

The Next Frontier: Is M&A a Feasible Strategy for Expansion?

Is acquisition of small, regional MFIs a strong growth strategy for large MFIs expanding into new states?
Photo: Mike Johnston

Indian microfinance has been growing like wildfire, with some institutions adding hundreds of thousands of borrowers to their rosters each month. However, a closer look at the numbers indicates that penetration is still not that geographically diverse, with many MFIs still being supported by a portfolio with 50% of borrowers in just one state. What are the pitfalls that make expansion into new states difficult? Should microfinance institutions consider acquiring existing organizations in new states, instead of treating each new area as the next frontier? Vineet Rai, Co-Founder of Aavishkaar Venture Management Services, explores the prospects for mergers and acquisitions in microfinance.

Think about this: 240 to 400 million target population; an estimated potential of US\$30-50bn; the largest microfinance institution (MFI) has less than US\$1bn in assets, and—hold your breath—there are 800 small and large MFIs vying for the space. Add to this a growth rate of 70% year on year and an average capital adequacy in excess of 25 to 30% at large for-profit MFIs, and you are staring at the exciting potential of Indian Microfinance.

These highlights are the reason behind the positive interest that Indian microfinance has generated among investors. However, the implication of challenges such as complex geography, cultural and linguistic diversity, and

nascent infrastructure development, especially in rural India, are yet to be understood.

Geographic Outreach: Not as Broad as You Think

As a sector, Indian microfinance remains a concentrated phenomenon with most of the microfinance operations still focused in Andhra Pradesh and other southern states. The increasing size of operations, influence of banks and private equity investors, and general counsel from the credit rating agencies pushed the microfinance institutions (MFIs) to make an effort in building a more diversified geographical outreach.

The above strategic move, though being

implemented with greater intensity after the Krishna episode in the state of Andhra Pradesh,¹ has yet to make a serious difference to the portfolio concentration of many large MFIs. Interesting insights may emerge if one analyzed the share of portfolio from new states among the top 10 MFIs with presence in more than 5-7 states. The numbers would reveal that the contribution of Andhra Pradesh to the portfolio remains above or close to 50% for most of them and interestingly, despite the talk of concerns about multiple borrowing, concentration and saturation, the portfolio growth in Andhra remains high for all of them.

What could explain this behavior? Maybe

it is not as easy to scale up in other states as we think? Or maybe the MFIs are not serious about scaling up in new states and the expansion plan and new branches are just a smoke screen to keep the lender and investors convinced that there is an “in principal” agreement on diversifying the portfolio?

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Barriers to Expansion

A quick discussion with some of the CEOs of microfinance institutions partially allays such fears. What seems to be the case is that large MFIs are witnessing variable performance and some states are performing much better than others. Ability to find strong on-the-ground leadership that can allow a push toward scale seems to be a major constraint. Other constraints cited include the low level of education of the borrowers in some states and the lack of discipline and understanding of loan products. In addition, dealing with local politicians and bureaucracies, that are yet to learn about microfinance, presents a challenge.

From an analytical point of view the problem appears to be related to classical organic growth challenges and may thus need a strategic shift in thought process. A question that may be relevant is whether there is merit in looking for inorganic growth through merger and acquisition (M&A) for these Indian MFIs to expand more rapidly. Additionally, would M&A strategies work in an essentially demand-driven space in terms of adding value to growth strategy?

Considering M&A for Growth

Both the above questions need to be looked at closely. M&A as a strategy works best if organic growth appears to be slowing down

(if the protagonist is already set in the market and competition is heating up). Conversely, if you want to enter into a new market that has huge potential but has reasonably established competition, an acquisition may give you sound footing to compete in the market.

With that background, it would be interesting to see if there is merit in Indian MFIs thinking about M&A and discovering whether their stakeholders would support this approach.

A key point that needs to be looked at carefully while discussing M&A in the context of microfinance is its social evolution. Currently there seems to be a belief that microfinance continues to remain promoter-focused and hence not amenable to ownership swap strategies.

Is there Merit to Forging Inorganic Growth?

Let me try to answer the first question by stating that while India is a single country, its diversity makes it a heterogeneous market. Each new state is a different market requiring a different mind set, different leadership and at times different products to successfully scale. For large MFIs, acquisition as a growth strategy to enter a new state may be a better strategy than rolling out its own branch network and going through start up growing pains again. Similarity of model (largely Grameen) would make the process of acquisition much less complex and acquisition of talent would solve the local leadership and management bandwidth issue making it easier to build value through this inorganic growth strategy.

Support from Stakeholders is Necessary

The second question on the support from stakeholders including investors appears to be not such a big challenge if the strategy for M&A by the MFI is clearly articulated and based on quelling the challenges that they have faced while entering new markets. Investors would view favorably the idea of addressing local human resource challenges in new states through acquisition if it takes into account the

quality of manpower being acquired and the compatibility of processes and systems.

The third question about the social entrepreneur and his/her influence in the business is a real issue. The two emerging trends that may allow such challenges to be addressed are a) The definitive movement of banks lending toward larger MFIs, leaving a bigger challenge of survival for the small, regional MFIs, at times forcing them to be more favorably disposed toward such offers b) Professional promoters with banking backgrounds have started setting up MFIs that are regional, bringing in a depth of local leadership and an open-minded approach towards ownership swap and acquisition.

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While the case for acquisition opportunities in Indian microfinance is quite clear, mergers remain a more complex and difficult proposition. It seems a merger in the Indian scenario can come about either driven by the goal of enormous scale to create value for investors, or by regional MFIs coming together to deal with larger pan-India partners. My belief is that many MFIs may not want to deal with the complexity of mergers, in addition to the management of egos, which are often the key drivers behind social enterprises. However, acquisitions may become a reality in the near future. ■

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1. A dispute between the government authority and MFIs in Krishna district, Andhra Pradesh. In 2006, accusing MFIs operational in Krishna district under the provision of the AP Private Lenders’ Act, of allegedly charging high interest rates and being responsible for the death of one of the borrowers, the district authorities closed down more than 54 microfinance branches. The root of the dispute was thought to be a competition between non-governmental MFIs and a subsidized microcredit scheme provided by the state and the central government, which was caused by the rapid expansion and concentration of MFI’s presence in the area. *The Economist* reported this incident as a turf war. See http://www.economist.com/businessfinance/displayStory.cfm?story_id=7803631