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Research Update:

Russian Real Estate Developer LenSpetsSMU Upgraded To 'B+/B' On Improved Financial Profile; Outlook Stable

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Overview

- Russia-based residential real estate developer CJSC SSMO LenSpetsSMU (LSS) has improved its financial profile, mainly as a result of its strong commissioning rate and higher funding diversification.
- We are therefore raising our long-term ratings on LSS to 'B+' from 'B', our Russia national scale rating to 'ruA+' from 'ruA', and our issue rating on the company's unsecured notes to 'B+' from 'B'.
- The stable outlook reflects our view that LSS should be able to retain sufficient liquidity to cope with a rebound in working capital and maintain its prudent financial policy.

Rating Action

On July 29, 2013, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Russian residential real estate developer CJSC SSMO LenSpetsSMU (LSS) to 'B+', from 'B', and its Russia national scale rating to 'ruA+', from 'ruA'. We also affirmed the short-term rating at 'B'. The outlook is stable.

At the same time, we raised our issue rating on the company's unsecured notes to 'B+' from 'B'. 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.

Rationale

The upgrade follows improvement in LSS' operating performance, especially sales, which rose by 15.9% year on year as of June 30, 2013. Prices in LSS' key St. Petersburg residential market are rising as demand is improving and supplies remain low. We believe these factors have allowed LSS to maximize its strong market position and good pricing strategy in the medium-class housing segment. As we anticipated, fairly low inventory and rising revenue in 2011 and 2012 resulted in LSS improving its free operating cash flow (FOCF) generation as of Dec. 31, 2012. 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 because lower revenue could temporarily offset the performance achieved during the previous year.

The upgrade is also supported by our view that the company significantly strengthened its capital structure through the issue of a Russian ruble (RUB) 5 billion bond in December 2012. This is because it has reduced the share of short-term debt in its total debt structure, which we previously viewed as high. In addition, the bond issue has allowed the company to diversify its sources of funding--public debt now represents 53% of its total debt--and decrease its exposure to foreign currencies to 34% of its total debt as of June 30, 2013, from 69% a year before.

We continue to assess LSS' business risk profile as "weak" and its financial risk profile as "aggressive," as our criteria define the terms. We believe LSS' business profile remains constrained by the inherent volatility and long operating cycle of the property development industry, Russia's high country risk due to the lack of administrative transparency and predictability, and LSS' revenue concentration in a single region of Russia

Liquidity

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

The main liquidity sources over the 12 months from June 30, 2013, include:

- Cash and short-term bank deposits of RUB6.3 billion.
- Availability under committed credit lines of RUB5.2 billion, of which RUB0.8 billion is dedicated to projects.
- RUB2.2 billion of incoming funds from operations.

The main liquidity uses over the same period included:

- Debt maturities of RUB1.4 billion.
- Working capital outflows of RUB5.0 billion, to be used for new real estate project developments.
- Capital expenditures expected at RUB520 million.

In our view, LSS derives additional financial flexibility from its significant headroom on its covenants, which would allow it to increase its indebtedness if needed.

Recovery rating

The issue rating on the senior unsecured RUB5.0 billion 12.9% notes issued by LSS is 'B+', in line with the corporate credit rating,. The recovery rating on these notes is '4', indicating our expectation of average (30%-50%) recovery prospects in the event of a payment default. The recovery rating is 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 subordination of the rated instruments to various debts.

We estimate a hypothetical interest payment default in 2016 driven by 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 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. Our valuation assumptions include stresses on the expected book value of LSS' properties at various discount levels, depending on the type of property and the stage of development. We apply a significantly higher discount-to-unfinished construction multiplier than that applied to completed properties. In our scenario, we apply a blended haircut of about 60% to the estimated inventory of the guarantor entity.

We calculate a stressed enterprise value of about RUB18 billion at our simulated point of default. After deducting about RUB1.3 billion of enforcement costs and about RUB7 billion of various secured or structurally senior claims, we estimate recovery prospects in the 30%-50% range for the noteholders, assuming RUB20 billion of senior unsecured claims outstanding at default including debt, trade and tax creditors, customer advances, and guarantees.

Outlook

The stable outlook on LSS reflects our opinion that its operating performance over the next 12 months should benefit from stable demand for apartments in St. Petersburg, and stable prices in the broader residential property segment. 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 prepaid sales and monitoring working capital absorption, which could rise in 2013 and 2014. We expect LSS' debt to EBITDA to not exceed the company's own limit of 4x and EBITDA interest coverage to remain close to 2x, in line with our definition of an "aggressive" financial risk profile.

We would take a negative view of LSS' abandoning its cautious strategy on phasing in new developments. Adverse developments in Russia's macroeconomic environment that affected demand for LSS' apartments more strongly than we currently anticipate could also lead us to consider a downgrade.

Rating upside is contingent, in our view, on LSS' ability to maintain positive FOCF over a more prolonged period than we currently anticipate.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Global Criteria For Single-Family Homebuilders, Sept. 27, 2011

- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings List

Upgraded

	To	From
CJSC SSMO LenSpetsSMU		
Corporate Credit Rating	B+/Stable/B	B/Positive/B
Russia National Scale	ruA+/--/--	ruA/--/--
Senior Unsecured	B+	B
Senior Unsecured	ruA+	ruA
Recovery Rating	4	4

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