can be misleading because it does not capture items such as customer prepayments, construction costs for future completion, or investments in plots of land, which are all reported under the changes in working capital.

Table 1

Reconciliation Of CJSC SSMO LenSpecSMU Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUR)*

	--Fiscal year ended Dec. 31, 2007--			
CJSC SSMO LenSpecSMU reported amounts				
	Shareholders' equity	**Operating income (after D&A)**	**Cash flow from operations**	**Cash flow from operations**
Reported	1,783	2,058	(3,267)	(3,267)
Standard & Poor's adjustments				
Reclassification of nonoperating income (expenses)	--	104	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	(374)	(374)
Reclassification of working-capital cash flow changes	--	--	--	4,644
Minority interests	315	--	--	--
Other	--	--	1,316	--

Table 1

Reconciliation Of CJSC SSMO LenSpecSMU Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUR)* (cont.)				
Total adjustments	315	104	942	4,270
Standard & Poor's adjusted amounts				
	Equity	**EBIT**	**Cash flow from operations**	**Funds from operations**
Adjusted	2,098	2,163	(2,325)	1,003

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. RUR--Russian ruble.

Table 2

CJSC SSMO LenSpecSMU--Peer Comparison*				
	CJSC SSMO LenSpecSMU	**OJSC KD Group**	**Southern Telecommunications Co. (OJSC)¶**	**OAO TMK¶§**
Corporate credit ratings**	B/Stable/B	B-/Stable/--	B/Watch Neg/--	B+/Negative/--
(Mil. $)	**--Fiscal year ended Dec. 31, 2007--**			
Revenues	362	97	823	4,179
EBITDA	87	33	307	918
Net income from continuing operations	42	32	49	487
Funds from operations (FFO)	41	20	193	615
Cash flow from operations	(95)	15	163	229
Capital expenditures	54	2	156	662
Debt	271	74	951	1,572
Equity	85	82	429	2,101
Adjusted ratios				
Operating income (before D&A)/revenues (%)	24.1	33.4	37.5	21.8
EBIT interest coverage (x)	6.9	6.4	1.8	7.6
EBITDA interest coverage (x)	6.8	6.4	3.3	8.9
Return on capital (%)	34.3	27.9	12.1	23.0
FFO/debt (%)	15.1	26.6	20.3	39.1
Cash flow from operations/debt (%)	(34.9)	19.8	17.2	14.6
Debt/EBITDA (x)	3.1	2.3	3.1	1.7

*Fully adjusted. ¶Fully adjusted (including postretirement obligations). §Excess cash and investments netted against debt. **As of March 26, 2009.

Table 3

CJSC SSMO LenSpecSMU--Financial Summary*				
		--Fiscal year ended Dec. 31--		
(Mil. RUR)	**12 months to June 30, 2008**	**2007**	**2006**	**2005**
Revenues	7,804	8,903	7,712	5,629
EBITDA	1,644	2,145	729	369
Net income from continuing operations	970	1,027	433	303
Cash flow from operations	1,123	(2,325)	(1,394)	(1,646)
Capital expenditures	705	1,336	109	525

Table 3

CJSC SSMO LenSpecSMU--Financial Summary* (cont.)				
Debt	5,345	6,655	2,606	1,568
Equity	3,219	2,098	1,068	654
Adjusted ratios				
Operating income (before D&A)/revenues (%)	21.1	24.1	9.5	6.6
EBIT interest coverage (x)	2.9	6.9	6.7	9.2
EBITDA interest coverage (x)	2.9	6.8	6.3	9.8
Return on capital (%)	20.6	34.3	25.9	23.6
Cash flow from operations/debt (%)	21.0	(34.9)	(53.5)	(105.0)
Debt/EBITDA (x)	3.3	3.1	3.6	4.2
Debt/debt and equity (%)	62.4	76.0	70.9	70.6

*Fully adjusted. RUR--Russian ruble.

Ratings Detail (As Of March 26, 2009)*		
CJSC SSMO LenSpecSMU		
Corporate Credit Rating		B/Stable/B
Russia National Scale Rating		ruA/--/--
Senior Unsecured (1 Issue)		B
Russia National Scale Rating (1 Issue)		ruA
Corporate Credit Ratings History		
07-Oct-2008	*Foreign Currency*	B/Stable/B
12-Dec-2007		B/Positive/B
22-Dec-2006		B/Stable/B
07-Oct-2008	*Local Currency*	B/Stable/B
12-Dec-2007		B/Positive/B
22-Dec-2006		B/Stable/--
22-Dec-2006		B/Stable/B
12-Dec-2007	*Russia National Scale Rating*	ruA/--/--
22-Dec-2006		ruA-/--/--
Business Risk Profile		Vulnerable
Financial Risk Profile		Highly leveraged
Debt Maturities		
(As of Dec. 31, 2008) 2009: $197 mil. 2010: $38 mil. 2011: $12 mil.		

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

Additional Contact:
Industrial Ratings Europe; CorporateFinanceEurope@standardandpoors.com

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