

India Ratings Affirms Surat Municipal Corporation's NCDs at 'IND AA+'; Outlook Stable

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India Ratings and Research (Ind-Ra) has affirmed Surat Municipal Corporation's (SMC) non-convertible debentures (NCDs) as follows:

Instrument Type	ISIN	Date of issuance	Coupon Rate (%)	Maturity Date	Size of Issue (million)	Rating/Outlook	Rating Action
NCDs	INE05NX24015	1 March 2019	8.68	1 March 2024	INR2,000	IND AA+/Stable	Affirmed

The frequency of the interest payment is semi-annual (1 September and 1 March each year), and the principal repayment will be bullet.

Analytical Approach: The rating continues to reflect SMC's operational and financial performance, the nature of the escrowed assets, the strength of the structured payment mechanism, and healthy debt service coverage.

The rating is based on the stability in the performance of assets that are escrowed (property tax, fees and user charges) and the enforceable nature of these collections by the corporation. The rating also factors in a sound legal foundation of the structured payment mechanism monitored and controlled by the trustee. The structured payment mechanism is backed by a prefunded debt service reserve account (DSRA) constituting of two semi-annual interest instalments, an interest payment account (IPA) and a sinking fund account (SFA). The NCDs are issued at a fixed rate of interest that mitigates interest rate risk. The rating benefits from SMC's coverage of debt servicing obligations (interest payment + proportionate principal deposited in sinking fund or instalment of principal redemption), which Ind-Ra expects to remain at healthy levels during the course of the bond.

KEY RATING DRIVERS

Adequacy of Escrowed Revenue Stream: Under the bond structure, revenues from property tax, fees and user charges, are escrowed for servicing the debt repayment obligations. The escrowed collections will be first utilised for meeting the minimum balance required to be transferred to the IPA and SFA. The revenue from these streams grew at a CAGR of 15.06% over FY16-FY20 to INR11,102.53 million in FY20 (FY19: INR10,819.74 million). The escrowed receivables from property tax, fees and user charges are likely to provide a strong cover for SMC's debt service obligations. Also the collection of property tax (including arrears) was above 80% on an average during FY16-FY20. Ind-Ra expects the collection efficiency to remain at healthy levels over the medium term.

Structured Debt Servicing Mechanism: Under the structure, a DSRA was created and funded on 27 February 2019 before the pay-in date of 1 March 2019 with an amount equal to annual interest payments. At all times, the DSRA is to be maintained at an amount equal to two semi-annual interest payments of INR173.6 million each.

SMC has created an escrow mechanism where in the funds (property tax and user charges) will be transferred to an escrow account on a daily basis, except the last day of the month. On the last business day of every month, the minimum balance – an aggregate of monthly fund requirement to service DSA – will be transferred to the DSA from the escrow account. The funds in the debt service account will be used in the following order of priority: a) to be transferred to the DSRA to meet a shortfall, if any b) monthly transfers to the IPA on the last business day of every month and c) monthly transfers to the SFA an amount equivalent to 1/11th of the annual principal redemption requirement on the last business day of every month.

The debenture trustees will verify the availability of the requisite funds for interest servicing T-25 days before the due date. In case of a shortfall, they will intimate SMC to cover up the shortfall by T-15 days. In case of any shortfall in the IPA at T-14 days prior to the interest payment date, the trustee will trigger the payment mechanism and instruct the bank maintaining the DSRA to transfer the shortfall amount from the DSRA so that funds equivalent to the next interest payment due are ensured by T-10 days.

The debenture trustee will also check the balance in the SFA at the end of the year and in case of any shortfall, SMC will replenish the account to that extent. The trustees will also check the amount lying to the credit of SFA at T-25 days prior to the redemption date. In case of any shortfall in the amount, the trustees will intimate SMC of the shortfall and SMC will meet the shortfall by T-15 days prior to the redemption date.

Trustee Monitoring: All accounts will be monitored by the debenture trustees. The amount deposited in the IPA, DSRA and SFA will be used solely for meeting the dues to the bondholders. Any surplus funds available in the escrow account can be transferred to the account of SMC. The trustee has confirmed that SMC is adhering to the structured payment mechanism.

Adequate Own Revenue Sources: The rating also reflects SMC's ability to generate adequate revenue from its own sources to fund its revenue expenditure. The tax and non-tax revenues constituted 41.11% and 8.43%, on average respectively, of the total revenue income over FY16-FY20. The corporation recorded a revenue income of INR28,898.28 million in FY20 (FY19: INR29,856.89 million) and its own revenue/total revenue income ratio stood at 65.47% (67.06%). Property, water, vehicle and professional tax collections were the key drivers of SMC's revenue from tax collections during this period. The share of grants in the total revenue income was 29.13% in FY20 (FY19: 28.29%).

Consistent Revenue Surplus: SMC generated consistent revenue surpluses over FY16-FY20 (FY20: INR5,054.53 million; FY19: INR7,600.79 million). The operating margins of the corporation declined to 18.45% in FY20 from 26.17% in FY19. The corporation funded its entire revenue expenditure out of the revenue income during this period. While the revenue balance in FY21 is likely to reduce from the historical levels, Ind-Ra expects it to remain in surplus and continue to be so over the medium term.

Debt Service Coverage: At FYE20, SMC did not have any additional debt other than the NCDs issued. The absence of any interest servicing obligations in the past has resulted in a healthy credit profile for the corporation. Its debt service coverage ratio was 19.2x in FY20, considering the debt service obligations from the issuance of the NCDs worth INR2,000 million. Ind-Ra expects the coverage of its instrument level debt servicing obligations based on the receivables from property tax, fees and user charges will remain healthy over the medium term. The agency will closely monitor the coverage adequacy during the entire tenure of the NCDs.

Liquidity Indicator – Superior: SMC's liquidity position is supported by sustained revenue surpluses, capital grants to fund capex, sizeable cash and bank balances and unencumbered investments. The debt servicing requirement pertaining to bonds is backed by way of escrow of receivables from property and other taxes and user charges. SMC's cash balances and unencumbered investments amounted to INR10,693.45 million at FYE20 (FYE19: INR13,832.18 million).

Healthy Capital Utilisation: SMC's capex constituted 50.53%, on average, of the total expenditure over FY16-FY20, with roads, water supply and sewerage being the key areas. The corporation's capital utilisation (capex/capital income) ratio stood above 1.33x on average over FY16-FY20, indicative of its ability to undertake capex in the core areas of civic services. Ind-Ra expects the capital utilisation ratio to remain above 1x over the medium-term.

Scope for Improvement in Civic Service Deliverables: SMC's service delivery levels for the water, sewerage and solid waste segments remained comfortable over FY16-FY20, as reflected in the coverage network (FY20: water supply: 99.1%; sewage network: 100%; solid waste management service: 100%), as against the benchmark levels (100%; 100%; 100%) set by the Ministry of Urban Development for all three services. The water supply stood at 156.9 litres per capita per day (benchmark: 135 litres per capita per day). However, SMC's performance was weaker than adequate in areas such as the extent of water metering (FY20: 13.7% against benchmark levels of 100%), wastewater recycle and reuse supply (FY20: 16% against benchmark levels of 20% and hours of water supply (FY20: four hours against the benchmark levels of 24 hours) over FY16-FY20.

RATING SENSITIVITIES

The rating of the NCDs will be downgraded on downgrade of SMC's rating, which forms the starting point for the rating of these NCDs.

Positive: Future developments could, individually or collectively, lead to a positive rating action includes:

- a) a sustained improvement in the operating margins to or above 30%
- b) a sustained improvement in civic service deliverables such as the hours of water supply, the extent of water metering, the segregation of municipal solid waste, wastewater recycle and reuse to the benchmark levels

Negative: The following developments could individually or collectively lead to a negative rating action:

- a) any breach of the financial covenant as per the term sheet
- b) an unexpected increase in debt levels, resulting in the DSCR falling below 2x for consecutive two years
- c) increased dependence on grants and/or deterioration in the revenue balance for two consecutive years
- d) property tax collection efficiency (including arrears) falling below 70% for two consecutive years

COMPANY PROFILE

SMC is a local self-government. It was established in 1966 under the Bombay Provincial Corporation Act, 1949. SMC is mainly responsible for the administration of the city, maintaining infrastructure facilities, and providing various civic services such as water supply, solid waste management, sewerage, education, health and others to its citizens. SMC covers 326.52 sq km and the Surat city is divided into seven zones namely, east, west, north, south, central, south west and south east zone. There are 29 municipal wards and each municipal ward has four seats of municipal councillors.

FINANCIAL SUMMARY

Particulars	FY20	FY21 (Revised Estimates)
Revenue Income (INR million)	28,898.28	29,856.69
Revenue expenditure (INR million)	23,843.85	30,180.38
Revenue balance (INR million)	5,054.43	-323.68
Capital expenditure/total expenditure (%)	44.03%	35.74%
Revenue expenditure /Revenue income (%)	82.5%	101.1%

Source: SMC, Ind-Ra

RATING HISTORY

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook	
	Rating Type	Rated Limits (million)	Rating	6 February 2020	1 March 2019
NCDs	Long-term	INR2,000	IND AA+/Stable	IND AA+/Stable	IND AA+(SO)/Stable

ANNEXURE

Covenants

- SMC will maintain the following financial ratios at all times and the same will be tested at least at the end of each financial year: DSCR (operating surplus/total debt service) for SMC will not be less than 1.25x
- The amount collected in escrow will be at least 1.25x of the debt service amount on an annual basis. In case the ratio falls below 1.25x, SMC will not borrow against the cash flow(s) of the escrow account. No permission to borrow further is required from the bond holders as long as this condition is met.
- DSA is defined as follows: DSA = interest payment for the month + proportionate principal deposited in the SFA or the installment of principal redemption
- SMC will not borrow any further funds against the cash flows of the escrow account in case there is a shortfall in the contribution to DSA and the shortfall has not been made good by SMC.

COMPLEXITY LEVEL OF INSTRUMENTS

For details on the complexity level of the instruments, please visit <https://www.indiaratings.co.in/complexity-indicators>.

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