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## Research Update:

# Italian Construction Company Salini Impregilo Affirmed At 'BB+' On Expected Bond Issuance; Outlook Stable

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## Research Update:

# Italian Construction Company Salini Impregilo Affirmed At 'BB+' On Expected Bond Issuance; Outlook Stable

## Overview

- Salini Impregilo intends to launch a new bond of up to €500 million to partly refinance its €400 million bond maturing in 2018 and repay debt used to finance its acquisition of Lane Industries in January this year.
- Salini's operating performance in 2015 was approximately in line with our expectations and we forecast resilient results and stronger leverage metrics over the next few years, owing to solid demand and a large order backlog.
- We are therefore affirming our 'BB+' ratings on Salini and assigning our 'BB+' rating to the proposed bond, with a recovery rating of '4'.
- The stable outlook reflects our view that Salini's adjusted funds from operations to debt will rapidly recover in 2017 to comfortably above 30%, after a temporarily decline in 2016 following the debt-funded acquisition.

## Rating Action

On June 10, 2016, S&P Global Ratings affirmed its 'BB+' long-term corporate credit rating on Italy-based construction company Salini Impregilo SpA. The outlook is stable.

At the same time, we assigned our 'BB+' issue rating and '4' recovery rating to the proposed senior unsecured unguaranteed notes of up to €500 million. The recovery rating indicates our expectations of recovery prospects in the lower half of the 30%-50% range in the event of a payment default.

The issue and recovery ratings on the proposed notes are based on preliminary information and are subject to the notes' successful issuance and our satisfactory review of the final documentation.

We also affirmed our 'BB+' and '4' issue and recovery ratings on Salini's existing €400 million senior unsecured unguaranteed notes maturing in 2018, based on our assumption that about €200 million of these notes will be refinanced with the new notes. The recovery prospects are in the higher half of the 30%-50% range.

## **Rationale**

Salini's operating performance in 2015 was roughly in line with our expectations, and we expect the company to continue posting resilient results over the next few years. This mainly reflects our forecast that Salini will generate organic revenue growth of more than 10% annually, on the back of solid demand for infrastructure and a large backlog that will provide strong revenue coverage.

However, we forecast that organic growth, pro forma the acquisition of U.S.-based construction company Lane Industries, will be somewhat subdued in 2016, due to delays in starting some new projects. We believe most of the revenue growth in the coming years will come from the U.S., where Salini's market position has strengthened significantly as a result of the Lane acquisition in January this year. We view the U.S. market as one of the most promising in terms of infrastructure needs, particularly following Congress' approval of a \$352 billion investment program over the next five years. We estimate that the North American market will contribute about 23%-25% of the group's revenues in 2016 and almost 30% in 2019. Nevertheless, revenue growth will also continue to depend on Salini's presence in emerging markets, as shown by the company's signing of a €2.5 billion contract for a hydroelectric dam in Ethiopia this year.

We project a decline in our adjusted EBITDA margin for Salini to about 9.5% in 2016 from 11% at year-end 2015, mainly due to the consolidation of Lane. In our opinion, the decline in profitability is not a weakness for the ratings. Lane's margins, particularly on its road paving business, are much lower than for bridges, tunnels, or water infrastructure, which have been Salini's traditional focus. However, we believe the new enlarged group's operations may reduce profit volatility over the next few years.

In our view, Lane's consolidation has improved Salini's geographic diversification, but Salini still shows significant exposure to emerging markets, which pose unpredictable risks. We continue to monitor the group's exposure to Venezuela and other high-risk countries, and outstanding litigation.

Salini's leverage metrics have deteriorated temporarily this year, owing to the Lane acquisition. We anticipate that our adjusted funds from operations (FFO) to debt metric will decline to about 27%-30% in 2016 from 37% in 2015, and debt to EBITDA will likely increase to 2.5x-2.7x from 2.1x. However, we believe these leverage metrics will recover in 2017, when we project FFO to debt will comfortably exceed 30%, and debt to EBITDA will be in the 2.1x-2.3x range.

Management's commitment to reduce its reported debt levels supports the ratings. However, rating headroom has reduced compared with 2015, and unexpected operating setbacks would put pressure on the ratings, given the structural volatility of the construction industry. We believe that free

operating cash flow (FOCF) will likely remain negative in 2016, due to high capital expenditure (capex), and turn modestly positive in 2017. In our view, the trend in working capital should improve in the next few years, however, also reflecting the new group perimeter and completion of some large projects.

Our adjusted debt figure is higher than the company's reported debt because we exclude cash and equivalents that we believe are not immediately available for debt repayment. Furthermore, we add to debt about €305 million in financial guaranties that Salini provides to nonconsolidated companies, as well as a few other minor items, such as operating leases and pension liabilities.

In our base case for Salini, we assume:

- Global real GDP growth of 3.3% in 2016 and 3.7% in 2017.
- Healthy growth of the infrastructure market through 2016-2018, mainly driven by new projects in the U.S. and emerging markets.
- Revenue growth of about 30% in 2016, largely reflecting consolidation of Lane, and more than 10% in subsequent years, supported by the current healthy backlog of orders.
- A decline of the adjusted EBITDA margin to about 9% (including Lane), reflecting lower margins but also lower risk from the U.S. operations, particularly paving and road construction.
- A negative working capital trend in 2016, but an improvement as of 2017.
- About €300 million-€350 million in capex annually in 2016-2017.

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

- An FFO-to-debt ratio of about 27%-30% in 2016, before recovering in 2017 to comfortably above 30%.
- Debt to EBITDA of 2.5x-2.7x in 2016, improving to 2.1x-2.3x in 2017.
- Negative adjusted FOCF in 2016 turning modestly positive in 2017.

## **Liquidity**

We view Salini's liquidity as adequate, based our estimate that liquidity sources will exceed funding needs by more than 1.2x in the 12 months started Dec. 31, 2015.

The main liquidity sources include:

- €1.4 billion of cash and short-term investments;
- €0.2 billion of undrawn credit facilities;
- About €0.4 billion of reported FFO that we forecast over the next 12 months; and
- About €400 million of committed lines to finance the Lane acquisition.

We estimate that Salini's liquidity needs in the next 12 months comprise:

- €0.5 billion of short-term debt;
- €0.5 billion of intrayear and year-on-year working capital outflow;
- €0.2 billion of maintenance and long-lead-time capex;
- The acquisition of Lane for about €350 million; and
- €30 million-€40 million in dividends.

## Outlook

The stable outlook reflects our view that Salini's adjusted FFO to debt will rapidly recover in 2017 to comfortably above 30%, after a temporary decline in 2016. The company's solid order backlog provides very high visibility on revenues and EBITDA in 2016-2017, reducing risk. However, rating headroom has reduced significantly after the Lane acquisition, and we expect it will start to widen only in 2017. Salini has stated that its dividend distribution policy will be more generous in the coming years, but we expect this will happen only after its leverage metrics recover to more comfortable levels.

### Downside scenario

Negative rating pressure may arise if the company's adjusted FFO to debt does not recover and remains below 30% for a sustained period. This would most likely happen if the group suffered a severe operating setback or adverse trend in working capital, particularly given its exposure to some high-risk countries.

We understand that Salini is not planning to pursue further debt-funded acquisitions in the next few years, and believe that any such activity may put pressure on the ratings. We may also lower the ratings if the company's liquidity position were to deteriorate, although we see this as unlikely.

### Upside scenario

An upgrade is unlikely over the next two years, since it would require FFO to debt comfortably above 45%, which is far from the levels we forecast for 2016-2017. However, beyond that period, we might consider raising the ratings if the company's continued strong backlog and favorable economic conditions translated into higher-than-anticipated earnings and debt reduction. An upgrade would also depend on whether Salini successfully manages its working capital and capex needs, such that FOCF turned sustainably and meaningfully positive.

## Ratings Score Snapshot

Corporate Credit Rating: BB+/Stable/--

Business risk: Fair

- Country risk: Intermediate
- 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)

## Recovery Analysis

### Key analytical factors

- Our 'BB+' issue rating on Salini's proposed €500 million notes is at the level of the corporate credit rating. The recovery rating is '4' and reflects the notes unsecured and unguaranteed nature as well as its structural subordination to a significant amount of prior-ranking claims. The recovery prospects are in the lower half of the 30%-50% range.
- The issue and recovery ratings on the proposed notes are based on preliminary information and are subject to their successful issuance and our satisfactory review of the final documentation.
- Salini intends to use the proceeds of the proposed notes to partly refinance the existing €400 million of unsecured notes maturing in 2018 and repay a portion of the €400 million bridge facility used to finance the Lane acquisition.
- The documentation for the new notes is expected to be similar to that for the existing notes, with one incurrence covenant stipulating a minimum consolidated interest coverage ratio of 2.5x, and permitted debt of the issuer or material subsidiaries of up to 15% of consolidated assets. We understand there won't be restricted-payment covenant, but the documentation will come with a €50 million cross-default threshold provision.
- In our hypothetical default scenario, we assume a prolonged economic downturn affecting the construction sector, combined with a decline in infrastructure projects and operational delays in completing existing ones, which would result in severe margin reductions. This would, in our view, reduce Salini's ability to meet its debt obligations and trigger a payment default in or before 2021.
- We value Salini as a going concern, based on its strong brand value, market position, and global presence.

### Simulated default assumptions

- Year of default: 2020
- EBITDA at default: about €260 million
- Implied enterprise value multiple: 5.0x
- Jurisdiction: Italy

### Simplified waterfall

- Gross enterprise value at default: about €1,300 million
- Administrative costs: €90 million
- Net value available to creditors: €1,208 million

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- Priority claims: €567 million
- Senior unsecured debt claims: about €1,573 million
- Recovery expectation: 30%-50% (lower half of the range)

## Related Criteria And Research

- Methodology: Jurisdiction Ranking Assessments - January 20, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Revised Revolver Usage Assumptions For Recovery Analysis In Corporate Ratings - November 20, 2014
- Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Key Credit Factors For The Engineering And Construction Industry - November 19, 2013
- Industry Risk - November 19, 2013
- Group Rating Methodology - November 19, 2013
- Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Corporate Methodology - November 19, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria Guidelines For Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt - August 10, 2009
- Use Of CreditWatch And Outlooks - September 14, 2009

## Ratings List

### Ratings Affirmed

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

### New Rating

Salini Impregilo SpA	
Senior Unsecured	
EUR500 mil nts	BB+
Recovery Rating	4L

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed

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