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Summary:

CJSC SSMO LenSpetsSMU

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Summary:

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Credit Rating:	B/Positive/B

Rationale

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

LSS's "weak" business risk profile is in our opinion 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's revenue concentration in a single region of Russia.

Although there is a structural demand for new homes in Russia, it remains highly correlated with GDP growth. We project Russia's GDP growth will slow in 2013 (3.7%) compared with 2012 (4.1%). The supply of housing developments also relies greatly on the current low interest rates. These risks are moderated, however, by LSS's favorable and recently expanded position in its core market of St. Petersburg and the surrounding region, and gradually improving demand for residential property in Russia. We believe that demand for residential housing has received a boost from a range of government initiatives that seek to address the shortage of quality housing, and the expansion of mortgage lending by banks. Further support for the rating is the company's established track record of completing projects and selling flats. We also believe that LSS's control of all the stages of property development should allow it to adequately manage quality and costs.

LSS's "aggressive" financial risk profile is constrained by the inherent volatility of cash flows arising from a long operating cycle as LSS takes 30 months in the construction phase of its projects, on average. We also note the analytical complexity associated with the company's completed-contract method of accounting, which creates a time gap between reported earnings and cash flow statement. That said, this method does reduce the risk of a downward revision of revenues. The financial risk profile is also moderated by LSS's track record of negative free cash flow generation, and consequently its rising debt levels. LSS's relatively high use of short-term debt funding is partially mitigated by the RUB5.0 billion five-year bond issued on Dec. 18, 2012 and the diversification of its capital sources following LSS's shares issuance and holding Etalon Group Ltd.'s (Etalon's; not rated) recent listing on the London Stock Exchange. LSS has been fully owned by Etalon, 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's, and our rating on LSS therefore reflects this.

S&P base-case operating scenario

We anticipate that LSS's key Saint Petersburg residential market should continue to see strong demand and rising prices supported by a low supply of modern houses and improving access to mortgage loans. Another driver is our forecast of still-high growth in Russia's GDP (3.7%) relative to other countries, its positive demographic trends, and moderate unemployment (6%) in 2013. We believe LSS's revenue in 2013 will be supported by a strong order book and preselling rate on projects under construction.

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

We anticipate that LSS's free cash flow generation will remain in positive territory at the start of 2013 as a result of increasing sales and a low 2012 inventory. But over full-year 2013, we anticipate that the sharp rise in inventory stemming from the high volume of projects being in construction phase at the same time--such as Letniy, Rechnoy, and Samotsvety--should offset the growth in funds from operations. As a result of the strong opening cash balance and high capacity to repay the debt, we anticipate the ratio of debt to debt and equity will remain below 40% over the next 12 months.

Liquidity

We classify LSS's 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 12 months from Dec. 31, 2012, include:

- Cash and short-term bank deposits of almost RUB12 billion;
- Availability under committed credit lines of RUB4.6 billion of which RUB1.2 billion are dedicated to projects; and
- RUB4.8 billion of incoming funds from operations (FFO).

The main liquidity uses over the same period included:

- Debt maturities of RUB3.7 billion;
- Working capital outflows of RUB3.0 billion, to be used for new real estate project developments; and
- Capital expenditures (capex) expected at RUB400 million.

We also believe the RUB5 billion five-year bond issued on Dec. 18, 2012, significantly strengthened LSS's liquidity profile.

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

Recovery analysis

The issue rating on the RUB5.0 billion 12.9% senior unsecured notes with a five-year maturity, issued by LSS, aligns with the corporate credit rating on LSS (B/Positive/B). We have also assigned a 'ruA' Russia national scale rating to the issue.

At the same time, we have assigned a recovery rating of '4' to the proposed notes, indicating our expectation of average (30%-50%) recovery prospects in the event of a payment default.

The existing RUB2 billion 14.5% senior unsecured notes due 2013 and $150 million series 2010-01 limited-recourse credit-linked notes (CLN) due 2015 are rated 'B', in line with the corporate credit rating. The recovery rating on the ruble notes and the underlying loan linked to the CLN is '4', indicating our expectation of average (30%-50%) recovery prospects in the event of a payment default.

We assume that part of the proceeds will be used to refinance the outstanding RUB0.6 billion Series ##-02 senior unsecured bonds due May 2013, respectively, according to its initial repayment schedule.

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 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 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's 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 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 RUB16 billion at our simulated point of default. After deducting about RUB1.1 billion of enforcement costs and about RUB6.8 billion of various secured or structurally senior claims, we estimate recovery prospects in the 30%-50% range for the noteholders, assuming RUB18.5 million of senior unsecured claims outstanding at default including debt, trade and tax creditors, customer advances, and guarantees.

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

We could consider revising the outlook to stable if LSS did not successfully increase its cash flow or strengthen its capital structure, against our current expectations. We would also take a negative view of LSS abandoning its cautious strategy on phasing in new developments. Adverse developments in Russia's macroeconomic environment could also lead to a downgrade.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Global Criteria For Rating Real Estate Companies, June 21, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

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