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Research Update:

Russian Real Estate Developer LSS Outlook Revised To Positive On Strong Market Position; 'B/B' Ratings Affirmed

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Overview

- Russia-based residential real estate developer CJSC SSMO LenSpetsSMU (LSS) has strong market positions in the Saint Petersburg metropolitan area.
- We are revising our outlook on LSS to positive from stable and affirming our 'B/B' long- and short-term ratings on the company.
- The positive outlook reflects our view that LSS should be able to improve its cash flow generation over the next six months as a result of increasing sales and low 2012 inventory.

Rating Action

On July 24, 2012, Standard & Poor's Ratings Services revised its outlook on Russian residential real estate developer CJSC SSMO LenSpetsSMU (LSS) to positive from stable. At the same time we affirmed our 'B/B' long- and short-term corporate credit ratings on LSS and our 'B' issue rating on its Russian ruble (RUB)2 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. The recovery rating on these instruments is unchanged at '4', indicating our expectation of average (30%-50%) recovery prospects in the event of a payment default. The 'ruA' Russia national scale rating remains unchanged.

Rationale

The outlook revision follows improvement in LSS' operating performance, especially sales, which rose 23% year-on-year as of June 30, 2012. LSS' key Saint Petersburg residential market is seeing demand improve, supplies remain low, and prices rise. We believe these factors have allowed LSS to maximize its strong market position and good pricing strategy in the middle-class housing segment to prompt this strong performance. We anticipate that relatively low inventory in 2011 and 2012 and rising revenue should result in LSS improving its free operating cash flow (FOCF) generation in the short term.

LSS uses the conservative completed contract revenue recognition method, which counts revenue only when transactions are completed, but we still remain cautious about 2013 as working capital could rise because of the high number of projects coming under construction, and lower revenue could temporarily offset the performance achieved during the previous year.

The revision is also supported by our belief that the company is strongly committed to further strengthening its capital structure. This is demonstrated by the steps LSS is currently taking to reduce the share of short-term debt in its total debt structure, which we currently view as high, and to reduce its exposure to foreign currency. This strategy, if implemented, would likely be positive for the ratings.

We continue to assess LSS' business risk profile as "weak" and its financial risk profile as "aggressive," as our criteria define the terms. LSS has been fully owned by Etalon Group Limited (Etalon; not rated), a Guernsey-based holding company, since 2008, and we consider LSS to be a core entity for Etalon as it generates 80% of its revenues and represented 100% of its consolidated debt as of Dec. 31, 2011. We view Etalon's credit quality as equal to LSS', and our rating on LSS therefore reflects this.

Liquidity

We classify LSS' liquidity as "adequate" under our criteria. We expect liquidity sources to meet funding needs by more than 1.2x in the next 12 months.

The main liquidity sources over the next 12 months as of June 30, 2012, included:

- Cash and short-term bank deposits of RUB7 billion;
- Availability under committed credit lines of RUB8.1 billion; and
- RUB4 billion of incoming funds from operations (FFO).

The main liquidity uses over the same period included:

- Debt maturities of RUB2.9 billion;
- Working capital outflows of RUB3 billion, to be used for new real estate project developments; and
- Capital expenditures (capex) expected at RUB400 million.

In our view, LSS also derives additional financial flexibility from its significant headroom on its covenants, which would allow it to increase its indebtedness in case of need.

Recovery analysis

The issue rating on the 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 our expectation of average (30%-50%) recovery prospects in the event of a payment default.

The recovery and issue ratings are supported by the group's tangible asset base, but constrained by the unsecured nature of the notes, our view of the Russian insolvency regime as unfavorable for creditors, and the contractual or structural subordination of the rated instruments to various debt facilities.

To estimate recovery prospects, we simulate a default scenario. Our hypothetical default scenario contemplates a default in 2014--versus 2013 under our previous scenario--driven by a combination of refinancing risk and a decline in business, due to deteriorating overall economic conditions, and in turn, a pronounced decline in residential real estate prices in St. Petersburg. We assume that the debt maturing in 2012 and 2013 will be refinanced.

We use a discrete asset valuation approach to assess the recovery prospects associated with the group's underlying value, given our view that it would likely sell off properties in the event of a payment default.

We calculate a stressed enterprise value of about RUB15.1 billion at our simulated point of default. After deducting about RUB1.1 billion of enforcement costs and about RUB4.0 billion of various secured or structurally senior claims, we estimate recovery prospects in the 30%-50% range for the note holders.

For more details, see "CJSC SSMO LenSpetsSMU Recovery Rating Profile," published Sept. 27, 2011, on RatingsDirect on the Global Credit Portal.

Outlook

The positive outlook reflects our view that LSS should be able to improve its cash flow generation over the next six months as a result of increasing sales and low 2012 inventory. We also believe the company's good standing in the market compared with other players and the steps it is currently taking could result in an enhancement of its capital structure in the short term. A positive rating action will hinge on the company achieving at least one of these two conditions.

For the current rating we assume that LSS' 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 LSS will maintain a good liquidity cushion to cover working capital requirements that could rise in 2013, and a ratio of debt/debt and equity below 50%.

We might consider revising the outlook to stable if LSS did not successfully increase its cash flow or strengthen its capital structure, as we currently expect. We would also see negatively LSS abandoning its cautious strategy on phasing in new developments. Adverse developments in Russia's macroeconomic environment would also have a negative effect.

Related Criteria And Research

- Corporate Ratings Criteria 2008, April 15, 2008
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Global Criteria For Single-Family Homebuilders, Sept. 27, 2011
- Corporate Criteria--Parent/Subsidiary Links; General Principles; Subsidiaries/Joint Ventures/Nonrecourse Projects; Finance Subsidiaries; Rating Link To Parent, Oct. 28, 2004

Ratings List

Ratings Affirmed

CJSC SSMO LenSpetsSMU	
Russia National Scale	ruA/--/--
Senior Unsecured	ruA
Senior Unsecured	B
Recovery Rating	4

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
CJSC SSMO LenSpetsSMU		
Corporate Credit Rating	B/Positive/B	B/Stable/B

Additional Contact:
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