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Strabag SE

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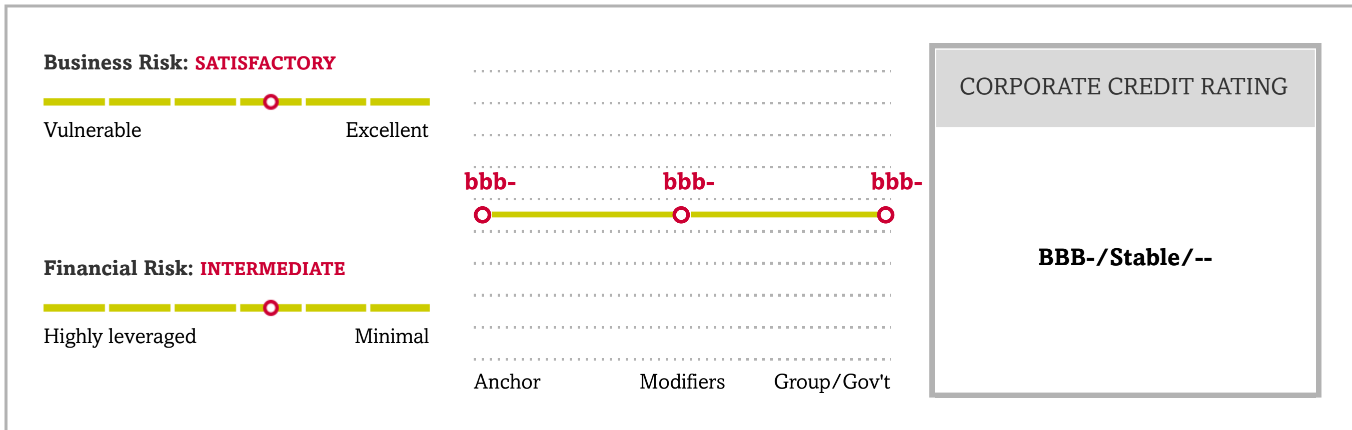
Strabag SE



Rationale

Business Risk: Satisfactory

- Leading market positions in construction markets 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.
- Cyclical and competitive industry that is inherently exposed to project risk.
- Relatively low adjusted EBITDA margin of 5.0%-6.5% historically, which is below the industry average.

Financial Risk: Intermediate

- Relatively low levels of adjusted debt translating into very strong core credit ratios for the financial risk profile assessment.
- Strong liquidity position.
- A volatile free cash flow generation profile with sizable seasonal swings in working capital.
- Growth-oriented and shareholder-friendly financial policy.

Outlook: Stable

The stable outlook on Austria-based engineering and construction group Strabag SE reflects our assessment that the group's credit metrics will remain strong for the current rating category. We believe that Strabag's significant headroom can accommodate expansionary investments in working capital, capital expenditures, and selected bolt-on or midsize acquisitions. In addition, we expect the group's funds from operations (FFO) to debt to exceed 45% and debt to EBITDA to remain below 2.5x at year-end.

Upside scenario

We could raise the ratings if Strabag's credit measures remain above levels we view as commensurate with a 'BBB-' rating, such as a ratio of FFO to debt of more than 45% and debt to EBITDA of less than 1.5x. We note that Strabag's financial metrics within the year, when working capital requirements peak, are significantly weaker. We would also consider a positive rating action if we observed a consistent track record of consistently positive discretionary cash

flows.

Downside scenario

We could consider a negative rating action if Strabag's debt-to-EBITDA ratio rises to more than 2.5x and FFO to debt drops to less than 35%. We believe that there is significant room for a potential weakening of operating performance at the current rating level. However, ongoing lengthy operating pressure could lead to a downgrade. Additionally, high debt, owing, for instance, to sizable acquisitions, increased shareholder returns, and deteriorating liquidity could also lead to a negative rating action.

Standard & Poor's Base-Case Scenario

Assumptions

- Slow volume growth in 2014 and mid-single-digit percentage growth in 2015-2016. Volume growth is expected to be backed by the company's sizable order backlog that provides good short-term visibility over activity levels. We also expect recovery in some regional European construction markets to translate into generally stable demand.
- Operating margins are likely to be shaped by continued intense pricing pressure, but past restructuring is likely to lead to stable profitability.
- Capital expenditures of about €475 million in 2014, increasing in 2015-2016, coupled with working capital investments, partly shaped by a reversal of advance payment trends, leading to negative free operating cash flow (FOCF) over our 2014-2016 forecast horizon.
- €50 million for bolt-on acquisitions annually.

Key Metrics

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

	2013a	2015e	2016e
EBITDA margin (%)*	6.1	5.5-6.0	5.5-6.0
FFO/debt (%)*	90.1	55-65	45-55
Debt/EBITDA (x)*	0.79	1.0-1.5	1.0-1.5

a--Actual. e—Estimate. *Data represent year-end figures when the group's net working capital position is at the lowest level of the year. For this reason, we believe that debt to EBITDA is understated by close to 0.7x at current profitability levels. Figures include several adjustments. See reconciliation table.

Company Description

With annual output of more than €13.5 billion in 2013 (€14. billion in 2012), Strabag is one of Europe's largest construction groups. It reports in terms of the following three segments:

- North and West (44% of 2013 output volume with an EBIT margin of 1.3%): This mainly includes the markets of Germany, Poland, Benelux, Scandinavia, Ground and Hydraulic Engineering and Offshore Wind;
- South and East (34% of 2013 output volume with an EBIT margin of 3.1%): This mainly includes mainly the markets of Austria, Switzerland, the Czech Republic, Slovakia, the Adriatic region, Russia, the rest of Europe, and neighboring countries, and Railway Structures; and
- International and Special Divisions (21% of 2013 output volume with an EBIT margin of 2.8%): This includes tunneling works, special ground engineering, project development, concessions, property & facility management,

and construction materials.

We think the company's medium-term strategy will continue to focus on margin improvements, by implementing efficiency improvements identified by a program known as "task force 2013ff", and through a strengthening of risk management policies. We also expect Strabag to continue to focus on both organic and inorganic growth opportunities with the aim of increasing the proportion of non-European operations.

Strabag is publicly listed with a free float of 13%. Core shareholders are the Haselsteiner family (25.5%) share, UNIQA/Raiffeisen (26.5%), and Rasperia Trading Ltd. (Rasperia) (25.0% plus one share). Rasperia is a subsidiary of Basic Element Holding, which is owned by Russian businessman Oleg Deripaska. The remaining 10% are treasury shares.

Business Risk : Satisfactory

The major factors supporting Strabag's "satisfactory" business risk profile are the group's leading market positions in Central and Eastern Europe's engineering and construction markets.

Strabag's long track record of relatively stable profitability is reflective of the group's generally effective risk management systems. Although underperforming projects impacted 2012 earnings and cash flow generation, we anticipate that the group's efforts to further sharpen risk policies will lead to somewhat improving, albeit low, profit margins in a difficult market environment.

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.

The industry's above-average risk profile constrains the group's business risk profile. 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. Strabag's operating margins are low and we consider its EBITDA margin of 5.5%-6.5% as below the industry average, which constrains the overall business risk profile assessment. Due to the competitive landscape and the inherent project risks in the industry, we believe that significant improvement of the operating margin would be difficult to achieve. That said, the group's strengthening of risk management systems and streamlining of parts of the organization under ithe "task force 2013ff" program could result in some operational improvements.

S&P Base-Case Operating Scenario

- We assume that the GDP of the eurozone (European Economic and Monetary Union) will grow at a sluggish rate of 1.1% in 2014 and 1.6% in 2015. We assume that the European construction market bottomed in 2013 as a result of a downward trend that started in 2009.
- An existing order backlog that covered about 1.1x of revenues at year-end 2013 should underpin revenue generation in 2014.
- As a result we anticipate Strabag will see low volume growth in 2014 and mid-single-digit percentage growth in 2015-2016.

- Performance is likely to be shaped by continued intense pricing pressure due to subdued public spending and economic growth patterns, but past restructuring should lead to stable profitability with adjusted EBITDA margins of about 6% over the next three years (following a decline to 5.2% in 2012).

Peer comparison

Table 1

Strabag SE -- Peer Comparison					
	Strabag SE	**Leighton Holdings Ltd.**	**VINCI S.A.**	**Ferrovial S.A.**	**Bouygues S.A.**
Rating as of Aug. 14, 2014	BBB-/Stable/--	BBB-/Stable/A-3	A-/Stable/A-2	BBB/Stable/--	BBB/Stable/A-2
	--Fiscal year ended Dec. 31, 2013--				
(Mil. €)					
Revenues	12,475.7	14,620.1	40,591.0	7,747.0	33,441.0
EBITDA	765.2	1,475.4	6,024.0	1,233.7	3,077.0
Funds from operations (FFO)	596.1	1,197.5	4,044.1	1,097.9	2,334.1
Net income from cont. oper.	113.6	330.3	1,962.0	727.0	(757.0)
Cash flow from operations	716.0	730.8	3,907.1	758.2	2,056.1
Capital expenditures	387.4	661.0	1,580.0	247.0	1,387.0
Free operating cash flow	328.6	69.8	2,327.1	511.2	669.1
Discretionary cash flow	290.9	(160.4)	1,270.7	(13.8)	78.1
Cash and short-term investments	507.7	389.9	1,000.0	1,186.8	1,348.0
Debt	655.4	1,583.5	17,667.7	0.0	7,180.9
Equity	3,238.8	2,107.6	14,011.9	3,305.0	8,672.8
Adjusted ratios					
EBITDA margin (%)	6.1	10.1	14.8	15.9	9.2
Return on capital (%)	7.3	17.0	11.4	26.3	10.0
EBITDA interest coverage (x)	7.3	7.3	7.5	13.5	6.8
FFO cash int. cov. (X)	10.8	9.3	8.0	3.4	9.0
Debt/EBITDA (x)	0.9	1.1	2.9	0.0	2.3
FFO/debt (%)	90.9	75.6	22.9	N.M.	32.5
Cash flow from operations/debt (%)	109.2	46.2	22.1	N.M.	28.6
Free operating cash flow/debt (%)	50.1	4.4	13.2	N.M.	9.3
Discretionary cash flow/debt (%)	44.4	(10.1)	7.2	N.M.	1.1

N.M.--Not Meaningful.

Our peer analysis includes construction companies such as Leighton. The rating on Leighton is influenced by our view of the credit quality of parent companies Hochtief AG and Grupo ACS. We also include Vinci, a diversified infrastructure company with a significant portion of revenues coming from more stable concession businesses. Ferrovial, in addition to its construction business, also has exposure to the service sector, which is less cyclical. Bouygues' operations are also more diverse, most notably through its 90.5% stake in Bouygues Telecom S.A., France's third-largest mobile telephony player, which also offers fixed broadband services.

We note that some of Strabag's direct peers have better ability to absorb higher leverage due to their comparatively higher share of less cyclical and lower risk operations.

Financial Risk : Intermediate

Strabag's "intermediate" financial risk profile reflects the group's strong balance sheet structure, with strong core credit metrics for the intermediate category. This takes into account hefty seasonal working capital swings that can amount to up to €500 million in the first three quarters of a given year. We expect Strabag to keep careful control over its debt levels as inherent industry risk can lead to significant deteriorations of metrics in a relatively short period.

Our assessment of Strabag's financial risk profile incorporates our view that the group has strong liquidity and good financial flexibility. We regard this as a positive rating factor. Strabag's demonstrated ability to obtain progress payments from customers, which generates working-capital resources, further supports our assessment.

That said, Strabag's growth oriented and shareholder-friendly financial policy moderates the abovementioned strengths. The group has a track record of expansionary spending and debt-financed acquisitions, which have frequently resulted in negative free operating cash flows after acquisition spending. A €237 million share buyback program in 2011-2013 also led to an increase in financial leverage.

In our base case, we expect FOCF to be negative in 2014, assuming an increase in capital expenditures and consumption of working capital following a significant inflow in 2013, partly due to the receipt of customer advances. Still, we expect Strabag's credit metrics to remain fairly robust for the current intermediate financial risk profile, at least at fiscal year-end. In the 12 months to Dec. 31 2013, adjusted debt to EBITDA was 0.9x and adjusted FFO to debt was 91%.

Although Strabag's proportional share of total nonrecourse debt in private-public partnership (PPP) projects is material, the debt is spread over 36 concessions, which are unlikely to fail simultaneously. The only fully consolidated project carrying a substantial amount of nonrecourse debt -- which is therefore reported on Strabag's balance sheet -- is AKA, a highway concession company located in Hungary. This debt amounts to about €585 million. 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 respect, however, and Strabag could decide to financially support its PPP projects beyond its 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 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 recent downgrades of Hungary. We understand that Strabag has so far had no problems collecting fees.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Capital expenditures of about €475 million in 2014, increasing in 2015-2016, coupled with working capital investments, partly shaped by a reversal of advance payment trends, leading to negative FOCF over our 2014-2016 forecast horizon.
- The core ratio of adjusted FFO to debt will remain well above 35% with necessary headroom to digest seasonality of working capital on a weighted average basis. Furthermore, we expect year-end credit metrics to be well

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positioned within the range we consider in line with a "modest" financial risk profile assessment.

- Overall, we expect the group's financial credit ratios to stay within the "intermediate" category in 2014 and 2015 due to weaker supplementary ratios.

Financial summary

Table 2

Strabag SE -- Financial Summary					
	--Fiscal year ended Dec. 31--				
	2013	**2012**	**2011**	**2010**	**2009**
Rating history	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--
(Mil. €)					
Revenues	12,475.7	12,983.2	13,713.8	12,381.5	12,551.9
EBITDA	765.2	681.0	823.9	805.3	745.4
Funds from operations (FFO)	596.1	527.5	701.3	603.7	621.3
Net income from continuing operations	113.6	60.6	195.0	174.9	161.5
Cash flow from operations	716.0	288.3	509.6	707.0	1,126.4
Capital expenditures	387.4	458.3	477.2	553.8	508.7
Free operating cash flow	328.6	(170.0)	32.5	153.1	617.7
Discretionary cash flow	290.9	(239.6)	(34.5)	91.1	548.6
Cash and short-term investments	507.7	350.0	350.0	350.0	350.0
Debt	655.4	744.0	364.3	0.0	0.0
Equity	3,238.8	3,162.5	3,149.8	3,232.4	3,099.1
Adjusted ratios					
EBITDA margin (%)	6.1	5.2	6.0	6.5	5.9
Return on capital (%)	7.3	6.5	11.1	10.7	10.1
EBITDA interest coverage (x)	7.3	6.0	7.7	8.6	7.6
FFO cash int. cov. (x)	10.8	8.9	13.5	13.0	11.8
Debt/EBITDA (x)	0.9	1.1	0.4	0.0	0.0
FFO/debt (%)	90.9	70.9	192.5	N.M.	N.M.
Cash flow from operations/debt (%)	109.2	38.7	139.9	N.M.	N.M.
Free operating cash flow/debt (%)	50.1	(22.8)	8.9	N.M.	N.M.
Discretionary cash flow/debt (%)	44.4	(32.2)	(9.5)	N.M.	N.M.

N.M.--Not meaningful

Liquidity: Strong

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 2014 and 2015.

Principal Liquidity Sources

- About €1.7 billion in cash (net of €20 million we consider to be tied to subsidiary AKA;
- Access to a fully undrawn €400 million syndicated loan facility maturing at the end of 2019. The facility, arranged in June 2014, replaced a facility of the same size, arranged in 2012, thereby supporting the group's liquidity position;

and
- Cash FFO generation of €450 million-€500 million.

Principal Liquidity Uses

- Short-term maturities of €369 million, but we note that a large proportion relates to bilateral bank lines that we expect the group to roll over;
- Capital spending of €475 million-€500 million per annum in the next two years;
- Bolt-on acquisitions of about €50 million annually in the next few years, although we see a risk that this number could be higher if Strabag identifies a large strategic acquisition target;
- Dividend payouts of about €46 million for 2014, which represents a rise after the dividend had been cut to about €37 million following the weak performance in 2013. We expect dividend payouts for 2015 to rise on the assumption that operating performance will stabilize; and
- Significant cash outflows related to seasonal working needs that can consume €400 million-€500 million by the end of the third quarter, when debt generally peaks.

Covenant Analysis

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.

Other Modifiers

Other modifiers have no impact on the ratings.

Reconciliation

Table 3

Reconciliation Of Strabag SE Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)										
	--Fiscal year ended Dec. 31, 2013--									
Strabag SE reported amounts										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	1,722.7	2,917.0	12,475.7	694.9	261.6	68.9	694.9	693.7	37.7	387.4
Standard & Poor's adjustments										
Interest expense (reported)	--	--	--	--	--	--	(68.9)	--	--	--
Interest income (reported)	--	--	--	--	--	--	43.1	--	--	--
Current tax expense (reported)	--	--	--	--	--	--	(109.9)	--	--	--
Operating leases	201.8	--	--	75.5	14.5	14.5	61.0	61.0	--	--

Table 3

Reconciliation Of Strabag SE Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €) (cont.)	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends paid	Capital expenditures
Postretirement benefit obligations/deferred compensation	500.6	--	--	--	--	21.4	(18.9)	(7.6)	--	--
Surplus cash	(1,184.7)	--	--	--	--	--	--	--	--	--
Dividends received from equity investments	--	--	--	25.9	--	--	25.9	--	--	--
Nonrecourse debt*	(585.1)	--	--	--	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	--	43.1	--	--	--	--	--
Non-controlling Interest/Minority interest	--	321.8	--	--	--	--	--	--	--	--
EBITDA - Other	--	--	--	(31.1)	(31.1)	--	(31.1)	--	--	--
OCF - Other	--	--	--	--	--	--	--	(31.1)	--	--
Total adjustments	(1,067.3)	321.8	-	70.3	26.5	35.9	(98.9)	22.3	-	-
Standard & Poor's adjusted amounts										
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Adjusted	655.4	3,238.8	12,475.7	765.2	288.1	104.9	596.1	716.0	37.7	387.4

*Non-recourse debt related to the group's Hungarian motorway concession contract.

Related Criteria and Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Industry Economic And Ratings Outlook: Global Engineering And Construction Firms Are Equipped To Weather Economic Uncertainty, Nov. 14, 2013

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	**Intermediate**	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	**bbb/bbb-**	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of August 14, 2014)

Strabag SE	
Corporate Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-
Corporate Credit Ratings History	
14-Nov-2007	BBB-/Stable/--
25-May-2007	BB+/Positive/--
30-May-2006	BB+/Stable/--

*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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