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Research Update:

Russia-Based Homebuilder Setl Group 'B+/B' Ratings Affirmed; Outlook Stable

April 21, 2020

Rating Action Overview

- We believe Setl Group's metrics are resilient to a stress test that assumes a 15% revenue decline, reflecting the spread of COVID-19.
- We continue to assess the liquidity of Setl Group as adequate, supported by moderate near-term maturities and availability of committed bank lines.
- Therefore, we are affirming our 'B+/B' long- and short-term ratings on Setl Group.
- Our stable outlook reflects our expectation that Setl Group will maintain adjusted debt to EBITDA below 1.5x excluding project finance loans and 3.5x including project finance loans, EBITDA cash interest coverage above 5.0x and debt to debt + equity of below 75%.

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Rating Action Rationale

Our rating affirmation reflects Setl's moderate metrics in a stress scenario of a 15% revenue decline in 2020. Setl Group's reported debt remained low at RUB12.7 billion (about €180 million) of bonds and loans, as per management at year-end 2019 (compared with about RUB14 billion at year-end 2018), translating into a solid adjusted debt-to-EBITDA ratio below 1.0x, in our estimate. We also calculate that Setl's EBITDA to cash interest was strong at over 10x in 2019. As Setl plans to gradually contract new project finance loans to fund new construction starting from 2020, its debt will increase to reach RUB50 billion-RUB60 billion by 2022 in our estimate. Nevertheless, we expect that Setl Group will not build up any debt other than project finance loans, which at maturity will be repaid with cash accumulated in escrow accounts. We also take into account that if Setl decides to defer launch of new projects, this would result in lower utilization of project finance loans, balancing potential pressure on EBITDA. We envisage that in case of a revenue decline of about 15% and 1-2 percentage-point margin compression, Setl's adjusted debt to EBITDA would remain below 1.5x excluding project finance loans and below 3.5x with project finance loans, while EBITDA to cash interest would be above 5.0x in 2020-2021. To factor in the expected leverage increase due to new project finance loans, we have revised our assessment of Setl's financial risk profile to significant from intermediate.

Setl's construction sites continue to operate, in line with the local government decision, but sales activity is likely to slow in April and May. As COVID-19 is spreading across Russia, the Russian government announced a several-week vacation for all of the population in order to ensure social distancing. The decision about whether to keep construction sites open was delegated to the local governments. Apart from Moscow and Moscow region, most regions so far have decided not to freeze construction. In St Petersburg and Leningrad region, where Setl's key operating assets are located, construction sites remain operational, subject to proper precautionary measures. Although Setl's sales offices continue to operate remotely, we understand that sales are likely to be very low during the period of self-isolation in Russia, as real estate purchases generally require physical viewings and office visits. That said, we understand that banks have partially resumed operations starting from mid-April, which should facilitate mortgage-backed sales.

We see risk to longer-term housing demand, which should be partly offset by the government industry rescue measures. We expect that the pandemic will put jobs and households' income at risk, while lower oil prices will reduce Russian economic growth. This will likely lead to pressure on affordability and could decrease demand for new homes. That said, the Russian government has proposed a number of measures to support the industry and stimulate demand, including a subsidized mortgage rate of 6.5% and government guarantees. Although this is not part of our current base case, we expect that in a stress scenario, Setl Group will likely be one of the beneficiaries of these measures, also because it has been included in the list of systemically important companies. An additional positive factor is that Setl's key operations are concentrated in St. Petersburg, where the household wealth levels, although lower than in Moscow, still remain above the Russian average.

Our rating remains supported by Setl Group's strong market position. Although Setl's operations are confined to St. Petersburg and Leningrad region with only minimal diversification in Kaliningrad region, our business risk assessment for Setl is supported by its strong position of the third-largest player in Russia (following PIK Group and LSR), with a market share of 2.59%, according to the Russian agency Dom.rf. In St. Petersburg and the surrounding Leningrad region, Setl occupies the leading market position, holding a market share of about 15% of new housing offered for sale in 2019, and about 19% of actual sales, according to management. Setl group demonstrates some product diversification, with the majority of sales generated in the mid-segment, roughly 10%-15% of sales in the higher-end segment, and a very low share in the low-end segment. Our business risk assessment for Setl factors in its sizable landbank of 764.4 hectares as of year-end 2019 (including 124.4 hectares under construction and 640.6 hectares in a design stage), supporting several years of operations. We assess Setl's profitability as average, with EBITDA margins of about 15%-17%.

We expect that Setl's financial policy will prove to be supportive even in a stress scenario. Setl Group has proven its commitment to a balanced financial policy over several years. More specifically, dividends have remained broadly stable, supporting the improvement of the debt-to-debt-plus-equity ratio to below 60%, from 89% on a reported basis. We also factor in that Setl has a track record of avoiding aggressive mergers and acquisitions. As a result, we have revised our assessment of Setl's financial policy to neutral from negative previously.

Outlook

The stable outlook on Setl Group captures the company's adequate liquidity and our view that strong cash interest coverage and low debt to EBITDA should support its current credit quality despite the negative impact of COVID-19 related measures. We forecast that Setl's established business model should enable the company to remain resilient under our base-case assumptions. In particular, we expect that Setl Group will maintain a ratio of debt to EBITDA below 1.5x excluding new project finance loans and a ratio of below 3.5x including project finance loans. We also expect Setl to maintain EBITDA to cash interest coverage of above 5.0x, and debt to debt plus equity of less than 75% over the next two years.

Downside scenario

We could lower the rating if Setl's S&P Global Ratings-adjusted debt to EBITDA were to exceed 1.5x when excluding project finance debt and 3.5x when including project finance debt. This could happen because of weaker operating performance brought about by COVID19 measures or macroeconomic headwinds resulting in unfavorable industry trends, margin pressure, or adverse working capital movements. Pressure on the rating could intensify if the company's external financial flexibility deteriorated and its overall liquidity management became more aggressive.

Upside scenario

Rating upside is currently remote, but could follow a substantial increase in scale and better diversification, coupled with supportive macroeconomic conditions. We could also raise the ratings if we saw a steady and sustainable improvement in Setl's EBITDA margin to a level comparable with that of its vertically integrated peers, in the 20%-30% range. Rating upside might also come from a financial policy that leans toward a more conservative approach, in terms of maximum debt to EBITDA and dividend payout ratio, with substantial improvement in the company's debt-to-debt-plus-equity ratio.

Company Description

Founded in 1994, Setl is a large Russian residential developer with International Financial Reporting Standards (IFRS)-based revenue of about RUB95 billion-RUB100 billion in 2019 (up by several percentage points year-on-year in ruble terms). Setl is based in Russia's second largest city, St. Petersburg. Its main operations are conducted in the surrounding Leningrad Oblast and the company is expanding to Kaliningrad (a Russian enclave in the North West) and its region. Between its foundation and the end of 2019, Setl completed and delivered over 6.74 million square meters (sqm) of total residential real estate and at year-end 2019 had a project portfolio with gross building area of around 5.7 million sqm under planning and construction. Setl generates about 96% of its revenue from its real estate development division; and about 4% from other segments (sale of building materials, real estate brokerage services, and others).

Setl is 70% owned by Maxim Shubarev, who also acts as chairman of the board; 24% owned by Yan Izak, also the group CEO; and 6% by Ilya Eremenko, the CEO of one of the key operating subsidiaries, Setl-City.

Our Base-Case Scenario

Our base case includes the following assumptions:

- About 15% year-on-year revenue decline in 2020 and moderate recovery in 2021-2022. At this stage, we expect 2020 completions and prices to be lower than the previous budgets. We assume that real income decline would likely pressure the discretionary demand for new housing. That being said, we expect that the supply/demand balance will be supported by some supply contraction coming from weaker or more leveraged developers, and by the government measures.
- Some margin compression in 2020-2021, resulting from lower sale prices and moderate inflation of costs.
- Significant working capital outflow supporting operations and resulting from transition to escrow accounts, in particular, in 2021-2022.
- Minimal capital expenditure.
- Relatively stable dividends.

Based on these assumptions, we arrive at the following credit measures:

- S&P Global Ratings-adjusted debt to EBITDA of below 1.5x in 2020-2021 excluding project finance loans, and below 3.5x including project finance loans;
- EBITDA to cash interest of above 5.0x in 2020-2021.

Liquidity

We assess Setl's liquidity position as adequate. We estimate that Setl's liquidity sources will cover uses by more than 1.2x in the 12 months ending Dec. 31, 2020.

For the 12 months ending Dec. 31, 2020, we estimate that Setl's principal liquidity sources comprise:

- Cash balances of about RUB12 billion;
- Undrawn committed bank lines (mostly from the Bank of St. Petersburg) maturing beyond 12 months of about RUB7.1 billion; and
- RUB5 billion-RUB6 billion of operating cash flow (which in our stress scenario could decline to RUB3 billion-RUB4 billion).

We estimate that Setl's principal liquidity uses comprise:

- Approximately RUB1.1 billion of debt maturities;
- About RUB10 billion-RUB15 billion of nonseasonal working capital outflow and sizable seasonal working capital outflows, as per our estimates;
- Limited maintenance capital expenditure;
- Dividends broadly in line with the previous years.

Covenants

We expect Setl to maintain adequate covenant headroom. Starting from 2018, Setl's key covenant is net debt to EBITDA below 2.5x tested on the basis of consolidated IFRS accounts of the group. We expect ample headroom of above 30% in 2020.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/B

Business risk: Weak

- Country risk: High
- Industry risk: Moderately high
- Competitive position: Weak

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bb-

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate

Entities, Nov. 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Setl Group LLC	
Issuer Credit Rating	B+/Stable/B