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CJSC SSMO LenSpecSMU

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Major Rating Factors

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

Strengths:

- Leading market position in St. Petersburg and the surrounding region in residential property development 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:

- Weak liquidity profile, characterized by substantial short-term debt and ongoing refinancing needs
- Severe cyclical downturn in Russia's property markets
- Lack of administrative transparency and predictability
- Risky industry profile, owing to volume and price volatility
- Limited business scope and diversity

Rationale

The ratings on Russia-based property developer CJSC SSMO LenSpecSMU (LSS) are constrained by the company's aggressive financial risk profile, according to our classifications. The company is exposed to liquidity risks because the substantial majority of its debt is short term and it has constant refinancing needs. Furthermore, LSS' operations are affected by the continuing weak demand for residential property in the Russian Federation (foreign currency BBB/Negative/A-3; local currency BBB+/Negative/A-2). Standard & Poor's Ratings Services believes this weakness is likely to continue well into 2010. Other negative rating factors are, in our view, the country's lack of administrative transparency and predictability, and its dependence on property development in a single region of Russia.

These risks are moderated, however, by LSS' leading and recently expanded position in its core market of St. Petersburg and the surrounding region, an established track record of completing projects, and brand recognition, which are all even more essential in times of the industry downturn. 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, has demonstrated proactive treasury management, established borrowing relationships, and historically has had good access to the Russian loan market.

Key business and profitability developments

LSS' operations continue to be affected by a severe downturn in local housing markets since late 2008. Although the company's operating trends are encouraging, we believe housing demand and pricing will remain under pressure in the near term due to negative macroeconomic dynamics and low consumer confidence. However, we believe that LSS will continue to mitigate this weakness by its demonstrated ability to manage its development pipeline in a context of falling demand and by its fairly stable inflow of customer orders in the first 10 months of 2009, even though these have been significantly lower than very robust 2008 levels. Housing orders are suffering only modest cancellation and default rates, but in our view they remain at risk in the current economic environment.

Management information indicates that LSS' operations are resilient to tight access to mortgage financing because mortgages fund only a small share of customer contracts.

We estimate that LSS will maintain its good profitability measures in 2009, achieving an EBITDA margin at 20%-30%, because the drop in home prices and new customer orders will likely be offset by reduced building materials prices and cost-cutting initiatives. On the negative side, any further potential 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.

Key cash flow and capital-structure developments

Like many of its peers, LSS entered the housing downturn with an aggressively leveraged balance sheet, owing to its ambitious largely debt-funded growth strategy over recent years. As of Dec. 31, 2008, reported debt reached a peak of about Russian ruble (RUR) 6.6 billion, which has subsequently been reduced using internal cash resources to about RUR4.5 billion as of Nov. 30, 2009, based on the company's information. We view this positively for credit quality, particularly in the context of weak markets.

Overall, LSS' financial profile has held up much better than some of its peers, but the company's cash flows are likely to face near-term pressures on lower order intake in 2009 year on year. The company's results for the 12 months to June 30, 2009, indicate that its credit ratios were above levels we consider commensurate for the ratings: debt to EBITDA was about 1.0x and debt to capital about 50%. However, these are not the most meaningful indicators because of the nature of real estate development and the company's completed contract method of accounting.

Liquidity

Despite the most recent refinancing events, we view LSS' liquidity as weak, according to our classifications, because of the company's ongoing exposure to refinancing requirements and current lack of available liquidity sources to fully cover its debt obligations in the next 12 months. Nevertheless, we believe that LSS' exposure to liquidity risk has decreased compared with the beginning of the year after it obtained a number of bilateral loans from its relationship banks. This helped the company to lengthen and better distribute its debt repayment profile.

It is our understanding that the company should be able to tackle its 2010 maturities and amortization payments of about $100 million with modest additional refinancing required. What's more, the company is currently in the final stages of arranging a RUR2 billion bond issue. A successful placement of this bond would fully address debt payment obligations until the end of 2010 and strengthen LSS' liquidity profile.

Inflow of new customer deposits and advances remains an essential component to LSS' financial flexibility to finance its ongoing operations and, in part, debt maturities. Management information indicates that the company has about $75 million of contracted cash flows in 2010 and about $35 million in 2011, although there is a risk of some customer contracts defaulting or being renegotiated in the current environment.

The recent restructuring of credit-linked note 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 proposed RUR2 billion ($65 million) unsecured notes to be issued by Russia-based construction and development group CJSC SSMO LenSpecSMU (B/Stable/B), are rated 'B' and have a Russia national scale rating of 'ruA', the same level as the corporate credit rating on the issuer. The recovery rating is '4', indicating Standard & Poor's expectation of average (30%-50%) recovery in the event of a payment default.

The $100 million ($24.4 million currently outstanding) credit-linked notes (CLNs) issued by Golden Ring Finance S.A. and guaranteed by LSS, are rated 'B', the same level as the corporate credit rating on the guarantor company. The recovery rating is '4', indicating Standard & Poor's Ratings Services' expectation of average (30%-50%) recovery in the event of a payment default.

For further information see “CJSC SSMO LenSpecSMU’s Recovery Rating Profile,” published on Dec. 11, 2009, on RatingsDirect.

Outlook

The stable outlook reflects our view that, despite the currently difficult credit markets, LSS will be able to refinance its short-term debt maturities. Furthermore, we believe that the management will stick to its financial discipline and prudent approach to a new development schedule in light of weak demand, two factors that we consider are essential factors in maintaining a credit profile commensurate with the current ratings.

We would consider lowering the rating if LSS fails to adequately address the constraints posed by its short-term debt maturities. Downward rating pressure could also stem from LSS abandoning its cautious strategy toward new developments or another sharp demand decline for residential assets. Adverse developments in Russia's transitional regulatory and administrative environment could also trigger negative rating actions. Ratings upside is unlikely in the near term given the dismal real estate market and uncertain outlook for recovery.

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 building (10%). With more than 20 years' experience, the company is the leader in a highly fragmented St. Petersburg market. In the 12 months to June 30, 2009, the company generated revenues of about RUR18 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 Industry Risk, But Has A Strong Local Market Position

We characterize LSS business risk profile as weak for the following reasons:

- The property development industry bears high risk. This is because of fierce competition and 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.

- The regulatory framework in Russia 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.
- LSS' business scope and diversity is limited. It depends 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.
- Profitability is highly exposed to cyclical movements in demand, selling prices, and input costs.

These risks are mitigated by:

- LSS' established management track record and the management's ability to effectively address key administrative and legal risks. Over its more than 20 years in business, LSS has managed to build a successful business model.
- A leading market position in a consolidating market. This is reinforced by its 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 of them are entities of the LSS group and are fully controlled by LSS.
- LSS' larger size compared with peers and longstanding operating track record. The company's 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.
- Good profitability. LSS has demonstrated its ability to adjust its cost base to falling workloads and selling prices, and hence preserve operating margins.

Financial Risk Profile: Aggressive, Due To An Ambitious Growth Strategy And Weak Liquidity

We characterize LSS' financial risk profile as aggressive for the following reasons:

- It has a very aggressive financial policy track record, reflected in its historically ambitious growth strategy, high debt tolerance, and high dependence on short-term debt.
- It is exposed to foreign currency fluctuations. 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 typically are burdened by considerable working-capital requirements because receipts from clients generally trail cash outflows for development costs and land acquisition.
- It has short-dated debt maturities. The need to raise additional funding and continually refinance short-term debt heightens LSS' financial risk, particularly in currently difficult financial markets.

These weaknesses are partly mitigated by:

- Management's demonstrated balanced approach toward new development activities and commitment to fairly prudent cost control and leverage reduction during the current downturn. As far as possible, the company links housing contract prices to the dollar, with an aim to counterbalance the 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.
- LSS' credit measures are above our guidelines for the 'B' rating. We view these measures as appropriate given the company's weak liquidity profile and difficult market conditions. What's more, 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 noted 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, 2008--					
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	3,048.0	3,668.8	577.4	2,085.2	2,085.2	371.7

Table 1

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

Standard & Poor's adjustments						
Capitalized interest	--	--	78.3	(78.3)	(78.3)	(78.3)
Reclassification of nonoperating income (expenses)	--	107.1	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	(640.0)	(640.0)	--
Reclassification of working-capital cash flow changes	--	--	--	--	1,269.6	--
Minority interests	835.7	--	--	--	--	--
Total adjustments	835.7	107.1	78.3	(718.4)	551.2	(78.3)

Standard & Poor's adjusted amounts

	Equity	EBIT	Interest expense	Cash flow from operations	Funds from operations	Capital expenditures
Adjusted	3,883.7	3,776.0	655.8	1,366.9	2,636.4	293.4

*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	Uralsvyazinform (OJSC)	Southern Telecommunications Co. (OJSC)	OAO TMK	OMZ
Corporate credit rating*	B/Stable/B	B+/Stable/--	B/Stable/--	B/Negative/--	B-/Stable/--
Business risk profile	Weak	Fair	Weak	Fair	Weak
Financial risk profile	Aggressive	Aggressive	Highly leveraged	Highly leveraged	Highly leveraged
(Mil. $)	**--Average of past three fiscal years--**				
Revenues	365.1	1,417.9	741.7	4,423.7	933.9
EBITDA	80.4	461.3	281.2	904.0	77.8
Net income from cont. oper.	34.8	69.3	18.0	376.2	49.7
Funds from operations (FFO)	50.0	340.9	160.8	599.4	58.2
Capital expenditures	24.9	292.4	144.2	613.4	68.3
Free operating cash flow	(62.6)	78.5	24.2	(224.1)	(59.7)
Debt	197.8	1,173.9	919.7	2,066.1	422.0
Equity	85.1	758.9	327.8	1,919.2	286.7
Adjusted ratios					
Oper. income (bef. D&A)/revenues (%)	22.3	33.3	38.1	20.3	8.3
EBITDA interest coverage (x)	6.1	4.2	3.1	6.0	1.9
Return on capital (%)	34.7	11.0	10.6	19.9	10.0

Table 2

CJSC SSMO LenSpecSMU -- Peer Comparison* (cont.)					
FFO/debt (%)	26.3	29.2	17.6	29.0	13.8
Free operating cash flow/debt (%)	(28.6)	6.7	2.6	(10.8)	(14.1)
Debt/EBITDA (x)	2.4	2.5	3.3	2.3	5.4
Total debt/debt plus equity (%)	69.4	60.7	73.8	51.8	59.5

*As of Dec. 11, 2009.

Table 3

CJSC SSMO LenSpecSMU -- Financial Summary*

Industry Sector: Capital Goods/Diversified

	--Fiscal year ended Dec. 31--				
(Mil. RUR)	**2008**	**2007**	**2006**	**2005**	**2004**
Revenues	13,023.6	8,903.2	7,712.0	5,629.2	6,145.2
EBITDA	3,805.8	2,087.1	728.9	369.4	187.8
Net income from continuing operations	1,307.0	1,077.4	432.9	303.1	104.8
Funds from operations (FFO)	2,636.4	1,009.1	562.3	276.8	0.0
Capital expenditures	293.4	1,335.6	109.4	524.6	0.0
Free operating cash flow	1,073.5	(4,970.4)	299.4	(2,171.1)	0.0
Debt	6,619.4	6,654.8	2,605.6	1,568.5	267.7
Equity	3,883.7	2,053.4	1,067.8	653.6	336.7
Adjusted ratios					
Oper. income (bef. D&A)/revenues (%)	29.2	23.4	9.5	6.6	3.1
EBIT interest coverage (x)	5.8	6.6	6.7	9.2	28.3
EBITDA interest coverage (x)	5.8	6.6	6.3	9.8	33.7
Return on capital (%)	38.4	33.2	25.9	23.6	32.6
FFO/debt (%)	39.8	15.2	21.6	17.6	0.0
Debt/EBITDA (x)	1.7	3.2	3.6	4.2	1.4
Debt/debt and equity (%)	63.0	76.4	70.9	70.6	44.3

*Fully adjusted. RUR--Russian ruble.

Ratings Detail (As Of December 11, 2009)*

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

Ratings Detail (As Of December 11, 2009)***(cont.)**		
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
Debt Maturities		
(As of Dec. 31, 2009) 2010: $102 mil. 2011: $23 mil. 2012: $14 mil. Thereafter: $18 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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