Following Scale with Profits: Explaining Fino's Unlikely Success

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It's tough being a business correspondent (BC) to banks in India. In a survey of India's leading BCs by Microsave, a financial inclusion consultancy, about 70% of BCs reported that they currently either do not meet costs or operate at a loss (Kapoor and Shivshankar 2012). The BC model involves banks appointing intermediaries, ranging from NGOs and microfinance institutions to specialized financial services firms, to offer a range of services on their behalf through a network of physical outlets spread across India to reach its unbanked population. BCs make a commission based on the number of new accounts they open for their client banks and the transactions they facilitate for these account holders.

The impetus behind this model is the RBI's financial inclusion agenda which makes it a prerogative for banks to show progress on several inclusion metrics ranging from opening a number of no-frills accounts to increasing the number of bank branches established in rural areas. However, the Microsave study shows that most BCs do not see this model working. Although there are many reasons for this, the most important, acknowledged by every BC in the study, is that the model is expensive to roll out and offers low margins. Furthermore, in order to scale this model to achieve higher volumes, BCs need to finance their considerable working capital requirements. This, despite having to work closely with some of the biggest banks in the country, has been difficult. Finally, Microsave points out that it is only once customers start using two or more products that the BC model becomes viable. Few BCs in India have achieved this, still earning most of their revenues through commissions from banks for opening accounts.

Despite this challenging environment, Mumbai-based FINO (Financial Inclusion Network and Operations) Paytech Ltd has found success where few others have. Founded in 2006, FINO is India's largest BC with a network of over 33,000 customer service points, or 'bandhus', and a customer base of over 60 million people. Its relentless focus on achieving scale has begun to pay off. After growing close to 300% per year between 2008 and 2010, FINO's gross revenues grew 85% in 2011 and 34% in 2012 (see Figure 1 & Figure 2). Though growth has slowed, profitability has improved significantly. FINO recorded its first profitable year in 2011 with a profit margin of 0.8% and improved on this performance in 2012 when its profit margin rose to 4.8% (see Figure 2Figure 1).

FINO's early investment in achieving economies of scale has begun to pay off. As the number of transactions facilitated by its network increases, its fixed costs per transaction drop and its profitability rises. With over 65% of India's population still unbanked, FINO faces vast potential to grow even further. However, a number of challenges remain, ranging from the entry of new players into the sector to managing growing short-term liquidity requirements and the need to diversify its product offerings.

Figure 1

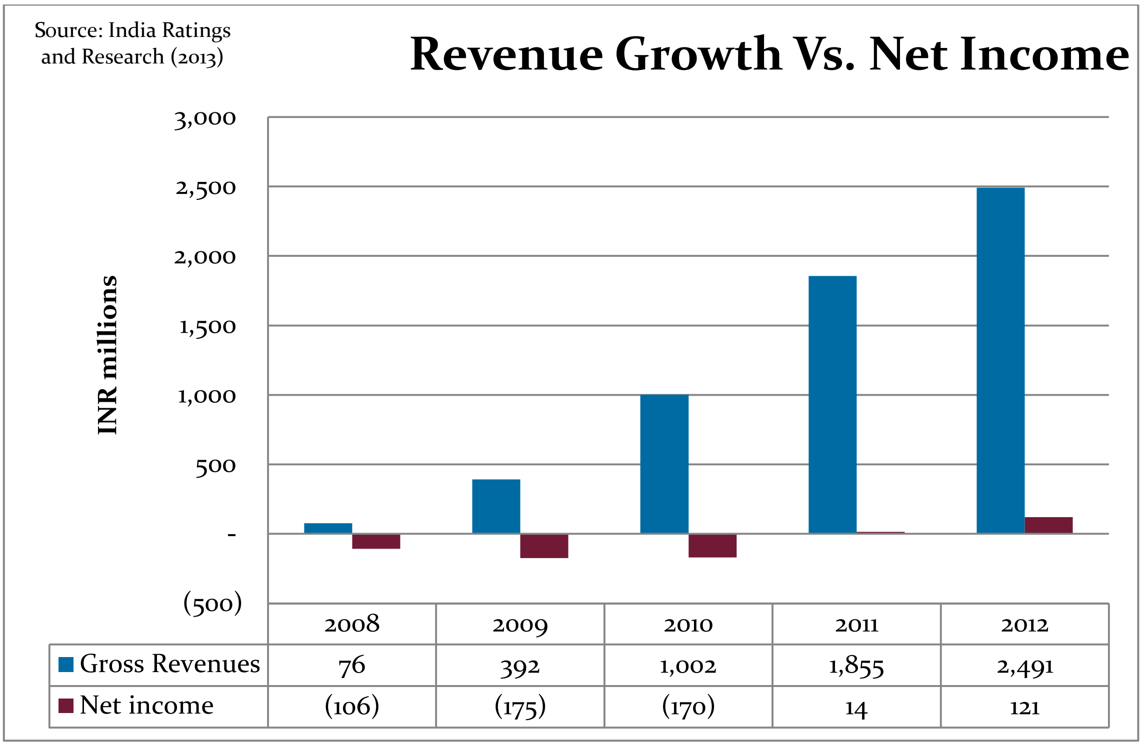
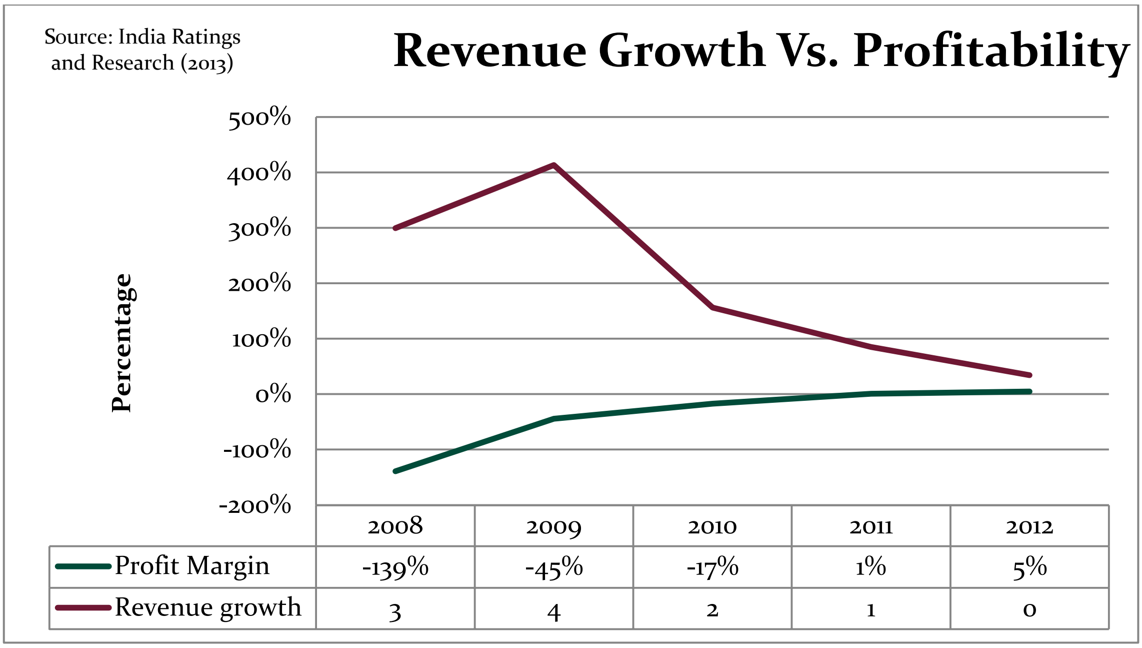


Figure 2



Pioneering the BC Model in India

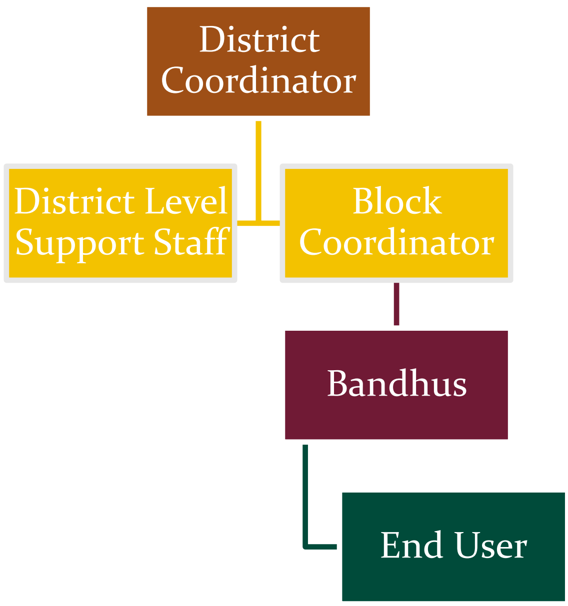
Born in 2006, FINO envisioned itself as a technology provider to banks and MFIs looking to extend the reach of financial services. Incubated by ICICI Bank, India's largest private sector bank, it was founded by a trio of former ICICI employees. Manish Khera, CEO and Managing Director of FINO, worked with ICICI for 13 years before he co-founded FINO. He has degrees from the Faculty of Management Studies in New Delhi, India, and the University of Cambridge in the UK and was recognized as a Young Global Leader by the World Economic Forum in 2011. Rishi Gupta, COO and Executive Director of FINO, graduated from the University of Delhi and worked for PricewaterhouseCoopers as a chartered accountant before joining ICICI. Rajeev Arora, CTO of FINO, worked in ICICI's Corporate Banking arm specializing in infrastructure projects and e-governance initiatives. He is a graduate of the Indian Institute of Management in Calcutta.

FINO's founders were a part of RBI's consultation group on access to financial services, which led to the establishment of the BC model as the preferred vehicle for financial inclusion in India. In 2006, the RBI issued a directive enabling banks to partner with intermediaries to extend the reach of their financial services. FINO soon decided that leveraging its technical prowess would enable it to act as an interface between banks and account holders at lower costs than other players in the BC segment. Prominent investors in FINO include a consortium of Indian public sector banks (22%), ICICI bank (19%), the International Finance Corporation (9.5%), the Blackstone Group (26%), and a number of Indian and foreign institutional and individual investors.

The backbone of FINO's model is a smartcard it issues to all its end users containing fingerprint information, demographic data, and details of a customer's financial relationship with up to eight banks. The customer brings the card, which also stores transaction history, to a bandhu (customer service point) equipped with a Bluetooth-enabled Point-of-Service (PoS) terminal with printing capabilities and a mobile phone. Any transaction is authenticated twice, validating the card against the database of hot listed cards stored in the PoS terminal's memory and the end user's fingerprint against the biometric information stored in the card. An additional layer of security is provided by requiring the bandhu to activate the PoS terminal at the start of each day using his/her personalized smartcard. The PoS terminal can print receipts of each transaction in the local language and securely stores the details of each transaction in its internal memory. This precludes the need for the PoS terminal to be connected to FINO's server at all times, a necessity given the often patchy connectivity in many parts of rural India.

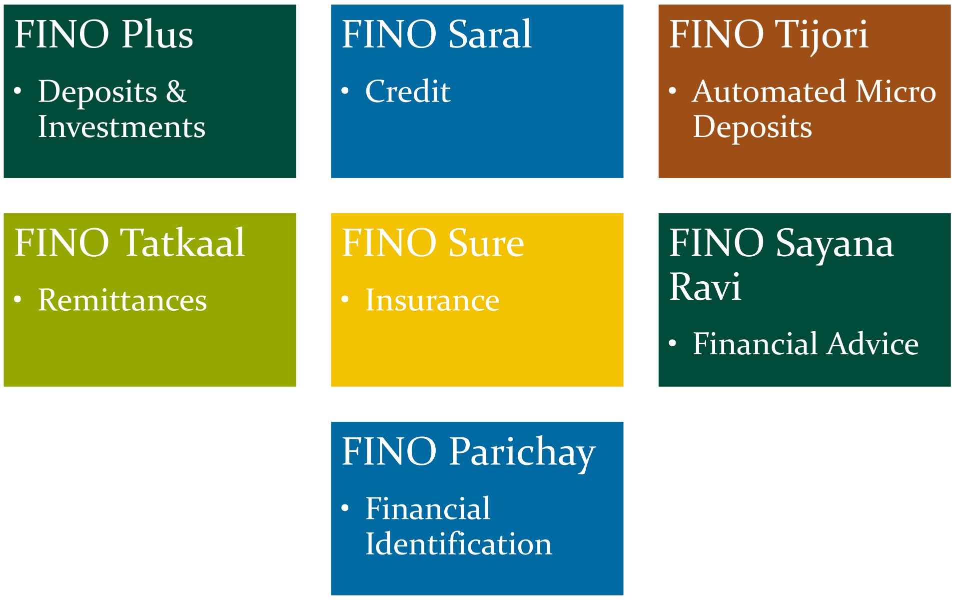
Bandhus, who are usually recruited from within a local community, report to a block coordinator who supervises cash float limits, collecting and disbursing cash as needed. The block coordinator reports to a district coordinator. Bandhus are also required to send a text message to FINO's server before leaving for work each day. This protocol, in addition to the real-time transaction data, gives FINO's managers a rich set of data to monitor daily activity levels.

Figure 3: The FINO Model



FINO's card-based platform is capable of servicing a number of different needs ranging from accessing a basic no-frills savings account to processing social security transfers such as pensions to making payments for utilities and basic insurance products. Figure 4 lists some of FINO's most prominent offerings.

Figure 4: FINO Products on Offer



A Changing Regulatory Environment

It has been seven years since the RBI first allowed banks to appoint third-party intermediaries or business correspondents (BCs) to offer services on their behalf. Since then, the RBI has instituted a number of 'enabling' reforms, including the decision to allow for-profit entities to undertake BC activity in 2010. Though the target to provide 74,200 villages across India with bank or BC services by March 2012 has been achieved, the RBI reports that over 75% of the no-frills accounts that have been opened remain dormant (Chopra, Sharma, and Sadana 2012). Part of the reason for this is that banks simply do not offer the kinds of products that rural and unbanked customers want to use, irrespective of how capable BCs may be of delivering them. The remuneration structure for BCs is also fixed by the RBI, providing little incentive to improve quality of service.

In response to criticisms of the way the BC model functions in India, regulators at the RBI and the Ministry of Finance have prepared a new set of guidelines. The revised framework divides the country into 20 clusters with one BC responsible for service delivery in each cluster for all public sector banks. This framework also fixes prices for the various services that the BC offers from account opening to sourcing loans and recoveries. Other changes to the regulatory framework include guaranteeing BCs a certain minimum compensation from the banks to reduce risk, a mandate to ensure 98% uptime of field and back-end services to ensure better quality, required support for inter-bank operability and multi-channel support, and establishment of customer grievance redress mechanisms.

Chopra, Sharma and Sadana (2012) argue that while the renewed focus on improving service quality for customers is indeed welcome, the revised policy framework is far from enabling real competition in the BC space. The cluster based approach ensures a monopoly for a given BC in up to 6 clusters for a period of 5-7 years. Fixing prices also restricts innovation in improving service and product diversification. Consumer protection and grievance redress have received inadequate attention, perhaps the most important task of consumer finance regulation, with few quantifiable metrics established to measure BCs and banks accountability.

Assessing the FINO Model: A SWOT Analysis

A SWOT analysis of FINO's business model reveals that its improving financial performance is not an aberration and its short to medium term outlook looks promising.

Strengths

- FINO continues to build its formidable network and will remain India's leading BC in terms of scale and client outreach. As the number of its end-users continues to grow, this investment in scale will continue to pay rich dividends.
- Alternative models of financial inclusion in India, such as a mobile money platform like M-Pesa, face the considerable challenge of designing a simple, easy-to-follow user experience that works on low-cost cellphones while still adhering to the RBI's Know Your Customer regulations. FINO's bandhus, on the other hand, are often members of the local community who are trained to assist unbanked customers with the unique challenges they face in accessing financial products.
- Compared to other BCs in India, FINO has the most diversified range of products to offer ranging from simple savings accounts to remittances, credit, and insurance. Additionally, FINO continues to leverage its technical expertise to offer a number of consulting services to banks to improve and lower the cost of delivering various products to underbanked areas.
- FINO has won contracts to exclusively serve public sector banks in 6 clusters. This secures FINO's income stream in these areas and protects it from the threat of new entry (India Ratings & Research 2012).

Weaknesses

- A credit report by India Ratings & Research, a subsidiary of Fitch Ratings, reveals that FINO's working capital requirements are set to increase as its bank clients delay payments. Appendix A presents consolidated financial statements for FINO.
- As FINO seeks to increase the number of products it sells to individual customers, it will face pressure from its dealer network to improve commissions. A CGAP study (Rotman 2010) notes that the average monthly profit for a FINO agent or bandhu is just about $23, far below what agents earn in Kenya ($130) or Brazil ($135). Given that Indian BCs already face agent churn of 35-40 percent periodically, increasing compensation will be key. This will undoubtedly put pressure on FINO's still precarious bottom-line (Kapoor and Shivshankar 2010).
- Microsave estimates that BCs have invested RS 120 million in float as of April 2012. This increases the working capital requirement for BCs. FINO faces the challenge of improving the value proposition for its end-users in such a way as to minimize the need to cash out.

Opportunities

- Business opportunities for FINO are set to expand as the RBI prepares to issue new bank licenses, increasing the number of players in the market. Financial inclusion has been identified as a clear goal in this exercise, and new banks will be expected to expand access to financial services in underbanked areas. Given FINO's market leading position, this is likely to mean improved business opportunities.
- Despite a general slowdown in India's GDP growth, rural incomes are surging on the back of an extremely favorable monsoon in 2013. Traditionally rural Indians save in gold and borrow from informal money lenders. This represents a significant opportunity for FINO

if they can offer investment and credit products that meet the unique preferences of rural India (Keohane 2013).

Threats

- With the RBI recently allowing telecom operators to enter the BC space—ICICI Bank, one of FINO's largest shareholders, has recently partnered with Vodafone to launch M-Pesa in India—FINO faces the prospect of competition from players whose reach and brand recognition far surpass what it has built so far. With revenues from voice services plateauing, telecom operators are looking to value added services like payments for continued revenue growth.
- One of FINO's key competitive advantages has been its proprietary biometric enabled smartcards that deliver financial services while meeting RBI's KYC requirements. This has enabled it to become the BC of choice for a number of leading banks. However, the expansion of India's national unique identification program, or Aadhaar, will reduce KYC compliance costs, and with it barriers to entry, for other BCs that can link to Aadhaar's servers to authenticate their end-users.

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Appendix

Note: Consolidated Financial Statements for FINO PayTech Ltd (Source: India Ratings & Research 2013). All figures in INR Millions.

Table 1. Summary Income Statement for FINO PayTech Ltd.

Summary income statement	2008	2009	2010	2011	2012
Gross revenues	76	392	1,002	1,855	2,491
Revenue growth	3	4	2	1	0
Operating EBITDA (before income from associates)	(129)	(155)	(18)	192	351
Operating EBITDA margin (%)	-16959%	-3967%	-184%	1035%	1409%
Operating EBITDAR	(112)	(134)	16	344	490
Operating EBITDAR margin (%)	-14692%	-3413%	155%	1854%	1965%
Operating EBIT	(151)	(210)	(153)	61	119
Operating EBIT margin (%)	-19777%	-5374%	-1523%	327%	477%
Gross interest expense	0	10	50	61	76
Pretax income	(104)	(172)	(170)	14	121
Net income	(106)	(175)	(170)	14	121

Source: India Ratings & Research Ltd.
All figures in INR, millions unless otherwise noted.

Table 2. Summary Balance Sheet for FINO PayTech, Ltd.

Summary balance sheet	2008	2009	2010	2011	2012
Cash & equivalents	336	201	112	81	770
Total net debt with equity credit	(34)	260	1,167	1,425	1,487
Working capital	98	112	431	894	1,183
Accounts receivable	56	156	491	681	1,915
Inventory	109	194	275	264	316
Accounts payable	67	238	335	50	1,048
Total debt with equity credit	303	460	1,280	1,506	2,257
Short-term debt	63	74	104	216	87
Long-term senior secured debt	0	146	236	363	493
Long-term senior unsecured debt	0	0	0	0	0
Long-term subordinated debt	240	240	940	927	2,427
Other debt	0	0	1	2	4
Equity credit	0	0	0	0	750
Total adjusted debt with equity credit	424	612	1,517	2,569	3,227
Total adjusted net debt with equity credit	87	411	1,405	2,489	2,457

Source: India Ratings & Research Ltd.
All figures in INR, millions unless otherwise noted.

Table 3. Summary Cash Flow Statement for FINO PayTech, Ltd.

Summary cash flow statement	2008	2009	2010	2011	2012
Operating EBITDA	(129)	(155)	(18)	192	351
Cash interest	39	10	(44)	(59)	(26)
Cash tax	(2)	(3)	0	0	(0)
Non-controlling interest					
Other items before FFO	39	20	6	2	50
Funds flow from operations	(93)	(148)	(63)	133	325
FFO margin (%)	-12123%	-3783%	-625%	717%	1304%
Change in working capital	(121)	27	(164)	90	(32)
Cash flow from operations	(214)	(121)	(226)	223	293
Total non-operating/non-recurring cash flow	0	0	(331)	129	204
Capital expenditure	(150)	(204)	(99)	(238)	(463)
Common dividends					
Free cash flow	(364)	(325)	(655)	114	35
Free cash flow margin (%)	-47693%	-8301%	-6541%	614%	141%
Net acquistions & divestitures	0	0	16	5	7
Other cash flow items	(240)	(31)	(940)	(377)	(830)
Cash flow from investing	(1)	(60)	(53)	(271)	(615)
Net debt proceeds	155	158	820	226	1,501
Net equity proceeds	675	63	687	5	(17)
Cash flow from financing	591	249	636	131	1,276
Total change in cash	226	(136)	(72)	(27)	696

Source: India Ratings & Research Ltd.
All figures in INR, millions unless otherwise noted.

