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CJSC SSMO LenSpecSMU

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Major Rating Factors

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

Strengths:

- A leading construction company in the St. Petersburg area
- Degree of vertical integration, with enhanced process and cost control
- Sound growth in scale, revenues, and profitability
- Favorable market conditions, fueled by Russia's positive economic and demographic characteristics
- Commitment to prudent development, marketing, and financial-risk policies

Weaknesses:

- Aggressive growth ambitions, including regional expansion
- Risky industry profile
- Fragmented and competitive markets
- Uncertainty associated with Russia's evolving political and business climate
- Limited business diversity
- Negative free operating cash flows

Rationale

The ratings on Russia-based construction and development group CJSC SSMO LenSpecSMU (LSS) are constrained by: its ambitious expansion plans; the industry's cyclical nature, with heightened sensitivity to economic dynamics and uncertainty associated with Russia's evolving political and business climate; and the country's lack of administrative transparency and predictability. Other negative rating factors are the group's dependence on property development in a single region of Russia; the property development industry's risky profile, including high competition and volume and price cyclicality; property investors' penchant for speculation; and negative free operating cash flows owing to heavy working-capital needs.

Conversely, the group's leading position in its core market, Northwestern Russia, combined with an established track record and brand recognition moderate these risks. LSS' control of all the stages of a project's evolution allows it to manage quality and cost effectively. Furthermore, management is committed to prudent development, marketing, and financial-risk policies, including careful liquidity management. The company is also able to effectively address key administrative and legal risks.

LSS has been able to improve its profitability because of dynamic trading activity in the St. Petersburg real estate market, which supported strong price appreciation for residential units, and management's increasing focus on managing risks and expanding economies of scale. As a result, its EBITDA margin is expected to have been 25%-30% for the full year 2007, up from 10% in 2006. We believe LSS' solid pipeline of projects and still healthy market demand will sustain operating performance in the near to medium term. Nevertheless, operating margins are likely to contract if property price appreciation slows again.

Fueled by favorable economic and market dynamics in Russia, the company has pursued an aggressive growth strategy with increased capital requirements. As a result, its total debt increased to Russian ruble (RUR) 6.5 billion on Dec. 31, 2007 (RUR6.0 billion on March 7, 2008, following the early repayment of RUR bond series 01), from RUR2.6 billion on Dec. 31, 2006. This increase was balanced by solid growth in revenue and EBITDA, which is likely to continue in the future. Total debt to EBITDA and asset coverage (total assets to total debt) are both expected to have been about 3.2x for full-year 2007, compared with 3.5x and 5.3x, respectively, in 2006.

Liquidity

LSS' current liquidity is adequate. On March 7, 2008, the company had RUR5.6 billion in untapped credit facilities, of which RUR1.4 billion were short term. This compares well with debt of RUR0.74 billion maturing before March 2009. Although the company's near-term investment requirements should not require material usage of debt, its financial flexibility relies on external funding from customer advances.

We expect LSS to continue to maintain adequate headroom within the guidelines of financial covenants under its credit-linked notes (CLN) obligations, such as a debt to EBITDA ratio of less than 4x and an interest coverage ratio of more than 2.5x.

Outlook

The positive outlook reflects Standard & Poor's Ratings Services view that the ratings could be raised one notch if LSS maintains its prudent financial policy of keeping debt to EBITDA at or below 3.5x, while successfully managing its work-in-progress to cash-conversion cycle in the context of rapid growth. Conversely, the company's outlook or ratings could come under pressure as a result of unexpected deterioration in operating profitability and the market, overly aggressive expansion into new markets or businesses, or adverse changes in the evolving regulatory and administrative environment.

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' industry experience, the company is one of the leaders in a highly fragmented St. Petersburg market, and had a market share of about 10% in 2007. The company generated revenues of about RUR8.0 billion in 2007.

Business Risk Profile: Vulnerable, But Benefits From Leading Positions In Expanding But Risky Markets

Risky industry characteristics in an evolving economic and legal environment constrain LSS' business risk profile. It is also hampered by limited business diversity and specifics that somewhat reduce the company's potential to diversify and expand across different markets. These negative factors are partly offset by LSS' proven business model, established management track record, and still favorable market fundamentals with good growth potential.

Industry characteristics/Market attractiveness: Good fundamentals support demand growth despite high industry-specific risks

Although affordability declined following strong price increases, particularly in 2006, good demand for new residential and commercial real estate in Russia is expected to continue in the near to medium term, helped by:

- The solid macroeconomic environment, with GDP growth that surpassed 8% in 2007 and which is expected to be 5%-6% in 2008, supported by strong foreign investments and impressive resilience in the manufacturing sector;
- Favorable demographic trends, such as increasing disposable income levels and the desire to improve the standard of living, given very low per capita residential space in Russia (20 square meters per person) by European industry standards (50 square meters per person), the sizable shortage of good-quality residential units, migration from the suburbs to large cities, and the potential for residential-asset price appreciation, which promotes the development of the currently immature rental market;
- Public policies supporting housing programs; and
- Increasingly favorable lending conditions, including lower mortgage rates and longer credit terms.

The company's home market, St. Petersburg, being the second-largest city and economic center in Russia has a quickly expanding economy. As part of the ongoing trend of rising investment in the region, many foreign multinationals set up operations that result in steadily increasing incomes and demand for residential real estate.

Industry-specific risks offset these favorable market and industry prospects:

- The cyclical nature of the real estate and construction markets that are also highly sensitive to the economic and political environment, which--albeit evolving--is far from mature;
- Heavy working-capital needs, as receipts from clients typically trail cash outflows for land acquisition and development; and
- Fierce competition and limited barriers to entry.

Regulation: Complex and evolving framework

Regulation of the construction industry, as in many other key sectors in Russia, is evolving. On the one hand, there is a strict, elaborate, and quite complex regulatory framework that covers various stages of a project from its initial consideration and approval through to the construction phase and final certification of completion. On the other hand, limited regulatory support is provided to property buyers, who are basically viewed as equity investors and fully share completion risks with the company developing the project. There is, therefore, potential for increased regulatory involvement, especially because of the fairly high incidence of people falling victim to unfinished and abandoned projects for which they have prepaid substantial amounts.

Another important regulatory issue stems from LSS' need to make significant efforts at building and maintaining administrative relationships with the local authorities in regions where it operates or plans to operate. Although a solid, established relationship with the authorities in St. Petersburg is advantageous, the company's ability to effectively replicate this in the other regions is uncertain. This is because the regional governments have different policies, which could hinder LSS' regional expansion plans.

Competitive Position: Leading market shares, but lack of diversity

The market is very fragmented, with the top-eight players accounting for about one-third of total development volume. Entry barriers are relatively low, and LSS competes with smaller local players. The company's competitive position is reinforced by its vertically integrated business model, which provides enhanced cost and quality control of projects at every stage. LSS' larger size compared with its peers, long-standing track record, brand recognition, and established administrative resource 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.

The ongoing market consolidation presents the opportunity for the company to solidify its leadership position, as well as increases the threat of competing players. At present, LSS' activities in mergers and acquisitions are limited to those that provide additional land ownership and space for the construction of projects, and we do not expect the company to become a major market consolidator in the near term.

In the medium term, LSS is planning to participate in promising regional markets marked by accelerating growth, although its competitive advantages are likely to be tempered by its limited size and recognition in other markets. In the medium term, the company faces key challenges if it pursues its growth plans and focuses on geographic diversification, among them: local competition, establishment of brand recognition, and the ability to construct effective working relationships with respective municipal authorities.

Business model/Risk management: Effective quality and cost management through control of all project phases

Over its relatively long history of more than 20 years, LSS has managed to build a successful business model that enables it to control nearly all stages of project development. Several of its operating subsidiaries and associated companies (in which LSS holds large minority stakes) include those that produce key building materials and provide construction services. This allows more efficient management of cost structure, quality control, and supply consistency. Internally produced materials and services cover about 90% of the company's production requirements, allowing it to minimize dependence on external suppliers.

LSS pursues developments speculatively and does not apply a pre-sell policy before starting construction works. This risky strategy has so far been supported by favorable market conditions, with generally 80%-90% of units sold before construction is completed; it, however, makes the company vulnerable to potential adverse changes in customer demand.

In the past, LSS was successful in acquiring land either through tenders or directly from owners. The company operates with land that is either leased (50%) or acquired. Owning plots of land helps it to secure a supply of projects and achieve higher top-line operating margins should land prices rise during the life of a project. Nevertheless, land ownership ties up capital and burdens the company's capital structure.

To increase the value-added component of sales, LSS offers apartment-finishing services, which bring the property to livable or move-in condition. However, only about 25% of buyers choose this option, while the rest use the small niche-market firms typical of the Russian market. This highlights the commodity-like mature of unfurnished apartments primarily sold by developers like LSS.

Ownership/Management/Corporate governance

LSS is a privately owned company. Its principal shareholder is the Zarenkov family, while the minority holders are Baring Vostok, a Russian private equity fund which holds 15%, and members of the group's management. Acting and retired managers of group entities also own minority stakes, although none of them hold more than 2.5%. The company does not plan to change its ownership structure in the short to medium term. However, after 2009, the group plans to offer 10%-20% of its share capital to the public. The IPO would take place either in Russia or abroad.

Profitability: Exposed to movements in selling prices and input costs

The company's profitability has improved, buoyed by strong upward selling price development and management's increasingly focused approach to managing risks and expanding economies of scale. As a result, LSS' EBITDA margin is expected to have improved to about 25%-30% for the full year 2007, from 10% in 2006. We believe the company's solid pipeline of projects and still healthy market demand should sustain operating performance in 2008 and 2009, although operating margins are likely to contract if property price appreciation slows. There is less visibility beyond this period, and it remains to be seen how future operating margins will develop, given uncertainty over the magnitude of price corrections for housing units and the need to secure land at higher prices.

Financial Risk Profile: Highly Leveraged. Aggressive, Partly Debt-Funded Growth Strategy

LSS's weak cash flow generation, burdened by considerable working-capital requirements, as well as high financial leverage impair its financial risk profile. Factors that partly offset these negative aspects are management's commitment to prudent development, marketing, and financial risk policies that include careful liquidity management.

Accounting

LSS provides audited reports in accordance with both Russian Accounting Standards and International Financial Reporting Standards (IFRS). In 2007, the company started reporting semiannually under IFRS. We did not make any material adjustments to its reported financial statistics (see table 1). 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.

Table 1

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

	--Fiscal year-ended Dec. 31, 2006--			
	Shareholders' equity	**Operating income (after D&A)**	**Cash flow from operations**	**Cash flow from operations**
Reported	1,004.5	687.8	489.4	489.4
Standard & Poor's adjustments				
Reclassification of nonoperating income (expenses)	--	92.5	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	(80.8)	(80.8)
Reclassification of working-capital cash-flow changes	--	--	--	153.4
Minority interests	63.2	--	--	--
Other	--	--	(1,802.5)	--
Total adjustments	63.2	92.5	(1,883.3)	72.7
Standard & Poor's adjusted amounts				
	Equity	**EBIT**	**Cash flow from operations**	**Funds from operations**
Adjusted	1,067.8	780.3	(1,393.9)	562.0

*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.

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, they represent 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.

Corporate governance/Risk tolerance/Financial policies

LSS' financial policy is aggressive, partly supported by Russia's favorable industry dynamics. Nevertheless, management's demonstrated commitment to fairly prudent cost control and weighted financial-risk appetite somewhat moderate the risks associated with aggressive growth.

The aim of the company's recently established internal financial policy is to maintain its debt-to-EBITDA ratio at less than or equal to 3.5x, which is somewhat more conservative than the 4x stipulated in the CLN documentation. The company's financial leverage peaked in 2007, but its free cash flows could recover from negative territory in the near to medium term.

Cash flow adequacy: Negative free operating cash flows with short-to-medium term potential for improvement

Helped by increasing EBITDA generation, funds from operations (FFO) are expected to have improved in 2007 compared with 2006. However, because of substantial investment spending on new projects, the company had to rely heavily on external sources of financing to close the gap between working-capital needs and inflows from internal cash generation and advances from customers. As a result, its debt increased materially and largely offset improved operating cash flow generation, with FFO to debt expected to have been about 20% for full-year 2007 compared with 22% in 2006. Financial leverage in relation to LSS' continuously expanding business scale could decline to more moderate levels and support improvements to cash-flow protection measures in the near to medium term.

Capital structure/Asset protection: High leverage following recent rapid growth

The company's aggressive growth strategy and high capital requirements caused total debt to increase to RUR6.5 billion by Dec. 31, 2007 (RUR6.0 billion on March 7, 2008 following the early repayment of RUR bond series 01) from RUR2.6 billion on Dec. 31, 2006. This, however, was offset by solid growth in revenue and EBITDA, which we expect to continue. Total debt to EBITDA and asset coverage (total assets to total debt) are both expected to have been about 3.2x for full-year 2007, compared with 3.6x and 5.3x, respectively, in 2006, which is well in line with the ratings.

LSS' asset structure mainly consists of receivables and inventories (construction in progress), which is typical for the sector and together account for more than three-quarters of total assets. Accordingly, the proportion of fixed assets is relatively small and for the most part comprises land plots. The bulk of liabilities consists of customer advances and payables, which we regard as an alternative source of funding.

Table 2

CJSC SSMO LenSpecSMU--Peer Comparison

	CJSC SSMO LenSpecSMU	OJSC KD Group	Southern Telecommunications Co. (OJSC)	JFC Group Co. Ltd. (CJSC)	Kazanorgsintez OJSC
Corporate credit rating*	B/Positive/B	B-/Stable/--	B/Positive/--	B-/Watch Neg/--	B-/Stable/--
(Mil. $)	**LTM ended June 30, 2007**	**--Fiscal year ended Dec. 31, 2006--**			
Revenues	385.4	43.2	680.3	381.8	616.6
EBITDA	77.4	9.8	265.2	42.5	163.7
Funds from operations (FFO)	70.3	5.5	105.7	32.6	128.0
Debt	167.0	44.3	946.7	192.0	496.0
Equity	78.8	29.0	326.4	N.A.	528.0
Adjusted ratios					
EBITDA/revenues (%)	20.1	22.7	37.7	11.1	26.5
EBITDA interest coverage (x)	17.5	2.2	2.8	N.A.	4.2
FFO/debt (%)	42.1	12.3	11.2	17.0	25.8
Debt/EBITDA (x)	2.2	4.6	3.7	4.5	3.1
Debt/total capital (%)	67.9	60.7	74.4	N.A.	48.4

*As of April 4, 2008. LTM--Last 12 months. N.A.--Not available.

Table 3

CJSC SSMO LenSpecSMU--Financial Statistics

(Mil. RUR)	**LTM ended June 30,**	**--Fiscal year ended Dec. 31--**	
	2007	**2006**	**2005**
Revenues	10,212	7,712	5,629
EBITDA	2,050	729	555
Funds from operations (FFO)	1,862	562	277
Debt	4,497	2,606	1,569
Equity	2,089	1,068	654
Adjusted ratios			
EBITDA/revenues (%)	20.1	9.5	9.9
FFO/debt (%)	42,1	21,6	17,6
EBITDA interest coverage (x)	17,5	6,3	14,7
Debt/EBITDA (x)	2.2	3,6	2,8
Debt/total capital (%)	67.9	70,9	70,6

RUR--Russian ruble. LTM--Last 12 months.

Ratings Detail (As Of April 4, 2008)*

CJSC SSMO LenSpecSMU	
Corporate Credit Rating	B/Positive/B
Russia National Scale Rating	ruA/--/--

Ratings Detail (As Of April 4, 2008)***(cont.)**		
Senior Unsecured		
Foreign Currency		B
Russia National Scale Rating		ruA
Corporate Credit Ratings History		
12-Dec-2007	*Foreign Currency*	B/Positive/B
22-Dec-2006		B/Stable/B
12-Dec-2007	*Local Currency*	B/Positive/B
22-Dec-2006		B/Stable/B
22-Dec-2006		B/Stable/--
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 March 7, 2008) 2008: $18.3 mil. 2009: $62.0 mil. 2010: RUR1.5 bil. 2011: $6.1 mil. 2012: $100.0 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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