**Press Release**

**Karnataka State Financial Corporation**

**August 13, 2020**

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Amount (Rs. crore)</th>
<th>Rating(^1)</th>
<th>Rating Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsecured Bonds Series I</td>
<td>-</td>
<td>-</td>
<td>Withdrawn #</td>
</tr>
<tr>
<td>Unsecured Bonds Series II</td>
<td>100</td>
<td>CARE AA-(CE); Negative [Double A Minus (Credit Enhancement); Outlook: Negative]</td>
<td>Revised from CARE AA-(CE); Stable [Double A Minus (Credit Enhancement); Outlook: Stable]</td>
</tr>
<tr>
<td>Unsecured Bonds Series III</td>
<td>200</td>
<td>CARE AA-(CE); Negative [Double A Minus (Credit Enhancement); Outlook: Negative]</td>
<td>Revised from CARE AA-(CE); Stable [Double A Minus (Credit Enhancement); Outlook: Stable]</td>
</tr>
<tr>
<td>Unsecured Bonds Series IV</td>
<td>200</td>
<td>CARE AA-(CE); Negative [Double A Minus (Credit Enhancement); Outlook: Negative]</td>
<td>Revised from CARE AA-(CE); Stable [Double A Minus (Credit Enhancement); Outlook: Stable]</td>
</tr>
<tr>
<td>Unsecured Bonds Series V</td>
<td>250</td>
<td>CARE AA-(CE); Negative [Double A Minus (Credit Enhancement); Outlook: Negative]</td>
<td>Revised from CARE AA-(CE); Stable [Double A Minus (Credit Enhancement); Outlook: Stable]</td>
</tr>
<tr>
<td>Unsecured Bonds Series VI</td>
<td>94</td>
<td>CARE AA-(CE); Negative [Double A Minus (Credit Enhancement); Outlook: Negative]</td>
<td>Revised from CARE AA-(CE); Stable [Double A Minus (Credit Enhancement); Outlook: Stable]</td>
</tr>
<tr>
<td>Issuer Rating(^2)</td>
<td>-</td>
<td>CARE BBB(Is); Stable [Triple B (Issuer); Outlook: Stable]</td>
<td>Reaffirmed</td>
</tr>
</tbody>
</table>

\(^1\)Complete definitions of the ratings assigned are available at [www.careratings.com](http://www.careratings.com) and in other CARE publications.

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**Detailed Rationale & Key Rating Drivers for the credit enhanced debt**

The rating assigned to the bonds of Karnataka State Financial Corporation (KSFC) is primarily based on credit enhancement in the form of an unconditional and irrevocable guarantee from Government of Karnataka for the payment of interest and repayment of principal.

**Detailed Rationale & Key Rating Drivers of Government of Karnataka**

Karnataka has been recording favorable economic growth over the years and continues to be fiscally strong. The state has been adhering to the fiscal consolidation norms prescribed by the Finance Commission i.e. maintaining a zero revenue deficit, Gross fiscal Deficit at less than 3% of GDP, interest costs at less than 15% of revenue receipts and debt at less than 25% of GDP. Owing to its favorable fiscal position, the state has been eligible for fiscal flexibility under the 14th Finance Commission of additional borrowing or fiscal deficit of 0.5% of GDP during FY17-FY20. The state has been maintaining a revenue surplus since FY05 and is fairly self-reliant with nearly 70% of its revenues comprising of own revenue sources – tax and non-tax sources. The state is also seen to be focusing on asset creation and has established a consolidated sinking fund for amortization of its debt obligations. In addition, the state has not availed ways and means advances or overdraft facility from the RBI, indicative of its prudent liquidity management practices.

At the same time, the state’s revenue expenditure has been growing at a faster pace than its revenue receipts leading to reduction in the quantum of revenue surplus. The increase in committed expenditure, subsidies and farm loan waivers have been weighing on the state’s finances in recent years.

The state’s financial position is likely to be pressured in FY21 owing to the disruptions caused by the Corona pandemic led lockdowns.

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\(^2\)Issuer rating of KSFC will be subject to it maintaining overall gearing of less than 3x as on March 31, 2021.
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Key Rating Drivers of Karnataka State Financial Corporation
The issuer rating of Karnataka State Financial Corporation (KSFC) continues to take into account consistent improvement in capital adequacy levels of the Corporation over the years from 16.71% as on March 31, 2016 to 31.38% as on March 31, 2020. The rating also takes note of consistent improvement in gearing levels (adjusted for pass through equity) from 5.54x as on March 31, 2016 to 2.21x as on March 31, 2020 aided by structured payment mechanism for repayment of debts and consistent support from GoK by way of equity infusion and stable profitability which has witnessed improvement during FY20. Further, the issuer rating continues to derive strength from strong parentage and support from Government of Karnataka (GoK) holding 91.90% stake (bonds guaranteed by GoK are rated CARE AA-(CE); Negative), long operational track record of 6 decades of the Corporation and comfortable resource profile and liquidity position. These rating strengths are partially offset by weak asset quality albeit improvement in FY20 and inherent risk associated with its customer segment.

Rating Sensitivities

Government of Karnataka
Positive Factors
• Higher growth in revenue receipts
• Further improvement in self-reliance
• Adherence to the stipulated target for fiscal deficit
• Creation of Guarantee Redemption Fund

Negative Factors
• Deterioration in the state’s finances
• Non adherence to the FRBM targets
• Additional loan waivers that could pressurize state finances

KSFC
Positive Factors
• Sustained improvement in scale, profits and asset quality.

Negative Factors
• Higher slippages impacting asset quality and profitability.
• Moderation in support from GoK.

Outlook: Negative
The outlook is being changed from stable to negative of Government of Karnataka on account of the likely adverse impact of the corona virus pandemic on the Karnataka’s economy and finances. The outlook can be revised to Stable if the State is able to attain the pre-pandemic level economic and fiscal strength.

Detailed description of the key rating drivers

Government of Karnataka
Favorable economic growth
Karnataka’s economy is estimated to grow by 7% (advance estimate) in FY20 over the 8% growth of FY19. In terms of annual growth rate, the state’s economy has seen a sustained moderation in growth from 13% in FY17 to an estimated 7% in FY20 AE. All main sectors viz. agriculture, industry and services are expected to see a positive growth in FY20. Though the agriculture sector is slated to see an improvement (4% v/s -2%), the industry (5% v/s 6%) and services sector (8% v/s 10%) are expected to see moderation in terms of annual growth in FY20 due to demand slowdown.

Fiscal Prudence
The state has been adhering to the fiscal consolidation norms prescribed the Finance Commission i.e. maintaining a zero revenue deficit, GFD/GSDP at less than 3%, Interest/RR within 15% and Debt/GSDP not surpassing 25%. The state has been eligible for fiscal flexibility under the 14th Finance Commission of additional borrowing or fiscal deficit of 0.5% of GDP during FY17-FY20.

Sustained Revenue Surplus
The state has been maintaining a revenue surplus since FY05. However, the quantum of revenue surplus is estimated to moderate in FY20. At Rs 285 crs, it is 58% lower than Rs 680 crs in FY19. This can be ascribed to higher growth in revenue expenditure (12%) compared with that of revenue receipts (7%). In FY21, the revenue surplus of the state is budgeted to be Rs. 143 crore, which is 50% lower than FY20.
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Self-reliance
The state is fairly self-reliant with nearly 70% of its revenues comprising of own revenue sources – tax and non-tax sources.

Focus on asset creation
The state government has been incurring higher expenditure towards asset creation. Capital outlay which accounts for nearly 75% of the total capital expenditure of the state is estimated to have increased by 7% in FY20 (RE) as against the 13% growth a year ago. Capital outlay of the state is mainly concentrated towards irrigation and flood control, transport, water supply and sanitation.

Prudent liquidity management
The state has not availed of WMA from the RBI since FY08, reflective of its prudent liquidity management practices.

Maintenance of CSF to meet contingencies
The state has been maintaining a consolidated sinking fund (CSF) since FY13, with a corpus of Rs 4,123 crs as end of May2020

Key Rating Weaknesses
Higher growth in revenue expenditure compared with revenue receipts
In FY20 RE, the revenue expenditure of the state is estimated to have at a faster pace (8%) when compared with the growth in revenue receipts at 7%. Revenue expenditure of the state is mainly incurred towards social services (education, sports, art and culture, social security and welfare, medical health and family welfare) and economic services (agriculture and allied activities, energy and rural development).

Absence of Guarantee Redemption Fund
As per data from RBI, the state does not have a Guarantee Redemption Fund.

Increase in Guarantees
There has been an increase in guarantees extended by the state government to state entities. The guarantees rose by 19% to Rs. 24,091 crore in FY19, 31% higher than that a year ago. The guarantees were mainly extended to irrigation (57%), power (18%), housing and urban development (9%), co-operatives (7%) among others.

Off budget borrowings
Borrowings by state PSUs and corporations in FY21 are budgeted to be Rs. 4,272 crore, 10% higher than that in FY20 (BE) (Rs. 3,874 crores). These borrowings are essentially off-budget borrowings.

Liquidity - Strong
In FY20, due to delay in GST settlements from GoI, State had to resort to avail Special Drawing facility for a few days to meet its expenditure commitments. The state has not availed of WMA from the RBI since FY04, reflective of its prudent liquidity management practices.

For Karnataka State Financial Corporation

Key Rating Strengths
Strong parentage and support from Government of Karnataka:
KSFC is backed by strong promoter with Government of Karnataka as the major shareholder with 91.90% stake as on March 31, 2020. GoK has infused Rs.100 cr in FY20 (FY19: Rs. 68.45 crore) to support KSFC's increasing scale of operations. The corporation also receives support from GoK in the form of interest subsidy. During FY20, KSFC received Rs. 71.50 crore of interest subsidy in FY20 (FY19: Rs. 99.94 crore) towards various schemes for SC/ST, women entrepreneur borrowers. Earlier, GoK had infused Rs. 610 crore of pass through equity in KSFC for further investments in state Govt. entities namely Krishna Jala Bhagya Nigam Ltd, Karnataka Neervari Nigam Ltd and Cauvery Neervari Nigam Ltd. KSFC transferred back Rs. 150 crore of the same in FY18 and balance Rs.460 crore was transferred in FY19 in favour of GoK.

Long operational track record and continuing growth in business albeit geographical concentrated operations:
KSFC has a long operational track record of 6 decades in the State of Karnataka. The scale of operations of KSFC has grown steadily over the years. KSFC has a branch network of 32 spread across 30 districts in Karnataka. The loan portfolio registered a 13.31% growth to Rs. 2208 crore in FY20 from Rs. 1949 crore in FY19. Since inception, it has made cumulative sanctions of Rs. 17884.72 crore as on March 31, 2020. The flow of assistance to micro and small scale enterprises accounts to Rs. 11,170 crore as on March 31, 2020 being 62.5% of the total sanctions. During FY20, KSFC has made sanctions of Rs. 667.81 crore (PY:
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Rs. 1098.73 crore) with disbursement of Rs. 727.9 crore (PY: Rs. 665.9 crore). Disbursements in FY20 were majorly towards Hotels, Food & Beverages, Engineering, Non-Metallic products, Manufacturing sectors, Textiles & Readymade Garments.

Improvement in profitability in FY20:
Interest income grew to Rs. 303.56 Crore in FY20 from Rs. 262.20 crore in FY19 which was in line with the growth in loan portfolio. Further, other income (Excluding income from Prudential written off accounts) increased from 9.3 cr in FY19 to 16.1 cr in FY20. Interest expenses have also come down marginally due to redemption of few bonds. This led to increase in Net interest income from Rs.141.3 cr in FY19 to 169.1 cr in FY20. Increase in total income coupled with moderate improvement in operating expenses led to improvement in PAT from 9.6 cr in FY19 to 31.4 cr in FY20. KSFC has provided Rs. 57 cr (Excluding provisions written off-Rs.27.63 cr) in FY20 (PY: 57.8 cr) of which Rs. 20 cr was for additional provisions to cover for COVID risk apart from Rs.1.47 cr (5% stipulation as per RBI for QYFY20). ROTA and RONW improved from 0.43% and 1.26% in FY19 to 1.37% and 4.42% respectively in FY20.

Comfortable gearing levels and structured payment mechanism for repayment of bonds:
With consistent profitability and equity infusion from GoK, KSFC’s gearing levels continued to remain comfortable. The total debt outstanding as on March 31, 2020 stood at Rs. 1566 cr (KSFC has borrowed Rs. 500 cr of term loans and had redeemed Rs. 218 cr) as against Rs. 1311cr outstanding as on March 31, 2019. However, gearing improved to 2.21 (PY: 2.3) due to equity infusion of Rs. 100 cr by GoK in FY20. KSFC’s has diversified its resource profile compared to FY19 which comprised of bonds and bank borrowings guaranteed by GoK.

Comfortable capital adequacy levels:
CAR and Tier I CAR stood comfortable at 31.38% (CAR Tier 1 Capital- 28.76%) as on March 31, 2020 as against 28.73% (Adjusting for pass through equity, CAR Tier 1 Capital: 26.51%) as on March 31, 2019. Improvement in the CAR is on account of equity infusion of Rs 100 Crores and accretion of profit. Company’s risk weighted assets increased from Rs.2099 crore as on March 31, 2019 to Rs.2397 crore as on March 31, 2020 in line with growth in portfolio. GoK has provided Rs 100 cr for KSFC in the Budget for FY21. Government Order for Rs. 50 cr has been issued and the amount is expected to come in the month of Aug’20.

Key Rating Weaknesses
Weak asset quality albeit improvement during FY20:
KSFC’s GNPA and NNPA levels though improved to 9.58% and 5.12% as on March 31, 2020 as against 11.95% and 6.09% as on March 31, 2019, continues to remain high. Improvement in asset quality was aided by lower additions of Rs. 60.13 cr (PY: 91.12 cr) to Net NPA and recovery of Rs. 63.71 crore (PY: Rs.89.24 crore) during the year which led to lower GNPA of Rs.211 crore as on March 31, 2020 against Rs. 233 crore as on March 31, 2019. The provision coverage ratio of KSFC remained comfortable at 49.09% as on Mar’20 (PY: 52.25%). Net NPA to Net worth of the company improved from 19.5% as on March 31, 2019 (adjusted for transfer of pass through equity) to 15.18% as on March 31, 2020 due to profit accretion and capital infusion by GoK. Given the current challenging macro environment scenario due to disruption caused by Covid-19, KSFC’s ability to avoid slippages remains a key concern.

Inherent risk associated with its customer segment:
The customer segment which KSFC serves are micro, small and medium enterprises (MSME), first generation entrepreneurs in semi-urban and rural areas with minimal or no access to bank financing. With inherently average credit risk profile for the borrowers, satisfactory performance of the portfolio is critical for KSFC credit profile.

Liquidity: Adequate
As per the ALM statement submitted by Corporation as on March 31, 2020, KSFC’s liquidity profile is characterized by positive cumulative mismatches till upto 1 yr bucket. The positive cumulative mismatches was on account of short tenure of advances as against longer tenor bonds.
Liquidity is also supported by constant support from the parent, GOK, which had infused Rs.100 crore in FY20. As on March’20, the corporation had cash and bank balance of Rs. 230 crore.

Analytical approach:
Credit Enhanced debt: Based on credit enhancement in the form of an unconditional and irrevocable guarantee from Government of Karnataka- Guarantor’s assessment.
Issuer rating: Standalone along with systemic importance to GoK.

Applicable Criteria
CARE’s Criteria on assigning Outlook to Credit Ratings
CARE’s Policy on Default Recognition
Financial ratios – Financial sector
Rating Methodology: Consolidation and Factoring Linkages in Ratings
Rating Methodology - Non Banking Finance Companies (NBFCs)
Rating Methodology-State Governments
Factoring Linkages in Ratings
CARE’s Issuer Rating

About the Company – Karnataka State Financial Corporation (KSFC)
Karnataka State Financial Corporation (KSFC) was incorporated in 1959, under the State Finance Corporations Act, 1951 by Government of Karnataka (GoK), with a mandate for assisting small and medium enterprises in the state with special focus to the industrially backward areas. GoK is the majority shareholder (91.90%) in the Corporation whereas SIDBI holds 8.05% as on March 31, 2020.

Covenants of rated instrument / facility: Detailed explanation of covenants of the rated instruments/facilities is given in Annexure-3

<table>
<thead>
<tr>
<th>Brief Financials (Rs. crore)</th>
<th>FY19 (A)</th>
<th>FY20 (A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total operating income</td>
<td>301.1</td>
<td>331.2</td>
</tr>
<tr>
<td>PAT</td>
<td>9.6</td>
<td>31.4</td>
</tr>
<tr>
<td>Interest coverage (times)</td>
<td>1.07</td>
<td>1.27</td>
</tr>
<tr>
<td>Total Assets</td>
<td>2010</td>
<td>2554</td>
</tr>
<tr>
<td>Net NPA (%)</td>
<td>6.09</td>
<td>5.12</td>
</tr>
<tr>
<td>ROTA (%)</td>
<td>0.71</td>
<td>1.37</td>
</tr>
</tbody>
</table>

A: Audited

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating History for last three years: Please refer Annexure-2

Annexure-1: Details of Instruments/Facilities

<table>
<thead>
<tr>
<th>Name of the Instrument</th>
<th>ISIN</th>
<th>Date of Issuance</th>
<th>Coupon Rate</th>
<th>Maturity Date</th>
<th>Size of the Issue (Rs. crore)</th>
<th>Rating assigned along with Rating Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer Rating-Issuer Ratings</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.00</td>
<td>CARE BBB (Is); Stable</td>
</tr>
<tr>
<td>Bonds</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>0.00</td>
<td>Withdrawn</td>
</tr>
<tr>
<td>Bonds</td>
<td>INE549F08475</td>
<td>January 25, 2011</td>
<td>8.60%</td>
<td>January 25, 2022</td>
<td>100.00</td>
<td>CARE AA- (CE); Negative</td>
</tr>
<tr>
<td>Bonds-Re redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>INE549F08509</td>
<td>October 18, 2012</td>
<td>9.24%</td>
<td>October 18, 2024</td>
<td>200.00</td>
<td>CARE AA- (CE); Negative</td>
</tr>
<tr>
<td>Bonds-Re redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>INE549F08517</td>
<td>February 04, 2013</td>
<td>9.08%</td>
<td>February 04, 2025</td>
<td>200.00</td>
<td>CARE AA- (CE); Negative</td>
</tr>
<tr>
<td>Bonds-Re redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>INE549F08525</td>
<td>September 01, 2014</td>
<td>9.19%</td>
<td>September 01, 2024</td>
<td>250.00</td>
<td>CARE AA- (CE); Negative</td>
</tr>
<tr>
<td>Bonds-Re redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>INE549F08533</td>
<td>December 26, 2014</td>
<td>8.58%</td>
<td>December 26, 2020</td>
<td>94.00</td>
<td>CARE AA- (CE); Negative</td>
</tr>
</tbody>
</table>
Annexure-2: Rating History of last three years

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the Instrument/Bank Facilities</th>
<th>Current Ratings</th>
<th>Rating history</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Type</td>
<td>Amount Outstanding (Rs. crore)</td>
</tr>
<tr>
<td>1.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>-</td>
</tr>
<tr>
<td>2.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>100.00</td>
</tr>
<tr>
<td>3.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>200.00</td>
</tr>
<tr>
<td>4.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>200.00</td>
</tr>
<tr>
<td>5.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>250.00</td>
</tr>
<tr>
<td>6.</td>
<td>Bonds-Redeemable Non Convertible Unsecured Taxable Bonds</td>
<td>LT</td>
<td>94.00</td>
</tr>
<tr>
<td>7.</td>
<td>Issuer Rating-Issuer Ratings</td>
<td>Issuer rat</td>
<td>0.00</td>
</tr>
</tbody>
</table>
Annexure-3: Detailed explanation of covenants of the rated instrument / facilities

<table>
<thead>
<tr>
<th>Bonds</th>
<th>Detailed explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. <strong>Financial covenants</strong></td>
<td>Not stipulated</td>
</tr>
</tbody>
</table>
| B. **Non-Financial covenants** | Structured payment mechanism for repayment of bonds:  
  i) At least 30 calendar days prior to the forthcoming due date for payment of interest and / or principal (T-30), KSFC shall credit the requisite funds to the TRA for servicing the bonds on the forthcoming due date and communicate it to trustee.  
  ii) The funds credited to TRA may be put as short term Fixed Deposit, only with Banks having rating equivalent to AA from any SEBI approved Credit rating Agency, with a lien on the Fixed Deposit in favour of the Trustee. At least 5 days prior to the due date, the amount invested in Fixed Deposit shall be transferred to the TRA and the interest earned thereon will be credited to the current account of KSFC. After making payment to all the bond holders, any amount lying in the credit of TRA may be withdrawn by the KSFC.  
  iii) In case KSFC does not deposit the funds in to TRA at least 30 days prior to the due date, it shall communicate this matter in writing to the Finance Department, Govt. of Karnataka, with a request to provide adequate funds to the TRA, indicating the forthcoming due date and amount payable to bondholders with a copy marked to the Trustee and the Credit Rating Agency.  
  iv) In case KSFC fails to intimate GoK as required in point (iii) above, the trustee shall intimate the Govt. of Karnataka at least 25 calendar days prior to forthcoming due date (T25).  
  v) In the event that GoK fails to ensure funds in the TRA at least 7 business days prior to the due date (T-7), the Trustee shall invoke the guarantee issued by the Government of Karnataka on (T-7) and inform the Credit Rating Agency about the same.  
  vi) On invocation of the guarantee, the GoK will deposit the necessary funds to the TRA at least 3 days prior to the due date (T-3)  
  vii) The KSFC will ensure the payment to the investors on the due date by way of RTGS/NEFT/Funds Transfer. Wherever such facilities are not available, Cheques/DDs will be despatched to the investors at least 5 days prior to the due date |

Annexure 4: Complexity level of various instruments rated for this company

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the Instrument</th>
<th>Complexity Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Issuer Rating</td>
<td>Simple</td>
</tr>
<tr>
<td>2.</td>
<td>Bonds-Redeemable Non-Convertible Unsecured Taxable Bonds</td>
<td>Simple</td>
</tr>
</tbody>
</table>

*Note on complexity levels of the rated instrument:* CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.
About CARE Ratings:
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Disclaimer
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Our ratings do not factor in any rating related trigger clauses as per the terms of the facility/instrument, which may involve acceleration of payments in case of rating downgrades. However, if any such clauses are introduced and if triggered, the ratings may see volatility and sharp downgrades.

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