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X5 Retail Group N.V. and Lenta Limited: Peer Comparison

Lenta's one-notch advantage driven by conservative financial policy, strong operating performance and robust liquidity position

RATINGS

X5 Retail Group N.V.

LT Corporate Family Rating	B2
NSR LT Corporate Family Rating	A3.ru
Outlook	Stable

Lenta Limited

LT Corporate Family Rating	B1
NSR LT Corporate Family Rating	A1.ru
Outlook	Stable

KEY INDICATORS – Lenta Limited

	Jun-11	Jun-10	Jun-09
Net sales, $ billion	2.7	2.0	1.9
EBITDA margin, %	8.5%	9.1%	7.1%
Debt/EBITDA, x	1.4x	2.1x	3.5x
RCF/net debt, %	56.5%	34.9%	20.3%
EBITA / Interest Expense, x	5.3x	2.2x	1.2x

Source: Moody's Financial metrics™

X5 Retail Group N.V.

	Dec-11	Dec -10	Dec -09
Net sales, $ billion	15.5	11.3	8.7
EBITDA margin, %	11.4%	10.9%	11.4%
Debt/EBITDA, x	4.9x	5.6x	4.1x
RCF/net debt, %	14.1%	14.0%	19.0%
EBITA / Interest Expense, x	2.1x	2.7x	2.5x

Source: Moody's Financial metrics™

Analyst Contacts:

MOSCOW +7.495.228.6060

Sergei Grishunin, CFA +7.495.228.6168
Assistant Vice President - Analyst
sergei.grishunin@moodys.com

Ekaterina Lipatova +7.495.228.6090
Associate Analyst
ekaterina.lipatova@moodys.com

>>contacts continued on the last page

» **Of the two leading Russian food retail companies, Lenta Limited (B1 stable) has a more conservative financial profile**. Its four-years average adjusted leverage (measured by adjusted debt/EBITDA) and adjusted retained cash flow(RCF)/net debt of 2.2x and 33%, respectively, are in line with the internal leverage target of reported net debt/EBITDA below 3.0x. These metrics are lower than those of X5 Retail Group N.V. (B2 stable), with four-years adjusted leverage and RCF/net debt of 4.7x and around 15%, respectively. We expect that Lenta will maintain its conservative financial profile in the next 12-24 months within its internal leverage target, whilst X5's financial profile will continue to be leveraged.

» **In the last 24 months, Lenta demonstrated stronger operational performance than X5**, reflected in several stronger metrics such as like-for-like (LFL) sales growth, revenue per square meter of retail space and capital usage (measured as EBIT/average book capitalisation (net of cash)). These metrics suggest that Lenta's business has grown organically at a faster rate, and support our expectation that Lenta's financial metrics will remain conservative in the next 12-24 months, as the incremental growth in revenues and EBITDA will compensate for the increase in debt used for capital expenditures. Conversely, X5's softer operating efficiency will (1) result in single-digit organic sales growth; (2) continue to weaken its financial profile; and (3) constrain its deleveraging in the next 12-18 months.

» **Lenta's liquidity position will remain robust in the next for the 12 months ending Q4 2013,** because of its comfortable debt maturity profile and flexible capex program. Conversely, **X5's liquidity position remains exposed to high refinancing risk**, with around $1.4 billion of its debt due in the next 12 months. We also note that given the expectation of soft performance, **X5's liquidity remains dependent on its actual cash flow generation ability and its ability to postpone capex**.

» **With almost 5x higher revenue and operations in 662 locations in Russia (as of end-September 2012), X5 benefits from larger size and stronger diversification than Lenta,** which operates from only 23 locations. As such, we believe that Lenta will lag X5 in terms size in the foreseeable future**.** X5's larger size provides it with stronger bargaining power and greater coverage of suppliers, and may suggest better access to financial markets. Lenta's limited geographical diversification exposes it to localised economic conditions in the particular regions where it operates.

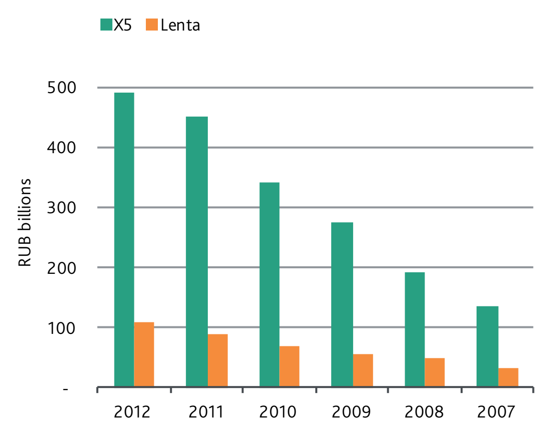
» **Historically, X5's shareholding structure has been stable, whilst Lenta has a history of shareholding disputes and a limited track record of operating, both with the current shareholding structure and the management team.** However, we acknowledge Lenta's commitment to a strategy of intensive organic growth, whilst focusing on operating efficiencies. Unlike X5, Lenta lacks strategic investors, as all its shareholders are financial investors; despite this, we understand that the investors are not contractually required to exit the business in the short term.

Detailed Discussion

X5 Benefits From its Larger Revenue and Stronger Diversification, Relative to Lenta

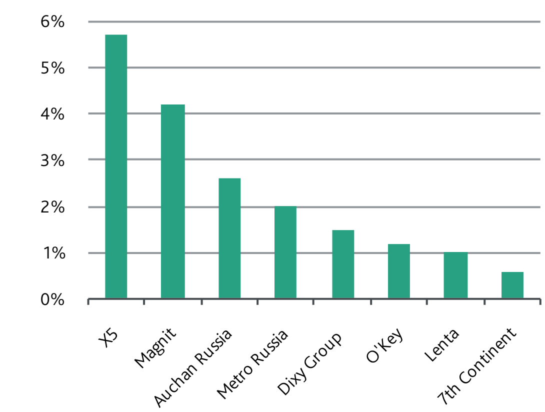
X5 significantly outperforms Lenta by size (measured by revenue) and market share (see Exhibits 1 and 2). Compared with Lenta, this provides X5 with stronger bargaining power in its relations with suppliers and may facilitate better access to financial markets, especially in times of market volatility. We also believe that despite our expectation that Lenta will register stronger revenue growth than X5 (see discussion below), Lenta will lag X5 in terms of size in the foreseeable future. Nevertheless, the disadvantages associated with its smaller size are partly compensated by Lenta's leading market share in its segment of operations (hypermarkets), where it occupies the number two position in Russia after Auchan (not rated).

EXHIBIT 1
X5 outperforms Lenta by revenue size



Source: Moody's Financial metrics™
Lenta's data are annualised as of 31 December

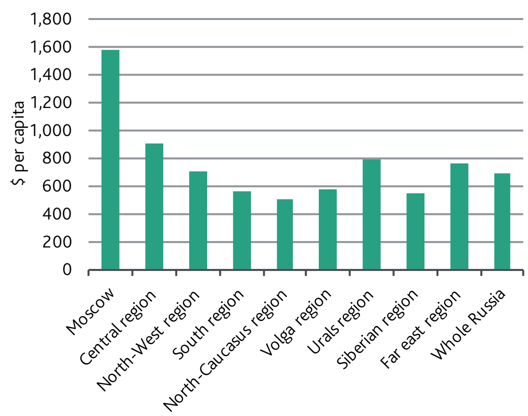
EXHIBIT 2
X5 has larger market share than Lenta



Source: Planet retail consulting, 2011

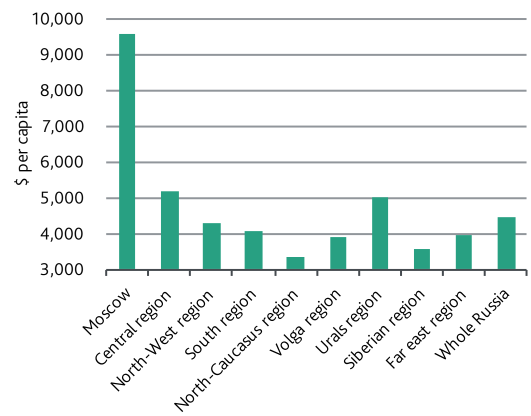
X5 also outperforms Lenta by level of geographical coverage within Russia. As of end September 2012, X5 had operations in 662 locations around Russia, covering all major cities with a population over 200,000. Lenta had operations in only 31 cities and only 18% of its target cities with a population of above 100,000. Stronger coverage reduces X5's exposure to localised economic conditions. In particular, we consider that the key constraining factors for Lenta's growth are (1) limited operations in Central region of Russia (2 locations compared with 10 for X5); and (2) the absence of operations in Moscow. Despite the elevated competition amongst retailers in this region, it is characterised by the highest income per capita and the largest retail sales per capita (see Exhibits 3 and 4). We note Lenta's plans to enter Moscow and Moscow district food retail markets in the next several years , with the first store due to open in 2013; however, we note that there are execution risks associated with store opening program.

EXHIBIT 3
Average monthly income per capita in Russian regions ($/person)



Source: Rosstat, 2011

EXHIBIT 4
Average annual sales per capita in retail in Russian regions ($/person)



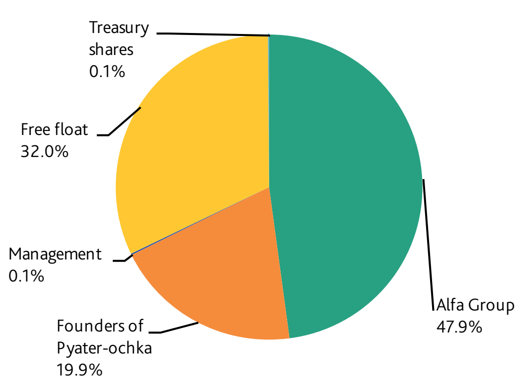
Source: Rosstat, 2011

Shareholding structures of X5 and Lenta

Historically, X5's shareholding structure has been stable, with no apparent conflicts amongst key shareholders since its formation in May 2006, after the merger of Pyaterochka Holding N.V. and Perekrestok. Alfa Group Consortium is X5's strategic and principal shareholder, while the founders of Pyaterochka hold the second-largest stake. The rest of shares are free-float in the form of global depositary receipts (GDRs) listed on London Stock Exchange (see Exhibit 5).

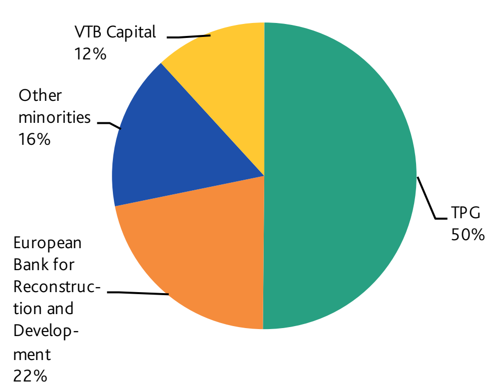
Conversely, Lenta has a history of shareholding disputes which started in October 2009. These disrupted the work of Lenta's top management and board of directors, resulting in a slowdown in the company's growth and operational inefficiencies, which prompted Lenta's weak performance in 2009-10. The dispute was resolved by the exit from the company of one of the key shareholders (which owned 41% of Lenta as of end-June 2011), and by US-based equity investment firm TPG Capital increasing its voting stake in Lenta to a controlling share (see Exhibit 6).

EXHIBIT 5
X5 has a history of shareholding with strategic investor



Source: X5 data, as of September 30 2012

EXHIBIT 6
Lenta lacks strategic shareholder in its ownership structure



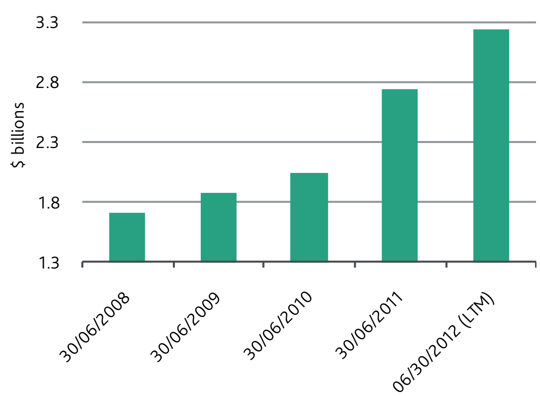
Source: Lenta's data, as of September 30 2012

We positively note that following the resolution of the shareholder dispute, Lenta significantly reinforced its senior management team by attracting foreign expertise and promoting best-management practices from the global retail industry. This change in management has already resulted in a turnaround in the company's operations (see Exhibit 7) captured by Lenta's strong operational metrics in the last 24 months. Lenta's management also stated its commitment to continue its strategy of intensive organic growth, whilst focusing on operating efficiencies.

EXHIBIT 7

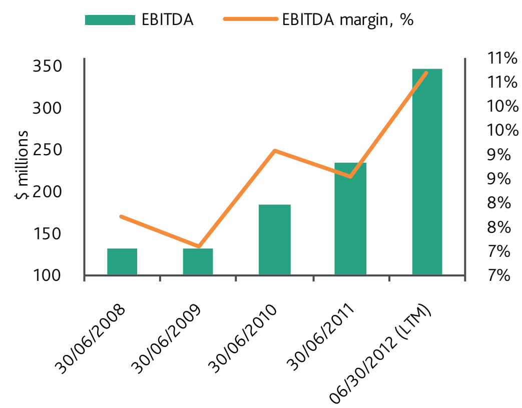
Turnaround of Lenta's operations after resolution of shareholding dispute (as adjusted)

Lenta's revenue (as adjusted)



Source: Moody's Financial metrics™

Lenta's EBITDA and EBITDA margin(as adjusted)



Source: Moody's Financial metrics™

At present, we believe there is a low likelihood of renewed conflict between Lenta's shareholders in the next 12-24 months. However, we note that (1) Lenta has a limited track record of operating since inception and under the current shareholding structure and management team; and (2) there is uncertainty associated with Lenta's long-term strategy and financial policies, given the company's unusual shareholding structure with no strategic investor. In addition, extra uncertainty stems from fact that the company's current shareholders are financial investors; as such, we believe that they will aim to exit the business in the next three to five years. However, these concerns are partly mitigated by (1) the fact that investors are not contractually required to exit the business in the short term; and (2) investors' stated commitment to achieving strong, longer-term operational and financial performance.

Lenta's stronger operational performance is due to management initiatives and unique sales format

Lenta's strong operating performance in the last 24 months was primarily driven by management efforts following the change in the shareholding structure. The efforts included (1) improving shop layouts and merchandising; (2) improving product quality and range; (3) structuring of promotion campaigns; (4) enhancing Lenta's loyalty program; and (5) accelerating new shop openings.

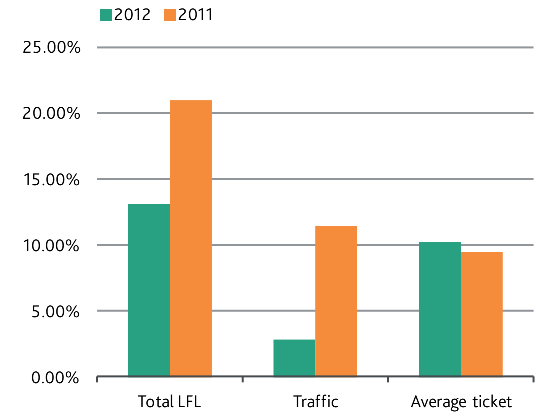
It is also driven by the higher attractiveness of Lenta's hypermarkets to middle class customers, compared with the formats offered by some of its competitors (e.g., soft discounters). Lenta's unique format provides customers with a wider assortment and higher quality of products as well as a higher level of services. Its format comprises a mix of a traditional hypermarket, cash and carry (with large packs) and discounter services, with a commitment to offer products with prices at least 5% cheaper than those of its competitors. Additionally, Lenta's "big box" model results in the minimisation of required storage capacity, which also drives the efficiency of capital usage.

Lenta's stronger operational performance is reflected in several metrics, such as LFL sales growth, revenue per square meter of retail space and capital usage (measured as EBIT/average book capitalisation (net of cash)) (see Exhibit 8). We note that companies with strong operational performance usually demonstrate faster growth and robust financial profiles, as incremental revenues and EBITDA compensate for increases in debt use to finance a company's expansion plans.

EXHIBIT 8

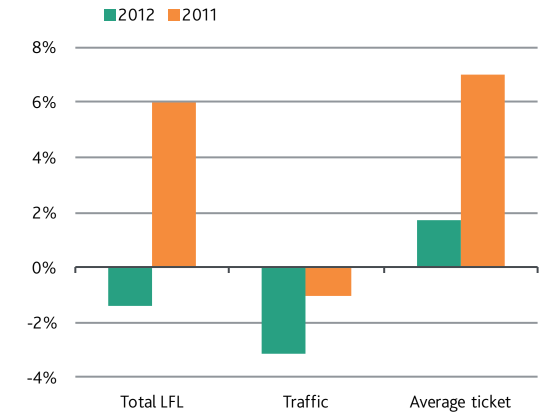
Lenta outperforms X5 by operating performance

Lenta's LFL sales growth



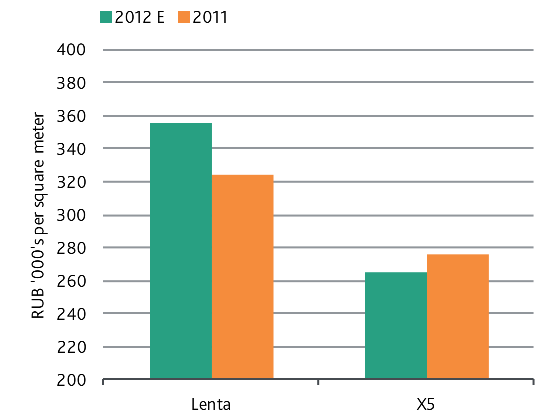
Source: Company's data

X5's LFL sales growth



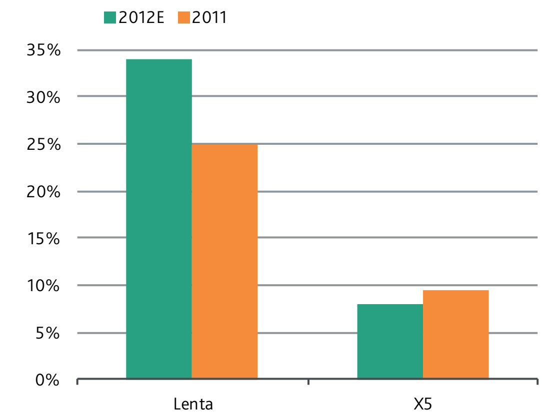
Source: Company's data

Sales per square meter of selling space



Source: Moody's Financial metrics™, Moody's calculations
Lenta's data are annualised as of 31 December

EBIT / Avg. Book Capitalisation (Net of Cash)



Source: Moody's Financial metrics™, Moody's calculations
Lenta's data are annualised as of 31 December

In 2012, Lenta's revenue growth, resumed after the resolution of shareholding dispute, slightly decreased in comparison to 2011(see Exhibit 9) due to delays of several stores openings to 2013 from 2012. We expect that in the next 12-24 months, Lenta will continue to demonstrate strong operating performance. Combined with new shop openings, this will translate into organic growth for US dollar-nominated revenue of above 20% and adjusted EBITDA profitability on a par with that of X5.

Unlike Lenta, X5 follows a strategy of a multi-format retailer (operating a chain of soft-discounters, supermarkets and hypermarkets) which it has developed through domestic acquisitions.[1] In our opinion, its soft operating performance in the last 24 month is driven by difficulties in achieving post-merger integration of various retail formats, the cannibalisation of traffic by newly opened stores, as well as some flaws in execution in shops and breaks in logistics that resulted in reduced footfall (see Exhibit 9). X5's performance was also affected by intense competition amongst food retailers, especially in the soft discounter format (these shops represent around 65% of X5's total revenue in 2012), as this format is close to saturation in the domestic market.

EXHIBIT 9

X5's sales growth has been softened which reflects slow down of its operational performance

Source: Moody's Financial metrics™, Moody's calculations
Lenta's data are annualised as of 31 December

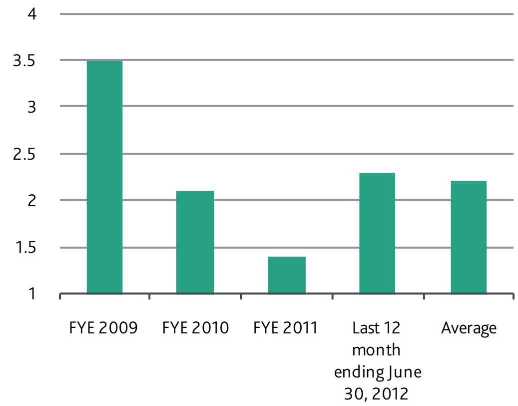
We understand that X5 is currently taking steps to accelerate growth, including strengthening its management team, undertaking organisational changes to better-integrate its various retail formats, and improving the quality of its offering. Nevertheless, we recognise the execution risks associated with this program and forecast that X5 will demonstrate soft operating metrics in the next 12-18 months, which will translate into soft revenue and EBITDA growth and a leveraged financial profile (see discussion below).

Lenta's more conservative financial profile than that of X5 is the key driver for Lenta's one-notch rating advantage

Lenta's shareholders and management are committed to a conservative financial policy, with the internal leverage target of reported net debt/EBITDA below 3.0x. As of FYE 2010 (ended 30 June 2010) and 2011 (ended 30 June 2011) and the last 12 months ended 30 June 2012, the company's adjusted leverage (measured by adjusted debt/EBITDA) amounted to 2.1x, 1.4x and 2.3x, respectively and RCF/net debt amounted to around 35%, 57% and 31% respectively (see Exhibits 10 and 11). We also forecast that as of FYE 2012 (ended 31 December 2012) Lenta's adjusted leverage and RCF/net debt will amount around 2.3x and 35%, respectively.

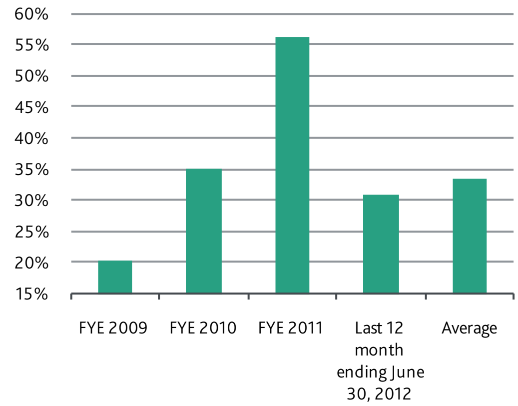
[1] The company bought a chain of hypermarkets "Karusel" in 2008, a chain of supermarkets "Paterson" in 2009 and a chain of soft discounters "Kopeyka" in 2010.

EXHIBIT 10
Lenta's has lower leverage (Debt/EBITDA)....



Source: Moody's Financial metricsTM, as adjusted
Lenta's financial years end is June 30th before 2012 and December 31st starting from 2012.

EXHIBIT 11
...and higher cash flow coverage (RCF/net debt) than X5

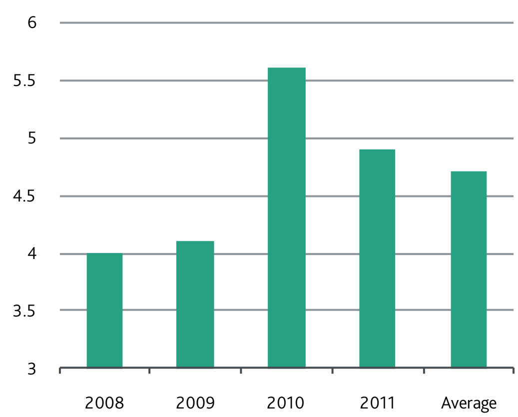


Source: Moody's Financial metricsTM, as adjusted

We expect that Lenta will gradually increase its debt position in FYE 2013 and 2014 due to the forecasted increase in development capex to around $600 million in these years (around $500 million as of FYE2012, $75 million as of FYE2011 and $26 million as of FYE2010). However, the company's adjusted leverage and RCF/net debt will remain at around 2.0x and 35%, respectively, as improved profitability following the turnaround and the expected double-digit incremental growth in revenues and EBITDA from Lenta's new stores will compensate for the debt increase.

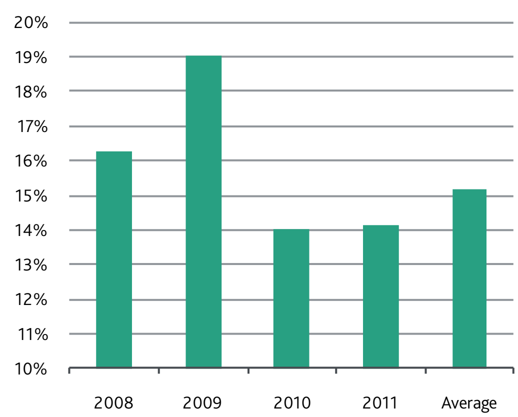
On the contrary, X5 has historically demonstrated more aggressive financial metrics (see Exhibits 12 and 13) with the company exhibiting a four-year average adjusted debt/EBITDA ratio of around 4.7x and RCF/net debt of around 15.2%. X5's high leverage reflects its strategy of growth through M&As with capital expenditure (capex) funded primarily with debt.

EXHIBIT 12
X5's leverage (debt/EBITDA) as adjusted



Source: Moody's Financial metricsTM

EXHIBIT 13
X5's RCF/net debt (as adjusted)



Source: Moody's Financial metricsTM

X5's adjusted debt/EBITDA remained elevated during the 12 months ended 30 September2012, at around 5.1x (2011: 4.9x), reflecting soft sales growth in the first nine months 2012 and large capex for full-year 2012 (estimated at around RUR30 billion (around $1 billion)). X5's adjusted RCF/net debt was around 12% during the 12 months ended 30 September 2012 (2011: 14%). We forecast that X5's deleveraging could be constrained by the soft growth in X5's sales, if this trend persists over the next 12-24 months.

Lenta will have a stronger liquidity position than X5 over the next 12 months

We expect that Lenta's liquidity position will remain robust for the 12 months to end-Q4 2013, despite negative cash flow generation in that period. Lenta's liquidity will be supported by (1) a comfortable debt maturity profile, with debt repayments starting only in 2015; (2) undrawn committed debt facilities of around $300 million to cover working capital needs; and (3) modest maintenance capex and the discretionary nature of the company's expansion capex, which may be easily scaled-down in case of a liquidity shortage or weaker-than-expected operating results. Lenta's liquidity profile could be improved further after a proposed issuance of RUB 10 billion (around $300 million) over the course of 2013.

Conversely, X5's liquidity position will remain constrained, because it is exposed to high refinancing risk, with around $1.6 billion of debt due in the next 12 months. Although X5's refinancing needs were fully covered as of end-December 2012 by $400 million of cash and around $1.6 billion of multi-year undrawn funds under long-term committed facilities, we note that the company is heavily reliant on external financing to service its basic cash obligations. Additionally, X5's liquidity remains dependent on its actual cash flow generation ability and its ability to scale capex, as X5's operating performance is likely to remain soft.

Moody's Related Research

Credit Opinions:

» Lenta Limited

» X5 Retail Group N.V.

Rating Action:

» Moody's assigns B1 rating to Lenta Limited; stable outlook, January 2013

Industry Outlook:

» European Retailers: Euro Area Sales Continue To Contract, But Are Diverging By Country, October 2012 (145574)

Sector Comment:

» European Meat Scandal Could Dent Consumer Confidence in Food Supply, February 2013 (150045)

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» contacts continued from page 1

Analyst Contacts:

DIFC +971.4.401.9536

David G. Staples +971.4.237.9562
Managing Director - Corporate Finance
david.staples@moodys.com

Report Number: 150505

Author
Sergei Grishunin

Editor
Gregory Davies

Production Associate
Sarah Warburton

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