

ICRA Lanka revises the ratings of MTD Walkers PLC to [SL]B- (Negative) from [SL]BB- (Negative)

Sep 21, 2018

| Instrument* | Current Rated Amount (LKR Mn) | Rating Action |
|--|----------------------------------|--|
| Issuer Rating | N/A | Revised to [SL]B- with Negative outlook from [SL]BB- with Negative Outlook |
| Senior Unsecured Redeemable Debentures | LKR 3,000 Mn | Revised to [SL]B- with Negative outlook from [SL]BB- with Negative Outlook |

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service has revised the Issuer rating to [SL]B- (pronounced S L B minus¹) with Negative outlook from [SL]BB- (pronounced S L double B minus) with Negative outlook for MTD Walkers PLC ("MTDWP"/"the Company"). ICRA Lanka has also revised the Issue Rating to [SL]B- with Negative outlook from [SL]BB- with Negative outlook for the company's senior unsecured redeemable debenture programme of LKR 3,000 Mn.

Rationale

ICRA Lanka has taken a consolidated view of MTD Walkers PLC and its subsidiaries as a whole, given the significant operational and financial linkages among them.

The revision in the ratings and reaffirmation of the negative outlook takes into consideration the deterioration of the profitability and the debt metrics during 3MFYE19, notwithstanding the recovery witnessed in the construction sector. The financial performance of the Group during 3MFYE19 and FY18 has remained highly adverse with the company reporting significant net losses and very high debt levels following the increase in the working capital requirements and capex spending for the new marine engineering projects during this period. ICRA Lanka notes that the deterioration of company's financial performance during the past two years was largely due to regulatory/industry uncertainty. However, since mid CY2016, after the reinstatement of the suspended mega construction contracts by the new government, tendering activity for new government projects witnessed a significant growth and has resulted in an increased competitive scenario in the construction industry. However the company is yet to benefit from this turnaround.

The group's thermal power plant, Northern Power Company (Private) Limited (NPC), still continues to be non-operational due to ongoing court proceedings on alleged environmental pollution charges that were leveled against the company. This has also negatively affected the group's financial performance due to ongoing financial losses and increasing receivable levels amidst the non-payment of the company's fixed capacity charge.

The Group's profitability has been adversely affected in the recent past due to relatively lower margins of the ongoing project portfolio, cost over runs, variations/additional works and the high finance cost owing

¹For complete rating scale and definitions please refer to ICRA Lanka's Website www.icralanka.com or other ICRA Rating Publications

to increased working capital requirements. In 3MFY19, the Group recorded a loss after tax of LKR 830.0 Mn, as compared to reported net losses of LKR 3,559.7 Mn for FY18. Also, the working capital intensity (as characterized by net working capital/operating income) of the Group witnessed significant increases during FY18 and 3MFY19 on the back of corresponding increases in the receivables position. The trade receivable days in relation to the execution of certain state funded construction contracts, have exceeded more than one year. Moreover, the company has already handed over the three UDA housing development projects, which were financed on a deferred contractor financing model and the total receivables from these three projects currently amount to ~LKR 6 Bn and the same is still to be paid by the Urban Development Authority (UDA), which was due to be paid six months after the completion of the respective projects. Therefore, ICRA Lanka will continue to monitor the receipt of these payments, which will be a rating sensitivity.

The ratings could be revised further downwards, going forward, if the Group is unable to successfully execute new orders (which have been received recently) in line with the scale of its operations, resulting in negative profitability and fails to demonstrate an improvement in its liquidity position through a recovery of its long pending receivables and the successful execution of the proposed assets monetarization exercises. Conversely, a meaningful improvement in the aforesaid factors could result in the revision of the outlook on the rating from Negative to Stable.

The group's continued financial losses have negatively affected the capital structure and debt protection indicators as they have further weakened over the past two years. The gearing level at the consolidated level of the group of companies in 3MFY19 and FY18 has increased to 7.0(x) and 6.9(x) respectively from 2.5(x) in FY17. Moreover, with interest and finance costs likely to increase further going forward, the debt protection indicators could further deteriorate.

At the standalone level, post the debenture issue of LKR 3.0 Bn, gearing level for the holding company in 3MFY19 has increased to 1.30x (from 0.2x before the Debenture Issue in FY15). As MTDWP is a non-operational investment holding company, its revenues are dependent on the fee income and dividend income received from its subsidiaries. Going forward, the management plans to establish a project-wise fee based income structure, to be charged from the operational subsidiaries, which would eventually improve the standalone financial strength of MTDWP, and aid the company in meeting its debt service obligations. However, this would require a significant turnaround in the financial performance of the operating entities and hence remains a concern.

Key rating drivers

Credit strengths

Experience of the promoters and the strength of the MTD Group: The ratings consider favourably the longstanding track record and established position of the MTD Walkers Group as a leading Engineering and Infrastructure Development Group in Sri Lanka. The ratings also take into consideration the project execution capability of the company, supported by regular project tracking and implementation systems of the company.

The MTD Walkers Group operates mainly in six sectors i.e. Civil Engineering, Engineering Services, Power Generation, Marine Engineering, Trading and Real Estate. For FY18, Civil Engineering Sector contributed approx. 75% of the Group's revenue, while Engineering Services & Trading Sectors and Real-Estate Sectors contributed approx. 13% and 10% of the group turnover during this period whilst the remaining 2% was contributed by the Marine Engineering and the smaller companies in the Group.

The largest subsidiary of the Walkers Group is CML-MTD Construction Limited (CML-MTD, a CS2 graded contractor, which is now the highest grade available, for Building Construction and Highway Construction by Construction Industry Development Authority), operating in the Civil Engineering segment. Some of the larger government projects that are currently being handled by CML-MTD were issued by the RDA (Road Development Authority) and UDA (Urban Development Authority). Walkers Piling (Private) Limited under the civil engineering sector carries out the piling business of the Group and accounted for approx. ~20% of the civil engineering segment's revenue in FY18.

Increased Order Book position and the positive industry outlook: Currently, the construction industry in Sri Lanka has received a large number of construction projects. Therefore, this has helped the construction contractors to selectively bid for projects, which have higher margins. Consequently, the company's order book position has increased compared to that of last year. The local construction contractors including MTD Walkers are involved in the construction of central expressway under the local construction contractor consortium of phase-II. The total value of this project awarded to MTD Walkers is about LKR 12 Bn and this project is expected to be completed in CY2020. Moreover, the company has been able to secure new road construction projects, totaling~ LKR 10 Bn. The construction of the company's high rise building project, in Maura Place is also expected to be commissioned in a few months and this high rise building project is valued at ~LKR 7 Bn. Although, the company had invested for their piling operation during FY2016, the piling operation during FY2017/18 was negatively affected due to slowdown in the construction of central expressway. Therefore, the ability of the company to successfully execute the ongoing construction contracts, without any disruptions/delays, notwithstanding the current liquidity constraints of the Group, would be key rating sensitivities.

Credit challenges

Negative Financial Profile: The Group's profitability during 3MFY19 and FY18, has been adversely affected and this is largely on account of the negative financial performance of the construction segment. Relatively lower margins of the ongoing project portfolio, cost over runs, variations/additional works and the high finance cost owing to increased working capital requirements have cumulatively impacted the financial performance of the group during 3MFY19 and FY18. The Group has recorded a loss after tax of LKR 830.0 Mn during 3MFY2019, from a reported net losses of LKR 3,559.7 Mn in FY18. Moreover, with the commissioning of the two onshore shipyards, the group's total debts have further increased to LKR 29.06 Bn in 3MFY2019 from LKR 19.4 Bn in FY2017. As a result, the capital structure and debt protection indicators, at the Group level have further deteriorated from the previous two years. The gearing level at the consolidated level for the group in 3MFY19 and FY18 has increased to 7.0(x) and 6.9(x) respectively from 2.5(x) in FY17. Moreover, other key debt service indicators have also deteriorated on account of the group's negative financial performance and the increased debt levels during 3MFY2019. In ICRA Lanka's view, the interest and finance costs are likely to increase further going forward and the debt protection indicators could further deteriorate, given the increased scale of the current operations.

The group is currently heavily reliant on government orders, thus any change in government policy towards the construction sector would impact the group: Currently, the group's construction segment accounts for ~75% of the total group revenue. Moreover, MTD Walkers being a leading civil engineering construction contractor, has a larger exposure to government's infrastructure and mega development projects. Therefore, the company is exposed to political and regulatory risks, especially with changes in government policies. Further, the company's significant exposures to government bodies and public sector clients have resulted in delayed payments amidst the government's fiscal constraints, where timely receipt of payment and delays in projects have affected the cash flows from operations. Moreover, the macro economic conditions such as interest rate

volatility, depreciation of Sri Lankan rupee and unskilled labour shortages would likely have an impact on the overall performance of the group.

Sharp increase in debt levels over the past two years following the increase in working capital requirements and the increased capex programme on the marine engineering operation: currently the company's increased debt levels are largely due to the UDA Housing development Projects as well as the debts taken up under the marine engineering segment. Further delays in the settlement of the debts taken up for UDA housing development projects would further affect the company's liquidity constraints due to increasing interest cost component.

The working capital intensity of the group has been steadily increasing over the last four years from 19.8% in FY12 to 90.9% in FYE16 to 112% in FY17 and 120% in FY18 on the back of a corresponding increase in the receivables position. This increase in the receivables position is attributable to the sizable increase in order book, size of projects executed and overwhelming exposure to government contracts, where the payments are stretched. Furthermore, the company is currently focusing on cash collections to meet the increased debt repayment commitments.

The non-operation of the Northern Power Company Ltd and consequently the increase in receivables pertaining to capacity charges: Northern Power Company (Private) Limited (NPC), which constitutes the only exposure of the group to the power generation segment, has been non-operational in FY17, FY18 and 3MFY19 due to ongoing court proceedings on alleged environmental pollution charges that were leveled against the company. NPC owns a thermal power plant in Jaffna and operated as an independent power producer with a Power Purchase Agreement (PPA) with the Ceylon Electricity Board (CEB) for a guaranteed production capacity of 27 MW for a period of ten years. The non-operation of the power plant has not only impacted the group's profitability but also the total trade receivables due to non-payment of the company's fixed capacity charge.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.
Links to applicable criteria: www.icralanka.com/images/pdf/Corporate%20Rating%20Methodology.pdf

About the company:

Walkers Group of Companies has been in operation in Sri Lanka for over 160 years with its origin in 1854 and has been a leading Construction and Engineering Group company in the country. Kapila Heavy Equipment PLC, which had been established as a public company in 1981 and listed on the Main Board of Colombo Stock Exchange in 1983, had subsequently acquired controlling interest of the Walkers Group. In April 2007, MTD Capital Bhd, a leading Malaysian based infrastructure development company, purchased a majority stake in Kapila Heavy Equipments PLC, the holding company of the Walkers Group of Companies. Kapila Heavy Equipments PLC was subsequently re-named as MTD Walkers PLC on 12th December 2007. The parent company (with majority shareholding in the company being held by MTD Capital Berhad, a Malaysian conglomerate focused on infrastructure sector), provides managerial and financial support on a regular basis.

MTD Walkers PLC remains a non-operational investment holding company with subsidiaries operating across Civil Engineering, Engineering Services, Real estate, Power Generation sectors, Marine Engineering and Trading. The key operating companies of the Group currently are CML-MTD Construction Limited, Walker Sons & Company Engineers (Private) Limited, Colombo Engineering Services (Private) Limited, Walkers CML Properties (Pvt) Ltd, Walkers Piling (Private) Limited, Walkers Equipment Limited and Northern Power Company (Private) Limited.

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