Cracks Are Widening In Italy's Large Construction Companies' Credit Quality

November 19, 2018

Key Takeaways

- High leverage, high reliance on short-term debt, and weak cash flow generation are dragging on the credit quality of Italy's large construction companies.
- S&P Global Ratings'-adjusted debt to EBITDA of the three companies we rate in this sector has deteriorated significantly in recent years to an average of 5.3x in 2017 from 3.8x in 2014, while that of European peers has improved to below 1x in 2017 from 2.5x in 2014.
- Italian companies' geographic diversification into risky countries and amplified project concentration risk compared to peers are among the main sources of their financial difficulties.
- Their bond yields have significantly widened in 2018 and could lead to refinancing risk and further credit weakening in the next few years.
- We've taken eight negative rating actions on the three companies we rate in this sector over the past 12 months, and further downgrades are possible over the coming few quarters.

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The year 2018 was among the worst ever for large Italian construction companies. Financial conditions of all companies in the sector worsened, and some have started, or could soon start debt restructuring. This is surprising at a time when the domestic construction sector is showing some timid signs of recovery after a decade of continuous downturn, and business conditions in rest of Europe and in other main developed markets remain supportive. The construction companies in financial distress have a total turnover of about €6.5 billion or 0.4% of domestic GDP, and their aggregated financial debt is about €5 billion.

Our credit rating actions spotlight the sector's worsening creditworthiness. Out of the three companies that we rate-- Salini Impregilo, Astaldi, and CMC di Ravenna (CMC), we took eight negative rating actions in the past 12 months. We believe further downgrades are possible over the next few quarters (see below "Our Rating Actions Over The Past 12 Months"). Poor working capital management and subsequent worsened financial leverage and liquidity pressure have been among key reasons for downgrades.

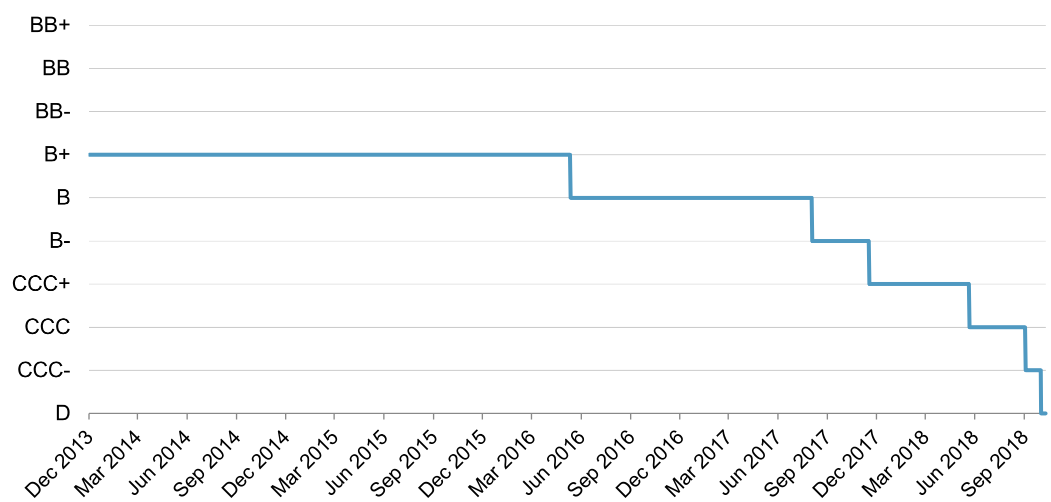
Our Rating Actions Over The Past 12 Months

Astaldi

We've taken four negative actions on Astaldi over the past year (see chart 1). In November 2017 we lowered the ratings to the 'CCC' category. On Oct. 2, 2018, we cut them to 'D' after the company applied to a court in Rome for a composition with creditors "with reservation," in accordance with Italian insolvency law, and said it would continue operations as a going concern. We consider this tantamount to a default, as the application foresees payment suspension of outstanding obligations, unless authorized by the court, during this process. We therefore don't expect Astaldi to make regular payments on its outstanding debt. On Oct. 13, the court granted the request for composition with creditors with a Dec. 16, 2018, deadline for submitting the final proposal of composition with creditors. The issuer rating will remain 'D' until payments resume according to the notes' terms or until financial obligations have been restructured. The delay in the sale of Astaldi's stake in its concession asset, the Third Bosporus Bridge (complicated by extreme Turkish lira volatility and Turkey's economic overheating, external leveraging, and policy drift) has accentuated the group's existing liquidity issues, hampering its capital strengthening plan, as the refinancing depends on progress in its disposal. We already saw increased short-term risks of a liquidity deficit when the group reported a substantial working capital cash drain in Q1 2018. Astaldi's liquidity position was already vulnerable to funding conditions, banks' willingness to roll over short-term lines, and any delays in cash collection or unexpected cash outflows.

Chart 1

Astaldi Rating Transition (2014-2018)



Source: S&P Global Ratings.

CMC di Ravenna

We took three negative rating actions on CMC in 2018. In September 2018 we put the 'B' ratings on CreditWatch negative and in October we lowered them to' B-'. On Nov. 13 we further lowered them to 'CC' and kept them on CreditWatch negative, following CMC's announcement that it would not have paid on time the interest due on one of its senior unsecured notes. CMC also announced that it is designing a plan to overcome its current liquidity tension, while guaranteeing business continuity, which would be followed by a negotiation of a general restructuring of its financial debt. We could lower the ratings to 'D' if CMC fails to make the interest payment on its senior note by the end of the grace period. Additionally, we incorporate our view that CMC could pursue a distressed exchange or other restructuring within the next few months, which would also lead us to lower the ratings on the company and its debt to 'D'.

CMC's liquidity position and credit metrics have weakened in the past few months. On Sept. 12, 2018, CMC released its financial results for second-quarter 2018 and reported a negative cash flow from operations of about €124 million. That was primarily due to six delayed project payments totaling about €110 million, mainly in Italy and Africa.

Salini Impregilo

In May 2018, we downgraded Salini Impregilo to 'BB' from 'BB+', as we believed the company's adjusted funds from operations (FFO) to debt will remain below 30% in 2018-2019. This followed a pronounced drop in 2017 as a result of reported sluggish operating cash flow generation and adverse movement in foreign exchange (forex) rates that hurt its net financial position. In August 2018, Salini Impregilo announced that it had signed a contract for the sale of its subsidiary, Lane Construction's Plants and Paving, for $555 million cash. To preserve its credit metrics, we believe Salini would need to use the vast majority of the $555 million cash proceeds from this sale, expected to close by year-end, to reduce gross and net debt. This is because the sale of this division will result in a significant decline in group EBITDA and cash flow.

On Nov. 15, 2018, Salini Impregilo presented a non-binding expression of interest to Astaldi and to its court-appointed commissioners, saying it was analyzing a potential integration consistent with its financial objectives. We see limited room in the ratings on Salini to absorb any debt-funded acquisitions or investments, and we believe that any such activity may put significant pressure on the ratings. Should Salini proceed with its plan to acquire Astaldi, we believe its free cash flow generation and ability to reduce gross debt over 2018-2019 could be impeded. This would negatively affect its credit metrics and liquidity.

High Leverage And Weak Cash Flows Are Behind Poor Performance

In our view, large Italian construction companies' weak financial conditions mainly reflect:

- High leverage, well above that of rated European peers;
- Weak cash generation during past few years; and
- High reliance on short-term debt, and generally weaker liquidity than European peers.

The companies' financial leverage is higher than rated European peers. Based on end-2017 data, Salini Impregilo had net debt to EBITDA of 3.1x and gross debt to EBITDA of 4.7x, which although the lowest among large Italian companies, compared poorly with competitors Strabag (zero net debt to EBITDA and 1.7x gross debt to EBITDA) and Hochtief (1.1x and 2.7x, respectively; see table 1). Almost all Italian companies' leverage had worsened in the period 2014-2017, while both Hochtief and Strabag were able to reduce their debt and improve their debt to EBITDA. On average, adjusted debt to EBITDA of the three Italian companies we rate has increased to 5.3x from 3.8x.

Table 1

Large Italian And European E&C Companies: Trend Of Financial Leverage

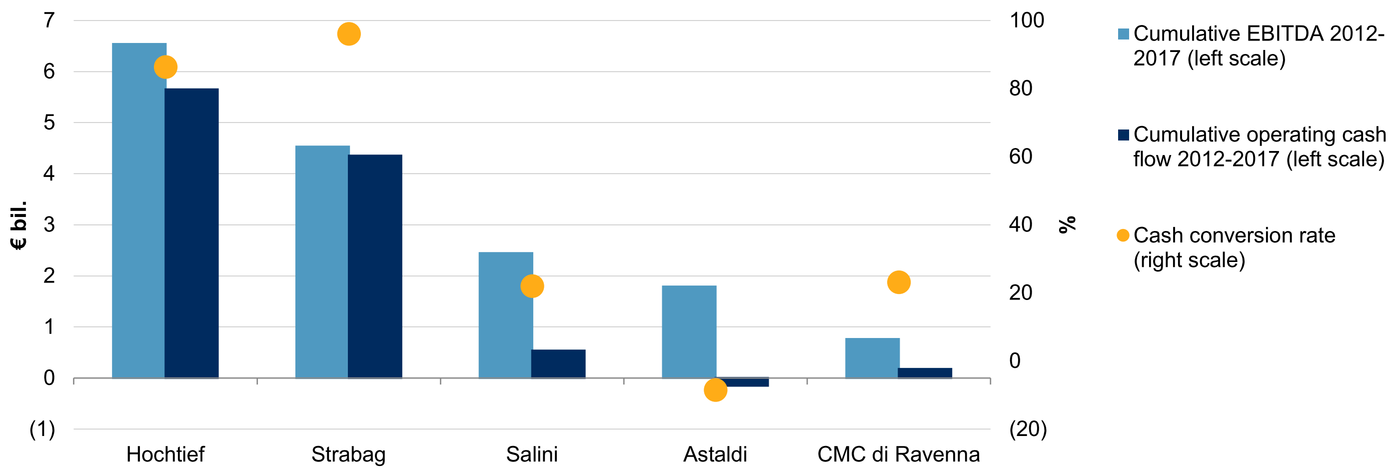
		Gross debt/EBITDA		Adj. net debt/EBITDA		
	2017 EBITDA (€ mil.)	2014	2017	2014	2017	Improved/weakened
Hochtief	1,474	7.6x	2.7x	4.3x	1.1x	↑
Strabag	946	2.5x	1.7x	0.7x	0.0x	↑
Salini Impregilo	617	3.8x	4.7x	2.4x	3.1x	↓
Astaldi	289	6.3x	9.5x	4.6x	7.5x	↓
CMC di Ravenna	180	4.2x	5.3x	4.2x	5.3x	↓
Trevi*†	76	4.9x	9.8x	3.0x	5.8x	↓
Impresa Pizzarotti*	68	3.5x	8.1x	1.9x	2.8x	↓

*Data of non-rated companies (Trevi and Impresa Pizzarotti) are unadjusted. For these companies, cash and cash equivalents are fully deducted from gross debt. †Latest data available as of fiscal year 2016.
Source: S&P Global Rating calculation, Companies' financial report

This primarily reflects Italian companies' weak cash flow generation in the past few years, which translated into increased debt. In the period 2012-2017, the companies we rate displayed poor cash flow conversion compared with rated European peers (see chart 2). Both Salini Impregilo's and CMC Ravenna's cumulative operating cash flows after working capital change failed reach 20% of cumulative EBITDA in the period, and Astaldi even reported almost zero cash conversion. In contrast, Strabag and Hochtief both reached more than 80%.

Chart 2

Rated Italian And European E&C Companies: EBITDA And Operating Cash Flow



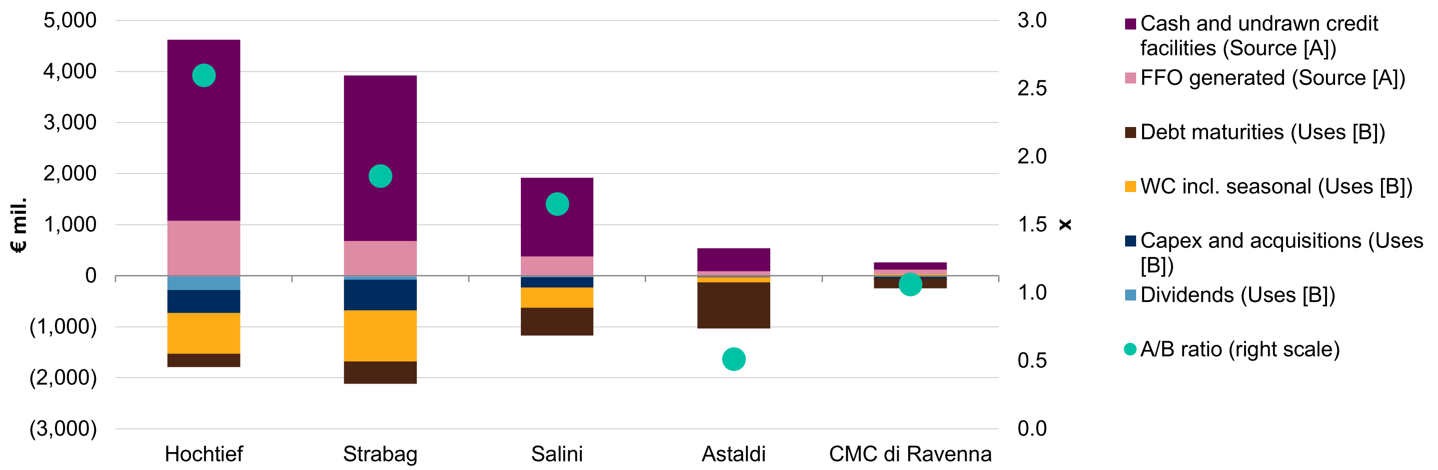
bil--Billion. Source: S&P Global Ratings calculation, companies' financial reports.

We believe the Italian companies' weak cash conversion is largely due to their difficult working capital management in the past few years, both in Italy, due to delayed payments from public bodies, and beyond. Notably, Italian construction companies increased their exposure to projects in high-risk countries during the past decade, resulting in recurrent delays in collections, and in few instances of litigation and impairment on work in progress. Salini Impregilo, for example, impaired around 50% of its Venezuelan trade receivables in 2017, reducing its total exposure to Venezuela to €314 million from €628 million, and has several claims toward the Panama Channel Authority (ACP) that are pending with various arbitration bodies and that relate to the Panama Canal extension project completed in 2016. Likewise, Astaldi wrote off €230 million of its €430 million working capital exposure to Venezuela. In addition, in 2017-2018 Astaldi's working capital was affected by delays in the collection of payments related to projects, such as in Algeria and Romania. By contrast, both Strabag and Hochtief operate largely in low- or medium-risk countries, and their working capital pattern has been almost cash-neutral in the same period.

Furthermore, large Italian construction companies display comparatively weaker capital structures and liquidity positions than peers, with a significant share of short-term debt relative to the amount of cash and available committed credit lines. This is even more significant considering that for some Italian companies, such as Astaldi, the balance sheet includes some long-term concession assets that should instead typically be funded through long-term debt. We assess Italian construction companies' liquidity profiles as adequate at best, while both Strabag and Hochtief have strong liquidity (see chart 3). Based on end-June 2018 data, we assessed CMC's liquidity as less than adequate. However, in light of company latest announcements, we estimate that it has further weakened.

Chart 3

Rated Italian And European E&C Companies: Liquidity Profiles



mil.--Million. Source: Companies' financial reports, S&P Global Ratings calculations.

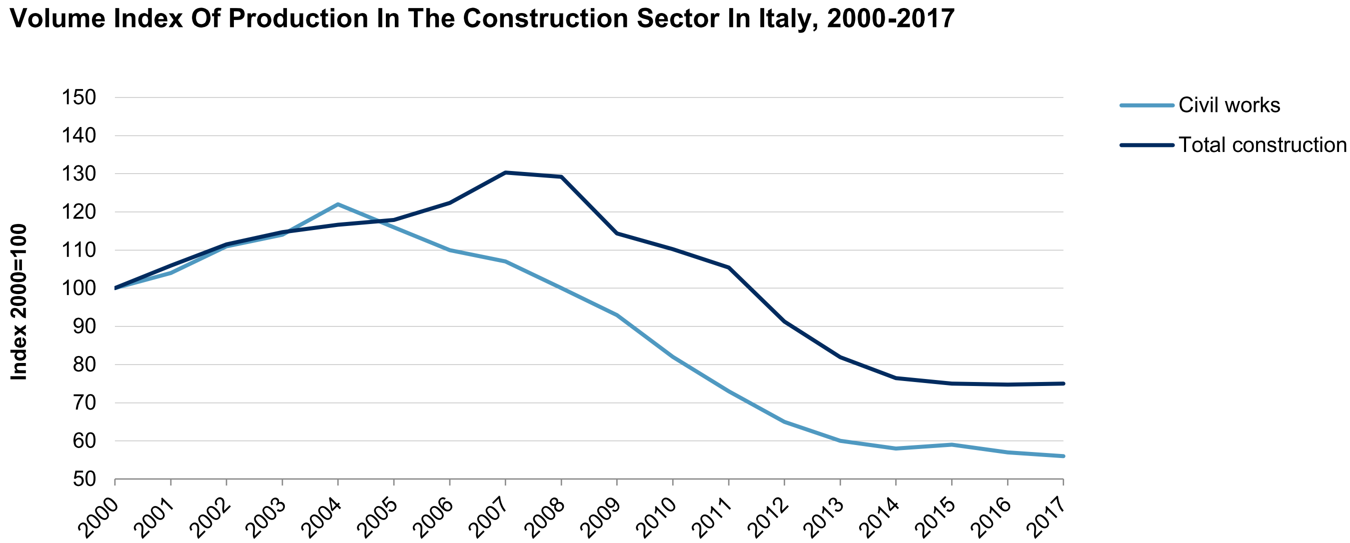
We consider it critical that construction companies have significant cash and committed lines. Compared with many other industries, engineering and construction (E&C) companies have highly sensitive working capital needs that can rapidly result in significant pressure on liquidity and credit quality when market conditions deteriorate. This is because construction projects are usually long term in nature, highly seasonal, and technically complex, and require uninterrupted cash funding to keep building processes under way. Projects are delivered in stages and payment flows are often quite irregular, which leads to high cash flow variance through the construction cycle. Failure to maintain timely receipts and payments on both the debtor and creditor sides can therefore rapidly affect liquidity. Currently, only Salini Impregilo displays adequate liquidity among rated Italian companies.

Diversification Outside Italy Has Been Generally Toward Risky Countries

Similar to other European countries that suffered a pronounced downturn of the construction cycle in the past decade, such as Spain, Italian large construction companies significantly diversified their exposure to outside Italy. However, unlike their European peers, their geographic diversification has been generally in risky countries, with a few notable exceptions, which heightened companies' financial difficulties.

The Italian construction output has nearly halved since the 2008 financial crisis. Compared with its 2010 level, it has dropped by 30% (see chart 4). Similarly, output related to civil engineering production lost more than half since the peak in 2004, and about 30% since 2010. The share of the construction sector in the Italian economy also declined: according to Eurostat, its gross value added as a share of GDP fell to 4.2% in 2017 from 5.4% in 2008.

Chart 4



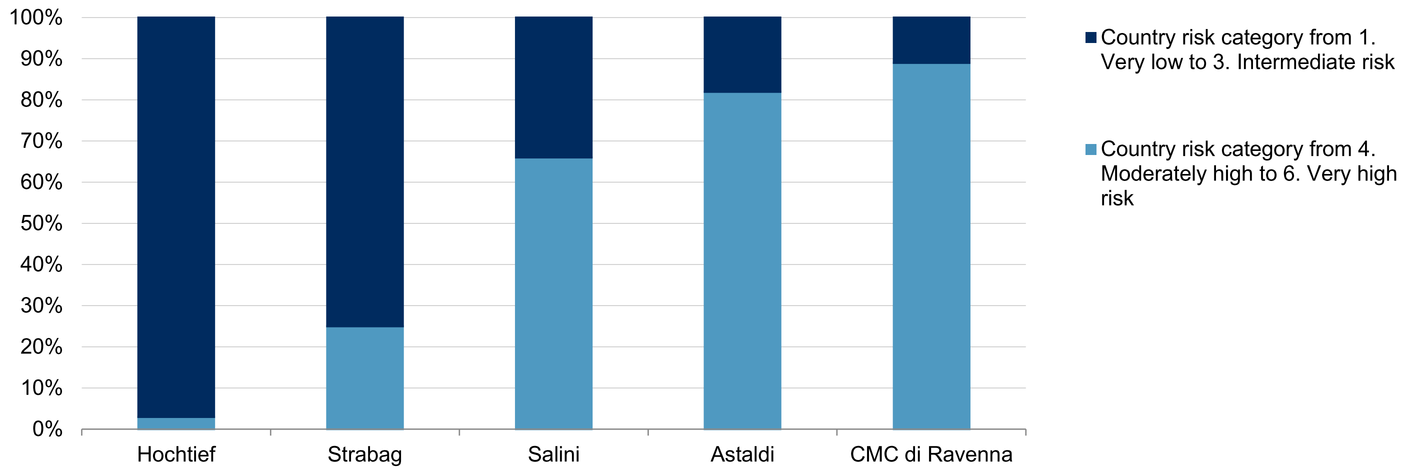
Sources: Eurostat, ANCE.

In this context, it is understandable that large Italian construction companies diversified deeply outside the country to preserve or expand their activity. According to Italian export credit agency SACE, foreign turnover related to Italian contractors surged to €14.1 billion in 2016 (73% of total turnover) from €5.5 billion in 2007 (47% of total turnover). At the same time, domestic turnover dropped to €5.3 billion in 2016 from €6.3 billion in 2007. For example, Astaldi's revenues outside Italy increased to 76% in 2017 from 61% in 2012. Salini Impregilo and CMC di Ravenna adopted similar trends. However, Italian contractors have commonly targeted risky peripheral countries, particularly in Africa and Latin America, which offered high margins but also brought high risks. They generally disregarded opportunities in developed countries, where the presence of a few large local players often makes it more difficult for foreign contractors to gain market entry. We've seen a few exceptions to this trend. Among rated companies, Salini Impregilo has pursued a strategy focused on strengthening its presence in the U.S., mainly through the acquisition of Lane Industries Inc. in 2016. Also, Pizzarotti SpA (not rated) makes more than 80% of its total turnover in low-risk countries.

Based on 2017 revenue data, Astaldi has sizable exposure to moderately high risk and high-risk countries, including 17% in Turkey, as per our latest country risk assessments (for further details see "Country Risk Assessments Update: October 2018", Oct. 24, 2018. Furthermore, CMC makes most of its revenues in both moderately high and high-risk countries, including about one-quarter in Africa. Salini Impregilo, notwithstanding its relevant growth in the U.S., still maintains significant exposure to the Middle East (26% of 2017 revenues) and Africa (13%). By comparison, European peers Strabag and Hochtief have almost zero high-risk exposures and limited exposures to moderately high risk regions.

Chart 5

Large Italian And European E&C Companies: Revenue Composition By Country Risk



Note: We applied S&P Global Ratings' regional Risk Assessment as of Oct. 24, 2018:
- 1. Very low, 2. Low, 3. Intermediate risk: North America, Australia New Zealand, Western Europe.
- 4. Moderately high, 5. High, 6. Very high risk: Southern Europe, Central Europe, Eastern Europe, Middle East, Latin America, Africa, Central Asia.

Sources: Companies' financial reports.

Their significant exposure to risky countries has not boosted Italian companies' cash flow generation. Rather, it has resulted in some delays in collections or project execution, litigation, and working capital impairment. In 2017, Astaldi and Salini Impregilo wrote down €230 million and €314 million, respectively, work in progress linked to projects in Venezuela when the country defaulted. In September 2018, CMC di Ravenna reported delayed project payments in Kenya due to a government reshuffle. The delay in the sale of Astaldi's concession assets in Turkey over 2018, caused by Turkey's prolonged economic overheating, has accentuated the group's already weak liquidity and ultimately led to the company asking for a composition with creditors in Sept 2018.

Limited Size Heightens Project Concentration

Italian contractors' limited size leads to more concentration by project compared with larger European national champions, such as Strabag, Hochtief, ACS, and Vinci. Based on 2017 data, the 10 largest projects of Italian contractors we rate accounted for about one-half of their total backlog on average, compared with less than 30% for European peers.

We consider high project concentration a negative rating factor that we incorporate in our assessments of construction companies' business risk profiles because cost overruns or payment delays on just one of few projects could be enough to impair a company's balance sheet and cash flow generation. For instance, as of September 2017, Astaldi wrote down €230 million of receivables and reclassified €203 million into fixed assets related to its railway projects in Venezuela totaling €433 million. This represented 25% of its work in progress. Similarly, client concentration can also result in difficulties collecting payment. In September 2018, CMC di

Ravenna reported disappointing cash flow generation due to delay in collecting project payments, partly from Anas SpA, the Italian roads and railways operator, which represents more than 30% of the total work in progress of the Italian construction group.

Business Prospects Are Mixed And Refinancing Risk Has Increased

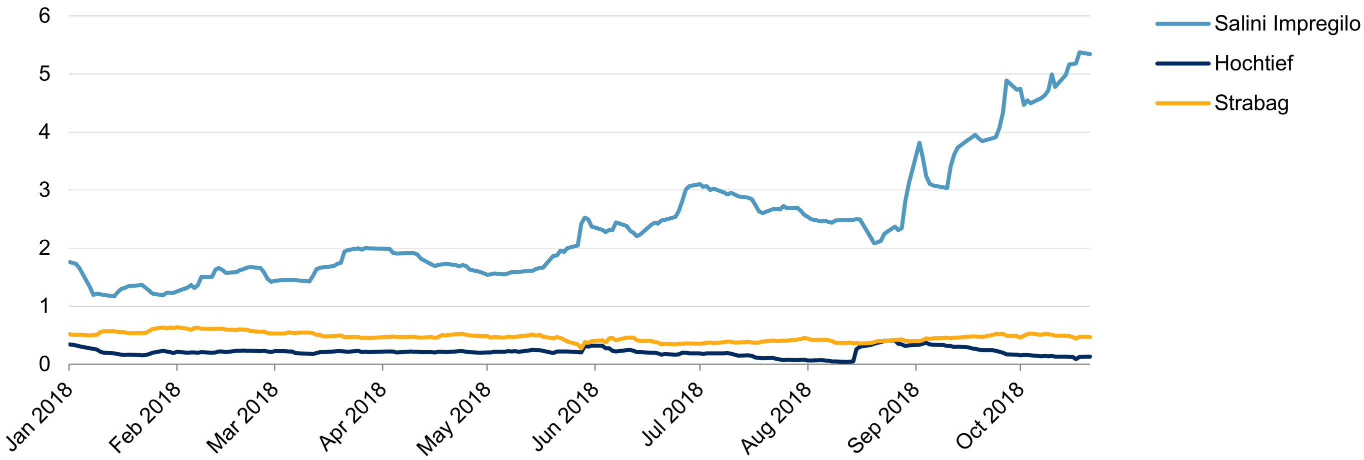
We see generally supportive prospects for the civil engineering construction business in 2019 in developed markets such as the U.S., Australia, and Europe. Some global trends such as energy and climate change, aging, and the need for infrastructure renovation should further support the construction industry over the medium to long term. At the same time, tough competition and the increased complexity of projects will shrink margins and require companies to tighten their risk management standards, also with the help of more digital techniques. In Europe, most countries should continue a gradual economic recovery, but at a slowing pace. We expect lower GDP growth of 2.3% in 2018 and 1.7% in 2019-2020, compared with 2.8% in 2017. Euroconstruct, a construction market forecaster, estimates that European construction output will grow 2.7% in 2018, down from 3.9% in 2017. It predicts growth should continue in 2019 and 2020, but at a slower rate, below 2%. We expect new housing construction in Europe to decelerate. We see a shift toward civil engineering construction, reflecting some infrastructure renovation programs announced in larger countries, such as Grand Paris in France and the Extraordinary Plan for Investments in Roads in Spain.

However, we are more cautious for Italy, reflecting current government ambiguity on key infrastructure projects in Northern Italy. Italian construction companies could win some projects in Europe (Salini Impregilo recently won a contract to construct a section of a new metro line for Grand Paris Express). However, we expect that most of the works outside Italy will be assigned to local players, and that the benefit for Italian companies could be limited. We nevertheless consider that Italian companies with a greater presence in the U.S., such as Salini Impregilo, could benefit from the positive momentum there at present.

Reflecting the difficult financial conditions for Italian construction companies, investors are demanding a much higher risk premium in the capital market, compared with low yields in 2016-2017. Bond prices reached record lows after the summer. Salini Impregilo's €600 million bond due in 2014 more than tripled its yield to 6.7% on Oct. 30, 2018, compared with 1.8% in October 2017 when it was issued. Its €680 million bond due in June 2021 reached a 6% yield on the same date compared with an average yield slightly below 2% over 2017. CMC di Ravenna's yield related on its August 2022 bond reached over 30% in October 2018 when the company announced it had failed to collect significant cash payments that it had expected at the end of September 2018. Peer companies such as Hochtief and Strabag have not suffered from this trend (see chart 6).

Chart 6

Bond Yields Related To Selected Italian And European Contractors



Source: Bloomberg.

One upside is that rated companies do not have bond maturities in 2019-2020. However, they have a significant share of bank debt, part of which is short-term. Absent a tangible improvement in the sector, it could become rather more difficult for Italian contractors to refinance their bond maturities in next few years. In the meantime, their cost of renewed bank debt may significantly increase, thus weakening their credit metrics further.

Related Research

- Italy-Based CMC di Ravenna Downgraded To 'CC' On Anticipated Missed Interest Payment; Ratings Still On Watch Negative, Nov. 13, 2018
- Country Risk Assessments Update: October 2018, Oct. 24, 2018
- Italy-Based Engineering And Construction Group Astaldi SpA Downgraded To 'D' On Applying For Composition With Creditors, Oct. 02, 2018
- Construction Company Salini Impregilo Ratings Lowered To 'BB' On Weaker Leverage Metrics; Outlook Stable, May 08, 2018

This report does not constitute a rating action.