

## ICRA Lanka reaffirms the issuer rating of [SL]A- for Construction Guarantee Fund

November 23, 2018

Instrument*	Current Rated Amount (LKR Mn)	Rating Action
Issuer Rating	N/A	[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 minus<sup>1</sup>) with stable outlook for Construction Guarantee Fund ("CGF" / "the Fund").

### Rationale

ICRA Lanka reaffirms the rating of Construction Guarantee Fund by primarily factoring in the Government of Sri Lanka (GOSL) ownership and the sovereign support to the fund; coupled with the well-established acceptance and position of the fund in the Sri Lankan construction sector with two decades of experience. ICRA Lanka notes the fund's unique operational model as a non-profit service organization in Sri Lanka, its relatively stringent underwriting standards, and its self-sustaining operational structure that requires minimal support from the GOSL. This coupled with the entity's senior management and governance system through a Board of Trustees, representing key public and private sector officials, has enabled the fund to operate as an autonomous body without direct interference from the GOSL.

The reaffirmed rating strengths are partly offset by the continued downturn in the domestic construction sector, which is closely correlated with the macroeconomic/political conditions of the country. Historically, the fund's bond exposure has been highly skewed towards the state funded construction contracts. Given the government's increased fiscal constraints, ICRA Lanka views this exposure on a negative note as delayed payments from the government sector is viewed as a major factor (as this not only impacts the cash flow profiles of contractors but also further aggravates their financial stability and capacity to undertake more contracts). Therefore, the ability of the fund to collect its levy incomes on a timely manner, whilst growing the fund's guarantee exposure remains as a rating sensitivity.

The continued downturn in the construction industry as well as the regulatory/government's policy changes in relation to the construction industry, have also affected the small to medium scale construction contractors in Sri Lanka. Therefore, this has led to financially weaker contractors to exit permanently from this industry. Moreover, the entry of new-inexperienced-contractors into the construction industry has also further affected the overall industry. Although, the fund has not experienced any legitimate claims/invocations over the past three years, the risk of contract defaults by the construction contractors are expected to further increase going forward, as the overall risks of the construction industry have increased in the wake of continued industry slowdown and the weaker macro-economic conditions that have prevailed in Sri Lanka. The guarantee fund is very selective in providing their services for such higher risk contractors/contracts and hence, the overall performance of the ongoing contracts liabilities and the new claims position remain to be reviewed going forward.

<sup>1</sup> For complete rating scale and definitions please refer to ICRA Lanka's Website [www.icralanka.com](http://www.icralanka.com) or other ICRA Rating Publications

The rating strengths are also partly negated by the higher business concentration risks of ongoing financial liabilities. During CY2017, the fund's effective liability in relation to a single contractor had increased noticeably. Moreover, the inability of this contractor to complete his ongoing projects due to liquidity constraints, had accentuated the fund's overall risk profile during this period under review. However, currently the fund's effective liability towards this contractor has substantially reduced, following the fund's taking over of the ongoing construction contracts and achievement of substantial construction completion. Therefore, ICRA Lanka will continue to monitor the progress of these contracts and therefore, the ability of the fund to successfully complete ongoing projects and reduce its financial liabilities remains as a key sensitivity to the reaffirmed rating.

During CY2017, the premium collection declined due to continued downturn in the local construction sector amidst the Government's fiscal constraints to fund the ongoing and new construction projects. During CY2017, the fund has recorded a premium income of LKR 55.75 Mn, as compared to LKR 67.12 Mn in the previous year. Moreover, during 9MCY2018, the fund has recorded a premium income of LKR 39.81 Mn. The expenses as a percentage to net levy collected have increased to ~100.9% due to relatively lower levy income collections during 9MCY2018 (however, additional levy incomes during this period has increased with the delays in the project executions).

ICRA Lanka notes the fund's comfortable liquidity profile and the healthy capitalization metrics commensurate with its business profile. The investments of the fund mainly consist of government securities and risk free assets. The leverage of the capital (the cumulative guarantees issued to capital) currently stands at 1.7(x), indicating sound capital buffer for its business albeit the maximum level set at 10(x) by the Board of Trustees (in the absence of regulatory capital requirements). Moreover, despite the overall adverse performance of the construction sector, the fund has been able to contain its claim levels to 4.1 % (total cumulative guarantee encashment from its inception to the total cumulative guarantee exposure in September 2018). During past few years, Construction Guarantee Fund has fully paid the guarantee encashment, which were mainly raised in CY2008-2012, amounting to~ LKR 80 Mn. The ability of the management to recover these amounts through legal means, remains a sensitivity of the reaffirmed rating.

## Credit Strengths

**Sovereign Support and operational independence;** The Construction Guarantee Fund was originally set up through an act of the parliament and the Government had disbursed a capital grant of LKR 55 Mn in three instalments. The Secretary to the Treasury was tasked as the settlor of the fund and manages the fund through a Board of Trustees, who are also appointed from reputed government regulatory bodies & from the private sector entities. Moreover, the Board of Trustees acknowledged in the Trust Deed, have provided the overall maximum liability that the fund could undertake (against its capital base) and further delegated responsibilities for the senior management. Therefore, this structure has helped the fund to operate as a self-sustained business, without direct influence from the government and also to operate without highly leveraging the fund's capital base over the past two decades. Moreover, the fund is still actively managed by the founding members of this organisation and therefore, the commitment of these members has also helped the fund to operate as an autonomous body without direct interference from the GOSL.

**Extensive Experience of the Management and conservative risk policy;** the fund is being guided by a very well experienced management team who have several decades of experience in the construction industry. The company also has a relatively strong Board of Trustees consisting of reputed Public and Private sector representatives of the industry. Over the past years, the management has been able to maintain a good relationship with all the stakeholders in the industry including the Ministry, Employers and contractors

and this has ensured the fund to have continuous service even when construction industry was experiencing a slowdown in the local economy. Moreover, Construction Guarantee Fund being a Government entity, is in a better position to negotiate any contract disputes on behalf of their clients, with the Government Employers such as RDA, UDA and Municipal Councils. This has also helped the fund to resolve the contract disputes more amicably and thereby reduce the level of claims/invocations over the past.

**Lower Competition in the industry;** Construction Guarantee Fund provides various guarantees/bonds without retaining any security, insurance money or property for the guarantees offered. However, Commercial Banks/Insurance companies also offer such facilities by retaining valuable properties as security in addition to higher service charges to mitigate their risks. Furthermore, the large scale construction contractors, generally get such facilities from commercial banks as the fund's continuous engagement with the ongoing projects are viewed negatively by large scale contractors. Therefore, the fund generally caters to small & medium scale construction contractors and encourages them to uplift their level to a higher contractor grade in an open manner. Moreover, most construction contractors, who have uplifted their contractor grade with the CIDA, then, shift to commercial banks from the fund. Generally, this would take relatively longer time and these type of contractors are generally replaced with emerging new small-medium scale contractors to the fund. Currently, commercial banks are very selective in funding of construction projects due to increased risks of the industry. Therefore, the demand for various guarantees offered by the fund has increased recently notwithstanding the continued slowdown of the industry in Sri Lanka.

**Relatively lower claims position;** During the past two decades, the fund has only experienced bond encashment, amounting to ~ LKR 80 Mn. These were largely underwritten during 2008-2011 wherein, the price variations rights of the small & medium contract agreements during this period were forbidden. Moreover, during the past three to four years, there were no legitimate claims from the employers and this is because the delays in project executions were largely due to employer's fault to settle the payment on behalf of the contractors. ICRA Lanka also take comfort of recent developments in the construction industry, especially in the contract dispute resolutions (such as adjudication & arbitration). Currently, several professional/independent bodies maintain a registry of professional arbitrators and therefore, contract disputes are now viewed as a right of the contractor. This has not only helped the Guarantee Fund to minimize/eliminate its number of claims during CY2017/18, but also to develop a good relationship between the Employer and the Contractor through the negotiation path, whenever a dispute arises. Although, the fund has not experienced any legitimate claims/invocations over the past three years, the fund is likely to face increased risk of legitimate claims/invocations going forward as the overall risks of the construction industry have increased in the wake of continued industry slowdown. Therefore, ICRA Lanka will continue to monitor the overall performance of the ongoing contracts liabilities and the new claims position going forward.

**Profitable Operation;** Over the past two decades, the construction guarantee fund has maintained a healthy financial profile and during CY2017, the premium collection has moderated due to slow movement in the local construction industry. During CY2017, the fund has recorded a premium income of LKR 55.7 Mn, as compared to LKR 67.7 Mn in the previous year. During 9MCY2018, the fund has recorded a premium income of LKR 39.8 Mn. Moreover, the fund has also been able to maintain administration and overhead costs at a low level, while also maintaining zero claims/invocations during this period. The fund's comfortable liquidity position with healthy capitalization metrics commensurate with its business risk profile. The investments of the fund mainly consists of government securities and risk free assets such as fixed deposits which earn moderate returns. The leverage of the capital (the cumulative guarantees issued

to capital) currently stands at 1.7 (x), indicating sound capital buffer for its business albeit the maximum level set at 10(x) by the board of trustees (in the absence of regulatory capital requirements). Moreover, despite the overall adverse performance of the construction sector, the fund has been able to contain its claim levels to 4.1 % (total cumulative guarantee encashment to the total cumulative guarantee exposure in September 2018).

## Credit challenges

**Macro-economic outlook and government policies;** The construction industry in Sri Lanka is a relatively high risk industry second to aviation and the industry outlook is highly correlated with Government policies. Currently, the outlook of industry has further deteriorated over the past two years due to Government's increased fiscal constraints to continue the ongoing and proposed construction activities. Moreover, the continued slowdown in the construction industry as well as the regulatory/Government's policy changes in relation to the construction industry, has also affected the small to medium scale construction contractors in Sri Lanka. Since the demand for various construction bonds/guarantees are driven by the growth in the local construction industry, the macro economic conditions such as increasing interest rate, depreciation of Sri Lankan rupee and other policy directives of the Government on this industry (as mentioned above) would likely have an impact on the overall performance of the Fund.

**Limited due-diligence and project execution risks;** The fund generally undertakes relatively high bond-liabilities without any financial securities and as a consequence, the fund has faced higher financial risks. Hence, any weaknesses of the fund's due-diligence process are likely to result in higher financial risks. However, the fund has been able to manage this over the past two decades by building expertise in managing the risk. ICRA Lanka takes comfort from the fund's sector expertise in the construction industry, and this has helped the fund to take over the construction projects on behalf of its contractor, (in order to reduce the fund's overall financial liabilities), in the event the contractor is unable to discharge its duties according to the conditions of the contracts. ICRA Lanka has noticed during CY2018, the fund's effective liability exposure (per client) has increased noticeably and moreover, the fund had taken over certain construction contracts in order to reduce its financial liabilities during this period. Currently, the fund's effective liabilities for these projects have declined substantially following the fund's taking over of these projects. In the event of a project takeover, ICRA Lanka is of the view that the fund would have to face additional project execution risks as the defaulted contractor had undergone and hence, the ability of the fund to successfully complete defaulted such projects and reduce its financial liabilities remains as a key sensitivity to the reaffirmed rating.

**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](http://www.icralanka.com/images/pdf/Corporate%20Rating%20Methodology.pdf)

## Entity Profile

Construction Guarantee Fund was established in the year 1998, with the view of providing facilities to the Construction community mostly the Private Sector. Since, there was no procedure to directly give state sponsorship to finance the Private Sector, the private organization named Construction Industry Guarantee Fund Ltd was liquidated and a fully state owned institute named Construction Guarantee Fund was established. The budget proposals for 1999 presented to the Parliament in 1998 established the Trust/Fund with a state grant and allocated LKR 100 Mn, whilst Secretary to the Treasury was tasked with implementing this proposal. Treasury Secretary as the settlor decided to establish the Fund and to manage it through a Board of Trustees. The government had only granted LKR 55 Mn in four installments after the establishment of the Fund. Construction Guarantee Fund in addition to providing financial facilities to construction contractors who undertake projects, has launched wide range of other services such as Bills

discounting (factoring), Contract Management & Administration and Dispute Resolution & Dispute Avoidance in the construction industry, targeting small & medium scale construction contractors. Sri Lanka is one of the few countries to have implemented this type of services and Construction Guarantee Fund provides various guarantees and indirect financial facilities required by contractors engaged in Local/domestic construction sector without retaining any security/collateral, insurance money or property for the guarantees offered.

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