IntelleCash-Arohan

Leading the Way in Consolidating the Microfinance Industry in India

October 2012

Introduction

On September 14, 2012, IntelleCash Microfinance Network Company (IntelleCash) announced that it had taken a majority stake in Arohan Financial Services (Arohan) and would consolidate the two businesses. IntelleCash is a subsidiary of Intellecap and has been providing incubation services to young and emerging microfinance institutions (MFIs) since 2008. IntelleCash also has its own retail loan portfolio across the Low Income States in India. Arohan, based in Kolkata, is one of the most respected MFIs in eastern India with a customer base of over 100,000 poor households.

In addition, IntelleCash has announced that it is interested in exploring additional acquisitions in the microfinance industry and a variety of industry sources suggest that several more MFIs in India are engaged in discussions regarding possible combinations, acquisitions, or mergers. We believe that the IntelleCash/Arohan transaction represents the "leading edge" of what is likely to be a growing trend toward consolidation in the Indian microfinance industry. This trend will be driven largely by (i) changes in the microfinance regulatory environment, (ii) the need for scale and efficiency of operations for MFIs to attract Debt and Equity capital, (iii) the realization by many microfinance industry Investors that attractive and practical "exit" and new investment opportunities can be provided through combinations of existing portfolio companies, and (iv) a market-driven and reality-based understanding by many MFI Promoters that their futures and ability to serve their clients will be enhanced by becoming part of a larger organization.

The Changing Regulatory Environment

In December 2010, the Government of Andhra Pradesh passed a law that effectively shut down the private sector microfinance in the State. Prior to the adaptation of this legislation, Andhra Pradesh was home to some of the larger Indian private microfinance providers and accounted for 30 percent of the total Indian microfinance loan portfolio[1]. Almost overnight, over 9.2 million loans worth about USD 1.5 billion became overdue in AP alone.[2]

Over the next 18 months, the crisis in microfinance in AP snowballed to the rest of the country. The negative impact on the industry has been well documented by several industry stakeholders, including Legatum[3], M-CRIL[4] and others, and the industry has yet to fully recover. In FY 2011-2012, for example, the MFI Growth Index for the 24 largest MFIs in India declined by 21 percent and remained 30 percent below the level of October 2010[5]. While most of this decline was due to significant reductions in Borrowers and Portfolios in Andhra Pradesh, Borrowers served by MFIs with almost no operations in AP increased in FY 2011-2012 by just 2 percent and the overall Financial Performance of these large MFIs declined significantly[6].

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[1] Intellecap estimate based on data analysis of Indian MFIs
[2] Mahajan, V, and Navin, T., Microfinance in India: Growth, Crisis and the Future, June 2012.
[3] See a note on the crisis and a White Paper on the same by Legatum, at and for more details.
[4] M-CRIL Microfinance Review 2011
[5] M-CRIL India Indices of Microfinance 2012
[6] M-CRIL India Indices of Microfinance 2012

In this context, many Indian banks, who had been the primary providers of Debt capital to MFIs for on-lending, significantly curtailed their lending to MFIs (and particularly to the smaller ones) across the country[7]. In addition, many Investors began to reconsider making new and follow-on investments in microfinance in India, generally calling into question the attractiveness and growth prospects for the industry in an environment of significant and on-going regulatory uncertainty. During the period October 2010 through February 2012, for example, only about USD 96 million in Equity capital was invested in the industry compared to about USD 520 million in FY 2011 through October 2010[8].

Responding to these market and political conditions, the Reserve Bank of India (RBI) announced a revised regulatory framework in August 2012, aimed at supporting and reestablishing the growth of Non-Bank Financial Company (NBFC) MFIs. These proposed new regulations also sought to assure higher levels of consumer protection for MFI Borrowers and to limit the ability of Borrowers to take loans from too many MFIs or become over-indebted.

From the perspective of many MFIs and their Investors and Promoters, the proposed new regulatory framework created a variety of incentives that encourage industry consolidation, particularly for smaller and medium-sized MFIs. The most important of these are set forth in Box 1.

Box 1: Proposed RBI Regulations Encouraging MFI Consolidation

- An increase in the Minimum Capital Requirement to about USD 1 million and a Capital Adequacy Ratio of 15percent. These regulations will require many smaller and medium-sized MFIs to look for ways to consolidate with or sell to larger institutions because they may not be able to meet the RBI capital requirements on their own.
- Introduction of a Margin Cap of 10 percent for MFIs with capital above USD 20 million and 12 percent for others. This Margin Cap limits the potential for MFI profitability and requires MFIs to seek more cost efficiencies in their operations and the benefits of economies of scale.
- Average Interest Rate on loans is not to exceed the MFI's Average Borrowing Cost plus the Margin Cap. This provides an impetus to reduce the Cost of Borrowings, again making scale critical to MFI success.
- Total Borrower Indebtedness is not to exceed ~ USD 1000 (INR 50,000). This limitation on total amount of indebtedness that one customer may have requires MFIs to increase their operational efficiency and scale if they are to.
- In addition, each borrower can avail only 1 group loan, and 1 loan as an individual. This restricts MFI growth within existing geographies by limiting the number of potential customers and creates incentives for MFIs to combine with other MFIs in their own geographies and to seek out new geographies for their operations.
- Each MFI must be a member of at least one Credit Information Company (CIC) and one Self- Regulatory Organization (SRO). This is expected to facilitate collaboration between MFIs operating in the same geography to assure that MFIs "know their customers" and that they do not participate in proscribed multiple lending or unwittingly facilitate customer over-indebtedness. This introduces additional costs for many MFIs and limits their prospects for attracting new customers as customer borrowing relationships will be more fully transparent and available through the Credit Bureaus. MFIs will be better able to absorb the additional costs and marketing limitations if they are operating with a larger customer base, further creating a case for consolidation.

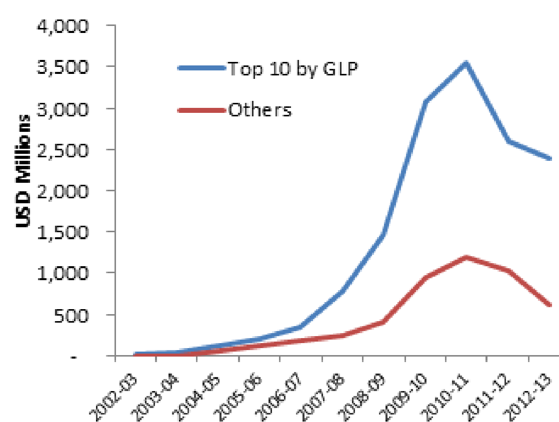
Source: *RBI Circular (NBFC-MFIs – Directions – Modifications). DNBS (PD) CC.No.300 /03.10.038/2012-13.*

[7] M-CRIL Microfinance Review 2011
[8] Indian Microfinance: Looking Beyond the AP act and its devastating impact on the Poor, Legatum Ventures

Need for Efficiency and Economies of Scale to Attract Debt and Equity Capital

The RBI regulatory framework clearly increases operating costs for NBFC MFIs while at the same time limiting their prospects for growth and profitability. While the size and depth of the financial inclusion market in India remains extremely large with more than 400 million[9] Indians still financially excluded, MFIs will need to increase their operating efficiency if they are to function profitably in the new regulatory environment. This will require them to spread their operating costs over more Borrowers and to maximize the efficiency of their overhead structures. Investments in new technology and the ability to keep borrowing costs low will be key components of the operating strategy for all MFIs, thus putting a premium on MFI size and scale of operations.

Figure 1: Gross Loan Portfolios of NBFC-MFIs



In addition, it is likely that the Indian banks who are the primary providers of Debt financing to MFIs will gravitate toward funding larger MFIs as their prospects for growth and profitability increase in comparison to the smaller and medium-sized MFIs. This is already evident in how the industry grew in the new regulatory environment; the larger MFIs enjoyed most of the growth and received the most capital as confirmed by Figure 1[10].

This trend is likely to continue and the Indian banking institutions will favor MFIs with larger Balance Sheets, broader geographical diversification, more experienced management teams, and greater access to Equity capital. We would expect these banks to perceive larger MFIs with more geographical diversification to be "less risky" and "better managed" and thus to provide more capital to these institutions at lower rates of interest and for longer terms than to the smaller MFIs. Under these circumstances, the smaller institutions will feel considerable pressure to look for opportunities to achieve larger scale making them perfect candidates for consolidation.

The AP crisis also highlighted the risks of MFI over-reliance on a single source of on-lending funds. Prior to the crisis, Indian commercial banks accounted for more than 70 percent of on-lending funds[11]. When this funding was withdrawn due to the regulatory uncertainty following the events in AP, many MFIs were left without funding for their operations. As a result, the largest MFIs began tapping into alternate sources of borrowings such as securitization of assets. During FY 2011-2012, 20 MFIs securitized or sold approximately USD 600 Million of microcredit loans, which represents a 100 percent increase from the FY 2010-11[12]. The ability of MFIs to access these alternative sources

[9] NABARD Estimates.
[10] The MIX Market.
[11] M-CRIL Microfinance Review 2011
[12] MFIN MicroMeter, Inaugural issue, July 2012.

of on-lending funds is clearly enhanced by greater MFI size and scale and thus provides another competitive advantage and cheaper source of funding for larger MFIs.

Equity Investors are also likely to prefer investments in larger MFIs going forward. With growth and profitability constrained for many MFIs due to the regulatory framework and limited access to Debt financing, as set forth above, many providers of Equity will focus only on those MFIs with broad and diverse geographical presence, experienced management teams that can scale and leverage operations, and regular access to a variety of sources of Debt funding. Equity Investors will conclude that these larger institutions have greater prospects for growth and profitability and thus for providing successful "exit" opportunities in the future. This Investor perspective will further disadvantage smaller and medium-sized MFIs as their ability to raise needed Equity capital is likely to be seriously curtailed in the new market environment.

Providing "Exit" and New Investment Opportunities for Investors

The IntelleCash/Arohan combination involved an innovative series of back-to-back transactions in IntelleCash and Arohan that totaled more than USD 10 million. These transactions were facilitated by AavishkaarGoodwell II, an investment fund that has a continuing strategy focused on achieving consolidation in the microfinance industry.

Aavishkaar put fresh funds into the transaction through both IntelleCash and Arohan, and existing Arohan investors India Financial Inclusion Fund and Michael & Susan Dell Foundation made additional investments in Arohan. Thus, the consolidation of IntelleCash and Arohan restructured and strengthened the Equity base and ownership of both IntelleCash and Arohan and will allow the combined entity to expand its retail presence across Bihar, West Bengal and other Low Income States. At the same time, the transaction generated significant value for all stakeholders involved.

As the pressures toward operating efficiency and the benefits of scale intensify for MFIs in the coming years, we expect that many Investors will drive and participate in a consolidation process along the lines that the IntelleCash/Arohan transaction exemplifies. This type of transaction can provide existing MFI Investors with the opportunity to continue their participation in the microfinance industry as it matures and continues to reach out to the more than 400 million people in India who are excluded from the financial services markets. In other types of transactions, complete or partial "exits" can be provided for Investors who might be otherwise locked into MFI investments that cannot grow and thrive in the new regulatory environment. Because we continue to believe that the financial services market for poor and low-income people is extremely large and still growing, we expect that many Investors will look for opportunities to invest new funds in the larger, more efficient, and more profitable MFIs that will be created as the drive toward consolidation moves ahead.

Better Serving Clients and Expanding Opportunities for Promoters

Most consolidation transactions are driven fundamentally by the recognition that the resulting entity will be better able to serve its existing clients and to reach out to new clients. The strengthened and larger organization should be able to provide more and better products and services cheaper, and to utilize new technologies more fully, than the smaller organizations that functioned previously. In addition, with a stronger Equity base and better ability to attract Debt financing, the new entity should be able to attract better management and assure more robust future growth and profitability.

For many Promoters, these new opportunities can be challenging and exciting. They allow the Promoters to become part of a large organization and to build a larger, more successful business that serves a broader client population, often with more products and services. In addition, many Promoters will have the opportunity to exchange their ownership position in the MFI they founded for a new ownership stake in the combined entity or to obtain new Equity and ownership as they work for the new organization. Thus, many Promoters are expected to be active participants in and drivers of the consolidation trend as they recognize and begin to promote the significant advantages that consolidation can bring to their clients and to themselves.

It is also worthy to note that there are multiple developments taking place in the technology and financial inclusion landscape in India. This includes widespread use of mobile telephony, money transfers, mobile wallets, the government driven Unique Identity (UID) Project, and biometric cards for bank accounts, among others. Adoption and use of these solutions could transform the manner in which MFIs are able to reach and service clients in future, resulting in significant productivity and cost gains over time. These technological innovations, however, require significant investments and the larger an MFI, the better placed it will be to invest in and leverage these opportunities. We expect that both Promoters and Investors will recognize the significant potential of these innovations and that they will together seek out opportunities for introducing and rolling out these products and services over larger client populations, thereby adding an additional impetus to the consolidation trend.

Conclusion

We believe the IntelleCash/Arohan combination signals a clear trend toward consolidation in the microfinance industry in India. As the industry slowly recovers and grows post the AP crisis, the new regulatory environment and the need for MFIs to be larger and more efficient will be primary drivers of this consolidation trend. We also believe that larger, stronger MFIs will serve their clients better while also creating lasting value for Investors and Promoters.

Photo Credit: Mohammad Raqibul Hasan, "Unity", Microfinance Insights