

The Truth about Private Equity and Microfinance

Interview: Sumir Chadha, Managing Director, Sequoia Capital India

One of the first “mainstream” investors to take the plunge into microfinance was Sequoia Capital. Its entry was one of the first indications that microfinance could be seen as purely profit-driven investment. Better known for its venture capital investments into Google, Yahoo, YouTube and Apple Computer, Sequoia invested US\$11.5m into SKS Microfinance, based in Hyderabad, India, in 2007. Since then the company has made an additional investment into Ujjivan, an urban microfinance institution based in Bangalore, India. *Microfinance Insights* sat down with Sumir Chadha, Managing Director with Sequoia Capital India, to learn about the motivations of the company with regards to microfinance, and the innerworkings of SKS.

Microfinance Insights (Insights): Just five years ago, SKS was an NGO. Sequoia is now India's largest MFI. How do you think these inflows of capital have changed SKS?

Sumir Chadha: One of the things I love about Vikram [Akula, the founder of SKS Microfinance] is that he's always been a man with a large vision: solving the poverty problem in India. The only way to solve it is to have tremendous scale. And scale requires massive equity infusions. Without it, unfortunately, it's not scaleable. The sad reality is, if you want to hit 150 million people in this country, you need to raise a lot of money, and you have to have a management team that is highly professional, highly driven. So, SKS had two choices: one choice was to remain small and nonprofit, but frankly not very impactful, or try to really change the country and adopt a lot of the best practices from business.

Insights: There are several investors—mainstream and not so mainstream—with a stake in SKS. Unitus. Sandstone. SVB. Kismet. How do you handle the changing priorities of different investors? How does the board manage each investor's expectations? Since no one has the majority stake how do you find balance?

Chadha: There is this outside perception that there is a conflict among the board. But there really isn't. If you were to attend one of our board meetings, I can tell you I am just as concerned about service quality as a social investor. There really hasn't been this big social versus profit debate. In practice it has been a non-issue.

Insights: In terms of Sequoia's perspective on things regarding financial versus social priorities and returns, would you say it's 50-

50, 60-40, 70-30? How would you weigh each of those priorities?

Chadha: Sequoia doesn't have a social bucket. Let me explain. What's interesting about us is that virtually all our investors are not-for-profits. So we are in the fortunate position of choosing the clients that we work for (meaning our investors). Interestingly, a lot of the social investors are for-profit investors.

Insights: Usually, an MFI promoter is not permitted to exit. And, yet, I've been told that Vikram has sold his stake. What is your position on this?

Chadha: Vikram has sold a small stake in the company. We typically do that in many of our companies. I know in the social sector people frown upon making money. We don't think it's a crime. We think it's okay to make money, we don't think it's anything we have to hide or be embarrassed about. It is ok to do good by doing well.

GROWTH, VALUES, RATES

Insights: You have said you want SKS to “dominate” the industry. But that word has some negative connotations, when we're talking about a social sector. There's talk of SKS poaching a lot of clients from other MFIs. What is your take on that?

Chadha: I think it's very positive. Why should a poor woman have to suffer because it's a social sector, and you can't compete for her attention? If SKS does a better job for that poor woman, that poor woman must benefit. If we charge a lower interest rate, or provide better customer service, I personally think that's a good thing. There should be competition for the poor woman's interests. With SKS a tiny part of the growth has come from taking other people's clients – perhaps five percent. Ninety

five percent of the growth has come from going into new areas where no one has been offering microfinance services. That makes it so exciting.

Insights: SKS has been growing at astronomical rates: in FY 2007-08, it grew at a rate of 200%. At what rate of growth would you say, “Beyond this, it's too risky.”

Chadha: Well, we are slowing down the growth rate. This year the growth is going to come down to slightly above a 100%. The growth rate is slowing down with scale. There are high risks to rapid growth.

Unfortunately, I don't think that if we grow, others can grow at that scale, because SKS is about 25-30% of the market share in the industry, and that share is growing. One of the challenges is that if we want to solve the poverty problem and slow the growth rate, it does have a negative consequence in terms of the whole industry's growth. So there is a strong social feeling in the pressure to grow.

One of the tensions is that we want to make sure that the service quality to clients remains very high, and that we keep following our processes, and our systems. I think what the company has done very nicely last year is to make huge investments in IT systems. There has been a huge emphasis on training. What I find impressive is that if we were to go and visit a center meeting in Bihar versus a center meeting in Andhra Pradesh – the center meetings run exactly the same way. What that standardization allows you to do is not dissimilar to what Henry Ford did with the Model T, and created a car industry in the U.S. This standardization allows you to produce a lot more and a lot faster.

EXITS

Insights: Exit prospects are limited these days. In the current economic environment, MFIs that were planning to IPO have had put those plans on the back burner. What are the most favorable exit options now?

Chadha: I think we are contemplating an IPO for SKS sometime next year, so that will provide an exit. But one thing that we have learned at Sequoia is that we tend to, by nature, be long term shareholders. We are in no hurry to exit. Especially when you see a very special company like SKS where, frankly, I will hold my personal shares for a long, long time. The reason we are contemplating an IPO is primarily because of Vikram's vision to solve the poverty problem in India. Through an IPO we can go out and raise over a US\$100m in new equity. Hopefully that will lead us to 30-40 million members and help us scale this, and solve the problem. To do it we need a lot more capital, and public markets offer us the ability to raise even more money.

Insights: So 2010 is the IPO?

Chadha: That's what we're contemplating. Nothing is done till it's done, but we're thinking about that.

VALUATIONS

Insights: At the Risk Roundtable held by Intelcap in Mumbai in January, about 15 mainstream investors attended, all expressing interest in making a microfinance investment. One of their main concerns: the high valuation paid by Sandstone last fall: US\$400m. Why did Sandstone pay such a high valuation? How does that change things for the overall investing environment?

Chadha: I think Sandstone got a very good deal. My personal thought is that Sandstone will make a lot of money on the last investment round. We don't disclose the multiples— but by traditional multiples, clearly they were high for the last SKS round. We faced the same issue. When we did the Series B investment in SKS in March 2007, we became the largest shareholder in the company. We invested US\$6m as part of a US\$11m round, led by Sequoia. People in microfinance were shocked. They said we were overpaying for the company. What we told people is that when a company is growing at 200% a year, it forgives a lot of sins. One way to think about it is if you pay X, every

year your price is dropping by two thirds, just because the profits are growing so fast, and so what appears high may not be so high if you're willing to take a 3 or 4 year view.

I think generally microfinance valuations are overheated. I think the challenge is that many investors wanted to get into SKS and they couldn't. Frankly, the effect is that everyone is trying to get into the next company. I don't want this to sound the wrong way, but not every company in microfinance is an SKS. Part of the problem has been that there are a lot of companies that have raised money at undeserved valuations in the industry.

Insights: As the goal of growing an MFI is to bring in more customers, more clients---is there a certain value per client?

Chadha: There is definitely value placed on clients. The problem with all those metrics once you are doing a late-stage round – like the last round of SKS, because then you have a real book value, you have real earnings. You have 2 million clients; you have a scale with which you can have real numbers. In the very early stage where we invest because the denominator so small, we find those numbers meaningless.

What we tend to look at more is quality of management team, quality of vision, size of the market opportunity, how big do we think we can be in 4-5 years, and almost always [we take] a minority stake. We prefer minority stakes because we want the entrepreneur and the management to be big beneficiaries of the company as well.

We've found that in the early stages, valuation doesn't matter that much. Whether you invest US\$5m or US\$10m, US\$15m, it tends to be less important. What matters more to us is ownership; we start as a small shareholder and then keep upping. We have found that by the time a company exits, the shareholder that makes more money is the largest shareholder, and it has very little to do with the valuation you paid if you came in early. So we tend to be far more focused on ownership and far less focused on valuations.

Initially the valuations caused shock in a lot of people. But I think today they are shocked they didn't invest in that valuation.

Insights: What do you have to say to critics who claim that private equity investors like

Sequoia, cause over-commercialization, and "mission drift"?

Chadha: I think it happens. I agree with the critics. I think it's very investor-specific. I'm sure that there are key investors that cause mission drift. I don't think every PE investor and every social investor are the same. I know that in the case of SKS and Ujjivan it has not happened. But the other thing I want to point out is that these things are very tricky. As I mentioned, a lot of social investors are for-profit. There is a lot of grey in the world. It's not all black and white.

Insights: Do you think PE investors in microfinance are dwindling now?

Chadha: I think it's definitely gone through a bubble. And I think this sort of market correction has definitely thrown some cold water on it. I know a lot of MFIs in India had high valuation expectations after the last SKS round, I also know many of them have not been able to raise money. You are seeing that imbalance, because unfortunately SKS creates expectations in this industry that not everyone can meet.

Today, when I talk to a lot of PE investors I hear there's a big gap. Microfinance companies come and say they want to raise money at 6x book value. And the PE investor says, "I'll give you money but I'll give it to you 2x book." So there's a big gap in the market which is why you see deals not happening. I won't name names, but if I look at the top five guys in microfinance in India, after SKS, I think four of them are fundraising for eight months and none of them have closed.

There's this big valuation gap. Everybody wants the SKS valuation, but doesn't have the SKS performance. And the key investors want to invest, but not at those prices, especially after the financial crisis, people are far more careful.

Microfinance is a very capital-intensive business, so they will have to keep raising capital for these companies. So at some time these lines are going to cross. I'm seeing a lot of microfinance companies dampen their expectations. I see investors being more willing to come in. But clearly this has gotten way overheated. There's been too much excitement and I think it's like many sectors where the leader will look great, but it's not really clear if everyone else will from a finance perspective.

If you're in a number seven in the industry, maybe there's no IPO or an exit. I think there's a lot of "me too" investing at this stage.

Insights: Do you see SKS or Ujivan making any acquisitions in the near future?

Chadha: I think it's a possibility. Both companies, and I don't want to speak for them,

are open to it. What's interesting is that the organic growth rates are so high today that if you look at just the number of new clients that SKS adds in a month is the size of a mid-size MFI. Part of the reality is that in 30 days we can grow our way into that, so why even do an acquisition? Because doing an acquisition involves a lot of work, a lot of effort a lot of

management integration risk. If the industry growth rate slows down you might see more consolidation. But today there isn't too much pressure on it because of the high growth rates. And also there is a lot of egoism in this industry. ■

Bold Valuation?

Paresh Patel, Sandstone, responds

In late 2008, Sandstone Capital led the largest private equity investment in microfinance, into SKS. In the aftermath, many "mainstream" private equity investors speculated that Sandstone paid too high a valuation. Lindsay Clinton, Managing Editor, spoke with Paresh Patel, CEO of Sandstone, about the rationale behind the valuation.

Insights: While many private equity investors are interested in the sector, many have expressed concern about the high valuation you paid last fall. A lot of investors thought that it was bold. In hindsight, do you think the valuation was right?

Patel: We could have paid a significantly higher price and we still would have made 35%+ IRRs. In fact we recently received an offer for investment from a globally recognized investor at twice the price we paid. It is still early, but we are extremely satisfied with the investment thus far and operating performance has exceeded expectations.

I think the question people had was that we did the deal in the middle of the financial crisis. I think that if that's your question, as an investor, then you haven't done your work, and you don't understand the sector or the business. To us, it's not a bold investment, microfinance is largely unaffected by the global recession and credit crisis. It's a very logical investment: microfinance is a nascent but enormous market and SKS is the market leader in terms of depth of team, size, scope, corporate governance, financial results and balance sheet strength.

Insights: There are various methods of valuation: Price/Book value, Earnings multiple, Cash Flow analysis. Is there a certain value per client?

Patel: That's one way of looking at it. Some people look at cable companies or wireless companies at EV per subscriber. It's possible. That said, I don't think microfinance investments are difficult to justify based on traditional metrics.

The major debate is whether you value these companies on Price to Book (P/B) or Price to Earnings (P/E). We prefer P/E, but certainly the P/B comps from the early days of HDFC, Axis Bank, Compartamos, etc... were extremely high given the early stage in their lifecycles. This sector should be valued similarly. Typically in financial services, institutions are not rewarded with high P/Bs, because to grow, you need to grow your equity, and in growing your equity quickly, there's a lot of dilution (and possibly loan losses).

But the opportunity in microfinance is slightly different. And this also a more nuanced reason of why we're attracted to microfinance. Despite industry-low lending rates, SKS can generate very healthy ROEs, and because of priority sector norms in India, it can sell many loans off balance sheet. Together these mean that the sustainable rate of growth is significantly higher than other financial services companies in India today.

If I look at one of the major banks, from 2003 to 2009, its market cap grew over 500%. Its earnings per share were up only by 70%. Think about that as a shareholder. How much value was really created? The bank financed growth not through high ROEs, but consistently large equity dilutions meant to build scale rather than shareholder value. The market cap goes up, but the existing shareholders aren't benefiting. Microfinance can avoid that. One misconception about microfinance is that huge growth is accompanied with significant equity dilution. You can run these businesses at sustainable rates of growth 40-60% without dilution due to the ROEs and off-balance sheet financing.

Microfinance also benefits from superior credit quality through multiple cycles. In traditional consumer finance or commercial banking gross NPLs will range from 1-5%. In microfinance our experience has been 0.2-3%.

What else is different? A branch network built around consistent and fair processes creates better relationships with borrowers than other rural brands. SKS has been selling a wide variety of products and services through the channel, generating significant fee income.

If you look at these arguments in totality it becomes clear that Price/Book as a metric is not as instructive: (a) microfinance has a different financial model, (b) the industry is early in its lifecycle and (c) above all the industry can be a distribution channel for other products and services. Given these points, DCF and Price to Earnings seem to be more valuable for the next 4-5 years as growth ramps and the distribution channel is utilized ■