Research Review
The Refereed Peer Reviewed International Journal
ISSN: 2321-4708
Vol. 10, Issue: 127, September, 2023
Paper ID: RRJ475928
https://www.researchreviewonline.com
Publishing URL: https://www.researchreviewonline.com/issues/volume-10-issue-127-september-2023/RRJ475928

Opportunity and Challenges for Microfinance Institutions through Mergers and Acquisitions

By
Dr. Vinod Movaliya
Assistant Professor
Gujarat Arts and Commerce College (Eve) Ahmedabad

Abstract

One of industries growing at fast pace is Microfinance in a developing country like India. There are limited number of mainstream Microfinance players in India,that are competing with traditional Microfinances, and most of which are from the co-operative society kind of structure. Merging of traditional MFIs into main stream MFIsis considered as one of the effective tool for growth and development. There are various opportunities and synergies on merger; mainly cost reduction, market expansion, product diversification etc. However, it is important to address various challenges like valuation, socio-cultural issues, funding issues etc. the current paper highlights various opportunities and challenges for merger and acquisition of MFIs, the failure and success of merger depends on careful estimation of benefit and challenges.

Key Words: Mergers, Acquisition, Microfinance, MFIs

After the Andhra crisis 2010, government has taken many steps through legislations and RBI intervention[1] to protect the interest of all stake holders of microfinance industry. It creates positive as well as negative impact on operations of Microfinance Institutes (MFIs). Since than many MFIs have come up under different forms and many MFIs (Mainly NGO or co-operative society based) have been close down or converted to some other form of MFIs. It is estimated that the growth of Indian microfinance sector will be nearly ten times by 2011 (Tripathi, 2014).

Like other industries, MFIs are also facing the pressure of protecting their net margins. On side constant increase in operating cost due to smaller loan size& higher loan volumes and increase in borrowing cost[2]. And limited scope of charging higher rate of interest on revenue side due to increase in competition in microfinance sectors within and between various forms of MFIs and statutory limitations imposed by various statutory bodies. (Uberoi, 2004) and (Thorat, 2005). Further most of the small MFIs (mainly NGO & Co-operative society based) have operating limitation of geographical area. This limitation affects the financial sustainability of MFIs. To overcome this limitation for sustainable growth various strategies are developed and adopted by various organization. According to focus note of WWB[3] A crucial driver of success and sustainability, growth allows microfinance institutions (MFIs) to expand their portfolio by providing financial services to a larger number of clients while at the same time fulfilling an MFI's social mission. Organizations can use a variety of organizational structures to facilitate expansion, including, growing existing operations; Legal restructuring; Franchising; Strategic alliances; Mergers and Acquisitions (Banking, 2005).

Merger and Acquisition is the most intensive expansion strategy, in terms of time and resources required, difficulty in implementation, and level of risk. There are also delicate cultural issues that require careful change management and regulatory issues that vary by country. A merger is the combining of two or

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[1] The Micro Finance Institutions (Development and Regulation) Bill, 2012; Micro Unit Development and Refinance Agency (MUDRA yojna) and December 2011, RBI directions for creating a special category 'NBFC-MFIs'.
[2] Reduction in government subsidy, donations and subsidized soft loans.
[3] WWB- Women's World Banking is a non-profit organization that provides strategic support, technical assistance and information to a global network of MFIs and banks that offer credit and other financial services to low-income entrepreneurs in the developing world, with a particular focus on women.

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more entities into one, whereas an acquisition occurs when an organization obtains control of another organization by purchasing its assets or shares (Banking, 2005).

Objective for merger

There are various types of MFIs having different Objectives. Some of them are socially driven not for profit whereas others are profit oriented MFIs. It is important for merging institutes to see their purpose, goal and mission. Profit objective is one of the things that setsnon-profit organizations distant from other institutions. The aim of not for profit organization is not wealth creation of shareholders but working for a social cause. There are many MFIs having double bottom line of wealth creation of shareholders and profitability. Apart from profit objective it is important to understand that each organization is unique with respect to its history, culture, purpose of its creation, business strategy and client network (McCarter, 2002). It is important to take care of all such issues while merging two or more different MFIs.

Opportunities for merger

The main purpose of merger is to get benefit of each unique feature and to gain together something extra. It is important to study exactly what they each lacked and what the other would bring to the table in the event of a merger. This SWOT (Strengths, Weaknesses, Opportunities, Threats) exercise helps both parties determine whether merging was a viable option(McCarter, 2002). Such examination for merger made not only philosophical sense but also commercial sense for building a strong microfinance institution that would be able to achieve individual and merged objectives. From the commercial point, it is important to study various properties like numbers and geographical position of branches, employee strength, loan portfolio and associated risk, capital structure, capital adequacy ratio, non-performing assets and profitability of individual MFI. According to WWB, the key value proposition in engaging in a merger or acquisition is to create value by realizing synergies(Banking, 2005). Following are the key opportunities on merger.

Reduction in Operating Cost:

The operating cost consists of cost incurred on serving the loan portfolio. MFIs having smaller loan size & higher loan volumes, results in to more operating cost. Cost incurred on employees for salary is included in operating cost. Efficiency, local market awareness and experience of employee affect the operating cost most. On merger of old MFI into new or upcoming MFI give opportunity to reduce operating cost by reducing duplicating functions and sharing operating activities or facilities. The merged firm gets the benefit of local trained employees for other products. It provides potential for MFIs to scale up and reach economies of scale in a timely way. Apart from cost on employee the merged firm has ability to spread organization's fixed costs over a large client base, providing more services at a lower cost to clients. It results into reduction in overhead and administrative costs and further result in Increase in efficiency.

Reduction in Cost of Finance

There are different forms of MFIs as per its legal status. Legal status restricts MFIs from generating finance from various source. Merger of MFIs having ability to generate finance through public deposit or through public issue with other MFIs, enable the merged firm to reduce its cost of finance and increase the spread. Further it helps in maintaining capital structure in efficient manner.

Expansion and Diversification

Merger gives opportunity to sharing infrastructure, IT facilities and other resources. Merger between MFIs operating in geographically different places, gives opportunity for geographical expansion and increase market share. With existing number of branches at different territory, increase number of distribution channels with new merged portfolio and client base. Organization can gain benefits through increased learning via new organizational competencies. Merger between two diversified MFIs helps in risk diversification. Merger gives ability to expand product offering in light of customer demand. A merged firm can achieve portfolio risk

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diversification through an expanded product offering. The risk diversified portfolio helps in improving Capital Adequacy Ratio.

Challenges

Despite having many benefits of merger and acquisition there are issues of failure. A careful due diligence is crucial for merger and acquisition. There are very few experts in the field of microfinance for MFIs valuation. Merger of MFIs is very challenging, as various aspects of microfinance are required to be considered.

Valuation Issues

Most of the MFIs in India are not for profit and registered under other than companies Act. Since they are not listed, issue of valuation becomes challenging exercise. It becomes difficult to estimate synergic gain over premium paid for acquisition. Overvaluation and over payment of merging MFIs, affects the returns of the acquiring company in post-acquisition period. Considering the limitations, promoters are required to hire a set of finance professionals in deciding the intrinsic value of the company and the appropriate market premium. Acquisition of Jeevika Livelihoods Support Organization in Central India by Allahabad based Sonata was the first in India in April 2007. The staff, clients and the portfolio of Jeevika were acquired at a premium which was based on parameters like cost spent on making clients, nurturing/seasoning them, geographical spread achieved, MIS, portfolio quality and the staff quality. Apart from considerations sometimes other benefits are also given. In the case of Jeevika it's director joined the merged MFI as a co-promoter and a member of its Board.

Socio-Cultural Issues

The diversification of socio-cultural aspect among MFIs and their mission affect the working of merged MFI, especially in a country like India which is highly diversified. Further organizational or corporate culture among the MFIs may conflict to each other. Such issues limits acceptance from clients, microfinance channel as well as from the employees. Managing cultural differences within and between organizations is important for successful merger. Cultural differences between the partners of a merger are one of the most common reasons for failure in mergers. Such differences may arise during pre-merger negotiations or post-merger integration. Such differences limit to form a new successful unit that is able to exploit all synergies (Bhat, 2010).

It is important for the promoter of the MFIs merger to consult with all stakeholders and build a consensus merger. According to Bhat, "The mergers might result in job losses, restructuring, and the imposition of a new corporate culture and identity which can possibly create uncertainty, anxiety and resentment among the targets' employees. In short, the fundamental DNA of the MFI often changes" (Bhat, 2010).

Over Estimation

Merger and Acquisition provide scope for expanding new channels and new products. However, it is more difficult to estimate the benefits that may restrict probability of success. According to WWB, "Companies often overestimate the amount of synergies that a merger of acquisition will create. Careful due diligence is required to assess the potential synergies of the resulting merger or acquisition. Organizations need to maintain a balance between achieving synergies and positioning themselves as a leader in the market" (Banking, 2005).

Regulatory Issues

Depending upon legal structure of each MFIs regulatory issues need to be considered for merger and acquisition. In India, in case of MFIs registered under the company'sAct, MFIs are required to fulfil the legal provisions as per Company's Act. Banking and non-banking financial institutes are required to get node from

Reserve bank of India. Apart from this other regulatory provisions may limit scope of merger and acquisition of MFIs.

Perception of Funders

Normally, the acquisition is through internal source or from banks debts. Due to its client risk portfolio most of the banks and formal financial institutions are conservative for financing despite of promising future of the industry. A merger and acquisition requires organizational restructuring. Other than bank, financer of strong MFI with balanced capital structure have vital concern on merger with comparatively weak MFIs. Further funders of program prefer covering program costs rather than operational cost. Sometimes it is difficult to protect the interest of each stakeholder. A careful formation of capital structure is essential for merger and acquisition.

Conclusion

The opportunity gain from merger and acquisition are excellent, provided due diligence is taken for various challenges of valuation, socio-cultural and other issues. In the recent scenario of high competition and emergence of new main stream MFIs, merger and acquisition is most upcoming tool for growth and expansion. The stakeholders expect substantial synergies from high premium acquisition transactions. Success for a merged MFI is achieved only when it approaches a 'people' centric holistic view, wherein the customers, employees and other stakeholders hold an integral position along with the financial performance of the MFI. To determine success, the merged MFI needs to delicately balance all the above parameters.

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