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Micawber Capital: For Mission or Profit?

It was a hot Friday afternoon in July 2010 in Mumbai, and Robert Drake, an MBA and senior director at Micawber (mi-KAW-bur) Capital,[1] one of India's largest microfinance organizations, was brainstorming ideas for a big presentation to the company's executives. Drake had been hired from the Gates Foundation in January 2010 and had quickly impressed his superiors. His latest assignment was to recommend a corporate structure and organization for Micawber after its initial public offering, which was scheduled for August 2010.

The IPO would bring Micawber new stakeholders, primarily financial institutions. Drake was skeptical that the new investors would share Micawber's commitment to help alleviate poverty in rural India through microcredit loans; he assumed their primary interest would be a good return on their investments. The two objectives—increasing return on investment and meeting the financial needs of the poor—seemed at odds with each other.

Drake mulled over possible options and how they would be received. How should the interests of clients and investors be represented in strategic decisions? How could the structure and corporate governance of Micawber be modified to balance the potentially conflicting values of the stakeholders?

Realizing he needed a break to clear his head, Drake left to work out at a nearby gym before going home for the day. As he packed his bag, his mind still echoed with the question, "What should I do?"

The Business of Microfinance Institutions

Microfinance institutions (MFIs) were organizations that provided thrift, credit, and other financial services and products in very small amounts to poor populations to foster improved income levels and standards of living.[2]

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[1] The company is fictional yet heavily based on the real-world examples of SKS Microfinance and Banco Compartamos. The exact numbers and situations have been changed based on access to data and information.

[2] Tara Nair, "Institutionalizing Microfinance in India: An Overview of Strategic Issues," *Economic and Political Weekly* 36, no. 4 (2001): 399.

Many large banks deemed extending credit to these populations as too risky and costly; because they had no collateral to offer, they also had no possibility of qualifying for a standard bank loan. MFIs filled the social need to provide financial services to the poor in developing countries through personal contact and face-to-face meetings with lending officers.

Initial microloans were used by small business owners to invest in items such as farming equipment, sewing machines, and even chickens for breeding.[3] These loans were not meant for personal consumption such as food, a car, or personal care. Rather, they were to be used to spark a self-perpetuating cycle of growth and help those living in absolute poverty to help themselves.

In India loans started at about Rs. 800 (about US$20) and averaged about Rs. 4,000 (US$100) for borrowers with good credit history.

Joint Liability Model

Under the joint liability model (or "solidarity lending"), created by Nobel Peace Prize winner Muhammad Yunus with the Grameen Bank in Bangladesh, individual borrowers voluntarily formed groups of about five people that shared the liability of the loan for each of its members. If any member failed to repay his or her loan on time, the other members of the group were required to repay that person's loan. Furthermore, no group member was allowed to borrow more money until the entire group's loan amount had been repaid. As a result of the strong social pressures for borrowers to repay their loans, the joint liability model enjoyed a default rate of 5 percent on average, which was lower than other small, uncollateralized loans.[4]

In the early years of the Grameen Bank's history, lenders found that women had much higher repayment rates, worried more about the social pressures of repayment, and tended to accept smaller loans than men.[5] Women also tended to invest additional income into home and children's welfare. As a result about 75 percent of clients for microfinance loans worldwide were women, and many MFIs lent exclusively to women.[6] Men were also in need of microloans, but their repayment rate was lower (approximately 85 percent[7]), so if they lent to men, MFIs needed to raise their rates to cover the higher incidence of default.

High Costs of Distribution

Most MFIs relied on the interest from their loans to cover their operating costs and loan defaults. Microfinance lending required a lot of labor in environments with little physical infrastructure; to meet with clients, loan officers at Micawber often had to ride scooters for miles on poor-quality roads (if any even existed) and record all transactions using pencil and paper.

As a result of these high operating costs, MFIs charged much higher interest rates than banks did for standard loans. In most of India, the average rate of return microloans needed to remain

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[3] Author's personal experience and estimates.

[4] Mix Market, http://www.mixmarket.org/mfi/trends/calculation_usd.write_off_ratio/2005-2009 (accessed May 17, 2011).

[5] Milford Bateman, *Why Doesn't Microfinance Work?: The Destructive Rise of Local Neoliberalism* (New York: Zed Books, 2010).

[6] Beatriz Armendariz and Jonathan Morduch, *The Economics of Microfinance* (Cambridge, MA: MIT Press, 2005).

[7] Armendariz and Morduch, *The Economics of Microfinance*.

sustainable was 30 to 40 percent.[8] Although the microfinance industry came under strong criticism for charging such high interest rates, the only alternative was borrowing from local moneylenders who charged upwards of 120 percent APR[9] and might arrange for the borrower to have an "accident" if the loan was not repaid on time.

Microlending generated positive returns on equity to shareholders. The average return on equity for MFIs in India was approximately 7.5 percent;[10] returns elsewhere ranged from 3.9 percent in East Asia[11] to 10.7 percent in South Asia.[12]

MFIs in India

Measured by the number of active borrowers, the five largest MFI lenders in India were Micawber, Spandana, Share, Bandhan, and AML. By the end of 2009, Micawber stood above the competition; it had nearly two million more active borrowers and a gross loan portfolio of more than $853 million. See **Exhibit 1** for additional information.

There had been little direct competition between the largest MFIs in India, as the major players had focused on expanding into areas not being served. Most microfinance activity was concentrated in the six of India's twenty-eight states that accounted for 32 percent of the population.[13] See **Exhibit 2** for a detailed map of India and its population density.

Additionally, India had hundreds—if not thousands—of smaller microfinance institutions. These institutions generally were poorly managed, with little or no growth strategy and highly inefficient systems and operations.

Micawber Capital

History

Sai Bhatia, the founder of Micawber, was struck with the severity of the poverty she witnessed during her trip to rural India in 1996. During her trip she saw hundreds of women and families struggling to improve their lives and communities but who were unable to do so because they had no access to financial capital, basic medicine, and sometimes even food. One year later Bhatia quit her job at Credit Suisse, moved to Karnataka, India, and raised US$42,000 to found a nongovernmental organization (NGO) called Micawber. (The name, which refers to "one who is poor but lives in optimistic expectation of better fortune,"[14] is derived from the hopeful character

[8] David Wright and Dewan Alamgir, "Microcredit Interest Rates in Bangladesh: Capping v. Competition," Donor's Local Consultative Group on Finance, March 2004, p. 13.

[9] Ibid.

[10] Mix Market, http://www.mixmarket.org/mfi/country/India (accessed May 17, 2011).

[11] Mix Market, http://www.mixmarket.org/mfi/region/East%20Asia%20and%20the%20Pacific (accessed May 17, 2011).

[12] Mix Market, http://www.mixmarket.org/mfi/region/South%20Asia (accessed May 17, 2011).

[13] Greg Chen, Stephen Rasmussen, Xavier Reille, and Daniel Rozas, "Indian Microfinance Goes Public: The SKS Initial Public Offering," Consultative Group to Assist the Poor, September 2010, http://www.cgap.org/p/site/c/template.rc/1.9.47613.

[14] Merriam Webster, "Micawber," http://www.merriam-webster.com/dictionary/micawber (accessed March 29, 2012).

in Charles Dickens's *Great Expectations.*) Micawber's mission was to improve the lives of impoverished women everywhere through promoting financial independence.

Bhatia knew there was a great need for Micawber; more than 1.3 billion people worldwide—some 70 percent of them women—lived in extreme poverty.[15] She started by hiring program lenders to drive their scooters to villages every week to work with the local women. After a rocky first year, as a result of its strong focus on client service delivery, Micawber's active-borrower base grew by an average of more than 100 percent per year. Micawber grew to include more than 100,000 borrowers, and held a portfolio of Rs. 60 crore[16] (US$16 million) before Bhatia's departure in 2005.

Delivering the Mission

Bhatia made a point of meeting with all new loan officers before they went out into the field. She wanted them—and everyone else working with Micawber—to understand the organization's mission to help lift people out of poverty. Large posters around the office in Karnataka featured pictures and stories of families Micawber had served. Sometimes Bhatia even rode with loan officers so she could reconnect with clients receiving loans.

Though she had a vision of growing Micawber to help those in extreme poverty all over the world, Bhatia focused first on the regions closest to Karnataka. Expanding to other areas would have required a large amount of research and local understanding to deliver the kind of service Micawber provided, and Bhatia and her management team were committed to reaching and serving clients efficiently so they could keep interest rates low.

Bhatia was constantly challenged to secure enough funding to keep up with Micawber's expansion. More money enabled her not only to expand Micawber's client base but also to invest in information systems to reduce costs and scale operations.

From NGO to IPO

> *Microfinance is not a highly profitable business or activity . . . . It's a very good thing to get the money to reach the poor. To meet capital needs and to reach more people, [a microfinance institution] must go the IPO route.*
>
> —C.S. Ghosh, founder and CEO of Bandhan, a Kolkata-based microfinance institution[17]

When Bhatia retired from Micawber in 2005, the board of directors named Evan Drago as CEO. Drago recognized that Micawber's NGO structure had limitations as well as benefits. As an NGO, Micawber enjoyed fewer and less stringent legal and regulatory restrictions than a for-profit institution, but it did not have ready access to capital that would enable significant growth and greater social impact (see **Exhibit 3**).

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[15] United Nations Report on the World Social Situation, 1997.

[16] 1 crore is equivalent to 10,000,000 Indian rupees.

[17] Christie Thompson, "SKS Microfinance IPO: Interview with C.S. Ghosh of Bandhan Microfinance," *Microfinance Insights*, July 31, 2010.

Drago looked into alternative corporate structures. Many of Micawber's competitors had converted from NGOs into nonbanking finance corporations (NBFCs),[18] mainly to raise capital from institutional investors. All NBFCs were regulated by the Reserve Bank of India and were required to use formal accounting and financial reporting standards.

In December 2005, Drago succeeded in persuading the board of directors to convert Micawber from an NGO to an NBFC as a way to raise capital to expand its client base and create an incentive for it to become more efficient and accountable for its operations.

Micawber as an NBFC

To convert to an NBFC, Micawber created three mutual benefit trusts (MBTs) (see **Exhibit 4**). The assets of the“old” Micawber NGO were transferred equally into the MBTs, which in turn invested in roughly US$1 million in Micawber for a 49 percent share of the newly formed NBFC. This resulted in clients becoming indirect shareholders in the new for-profit Micawber Capital. An additional US$2 million investment from private equity and commercial investors in the United States purchased a 20 percent share. The remaining 31 percent was held by the Indian government (see **Exhibit 5**). The NBFC also created a new NGO called Micawber Humanity.

The primary beneficiaries of the MBTs were the clients they served. Each MBT was governed by a body of fifty elected clients who ensured their interests were represented. When the MBTs were formed, Micawber named a trustee for each to make decisions on behalf of its shareholders. In the months following the NBFC conversion, the newly designated trustees disagreed with the Micawber board of directors about the extent of the MBTs' role in corporate governance. After many changes and revisions to the trustee arrangements, several trustees resigned.[19] Ultimately, the decision-making power of the MBTs was left solely with Drago and with Ajay Patel, the new director of Micawber Humanity.

Even after the changes, governance problems remained. The purpose of each MBT's governing general body was to hold its designated trustee accountable, but the clients elected to serve on the general body did not have enough sophistication or experience to appreciate the financial decisions being made by the trustees. Additionally, it proved difficult for clients to disagree with their trustee when he was also the CEO of the company that provided their financial lifeline.

Additional rounds of financing after the initial NBFC resulted in the private equity and commercial investors owning a majority share of Micawber prior to the IPO (see **Exhibit 6**).

Public Discontent

The infusion of $2 million capital led to rapid growth of new clients and new products. Within the first three months, Micawber hired more financially sophisticated employees, including one hundred new loan officers, each of whom could serve an average of 350 clients. By 2008, Micawber also began offering life insurance, money transfers, and pension funds. The

[18] Chen et al., "Indian Microfinance Goes Public."

[19] Ibid.

combination of new products and new clients raised Micawber's return on equity from 10 percent in FY2008 to 20.5 percent in FY2009.

Micawber's moves were not universally admired, however. In 2009 a local newspaper accused the company of taking from the poor to enrich private shareholders. The writer found it absurd that Micawber was charging high interest rates and doubling its return on equity. Calling for lower interest rates instead of more borrowers, the writer criticized Drago personally, accusing him of wanting to build an "empire."

Despite the negative press, Drago felt confident that converting to an NBFC had been the right decision. He saw no conflict between Micawber's mission and increasing its value; firmly believing the company was truly bettering the lives of those it served, he looked for opportunities to further increase its size and services. With more access to capital, he argued, Micawber could expand faster, reach more people, and achieve a higher degree of self-sustainability.

Yet the criticism continued. A few months later, another editorial questioned the social benefit of MFIs, claiming that they were no longer "helping the poor help themselves." The explosion of MFIs in India, combined with their increasingly commercial orientation, caused concern among social activists in the region—and around the world. The writer singled out Micawber's fast growth and focus on profits in the saturated Indian market, warning that it and similar MFIs risked outstripping their internal controls and ultimately eroding credit discipline.[20]

"So we make a profit, big [expletive] deal!" Drago said at his weekly managers' meeting. "The whole idea behind this type of industry is to make money while benefitting the poor. Consumer packaged goods companies sell small packets of detergent to millions of people and make good money while doing it. There's demand for our products at these interest rates, and the more profitable we are, the more people in need we are able to reach. It's part of the market. If anything, we need to take this company a step further and find more investors."

The Move to an IPO

Under Drago's leadership, Micawber expanded to cover twelve states and grew its portfolio to Rs. 3,400 crore (US$850 million), with 5.2 million borrowers by the end of 2009. However, Drago realized that continuing the company's growth required a constant stream of equity investment and a board of directors skilled in scaling organizations quickly. In November Micawber's executive team initiated the process of filing for an IPO on the Bombay Stock Exchange (BSE).

Micawber needed to make significant operational and governance changes in preparation for becoming a public company: It needed to keep more transparent financial records, be accountable to a larger number of shareholders, and prepare for more public scrutiny.[21] Rules also limited the number of relatives who could serve as directors and required that at least one-half of the directors be independent from management. Other regulations barred transactions between related parties.

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[20] Ibid.

[21] Ibid.

Drago began looking for a leader skilled in organizational structure who shared his passion for social enterprise. Robert Drake was hired in January 2010, seven months before the IPO was scheduled. His first assignments were mainly compliance projects ensuring Micawber had all its business processes in order.

Drake knew that life for Micawber after the IPO would never be the same. The IPO would bring new key stakeholders, new regulations, and of course the opportunity to reach many more clients. New voices would be at the table when decisions were made, and Drake worried that the stakeholders would not all agree on the objectives for Micawber's business.

Stakeholders

Commercial Investors

The private equity companies and other commercial investors, which included BNP Paribas and Morgan Stanley, were pleased with the performance of their investments in Micawber. Of the eleven seats on the board of directors, four were held by these large institutional shareholders.

Drake had little doubt that these institutions' primary interest was Micawber's high financial returns. Some of them had already gone as far as suggesting the company expand microloans to male borrowers and raise interest rates to further increase Micawber's returns. Their demands for aggressive expansion were moderated by an aversion to reputational risk, however; they did not want to risk alienating any of their stakeholders by owning shares in an MFI that generated too much negative publicity by charging unusually high interest rates.

Microloan Clients and MBTs

The clients on the MBT governing boards were unhappy that their ownership share had been diluted to 17 percent before the IPO (see Exhibit 6). Not only did they feel poorly represented in the decision-making process, they also did not trust Drago's intentions, especially once they learned his Micawber options would be worth US$42 million after the IPO. In addition, Micawber Humanity was all but ignored; it had not received significant funding for community development and aid projects since the decision to file for an IPO in November 2009.

Decision Time

The major question confronting Drake was how Micawber should be structured after the IPO. Micawber had grown so rapidly that it desperately needed investment in information systems, as well as additional loan officers and innovative new products. After the IPO, new stakeholders likely would encourage further growth and expansion, perhaps by diversifying into new financial products, acquiring other MFIs in India, or even venturing into other businesses in the banking industry. The IPO could also enable Micawber to expand into more rural areas with extreme poverty and provide its products and services to new clients.

Drake was concerned that even socially motivated expansion could look like "empire building" to an already sensitive media. He needed to come up with a structure that would integrate the new demands for shareholder returns with the original mission of alleviating poverty through microlending. Drake knew that Micawber needed to alter the composition of the new board of directors to find a better balance between the seemingly disparate desired outcomes after the IPO—but how? What other aspects of the structure and corporate governance should be changed? What should the partnership of Micawber and Micawber Humanity look like going forward?

As he left for the gym, Drake knew the weekend ahead would not be as relaxing as he had hoped. In the morning he would need to begin formalizing his proposal of the best structure for Micawber to grow profitably and fulfill its social purpose.

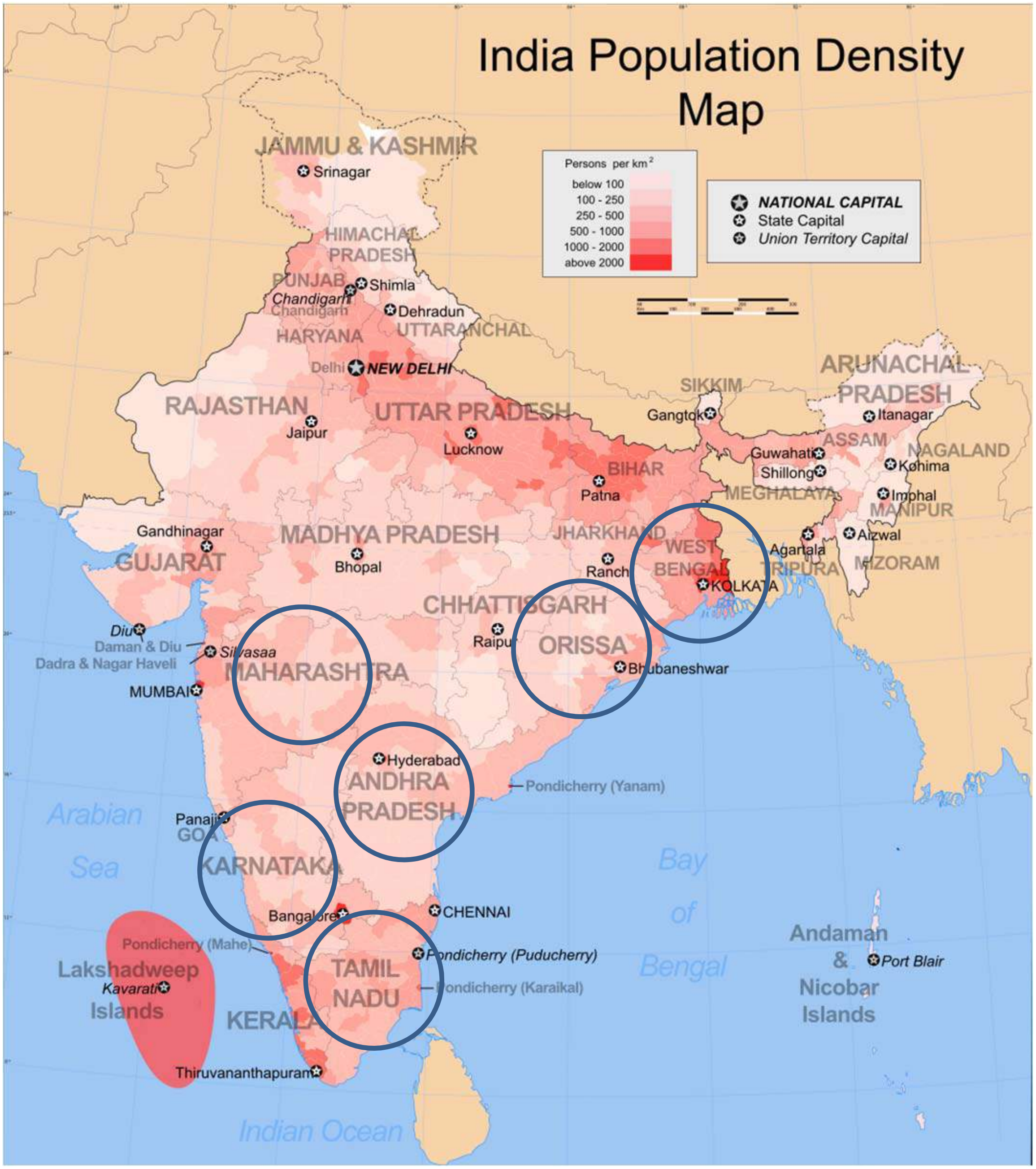
Exhibit 1: Top Five MFI Lenders in India Based on Number of Active Borrowers, 2009

Name	Number of Active Borrowers	Gross Loan Portfolio (US$)	Returns on Equity (%)	Operational Self-Sufficiency[a] (%)
Micawber	5,235,004	853,360,344	20.50	138.88
Spandana	3,662,846	787,304,262	55.67	180.04
Share Microfin Ltd.	2,357,456	643,763,103	45.18	154.94
Bandhan	2,301,433	332,462,204	38.21	158.30
AML	1,340,288	315,439,007	40.07	146.66
Industry average in India	9,993	4,758,007	7.55	109.12

[a] Operational self-sufficiency is the percentage of operating expenses covered by operating income.

Source: Mix Market, http://www.mixmarket.org/mfi/country/India (accessed May 2011).

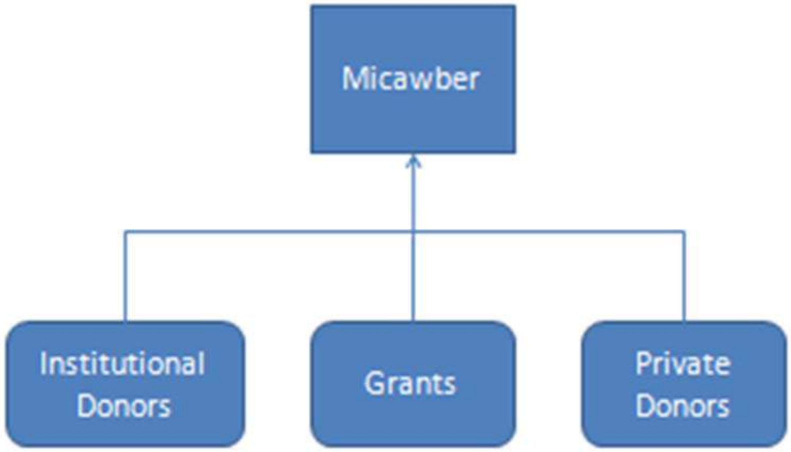
Exhibit 2: Map and Population Density of India Based on 2001 India Census Data



Note: Circles indicate the six states with the most MFI clients.

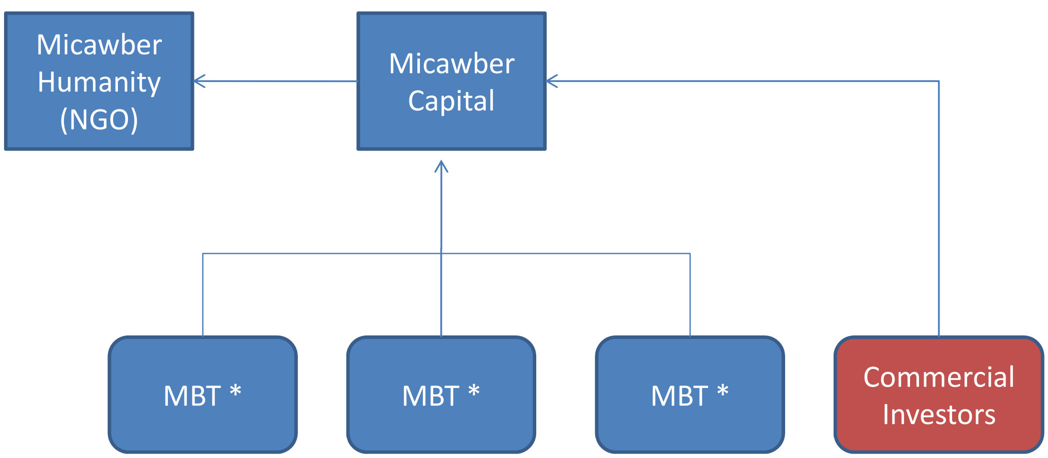
Source: Wikipedia, "India Population Density Map," 2011.

Exhibit 3: Micawber NGO Funding Structure



Note: Arrow indicates the direction of funding.

Exhibit 4: Micawber NBFC Funding Structure



Note: Arrows indicate the direction of funding.

* Each MBT was governed by a fifty-member general body of Micawber clients.

Exhibit 5: Micawber Ownership, January 2006

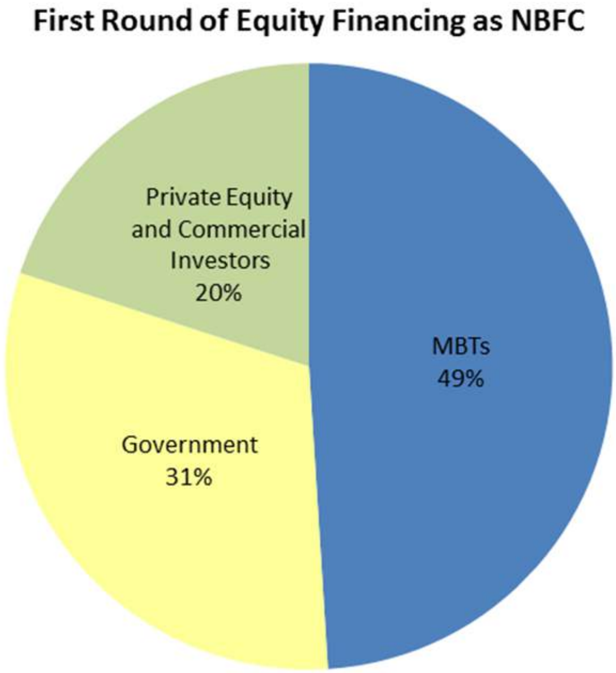


Exhibit 6: Micawber Ownership, July 2010