

Sagun Construction

Ratings

Instrument / Facilities	Amount (Rs. Million)	Rating ^[1]	Rating Action
Long-term Bank Facilities	145.90 (Increased from Rs. 102.87 Mn)	CARE-NP BB [Double B]	Reaffirmed
Short-term Bank Facilities	50.00	CARE-NP A4 [A Four]	Reaffirmed
Long-term/ Short-term Bank Facilities	1,304.10 (Reduced from Rs. 1,347.13 Mn)	CARE-NP BB/ A4 [Double B/ A Four]	Reaffirmed
Total Facilities	1,500.00 [Rs. One Billion and Five Hundred Million Only]		

Details of instrument / facilities in Annexure-1

CARE Ratings Nepal Limited (CRNL) has reaffirmed rating of 'CARE-NP BB' for the long-term bank facilities and 'CARE-NP A4' for the short-term bank facilities of Sagun Construction (SGC).

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities of SGC continue to be constrained by its short track record of operations, working capital intensive nature of business due to high collection period, tender based nature of operations, highly competitive construction industry, proprietorship nature of constitution and exposure to volatile interest rate. The ratings are further constrained by low profitability levels and risk of delay in project execution

The ratings, however, derive strength from experienced proprietor, moderately leveraged capital structure and debt service coverage indicators of the firm. The ratings also factor in the escalation clause in majority of the contracts and moderate order book position.

Ability of the company to successfully execute projects in time and recover contract proceeds, maintaining its profitability margins and capital structure will be key rating sensitivities. Further, ability to manage its working capital requirements and improve its orderbook will also be the key rating sensitivity.

Detailed description of the key rating drivers

Key Rating Weaknesses

Short track record of operations and low profitability margins

SGC commenced its business operations in 2015 and has a relatively short track record of operations as compared with other established players. 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 while executing the same remain crucial from analytical perspective. Furthermore, the company has almost stable total operating income (TOI) which stood at Rs. 625 Mn in FY20 (audited, refers to 12 months period ended mid-July, 2020). However, the proprietor has around two decades of experience in execution of construction contracts through his association with other construction companies which partially offsets this risk. Furthermore, during FY21 (based on provisional results), TOI of the company increased significantly and stood at Rs. 1,574 Mn.

Being a relatively new player in the industry, the firm has to bid aggressively for being a successful bidder which results into low profitability margins. PBILDT margin remained range bound between 7-8% in FY19 and FY20. Furthermore, high interest and depreciation expense restricted the net profitability in FY20. During FY21, PBBILDT and PAT margins have shown improvement on account of execution of better margin contracts.

¹Complete definitions of the ratings assigned are available at www.careratingsnepal.com

Higher collection period leading to elongated operating cycle

The company has high operating cycle on account of elongated collection period. Furthermore, the operating cycle has been increasing on y-o-y basis in the last 3 FYs (FY19-FY21). Normally the bills are realized within 45-60 days; however, on account of higher billing towards financial year end, the average collection days stood high on the balance sheet dates. Though the collection period is high, debtors default risk is negligible as majority of the customers are government departments.

SGC has to maintain minimum inventory at different sites for smooth execution of contracts and billing of the work done is normally on milestone / monthly basis based on the approvals from the respective employers leading to an average inventory holding of around 30 days in last 2 financial years (FY20 – FY21) and the firm receives a payable period of around two months from its suppliers; entailing all lead to high operating cycle.

Tender based nature of operations leading to highly competitive nature of industry

The firm majorly undertakes government contracts either directly or on sub-contract basis, which are awarded through the tender-based system. The tender-based business is characterized by intense competition and the growth of the business depends on its ability to successfully bid for the tenders and emerge as the lowest bidder. The concentration on government contracts also makes the company susceptible to any changes pertaining to government policy in regard to awarding tenders to contractors. Moreover, the company is dependent on government spending for the total capital expenditure presented in the union budget every year.

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.

Risk of delay in project execution

SGC's business is susceptible to the financial loss arising out of delay in project execution, as generally, there is a penalty clause for delay in contract execution. However, SGC has relied on the experience of its management team with strong project execution skills which has enabled the company to build satisfactory standing in the industry as indicated by the repeat orders awarded by its clients.

Key Rating Strengths**Experienced promoter and associate entities involved in construction fields**

SGC being a proprietorship firm is managed by Mr. Sahadev Khadka. He has extensive work experience of around two decades in the field of construction business and is looking after the overall affairs of the firm. The proprietor is further supported by an experienced team across various functions/ departments. The proprietor has also been infusing funds to support financial requirements of the firm.

Moderate capital structure and debt service coverage indicators of the firm

Total debt of the firm increased by Rs. 101 Mn to Rs. 186 Mn as on mid-July, 2020 over previous balance sheet date and total debt comprising term debt of Rs. 60 Mn, working capital loan of Rs. 35 Mn, unsecured loans from family / friends of Rs. 77 Mn and mobilization advance of Rs. 13 Mn. The capital structure of the firm stood moderate marked by debt equity ratio of 1.09x and overall gearing ratio (including mobilization advance) of 1.48x at the end of FY20 (consolidated

basis). The gearing ratio deteriorated on the balance sheet date of FY20 over previous balance sheet date mainly due to fund infused by the proprietor in the form of loans to fund operations of the firm. The average utilization of the company remained moderate at 48.63% during 12 months period ended mid-July, 2021. Interest coverage ratio of the firm was moderate at 3.55x while Total debt/ Gross Cash Accruals was high at 6.66x in FY20.

Escalation clause in majority of the contracts

The firm has inbuilt price escalation clauses in majority of contracts (both government and private contracts) in order to insulate the firm from any adverse fluctuation in construction material prices and labour expenses. This enables the firm to pass on increase in raw material prices to its customers. Ability of the firm to pass on increased price burden to the customers in a timely manner and maintain profitability margins is critical from credit perspective.

Moderate order book position with short term revenue visibility and diversified projects

The unexecuted orders in hand of the firm stood at Rs. 2,771 Mn as on July 25, 2021 which is approximately 1.76x of its total operating income for FY21 (on consolidated basis) providing short to medium term revenue visibility. The order book of the company has been diversified towards infrastructure projects and civil construction projects. Timely completion of the projects and thereby increasing its scale of operations would be critical from the credit perspective for SGC.

Analytical Approach

CRNL has analyzed SGC's credit profile by considering the standalone financial statements comprising SGC and its joint venture entities related to the construction works.

About the Company

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 civil construction works, water supply & sanitation works, road works, bridge works, irrigation projects, embankment works etc. across Nepal. SGC also enters into joint venture (JV) with other companies in order to meet the eligibility criteria for the projects.

Financial Performance

(Rs. Million)

For the Period Ended / as at Mid-July,	2019	2020
	(12m, A)	(12m, A)
Total Operating Income	624	625
PBILD Margin (%)	6.04	7.00
Overall Gearing Ratio (times)	1.08	1.48
Total Outstanding Liabilities/Tangible Net worth (times)	2.88	2.54
Interest Coverage (times)	3.78	3.55
Current Ratio (times)	1.35	2.04
Total Debt/Gross Cash Accruals (times)	3.78	6.85

A: Audited

Annexure-1: Details of Instrument / Facilities

Name of the Instrument / Bank Facilities	Type of the Facility	Amount (Rs. in Million)	Rating assigned
Long Term Bank Facilities	Term Loan	145.90	CARE-NP BB
Short Term Bank Facilities	Fund Based Limits	50.00	CARE-NP A4
Long Term/ Short Term Bank Facilities	Non-Fund Based Limits	860.00	CARE-NP BB/ A4
Long Term/ Short Term Bank Facilities (Proposed)	Non-Fund Based Limits	444.10	CARE-NP BB/ A4
Total		1,500.00	

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About CARE Ratings Nepal Limited:

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