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Summary:
Strabag SE

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Summary:

Strabag SE

Credit Rating:	BBB-/Stable/--

Rationale

The rating on Austria-based engineering and construction group Strabag SE reflects its satisfactory business risk profile as a leader in road construction and civil engineering in Central and Eastern Europe (CEE). In addition, Strabag benefits from vertically integrated operations, which provide barriers to entry and strategic access to raw materials. It has good geographic diversification, a favorable operational track record, and a still-robust contract backlog. Furthermore, Strabag has a solid capital structure, which provides a cushion against adverse market conditions.

The rating is constrained by the company's high operating risk in the construction industry, which is cyclical, competitive, and low margin. In addition, Strabag is exposed to project-related execution risks, whereby cost overruns or delays in large projects could impair its earnings. Strabag's credit profile is also weighed down by negative free operating cash flow, largely due to heavy expansion-related spending. Furthermore, Strabag's credit profile continues to be constrained by concerns over its financial policies and corporate governance practices following recent shifts in its ownership structure.

Key business and profitability developments

Strabag's revenue and earnings have grown consistently over the past few years, with reported 2008 output volume up by 28% and EBITDA up by 9% year on year. However, operating performance is now increasingly coming under pressure because of the sharp decline in construction markets. The company's order backlog of about €13.3 billion was still robust on Dec. 31, 2008, and gives good visibility for 2009 performance if there are no delays or cancellations in major projects. Nevertheless, less visibility exists from 2010, owing to the slide in new orders that has accelerated since the beginning of 2009, with nonresidential sectors in Europe, in particular, feeling the impact of the overall economic downturn.

This has increased Strabag's reliance on the European infrastructure sector, which is likely to benefit from local government stimulus packages and EU-sponsored investment programs directed particularly toward the Eastern European region. Consequently, Strabag's ability to maintain its positive operating trend in the infrastructure sector will be an important factor in helping to moderate the general industry decline. Nonetheless, operating margins are likely to be affected by the intensified competition and will largely depend on the company's ability to align its fixed cost base to falling workloads.

Key cash flow and capital structure developments

Strabag has pursued its extensive expansion, as expected, through several acquisitions and heavy growth capital spending over the past year, which resulted in negative free operating cash flows in 2008. In 2008, the ratio of capital expenditures and acquisitions to sales was relatively high at about 10%, of which about 7% related to industrial capital spending. Nevertheless, management's announced capital spending curtailments should benefit operating cash flows in 2009, which we view positively for credit quality, particularly in the context of declining markets.

Strabag's reported net cash position (excluding nonrecourse debt and cash in the Alföld Koncessizios Autopalya AKA concession in Hungary) declined substantially to €110 million as of Dec. 31, 2008, from €927 million as of Dec. 31, 2007. Consequently, credit measures weakened in 2008, but remained at a level comfortably adequate for the rating, with adjusted funds from operations (FFO) to debt of about 193% and adjusted debt to EBITDA of 0.6x (excluding nonrecourse debt).

Liquidity

Liquidity is adequate. As of Dec. 31, 2008, Strabag had €1.49 billion in cash and cash equivalents, and €400 million availability under short-term revolving credit facilities. Liquidity is likely to weaken over the next quarters, due to an outstanding payment of about €310 million for an acquisition that is pending approval. However, it should remain sufficient to service near-term debt obligations and working capital swings. Furthermore, Strabag has some capital spending flexibility, which could provide a cushion to operating cash flows if markets decline more sharply than expected.

The short-term tenor of revolving working capital credit facilities, which have to be renewed each year, poses a liquidity risk. This risk is partly offset by credit lines granted by various banks with which Strabag has longstanding relationships. We expect the company to refinance or roll over its existing revolving lines well ahead of their maturities, and to actively seek to secure a longer term working capital financing over the near term. Bank and guarantee facilities include financial covenants and material adverse effect clauses. Headroom under the covenants is expected to remain sufficient.

Strabag's liquidity is supported by its manageable debt-maturity profile. As of Dec. 31, 2008, the company reported debt of €1.71 billion, of which about €274 million was short term, with less than one-half related to drawings under the short-term working-capital credit lines. In addition, the debt structure included the following:

- €798 million of nonrecourse funding related to an "availability-type" AKA concession, under which a fixed fee in exchange for service is paid to Strabag by the local government, of which €41 million was short term;
- €370 million in unsecured bonds, of which €50 million was short term;
- €116 million in liabilities from finance leases, of which about €25 million was short term; and
- Debt related to project financing, which is secured by cash flows generated by respective projects.

Outlook

The stable outlook reflects our view 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 in a cyclical downturn, which is characterized by more aggressive competition.

Furthermore, we expect Strabag's future corporate governance practices to be executed in a way that sustains Strabag's credit profile. We believe the company will be able to comply with adjusted FFO to debt of more than 30% and adjusted debt to EBITDA at less than 2.5x, which are commensurate with a '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 more aggressive-than-expected acquisition spending or higher-than-expected shareholder returns; and/or deteriorating liquidity. Upside rating potential is currently limited, given the increased uncertainty surrounding the company's business prospects.

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