MARC RATING METHODOLOGY

CONSTRUCTION COMPANIES

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INTRODUCTION

OVERVIEW

MARC's approach to rating construction companies incorporates many of the same key rating factors used to assess corporate debt using a format that divides the analytical task into several categories and providing a framework that ensures all salient issues are considered. The major rating considerations for evaluating the credit quality of construction companies can be classified into four broad categories as follows:

- Business Risk Analysis
- Financial Risk Analysis
- Issue Structure and Terms
- Management and other Qualitative factors

The business risk analysis is divided into two main subsections; industry outlook and characteristics and competitive position. The financial risk analysis of a company, would involve an analysis of its financial policies, capital structure, profitability, cash flow/debt service capacity and its financial flexibility, which would provide the analyst with insight into the

company's business risk profile. The analysis of the issue structure and terms on the other hand would evaluate the suitability of the instrument in the context of the company's business model and financial profile. Also evaluated are the competencies and track record of management and other qualitative factors such as parent strength, formal support agreements and ownership.

Industry outlook is considered to evaluate the level of risk involved in participating in a particular business or businesses. Some of the pertinent factors out of the many an analyst would consider would be demand growth, pricing flexibility, research and development requirements, barriers to entry and regulatory framework and where appropriate, benefits of diversification. Put simply, companies operating in industries with high-risk outlooks will require more conservative financial profiles/ policies to achieve the same rating level as those operating in industries with more favourable outlooks.

BUSINESS RISK ANALYSIS

A rating analyst would initially begin an analysis with an assessment of the company's environment. The analyst would examine the dynamics of a particular business to determine the degree of operating risk facing a participant in a given business. This analysis would focus on the strength of industry prospects, as well as the competitive factors affecting that industry.

Factors that the analyst would be required to assess would include industry prospects for growth, stability or decline especially in the increasingly competitive operating environment facing construction companies in Malaysia. Due to the cyclical nature of the industry, an assessment of the level of competition and the position of the company in the industry would be required. While assessing where the company is positioned in the current cycle, the analyst would also need to evaluate the size and quality of the company's existing order book and the length of time the order book will be able to sustain operations. When assessing the quality of contracts, the percentage of overseas contracts and its accompanying risks would also need to be considered.

It is also important to determine the construction company's vulnerability to labour shortages or regulatory interference. The crackdown and repatriation of illegal workers by the Malaysian government in 2004 showed how vulnerable some construction companies were to labour shortages that arose as a result of this action.

The analyst would need to gain insight into the industry structure and its basic growth drivers to determine the position of the company within this framework while providing insight into the existence of any barriers to entry. The existence of government support would to some extent lend support in assessing the outlook on the industry.

A significant trend seen in the operations of large construction companies is the larger proportion of overseas projects being taken on, in some cases exceeding 50% of their order books. In these instances, sovereign credit risk and operational risks including construction, supply and concession risks will also be considered in the assessment of these corporates. Sovereign risk comes into play because the unique, wide ranging powers and resources of a national government affect the financial and operating environments of entities under its jurisdiction. In view of this it is becoming an increasingly important consideration in the assessment of construction companies with large exposures to overseas projects.

The analyst's evaluation of risks associated with international ventures would include an assessment of how these risks are mitigated. In the case of Build Operate and Transfer (BOT) projects the company might enter into long term off take agreements or take or pay arrangements to mitigate market risks. An evaluation of payment risks associated with an off-taker would also be required, while companies with substantial overseas contracts may be susceptible to forex translation risks.

An analysis of the operating environment would provide a gauge on the level and impact of operational risks. Pricing and other strategies that the company utilizes to mitigate cost overruns would also be considered. A company may choose to minimize the impact of financial risk through joint venture structures or by minimizing capital expenditure with funding requirements being raised at the project company level.

FINANCIAL RISK ANALYSIS

Having evaluated the issuer's competitive position and operating environment, the analyst proceeds to evaluate the company's financial risk. Financial risk is portrayed through quantitative means, particularly by using financial ratios. The construction company's financials would be benchmarked against MARC's portfolio of rated construction companies. Analytical adjustments may be required to enable meaningful comparisons to be made.

Quality of Accounts

Ratings rely on management/ audited data, and the rating process does not entail auditing a company's financial records. Analysis of the financials begins with a review of accounting quality. The purpose is to determine whether ratios and statistics derived from financial statements can be used accurately to measure a company's performance and position relative to both its peer group and the larger universe of construction companies.

Accounting issues to be reviewed would include:

- Consolidation basis – For analytical purposes it is necessary to separate the various businesses and evaluate each type of business in its own right.
- Income recognition – e.g. the percentage of completion versus completed contracts is often found in the construction industry.
- Depreciation methods and asset lives.
- Impact of purchasing accounting and treatment of goodwill.
- Various off balance sheet liabilities.

MARC attaches great importance to a company's philosophies and policies involving financial risk. A surprising number of companies have not given this question serious thought, much less reached strong conclusions. For many others debt leverage is the only focal point of such policy considerations. More sophisticated business managers however have thoughtful policies that recognize cash flow parameters and the interplay between business and financial risks.

Many firms that have set goals do not have the discipline or management commitment to achieve these objectives. For example, a company's leverage goals need to be viewed in the context of its past record and the financial dynamics affecting the business. If management states that its goal is to operate with a 35% debt to capital, MARC would factor that into its analysis only to the extent it appears plausible. For example if this same company has aggressive spending plans, that 35% goal would carry little weight unless management has put in place actions that would produce the desired results.

Financial policy should be consistent with the needs of the business rather than an arbitrary constraint. If opportunities are foregone merely to avoid financial risk, the firm would be making poor strategic decisions. In actual fact, it may be sacrificing long-term credit quality for the facade of low risk in the near term. In any event pursuit of the highest rating attainable is not necessarily in the company's best interests. A company with virtually no financial risk is not optimal whilst an under leveraged firm is not minimizing its cost of capital thereby depriving its owners of potentially greater value for their investments. Whatever a company's financial track record, an analyst must be skeptical if corporate goals are implicitly irrational.

Profitability and Coverage

Profit potential is a critical determinant of credit protection. A company that generates high operating margins and returns on capital has a greater ability to generate equity capital internally, attract capital externally and withstand business adversity. This earning power will ultimately attest to the value of the company's assets as well. In the absence of profits or the potential for profits, equity capital will be difficult to come by and debt capital will be costly, if available at all.

The more significant measures of profitability are:

- Pretax pre-interest return on capital
- Operating income as a percentage of sale
- Earnings on business segment assets

While the absolute levels of ratios are important, it is equally important to focus on trends and compare these ratios with those of competitors (peer analysis). Various industries follow different cycles and likewise the construction industry generally moves in tandem with the overall economy, specifically the commercial and residential property sectors but for the larger corporates, a significant portion of their order books are dependant on mega contracts which are traditionally awarded by the government for infrastructure developments. Comparisons with a company's peers influence Marc's opinion of a firms competitive strengths and pricing flexibility.

The analysis then proceeds from historical performance to projected profitability. Because a rating is an assessment of the likelihood of timely payments in the future, the evaluation emphasizes future performance. However, the analyst does not attempt to forecast future performance precisely or to pinpoint cycles. Rather the analysis considers variability of future performance based on a range of economic and competitive scenarios through the process of stress testing the cash flows under various scenarios.

Particularly important today are management's plans for achieving earnings growth. Can a company's existing business provide satisfactory growth especially in the increasingly competitive construction sector environment and to what extent are acquisitions and divestitures necessary to achieve corporate goals. At first glance, a mature cash generating company offers a great deal of bondholders' protection but MARC assumes a company's central focus is to augment shareholders value over the long run. In this context, a lack of indicated earnings growth potential is considered a weakness. By itself, this may hinder a company's ability to attract financial and human resources. Moreover, limited internal earnings growth potential may lead management to pursue growth externally, implying greater business and financial risks. This is the prevalent trend among the large construction companies in Malaysia today where increasingly more of them are seeking contracts externally.

Earnings are also viewed in relation to a company's burden of fixed charges, otherwise strong performance can be affected detrimentally by aggressive debt financing with the opposite also true. The interest coverage ratio measures the number of times operating profit before interest and taxes covers gross interest expense. By gross interest expense we are referring to interest before any offset for interest income or capitalized interest. Variations in results among companies in the construction industry can be attributed to either differences in profitability

or to level of interest expense. Interest coverage is a useful measure for drawing distinctions among companies within the industry.

Capital Structure/Debt Leverage

A company's Capitalisation and Financial policies are often indicative of its risk orientation. The extent to which a company decides to finance its operations with debt rather than equity will influence the analyst's rating recommendation. Traditional measures focusing on long-term debt have lost much of their significance, since companies rely increasingly on short-term borrowings. It is now commonplace to find permanent layers of short-term debt, which finance not only seasonal working capital but also an ongoing portion of the asset base.

Analysts should recognize that very low financial leverages may not necessarily be the most appropriate strategy. Equity financing is usually more expensive than debt financing and so a balance between the two forms of financing is reasonable.

Several ratios are normally computed to measure debt leverage. The standard measure is Total Debt/ Equity, which considers all on-balance sheet debt obligations. This measure can be further segmented into Long-term debt/ equity and short-term debt/ equity. While short- term debt exposes a company to refinancing risk, its use within reasonable limits is justified by cost and asset matching considerations. Equity above refers to book equity although a useful variation would be to use the market value of equity. If market value is well above book value there is a higher probability that the company will be able and willing to sell additional equity if the need exists.

Cash Flow Protection

Interest or principal payments cannot be serviced out of earnings, which are just an accounting concept; payment has to be made in cash. Although there is usually a strong relationship between cash flow and profitability, many transactions affect one and not the other. Analysis of cash flow patterns can reveal a level of debt servicing capability that is either stronger or weaker than might be apparent from earnings.

The cash flow analysis is considered one of the most critical aspects when arriving at a rating decision. Companies with investment grade ratings generally have ready access to external cash to cover temporary shortfalls. In the construction sector, access to cash will also determine the readiness of a company to take on projects and this can be noted in the balance sheets of large construction companies where sizeable amounts of cash balances are maintained.

Annual cash inflows from operating and non-operating activities are compared to annual cash outflows, both on historic and projected bases. This is referred to as the cash flow match, and indicates the extent to which

the company has been reliant on external funds in the past and is likely to do so in the future.

Cash flow ratios show the relationship of cash flow to debt and debt service and also to the company's needs. Since there are calls on cash other than repaying debt, it is important to know the extent to which those requirements will be used for debt service.

In scoring the cash flow generating ability/ debt servicing capacity of a company, the analyst should remember that good scores should not be automatically given to companies whose forecasts, even when stressed, indicate future cash flow surpluses. Any cash flow surplus needs to be considered in terms of the debt interest and principal it needs to service and to the competitiveness of the company if the surplus is in fact used to reduce debt rather than for reinvestment.

Apart from cash flow match, the other ratios used to assess cash flows are Cash flow from operations (CFO) interest coverage, CFO debt coverage, CFO capital expenditure (capex) and capex/depreciation. The CFO interest coverage ratio is a variation on the operating profit interest coverage ratio considered under profitability. The CFO debt coverage ratio compares funds from operations to the overall level of debt outstanding. Capex/ depreciation is a way to quickly judge whether a company is replacing its aging property, plant and equipment.

Focusing on debt service coverage and free cash flow becomes more critical in the analysis of a weaker company. Interpretation of these ratios is not always simple, higher values can sometimes indicate problems rather than strength. There is no correlation between creditworthiness and the level of current cash flow.

Analysis of cash flow in relation to capital requirements begins with an examination of a company's capital needs, including both working and fixed capital. Whilst this analysis is performed for all debt issues it is critically important for construction companies as new projects will inevitably involve capex especially if new projects are located overseas. Because MARC evaluates companies as ongoing concerns, the analysis assumes that companies will provide funds continually to maintain capital investments as modern efficient assets.

Financial Flexibility

The previous assessments of financial factors (profitability, capital structure, cash flows) are combined to arrive at an overall view of financial health. Additionally, considerations that do not fit in other categories are examined such as serious legal problems, lack of insurance coverage or restrictive covenants in loan agreements that place the company at the mercy of its bankers.

An analytical task covered at this point is the evaluation of a company's options under stress. The potential impact of various contingencies is considered along with the company's contingency plans. The company's access to capital markets, affiliations with other entities, its free cash availability as well as its ability to dispose assets are important factors.

Flexibility can be jeopardized if a company is overly reliant on bank borrowings or commercial paper. Company size and its financing needs can play a role as to whether it can raise funds in the debt markets.

Access to funds from the stock market may primarily be a question of whether management is willing to accept a dilution of earnings per share, rather than a question of whether funds are available. As going concerns companies should not be expected to repay debt by liquidating assets. Nonetheless, a company's ability to generate cash through asset disposals enhances its financial flexibility. Environmental liabilities and serious legal problems restrict flexibility, as a major lawsuit against the company would result in suppliers and customers shying away while the company's access to capital may also be impaired, at least temporarily.

ISSUE STRUCTURE AND TERMS

An evaluation of the issue structure and terms is made to determine if the proposed facility is appropriate for the company's business and financial profiles and its strategic plans.

The analyst will have to look at the type and ranking of the debt, whether it is secured; senior secured or subordinated including the effect of covenants and restrictions on credit risk. Ranking simply means the priority of a security in a firm's capital structure. Senior secured debt has priority over senior unsecured debt, which has priority over subordinated debt. The ranking of debt comes into play in a default situation. Theoretically, those with higher ranking are fully paid before other claims are considered. Analysts should also recognize that tax authorities and possibly other government bodies have higher priority over any debt holder.

Other considerations include the tenure of the issue or facility, the likely pricing, any concurrent fund raising exercise such as rights issues or new share placements and financial covenants agreed to by the issuer in connection with the placement. An issue structure and the affirmative and negative covenants may influence credit risk in two ways:

a. by the effect on the probability of default
b. by the effect on post default recovery

The tenure of the instrument being rated should preferably in some way be related to the assets or activities financed by the instrument. This consideration would diminish in importance as the company issuing the obligation becomes stronger, as in such cases the repayment of the

instrument will typically be less reliant on cash flows attributable to the investment financed by the subject issue.

An analyst would also be required to look at the type of security being offered as cover for the facility and this can take the form of specific collateral or a lien on all assets. Considerations that the analyst would have to address for an issue secured with specific collateral to be possibly rated above the stand alone credit rating of the company would be:

a. Can the security be separated from the estate of the company in the event of a breakup situation upon liquidation.
b. If the security will maintain value regardless of the company's fortunes.

In the absence of these conditions, no rating benefit shall be attributed to specific collateral.

Support in the form of reserve or sinking funds may in certain instances add confidence that cash will be available for debt service on a timely basis. To be considered positively in the rating process, accounts established have to be separately managed by responsible parties and mechanisms must be established to ensure that the pledged revenues are in fact captured.

Covenants that the analyst would expect to see, even if the issues being rated are supported by external credit enhancements such as Bank or Corporate guarantees, are the following:

Limits on additional debt – This can be proposed in several ways either in absolute amounts or via caps on debt in relation to equity, or as interest coverage. Such a test might indicate for example that no additional debt will be incurred unless earnings before interest and taxes for the past twelve months are at least two times proforma interest expense.

Limits on distribution – Such covenants place controls on dividends, advances or loans upstream or downstream and sales and disposition of assets and uses of proceeds therefrom i.e. proceeds from significant asset sales should be used to repay debt or reinvested in similar assets within a reasonable short time frame.

Events of default – These spell out the conditions under which a debt holder has the right to accelerate payment. Of importance is the cross default provision, which would state that a default on any obligation represents a default on all obligations. This precludes the borrower from paying certain debts over others.

The inclusion of covenants is a statement by management that it is willing to operate within certain boundaries and as such should be viewed positively although a company agreeing to abide by covenants does not necessarily mean that it will be able to do so. MARC would be concerned if covenants imposed are too tight such that a small variation from plan would cause an event of default.

MANAGEMENT EVALUATION

Management is assessed for its role in determining operational success and also for its risk tolerance. The first aspect is incorporated in the competitive position analysis and the second is weighed as a financial policy factor.

In the Malaysian context, credibility, track record and experience are also considerations to be factored in the analysis. Subjective judgments often help determine each aspect of management evaluation. Opinions formed during meetings with senior management are as important as track record. While track record may seem to offer a more objective basis for evaluation, it is often difficult to determine how results should be attributed to management's skills. The analyst must assess to what extent they are the result of good management, devoid of management influence or achieved despite management.

Plans and policies should be judged for their realism and how they are implemented determines the view of management's consistency and credibility. Credibility can become a critical issue when a company is faced with stress or restructuring and the analyst must decide whether to rely on management to carry out plans for restoring creditworthiness.

Organizational considerations that an analyst should be sensitive to include situations where there is significant reliance on an individual, especially one close to retirement; a relatively large number of changes occur within a short period; the relationship between organizational structure and management strategy is unclear; and the potential influence of significant shareholders.

CONCLUSION

In conclusion, when evaluating construction companies, MARC analyses the companies' cash flow generation capabilities, their financial conditions, operating trends and management strategies in the context of the broader industry and economic conditions. The scoring for the various factors will be benchmarked against the relevant risk scores assigned to other MARC-rated construction companies. The objective of the assessment is to determine the risk in respect of the timely payment of principal and interest on a particular debt instrument.

MARC has refined its methodology for assessing Construction Companies. This methodology partly amends and supersedes MARC's "Rating Approach to Construction Companies published in 2006. The revised methodology should be read in conjunction with MARC's "Corporate Debt Ratings" methodology which is available on MARC's website at www.marc.com.my.

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