

Survey of Microfinance Investment Vehicles

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Recent Developments

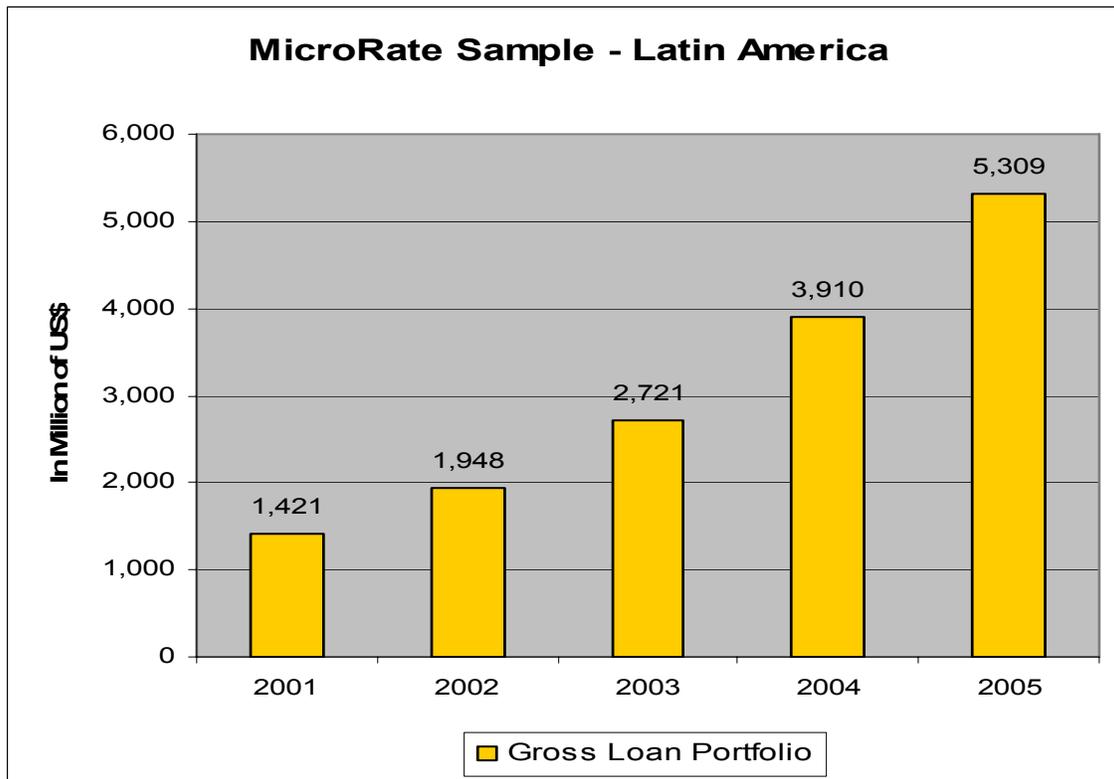
Microfinance Investment Vehicles ('MIVs') have been around in some form for many years. But their recent explosive growth is the result of what is happening in the microfinance industry which they serve. That industry in turn is extraordinarily difficult to measure accurately, because there is no consensus on what should be regarded as microfinance. If you include all loans below a certain size, then the numbers become very large – hundreds of billions of dollars – because this definition also captures consumer lending. If, on the other hand, microcredit is regarded as cash-flow based lending (as opposed to collateral-based lending) to the poor, then we are dealing with a much smaller universe. Well below \$100 billion and most likely still below \$50 billion. My best guess is that all outstanding microcredit adds up to about \$20 – 30 billion. Because of all of the publicity surrounding microfinance, we tend to forget that these are still quite modest numbers both when measured by capital market standards and when compared to the potential needs for productive credit by the poor in developing countries.

What has caused the recent explosive growth of MIVs is not so much the absolute size of microfinance – whatever that may be – but its growth. The MFI growth numbers used in this paper are based on a sample of Latin American microfinance institutions (MFIs), which MicroRate – the first rating agency specializing in microfinance – has tracked for at least five years. The MicroRate data have the advantage that they are verified (the MFIs have been rated by MicroRate) and that they have been adjusted to eliminate subsidies and differences in accounting practices.

For a number of years, the MicroRate sample has been growing at an average rate of nearly 40%. Remarkably, that growth has not slowed down as the MFIs became larger.

Outstanding Loan Portfolio

40 Latin American MFIs

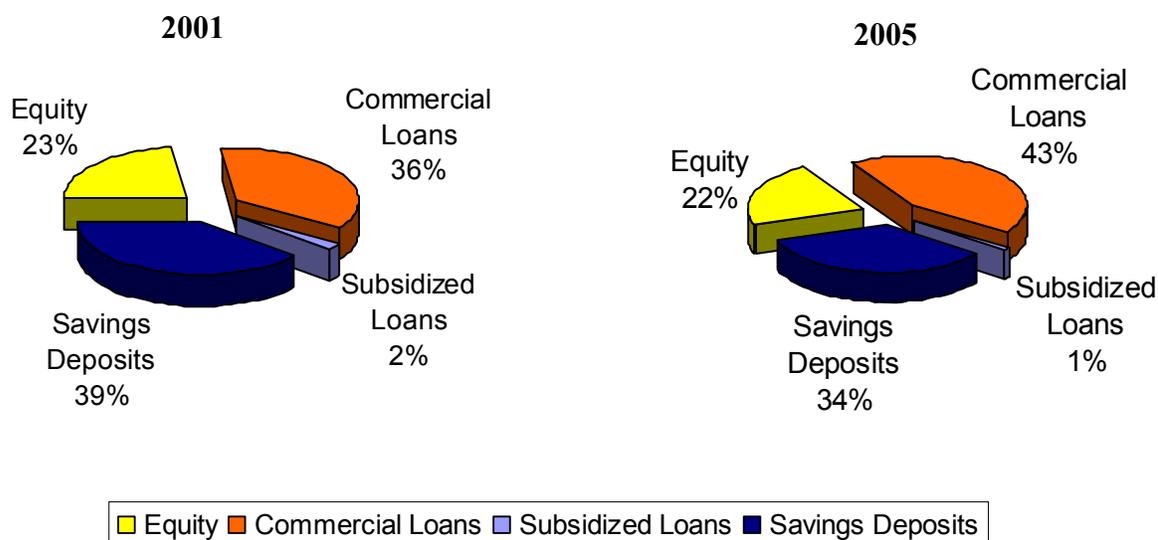


Source: MicroRate

As can be seen from the graph, the amounts of money lent by just these 40 institutions are becoming very large. Their outstanding loans grew by \$1.9 billion in 2005 alone. Microfinance has long ago outgrown the funding capacity of donors. More recently it has outgrown the international development institutions as well. How are MFIs then funding their extraordinary growth?

In the case of the MR sample, the bulk of the funds came from commercial banks. Savings deposits were the second-largest source, but remarkably, savings mobilization has not kept up with the rate of growth of these institutions. They also plowed back their considerable profits into their operations to increase their equity base.

MFI Funding Sources



Source: MicroRate

Commercial borrowings by MFIs have not only grown very fast, they have also become much more sophisticated. Six years ago, MFIs would typically borrow from a local government development bank that in turn would obtain its funding from international financial institutions (IFIs) like the World Bank, the Inter-American Development Bank or the Central American Bank for Economic Integration. Today, MFIs routinely borrow from commercial banks and from MIVs. The most advanced among them have learned how to issue bonds in their local markets. Many of them borrow from a dozen or more lenders at the same time and their funding operations have become quite sophisticated. This paper describes how MFIs are interacting with foreign lenders and how funds specialized in microfinance have emerged to channel investment from capital markets in rich countries to MFIs in developing countries.

It is important however, when discussing foreign funding sources, to remember that they only account for a small part of the overall funding of MFIs. In MicroRate's experience, foreign funding from both MIVs and International Development Institutions (IFIs) rarely exceeds 20% of total capitalization and we estimate that it averages about 15%.

Microfinance Funds

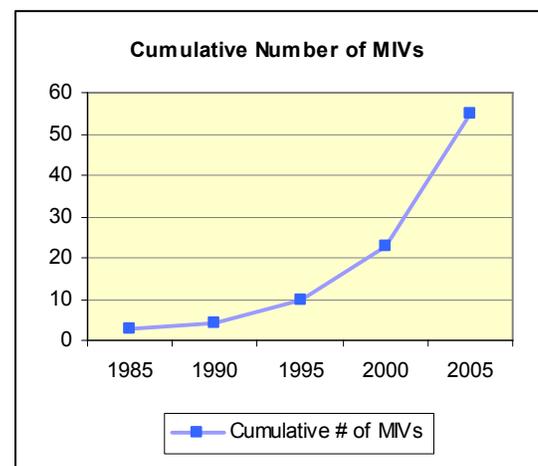
Funds rarely flow directly from private foreign lenders and equity investors – in this review the term “investor” is used for both – to MFIs. Rather, during the last few years a new type of intermediary has evolved, that mobilizes funds from investors in rich countries and then channels them to MFIs in the developing world. These Microfinance Investment Vehicles (“MIVs”) are the subject of this analysis.

The most striking feature of MIVs is their explosive growth. In 2005 alone, their combined microfinance portfolios have nearly doubled reaching \$1 billion by the end of the year. The engine driving this growth is of course the expansion of MFIs themselves and their ever-increasing hunger for funding. Gradually, and somewhat haltingly, microfinance is evolving into an asset class.

MIVs evolved more or less spontaneously to accommodate investors who want to place money in microfinance, but who do not have the expertise to operate in developing countries or to evaluate microfinance institutions. A MicroRate study of MIVs¹ showed that at the end of 2005, 54 MIVs identified by the survey had invested \$981 million in microfinance – a 91% increase over 2004. The composition of their microfinance portfolio was 76% debt, 23% equity and 1% guarantees. Additionally, the growth in MIVs has been remarkable, with 34 of the 54 beginning operations after 2000 and 16 launching in 2005 alone.

A striking feature of the MIV sector, in addition to its surprising growth, is its diversity. MIVs come in a large number of shapes and sizes. Only a small minority are

“funds” in the narrow sense of the word. Others are specialized investment vehicles like Collateralized Debt Obligations (CDOs), cooperatives, finance companies, special accounts established as part of larger development entities, holding companies, etc. The dominant



¹ Microfinance Investment Vehicles – An Emerging Asset Class. MicroRate, Washington DC, 2006

impression is that this is a new industry that has not settled on preferred legal or organizational forms. Nor are there yet industry-wide performance measures or standards. Indicators, benchmarks, and investor guidelines have not been established. Little wonder, then, that investors are bewildered. The wider MicroRate survey of 55 MIVs was then narrowed down to 14 of the most important entities, which provided more detailed data.

Principal Microfinance Investment Vehicles

December 2005

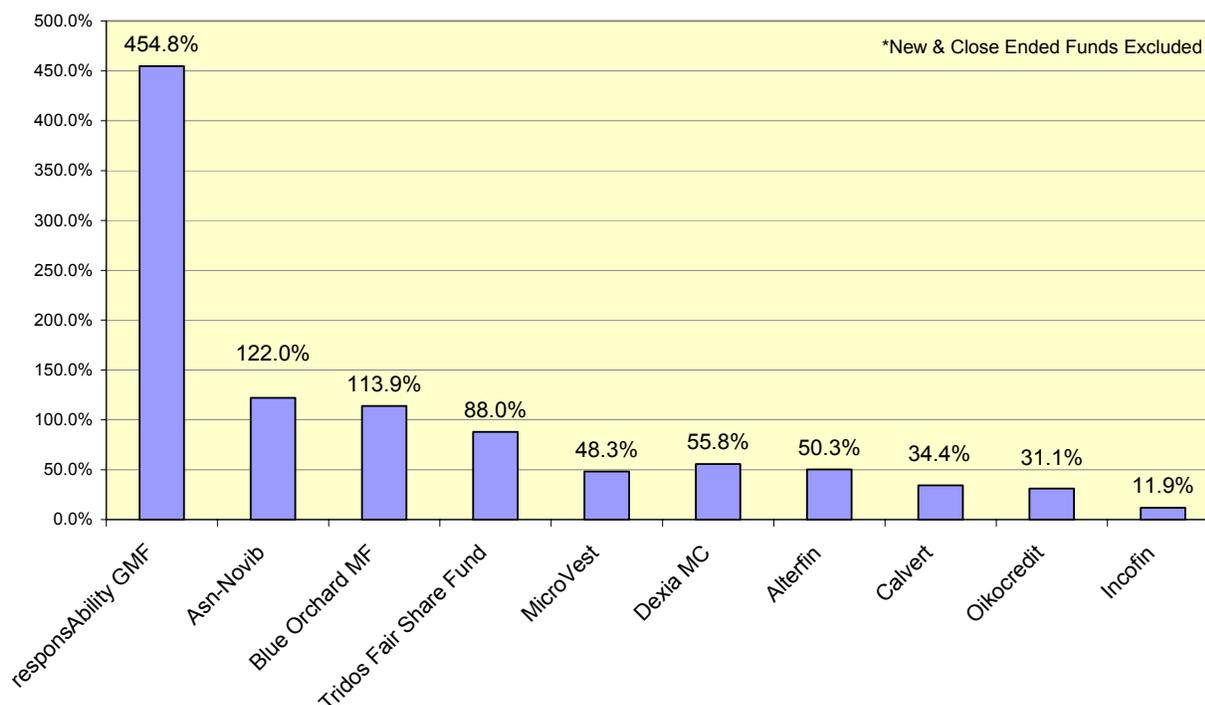
| <u>MIV Name</u> | <u>Microfinance Portfolio</u> (USD Millions) | <u>Microfinance Portfolio Growth '05</u> | <u>Total Assets</u> (USD Millions) | <u>Total Asset Growth '05</u> |
|---------------------|---|--|---------------------------------------|-------------------------------|
| Oikocredit | 126.3 | 31.1% | 342.7 | 2.4% |
| Blue Orchard MF | 81.3 | 113.9% | 84.0 | 118.6% |
| Dexia MC | 69.0 | 55.8% | 88.5 | 44.7% |
| responsAbility GMF | 40.1 | 454.8% | 43.1 | 421.8% |
| Calvert | 23.2 | 34.4% | 122.1 | 15.6% |
| Lacif | 20.6 | FIF | 20.8 | FIF |
| Asn-Novib | 20.0 | 122.0% | 41.9 | 46.0% |
| MicroVest | 13.5 | 48.3% | 15.9 | 47.0% |
| Triodos Fair Share | 13.2 | 88.0% | 19.7 | 74.8% |
| Accion IM | 11.7 | FIF | 13.8 | FIF |
| Impulse | 10.3 | YI | 11.3 | YI |
| Alterfin | 4.9 | 50.3% | 13.8 | 23.6% |
| Incofin | 4.5 | 11.9% | 6.6 | 17.1% |
| Global Partnerships | 2 | YI | 2 | YI |

Source: MicroRate

The detailed findings reveal that the 14 MIVs are growing at a torrid pace. Their asset size increased on average 35% annually from 2003-2005 while their microfinance portfolios grew 76% annually during the same period. Interestingly, the highest growth rates were experienced by those MIVs which had developed mechanisms to reach retail investors. Growth was led by

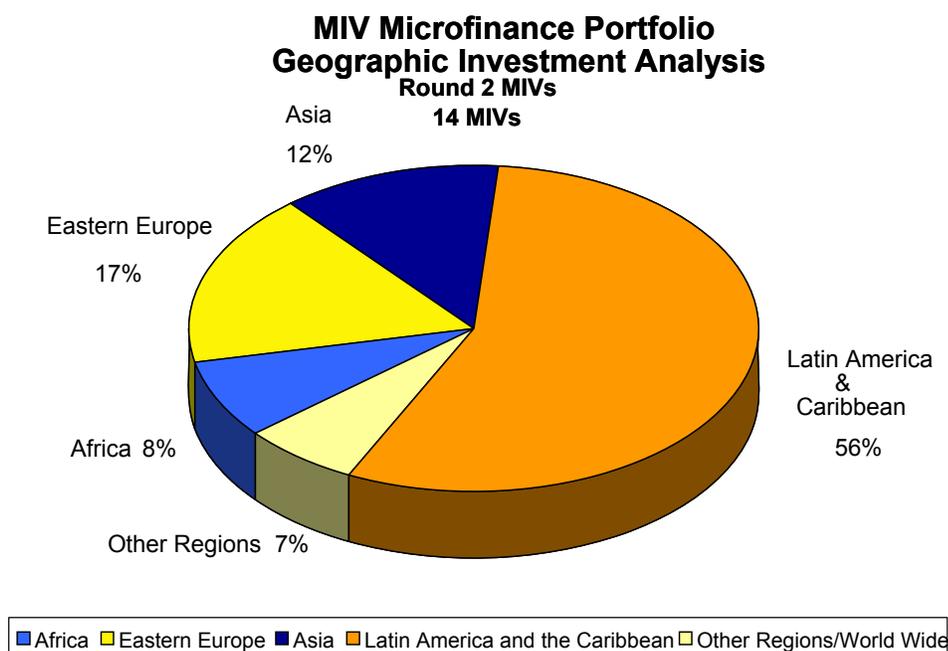
the *responsAbility* fund with an astonishing 455% growth rate in 2005, followed by the *ASN NOVIB* fund (now known as *Triple Jump*) and *Blue Orchard Microfinance Securities* with 122% and 114% growth respectively.

Microfinance Portfolio Growth
Round 2 MIV Survey
2004-2005



Not surprisingly, the more commercial MIVs tend to invest in debt. Most of the equity investments of the 54 MIV in the sample were made by one entity: ProCredit Holdings. As the name already suggests, this is not a ‘fund’ but a holding company controlled by IPC, Germany firm which manages highly successful MFIs in Eastern Europe, Latin America and Africa. ProCredit Holding is different from other MIVs in that it does not see itself primarily as a conduit for investor money to microfinance, but as a tool through which its owners control a network of MFIs. Other MIVs still see equity investments as comparatively risky and they are aware that exits from equity can be difficult. As the debt market becomes more competitive and the equity market becomes more transparent and offers real exit alternatives, a secondary market will develop and commercial MIVs will become more important players in equity as well.

Geographically, MIV microfinance portfolios are heavily concentrated in Latin America. As competition for top tier MFI investments increased, MIVs are beginning to look to other markets such as Eastern Europe and Central Asia. Africa remains under-served by MIVs.



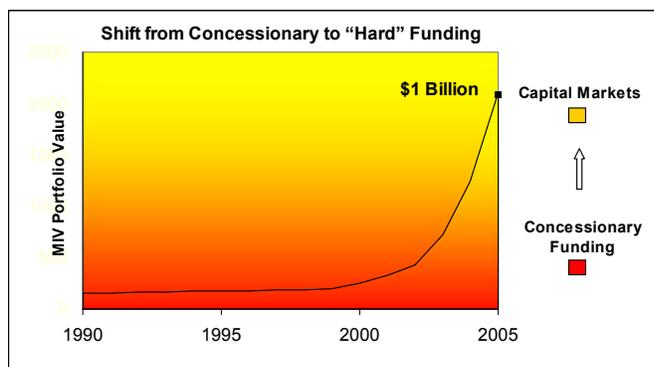
Changing Funding Sources – Funding “Hardens” as MIVs Grow

The growth of microfinance over the last decade has been remarkable but it has still penetrated only a relatively small part of its potential market. A preliminary survey conducted by CGAP² indicates that growth of MIVs continued at the same pace in 2006 and that the disbursed microfinance portfolio of all MIVs reached \$ 2 billion by the end of the year. Given the demand, rapid growth is likely to continue. Today’s flow of funds through MIVs therefore is still only a small fraction of what it will be in the future. As MFI demand for funding increases worldwide from tens of billions to hundreds of billions of dollars the amounts of money raised by MFIs from commercial sources will be very large. Most of those funds will be raised in the countries, where the MFIs are located. But a smaller part of their funding – historically between 15% and 20% - will be raised internationally. That is the market served by the MIV industry.

² Consultative Group for Assistance to the Poorest, Washington DC, USA, a donor coordination mechanism specializing in microfinance.

Projecting past patterns into the future is not a good way of forecasting demand. Nonetheless, such projections do convey an idea of the orders of magnitude we will be dealing with. If the microfinance portfolios of MIVs continued to grow at the same pace as they grew between 2003 and 2006, they would reach about \$20 billion in 2010. Clearly, actual growth rates will vary, but it is equally clear that the MIVs will have to mobilize very large amounts of capital. In the early days MIVs obtained their funding nearly entirely from donors. Then, in the last five years or so, International Financial Institutions (IFIs) and investors willing to lend on concessionary terms became the dominant funding source for many MIVs. More recently MIVs have turned to commercial investors. The CDOs (Collateralized Debt Obligations) issued since 2004 bear testimony to this progressive hardening of the terms at which MIVs fund themselves. MicroRate believes that this shift to more commercial funding sources will continue and even accelerate

So far investors have often been microfinance enthusiasts. For many of them, it was enough to know that their money would go to microfinance and that they would recover their principal. If



in addition they earned a small return as well, that was welcome news, but it was not a decisive factor in their investment decision. Development MIVs cater to this market. The largest one of them (Oikocredit), for example, caps returns to investors at 2%. Other MIVs have similar restrictions. But the pool of enthusiast

investors is not large enough to meet future MIV funding requirements. As MIVs grow and multiply, they have to deal with investors seeking real double bottom line returns and eventually with true commercial investors. This is already visible in the CDOs, which are aimed at a more commercial public. To attract investors, CDOs pay relatively high interest and they protect senior lenders through a large cushion of subordinated funding.

Although MIVs already experience a significant "hardening" of the terms at which they raise funding, we are still at a relatively early stage of the transition from concessional-, to market-

based funding. One reason is that we are seeing a – no doubt temporary – disequilibrium between the demand for foreign funding from MFIs and the supply of funding raised by MIVs. Astonishingly (considering their fast growth), that disequilibrium today favors the microfinance institutions. They cannot easily absorb the funding which is being raised by MIVs. MicroRate has observed that well-known MFIs in particular are being flooded with funding offers, most of which they are turning down. This phenomenon is temporary because in part it is driven by a fad. The publicity surrounding last years’ Peace Nobel Prize has created the impression that microfinance is a kind of “wonder-drug” that will abolish poverty in the world. That is of course nonsense. Microcredit is a powerful tool that allows certain people – the “productive poor” - to lift themselves out of poverty. But by itself it will not abolish underdevelopment. Far from it. Indeed, in the wrong hands, microcredit can be outright dangerous.

Nonetheless the extraordinary publicity surrounding microfinance has prompted many investors to look for ways in which they can put their money into this activity. Whenever supply exceeds demand, prices drop. Microfinance is no exception. Today, MIVs lend at rates which would be normal if the loans were being made in developed countries, but which ignore the risk posed by most of the countries where MFIs are located. Likewise, MIVs offer returns to investors, which again don’t account for the fact that the money goes to relatively small financial intermediaries, which make unsecured loans in often unstable countries. A two-, to three percent return is what most MIVs have so far been able to achieve for their investors. Very few have been able to do better.

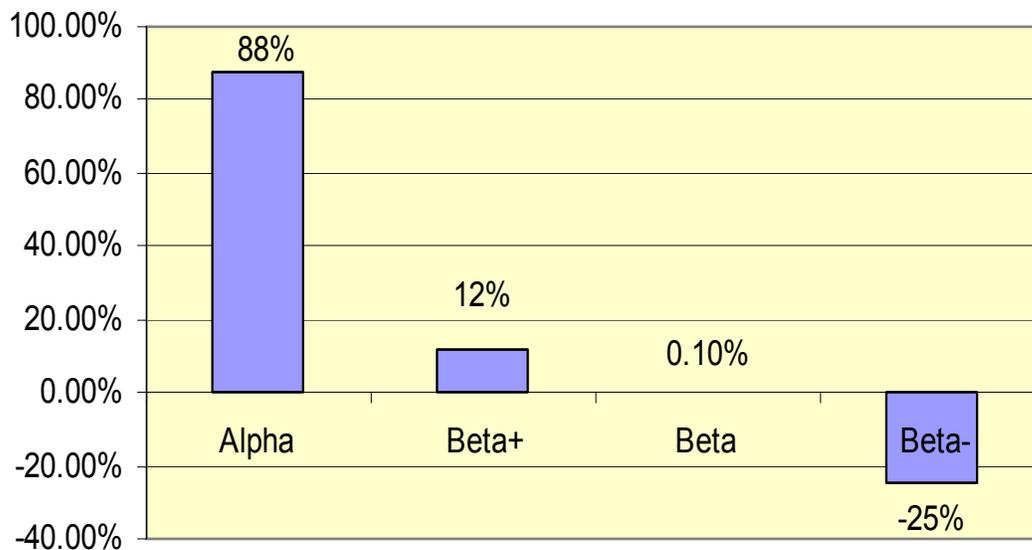
The ‘Crowding Out’ Controversy

The impact of oversupply on returns earned by MIVs is made worse, because official development institutions have been slow to react to the rapid growth of MIVs. Rather than stepping back and allowing private funding to flow to the most creditworthy MFIs these “IFIs” have in turn increased their lending for microfinance. To make matters worse, they have concentrated their funding on the same top-rated, creditworthy MFIs that are the natural target of private lenders. A recent report published by MicroRate³ documents this phenomenon.

³ Role Reversal – are Public Development Institutions Crowding Out Private Investment in Microfinance? MicroRate, March 2007.

In 2005, Development Institutions strongly expanded their lending to top rated MFIs. In all of these cases, a number of MIVs were also trying to lend to those same microfinance institutions, but they were unable to match the terms offered by official lenders. In other words, public development institutions are crowding out private lenders.

**International Financial Institution's
Lending to Latin American MFIs Rated by MicroRate 2005**
Growth Rates



In 2005, IFIs **increased** their investments in the *strongest* MFIs and **decreased** their investments in the *weakest* MFIs.

At first sight, the behavior of development institutions is puzzling, since they are supposed to catalyze private funding, not compete with it. Their own policies require them to take risks private investors are not yet ready to assume and to pave the way for commercial funding flows. But on closer inspection, the behavior of these official development institutions follows a certain logic. Microfinance is recognized by public opinion as being highly developmental. By building up sizeable microfinance portfolios, official development institutions signal to the public that they too are involved in development. If the goal is to establish a developmental alibi, then the size of the loan becomes more important than its impact. In this so-called 'trophy lending', the development institution tries to lend to MFIs as much money as possible, with the least expense

and at the lowest risk. Since it is much cheaper and less risky to make a few large loans to top MFIs than to lend to small, less developed microlenders, the logic that led development institutions into ‘trophy lending’ becomes understandable.

Trophy lending is being practiced by virtually all large development agencies. In its ratings of top-level MFIs, MicroRate has found recent loans from a virtual “who-is-who” of the official development world. All these MFIs have in common in that they have easy access to funding – both local and foreign – and that they do not need the loans offered to them by development agencies. MicroRate has heard MFI managers wearily describing being pursued by IFIs who literally outbid MIVs in the competition to place loans. In two recent cases involving two Washington-based international organizations, these development agencies “sweetened” their offers to two reluctant borrowers with free Technical Assistance grants, to persuade MFIs to take their money. Among development agencies KfW, the German development bank, has the distinction of having the largest microfinance portfolio. IFC, the private sector arm of the World Bank and AECI, the Spanish Government development agency are disputing second place. Whereas the microfinance portfolios of KfW and IFC contain a mixture of trophy loans and operations that actually have some developmental merit, the same cannot be said in defense of AECI. No other development agency known to MicroRate so consistently ignores whether the recipients of its loans actually need their money. AECI seems to pursue one goal, and one goal only: to place the annual allocation it receives from the government budget for microfinance as quickly, cheaply and safely as possible. Developmental considerations are seemingly not allowed to interfere with this process.

Outlook

Microfinance is beginning to penetrate international capital markets. Originally aimed exclusively at “socially responsible investors” MIVs are now raising their sights to more commercial sources. Eventually, microfinance will become a mainstream investment opportunity. The present disequilibrium between supply and demand will work itself out. The Development Institutions, which have helped create this disequilibrium have already begun to review their practices - the days of the ‘trophy loan’ are probably numbered. MIVs are penetrating international capital markets with astonishing speed and as this process continues,

their characteristics will more and more resemble those of regular investment funds. Their lending rates will reflect risk – which they don't do yet – and their operating costs will come down. All of this will translate into higher returns for investors.

This process of transition from largely philanthropic funding to completely commercial capital is highly unusual, as a recent report commissioned by the World Economic Forum⁴ concludes. Such a transition holds unprecedented promise in that it taps the vast resources of the markets, but it also presents substantial dangers if “significant new blended value investments turn out to be founded on poor due diligence or faulty risk management”. A few imprudent investments could set back the transition by years.

Under the present conditions of over-supply of funds and of over-enthusiasm for microfinance, the stage is set for irresponsible investments. To date, in a comparatively benign political and economic environment, there have been virtually no failures of microfinance institutions. This cannot last. Economies move in cycles. Moreover microfinance is particularly vulnerable to populist rhetoric (“Why should the poor pay more for credit than the rich?”; “Credit is a human right!”). Not long ago, MFIs were still too small to attract the attention of politicians, but that has changed. We have already seen populist outbreaks in India, Bolivia and Ecuador during the last year. Others are sure to follow. If economic or political factors will not cause some MFIs to stumble, then human factors will. Some managers will turn out to have misjudged the risks they face and their MFIs will get into difficulties. Those difficulties will feed through to the Funds that lent them money and eventually some investors will suffer losses. None of this is particularly worrying. It happens in all sectors of the economy all the time. To the contrary, a mild correction would be a healthy thing: it would allow microfinance to find its limits. In that sense it can be seen as a necessary part of growing up.

The challenge is to keep this correction from triggering an over-reaction. Periods of exuberance often bear within themselves the seeds of a backlash. At MicroRate we see greater transparency as the best defense against that happening. Over-extended MFIs and risky Funds are not the

⁴ Blended Value Investing: Capital Opportunities for Social and Environmental Impact. World Economic Forum, March 2006.

greatest danger facing us. The greatest danger lies in risks investors cannot see. At the level of MFIs, much has been done already to create greater transparency. MicroRating International, the recently concluded alliance between MicroRate and M-CRIL, the worlds two leading specialized microfinance rating agencies, rates about 130 MFIs each year. Investors have ready access to a detailed analysis of the strengths and weaknesses of these microfinance institutions. But the same is not true for microfinance investment vehicles. Apart from what these Funds are saying in their promotional material, no data are available on their investment policies, their track record or the composition of their portfolios. Investors who do not have the resources to analyze Funds themselves are essentially blind. That is a dangerous state of affairs, which must be corrected before microfinance can be fully accepted by capital markets.

In the debate over foreign funding of MFIs, it is easy to overlook, that the extraordinary growth of microfinance is based largely on local funding. Borrowings from local banks, savings and retained earnings (in that order) have all been more important sources of funding than foreign borrowing. Nonetheless, access to international capital markets could one day prove to be crucially important for MFIs. Looking into the future, funding requirements are likely to be enormous, because the potential demand for microcredit is so large. For a number of years, developing countries have enjoyed unprecedented liquidity. Banks had plenty of money to lend and MFIs had little difficulty in funding their growth. But as this growth continues at a fast pace – at a 40% growth rate, the size of an average MFI nearly doubles every two years – microfinance institutions will eventually reach the limits of local savings. If developing economies fall back into the kind of illiquidity that characterized them in the 80s and 90s, then those limits could be reached quite soon. When that happens, growth of MFIs will suddenly depend on access to foreign capital markets.

Now therefore, is the time when the tools must be forged that make this access possible. The well managed and transparent Funds that deserve investors' confidence, the information infrastructure that allows markets to measure risk, the mechanisms that protect against foreign exchange fluctuations, must be created now. Instead of competing with private MIVs, official development organizations need to help forge those tools.