Combating Challenges

The ability to manage the debt and equity mix while controlling the overall cost structure will be a determinant for success, believes **DR Dogra**.

Being the key driver for economic growth, the infrastructure industry has, in the recent past, received a major thrust. The Government of India has set ambitious targets for increasing the proportion of infrastructure investment to GDP. For any country to sustain its economic growth, infrastructure development is an imperative task. However, due to reasons both internal and external to the industry and the country, FY11 was a muted year for the construction sector. Externally, the impact of the global slowdown and consequent limitations of funding through the FII and the FDI routes was a dampener for accelerated economic growth of the sector. Internally, factors like inflation, combined with rising interest rates, posed challenges to the mobilisation of resources – a key requirement for large scale projects. Besides, in a sector requiring government spending and administrative support, instances of issues pertaining to governance led to a slowdown in decision making, consequently putting brakes on the award of new contracts, delaying environmental clearances for projects and land acquisition issues.

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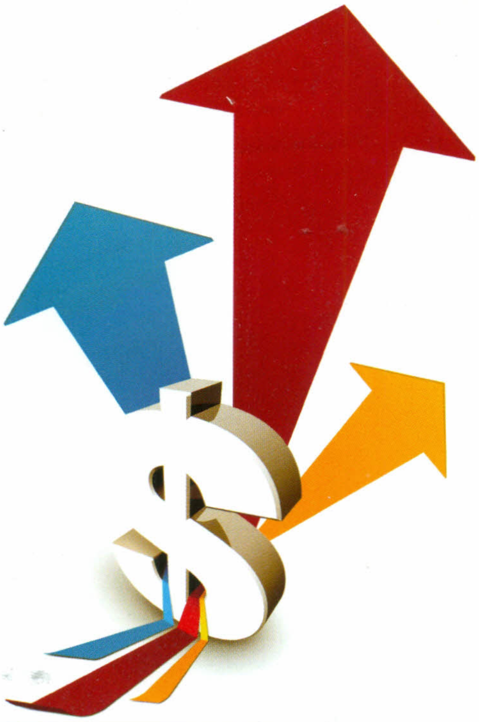

Lull in economic growth

With the slowdown in the economic growth in Q1FY12, the growth of the construction GDP has also slowed down. Construction GDP grew at a lower rate of 1.2 per cent on a year-on-year basis, down from 7.7 per cent in Q1FY11. The slowdown in construction is mainly on the account of rising interest rates, delays in the project awarding process due to environmental clearance hurdles and other political issues. At the end of Q1FY12, the order backlog to net sales ratio for major construction companies was in the range of three to five times. Contribution of construction to the GDP of the country has also declined to 7.7 per cent in Q1FY12 as compared to 8.2 per cent in Q1FY11, pointing to a slowdown in the growth of the sector. (*Source: Central Statistical Organisation*)

A few encouraging signals in these times have been the governments' commitment to infrastructure as a prime driver of the nation's economic growth as well as its willingness to adopt the Public Private Partnership (PPP) model for furthering its goals. The involvement of private companies as stakeholders will help in achieving on-the-ground results with minimal cost and time overruns. The investment in infrastructure is expected to increase to 8.37 per cent in the final year of the Eleventh Plan and likely to touch 10 per cent of the GDP in the Twelfth Five Year Plan (2012-2017). With increasing investments, the share of the private sector in the total investment on infrastructure has increased rapidly. The contribution of the private sector in total infrastructure investment in each of the first two years of the Eleventh Five Year Plan (2007-2012) was around 34 per cent. This is higher than the Eleventh plan's target of 30 per cent and 25 per cent achieved in the Tenth Plan period. This investment is expected to rise to 50 per cent during the Twelfth Plan (2012-2017).

However, intense competition in the sector is adding further pressure on the profitability margins of the private players as they have to resort to aggressive bidding to secure projects. Aggressive bidding in the wake of rising commodity and manpower costs and technological impediments may hit the companies in the long-term.

Overall cost structure

In the construction industry, the cost structure of a company depends upon its order mix. Raw materials and subcontracting together account for about 60-70 per cent of the total cost. Other costs include employee cost, administrative and other operating expenses. A major chunk of the raw material cost is contributed by cement and steel. During the construction of any project, an adverse variation in the prices of these two basic raw materials can have a direct impact on the cost of the project and in turn, on the profitability margins of the companies. To safeguard the construction companies against variations in raw material prices, contract documents have built-in escalation clauses. But, unprecedented variations in the prices of these raw materials exert pressure on the profitability margins as the additional cost cannot be completely recovered from the contractees.

Over the past few months, steel and cement manufacturers have hiked up prices owing to higher input prices. As a result, construction companies grappled with higher raw material costs. During the June 2011 quarter, raw material expenses of the construction industry rose by a sharp 14.1 per cent. Its wage bill and other expenses rose by 17.7 per cent and 10.6 per cent, respectively. (*Source: CMIE*)

CARE believes that rising commodity prices coupled with spiraling interest costs, added to the woes of the construction players, pulling down the profitability margins further, as the industry is working-capital intensive, and players rely heavily on bank borrowings to fund their operations.

Manpower

The labour population in India is mainly dominated by a concentration of rural labourers and unskilled workers (with large-scale participation of women workers). Many of these rural workers have an agrarian

Various government projects have led to a diminishing pool of unskilled workers.

background and work in the industry on a seasonal basis, ie, during the non-harvest period. The labour profile of the industry is typically characterised by a high degree of transitory employment. The government needs to provide a regulatory framework for the benefit of such construction workers to tackle this. In the recent past, even the pool of unskilled workers available during the peak construction seasons has diminished on account of various government projects like Jawaharlal Nehru National Urban Renewal Mission (JNNURM) and Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA), encouraging migrant labourers to look for employment within their own states and also by increasing the costs associated with the hiring of such labour.

Even though the government's focus on infrastructure has provided an impetus to the construction industry, it genuinely faces a scarcity of quality manpower, both at the operational and management levels. To enhance productivity, project level personnel need to be trained on the various aspects like management of manpower, finances and risks. The need of the hour is to include specialised courses like highway engineering and construction management in the curriculum, apart from generalised civil engineering courses. The industry lacks an institutional framework (apart from few initiatives from the Construction Industry Development Council and corporates) to impart training to industry personnel. Thus, there is an exigency to take steps to provide for training, testing and certification of human resources in the industry. Lack of focus on training the manpower of the construction industry in India has emanated as a major problem of insufficiency of workforce in terms of both, skill level and quantity.

CARE observes that in the current scenario of high interest costs and commodity prices, the increase in labour costs in an industry that is highly labour-intensive has further dented the financial health of construction companies.

New innovations

To address the twin challenges of managing rising costs along with fixed timelines, it is essential for construction companies to invest continually for improvements in construction technology. On the technology front, the Indian construction industry lags behind other developing countries and even behind the other sectors of our economy. High tariff on equipment and machineries required for construction (leading to high prices) acts as a major hindrance for mechanisation in the construction industry. Most of the technology developments in the construction field in India have been via the import of foreign technologies rather than any indigenous research. Low technological levels in the industry lead to low productivity and moderate quality level coupled with time overruns. This in turn makes the operations labour intensive with low mechanisation.

Future prospects

Increasing contribution of private sector by way of PPP projects and rising costs are increasing the debt burden of construction players. CARE believes that the success of industry players hinges on their ability to manage the debt and equity mix judiciously while controlling the overall cost structure prudently. CW

About the author

One of CARE's first employees and an integral part of the top management since 1993, **DR Dogra, Managing Director and CEO, CARE Ratings** *has overseen the strategic growth and development of the company over the years. Having over 33 years of experience in credit rating and commercial banking, Dogra holds a post-graduate degree in Management from FMS, University of Delhi. He is a gold medalist in his Post-Graduate Degree in Agriculture from Himachal Pradesh University. He is also a Certified Associate of the Indian Institute of Bankers.*