INDIAN CONSTRUCTION INDUSTRY:

HAS THE COVID-19 DEVELOPED CRACKS BEYOND REPAIR FOR THE SECTOR?

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The global economy has been hit hard by the unexpected outbreak of COVID-19, which has now posed fresh challenges across all geographies and sectors. For the Indian construction industry, which was on the cusp of deriving the benefits from a major push in the government spending, the impact is likely to be 'medium' to 'high' depending on the profile of the company and its liquidity and the outlook on the sector is expected to be 'negative'.

Nevertheless, construction is one of the critical activities and hence it is highly likely that the construction activities may be allowed to be gradually started. However, the journey towards normalcy is expected to be tough. The impact of COVID-19, the mitigants to counter the damage and the possible impact on the credit rating and outlook is presented below.

1. Impact of COVID

i. Major execution slowdown during and immediately after the lockdown period
ii. Panic amongst construction workers
iii. Increase in working capital cycle intensity in near to medium term
iv. Slower roll out of new order awards likely
v. Fixed costs to put pressure on cash flows and profitability

i. <u>Major execution slowdown</u>

<u>Short-term</u>

- *<u>Impact on execution in the short term:</u>* The short-term impact would be to the extent of around 5-8% hit on the revenue for FY20. The first quarter would also remain impacted on account of complete halt of activities due to the lock-down and its subsequent effects. The duration of the lockdown is most likely to increase with the recent bump in the cases. The execution would be tepid in Q1FY21 and would further continue with the onset of the monsoons at the start of Q2FY21 when the construction activities are low due to weather conditions.

<u>Medium-term</u>

- *<u>Impact on execution in FY21:</u>* The second half of the fiscal usually contributes major portion of revenues around 60% for the top construction players. Therefore, we expect the execution to be hit by around 30% considering the current situations. However, if containment of the outbreak takes a longer time than expected it may lead to a protracted lock-down situation and the impact on execution could be even higher.
- *<u>Restart of operation may take some time:</u>* From the start of operations with full mobilisation of site, it may take some time may be 1.5-2 months to achieve performance milestones and restart billing for works.

ii. Timely return of construction workers to pose a challenge

The spread of COVID-19 and subsequent lockdown has led to migrant workers returning to their hometowns. Further, timely return of workers post lockdown to the construction sites would be a huge challenge account of uncertainty and health concerns which may lead to slower ramp up of construction activities even after the lockdown is lifted.

Major Hotspots sub-segments of the construction industry which likely to be impacted more than other sub-segments. The sub-segments and the major reasons impacting their performance are as under:

Key Reasons → / Hotspots ↓	Demand Slowdown	Execution slowdown	Increased WC intensity	Shortage of labour	Limited access to site
Real Estate	✓		✓	✓	
Factory Buildings	✓	✓		✓	
Overseas Projects		✓		✓	✓
Sites in metros		✓		✓	✓

iii. Timely return of construction workers to pose a challenge

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iv. Increase in working capital cycle intensity in near to medium term

- *Likely elongation in receivables and short term borrowings:* Major part of collection is clustered in the last fort-night of March and hence the collections are likely to have been tepid during this period leading to high level of working capital borrowings at the end of March 2020.
- *Slower than expected realisations of receivables:* The lockdown is likely to affect most of the clients of construction companies and would slower down their capex plans and may also lead to slower payments to the construction companies executing their orders. This would further lead to elongation in the receivables post the lockdown.

v. Slower roll out of new order awards likely

- *Pace of new order awards may slow down:* With the government prioritising its cash flows towards more pressing social measures and likely cash outflows by National Highway Authority of India (NHAI) towards compensation of toll road projects due to lockdown, there may be a slower roll out of new tenders in the coming months leading to run down in the order books of the construction companies in the medium term.

vi. Fixed costs to put pressure on cash flows and profitability

- *Fixed costs:* The cash outflow in terms of fixed overheads typically comprising of employee expenses, rentals, other basic expenditures which comprise 8-10% of revenues of a company in the construction sector have continued. With lower absorption of fixed costs and decline in levels of execution in H1 FY 21, the PBILDT for the entire year is expected to be substantially lower in FY21 compared to FY 20 levels.
- *Debt servicing immediately after moratorium:* Most of the lenders are likely to allow a moratorium to their borrowers as per Reserve Bank of India's circular of March 27, 2020. However, due to expected slower ramp up in cash flows, the interest payments for the moratorium period and the principal payment ensuing the moratorium period is likely to put pressure on the cash flows of the companies. At the end of the moratorium period, there would also be an increase in the bank charges for bank guarantees (BGs) and interest expense on mobilisation advances. Mobilisation advances get repaid with the billings for the work done. As such, with halting of all activities, the progress of work to come back to its flow will take some time and additional finance cost on extended period of mobilisation advances along with extension of BGs utilised for availing the same, will further assert pressure on profitability of companies.

2. Mitigants to counter the damage

a. Moratorium for 3 months to give a short term relief
b. *Many states have announced compensation for workers* like one month free food grains along with Rs 1,000 as compensation to daily wage workers affected due to the outbreak of deadly virus
c. *Decline in commodity prices* amidst volatility, and concerns over global economic growth as the COVID-19 pandemic spreads is likely to reduce the working capital requirement for purchase of material and is likely to benefit players which have fixed price contracts
d. *Liquidity buffer available to most of the top rated entities:* Most of the top construction companies have adequate liquidity by way of unutilised fund based limits and unencumbered cash balance to meet the fixed overheads.
e. *Preparedness to restart activities at construction sites:* Entities which continued to mobilise all forms of available resources to maintain the pace of activities, till the lockdown was declared would be in a better position to restart of operations faster. Further, the companies would need mobilisation liquidity at the time of restart of operations. With the burden of fixed overheads and increase in the financial expenses and the requirement of initial liquidity to restart operations, the companies would have to conserve cash in all possible ways and the ones with the requisite liquidity would be better placed than the others in the sector.

3. Impact on credit rating /outlook

The overall outlook on the sector is expected to be negative given the uncertainty with respected to stabilisation of operations once restarted. The impact matrix may be as under:

Companies having →	Liquidity buffer			Site preparedness			Strong counter parties			Investment in SPVs		
Impact ↓	H	M	L	H	M	L	H	M	L	H	M	L
High (H)			✓			✓			✓	✓		
Medium (M)		✓			✓			✓			✓	
Low (L)	✓			✓			✓					✓

It is expected that the construction activities being critical in nature would gradually start resuming post lifting of lockdown. The liquidity buffer and site preparedness would be two crucial parameters that would determine the pace of recovery for the players.

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