The Pakistan Credit Rating Agency Limited

Rating Report

Habib Construction Services Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
16-Oct-2020	BBB	A2	Stable	Maintain	-
22-Oct-2019	BBB	A2	Stable	Maintain	-
22-Apr-2019	BBB	A2	Stable	Upgrade	-
18-Jan-2019	BBB	A3	Negative	Downgrade	YES
30-Jun-2018	A-	A2	Stable	Maintain	-
29-Dec-2017	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The company has executed multiple large projects over the last couple of years. One of the mega project that was delivered is Orange Line Metro Train. Although the size of the project was grand, the company faced certain difficulties in execution and revenue generation. As of today, the company has completed its role in the project and consequently all the performance guarantees have been released. Currently, the company is in arbitration with Lahore Development Authority (LDA) in respect of various claims pertaining to Lahore Orange Line Metro Train. The company is pursuing the claim, if materialized will improve its liquidity. HCS is now focused towards multi-lateral financed and multiple small projects. Along with different new projects, company has taken up a project of Airport Runway Project costing ~PKR 6.5bln, joint venture between a Chinese company holding 50%, HCS holding 25% and Matracon holding 25%. Due to wide spread pandemic, company couldn't sustain the previous year turnaround in its performance i.e. from gross losses to breakeven, for a longer period and hit a negative figure at gross level in Jun20, resultantly ending up the net performance of the company in red. However a heavy risk absorption capacity through sizeable equity provide comfort to the ratings. The future prospects are healthy as the company has projects worth several billion rupees in its pipeline and also has started taking up and executing projects from private sector. This will further ease off the pressure on company's revenues. However due to new projects, company's reliance on short term borrowing and non-funded lines is expected to increase. Meanwhile, timely release of funds from diversified projects will bode well for the company’s ability to pay its obligation.

The ratings are dependent on sustaining a steady revenue stream and maintaining a low leveraged capital structure . Any prolonged downturn in subdued business volume can negatively affect the ratings. Good corporate governance practice is considered essential.

Disclosure

Name of Rated Entity	Habib Construction Services Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Construction(Mar-20)
Rating Analysts	Bazahtul Qamar | bazahtul.qamar@pacra.com | +92-42-35869504

Profile

Legal Structure Habib Construction Services Limited (referred as ‘‘the Company’’ or ‘‘HCS"’) is a Public Limited Company (unquoted) incorporated in 2009. The legal status of company changed to public in 2016.

Background Within a span of 10 years, HCS has completed 44 mega projects related to infrastructure. HCS has expertise in executing large & complex infrastructure and is driven to deliver projects ‘On-Time’. HCS holds a good position in the construction industry of Pakistan.

Operations HCS is registered with the Pakistan Engineering Council (PEC) and holds the C-A (no limit) license. HCS has completed projects like highways, airports, buildings, flyovers & bridges, etc. Significant projects to its credit are Lahore Ring Road, 2x2.5 MW hydel power project at Chashma, Bahria Grand hotel, Benazir Bhutto international airport civil works, Beijing underpass Lahore, Kalima Chowk underpass & overhead bridge, Metro Bus projects in Islamabad, Lahore & Multan.

Ownership

Ownership Structure HCS is owned by 26 shareholders. Three Directors (Shahid Saleem, Azam Bhatti (late), M. Shabbir) own 72% of the shares while the management team while rest is held by personnel in management. The share of Mr. Bhatti shall be dispersed among those next in kin, after formal proceedings.

Stability HCS is majority owned by Shahid Saleem, holding 51% shares. All executive directors, have extensive experience in relevant fields and power to direct relevant activities of the company. Ownership structure of HCS is seen as stable as no ownership changes are expected in near future.

Business Acumen All majority shareholders have strong knowledge and formal education in their respective fields of expertise. They posses extensive experience in the industry as well. Mr. Shabir has expertise in 'Quantity survey', whereas Mr. Mohsin is a member of ICAP. Mr. Mohsin has 30+ years of experience at different positions ranging from manager to Executive Director in different private sector construction companies.

Financial Strength The shareholders have high stakes in HCS, as most shareholders are not engaged in other businesses, and have always aspired to finance the company without relying heavily on funded facilities or long term debt. The company has 50% stake in an associated company 'Shajar roads Ltd' as well. The sponsors stand by to support as they have provided in the past in the form of personal guarantees

Governance

Board Structure HCS reconstituted its board on January 2019, after re-election and the death of Chairman Azam Bhatti in May 2019, whose position is currently vacant. Overall control of the company now vests in a three-member BoD who have executive roles. Governance structure has room for improvement as currently, there is no independent director.

Members’ Profile All the board members are qualified individuals who carry extensive experience of the construction industry.

Board Effectiveness HCS has constituted two board committees (Audit Committee and Human Resource & Remuneration Committee) to ensure rigorous monitoring of management’s policies and entity’s operations. Attendance recorded during the board and its committees’ meetings was good and minutes have been properly documented.

Financial Transparency M/s. Tariq Abdul Ghani Maqbool & Co. Chartered Accountants, Auditor is listed in “B” category of the State Bank’s panel of auditors. The external audit for the period ended June 30th, 2020, is in process. The auditors have expressed an unqualified audit opinion on the financial statements of HCS for the year ended June 30, 2019.

Management

Organizational Structure A simplified organizational structure where operations are segregated into six departments, (i) Engineering Department, (ii) Information Technology Department, (iii) Contract Management Department, (iv) Surveyor Department, (v) Construction Managing Department, and (vi) Finance Department. Clear lines of responsibility are defined for each department.

Management Team The senior management consists of 3 project managers who report directly to the CEO, each with more than 25 years of experience in construction and 8 years with HCS, while the technical team mainly consists of planning engineers & site in-charge.

Effectiveness No formal management committees are in place. However, meetings are conducted by the senior management on a need basis for discussion and decision making purposes. Moreover, the management reviews MIS based reports regularly, aiding in informed and timely decision making.

MIS HCS is currently using an ERP software customized for the construction industry from BE-Tech. The software keeps track of receivables, payables, general ledger, accounts, etc. The MIS generates quarterly reports for the Board, whereas the project management module is used on a daily basis which keeps track of all the elements related to specific projects.

Control Environment HCS has a internal audit department but it is considered weak. The management is committed to improve the scope of internal audit department.

Business Risk

Industry Dynamics Construction as a sub sector contributes 13.5% in industrial sector and 2.82% in GDP against the share of 2.74% last year; it absorbs 7.31% of labor force. PSDP allocation has been increased in FY2020 stimulating construction sector. A special package for construction sector is introduced. Package includes amnesty scheme, tax exemptions and PKR 30 bln subsidy for Naya Pakistan. This will jack up the construction industries, specially cement, and shall also generate employment.

Relative Position Out of the 10,000+ firms registered with Pakistan Engineering Council as Constructors / Operators, only ~100 (1%), including HCS, hold the prestigious CA category (no limit) license which enables them to be on the pre-qualifying list of approved constructors. HCS holds a favorable position among its peers.

Revenues During FY20, the entity’s revenue witnessed a significant drop of ~33%, standing at PKR 2,341mln (FY19: PKR 3,483mln). This decline was due to Orange Line Metro Train Project (OLMTP) case, as the company's resources and working capital are held up in the project. HCS is focused on procuring new projects and recovering the amounts relating to the OLMTP case.

Margins During FY20, though topline dropped substantially, gross margin turned down to negative -7% in FY20 (FY19: 0.5%). Net profit margins resultantly remained negative (FY20:- 22.1%, FY19:-15.8%). The primary target of HCS shall be to revive its revenue stream, and recover the losses.

Sustainability Sustainability remains under pressure on account of lower PSDP budget and slowdown in economy. However, short term pressure has seen an ease in pressure due to ongoing projects that are projected to earn sufficient revenue in FY20, to break even and revive the topline and FCFO, unless some large project is halted. HCS is hopeful of recovery of claims against OLMTP in FY21.

Financial Risk

Working Capital For working capital needs, which is a function of inventory and receivables, a construction company relies on both internal cash flows as well as mobilization advance. For further equilibrium the company uses its ST funding limits i.e. (letter of guarantee, insurance guarantee or letter of credit). The short term trade leverage for the period was -1.8% (FY19: 17.4%), which indicates a need for liquidity.

Coverages In FY20, FCFO showed a deficit of PKR 313mln (FY19: 198mln). Due to higher negative cashflows the coverages remained negative in current period. Further, release of funds are expected from government on newly awarded & ongoing projects which shall strengthen the liquidity of the company.

Capitalization Leveraging of construction companies is usually minimal, since exposures are in the form of Letter of Guarantees – an Off Balance Sheet Exposure. Short term funding is an outcome of liquidity pressure but its quantum is insignificant against the equity base of PKR 3,487mln.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Habib Construction Services Construction Services	Jun-20 12M	Jun-19 12M	Jun-18 12M
A BALANCE SHEET			
1 Non-Current Assets	2,593	2,854	3,011
2 Investments	-	-	-
3 Related Party Exposure	(17)	70	281
4 Current Assets	5,213	4,296	5,571
a Inventories	*113*	*177*	*394*
b Trade Receivables	*3,430*	*2,998*	*3,770*
5 Total Assets	7,790	7,220	8,863
6 Current Liabilities	3,900	2,288	4,061
a Trade Payables	*3,228*	*1,608*	*2,397*
7 Borrowings	377	721	116
8 Related Party Exposure	-	-	-
9 Non-Current Liabilities	24	24	19
10 Net Assets	3,487	4,186	4,667
11 Shareholders' Equity	3,487	4,115	4,667
B INCOME STATEMENT			
1 Sales	2,341	3,483	10,508
a Cost of Good Sold	*(2,504)*	*(3,467)*	*(12,003)*
2 Gross Profit	(163)	16	(1,495)
a Operating Expenses	(128)	(158)	(154)
3 Operating Profit	(292)	(142)	(1,649)
a Non Operating Income or (Expense)	*69*	*(40)*	*469*
4 Profit or (Loss) before Interest and Tax	(223)	(182)	(1,180)
a Total Finance Cost	*(131)*	*(105)*	*(83)*
b Taxation	*(164)*	*(263)*	*(709)*
6 Net Income Or (Loss)	(518)	(550)	(1,971)
C CASH FLOW STATEMENT			
a Free Cash Flows from Operations (FCFO)	*(313)*	*(198)*	*(1,840)*
b Net Cash from Operating Activities before Working Capital Changes	*(443)*	*(231)*	*(2,256)*
c Changes in Working Capital	-	*58*	*1,924*
1 Net Cash provided by Operating Activities	(443)	(173)	(332)
2 Net Cash (Used in) or Available From Investing Activities	143	137	375
3 Net Cash (Used in) or Available From Financing Activities	268	33	(36)
4 Net Cash generated or (Used) during the period	(33)	(3)	6
D RATIO ANALYSIS			
1 Performance			
a Sales Growth (for the period)	-32.8%	-66.9%	-41.4%
b Gross Profit Margin	-7.0%	0.5%	-14.2%
c Net Profit Margin	-22.1%	-15.8%	-18.8%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	-13.4%	-4.0%	0.8%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	-15.4%	-12.0%	-36.8%
2 Working Capital Management			
a Gross Working Capital (Average Days)	524	385	163
b Net Working Capital (Average Days)	147	175	83
c Current Ratio (Current Assets / Current Liabilities)	1.3	1.9	1.4
3 Coverages			
a EBITDA / Finance Cost	-1.0	-0.4	-77.8
b FCFO / Finance Cost+CMLTB+Excess STB	-2.4	-5.0	-130.8
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	0.0	0.0	0.0
4 Capital Structure			
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	9.8%	14.9%	2.4%
b Interest or Markup Payable (Days)	16.3	47.3	87.9
c Entity Average Borrowing Rate	30.0%	12.0%	10.0%

Credit Rating

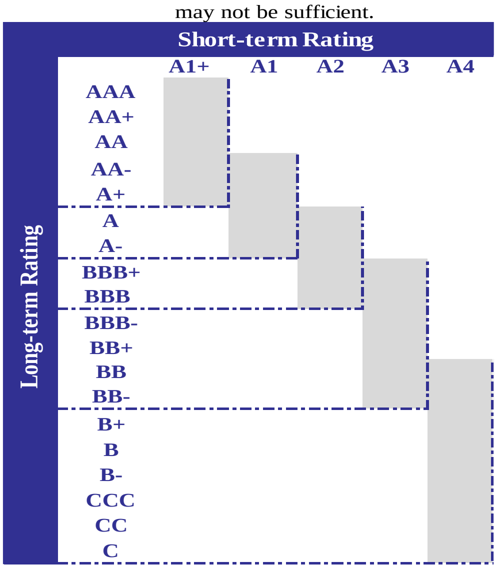
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities
a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information