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Is Going Public a Good Path for Microfinance Institutions? A Case Study Analysis of SKS's IPO and its Post-Issue Performance

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Is Going Public a Good Path for Microfinance Institutions?

A Case Study Analysis of SKS's IPO and its Post-Issue Performance

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Abstract:

Companies go public in order to obtain more attractive financing prices from stock markets in exchange for the promise of delivering profits to the investors who buy their stock. Microfinance Institutions (MFIs) aim at alleviating poverty in the society by providing the poor with opportunities for the creation and development of income generating activities. The uprise in the number of connections between capitalist interests and social ones originated several discussions and controversies among the microfinance community. This paper presents SKS Microfinance IPO, which was the first Microfinance Institution in India to go public. The IPO was a success and so were the ensuing 5 weeks. However, soon afterwards a crisis was triggered in the industry, making SKS's value fall enormously. In this study it is our goal to understand the reasons behind SKS's performance and whether going public is a viable path for Microfinance Institutions. Our analysis focuses on the internal and external factors behind the company's market performance, its operational evolution, and its position relative to its peers. We discover that the factors influencing SKS performance were specific to its managerial distress and to external conflicts arising in the sector. With strategic coherence and market transparency we believe there is an open way for MFIs to go public.

Key words: Microfinance, IPO, SKS, Proceeds, Stock, MFIs, Poverty.

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Résumé

Les entreprises s'introduisent en bourse afin d'obtenir du financement à un meilleur prix sur le marché. En échange, elles promettent des bénéfices aux investisseurs qui achètent leur stock. Les Institutions de Microfinance (IMF) visent à réduire la pauvreté sociale: elles offrent aux plus démunis la possibilité de générer une activité rémunératrice qui leur permettra de sortir de leur condition. L'augmentation des liens entre les intérêts capitalistes et les intérêts sociaux ont généré de nombreuses discussions et controverses parmi les experts en microfinance Cet article présente l'introduction en bourse de SKS Microfinance, la première institution de microfinance en Inde à s'introduire en bourse. Cette introduction a été un succès pendant les 5 premières semaines. Cependant, une crise dans l'industrie se déclanche à ce moment, entraînant une chute significative de la valeur de SKS. Nous avons ici l'intention d'étudier les raisons qui expliquent la performance de SKS ainsi que de discuter si l'introduction en bourse est une voie viable pour les institutions de microfinance. Notre analyse se focalise sur les facteurs internes et externes liés à la performance de cette entreprise, sur son évolution opérationnelle, et sue sa position par rapport aux autres entreprises. Au terme de cette étude, nous concluons que les facteurs influençant les performances de SKS étaient liés aux problèmes de management et aux conflits externes propres au secteur. Ainsi, nous croyons qu' avec une stratégie cohérente et de la transparence dans le marché, les IMF peuvent trouver leur place en bourse.

Mots-clés: Microfinance, IPO, SKS, Recettes, Action, Institution de Microfinance, Pauvreté.

Resumo

Uma empresa é cotada em bolsa com o objectivo de obter melhores condições de financiamento "pagando" aos investidores parte do lucro do seu negócio. As Insituições Microfinanceiras (MFIs) têm como objectivo reduzir a pobreza na sociedade e dar uma oportunidade aos menos favorecidos de produzir um negócio rentável. A capitalização bolsista de Instituições Microfinanceiras originou muitas controvérsias entre os especialistas de microfinanças, por ligar objectivos sociais e capitalistas. Este artigo estuda a listagem da SKS Microfinance, primeira MFI na Índia. A Oferta Pública de Venda (OPV) foi um sucesso durante 5 semanas mas, uma crise na indústria desencadeou-se e o valor do SKS caiu substancialmente. Através de um estudo exploratório não só das variáveis que influenciaram a ação nos mercados, como da sua robustez operacional e financeira, pretendemos compreender as razões por detrás da performance do SKS. Deste modo, tentamos compreender se a introdução nos mercados é um caminho viável para as MFIs. Descobrimos que os fatores que influenciaram a performance do SKS foram especificamente devidos, por um lado a uma ineficiente gestão e por outro devido a conflitos no sector. Concluímos que, com uma estratégia coerente e transparência nos mercados, existe um caminho aberto para a cotação em bolsa das MFIs.

Palavras-chave: Microfinanças, OPV, SKS, Acção, Mercados, Instituição Microfinanceira, Pobreza.

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Paris, 9th May 2012

TABLE OF CONTENTS

TABLE OF FIGURES

TABLE OF TABLES

List of Abbreviations

BSE – Bombay Stock Exchange

CGAP – Consultative Group to Assist the Poor

CRISIL – Credit Rating and Information Services of India Limited

ESOP – Employee Stock Option Plan

JLG – Joint Liability Group

MBT – Mutual Benefit Trust

M-CRIL – Micro Credit Rating International Limited

MUC – Mauritius Unitus Corporation

NBFC – No Banking Financial Company

NGO – Non-government organization

NSE – The National Stock Exchange of India Limited

RBI – The Reserve Bank of India

SEBI – The Securities and Exchange Board of India

SCI II – Seqoia Capital India II LLC

SCIGI – Seqoia Capital India Growth Investments I

SHG – Self Help Group

SIDBI - Small Industries Development Bank of India

SIP – Sandstone Investment Partners I

Currency and units of presentation

All references to “INR”, “Rupees” or “Rs.” are to Indian Rupees, the official currency of the Republic of India. All references to “US$”, “USD” or “U.S Dollars” are to United States Dollars, the official currency of the United States of America.

Units commonly used in South Asia are several times referred in this paper. A crore is equal to ten million units (10,000,000; 10^7); a lakh is equal to one hundred thousand units (100,000; 10^5).

The Financial Years defined by the company as starting in March t and finishing in March t+1, use as notation FYt+1. As for example, the current FY starting in March 2012 and finishing in March 2013 will be referred to as FY2013 by the company.

1. INTRODUCTION

On August 16th 2010, SKS, India's largest microfinance institution (MFI) decided to issue 23.3% of its capital to the general public. The need for amplifying its outreach and improve its services were the stated reasons behind this public offering.

The company's Initial Public Offering (IPO) was extremely successful, being oversubscribed thirteen times. It stock rose by 40% in the five weeks post to the issue. However, the tide changed for SKS as it was confronted with several adversities that damaged the company's value and financials.

Following this event, and all across the microfinance community, several diverging reactions arose, many of them questioning if microfinance institutions should go public or even be for-profit at all. Muhammad Yunus, 2006 Nobel Prize Winner took a public stand against the mixing of microfinance activities with "capitalism", backed up by his Grameen Bank, which remains an NGO largely financed through donors' grants and awards.

But, the limited availability of donations and the restrictions it imposes on MFI's outreach, led many MFI's around the globe to defend a for-profit model. These companies defend that their business model is not only more sustainable, but also capable of reaching a higher amount of poor people who would have no other access to loans.

Still, defenders of the non-profit MFIs question the integrity behind a business that is intended to alleviate poverty while simultaneously meant to provide its investors with financial returns. Should investors profit from a service that seeks to help people escape poverty?

This paper aims to find, through the analysis of SKS example if MFIs can successfully operate satisfying both capitalist and societal goals. We aim to go deep into the situation of SKS, from the moment of its creation to the present, in order to understand exactly what went wrong with the company. We expect this to provide a solid starting point for a better understanding of whether going public is a viable path for other MFIs.

In order to achieve this purpose we need to understand several aspects of the Microfinance and commercial investment sectors. We need to answer questions such as – If investors decide to buy SKS's stocks, do their expectations regarding the company take into account the type of business it performs? Do they know what lies behind SKS's stock price?

SKS's goal by going public was to invest in better services and amplify its outreach, but at the same time, several managers and investors who owned shares of the company profited millions of dollars, for their own personal wealth. Can both advantages coexist?

If harmony between investors' returns and clients' service improvement exists, then the public issue should be regarded as a creative and alternative way of providing microfinance services to those who require them.

India alone has about eight hundred million people living in poverty according to the World Bank. The main obstacle for escaping poverty is the lack of access to formal financial services. These people demand loans and MFIs can supply them. The issue here regards the risks of deterioration of the quality and effectiveness of MFI's services to really alleviate clients' poverty situation upon a massive growth such as SKS's.

Through this analysis we wish to understand firstly the variables to which SKS was exposed to and what explains its post-issue performance. Secondly, understand if having access to capital markets implies an improvement or deterioration of MFIs' service quality and therefore conclude if going public can be a good path for MFIs or not.

This research paper is divided in six sections. We begin by introducing to the reader a concise overview of the general context. Secondly, the reader will have access to relevant literature review. In that chapter we have covered subjects related to the Microfinance industry and IPOs. Posteriorily, we describe the methodology strategy selected, explaining the research methods that have been used and motivations behind their selection. On the next chapter, we introduce the selected case study in this research as well as the details behind its analysis. In the fifth chapter, we conduct a discussion forum regarding the key issues related to this research and its dimensions. Finally, in the conclusion we present the main discoveries of this study as well as its main limitations and suggested future research.

2. LITERATURE REVIEW

2.1. Introduction to Microfinance

Microfinance can be defined as a financial service whose goal is to reach the individuals who do not have access to mainstream banking services, that live in remote areas or have none or very low-income. It is important to mention that microfinance is not a “trendy” word that became popular these days. Its importance has been increasing since the end of the 20th century. However it is because of 2006 peace Nobel Prize winner, Muhammad Yunus, that microfinance became a worldwide relevant subject. Many economists consider microfinance to be a crucial tool to obtain higher levels of income equality within emerging countries.

Although not extensively recognized, Microfinance already existed in Europe in the eighteen century. For example, the Irish loan funds were a self-sustainable microcredit organization which provided millions of loans to the poor population in Ireland (Hollis and Sweetman, 1997).

Even though credit is the main instrument that microfinance institutions provide to its clients, a number of other services have been developing over the years. As an example, we can mention the increase in the use of savings, insurances and leasing.

2.1.1. Poverty and Financial Exclusion

As we mentioned before, the goal of microfinance institutions is to provide financing to the very low income sectors of the population or the financially excluded. The main receptors of these services are individuals that live below the poverty line. However, before continuing with our study, we must state what we mean when we say poverty.

The definition is somehow relative and has been evolving throughout time. We have chosen the definition given by the World Bank Organization that defines poverty as an income level below a social acceptable minimum. Nevertheless, Laderchi, Saith, Stweart (2003) elaborated a comparative analysis on poverty definitions and concluded that all of them contain some arbitrary and subjective elements, often imposed by the external observer. Furthermore, they state that a clearer and more transparent definition is a crucial prerequisite “for any development policy that puts poverty in the centre” (Laderchi, Saith, Stweart, 2003, pp. 2).

Linked with poverty there is the social problem of financial exclusion. Leyshon and Thrift (1994) described the important implications of financial exclusion on development. It inevitably amplifies the social and income gaps that exist within societies. When the poor or disadvantaged social groups are blocked from obtaining access to the financial systems due to structural processes, we say that we are in the presence of financial exclusion.

Microfinance wishes to reach out for the financial excluded. Being excluded can arise from different causes: very low-income population who is not seen as suitable for a formal loan, non-educated/illiterate people, or habitants in remote areas where formal financial services do not go.

2.1.2. Microfinance Agents

In the 1980's microfinance services were mainly offered by NGO, which relied principally on donors' subsidies and government support. In general, these NGOs were formed by small teams that only covered a narrow number of villages. Their size allowed them to deeply access clients and to guide them throughout the entire process. On the last three decades, the microfinance industry went through a series of changes. A relevant number of NGOs transformed into regulated microfinance institutions (Fernando, 2004). The first one was in 1992 in Bolivia, when *Fundación para la Promoción y el Desarrollo de la Microempresa* (PRODEM) became *BancoSol*. Several NGOs have followed this trend across the world. Although this new institutions are not that numerous, their impact is significant. The phenomenon of transformation of NGO's into Regulated Microfinance Institutions is motivated by the access of wider sources of capital and an increase in leverage. This allows the organizations to skirt around the limitations of donors grants and soft loans (characteristic to NGOs), which do not support an effective growth strategy.

MFIs are for-profit microfinance institutions which aim to stretch out their access to clients and manage a financially sustainable model which allows them to achieve the intended growth with efficiency. These institutions are characterized by their enormous size, systematization of loan processes, high coverage of cities and states, new products (loans and insurance) and some internationalization. Although NGOs still exist and perform on generating loans and guidance to the poor, many of them have evolved into for-profit companies.

Hishigsuren (2006) explores the main motivations and challenges faced by NGOs when trying to transform into regulated MFIs. The motivations referred are: access to additional/commercial sources of funds, wider range of financial services, self-sustainability and profitability, private sector ownership, higher efficiency and financial performance, improved customer service and improved financial transparency and accountability. The main challenges presented to NGOs crossing transformation are: the obtaining of license, the understandability and support of previous employees, the lack of banking knowledge of managers, ownership issues, balancing the services with balancing the books, facing the competitive environment, reporting requirements difficult to meet, higher required levels of liquidity, and many others.

As it is broadly shared among the microfinance community, there has been no empirical evidence of the benefits that Regulated MFIs generate. Although it is generally accepted that they increase their outreach, the effectiveness and quality of their services are severely doubted. This is mainly due to their standardized processes and cost awareness.

Rhyne (2002) defines the transformation of NGOs into regulated MFI as mainstreaming. It implies the upscaling of NGOs switching from donors grants and soft loans into a sustainable model (or for-profit model). On the other side, there are some important and well established banks that have developed microfinance branches in order to serve the poorer segment of the population. The author defines this process as downscaling.

2.1.3. Microfinance Models

Group Lending is by far the most distinguished microfinance innovation. There are several variations group lending techniques that are currently used. This practice can take numerous forms and become rather complex. The key objective is to achieve an extra incentive system for borrowers to perform on their loans and to be able, as a lender, to control the clients in a more effective and cost efficient manner. In this study we will analyze four types of group lending: joint liability, self-help groups (SHG), groups of groups and village banks.

Joint liability lending is mainly performed by MFIs. Through this lending technology, also known as *solidarity group*, a small group is in charge of an amount of money. In other words, instead of having the loan directly distributed to an individual, the money is given to an aggregation usually made up by five members. Posteriorly, the money is allocated to each person. Usually, the loans are collateralized with the client's future access to credit. Therefore, when a member goes into default, he blocks his future access to loans. In a *joint liability,* the default of an individual harms the entire group.

Other particular characteristics of this lending technique are the small size of loans, high frequency of repayments, high interest rates and peer monitoring to overcome informational problems.

There are at least three major benefits of using this lending technology (Conning, 1999). First, group members in a given village already know who are the “bad risks” and therefore can exclude them from their group. Therefore, group lending provides a first screening process. Secondly, it decreases the cost of monitoring since each group has an incentive to control their compeers and verify there is not any squander occurring. Lastly, members have incentive to support others, contributing in the repayment of a debt if someone is in difficulty, or mentoring others in the group.

Opposing to this, (Besley and Coate, 1995) describe the risk of domino effect. This occurs when a member defaults and the rest follows since they would lose the access and bear the consequences of defaulting either way.

While joint liability technique is used by MFIs, SHG typically involves a NGO in collaboration with a bank. The NGO coordinates the capacity-building services to the SHG and does the communication with the bank. SHGs are by norm bigger than Joint Liability groups (10 to 20 members). Because it is coordinated by a NGO there is not so much peer pressure to repay the loan.

Group of Groups, also known as Grameen Model evolved particularly in Bangladesh. It was conceived and implemented by Muhammad Yunus in 1976. In this lending technology, clients are asked by the microfinance organization to organize themselves into groups of five, each with a leader. Groups are joined (centre) into 5 to 7 groups (of groups). Loan requests have to be approved by other group members and centre members. Every member must contribute with a regular amount of savings. If a client is not capable of paying it, the concerned group or centre group pays up for her.

Village Banking has its roots in Latin America. The microfinance institution establishes in the village and organizes the groups, usually around 40 members, providing them with training and guidance. It is a variation of the solidarity group, in the sense that the group forms an internal account and each member relies on the others to comply. Again social pressure is key in motivating members to conform.

2.1.4. Risks, Efficiency Measurement and Crisis

Lately, Microfinance has been under the watch of international organizations and local governments. This is not only for its perceived activist contribution to the real alleviation of poverty, but also for its resurgent problems. For instance, cases associated with over indebtedness and multiple borrowing, non-real improvement of clients economic situation, and specifically in India, the suicides in the Andhra Pradesh region.

The impact assessment of microfinance in the clients lives is a difficult procedure. This cannot be measured exclusively using a quantitative approach, but must be addressed on a qualitatively manner regarding the client's quality of life and social improvement. The intricacy is to evaluate if a client can make a living out of firsts loans and create a relatively flourishing business or oppositely, if after the loan life the clients remains in the same poverty and social situation.

The impact study process is still very underdeveloped and no clear conclusions have been yet discovered. Duflo and Parienté (2009) have joined together different researches, and concluded that primary impact studies have yet no conclusive results. Banerjee and Duflo (2009) found no obvious impact registered in non-economic variables, such as education, health and the empowerment of women. However there is a clear impact on economic activity and household consumption.

Further variables are important to assess when measuring the efficiency of microfinance, such as the repayment success and the demand for new loans. Repayment was discovered not to be influenced by the level of interest rates. Higher or lower rates result at the same level of repayment. But these are influenced by dynamic incentives, such as the attribution of higher interest rates in case of defaulting, which proves the existence of moral hazard (Karlan and Zinman (2006)). The demand for loans varies according to the characteristic and complexity of the loans, but no clear pattern has been discovered yet. Usually, the more complex is a loan in terms of conditions and required information disclosure, the less clientele this will have.

On the other end of the line, regulated institutions emergence has called out for a measurement of their efficiency. The financial and operational efficiency of regulated MFIs can be measured through an in-depth analysis of the institutions books, particular ratios and rubrics. But additionally, and as microfinance specialists advocate, what really matters is in fact their contribution to clients living conditions. As explained in the above paragraph: the qualitatively efficiency and the social impact. These are positively affected by the quality of the institution guidance programs, peer monitoring and supervision.

From an external perspective there are still further risks MFIs face. CGAP – Focus Note Feb 2010 reported the alarms of excessive expansion for MFIs, and inferred that this massive growth was directly related to the repayment crises. “Concentrated market competition and multiple borrowing, overstretched MFI systems and controls, and the erosion of MFI lending discipline”. This is directly linked with SKS Microfinance main criticisms and controversies.

2.1.5. Microfinance in India

India is a vast country characterized by its ultra populated and modern cities but also by its immense rural area, isolated villages and poor rural population. In the last century, before India’s independence, during the colonial administration, the vast majority of the rural population lacked access to formal banking systems. Banks were agglomerated in wealthy urban areas where their business could be profitable. Devaraja (2011) brilliantly explains all the progress of the rural credit in India since the 50’s and its evolution to microfinance.

As the author mentions, money lenders were the key providers of credit in the rural India. Their practices are well documented by the Central Banking Enquiry Comitee (CBEC) in 1929. Money lenders technique was usurious and highly opaque. They demanded prompt payments when farmers could not still profit from their harvestings. In addition, they fiddled interest rates, they did not disclose their accountings and they were usually powerful influential actors in society. Poor farmers would always have to borrow more in order to repay them and the process would become a vicious cycle.

Nevertheless, the colonial administration created acts attempting to improve farmers’ credit condition such as Deccan Agricultural Debtors’ Relief Act (1879) or Agricultural Loan Act (1884) and others. But these were not effective enough to move away money lenders, neither to improve farmers’ situation.

In 1947, formal credit institutions provided less than 9% of rural credit needs in India, while 75% of these were supported by money lenders.

From 1969 onwards, commercial banks in India were nationalized in order to reach the rural areas. They became key actors in providing financial services to the poor. The nationalization aimed to fix inequalities; the government aspired to enlarge commercial banks access to the rural areas. Incentives were created and rules were established. Banks required a certain (high) percentage of rural branches and certain rural to urban deposits/credit ratios, which lead into an inefficiency collapse and several losses. Serving a huge amount of rural areas and expanding into undeveloped places just because it was ordered by the state was not efficient for banks. Many of these financial institutions were not able to keep their business profitable and the cap imposed on interest rates by the RBI (4% to 9%) contributed to the process of failure.

Following with the author, in 1976 Regional Rural Banks (state owned) were created to develop rural economy and supply credit and other facilities. Until the 1990's almost 35.000 of these banks were created to coverage the priority sectors (agriculture, small scale activities, etc).

Throughout this era, money lenders presence did in fact decline. However, the goals settled by the government programs, such as increase real wages in agriculture, reduce aggregate poverty and reduce the rural to urban poverty gap, were far from achieved. The programs failures were due to a flawed organization and lending methodology. Support was not given to clients who misused their assets, client selection beneficiated the least poor and little information was recorded on them. As the author explains, "quality of lending was completely undermined".

Millions of defaulters, debts in delay and great losses for the commercial banks, this was the situation in the 1980's. The reforms in 1991 brought liberalization and deregulation. Commercial banks were able to compete again and immediately got out of the rural areas. Their rural branches were closed, leaving the population again without access to formal credit and dependent on exploitative money lenders.

"It is in this vacuum created by the withdrawal of the state in rural credit that microfinance has entered". The microfinance phase in India is introduced by Self Help Groups (SHG) – bank linkage (SBL) and MFIs.

SBL uses the same methodology as the SHG approach, but with the exception that they are sponsored by the government and are linked with formal financial institutions. It is exclusively practiced in India under the NABARD program elaborated in 1992. Hundreds of SBLs were created in the country and it was, according to the author, the biggest provider of credit during the 90's.

Currently, in a report published by Bharat Microfinance, it was estimated that in 2009 in India, 22.6 million people were MFI's clients and 63.6 million people were SHG clients. In 2008 there were more than U$S 4.3 billion distributed in microcredit loans in India.

At the moment, there are three governmental entities in India that regulate the microfinance industry. These are SIDBI, NABARD and the RBI. These institutions have worked together with the goal of support the microfinance industry in India.

The RBI is India's central bank, and is in charge of controlling, among other things, the monetary policy of the country. The bank plays an important role in the development strategies of the government. The RBI has come with a number of initiatives to improve the industry. Commercial Banks in India are required by law to lend a minimum percentage of their money to specific sectors of the population and industry. These are usually less developed sectors and examples include agriculture, SMEs, education, housing.In 2007, the RBI established that microfinance loans are to be included within these mandatory sectors. These new initiatives allowed commercial banks to loan money to SHGs and MFIs so this way they could comply with the priority sector lending requirements.

SIBDI is financial institution funded by the national Indian government. It is the main financial institutions of the country in charge of the promotion, development and financing of the microfinance industry in the small-scale sector. SIBDI is in charge of coordinating and funding microfinance institutions in the country. This institution has taken on a series of initiatives to encourage the development of the industry. It has provided funding to newly created MFIs and it was one of the first to lend money to microfinance institutions without asking collaterals.

Lastly, the National Bank for Agriculture and Rural Development (NABARD) was established in India in 1982 and its main goal is to improve and develop rural India generating a credit flow in agriculture and in the rural non-farming sectors.

2.2. Going Public

So far we have covered the basics of the microfinance world and its evolution in India. However, before going on with our study, we should define properly what an IPO is and go through the main theories behind it.

2.2.1. IPO Definition

An initial public offering takes place when a company sells its securities in the financial markets for the first time. The securities offered can either be debt or equity, and after being issued a liquid market is expected to develop. The proceeds obtained by the public issue allow companies to finance themselves with cheaper capital. Even though IPOs can be beneficial for companies, a number of costs arise when firms become public. As an example, we can mention the quarterly disclosure of information to regulators and investors. Direct costs of IPOs include the auditing, lawyers and underwriters fees and among indirect costs we can mention the management time and the share price dilution. Companies are subject to disclosure requirements which differ from industry to industry, being some industries more regulated and severe than others according to their past history, such as oil and banking. (Ritter, 1998)

During the first day of trading, the price of the securities tends to increase significantly. This phenomenon observed, the first-day return, is referred to as underpricing and is one of the most popular anomalies discussed in IPO literature. Companies normally issue to the public 20 to 40% of their stock (Ritter (1998)). The underwriter takes a central part in the conducting of the offering, the pricing of the stock, the marketing to the investors and the due diligence of the firm. Companies go public for a diversity of reasons. Normally, they wish to increase their liquidity in order to expand and make investments such as new projects or acquisitions.

2.2.2. IPO Popular Issues

Initial Public Offerings are a central issue in corporate finance and one of main targets of markets' and investors' attention. Interestingly associated with some empirical patterns, IPOs are subject to innumerous research studies. The most important studied anomalies are underpricing and long-run underperformance.

2.2.2.1. Underpricing

Underpricing is the name given to a stock's first day return when it goes public and it is widely observed in almost all countries. According to Ritter's U.S market database, from 1980-2011, the average equally weighted first day return was 17.9 %.

There has been extensive research on the motives behind underpricing. Baron (1982) attributes it to asymmetry of information between companies and underwriters. The logic is that companies might not disclose some information to underwriters in order not to prejudice the operation. The revision of the price of the stock before the issue day is a strong and influential signal of the potential stock's underpricing. Before the issue to the public, the price may be lowered down by the underwriters. This suggests that institutional investors (informed investors) are not interested in the newly created stock. Rumours and information spread across the investment community, signaling that the company's equity is not a good investment. The opposite occurs when the price is revised upwards before the first day of trading. This is considered by the investment community as a good indicator and signals the quality of the firm to the market. Usually firms that have had their prices revised upwards tend to have higher first-day returns.

Ritter (1998) developed several popular underpricing rationalizations such as the winners curse hypothesis and the market feedback hypothesis. Booth and Booth (2003), argue that underpricing arises naturally from the divergence of opinion and ownership constraints. To comply with stock listing requirements, shares have to be delivered to both institutional and uninformed investors. Therefore the offer price needs to be set below the market-clearing price which will lead to excess demand and oversubscription of the issue.

2.2.2.2. Money left on the table

Investors obtain gains by taking advantage of the lower price and the "immediate" first-day return. This results on money left on the table, the mismatch of the opportunities between the issuer and the buyer. Money left on the table is defined as the first-day price return multiplied by the number of shares sold. In fact, companies do not complain about big amounts of money left on the table given that if it takes place it usually means that the IPO was a success.

2.2.2.3. Long-run Underperformance

The second most studied anomaly is the long-run underperformance of the stocks. Newly issued stocks on the first 5 year period following the IPO, tend to underperform against the market and private firms with similar characteristics. According to Ritter (1998), the average return of newly issued stocks in the U.S market is negative 5,2%.Santos (2010) analyzed the relation between underpricing and long-run underperformance discovering interesting patterns. New issues in low underpricing periods do not underperform in the long run, while new issues in high underpricing periods do.

2.2.2.4. IPO Fluctuations

IPOs fluctuate in cycles. Ibbotson and Jaffe (1975) were the first to observe the existence of an IPO market clustering both in terms of volume and average initial returns. According to

Lowry (2003) this can be explained by factors such as financing availability, investors' sentiment and business cycles.

A Hot Issue Market is a period of high average initial returns and rising volume of IPOs. Allen and Faulhaber's (1989) explain that following a technological shock, a vast number of companies, usually young and small, will try to extract financing from the investors' optimism. A recent big bump was the dotcom bubble of 1999-2000, where 323 internet companies went public, and 10 years after only a small number are trading above their issue price. More mature and established firms tend to go public during cold periods and these usually underperform less.

2.2.3. The IPO Market in India

Indian IPO Market is observed under an emerging market context. In comparison with developed markets and according to Loughran, Ritter and Rydqvist (1994), higher underpricing exists in emerging markets due to three main reasons: large government interference, early set of the offering price and riskier firms going public.

Nevertheless, the Indian economy has experienced some critical changes during the 1990's such as the liberalization program in 1992 and the abolition of the Controller of Capital Issues (CCI). Those have permitted large Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) inflows, inciting the growth and development of the Indian capital market. In fact, nowadays the Indian capital market is amongst the best regulated in the world. India has around 6.000 companies listed (similar to US). The Bombay (Mumbai) Stock Exchange (BSE) and the National Stock Exchange (NSE) are the two most important of the 22 stock exchanges in the country.

The pulse of the Indian domestic stock markets is tracked by BSE Sensitive Index (SENSEX) and S&P CNX Nifty. These indexes are composed by 30 and 50 companies respectively, which are some of the principal and most actively traded stocks and also representative of various industrial sectors of the Indian economy. Furthermore, there is the BSE IPO Index launched in August 2009 which tracks the performance of newly issued stocks during their first two years.

Ghosh (2004) explores the hot and cold primary Indian market from 1993 to 2001, verifying that the IPO volume is autocorrelated. IPO volume can be defined as the number of new issued companies on a particular month. The autocorrelation indicates that the number of previous companies going to the market influences the decision of others to go public. Eventually, no relation is discovered regarding the level of underpricing and the time of the issue (hot or cold markets). Similar to the behavior in the U.S. market, more mature firms tend to go to the market on slump periods.

Krishnamurti, Thong and Vishwanath (2009) covered the investment sentiment on Indian IPO markets and the after-market performance. They were able to justify the existence of a grey market and the possibility of profiting from it using short-selling strategies. Due to deeper information asymmetry problems, emerging markets have superior returns on their IPO listing days than developed economies. Recorded average underpricing from 2001 to 2005 was 46.63%. (Sharma and Seraphim, 2010). Adding to this, a main difference in emerging capital markets is the stronger presence of uninformed investors. These are leaned much more toward sentiment than institutional investors, demonstrating a higher irrationality that may further explain high opening returns.

Indian investment banks act as intermediaries between issuers and investors. They decide the issue price, allocating shares to certain investors and endorsing the economic rationality of the issue to the Securities & Exchange Board of India (SEBI).

Regarding the post performance of IPOs, Sahoo and Rajib (2007) studied a sample of 92 companies during their first 36 months in the Indian market. They discover that investors who buy stocks on the offering day are expected to earn negative returns on the first 12 months, following by positive returns.

2.2.4. Microfinance Going Public

The phenomenon of transformation from NGOs into Regulated Microfinance Institutions is motivated by the possibility of accessing bigger sources of capital. This is in order to skirt around the limitations of donors grants and soft loans, which do not assure a wider growth or long-term sustainability. Therefore a step forward was taken by Compartamos in 2007, succeeding to access the public capital markets as a purely microfinance bank.

But first, crossing the Pacific Ocean, we find other case of a bank specialized in low-income population going public in November 2003. Bank Raykat Indonesia can be used as a proxy for comparison the IPOs of microfinance institutions, but it is not regarded as a purely microfinance institution because it operates also

Schmidt (2008) explores Compartamos' IPO and the dark side of micro crediting. It presents several ethical questions regarding the commercialization of MFIs and its sustainable model, which in reality achieves the goal of reaching a bigger slice of the population in need. He suggests that Grameen's Bank critical position regarding for-profit MFIs may be "unfair" due to the reasoning that the former is a type of unsustainable bank that has been able to flourish only due to high amounts of donations and subsidies from foreign investors who are embraced by Yunus speeches.

Before Compartamos IPO, Copestake (2006) already dives into the hazy and drifted goals of microfinance institutions. The author suggests that for-profit MFIs should pay more attention to their social performance and find ways to actively measure it.

CGAP reflections about Compartamos IPO in June 2007 lead to some intriguing thoughts. Compartamos from Mexico was created in 1990, starting out from donors' grants and subsidies as a Microfinance NGO. In 2000 it transformed into a regulated for-profit finance company and in 2002 it issued debt for the first time on the Mexican bond market. Before the IPO it was authorized by the Mexican government to operate as a full service bank. It finally became the first microfinance institution to go public on April 20th, 2007. The issue was 13 times oversubscribed and considered a financial success. The first day return was 22%. Reasons for the success were among the past outstanding performance of the bank, perceived quality of the management and the appeal of the microfinance sector. Shares were bought mostly by commercial investors and international funds. This translated into a reposition of microfinance presence in the market, because not only it could eventually serve a social purpose, but also it could be capital efficient, profitable and fruitful for an investor.

Compartamos' IPO raised several moral questions within the microfinance community. First, due to the abnormally high interest rates charged by the bank: 104% on average (with 15% taxes added) (Rosenberg, 2007). Secondly and consequently, due to the vast profits obtained by its management team and shareholders. However, Compartamos defends its position by claiming they are acting on the best interest of their clients, highlighting the obvious lack of alternative for the population (otherwise clients wouldn't come to them). Microfinance specialists still don't understand why such efficiency does not lead to a decrease in interest rates. Yunus (2007) considers the company's position as heartless and unconscionable. Compartamos business model is simple: small loans, high interest rates and no collateral requirements. Clients are low-income women that wish to create very small businesses or enterprises.

Cull et al (2009) do a comparative analysis of the biggest microfinance institutions in the world. The evidence shows that from an investor's perspective, few MFIs would be of interest to invest money. In 2009 the future of microfinance relied between social driven institutions and profit-seeking ones. On the one hand, if a MFI wishes to achieve a bigger outreach, the for-profit business model can work. On the other hand, social based institutions are more competent in reaching and efficiently guiding the poorest of the poor, although in a much smaller number. "The market is a powerful force, but it cannot fill all the gaps" (Cull et all, 2009, 3)

Gunjan et al (2010) also perform a comparative analysis between the business models of three major microfinance banks: SKS Microfinance, Grameen Bank and Compartamos. They strive to identify the scope of SKS' decision to do the IPO (before this was done) measuring the tradeoff between sticking to the social mission of alleviating poverty and becoming profitable and sustainable. They conclude that this perceived paradox can be aligned.

With a broader notion of the literature related to our case study we shall now present the history and progression of SKS Microfinance. Subsequently, we will present a horizontal analysis of SKS main variables to track the effect of the IPO.

3. METHODOLOGY

This research paper carries out an exploratory study on MFIs and, in particular, on their profit orientation and capital structures. According to Sampieri (2006), exploratory studies' objective is to study a relatively new subject, where many questions are still unanswered and where there is little information available.

Even though the microfinance industry has grown significantly in the past few years, this remains an unexplored topic, especially in what regards the topic of capital structure and initial public offerings in this industry.

In this study we use both primary and secondary sources of data. As a primary data source, we have interviewed specialists in the field. As a secondary source, we use previous research papers were obtained from online sources, such as EBSCO and JStore. Also, financial data published on the company's website, Bloomberg and Mix Market Portal was also gathered. Very relevant information for this study was extracted from these last sources.

We selected SKS, an Indian MFI that has recently gone public, as a case study. The objective is first to assess the factors that led to the underperformance of SKS and second to understand if going public can be a viable path for other MFIs.

To assess SKS' stock vulnerability to market fluctuations, we run a simple regression analysis, using daily returns of SKS's stock and of the SENSEX index and Nifty Index (India's most important stock index).

Subsequently, in order to understand the corporate financial evolution pre and post-IPO, we conduct a simple horizontal analysis. We start by analyzing the quarterly results of the last 2 years and the outreach indicators, such as number of active borrowers and gross loan portfolio. Following this, we analyze the company's efficiency through the evolution of its profit margin, disbursements, portfolio yield and operational expense ratio. As we move forward, we gain a better understanding the evolution of risk indicators such as provisions, write-offs, and non-performing loans. We observed the company's overall financial performance by analyzing key ratios such as return on assets (ROA[1]), return on equity (ROE[2]), earnings per share (EPS[3]), price earnings ratio (P/E[4]) and market to book value ratio (P/B[5]). Finally, we performed a comparable analysis where a peer group composed of Indian MFIs was used. In this analysis we compare key financial and operational data to understand the evolution of SKS against its peers.

Lastly, and because we understand that this subject has a strong social connotation, we complement our quantitative analysis with interview data of three specialists on the field of Microfinance. Through the interviews we were able to gather diverging opinions on key issues of the Microfinance sector. Moreover, we complement this information with public reports of other international experts' opinions.

[1] ROA = (Net Operating Income – Taxes) / Total Assets
[2] ROE = (Net Operating Income – Taxes) / Total Equity
[3] EPS = (Net Income – Dividends) / Average Outstanding Shares
[4] P/E = Market Value Per Share / Earnings Per Share
[5] P/B = Market Value / (Total Assets –Intangible Assets and Liabilities)

4. CASE ANALYSIS

4.1. SKS Creation

4.1.1. The NGO

In 1996, after having won a Fullbright Scholarship, Vikram Akula aspired to play a more active role in the alleviation of poverty in his country. He started looking for financing to build his new microfinance project. Akula's family and friends made a first major contribution in his search of capital, and he was able to raise USD 52.000.

In 1997, he forms Swayam Krishi Sangam (SKS) as a public society in the state of Andhra Pradesh. The society was to function as a NGO, following the Grameen lending technology model.

Operations started in June 1998 with the establishment of the first women's banking *sangam*[6] (center) in Narayankhed, in the region of Medak District of Andhra Pradesh. This was and still is one of the poorest areas in India. On the first financial year SKS reached 19 female borrowers and the average net loan per client was USD 250. The client base increased to 191 in 1999.

Since its establishment, SKS embraced the use of top technology in its operations and dedicated to the development of highly specialized software. Their "state of the art" microfinance technology was reflected in the awarded Smart Card and Palm Pilots project. These tools were used by the staff and enabled them to reduce time spent in collecting information and on tracking transactions. This pioneering project won the CGAP Pro-Poor Innovation Award[7]. SKS began collaborating with Grameen Foundation USA and Digital Partners in the development of Smart Card technology for not only SKS but for the use in microfinance programs around the world.

SKS knew from the beginning that their greatest challenge was sustainability. Therefore they sought to combine the "best practices" of microfinance with corporate efficiencies. Their growth aspirations were translated into their ambitious expansion goals documented in the corporate reports.

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[6] As explained in the literature review, groups of five women were created and then trained. These groups were joined in a *sangam* (center), with a limit of 8 groups or 40 members. A main leader would be attributed and took responsibility for the organization of the weekly meetings and for the collection of the savings and the loans repayments.

[7] The award had a respective prize of USD 50.000.

4.1.2. The Growth and Funding

The swift growth throughout Medak District led SKS to increase to a number of 129 centers in July 2001 serving approximately 5.000 people. But further expansion was within sight. SKS planned to enter in a new District, the Nalgonda District, and reach over 30 villages and 500 families by October 2001. Indeed, in the FY2002 clients' base surpassed 10.000 and it increased on average 250% on the following years. In FY2005 it provided credit to over 172.970 clients and in the FY2007 it served more than 1,6M clients. It was in FY2009 that they reached the astonishing figure of 5,8M clients.

This remarkable expansion was possible on the one hand due to the highly efficient methodology practiced by SKS and on the other hand due to the various sources of financing, since foundations soft loans to private equity investments.

SKS started its conduit for profit when it registered within SEBI in 2003, issuing 99.5% of the fully diluted capital to five SKS Mutual Benefit Trusts.

Most of MFIs which have transformed from non-profit institutions to for-profit NFBCs[8] have used the same techniques to successfully achieve this. The MFIs transferred their assets to special entities called mutual benefit trusts (MBTs). Afterwards, the MBTs invested in the newly formed NFBC by buying their shares.

When analyzing the particular case of SKS, we find that five different MBTs were created. Capital was injected into these MBT that came from SKS Society as well as other sources. These MBTs would later invest in what today we know as SKS Microfinance. In 2003, five SKS Mutual Benefit Trust Funds (MBTs) were issued within SEBI. The investments that these entities did in SKS totaled USD 7.9 million. When discriminating down this number we find that USD 0.9 came from philanthropic sources (soft loans). The rest of the money came from private equity investors.

M-CRIL[9], a global leader in the financial rating of microfinance institutions around the world, awarded SKS with an alpha minus (α-) which defined SKS as a recommended company, reasonably safety and with good systems.

8 Non-Banking Financial Institutions – These are similar to commercial banks but do not take deposits or give out checks.
9 Micro-Credit Ratings International Ltd.

In 2005, SKS was finally registered as a Non Banking Financial Company (NBFC) with the RBI. This allowed them to expand into more districts, pass from thousands to millions of clients in less than 3 years and use the institution profits to finance further growth.

SKS reputation was being built and it actually became a distinct and reliable MFI, as it was awarded the CGAP Transparency Award 2005.

With the arrival of March 2006, SKS decided to raise its first round of equity valuing INR 5.232 crores (approximately USD 1.6 M). On total it was allotted 5.323 thousand shares to Unitus Equity Fund, Mr. Vinod Khosla, Ravi and Reddy, and lastly Small Industries Development Bank of India (SIDBI). The proceeds were attributed to the MBTs in order for them to buy additional shares from SKS.

One year later, SKS raised a second round of equity to a number of private investors totaling INR 51.172 crores (approximately USD 12M). Seqoia was prominently the lead investor, obtaining practically half of the issue.

On January 2008, SKS does a third equity round of an average amount of INR 147.308 crores issuing 20 millions shares.

To note is the evolution of the price as we go further in the equity rounds. The price of the issue jumps 40% from 2007 to 2008, from INR 49,77 to INR 70,67 (for 10,00 as face value). From 2008 to 2009 it increases 4,25 times to INR 300. This reflects the higher importance and valuation given to the company on that time. This fourth funding round counted again with a number of private equity investors with no previous connection to microfinance, for instance Sandstone Capital.

For two years, Vikram Akula left his CEO post to work as a management consultant in the United States and Sitaram Rao was appointed as the new CEO of SKS.

The trail had started and the preparations to go public were already in the mind of the board. SKS Microfinance was continuing to build a reputation and in 2007 it won the Excellence in Information Integrity award. In 2008 the firm is listed among the World's Most Influential Emerging Companies. Furthermore, it is the first MFI to receive the ISO 9001:2000 certification of its Internal Auditing Department.

In 2009 it is ranked number one MFI in the country and number two in the world by Mix Market. Meanwhile Vikram Akula comes back for the Chairman position at SKS.

As part of compensation plans, stock options were given under an Employees Stock Option Plan. This gave the possibility to certain employees to exercise share options after a defined period. The rationale behind the plans was to amplify employees' motivation with rewards and management opportunities and to align their interests with the long-term interests of the company. On the 24th of December 2009 and 23rd of March 2010, a number of share options were sold by Chairman Dr.Vikram Akula and CEO Mr.Suresh Gurumani respectively.

In particular, 1.17 Million shares were sold to Tree Line Asia Master Fund (Singapore). Tree Line is an investment company focusing on the Asian Pacific, established in Singapore and Hong Kong. The shares were sold at USD 11.67, approximately 647 Rupees. This implied a total profit of 11.9M dollars for Vikram Akula. He was able to achieve this by selling privately his stock options. The CEO on the other hand, was able to take home a total of 1,67M dollars.

In beginnings of 2010, investors' sentiment was positive since SENSEX and BSE IPO Index were both on a 2 year high (see Figure 28 in Appendix). The preparations for the IPO started and rumors arose in the investor community around the world. A "social business" company wanted to become a player in the capital markets.

4.2. The IPO

On July 2010 SKS becomes the first MFI in South Asia to launch an IPO and get listed. The goals of this issue were, on the one hand, to augment the institution capital base in order to support the expansion plans. On the other hand, they wanted to take advantage of the benefits of being a listed company.

The underwriters, formally called Book Running Lead Managers (BRLM), were characterized by a group of institutions that combined local Indian knowledge and global expertise. To carry out the transaction the following were selected: Kotak Mahindra Capital Company, Citigroup Global Capital Markets and Credit Suisse Securities (India).

From the BRLMs' perspective this was a great opportunity not only due to the company's performance track but also due to the specific sector in which it played. In fact, the proliferation potential of the Microfinance sector in India and the capacity of MFIs to be profitable and sustainable solidified the prospective of the issue.

The Promoters Group are defined by SEBI[10] as the shareholders who have overall control of the company, who have an active role in the issue decision or who are named promoters in the issue. In this issue, it was constituted by Dr. Vikram Akula, SKS MBTs, SCI II, SCIGI I, Kismet Microfinance and MUC. Apart from Dr. Vikram Akula and SCIGI I, the remaining promoters were in fact the selling shareholders, who sold 26% of their position.

The intention of SKS was to offer to the general public 16.791.579 shares. From which 44% came from new emissions and the rest, 56%, was offer for sale by previous shareholders. These were to be traded on the Bombay and National Stock Exchange.

The shares were priced at 98.5 times the face value of the stock (10.00) to Qualified Institutional Buyers (QIB), Mutual Funds and Non-Institutional Investors. While to Retail Investors they were priced with a 50 discount, at 93.5 times. The Retail Investors were to be allocated at least 30% of the issue, while QIB 60%, being the 10% left directed to Mutual Funds and Non-Institutional. In order to simplify our analysis, we assume the issue price (received by the selling shareholders) to be a weighted average of both prices offered to QIB and to retailers, INR 970.

[10] Securities Exchange Board of India

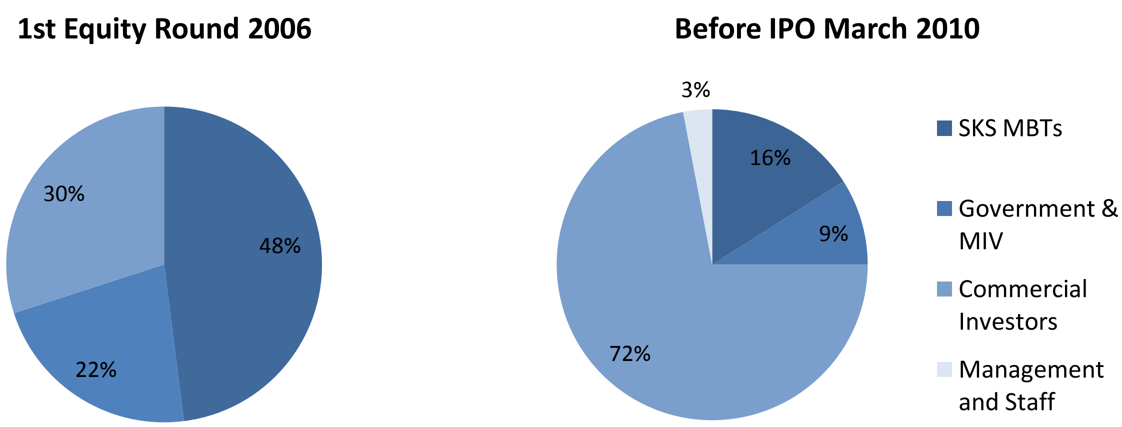
4.2.1. SKS Shareholding Structure

Pre-Issue

As referred to in section 4.1, the first major shareholders were the MBT funds. These were created with the donations from SKS Foundation and others, allowing them to invest in the newly created NBFC in 2005. From the first equity round in 2006 to a moment before the IPO, SKS evolved into a company owned mainly by commercial investors, specifically private equities. Many of these prosperous investors had no previous association with the microfinance sector.

Before the IPO there were some relevant transactions. For example, 937.770 shares were sold to Catamaran Fund, a private equity with a focus in health and technology. From Figure 1, we can observe that previous to the IPO, SKS held 64.527.219 shares distributed between Commercial Investors (72%), the MBTs (16%), the Government and Microfinance Investment Vehicles (9%) and the rest belonged to the management and staff.

Figure 1 – Shareholder Structure Before IPO



Source: SKS Data

Post-Issue

Within the Promoters Group, the selling shareholders were: SKS MBTs, Seqoia Capital India (SCI II), Kismet Microfinance and Mauritius Unitus Corporation (MUC). Each shareholder sold on average 30% of their stock. The share dilution due to the issue of new shares can be observed on Table 1.

Several Anchor Investors with no previous connections to microfinance sector subscribed to the shares such as J.P Morgan, BNP Paribas, Credit Agricole and George Soros Quantum Fund. Up to 30% of the QIB portion was directed to these Anchor Investors. After the issue, about 80% of SKS shareholders were to be private investors, from which 23.93% were general public.

Table 1 – Shareholder Distribution Before and After the IPO

Shares Distribution	**BEFORE IPO**		**AFTER IPO**	
1) Promoter and Promoter Group				
SKS MBTs	16,53%	10.368.425	11,91%	8.354.649
SCI II	14,50%	9.095.550	7,28%	5.105.847
SCIGI II	7,89%	4.951.474	7,06%	4.951.474
Kismet Microfinance	12,62%	7.914.205	8,03%	5.634.809
MUC	5,89%	3.692.129	3,75%	2.628.748
2) Non-Promoter Group				
SIP I	13,30%	8.341.792	11,89%	8.341.792
Mr. Vinod Khosla	6,76%	4.238.866	6,04%	4.238.866
Kismet SKS II	5,84%	3.660.500	5,22%	3.660.500
Yatish Trading Company Private Limited	2,48%	1.556.114	2,22%	1.556.114
Tejas Ventures	2,81%	1.760.552	2,51%	1.760.552
BALICL	2,66%	1.666.666	2,38%	1.666.666
Tree Line	2,38%	1.492.924	2,13%	1.492.924
Catamaran Management Services Private Limited	1,50%	937.770	1,34%	937.770
ICP Holding I	1,28%	802.018	1,14%	802.018
Quantum (M) Limited	0,48%	300.000	0,43%	300.000
Infocom Ventures	0,45%	283.020	0,40%	283.020
SIDBI	2,88%	1.807.461	2,58%	1.807.461
3) Others				
SKS Employees & EWT	2,58%	1.619.633	2,31%	1.619.633
Dr. Tarun Khanna	0,01%	8.080	0,01%	8.080
Others	0,05%	30.040	0,04%	30.040
Public Pursuant to Issue			23,93%	16.791.579
TOTAL		**62.719.758**		**70.165.081**

4.2.2. Valuation

The share's price was decided upon the increased appreciation of SKS shares while privately traded (see Table 9 in Appendix) and also on the potential of earnings arising from Microfinance's vast growth perspectives in India. Moreover, SKS hold a relatively diversified portfolio of the clients sector of activity which further decreased its exposure to seasonality or sectorial crisis (see Figure 26 in Appendix). Other factor increasing SKS safety as an investment was its low indebtedness, which translated its potential to still finance through debt. These qualities of the company were translated also into the IPO success.

Throughout the years, the price of private issues jumped 40% from 2007 to 2008 to INR 70.67. From 2008 to 2009 it increased 4.25 times to INR 300. This reflects the higher importance and valuation given to the company and to the sector on that time. Further, under the exercise of stocks, 1.17 Million shares were sold at approximately INR 628.82 in March 2010. This were the share options held by Dr. Vikram Akula (Chairman) and Mr.Suresh Gurumani (CEO at the time), under the Employees Stock Option Plan 2007[11] (ESOP 2007) and ESOP 2008 program respectively. The shares were sold to Tree Line Asia Master Fund at US$ 13.67 (which was approximately 628.82 Rupees), 12.6 times the original exercise price of the option.

Because less than 25% of the post-issue capital was to be issued, the SEBI regulations permitted the issue to be done through a 100% book building process. This meant that the price would be the process of collection of Bids among Qualified Institutional Investors (QIB), on the basis of the Red Herring Prospectus[12] within a price band decided by SKS and the Selling Shareholders in consultation with the Book Running Lead Managers (BRLM). The Floor Price (minimum price) was INR 850 and the Cap Price (maximum price) was INR 985. The Price Band was advertised two working days before the Bid/Issue opening period, which lasted 5-days. On the Pricing Date it was announced that the price per share was INR 985 for all investors with a 50 rupees discount for Retailer Investors.

4.2.3. Risks

On the other side, investors faced risks concerning the industry and the company specific capabilities. Investors needed to take into account the limited past history of SKS and limited knowledge about the microfinance industry. Two important factors to take into account were the company capability to manage growth efficiently and the inexistence of regulation in the sector.

Furthermore, investors needed to consider external risks. Since the company finances itself with debt, it is exposed to fluctuations of the interest rates of the country. Also, the risks arising from the specificities requirements a company has to follow once it is traded on capital

[11] ESOP 2007 was awarded in September 2007 and valid up to September 2011. The total number of options granted was 1.852.158 at an exercise price of 49.77. These were fully granted to Dr. Vikram Akula.

[12] Red Herring Prospectus is a prospectus that does not disclose the price or the number of the shares to be offered on the issue. However it discloses the lower and upper band proposed for the price by the Company and the Selling shareholders.

markets. As investors are for sure aware, SKS market capitalization will be subject to fluctuations and a decrease on its share price will immediately imply a decrease on the company's value. Since the company is the first in the microfinance sector to list in the capital markets, there is the possibility that a liquid market does not arise.

Once the company became a NBFC it was awarded a rating by M-CRIL of alpha minus (α-) which defined SKS as a recommended company, reasonably safety and with good systems.

Upon the issue, the rating received by CARE Ratings[13] was assigned on a scale from 1 to 5. Grade 5 suggests strong fundamentals while Grade 1 suggests poor fundamentals. CARE attributed Grade 4 to the IPO indicating Above Average Fundamentals. This translated the company's efficiency, management experience and asset quality. However, the grading was slightly restrained by the sensitiveness of SKS to operational risk due to the large volume of cash transactions and decentralized operations spread all over the country. Furthermore, the grading took into account the possible future changes in government policies.

4.2.4. Proceeds

Proceeds of the Issue – SKS

The gross proceeds allocated to SKS are the ones derived from the fresh new issue of 7.445.323 shares. These proceeds amounted up to 7.222,96 Million rupees.

The expenses related to the issue were only 3.95% of the Issue Size, and sum a total of 644.15 Million rupees. (see Table 10 in Appendix) These were equally shared by the company and the selling shareholders, except for the listing fees which were covered only by the company. Therefore, the net proceeds SKS obtained from the fresh issue were 6.842,18 Million rupees (Table 2).

Table 2 – Proceeds to the Company

Particulars	***(Rs. in Million)***
Proceeds of the Fresh Issue	7221,96
Issue related expenses	379,78
Net Proceeds of the Issue	6842,18

Source: SEBI IPO Report

Proceeds of the Issue - Investors

[13] CARE (Credit Analysis and Research Limited) Ratings is the second largest credit rating agency in India. CARE Ratings is considered leading agency for IPO grading.

26% of the shares hold by the selling shareholders was offered to the general public. We can notice that the interest for this stocks rose close to the IPO since from the shares offered to sell, 9.5% were acquired one year previous to the IPO, and 28.5% approximately 6 months before the IPO.

As we can understand from Table 3, the selling shareholders amounted from the sale a total return of 8.106,19 Million Rupees. This was on average 20 times the initial investment. The MBTs since they were the oldest shareholders were the promoters with the biggest Total Shareholder Return (TSR) of 29 times their initial investment. SCI II was the promoter in the group with the smallest TSR of 15 times, since it had the biggest average cost per share.

Table 3 – Total Shareholder Returns

Promoters	**Shares Sold**	**% of Position**	**Avg Cost per Share**[14]	**Total Cost ('000)** (A)	**Proceeds INR ('000)** (B)	**Profit INR** (B) - (A)	**TSR**
SKS MBTs	2.013.776	19%	32,43	65.246	1.888.116	1.822.870	**29**
SCI II	3.989.703	44%	61,21	244.090	3.625.922	3.381.832	**15**
Kismet Microfinance	2.279.396	29%	54,56	124.295	2.086.719	1.962.423	**17**
MUC	1.063.381	29%	43,48	46.204	985.276	939.072	**21**
Total/*Average*	**9.346.256**	***30%***	***47,92***	**479.836**	**8.586.033**	**8.106.197**	***20***

Lock-Ins

Several shareholders were required to lock-in their shares and stock options in order to enhance their motivation and managerial efficiency in the company and as also, to align their interests with SKS long-term interests.

At the moment of the Issue, Dr. Vikram Akula consented to lock in 2.676.371 stock options (under ESOP 2010 program), for a 3 year period beginning in the date of the issue. At the time of the IPO the value of his stock options would be about USD 55 Million (approximately INR 2.6 Billion).

Accordingly to SEBI Regulations, the Promoters were subject to a lock-in period of 20% of their post-issue diluted capital for a period of also 3 years from the date of the Allotment of

[14] Average Cost Per Share includes the Issue Related Expenses attributed to the Promoters Group of 264,37 Million. These were assumed to be distributed according to each promotes sold shares weight.

Equity Shares in the Issue. This represents at least 5.335.105 shares that to be locked till August 2013[15].

Lastly, the equity shares allotted to the Anchor Investor were locked for a period of 30 days from the date of the Allotment of Equity Shares in the Issue.

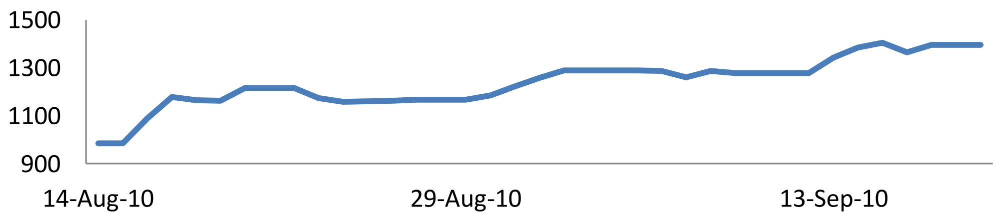
4.2.5. The First Trading Day

The first trading day happened two weeks after the final close of the IPO on the 16th of August 2010. The issue price appreciated 11% to INR 1088.6. Although below comparable first day returns of Indian IPOs (28%[16]), SKS underpricing still shows investors optimism. Furthermore, 20.6M SKS shares were traded upon that day on both NSE and BSE, a volume 1.2 times the offer of the issue.

The amount of money left on the table by SKS was 1.991,14 Million (approximately USD 42.6 Million). It caught the attention of more investors and left them optimistic about the issue. The money left on the table signals confidence regarding the upwards trend of the stock and in this case attracted investors not only to the stock but also to the story of microfinance.

During the weeks following, the stock valued at a 5 week maximum of 40% above the issue price on the 15th September. (Figure 2)

Figure 2 – 5 weeks SKS Stock Price Evolution



4.2.6. Comparison with the industry

Before entering in the analysis of the 20 months post IPO performance, we should have a clear idea regarding the valuation of SKS in relation to the banking industry in India, and in relation to the other Indian MFIs.

According to CGAP analysis in September 2010, the public listed banks relevant for a peer comparison were HDFC Bank, ICICI Bank, JP Morgan LIFI Index (an index of 8 publicly traded emerging markets low-income financial institutions) and Compartamos from Mexico.

[15] Under specific exceptions (SEBI SKS IPO Final Document page 35)
[16] Jain and Padmavathi (2012)

HDFC Bank is the 5th largest bank in India by assets and ICICI Bank is the 2nd largest. The JP Morgan LIFI index is composed by 8 emerging markets publicly traded low-income financial institutions and Compartamos is the only pure MFI publicly traded in the world. From the table below we perceive that SKS is was valuing 4.2 times its post issue book value, which was in accordance with the Indian average. Furthermore, it was valued 40 times its year earnings which is considerably higher than its peers P/E ratios.

Table 4 – Public Listed Peer Group Comparison

	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

Source: CGAP Analysis September 2010

In relation to the MFI industry in India, we can observe from Table 5 that SKS is consistent with its peers. The portfolio yield is similar among Indian Top MFIs and lower than the reported 29% charged by the 150 NBFIs. Furthermore, SKS has higher operational expenses which allegedly come from investments in staff and systems and a bigger non-loan income weight which is derived from insurance fees and commissions.

Table 5 – India MFIs Peer Group Comparison

Mar-10	SKS	Top 5 MFIs (median)	Mix 150 MFIs (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 CGAR (5 yrs)	166%	89%	36%
Portfolio yield	25.7%	25.9%	29.0%
Non-loan income/assets	1.6%	0.2%	n/a
Operational Expense Ratio	10.2%	6.4%	14.5%
Financial Expense Ratio	8.8%	9.1%	6.5%
PAR30	0.40%	0.28%	3.95%

Source: CGAP Analysis September 2010, MIX (2009)

With this we conclude the specificities and values behind the IPO analysis. We can mainly suggest that the company's equity was favorably valued in the market and that it presented fine growth perspectives to investors. We are going to introduce the post-issue performance of SKS in the next section.

4.3. Analysis of SKS Post-Issue Performance

4.3.1. The Stock Evolution

SKS stock started out quite well, boosting 40% on the first 40 days of trading. Investors were optimistic with the new capital markets sector, supported by the precedent success of the NBFC. It arouse into a relatively liquid stock, trading on average 1,5M shares a day (both in the NSE and BSE).

SKSM [17] reached its peak on the 15th of September 2010, valuing INR 1404.85. From that day on, the stock did not witness anything else than a descending order. One month following its peak, the stock lost 20% of its value, falling to INR 1135.9. At the end of the year, SKS Microfinance was valuing INR 644.7, which meant a 54% loss in value from its higher peak, or a 35% loss from its issue price.

The year 2011 did not bring any improvements to the stock behavior. It lost on average 7% in value per month, reaching the year end at INR 93.65 price level. This translates into a total loss of 90%, if comparing with the stock's first trading day value. In terms of market capitalization; SKS lost INR 63.353,83 Million in market value since its public issue, which is approximately USD 1.185,4 Million.

The behavior of SKSM is indeed intriguing and was unexpected at the time of the issue. Therefore, we wish to identify the main causes of this descending path.

First of all, we observe the relation between SKS and SENSEX (BSE Index); and SKS and Nifty (NSE Index). Secondly, we analyze market reactions to five main events, such as the firing of the CEO, Mr. Suresh Gurumani, and the exit of Vikram Akula; and external events such as Andhra Pradesh Crisis and RBI's legislations Acts.

4.3.1.1. SKS stock behavior analysis

SKSM and the Indian market

Since its IPO, SKSM underperformed SENSEX India by 85% (Figure 4) and Nifty index by 86% (Figure 3). This simply means that if an investor had invested on SKS stock and on SENSEX (Nifty) index by the time of the IPO, he would have lost 89% of the share value but only 4% (3%) in the index value. In order to understand how much of the SKS stock behavior was influenced by the Indian market, we conducted a simple regression analysis

[17] SKSM is the ticker in BSE and NSE

between SKS daily return and the SENSEX daily return, during the period that ranges between 16th of August, 2010 (the day that SKS went public) and 30th of April, 2012.

The regression's R^2 – indicator that measures the power of the regression, or how much of the dependent variable variations can be explained by variations of the independent variable(s) – revealed to be only 4.7% in relation to SENSEX and 4.04% in relation to NIFTY, which shows little regression power, or that neither SENSEX neither Nifty fluctuations are influencing significantly SKS's.

Figure 3 – SKS vs SENSEX

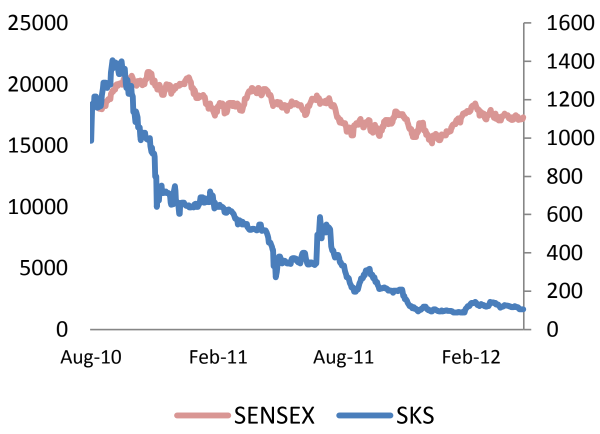
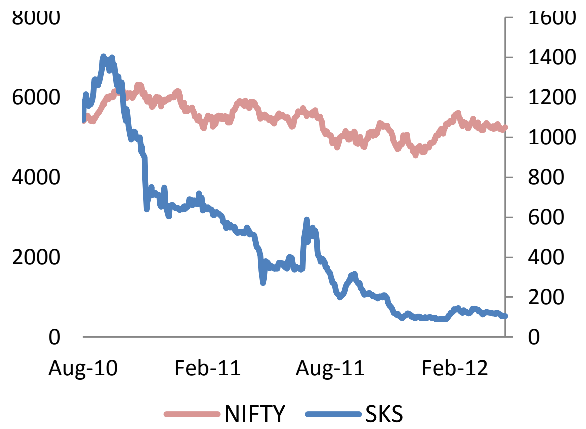


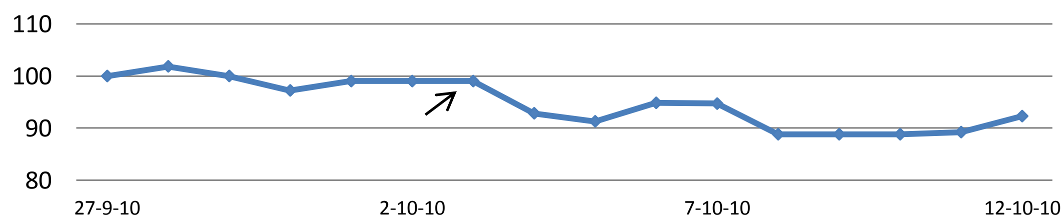
Figure 4 – SKS vs NIFTY



<u>Reactions to CEO Mr. Suresh Gurumani Sack – October 4th 2010</u>

A management conflict is one event that can harm the situation of a company and damage the value of its stock. The termination of Mr. Suresh Gurumani era as MD and CEO of SKS was decided on the 4th of October, during a board meeting. Upon the meeting, Mr. Rao was named the successor of Mr Gurumani. The sacking hinted a "power struggle" on SKS's top management, surprising investors. As we can observe from Figure 5, the stock fell 7.4% on the two subsequent days and plus 3% in the three trading days after.

Figure 5 – CEO Sacking - Price Reaction



The graph starts at a 100 base one week previous to the announcement (5 trading days). The magnitude of the reaction is quite noticeable.

Reactions to Andhra Pradesh Crisis News – October 2010

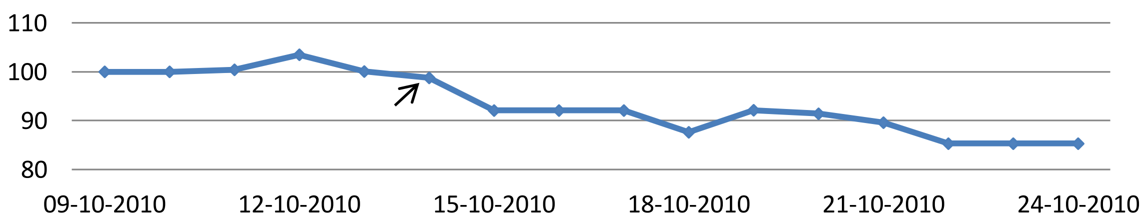
The microfinance crisis in the Andrha Pradesh region was triggered by a number of suicides in the region. In late 2010, more than 200 farmers working in the state committed suicide allegedly due to MFIs pressures and employees coercive practices. The news spread in October 2010 - Several of these farmers were clients of SKS Microfinance and evidence collected suggested that the institution could be related with some suicides. In fact, an investigation commissioned by SKS itself, linked employees of the company to at least seven deaths.

We identify two crucial days within this crisis, and study how the stock fluctuated around those. The first is the day of the Andhra Pradesh Ordinance, released in October 15th 2010. This law, among other things, prohibited MFIs from collecting money from borrowers on a weekly basis and imposed interest caps. This generated concern in the industry, given that several lenders were unable to recover many of the loans made. Therefore, it obliged investors to review their estimates regarding the stock expected earnings. The second is the day Andhra Pradesh Microfinance Institutions Act was passed on the 14th December 2010, which was practically a copy-paste of October 15th's ordinance. We intend to observe the market reactions to both legislative announcements.

Andhra Pradesh Ordinance – October 15th 2010

The trading day after the Andhra Pradesh Ordinance, the stock price fell 5%, from INR 1135.9 to INR 1082.5. 10 days following it fell a further 8.6%.

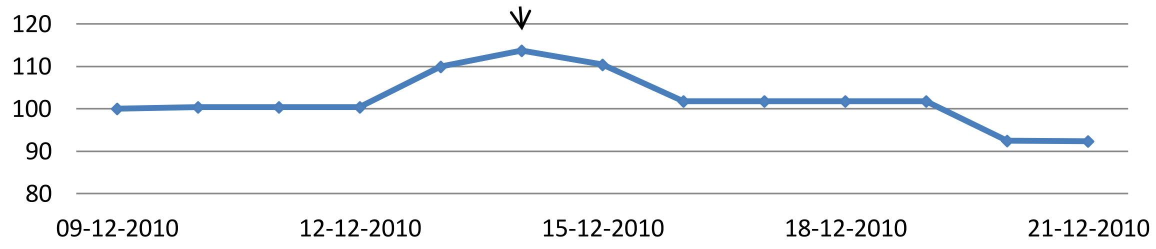
Figure 6- Andhra Pradesh Ordinance - Price Reaction



Andhra Pradesh Act – December 14th 2010

On the two subsequent days that followed Andhra Pradesh Microfinance Institutions Act, SKS's stock fell 12.68%. The week following it had decrease a total of 19.25%, from INR 747.45 to INR 603.6.

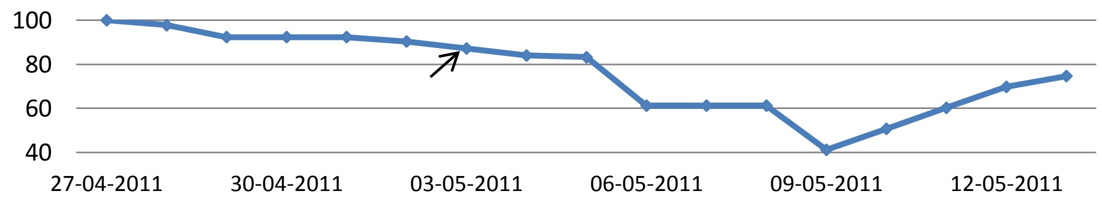
Figure 7 – Andhra Pradesh Act - Price Reaction



<u>Reactions to RBI's 2011 Regulations to MFIs May 3rd 2011</u>

The RBI's governor, D.Subbarao, announced on May 2011, in the 'Monetary Policy Statement for 2011-12', a handful of legislations to be put in practice, which had been suggested by the Malegam Committee. Although more liberal than suggested by the Committee in terms of pricing and market conduct, the measures were welcomed by several microfinance institutions and microfinance rating agencies. All in all, it would establish a framework of microfinance operations and a basis for MFIs relationships with clients and other stakeholders. One of the most fundamental issues was the creation of a separate category for NBFC-MFIs. As we can observe from the Figure below, RBI policies had a severe effect on SKS stock, as it decreased 36.8% during the following week, from INR 430.1 to INR 271.45.

Figure 8 – RBI Regulations - Price Reaction

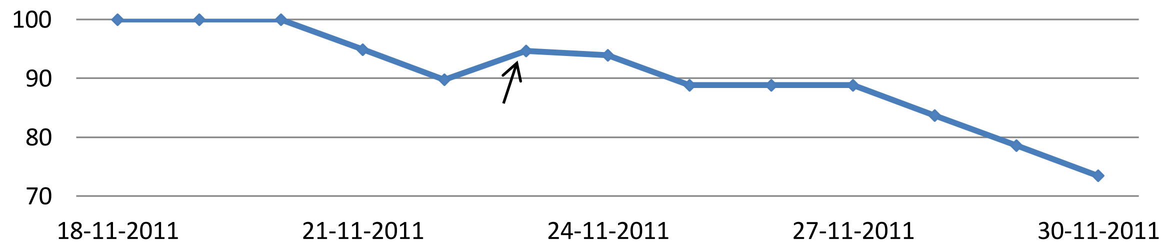


<u>Reactions to Vikram Akula Exit – November 23th 2011</u>

On November 23th of 2011, Vikram Akula resigned from the Chairman and Board Director positions, giving away the control of SKS Microfinance. At the time, Mr. Akula refused to make any remark regarding his situation. However, the industry actors claimed not to be surprise as it was known that a steep dispute was being undertaken between him and the rest of the board. The new Chairman P.H. Ravikumar considered the dispute to be "purely strategic", and deriving from the first Andhra Pradesh Government Act in October 2010.

Although reactions were not strong at first, on the subsequent week the effect was visible. The stock lost 19% of its value, reaching an all time low of INR 93.4.

Figure 9 – Vikram Akula Exit - Price Reaction



With this analysis we were able to observe the consequences arising from main events which affected the stock performance in the markets. We can conclude that Andhra Pradesh was a first trigger into subsequent government action. These events have certainly influenced analysts' forecasts regarding the microfinance sector, which reduced SKS popularity and price valuation. As a result, the stock followed a descending path throughout the last year and a half.

This not only affected SKS market valuation. As we will find later, Andhra Pradesh crisis did not only influenced the stock price in the market but it generated a cascade effect in the company's efficiency and following earnings. Those by turn aggravated analysts' forecasts and expectations regarding the company, and therefore SKS continued to fell.

4.3.2. Corporate and Financial Indicators Analysis

After analyzing the main specific events which adversely affected SKS stock we are going to lead a horizontal analysis throughout some key variables of SKS's corporate financial information. The data used is published in Mix Market and SKS Corporate Reports. The goal of this analysis is to understand the evolution of several key indicators and subsequently conclude its implications.

We will conduct a quarterly analysis for most operational variables in order to clearly understand the pre-IPO and post-IPO performance. Upon some financial ratios, we will conduct an annual analysis with a small constraint for the FY2012 (Mar11-Mar12) which was not published in the time of this investigation. Therefore, when necessary we assume Mar-12 to be a weighted average of the three previous quarters in order to have an approximation for the last financial year.

From the following analysis we can define three main eras in SKS performance: first, before the IPO where financials were relatively robust and stable; secondly, after the issue and before the last quarter of 2010 (or Q3FY11) where it excels; and the last era is the after Andhra Pradesh crisis where it drastically falls in performance. The data reveals that a saturation point was achieved at SKS level of operational efficiency in the last quarter of 2010. It indicates that the difficulties SKS was going through arise from clients default. But this clients' default arise on a great extent due to the turmoil triggered in Andhra Pradesh (Andhra Pradesh state weights 30% in SKS portfolio).

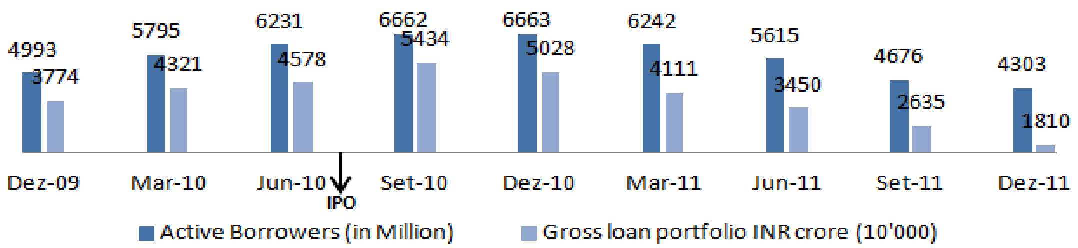
Consequently, the fall in performance from clients implied the fall in performance of SKS which affected its earnings and analysts expectations for the company, ultimately affecting the stock in the market.

4.3.2.1. Outreach Indicators

Following the IPO, SKS active borrowers reached a peak of 6.67 Million people, growing more than 33% over the year 2010. Similarly, the gross loan portfolio grew also at the same percentage to a value of INR 50,28M. As we can observe from Figure 10, during 2011 SKS could not lever a sustainable position at 6.67 Million clients and it resent a decrease in its active borrower's base of 31%, back to the numbers of the beginnings of 2010.

Likewise, the gross loan portfolio suffered a decrease of 56% during 2011 to INR 18 Million. This parabolic effect suggests that SKS reached a saturation point when pursuing the expansion strategy allowed by the IPO financing. It stopped being able to attract new clients. This was possibly due to the rumors associating the company with coercive behaviors and due to Andhra Pradesh Act restringing new loans to indebted clients.

Figure 10 – Active Borrowers vs Gross Loan Portfolio Evolution



4.3.2.2. Efficiency Indicators

Profit Margin

SKS profits have suffered tremendously in the last year because of the strong increase of the company's provisions, write-offs and operational costs, contrasted with the decrease of various sources of revenues such as insurance and new membership fees. Before the IPO quarterly profits after tax averaged INR 400 Million but since March 2011, they have averaged negative INR 275 Million. Only in the last quarter of December 2011, SKS losses were 428 Million, and forecasts estimate a total loss of the next financial year to be INR 1.376 Million. This reflects in the profit margin of the company, which has been 20% before September 2010 and is -320% for December 2011 period.

Figure 12 – SKS Profit Margin 2010

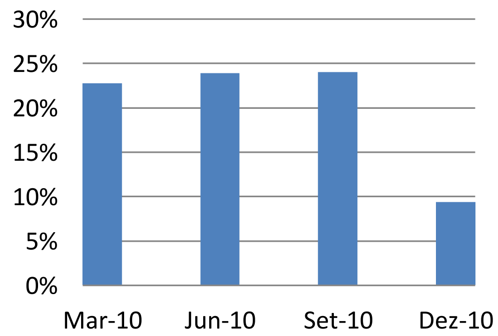
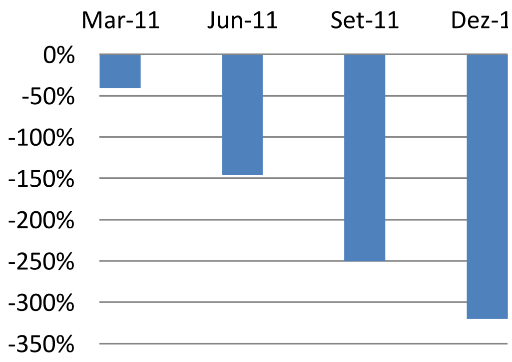


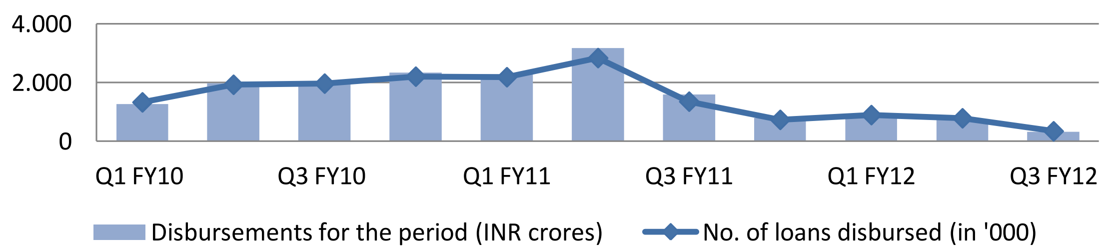
Figure 11 – SKS Profit Margin 2011



Disbursements

The number and value of disbursements provided by SKS were highly affected by the Andhra Pradesh law enactment. They went down 52% during the last quarter of 2010 to INR 1.590 crore and continue to decrease throughout the year reaching a minimum of INR 322. crore in the end of 2011 (Figure 13). Due to the stringent rules imposed by the government in that area, SKS continues to find difficulty in disbursing fresh loans.

Figure 13 –SKS Disbursements evolution



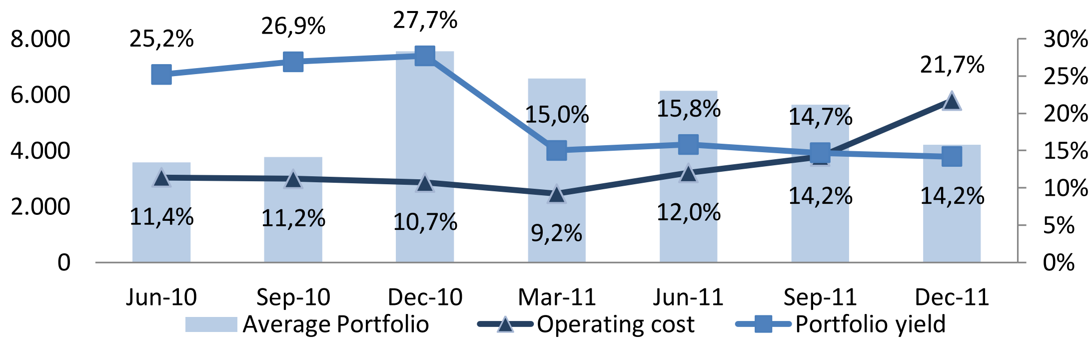
Portfolio Yield

The portfolio yield is the best proxy of the interest rates charged by the MFIs. It indicates the net interest income of the bank. SKS has always been consistent among his peers with an average portfolio yield of 25%. As expected during the year 2011 some pressure was felt on the yields due to the margin cap imposed by RBIs and due to the increase in borrowing costs. Precisely, during the year of 2010, the yield remained stabilized roughly at 26%. But entering in the first quarter of 2011 we observe a steep fall in the portfolio yield to 15% (see Figure 14).

Operating Expenses

By observing the Operating Cost as a percentage of the Gross Yield we can monitor its significant increase since March 2011 while the active borrowers figure simply continued to decrease. This reveals that operating costs weight in the overall expenses is increasing and is confirmed by the Operating Expense Ratio (OER) which expresses the operating expenses in relation to the loan portfolio outstanding of the period. OER improved until March 2011. But, as it can be observed in Figure 14, it doubled to 21.7% on December 2011. From this we can mainly conclude that the operational efficiency of SKS was harmed during the last year. However we have to consider the hypothesis that operation costs might have increased due to SKS attempts in improving its services to reestablish its reputation (personnel costs are not included in the operational costs).

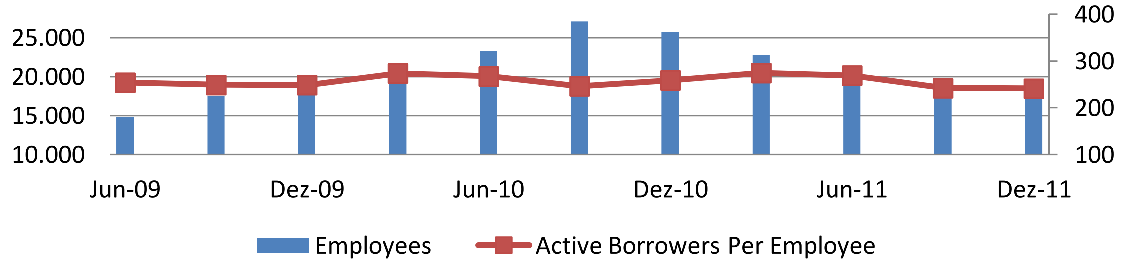
Figure 14 – SKS Efficiency Deterioration



Personnel

SKS employees figure decreased peaked in June 2010 at 27.733. But during the following year it fell to 17.845. This was mainly due to the company's clients withdrawals which did not justify the level of employees. This can be observed in the Figure X below that it was undertaken in order to stabilize the ratio of active borrower per employee at 260-270.

Figure 15 – Employees Evolution



4.3.2.3. Risk and Liquidity Indicators

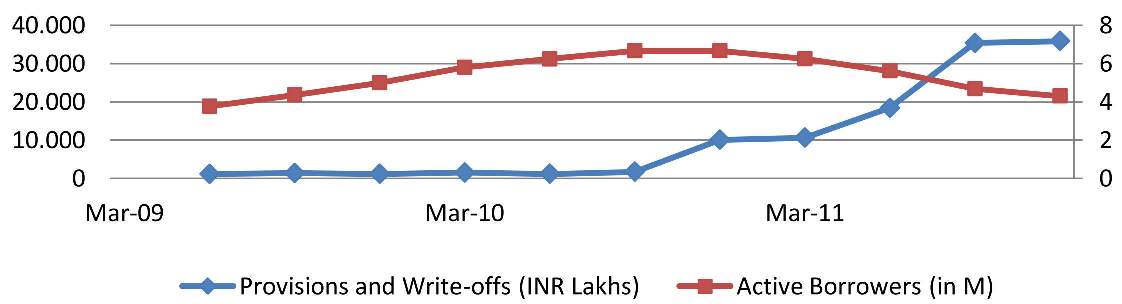
Provisions and Write-offs

Provisions are set as an allowance for bad loans, while write-offs are the recognition of the loss of a loan's value. These are two particular interesting figures in SKS financial accounts, which appear together as a sole figure, therefore we will analyze them jointly.

Before the IPO at the close of the financial year in March 2010, write-offs summed up to INR 520.000. One year later this figure jumped practically 5 times. Conceivably expectable in this stage of the analysis, the turning point was indeed and again in the end of the year 2010.

This represents the emergence of non-quality loans and enforces the default of the company clients and consequently of SKS performance. This was largely influenced by the weight of the loan portfolio in the Andhra Pradesh region as we will see later on.

Figure 16 – Provisions and Write-Offs vs Active Borrowers evolution



Non-Performing Loans

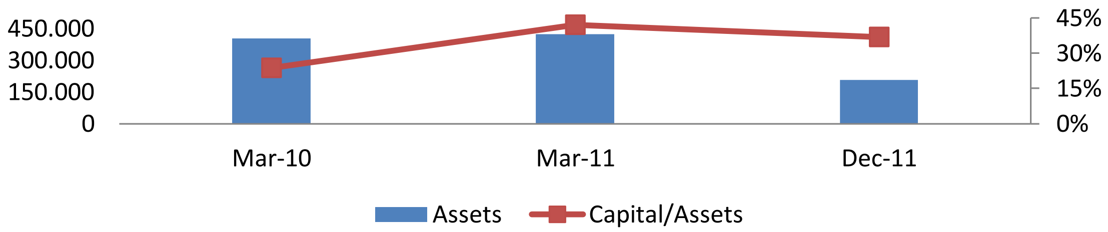
To assess non-performing loans we use as proxy the non-performing assets figure. This figure illustrates the percentage of loans provided by the bank that are not repaid. Appraising SKS non-performing assets, this figure tended to be steady around 0.2-0.4%. But it started rising in the end of 2010. In March 2011 non-performing loans were representing 2.42% of loans outstanding. This represents a 5 times increase. This increase in non-performing loans comes largely from Andhra Pradesh district as we will explore later on this paper. Neither subsequent period data neither analyst's forecasts has been yet disclosed regarding this figure.

4.3.2.4. Financing Structure

Capital Asset Ratio (CAR)

The assets of SKS, as any normal bank are mostly the loans held by clients. The assets decrease which we can observe from the figure is directly caused by the decrease in the active borrowers. As a general rule, the better the CAR the more sound is the bank, since it is less risky and more protected against operational losses. CAR increased from March 2010 to March 2011 due to the IPO amplified liquidity, but it decreased 12% to December 2011 due to the descending stock price which decreased SKS capital value. However, it continues to be above the CAR of the MFI Industry (18.28%) and above its Top 5 MFIs Peers (22.5%).

Figure 17 – Capital to Asset Ratio Evolution



4.3.2.4. Overall Financial Performance

All in all the evolution of the company's financial ratios reflect the crisis SKS and the microfinance sector were and are still going through. From the following table we can define three main eras in SKS performance: first, before the IPO where financials were relatively robust and stable; secondly, after the issue and before the last quarter of 2010 (or Q3FY11) where it outperforms; lastly, the after Andhra Pradesh crisis where it underperforms reflecting the very weak financial indicators.

Table 6 – Financial Ratios Evolution

	Mar-08	Mar-09	Mar-10	Mar-11	Dec-11*
ROA	2,33%	3,86%	4,93%	2,35%	-46%
ROE	11,69%	18,19%	21,66%	7,55%	-94%
D/E	3,7	3,2	2,8	1,3	1,4

*Dec 2011 is the latest quarter published

SKS ROE before the IPO was roughly around 17%. After the issue and before the microfinance crisis it improved to an average 20%. From thereafter it declined to values which do not fashion any optimism within the investors' community. Indeed, the latest quarter of December 2011 reported a ROE of -176.2%. SKS ROA follows the same descendent trend. Previous to the IPO it walked around modest values of 3%. Subsequent to the issue and before the microfinance crisis, it was up to 5% and afterwards it became negative.

Debt to equity ratio demonstrates the weight of financing through debt of a company. Usually a high D/E ratio indicates that the company is more risky but this is very dependent on the industry. In the banking industry the gearing is on average 1.3. Among Indian MFIs[18] it is 4.48. Before the IPO, SKS D/E was 2.8, but after the IPO it decreased to 1.3 which is more aligned with the banking industry but less with the MFIs industry.

Table 7 – Financial Ratios Quarterly Evolution

	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
P/E	30,8	27,7	31,8	-	-	-	-
P/B	13,1	9,0	4,2	3,6	2,7	2,5	1,5
EPS diluted	10,04	10,99	4,47	-9,18	-30,24	-53,15	-59,12

* Earnings were negative for the period the ratio is not informative

The price to earnings figure translates the company future prospective growth. The higher amount investors are willing to pay for the company's stock in relation to the company's earnings the greater beliefs they have in the its capability to grow and profit. As forecasted, upon the IPO SKS started out strongly, and it is higher than its listed peers (see Table 4 in Section 4.2). But on May 2011 earnings befall on a negative terrain and the ratio is no longer

[18] Mix Market median average of 180 MFIs

informative. This spreads pessimism among markets and analysts. For four consecutive quarters, the company has not been able to recuperate its earnings to a positive field.

Price to book ratio (P/B) translates by how many times the market value of the company is above its book value. Since the company during this period has lost 33% of its book value, but 90% of its market value, P/B ratio experienced a steep fall, from 13.1 in June 2010 to 1.5 in December 2012. This suggests markets considered SKS to be overvalued.

The earnings per share diluted figure (EPS) further sustain the difficulties of the company as it falls from INR 10.04 in June 2010 into negative terrain since March 2011. It hit its lowest of INR -59.12 in the last published quarter of December 2011.

4.3.3. Andhra Pradesh Influence

At this time of the analysis we can perceive the link between SKS performance turning point and the Andhra Pradesh predicament. The fall of SKS is not only related to the so called reckless SKS growth but also to the Andhra Pradesh crisis.

According to M-Cril Microfinance Review 2011: *"The disruption in Indian microfinance caused by the AP ordinance is substantial. The apparent reasons for the ordinance were: the excessive lending by MFIs in the state of Andhra Pradesh leading to over indebtedness which caused distress to low income microfinance borrowers; and the coercive behavior by MFIs in collecting from these over indebted borrowers suffering from the stress of keeping with their repayments obligations."*

Andhra Pradesh is one of the 28 states in India. The state is the fifth largest by population and the fourth largest by area. Andhra Pradesh's GDP ranks third in India and a significant part of its income comes from the rice crops. The total exposure of MFIs in the state of Andhra Pradesh was about INR 7200 crore in 2010. From that amount they have been able to recover approximately 10%. At the end of March 2012 MFIs were carrying on their books INR 6500 crore worth of bad assets.

Many of the institutions are trying to restructure part of their debts given by local banks. However, commercial banks, which provide approximately 90% of resources that MFIs use for doing business are not giving money due to increase in fear.

Because of its undeniable influence, SKS specified in its latest quarterlies accounts the proportion of Andhra Pradesh loans in their portfolio and its influence in the figures such as provisions and write-offs.

Figure 19 – SKS Andhra Pradesh Portfolio

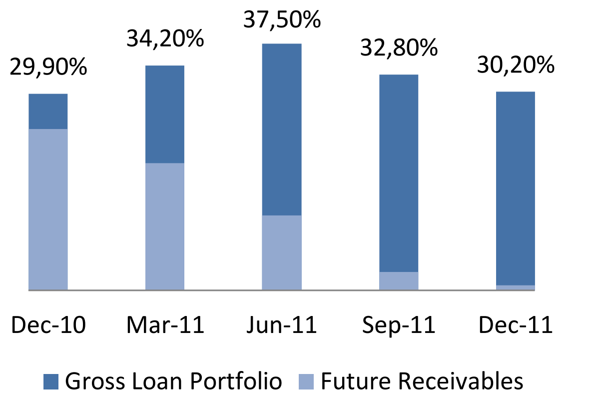
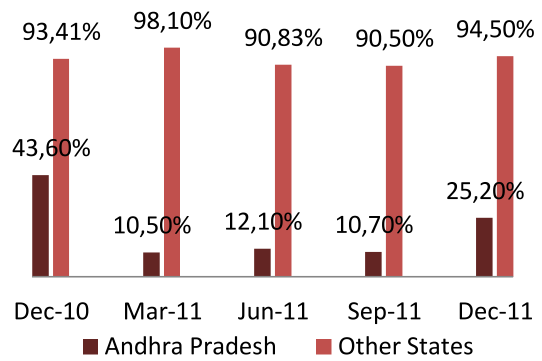


Figure 18 – Loans Recovery Efficiency



Before the IPO, Andhra Pradesh weight was about 28% in the company portfolio. It increased to 37.5% in June 2011. This was not followed by the weight of future receivables on Andhra Pradesh region, which accounted solely for 11.4% of the company future receivables. Meaning, less than 3 times the weight of the company portfolio was being covered by only a tenth of the company's future receivables. In the last quarter of 2011 this figure was aggravated to 0.8%. (Figure 19) Furthermore, the collection efficiency in Andhra Pradesh was by far the lowest. (Figure 18) While the other states recovered efficiently on average 96% of their loans, Andhra Pradesh was only recovering 11% in March 2011, improving to 25% in December 2011. Furthermore, roughly 93% of SKS last quarter's writte-offs were for loans in the Andhra Pradesh Region, this illustrates the seriousness of the situation in the district and how it influenced SKS performance. 90% of provisions in June 2011 accounted from Andhra Pradesh state.

Figure 21 – Bad Loans Written-offs

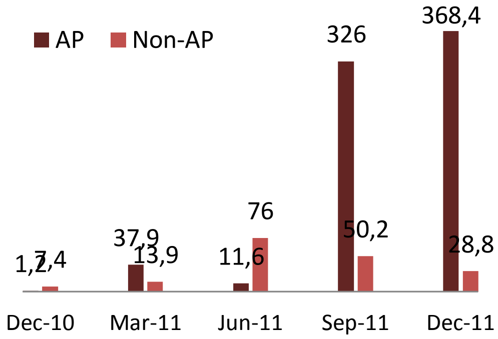
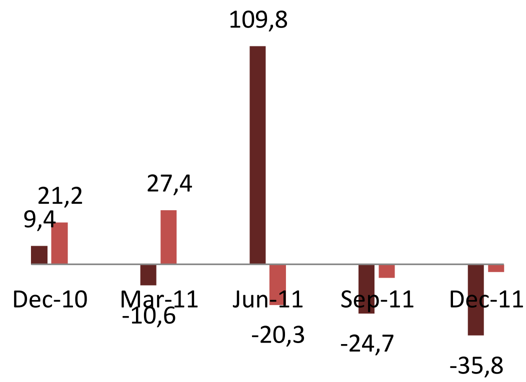


Figure 20 – Provisions for NPA



4.3.4. RBI's Legislations Following Andhra Pradesh

Andhra Pradesh crisis influenced the microfinance industry in several ways: it brought bad publicity to big MFIs, and it led to the enactment of regulations by the government which affected the companies' situation.

After understanding about the origins of the crisis triggered in the state, the government of Andhra Pradesh, where more than a quarter of the income of the microlending industry was generated, passed a law to control microlenders. It was called "A Bill to protect The Women Self-Help Groups from Exploitation by the Micro Finance Institutions in the State of Andhra Pradesh and for Matters Connected Therewith or Incidental Thereto" and was passed by the Andhra Pradesh Legislative Assembly on December 14, 2010.

The law applied to all entities engaged in the microfinance business including NBFC[19]s. Among other things, it prohibited MFIs from collecting money from borrowers on a weekly basis and prohibited clients to perform publicly their payments. This law generated concern in the industry given that many lenders were unable to recover a significant part of the loans made.

This raised also concerns within the RBI. They understood that if different states start passing their own legislations, a conflict of plurality of regulations would arise in the country and adversely affect both clients and MFIs operating on several states.

RBI defended a homogenization of the regulation in the country. It announced in its Report on Trend and Progress of Banking in India (June 2011) that since it is responsible for the regulation of NBFCs' it should also become responsible for the NBFC-MFIs.

MFIs finance largely with commercial banks, on average 60 to 80%[20]. Thus the RBI defined, from April 2011 onwards, restrictions on the lending by commercial banks to MFIs. For example, it defined that banks can provide loans to MFIs that have a minimum of 75% portfolio of loans dedicated to income generating activities. Also, 85% of MFIs total assets should be in the nature of qualifying sectors. Furthermore, MFIs must comply with the cap in interest rate set at 26% and the margin at 12% from their borrowing costs. MFIs which cope

[19] Regulated by the RBI Act, 1934
[20] Article from Microfinance Africa / Microfinance Around the World – November 2011

with the restrictions will be eligible as priority sector, hence they obtain better financing conditions with commercial banks.

But further legislations are yet to come. The parliament announced in November that MFIs will be allowed in the near future to collect small deposits. The rationale behind it is that MFIs will be able to bring down their costs of funds and improve margins. Additionally, the RBI will become the sole regulator to govern the microfinance sector and overrule all state-level legislations. This is expected to become a law allegedly around May/June 2012.

From the previous analysis we can define three main eras in SKS performance: first, before the IPO where financials were relatively robust and stable; secondly, after the issue and before the last quarter of 2010 where SKS excels; and the last era is the after Andhra Pradesh crisis where it drastically falls in performance. The data reveals that a saturation point was achieved at SKS level of operational efficiency in the last quarter of 2010. It indicates that the difficulties SKS was going through arise from clients default. But this clients' default result on a great extent from the turmoil generated in Andhra Pradesh.

Furthermore, the Andhra Pradesh Act on December 2010, followed by the RBIs legislations on April 2011 amplified SKS difficulties in recovering past loans and on obtaining new clients which further justifies its incapability to recover its financial situation. To finalize, the future legislations announced by the RBI are possibly preventing SKS tactic into a recovery strategy since the full length of the regulations are yet uncertain.

4.4. MFI's Peer Group Comparison

4.4.1. Top Indian MFI's

Currently in India there are among 1.109[21] MFIs. Only 7 MFIs reach at present more than 1 million people and roughly 100 MFIs reach less than 100.000 clients. The top 5 MFIs in India reach over 55% of the clients, and the top 7 reach over 68%. This indicates a critical degree of concentration in such dispersed industry with hundreds of small players.

Andhra Pradesh crisis and the following RBI actions did not affect solely SKS but the entire microfinance sector. In fact, from the perspective of commercial banks which provided loans to MFIs, SKS was perceived as one of the safest due to its recent and not yet fully invested proceeds from the IPO. On the whole, all the Microfinance Sector, from NGOs to for-profit MFIs are currently going through some intricacies due to the external facts previously referred.

We conducted a brief analysis of the top 5 MFIs in India, which are considered the relevant comparative group due to their significant size in terms of active borrowers and loans outstanding (all serve over 1 million clients) and due to their similar corporate governance.

Figure 22 – Peer Group Size Indicators

MFIs - Dec 2011	Active Borrowers	Gross loan portfolio	Assets	Average Loan p/ Borrower	Borrowers p/ staff member	Equity/ Assets	Personnel
SKS	4.303.000	341.123.257	389.370.524	79	241	36,88%	17.854
Spandana	3.507.991	519.685.018	500.523.559	148	335	38,38%	10.486
Bandhan	3.388.317	598.763.757	652.518.122	177	359	19,17%	9.441
SHARE	2.604.704	337.890.734	417.786.998	130	557	39,47%	4.675
SKDRDP	1.805.303	231.432.601	249.801.947	128	338	2,12%	5.346
BASIX	1.191.213	155.280.155	159.226.188	130	187	5.14%	6.378
Average 5 peer	**2.499.506**	**368.610.453**	**395.971.363**	**143**	**355**	**24,79%**	**7.265**

Source: Mix Market

Despite SKSs decline, it is still the biggest Microfinance Institution in India in terms of active borrowers (4.3 Million). Furthermore it has the highest number of personnel of 17,854. The MFIs that follow are also particular large and relevant in the Indian market:

21 2008-2009 Annual Report published by the National Bank for Agriculture and Rural Development (NABARD)

Spandana

Spandana Sphoorty Financial Limited is the second largest MFI in India and one of the world's largest. They started operating as a NGO in 1998 under the name Spandana, a word that stands for responsiveness. The entity was created by Padmaja Reddy. In 2002 Spandana had a client base of 15.000. It transitioned to an NBFC in 2005. By the end of 2011 they served more than 4 Million clients. Accordingly, the number of branches has increased from 8 in 2002 to 1.600 in 2011

Bandhan

Bandhan was created in 2001 under the leadership of Chandra Shekhar Ghosh and began operations in microfinance in 2002. They started working in West Bengal and later expanded across the country. It upgraded to NBFC in 2007. In 2012, the company has 1.553 branches operating across India and employs more than 9.500 people. The company serves approximately 3.4 Million clients. It is currently the second largest institution in India in terms of active borrowers.

SHARE

SHARE Microfinance Limited is the third largest microfinance institutions in India. It started its operations in 1989 as a not for-profit society, but it was in fact the first microfinance institution in India to obtain a Non Banking Financial Company (Non Deposit) license in the year 2000. SHARE has adopted a for-profit approach. They believe this will allow them to create social returns by channeling funds from development institutions and commercial banks as collateral-free loans to Joint Liability Groups (JLGs). The company has 1.076 branches and employs 5.640 persons across the country. As of March 2012 the company has a client base of 2.6 Millions.

SKDRDP

Shri Kshetra Dharmasthala Rural Development Project, commonly known as SKDRDP is charitable trust that is promoted by Veerendra Heggade. Their main goal is to empower rural women by organizing self-help groups on the lines of joint liability groups. It provides also financial services and infrastructure through micro credit. It transformed into a NBFC in 2008. SKDRDP bases its projects hoping to enrich all aspects of rural life. The institution works with more than 1.8 Million clients located in India and Bangladesh and employs 5.346 people across all its branches.

BASIX

BASIX is a livelihood promotion institution established in 1996. They are present in 17 states and more than 40.000 villages in India. They have an active borrowers' base of 1.9 Million people of which 90% of them are rural poor households and about 10% are located in urban slum dwellers. The institution has a permanent staff of over 10,000 of which 80 percent are based in small towns and villages.

On Table 8 we recover from CGAPs analysis and update it for the latest annual corporate reports. Once a star, now SKS shadows in relation to its peers averages in both ROE and growth. SKS's portfolio yield values are comparatively high, but as we have observed in the previous section they have been pressed in the latest quarters of 2011.

Table 8 – SKS vs Top 5 MFIs

	Mar-10		Mar-11	
	SKS	**Top 5 MFIs**	**SKS**	**Top 5 MFIs**
ROE	22%	40%	7,93%	13,3%
ROA	5.0%	5.0%	2,40%	1,4%
Debt/equity	3.2	7.9	1.38	13.7
Portfolio Growth	54%	68%	-4%	29%
Portfolio CGAR (5 yrs)	166%	89%	71%	55%
Portfolio yield	25.7%	25,9%	24,48%	19,8%
Non-loan income/assets	1,6%	0,2%	13%	13,39%
Operational Expense Ratio	10,2%	6,4%	10,68%	7,5%
Financial Expense Ratio	8,8%	9,1%	9,96%	13,3%
PAR30	0,4%	0,28%	n.a	27,6%

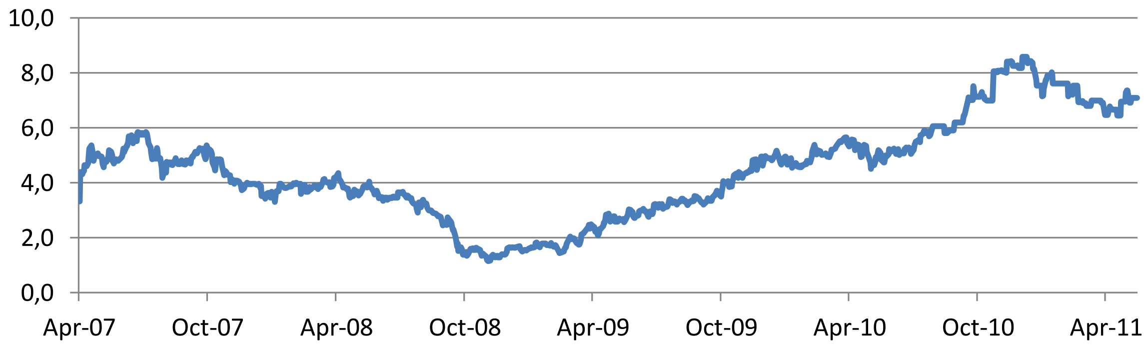
We can conclude that the sector was as a whole affected by the Andhra Pradesh crisis, its revolutions and government actions. The portfolio growth was severely affected and the main MFIs institutions, once robust and wealthy saw their profitability squeezed and their operational and financial costs increase.

To note is the evolution of the Portfolio at Risk at 30 days (PAR30) which rises sharply due to three institutions: Spandana (48%), SHARE (52.1%) and BASIX (37.4%).

4.4.2. Comparison with Compartamos

Although SKS's performance has not been as expected, there is one other pure MFI example that has had positive returns. Compartamos was the first microfinance institution to go public on April 20th, 2007, listed in the New York and Mexican Stock Exchanges under the ticker BMOSF. It was 13 times oversubscribed and considered a financial success. The first day return was 22%. Reasons for the success were among the past outstanding performance of the bank, perceived quality of the management and the appeal of the microfinance sector. Shares were bought mostly by commercial investors and international funds.

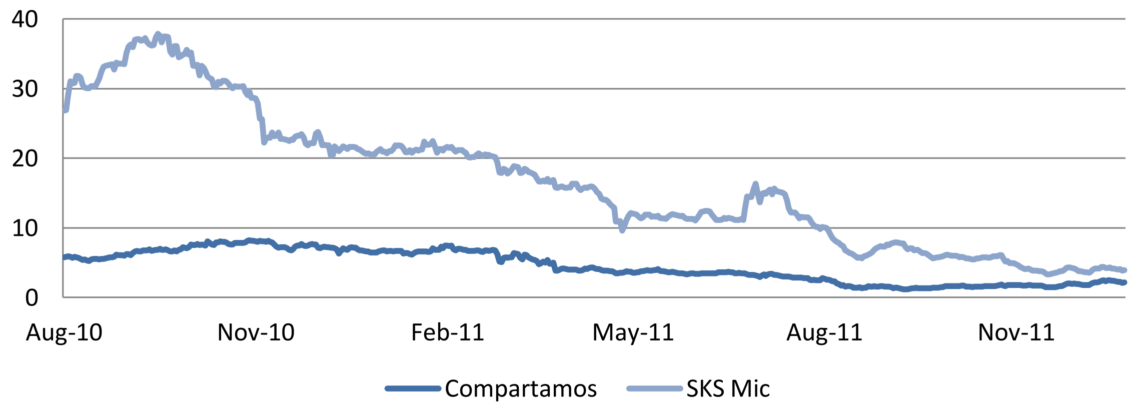
Figure 23 – BMOSF Price Evolution (USD)



Compartamos stock has increased 44% in value since it went public, and on April 30th 2012 was valuing US$ 4.7 and had a market capitalization of 2.3 Billion dollars. But its historical high was US$ 8.58 on December 22nd 2010, meaning it has lost about 50% of its maximum value. However, it is an extremely illiquid stock and it is exchanged few times per month. Last year it announced its intention to buy an 82.7% stake in a Peruvian MFI, Financiera Creditos Arequipa SA (Financiera Crear), for USD 63 Million.

Although Compartamos is an unusual MFI, it is the only one, excluding SKS, quoted in the markets. Nevertheless, we believe that its comparison with SKS is not relevant because of two main reasons: their methodology is extremely different (Compartamos charges about 100% interest rates) and the environment they are subject to is not similar. Below you may find the comparison of both stocks in USD since SKS's IPO date. As it can be observed, Compartamos fell in February 2011 and has averaged USD 4-5 since then.

Figure 24 – Compartamos vs SKS (USD)



5. DISCUSSION AND OPINIONS

Through interviews led with 3 specialists in the field we have gathered several beliefs and opposite points of view. Complemented with experts' opinions around the world, we were able to cover both dimensions of the key issues of discussion in the Microfinance society.

We have interviewed Mr. N. Srinivasan, the author of the Microfinance India State of the Sector Report who holds consultant positions for World Bank, CGAP and other Microfinance Institutions. He is a key expert in policy, strategy and operations in microfinance, rural finance, development finance and rural development.

We have interviewed Yuvraj Phatak who has spent 1 year with a Microfinance Institution in India. He is a Masters student in Development Economics and holds an engineering material science degree.

We have also interviewed Agathe Gouot who has been with Planet Finance, an international microfinance NGO, as an Analyst and Microcredit Assessor and is doing investigation on Microfinance.

The key issues discussed below were chosen taking into account the study performed in this research paper. We must highlight that there are several other crucial issues to Microfinance, subject of other researches. For example, women empowerment, interest rates, loans structuring and so forth.

From reaching masses or target effectively a small group of people, to going public and profiting from the business, with this discussion we intend to show the different opinions that knowledgeable people defend about the industry.

Key issue: Reaching Masses or Not?

As stated in the literature review, one of the main problems of the rural areas and hence of Indian poor is the lack of access to formal banking institutions. Without them poor people usually rely on money lenders. Therefore, what is more important? Yuvraj Phatak defends that *"Personally, reaching out millions is more important than reaching a small portion efficiently. The all problem is about inequality. On a macro level if you can grow at 8% but increasing inequality, or rather grow at 4% but decreasing inequality, I would go to the last one"*

But skeptical argue that the business model of "big MFIs" is somehow thoughtless and ends not being truly efficient. Their methodology lacks trustworthy and guidance to people when comparing with the small MFIs who are incorporated in a small number of villages once at the time. As Agathe believes that the mainstream MFIs do not invest their time or resources in effective (although costly) microfinance programs. She defends "*I believe it is more important for MFIs to reach a smaller number of households while concentrating efforts on the quality of the programs implemented"*.

But reaching millions does not necessarily mean we have to reduce the efficiency of the service, Mr. Srinivasan defends that outreach and efficiency are both extremely important and that: *"When resources are spent to lift a mass of people out of poverty, why only a small number is to be covered under the name of quality? Poverty alleviation is a welfare objective and if the state and public funders take up the welfare load, service providers such as MFIs will be able to cover any number of people with quality."*

Non-profit microfinance institutions which transform into for-profit ones, as SKS did, continue to state that they do it in order to be able to finance their outreach and therefore access more people and create a bigger impact in society through poverty alleviation. Doing that does not mean they cannot do it effectively, but the service strictly needs to be provided on an efficient manner.

Key issue: The efficiency and impact assessment

Following Moumita Sem Sarma's a Chartered Accountant tand formerly the Head of Microfinance & Sustainable Development at ABN AMRO Bank India, now an activist in Microfinance: "It is perhaps a time to pause and introspect. In the end, shouldn't the true measure of a MFI's success be when people on the street instead of asking in surprise 'So is microfinance really that profitable?' as they did in the wake of SKS IPO, ask rather 'Is microfinance really that impactful?' We need to shift our focus away from the means and on to the end." [22]

The problem of efficiency relies on the information and tools that clients need in order to proliferate their activity. The money received ought to be applied correctly and they need to have enough time to make their activity profit. *"Not only having the loan allows a person to get out of poverty. People sometimes don't have the right kind of information. Do not know which assets to buy, right quality of seeds, right quality of fertilizers, etc and do not use the loan in the best possible way"*(Mr. Phatak)

Therefore the key issue is that any type of MFIs, from the smallest NGOs to the biggest NBFCs should be able to, in addition to the loan, provide the right specific information each client needs in order to invest their money correctly. However, the measurement of efficiency is difficult. A real extensive, quantitative and qualitative impact study of microfinance has not yet been made. Most believe that somehow microfinance helps, but the problems lie in understanding by how much it does help and where it has to be improved.

Key issue: Andhra Pradesh and Government Policies

The Andhra Pradesh crisis activated a lot of concerns in the microfinance sector and instigated the local government of Andhra Pradesh to act. Ultimately it led the RBI to create new legislations which narrow MFIs freedom. These measures were welcomed by several institutions which believe that regulation is essential in order to protect the clients. "*Weekly repayments are insensible as also as the type of pressure employees do in defaulting clients to repay"*[23].

But Mr. Phatak defends that although the crisis might have been triggered by the over indebtedness of the people, the blame cannot be attributed to the big MFIs *"The suicides*

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[22] CGAP Discussion – Was SKS ready for the IPO? October 2010
[23] Anitha Prama – "Microfinanças Brazil" November 20th 2011

would happen even if there were no MFIs, because these people would have gone to money lenders, or even if there were no money lenders, because these people would have had no money at all" Mr. Srinivasan also agrees that the problem was not caused by SKS and other MFIs, he believes that the "*AP conflict was a Provincial Government triggered problem."* He also defends that the problem was the *"overheated market"* and that it could have been *"dealt with more sensitivity and finesse by the government"*.

The new legislations announced by RBI are for sure going to alter the industry and perhaps transform it into a more competitive one. This by turn may finally press down the interest rates charged, but will this improve a MFI efficiency?

Key issue: Should managers and investors profit from the business or not?

It is not publicly known the compensations received by Vikram Akula upon its exit. But it is known that recently, at least 906.734 shares were allotted to him at a price of INR 10, pursuant of ESOP 2007. In the markets the stock was valuing INR 96. If he sells at this time he still makes a profit around 80 Million Rupees (approximately 1.5 Million Dollars). Nevertheless, there were 2 Million shares locked-in under ESOP 2010 till the period of 2013. It has not been disclosed any information concerning them.

The high salaries of SKS managers and the profits obtained by Vikram Akula and Suresh Gurumani were target of several discussions. From the perspective of Muhammad Yunus and his followers, microfinance original pursue should not awake desire for profits. Yunus himself states "I get very worried when investment funds come to microfinance" "I don't want to excite businessmen that there is profit to be made here"[24].

But what bankers and PE investors like to believe is that the demand is there and the people are willing to pay for the service because they have no better alternative. Therefore some believe if undertaken with efficiency the business can be scaled-up profitably and still serve to alleviate a class of people. *"A well paid professional staff, staff with their skin in the game through stock based incentives and commercial equity are not bad things"* defends Mr. Srinivasan. From investors perspective, if they understand that *"Regardless of growth prospects, if the company moderates its enterprise value and sells equity to investors under conditions of low ROE and ROA, the pressure for super profits will not arise"*

[24] Business Outlook India - Jan 23, 2010

Key issue: What did go wrong in SKS case?

Throughout this analysis we prove that the factors affecting SKS performance were a mix of corporate governance inefficiency and external events. The external events affected all the industry. But SKS was the only public company and it saw its market capitalization suffer immensely. Investors' reaction to the profits' decline of SKS may have generated a downward spiral in the company's stock. The new SKS's Chairman stated: "We probably underestimated the negative reaction and probably did not handle it well [referring to management high salaries]"

Mr. Srinivasan understands that *"SKS model was efficient and scalable. The problem was in their trying to make existing customers pay for growth; in having inappropriate products that ill-suited the poor. The patience required of the equity investors in making money out of the poor was missing. SKS could have been mature in terms of its expansion plans, moderate in its ROA and ROE targets and should have demanded superior governance standards from its board and senior management."*

SKS robustness continues unstable, especially if we compare to what it used to be. Rumors in the press reveal that the new management is thinking about restructuring its strategy and business model. It was in fact suggested that SKS was reflecting about changing from an exclusive micro-lending institution to a broader financial services company. Nevertheless, the center would continue to be the rural. However, this new model was not yet disclosed publicly. Therefore it is creating uncertainty regarding SKS future pursuant strategy.

Key issue: After all, is going public a good path?

Defendants of the pro-profit system of MFIs see the going public as an increase in maturity of the microfinance industry. But others just do not accept that investors can make money from a "social business".

Agathe understands that it is probably the trend but that still, for-profit *"MFIs dual objective is not compatible. Their goal cannot be to truly alleviate poverty if they have to make profits out of it."*

Perhaps the intricacy relies in how to reposition and how to qualify for-profit MFIs in the industry. They are not charity houses and they wish to provide a service which is in fact highly demanded, just like Wal-Mart: « (…)The commercialization of microfinance is a 'done deal.' (…) When BASIX was started in Hyderabad our mission said we hoped to "access mainstream capital." Now microfinance is a mainstream business, it's been "Wal-Martised," whether we like it or not, Compartamos and now SKS have shown the way, and soon many more will follow. The clock cannot be put back»[25].

Mr. Srinivasan opinion is that of an economist who understands that the sector can go public if all players in the market understand the conditions of the industry: *"I do not think that MFIs going public is a bad idea. Enterprise valuation while going public and the pricing of equity are the aspects that can create problems." "Regardless of growth prospects, if the company moderates its enterprise value and sells equity to investors under conditions of low ROE and ROA, the pressure for super profits will not arise. There are a number of companies that have gone public and doing responsible business – in health, education and finance – dealing with the poorer sections of society as customers."*

These arguments were supported by Mr. Pathak *"MFIs going public is definitely sustainable, there is a market that exists for sure and there aren't still enough players tapping it."*

6. CONCLUSION AND RECOMMENDATIONS

This study was developed with the goal of better understanding whether a business that is regarded as a social by nature, can or cannot be publicly financed by investors whose primarily goal is to see their profits maximized. SKS was the first Indian MFI to go public and as a consequence, it became the target of several criticisms within the Microfinance community.

Currently, 828 million poor people live in India[26]. The country is one of the cradles of microfinance and the home of many of the individuals who revolutionized the industry. Standing on the non-profit side of the debate there is the economist Muhammad Yunus, known as the creator of microcredit, whose ambition to end poverty inspired thousands of social entrepreneurs. On the for-profit side there is Vikram Akula, a manager consultant, academic research, and author, whose aspiration to end poverty through profits inspired a different type of entrepreneurs.

The specific focus of this paper is to understand if markets will welcome future public MFIs and if the outreach achieved by large MFIs who finance their growth through capital markets

[25] Malcom Harper "Is SKS any different than Wal-Mart?" CGAP Publication; October 5, 2010
[26] World Bank – Poverty Report 2010

may bring greater benefits to the society than harm. By society we mean all the stakeholders taking part in the microfinance sector: clients, employees, managers, shareholders, debtholders, etc.

The original purpose of microfinance is poverty alleviation and that continues to be the core goal defended by for-profit microfinance institutions. Discovering if MFIs are effective or not requires that we carry out an impact assessment on clients' situation, and an efficient methodology is not yet fully developed and is extremely difficult to perform. The impact on clients' welfare is by far the most important factor of this business. It is the one that distinguishes effective MFIs from non-effective MFIs. Therefore, it seems unethical to make investors profit when clients are not improving their poverty situation.

6.1. Why did SKS underperform?

The 89% deterioration of SKS market price, which was quite above the common underperformance of newly public companies,[27] was the consequence of three major factors resulting from both internal and external events.

1) Inefficient Corporate Governance

First of all, the company was not governed in the most efficient and proper way. Factors such as the sacking of the CEO Mr. Suresh Gurumani in early October 2010 immediately affected 8% of the stock value. The exit of Dr. Vikram Akula in November 2011 further led the stock to the historical minimum of INR 93.4 on the subsequent week. In addition, the pejorative news about SKS employees' coercive manners, among other behaviors, all contributed to the negative image of the corporation. Therefore the markets' reaction was inevitably adverse as they simply responded to the accumulation of bad news. This in turn generated a cascade effect in the company's efficiency and following earnings, subsequently worsening analysts' perspectives and expectations regarding the company as it continued to fall. This explains in part SKS's incapability to recover its market price.

2) Andhra Pradesh Crisis

In the district of Andhra Pradesh, the microfinance system crashed due to clients over indebtedness and persuasive MFIs loan recovering systems that resulted in a number of

[27] 5.2% US Markets (Ritter, 1998)

clients' suicides. 37.5% of SKS's gross loan portfolio was allocated to that district – the combination of both factors resulted in a devastating effect to SKS.
The total exposure of MFIs in the state of Andhra Pradesh was about INR 7200 crore in 2010. At the end of March 2012, MFIs were still carrying on their books INR 6500 crore worth of bad assets, proving that this was a crisis specific to microfinance that tremendously influenced SKS performance. All in all, it affected the company's capability to gather new clients, to disburse new loans and it drastically increased the loss arising from non-repayments (bad-loans).

3) Present and Future Government Actions

Linked to this conflicts came the first government actions in order to regulate MFIs. The Andhra Pradesh Microfinance Institutions Act 2010, first an ordinance and subsequently a law, mainly prevented MFIs from opening new accounts for those clients who were already indebted to formal banking systems, and from collecting loans weekly in the State of Andhra Pradesh. Soon all the country will be under the same RBI regulation as it was announced in November 2011 and major changes, such as taking deposits from clients, will revolutionize the industry.

This is one main thing preventing the recovery of SKS' stock, as the market is expectant and suspicious about the new policies that may arise and further press down SKS ability to be profitable.

We conclude that the underperformance of SKS in the market was a combination of external pressures and the incapability to manage them – the board's incoherent vision, which resulted in the two referred surprise exits, and in conflicts regarding the strategy to be undertaken. This situation cumulated with the growth saturation point and its following decrease resulting from the various events studied. The decrease in earnings disappointed analysts' forecasts and put SKS on a downward trend, which was grown worse by the external conflicts, and consequently led to a further decrease in the stock's value.

Therefore, we believe that SKS's loss in the market was caused by specific factors to the company and to the timing of its decision to go public. It does not imply that other MFIs deciding to go public will suffer the same fate. As any other business, a company's performance in the market depends on the company's profits expectations, on its managerial capacity, in the image it translates to the markets, in the strategy coherency it performs and in the revolutions the sector is exposed to.

6.2. Are other MFIs going public?

Other MFIs will follow SKS into the markets, but most likely not in the near future. Currently, there are several factors pulling back MFIs from financing themselves in capital markets: firstly, MFIs or MFIs-NBFCs, are waiting for SKS's underperformance in the markets to go by; second, MFIs are waiting for the Andhra Pradesh crisis to be forgotten and for Microfinance's association with the scandals to be lessened; finally, MFIs are expectant about the new government regulations announced for 2012 which may oblige them to reformulate their business models.

MFIs may still, in addition, be confronted with some difficulties on their equity valuation and categorization in the market. Should its condition of a "social business" intended to provide a service for helping poverty alleviation be highlighted in the markets? In order to make the Microfinance society (the specific part opposed to the for-profit model which benefits investors and managers) accept their positioning, these for-profit MFIs must be transparent and modest. As such, making clear to investors that their profits may be more moderate than other quoted companies is a must, assuming they wish to be consistent with their statement of reducing poverty in the world. Overall, MFIs should demonstrate the best efforts in improving their business by reinvesting the maximum possible share of profits in it.

6.3. Limitations and Future Research

There are some limitations in this study, mainly related to the availability of relevant data. All data used in our analysis comes from public sources and as such, certain details regarding SKS's reinvestment policies and future goals are not disclosed. In addition, the financial year figures for FY2012 are not yet published and therefore a number of assumptions were made in the horizontal analysis that in case they not hold may affect part of the results. We should also note that it has been only twenty months after the public issue of SKS, and so the continuous tracking of SKS's performance and the further investigation of its corporate evolution are of the greatest importance.

We acknowledge the above-mentioned facts as limitations to our analysis but nonetheless we are confident in the relevance of our findings for both financial theory and practice.

In conclusion, we would like to propose some issues for further investigation regarding the share of profits invested in MFI's business and the share of profits that are distributed.

Although this has not been the core of this research we would like to suggest a system of assessing the quality of MFIs, which should be based on three main factors:

Social Assessment:

- Regarding being for profit or not, most MFIs state clearly on their corporate goals their intention to help alleviating poverty. The extent to which the clients' – (who are mostly women) poverty situation really improves once they access the loans should be one of the most crucial factors defining the efficiency of MFIs. This type of assessment is however extremely challenging. It is nearly impossible to understand from a MFI's books whether a client has improved or not her situation. As explained in section 5, clients' main obstacles are their lack of knowledge about the activities they wish to invest in and their lack of education and training on basic commerce activities. The resurgence of a client (coming back to obtain more loans) may suggest two opposite things: they either need more capital to repay previous debts since they were not able to profit from their activity, or they need it to continue to make their business proliferate even more. Therefore it is quite understandable why this area continues to be one of the most inconclusive areas in microfinance.

Operational Assessment:

- The sustainability and cost efficiency of a MFI must be one of the core assessment factors. Until the present date, most MFIs have been largely debt financed, a debt which they repay thanks to the high margins they charge to their clients. If MFIs start taking deposits, what changes will this bring to their financial costs? Will they be able to decrease the interest rates charged?

  Other relevant issue is employees training and vision. MFIs contact with clients is made through employees who need to transmit the company's vision and a sense of trust to its clients. Their role is essential. Do MFIs train their employees in order to guide the clients in the best possible way? All this issues should be part of the company operational efficiency assessment.

Financial Assessment:

- Are investors aware of the specific type of business they are financing? Do they understand that profits should perhaps be more moderate than other businesses? Should MFI's financial ratios such as ROE, ROA and EPS be compared with other quoted commercial banks, or to banks such as Compartamos, since it charges an atypical price among MFIs?

These are three main dimensions of an MFI efficiency assessment that should be applicable to not only for-profit but also non-profit ones. If a standard is founded we might be able to compare MFIs with different methodologies within and across countries, not basing our judgments upon the profits or number of loans made by each.

In conclusion, it is our expectation that this analysis shed some light on the debate of MFIs profit orientation and capital structure. Throughout our study we analyzed, on a first stage, the variables to which SKS was exposed to (pre and post IPO) and the main factors explaining its post-issue performance. To this purpose we carried out an exploratory study in which firstly, we address SKS's creation and evolution, and secondly, explore the values, reasons and expectations behind SKS's IPO. On a second stage, we sought to understand whether access to capital markets implies an improvement or deterioration of MFIs' service quality. We expect that our findings are a relevant contribution to the discussion of whether going public can be an advisable route for MFIs.

"I won't paint a very rosy picture but the balance sheet of SKS will start looking healthy."

25 Dec 2011

P. H. RAVIMUKAR

New non-Executive Chairman-Interim of SKS
Microfinance

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APPENDIX

Figure 25 – Milestones SKS

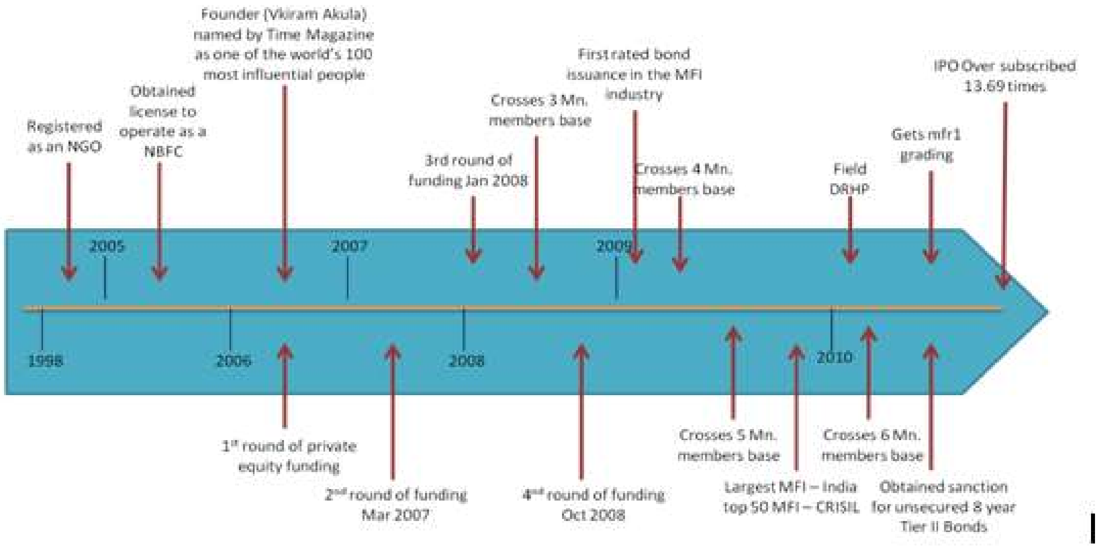


Figure 26 – Evolution of SKS Portfolio

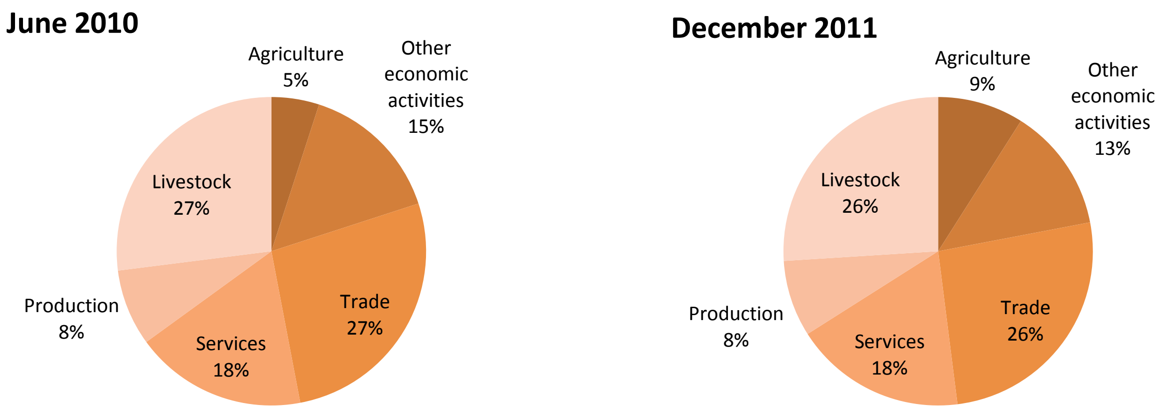


Figure 27 – USD/INR Exchange Rate Historical Data

Figure 28 – BSEIPO INDEX

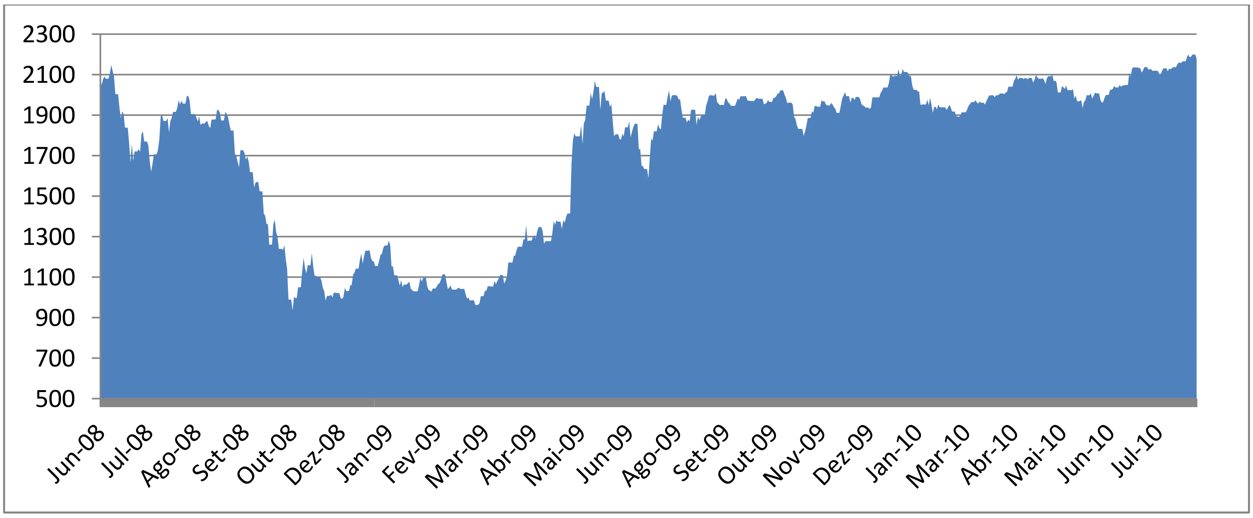


Table 9 –Historical SKS Equity Shares Allotment

Date of Allotment	Number of Equity Shares	Nature of Allotment	Face value (INR)	Issue Price (INR)
22-Sep-03	10	Subscription to Memorandum of Association	10	10
21-Nov-03	50	Allotment to Employees	10	10
19-Dec-03	2,050,000	Allotment to Mutual Benefit Trusts	10	10
20-Feb-06	500	Allotment to SIDBI	10	10
16-Mar-06	1,065,120	Allotment to Ravi and Pratibha Reddy Foundation Inc	10	10
22-Mar-06	4,550,000	Allotment to Mutual Benefit Trusts	10	10
31-Mar-06	5,732,000	Allotment to Unitus, Vinod Khosla, Ravi and Pratibha Reddy Foundation Inc & SIDBI	10	10
31-Mar-07	2,454,138	Allotment to Employees unders ESPS 2007 & Vikram Akula	10	10
31-Mar-07	10,281,739	Allotment to MUC, Vinod Khosla, SKS Capital, Sequioa & Odessey	10	49.77
20-Nov-07	514,25	Allotment under ESPS 2007	10	49.77
22-Jan-08	3,863,415	Allotment under ESPS 2007	10	70.67
22-Jan-08	16,981,184	Allotment to SIDBI, Yatish, Infocom, Vinod Khosla, MUC, Sequioa, Columbia Pacific Opportunity, SVB & Tejas Ventures	10	70.67
25-Aug-08	517,5	Allotment under ESPS 2007	10	70.67
26-Mar-09	3,051,875	Allotment to Sandstone, Kismet & ICP	10	300
18-Aug-09	424,746	Allotment to Tarun Khanna & Bajaj Allianz	10	300
8-Dec-09	10,405,625	Conversion of CCPS to Equity shares of Sandstone, Kismet, ICP & Bajaj Allianz	10	300
8-Dec-09		Conversion of partly paid shares of MBTs to fully paid		
24-Dec-09	945,424	Allotment to Vikram Akula under ESOP plan 2007	10	49.77
31-Dec-09	17,383	Allotment to Employees	10	300
19-Jan-10	937,77	Allotment to Catamaran	10	300
23-Mar-10	225	Allotment to Suresh Gurumani under ESOP 2008	10	300
12-Aug-10	2,233,597	Initial Public Offer (Retail)	10	935
12-Aug-10	5,211,726	Initial Public Offer (Other than Retail)	10	985

Source: SKS Microfinance Reports

Table 10 – Equity Issue Related Expenses

Activity	**Expense** (Rs.in million)	**Expense** (% of total expenses)	**Expense** (% of Issue Size)
Lead Management, Underwriting and Selling Comission, Brokerage	413.86	64,25	2,54
SCSB Comission	5.11	0,79	0,03
Advertising and marketing expenses	105.67	16,41	0,65
Printing and stationery (including courier, transportation charges)	27.7	4,3	0,17
Others (Registrar fees, legal fees, listing costs etc)	90.78	14,09	0,55
Fees paid to IPO Grading agency	1.03	0,16	0,01
Total	**644.15**	**100**	**3,95**

Source: SEBI IPO Report

Table 11- 5-Top MFIs Key Operational and Financial Indicators

MFIs March 2011	**PAR30**	**ROA**	**ROE**	**Portfolio Yield**	**Profit Margin**	**OER**	**FER**	**D/E**	**Non-loan income/assets**
Spandana	48%	-0,30%	-1,89%	7,74%	0,05%	6,08%	17,43%	5,54	6,29%
Bandhan	0,6%	5,3%	41,1%	21,3%	36,1%	6,1%	8,2%	6,24	20,60%
SHARE	52,1%	0,3%	2,4%	30,3%	3,2%	6,8%	19,3%	7,15	12,05%
SKDRDP	0,3%	1,0%	19,9%	12,0%	10,4%	4,1%	9,88%	43,17	13,04%
BASIX	37,4%	0,7%	4,7%	27,9%	4,1%	14,3%	11,74%	6,44	14,99%
Average 5 peer	**27,6%**	**1,4%**	**13,3%**	**19,8%**	**10,8%**	**7,5%**	**13,3%**	**13,71**	**13,39%**

Source: Mix Market
FER (Financial Expense Ratio) = Financial Expenses/Assets

Table 12- SKS Yearly Operational Information

	FY11	FY10	FY09	FY08
Branches	2,379	2,029	1,353	770
States	19	19	18	16
Districts	378	341	307	219
Centers (Sangam)	274,78	226,017	129,461	63,142
Employees	22,733	21,154	12,814	6,818
- Loan officers	15,331	11,878	7,943	3,74
- Trainee assistants	95	3,011	774	1,306
- Branch management staff	3,957	3,455	2,217	1,035
- Area office managers	177	198	139	52
- Regional office staff	2,772	2,215	1,458	529
- Head office staff	401	397	283	156
Members (in '000)	7,307	6,78	3,953	1,879
Active borrowers (in '000)	6,242	5,795	3,521	1,629
No. of loans disbursed (in '000)	7,09	7,397	4,7	2,052
Disbursements for the period (INR crores)	7,831	7,618	4,485	1,68
Gross loan portfolio (INR crores) (A+B)	4,111	4,321	2,456	1,051
- Loans outstanding (INR crores) (A)	3,479	2,937	1,417	781
- Assigned loans (INR crores) (B)	632	1,384	1,039	270
Disbursements / No. of Loans Disbursed	11,045	10,299	9,542	8,188
Gross loan portfolio / No. of active borrowers	6,585	7,456	6,977	6,447
Gross loan portfolio / No. of loan officers (INR '000)	2,683	3,638	3,093	2,809
Members / Branches	3,071	3,342	2,922	2,441
Members / Loan officers	477	571	498	502

Source: SKS Microfinance Financial Reports

Table 13 - SKS Yearly Income Statement

Amount in INR crs	**FY11**	**FY10**	**FY09**	**FY08**
Income from Operations				
Interest income on portfolio loans	1,031	756	450	142
Income from assigned loans	119	101	48	17
Membership fee	10	16	8	4
Other Income				
Insurance commission	11	19	12	0
Group insurance administration charges	71	32	18	4
Income on investments	16	27	17	2
Miscellaneous income	12	7	1	1
Total revenue	1,27	958	554	170
Financial expenses	348	288	194	57
Personnel expenses	326	216	136	47
Operating and other expenses	170	122	75	28
Depreciation and ammort	16	13	11	5
Total operating cost	513	351	222	80
Provision and write-offs	236	52	13	4
Total expenditure	1,097	691	429	141
Profit before tax	172	267	125	29
Tax expense	61	93	45	12
Profit after tax	112	174	80	17
EPS - Basic (INR)	16.10	32.98	17.83	5.50
EPS - Diluted (INR)	15.24	27.47	16.08	5.38
Book Value (INR)	246.23	147.27	136.70	47.88
No.of shares outstanding (crores)	7.23	6.45	4.79	4.43

Source: SKS Microfinance Financial Reports

Table 14 – SKS Yearly Balance Sheet

Amount in INR crs	**FY11**	**FY10**	**FY09**	**FY08**
Equity share capital	72	65	48	44
Preference share capital	0	0	9	0
Stock options outstanding	9	4	2	0
Reserves and surplus	1,699	889	605	168
Capital and reserves	1,781	958	664	212
Loan funds	2,236	2,695	2,137	790
Current liabilities and provisions	283	402	238	87
Liabilities	2,519	3,097	2,375	877
Total Liabilities	4,3	4,055	3,039	1,089
Fixed assets	22	19	12	8
Intangible assets	9	5	7	7
Investment	4.00	0.20	0.00	0.00
Deferred tax assets (net)	36	9	4	1
Sundry debtors	2	3	2	0
Security deposit	169	193	121	14
Short term deposit	55	555	1,268	102
Current account balance and cash in hand	334	226	159	159
Total cash and bank balances	389	781	1,427	261
Other current assets	16	62	32	5
Portfolio loans	3,479	2,937	1,417	781
Other loans and advances	175	38	17	12
Total loans and advances	3,654	2,975	1,434	793
Miscellaneous expenditure	0	8	0	0
Total assets	4,3	4,055	3,039	1,089

Source: SKS Microfinance Financial Reports

Table 15- SKS Spread Analysis

	FY11	FY10	FY09	FY08
Gross yield (I)	27.04%	28.30%	31.59%	25.63%
Portfolio yield	24.50%	25.31%	28.43%	23.94%
Financial cost	7.41%	8.51%	11.09%	8.51%
Operating cost	10.93%	10.36%	12.67%	12.12%
Provision and write-offs	5.03%	1.53%	0.77%	0.63%
Taxes	1.30%	2.74%	2.53%	1.86%
Total expenses (II)	24.67%	23.14%	27.05%	23.13%
Return on average gross loan portfolio (I) - (II)	2.38%	5.16%	4.54%	2.50%
Efficiency:				
Cost to income	55.66%	52.36%	61.77%	70.80%
Asset quality:				
Gross NPA	2.42%	0.33%	0.34%	0.20%
Net NPA	1.28%	0.16%	0.18%	0.16%
Leverage:				
Debt : Equity	1.30	2.80	3.20	3.70
Capital adequacy ratio	45.39%	28.32%	38.99%	24.73%
Profitability:				
Return on Average Assets	2.35%	4.93%	3.86%	2.33%
Return on average equity	7.55%	21.66%	18.19%	11.69%
Return on adjusted equity (assuming RBI mandated capital adequacy of 15%)	2.03%	3.66%	2.93%	1.94%

Source: SKS Microfinance Financial Reports

Situation-Customer Sentiment in Andhra Pradesh

Figure 29 – Sources of Credit (in absence of MFI Loans)

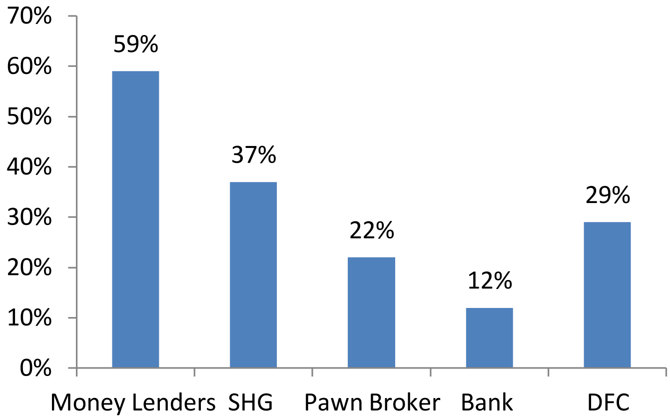


Figure 30 – Reasons for repaying MFI loans

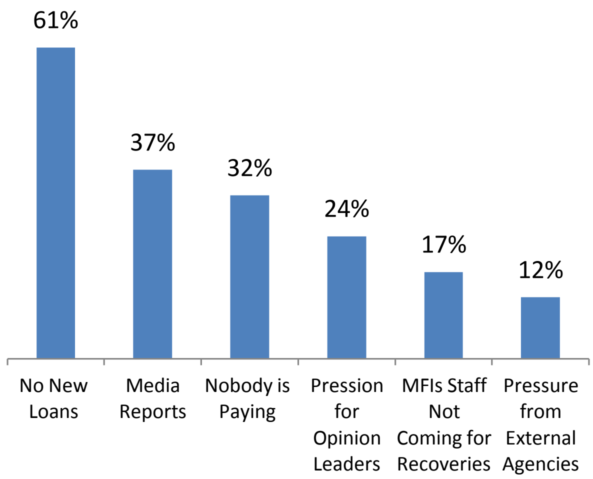


Figure 32 – Interest rates charged by Informal Sources (in absence of MFIs)

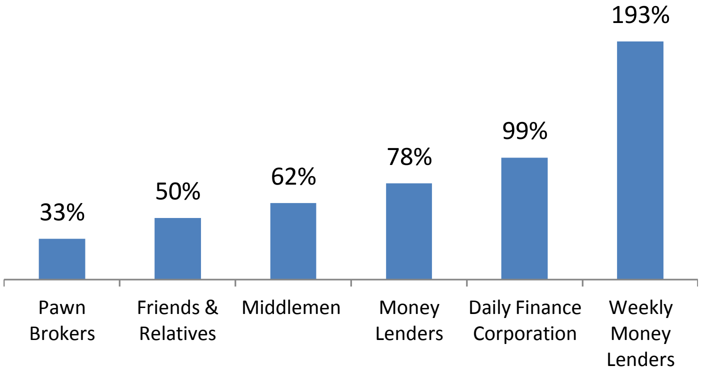
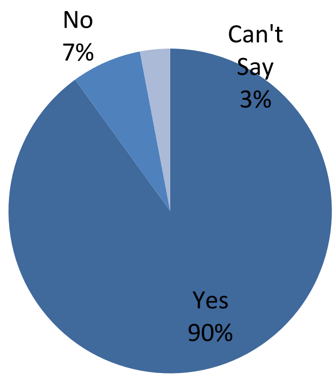


Figure 31 – Willingness to Repay



Source: What are Clients doing Post Andhra Pradesh MFI Crisis? MicroSave, 2011

Déclaration sur l'honneur

Je, soussignée, Ana Sofia Rodrigues Peres Ramos Reis, certifie sur l'honneur que je n'ai rien plagié dans le travail ci-joint, ce qui signifie que je suis le seul auteur de toutes les phrases dont le texte est composé. Toute phrase ayant un autre auteur que moi a été mise entre guillemets, avec indication explicite de sa source. Je suis consciente qu'en contrevenant à la présente règle je transgresse les principes académiques reconnus et m'expose aux sanctions qui seront prononcées par le conseil de discipline.

J'atteste également que ce travail n'a jamais été présenté dans le cadre d'études antérieures à ESCP Europe.

S'il s'agit d'un travail réalisé dans le cadre d'études effectuées en parallèle, je dois le préciser.

Les propos tenus dans ce mémoire n'engagent que moi-même.

Fait à Paris le 9 du mai 2012

Affidavit

I the undersigned, Ana Sofia Rodrigues Peres Ramos Reis, certify on the honor that I have not plagiarized the paper enclosed, which means that I am the only author of all the sentences this text is composed of. Any sentence from a different author than me was written in quotation marks, with explicit indication of its source. I am aware that by contravening to the present rule, I break the recognised academic principles and I expose myself to the sanctions the disciplinary committee will decide on.

I also confirm this work has never been submitted during studies prior to ESCP Europe.

If this work has been written during studies conducted in parallel, I must precise it.

The remarks written in those pages only commit me.

Paris, 9th May 2012