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Research Update:

Italian Construction Company Salini Impregilo Upgraded To 'BB+' On Strong Credit Ratios; Outlook Stable

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Overview

- Supportive market trends, a large backlog of orders, and lower interest expenses should enable Italy-based construction company Salini Impregilo to achieve stronger credit ratios than we had previously expected.
- We are therefore raising our long-term corporate credit rating on Salini Impregilo to 'BB+' from 'BB'.
- The stable outlook reflects our view that the company will maintain adjusted funds from operations (FFO) to debt of more than 45% because of the favorable operating environment and a large order backlog.

Rating Action

On June 24, 2015, Standard & Poor's Ratings Services raised its long-term corporate credit rating on Italy-based construction company Salini Impregilo SpA to 'BB+' from 'BB'. The outlook is stable.

At the same time, we revised our issue rating on Salini Impregilo's €400 million senior unsecured notes maturing in 2018 to 'BB+' from 'BB-'. The recovery rating on the notes is '4', indicating our expectations of average (30%-50%) recovery for the creditors in the event of a payment default.

Rationale

The upgrade reflects our view that Salini Impregilo should achieve stronger credit ratios than we had previously expected because of supportive market trends, a large backlog of orders, and reduced interest expenses.

Earnings growth and lower interest expenses should enable Salini Impregilo to post FFO to debt of about 45% in 2015. We calculate that the company will grow its EBITDA by 10%-15% annually over the next two years on the back of a strong demand for infrastructure and a large order backlog, which amounted to nearly eight years of revenues at year-end 2014. We understand that the Salini-Impregilo merger is proceeding as planned and remaining synergies could also support profitability. In addition, a reduction in interest expenses will bolster FFO generation; Salini Impregilo substantially reduced its cost of debt by refinancing bank facilities at the beginning of 2015.

However, weak free operating cash flow (FOCF) and the volatility of the company's business model constrain the ratings. We think that adjusted FOCF, which reached minus €138 million in 2014, should remain negative in the next two years as a result of high capital expenditure (capex) and rising working capital. While management's commitment to reduce its reported net debt supports the rating, we see some uncertainties in the next few years as the construction sector remains structurally volatile. In addition, we do not rule out that Salini Impregilo's exposure to emerging markets could result in unexpected operating setbacks. However, we think that the company has enough headroom at its current rating level to accommodate unexpected cash outflows.

Good geographic diversity and a focus on infrastructure support Salini Impregilo's business profile, in our view. Emerging markets generate about 60% of the company's earnings and Italy accounted for only 13% in 2014. We think that infrastructure has attractive growth potential, benefiting from increasing urbanization and the growing weight of the middle classes in emerging markets, and from the need to replace aging facilities in developed countries.

Nevertheless, the company's high exposure to emerging markets also creates unpredictable downside risk that constrains the rating. Furthermore, Salini Impregilo has a negligible presence in concessions, which we consider to be more stable than construction. The company also remains much smaller than higher-rated European companies such as Strabag, Bilfinger, and Vinci.

Our base case assumes:

- Real world GDP growth of 3.4% in 2015 and 3.9% in 2016.
- Healthy growth of the infrastructure market through 2015 and 2016, driven by new projects in emerging markets and renewals in developed countries.
- Annual revenue growth of about 10%-15% over the next two years, supported by a healthy backlog of orders.
- A stabilization of adjusted EBITDA margin at about 11%.
- A decline in interest costs, thanks to Salini Impregilo refinancing its bank debt at the beginning of 2015.
- Limited negative working capital fluctuations.
- About €500 million of capex overall for 2015-2016.
- Prudent financial policy.

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

- A stabilization of the adjusted EBITDA margin at about 11% over the next two years.
- FFO to debt increasing gradually to about 45%-50% in 2016 from 42% in 2014.
- Negative adjusted FOCF in 2015 and 2016.

Liquidity

We view Salini Impregilo's liquidity as "adequate" according to our criteria. We base our opinion on our estimate that liquidity sources will exceed funding needs by more than 1.2x in the 12 months from Dec. 31, 2014.

On Dec. 31, 2015, we assessed liquidity sources at approximately €1.6 billion, including:

- €1 billion of cash and short-term investments;
- €0.2 billion of undrawn credit facilities; and
- €0.4 billion of reported FFO forecast over the next 12 months.

We estimate Salini Impregilo's liquidity needs in the next 12 months to be about €1 billion, comprising:

- €0.5 billion of short-term debt;
- €0.2 billion of year-on-year working capital outflow;
- €0.2 billion of seasonal variation in working capital;
- €0.2 billion of maintenance and long-lead time capex; and
- €0.02 billion of dividends.

Outlook

The stable outlook reflects our view that a favorable operating environment and a sizable backlog of orders will enable Salini Impregilo to keep growing its earnings at a healthy pace and maintain adjusted FFO to debt of about 45% in the next two years, despite negative FOCF. We also assume that the company will maintain strong risk-control management to minimize the risks associated with its exposure to projects in emerging-market countries.

Upside scenario

We could raise our ratings on Salini Impregilo if it sustained meaningfully positive FOCF, or if FFO to debt improved toward the strong end of the 45%-60% range. This could happen if the company's large backlog and favorable economic conditions translated into higher-than-anticipated earnings growth. A positive outlook would also require Salini Impregilo to successfully manage its working capital and capex needs.

Downside scenario

We could consider lowering the rating if Salini Impregilo's adjusted FFO-to-debt ratio fell below 30%. Such a scenario could unfold if it made a large acquisition, chose to offer generous shareholder remuneration, or suffered a severe operating setback. We could also downgrade the company if liquidity became less than adequate.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Stable/--

Business risk: Fair

- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+
- Group credit profile: bb+
- Entity status within group: Core

Recovery Analysis

Key analytical factors

- We have raised our issue rating on the €400 million senior unsecured notes to 'BB+' from 'BB-'. The two-notch upgrade results from a one-notch upgrade of the corporate credit rating to 'BB+' from 'BB' and one-notch improvement from the revision of our recovery rating to '4' from '5'. We now expect recovery prospects for the unsecured notes to be at the higher end of the 30%-50% range.
- The revision of the recovery rating to '4' from '5' results from a higher estimated valuation of the company at default, based on an EBITDA multiple approach. The recovery rating remains constrained, in our view, by the unsecured nature of the notes and by its structural subordination to a significant amount of debt at subsidiaries.
- In our hypothetical default scenario, we assume a prolonged economic downturn affecting the construction sector, combined with operational delays in completing projects, which would result in margin reductions. This would reduce Salini's ability to meet its debt obligations.
- We value Salini Impregilo as a going concern, based on its strong brand value, strong market position and global presence.

Simulated default assumptions

- Year of default: 2020
- EBITDA at emergence: €202 million
- Implied enterprise value multiple: 5.0x
- Jurisdiction: Italy

Simplified waterfall

- Gross enterprise value at default: €1.01 billion
- Administrative costs: about €70 million
- Net value available to creditors: €940 million
- Priority claims: €365 million
- Senior unsecured debt claims: €1.32 billion*

- Recovery expectation: 30%-50% (higher half of range)

*All debt amounts include six months of prepetition interest.

Related Criteria And Research

Related Criteria

- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt, Aug. 10, 2009
- Revised Revolver Usage Assumptions For Recovery Analysis In Corporate Ratings, Nov. 20, 2014
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013

Ratings List

Upgraded

	To	From
Salini Impregilo SpA		
Corporate Credit Rating	BB+/Stable/--	BB/Stable/--
Senior Unsecured	BB+	BB-
Recovery Rating	4H	5

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