Aadarsh Construction: [ICRANP] LBB-/A4 assigned

March 18, 2024

Summary of rating action

Instruments (Amounts in NPR million)	Rated Amount	Rating action
Long-term, fund-based loan limits	19.30	[ICRANP] LBB-; assigned
Short-term, fund-based loan limits	495.78	[ICRANP] A4; assigned
Short-term, non-fund-based loan limits		
Total	**515.08**	

Rating action

ICRA Nepal has assigned a long-term rating of **[ICRANP] LBB-** (pronounced ICRA NP L Double B minus) to the long-term loan limits of Aadarsh Construction (Aadarsh), and a short-term rating of **[ICRANP] A4** (pronounced ICRA NP A four) to the firm's short-term loan limits.

Rationale

The assigned ratings factor in the firm's healthy revenue CAGR of ~69% over the last four years ending mid-July 2023 (albeit on a low base), along with steady improvement in operating profit margins (OPM). The ratings also derive comfort from the firm's satisfactory capitalisation structure, characterised by total outside liabilities to tangible net worth (TOL/TNW) of 2.1 times and total debt to OPBITDA of 2.9 times, with moderate coverage indicators debt-service coverage ratio (DSCR) of 2.2 times for FY2023. The ratings also factor in the low counterparty default risk as the firm's entire projects-on-hand relate to the bodies and agencies of the Government of Nepal (GoN).

Nonetheless, the ratings remain constrained by Aadarsh's relatively small scale of operations despite its long operational track record and heavy reliance on the GoN's capital expenditure, which has witnessed recent slowdowns. While the long-term outlook for the construction sector is expected to remain positive, given the infrastructural gaps in the country, the firm is likely to face medium-term challenges due to its low pending order book status as of end-February 2024 at ~1.0 time of FY2023 revenues. Rating concerns also arise from the limited sectoral diversification with ~61% of the pending work relating towards the road segment. The ratings are also impacted by Aadarsh's stretched liquidity profile with modest working capital intensity (net working capital to operating income ratio, NWC/OI of ~21% as of mid-July 2023). Further, the frequent policy changes create uncertainty in regulatory environment surrounding the construction sector. Going forward, the firm's ability to adequately scale up its operations, while ensuring adequate margins, will remain a key monitorable.

Key rating drivers

Credit strengths

Healthy revenue growth, albeit on a low base, along with steady improvement in OPM – Aadarsh's operating income reported a healthy CAGR of ~69% in the past four years (albeit on a low base) ending on mid-July 2023. This has also led to consistent improvement in OPM (~8% in FY2023 against ~4-6% in earlier years), albeit remaining lower among similar sector peers.

Satisfactory capitalisation and coverage metrics – The firm's capitalisation remains satisfactory, characterised by gearing levels of 1.9 times, TOL/TNW of 2.1 times and TD/OPBITDA of 2.9 times for FY2023. The controlled debt burden so far has supported its DSCR at 2.2 times in FY2023. However, the firm's ability to report similar indicators, amid the proposed debt-funded capex plans, remains to be seen.

Credit challenges

Small scale of operations – Aadarsh has been in operation for around fifteen years and was initially engaged in small-scale projects with the major spike in scalability seen in last two years. Despite the same, the firm has a relatively lower scale, which also limits its bidding capacity for large projects and, thus, necessitates joint ventures (JVs). Its small scale, across revenue and reserves, also makes the firm less resilient towards any incremental business/liquidity shock.

Liquidity risk – The firm reported a relatively modest working capital intensity of ~21% for FY2023 amid sustained spike in inventory and debtors, thus leading to modest cash flow indicators. Though the spiked inventory mostly related to unbilled work-in-process and the piled-up receivables were mainly due to the delays in certification and verification by the employer, this has increased Aadarsh's dependence on bank finance for its working capital requirements.

Low pending order book, with sectoral concentration – Aadarsh largely deals in small-to-medium scale road, building and bridge projects, which generally have a short execution timeline. As its pending order book as of end-February 2024 was ~1 times of FY2023's revenues, its ability to constantly secure new projects could remain crucial. Further, most of its projects are from the road segment, thereby leading to sectoral concentration risks. Any change in the dynamics of the segment could affect Aadarsh's financial and operational profiles. Moreover, some of the projects are running behind their schedule, exposing the firm to project execution risks. Additionally, its legal registration as a proprietorship firm could also remain a competitive disadvantage in certain tenders (which require company as one of the eligibility criteria).

Intense competition and slowdown in Government capex – There is a stiff competition in the construction sector of Nepal, given the presence of a large number of players. Moreover, the bidding requirement for public projects (entire portfolio for Aadarsh as of now) creates uncertainty over the firm's future revenue inflow. The capital spending pattern of the GoN has also slowed down in the recent years. This, coupled with the procedural bottlenecks, site clearance issues, etc, could significantly impact the project execution ability and revenue profile of contractors like Aadarsh.

Exposed to regulatory risks – As Aadarsh is concentrated in the public construction sector, it remains exposed to the risk of regulatory changes, mainly in the Public Procurement Act and the related regulations. This risk further increases, considering the frequent regulatory changes brought in by the amendments. Any future amendments imposing stricter provisions for timely completion and/or provisions of liquidated damages, could have a material impact on players like Aadarsh. Rating concerns also emanate from the industry-wide practice of underbidding in majority of the projects, which could affect the firm's profitability and its ability to deliver projects within estimated time/cost.

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

Links to the applicable criteria:

[Corporate Credit Rating Methodology]

[Rating Methodology for Construction Entities]

About the firm

Aadarsh Construction was established in 2008 under the sole proprietorship of Mr. Shiva Shankar Yadav. The firm deals in civil construction works, primarily related to residential and commercial buildings, bridges, road projects, etc., mainly in the public sector, mostly through subcontracting. The firm reported annual turnover of ~NPR 228 million in FY2023 and had pending order book of ~NPR 230 million as of end-February 2024.

Key Financial Indicators (Standalone)

	Audited			Provisional
	FY2020	FY2021	FY2022	FY2023
Operating Income-OI (Gross revenues in NPR million)	71	95	216	228
OPBDITA/OI (%)	3%	4%	6%	8%
Total Debt/ Tangible Net Worth (TNW; times)	0.4	0.8	1.8	1.9
Total Outside Liabilities/TNW (times)	1.6	1.8	2.1	2.1

	Audited			Provisional
	FY2020	FY2021	FY2022	FY2023
Total Debt/OPBDITA (times)	1.2	1.5	3.0	2.9
OPBDITA/Interest (Interest coverage; times)	5.4	11.7	3.6	3.1
DSCR (times)	5.1	10.1	2.6	2.2
Net Working Capital/OI (%)	-3%	0%	22%	21%
Current Ratio	1.6	1.0	1.3	1.4

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About ICRA Nepal Limited:

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For more information, visit www.icranepal.com

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