Valuing Microfinance Institutions

Insights from the Financial Inclusion Equity Council

FINANCIAL INCLUSION EQUITY COUNCIL

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Where Are We Now

Insights from the Financial Inclusion Equity Council

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As one of the first impact sectors, and the sector that still has the highest proportion of assets under management (excluding investing outliers),[1] microfinance is a sector with a successful track record. And yet, more than a decade after Clay O'Brien produced the first paper to look specifically at the topic of valuing microfinance institutions (MFIs), it remains an essential and difficult task to determine the value of such investments. With this paper and other interventions, the Financial Inclusion Equity Council (FIEC) aims to play an active role in addressing this challenge.

In the financial inclusion sector, high valuations may be a precursor to an overheating market, while low valuations can represent a missed opportunity. Impact investors need more reliable valuation data and standard valuation methods to make sound investment decisions and forward their financial inclusion objectives. However, without more transparent, consistent and precise valuation data and more robust valuation methodologies, microfinance will remain a less mature asset class and social investors will be limited to a relatively small pool of known actors with whom to transact. As MFIs and other financial inclusion institutions evolve and mature, and as social investors look beyond the known pool of investors for exit options, reliable valuation data and practices will only gain in importance.

We interviewed members of FIEC's valuation working group to assess how much progress the industry has made since O'Brien first raised the topic in 2006, to determine how members today are pricing microfinance and related investments and to understand their views on the next valuation challenge. Our discussions revealed little progress on the valuations of MFIs. In general, valuation methodologies have become proprietary and complex, and FIEC members have adopted a more conservative approach to making assumptions, especially with respect to expected growth rates. There is broad recognition that even the slightest change in assumptions can lead to significant valuation variability, and that emerging fintech investments are even more challenging to value objectively. FIEC members require their investees to pursue a social mission, but social mission is not accounted for in valuations. We expound upon all of these topics, summarizing the working group members' comments, in the following text.

Changes in the Past Decade

In *Valuing Microfinance Institutions* (2006), the first paper to look specifically at the topic of valuing microfinance institutions, author Clay O'Brien surveyed FIEC members and found insuffIcent transparency in valuation methodologies and benchmark data. The social mission was considered as a negative valuation characteristic and prices paid for MFIs were overly discounted. O'Brien recommended using a discounted cash flow (DCF) methodology, when feasible, but this methodology has not been widely adopted because it requires too many variables and assumptions. DCF makes members uncomfortable because it can produce such a wide variation in valuations depending on how the discount rate and terminal value are adjusted.

Over the past decade, the industry has seen a number of MFI initial public offerings (IPOs) (e.g., Compartamos, Equity Bank, SKS, Equitas, and Ujjivan) with mixed public reactions; a global financial crisis; and several country-level microfinance crises. There has been a slowdown in investor interest in

[1] Mudaliar, Abhilash , Hannah Schiff, Rachel Bass, and Hannah Dithrich. "Annual Impact Investor Survey." *Global Impact Investing Network* 7 (May 2017). https://thegiin.org/assets/GIIN_AnnualImpactInvestorSurvey_2017_Web_Final.pdf

microfinance, and adjacent sectors like fintech have been growing faster. Not surprisingly, in terms of valuation data and comparables, the amount of publically available information has actually worsened. CGAP and JP Morgan carried out valuation surveys, but these concluded in 2012, and the deal information MicroCapital Monitor once regularly published has also faded away, leaving almost nothing for investors to use as comparables. With a small market and few transactions, investors can't remain anonymous when they contribute their data to valuation studies, and they are therefore reluctant to share valuation data.

The valuation of microfinance institutions has always been more an art than a science. It will continue to be an art, but should be supported by a more common industry understanding of tools and methodologies.

Methodologies

How do you value your investments in financial inclusion? How have valuation methods evolved over the years? What valuation methodologies do you think others outside the world of financial inclusion are using?

Impact investing funds usually value their investments are usually valued quarterly or annually, using multiples of price-to-book or price-to-earnings. To get to those multiples, members use complex equations taking into account mostly return on equity (ROE), as well as size, growth, and as many other relevant indicators as possible that help to benchmark performance relative to comparable companies, if available. Relevant market and comparable data is found through MIX Market, publically available transactions, and sometimes by adjusting data from the CGAP-JP Morgan reports, which ceased publication after 2012. Outside the financial inclusion world, many use DCF, and some use multiples of earnings before interest, tax, depreciation and amortization (EBITDA) linked to cash flow.

Fewer investors in microfinance reported using DCF analysis because discount rates are still difficult to determine for any small company in an emerging market, including MFIs. For one, valuations can vary widely; as one investor put it, "you could be off by millions of dollars by changing an assumption slightly." Additionally, if markets are illiquid, comparables don't exist. When the institutions are smaller, members reported keeping the investment at cost. Generally, there is a sense of conservativism in valuing investments, given how difficult is it to obtain relevant comparables in most markets.

> "You could be off by millions of dollars by changing an assumption slightly."

Members reported that over the years their internal valuation methodologies have evolved to become more professional, elaborate and sophisticated, using a variety of methodologies to trangulate on the value, often to compensate for the lack of external data and transparency. Ten to fifteen years ago, most members were using just book value or cost, but today there is a historical record, and investors have begun to lean toward fair market value (FMV), the price that a given asset would fetch in the marketplace. While the prices paid for equity stakes in financial inclusion institutions have trended higher over the past ten years, ROE and growth assumptions have become more conservative. This makes investors wary that the high valuations are not necessarily justified and there may be overheating, especially in certain markets (India was mentioned).

Pros and Cons of Commonly Used Valuation Methods[2]

Method	Pros	Cons
Multiple: Price to Book	• Simple and most widely used in the industry • Book value being a positive number, P/BV is always meaningful • Looking at multiples is an alternative way to address the issue of premium / discount	• Comparison with other transactions is difficult because of differences in context, accounting standards, tax treatment, and different leverage of institutions (no true comparable) • Book value does not indicate future earnings power of the institution • Multiples comparison is subject to market exuberance (bubbles)
Multiple: Price to Earning	• Simple and widely used in the industry • Looking at multiples is an alternative way to address the issue of premium / discount	• Comparison with other transactions is difficult because of differences in context, accounting standards, and tax treatment (no true comparable) • Cannot be used if earnings are negative; mostly used in the case of a stable and predictable earnings stream • Historical earnings do not indicate future earnings power of the institution • Multiples comparison is subject to market exuberance (bubbles)
Discounted Cash Flow Analysis	• Detailed valuation method • Conceptually sound method, investor should be willing to pay for present value of future cash flows	• Not appropriate for young MFIs, for which future assumptions may be unrealistic • Valuation is very sensitive to terminal value and discount rate used in the valuation, which by nature are subject to error • Not the best method in the case of minority shareholders, because only majority shareholders can decide the use of future cash flows

Comparables

What is your comparable return universe? Do you look at comparable investments globally or just in the country you are investing?

Members reported looking for comparables as close as possible in terms of location, size and target clients. Often, this is a similarly-sized bank within the same country but, for larger financial institutions, the comparable universe might become regional. All members reported that relevant comparables are not easy to find because of the lack of publically available data. In markets where there are two public transactions over five years, how do you consider those comparables?

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[2] Adapted from O'Donahoe, Nicholas P., Frederic Rozeira De Mariz, Elizabeth Littlefield, Xavier Reille, and Christoph Kneiding. "Shedding Light on Microfinance Equity Valuation: Past and Present." *CGAP Occasional Paper* 14 (February 2009). http://www.cgap.org/sites/default/files/CGAP-Occasional-Paper-Shedding-Light-on-Microfinance-Equity-Valuation-Past-and-Present-Feb-2009.pdf

Most members create and maintain internal comparable databases that may include a combination of transactions they are involved in, publically listed banks (discounting for the illiquidity of private equity investments), or transaction estimates based on informal market intelligence or available data (e.g., press releases, word of mouth). However, relying on publically available data is challenging because it is scarce and rarely provides relevant details (e.g., put options, board seats, ownership stakes, etc.).

Growth Rate Assumptions

How do you come up with growth rate assumptions? If the growth rates are too high for too long in markets with limited growth potential, what are the valuation implications? What are the implications of growth rate assumptions for exiting responsibly?

Growth rate assumptions are determined by looking at a number of factors related to the market and institution. In the market, members look at gross domestic product (GDP) growth, average client and portfolio growth, competition/saturation, and market size and demand. However, these indicators sometimes fail to present a complete picture. For example, market research shows a large market in Nicaragua, which would indicate that all financial inclusion institutions can grow there, but the plethora of credit availabile on the market, including formal and informal, consumer and business lending channels, make it tricky to predict actual market size and saturation.

To determine an institution's growth potential, factors include the stage of development (early or mature), achievements to date and management projections. It is important to understand the underlying drivers of the institution's growth and to question assumptions. Is the portfolio made up of productive loans or consumer loans? If clients have multiple loans, is that contributing to over-indebtedness or does it indicate a small and medium-sized enterprise (SME) client?

Most members reported trying to moderate growth rate assumptions, coming up with independent conservative projections and/or taking cuts of management projections. Some look for consolidations and merger opportunities to encourage inorganic growth. To some, slowing growth appears to run counter to their mission of reaching more clients. Others think responsible investors should challenge growth expectations and ensure that they take into consideration client demand, corporate infrastructure and resources, and the operating and regulatory environment.

Valuations are often done as exits are contemplated, but they should come out of an exit discussion instead of driving it. When high valuations are used in exits, the financial institution will face pressure from new owners to continue growth at all costs. One member commented, "we aren't selling to people who are new to this sector, so, to some extent, it is buyer beware." It is important for buyers to do due diligence and feel comfortable with the market and growth projections of the financial institution.

"High valuations, if being used for exit purposes, means that the growth must continue at all costs."

Social Mission

How does pursuing a double-bottom line impact valuations? Is a financial institution's social mission explicitly recognized in the valuation? How does the mission to invest in challenging countries impact risk, discount rates, and equity premiums?

> Not one investor reported paying a higher multiple becase it was a double-bottom line company.

As social investors, FIEC members only consider investments in institutions serving low-income segments, so the social mission acts as an initial investment screen. Non-financial scorecards exist to evaluate the social performance and commitment of an investment, but those investments still need to meet a financial return hurdle. No one reported paying a higher multiple for a double-bottom line company. By and large, the social mission does not play into the financial value (although some FIEC members are exploring new fund structures to allow for this). Some believe that the social mission should be in-line with the financial mission as growth implies serving more clients. Equity investors in particular can play a unique role in facilitating growth because equity can be leveraged to raise debt and board representation can drive strategy to improve efficiencies. As mentioned above, equity investors can also influence the company's activities to ensure growth is responsible and does not lead to over-indebtedness.

As for challenging markets, one respondent said that while all investments must meet an expected 15 percent internal rate of return (IRR), they don't differentiate in terms of country risks, a method that admittedly could lead to a higher profitability requirement for riskier countries. Overall, the riskier the country, the higher the expected return, as is to be expected. One member broke down risks into two categories: political and economic. To avoid political risk, the member chooses not to invest where there are known political challenges. Relying on quarterly country ratings helps to mitigate economic challenges and gauge whether an investment is possible. If so, then the team considers returns and runs stress tests to determine the political viability of getting their money back. "I would not invest in Ecuador…or Central Asia right now, unless we got a put option to someone viable outside the region."

FinTech Valuation

Are fintech investments being valued differently from other financial institutions—not driven by traditional asset valuation and earnings multiple but by perceptions about the business models?

Determining the value of fintechs remains challenging as some are pre-profit or even pre-revenue, and price to future earning assumptions are even more subjective than those of traditional double-bottom line financial institutions. One member felt revenue multiples and/or EBITDA multiples are best for fintech investments (depending on their stage of development) since profit multiples would be hard to find. Assessing risk for fintechs is a unique endeavor because of the scalability inherent insome fintech business models, which untethers them from the equity base and many operating expenses. Fintech is generally not as capital intensive as the banking industry. Price-to-book does not apply when assets are often not on the balance sheet.

“We don’t want to go back to the pie-in-the-sky dot com valuation methodologies.”

What lessons can we glean from tech company valuations outside of financial inclusion world, in Europe and the U.S.? Not much, as it turns out, since developing markets are very different. There is tremendous potential for fintech as more people acquire phones and spend more time online, but there is still volatility in emerging markets, and so members have to build in a country risk discount rate. Given the early stage of many fintech companies, and some past failures in this segment, there is cautious optimism. “We don’t want to go back to the pie-in-the-sky dot com valuation methodologies,” one member warned.

Going Forward

What are the valuation challenges that could be addressed by collective FIEC action?

Over time, valuation methodologies have become more sophisticate and growth rate assumptions have become more conservative.

There is an urgent need for more shared, comparable data that can be used to effectively benchmark impact investments. Impact investors have developed separate sophisticated approaches for something that should be simpler. FIEC is working to address this need by developing a valuation database for its members to share valuation data confidentially and anonymously. FIEC members will be required to contribute valuation information in order to access the database, in an effort to help build a comprehensive and reputable body of data that members can trust. The valuation database is intended to fill a critical gap in the market by providing members with reliable data and high-level market and trend analysis.

FIEC also plans to gather and disseminate best practices for valuation, including country discount rates, and to undertake more research on venture and tech investing, as MFIs are starting to modernize and optimize their businesses and will look different in the near future.

The Center for Financial Inclusion at Accion (CFI) is an action-oriented think tank that engages and challenges the industry to better serve, protect and empower clients. We develop insights, advocate on behalf of clients and collaborate with stakeholders to achieve a comprehensive vision for financial inclusion. We are dedicated to enabling 3 billion people who are left out of – or poorly served by – the financial sector to improve their lives.

www.centerforfinancialinclusion.org
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The Financial Inclusion Equity Council (FIEC) is the first membership organization to bring together the leading private entities that make equity investments in financial inclusion institutions in the developing world. FIEC members seek both social and financial returns from their investments in these institutions, which provide a range of enabling financial services to the financially excluded. Through the council, members seek ways to improve their oversight of their investees, enhance the performance of their investments and develop best practices and standards for the industry.

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