

1. Introduction

The microfinance sector is evolving from being predominantly grant driven to a stage where it is looking forward to attracting commercial capital. MFIs have been successfully utilizing commercial debt funds and are increasingly looking forward to commercial sources of equity.

In the past an MFI that achieved a Financial Self Sufficiency of 100% was assumed to have reached the epitome of sustainability. However, Financial Self Sufficiency may not necessarily mean commercial sustainability. In the most widely accepted definition of FSS, the cost put to equity is just the inflation rate, which we know is not true. The cost of equity depends on the risky-ness of the business the equity is invested in and will always exceed the inflation rate by an amount equal to atleast the risk-free rate. In effect, FSS puts no real cost to equity.

2. Book value method to equity valuation: Not appropriate

Thus, there is a need to value equity investments in microfinance which puts a market cost to it. In the absence of market information, (as the sector is still in a nascent stage and MFI's stock don't trade except for a few exceptions), it is natural for most investors to value an MFI based on its Book Value – utilizing a valuation range constructed from multiples of book value . Book value – variously called shareholder equity and net worth – is broadly defined as total assets minus total liabilities. This difference is the excess value a business has generated in its life. Book value is then multiplied by pre-determined coefficients to create the valuation range. However, the Book Value method may not be appropriate for valuing MFIs because of the following reasons:

2.1 Backwards Looking Nature

Book value is sum of the total excess value generated by a business. Hence, book value measures only what a business has done, and does not necessarily have bearing on what it will do. In mature companies and industries, past history is often a strong indicator of future performance; in such situations, book value is an effective tool for determining a company's present value. Microfinance, however, is not a mature industry, nor are many MFIs truly mature companies. Prior operating history is therefore not a good predictor for future results.

Historically, the microfinance industry operated along purely social lines. MFIs have sourced operating funds from donors and philanthropic organizations in the form of grants, soft or subsidized loans. These investments do not require profit maximization; at

most, some investments required a nominal interest rate and future return of capital. MFIs utilized these funds as budgets, not as commercial equity investments; the firms did not have an incentive to build a surplus. Excess funds were generally utilized to explore new niches or to lower borrowing costs. Additionally, microfinance activities were often only one of many initiatives under an NGO's umbrella. Surpluses, if any, generated through microfinance quickly flowed back into other parts of the NGO.

MFIs looking for commercial financing have refined their outlook to marry their social missions with the profit seeking ends of capitalism. There is an increasing realization that the bottom of the pyramid represents a worthy clientele. Managing their businesses for profit while offering financial services to the poor and very poor allows MFIs to dramatically scale their businesses. Commercially financed MFIs will necessarily operate very differently than they have in the past; investments can no longer be viewed as budgets, and an entire class of investors will demand profit maximization. Examining their history of value creation – the premise behind a book value valuation approach – is a misleading method of determining an MFI's value creation potential.

2.2 Lack of Comparables:

Without commercial history in the microfinance sector comparables to assess potential MFI profitability and an MFI's risk profile do not exist. Selecting the appropriate coefficients for book value is impossible in such an environment. Multiple coefficients for the book value approach are based upon two factors: one, the return to an investor a unit of book value will yield, and two, the return an investor expects from a particular investment. In practice, the amount of profit delivered per unit of book value (or sales or assets, or otherwise) is generally not known to any degree of specificity. This value is generally determined by examining multiples ascribed to similar companies or by examining a "standard" long term business model of a company or industry. Owing to its unique evolution and young age, microfinance sector does not have a set of comparable companies from which to draw from. A long term "standard" business model for the microfinance sector is also difficult to ascertain; at this stage, no one knows if a 2% return on assets, a 20% return on sales, or a 15% return on net portfolio outstanding is appropriate. Without either tool, determining the appropriate multiples is impossible.

The situation is further complicated by the differences between microfinance firms. Due to the youth of the industry, a plethora of models continues to persist. Each model has different operating profiles, different profit potentials, and carries different risks. Some key differences include:

Full Grameen model vs. Self Help Group – Grameen hybrid

Livelihood consulting vs. pure MFI

Full intermediation vs. service company operations

In addition, there are significant regional variations.

A multiple used to value one microfinance firm rarely transfers to another. Hence, even after a handful of MFIs successfully source investments in the near to medium term,

selecting book value multiples based on comparables will be difficult. An effective approach must both be forward looking and function in a nascent industry. A valuation approach that meets these requirements is the discounted cash flow (DCF) valuation.

3 Using Discounted Cash Flows (DCF) model for valuation

Free Cash Flows are defined as cash flows that remain after we subtract from expected revenues any expected operating costs and the capital expenditures necessary to sustain, and hopefully improve, the cash flows. The Free Cash Flows to Equity (FCFE) represent the free cash available to the equity holder of the company and is good measure of the company's capacity to pay dividends and provide capital gains opportunity to its equity investors. Discounted FCFE, is therefore, is appropriate way to value equity of a company which is in its initial life cycle stage, does not trade in public and so far has not paid dividends like most MFIs.

4 Peculiarities involved in valuing MFI's equity

Financial services firms including MFIs have certain peculiarities, and therefore FCFE calculation has to be more measured and careful.

Regulation: Banks and financial services firms are heavily regulated. In general, these regulations take three forms. First, banks are required to maintain capital ratios to ensure that they do not expand beyond their means and put their claimholders or depositors at risk. Second, financial service firms are a minimum level of Net Owned Funds or Net Worth. Third, entry of new firms into the business is often restricted by the regulatory authorities. From a valuation perspective, assumptions about growth are linked to assumptions about reinvestment. With financial service firms, these assumptions have to be scrutinized to ensure that they pass regulatory constraints, particularly relating to capital adequacy levels.

Reinvestment: If we define reinvestment as necessary for future growth, there are other problems associated with measuring reinvestment with financial service firms. Primarily, – net capital expenditures and working capital, could be considered as reinvestments required for growth. However, measuring either of these items at a financial service firm can be debated. Unlike manufacturing firms that invest in plant, equipment and other fixed assets, financial service firms invest primarily in intangible assets such as brand name and human capital. Not surprisingly, the statement of cash flows to a bank show little or no capital expenditures and correspondingly low depreciation. Similarly, if we define working capital as the different between current assets and current liabilities, a large proportion of a bank's balance sheet would fall into one or the other of these categories. Changes in this number can be both large and volatile and may have no relationship to reinvestment for future growth. For example a bank may accrue a large interest cost on its deposits while the actual payouts on account of withdrawals are much less. The bank's cashflow would in this case, gets artificially inflated.

----- Atul