Opportunity from the infrastructure sector galore but execution remains the key …

CARE Research

November 15, 2011

Analytical Contact:

Ms. Revati Kasture - Head - Industry Research
revati.kasture@careratings.com
(D): +91-22-6754 3465

Mr. Chaitanya Raut - Sr. Manager
chaitanya.raut@careratings.com
(D): +91-22-6754 3410

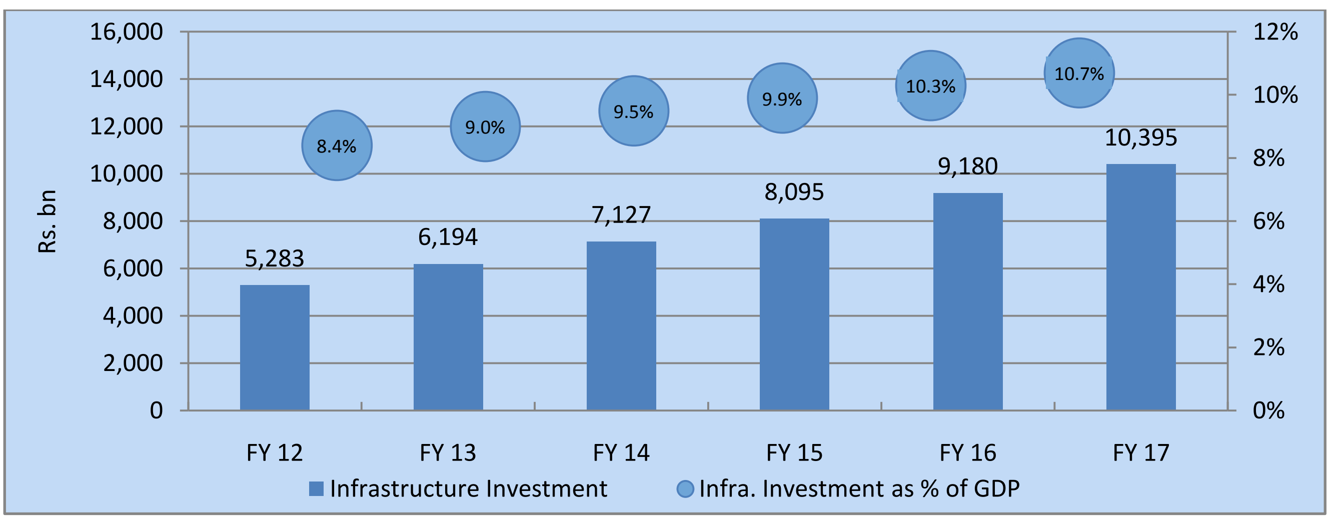
Ms. Supriya Shetty - Analyst
supriya.shetty@careratings.com
(D): +91-22-6754 3417

Infrastructure investment expected to double in the next Five Year Plan …

Investment in the infrastructure sector plays a crucial role in the growth of the economy and in turn the construction industry. In the last few years, the rapid growth of the economy has put a tremendous pressure on the physical infrastructure of the country. In order to sustain the economic growth momentum, the Government of India (GoI) has been focusing on increasing the infrastructure investment in last few Five Year Plans. Expected investment in the Eleventh Five Year Plan is almost 2.2 times that achieved in the Tenth Five Year Plan. Moreover, the total investment planned in the infrastructure sector during the Twelfth Five Year Plan is estimated to double that in the Eleventh Five Year Plan.

The Planning Commission has estimated that, for the GDP to continue to grow at 9%, the proportion of investment in infrastructure as a percentage of GDP is required to increase from the targeted 8.4% in FY12 to 10.7 % by the terminal year of Twelfth Five Year Plan i.e. FY17. The following chart shows the corresponding infrastructure investment in each year:

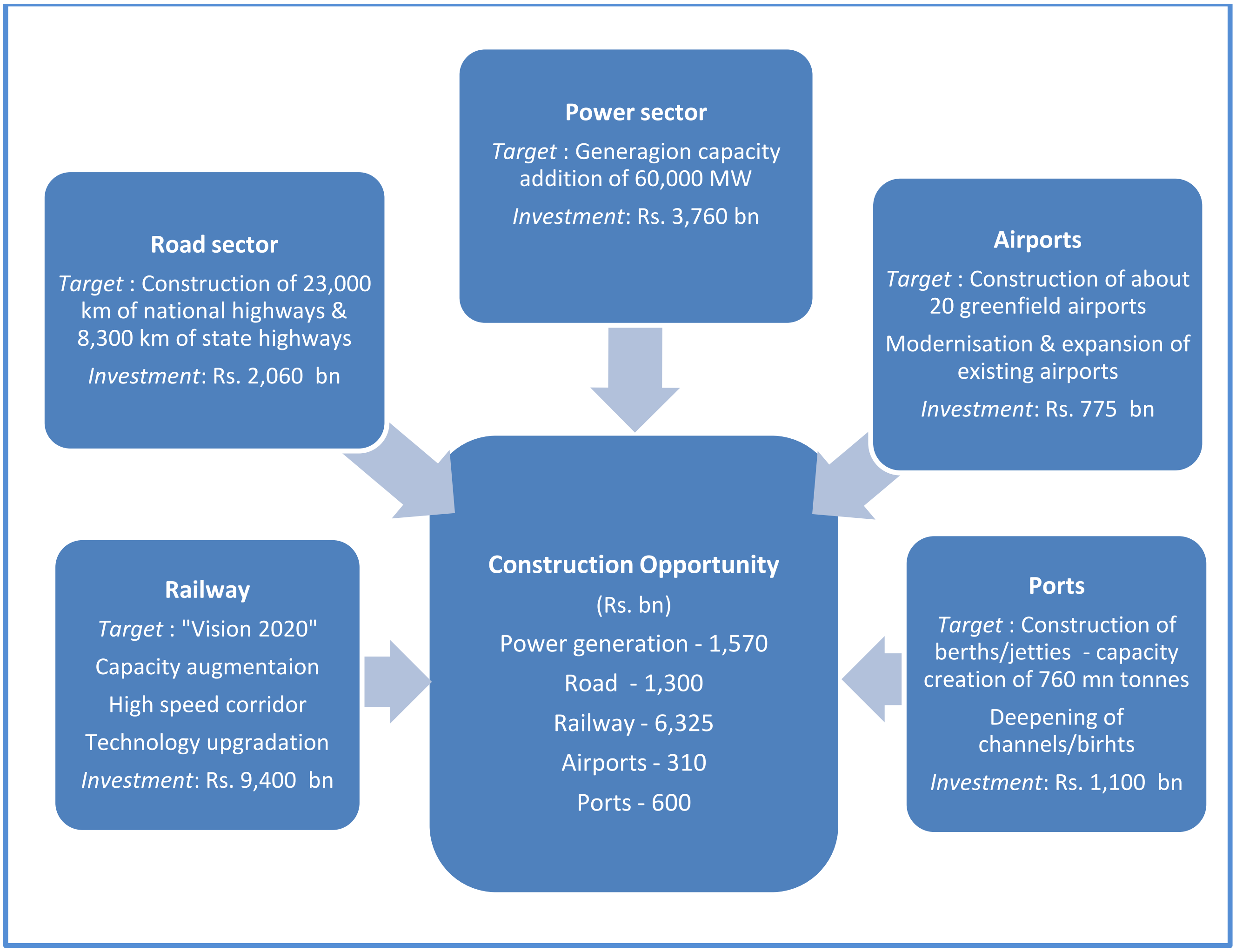
Trend of anticipated infrastructure investment in the Twelfth Five Year Plan



Source: Planning Commission

Using the top-down approach, the investment in the infrastructure sector during the Twelfth Five Year Plan is estimated at a massive Rs.41,000 bn. The construction industry has an opportunity to capitalise on the order flow expected to come from the infrastructure projects. Based on construction intensity of the various infrastructure projects and similar allocation among sectors during the Eleventh Five Year Plan, CARE Research estimates the indicative effective construction investment at whopping Rs.20,000 bn during the Twelfth Five Year Plan.

Sectorwise targets in some infrastructure sectors and potential construction opportunity …



Industrial sector to throw construction opportunity of more than Rs.4,200 bn …

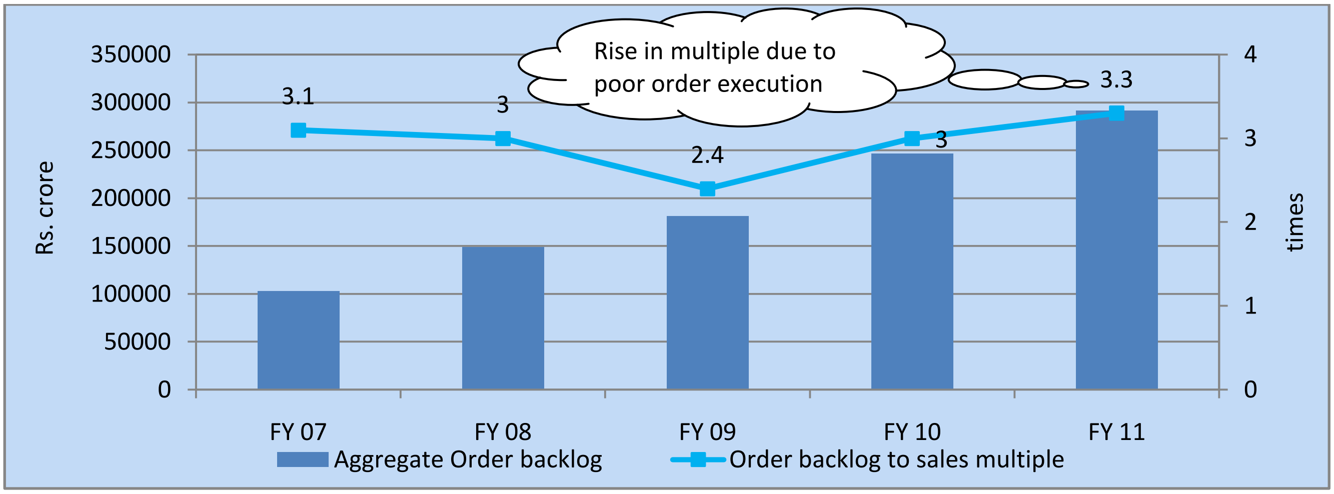
Apart from infrastructure projects, the construction industry also receives orders from different manufacturing industries to execute construction work for industrial plants and related civil construction. The construction industry had been benefiting from the rise in industrial production in the past few years. As on June 30, 2011, the total outstanding investment in the industrial sector stood at about Rs.35,000 bn. Out of total outstanding investment in the industrial sector, the major chunk is dominated by metal, oil & gas and chemical sectors. These three sectors together, account for almost 69% of the total outstanding investment. Omitting the investment which is already under implementation from the total outstanding investment, CARE Research estimates the effective construction investment of more than Rs.4,200 bn during the next 4-5 years period.

Eventhough, the construction opportunity from both the sectors looks immense; order inflow in the near term is likely to be affected due to slowdown in capex cycle and awarding of infrastructure projects by the government.

Delay in project execution to hamper the revenue growth...

With the improvement in the macroeconomic conditions and the growing emphasis of the GoI on improving infrastructure in the country, construction companies have been benefited in past few years. This is evident from the bulging order backlog positions of the leading construction companies. During the period of FY07-11, aggregate order backlog of the set of major construction companies grew at CAGR of 29.8%.

Trend of aggregate order backlog and multiple of aggregate order backlog to sales



Source: CARE Research

In FY 09, due to the overall economic slowdown and poor liquidity conditions, the multiple of aggregate order backlog had declined to a level of 2.4 times. With the improvement in the macroeconomic scenario in FY 10, awarding of infrastructure projects caught pace and the multiple increased to 3 times. At the end of the FY11, the multiple reached a level of 3.3 times which was mainly on account of the muted topline growth due to poor order execution. Eventhough, the multiple of 3.3 times shows the decent revenue visibility for the construction companies, execution of the order backlog remains a key challenge due to various constraints.

Issues faced by the construction industry

Land acquisition

- The fragmented nature of the land holding, lack of clear titles, agitations over land compensation, resettlement and rehabilitation related issues etc. tend to delay the process of land acquisition.

Enviroment Clearance

- Need to obtain clearances from multiple agencies at the Centre, State and local levels, delays the project execution. Moreover, any changes in the policy framework by the Ministry of Environment & Forest (MoEF) adversely affects the project execution.

Political issues

- The political uncertainty and local agitation in many states (like AP in recent times) delays the project execution. Unveiling of various scams in the recent past have made various government agencies/bodies more vigilant towards granting approvals which has slowed down the execution of construction projects.

Manpower issues

- The supply of skilled and unskilled manpower has failed to keep in pace with the growth of the construction industry. As a result, attracting and retaining the manpower has become a major challenge for the construction industry to ensure execution of projects without time overruns.

To affect the project execution and drag down the revenue growth

On account of the above mentioned issues, almost 30-35% of projects in the existing aggregate order backlog are slow moving or stuck which can hamper the project execution to a great extent and drag down the revenue growth. Taking this into consideration, CARE Research estimates that construction companies are expected to register revenue growth at a CAGR of 29% during the period FY 11-14, much below the potential revenue growth.

No respite on the margins front for construction companies …

The PBIDT margin of construction companies largely depends on the order backlog mix, movement in prices of key raw materials and the extent of escalation clauses built into the contracts. Over the years, the increasing proportion of the high margin segments in the total order book of the construction companies has led to the rising trend in PBIDT margin. The proportion of high margin segments such as power and water infrastructure taken together has increased from 33% in FY 07 to 43% in FY 11 whereas proportion of low margin segment like transportation has decreased from 13% in FY 07 to 9% in FY 11. Despite of the favourable order backlog position, the PBIDT margin of construction companies was under pressure in FY11 due to sluggish revenue growth led by the delay in order execution and fairly high prices of key input materials like steel, cement, bitumen, copper etc.

In FY 12, prices of key input commodities are expected to remain firm. With intensified competition and delay in execution of order backlog, profitability of the construction industry will remain under pressure. The PBIDT margin of construction companies is expected to remain in the range of 15-16% in FY 12. Moreover, increased borrowings and high interest rates will continue to hit the bottom line of the construction industry.