

**Rating Rationale**  
**Sagun Construction**

**Rating**

Facility	Amount (Rs. In Million)	Rating <sup>1</sup>	Rating Action
Long Term Bank Facilities	101.79	CARE-NP BB [Double B]	Assigned
Short Term Bank Facilities	1,398.21	CARE-NP A4 [A Four]	Assigned
<b>Total Facilities</b>	<b>1,500.00</b>		

*Details of Facilities in Annexure 1*

CARE Ratings Nepal Limited (CRNL) has assigned rating of ‘CARE-NP BB’ to the long-term bank facilities and ‘CARE-NP A4’ to the short-term bank facilities of Sagun Construction (SGC).

**Analytical approach:**

CRNL has analyzed SGC’s credit profile by considering the standalone financial statements.

**Detailed Rationale & Key Rating Drivers**

The ratings assigned to the bank facilities of SGC are constrained by nascent track record and small scale of operations of the firm in executing various construction works and tender based nature of operations in highly competitive construction industry. The rating is also constrained by working capital intensive nature of business, proprietorship nature of entity and exposure to volatile interest rates. The ratings, however, derive strength from experienced promoter and associate entities involved in construction industry and financial profile characterized by growth in sales and profitability margins in FY20 (Unaudited, refers to 12 months’ period ended mid-July 2020). The ratings also factor in comfortable capital structure and debt service coverage indicators of the firm; mid-term revenue visibility due to overall comfortable order book position and diversified projects; moderate counter party risk and escalation clause in majority of the contracts. Ability of the firm to successfully execute projects in time and recover contract proceeds and ability to manage healthy revenue growth and maintain profitability margins without deterioration in its financial risk profile will be key rating sensitivities. Further, ability to manage the impact of Covid-19 on the operations and financials of the firm will be the key rating sensitivity.

***Impact of Covid-19 on the business of the firm***

The global outbreak of Coronavirus disease 2019 (Covid-19) has affected Nepal as well. Government of Nepal (GoN) imposed countrywide lockdown since March 24, 2020 halting operations of most of the organizations and slowing down of the economic activities. The construction activities of the firm were also subdued on account of the lockdown. Also, since construction activities in Nepal usually takes momentum on second half of the financial year and with country’s economy and construction sector being significantly impacted since March 2020, it had a negative impact on the revenue and profitability

<sup>1</sup>Complete definitions of the ratings assigned are available at [www.careratingsnepal.com](http://www.careratingsnepal.com)

of the firm in comparison to the normal operations. The firm's ability to achieve its projected revenue for FY21 and maintain profitability margins will be key rating consideration.

### **Detailed Description of the Key Rating Drivers**

#### **Key Rating Weaknesses**

##### ***Nascent track record in executing various construction works***

SGC has a nascent track record of over 5 years in the construction of water supply & sanitation projects, building works, road works, embankment works etc. ranging from small sized to mid-sized projects either individually or sub-contract or through its JV entities. Due to the relatively short track record of the firm in construction field, its ability to successfully bid for construction contracts, improve its order book position and revenue profile over the years remains key rating consideration.

##### ***Working capital intensive nature of business***

The operations of the firm are working capital intensive in nature as firm primarily works with government departments and funds are released only after the work certification process is completed and finalization of the bills. SGC maintained construction materials as an inventory which was low around 9 days in FY20. Also, the cash flows of the firm are blocked in retention money which is deducted by the client from running bills and gets refunded only on successful execution of the contracted work. The total operating cycle of the firm was 42 days in FY20 which was at same level in FY19. These factors lead to reliance of the firm on bank finance to meet its working capital requirements. The maximum working capital limit utilization of the firm against drawing power for last 12 months ending mid-July, 2020 was 89.20%.

##### ***Proprietorship nature of constitution***

Sagun Construction, being a proprietorship firm, is exposed to inherent risk of the Proprietor's capital being withdrawn at time of personal contingency and firm being dissolved upon the death/retirement/insolvency/decision of the proprietors. Furthermore, proprietorship firms have restricted access to external borrowing as credit worthiness of proprietor would be the key factors affecting credit decision for the lenders.

##### ***Tender based nature of operations in highly competitive construction industry***

The firm receives its work orders from government departments. All government contracts are tender-based wherein the firm has to quote the bid and hence it has to face the risk of successful bidding for the same, which again comes with the risk of quoting a low price to sustain competition. Also, the promoter's reasonable industry experience in related field mitigates risk of competition to some extent.

##### ***Exposure to volatile interest rates***

Nepalese banking sector fixes lending interest rate based on quarterly base rate and interest rate can be changed accordingly on quarterly basis. Due to tight liquidity in the market, the interest rate has been high

and volatile during the last 12 months. Therefore, funding from banks and financial institutions is subject to volatile interest rate.

### **Key Rating Strengths**

#### ***Experienced promoter and associate entities involved in construction fields***

SGC is a proprietorship firm and is promoted by Mr. Sahadev Khadka. Mr. Khadka, proprietor, has extensive work experience of around 20 years in the field of construction business and is responsible for overall management of the projects executed and business development of the firm. He is the Managing Director of Bhimeshwor Drilling Tatha Nirman Sewa Private Limited and Swikar Construction & Deep Tubewell Co. Private Limited, both of the companies are associated in construction field. The proprietor is further supported by an experienced team across various functions/ departments. The proprietor of SGC has also infused Rs. 12 Mn as capital fund during FY20 to support operations of the firm.

#### ***Financial profile characterized by growth in sales and profitability margins in FY20 although impacted by Covid-19***

Total revenue increased by ~5% to Rs. 631 Mn in FY20 despite impact of COVID-19 on construction activities, on back of increase in execution of the contracts in hand. Further, with decline in direct costs of the firm during FY20, PBILDT margin of the firm improved in FY20 to 8.53% compared to PBILDT margin of 6.09% in FY19 (Audited, refers to 12 months period ended mid-July 2019). PAT margin of the firm was low at 1.35% in FY19 which improved to 2.44% in FY20.

#### ***Comfortable capital structure and debt service coverage indicators of the firm***

The capital structure of the firm is marked with low debt equity ratio of 0.55x and overall gearing ratio of 0.96x at the end of FY20 (vis-à-vis 0.84x and 1.28x respectively at the end of FY19). The gearing ratio improved in FY20 mainly on account of increase in networth due to accretion of profit to networth & introduction of additional capital which was partially offset by increase in working capital loans to fund increased operations of the firm. Interest coverage ratio of the firm was comfortable at 4.58x in FY20. Also, Total Outside Liabilities/ Tangible Networth and total debt/ Gross Cash Accruals of the firm was at 2.28x and 2.78x respectively in FY20.

#### ***Mid-term revenue visibility due to overall comfortable order book position and diversified projects***

Till September, 2020, the unexecuted orders in hand of the firm stood at Rs. 2,024 Mn. The present order book to FY20 revenue is around 3.21x which provides medium term revenue visibility. The order book of the firm is diversified over various projects such as water supply & sanitation project, road, building works, irrigation & river training works etc. received from various government authorities of Nepal. Timely completion of the projects and thereby increasing its scale of operations would be critical from the credit perspective for SGC.

**Moderate counter party risk**

Revenue of SGC is generated via contracts from government departments and subcontract works related to road works, building works, water supply and sanitation works, irrigation and river training works etc. Average collection period of the firm was high at 105 days in FY20 (vis-à-vis 107 days in FY19) mainly due to high billing done by the firm to government departments at the year-end for completed works. However, the counter party risk is moderated by the fact that majority of the construction contracts are obtained from government departments and it has been making timely payment to the firm in past.

**Escalation clause in majority of the contracts**

SGC procures construction materials mainly from the local vendors which has risk of volatility in raw material prices. The firm has inbuilt price escalation clauses in majority of contracts in order to insulate the firm from any adverse fluctuation in construction material prices and labor expenses.

**About the Firm**

Sagun Construction is Class “D” construction firm of Nepal which was registered in the year 2015 and has registered office based in Butwal, Rupandehi, Nepal. The firm is involved in construction of building works, water supply & sanitation projects, road works, irrigation projects, embankment works etc. mostly in the western region of Nepal. SGC also enters into Joint Ventures (JV) with other companies in order to meet the eligibility criteria for different construction projects.

Brief financials of SGC for last three years ending FY20 are given below:

(Rs. Million)

For the year ended Mid July	FY18	FY19	FY20
	(Audited)	(Audited)	(Provisional)
Income from Operations	440	604	631
PBILDIT	29	37	54
PAT	10	8	15
Overall Gearing (times)	4.85	1.28	0.96
TOL/ TNW (times)	12.21	3.26	2.28
Interest Coverage (times)	5.78	3.69	4.58

<b>Analyst Contact</b> Mr. Utsav Baral <a href="mailto:utsav.baral@careratingsnepal.com">utsav.baral@careratingsnepal.com</a> Tel No.: +977-01-4012630	<b>Group Head</b> Ms. Shalini Sanghai <a href="mailto:shalini.sanghai@careratingsnepal.com">shalini.sanghai@careratingsnepal.com</a> Tel No.: +977-01-4012630	<b>Relationship Contact</b> Mr. Sajan Goyal <a href="mailto:sajan.goyal@careratingsnepal.com">sajan.goyal@careratingsnepal.com</a> Tel No.: 9818832909/+977-01-4012628/29/30
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**Annexure 1: Details of the Facilities rated**

<b>Nature of the Facility</b>	<b>Type of the Facility</b>	<b>Amount (Rs. In Million)</b>	<b>Rating</b>
Long Term Bank Facilities	Term Loan	101.79	CARE-NP BB
Short Term Bank Facilities	Working Capital Loan	50.00	CARE-NP A4
Short Term Bank Facilities	Non-Funded Loan	860.00	CARE-NP A4
Short Term Bank Facilities	Non-Funded Loan (Proposed)	488.21	CARE-NP A4
<b>Total</b>		<b>1500.00</b>	