

Research Update:

Engineering And Design Firm Arcadis NV Assigned 'BBB-' Rating; Outlook Stable

March 9, 2023

Rating Action Overview

- Netherlands-based Arcadis N.V. has successfully issued €500 million in senior unsecured notes, to repay a similar amount of its €750 million bridge financing for the IBI and DPS acquisitions, which closed in September and December 2022, respectively.
- Full-year 2022 results are slightly ahead of our expectations, like for like, supported by high backlog, resilient profits, and integration of the acquired businesses as anticipated, leading us to forecast about €470 million-€480 million of EBITDA in 2023, in line with our preliminary estimates.
- As such, our base case continues to point to adjusted funds from operations (FFO) to debt of about 35% in 2023, improving toward 45% in 2024, boosted by strong recurring free cash flows and prudent financial policy.
- We therefore assigned our 'BBB-' issuer and issue ratings to Arcadis N.V. and its senior unsecured notes, in line with our preliminary ratings.
- The stable outlook reflects our view of strong and fairly predictable free cash flows that should enable the company to maintain FFO to debt at the high end of the 30%-45% range and discretionary cash flow to debt of over 15%.

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Rating Action Rationale

Arcadis' 2022 performance is in line with our expectations. Full-year S&P Global Ratings-adjusted EBITDA was about €406 million when including three months contribution from IBI and one month from DPS. Stand-alone performance is about €10 million above our September 2022 estimate for full year, and reflects the company's ability to sustain margins despite the inflationary and volatile macroeconomic environment. IBI's and DPS' EBITDA contributions were respectively modestly above and in line with our base-case expectations. Backlog stood at €3.1 billion at the end of December 2022 (including IBI's and DPS') reflecting 4.2% growth on an organic basis and 8.9% pro forma. These reflect continued dynamic bidding activity and favorable demand momentum in engineering, supported notably by resilient customer investments in energy

transition and manufacturing projects. Organic revenue growth reached 8.9% over 2022, with company-defined operating EBITA margin of 9.8%, up 20 basis points year on year, capturing sound cost and salary inflation management, together with an ongoing pricing strategy.

Arcadis' size is moderate but should be sufficient to compete with larger pure play and integrated rivals in a highly fragmented market. Arcadis is the No. 2 global pure play operator in the highly fragmented design and engineering sector, with an estimated 1% market share and about 35,000 employees. With forecast revenue of close to €4.8 billion for 2023, and EBITDA of €470 million-€480 million, we consider the group's scale to be moderate, yet sufficient to compete with larger pure play rival WSP Global and competitors that are integrated into construction companies, such as Jacobs Engineering Group Inc., AECOM, Worley Ltd. and SNC-Lavalin Group Inc. Nonetheless, we believe some larger peers, such as AECOM, have better diversification as they also operate in the pure construction segment.

Arcadis' typically small and short projects will continue to limit revenue visibility. A material portion of the group's projects are small in size (typically worth less than €100,000) while turnaround time is typically in the order of weeks or months. Consequently, the order book has a maturity of about 8 months-12 months and provides limited visibility of revenue streams beyond that horizon. The short backlog means the company is often involved in bidding activities and exposed to potential swings in business inflow, including from (the partly cyclical) demand in the construction sector, from end market competition, and pricing competition. Arcadis has a relatively resilient track record of activity, a high order backlog, and a strong contract award rate according to the company's management. By comparison, some larger competitors tend to have more technical or industrial-type, multi-year projects leading to better visibility on revenue.

Arcadis' diversification by project type, customer, geography, and end market continues to provide stability. The company operates around 35,000 projects per year and has about 8,000 public and private customers (each accounting for about half of the company's sales). Of those customers, 200 key clients generate about 50% of revenue, provide a reasonable level of repeat business, and have generally long-standing relationships. We see no single client concentration. The company has a balanced global presence with a focus on developed economies. The Americas account for 45% of pro forma revenue, Europe 42%, and Asia-Pacific 13%. On a pro forma basis, including the planned acquisitions, the U.S. and Canada will together represent 42% of revenue, U.K. 18%, Western and Southern Europe 14% (of which Germany is about 4%), China 5.5%, and Australia 5%.

Specialization provides some competitive advantage. The company has built brand recognition based on its expertise in niche areas of its key markets, including buildings expertise (39% of revenue), infrastructure (26%), environment (24%), and water (11%). That specialization notably relates to hazardous waste management and environmental remediation (including for example perfluoroalkyl and polyfluoroalkyl (PFAS) decontamination), plant design for auto or battery manufacturing, water management projects, and climate adaptation design to protect urban areas from storms and hurricanes. These specialty applications mitigate comparison with larger peers, which are typically involved in more technical, larger-scale, and longer projects, notably in the industrial sector, although Arcadis may be reducing that gap as part of its strategy to increase exposure to industrial manufacturing (currently about 30% of backlog).

Margins are resilient but likely to remain relatively low, in line with sector norms. Arcadis has unadjusted EBITDA over net revenues of around 12%-13%, while its pure-play rival WSP Global is at about 14%-16%. We consider those margins to be relatively modest given the high level of expertise inherent to the businesses, and note they are lower than is typical among expertise-driven consulting services (business services). The margins are, however, markedly higher than the 6%-8% recorded by competitors integrated into construction companies. We believe margins will remain near current levels due to pressure from competition, industry fragmentation, and proximity to the low-profitability construction sector.

Arcadis' high portion of short-term projects should continue to limit risks from inflation and cost overruns. The company's biggest cost is personnel, which means profit-margin management is largely focused on staffing rates, workforce flexibility, and management of wage inflation (particularly in the current environment). This task is complicated by the necessity of maintaining sufficient spare staff to enable the company to quickly respond to new engagements. We understand there is a certain level of interchangeability in the workforce, given their end-market specialization, and that flexible remuneration is about 5% of compensation. Yearly staff turnover of about 15% allows for some management of payroll costs.

The lower risk associated with Arcadis' shorter-term contracts enables the company to utilize a high proportion of fixed price contracts (about half of its total contract base), which tend to be more profitable than cost-flexible contracts. We also note Arcadis' track record of profit resilience, and its efforts to preserve cash, through the pandemic and the global financial crisis.

The company's capital-light business model supports strong, recurring free cash flows. We estimate the company's capital expenditure (capex) will be about €70 million in an average year, equating to less than 2% of revenue. Free cash flow conversion has been strong at 70%-80% in recent years, though it dipped in 2019 when the company rolled-out a new enterprise resource planning (ERP) system that resulted in higher capex. That investment has, however, enabled the company to generate sustainable additional working capital inflow, linked to payments optimization. We expect continued strong recurring free cash flows to offer deleveraging potential.

The acquisitions of IBI and DPS, at reasonable earnings multiples, combined with prudent debt and cash funding is supportive of Arcadis' credit metrics over the forecast horizon. The €830 million total cash consideration for the two businesses has been funded through €750 million of bridge financing, maturing up to 2024, cash on hand, and drawdowns under the revolving credit facility (RCF) which was fully repaid and entirely available at end 2022. In addition, the €500 million senior unsecured bond proceeds have been used to repay an equivalent amount of the €750 million bridge financing. We forecast the projected capital structure will leave Arcadis with adjusted FFO to debt of 35% in 2023, on a pro forma basis, and 45% in 2024. We view these levels as comfortable given the group's intermediate financial risk profile. Moreover other credit metrics are fairly strong for the rating level, and notably discretionary cash flow to debt, which we expect will remain above 15%. We consider there to be some risk inherent to the acquisitions because of the relatively large size of the acquired EBITDA, and the challenge of integrating two separate businesses, although we understand the process was on track at end 2022.

Prudent financial policy underpins the company's solid commitment to the 'BBB-' rating. Management is targeting net debt to EBITDA (unadjusted, including IFRS 16 leases) of 1.5x-2.5x. The company has consistently operated at the lower end of that range, and more recently at below 1.5x. We understand this prudent approach will continue, with the upper side of the target being considered a temporary maximum. We consider the dividend policy to be clear at 30%-40% of net

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income from operations--following a one-off exceptional dividend in 2022 and two years of reduced payments due to the pandemic. These shareholder returns will therefore be captured in our discretionary cash flow (DCF) to debt metric.

Strengths within the fair business risk profile, and financial metrics strengths within the intermediate financial risk profile, lead us to adjust the anchor score upward by one notch to arrive at our 'BBB-' rating. This captures the resilient and cash-generative nature of the business, and strong financial ratios for the rating.

Outlook

The stable outlook reflects our expectation of an improving earnings base following the acquisition of IBI and DPS, of strong business resilience (in line with Arcadis' track record), and the current high order backlog. We also anticipate the company will progressively improve its profitability margin over 2023-2024. We consider the 'BBB-' rating to be commensurate with adjusted FFO to debt at the higher end of our intermediate financial risk profile (30%-45%) and with DCF to debt remaining above 15%.

Downside scenario

We could lower the rating if we observe significant pressure on EBITDA, for example, due to a sharp drop in contracted missions that reflects lower growth or a recessionary environment, or due to inflation that substantially increased the group's cost base. We might also lower the rating if S&P Global Ratings-adjusted FFO to debt declined to below 37.5% (the middle of the intermediate financial risk profile range) without the expectation of an imminent recovery, or if DCF to debt dropped below 15%. That could result from higher-than-expected shareholder remuneration, or another large, debt-funded acquisition.

Upside scenario

We could raise the rating if the company successfully increases the scope of the business and demonstrates a commitment to more conservative financial policies. This scenario is unlikely at this stage, given the company's overall limited scale and modest margins.

Company Description

Arcadis is a global engineering and design firm focused on natural and built assets consulting. It was founded in 1888 and is incorporated in Amsterdam. The company is expected to generate about €470-€480 million of EBITDA and €4.8 billion of revenue in 2023, following the integration of IBI and DPS. Arcadis employs about 35,000 people across 30 countries. Its combined order backlog was €3.1 billion at the end of December 2022.

The company's operations have been split in four segments since 2022: Resilience (35% of pro forma revenue) is focused on natural assets, energy and resource management projects; Places (42%) is largely dedicated to built asset projects, including residential construction and nonresidential construction, such as plant design for manufacturers, public services construction engineering, and urban planning; Mobility (21%), which integrates projects relating to transport infrastructure, namely rail and transit solutions, highways, ports, and airports; and Intelligence (new segment), which will leverage IBI's capabilities in digital and systems and will interact with

the other divisions.

Our Base-Case Scenario

Assumptions

- Like-for-like low to mid-single digit revenue growth across the company's core segments over 2023-2026. This includes consideration of the integrated businesses and expected moderate revenue synergies, and reflects a portion of already contracted business (for 2023), some level of recurrence in orders, as well as favorable business flows from underlying megatrends such as climate change, energy transition, resource management, and urbanization.
- EBITDA margin (calculated over gross revenues) of 9.9% in 2023, and 10.6% in 2024. This includes the contribution from IBI and DPS, assumes some cost synergies, and integration costs front-loaded in the two years after the deals close.
- Working capital outflow of €60 million in 2023 and €40 million in 2024.
- Capex of €70 million per year.
- Dividends of 30% of prior year net income.
- €30 million cash considered as restricted.
- Lease liabilities (IFRS 16) of about €323 million at end 2022, including IBI's and DPS' contributions, in line with our preliminary estimates.
- Pension deficit of about €27 million, in line with our preliminary estimates.

Key metrics

- Adjusted EBITDA of €470 million-€480 million in 2023, and about €530 million in 2024. This follows €406 million in 2022, which includes only three months of IBI and one month of DPS' contributions.
- Adjusted FFO to debt of about 35% in 2023, improving to 45% in 2024. That reflects cash build-up from positive DCF, EBITDA improvements due to growth, realized synergies, and lowering of integration costs.
- Adjusted debt to EBITDA of 2.1x in 2023, and 1.6x in 2024, after 2.5x pro forma in 2022.
- Free cash flow of €230 million-€300 million per year over 2023-2026.
- DCF to debt of above 15%.

Liquidity

We view Arcadis' liquidity as adequate, reflecting that liquidity sources will exceed uses by over 1.2x over the 12 months started Jan. 1, 2023. We assume that the outstanding portion of the bridge facility for the acquisitions will be refinanced sufficiently ahead of its maturity, which can be extended up to 2024. We estimate that portion came down to €250 million at the end of February 2023, following the issuance of a €500 million senior unsecured bond. We also factor in the limited short-term debt maturities, while the company benefits from a significant buffer under

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its currently unused €500 million senior unsecured RCF.

Principal liquidity sources (for the 12 months started Jan. 1, 2023):

- Accessible cash balance of €243 million at end 2022,
- €500 million fully available RCF maturing 2026,
- About €250 million–€300 million cash FFO in 2023,
- €500 million bond proceeds from the February issuance,

Principal liquidity uses:

- €500 million repayment on the bridge financing, leaving €250 million outstanding and maturing up to 2024,
- €71 million of short-term debt at end 2022,
- €50 million working capital outflow over the period, reflecting revenue growth, business integration, and with potentially moderate intrayear fluctuations.
- €70 million capex.
- €66 million dividend paid in 2023.

Covenants

Arcadis is subject to financial covenants on its €500 million syndicated RCF and its 2020 Schuldschein notes, which require maximum net debt to EBITDA of 3.5x measured semi-annually (the ratio stood at 1.6x as of Dec. 31, 2022). The outstanding Schuldschein loans and the syndicated RCF no longer contain an interest coverage ratio. We expect covenant headroom to remain comfortable.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors are an overall neutral consideration in our credit rating analysis of Arcadis. The company benefits from sustainability-driven megatrends such as natural resources management, energy transition and climate change, electrification of mobility, and addressing social needs created by growing urbanization. These environmental and social constraints have been fueling the company's order book in recent years and have become central to the company's operational strategy.

For example, Arcadis is engaged in various smart city projects aimed at reducing their environmental impact and improving the quality of life in urban environments. The company is also working on Singapore's deep tunnel sewerage system extension, which is expected to improve the water recycling rate in the city to 55% by 2025, from 30% currently, and is a key engineer for New York's Big U project, where it is designing infrastructure and protection against floods resulting from rising sea level in lower Manhattan.

The company estimates about 78% of its project portfolios include a significant sustainability driver. This compares, for example, with rival Worley's 32% exposure to renewables and

decarbonization.

Subordination Risk Analysis

Capital structure

Arcadis' capital structure as of Dec. 31, 2022, pro forma for the bond issued February 2023, included the following:

- The recently issued unsecured notes of €500 million, due in 2028, replacing an equivalent portion of the €750 million bridge financing outstanding at end 2022 and maturing up to 2024.
- €250 million remaining bridge financing.
- €190 million of unsecured Schuldschein debts due in 2023, 2025, and 2027.
- A priority debt of €20 million at a 6.5% interest rate due in 2025 at the acquired subsidiary, IBI.
- €15 million in bank overdrafts.
- Minor priority debt at other subsidiaries.
- The company also has a €500 million revolving credit facility maturing in 2026, and €120 million of uncommitted short-term lines of credit (both not rated).

Analytical conclusions

Our analysis points to no structural subordination given that all debt in Arcadis' structure is senior unsecured. There is no secured debt in the structure.

We have treated €20 million of debt rolled-over at IBI, and a minor amount at other subsidiaries, as priority liability. The company plans to repay the debt rolled over from IBI only in 2024, at which point early repayment would not incur penalty fees. This instrument matures in 2025.

Ratings Score Snapshot

Issuer Credit Rating	BBB-/Stable/--
Business risk:	Fair
Country risk	Low
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)
Financial policy	Neutral (no impact)

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Issuer Credit Rating	BBB-/Stable/--
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Positive (+1 notch)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

New Rating; Outlook Action

	To	From
Arcadis N.V.		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Stable/--(Prelim)
Senior Unsecured	BBB-	BBB-(Prelim)

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