CONSTRUCTION GRADING

CARE Ratings

Professional Risk Opinion

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ABOUT CARE

CARE Ratings is an India-headquartered full-service credit rating company that offers a wide range of credit rating and grading services across sectors besides in-depth market research on various industries. CARE has an unparalleled depth of expertise in this field and the methodologies pursued are congruent with the best international practices. CARE follows a rigorous process in rating and has a unique system of an External Rating Committee appraising each and every proposal. This has lent a cutting edge advantage in terms of rating being professional, unbiased and credible.

CARE Ratings, since its inception in April 1993, has completed over 8,600 rating assignments valued at around Rs. 26,960 billion as on October 31, 2010. CARE is now the second-largest rating agency in India. Its rating coverage extends to a variety of sectors covering Banks, Finance companies, Manufacturing sector, Services companies, Municipal bonds, Government-guaranteed debt, Insurance companies and Securitization transactions. CARE has a leadership position in terms of rating coverage in several sectors.

CARE is recognized by the capital market and monetary authorities of India, viz Securities and Exchange Board of India (SEBI), Government of India (GoI) and Reserve Bank of India (RBI). CARE was promoted by major Banks/Financial Institutions in India and the three main shareholders are IDBI Bank, Canara Bank and State Bank of India. CARE Ratings has seven offices in India. CARE Ratings provides/has MOUs for providing technical assistance to rating agencies in other countries such as Mexico, Bangladesh, Nepal and Ecuador.

CARE in Maldives

The Capital Market Development Authority (CMDA) has granted a license to CARE for credit rating/grading, research and information services in Maldives. CARE is the first credit rating agency to be granted such a license in Maldives.

CARE Products

CARE's Credit Rating is an opinion on the relative ability and willingness of an issuer to make timely payments on specific debt or related obligations over the life of the instrument. CARE undertakes credit rating of all types of debt and related obligations, quasi-debt and structured finance products.

CARE offers a variety of products in rating/grading such as:

- Credit Rating of Debt Instruments (CP, FD, Bonds, Debenture, Redeemable Preference Shares, Loans, CDs and Structured Obligations) along with Issuer ratings, Loan ratings, Recovery Ratings, Fund Credit Quality Rating, Rating of Capital Protection Schemes, etc.
- Securitisation Rating: ABS/MBS and Corporate Governance Ratings
- Other Rating Products - SME Rating, Infrastructure Rating
- Grading Products – Equity Grading, IPO Grading, Microfinance Institution (MFI) Grading, Grading of the Construction Entities, Grading of Courses Offered by Maritime Training Institutes (MTIs), Grading of Educational Institutes etc.
- Ratings in the Public Finance domain - Sub-Sovereign Rating, Urban Local Bodies (also under special schemes) /Municipal Bonds

CARE Research

CARE Research & Information Services is an independent division of CARE and is distinct in its in-depth knowledge of the Indian Economy and rigorous application of analytical tools thereby adding value to data points and information. The main products and services of CARE Research may be broadly classified as Customised Research providing need-based solutions and Sector Research concentrating on sector-specific trends and forecasts. Around 25 industries are presently covered through extensive research reports. CARE Research has also launched its special product termed 'Equi-grade' for an assessment of the fundamental quality of a company and the valuation of its equity shares.

Regular economic research reports are also put out by the Economics Division of CARE which monitor and analyse all major domestic and global economic developments.

GRADING OF CONSTRUCTION ENTITIES

The construction industry plays a key role in any economy. The sector assumes its importance by way of being a large consumer of resources, supporting a large ancillary industry and a significant employment generator. Growth of the sector is highly crucial to facilitate development of infrastructure. Government focus on infrastructure as a priority sector has permitted the entry of private and foreign investments in the core areas of power, ports, roads etc. Barring a handful of large companies, the industry set-up is characterised by the predominance of the small unorganised contractors. To counter the growing competition and keeping in view the rising outlays on construction projects, the larger companies in the sector are increasingly investing in capital equipment. Most contracts being awarded could be of a fixed turnkey type, which carry penalties and incentives for delay and early completion, respectively. The changing structure of the construction industry has paved the way for the organised sector to play a more active role in the development of the sector.

Need for a Grading system:

Lack of a reliable system to identify and allocate risks in the construction sector has led to the sector being unable to establish adequate comfort with investors and lenders. This has resulted in the sector being deprived of institutional and bank funds. Further, certain medium and large-sized companies believe that they are losing out on good projects in the bidding process to less-worthy competitors, owing to the policy of price cutting adopted by these fringe players. The larger companies have accordingly expressed a desire to get themselves graded, to separate from players with questionable credentials. Bearing in view, the large outlays typically involved in construction projects, a detailed planning of the project along with all other activities is essential to ensure timely implementation. The grading system aims to tackle this problem by evolving a framework to grade various entities in the construction sector.

Main entities in the Sector:

The main players in the construction sector to be graded are;

i. The Project Developer / Sponsor
ii. The Consultant
iii. Construction Contractor
iv. The Project

Grading of the above-mentioned entities would be in the nature of performance rating, as distinct from credit rating. Grading would be an opinion on the ability of the respective entity to carry out the stated objectives, within a specified time frame. The exercise involves an evaluation of business and financial risks facing each entity.

"Methodology for grading of entities in the construction sector"

The methodology for grading entities in the construction sector can be broken down into two principal elements:

(i) Operating Environment including the regulatory framework.

(ii) Managerial and Financial fundamentals

The criteria considered to assess these risks are discussed below:

I) GRADING OF PROJECT DEVELOPER / SPONSOR

A) Operational Risks

- Constitution
- Details of the promoters and their background
- Management Evaluation / Track Record
- Organisation Structure, Corporate Strategy
- Management Information Systems
- Details of group companies
- Examine the legal framework

- Technology

B) Financial Risk

- Existing financial position
- Leverage / Financial Flexibility
- Receivables management
- Expense levels / overheads
- Contingent liabilities

II) GRADING OF CONSULTANTS

A) Operational Risks

- Track record
- Engineering and design strengths
- Area of operation

B) Financial Risk

- Financial position
- Financial flexibility
- Cash flows
- Ability to pay liquidated damages

III) GRADING OF CONSTRUCTION CONTRACTOR

A) Operational Risks

- Constitution
- Area of operation
- Track record of project implementation
- Technical and engineering expertise
- Arrangement for insurance
- Order book

B) Financial Risk

- Financial position
- Funding sources
- Financial flexibility

IV) GRADING OF PROJECT

CARE's analysis focuses on risks associated with project implementation and its financing.

A) Operational Risk

- Comparison with similar projects implemented
- Evaluation of land acquisition needs
- Examining factors such as natural calamities, social disturbances
- Arrangements for periodic physical assessment of the project
- Statutory approvals and clearances to facilitate smooth progress
- Examine the legal framework
- Structuring and credit enhancements, if any

B) Financial Risk

- Funding profile
- Financial flexibility
- Liquidity / Cash flow adequacy
- Working capital management
- Accounting quality

Issues to be examined under the above heads are discussed briefly below:

Under **'Operational Risk'** analysis the following aspects are studied in detail:

- The Constitution of the entity viz. individual / company / public limited / private limited etc is examined.
- Credibility of promoter and his track record in executing projects is perhaps the single most important factor in analysing the quality of management. Credibility of the management becomes an important issue especially when the project is facing adverse circumstances.
- Management evaluation comprises examining the quality and reputation of the management / Board. This helps to analyse the strength of the management and its ability to cope with the changes or volatility in the market place. Key factors in evaluating the quality of management include its strategy, appetite for risk taking as also its philosophy towards accounting, financial management and corporate disclosure.

- Organisational Structure of the company is examined to study the extent of decentralisation. The systems that the management has in place to monitor progress of projects on a regular basis and to compare with project schedules are also studied. The quality of MIS is evaluated by studying the depth and relevance of information routinely generated.
- The performance of other companies (associates/subsidiaries) in the group is also assessed.
- In case of any technical collaboration, the nature of the arrangement is examined. Also the history of the collaborator and track record of projects implemented is considered. Description of technology, its likely obsolescence and comparison with technology of competitors - domestic / international is made.
- The legal framework is examined to ensure the smooth implementation of the project.
- Technical expertise is assessed to ascertain the overall project engineering skills. The order book is studied in terms of its size and composition. The average size of contracts is also taken into account.

Under '**Financial Risk'** analysis the following points are examined in detail:

- The existing financial position of the entity is reviewed. Overall gearing, interest coverage and their trends are taken as measures of financial risk arising as a result of funding decision.
- Funding profile - This is among the most important as it would determine the overall financial risk profile of the company. Composition of funding sources and the shift in funding profile over the years are studied in detail.
- Financial flexibility viz Ability to access various funding markets and raise capital from public/private sources in the event of any financial distress is taken into account. Alternative sources of raising finances could be unencumbered marketable securities, unutilised lines of credit, support from the group and ability to access capital markets to raise capital. This would be largely determined by reputation of the promoters.

- Alternative sources of liquidity such as marketable securities support from group companies, unutilised bank limits, etc are considered. Group support is assessed to ascertain if the company can depend on this support to tide over any financial distress.
- Working capital management comprising receivables management, debtors management etc. Cost structure is analysed to study the expense levels and their impact on overall profitability.
- Contingent liabilities are studied for their quantum and the impact they would have on the overall financial position of the company. Relevant adjustments are made to the overall gearing to reflect the financial risk.
- Ability of the entity to meet any claims for 'liquidated damages' in the event of its non-conformance to any contractual obligations is assessed.

BENEFITS OF THE GRADING SYSTEM:

- The exercise would facilitate the short listing and selection of quality entities, who in turn can get themselves empanelled with Government departments such as PWD, Municipal Corporations, Urban Bodies, etc.
- The proposed system would aid potential investors in making an objective assessment of the sector, thus enabling an increased flow of funds to the construction sector. The system also aides the entity in securing long-term finance at competitive rates.
- The grading process would also help in reducing the time involved in the tendering / bidding, as the project developer needs to invite bids only from the shortlisted entities.

Grading Symbols:

GRADING OF PROJECT CONSULTANTS

Grade / Symbol	Explanation
CC1	Technical, design and engineering strengths are very high. Ability to pay liquidated damages in the event of non-conformance to contractual obligations is very high.
CC2	Technical, design and engineering strengths are high but marginally lower than CC1 category. Ability to pay liquidated damages in the event of non-conformance to contractual obligations is high.
CC3	Technical, design and engineering strengths are moderate. Ability to pay liquidated damages in the event of non-conformance to contractual obligations is moderate. Assumptions that do not materialise may have a greater impact as compared to the consultants graded higher.
CC4	Technical, design and engineering strengths are inadequate. Ability to pay liquidated damages in the event of non-conformance to contractual obligations is low. Assumptions that do not materialise may have a greater impact as compared to the consultants graded higher.
CC5	Technical, design and engineering strengths are poor. The consultant has been unable to deliver as per contractual requirements.

GRADING OF PROJECT DEVELOPER

Grade / Symbol	Explanation
CD1	Competence in project management and arranging adequate funding for the project is very high.
CD2	Competence in project management and arranging necessary funding is high, though marginally lower than CD1 category.
CD3	Backing for the project either in terms of project management or arranging funding is moderate. Assumptions that do not materialise may have a greater impact as compared to the developers graded higher.
CD4	Backing for the project either in terms of project management or arranging funding is inadequate. Assumptions that do not materialise may have a greater impact as compared to the developers graded higher.
CD5	Track record in managing and completing projects is poor.

GRADING OF CONSTRUCTION CONTRACTOR

Grade / Symbol	Explanation
CCt1	Project execution capabilities are very high. Ability to pay liquidated damages for non-conformance to contractual obligations and to complete the project as per schedule and without any time overruns is very high.
CCt2	Project execution capabilities are high. Ability to pay liquidated damages for non-conformance to contractual obligations and to complete the project as per schedule and without any time overruns is high, though marginally lower than CCt1 category.
CCt3	Project execution capabilities are moderate. Ability to pay liquidated damages for non-conformance to contractual obligations and to complete the project as per schedule and without any time overruns is moderate. Contract completion can be affected by any adverse changes in the industry prospects. Assumptions that do not materialise may have a greater impact as compared to the contractors graded higher.
CCt4	Project execution capabilities are inadequate. Ability to pay liquidated damages for non-conformance to contractual obligations and to complete the project as per schedule and without any time overruns is inadequate. Contract completion can be affected by any adverse changes in the industry prospects. Assumptions that do not materialise may have a greater impact as compared to the contractors graded higher.
CCt5	Project execution capabilities are poor.

GRADING OF PROJECT

Grade / Symbol	Explanation
CP1	Very good project. All project risks have been identified and measures taken to contain these risks. Likelihood of project implementation as per schedule is the highest.
CP2	Good project. Likelihood of project implementation as per schedule is high though marginally lower than CP1 category.
CP3	Moderate project. The project risks are moderate and any change in assumptions or external factors can have an adverse bearing on timely project completion. Assumptions that do not materialise may have a greater impact as compared to the projects graded higher.
CP4	Weak project. Risk factors are high. Probability of adherence to project schedules is negligible. Assumptions that do not materialise may have a greater impact as compared to the projects graded higher.
CP5	Poor project. Chance of project failure is high.

A '+' or '-' sign may be shown after the assigned grading to indicate the relative position within the band covered by the grading symbol.

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