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Outlook On Russian Real Estate Developer LenSpetsSMU Revised To Stable; 'B+/B' And 'ruA' Ratings Affirmed

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Russia-based residential real estate developer JSC SSMO LenSpetsSMU continues to pursue prudent liquidity management and maintain a sound capital structure.

We think an increasing contribution from projects in the capital city of Moscow will support the company's operating performance.

We are revising our outlook on LenSpetsSMU to stable from negative and affirming our 'B+/B' global scale and 'ruA' Russia national scale ratings.

The stable outlook reflects our view that the company's established track record of prudent financial management should help it to withstand adverse market conditions and declining demand for new properties in its markets.

MOSCOW (S&P Global Ratings) June 3, 2016--S&P Global Ratings today revised its outlook to stable from negative on Russia-based residential real estate developer JSC SSMO LenSpetsSMU. At the same time, we affirmed our 'B+' long-term and 'B' short-term global scale corporate credit ratings and 'ruA' Russia national scale rating on the company.

We also affirmed our 'B+' issue and 'ruA' national scale ratings on LenSpetsSMU's senior unsecured debt.

The outlook revision reflects our view that LenSpetsSMU's consistently prudent liquidity management and sound capital structure continue to mitigate some weakening in operating performance and an increase in its debt leverage. The company has a track record of refinancing its debt in advance and a preference for manageable repayment schedules linked to its operating cycle. Its average debt maturity is consistently more than two years (2.8 years as of March 2016), and it has no exposure to foreign currency risks on the debt side. Its maturities in the next two years are sizable but fully covered by large cash balances and undrawn long-term credit lines.

The affirmation of the 'ruA' national scale rating incorporates our view of LenSpetsSMU's credit quality at the lower end of what we see as commensurate for a 'B+' global scale rating. Under our current base-case forecast, the company's leverage will likely increase further, with EBITDA interest coverage declining to about 2.2x-2.5x in the next several years from 4.2x in 2015, due to decreasing EBITDA and rising interest costs. We continue to assess the company's financial risk profile as aggressive.

Russia's macroeconomic environment remains weak, with falling real disposable incomes and consequently sluggish demand for residential real estate. The government's subsidized mortgage program partially offsets the higher cost of mortgages and the slumping demand. The current government program is available until December 2016, but we expect that the government will continue some forms of support given that the affordability of housing remains a social issue in Russia.

We continue to think that primary residential real estate markets outside Moscow are particularly sensitive to the difficult economic conditions. At the same time, we consider that LenSpetsSMU's competitive position is supported by its larger size than peers' and favorable position in St. Petersburg.

LenSpetsSMU currently owns one Moscow-based project, Etalon-city, and expects three other projects to be transferred from its parent holding company Etalon Group in the second half of 2016. We understand these projects are currently debt free. As a result, we expect that volumes of Moscow projects, based on completions, will comprise 30%-50% of the company's total volumes to be delivered in 2016-2018.

We regard LenSpetsSMU's established track record of completing projects and selling flats as additional support for the rating. We also think that the company's control of all the stages of property development should give it a competitive advantage in managing its costs. Still, rising construction and marketing costs will likely erode EBITDA margins.

We forecast that LenSpetsSMU will increase its investments in construction in 2016-2018 to about Russian ruble (RUB) 30 billion ($450 million) per year and that operating cash flow before development rights and land acquisitions will remain negative in 2016. This is due to insufficient working capital funding available from new sales and presales to customers, with positive operating cash flow expected only in 2017, when the size of presales of Moscow projects will increase.

In our base case for LenSpetsSMU, we assume:
In Russia, inflation of 8.5% in 2016 and 5.7% in 2017, and a 1.3% contraction in GDP in 2016. This will put pressure on real disposable incomes in 2016, with recovery expected in 2017.
A 10%-15% volume decline in sales and presales of residential apartments in 2016 and a low-single-digit increase in volumes in 2017-2018, with below-inflation price growth for all three years.
High-single-digit revenue decline under International Financial Reporting Standards (IFRS) in 2016 and significant recovery starting from 2017, reflecting an increasing contribution from deliveries in Moscow-based projects. IFRS revenue reflects actual building completions and lags in the recognition of actual presales.
An EBITDA margin narrowing to about 14%, due to rising construction and marketing costs.
Average cost of debt of about 14%.
Negative free operating cash flow in 2016 in the range of RUB2 billion-RUB3 billion, mostly due to working capital outflows, and then turning positive in 2017.

Based on these assumptions, we arrive at the following credit metrics:
Gross EBITDA interest coverage of 2.2x in 2016, improving to about 2.5x in 2017.
Gross debt to EBITDA of 4.0x in 2016, decreasing to about 3.5x in 2017.

We assess LenSpetsSMU as a core subsidiary of Russian real estate developer Etalon Group, mainly because the company accounts for more than 70% of Etalon Group's revenues. We assess Etalon Group's group credit profile at 'b+'.

We equalize our issue ratings on the senior unsecured bonds with our corporate credit rating on the company.

We consider that recovery prospects for these bonds will exceed 30% because the share of priority liabilities is less than 15% of adjusted assets.

The stable outlook reflects our view that LenSpetsSMU's established track record of prudent financial management should help it to withstand the adverse market conditions and declining demand for new properties in Russia. We assume that the company's management will continue its prudent financial policy of tailoring cash outflows into ongoing construction to the cash inflows from committed and partly prepaid sales. We expect LenSpetsSMU's debt to EBITDA will not exceed the threshold of 4x for the current rating, with EBITDA interest coverage remaining at more than 2x.

We could lower our long-term global scale rating if LenSpetsSMU is unable to maintain its adequate liquidity as it faces higher-than-expected working capital outflows over the next year. We might also lower the rating if LenSpetsSMU does not maintain its credit metrics in line with an aggressive financial risk profile, with debt to EBITDA exceeding 4x and EBITDA interest coverage declining and remaining significantly below 2x. This would likely stem from a continued fall in demand in St. Petersburg and insufficient demand for apartments in the company's Moscow projects. We will monitor the amount and maturity profile of secured debt loans expected to be used in LenSpetsSMU's Moscow-based projects. We might then lower the rating because of a potential negative impact on liquidity or we could lower our issue rating on the company's bonds if we see an increased proportion of priority liabilities.

Rating upside is currently remote, but could follow stabilization of demand for residential properties in Russia and an overall improvement in the macroeconomic backdrop. Rating upside also hinges on LenSpetsSMU's ability to consistently generate material positive free operating cash flow.

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