POISED FOR A RISE, ALBEIT SLOW

Uncertain global economy, rising interest rates, regulatory bottlenecks, etc are major challenges facing the engineering, procurement and construction (EPC) sector in India. In an interaction with Rakesh Rao, the two industry veterans offer insights into some of these issues and their probable solutions.

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Is the current uncertainty in Europe and other developed countries affecting the EPC industry?

P D Samudra (PDS): It will certainly affect the EPC industry globally, as well as in India. In fact, the signs are visible; and several projects that were scheduled to take off are slowly getting delayed.

Pothen Paul (PP): Uncertainties always make everyone apprehensive about the future, and cautious about spending money, especially on discretionary purchases. This in turn affects demand and the need for creating additional production capacities. Unfortunately, what is unknown today is how long it will take for the European muddle to resolve and also the direction it might take. Had it been known, for instance, that in two years everything might be back to normal, it would have been a good time for cash-rich organisations to invest and take advantage of competitive prices of capital goods & contract services available now, and be ready for entering the market as demand picks up again. But, uncertainty about the duration of current downturn, compounded by tight liquidity situation and high cost of funds, makes such decisions difficult.

Fortunately, India is rather uniquely placed, because its low export trade dependency insulates it from the vagaries of demand shrinkages elsewhere. Moreover, the huge unmet demand for power & all kinds of infrastructure remains intact, whether there is a downturn or not. So, if governance issues are dealt with, a sense of well-being will improve, and inflation, interest rates & ₹ valuation will stabilise at workable levels. This will lead to improvement in the investment climate.

Compared to 2007-08 slowdown, how is the situation now?

PP: I believe it is worse, especially for India, because the country is a lot less equipped to deal with it, both politically and financially. This is typically the kind of time, when in the national interest, the political class should keep aside differences and work together to get the nation back on track. Unfortunately, the maturity and wisdom needed for it seems to be missing.

PDS: Actually, it is not prudent to compare the recession of 2007/2008 with the anticipated slowdown in 2012/2013. This is due to the fact that most of the EPC companies have a better order backlog now, which can ensure operation of the organisations comfortably. The last recession was due to the gross errors in the financial management, whereas the expected recession in 2012 is arising, in my opinion, due to the continuously maintained high level of oil prices resulting in high energy costs; the European crisis leading to a global affect, prolonged recession in the US; political upheaval in the African continent; as well as political disturbances in emerging markets like India.

How has been the impact of the rising interest rates on EPC projects in India?

PDS: The hike in the interest rates is a further blow to the EPC companies. With the reducing number of projects, such negative actions will result in high project costs; and investors will lose interest in setting up new units, for the time being.

PP: It is a fact that few projects are fully funded by internal accruals. As a result, a vast majority of them are domestic interest rate sensitive, especially since a near 20 per cent devaluation of the ₹ and associated uncertainties make overseas borrowings not an option in many instances. Due to this, quite a few projects in the planning phase have already been put on hold and it is likely that more will follow.

For the time being, oil/gas exploration and production companies seem to be sustaining their investment programme, which is good for those EPC companies that have oil & gas business in their portfolio. The Middle East too seems to be unaffected. But this alone is not good enough, and so EPC companies will have no option but to tighten their belts & wait for the situation to improve. Unfortunately, this is the kind of time when those having poor risk evaluation and management systems underbid and land up in serious difficulties.

Is depreciating rupee against the dollar a cause of concern?

PDS: Obviously, the imported equipment cost will increase. Also, a large number of items manufactured in India will have to incur a higher cost for the imported raw materials. Thus, the overall project cost is certainly going to increase. It will, therefore, add to the woes of investors interested in setting up chemical projects. The silver lining is that the export of 'engineering services' will witness some improvement due to the higher income in rupees, from the dollar.

PP: EPC industry is affected not only by the impact of ₹ devaluation on direct imports of capital goods and bulk installation materials, but also by the way its domestic capital goods supplier base, which depends on imports of raw materials and components, is affected. Unfortunately, relative stability of the ₹ till August encouraged many to unwisely dispense with currency hedging.

How can companies limit the impact of rising commodity/ raw material prices?

PP: Commodity prices have been volatile for quite some time due to which the EPC industry is fairly used to it. What it is not used to, however, is the added impact of ₹ devaluation. In order to minimise the impact, EPC companies tend to opt for back-to-back agreements with all major suppliers and bring in price revision clauses in their contracts with clients.

PDS: In my opinion, the strategy for EPC companies is to find ways and means to become competitive, which involves optimum utilisation of engineering hours, sourcing of equipment/components from less expensive countries, good financial engineering in implementation; and employing multiple small size construction subcontractors.

Outlook for the EPC industry in 2012

PDS: As explained above, the outlook is not so good, mainly because only few projects will be realised in the process industry.

PP: From a global perspective, it does not look good. However, India has the potential to perform slightly better, if the Central Government succeeds in getting back on the saddle and the opposition parties behave a lot more responsibly than at present. 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.

My advice to EPC companies at this time of economic uncertainty is to remain watchful and not get tempted to short circuit prudent risk evaluation & management practices. ■

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