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Investing in Financial Inclusion & the Bottom of the Pyramid

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Introduction

After earning his MBA from Columbia Business School in 2017, David Morningside had just started his new job as an investment associate at Columbia Impact Capital (CIC), an impact venture fund with a sterling reputation for investing in high-growth, high-impact social enterprises around the world. As he sat down at his desk on his first day and opened his laptop, he received a frantic email from one of the venture partners, who was getting on a flight from Johannesburg back to New York:

> *David,*
>
> *Welcome to CIC! Great to have you on board. I hate to throw you into the fire so quickly, but as you know, we're looking to finish deploying the capital raised from our most recent fund. We've narrowed our opportunity set down to a few promising social enterprises, but I'd appreciate your input on the three that we've short-listed. Please see the attached for the relevant diligence information we've received. I have an investment committee meeting tomorrow and need a point of view on where we should prioritize our efforts. I look forward to your recommendation when I land in NY tomorrow.*
>
> *– Mark*

Of course, Morningside understood that time was of the essence for getting term sheets in front of prospective portfolio companies. CIC's most recent fund was thematically focused on solutions in the financial inclusion space, in which Morningside was very interested. He believed that there were significant opportunities to deliver market-level returns to CIC's limited partners (LPs) as well as to meaningfully influence the well-being of those living in

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poverty in several key emerging markets. After perusing some data on the three investment opportunities, Morningside was struck by the range of solutions they offered. One was in the digital payments space that had been heating up for years following the success of mobile money plays in East Africa. Another opportunity, in the Indian market, was focused on providing wealth management products and advisory services to the rural poor. The third was to fund the growth of a mobile microinsurance provider that was already achieving global scale. At first glance, all three seemed both viable and unique opportunities.

Financial Inclusion: The Challenge and the Opportunity

Circa 2016 over two billion individuals and 200 million businesses lacked access to affordable financial services such as health, property, or life insurance, credit, savings accounts, or even deposit accounts.[1] For the very poorest who grapple with low and often unpredictable income streams, the challenge is immense. How might they afford the seeds and fertilizer needed to grow this year's crops? How will they bear the expense of medical treatment for an unforeseen injury? How can they save for their child's school fees? Being included in the formal financial system enables individuals and small enterprises to preserve and grow their savings, smooth their consumption, invest in the growth of their businesses, and mitigate the risk of cash flow shocks, thereby improving their overall well-being. Indeed, research suggests that financial inclusion was not only correlated with growth and higher employment levels, but also causally impacted the growth of developing economies.[2] Start-ups and existing companies were increasingly looking to provide solutions to the challenges faced by the financially excluded. Microfinance, mobile money, microinsurance, and innovative savings and investment solutions were all emerging in key developing markets, including those in South Asia, sub-Saharan Africa, and Latin America.

CIC saw that its recent financial inclusion fund provided a significant opportunity in that space. The firm was looking to capitalize on the growth trends and to invest in organizations addressing the pressing social challenge of financial inclusion through market-based solutions that would also deliver market returns to the fund's LPs. But how would CIC choose among the three short-listed potential investments?

IFMR Holdings and the KGFS Model

IFMR Holdings (IFMR) was established in 2008 as a financial services organization with the mission of facilitating complete financial inclusion across all of India. The firm was organized around a holistic platform for creating markets and making a significant impact in the lives of its customers through a three-pronged approach:

- **High-Quality Risk Origination:** IFMR developed a one-stop shop for an integrated suite of financial products and services tailored to the needs of rural Indians and delivered through a dedicated, high-touch wealth management approach known as the Kshetriya Gramin Financial Services (KGFS) model. The products and services used were a combination of those purpose-built by IFMR as well as those developed by specialized partners (i.e., insurance underwriters). IFMR also developed the sophisticated back-end tools, processes, and technology solutions needed to effectively deliver those products and advisory services.

- **Risk Aggregation:** Through its IFMR Investments arm, the firm offered risk monitoring services to investors, providing investment advisory and fund management services specifically in asset classes that impact the financially excluded. This segment of the business looked to raise, advise, and manage long-term funds for both impact and mainstream capital investors with a focus on long-term debt. IFMR Investments' funds were concentrated on microfinance, small business loans, affordable housing finance, and vehicle finance.
- **Risk Transmission:** The final arm of the IFMR Holdings structure—IFMR Capital—served as an investment banker to midmarket nonbank financial companies (NBFCs) that served households in the informal sector by providing credit. IFMR Capital provided key investment banking services such as lending, syndication, securitization of loan portfolios, and ratings advisory, as well as principal investments off the firm's own balance sheet.[3]

IFMR CEO Sucharita Mukherjee was the founding CEO of IFMR Capital and served there from 2008 to 2012, overeeing the firm's investment banking business. Earlier in her career she was a VP at Morgan Stanley in London, where she led the origination and structuring effort in credit derivatives and structured finance for corporate clients.

THE KGFS MODEL

CIC's opportunity now was specifically to invest equity in IFMR's risk-origination arm to fund the growth of the KGFS business. KGFS was built particularly to address the key issues of financial exclusion faced by most of India's rural poor. Even in 2016, a majority of Indians either lacked access to or had not adopted the use of formal financial services. A recent World Bank study had found that only 11.6% of Indian adults had saved money in a formal institution in the last year. In stark contrast, the study found that that figure was much higher for other countries, such as the People's Republic of China (32.1%) and the United Kingdom (43.8%).[4]

Using an advisor-driven wealth management approach, the KGFS solution provided a comprehensive, holistic suite of financial services and products for Indians living in remote rural areas. These products and services were designed to be simple, user friendly, and tailored to the needs and goals of each customer. The offerings included a range of credit products (including joint-liability group loans, enterprise term and working capital loans, and livestock loans); savings and investment products (SB accounts, recurring deposit accounts or RDs, pensions, and gold investment); and insurance products (personal accident insurance, term life insurance, shopkeeper's policies). Loans were typically between US $300 and US $400, and revenues were derived from interest, premiums, and other liability product fee income. The KGFS model used a broad financial well-being report to assess a potential borrower's or household's financial position, understand their financial goals, and to link the financial products and services offered to that borrower or household to those specific needs and goals.

Customer centricity was at heart of the KGFS model, and the firm accordingly developed a highly localized network of 236 branches that served approximately 680,000 people. Each branch served clients in a radius of approximately just five kilometers, reflecting a sustained effort to operate locally. After setting up a branch, personnel would focus on establishing relationships in their service area. KGFS recruited and trained wealth managers—often from the local communities they served—who had little to no formal financial services background and most frequently no university degree. This choice reflected a belief that those with a traditional sales-oriented wealth management background might not be best positioned to gain the trust of a population that often viewed investment—and financial services more broadly—with skepticism. New advisors underwent an intensive training course that focused on developing both customer relationships and appropriate holistic financial goals for clients. Advisors' incentives were also tied to households meeting their goals and improving their financial position, rather than to cross-selling financial products and services.

By 2016 KGFS had grown significantly and more than doubled its 2014 revenues. The firm's focus on the rural poor was reflected in its customer distribution. Seventy percent of its customers were thought to earn less than US $5 per day, while only 4% earned more than US $10 per day.[5] However, IFMR believed KGFS would be able to serve a broader population subset as the financial position of its clients improved; with such a diverse set of financial products and capabilities, KGFS considered that it could remain relevant and serve the mass market segment as well.

After eight years in operation, KGFS branches were yielding mixed results on the bottom line. While four of six business units had achieved breakeven or profitable results by 2016, the remainder were still generating losses for the firm. Rather than focus on achieving profitable operations in a limited set of branches early on, IFMR chose to continually invest in expansion into new markets within India to build its customer base and deepen brand awareness. The business model was also built on a network of brick-and-mortar branches staffed with advisors and was not a nimble, asset-light operation; adopting the high-touch, highly customized wealth management approach increased costs considerably. However, the firm's executive team consciously chose to develop the business in that direction. As one impact investor with a major equity stake in IFMR said, "Because we are selling liability products (savings and insurance), we fundamentally think we need to build trust on the ground. It is a more expensive approach—our cost ratio is higher than the competition, but we think this will pay off in [the] long-term. We can sell liability products and build stickier relations." Profitability thus remained a concern for both management and investors alike in the short term, and achieving sufficient scale would be critical for unlocking long-term profitability.

Nevertheless, IFMR had driven significant improvement in its clients' household financial well-being. A study of results from KGFS's most mature branch demonstrated that customers who used its services had experienced a 48% increase in the number of assets, a 200% increase in the value of their assets, and a 254% increase in their annual household income. Preliminary results of an ongoing study also suggested that KGFS customers were also much more likely to adopt the use of other formal financial services. These customers had a 40% higher incidence of formal borrowing, on average, than those who didn't use KGFS's services and borrowed from informal lenders.[6]

Zoona

Morningstar's research revealed that in much of southern Africa, cash transactions dominated the economy, most consumers were unbanked, and lending was originated by informal financiers with no regulatory oversight. In Zambia, for example, 61.8% of the adult population was unbanked in 2014.[7] In particular, payments were a pain point due to the immature financial infrastructure, high transaction costs, and the physical distances between where individuals earned money and where their families lived. Many household breadwinners were in need of a mechanism for sending money home, and small business owners required a tool for making payments to suppliers who might not be locally based.

Zoona (formerly MTZL) addressed this problem by managing a network of over 1,500 mobile-enabled money transfer outlets across Zambia, Malawi, and Mozambique. The core offering was an agent-based or over the counter (OTC) mobile money transfer platform. Zoona-branded kiosks, where end users could conveniently transfer money over the Zoona platform via the agent's mobile device, were ubiquitous across much of Zambia. Value was transferred via the mobile wallet of the agent and could be redeemed by the recipient at any Zoona outlet across the network. The OTC model enabled a secure and efficient transfer of funds without the need for customers to have a bank account, mobile wallet, or even a mobile phone of their own. Zoona believed that about 24% of its customers were from the very bottom of the pyramid and earned less than US $5 per day, but over half were higher earners (those who were making more than US $10 per day). The product worked across income strata, attracting relatively wealthier net senders of funds as well as relatively poorer net recipients.[8]

To be sure, money transfer products using mobile infrastructure were not a new innovation in sub-Saharan Africa. Safaricom's m-Pesa product had become the quintessential success story of the convergence of mobile technology and financial services in the developing world. Their success stimulated copycat efforts by many other players in Zoona's core market of Zambia, such as MTN and Airtel, that were also operators of mobile communications networks venturing into the payments space.

Zoona, however, leveraged a markedly different approach to mobile payments by focusing on building a broad network of agents and fine-tuning the agent–customer experience to drive client loyalty. Zoona's true customer base was not the end users of their transfer services, but rather the network of agents that operated Zoona kiosks. Agents were franchisees of the Zoona brand and eligible to finance the purchase of their booths, phones, and the marketing materials needed (e.g., signage) to run their business, which the agents paid back over time. Agents received an account on the Zoona system that enabled them to process transactions over the

Zoona network. This account was linked to their formal bank accounts, and this link was what enabled the transfer from currency to Zoona electronic credit. An end user gave cash to the agent at a Zoona kiosk; the money was converted to electronic credit and transmitted across the network, and it was then available to be reconverted into cash at any Zoona outlet by the recipient. Circa 2016 the total fee for this type of transaction was estimated to be 3%–4%, on average. Zoona collected a share of the fee, and the agent received a share as commission. Since agents needed to manage their own float to cover the transactions, Zoona also offered working capital financing to agents. Although competitors priced their transfer services slightly lower, Zoona believed it was able to differentiate its offering based on the breadth and ubiquity of its kiosk network as well as its superior customer experience.[9]

Zoona's business, while focused almost entirely on money transfer in 2016, had taken a circuitous route there. In 2008 Brad and Brett Magrath founded MTZL, with funding from USAID and a US-based cotton company, to facilitate digitized payments and communication between rural cotton farmers. However, the product never reached more than a few thousand farmers and wasn't able to generate sustainable unit economics. In 2009 the Magraths teamed up with Mike Quinn, a Canadian MBA, and eventually pivoted to focusing on the distribution of agricultural inputs for farmers through electronic vouchers that could be used in the local economy. MTZL then acquired the necessary expertise in developing software to handle bulk ordering, invoicing, and payment systems. That ultimately led to a partnership with Zambian breweries, who contracted to use Zoona's technology to collect payments from their microdistributors. In 2014 the firm committed to refocus its efforts on the payments business for consumers.

As of 2015, Zoona had over 762,000 subscribers. Since 2011, their revenues had grown at a CAGR of 84%,[10] and the firm had expanded beyond Zambia to include operations in Malawi and Mozambique. As Zoona looked forward to the future, it planned to enter additional markets in the region and introduce an international remittance product to facilitate cross-border transactions. Zoona proved out the economics of its business when it achieved the operating breakeven point in 2014. However, the firm was in a period of reinvestment for expansion as it broadened its growth ambitions.[11] In 2017 Zoona was raising a Series B, and so far had attracted over US $15 million in new equity financing.

Demand for a highly accessible and user-centric payments product continued to be very strong in Zoona's regional market. The firm believed there was significant unmet demand beyond their current capacity, suggesting that there was room to densify its agent network and continue high growth. In addition to improving its financials, the firm was also effecting positive changes for its agent customers and end users. Zoona had generated employment for 906 agent entrepreneurs who themselves employed 1,809 tellers.The firm was also focusing specifically on providing employment opportunities, business acumen and financial literacy training, and positive motivation to female entrepreneurs and targeting them as potential Zoona agents. Finally, digital payments had enabled individuals to safely and quickly move over US $1 billion without having to travel long distances or handle cash, thereby giving them additional time to focus on income-generating economic activities.[12]

BIMA Mobile

The third and final investment choice for CIC was a follow-on growth equity investment in BIMA Mobile (BIMA), an emerging market-focused mobile network operator (MNO) strategically backed by a Swedish private equity group. BIMA had developed a highly innovative model to provide life and personal accident insurance coverage to people living at the bottom of the pyramid. Due to often sub-standard living and working conditions, this population segment was among the most exposed to the risks of disease and personal injury. A sudden illness or death to a key earner in these households created a significant economic burden and cash flow shock that families simply were unequipped to deal with, given their predominant lack of savings. Moreover, due to a lack of information about the benefits of insurance, a deep skepticism that claims would actually be paid out, or a simple lack of access, few individuals maintained any form of insurance to mitigate these risks.

THE BIMA MODEL

While insurance coverage rates in the markets in which BIMA operated were low (<3%), mobile phone penetration there was quite high (>80% of those markets, on average), creating a new channel through which low income customers could be served. BIMA partnered with MNOs and local insurance underwriters to create value through expert product design, widely accessible distribution, and a carefully managed customer experience. At the core of BIMA's success was the alignment of incentives between the firm and its MNO partners. While customers in developed markets tended to have long-term relationships with their mobile provider and maintain a postpaid line in which they received a monthly bill for mobile services, emerging market customers tended to use prepaid offerings and opportunistically switch between carriers to take advantage of promotional pricing. Often, these consumers would simultaneously hold three or more SIM cards. MNOs were consistently looking to increase their average revenue per user (ARPU) in these markets to help improve the margins on a per customer basis. As such, they often sought to differentiate themselves by offering value-added services in addition to mobile telephony. In this environment, BIMA found a natural set of partners with whom to enter the market.

BIMA provided end users with low-cost, simple, insurance built around the needs of the customer. In 2016 BIMA's portfolio included life and personal accident insurance as well as mobile health services (i.e., telehealth consultations). BIMA customized products to meet the needs of each MNO and to match the behaviors of customers in the local market. BIMA's revenue model had evolved from a "freemium" model, where coverage was earned in exchange for loyalty to an MNO through a minimum monthly spend on the network, to a paid model, where the end customer voluntarily purchased additional coverage. In the paid model, users bought the insurance via a deduction of small daily amounts of their prepaid airtime credit. In 2016 BIMA also collected payments via mobile money and offered postpaid billing for higher income customers. Given the lack of trust in insurance or financial companies in many emerging markets, BIMA most frequently went to market using its MNO partner's brand in order to build credibility in the new product. However, BIMA itself managed the distribution force, who were trained to provide vital education about how the product worked as well as to assist customers in enrolling directly on their mobile phones.

Since its founding in 2011, the paid model had achieved considerable success. In 2016 BIMA added subscribers at a rate of 500,000 per month, and the firm doubled its revenue year-on-year from 2014 to 2015. Moreover, over half of those who received complimentary coverage in exchange for MNO loyalty chose to purchase additional coverage.[13] This demonstrated that customers were able and willing to pay for the product and also offered some validation of the business model. In 2017 BIMA operated in over 16 countries and reached over 24 million subscribers, despite the fact that over 70% of those users previously lacked access to or information about insurance coverage. BIMA estimated that over 53% of its customers lived on less than US $2.50 per day and that 93% lived on less than US $10 per day. In 2016 the firm was pushing its users toward financial inclusion in a meaningful way. BIMA was often the first formal provider of financial services these consumers interacted with. Indeed, 75% of BIMA’s customers were accessing insurance for the first time, and 47% of BIMA’s users worldwide were completely unbanked.[14]

Looking forward, BIMA was striving to achieve profitable results on a consolidated basis. Although the firm had demonstrated the profitability of its unit economics and operated a typical technology business model that was asset light, the success of the strategy was predicated on continued growth and the ability to achieve economies of scale. To realize sustainable profitability, BIMA planned to enter between one and seven new markets annually going forward.[15] Growth had been impressive to date, but positive future results would not be secured without challenges. There was a lack of inherent demand for insurance services, and top-line growth required significant investment in the acquisition of new customers through the training of the sales force to educate new clients. Questions also remained about whether MNOs could themselves play in BIMA’s niche. Nevertheless, BIMA had raised over US $75 million in venture funding from strategic players (MNOs) and traditional impact venture funds. In their last round, all existing investors on the capitalization table had recommitted and maintained their pro rata share in BIMA.

Evaluating the Choices

After looking through the pitch decks and financials sent by the management teams of each of these firms, Morningside started to think about how to tease out the relative benefits and potential risks of an investment in each of the three companies. First, however, he was struck again not by their differences but by some of the themes they had in common. Each of these companies was purpose built to be user centric and had developed a business model to serve a need unique to the bottom of the pyramid. Each also seemed to be following a similar growth trajectory, focusing on top-line growth and geographic expansion to ultimately generate the operating leverage and scale needed to return a consistent profit. Nevertheless, there were real trade-offs to be made by making an investment in one of the companies relative to another. BIMA and Zoona both appeared to have business models with potentially global reach, and indeed, BIMA had already demonstrated that possibility by operating in sub-Saharan Africa, Latin America, South Asia, and Southeast Asia/Oceania. Thus, the potential market opportunity for BIMA and Zoona seemed large enough not to be a concern. IFMR, on the other hand, was deeply focused on the Indian market. Was there sufficient headroom there to sustain the growth of the firm over the long haul? As Morningside continued to think about IFMR's growth potential and strategy, he was also persistently struck by the cost structure needed to effectively deliver on the firm's brand promise. Was the model sufficiently scalable? And was IFMR doing enough to leverage technology to reduce some of their fixed costs? At the same time, IFMR had perhaps the deepest impact of the three on its clients' financial well-being and inclusion in the formal financial system.

This last thought raised a higher-order question for Morningside. How should he think about the trade-off between financial return and the impact on individuals? And for that matter, was it more important to achieve broad impact that maximized the number of lives touched or to focus on deeply impacting and improving the lives of a more limited universe of customers? Looking forward, Morningside started to also consider the importance of the profile of the customer base. Was it critical to serve the poorest of the poor? IFMR and BIMA certainly did today; however, they both had mass market aspirations for the future. Would they still be generating serious social impact five years from now?

In making a bet on any of these companies, it was also critically important to consider whether they had the right management in place. Zoona had a highly entrepreneurial management team that had effectively pivoted the focus of its business twice, but was its CEO the right individual to take the firm from US $10 million in revenue to US $100 million? Zoona certainly felt like an earlier stage firm than IFMR and BIMA, which increased its risk profile somewhat; IFMR and BIMA also seemed to have much more experienced CEOs in place. Conversely, was it too late to make a meaningful investment in BIMA, given its current size and reach? How should that be weighed in a decision? There was also the issue of governance. Would these firms accept a partner from CIC on their board? And what would the time commitment be like for each of them?

All of these questions would need to be answered. To be sure, each of the three companies could create returns for the fund's investors and meaningfully improve the lives of some of the world's very poorest people, but CIC only had sufficient uncommitted capital to make a single investment before closing the current fund. With those considerations in mind, Morningside returned to his diligence materials to review them again.

Endnotes

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