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Research Update:

Israel-Based Shikun & Binui Ltd. Assigned 'BB' Corporate Credit Rating; Outlook Stable

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Research Update:

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Overview

- We have assigned our 'BB' long-term corporate credit rating to Israel-based engineering and construction and residential development company Shikun & Binui Ltd.
- We view Shikun & Binui's business risk profile as "fair," reflecting its exposure to moderately high industry and country risks in its engineering and construction division, mitigated by the company's long track record, leading position in its core activities, and strong leadership in residential development in Israel.
- The company's financial risk profile is "aggressive," in our opinion, essentially reflecting its leverage measures of 4.0x-4.5x debt/EBITDA and 2.5x-3.0x EBITDA/interest coverage.
- We view Shikun & Binui's asset base as supportive of the rating, mainly based on the company's ownership of the largest private land bank in Israel and its stakes in stable concession projects.
- The outlook is stable, reflecting our view that the company's growth plan for the next two years will be accompanied by a partial realization of some of the company's assets to balance its leverage.

Rating Action

On Dec. 30, 2014, Standard & Poor's Ratings Services assigned its 'BB' long-term corporate credit rating to Israel-based engineering and construction (E&C) and residential development company Shikun & Binui Ltd. The outlook is stable.

Rationale

Shikun & Binui operates mainly in the civil infrastructure construction and concession segment internationally and in the real estate development segment in Israel. The rating reflects our assessment of the company's exposures to moderately high industry and country risks in its E&C division, mitigated by its extensive experience and leading position in the fields of its core activities, and especially its strong leadership in residential development in Israel.

We assess the risks inherent in E&C operations as above average due to factors including high working-capital requirements, exposure to raw material price increases, and higher investment in equipment. In our view, this risk is partly moderated by the company's risk-management policies and its

above-average operating margins.

Moreover, Shikun & Binui's business risk in the E&C segment is amplified, in our opinion, by its activities in developing countries, mainly in Africa, which suffer from political instability and weak economies. This risk is well moderated by guarantees from the World Bank or other international financial institutions that cover a significant portion of the company's proceeds in the above projects. In this context, the company is exposed to a client concentration, with one major client--the Federal Republic of Nigeria (BB-/Negative/B)--accounting for about 20% of its total income. In our opinion, this risk is mitigated by the company's more than 50 years of experience in the country and its budgetary control policy of matching the investment in projects with customer's advance payments.

On the other hand, the company's above-average operating margins in the E&C segment, with gross margins of about 20% in its international activity and 6% in Israel, reflect, in our view, the company's well-established market position, both in its international and local E&C operations. We believe that significant order books, covering two years of operation--both in Israel and abroad--support stability in the company's activity over the next two years.

Shikun & Binui is the leading player in the residential development segment in Israel, selling approximately 1,000 units annually. The company's activity in this segment benefits from factors including a significant comparative advantage inherent in its long-held land inventory of about 15,000 housing units, which is triple that of the second-largest player in the market. Israel's real estate development sector, which accounted for about 25% of company gross income in the first nine months of 2014, enjoys high profitability margins of about 25%, boosted by the economic value of the company's large land reserves, which is well-above their book value. In our base case, we expect prices and demand to remain stable in the next years to support the group's solid performances in the near future.

In addition, we regard as positive factors the company's holdings in completed concession projects and income-producing real estate assets. We believe that the concession projects that the company is involved in in Israel are low risk compared with other contract projects, given the guarantees from the government or government bodies and the nonrecourse funding structure. These holdings are reflected, together with the above-mentioned economic excess value of land inventory, in our assessment of positive capital structure credit modifier.

We view Shikun & Binui's financial risk profile as "aggressive," based on 4.0-4.5x debt/EBITDA and 2.5-3.0x EBITDA/interest coverage. The company's debt consists of both senior secured finance, mainly at the project level, and unsecured bank and bonds finance in the corporate holding-company level, leading eventually to a relatively complex structure. In addition, an application of International Financial Reporting Standards 10, 11, and 12, which--among other regulated consolidation accounting--lead to deconsolidating of some concession projects under construction, as they are deemed not under

control. In our analysis, we base our credit measures on balance-sheet consolidated net debt amounts.

Our base case for 2015 is based on the following assumptions:

- E&C revenue low-single-digit growth based on the existing backlog equivalent to 2.0x revenues and a historical rate of conversion into revenues.
- Residential development low-single-digit growth based on the projects in progress, the majority of which have a high sales rate.
- EBITDA margins of about 16%-17%, somewhat below the average in previous years of approximately 18%. We base our assumption for lower margins on possible intensified competition from low-cost Chinese construction companies in Africa and the cost of entry in the Colombia and U.S. markets, which the company considers to be one of its significant future growth engines.
- Relatively high investment needs in the next two years of €0.2 billion-€0.3 billion, owing mainly to its recently won large-scale concession projects in Israel and Colombia.
- We assume management will partially sell some of its mature assets.

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

- Adjusted EBITDA of approximately €200 million.
- Adjusted debt leverage as reflected in debt/EBITDA of 4.0x-4.7x.
- Adjusted EBITDA/interest coverage ratio of 2.5x-3.0x.
- Adjusted funds from operations/debt of above 12% and adjusted free operating cash flow/debt of more than 5%.

Liquidity

In our opinion, the company's liquidity is "adequate." We examine liquidity on a holding-company basis because most of the company's corporate debt is issued at the Shikun & Binui Ltd. level. The company's sources of liquidity that we regard as highly likely for 2015 outweigh the anticipated uses by 1.2x-1.3x.

According to our methodology of liquidity analysis, we assume that the sources available to the company (on a stand-alone basis) for 2015 include:

- Cash, deposits, and an unused balance of the committed credit lines totaling approximately €130 million;
- Cash flow from subsidiaries (dividends, loans, and management fees) and from concession holdings totaling €90 million-€100 million;
- Proceeds from signed asset sales of €20 million.

Our assumptions about the uses of the company for 2015 are:

- Payment of debt maturities of about €30 million;
- Interest and general and administrative expenses of about €70 million;
- Investments in current projects of about €70 million-€90 million; and
- Dividends totaling about €40 million.

From the liquidity snapshot, we excluded, according to our criteria, the amounts that are currently pending and that are not contractually obligated.

Outlook

The stable outlook reflects our assessment that core activities will continue to benefit from relatively high visibility of future cash flows based on the current order books for infrastructure projects, both in Israel and abroad. We've also taken into account the proceeds from housing units sold in the company's homebuilding operation in Israel. We assume that the company's growth plan for the next two years will be accompanied by a partial realization of some of its mature assets to balance its leverage. Our assessment is further underpinned by the company's excess financial flexibility owing to its possession of the largest private land bank in Israel as well as its stakes in mature concession projects and income producing real estate assets, which we regard as supportive for the company's ability to serve debt.

Upside scenario

We do not foresee a positive rating action in the short term owing to the company's investment needs in the coming two years in relation to its growth plan. However, we would consider a positive rating action if the company achieves a sustainable improvement in its financial profile, reflected in improved leverage and coverage ratios to debt to EBITDA of no more than 4.0x and EBITDA to interest of no less than 4.0x on a sustainable basis, together with maintaining business stability. We believe that improved coverage ratios will be possible in the medium-to-long term after a large-scale realization of the company's main mature projects.

Downside scenario

We would consider taking a negative rating action if the company does not maintain adjusted ratios of debt to EBITDA of 4.5x and EBITDA to interest of at least 2.5x. We assess that this scenario could materialize if there were a deterioration in the company's business environment that negatively affected the operating margins in its core operations. Another factor that, in our view, could erode the company's financial performance is an aggressive expansion strategy that results in a significantly higher pace of investments than we assumed in our base case.

Ratings Score Snapshot

Corporate Credit Rating: BB/Stable/--

Business risk: Fair

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

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Positive (+1 notch)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb

- Group credit profile: bb
- Entity status within group: Ultimate parent

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Revised Revolver Usage Assumptions For Recovery Analysis In Corporate Ratings, Nov. 20, 2014
- Methodology For Applying Recovery Ratings To National Scale Issue Ratings, Sept. 22, 2014
- Standard & Poor's Maalot (Israel) National Scale: Methodology For Nonfinancial Corporate Issue Ratings, Sept. 22, 2014
- Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria Guidelines For Recovery Ratings On Global Industrial Issuers' Speculative-Grade Debt, Aug. 10, 2009

Ratings List

New Rating; CreditWatch/Outlook Action

Shikun & Binui Ltd.

Corporate Credit Rating BB/Stable/--

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