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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 operating margins, which indicates generally good project execution and cost management.
- Solid capital structure and strong liquidity.

Weaknesses:

- Cyclical and competitive industry that is inherently exposed to project risk.
- Relatively low adjusted EBITDA margin of between 5% and 6%, which is typical for the industry.
- Historically weak, although recently improved, cash flow generation profile.
- Growth-oriented and shareholder-friendly financial policy.

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, marked by the group's leading market position 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 further underpin the ratings, despite the currently difficult industry conditions. What's more, Strabag's solid capital structure and strong liquidity offers a cushion against adverse market developments and potential project failures.

These strengths are offset, in our view, by the company's exposure to high project-execution risks in the construction industry, which is cyclical and competitive and low-margin. Furthermore, Strabag's credit profile is constrained by its track record of growth-oriented and shareholder-friendly financial policies and resulting negative free operating cash flows (FOCF). We see, however, that Strabag's free cash flows have turned positive since 2009 after the company reduced growth-related spending. This could potentially reverse in 2011 because the company has resumed a higher level of expansionary investments.

S&P base-case operating scenario

We consider the group's order backlog as the main impetus for revenue growth, covering about 1.1x revenues for the 12 months to Sept. 30, 2011. However, we believe that acquired companies should also make some small contribution to revenue expansion. We also believe that Strabag's good geographic diversification, and limited exposure to Southern European construction markets, will support future revenue generation because a declining order intake from slowing construction markets such as Poland could be balanced by growth in others. These assumptions take into account Standard & Poor's economists' economic base case assumption of a mild recession instead of a more severe double dip (for which our economists currently see a 40% likelihood; for further details see

"European Economic Outlook: Back In Recession," published on Dec. 01, 2011). We anticipate that Strabag will report revenues of about €13.1 billion in 2011, somewhat below last-12-month (LTM) revenues as of Sept. 30, 2011. For 2012 and 2013, we expect revenues to stay fairly flat. Furthermore, we believe that competitive pressures will increase in a difficult market environment, which we expect could be shaped by public austerity measures that could negatively affect Strabag's pricing power, in particular in its Civil Engineering segment. As a result, we assume that Strabag's adjusted EBITDA margin will decline to about 5.0% in 2012, after a still robust 5.5% in 2011 (this compares with the 5.7% it achieved in 2010) and to show further small declines in 2013.

S&P base-case cash flow and capital-structure scenario

In our base-case assumption we expect that Strabag will be able to generate adjusted funds from operations (FFO) in the range of €550 million to €600 million in 2011, which is broadly in line with its adjusted FFO generation of about €577 million for the 12 months ended Sept. 30, 2011. For 2012 and 2013, we forecast FFO will drop to between €450 million and €500 million and to between €400 million and €450 million, respectively, mostly driven by lower earnings, but also affected by higher funding costs. In our base case, we also anticipate that working capital requirements will lead to moderate cash outflows, owing to an anticipated decline in advance payments to be received by Strabag. We assume capital expenditures (capex) in line with the company's budgeted of €580 million and €475 million for 2011 and 2012, respectively, followed by about €500 million per year in 2013.

As a result, we expect that FOCF will be slightly negative over our forecasting horizon of two years and we expect that this could moderate cash flow protection ratios. This follows four years of very strong ratios caused by low adjusted debt levels, during which time Strabag had an adjusted net cash position for 2009 and 2010. We have also assumed the company will make full use of its share-buyback program that had already led to a cash outflow of about €137 million in the first nine months of 2011. We do not expect more than a cumulative €260 million cash outflow related to the share-buyback program for 2011 and 2012 and a moderate yearly increase in dividend payouts from 2010 levels. In addition, we assume the company will pay out €150 million in acquisitions per year.

In our base-case assessment, we forecast debt to EBITDA, as adjusted by Standard & Poor's, will increase to about 1.3x for 2012, and to about 2.0x for 2013. This would still be below the 2.5x we view as commensurate with the current ratings. For 2011, we assume debt to EBITDA will be slightly down to 0.6x, from 1.1x as of Sept. 30, 2011, owing to the group's usual seasonality of cash and earnings generation that causes volatility of credit protection measures in any given year.

Liquidity

We consider Strabag's liquidity position as "strong" under our criteria. Available liquidity sources should remain sufficient to service near-term debt obligations and working capital swings. We estimate that liquidity sources will exceed liquidity needs by about 1.7x in 2011 and about 1.4x in 2012. As of Sept. 30, 2011, Strabag had about €1,298 million in cash and cash equivalents and €272 million available under short-term revolving credit facilities. Furthermore, Strabag has some capital spending flexibility, which creates a cushion to operating cash flows if markets decline more sharply than we currently expect.

The short-term tenor of revolving working capital credit facilities poses a liquidity risk, in our view. This 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.

We estimate liquidity sources for 2012 of about €1.6 billion. These include:

- Surplus cash of about €1.1 billion, excluding €370 million of cash that we consider to be tied up for operations and the M5 highway concession company AKA in Hungary that Strabag owns. On Sept 30, 2011, Strabag reported consolidated cash and equivalents of €1,298 million; and
- About €450 million to €500 million of reported FFO.

We do not assume for our liquidity analysis that the company would be able to rely on its bilateral credit lines given their short-term nature.

Strabag's liquidity is supported by its undemanding debt-maturity profile. As of Sept. 30, 2011, the company reported debt of €1.8 billion, of which about €468 million was short term. Furthermore, the debt structure included the following:

- €756 million of nonrecourse funding (of which €103 million was short term) related mostly to an "availability-type" concession at Hungary-based AKA. About €61 million is related to a motorway public-private partnership (PPP) project in Denmark. Both projects have contracted fixed fees that Strabag receives from the local governments; and
- €425 million in unsecured bonds (of which €75 million is short term).

Outlook

The stable outlook reflects our expectation that, although Strabag's credit metrics could weaken they will remain in line with levels view as commensurate with the ratings. This includes debt to EBITDA of less than 2.5x. We assume the group will maintain an adjusted EBITDA margin above 4.5% over the coming two years and avoid significantly negative free operating cash flows. We view Strabag's disciplined capital investment policy and its attention to risk control management as key factors in helping the company maintain a rating-commensurate financial profile should operating profits come under pressure. We believe that Strabag's demonstrated prudent bidding strategy is even more essential during soft market conditions, which are characterized by more aggressive competition.

We could raise the ratings if Strabag's credit measures stay above levels we view commensurate with a 'BBB' rating, such as FFO to debt of more than 45%, and debt to EBITDA of less than 1.5x. However, we don't expect that this would be the most likely scenario in the currently deteriorating economic environment. We believe an upgrade would also necessitate an order backlog that gives sufficient visibility for 2013, which we think could potentially be a difficult year for late-cyclical companies such as Strabag.

Downside risks to the rating could increase should Strabag increased its leverage ratio sustainably above debt to EBITDA of 2.5x. Downside risks would also likely be driven by weaker-than-expected conditions in the company's major markets, in particular the infrastructure sector; excessive debt levels from acquisition activities and/or shareholder returns; and/or deteriorating liquidity.

Business Description

With an annual output of more than €12.8 billion in 2010 (€13.0 billion in 2009), 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%);
- Free float (15.5%); and
- Treasury shares (7.5%).

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

The major factors supporting Strabag's "satisfactory" business risk profile are, in our view:

- Leading market positions across Central and Eastern Europe (CEE). Strabag is the market leader in road construction in Austria, Germany, Hungary, Slovakia, Romania, and Poland. The company enjoys a decent presence in other Eastern European markets, as well as in Italy. In the current environment, we see Strabag's relatively limited exposure to other Southern European construction markets, such as Spain and Portugal, as a positive factor for its business risk.
- Vertical integration, which yields a competitive edge. Strabag operates an extensive network of asphalt- and concrete-mixing plants (self-sufficiency of 82% in asphalt and 38% in concrete) and gravel quarries and pits (self-sufficiency of 20%), 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. This is 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. Furthermore, Strabag's decent diversity of order backlog by contract size, client, and industry segment also helps the company maintain relatively stable operating margins.
- 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 supporting factors may, however, 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 weakened industry prospects 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, we understand that Strabag will continue to engage in projects outside its core markets, in areas such as Africa, the Middle East, and India, where it can capitalize on its expertise in infrastructure construction, but which are partly more exposed to country risks.
- Exposure to the fragmented and very competitive German construction market. Strabag is the leading player in the German market, which accounts for about 40% of its output volume. Although market conditions have improved over recent years, we consider that this material share constrains geographic diversity.

Financial Risk Profile: A Solid Capital Structure Offsets Growth-Oriented And Shareholder-Friendly Financial Policies

We view the main strengths of Strabag's "intermediate" financial risk profile as:

- A solid capital structure and strong liquidity profile. Balance-sheet cash and cash equivalents exceeded €900 million at each reporting date over the past three years and the average debt-to-capital ratio was 11% over the past two years. Given the high industry risks, Strabag needs a strong balance sheet and robust liquidity 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. Nevertheless, we believe that Strabag will use some of this headroom for acquisitions and/or other expansionary investments such as in the environmental technology sector and wind energy sector, over the near to medium term. We believe that growth investments are 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.
- Structurally good operating cash flows to fund maintenance capital expenditures. This is supported by Strabag's demonstrated ability to receive progress payments from customers, which generates working-capital resources.

These strengths are moderated, in our view, by:

- High intra-year working capital requirements. Strabag faces significant intra-year working capital funding needs due to its business seasonality. Credit metrics are therefore strongest at year-end, with peak debt levels usually occurring at the end of the third quarter. Working capital needs amounted to up to €500 million in the past two years.

- A growth-oriented and shareholder-friendly financial policy. The company has a track record of expansionary spending and debt-financed acquisitions, which have frequently resulted in negative free operating cash flows after acquisition spending. Although Strabag has significantly scaled back its discretionary spending in 2008 and 2009, it has returned to its growth-oriented strategy in late 2010 as demonstrated by its €70 million advance payment made for a 26% stake in Russian construction company Transstroy (a subsidiary of Basic Element that is owned by Strabag's shareholder Mr. Oleg Deripaska) and several additional acquisitions it has undertaken since then. In addition to this, Strabag announced a share-buyback program in 2011, a year when Strabag's discretionary cash flows are likely to be negative. The share-buyback program is expected to lead to cash outflows of about €200 million to €260 million.

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. Nevertheless, we note the absence of disclosure on the progress of individual contracts (even the largest ones), which is typical for the industry.

Although Strabag's proportional share of total nonrecourse debt in PPP projects is material (€2.1 billion as of Dec. 31, 2010), the debt is spread over 33 concessions, which are unlikely to fail simultaneously. The Hungarian nonrecourse debt proportion accounts for about €715. So far, the Hungarian government has fulfilled all of its obligations. Furthermore, if a project faced 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. Similarly, we deconsolidate the earnings and cash flows contributed by the PPP projects. In our analysis, we also take into account eventual counterparty risks, which in our view have increased over recent years, as demonstrated by the downgrades of the Republic of Hungary (BBB-/Watch Neg/A-3). We understand, that Strabag so far has not had any problems collecting its fees.

As is common industry practice, Strabag must issue bank guarantees, performance bonds, and customer payment bonds to support its contract obligations. As of Sept. 30, 2011, these obligations were about €4.2 billion. We do not add these contingent liabilities to debt for ratio calculation because there should be limited impact from them as long as Strabag maintains its work and product quality.

- In calculating Strabag's financial metrics for the 12 months to Sept. 30, 2011, we made the following adjustments to Strabag's reported figures (see also table 1): We capitalized operating leases as of Dec. 31, 2010, using the net-present-value method. This increased the group's debt by €224 million.
- We made an adjustment for unfunded postretirement benefit obligations as of Dec. 31, 2010, adding about €444 million to Strabag's reported debt.
- We reduced total cash of €1,298 million by close to €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 €928 million of surplus cash from adjusted gross debt.

- We reduced total reported debt of about €1.8 billion by about €756 million of nonrecourse debt, mostly in the AKA concession.

Table 1

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

	--Rolling 12 months ended Sept. 30, 2011--									
Strabag SE reported amounts.										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	1,799.2	2,940.6	13,201.8	764.2	340.9	51.5	736.7	736.7	67.3	507.0
Standard & Poor's adjustments										
Operating leases	224.0	--	--	8.7	8.7	8.7	58.7	58.7	--	47.1
Postretirement benefit obligations/deferred compensation	444.2	--	--	--	--	22.5	(0.2)	(0.2)	--	--
Surplus cash	(928.0)	--	--	--	--	--	--	--	--	--
Nonrecourse debt	(755.6)	--	--	--	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	--	57.7	--	--	--	--	--
Changes in assets and liabilities	--	--	--	--	--	--	--	(182.3)	--	--
Non-controlling Interest/Minority interest	--	188.6	--	--	--	--	--	--	--	--
EBITDA - Other	--	--	--	(36.1)	(36.1)	--	--	--	--	--
FFO - Other	--	--	--	--	--	--	(36.1)	(36.1)	--	--
Total adjustments	(1,015.4)	188.6	0.0	(27.5)	30.3	31.2	22.4	(159.9)	0.0	47.1
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Dividends paid**	**Capital expenditures**
Adjusted	783.8	3,129.2	13,201.8	736.7	371.2	82.7	759.1	576.8	67.3	554.1

Table 2

Strabag SE -- Peer Comparison

Industry Sector: Engineering & Construction				
	Strabag SE	**Technip**	**SNC-Lavalin Group Inc.**	**Leighton Holdings Ltd.**
Rating as of Dec. 20, 2011	BBB-/Stable/--	BBB+/Stable/A-2	BBB+/Stable/--	BBB-/Stable/A-3
(Mil. €)	--Fiscal year ended Dec. 31, 2010--			--Fiscal year ended June 30, 2011--
Revenues	12,381.5	6,100.0	4,230.2	11,470.2
EBITDA	707.2	821.9	510.6	420.4
Net income from cont. oper.	174.9	417.6	327.8	(301.9)
Funds from operations (FFO)	512.6	609.4	458.9	689.0
Capital expenditures	600.9	446.0	407.5	1,063.7
Free operating cash flow	111.9	(337.5)	(58.1)	117.5
Discretionary cash flow	49.9	(481.1)	(135.1)	(205.7)
Cash and short-term investments	366.3	316.3	966.4	443.1

Table 2

Strabag SE -- Peer Comparison (cont.)				
Debt	0.0	0.0	584.3	1,519.3
Equity	3,232.4	3,173.0	1,350.0	1,706.9
Adjusted ratios				
EBITDA margin (%)	5.7	13.5	12.1	3.7
EBITDA interest coverage (x)	8.1	8.5	15.5	2.4
EBIT interest coverage (x)	3.9	7.8	12.2	(1.2)
Return on capital (%)	10.5	24.7	21.5	(6.0)
FFO/debt (%)	N.M.	N.M.	79.0	45.9
Free operating cash flow/debt (%)	N.M.	N.M.	(6.2)	11.3
Debt/EBITDA (x)	0.0	0.0	1.1	3.6
Total debt/debt plus equity (%)	0.0	0.0	30.2	47.1

N.M.--Not meaningful.

Table 3

Strabag SE -- Financial Summary

Industry Sector: Engineering & Construction

		--Fiscal year ended Dec. 31--				
(Mil. €)	**LTM 3Q 2011**	**2010**	**2009**	**2008**	**2007**	**2006**
Rating history	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BB+/Stable/--
Revenues	13,201.8	12,381.5	12,551.9	12,227.8	9,878.6	9,430.6
EBITDA	736.7	707.2	667.0	636.4	568.0	482.6
Net income from continuing operations	178.8	174.9	161.5	157.0	170.2	191.4
Funds from operations (FFO)	576.8	512.6	603.0	654.2	464.5	424.9
Capital expenditures	554.1	600.9	646.2	921.5	588.2	370.1
Free operating cash flow	205.0	111.9	485.3	(189.1)	(69.8)	(149.2)
Discretionary cash flow	137.7	49.9	416.2	(259.1)	(152.7)	(257.9)
Cash and short-term investments	370.0	366.3	366.3	366.3	300.0	200.0
Debt	783.8	0.0	0.0	399.8	0.0	975.9
Equity	3,129.2	3,232.4	3,099.1	2,979.0	3,096.5	1,035.9
Adjusted ratios						
EBITDA margin (%)	5.6	5.7	5.3	5.2	5.7	5.1
EBITDA interest coverage (x)	8.9	8.1	7.2	6.9	5.9	4.7
EBIT interest coverage (x)	4.5	3.9	3.6	3.9	3.9	3.1
Return on capital (%)	9.6	10.5	10.0	10.9	14.5	16.3
FFO/debt (%)	73.6	N.M.	N.M.	163.6	N.M.	43.5
Free operating cash flow/debt (%)	26.2	N.M.	N.M.	(47.3)	N.M.	(15.3)
Debt/EBITDA (x)	1.1	0.0	0.0	0.6	0.0	2.0
Debt/debt and equity (%)	20.0	0.0	0.0	11.8	0.0	48.5

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
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
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Ratings Detail (As Of December 20, 2011)	
Strabag SE	
Corporate Credit Rating	BBB-/Stable/--
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 Dec. 31, 2010 2011: €240 million Thereafter: €1.32 billion	

*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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