The Compartamos microfinance IPO: Mission conflicts in hybrid institutions with diverse shareholding

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Arvind ASHTA

Holder of the Microfinance Chair of the Burgundy School of Business

Groupe ESC Dijon-Bourgogne, CEREN, CERMi

29 rue Sambin, BP 50608, 21006 DIJON Cedex (Fr)

Tél. +33 (0) 380 725 966

Arvind.ashta@escdijon.eu

Marek HUDON

Université Libre de Bruxelles (ULB), CEB, CERMi

50, avenue Roosevelt, CP 133/02, 1050 Brussels (B)

Tel: +32 (0) 2 650 42 47

mhudon@ulb.ac.be

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1. Introduction

Why would a successful private equity backed model be criticised so much? Private equity makes money by investing in a number of risky firms, some of which would make losses and others would make very high returns. What separates the latter from the former firms may be a number of governance and situational factors, but the very successful models such as E-bay or Google are hailed by one and all. Yet a very successful model in the microfinance industry, giving financial returns of over 200 times the initial investment, received brickbats instead of kudos. This is despite the fact that social performance indicators also showed that total outreach increased and depth of outreach (reaching poorer people) was maintained. Our research analyses these criticisms in terms of mission and governance.

Microfinance is today a well-known instrument in development policies. With between $800 million and $1 billion of subsidies per year (2004) and more than $8 billion of assets under management at the end of 2009 mainly through socially-driven investment funds (CGAP, 2008), donors and social investors contribute to the boom of the microfinance sector. Nevertheless, even if MFIs have reached over 200 million clients, most of them previously excluded from the traditional financial sector (Maes and Reed, 2012), most of the population remains financially excluded in many countries. Donors' money will probably not be sufficient to finance the growth of MFIs. These institutions therefore face some strategic decisions when they decide their financing structure and look for new solutions such as collecting more deposits or tapping the financial markets through private equity funds who later exit through IPOs.

The Mexican MFI *Banco Compartamos* is one of the most famous and controversial microfinance leaders. At the end of 2005, Compartamos was charging high interest rates of 86% p.a., net of taxes on its loans to the poor[1] (Rosenberg, 2007). This strategy led to high profitability and a booming book value of the shares that reached 21 times the paid-in-capital by December 2006. The Return on Equity was higher than 50% p.a., much more than the Mexican banking sector and that of most MFIs in the rest of the world, causing the growth rate in outreach to double from 24% per year in the 1996-2000 period to 46% in the 2000-2006 period.

In April 2007, *Compartamos* issued shares in a secondary offering IPO. 30% of existing shares were sold at 12 times their book value to new investors, providing existing shareholders a net profit of about 460 million dollars. The selling investors included NGOs such as Compartamos AC and ACCION, as well as IFC, the private lending arm of the World Bank group. Private individuals, who held a minority of shares, captured over $150 million from the sale. The backlash to the issue was a lot of accusations that poor people paying very high interest rates were sacrificed for rich investors. For instance, immediately after the IPO, Lewis (2008), wondered if the IPO is "a warning that microfinance is going awry". On the other hand, the Compartamos IPO has served to bring a massive private sector infusion of investment to alleviate poverty (Rhyne and Guimon, 2007).

This paper will discuss some governance questions related to *Compartamos* financing strategy. It will zoom in upon conflicts between different types of shareholders with diverging missions, which make the resolution of stakeholder problems more difficult. Hence, it raises questions on the role and the missions of non-profit or socially-oriented associations and enterprises. In this paper, we will focus on the history of Compartamos before and just after the 2007 IPO. The IPO launched a controversy that affected the whole microfinance sector and forced the managers to decrease interest rates afterwards. Even if Compartamos IPO launched a debate in the sector (Ashta and Bush, 2009; Cull et al., 2009; Gunjan et al., 2010; Pache and Santos, 2010), the mission and private equity aspects have not been directly studied in the academic literature.

The paper is structured as follows. Section 2 will present a theoretical framework on governance and financing issues in microfinance. Section 3 briefly presents the facts of the Compartamos case up to the IPO in April 2007. Section 4 will present the core analysis of the case and suggest some ethical issues raised in the governance of microfinance institutions in particular and NGOs or hybrid institutions in general when shareholders have diverging motives between themselves. Finally, Section 5 will draw some conclusions.

2. Governance and financing of double-bottom line microfinance institutions

This section will present a theoretical framework on the governance of MFIs and how they relate to strategic changes such as IPOs. We present an overview of the governance literature, followed by a brief but specific literature review of private equity and, finally, the issues which have been raised in this context in a double bottom line sector such as microfinance.

Governance has different definitions, but in the microfinance context, it generally includes issues such as mission, boards, donors, regulation, apex associations, competition, mismatch in liability/assets and the influence of local communities and regulators (Labie, 2001; Labie, 2003;

Hartarska, 2005; Mersland, 2008). In this research, we are focusing on mission and private equity governance.

Traditional private equity firms find mispriced firms to buy cheap, add value and sell out. Within the private equity literature, there is a distinction between the role of business angels, venture capital, mezzanine capital, buyouts and distressed firms (Metrick, 2007 pp 3-9) and we are focusing on the venture capital model which is relatively early stage (usually after business angels, though). Venture capitalists invariably target high growth industries (Zider, 1998) and select appropriate firms in niches where they specialise either in terms of industry or in terms of technology (process or products) (Colombo and Grilli, 2009; Wong et al., 2009). In addition, they usually align managers' incentives through appropriate contracts (Fluck, 2010) and make quick decisions since they are privately owned (Barber and Goold, 2007). They leverage debt, focus on cash flows and not on earnings, they reduce costs, they focus on core businesses where the target can outperform its rivals. In recent years, the guidance role of nurturing the small business to scale is being stressed (Ghalbouni and Rouziès, 2010). Finally, and most relevant to our study, they have a good exit strategy (Kiechel III, 2007) such as Private Placements, Mergers and Acquisitions or IPOs so that the financial returns can materialise.

The impact of governance on the success or failures of IPOs has been analysed in the management literature. IPOs have some well-known drawbacks related to legal and managerial issues (Pastor et al., 2009; Chemmanur et al., 2010). Hartzell et al. (2008) find that firms with stronger governance structures have higher initial IPO valuations and better long-term operating performance than their peers. Nelson (2003) studies the investor reaction to founder-led firms at IPO and found that the stock market reaction is higher to founder-led firms.

Within this private equity offering, most venture capital, including state sponsored venture capital, focus exclusively on economic returns such as profits and employment, but some focus on social returns either for correctional purposes or for additional impact (Rubin, 2009). Davies et al. (2009) analyse the first fair trade company to have an initial public offering (IPO). Cafédirect. Doherty and Tranchell (2007) argue that mainstreaming with financial markets can actually strengthen the transformative message of fair trade.

To understand the impact of strategic decisions when MFIs decide their financing structure, it is important to understand the underlying governance of these institutions and their mission. Microfinance institutions (MFIs) are examples of hybrid institutions that have multiple goals (e.g. social or developmental and financial bottom lines) or institutional logics (Battilana and Dorado, 2010). Governance of double-bottom line institutions, such as the MFIs, has been studied for a long time. Part of this literature analyses the differences between the organisation forms of institutions. Microfinance experts have historically considered that non-profit institutions would be more socially-oriented while for-profit institutions would be more financially oriented (Rock et al., 1998). Hansmann (1996) argues that the intrinsic differences between SHFs, COOPs, and NGOs lie in the control of the organization and those who receive the profit from it.

Most MFIs have started their activity as NGOs and, even if we don't have figures on all MFIs, the majority of MFIs are probably still NGOs. Nevertheless, some of these NGOs have then transformed into shareholders firm (SHF) or have even started as SHF (Mersland and Strøm, 2008). Mersland (2009) explains that for-profit and SHF would be favored because of their lower costs, governance designs, and openness to new investors, while non-profit organisations would exhibit insufficient know-how and efficiency.

A vast number of MFIs still seem to rely on subsidies (Hudon and Traça, 2011). At the same time, a few for-profit SHFs have however become very profitable over time (Cull et al., 2009) and many of them even during the crisis of 2009 (Constantinou and Ashta, 2011). This profitability has refuelled the debate on mission drift of MFIs (Armendariz and Szafarz, 2011). Mersland (2008) points out that this question keeps repeating itself in history by examining the history of savings banks in the 19^{th} century. Savings banks sought out wealthier clients but this did not detract them from serving the poor.

Private equity backed Microfinance firms are many, but very few have shown such exemplary growth and exited through an IPO. Our case study of Compartamos will thus also help us to analyse in depth a concrete example of how interest rates are part of the governance and strategic debates of MFIs.

3. Compartamos case study (2000 to April 2007)

We will present the Compartamos case as a model execution of private equity governance while simultaneously examining mission alignment in this hybrid institution.

An exemplary case study in private equity

Compartamos AC was an NGO established in 1990 as a not-for-profit institution to provide microcredit to poor people. During the period 1990-2000, this NGO received donor funds of $6.3 million. Donors included the CGAP[2], a consortium of public and private donors hosted by the World Bank as well as other international donors, as well as the NGO ACCION International, which was financed by the American development agency USAID. Thus, donor agencies were the principals and Compartamos AC was the agent whose mission was to aid the poor by offering them credit.

In order to maximize outreach, a decision was made to use a for-profit, private equity approach. Accordingly, in consonance with the literature reviewed, in 2000, a for-profit finance company named *Financiera Compartamos* was formed with a paid-in capital of $6 million. The goal was to make the management more professional and aggressive to reach its targeted outreach to ensure financial sustainability thorough economies of scale. The shareholders of *Financiera Compartamos* included the NGO, Compartamos AC, as well as the equity investment fund Profund, ACCION International and IFC, the private lending arm of the World Bank group. Compartamos chose private equity partners specialised in the development sector to get the best coaching and advice. These agencies were themselves interested in this sector because it was a booming sector, growing at a rate of 30% per year in Mexico, which was a large potential market.

However, in 2000, very little data was available on microfinance and with few MFIs structured as private equity firms. Thus, the investment in Compartamos represented a risk and the private equity funds reduced this risk through syndication. Together, these three agencies with development missions had 68% of the shares in the for-profit *Financiera Compartamos*. These agencies are themselves agents for donors or for tax-payers (Mersland, 2008). The alignment of manager's incentives with the development private equity organization was implicit because the rest of the shares were predominantly with directors and managers with some outside private holding.

Insert Figure 1 about here

Thus, we can resume that public funds given to agencies were given to an NGO, who in turn invested it in a for-profit agent. As such, the finance company was a for-profit agent of a line of not-for-profit principals, as summarised in Figure 1. Although this itself raises some governance issues, it must be reminded that many public agencies sub-contract a good part of their mission to private companies. Here, the mission of the development agencies was to raise the standard of the poor.

The mission of the Mexican NGO was to raise the standard of the poor by aiding them to get credit. The mission of the for-profit was to give credit to the poor in a financially sustainable manner. The idea was to attain independence from the vagaries of donor financing.

The high interest rates led to high profitability which ultimately financed outreach growth. At end-2006, the book value of the initial paid-up shares of \$ 6 million had reached \$ 126 million, an increase of 21 times! Outreach extended to over 600,000 clients. The average loan size in 2006 was about \$ 450, about 6% of Mexican per capita income, suggesting that Compartamos aims at poorer people than do many Microcredit and consumer finance institutions[3].

In 2006, the company obtained a banking licence and transformed itself into *Banco Compartamos*, in order to be able to raise deposits. In 2007, an IPO was made by *Banco Compartamos* in which existing investors sold 30% of existing stock. No new stock was issued. They received \$ 470 million (12 times the book value and a multiple of 261 times their paid-in capital!). This puts them in the top 1.7% of venture capital investments earning returns of more than 100 times the paid in capital (Metrick, 2007 p 127). The IPO was 13 times oversubscribed and considered a huge success by any financial market standard. Pent-up demand caused the share price to surge 32% in the first day of trading.

Mainstream international fund managers and other truly commercial investors - not socially responsible investors - bought most of the shares. Roughly 6,000 new shareholders, including about 160 institutional investors, in Banco Compartamos own 30% of the stock. The rest was retained by existing shareholders. Who got the money? Two thirds of proceeds went to the three NGOs and development agencies. One third of the proceeds, around \$ 150 million, went to private individuals.

Raising questions of mission alignement

To resume the discussion in terms of mission alignment, during the donor stage (pre 2000), donor mission and NGO mission seem to be aligned in terms of outreach and depth of outreach. During the venture capital backed growth stage (2000 to 2006), the hybrid institution had a double bottom line mission. In terms of financial mission, Compartamos made extremely high profits. In terms of social mission, total outreach grew nine fold and in depth of outreach, Compartamos continued to offer lower size loans aimed at poor people. Thus, on both accounts, Compartamos seems to be a perfect execution.

Yet there were a spate of criticisms and within two months, CGAP (through Rosenberg (2007)) and ACCION (Rhyne and Guimon, 2007) published papers in defence of the Banco Compartamos IPO. Compartamos AC also listed arguments in this line on its website. We discuss both sides of the debate in the next section and relate them to the double bottom line mission to show the how inappropriate indicators of social performance led to these problems.

4. **Discussion: Mission alignment in hybrid institutions**

As we can see, this is a complicated case involving complex governance issues of hybrid institutions. The principal agency problems were highlighted in Figure 1. There are a number of principal agency relationships, including sub-agents. However, this fact alone does not raise ethical questions, except that, at each stage, the questions posed can be different. Before addressing these issues, we will first question the mission of some non-profit or socially-oriented institutions offering financial services.

Issues related to missions of firms in a double bottom-line industry

A broad question of missions for all hybrids is whether the objective of a hybrid to make profits while serving the poor? Thus, we are talking about the mission conflict of social enterprises.

A **first** problem related to mission conflict is: whether NGOs should create for-profit entities. NGOs use contractual relationships with for-profits all the time. However, this is an arms-length relation. In this case, the NGO had created a controllable for-profit organization. Thus, the ethical issues are not the same because the principal-agency relationship is different. It may be noticed that this is exactly the inverse problem to the one being debated in Corporate Social Responsibility where Friedman (1970) feels that the managers are misappropriating funds by distributing them as donations: if shareholders wanted to give donations, they could do so from the dividends they receive. As such, the debate is wider than the narrow debate of whether NGOs can start for-profits. It encompasses all cases where an organisation with one mission is attempting to create another organization with a different mission. A related problem is at what level of profits should a double bottom line institution operate? What amount of profits should be sacrificed for social motives? For instance, based on deontological arguments on the fragility of the clients, Muhammad Yunus considers that MFIs charging higher rates than the costs of funds plus a 15% margin should be considered as imitating money-lending activity (RESULTS, 2006). Are there cases which justify grants to for-profits? Who should decide this?

Stemming from the above questions, the **second** question is whether NGOs should provide the seed capital of private enterprise. If the role of NGO's is not-for-profit, should this seed capital be only in the form of grants or interest-subsidized loans?

The **third** question is related to the profit level that is appropriate for a non-profit organisation: If the answer to the first question is in the affirmative, that is a not-for-profit can make profits, a subsidiary question leads to further debate: how much profit should a not-for-profit make before it is considered exploitative of the poor. According to Yunus and Weber (2007), a social enterprise is not entitled to any profit. However, many social investors say that an interest rate covering inflation and perhaps a minimal amount of administrative costs would be reasonable. They argue that this makes borrowing MFIs more responsible rather than giving them free gifts. This issue also has reverberations in the Grameen Danone social business (Yunus and Weber, 2007): Muhammad Yunus wants to create social businesses in which the investors get a zero return. However, Danone wants to be careful to get at least a 1 to 3% return, to show that it is balancing economic and social goals at the same time.[4] Finally, some socially responsible investors feel that near market rates are quite acceptable but the notion of market rates can be controversial. If other operators are charging 150%, and Compartamos charges 100% in a similar context, would these market interest rates be ethical?

Related to this is the use of microcredit banner by Compartamos[5]. Essentially, if Banco Compartamos had never used the microcredit label and had taken the same growth rate, it may not have been criticised as vociferously. However, at a time when the public image of microcredit as an instrument to alleviate poverty was crowned by the giving of a Nobel prize to Grameen Bank and its founder, M. Yunus, it was greeted by criticism as being unethical (Lewis, 2008). Thus, the context also shapes ethics. A related contextual question would be whether the attention given to this bank would have been the same had it not made profits, but losses. There are a number of ventures supported by IFC and ACCION, but they are not the issue of serious ethical discussion.

Fourth, the Compartamos case raises the question of the end or exit strategy of public donors investing in socially-responsible or social enterprises. While it is increasingly argued that governments should not take private initiatives because of high entrenchment costs, the question comes: can successful social enterprises ever be terminated? If social enterprises go awry, what controls is there that their managers or founders would be placed under legislative or self-imposed restrictions? A possible solution could be to recognize that not-for-profit or social enterprises can make surpluses but they are required not to distribute these surpluses. Nevertheless, the question of consistent non-distributed surpluses raises the question of who (which stakeholder) these surpluses belong to? The entry of hedge funds with the IPO in the shareholding structure is likely to acerbate the tensions between the stakeholders.

Entry of hedge funds and very commercial players into non-profit or socially-oriented MFIs: Which board do you want?

A second group of mission problems stems from the different kinds of shareholders present in this particular case. This relates to the motivation of minority for-profit shareholders, founder shareholders, majority NGO shareholders and employee shareholders. For-profit shareholders may not necessarily have a double bottom line of social and financial goals. More specifically, the Compartamos case raises two questions on the shareholding structure. First, how to manage co-existence of more socially-minded shareholders (an NGO or a donor) and profit-minded ones? Second, should donors or NGOs (funded by public money or general audience) sell their share to commercial players (rather than Socially Responsible Investors, for instance) and thus indirectly use some previously public money to finance future commercial goals.

In order to better analyse the board dynamics, we will thus analyse the problems or challenges caused by each of these four groups of shareholders, indicated above.

<u>First, we take the case of minority private shareholders:</u> a main challenge is created by the presence of minority private shareholders. If all the shareholders had been not-for-profits, the problem of capital gains would not have arisen because all the gains should have gone back for developmental objectives. However, if minority private shareholders gain, the question comes in whether the minority wasn't, in fact, controlling the majority to ensure that impact on poor people was sacrificed so that the majority NGOs could have peace of mind through viability. Private shareholders would also gain from the ultimate capital gains (increase in book value AND increase in market value). Thus, what is being questioned is the end result "did private shareholders gain?" Nevertheless, this

question would not have been posed if there were no NGOs involved. So, the question is: "did private shareholders unduly benefit from the distribution of public funds"?

An alternative question is why an NGO included minority shareholders to start with. The NGO itself is a piece of paper, managed by real people. What is the relationship of these directors of the NGO with the outside shareholders?

Minority rights have a semiotic correspondence to duties of majority shareholders to preserve values for minority. In this legislative and cultural context, could the NGO majority shareholders have done otherwise than to maximise profits for the minority private holders? Would it have been ethical for NGOs to sacrifice the profits of the minority private shareholders just to ensure its own mission? Thus, existing laws in other fields (minority interests in for-profit organizations) may make NGOs respect rights of minorities even when those minorities have come in knowing fully well the social objectives of the venture.

<u>Second, we look at the problems created by the presence of founder shareholders:</u> this problem concerns a specific type of shareholder who could be in majority or in minority, the founder of a company. It is often argued that at some stage, in a for-profit context, that founders need to exit to make room for more suitable managers in view of the growth stage of the firm. These founding shareholders would exit through a sale of their shares. ACCION (Rhyne and Guimon, 2007) raises the question of the compensation to founding members of an NGO as such institutions increasingly turn to becoming for-profit. This question had already been raised in the Consensus Statement of the Council of Microfinance Equity Funds who considers that, while it is legitimate that founders benefit for value created, "appropriate mechanisms for compensation are complicated by the non-profit structure of the NGO and the presence on the balance sheet of donated funds" (CMEF, 2005). This view bifurcates NGO MFI founder-shareholders in two parts: individuals and non-profits. If the NGO MFI had been started uniquely by individuals, and if a commercial enterprise offered to buy out the founders, it is obvious that the founders should have the right to sell and the right to capture the increase in value. After all, why should all the increase in value go to the commercial enterprise which is taking over?

However, when the invested money belongs to not-for-profits, do they have the right to make a profit? The question goes back, as CGAP put it, to the time when the not-for-profit entered the MFI. As such, we go back to the initial question above of whether a not-for-profit should invest in shares at all? Does the not-for-profit have the right to make money on its portfolio? Can it maintain the value of portfolios by investing in shares and, if not, can it invest in bonds? If so, does maintaining value include participating in governance of the targeted companies? How about participating in managements?

Third, the case is complicated by NGO and development oriented majority private equity type shareholders: in preceding sections, we have already talked about the difficulty of NGO shareholders using the principal-agency framework. However, what complicates these issues is that not all the NGO shareholders have the same mission. Thus the mission of the IFC is to invest in private enterprise. The mission of ACCION who received USAID funds is to develop microcredit and impact the poor. Thus within two NGOs, there is a conflict on interest where the mission of the IFC is closer to shareholder interest and the mission of ACCION and Compartamos AG (the NGO) would be more aligned with the interests of borrowers. Before the IPO, ACCION held 18.1%, IFC had 10.6% and Compartamos AG (the NGO) held 39.2%. Since no one NGO had majority control, the final decision would be based on horse-trading and political wrangling, including obtaining support of private minority shareholders who held the balance 32.2%. In such a situation, the private minority shareholders may get de facto control and could subvert the mission of each of the NGO shareholders.

Finally, another problem is the problem of incentives through employee shareholding, particularly with the managers. Employee shareholding with directors and managers is one of the favourite tools of private equity to boost performance. However, in a setting of NGO missions to aid the poor, the objective of the employees (agents) gets aligned with profits and shareholder "value", not shareholder "values", where the latter concerns the professed value of the majority NGO shareholders. Again, it is the deontological misalignment which is being questioned.

5. Conclusion

In private equity backed firms, the objective of a firm is to make profits. Our case study points out that if the firm is in a double bottom line sector, it needs to make profits but these should also be in concordance with social expectations.

One typical indicator of social performance for microfinance has been average loan size to reflect depth of outreach. Our study shows that Compartamos respected this indicator but was criticised for his social performance. Therefore, our research indicates a need for focusing on other more relevant indicators to judge the social mission of hybrid institutions in the microfinance sector.

The focus of the debate on Compartamos on high interest rates and high return on equity indicate that the social consciousness places “informal usury ceilings” on acceptable interest rates and that firms have to be sensitive to these informal ceilings even in countries where the legislator may not have enacted one.

This Compartamos case study shows how difficult it is to manage co-existence of more socially-minded shareholders (an NGO or a donor) and profit-minded ones. Moreover, the entry of new types of investors in microfinance, even more commercially-oriented, will put in question the role of private equity funds that are partially owned by public institutions like the IFC. It is also likely to acerbate the tensions between the stakeholders.

Compartamos IPO has severally affected the legitimacy of the microfinance sector according to many observers. This paper has raised future agendas for thought raised by the Banco Compartamos IPO. Exorbitant returns followed by the sale of shares might attract new investors, such as the hedge funds or other commercial investors, but this will likely be at the price of the loss of the social identity of microfinance. Other strategies of financing can be adopted such as the bonds, or the use of CSR funds expecting lower returns.

The heated debate on the Compartamos IPO has culminated in a first step taken: On April 21-23 2008, some leading microfinance personalities signed "The Pocantico Declaration" at the Microfinance Leaders Retreat. This is a step toward a self imposed voluntary code of deontology. Another step has been the launch of the Smart Campaign by ACCION. So, the experience and the ethical debate have led to new lessons and some action based on these. It is still doubtful today to say that this level of self regulation will be sufficient to address the various challenges raised in the paper.

Many of the key questions of governance go beyond microfinance to all institutions dealing with social justice. The paper also has not gone into the reverse area: should for-profit businesses invest in not-for-profits?

It raises governance and ethical questions and is a bonanza for future research to reply to these questions. We believe the raising of these questions, explicitly and clearly, is necessary for this debate and for further regulation of microcredit in particular and NGOs in general.

[1] When we include VAT, clients ended up paying around 100% p.a.

[2] The Consultative Group to Assist the Poor (CGAP) includes 11 multilateral donors like the World Bank, IFC, EBRD; 4 private donors (Ford, Dell, Gates, Omidyar) and the rest are bilateral donors (essentially from OECD governments).

[3] All facts and figures in this paragraph are taken from Rosenberg, R. (2007). CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits. Washington D.C. or Rhyne and Guimon Rhyne, E. and A. Guimon (2007). The Banco Compartamos Initial Public Offering. Accion Insight Accion..

[4] However, neither Yunus nor Danone executives have really got the point: its not the level of dividends which is important because the price of the shares will capture any growth component which will also lead to capital gains.

[5] This issue has been raised a few times by M. Yunus in this case, calling Compartamos ‘exploitative’ or active in the ‘moneylending business’.

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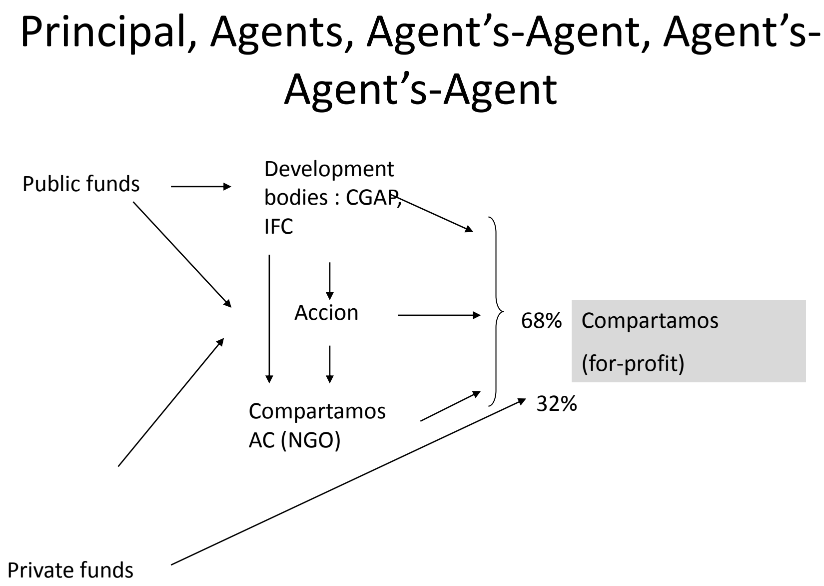

Figure 1: Principals and Agents in the Compartamos case