

December 29, 2022

Mangalore Electricity Supply Company Limited: Ratings upgraded

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based term loans	1631.87	1595.43	[ICRA]A- (Stable); upgraded from [ICRA]BBB+ (Stable)
Fund-based overdraft	500.00	500.00	[ICRA]A- (Stable); upgraded from [ICRA]BBB+ (Stable)
Non-fund-based letter of credit	200.00	200.00	[ICRA]A2+; upgraded from [ICRA]A2
Unallocated	18.13	54.57	[ICRA]A- (Stable)/[ICRA]A2+; upgraded from [ICRA]BBB+ (Stable)/[ICRA]A2
Total	2350.00	2350.00	

*Instrument details are provided in Annexure-1

Rationale

ICRA's rating upgrade for Mangalore Electricity Supply Company Limited (MESCOM/the company) factors in its improved financial profile as the tariff realisation rose following the tariff hike approved by the regulator and the recovery in demand from industrial customers in FY2022 and H1 FY2023. Other factors favouring the upgrade include reduction in distribution losses, power purchase costs (PPC) within the regulatory approved level and recovery of past dues from the government. This has improved the company's cost coverage ratio¹ to over 1.00x in FY2022 from 0.90x in FY2021. The leverage level has remained moderate with gearing of 1.05x as of March 2022 and the debt coverage metrics remain comfortable with debt service coverage ratio (DSCR) of over 2.0x. The coverage metrics are expected to remain healthy in FY2023 with PPC within the regulatory approved level and reduction in working capital borrowings in H1 FY2023.

The ratings continue to consider the 100% ownership of MESCOM by the Government of Karnataka (GoK), its strategic importance to the state power sector and the monopolistic nature of business supported by cost-plus tariff-based principles. The ratings continue to derive support from the healthy operating efficiency of MESCOM, reflected in the relatively low distribution loss levels of 9.02% in FY2022, which is the lowest among the five distribution utilities (discoms) in Karnataka. The ratings also factor in the established regulatory process in the state, evident from the presence of a multi-year tariff (MYT) regime, the regular issuance of tariff orders with upward tariff revision and the annual true-up of the actual performance of the distribution companies (discoms). Further, the ratings draw comfort from the considerable cash inflows of MESCOM from consumer contributions and grants towards capital assets, equity infusion from the GoK and security deposits from consumers.

The ratings, however, remain constrained by the dependence of MESCOM's PPC on the power allocation policy of the GoK and its vulnerability to the overall power procurement mix and in particular, to the proportion of power sourced from the hydel stations of Karnataka Power Corporation Limited (KPCL); any shortfall in these stations could lead to dependence on high-cost power, as seen in the past. Also, increasing the procurement of renewable power in the power purchase mix of MESCOM in recent years has led to backing down of long-term thermal stations, wherein the discom would continue to pay the fixed charges, thus increasing the PPC per unit. This is further accentuated by the company's inability to pass on the increase in PPC

¹ Ratio of the actual cash collections from customers including subsidy realised and the costs incurred by the company towards electricity distribution (including power purchase cost, other operating costs, interest, depreciation and taxes)

to consumers under the fuel cost adjustment (FCA) framework, approved by the Karnataka Electricity Regulatory Commission (KERC).

The ratings are further constrained by the moderately high receivable position of MESCOM, comprising subsidy receipts from the GoK, given the free power policy for agriculture consumers, and electricity dues from state government bodies. ICRA, however, notes that the subsidy collections have witnessed a significant improvement in FY2022 and H1 FY2023. ICRA further takes note of the high level of cross-subsidisation, with higher tariffs charged to commercial and industrial consumers, which compensates for the lower rates for domestic and agriculture users. This, however, has resulted in the loss of high-paying industrial consumers for MESCOM over the past few years. The ratings also factor in the sizeable capital expenditure plans by MESCOM, related to system improvements, that are funded through a mix of long-term debt, capital receipts and equity from the GoK.

The Stable outlook on the rating of MESCOM's bank facilities reflects ICRA's opinion that the entity will maintain its strong operational efficiency and continue to be supported by the GoK, given its strategic importance as one of the state power distribution utilities. However, MESCOM's ability to maintain its profitability metrics through growth in volume sales and tariff revisions in tandem with its cost structure will remain crucial from a credit perspective.

Key rating drivers and their description

Credit strengths

State-owned power distribution company with cost-plus tariff - MESCOM is a GoK-owned power distribution utility that supplies electricity to consumers in four districts of Karnataka. The utility receives regular support from the GoK in the form of equity and capital grants. The monopolistic nature of the business with cost-plus tariff principles allows the utility to pass on the variations in cost structure to consumers.

Established regulatory processes in Karnataka - The operations of MESCOM are supported by well-established regulatory processes in Karnataka, with the presence of MYT regulations along with regular and timely issuance of tariff orders by the KERC, including annual true-up in the past years. The tariff order for FY2023 was issued in April 2022, with an average tariff hike of 4.50%.

Healthy operating efficiency with lowest distribution loss among all Karnataka discoms - MESCOM's distribution loss level of 9.02% in FY2022, reduced from 9.86% in FY2021, is the lowest among all the discoms in Karnataka. This is supported by the moderately favourable customer profile, with industrial and commercial consumers accounting for 29% of the volume sales in FY2022, which is higher than three of the other four discoms in Karnataka.

Comfortable financial profile - The financial profile of MESCOM has improved in FY2022, supported by the improved tariff realisation and power purchase costs (PPC) within the regulatory approved level. Also, reduction in distribution losses and recovery of past dues from the Government have supported an improved financial profile. This has enabled an improvement in the cost coverage ratio to over 1.00x in FY2022 from 0.90x in FY2021. Further, the leverage level has been moderate, and the debt coverage metrics have remained comfortable, with DSCR of over 2.0x. The coverage metrics are expected to remain healthy in FY2023, with the PPC within the regulatory approved level and reduction in working capital borrowings. Further, the financial profile is supported by cash inflows from consumer contributions and subsidy grants towards capital assets, security deposits from consumers and equity infusion from the GoK. The aggregate cash inflow from grants, consumer contribution and equity stood at Rs. 76 crore in FY2022.

Credit challenges

Sensitivity of power purchase cost to GOK's power allocation policy - The PPC for MESCOM depends on the allotment of power sources by the GoK each year, rendering it susceptible to the availability of power supply from KPCL hydel stations. Any shortfall in availability here leads to dependence on high-cost power, as seen in the past. Also, the growing sharing of

renewables in the power purchase mix in recent years has led to backing down of thermal stations (wherein discoms would continue to pay the fixed charges), putting upward pressure on PPC. This increase is further accentuated by the inability of the company to pass on the increase in PPC to the consumers under the existing quarterly FCA framework.

The FCA framework approved by the KERC does not allow pass-through of PPC variation from sources other than long-term thermal stations and is limited to variation in energy charges at these plants. Further, the approval of this variation in PPC during the annual true-up process happens with a lag. Nonetheless, in FY2022, MESCOM benefitted from a favourable allocation of power sources with higher procurement from the hydel power sources. This has reduced the PPC to Rs. 4.34 per unit from Rs. 5.13 per unit in FY2021 and further, remained within the KERC-approved power purchase cost of Rs. 4.71 per unit for the year. The PPC continues to be within the approved level in H1 FY2023.

Exposure to agriculture segment and government bodies keeps subsidy dependence and receivable position moderately elevated - The financial profile of MESCOM is constrained by the moderately high receivable position, comprising subsidy receipts from the GoK in lieu of the free power supply policy for agriculture consumers, electricity dues from Government bodies and regulatory assets. This results in dependence on short-term borrowings and payables to the state-owned power generation company, KPCL. Further, exposure to agriculture consumers and a lower share of industrial and commercial consumers in the energy sales mix leads to subsidy dependence, which remained relatively high at ~22% of the operating income in FY2022. However, in FY2022, MESCOM recovered the previous subsidy dues of Rs. 500 crore in addition to the entire subsidy booked for the year. The overall receivable position reduced to Rs. 1,812 crore as on September 30, 2022 from Rs. 2,549 crore as on March 31, 2021 with considerable reduction in the subsidy receivable and adjustment to regulatory assets in FY2022.

High tariff cross-subsidisation with subsidised supply to agriculture and domestic consumers - The cross-subsidisation requirement with higher tariff rates for commercial and industrial consumers to compensate for the lower rates charged for domestic and agriculture consumers persists. This has led to a loss in industrial consumers for MESCOM over the past few years, given the availability of cheaper power in the open-access market.

Large capital expenditure plans - The company has sizeable capital expenditure plans related to investments on infrastructure improvement, feeder separation programme, consumer and feeder metering etc., which will be funded through a mix of debt, equity, consumer contribution and capital grants. While the cost associated with capital investments is considered for recovery under the cost-plus tariff principles, any delays in implementation would increase the project cost, which is exposed to the risk of disallowance by the KERC. Moreover, the largely debt-funded capex puts pressure on the leverage level.

Liquidity position: Adequate

The liquidity profile of MESCOM remains adequate and is supported by the presence of a moderately favourable consumer profile that ensures healthy collections from consumers, monthly subsidy payments by the GoK and availability of working capital funding limits. Moreover, the dependence on short term debt has been lowered with the company realising subsidy arrears in FY2022 and its improved profitability position. Also, the company has historically demonstrated the ability to raise short-term debt from banks and financial institutions, whenever necessary. Further, the capex funding is met through fresh equity, capital grants, consumer contributions and long-term debt.

Rating sensitivities

Positive factors – Timely issuance of tariff orders allowing pass-through of cost variations to customers, sustenance of a healthy operating efficiency and reduction in the receivable position, leading to an improvement in the cost coverage ratio to 1.00 times or higher on a sustained basis would be the positive triggers for an upgrade. Further, the ratings also remain sensitive to the credit profile of GoK.

Negative factors – The ratings could face pressure in case of significant delays in issuing tariff orders or inadequacy of the approved tariff, which adversely impact the profitability and cash flows, Also, an increase in the receivable position or higher-

than-approved distribution loss levels would exert pressure on the ratings. Further, the ratings remain sensitive to the credit profile of GoK.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Rating Methodology for Power Distribution Utilities Rating Approach - Implicit parent or group support
Parent/Group support	The assigned rating factors in the systemic importance that MESCOM holds to the state power sector, which we expect should induce the GoK to extend timely financial support to the rated entity, should there be a need.
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of MESCOM.

About the company

MESCOM, incorporated in 2002, is one of the five state-owned distribution utilities in Karnataka, which are licensed to supply electricity in the five designated areas of the state. MESCOM is licensed to distribute electricity to four districts of Karnataka namely, Dakshina Kannada, Udupi, Shivamogga and Chikkamagaluru, covering an area of 26,222 sq. km with total consumers of 2.51 million as on March 31, 2021. The other distribution utilities in Karnataka are Bangalore Electricity Supply Company Limited (BESCOM), Gulbarga Electricity Supply Company Limited (GESCOM), Hubli Electricity Supply Company Limited (HESCOM) and Chamundeshwari Electricity Supply Corporation Limited (CESCOM). The transmission function in Karnataka is under state-owned Karnataka Power Transmission Corporation Limited (KPTCL), while the state-owned power generation assets are under KPCL.

Key financial indicators

MESCOM Standalone (audited)	FY2020	FY2021	FY2022
Operating income (Rs. crore)	3876.3	4251.5	4283.1
PAT (Rs. crore)*	43.6	-53.0	32.7
OPBDIT/OI (%)	9.7%	11.5%	23.5%
PAT/OI (%)*	1.1%	-1.2%	0.7%
Total outside liabilities/Tangible net worth (times)	2.99	3.17	2.76
Total debt/OPBDIT (times)	3.41	3.28	1.74
Interest coverage (times)	2.45	3.03	6.24

PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; *PAT has been adjusted for prior period regulatory changes

Status of non-cooperation with previous CRA: Not Applicable

Any other information: None

Rating history for past three years

Instrument	Type	Current rating (FY2023)			Chronology of rating history for the past 3 years					
		Amount rated (Rs. crore)	Amount outstanding as on Oct 31, 2022 (Rs. crore)	Date & rating	Date & rating in FY2022			Date & rating in FY2021	Date & rating in FY2020	
					Dec 29, 2022	Sep 28, 2021	Jun 29, 2021	Apr 17, 2020	-	
1	Term loans	Long-Term	1595.43	1274.81	[ICRA]A-(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	-
2	Fund-based	Long-Term	500.00	-	[ICRA]A-(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	[ICRA]BBB+(Stable)	-
3	Non-fund based	Short-Term	200.00	-	[ICRA]A2+	[ICRA]A2	[ICRA]A2	[ICRA]A2	[ICRA]A2	-
4	Unallocated	Long-Term / Short-Term	54.57	-	[ICRA]A-(Stable) / [ICRA]A2+	[ICRA]BBB+(Stable) / [ICRA]A2	-	-	-	-

Complexity level of the rated instruments

Instrument	Complexity Indicator
Fund-based – Term loan	Simple
Fund-based – Overdraft	Simple
Non-fund based – Letter of credit	Very Simple
Unallocated	NA

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: [Click Here](#)

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term loan	Jun 2016	-	May 2024	22.62	[ICRA]A- (Stable)
NA	Term loan	Aug 2015	-	Jul 2024	10.93	[ICRA]A- (Stable)
NA	Term loan	Dec 2018	-	Oct 2028	101.39	[ICRA]A- (Stable)
NA	Term loan	Sep 2016	-	Aug 2024	26.17	[ICRA]A- (Stable)
NA	Term loan	Jul 2015	-	Jun 2023	6.57	[ICRA]A- (Stable)
NA	Term loan	Sep 2016	-	Aug 2024	13.40	[ICRA]A- (Stable)
NA	Term loan	Nov 2017	-	Oct 2027	138.89	[ICRA]A- (Stable)
NA	Term loan	Mar 2020	-	Feb 2030	122.22	[ICRA]A- (Stable)
NA	Term loan	Jun 2018	-	May 2028	94.44	[ICRA]A- (Stable)
NA	Term loan	Mar 2020	-	Feb 2030	211.86	[ICRA]A- (Stable)
NA	Term loan	Jun 2021	-	May 2031	269.62	[ICRA]A- (Stable)
NA	Term loan	Mar 2022	-	Mar 2032	220.00	[ICRA]A- (Stable)
NA	Term loan	FY2021	-	FY2034	357.32	[ICRA]A- (Stable)
NA	Fund-based limit	-	-	-	500.00	[ICRA]A- (Stable)
NA	Non-fund-based limit	-	-	-	200.00	[ICRA]A2+
NA	Unallocated	-	-	-	54.57	[ICRA]A- (Stable) / [ICRA]A2+

Source: Company

[Please click here to view details of lender-wise facilities rated by ICRA](#)

Annexure II: List of entities considered for consolidated analysis

Not Applicable

ANALYST CONTACTS

Sabyasachi Majumdar
+91 124 4545 304
sabyasachi@icraindia.com

Girishkumar Kadam
+91 22 6114 3441
girishkumar@icraindia.com

Vikram V
+91 40 4067 6518
vikram.v@icraindia.com

Vinayak Ramesh
+91 40 4067 6535
r.vinayak@icraindia.com

RELATIONSHIP CONTACT

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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For more information, visit www.icra.in

ICRA Limited



Registered Office

B-710, Statesman House, 148, Barakhamba Road, New Delhi-110001

Tel: +91 11 23357940-45



Branches



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