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# Leadership in Management of **GLOBAL** **Business**

Edited by  
**Vivek Deolankar**



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## Leadership in of Global

Leadership in Management of Global Business is important for guiding the organization towards its objectives and for effective management functions. Today, management functions do more than manage and direct others; they involve staffing, motivating, and ensuring the well-being of employees because this is how management facilitates the process of building a competitive edge. Countries like China, U.S.A., U.K., European countries, Singapore, Indonesia, Israel, Mexico, Brazil, Oman, Dubai, Pakistan, and now India will have to take a new stance towards leadership and global business and leadership in the terms of number of industries.

This volume covers the fundamentals of Corporate Leadership and role-efficacy in a simple and easily understandable manner. It is based on research scholars, corporate managers, and executives. It is an India-specific text giving comprehensive coverage to leadership and role-efficacy of management against current corporate challenges, capturing live in action in the corporate world. It covers corporate transformation, crucial management functions, the role-efficacy of the manager, and enhancing overall effectiveness.

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## PRIVATE EQUITY AND MFIs IN INDIA

*Dr. K.Venkateswarlu*

### **Introduction**

The Government of India emphasized on providing financial services to the poor and underprivileged since independence. Most of these were supply side programs (ignoring the demand side of the economy) aided by corruption and leakages, achieved little. The share of the formal financial sector in total rural credit was 56.6 per cent, compared to informal finance at 39.6 per cent and unspecified sources at 3.8 per cent.

The Indian microfinance Industry is close to Rs. 30,000 crore in outstanding loans to 30 million borrowers is going through a rough tide at present. The situation will blow over with some corrections. Almost a series of economic and political factors in the recent past have been affecting the microfinance industries in India. Since the Microfinance crisis in Andhra Pradesh in 2010 the news for MFIs has been negative. It appears microfinance in India resembles the subprime lending which led to the crash in the capital markets of USA.

In India the formal credit flow has been quantitatively low and also uneven. The collateral and paperwork based system shielded away from the poor. The vacuum continued to be filled by the village moneylender who charged interest rates of 20 per cent per month. 70 per cent of landless/marginal farmers do not have a bank account and 87 per cent had no access to credit from a formal source. In March 2004 the Indian MFIs sector was



whole had loans outstanding of about Rs. 5 billion reaching less than 2 million people, a tiny fraction of the poor people in India. It is in this back ground that the Micro-finance Institutions assume importance on the financial map of the rural areas.

This study focuses on private equity funding for MFIs the reasons for their interest in micro-finance institutions and the problems associated with this development. At the end we raise crucial questions which MFIs must consider for their growth.

### **Growth of Micro-finance**

Finance is an essential part of development process. Access to finance has become more critical issue in development than availability of finance. However the problem of lack of finance cannot be overcome without adequate funding of the institutions that act as intermediaries between those who have deficit funds and surplus funds. Research in development economies now focuses on reducing inequalities through better access to finance and financial inclusion. Access to finance helps to equalize opportunities and reduce inequalities.

The RBI defines Micro-credit as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards. Micro-credit Institutions are those which provide these facilities. The rise of micro finance as a service has been traced by some to the recognition in the early seventies of what came to be termed as the informal economy and to its need for funds for operational performance.

There are several legal forms of Micro-finance Institutions (MFIs). However, firm data regarding the number of MFIs operating under different forms is not available. It is roughly estimated that there are about 1,000 NGO-MFIs and more than 20 Company MFIs. In Andhra Pradesh, nearly 30,000 cooperative organizations are engaged in MF activities. However, company MFIs are major players accounting for over 80 per cent of the microfinance loan portfolio. In the past few years, Indian microfinance has seen unprecedented growth. As early as 2005-6, major Indian MFIs were able to expand their active borrower base by about 110 per cent making the sector one of the fastest growing world-wide.



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### Supply and Demand Imbalance

Despite the growth, there is considerable unmet demand for credit in India. A group of micro-finance practitioners estimated the annualized credit usage of all poor families (rural and urban) at over Rs. 45,000 crores, of which some 80 percent is met by informal sources. According to a World Bank report, only 9 percent of poor families in India are covered by microfinance. Of the projected credit requirement of \$10909 million, only \$1050 million is met by microfinance. Thus there is a supply and demand gap in reaching the needy.

The Self-Help Groups were to facilitate collective decision making by the poor and provide 'door step banking', the banks as wholesalers of credit, were to provide the resources, and the non Governmental Organizations were to act as agencies to organize the poor, build their capacities and facilitate the process of empowering them.

The supply-demand gap in fund mobilization and meeting the requirements of their clientele needs to be bridged if MFIs are to play an important role in realizing the potential of human resources. In order to meet the huge demand for finance across various economic activities, continuous funding of these institutions through various sources is necessary. The high and usurious interest charged by money lenders can be partly attributed to lack of adequate sources of funds for them. It is necessary to prevent the MFIs from going in that direction.

The Government of India vide their notification dated August 29, 2000 have included 'Micro-credit/Rural Credit' in the list of permitted non-banking financial company (NBFC) activities for being considered for Foreign Direct Investment (FDI)/Overseas Corporate Bodies (OCB)/Non-Resident Indians (NRI) investment to encourage foreign participation in micro-credit projects. This covers credit facility at micro level for providing finance to small producers and small micro enterprises in rural and urban areas.

Robinson points out that, 'Donor-funded non-governmental organizations were among the first to identify the vast unmet demand for micro-credit in developing countries. To develop methodologies for delivering and recovering small loans, and to begin credit programmes for the poor.



### **Significance of Funds**

The micro-finance institutions provide services very similar to banking institutions but usually involve small amounts of loans, savings etc. However, the MFIs themselves do not present a picture of homogeneous group. A number of them are transforming from an NGO to a regulated deposit taking intermediary. Such a transformation is significant for both diversifying and augmenting financial resources. While the raising of funds is in itself a challenge, allocating resources pushes them into contact with completely different customers and markets which require new products and unconventional business models.

The MF industry also needs to adjust to the rigors of the commercial world and the demands of a stream of investors. Profitability is difficult in a very low cost environment with a high volume of low value products. Most of the industry lacks capacity and competitive investment opportunities are rare. If the MFIs are not adequately funded, there may be a liquidity crisis which will be a worst scenario for them. Incapability to raise finance severely affects their ability to expand the scale of operations and widen their customer base. This is because growth is ultimately limited by the ability to raise sizeable funds to increase their assets.

The Government of Andhra Pradesh has been a lead state in microfinance activities and has initiated the Velugu Project as part of its rural poverty elimination program. In India there is an acute deficiency of investment in the MF space which can be attributed to lack of funds for such tiny institutions engaged in the noble yet profitable cause. The paucity of funds has inadvertently necessitated the participation of private equity players in the high potential MF space. The net work of financial service delivery points has increased the access facilities and facilitated the development of what Basu and Srivastava term as a relatively deep financial system.

### **Private Equity in MFIs**

As various financial intermediaries are selling all sorts of financial products under one roof, the distinction between financial sector players and products is getting blurred. The

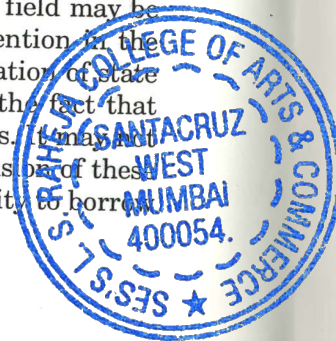


MFI's have been attracting considerable interest from financial institutions. For example, commercial banks have increased involvement in the sector as part of their corporate social responsibility and to meet 'priority sector' lending needs. The sector's business potential is also driving their interest.

The micro-finance scenario in India has witnessed participation by formal private equity capital and other non-state units too. In fact such organizations as the Self Employed Womens' Association, Womens' Co-operative Bank etc. were considered to be pioneers in this field. This participation has grown in the post liberalization period and as of date a number of private capital MFIs have been established in the country. Further more the growth potential of the MF industry has occasioned investments by venture capital funds in this sector. There are several social venture capital funds in India like Aavishkaar-Goodwell that have been established with the explicit mandate to create both social and economic value. Some of their investments are in MFIs.

As the demand for finance from MFI is increasing some micro-finance NGOs have been able to increase their liabilities by borrowing from international lenders or international funds capitalized by donors, social funds, large commercial banks and other sources both on commercial and non-commercial terms. Most of the international lenders issue loans denominated in foreign rather than local currency, a condition that raises foreign exchange risk to a level many MFIs are unprepared to take. The CGAP, Report 2005, highlights that 92 per cent of debt issued to MFI s is in hard currency.

The foreign investors perceive the Indian rural sector as being too opaque and complex. Therefore instead of opening new shops, they have started their operations by acquiring equal status in the existing MFIs. The entry of big money in to this MFIs requires that state intervention in this field may be necessary sooner than later. While, state intervention in the form of regulation is desirable, the direct participation of state should be consciously avoided, notwithstanding the fact that it has benefited in some states in their early stages. It may not be out of context to say that the growth and expansion of these institutions is limited by their willingness and ability to borrow.



from commercial banks and other sources, such as the private equity.

The MFIs can enter into collaboration with other institutions in a unique risk-sharing model. For example, SKS MF and Citibank, share micro-finance with Legatum, a UAE based international firm share and Avishkar Goodwell, Spandana and Wester Union Money transfer etc. This augurs well for the nascent MF industry by increasing fee based income and ultimately reducing transaction costs for new services and cost of loans for them. Thus there is ample scope for the growth of MF industry in India. The requirements are large and the present reach of micro finance is low.

#### **Reasons for Entry of Private Equity (Pe) in MFIs**

The MFIs are now considered as a success story because there is a vibrant market for rural credit. They have demonstrated that high interest rates are not a concern for the borrowers at very low amounts; instead they are willing to pay interest rates lower than that of money lenders, if the transactions are carried out with dignity and ease. This has enabled some of the MFIs, to make super normal profits and a range of private equity firms and investment bankers are ready to chip in their money. Accordingly, it is no surprise that the results from a recent CGAP/MIX survey of 140 MFIs indicated that MFIs generally perceive the lack of funds as the greatest constraint to growth.

Private equity firms typically seek extraordinary returns and are seen as aggressive, non-transparent, difficult to regulate and uninterested in the broader social aspects of businesses they invest in. These firms have shown considerable interest in investing in India's MFIs, particularly those registered as non-banking finance companies. PE firms typically invest in closely held companies in which they see possibilities of extraordinary returns that can be obtained through an exit strategy involving initial public offer (IPO) or takeover by large firms.

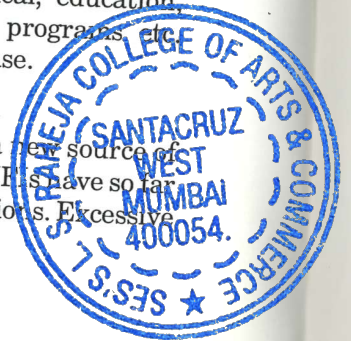
Since 2007, there have been at least four PE investments in Indian MFIs totaling \$43 million. Such investments are expected to accelerate. The private equity investors now perceive the MFIs as a non-traditional area, with a sizeable target market that can yield strong levels of profit. The scope for private equity may be considered on the basis of the following reasons:



1. The MFIs have a healthy repayment rate of 98-99 per cent
2. There is a growing perception that this sector is capable of providing extraordinary returns. For instance, Comparators, a Mexican bank specializing in microfinance, made a successful IPO of 30 per cent its shares with a valuation at 12 times its book value, implying an internal rate of return of roughly 100 per cent per year from the time it became a for-profit entity. Majority of the proceeds went to public service institutions, the main shareholders, but a third went to private shareholders. But the fact that these profits came from very high annual interest rates of around 100 per cent charged to borrowers didn't go unnoticed.
3. The global splurge in PE and increase investment interest in India is another reason.
4. There are no studies to indicate that returns from the sector are sensitive to swings in global economic cycles or that they contribute to cyclical phenomenon. This makes such investments desirable for risk diversification.
5. The supply of capital is exceeding the limited opportunities for investment in the organized sector.
6. According to a study conducted by The Centre for Micro Finance (CMF), there is no evidence that multiple borrowers are experiencing repayment problems.
7. The wide network of MFIs can be used profitably for selling insurance, money transfer procurement and supply chain financing for agriculture and its allied activities. All this for increasing fee based income.
8. The MFIs could be utilized for production, asset distribution and services such as medical, education, paramedical, public health, awareness programs etc. This is possible due to their huge data base.

#### **Advantages to Micro-finance Sector**

The supply of finance through PE opens up a new source of funding for the Indian microfinance sector. The MFIs have so far relied on commercial bank funding to drive operations. Excessive



reliance on bank funding has resulted in high leverage (debt-to-equity) ratios for some of the leading Indian MFIs. Availability of PE could help MFIs increase their equity, resulting in more sound leverage levels.

Secondly, the funding from PE could enable MFIs to build scale, reducing their average costs. With more funding, MFIs can invest in cost reducing technologies, which in turn may lower lending rates. This will give rise to new strategies based on lower effective lending rates, and may spur MFIs to offer new products to their customers.

Finally, the PE investors could bring in international expertise in finance and technology to the microfinance sector. This could also bring more healthy competition between the various constituents of the financial system.

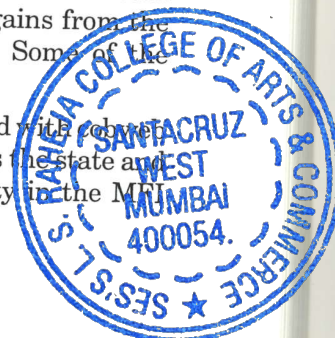
It then goes without saying that the private equity in MFIs can be an ideal combination of corporate social responsibility and intelligent investment. This should have been the reform process in the Indian financial sector. The private equity firms consider the following factors prior to their supply of funds in MFIs:

- (i) The extent to which MFIs fulfill social obligations
- (ii) The extent to which an MFI can sustain its earnings
- (iii) Expectations of a return of 30 per cent in some cases

#### **Problem Areas**

A number of high volume private capital based MFI units have established operational centers due to support measures by the State. Considering that even large MFIs might lack the resources to provide insurance services, an alternative is that MFIs act as insurance agents and insurance companies, on their part design customized insurance schemes relating to agriculture, trade, industrial activity and health. This would reduce the risk of default and delinquency. The gains from the Private Equity in MFIs are not without pains. Some of the problems are:

- (1) Absence of transparent legal norms coupled with complexity of multiple rules at different levels, such as the state and the central have resulted in lack of clarity in the MFI space.



- (2) The existing foreign investment regulations for NBFCs, which are not micro-finance specific, often entail inefficient use of funds, since MFIs do not need equity injections in the minimum quantities laid down. A modification of the regulations would enable smaller quantities of equity to be provided when needed (Ghate, 2007).
- (3) There are regional imbalances in the growth of MFI, which is largely concentrated, in the southern states. This adversely affects the over all growth of the industry.
- (4) MFIs operating expenses are higher than those of other financial service providers that serve more up market segments and the cost burden in the form of higher interests is borne by customers of MFI.
- (5) MFIs are also facing competition from established players like GE money, city financial, Shriram Group etc. The MFIs may have to augment their ability to scale and reach out to more clients with increasing investments from global investors.
- (6) Involvement of PE firms may lead to undue attention to semi-urban areas, as it is easier to attract skilled manpower and the transaction costs of lending are lower. Moreover, as bigger loan sizes tend to reduce transaction costs, lending policies may lead to targeting of more well-off segments of the population who can service bigger loans. These developments may negatively impact RBI's financial inclusion goal.
- (7) There are cases where MFIs have also been charging high interest rates thus evoking fears of a highly regulated environment in future. Further competition among MFIs may bring down interest rates in the long run and also RBI's policy towards liquidity in the money market.
- (8) MFIs have to strike a clear balance between development goals and business interests.



### **Conclusion**

Given their very nature MFIs cannot and should not indulge in profiteering and unethical practices. MFIs on their own have to take certain measures which would help them to overcome their problems and shake off the charge of being unethical and charging usurious to interest rates. The voluntary code of conduct adopted by the Andhra Pradesh, MFIs is a welcome step and could be adopted by other MFIs in the country.

The trend of global investment communities investing more in MFIs is positive for the MFIs in the short run. The long term may be favorable or unfavorable depending upon whether PE is available for long-term or else investments could have a negative impact on the sector's development. The efficient development of capital by MFIs would depend on the liquidity they have to maintain. The size of hedge funds or short term investors would affect the allocative efficiency of MFIs.

The fund raising opportunities for the microfinance institutions have been limited owing to a large number of regulatory constraints. However there are challenges for the microfinance institutions in India to tap the capital markets as a major source of funding. Surely, this has been due to the Andhra Pradesh microfinance crisis, which has had a severe negative impact on investor confidence. As the accounting and reporting methods and the monitoring mechanism adopted by MFIs are quite different from conventional practices that the investors are used to, the MFIs need to strengthen their accounting and monitoring methods, which would give the capital market investors greater confidence to invest in MFIs.

The entry of MFIs in the financial system has given a boost to the rural economy by encouraging entrepreneurship, on the one hand and fulfilling their social commitment in areas like, education, health and literacy. It could contribute to both efficiency and equity in the economy. As a final note on this article it may be added that Janalakshmi which literally means "People's Wealth" raised Rs. 325 crore through the private equity capital route and to date this is the largest transaction in the Indian microfinance sector since the 2010 Andhra crisis. This augurs well for the developing largest democracy in the world.



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