

ICRA Lanka assigns issuer rating of [SL]A- to Construction Guarantee Fund

September 28, 2016

Instrument	Amount (in LKR Mn)	Rating Action
Issuer Rating	N/A	[SL]A- (Stable) Assigned

ICRA Lanka Limited, Subsidiary of ICRA Limited, a group company of Moody's Investors Service has assigned an Issuer rating of [SL]A- (pronounced S L A minus¹) with stable outlook for Construction Guarantee Fund ("CGF" / "the Fund").

The assigned rating factors in the Government of Sri Lanka (GOSL) ownership, which provides a likelihood of sovereign support to the fund; coupled with the well-established acceptance and position in the Sri Lankan construction sector, stringent underwriting standards, and two decades of experience of the fund. ICRA Lanka notes the fund's unique operational model as a service organization in Sri Lanka and its self-sustaining operational structure that requires minimal support from the GOSL. This coupled with the entity's management & 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 on its operations.

These rating strengths are partly offset by high business concentration risk in the domestic construction sector, which is closely correlated with the macroeconomic conditions. Historically, the fund's bond exposure has been highly skewed towards the state funded construction contracts. ICRA Lanka views this exposure on a negative note as delayed payments from the government sector is viewed as a national issue, as this not only impacts the contractors' cash flow profile but further aggravates the contractors' financial stability. Therefore, the ability of the fund to collect its levy incomes on timely manner, whilst growing the fund's guarantee exposure in the expected manner remains a rating sensitivity.

The assigned rating also considers the fund's concentration of exposure on a single contractor, R & J Engineering (Pvt) Ltd, which has accounted for more than 40% of the total cumulative bond exposure as of July 2016. ICRA Lanka will continue to monitor this project exposure and the ability of the management to reduce its relatively high dependency on few construction projects would act as a sensitivity to the assigned rating.

Over the past couple of years, the premium collection has been moderate due to the slowdown in the local construction sector amidst the suspension of government funded projects for reviews. During FYE Dec 2015, the fund has recorded a premium income of LKR 37.3 Mn, as compared to LKR 106.9 Mn in the previous year. During 7M ending FYE Dec 2016, the fund has recorded a premium income of LKR 19.0 Mn. Further, administration expenses have also increased to LKR 52 Mn in FY2015 from LKR 46 Mn due to the change from the manual system to fully automated computer base Information System. The expenses as a percentage to net levy collected have increased sharply to ~150% due to relatively lower levy income collections during FYE Dec 2015/16 compared with FYE Dec 2013/14. However, the prospects for the Construction Guarantee Fund are healthy with the expected recovery of the construction sector and hence the premium income is expected to increase going forward.

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

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 1.4(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 5.4 % (total cumulative guarantee encashment to the total cumulative guarantee exposure in July 2016). During FYE Dec 2015, Construction Guarantee Fund has fully paid the guarantee encashment, which were mainly raised in FYE Dec 2014/15, amounting to LKR 70.4 Mn. The ability of the management to recover these amounts through legal means, remains a sensitivity of the assigned rating.

Fund Profile

Construction Guarantee Fund was established in the year 1998, with the view to 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 was liquidated and a fully state owned entity named Construction Guarantee Fund was established. The budget proposals for 1999 presented to the Parliament in 1998 proposed to establish the Trust/Fund with a state grant & allocated LKR 100 Mn, whilst Secretary to the Treasury was tasked with implementing this process. Treasury Secretary as the arbiter 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 to establish the Trust/Fund. Construction Guarantee Fund in addition to providing financial facilities to construction contractors who undertake projects, has launched wide ranging other services such as Contract Management & Administration and Dispute Resolution & Dispute Avoidance in the construction industry targeting small & medium scale construction contractors.

The Fund reported a surplus income over expenses of LKR 36.9 Mn on a total operating income of LKR 89.0 Mn in FYE Dec 2015, compared with LKR 133.5 Mn reported on a total operating income of LKR 179.7 Mn in FYE Dec 2014. During 7M ended FYE Dec 2016, the Fund has registered a surplus of LKR 26.4 Mn on a total operating income of LKR 56.4Mn.

September 2016

For further details, please contact:

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 Contacts:

Mr. W Don Barnabas, (Tel. No. +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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