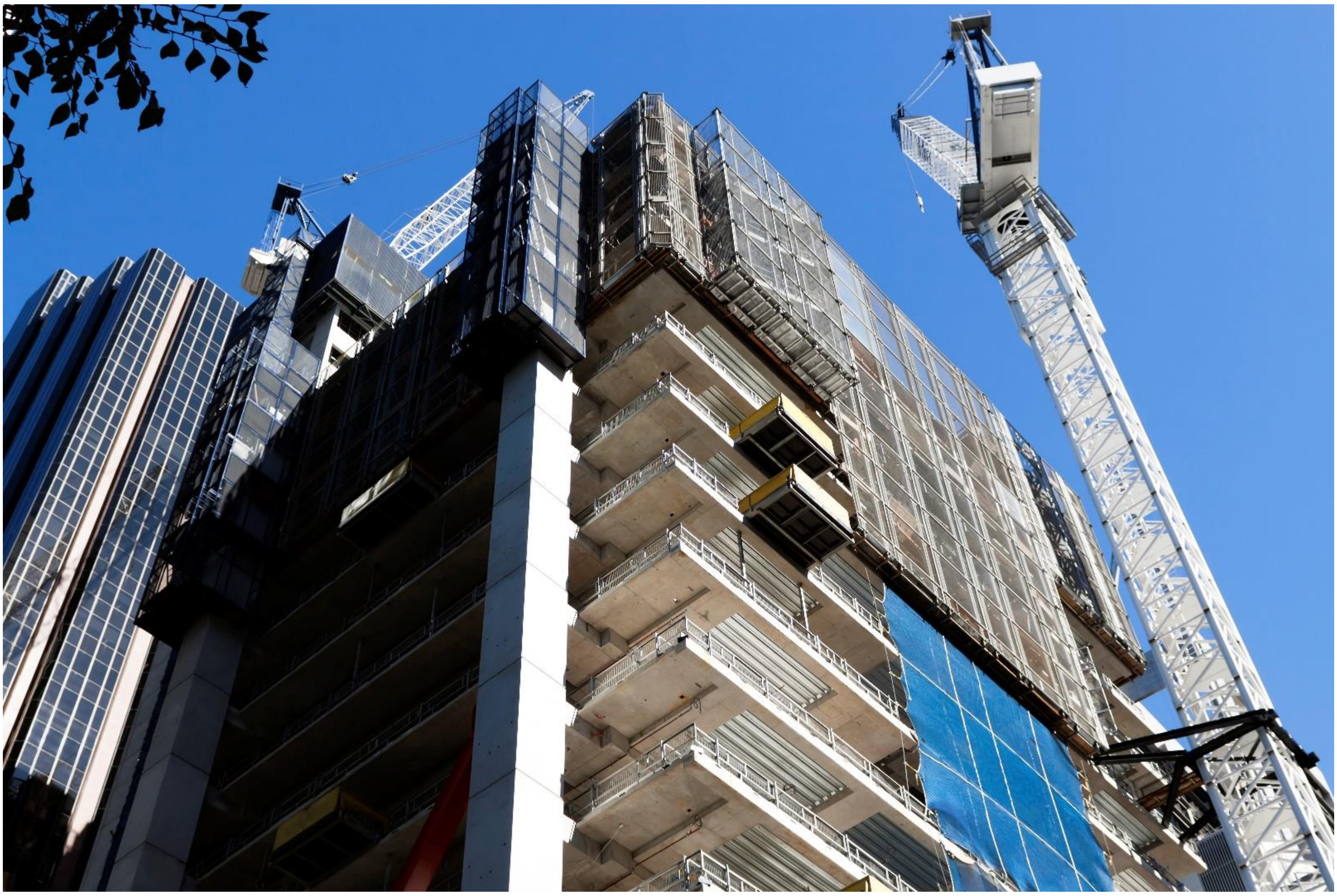
Deconstructing a slump

The construction industry in a pandemic-hit fiscal

June 2020



Construction industry hits a wall

The extended lockdown to stem the Covid-19 pandemic has compounded India's growth woes. Along with external risks such as weak global demand, supply disruptions, and global financial shocks, the economy now faces factory shutdowns, reduced discretionary spending, and delayed capex cycle.

The construction industry, which mirrors the economy, is expected to take a huge blow from all this. A CRISIL Research analysis indicates a 12-16% contraction in construction investments for the industry this fiscal to Rs 7.3 lakh crore from Rs. 8.6 lakh crore in fiscal 2020.

The estimate factors lower capex by central and state governments due to diversion of funds towards healthcare, public welfare and social obligations. This, at a time when their finances are already strained and gross budgetary support to infrastructure is expected to decline due to lower revenue receipts. Budgetary allocation to infrastructure by the central government for fiscal 2021, is lower compared with fiscal 2020.

It also factors the lockdown impacting construction activity and movement of labour in the first half of fiscal 2021.

With construction activities deferred, players in the construction sector are expected to log a 13-17% drop in revenue in fiscal 2021. What's worse, earnings before interest, taxes, depreciation and amortisation (Ebitda) margins are estimated at 4-6% for the fiscal, down from 7-9% expected in the preceding one.

First quarter to draw a blank

With the continuing lockdown, labour issues and supply chain disruptions, CRISIL research believes the current quarter will be a washout.

The government has allowed construction of roads in rural belts and irrigation and renewable energy projects in virus-free zones or regions with no positive cases in the preceding 28 days from April 20.

However, construction companies face challenges in arranging transportation and accommodation for labour, maintaining social distancing at construction sites, obtaining clearances from district officials for intra- and inter-district projects, and ensuring raw material availability.

Industries such as transportation, quarrying, steel, cement and forging need to be up and running for meeting the raw material requirements of the construction sector. Add to this the workforce issues and the need to have permits and clearances in place before construction can resume, the sector is likely to take some time to return to normalcy even after the lockdown is lifted.

The bulk of construction activity, therefore, will likely resume only in the third quarter this fiscal.

Revenue outlook for the construction industry this fiscal

Quarter	Share in demand (trend)	On-year growth	Impact	Takeaways
Q1 FY21	20%	(80-70)%	High	• Shortage of migrant labour • Government directive to employers to pay labour for the duration of lockdown, to see delays in return of labour
Q2 FY21	22%	(9-7)%	Medium	• Second quarter is seasonally weak due to monsoon, affecting construction activity • Workforce strength improving • Rural belt to see traction with Pradhan Mantri Awas Yojana – Grameen (PMAY-G) and Pradhan Mantri Gram Sadak Yojana (PMGSY)
Q3 FY21	25%	13-15%	Low	• Workforce strength returns to pre-lockdown levels • Completion of stuck projects
Q4 FY21	33%	22-24%	Low	• Pick-up in pace due to pent-up demand and lower base effect • Ministries' backload spending to meet allocations • Growth mainly due to low base of Q4FY20

Source: CRISIL Research

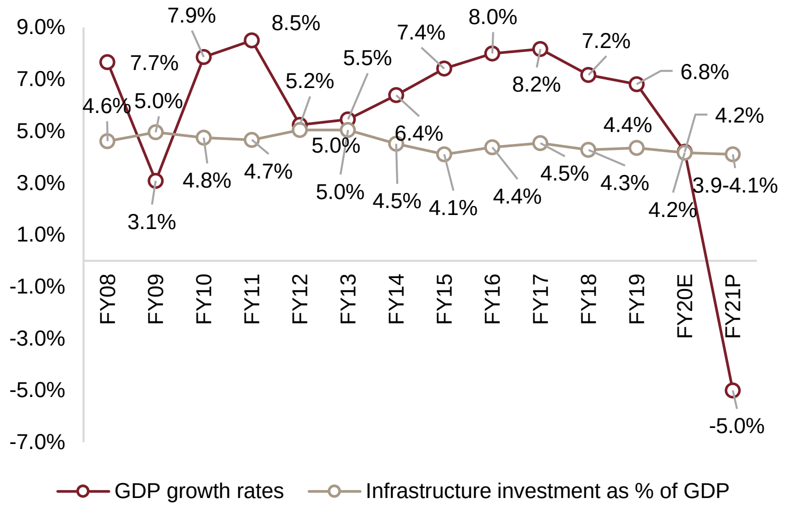
Construction investment components

Note: 1) The split is over fiscals 2017 to 2019

2) Infrastructure segment comprises roads, railways, power, urban infrastructure (metro, water supply systems, smart cities), airports, warehouses, ports, irrigation and telecom towers

Source: CRISIL Research

Infrastructure spend as a proportion of GDP on a downtrend, Covid-19 to steepen decline



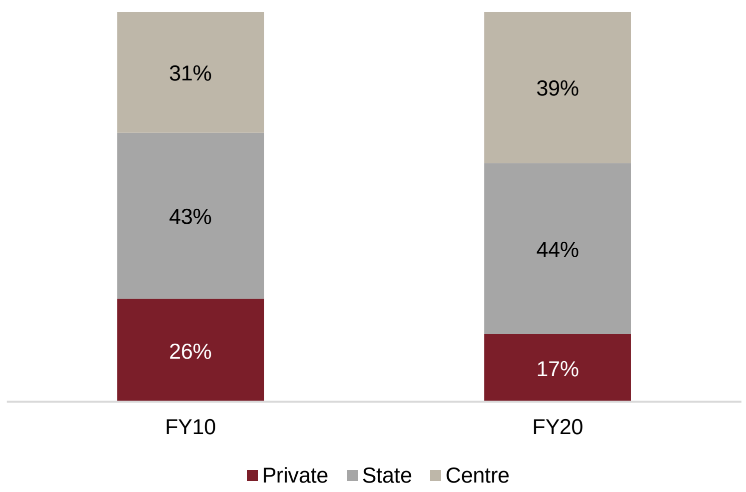
Note: 1. GDP growth rates for GDP at constant prices with FY12 base

2. GDP at current rates used for infrastructure as % of GDP

Source: CRISIL Research, Ministry of Statistics and Program Implementation

Infrastructure investments as a proportion of gross domestic product (GDP) stagnated between 4.5% and 5% till fiscal 2017, and have moved lower since then. The Covid-19 pandemic and subsequent nationwide lockdown till May 31 are likely to result in a drop in infrastructure investments as funds are diverted for meeting healthcare and social spends such as feeding and housing migrant labourers, paying for shramik train fares, and procuring personal protective equipment.

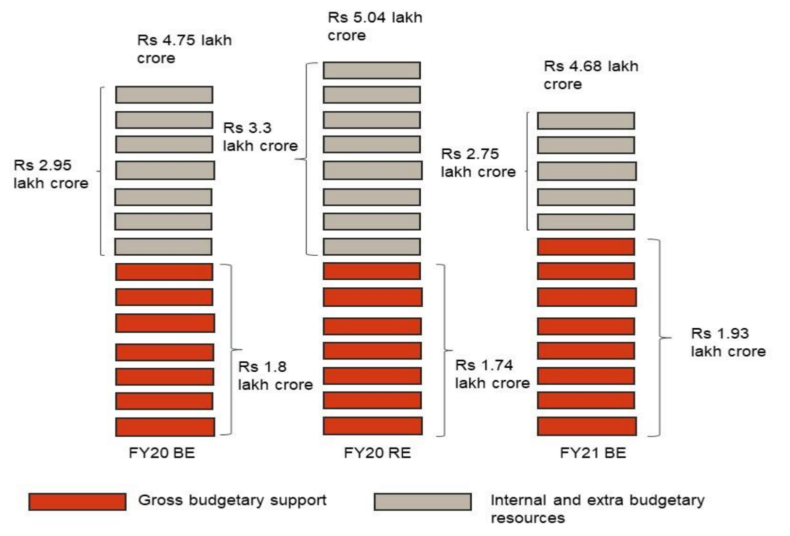
Higher dependency on public funds for construction spends



Source: CRISIL Research

The share of private spending has fallen from ~26% in fiscal 2010 to ~17% in fiscal 2020 as public–private partnership (PPP) models have failed to take off in most infrastructure sectors, except airports and roads, due to private entities having to bear majority of the risks in PPP models.

Drop in budgetary allocations pre-Covid not a good sign for infrastructure sector



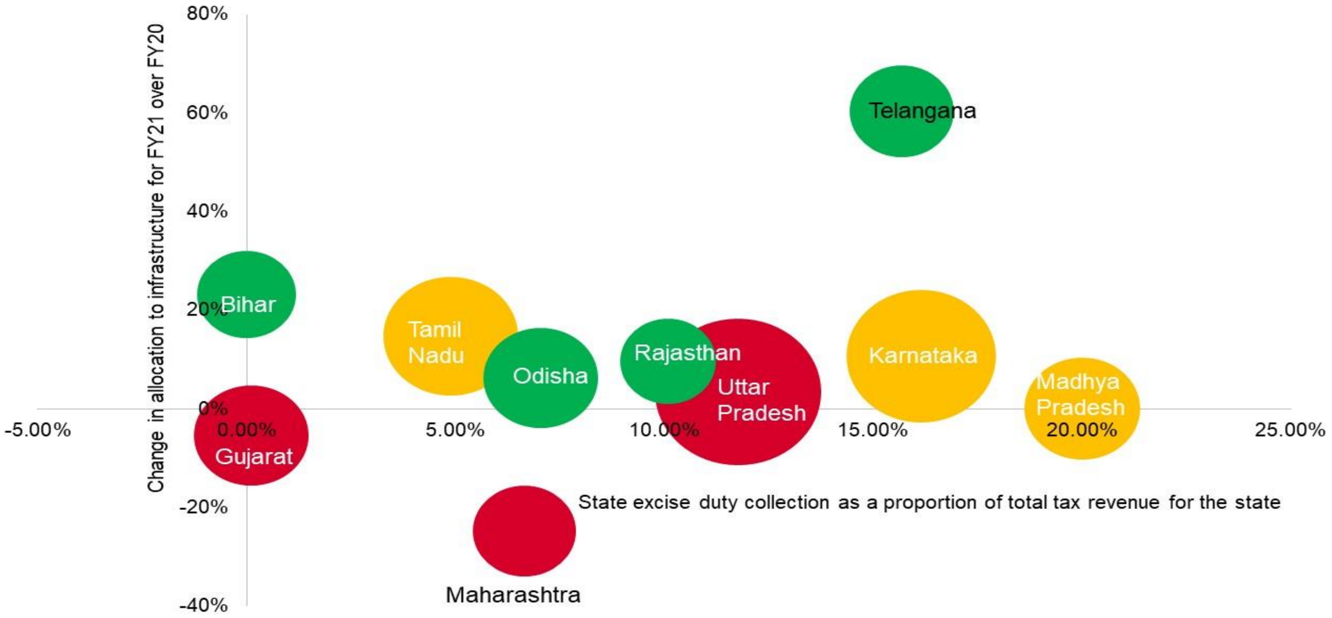
Source: Union budget documents, CRISIL Research

The budgetary allocation for fiscal 2021 for the sector witnessed a 7% decline over the revised estimate for fiscal 2020. The proportion of gross budgetary support increased to ~41% of the total budgetary allocation in fiscal 2021 from ~35% in fiscal 2020. The pandemic and the subsequent lockdown will impact government revenue receipts as direct and indirect tax collections are expected to be hit with the reduction in economic activity. The turmoil in the global economy and financial markets would also impact the external borrowing capability of the central and state governments.

States' infra allocations had fallen even before the pandemic struck

Allocation to infrastructure for fiscal 2021 has moderated even for states with higher spends on the sector.

Uttar Pradesh, Maharashtra and Gujarat, which account for 26% of the pie have seen a decline in outlay compared with the previous fiscal, while for Karnataka, Tamil Nadu and Madhya Pradesh, which account for 24%, it is flat.



Note: 1. Size of the bubble indicates FY21 budget estimates for capex investments in Rs crore

2. Green colour indicates on-year growth in infra spends for FY21 is higher than the last 3 years' average; Yellow colour indicates on-year growth in infra spends for FY21 is around the last 3 years' average; Red colour indicates on-year reduction in infra spends for FY21 over the last 3 years' average

Source: CRISIL Research, state budget documents

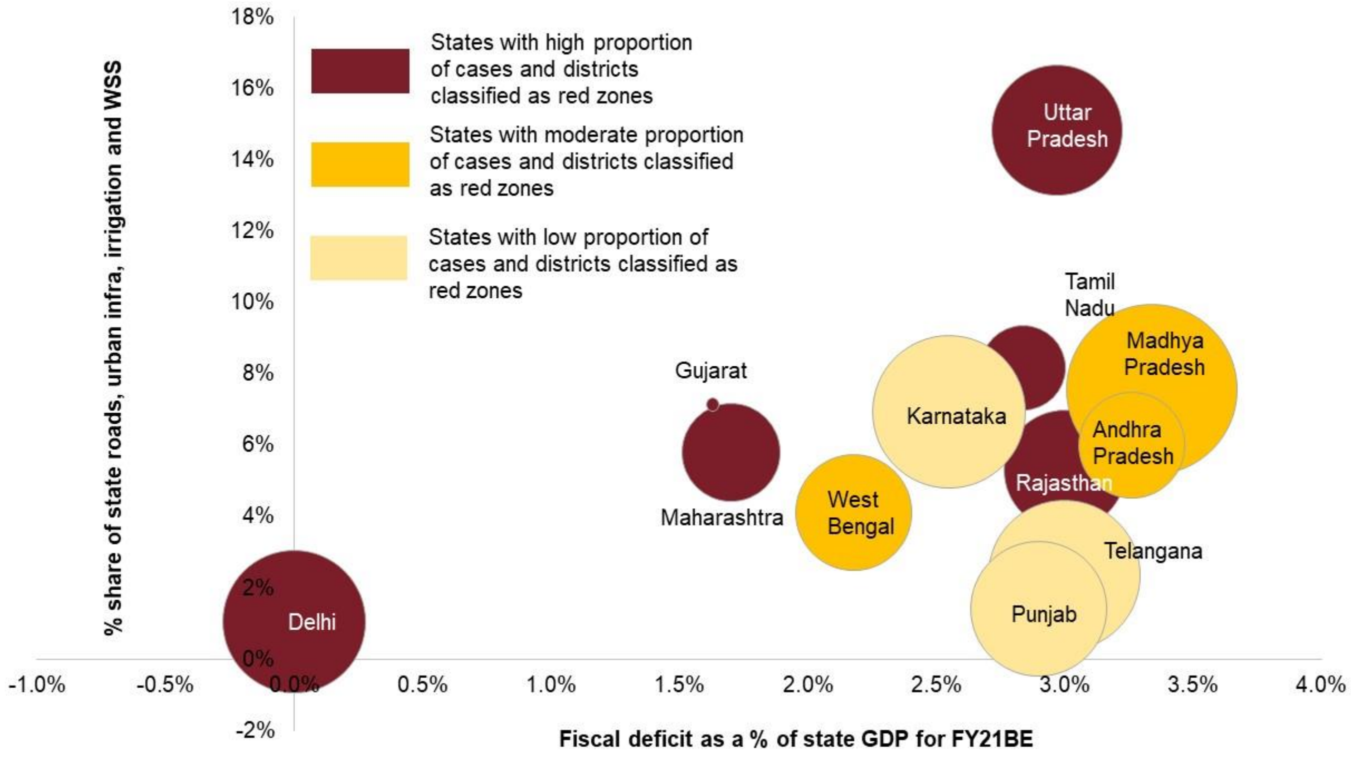
States most affected by Covid-19 among top spenders on infra

States contribute the bulk of investments in urban development, water supply systems (WSS) and irrigation sectors.

However, with many of the top-spending states hit hard by the pandemic, and the subsequent lockdown, the priorities have shifted.

To add to their woes, state excise duty collections (on alcohol and fuel) are likely to drop as alcohol sale was banned for a month post lockdown imposition and fuel consumption has reduced to a trickle.

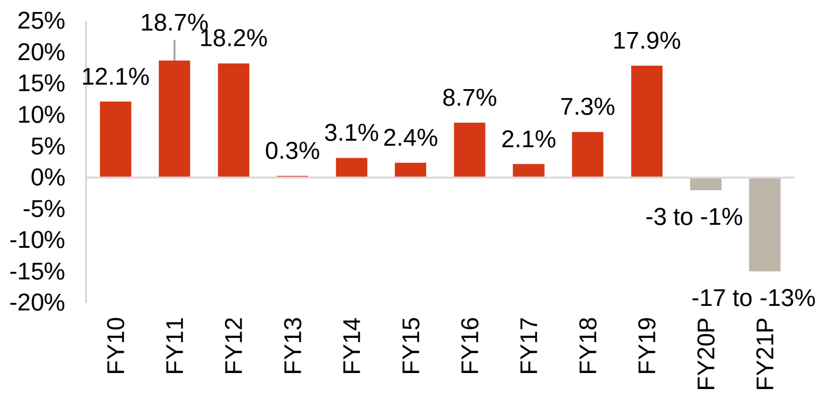
Consequently, investments in these sectors are likely to be hit as states utilise funds for meeting healthcare – which is a state subject – and social expenses arising due to the pandemic.



Note: Size of the bubble indicates budgeted state excise duty as a percentage of total tax collections for FY21

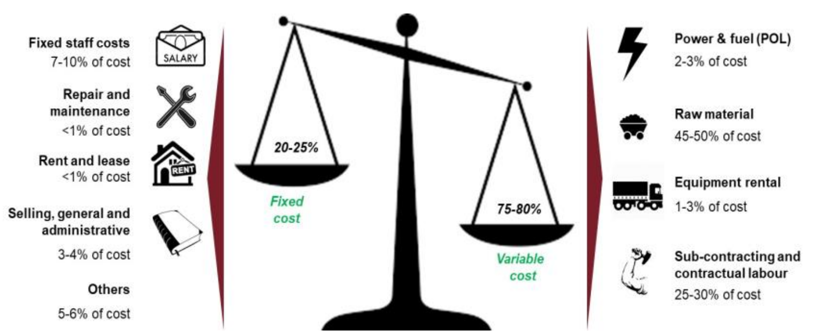
Source: Ministry of Health and Family Welfare, state budget documents, CRISIL Research

Revenue set to decline second year in a row



Construction firms are expected to see a 13-17% on-year drop in revenue due to the suspension of construction activities and slow pick-up post lifting of the lockdown. The sector is likely to return to normalcy only in the third quarter of fiscal 2021.

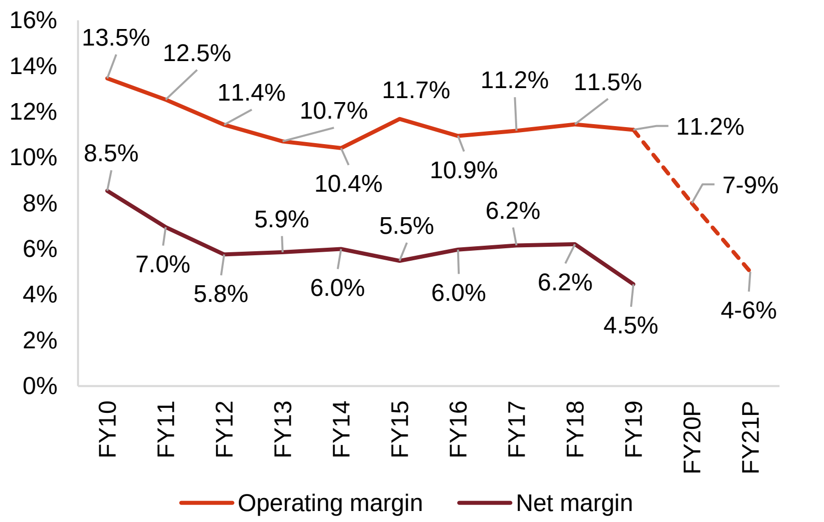
Lower proportion of fixed costs to cushion margins for construction firms



Source: CRISIL Research

Construction firms typically have a higher proportion of variable costs related to raw materials, electricity charges, equipment rentals and daily labour costs. Fixed costs are limited to compensation of full-time staff, maintenance of equipment and rentals.

Ebitda margin at an all-time low



CRISIL Research expects Ebitda margin for the sector to contract 200-300 basis points to 4-6% in fiscal 2021 from estimated 7-9% in fiscal 2020.

Higher proportion of variable costs for construction firms cushion the margin from a sharper drop in revenue. Benefits of lower inputs costs are unlikely to improve margins of players as most contracts have in-built material price escalation clauses

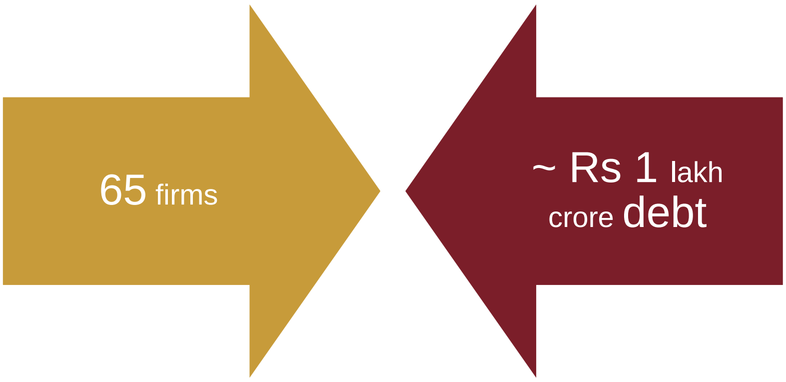
At the net level, players may make losses.

Note: The sample set includes 65 listed companies in the construction sector

Source: CRISIL Research, company reports

50% of debt among listed 65 players indicate weakening of profiles

A sample analysis of 65 firms with a total debt of ~Rs 1 lakh crore as of September 2019, threw up interesting results.



- 37 firms, accounting for 57% of the sample and holding 39% of the sample's debt, have an interest service coverage ratio (ISCR) below 1, while 12 firms, accounting for 18% of the sample and holding only 7% of the debt, have a comfortable ISCR above 3
- 24 firms holding 49% of the sample's debt have a relatively high net debt/Ebitda ratio above 3
- 31% of the sample's debt has a quick ratio less than 0.1

Interest service coverage ratio	No. of firms	Debt
<1	**57%**	**39%**
1-3	25%	54%
3-5	**12%**	**5%**
>5	6%	2%
	65	~Rs 1 lakh crore

Net Debt/EBITDA ratio	No. of firms	Debt
<0	23%	13%
0-1	**20%**	**2%**
1-3	20%	37%
>3	**37%**	**49%**
	65	~Rs 1 lakh crore

Quick ratio	No. of firms	Debt
<0.1	**28%**	**31%**
0.1-0.5	39%	59%
0.5-1	20%	10%
>1	13%	<1%
	65	~Rs 1 lakh crore

Note: 1. ISCR = EBIT/Interest for H1FY2020

2. Net Debt/EBITDA = (Total Debt – Cash)/ EBITDA. Debt is as on 30/09/2019 while EBITDA is on TTM basis i.e. H2FY2019 and H1FY2020

3. Quick ratio = (Debtors + Cash)/Current Liabilities as on 30/09/2019

Source: CRISIL Research, company reports

Roads EPC players relatively better off, real estate players may need course correction

Analysis of the sample split by type of construction activities (road players, diversified construction and real estate) indicate road players have a healthier credit profile compared with diversified construction firms and real estate players, in terms of ISCR, Net Debt/Ebitda and quick ratios.

	Road players	Diversified construction	Real estate players
Interest service coverage ratio	3.5	1.1	1.2
Net Debt/EBITDA	2.8	4.2	4.7
Quick ratio	0.4	0.3	0.1
No. of firms	6	29	30
Debt	9% of sample's debt	59% of sample's debt	32% of sample's debt

Note: 1. Road players and Diversified construction firms are considered on a standalone basis while Real estate players contain 10 consolidated and 20 standalone players

2. ISCR = EBIT/Interest for H1FY2020

3. Net Debt/EBITDA = (Total Debt – Cash)/ EBITDA. Debt is as on 30/09/2019 while EBITDA is on TTM basis i.e. H2FY2019 and H1FY2020

4. Quick ratio = (Debtors + Cash)/Current Liabilities as on 30/09/2019

Source: CRISIL Research, company reports

Annexure

Funding pattern for infrastructure sub-sectors

Private	14-16%	20-30%	10-15%	0-10%	<1%	<1%	30-40%
Public	84-86%	70-80%	85-90%	90-100%	~100%	~100%	60-70%
Central	46-48%	25-30%	85-90%	30-35%	0-10%	20-30%	35-40%
State	36-40%	40-55%	<1%	60-65%	90-100%	70-80%	25-30%

Note: Numbers are for fiscal 2020

Source: CRISIL Research

State funds contribute close to 45% of spends on infrastructure. While some sectors are solely dependent on state funding, others get a lion's share of the central contribution. Private spending is already at an estimated all-time low of 17% in fiscal 2020 compared with 26% in fiscal 2010. It is expected to further dip in fiscal 2021 with the revenue of private players and capacity utilisation of their existing projects impacted significantly.

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