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Summary: Strabag SE

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Summary:

Strabag SE

Credit Rating: BBB-/Stable/--

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 currently difficult industry conditions. What's more, Strabag's solid capital structure 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-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 resulting negative free operating cash flows, as well as low transparency concerning the group's corporate governance. We see, however, that Strabag's free cash flows have turned positive since 2009 after the company reduced growth-related spending.

Key business and profitability developments

In the first half of 2011, Strabag continued the solid operating performance that it demonstrated throughout the recent downturn. In that period, the group's revenues were up by 17% whereas its EBITDA showed a less significant improvement of 6%, partly because earnings in the first half of 2010 benefited from some one-off effects. As a result, Strabag's EBITDA margin decreased to 3.3% from 3.7% a year earlier. As at June 30, 2011, the group's order backlog stood at about €14.9 billion, which equals 1.2x 2010 revenues, thereby providing good near-term visibility, in our view. We note, however, that the order backlog is declining, owing to a slowdown of construction activity in the recently strong Polish road market and project cancellations in Libya due to the current political unrest.

We believe Strabag will continue to benefit from its good geographic diversification that should allow it to level out the impact of economic cycles in different regions. On the other hand, we see a potential gradual slowdown of order intake given Strabag's high exposure to infrastructure construction and, consequently, public spending levels, which could be hampered by the frail state of treasury budgets among several European countries. Strabag's exposure to Southern European construction markets is relatively limited, but a higher than currently anticipated slowdown of the European economy or an escalation of the European sovereign debt crisis would likely damage construction markets significantly and thereby Strabag's operating performance.

Key cash flow and capital-structure developments

Strabag's credit measures remain strong for the rating. In the last 12 months ended June 30, 2011, funds from operations (FFO) to debt stood at 124% and adjusted debt to EBITDA at 0.6x. In the first six months of 2011, Strabag saw a significant build-up of working capital, which is typical for the business due to its significant seasonality, accompanied by lower activity during the winter period. The build-up of about €394 million was,

however, less severe than last year. Lower working capital requirements, along with higher FFO in the first half of 2011, resulted in negative free operating cash flows of about €540 million, compared with negative €673 in the first half of 2010.

As of June 30, 2011, Strabag's adjusted debt was about €478 million, up from a net cash position as at Dec. 31, 2010, but down from adjusted debt of about €741 a year earlier. This excludes nonrecourse debt and cash at Strabag's concession company Alföd Koncessizios Autopalya Zrt (AKA) in Hungary, but includes about €557 million related to operating leases and pension obligations. We believe, however, that debt could increase over time as a result of likely higher working capital outflows absent large advance payments that would offset those received in a road contract in Poland in 2010; higher investments and acquisition payouts; and the announced share-buyback program of up to 10% of share capital that might lead to a cash outflow of between €200 million to €300 million, if current share prices are considered.

Liquidity

Liquidity is strong, in our view. As of June 30, 2011, Strabag had about €1,240 million in cash and cash equivalents, and €332 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 June 30, 2011, the company reported debt of €1.67 billion, of which about €396 million was short term, with more than half related to drawings under the short-term working-capital credit lines. Furthermore, the debt structure included the following:

- €722 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
- €425 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 a 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 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.

Furthermore, we expect Strabag's future financial policy to be executed in a way that sustains its 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. We view these metrics as commensurate

with the 'BBB-' rating.

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 and/or shareholder returns; 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.

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