

Aarogya Construction Private Limited

Ratings

Facilities	Amount (Rs. in Million)	Ratings ¹	Rating Action
Long Term Bank Facilities	16.49	CARE-NP BB- [Double B Minus]	Rating revised from CARE-NP BB
Short Term Bank Facilities	455.66	CARE-NP A4 [A Four]	Reaffirmed
Long Term/ Short Term Bank Facilities	2,096.10	CARE-NP BB-/ A4 [Double B Minus/ A Four]	Rating revised from CARE-NP BB/A4
Total Facilities	2,568.25		

Details of instruments/facilities in Annexure 1

CARE Ratings Nepal Limited (CRNL) has revised the rating assigned to the long term bank facilities of Aarogya Construction Private Limited (ACPL) to 'CARE-NP BB-' from 'CARE-NP BB'. CRNL has reaffirmed the rating of 'CARE-NP A4' assigned to short term bank facilities of ACPL.

Detailed Rationale & Key Rating Drivers

The revision in the ratings assigned to the bank facilities of ACPL takes into account its elongated operating cycle resulting to working capital intensive nature of business and stretched liquidity position. The ratings also factor in ACPL's leveraged capital structure, fluctuating profitability margins and its presence in highly competitive construction industry coupled with tender based nature of operations, exposure to volatile interest rates and government regulations and risk of delay in project execution.

The ratings, however, derive strengths from experienced promoters and moderate track record of operations, moderate order book with mid-term revenue visibility, moderate counter party risk and escalation clause in majority of the contracts. The ratings also take cognizance of growth in total operating income (TOI) in FY21 (Audited, refers to the twelve-month period ended mid-July 2021).

Going forward, the ability of the company to successfully execute projects and recover contract proceeds in a timely manner, profitably scale up the operations of the company leading to sustained revenue growth and rationalization of its debt through efficient working capital management would be the key rating sensitivities.

Detailed Description of the Key Rating Drivers

Key Rating Weaknesses

Highly elongated operating cycle resulting to working capital intensive nature of business

The operations of the company are working capital intensive in nature. Net Operating cycle of the company was very high at 719, which increased from 365 days in FY20. ACPL's operating cycle is in increasing trend in the past 3 financial years (FY19-FY21). In FY21, the operating cycle substantially increased to 719 days from 365 days in FY20 (221 days in FY19) due to increase in average collection period to 487 days in FY21 from 319 days in FY20 (244 days in FY19) coupled with high inventory holdings of 622 days in FY21 (736 days in FY20 & 322 days in FY19).

A major factor that resulted in high inventory was accumulation of inventory on account of unexecuted projects due to delay in clearance from the government authorities for laying of fibre optic cables. The funds are released only after the work certification process is completed and finalization of the bill is done. Customer base includes government departments and private entities. The certification and realization of the bill generally takes a period of around three months. There is usually a procedural delay in the recovery of debtors, and at times, the same exceeds a year. Consequently, average

¹Complete definitions of the ratings assigned are available at www.careratingsnepal.com and in other CRNL publications

collection period of the company was high at around 487 days in FY21. An elongated operating cycle resulted in a stretched liquidity position of the company, increasing its reliance on the bank finance for meeting its working capital needs, resulting in increased debt levels.

Interest coverage ratio of the company was moderate at 2.20x in FY21 which deteriorated from 2.93x in FY20 on account of increased interest expenses due to increased working capital loans availed by the company. However, Total debt/ GCA of the company deteriorated substantially to 14.11x in FY21 from 4.81x in FY20, with impact of increased working capital borrowings of the company.

Below average financial risk profile marked by fluctuating profitability margins and leveraged capital structure

ACPL's TOI grew ~16% year-on-year to Rs. 94 Mn during FY21 boosted by execution of projects after being impacted by the pandemic during FY20 when total operating income had declined ~43% over FY19. The business generation of the company is through bidding and tendering process and profitability margins are directly associated with the nature of contracts executed by the company. The PBILDT margin has also remained highly volatile and fluctuated between 32%-45% during the last 3 financial years (FY19-FY21). With increase in interest expenses, PAT margin of ACPL declined to 3.79% in FY21 from 4.12% in FY20.

Capital structure of the company stood leveraged on account of higher short-term debts availed by ACPL for funding the working capital needs of the company and the same has been reflected from high overall gearing of 3.18x as on mid-July 2021, deteriorating from 1.16x as on mid-July 2020. Furthermore, Total Outside Liabilities (TOL)/ TNW of the company deteriorated to 3.53x in FY21 from 2.01x in FY20.

Tender based nature of operations in highly competitive construction industry

Majority of the ACPL's projects are tender-based government contracts wherein the company has to quote a bid. With multiple players active in the industry, ACPL's business is vulnerable to under bidding at a relatively low cost in order to secure the projects, in the highly competitive construction industry. Furthermore, the business also remains dependent on sustained capital expenditure by the government towards construction projects, overall stability in government policies and fiscal position of the government. Government of Nepal (GoN) has put certain restrictions on the contractors to participate in tenders such as prohibiting foreign companies to participate in tenders having value less than Rs. 3,000 Mn, which augurs well for domestic players. Furthermore, the GoN has also placed a cap on total active projects of construction companies at five, which could limit growth prospects.

Exposure to volatile interest rate

Nepalese banking sector has a floating interest rate regime, where a certain premium is added to the quarterly base rate and interest rate is changed accordingly on quarterly basis. The base rates of the banks and financial institutions (BFIs) in Nepal remain quite volatile as they are impacted by available liquidity in the system which leads to change in interest rates. The volatility in interest rate is more evident currently on account of the ongoing liquidity stress in the economy. Furthermore, increased bank rates announced in the Monetary Policy for FY23 is likely to add to the upward pressure on interest rates going forward. Any significant rate hikes could put increased interest burden on the company, squeezing its profitability and impacting its liquidity position. Therefore, funding taken by the company from BFIs is subject to volatile interest rate.

Risk of delay in project execution

Given the nature of projects awarded, ACPL is exposed to inherent risk in terms of delays in certain projects undertaken by the company due to delay in procedural approvals and clearance of project sites, etc, thus exposing the company towards the risk of delay in projects resulting in a delay in the realization of revenue growth. Furthermore, the company ability to execute a project in timely manner would be led by its own operational efficiency and timely stage payments received from clients.

Key Rating Strengths**Experienced promoters and moderate track record of operations**

ACPL is promoted by Mr. Amod Jung Thapa, Managing Director, who has been leading the company since November 2012. Mr. Thapa has experience of more than two decades in the construction sector which bodes well for the overall business prospects of the company in an increasingly competitive industry. He is responsible for planning business strategies of the company. Furthermore, the board is supported by an experienced team across various functions. The company has moderate track record of operations of around a decade in the construction of various infrastructure projects all over Nepal.

Moderate order book position with diversified projects

As on May 08, 2022, the unexecuted orders in hand of the company stood at Rs. 894 Mn, which is 9.51x of the income from contract of FY21, providing moderate revenue visibility. The order book is moderately diversified and consists of various construction projects but remain primarily concentrated towards building projects (~60%) and others include laying/installation of underground optical fibre cable, road, bridge and hydropower projects by entering into JVs. Timely completion of the projects would be critical for the business prospects of the company and also has a direct bearing on its margins.

Moderate counter party risk

Revenue of ACPL is generated via contracts from both government departments and private parties. The order book is primarily concentrated towards building projects from government departments. Counter party risk remains moderate given the projects are from government departments, which have been making timely payment to the company in the past.

About the Company

ACPL is a Class "D" construction company of Nepal incorporated on November 17, 2011 with its registered office based in Kathmandu, Nepal. The company is involved in building construction, optical fibre installation and maintenance, road construction. In addition to doing projects independently, ACPL also enters into Joint Ventures (JVs) with other companies in order to meet the eligibility criteria for different construction projects.

Financial Performance

For the Period	(Rs. Million)		
	FY19 (A)	FY20 (A)	FY21 (A)
Income from Operations	143	81	94
PBILDT Margin (%)	32.28	44.02	44.73
Overall Gearing (times)	1.33	1.16	3.18
Total Outstanding Liabilities/Tangible Net worth (times)	2.51	2.01	3.53
Interest Coverage (times)	2.32	2.93	2.20
Current Ratio (times)	1.21	1.07	1.04
Total Debt/Gross Cash Accruals (times)	2.26	4.81	14.11

A: Audited

Annexure 1: Details of the Facilities Rated

Name of the Bank Facilities	Type of the Facility	Amount (Rs. In Million)	Ratings
Long Term Bank Facilities	Term Loan	16.49	CARE-NP BB- [Double B Minus]
Short Term Bank Facilities	Fund Based Limits	455.66	CARE-NP A4 [A Four]
Long Term/ Short Term Bank Facilities	Non Fund Based Limits	2,096.10	CARE-NP BB-/ A4 [Double B Minus/ A Four]
Total		2,568.25	

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About CARE Ratings Nepal Limited:

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