

Annexure A - Rating Rationale for Andhra Pradesh State Financial Corporation Fixed Deposit Programme

**Andhra Pradesh State
Financial Corporation**

Issue Rating: BWR A+

Brickwork Ratings has assigned BWR A+ (Pronounced BWR A+) to Andhra Pradesh State Financial Corporation (APSFC) proposed fixed deposit programme for Rs. 180 Crore or INR 1.8 billion. The rating reflects several factors including, majority ownership of the Government of Andhra Pradesh, favorable operating spread and returns, lower NPA, highly diversified loan portfolio, adequate capital ratio, and good management practices. In the present turmoil of financial crisis, the government ownership is a comforting factor.

While APSFC's cost of funds at 8.91% is lower than that of peers, APSFC has shown higher returns at 15.15% and higher spread of 6.24%. APSFC's Net NPA at 4.27% is quite reasonable compared to its peers with Net NPAs level of 21.01%. This has significantly lowered its loan loss provision from INR1.08 Billion in 2006-07 to INR 0.317 Billion giving greater operating flexibility to APSFC. In addition, APSFC's Return Over Assets (ROA), at 5.49% compares very well with its peers at 2.10%.

APSFC's return has been more from interest income, which is at 12.28% compared to its peers who are at 10.71%. Moreover, corporation has highly diversified loan portfolio distributed across the industry, which is a key factor in mitigating industry risk.

Financials

(INR Billion)

(As on 30th March 2008)

Total Income	2.2687
Interest Income	2.0022
Non-Interest Income	0.2665
Interest Expense	1.0825
Net Profit	0.8951
Net Interest Margin	5.89%
ROA	5.49%
Loan Loss provision (% of Total Asset)	1.94%
Net NPAs (% of Loans & Advances)	4.27%
CRAR	15.80%

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Profile:

APSFC has been one of successful SFCs in India with default free track record for five decades

Andhra Pradesh State Financial Corporation was established on 1st November, 1956 under the State Financial Corporation Act (1951) with the merger of Andhra Financial Corporation and Hyderabad Financial Corporation. APSFC has a default free repayment track record with its creditors for over five decades and has achieved good performance in key operational areas of sanctions, disbursements and recoveries that facilitate its preeminence among all State Financial Corporations in India.

APSFC provides credit in the form of Term Loans / Working Capital Term Loans to Micro, Small and Medium Enterprises (MSME). The Board of APSFC has professional directors nominated by SIDBI, LIC, Andhra Pradesh state Government, co-opted by the board and elected by shareholders.

APSFC has a Tripartite MoU with SIDBI and the State Government to revive its operations. The state government is a majority shareholder with a stake of 85.85 percent followed by SIDBI that has 14.02 percent stake.

Shareholding Pattern

Shareholders	Stake %
State Government	85.85
SIDBI	14.02
LIC of India	0.11
Individuals, Co-Op.Banks, PF Trusts etc.	0.02

The government ownership is a significant comforting factor at times of financial crisis.

Business Outlook:

APSFC is well positioned to sustain itself on a meaningful scale

APSFC's total Income has increased by 43.03% to reach INR 2.27 Billion as on 31st March 2008 from INR 1.58 Billion during the previous year, due to improvement in recoveries of written-off loans as well as high interest income. The net interest income increased to INR 0.91 Billion during 2007-08 as against INR 0.56 Billion in the previous year. The increase in net income during 2007-08 enabled APSFC to wipe out the entire accumulated loss of INR 0.84 Billion as on 31st March 2007. Its operational profit also increased to INR 0.15 Billion as on 31st March 2008 from INR 0.085 Billion during the previous year. It may however be noted that over Rs 20 Crores of APSFC's increased profits were due to switch over from cash to accrual system of accounting in the FY 2008-09.

Economic Structure of Andhra Pradesh

Andhra Pradesh is the fourth largest state in India in terms of area and fifth largest in terms of population. It has the fourth highest Net State Domestic Product (NSDP) amongst Indian states. The state's GSDP (at current prices) grew 16.10% during (FY'07-08) as compared to 14.04% during the previous year. The Agriculture sector has registered growth rate of 10.08% as against 4.50% at national level. The industry has grown by 9.88% as against the national average of 8.5%. Andhra Pradesh government is paying special attention to improve agricultural growth rate.

To achieve this state has announced initiatives in the area of agriculture, irrigation and water conservation. In the education sector, the state has placed emphasis on imparting computer-aided education.

AP's social infrastructure is among the average in the country. Social indicators such as birth rate, death rate, infant mortality rate, life expectancy are marginally better than the national average.

The present Government is also trying to improve the industrial climate by attracting knowledge based industries (including IT, Pharmaceuticals, Life Science companies) to the state and has taken initiatives by announcing favorable industrial policies, formation of seed fund for industrial development and setting up of different Special Economic Zones (SEZ). The recent Satyam fraud case could be an embarrassment and the state should be vigilant in future and promote corporate governance in the state companies.

Andhra saw the emergence of regional parties akin to its neighbors. One of the countries dominant parties snatched the power back. The state is now poised for elections with three regional outfits in the fray. The resultant governance, on one hand might bring in more consensus in decision making and on the other might also cause delayed decisions.

State Government Finances:

The GSDP at current prices for the year 2007-08 stood at INR 3125 Billion registering a growth of 16.10 percent over previous year.

The Revenue Receipts as percentage of GSDP have increased in 2007-08 to 18 per cent as compared to 2004-07 (average) of 15 per cent. Sales taxes are the most important tax revenue of the States contributing almost half of the total (59.7%) own tax receipts. The revenue increase was due to bullish economy, FDI and FII inflows, resultant jobs in IT and other industries, buoyant real estate sector etc. The buoyancy helped the state to mobilize funds through sale of land (disinvestment). In 2008-09, AP budgeted INR 120 Billion under non-debt capital receipts. The state will now face recession brought over both from foreign and domestic excesses and the revenue growth in future is expected to decline.

While the states own tax revenues are 56% of revenue receipts, and growing, they are about 10 percentage points lower than neighboring states like Maharashtra, Karnataka and Tamil Nadu. Sales Taxes contribute over 36% of revenue receipts and comparable to most industrialized states. The state excise revenues are just 7.4 % of the revenue receipts and the state has the potential to increase these revenues.

The state's Own Non-Tax revenue as percentage of GSDP for 2007-08 was 2.2 percent, well above the neighboring states ratios (Karnataka: 0.8%, Maharashtra: 1%, Orissa: 1.9% & Tamil Nadu: 1.1%). The composition of the non-tax revenue is primarily interest receipts and not user fees.

While Andhra Pradesh state government has generated a Revenue Surplus of INR 4.51 Billion. Yet the figure is lower than the Revenue Surpluses of other states such as Karnataka - INR 29.81 Billion, Maharashtra - INR 27.6 Billion, Orissa - INR 16.82 Billion

and Tamil Nadu - INR 9.18 Billion. However, the state will find it difficult to show substantial surplus in the coming years of recession.

The Andhra Pradesh government has also been successful in reducing the GFD- GSDP ratio to target of 3 percent. The Debt-GSDP ratio for Andhra Pradesh is 37.5 percent, which is above the recommended level of 30.8 percent.

The state's own tax revenues were budgeted at INR 378.66 Billion. The state will experience shortfall in the revenues of vehicle taxes, stamps and registration as well as sales taxes, due to recession. The state's non-discretionary expenditure is over INR 400 Billion that includes – over INR 202.34 Billion in general services – salaries, pension, interest payments, about INR 25 Billion power subsidy, INR 100 Billion in teachers' salaries, INR 30 Billion in salaries in health sector. While the state spends 33% of revenue receipts each in social and economic services, the non-plan component of this expenditure is over 15% each. The total non-plan component of economic and social services works out to be over INR 240 Billion.

While the state will face pressure on its finances in the recession years, the state's economic base will see it through with discipline in controlling non-plan expenditure.

Capital Adequacy:

APSFC capital adequacy ratio is better than its peers' average

APSFC has reported total capital adequacy ratio of 15.8% as on 31st March 2008 as

compared to 6.5% for the same period a year ago. The added capital infusion was via Government's capital infusion to the extent of INR 1.08 Billion, in the form of 271 acres of land. The capital adequacy is better than 15.26% of its peers. RBI recommends a minimum of 10% capital adequacy for the Non Banking Financial Corporations and State Financial Corporations.

APSFC significantly reduced its leverage to 6.3 as on 31st March 2008 as compared to 15.3 for the same period a year ago. It is slightly lower than that of its peers.

Asset Quality: APSFC's asset quality trends remain stable compared to its peer group

APSFC's asset quality remains strong and showed improving trends during 2007-08. The Standard assets reached INR 13.8 Billion as on 31-March 2008 from the previous level of INR 10.62 Billion. The Sub-standard assets, doubtful and loss category loans were brought down. APSFC was able to collect over INR 0.77 Billion NPAs that were provided as provision for NPAs earlier. The Net NPAs as a percentage of loans and advances came down to 4.27 per cent as on 31st March 2008 from 25.78 per cent as on 31st March 2004. APSFC's NPA are 4.27% compared to 21.01% of its peers. APSFC had to make only 1.94% loan loss provision this year since a large portion was provided for last year.

Profitability:

APSFC's ROA has been significantly higher than that of peers.

APSFC's total income is INR 2.27 Billion, 88% of which is interest income. Its operating profit

went up 84% from INR 0.0815 Billion to INR 0.15 Billion. In addition, the Net profit grew 229% from INR 0.27 Billion in the year 2006-07 to INR 0.895 Billion in FY 07-08. APSFC's ROA at 5.49% is higher than 2.1% of peers. APSFC operating profits have grown and the corporation has kept administrative expenses in check.

Management of Risk:

APSFC's risk management system is adequate in relation to the peer group.

APSFC has developed risk management framework to manage risks at portfolio level and individual borrower's level. For this purpose, APSFC has developed risk-rating models that apply to all the term loans, additional term loans and working capital term loans. To manage operational risks, APSFC has established procedures for conducting business at Head Office and branch level. The Internal Audit Department examines these on a regular basis.

Credit risk is the major risk faced by APSFC. To manage these risks, APSFC has developed procedures and models for due diligence of the loan proposals and evaluation of the projects. APSFC has defined exposure limits for different types of borrowers, industries, sensitive sectors in order to mitigate risks at portfolio level.

Loan Portfolio (Industry-wise):

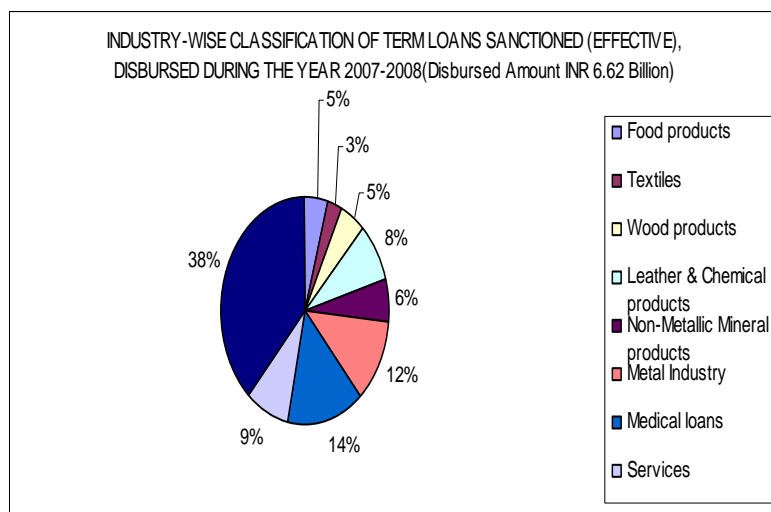
APSFC's loan portfolio is very well diversified.

APSFC's term loan sanctioned (Effective) during F. Y. 2007-08 amounted to INR 9.12 Billion recording a growth of 45.56% over

previous year while disbursements increased to INR 6.63 Billion from INR 5.23 Billion registering a rise of 26.76% over the previous year.

Corporation sanctioned loans in different industries like food, textiles, metal, non-metal, medical, leather industry etc. APSFC has exposure of 16% in medical loans, 14% to metal industry units, and over 8% to leather and chemical industry. In addition, INR 1.09 Billion was sanctioned for services industry, which includes hotels and road transport units. Food products, textile, wood products, non-metallic and other industry loans amount to INR 4.15 Billion.

The chart below indicates that the loans sanctioned & disbursed are well diversified and distributed among different industries.



Significant Developments:

Last few years, APSFC has not only been able to cut its cost but also has been able to increase its asset base. APSFC offered VRS to 200 employees, which led to decrease in employee expense as a percentage of total revenue from 14.75% in FY-07 to 12.98% in FY-08. In

In addition to a above, it has also moved towards technological upgradation. Moreover, APSFC has been able to prepay its expensive bonds and restructure the balance sheet at a lower interest cost.

On the other hand, APSFC has been able to bring more equity in terms of land valued at INR 10.9 Billion. The Government of Andhra Pradesh has granted 271 acres of land near Hyderabad to propel industrial development in the region. APSFC is looking forward to have a new office at the coming up financial district in Hyderabad, APSFC has been appointed the nodal agency of the Government of Andhra Pradesh to distribute subsidy sanctioned by the Industries department. This mechanism helps APSFC with a free float of Rs 70 Crore any time.

Rating Outlook:

Brickwork issuer ratings are based on CAMEL-TP Framework, which is used to assess the APSFC's financial health and risk exposures.

The rating reflects APSFC's ownership structure that is supported by the Government of Andhra Pradesh, its diversified loan portfolio, its asset quality as well as its capital adequacy.

The ratings factored the quality of assets, significant return on assets, reduction in net NPA and adequate capital. However, managing risk associated with its credit and loan portfolio is a key challenge in the present turmoil of financial crisis and changing economic conditions. APSFC's identification of certain projects in sunrise industries like drugs, pharmaceuticals, agro and food processing, tourism will help them increase their portfolio.

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Annexure I:

Andhra Pradesh State Financial Corporation - Common Size Profit & Loss Statement (% of Total Income)					
Financials	31-Mar-08	31-Mar-07	31-Mar-06	31-Mar-05	31-Mar-04
I. Total Income (INR Billion)	2.26	1.58	1.38	1.30	1.43
Interest Income	88.25%	91.28%	93.82%	92.49%	91.28%
Non-Interest Income	11.75%	8.72%	6.18%	7.50%	8.71%
II. Expenditure					
Interest on Deposits	2.10%	3.06%	4.09%	2.91%	0.43%
Interest on Borrowings	45.61%	52.43%	59.24%	73.69%	74.37%
Financial Charges	0.25%	0.48%	0.17%	0.40%	0.26%
Employee Expenses	12.98%	14.75%	14.66%	13.71%	17.02%
Administrative Expenses	1.98%	2.92%	2.90%	2.78%	2.64%
Depreciation	0.33%	0.49%	0.62%	0.78%	0.96%
Bad Debts Written off	30.13%	20.72%	12.63%	0.39%	0.08%
III. Profit					
Operating Profit (INR Billion)	0.15	.0815	.0783	.069	.0601
Operating Profit As %	6.61%	5.14%	5.65%	5.31%	4.20%
Provision for NPAs written Back (INR Billion)	0.7713	0.242	0.2747	0.0508	0.0442
Provision for NPAs written Back as %	34.00%	15.25%	19.83%	3.90%	3.09%
Net Profit for the Year (INR Billion)	0.8951	0.2721	0.2458	0.1314	0.101
Net Profit for the Year as %	39.46%	17.16%	17.75%	10.10%	7.06%
Andhra Pradesh State Financial Corporation - Common Size Balance Sheet (% of Total Assets)					
Financials (INR Billion)	31-Mar-08	31-Mar-07	31-Mar-06	31-Mar-05	31-Mar-04
Liabilities					
Capital	14.37%	10.96%	12.11%	8.85%	8.58%
Reserves & Surplus	1.45%	1.52%	1.57%	1.69%	1.68%
Deposits	3.24%	3.28%	5.70%	5.95%	2.78%
SLR Bonds(guaranteed by Govt. of AP)	8.21%	12.70%	14.59%	22.57%	41.09%
Non SLR Bonds	9.73%	0.00%	0.00%	0.00%	0.00%
Borrowing from SIDBI	45.77%	48.17%	50.09%	46.06%	39.21%
Medium Term Loan – SIDBI	3.13%	5.48%	7.63%	6.29%	0.04%
Tem Loans from Banks (guaranteed by Govt. of AP)	4.14%	6.38%	0.00%	0.00%	0.00%
Current Liabilities & Provisions	9.96%	11.50%	8.31%	8.60%	6.63%
TOTAL LIABILITIES (INR Billion)	18.40	14.19	12.84	11.92	12.00
Assets					
Cash & Bank Balances	8.60%	7.14%	7.02%	4.60%	5.94%
Investments	2.23%	0.08%	0.04%	0.05%	0.00%
Loans & Advances	78.33%	81.67%	78.84%	78.17%	75.81%
Fixed Assets	7.09%	1.46%	1.62%	1.67%	1.69%
Current Assets	3.74%	3.70%	3.91%	4.23%	4.24%
P&L Account	0.00%	5.94%	8.57%	11.29%	12.31%
TOTAL ASSETS (INR Billion)	18.40	14.19	12.84	11.92	12.00

(1 INR Billion = Rs. 100 Crores)

Note : over Rs 20 Crores of APSFC's increased profits were due to switch over from cash to accrual system of accounting in the FY 2008-09.

Annexure II:

Andhra Pradesh State Financial Corporation - Key Ratios					
Year	31-Mar-08	31-Mar-07	31-Mar-06	31-Mar-05	31-Mar-04
1. Operating Ratios					
Cost of Deposits	8.98%	8.11%	7.87%	7.25%	1.84%
Cost of Borrowings	8.85%	8.48%	9.00%	10.31%	11.03%
Cost of Funds	8.91%	8.29%	8.44%	8.78%	6.43%
Return on Funds	15.15%	13.32%	13.36%	13.05%	28.70%
Spread (Difference RF-CF)	6.24%	5.03%	4.92%	4.27%	22.26%
NIM	5.89%	2.07%	5.08%	7.57%	12.51%
2. Earnings (As % of Assets)					
Interest Income	12.28%	10.71%	10.49%	10.05%	10.88%
Interest Expense	6.64%	6.51%	7.08%	8.32%	8.91%
Net Interest Income	5.64%	4.20%	3.41%	1.73%	1.96%
Loan Loss provision	1.94%	8.05%	10.74%	13.41%	N/A
Bad Debt Written Off	4.19%	2.43%	1.41%	0.04%	0.01%
Non-Interest income	1.64%	1.02%	0.69%	0.81%	1.04%
Non-Interest Expense	6.32%	4.56%	3.45%	1.92%	2.47%
PBIT	0.92%	0.60%	0.63%	0.58%	0.50%
3. Profitability					
ROA	5.49%	2.01%	1.98%	1.10%	0.84%
ROE	41.51%	220.23%	-165.30%	-33.31%	-11.87%
Net worth (INR Billion)	2.1566	0.1236	-0.1487	-0.3945	-0.8508
4. Asset Quality (As % of Advances)					
Net NPA (INR Billion)	0.6161	0.9698	1.6312	2.0504	2.3464
NPA as % of Loans & Advances	4.27%	8.37%	16.11%	21.99%	25.78%
5. Capital Adequacy					
Leverage	6.3	15.3	19.6	-132.5	-48.7
CAR	15.8%	6.5%	5.1%	-0.8%	-2.1%

(1 INR Billion = Rs. 100 Crores)

Annexure III:

Andhra Pradesh State Financial Corporation - Key Ratio Comparison with Peers		
Year - Mar – 2008	APSFC	Peers
1. Operating Ratios		
Cost of Deposits	8.98%	9.77%
Cost of Borrowings	8.85%	8.77%
Cost of Funds	8.91%	9.27%
Return on Funds	15.15%	15.03%
Spread (Difference RF-CF)	6.24%	5.76%
NIM	5.89%	5.81%
2. Earnings (As % of Assets)		
Interest Income	12.28%	10.37%
Interest Expense	6.64%	7.26%
Net Interest Income	5.64%	3.11%
Loan Loss provision	1.94%	7.11%
Bad Debt Written Off	4.19%	0.10%
Non-Interest income	1.64%	2.22%
Non-Interest Expense	6.32%	4.11%
PBIT	0.92%	3.02%
3. Profitability		
ROA	5.49%	2.10%
ROE	41.51%	18.26%
Net worth (INR Billion)	2.15	2.08
4. Asset Quality (As % of Advances)		
Net NPA (INR Billion)	0.6161	1.8140
NPA as % of loan & Advances	4.27%	21.01%
5. Capital Adequacy		
Leverage	6.3	6.71
CAR	15.8%	15.26%

(1 INR Billion = Rs. 100 Crores)

Annexure IV: State Finances 2007-08

2007-2008 Revised Estimates	Andhra Pradesh	Peers (average)
GSDP (INR Billion)	3125	2975
Revenue Receipts (INR Billion)	561	444
of which:		
State's Own Tax Revenue as % of RR	56%	57%
of which:		
(a) Sales Tax	36.65%	32.61%
(b) State Excise	7.35%	7.37%
(c) Taxes on Vehicles	3.37%	3.36%
(d) Taxes on Goods and Passengers	0.14%	2.25%
(e) Taxes and Duties on Electricity	0.31%	1.56%
(f) Entertainment Tax	0.13%	0.16%
(g) Other Taxes and Duties	0.32%	0.60%
Capital Receipts (INR Billion)	229.43	57.22
Total Receipts (INR Billion)	790.69	501.54
Non-Plan Expenditure (INR Billion)	466.24	383.32
Plan Expenditure (INR Billion)	329.75	155.83
Total Expenditure (INR Billion)	795.99	539.15
Select Committed Expenditures as Ratio to Revenue Expenditure		
Interest Payments / Revenue Expenditure	15.50%	7.93%
Administrative Services / Revenue Expenditure	7.70%	3.67%
Pension / Revenue Expenditure	8.50%	4.67%
Total Committed Expenditure / Revenue Expenditure	31.70%	16.26%
Revenue Deficit(-)/Surplus(+)(INR Billion)	4.51	20.85
Gross Fiscal Deficit (INR Billion)	-92.37	-62.32
Tax / GSDP	10.05%	9.39%
Revenue Deficit / GSDP	0.35%	12.67%
GFD / GSDP	-2.96%	-2.08%
Outstanding Debt / GSDP	37.50%	30.13%
Interest Payments / RR	15.37%	15.29%

(1 INR Billion = Rs. 100 Crores)