

Karnataka State Financial Corporation

	Amount In Rs. Crore ¹	Rating Action
Non-Convertible Bond Programme	77.00	[ICRA]AA-(SO); upgraded from [ICRA]A+(SO)

ICRA has upgraded the rating for the Rs.77.00 crore non-convertible bond programme of Karnataka State Financial Corporation (KSFC)[†] from [ICRA]A+(SO) (pronounced ICRA A plus structured obligation) to [ICRA]AA-(SO) (pronounced ICRA double A minus structured obligation). The letters SO in parenthesis suffixed to the rating symbol stand for Structured Obligation. An SO rating is specific to the rated issue, its terms, and its structure. SO ratings do not represent ICRA's opinion on the general credit quality of the issuers concerned.

The rating upgrade reflects the improvement in the credit profile of the Government of Karnataka (GoK), which has unconditionally and irrevocably guaranteed the rated instrument. The rating assigned to KSFC's debt primarily reflects the credit quality of the GoK and the integrity of and expected adherence to the structured payment mechanism, incorporating an escrow account that is monitored by a Trustee.

KSFC is a state financial corporation incorporated with the objective of promoting industrial activity in Karnataka by providing financial assistance to small and medium sized industries. During FY2016, KSFC's loan portfolio declined by 0.9% to Rs. 1,819 crore as on March 31, 2016 because of subdued credit off-take. ICRA takes note of the credit risks involved in lending to KSFC's marginal customer segment, which is reflected in the high level of non-performing assets of 13.5% as on March 31, 2016. KSFC raises funds largely through government guaranteed bonds, which comprised about 98% of its total debt outstanding as on March 31, 2016. The entity's gearing improved from 2.2 times as on March 31, 2015 to 1.8 times as on March 31, 2016 because of the decline in its portfolio and an equity infusion of Rs. 75 crore by GoK during FY2016. GoK, given its majority shareholding (94.6% as on March 31, 2016) is likely to provide timely liquidity and capital support to KSFC. The corporation registered a net profit of Rs. 32.1 crore during FY2016; it had registered a higher net profit of Rs. 44.5 crore during FY2015 supported by one-time gains following a loan settlement arrangement with Small Industries Development Bank of India (SIDBI). Going forward, the corporation's ability to grow its loan book, diversify its funding sources and improve its asset quality would be critical for improving its profits.

Government of Karnataka's Finances

The relative improvement in the credit quality of GoK is reflected in the above-average growth of the state's own tax revenues (SOTR; CAGR ~13%) and the narrowing of the pace of growth of its revenue expenditure during FY2012 to FY2016 revised estimates (RE), unlike several other states. Such trends have contributed to a healthy fiscal balance, including an uninterrupted revenue surplus position since FY2005, which has created the fiscal space for a sustained increase in capital spending since FY2014. The rating upgrade also factors in the efforts of the GoK to restrain the growth of revenue expenditure by curtailing the power and food subsidy outgo, through efforts such as eliminating fake cards, and limiting the quantity of food grains supplied to beneficiaries.

The Fourteenth Finance Commission (FFC) recommended an increase in the *inter se* share of Karnataka in the shareable Union taxes to 4.713% for its award period (FY2016 to FY2020) from 4.328% for the Thirteenth Finance Commission's award period (FY2011 to FY2015), which would support the state government's revenue collections over the medium term. With the composition of Karnataka's economy dominated by the services sector, ICRA expects the GoK's revenues to be favourably impacted by the migration to the Goods & Services Tax (GST) regime, contingent on the GST rate on the services being higher than the current service tax rate. Further, the leverage levels of the GoK, which are among the lowest in its peer group, would not be impacted by participation in the Ujwal Discom Assurance Yojana (UDAY). This is because the state government plans to implement measures for improving the operational efficiencies of the state discoms, while not taking over any discom debt under this scheme, in contrast to various other states.

¹ Rs. 1 crore = Rs. 10 million = Rs. 100 lakh

[†] For complete rating scale and definitions, please refer to ICRA's website (www.icra.in) or other ICRA rating publications

KSFC Profile

KSFC was formed under Section 3 of the State Financial Corporation Act, 1951 on March 31, 1959. The objective of the corporation is to promote industrial activity in Karnataka by providing financial assistance to industries, particularly to the small and the medium sized units. The assistance is usually in the form of term loans up to Rs. 10 crore, mainly to first-generation entrepreneurs. KSFC also provides fee-based financial services such as distribution of insurance, mutual fund products and advisory services. As on March 31, 2016, GoK had 94.6% stake in KSFC and SIDBI held 5.4% stake.

Recent Results

During FY2016, KSFC reported a net profit of Rs. 32.1 crore on a total asset base of Rs. 2,608.9 crore as on March 31, 2016 as compared with a net profit of Rs. 44.5 crore during FY2015 on a total asset base of Rs. 2,576.4 crore as on March 31, 2015.

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For further details please contact:

Analyst Contacts:

Mr. Kalpesh Gada (Tel. No. +91 22 6114 3445)
Head- Structured Finance
kalpesh@icraindia.com

Mr. Jayanta Roy (Tel. No. +91-33-2287 6617 / 2280 0008)
jayanta@icraindia.com

Mr. A M Karthik (Tel. No. +91 44 4596 4308)
a.karthik@icraindia.com

Mr. L Vivekanandan (Tel. No. +91 44 4297 4306)
l.vivekanandan@icraindia.com

Relationship Contacts:

Mr. L. Shivakumar, (Tel. No. +91 22 6114 3406)
shivakumar@icraindia.com

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**Registered Office****ICRA Limited**

1105, Kailash Building, 11th Floor, 26, Kasturba Gandhi Marg, New Delhi 110001
Tel: +91-11-23357940-50, Fax: +91-11-23357014

Corporate Office**Mr. Vivek Mathur**

Mobile: +91 9871221122

Email: vivek@icraindia.com

Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon 122002
Ph: +91-124-4545310 (D), 4545300 / 4545800 (B) Fax; +91- 124-4050424

Mumbai**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

3rd Floor, Electric Mansion
Appasaheb Marathe Marg, Prabhadevi
Mumbai—400025,
Board : +91-22-61796300; Fax: +91-22-24331390

Kolkata**Mr. Jayanta Roy**

Mobile: +91 9903394664

Email: jayanta@icraindia.com

A-10 & 11, 3rd Floor, FMC Fortuna
234/3A, A.J.C. Bose Road
Kolkata—700020
Tel +91-33-22876617/8839 22800008/22831411,
Fax +91-33-22870728

Chennai**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

5th Floor, Karumuttu Centre
634 Anna Salai, Nandanam
Chennai—600035
Tel: +91-44-45964300; Fax: +91-44 24343663

Bangalore**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

'The Millenia'
Tower B, Unit No. 1004, 10th Floor, Level 2 12-14, 1 & 2,
Murphy Road, Bangalore 560 008
Tel: +91-80-43326400; Fax: +91-80-43326409

Ahmedabad**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

907 & 908 Sakar -II, Ellisbridge,
Ahmedabad- 380006
Tel: +91-79-26585049, 26585494, 26584924; Fax:
+91-79-25569231

Pune**Mr. L. Shivakumar**

Mobile: +91 9821086490

Email: shivakumar@icraindia.com

5A, 5th Floor, Symphony, S.No. 210, CTS 3202, Range
Hills Road, Shivajinagar, Pune-411 020
Tel: + 91-20-25561194-25560196; Fax: +91-20-
25561231

Hyderabad**Mr. Jayanta Chatterjee**

Mobile: +91 9845022459

Email: jayantac@icraindia.com

4th Floor, Shobhan, 6-3-927/A&B. Somajiguda, Raj
Bhavan Road, Hyderabad—500083
Tel:- +91-40-40676500