

India Ratings Assigns Surat Municipal Corporation's Proposed NCDs 'Provisional IND AA+'; Outlook Stable; Affirms Existing Ratings

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India Ratings and Research (Ind-Ra) has taken the following rating actions on Surat Municipal Corporation's (SMC) non-convertible debentures (NCDs):

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
Proposed NCDs [*]	-	-	-	-	INR2,000	Provisional IND AA+/Stable	Assigned

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

^{*}The rating on the proposed NCDs is provisional and pending execution of the documents as detailed in Annexure. The final rating, upon the receipt of executed documents consistent with the draft documents and the approval from the government of Gujarat for the issuance, shall be assigned within 90 days from the date of issuance of the instrument. The provisional rating may be extended by another 90 days, subject to Ind-Ra's policy, if the execution of the documents is pending. In the absence of the documentation considered while assigning the provisional rating, the agency would have assigned a rating of 'IND AA' to the proposed instruments.

Analytical Approach: Ind-Ra has taken a standalone approach while assessing SMC's ratings.

The ratings reflect the operational and financial performance of SMC in FY23, the nature of the escrowed assets and adequate debt service coverage. The ratings are based on the stability in performance of assets that are escrowed (tax revenues: property taxes, profession taxes, water charge, etc, non-tax revenues, and other income) and the enforceable nature of these collections by the corporation. The ratings also factor in the structured payment mechanism, which is monitored and controlled by the debenture trustee (DT). The structured payment mechanism of the outstanding bonds is backed by a prefunded debt service reserve account (DSRA), interest payment account (IPA) and sinking fund account (SFA).

As per the draft term sheet, the proposed green bonds have a structured payment mechanism backed by an IPA and an SFA. For the proposed bonds worth INR2,000 million, the IPA would be pre-funded with two semi-annual interest instalments, which is the required debt service reserve (DSR) amount, instead of creating a separate DSRA to meet the requirements of the Securities and Exchange Board of India's circular in relation to the 'Continuous Disclosures and Compliances by the listed entities under the Securities and Exchange Board of India (Issue and Listing of Municipal Debt

The structured payment mechanism would be monitored by the DT. Since the NCDs will be issued at a fixed rate of interest, it mitigates interest rate risk. The rating benefits from SMC's comfortable coverage of debt servicing obligations (interest payment + proportionate principal deposited in SFA or instalment of principal redemption), which Ind-Ra expects to remain above 2x over the medium term.

Key Rating Drivers

Adequacy of Escrowed Revenue Stream: Under the proposed bond structure, the entire own revenue is escrowed for the servicing of debt repayment obligations. Own-revenue includes all tax, non-tax and other income of the corporation except for any government grants and compensation. The escrowed collections are first utilised for meeting the minimum balance required to be transferred to DSRA (for existing NCDs), IPA and SFA.

SMC's revenue is primarily driven by tax collections. The escrowed tax revenue grew 8.2% yoy to INR16.09 billion in FY23 on cash basis. Tax revenue collection was robust with 22.5% yoy growth to INR13.90 billion over April-December 2023. Ind-Ra expects the own-revenue to remain healthy and provide a strong cover for SMC's debt service obligations during the entire bond tenor.

Structured Debt Servicing Mechanism: SMC has maintained the DSRA for the existing NCDs at an amount equal to two semi-annual interest payments of INR173.6 million at all times as required under the terms of the structure. The revenue collection from identified sources are 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 debt service account (DSA) – will be transferred to DSA from the escrow account. The funds in DSA shall be used in the following order of priority: a) transfer funds from DSA to DSRA to make good any shortfall, if any, in DSRA, b) monthly transfers to IPA on the last business day of every month, and c) monthly transfers to SFA an amount equivalent to 1/11th of the annual principal redemption requirement on the last business day of every month.

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

The terms of the structure for the proposed green bonds are somewhat similar to those of existing bonds. The investors shall have first and pari passu charge over the escrow account and the collection account(s). The DT will verify the availability of the requisite funds for interest servicing T-25 days before the due date. In case of a shortfall, the DT will intimate SMC to cover up the shortfall by T-10 days. In case of a shortfall in IPA at T-9 days prior to the interest payment date, the DT shall trigger the payment mechanism and instruct the escrow bank to utilise the DSR amount (on T-7 days) lying in IPA to make coupon payment on the due date. The DT shall also check the balance in SFA at the end of the year, and in case of any shortfall, SMC shall replenish the account to that extent. The DT shall check the amount lying to the credit of SFA at T-45 days prior to the redemption date. In case of any shortfall in the amount, the DT shall intimate SMC of the shortfall and SMC shall make good the shortfall by T-15 days prior to the redemption date.

Trustee Monitoring: All accounts are monitored by the debenture trustees. The amount deposited in IPA, DSRA and SFA are 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. The corporation has adhered to the SFA amount obligation of INR1,900 million till November 2023 and had already accumulated INR1,932.2 million as on 30 November 2023. The IPA is also funded timely before the due date of payment.

Own Revenue Dependence: Ind-Ra expects SMC's own revenue streams to remain satisfactory over the medium term. The rating reflects SMC's ability to generate adequate revenue from its own sources to fund its revenue expenditure. Tax and non-tax revenues constituted 41.9% and 22.6%, on average respectively, of the total revenue income over FY19-FY23. The corporation's revenue income, which expanded at a CAGR of 5.3% over FY19-FY23, stood at INR36.03 billion in FY23 (FY22: INR33.63 billion) on accrual basis. SMC's own revenue/total revenue income ratio stood at 69.9% in FY23 (FY22: 63.2%) and the share of grants and compensation in the total revenue income was 25.3% in FY23 (FY22: 32.2%). Property, water, vehicle and profession tax collections were the key drivers of revenue during this period. The current demand collection efficiency of property taxes was higher at 93.9% in FY23 (FY22: 91.2%). The corporation expects to further improve its collection efficiency to over 95% in FY24.

Consistent Operating Revenue Surpluses: Ind-Ra expects SMC's revenue balance position to remain in surplus over the medium term. SMC maintained its revenue surplus position in FY23 at INR4,311.93 million (FY22: INR4,414.13 million). The corporation funded its entire revenue expenditure out of revenue income in FY23.

Strong Debt Service Coverage: At FYE23, SMC did not have any additional debt other than the NCDs issued. SMC's debt service coverage ratio (DSCR) was 15.24x in FY23 (FY22: 9.65x). Ind-Ra expects the coverage ratio to remain healthy over the medium term. The agency will also closely monitor the coverage adequacy during the entire tenor of the NCDs.

Liquidity Indicator – Superior: SMC's liquidity position is supported by the sustained revenue surpluses, capital grants to fund capex, sizeable cash and bank balances and unencumbered investments. Its debt servicing requirement pertaining to bonds is INR173.60 million annually (till FY24). The monthly amount required to be collected in IPA and SFA, combined, is INR48.36 million as per the terms of the instrument. SMC has contributed to the SFA on a monthly basis for the redemption of the existing INR2,000 million NCDs. SMC would be able to meet this comfortably from SFA. SMC's cash balances and unencumbered investments were INR11,922.33 million as on 30 September 2023 (FYE23: INR6,454.36 million). Ind-Ra believes the cash and investment position is more than adequate to fund debt servicing obligations, if required, in the near term.

In addition, there is financial covenant on the borrowing limit for the existing NCDs. The amount collected in escrow shall be at least 2x the debt service amount on an annual basis. In case the ratio falls below 1.25x, SMC shall not borrow against the cash flow(s) of the escrow account.

Capital Utilisation and Scope of Improvement in Civic Services Delivery: Ind-Ra expects the capital utilisation ratio to remain above 1x in the medium term. The consistent revenue surplus has enabled the corporation to undertake significant capital expenditure which stood at INR25,156 million in FY23 (FY22: INR18,686.68 million) where road works and street lighting together constituted 29% and sanitation-sewerage work constituted 13% on average, of the total capital expenditure during FY19-FY23. Water supply and sewerage were the other key areas of capex during this period. The corporation's capital utilisation (capex/capital income) ratio stood above 1.31x on average during FY19-FY23, which indicates SMC's ability to undertake capex in core areas of civic services.

SMC's service delivery levels for the water, sewerage and solid waste segments remained comfortable as reflected in coverage network (water supply: 93.6%; sewerage network: 100%; solid waste management service: 100%), as against the benchmark levels (water: 100%; sewerage: 100%; solid waste: 100%) set by the Ministry of Housing and Urban Affairs for all three services. The supply of water stood at 152.7 litres per capita per day in FY23 (benchmark: 135 litres per capita per day). However, SMC's performance was weaker than adequate in areas such as the extent of water metering, wastewater recycle and reuse and hours of water supply during FY19-FY23.

Rating Sensitivities

Positive: The positive rating triggers are not applicable for the rated instrument of the urban local body as the instrument rating will have a cap of 'IND AA+' in absence of any unconditional, irrevocable, pre-default and continuing guarantee from the sovereign for principal and interest payments throughout the life of the instrument or a full/partial credit guarantee from any multilateral donor agency.

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

- any breach of financial covenants as per the term sheet
- an unexpected increase in the debt levels resulting in DSCR falling below 2x for consecutive two years
- a reduction in own revenues due to low property tax collection efficiency, leading to higher dependence on grants and/or deterioration in the revenue balance position
- current demand property tax collection efficiency falling below 75% for two consecutive year
- failure or breach to comply with SEBI listing requirements with regard to timely disclosure on a sustained basis

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on SMC, either due to their nature or the way in which they are being managed by the entity and sponsor. For more information on Ind-Ra's ESG Relevance Disclosures, please click [here](#). For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click [here](#).

Company Profile

SMC, a local self-government, was established in 1966 under the Bombay Provincial Corporation Act, 1949. The corporation 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 462.15 sq km and the Surat city is divided into nine zones namely, east, west, north, south a, south b, central, south west and south east A, south east B zone. There are 30 municipal wards and each municipal ward has four seats of municipal councilors.

FINANCIAL SUMMARY

Particulars (INR billion)	FY22	FY23
Revenue income	33.63	36.03
Revenue expenditure	29.22	31.72
Revenue balance	4.41	4.31
Debt service coverage ratio (x)	9.65	15.24
Debt payment/Revenue income (%)	1.52	0.84
Source: SMC, Ind-Ra		

Non-Cooperation with previous rating agency

Not applicable

Solicitation Disclosures

Additional information is available at www.indiaratings.co.in. The ratings above were solicited by, or on behalf of, the issuer, and therefore, India Ratings has been compensated for the provision of the ratings.

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APPLICABLE CRITERIA

Local and State Government Rating Criteria

Evaluating Corporate Governance

Policy on Provisional Ratings

The Rating Process

Rating History

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook			
	Rating Type	Rated Limits (million)	Rating	3 February 2023	4 February 2022	5 February 2021	6 February 2020
NCDs	Long-term	INR4,000	IND AA+/Stable	IND AA+/Stable	IND AA+/Stable	IND AA+/Stable	IND AA+/Stable

Annexure

Sr. No.	Pending documentation/steps considered while assigning the provisional rating	Risks associated with the provisional nature of the credit rating in the absence of completed documentation/steps
1.	Debenture trust deed	Weaker structure and monitoring; risks to timeliness of payment; lower protection to investors
2.	Escrow agreement	
3.	Final term sheet	
4.	Final information memorandum	
5.	Statement of interest payment account showing one annual instalment of debt service reserve amount one day prior to the pay-in date	Pending funding of the DSR amount would increase vulnerability to cashflow mismatches and a risk of timely debt servicing

* Additionally, any other relevant documents executed for the transaction should be provided to the agency.

Covenants

1. SMC shall maintain the following financial ratios at all times and the same shall be tested at least at the end of each financial year:

DSCR not below 1.25x

DSCR = operating surplus/total debt service

2. The amount collected in escrow shall be at least 2x the debt service amount on an annual basis. In case the ratio falls below 1.25x, SMC shall 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 instalment of principal redemption

3. SMC shall 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

Instrument Type	Complexity Indicator
NCDs	Low

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

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Ind-Ra currently maintains coverage of corporate issuers, financial institutions (including banks and insurance companies), finance and leasing companies, managed funds, urban local bodies and project finance companies.

Headquartered in Mumbai, Ind-Ra has seven branch offices located in Ahmedabad, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata and Pune. Ind-Ra is recognised by the Securities and Exchange Board of India, the Reserve Bank of India and National Housing Bank.

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