

# MicroSave India Focus Note 36

## Consolidation of MFIs - Need and Challenges

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### Background

Microfinance is metamorphosing into a major business and there are many examples of MFIs transforming into or starting as for-profit entities in response to this opportunity. These institutions have sensed the need for microfinance in India. A growing number of promoters have divested or significantly diluted their stakes in their MFIs and raised money from PE/VC funds. This money is used to fund operations.

But all the MFIs will not be able to serve the clients effectively. It has been observed in the past that, in any sector (like steel, cement), whenever there is an increase in the number of players, many smaller firms struggle in the face of competition. They either sell-out to bigger firms, close operations or remain small and niche.

Consolidation is common across diverse sectors like telecom and banking in India, through both mergers and acquisitions. Many others like insurance are following suit. "Now access to capital is shrinking and this is likely to continue for the next six months to one year. Consolidation makes sense in this scenario," says Shikha Sharma, MD, ICICI Prudential Life Insurance. "In every business, there will normally be four to five major players and 10-12 players altogether. There is, therefore, an immense potential for consolidation within the industry here", says Sharma.

### Why Merger?

Companies generally see for mergers when they have grown enough organically and they want to accelerate their pace of growth. Organic growth generally takes time and energy. According to N. Srinivasan's State of the Sector Report on Microfinance, over 800 MFIs now operate in India, reaching out to over 140 lakh clients, with an outstanding cumulative small loans of Rs. 5,900 crore. Leading MFIs such as SKS, Spandana, Bandhan, Share etc. have healthy balance sheets and strong net worth (SKS had a net worth of Rs. 240 crores and Share has a net worth of Rs. 144 crores as of September 2008<sup>1</sup>). Banks also lend to these larger MFIs without much hesitation

(recently Bandhan got a loan of Rs.150 crores from PNB, securitisation deals by Equitas-IFMR, SKS, Spandana of Rs. 48 crores, Rs. 200 crores and Rs. 300 crores respectively). Estimates suggest that the current supply of micro-credit is roughly only 7%<sup>2</sup> of the potential demand (about \$55 billion demand). This translates into a huge scope for growth for players like SKS, which has an ambitious plan to reach 15 million households by 2012. As of December 31<sup>st</sup> 2009, SKS had 5.74 million customers across 19 states in India.

If companies like SKS want to maintain the extraordinary rates at which they grew last year (SKS grew at 188% last year), inorganic growth is very essential. "The consolidation process by Indian microfinance institutions may begin in less than a year and may become a norm in three years from now", says Aavishkaar CEO Vineet Rai. "Consolidation would become necessary for MFIs which are large in size, while those smaller MFIs work at the grass roots level and hold the key to engage the borrowers. Here, the big MFIs would prefer to take over the district and semi-urban MFIs to get access," opines Mr. Rai.

### The Anatomy of a Merger

Generally a merger is a combination of 2 or more companies into a single entity. The company which buys another company is called 'acquirer' and the company which is bought is called the 'target'. Both these entities generally look for synergy after a merger. Some of the distinct advantages which can be realised by the MFIs after the consolidation:

- Lower cost of funds
- Sharing of IT and resources
- Lesser time in acquiring clients
- The 'synergy' effect
- Economies of scale
- Attain market share
- Inorganic growth – easy entry into other states, sectors, client groups.

Prima facia, these advantages look very good from the acquirer point of view. But these will come with many

<sup>1</sup> CRISIL, "India's Top 50 Microfinance Institutions", October 2009

<sup>2</sup> Intellectap, "Inverting the Pyramid: The Changing Face of Indian Microfinance", 2007

<sup>3</sup> KPMG, "Unlocking Shareholder Value: The Keys to Success", 1999

challenges for the acquirer firms. And given the fact that mergers and acquisitions across the globe have very low success ratios (about 80% have been unsuccessful!)<sup>3</sup>, MFIs which go for such an exercise will need to be extra cautious. Certain challenges which can be faced by Indian MFIs include:

#### ***Valuation Issues/negotiation:***

Since there is no single listed MFI in India, the valuation exercise will be a real challenge. Conventionally valuations are arrived at by averaging the values obtained from three to four standard methods of valuations like DCF<sup>4</sup>, market multiples and option valuation<sup>5</sup>. Presence of some listed competitors greatly aids the process, which is not the case in the Indian context. Sometimes, the failure of an acquisition to generate good returns for the parent company may be explained by the simple fact that they paid too much for it. Having bid over-enthusiastically, the buyer may find that the premium they paid for the acquired company's shares (the so-called "winner's curse") wipes out any gains made from the acquisition. The target MFI promoter will then have to hire a set of finance professionals whenever they aim for such an exercise. This will help in deciding the intrinsic value of the company and the appropriate market premium.

It is observed in India that to raise funds, MFIs generally securitise their portfolios and sell them to banks. The first microfinance deal in India was the acquisition of the microfinance operations of Jeevika Livelihoods Support Organization in Central India by Allahabad based Sonata in April 2007. Here the target offered its staff, clients and the portfolio for a premium. The premium was decided on various parameters like the cost spent on making clients, nurturing/seasoning them, geographical spread achieved, MIS, portfolio quality and the staff quality. Sometimes along with the premium other sweeteners are also included. In the above acquisition, Jeevika's Executive Director joined the Sonata team as a co-promoter and had also been invited to be a member of its Board.

#### ***Managing cultural differences between organisations:***

It is widely recognised that cultural differences between the partners of a merger are one of the most common reasons for failure in mergers. This may happen during pre-merger negotiations or during post-merger integration. Despite all due diligence, the two partners of a merger may fail to form a new successful unit that is able to exploit all synergies. Fostering an attitudinal and behavioural change throughout the new entity will take time.

<sup>4</sup> Discounted Cash Flow technique

<sup>5</sup> Black-Scholes valuation model

MFI leadership will have to consult with stakeholders (Board, staff and clients) at all levels and build a consensus before change. The mergers might result in job losses, restructuring, and the imposition of a new corporate culture and identity which can possibly create uncertainty, anxiety and resentment among the targets' employees. In short, the fundamental DNA of the MFI often changes.

#### ***Arrange Funds for Buying Target***



Generally the source of funds for the acquirers are the internal accruals or borrowing from banks (in case of an all cash deal). Considering the fact that microfinance is a relatively new field, bankers would be reluctant to fund such deals. Microfinance sector has not yet gained full acceptance in the banking community though the future is very promising. Furthermore, banks lend to MFIs to achieve priority sector lending norms and financing buy-outs will not achieve this!

#### ***Clash of Management Styles/ego***

Management styles tend to differ across firms. When older managers are replaced by newer ones, the difference in dealing with ground level staff, the performance appraisal systems, the ego clashes of senior managements etc. are all smaller issues which look very trivial on the outset, but can develop into very significant issues.

#### ***Conclusion***

Having discussed the caveats of consolidation of MFIs, if done properly, the synergies are excellent. In an environment where high premiums are paid, stakeholders expect significant synergies from their transactions. Success, then, comes with a holistic approach where the "people" aspects are viewed as an integral part along with the normal focus on financial performance, for one cannot exist without each other. It is the effective handling of this delicate balance which actually determines success.