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Mergers and Acquisitions in Pandemic Recovery: What MFI Leadership Should Know

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The COVID-19 pandemic has emphasized the important role of financial services in helping low-income people manage uncertainty and economic shocks. Many low-income customers rely on microfinance institutions (MFIs) to provide those financial services; however, the pandemic has also sent many MFIs themselves into crisis and many continue to face serious solvency concerns. What happens when MFIs struggle to remain solvent? What can MFIs do when their continued operations are at risk and they face the possibility of no longer being able to serve their customers? If an MFI must resort to consolidation with another entity, what should leadership consider when debating options?

To help guide MFIs in answering these questions, CFI worked with the International Transactions Clinic of the New York University School of Law to examine potential merger and acquisition (M&A) scenarios for institutions contemplating consolidation. The following outlines various considerations and options for MFIs to consider if facing the need for potential consolidation. The contents are not limited to current events — they may also assist MFIs in the post-COVID-19 world.

Decision Points: Ensuring the Best Decision for the MFI and Its Clients

Consolidation refers to the legal combination of two or more businesses into a single entity. There are several strategic reasons an MFI may want to exit and pursue a consolidation, including but not limited to: unsustainable financial performance, oversaturation in a specific market, inability to further grow market share, or changes to the strategy or business model. When pursuing a potential consolidation, the MFI's existing clients always should be the first consideration — who will continue to provide financial services to the exiting MFI's customers, and will the resulting entity have their best interests in mind?

Before embarking on a path toward consolidation, MFI leadership and board directors must ensure that the right people are at the decision-making table and consider whether this is, in fact, the right path for the institution. The following should be discussed:

1. **Process Ownership:** M&A is not a routine fund raise that can be conducted under business-as-usual circumstances. The

process and activities should be owned by the board finance committee or, if warranted, an extraordinary committee.

2. **Alternatives:** Although it may seem that there are limited options in difficult times, it is incumbent on the leadership team and board to explore multiple alternatives, even if they are ultimately rejected. Sometimes objective evaluation criteria can have surprising results.

3. **Fundamentals:** Leadership and board directors should consider if the proposed options are good for the long-term interests of:

    a. **Clients:** What will be the impact, if any, on clients and how will they be informed?

    b. **MFI:** Does the option fit the MFI's strategy or is it against its core DNA? For example, is the MFI selling its core portfolio to a competitor that does not share its commitment to serve low-income clients? What options exist to embed social impact considerations in the term sheet and shareholder agreements?

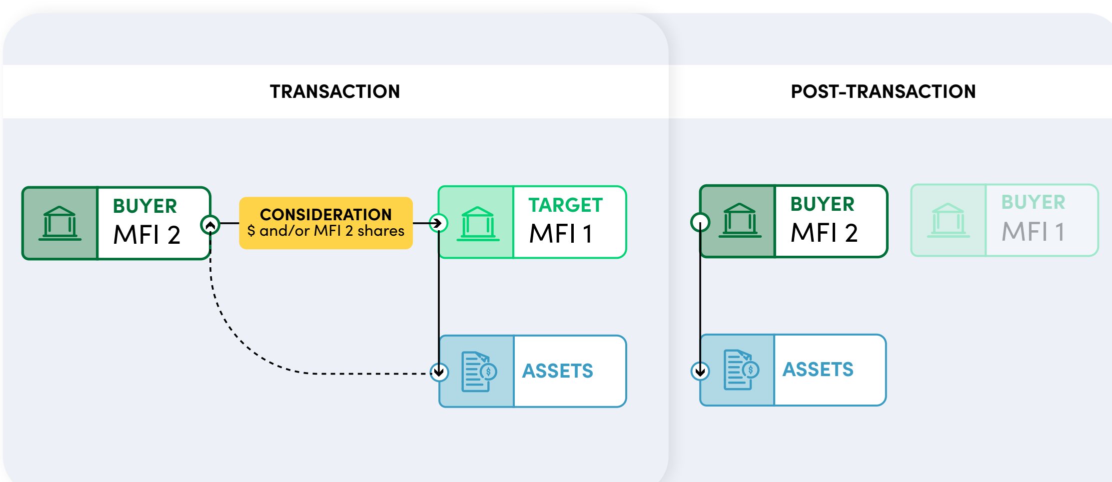
    c. **Staff:** Will the decision result in staff reductions and what are the implications? Labor laws can be quite onerous with respect to remuneration for layoffs.

    d. **Market:** What will be the impact on the market? Will consolidation result in strengthening the market or creating a potential monopolistic situation?

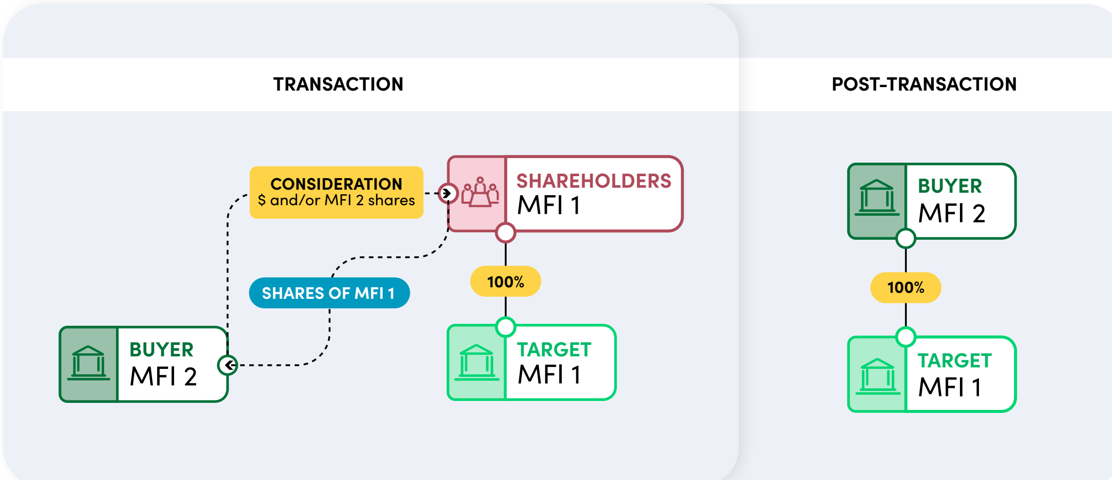
Five Consolidation Options for MFIs to Consider

There are several consolidation structures that may be available to MFIs. If contemplating a consolidation, MFI leadership should run several financial scenarios on multiple consolidation options to be able to weigh the pros and cons for each. Our research examined five structures for MFI leadership to consider when faced with a solvency crisis: asset purchase, share purchase, forward merger, triangular merger, and reverse triangular merger. The following shows the transaction process and what the entity looks like post-transaction for each.

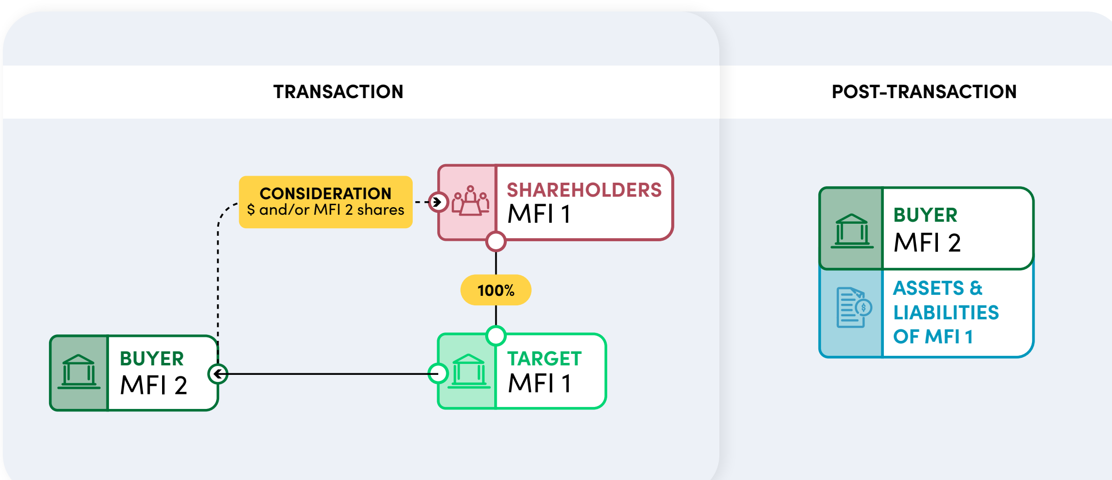
1. **Asset Purchase:**
A buyer purchases specified assets (and assumes specified liabilities) from the target MFI.



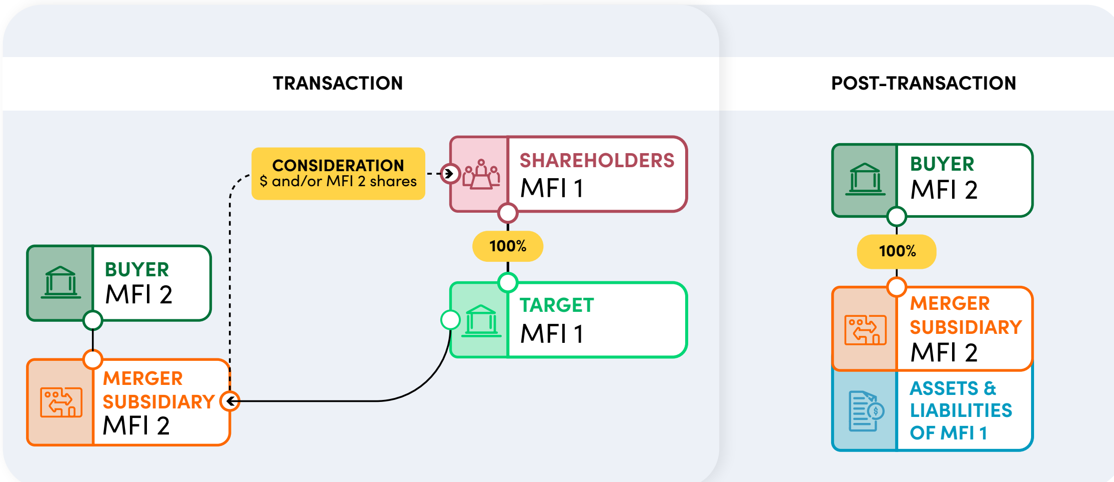
2. Share Purchase:
Buyer purchases shares of the target company from the target company shareholders.



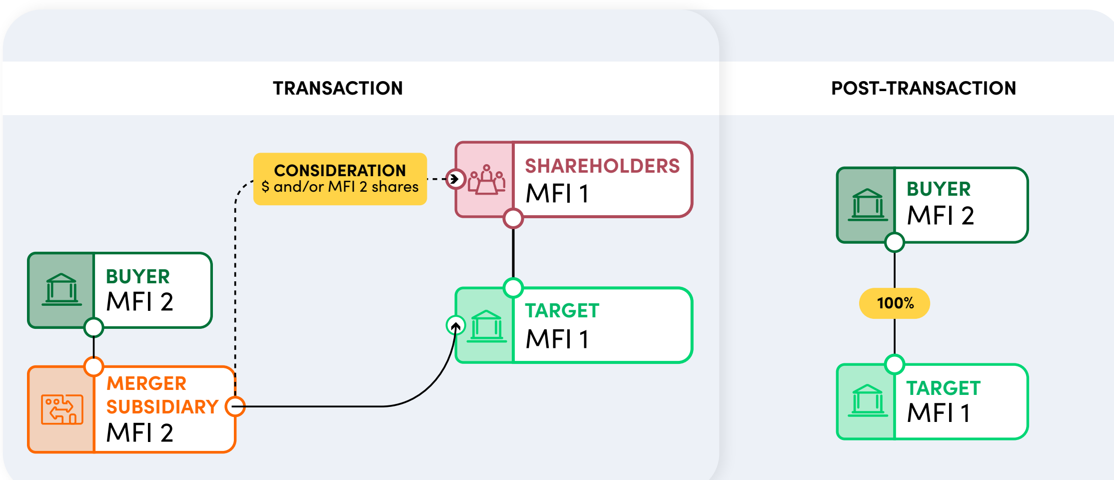
3. Forward Merger:
Target MFI merges into the buyer and ceases to exist, as the buyer becomes the surviving company and holds the assets and liabilities of both the target and the buyer.



4. Triangular Merger:
Buyer creates a subsidiary or shell company ("catalyst"). The target company merges into the shell company so that the shell survives.



5. Reverse Triangular Merger: Buyer uses a catalyst to merge into the target, so the target company remains. Target shareholders receive consideration in exchange for their shares and the buyer ultimately holds all the shares of the target.



TYPE OF DEAL STRUCTURE	PROS	CONS
Asset Purchase	↗ Buyer purchases only designated assets and assumes only designated liabilities from the target, so can avoid unwanted, unforeseen, or undisclosed assets and liabilities. ↗ Buyer may obtain a "step-up" tax basis as the price paid for the assets will be the new tax basis. ↗ Buyer may obtain tax deductions for the depreciation of the acquired assets. ↗ Process may be simpler since fewer corporate approvals may be required.	↗ Buyer may require new licenses and permits. ↗ Anti-assignment provisions may be triggered, requiring consents to be given for the buyer to assume the target's liabilities or take assignment of contracts. ↗ Target employees may need to be hired by the buyer. ↗ Assets, including intangible assets, may need to be valued. ↗ Transaction may incur greater aggregate tax liability (two levels of taxes — company level on sale of assets and shareholder level on distribution of proceeds to shareholders). ↗ Assets can be complicated to transfer to the buyer due to administrative, technical, and legal obstacles. ↗ Recording of some assets requires various types of registration (e.g., patents, motor vehicles).
Share Purchase	↗ Execution is simple since only shares change ownership, rather than assets. ↗ There is no change of employer for target employees. ↗ Transaction is only taxed once (shareholder level). ↗ Assets do not need to be valued. ↗ Anti-assignment provisions are usually not triggered.	↗ Minority shareholders could delay transaction. ↗ Target retains all its liabilities. ↗ Buyer is unable to depreciate assets of the target. ↗ Change of control provisions may be triggered in contracts. ↗ Process could result in two uncombined entities, which would require duplicative requirements (e.g., two licenses, two sets of annual corporate approvals).

TYPE OF DEAL STRUCTURE	PROS	CONS
Forward Merger	Process is uncomplicated and efficient since transfer of assets and liabilities occurs automatically by law. Lacks a minority holdout exposure as all shareholders do not need to approve the merger for it to be effectuated (subject to dissenter rights).	Likely inappropriate for a buyer and a target incorporated in different jurisdictions (and may involve varying mechanics). All of target's liabilities are transferred to the buyer. Anti-assignment clauses in third-party contracts may be triggered even though contracts transfer as a matter of law. Target employees need to be offered employment, as in an asset purchase. Recording of some assets requires various types of registration (e.g., patents, motor vehicles).
Triangular Merger	Since target ends up as a wholly owned subsidiary (instead of merging into the buyer), the buyer is protected from target's liabilities. Offers flexibility to allow for tax-free reorganization. Avoids minority shareholder holdouts (subject to dissenter rights). Catalyst can be formed in jurisdiction of target to avoid multi-jurisdictional impediment to merger.	Anti-assignment clauses in third-party contracts may be triggered even though contracts transfer as a matter of law. Has a similar effect to an asset purchase but may be more complicated to implement. Target employees need to be offered employment, as in an asset purchase.

TYPE OF DEAL STRUCTURE	PROS	CONS
Reverse Triangular Merger	↗ Accomplishes the structure and gives the advantages of a share purchase without requiring each shareholder to sell separately. ↗ Preserving the target can be beneficial in keeping good will. ↗ Avoids assignability problems raised in other types of mergers because assets and liabilities remain in the target company. ↗ Target employees avoid a change of employer. ↗ As in a triangular merger, catalyst can be formed in jurisdiction of target to avoid multi-jurisdictional impediment to merger.	↗ There may be material contracts with "change of control" provisions that are triggered by an acquisition of the target company. ↗ Transaction may be subject to dissenter rights.

Moving into year three of the pandemic, as we continue to navigate the uncertainty and the economic ramifications of the COVID-19 crisis, it behooves MFIs and supporting actors to understand merger options so as to be informed and equipped should there be a need to engage in these types of discussions. While consolidation is not an easy process, MFI leadership and boards armed with sound information and a clear understanding of the challenges of any prospective consolidation or similar strategic move will be better prepared to work towards a satisfactory resolution for the institution and, most importantly, for its clients.

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