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FOCUS NOTE

Indian Microfinance Goes Public: The SKS Initial Public Offering

On 28 July 2010 SKS (www.sksindia.com), India's largest microfinance institution (MFI) with 5.8 million clients, became the first MFI in India to float its shares through an initial public offering (IPO).[1] The IPO was successful by any financial market standard: the offering was 13 times oversubscribed and attracted leading investment groups, such as Morgan Stanley, JP Morgan, and George Soros' Quantum Fund. The company valuation reached the top of the offer band price at US$1.5 billion,[2] and five weeks after trading began, the share price rose 42 percent.

SKS is among a handful of MFIs globally to have gone public,[3] following the pathbreaking IPO by Banco Compartamos in Mexico in 2007 (see Rosenberg 2007). SKS is also the first to list its shares in the competitive and fast-growing Indian microfinance market. Over the past four years Indian MFIs have grown from 10.5 million to 26.7 million clients (Access Development Services 2007, 2008, 2009, and forthcoming), and for the past three years SKS has stood at the top of this market in terms of size and access to capital. Globally, SKS has been among the fastest growing MFIs in the world, with a compound annual portfolio growth rate of 165 percent since 2004.

The IPO is important not only because SKS is an influential player in a big market but also because it marks an important transition—for the first time individual investors in India can buy shares of an MFI. The IPO and its implications are also being watched carefully by investors, managers, and policy makers around the world, fueling conversations about the rewards and risks of tapping into mainstream capital markets.

This paper has been published to share facts, ask questions, and contribute to the global discussion of this milestone event. The first part of this paper briefly describes the main features of the microfinance sector in India and provides background about SKS. The next section analyzes the details of the IPO transaction and the high valuation. The paper concludes with a discussion of the possible implications of the IPO, especially for poor people.

Our analysis is based on information available at the time of publication, drawing from a range of sources, including market data, press reports, and the documents SKS was required to submit to the Securities and Exchange Board of India (SEBI) as part of the IPO process. In addition, the founder and chairman of SKS, Vikram Akula, provided comments to a draft of this paper. As this paper was published just weeks after the IPO, we expect that as more time goes by more information may become available and other insights and issues are bound to emerge.

The Setting: Microfinance in India

Three quarters of India's 1.2 billion inhabitants live on less than US$2 per day (World Bank 2005), making it by many estimates the largest potential microfinance market in the world. India has long recognized the unmet financial needs of poor people and has initiated and supported many progressive financial inclusion efforts beginning as early as the 19th century. Notable examples include the postal savings bank, cooperative financial institutions, and regional rural banks. In the past 20 years two other approaches have gained prominence: self-help groups (SHGs), which borrow directly from banks and extend credit to 4.5 million groups whose membership includes 58.5 million individuals, and standalone MFIs that reach 26.7 million clients (Access Development Services forthcoming). Both the SHG approach and MFIs have been aided by the Reserve Bank of India's priority sector lending policy, which requires domestic banks to lend significant portions of their loan portfolio to underserved sectors and small producers. Lending to SHGs and MFIs meets part of this requirement.

Ten years ago most Indian MFIs operated as nongovernment organizations (NGOs) focused on

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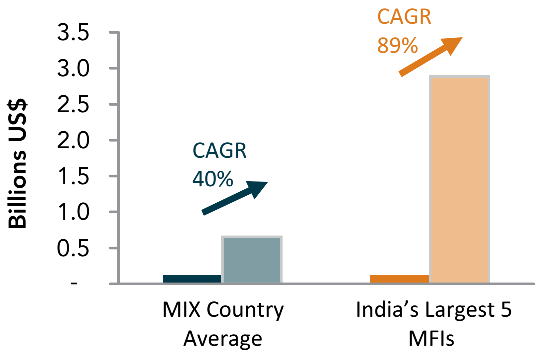
1 At least one other MFI in India, Capital Trust, is publicly traded, but this was a company that switched to microfinance from another line of financial sector work and was therefore not put through an IPO as a microfinance lender.
2 Unless otherwise indicated, all SKS and Indian MFI data are as of 31 March 2010, using the exchange rate of US$/INR 44.97. For IPO-related data, the US$/INR exchange rate used is 46.5, the prevailing rate at the time of the IPO.
3 In addition to SKS and Banco Compartamos there are a few other publicly traded financial institutions with microfinance operations or close links to microfinance. Several are discussed in Lieberman et al. (2008).

Figure 1: Portfolio growth 2004–09



Source: MIX Market. CAGR = compound annual growth rate

adapting the group-lending model from Bangladesh. At that time a few NGO MFIs began to transform to nonbank finance companies (NBFCs) in order to tap equity investment. This shift in legal form enabled MFIs to raise more capital and grow much faster (see Figure 1), and NBFC MFIs now account for more than four-fifths of all MFI loans, dominated by the five largest MFIs, including SKS (Intellecap 2010). The largest MFIs in India get most of their equity from commercial sources and can leverage that equity with borrowings from banks relatively easily.

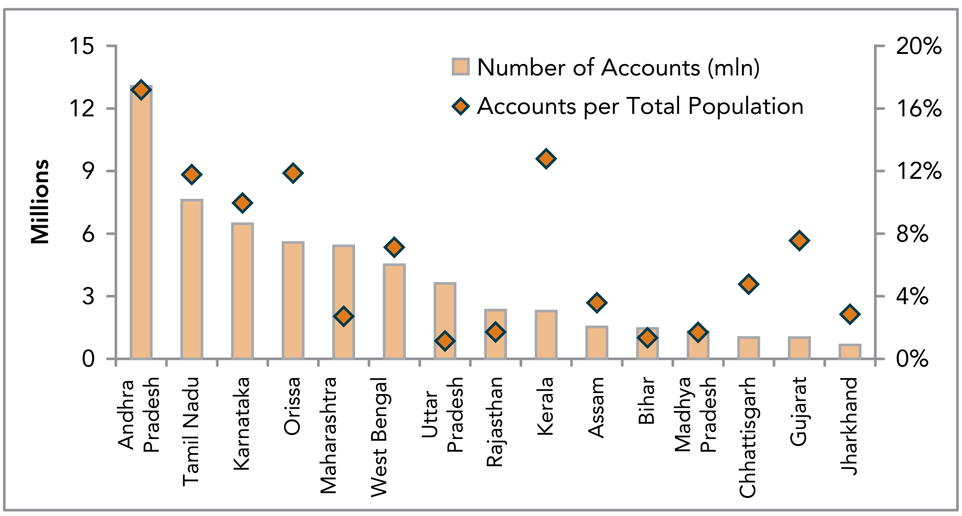
Microfinance growth has been concentrated in six of India's 28 states. These states have 70 percent of all MFI and SHG clients even though they account for only 32 percent of the population (Figure 2). And unabated rapid growth in parts of these markets that may already be saturated could heighten market vulnerabilities (Chen, Rasmussen, and Reille 2010). The resulting competition among lenders gives clients more choices, but it can also lead to multiple MFIs and SHGs lending to the same clients. This may introduce new market dynamics and change client relationships in ways that lead to repayment problems. Leading MFIs in India are aware of these pitfalls and recently formed the Microfinance Institutions Network (MFIN), an association comprising almost all of the large MFIs, to enforce a code of conduct and build a microfinance credit bureau (Mahajan and Vasudevan 2010). It remains to be seen whether MFIN's collective actions can effectively manage these risks. In the meantime MFIs continue to grow at a fast pace.

The company

SKS traces its roots back to SKS Society, an NGO established in late 1997. In its early years, SKS Society was funded by individual and institutional donations[4] and remained focused on markets within its home state of Andhra Pradesh. By April 2005 SKS Society launched an aggressive growth plan, expanding beyond Andhra Pradesh for the first time and going through the process of transferring its microfinance operations to a new NBFC named SKS Microfinance, but known simply as SKS.

SKS's core business is the delivery of basic credit products common to many MFIs in South Asia, with

Figure 2: Combined SHG and MFI outreach



Source: Access Development Services 2009

4 CGAP provided a US$50,000 grant to SKS Society under a Pro-Poor Innovation Challenge Program in 2001.

a standard 50-week, group-based loan making up 85 percent of its portfolio. Most of the remaining portfolio consists of smaller supplemental loans made to clients who already have a standard loan. Additional services, such as the distribution of life insurance policies, generate noninterest income that makes up about 6 percent of SKS's total revenue.

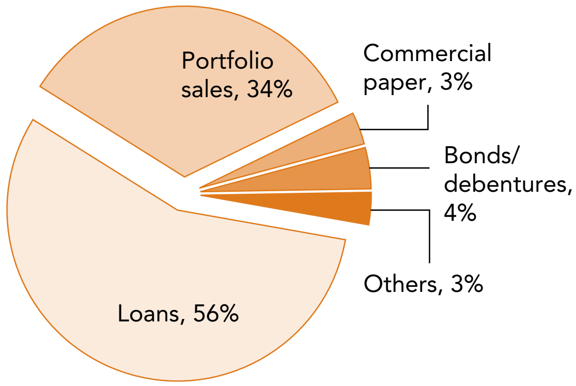
SKS's founder and chairman, Vikram Akula, motivated by the desire "to never have to say no to any poor person who is simply asking for an opportunity," drew inspiration from scalable for-profit business models (GlobalX 2008). When designing loan officer training programs, for example, SKS learned from McDonald's and Starbucks and developed training processes that allow SKS to train more than 500 new loan officers per month and add more than two new branches per day.

SKS has further innovated by drawing heavily on commercial venture capital from outside India to fuel its growth. Two of the early investors, Vinod Khosla and Unitus[5] were both closely connected to the U.S. venture capital community, and they proved influential in later bringing on board California-based Sequoia Capital, a leading global private equity firm with no prior investments in microfinance.

Aside from access to private equity, SKS's other funding is more typical of Indian MFIs, with 90 percent of its portfolio funded in local currency by Indian banks and financial institutions, either through loans or portfolio sales. Other sources of funds are small (Figure 3), with no funding from savings since NBFC MFIs are effectively barred by regulation from mobilizing deposits.

SKS remains closely affiliated with its NGO predecessor, SKS Society, which carries out a variety of development programs. This includes a pilot Ultra Poor project that uses grants to build the capacity and assets of people who are too poor to participate directly in mainstream microfinance with the aim of helping them eventually graduate into

Figure 3: Sources of portfolio funding



Source: SKS company data

becoming microfinance clients.[6] SKS Society also has an education program operating 55 pilot schools, and it recently formed a partnership with the health campaign Deworm the World, which leverages the outreach of SKS to distribute deworming tablets to the children of SKS's borrowers.

Financial performance

For the past four years SKS has been known mostly for its pursuit of growth (Figure 4). Impressively, this growth has been matched with a strong increase in profitability.

Its 2010 return on assets of 5 percent is consistent with the largest five Indian MFIs (Table 1), although its return on equity (ROE) at 22 percent significantly trails this peer group. The latter is largely the result of SKS's far lower leverage, which leaves it with substantial room for increasing investor returns by borrowing more to fund growth (Figure 5).

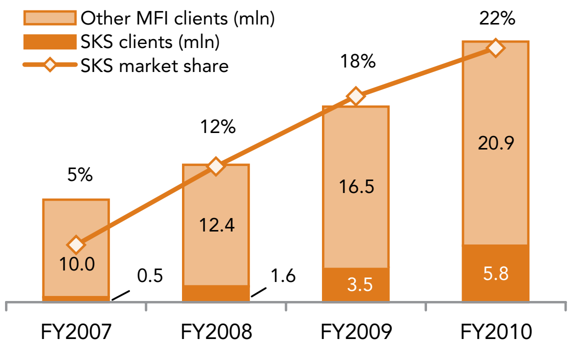
On the revenue side, SKS's portfolio yield, at 25.7 percent, is in line with its Indian peers, but significantly lower than the 33 percent 2009 global median for all NBFIs reporting to MIX.[7] At the same time, SKS also stands out for the high share of revenue it earns as noninterest income, including portfolio sales and insurance fees and commissions. Within India, SKS earns significantly more nonloan revenue than its peers.

5 Khosla is a co-founder of Sun Microsystems, a U.S.-based information technology firm. Unitus is a U.S.-based nonprofit microfinance organization that invests in SKS via its affiliated Mauritius Unitus Corporation. Unitus the nonprofit recently announced a decision to wind down its microfinance functions.

6 This program is one of nine worldwide pilots that are affiliated with the CGAP–Ford Foundation Graduation Program, which adapts the successful BRAC Bangladesh Ultra Poor program in other settings. Under this program SKS Society has received some funds and other support.

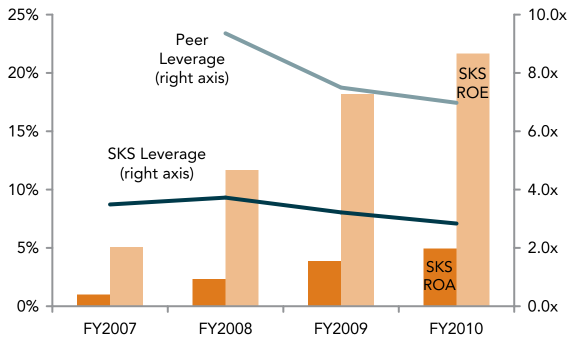
7 Extensive portfolio sales by SKS and its Indian peers create distortions when using yield as a proxy for the effective interest rates being paid by clients, though it is the closest metric available at the present time.

Figure 4: Growing share of a growing market



Source: SKS company data, Access Development Services

Figure 5: Rising ROE despite decreasing leverage



Source: SKS company data, MIX market

The cost structure, while low by global standards, sets SKS apart from its Indian peers. Investments in branches, staff, and systems required to support rapid growth have inflated the company's operating expense ratio (OER) to 10.2 percent, well above that of its competition. However, costs have also shown steady improvement, with OER falling significantly from 2007 to 2010 (Figure 6). Part of this improvement may be attributed to gains in operating efficiency as well as a maturing client base that generates higher average loan balances. Once the pace of growth slows and more clients mature, OER should decline further.

Table 1: SKS and its peer groups

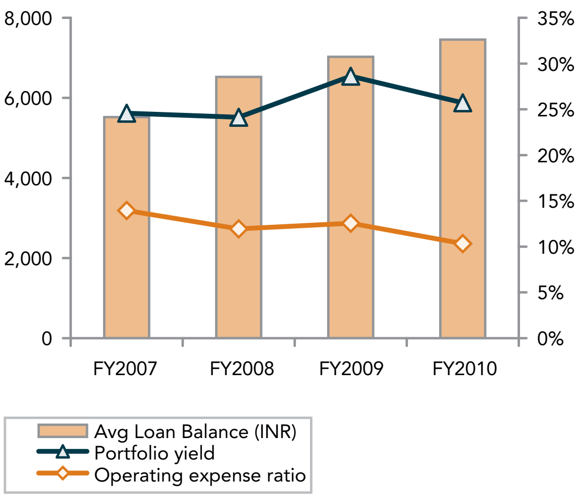
	SKS	Largest 5 Indian MFIs (median)	MIX Largest 150 NBFIs (median)
ROE	22%	40%	11%
ROA	5.0%	5.0%	2.1%
Debt/equity	3.2	7.9	4.1
Portfolio growth (08–09)	54%	68%	21%
Portfolio CAGR (5 yrs)	166%	89%	36%
Portfolio yield	25.7%	25.9%	29.0%
Nonloan income/assets	1.6%	0.2%	n/a
Operating expense ratio	10.2%	6.4%	14.5%
Financial expense ratio	8.8%	9.1%	6.5%
PAR30	0.40%	0.28%	3.95%

Notes: Portfolio growth & CAGR, OER, and Yield include sold portfolios; Operating expense ratio = Operating expense / average loan portfolio; PAR30: PAR30 / average loan portfolio
Source: MIX (2009), annual reports for SKS and Indian MFIs (March 2010)

Equity funding: The road toward the IPO

By August 2005 the new SKS NBFC was operational, having completed its transformation via the creation of five MBTs (see Box 1), which became the new company's initial shareholders. In March 2006 SKS raised its first round of equity totaling US$1.6 million from Unitus, the Small Industries Development Bank of India (SIDBI), Vinod Khosla, and Ravi Reddy.[8] Using the proceeds,

Figure 6: Improving efficiency



Source: SKS company data; ratios account for portfolio sales

8 SIDBI is a government-owned financial institution that promotes small enterprises. Its financing of MFIs is mostly through lending, although it has minority shareholdings in SKS and several other NBFC MFIs. Reddy is co-founder of Vistaar Technologies.

Box 1. Mutual Benefit Trusts—What's at Stake for SKS's Clients?

Several MFIs in India that began as nonprofit NGOs have shifted their operations to for-profit NBFCs. To manage this shift in the Indian regulatory environment, these MFIs transferred assets to newly created mutual benefit trusts (MBTs), which in turn invested in the shares of newly formed NBFCs.[a]

In the case of SKS, five MBTs were created with donations from SKS Society and other sources, and these MBTs in turn injected equity into the newly formed SKS. The structure of the MBTs also ensured that SKS's clients were the targeted beneficiaries of the trusts. In all, the five MBTs made investments in SKS totaling US$7.9 million, of which US$0.9 million came from philanthropic sources. The remaining US$7.0 million was funded indirectly by private equity investors via two separate transactions.[b] At the time of the IPO, the shareholdings of the five MBTs were worth US$220 million. The potential benefit to SKS clients from this windfall is a positive and innovative feature of the IPO.

However, it is a complicated matter to establish mechanisms to include the voices of millions of clients and represent their interests. This task is all the more challenging for a company the size and complexity of SKS subject to laws and regulations that can sometimes be difficult to understand and comply with. In addition, the MBTs were established five years ago when SKS was a much smaller organization largely focused in the state of Andhra Pradesh. As SKS has grown, the MBTs face the daunting challenge of effectively representing a much larger number of clients throughout India.

At the time of the IPO each MBT was governed by a 100-member general body elected from among SKS clients. The MBTs' legal documents, designed by SKS Society, named trustees to make decisions on behalf of the MBTs. In the months leading up to the IPO the trustee arrangement underwent some revisions with several trustees resigning, leaving only Vikram Akula, the founder and chairman of SKS, and Ankur Sarin, a former director of SKS Society, as the two trustees. This placed considerable decision-making powers in the hands of two individuals with close connections to SKS or SKS Society. In theory each MBT's general body holds the trustees accountable, but given that the trustee arrangement was originally structured by SKS Society and that clients are unlikely to have the knowledge or experience to fully appreciate the financial decisions being made, it is not clear how well accountability works in practice. Moreover, it could be difficult for SKS clients to hold accountable the founder and chairman of the company that provides them financial services.

The challenge of MBT governance was underscored by the MBTs' January 2010 gift of SKS stock valued at US$1.3 million (about 1 percent of the MBTs' total assets at the time) to the family of Sitaram Rao, a former managing director of SKS who unexpectedly passed away in 2009. Rao had helped build SKS, was the director nominee of the MBTs on the SKS Board, and was instrumental in negotiating with SKS investors to enable the MBTs to retain significant shareholdings in SKS. There is not enough information available to draw definitive conclusions about the propriety of the gift. For example, it would be useful to know if the views of other investors were sought or if other options were explored to provide compensation from the company or investors in a way that did not diminish the holdings of the MBTs. However, the size of the gift raises questions and also highlights the potential deficiencies in the accountability and oversight of the MBT trustees.

In the months and years ahead the governance demands upon the MBTs will, if anything, increase. The MBTs' shares are worth large sums, and although much of the shares are locked in for a few more years, the US$42 million in cash the MBTs have already received from the IPO sale need to be managed with care. The intention of the MBT legal documents and the MBT trustees is to donate the proceeds to SKS Society, which was the institution that created the MBTs in the first place. Among other things, SKS Society aspires to rapidly expand the number of schools that serve the children of SKS clients. However, SKS Society is still a small NGO and does not have a track record of operating at a national scale or of absorbing the amount of funds the MBTs aim to provide. The MBTs do have some discretion about the use of funds, and it is worth examining the priorities and capabilities of SKS Society, the possibility of the MBTs funding other NGOs instead, and even the possibility

(Box continues on next page)

Note: This Box draws on Kumar and Rozas (2010) and key facts about the MBTs provided by Vikram Akula. Many details were further confirmed from SKS annual reports and the SKS draft and final red herring prospectuses.

[a] The use of MBTs by MFIs in India has been common. However, the specific transactional details of each MFI are probably different in important ways and should be examined on a case-by-case basis.

[b] The first transaction happened in 2006 when SKS used investor capital to purchase SKS Society's portfolio at a premium (approximately US$1.25 million). SKS Society in turn transferred most of these funds back to the MBTs to invest in SKS. The second transaction was in January 2008 during the third equity round when the MBTs were allocated shares valued at US$6.1 million in return for an initial payment of only 5 percent of this amount. The remainder was paid nearly two years later, in December 2009, funded by a loan from another SKS investor. Notably, the valuation at which these shares were finally purchased was at the original January 2008 price, or nine times below the prevailing price in December 2009. The advance purchase at the low price amounted to a capital gain of about US$50 million for the MBTs.

Box 1 (Continued)

of SKS clients receiving cash payouts. Installing trustees who are qualified, independent individuals without prior or current affiliations with either SKS or SKS Society would help ensure that decisions will be based on the best interests of SKS clients.

There is also the ongoing challenge of representing the interests of SKS clients on the board of SKS. At present clients' interests are primarily represented by Akula, who himself has a large amount of his own financial interests in SKS shares. Having this kind of influential voice in the past helped the MBTs obtain and hold a substantial stake in SKS. Going forward it will be important to consider the best way to represent the interests of SKS clients as SKS continues to grow in size and sophistication.

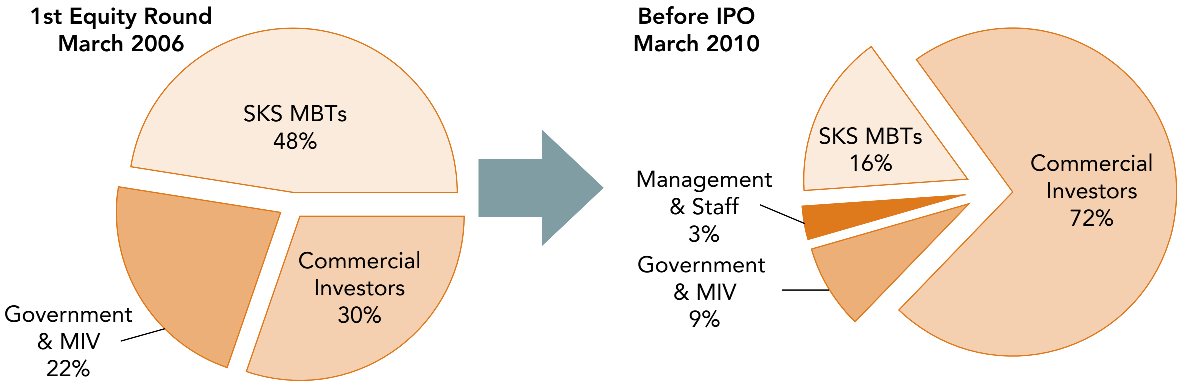
SKS purchased the microfinance operations and loan portfolio from SKS Society for US$1.25 million, or 3.5 times book value, a substantial premium over the 1.7 times median book value paid for MFIs worldwide in 2005 (Reille 2010). In turn, SKS Society channeled nearly all of the sale proceeds back to the MBTs to enable them to purchase additional shares in SKS.

In March 2007 SKS closed a second round of equity financing totaling US$12 million led by Sequoia. Only nine months later SKS secured an additional US$37 million in a third round, mainly raised from existing shareholders, including another US$4.7 million from Sequoia. This trend continued even with the global financial crisis unfolding during the fall of 2008 when SKS closed a fourth funding round for US$75 million led by Sandstone Capital, another mainstream private equity fund with no prior deals in microfinance.

In all, from 2005 to 2009, SKS grew from a company owned largely by the original MBTs to one owned mainly by private equity investors (Figure 7). And by 2009 it was widely known that SKS was preparing for an IPO as a potentially lucrative exit for its equity investors.

During the final months of preparations for the IPO a number of notable stock transactions were completed. In January 2010 SKS sold a 1.5 percent stake to Catamaran Fund, which was created by the well-known Infosys founder Narayana Murthy. This stake was sold at the bargain price of Indian rupees (INR) 300 per share, less than half the price of other private equity sales by SKS at that time. Murthy was also named chairperson of a new advisory board of SKS, putting the name of one of the most respected investors in India behind SKS and bolstering the company's credentials leading into the IPO (Chanchani 2010).

Figure 7: Evolution of SKS ownership



Source: SKS company data

There were also significant sales of stock by key personnel in the months leading up to the IPO, including by Chairman Akula and CEO Suresh Gurumani. Each exercised about a quarter of the options they had been granted in 2007–2008, netting US$11.9 million and US$1.6 million, respectively (see Box 2). Both individuals have locked in their unexercised options, valued at a combined US$85 million, for three years following the IPO, thus helping align their financial incentives with the longer term stock performance of the company. While stock options for senior managers are common in mainstream business, executive compensation is a hotly debated subject globally in view of the recent financial crisis. The SKS IPO has prompted many to question if these high levels of executive compensation are healthy or sustainable for an organization or industry whose clients are the poor. (See Table 2 for a list of SKS directors at the time of the IPO.)

SKS Timeline

1997

- SKS Society (NGO) founded

2003 11,000 clients

- MBTs created, capitalized with $500,000 from private donations
- SKS created, with MBTs as the sole (99.5%) investors

2005 74,000 clients

- SKS registers as NBFC
- SKS purchases SKS Society's portfolio; sale proceeds transferred to the MBTs

2006 173,000 clients

- First equity round ($1.6 million)
- MBTs invest additional $1.0 million

2007 513,000 clients

- Second equity round ($12 million)
- Sequoia buys 19% stake

2008 1,630,000 clients

- Third equity round ($37 million)
- MBTs purchase partly paid shares (see Box 1)
- Sequoia increases stake to 27%
- Vikram Akula resigns MD/CEO post; continues as chairman

2009 3,520,000 clients

- Fourth equity round ($75 million)
- MBTs pay outstanding balance for shares issued in 2008
- Sandstone buys 12% stake

2010 5,800,000 clients

- Shares issued to Murthy's Catamaran Fund
- IPO raises $155 million

The IPO

To execute the transaction, SKS management selected Citigroup Global Capital Markets, Kotak Mahindra Capital, and Credit Suisse Securities (India), an investment banking consortium that combined local Indian market knowledge with links to global institutional investors. On 28 July 2010 SKS floated a 23.3 percent stake on the Bombay and National Stock Exchanges for US$350 million. The deal consisted of 10.3 percent new issuance amounting to US$155 million in fresh capital for SKS. An additional sale offer by existing shareholders of 13.0 percent of post-issue stock generated US$195 million back to the selling shareholders. These selling shareholders (the promoter group) each sold about one-quarter of their shares in the IPO, and to comply with regulations, locked in about 60 percent of their remaining holdings for three years. The promoter group consists of affiliates from three private investor groups—Sequoia, Kismet, and Unitus—as well as the MBTs (see Appendix I for a full list of investors).

The deal was well received by the stock market, with the total offering 13 times oversubscribed at the top of the pricing band of INR 850–985 per share. Retail investors who were eligible for a pricing discount of INR 50 per share oversubscribed by 2.8 times.[9] The deal proved particularly popular among

9 Indian IPO information site: www.chittorgarh.com/ipo/ipo_detail.asp?a=253

Table 2: SKS Directors at the time of IPO

Name	Category	Description
Vikram Akula	Management	Chairman and Founder of SKS
Suresh Gurumani	Management	CEO of SKS
V. Chandrasekaran	Investor Nominee	Nominee and Former Executive Director of SIDBI
Sumir Chadha	Investor Nominee	Nominee and Managing Director of Sequoia Capital India
Ashish Lakhanpal	Investor Nominee	Nominee and Managing Driector of Kismet Capital
Paresh D. Patel	Investor Nominee	Nominee and CEO of Sandstone Capital
Geoffrey Tanner Woolley*	Other	Former board member of Unitus; venture capital executive
P. H. Ravi Kumar	Other	Financial services executive
Tarun Khanna	Other	Professor, Harvard Business School; expert on emerging markets
Pramod Bhasin	Other	Offshoring industry executive; CEO of Genpact

** From 2006 to 2009 was Investor Nominee of Unitus, then reappointed as SKS Director in his individual capacity*
Source: SKS Company data

international institutional investors, with leading global financial institutions, such as JP Morgan, George Soros' Quantum Fund, BNP Paribas, and Credit Agricole, subscribing to the offering.

This was the 38th and the fourth largest IPO on BSE in 2010. The timing was also favorable as the IPO took place at the two-year peak of the BSE Sensitive Index (SENSEX). The BSE IPO index, which tracks the performance of newly listed stocks, was also at a two-year high. (See Box 3 for a summary of details of the IPO.)

High valuation

The IPO valued SKS at 4.2 times its post-issue book value and 40 times its fiscal year 2010 earnings (Table 3).[10] SKS's valuation is high compared with publicly listed low-income finance institutions, such as Bank Rakyat Indonesia or Compartamos, that trade at an average of 2.6 times book value in 2010[11] (Table 4). However, the SKS valuation is more consistent with Indian banks, which are trading between 1.8 and 4.8 times book value.

Box 2. Executive Compensation

Table B2-1: Stock options (mln US$)

Award Date	Realized Gain	Remaining Unrealized Value**
Vikram Akula	**15.2**	**68.9**
Mar-07*	3.3	-
Oct-07	11.9	26.6
Nov-08	-	42.3
Suresh Gurumani	**1.6**	**16.1**
Dec-08	1.6	16.1

** Approved as option grant in March 2006, but issued as stock a year later due to tax considerations.*
*** As of 17 September 2010; options locked for 3 years after IPO*
Source: SKS company data, NSE, BSE

Compensation of senior managers, especially the chairman and the CEO, has consisted primarily of stock options. With the exception of the March 2007 discounted stock sale to Akula, which a year prior had been approved originally as an option award, all other options were issued with an exercise price consistent with the prevailing price of private equity transactions, ensuring that management could benefit only if the company's stock appreciated in value. Besides the two top executives who have received about 50 percent of total options allotted, SKS has also allotted 8 percent to two other individuals on the senior executive team. The remaining 42 percent was allocated for senior and mid-level staff based on a combination of length of tenure and level of responsibility, covering about a quarter of SKS employees (Kumar and Rozas 2010).

10 The SKS IPO valuation represents 7.5 times its fiscal year 2010 book value, while in 2009 Indian MFIs were trading at an average of 5.9 times book on the private market, according to Reille et al. (2010).
11 These valuation multiples are also high compared to emerging market banks that trade at an average of three times book value.

Box 3. SKS IPO Details

Date of the IPO: 28 July to 2 August 2010

First day of Trading: 16 August 2010

Issue Size: US$350 million, of which US$155 million were fresh equity shares and US$195 million were stock sales from existing shareholders—representing a combined total of 23.3 percent of post-IPO shares.

Market Capitalization of SKS: US$1,525 million (as of IPO close on 2 August 2010)

Structure: 60 percent of shares sold to institutional investors (qualified institutional buyers [QIBs]), 30 percent to retail investors, and 10 percent to noninstitutional investors, primarily high net worth individuals.

Promoters: MBTs, Kismet, Sequoia Capital, and Unitus

Anchor Investors: SKS secured an initial US$64 million from a group of 18 anchor investors who agreed to buy 18 percent of the offering at the top of the offering window of INR 985 per share. The anchors included JP Morgan, Morgan Stanley, India ICICI Prudential, Reliance Mutual Fund, and George Soros' Quantum Fund. They are required to hold the shares for at least 30 days.

Underwriters: Citigroup Inc., Credit Suisse Group AG, and Kotak Mahindra Capital Co.

Stock Exchanges: Bombay Stock Exchange (BSE) and National Stock Exchange (NSE)

Trading Symbol: SKSMICRO

On price-to-earnings multiples, SKS is truly an outlier. At 40 times its fiscal year 2010 earnings, the valuation exceeds that of the best performing Indian banks. It even exceeds the valuation of Compartamos at its IPO (26 times) despite the fact that Compartamos' ROE at the time was more than double that of SKS's today.

SKS's valuation at 4.2 times book value is not consistent with its fiscal year 2010 ROE of 22 percent. For financial institutions, there is a positive relationship between book value and ROE (Figure 8), which suggests that SKS's current ROE should command a valuation around 2.0 times book.

The earnings potential of SKS in the coming years raises questions about whether the valuation is too high. On the positive side, given the potential of India's microfinance market, SKS still has a lot of room for growth. It is also far less leveraged than its Indian MFI peers, so growth through more borrowings would substantially increase investor returns. And as its many newer branches mature, operating margins should increase further.

Nevertheless, there are other factors that could affect earnings. Portfolio yields could face downward pressures from increased competition and political

Table 3: SKS valuation at IPO

		US$ (mln)
A	Fresh capital raised	155
B	Market capitalization as of IPO	1,525
C	Earnings FY2010	38
D	Shareholder equity (March 2010)	204
	Post-money P/B : B / (A + D)	4.24
	Pre-money P/B: B / D	7.46
	Price/earnings FY2010: B / C	40.55
	Price/earnings FY2011e	22 to 27

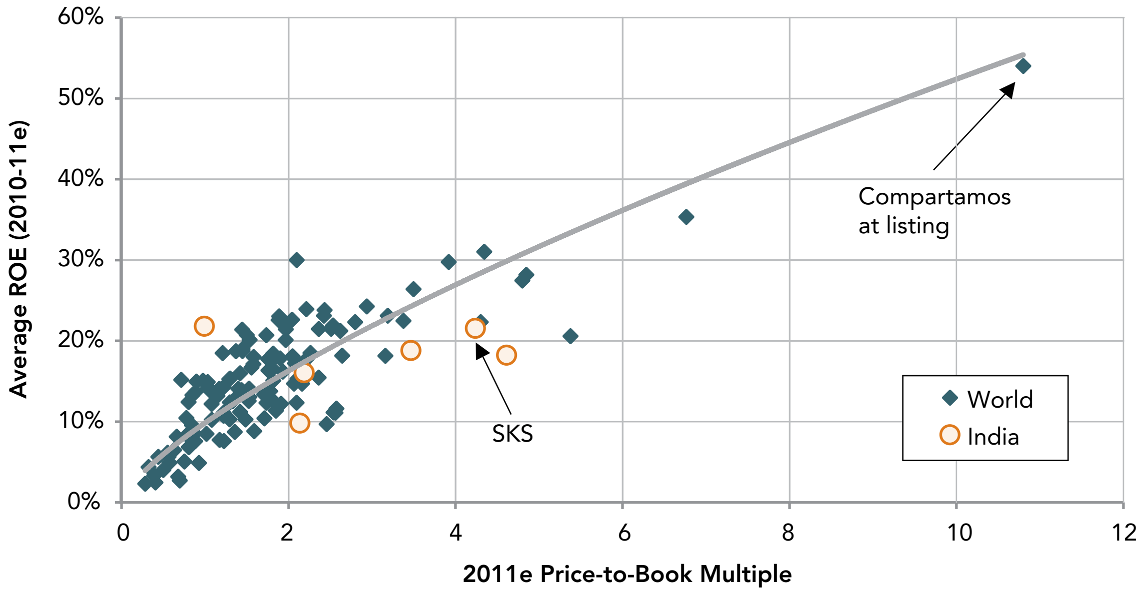
Source: CGAP analysis, www.chittorgarh.com, analyst reports

Table 4: Valuation comparables

	Price to Book 2010e	ROE 2010e	Price to earnings 2010e
Compartamos	6.8x	37.0%	17.3x
HDFC Bank	4.6x	17.1%	25.4x
SKS Microfinance	4.2x	21.6%	40.5x
JP Morgan LIFI Index	2.6x	21.0%	12.4x
ICICI Bank	2.1x	8.9%	23.2x

HDFC, ICICI: Indian commercial banks; JPM LIFI Index—index of 8 publicly traded emerging market low-income financial institutions
Source: JPMorgan, SKS company data, CGAP analysis

Figure 8: SKS an outlier among banks worldwide, measured by price/book vs. ROE



Source: J.P. Morgan estimates, Bloomberg. Prices as of 30 August 2010. Price-to-book multiples use the current price divided by the latest available book value per share. The axis for ROE uses the average of ROE for those institutions for 2010e and 2011e.

scrutiny, which keeps interest rates low. MFI loan delinquency and provisioning for nonperforming loans may also increase in the absence of a well-functioning credit bureau. While such a bureau is in the process of being established in India, it is unclear how soon it will become fully operational and what level of coverage it will provide.

In the lead-up to the IPO, several equity analysts emphasized the solid prospects for SKS, but balked at the high valuation of the IPO.[12] The relatively high IPO price probably reflects investor appetite for Indian financial institutions as well as strong demand by institutional investors for publicly traded microfinance securities.

Post-IPO trading

As per Indian securities regulations, SKS shares began to trade on the two listed exchanges two weeks after the completion of the IPO. The market responded positively. On the first day of trading, 20.6 million shares (or 1.2 times the initial offering) changed hands, racking up a post-listing gain of 11 percent. The valuation continued to rise over the next five weeks, closing that period 42 percent over listing price, with a total of 4.1 times the number of originally listed shares trading hands, according to Bloomberg.

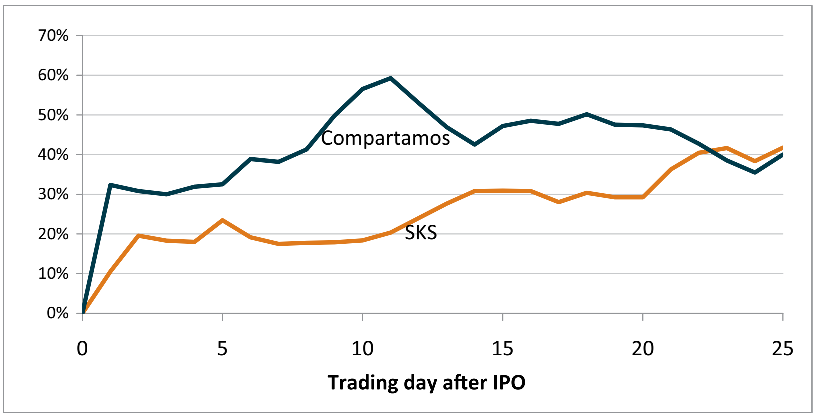
The initial price increase was greater for Compartamos than SKS after the IPO, but within the first five weeks SKS had caught up (Figure 9). SKS trading volume has also been consistently higher than that of Compartamos. One notable detail from early trading is that a significant number of SKS staff have taken the opportunity to cash in company stock, often netting US$30,000 or more per person.

What Might the IPO Mean? Will Poor People Benefit?

The SKS IPO has already generated much discussion and debate globally, including in the mainstream press, with an especially spirited debate in India. These discussions are embedded in a wider discussion about the merits and dangers of commercializing

12 For example, Bhattachariya (2010)

Figure 9: Change in price following IPO. Day 0 = IPO.



Source: Bloomberg, NSE, BSE

microfinance that has been going on for more than a decade. Microfinance today blends commercial and social goals. Drawing in some private commercial capital is seen by many as necessary to ensure sustainability and scale. At the same time, many are wary that excessive commercialization will tilt the gains heavily toward investors at the expense of the poor. The SKS IPO is significant within this larger debate because it is an influential MFI in a large market and because the IPO further increases the stake of investors whose primary objectives are more decidedly commercial.

This paper was written only weeks after the IPO. So the story is still unfolding, and many important questions remain to be answered over the coming months and years. But certain observations can already be made at this early stage about the implications of the IPO and commercialization in general.

Will more MFIs and their investors be encouraged to push for an IPO?

The founders and promoters of SKS determined early on that they wanted to build an MFI that could break through a key barrier to reaching large scale: access to capital. At the time, access to mainstream private equity and listings on stock exchanges were almost unheard of for MFIs. With the execution of the IPO, SKS has demonstrated clear success in this objective. As a pathbreaking transaction in the Indian market, the SKS IPO opens the way for others to follow, while it also establishes a benchmark against which others will be compared.

Other MFIs in India are potential candidates for an IPO over the next one to three years. There are two dozen or more MFIs that have attracted private equity investors. In fact, in 2009 nearly one-third of all microfinance private equity investments were in India (CGAP 2010). Already in August 2010 the press reported that another large MFI based in Andhra Pradesh, Spandana Sphoorty Financial, has shortlisted investment banks for an IPO planned for early 2011 (Reuters 2010).

India is well positioned for more IPOs because it combines fast-growing MFIs funded by commercial private equity with well-developed capital markets and significant unmet market demand. A few other countries also meet these preconditions and might expect microfinance IPOs. However, most emerging markets do not have sufficiently large MFIs, well-developed capital markets, or significant market growth potential to contemplate an IPO.

How might the market structure for MFIs change?

The large size and sustained high growth rate of SKS were important to make the IPO transaction economical and to demonstrate the sector's potential to investors. India is already the fastest growing microfinance market in the world, and the pace of growth could accelerate even more as other MFIs follow the SKS path. This could be one of the most significant outcomes of the IPO, since growth could result in many more poor people gaining access to credit. However, as CGAP and Indian microfinance experts have cautioned[13] there is a danger that fast growth continues even in geographies that are already fully saturated or that the pace of growth outstrips MFI internal controls and erodes credit discipline.

Other consequences may follow. As financial sectors grow and mature, they often consolidate, so opportunities for mergers and acquisitions in Indian microfinance might increase. Even before the IPO, microfinance market share was increasingly dominated by a small group of MFIs. The IPO could reinforce this trend if SKS and other MFIs with access to large amounts of equity seek to acquire other MFIs.

It is not clear, however, whether India is suited to a market structure that is dominated by a few large nationwide MFIs. India is highly diverse, and there has been discussion in the microfinance community that expansion to northern states of India might present more formidable challenges to growth given their more entrenched poverty, lower levels of literacy, less reliable law and order, and less freedom for women. Some Indian experts think that India is too diverse to be served by a few large nationwide players, and a more diverse industry of multiple regionally specialized local financial institutions would penetrate more deeply and offer better services.[14]

The entry of new players could also affect market structure. The high profile of microfinance could generate greater interest from nonmicrofinance NBFCs and banks that might want to acquire MFIs. Or new players might seek to start their own MFIs mainly in pursuit of quick profits rather than delivering long-term value for customers and shareholders. New entrants may be less concerned with or aware of the repercussions this could have on the microfinance market, creating credit and operational and reputational risks for other MFIs and their clients.

Will prices and service quality improve for clients?

The effects on interest rates from further growth, competition, or consolidation are difficult to anticipate. Rising competition in India in recent years has not brought portfolio yields down significantly. SKS's portfolio yield has remained near 26 percent since 2004, though it spiked in fiscal year 2009 only to fall again in 2010 before the IPO. It is possible that, with further growth and consolidation, SKS and other MFIs will lower interest rates and that greater political scrutiny would add further downward pressures on rates. In Mexico, three years after its IPO, Banco Compartamos has partially addressed one of the biggest criticisms it faced before and at the time of the IPO by slightly lowering interest rates (Rosenberg 2009). In India rates could drop but it's also possible to imagine a situation where a few large MFIs might be able to defy competitive or political pressures to keep rates higher than necessary.

The extremely fast growth of Indian MFIs has been largely based on a standard approach and loan product. Small groups of borrowers are formed with each person receiving a 50-week loan to be repaid in equal small amounts on a weekly or bi-weekly basis. MFIs have relied on this standardized approach to become profitable, grow, and attract investors. White it is widely agreed that poor clients need a wider range of high-quality, affordable loan products and other financial services, movement in that direction has been relatively slow so far. It remains to be seen if the additional resources brought in by the IPO will spur SKS to move more aggressively to expand its range of services and improve service quality.

How might policy makers react?

India has long supported and subsidized a wide variety of approaches to promote financial inclusion. One policy from which MFIs have especially benefited

13 For example, Sriram (2010).

14 This is a view articulated by Nachiket Mor, formerly of ICICI Bank, and Bindu Ananth, the president of IFMR Trust, in various public events and in correspondence with the authors.

is their eligibility to meet a portion of Indian banks' priority sector lending requirements. Despite this endorsement, some policy makers hold mixed views about the value of commercial microfinance. In the run-up to the IPO some policy makers and Reserve Bank of India officials have questioned whether commercially oriented MFIs should continue to qualify for priority sector loans from banks if the benefits of growth accrue to private investors, given that the purpose of this aspect of priority sector lending is to benefit poor rural people.[15]

The IPO has raised the profile of MFIs further, even in the political arena. This will generate more discussion about the purpose and value of MFIs. Even before the IPO there was considerable discussion about whether or not MFI interest rates are too high, whether MFI lending practices are contributing to over-indebtedness of poor people, whether government should focus more of its attention on the bank–SHG linkage model than on MFIs, and other related issues. Perceptions about the SKS IPO will add to these debates and could even lead to policy changes.

How will MFI boards and managers balance the interests of the poor with commercial imperatives?

SKS's experience with the MBTs (Box 1) highlights how challenging it can be to represent the interests of clients on the board or in the shareholding of MFIs that grow large. And the IPO shines a spotlight on executive compensation raising the question whether extraordinarily high pay in an industry focused on serving the poor is healthy or can be sustained. These are important issues, but there are at least two other changes that the IPO brings that should not be discounted.

The shift from privately held to publicly listed company brings with it new and heightened corporate governance requirements. Board director rules limit family relatives on boards and bar related party transactions. Most listed companies are required to have at least one-half of their directors be independent of management, a requirement SKS has already met. More important, public listing will require SKS to increase transparency, for example publishing quarterly performance reports, and meeting more stringent audit and disclosure standards.[16]

As things stand today, the IPO has attracted institutional investors, such as JP Morgan and BNP Paribas. Institutional investors serve a larger group of stakeholders and therefore tend to be more conscious about their reputations and more likely to take measures to avoid associating with a microlender that lacks strong client protection policies, charges unusually high interest rates, or generates negative publicity.

Looking Ahead

Having completed the IPO and raised fresh capital, SKS has several options for future development. Will it pursue a bank license, buy other MFIs, diversify financial products, or venture into other businesses? Might SKS venture beyond India? SKS has made a name for itself defying expectations and pushing beyond established microfinance boundaries. Whatever its choices the long-term success of SKS will ultimately depend on the satisfaction and loyalty of its clients, and whether SKS finds new ways to improve its products and offer poor people even better services.

15 A high official of the Reserve Bank of India discussed this with CGAP in private conversations.
16 Securities and Exchange Board of India, Corporation Finance Department Circular on Clause 49 of the Listing Agreement, 29 October 2004.

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Appendix 1: Shareholding Structure

	Pre-Issue %	Post-Issue % (diluted)	Current Value ($ m)[a]	IPO Proceeds ($ m)[b]
Promoter Group				
Sequoia (SCI II & SCIGI I)	21.8	14.0	213.0	83.2
SKS MBTs	16.1	11.6	177.0	42.0
Kismet (SKS Capital)	12.3	7.8	119.4	47.5
Unitus (MUC)	5.7	3.7	55.7	22.2
Total Promoter Group	**55.8**	**37.1**	**565.1**	**195.0**
Public	-	**23.3**	**355.7**	
Nonpromoter Group				
Sandstone (SIP I)	12.9	11.6	176.7	
Vinod Khosla	6.6	5.9	89.8	
Kismet (Kismet SKS II)	5.7	5.1	77.5	
Yatish Trading Co.	2.9	2.6	39.3	
SIDBI	2.8	2.5	38.3	
Tejas Ventures	2.7	2.4	37.3	
Bajaj Allianz (BALICL)	2.6	2.3	35.3	
Tree Line Asia Master Fund	1.5	1.6	24.8	
Catamaran Fund	1.5	1.3	19.9	
ICP Holding I	1.2	1.1	17.0	
Infocom Ventures	0.4	0.4	6.0	
SKS Employees & EWT[c]	3.0	2.6	39.6	
Others	0.2	0.2	2.4	
Total Nonpromoter Group	**44.2**	**39.6**	**603.8**	
Total Post-Issue Share Capital	**100**	**100**	**1524.6**	

[a] Value is calculated at the INR 985/share price. Proceeds are calculated at INR 970/share due to the INR 50/share discount provided to retail investors.
[b] Nonpromoters are not selling shares in the IPO, hence receive no proceeds.
[c] EWT = SKS Employee Welfare Trust

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