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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.

Weaknesses:

- Cyclical and competitive industry that is inherently exposed to project risk.
- Relatively low adjusted EBITDA margin of between 5% and 6% historically, which is typical for the industry.
- A somewhat volatile free 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. In addition, Strabag benefits from good business diversity and vertical integration that represents a barrier to entry and provides strategic access to raw materials. Despite the group's relatively weak performance in 2012, we believe that the company's favorable operational track record and currently sizable contract backlog further underpin the ratings. Strabag's solid capital structure and adequate liquidity offer a cushion against adverse market developments and potential project failures, which is a further rating support.

These strengths are partly offset, in our view, by the company's exposure to high project-execution risks in the construction industry, which is cyclical, competitive, and low margin. Furthermore, the rating is constrained by increasingly difficult industry conditions, given a declining pipeline of infrastructure projects, in particular across Eastern Europe, and the resulting fierce competition. We also believe that because the profitability of Strabag's order book, and therefore its earnings base, will likely decline, the company might find it difficult generating free operating cash flows over the coming two years. Furthermore, Strabag's credit profile is constrained by its track record of growth-oriented and shareholder-friendly financial policies.

S&P base-case operating scenario

We consider the group's order backlog as the main impetus for revenue generation in 2013 because it covers about 1.1x revenues for the 12 months to Sept. 30, 2012. Nevertheless, we consider it somewhat inflated by several multiyear orders, including a €1 billion Italian order that was booked in early 2012. On the other hand, we consider the economic

outlook to be a constraining factor, further aggravated by tight public budgets across Europe that we expect to translate into a lower number of public infrastructure projects.

We anticipate that Strabag will report a mid-single-digit revenue decline in 2012, after the €13.7 billion reported for 2011. We assume further mid-single-digit revenue declines in 2013 and 2014, owing to the dependence of the company's infrastructure activities on public spending. We also anticipate intensifying price pressure, in particular for transportation infrastructure projects, will impede the company's profitability. The operating result in 2012 is burdened to a significant degree by effects that we consider to be nonrecurring, most notably related to the expected compensation payment to Cemex of €43 million related to the failed acquisition of activities in Hungary and Austria, and late settlements with Polish public sector clients. As a result, we assume under our base case that Strabag's reported EBITDA margin will decline to the mid 3.5%-4.0% range in 2012 and then recover steadily toward 5.0% for 2014. This compares with the 5.4% the company achieved in 2011.

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

Under our base-case operating scenario, we forecast that Strabag will generate moderately negative free operating cash flows in 2012 and 2013. This is despite our assumptions of continuously tight working capital control and a reduction of capital expenditure to about €480 million in 2012 and €445 million in 2013, from an average of about €580 million in 2010 and 2011. Our base case also assumes that the company will refrain from undertaking medium- to large-size cash or debt-funded acquisitions and that it will reduce shareholder payouts, as it did during the cyclical downturn in 2009.

We anticipate that credit metrics will remain consistent with our guidelines for the rating, such as adjusted debt to EBITDA of less than 2.5x. This is owing to the headroom Strabag currently has under the credit measures for the 'BBB-' rating, but also factors in our expectation of a steady improvement in earnings and the adaption of a disciplined financial policy over the coming two years. In the 12 months to Sept. 30, 2012, the ratio of adjusted debt to EBITDA was at about 2.2x, which fully reflects the seasonal working capital build-up that the group usually incurs. We expect this ratio will improve to about 1x by year-end 2012.

Risks to our base-case operating scenario include a weaker economic environment than we currently forecast, which could result in further cuts in public spending and, potentially, pressure on private investment in engineering and construction. This, coupled with additional possible significant cost overruns on individual projects amid harsher bidding conditions, could further hamper the company's operating and financial performance.

Liquidity

We consider Strabag's liquidity position to be "adequate" 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 comfortably more than 1.2x in 2013 and 2014.

Strabag's liquidity sources as of Sept. 30, 2012, consists of:

- Surplus cash of about €0.6 billion, excluding about €370 million of cash we consider tied to the operations and the M5 highway concession company AKA in Hungary that Strabag owns. On Sept. 30, 2012, Strabag reported consolidated cash and equivalents of €972 million.
- Strabag's liquidity is also supported by its undemanding debt maturity profile. As of Sept. 30, 2012, the company

reported about €1.7 billion in debt, of which about €410 million was short term.

Furthermore, Strabag's debt structure included the following:

- About €652 million of nonrecourse funding (of which about €44 million was short term) related to an "availability-type" concession at Hungary-based AKA that has contracted fixed fees that Strabag receives from the local government; and
- €450 million in unsecured bonds, of which €75 million falls due in 2013.

Strabag has recently entered into a new €400 million syndicated revolving facility maturing in 2017, which is further underpinning liquidity.

We also believe that Strabag has some capital spending flexibility, which creates a cushion for operating cash flows if markets decline more sharply than we currently expect. Bank and guarantee facilities are subject to financial covenants and material adverse-effect clauses. We expect headroom under the covenants to remain sufficient.

Outlook

The stable outlook reflects our assessment that Strabag's credit metrics will likely weaken in 2012, but recover somewhat in 2013 and remain commensurate with the rating. This includes debt to EBITDA of less than 2.5x. We assume the group will manage to prevent its EBITDA margin from falling significantly below 4.0% over the next two years. We also view Strabag's disciplined capital investment policy and attention to risk-control management as key to helping it maintain a rating-commensurate financial profile should operating profits decline, as we currently assume. Consequently, we factor into the rating that Strabag will curb its investments to avoid generating significantly negative free operating cash.

We could consider a negative rating action if Strabag's operating profitability weakened significantly, posing the risk that the group's debt-to-EBITDA ratio could rise to more than 2.5x throughout the financial year. Downside risks would also arise from highly elevated debt, owing for instance to acquisitions or shareholder returns, and deteriorating liquidity.

We could raise the ratings if Strabag's credit measures stayed above levels we view commensurate with a 'BBB' rating, such as a ratio of funds from operations to debt of more than 45% and debt to EBITDA of less than 1.5x. However, we don't expect this to be the most likely scenario in the deteriorating economic environment. We believe an upgrade would also necessitate an order backlog and earnings recovery that gives sufficient visibility for 2013 and 2014, which we think could be difficult years for late-cyclical companies like Strabag.

Business Description

With an annual output of more than €14.3 billion in 2011 (€12.8 billion in 2010), Strabag is one of Europe's largest construction groups. The company has recently changed its segment reporting and now reports along the following three divisions:

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- North and West: This includes mainly the markets of Germany, Poland, Benelux, Scandinavia, Ground and Hydraulic Engineering and Offshore Wind;
- South and East: This includes mainly the markets of Austria, Switzerland, Czech Republic, Slovakia, Adriatic, Rest of Europe, Russia, and neighboring countries, and Railway Structures; and
- International and Special Divisions: This includes tunneling works, special ground engineering, project development, concessions, facility management, and construction materials businesses.

Business Risk Profile: Supported By A Leading Market Position In CEE And Vertical Integration

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, Poland, Hungary, and Slovakia. 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. Its sizable exposure to the Polish construction market in the current market environment, on the other hand, could remain a negative factor for the group's earnings generation for the years ahead.
- Vertical integration, which yields a competitive edge. Strabag operates an extensive network of asphalt- and concrete-mixing plants (self-sufficiency of 83% in asphalt and 34% 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 5.4% 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. Although the company's profitability has suffered significantly in 2012, partly owing to special items that we consider nonrecurring, we believe Strabag has applied 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 40% of revenues, raw materials 28%, 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. We have also observed that operating

margins have come under significant pressure in 2012, partly due to special effects that we do not assume will reoccur in the coming years. We also expect that some operational improvements may come from the current ongoing organizational restructuring program, although transformational charges might offset some of the benefits initially. In our view, the group's profitability is likely to remain below historical averages over the coming two years, owing to the weakened industry prospects and more intense competition.
- Limited presence outside Europe. We understand that Strabag will focus on its key European markets. 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 the Americas, 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 its geographic diversity.

Financial Risk Profile: A Solid Capital Structure But Somewhat Volatile FOCF Generation

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

- 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 debt-to-capital ratio was about 10% in 2011, given the company's low adjusted indebtedness. As a result of 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 rating-commensurate, in our view. Nevertheless, we believe that Strabag will need some of this headroom to absorb a weaker operating performance over the near to medium term. We believe that investments are likely to be controlled closely, owing to the group's recently weak operating performance and management's focus on operational restructuring in the near term. We anticipate that Strabag will maintain adjusted debt to EBITDA at less than 2.5x, positive free operating cash flows (before expansionary capital expenditure) over the cycle, 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. Seasonal working capital needs amounted to up to €500 million over the past three 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 its discretionary cash flows were significantly negative. The share-buyback program led to cash outflows of about €220 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 private-public partnership (PPP) projects is material (€2.0 billion as of Dec. 31, 2011), the debt is spread over 37 concessions, which are unlikely to fail simultaneously. The Hungarian nonrecourse debt proportion accounts for about €674 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 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 Hungary. 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, 2012, these obligations were about €4.0 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, 2012, we made the following adjustments to the company's reported figures (see also table 1):

- We capitalized operating leases as of Dec. 31, 2011, using the net-present-value method. This increased the group's debt by €239 million.
- We made an adjustment for unfunded postretirement benefit obligations as of Dec. 31, 2011, adding about €455 million to Strabag's reported debt.
- We reduced total cash of €972 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 €602 million of surplus cash from adjusted gross debt.
- We reduced total reported debt of about €1.8 billion by about €652 million of nonrecourse debt, related to the AKA concession.

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, 2012	BBB-/Stable/--	BBB+/Stable/A-2	BBB+/Negative/--	BBB-/Stable/A-3
(Mil. €)	**--Average of past three fiscal years--**			
Revenues	12,882.4	6,460.4	4,341.1	10,710.8
EBITDA	699.5	832.3	384.6	1,010.5
Net income from cont. oper.	177.1	365.1	294.4	150.1
Funds from operations (FFO)	626.0	637.9	370.7	1,210.5
Capital expenditures	600.0	518.5	116.4	1,041.6
Free operating cash flow	186.6	(4.0)	238.3	(2.3)
Discretionary cash flow	120.6	(146.4)	160.6	(213.9)
Cash and short-term investments	366.2	396.8	889.4	423.8
Debt	112.5	64.2	605.1	1,764.9
Equity	3,160.4	3,168.5	1,289.8	1,759.9
Adjusted ratios				
EBITDA margin (%)	5.4	12.9	8.9	9.9
EBITDA interest coverage (x)	7.5	8.2	13.4	5.8
EBIT interest coverage (x)	3.7	7.4	12.2	2.8
Return on capital (%)	10.5	23.9	19.5	14.8
FFO/debt (%)	556.3	993.5	61.7	69.0
Free operating cash flow/debt (%)	165.8	(6.3)	41.1	3.4
Debt/EBITDA (x)	0.2	0.1	1.6	1.7
Total debt/debt plus equity (%)	3.4	2.0	32.1	50.5

N.M. - Not meaningful.

Table 3

Strabag SE -- Financial Summary

Industry Sector: Engineering & Construction

		--Fiscal year ended Dec. 31--				
(Mil. €)	**LTM 3Q 2012**	**2011**	**2010**	**2009**	**2008**	**2007**
Rating history	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--	BBB-/Stable/--
Revenues	13,294.2	13,713.8	12,381.5	12,551.9	12,227.8	9,878.6
EBITDA	538.1	724.3	707.2	667.0	636.4	568.0
Net income from continuing operations	13.9	195.0	174.9	161.5	157.0	170.2
Funds from operations (FFO)	442.0	762.3	512.6	603.0	654.2	464.5
Capital expenditures	540.4	552.9	600.9	646.2	921.5	588.2
Free operating cash flow	(174.5)	(37.4)	111.9	485.3	(189.1)	(69.8)
Discretionary cash flow	(243.8)	(104.4)	49.9	416.2	(259.1)	(152.7)
Cash and short-term investments	370.0	366.0	366.3	366.3	366.3	300.0
Debt	1,158.8	337.6	0.0	0.0	399.8	0.0

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Table 3

Strabag SE -- Financial Summary (cont.)						
Equity	3,059.5	3,149.8	3,232.4	3,099.1	2,979.0	3,096.5
Adjusted ratios						
EBITDA margin (%)	4.0	5.3	5.7	5.3	5.2	5.7
EBITDA interest coverage (x)	4.4	7.2	8.1	7.2	6.9	5.9
EBIT interest coverage (x)	1.3	3.7	3.9	3.6	3.9	3.9
Return on capital (%)	3.8	11.0	10.5	10.0	10.9	14.5
FFO/debt (%)	38.1	225.8	N.M.	N.M.	163.6	N.M.
Free operating cash flow/debt (%)	(15.1)	(11.1)	N.M.	N.M.	(47.3)	N.M.
Debt/EBITDA (x)	2.2	0.5	0.0	0.0	0.6	0.0
Debt/debt and equity (%)	27.5	9.7	0.0	0.0	11.8	0.0

N.M. - Not Meaningful.

Table 1

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

	--Rolling 12 months ended Sept. 30, 2012--									
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	1,718.50	2,803.00	13,294.20	556.1	139.4	85.3	351.7	351.7	69.4	465
Standard & Poor's adjustments										
Operating leases	239.1	--	--	8.8	8.8	8.8	60.3	60.3	--	75.5
Postretirement benefit obligations/deferred compensation	454.6	--	--	--	--	27.4	-15.2	-15.2	--	--
Surplus cash	-601.8	--	--	--	--	--	--	--	--	--
Nonrecourse debt	-651.7	--	--	--	--	--	--	--	--	--
Non-operating income (expense)	--	--	--	--	32.3	--	--	--	--	--
Reverse changes in working capital	--	--	--	--	--	--	--	76	--	--
Non-controlling Interest/Minority interest	--	256.5	--	--	--	--	--	--	--	--
EBITDA - Other	--	--	--	-26.8	-26.8	--	--	--	--	--
FFO - Other	--	--	--	--	--	--	-30.8	-30.8	--	--
Total adjustments	-559.7	256.5	0	-18	14.3	36.2	14.3	90.4	0	75.5
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Dividends paid**	**Capital expenditures**
Adjusted	1,158.80	3,059.50	13,294.20	538.1	153.8	121.6	366	442	69.4	540.4

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Related Criteria And Research

- Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Principles Of Corporate And Government Ratings, June 26, 2007

Ratings Detail (As Of December 28, 2012)	
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/--
Business Risk Profile	Satisfactory
Financial Risk Profile	Intermediate
Debt Maturities	
As of Dec. 31, 2011 2011: €433 million Thereafter: €1.30 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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