Microfinance Private Equity: Taking the Pulse of an Emerging Investment

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In May 2009 the International Association of Microfinance Investors (IAMFI) and Intellecap joined forces to assess investor views on microfinance private equity investment. Our goals were to understand the risk and return perceptions of microfinance investors, gauge the impact of the global economic crisis on microfinance investing, and evaluate investors' expectations for the investment class. In this collaboration, IAMFI and Intellecap conducted an online survey in early May, presented the findings at a Forum held on 21 May in New York, NY and created the venue for equity investors to share perspectives and to network among peers.

IAMFI-Intellecap Microfinance Private Equity Investment Survey

In the following survey summary, we take a reading of the tea leaves and share the survey findings. For a visual representation of the survey findings, please see pages 50-51 in this issue.

Before we started this survey, we were certain about two things: microfinance limited partners (LPs) are an elusive bunch, and there is a distinct communication gap between LPs and General Partners (GPs). Our survey undertook to learn about the differences in GP and LP investment expectations regarding risk and return, and also to gauge the effect of the economic crisis on these two parties.

Survey Sample

Our sample consisted of 27 general partners and 19 limited partners. Although the total sample of 46 investors may seem small, it is actually quite relevant; there were 30 microfinance investment vehicles (MIVs) in our sample, or 50% of the total international pool of 60 MIVs that make equity investments.[i]

Most (55%) of the respondents are MIVs with a consolidated fund size below US$100m, which is not surprising considering that most microfinance institutions (MFIs) can't capitalize more than several million dollars at a time. Half of all respondents make 50% of all their equity investments in microfinance only.

As expected, many of the LPs are fairly green to microfinance investing. Sixty percent have entered the microfinance market within the last four years, and half of LP respondents have invested less than 25% of their private equity portfolio in microfinance.

Divergence in Return Perceptions

The first major discrepancy in terms of perception arose in relation to return expectations. Forty-two percent of LPs had decreased their return perceptions, significantly higher than the reported rate of decrease by GPs, which was only 12%. The primary reason LPs cited for decreased return expectations was a commensurate expected decline in valuations. While LPs believe declining valuations reduce the value of existing portfolios, they also create attractive investment opportunities.

As LPs predicted, valuations in microfinance investment have been declining, though to a very limited degree. GPs tend to disagree, with 38% finding that there was no change in valuation. Of those that responded that there was a change in valuation, half found that valuations had decreased by less than 20%, and 30% found that they had dropped between 20 and 40%. Although the drop between 20 and 40% is of concern, we have found that valuations in microfinance have not declined to the extent that they have in more established sectors. We conjecture that this reported decline is in line with the financial market and part of an organic downward correction, and less a statement about the sector itself.

Risk Perceptions

When asked about risk perceptions, GPs and LPs agreed on one thing: management quality/capability is the top concern. It is a perspective reported in several other recent surveys, including the Banana Skins 2008 report in which investors cited Management Quality as the top risk.

GPs and LPs diverge when it comes to secondary and tertiary risks. GPs cited exits, or lack thereof, as their second top risk, and valuation/portfolio quality as their next biggest concern. On the other hand, LPs were more concerned about inadequate internal systems to handle high growth, and currency risk as it relates to the volatility of the economic environment.

Interestingly, 59% of LPs reported an increased perception of risk over the last 12 months citing several reasons for this change: global financial crisis and the resulting slowdown of the sector's growth; increasing portfolio at risk (PAR); overall market volatility; inefficient use of capital while waiting for tranches to close; and a delay in their ability to recoup investment.

To counterbalance these risks, LPs expressed a desire for more control over investee MFIs. They specifically mentioned the need to require certain performance benchmarks, terms or other covenants (89%), to make field visits with the MIVs to see onsite MIV due diligence (78%), and to conduct their own on-site due diligence (78%).

GPs echoed the need for stricter evaluation and due diligence, and also mentioned a need to seek out less aggressive business plans. Perhaps the days of 200% growth have stalled.

Global Financial Crisis and Microfinance Investment

When it comes to evaluating the effects of the global financial crisis on microfinance investment, 45% of GPs and LPs agree that there are variations in impact depending upon region. An equal number of total respondents (45% of GPs and LPs) stated that the impact on microfinance is far less than on other asset classes—a perspective that bodes well for future microfinance investment flows.

GPs have not felt drastically negative consequences of the financial turmoil. Private equity investment in microfinance has been rather stable during the last 12 months. For many questions related to the impact of global recession, "No change" was a dominant response. This trend can be seen through three elements: equity and debt deal flow, fund raising, and allocation of equity investment in total portfolio. In fact, attractiveness of the sector has not decreased significantly for the majority. Forty-four percent of GPs reported an increase in the equity deal flow in the past 12 months. Fifty-eight percent reported that they raised the targeted amount of funds in the last 12 months.

Paradoxically, while the LPs reported increased risk perception (see Risk section above), the GPs' perception is corroborated by the LPs who, despite the global financial crisis, have in large part kept their allocation to microfinance the same (61%) or increased it (31%).

No Exit

Exits, of course, are still hard to come by. More than half of GPs (58%) responded that they had delayed an exit in the last 12 months as a result of the global financial crisis and 56% said that "No Exit Was Planned." Only two out of 16 of GP respondents have made an exit and their return was between 0-9%. Only one out of seven LPs reported making an exit.

Outlook

GPs predict that we will see a consolidation of MFIs and/or a reduction in MFI and/or MIV growth rates in the near future. This supports the findings in the Intellecap Risk Roundtable Study, conducted in January 2009, in which investors predicted an increased amount of mergers and acquisitions (see article by Vineet Rai on page 24 about M&A).

LPs, when looking at their future allocation of funds to MIVs, have projected increased growth for equity focused MIVs, direct equity investments, and debt-focused funds but have projected a decrease in direct debt (80% of respondents). The implications of a decrease in direct debt investments will likely be slower growth of MFIs and lower leverage.

IAMFI-Intellecap Microfinance Private Equity Investment Forum

Over 40 LP investors, GP investors and industry service providers such as wealth advisors, law firms and rating agencies attended the Forum. Some were experienced microfinance investors while others were beginning their evaluation of the sector. J.P.Morgan, an IAMFI Charter Member, hosted the event at in Manhattan. The meeting offered participants the opportunity to hear the summarized survey feedback from LP and GP investors in microfinance equity, presented by Anurag Agarwal, Intellecap Vice President, Investment Banking, and to network among peers.

During facilitated breakout sessions that followed the survey presentation, attendees discussed 1) the gap in LPs' and GPs' perceptions of microfinance private equity risk and return, 2) the role of development financial institutions in private equity investment, and 3) the discrepancy between LPs' stated allocation to microfinance and many MIVs' fundraising shortfalls. The take-aways from those sessions are highlighted below.

There is a gap in knowledge and communications between GPs and LPs. This likely accounts for divergent perceptions of risk and return in our survey. Many LP investors in microfinance make a small allocation of their portfolio to microfinance, and cannot justify conducting lengthy due diligence and monitoring. The sense that they don't have direct knowledge regarding their microfinance investments may make LPs perceive greater risk. GPs would do well to increase feedback to their LP investors on the microfinance sector and their fund's performance. Those LPs seeking more information should make periodic field visits with their GPs and conduct independent due diligence as required.

Despite "crowding out" concerns, DFIs play an important role in microfinance. DFIs were early investors in microfinance equity, creating opportunities for the private sector to enter the market. DFIs regularly facilitate the exit of private investors, and the DFIs' continued commitment to the microfinance sector in this turbulent time brings stability and comfort. However, anecdotal comments by private investors indicate that in some instances DFIs continue to offer capital at below-market pricing, effectively "crowding out" private investment. The consensus view is that 1) DFIs should only make investments that private investors are unwilling or unable to make, e.g. in lower-tier or greenfield MFIs, 2) DFIs should focus on catalytic investments that entice private investment, especially in the current economic downturn, and 3) DFIs should exit investments once they have achieved the demonstration effect and private investors are ready to supply substitute funds.

The nascent nature of microfinance private equity reveals infrastructure needs in the sector. LPs observe that few MIV managers possess a private equity background in emerging markets and microfinance investing experience. The small deal size is a constraint for large institutional investors; one group discussed the potential role for brokers to bundle transactions and provide related due diligence. A participant advocated for the establishment of a global microfinance stock exchange to promote a secondary market.

There is concern that a backlash against commercialization will make microfinance "the stillborn asset class." The case for commercialization must be made in a collegial way: clear and compelling in order to generate market demand, while acknowledging the significant role that philanthropic actors and non-profit leaders have played in the sector's development. Energetic debate continues about whether a for-profit business can truly maintain a "double bottom line." Lack of consensus on social performance metrics persists among donors, "Social First," and "Financial First" investors.

Valuation of microfinance equity is problematic. It is difficult to value MFIs in the absence of a secondary market or other avenues for equity investment exits. Valuations are highly specific to each MFI and to local macroeconomic, legal and regulatory conditions. The relative value of microfinance private equity as compared with general emerging markets private equity is unclear.

Current investment trends are mixed**.** Participants were encouraged that 58% of MIVs met recent funding targets despite liquidity challenges and market turmoil. In general, however, attendees believe that investor risk appetite is down. LPs feel that equity multiples are not dropping as quickly or as low as they expect. Some GPs have observed an LP paralysis, as LPs are in no rush to invest in a market they believe will drop further. One investor noted that GPs must better articulate to LPs the value proposition of microfinance. While some countries struggle, equity investment activity in others such as India is strong.

Going Forward

In addition, to the survey presentation and breakout sessions, the Forum provided a separate space for LPs and GPs to meet privately and discuss investment goals and options. After the Forum, participants indicated that they obtained valuable market intelligence and made important new contacts. Intellecap and IAMFI will each continue to promote scale and sustainability in serving the financially excluded through for-profit investment.

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IAMFI is a New York-based global membership organization dedicated to helping current and potential commercially oriented microfinance investors achieve their goals by offering industry information from an objective viewpoint, conducting research, hosting educational and networking events, and facilitating dialogue among industry actors to improve the global environment for microfinance. Please visit www.iamfi.com for more information.

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[i] Research conducted by IAMFI.