

Kerala Finance Corporation: Assigned

Name of the Instrument	Amount (Rs. Crore)	Rating/Outlook
Secured, Redeemable, Taxable Non-Convertible Debentures	250.00	SMERA AA (SO)/Stable* (Assigned)

**Credit enhancement on account of structured payment mechanism in the form of a Debt Service Reserve Account (DSRA)*

SMERA has assigned rating of '**SMERA AA (SO)**' (read as **SMERA Double A (Structured Obligation)**) on the Rs.250.00 crore secured, redeemable, taxable, non-convertible debentures issued by Kerala Finance Corporation (KFC). The outlook is '**Stable**'.

The rating draws support from the strong credit enhancement mechanism wherein KFC is to maintain funds equivalent to atleast 20 per cent of the issue size (i.e. Rs.50 crore) at all times in the form of a fixed deposit – lien of which would rest with the debenture trustee. KFC's risk profile is further strengthened by the expected support from the Government of Kerala on account of its systemic importance to the state and high shareholding (97 percent) by the state government. The Government of Kerala's credit profile is marked by a robust economic structure and healthy revenue structure. On a standalone basis, the rating is also driven by KFC's comfortable scale of operations and strong resource mobilisation ability. However, these strengths are partially offset by its deteriorating asset quality and decline in profitability indicators.

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

1. The interest payment is to be 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).
2. The Principal amount – payable in four annual instalments beginning at the end of the fourth 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 on 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.
3. The lien for all these FDs will lie with the debenture trustee and failure to furnish the entire amount by T-1 day will empower the trustee to draw funds from the cash collateral placed in the DSRA and service the coupon and/or principal payment (as applicable). In case any part of the cash collateral is utilised, KFC must replenish it within one month.

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 systemic important role played by the corporation in implementing key financial and developmental objectives of the state. 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 maintains a robust revenue profile on the back of large tax revenue base. However, its credit risk profile is

constrained by the relatively high fiscal and revenue deficit as a per cent of the Gross State Domestic Product. Further, the Debt-to-Gross State Domestic Product Ratio for the state continued to exceed the FRBM target by stabilising at over 30 per cent for the last five years.

KFC's loan book size stood at Rs.2400.19 crore on 31 March, 2016 (Rs.2038.18 crore on 31 March, 2015). Further, the rating also draws support from the high resource mobilisation ability and low cost of borrowing of the corporation.

The rating is constrained by both geographic and sectoral concentration in its asset portfolio. As on 31 March, 2016, 31.57 percent of the outstanding loan book comprised advances to the hospitality sector followed by 24.03 percent of the advances to the commercial real estate sector.

KFC's Gross NPA ratio increased to 10.57 per cent as on 31 March, 2016 from 7.85 per cent on 31 March, 2015. The increase in GNPA is primarily due to prevailing recessionary trends coupled with government policy changes in the hospitality sector. The increase in GNPA coupled with decline in Net Interest Margin (NIM) to 6.05 per cent in FY2016 from 7.23 per cent in FY2015 weighed down on KFC's Return on Average Assets. The Return on Average Assets (RoAA) declined to 0.22 per cent in FY2016 from 0.69 per cent in FY2015.

Outlook: Stable

SMERA believes that 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 the Structured Payment Mechanism. The outlook may be revised to 'Positive' in case of significant improvement in the asset quality and profitability margin coupled with improvement in Government of Kerala's credit profile. Conversely, the outlook may be revised to 'Negative' in case of non-adherence to the Structured Payment Mechanism, worsening of the credit risk profile of the Government of Kerala and/or further worsening of the asset quality and profitability.

Rating Sensitivity Factors

- Adherence to the Structured Payment Mechanism
- Timely support from the Government of Kerala
- Credit profile of Kerala government
- Movement in asset quality and profitability indicators of KFC
- Movement in profitability indicators of KFC

Criteria applied to arrive at the rating:

- Non-Banking Finance Companies
- State Government Notch-up

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 reorganisation 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, KFC recorded PAT (profit after tax) of Rs.5.33 crore on total income of Rs.308.47 crore against PAT of Rs.14.37 crore in FY2015 on a total income of Rs.287.06 crore.



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