

# Sector Outlook | Construction

## Construction Sector Outlook in the post-confinement period

June 2020

### Key Takeaways

Construction sector is expected to demonstrate resilience compared to other economic sectors of Sri Lanka. We base our assessment on four key reasons;

- The construction projects are expected to gradually pickup pace and broadly stay within the original timelines
- Current domestic raw material production level and inventories are expected to sustain ongoing projects
- Construction companies are largely insulated from the adverse effect of raw material price volatility due to currency depreciation
- Availability of funding support

However, ICRA Lanka would also like to highlight the fact that the effect of the four reasons mentioned above can be undermined by the following deterrents;

- New order inflows would be muted in the medium term
- Moderation in profitability is expected due to the lockdown

## Introduction

Sri Lanka's economic activities had slowed down during Q1 CY2020 and the economy is expected to contract by 4.5% in Q2 as per ICRA Lanka's assessment, amidst the outbreak of the COVID-19 virus.

Read ICRA Lanka's report on [the economic impact of COVID-19](#).

Sri Lankan government has taken containment measures affecting the entire country for several weeks and construction activities have been stalled to an extent during this period. At the business entity levels, the ability of some construction companies to withstand the effects of COVID-19 pandemic, will depend on several factors such as duration and severity of the pandemic, parent company support, GoSL's policies, availability of additional capital buffers etc.

Notwithstanding the relief package introduced by the GoSL, ICRA Lanka expects the disruption to have some impact on the operating income, profitability, and liquidity position of the construction companies in the short term (especially during the lockdown period). However, this sector is expected to demonstrate resilience compared with other economic sectors of Sri Lanka. We base our assessment on four key reasons as described below.

ICRA Lanka also notes that currently, there is a high degree of uncertainty. ICRA Lanka will continually monitor the developments and will provide updates whenever necessary. The readers are requested to kindly take note that this review is based on data collected as of end May 2020.

### Reason 1: The construction projects are expected to gradually pickup pace and broadly stay within the original timelines

In mid-March the government implemented a lockdown to contain the spread of COVID-19. With this, the construction activities, particularly within the Western Province, which encompasses sizeable portion of the entire market came to an abrupt stop. Majority of the construction labourers migrated to their home towns during the lockdown period. Return of the migrant labourers would be gradual as the lockdown gets eased, thereby leading to labour shortages in the near-term.

However, even before the spread of COVID-19 pandemic, most GoSL funded construction projects had experienced a slowdown due to delays of GoSL payments, especially during early CY2020. Most foreign funded projects did not experience such slowdown during the said period given the availability of sufficient funding support. In any event, March/April period is generally regarded as a "go-slow" period in the construction industry as the project work breaks for New Year holidays in mid-April. Hence, effective loss of productivity due to the lockdown may not be as high as one would have expected, if the lockdown does not continue for a longer period.

**Most foreign funded projects did not experience slowdown during the said period given the availability of sufficient funding support.**

Even during the lockdown period, some of the construction projects continued with special permissions from the authorities. This is expected to help such projects to keep up with the original timelines and cushion the impacts from higher overheads.

In spite of the financial challenges that are likely to be faced by the Government, given the strong legal/contractual protections available for construction contractors in the event of suspensions of ongoing projects, ICRA Lanka expects the ongoing projects, especially the GoSL funded ones to recommence operations soon. With the lifting of the lockdown, most foreign funded projects are expected to recommence their operations as they do not face such challenges.

In addition, most construction contracts contain *force majeure* clauses which can provide relief in the current situation. COVID-19, a non-political force majeure event, will make the contractors be entitled to an extension of timeline in the project completion schedule to the extent of the disruption. ICRA Lanka views this on a positive note as construction contractors with such provisions are in a better position to avoid the risk of penalties/liquidated damages on account of non-completion of the project within scheduled timelines.

## Reason 2: Current domestic raw material production level and inventories are expected to sustain ongoing projects

Sri Lanka's high reliance on imports for the construction sector can pose value chain disruption risks to the sector given the stringent trade controls imposed. But the current domestic raw material production level and inventories are sufficient to sustain ongoing projects.

Over the past several years, China and India emerged as the main import markets for raw materials for local construction industry, collectively accounting for 53% of the total imports for the construction industry in CY2018. Apart from China, other East Asian countries such as Thailand and Malaysia also export some moderate quality mineral based product categories to Sri Lanka. Malaysia dominates sawn and fibreboard wood products in the import basket. Sri Lanka's most popular roofing material, Asbestos, is mainly sourced from Russia. Sri Lanka also imports capital goods such as machinery required for the construction. Though Sri Lanka imports majority of the heavy machinery from India and China, some local buyers prefer top of the range products from destinations such as Japan, South Korea and Germany. Some European origin countries such as Italy is famed for high-end items such as ceramics, marble, furniture etc and the preferred choice by the developers catering to ultra-luxury segment.

After the spread of COVID-19, the Government has imposed a set of import restrictions on selected items effective for 3 months from April 16, 2020. Some of the key inputs to the construction sector have also being restricted under this scheme. This step is likely to deter importers from stockpiling or building inventories to take advantage of lower global prices. Given the deteriorating external position of Sri Lanka, it is expected that GoSL may be compelled to extend the import restrictions further following the expiration dates. Nevertheless, most imports for the construction industry have alternatives in Sri Lanka.

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One of the most critical input to the construction sector is cement. Main players in the cement industry in Sri Lanka involve 2 cement manufacturers, 5 bulk cement importers and 40 bag cement importers. Sri Lanka can currently produce 8.8 million tonnes of cement with plants, running at 85 percent capacity. Hence, in the short term, the requirements may be met with local production and existing stocks.

However, according to industry sources, higher value added input imports have no viable alternatives in Sri Lanka. Steel structures (used for the construction of bridges), energy efficient air conditioners etc, are few examples of these product categories. The GoSL may need to lift the import restrictions for such product categories, considering the significance of this industry in the Sri Lankan economy.

### **Reason 3: Construction companies are largely insulated from the adverse effect of raw material price volatility due to currency depreciation**

Currently, the prices of industrial metals and oil have fallen drastically to their two-year lows. Prices of metals that are critical to the construction industry have experienced over 10% decline from year open to end May (e.g. Copper -14%, Aluminium -16%, Lead -16%). Steel, a key input for the construction sector has also plummeted amidst weaker global demand. Oil, which is used for producing construction raw material like tar, has fallen almost by 50%. The lower prices of the metals and oil are expected to set off the effects of currency depreciation.

Some of the foreign funded projects are foreign currency denominated and therefore, these contracts provide a natural hedge against the increasing costs due to forex risks from the trade receivables. However, most construction projects in Sri Lanka is local currency denominated.

Moreover, there are two main types of construction contracts; item rated contracts and lump sum contracts. Item rated contracts have some provisions in the condition of contracts that would enable the construction companies to claim raw material cost increases based on the monthly published price indexes, which are essentially in line with the price increases of fuel, steel and cement. Moreover, these indexes also cover the effects of currency depreciation through these three parameters. Therefore, in the post COVID-19 period, the construction contractors are unlikely to experience margin erosions/gains due to raw material price volatilities. However, lump sum contracts are fixed price contracts and therefore, under these contracts, the contractors may be exposed to the raw material price volatilities. Most of the short term construction contracts are lump sum contracts.

**Item rated contracts have some provisions that would enable the construction companies to claim raw material cost increases based on the monthly published price indexes.**

### **Reason 4: Availability of funding support**

Most major construction projects in Sri Lanka are funded by funding arrangements from multinational agencies and international financial institutions such as ADB, JICA, World Bank, IDA, or bilateral arrangements with countries like China. These agencies/institutions nominate a foreign contractor as the main construction contractor of these projects. Local construction companies then tie up as subcontractors with the main construction contractors.

Generally, subcontract assignments have relatively lower profit margins and also have lower risks. However, local subcontractors could also negotiate back-to-back subcontract agreement, where subcontractor is also entitled for similar contractual rights including payment rights as the main foreign contractor. In these instances, timely settlement of invoices is likely and liquidity constraints will be less.

However, most foreign funded projects generally require the government's initial financial commitment (up to 20-30% of the project value) to be invested before the utilizations of foreign funding lines. In the past, there have been reports of failure of foreign funded projects due to government's inadequate initial funding commitments. Projects that are subject to this arrangement at this stage of implementation may face challenges. But such projects may be limited in number at this stage.

Sri Lanka also has initiated a number of projects where the funding may be coming from treasury or from local banking sources. These projects are mostly undertaken by local contractors. The projects that are funded directly by the treasury may face challenges given the current fiscal position of the government. But the projects that have funding arranged from local banking sources may not face such challenges.

However, ICRA Lanka also would like to highlight the fact that the effect of the four reasons mentioned above can be undermined by the following deterrents.

### **Deterrent 1: New order inflows would be muted in the medium term**

Given the major fiscal challenges of the government, new tenders are likely to remain muted in the near term. The foreign funded national infrastructure order book also remains muted due to current global crisis. Therefore, these will dampen the overall industry outlook in the medium term.

### **Deterrent 2: Moderation in profitability is expected due to the lockdown**

The idling of machines, manpower, and other fixed costs during the confinement would affect the profitability and liquidity position of most construction contractors to an extent. Since the fixed cost component of the construction contractor is considerable, the companies are expected to witness a moderation in profitability due to reduction in operating profit margins during the confinement period. The companies which are into high capital-intensive segments like piling would be greatly affected.

Liquidity and working capital cycle could come under pressure due to lengthening of the cash conversion cycle amidst the delay in release of funds and operational delays in the processing of bills by the clients. ICRA Lanka views that the provision of working capital support payments, such as mobilisation advances or interim payments between milestones, especially for small to mid-sized contractors during this period is key to help reduce the liquidity pressure to an extent.

However, the proposed debt moratorium/concessions for corporate entities, is expected to cushion the liquidity constraints to some degree during the second half of the year.

**The projects that have funding arranged from local banking sources may not face funding challenges.**

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## Abbreviations

CBSL	Central Bank of Sri Lanka
CY	Calendar Year
GoSL	Government of Sri Lanka

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