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Research Update:

Russia-Based O1 Properties Rating Removed From CreditWatch And Affirmed At 'B+'; Outlook Negative

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Table Of Contents

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Overview

- Russia-based real estate investment company O1 Properties Ltd.'s credit ratios have weakened only modestly after asset revaluation and discounts granted to tenants.
- We are therefore removing our long-term rating on O1 Properties from CreditWatch negative, where we placed it on Jan. 20, 2015, and affirming it at 'B+'.
- The negative outlook reflects the risks of additional rent negotiation and tightening covenant headroom.

Rating Action

On April 15, 2015, Standard & Poor's Ratings Services affirmed its 'B+' long-term corporate credit rating on Russia-based real estate investment company O1 Properties Ltd. At the same time, we removed all ratings from CreditWatch negative, where we placed them on Jan. 20, 2015. The outlook is negative.

Rationale

The affirmation reflects our expectation that O1 Properties' credit metrics will remain commensurate with our assessment of its "aggressive" financial risk profile. We expect EBITDA interest coverage to be about 1.5x in 2015-2016 and the debt-to-debt-plus-equity ratio to be about 65%. Rent reductions and asset portfolio revaluations for O1 Properties are modest compared with the scale of ruble devaluation. The depreciation of the Russian ruble (RUB) puts pressure on real estate investment trusts' tenants, whose revenues are in rubles, but whose rent payments are linked to U.S. dollars. At the same time, O1 Properties' ability to give only limited discounts to tenants proves the good quality of its assets and its strong competitive position. We don't expect further meaningful revisions of rent agreements because vacancy rates for prime office space in the historical central business district of Moscow remain low.

O1 Properties' good-quality, income-producing property portfolio underpins our view of business risk as "fair." Most of O1 Properties' offices are in the center of Moscow and the overall occupancy rate was about 91% at the end of 2014. The company is large; it is worth $4.2 billion, based on asset value.

Recurring cash flows are supported by well-spread lease maturities averaging 3.9 years, contracted with a large base of good-quality tenants. Large multinational companies contribute more than 70% of total net operating income. The tenant base is well diversified across industries. The company's share of developments is low, at about 2% of the portfolio value.

The rating is constrained, in our view, by high country risk in Russia, which suffers from structural weaknesses such as the economy's strong dependence on hydrocarbons and other commodities.

O1 Properties benefits from a long-term debt maturity profile; it has limited maturities in 2015-2016. Its U.S. dollar-denominated debt matches U.S. dollar-linked rental income.

Under our base case, we assume:
- A 7% decline in portfolio asset value in 2014 and 3% in 2015;
- A 12% decline of rental revenues in 2015 and 5% in 2016, based on discounts to tenants and relatively stable occupancy;
- The EBITDA margin will steady at about 90% over the next two years; and
- The amount spent on acquiring assets in 2015 will equal the amount spent in 2014 and will be financed by issuing equity.

Based on these assumptions, we arrive at the following credit measures:
- Standard & Poor's-adjusted ratio of debt to debt plus equity to remain at about 65% over the next two years; and
- EBITDA interest coverage to be about 1.5x in the next two years.

Liquidity

We view O1 Properties' liquidity as "adequate" under our criteria as we foresee that liquidity sources will cover uses by more than 1.2x, as of Dec. 31, 2014, for the next 12 months.

We understand that headroom under the company's covenants has tightened significantly. We understand that O1 Properties can deposit cash to match the marginal difference if, for example, the loan-to-value (LTV) ratio significantly declines because of asset revaluation. Therefore, we anticipate that the company will be able to comply with its covenants. Headroom has tightened because of asset portfolio revaluation and lower LTV ratios. O1 Properties has covenants at the level of each asset and no cross-default or cross-guarantees with other group assets.

We anticipate the company will have the following principal liquidity sources over the 12 months from Dec. 31, 2014:
- Cash balances of about $186 million on Dec. 31, 2014; and
- Our forecast of funds from operations (FFO) of about $100 million.

We anticipate the company will have the following principal liquidity uses over the same period:
- $51 million of debt amortization; and

- $150 million bullet debt repayment.

Outlook

The outlook reflects our opinion that, despite our expectation that O1 Properties should be able to maintain a ratio of EBITDA to interest of about 1.5x and repay upcoming debt maturities using its cash balances and free cash flow, there is a risk that tenants might require additional discounts for 2016 and following years and this might put additional pressure on O1 Properties' credit metrics.

The negative outlook also reflects the risks of potential covenant breaches constraining the company's liquidity if cash amounts required to remedy these breaches exceed our expectations.

Downside scenario

We could lower the rating if O1 Properties' interest coverage ratio fell to less than 1.5x on a sustained basis as a result of a drop in rental rates or if the debt-to-debt-plus-equity ratio declines and remains below 65% because assets are devalued by more than we currently expect. We also could lower the rating if we were to revise the company's liquidity to "less than adequate" from "adequate" because the need to remedy potential covenant breaches caused O1 Properties' cash uses to increase significantly.

Upside scenario

We could revise the outlook to stable if we see that O1 Properties continued to maintain its metrics at the level commensurate with an "aggressive" financial risk profile assessment despite pressure from its tenants to renegotiate lease terms and at the same time, it keeps its liquidity at an adequate level.

Ratings Score Snapshot

Corporate Credit Rating: B+/Negative/--

Business risk: Fair
- Country risk: High
- Industry risk: Low
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)

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

Recovery Analysis

Key analytical factors

- The 'B+' issue rating and '4' recovery rating on O1 Properties' RUB6 billion senior notes due 2018 reflect their unsecured nature, their structural and contractual subordination to a significant amount of senior bank debt, and our unfavorable view of the Russian insolvency regime. That said, the recovery rating is supported by O1 Properties' strong market position and the high quality of assets in its portfolio. We expect recovery prospects at the lower end of the 30%-50% range.
- We use a discrete asset valuation approach, applying stress of 30% on the fair market value of completed projects, which comprises most of the value of the group.
- The notes' recovery prospects are very sensitive to small changes in the haircuts applied to the assets in our stressed valuation. For example, recovery prospects would be nil if we increased the haircut to 40% from 30%.
- Our hypothetical default scenario would be triggered by downward pressure on rental income and the threat of rising costs stemming from the still-immature administrative and regulatory environment in Russian real estate. These factors could cause O1 Properties to be unable to meet interest and principal repayments

Simulated default assumptions

- Year of default: 2018
- Jurisdiction: Russia

Simplified waterfall

- Gross enterprise value at default: $2.9 billion
- Net value available to creditors: (after administrative costs and priority liabilities--finance leases and secured bank debt): $55 million
- Unsecured debt claims: $159 million*
- --Recovery expectation: 30%-50% (lower end of range)

*All debt amounts include six months' prepetition interest.

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- Corporate Methodology, Nov. 19, 2013

- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
O1 Properties Ltd.		
Corporate Credit Rating	B+/Negative/--	B+/Watch Neg/--
O1 Properties Finance		
Senior Unsecured	B+	B+/Watch Neg
Recovery Rating	4L	4

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