How to IPO Successfully & Responsibly

Lessons From Indian Financial Inclusion Institutions

Fall | 2016

Author
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FINANCIAL INCLUSION
EQUITY COUNCIL

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About This Paper

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Grassroots Capital Management PBC (Grassroots) invests in and provides advisory services to multiple bottom-line businesses. Together with its partners Caspian Impact Investment Adviser (www.caspian.in) in India and Bolivian Investment Management Ltd (www.biminvestments.com) in Latin America, Grassroots seeks to increase its accountability and track progress towards its goal of helping low-income and disenfranchised populations better their lives and build resilient communities. As manager of the Gray Ghost Microfinance Fund in 2003–2014, Grassroots helped launch a number of leading impact managers, including Caspian. In 2005, Caspian created Bellwether, the first fund to be a source of Indian equity to Indian microfinance institutions (MFIs), enabling them to grow responsibly and reach scale. Now, 12 years later, two of its longstanding portfolio companies have tapped public markets in India to increase domestic ownership while maintaining their commitment to their missions.

Sponsor

The Financial Inclusion Equity Council (FIEC), previously known as the Council of Microfinance Equity Funds, is the first membership organization to bring together the leading private entities that make equity investments in financial inclusion throughout the developing world. Council members seek both social and financial returns from their investments. The Center for Financial Inclusion at Accion (CFI), an action-oriented think tank working toward full financial inclusion, is the secretariat for FIEC. CFI contributes to full inclusion by collaborating with sector participants to tackle challenges beyond the scope of any one actor, using tools that include research, convening, capacity building and communications. CFI also initiated and administers the Smart Campaign for client protection in microfinance. To learn more, visit FIEC's website at fiecouncil.com and CFI's website at centerforfinancialinclusion.org.

Companies

Equitas Holdings

Founded in 2007 to provide the underserved and disenfranchised people in the Indian State of Tamil Nadu with reasonably and transparently priced microcredit, Equitas diversified after the microfinance crisis in 2010 into affordable housing, small and medium enterprise (SME) and vehicle loans. At the time of its April 2016 IPO, traditional microlending made up slightly more than half of the total portfolio, with over half of assets under management in Tamil Nadu.[i]

In September 2015, Equitas was one of ten companies to receive in-principle approval from the Reserve Bank of India (RBI) for the Small Finance Bank (SFB) license. In order to become an SFB, regulations require that Equitas bring foreign ownership, which comprised 93 per cent of equity before the IPO, below 49 per cent. This requirement was one of the key factors behind the IPO. Once Equitas transitions to a SFB, it will be able to accept deposits, starting with its client base of approximately 3 million.

Ujjivan Financial Services

Founded in 2005, Ujjivan Financial Services' vision was to make financial services available to the urban working poor in India. At the time, most Indian microfinance was focused on the rural population. Started as a four-person team in a Bangalore garage, at the time of its IPO in April 2016, the company had 8,000 employees, three million borrowers, disbursed loans worth Rs.15,600 crore (approx. USD 2.6 billion), and had operations in every Indian state. Like Equitas, Ujjivan received approval to become a SFB and therefore also needed to reduce foreign shareholding. As of September 2016, Ujjivan was on its way to becoming a SFB with diversified product lines.

Executive Summary

Initial public offerings (IPOs) are widely viewed as markers of commercial success. However, in the financial inclusion industry, many have viewed IPOs with suspicion, if not alarm. While increasing access to capital through the public markets builds scale and reach, there are undoubtedly challenges posed when a private company founded by a small, stable group of investors and managers aligned around a double-bottom line mission becomes a public company. As a public company it becomes answerable to a large, diverse and fluid group of shareholders who may not share or even be aware of the company's founding social mission.

Furthermore, in an industry like financial inclusion catering to the poor and vulnerable, the valuation of the IPO is also a concern. Funding that comes at high valuations creates a risk of abuses of the very populations that were intended to benefit: management may feel pressure to grow at rates that strain internal controls and resources; hire staff without proper qualifications, training or oversight; discontinue innovative products that may be less profitable but have value to clients; or in the case of financial services, make loans at rates that their clients might not be able to afford. When combined with pressure to maintain and increase public stock price, this could contribute to misaligned incentives leading to overly aggressive collections and employee fraud.

However, these challenges can be mitigated and managed through unambiguous articulation of the company's objectives and character; clear, up-front communication with investors; incorporation of provisions in a company's by-laws that give tangible effect to these social objectives; and a governance structure that serves as guardian of the company's core identity. Taken together, these features are referred to throughout this paper as "hardwiring" social mission and while this paper focuses on IPOs in particular, hardwiring is relevant to any double-bottom line company raising capital from new investors. With an IPO, the company benefits from a stronger capital base, increased participation of domestic retail investors and the introduction of new investors to the sector. Companies that embed their social missions in offering documents, shareholder agreements, organizational policies and governance can take advantage of a larger and more diverse pool of investors with an IPO, while maintaining the commitment to their social missions.

This paper examines the 2016 IPOs of two Indian microlenders – Equitas Holdings and Ujjivan Financial Services – and how they "hardwired" their missions to prioritize their clients, setting them apart and driving their success.

Though still in their early days, the two 2016 IPOs analyzed in this paper provide evidence that the IPO route can be used to increase scale and capabilities without compromising the core social mission of the institution.

These companies' decisions to go public were driven by the need to reduce foreign ownership in order to meet regulatory requirements for becoming Small Finance Banks (SFBs) – a recent regulatory innovation that would enable these companies to accept public deposits, introduce new product lines and meet more of their clients' needs..

In both cases, the shares were offered at reasonable and attractive valuations – under two times post-IPO book value – stimulating demand from domestic investors while setting reasonable expectations for future growth rates and profitability. Furthermore, both Equitas and Ujjivan are board-led companies with strong, independent boards aligned behind their social missions,

providing continuity and signaling that commitment to mission will continue even as the shareholder base diversifies.

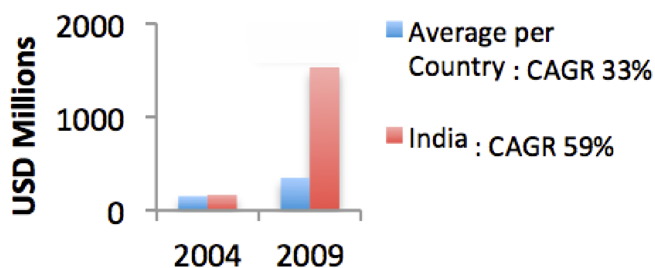
The experience of these two companies suggests how a responsible financial services company can position itself to go public while maintaining its social mission. In this paper, we will examine features that enabled Equitas and Ujjivan to “hardwire” their missions into their operations and corporate culture, and how these features, combined with the strengthened operating and regulatory environment and the maturation of the financial inclusion and broader global impact industries, contributed to the success of these IPOs.

Indian Financial Inclusion Sector

Growth

In 2005, the Indian microfinance landscape consisted mostly of non-governmental organizations (NGOs) and self-help groups (SHGs) concentrated in rural areas. At the time, considering the potential demand for microfinance services – 400 million people living below the poverty line of $1.90 per day[1] – the supply was limited: there was insufficient domestic or foreign capital flowing to the sector and few MFIs with professional management and the capacity to scale. This dramatic imbalance between supply and demand reflected the extreme regulatory complexity and government domination of the financial sector.

Figure 1. Growth of Indian Loan Portfolio



Reproduced from CGAP Focus No. 61[iii]; CAGR represents the year-over-year growth rate over a specified period.

Over the next five years, the Indian microfinance industry grew dramatically: the aggregate gross loan portfolio grew at a compound annual growth rate of 59 percent, with total staff numbers growing more than fourfold, according to MIX data.[iii]

In 2010, there were historic levels of private equity activity in the Indian microfinance sector, with 20 deals worth more than $135 million, according to VCCedge, the financial research platform of VCCircle.[iv] Also in that year, SKS Microfinance conducted the first microfinance IPO.

AP Crisis

In 2010, portfolios remained concentrated in six of India's 28 states, including Andhra Pradesh (AP). AP accounted for over one quarter of outstanding microfinance loans in India.[v] This growth was largely funded by private equity investment, often at high valuations that put pressure on MFIs to reach unrealistic growth and profitability targets. SKS, India's largest microfinance institution in 2010, had 30 percent of its portfolio in AP.[vi] The IPO of SKS brought issues of portfolio concentration, over-lending, rapid growth, high valuations and excessive management compensation to the public view. The press attention and political response to the SKS IPO was one of many contributing factors to a crisis that started in AP, but affected the entire microfinance sector in India and beyond.[v]

In October 2010, the AP government issued a law restricting the activities of MFIs that led to a dramatic fall in MFI borrowers' loan repayment rates in the state from 98 percent to 10-20 percent. Banks also suspended their lending to MFIs – not just in AP – and valuations in the sector subsequently fell.[iv] Even MFIs with no direct exposure to AP were affected as new lending dried up and assets under management shrank across India. MFIs with significant operations in AP saw portfolios decline by 35 percent and several were forced into corporate restructuring.[vii]

Client Focus

Although the MFI closures throughout the country were a major setback for the sector, there were a number of positive outcomes resulting from the AP crisis, including regulations creating a new category for non-bank finance companies called "NBFC-MFIs," and a greater focus on client protection. The Microfinance Institutions Network (MFIN), an association created before the crisis comprising almost all of the large for-profit MFIs in India, instituted and self-enforced a

code of conduct and built a microfinance credit bureau.[viii] Additionally, third-party assessments like M-Cril's Code of Conduct Assessments (COCA) and Smart Campaign (smartcampaign.org) client protection assessments began to provide more legitimacy behind self-enforcement and strengthened the sector's understanding of client protection practices. By 2013, 19 MFIs in India had in-depth assessments of their client protection practices using the Smart Campaign Assessment tool, and four were Client Protection Certified by the Smart Campaign.[ix]

Beyond the Crisis

By the end of 2015, microfinance portfolios and client numbers had surpassed pre-crisis levels and were again growing at a rapid pace within a strengthened regulatory framework and the credit bureau infrastructure. This confluence of regulation, strategic reassessment, and reinvigorated management set the stage for the IPOs of 2016.

Indian Financial Inclusion IPOs

On April 7, 2016, Chennai-based Equitas Holdings Ltd., the holding firm for the fifth-largest microlender in India, tapped primary markets to raise Rs 720 crore (approximately USD 108 million). The issue was oversubscribed[2] 17 times, led by high net worth individuals (HNIs) whose quota was oversubscribed more than 57 times.[x] The IPO was the largest only-domestic Indian IPO in the banking and financial services industry and the first to be oversubscribed without any foreign participation.[i]

Three weeks later, the IPO of Bengaluru-based Ujjivan Financial Services Ltd., the fourth-largest microfinance lender in India by assets, broke that record by being oversubscribed 41 times in its IPO, which raised Rs 358 crore (approximately USD 54 million).[x]

The Equitas and Ujjivan offerings were comprised of primary shares, where the companies sold new shares to investors, comprising 33 and 41 percent for Equitas and Ujjivan, respectively, and a secondary offering that allowed existing shareholders to liquidate some of their holdings. Shareholders included private equity funds like Lok Capital, Sarva Capital, Creation Investments, the India Financial Inclusion Fund, Sequoia Capital, the International Finance Corporation (IFC), and Dutch development financial institution FMO. Figure 2 on page 14 shows average annual dollar returns by investor.

Table 1. IPO Details

	Equitas	Ujjivan
Tatal Offering (USD Million)	335.00	136.00
Primary (%)	33%	41%
Secondary (%)	67%	59%

The companies' share prices continued to increase over the next several months, driven by performance over the quarter ending March 31, 2016 and apparent success in complying with the domestic ownership requirement for the Small Finance Bank (SFB) license from the Reserve Bank of India (RBI).[3] Two months after their IPOs, Equitas and Ujjivan shares were trading 56 and 80 percent higher than their respective listing prices.[x]

Why Did They Pursue IPOs?

As noted above, the primary impetus for the IPOs of these two companies was the need to comply with the RBI's Small Finance Bank (SFB) ownership requirements. The capitalization of Indian MFIs is comprised in large part by private equity investment. Regulations require MFIs aiming to become SFBs to reduce foreign shareholding below 50 percent. To date, this more balanced capital structure has not been achievable by Indian private equity alone. Both Equitas and Ujjivan plan to complete the transition to a SFB by early 2017. Before the IPO, Ujjivan and Equitas' foreign shareholders comprised 91 and 93 percent of the capital base, respectively. The amount that domestic investors, like mutual funds and insurance companies, are able to allocate to investments in unlisted entities cannot meet the capital needs of companies of this size. In the Indian context, an IPO is arguably a necessity for those MFIs that are looking to expand beyond a certain size.

In addition to addressing the domestic equity requirement for SFBs, IPOs also provide more generic benefits. For example, they provide liquidity to existing investors and the company's employees (through Employee Stockholder Plans, or ESOPs) and create another avenue to generate the capital necessary to continue to scale the business.

Additionally, going public introduces a wider range of investors to the financial inclusion sector, deepening the pool of prospective investors and enhancing confidence that the sector's future capital needs can reliably be met. The demonstrated ability of the Indian public market to comfortably supply the amount of capital sought by these two MFIs confirms solid domestic investor interest in financial inclusion and will likely lead to more MFIs pursuing IPOs in the medium term.

As SFBs, the companies will be able to mobilize deposits, which both lowers their cost of funds, and will make savings services available to their clients, for whom appropriate savings products are often a critical but largely unmet element of full financial inclusion.

Table 2 summarizes some key issues for financial inclusion companies to consider when going public. The following paragraphs examine these issues in more detail, using the IPOs of Equitas and Ujjivan as examples.

Table 2. Benefits and Risks Surrounding Financial Inclusion IPOs

Mission	Governance	Funding/ Growth	Pricing
+ Public companies are governed by regulations that require truth in advertising and staying true to core principles that can keep company on track	+ Regulations require upholding mission, reporting, internal controls	+ IPOs enable large-scale fundraising necessary for MFIs to diversify product offerings and accept deposits	+ Attractive, stable returns are necessary to entice new investors
- Can be a legal imperative for public companies to maximize profit for the shareholders	+ Less likely for single nominee to dominate and disrupt decision-making		+ Employees can participate in the company's success through Employee Stock Ownership Plans (ESOPs)
- MFIs risk losing the ability to maintain commitment to core values	- Reactive markets that might be less informed/ knowledgeable about the mission or business makes public companies more prone to "manage to headlines"	- MFIs can instead continue to mobilize funds from private institutional investors and retain control of company and who invests	- High valuations can lead to misaligned incentives – investors will expect high growth and profits
	- Managers/founders lose control over who sits on Board		

Hardwiring Social Mission

There are three primary dimensions through which Ujjivan and Equitas have consistently taken steps from their earliest days to ensure that their core social mission was "hardwired" into the organization and likely to survive whatever changes in leadership, shareholding and regulatory structure they would face: creating the corporate "DNA"; articulating in core documentation explicit and concrete goals and constraints that express that DNA; and providing for a governance structure that will guard the institution's identity as it faces the inevitable twists and turns of growth, maturation and adaptation.

Creating a clear corporate identity or DNA from the earliest days can be a critical but often overlooked first step. Organizations that feel it is important to first demonstrate commercial viability before turning their attention to their "social mission" clearly express their corporate priority and purpose: to be commercially successful. In contrast, companies with strong social DNA, like Ujjivan and Equitas, do not sequence their objectives, but rather make clear that their purpose is to create social value, and that a successful commercial model is a means to that end.

From its earliest days, Equitas embedded a set of unique social constructs in its corporate structure: a cap on interest rates of 26 percent even before rates were subject to regulatory caps; a target return on equity (ROE) of around 20 percent and a cap of 25 percent to ensure that the clients benefit from increased efficiencies; a cap on CEO salary of 40 times that of the lowest paid employee; and an annual 5 percent allocation of company profits to social programs.[xi]

As Equitas' founder and Managing Director, P N Vasudevan commented at the time of the listing, the IPO provides Equitas with "a tremendous opportunity to showcase our social initiatives and show the markets that it is possible to run an extremely efficient and client-focused MFI operation with all prudent lending philosophies and at the same time, contribute 5 percent of our profits to our trust and do some truly remarkable social support activities for our clients on a scale which is not seen often. Thus we don't have to be either social-focused or profit-focused, but can be focused on both with equal success on both fronts."[xi]

Equitas' social programs address housing, food security, healthcare, livelihood skill development, and supplemental education for Equitas' clients and the ultra poor (individuals at the bottom of the socio-economic ladder living on less than $1.25 a day). The trust[4] is managed separately, and Equitas Holdings Ltd is one of the trustees.

Measuring outcomes is an essential part of these programs for Equitas; the company has partnered with Sorenson-Unitus Ultra Poor Initiative in 2009 to measure the outcomes of a pilot to help the urban ultra poor, and is participating in efforts by Freedom from Hunger and the Microcredit Summit Campaign to integrate microfinance and health. More generally, the Smart Campaign also certified Equitas for its strong client protection practices. Overall, these relationships and ongoing efforts to assess and confirm the effectiveness of operationalizing social mission give substance to the high-level framework articulated in the by-laws.

Like Equitas, Ujjivan has sought ways to embed an employee and customer-centric approach in its operations since inception. When accepting new investors, founder and CEO Samit Ghosh was explicit and direct about the priorities and values of the company: "scaling the company should not take away Ujjivan's 'soul' and 'double bottom line' focus."[ii]

Ujjivan has enshrined transparency and accountability into its corporate practices. Per its Corporate Governance Code (updated in December 2015 after Ujjivan began the IPO process), in pursuing its mission of "providing a full range of financial services to the economically active poor, to build a better life," Ujjivan has been balancing its dual objectives of social and financial goals since its inception. To better incorporate discussion of social issues into the formal board meetings, Ujjivan created a Social Performance Committee in 2010, ahead of 2013 regulations to create a Corporate Social Responsibility Committee (CSR). The committee oversees "social programs undertaken by the Company and monitors economic and social impact on customer" and the amount of expenditure on these social programs.[xii] Ujjivan's board has been allocating a percentage of profits to its "Community Development Programs" since it achieved breakeven in 2010. These programs address critical community needs in the communities where Ujjivan operates, like healthcare, water purity, environment and social welfare.[xviii]

As with Equitas, Ujjivan has been sharing the benefits of increased efficiency with clients through lower interest rates. Ujjivan voluntarily lowered rates to 22-25 percent effective July 2010, long before required by RBI regulations, when the average industry interest rate was around 27-30 percent, [xiv] and SKS was still at approximately 27 percent.[xv]

Additionally, both companies were early adopters of Codes of Ethics, endorsers of the Smart Campaign for Client Protection and other local efforts to maintain social performance standards, and were active members of the Social Performance Task Force. Their performance was corroborated through third party certifications by the Smart Campaign and ratings like the Global Impact Investing Rating System and other independent agencies.[5]

Through these measures and practices, these companies translated their espoused missions into concrete, substantive action, reflecting their corporate character and DNA. The final piece was to structure governance in such a way as to ensure that their commitment to social value creation would be preserved and enhanced as the organization grew, attracted new investors and adapted to the changing operating environment.

Governance

From inception, both Equitas and Ujjivan had intentionally diversified their capital structure by stipulating that each investor had a limited stake in the company, thereby limiting the ability of any one shareholder to dominate decision-making. Prior to its IPO, Equitas limited each shareholder's ownership to 15 percent. Ten investors owned 81 percent of Ujjivan pre-IPO; post-IPO the shareholders numbered over 40,000.[xiii] Per one of Ujjivan's early investors, "having a board-run company even when we were small and private really helped to ensure fair play and transparency."[ii] It was important for the founders and initial shareholders that the boards ran the companies rather than a single or small number of individual investors. This ensured continuity of governance and commitment to the social mission even if the composition of shareholders changed.

Furthermore, as a diversified shareholder base and strong governance practices are requirements for a SFB license, these were also among the reasons Equitas and Ujjivan were given early approval to become banks. Adherence to regulations applicable to commercial banks will further professionalize these companies that voluntarily implemented what many regulations required before being mandated.

With the mission preserved through these foundational elements, the companies have succeeded in managing organizational growth and change while preserving their essential double bottom line character, including navigating the IPO process. The positive response from the markets thus far has further underscored these aspects.

Growth

Although the high growth of the microfinance industry has been cited as an important contributing factor in the crises in India and other markets, growth per se is not necessarily problematic. Since inception, Equitas has been one of the fastest growing companies in the Indian financial inclusion sector. In 2009, only two years after its launch, Equitas was serving 1 million clients. As of December 2015, it had nearly 3 million clients and a gross loan portfolio of USD 800 million. While this growth could be worrisome in the absence of appropriate systems and internal controls, Equitas' rapid growth was supported by investments in technology, a focus on efficiency, and a steadfast commitment to governance and transparency. With a vision to serve 5 percent of Indian households by 2025, according to Equitas' chairman, the IPO route is possibly the only option that was available to Equitas to fund that growth given the company currently serves 1 percent of Indian households.[xvi]

Ujjivan also achieved strong growth since its inception in 2005, led by branch expansion across India. In 2016, Ujjivan had the largest geographical reach of any MFI with 470 branches in 209 districts. In recent years, the company has been able to maintain high rates of customer retention while continuing its geographic expansion.[xiii]

Equitas' total microfinance assets (54 percent of the business) experienced a 53 percent growth in fiscal year 2016 compared to 2015,[xvii] and the company expects overall assets to grow at the same levels over the near term.[xviii] The entire microfinance industry saw 60 percent growth compared to the 2015 fiscal year.[xix] This growth is concentrated in several southern states, which is prompting renewed concern from a number of analysts and industry experts.

Price/Valuation

Pricing is a delicate balance in any transaction, but for an IPO in the financial inclusion industry where the ultimate consumers are poor and vulnerable, it is even more important to ensure that commercial interests do not overtake the social mission. There are various options available to a responsible financial institution looking to achieve greater scale – increasing leverage, fundraising from private equity investors, or becoming a regulated deposit-taking bank, to name a few. With an IPO, high valuations set the stage for future strategy, necessitating high growth rates and profits in an attempt to justify and maintain a continuously elevated stock price.

Equitas and Ujjivan pursued IPOs primarily to increase levels of Indian ownership to meet requirements for a SFB license. The need to bring down the foreign shareholding to 49 percent also affected pricing considerations. Slightly more than half of the proceeds of the issues provided an exit to some of the existing foreign shareholders with the balance to be used for capital requirements.

Equitas' listing was priced slightly lower than the company's original target, which served to galvanize investor demand. At over 17 times the offered shares, the IPO drew strong interest from all categories of investors: high net worth individuals (HNIs) were subscribed 57 times, institutional investors 15 times, and retail investors 1.4 times. A few months later, it was trading 50 percent higher than the listing price.

Equitas and Ujjivan IPOs forged a path for Indian investors to support the financial inclusion agenda without "excessive" profit maximization on the part of existing investors and founders.

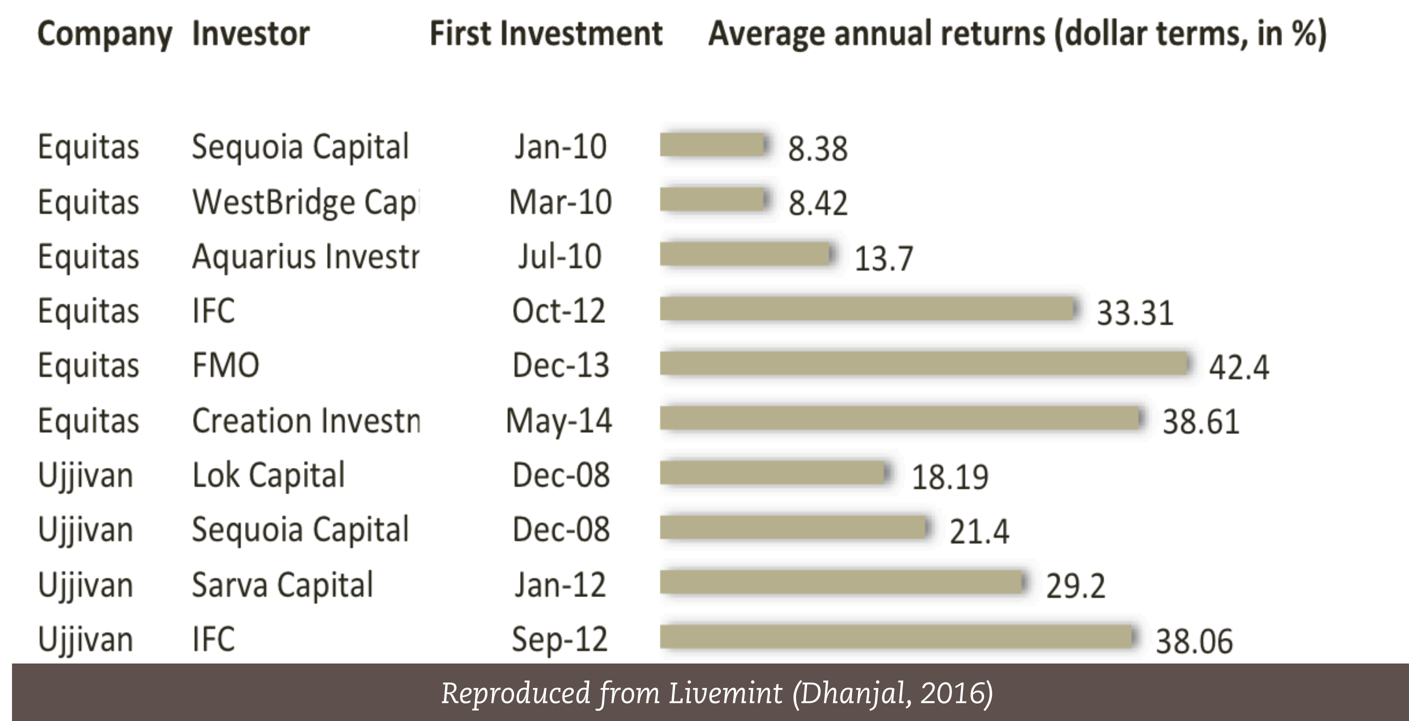
Ujjivan raised Rs 358 crore (approximately USD 54 million) through the IPO in late April and was subscribed more than 40 times.[x] As of mid-July 2016, Ujjivan had seen a steep rally in its share price and was trading about two times higher than the IPO price.[xx] As of October 2016, the demand from foreign shareholders was still strong, and international investors again needed to sell off shares to bring domestic shareholding in line with RBI requirements.

Both Equitas and Ujjivan were priced at 1.8 and 1.7 times price to post-IPO book, respectively (compared to other listed microlender SKS, which was trading at 3.8 times in April 2016). With pricing in line with the underlying business and client base compared to the overvaluations that prevailed before the Indian microfinance crisis and that characterized previous IPOs (see Table 3 for more details), the Equitas and Ujjivan IPOs are models from a responsible exits perspective. The attractive prices of the shares contributed to the high domestic demand and participation of retail investors, and the policies and processes in place suggest that the institutions and their boards are likely to continue responsible behavior like maintaining manageable growth rates and their commitment to mission-driven programs even after founding investors liquidate their positions.[6]

Investor Returns

The IPO provided a strong exit for Ujjivan's and Equitas' shareholders, which included a mix of socially responsible investment funds and traditional private equity investors.

Figure 2. Returns by PE Investors in Equitas and Ujjivan



Reproduced from Livemint (Dhanjal, 2016)

According to an analysis conducted by Mint, an Indian business news publication, based on data available in the IPO prospectuses filed by Equitas and Ujjivan, investors' average annual returns in dollar terms ranged from 8 to 42 percent.[xxi]

However, for pure financial investors like conventional private equity or venture capital (VC) funds, the Indian press speculated that the returns might not be "satisfying, especially when compared with the returns they get from sectors such as information technology."[xxii]

"Crowding in" or catalyzing investment from a new set of investors has been an argument in favor of higher valuations. The reasonable returns achieved could suggest a more moderate crowding in effect. However, the traditional investors exiting Ujjivan, like Sequoia Capital, have spoken highly of their experience, citing not only the financial returns but also the enduring impact of their investment in the company through its strong governance, transparency, and client focus.[ii] As mentioned above, the founders of Equitas saw its listing as an opportunity to showcase its commitment to mission and shape industry trends more effectively using the more visible platform afforded to a public company.[xi]

Are These IPOs Different?

While attractive returns are necessary to entice new investment and grow the industry, the perception or reality of "excessive" enrichment of founders and early investors has also led to criticism that can damage the reputation of the sector. Previous IPOs of Banco Compartamos in Mexico and SKS in India were also successful and initially well received but the public discourse turned from praise to heated debates over whether the pursuit of commercial microfinance is antithetical to a business whose social mission is to serve the poor and vulnerable.

As early movers, Compartamos and SKS garnered attention – both good and bad. These companies were attempting to prove the commercial viability of microfinance with the objective of engaging the private sector to bring the industry to scale. While it seems logical that the founders and management that led these companies to successful IPOs should also share in the financial success, when the success was driven by high profits made possible by high interest rates (e.g., Compartamos) or high growth without the necessary regulatory framework or internal controls (e.g., SKS), concerns are bound to arise about unbalanced incentive structures that reward management and founders exclusively for financial success.

As there are other papers and blogs[7] that analyze previous IPOs in depth, this paper will not go into detail about these earlier IPOs. To provide more context, Table 3 below summarizes key features of the IPOs of Equitas, Ujjivan and three earlier institutions.[8]

Table 3. Comparison to Other Financial Inclusion IPOs

Features	Equity Bank	Compartamos	SKS	Equitas	Ujjivan
Country	Kenya	Mexico	India	India	India
Date of IPO	7-Aug-06	20-Apr-07	28-Jul-10	7-Apr-16	10-May-16
Total Value of Offering	USD 87 million	USD 474 million	USD 350 million	USD 335 million	USD 136 million
Post-IPO Book Value (BV)	NA	12.8x	4.2x	1.8x	1.7x
IPO PE	NA	26x	40x	25x	19x
Avg 3-Year Gross Loan Portfolio growth <IPO	85%	63%	166%	50%	60%
ROE (at time of IPO)	40%	58%	22%	13%	19%
Use of Proceeds/ Main Beneficiaries	Not IPO, but listed on Kenyan stock exchange (from trading over-the-counter) to enable employees and clients to purchase stock	Founders and international investors were main beneficiaries of IPO; the bank did not receive proceeds	Approx. 45% of shares were new; the remainder (approx. 55%) were sales from existing shareholders	Main purpose was to lower foreign shareholding; Pre-IPO, founder held 3% in the company and no investor held more than 15%	Main purpose was to lower foreign shareholding; Pre-IPO, investor base was diversified and employees owned approx. 40%

A decade later, the microfinance industry has grown stronger, in part due to the discussions spurred by the previous IPOs which led to a greater awareness of the advantages and limitations of microfinance. Some key differences distinguishing the Equitas and Ujjivan IPOs from previous financial inclusion IPOs was the pricing, which set reasonable expectations of growth and profitability, and the more moderate enrichment of the founders.[9] In addition, these companies were able to better communicate their performance and mission expectations to the market, which was reassured by the longer track record of microfinance and the stronger regulatory framework that arose after the 2010 AP microfinance crisis.

Conclusion

This paper has focused specifically on the question of whether IPOs can be compatible with the character of double bottom line, mission driven companies, but the discussion is generally relevant to any mission-driven company that is growing and attracting new investors: How can the company ensure that new investors will support its core objectives and priorities, particularly with regard to social value creation?

With only six months since the Equitas and Ujjivan IPOs, it is difficult to draw definitive conclusions; however, initial evidence suggests that a balance can be struck that enables companies dedicated to financial inclusion to access the benefits of IPOs without compromising their character or mission by clearly aligning expectations through the signals delivered to the market.

Time will tell whether this positive trajectory will last, however there are indications that Equitas and Ujjivan will continue their commitment to their social missions. The markets have a better understanding of the companies as a result of the longer track record of the microfinance industry and both companies' clear communication on how they have institutionalized their social missions. Both Equitas and Ujiivan have carefully put in place foundational elements that greatly increase the likelihood that their character will be preserved: a well defined and articulated corporate "DNA"; concrete and substantive policies and practices that express this DNA; and governance that acts as a guardian to preserve this core character as the companies grow and adapt. Taken together, we refer to these foundational features as "hardwiring" the social mission.

Both the Equitas and Ujjivan IPOs exhibit strong independent governance and pricing that aligns incentives of management and shareholders with the social mission. While these features were present to some extent in previous IPOs, in these companies, when coupled with mission-lock elements like limits on enrichment of top management and profit allocation structures that "hardwire" their social missions, there is less potential for the companies to weaken their commitments to their social objectives. When these companies become SFBs, these features will become further enshrined as requirements of the SFB license. Additionally, the reasonably priced listings are in line with prudent growth rates and responsible lending behavior.

Dedication to social missions was among the reasons socially motivated private equity investors were attracted when these companies were lesser-known start-ups. The concrete demonstration of commitment to their social missions, like the aforementioned profit allocation to social programs, was deep-rooted in the corporate culture of the institutions and established in the shareholders agreements with all investors. These social commitments were conditions to receiving the SFB license and were also embedded into their public offerings: their commitment to their social programs and focus on serving the underserved populations is documented in their prospectuses.

Using the 2016 Indian financial inclusion IPOs as examples, we examine three key questions:

1. How can financial inclusion companies go public and maintain social mission?
While every situation is different, certain guidelines have emerged that can help financial services companies increase scale through an IPO or other avenues while reconciling market and social dimensions.

- **Hardwiring mission:** Embedding their commitment to clients in corporate culture were key features of both Equitas and Ujjivan. These companies ensured their social missions weren't just superficial – they lowered interest rates and ensured these rates were transparent even before regulatory requirements; they started a credit bureau; they were among the first to be certified by the Smart Campaign for their client protection practices; they devoted a portion of their profits and resources to social programs via a separate independently managed trust or sister non-profit. They did not stray from this commitment even when it may have benefited their financial bottom line, largely because these features were integrated in their corporate documentation, shareholders agreements and offering materials, including their IPO prospectus.

- **Commitment to professional and independent governance:** As with any multiple bottom line company, MFI boards and managers must balance interests of their clients with commercial imperatives, whether these companies are public or private. Financial inclusion companies interested in going public require best-in-class governance long before the IPO, given the significant resources required for a company to go public. Both Equitas and Ujjivan have been at the forefront of good governance as private companies – maintaining independent directors, prioritizing transparency and limiting conflicts of interest. Having these structures in place as private companies indicates they are likely to continue their commitment to their social mission in the face of inevitable pressures to maximize profits.

- **Pricing that aligns incentives with social mission:** Price setting during the IPO process is complicated. While the market ultimately decides the offer price, the underlying fundamentals of growth and profitability are key drivers of the valuation. High valuations can lead to misaligned incentives as investors will expect continued high growth and profits to justify the elevated price. When the valuations are driven by irresponsible growth rates, or high profits that are powered by high interest rate, it leads to negative perceptions of mission drift. In previous cases, the enrichment of founders exacerbated concerns. In the case of Ujjivan and Equitas, the post-IPO book value multiple was below two times – lower than banks trading at the time and previous financial inclusion IPOs. The founders of both Equitas and Ujjivan had modest ownership in the companies, with shareholding diversified among ten or more investors. Both companies pursued IPOs for working capital and to increase domestic ownership in order to become Small Finance Banks.

These are features that we expect will enable financial services companies pursuing an IPO to successfully balance the commercial and social aspects, and these features should be present in any other route to scaling up to ensure the commitment to mission is maintained.

2. Are we likely to see more IPOs in the Indian financial inclusion sector?
The market has changed since the SKS IPO and the Andhra Pradesh microfinance crisis in 2010. The two financial inclusion companies that listed in 2016 have longer track records and face a less reactionary public view of microfinance. In the case of SKS, the market responded favorably at the time of the IPO, but within six months, SKS' stock was trading at 40 percent below the offering price due to the microfinance crisis. Ujjivan and Equitas, on the other hand, were trading at approximately 80 and 50 percent above their offering prices, respectively, six months after their IPOs. The industry has not only rebounded but surpassed pre-crisis levels: according to a report by Sa-Dhan, a self-regulatory organization of MFIs, the industry saw more than 60 percent expansion in 2015-16 compared to the previous year.[xix] Given the enormous potential market of underserved low-income populations in many pockets of India, we expect to see more IPOs in this space. The credit bureau and regulatory framework now in place give some comfort that consumers – and investors – are better protected, but continued diligence on the part of all institutions and investors is required to ensure overindebtedness and aggressive practices do not resurface.

3. What do these IPOs mean for other impact sectors and countries?
Investing in financial inclusion is different than traditional private equity investing and even investing in other impact sectors. Credit bureaus and regulations can only go so far, particularly when dealing with largely informal markets and unskilled populations. Ultimately the onus of acting responsibly falls to the practitioners themselves – the financial institutions and their investors. Profit vs. impact choices often arise when managing a "social" business with poor or vulnerable people as the primary clients or suppliers. In these cases, there is usually no opportunity for cross subsidy or extracting higher margins from relatively well-off clients. Increasing the financial bottom line of the company often comes at the expense of decreasing the social bottom line by negatively impacting poor and vulnerable clients.

Client protection and responsible growth should always be paramount in any industry dealing with the poor and vulnerable. With an IPO, financial inclusion companies not only receive a huge influx of capital, but also lose some control of their social missions. When faced with the priority to maximize shareholders' profits, public companies can begin to stray from social objectives. This "mission drift" can happen in private companies as well, making it important to have mission-lock mechanisms in place regardless of the method employed to advance along the company's life cycle.

The response to the 2016 IPOs of Equitas and Ujjivan suggests that the emphasis these companies have placed on clear corporate priorities in dealing with underserved and vulnerable clients have positioned them well for continued success. These IPOs set a standard of transparency and double bottom line corporate behavior, bring visibility to the financial inclusion agenda and the broader impact investing sector and introduce a wider range of investors to impact investing.

Endnotes

1 Country Dashboard http://povertydata.worldbank.org/poverty/country/IND

2 "Oversubscribed" indicates investor demand for an IPO based on preliminary orders exceeds the total number of shares issued by the underlying company. An oversubscribed IPO will typically trade above the offering price when it begins trading on a stock exchange.

3 "In an effort to increase outreach to the underserved, in September 2015 the RBI gave in-principle approval to 10 entities to set up Small Finance Banks. Under RBI's statutory guidelines, small finance banks should lend at least 50 per cent of their loans in an average ticket size of below Rs 25 lakh (approximately USD 37,500)."

4 For more information on the trust, see http://www.equitascsr.in/

5 In April 2015, Ujjivan received a high "Social Performance Rating" of S1 (the highest) from an independent agency that affirmed its strong performance across multiple dimensions, including social goals and strategies, client and employee responsibility, products and services, and balanced social and financial performance (Ujjivan, 2016)

6 For a more in-depth analysis of responsible exits, see the 2014 CGAP and CFI paper "The Art of the Responsible Exit in Microfinance Equity Sales" https://www.cgap.org/sites/default/files/Forum-Art-of-the-Responsible-Exit-April-2014.pdf

7 See Microfinance and Capital Markets: The Initial Listing/Public Offering of Four Leading Institutions http://www.centerforfinancialinclusion.org/publications-a-resources/browse-publications/301-microfinance-and-capital-markets-the-initial-listing-public-offering-of-four-leading-institutions

8 There have been other listed microlenders globally (e.g., Bank Rakhyat in Indonesia) and in India (e.g., Satin). The authors do not intend the comparisons to be exhaustive and have focused on those institutions that count microfinance as a major business line, were predominantly privately owned at the time of the IPO, and went through the entire listing process.

9 For more information on the Compartamos and SKS IPOs, see "The Banco Compartamos Initial Public Offering," Accion Insight No. 23, June 2007 and CGAP Focus Note No. 65 "Indian Microfinance Goes Public: The SKS Initial Public Offering," September 2010

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The Financial Inclusion Equity Council (FIEC), previously known as the Council of Microfinance Equity Funds, is the first membership organization to bring together the leading private entities that make equity investments in financial inclusion throughout the developing world. Council members seek both social and financial returns from their investments.

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