

Rating criteria for the construction industry

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Executive summary

The construction industry is one of the important sectors in India as it supports a large number of upstream and downstream industries. Moreover, it has strong linkages with the overall economy and enjoys a large economic multiplier effect.

The Indian construction industry can be classified into three broad sub-groups:

Category	List of construction activities
Residential and commercial/industrial	Residential and commercial buildings and complexes such as houses, offices, hospitals, restaurants, shops and shopping complexes.
Infrastructure	Roads, ports, bridges, flyovers, dams, power plants, telecommunication (telecom) facilities, and oil and gas plants, refineries.
Urban infrastructure	Municipal roads, water supply, sewerage and drainage, sanitation, and solid-waste management systems.

A very large number of players of various sizes and competencies operate in this industry. But other than a few large and medium-sized companies, the majority are small contractors, whose activities are restricted to constructing residential and commercial units.

Scope

CRISIL's extensive experience in the credit evaluation of construction companies has led to the evolution of a specific rating methodology for them. Though the broader criteria of manufacturing companies¹ applies, this article² gives a brief insight into industry-specific risk factors, which impact the operations and financial flexibility of players in the sector

Business Risk

Market position

Area of expertise and business potential therein

Construction companies, which have expertise, or are active, in sectors of the industry where higher activity levels are anticipated, benefit from significantly better business prospects than their counterparts whose area of expertise has a relatively lower growth expectation. It is CRISIL's view, as indeed that of most observers of the Indian economy, that the country's physical infrastructure needs significant improvement. This includes roads, ports, energy, and

¹ The detailed criteria is on the CRISIL website under the "Criteria and Methodology" section – Rating Criteria for Manufacturing and services sector companies and "CRISIL's approach to financial ratios"

² For accessing previous published document on "Rating Criteria for construction Industry", Kindly follow below mentioned link:

https://www.crisil.com/content/dam/crisil/criteria_methodology/industrials/archive/Construction-Industry.pdf

housing, with each sector carrying a demand potential that would call for an expenditure of several billion rupees. The timing and extent of activity in each sector would, however, depend on the interplay of numerous factors.

Using its knowledge and understanding of the economic environment, CRISIL continually attempts to identify segments of the construction industry that are likely to witness more activity than others. This view is coupled with the area of expertise of individual construction companies to arrive at their demand potential.

Diversity and dispersion of project portfolio

CRISIL views construction companies that have a diversified project portfolio, both across sectors and geographies of implementation, more favourably than those that tend to have a more concentrated portfolio. Also, other things remaining equal, a company with a large number of small projects would be viewed more favourably from a credit perspective than one whose portfolio includes a small number of large projects. Such diversity and dispersion enables the company to better withstand unforeseen adverse developments in any project that is being implemented. However, the factors of domain expertise, tendency of the industry to be local to the environment of implementation, and the as yet nascent level of construction activity in the Indian market place are limitations on the extent of portfolio diversity achievable.

Operating efficiency

Track record and implementation expertise

Construction companies that have a strong track record of project implementation to the required quality standards and without cost or time overrun enjoy a strong position with respect to winning future business in their areas of expertise. That's because most construction projects are awarded on a tender basis, where experience in the sector is a prerequisite for bidding. Prior experience also enhances execution skills. This is also the driver for construction companies tending to operate in their respective areas of expertise. Some large players, however, have been able to establish project management expertise spanning a much wider range of technical skills.

Cost structure and operating philosophy

The cost structure is an important element determining operating efficiency. A high fixed cost structure will make it unviable to quote aggressively for projects and impact the success ratio. An aggressive quote may not cover costs. Therefore, several companies operate extensively through sub-contractors to increase the variable element of their cost structures. Thus, having an optimum cost structure is critical for the long term viability of a construction company. While analysing operating efficiency, CRISIL considers the operating philosophy, cost structure, past track record in tenders, and reasons for losing tenders.

Knowledge of and comfort with the local environment

Construction companies that are more aware about the environment in which they operate are significantly better equipped to handle uncertainties and surprises that are a potential part of all construction projects. With increasing globalisation, most business activities have tended to span national and regional boundaries. However, this process has been particularly slow in the construction industry, which has retained its predominantly local character in most markets. This is likely to continue over the medium term, given the continuing importance of the awareness of nuances and detail about the local environment for the success of project implementation. Consequently, all other things remaining equal, a player that is local to the environment in which the project is being implemented would tend to score over other players.

Working Capital Management

Construction companies have significant amount of funds tied up in working capital. Thus their ability to manage the working capital is a critical parameter in evaluating the operating efficiency and overall assessment. CRISIL evaluates the working capital management of construction companies through analyzing Gross Current Assets Days (GCA Days) and debtor days.

Financial Risk

CRISIL's analysis of financial risk for construction companies is broadly in line with the criteria adopted for other manufacturing companies. This is articulated in detail in the CRISIL publications 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios'. Given the unique nature of construction companies, the following elements are centrally included in the analysis for them.

Accounting quality

Construction companies that follow a consistent, transparent, and conservative policy on financial accounting tend to be viewed more favourably than those that do not. As construction companies can and do adopt varying accounting policies for income and profit recognition, analysis of accounting policies is a very critical first step in their financial risk analysis.

The accounting standards issued by The Institute of Chartered Accountants of India allows booking of turnover and profits on a percentage completion basis. Construction companies have followed diverse policies with respect to income recognition. CRISIL distinguishes between an aggressive, optimum, and conservative income recognition policy to arrive at an appropriate level of work executed and cash accrual. The analysis focuses on project-wise activity on a year-to-year basis in order to determine the effective business level.

Cash flow and liquidity analysis

Revenue and cash flow could be lumpy given the nature of business. Additionally, there could be a sharp distinction between cash flow and accrued income. Therefore, conventional techniques of ratio analysis are often not sufficient to ascertain the credit worthiness of a construction company. CRISIL tends to focus on a cash-based analysis of revenue, expenses, and other financial indicators. Assessment of the working capital cycle and cushion available in the bank limit carry significant weightage. Construction companies that have stronger liquidity and more predictable project cash flow are viewed more favourably from a credit perspective. Predictability of cash flow is often supported by project, geographic, and customer diversification and hence companies with diversified revenue streams may be viewed more favourably than those with concentrated revenue streams.

Management Risk

CRISIL follows the standard criteria used for all manufacturing companies for assessment of management risk. This is presented in detail in the CRISIL publication, 'Rating Criteria for Manufacturing and Services sector Companies'.

Conclusion

CRISIL's analysis of construction companies is unique from that of a typical manufacturing company. This approach leverages on CRISIL's in-depth understanding of this sector and its specific nuances. The key success factors for the construction sector include:

- Expertise in high-growth segments
- Diversified and dispersed project portfolio
- Strong track record of project implementation
- Optimum cost structure with adequate knowledge of local environment
- Strong cash flow generation capability

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