Feature Articles

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Indian MFIs: Growth for Old and New Institutions Alike

Devyani Parameshwar, Neha Aggarwal, Roberto Zanchi, Sagar Siva Shankar

Introduction

The **Inverting the Pyramid** series was launched by Intellecap in 2007 as an attempt to capture the growth of the microfinance industry in India on an annual basis and track the efforts made, success achieved and challenges that remain. Every year, it maps the microfinance landscape in India, identifies key highlights of the year, explores strides made in addressing the huge demand-supply gap that exists and analyzes the performance of MFIs. Further, it identifies key drivers for future growth and sustainability of this industry, its capital needs and its risks and priorities in the short to medium term.

The third edition, **Indian Microfinance: Coming of Age** finds India at the center of global attention, the most closely watched microfinance market in the world. While its large unbanked population is a significant contributor to this attention, its fast growth, high investor interest, planned IPOs and continued strong operational and financial performance have also piqued the interest of investors, thought leaders, media and the public alike.

This MicroBanking Bulletin issue includes the third chapter of Intellecap's publication, entitled **Indian MFIs: Growth for Old and New Institutions Alike**. This chapter captures an Indian microfinance market whose structure and dynamics are vastly different from what they were two years ago. The industry emerged from the financial crisis more consolidated - the market that was made of numerous, small and medium sized, non-profit players gave way to one dominated by fewer large commercial players that are successfully attracting equity and debt capital, human resources and clients at a fast rate.

The traditional tier classification of MFIs based on their portfolio size fails to capture the emerging dynamics and activity in the market, which led Intellecap researchers to create an alternate classification that accounts for growth rates. Using this method, the authors identify three major classes of MFIs: the *Leaders*, the *Moderates* and the *Young Turks*. In chapter three, the growth and performance of each of these segments is examined in greater detail. Towards this, Intellecap uses financial and operational data of a sample of 29 MFIs in the country that constitute 80% of the market by portfolio outstanding.

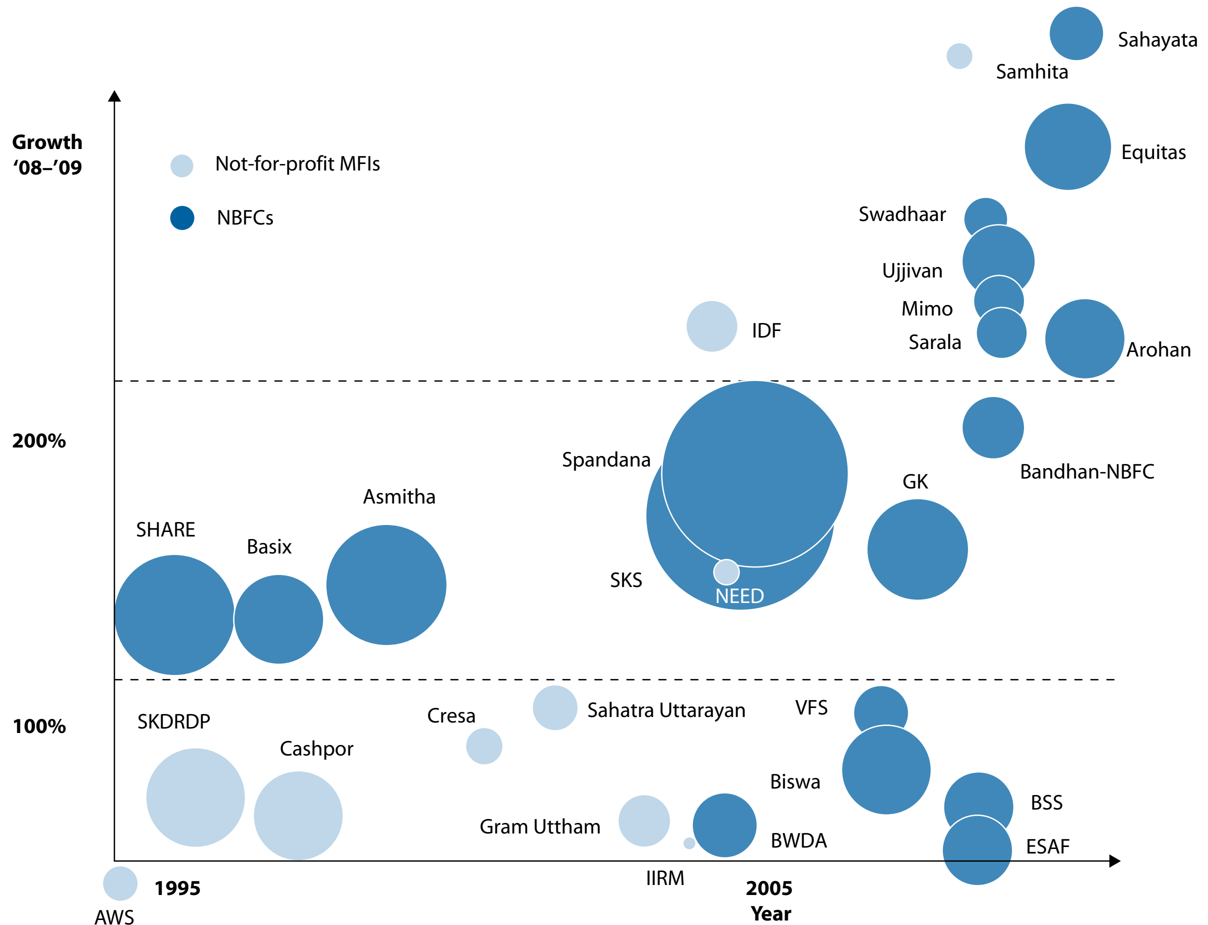
(Refer to Page 7 for a full list of abbreviations to be used in this article)

Dramatic Industry Evolution

Over the last two years the organization and dynamics of Indian microfinance has evolved. The industry emerged from the financial crisis more consolidated; the market that was made-up of numerous, small and medium sized, non-profit players gave way to one dominated by fewer large commercial players that are successfully attracting equity and debt capital, human resources and clients at a fast rate. New age MFIs, with professional management teams and aggressive growth plans, are also managing to attract equity and debt, and successfully weather the crisis. In sharp contrast, some of the older and smaller players, many of which failed to attract equity or transform legal structures before the crisis, are shrinking or slowing their growth, sometimes losing human resources and clients to the bigger players. The NBFCs have grown to capture 81% of the market, attracting unprecedented investor interest and media attention and have created a self-regulatory body, MFIN.

In the new market scenario, for-profit MFIs can be categorized into three groups based on their portfolio growth rate, organizational age and portfolio size: *Leaders*, *Moderates* and *Young Turks*. While the aggregate portfolio of the industry has grown by ~103% since 2008, the growth in portfolios of individual MFIs has been variable. The *Leaders* grew between one and two times the industry average, the *Moderates* grew at a rate below the industry average and the *Young Turks* grew more than twice the rate of the industry.

Figure 1: Sample MFIs by Growth Rates, Age & Portfolio Size



Note: The size of the circle denotes GLP (figure not to scale)

MFI Class	Description
Leaders	This group includes SKS, Spandana, SHARE, Bandhan, Asmitha, BASIX and Grameen Koota - the largest NBFC MFIs in the country, together managing 65% of the industry portfolio. SKS is the largest and fastest growing MFI, Spandana enjoys high efficiency and robust bottom-lines, SHARE was the first MFI to acquire an NBFC license, Bandhan has demonstrated scale despite having had a non-profit structure for a long period, Asmitha is the youngest of the Leaders, BASIX is the first MFI to start as a NBFC and provide integrated livelihood support services to its clients and Grameen Koota has emerged as a strong regional player.
Moderates	This group includes MFIs that have transformed from non-profits to NBFCs and have demonstrated moderate growth. MFIs such as BISWA, BSS, BWDA, ESAF and VFS are part of this group. Many of these MFIs started as NGOs and maintained their non-profit legal status for a longer time than the Leaders, but eventually transformed into NBFCs in order to ensure sustainability, wider access to funds and achieve greater outreach.
Young Turks	These are high growth young MFIs promoted by teams with prior experience in banking, financial services or microfinance. This group includes MFIs such as Arohan, Equitas, Mimo, Sahayata, Sarala, Swadhaar and Ujjivan. Many of these institutions started their operations in unexplored or underserved geographies (refer Figure 3 in Chapter one), are backed by strong senior management and governance and are highly capitalized. These MFIs have demonstrated the robustness of their business model within two to three years of starting operations, and their growth rates have outpaced those of the Leaders primarily because of their small size, although Ujjivan and Equitas have managed to attain a significant size in a short span of time.

The following analysis utilizes data for the 19 NBFC MFIs in the Intellecap sample.

On average, the portfolio of the *Young Turks* has grown three to five times between 2008 and 2009, with Equitas and Sahayata showing extremely high portfolio growth of 13x and 16x respectively. The *Leaders* have also exhibited consistent performance, averaging 122% growth, with Bandhan-NBFC showing the highest growth at 183%, followed by Spandana at 156%. Growth rates of the *Moderates* have been lower with a 37% average growth, and only VFS showing close to 100%.

Leaders and Young Turks Attract Investors

Since 2007, when equity investments in the sector took off, investors have consistently shown a preference for MFIs that have high growth potential. Thus, the *Leaders* and the *Young Turks* dominate investor pipelines.

Infusion of equity has fuelled the growth of the *Young Turks*, which have grown 416% and 627% year on year in 2008 and 2009 respectively. While the GLP of the *Leaders* is 14.7 times that of the *Young Turks*, their equity base in merely 5 times that of the *Young Turks*, indicating that the *Young Turks* have been able to instil investor confidence and attract equity early in their life cycle. These MFIs also dominated the scene with highest number of equity investments, seven in FY 2009 absorbing INR 233 crores (USD 50.6 mn). While the *Moderates* also received six equity investments,[58] the amount was much lower at INR 137 crores (USD 29.8 mn). SKS Microfinance alone raised INR 366 crores (USD 79.6 mn) pushing the total of *Leaders* to three equity investments totaling INR 441 crores (USD 95.8 mn).

Decrease in Spread; MFIs Bear Rise in Financial Costs

The media has been critical of the microfinance industry in India recently: The Wall Street Journal,[59] The Economist and The Economic Times have questioned the industry for its high interest rates, accumulation of profits, and contribution to the over-indebtedness of clients.

Intellecap's analysis shows that these critiques are not entirely sound. While the incomes of MFIs have increased, the growth in income is not proportional to the rising the cost of debt, indicating that MFIs are absorbing part of the rising costs. The yield for all MFIs in the sample is 29% for 2009, up from 21.5% in 2007.[60] Some of the drivers that allow for greater yields are:

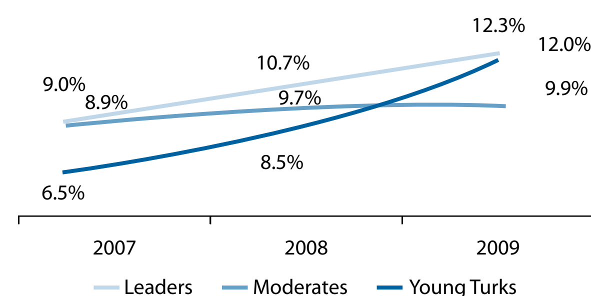
1. Increasing non-interest income through fees and other credit-related activities such as selling of insurance, remittance services and livelihood promotion activities

2. Recognizing premiums upfront for portfolio-buyout transactions[61]

3. Levying higher interest rates in new geographies, while remaining competitive in mature markets

The cost of borrowing[62] for MFIs has been consistently growing, with a marked increase in 2009 because of the global economic slowdown and the liquidity crisis (see Figure 2). The average cost of borrowings for the sample has grown to 12.1% from 10.5% in 2008, an increase of 15%.

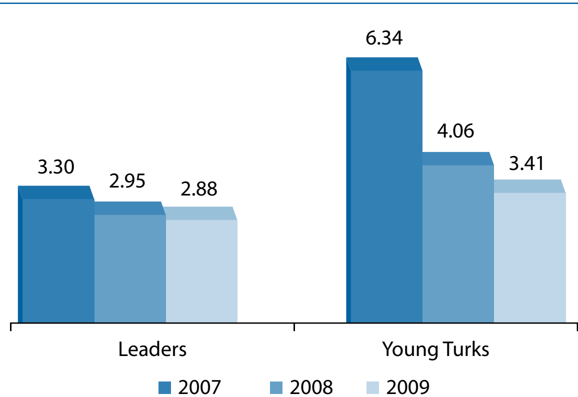
Figure 2: Cost of Borrowing



Until October 2008, both the repo rate[63] and the reverse repo rate[64] were kept high in order to combat inflation, amplifying the liquidity pressure on banks which increased their lending rates to MFIs. Although the poor's demand for credit is fairly elastic, MFIs did not pass the entire increase in the cost of borrowing to their clients. This finding has been validated through interviews with promoters and management of MFIs. With the easing of monetary policy towards the end of 2008, there has been an easing of liquidity pressure too, through a gradual reduction in the cost of debt for Indian MFIs.

Figure 3 shows the ratio of total income of an MFI to financial expenses, which appears to be declining for both *Leaders* and the *Young Turks*. The *Leaders* absorb some part of the increase in financial expenses and do not pass the entire cost to the clients. Although the *Young Turks* are still showing a high ratio, it is

Figure 3: Ratio of Total Income to Financial Expense



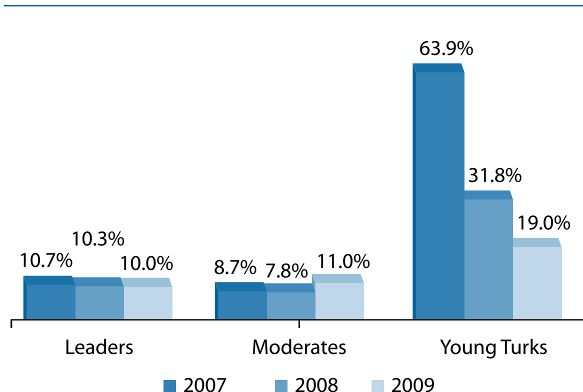
comparable to that of the *Leaders* in 2007. It is thus expected that the *Young Turks* too will follow a declining trend.

Leaders Raise the Bar for Operating Efficiency

The *Leaders* are stable in their Operating Expense Ratio (OER), achieving only minor improvements over three years (see Figure 4). However, based on each MFI's operating model, region of operations and strategy there are variations within the group–Spandana is the most efficient with an OER of 6%, while BASIX and SKS have very high OERs at 16% and 13% respectively. Factors affecting operating costs of an MFI include:

1. Expansion strategy: Aggressively investing in expansion to new geographies versus deepening engagement with existing clients and in older geographies

Figure 4: Operating Expense as a % of Average GLP



2. Transaction model: Reducing the time spent in conducting group meetings, increasing the group size and maintaining higher borrower to client ratios contribute to increasing the staff's payload

3. Urban-Rural composition: Running operations in urban areas leads to a higher OER, owing to higher salary and rent costs

4. Investments in infrastructure: higher recurring expenditure on technology has an impact on the cost structure

The *Young Turks* show very high OERs initially owing to heavy investments to fuel their growth, but rapidly fall as these institutions grow. The *Leaders* have been able to reduce their costs by taking advantage of economies of scale. New MFIs typically take 4–5 months or longer to operate at capacity.

It is also worth noting that reduction in OER is primarily driven by reductions in non-personnel expenses. For all NBFCs in the sample, the personnel expense ratio has increased from 6.1% in 2007 to 6.7% in 2009; the non-personnel related operating expenses have reduced from 4.7% in 2007 to 3.8% in 2009.

Improved Productivity Drives Operating Efficiency

Greater efficiency also results from improved staff productivity in terms of both volume and value. The *Young Turks* have shown a marked improvement of 115% over two years in their borrowers per personnel (management and field staff) ratio, which now stands at 246, better than the *Moderates* at 167 but still lower than the *Leaders* at 304. The loan officer to client ratio in the industry is significantly higher.

Equitas, the current market leader in staff productivity has 484 borrowers per staff member. This is because of its innovations in the operating model, based on standardising and differentiating roles of loan disbursement and loan collection, thus allowing field staff to handle the higher workload. The *Leaders* are above the 300 mark with the exception of SKS and BASIX. SKS maintains higher head office staff and technology costs by design to manage their ambitious expansion. BASIX staff members have a higher workload given their non-traditional model which includes multiple credit plus offerings and door to door collections.

Figure 5: Average Loan Outstanding

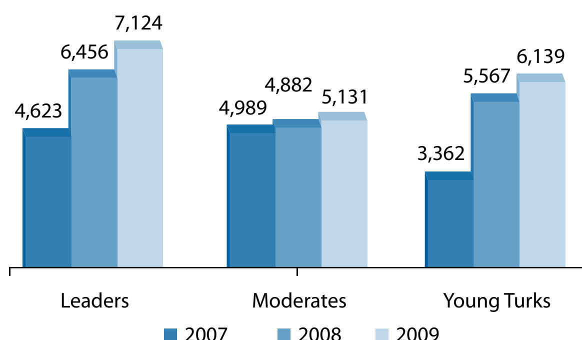
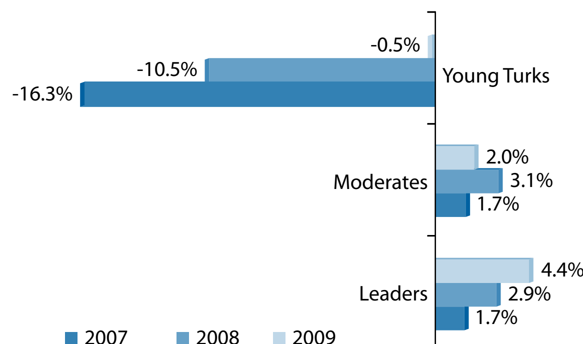


Figure 6: Return on Assets



The portfolio managed per staff also increased by 93% since 2008 for the *Young Turks*, reaching INR 15.1 lakhs (USD 32,843) while for the *Leaders* it is INR 21.6 lakhs (USD 47,006). This improvement is a combined effect of the improvement in personnel productivity and higher average loan outstanding per borrower, as shown in Figure 5. *Moderates* too have shown an improvement, with GLP per staff increasing by 24% from 2008 to 2009 standing at 7.4 lakhs (USD 16,043).

The factors contributing to the increase in loan sizes are:

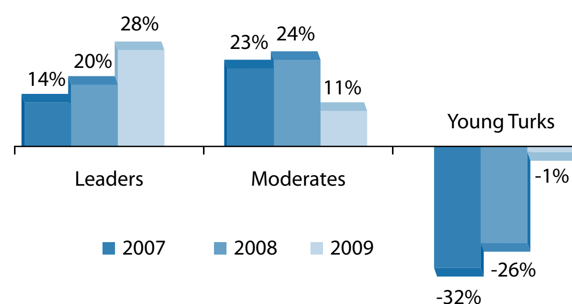
1. Graduation of clients in mature markets to higher loan sizes
2. Increased focus of MFIs on urban clients with higher credit needs than rural clients
3. Introduction of individual lending
4. Increased ticket size for the first loan to new customers by some MFIs

Increasing Profitability

As shown in Figure 6, the *Leaders* exhibit a consistently rising Return on Assets (ROA) - 4.4% in 2009. The Young Turks on the other hand, while showing explosive growth rates, have not all achieved break-even, as they are heavily investing in their expansion.

A similar trend is observed in Return on Equity (RoE) where the *Leaders* and *Young Turks* are continuously improving their performance. The *Moderates* have shown a decline mainly because many were undergoing transformation in 2007 and 2008, while in 2009, as NBFCs, their equity base is higher than their previous donor capital base.

Figure 7: Return on Equity



The rising profitability of the *Leaders* is driven by their ability to take advantage of economies of scale, as they are able to better leverage their initial investments. These MFIs are also successfully supplementing their interest income with fee based revenue through insurance, managing portfolios, and other product sales. The *Young Turks* and *Moderates* are expected to follow the same path in the coming years.

Deleveraging Balance Sheets

While there has been a general fall in debt-equity ratios across all MFIs, it has been most pronounced among the Moderates because of their transformation from unregulated not-for-profit entities to NBFCs with minimum capital adequacy requirements (CAR). The Young Turks are the least leveraged MFIs, with Ujjivan and Sahayata at less than 1x. These MFIs have large equity bases which allow them to be less dependent on commercial debt which is difficult to access for early stage MFIs. The next step for these MFIs is to start leveraging their equity, which should not be difficult given that they now have a proven record and seasoned portfolios.

The debt-equity ratio in the industry is expected to stabilize at between 4x and 5x, given the more stringent capital adequacy norms that will require NBFCs to maintain a 15% CAR starting in 2012. Most NBFCs are already working toward complying with this stricter requirement, which explains their reducing debt-equity ratios.

Portfolio Quality: Deterioration in Pockets, Healthy Overall

While global PAR > 30 deteriorated from a median of 2.2% to 4.7% during the first five months of 2009,[65] the average PAR > 30 for Indian MFIs stood at <1% in 2009. The Young Turks exhibit the best performance at 0.72%, down from 1.32% in 2008. While there have been instances of increases in PAR in Kolar, Lucknow, Mysore and Tumkur districts, the industry as a whole exhibits a healthy portfolio.

NBFCs Exhibit Higher Costs and Profitability, Lower Leverage

A performance comparison of NBFC MFIs is presented against the not-for-profit (NFP) MFIs Table 1.

Table 1 Key Financial Metrics for FY 2009 by Legal Structure

	NBFCs	NFPs
Total Yield	29.0%	18.6%
Operating Expense/GLP	10.5%	7.0%
Cost of borrowing	11.9%	9.8%
Funding Expense Ratio	9.98%	10.37%
PBT margin	24.2%	4.1%
RoA	4.0%	0.6%
RoE	23.0%	17.0%
Debt: equity	4.10	20.62

The yield for NBFCs is very high compared to NFPs. However, higher yield cannot be attributed to higher interest rates. NBFCs have increased their revenue through fee-based income. The cost of borrowing is also low for NFPs due to their access to concessional debt and savings as debt, both of which also allow for higher leverage.

Table 2 shows increase in interest yield of some NGO-MFIs over last three years-

Table 2 Yield of Select NGO-MFIs

NGO-MFI	2007	2008	2009
Cashpor	14.3%	25.4%	23.3%
Gram Utthan	15.9%	16.3%	18.5%
IIRM	7.9%	13.9%	25.9%

Indian MFIs: Lowest Costs, Highest Returns

A comparison between the Indian microfinance industry and global markets shows that Indian MFIs have the lowest yields, lowest operating costs, and the highest return on assets. This comparison explains why Indian MFIs are increasingly becoming an attractive option for global investors. Higher operating efficiency allows Indian MFIs to charge amongst the lowest interest rates in the world, and still achieve high returns.

Conclusion

The chapter you have just read explores one aspect of Indian microfinance covered in Intellecap's 2009 report. **Indian Microfinance: Coming of Age** also includes sections about the following related topics: Exploring Pressing Issues in Indian Microfinance; Demand and Supply in the Microfinance Market of India; the Sector through and Investment Lens; the Global Economic Slowdown and Indian Microfinance Clients; and the Road Ahead. If you would like to read more about these topics, please click here to purchase the report.

Table 3 Global benchmarking[68]

Ratio[66]	Africa	MENA	ECA	LAC	Asia	India[67]
Total Yield	38%	31%	32%	47%	31%	28%
Operating Expense Ratio	45%	27%	19%	45%	23%	10%
Return on Assets	-3%	1%	-0.5%	0.5%	-1%	3.6%

List of Abbreviations

BC	Business Correspondent
BLP	Below Poverty Line
BISWA	Bharat Integrated Social Welfare Agency
BSFL	Bharatiya Samruddhi Financial Limited
BSS	Bharatha Swamukti Samsthe
BWDA	Bullock-Cart Workers Development Association
CAR	Capital Adequacy Ratio
CAGR	Compounded Annual Growth Rate
CGAP	Consultative Group to Assist the Poor
CP	Commercial Paper
CRR	Cash Reserve Ratio
DFI	Development Finance Institution
ECA	Eastern Europe and Central Asia
ECB	External Commercial Borrowing
ESAF	Evangelical Social Action Forum
FCRA	Foreign Contribution Regulation Act
FDI	Foreign Direct Investment
FMO	The Netherlands Development Finance Company
FWWB	Friends of Women's World Banking
FY	Financial Year
GDP	Gross Domestic Product
GLP	Gross Loan Portfolio
HNI	High Net-worth Individuals
INR	Indian National Rupee
IRDA	Insurance Regulation Development Authority
IPO	Initial Public Offering
KYC	Know Your Customer
LAC	Latin America and the Caribbean
MACS	Mutually Aided Cooperative Society
MENA	Middle East and North Africa
MFI	Microfinance Institution
MFIN	Microfinance Institutions Network
MIS	Management of Information System
MIV	Microfinance Investment Vehicles
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Financial Company
NCD	Non-Convertible Debentures
NFP	Not-for Profit
NGO	Non-Government Organization
NRIFS	National Rural Financial Inclusion System
OER	Operating Expense Ratio
PACS	Primary Agricultural Cooperative Societies
PAN	Permanent Account Number
PAR	Portfolio at Risk
PAT	Profit After Tax
P/BV	Price to Book Value
PCO	Public Call Office
PE	Private Equity
PLR	Prime Lending Rate
PSL	Priority Sector Lending
PTC	Pass Through Certificate
RBI	Reserve Bank of India
RMK	Rashtriya Mahila Kosh
ROA	Return on Assets
Roe	Return on equity
RRB	Regional Rural Banks
SBLP	Self Help Group-Bank Linkage Programme
SEBI	Securities and Exchange Board of India
SHG	Self Help Group
SLR	Statutory Liquidity Ratio
SSI	Small Scale Industry
SIDBI	Small Industries Development Bank of India
SIP	Systematic Investment Plan
SKS	Swayam Krishi Sangam
SPV	Special Purpose Vehicle
UID	Unique Identification
UP	Uttar Pradesh
USD	United States Dollar
VC	Venture Capitalists
VFS	Village Financial Services