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MICROFINANCE CRACKING THE CAPITAL MARKETS SOUTH ASIA 2010

Conference Highlights

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Microfinance Cracking the Capital Markets, South Asia 2010

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Has microfinance finally cracked the international capital markets? On July 27, 2010, India's largest microfinance institution—SKS Microfinance Ltd.—sold 3 million shares to institutional investors in the first stage of its IPO, which subsequently was oversubscribed by more than 13 times on the public market. To many in the microfinance sector, the SKS IPO is not just a crack but rather a breakthrough entrance that will engage the global capital markets with microfinance more than ever before. Coincidently, a few weeks prior to this sale, equity and debt investors, bankers, venture capitalists, microfinance leaders, and others gathered in New Delhi for ***Microfinance Cracking the Capital Markets, South Asia***, India's premiere microfinance investment conference, which was organized by ACCION International.

The Investment Landscape

The industry landscape in India has grown exponentially. As Victoria White, Vice President and Regional Director, India at ACCION International cited in her welcoming remarks, "The number of microfinance clients in India has tripled since 2005—up to 70 million today." This rapid growth comes with challenges. In his opening comments, Robert Annibale, Citi's Global Head of Microfinance, noted that unlike the rest of the world, the Indian microfinance sector does not suffer from a liquidity crunch. However, Annibale went on to say, "it is important to understand how to achieve growth with more security in terms of the balance sheet, especially since the majority of Indian MFIs only provide microcredit. We need to fund the balance sheets of Indian MFIs beyond borrowed capital, for example, by collecting savings." Ravi Kapoor, Managing Director and Head of Global Banking for Citi India, was enthusiastic about the opportunities for investors in the Indian microfinance industry. He emphasized the importance of MFIs diversifying their equity base beyond foreign investments, declaring, "There is an important opportunity in raising capital from private, domestic sources, including private wealth and the public markets."

The key themes discussed below emerged during the conference and reflect the issues that are currently stirring passionate discussions within the Indian microfinance sector at what is seen as a transformative time in its development.

The Credit Mono-Product

Investors discussed the risks associated with the reliance on a mono-product microfinance model—the group-lending, working-capital model—in India. Their focus is not unjustified. A 2007 MIX study of India found that within a sample of microfinance institutions (MFIs), 40 percent operated under the Grameen (group lending) model, 47 percent operated under the Self-Help Group (SHG) model, and only 13 percent operated under the individual bank model (mainly cooperatives).[1] Another study by Sa-Dhan, a network of Indian microfinance institutions, found that only seven percent of microfinance loans in India were made to individuals.[2]

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[1] M-CRIL and the Microfinance Information Exchange, *India Microfinance Review 2007*, http://www.themix.org/sites/default/files/2007%20India%20Microfinance%20Review.pdf.

[2] Somanadha Babu and Anup Singh, "The Need for Individual Lending in Mature MFIs," http://www.ifmr.ac.in/cmf/eomf4-needforindividual.html.

Few of these providers offered financial services beyond group lending. In 2008, of the 71 Indian MFIs that reported to the Microfinance Information Exchange (MIX), only 14 were authorized to take deposits.[3] The situation is similar for other financial services. Leapfrog Investments, which is seeking to build the microinsurance space in India, estimates that market penetration for microinsurance stands at only nine percent of the more than 1 billion low-income Indians that could use this service. [4]

Investors strongly recommended product diversification, both to reduce risk and to better meet client needs. They recognize that institutions providing a range of products offer greater value to clients and are better positioned for long-term sustainability and profitability.

On the other hand, institutions offering just one product face risks because a single, inflexible product cannot meet the needs of many clients, leaving these institutions vulnerable to a single income source and market segment.

On one panel, S. Viswanatha Prasad, Managing Director of Caspian Advisors, predicted that valuations will begin to drop over the next two or three years for traditional single-product MFIs. He suggested that when that happens, MFIs will embrace a strategy of product diversification. Rajender Sehgal, Senior Executive Vice President & Head for Microfinance & Government at HDFC Bank, identified the current single-product business model as the third greatest risk facing the industry.[5] Sanjay Sinha, Managing Director of microfinance rating agency M-CRIL, emphasized that flexible and suitable products are key to competing in a crowded market.

While recognizing the need to move beyond mono-product microcredit, investors were also the first to acknowledge its appeal as the simplest model for rapidly scaling operations. In fact, the ease with which the mono-product model can be replicated and scaled is a key driver of the exponential growth experienced by microfinance in India in the last five years.

Sandeep Farias, Managing Director of Elevar Equity, wondered why it was difficult for MFIs with multi-product strategies to achieve scale. He suggested that we go back to the drawing board and design new models that offer client-focused pricing and innovation within products.

How do we achieve new product development and quality service delivery? Vishal Mehta, Managing Director of Lok Capital, explained that that innovation is impossible without the development of proper and sophisticated HR and IT departments.

The Regulatory Environment

Two proposed changes in regulation of NBFCs by the Reserve Bank of India could dramatically alter the ability of Indian MFIs to access capital for growth. The first of these policies is India's priority sector lending requirement, which mandates that 40 percent of a bank's net credit be disbursed to the priority sector, which broadly includes the agriculture and rural sectors as well as microentrepreneurs and members of self-help groups (SHGs). As a result of this mandate, many Indian MFIs have been able to

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[3] MIX Market, "Microfinance in India," www.mixmarket.org.

[4] Shrija Agrawal, "Future of Financial Inclusion Lies in Microfinance Beyond Credit," *VC Circle*, April 20 2010, http://www.vccircle.com/500/news/future-of-financial-inclusion-lies-in-microfinance-beyond-credit.

[5] The first and second greatest risks identified by Mr. Sehgal were 1) a change in the priority sector lending guidelines and 2) the need for a body (such as AMFIN) to serve as a liaison with politicians and regulators.

borrow from and sell loans off their books to large commercial banks that are seeking to fulfill their priority sector requirement.

The question today is whether Indian MFIs have become too dependent on Indian banks as a source of funding, as Eric Geurts, Senior Equity Investment Officer of microfinance investor Triple Jump, suggested. What would happen if the Reserve Bank of India (RBI) eliminated microfinance as a qualifying sector for priority sector lending? Mr. Sehgal saw this as the greatest risk facing Indian microfinance today.

Ideas differed on how likely it is that priority sector lending requirements might change. Ashish Lakhanpal, Founder and Managing Director of Kismet Capital, stated, "Negative press [on microfinance] leads to a regulatory response that might impede progress…One player might be just one, but can affect the whole industry." And as Paul Beckett, South Asia Bureau Chief for The Wall Street Journal pointed out, the Indian microfinance sector has received some negative press lately, with articles highlighting over-lending to clients and characterizing some promoters as greedy and serving their own interests before those of the MFI.

Another important regulatory risk comes in the form of a newly drafted proposal from the RBI that could limit the ability of NBFC MFIs to raise funds via securitization of their loan portfolio. The RBI has proposed new guidelines for securitization in response to the global financial crisis; this proposal strives to better align incentives among originators and buyers in securitizations, preventing banks from originating weak loans because in the past they have been able to sell them to investors within weeks. As currently drafted, the proposal would require NBFCs to hold loans for at least nine months (for loans with tenure less than 24 months) and 12 months (for longer loans). It would also require that the originator continue to hold at least five or ten percent of the principle (depending on loan maturity) on its balance sheet as a first loss provision.

The problem for NBFC MFIs arises from the fact that so many microfinance loans are shorter in tenor than the minimum holding period of nine months. Additionally, the holding requirement does not apply to a lending relationship with a client but instead to each individual loan, so immediate renewals would count as two separate loans. As such, the proposed regulation would effectively make it impossible for India's MFIs to conduct securitizations. The regulation could also create problems for existing priority sector lending requirements, as many banks fulfill their quotas by buying securitized microloans from the same NBFCs that would be affected if the proposed regulation were enacted.

Questions from the floor revealed concern over the potential consequences of such regulation. Meenal Madhukar, Head of Investor Relations at IFMR Capital, suggested that regulation could be amended for MFIs to state that the minimum holding period for securities be nine installments (as opposed to nine months), which would achieve what the regulators are truly seeking without hindering growth prospects for the sector. Conference participants noted that some microfinance stakeholders plan to engage in conversations with the RBI, hoping that the regulators will shape a policy that is beneficial for all.

Are Indian MFI Valuations Too High?

A recent study on microfinance valuations by the Consultative Group to Assist the Poor (CGAP) and JP Morgan stated that the Indian microfinance sector in particular has been "showing unusually high valuations, with large MFIs trading at nearly six times their book value, or nearly three times the global median."[6] Such valuations have launched a widespread debate on today's valuations and tomorrow's promise.

There were a multitude of conflicting opinions. Mr. Prasad from Caspian asked, "Do investors really know what they are buying into? There is not yet a business case for MFIs." He believes that returns in the next several years will stabilize below current levels as the sector matures.

Most conference participants agreed with Alok Mittal, Managing Director of Canaan Partners India, who said, "In regards to valuation—beauty is in the eye of the beholder." Mr. Mittal argued that current valuations are justified in part by the talent and opportunities available in India's microfinance sector. He also said that Indian entrepreneurs are socially-oriented and focused on the sustainability needed to achieve a strong double bottom line.

Padmaja Reddy, Founder & CEO of Spandana, disagreed that there is overvaluation in the Indian microfinance sector. She argued that microfinance institutions are comparable to banks and the microfinance business model is well tested. As she explained, the greater growth and returns experienced in the microfinance sector over the traditional banking sector are indicative of microfinance's real value.

Christian Bannò, CEO of Microventures India, took a middle position, stating that it's really too early to anticipate future trends in valuations. He pointed out that with only six investment exits to date in the Indian microfinance-equity space, it is hard to determine what kind of returns an investor should expect.

But if overvaluation exists, what is causing it and how do you prevent it? Mr. Prasad shared his view that overvaluation in India was the result of macro-liquidity in the investment space meeting the unique benefits of investing in the Indian microfinance sector. Avnish Bajaj, Managing Director of Matrix Partners India, explained that high demand to invest in Indian microfinance was spurred by success stories like that of SKS, even though the supply of such institutions was limited. He also noted that he does not believe that risk is properly factored into valuations by investors; if investors remembered that these loans are uncollateralized and that a non-performing loan (NPL) ratio of one percent is not guaranteed, they might value Indian MFIs differently.

In addition to better assessing risk, investors should also recognize that the microfinance industry is still highly localized in nature. Comparing valuations of more mature Latin American MFIs to Indian MFIs is difficult, and understanding the local sector is crucial. Moreover, an institution's business plan, management, capital constraints, and the value of its innovations and technology, are all equally important to keep in mind.

The perception of overvaluation is keeping some investors out of the market. Mr. Bajaj explained that investors either love or hate microfinance; half will say no right away, believing that this sector is no different than the subprime market, while the other half want to invest but are experiencing "investor

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[6] Nick O'Donohoe, Frederic Rozeira de Mariz, Xavier Reille, Christoph Kneiding, and Daniel Rozas, "All Eyes on Microfinance Asset Quality," March 2, 2010, 3.

fatigue" as a result of attempting to find what they consider fairly-valued institutions with promising potential.

Management Matters

All speakers agreed that a primary factor in any investment decision is the quality of the management and leadership of a company. While not rocket science, it was interesting how this point was made repeatedly. Investors seek out management teams that both execute well and demonstrate strong leadership. One investor explained that his ultimate decision to invest is influenced by a gut feeling when "looking a promoter in the eye." Other investors mentioned intangible aspects of leadership, such as having pure "force of will," a dynamic personality, and the staying power to get through tough times as the company matures.

Panelists brought up the importance of aligning views and interests among the institution's management and its investors. Often, deals happen because an institution has found a like-minded investor or vice versa, a partner that has the same mission and philosophy about achieving it.[7] The working style of the management team and the investor must also be in sync; some investors want to be active on the institution's board and choose to invest only in institutions that will allow them to do so. Even regarding the question of valuation, management plays an important role. Ms. Reddy said that agreement with an investor is sometimes the result of an MFI finding the investor that agrees with the MFI's own valuation of itself.

Investors care about management because the institutional leaders are the ones who will make difficult decisions about other issues that investors care about, from introducing new product lines, to managing reputational and regulatory risks, to strategizing and funding the institution's growth. Getting it right on management can mean getting it right on those other issues as well.

Perspectives on Growth Differ Considerably

Not surprisingly, a significant part of the conference centered on the rapid growth of the Indian microfinance sector, particularly in the last five years. However, the speakers' reactions to this growth trajectory were quite varied. While equity investors find rapid growth attractive (and a prerequisite for investment), this same growth pattern makes debt investors nervous because it can signal potential systems breakdowns leading to instability in the portfolio. As Kaushik Modak, Managing Director at Rabo India Finance, explained, "When microfinance is showing great ROA this is not what a debt provider wants to see. Debt investors don't want high growth with sustainability doubts."

Several speakers noted that while growth is good for the sector and the clients, if it takes place incorrectly, it can be detrimental. Specifically, as Mr. Bannò highlighted, investors and providers are concerned about a vicious side to the growth cycle: MFIs seeking capital overpromise growth and returns to investors, which then can lead to over-lending followed by deterioration of portfolio quality, which is ultimately harmful to all stakeholders, especially clients.

Many participants brought up the risks of client over-indebtedness and market overheating. M-CRIL's Sanjay Sinha argued that microfinance is overheating in regions around the world for the first time. He called on the industry to find ways to contain growth, which he compared to a charging bull. Investors

[7] Ira W. Lieberman, Elisabeth Rhyne, Brian Bush, Stephanie Dolan, "Aligning Interests; Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations," (September 2009).

noted that one of their responses to overheated markets is to look for investees that are able to diversify themselves geographically, demographically, and in product offering.

Attracting Indian Private Capital

To date, no Indian private wealth foundations or individuals have invested in microfinance, but this may change soon.[8] Panelists noted that private investment in microfinance equity from purely Indian sources is notably lacking in the sector, possibly due to current valuations. However, they agreed that in the future, the foundations or social investment arms of India's top families could well be domestic investors in the Indian microfinance sector.

Vikram Gopalakrishnan, Director and Head of Investments at Citi Private Bank India, stated, "Throughout India, there are wealthy families which collectively are an untapped source of capital. When dealing with an individual's money, there is an emotional tie—entrepreneurship is a shared value, especially in India—and social returns matter to individuals." However, in the current investment atmosphere in India, he went on to note that "People today are nervous about the listed markets; taxation favors equity investments and debt is not moving. Cash is sitting around." Mr. Gopalakrishnan highlighted ICICI Prudential's recent involvement with the IFMR and Equitas securitization deal as a step in the right direction for involving Indian private capital, but he also emphasized that more mutual funds and private banks need to be present in future industry discussions on investment.

This request was answered the following day when A. Balasubramaniam, CEO of Birla Sun Life Asset Management Company, spoke about the potential role of mutual funds in the microfinance industry. He explained that before mutual funds begin to take an active role, microfinance will have to mature because such funds look for "seasoned" portfolios. At the same time he explained that opportunity does exist for greater engagement in the sector because it offers a predictable and continuous cash flow, which is the most important quality that mutual funds look for before entering a new space. Although much still has to happen to make financing from mutual funds more accessible to MFIs, the interest from both MFIs and investors was evident and it may not be surprising to see more mutual funds and private bankers participating in future microfinance investment deals.

India's Microfinance Sector in the Next Decade

Predictions about investment in the Indian microfinance sector in the next five years ranged from confident assertions that the industry's growth is healthy and decidedly different from that of the technology sector in the 1990s (bubble and crash), to equally confident predictions that a bubble is right around the corner.

One question that received much attention focused on the potential for consolidation within the industry in India. Most speakers argued that market consolidation in the Indian market is unlikely, despite the existence of an estimated 800 MFIs throughout the country.[9] Most of them are small institutions that are unlikely to grow significantly and offer the diversity of product and reach that can be accomplished by larger MFIs. Bejul Somaia, Managing Director of Lightspeed Advisory Services India Private Ltd., mentioned that despite well-accepted economic laws about highly fragmented markets consolidating when a few players receive more capital, this has never happened in India—not with the

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[8] Khyati Dharamsi, "Microfinance now seeks to tap the loaded gentry," *Daily News and Analysis*, March 15, 2010, http://www.dnaindia.com/money/report_microfinance-now-seeks-to-tap-the-loaded-gentry_1359119.

[9] National Bank for Agricultural and Rural Development, "MF Institutions," http://www.nabard.org/microfinance/mf_institution.asp.

telecom, IT, health, or the educational/vocational training sectors. His colleagues agreed that cultural factors and the hands-on nature of Indian entrepreneurs, who build businesses for life and for family inheritance, are reasons why microfinance mergers in India would be difficult to execute.

Investors agreed that more will be expected from the next generation of great MFIs: they will offer a range of financial products much more suited to the needs and convenience of clients; they will have invested heavily in their HR and IT departments; they will have superior impact evaluation methodology; and they will be highly differentiated from their peers.

Overall, panelists agreed that the explosive growth of the Indian microfinance sector will not last indefinitely.

Conclusion

What do these themes tell us about microfinance in India? They highlight that despite where people stand on individual issues, the big picture encompasses an industry with the potential for more growth if it is not curtailed by lack of funding, regulatory changes, or oversaturation. In terms of valuation by equity investors, growth will not be judged solely on the number of clients served but by the diversity, suitability, and quality of the financial products offered. Clearly there is an opportunity to bring in new funding—both debt and equity—from within the Indian capital markets and private wealth individuals. In addition, if the non-convertible debentures framework is approved on a permanent basis, a large number of foreign debt funds stand poised to provide capital to Indian MFIs. Last, effective management is equally as important as a strong balance sheet when equity investors decide to place their money with an MFI. While the Indian microfinance sector has made great inroads into cracking the capital markets, it is far from the finish line. In fact, it might just be at the starting line of a greater and more exciting race to provide financial services to the hundreds of millions as yet not served.