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Rethinking responsible equity exits: A call to action for impact investors

"We simply have to have a higher standard care when working with poor people."
- Kate McKee

By their very name, impact investors are guided by more than just the pursuit of profits. While their goals and motivations vary greatly, in the financial inclusion sector, nearly all impact investors ascribe to one common element – protecting clients from harm – along with other impact objectives that together fall under the rubric of social responsibility.

For most impact investors, that social responsibility receives its biggest emphasis at the start of the process – choosing where to invest. That is, after all, the basic tenet of ESG screenings, encapsulated in the term itself – *screening* – i.e. deciding which companies and industries meet the threshold criteria and which don't. Many investors go further, maintaining their social impact commitments throughout the life of their investments, not only via monitoring, but also by collaborating with investee companies to pursue these objectives.

When it comes to impact objectives, the last stage – **the exit** – is far too often forgotten, or at best, given minimal attention. And yet, for equity investors, that last step can be as important as the initial investment or the work done throughout the life of the investment. A bad exit could easily undo decades of social impact work.

Consider an NGO that spent decades incubating a strong social mission in a financial institution serving poor clients, ending its involvement by selling all of its shares to an investor focused entirely on maximizing profits. Following the purchase, the buyer steers the institution away from its poorest clients, refocusing entirely on profits and dispensing with the niceties of impact measurement or even basic client protection. No socially responsible framework would countenance that as a good outcome, no matter the financial windfall to the NGO. And yet, this description accurately reflects several real-world cases.

There are examples of success too, and they don't require selling solely to other impact investors who are already bought into the mission. Impact investors have been able to find buyers that may not necessarily share the same goals as the sellers, but nevertheless share a common *vision* – a long-term investment horizon that prioritizes sustainability over short-term profits[1]. After all, that vision aligns surprisingly well with a great deal of social impact work – building a deep understanding of clients' needs and providing the right mix of products and services, all the while emphasizing strong, long-term engagement with clients and their communities. When the transition is done right, the new shareholders can evolve the institution's mission beyond that of the original shareholders; and when those new shareholders have deep local or regional roots, they can provide the kind of long-term commitment and leadership that outsiders cannot.

No organizational mission, social or otherwise, should remain forever static. As markets change, institutions serving them must change too. Exiting responsibly ultimately means selling to a buyer that can build on the original mission in a way that stays true to its core principles. However, in markets with a high degree of credit saturation and competition, exits from leading institutions don't just affect the institution itself; they can have important repercussions in the broader sector too.

[1] As an example, see the 2018 exit by shareholders of AMK who implemented a Fitness and Compatibility Review of potential buyers: *https://www.microcapital.org/special-report-responsible-investment-requires-responsible-exits-applying-a-fitness-and-compatibility-review-matrix-to-choose-an-equity-buyer-for-amk-cambodia/*

The importance of responsible exits in overheated markets

Leading institutions are influential in any market. Their growth strategies, operations, and client relationships are often emulated by others, their voice is stronger within their networks, and they typically hold greater sway with government authorities. But in overheated markets, where competition and growth are raising the risk of credit oversupply and high levels of client overindebtedness, those discussions are often more urgent and more fateful. Such markets also tend to have substantial levels of multiple borrowing, and, as a result, large institutions directly affect not only their own clients, but also the other lenders with whom those clients have relationships.

When such institutions shift their growth strategy – a common occurrence following a change of shareholder control – that shift will have large downstream effects. If an institution accelerates its growth, its competitors may feel pressured to up their growth too, if only to maintain their market share. If it starts offering new products or enters new sectors, others will follow. And if it starts placing more emphasis on collections, that too will have its (often negative) impacts.

Minimum targets at different valuations

	Low	Med	High
Valuation (P/B)	1.2x	1.8x	2.4x
Min ROA	1.5%	2.0%	2.5%
Min Growth	8.2%	18.4%	22.7%

Assumes 17% equity ratio, 7% discount rate, 7-year horizon

So what is an exiting investor to do? This is not an argument *against* exits in overheated markets, but an argument for *responsible* exits. No one can know with certainty what a new shareholder will do, but there are important signs that can help forecast it – especially if there are existing concerns about credit oversaturation and overindebtedness. In such market situations, there are two key indicators to watch: the price of the shares sold and how that purchase is funded.

The **price paid for shares** – typically referred to as valuation and often expressed in terms of *price-to-book-value* – is effectively a bet made by the buyer on the future profitability and growth of the institution. An investor paying a high price is locked into a limited set of strategies marked by the pursuit of profits and growth, and is far less flexible than an investor paying a lower price.

Take the illustrative example in the box. To break even, an investor paying 1.2x valuation would need to ensure average annual growth of 8.2% and profitability of 1.5% (measured as return on assets, or ROA). On the other hand, an investor paying double that, at 2.4x valuation, would have to average much higher growth (22.7%) and also far higher profitability (2.5%) over the same period.[2]

Consider a post-exit scenario in which the market hits a downturn lasting a few years. To protect clients and their own institutional sustainability, lenders may have to significantly increase loan rescheduling and restructuring of existing loans, set aside higher provisions for credit losses, and shrink new lending (i.e. undergo a period of negative growth). The investor paying 1.2x valuation can make such adjustments and still break even – the period of losses and negative growth can be offset by modestly higher profits and growth during other years and still meet the investor's minimum targets. However, the high-valuation investor would be facing a high risk of financial loss – the targets are already aggressive, leaving no room for maneuver. Facing such a scenario, the latter can be expected to resist efforts to consolidate and retrench, instead pushing the organization to maximize loan collections and lending in a bid to grow through the downturn.

Another key factor is **how the purchase is funded**. When the purchase is done via a leveraged buyout – using mostly borrowed funds to acquire the shares – it will likewise limit the options available to the buyer. Depending on the amount and cost of debt, a *leveraged buyout* may not necessarily require high growth or exceptionally high profits, but it does require continued positive cashflow to service the debt. The scenario of the downturn above would be a difficult one for the leveraged investor, since it would reduce the cashflow generated by the institution, and efforts to maintain it under those circumstances, whether through staff cutbacks or increased emphasis on collections, could undermine not only client protection efforts but the sustainability of the institution itself.

[2] There are no recent public valuation benchmarks for equity transactions in the sector. However, the last available analysis, published in 2012, put the average valuation at 1.4x globally and 1.8x in Asia, which featured several fast-growing markets at the time. See *Volume Growth and Valuation Contraction: Global Microfinance Equity Valuation Survey 2012*.

In such a market downturn scenario, a large institution whose owners have strong incentives to 'double down' on strategies of aggressive growth or profitability can seriously undermine sector-wide efforts to implement client protection measures. For example, while increased loan rescheduling and restructuring might well mitigate the effects of the downturn on struggling clients, such an institution would not only resist implementing those efforts itself, but can be expected to also exert its influence on any self-regulatory efforts, as well as to lobby regulators and policymakers against implementing meaningful measures. And when there are several such institutions present in the market, the result would be not only greater pressure on clients, but also a far higher chance of a catastrophic market collapse – the consequence of several major institutions committing to an aggressive strategy when the market can least sustain it.

The downturn scenario above is not the only situation where a high-valuation or high-leverage buyout would pose unacceptable risks to client protection. Any market facing serious concerns about overheating and overindebtedness is likely to feature many of the same demands that would undermine the growth or the cashflow requirements that such exits create. Barring clearly defined mitigating factors, **an exit featuring either high valuation or high leverage is irresponsible in overheated markets**.

When is an exit responsible?

High valuation and high leverage aren't the only indicators that entail increased risk to client protection. For investors looking to exit their positions responsibly, there are many other factors to consider. What is the buyer's investment time horizon and is it flexible or fixed? (Short & fixed horizons pose the highest client-protection risk). Does the buyer have access to additional capital to buffer an institution in the midst of a severe downturn? (Access to additional capital lowers risk). Is the buyer willing to commit to maintaining the institution's impact mission and client protection practices? (The answer speaks for itself).

Exiting investors have a duty to assess potential buyers across all these, and many other factors. The paper *Caveat Venditor: Towards a Conceptual Framework for Buyer Selection in Responsible Microfinance Exits*[3] outlines two distinct strategies to guide exits: *Do No Harm* and *Best Interests*, which reflected at the time the two most common approaches adopted by impact investors.

The *Do No Harm* framework – at the time practiced by much of the inclusive finance sector – posits that after clearing certain reputational hurdles, the financial offer would be the dominant criterion in selecting buyers. As one impact investor put it, "once you get past the *clearly* disreputable buyers, you have to take the best offer." This strategy contravenes the basic tenets of impact investing and is particularly inappropriate in overheated markets.

By contrast, an important minority of investors at the time adopted a more proactive approach, the *Best Interests* framework, in effect reversing the prevailing practice and arguing instead that the financial offer should serve only as the initial threshold, and once the investor's target return is met, other aspects of the buyer – its strategic value to the investee and its ability to carry the baton of the social mission into the future – should predominate. In effect, this recognizes that **exiting impact investors have a responsibility to maintain the social mission** - and that this is a *positive* obligation – i.e. the obligation to do something, rather than to merely not let something else happen.

The *Best Interests* framework provides a process featuring a series of guiding questions, included the Annex below. These should help investors develop clear profiles of buyers and potential exits (including appropriate valuation and funding) against which the sellers can assess bidders.

[3] For additional case studies of equity investors seeking to exit responsibly, see *The Art of the Responsible Exit, CGAP 2014*.

A call to action

Equity investors play an outsized role in the financial inclusion sector. As the ultimate owners of the institutions, they set the business strategy, hire the management, and then hold that management accountable for carrying out their strategy. And in overheated markets, owners of leading institutions hold perhaps the greatest role of all – a small handful of investors essentially can effectively set the tone for the market.

The consequences of an equity exit can have aftereffects that last for years. Getting it wrong can be very costly indeed. And in markets featuring high levels of credit saturation and overindebtedness risk, the risk of irresponsible exits undermining both institutional and sector-wide efforts to strengthen client protection is very real.

Impact investors who consider themselves socially responsible should undertake that task with a sense of real responsibility that is commensurate with the importance of their role and enter into active dialogue on what responsible exits should look like and how to ensure that they do not undermine efforts to protect clients, both now and in the future.

"For exits in private equity we need to strive to think about what is reponsible and what is not or the impact we claim will go away."

- Impact investor

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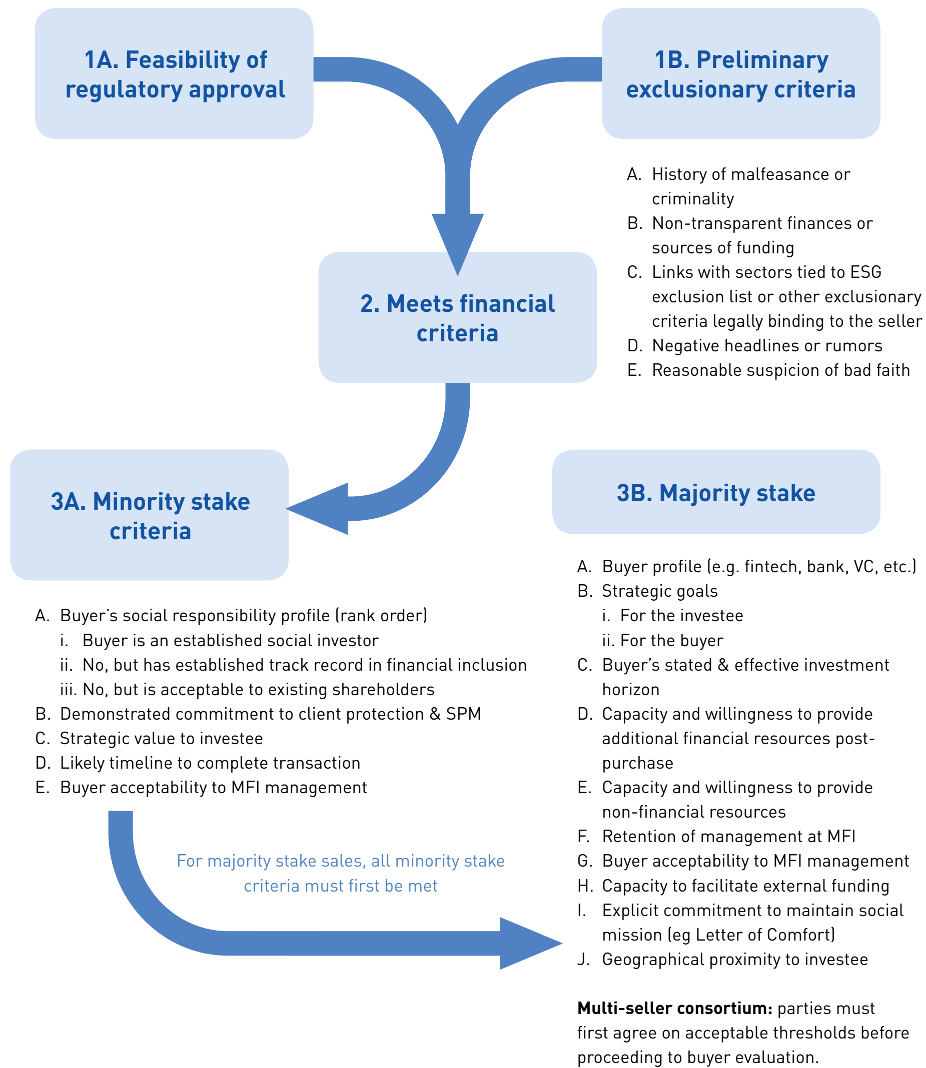
Annex: The Best Interests Framework and Explanatory Notes

Extracted from Sam Mendelson and Daniel Rozas, *Caveat Venditor: Towards a Conceptual Framework for Buyer Selection in Responsible Microfinance Exits*, NPM, FIEC and e-MFP, 2018.



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EXPLANATORY NOTES 1/3

CATEGORY	#	DESCRIPTION
1A. Initial likelihood of regulatory approval		Is there reason to believe that the regulator in the MFI's market may reject or otherwise have cause to look unfavorably upon the buyer?
1B. Absence of Preliminary Exclusionary Criteria	A	**History of malfeasance or criminality**. Does the buyer have any formal record or a sufficiently pervasive reputation for criminal activities, such as corruption, fraud, money laundering, or illegal or unethical labor practices?
	B	**Non-transparent finances or sources of funding**. Can the provenance of buyer's funding be reasonably traced in order to determine legality or ties to illicit or otherwise unacceptable activities?
	C	**Links with sectors tied to ESG exclusion list or other exclusionary criteria that are legally binding to the seller**. Does the buyer have investments in assets or sectors that fall under ESG or other exclusions that prohibit the seller from selling to that entity? This is a standard concern for direct or indirect investments by public entities and DFIs.
	D	**Negative headlines or rumors**. Does the buyer have significant amount of negative press coverage or is subject to concerning rumors among individuals active in the buyer's area of operations.
	E	**Reasonable suspicion of bad faith**. Does the seller have reasonable suspicion that the buyer has a history of acting in bad faith, or does the buyer and the proposed acquisition not 'smell right'?
2. Financial Criteria		**Meets financial criteria**. Does the buyer's offer meet the target price defined by the seller(s) prior to soliciting bids? The target price should be guided by the fund's *overall* financial return objectives and reflect realistic evaluation of what the asset may be worth. Defining the target price in advance reduces the temptation to change the target based on the bids received, which would serve to steer the buyer selection back towards the financial offer (and *do no harm*) and away from the *best interests* objective.

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EXPLANATORY NOTES 2/3

CATEGORY	#	DESCRIPTION
3A. Minority Stake Criteria	**A**	**Buyer's social responsibility profile**. Is the buyer an established social investor, of a similar profile to the seller? If not, does the buyer nevertheless have a track record of investing in the financial inclusion sector? If not, does the buyer nevertheless demonstrate sufficient social bona fides to be acceptable to the seller and other investors?
	B	**Demonstrated commitment to client protection and SPM**. does the buyer have a demonstrable track record that indicates support for client protection or other SPM initiatives, including investing in other financial inclusion entities that have a continued commitment to client protection? If not, are there any other activities, partnerships, or statements that positively indicate such a commitment?
	C	**Strategic value to investee**. Is the buyer able and willing to offer value to the investee, for example partnerships that provide access to digital finance platforms?
	D	**Likely timeline to complete transaction**. Is the reasonable timescale for completion reasonably expedient and convenient for the seller, buyer and investee?
	E	**Buyer acceptability to MFI management**. Does the MFI's management see the buyer as a good fit for the organization and its mission?
3B. Majority Stake Criteria	**A**	**Buyer profile**. Does the buyer have a profile that warrants additional due diligence? Investors have expressed that buyers such as fintech and venture capital companies typically require additional due diligence to establish their strategic goals and likelihood to sustain the investee's social mission.
	B	**Strategic goals (i - for the investee)**. How does the buyer envision the strategy of the investee post-purchase? Is this strategy in line with the overall social mission of the investee and the intentions of the seller? **Strategic goals (ii - for the buyer)**. What role does the purchase of the investee play in the buyer's overall business strategy (e.g. expansion into a new region or segment, portfolio diversification, growth & capital appreciation)?
	C	**Buyer's stated and effective time horizon**. What is the time horizon of the buyer's strategy for the investment (i.e. what are its own exit plans, if any)? Is this time horizon consistent with the buyer's legal/financial structure (e.g. a venture capital fund would not typically be able to sustain a long-term horizon)

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EXPLANATORY NOTES 3/3

CATEGORY	#	DESCRIPTION
3B. Majority Stake Criteria	**D**	**Capacity and willingness to provide additional financial resources post-purchase**. Does the buyer have "deep pockets," i.e. additional capital that can be made available either to fund investee's future growth or to inject equity to support the investee during a market downturn. Is the buyer willing to make such additional equity investments?
	E	**Capacity and willingness to provide non-financial resources**. Does the buyer have non-financial capabilities, such as operating a digital finance platform or an agent network, expertise in new products (savings, insurance), access to new market segments or geographic areas, or other capabilities that would be valuable in furthering the investee's mission? Is the buyer committed to making these capabilities available to the investee in an effective manner?
	F	**Retention of management at MFI**. Does the buyer intend to retain a significant proportion of senior staff and management at the MFI after purchase of a controlling stake (for example, by signing employment contracts as part of the sale agreement)?
	G	**Buyer acceptability to MFI management**. Does the MFI's management see the buyer as a good fit for the organization and its mission? Note that for majority sales, this question should typically receive considerably more weight than for minority sales.
	H	**Capacity to facilitate external funding**. Is the buyer of a controlling stake in the investee able and willing to assist the company in accessing debt finance through capital markets, especially at competitive rates in local currency?
	I	**Explicit commitment to maintain social mission (e.g. 'Letter of Comfort')**. Has the buyer made a written (although non-binding) commitment or covenant to maintain a particular social focus within the investee, such as limits on interest rates, outreach to low-income segments, or commitments with respect to reaching client protection certification milestones?
	J	**Geographical proximity to the investee**. Is the buyer located in the same country/region as the investee, and with convenient transportation routes?