

Microfinance: investing with an impact

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In this era of multiple bottom line goals and the emergence of the four billion people living at the base of the socioeconomic pyramid as a target market for products and services, many investors are attracted to the concept of doing well by doing good. Microfinance investment offers them the opportunity to leverage capital effectively to achieve financial and social returns. This article offers a microfinance industry overview, presents the business and social case for microfinance investing, describes sample investments, and discusses future trends for the industry.

Microfinance provides financial services to low-income individuals lacking access to the formal banking sector. The first microfinance institutions (MFIs) were non-profit organisations with a social mission to alleviate poverty by helping the poor develop vocational and business management skills, and by giving them small, uncollateralised loans for working capital. From this modest yet revolutionary beginning in South Asia and Latin America in the 1970s, microfinance now encompasses 10,000 charitable organisations and regulated financial institutions across the globe, which offer a burgeoning array of credit, savings, housing finance, remittance, and insurance products to the base of the pyramid.

As MFIs have transformed from non-profit organisations to regulated entities and have proven their investment viability, microfinance funding has transitioned from primarily philanthropic to investor sources, and the flow of capital to the sector has grown dramatically, via direct investment in MFIs and indirect investment in microfinance investment vehicles (MIVs). The latest figures indicate that total investment in the microfinance sector has expanded to around US\$30bn. However, industry experts estimate that an additional US\$270bn is needed to provide financial services to the world's 1.5 billion working poor.

Microfinance clients are predominantly engaged in income-generating activities in the informal economy in emerging countries, as a means to self-reliance in the face of high, systemic unemployment. They are street and market vendors, small-scale farmers, cottage industry participants such as weavers, and in some cases medium-enterprise business owners not eligible for loans from mainstream banks. Globally, clients number over 100 million including both borrowers and savers. Many MFIs target women borrowers since research shows that they devote a larger percentage of income to improving the family's dwelling, nutrition and health care, and to keeping children in school.

Microborrowers may access loans either through a group lending model or through individual loans. In the first instance, the joint liability of all group members to repay a defaulted loan provides 'moral collateral' in the absence of a material guarantee. This solidarity system has proven extremely successful in generating high loan repayment rates. Loans can be as small as US\$100 per borrower (higher in dollarised economies), tenors are short (six to 18 months) and loan repayment rates are 95%-98% across the industry.

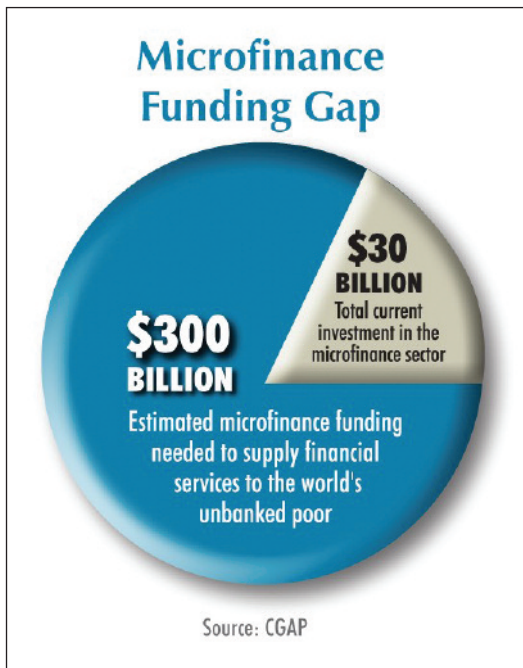
Under the individual loan model, the borrower has sole liability and provides some type of collateral. Such borrowers usually manage more stable microenterprises and may be creating jobs for others in the community, an important social benefit. However, repayment rates in this lending model are lower at 80%-90%.

Microfinance lending has high operating costs which are covered by elevated interest rates. These vary according to country and effective rates can top 100% in some markets, but the average is around 35%. While astronomical by mainstream lending standards, MFI rates are cheaper than those offered by informal moneylenders, which can reach 30% *per month*. Borrowers are able to repay MFI loans because the incremental income from a small amount of capital in their labour-intensive businesses outpaces the interest burden.

Microfinance institutions and funders

The MFI landscape is complex, encompassing a broad range of legal structures, lending methodologies and product offerings. Regulated, and therefore investable, MFIs comprise credit unions, co-operatives, other non-bank financial entities, microfinance banks, and commercial banks moving down-market.

Currently, about 250 MFIs possess strong enough balance sheets to be eligible for investment, and financing is concentrated in this top segment.



According to the most recent data from the Consultative Group to Assist the Poorest (CGAP), in 2007 10 MFIs received 60% of MIV investment (one of these is a holding company of 22 MFIs). In its January 2009 report, *Microfinance – Testing its Resilience to the Global Financial Crisis*, Fitch Ratings corroborates the concentration of microfinance activity by estimating that the 100 largest MFIs represent 80% of sector assets.

Funding for microfinance comes from local and international sources. Depositors, government agencies, charitable organisations and the private sector provide local currency funding. In Asia and Latin America, several larger MFIs have successfully issued bonds and access local bank loans. However, foreign capital has fueled microfinance's double-digit growth. These investors include socially responsible individuals in Europe and the US, the private sector branches of governments which support development in emerging nations (known as development financial institutions or DFIs), and private sector institutions such as banks, insurance companies, pension funds, endowments, foundations undertaking mission-related investment, hedge funds, and the family offices of ultra-high net worth individuals.

The unprecedented flow of private sector funds has spawned the creation of 95 MIVs, which channel approximately half of all investment from private sources into MFIs. MIVs may offer fixed income, equity or mixed investment options and run the gamut of registered mutual funds, private equity funds, microfinance bank holding companies and structured finance vehicles. Their level of commercialisation and corresponding return targets range from development

funds that seek capital preservation, quasi-commercial funds that pursue a blended social/financial objective and are willing to accept below-market financial returns, and fully commercial funds seeking risk-adjusted returns.

In 2007, DFI investment totalled US\$3bn, and MIVs' assets under management totalled US\$3.7bn (some double counting occurs given that DFIs may channel investments through MIVs as well as directly into MFIs). CGAP estimates that during 2004-2007, the compound annual growth rate (CAGR) of DFI investment was 40%, and MIVs registered an astounding 80% CAGR. Over 40 new MIVs have entered the field in the past three years.

The business and social case for microfinance investing

Commercial microfinance investment presents challenges as well as opportunities for both investors and MFIs. From the investors' perspective, the industry suffers from a dearth of information, a low level of transparency, a lack of accepted guidelines and standards, and an absence of many investor services common in more established asset classes such as uniform credit ratings, credit bureaus, debt default tracking, objective equity valuations, exit strategies, a secondary market for liquidity, and fund manager rankings. Local legal, regulatory and fiscal environments can give rise to daunting hurdles. Furthermore, the vast majority of commercial MFIs have their roots in non-profits that transformed to regulated entities, and ownership, governance and management capacity often raise concerns.

In the view of many MFI managers and social investors, commercial funding may cause mission drift. Regulated MFIs' loan portfolios reflect a higher average loan size, a smaller percentage of women borrowers and a lower ratio of rural to urban clients; this evolution in client profile indicates that given their obligations to lenders and shareholders, commercial MFIs may lose sight of serving the poorest of the poor.

On the other hand, there are compelling business and social justifications for the increasing commercialisation of microfinance. From the investor's perspective, the market demand for microfinance is significant. Penetration in eight large emerging countries is only 4.4%, and the industry overall offers a 15x growth factor. MFIs exhibit attractive business attributes: (i) a loyal client base to lower acquisition costs, (ii) high interest rates to cover hefty operational expenses, (iii) excellent loan repayment rates due to strong portfolio quality, and (iv) high solvency and liquidity resulting from short loan tenors.

In addition, microfinance offers investors broader emerging market diversification, thanks to exposure to

MICROFINANCE INVESTMENT FAST FACTS

- Total estimated microfinance loans outstanding: \$30 billion
- Total estimated microfinance customers: 100 million
- Total estimated potential customers: 1.5 billion
- Total number of microfinance institutions eligible for commercial funding: 250
- Total estimated investment (2007) by government-owned international financial institutions (IFIs): \$3.0 billion
- Estimated compound annual growth rate of IFI investment 2004-2007: 40%
- Total estimated investment (2007) by microfinance investment funds (MIVs): \$3.7 billion
- Estimated compound annual growth rate of MIV investment 2004-2007: 80%
- Number of MIVs (2008): 95
- Percent debt deals (2007): 77%
- Percent equity deals (2007): 21%
- Microfinance funding gap to meet demand: \$270 billion

Source: CGAP

countries not typically covered by emerging market instruments. Microfinance helps investors align their investments with their values in an active way, not just through passive screening.

MFI's likewise recognise the many benefits of commercial funding. Philanthropic contributions are insufficient to close the US\$270bn microfinance funding gap. The turmoil in financial markets reduced many US foundations' endowments by 30% to 40% in 2008, which will necessarily lower grant volume in the coming year.

In contrast, private sector funding allows MFIs to increase loan portfolios on a greater scale. Debt and equity instruments further diversify MFIs' funding sources and create a more stable financial structure with longer-term capital, helping them reach sustainability. This supports MFIs in fulfilling their social mission by expanding outreach to more unbanked individuals.

A fundamental argument in favour of MFI transformation from a non-profit to a for-profit business model relates to the legal constraints prohibiting non-regulated institutions from accepting

deposits. Evidence shows that savings – not loans – alleviate poverty by providing families with a safety net in the event of an illness, natural disaster, or economic crisis. Furthermore, deposits provide an inexpensive, stable source of capital for MFIs.

Significantly, the profit motive has proven fundamental in accelerating MFIs' expansion, which both increases access to financial services for the unbanked and drives down interest rates thanks to competition.

Microfinance sample investments and returns

Given MFIs' small size and relative lack of financial sophistication, except for a few local bond issues and four publicly traded MFIs, direct microfinance investments are private transactions. While DFIs, some banks and hedge funds have made direct investments, most investors entrust their funds to MIVs. These have the capacity to conduct the specialised due diligence and monitoring required for sound investing in this niche market, and fund investing confers the added benefit of diversification across many MFIs, countries and currencies.

Until 2007, lending was the predominant investment strategy, and debt represents about 75% of sector funding. However, with too much capital chasing too few deals, pricing has become unattractive for debt investors seeking market returns. Furthermore, many MFIs have reached leverage limits. Consequently, investors and MFIs have been exploring equity investment opportunities more aggressively. According to the J.P. Morgan – CGAP microfinance equity valuation study published in February 2009, 24 specialised equity funds manage a total of US\$1.5bn. Several MIVs that previously invested exclusively in debt have been allocating a percentage of their portfolios to equity.

Unfortunately, microfinance debt and equity investment have decreased as a consequence of the current financial crisis, and MIVs have adjusted their fundraising targets downward. European funds appear to be less impacted than their US counterparts by the market paralysis, possibly due to a stronger social orientation among investors.

Debt returns have performed remarkably well in 2008 *vis-à-vis* mainstream assets. For example, Geneva-based fund manager BlueOrchard S.A.'s Dexia Micro-Credit Fund posted a 5.31% return in 2008 in US dollars, with a five-year average of 5.94%. The target annual return is six-month Libor plus 100-200 bps. A Luxembourg fund and publicly traded, the Dexia Micro-Credit Fund attracts retail and institutional investors, offers monthly liquidity, manages total assets of US\$428,567,621 and has a blended-value target return.

For comparison purposes, a small, private US-based closed-end debt fund created three years ago generated a 7.2% return for investors in 2008. Based on holdings and cost structure, the fund forecasts a four-year average of slightly over 6%. The fund's higher expense base relative to assets under management constrains returns, and investors must wait for the fund to terminate to redeem their investment.

One of the key factors for stable microfinance debt performance is its relatively low default rate. In 2008 the International Association of Microfinance Investors (IAMFI) conducted the first comprehensive analysis of commercial microfinance debt default by MFIs to MIVs. MFI debt is estimated to correspond roughly to a BB to B rating using mainstream rating agency criteria. IAMFI determined the historical microfinance debt default rate to be 2%. Due to fundamental differences between microfinance and commercial approaches to measuring and tracking default rates, direct comparison of the microfinance debt default rate and the mainstream raters' cumulative default rates is methodologically flawed. However, in an admittedly apples-to-oranges comparison, microfinance's 2% debt default rate would correspond to a BBB rating grade. Microfinance debt has behaved as if it were higher rated.

A principal risk in debt funding is the currency mismatch created by euro and US dollar loans to MFIs which on-lend in local currency, with the MFIs carrying the foreign exchange risk. In the past three years, four specialised entities have launched to offer microfinance hedging strategies, which previously were difficult to structure due to the exposure to frontier currencies and the small deal size.

Blended debt/equity funds generated positive returns in 2008. Marilou van Golstein Brouwers, Managing Director of Dutch fund manager Triodos Investment Management BV, reports that the Triodos Fair Share Fund returned 7.5% in euros, with a five year average of 5.3%. Its portfolio allocation is 75% debt, 15% equity and 10% cash and equivalents, and it is open to Dutch retail investors.

The microfinance equity market is young and presents both attractive opportunities and maddening obstacles for investors. These include the low number of investable MFIs, difficulty in valuation, the lack of a secondary market or alternative exit options, and governance issues such as divergent views on organisational vision and mission among the founders and new, perhaps more market-oriented, shareholders.

Based on data obtained from the J.P. Morgan CGAP study of 144 private equity transactions, 10 publicly traded MFIs and 10 financial institutions targeting low-income clients, J.P. Morgan analysts determined that historical median valuations in private equity have ranged between 1.3x and 1.9x historical

book, and between 7.2x and 7.9x historical earnings, from January 2005 through September 2008.

The study cited five MFI characteristics that justify a different valuation approach compared to traditional banks: the double bottom line return target, excellent asset quality, high net interest margins, high operating costs, and longer-term funding provided by developmental investors. It also indicated that MFI valuations should receive a liquidity discount due to the industry's small size.

According to a MIX MicroBanking Bulletin published in 2006, return on equity (ROE) averaged 17% among the larger, mature MFIs. The J.P. Morgan CGAP study gathered ROE data that diverged widely according to region and country, ranging from -3% in Africa to 23% in Bolivia and Cambodia. Additionally, the data demonstrated no link between profitability and valuation. The analysts ascribed this phenomenon to the immaturity of the microfinance private equity market and the lack of consensus on MFI valuation.

Correlation studies on microfinance and established asset classes indicate that microfinance may dampen investment portfolio volatility and enhance returns. Nicolas Krauss and Ingo Walter of New York University analysed data from 1998 to 2006, comparing leading MFIs to emerging market companies and commercial banks on a series of variables. They found that the MFIs displayed no correlation with global capital markets and lower correlation with domestic GDP than other emerging market institutions; although they cautioned that the absence of marked-to-market valuation was a key constraint of the study.

In another study conducted at the University of Leichtenstein, Oliver Oehri tested portfolio optimisation scenarios by substituting 5% of a selected asset class with a microfinance debt proxy (the Dexia Micro-Credit Fund) from January 1996 through June 2008. He concluded that adding the microfinance debt fund reduced risk for defensive and balanced portfolios, regardless of the asset class being replaced. The Sharpe ratio improved for all portfolios except when substituting microfinance debt for the hedge fund allocation.

Industry outlook

The historical low-correlation findings were corroborated in 2008 as microfinance outperformed most other components in investors' portfolios. However, all industry experts caution that microfinance is not immune to the global economic crisis affecting mainstream markets, and that some convergence is probable in the near term. In the longer term, MFI growth will slow from its 50%-70% rates over the past five years to 20%-25% – still high but reduced from its

unsustainable levels, according to Ann Miles, Managing Director of BlueOrchard Finance USA. Correlation will likely increase as the microfinance sector integrates further into the capital markets.

Key risks to debt investment include the difficulty that microborrowers may have in repaying loans due to fuel and food price volatility. The credit crunch has reduced funding availability to MFIs while raising costs by 200-800 bps, depending upon the country. As a result, loan portfolio net interest margins will be affected if MFIs cannot pass the full interest rate increase to customers. Furthermore, the industry's high repayment rates may suffer due to moral hazard: borrowers are motivated to repay loans to ensure renewal at maturity. If MFIs must cancel loans based on portfolio reductions, some clients may respond with defaults (and savings withdrawals). Any deterioration in loan portfolio quality and growth will reduce overall financial performance, impacting equity investors as well.

On the positive side, rising spreads and the decrease in funding supply may help investment in debt instruments become attractive again. In equity, the expectation is that pricing will drop in the near term – approaching 1x historical book value according to J.P. Morgan – but will rebound, creating opportunities for investors with the appropriate risk appetite. The long-term view of Raimar Dieckmann, Senior Economist at Deutsche Bank Research, is that individual and institutional investment in microfinance will grow significantly to US\$20bn by 2015.

Conclusion

In summary, the microfinance sector presents a unique investment opportunity for investors seeking social impact and financial profits that can range from below-market to risk-adjusted returns. Industry leaders share the belief that microfinance will evolve further into a

niche investment alternative, appealing both to socially responsible investors seeking impact and to a growing range of commercial investors pursuing portfolio diversification. Concomitantly, MFIs will continue the trend toward investment-readiness. Based on these assumptions and the industry's attractive fundamentals, the long-term outlook for microfinance investment is positive.

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