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
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

There is squeeze in the profitability of the company, given current economic environment and slow down in projects related activity. This is exacerbated by a financial set-back on one of the mega project that Habib Construction was working on. The company incurred significant loss on this project in recent year. The company is in arbitration on this project concerning (i) de-notification of already approved rates on Non BOQ items; and (ii) delays arising from stay orders. Positive settlement of this would support Habib Construction's financial profile. Going forward, the company is looking for different new projects. Also, Habib Construction is devising a fresh strategy to cater to the evolving dynamics. Habib Construction Services has delivered a number of infrastructure projects in the last couple of years and has built its repute as a "Fast Track" execution company. The majority shareholder is Mr. Shahid Saleem, while other executives and management members have remaining stake – furnishing fuel to the company's growth. Habib Construction Services has a number of banking lines, predominantly non-funded, required for its construction business.

The ratings are dependent on sustaining a steady revenue stream and financial risk profile. Any prolonged downturn in subdued business volume can negatively affect the ratings. Good corporate governance practice is considered essential. Adherence to debt related covenants and overall coverage matrix is essential to ratings.

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-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Construction(Apr-18)
Rating Analysts	Muhammad Obaid | muhammad.obaid@pacra.com | +92-42-35869504

Profile

Legal Structure Habib Construction Services Limited (hereinafter referred to as ''the Company'' or ''HCS'') is a Public Limited Company (unquoted) incorporated in 2009. The legal status of company changed to public company with effect from July 15, 2016.

Background Within short time span of 9 years, HCS has completed 44 projects related to highways, airports, buildings, flyovers & bridges, etc. HCS has expertise in executing large and complex infrastructure projects and is driven with the philosophy to deliver projects 'On-Time'. The company stands tall in the construction industry of Pakistan as the pioneer of 'Fast Track' project execution culture.

Operations HCS is registered with the Pakistan Engineering Council (PEC) and holds the C-A (no limit) license. Different license codes range from C-6 to C-A based on the contract value allowed to undertake, within a specific contract band. Company has permanent staff of 1500+ employees and additional labor is temporarily hired according to the requirement of projects.

Ownership

Ownership Structure HCS is owned by 29 shareholders. Three Directors (Shahid Saleem, Azam Bhatti, M Shabbir) own 72% of the shares while the management team holds the rest.

Stability HCS is majority owned by Shahid Saleem, holding 51% shares. All executive directors, with strong knowledge of the industry, have extensive experience in relevant fields and power to direct relevant activities of the company.

Business Acumen The sponsor, Shahid Saleem, carries strong business acumen as they have extensive industry experience of over 30 years spanning over different positions ranging from manager to Executive Director in different private sector construction companies.

Financial Strength The company is entirely equity financed and if in the future need arises, the sponsors stand by to support as they have provided in the past in the form of personal guarantees to sanction running finance facility.

Governance

Board Structure The overall control of the company vests in seven-member board of directors (BoD). Apart from the CEO, three directors have executive roles, one is an independent director while two seats remained vacant. However, company intends to reconstitute its board on January 21, 2019, where size of the board will be reduced to four. Governance structure has room for improvement as currently, there is only one independent director.

Members' Profile All the board members are qualified, have experienced individuals and carry extensive experience of the construction industry. Mr Shahid Saleem, CEO, and one of the founding members of HCS, has over 30 years of experience in various appointments in renowned private sector construction companies.

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 Although the presence of an independent director is important to ensure effective, transparent and independent oversight, the company would do better if it had its own internal audit function which could report directly to the board audit committee. M/s. Tariq Abdul Ghani Maqbool & Co. Chartered Accountants, is the external auditor of the company. The auditors have expressed an unqualified audit opinion on the financial statements of Habib Construction Services for the year ended June 30, 2018.

Management

Organizational Structure A simplified organizational structure exists. Operations are segregated into six broad 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 Mr M. Azam Bhatti, Chairman of the Board, is a professional engineer and has 41 years of experience both in Army as well as in the private sector. Mr Muhammad Shabir is a graduate in Quantity Surveying from UK and has worked in Quantity Surveying Consultancy in UK and upon returning to Pakistan has worked with NLC and NHA in various capacities.

Effectiveness Functions of the management are clear and well-defined to effectively achieve its underlying goals and objectives. The system of internal control is in place and has been effectively implemented. Although, continuous review of these controls by an internal audit department would have ensured further effectiveness of the management.

MIS HCS is currently using an ERP software customized for the construction industry from E-Tech. The software keeps track of receivables, payables, general ledger, accounts, etc. The company's 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 The payables module installed by HCS further bifurcates into ledger based payables and un-invoiced payables, as unique to construction industry, materials are continuously arriving at project sites and at times even before a formal invoice is received by the company. To keep track of this movement in payables, this customization has been done so that management is always cognizant of its liabilities.

Business Risk

Industry Dynamics The construction industry is playing an important role in economic growth of Pakistan. Recent (provisional) estimates published in the Economic Survey of Pakistan show that the industry grew 9.1% in FY17 and contributed 2.7% to the country's gross domestic product (GDP). Macroeconomic factors affecting the dynamics of the construction industry are vital. A substantial increase in interest rates, oil, electricity and coal prices will further hamper the growth of the sector.

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.

Revenues During FY18, the entity's revenues witnessed a huge drop of 41.4% in comparison to prior year decline of 9.2% (FY18: PKR 10.5bln; FY17: PKR 17. 9bln). This decline in revenue was due to Orange Line Metro Train Project (OLMTP) as the company's resources and working capital was stuck in the project. HCS had recognized 43% (PKR 10.4bln) of the total contract revenue in FY17, and only 27% was recognized in current year (PKR4.7bln).

Margins During FY18, though topline dropped substantially, the cost of sales did not follow same trend and was decreased by 20% only, causing gross margins to diminish beyond breakeven. (FY18: -14.2%, FY17: 16.6%). This decline also relates to OLMTP. Gross Profit Margin on OLMTP reduced from 18% to 8%.

Sustainability In addition to incurring a loss in FY18, HCS sustainability remains under pressure on account of lower PSDP budget for FY19 and slowdown in economy. HCS is hopeful of recovery of claims against OLMTP in FY19, furthermore retention money, relating to projects approaching completion, will be released. New projects in pipeline stand to lift the topline as the company eyes geographical diversity in its business stream. However, the company is not mobilized for any of the upcoming projects raising concern on its viability.

Financial Risk

Working Capital For working capital needs, which is a function of inventory and receivables, HCS relies on both internal cash flows as well as short term borrowing (STB). Net working capital days decreased substantially, (FY18: 11 days, FY17: 31 days), however it may be misleading as contingent receivables amounting to ~PKR 4 bln are not accounted for in these ratios. Furthermore, ~300 mln worth of usance L/C is due by April19.

Coverages In FY18, HCS's operating cashflows (FCFO) dropped to a deficit of PKR 1.84bln (FY17: PKR 1.70bln) on account of gross loss incurred in current year (-14.2%) as compared to gross profit of 16.6% from last year. Although short term borrowings decreased during the year but earning negative FCFO makes assessment of coverage ratios irrelevant (FY17: 18.7x).

Capitalization At end-FY18, the company had an unlevered capital structure, with a debt to debt plus equity ratio of 2.4% (FY17: 2.2%) as the short term borrowings were slashed down to PKR 116mln (FY17: 153mln, FY16: 3,379mln). Historicaly, HCS has had no relaince on long term debt for its business requirement.

Habib Construction Services Limited

PKR mln

BALANCE SHEET	30-Jun-18	30-Jun-17	30-Jun-16	30-Jun-15
	Annual	Annual	Annual	Annual
Non-Current Assets	**3,011**	**3,345**	**2,358**	**1,236**
Investments (Incl. Associates)	**251**	**7**	**-**	**24**
Equity	251	7	-	24
Debt Securities	-	-	-	-
Current Assets	**5,601**	**8,121**	**12,357**	**3,809**
Inventory	394	411	726	102
Trade Receivables	1,250	2,580	2,385	1,445
Others	3,957	5,129	9,246	2,262
Total Assets	**8,863**	**11,472**	**14,715**	**5,068**
Debt	**116**	**153**	**3,379**	**-**
Short-Term	116	153	3,379	-
Long-term (Incl. Current Maturity of Long-Term Debt)	-	-	-	-
Other Short-Term Liabilities	4,061	4,667	6,882	2,337
Other Long-Term Liabilities	19	16	12	9
Shareholder's Equity	**4,667**	**6,636**	**4,442**	**2,722**
Total Liabilities & Equity	**8,863**	**11,472**	**14,715**	**5,068**
INCOME STATEMENT				
Turnover	**10,508**	**17,935**	**19,729**	**10,102**
Gross Profit	(1,495)	2,976	3,386	1,550
Other Income	471	50	(11)	6
Financial Charges	(83)	(91)	(171)	(22)
Net Income	**(1,969)**	**1,391**	**1,507**	**728**
Cashflow Statement				
EBITDA	(1,093)	2,992	3,404	1,575
Free Cashflow from Operations (FCFO)	(1,839)	1,704	1,971	903
Net Cash changes in Working Capital	1,924	1,499	(4,842)	(750)
Net Cash from Operating Activities	(332)	3,112	(3,042)	132
Net Cash from InvestingActivities	374	(361)	(1,017)	(310)
Net Cash from Financing Activities	-	-	-	(200)
Net Cash Generated during the period	43	2,752	(4,059)	(378)
Ratio Analysis				
Performance				
Gross Margin	-14.2%	16.6%	17.2%	15.3%
Net Margin	-18.7%	7.8%	7.6%	7.2%
ROE	-34.8%	25.1%	42.1%	29.6%
Coverages				
Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB)	-22.3	18.7	11.5	22.3
Interest Coverage (x) (FCFO/Gross Interest)	-22.3	18.7	11.5	22.3
Debt Payback (Years) (Total Lt.Debt (excluding Covered Short Term Borrowings) / FCFO)	0.0	0.0	0.0	0.0
Liquidity				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	11	31	21	27
Capital Structure (Total Debt/Total Debt+Equity)	2%	2%	43%	0%

Rating Scale

Credit Rating Scale & Definitions

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.

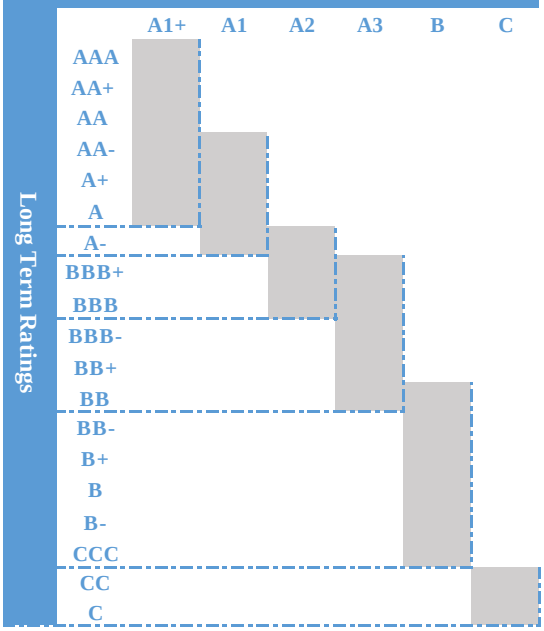
Long Term Ratings

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 Ratings

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 conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.

Short Term Ratings



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, a) some material identifiable event and/or b) deviation from expected trend. 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 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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) 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.

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