IMAP | India

Emerging Trends In Indian Microfinance Sector

Transition to Small Finance Bank and opportunity for Banking Correspondents

2018

In this issue:

$19 bn

Microfinance Loan Book
(Dec 2017)

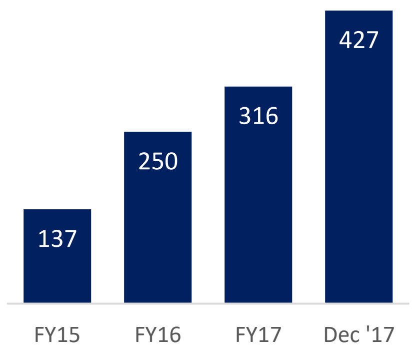
15%

Expected CAGR growth

24 mn

Client Outreach

MFI-NBFC Loan Book
(INR bn)



Source: Microscape & Micrometer

Introduction

Microfinance sector has its origins dating back to 1970s with the emergence of Self Help Groups (SHGs). Whilst Microfinance has taken giant leaps since then, a large portion of India's population still does not have access to formal credit / banking channels.

With Reserve Bank of India (RBI) recognising and addressing the needs of Microfinance Institutions (MFIs) by allowing differentiated financing models coupled with the significant under penetration of the market, the MFI sector has a long runway ahead.

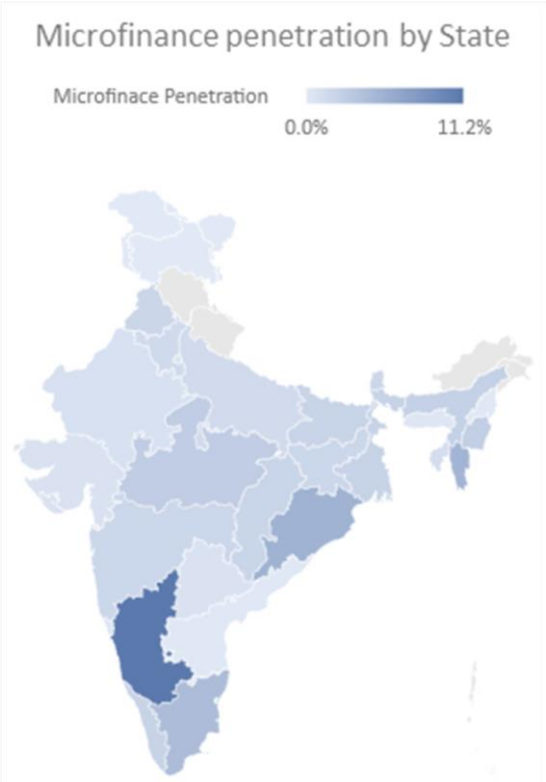
New models are emerging such as the Banking Correspondent (BC) which caters to the specific need of the segment and offer a win-win solution for all three stakeholders – borrower, lender and the regulator.

One of the fastest growing segments despite setback on Demonetisation

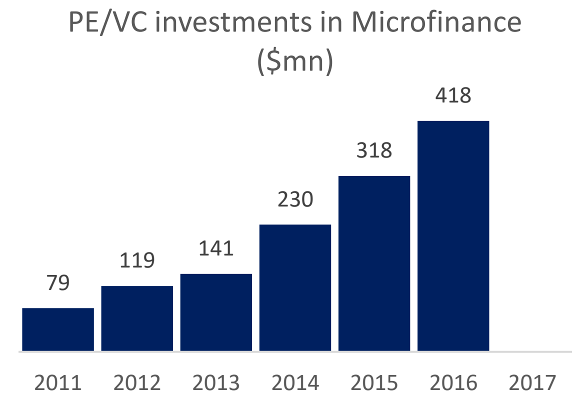
The Indian microfinance sector has moved into a high growth phase after recovering from the Andhra Pradesh crisis. The MFI-NBFC loan book has grown to INR 427 bn in December 2017, registering a CAGR of 35% from FY15.

During November 2016, the Indian Government announced Demonetisation of currency notes of INR 1,000 and INR 500 which had cranked up delinquencies, affected borrower behaviour and worsened asset quality. This was a major setback to MFIs and banks who curtailed disbursements. MFIs were quick to adapt and are increasingly resorting to cashless disbursements since demonetization. Further, digitization efforts on loan processing and back-end have started to bear fruits.

Since June 2017, the microfinance portfolios are now showing a distinct improvement and stability in asset quality and have shrugged off the impact of demonetisation. Collection efficiencies of over 99% for newer originations indicate improving market environment and better borrower discipline.



Source: Sa-dhan, Census of India 2011 & Catalyst
Note: Penetration = number of borrowers (client outreach) as a % of total population.



Source: Venture Intelligence

Concentrated in South

Out of the total client base of 29.5mn, Southern region alone contributes to 38% followed by 25% in East and 19% in Central region whereas West and North have 9% and 6% of total outreach respectively. Not only does South have higher penetration but higher ticket sizes as well.

Karnataka and Tamil Nadu have traditionally been the base of business for MFI post the AP crisis. In Western India, we see a lot of focus in Maharashtra which is the third largest market after the above-mentioned states.

In recent years, non-southern states have seen strong growth. UP which has the highest population from a state perspective is seeing a lot of interest in recent years. The number of borrowers has grown by ~30% CAGR since FY12 and similar growth rates are visible in Madhya Pradesh, Bihar and Gujarat.

Strong investor appetite

Investor appetite for both equity and debt capital market issuances of MFIs have remained strong. CRISIL estimates that MFIs have raised around INR 40 bn of equity and INR 70 bn of debt since demonetisation (Nov 2017).

Additionally, banks and refinance institutions also continue to extend funding to MFIs.

8

Microfinance Institutions
setting up Small Finance Bank

Disha Microfin
Equitas Holdings
ESAF Microfinance
Janalakshmi Financial Services
RGVN (NE) Microfinance
Suryoday Micro Finance
Ujjivan Financial Services
Utkarsh Microfinance

Top 10 MFIs of 2016		Loan Book (In INR crore)
Janalakshmi	●	10,983
SKS / Bharat Fin	■	7,682
Ujjivan	●	5,389
SKDRDP		4,994
Equitas	●	3,283
Satin Creditcare		3,271
Grameen Koota		2,539
Spandana Sphoorty		2,282
ESAF	●	1,925
Share Microfin		1,540
Total		**43,888**

Source: Sa-Dhan

● Transitioning to a SFB
■ Merging with a Bank

Small Finance Banks (SFB)

In late 2015, RBI granted "in-principle" approval to 10 entities for setting up small finance banks, of which 8 were MFIs, recognising the important role played by MFIs in financial inclusion.

The key benefit to these SFBs is the ability to accept deposits provided they maintain prudential norms and capital adequacy. They will play a key role in serving the under-served within the ambit of stable regulatory framework. Moreover, in due course, these applicants would be considered for universal banking license if they are successfully able to build a profitable business model and achieve the desired objectives.

Top 10 MFIs of 2016: Four have become SFBs and one has been acquired

Four of the Top 10 MFIs of 2016 have applied to the RBI to convert into a SFB. One of the Top 10 (Bharat Financial Inclusion) is in the process of being merged with IndusInd Bank. Together these contributed 67% of the total loan book of 2016.

The conversions to SFB have made way for smaller MFIs to capture the Top 10 space and the rate at which these smaller MFIs have been growing will propel them to soon become players of critical importance to the Microfinance ecosystem.

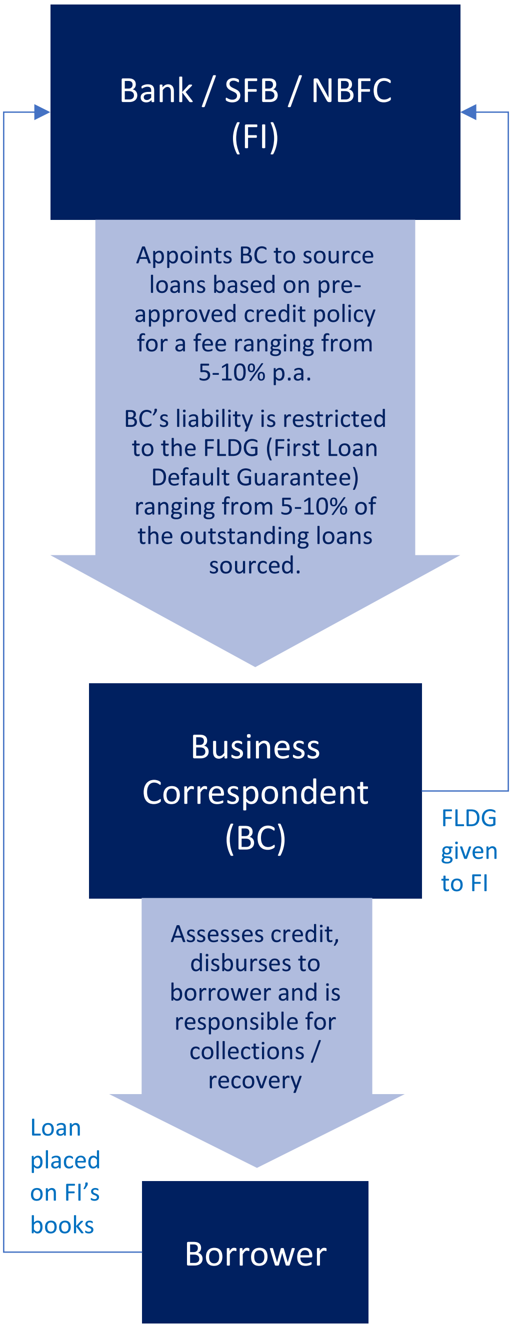
The other MFIs which have converted to SFBs in the recent years are FinCare, RGVN, Suryoday and Utkarsh. Bandhan has been granted a license to become scheduled commercial bank.

Focus of SFBs has moved to building the liability side

Prior conversion to SFBs, the MFIs were solely reliant on wholesale borrowings from other banks and financial institutions. They would now have to build the liability franchise: Current & Savings account and Term Deposits which are more granular and retail in nature and would require significant investments.

With limited management bandwidth and resources, the focus of SFBs has now moved to building the liability side and increase reliance on other channels to build the asset side of the business.

BC Model



Role of Business Correspondents

The RBI has allowed banks to appoint entities and individuals as agents for providing basic banking services in areas where they can't start a branch. These agents are called business correspondents ("BC").

BCs are considered as practical solutions to extend basic banking services to unbanked and under banked areas and are instrumental in facilitating financial inclusion. BCs can provide both asset side services (lending and collections) and liability side services (deposits).

Currently, BCs are not regulated by RBI but are in a way indirectly regulated as their activities in the books of FIs are subject to RBI audit.

Priority sector focus driving banks to lend through BCs

RBI has mandated banks to lend at least 40% of the total loan book to "Priority Sector" which includes of agriculture, micro small and medium enterprises (MSMEs) and economical weaker section.

The operating costs for banks and its employees are much higher to reach the priority sector. The current business model of banks is geared towards low-risk customers and higher ticket size and therefore there are only a very few private banks which are lending to the priority sector on their own. Most private banks either *buy out* priority sector loans from MFIs or are lending through BCs as it is a far more cost-effective manner to reach to the low-end customer segment.

SFBs to also rely on BCs for MFI / MSME lending

Cost of building a branch would have a negative impact on the banks' earnings during the initial years. To accelerate customer acquisition and retention strategies, select SFBs are rather resorting to BCs to acquire and retain customers as the operating costs are far lower than that of a branch model.

Most SFBs would look at a combination of physical branches as well as BCs to reach their customer segment.

BC can serve multiple FIs and multiple products.

Inter-operability of BCs and their Branches

Inter-operability of BCs and their branches (i.e. at the point of customer interface) is permitted, provided each product offered by a branch is exclusive to a financial institution ("FI" – a bank or an NBFC). This enables a BC to serve multiple FIs and multiple products.

For example, a BC can not only serve multiple FIs at the company level it can offer MFI loans for Bank A and MSME loan for NBFC B from the same branch. This leads to several synergies on credit assessment and recovery and is much more cost efficient for both the bank and the NBFC who have different focus segments. In the end the borrower is benefitted with better access to products and cheaper rates of funding.

150+
Rs. billion
Size of BC Market

20%
CAGR
Growth in BC Market

BC model is coming of age and is poised to clock over 20% CAGR over the next few years

The BC model evolved recently (c. FY12) and lacked pace initially. The sudden surge in lending through BCs is a phenomenon of the last 3-4 years where banks have started giving more limits to their existing partners after deriving comfort from initial years of successful partnership.

There is no formal data to track the amount lent through BCs as the same is not reported to either RBI / industry associations. As of December 2017, banks share in micro finance is c. INR 456 bn. This includes both direct lending as well as indirect lending through BC partnerships. Excluding direct lending by Bandhan, HDFC Bank, Axis and ICICI; and adding Reliance Capital's BC portfolio it can be estimated that the BC market size is c. INR 150 – 200bn.

With SFBs also joining the fray of relying more on BCs for microfinance loans the overall BC market can easily outpace the MFI growth and has a potential to grow at a CAGR of >20% over the next few years.

At IMAP, we believe that more and more banks will be reliant on BCs to meet their Priority Sector Loan targets and this would result in significant deal activity in the MFI / BC space in 2018 & 2019.

4. M&A and PE Transactions (2014-17)

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Year	Investor	Company	Deal type	Deal Details
2018	Creation Investments, Oikocredit and GAWA Capital	Fusion Microfinance	PE	Raised INR.. 80 crores
2017	CreditAccess Asia	Grameen Koota	M&A	99% stake acquired
2017	TPG	Janalakshmi Financial	PE	Raised INR. 1000 crores
2017	IndusInd Bank Ltd	Bharat Financial Inclusion Ltd	M&A	INR. 15000 crores
2017	AV Thomas Group	Madura Micro Finance Ltd	PE	
2017	Kedaara Capital and others	Spandana Sphoorty Financial Ltd	PE	Raised INR. 820 crores
2017	Centrum Group	FirstRand Bank's India microfinance business.	M&A	
2017	Inditrade Capital,	Varam Capital	M&A	80% stake
2017	Bamboo Capital	Annapurna Microfinance	PE	
2017	Maj Invest	Arohan Financial Services	PE	
2017	Muthoot Microfin	Muthoot Microfin	PE	
2017	TA Associates, True North, Tata Opportunities Fund and LeapFrog Investments	Fincare Business Services	PE	Raised INR. 500 crores
2017	responsAbility	Utkarsh Small Finance Bank	PE	
2016	IDFC Bank	ASA International India Microfinance	PE	IDFC acquired 10% stake
2016	DCB	Annapurna Microfinance	PE	5.81% equity acquired by DCB
2016	Kotak Mahindra Bank	BSS Microfinance	M&A	Acquired 99.5% of company
2016	IDFC Bank	Grama Vidiyal Microfinance		
2016	Creation Investments	Belstar Investment & Finance	M&A	Acquired 65%
2016	Gaja Capital, ASK Pravi, IDFC, HDFC Standard Life & others	Suryoday Microfinance Pvt. Ltd	PE	Raised INR. 225 croresores
2016	RBL	Swadhaar FinServe		
2016	IIFL	Samasta Microfinance Ltd	M&A	
2016	RBL Bank, SIDBI and other PE	Utkarsh Micro Finance Pvt.	PE	10% stake
2016	Equator Capital	Chaitanya Rural	PE	
2016	Morgan Stanley, TPG, GIC & others	Janalakshmi Financial Services Pvt. Ltd	PE	Raised INR. 1365crores
2015	Tano Capital	Arohan Financial Services	PE	
2015	CDC, CX partners, Newquest	Ujjivan	PE	
2015	SIDBI, IFC, GIC Pvt Ltd	Bandhan Financial Services Ltd	PE	Raised INR. 1100 crores
2014	Manappuram	Asirvad Microfinance	M&A	90% stake acquired

Year	Investor	Company	Deal type	Deal Details
2014	Morgan Stanley, Tata Capital, TPG	Janalakshmi	PE	
2014	IFC, FMO, CDC, DEG, IFIF, Creation	Equitas	PE	
2014	IFC, CDC, Aavishkar, Lok Capital, NMI	Utkarsh Micro Finance Pvt.	PE	
2014	OikoCredit, NMI, Dia Vikas Capital	RGVN	PE	
2014	Lok Capital, Creation	Equitas	PE	
2014	Incofin, Belgian Investment	Annapurna Microfinance	PE	
2014	Norwegian Microfinance Initiative	Satin	PE	
2014	Morgan Stanley, TPG and others	Janalakshmi Financial Services Pvt. Ltd	PE	Raised INR. 490 crores

Source: Multiple Industry News

191

Deals closed in 2017

$12+ bn

Transaction value of deals closed in 2017

36%

Cross border transactions share in 2017

About IMAP

IMAP is a global network of investment banking firms with presence in 35 countries. IMAP closed over 2100 transactions valued at $90+bn in last 10 years. IMAP is ranked 7th in the world in the mid-market segment by Thomson Reuters and has executed 191 transactions worth US$12 billion in 2017. IMAP has 48 offices in more than 35 countries, > 400 M&A professionals. IMAP India is exclusive India partner of IMAP.

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