

Driving past potholes

May 2017



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Host of factors help road EPC companies turn things around

The hybrid annuity model (HAM) and engineering, procurement and construction (EPC) model of road construction are gaining currency, replacing the older build-operate-transfer (BOT) route.

CRISIL analysis found that, in the past three years, over 80% of highway projects in the country have been bid out under non-BOT channels. While EPC contracts ruled the roost until fiscal 2016 (72%), it is estimated that 56% of highway projects were bid under HAM in 2016-17.

The benefits of these models, especially the lowering of implementation risks on account of substantial pre-acquisition of land, and no traffic risk, have translated into higher growth for companies in the sector.

Revenues of 50 EPC companies rated in the investment-grade by CRISIL grew at a compound annual growth rate (CAGR) of 20% through three years ending March 2017 – a trend that is expected to sustain in the medium term on copious orders. Not just that, profitability and credit profile projections of these companies, too, look optimistic.

Background

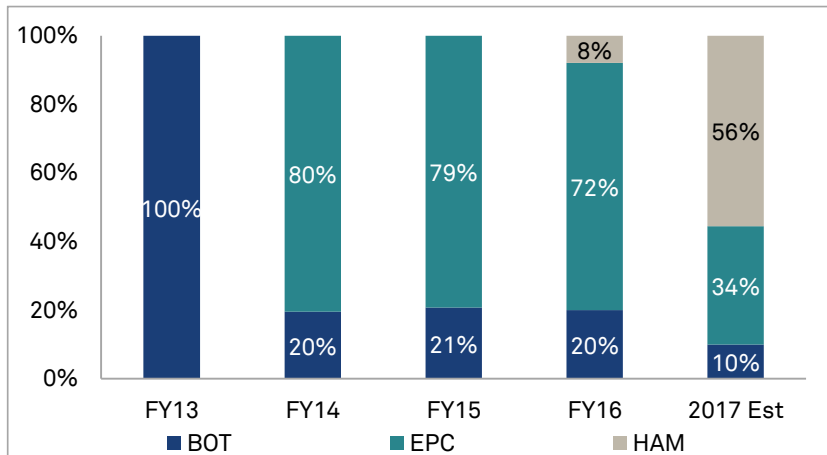
The infrastructure sector is plagued by balance sheet distress, reflected in mounting debt and deteriorating debt-servicing metrics. Aggressive bidding, leverage, and a slowing economy had affected the credit profiles of companies in the sector in the past few years. However, there has been a visible turnaround in the performance of EPC companies in the road sector, primarily backed by healthy order book growth and their established execution capabilities.

CRISIL Ratings analysed 50 road EPC companies it has rated in the investment grade (80% of these have revenue below Rs 1,000 crore). Not surprisingly, increased government spend in infrastructure projects has begun to tell, as reflected by the credit ratio (ratio of upgrades to downgrades) which improved from 0.11 in fiscal 2014 to 2.0 in 2017, and revealed the following trends.

Shift from BOT to EPC

Over the recent years, the Ministry of Road Transport and Highways (MoRTH) and the National Highways Authority of India (NHAI) have increasingly bid out projects through the HAM or the pure EPC model. In each of the past three years, over 80% of the highway projects went to bidders under these models. Not surprisingly, 50 EPC companies rated in the investment-grade by CRISIL have benefited from the trend, their revenue growing at a compounded annual growth rate (CAGR) of 20% in this period.

NHAI project awards: From BOT to EPC to HAM

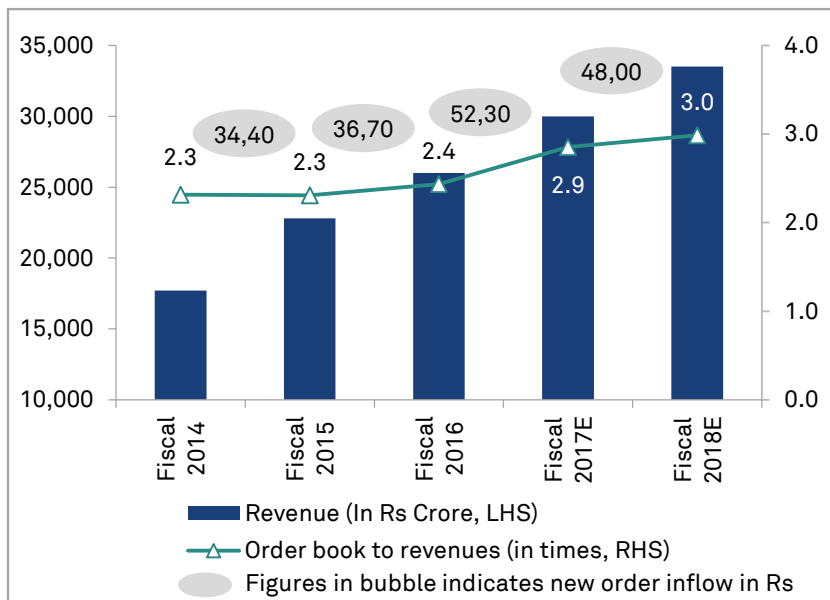


CRISIL estimates and NHAI

Order book swells, strong revenue visibility to continue

The 20% CAGR growth was fueled by the surge in the order book position of these companies; with pending orders growing two-fold from Rs 41,000 crore in fiscal 2014, to Rs 85,600 crore in 2017. These companies, put together, are likely to see order inflow of ~Rs 48,000 crore this fiscal.

Revenue and order-book profile of select EPC companies



CRISIL estimates and company reports

The combined order book of the 50 companies is likely to touch Rs 1 lakh crore this fiscal, driven by increased government spend in the road sector. The budgetary allocation for highways rose by 11% to Rs 64,000 crore for the current fiscal. This, in turn, is expected to keep the orders flowing in for road EPC companies over the medium term, sustaining revenue growth momentum.

Besides healthy order inflow, CRISIL Ratings estimate an increase in unexecuted orders to annual revenues of 3 times for this fiscal, compared with 2.3x in fiscal 2014, which also augurs well for the revenue visibility of these companies.

Judicious bidding propped profitability in the past, and will do so in future

The revenue scale-up was complemented by steady rise in profitability. Operating margin in fiscal 2017 was estimated at 12.5%, supported by efficient pass-through of raw material price variation, and relatively low competitive intensity.

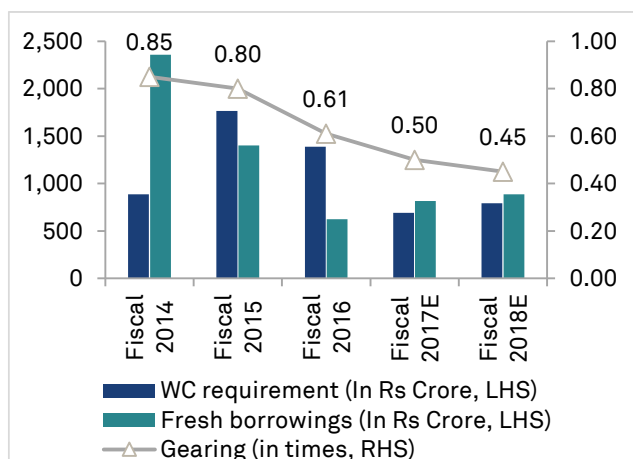
Further, ten of these companies had also entered into road BOT space, to forward integrate their business. While some of the larger EPC players burnt their fingers due to aggressive bidding, and delayed land acquisition and clearances, these companies have sustained their credit profiles while bidding conservatively for new projects and focusing on completion of the existing projects. Consequently, equity commitment/support requirement for these projects remain low.

CRISIL believes players will sustain operating profitability at 12.5%, with an expected return on capital employed of 19% this fiscal.

Prudence improves financial risk profile

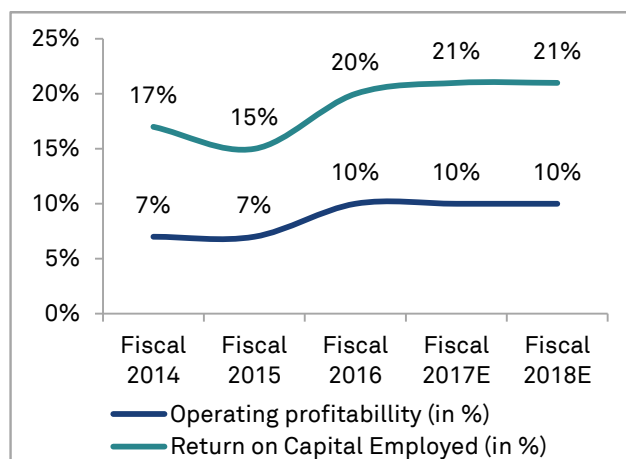
In congruence with robust revenue growth, the players have sustained comfortable capital structure, with gearing close to 0.5x at an aggregate level. Despite steady increase in revenue, an efficient working capital management, and lower capex and support required for BOT projects, have helped them restrict their dependence on external borrowings. This has translated into gradual improvement in their key credit metrics, as reflected by leverage and debt coverage indicators. Total outside liabilities / total net worth, and interest coverage ratio improved to 1.4x and 3.8x, respectively, in fiscal 2016. They are expected to further improve to 1.3x and 4.0x, respectively, for fiscal 2017, and sustain in the current fiscal.

Working capital management helped capital structure



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Key financial indicators improved



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Conclusion

Given their demonstrated project execution capabilities and prudent management policies, CRISIL expects these companies to sustain revenue growth momentum and working capital cycle over the medium term. Timely availability of 'right of way' and other approvals, however, remain critical to sustaining the pace of project execution and revenue growth.

Overall, CRISIL believes EPC players will sustain improvement in credit profiles over the medium term, subject to continued prudence in bidding, low gearing, and healthy working capital management. The government's continued thrust on the road sector and favourable policy measures will go a long way in ensuring this.

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Last updated: April 2016