

# Ratings



## Rating Rationale

January 18, 2019 | Mumbai

### North Karnataka Expressway Limited

Rating downgraded to 'CRISIL A+(SO)'; continues on 'Watch Negative'

#### Rating Action

Rs.28.9 Crore Non Convertible Debentures <sup>1</sup>	CRISIL A+(SO) (Downgraded from 'CRISIL AA+(SO)'; Continues on 'Rating Watch with Negative Implications')
Rs.32.2 Crore Non Convertible Debentures <sup>1</sup>	CRISIL AA+(SO)/Watch Negative (Withdrawn)

<sup>1</sup> crore = 10 million

Refer to annexure for Details of Instruments & Bank Facilities

<sup>1</sup> Refers to the issue value of the zero coupon bonds yet to be redeemed

#### Detailed Rationale

CRISIL has downgraded its rating on the non-convertible debentures (NCDs) of North Karnataka Expressway Ltd (NKE) to 'CRISIL A+(SO)' from 'CRISIL AA+(SO)'. The rating remains on 'Rating Watch with Negative Implications'.

CRISIL has also **withdrawn** its rating (*details in Annexure 1*) on NCDs that were redeemed, after obtaining independent confirmation from the trustee.

NKE is a subsidiary of IL&FS Trust Company Ltd - ITNL Road Investment Trust and part of Infrastructure Leasing and Financial Services Ltd (IL&FS) group.

The rating action follows a reversal of the management's earlier stance of maintaining the integrity of ringfenced structure and structured payment waterfall in some of its special purpose vehicles (SPVs), including Jharkhand Road Projects Implementation Co Ltd (JRPICL; 'CRISIL BB(SO)/Watch with Negative Implications'), by invoking the National Company Law Appellate Tribunal's (NCLAT) interim stay order. Since the order covers all SPVs in the group including NKE, this development has spawned untested legal risks for other bankruptcy-remote SPVs in the group as well. Consequently, uncertainties regarding future debt servicing by NKE has increased sharply.

NKE is an SPV where annuities are received in a ringfenced, trustee-controlled escrow account. This and the waterfall mechanism protects its cash flows from stress at the sponsor company. Further, a Debt Service Reserve Account (DSRA) is also created in NKE to ensure timely debt servicing in case of any procedural delay in annuities or any other contingencies. Together, these structural features ensure high certainty of timely debt servicing.

NKE has a strong track record of smooth operations and receives its annuities in a timely manner. As a result, it can comfortably service NCDs from its own cash flows with the additional comfort of a DSRA equivalent to one semi-annual debt service. As on December 31, 2018, NKE had Rs 44 crore liquidity available for debt servicing (~1.4 times the semi-annual debt servicing of Rs 31 crore due in January 2019).

CRISIL had, through its Credit Bulletin on JRPICL and NKE on January 15, 2019, informed about the likely impact of the management's action to withhold debt servicing in JRPICL by invoking Clause 6 of NCLAT's order dated October 15, 2018, on specific lender actions. The management had, on January 4, 2019, written a letter to IDBI Trusteeship Services Ltd, the trustee of its NCDs, to stop further debits from the company's escrow account to service debt obligations.

CRISIL notes that management's action is contrary to its earlier stance (*please refer to CRISIL's Rating Release on NKE dated November 5, 2018*) that the proposed resolution plan of the IL&FS group will not compromise on JRPICL's ringfenced structure, structured payment waterfall, or debt servicing. This also indicates management's lack of willingness to service debt in a timely manner.

Further, JRPICL and NKE are recognised as separate legal entities under the Companies Act, 2013, distinct from its parent and shareholders. The invocation of NCLAT's order by JRPICL challenges the legal standing of ringfenced nature and bankruptcy-remoteness of the SPV and its validity will be tested in a court of law. At the same time, this has led to the emergence of legal risk for the ringfenced transactions in bankruptcy-remote entities such as NKE as well. Though NKE has not invoked the NCLAT order to restrict debt servicing so far, this cannot be ruled out in future as NKE is also covered under the NCLAT order. At present, NKE is fully capable of servicing its debt from its own resources and the most recent debt repayment due on January 15, 2019, was serviced on time. Incidentally, NKE has not availed of any subordinated debt from its sponsors.

However, due to the emerging legal risk and the group's lack of willingness to service debt in timely manner, NKE is also witnessing increased risk of irregular debt servicing.

At present, the matter is sub-judice and the next hearing in NCLAT is scheduled on January 28, 2019. CRISIL will monitor the proceedings very closely and take appropriate rating action based on the outcomes at NCLAT.

CRISIL has kept the rating on 'Watch Negative' due to uncertainty over:

- trustee actions towards making the payment
- NCLAT's final view on debt sustenance of self-sufficient ringfenced projects of IL&FS in the debt resolution plan of the group
- any steps that the parent may take to rationalise the reserve or alter terms of the transaction that enable them to tap into the surplus cash at NKE

CRISIL will keep a close watch on the developments and resolve the watch once clarity emerges on these aspects. Adverse developments on aforesaid events may result in a potential breach of the ringfenced payment waterfall mechanism which could precipitate a default on the NCDs issued by the SPVs.

CRISIL continues to closely monitor developments for any potential impact on NKE. While operations and maintenance (O&M) work is being undertaken by IL&FS Transportation Networks Ltd (ITNL), NKE should be able to build up sufficient MMR to undertake the remaining maintenance activities.

The rating continues to reflect the benefits that NKE derives from the annuity nature of its ongoing build-operate-transfer project, healthy

operational track record, and adequate DSRA and major maintenance reserve account (MMR). These strengths are partially offset by increased legal risks, exposure to risk relating to O&M, and uncertainties regarding the management's intent to timely service NKEL's debt.

### Analytical Approach

The structured obligation (SO) suffix to the rating on NKEL's debt instruments reflects the escrow mechanism through which annuity payments are routed.

### Key Rating Drivers & Detailed Description

#### Strengths

##### \* Strong counterparty providing annuities

The rating factors in the strong credit quality of NKEL's sole counterparty, the National Highways Authority of India (NHAI; rated CRISIL AAA/Stable), and the annuity nature of NKEL's ongoing build-operate-transfer project that ensure steady revenue visibility. As per the concession agreement, the NHAI has provided a letter of comfort to NKEL that can be invoked if the annuity is not received on time or in full.

##### \* Robust transaction structure, with a well-defined payment mechanism

The rating also factors in NKEL's adequate DSRA and debt service coverage ratio, the payment mechanism, and the legal structure of the transaction. As per the structure, the annuity from NHAI, which will be received semi-annually, will first be used by NKEL for debt servicing, necessary reserves, and expenses. Any excess cash thereafter will be used for other payouts.

Despite the robust payment waterfall mechanism, the recent letter sent by JRPICL to the trustee and investors (dated January 4, 2019) underscores the lack of management intent to protect the integrity of the ringfenced payment structure and ensure timely debt servicing to NCD holder from project cash flows. Any similar event for NKEL would be a key rating monitorable.

##### \* Good quality of the road, though timely and full receipt of remaining annuities is crucial

The quality of the road is good with recent tests (such as bump integrator and character deflection) exceeding benchmarks. However, the reduction in reserve means that timely and full receipt of the annuities is crucial to meet operating expenses, including major maintenance expenses, and avoid dipping into the DSRA. NKEL has tied up a bridge facility of Rs 10 crore with the lender to avoid cash flow mismatches and start incurring the major maintenance expense before receipt of the final annuity.

#### Weakness

##### \* Increased legal risks

As per the letter sent by JRPICL to their trustees, the company considers that the NCLAT stay order encompasses normal debt servicing as well. Although in the trustee's view, the stay is only against lender action (unauthorised set-offs etc.), there is now heightened legal risk linked to the final interpretation of this, which could impact NKEL as well. Additionally, there is a risk that the NCLAT may not ensure the integrity of the SPV's ringfenced structure, given the ongoing resolution at the IL&FS group.

##### \* Exposure to O&M and major maintenance risk

NKEL appointed ITNL as its O&M and major maintenance contractor with a fixed-price contract. Although the maintenance is being carried out by a related party, the presence of adequate maintenance reserves (though lower than before) and the execution track record of ITNL mitigate risks. Nevertheless, weakening financial position of the sponsor and ability to continue to adequately perform O&M and major maintenance will be the key monitorables.

#### Liquidity

As on January 16, 2019, NKEL had surplus cash and DSRA of Rs 44 crore, after servicing Rs 31.8 crore debt on January 15, 2019. Additionally, the company is maintaining an MMR of Rs 21 crore. The company is likely to have cash accrual of Rs 67 crore in fiscal 2020 (excluding MMR provisioning of Rs 19 crore) against debt obligation of Rs 64 crore. NKEL also has a liquidity line of Rs 10 crore available.

#### About NKEL

NKEL is an SPV promoted by IL&FS, ITNL, and Punj Lloyd Ltd to design, develop, construct, operate, and maintain a 77 km stretch of the Belgaum-Maharashtra border road on National Highway 4. The project involved strengthening and widening of the existing two-lane highway, and constructing two additional lanes with dual carriageway, on an annuity basis.

NHAI has signed a 17.5-year concession agreement, including 2.5 years' construction period (thus, effective operating period for the concession is 15 years) with NKEL. NKEL is the concessionaire for implementation and O&M of the project. The project became operational in July 2004, and NKEL has operated and maintained the road so far. The company has been receiving semi-annual annuity payments of Rs 50.51 crore as per the agreement schedule from NHAI.

NKEL had reported standalone revenue of Rs 31 crore and profit after tax of Rs 9 crore for fiscal 2018 against Rs 37 crore and Rs 12 crore, respectively, for the previous fiscal, based on the restated financial statement under the Indian Accounting Standards (Ind AS). In the restated financials as per Ind AS, receipt of annuity from the concession granting authority is apportioned as finance income, O&M income, major maintenance and repair income, and allocation towards recovery of the receivables from the concession granting authority (receivables under service concession arrangements) based on annual effective rate/internal rate of return.

#### About ITNL

ITNL was incorporated in 2000, by IL&FS to consolidate its road infrastructure projects and to pursue new projects in the area of surface transportation infrastructure through the public-private-partnership model. ITNL is primarily engaged in development, operations, and maintenance of national and state highways. The company has diversified into other transportation segments such as mass rapid transport system, urban transportation infra system, car parking, and border check-post.

ITNL's credit risk profile deteriorated due to elevated debt. ITNL and many of its SPVs reported defaults over the past 6-9 months.

#### About IL&FS

IL&FS is one of India's leading infrastructure development and finance companies. IL&FS was promoted by the Central Bank of India ('CRISIL A+/CRISIL A/Stable'), Housing Development Finance Corporation Ltd ('CRISIL AAA/FAAA/ Stable /CRISIL A1+') and Unit Trust of India. Over the years, IL&FS has broad-based its shareholding and inducted Institutional shareholders including State Bank of India ('CRISIL AAA/CRISIL AA+/FAAA/Stable/CRISIL A1+'), Life Insurance Corporation of India, ORIX Corporation - Japan and Abu Dhabi Investment Authority.

IL&FS and its group companies (including ITNL) are going through severe financial stress. IL&FS has been defaulting on some of its outstanding debt since August 2018. In the wake of continued financial stress at both the sponsor, ITNL, and the ultimate parent IL&FS, the Government of India had, on October 1, 2018, replaced the board of directors at IL&FS. The move was an effort to turn around the group and restore the confidence of financial markets after the spate of recent defaults by IL&FS and its group companies.

#### Key Financial Indicators\*

Particulars	Unit	2018	2017
Revenue	Rs crore	31	37
Profit after tax	Rs crore	9	12

<b>PAT margin</b>	<b>%</b>	<b>30.7</b>	<b>32.1</b>
<b>Adjusted debt/adjusted network</b>	<b>Times</b>	<b>0.96</b>	<b>1.20</b>
<b>Interest coverage</b>	<b>Times</b>	<b>1.02</b>	<b>1.24</b>

\*reported financials as per IndAS

Any other information: Not applicable

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**Annexure - Details of Instrument(s)**

ISIN	Name of the instrument	Date of allotment	Coupon rate (%)	Maturity date	Issue size (Rs cr)	Rating assigned with outlook
INE898G07187	Debentures^	09-Dec-10	9%	15-Jul-19	14.8	CRISIL A+(SO)/Watch Negative
INE898G07195	Debentures^	09-Dec-10	9%	15-Jan-20	14.1	CRISIL A+(SO)/Watch Negative
INE898G07161	Debentures*	09-Dec-10	9%	16-Jul-18	16.6	Withdrawn
INE898G07179	Debentures*	09-Dec-10	9%	15-Jan-19	15.6	Withdrawn

\*Refers to the issue value of the zero coupon bonds

^Refers to the issue value of the zero coupon bonds yet to be redeemed

**Annexure - Rating History for last 3 Years**

Instrument	Type	Current		2019 (History)		2018		2017		2016		Start of 2016
		Outstanding Amount	Rating	Date	Rating	Date	Rating	Date	Rating	Date	Rating	Rating
Non Convertible Debentures	LT	28.90 18-01-19	CRISIL A+(SO)/Watch Negative	15-01-19	CRISIL AA+(SO)/Watch Negative	05-11-18	CRISIL AA+(SO)/Watch Negative	07-06-17	CRISIL AAA(SO)/Stable	15-12-16	CRISIL AAA(SO)/Stable	CRISIL AAA(SO)/Stable
						15-10-18	CRISIL AA+(SO)/Negative					
						03-09-18	CRISIL AA+(SO)/Negative					
						30-07-18	CRISIL AAA(SO)/Stable					
						30-06-18	CRISIL AAA(SO)/Stable					

All amounts are in Rs.Cr.

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[CRISILs Approach to Financial Ratios](#)

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[Rating Criteria for Toll Road Projects](#)

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