

ICRA Lanka reaffirms the [SL]A+ long term Ratings of Access Engineering PLC

January 14, 2019

Instrument*	Current Rated Amount(LKR Mn)	Rating Action
Issuer Rating	N/A	[SL]A+ with Stable outlook reaffirmed
Senior unsecured debenture programme	LKR 5,000 Mn	[SL]A+ with Stable outlook reaffirmed

Rating action

ICRA Lanka Limited, Subsidiary of ICRA Limited, group Company of Moody's Investors Service has reaffirmed the Issuer rating of [SL]A+ (pronounced S L A plus¹) with Stable outlook for Access Engineering PLC ("AEL" / "the Company"). ICRA Lanka has also reaffirmed the Issue Rating of [SL]A+(pronounced S L A plus) with Stable outlook, for the Company's Senior unsecured redeemable debenture programme amounting to LKR 5,000 Mn.

Rationale

ICRA Lanka has taken a consolidated view on Access Engineering PLC and its subsidiaries as a whole, in reaffirming the ratings, given the operational and financial linkages among them.

The reaffirmation of the ratings takes into consideration the longstanding track record and established position of the Access Engineering group as a leading Engineering, Procurement and Construction (EPC) contractor in Sri Lanka. AEL has significant experience in the design and construction of Roads & Bridges, High-Rise Buildings, as well as foundations & sub-ground work for high-rise buildings. Further, AEL also has varied experience of undertaking EPC works in engineering segments such as water infrastructure, telecommunications, ports, airports, etc. The ratings also take into consideration the professional management team of the Company, the healthy relationships with various stakeholders in the construction industry and, the reputation in the industry for technology-innovation and timely delivery compared with the industry competitors. These apart, the ratings also factor in AEL's healthy financial profile backed by its comfortable profitability, and the healthy capitalization with relatively lower gearing levels. AEL (Consolidated) operates mainly in four sectors i.e. Civil Engineering, Construction Material sales, Commercial Real Estate, and Automobile dealership. For the FYE2018, Civil engineering segment contributed approximately 57% of AEL's revenues, while the auto dealership segment contributed 31%, construction materials segment contributed 10% and the remaining 2% was contributed by the commercial real estate operations of AEL.

During FY2017-18, the construction sector in Sri Lanka has experienced a slowdown, amidst the weaker macro-economic conditions that prevailed in the country. This has, to an extent, affected the Company's key construction projects during this period. The Company had a strong order book of on-going projects. This has helped the group to increase the consolidated revenue by ~YOY 27% to LKR 26.05 Bn in FY2018 from LKR 20.45 Bn in FY2017. However, the group's profitability (after excluding for revaluation gains) during FY2018 was negatively affected because of the moderation in operating profit margins amidst the slowdown in the industry during this period. During H1FY2019, the group's profitability has increased noticeably following the commencement of the Company's key construction projects (such as the

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

construction of Central expressway). Backed by relatively stable working capital intensity and comfortable profitability margins in the past, AEL has been able to maintain strong capitalization metrics with relatively low gearing level at the standalone level. ICRA Lanka also notes, notwithstanding the Company's healthy gearing levels of 0.4(x) in FYE2018 and coverage indicators in the past, the working capital requirements are sizable and could expose AEL to liquidity risk in case of increasing commitments towards larger projects and increasing scale of operations and therefore, this remains as a concern.

Sathosa Motors and Access Projects together had total borrowings to the extent of ~LKR 2.2 Bn in FYE2018 (which is largely from Sathosa Motors PLC). Access Realities and Sathosa Motors have well established operations with positive cash flows and adequate debt servicing ability and hence no financial support is generally anticipated towards these businesses. Moreover, Blue Star Realities (Pvt) Ltd, associate Company of the group has currently undertaken the real-estate project, "Capital Height" and the same is expected to be completed in FY2020. Further, AEL has invested cumulatively around LKR 2.7 Bn in "Harbor Village", a mixed development project, with other shareholders, being China Harbor Engineering Company Ltd and Mustafa's Pvt Ltd (Singapore). ICRA Lanka expects that the Company's financial support and commitments for this newly started project in the short to medium term is likely to be minimal given the strong financial capacity of the partners, as well as healthy presales proceeds. The ability of the Company to manage the market related risks, while successfully completing these projects will be critical in maintaining the strong credit profile.

Credit strengths

Leading Construction and Engineering group in Sri Lanka; Access Engineering PLC (AEL) has a longstanding presence in the Engineering, Procurement and Construction (EPC) business in Sri Lanka. The Company is one of the top five construction contractors in Sri Lanka. The Company's in-house services offer fully integrated project solutions including Project Design, Piling etc., whilst the Company also has its own materials supply chain, an island wide network of quarries, crusher plants, asphalt plants and concrete batching plants. This has helped the Company to have better control over the construction projects. Majority of the contracts are carried out by the Company, while the sub-contract work is only limited to supply of labour (and this is also on back to back basis). Therefore, this has helped the Company to record relatively higher operating profit margins compared to other competitors in the industry.

Experience of the promoter/s and the management: The Company and the Group as a whole have been driven by the rich promoter experience and the strong and experienced management team in place, which has guided the Company through several business cycles. The Company has a relatively strong corporate structure in place with well-planned succession management policies and also has a better corporate governance structure. This has ensured business continuity over the past several decades. The management attends to their business-related issues promptly and this has helped the Company to successfully manage their operational challenges much faster than other competitors.

Increased order book position; Although, the construction industry in Sri Lanka during past two years has slowed down, the Company has been able to secure the highest number of construction contracts during this period. This was further witnessed during FY2018 as the Company has outperformed the sector with a top line growth of ~ 20 %. Since Sri Lanka's construction industry is on a long-term growth phase (despite short term slowdowns), the Company intends to bid selectively only for lucrative contracts and thereby benefit from the increased opportunities. AEL being a leading construction Company in Sri Lanka, is expected to further benefit from these new development projects in the medium/long term. ICRA Lanka

takes comfort from the currently ongoing order book of ~LKR 40 Bn as compared to LKR 29 Bn, in the previous year.

The construction of the central expressway project will be a major infrastructural project of the Company over the next two/three years and currently, this project accounts for approximately 30-40% of the Company's revenue. Recently the Company has been able to secure lucrative new construction projects such as the construction of Wind power project funded by ADB and a new Anuradhapura Water supply project, which are collectively valued at LKR 8.5 Bn. Further, there have been a number of large scale projects from the private sector and most of these projects that had been scheduled earlier are currently in the implementation stages. Therefore, the ability of the management to successfully manage the ongoing key project-risks while growing the revenue contribution, will remain to be reviewed going forward.

Diversification into real-estate sector; In view of AEL's concentration in the EPC segment, the Company is looking at diversification by entering into asset and real-estate businesses. Currently, the Company has invested in three real estate projects. Blue Star Realities (Pvt) Ltd is a real estate Company, which is into the real-estate segment of Sri Lanka. Moreover, AEL has invested cumulatively around LKR 2.7 Bn in "Harbor Village", which is a mixed development project, with other shareholders being China Harbor Engineering Company Ltd and Mustafa's Pvt Ltd (Singapore). This project is anticipated to contribute to future revenues of the group. The financial performance of Access Realities has improved noticeably during FY2018 following the opening of Access Tower-II, and hence no financial support from the standalone level is anticipated towards these businesses. Moreover, ICRA Lanka takes comfort from the Company's increased dividend-upstream policy from Access Realities Pvt Ltd, given the Company's larger debenture repayment commitments in FY2021. ICRA Lanka will also continue to monitor the progress of the large scale, Harbour Village project and the ability of the management to successfully implement the initial stages of this envisaged investment, while managing the project-related risks will remain to be reviewed going forward.

Profitable Operation; During FY2017-18, the construction sector in Sri Lanka has experienced slow growth, amidst the weaker macro-economic conditions that prevailed in Sri Lanka. This has affected to an extent the Company's key construction projects during this period. Therefore, the Company has strategically utilized its capacity in the private sector construction projects. Therefore, the group's revenue has increased by ~YOY 27% to LKR 26.05 Bn in FY2018 from LKR 20.45 Bn in FY2017. However, the slowdown in the Company's key projects and the construction of the Access Tower-II, by the Company (at a lower operating profit margins), have collectively impacted the Company's operating profit margins during FY2018 and Q1FY2019. Currently, the Company's key construction projects, such as the construction of Central Expressway and the Town East Water supply projects have progressed and therefore, the Company's operating profit margin has increased noticeably during Q2FY2019. This along with the increased-dividend incomes from the Access Realities Pvt Ltd and the capital gain of~ LKR 140 Mn from the disposal of one of Horizon-Investments during this period, has helped the Company to increase the net profits to LKR 1,020 Mn in H1FY2019 from LKR 878 Mn in the same period of the previous year.

Backed by relatively comfortable profitability margins in the past, and coupled with the sizable proceeds from the debenture programme of LKR 5 Bn in FYE March 2016, AEL has been able to maintain strong capitalization metrics with relatively low gearing level at the standalone level. Further, it had sizable cash and short term liquid investments of ~ LKR 2.0 Bn in FYE2018 (at the standalone level) which could be utilized towards additional working capital requirements, given the increasing interest rate scenario. AEL's subsidiaries -Sathosa Motors and Access Projects together had total borrowings to the extent of ~LKR 2.2 Bn in FYE2018 (which is largely from Sathosa Motors PLC). Access Realities and Sathosa Motors have well established operations with positive cash flows and adequate debt servicing ability and hence no financial

support is generally anticipated towards these businesses. A substantial portion of the debts taken up by Sathosa Motors during FY2018 was utilized to increase the capacity levels (including the purchase of land and construction of new workshop).

ICRA Lanka also notes, notwithstanding the Company's healthy gearing levels of 0.4(x) in FYE2018 and coverage indicators in the past, the working capital requirements are sizable and could expose AEL to liquidity risks in case of increasing commitments towards larger projects/working capital intensive projects and increasing scale of operations. Therefore, ICRA Lanka will continue to monitor the Company's working capital position and the resultant impact on the Company's profitability and the capital structure.

Credit challenges

Increased competition and negative industry/economic outlook; During CY2017, the construction and engineering sector in Sri Lanka has grown only by YOY 3.0% compared to a YOY 8.3% in CY2016. Further, the construction sector's contribution to the industries stood at 23.80%, a marginal growth from 2016. Therefore, during CY2017, macro-economic outlook of the construction industry (especially the state funded projects) has been affected to an extent because of delays in the Government decision-making process, depreciation of the rupee, and changes in the corporate tax structure. Further, if this industry downturn further continues in FY2019/20, the Company's performance is likely to be affected to an extent, notwithstanding the current healthy order book position of the Company. During past two years, the Company's higher margin-key construction projects (such as Central Expressway and Towns East of Colombo District Water Supply Project) had experienced some delays due to delays in the government decision making process and curtailed fiscal budgets.

Sri Lanka's macro-economic conditions such as increasing interest rate, depreciation of Sri Lankan rupee and other policy directives of the government on the construction industry would likely have a direct impact on the overall performance of the Company. Construction industry in Sri Lanka has faced many challenges including the shortage of skilled labour and raw material supply shortages (such as sand). Therefore, ICRA Lanka will continue to monitor these issues and the ability of the management to successfully manage these issues will remain as a challenge. During FY2018, overall debt levels of Sathosa Motors has increased noticeably amidst the import-restriction regulations. This has largely affected the overall debt levels of the Access Group and therefore, ICRA Lanka will continue to monitor the financial performance of Sathosa Motors PLC.

Some of the Company's construction contracts are foreign currency denominated contracts. Therefore, the Company naturally hedges the foreign currency risks from its trade receivables (against the cost of imports). Moreover, the Company's item rated contracts have certain provisions in the condition of contracts that would enable the Company to claim for raw material cost increases based on the monthly publishing price indexes. However, during FY2018, the Company had two UDA- Lump sum contracts. These two projects are UDA-Henamulla housing project (which was fully completed in CY2017) and UDA-Public Servants real estate project, which is currently ~70% completed. Furthermore, the Company is currently reviewing to undertake a larger working capital intensive UDA-lump sum contract in FY2019/20. Therefore, with these new developments, the impact from the increasing raw material costs on the Company's profitability is expected to be reviewed going forward.

Increasing working capital intensity; During FY2018 and H1FY2019, the Company's working capital intensity has further increased on account of increasing debtors and inventory levels. Moreover, the working capital intensity of the group has also increased further due to growing real estate operation and the increased working capital requirements of Sathosa Motors. The Company's debtor levels have increased

noticeably during past two years, due to increased working capital intensive UDA Housing development projects undertaken by the Company. However, during FY2018, the Company has reduced its exposure in the working capital intensive UDA Projects including UDA-public servant housing development project, which is currently 70% completed. This project is a Private Public Partnership (PPP). The payments terms of this project happen according to the mile stone achievements (from the proceeds of presales) and currently, the payment terms of this project is satisfactory due to increased demand from the public sector employees. ICRA Lanka notes that the Company is recently reviewing undertaking another similar working capital intensive-housing development project by UDA, which is expected to be funded entirely by the construction contractor. ICRA Lanka forecasts a higher working capital intensity (at the standalone level), in the event the Company decides to carry out this contract over the next two years.

ICRA Lanka takes comfort from the Company's recent disposal of Investments under Horizon Holdings Ltd. This exercise will cumulatively raise total cash proceeds of ~LKR 1.5 Bn during FY2019 and the same is to be utilized for the Company's increased working-capital requirements. However, given the Company's ambitious new real estate investment plans (such as the construction of Access Tower III), the growing scale of the ongoing project portfolio, and the medium term debt repayment obligations, ICRA Lanka will continue to monitor the Company's working capital position going forward and therefore, this remain as a key rating sensitivity to the reaffirmed ratings.

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:

Access Engineering PLC (AEL) started its operations in 2001 as the Engineering, Procurement and Construction arm of the Access Group. Promoted by Mr. Sumal Perera, Mr. Christopher Joshua, and Mr. Ranjan Gomez, the Access group has presence in telecom, healthcare, power & renewable energy, and information technology also, in addition to the aforesaid businesses, under AEL and its subsidiaries. Over the last 15 years, AEL has become one of the leading players in the Civil Engineering and Construction industry of Sri Lanka. The Company was listed on the Colombo Stock Exchange in March 2012 following an initial public offering. Since then, AEL has grown sizably with acquisitions of businesses, and through expanding its presence in construction, real estate and other segments. In February 2012, Access Engineering acquired Sathosa Motors PLC (Sathosa), which holds the franchise for Isuzu commercial vehicles. Also, Sathosa's subsidiary - SML Frontier Automotive (Pvt.) Ltd. - is the sole agent for Jaguar Land Rover in Sri Lanka. This apart, Access Realties (Private) Limited, which owns a commercial office property - 'Access Towers' - and its subsidiary, Access Realties 2 (Private) Limited, which has developed another commercial property - "Access Tower II", are fully-owned subsidiaries.

ANALYST CONTACTS

Mr. Raghunath T,
Tel. No. +91-4445964440
Raghunath.t@icraindia.com

Mr. Danushka Perera,
Tel. No.+94-77-4781591
danushka@icralanka.com

RELATIONSHIP CONTACT

Mr. W. Don Barnabas
+94 11 4339907
wdbarnabas@icralanka.com



Subsidiary of

ICRA Limited

A Group Company of Moody's Investors Service

CORPORATE OFFICE

Level 10, East Tower, World Trade Center, Colombo 01, Sri Lanka

Tel: +94 11 4339907; Fax: +94 11 2333307

Email: info@icralanka.com; Website: www.icralanka.com

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