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Strabag SE

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Strabag SE

Major Rating Factors

Corporate Credit Rating
BBB-/Stable/--

Strengths:

- Leading market positions in road construction in Central Europe and some parts of Eastern Europe.
- Vertical integration, which provides barriers to entry and strategic access to raw materials.
- Track record of relatively stable, albeit thin, operating margins typical for the industry, which indicate generally good project execution and cost management.
- Solid capital structure.

Weaknesses:

- Cyclical and competitive industry, inherently exposed to project risk.
- High exposure to the low-margin German construction sector.
- Historically weak, although recently improved, cash flow generation profile.
- Evolving corporate governance practices and financial policies.

Rationale

The ratings on Austria-based engineering and construction company Strabag SE reflect Standard & Poor's Ratings Services' view of its "satisfactory" business risk profile, according to our classifications, as a leader in road construction and civil engineering in Central and Eastern Europe (CEE). In addition, Strabag benefits from good business diversity and vertical integration, which provides barriers to entry and strategic access to raw materials. The company's favorable operational track record and sizable contract backlog, despite difficult industry conditions, further underpin the ratings. What's more, Strabag's solid capital structure offers a cushion against adverse market developments and potential project failures.

These strengths are offset by the company's exposure to high project-related execution risks in the construction industry, which is cyclical and competitive and offers low margins. Furthermore, Strabag's credit profile is constrained by its track record of aggressive financial policies and the resulting negative free operating cash flows, as well as limited transparency concerning the group's corporate governance. We see, however, that Strabag's free cash flows turned positive in 2009 because it reduced growth-related spending.

We believe that the return of Mr. Oleg Deripaska as a main shareholder, with 17% of the outstanding shares, has no immediate impact on the company's credit profile. We will, however, closely monitor the company's approach to its likely expansion in Russia to assess the potential impact on our assessment of Strabag's business and financial risk profiles.

Key business and profitability developments

Strabag's operating performance throughout 2010 has shown more resilience to the difficult operating environment than we previously expected. In the first nine months of 2010, Strabag's reported revenues of about €8.9 billion were down only slightly by 2% year on year, supported by a healthy 2009 order backlog and stronger-than-anticipated order intake levels over past quarters. Over the same period, Strabag largely maintained its profitability measures, with the EBITDA margin increasing modestly to 5.4% from 4.8% year on year.

We believe that Strabag's order backlog of about €14.9 billion on Sept. 30, 2009, improves its near-term prospects, providing there are no delays or cancellations of major projects. Over the medium term, however, Strabag might face an increasingly difficult operating environment, given its high exposure to infrastructure construction and, consequently, public spending levels, which could be hampered by the frail state of treasury budgets across many European countries. We believe that likely lower demand from the public sector could be partly balanced by recovery in the private and industrial construction sectors in some European countries and opportunistic orders from other regions, such as the Middle East and Africa.

Key cash flow and capital-structure developments

Following strong cash generation in 2009 on the back of substantial capital expenditure cuts and stringent control of working capital, which resulted in a positive adjusted net cash position at year's end, the company faced typical working capital cash outflows over the first nine months of 2010. In the 12 months to Sept, 30, 2010, adjusted funds from operations (FFO) to debt and adjusted debt to EBITDA (excluding nonrecourse debt and related earnings and cash flows) were still strong for the rating at about 100% and about 1x, respectively. We believe the fourth quarter to be normally cash generative because of the seasonality of the business. This is likely to result in even stronger credit-protection measures at year-end 2010.

As of Sept. 30, 2010, Strabag's adjusted debt was about €635 million. This excludes nonrecourse debt and cash at Strabag's concession company Alföd Koncessizios Autopalya Zrt (AKA) in Hungary, but includes about €670 million related to operating leases and pension obligations. Although these credit measures are above the guidelines we consider typical for the ratings, we believe that Strabag will use some of this headroom for acquisitions and/or other expansionary investments over the near to medium term.

Liquidity

Liquidity is adequate, in our view. As of Sept. 30, 2010, Strabag had about €1,227 million in cash and cash equivalents, and €406 million available under short-term revolving credit facilities. Available liquidity sources should remain sufficient to service near-term debt obligations and working capital swings. Furthermore, Strabag has some capital spending flexibility, which creates a cushion to operating cash flows if markets decline more sharply than we expect.

The short-term tenor of revolving working capital credit facilities poses a liquidity risk, which is partly offset by credit lines from various banks with which Strabag has long-standing relationships. Bank and guarantee facilities are subject to financial covenants and material adverse-effect clauses. We expect headroom under the covenants to remain sufficient.

Strabag's liquidity is supported by its undemanding debt-maturity profile. As of Sept. 30, 2010, the company reported debt of €1.56 billion, of which about €302 million was short term, with about one-quarter related to drawings under the short-term working-capital credit lines. Furthermore, the debt structure included the following:

- €737 million of nonrecourse funding (of which €41 million was short term) related to an "availability-type" concession at Hungary-based AKA, which is secured by a fixed fee that Strabag receives from the local government; and

- €320 million in unsecured bonds (of which €75 million is short term).

Outlook

The stable outlook reflects our opinion that, despite difficult markets, Strabag's satisfactory business profile, marked by its leading market positions and good operating track record, will continue to support its current credit profile. We view Strabag's disciplined capital investment policy and its attention to risk control management as key factors in helping the company to maintain a rating-commensurate financial profile if operating profits come under pressure. Its prudent bidding strategy is even more essential during soft market conditions, which are characterized by more aggressive competition.

Furthermore, we expect Strabag's future financial policy to be executed in a way that sustains Strabag's credit profile. We believe the company will be able to maintain adjusted debt to EBITDA of less than 2.5x, positive free operating cash flows (before expansionary capital expenditure), and adequate liquidity, which are commensurate with metrics at the 'BBB-' rating level.

Downside risks to the rating would primarily be weaker-than-expected conditions in the company's major markets, in particular, the infrastructure sector; excessive debt levels from acquisition activities; shareholder returns that are more generous than we expect; and/or deteriorating liquidity.

We would consider a positive rating action if we believe that the company's credit measures will remain consistently in line with a "modest" financial risk profile, and the company demonstrates a financial policy commensurate with a higher rating, while ensuring that the business risk profile does not weaken.

Business Description

With annual output of more than €13.0 billion in 2009 (€13.7 billion in 2008), Strabag is one of Europe's largest construction groups. The company has three divisions:

- Building Construction & Civil Engineering: Commercial and industrial building, public building, general and residential building, and various civil-engineering projects;
- Transportation Infrastructures: Asphalt and concrete road construction, railway construction, and production of building materials for internal and external supply; and
- Special Divisions & Concessions: Tunneling works, special ground engineering, project development, concessions, and facility management.

Following recent changes, the current shareholder structure is as follows:

- Raiffeisen/UNIQA Group (30.5%);
- Haselsteiner Group (29.5%);
- Rasperia Trading (17.0%); and
- Free float (23.0%).

Business Risk Profile: A Broad Supply Network Underpins Leading Market Positions In Risky, Low-Margin And Cyclical Markets

The major supports for Strabag's satisfactory business risk profile are:

- Leading market positions across CEE. Strabag is the market leader in road construction in Austria, Germany, Hungary, Slovakia, and Romania. It is also one of the three largest construction companies in the Czech Republic, and Poland. The company enjoys a decent presence in other Eastern European markets, as well as Italy and Switzerland.
- Vertical integration, which yields a competitive edge. Strabag operates an extensive network of asphalt- and concrete-mixing plants (self-sufficiency of 79% in asphalt and 38% in concrete) and gravel quarries and pits (self-sufficiency of 17%), which provides direct access to strategic raw material supplies. This creates effective barriers to entry, given that customers frequently require contractors to provide internally produced raw materials and there are typically strict environmental regulations regarding the establishment of new quarry sites.
- Relatively stringent risk control processes, in our view, to monitor work in progress, with profit centers for each project. These include a standardized approval process for new projects. Nevertheless, visibility on individual contractual exposures, delays, or progress is low, and we rely principally on publicly disclosed information.
- A long track record of relatively stable profitability, reflected in EBITDA margins of about 5.5% and an adjusted return on capital of about 12% on average over the past six years--broadly in line with industry averages--despite meaningful business expansion and integration of lower-margin companies. We believe this indicates reasonably effective risk management, although margins are typically thin. Also, decent diversity of order backlog by contract size, client, and industry segment also helps the company maintain a relatively stable operating margin.
- Flexibility to adjust the cost base if operating profits were to come under pressure. This is because third-party services/outsourcing account for 42% of revenues, raw materials 23%, and labor 22%. Flexibility to shift construction resources from one segment to the other is fairly limited, however, because specialized skills for general construction cannot be easily deployed in infrastructure works and vice versa.

These supports, however, may be challenged by:

- Above-average industry risk. Low barriers to entry, litigation and cost-overrun risks, cyclicality, and seasonality characterize the sector. The combination of 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 heighten operating risks.
- Low operating margins. Although generally consistent, Strabag's margins are thin, which is typical for the industry, and could deteriorate if there are cost overruns or delays on major projects. In the near to medium term, the group's profitability could come under pressure, due to the industry downturn and more intense competition.
- Limited presence outside Europe. We understand that Strabag will focus on its key European markets, where it generates good operating results. To partly counterbalance the lack of geographic diversity, Strabag will continue to engage in projects outside its core markets, in areas like Africa, the Middle East, and India, where it can capitalize on its expertise in infrastructure construction.
- Exposure to the fragmented, very competitive, and low-margin German construction market. Strabag is the leading player in the German market, which accounts for about one-third of its output volume. We consider that this material share constrains geographic diversity.

Financial Risk Profile: A Solid Capital Structure Offsets Aggressive Financial Policies

The main strengths of Strabag's "intermediate" financial risk profile are:

- A solid capital structure and strong liquidity profile, with balance-sheet cash and cash equivalents exceeding €800 million at the reporting date, over the past two years. Given the high industry risks, a strong balance sheet and robust liquidity is necessary to cushion unexpected occurrences. Furthermore, a sound capital structure provides a competitive edge because customers favor financially robust counterparties when awarding large contracts.
- Credit measures that are better than our guidelines for the ratings. We believe, however, that Strabag will use some of this headroom for acquisitions and/or other expansionary investments over the near to medium term.
- Structurally good operating cash flows to fund maintenance capital expenditures, supported by demonstrated ability to receive progress payments from customers, which generates working-capital resources.

These strengths are moderated by:

- An aggressive financial policy. The company has a track record of expansionary spending and debt-financed acquisitions. Although Strabag has significantly scaled back its discretionary spending over the past several quarters, we believe that growth through acquisitions is likely to remain a key element of the group's strategy. We believe, however, that expansionary policies will be implemented in a manner that preserves the company's credit quality, particularly because of soft market conditions. Consequently, we anticipate that Strabag will maintain adjusted debt to EBITDA at less than 2.5x, positive free operating cash flows (before expansionary capital expenditure), and adequate liquidity, commensurate with the 'BBB-' rating.
- Evolving corporate governance practices and high risk tolerance as demonstrated by a track record of negative free operating cash flows. We view positively the cash preservation policy Strabag implemented in 2009 in response to challenging industry conditions. We believe, however, that the company is likely to resume its expansionary policy once construction markets recover.

Financial Statistics/Adjustments

Strabag reports under International Financial Reporting Standards. It recognizes its revenues from construction projects according to the percentage-of-completion method. Although this is less conservative than recognition upon delivery, expected losses are immediately reported as expenses, and we expect Strabag to continue to have the expertise and resources needed to measure costs and track potential overruns accurately. We remain concerned, however, about the absence of disclosure on the progress of individual contracts (even the largest ones), which is typical for the industry.

Although Strabag's share of total nonrecourse debt in public-private partnership (PPP) projects is material (€1.9 billion as of Dec. 31, 2009), the debt is spread over 29 concessions, which are unlikely to fail simultaneously. Furthermore, if a project were to face operational problems, leading to a major liquidity shortfall, we would not expect Strabag to provide financial support unless it was contractually obliged to do so. There is little precedent in this regard, however, and Strabag could decide to financially support its PPP projects beyond the contractual requirements to avoid tarnishing its reputation or to protect its investment. Accordingly, we consider on- and off-balance-sheet nonrecourse debt relating to such investments in our liquidity analysis, but do not include it in any of our reported financial ratios.

As a common industry practice, Strabag must provide security, such as bank guarantees, performance bonds, or customer payment bonds to support its contract obligations. As of Sept. 30, 2010, these obligations were about €4.1 billion. We do not add these contingent liabilities to debt for ratio calculation because there should be limited impact as long as Strabag maintains its work and product quality.

In calculating Strabag's financial metrics for the 12 months to Sept. 30, 2009, we made the following adjustments to Strabag's reported figures (see table 1):

- We capitalized operating leases as of Dec. 31, 2009, using the net-present-value method. This increased the group's debt by €236 million.
- We made an adjustment for unfunded postretirement benefit obligations as of Dec. 31, 2009, adding about €435 million to Strabag's reported debt.
- We reduced total cash of €1,227 million by €370 million, which we considered as structurally encumbered and therefore not available for other purposes (about €70 million relates to AKA concessions). We therefore deducted about €857 million of surplus cash from adjusted gross debt.
- We reduced total reported debt of €1.56 billion by €737 million of nonrecourse debt in the AKA concession.

Table 1

Reconciliation Of Strabag SE Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)*

	--12 months ended Sept. 30, 2010--						
Strabag SE reported amounts							
	Debt	**Operating income (before D&A)**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Cash flow from operations**	**Cash flow from operations**	**Capital expenditures**
Reported	1,557.8	670.5	670.5	252.3	890.3	890.3	592.1
Standard & Poor's adjustments							
Operating leases	235.6	52.2	7.1	7.1	45.0	45.0	137.4
Postretirement benefit obligations	434.6	--	--	--	(0.3)	(0.3)	--
Surplus cash and near cash investments	(856.8)	--	--	--	--	--	--
Nonrecourse debt	(736.5)	(28.3)	(28.3)	(28.3)	(28.3)	(28.3)	--
Reclassification of nonoperating income (expenses)	--	--	--	117.0	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	33.4	33.4	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	(330.6)	--
Minority interests	--	--	--	--	--	--	--
Total adjustments	(923.2)	23.9	(21.2)	95.9	49.8	(280.8)	137.4

Table 1

Reconciliation Of Strabag SE Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)* (cont.)

Standard & Poor's adjusted amounts

	Debt¶	Operating income (before D&A)	EBITDA	EBIT	Cash flow from operations	Funds from operations	Capital expenditures
Adjusted	634.6	694.3	649.3	348.2	940.0	609.4	729.5

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. ¶Standard & Poor's adjustment for surplus cash and investments does not allow debt to be less than zero.

Table 2

Strabag SE--Peer Comparison*

	Strabag SE	Technip	SNC-Lavalin Group Inc.¶	Leighton Holdings Ltd.
Corporate credit rating as of Dec. 29, 2010	BBB-/Stable/--	BBB+/Stable/A-2	BBB+/Stable/--	BBB/Stable/A-2
(Mil. €)	**--Fiscal year ended Dec. 31, 2009--**			**Fiscal year ended June 30, 2010**
Revenues	12,551.9	6,486.2	3,719.9	10,028.6
Net income from continuing operations	161.5	170.4	239.0	422.0
Funds from operations (FFO)	636.4	438.3	444.8	1,561.3
Capital expenditures	646.2	591.6	257.1	861.5
Free operating cash flow	518.7	108.2	23.1	551.9
Debt	0.0	0.0	566.2	1,661.2
Equity	3,099.1	2,703.6	1,000.5	1,763.7
Adjusted ratios				
Operating income (before D&A)/revenues (%)	5.7	11.5	11.8	15.9
EBIT interest coverage (x)	3.6	5.8	13.3	3.9
EBITDA interest coverage (x)	7.2	8.4	16.7	6.7
Return on capital (%)	10.0	18.7	24.6	22.7
FFO/debt (%)	N.M.	N.M.	78.8	95.2
Free operating cash flow/debt (%)	N.M.	N.M.	7.1	42.5
Debt/EBITDA (x)	0.0	0.0	1.4	1.2
Total debt/debt plus equity (%)	0.0	0.0	36.2	48.5

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. ¶Excess cash and investments not netted against debt. N.M.--Not meaningful.

Table 3

Strabag SE--Financial Summary*

		--Fiscal year ended Dec. 31--				
	12 months ended Sept. 30, 2010	2009	2008	2007	2006	2005
Rating history	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BB+/Stable/--	BB/Positive/--
(Mil. €)						
Revenues	12,349.7	12,551.9	12,227.8	9,878.6	9,430.6	6,955.8
Net income from continuing operations	167.0	161.5	157.0	170.2	191.4	49.9

Table 3

Strabag SE--Financial Summary* (cont.)						
Funds from operations (FFO)	609.4	636.4	652.3	463.8	424.9	324.6
Capital expenditures	729.5	646.2	921.5	588.2	370.1	277.3
Free operating cash flow	210.5	518.7	(191.1)	(70.6)	(149.2)	5.2
Debt	634.6	0.0	399.8	0.0	975.9	989.2
Equity	3,147.0	3,099.1	2,979.0	3,096.5	1,035.9	905.5
Adjusted ratios						
Operating income (before D&A)/revenues (%)	5.6	5.7	5.4	5.9	5.3	5.1
EBIT interest coverage (x)	2.8	3.6	3.9	3.9	3.1	2.9
EBITDA interest coverage (x)	5.2	7.2	6.9	5.9	4.7	4.7
Return on capital (%)	9.0	10.0	10.9	14.5	16.3	11.6
FFO/debt (%)	96.0	N.M.	163.2	N.M.	43.5	32.8
Free operating cash flow/debt (%)	33.2	N.M.	(47.8)	N.M.	(15.3)	0.5
Debt/EBITDA (x)	1.0	0.0	0.6	0.0	2.0	2.9
Debt/debt and equity (%)	16.8	0.0	11.8	0.0	48.5	52.2

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. N.M.--Not meaningful.

Related Criteria And Research

- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Principles Of Corporate And Government Ratings, June 26, 2007

Ratings Detail (As Of December 29, 2010)*	
Strabag SE	
Corporate Credit Rating	BBB-/Stable/--
Senior Unsecured (4 Issues)	BBB-
Corporate Credit Ratings History	
14-Nov-2007	BBB-/Stable/--
25-May-2007	BB+/Positive/--
30-May-2006	BB+/Stable/--
Business Risk Profile	Satisfactory
Financial Risk Profile	Intermediate
Debt Maturities	
(As of Sept. 30, 2010) 2011: €302 mil. Thereafter: €1.26 bil.	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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