www.epcworld.in JUNE 2013 Vol. 5 Issue 1 ₹ 150/-

EPC World

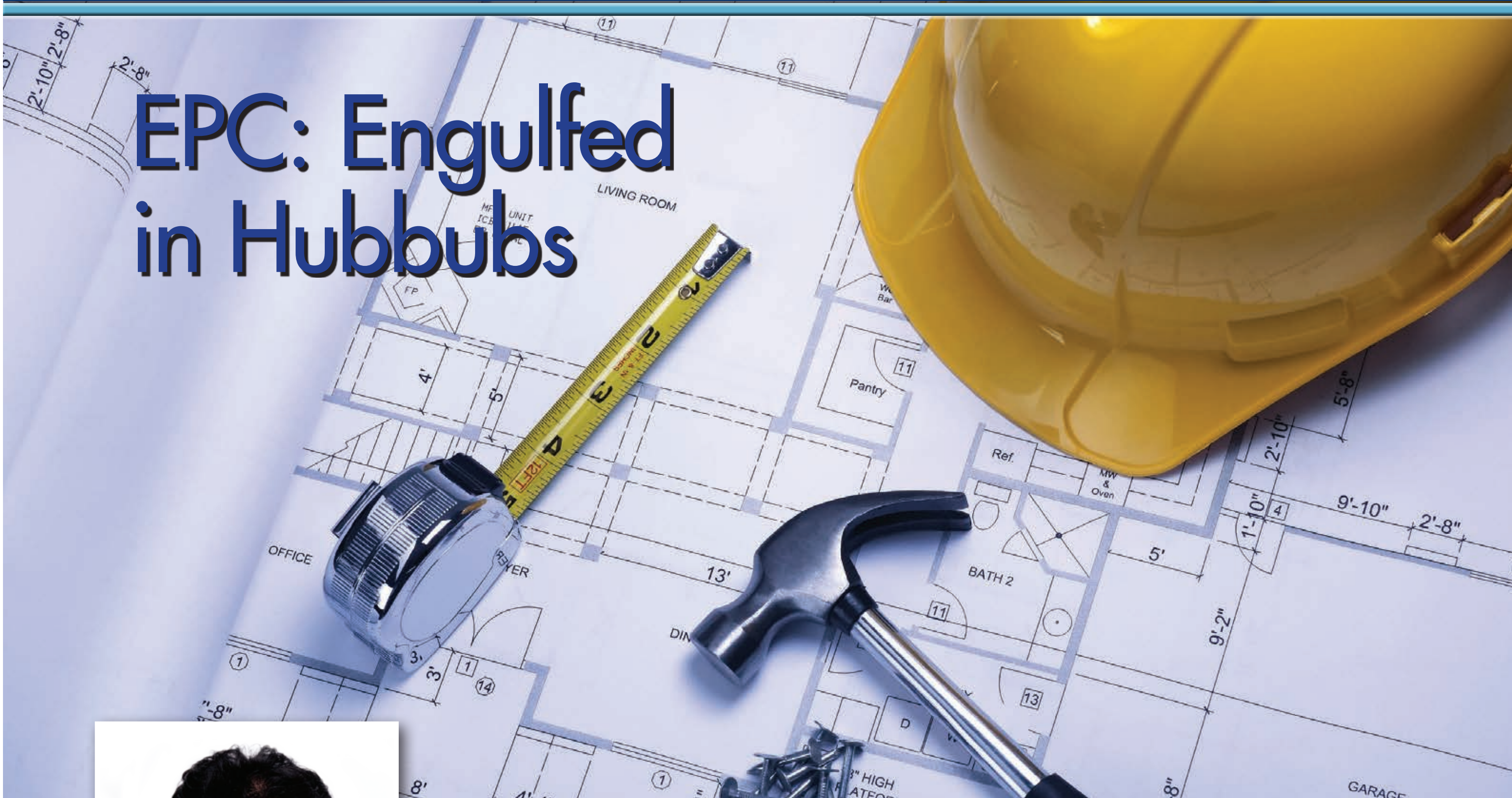
Engineering Projects Construction

Extensive Coverage Obsessive Readership

EXTENSIVE COVERAGE OBSESSIVE READERSHIP
4th ANNIVERSARY
EPC World

CONTENTS

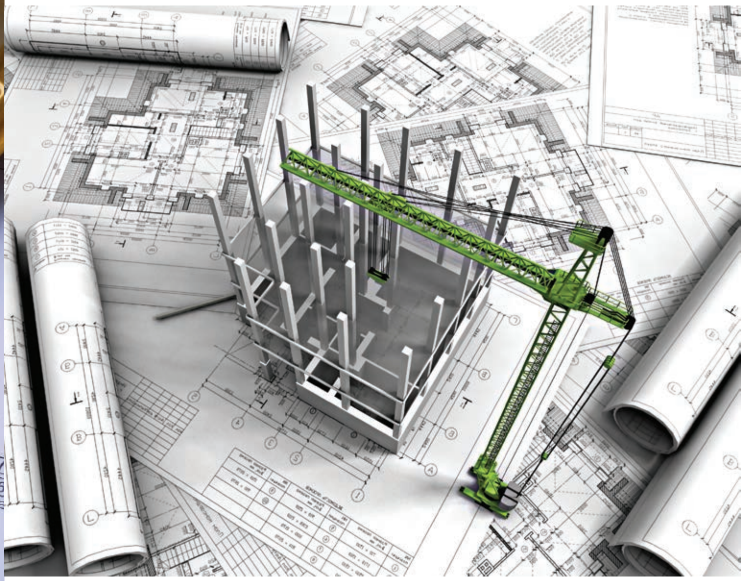
EPC: Engulfed in Hubbubs



Rishabh Sethi, Executive Director, SPML Infra Ltd shares insight on the how the current uncertainties in the European, the US and the African continent is impacting the Indian EPC market. He also throws light on the impact of depreciating Rupee, rising raw material costs and difficulty in obtaining finance.

The global economic growth still remains at unsustainable level as the developed countries are not able to gather any steady impetus. The US economy though re-gaining some footing; the pace of activity still remains uneven. The US GDP growth climbed to 2.4% in the first quarter of 2013 from the negative (-0.8%) in Q4 2012. The pace of narrowing also slowed in the European Union (-0.1%, compared with -0.5%) and in the Euro area (-0.2%, compared with -0.6%) in Q1 2013-14 as compared to the last quarter of previous year. In the United Kingdom and Germany, GDP grew by 0.3% and 0.1% respectively, rebounding from the contractions of 0.3% and 0.7% correspondingly in the previous quarter. In France, GDP contracted for the second consecutive quarter by 0.2% whereas in Italy, GDP declined for the seventh consecutive quarter but with the pace of contraction slowing to 0.5%, compared with 0.9% in the previous quarter. With projected growth of 4.8% in 2013, Africa's growth performance would continue to remain below average growth of around 6% in the three years proceeding the 2009 global recession. The latest fiscal development in the euro-zone possibly increases such uncertainty even further.

India's economy registered a slight growth, 4.8% in the Q1 2013 from 4.7% in the last quarter of 2012. The government has kept the target of 5% for the current fiscal. Infrastructure growth was 3.2% during 2012-13 as against 5% during the year 2011-12. Power generation grew by 4% during 2012-13 as against 8.1% growth during 2011-12, while steel production grew by 2.5% during 2012-13 as compared to 10.3% during 2011-12. However, India has the potential to perform better, if the Central Government succeeds in getting back on the saddle of infrastructure development as per ambitious XII Five Year Plan, the situation will be different. A unique weapon at the disposal of the government is its ownership of many cash-rich



public sector companies, which can be persuaded to invest. If implemented, it can go a long way in softening the blow of global slowdown on the Indian economy.

The Indian EPC sector has come up in a big way in last one decade. The opportunity for EPC sector is massive as the government is focusing on robust growth in infrastructure development. But EPC companies at this time of economic uncertainty need to be watchful and not get tempted to short term gain by careful risk evaluation and management practices.

Concerns for EPC Companies

The rising interest rate is a grave concern for EPC companies. Coupled with almost 25% devaluation of Indian rupee in the last one year and economic uncertainties has put tremendous pressure on EPC companies. International funding has become difficult to obtain due to global economic situation. The beleaguered funding situation has seen a number of projects already been put on hold in the planning stage itself and it is likely that more will follow. With the reducing number of projects, adverse financial situation will result in high project costs; and investors will lose interest.

The Indian Rupee has had a disappointing run of late as it has drifted to the lowest levels seen in Indian history. The rupee touched a life-time low of almost 57 against the dollar, together with structural issues faced by the domestic economy such as record high current account deficit and rising fiscal deficit has made the infrastructure sector suffer the losses. The depreciating Indian currency has mixed impact on the EPC sector. The continuous fall in rupee will also put more inflationary pressures on the economy as the cost of imports is going high. The year so far has been challenging for companies engaged in project execution with higher rate of interest, costly raw materials, ever increasing labour cost, sluggish financial situation and fewer projects being awarded and with the rupee depreciating, the going got tougher.

Further, the cost of raw materials remains the top concern among EPC companies. With the sliding down of Indian currency, the raw materials market remains volatile. Companies have a hard time in correctly judging the risk of intensely fluctuating raw material costs. To minimize the impact, EPC companies are going for agreements for the entire supplies of a project with all major suppliers and also putting the price revision clauses in their contracts with the clients. Other measures are the optimum utilization of work hours and labour force, sourcing of machineries from local manufacturers or from less expensive countries and good financial engineering in implementation and execution.

Trends in EPC Project Contracting Models

The business environment in our country has rapidly evolved over the years. Gone are the days when the scope was restricted to engineering and procurement and the construction was done by the clients themselves as the risk perceived to be too great for the contractors. Initially, there were few contractors having adequate technical knowledge and financial strength who could take the overall responsibility of large projects. Hence, large projects used to be divided into smaller EPC packages with a specific focus on the area of execution (e.g., for a water supply project, separate packages like pipeline, treatment plant, pumping station, distribution network, metering & billing etc.). Slowly with the passage of time, the developers became financially and technically competent and they gradually expanded their presence across multiple packages and the whole work being awarded as a single LSTK (Lump Sum Turn Key) contract. SPML is executing a number of projects on EPC + O&M basis, a trend established in the industry where the developer is supposed to manage the operations and maintenance even after the execution and commissioning of an EPC project for a given number of years.

Other model is EPC Management (EPCM) contracts, wherein one single company having the knowledge of integration requirement of the entire project, takes the charge for the complete execution. It in turn engages separate EPC contractors to execute the projects on package basis. In such cases, EPCM company takes the obligation of the projects integration and have an overall management control of the project; though directly not responsible for the project cost and schedule, which remains with the client.

The traditional contracting models of built, operate and transfer (BOT), built, own, operate (BOO) and built own,

operate and transfer (BOOT) are still in use. In the BOOT model, the EPC contractors not only execute and commission the projects but also earn revenue by operating the same for a specified period of time before handing it over to the clients. There are a lot of projects awarded in this mode for road and highways and airports. SPML is currently executing a number of water supply projects in BOOT mode including Aurangabad, Bhiwandi, Delhi amongst others.

Equity funding

With the demanding time line from the design concept to completion in EPC projects, it is imperative that the most suitable contract strategies should be adopted to satisfy all quality and financial requirements. But the execution of design and engineering will only be possible when the required finances are in place. Financial crisis has led to tightened credit, which is critical to financing capital intensive infrastructure projects. Funding has become a challenge with banks approaching their lending limits amid stalled projects and rising requests for loans restructuring.

Public spending growth slowed to 0.6% during the first quarter from 2.2% a quarter ago after Finance Minister slammed the brakes on public spending to retain India's investment-grade sovereign rating. Although this step helped in narrowing the fiscal deficit to 4.9% of GDP in 2012-13, below a revised official estimate of 5.2% and much lower than 5.8% a year ago, but this led to slowing down the growth in capital investment and private spending. The EPC companies which were already stretched in terms of their project delays and challenging finances, suffered more from liquidity and credit shortage in the absence of adequate mobilization advance for not obtaining the financial closure on time.

Latest technologies and services

There are several initiatives in terms of new technologies available for EPC companies. The engineering designs have become 3-dimension format, minimizing errors and improving productivity during the entire implementation process. The advanced technology for transport focuses on intelligent logistics, infrastructure, and mobility and makes project execution more attractive and efficient.

EPC tracker is another technological advancement that incorporates the use of smart phones and tablets in project execution, the real time information between work teams and the management helps in taking remedial steps by improving several areas that hamper the work due to avoidable reasons.

There is software available for collection and dissemination of data during the construction phase of an EPC project to help an updated planning and to determine the degree of progress of the project in comparison with planned, to detect deviations and to act in a timely manner. During a construction phase where mistakes are more expensive that delays the project and loss of control over the progress has more dangerous impact on the margins.

A report suggests that the EPC sector is expected to generate opportunities worth ₹17.1 trillion during 12th Five Year Plan. Indian companies are very competent and cost-effective, however we need to do some fine tuning and adopt modern construction management techniques. From our own experience as a developer, good project developers are those who are creative in their thinking, innovative to think out of the box, and are daring enough to take the risks.

EPC - an era towards Sustainable Growth

The recent report by Organization for Economic Co-operation and Development (OECD) suggest that India has probably surpassed Japan to become the world's third largest economy after the US and China. This is good news that is going to support the growth of EPC sector as well. The long-term outlook of the industry remains optimistic due to the strong underlying industry and economy fundamentals. India's focus on infrastructure growth, rising disposable income, lowering age of high income individuals, all point towards the fact that the long-term growth of the EPC industry in a steadily growing economy can be expected to be good. With Indian manufacturing companies producing quality equipment and raw materials, it is expected that input costs pressures could moderate which would be another positive for the sector. With the economic performance, we see the consistent policies, government investment in infrastructure is stepped up, raw materials and equipment are available locally and all the required clearances being granted on time along with land for the development, and clarity in the concession agreements. With these positives, EPC sector will see sustainable growth in the years to come in India. EPC World