Global Credit Portal
RatingsDirect®

November 19, 2010

CJSC SSMO LenSpecSMU

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Major Rating Factors

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

Strengths:

- Favorable market position with an established track record and brand recognition.
- High degree of vertical integration, including enhanced processes and cost controls.
- Commitment to prudent property development, marketing, and financial-risk policies.
- Adequate liquidity.

Weaknesses:

- Risky industry profile, owing to volume and price volatility.
- Lack of administrative transparency and predictability.
- Limited business scope and diversity.
- Substantial investment needs in 2011-2012 and a long operating cycle.

Rationale

The ratings on Russia-based property developer CJSC SSMO LenSpecSMU (LSS) reflect Standard & Poor's Ratings Services' view of the company's business risk profile as "weak" and its financial risk profile as "aggressive". LSS' business risk profile is constrained by the inherent volatility of the property development industry and a long operating cycle. In addition, we think further constraints include the country's lack of administrative transparency and predictability, in our view, and LSS' dependence on property development in only one region of Russia. We consider these risks to be partly offset by LSS' favorable and recently expanded position in its core market of St. Petersburg (BBB/Stable/--) and the surrounding region, gradually improving demand for residential property in the Russian Federation (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2), an established track record of completing projects, and an ability to effectively address key administrative and legal risks. We also think that LSS' control of all the stages of a project's evolution should enable it to manage quality and costs adequately.

LSS' financial risk profile is constrained by our expectation of negative cash flow from operations in the second half of 2010 and through 2012. Consequently, we think there is a risk of rising debt levels, as well as inherent volatility in its cash flow. Another important constraint, in our view, is the analytical complexity associated with the company's completed-contract method of accounting, which reduces the visibility of current operating trends. However, we view the financial risk profile as supported by adequate liquidity, which should enable the company to fund new developments, as well as by its proactive treasury management and moderate financial policy.

Key business and profitability developments

In the first eight months of 2010, LSS' total area of properties sold increased by about 40% compared with the corresponding period in 2009. We understand that this resulted from improving demand for residential property, which is a direct consequence of stabilizing economic conditions. We further understand that property prices have remained fairly stable. However, cash inflow from customers are lagging behind development costs and are currently about 10% less than 2009 levels, which also reflects the very weak sales from the previous year. In the absence of any new economic shocks, we expect cash inflow from customers to improve in 2011 on the back of increased construction activity levels. However, customer orders and prices remain vulnerable to wider economic conditions, in our view.

LSS is currently ramping up its construction activity--which it curtailed in 2009--and starting new development projects because the stock of completed apartments available for sale is decreasing.

We estimate that LSS' profitability in the future will be less than the record levels achieved before the economic downturn because of continuously weak housing prices. However, we believe this effect could be partly offset by lower building material prices and the company's cost-cutting initiatives.

Compared with the corresponding period of 2009, LSS' revenue for the first six months of 2010 decreased by 10.8% to Russian ruble (RUB) 8.6 billion ($290 million), and its operating margin reached 42.1%, up from 39.5%. We note, however, that LSS uses the completed-contract method of accounting, so revenues and profits booked in 2010 largely relate to projects either sold or partly constructed before the downturn in 2009. As a consequence, we think this method reduces the analytical relevance of these metrics.

Key cash flow and capital-structure developments

We anticipate that LSS' operating cash flow will be negative in the second half of 2010 and through 2012 because cash inflow from customers will lag the costs of development for new projects. This could lead to increased leverage, in our view. However, we think this is partly offset by the availability of funding in the form of cash and committed lines to meet the cash flow shortfalls. Additionally, the company can curtail constructions works if demand for property weakens or if credit markets deteriorate.

As of June 30, 2010, LSS' gross debt was RUB5.4 billion compared with RUB1.5 billion of cash. In addition, the company had about RUB2 billion of guarantees, which it provided to banks for the benefit of its customers. We note also the company's exposure to foreign exchange risk: 56% of its gross debt is denominated in U.S. dollar. This risk is partly offset by the prices for LSS' apartments being pegged to the dollar, however.

Liquidity

LSS's liquidity has improved following the placement of a $150 million credit-linked note (CLN) in November 2010, and we currently consider the position to be "adequate". We estimate that the ratio of sources to uses is about 2x and there are no substantial shortfalls in the second year out.

The key sources of liquidity include:

- Cash and short term bank deposits of $29 million (excluding an estimated $20 million that is tied to operations);
- Availability under committed credit lines of $60 million; and
- $150 million from a CLN placement.

Key potential uses of liquidity include:

- Debt maturities of $41 million in the next 12 months ($73 million in the second year out); and
- Negative cash flow from operations, which we estimate to be about $70 million in the next 12 months.

We also note LSS' conservative approach to liquidity management and improving debt maturity profile. We estimate that the company has substantial headroom under the covenants of the CLN.

Recovery analysis

The RUB2 billion Series 1 and RUB2 billion Series 2 unsecured notes issued by LSS, are rated 'B', the same level as the corporate credit rating on LSS. The notes also carry a Russia national scale rating of 'ruA'. The recovery rating is '4', indicating our expectation of average (30%-50%) recovery in the event of a payment default.

Recovery prospects for the debt instruments reflected above have improved because of the recent repayment of a number of secured bank loans and finance leases. At the same time, we expect debt levels to increase as the company accelerates its investments in new developments. As a result, we think the company's coverage levels will decrease slightly over the medium term. Material Russian ruble depreciation versus the U.S. dollar could also depress estimated recoveries, in our view.

Our assessment of recovery prospects is based on a discrete-asset-based valuation of about RUB12.6 billion ($409 million). Recovery and issue ratings take into account the unsecured nature of the rated issues and the Russian jurisdiction, which we regard as relatively creditor unfriendly.

We believe that the Series 1 and BO-2 issues rank pari passu when compared with the senior unsecured loan, which the company onlent to CJSC SSMO "LenSpecSMU" (not rated) with the proceeds of the $150 million CLN (issued in November 2010 by North Star S.A., a Luxembourg-registered special purpose entity, on behalf of LSS). Under the trust deed, the notes benefit from guarantees provided by LSS and some of its subsidiaries. The loan documentation includes a relatively weak negative pledge, in our view, as well as a suite of incurrence covenants. For further information please see "CJSC SSMO LenSpecSMU's Recovery Rating Profile," published Dec. 11, 2009, on RatingsDirect.

Outlook

The stable outlook reflects our view that the company will be able to finance increased construction activity via available funding and gradually improving cash flow in 2011-2012. It also reflects our assumption that LSS' management will continue to adhere to its prudent financial policy.

Ratings downside could stem from LSS abandoning its cautious strategy toward debt management and new property developments. We could also lower the ratings if the cash flow from LSS' customers does not improve in 2011. Adverse developments in Russia's economy could also trigger negative rating actions.

Over the medium term, we think ratings upside could result from a further recovery in the property market and improving cash flow generation to the point where free operating cash flow is at least neutral.

Business Description

Based in St. Petersburg, Russia, LSS specializes primarily in the development and construction of residential real estate projects (90% of revenues) and industrial buildings (10%). With more than 20 years' experience, the company is one of the leaders in a highly fragmented St. Petersburg market. In the 12 months to June 30, 2010, the company generated revenues of about RUB17 billion.

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: Exposed To High-Risk Industry But Benefits From A Strong Local Market Position

The main risks associated with LSS' "weak" business risk profile are:

- A high risk industry. The property development industry is characterized by fierce competition, limited barriers to entry, heavy working-capital needs, 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, although evolving, is far from mature.
- A complex regulatory framework in Russia. In our view, the framework is complex, still developing, and lacks 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. Moreover, the regulatory framework provides little protection to buyers of real estate if the developer experiences financial difficulties. Consequently, we view sales of developments as confidence sensitive.
- Limited business scope and diversity. The core operations are dependent on property development in a single region of Russia. Furthermore, we think market specifics, such as the need to establish effective working relationships with local officials, make it very difficult to diversify and expand across different markets.
- Profits highly exposed to cyclicality. This relates to swings in demand, selling prices, and input costs.
- Exposure to Russian country risks. These include weak institutions and a volatile economy, national income, and currency. In addition, the country's financial system is still developing, in our view.

These risks are offset by:

- A track record of effectively addressing key administrative and legal risks. With more than 20 years of operation, we think LSS' management team has managed to build a successful business model.
- A favorable market position in a gradually consolidating, but still fragmented, market. This is reinforced by the company's vertically integrated operations, which provide enhanced cost and quality control of projects at almost every stage. Exposure to subcontractors' credit quality is limited because most are entities of the LSS group and are fully controlled by LSS. The company's competitive position was further enhanced by its ability to withstand the general market downturn in 2008-2009, unlike certain of its peers.
- A relatively large size and longstanding operational track record. The company's brand recognition and established administrative resources provide it with a number of competitive advantages, in our view. These include cost synergies, greater purchasing power, and frequently the first pick of government-related deals--usually federal housing programs, because authorities favor well-established counterparties.
- Good profitability historically. Although any analysis of profitability is complicated by the company's revenue recognition method. LSS has demonstrated its ability to adjust its cost base to falling workloads and selling prices, and hence preserve operating margins.

Financial Risk Profile: Weighed Down By Expectations Of Negative Operating Cash Flow

The main risks associated with LSS' "aggressive" financial risk profile are:

- A very aggressive financial policy. This is reflected in the company's historically ambitious growth strategy, high debt tolerance, and high dependence on short-term debt.
- Exposure to foreign currency fluctuations. We view devaluation of the Russian ruble against the U.S. dollar as a risk for the company because of the mismatch between dollar-denominated debt and the largely Russian ruble-denominated cash flows.
- Pressure on operating cash flow. Typically, cash flow is burdened by considerable working capital requirements because receipts from clients generally trail cash outflows for development costs and land acquisition.
- Short-dated debt maturities. The need for LSS to raise additional funding and continually refinance short-term debt heightens its financial risk, in our view, particularly at a time of difficult financial market conditions.

These weaknesses are partly offset by:

- Management's demonstrated balanced approach. This applies to new development activities and its commitment to fairly prudent cost controls and leverage reduction during the recent downturn. As far as possible, the company links housing contract prices to the U.S. dollar, with an aim to counterbalance the foreign currency exposure.
- Proactive treasury management. In addition, LSS benefits from established borrowing relationships and historically good access to the Russian loan market. Company data indicates that LSS is the largest house builder in St. Petersburg and the wider region, which should also facilitate access to funding.
- Credit measures above our guidelines for the 'B' rating. We view these measures as appropriate given the company's weak liquidity profile and difficult market conditions. Furthermore, we believe that LSS will use some of this headroom for expansionary investments once the markets recover.

Financial Statistics/Adjustments

LSS provides audited reports in accordance with Russian Accounting Standards and International Financial Reporting Standards (IFRS). 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, we think 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. As a result, current cash outflows relate to developments for which revenues and margins will be booked a few years from now.

In our analysis, we consider operating cash flow 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 (see table 1).

Table 1

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

	--Fiscal year ended Dec. 31, 2009--					
CJSC SSMO LenSpecSMU reported amounts						
	Shareholders' equity	**Operating income (after D&A)**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Capital expenditures**
Reported	6,433.1	5,911.5	803.5	2,944.4	2,944.4	325.1
Standard & Poor's adjustments						
Capitalized interest	--	--	8.3	(8.3)	(8.3)	(8.3)
Reclassification of nonoperating income (expenses)	--	157.1	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	(777.5)	(777.5)	--
Reclassification of working-capital cash flow changes	--	--	--	--	2,740.0	--
Minority interests	1,026.9	--	--	--	--	--
Total adjustments	1,026.9	157.1	8.3	(785.8)	1,954.2	(8.3)
Standard & Poor's adjusted amounts						
	Equity	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Capital expenditures**
Adjusted	7,460.0	6,068.6	811.7	2,158.5	4,898.5	316.8

*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. RUB--Russian ruble.

Table 2

CJSC SSMO LenSpecSMU--Peer Comparison*

	CJSC SSMO LenSpecSMU§	**Alliance Oil Co. Ltd.**	**Evraz Group S.A.¶**	**OAO TMK¶**
Rating as of Nov. 19, 2010	B/Stable/B	B+/Stable/--	B/Stable/--	B/Negative/--
	--Fiscal year ended Dec. 31, 2009--			
(Mil. $)				
Revenues	603.5	1,726.4	9,772.0	3,461.0
Net income from cont. oper.	112.4	343.8	(1,251.0)	(315.7)
Funds from operations (FFO)	162.7	294.3	337.0	(135.1)
Capital expenditures	10.5	208.3	465.3	395.3
Debt	201.9	570.8	8,080.1	3,778.2
Equity	247.8	1,584.5	10,515.2	1,516.7
Adjusted ratios				
Oper. income (bef. D&A)/revenues (%)	33.4	22.8	10.8	9.0
EBIT interest coverage (x)	7.5	7.2	(0.8)	(0.1)
EBITDA interest coverage (x)	7.5	9.6	1.6	0.7
Return on capital (%)	48.5	13.5	(3.0)	(0.7)
FFO/debt (%)	80.6	51.6	4.2	(3.6)
Debt/EBITDA (x)	1.0	1.5	7.7	12.1

Table 2

CJSC SSMO LenSpecSMU--Peer Comparison* (cont.)

*Fully adjusted. Excess cash and investments netted against debt. ¶Fully adjusted (including postretirement obligations). §Excess cash and investments not netted against debt.

Table 3

CJSC SSMO LenSpecSMU--Financial Summary*

	--12-months to June 30--	--Fiscal year ended Dec. 31--				
	2010	**2009**	**2008**	**2007**	**2006**	**2005**
Rating history	B/Stable/B	B/Stable/B	B/Stable/B	B/Positive/B	B/Stable/B	--/--/--
(Mil. RUB)						
Revenues	17,134.3	18,169.8	13,023.6	8,903.2	7,712.0	5,629.2
Net income from continuing operations	3,958.2	3,385.1	1,307.0	1,077.4	432.9	303.1
Funds from operations (FFO)	3,916.5	4,898.5	2,636.4	1,009.1	562.3	276.8
Capital expenditures	267.1	316.8	293.4	1,335.6	109.4	524.6
Debt	5,365.4	6,078.8	6,619.4	6,654.8	2,605.6	1,568.5
Equity	9,999.1	7,460.0	3,883.7	2,053.4	1,067.8	653.6
Adjusted ratios						
Oper. income (bef. D&A)/revenues (%)	34.3	33.4	29.2	23.4	9.5	6.6
EBIT interest coverage (x)	7.5	7.5	5.8	6.6	6.7	9.2
EBITDA interest coverage (x)	7.5	7.5	5.8	6.6	6.3	9.8
Return on capital (%)	39.2	48.5	38.4	33.2	25.9	23.6
FFO/debt (%)	73.0	80.6	39.8	15.2	21.6	17.6
Debt/EBITDA (x)	0.9	1.0	1.7	3.2	3.6	4.2

*Fully adjusted. RUB--Russian ruble.

Ratings Detail (As Of November 19, 2010)*		
CJSC SSMO LenSpecSMU		
Corporate Credit Rating		B/Stable/B
Russia National Scale Rating		ruA/--/--
Senior Unsecured (2 Issues)		B
Russia National Scale Rating (2 Issues)		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		Weak
Financial Risk Profile		Aggressive

Ratings Detail (As Of November 19, 2010)***(cont.)**
Debt Maturities
(As of Sep. 30, 2010) 2010: $13 mil. 2011: $45 mil. 2012: $86 mil. Thereafter: $47 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.

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