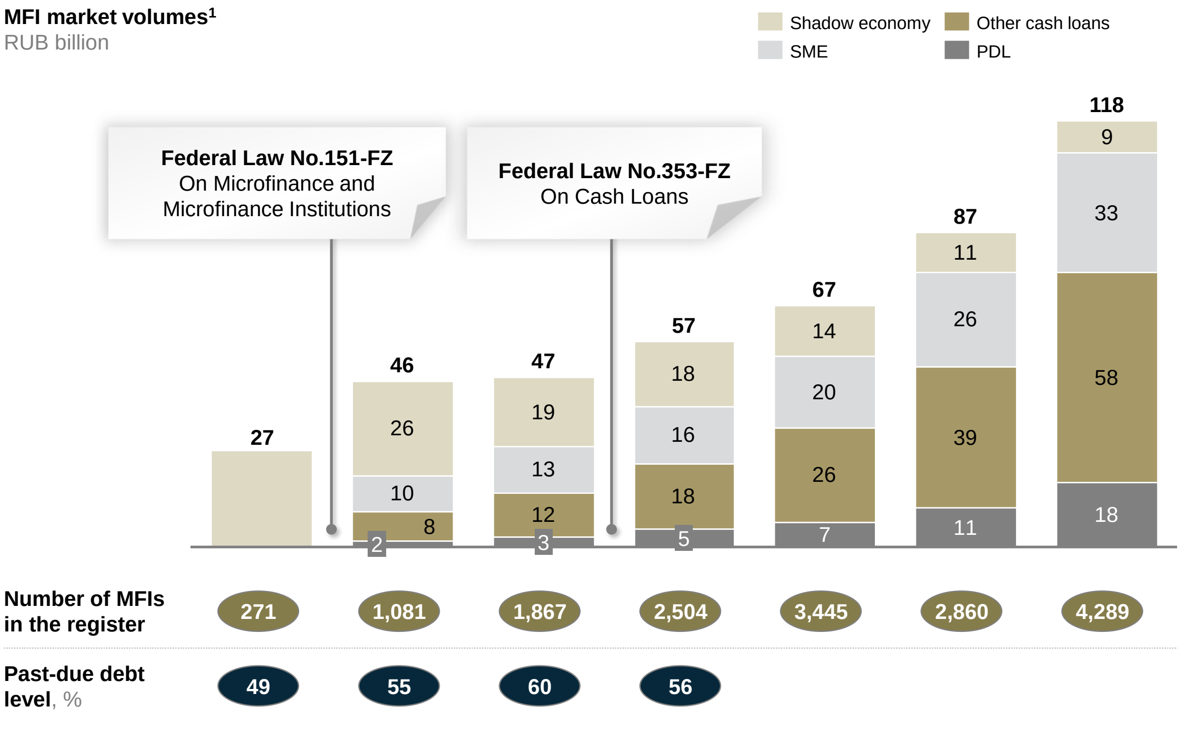
Russian Microfinance Market – It’s Time to Grow Up

FEBRUARY 2015

In 2010, following the adoption of Federal Law No. 151-FZ On Microfinance and Microfinance Institutions, the Russian microfinance market experienced a boost. The law has become the first step toward regulation of pop-up microfinance market to be intended to fill a niche of opportunities for lending to individuals and small businesses beyond the interests of commercial banks.

At year-end 2014 microfinance market continued to grow explosively and, likely, will keep this up (general data on MFIs market with growth forecasts for the period of up to 2017 are shown in Figure 1). The market is far from saturation; the players are expanding rapidly, and yet only some of them have substantial competitive advantages (e.g. Evgeny Bernshtam’s Home Money LLC captured the opportunities in attracting investments and retaining the leading position in its segment).

Figure 1.
Russian microfinance market: general overview



1 MFI market volume does not include consumer credit co-operatives

Source: Expert RA, National Partnership of Microfinance Market Stakeholders, Russian Microfinance Center, register of the Central Bank of the Russian Federation, MCG studies

There are two key laws having an effect on Russian MFI market: No.151-FZ dd. 02/07/2010 and No.353-FZ dd. 21/12/13. The main provisions of the laws and assessment of their impact on MFI market are presented in Figure 2.

Figure 2.
There are two key laws regulating Russian MFI market

	Federal Law No.151-FZ On Microfinance and Microfinance Institutions	**Federal Law No.353-FZ** On Cash Loans
Date of enactment	02.07.2010 (rev. 21.12.2013)	21.12.2013
Effective date	04.01.2011	01.07.2014
Right and obligations of MFIs	• MFIs are obliged to provide publicly available information about the legal entity in the state register • MFIs may control the intended purpose of the loan, and raise funds (except from individuals) • MFIs may not provide loans in foreign currency and loans for the amount of more than 1,000,000 rubles, carry out professional activity on securities market and charge a borrower with penalties for early repayment • Borrowers are guaranteed to be provided with full and reliable information about the terms and procedure for the conclusion of agreements, and complied with confidentiality requirements as to transactions	• MFIs are obliged to use standard form of agreement including general and special terms and conditions • The maximum loan amount shall not exceed 4/3 of the average market cost of cash loan calculated by the Bank of Russia quarterly • MFIs are obliged to send borrower data to NCB[1] • Borrower may obtain full information about the terms of loan arrangement and repayment for free
Impact	• Creating legal environment for MFI activities • Introduction of the state register • Availability of official market statistics	• Strengthening market discipline • Reduction of maximum profitability and probability of defaults • Increasing borrower rights protection

1 National Credit Bureau

In the context of sector regulation tightening new MFIs (microfinance institutions) often have advantages over existing players as they may start business from scratch and offer products complying with market requirements, while existing players need to make efforts to reconstruct and adapt products, and retrain personnel, thus, resulting in reduction of portfolio efficiency and additional investments in operations models.

Does it mean that microfinance business today is a robust opportunity to create a strong and rapidly growing company capable to become a top performer? Let's consider this in more detail.

Microfinance market may be split into 3 main segments distinguished by target groups, volumes, terms and effective interest rates: payday loans (PDL), cash loans for individuals (Installments) and microloans for legal entities (SME). General description of each segment is given in Figure 3.

Figure 3.
Russian microfinance market segment: summary

	Segment 1. Payday loans (PDL)	Segment 2. Other cash microloans (Installments)	Segment 3. Microloans for SME (SME)
Segment volume RUB billion	7	26	20
Segment share	14%	49%	38%
Segment growth, %, 2012-2015	57%	47%	29%
Debts 30 days	55%	37%	16%
Profitability	1-4%	3-6%	5-8%
Top 5 companies share	58%	35%	21%
Top performers:	Быстроденьги, Просто Деньги, Деньги Сразу, MoneyMan.ru, Срочно Деньги	Домашние Деньги, Народная Казна, МигАгент, Viva Деньги	Финотдел, Микрофинанс

With some minor exceptions, all market players are focused on certain segments. Let's consider each segment in detail.

Payday loans (PDL)

Though this group accounts for 14% of the total microfinance market loan portfolio only, the market owes its poor image to such loans. To obtain PDL minimum documents are required, the term of a loan usually does not exceed 30 days, and effective interest rates amount to 800-900%. These loans are intended for the poorest and financially illiterate social groups, and significant share of loan defaults is offset by excessive rates and short fund turnover time.

The most prominent players of the segment are Bystrodengi (Figure 4), Prosto Dengi and Dengi Srazu.

Figure 4.
Example 1. Market leader in PDL segment

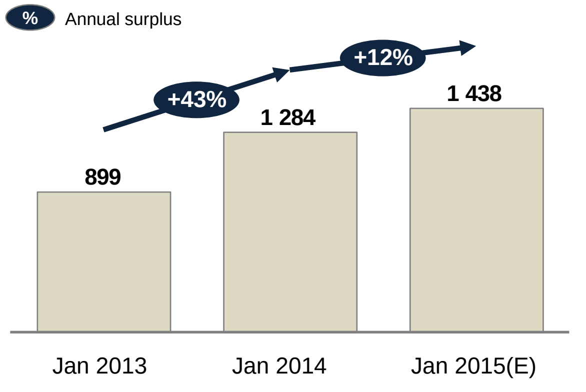
Bystrodengi

Established:	2009
Rating[1]:	A++ (highest)
Coverage:	federal (175 cities, more than 500 offices)
Share in the segment:	20%
Loans granted (1H 2014):	1,416,000
Comment:	Leader among MFIs by the number of loans

Example of a product (microloan)

Receipt of funds	in the office
Form of payment	cash
Lead time	20+ minutes
Amount, RUB	1,000-16,000
Period	7-16 days
Rate	730% per annum

Loan portfolio volume, RUB million



Share in the segment, %

Jan 2013	Jan 2014	Jan 2015(E)
28%	25%	20%

1 Expert RA, 2014

Source: bistrodengi.ru, Expert RA, MCG studies

The segment is well consolidated: five major players hold 58% of portfolio. The absolute majority of PDL segment players are small institutions carrying out their activities within one region or even location. According to experts, companies' business in PDL segment remains profitable until past-due debt level exceeds 35-45% of the portfolio. However, in practice we encountered a situation when MFI with the past-due debt level of 60% continued its lending activity.

The segment is attractive due to small amount of investments required (operating expenses for an office with 2-3 managers responsible for giving and collecting funds, and working capital in the amount of 1.5 million rubles per month for lending). Ideally, capital turnover in this segment is not more than a month. But practically at the high level of past-due debt and loan defaults this indicator is growing significantly.

In 2014 some hundreds of microfinance institutions were taken off the state register, the majority of which carried out activities in PDL segment particularly.

Other cash loans for individuals (Installments)

Loan portfolio of MFI in this segment accounts for 49% of the overall market. Standard offer: loan of 10,000-50,000 rubles for a term of 6-12 months. The loan rate is manyfold higher than the rate of similar products offered by commercial banks (MFI cash loan effective interest rate is 250-350% p.a. while bank loan rates usually do not exceed 40-50%). The main target group of the segment includes relatively reliable individuals falling out of the focus of commercial banks for some reason (e.g. with permanent registration in the region of residence of less than 5 years, or with no permanent source of income). According to analysts, the total size of the target group of this segment in Russia is up to 14 million people. The most prominent player in this segment is Home Money which is a part of Adela Financial Retail Group (Figure 5).

Figure 5.
Example 2. Market leader in Installments segment

Home Money

Established: 2007

Rating [1]**:** A++ (highest)

Coverage: federal
(420 cities, over 2,500 offices)

Share in the segment: 20%

Loans granted (1H 2014): 103,000

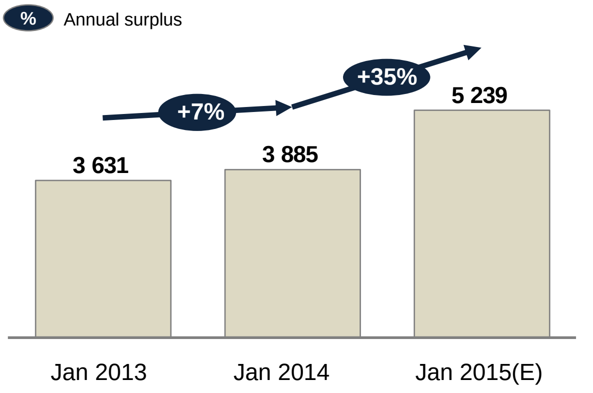
Past-due debt >28 days[2]**:** 51%

Comment: Part of Adela Financial Retail Group;
Leader among MFIs by the portfolio volume

Example of a product (microloan)

Receipt of funds	home delivery
Form of payment	cash
Lead time	within a day
Amount, RUB	10,000-50,000
Period	26-52 days
Rate	270-350% per annum

Loan portfolio volume, RUB million



Share in the segment, %

Jan 2013	Jan 2014	Jan 2015(E)
30%	22%	20%

1 Expert RA, 2014

Source: domadengi.ru, Expert RA, MCG studies, data as of the end of 2013, on the basis of IFRS statements

Founded by Evgeny Bernshtam as far back as 2007, having experience in working for Home Credit and Alfa-Bank, Home Money has successfully adapted scoring banking system to serve its customers. In 2014, the company holds about 20% of the segment's loan portfolio (expected company's portfolio volume at the year-end is 5.2 billion rubles) and has 250,000 unique customers with offices in 420 Russian cities. The share of repeat visits to Home Money is 30% of the client database. For many people the loan with the interest rate of 250-350% p.a. is the only possibility to get money. The company number two Migcredit falls far behind the leader (9% of the segment's loan portfolio, 2.5 billion rubles according to the estimates as of 01.01.2015).

Past-due debt level of the segment's players is 20-30%, thus, obviously exceeding bank institution figures. However, no requirements as to debt provisioning and relatively high loan interest rate allowed the segment's players to make profit. As the capital turnover in the segment is rather long (6 months and more), and it requires investments in the simplest scoring system in the amount of several million of rubles, the number of entrepreneurs starting such business is limited. On the other hand, a long present player of the sector with an average past-due debt level may expect net profit in the amount of up to 10% of the portfolio value.

Microloans for legal entities (SME)

Loan portfolio for legal entities accounts for the rest 38% of the market. Though, upon stabilization of the growth of individual consumer lending, bankers pay much attention to the growth of loan portfolio for legal entities particularly, demanding standards and tough requirements to entities lending and application processing time often give no chance to small companies to get "past the filter" and raise required funds.

Standard business loan provided by MFI is a loan of the amount of 50,000 - 1,000,000 rubles for a term of 6-24 months. Obtaining a loan may require collateral or guarantee. Effective interest rate is at least 50% p.a. which is twice as high as similar bank loan rates. The segment leader is Evgeny Bernshtam's Finotdel (a part of Adela Financial Retail Group) (Figure 6) with a loan portfolio as of the end of 2014 of 1.5 billion rubles which is about 7% of the segment's volume. Finotdel has representative offices in 84 Russian cities.

Figure 6.
Example 3. Market leader in SME segment

Finotdel

Established: 2009

Rating [1]**:** A (high)

Coverage: federal (84 cities)

Share in the segment: 7%

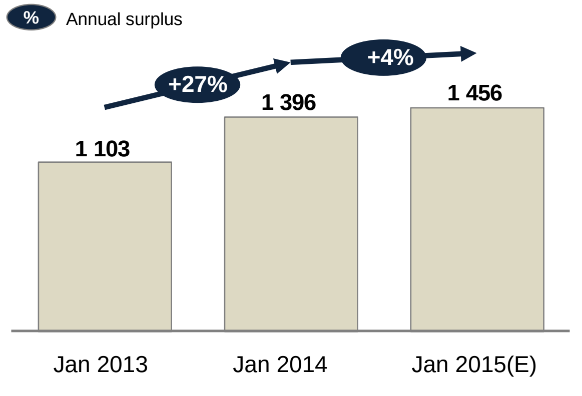
Loans granted (1H 2014): 1,366

Comment: Part of Adela Financial Retail Group

Example of a product (microloan)

Receipt of funds	in the office
Form of payment	transfer to bank card
Lead time	1+ day
Amount, RUB	50,000-1,000,000
Period	2-24 days
Rate	70-650% per annum

Loan portfolio volume, RUB million



Share in the segment, %

Jan 2013	Jan 2014	Jan 2015(E)
8%	9%	7%

1 Expert RA, 2014

Source: finotdel.ru, Expert RA, MCG studies

This market segment requires maximum investments for entering. Thus, the investments in Finotdel established in 2007 were USD 10-15 million; the company achieved breakeven point 2 years after incorporation. To succeed in the segment, not only effective scoring system and operations model, but also proficiency in dealing with collateral and guarantees are required.

In addition, a decision to enter business loan microfinance market is a decision to directly compete with the banking sector aiming, in an increasingly competitive climate, at more flexible credit scoring system and reduction of decision time. Banks with a larger range of available funds for financing and wide well-established branch network may offer their customers much more attractive lending terms.

As with cash loan segment, this segment is attractive for investors having expertise and ambitions in financial sector. Establishing a new retail bank is a cost-intensive process. Furthermore, a number of banking licenses in the market is regularly reducing, while MFI regulation is still liberalized. However, today it is hardly thinkable that a successful new sector's player has no past banking experience and a considerable amount of funds for long-term investments.

Though payday loans segment has minimum barriers to enter (relatively low investment threshold and short estimated time-to-profitability), expected net profit of such company is not high while the risks associated with loan defaults and dealing with bad debtors are too great. The players of this segment shall either rely on fast turnover time and possibility to use exceptional lever of pressure on debtors, or have to withdraw from market. This is particularly the reason why many players in the segment are small and not intending to go beyond the region or location.

On the other hand, investments in MFI in other segments of cash microloans for individuals and legal entities are more significant. But expected net profit and growth possibilities here are more predictable and attractive for investors. Knowledge of "the rules of the game" in the banking sector and access to long-term funding sources may significantly increase the chances of these investors for rapid and sustainable growth.

Comparison of "admission tickets" and average expected profit for segments are presented in Figure 7.

Figure 7.
Evaluation of market segment attractiveness

		PDL	Other cash microloans	SME microloans
Parameters	Number of loans granted per month	200	200	100
	Average loan amount	5,000	20,000	200,000
	Average rate (annual)	750%	350%	140%
	Average loan term	30 days	26 weeks	12 months
	Past-due debt	50%	40%	16%
	Provision for impairment	20%	20%	16 %
	Operating expenses, rubles/month	200,000	300,000	400,000
Indicators	**Average amount of investment required,** rubles	**1,500,000**	**10,000,000**	**25,000,000**
	Estimated net profit, % of revenues	**1-3%**	**3-6%**	**4-8%**
	Breakeven point, months	**~ 3 months**	**9-12 months**	**18-24 months**

Source: MCG analysis and estimates

So, each of the segments analyzed above may be attractive for entrance for different categories of investors.

As the next step we suggest to figure out what actions and skills may proactively increase chances for long-term success in each of the segments.

Operational process enabling operations in any of the above-mentioned MFI segments is shown in Figure 8. Here we also outlined some companies which, in our opinion, have certain competitive advantages over other players ensuring market leadership.

Figure 8.
Microfinance institution value chain

	Attraction of financial resources	Scoring, lending decision	Loan granting	Loan servicing	Debt collection	Customer base support and expansion
Main activity	Search and attraction of resources for regular lending	Simple and fast algorithm of the highest-risk borrower screening out, making decision on the size, requirement and adequacy of guarantor/collateral, and other loan terms	Customer-friendly and efficient for the company lending method	Maintaining regular records, successful cash flow planning, minimization of operations costs for a network	Efficient and low-cost service method of reminding of forthcoming payments (soft collection) and decision-making algorithm on transfer of past-due debt to collectors or penalty charging and collection using its own resources (hard collection)	Acquisition of the most attractive (faithful and financially reliable) customers
Best practice example	Home Money LLC: issue of bonds in the amount of one billion rubles at the rate of 18-19% for 3 years		MigCredit LLC: automated lending decision making on-line, transfer of funds to customer's bank card within 10 minutes	Money Man LLC: all transactions are carried out on-line, no expenditures for courier and sales offices	Revo Technologies: rigid loan repayment reminder algorithm, transfer of past-due loans to collectors (no hard collection expenses)	Home Money LLC: share of repeat borrowers is <30% of the customer database

Source: MCG analysis, public sources

Let's consider each stage of the value chain in more detail.

Attraction of financial resources

Provision of funds adequacy for regular lending is one of the high priority tasks in MFI segment.

Financing sources for any company include (1) shareholders, (2) third-party investors, (3) loans and loan facilities, (4) debentures or shares (including public company's shares).

For MFI the vast majority of funds attracted by the company are typically the funds of shareholders.

One more popular source is money of third-party investors. According to the law, MFIs may raise any funds from legal entities, as well as funds from individuals in the amount of 1,500,000 rubles and more. As of the end of 2014, MFI offered depositors to place their funds at the interest of 15-35% p.a. The rate depends significantly on the length of deposit, rating and recognition of MFI taking the deposit. The deposit insurance scheme does not cover investment deposits. Furthermore, relatively high minimum threshold for investments from individuals is a serious barrier for wide use of such source.

Loans and loan facilities from banks and other financial institutions are also commonly used as the sources of financing for well-established MFIs. This financing source is the most popular for MFIs affiliated with bankers (e.g. 19.9% of Migcredit is owned by Otrkitie Financial Corporation; 10% of Microfinance's shares are held by VTB 24).

The last source - securities - is not widespread in the Russian market yet (today the only example of the use of securities is Home Money's bonded loan of 1 billion rubles for a term of 3 years with the interest rate of 18-19% p.a. placed in 2012), and, taking into consideration the level of Russian financial markets, we do not expect this source to become significant for Russian MFIs in the next 3-5 years.

Hence, if a potential investor fails to obtain bank loans, the financing sources are limited to his own funds or attraction of third-party investors (both individuals and legal entities). To attract third-party investors, a new MFI shall require not only properly calculated interest rate ensuring attraction of adequate funds and maintaining business profitability, but also a professional business plan providing rationale for investment attractiveness, and PR and marketing process attracting the most potential depositors.

Scoring and loan approval

Though many players, in PDL segment particularly, neglect scoring system making decisions on loans based on the algorithm of assessment of the borrower’s living conditions and personal appearance (e.g. certain tatoos on hands and arms, whether he came alone or accompanied by somebody, whether his actual residence address is the same as registered in the passport), MFI are able to set up faster and more precise credit scoring system using Internet capabilities and all types of databases.

E.g. “mili.ru” project launched at the end of 2013 takes decisions on granting PDL based on social media activity of a borrower. Investments in development of know-how for statistical analysis and arranging of scoring model on the basis of social media activity are paying their way: currently, the share of past-due debt of mili.ru is 20% which is significantly lower than the threshold of 35-40% in PDL segment, should such level be exceeded, the business becomes unprofitable.

Maximizing inputs for potential borrower risk assessment not always results in anticipated effect (reduction of the past-due debt level). For successful use of available information about a potential customer, MFI shall develop fully-automated (to ensure the speed) and consistently improving process providing acceptable level of screening of defaulters.

This automated process may also generate offers for reduction/increase of effective rates and terms of loans for certain groups of potential customers.

Our consultants practiced scoring system development for banks and MFIs both based on existing systems and from scratch. Investment in establishing or implementing scoring programs may boost business profitability.

Granting and servicing of loans

Until recently direct communication of a customer and a company's manager was an essential prerequisite for loan granting. Today, with the use of customer's electronic signature system direct communication is not required. No need for office service and staff enables to reduce MFI's operating expenses significantly, while transfer of funds to customer's card or e-wallet provides MFI with an opportunity for additional verification during the scoring process.

On the other hand, no need for direct communication with a borrower eliminates the possibility to verify "the last mile" and increases fraud risk. The decision on need/no need for direct communication with a borrower shall be taken after the cost of direct communication arranging is compared with the cost of loan default risk. In this case the risk of total loan default is increased, so the calculations will be rather apparent.

All MFI's operating expenses may and shall be evaluated in terms of their reasonability and possibility to be reduced. Thus, expansion of lending channels (e.g. through partner companies networks) shall be justified by additional profit from such channels.

In addition, constantly improving technologies may have a significant effect on customer preferences and profitability of distribution channels. In their work our consultants set targets and achieved results as to reduction of a company's operating expenses by 15-20%.

Debt collection

For MFIs a streamlined past due debt collection process is the critical line separating efficiently-run companies from those who are sentenced to extinction. The process starts with soft collection phase when collectors, carefully and tactfully, remind a borrower of forthcoming date of payment, promptly register all received payments, additionally remind and urgently request for payment, provide suggestions and additional incentives to perform early payments with minor delay.

MFIs independently determine overdue time period upon the expiration of which hard collection phase begins: urgent requests for payments, involving court bailiffs and/or transition of debtors database to collection agencies.

Based upon our practice, transfer of bad loans to collection agencies upon expiration of a 30-days overdue time period was often economically feasible, as probability of repayment is low while the cost of hard collection process in any one MFI was not reasonable.

Hard collection phase for legal entities cash loans segment is not possible without proper organization of operations with collaterals which certainly materially affects the cost of business operations.

Customer base support and expansion

Though this phase is an important part of value chain for MFI, it has not become the key phase enabling to determine whether the company is successful in the segment: the demand for MFI's services is not satisfied and the majority of offers promptly find their consumers.

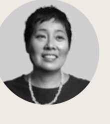
However, another part of the phase – retention and loyalty of faithful and financially reliable customers may significantly reduce portfolio default share. Timely follow-up loan proposal, attractive both for MFI and a borrower, may have a significant effect on the overall profitability of the segment's companies. Such proposals may often be generated automatically and sent out by MFI's CRM system, but the calculation of the proposal and methods of communication with potential repeat borrowers may become strong competitive advantage for a market player.

As MFI market in Russia is still going through development stage today, market players need for continual improvement and clarification of proposals, scoring systems and operational processes. In our practice we offered the companies a pilot approach to the tasks of increasing revenues and profitability: various initiatives which efficiency is measured with a limited sample of customers and offices within a number of weeks. As soon as initiative efficiency is measured, the management made decision on further upscaling of improvements to the entire company's system.

This approach enabled our clients to plan system improvements and choose for implementation only the most potentially value-added projects.

About the authors

Dmitry Plotnikov
Partner at Moscow Consulting Group. More than 15 years of experience in management consulting. Implemented strategic and operational projects with a focus on financial services, FMCG, retail & e-commerce, construction & development in Russia and CIS. Received an MBA at Hult International Business School (USA).



Galina Kan
Partner at Moscow Consulting Group. More than 20 years of experience in management consulting and private equity. Implemented strategic and operational projects with a focus on healthcare, education, financial services, public sector and government organizations. Received an MBA at Vanderbilt University (USA).

About Moscow Consulting Group

Moscow Consulting Group was established by management consultants from McKinsey & Company to provide high quality consulting services for companies of different sizes in Russia and CIS. MCG offers its clients unique flexible business model by combining in-house consultants with carefully selected independent consultants with experience in top tier global firms. MCG works with more than 500 consultants and 1000 experts across different industries. MCG focuses on strategic and operational management consulting projects. For more information about Moscow Consulting Group please visit mcgroup.ru or contact us at info@mcgroup.ru .

