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January 10, 2012

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 in residential property development in St. Petersburg and the surrounding region, with an established track record and brand recognition.
- Considerable vertical integration, with enhanced process and cost controls.
- Adequate liquidity.

Weaknesses:

- Cyclical demand and prices in the housebuilding industry reflect consumer confidence and the availability of consumer funding.
- Exposure to regulatory risks in the areas of planning and construction oversight.
- A long operating cycle, combined with capital tied up in land bank investments.
- Exposure to volatility in the cost of building materials and labor.

Rationale

The ratings on Russia-based property developer CJSC SSMO LenSpecSMU reflect Standard & Poor's Ratings Services' view of the company's business risk profile as "weak" and its financial risk profile as "aggressive."

LenSpecSMU's business risk profile is in our opinion constrained by the inherent volatility and long operating cycle of the property development industry, Russia's lack of administrative transparency and predictability, and LenSpecSMU's dependence on property development in a single region of Russia. These risks are moderated, however, by LenSpecSMU's favorable and recently expanded position in its core market of St. Petersburg 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). Further support for the rating and established track record of completing projects and effectively addressing key administrative and legal risks.

We also believe that LenSpecSMU's control of all the stages of a property development project should allow it to manage quality and costs adequately.

LenSpecSMU's "aggressive" financial risk profile is constrained by our projection of negative cash flow from operations in 2011 and in following years, consequently rising debt levels, and the inherent volatility of cash flows arising from a long operating cycle. On average, LenSpecSMU takes 30 months in the construction phase of its projects. We also note the analytical complexity associated with the company's completed-contract method of accounting, which reduces the visibility of current operating trends. That said, this method does reduce the risk of a downward revision of reported results. We assess LenSpecSMU's liquidity profile as "less than adequate," due to the company's stated aim of starting a new phase of real estate development over the next two years. LenSpecSMU's relatively high usage short-term debt funding is partially mitigated by the diversification of capital sources following its recent listing on the London Stock Exchange.

S&P base-case operating scenario

We anticipate that LenSpecSMU's cash inflow from customers will improve in 2011 on the back of increasing activity levels. However, customer orders and prices remain vulnerable to potential new economic shocks, in our view.

At the same time, LenSpecSMU is ramping up its construction activity, which was curtailed in 2009, and will start new development projects as its stock of completed apartments available for sale reduces.

S&P base-case cash flow and capital-structure scenario

We anticipate that LenSpecSMU's operating cash flow will be negative in the second half of 2011 and in 2012-2014 because cash inflow from customers will lag outflows on the development of new projects. As a result, leverage will in our view likely increase. This increase should be partly offset, in our view, by the availability of funding in the form of cash and committed lines to meet the cash flow shortfall, and by the company's ability to curtail constructions works if demand for property weakens or if credit markets deteriorate. LenSpecSMU's debt leverage also remains relatively low at 2.1x, which helps to moderate refinancing risks.

As of June 30, 2011, gross debt was Russian ruble (RUB) 9.2 billion versus RUB1.6 billion of cash.

We note LenSpecSMU's exposure to foreign exchange risk, 56% of its gross debt being denominated in U.S. dollars. This is partly offset by prices for LenSpecSMU apartments being pegged to the U.S. dollar.

Looking ahead, we estimate that LenSpecSMU's profitability will be below the record levels achieved before the global downturn because of the risk of housing prices in Russia lagging general price inflation. However, this should be partly offset by lower building materials prices and cost-cutting initiatives.

LenSpecSMU's revenues for the first six months of 2011 decreased by 5.3% year on year to RUB16.2 billion, and the operating margin of 25.7% was below last year's figure of 33.3%. Both figures reflect depressed sales in 2009. New sales agreements have been growing at an annualized rate of more than 20% in 2010 and 2011, increasing the potential for cash inflows and operating profitability in 2012 and 2013.

Liquidity

We assess LenSpecSMU's liquidity position as "less than adequate" under our criteria. Although liquidity has improved following the IPO in April 2011, it has now deteriorated due to the large cash outflows for future developments. We estimate that the ratio of sources to uses will be about 1.1x in 2011. In 2013, we anticipate that liquidity should return to a level that we would deem "adequate" on the back of significantly lower working capital outflows.

The main sources of liquidity in the 12 months to December 2012 include:

- Cash and short-term bank deposits of RUB2.4 billion;
- Availability under committed credit lines of RUB2.8 billion;
- RUB1.9 billion incoming funds from operations (FFO); and
- RUB2.1 billion of increased share capital from the recent IPO and an RUB1 billion one-off asset disposal.

Potential uses of liquidity over the 12 months to December 2012 include:

- Debt maturities of RUB1.7 billion;
- Working capital outflows of RUB7.6 billion, which is used for new real estate project developments; and

- Capital expenditures expected at RUB169.2 billion and RUB50 billion for acquisitions.

Recovery analysis

The issue rating on the LenSpecSMU-guaranteed RUB2 billion 14.5% senior unsecured notes due 2013, RUB2 billion senior unsecured 16% notes due 2012, and $150 million series 2010-01 limited-recourse secured notes due 2015 is B', in line with the corporate credit rating. The recovery rating on the notes is '4', indicating expectations of average (30%-50%) recovery prospects in the event of a payment default.

Outlook

The stable outlook reflects our view that LenSpecSMU should be able to finance increasing construction activity with available funding and gradually improving cash flows. We assume that LenSpecSMU's management will continue its prudent financial policy of tailoring cash outflows into ongoing construction to the cash inflows from committed and partly pre-paid sales. We also assume that LenSpecSMU will continue to roll over its short-term funding due the track record of maintaining a steady bank group relationship.

Downward rating pressure could arise if LenSpecSMU abandons its cautious strategy in respect of phasing in new developments, or if there are adverse developments in Russia's macroeconomic environment. Rating upside is contingent, in our view, on LenSpecSMU's ability to reduce the share of short-term debt in its funding structure, as well as the indication of operating cash flow trends for the next two years. The latter should become more visible after the publication of financial year 2011 results and trading updates for the first half of 2012.

Business Description

Based in St. Petersburg, Russia, LenSpecSMU 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 construction market. In the six months to June 30, 2011, the company generated revenues of about RUB7 billion, compared with RUB9 billion over the same period a year earlier.

LenSpecSMU is privately owned. Its principal shareholder is the Zarenkov family (47%), with minority stakes held by Russian private-equity fund Baring Vostok (11%) and members of the company's management team.

Business Risk Profile: Weak, Driven by Uncertain Regulatory Environment in Russia

The major constraints for the "weak" business risk profile of LenSpecSMU are:

- The high risks involved in the property development industry. 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, which 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. The regulatory framework also provides little protection to buyers of real estate should the developer experience financial difficulties. Hence, consumers are sensitive to the reputation and financial standing of real estate developers.
- The company's limited business scope and diversity. LenSpecSMU 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 difficult to diversify and expand across different markets.
- The high exposure of profitability to cyclical movements in demand, selling prices, and input costs.
- The company's exposure to Russia country risks, including weak institutions, a volatile economy, national income and currency, as well as a still-developing financial system.

These constraints are mitigated by:

- Management's ability to effectively address administrative and legal risks. With more than 20 years in business, we believe the company has managed to build a successful business model, resulting in profitable growth.
- A favorable market position in a gradually consolidating, but still fragmented market. This is reinforced by LenSpecSMU's vertically integrated operations, which in our view 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 group and are fully controlled by LenSpecSMU. The company's competitive position was further enhanced by its ability to withstand the market downturn in 2008-2009, unlike some of its peers.
- LenSpecSMU's larger size compared with peers, and its 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.
- Historically good profitability, although our analysis of profitability is complicated by the company's revenue recognition method (see accounting section). LenSpecSMU has demonstrated its ability to adjust its cost base to falling workloads and selling prices, and hence preserve its operating margins.

Financial Risk Profile: Aggressive; Adversely Affected By A Relatively Low Level of Liquidity

The main weaknesses of LenSpecSMU's "aggressive" financial risk profile are:

- Cash flows that are inherently volatile and reflect fluctuating demand for residential property. This demand in turn depends on the macroeconomic conditions in the Russian Federation.
- Operating cash flows that are typically burdened by considerable working-capital requirements, because receipts from clients generally trail cash outflows for development costs and land acquisitions.
- Exposure 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. This is partly offset by the fact that selling prices for properties are largely pegged to the U.S. dollar.

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 in periods of weak demand.
- LenSpecSMU's ability to curtail development spending in periods of declining demand and sales, which enables it

to generate positive cash flow and reduce debt as occurred in the downturn of 2008-2009.

- Proactive treasury management and an improving debt maturity structure, with moderate maturities in 2011-2012 ahead of an increase in cash outflows into new development planned for 2012-2013.

Financial Statistics/Adjustments

LenSpecSMU provides audited reports in accordance with Russian Accounting Standards and International Financial Reporting Standards.

Off-balance-sheet liabilities include guarantees, which the company provides for its customers, in favor of banks; guarantees for leased equipment; and industry-specific project-completion or performance bonds, which we consider in our analysis, but do not include in any of our financial ratios.

LenSpecSMU 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 adopted by most property developers. The completion method of accounting typically generates a delay between the time the company receives cash from customers as a project progresses and the time it books the related revenues 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 LenSpecSMU's actual cash generation. The use of FFO--the most frequently used credit measure in industrial credit ratings--can be misleading. This is because FFO 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

	--Fiscal year ended Dec. 31, 2010--									
CJSC SSMO LenSpecSMU reported amounts										
(Mil. RUB)	**Debt**	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	9,164.0	10,173.3	17,708.5	5,575.0	5,393.1	604.7	(1,245.0)	(1,245.0)	--	169.2
Standard & Poor's adjustments										
Reclassification of nonoperating income (expenses)	--	--	--	--	112.4	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	--	(704.1)	(704.1)	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	5,790.0	--	--
Minority interests	--	1,086.3	--	--	--	--	--	--	--	--

Table 1

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

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Total adjustments	0.0	1,086.3	0.0	0.0	112.4	0.0	(704.1)	5,085.9	0.0	0.0
Standard & Poor's adjusted amounts										
Adjusted	9,164.0	11,259.6	17,708.5	5,575.0	5,505.5	604.7	(1,949.1)	3,840.9	0.0	169.2

RUB--Russian ruble.

Table 2

CJSC SSMO LenSpecSMU Peer Comparison

	CJSC SSMO LenSpecSMU	Taylor Wimpey PLC	Zhong An Real Estate Ltd.	Lennar Corp.	KB Home
Rating as of Jan. 10, 2012	B/Stable/B	B+/Positive/(B)	B+/Negative/--	B+/Stable/--	B+/Negative/--
	--Fiscal year ended Dec. 31, 2010--			--Fiscal year ended Nov. 30, 2010--	
(Mil. $)					
Revenues	590.8	4,076.5	188.3	3,074.0	1,590.0
EBITDA	186.0	267.1	68.7	318.6	124.2
Net income from continuing operations	124.6	406.0	57.5	95.3	(69.4)
Funds from operations (FFO)	128.1	(52.5)	27.6	232.7	(6.9)
Capital expenditures	5.6	26.6	29.0	5.1	2.9
Free operating cash flow	(70.7)	262.6	(213.1)	301.3	(128.7)
Discretionary cash flow	(70.7)	262.6	(213.1)	271.7	(147.9)
Cash and short-term investments	91.8	288.0	152.6	1,283.7	904.4
Debt	305.7	1,663.2	427.8	3,241.9	1,802.0
Equity	375.6	2,854.8	728.9	3,194.4	631.9
Adjusted ratios					
EBITDA margin (%)	31.5	6.5	36.5	10.4	7.8
EBITDA interest coverage (x)	9.2	0.9	4.1	1.7	1.0
EBIT interest coverage (x)	9.1	0.9	3.8	1.6	0.9
Return on capital (%)	31.4	6.3	6.0	5.1	4.6
FFO/debt (%)	41.9	(3.2)	6.5	7.2	(0.4)
Free operating cash flow/debt (%)	(23.1)	15.7	(49.8)	9.3	(7.1)
Debt/EBITDA (x)	1.6	6.2	6.2	10.2	14.5
Total debt/debt plus equity (%)	44.9	36.8	37.0	50.4	74.0

Table 3

CJSC SSMO LenSpecSMU Financial Summary

	--Fiscal year ended Dec. 31--				
	2010	2009	2008	2007	2006
Rating history	B/Stable/B	B/Stable/B	B/Stable/B	B/Positive/B	B/Stable/B

Table 3

CJSC SSMO LenSpecSMU Financial Summary (cont.)

(Mil. RUB)					
Revenues	17,708.5	18,169.8	13,023.6	8,903.2	7,712.0
EBITDA	5,575.0	6,064.6	3,805.8	2,087.1	728.9
Net income from continuing operations	3,734.1	3,385.1	1,307.0	1,077.4	432.9
Funds from operations (FFO)	3,840.9	4,906.8	2,714.8	1,009.1	562.3
Capital expenditures	169.2	325.1	371.7	1,335.6	109.4
Free operating cash flow	(2,118.3)	1,841.7	1,073.5	(4,970.4)	299.4
Discretionary cash flow	(2,118.3)	1,841.7	1,065.3	(5,307.9)	257.5
Cash and short-term investments	2,751.3	2,157.8	134.8	167.6	83.6
Debt	9,164.0	6,078.8	6,619.4	6,654.8	2,605.6
Equity	11,259.6	7,460.0	3,883.7	2,053.4	1,067.8
Adjusted ratios					
EBITDA margin (%)	31.5	33.4	29.2	23.4	9.5
EBITDA interest coverage (x)	9.2	7.5	6.6	6.6	6.3
EBIT interest coverage (x)	9.1	7.6	6.5	6.6	6.7
Return on capital (%)	31.4	48.5	38.4	33.2	25.9
FFO/debt (%)	41.9	80.7	41.0	15.2	21.6
Free operating cash flow/debt (%)	(23.1)	30.3	16.2	(74.7)	11.5
Debt/EBITDA (x)	1.6	1.0	1.7	3.2	3.6
Debt/debt and equity (%)	44.9	44.9	63.0	76.4	70.9

RUB--Russian ruble.

Related Criteria and Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009

Ratings Detail (As Of January 10, 2012)		
CJSC SSMO LenSpecSMU		
Corporate Credit Rating		B/Stable/B
Russia National Scale Rating		ruA/--/--
Senior Unsecured (3 Issues)		B
Russia National Scale Rating (2 Issues)		ruA
Corporate Credit Ratings History		
07-Oct-2008		B/Stable/B
12-Dec-2007		B/Positive/B
22-Dec-2006		B/Stable/B
12-Dec-2007	*Russia National Scale Rating*	ruA/--/--
22-Dec-2006		ruA-/--/--
Business Risk Profile		Weak

Ratings Detail (As Of January 10, 2012) **(cont.)**	
Financial Risk Profile	Aggressive
Debt Maturities	
As of June 30, 2011: 2012: $75 mil. 2013: $104 mil. 2014: $83 mil. Thereafter: $67 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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