



Looking ahead: Microfinance borrowers meet at Domakonda village in Andhra Pradesh. The state government, through an ordinance in October, sparked off a crisis in the microfinance industry, and now that the ordinance is a Bill, MFIs have to start focusing on multi-faceted reforms.

POTENTIAL FOR GROWTH

Microfinance in India: An opportunity in crisis

In an economy that hasn't yet been able to ensure financial inclusion, the role of MFIs can't be ignored

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The microfinance and software industries in India are similar in many ways—both are hyper-growth industries, large scale employers, proven to have sound business models, were insufficiently regulated in their early years, face significant challenges in sourcing and retaining trained human capital but have immense potential for growth.

In several ways, they also have starkly contrasting features—software is significantly reliant on export, while microfinance is purely domestic;

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software is not capital intensive and operates on low financial leverage, while microfinance is capital intensive and operates on higher financial leverage; software requires highly educated people who are paid handsomely, while microfinance requires people with more humble education who are paid far lesser; and software has deeper and broader management teams and more intricately laid-out processes, while microfinance has recently commenced moving in that direction.

The most interesting aspect from an investment viewpoint is the frenzied appetite of both public and private markets for software companies in the early stages of the industry. In the late 1990s, valuations of information technology (IT) com-

panies were at an all time high and a rush of initial public offers (IPOs) that hit the market. This was followed by the dot-com bubble bursting; unbridled euphoria gave way to saner valuations, stricter due diligence, emphasis on soundness of business; the entry of professional management into entrepreneur-led firms, and a wave of consolidation.

We expect the situation to not be very different for microfinance institutions (MFIs). The Andhra Pradesh government's ordinance in October sparked off a crisis in the industry and history could well recognize this as the turning point. Now that it is a Bill—the legislation retains its spirit and places harsh curbs on the functioning of microfinance companies, effectively rendering the business unprofitable if it doesn't change—microfinance companies have to start focusing on multi-faceted re-

forms.

These include measures to curb multiple loans to the same individual or group, assessment of a borrower's repayment capacity, transparency, effective but fair recovery techniques, increased automation and the creation of a multi-product strategy that goes beyond plain-vanilla group credit.

All stakeholders in the microfinance ecosystem, including regulators and politicians, need to actively participate so as to significantly further financial inclusion efforts. Charles Darwin's theory on evolution and survival of the fittest will catalyze a shake-out, which will lead to higher entry barriers and a gradual disappearance of the "long tail".

The BCG growth-share matrix is a widely used management tool that maps each product within a firm into one

of four options (question mark, star, cash cow or dog) and helps decide where to focus organizational resources at a strategic level, by assessing the profitability, cash flows, growth potential and present life cycle stage of each product. This framework is highly relevant for the microfinance industry.

"Cash cow" products have a high market share in a slow-growing industry. These typically generate significantly positive cash and are "milked" continuously with as little investment as possible, since such investment would be wasted in an industry with low growth. "Star" products have a high market share in a fast-growing industry, which will gradually become "cash cows" as the industry matures and the growth tapers off. Sustaining the market leadership of a "star" may require extra cash, but this is an investment for the future. "Question mark" products grow rapidly and thus consume large amounts of cash, but because they have low market shares, they do not generate much cash, resulting in significant net cash consumption. A "question mark" has the potential to gain mar-

ket share and become a "star", and eventually a "cash cow" when the market growth slows. If the "question mark" does not succeed in becoming the market leader, then after perhaps years of cash consumption it will degenerate into a "dog", when the market growth declines.

Post the microfinance crisis, the group credit product of larger MFIs will be seen as a "star" moving on to become a "cash cow" in a few years, albeit, with room for present growth. The internal accruals from this flagship product will finance experimentation with newer "question mark" products (micro-savings, micro-pensions, loans to small enterprises, asset-backed individual loans, remittances, etc.). This will lead to the discovery of technology-supported innovative ways to scale up "question mark" products to "star" products, so that they can become the next wave of potential "cash cow" products of the future.

With the Malegam committee expected to submit its report on microfinance shortly, there will soon be clarity on

regulation and stricter rules for ensuring implementation of good corporate governance, sound business practices and transparency. Currently, investor interest is at a low and we believe that the time is ripe to bet on the microfinance sector. In order to quickly capitalize on the attractive valuations available, the investor community needs to focus on identifying the right businesses, which can leverage the network of client relationships that they have built and which will withstand this shake-out. Currently, microfinance firms are willing to entertain a range of strategic options including M&A and stake sales. They were not willing to consider this prior to the crisis and may not be willing to consider it in the future when normalcy returns. Once the situation stabilizes and the microfinance industry emerges stronger, there will be a strong and sustained growth phase, very much akin to the software industry. The vast untapped demand for multi-product services of microfinance companies reflects that maturity of the sector is still some time away.

The prophets of doomsday

Stakeholders in the microfinance ecosystem need to actively participate to further financial inclusion efforts

might continue to paint a bleak picture of the future of microfinance just like they had for the software sector after the dotcom bubble burst. Yet, the fact is that as a country, we have 15,000 people

for every scheduled commercial bank branch in the country as compared with one-tenth that figure for a developed economy such as France. To exacerbate the problem, the share of rural branches is consistently diminishing, thus expanding the urban-rural divide—only 5% of around 600,000 habitations in the country have access to a commercial bank branch. In an emerging economy which is growing at around 9%, and where the entire financial system has not been able to adequately address financial inclusion 63 years after independence, the importance and role of microfinance cannot be wished away.

You can love it or hate it, but you cannot ignore microfinance.

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