# Rating Criteria for Engineering, Procurement and Construction (EPC) Companies

## Executive Summary

Over the years, several types of contracts have evolved in the infrastructure projects in different forms of contracting from turnkey contract to packages-based contract, to lump sum, fixed price, and time bound contracts. One such form of contracting increasingly being adopted is Engineering, Procurement and Construction (EPC), wherein the responsibility of the design, procurement of material and construction lies with the contractor. In a typical EPC contract, the risk is shared between owner/developer and contractor. The onus of delivering the project for a guaranteed price within a fixed period lies with the contractor, with performance based on pre-committed standards. A company that enters a fixed-price contract would be exposed to increased prices, which could impact margins. In such a scenario, the risk of time and cost overruns shifts towards the contractors. However, the responsibility of land acquisition during project implementation, and operation and maintenance, and local issues after the completion of the project lies with the project owner (Principal). While subcontracting is a common phenomenon in this industry, the ultimate responsibility of executing the project remains with the EPC contractor. EPC contracts are not only limited to the urban infrastructure and construction industry but also have a presence in the power, renewable energy, airport development, marine, railways, industrial, tunnelling, mining, water resources, oil and gas sectors, among others.

The sharp focus of the government in Union Budget 2021-22 on boosting infrastructure, with the setting-up of a Development Finance Institution (DFI) and allocating Rs. 20,000 crore with a lending target of at least Rs. 5 lakh crore, presents immense opportunities for the infrastructure sector. The Indian EPC sector has both Indian and international EPC contractors. While several international EPC players have already established their presence in the Indian market in specific segments such as construction, some have recently entered India, and some are considering entering amid stagnant markets in Europe and the US. India witnessed growth in the construction development sector and is set to become the world's largest construction market by 2022. With the advent of various policy initiatives by the government (Housing for All, Smart City Mission, Regional Connectivity Scheme), the EPC sector stands to gain attractive opportunities for growth. The sector has been de-licensed and enjoys 100% FDI.

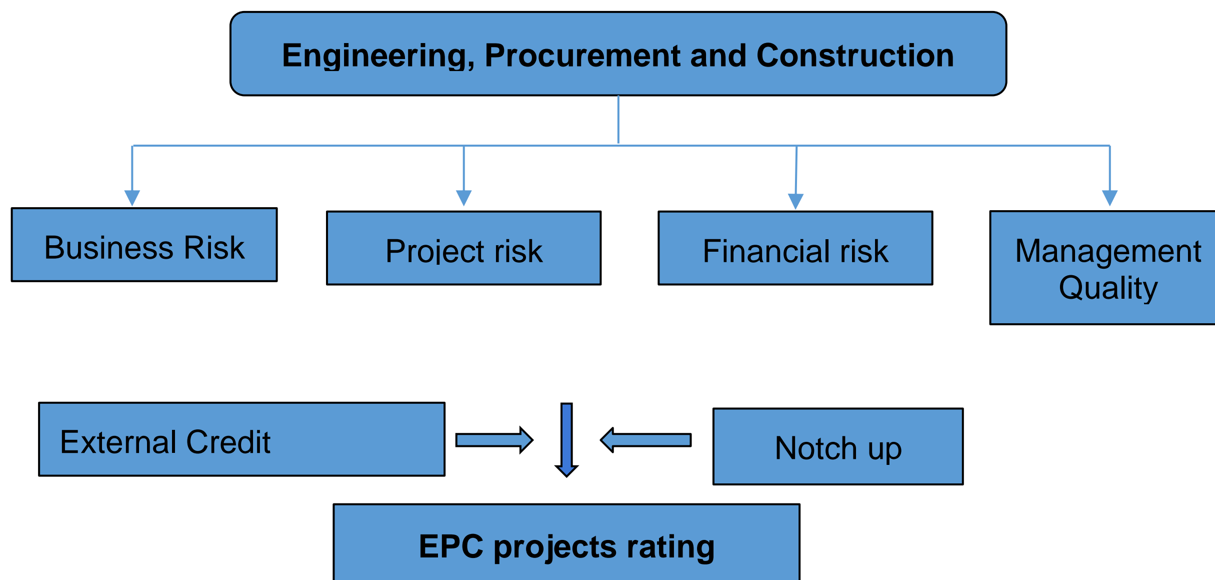
## Scope of the Criteria

The document provides a brief analysis of the attributes considered by Brickwork Ratings (BWR) in rating EPC projects. The scope of this document is to capture the key risks assessed by BWR while arriving at the rating of EPC companies. A brief summary of the effect of these attributes on the overall credit rating of EPC companies is highlighted, which helps ascertain the companies' debt servicing capability as against the generation of cash flow and the ability of these contractors to undertake large-scale projects.

## Risk Assessment and Rating Criteria at Brickwork Ratings

BWR factors in various quantitative and qualitative risks that the EPC companies are exposed to, while assessing the risks in these projects. As highlighted above, the key broad risks that EPC contractors may face during project implementation are business, industry, financial and management risks. These primary risks and how they are incorporated in the rating framework are discussed in detail below.

**Structure of EPC projects**




EPC contracts are exposed to multiple risks which, in general, can be bucketed under four main categories. Each of these categories can be further divided into multiple factors, the intensity and degree of which are assessed by BWR while assigning ratings to EPC companies.

### 1. Business Risk

a) **Competition:** The Indian construction industry is highly fragmented, with very low entry barriers and players of all sizes operating across India. While the margins for routine and run-off-the-mill EPC works get impacted due to this, the higher the complexity levels, the lower is the competitive intensity, leading to more protected margins. While assessing an EPC company, BWR would assess the extent of impact such a factor has had/ is likely to have on the entity.

b) **Track record:** An established player with a proven track record would be better placed from an execution perspective, which would enhance the issuer's credibility, and this would be reflected in the rating. BWR would assess the issuer's profile from a timely execution perspective and also assess if, historically, any penalty has been levied on the contractor. BWR also assesses if the escalation clause adequately captures the actual cost increases for the issuer.

c) **Order book:** The 'bread and butter' of an EPC company is the orders on hand, which reflect revenue visibility, and thus, the certainty of the company being able to sustain its operations. A diversified order book in terms of geography, clientele and segments augurs well for the overall profile of the issuer, which would essentially be integrated in the ratings. Higher diversification would imply that the cash flows are more insulated for any potential negative development at a specific geography or any specific client/segment.

d) **Adequacy of banking limits:** An essential part of an EPC company's operations is the adequate availability of working capital banking facilities, especially non fund-based limits, since around 20%-25% (of estimated project cost) equivalent of bank guarantees is the thumb rule requirement for a project to see the light of day. An issuer with higher available bank lines, ceteris paribus, would score more than an issuer starved of banking lines.

e) **Bid aggression:** A key determinant of the order book is the discount or premium (to the counterparty's estimated cost) at which the project is bagged. A history of consistently bagging contracts at a discount would not bode well for the issuer's credit profile.

f) **Counterparty risk:** The credit profile of the Principal (contract owner) invariably determines the timely flow of funds and thus, has a direct impact on the on-time execution of contracts. BWR also assesses concentration risk in the sense that a high exposure to few smaller counterparties may have a negative impact on the rating as against concentration to an entity with a better credit profile.

## 2. Project Risk

It includes all those uncertain events or conditions that occur during the construction phase of an EPC project, which may stall its progress.

a) **Asset mix:** Over the years, various contractors have evolved into developers, thus exposing them to funding tie-up risks and high leverage levels. These contractors-cum-developers are also committed to bringing in timely equity/ other forms of sponsor funds not only from implementation, but also to fund possible overruns. The exposure of an issuer to the arrangement of such funds (including possible shortfalls at the SPV levels) is assessed by BWR while arriving at the rating.

b) **Implementation risk:** The ability of entities to execute projects without cost and time overruns demonstrates expertise and also improves the chances of winning more projects in the future, given the tender-based nature of the construction industry. The experience of dealing with local issues is an important element for timely implementation. The experience of an issuer in executing projects in terrains similar to the ones present in the order book would work well for the overall ratings profile of the issuer. Access to capital equipment and a backward-integrated model would result in quicker execution and reduce implementation risks.

c) **Track record of sub-contractor:** For issuers where there is a history of subcontracting larger parts of the works, BWR would essentially assess the credentials of the subcontractors and the timely delivery of the project. Apart from this, BWR assesses the overall adequacy of resources viz. equipment, manpower, the ability to tie-up funds, project management systems and the overall ability of the company to execute the order book.

## 3. Financial Risk

Setting-up large projects requires huge sums of funding, and EPC projects mostly having long gestation periods are exposed to several financial risks during their construction and operating period. BWR assesses the following ratios to determine the extent of financial risks the EPC company is exposed to:

a) **Profitability ratios:** An EPC entity that follows a more transparent and consistent accounting approach would likely score. Given the variance in accounting policies, the assessment of various ratios whether from a cash flow-based approach or an accrued income perspective could tweak the ratios significantly. A sustained track record of an entity maintaining margins similar to industry benchmarks would augur well for the overall credit.

b) **Capital structure and coverage ratios:** These helps ascertain the level of debt held by contractors to gauge their ability to pay-off their interest and principal debt servicing obligations. A higher exposure to BOT projects could expose the issuer to higher leverage and an increased risk of incremental debt tie-up. While most BOT projects are funded on a non-recourse basis, BWR believes that the issuer, more often than not, either through explicit undertakings/guarantees or implicitly will be inclined to support its portfolio of projects. Thus, the assessment of risks in each project and the parent's ability to support the projects through the infusion of funds, when in need, would be critically evaluated.

c) **Cashflows-based approach:** Financial accounting policies and liquidity analysis are additional characteristics considered for EPC entities. As highlighted earlier, the buffer available in the banking limits are viewed favourably from a credit perspective. While the funds from operations denote stronger debt servicing ability, the cash flow from operations indicates an entity's ability to efficiently

manage its suppliers and debtors. The resultant leverage and coverage ratios ascertain the ability to pay-off fixed interest obligations.

d) **Dependency on promoters for equity funding:** EPC companies usually work in a very competitive environment, and to improve the chances of winning a bid or for meeting the eligibility criteria, many EPC companies bid for contracts through created SPVs. These SPVs are fully dependent on the promoter EPC (holding) companies for equity funding support. Quite often, an EPC company has multiple SPVs, supported by equity. Although the SPV wins the contract, execution is by the EPC company entrusted with the responsibility by the respective SPV. While multiple project orders result in potential higher cash inflows, it could also result in the utilisation of (limited) resources across projects and could hamper execution and thus, the margins.

### 4. Management and Corporate Governance

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets and also helps improve the financials of a company. BWR assesses the consistency of performance demonstrated by the management and the quality of corporate governance adopted by the entity. Red flags, if any, highlighted by internal or external stakeholders would negatively reflect in the rating. The financial flexibility of the management, tested by the empirical evidence of successfully supporting the group companies/projects, past track record of project execution and quality of corporate governance practices followed by the company, are factored in while assessing the company's overall credit profile.

## Conclusion

BWR primarily analyses issuers basis the above-mentioned risks and attributes, along with financial projections over the life of the facility and the adequacy of cash flows to meet debt service obligations to arrive at the overall assessment of the credit quality of an EPC contractor. While the methodology comprises the comprehensive analysis of various risks associated with project implementation, regulatory aspects, financial risk, industry, operational and business risk, and the competitive profile, the final rating is assigned based on overall credit assessment of EPC companies. Due to the long gestation period of construction projects, the financial profile of promoters, subcontractors and group companies associated with the project are critically assessed to service debt obligations.

**About Brickwork Ratings:** Brickwork Ratings (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by Reserve Bank of India [RBI], offers credit ratings of Bank Loan, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. BWR has rated over 11,400 medium and large corporates and financial institutions' instruments. BWR has also rated NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations. BWR has Canara Bank, a leading public sector bank, as one of the promoters and strategic partners. BWR has its corporate office in Bengaluru and a country-wide presence with its offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi along with representatives in 150+ locations.

**Disclaimer:** It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon the peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.
Brickwork Ratings India Pvt. Ltd. (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by the Reserve Bank of India [RBI], offers credit ratings of Bank Loan facilities, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. [hereafter referred to as "Instruments"]. BWR also rates NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations.

BWR wishes to inform all persons who may come across Rating Rationales and Rating Reports provided by BWR that the ratings assigned by BWR are based on information obtained from the issuer of the instrument and other reliable sources, which in BWR's best judgement are considered reliable. The Rating Rationale / Rating Report & other rating communications are intended for the jurisdiction of India only. The reports should not be the sole or primary basis for any investment decision within the meaning of any law or regulation (including the laws and regulations applicable in Europe and also the USA).

BWR also wishes to inform that access or use of the said documents does not create a client relationship between the user and BWR.

The ratings assigned by BWR are only an expression of BWR's opinion on the entity / instrument and should not in any manner be construed as being a recommendation to either, purchase, hold or sell the instrument.

BWR also wishes to abundantly clarify that these ratings are not to be considered as investment advice in any jurisdiction nor are they to be used as a basis for or as an alternative to independent financial advice and judgement obtained from the user's financial advisors. BWR shall not be liable to any losses incurred by the users of these Rating Rationales, Rating Reports or its contents. BWR reserves the right to vary, modify, suspend or withdraw the ratings at any time without assigning reasons for the same.

BWR's ratings reflect BWR's opinion on the day the ratings are published and are not reflective of factual circumstances that may have arisen on a later date. BWR is not obliged to update its opinion based on any public notification, in any form or format although BWR may disseminate its opinion and analysis when deemed fit.

Neither BWR nor its affiliates, third party providers, as well as the directors, officers, shareholders, employees or agents (collectively, "BWR Party") guarantee the accuracy, completeness or adequacy of the Ratings, and no BWR Party shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of the Rating Rationales or Rating Reports. Each BWR Party disclaims all express or implied warranties, including, but not limited to, any warranties of merchantability, suitability or fitness for a particular purpose or use. In no event shall any BWR Party be liable to any one for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Rating Rationales and/or Rating Reports even if advised of the possibility of such damages. However, BWR or its associates may have other commercial transactions with the company/entity. BWR and its affiliates do not act as a fiduciary.

BWR keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of the respective activity. As a result, certain business units of BWR may have information that is not

available to other BWR business units. BWR has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

BWR clarifies that it may have been paid a fee by the issuers or underwriters of the instruments, facilities, securities etc., or from obligors. BWR's public ratings and analysis are made available on its web site, www.brickworkratings.com. More detailed information may be provided for a fee. BWR's rating criteria are also generally made available without charge on BWR's website.
This disclaimer forms an integral part of the Ratings Rationales / Rating Reports or other press releases, advisories, communications issued by BWR and circulation of the ratings without this disclaimer is prohibited.

BWR is bound by the Code of Conduct for Credit Rating Agencies issued by the Securities and Exchange Board of India and is governed by the applicable regulations issued by the Securities and Exchange Board of India as amended from time to time.