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The Art of the Responsible Exit in Microfinance Equity Sales

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As the microfinance industry matures, a question that has come into sharper focus is how social investors committed to advancing responsible finance practices should "exit responsibly" from the microfinance institutions (MFIs) in which they have invested over the years. As they prepare to sell their stakes, what options do development-minded investors have to help ensure responsible behavior by their partner MFI into the future and healthy development of the broader market?

In this paper the Center for Financial Inclusion at Accion (CFI) and the Consultative Group to Assist the Poor (CGAP) seek to spark discussion among the stakeholders working to advance financial inclusion and in particular the investor community that will result in greater clarity around the goal of responsible exits and the policies and practices that would support it.

Acknowledgments

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SECTION 1

Introduction

Equity as a funding instrument is particularly important to responsible development of financial markets. At its core, it supports the growth and diversification of microfinance institutions (MFIs) and other financial institutions that serve the poor, and it is especially vital to the expansion of deposit services.

But beyond that, equity holdings can add value when paired with active governance.[1] First, they offer development-minded shareholders the opportunity to provide leadership to partner MFIs, including guidance to ensure that the overall strategy and specific products and practices are responsible. Second, they can promote responsible development of the broader market to the extent that they demonstrate the viability of responsible MFI business models (including by sharing relevant information on partner MFIs' performance with other market actors) and crowd in additional investors with goals and funding types that are appropriate for microfinance. This point is especially important for development finance institutions (DFIs), which are owned by donor governments and thus are mandated to be catalytic and "additional" in promoting private sector development.

Most microfinance investment intermediaries (MIIs) and DFIs have committed explicitly to do right by clients through industry initiatives such as the Smart Campaign and the Principles for Investors in Inclusive Finance (PIIF), which urge and support them to choose partners carefully and integrate specific responsible finance practices throughout their investment processes.

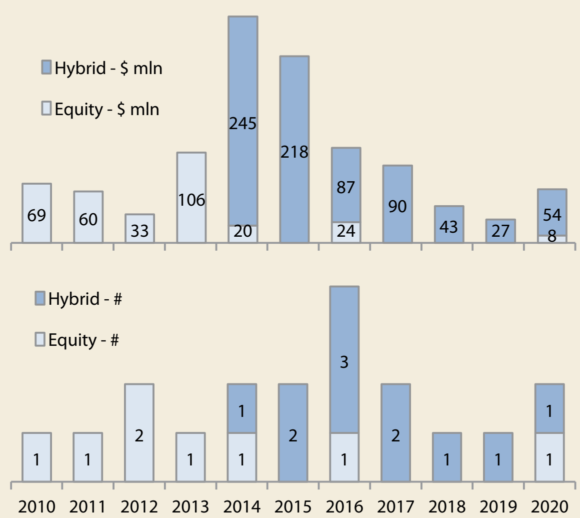
As the holdings of MIIs and DFIs mature, the sale of equity stakes is becoming an increasingly important task and one that requires consideration of additional dimensions of responsible finance and responsible market development. When investors that seek to be socially responsible exit, they face the challenge that they will give up their right to help oversee or govern the investee. To what extent can—or should—investors seek to ensure that the sale of their stakes in MFIs will result in ongoing responsible behavior by their (former) partners and new owners and even contribute to healthy development of the overall market? And what if they reinvest the proceeds from a sale into younger mission-focused institutions and underserved markets: is such an exit then automatically socially responsible?

Equity exits are not a new phenomenon in a sector where the first funds were created well over a decade ago and a number of sales have already happened (Glisovic, Gonzalez, Saltuk, and Rozeira de Mariz 2012). They are also expected to accelerate. According to MicroRate/Luminis, between 2014 and 2016, at least two equity and six hybrid funds worth nearly $600 million are scheduled to mature (Figure 1).

In this context, this paper seeks to explore the concept of a responsible exit along four strategic decisions: (*i*) the timing of the equity sale, (*ii*) buyer selection, (*iii*) the governance and use of shareholder agreements to achieve social objectives, and (*iv*) how social and financial returns are balanced when selecting among bids. We also examine how DFIs can use exits

FIGURE 1

Microfinance Fund Maturity Schedule



Source: MicroRate/Luminis

1. However, DFIs and MIIs do not always succeed in providing active governance support to partner MFIs. McKee (2012) and recent studies from CFI on governance and investor and board behavior during sectoral crises document that equity investors often fail to provide adequate guidance and expertise in the board room and other governance processes.

to encourage responsible market development given their particular role as publicly funded entities. We interviewed more than 40 representatives from MIIs, nongovernment organizations (NGOs), DFIs, MFIs, and merger-and-acquisition (M&A) specialists to capture their experience, perspectives, and emerging lessons on equity sale transactions. In addition, we conducted six case studies of equity exits, which are described in detail in the appendices.

This paper is not intended to be prescriptive. The practice of selling equity in MFIs is still evolving, and the complexities of the transactions make each sale unique. Rather than setting out specific guidelines, we hope to draw on investor experiences to highlight key exit-related decisions for MIIs and DFIs, and in so doing, we hope to spur a focused debate on how to exit in such a way that the interests of investors, MFIs, and their clients are balanced.

BOX 1

Key Findings

Exits of equity investments are still relatively recent but lessons on how to ensure ongoing responsible behavior by partners and the broader market are emerging. There are several overarching themes that affect the options that investors are likely to face: market context and stage of development; share of ownership being sold; and the MFI's ownership structure, governance arrangements, and place in its life cycle. As a result, there is no single approach to ensure a responsible exit. However, investors need to carefully think about four main strategic decisions:

1. When? The desired timing and avenue of exit should form a key part of an investor's decision to invest. These plans and preferences should be discussed with the other equity investors and the MFI's management. That said, rarely did the exit opportunity materialize exactly as planned, and ability to adapt and respond flexibly was a feature in many exits. For fixed-term funds, exit timing is built into the prospectus, but at least one case study suggests that this structure may not be optimal for the specific role of anchor investor.

2. To Whom? There are advantages and disadvantages of selling to a microfinance investor versus an investor outside of the microfinance ecosystem. On the one hand, it is easier to find a like-minded buyer within the ecosystem, which can mitigate concerns about mission drift or reputation risk. On the other hand, for more mature MFIs, investors such as local or regional banks might be better placed to play a strategic role by bringing strong balance sheets, operational expertise, and local market linkages that the MFIs need to develop further. Exiting DFIs and MIIs can be guided by careful and deliberate due diligence to ascertain the buyer's intentions and commitment to the MFI's mission, combined with judgment about the kind of capital and expertise the MFI most needs in its next chapter.

3. How? In principle, putting provisions in shareholder agreements and setting up alternative mission-oriented governance structures could help enshrine the MFI's mission and social commitments to send an important signal to potential investors when current owners seek a buyer for their shares. We analyze several examples of this approach. It should be noted, however, that the legal enforceability of such provisions varies widely and their relevance may be limited when a controlling stake is being sold. The risk also exists that overly restrictive and complex legal provisions could pose unreasonable barriers to exit.

4. How Much? The selling party may have multiple offers to choose from, with each bidder offering a different mix of price and nonprice characteristics. Since cashing out nearly always entails giving up say over the investee's future social or developmental mission, we examined more specifically how investors described weighing price- versus mission-related features of the potential new owner. The findings suggest that many investors currently may be using a two-step process in which they first screen buyers for suitability (including mission fit) and then make their final selection based on the most attractive price. We also note that high-priced sales to new buyers in the microfinance sector may risk locking an MFI into a strategy that may harm both its clients and the broader market.

Finally, because of their specific mandate, DFIs have a special role to play in private-sector development. The way they exit—when, how, to whom, and for how much—can send important signals to other market players. By integrating a market development dimension into these four key decisions, DFIs have an opportunity to fulfill their mandate to play a broader catalytic role.

SECTION 2

Four Decisions

As noted in Box 1, there are four key questions equity investors have to wrestle with when trying to responsibly exit an MFI: (1) when to sell, (2) who to sell to, (3) with what conditions, and (4) at what price. Several overarching themes affect these decisions and the actual options that investors have: the context and stage of development of the market (e.g., less-developed markets tend to have more circumscribed exit opportunities); the size of the stake being sold ("anchor" investors face a different set of choices than investors selling noncontrolling stakes); and the MFI's stage in its own life cycle, ownership structure, and governance arrangements. The decision might also create tensions with other shareholders and/or the MFI management, making the selling process more complicated to manage. Ultimately, the final decision requires balancing among competing demands, demonstrating that exiting responsibly is an art of tradeoffs.

2.1 When?

Plan your exit before you enter. This phrase was repeated in so many interviews that it seems almost a mantra for equity investors. In fact, the exit plan can be an integral part of their decision to invest. Our findings suggest that a few investors are starting to integrate exit criteria into their pre-investment due diligence, including the possible exit strategies according to the stage of market development. Some investors also suggested discussing exit planning upfront with pre-existing shareholders, co-investors, and the MFI's management, and referencing the question of exits in the shareholders' agreement or the MFI's charter.

Upfront plans notwithstanding, exits rarely materialize exactly as planned—the ability to adapt and respond flexibly to unexpected circumstances is no less important. When the early stage investor Aavishkaar Goodwell invested in Equitas in India (Appendix B), the plan was to stay in for at least five years, during which Aavishkaar Goodwell expected to be actively involved in governance and provide technical support. However, within two years Equitas had grown so fast that it had far outstripped the needs of typical early stage MFIs. Aavishkaar Goodwell's stake had been diluted in the process, and it had to give up its board seat. Unable to put up additional capital and continue its influential advisory and governance roles, Aavishkaar Goodwell decided to sell half of its shares and worked with the MFI management to select the most appropriate buyer. Despite the unusual limitations attached to Equitas' stock, the investor had no difficulty in finding willing and suitable buyers. Indeed, the MFI's extraordinary growth as well as the excitement around the SKS initial public offering (IPO) created attractive conditions.[2] The fund was then able to redeploy its capital in younger markets and institutions where it expected to have a greater impact and better fulfill its double bottom line.

For fixed-term funds and their investees, the "when" question can be particularly challenging. For example, the Indian fixed-term fund Bellwether was an anchor investor in Arohan and had been instrumental in supporting this MFI in its early stages of growth (Appendix D). However, when Arohan was facing a severe liquidity shortage at the height of the Andhra Pradesh microcredit crisis, Bellwether was unable to provide the capital Arohan needed. With its equity already fully invested and the fund itself scheduled to mature soon, Bellwether had few options. Meanwhile, with Arohan struggling for survival and the sector in crisis, conditions for sale were exceptionally poor. Ultimately Bellwether found a willing buyer in Intellecash, but this was not the exit it had planned.

Bellwether's example highlights the important role of anchor investors and their investing strategies. Anchor investors generally hold a large (although not necessarily majority) stake that comes with a governance role that is often more active than that of other shareholders. Ideally, anchor investors should have sufficiently long investment horizons and deep enough pockets to be able to support their investees with additional capital when needed, while providing strategic guidance and necessary expertise on the board of directors. However, as Bellwether's case demonstrates, the fixed-term funds' timing limitations and limited capacity for later stage investment may result in negative consequences for both the investor and the MFI. Fixed-term funds can play an important role in bringing diversified capital into the sector, especially by crowding in local sources of funding, but their structures may not be best suited for the role of anchor investor.

2. On 28 July 2010 SKS, India's largest MFI, became the first Indian MFI to float its shares through an IPO.

For anchor investors, the stakes are higher in an exit, especially with respect to balancing social and financial returns. Consider the case of the sale of Edyficar in Peru by the large international NGO CARE International (Appendix E). CARE founded Edyficar as an NGO MFI in 1985 and, over the next quarter-century, supported its development, including transformation into a regulated, deposit-taking institution. However, following Edyficar's transformation, CARE was increasingly unable to provide the requisite technical expertise and governance support. Having recognized that it was becoming an impediment to Edyficar's development, CARE sought to sell its anchor shareholding position. Unlike Bellwether, it did not face any fixed exit horizons, yet CARE's decision to sell Edyficar was not easy, especially in light of the long and close history of the two institutions.

Edyficar's sale illustrates the critical role anchor investors play in MFI development. In the course of our research, we identified cases where the limited capacity of such anchor investors (including founding NGOs) to provide growth capital and technical expertise may have constrained the partner MFI's ability to diversify products and scale up. (In some cases, lack of access to growth equity may even force MFIs to finance growth with retained earnings, which in turn can create pressure to maintain higher profit margins including through higher prices for their clients.)

2.2 To Whom?

No other aspect of an equity sale looms quite as large as the selection of the buyer. The decision consists of two key issues: first, ascertaining to what extent the buyer is a like-minded investor that shares a commitment to the MFI's stated mission and can be trusted to "stay the course" over time; and second, whether the buyer can add value to the MFI in terms of strategic direction, specialized expertise, and growth capital.

For purposes of defining "like-minded investor," prospective buyers fall into two broad categories: members of the microfinance investment ecosystem (such as current shareholders, MIIs, DFIs, or large MFIs or their holding companies) and external actors (often local or regional investors, including commercial banks and venture capital firms).

Within the microfinance ecosystem most investors share somewhat similar goals and responsible finance commitments, and nearly all tend to subscribe to the sector's basic set of client protection principles and social performance expectations.[3] Most importantly, the small size of the ecosystem and the limited number of actors involved mean that a seller is likely to have longstanding knowledge of the buyer and its reputation. As a result, selling within the microfinance ecosystem simplifies the process of meeting the minimum standard for a "responsible" buyer and is less likely to raise significant concerns about mission drift or reputation risk.

A good example of a sale within the microfinance ecosystem is the purchase of Accion Investments (AINV) by Bamboo Finance (Appendix A). Both Accion and Bamboo are long-term members of the sector and subscribe to the same responsible finance commitments. The familiarity goes further still—Bamboo and its former sister organization, Blue Orchard, had direct investments in many of Accion's MFIs, and one of Bamboo's senior staff was a director of AINV. As the seller, Accion had little need to evaluate the buyer's like-mindedness on the issues that mattered; it knew where Bamboo stood.

Despite the apparent advantages, selling within the ecosystem is not necessarily the best course of action. In some cases, seeking buyers outside the microfinance ecosystem is an outright necessity: most MIIs in the market do not have sufficient capital to buy large stakes in mature MFIs while maintaining a diversified portfolio. For mature MFIs, local actors such as domestic commercial banks can make excellent strategic investors, bringing operational depth, a more diversified product line, and longstanding regulatory relationships, in addition to capital and access to low-cost deposits. Such actors are usually found in markets with growing economies or relatively well-developed financial sectors—the same markets where large MFIs are also more likely to develop. As a result, for selling shareholders, finding such investors has not generally been difficult.

The chief challenge of going outside the microfinance ecosystem is the difficulty of assessing buyer like-mindedness. To start with, the seller is less likely to be familiar with the potential buyer. And such buyers are also less likely to be aware of, and have subscribed to, industry standards such as the Smart Campaign Client Protection Principles. In our interviews, selling investors mention paying close attention to the following in their due diligence on prospective buyers:

- The buyer's rationale for the purchase and its strategic plans and alignment with the MFI's own strategy
- Willingness to reference mission-related objectives in the shareholder agreement among owners of the MFI[4]

3. The Social Performance Task Force (SPTF) brings together more than 1,500 members (MFIs, donors, investors, associations, etc.) to agree on a common social performance framework and to develop an action plan to move social performance forward. SPTF facilitates a social investors working group that aims to explore good practices related to investment for social as well as financial outcomes and also promote social investment.
4. A shareholders' agreement is an agreement among the shareholders of a company, and it supplements (or supersedes) the company's charter. It is common practice in a company where there are a relatively small number of shareholders and often regulates issues such as voting rights, control and management, dispute resolution, etc. Shareholders' agreements are not always legally enforceable.

- The prospective buyer's prior activities or investments in micro, small, and medium enterprises (MSME) or low-income finance

- The comfort level of the MFI's management and, where relevant, the founding NGO/promoter with the potential shareholder

One example of the challenge of assessing buyers is the case of Sathapana, a Cambodian MFI held by several social and development investors (Appendix F). The outside-the-ecosystem bidder in that case was Maruhan Japan Bank (MJB), an existing commercial bank in Cambodia that was already lending to Sathapana and other MFIs. The bid was financially attractive and brought many strategic advantages. However, one concern that arose was that MJB was wholly owned by Maruhan Corporation in Japan, whose business includes slot-machine gaming. To address this concern, the sellers requested a specific legal commitment from the parent company that the scope of its Cambodian operations would remain limited to the banking sector and would not extend into gaming.

Another example is the case of CARE's sale of Edyficar (Appendix E). As an NGO focused on fighting poverty around the world, CARE faced a considerable challenge in assessing like-mindedness when it sold its majority stake in Edyficar to Banco del Credito del Peru (BCP), a purely commercial bank with no explicit social mission. However, BCP offered Edyficar the banking expertise and balance sheet strength that CARE could not possibly provide. A key factor that played into CARE's decision was BCP's claim that it would in fact maintain Edyficar's mission—and do so out of largely commercial motives. BCP had previously tried to build its own microcredit operation. While it was not successful, the bank took away the lesson that microfinance required an inherently different approach from its retail banking model. This experience enhanced the credibility of BCP's assertion that it would not change Edyficar's mission or operations, especially when BCP underscored its commitment by agreeing to sign year-long contracts with key management. The signals proved convincing, and CARE chose BCP from among its options. Even now, with three years of hindsight, both CARE and Edyficar's long-time management regard the sale as successful and consistent with the long-term goals of all parties to the transaction.

However, not all such sales to buyers outside the sector end as well. Our interviews yielded cases that were described as less successful, including the 2005 sale of Russian KMB Bank to Italian bank Intesa, which within a few years had abandoned KMB's original focus on SME lending, largely undoing the efforts of its founding investors. Another scenario that could become increasingly common is that of a commercial bank bidder that engages in substantial consumer lending directly or through an affiliate. This fact might merit additional due diligence on the seller's part to assess the bidder's commitment to responsible finance and better understand whether and how this line of business might affect the character of the MFI.

In summary, when looking for a buyer, it helps to consider whether an existing microfinance investor is likely to come forward, since such investors almost by definition pose a lower risk to the MFI's mission. However, particularly when large equity stakes are involved, such buyers may prove unsuitable or altogether unavailable, and going outside the microfinance ecosystem can bring other advantages and may prove a better choice. In such cases, most of those interviewed found it likely that a seller with a careful and deliberate due diligence process could reasonably ascertain the bidder's intentions. At the same time, the microfinance investment sector also would benefit by broadening the capacity of socially responsible funds to absorb larger-ticket equity transactions (see Box 2).

BOX 2

A Fund to Invest in Mature MFIs

For some time, MIIs have exhibited a common investment model: each usually seeks to invest around $3 million to $5 million, most want a board seat, and most have an eventual exit timeline. This limits the range of investable MFIs to small and mid-sized operations. Institutions that grow past that threshold—around $100 million in assets—no longer present realistic investment options for these funds.

The recent launch of the responsAbility Participations fund is meant to fill this void. Specifically designed to invest in mature MFIs and small emerging market banks, the fund expects its typical investments to be in the $20 million to $25 million range, entitle the fund to a board seat, and be subject to social performance requirements. In other words, it meets the "desirable buyer" criteria for many other funds seeking to sell their stakes in mature MFIs. The fund is distinctive in one other dimension—it has an "evergreen" structure that focuses on delivering dividend yield rather than capital gains, which enables it to avoid a specific exit timeline.

2.3 *How?*

While efforts to assess buyer like-mindedness and commitment to the MFI's mission are critical, these are not the only doors through which development-oriented sellers can exit gracefully. What if they could put in place some mechanism to constrain buyers from steering the MFI away from its mission even after the sale? The research uncovered growing interest in, and use of, the shareholders' agreement to codify the MFI's mission and social commitments. Such provisions can send an important signal to potential investors, a warning to those who would prefer not to be thus constrained. That said, the legal enforceability of such shareholder provisions varies widely from one jurisdiction to another, and this approach would work only so long as the majority of investors support these commitments. (And this option can become moot in cases where a controlling stake is being sold.)

Shareholders' agreements in the microfinance sector often have provisions that serve to protect minority shareholders when others are seeking to exit. In fact, the right of first refusal (ROFR) was commonly cited during our interviews.[5] ROFR permits existing investors to acquire shares before a third party buys them. It can enable existing investors to send strong signals to potential bidders, keep a tighter control on who buys the MFI's shares, and protect its adherence to its mission and social commitments. Minority shareholders can typically use these protective provisions to exit when the proposed transaction significantly alters their planned strategy for the MFI, or more simply, to take advantage of a favorable price. But couldn't such rights also be exercised to protect the social mission of the institution?

Such minority shareholder protections can have down sides, however. For one, they set up a structure of dual rights among the shareholders (those initiating the sale and those exercising minority protections) that can lead to tension among shareholders. They can also have unintended consequences. For example, when one social investor decided to exit from an MFI owned by a mix of social and commercial shareholders, a commercial investor decided to exercise its ROFR prerogative to buy the stake. This threatened to shift the balance on the board away from the social investors that made up the governing majority unless the remaining social investors exercised their own ROFR rights to increase their stakes (which they did). Some investors mentioned situations where minority shareholder protections present so great a barrier for the seller as to make an exit impossible altogether.

Minority shareholder rights are not the only means for keeping an MFI focused on its mission. Other avenues include executing long-term contracts with existing management or putting in place self-perpetuating governance structures that prevent takeover by any one shareholder. There are also examples where investors can exercise post-exit influence (e.g., by adding the requirement that key institutional decisions be made by a super-majority or ascribing majority voting rights to minority shares). Some legal structures[6] specifically allow minority shareholders to have a significant say on certain key issues, including changes to the institution's mission, while other structures may allow minority shareholders to exercise outright control (see Box 3).

These structures need to be approached with care, to ensure that otherwise suitable potential investors are not put off by having less say in governance. However, when done correctly, alternative governance structures to support a strong social mission can remain attractive on a strictly commercial basis.

Equitas offers one such example (Appendix B). Since a majority of its board members serve as independent directors, shareholders are prevented from having full run of the institution's governance. Furthermore, Equitas' shareholder agreement sets a return on equity (ROE) ceiling of 25 percent and earmarks funds for charitable activities. Despite these limitations and lack of shareholder control, Equitas has remained attractive to purely commercial investors. One private equity firm, Canaan Partners, which purchased Equitas shares before the Andhra Pradesh crisis pointed out that it was drawn by the fact that Equitas' governance structure, combined with its strong management, helped generate solid but stable returns over the long term, in clear contrast to the potentially higher-return but more volatile model of many of Equitas' competitors at the time.

BOX 3

Governing from a Minority

Companies can choose to have multiple classes of common stock, usually denoted as Class A and Class B shares with one class having more voting rights than the other. This can set up a system whereby a relatively small minority of shareholders could maintain governing control of the company. For example, in 2006, when McDonald's sold its Class B shares of Chipotle Mexican Grill it provided its holders 10 times the voting power of Class A holders' while holding fewer outstanding shares.

Other examples of such governance include family-owned institutions and entities chartered by foundations, where the founders seek to retain significant say in governance, even as they raise equity from public investors. State-owned enterprises, especially where governments own minority stakes, are likewise vehicles that provide a strong governing voice with a limited equity investment.

5. First refusal rights are common to commercial private equity and venture capital investments and are not unique to microfinance.
6. Such as the *Kommanditgesellschaft auf Aktien* in Germany.

Mechanisms that embed a self-sustaining social mission in organizational governance structures are among the least understood elements of social investing. Future analysis could shed further light on how such techniques can attract a broader spectrum of capital while maintaining a strong social mission.

The board of directors plays a leading role in changes in shareholder composition and governance structures. An exit that entails a significant change in board composition is likely to bring with it important changes in the governance balance among directors and that between directors and the CEO. Naturally, that would include cases where the exiting shareholder is selling a controlling stake. But minority shareholders may also have an outsize influence on the institution's governance. Such influence may be exercised by founding investors whose stakes may have diluted over time, or perhaps by network NGOs that provide technical assistance and institutional support as well as equity. An exit by such investors may substantially shift the institution's governance—a change for which boards should prepare in anticipation of the exit.

Beyond the board, the perspective of the CEO and the top leadership team is no less important. Except in cases where management is expected to be replaced, getting its buy-in is critical. If management's incentives are not aligned with the sale, the result can be problematic to all parties involved (Rhyne, et al. 2009). This was a key consideration for both Edyficar and Sathapana, whose managers had been leading the organizations for many years. Their buy-in and comfort with the new shareholder was key, and the buyers' willingness to extend management contracts as part of the purchase agreement played an important role in securing the confidence of both management and the selling shareholders.

2.4 How Much?

The concept of balanced returns is relevant to all MFIs and their funders but takes on particular significance for MII and DFI equity investors. Unlike creditors, shareholders earn their primary (and sometimes only) financial return upon sale. Yet the sale nearly always entails giving up a say over the investee's future social or developmental mission.

Thus, the fourth key decision we explored is the price investors look for when they sell their shares and how they choose between competing bids that offer different combinations of financial versus (future) social returns. Despite its critical importance to achieving balanced returns, pricing is one of the areas that few investors proved willing to comment on in-depth. One of the most common themes voiced by those interviewed for this paper was that price was an important, but not the driving element, in deciding which offer to accept. Among the cases studied, only one shareholder volunteered that the price was the topmost factor in its decision. And yet, delving deeper into other cases, it became apparent that the final sale nearly always went to the highest or second-highest bidder.

Since few investors were willing to discuss details of their decisions on price and accepted (and rejected) bids, we attempted an experiment, by presenting a focus group of 33 equity investors with a hypothetical scenario in which they were selling an MFI with social objectives (Appendix G). All sale prices were purposefully set well above a reasonable return threshold (substantially exceeding average stock-market returns, for example), and the hypothetical buyers offered a wide range of social returns: a local commercial bank that appeared to provide partial support to the MFI's social objectives made an offer equivalent to 2.1 price-to-book (P/B), a holding company with a strong social focus offered 1.6 P/B, and a private equity investor with no documented social mission offered 2.7 P/B.

Stating that they were "going with their mind, rather than their heart," most investors chose the mid-priced offer (67 percent average annual return) from a local commercial bank, which held out the benefit of a strong balance sheet and local and regional market depth but only partially sup-

BOX 4

The Perils of High Valuations

Under normal circumstances investors will choose a higher price over a lower one, all else being equal. But is there such a thing as too high a price?

For social investors, the answer should be yes. An equity valuation is a reflection of the buyer's expectations of future profits and gains in enterprise value. If those two factors run significantly below expectations, the buyer may not meet its required return or potentially suffer a loss—even if the institution itself remains profitable. As a result, when the purchase price is based on expectations of very high profits and/or growth, it can make it difficult for the company to change course down the road.

Consider the examples of Compartamos and SKS, whose IPOs both commanded high valuations. In the case of Compartamos this may have affected management's willingness and ability to reduce interest rates charged to clients. In the case of SKS, the high valuations paid in the run up to the IPO may have contributed to what has now proven to be unsustainable growth. In both cases, the exceptionally high valuations either attracted unsuitable buyers or motivated unsustainable behaviors by the institutions themselves or by others seeking to capitalize on the apparent high profits in the sector.

Source: O'Donohue, et al. (2010).

ported the MFI's social objectives. Only one out of the four investor groups chose the lowest-priced, but still highly profitable offer (46 percent average annual return), even though most investors acknowledged that the buyer provided the best support for the MFI's social objectives. Meanwhile, all investors unanimously rejected the highest-priced offer (91 percent average annual return) from a short-term investor with no interest in the MFI's social mission.

If this admittedly primitive experiment indicates actual investor preferences, then the outcome could be interpreted to suggest that investor choices may be guided by a two-step process in which they first screen buyers for suitability and then make their final selection based on the most attractive price. This example stresses the trade-offs investors face in balancing returns of social and financial performance.

To the extent that DFIs or MIIs seek to maximize their profit—even after first applying a social performance filter to the bids—merits further investigation, since a high-priced sale could lock an MFI into pursuing a strategy that could hurt its clients or even pose risks to the broader microfinance sector. When an MFI's shares command too high a price, two factors are at play: high growth, high profit margins, or both. High-priced equity can increase risks of market volatility compared to markets with moderately priced equity.

SECTION 3

Market Development Considerations for Exiting DFIs

As publicly funded institutions, DFIs' mandate is to provide longer-term, patient capital to the private sector for investments that promote development. As a result, their investments are best placed where private investors fail to invest sufficiently because of real or perceived risks. But beyond developing individual retail institutions to the point where they can demonstrate the viability of the business and attract private investments, DFIs could aspire to play a broader catalytic role in developing more inclusive financial markets. They could make their investment decisions based on a broader and a more detailed assessment of market needs (El-Zoghbi and Lauer 2013). Often, the most catalytic priorities for market development are in three areas: (1) improving information, (2) building the capacity of all market actors, and (3) creating market incentives and an enabling policy environment. DFIs may already engage in these different areas to some extent, depending on the nature of their funding instruments among other factors. But they face inherent limitations in their ability to be the local, neutral, flexible "facilitator" that could support market-building across the board over the longer term. In fact, DFIs likely will contribute more to market development to the extent they can coordinate closely with local "facilitators" that undertake deep and ongoing market analysis and engage in these three catalytic areas.

This market development perspective has implications for DFIs' equity investments at both the entry and exit stages that require further analysis and discussion. For example, entry into a relatively immature or "frontier" market might itself have a more catalytic effect than putting the same funds into a more established market, as it offers more opportunities to demonstrate the viability of base-of-the-pyramid market segments and the MFI business model. Whether the MFI partner is a startup or an existing institution, the specifics of how a DFI engages over time, including in governance, can encourage private investors to "crowd in" or even take the DFI's place outright.

The way a DFI exits—when, how, to whom, and for how much—can send important signals to other market players. To the extent that the buyer is a local commercial investor or bank, rather than another DFI or DFI-funded entity, this might offer stronger proof of the attractiveness of the core microfinance business. Likewise, a DFI's return expectations can provide an important indication for what other market actors ought to expect. On the one hand, relatively high returns could help bring in mainstream sources of capital, but as noted, when price expectations go beyond a certain range, they also risk attracting future buyers with growth and profitability goals that are hard to reconcile with the nature of microfinance products and clients segments. As the sector's viability is proven, the risk premium should decrease over time in most markets.

To date there has been only a handful of DFI exits from MFIs. Several factors explain this. Our research suggests that while DFIs analyze and discuss their future exit options at entry, DFIs' longer time horizon and incentives may weaken the "exit culture." In their desire to mitigate reputational risk and/or help ensure steadfast commitment of MFIs to their mission, some of these publicly funded institutions have tended to include a number of restrictions in their shareholder agreements. When they do look to sell, these provisions combined with the overall complexity of the legal documents and procedures have had the effect of slowing down the sales process or putting off interested buyers. In addition, DFIs typically have preferred taking a minority stake, which can be less attractive to potential bidders (especially if the holding period is long and the stake has been diluted). While these present serious challenges, our interviews suggest that DFIs are starting to push themselves to find ways to exit.

One example of DFI exits is with start-ups or "greenfield" institutions sponsored by international networks or holding companies (Appendix C). These retail institutions are often created in frontier markets and are meant to set examples for others to follow, by demonstrating the viability of the microfinance segments they serve, as well as efficient operations and responsible practices.[7] After showing several years of sustainability, some DFIs have sold their greenfield MFI shares back to the holding company. The result typically changes only the nature of their involvement in the MFIs' governance, without changing its ultimate ownership since they usually are also a major shareholder in the holdings.

7. A recent IFC and CGAP study shows that in Ghana, the DRC, and Madagascar, the most important effect on market building has come from greenfield MFI investment in staff training and development while playing a pioneering role in expanding access to financial services. See, Earne, Jansson, Koning, and Flaming (2014).

Applying a market development perspective raises questions about this exit strategy: does the DFI continue to add value at the holding company level (as many sponsors seem to believe)? Were lessons about the business model and performance widely shared with the market to ensure demonstration effects? Would the market impact have been greater if the DFI had sold its shares to a suitable private investor instead of the holding company? Should the proceeds be re-invested in other frontier markets? These questions merit further discussion among development finance professionals.

SECTION 4

Responsible Exits: Looking Ahead

The aim of this paper is to explore the issues of responsible investing during equity sales and stimulate debate without prescribing practice, which we consider premature. However, as exits start to accelerate, we hope that the four key decisions—when, to whom, how, and how much—will provide a useful framework for development-oriented investors to use in evaluating their exit options. In addition, we see a number of specific areas that warrant further exploration.

Active governance of MFIs through to exit. Active and balanced engagement in MFI governance by social investors is widely reported to be a weak spot overall (McKee 2012). Most of those interviewed for this paper felt that among the governance areas that need strengthening, boards need to pay more attention to the specific goal of responsible exit and how to best achieve it. Waiting until exit is imminent to raise the question at the board level is unlikely to optimize the outcome for the selling investors, the MFI, or the other stakeholders. Further discussion and exchange of experience is needed on the role of new ownership models and shareholder agreement provisions, along with further analysis of alternative governance models that rely on independent or minority control to sustain an MFI's social mission.

Exploring new equity investing models. The first generation of equity investing is carried out mainly by fixed-term funds, and with a governing minority stake for most investors including the DFIs. Over time, this model has had positive effects in creating strong institutions serving the poor. Some shortcomings are also coming into focus, however. Fixed-term funds do not offer the flexibility that is required in an evolving sector where market conditions can still be unpredictable. However, some investors are showing interest in taking majority stakes. Other models that prioritize delivering dividend yield rather than capital gains are also gaining traction. Other equity investing models merit further analysis since they could reduce exit trade-offs.

Balanced returns and reasonable growth. The microfinance investment sector is currently involved in a lively debate about how best to balance the financial bottom line with one or more social or development objectives. While the concepts of and emerging metrics for "balanced returns" and "reasonable growth" extend well beyond the specific issues surrounding responsible exit, the four exit decisions explored in this paper are deeply rooted in the double bottom line nature of MFIs and their owners. Each investor has its own goals preferences that it seeks to achieve at exit, and the market would benefit from improved articulation of those preferences and how best to advance them.

APPENDIX

A Accion Investments: Selling an Entire Portfolio

In late 2009, the board of Accion Investments (AINV) was pondering its future. The larger investments were beginning to outgrow the fund, while the less mature investments required continued financial and governance support. Recapitalization was possible but not necessarily desirable. Some of the fund's investors wanted to sell their entire stake. Others were willing to remain but wanted an external sale to provide a reality check on how the market valued the fund's investments.

AINV was one of the first equity funds in microfinance, created when MFIs desperately needed equity and the commercialization of MFIs was just emerging. By design, as the portfolio of AINV grew, it came to include a mix of established MFIs in South America, younger ones in Central America, and recent start-ups in Africa.

When the fund's board tasked its managers to present the available exit options, they named a set of principles that should be followed: any transactions should leave portfolio companies with solid shareholding structures, be fair and transparent and coordinated with co-investors, and provide fund investors with a profitable return.

The managers identified four options for an exit: floating the company on a small stock market, recapitalizing the fund, selling it whole to a like-minded investor, or selling individual MFIs. Among these, a stock flotation seemed of limited value—AINV was relatively small and too globally diversified. The diversity of the fund also posed a challenge to finding a single investor that would be interested in all the company's assets. A case-by-case sale seemed the most likely strategy, allowing management to find the right kind of buyer for each MFI or group of MFIs. However, such an approach posed its own risks—larger, more mature investments could sell quickly, leaving the fund with smaller, less profitable companies that would be more costly and take longer to sell. Moreover, microfinance is a small, interconnected world. The process would not stay quiet for long and could lead to difficult questions: how would Accion International (AINV's sponsor) explain its disengagement from Latin American partners, for example?

Thus, when an AINV shareholder, Bamboo Finance, expressed interest in the entire portfolio in June 2011, management and board were immediately intrigued. Bamboo was an established global private equity group with years of experience in microfinance investing. Surely, a sale to a single investor would come with fewer complications, and as a longstanding actor within the microfinance ecosystem, Bamboo easily met the test of a like-minded investor. As an existing investor in AINV, Bamboo was familiar with its portfolio companies making for a simpler due diligence process and a faster sale. It also helped that in most of these investees, AINV held a relatively small stake, meaning that an exit did not entail a strategic shift in ownership of its MFIs.

Still, there were complications. AINV held strategic (i.e., larger) stakes in some portfolio companies, while other investees required more technical support than Bamboo could provide. The solution was to carve out less mature MFIs in Africa and sell them jointly to Bamboo and Accion International, thus ensuring ongoing support from Accion International's capacity-building operation. Additionally, as an anchor shareholder of BancoSol in Bolivia, Accion International agreed to buy AINV's interest in that MFI.

Given AINV's close relationship with Accion International and Bamboo's existing stake in the fund, conflicts of interest were inevitable. This was recognized early on, and the fund engaged a legal specialist in conflict of interest to guide management and the board. This meant taking steps to clearly differentiate buyers from sellers: those AINV directors who held roles at Accion International or Bamboo recused themselves from all board decisions related to the sale.

While the final negotiations took place among three parties—AINV, Bamboo, and Accion International—the number of stakeholders in the transaction was far greater. MFI boards and management had to be apprised of the plans, and regulators in each of the countries were informed of the potential transaction, which also involved engaging local legal counsel in each of the relevant countries.

Completion of the transaction required 18 months as the result of cooperation needed from over a dozen institutions and their boards, as well as regulators, outside investors, and other microfinance equity funds.

APPENDIX B

Equitas: Separating Governance from Ownership

In mid-2010, when Aavishkaar-Goodwell was considering selling part of its stake in the South Indian MFI Equitas, it found itself in a rather peculiar position. Aavishkaar-Goodwell views itself as an early-stage investor, yet here it was contemplating an exit, just two years into its investment as a founding investor. Equitas had grown so quickly that Goodwell was becoming too small to maintain a significant share in the company. Moreover, Equitas' development was outpacing the type of close advisory and governance involvement that Goodwell normally seeks to provide portfolio companies.

The other peculiar position for Aavishkaar-Goodwell is that its search for an appropriate investor proved perhaps simpler than it might have been. After all, this was during the height of the microcredit bubble, just months before the SKS IPO. Bids from venture capital funds seeking quick gains in what was then seen as a quick path to an IPO were easy to come by. But Equitas was different in many ways.

Like most of its peers in microfinance, Equitas was a nonbank financial company (NBFC). What sets it apart are some highly unusual governance and social commitments, which are enshrined in the company's initial Articles of Incorporation:

- **Majority independent board**. The board is composed of a majority of independent directors, chaired by an independent and nonexecutive director—all of whom are well-known and accomplished individuals with backgrounds mainly in finance and development.

- **No controlling shareholder**. During the initial subscription round, no shareholder was allowed to own more than 15 percent of the company, and the board can reject any transactions that would result in a stake of more than 24 percent.

- **Explicit social commitments**. Equitas enshrined several substantial commitments to its social mission, including donating 5 percent of its profits to pay for children's education, as well as a commitment to employ one corporate social responsibility staff for every 10 branches, whose job would be to conduct medical and skill development camps.

- **Financial return ceiling**. Equitas capped its ROE at 25 percent and set a minimum capital adequacy of 20 percent (including off-balance sheet transactions).

Together, these steps limit the financial returns of investing in Equitas (though at a rather competitive level), while keeping in place the financial downside of fixed profit allocations to charitable activities. Meanwhile, by vesting independent directors—themselves selected on the basis of their professional independence—with final say over the company's affairs, Equitas has made it effectively impossible for investors to alter those original commitments.

While these embedded commitments create a self-selecting pool of potential investors who are comfortable with such limits, Aavishkaar worked with the Equitas team to select the most appropriate buyer from among the bidders. Their final choice was Canaan Partners, a traditional U.S.-based venture capital firm focused entirely on financial returns.

For Canaan, Equitas was in many respects a departure from the norm—it is the only investment in India in which Canaan does not have a board seat, and it is the only one with explicit social commitments and an earnings cap. However, in this structure, as well as in the company's focus on efficiency and quality of execution, Canaan saw the prospects of solid, but stable returns over the long term—the very opposite of the high-return, but also high-risk deals that were taking place in other Indian MFIs at the time.

Clearly, the unusual self-perpetuating governance and mission focus at Equitas did not limit its ability to tap commercial capital, but in fact may have helped maintain the company on the kind of stable footing that many of its competitors had lost during the go-go years of Indian microfinance.

APPENDIX C

KfW: Selling Back to the Holding

With an equity portfolio amounting to close to US$950 million, KfW may well be the largest single investor in MFIs and small banks. It has also never fully exited from any of its positions in retail financial service providers, with one notable exception: KfW has already completed seven exits in ProCredit banks around the world.

While an important part of its investment strategy, these seven transactions are in some ways closer to an internal institutional reorganization of an ownership stake than a full exit. KfW has a dual interest in ProCredit: as a direct investor in many ProCredit subsidiaries around the world, as well as one of the anchor investors in ProCredit Holding. Part one of KfW's strategy involves investing in new ProCredit subsidiaries and staying closely involved in the retail institution's governance—an involvement that demands extensive time from KfW's staff. In response, part two of KfW's strategy aims to rationalize its resources, by selling the ProCredit subsidiary back to ProCredit Holding at some point, while continuing to support the latter with additional capital investments as needed.

The decision to exit is based primarily on assessment of the subsidiary's sustainability and ability to maintain and further develop institutional capacity, while generating moderate annual growth of 5–10 percent using retained earnings. The subsidiary must also demonstrate that it adheres to its mission, acts as a market standard-setter, and promotes healthy (but not excessive) competition.

To avoid the potential for conflict of interest of selling to a related institution in the form of the holding company (and one in which KfW has a major stake), the valuation and pricing is calculated by an external party, and the premium tends to be modest. Even after these sales, KfW continues to promote a supportive environment in which the subsidiary (and other market players) can have lasting positive impact, including by developing credit bureaus, deposit insurance schemes, and other financial sector infrastructure improvements.

APPENDIX D

Arohan: A Distress Sale

It was spring 2012, and the Hyderabad-based fund manager Caspian faced a dilemma. One of its holdings, Arohan Financial Services in Calcutta, was losing money fast. During the prior 18 months since the start of the crisis in Andhra Pradesh, Arohan had shrunk to a third of its peak size, losing nearly half of its equity.

As a manager whose two funds owned a combined 55 percent stake in Arohan, Caspian felt the problem acutely—the MFI was continuing on a downward spiral and may not have survived without an infusion of new equity. To make matters worse, the dominant position—40 percent of Arohan—was held by Bellwether, Caspian's oldest fund that was set to mature in two years.

The trouble afflicting Arohan was shared by many small- and mid-sized MFIs throughout India. Since the start of the Andhra Pradesh crisis in late 2010, Indian banks, which at the time, constituted the primary source of the sector's funding had either turned off or greatly restricted lending to all but the largest and most stable MFIs.

The situation at Arohan was especially acute. On the eve of the crisis, Arohan had embarked on a growth surge aimed at doubling its portfolio by March 2011, and it had just doubled its branches and staff. With the onslaught of the crisis, bank funding was frozen; not only was portfolio growth impossible, but Arohan was forced to severely curtail its lending. By spring 2012, Arohan's portfolio shrank to less than half its peak size.

Expecting the market to recover, Arohan had retained most of its staff and branches. When the market failed to stabilize, Arohan had to face substantial losses. Besides eroding equity, the losses had two additional impacts on Arohan: first, they further exacerbated its liquidity predicament, given that banks were even less willing to lend to a loss-making institution. Second, the losses eroded the value of the enterprise, making the exit from Arohan still more difficult sell. Arohan faced an additional hurdle: its share of foreign ownership was already near its legal limit of 75 percent. Any investment would thus have to come from local sources—many of whom were already burned by exposure to Indian MFIs.

Many rejected the offer—from private equity funds and from other MFIs. But Arohan's star was not so easily extinguished. Intellecap, the investment firm hired by Caspian, was affiliated with Intellecash, which prior to the crisis had served as an incubator for aspiring microfinance start-ups, providing them with the full suite of tools to start and operate an MFI. Intellecash also managed its own small microfinance operation in an area adjacent to Arohan.

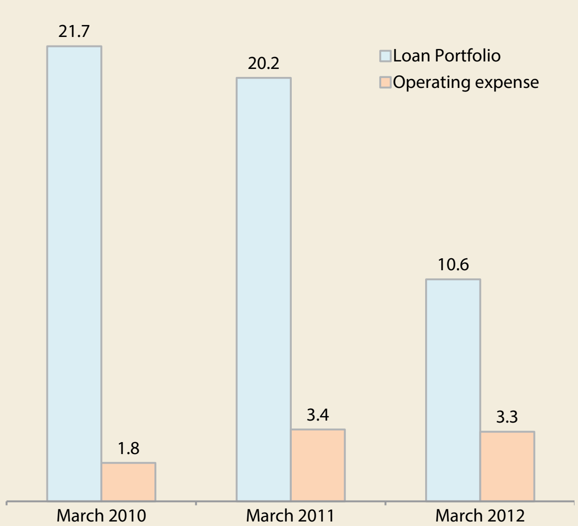
At the time Intellecap was seeking out potential Arohan investors, Intellecash had just embarked on a new acquisition-based strategy. Here was an organization looking for exactly the kind of challenge that Arohan presented, and through its strong ties to the Aavishkaar-Goodwell fund, it could raise sufficient capital to both buy out Bellwether's stake and infuse Arohan with the capital it required.

Intellecash brought more than just capital to the table. Its experience working with many different MFIs made it in many ways the perfect partner in a merger, while its strong ties to the banking community in India was critical when it came to helping pull Arohan out of its liquidity squeeze. The heads of both Arohan and Intellecash both had competencies and interests that supported a positive partnership. Finally, the financial engineers at Intellecap were able to structure the transaction in a way that greatly reduced Arohan's foreign-ownership share, thus greatly improving its prospects for future investment.

What looked promising at the outset has not disappointed. In the half-year since the merger, Arohan has returned to profitability and has begun to grow. By all accounts, the man-

FIGURE AD-1

Cost Basis Rises as Portfolio Shrinks



aging team is functioning well—an item of some importance when the merger involves the company's founder. And most importantly, Arohan seems to have succeeded in escaping its liquidity squeeze.

However, given that Arohan had no other interested buyers besides Intellecash, it is hard not to conclude that the sale and its subsequent success owe much to sheer luck. With its partnerships in capital markets via Intellecap, and its explicit acquisition-focused strategy backed by the Aavishkaar-Goodwell fund, Intellecash was a unique organization that had positioned itself to play the very role it was now undertaking in Arohan's turnaround.

But by all accounts, the offer from Intellecash was unexpected by both Caspian and Arohan. So one has to wonder—what if there had been no Intellecash? Did Arohan have any other options?

Not many. Its existing investors (Bellwether, The Dell Foundation, and Caspian's other fund, the India Financial Inclusion Fund) all wanted Arohan to survive and were willing to pursue a Plan B—an infusion of limited equity, just enough to keep the organization afloat, but critically, probably not enough to pull it out of its liquidity squeeze. Under this scenario, Bellwether would have maintained (but not increased) its stake, essentially buying time and hoping that the India microfinance sector would recover sufficiently to sell Arohan in the next two years. But certainly, there were no guarantees, and infusing more equity was simply beyond the capacity of its existing shareholders.

APPENDIX E

Edyficar: An NGO Selling to a Bank

In summer 2008, the management of CARE was facing a choice: should it sell its single largest asset, Edyficar?

A decade earlier, CARE created Edyficar as part of its poverty fighting program in Peru. Now, it was a thriving enterprise, the third largest MFI in Peru, employing a thousand staff, serving 180,000 borrowers, and accounting for over 20 percent of all of CARE's total assets. That same year, Edyficar transitioned from a microenterprise lender (an EDPYME) to a *Financiera* (an NBFI), under the Superintendency of Banks.

CARE is an NGO focused on fighting poverty around the world. While a large part of that includes financial services for the poor—mostly through the promotion of village savings and loan associations (VSLAs)—full-service banking had never been part of CARE's domain of activities. Yet that's where Edyficar was heading, and moreover it would not be long before Edyficar would grow to be larger than its parent.

It was also clear that the VSLA model, which targeted far poorer rural residents in countries poorer than Peru, was a closer match to CARE's mission than Edyficar was, whose loans at that point were averaging about $1,000 per client.

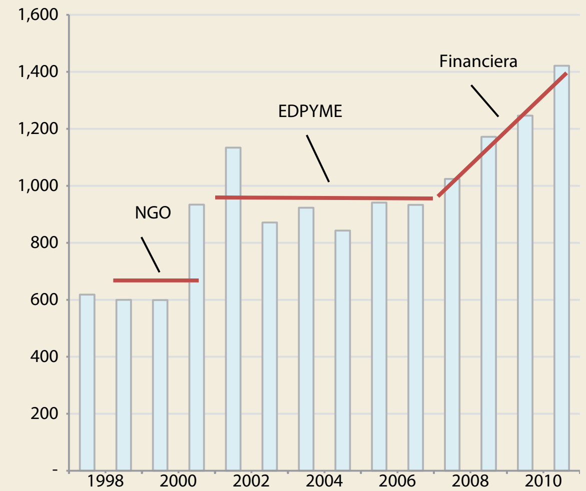
Those same elements that distanced Edyficar from CARE also meant that CARE was increasingly less able to support the MFI on its journey. Further growth meant more capital and deeper expertise—something CARE would have been hard-pressed to come up with.

By 2008, its management recognized the difficult decision they had to make: they would have to sell Edyficar. After some deliberation, they also recognized that a partial sale would not work—they had to sell the whole thing. Since its transformation to a *financiera*, the evolutionary path for Edyficar was leading it ever further away from CARE's core mission (see Figure AE-1 for a look at Edyficar's fast-rising average loan amount starting in 2008). Selling a partial stake and retaining significant say in governance would simply serve to slow that evolutionary process, and would serve neither party well.

As a global NGO with many stakeholders, CARE took a methodical approach to preparing for the sale, seeking internal consensus, including buy-in from Edyficar's senior management. It also maintained close consultation with minority shareholders, as well as with the Banking Superintendency. Recognizing its own limited knowledge of the process, CARE retained Morgan Stanley, which had expertise in both mergers and acquisitions and microfinance, along with a strong ground presence in Peru.

FIGURE AE-1

Edyficar's Legal Status Reflects on Average Loan Size ($)



In time, it had fielded four serious offers, all from local or regional organizations, including banks and other MFIs. Among these, CARE selected Banco de Credito del Peru (BCP) as the winning bidder. BCP offered $96 million for buying out all of Edyficar's shareholders, representing a P/B valuation of 2.5 times. This was high by both global and country standards, but considering its profitability (30 percent average ROE during 2007–2009), the price was in fact well below that of its peers, which by JP Morgan estimates should be 3.5 times P/B for that ROE level (CGAP and JP Morgan 2011).

Nevertheless, from CARE's perspective, the price was not the driving factor in its decision. Rather, the main reason was a qualitative one: BCP's strategy was to keep Edyficar as it was. During the due diligence period, BCP was especially respectful of Edyficar's management and staff, and it committed to keep existing branding, management, and the mission all in place. To demonstrate that commitment, BCP agreed to sign one-year contracts with Edyficar's most senior executives as part of the transaction.

As both CARE and Edifycar understood at the time, BCP's perspective was guided by a recognition that microfinance was very different from banking. Some years before, BCP had tried and failed to launch its own microfinance operation. That experience and its lessons were encapsulated by something one of BCP's directors said during the negotiations: "If we were to try to do what Edyficar did, we would fail."

This is not to say that selling to BCP entailed no change. Both parties understood that back-end operations, IT systems, regulatory reporting, and other relevant services would be either merged or leveraged in some way. And as one of the leading banks in Peru, BCP could also unlock access to the capital markets as well as its own balance sheet. In short, BCP would be the partner that could fulfill the potential Edyficar had gained by becoming a *financiera*, and do so without undermining Edyficar's internal ethos.

These expectations have largely proved correct. Edyficar continues to be led by the same general manager as before, and it continues to focus on microenterprise lending. It has also continued on its rapid growth path, with the portfolio chalking up a 44 percent cumulative annual growth rate (CAGR) for the three years since the sale. And while this also reflects an increase in average loan size, that's in many ways less a reflection on Edyficar's new owner, than on the changing market landscape in Peru, where average MFI loan amounts exceed those of Edyficar. Deposits have also expanded enormously, from $30 million at the time of sale to over $500 million now, though this consists almost exclusively of very large private and institutional accounts, averaging $300,000. Savings products for Edyficar's microfinance clients have not yet been rolled out.

Edyficar today is far from the organization that CARE founded 15 years ago. It has charted its own path, and BCP has proven the right partner to join it for the past three years and walk with it into the future. Meanwhile, CARE was able to put the proceeds to work combating poverty both in Peru and around the world.

APPENDIX F

Sathapana: A Multi-Stakeholder Exit

Sathapana is in many ways the quintessential MFI story. Founded in 1995 as an NGO focused on providing health and education services to the poor of Cambodia, it quickly found its way to microfinance. During the early 2000s, it was supported by GTZ and the World Bank. In 2003 it had transformed into a commercial enterprise and established a credit relationship with Triodos Investment Management and Blue Orchard. The original shareholders included the founding NGO and the staff association. In 2004, it received its first equity investment—from ShoreCap—and in 2006, welcomed FMO and Triodos-Doen[8] as additional equity investors.

In 2009, it received a nonbanking deposit license and saw its first equity sale, when Developing World Markets (DWM) bought ShoreCap's stake. By 2012, the MFI had assets of $150 million, deposits of $67 million, and a CAGR that averaged 51 percent over the 12 years since 2000. ROE since its first commercial investment from ShoreCap averaged 25 percent.

Since about 2008, Sathapana held the position of the fourth largest MFI in the country, with a market share of about 5 percent. However, in many ways, Sathapana stood apart from the field. Its focus had been shifting toward the SME sector, and by 2011, over 25 percent of its portfolio was in SME loans, averaging $8000—nearly 10 times the sector average.

In 2012 the shareholders approved a new strategic plan that envisioned transforming Sathapana into a commercial bank, broadening its products and services, and positioning it for a potential regional expansion. The plan also entailed a significant capital increase, with a further equity infusion envisioned within a few years. FMO and Triodos had been hands-on investors: both held board seats, were actively engaged in governance, and supported training programs. However, it had now been six years since their investment, and Sathapana had reached a new level of maturity in terms of performance, footprint in the market, risk management, and governance. They considered the timing appropriate for an exit for these reasons as well as their desire to reduce their Cambodia exposure (both also held stakes in other Cambodian MFIs). In light of Sathapana's new strategy, the time was ripe to bring in a new strategic shareholder that shared Sathapana's vision and had the resources and capacity to help implement it.

FIGURE AF-1

Growing MFI in a Growing Market

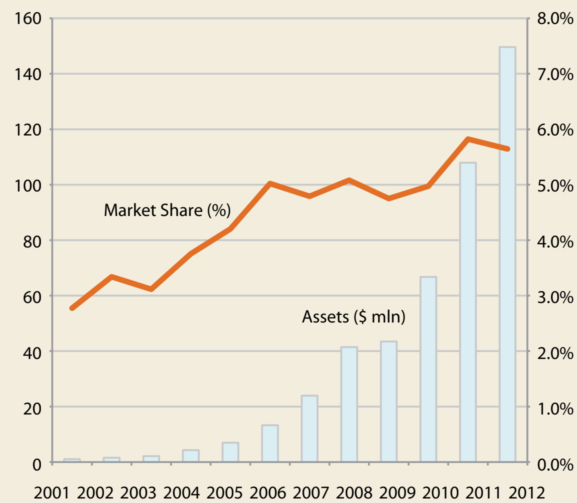
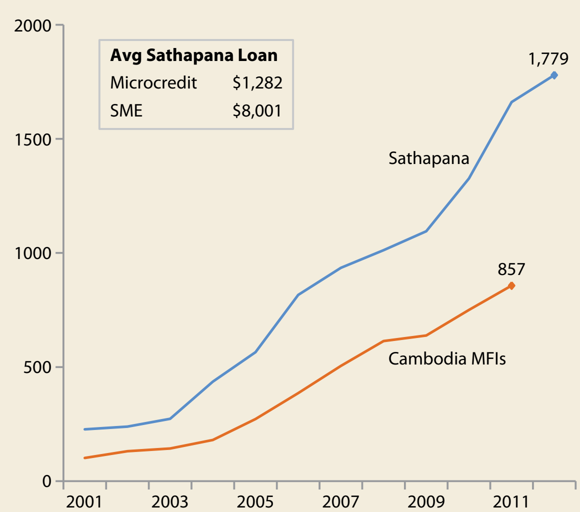


FIGURE AF-2

Average Loan Amounts (USD)



8. Triodos-Doen Foundation (Triodos Doen) was launched in 1994 by the DOEN Foundation and Triodos Bank. Since December 2013 it has been operating as Triodos Sustainable Finance Foundation, under the exclusive management of Triodos Investment Management and without active involvement of the DOEN Foundation.

When FMO and Triodos decided to sell, they informed Sathapana's other shareholders, senior management, and the board of their decision. In these discussions, it became apparent that the sale would have to be done on a cooperative basis—FMO and Triodos together held 40 percent of Sathapana, in other words, a major but noncontrolling stake. However, selling a controlling stake could yield significantly more interest and potentially a better price from the type of strategic investor they were seeking. The other shareholders—including DWM, which owned the largest stake (35 percent)—also held tagalong rights, which gave them the right to sell their shares alongside those of FMO and Triodos. The sellers thus had to seek a buyer willing to buy these additional shares.

For the tagalong shareholders, the sale was a significant opportunity. Although DWM had only recently invested in Sathapana, it recognized that joining in a strategic sale would likely produce a better outcome than retaining its shares. Besides providing a higher price, the bid also met DWM's strategic objective to develop deeper links among its partner MFIs and the broader financial systems within which they operate. For the staff association, comprised mainly of middle- and lower-middle-income Cambodians, this was an unusual opportunity to monetize their shares, and the shareholders, through their M&A adviser, sought to make sure the staff association was fully informed about the consequences of joining the sale or retaining their shares. Finally, for the founding NGO the sale presented an opportunity to monetize part of its stake, while retaining a voice in post-sale governance.

However, the presence of tagalong rights had consequences. DWM and its tagalong partners had the flexibility of participating (or not) in the sale, but with fewer obligations than FMO and Triodos, which had initiated the process and were ultimately responsible for carrying out the deal. Over the course of the transaction, this mix of different rights and responsibilities increased the complexity of the process.

In view of this complex and intensive process, FMO and Triodos engaged ShoreBank International (SBI)[9] as the M&A adviser right from the beginning. In addition, Sathapana's CEO was actively involved, providing input on the initial list of potential investors who had already demonstrated interest (this included the winning bidder) and facilitated close communication with the National Bank of Cambodia, which had to provide regulatory approval for both the transaction and the buyer.[10] The selection criteria for the bidders focused on three key areas: strategic fit with Sathapana and its mission, financial capacity, and a competitive price.

The auction was competitive, attracting local, regional, and international institutions. Ultimately, the sellers selected Maruhan Japan Bank (MJB), a local commercial bank established in 2008 that was already lending to multiple Cambodian MFIs, including Sathapana. In addition to offering the highest bid, MJB also had a regional growth strategy aligned with Sathapana's—both saw Cambodia as a home base for what would ultimately be broader operations in Southeast Asia. Because MJB had only a single branch and no overlap with Sathapana's client base, integrating operations was also not a significant factor. Plus, MJB was favored by Sathapana's management, whom the buyer sought to retain by extending employment contracts with the CEO and his key staff.

However, along with its strong strategic fit, MJB also posed a dilemma: in addition to owning banks across the ASEAN region, MJB's parent company, Maruhan Corporation, operates a large number of slot machine-type parlors (Pachinko) across Japan.[11] To resolve this dilemma, the sellers asked for special assurance—a request to the parent company for a specific undertaking that the scope of its Cambodian operations would remain limited to the banking sector. This helped separate the positive aspects of MJB from the concerns posed by its owner's gaming business. As social investors, the sellers wanted to ensure that Sathapana's social and developmental mission would continue following the sale. To that end, they led the amendment of the MFI's charter (to which MJB became a signatory) to clearly spell out its commitment to provide financial services to the poor. In addition, MJB agreed to accommodate the founding NGO's request to sell only half of its shares while contracting options to exercise the remainder at a later time. This allowed the NGO to retain its board seat, through which it could help maintain Sathapana's mission focus after the sale.

The offer from MJB also met the expectations of the tagalong shareholders, all of whom joined the sale. Though these tagalong rights divided the shareholders and may have complicated the process, they did not change what ultimately was a positive outcome for all. In the end, MJB acquired 95.1 percent of Sathapana's shares, with the remaining 4.9 percent retained by the founding NGO. With this, Sathapana had closed its social investor chapter, setting forth on a new path.

9. SBI was a part of the ShoreBank group to which Sathapana's earlier investor, ShoreCap, had belonged, and thus were also well-acquainted with Sathapana and the Cambodia market. As of October 2013, SBI is operating as Enclude.

10. The transaction faced greater regulatory scrutiny because the buyer was deemed influential according to Cambodian law, meaning it would own more than 20 percent of the financial institution. Such investors face greater obligations toward the regulator, which may enjoin influential shareholders to increase the company's capital until solvency standards are met.

11. While gambling is illegal in Japan, Pachinko is not, in part because it can be also used as a recreational arcade game. Historically, Pachinko has been a widely accepted activity in the country.

APPENDIX G

Focus Group on Social vs. Financial Return

The following scenario was presented to a group of investors. Participants, all representatives of microfinance equity funds, were divided into four groups and asked to choose which offer they would accept. Three groups chose the local commercial bank, even though two of them recognized that the holding company held out higher social return (one investor described the choice as "going with my mind, not my heart"). One group chose the holding company, citing mission alignment as the reason. No investors chose the private equity investor as a viable option, due to its lack of fit with the MFI's mission, though some did mention that it was a painful choice, given that they were giving up substantially higher financial returns.

Consider the following scenario

You are a 30 percent shareholder in an MFI that you invested in five years ago. Now, it has a $90 million portfolio and almost 90,000 borrowers. Two years ago it acquired a banking license, and now has 30,000 deposit accounts at $15 million total raised. The remaining 70 percent of the MFI's portfolio is funded via debt, mostly from foreign sources. For the past five years, the MFI has been growing at 30 percent CAGR.

One of the MFI's goals is to broaden its loan offerings (currently 93 percent of its portfolio is in microenterprise loans, 4 percent in housing, and 3 percent in emergency loans). On the savings side, it has set a goal of depositors surpassing borrowers in three years and deposits reaching 70 percent of loan portfolio. However, it has had trouble keeping deposit accounts active (40 percent of the deposit accounts have negligible balances; two-thirds of deposits come from the largest 500 accounts, averaging $20,000 each). The MFI needs an additional $10 million in equity to continue its growth.

Five years ago, the fund you manage invested $3.2 million in this MFI, which at the time was just two years old (your original 40 percent share has since been diluted to 30 percent). Since the beginning, you've played a leading role in governance and were the driver behind the MFI's transformation into a bank and its push for savings. Another three smaller investors (combined 50 percent stake) have indicated that they would probably sell together with you, thus a total of 80 percent could be sold (the rest is mostly management shares, some local wealthy investors, and a stake in an employee stock ownership plan).

The offers

Local commercial bank	Holding company	Private equity investor
Background	**Background**	**Background**
The third largest bank in the country, seeking to expand its down-market presence. It has previously tried to build its own microfinance lending program, which was unsuccessful. The bank would like to keep MFI operations separate, integrating only main back office functions and MIS. It agrees to sign a one-year contract with current management.	A moderate-size holding company with six MFIs in its portfolio, mostly in the same region. It has developed an especially strong savings methodology (five of its MFIs have more savers than borrowers, and portfolios mostly funded by deposits). Deposits average $400–600. The holding company wants to keep the CEO (who holds the holding company in high regard). It will bring two of its savings experts to align the MFI's savings program to its methodology.	Foreign private equity fund active in the region. Has made several recent investments in consumer finance companies in nearby countries. Most of its investments are resold in 3–4 years. Other finance companies have sought partnerships with large household retailers. Also offers short-term loans to wage-earners (payday loans), at prices slightly above MFI rates for comparable products. Offers management significant options as part of the deal. Management is interested.

Continued

Local commercial bank	Holding company	Private equity investor
Social Mission No explicit mission, but regulator (Central Bank) is well-run and includes requirements such as standard pricing disclosure and has expressed concerns about avoiding market overheating. It's clear the bank is mostly interested in growing the high-yield MFI portfolio, though larger clients will be able to access the bank's broader offerings. It has a broad ATM network and money transfer service, but has very few deposit accounts below $500.	**Social Mission** Primary mission to expand savings and credit services to the poor. Focus less on microenterprise lending and more on financial inclusion, including low-income wage-earners. Loan portfolios of other MFIs include up to 10 percent in housing loans and as high as 25 percent in consumption loans. Has engaged a rating agency to conduct Smart Certification for one of its MFIs. Plans to roll out to others in time. Partners with research institutions to evaluate its level and quality of outreach, but largely uninterested in client impact analysis.	**Social Mission** No social mission. Regulator (Central Bank) is well-run and includes requirements such as standard pricing disclosure and has expressed concerns about avoiding market overheating.
Price $13.9 million, or 2.1 P/B. Extends same offer to the other investors, conditional upon your sale.	**Price** $10.6 million, or 1.6 P/B. Prefers to buy just your stake, plus $10 million in fresh shares. Agreed to sign a three-year buy-out option with other investors, who are comfortable with offer.	**Price** $17.8 million, or 2.7 P/B. Extends same offer to the other investors, conditional upon your sale.

Which one will you accept and why?

APPENDIX H

List of Interviewees

Name	Organization
Sushma Kaushik	Aavishkaar
Mary Chaffin John Fischer	Accion
Anne-Marie Chidzero	Africap Microfinance Fund
Marcus Fedder	Agora Microfinance
Anne Contreras	Arendt & Medernach
Shubhankar Sengupta	Arohan
Ximena Escobar de Nogales Xavier Pierluca	Bamboo Finance
Melchior de Muralt	BlueOrchard
Alok Mittal	Canaan Partners
Laté Lawson Peter Buijs	CARE
Vishal Bharat	Caspian Advisors Private Limited
Fernanda Lima Brad Swanson	Developing World Markets
Ana Maria Zegarra	Edifycar
Edvardas Bumsteinas	EIB
Laurie Spengler Ian Callaghan Jesse Fripp	Enclude (formerly ShoreBank International)
PN Vasudevan	Equitas
Arno de Vette	FMO
Els Boerhof	Goodwell Investments
Paul DiLeo	Grassroots Capital Management
Martin Holtmann	IFC

Name	Organization
Dina Pons	Incofin IM
Anurag Agrawal	Intellecap
Manoj Nambiar	IntelleCash Microfinance Network Company
David Munnich	Investisseurs & Partenaires
Matthias Adler Martin Hagen	KfW
Ira Lieberman	LIPAM International, Inc.
Kaspar Wansleben	Luxembourg Microfinance Development Fund (LMDF)
Geeta Goel	Michael & Susan Dell Foundation
Doug Young	MicroVest
Fernando Campero	MIF
Stefan Harpe Frank Rubio	Oikocredit
Alex Silva	Omitrix
Jean-Gabriel Dayre Elodie Parent	Proparco
Michael Fiebig Henry Gonzalez	responsAbility
Mildred Callear	SEAF
Frank Streppel	Triodos
Mark van Doesburgh Luis Guerra	Triple Jump
Judith Mayer	University of Munich
CJ Juhasz	WWB Asset Management

APPENDIX

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