



Rating Methodology for Construction Entities

This rating methodology document explains ICRA NEPAL's approach to analysing business and financial risk for construction sector entities. The objective of the rating methodology is to provide a reference tool and its purpose is to help issuers, investors and other interested market participants understand ICRA NEPAL's approach to analysing the quantitative and qualitative risk characteristics of the construction entities that are likely to affect the rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in the ratings but would enable the reader to understand the rating considerations that are usually the most important. In this document, construction entities are also referred to as 'contractors'.

Overview

The construction sector plays a major role in supporting economic growth and generating employment and occupies a pivotal position in the country's development plans. In Nepal, the sector contributes about 9.81% to the GDP (one of the largest amongst the sectors).

The construction sector can be classified into three main segments - real estate, infrastructure, and industrial construction. Real estate construction includes construction of residential and commercial real estates. Infrastructure construction includes construction of transportation infrastructure (roads, railways, civil aviation, ports), utilities (power, irrigation), urban infrastructure, etc. Industrial construction includes construction of oil and gas refineries, laying of pipelines, setting up of manufacturing plants etc. Infrastructure construction forms the largest segment of the construction sector.

While real estate and industrial projects are predominantly developed by the private sector, infrastructure projects are often funded by the Government. Though there has been an initiative for private sector participation in funding infrastructure projects, they still remain heavily dependent on Government funding. With increased focus on infrastructure investment by the Government, the construction sector has witnessed active interest from lenders, investors and other stakeholders over the years.

ICRA NEPAL's Credit Risk Assessment Framework

This note highlights some of the key factors that are evaluated while assessing the credit quality of a construction entity. For analytical convenience, these factors have been grouped under the following categories:

Credit Risk Categorisation

Industry Risk

- » Fragmented and competitive intensity
- » Cyclicalities

Business Risk

- » Competitive Position
- » Order Book Analysis
- » Adequacy of Resources

¹ Economic Survey 2020/21, Ministry of Finance

Financial Risk

- » Revenue and Profitability
- » Capital Structure and Coverage
- » Working Capital (including Bank Guarantees), Liquidity and Cash Flows

Management Risk

- » Management Quality and Financial Policies
- » Risk Management Practices

Public Private Partnership (PPP) Exposure

- » Project Related and Market Risks
- » Funding Risks

Industry Risk Assessment**Fragmented and competitive intensity**

The construction industry in Nepal is highly fragmented with the presence of a number of players. The sector has more than 100 medium-to-large players and faces competition from some international players in Nepal. Apart from the big players, there are a large number of unorganised small players in the industry. However, due to the bidding criterion their participation is restricted to smaller projects only and many work on a subcontracting basis. To execute more critical projects, often players form a consortium to bid for projects.

The large number of players in the construction sector, often results in intense competition, particularly during a slowing investment cycle. The competition also comes from the sizeable capex which construction companies have to incur, which impact profitability, during a slack period which result in idling of equipment.

Cyclicality

The construction sector exhibits a certain degree of cyclicality, being dependent on the real estate and infrastructure development activities and also on the overall economic growth of the country. Further, the industrial segment depends on the capex undertaken by other industries, which is cyclical and depends on the demand- supply scenario in the underlying industries. The construction sector is also dependent on Government policies as apart from the direct projects awarded by the Government institutions, the approval and clearances are also a must for the smooth functioning of the sector.

Business Risk Assessment**Competitive Position**

The competitive position of a construction entity plays an important role in its ability to secure fresh orders. Entities with large scale of operations, a long-established market presence and track record are better placed to bid for and execute projects as opposed to new entrants. A strong competitive position of the incumbent (in its addressable region and segment) also serves as an entry barrier for others, while also giving the incumbent a higher bargaining power with sub-contractors and suppliers.

ICRA NEPAL evaluates the competitive position of a construction entity on the following key parameters:

- » Scale of operations
- » Client and project profile
- » Track record
- » Bid Capacity
- » Control over projects handled by the joint venture (JV) partner/s

Scale of operations

The scale of a construction entity's operations indicates its relative market strength, operating flexibility, and its ability and expertise to undertake large projects. Moreover, the scale of the entity in terms of revenues and net worth becomes an

important eligibility criterion when larger projects are bid for.

Client and project profile

The composition of clients in the contractor's order book is one of the indicators of its competitive position. The presence of large and financially strong corporate entities, federal/state government bodies, and projects sponsored by multilateral bodies are reflective of a strong client profile and viewed favourably by ICRA NEPAL. The contractor's ability to maintain strong relationships with its clients can also be gauged from the extent of repeat orders, and lack of or limited number of disputes.

ICRA NEPAL also assesses the relative complexity and size of the projects handled, and the demonstrated capability of the contractor in each of the segments it has presence. A construction entity with a successful track record of executing large and complex projects such as bridge, hydropower, hilly highways tunnelling projects etc., is viewed positively as such a track record supports favourable positioning and pricing power of the contractor. In comparison, entities that are involved in jobs such as small irrigation projects and road and building construction, remain prone to intense competition because of the presence of a large number of players in these segments.

As construction activities generally involve liaisons with local residents and Government bodies, understanding of local environment helps in mitigating execution impediments. Many construction entities tie up with local entities or sub-contract labour-intensive work for faster execution. In this regard, ICRA NEPAL assesses the quantum and the type of the work sub-contracted.

Track record

The competitive position of a contractor is assessed from its experience and execution record, which is an important input in the assessment of its ability to efficiently execute its order book. Moreover, the contractor's track record becomes an important bidding criterion and hence its ability to procure fresh projects.

While assessing the track record, ICRA NEPAL's critical focus is on the size and complexity of the projects executed, and the timeliness and quality of construction. If there are any delays in the completed projects, the reasons for the same are studied to ascertain whether those are attributable to the contractor. For assessing the adherence to quality parameters, ICRA NEPAL looks at the instances of liquidated damages or penalties levied by clients in the past and the reason thereof. Feedback from the bankers regarding invocation of the performance guarantees, which the contractor furnishes in favour of its client, also serves as an important input. On the other hand, the earlier-than-scheduled completion of contracts and the consequent receipt of bonus from client, is viewed favourably by ICRA NEPAL. During the rating exercise, ICRA NEPAL's team also visits some of the completed and ongoing projects.

Bid Capacity

Bid capacity is the requirement of Public Procurement Act 2063 (2007)/Public procurement bylaws which determines the bidding capacity (for public projects) of the contractors. 8th amendment to the public procurement bylaws of Nepal has tied up the bidding capacity of the contractor with their revenues and order in hand. This has been done in order to prevent contractors from raking up too many projects compromising their ability to execute those projects within timeline.

The method of calculation of bidding capacity is shown below:

Bid Capacity: $[(7XA)-B]$

A=Average Annual Construction Turnover of the Best Three Years of last ten Year

B= Average Annual value of the existing commitments and works (ongoing) to be completed

For the contractors working exclusively in the public projects, having a higher bid capacity remains favorable from the incremental revenue perspective, compared to the ones with low bidding capacity.

Control over projects handled by the joint venture (JV) partner/s

In-order to fulfill the technical requirement/bidding criteria, it is quiet common in the Nepalese construction industry that the construction players form joint ventures (JVs) for joint bidding. In some complex/International Competitive Bidding (ICB) type of projects, JVs are even formed with international players. However, in practice the execution is generally undertaken by one of the parties. Public procurement regulations/ the agreement with the employer makes each party of JV jointly and severally liable for the project execution. In this context, having a control (by way of project progress, taking over the project in case of substantial delay because of the executing partner etc.) over the project/s being executed by another partner of the JV limits the risk arising because of BG devolvement, blacklisting on account of non-performance. This also limits the potential liability or penalty. Accordingly, having control/track over the projects being handled by the JV partners are considered more favorably from the rating perspective against the one without control or track.

Order Book Analysis

Order book analysis plays a critical role in business risk assessment of a construction entity. ICRA NEPAL undertakes assessment of the following aspects of the order book of a construction entity:

- » Revenue (also referred as Operating Income) visibility
- » Diversification
- » Risk profile of orders

Revenue Visibility

The order book of a construction entity provides insights into its revenues over the short to medium term. For evaluating the revenue visibility of a construction entity, ICRA NEPAL looks at the following key parameters:

- Size of the order book adjusted for slow-moving or stuck orders
- Ratio of the order book to past revenue in comparison with residual execution period of orders
- Estimation of execution schedule for each order
- New order inflows and bid success ratio

The size of the order book and its execution schedule provides inputs into the revenues that a construction entity can generate over the medium term. However, while assessing the size of the order book, adjustment is done for any slow-moving or stuck project, which would likely not be contributing to the revenue in the near term. The adjustment would depend on the expected traction in the order and would typically be exclusion of stuck orders from the order book from the revenue visibility perspective.

The size of the order book is also viewed in relation to both the past execution track record and the current execution schedule. For this, ICRA NEPAL compares the ratio of the entity's order book to the previous year's operating income (referred to as OB/OI ratio) with the weighted-average residual execution time of its order book. A large OB/OI ratio could be the result of an aggressive bidding and can have an adverse impact on the future profitability and result in enhanced execution risks because of the challenges associated with rapid scaling-up. On the other hand, lower ratio could be a result of an entity's inability to perform well in execution of its prior contracts and/or its unfavorable cost structure, or lack of bidding capacity arising from technical/financial shortcomings.

ICRA NEPAL also evaluates the revenue visibility of a construction entity by estimating execution phasing for each order in its order book. The execution schedule for each order is estimated based on its scheduled timeframe, current status of the order, nature of contract, execution challenges, etc.

In addition to the revenue visibility from the existing order book, ICRA NEPAL also evaluates the prospect of new order inflows for the entity. In this regard, ICRA NEPAL relies on its outlook on the new projects in the segments in which the entity has presence. In addition, ICRA NEPAL also looks at the tenders bid for and the orders secured (both in terms of number and contract value) over the past three to four years, to estimate the new order inflows.

The ratio of orders secured to tenders bid for and finalised during a financial year (referred to as '*bid success ratio*') can throw some light on new order inflows. However, the bid success ratio for an issuer needs to be looked at in conjunction with other factors like total tenders bid for and the competitive intensity. A very high bid success ratio generally indicates either low competition, or the contractor's strong competitive position. However, this could also be a result of aggressive bidding by the contractor and is looked at by ICRA Nepal in relation with the bids of other players as well as total tenders bid by the issuer in comparison to its revenues.

Diversification

A diversified order book provides stability to a contractor's revenues because of lower reliance on a specific geographic region, client, segment, or project. This factor is assessed in conjunction with the entity's capability to manage the diversified projects and deliver them in accordance with the cost, time, and quality parameters. ICRA Nepal assesses order book diversification on five key aspects – execution stage, geography, client, segment, and nature of projects.

Execution Stage of Projects

The execution stage of the projects in the order book plays an important role in its assessment. The financial progress on projects is used as proxy for the execution stage of the projects. For classification, the projects are divided into various buckets depending on the work done. An indicative bucket based on work done can be as follows: *Not yet started, between 0-10%, 10-25%, 25-50%, 50-80%, and more than 80% work done*. ICRA NEPAL views the concentration of order book on projects in the first two categories i.e. *not yet started or less than 10% work done* as a relatively challenging situation as the start of the execution of a project is typically prone to delays and cancellation. In case of a delay at the start of the project, the conversion of the order book to revenues will get deferred. Furthermore, such projects can also be relatively more prone to cancellations. Hence, a well distributed order book is looked at more favourably.

Geographical Diversification

Construction entities have to comply with several regulatory, environmental and safety norms. Many of these norms vary from state to state, and hence entities that have a geographical diversity in their operations have lower exposure to regulatory risk pertaining to a particular region. Geographical diversification also reduces the impact of regional economic cycles on the entity and allows it to cope better with delays in projects (and, therefore, cash flows) caused by natural events like floods, droughts and earthquakes in the affected areas. However, over diversification with limited scale of operations could result in the suboptimal utilisation of resources and inadequate management attention.

Segment Diversification

Construction entities operating in diverse construction segments (such as roads, bridges, power plants, oil and gas, railways, and irrigation) have a lower susceptibility to regulatory risks. Further, diversification also reduces the contractor's exposure to demand volatility and competition in any particular segment. However, such diversification is viewed in conjunction with the entity's ability to execute diverse projects and its track record of project execution.

Client Diversification

ICRA NEPAL looks at the diversification of revenues in terms of clients. Although government backed projects are taken more favourably by ICRA Nepal, for private sector having low concentration over a single party is considered more positively compared to a significant reliance over a single party.

Project Diversification

Excess exposure to a few large-sized projects can lead to high project concentration and counterparty credit risk for a construction entity. At the same time, a large number of smaller contracts can increase execution risks significantly as simultaneous execution makes greater demands on management bandwidth and project management systems. ICRA NEPAL, in its analysis, calculates the contribution of the top five projects to the contractor's total order book; higher values (typically more than 65-70%) indicate high project concentration risk for the entity concerned.

Risk Profile of Orders

ICRA NEPAL assesses the risk profile of orders of a construction company to evaluate the impact on its profitability, the working capital cycle, and the counter-party credit risk. There are a large number of players that invite tenders for construction projects, including Federal and state Government entities, as well as private firms and risk profile can vary significantly across these entities. Private sector orders usually have a shorter and less cumbersome bidding process and the easier availability of the project site and other requisite approvals also support a shorter execution period. Public sector orders, on the other hand, provide more stability to revenues as they are relatively less prone to economic cycles. Furthermore, the counterparty credit risk is generally lower in case of public sector orders compared to private sector orders. However, for public sector projects, the source of funding and criticality of the project for the Government becomes an important parameter to assess whether the Government will support the project. Hence, for large projects ICRA NEPAL also looks at the source of funding of projects whether the funding is approved in the Federal/State budget or supported by multilateral organisations as well as the importance of the project, and the payment cycle. A healthy mix of public and private sector projects enables a contractor to have a more stable revenue stream, manage working capital cycle better

and also lower the customer credit risk. ICRA NEPAL also assesses any elongation of the receivable cycle, and ageing analysis of receivables to evaluate any long pending receivable.

An analysis of the larger orders in the contractor's order book is carried out to assess the associated risks including the likelihood of delays in their execution. ICRA NEPAL undertakes the following assessment for key orders:

- Project secured through aggressive bidding
- Execution risks like status of right of way / land, clearances, project funding, etc.
- Complexity of the order
- Provision for raw-material price escalation
- Key contractual terms

For large orders, ICRA NEPAL evaluates the difference between the top two bids (lowest bid or L1, and second lowest bid or L2) for the tender in case of competitive bidding. This helps in assessing any aggressive bidding involved in procurement of order, in which case the profitability could be lower.

ICRA NEPAL also makes the assessment of execution risks related to some larger orders. Some of the factors that can lead to delays in project execution and which are beyond the control of the contractor are unavailability of the site, lack of environmental clearance, absence of other requisite approvals, change in Government policies/regulations, and delay in financial closure (in the case of private sector orders). Difficult terrain and an unpredictable climate also increases the risk of delays if the scheduled construction time does not have room for contingencies. The complexity of the order is another important factor that can result in delays. In case the contract does not adequately cover the construction entity for cost overruns and idling charges, its profitability can be severely impacted by delays. Moreover, these delays lead to the deferment of cash flows for the contractor, thereby having an adverse impact on its debt-servicing capability and also curtailing its bid capacity by the extent of the value of the delayed projects.

Construction contracts are often priced assuming a certain level of input (raw material) prices. Thus, any steep increase in raw material prices during project execution can push up the project cost significantly beyond the initial estimates. Moreover, delays in land acquisition or regulatory approvals may extend the construction period, thereby exposing the entity concerned to possible escalations in commodity prices. An entity that has entered into a fixed-price contract has to absorb this increase in prices, which in turn would drive down its profit margins. In the case of contracts having a cost escalation clause, ICRA NEPAL also reviews the specific terms to assess the adequacy of the escalations allowed under the contract to cover for the actual cost increase for the contractor. For instance, some contracts allow escalations in input prices in line with the inflation rate (Wholesale Price Index, or WPI). In case the actual increase is much higher than this rate, it would expose the contractor to input price risk, notwithstanding the presence of a cost escalation clause in the contract. The other important contractual terms examined include penalty clauses, obligations and responsibilities of the client and the contractor, the terms of payment and flexibility in the extension of the project's time schedule if the delay is not attributable to the contractor.

Adequacy of Resources

ICRA NEPAL, in its analysis, takes into account the adequacy of the various resources of the entity concerned, viz. manpower, management bandwidth, project management systems, machinery and equipment, tie-ups with subcontracting firms, financial resources and financial tie-ups, to assess its ability to successfully execute the order book. Assessment of the contractor's execution capability is important as any delays in project execution can significantly impact its profitability and cash flows. Moreover, delays can affect the entity's market position, thereby impacting its ability to obtain orders, both fresh and repeat.

Attracting and retaining skilled manpower is also one of the key challenges for contractors, as is the training of human resources, given the increasing complexity of projects. Apart from possessing skilled manpower, having good relationship with labour contractors and being in compliance with the local labour laws are necessary for uninterrupted operations. These factors apart, ICRA NEPAL also looks at the experience profile of the key executives of the entity concerned.

In addition to adequate manpower, appropriate mechanisation of operations including adequate machinery and equipment base is required to optimise construction time and achieve the desired quality levels. In this regard, ICRA NEPAL looks at the issuer's Operating Income to Gross Block ratio (OI/GB ratio) and compares it with its peers. While it is assumed that the Gross Block of a construction entity would be primarily equipment, in case of other assets, an adjustment is made to reflect only the equipment-related Gross Block. In case of a major deviation in OI/GB with peers, the reasons for the same are evaluated. A lower OI/GB ratio generally indicates underutilisation of equipment or more reliance on self-owned equipment, whereas a higher OI/GB ratio could be because of higher dependence on leased equipment. However, the

OI/GB is looked at in conjunction with other factors like the recent addition of equipment, proximity of multiple project sites to each other and so on.

Since a contractor may be executing several projects in different geographies at any point in time, implementation of effective project monitoring systems is necessary to enable the top management to continuously monitor the progress of the projects and also make the right intervention as and when required. In addition, the entity's ability to raise funds via either equity or debt and tie up adequate non-fund-based limits is critical for it to be able to meet its capital expenditure and working capital requirements.

Financial Risk Assessment

The financial risk analysis is concerned with assessing the ability of an entity to generate sufficient cash flows to meet its debt servicing obligations and is influenced by the degree of financial leverage. As a starting point, ICRA NEPAL takes into account an entity's reported financials to get a glimpse of its financial risks. However, financial risk analysis is not undertaken by ICRA NEPAL solely on the basis of a given year's performance results as it may result in a point-in-time analysis bias, because of reasons such as recent capital expenditure, recent equity infusion or fund-raising for expansion, or the stage of the business cycle. ICRA NEPAL analyses long-period past performance trends and makes estimates of future financial performance to assess the financial risk exposure of an entity. Moreover, ICRA NEPAL recognises the potential pitfalls of relying on financial risk analysis, solely based on accounting numbers as these may not adequately reflect the intrinsic or market value of a business. Yet, accounting ratios do offer a useful reference to evaluate the performance trends of an entity over a given time period as well as to compare an entity's financial performance metrics with that of its peers.

Since the prime objective of a rating exercise is to assess the adequacy of the issuer's debt-servicing capability, ICRA NEPAL draws up projections on the likely financial position of the entity under various scenarios. Future cash flows are projected after taking into account the entity's current order book position and the likely conversion of the same into earnings; bids in the pipeline and the growth it envisages for itself; the margin money required for additional bank guarantees; capital expenditure plans, its funding requirements; the debt repayment schedule; and the funding options available to it. Besides, ICRA NEPAL takes into account the commitments of the entity towards other group entities and new ventures, and its investments in subsidiaries/SPVs. These cash flows are then used to determine the entity's future debt-servicing capability under various scenarios.

The various financial metrics assessed by ICRA NEPAL could be divided into three categories viz., Revenue and Profitability, Capital Structure and Coverage, and Working Capital, Liquidity and Cash Flows. Besides, there are a few additional elements of financial risk like accounting policy, off-balance sheet exposure, and financial flexibility which are also assessed by ICRA NEPAL. This document provides a brief summary of why ICRA NEPAL considers these metrics to be important. For a more detailed description, readers may refer to the note titled - Approach for Financial Ratio Analysis published on ICRA NEPAL's website.

Revenue and Profitability

ICRA NEPAL analyses growth in revenues (also referred as operating income) over a period of multiple years and makes a comparison with that of the other entities operating in the same segment. However, growth in revenues is looked at in conjunction with profitability. A contractor's ability to achieve higher growth in revenues without compromising on profitability is generally a reflection of its strong execution capabilities.

The trends in operating profit margin and return on capital employed¹² are also analysed and compared with peers. The complexity of the jobs done, the presence of escalation clauses, and the extent of sub-contracting are some of the main factors that determine the profitability of construction entities. The ability to complete projects before time can also make the entity eligible for a bonus from the client and enhance profitability. An entity with higher profit margins and returns on capital has a greater ability to generate internal accruals, attract external capital and withstand business adversity.

Capital Structure and Debt Coverage

² Return on Capital Employed (RoCE) = Profit before Interest & Tax / (average Total Debt + average Tangible Net Worth)

For capital structure and leverage, ICRA NEPAL looks at the total outside liabilities to the net worth ratio (TOL/TNW ratio), and the total debt to operating profit ratio (TD/OPBIDTA ratio) of construction entities and compares it with that of its peers to determine its relative leverage position. For construction companies, a sizeable liability is in the form of mobilisation advances from clients, hence the TOL/TNW ratio gives a holistic view of the leverage. Conservative leverage ratios are viewed favourably as the same involves lower committed debt servicing outflows i.e. interest and principal repayment.

Entities with higher profitability and lower leverage will generally have better coverage ratios and thereby healthier financial risk profiles. The debt coverage indicators that are examined include Interest Coverage Ratio, ratio of Net Cash Accruals to Total Debt and Debt Service Coverage Ratio (DSCR). Further, the profile of debt in terms of maturity and average cost is also analysed. High leverage also exposes an entity to interest rate risks.

Adjustments in case of PPP projects: If a construction entity has made an investment in PPP projects, additional adjustments to its debt and net worth need to be made. If the project is being developed in a special purpose vehicle (SPV) with the debt availed by the SPV having no recourse on the construction entity, ICRA NEPAL will generally not consolidate the debt of the SPV with the construction entity for financial analysis. If the project is being developed in the construction entity itself or the debt for the project has recourse on the construction entity, ICRA NEPAL will generally take a view on the consolidated financials of the entity along with the SPV.

Working Capital, Liquidity and Cash Flows

ICRA NEPAL's evaluation of the financial position of a construction entity also involves a detailed assessment of its working capital management, with the emphasis being more on its cash flow generation ability. Some of the factors that impact the contractor's working capital requirements include its inventory and receivables management policies, project monitoring systems, billing frequency (milestone-based or time-based), payment terms (with clients), retention money involved, and bargaining power (with suppliers and sub-contractors). Other than these, adherence to quality and time stipulations, which are linked to the contractor's execution capability, also facilitate faster release of payments from clients. Some contracts have the provision of mobilisation advances (generally 10 to 15% of the total project value) by the clients concerned, which reduce the contractor's working capital requirements. However, these can have a bearing on the entity's financial profile, depending on whether these mobilisation advances are interest-bearing or not (are generally interest free). High dependence on interest-bearing mobilisation advances could also be an indicator of the contractor's limited financial flexibility.

ICRA NEPAL looks at the trend in working capital movement and compares various working capital ratios of the entity with those of its peers. Any significant deviation in the ratios like debtor days and inventory days gives an indication of a possible dispute with a client with regard to certification of work executed, recognition of revenue, and/or release of payments. Any build-up in receivables, or inventory can be a sign of weak client or slow-moving/stalled project and needs to be explored in-depth. Further, ICRA NEPAL also looks at the proportion of unbilled revenues in the balance sheet and its movement over the years.

Apart from the fund-based working capital, construction entities also require sizeable non-fund-based limits mainly bank guarantees (BG). BGs are required typically towards bid security (given at the time of bidding), performance security (given after contract is awarded), Advance Payment Guarantee (given against mobilization advances) and against the release of retention money during the defect liability period (post completion of the project). For construction entities with long execution cycle and defect liability period, the BG requirement keeps on adding over time. ICRA NEPAL assesses the availability of sufficient non-fund based bank lines as a key credit factor as in the absence of the same, the company will not be able to take up new projects. This can also have an adverse impact on the company's ability to efficiently execute the ongoing contract since during the execution phase, the company would require the BG to avail mobilisation advance and release retention money. Further, as non-fund based limits also require margin (typically in the form of Fixed Deposits, and/or collateral assets), availability of surplus liquidity/unencumbered assets provides a cushion to enhance non-fund based bank lines, if required.

ICRA NEPAL lays emphasis on analysis of the cash flows of the entity analysed here are the trends in the contractor's Funds Flow from Operations (FFO) after adjusting for working capital changes, the Retained Cash Flows and the Free Cash Flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis also helps in understanding the external funding requirement that a construction entity has to meet its maturing obligations.

Other Elements of Credit Risk Assessment

Accounting quality

The financial analysis begins with a review of the contractor's accounting quality. Here, the Accounting Policies, Notes to Accounts and Auditors' Comments that are part of the Annual Report are reviewed. Accounting practises such as the income recognition method (percentage of completion versus completed contracts method), depreciation policy and treatment of contingent liabilities, are reviewed and compared with the industry practises. The financial statements of the entity are adjusted to reflect the impact of such deviations.

The construction entity's policies on the recognition of disputed revenues and disclosure of contingent liabilities are also examined while assessing its accounting quality. When projects get delayed, claims for idling of resources and cost overruns are submitted by the contractor and in some cases counter-claims are lodged by clients. Such disputes usually take a long time to get resolved. A construction entity that recognises such claims as revenues without the final settlement is viewed negatively by ICRA NEPAL. However, if there are counter-claims, adequate provisioning and inclusion in contingent liabilities, these are considered more prudent.

Risks associated with contingent liabilities including Bank Guarantees:

Typically, a contractor has to provide multiple bank guarantees for bid security and performance guarantee. These bank guarantees form a sizeable part of the contractor's contingent liabilities. ICRA NEPAL, in its analysis, assesses the risk of BG invocation and the pressure that the invocation would exert on the entity's cash flows and liquidity position. The BG invocation risk is assessed looking at the past track record of the contractor, as well as the execution status of the project (whether running with delay), availability of extension period and current status of project (how has been the incremental progress on the project in the recent past). In case of concentration of the bank guarantees on few projects, the performance of those projects becomes important. ICRA NEPAL compares the amount of BG at risk with the liquidity position of the company and the company's ability to withstand if these BGs get invoked.

In case there are any other contingent liabilities like corporate guarantees and cases in disputes, the impact of the same on the contractor's credit profile is also assessed.

Asset-Liability Mismatches (ALM), Liquidity and financial flexibility:

The construction industry remains highly dependent on the banking system to meet its working capital requirements. As part of the contractual terms, a part of the billed amount is retained by the client (retention money) and is often not considered while calculating its drawing power. While in some cases, there is an alternative to get the retention money released against Bank Guarantees (BG), the availability of adequate BG limits could act as a constraint in realising this. Further, in some cases clients require security deposits from the contractor which also gets blocked for the duration of project execution. On the other side, construction companies generally have limited access to long-term funds. Due to these factors, these companies often face asset liability mismatch with higher long-term assets compared to the long-term liabilities.

ICRA NEPAL assesses the management's approach and track record of maintaining sufficient liquidity and company's financial flexibility to access longer tenure funding to absorb any reasonable stress on cash flows. Liquidity ratios measure the buffer, which an entity has in the form of cash or cash equivalents with respect to its obligations that can be utilised in case of any temporary cash flow mismatch. As the construction companies have high BG exposure, and invocation of a BG would result in immediate fund requirement, financial flexibility to meet short-term obligations are assessed. An entity's financial flexibility is assessed by its un-utilised bank/ credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries. Financial flexibility could also depend on other factors such as the entity's large-scale operations with strong financials, unencumbered assets/ flexibility to borrow against existing assets, or its strong parentage or linkages with a strong group.

Parentage / Group Support

Apart from standalone credit considerations, the likelihood of extraordinary support coming in from the parent to an entity or the support that an entity is likely to extend to the other Group companies is factored while assessing the credit profile of the entity. This process involves an assessment of the ability and willingness of the parent to extend support to the entity (and vice versa), in addition to evaluating the entity's own fundamental credit strength.

Management Risk Assessment

In addition to the business and financial risk analysis, ICRA NEPAL also undertakes an assessment of the rated entity's management, the financial policies and the risk management practises.

Management Quality and Financial Policies

As a part of its process, ICRA NEPAL undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies and the outlook on the industry. Some of the points assessed are:

- » Experience of the promoter/ management in the industry
- » Commitment of the promoter/ management to the rated entity
- » Organisation structure and level of delegation of responsibility
- » Risk appetite of the promoter/ management on taking up new projects, acquisitions and expansions
- » Policies on leveraging, managing interest rate risks and currency risks
- » Ownership pattern and presence of independent directors on board
- » Corporate governance practises and related party transactions

Periodic interaction also helps in ascertaining their tendency to deviate from stated philosophies and policies during times of stress. ICRA NEPAL also interacts with external auditors to understand their view on the entity's policies and corporate governance.

Risk Management Policies

Construction entities are prone to cost-overrun risks and hence special emphasis is laid on their operating efficiency and risk management policies. The two key parameters assessed for risk management policies related to operations of a construction entity are:

- » Bidding Policy - Trade-off between growth and profitability
- » Sub-contracting Policy – Extent of work sub-contracted, selection/management of sub-contractor

The risk management policies adopted by an entity are an important input for rating. Construction entities with formalised policies and procedures — mandatory bid evaluation by a bid assessment committee, third-party project appraisal, and consistent bidding policies, among others — are viewed favourably by ICRA NEPAL. The project- monitoring systems implemented by an entity, the policies put in place to mitigate credit risk and other control mechanisms instituted for functions like management of supplier and/or subcontractor relationships and review of their execution strength, are also assessed.

Summing Up

ICRA NEPAL's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the rated entity's industry, business and financial risks, its likely cash flows and the adequacy of such cash flows vis-à-vis the debt-servicing obligations and other funding requirements. ICRA NEPAL's rating approach also involves making an assessment of the entity's management quality and governance practises. In addition to these considerations, an entity's credit rating may also be influenced by its ownership, the nature of linkages with its parent or group entities, degree of financial flexibility, the corporate legal structure, track record of operations and that of debt servicing, and vulnerability (if any) to discrete event risks.

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