The Role and Impact of Private Sector Capital in the Global Microfinance Sector

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Introduction

Over the last years, there has been a surge in the number of new microfinance investment vehicles (MIVs) that offer a wide range of funding instruments, catering to the growing needs of microfinance institutions (MFIs), be they non-governmental organizations (NGOs), credit-only institutions, or even regulated deposit-taking for-profit entities. More than half the assets under management (AUM) of such vehicles have been provided by institutional investors, who have positioned their relatively recent entry into the sector as a strategic investment that offers a double bottom line return: financial and social. Despite the consistent increase in funding supply, there still is significant unmet demand for particular funding instruments by MFIs.

To this end, the financial needs of the end borrowers of MFIs often remain unmet. This is a result of not only a lack of capacity at the MFI level, but also a lack of in-depth knowledge of the true financial needs of the MFIs’ end borrowers by the MFIs’ funders. MFIs end up with a restricted portfolio of financial products that meets the general risk averse appetite of MFI funders, rather than what would be a potentially diversified product offering.

The end borrowers of MFIs are traditionally low-income entrepreneurs who do not have access to consistent and reliable financial instruments that would normally allow them to weather financial, health, or day-to-day living emergencies that put them in an extreme and detrimental cash-strapped position. While MFIs should and would normally cater to the growing needs of their clients at the lower end of the income scale, many MFIs are bound by their still nascent financial acumen and infrastructure capacity that hinders them from developing adaptive financial instruments that cater to the specific cash flow capabilities of the end borrowers. Moreover, and perhaps more importantly, meeting the end borrowers’ financial needs is often bound by the intrinsic risk appetite of MFIs’ funders.

In parallel, development finance institutions (DFIs), mandated with providing much needed access to finance in developing and emerging markets, have continued to grow their portfolios in the microfinance sector trying to bridge the gap in unmet funding demand. DFIs’ mission has been and continues to be to foster private sector involvement in markets historically considered to be risky or non-investable by mainstream financial investors that expect a straight-forward relation between a return commensurate with risk. Yet, as the microfinance sector continues to
develop and strengthen as a commercially viable business model, DFI involvement has been cited to overlap with, and at times even crowd out, private sector involvement.

The following paper attempts to understand the reasons behind the prevailing mismatch in funding, and the prevailing overlap between the roles of the DFIs and private sector institutional investors. It also describes the reasons behind the entry of private sector commercial investors into the microfinance sector, with a view to confirm or qualify the argument that microfinance is now a proven business model providing both credible social impact coupled with attractive financial returns.

Much of the views and opinions presented in the following paper have been developed based on several discussions and interviews with the main players in the microfinance sector. We have interviewed representatives from MIVs, DFIs, and private sector institutional investors. Our respondents come from institutions, which taken together represent more than 70% of the global microfinance asset base. More detailed information on the literature review and the institutions interviewed is available in the bibliography section of this paper.

Mismatch between Supply and Demand of Funding Resources

The recent growth of the global microfinance sector has been largely driven by donors, DFIs, and private social institutional investors that have channeled a significant supply of funding, that resulted in MFI's growing ever more rapidly, and at times not so prudently. As the microfinance sector’s attractiveness grows, MFI's are being chased by cheap or subsidized funding that tends to defy their respective prudential absorption capacities.

Despite the economic downturn, and the recent debt defaults in the microfinance sector, total funding channeled to microfinance globally continued to increase all the while at a decreasing pace. According to the CGAP 2010 MIV Survey, 122 MIVs are currently active with over USD 8.2 billion in AUM, which grew at an impressive rate over the past three years: 25% in 2009, 34% in 2008, and 86% in 2007. More important has been the consistent trend of institutional investors remaining as the main funders of the MIVs, representing approximately 50% of the funding supply. Despite this significant growth in AUM, the target exposure of the MIVs to the different funding instruments, maturity level of MFI's, and geographies has remained
constant, largely concentrated in straight hard currency medium-term debt instruments targeting Tier I MFIs in Latin America, the Caribbean, Eastern Europe, and Central Asia.

In parallel, the growth in the global microfinance portfolio lagged behind, registering a growth in 2009 of only 18% (vis-à-vis a growth of 25% for AUM). This has resulted in a record level of liquidity for the total universe of MIVs of 17% in 2009, compared to 10% in 2008, and 13% in 2007.

Placement of assets has become ever more difficult. Many funders, driven by the recent demonstration of commercially viable – and very profitable - microfinance models, have been chasing the same best performers globally, creating significant risk concentrations. Despite such evident concentrations and increasing competition, there has been no credible evidence of a shift towards down market players which – with some capacity building and institutional strengthening, could prove to be very viable and potentially rewarding investments. In fact, the prevailing trend continues to be a large funding base chasing a select universe of Tier I well-established MFIs. This is symptomatic of the risk appetite where private investors and DFIs alike are shying away from going down market to more risky investment opportunities. In many underserved markets, some promising MFIs are gearing up towards accessing more private funding, with a promise to combine social impact with double digit growth rates and plenty of room for upside. Yet the staggering hindrance remains local regulation, which has restricted the pool of investable MFIs. Further reinforcing the increased liquidity is the lack of available credit worthy institutions to place funds and the limit of the absorptive capacity of Tier I MFIs.

According to the MicroRate 2010 MIV Survey, “the pressure to disburse funds, coupled with the decrease in investment opportunities, could lead to the deteriorations of portfolio quality as managers find themselves under increasing pressure to reduce liquidity. [Yet this] could be seen as an opportunity for MIVs to strengthen their operations and focus on developing the products and services that microfinance institutions truly require.”

Intuitive wisdom suggests that private sector investors begin accessing the microfinance sector through tapping into Tier I MFIs, with a view to build a certain knowledge base and comfort level with the sector. Subsequently, investors are tempted to go down market where unmet demand and competitive advantage is still high. Yet the recent global crisis has impeded this natural evolution decreasing the risk appetite to enter riskier markets. While microfinance has always
been cited to be immune or resilient to economic downturns, this has not been the case during the last global financial crisis when many microfinance borrowers were hard hit by loss of livelihoods, which has resulted in impaired repayment capacities, a decrease in savings, and a drying up of remittance flows. As a result, the more mature and established MFIs continue to be able to source their needed funding to the detriment of the smaller more fragile institutions in more desperate need for funding, particularly the institutions that are not allowed or unable to tap into savings as a funding base.

As returns are dropping and credit risks are rising, microfinance investors are facing increasing challenges in a market once thought to be immune. Performance was affected and yet supply of funding continues to grow without the necessary coupling of proper institutional oversight, capacity building, and technical expertise transfer. According to CGAP’s “Growth and Vulnerabilities in Microfinance” Focus Note, “the recent delinquency crises are a reminder that microfinance remains a risk management business.”

The rise in liquidity in the MIVs’ portfolio has resulted in a realization that perhaps the funding available is not adequately catering to the real needs of the MFIs. Speaking to the various microfinance investors, multiple reasons were cited for the prevailing mismatch of funding supply and demand, including risk appetite, product mismatch (currency, tenor, and type), aggressive fund raising efforts coupled with delays in placement, and, albeit the least important, some perceived competition with public sector investors. Perhaps another underlying reason has been the complacency of some of the larger more-established MFIs, reinforced by their relatively easier access to funding, to develop products that cater to the real needs of their customers. As a result, MFIs can continue to cruise on a naturally oligopolistic position with a very simple range of products that are not growing with their clients growing sophistication and needs.

Around two-thirds of our respondents pointed out that there is not enough risk appetite to invest in less regulated, early stage MFIs which are in most need of capital. The smaller MFIs need equity capital to grow and establish their track record before they are able to develop sustainable relationships with debt funders. When many of the larger MIVs were established, the institutional investors were promised a certain risk-return profile that limits a fund’s capacity to invest down market. Moreover, many MIVs display the same risk-return profile, with an average of 30% of AUM invested in Tier III MFIs versus 43% in Tier I institutions; this compares poorly with the multitude of Tier III and Tier IV MFIs in the market seeking commercial capital. While
growth can be achieved not just by going down market to higher tier and smaller MFI’s but also to new geographies, MIVs are quite limited as many countries lack an adequate regulatory framework. In general, institutional investors share a similar risk appetite. One respondent pointed out that “all of the funds are looking for well-managed and sound institutions. The sector as a whole is going down market, however it will be very difficult for the funds to go to Tier III and Tier IV MFI’s while meeting their risk-return expectations.” Moreover, almost four fifths of the MIVs we spoke to claim to have enough flexibility to go into riskier markets, but that they are unable to provide capital to early-stage and greenfield institutions, NGOs, or transforming entities with very little track-record.

This trend begs the question whether microfinance is truly an asset class in and of itself. Given the un-treaded tiers of less regulated earlier stage MFI’s, this asset class is perhaps only tried and tested for larger more established MFI’s. This is not counterintuitive, as early stage and start-up MFI’s normally need a fair amount of subsidies to facilitate a quick operational ramp-up and to build an enabling investment opportunity for commercial social investors.

When it comes to product mismatches, and as evidence by the growing maturity of some geographic regions, microfinance investors are finding it increasingly challenging to place debt. MFI’s are finding cheaper sources of local currency debt in their local markets. Furthermore, MFI’s are requesting longer tenors, which MIVs are not adequately structured to provide, and hence MFI’s continue to look to their local markets to structure such instruments adequately. Simultaneously, while investors are becoming more comfortable with the microfinance business model and are seeking to take equity positions in MFI’s, the sector is not requesting as much equity or senior debt. Instead there is a growing demand for subordinated or convertible debt, which are riskier instruments than senior debt, and with a limited equity upside. Several microfinance investors are considering establishing specialized funds that would offer riskier fixed income products to MFI’s, therefore investing in subordinated debt. This may be a step in the right direction to support an enabling environment for MFI’s to tread beyond traditional “plain vanilla” products to their clients and adapt financial instruments to cater to specific needs and cash flows of the end borrowers.

A third reason for the increased liquidity was cited to be the aggressive fundraising efforts with potential delays in placing such funds. “Funds have been too ambitious in fund raising and promised unrealistic returns to investors.” Approximately two thirds of the respondents
interviewed are currently raising funds and / or looking to expand their sales force in order to meet the fundraising targets. Most of the funds however are being raised for riskier products with lower return hurdles in order to meet the market demand. Such funds are a sector-wide attempt to build capacity in early stage MFIs, coupled with more realistic return expectations due to the increased risk of early stage investments.

Finally and perhaps being cited as least important, is the perceived competition with DFIs that are able to offer subsidized technical assistance funding as deal sweeteners or even cheaper funding rates. Yet despite this being one of the least critical reasons, it is important to point out the overlap in roles between the private sector and DFIs, which may seemingly have a negative impact on the development of the sector.

**The Role of Development Finance Institutions**

Development finance institutions (DFI) have a general mandate to provide financing by way of debt, equity, or guarantee instruments to the private sector in what are considered high risk environments in developing and emerging countries, thereby promoting development and job creation. They have played a crucial role in fostering the entry of private sector financial institutions through simple demonstration, but also through effectively working to enhance institutional governance of their investee companies, building much needed capacity and skills training through technical assistance packages, and also by providing political guarantees in many volatile environments. DFIs have been catalytic in engaging in countries where market forces have failed to invest sufficiently, thereby engaging countries where there is restricted access to domestic or foreign capital markets.

Given their mission to support sustainable private sector development, DFIs have engaged with microfinance programs and institutions globally, taking the lead in the early 1990’s from donor agencies who began supporting this vital sector as early as the 1970’s. The DFIs assumed the risk of a sector that had an unproven business model, bringing in a more commercial approach, coupled with much needed capacity building expertise and technical know-how.

As the microfinance sector grew globally, proving commercial viability, DFIs have been slow to adapt to the growing appetite of private investors to engage and invest in this sector, at times
creating unhealthy competition, which could be considered to “crowd out” private sector investors by undercutting pricing or offering the advantage of generous technical assistance packages as “deal sweeteners”.

Being public institutions, DFIs are not primarily profit-driven. With the lack of credible and tangible data to demonstrate the true impact of investing in microfinance, and therefore relying on the continuing assumption that microfinance is primarily a poverty alleviation tool, they are evaluated more by how much money they place rather than the ultimate impact of the funding they place. While the logic would stand that DFIs should be assuming the risks that private investors are still not willing to assume, DFIs still need to maintain a standard of credit risk rating, thereby further reinforcing the drive to stay within a very conservative perimeter of mature and well-performing MFIs. This is further reinforced by the DFIs’ inability to make small ticket investments – as needed by early stage MFIs – given their laborious operating cost structures (one mitigant for this has been the aggressive involvement of DFIs with microfinance networks, through which large sums can be channeled piecemeal through smaller investments). All this has counter-intuitively led private sector investors to seek opportunities among the smaller and riskier MFIs.

Although DFIs are often keenly aware that they need to exit some of the more developed markets, allowing the private sector to kick-in, it is not always obvious – particularly when it comes to equity positions. Long-term commitment in a certain geographic region or a certain sector is crucial to any DFI’s social mission. Therefore, exiting institutions or markets does lend to significant rhetoric at the political level in terms of the necessity to recycle funding from institutions to others within the same region, otherwise, it is politically difficult to exit a market altogether. Finally, while DFIs’ mission should be to pioneer in relatively unstable political and socioeconomic contexts, they are still held to high standards in terms of not subjecting their investment portfolio to undue risk.

DFIs need to re-evaluate where they are needed most, rather than doing more of the same. It is certainly very encouraging that private sector investors are engaging with the microfinance sector with large volume. Yet it is important to ensure that there is no overlap, only complementarity, since while there may be an over-supply of funds, there is still much unmet demand.
Perhaps it is then important to acknowledge the different roles played by the DFIs and private sector investors, with a view to foster more differentiation and complementarity.

Based on our survey, the majority of DFIs target a rate of return slightly above 10%. On the other hand, the majority of MIVs target a rate of return above 20%. Despite this converging market approach, more than three quarters of our respondents claimed to be co-investing with DFIs, even though this not being an investment requirement.

A DFI’s role comes in at an early-stage of an MFI’s growth and development with a view to strengthen its governance, systems, internal controls, and technical expertise transfer. At a certain point, when an upward growth path necessitates more capital and a more proactive involvement at the governance level, the private sector kicks-in. Yet the problem arises when roles are confused and competition ensues.

From a DFI’s perspective, both types of investors have a similar role and provide a similar value proposition to the institutions they choose to finance, therefore having many overlaps between MIVs and DFIs. Despite this, DFIs are encouraged by the participations of MIVs as it demonstrates the sustainability of the business model, or the hope of it. They bring in private sector funding and experience, playing a proactive role at the governance level with a view to strengthen the institutional infrastructure over the shorter investment horizon when compared to a DFI.

On the debt side, many of our MIV respondents cite some form of pricing competition which forces them to go to markets that DFIs do not want to target, however those areas tend to be the ones that are in most need of technical assistance and subsidized capital. While there may not be direct pricing competition, DFIs continue to have a competitive advantage in terms of offering capacity building programs and technical assistant packages which does not necessarily level the playing field.

On the equity side, contrarily, investors see a clear role and value adding proposition by the DFIs, as they play an important role in improving the corporate governance of the institution and they are very useful in assuring a smooth relationship in rather volatile political environments. The main problem when it comes to equity tends to arise at exit where it is clear that return requirements and market engagement approaches diverge, at times becoming a blocking factor.
when exiting investments. It is still very unclear as to a DFI’s mandate to exit, as while DFIs may have an initial investment horizon of five to seven years, there are little or no specific internal guidelines in terms of the stage of the investment at which a DFI should exit. As a consequence, DFIs tend to stay longer than anticipated.

Furthermore, most microfinance investors position themselves as private equity investors – implicitly implying an entry at a relatively mature stage after an institution has weaned off donor funding and subsidized technical assistance packages. Yet, it is still counter intuitive to put such a strain on nascent sector that is in desperate need of much ramping up and capacity building to implicitly assume the subsidized donor funding will always be there at the early stages. It is time for the sector to come to terms with the reality that more venture capital type investors are needed to ramp up the business model in order for it to become truly mainstream.

**Increasing Participation of Commercial Private Investors**

Increasingly over the past decade, socially motivated high net worth individual investors have begun to play an important funding role in the microfinance sector, engaging as venture philanthropists.

Subsequently, as the sector continued to develop, institutional investors, including international banks, pension funds, insurance companies, and even some mainstream private equity funds, took a keen interest in entering the sector, either through earmarking some funds for socially responsible investment portfolios, or blended and diversified in their core investment portfolios.

The entry of private capital brings with it a private sector approach to managing institutions with solid governance principles. While bringing in private sector capital may result in questioning the true nature of microfinance and whether the need for commercial gains will forsake the original social mission, “institutional investors serve a larger group of stakeholders and therefore tend to be more conscious about their reputations and more likely to take measures to avoid associating with a micro lender that lacks strong client protection policies, charges unusually high interest rates or generates negative publicity.” (CGAP 2010)
The recent successful IPO of SKS India, and before that Compartamos in Mexico, has demonstrated the ability of social commercially viable MFIs to tap into mainstream capital markets to reach significant scale and growth. Both offerings have furthered the arguments that social goals can be achieved alongside financial returns in certain circumstances. According to Credit Suisse’s Equity Research group, “the very strong investor interest in these two landmark microfinance IPOs suggests two things to us: First, investors are eager to gain microfinance exposure, and second, that the market is open for further MFIs tapping the capital market to help fund their growth.”

The recent valuations do question the double bottom line approach. While high entry valuations are not necessarily to the detriment of the low-income target market the MFIs serve, actively trying to recover the entry price in addition to attaining healthy return through “squeezing” interest rates becomes questionable. On the other hand, reaping the benefits from an over-subscribed IPO simply demonstrates the intrinsic value of relying on supposedly efficient market forces.

If microfinance is put to the test against traditional financial asset classes that have a relationship between risk and return as expressed by a country risk premium incorporated into the valuation of the entity, then many of the private sector microfinance investors do not believe this relationship holds for the sector. Perhaps on the equity side, returns are commensurate with the risks, but on the debt side, risk-adjusted returns are skewed. Several interviewees suggested that for a purely financial investor, there might be better uses of capital. Microfinance is only attractive if the investor is targeting a double bottom line, which would justify the relatively low return, making it perhaps defy the fundamental characteristics of an asset class.

While entry of the private sector lends much credibility to the basic operating business model of microfinance, even though the dust has not settled on adequate pricing policies that take into account the underlying moral imperative of not abusing the poor - it is still unclear how returns were determined. Speaking to a multitude of MIVs, more than four fifths described their return targets as investor driven, while the remaining claimed to base the target on the historical track record of the sector.

All the traditional finance investors interviewed hold their investments in microfinance as part of their core, for-profit, investment portfolio and target returns in line with their emerging markets
portfolio, approximately ranging between 20% and 25%. They agree that the only way of achieving a traditional emerging market return is through the expertise of the portfolio managers in finding those leading institutions in their areas of operations with the best risk return profile. They hold these investments mostly due to their growth potential, diversification and only much less due to the social mission of the entities, with the added kicker of the social return.

Perhaps institutional private investors may have been initially driven by the lucrative financial returns of some MFIs. As returns begin to depress, private sector investors are beginning to realize that the risk-adjusted returns do not necessarily reflect true market dynamics. As such, if investors are not fully compensated for the investment risks assumed, they have to factor in other types of returns like social priorities.

The sector has been historically credited as being a poverty alleviation tool. This underlying assumption is now being put to serious test. As social returns are being questioned, investors are increasingly requiring “proof” through detailed reporting on social impact, but more importantly measurement of the so claimed “social impact”.

According to CGAP’s 2010 MIV Survey, more than two thirds of the MIVs – more than 50% of which are funded by private institutional investors, are presenting a growing trend in commitment to Environmental, Social, and Governance issues. According to CGAP MIV Survey, 40% use an environmental exclusion list, 81% have endorsed the Client Protection Principles, and 69% report on ESG issues to their investors.

As market competition increases with the ever growing supply of funding, private investors will need to seek ways to differentiate themselves and underscore the double bottom line mission.

**Conclusions**

The microfinance sector is not yet an established asset class that has successfully mainstreamed into traditional finance investors. The business model has a long way to go in developing a framework that sustainably meets the specific needs of its clients.
It is imperative that the different investors move away from the prevailing overlap in investment strategies and move towards a more complementary approach to developing the sector.

The key fears for longer term development of the sector are mostly regulatory risk, including the pricing risk as interest rates continue to compress, a lack of sectorial infrastructure, and on a case by case basis, the over-supply of funds that might lead to unprofitable growth. Such key regulatory risks will force MFIs to re-invent themselves further differentiating between the well-established solid performers and the rest.

With the microfinance sector undergoing rapid and continuous development and transformation, much development still needs to be done when it comes to arriving at a sector-wide understanding of how to bridge the gap between reaping commercial returns commensurate with the risk profile assumed, and the moral high ground of dealing with the low-income generators.

Traditional finance investors may have been attracted to the high returns of some solid-performing MFIs. Nevertheless, as returns begin to depress to more realistic levels, traditional finance investors are seeking to be additionally compensated through social returns, and hence an aggressive drive to measure and account for the “social impact” factor.

Yet for such traditional finance investors, the social mission does not necessarily justify investments in MFIs on a stand-alone basis. Deviation from the microfinance traditional mission is seen on a case-by-case basis as accretive as it provides a diversified stream of revenues to the MFI. In fact, most traditional finance investors consider “a slight deviation from mission by moving to a diversified portfolio as the future of most microfinance entities. This is not contradictory to simultaneously meeting the needs of the poor as having a diversified stream of revenues will allow the company to lower its business risk and address better the needs of its clients”.
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Literature Review:


