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November 11, 2011

Research Update:

Outlook On Russian City Of Novosibirsk Revised To Positive On Stronger-Than-Expected Revenues; 'BB/ruAA' Ratings Affirme

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Overview

- Russian City of Novosibirsk has enjoyed stronger revenue growth than we expected in our base-case scenario, thanks to economic recovery and stronger support from Novosibirsk Oblast.
- Management's prudent policies have helped extend the debt profile.
- We are revising our outlook on the city of Novosibirsk to positive from stable and affirming the 'BB/ruAA' ratings on the city.
- The positive outlook reflects a more that 30% likelihood of an upgrade should Novosibirsk's budgetary performance exceed our existing base-case assumptions for 2011-2012 thanks to stronger-than-expected revenue growth. A stronger performance might also have a positive effect on the city's borrowing needs and result in a lower debt burden.

Rating Action

On Nov. 11, 2011, Standard & Poor's Ratings Services revised its outlook on the City of Novosibirsk to positive from stable. At the same time, we affirmed the 'BB' long-term issuer credit rating and the 'ruAA' Russia national scale rating on the city.

Rationale

The outlook revision reflects stronger revenues stemming from higher tax receipts and solid grants from Novosibirsk Oblast (not rated), which could result in better budgetary performance for 2011-2012 than we previously expected. We also recognize that the city's continuation of prudent debt policies has translated into further extension of its debt profile.

The ratings on Novosibirsk are constrained by what we see as limited financial flexibility and predictability, and low economic productivity. These constraints are mitigated by Novosibirsk's moderate debt, favorable debt profile, improved revenue growth, reasonable cost controls that stimulate moderate financial performance, and a relatively diverse economy.

Novosibirsk has enjoyed faster revenue growth in 2011 than we expected, which will likely result in better budgetary performance that we envisaged in our base-case scenario for 2011-2012. Stronger revenues stemmed from solid tax revenue growth due to economic recovery and increased operating and capital grants from Novosibirsk Oblast. Should this support continue through 2012, in our view Novosibirsk will probably be able to withstand spending pressures triggered by a pre-election hike in public salaries and material capital needs, as well as delivering operating surpluses over 5% of operating revenues.

Capital support from the oblast and federal budgets via subsidies and loans will likely help the city maintain capital spending at 23%-25% of total expenditures. Recovering property markets will also contribute positively to capital revenues in 2011-2012. Because of these factors, we think Novosibirsk will have only moderate deficits, if any, after capital accounts in 2011-2012.

We take note of management's continued prudent policies to extend Novosibirsk's debt profile. By Oct. 31, 2011, the city had managed to secure several five-year committed bank facilities, which further suppressed debt service and extended the average debt maturity to 3.5 years (from 2.7 years a year ago). Now more than 50% of the city's direct debt repayment needs fall beyond three years, compared with only about 13% in late 2010.

By year-end 2011, tax-supported debt will likely comprise roughly 30% of consolidated operating revenues, which we see as modest by international standards. New loans from the federal budget, which are less predictable, but cheap and long-term, might slightly increase debt levels, yet our base-case scenario does not anticipate that the city's debt burden will exceed a moderate 35% of consolidated operating revenues in the medium term.

As with other Russian local and regional governments, Novosibirsk's financial predictability and flexibility is severely limited because the federal government regulates tax rates and shares and the distribution of responsibilities to different layers of government. We still regard Russia's institutional frameworks as "developing and unbalanced" (see "The System For Russia's Regions Is Developing And Unbalanced", published Oct. 21, 2011, on RatingsDirect on the Global Credit Portal).

Novosibirsk's economy continues to recover. However, wealth levels are still only slightly above the Russian average. The city economy suffers from low productivity, especially in the industrial sector, and the poor state of municipal infrastructure, with a number of bottleneck issues such as obsolete transport, utilities, and housing. These constraints are mitigated by the city's role as a regional economic center, with important service, transport, and research and development sectors, which in our view help support the city's economic potential.

Liquidity

We see Novosibirsk's liquidity position as "neutral". As of mid-October 2011, the city's free cash comfortably covered its debt service over the next 12 months. The city's earliest principal debt payment is scheduled in April-May 2012 and consists of minor bank loans.

The city's cash on average has historically been low and volatile, which we factor in as a credit concern. Moreover, despite currently high cash reserves (including earmarked funds from regional and federal governments), it is expected to remain volatile in the absence of a more prudent and established cash policy. However, this is mitigated by the city's access to a wide range of bank facilities. In July-October 2011 Novosibirsk obtained several committed bank lines. As of late October 2011, about 40% of the available total was not withdrawn.

The terms of Novosibirsk's access to bank lending are more favorable than those for many higher-rated entities, with a number of local and federal banks reserving internal lending limits for the city. Nevertheless, according to our methodology, we qualify Novosibirsk's access to financial markets as "limited" by international standards because of what we see as a weak domestic bank system and the limited development of Russia's capital market.

Outlook

The positive outlook reflects a more that 30% likelihood of an upgrade should Novosibirsk's budgetary performance exceed our existing base-case assumptions for 2011-2012 thanks to stronger-than-expected revenue growth. Under this scenario, the city's operating surplus would exceed 5% of operating revenues, whereas its deficit after capital accounts would stay below 4%-5% of total revenues. A stronger performance might also have a positive effect on the city's borrowing needs and result in a lower debt burden.

We would consider a positive rating action if the city's financial performance reaches our upside-case indicators in 2011-2012, which would also likely result in a somewhat lower debt burden. Positive actions would also depend on the city's ability and willingness to institutionalize its cash and liquidity policies, ensuring a structurally stronger and less volatile cash balance.

Our scenario for revising the outlook to stable assumes that the pace of operating spending growth would offset the currently observed revenue growth and lead to the budgetary performance envisaged in our base-case scenario and the stabilization of the debt burden at the existing level.

Related Criteria And Research

- Public Finance System Overview: The System For Russia's Regions Is Developing And Unbalanced, Oct. 21, 2011
- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010

Ratings List

CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Novosibirsk (City of)		

Issuer Credit Rating	BB/Positive/--	BB/Stable/--

Ratings Affirmed

Russia National Scale Rating	ruAA

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