

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

May 30, 2018

Instrument*	Current Rated Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	Revised to [SL]BB- with Negative outlook from [SL]BB+ with Negative Outlook
Senior Unsecured Redeemable Debentures	LKR 3,000 Mn	Revised to [SL]BB- 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]BB- (pronounced S L double B minus¹) with Negative outlook from [SL]BB+ (pronounced S L double B plus) with Negative outlook for MTD Walkers PLC ("MTDWP"/"the Company"). ICRA Lanka has also revised the Issue Rating to [SL]BB- 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 rating and reaffirmation of the negative outlook takes into consideration the deterioration of the profitability and the debt metrics during 9MFYE18, notwithstanding the recovery witnessed in the construction sector. The financial performance of the Group during 9MFYE18 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 to a large extent driven by 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. Moreover, ICRA Lanka views the company's strong order book position and the engagement in the construction of large Central Express Way Phase-2, and new road development projects, positively, along with other leading government funded development projects.

The group's thermal power plant, Northern Power Company (Private) Limited (NPC), is still 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

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

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 to increased working capital requirements. In 9MFY18, the Group recorded a loss after tax of LKR 2,367 Mn, from a reported net profit of LKR 86 Mn for the same period in FY17. Also, the working capital intensity (as characterized by net working capital / operating income) of the Group witnessed a significant increase during FY17 and 9MFY18 on the back of a corresponding increase 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 a total receivables of LKR 5.6 Bn and the same is expected to be paid within six months after completion of the respective projects. Therefore, ICRA Lanka will continue to monitor the receipt of these payments and this 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. 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 previous two years. The gearing level at the consolidated level of the group of companies in 9MFY18 has increased to 4.9(x) from 2.5(x) and 1.7(x) in FY17 and FY16 respectively. Moreover, with interest and finance costs likely to increase further going forward, the debt protection indicators could further deteriorate. In ICRA Lanka's view, a meaningful reduction in the working capital intensity would be critical in improving the liquidity & financial flexibility of the company and therefore, this would be a key credit sensitivity.

At the standalone level, post the debenture issue of LKR 3.0 Bn, gearing levels for the holding company in 9MFY18 has increased to 1.20x (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 favorably 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 professional management team 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 FY17 Civil Engineering Sector contributed approx. 75% of the Group's revenue, while Engineering Services & Trading Sectors and Real-Estate Sectors contributed approx. 14% and 9% 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 are 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. 18% of the civil engineering segment's revenue in FY17.

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 significantly 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 was negatively affected due to slowdown in the construction of central expressway. However, currently, with the commissioning of this project, the company's piling order book has significantly increased upto LKR 3-4 Bn over the next six months. Therefore, the ability of the company to successfully execute the ongoing construction contracts, without any disruptions/delays, while carrying out any additional work/variations with the proper legal documentations/negotiations with the governmental authorities, would be key rating sensitivities.

Continuing diversification into different infrastructure and engineering sub-segments; The Company has recently completed the construction of Trincomalee shipyard and the Colombo shipyard, which is located in the former Mutwal Fishing Harbour, which is adjacent to the port of Colombo. The Colombo shipyard operation is expected to commence in May 2018 and the onshore operation of Trincomalee shipyard has commenced recently. The total investment of this venture is about US\$ 18 Mn, excluding the proposed Galle shipyard project. As of the end of December CY2017, the group has cumulatively injected US\$ 8 Mn as equity contribution, largely from the proceeds of the debenture issue, while the balance was funded by borrowings. These investments are intended to increase the vessel repair capacity for the onshore operation, which has higher margins than offshore repairs. The financial performance of this operation is expected to stabilize over the medium term and ICRA Lanka will continue to monitor the financial performance of marine engineering segment going forward.

Credit challenges

Negative Financial Profile: The Group's profitability during 9MFY18, has been adversely affected and this is largely on account of the negative financial performance of the construction segment, notwithstanding the recovery of the construction industry. 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 9MFY18. The Group has recorded a loss after tax of LKR 2,367 Mn during 9MFY2018, from a reported net profit of LKR 86 Mn in the same period in FY17.

Also, the working capital intensity (as characterized by net working capital / operating income) of the Group witnessed a significant increase during FY17 and 9MFY18 on the back of a corresponding increase 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. This was further exacerbated by the increased working capital intensity of the three UDA housing development projects. Moreover, with the commissioning of the two onshore shipyards, the group's total debts have further increased to LKR 26.7 Bn in 9MFY2018 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 over the previous two years. The gearing level at the consolidated level of the group of companies in 9MFY18 has increased to 4.9(x) from 2.5(x) and 1.7(x) in FY17 and FY16 respectively. Moreover, other key debt service indicators have also deteriorated on account of the group's negative financial performance and the increased debt levels during 9MFY2018. In ICRA Lanka's view, the interest and finance costs are likely to increase further going forward and the debt protection indicators could also 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 exposure 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 could affect cash flow 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 continuing 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. The settlement of the debts taken up for UDA housing development projects would help the company to reduce the overall high debt levels to an extent.

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 116% in 9MFY18 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 the government contracts, where the payments are relatively stretched. Furthermore, the company is currently focusing on the cash collections to meet the increased debt repayment commitments. The company currently funds the ongoing projects through back to back project financing facilities and therefore, the exposure to the general working capital facilities are largely limited.

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, was non-operational in FY17 and 9MFY18 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%20Methology.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.

Key consolidated financial indicators (audited)

Revenue and profitability indicators-Figs are in LKR Mn	FY14	FY15	FY16	FY17	9MFY18*
Operating Income	10,167.80	14,046.24	11,996.66	13,465.97	11,301.60
OPBDITA	1,731.75	2,555.23	1,489.65	2,220.26	- 296.75
PAT	454.67	1,107.27	- 121.37	- 236.10	- 2,367.90
ROCE (%)	19.54%	19.48%	6.28%	9.73%	-4.86%
NWC / OI(%)	39.14%	51.79%	90.91%	112.05%	116.84%
Total Debt	5,761.09	8,264.50	13,689.70	19,443.09	26,784.12
Networth	4,983.85	8,390.82	8,262.62	7,837.80	5,469.90
Gearing (x)	1.16	0.98	1.66	2.48	4.90
OPBDITA/Interest & Finance Charges(x)	2.33	3.84	1.35	1.22	N/A
Total Debt/OPBDITA (x)	3.33	3.23	9.19	8.76	N/A

Note;- Net Profits for FY2017 was adjusted for the revaluation gain of investment properties, *-Unaudited Financials

Rating history for last three years:

Current Rating (FY2018)			Chronology of Rating History for the past 3 years				
Instrument	Type	Amount Rated (LKR Mn)	Date & Rating	Date & Rating	Date & Rating	Date & Rating	Date & Rating
			May 2018	Sep 2017	Nov 2016	May 2016	Feb 2015
Issuer rating	N/A	N/A	[SL]BB- (Negative)	[SL]BB+ (Negative)	[SL]BBB- (Negative)	[SL]BBB (Negative)	[SL]BBB+ (Stable)
Issue rating	Debenture	3,000	[SL]BB- (Negative)	[SL]BB+ (Negative)	[SL]BBB- (Negative)	[SL]BBB (Negative)	[SL]BBB+ (Stable)

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