Sharma & Co Private Limited: [ICRANP] LBBB-/A3 assigned

July 14, 2020

Summary of rated instruments:

Instrument*	Rated Amount (NPR million)	Rating action
Fund-based; long-term limits	464.03	[ICRANP] LBBB-; assigned
Fund-based; short-term limits	615.00	[ICRANP] A3; assigned
Non-fund based; Long-term limits[1]	6,621.86	[ICRANP] LBBB-; assigned
Non-fund based; short-term limits-within fund-based limits	(110.16)	[ICRANP] A3; assigned
Total	**7,700.89**	

* Instrument details are provided in Annexure-1

Rating action

ICRA Nepal has assigned a long-term rating of [ICRANP] LBBB- (pronounced ICRA NP L triple B minus) to the fund-based long-term limits of NPR 464.03 million and non-fund based long-term limits NPR 6,621.86 million (interchangeable with short-term non-fund based limits) of Sharma & Company Private Limited (Sharma). ICRA Nepal has also assigned a short-term rating of [ICRANP] A3 (pronounced ICRA NP A three) to the short-term fund-based limits of NPR 615.0 million (including embedded non-fund based limits of NPR 110.16 million).

Rationale

The assigned ratings consider Sharma's established track record of over five decades in the Nepalese construction sector and its experienced promoters/management. The ratings also factor in the strong market positioning of the company as evidenced by the strong growth in revenue and operating profits of Sharma in the last two to three years. Healthy pace of new order inflows in the last two years ending FY2019 has helped Sharma maintain a comfortable order book position with the value of pending contracts equivalent to ~1.5 times of FY2019 operating income, which provides a medium-term revenue visibility. The rating also takes comfort from the positive long-term outlook for contractors, given the Government of Nepal's (GoN) impetus to the infrastructural development of the country, given the large infrastructure deficit in Nepal. This will provide opportunities for contractors like Sharma, which is a positive for their growth and profitability. The rating also takes comfort from the diversified order book (across the segments, geographies, and projects), and low counterparty risk as the entire current order book (as of June-end 2020) consists of mainly Government projects. Financial profile of Sharma also remains adequate, supported by its scale of operations and healthy profitability and cash accruals. Sharma's reliance on funded bank limits remains low because of the supplier's credit and execution of majority of projects through its JV partner. This has supported the liquidity profile as well as the debt coverage ratio of the company despite its overall gearing (as reflected in its high total outside liabilities-TOL to total net worth-TNW ratio) remaining on the higher side,

The rating is, however, constrained by a significant portion of the slow-moving projects in Sharma's current order book. As of June-end 2019, ~70% of the contracts by value were moving at a slower pace vis-à-vis the projects' scheduled timeline, which exposes the company to the risk arising from the non-performance of contracts (e.g. BG devolvement, etc). However, almost entire slow-moving projects are Government-owned where the project execution is delayed because of external factors and Sharma has been granted the time extension by the employers, mitigating the risk to some extent. The rating also factors in the operational risk for Sharma, given its high reliance on the JV partners for the project execution, where Sharma has limited control. The probability of non-performance and related risks from those projects remain a rating concern. While the opportunities for the construction contractors are likely to remain healthy, the intense competition in the construction sector and bidding requirement for the public projects, coupled with the ongoing Covid-19 pandemic, results in uncertainty on the new order inflows and long-term revenue prospects. The rating also factors in the regulatory risk associated with the construction sector in the country.

[1] *interchangeable with short-term non-fund-based limits*

The company's ability to secure new orders, execute its pending orders (along with execution by the JV partners) on time or obtain an extension for the slow-moving projects thereby mitigates the risk arising from non-performance and is a key monitorable and rating sensitivity. Timely debtor recovery in the post-Covid era and the ability to maintain liquidity cushion also remains a rating sensitivity.

Key rating drivers

Credit strengths

Long track record of operation – Operating since 1966 as a proprietorship firm and registered as a private limited company in 1980, Sharma is one of the large and established players in the Nepalese construction sector. The company is classified as Class A contractor as per the classification norms of public procurement regulations, factoring in the prior experience, financial strength and resources including, human and equipment. The promoters also have adequate experience of the construction industry, having completed projects in the diverse segments like buildings, roads, bridges, irrigation, drinking water supply, among others.

Healthy revenue growth, comfortable coverage ratios – Sharma's operating income registered a strong growth of CAGR ~77% in the last four years ending FY2019. This coupled with healthy operating profit margins has resulted in a strong OPBDITA and net profit levels for the company. Liquidity position also remains comfortable supported by mobilisation advances, adequate credit period from suppliers (creditors) and execution of a major portion of the order book through JV partners with resulting low reliance on funded bank limits. This results in a relatively comfortable gearing level (debt to net-worth ratio of ~1 time as on mid July 2019) despite its overall gearing remaining on the higher side with TOL/TNW of ~7 times for FY2019 end. Similarly, the interest coverage and DSCR[2] also remain strong at ~11 times and ~2 times respectively for FY2019. Net cash accruals to the total debt (NCA/TD) remained healthy at 28% for FY2019. Moreover, the working capital intensity (NWC/OI) of the company remained at a negative 10% primarily supported by the substantial credit period from the suppliers of the company which is a positive from the liquidity perspective.

Low counter-party risk – A majority of the current projects being handled by Sharma relates to the public sector wherein the employer is either the Government of Nepal, its ministries, or the related agencies. As of the end of June 2020, almost the entire pending order book comprises Government contracts. As the clients are primarily Government entities, the counter-party credit risk remains low and mitigates the risk arising from relatively high debtor days to a large extent.

Strong and diversified order book position and adequate headroom in the bidding capacity –The order book position of Sharma remains comfortable with total contract worth ~NPR 20.5 billion (consolidated basis considering Sharma's share in JVs) as of June-end 2020 and pending value of contract worth NPR 10.7 billion; which is equivalent to ~1.5 times of the operating income for FY2019. This provides a medium-term revenue visibility for Sharma. The order book also remains fairly diversified across different segments with ~42% order book comprising road-related projects. Sharma is also among the larger players in the construction sector with high bidding capacity as per the current regulations. As of June-end 2020, Sharma has a bidding capacity for fresh contracts worth NPR 13 billion, which, coupled with the proven track record, provides headroom for future growth opportunities. The company has a track record of healthy pace of addition of fresh contracts in the last two to three years, which also remains positive for the sustainability of revenue and its overall financial profile.

Credit Challenges

Operational risk arising from slow-moving projects and high reliance on JV partners - The majority of the projects in the order book of Sharma are running behind schedule, exposing the company to project execution risk and risk arising from non-performance of the contracts (such as BG devolvement, blacklisting, etc). Moreover, a majority of such projects are being executed by the JV partners. However, most of the slow-moving contracts are Government ones where delays are on account of factors beyond the control of the contractors such as non-clearance of site, obstruction from different stakeholders like local community, climactic conditions, etc which are documented by Sharma and being and used as evidence for obtaining an extension of time (EOT) from employers, thereby mitigating the risk to some extent. Nonetheless, sustained delays in project execution, especially by the project executing JV partner by the contractors,

[2] *DSCR-Debt Service coverage ratio*

could lead to penal consequences for the company and adversely impact its financial profile. Although project execution through JV partner has helped Sharma lower its reliance on funded lines for project execution, thereby improving the gearing level and debt coverage ratios, this also exposes the company to the risk arising from the non-performance of JV partners, which remains a rating concern.

Intense competition amid the bidding requirement for the public contract projects - The construction sector in Nepal is highly competitive arising from the presence of many small and big players. Moreover, the bidding requirement for the public projects (major portfolio for Sharma) creates uncertainty regarding future revenue inflow. The competition has been further intensified in the recent period by the recent regulatory changes allowing international contractors to bid for projects with value above NPR one billion (erstwhile, the floor was NPR two billion).

Regulatory risk- Being a company concentrated in the public construction sector, Sharma remains exposed to the risk of regulatory changes, mainly in the Public Procurement Act and the related regulations. This risk remains further underlined, considering regulatory changes brought in by way of amendments (8^{th}, 9^{th} and 10^{th}) the public procurement regulations by the Government. Further, a bill to amend the Public Procurement Act 2064 (the Act governing public contracts and the bidding process); is currently under consideration in Parliament. With the Government of Nepal (GoN) looking to expedite the pace of Government projects, if it implements stricter regulations, it could have a material impact on the players like Sharma.

Analytical approach: For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below.

Links to applicable criteria:
Corporate Credit Rating Methodology

About the company

Sharma & Co. Private Limited (Sharma) is one of the large and established players in the Nepalese construction sector. It was started in the year 1966 (registered as private company in 1980) by Mr. Radha Krishna Sharma, the chairman. His son, Mr. Ramesh Sharma is the current managing director of the company.

The company is involved in the different segments such as buildings, roads, bridges, water supply projects, among others. Sharma mainly deals in the public contracts and it reported an annual consolidated turnover of ~NPR 7.4 billion (provisional) in FY2019 (with standalone turnover of ~NPR 1.5 billion). As on June-end 2020, the company's pending order to be executed was at ~NPR 10.7 billion.

Sharma is a family-owned business wherein Mr. Radha Krishna Sharma, Chairman and the Director hold the largest stake of 29%, followed by 27% held by Mr. Ramesh Sharma, Managing Director of the company. The remaining stake is held be six individuals.

Key Financial Indicators (Consolidated)

Amount in NPR million	Audited		Provisional
	FY2017	FY2018	FY2019
Operating Income	2,820.0	4,873.5	7,406.2
OPBDIT/OI (%)	8.3%	8.6%	7.0%
PAT/OI (%)	5.9%	4.1%	3.4%
Gearing (times)	0.9	0.8	0.9
OPBDITA/Interest (times)	11.9	10.4	11.1
DSCR (times)	2.1	2.0	2.1
NWC/OI (%)	-14%	-16%	-10%
Total Outside Liabilities/TNW (times)	6.1	6.4	6.7
Total Debt/OPBDITA (times)	1.8	1.2	1.3

Annexure-1: Instrument Details

Instrument	Rated Amount (NPR million)	Rating action
Long-term loans; fund-based (Hire Purchase loan/Term loan)	464.03	[ICRANP] LBBB-; assigned
Fund based; short term limits (overdraft/short term loan/contract loan)	615.00	[ICRANP] A3; assigned
Non-fund based; Long-term limits* (LC/Bank guarantees)	6,621.86	[ICRANP] LBBB-; assigned
Fund based; short term limits-within non-fund based (Demand loan/STL/Contract loan)	(110.16)	[ICRANP] A3; assigned
Total	**7,700.89**	

Interchangeable with short-term non-fund-based limits

Analyst Contacts:

Mr. Kishor Prasad Bimali, (Tel No. +977-1-4419910/20)
kishor@icranepal.com

Mr. Sailesh Subedi, (Tel No. +977-1-4419910/20)
sailesh@icranepal.com

Relationship Contacts:

Ms. Barsha Shrestha, (Tel No. +977-1-4419910/20)
barsha@icranepal.com

About ICRA Nepal Limited:

ICRA Nepal Limited, the first Credit Rating Agency of Nepal, is a subsidiary of ICRA Limited (ICRA) of India. It was licensed by the Securities Board of Nepal (SEBON) on October 3, 2012. ICRA Nepal is supported by ICRA Limited through a technical support services agreement, which envisages ICRA helping ICRA Nepal in areas such as rating process and methodologies, analytical software, research, training, technical and analytical skill augmentation.

Our parent company, ICRA Limited, was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies.

For more information, visit www.icranepal.com

ICRA Nepal Limited,
Sunrise Bizz Park, 6th Floor, Dillibazar, Kathmandu, Nepal.
Phone: +977 1 4419910/20
Email: info@icranepal.com
Web: www.icranepal.com

All Rights Reserved.
Contents may be used freely with due acknowledgement to ICRA Nepal.

ICRA Nepal ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. The ICRA Nepal ratings are subject to a process of surveillance which may lead to a revision in ratings. Please visit our website (www.icranepal.com) or contact ICRA Nepal office for the latest information on ICRA Nepal ratings outstanding. All information contained herein has been obtained by ICRA Nepal from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA Nepal in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. All information contained herein must be construed solely as statements of opinion and ICRA Nepal shall not be liable for any losses incurred by users from any use of this publication or its contents