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## Research Update:

# Austria-Based Strabag Upgraded To 'BBB' On Strengthened Credit Ratios; Outlook Stable

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## Overview

- We believe Austria-based engineering and construction group Strabag will continue showing strong credit metrics in 2015 and 2016, thereby improving its financial risk profile.
- We are raising our long-term corporate credit rating on Strabag to 'BBB' from 'BBB-'.
- The stable outlook reflects our view that Strabag's adjusted EBITDA margin will be around 6% over 2015 and 2016, and that it currently has some headroom within its leverage metrics to absorb some expansionary investments in working capital, capital expenditures, and selected bolt-on or midsize acquisitions.

## Rating Action

On June 22, 2015, Standard & Poor's Rating Services raised its long-term corporate credit rating and senior unsecured debt rating on Austria-based engineering and construction group Strabag SE to 'BBB' from 'BBB-'. The outlook is stable.

## Rationale

The upgrade reflects our view that Strabag will continue to show strong credit ratios in 2015 and 2016 significantly above the level we considered commensurate with the previous 'BBB-' rating. Strabag's credit ratios over the past few quarters were significantly above our expectations. Funds from operations (FFO) to debt was about 85% for the 12 months ended March 31, 2015, and we expect the company will maintain similar levels in 2015 and 2016. At the same time, we expect Strabag's free operating cash flow (FOCF) will be negative in 2015, owing to capital expenditures and reversal of working capital inflow of about €200 million in 2014, and due to the receipt of customer advances. Still, we expect Strabag's credit metrics will remain fairly robust and commensurate with a "modest" financial risk profile.

As is typical in the engineering and construction industry, Strabag has substantial seasonal working capital swings over the year, which can amount to up to €500 million in the first three quarters. We expect Strabag will keep careful control over its debt levels because inherent industry risk can lead to significant deterioration in credit metrics over a relatively short period.

We consider on- and off-balance-sheet nonrecourse debt relating to public-private partnership (PPP) investments in our analysis of Strabag's liquidity, but do not include it in any of our reported leverage ratios. This is because we do not expect Strabag will provide financial support to those concessions in case of need.

We continue to assess Strabag's business risk profile as "satisfactory", supported by the group's leading market positions in Central and Eastern Europe's engineering and construction markets. The group's good order backlog, usually covering about one year of earnings, provides decent forward visibility. We also consider its cost base to be relatively flexible, which underpins the group's credit profile. We assess as positive the company's generally effective risk management and low volatility in profitability metrics displayed over the past few years. At the same time, profitability levels, although likely to improve somewhat over the next few years, are still below the industry average. This also reflects the competitive landscape of the industry in countries and segments where the company operates.

The industry's above-average risk constrains our assessment of Strabag's business risk profile as "modest." Fixed-cost contract pricing and the risk of misjudging project expenses or timing can lead to cost overruns, which are usually the liability of the contractor. In civil engineering, competitive tenders and large projects with low insight in terms of contract risk and performance heighten operating risk.

We believe Strabag's business risk profile is weaker than some peers we assess as having "satisfactory" business risk, reflecting its comparatively low geographic diversification and profitability. We reflect this in our negative comparable rating analysis modifier.

Under our base case, we assume:

- Low single-digit volume growth in 2015 and 2016. We expect the company's sizable order backlog, that provides good short-term visibility over activity levels, will back volume growth. We also expect some growth in Strabag's international business and property and facility services.
- Operating margins should benefit from past restructuring and Strabag's risk management program, which should compensate the negative impact from continued intense pricing pressure.
- Capital expenditures of about 3.0%-3.5% of sales between 2015-2017, coupled with working capital investments, partly shaped by a reversal of advance payment trends.
- About €50 million-€100 million for bolt-on acquisitions annually.

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

- FFO to debt of above 60% and debt to EBITDA of less than 1.5x in 2015 and 2016.
- Comparatively weaker FOCF to debt over the next few years, which we estimate will be in the "intermediate" financial risk profile category.

### Liquidity

We consider Strabag's liquidity position to be "strong" as defined by our criteria. We estimate that liquidity sources will exceed needs comfortably by more than 1.5x in 2015 and 2016.

Principal liquidity sources are:

- About €1.9 billion in cash (net of €20 million we consider to be tied to subsidiary AKA) on March 31, 2015.
- Access to a fully undrawn €400 million syndicated loan facility maturing in June 2019.
- Annual cash FFO generation of €550 million-€650 million.

Principal liquidity uses are:

- Short-term maturities of €447 million by the end of March 2015, but we note that a large proportion relates to bilateral bank lines that we expect the group will roll over.
- Capital spending of about €400 million per year over the next two years.
- Significant cash outflows related to seasonal working needs, due to the nature of the business, of about €500 million by the end of the third quarter, when debt generally peaks.
- Bolt-on acquisitions of about €50 million-€150 million annually for the next few years.
- Dividend payments of about €60 million-€80 million annually.

Strabag's syndicated loan facility is subject to a financial leverage covenant, but headroom is currently ample and we assume no tightening in our base case.

## Outlook

The stable outlook reflects our view that Strabag's adjusted EBITDA margin will be around 6% in 2015 and 2016. We believe that Strabag currently has some headroom in its leverage metrics to absorb some expansionary investments in working capital, capital expenditures, and selected bolt-on or midsize acquisitions. We expect Strabag's FFO to debt will exceed 45%, debt to EBITDA will remain below 2x, and liquidity will remain strong over the next few years.

### Upside scenario

We could raise the ratings if we observed a track record of consistently positive discretionary cash flows, while at the same time FFO to debt and debt to EBITDA were more than 60% and less than 1.5x, respectively. We note that Strabag's financial metrics within the year are generally significantly weaker, mainly reflecting seasonal working capital requirements. We could also raise the ratings if the company's operating performance improves significantly, thus leading to much stronger profitability metrics.

### Downside scenario

We could consider a negative rating action if Strabag's debt-to-EBITDA ratio rises to more than 2x and FFO to debt drops to less than 45% over a sustained period of time. We believe that there is significant room for a potential weakening of operating performance at the current rating level. However, a weaker operating performance and higher working capital needs could result in weaker leverage metrics and thus put pressure on the ratings. Downside pressure on the ratings may also arise from high debt, owing, for instance, to sizable acquisitions or increased shareholder returns.

## Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/--

Business risk: Satisfactory
- Country risk: Low
- Industry risk: Moderately high risk
- Competitive position: Satisfactory

Financial risk: Modest
- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Negative (-1 notch)

## Related Criteria And Research

### Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Upgraded

| | To | From |
|---|---|---|
| Strabag SE | | |
| Corporate Credit Rating | BBB/Stable/-- | BBB-/Stable/-- |
| Senior Unsecured | BBB | BBB- |

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