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### **A TALE OF RETAIL**

**by Suresh S.  
Director, DMS Financial Services (P) Ltd.**

- Organised Retail is down and tottering. But it is probably a good time for investors to get serious about Retail.
  - The Retail industry is estimated to be at Rs.12,00,000 crores. Of this the unorganized sector is 95%. Organized Retail is still micro in size.
  - However Organised Retail has come to stay. There is no doubt an overlap between 'organised' and 'unorganised' but each would over time tend to define their market segments. Kirana format of stores have necessarily to accept that Organised Retail has a loyal customer base and USP.
  - ICIER report 2008 estimated 'organised retail' would grow by 45-50 per cent annually and constitute 16 per cent of total retail market by 2011-12 as against 4 per cent in 2006-07. This was based on an assumption of Indian GDP growing at 8-10 per cent annually for the next five years.
  - Due to the slowdown the estimated growth of organized retail is now put at 10.4 per cent against the original 16 per cent.
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### Global comparisons - Share of Organised Retail in Total Retail (%)

Country	Volume (\$ billion)	% share
USA	2983	85
Japan	1182	66
Brazil	284	36
Russia	276	33
Vietnam	26	22
China	785	20
India	322	4
Pakistan	67	1

- With the recovery of the Indian economy, the Retail Industry will rebound.
- The sob stories of players today are explainable and variables measurable.
- Globally malls can be classified into three categories: i. Neighbourhood malls, ii. speciality malls, and iii. Destination malls. Indian malls do not follow that distinction. Most are replicas of each other in size and appearance.
- Malls are supposed to offer ‘convenience; but parking facilities in Indian malls are poor.
- Fashion accounts for 10-15 per cent of a consumer’s disposable income. But 60 per cent of the stores in malls are for Fashion. Due to recession spend in Fashion has declined.
- Conversions that were at one time 10-15 per cent of footfalls have now declined to 2-3%.
- When consumption was growing rapidly retailers borrowed heavily to invest in real estate and working capital. The rentals for real estate zoomed. When consumption nose-dived, the retailers were left holding the baby of inventory in their hands. Shelf-life being limited, this hit them very badly in terms of saleability.

### Trend in Rentals Vs. Profit margins

Year	Rentals (%)	Profit margin (%)	Profit + Rental
2008	80	20	100
2005	68	32	100
2003	52	48	100

- Subhiksha is down with a debt burden of Rs. 750 crores and has put down shutters on 1600 outlets. This is on a base of Rs. 32 crores share capital (although Shareholder Funds is Rs. 180 crores).
- An equal amount of debt is hitting Vishal Retail.
- Rentals have fallen by 15-30 per cent. Retailers have renegotiated lease contracts.
- Those players who have not collapsed are likely to shine with improvement in the economy.
- Reliance is converting its super stores into specialist formats such as Reliance Footprints (footware), Reliance Trends (apparel)
- Spencer's Retail (RPG group) has shut down/relocated 56 unviable stores

#### **Size-wise quoted companies (Rs./crores)**

- The largest investment for Retail is typically in Inventory.

	Inventory	Total Assets	Gross Block	Net Sales
Pantaloon	1430	4036	1369	5296
Koutons	544	769	75	793
Trent	79	671	143	514
Shoppers Stop	170	470	325	1146
Provogue	154	458	62	336
Brandhouse	63	170	59	314
Kewal Kiran	28	169	47	160

- As demand revives and Sales shoot up, Inventory levels will normalize. This will enable higher Asset-Turnover and reduce Interest costs thereby generating better ROIs.

Present performance parameters are given below:

	Inventory	Total Assets	Net Sales	Assets Turnover (Times)
Pantaloon	1430	4036	5296	1.3
Koutons	544	769	793	1.0
Trent	79	671	514	0.7
Shoppers Stop	170	470	1146	2.4
Provogue	154	458	336	0.7
Brandhouse	63	170	314	1.8
Kewal Kiran	28	169	160	0.9

- Share prices in spite of the fall in the last eight months reflect high PEs ranging from 15 to 40 depending on the company. Further fall in the PEs would be an inviting situation to invest in this Industry.

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## MANAGING CONSTRUCTION RISKS IN AIRPORT PRIVATIZATION

*by Padmalatha S.*

Since the privatization of the British Airport Authority [BAA] in 1987, private sector participation in airport infrastructure has substantially expanded and evolved in many countries around the world.

The air transport industry can be viewed in four components – aircraft manufacturing, airline operations, airport infrastructure and air navigation services. The private sector has been having a dominating presence in aircraft manufacturing and airline operations. Hence, it is only logical that the sector plays a larger role in airport infrastructure as well. However, provision of Air Navigation Services [ANS] is likely to remain a core public sector responsibility, due to the strategic nature of airport assets, and the increase of security concerns and threats.

The World Bank and other nodal agencies have underscored the significance of a well functioning air transport sector in economic development and poverty alleviation in developing economies. In addition, the sector has the potential to be financially self-sustaining. When this sector starts making a positive contribution to the expanded economy, the respective governments, currently having substantial involvement in existing air transport infrastructure, would be able to restrict their focus to safety and security regulation, along with competition policy and economic and environmental regulation.

Private sector participation has increased substantially over the last two decades in the airport sector through a variety of schemes and models, such as

Sale of a concession to a private sector entity (consortium of operator, financier and developer) to operate and develop a single airport for a stipulated concession period ranging from 20 to 50 years,

Sale of a concession to a private sector entity to operate and manage a system of several airports on behalf of one or more strategic investors, or on behalf of the public at large as shareholders, for a stipulated concession period [Operations and Management Contracts],

Sale of shares in a national airports authority to the private sector (entirely or in partnership with government), such that the authority becomes an entity in the private sector [divestiture],

Sale of a concession to a private sector entity to develop and operate a facility on a government-owned airport (passenger terminal, cargo centre etc.) for a stipulated period of time, after which ownership in the facility may revert to the state. This is the typical Build-Operate-Transfer (BOT or BOOT) project under the much discussed ‘Public Private Partnership’ route.

What makes airport infrastructure development attractive for private investors?

The commercial viability of operating airport infrastructure for the private sector arises from being able to price its services effectively, and the customers being able and willing to pay for these services. Sound pricing helps in generating cash flows that can be used to pay for the operations, maintenance, and development of the facility. The cash flows also allow for debt service and adequate returns to equity holders.

International studies have shown that most mature airports remain profitable through the vagaries of the airline industry, due to the fact that they earn a high proportion of their income from non-aeronautical revenues!

*Aeronautical revenues* arise primarily from the following activities at the airport: [a] Route Navigation Facilitation Charges [RNFC], [b] Landing, Housing and Parking charges, [c] Terminal Navigation Landing Charges [TNLC], and [d] X Ray baggage charges

The important sources of *Non-aeronautical revenues* are as follows: [a] Duty free shopping, [b] Catering and Restaurants, [c] News, Shops, Banks, Communication facilities, etc., [d] Airline Terminal rents and Real Estate, and [e] Others, such as Hotel and Travel services

It therefore follows that, if privatized airports are to be profitable on a sustained basis, the airport infrastructure should include non aeronautical facilities developed to mitigate the airline industry risk.

### ***Privatization of Indian Airports***

Airports are an important gateway to India's globalization and fast track economic development agenda. At present there are 449 airports / airstrips in the country. Of these, the Airports Authority of India [AAI] manages 126 airports [89 domestic, 11 international, and 26 civil enclaves at defense airstrips]. With the opening up of the civil aviation sector, the process is on for upgrading metro airports through the PPP / Greenfield route.

Indian airports at present derive bulk of their revenue through aeronautical sources, with the metro airports contributing the bulk of non aeronautical income. Even in such cases, non aeronautical income hovers around 20% of total income. Contrast this with other international airports whose non aeronautical incomes are in the range of 60%-80% of total income. It appears that at the present level of aeronautical revenue generation, the viability of airports would be in doubt. Hence, large scale Greenfield investments by the private sector are required for development and operating these airports on international standards

Herein lie the challenges and the opportunities.

### ***Risks in airport projects***

Airport privatization projects, though profitable, carry risks for all parties involved.

The private investor's consortium, entering into the concession agreement with the host government faces *construction and completion risks*.

Thereafter, *operational and market risks* could impact the expected cash flows.

The host government runs the risk of project sponsors being unable to generate sufficient returns to carry the project through the concession period, or having to make substantial capital investment for upgradation after the concession period

The project company's highly leveraged capital structure with 'limited recourse' financing by lenders [through adopting the 'project finance' model, the most preferred financing alternative for large scale investments by the private sector] implies that any development impacting project assets or expected cash flows would directly affect the debt service capacity of the project.

Government policy changes and environmental impact could also turn out to be decisive risk factors in many projects.

### ***Construction and completion risks***

Construction Risks involved in an airport project are as great as any a company normally faces, and yet these risks are different from the kind companies are accustomed to. However, the consistent attention given to and tools employed in managing other risks are sometimes seen to be missing from the management of construction risk.

Why do construction risks assume such significance in infrastructure projects such as airports? How are these investments different from other capital expenditure decisions for companies wanting to invest in large projects?

The investment in airport privatization projects, like other large scale infrastructure projects, can generate significant financial, developmental and social returns when successful. However, these projects also require very large doses of capital upfront, followed by uncertain positive cash flows over a long period of time. The risks of these projects could give rise to high distress costs. Likewise, the project assets are significantly different from other capital assets. They are huge, tangible, take a long time to construct, assuming value and economic independence only after completion. They have very specific uses, with little or no alternative uses, and cannot be moved or divided. Moreover, most cash outflows occur before one rupee of cash inflow.

Past experience with airport privatisations in various countries suggests that risks have generally been underestimated. One reason for construction risk to be underestimated is the feeling that construction is 'old technology'.

There are basically three types of construction risk that could happen in two phases. The first type of risk is financial – project cost overruns that could leave the project unfinished and endanger the financial health of the investors. Research has borne out that construction costs are, in most cases, underestimated. Why do cost overruns occur? Are they due to bad execution or supervision? More often than not, they are due to bad planning, pricing and execution.

Another type of risk arises due to time overruns, whose implications are largely financial. When projects are completed with delays, the financial loss has to be borne by the investors or the EPC contractors, if the contract provides for damages due to cost and time overruns.

The third type of risk is related to design – the completed infrastructure does not meet the needs of its customers.

International experience with airport privatization projects has exposed the following 'practices', which lead to construction risks described above: .

Private bidders prepare optimistic forecasts, leading to an over-estimation of revenue, or under-estimation of capital costs.

Natural features of the terrain jeopardise aircraft safety. For example, in the Wellington airport privatisation, significant risk arose from the runway area extending on to narrow land, surrounded by sea.

Violation of international safety standards — the bidders' profit motive could cause airport designers to adopt a minimalist approach to reduce capital cost.

Many problems arise due to design incompatibility with the needs of the airport beyond the concession period. For example, site expandability problems were noticed in airport privatisations in Europe and New Zealand.

Changes in aircraft mix and airline alliances altered risk dimensions for a privatised airport in Canada.

One dominant partner influences the bids. If this partner is also a developer, attempts to minimise costs using substandard material may ensue, as was the case in Toronto.

Government policy changes and environmental impact were risk factors in many projects. In the absence of government's detailed development plans, bidders determined the project's form and

scale that met the profit objective of the private investor, but conflicted with traffic needs or government's plans, as in the case of the Manila airport.

It therefore appears that the onus is largely on the government in privatising substantial and sensitive infrastructure such as airports. It also follows that the government should take the lead in specifying the terms of reference for various bids from the private sector. Leaving the determination of the project's form and scale to bidders could be a prescription for failure in this sensitive sector.

However, construction and completion risks injure the interests of the developers / EPC contractors as well. How can they mitigate the risks and use their construction expertise to ensure that the project is completed on time and within the specified cost?

### ***Some tips for mitigation of construction risks by EPC contractors***

Identify all risks that could happen and address them both at the 'pre construction' and 'construction and settlement' phases. At the preconstruction /design phase insist on clarity regarding specifications so that problems similar to the ones stated above could be avoided. In the construction phase, the emphasis would move from planning to supervision.

Assess the severity of these risks on the project. For example, the site offered for the project itself could form a risk element, if the environmental /social risks connected with the site / terrain are not resolved before the project commences. Have necessary permits /licences been obtained? Is there insurance coverage for lost revenues/ pre completion force majeure events? Will the government compensate in case it causes delay? Is the construction team's capability commensurate with the risks / quality demanded by the project?

Classify the risks based on their severity as – high, medium or low. A high risk element will have a high probability of occurrence and lead to high economic damage if the risk materialized. A low risk element would have a low probability of occurrence and cause little economic damage even if the event occurred. All other risk elements can be classified as 'medium'. 'Economic damage' will have to be quantified – it could be in the nature of liquidated damages, or loss of profit or even project failure. So would the probability of occurrence, based on the contractor's previous experience in this sector.

Formulate different risk mitigation strategies for each type of risk severity. High risk components suggest that 'performance' should be emphasized. Low risk components can be looked at for price advantage. Other risks can be mitigated through a combination of 'contracts' and insurance.

Contracts work best when risks are identifiable, outcomes verifiable and contracts are enforceable. This presupposes a sound legal system – check out how strongly the prevalent legal system supports your contracts.

Finally, once construction commences, monitor, monitor, monitor. There is no substitute for close supervision, detecting problems at the incipient stage and taking corrective action.

### **Conclusion**

In many large infrastructure projects, it is customary for one or more of the equity investors to also be the EPC contractors. In the present BOOT structure being preferred for airport privatization in the country, the equity investors / EPC contractors winning the bid also have to take on the responsibility of project financing the venture. Lenders would be willing to finance the project only if the risks have been identified, their severity assessed, and mitigation measures are in place. The severity of construction risks in such projects are often underestimated due to

the previous experience / expertise of the EPC contractors and the contracts which bind their performance. Each airport is unique and so will be its construction. Hence construction risks can be mitigated only with proper specification, planning, designing and pricing of the project. There are also exogenous risks such as environmental/social that can stall projects completely. Here both the government and the EPC contractors will have to take equal responsibility to mitigate exogenous and endogenous project risks.

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**For details, please contact Mr.Karthi on 044-24995672.**