

May 05, 2016

Facility	Amount (Rs. Crore)	Rating
Proposed, Secured, Redeemable, Taxable, Non-Convertible Debentures (NCD)*	250.00	SMERA Provisional AA (SO)/Stable*

**The rating is provisional with a validity of 90 days from the date of this document. Its conversion to final rating will be subject to fulfilment of the following conditions-*

- *Appointment of SEBI Registered Trustee*
- *Receipt of Signed & Executed Trust Deed that clearly outlines the Structured Payment Mechanism (SPM)*
- *Creation of the DSRA (in the form of FD accounts with exclusive lien/charge resting with the debenture trustee) required for the enforcement and smooth functioning of the SPM (as confirmed by the trustee and Kerala Finance Corporation)*

SMERA has assigned rating of '**SMERA Provisional AA (SO)**' (**read as SMERA Provisional Double A (Structured Obligation)**) to the Rs.250.00 crore Secured, Redeemable, Taxable, Non Convertible Debenture (NCD) Issue by Kerala Finance Corporation (KFC). The outlook is '**Stable**'. The rating draws support from a strong credit enhancement mechanism wherein KFC is to maintain funds equivalent to at least 20 per cent of the issue size (i.e. Rs.50 crore) at all times in the form of a fixed deposit – exclusive lien/charge of which would rest with the debenture trustee. KFC's risk profile is further strengthened by the strong support from the Government of Kerala on account of its Systematic Importance and high shareholding by the state government. The Government of Kerala's credit profile is marked by a robust economic structure and healthy revenue structure. The rating is also driven by KFC's comfortable scale of operations and healthy market position coupled with strong resource mobilisation ability. However, these strengths are partially offset by its deteriorating asset quality and decline in profitability indicators.

The rating is provisional and the final rating is subject to the execution of the trust deed (with a SEBI registered trustee) that will clearly lay down the legal structured payment mechanism. The trust deed must also lay down the rights and obligations of all the parties distinctly. It also entails creation of a Debt Service Reserve Account (as confirmed by the borrower and the trustee) and FD accounts required for the smooth functioning of the SPM.

The rating factors in adherence to the specific legally structured payment mechanism to be administered by the trustees of the NCD. The SPM is founded on three key covenants:

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- The semi-annual interest payment is to be brought in and placed in the form of a fixed deposit in two tranches. While half of the interest payment is to be brought in three months before the due date, the rest will be brought in one month prior to the due date. Both amounts must be placed in the form of a fixed deposit with maturity one day before the due date (T-1 day). On maturity, the sum shall be directly credited to the Escrow Account from where coupon payment will be made.
- The Principal amount – payable in 4 equal annual installments beginning at the end of the 4th year – must also be brought in seven days before the due date (T-7 days) and must be placed in the form of a fixed deposit expected to mature one day before the due date (T-1) day. On maturity, the sum shall be directly credited to the Escrow Account from where the amount shall be disbursed to the bondholders.
- KFC would also maintain a fixed deposit of 20% of the issue size (Rs.50 crore) in the form of a Debt Service Reserve Account (DSRA), to be available for servicing of interest and principal payment throughout the tenure of the debenture issue. The exclusive lien/charge of this FD will lie with the debenture trustee and failure to fund the escrow account to the tune of the entire amount of principal or interest due, one day before the respective due date (T-1 day) will require the trustee to draw funds from this FD account and service the coupon and/or principal payment (as applicable). This designated FD account has to be replenished by KFC in proportion of the utilized quantum within a month's time.

The rating is also supported by significant amount of financial, operational and managerial support KFC receives from the Kerala government by virtue of being a State Financial Corporation (SFC) incorporated under the SFC Act. The rating factors in the high degree of government shareholding in KFC along with the systematically important role played by the corporation in implementing key financial and developmental objectives of the state. Moreover, the rating also takes into account the adverse implications of default by KFC on the credibility and perception of the Kerala government. SMERA thus believes that KFC will continue to receive significant support from the government.

Kerala's risk profile is characterised by healthy human development indicators marked by high literacy rate, low unemployment levels and a high degree of financial inclusion. The state also benefits from the per capita Gross State Domestic product that stood at Rs.97,194 in FY2015 against Rs.90,623 in FY2014. The state also maintains a robust revenue stream marked by high proportion of tax revenues as a percentage of total revenue. However, its credit risk profile is constrained by the relatively high fiscal and revenue deficit that stood at 4.13 per cent and 3.06 per cent of the Gross State Domestic Product, respectively. Further, the Debt-to-Gross State Domestic Product Ratio for the state continued to remain high at over 30% for the last 5 years.

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KFC also benefits from its healthy quantum of Assets Under Management (AUM) that stood at Rs. 2396.96 crore in FY2016 (provisional) against Rs.2038.15 crore in FY2015. Further, the rating also draws support from the healthy liquidity profile marked by positive liquidity match, low cost of borrowing and ease of resource mobilisation.

However, the rating is partially constrained by its deteriorating asset quality marked by an increase in the Gross Non-Performing Assets from 7.85 per cent of total assets in FY2015 to 9.94 per cent in FY2016, leading to higher provisioning requirements and pressure on profitability. The rating is further constrained by both geographic and sectoral concentration in its asset portfolio.

Rating Sensitivity Factors

- Increase in the fiscal and revenue deficit of Kerala government along with a deterioration in its coverage indicators
- Significant deterioration in its asset quality and capital adequacy ratio of KFC
- Significant decline in profitability indicators of KFC

Outlook: Stable

SMERA believes the outlook on KFC will remain 'Stable' over the medium term on account of the continued support from the Government of Kerala and adherence to a strong Structured Payment Mechanism. The outlook may be revised to 'Positive' in case of significant improvement in the asset quality along with an improvement in Government of Kerala's Risk profile. Conversely, the outlook may be revised to 'Negative' in case of deterioration in the credit risk profile of the Government of Kerala or it registers further worsening of the asset quality, capital adequacy and operational efficiency.

About the Corporation

KFC was incorporated under the State Financial Corporation Act of 1951. It was established as the Travancore Cochin Financial Corporation on 1st December, 1953. Consequent to the reorganization of states on linguistic basis in November 1956, Kerala State was formed and the Travancore Cochin Financial Corporation was renamed as Kerala Financial Corporation. KFC has 16 branch offices and is headquartered at Thiruvananthapuram.

In FY2016 (provisional figures), KFC recorded PAT (profit after tax) of Rs.8.99 crore on total income of Rs.347.59 crore against PAT of Rs.14.37 crore in FY2015 on a total income of Rs.287.06 crore.

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