Rating Criteria for Construction Industry

The construction industry is one of the important sectors in India today. The industry's importance can be gauged from the fact that it supports a large number of upstream and downstream industries. Moreover, the industry 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 as under:

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 etc.
Infrastructure	Roads, ports, bridges, flyovers, dams, power plants, telecom facilities, oil and gas plants, refineries.
Urban Infrastructure	Municipal roads, water supply, sewerage and drainage, sanitation, solid waste management systems etc.

As would be expected of an industry of this size and diversity, 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, a majority of these players are small contractors, whose activities are restricted to constructing residential and commercial units.

CRISIL's extensive experience in the credit evaluation of construction companies has led to the evolution of a specific rating methodology for companies in this industry. A discussion of the specific parameters used in the methodology follows.

BUSINESS RISK ANALYSIS

Market position

Area of expertise and business potential therein

Construction companies, which have expertise in or are active in sectors of the construction 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 areas of construction activity like roads, ports, energy and housing, with each sector carrying a demand potential that would call for an expenditure of several billion rupees each. 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 the demand potential for those companies.

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 companies that tend to have a more concentrated portfolio. In a similar vein, other things remaining equal, a construction company with a large number of small projects would be viewed more favourably from a credit perspective than a company 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. It may be noted, however, that 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 a limitation 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, in CRISIL's opinion, a strong position with respect to winning future business in their areas of expertise. The track record's importance arises from the fact that most construction projects are awarded on a tender basis, where experience in the sector is a pre-requisite for bidding. Moreover, this prior experience also enhances the company's execution skills. This fact 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 much wider range of technical skills.

Cost Structure and Operating Philosophy

Construction companies' cost structure is also an important element determining its operating efficiencies. A high fixed cost structure will make it unviable for the company from quoting aggressively for projects and impact success ratio. Similarly, if such companies quote aggressively, then they may not be able to cover their 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 analyzing the operating efficiency of a company, CRISIL will assess the company's operating philosophy, its cost structure, past track record in tenders, reasons for losing tenders etc.

Knowledge of and comfort with the local environment

Construction companies that are more knowledgeable 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. In CRISIL's view, this is likely to continue over the short to medium term, given the continuing importance of the awareness of nuances and detail about the local environment as an ingredient of successful project implementation in the construction industry. Consequently, all other things remaining equal, a player local to the environment n which the project is being implemented would tend to score over other players.

FINANCIAL RISK ANALYSIS

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

Accounting quality

Construction companies that follow a consistent, transparent and conservative policy on financial accounting tend to be viewed more favourably in CRISIL's credit analysis than those that do not. Since 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 the financial risk analysis of such companies.

The accounting standard issued by The Institute of Chartered Accountants of India (ICAI) 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 accruals generated by a company. The analysis focuses on project-wise activity on a year-to- year basis in order to determine the company's effective business level.

Cash flow and liquidity analysis

Construction companies revenue and cash flow profile could be lumpy given the nature of business they undertake. Additionally, there could be a sharp distinction between cash flows and accrued income. Therefore, conventional techniques of ratio analysis are often not sufficient to ascertain the credit worthiness of a construction company. CRISIL's analysis of construction companies tends to be more focused on a cash based analysis of revenues, expenses and other financial indicators. Construction companies that have a stronger liquidity position and a more predictable project cash flows are viewed more favourably from a credit perspective. Predictability of cash flows is often supported by project, geographic and customer diversification and hence companies with diversified revenue streams may be viewed more favourably compared to companies with concentrated revenue streams.

CONCLUSION

CRISIL's analysis of construction companies is unique from that of a typical manufacturing company. This unique approach leverages on CRISIL's in-depth understanding of this sector and its specific nuances. In CRISIL's opinion, 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, and
- Strong cash flow generation capabilities