Microfinance Industry in India

Lok Capital

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EXECUTIVE SUMMARY

- The microfinance sector in India has developed a successful and sustainable business model which has been able to overcome challenges traditionally faced by the financial services sector in servicing the low income population by catering to its specific needs, capacities and leveraging pre-existing community support networks. As of March 2009, microfinance institutions ("MFIs") in India reached over 22 million borrowers and had a portfolio outstanding in excess of $2.3 billion.
- The microfinance business model in India typically generates a Return on Equity ("ROE") of between 20% and 30%, driven by financing from commercial banks, strong operating efficiency and high portfolio quality.[1]
- Despite achieving rapid growth with a CAGR of 86% in loan portfolio outstanding and 96% in borrowers over the last five years, the microfinance sector still faces a large unmet demand which means that it still has great potential for continued growth.
- The microfinance sector is maturing and beginning to diversify its product and service base to address other unmet financial and non-financial needs of the low income population either directly or by acting as a conduit for third-party providers – savings, insurance, remittance and low cost education and healthcare services being some of the key examples.
- Given this growth and maturity dynamic, the Indian microfinance sector is increasingly becoming a viable investment sector with commercial investors joining social investors who have been nurturing the industry thus far.
- Equity valuations in the Indian microfinance sector are higher than the financial sector due to the high growth expectations and substantial availability of debt to fuel its rapid expansion. This availability of debt to support expansion is expected to grow as more domestic banks take exposure to the industry and alternative debt providers enter the market.
- Over the short and medium term, MFI shares are expected to trade at significant premia to book value as they realign their business models to capitalize on unsatisfied demand, and cool down over the longer term as the industry matures and begins to consolidate.
- Currently, several exit opportunities exist including secondary and trade sales which are increasing as more mainstream investors enter the market. Another likely exit scenario is M&A, as larger MFIs seek to acquire players with product or geographical niches and banks also seek to enter the sector by forming alliances with existing MFIs. Larger MFIs may also consider IPOs although that may be a less likely exit option for most MFIs in the short to medium term.

INTRODUCTION

The poor, like the rest of society, need financial products and services to build assets, stabilize consumption and protect themselves against risks. Microfinance serves as the last-mile bridge to the low-income population excluded from the traditional financial services system and seeks to fill this gap and alleviate poverty. Microfinance loans serve the low-income population in multiple ways by: (1) providing working capital to build businesses; (2) infusing credit to smooth cash flows and mitigate irregularity in accessing food, clothing, shelter, or education; and (3) cushioning the economic impact of shocks such as illness, theft, or natural disasters. Moreover, by providing an alternative to the loans offered by the local moneylender priced at 60% to 100% annual interest,[2] microfinance prevents the borrower from remaining trapped in a debt trap which exacerbates poverty.

Microfinance loans in India range in size from $100 to $500 per loan with interest rates typically between 25% and 35% annually. The microfinance model is designed specifically to help the low income population overcome typical challenges such as illiteracy, lack of financial knowledge and deficiency of collateralizable assets. At the same time, the model takes advantage of existing community support systems and networks to encourage financial discipline and ensure high repayment rates.

GLOBAL TRENDS IN THE MICROFINANCE INDUSTRY

As of December 31, 2009, there were 1,395 MFIs globally with an estimated borrower base of 86 million with a total outstanding portfolio of over $44 billion as reported by the MFIs to the Microfinance Information Exchange or "MIX Market", excluding MFIs that do not report to MIX Market.[3] If they did report, the total size of the global microfinance industry is estimated to be roughly 200 million borrowers.[4] From 2003 to 2008, the global industry experienced a growth in borrowers at a CAGR of 12% and a portfolio outstanding CAGR of 34%.[5] Inter-regionally, South Asia, East Asia and the Pacific region had the highest growth rates in terms borrowers, and Sub-Saharan Africa, Middle East and North Africa have experienced the slowest growth. Latin America continues to lead in terms of portfolio outstanding with $16 billion or 36% of the total global portfolio; however, South Asia has the lead in terms of borrowers with over 50% of the global borrower base.[6] The disparity between these two trends is explained by the variance of average loan sizes in the two regions, which is a product of their economic well-being and the business models followed by their respective microfinance sectors.

MICROFINANCE IN INDIA – AN OVERVIEW

The Indian microfinance sector presents a strong growth story. Its growth performance was impressively sustained through the liquidity crunch and continued at an increased rate in the second half of 2009. As of March 2009, the MFIs in India reported a client base of 22.6 million with an outstanding portfolio of more than $2 billion.[7] Over the past five years, the sector has delivered a CAGR of 86% in the number of borrowers and 96% in portfolio outstanding. In the 12 months from March 2008 to March 2009, the microfinance industry experienced a 59% growth in its client base from 14.2 million to 22.6 million and 52% growth in its portfolio outstanding which increased from $1.5 billion to $2.3 billion.[8] This reflects a 14% increase in the absolute growth in portfolio outstanding and 33% increase in the absolute growth in the number of borrowers from 2008 to 2009.

Growth in Indian Microfinance Sector						
Year Ending March 31st	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Outstanding Portfolio ($ million)	$80	$252	$496	$824	$1,535	$2,346
Growth Rate		*215.00%*	*96.80%*	*66.10%*	*86.30%*	*52.80%*
Borrowers (million)	1	2.3	4.9	7.9	14.2	22.6
Growth Rate		*130.00%*	*113.00%*	*61.20%*	*79.80%*	*59.20%*

Source: Microfinance India State of the Sector Report 2009

These numbers demonstrate the fundamental strength of the industry and the potential it still has to expand. Nonetheless, as presented by the table, the year-on-year growth rate has been declining, illustrating the increasing maturity of the sector. Though decreasing, the growth rate is still high and is reflective of the industry approaching a more sustainable rate of expansion rather than a reversal of the trend observed thus far. As the industry matures, it is also nearing an inflexion point and is considering more sophisticated growth strategies through diversifying product offerings, client targeting and creative financial and non-financial solutions, which will allow the sector to grow at a continuous pace while preserving its solid performance and abiding by its social mission.

The equity financing flowing into the industry is reflective of the growth story it has experienced. Microfinance is gaining increasing ground as a viable investment sector. Since 2006, in India more than 25 equity transactions totaling more than $295 million in primary investments in the microfinance space have been completed. While the liquidity crunch did affect the availability of equity for microfinance players in the second and third quarters of fiscal year 2008-09, contrary to the trend in the financial services sector overall, Indian microfinance saw a surge in equity infusions in the first quarter of fiscal year 2009-10. In fact, the current fiscal year has also witnessed the entrance of mainstream private equity firms in the microfinance space, which had been previously occupied singularly by socially oriented investors such as Lok Capital. While the sector is

still dominated by socially-focused investors, pure commercial investors are beginning to play a significant role by participating in a few, but large transactions.

Primary Investments in Indian MFIs 2006 - Present

Date	MFI	Investment ($ million)	Investors
Jan-10	Bandhan	11.0	Small Industries Development Bank of India
Dec-09	Utkarsh	0.7	Aavishkaar Goodwell, IFC
Nov-09	Sonata	4.4	Bellwether, Michael and Susan Dell Foundation
Nov-09	Grameen Koota	6.0	Microventures, Incofin, Aavishaar Goodwell
Oct-09	Spandana	47.1	Temasek
Oct-09	Equitas	0.0	Sequoia
Sep-09	Asmitha	5.5	Blue Orchard
Sep-09	Asirvad	1.5	Lok
May-09	Suryoday	1.0	Aavishkaar Goodwell
Feb-09	Equitas	11.0	Bellwether, Microventures
Jan-09	ASA-GV	4.4	Microvest
Dec-08	BASIX	7.1	Lok, Aavishkaar Goodwell
Dec-08	Asomi	0.6	Incofin
Nov-08	SKS	80.3	SVB Financial Group, Kismet
Nov-08	Ujjivan	20.6	Lok, Sequoia, Existing
Nov-08	Spandana	21.9	Valiant
Sep-08	Asmitha	5.5	Blue Orchard
Jul-08	MMFL	6.0	Unitus
Jun-08	Arohan	1.4	Lok
Apr-08	Sonata	0.4	Bellwether
Dec-07	ASA	2.6	Unitus
Dec-07	SKS	32.3	Sandstone
Aug-07	Spandana	10.7	Lok, JM Financial
Aug-07	Satin	1.1	Lok
Mar-07	SKS	10.6	Unitus, Sequoia
May-06	Ujjivan	0.5	Bellwether, Unitus
	Total	**295.2**	

Source: Lok Capital

To fulfill the growth projections at play in the microfinance industry, it will continue to rely increasingly on equity versus debt. This need is compounded by the Reserve Bank of India's ("RBI") capital adequacy requirement for the sector which is currently 12% and is set to increase to 15% by April 2010. According to internal estimates, growth targets and capital adequacy requirements together create an annual equity need of approximately $200 million for the top ten MFIs until fiscal year 2013.

The growth of Indian MFIs has been enhanced by the availability of debt financing from both private and public sector banks, which have significantly increased their exposure to microfinance over the last five years. As of March 2009, banks and financing institutions had a total exposure to MFIs of $2.45 billion. This represents an almost 150% increase from the exposure in March 2008 of $984.8 million and a 200% increase from the exposure in March 2007 of

$805.6 million.[9] The priority sector lending ("PSL") requirements set by the RBI have encouraged banks to lend to MFIs as a way to satisfy their financial inclusion quotas for lending to agriculture and weaker and more deprived sections of society. During the 2008 liquidity crisis, some banks reduced on their exposure to microfinance, particularly to smaller MFIs. However, the Small Industries Development Bank of India ("SIDBI") played an important counter-cyclical role, and the new public sector banks such as Punjab National Bank and State Bank of India entered as significant debt providers to Indian MFIs. As liquidity conditions eased by early 2009, the market witnessed the entrance of non-bank debt entities such as IFMR Trust. The large private Indian banks such as HDFC Bank and ICICI Bank that have historically lent to Indian MFIs, have begun to increase their exposure to the microfinance sector. ICICI Bank increased its exposure from fiscal year 2008 to fiscal year 2009 by 176% to $567 million, and HDFC increased its exposure over the year by 260% to $568 million.[10] Other private sector banks such as Karnataka Bank, Kotak Mahindra Bank, Dhanalakshmi Bank and a couple others have also entered the debt financing market. Besides term loans, there has been a rise in non-traditional products such as non-convertible debentures, securitizations and portfolio buyouts available to MFIs through domestic as well as foreign debt funds. As of the end of fiscal year 2008-09, banks and new entrants had capital worth $100 billion available for lending to MFIs.[11] As a result, today, larger MFIs have adequate and easy access to debt financing. However, smaller and emerging MFIs are still struggling to find adequate funds as they have unproven business models and present a higher default risk to banks. Alternative debt providers are emerging in an attempt to fill this gap with subordinated-debt, guarantees and pooled securitizations.

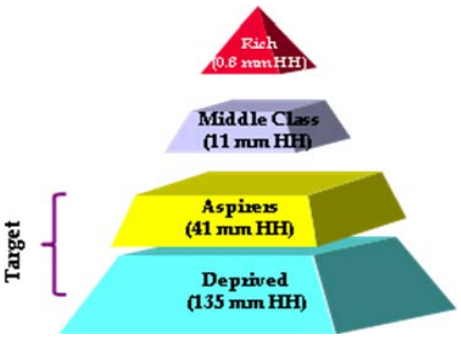
Indian Microfinance in the Global Context

It is critical to evaluate the progress of the Indian microfinance sector within the context of global microfinance. With one of the highest growth rates globally since 2002, the Indian microfinance sector has emerged as one of the most socially conscious, commercially viable, and financially sustainable. According to a MIX market study, India has one of the lowest average loan sizes of around $150 as well as the lowest yield on portfolio of 21.2%. The small loan size combined with the low interest rates testify to the social inclination of Indian MFIs, which seek to genuinely foster financial inclusion among the poor and alleviate poverty. In conjunction with this goal, Indian MFIs have succeeded not only in comfortably covering costs, but also returning healthy profits and Return on Assets (ROA). This highlights Indian MFIs' operational efficiency and ability to function on tight budgets. True, MFIs in other countries such as Brazil and Mexico have higher profit margins, but they offer significantly larger loans with interest rates typically between 40-65%.[9]

The inherent efficiency and resiliency of the Indian microfinance industry proved critical during the recent financial meltdown during which growth continued unabated despite a slowdown in the flow of funds which negatively affected growth in microfinance in other markets around the world. This demonstrated self-sustainability is prognostic of the long-term viability and potential of the sector. Moreover, the Indian financial system as a whole has demonstrated its long-term confidence in the industry through its own investment choices. Whereas the global average of domestic investment in microfinance hovers around 65%, over 90% of the funding in India comes through domestic channels, highlighting confidence in the underlying business model and expectations of high future growth and returns.

TARGET OF MICROFINANCE

The fundamental reason behind the Indian microfinance industry's impressive growth is that it is fulfilling a critical need of its target audience, the low-income population, which has thus far remained unaddressed by the traditional financial services sector. Currently, a total population of 1.1 billion is being served by 50,000 commercial banks, 12,000 co-operative bank offices, 15,000 regional rural banks and 100,000 primary agriculture societies.[12] This density of financial services, however, belies the availability of financial services to low-income households, which make up a significant chunk of the Indian population. Before exploring why financial services have failed to reach this segment of the population, it is necessary to first define their target..



Source: Lok Capital

The Indian population can be divided into four categories based on household income levels. The Rich who make up 0.4% of the households have an annual household income greater than $20,000. The Middle Class comprises 11 million households, or 5.9% of the total households, and has an annual household income between $4,000 and $20,000. The Aspirers make up nearly 22% of the households and have an annual household income between $1,800 and $4,000. Lastly, the Deprived segment, the prime target of the microfinance industry, comprises 135 million or 72% of the households and has an annual household income below $1,800. [13]

Despite the density and robustness of the formal Indian financial system, it has failed to reach the Deprived segment, leaving approximately 135 million households entirely unbanked. The size of India's unbanked population is one of the highest in the world, second only to that of China. The microfinance sector targets the poorer portion of the Aspirer segment and the mid to richer portion of the Deprived segment. The industry has thus far been able to create a service model and products that are suitable to these segments and these services and products have proven successful in affecting improvements in the clients' economic status.

The reasons behind the formal financial sector's failure to reach such a large segment of the Indian population are manifold and operate in a self-reinforcing manner. The principal prohibiting factor is that banks face extremely high fixed and variable costs in servicing low income households, resulting in high delivery costs for relatively small transactions. Much of the low income population is

located in rural areas that are geographically remote and inaccessible. For this population, the cost of visiting a traditional bank branch is prohibitive due to the loss of wages that would be incurred in the time required. Concurrently, from a bank's perspective, the cost of operating a branch in a remote location is financially unfeasible due to the low volume and high cost dynamic. Moreover, low income households are not interested in the same products that are usually utilized by the rest of the population because they have different immediate needs, lower financial capacities and variable income streams. The unsuitability of existing credit products for low income households is exacerbated by a general unavailability of collateralizable assets. Additionally, the low income population is often illiterate and lacks financial knowledge, making it nearly impossible for it to even contemplate availing existing financial services, which provide no ancillary support to mitigate these challenges.

In the absence of access to formal financial services, the low income segment has traditionally relied on local moneylenders to fulfill their financial needs. While this money is readily available, it is often exorbitantly priced at 60%-100% annual yields and forces the borrower into a classic debt trap, entrenching her in poverty. Credit from moneylenders has not traditionally acted as a tool for business expansion or enhancement of quality of life, but rather as a lifeline for immediate consumption or healthcare needs.

THE MICROFINANCE BUSINESS MODEL

The microfinance business model is designed to address the challenges faced by the traditional financial services sector in fulfilling the credit requirement of the low income segment at an affordable and sustainable cost. Most MFIs follow the Joint Liability Group (JLG) model. A JLG consists of five to ten women who act as co-guarantors for the other members of their group. This strategy provides an impetus for prudent self-selection of reliable and fiscally responsible co-members. Moreover, the JLG has an inbuilt mechanism that encourages repayment in a timely fashion as issuance of future loans is contingent upon the prior repayment record of the group.

Metric	Amount (in India)
Interest rate charged	Typically 25-35% p.a.
Interest on debt	12-16%; lower for larger MFIs
Operating expense ratio	6-15% depending on level of efficiency
ROA	Typically 3-5%
Debt/Equity	Typically 5-8x
ROE	20-30%

Source: Lok Capital

Micro-loan sizes vary from an initial loan size between $100 and $150 to subsequent loans of $300 to $500 with an annual interest rate between 25% and

35%.[14] The term loans are structured with weekly or monthly repayment schedules and a 6-month to 2 year term. Microfinance institutions typically charge a higher rate of interest to their clients than traditional commercial banks as the administrative costs of servicing smaller loans is far higher in percentage terms than the cost of servicing larger loans. Additionally, MFIs provide doorstep services to their customers, a strategy that has a high cost associated with it, especially in rural areas where population densities tend to be low. Because of this model, MFIs generally face an operating expense ratio ("OER") between 6% and 15%, depending on the scale and efficiency level of the particular MFI as well its area of operations. Additionally, today, MFIs face borrowing costs in the range of 12% to 16% per annum, depending on the size and track-record of the individual MFI. This model allows well-run MFIs to achieve a ROA of about 3% to 5% and a ROE of as much as 20% to 30%. These high ROA and ROE numbers are contingent upon low cost financing from commercial banks and the ability to maintain high portfolio growth along with high portfolio quality. The portfolio quality for MFIs is typically superior to commercial banks with total Non-performing Assets 180 days past due of 0.2% to 3% as opposed to 3% to 10% for commercial banks. MFIs typically enjoy extremely low delinquency rates despite the nonexistence of security. This portfolio quality is driven by the discipline embedded in the JLG model through the self-selection of the group members as well as the mutual support informally embedded in the groups in relation to members' loans.

The 3% to 5% ROA range is a product of both the maturity level of MFIs and the basic business model to which they subscribe. No MFI typically begins by achieving a 3% ROA, but it can be achieved and becomes sustainable as the MFI refines its business model and scales enough to become profitable. Within this range, however, an MFI's ROA will be determined largely by its particular business model. For example, within Lok Capital's portfolio, Spandana has consistently had an ROA above 5% since Lok's investment in August 2007. By and large, Spandana faces the same cost of debt as the rest of the industry, however, its single-product business model hinges on maintaining a consistently low OER, which has also been below 6% since the time of Lok's investment. This low OER allows Spandana to charge one of the lowest interest rates on its loan products in the industry and thus successfully serve its social mission. By contrast, Bhartiya Samruddhi ("BASIX") is a mature MFI with an ROA between 2% and 4% and a different approach to the microfinance business model. As a mature MFI, BASIX has begun exploring alternative products and services, financial and non-financial to form deeper linkages with its existing clients and maintain its competitiveness. While BASIX may make slight improvements in its OER in the future, that will not be its key focus. Nevertheless, as it continues to strengthen its client base, develop its product base and expand at a sustainable rate, BASIX will continue to comfortably produce an attractive ROA. Ujjivan presents a blend between the models of Spandana and BASIX. Ujjivan, which is a

less mature MFI partner, has only recently achieved an ROA above 3%. Ujjivan's business model currently operates on an assumption of an OER in the mid-teens as it is still in the process of ramping up its operations at an extremely high rate. Ujjivan seeks to become a larger commercial player in the sector, but it is simultaneously dedicated to expanding into untested geographical territories and targeting clients who continue to be excluded from the microfinance sector. The groundwork required in this approach makes for inherently high operating costs. As Ujjivan matures and its business model gains more cogency, its OER will certainly continue to decline, ensuring a healthy and sustainable ROA going forward. These three examples are reflective of trends in the sector overall. Nascent MFIs make gains in ROA as they scale their businesses and then remain within the 3% to 5% range as they streamline their business models to reflect their longer-term goals.

Social Mission and Financial Inclusion

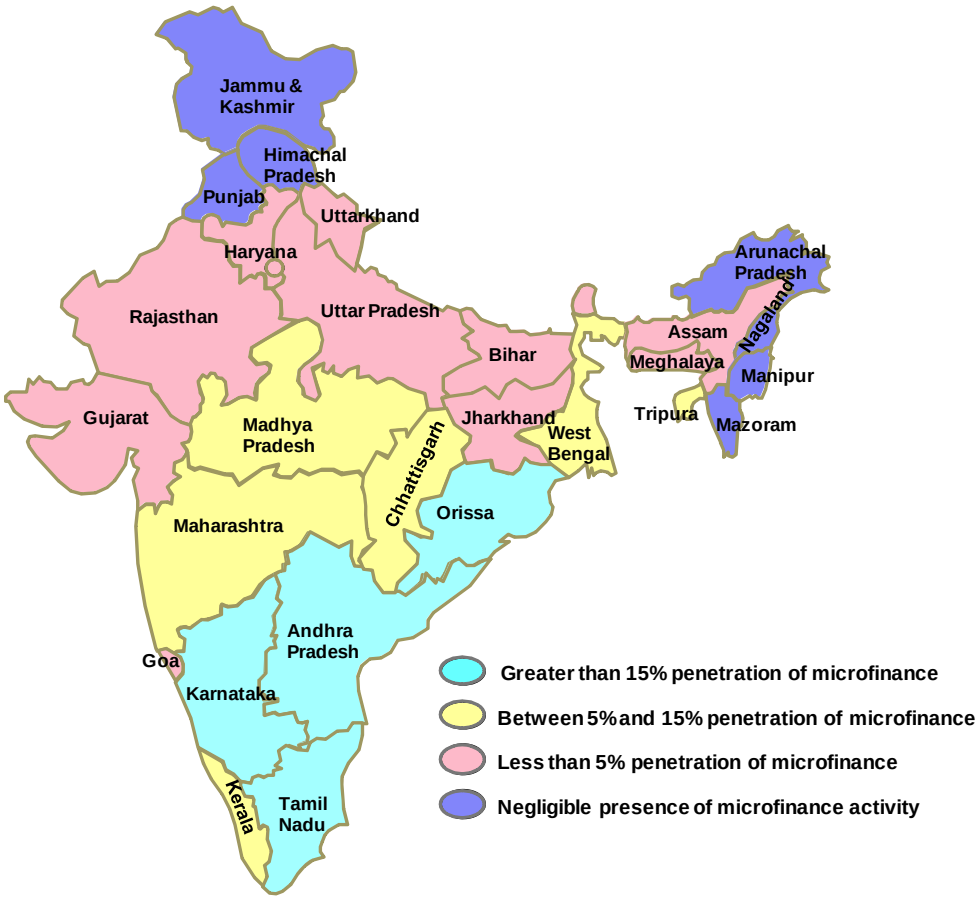
While microfinance presents a viable commercial opportunity, the sector cannot ignore its underlying mission to foster financial inclusion and the mission's importance to ensuring its long-term sustainability. Being constantly vigilant of its social impact and implementing a definitive program to foster inclusion, will serve to deepen the microfinance sector's commitment to the social mission that it was created to execute and prevent it from becoming disengaged from its social agenda even as it gains scale. In other words, even as they become commercially successful, MFIs need to keep the interests of their current and potential customers at the forefront of their strategic decision-making process. Awareness of the customers' interests feeds into the sector's strategy from two angles: capacity and need. MFIs have a responsibility to be truly discerning of potential customers' capacities to avoid over-indebtedness and credit-dependence which ultimately keeps them trapped in poverty. From a need angle, microfinance institutions cannot hope to ensure successful long-term futures by offering a single product to their consumers, who wish to utilize their increased financial capacities to acquire services and products such as education and healthcare that improve their quality of life. Moreover, MFIs need to diversify their customer base through exploring untapped geographies and still excluded segments of the low-income population. This strategy will ensure that the social mission of MFIs remains intact and that the business continues to be successful over the long run, achieving the ultimate social-commercial balance and strengthening the double bottom line advantage.

MARKET TRENDS

As the Indian microfinance sector matures, Lok Capital expects the year-on-year growth rate to decline to still high, but more sustainable levels. Over the next four years, Lok Capital projects the number of borrowers to grow at 34%, which is 60% less than the historical 5-year CAGR of 86% and the portfolio outstanding to grow at 40%, which is 58% less than the historical 5-year CAGR of 96%. Even with these cautious assumptions, Lok Capital expects MFI borrowers to increase from 22.6 million to 64 million and portfolio outstanding to increase from $2 billion to $8 billion by 2012. With maturity, MFIs will have to begin

reassessing and re-engineering their growth strategies in a couple of years. They will have to take into account market opportunities and risks and adjust their geographical exposure, client base and product offering to remain competitive. Hints of market conditions that MFIs will have to navigate in the coming years are present even today, and MFIs are beginning to recognize these factors as they continue to grow. Below we explore the changing market dynamics in terms geographical spread of microfinance, client profile and product offerings and evaluate how MFIs might respond.

GEOGRAPHICAL SPREAD



Source: Lok Capital

Despite the rapid expansion of microfinance, large areas of India continue to be underserved. Lok Capital estimates that the penetration potential of the existing microfinance model is between approximately 43 million and 52 million households, out of which 22.6 million are existing customers. This implies an unaddressed demand of 20million to 29 million customers. Currently, as many as

54% of all microfinance clients are concentrated in the Southern States: Andhra Pradesh, Karnataka, Kerala and Tamil Nadu.[15] Alternatively, there is an extremely limited microfinance presence in the North and North-east. MFIs are beginning to realize, however, that the South is becoming overly saturated and there is a commercial need to expand to newer geographies to ensure continued growth and maintain the quality of their portfolio. It has become imperative that MFIs diversify their operational base and limit overexposure to heavily serviced areas and clients. The Karnataka episode (detailed below) has demonstrated the urgent need to re-engineer expansion strategies to avoid over-lending to a cluster of clients and hedge against regional disturbances, economic, political and social.

The Karnataka Issue

In the first half of 2009, part of Karnataka was swept by a large number of defaults. The defaults were triggered by a transport strike which hampered the local economy and thus the borrowers' ability to repay their existing debts. The repayment problem, which was limited in scale, was escalated into a more widespread and urgent issue by some Muslim community leaders who urged group defaults by citing communal factors. In Mysore, two bouts of communal rioting forced some of the borrowers to temporarily migrate out of the area leading to defaults which eventually escalated into group defaults.

While the issues were in fact escalated by communal leaders, there were some underlying issues related to over-lending which were present in each of the areas affected. The issue highlights the need for lending and expansion strategies that are more cognizant of the clients' true financial capacities and risk profiles. From an operational viewpoint, this entails that MFIs expand over a variety of geographies and tap varied client profiles. One of the critical ways to achieve greater inclusion is by serving a larger segment of the disenfranchised, from the perspective of geographies and client profiles. A more inclusive approach will help MFIs diversify their risk, cushion negative impacts from future crises and ameliorate unhealthy competition in a single area. Moreover, reaching out to untapped markets will limit over- lending to clients in microfinance saturated areas, in turn, better serving the MFIs' social missions over the long run.

MFIs coming out of the crisis, have written off their losses. The four to five major MFIs operating in Karnataka are collectively addressing the situation and working even more closely with local administration and the community leaders to resolve the issue. MFIs are making individual efforts at the field level to influence the clients to repay. It has been observed that the clients are now being selective and trying to repay to the MFIs who have managed to develop better and stronger client relationships.

CLIENT PROFILE

We have begun to see greater microfinance activity in states such as Maharashtra and Madhya Pradesh, but MFIs are approaching the North and North-east with more caution and hesitancy because these areas present a very different type of client base compared to South or Central India. Nonetheless, the trend toward expanding in uncharted territories will continue, albeit slowly. In addition, MFIs are trying to start tapping different portions of the low income segment. Thus far, a very narrow band of the low-income population segment has been served through microfinance. There is an ultra-poor segment as well as a wealthier one which have drastically different needs and capacities from the segment currently being served. Small efforts are underway to explore these segments' needs and

capacities and evaluate what kind of products and services would allow them to be brought under the financial inclusion umbrella. For example, with help from Lok Foundation, Ujjivan is currently participating in a pilot program for the urban ultra poor which seeks to equip them with knowledge and skills that will allow them to eventually avail microfinance services.

Moreover, the government has also of late turned its focus toward financial inclusion. This means that policy and regulatory attention on microfinance has increased with the government constituting two high-level committees to provide suggestions on how to improve the financial inclusion scenario in India. This new trend will provide impetus to devise strategies for more inclusive growth that makes commercial as well as social sense.

PRODUCT OFFERING

Thus far, microfinance institutions have largely limited their product and service offering even within the confines of financial inclusion. In fact, their product innovation has been limited to credit which is intended to serve a variety of needs as shown by the box below. The limited product innovation is understandable given the sector's primary focus has been on refining its business model and gaining scale to become financially sustainable. Despite following a single-product model, the sector has experienced remarkable growth. This growth can only be expected to continue as product innovation and diversified service offerings attract and retain greater number of customers with a variety of needs.

	Product	Purpose
Existing Products	Micro-enterprise /small business loan	Working capital/business start-up
	Agricultural Loan	Crop/Farm-related
	Livestock Loan	Dairy/Poultry
	General	Consumption
New/Niche Products	Education Loan	Academic/vocational
	Housing Loan	Home improvement/new home

Source: Lok Capital

The very same clients that the sector currently serves have a plethora of alternate needs for basic products and services, financial and non-financial which can affect sustainable, long-term achievements in their quality of life. Fortunately, recognizing this pent-up demand, mature MFIs are beginning to take concrete steps toward expanding their product basket, at least within the context of financial services. Along with credit, MFIs are heavily exploring the possibility of providing savings/deposit services, micro-insurance and remittance services.

SAVINGS

Access to a savings mechanism like that which is available through commercial banks, is usually held by the microfinance industry to be the most urgent need to enhance the economic security of the poor. Due to RBI regulations, Non Banking Microfinance Company ("NBFC") MFIs cannot currently accept interest-bearing deposits, unless they provide the service through a Section 25 Business Correspondent conduit. This structure prohibits the conduit from charging any fees to execute this function and limits its reach within a limited radius of the bank branch. MFIs are lobbying the RBI to relax these regulations to allow NBFCs to operate as business correspondents, charge an extra fee for the deposit-taking service and delimit the geographical reach of their operations. These changes would not only make deposits a viable commercial product, but also allow MFIs to offer it to a broader set of clients.

INSURANCE

While credit can serve to enhance a household's income, insurance can serve to cushion the negative economic impact in the event of an emergency. Without insurance, a single incident can often impoverish a household, even with access to micro-credit, especially if the emergency affects the main earning members. A number of MFIs already offer micro-insurance products to their clients. The most basic products insure against health and accidental death. Companies such as Satin and BASIX usually tie the insurance products to their credit products, which makes the availability of credit contingent on the client availing insurance. The rationale behind packaging the loan and insurance together is that often clients do not understand the importance or benefit of insurance until they face an emergency. From a commercial viewpoint, the MFI is in effect insuring its loan against a crisis in the client's household, since insurance hedges against total financial collapse and thus ensures repayment of the loan, albeit in a delayed fashion. Similar to customers, BASIX also links livestock loans to livestock insurance for a similar reason – it cushions the financial blow and increases the likelihood of a successful loan recovery. We can expect the number of insurance products available to increase as MFIs expand beyond their core credit product and clients become more aware of the benefits of insurance.

REMITTANCE

Domestic labor migration has a long history in India and is on the rise given disparities in growth across states – migrants need a fast, low-cost, convenient, safe and widely accessible money transfer service. In India, remittance services can be enabled by the provision of savings and thus need to be provided in tie-ups with banks and post offices. In some cases, MFIs provide remittance services

by establishing their presence in a migrant destination to channel remittances back to the community in the migrants' area of origin or by establishing a tie-up with another MFI, bank or money transfer company in the area of origin. Going forward, the role of technology will become more important in facilitating the development of alternative channels and payment mechanisms.

NON-FINANCIAL PRODUCTS

Within product offerings, MFIs are considering expanding their activities beyond the realm of financial services since this can provide synergies linked to future expansion. Microfinance clients have myriads of unmet needs such as healthcare and education as well as livelihood requirements which can enhance their income, employment potential or quality of life. Given MFIs' existing relationships with this population segment, they would be an ideal channel to provide these services. While MFIs may not want to delve into product lines that are fundamentally different from their core business, they could easily act as conduits to allow other agents to deliver these services to their customers. The microfinance industry as a whole is now experimenting with a wide variety of potential models that could be used to deliver non-financial services.

For example, BASIX offers a host of alternative services to its clients. Beyond the basket of credit and other financial products and services, BASIX also provides low income customers with livelihood services, including agricultural and business development consulting services, to help microfinance clients use their loans more effectively. BASIX offers these alternative services to its clients through different entities housed under one umbrella. These groups have tremendous synergy and contribute to each other's growth and prosperity. The credit business enables customer acquisition, while the insurance business mitigates risk, and agricultural and business development service enables customer retention. The consulting and IT business enhances BASIX's revenues, while the social businesses enable research and development which contribute to BASIX's strategy development.

In addition to livelihood services, several MFIs are examining the feasibility of providing critical basic services to deliver low cost healthcare, education and vocational training. For example, Spandana is currently developing a comprehensive low cost healthcare delivery model focused on the healthcare needs of women and children. BASIX has launched a vocational training academy to impart education in rural development and management to potential job seekers from low income communities. These participants would be deployed in the rural/semi urban areas with BASIX or other organizations offering financial services to the poor. In addition to being important avenues for productive utilization of credit by MFI clients, these types of services have a strong potential

to reinforce long-term client relationships. Most importantly, the evolving delivery model for low cost education and healthcare has similar operational elements as the highly successful microfinance model including efficient distribution, high-throughput and para-skilling of low cost resources to address the last mile inclusion challenge.

POTENTIAL END GAME SCENARIOS

Since MFIs' asset growth rates may be more moderate over the medium term, they will need to make strategic choices based on their capabilities and the competitive environment. National players will focus on achieving pan-India scale and efficiently delivering fewer closely-linked products while regionally focused MFIs will try to leverage their deeper ties with clients (due to proximity and awareness of local dynamics) and provide additional services.

Based on Lok Capital's assessment of what directions the sector will take, we anticipate three possible end-game scenarios for Indian MFIs:

Potential End Game Scenario	What it will take (Business elements)
1. A large, standardized, low cost, highly efficient MFI that will deliver limited number of loan products to a large client base	Efficient, highly scalable platform. The organisation's strength is in execution and finding efficient ways to deliver similar, closely-linked products to more and more, similar clients. In a low-cost, standardized model, delivery of newer products/service, requires additional focus on human resources and organizational development, due to the challenges of using a highly stretched workforce.
2. A geographically spread banking type institution that can deliver multiple financial products	In a multi-product system, innovation to successfully pilot and launch new products is the key requirement. The leader has to be a visionary and strategist with the ability to build alliances with external partners and a robust organisational structure with strong governance and human resources.
3. A regionally focused service provider that can deliver financial and/or non-financial product/services	Creativity to be able to create niche positioning and patient testing and capital required to introduce non-financial services. Some of the new services have a very apparent demand and the first mover can gain substantial advantage. Strong working knowledge of a unique geography, deep client relationship and a relatively skilled ground staff are the key requirements.

INVESTMENT CLIMATE

Today, microfinance is gaining prominence as a viable asset class globally, particularly in India. MFIs in India have continued to attract large amounts of capital despite the global economic recession. Currently, it is reported that over 100 microfinance investment vehicles ("MIVs") exist globally, and India is a focus for many of them due to its large market size, growth capacity, profitable business models and potential development impact. Moreover, mainstream investors are beginning to participate in this sector, picking up larger stakes than the social investors that have been dominant so far. The entrance of mainstream investors is indicative of an industry that is maturing, but is still expected to grow at a high rate.

Valuations in the microfinance sector reflect this expectation and surpass that of traditional institutions in the financial services space. Moreover, Indian MFIs trade at significant premia to MFIs in other parts of the world. MFIs across the world face an equity valuation of 1.5x to 3.0x book value, whereas Indian MFIs face a valuation that is 3.0x to 4.0x book value. This premium is driven partly by the generous amounts of debt available to the industry to expand which in turn enables MFIs to achieve returns on equity of approximately 20% to 30%.[16] These premium levels are also identical to the premia to book value at which private sector banks and non-banks have traded in the Indian capital markets – which have averaged over 3.5x to 4.0x book value throughout the last seven to ten years. In the short run, as mainstream investors gain interest in the Indian microfinance industry and infuse larger amounts of capital at higher prices, equity will continue to trade at a premium.

A point to note here is that even though the microfinance industry is reaching maturity, the large amounts of untapped geographical territory and client base combined with the MFIs' wide network create potential for enormous sustainable growth in the future. As discussed earlier, MFIs and other service providers are beginning to realize the significant value of the network that has been created by MFIs and efforts are underway to utilize them to deliver both, financial and non-financial products and services. These factors will continue to impact the supply of equity for Indian microfinance and hence the equity valuations. Furthermore, since this untapped demand is unlikely to be satisfied in the short or medium term, while valuations will be tempered by cautious investors, premia driven by fundamental growth expectations can be expected to prevail through the short and medium term as MFIs re-engineer their strategies to take advantage of the unsatisfied microloan demand.

EXITS

For early stage investors like Lok, the most likely source of exit remains secondary or trade sales. Given the multiple rounds of capital raisings that fast growing MFIs need to complete and the increasing investor interest (including from large commercial investors) in taking direct exposure to Indian microfinance institutions, there is significant opportunity for early-stage, nimble investors to sell their stake in subsequent rounds. For example, as part of Spandana's current capital raise of approximately $40 million from mainstream investors, Lok is doing a partial exit of its shareholding in the company, realizing a cash on cash multiple of 8x on the shares sold. Early stage investor Kalpathi Suresh recently sold a 10% stake in Equitas to Sequoia Capital, generating over 12x returns, demonstrating that it is possible for minority investors to successfully exit their microfinance investments.

In terms of potential M&A exit scenarios, the most likely scenario is the entry of banks as acquirers in the medium term with the RBI's and the government's emphasis on using banks to deliver more effective financial inclusion – they could leverage MFIs as the last-mile distribution platform for the existing banking system. Banks could potentially find it easier to complete acquisitions compared to large MFIs as they are less promoter driven and have better institutional capacity to integrate acquisitions. Acquisitions of regional MFIs by large national MFIs is also possible given certain conditions – the regional MFI would need to have strong penetration in its local market, a similar basic operating model as the acquiring MFI and a certain minimum portfolio size of approximately $50 million to $75 million. The MFI sector could also see a merger of equals between two mid to large sized MFIs as the industry matures and consolidates over the medium term.

Some large MFIs including two to three in Lok Capital's portfolio could consider a potential listing in one to two years, but IPOs will be a challenge for the sector overall given limited market experience in listing socially-focused firms. Criteria for a successful IPO will include size; the capacity to absorb large amounts of capital and generate post-issue liquidity of the listed shares; operating experience of the management team; track-record of value creation; and institutional capacity to deal with the listing process, compliance requirements and public scrutiny. In this regard, the experience of SKS Microfinance in executing its proposed IPO in 2010 will be a useful learning experience for the microfinance sector to determine the extent to which a social business model such as microfinance can be accepted by mainstream and particularly retail investors, and the value these investors are willing to ascribe to its potential.

That exits are still uncommon in microfinance means that for early stage investors like Lok, entrepreneurs need to be made aware of their exit obligations, and investors' relationships with entrepreneurs will be key in realizing exits, especially for minority shareholders. The ability to work with different mainstream investors, MFI promoters, banks and industry regulators as well as investors' prior experience and track-record of executing exits in the Indian market will be the key to completing successful exits in Indian microfinance companies.

Microfinance Is Not Sub-prime Consumer Lending

In a market reeling from the aftereffects of the subprime crisis, it is important to note the key differences between microfinance and uncollateralized sub-prime consumer lending. The prime differentiator between the two is that a microfinance loan does not inherently assume a higher chance of default and does not subsequently charge a higher rate of interest (the higher rate of interest arises from the higher operational costs associated with smaller loan sizes). This assumption is backed by a process of verifying the intended use of the loan and the repayment capacity of the client. This dynamic is given veracity by the low default rates on microfinance loans, nothwithstanding extenuating circumstances. Moreover, unlike sub-prime borrowers, microfinance clients do not have unattractive credit histories, but rather the complete absence of a credit history, which is not a precondition for determining credit-worthiness. The performance of the sector thus far is a testament to the underlying strength not only of the microfinance business model but also the long-term credit-worthiness of its clients.

CONCLUSION

The strength and sustainability of the Indian microfinance business model lies in the fact that it is serving a large unmet need for financial inclusion. It has thus far successfully tackled challenges that have faced other financial service providers in meeting the demands of this sector through creative product innovation with awareness of the segment's particular needs and capacities and use of the joint liability group mechanism to manage risk. The model has been successful in maintaining excellent portfolio quality even with extremely rapid expansion over the last few years. The large size of the currently unbanked population in India and diversity of geography means that the microfinance sector has great potential for continued high growth. Moreover, as the sector approaches maturity, there will be increasing attention focused toward client and geographical diversification and product innovation, financial and non-financial. Besides expanding their own services, MFIs are also being viewed as potential channels for delivery of other products and services to low income and rural populations. Since the scale of the Indian MFI industry has exceeded 20 million clients, other consumer product and service providers are beginning to attach greater value to the microfinance distribution network. Given this growth and maturity dynamic, the Indian microfinance sector is increasingly seen as a viable investment target with commercial investors joining the social investors who have been nurturing the industry thus far. Equity valuations in the Indian microfinance sector are higher than the financial sector in general and global MFIs in particular due to the high growth expectations and substantial availability of debt to fuel its rapid expansion. MFI shares are expected to trade at significant premium to book over the short and medium term as MFIs realign their business models to capitalize on unsatisfied demand, and cool down over the longer term as the industry matures and begins to consolidate. As more investors enter the market, exit opportunities are also increasing in the form of secondary and trade sales. Larger MFIs may also consider IPOs, although that may not be a realistic exit option for most MFIs in the short to medium term. Another likely exit scenario is M&A, as larger MFIs seek to acquire players with product or geographical niches. The industry is in its initial stage and its development could take many forms, but we expect growth, innovation and financial performance to continue on an encouraging path.

ABOUT LOK CAPITAL

Founded in 2004, the Lok Capital Group is an innovative platform delivering equity capital combined with technical and strategic advice to Indian MFIs and social enterprises serving the bottom of pyramid (BOP) segment. Lok Capital has invested in eight MFI enterprises which are well diversified with respect to geography, business model, rural/urban exposure and size. Today Lok's MFI partners collectively reach more than 5 million clients, have portfolio outstanding in excess of $850 million and a distribution footprint across the country, with over 1,600 branches spread among 19 states and Union Territories of India.

Lok Capital's founders include:

Rajiv Lall
Mr. Lall has over 22 years of experience as an investor and advisor with Warburg Pincus in Singapore and New York, as an economist and policy advisor with Morgan Stanley in Hong Kong, the World Bank in Washington D.C., the Asian Development Bank in Manila, Philippines, and in academia. Mr. lall is currently CEO and MD of IDFC Ltd.

Donald Peck:
Mr. Peck has over 30 years experience investing in emerging markets with Actis (where he was a founding partner), IFC and Morgan Grenfell, including over 10 years in India building and heading the Indian private equity business of Actis. Mr. Peck has become a social investor pursuing a range of interests from Indian microfinance through education to biodiversity projects.

The Lok Capital team comprises of eight members. Below are bios of the managing directors.

Vishal Mehta, Managing Director
Mr. Mehta was also the founder of Lok Capital, leading the close of its first fund and investments in five portfolio MFIs. He previously worked for ten years in the financial services and telecom sectors in the US, Europe and Asia with Capital One, Siemens and PRTM. Mr. Mehta holds an MBA from University of Michigan and Engineering degree from Delhi University.

Venky Natarajan, Managing Director
Mr. Natarajan has over 14 years of experience in product development and venture capital at Intel. He also led several equity deals in design software, computing and wireless technology sectors and acted as operational consultant to various MFIs in India. Mr. Natarajan holds an MBA from Cornell University and Engineering degree from Annamalai University, Chennai.

ENDNOTES AND REFERENCES

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