

Press Release

Kerala Finance Corporation (KFC)

February 15, 2018

Rating Reaffirmed & Assigned



Total Instruments Rated*	Rs. 500.00 Cr.
Long Term Rating	SMERA Provisional** AA (SO)/Stable (Assigned)
Long Term Rating	SMERA AA (SO)/Stable (Reaffirmed)

Refer Annexure for details

** The rating will be converted to a final rating after the:

i. Appointment of a SEBI Registered Trustee

ii. Execution of the Trust Deed with the proposed Structured Payment Mechanism (SPM) duly incorporated

Rating Rationale

SMERA has assigned the long-term rating of '**SMERA Provisional AA SO**' (read as **SMERA Provisional double A (Structured Obligation)**) to the Rs. 250.00 crore Proposed Secured Redeemable Non-Convertible Debentures of Kerala Finance Corporation (KFC) and reaffirmed its ratings on the existing Secured Redeemable Non-Convertible Debentures aggregating to Rs. 250.00 crore at **SMERA AA (SO)** (read as **SMERA double A (Structured Obligation)**). The outlook is 'Stable'.

KFC has been incorporated under the State Financial Corporation (SFC) 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 is headquartered at Thiruvananthapuram. It is a systemically important entity and under the provisions of the SFC Act, the State Government is expected to provide necessary assistance to the SFC from time to time. 97.19% of the total shares of KFC are held by the Government of Kerala (GoK) and balance is headed by domestic banks and other institutions.

The rating is supported by presence of Structured Payment Mechanism and DSRA Account, and continuing support of Government of Kerala, importance of KFC for industrial development of Kerala.

Key rating drivers

Strengths

• Adherence to Debt Service Reserve Account (DSRA) and Structured Payment Mechanism (SPM)

The rating factors in adherence to the specific legally structured payment mechanism to be administered by the trustees of the NCD. The credit enhancement terms are based on the three covenants:

- 20 per cent cash collateral in the form of Govt. Sec. / FDs.
- Upfront DSRA of 6 months interest servicing.
- Structured Payment Mechanism.

SPM focuses on funding of escrow account for principal and interest payment on timely basis. In respect of principal repayments, funds are expected to be brought in 7 days before the due date (T-7). In case of the interest portion, it is to be placed in the FD to be matured at (T-1) days with T being the due date.

• Ownership and Support from the Government of Kerala

A State Financial Corporation (SFC), KFC shall receive a significant amount of support from the Government of Kerala. It is the responsibility of the state government to ensure the solvency of the respective SFCs and to that extent; SFCs are regularly extended budgetary support by the state government's annual budget. All support required by KFC to meet its financial obligation is looked into by the Government of Kerala. On account of the 97.19% shareholding by the state government of Kerala, 3 out of the 9 Directors are civil servants appointed by the government of Kerala. Furthermore, other directors represent SIDBI, LIC of India, Bank of India and State Bank of Travancore – indicating a strong level of government support from both prominent public sector enterprises and the government of Kerala.

KFC is also entitled to borrow funds from the Reserve Bank of India vide Section 7 of the Act. Any such borrowings shall de facto be guaranteed by the state government and are generally expected to be tapped in cases of extreme financial distress. Therefore, there exists an implied obligation on the central government to extend the necessary support towards KFC in case of financial distress.

The Gross State Domestic Product of Kerala for 2017-18 at current prices is estimated to be Rs 7,47,945 crore which is 12.8 per cent higher than the revised estimate for 2016-17. Revenue deficit for the next financial year is targeted at Rs 16,043 crore, or 2.14% of the state Gross Domestic Product (GDP). Fiscal deficit is targeted at Rs 25,756 crore (3.44% of state GDP) which is slightly high.

• Policy role of Kerala Financial Corporation

KFC is a Nodal Agency for several policy initiatives by the State Government of Kerala.

Interest Subvention Schemes is based on the budget targets, KFC also is the central agency for purveying easy credit to MSMEs along with massive interest subvention schemes. Over the next 3 years, the state of Kerala has decided to focus on the growth of MSMEs in the state of Kerala – the entire financial assistance for which is expected to be routed via KFC.

Women Development and Social Upliftment Schemes, nearly all schemes with respect to the emancipation of marginalized communities are funded via the KFC. It acts as the nodal agency for extending all forms of financial assistance from time to time.

Food Safety Loans: KFC is also responsible for extending Food Safety loans towards the establishment of food testing labs and waste management plants.

As a result, any instance of default by KFC will endanger the state government's ability to continue the smooth implementation of these schemes which are indispensable with respect to ensuring economic growth and prosperity in the state of Kerala.

Weaknesses

• Weak asset quality resulting in modest profitability metrics

On account of a significant concentration of the loan book in the Hospitality sector and with the recent cancellation of bar licenses in the state of Kerala, the asset quality has significantly deteriorated.

Vide its order on the 29th December, 2015 the Supreme Court upheld the Kerala Government's liquor policy which confines bar licenses to only 5-Star hotels. As a result, SMEs in the hospitality sector – especially hotels – which relied on its income from the sale of liquor have been adversely affected. This has impacted their ability to service their debt in a timely manner – which has in turn worsened KFC's asset quality. This asset quality has further worsened on account of the Supreme Court imposed ban on sand mining activities from 6 rivers for the next 3 years (in February, 2015). However, with the gradual revival of the tourism sector and restructuring of certain stressed accounts, the GNPA has marginally improved in FY2017. The absolute value of GNPA declined

from Rs. 253.8 crore on 31 March, 2016 to Rs. 210.61 crore on 31 March, 2017. The Net Interest Margin stood at 6.38 per cent as on 31 March, 2017 as against 6.04 per cent as on 31 March, 2016. The Return on Average Asset stood at 0.21 per cent as on 31 March, 2017 as against 0.22 per cent as on 31 March, 2016

Analytical approach:

SMERA has taken a standalone view of the above entity, factored in the support from the GoK and also taken into account the robustness of the structured payment mechanism in arriving at the final rating.

Outlook – Stable

SMERA believes that the rated instruments will maintain a 'Stable' risk profile in the medium term due to adherence to the SPM by the issuer and the debenture trustee and continued support from the GoK. The outlook may be revised to positive in case of significant improvement in credit profile of GoK over the near to medium term. The outlook may be revised to negative in case of non-adherence to the SPM or in case of events which may impinge GoK's ability to provide financial and operational support to KFC.

About the Rated Entity – Key Financials

Particulars	Unit	FY17	FY16	FY15
Total Assets	Rs. Cr.	2732.17	2597.69	2200.77
Total Income	Rs. Cr.	163.97	139.46	143.35
PAT	Rs. Cr.	5.69	5.33	14.37
Net Worth	Rs. Cr.	435.45	429.17	423.92
Return on Average Assets (RoAA)	(%)	0.21	0.22	0.69
Return on Average Net Worth (RoNW)	(%)	1.32	1.25	3.43
Total Debt/Tangible Net Worth (Gearing)	Times	4.68	4.48	3.70
Gross NPA	(%)	8.98	10.57	7.85
Net NPA	(%)	4.25	5.93	3.71

Any other information:

Not Applicable

Applicable Criteria

- Default Recognition - <https://www.smera.in/criteria-default.htm>
- Non - Banking Financing Entities - <https://www.smera.in/criteria-nbfc.htm>
- Financial Ratios And Adjustments - <https://www.smera.in/criteria-fin-ratios.htm>

Note on complexity levels of the rated instrument

None

Status of non-cooperation with previous CRA (if applicable):

None

Rating History (Upto last three years)

Name of Instruments	FY 2018 (Current)			FY2016		FY2016	
	Scale	Amount (Rs. Crore)	Rating with Outlook	Date	Rating	Date	Rating
Secured Redeemable Non-Convertible Debentures	LT	250.00	SMERA AA (SO*)/Stable (Reaffirmed)	16 Nov, 2016	SMERA AA (SO)/Stable* (Assigned)	05 May, 2016	SMERA Provisional AA (SO)/Stable*
Proposed Secured Redeemable Non-Convertible Debentures	LT	250.00	SMERA Provisional AA (SO*)/Stable (Assigned)	-	-	-	-

*Annexure – Details of instruments rated

Name of the Facilities	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. Cr.)	Ratings/Outlook
Secured Redeemable Taxable Non-Convertible Bonds	9 May, 2016	8.90%	9 May, 2023	250.00	SMERA AA (SO)/Stable*
Proposed Secured Redeemable Non-Convertible Debentures	NA	NA	NA	250.00	SMERA Provisional AA (SO)/Stable*

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ABOUT SMERA

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