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# Equity Investment in Indian Microfinance

## A Guide for Practitioners


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# 1. Introduction

In July 2007, Mexican microfinance institution (MFI) Compartamos sold 30% of its shares in an initial public offering (IPO) that was oversubscribed 13 times and netted US$467 million for the original investors. The spectacle of what was once a socially-motivated organization generating huge profits for its investors sparked an intense debate in the microfinance community over the direction microfinance had taken in recent years. One thing the Compartamos IPO made clear is that microfinance had finally entered the world of mainstream finance.

The Compartamos IPO was in fact just the tip of the iceberg when it comes to investments in microfinance institutions. Drawn by the potential for social as well as financial returns and the opportunity to add depth to their portfolios, investors have flocked to microfinance in recent years. According to the Consultative Group to Assist the Poor (CGAP), total funds mobilized by microfinance investment vehicles grew five-fold from 2003 to 2007, from US$600 million to US$3.1 billion (Reille, 2007).

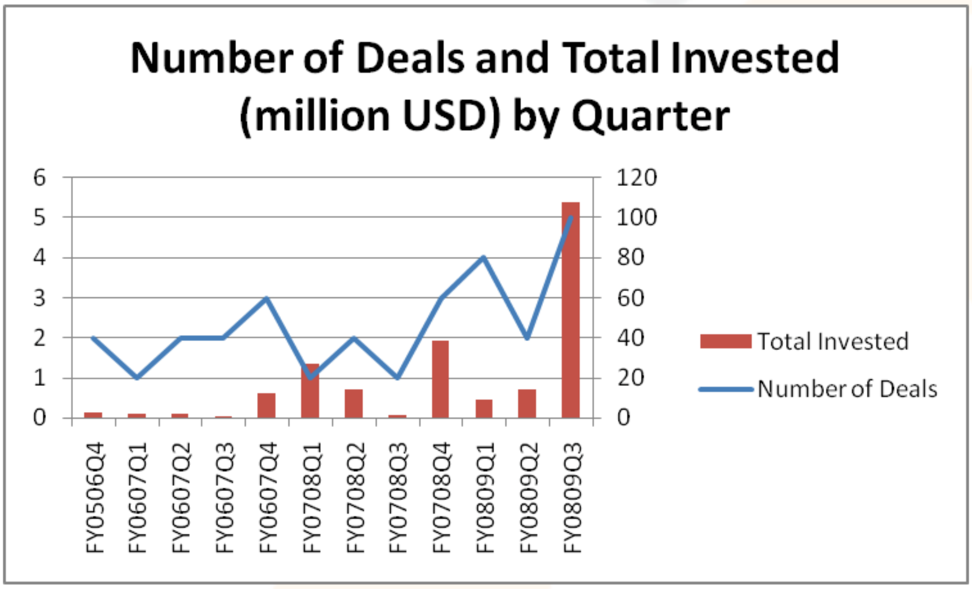
The wave of private equity in microfinance was slow to reach Indian shores. Until recently, Indian MFIs relied almost exclusively on debt as a source of funds with outside investment contributing a very small share of overall financing. According to a 2005 survey conducted by the microfinance rating agency Micro-credit Ratings International Limited (M-CRIL), leverage ratios of Indian MFIs had risen to "astronomical levels," with only 4 of the 8 largest MFIs having a capital adequacy ratio in excess of 12%. In addition, a large portion of the equity of the Indian MFIs surveyed in M-CRIL's report came from donor financing rather than paid-in equity (M-CRIL, 2005).

The situation has changed considerably over the past two years, with the creation of several new local microfinance-focused investment funds and a significant increase in the asset bases of existing microfinance focused funds. In addition, a raft of new deals were announced in 2007 and the first half of 2008, many at extremely high valuations. While the rate of new deals has slowed considerably in the wake of the global financial crisis, investors are still keenly eyeing the faster growing MFIs.

In this report we document the recent rise in equity investment in Indian microfinance and describe the process of obtaining equity financing and working with investors in detail. At the end of the report, we briefly describe two new alternative methods of financing for MFIs – portfolio buyouts and securitisation.

# 2. Recent Trends in Equity Investment in Indian Microfinance

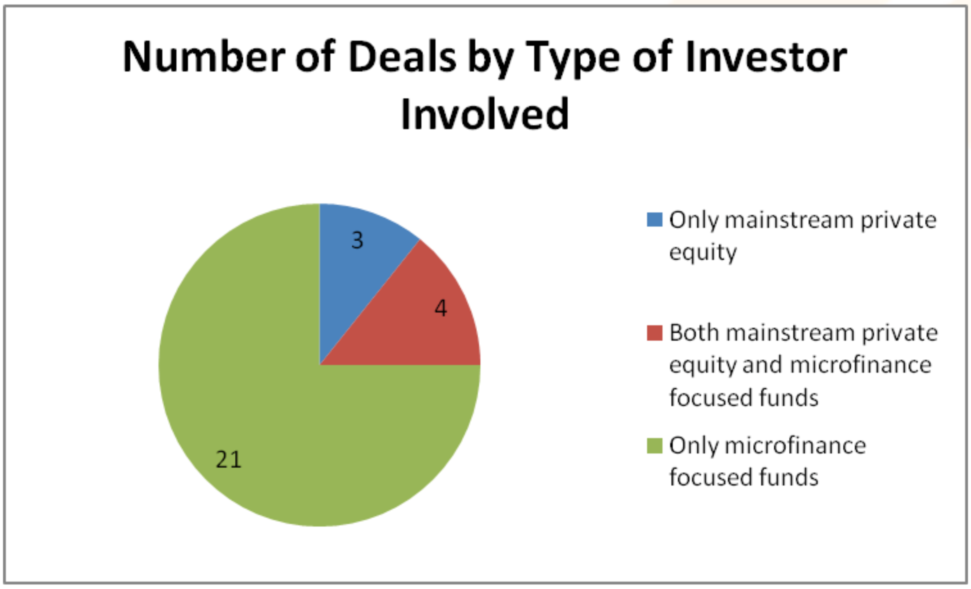
From a slow start in 2006, equity investment in Indian microfinance has skyrocketed over the past three years. The total amount of funds invested in the sector grew by 390% from FY0607 to FY0708 and by 61% from FY0708 to FY0809.



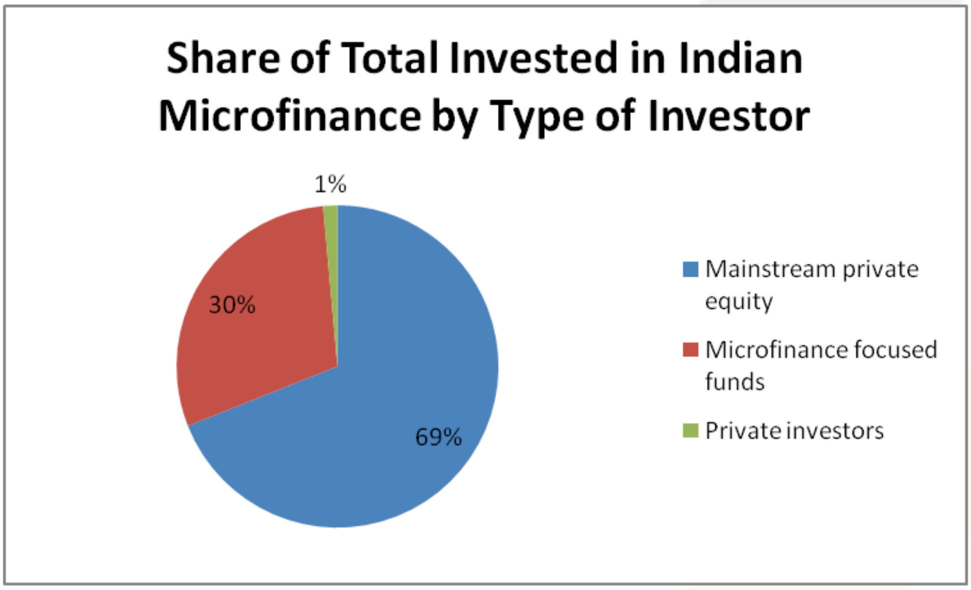

**Source: Information provided by fund managers, fund websites, and various news articles.**

Recent research from CGAP reveals that not only was there a surge in the number of deals in the Indian microfinance sector, but also that the prices investors paid for shares in Indian MFIs were among the highest in the world. In a study analysing prices investors paid for equity stakes in MFIs across the world, the authors found that investors valued Indian MFIs, in price per book value terms, significantly higher than MFIs of any other country (Kneiding et al, 2009).

This growth in equity investment has been fuelled by a concomitant growth in investment funds targeting the sector. Over the course of FY0708 and FY0809, two new funds specifically targeting Indian microfinance, Aavishkar Goodwell and the India Financial Inclusion Fund, were created. Two existing microfinance focused funds which invest primarily in India – Unitus Equity Fund and Lok Capital – significantly increased their asset base. And several mainstream private equity players, most with no previous experience investing directly in microfinance institutions, invested in Indian MFIs. This last trend is especially significant considering the relatively large amounts of capital available to these investors compared to the microfinance focused funds. As the charts below show, while microfinance focused funds have chalked up a much greater number of deals than mainstream private equity players, mainstream private equity players have collectively supplied a majority of the equity financing to Indian MFIs over the past few years. This is not to deny the importance of the microfinance focused funds which provide a very important source of early risk capital and help nurture early stage MFIs, but does indicate that mainstream private equity players will most likely play an increasingly important role in directly financing MFIs in the future.




**Source: Information provided by fund managers, fund websites, and various news articles. Some of these deals also involved private individuals. Due to the relatively small amounts invested by private individuals, they have not been included in the analysis**




**Source: Information provided by fund managers, fund websites, and various news articles.**

For the most part, the strong fundamentals of the Indian microfinance sector explain the large growth in equity investment and high valuations of Indian MFIs. The total number of clients of MFIs reporting to Sa Dhan, an industry group to whom the vast majority of medium and large MFIs supply data, grew at 46% compound annual growth rate (CAGR) over fiscal years 2007 and 2008 with total amount in loans expanding by 44.5% CAGR over the same period (Sa Dhan, 2008). A recent report by Intellecap, a research and consulting group which focuses on multiple bottom line industries, reveals that the largest Indian MFIs are even managing to decrease costs at the same time as they are expanding rapidly, with operating costs of tier I MFIs in their research sample dropping from 20% to 9% from 2003 to 2007 (Intellecap, 2008).

Further, microfinance proponents have long argued that microfinance as an asset class deserves special attention due to its low beta, or low correlation between the performance of microfinance assets and the overall economy. This claim first achieved prominence in the wake of the Asian financial crisis of 1996 when Bank Rakyat Indonesia, an Indonesian bank with a large microfinance portfolio, managed to escape the crisis relatively unscathed. Recently, academic research has given some tentative support for this claim. [1] Although no formal

[1] Krauss and Walter find that the performance of MFIs which provide information to the Microfinance Information Exchange exhibits relatively low correlation with national GDP and very low correlation with global markets. Due to limits of the dataset used by the authors though (for example, the authors are forced to rely on accounting data

research has yet been conducted on the impact of the global financial crisis on repayment rates of microloans, anecdotally it appears that there has been little reduction in the repayment rates of microfinance loans in most areas of the world.[2] In India, where microfinance remains a predominantly rural phenomenon and extremely few borrowers participate in the formal economy, it is likely that the beta of microfinance assets is even lower than for microfinance assets from other countries.

Yet interviews with investors revealed that while the fundamentals of Indian microfinance are undoubtedly sound, there are still several issues dampening enthusiasm in the sector by potential investors. Investors complained of weak governance, excessive reliance on "key men," and low quality management information systems as problems endemic in the industry. Some investors, with the lessons of the subprime crisis fresh in their minds, are particularly anxious about the lack of information regarding multiple borrowing in the industry. These investors worry that in the context of sparse information sharing among MFIs, the frenetic growth of the industry could lead to a situation where clients take on too much debt and a crisis eventually ensues. Other investors expressed concern that banks would poach MFIs' clients as they increasingly try to reach out to bottom of the pyramid clients due to pressure from India's central bank. A few investors, though not all, worry about the possibility of another political crisis such as that which occurred in Andhra Pradesh in 2006.[3]

In terms of future growth, the global financial crisis will, no doubt, slow the pace of new investments in Indian microfinance over the short to medium term. Ominously, not a single new deal was announced in the final quarter of fiscal year 2008-09. Yet the impact of the global financial crisis should not be overstated. Fund managers interviewed by the authors asserted that while they were being slightly more "patient" in selecting deals, they were still actively looking for investments and many stated that they have deals in the pipeline. Fund managers further

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rather than stock prices due to the very limited number of MFIs which have had IPOs), care should be taken in interpreting these results. (Krauss and Walter, 2008)

[2] See, for example, "Sub-par but not Subprime", *The Economist*, available at http://www.economist.com/finance/displaystory.cfm?story_id=13342261. It should be noted that one of the investors interviewed for this report stated that some MFIs, especially those based in Latin America, have witnessed deterioration in repayment rates since the onset of the financial crisis.

[3] In March of 2006, simmering tension between a government-supported microfinance program and privately run MFIs came to a head in Andhra Pradesh (AP). State officials raided and shut down nearly all MFI branches operating in Krishna, one of the districts of AP with the highest penetration of microfinance. Immediately after the raids, officials spread the word that borrowers need not repay their loans to the MFIs as the MFIs had engaged in various illegal practices causing massive defaults in the district.

asserted that while raising funds had become more difficult in the current environment, it was by no means impossible. Given that, at the back end, many of the investors in the microfinance focused funds are international financial institutions such as the International Finance Corporation and development banks such as KfW Bankengruppe and FMO, which are unlikely to be severely hurt by the financial crisis, this is not too surprising.

# 3. Prerequisites to Receiving Equity Investment

The remainder of this report, excluding the final section, is intended to serve as a rough guide for how to navigate the process of raising equity capital. In this section we describe two key steps MFIs must take prior to reaching out to potential investors to ensure that they will be seen as viable, attractive investment opportunities. These steps are certainly not intended to be exhaustive – there are many other things MFIs could do to make themselves more attractive to potential investors – but, in our view, these steps are the most essential.

### 3.1.1. Become a Non-Banking Finance Company (NBFC)

The first and most crucial step to potentially receiving equity investment is attaining NBFC status. Without NBFC status, MFIs cannot offer dividends, a deal breaker for nearly all potential investors.[4] In addition, MFIs should ideally achieve NBFC status well before reaching out to potential investors. The Reserve Bank of India (RBI) regulates NBFCs, and as such NBFCs must submit regular reports to the central bank. Having a track record of reporting to the RBI provides investors with a level of comfort that the MFI's books are in order.

Unfortunately, attaining NBFC status is a difficult and complicated affair. There are two options available to MFIs seeking to become NBFCs: they may either purchase an existing NBFC or apply for a license from the RBI to become a new NBFC. The relative advantages and disadvantages of both options and the steps involved in each are described in detail in Appendix A.

[4] The exception to this rule is the Bellwether Microfinance Fund which has invested in several MFIs at the initial start-up stage and subsequently aided them in becoming NBFCs.

### 3.1.2. Develop a Strong Board

For management of MFIs, developing a strong board can seem like an unnecessary distraction from focusing on the hectic daily responsibilities involved in leading a rapidly growing organisation. For investors, many of whom view the board as the primary conduit for interacting with the MFI, a strong board and sound governance systems are essential.

To ensure a strong and effective board, board members should have a range of experience and not be closely connected to MFI management. Board meetings should take place on at least a quarterly basis and all members should actively participate in meetings.

### 3.1.3. Other steps MFI can take to make themselves attractive to investors

In addition to these key steps, there are several other steps MFIs can take to make themselves more attractive potential investments. First, and most obviously, MFIs should demonstrate strong growth potential and efficient operations. Second, investors we talked to uniformly stressed the value of a high quality management information system which not only allows MFIs to operate more efficiently but also provides management and investors increased visibility into the performance of the MFI's loan portfolio. Third, investors value consistency: as early as possible, MFIs should articulate a clear mission and goals and stick to them closely.

# 4. The Process of Raising Equity Capital

Despite the increased availability of investment funds for microfinance, raising capital from outside investors can still be a daunting process for the uninitiated. In this section, we describe in detail the process of raising a single round of equity capital for an MFI. In places, we provide advice to MFIs based on interviews with MFIs which have gone through this process.

Before delving into the equity raising process, it is important to note the importance of finding domestic sources of capital. NBFCs that are not listed on a public stock exchange fall under the regulatory purview of RBI. RBI's Foreign Investment Promotion Board (FIPB) has set up the following foreign direct investment (FDI) rules for start-up companies not traded publicly on a stock exchange, which includes NBFCs:

- FDI can be up to 51% for companies with USD $.5 million or less in capitalization
- FDI must be below 75% for companies with USD $.5 – $5 million in capitalization

- FDI can be above 75% for companies with USD $50 million or more in capitalization

International investors that set up local semi-independent funds for investing in India (e.g., Blackstone, Sequoia Capital) possess foreign origins, and therefore fall under the above restrictions for foreign capital. According to practitioners that the authors discussed this issue with, the two main sources for domestic capital are currently SIDBI and NABARD, and emerging local microfinance focused funds such as Bellwether Microfinance Fund and Aavishkaar Goodwell. Finding domestic sources of capital can be difficult, and therefore when going through the equity raising process, practitioners should identify potential domestic sources of capital early on in the process.

## 4.1. Preliminary Note on Time Required to Raise Equity

Raising equity is a lengthy process which requires substantial attention from senior management. According to Jaydeep Chakrabarty of Unitus Capital, raising a first round of equity typically takes between three to six months and consumes 30-50% of the Chief Executive Officer's time. Later rounds of equity take less time as the MFI is more comfortable with the process and existing investors are often willing to supply a substantial portion of new equity needs, but the process still lasts at least a few weeks.

Due to the large effort required to raise capital, MFIs typically attempt to sell enough equity stake in each round of capital raising to finance roughly 18 to 24 months of expansion. (Most investors are only willing to provide enough equity for at most two years of growth in a single round.)

## 4.2. Guides to the Capital Raising Process

Raising equity can be a bewildering process for those who have never been through it before. MFIs' relative lack of experience in capital raising process can leave them at a substantial disadvantage when negotiating with savvy investors who have been through the investment process numerous times. Fortunately, there are now several organisations in India which specialize in providing advice to MFIs seeking to raise capital including Unitus Capital, Intellecap Investment Banking Advisory Services, and Grameen Capital. These organisations provide guidance to client MFIs at all stages in the capital raising process. In the development of an MFI's business plan, an advisory service can help illuminate what information investors value and what information they see as superfluous. During the process of valuing the MFI, the advisory service can guide the MFI on appropriate valuation methods and help them arrive at a more realistic valuation through the use of benchmarks based on their previously conducted valuations. When reaching out to investors, an advisory service can help an MFI better prioritize which potential investors to target through their in-depth knowledge of investors' philosophies and investment styles. In negotiations with potential investors, an advisory service can help MFIs accurately price any additional clauses such as call or put options that investors may request. Additionally, such services can suggest innovative structuring arrangements such as buy-backs to allow MFIs to reach final agreement with potential investors.

That said, when selecting an advisory service, microfinance practitioners should have a clear understanding of how the advisory service will assist in the equity raising process. Outlining the specific activities that an advisory service will provide support for, before partnering with such a service, can help both parties understand expectations.

## 4.3. Step 1: Develop a Business Plan

An MFI's business plan will be the key element investors use to evaluate a potential investment in an MFI. In addition, a business plan serves an important internal purpose: it helps the MFI to estimate how much capital it will need to achieve its growth targets and thus how much equity stake it should sell.

The business plan an MFI shares with potential investors should include three key components: historic financial and operational data, future growth projections, and non-financial information.

### 4.3.1. Gather Historic Financial and Operational Data

Potential investors want access to core numbers that help indicate the growth and operational efficiency of a microfinance institution. At a high level, an MFI's ability to provide key financials exhibits an MFI's transparency and accounting standards. Moreover, if an MFI has only recently become a non-banking financial company (NBFC), an MFI's ability to clearly document its financial history is especially important. Past financial history should include the following broken down on a monthly basis: 1) total branches, 2) total centres, 3) number of clients, 4) loans outstanding, 5) average loan size, 6) asset size, 7) equity size and investor information (if applicable), and 8) expenditures (e.g., total salary costs, leasing costs, administrative overhead).

### 4.3.2. Estimate Future Growth

MFIs can help potential investors understand their growth by providing a financial model which includes such projections. The MFI should include estimated values for the key indicators (e.g., number of clients, loans outstanding, staff numbers/expenses etc.) highlighted in the MFI's past financial and operational history. Using such a strategy creates continuity between past and projected numbers, which makes it easier for potential investors to follow.

According to Samit Ghosh, founder and CEO of the MFI Ujjivan, a key element of any MFI's future projections should be a timeline for raising future sales of equity, not just the equity being sold in the current round of capital raising. Creating a calendar for future equity needs helps set expectations and reassures investors that the MFI has a long term vision for expansion.[5] (Ghosh, 2009) As mentioned earlier, MFIs typically attempt to sell enough equity in each round of capital raising to finance 18 to 24 months of expansion. In estimating equity needs, MFIs should also be mindful of the minimum capital adequacy ratios prescribed by the RBI for NBFCs – 10% for NBFCs with assets less than 100 crore and 12% for NBFCs with assets 100 crore or above (to be raised to 15% on 1st April, 2010).[6]

Future projects need not be limited to one set of numbers. MFIs may create several set of projections based on alternate assumptions. According to Anurag Agrawal, head of Intellecap's investment banking advisory services team, developing alternate scenario-based projections helps investors to conduct sensitivity analysis.

### 4.3.3. Compile Non-Financial Information

In the words of Anurag Agrawal, a business plan is "more than just numbers." In addition to historic data and future growth projections, MFIs should also provide investors with a clear mission statement and, if applicable, specific information on how the MFI intends to fulfil social objectives. For example, an MFI may list the low-income areas to which it seeks to

[5] MFIs will, of course, still have to develop a new business plan for each subsequent round of capital raising.
[6] http://www.thehindubusinessline.com/2008/06/03/stories/2008060352240600.htmhttp://rbidocs.rbi.org.in/rdocs/notification/PDFs/86133.pdf

expand, or present a target for percentage of clients that fall below the poverty line that it wishes to reach.

Investors and other interviewees we spoke to stressed that non-financial information can be just as important as financial information in investors' decision of whether to make a bid on an MFI. Inclusion of such information can also help set clear expectations between the MFI and investors to help minimise future misunderstandings. For example, if the MFI has a strong social mission, articulating this clearly in the mission statement and growth plan can attract socially-minded investors and also make clear to for-profit investors that the MFI cares about more than just achieving high profits.

## 4.4. Step 2: Estimate the Value of the MFI

Before interacting with potential investors, MFIs should attempt a valuation—the act of valuing the MFI's future stream of profits to arrive at an approximate range of values for the MFI's overall worth. These valuations are typically not included in the information sent out to potential investors, as interested investors will conduct their own valuations of the MFI. (In rare cases, MFIs have in fact included specific valuation models in the information sent out to investors, but investors we spoke to claimed that this information had little influence over their own valuations.) Rather, the valuations are for the MFI itself so that management may have a rough idea of their own worth heading into negotiations.

The end result of the valuation process is typically a rough range of values rather than a specific number. Numerous valuations methods exist, each with their own advantages and disadvantages. The range of methods lead to widely divergent estimates of the MFI's overall worth. (See Appendix B for a listing of major valuation methods along with a discussion of their advantages and disadvantages.) Further, in a context of extremely high growth such as that found in the Indian microfinance sector, small changes in initial assumptions can result in large differences in the estimated value. Lastly, while in other sectors investors may rely on benchmarks derived from previous deals, due to the relative infancy of microfinance as an asset class, there are few examples of microfinance deals on which to base such benchmarks.[7] Most of

[7] Researchers at CGAP and JP Morgan have made a valiant effort to address this gap by compiling private data on MFI equity transactions throughout the world. As mentioned earlier, the authors found that the average price to book value for deals involving Indian MFIs was 6.7 – significantly higher than the comparable figure for any other region. Yet due to relatively short history of significant equity investment in Indian microfinance and the

those interviewed in this article recommended using all of the major valuation methodologies and several different scenarios for growth to arrive at a final range of values.

## 4.5. Step 3: Reach out to Potential Investors

Once it has put together a clear business plan and estimated its own worth, the MFI is finally ready to reach out to potential investors. Most of the people interviewed for this report recommended that MFIs adopt a targeted approach to selecting which investors to contact, which would mean evaluating the pool of potential investors and only contacting the few likely best matches. According to our interviewees, interacting with potential investors requires substantial time and energy, and if too many investors are contacted initially, the process can quickly become unmanageable.

In screening potential investors, MFIs should first ensure that the investor's size is appropriate to the MFI's stage of growth. According to Samit Ghosh, CEO of Ujjivan, MFIs should seek different types of investors at different stages. At the initial start-up stage, MFI promoters will most likely seek friends and others in their close network to provide seed capital. In early stages of growth, MFIs can then turn to microfinance focused funds. As shown in the table below, microfinance focused funds and private investors typically make significantly smaller investments in MFIs than mainstream private equity.

**Size of Equity Investment**

***by Investor Type***

| Investor Type | Investment Range (USD) | Mean (USD) | Median (USD) |
|---|---|---|---|
| Microfinance focused funds (n=25) | $.14 – $9.8 mill. | $2.89 million | 2 million |
| Mainstream private equity funds (n=7) | $9 – $51 mill. | $24.1 million | 23.75 million |
| Private investors (n=2) | $1.5 – $2 mill. | $1.75 million | 1.75 million |

**Source: Information provided by fund managers, fund websites, and various news articles.**

exuberance environment during which most of the deals included in the dataset were presumably consummated, readers are cautioned that the this benchmark may be significantly over-optimistic.

As mentioned in the next section, in addition to providing capital microfinance-focused funds also can serve as a valuable resource for the MFI's management team as they work through operational challenges (e.g., developing a strong management information system (MIS) and determine the best strategic plan for the MFI. Later, as the financing needs of the MFI outstrips the funding potential of this class of investors, MFIs can turn to mainstream private equity players (Ghosh, 2009 and private interview with Ghosh). A second, but not less important, criterion in evaluating potential investors is the philosophy and social objectives of the investor.

After receiving an MFI's business plan, investors typically respond with requests for additional information. If sufficiently interested in the MFI, a potential investor will conduct a site visit which may last anywhere from 2 days to a week. During this time, the investor will want to see the operations in a typical branch, accounting at the head office, and the MFI's management information system.

Finally, if an investor decides to make a bid on the purchase of the MFI's equity, it will submit a "term sheet" which contains all details of the investor's bid. Such information includes the amount of equity the investor seeks to purchase; the amount the investor is willing to pay; and any requirements the investor may have such as call or put options on the stock, or that the stock be issued by preferred shares rather than common stock. Moreover, the term sheet may include other operations-related requests that are part of the investor's bid, including:

- Veto rights on key decisions (e.g., changing the capital structure, hiring a new CEO)
- Board seats (i.e., investor usually requests one seat, sometimes two)
- Quarterly updates on financials

These conditions will depend on the individual investor, and the existing level of corporate governance at the MFI. If the investor feels that an MFI's governance is strong, they will likely be less concerned with these more detailed term requirements.[8] [See Appendix C for a sample term sheet outline and links to example term sheets]

[8] Sample term sheets can be found online. For a couple examples, you can review the National Capital Venture Association (NCVA) and Docstoc term sheets, found, respectively, at the websites provided below:
http://www.nvca.org/index.php?option=com_content&view=article&id=108:model-legal-documents&catid=43:resources&Itemid=136
http://www.docstoc.com/search/sample-term-sheet/

## 4.6. Step 4: Negotiate with Interested Investors

Once it has received bids from interested investors, the MFI's job is far from over. Negotiating with interested investors can be a long and complicated process. MFIs must juggle diverse demands from multiple actors to arrive at a single price-and-deal structure to which all investors can agree.

There was no clear consensus among those interviewed for this report on the best approach to negotiations with investors. Some recommended a one-on-one approach with the most "attractive" bid, where the "attractiveness" of the bid depended not only on the price, but also on other factors such as the amount of support the investor could provide. Using this approach, one MFI conducted one-on-one negotiations with the investor with the most "attractive" bid and then tried to sell the deal agreed on with this investor to other interested investors. Others thought this one-on-one approach impractical, recommending instead that MFIs engage multiple investors in a transparent manner from the beginning of negotiations. Having a next best alternative, in this case another potential investor, may be beneficial during the negotiation process.

# 5. Working with Investors

Working with investors often differs considerably from working with lenders. In the section below, we broadly describe what it is like to work with each of the two typical types of investors currently active in the Indian microfinance sector: microfinance focused funds and mainstream private equity funds. It should be remembered that each individual investor is unique and may not conform to the general descriptions below. For example, while mainstream private equity firms as a whole tend to focus less on social objectives than microfinance focused funds, some mainstream private equity firms rate social objectives as a high priority.

## 5.1. Microfinance Focused Funds

To the authors' best knowledge, there are currently seven organisations which specifically target the microfinance sector for investment and which have invested directly in an Indian MFI: Lok Capital, Bellwether Microfinance Fund, Unitus Equity Fund, Michael and Susan Dell Foundation, Aavishkaar Goodwell, MicroVentures SPA, and Blue Orchard Private Equity

Fund.[9] Compared to mainstream private equity funds, these funds tend to have much smaller asset bases, ranging in size from $20 million to $131 million.

Microfinance focused funds are much more hands-on than mainstream private equity players. Managers of these funds, who often have deep experience in the microfinance industry, provide support in a range of areas, from upgrading the MFI's management information systems to recruiting senior management to accessing additional sources of finance. Indeed, many of the MFIs we spoke to indicated that they interact with these investors as frequently as every week to seek advice on important management decisions.

In addition, microfinance funds often impose additional reporting requirements on the MFIs in which they invest. Reporting requirements vary from investor to investor, but commonly include an indicator of the MFI's clients' poverty levels based on clients' assets and expenditures. A typical method of gathering this data is through the use of a short survey. For example, the Grameen Foundation developed the Progress out of Poverty Index, a survey conducted during the initial customer enrolment stage. Investors may also request the MFI to provide data on the poverty levels and the existing status of financial access in new areas to which the MFI seeks to expand, or to submit to an external rating of their progress on social impact objectives such as those conducted by EDA Rural Systems. More rarely, investors may require regular reports on the environmental impact of the MFI's operations through information such as the electricity usage at each branch.

While additional reporting requirements may appear intrusive and unnecessary at face value, management of microfinance investment funds we spoke with insisted that in most cases these reporting requirements simply reflected the MFIs' own social objectives as outlined in their mission statements.

## 5.2. Mainstream Private Equity Funds

While the majority of equity deals in Indian microfinance to date have been financed by microfinance focused funds, mainstream private equity funds have also begun to enter the sector. To the authors' best knowledge, over the past two years, six mainstream private equity funds

[9] While we label these organizations as "microfinance focused funds" several of them have invested in organizations other than MFIs. For example, Bellwether has invested in A Little World, a maker of biometric and mobile platforms technology for recording microfinance and other transactions targeted for low-income households. Similarly, Unitus has invested in COMAT, which provides e-governance solutions. In addition, Michael and Susan Dell Foundation is primarily a grant-giving organization but has made investments in Indian MFIs in the past.

(Sandstone Capital, Silicon Valley Bank, Columbia Pacific, Kismet Capital, Sequoia Capital, and Legatum) have invested in Indian MFIs, though it should be noted that the vast majority of these funds invested in a single MFI – SKS Microfinance. In addition to SKS, Ujjivan and Share Microfin also received investments from the funds mentioned above, and in 2007 Spandana received Rs. 40 crore (USD$10 mill.) from the JM Financial India Fund. Moreover, other major private equity funds such as Blackstone and Reliance Capital have actively researched and considered investing in Indian MFIs.

In general, mainstream private equity funds tend to be more profit-driven and less focused on social impact than microfinance focused funds. Often, microfinance focused funds have a specific mission which entails improving and scaling up microfinance. Mainstream private equity funds do not have such a focused mission, particularly with regards to microfinance. In terms of support and interaction, mainstream private equity players, whose staff rarely have direct experience in the microfinance industry, typically limit their role to serving on the board of the MFI, providing contacts, and offering advice on raising additional equity. One area in which mainstream private equity players may, in the future, provide valuable support to the MFIs they invest in is conducting an IPO. Mainstream private equity players have deep experience in guiding companies through the process of conducting an IPO. So, even though microfinance focused funds typically hire people who used to work for MFIs, the fact that mainstream funds tend to attract staff from traditional investment backgrounds can be beneficial.

Moreover, what mainstream private equity funds lack in microfinance expertise they make up with deep pockets. Mainstream private equity funds have access to much larger fund bases than microfinance focused funds. For example, Blackstone manages over USD$120 billion in funds globally and their minimum deal size for the Indian market is USD$50 million.

Some in the microfinance community have raised concerns that mainstream private equity players may pressure MFIs to adopt strategies which focus too heavily on profit maximisation and thus move the industry further away from the social mission on which it was founded. While it is impossible to draw firm conclusions at this early stage, we uncovered no specific examples in which a mainstream private equity investor exerted pressure on an MFI investee in this way during the course of our interviews.

# 6. Alternate Sources of Financing

In addition to debt and equity, several MFIs have obtained financing through portfolio buyouts and securitisation in recent years. While these financing mechanisms are fundamentally different from equity investments, warranting their own full report, we include a brief overview of these topics as they may be of interest to MFIs seeking additional options for obtaining financing other than debt.

## 6.1. Portfolio Buyouts

A **portfolio buyout** occurs when a bank (or other agent) purchases the rights to the future payment stream from a set of loans granted by the MFI. Portfolio buyouts have risen in popularity in recent years as they provide a relatively easy way for banks to "cherry pick" the MFI's portfolio for those loans which meet its priority sector lending requirements.[10]

Portfolio buyout contracts typically include a clause which specifies that the MFI is responsible for making up any loss in repayment up to a certain percentage of the overall portfolio (typically 10%). This clause, also known as a "first loss default guarantee", is seen as essential to ensuring that the MFI retains the correct incentives to collect on these loans. It is important to note that MFIs can only sell off as much of their portfolio as is financed by accumulated earnings or equity, not term loans from banks, in a portfolio buyout. This is because the payment stream from those micro-loans is already guaranteed to the bank which granted the term loan. Also, because the financing obtained through a portfolio buyout as well as the microloans themselves purchased through the buyout do not show up on the MFI's balance sheet, portfolio buyouts are a form of "off-balance sheet financing."

For MFIs interested in having their portfolio bought out, good financial performance is key. As Spencer Dudley of IFMR Capital explained during an interview with the authors, portfolio at risk, default rate, and volatility of defaults should be sufficiently low. Interested MFIs should also have up-to-date, audited financial statements.

[10] The RBI's priority sector requirements stipulate that 13.5% of domestic banks' net credit must go directly toward agricultural purposes and 10% must go toward "weaker sections". Banks that fail to meet this target are required to deposit the shortfall with NABARD, a public sector bank focused on agricultural lending, for which they receive below-market rates of interests (typically 3.5% to 6% depending on the size of the shortfall). Loans which a bank purchases from an MFI through a portfolio buyout shift from the MFI's books to the banks and thus qualify towards these targets despite the fact that the bank did not play a role in originating the loan.

In addition, strong management and management information systems (MIS) are important. Regarding management, an MFI should have a capable CEO and other senior managers should also be very competent. That way, if an MFI loses its CEO, banks can be confident that the MFI will continue to operate effectively. Having a strong MIS provides banks assurance that management can monitor performance adequately, and is especially important for a rapidly expanding MFI. In addition, an MIS adds value for potential portfolio buyouts if the system can track a specific group of loans (e.g., the portfolio of micro-loans that a bank wishes to purchase). If the system includes information that allows loans to qualify as "direct agriculture" or "weaker sections" under RBI's priority sector reporting guidelines, banks find these loan types particularly valuable.

## 6.2. Securitisation

In microfinance, **securitisation of microloans** refers to a transaction in which the repayments from a set of microloans from one or more MFIs are packaged into a special purpose vehicle, from which tradeable securities are issued.[11] For the MFI, there is little practical difference between securitizing a portion of its loan portfolio and selling it off directly to a bank via a portfolio buyout. In both cases, the MFI retains a first loss default guarantee and is obligated to continue to collect repayments on the sold off loans. Similarly, with both securitisations and portfolio buyouts, MFIs can only sell off as much of their portfolio as they have financed through accumulated earnings and equity. The main differience is that securitisations require a rating, while a portfolio buyout does not, and that the ability to re-sell securitised microloans may attrract more potential buyers.

Proponents of securitisation argue that it holds great potential for decreasing cost of funds to MFIs by allowing for more complex structuring of the underlying product; by providing easier secondary sales of the assets; and by reaching out to new types of potential investors. With portfolio buyouts, there is only one buyer and one seller in each transaction. With securitisation, it is possible (though it has not happened to date), to pool together loans from different MFIs to diversify risk. It is also possible to slice the securitised portfolio up into different tranches with

[11] Confusingly, in the microfinance sector, securitisation may also refer to the packaging of loans from banks to MFIs into a special purpose vehicle or even to straight portfolio buyouts in which no actual security is created. It is important to point out that these are not true securitisations of microloans in the technical sense.

different levels of seniority to cater to the different risk appetites of investors. Further, the standardised nature of the product means it is easier for the original purchases of the security to resell the asset. Lastly, through securitisation, MFIs may be able to tap new sources of investment funds. Certain types of large investors, especially mutual funds, are barred from directly investing or lending to MFIs but not from investing in the securitised microfinance loan assets.

To date, to the authors' knowledge, there has been only one true securitisation of microloans in the world. In March 2009, microfinance lender Equitas, in collaboration with IFMR Capital, completed a securitisation of a portion of Equitas' microloan portfolio worth Rs. 157 million. A key element of the deal was that the securities were divided into two tranches. A senior tranche comprised 80% of the portfolio and was sold to institutional investors, while a junior tranche consisting of the remaining 20% was sold to IFMR Capital. This arrangement effectively means that IFMR Capital holds the second loss default guarantee for the loans.

As the United States subprime crisis has demonstrated, securitisation may lead to systemic risks if proper precautions are not taken. While it is tempting to draw parallels between the securitisation of microfinance loans and the securitisation that took place in the United States subprime mortgage market, there are several major differences between the two situations. First and most importantly, in the subprime market, the originator of the loans often had no "skin in the game" once the loan was sold. In contrast, through the use of the first loss default guarantee clause, MFIs remain liable for a large portion of loan repayment and are thus incentivised to collect on repayments. Second, microfinance securitisation deals in India, indeed all securitisation deals in India, are much less complex than the intricate, multi-layered transactions which occurred in the subprime in the United States and which led to such confusion. Third, it should be remembered that the underlying assets, and the way in which loans are approved, are very different. In the United States subprime market, lenders often granted mortgages simply on the basis of a credit score without any real interaction with the borrower. In microfinance, the joint liability of groups has been proven as an effective screening mechanism.

## 6.3. Ratings

With both portfolio buyouts and securitisation, the assets sold can obtain a **rating**.[12] In the case of a portfolio buyout, the asset rated is the total loan portfolio which is sold. In the case of securitisation, each tranche of securities created in the deal is rated separately. Ratings are conducted by an external rating agency, such as Credit Rating Information Services of India Limited (CRISIL), which conducts extensive analysis of such factors as historical repayment rates of the microloans of the MFI to assign a final letter rating to the assets.

Obtaining a rating allows banks and other investors to purchase the assets with more confidence as they have a third party opinion of the relative riskiness of the asset. For banks, purchasing an asset which has been rated by an approved rating agency holds an additional benefit. Under the BASEL II banking norms which the RBI has subscribed to, assets which have been rated by an approved rating agency are considered less risky than unrated assets when calculating capital for capital adequacy requirements. Effectively, this means that it is cheaper for Indian banks to hold an asset which has been rated than an unrated asset.

## 6.4. Potential Legal Complications

On 12th January, 2009, in a case between Kotak Mahindra Bank and a delinquent borrower whose loans had been sold to a third party, the Gujarat High Court ruled that Kotak Mahindra did not have the right to sell the borrower's loan. The ruling declared that such sale of loans violated the Banking Regulation Act of 1934 and that the borrower was under no obligation to repay the loan to the new holder of the debt.

The Gujarat High Court's ruling, if upheld by the Supreme Court, will effectively render portfolio buyouts and securitisation, not just in the microfinance sector, but for all other sectors as well, illegal. As of the time of publication of this report, the ruling has been stayed by Supreme Court but the final outcome remains unclear. MFIs considering selling or arranging for a securitisation of a portion of their portfolio should seek an update on the status of the High Court's decision.

[12] In microfinance, ratings may also refer to a rating of the microfinance institution as whole. The term "rating", as used here, implies a rating of a portfolio of microloans or set of securities backed by repayments on microloans.

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# 8. Appendix A: Becoming an NBFC

To become an NBFC, there are two main routes, 1) starting a new NBFC, and 2) acquiring an existing NBFC, which minimizes initial capital requirements. NBFCs registered before 1999 need initial equity of Rs. 25 lakhs (~USD $50,000), while the required equity for a new NBFC license is Rs. 200 lakhs (~USD $400,000). Partly due to the high initial capital requirements, many MFIs choose to purchase the license of a pre-1999 NBFC. Bellwether Fund has worked with several MFIs to execute the NBFC transformation, and the Fund's investments director Mr. Ravi Narismham describes the process as follows:

- Identifying the NBFC that you would like to acquire.
- Conducting financial and reputational due diligence – do not want bad prior history to be associated with your company.
- Agreeing on a premium for the license purchase. The price depends on geography because the price is higher in southern states where microfinance is more established. Typically, the price is between Rs. 6 to 10 lakhs (~USD $12,000 – $20,000).
- Undergoing process of transferring assets and bank accounts from old MFI structure (e.g., trust, section 25 company) to the new NBFC.
- Creating a new Board.

There are also significant regulatory requirements involved in the NBFC licensing process. In Mr. Narismham's experience, when you combine the steps above with RBI regulatory approval steps, the process of purchasing an old NBFC license typically takes 6-12 months to complete. To help frame the regulatory licensing process, below we outline requirements for a new NBFC license and the purchase of an old NBFC license:

| Starting a New NBFC | Purchasing the License of an Old NBFC (pre-1999) |
|---|---|
| • Must have Rs. 200 lakh in initial equity to qualify<br>• Must provide RBI 30 days notice prior to acquiring an NBFC license | • Entity must have RS. 25 lakh in initial equity to qualify<br>• Need to provide advance public notice regarding the sale/transfer of ownership – 30 days for RBI and other regulators to review the proposed acquisition[5]<br>• Must provide RBI 30 days notice prior to purchasing the NBFC license<br>• Public notice should be given in at least one local and one national daily<br>• Must adopt, and likely modify, the Memoranda and Articles of Association of existing NBFC |

# 9. Appendix B: MFI Valuation Methods

There are several different valuation models, none of which have been established as the pre-eminent model. Some of these models are microfinance-specific, while others are traditional valuation methods. Below we briefly detail several of the leading methods:

| Valuation Type | Description | Pros | Cons |
|---|---|---|---|
| Price to Book Value (P/BV) | The P/BV multiple is the ratio of market price per share to book value per share. To find book value, subtract total liabilities from total assets. | Very widely used in the microfinance industry. Book value is always a positive number, meaning P/BV consistently has real meaning. | Book value does not take into account MFI future earnings potential. |
| Price to Earnings (P/E) | P/E is the ratio of market price per share to the earnings per share. An institution's estimated earnings per share is the main driver of the P/E ratio. | Widely used in the microfinance industry. | Cannot be used if MFI has negative earnings. Historical earnings do not indicate institution's future earnings power. |
| Discounted Cash Flow Analysis | Estimating future earnings flows and discounting them to the present. This method requires 5-10 year company revenue forecasts. | Rigorous valuation method. If analysis is sound, investor should be willing to pay for the present value of future cash flows. | Not for young MFIs because developing future assumptions and value predictions would be quite subjective. Valuation is very sensitive to discount rate, which is subject to improper estimation, and therefore, error. |
| Residual Income | Hybrid that starts with current book value and adds this current value to the expected residual income over the next several years. | Rigorous valuation method. More appropriate for young MFIs which do not have short-term earnings. | Valuation is very sensitive to discount rate used in the analysis. If MFI's capital structure (e.g., new investors, portfolio buyouts) may significantly, analysis has less relevance. |

**Source: Kneiding et al (2009) "Shedding Light on Microfinance Equity Valuation", pages 12-16.**

# 10. Appendix C: Sample Term Sheet: Potential Investor to Company (MFI)

**ABC INC**
**MEMORANDUM OF TERMS**[13]

This Memorandum of Terms represents only the current thinking of the parties with respect to certain of the major issues relating to the proposed private offering and does not constitute a legally binding agreement. This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [____________], Inc., (the "**Company**"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties.

**THE OFFERING**

| | |
|---|---|
| ***Issuer:*** | ABC Inc, (the "***Company***") |
| ***Securities:*** | Series A Preferred Stock (the "***Series A Preferred***") |
| ***Valuation of the Company:*** | $9,000,000 pre-money |
| ***Amount of the offering:*** | Up to $2,000,000 |
| ***Consideration:*** | Cash |
| ***Number of securities:*** | 1,000,000 shares |
| ***Price per share:*** | $2.00 |
| ***Investors:*** | Acme Partners or affiliated entities, and other investors acceptable to the Company. |
| ***Anticipated closing date:*** | On or before June 30, 2009. |

**TERMS OF THE PREFERRED**

| | |
|---|---|
| ***Dividends:*** | *Dividend rate:* 0%<br>*Cumulation:* Noncumulative<br>*Priority:* Senior to common.<br>*Participation:* Common may not receive any dividends unless Series A Preferred receives a dividend (including the preference amount) equal to the amount it would have received if converted to common. |
| ***Liquidation preference:*** | *Amount:* Original purchase price plus accrued dividends.<br>*Priority:* Senior to common.<br>*Participation:* After payment of preferential liquidation proceeds, the Series A Preferred does not participate in further liquidation proceeds. |

[13] Sample term sheet shortened from a fuller version found at *Docstocs*. Fuller version found at http://www.docstoc.com/search/sample-term-sheet/

| | |
|---|---|
| | *Deemed liquidation:* A sale of all or substantially all of the Company's assets or a merger or consolidation of the Company with any other company will be treated as a liquidation of the Company. |
| ***Redemption:*** | Outstanding shares of Series A Preferred will be redeemable at the election of holders of a majority of the outstanding Series A Preferred in three equal annual installments commencing six years from the date of purchase. The redemption price will be the purchase price plus declared dividends from the closing date. |
| ***Conversion:*** | The Series A Preferred may be converted at any time, at the option of the holder, into shares of common stock. The conversion rate will initially be 1:1, subject to anti-dilution and other customary adjustments. |
| ***Automatic conversion:*** | Each share of preferred stock will automatically convert into common stock, at the then applicable conversion rate, upon (i) the closing of a firmly underwritten public offering of common stock at a price per share that is at least $20.00 (a "***Qualified Public Offering***"), or (ii) the consent of the holders of at least 66% of the then outstanding shares of the preferred stock. |
| ***Anti-dilution:*** | *Adjustments.* The conversion price of the Series A Preferred will be subject to adjustment, on a broad-based weighted-average basis, if the Company issues additional securities at a price per share less than the then applicable conversion price.<br><br>*Exceptions.* There will be no adjustment to the conversion price for:<br>• shares issued upon conversion of the Series A Preferred;<br>• shares or options, warrants or other rights issued to employees, consultants or directors in accordance with plans, agreements or similar arrangements, but not to exceed a total of {_______} shares issued after the closing date or such greater number as approved by the board;<br>• shares issued upon exercise of options, warrants or convertible securities; |
| ***General voting rights:*** | Each share of preferred stock will have the right to a number of votes equal to the number of shares of common stock issuable upon conversion of each such share of preferred stock.. |
| ***Voting for directors:*** | The holders of Series A Preferred will be entitled to elect one director. The holders of common stock will be entitled to elect two directors. Any additional directors will be elected by the holders of preferred stock and common stock voting together. |
| ***Protective provisions:*** | Consent of the holders of at least 50% of the Series A Preferred will be required to: |

- alter any provision of the certificate of incorporation or the bylaws if it would adversely alter the rights, preferences, privileges or powers of or restrictions on the preferred stock or any series of preferred;
- approve any merger, sale of assets or other corporate reorganization or acquisition;
- approve the voluntary liquidation or dissolution of the Company; or
- declare or pay any dividend or distribution or approve any repurchase with respect to the preferred stock (except as provided in the certificate of incorporation) or the common stock (subject to customary exceptions).

**INVESTOR RIGHTS**

***Registration rights:***

*Registrable securities.* The common stock issued or issuable upon conversion of the preferred stock will be "***Registrable Securities***."

*Demand registration.* Subject to customary exceptions, holders of at least 50% of the Registrable Securities will be entitled to demand that the Company effect up to two firmly underwritten registrations (*provided* that each such registration has an offering price of at least $10.00 per share and has aggregate proceeds of at least $20,000,000) at any time following the earlier of (i) five years following the closing of the financing and (ii) 180 days following the Company's initial public offering.

*"Piggyback" registration.* The holders of Registrable Securities will be entitled to "piggyback" registration rights on any registered offering by the Company on its own behalf or on behalf of selling stockholders, subject to customary exceptions.

*Expenses.* Subject to customary exceptions, the Company will bear the registration expenses (exclusive of underwriting discounts and commissions) of all demand and piggyback registrations, *provided* that the Company will not be required to pay the fees of more than one counsel to all holders of Registrable Securities.

*Termination.* The registration rights of a holder of Registrable Securities will terminate on the earlier of (i) such date, on or after the Company's initial public offering, on which such holder may immediately sell all shares of its Registrable Securities under Rule 144 during any three-month period and (ii) three years after the initial public offering.

*Transfer.* Registration rights may be transferred by a holder of Registrable Securities to current and former partners and members, and affiliates of that holder and to other persons acquiring at least {_______} shares of the Company's outstanding capital stock, *provided* the Company is given written notice.

***Right of first refusal:***

In the event proposes to transfer any common stock, the Company will have a right of first refusal to purchase any or all the shares on the same terms as the proposed transfer.

If the Company does not exercise its right of first refusal, holders of Series A Preferred will have a right of first refusal (on a *pro rata* basis based on the Company's outstanding securities (on an as-converted and as-exercised basis)) with respect to the proposed transfer.[ Rights to purchase any unsubscribed shares will be reallocated *pro rata* among the other eligible holders of Series A Preferred.]

The rights of first refusal will be subject to customary exceptions and will terminate on a Qualified Public Offering.

***Director liability:***

The directors will be entitled to customary indemnification from the Company and reimbursement of reasonable costs of attendance at board meetings. The Company will also obtain D&O insurance reasonably satisfactory to the Company and its directors.

***Information rights:***

The Company will deliver to each holder of at least {_______} shares of Series A Preferred:

- unaudited annual financial statements within 120 days following year-end;
- unaudited quarterly financial statements within 45 days following quarter-end; and
- annual operating plans 30 days before each fiscal year.

[Holders of at least {_______} shares will be entitled to inspection rights.]The information rights will terminate upon an initial public offering.

**EMPLOYEE MATTERS**

***Vesting of employee shares:***

Subject to the discretion of the board, shares and options issued to employees, directors and consultants will be subject to four-year vesting, with 25% vesting on the first anniversary of the commencement of services and the remainder vesting monthly thereafter. The Company will have the right, upon termination of services, to repurchase any unvested shares.

***Proprietary information agreements:***

The Company will have all employees and consultants enter into proprietary information and inventions agreements.

**OTHER MATTERS**

***Purchase agreement:*** The investment will be made pursuant to a stock purchase agreement which will contain, among other things, appropriate representations and warranties of the Company and the investors and appropriate conditions of closing.

***Finders:*** The Company and the investors will each indemnify the other for any finder's fees for which they are respectively responsible.

***Legal fees and expenses:*** The Company will pay the reasonable fees and expenses of a single counsel to the investors, up to a maximum of $50,000, if the financing closes. Fees and expenses payable hereunder will be payable at closing by wire transfer.

***Conditions precedent:*** The investment will be subject to customary conditions, including but not limited to:

- completion of due diligence to the satisfaction of the investors;
- negotiation and execution of definitive agreements customary in transactions of this nature;
- receipt of all required authorizations, approvals and consents;
- delivery of customary closing certificates and an opinion of counsel for the Company; and
- the absence of material adverse changes with respect to the Company.