



India Construction Sector – Moving Forward

Apr 2015

Key messages

- Construction sector is today facing a severe financial crisis which is fast becoming an existential one
- There are solutions that are doable and can be rapidly implemented
- The Construction Industry is important and essential for the success of every major program announced by the Government, and will contribute substantially to creating new jobs (15M jobs need to be created each year for the next 20 years)

India construction sector – key issues

Claims related

- **Delays in claims settlement/payment** across different Govt employers
 - Claims awarded by Arbitrators normally challenged in court by employer (~6.5 yrs to settle; 85% of claims raised currently pending*)
 - Settlement delays force contractor to fund the project

Banking & financing related

- **Banks encash BG's immediately upon presentation** (within 48 hours) which does not give contractors time to react
- **Extremely restrictive conditions** on lending and restructuring of bad debts

Contracts related

- **Non-standardized contracts with various unfair clauses e.g.,**
 - Unconditional BG encashment
 - Interest on advance payments, provisions for both retention and performance BGs, etc.

We propose five action items for the Government to help solve issues faced by the construction sector

- 1 Direct employers to pay ALL unsettled claims that have been awarded by Arbitrators, till date
 - Employers to be allowed to float bonds to make payments, if faced with fund issues
- 2 RBI to issue new directive to banks to inform contractors promptly and wait at least 30 days before BG encashment
- 3 EPC companies should be considered under definition of infrastructure. RBI to allow 5:25 financing structure for construction sector. Presently, only infrastructure owners are considered as infra companies. Also, relax guidelines classifying CDR and NPAs
- 4 Mandate employers to pay claims certified by Independent Engineers/ awarded by Arbitrators, before challenging these further
- 5 Push for standardized contracts across all employers which have:
 - Internationally followed conditions for BG encashment (eg, documented explanation of breach of obligation by contractor)
 - No interest on mobilization advance or mobilization advance paid as a work-related milestone item
 - Either retention money clause or performance BGs, not both
 - Condition on employer to pay compensation for time overruns not attributable to contractor along with milestone payments (to be certified by independent engineer)

Construction sector is essential part of the economy, and will contribute to the success of every govt. program

CONTRIBUTES TO ECONOMIC GROWTH AND EMPLOYMENT GENERATION

- **Directly contributes 8% (~INR 4T*)** of India's GDP
- **Generates growth in other sectors** through 1.8-2x multiplier effect
 - Backward: Construction materials (steel, cement etc.)
 - Forward: Manufacturing, Real estate etc.
- **Amongst India's largest direct employers** (~10% of total workforce, 46M people); **generates indirect employment** in other sectors

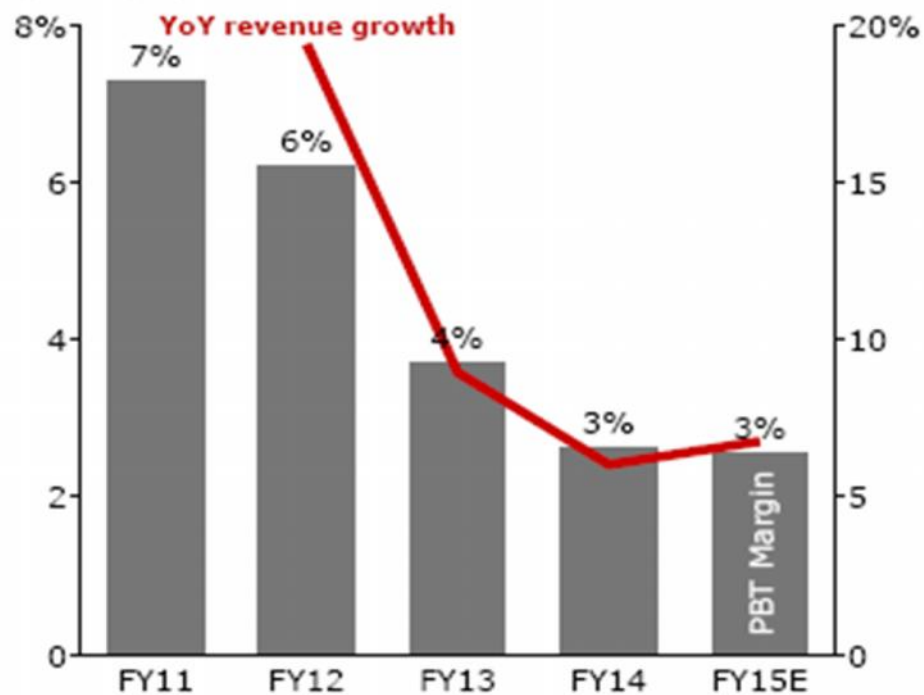
ESSENTIAL FOR SUCCESS OF MAKE IN INDIA

- Almost all Make in India **sectors rely on good infrastructure** (High quality transportation networks , uninterrupted power, Industrial clusters etc.)
- Development of supporting infra (100 smart cities, 7 greenfield electronics mfg. clusters, etc.)
- Waste mgmt. & public health facilities to be built across India as part of Swachh Bharat Abhiyan and various other initiatives such as growth of SMEs, strengthening India's Infrastructure (power, freight, etc.)

Indian construction industry is in a financial crisis today, with companies facing an existential threat

REVENUE GROWTH AND PBT MARGINS HAVE DECLINED SIGNIFICANTLY

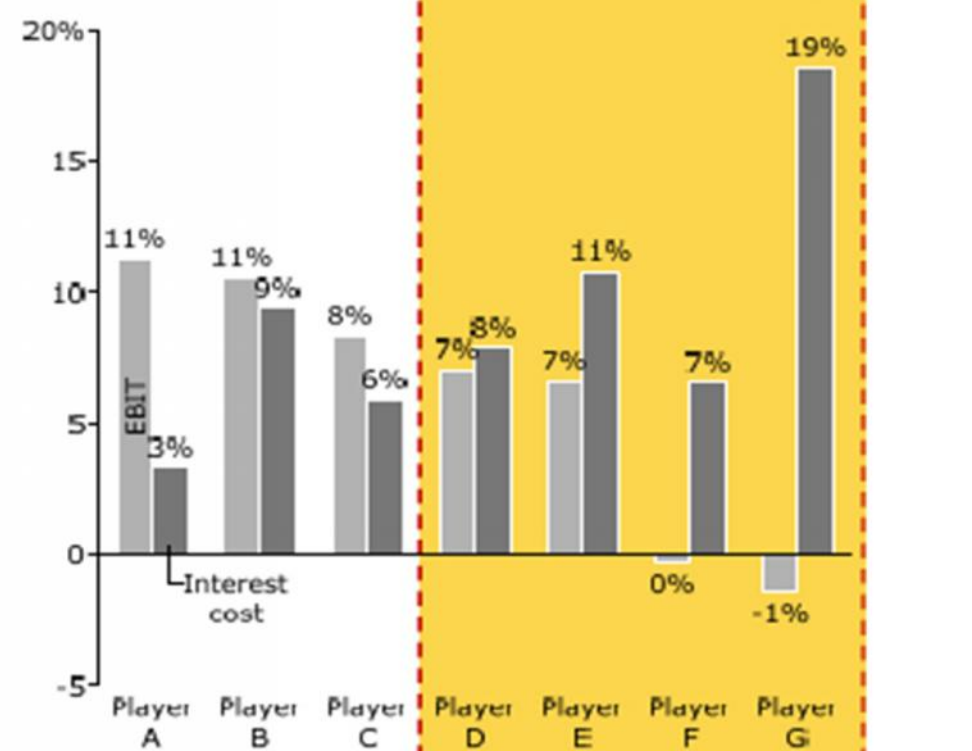
PBT margin of top EPC players



YoY revenue growth of top EPC players

MOST COMPANIES UNABLE TO COVER INTEREST COSTS FROM EARNINGS

EBIT and interest costs as a % of revenue (FY14)

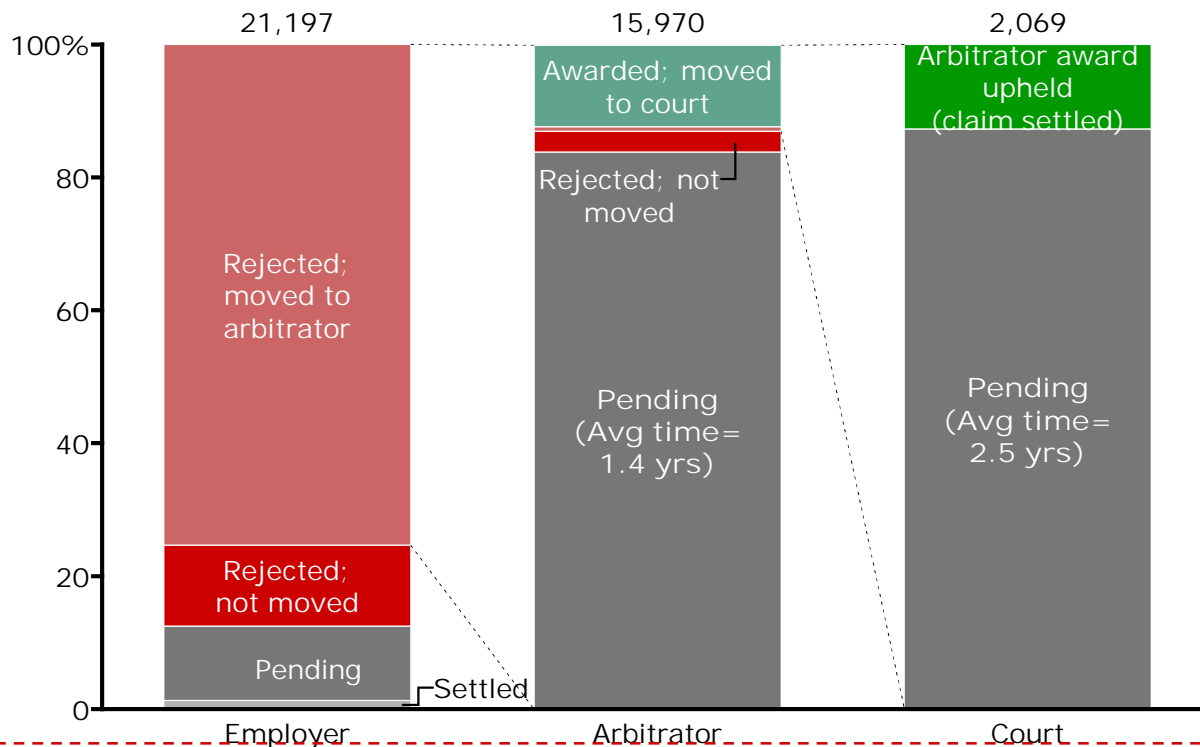


Crisis is driven by unsettled claims; ~85% claims raised are still pending and average settlement time is ~6.5yrs

PRELIMINARY

DATA SHOWN FOR 7 TOP EPC COS*

Claims for Govt projects (WIP and completed in last 3 years, INR Cr.)



Time taken for decision (Years)	Employer	Arbitrator	Court
	1.1	3.1	2.5**
% pending of total claims at each stage	11%	84%	87%

KEY OBSERVATIONS

- ~84% claims are pending
 - 11% at employer, 64% at arbitrators, 8.5% at Courts
- It takes average 6.7 yrs to settle a claim
- No "awarded claims" get settled after the Arbitrator's decision
- Almost all court orders uphold the arbitrator's decision
 - Referring claim to judiciary only helps employers delay payout by 2.5 years

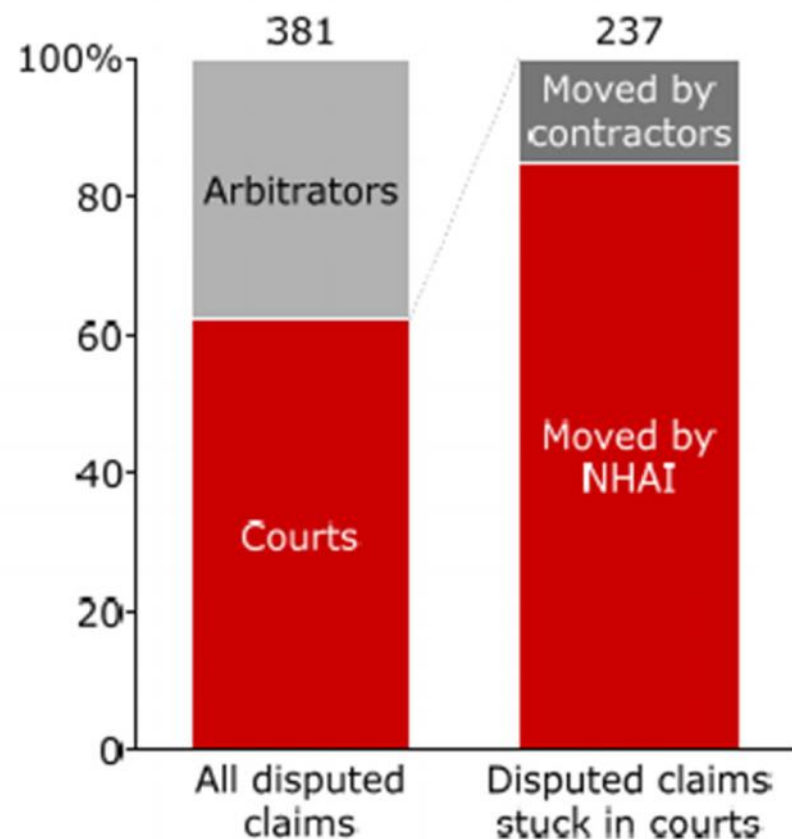
*Data shown for HCC, PLL, IVRCL, NCC, Ramky & C&C Infra; ** ~50% cases settled after >2 years (from analysis of 25 Delhi HC cases in last 12 months related to claims settlement for NHAI, NHPC and NTPC)

Source: Internal data; Delhi HC case database

Employers almost always take awarded claims to courts to delay payments; courts normally uphold arbitrators' decisions

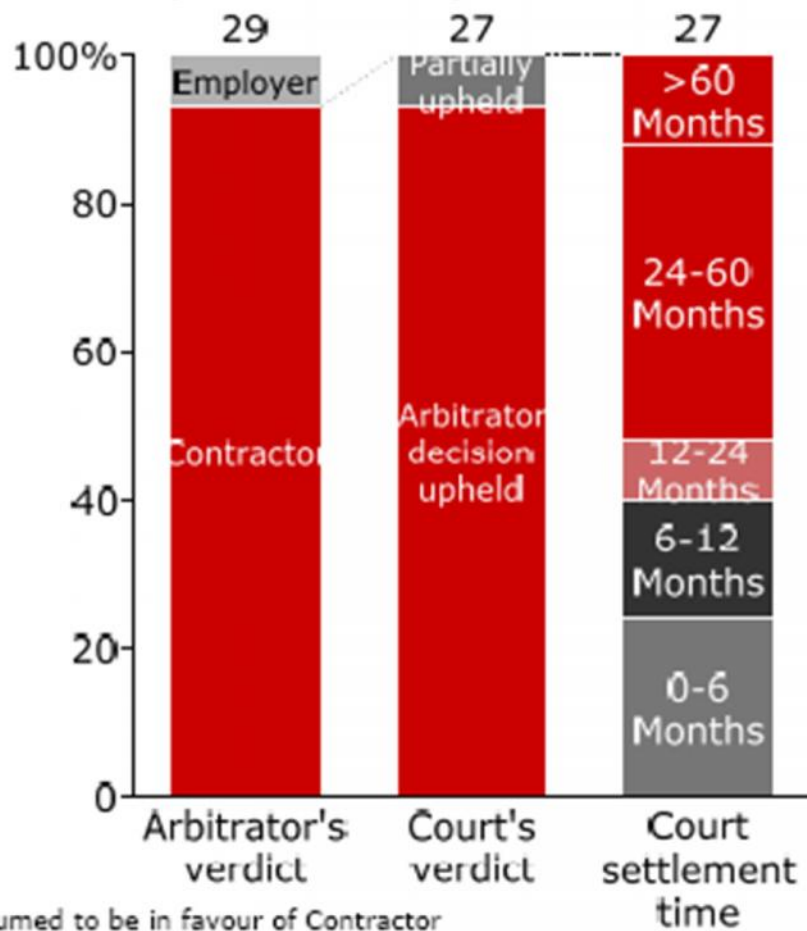
STATUS OF DISPUTED CLAIMS

No. of NHAI disputed claims as of Mar 2015



VERDICT OF COURT SETTLED CLAIMS

Number of NHAI/NTPC/RVNL claims settled by Delhi HC (last 12 months)



Note: Arbitrator's verdict where portion of claim is awarded to contractor is assumed to be in favour of Contractor

There are significant time & cost overruns in projects across sectors, which lead to claims

PRELIMINARY

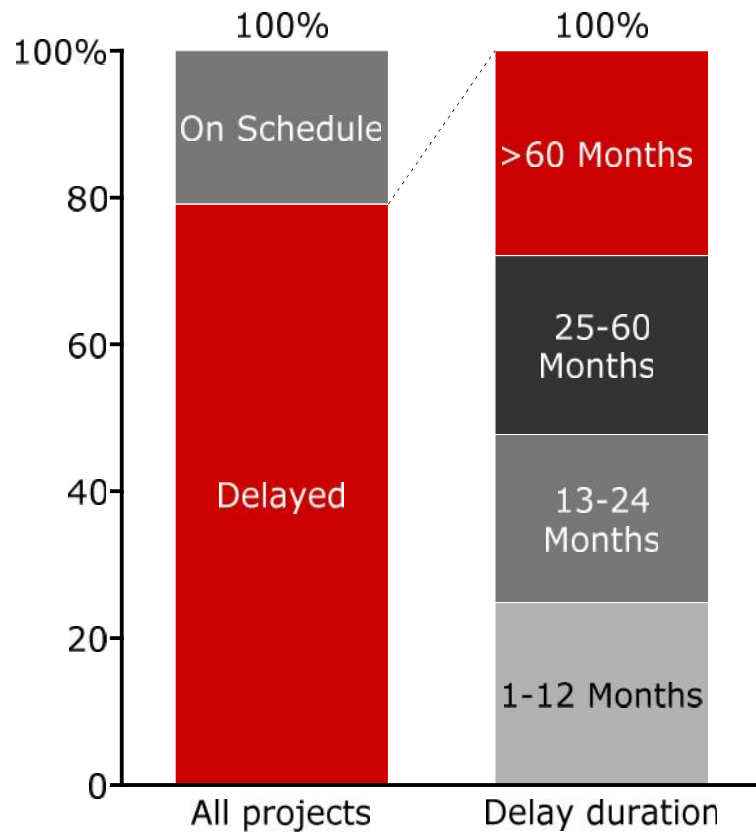
TIME OVERRUN:

~80% DELAYED; ~30% DELAYED BY >5 YRS

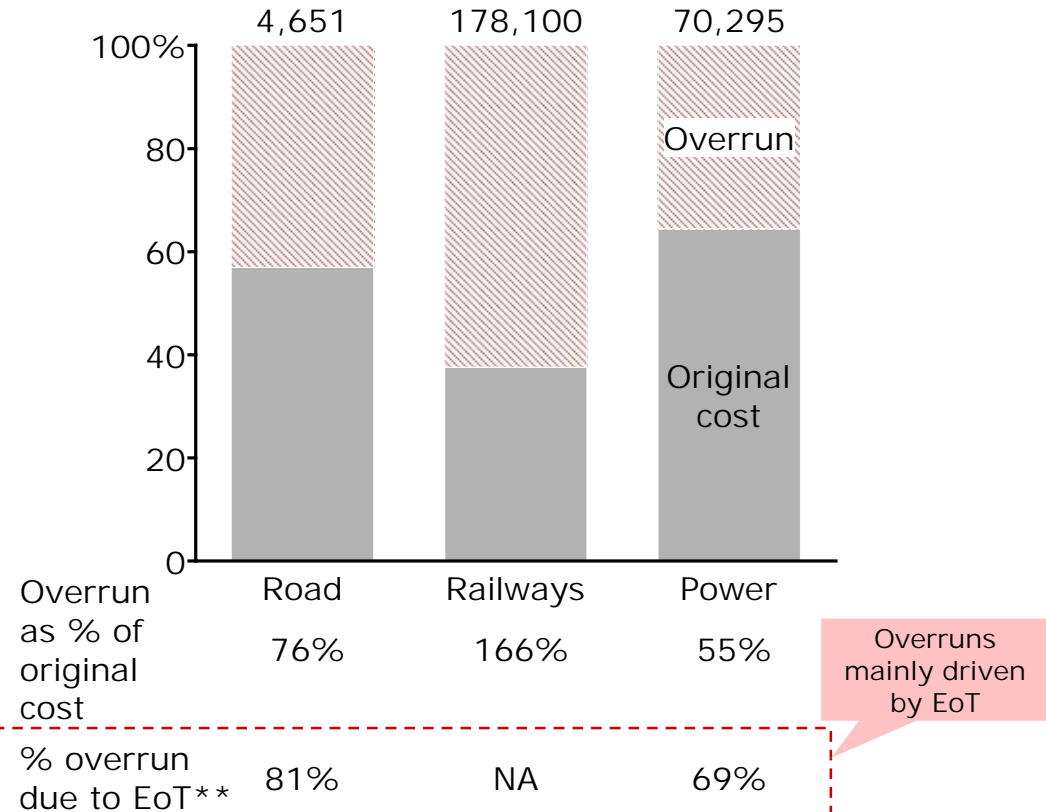
COST OVERRUN:

55-165% OVERRUN OVER ORIGINAL COST

Sample of projects tracked by MoSPI*



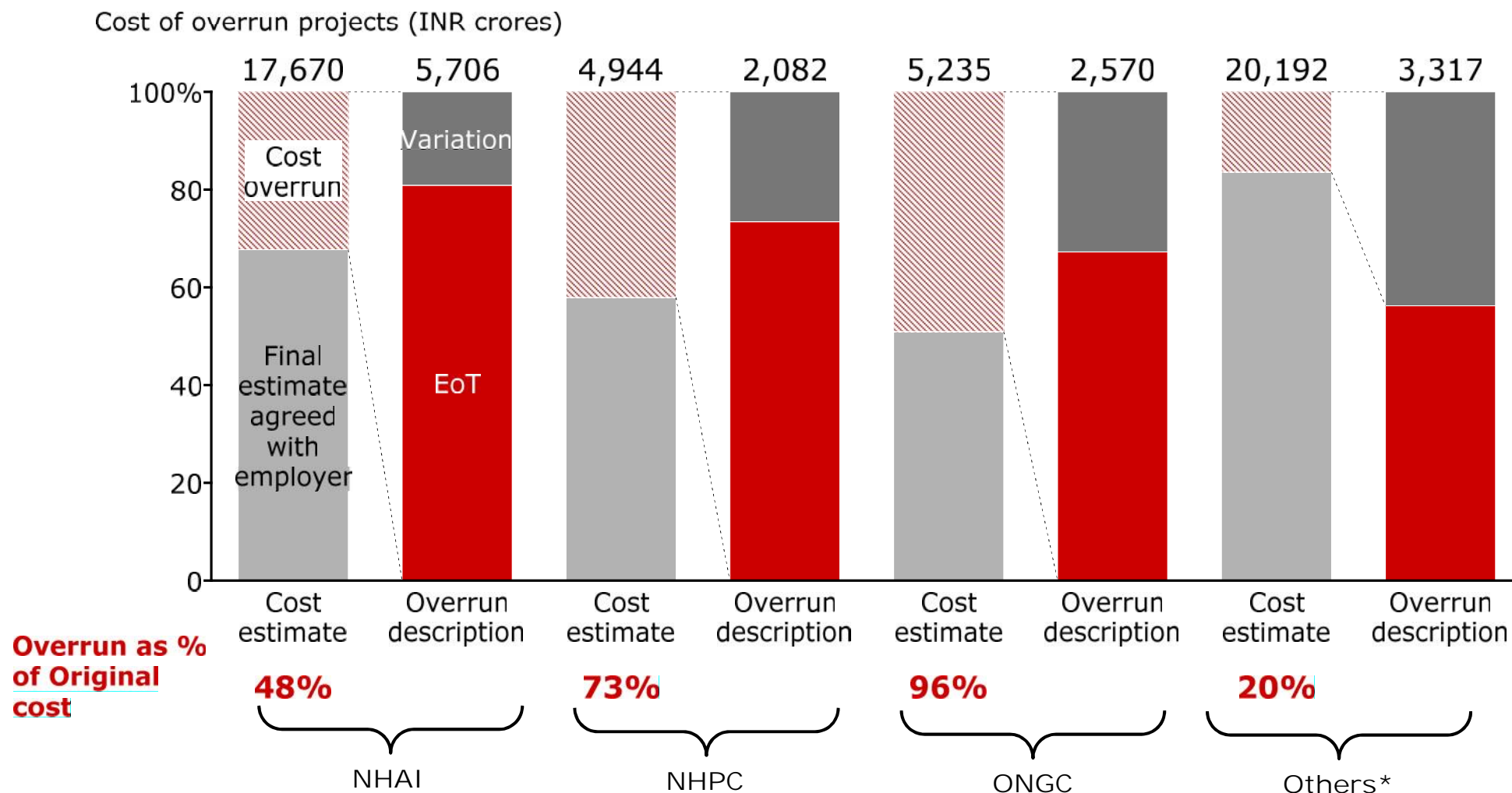
Cost of overrun projects* (INR crores)



*Includes central sector projects of value INR >150 cr and a defined commission date; data as of Oct 2014 as reported by MoSPI; ** From analysis of overrun data for projects completed in last 3 years or WIP for HCC, IVRCL and PLL (NHAH data used for Roads and NHPC & NTPC for Power); Overrun data only available for 9 Rail projects
Source: MoSPI

Projects across different Govt employers suffer from cost overrun of 50-100%, primarily driven by EoT

PRELIMINARY

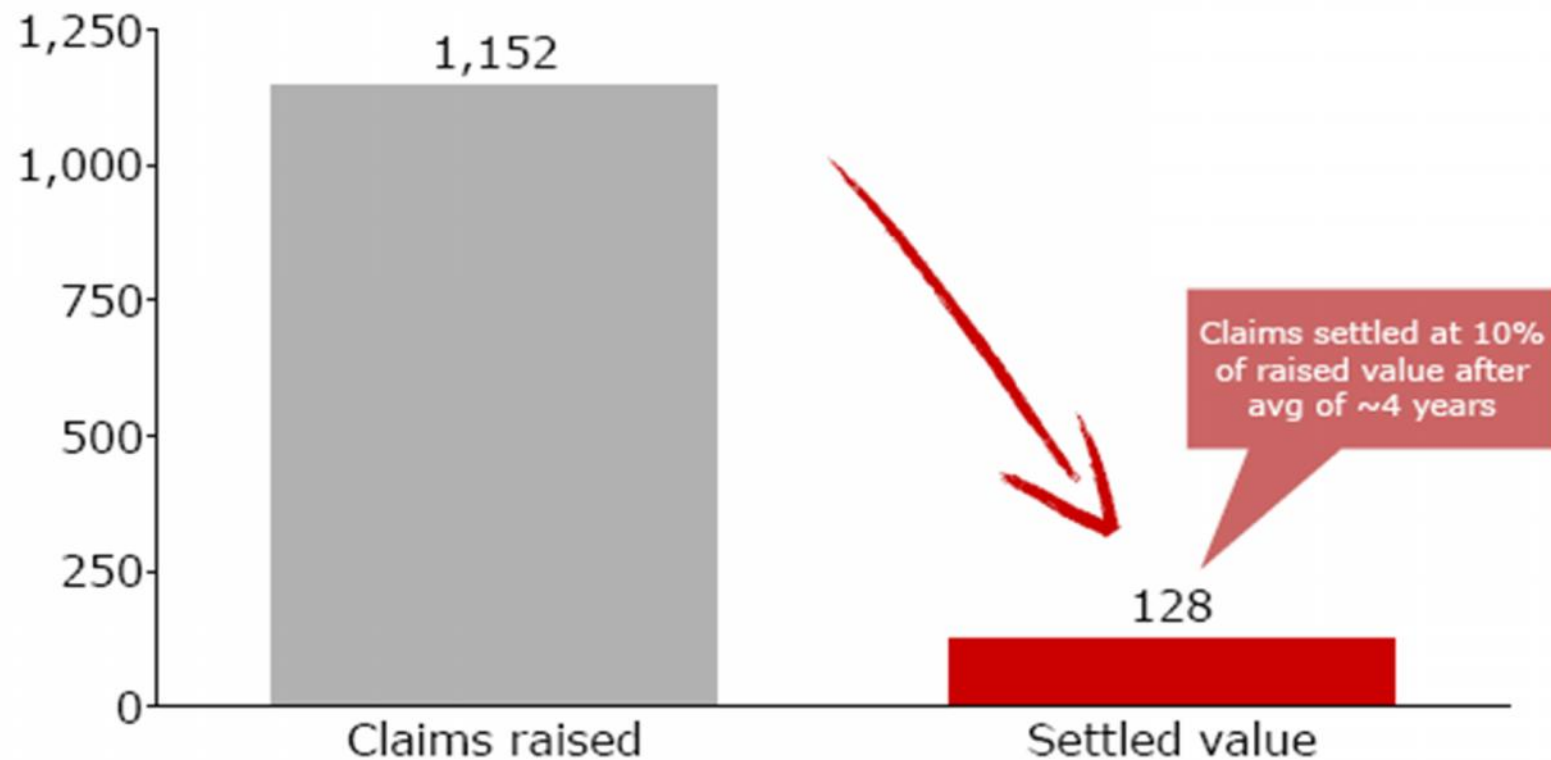


Note: Data shown for HCC, PLL, IVRCL and Ramky; Includes all top projects for gov. bodies which were completed in last 3 years and those currently in progress for which cost overrun data available; * Others include projects for Railways, State owned power companies and Urban development bodies
 Source: Internal data

One-time-settlements by NHAI have only been at ~10% of original raised value and have come after 4 years

NHAI CLAIMS ONLY PRELIMINARY

NHAI claims settled under OTS (INR Cr.)



ICC's Uniform Rules for Demand Guarantees (URDG) prevent unfair BG encashment

URDG GUARDS CONTRACTORS AGAINST UNFAIR BG ENCASHMENT

URDG rules	Benefit to contractor
<ul style="list-style-type: none"> • Demand for BG encashment must be accompanied by a set of documents (as specified in the contract) explaining breach of contractor's obligations 	<ul style="list-style-type: none"> • Documents provide basis on which encashment demand can be challenged in court
<ul style="list-style-type: none"> • Guarantors (Banks) must inform the contractor "without delay" about the demand for BG encashment • Guarantors (Banks) must examine the encashment demand within 5 working days 	<ul style="list-style-type: none"> • Provides time for negotiations between contractor and employer • Gives sufficient time window for contractors to act against unfair encashment demands (submit counter guarantee, go to court etc.)
<ul style="list-style-type: none"> • Guarantors (Banks) may suspend payment for maximum of 30 calendar days after receipt of demand 	

ENDORSED BY SEVERAL ORGANIZATIONS

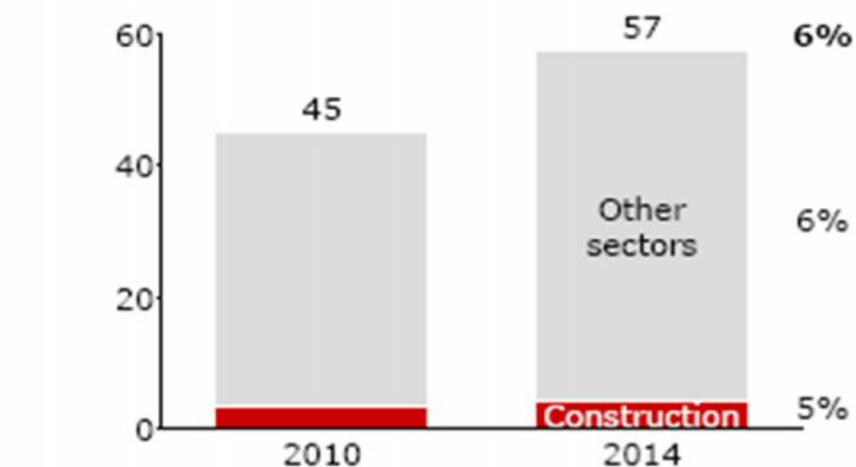
- International bodies such as World Bank and FIDIC (International Federation of Construction Engineers) and UNCITRAL (UN Commission on International Trade Law)
- Other stakeholders such as bankers, traders and industry associations

Construction sector plays a critical role in the growth of India's economy and employment generation

**CONSTRUCTION CONTRIBUTES TO ~8% OF GDP,
SPURS ~2X MULTIPLIER ON OTHER SECTORS...**

**... AND IS ONE OF THE LARGEST GENERATOR OF
DIRECT & INDIRECT EMPLOYMENT**

India's real GDP at factor cost (Rs. T) CAGR
(10-14)

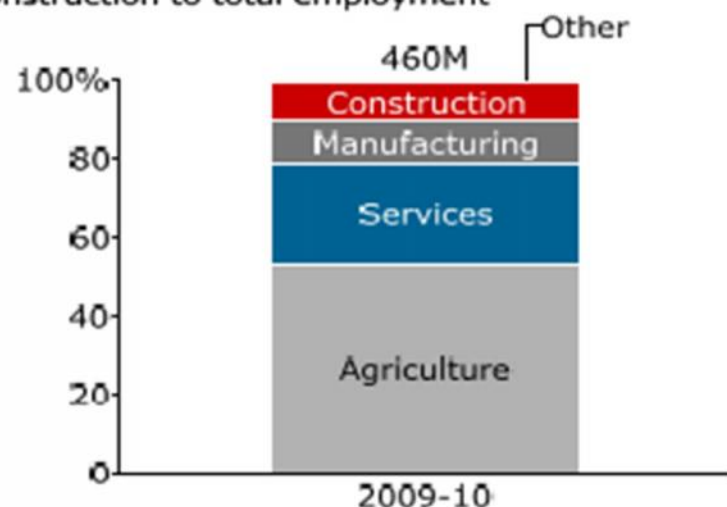


**Share of
Construction**

7.8%

7.4%

% contribution of
construction to total employment



**Share of
Construction**

9.6%

- **1.8-2x multiplier effect** on other economic sectors
 - *Backward multiplier:* Construction materials (steel, cement etc.) ~67% of construction costs
 - *Forward multiplier:* Manufacturing, Real estate etc - ~70% cost is construction

- Over **40 mn people** are employed in this sector
- **Every INR 1 Lakh invested** in construction creates **2.7 new jobs** in the economy

Note: Real GDP at factor cost (2004-05 prices)

Source: India Govt data platform; CRISIL Research; 12th Five Year Plan; National Council of Applied Research, April 2014

Construction sector is a critical enabler for the success of “Make In India”

POOR INFRA QUALITY IS A BIG DISADVANTAGE

Country	Infra quality score (Higher is better)	Manufacturing cost index (Lower is better)
Mexico	4.2	91
Indonesia	4.4	83
Brazil	4.0	123
China	4.7	96
India	3.6	87

QUALITY INFRASTRUCTURE IS CRITICAL FOR THE COMPETITIVENESS OF MAKE-IN-INDIA SECTORS

- Almost all sectors* chosen in the “Make in India” program **rely on availability of good quality infrastructure** as a key enabler
 - High quality transportation network (roads, railways and ports)
 - Uninterrupted power supply; Industrial parks/clusters
 - Easy access to raw materials

“Regardless of industry, **India must invest heavily in all forms of hard infrastructure**, both for domestic purposes and to **attract FDI (in manufacturing)**”

World Economic Forum paper on CEO recommendations

“**Robust infrastructure in India will make manufacturing sector efficient and cost-effective**, which in turn, will make Indian goods more competitive in the global markets”

Business Standard, Sept 2014

In addition, the industry is a large consumer of domestically manufactured products – over Rs. 700,000 cr

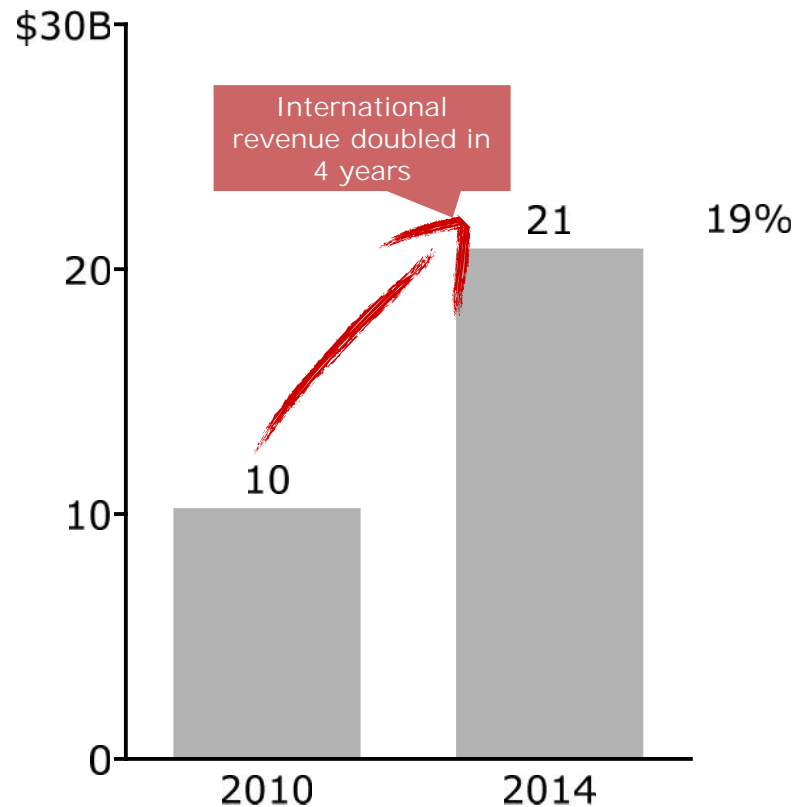
*All sectors except Tourism & Hospitality and IT & BPM

Source: World Economic Forum competitiveness report 2014-15; Consulting report on manufacturing competitiveness (Aug 2014)

A strong domestic construction sector can spur exports of construction related services

CHINESE CONSTRUCTION COS RAPIDLY EXPANDED GLOBAL FOOTPRINT...

International revenues of top 5 China construction companies* (\$B) $\frac{\text{CAGR}}{(2010-14)}$



...WITH SUPPORT FROM GOVT OWNED CHINA DEVELOPMENT BANK (CDB)

Loans/lines-of credit for foreign expansion

- Access to line-of-credit: High volume LoCs by CDB to enable cos. to obtain short term loans from banks

Dedicated equity funds:

- Africa development fund: CDB funded; Offers cheap financing and financial advice for Chinese firms investing in Africa

Funding to foreign entities buying domestic services:

- Energy backed loans: Offered by CDB to foreign energy cos. & govt. using Chinese contractors or construction equipment