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Positioning Microfinance Institutions for the Capital Markets

"If it talks like a duck, walks like a duck, and looks like a duck, then it's a duck"

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Abstract

This paper explores key elements of the microfinance industry as they relate to increased access to capital markets. It identifies specific areas in which the microfinance industry can consider making improvements for better access to investment, including industry language, organizational behavior of microfinance institutions, and deal structure. These areas were identified based upon more than three-dozen conversations with investment professionals, review of industry research, and practitioner experience.

The current predominant industry approach in microfinance regarding the raising of capital presents challenges to attracting investors. Most institutions remain steeped in a non-profit mindset, seeking donor support. For microfinance to be successful in raising private investment, institutions must orient themselves in a new direction. There is, however in fact, a growing sophistication among a strong, vocal minority towards capital investment and an increasing number of successful examples of these investments. Private capital transactions are highlighted, as well as specific suggestions of ways for MFIs to increase their likelihood of success in this arena.

Biography & Acknowledgements

Drew Tulchin is currently a Program Officer for Grameen Foundation USA (www.gfusa.org) responsible for the High Growth Partners Project and Capital Markets. Grameen Foundation USA is dedicated to empowering the world's poorest by supporting sustainable microfinance institutions. He was previously a Partner of Social Enterprise Associates (www.socialenterprise.net). The company provides services and research in new ventures, microfinance, and non-profit earned income strategies.

Mr. Tulchin's professional experience includes work with for-profits, non-profits and in government. His consulting spans four continents. Before Grameen, he contributed two years to Prisma Microfinance, a for-profit company 100% financed through private investment.

He has written dozens of business plans, including co-authoring Prisma's award winning *Global Social Venture Competition* plan and a Ford Foundation study entitled *Microfinance's Double Bottom Line*, a version of which received a prize from BYU's *Center for Self-Reliance*.

Mr. Tulchin received his BA, Cum Laude, from *Washington University,* St. Louis, which included a study abroad year at the *University of Sussex*, England. He earned his MBA from the *University of Washington,* Seattle, where he received the Leadership and Entrepreneurship Award from the *Graduate Business Foundation*.

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Positioning Microfinance Institutions for the Capital Markets

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I. INTRODUCTION

A significant challenge for microfinance, to serve as a sustainable poverty alleviation tool, is reaching sufficient scale to fulfill demand for financial services. Microfinance analysts estimate only 10% of the market has been penetrated;[1] total market potential is $300 billion.[2] Satisfying demand requires exponentially increasing cash flows, with existing funding resources insufficient. Donors, for example, account for less than $1 billion a year.[3]

To address this shortfall new capital sources are vital. The capital markets are an attractive option, but accessing investment has, to date, fallen short of expectations. In the words of an evaluator of ProFund, one of the oldest microfinance investment funds, "It appears the curve [of private investment] should be shifted out and flattened…the private sector response will take longer and be smaller than anticipated."[4]

There is an American saying, "If it talks like a duck, walks like a duck, and acts like a duck, then it's a duck,"[5] meaning that actions and appearances must be in sync. For microfinance to engage financial markets, it must approximate established 'products' now consumed in that marketplace. Much work is required for microfinance institutions (MFIs) to grow as an asset class and, thus, increase investment potential.

This paper explores what 'ducks' look like. It provides insights for investors and recommends actions for MFI managers. Investment examples are illustrated. Commentary was culled from industry documentation and practitioners' remarks. In addition, more than three dozen conversations were held with investment professionals / financial managers.

II. UNDERSTANDING THE CUSTOMER: INVESTORS IN MICROFINANCE

For the microfinance industry to access more capital, it must understand their sources. Microfinance managers, the 'sellers', must know whom there are soliciting for capital – their 'customers'. This section considers three target segments: donors, investors, and socially responsible (SR) investors.

DONORS

Microfinance owes much to international donors, and microfinance institutions know well how to appeal to this target group. Microfinance networks are highly effective at showing figures like cumulative money lent (and repaid), total number of loans made, portfolio size, and a low average

[1] Littlefield, E. *Donor and Investor Support of Microfinance*. CGAP Powerpoint presentation, 2001. See also works by Jannson, T, Inter-American Development Bank
[2] See CGAP, MicroCredit Summit, and others.
[3] Rauenhorst, M. Deutsche Bank Microcredit Development Fund, at Columbia University presentation, 3/2003.
[4] DiLeo, P & Cuadra, M. *Evaluation of ProFund.* April, 2002
[5] Term with many attributions. One prominent etymology was for politicians in the early twentieth century to identify if foreign political leaders were Communists. If they acted like one, talked like one, and behaved politically like one, it was commented, they were considered to be Communist whether they said they were or not.

loan size. Industry literature commonly provides moving profiles of borrowers, and the impact small loans have on their lives.[6]

Donors value 'good' - social impact and community change. Donations aim to maximize social benefits in line with their 'mission' and in accordance with giving guidelines. 'Free money' (some argue there are costs even if it is not expected to be returned) is for charitable means.

While donors are valuable contributors, they are not the most desirable target group for MFIs. They are not a sufficient or sustainable source of funds. Donor interests' are fickle, their support is often temporary, staff typically lack specialization, and strategies can be vague.[7]

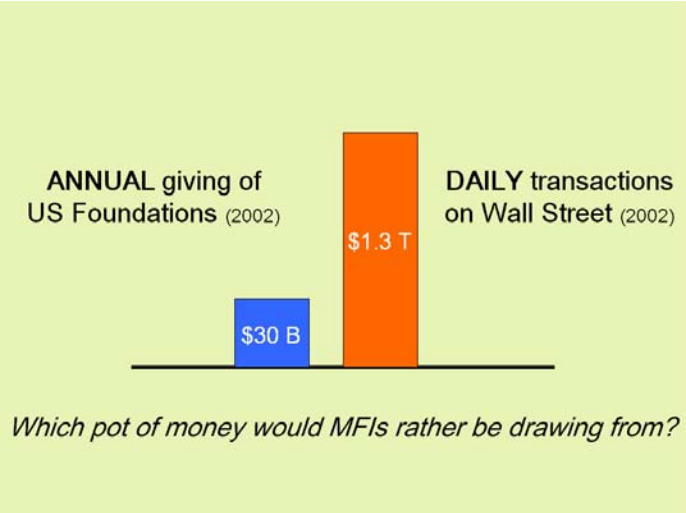
From a business perspective, this segment is not growing and its loyalty is questionable. For example, United States (US) foundation giving was $30 billion in 2002.[8] Disbursements to US non-profit organizations (NGOs) nearly doubled through the 1990s. The number of NGOs also doubled in that time.[9] Since 2000, giving is down as much as 20%, largely due to low stock market returns, with the result that many NGOs struggle to meet their budgets.[10]

INVESTORS

For the framework of this paper, investors are defined as those providing inputs to the capital markets. Investors are not one monolithic entity. There are numerous populations with interests, such as 'Angels' (wealthy individuals), Institutions (insurance companies or pension funds), commercial banks, and 'The Street' (Investment Banking characterized by Wall Street). While characteristics do vary, this paper emphasizes the common denominator of behaviors and perspective. Capital markets are larger than the donor / foundation supply – $1.3 trillion transacts each day on Wall Street.[11] To date, investor participation in microfinance has been heralded, but limited. Regardless, it remains valuable as even miniscule access by microfinance to this pool of funds is a sizeable victory.

[6] See network newsletters i.e. Opportunity International, ACCION, Women's World Banking, ProMujer, etc.
[7] See Foundation Strategy Group (www.foundationstrategy.com) and their publications by Kramer, Mark and Porter, Micheal, particularly Philanthropy's New Agenda, Creating Value. Harvard Business Review, #99610 1999. Also, Helms, B & Latortue, A. *Tackling Aid Effectiveness from the Top: Microfinance as a Test Case*. CGAP 2003
[8] Guidestar (www.guidestar.org) Giving Annual Report, 2001
[9] IRS report on non-profits
[10] Foundation Center Annual Report data available at (http://fdncenter.org/funders)
[11] Reported in the popular press by Thomas Friedman in Newsweek and in *The Lexus and the Olive Tree.*

Figure 1 – Funding Comparison



As a target market segment, investors have different interests from donors. Broadly speaking (not universally, but stereotypically), investors seek to maximize return, dislike uncertainty, and weigh risk against potential return.[12] Risks, including country, currency and organization, are to be identified, measured, mitigated, and compensated for with higher returns. This behavior is how banks and some MFIs assess their customers.

Investors are interested in proven track records and documented performance. They require data, like financial reports and ratings, to inform their decision. Historical and current documentation is important, whereasdonors are more willing to support based on information about current need and future potential). For example, American banks outright reject businesses with less than two years of tax returns.[13] Investors find 'comps' or comparable choices helpful to weigh against each other for an investment decision. This can be microfinance vis-à-vis another option or multiple institutions within microfinance. While 100-200 MFIs have well documented successes, most organizations' numbers do not yet stand-up to attract investors. Fewer than 10% of the MFIs counted by the MicroCredit Summit are profitable.[14] From this perspective, it is understandable why investors have remained largely on the sidelines.

SOCIALLY CONSCIOUS INVESTORS

A third customer segment offers great potential for MFIs. Socially Conscious Investors (SCI) value the '*Double Bottom Line*' – financial, as well as social return. The term Socially Responsible Investor is also used, but we believe Socially Conscious term better reflects peoples' choices and motivations. This meshes with the microfinance industry's focus on financial performance and social benefits. The socially conscious investing universe is characterized by three activities: shareholder activism,

[12] See Jansson, T. From Village to Wall Street, IADB
[13] Conversation with multiple commercial lenders.
[14] Microcredit Summit (www.microcreditsummit.org)

social screening, and community investing.[15] The latter is of the greatest interest to MFIs, and several organizations, including the Calvert Foundation and Blue Orchard, already invest in the sector.[16]

It is a significant market, with $2.4 trillion in assets. 1 out of every 9 professionally managed dollars in the US is invested in a SR vehicle.[17] Community investing is the smallest piece at $15 billion, including US investing,[18] but this entire pie is the fastest growing segment of the financial market. There is an apparent match in interests between what SCIs value and MFIs' value proposition in mixing stereotypically moderate financial return with quantifiable social value creation.

THE INVESTMENT OPPORTUNITY

Two current market dynamics provide the microfinance industry increased opportunity for access to the capital markets. The first is *return malaise*. In the 21st century, the US stock market experienced three straight years of decline, the worst period since the Great Depression.[19] Traditional alternatives to US equities are also not particularly attractive – US T-bill returns are anemic; the international stock sector (typically a counterbalance to the American market) is weak; the US dollar is low vis-à-vis the Euro; and gold prices have already appreciated as investors fled to quality. Although the stock markets have rebounded significantly, investors are wary. As the 'baby boomer' generation plans for retirement, the amount of money that has gone into 'the market' is exponential. Investors are open to asset classes with good prospects.

Secondly, *microfinance data trends are increasingly positive*.[20] The industry has experienced sustained growth rates of over 30% for the last decade. Select institutions worldwide have strong track records, like double digit Return on Investment (ROI).[21] Aggregate industry portfolio value has reached the billions, attracting more attention. Relatively uniform organizational structures make MFIs comparable, and the market aligns uniform best practices.

To drive new financing, microfinance needs to capitalize upon these two factors. Just as MFIs increasingly cater to meet client needs by designing retail products and aligning operations, the same practice is needed to attract investors. The industry must package its strengths attractively and counter its weaknesses *relative to other asset classes*. MFIs must tailor, and effectively pitch, new investing 'products' for this valuable 'customer' – i.e. investors.

III. TALKS LIKE A DUCK – USE OF LANGUAGE IN THE MICROFINANCE INDUSTRY

In the effort to appeal to investors in the capital markets, one factor that MFIs should attune to is *language*. While it is not necessary to present deconstruction theories promulgated by post-modernists like Foucault, language is a primary form of communication and behavior indicator. Catering to investors' actions and emulating what they say increases commonalities.

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[15] See Social Funds (www.socialfunds.com)
[16] See www.calvertfoundation.org & www.blueorchard.ch)
[17] Data from SRI World Investment (www.socialfunds.com) and in conversation with Kristin Martinez, Principal, Sound Point Ventures, (www.soundpointventures.com). Most SR investing is currently in screens.
[18] Coop America & Socialfunds.com, interview with staff
[19] Wall Street Journal article 6/03.
[20] Data gathered from various sources including: Microcredit Summit, Microfinance Gateway, Virtual Library on Microfinance, and others.
[21] The Mix Market and MicroBanking Bulletin are excellent sources. ADOPEM in the Dominican Republic, for example, posted an average annual ROE of 28% since 1998.

A first consideration is defining the scope of microfinance. It is most often considered a field of international development, which carries a donor connotation.[22] Given maturation, size, and world-wide reach, however, an investor orientation as an industry is reasonable.[23]

Microfinance behavior is not the most conducive to outsider participation. It promotes its own standards (i.e. best practices) and systems (like microfinance specific ratings). Although these efforts do increase transparency and standardization, they also obscure ready analysis by outsiders. Evaluation tools are increasingly specialized, thus decreasing comparability with other development or investment choices. One financial manager commented that microfinance ratings were a good step but only marginally helpful if they did not evaluate the MFI as an investment or as an asset class.[24]

A greater challenge within the industry is the divergence of opinion on 'identity' or 'direction,' which loosely connects to the 'poverty versus sustainability' debate. There is an increasing disconnect between the assertion of financial success and the continuation of subsidized funding. Microfinance as a body needs to transcend this divergence – an extraction of Jonathan Morduch's 'schism' - to accomplish a higher, underlying goal: raising the money necessary to give impetus to institutions to endure as tools for poverty alleviation. Towards this end, language may represent a larger ideological issue within microfinance.[25]

Language promotes identity, positioning, and marketing. For example, microfinance's 'best practices' emphasize financial and operational self-sufficiency, called FSS and OSS. But, investors value profitability and net income. Microfinance refers to outreach and clients, while businesses count customers. (Note: in many languages, client is simply a more universal term). MFIs discuss strategic plans for funded projects, not business plans to achieve marketing goals.

Table 1 – Language Comparison

Donor Oriented Language	Investor Oriented Language
Clients	Customers
Outreach	Marketing
Sustainability	Profitability
Socially Motivated Returns	Financially Motivated Returns

For best customer messaging, even if seemingly superficial, developing an investor-oriented language is a step that is firmly in microfinance managers' control. Some argue that commercialization is better left for later in an MFI's development when it is transforming to a regulated entity. This does not preclude a business mindset from the onset. Changing organizational culture is difficult.[26]

[22] E.g. Rhyne, E. & Peck Christen, R. *Microfinance Enters the Marketplace*. One of many examples.
[23] Helms, B. *Microcredit for enterprise development vs. microfinance as an industry: what is the difference?"* CGAP Occasional Paper.
[24] Conversations with investors, 2002.
[25] Morduch, Jonathan. *The Microfinance Schism*. World Development Vol. 28, No. 4, pp. 617-629, 2000 & Woller, G., Dunford, C., & Woodworth, W. *Where to Microfinance?*
[26] McCarter, Elissa. *Tying the Knot: A Guide to Mergers in Microfinance*. Catholic Relief Services, 2002.

Given the prevailing conventional wisdom of three to five years of subsidized funding to obtain sustainability (a.k.a. profitability), adopting business language indicates (but does not guarantee) a dedication to such principles, instead of instituting them later.

There is presently a linguistic difference between most MFIs and investors. While a seemingly minor point, it epitomizes the differences between the two populations. By understanding and addressing this difference, MFIs can reduce a barrier to investment.

IV. LOOKS LIKE A DUCK: MFIS TO RESEMBLE OTHER CAPITAL MARKET INVESTMENTS

This section explores the MFI image, how it differs from investor expectations, and potential fixes for this divergence. Greater access to financing may be achieved by modeling capital-raising in microfinance after other successful investments. Although there is an increasing amount written on private investment in microfinance,[27] there is little literature comparing microfinance investments to other businesses and similar asset classes. There is even less matching Socially Responsible Investors to MFIs and how they make their selection.

The stereotypical non-profit image, regardless of true performance, is of an entity with a social mission, a board lacking governance expertise, an organization with a weak balance sheet, and managers' performance metrics – driven by donors – including esoteric items like average loan size and financial self-sufficiency. Crassly, MFIs, 95% of which are non-profits, are seen as informal institutions run by social workers to help poor people.[28]

Naturally, there are a number of fantastically run MFIs with excellent track records for which this is demeaning. However, given *investors' perceptions* (gathered from dozens of investor communication), this remains a valid perception critique that must be taken seriously. A successful MFI, a 'diamond in the rough' faces the dual challenge of demonstrating its merits to investors and overcoming negative images.

Investors, as a defined segment, are not motivated to educate themselves sufficiently to understand this investment opportunity. An investment in microfinance must be on par or better than other choices and provide comparable risk adjusted return. Furthermore, there must be enough data available to inform due diligence.

MFI behavior can address the investor perspective. Investors respond to physical spaces that convey good business - attractive, professional, and clean. They value managers who are able to produce frequent and consistent financial reports. Investors desire staff who can interpret financial data and act upon it. Metrics tracked should inform investment performance and goals, like sales targets, budget vs. actual accounting, and ROI.

An investor has expectations going into an investment. Equity implies a specific ownership share along with a proportionate guarantee of access or board representation. Directors own the enterprise. Employees should be provided ownership as an incentive (dot-com stock options, despite the bubble bursting, produced wealth in successful institutions).

[27] Inter-American Development Bank has published some very good work, available at www.iadb.org. "Private investment" in Microfinance Gateway's publication database yielded 96 matches (www.microfinancegateway.org).
[28] Various industry literature, for example CGAP, Microcredit Summit, IADB.

POTENTIAL REMEDIES FOR MICROFINANCE INVESTMENT

The following remedies are offered as ways to mitigate investors' negative stereotypes of MFIs.: 1) making a professional presentation, 2) putting the house in order, 3) presenting meaningful metrics, 4) providing solid governance, and 5) detailing ownership.

1) Professional Presentation. MFI management must balance social drive with financial performance. MFIs are past the stage that it is enough to do 'good work' to help the poor. The industry can (and must) formalize without abandoning its original mission. Physical locations should be comfortable for customers (poor people) to enter, but look professional. An orderly, clean space also improves the working environment for staff. Staff require responsible attire, uniforms, or at the very least, identification. Promotional materials can be comprehensive, without being expensive and flashy. While cultural appropriateness is important, content should be easy to understand and have correct spelling.

Professionalism extends to management, as well. There is an old adage, 'you get what you pay for'. An organization needs to hire experienced staff at reasonable wages and ensure existing staff are properly trained. Organizational development literature documents that investment in human resources pays for itself twice over through increased productivity, reduced turnover, and less required management oversight.[29]

A leader's challenge is to do what is best for the organization. This includes bringing on new staff that may be different from him/her. It could also entail having the wisdom to see the necessity to bring in someone above them or even to step aside, a difficult decision.

2) 'House in Order'. Because of the double standard of perception by investors irrespective of performance, mentioned above, MFIs need accurate documentation. This includes up-to-date financial books and a management information system (MIS) that gathers requisite information to monitor performance. A good MIS is not necessarily a technology-heavy solution. Rather, it should be efficient and easy for staff to understand and use. Data produced should inform management decisions.

Business-like presentation includes many aspects. An easy step is producing good accounting books available on a monthly, if not an instantaneous, basis. Reports should comply with local standards and ideally international ones (like GAAP and FASB) with audits conducted regularly. These should be made available in a transparent fashion through publicly available annual reports. Organizations should have proven service records and demonstrate a customer focus, validated in focus groups, surveys, etc.

3) Meaningful Measurement Metrics. MFIs measure a large number of performance indicators as donors have varied and diverse requirements. Industry 'best practices' seek standardized measurements.[30] Many MFI metrics, however, like average loan size and total clients to date, do not explicitly address investors' concerns. Investors are interested in performance related to the investment. Their bottom line is Net Income (NI) and calculating the resulting ROI. They care about the implications of information and management's analysis as it pertains to investment risk.

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[29] Conversation with private sector managers & Executive MBA professors in the US, 2003.
[30] See SEEP Network ratios, www.seepnetwork.com, and CGAP's Technical Guides, www.cgap.org/html/p_technical_guides.html.

Some steps to tackle investor concerns are already undertaken by MFIs. Posting default rates, for example, is helpful. Tracking Portfolio at Risk (PAR) in a payment aging table and adhering to loan write-off schedules is even better. MFI staff should know write-off and loan-loss policies, and these should be codified in a written operations manual. Financial reporting requires a balance sheet as well as an income statement. Transparency improves by tracking indicators for the current period versus previous periods. Documentation should include budget versus actual performance, with discrepancies between the two clearly explained.

4) Governance. Governance is defined as "the process by which a board of directors, through management, guides an institution in the fulfillment of its corporate mission and protects the institution's assets."[31] In order to increase their attractiveness to investors, MFIs need better governance. A key ingredient of good governance is a well-informed board, capable of leading the organization. Non-profits (and some companies) are often criticized for rubber stamp boards stacked with cronies or stakeholders lacking relevant skills. While management's interest in maintaining board control is understandable, there needs to be a balance with professional reliability. This can be achieved through the appointment of outside directors, appropriate board representation, and training.

Management must consider leading the board 'from below'. While not kowtowing to investors, a congenial board environment for investors is valuable. A maturing MFI engages different stakeholders. Consequently, management must consider how the interests of investors, particularly those who own equity and have board representation, will be reconciled with those of donors. For example, some investors will shy away from an MFI table of other investors that includes the IFC and the Norwegian government. Most private investors are not used to working alongside donors and may perceive their motivations for investment as different from theirs. In a scenario where the board is called upon to address a severe dip in performance, private investors may prioritize the preservation of their capital, while donors might value ongoing social benefits of the institution.[32]

There are exceptions, in microfinance and elsewhere, where donors and investors operate harmoniously. The community investment movement has clearly demonstrated that investments offering minimal returns with social value are successful for all stakeholders.[33] The US affordable-housing market is such a segment, even taking into account that it has numerous government incentives for investors, like guarantee funds and the CRA (Community Reinvestment Act) to motivate banks.

5) Ownership Structure. The preponderant ownership structure of MFIs is a barrier to investment. Most MFIs are, or at least start out as, non-profits.[34] Ownership in non-profits is ambiguous. The board has fiduciary responsibility, but assets are considered to be for the public good. Many NGO MFIs operate outside their country's regulatory environment for lending. Investors are understandably nervous about legal recourse to cash out in a negative scenario.[35] Also, exit has not taken place in most MFI investments to date, so even productive investments in microfinance often do not have documented returns.

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[31] Otero, M. *Governance and Ownership of Microfinance Institutions.* DAI, 2001
[32] Comments from interviews with professional financial managers, 2002.
[33] Coop America website, www.coopamerica.org
[34] Throughout most of Latin America, for example, many MFIs are called 'Foundaciones'. They operate as American NGOs do, not like US foundations that are a specific IRS charitable designation for giving away money.
[35] Identified in conversations with financial professionals, 2003.

An ownership structure more familiar to investors is a private, incorporated, and legal entity. They understand this structure and the rules governing behavior are in line with those of their other financial relationships. Legal businesses are more likely to be regulated, and in countries with a viable rule of law, this is a positive step for an investor.[36]

There is nothing that restricts any MFI from being a for-profit entity. In fact, there are numerous examples of non-profits running and/or owning for-profit institutions. Regulated microfinance for-profits, like banks, need to be profitable to maintain a license. In Kenya, K-REP Bank is 25% owned by its non-profit antecedent, K-REP Holdings, similar to BancoSol in Bolivia from its progenitors, PRODEM and ACCION.[37] In Nicaragua, a private entity called Crecer (not to be confused with MFIs in other countries), reported profitable operations with a portfolio over $3 million in 2002, within three years of operation, placing it among the ten largest MFIs in that country.

Two fears of NGOs operating for-profits are taxes and mission drift. Taxes are a part of doing business for profitable entities. While they should be minimized, the argument that they prevent financial self-sustainability is extensive. Paying taxes is a problem an organization wants to have to worry about. For a social service entity, paying taxes can be a contribution to social good and the community. As such, an MFI acts as a role model and a 'corporate citizen' through proper actions.[38]

The second fear is mission drift, that a profit-motivated organization abandons social motivations and poorer customers for more lucrative market segments. This is a legitimate concern, but not a priori. By growing the entire pie, MFIs also grow pieces. An organization that grows by 100% has still increased service to the poor even if only half of its customers are among the poorest. Some institutions argue larger loans afford smaller ones.[39] Larger loans are often to people who are less poor and still carry positive externalities – like increasing community consumption and more promise of employment generation.[40] From an investment perspective, despite prevalent fear expressed in literature and on listservs, this is a red herring. For donor funding, concern is warranted, but for investors, as long as it is transparent and planned, this could be a good alternative.

Table 2 – Critiques of Microfinance Institutions and Potential Compensations

Critique	Compensation
Unprofessional	Professional Presentation
Sloppy	House in Order
Weak governance	Leading boards
No one has ownership	Provide Ownership
Donor based measurements	Business oriented Metrics and reporting

[36] See arguments in documents by ACCION (Rhyne, E.) & Inter American Development Bank, (Jansson, T.)
[37] Otero, Maria. *ibid*
[38] MFI managers comment taxes in a corrupt environment do not serve the common good, so are to be avoided. While understandable, is avoiding the system the best recourse? CARD's CEO expressed he gets positive government response from ministers now that the transformed entity pays taxes.
[39] Prisma Microfinance's award winning business plan and its pyramid portfolio strategy, 2002
[40] Business Development Services Panel, SEEP Annual Conference, 2003

SECTION IV CONCLUSION

The microfinance industry is a potentially attractive asset class for investors. However, numerous behaviors and structures impede potential relationships. Regardless of which investor segments an MFI targets, both general and specific steps are encouraged. While some MFIs already incorporate many of these suggestions; the industry, by-and-large, must overcome its image (perceived or real) as a donor refuge in order to orient itself with a new paradigm that addresses industry activities from investors' perspectives.

V. ACTS LIKE A DUCK – WHAT A DEAL HAS TO LOOK LIKE

International financial market conditions coupled with ever-stronger MFI's track records increase the potential for their successful access to capital from investors. For microfinance to 'matter' as investment vehicles, an MFI opportunity must satisfy desirable deal profiles. Anticipating and working towards this end is an important current need. MFIs need to package themselves better for investors. This section considers investor critiques of MFIs and recommends ways to address them. Critiques include: 1) lack of profitability, 2) small size, 3) weak balance sheets, 4) extensive risk, and 5) poor investment 'fit'. Most of these critiques can be rectified with little cost, but do require management leadership, strategic intent, and time.

CRITIQUES

1) Lack of Profitability. Investors value financial return. Return prospects, the dot-com era not-withstanding, are unattractive for organizations that lose money. Of 10,000 'counted' MFIs, few (below 3%) are financially self-sufficient and have positive net incomes.[41] Institutions need to value and demonstrate sustained profitability.

2) Small Size. Microfinance, despite strong growth, is still a young, fragmented industry. The market, estimated at 66.7 million customers and billions in assets,[42] is respectable but pales compared to other financial sub-sectors. Also, customers are spread over hundreds of countries. US home ownership, on the other hand for example, is exponentially larger and more geographically concentrated. Other international development fields have greater cash flow; donor support for water, for example, is estimated at $30 billion a year.[43]

The majority of MFIs are small. More than 90% have fewer than 10,000 customers. 33% of Microcredit Summit's 2004 data of the 64 million poor people reached by microfinance comes from eight institutions which have above one million customers each, out of 2,572 MFIs. Wall Street prefers 'significant' deal sizes, with $50 million considered a healthy minimum.[44] Therefore, microfinance most likely requires aggregation, mergers, and/or securitization to attract Wall Street.

3) Weak Balance Sheets. MFI income statements garner extensive attention. Balance sheets are also important. Maintaining a good balance sheet takes time, just as developing a bank relationship is a long-term process. Some managers lack complete understanding of the balance sheet and the

[41] Estimation based upon MicroCredit Summit, CGAP, IADB, and Microrate information.
[42] MicroCredit Summit report.
[43] World Bank data, 2002.
[44] Conversations with Investment Bankers, 2003

implications of its interacting parts on their organization. Consequently, this further feeds the perception of MFIs as social workers trying to be bankers.

4) Extensive Risk. Microfinance is risky, despite many MFI success stories and the fact that MFI risk tends to have low correlation with national level risks. One investor quipped, "There are five substantial risk layers between Wall Street and an institution making loans to poor farmers in Guatemala."[45] The Paraguayan Multibanco, a well-known MFI, was taken over by the Bank Superintendent due to conditions that threatened the institution with failure.[46]

Some risk layers are exogenous, like inflation and country risk, affecting even successful organizations. Bolivia's BancoSol was challenged in the late 1990s, partly due to macroeconomic factors. The customer segment is, however, arguably buffered from macroeconomic shocks, as demonstrated by BancoSol's above-average showing compared to Bolivian banks in that period[47] and the high MFI repayment rate even in hyper-inflationary economies or under condition of war.[48] Currency risk is also of great concern for international investors. Individual country risks include weak and poorly enforced laws and contracts. MFIs do not always address these issues. They are rarely primary concerns of donors and do not even appear in some MF ratings.

5) Poor Investment 'Fit'. MFIs must match their deals with appropriate sources of capital. Microfinance as an industry is not one investment. Although donor subsidies originated the sector, they now cloud investor involvement. Despite a minority of examples, *as an industry, microfinance lacks a systematic demonstration of its value proposition for investors*.[49] In extreme cases, microfinance risks a 'black eye' from callously approaching investors, 'shopping' bad deals, and demonstrating a lack of understanding of investors' needs. Such actions, when done by individuals, reaffirm a collective negative stereotype.

Microfinance's donor relationships, particularly regarding subsidies, exacerbate the problem. Donors support institutions with grants and soft money, even among those that can afford to pay market rates.[50] The industry culture accepts five years for profitability. A more rigorous standard is needed, and is possible, without sacrificing mission.

POTENTIAL REMEDIES

Despite these challenges, there are readily available actions MFIs can undertake to mitigate these factors: 1) manage growth, 2) standardize reporting, 3) increase well considered regulations, 4) focus donors' role, and 5) establish appropriate investor-oriented deals.

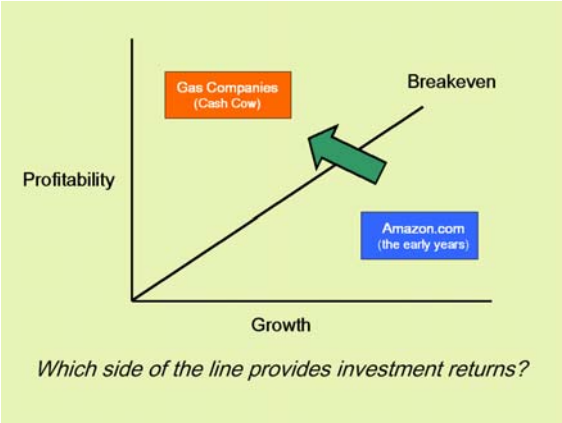
1) Manage Growth. Investors value profit. Managers make choices affecting profitability. High growth reduces profitability. Recent dot-com behavior provides case studies; Amazon.com is a prominent example. The company has doubled in size for years in customers and sales, but has yet

[45] Investor conversation, 2002
[46] Ohio State University Listserv. Banks in Paraguay and throughout the region have also failed, so Multibanco's risk profile should be understood in the larger financial market context.
[47] Jansson, T. From Village to Wall Street, IADB
[48] Or both, as in the case of Fonkoze in Haiti, among many other examples.
[49] Positive examples to be commended include Blue Orchard's recent transaction, Share's securitization to ICICI Bank, and Latin American MFI bond offerings – led by Compartamos in Mexico.
[50] De Schrevel, Jean-Philippe. Comments on donor funding. Reported as a sidebar Pouloit, Robert. *Private Capital in Microfinance: How to turn the Faucet On*. Microenterprise Development Review, Aug. 2002, Vol. 5. No.1 p. 3.

to post a complete year of profits from sales.[51] Growth rates and cash expenditures are throttles, overseen by management, directly driving the bottom line.[52]

Slower growth with greater profitability runs counter to the MFI 'massification' argument but may ultimately be more sustainable for operations by increasing the industry's appeal for investors. Consider the relationship between growth and profitability (graph below). Breakeven is the 45 degree angle, where the two are balanced. Mature entities, like gas companies, are 'cash cows', operating profitably with low growth. Younger organizations, like Amazon.com, value growth and market position, spending liberally to achieve these goals. MFIs typically align themselves with the Amazons. Controlling profitability and growth, and demonstrating managerial control over both will yield increased investment in the long run, a net gain.

Figure 2 – Growth Graph



2) Standardize Reporting. Top tier MFIs perform well, but need better documentation of activities. Industry 'best practices' establish the norms for successful management. However, MFI reporting is neither investor-centric nor in their language. MFIs have complained, and quite rightfully so, about donors having varied reporting requirements. The industry, by establishing standardized reporting, can circumvent this difficulty.

A base format is not unreasonable and is worth getting right. General standards suggest regular, timely information produced from a reliable MIS. Reports should compare the current period with the previous one, with respect to budgeted expectations. A written explanation should be provided for significant discrepancies between budgeted and actual figures.

3) Improve Well-Considered Regulations. Regulations, nationally and internationally, are powerful drivers for microfinance. In countries such as Bolivia and Bangladesh, they drive the market. Regulations move the industry towards more formality and structure, qualities investors value. Bolivia and Bangladesh, among others, have created special MFI designations.

National level regulation is now common. In Latin America, twelve countries have enacted legislation pertaining to microfinance since 1999.[53] It is too soon to scientifically assess their impact. Quality microfinance regulation is difficult given international breadth, specialization, and market size. It is a challenge and is costly for regulators. The quality in rule of law varies as well. In Kenya and Nicaragua, politicians enacted legislation close to election times capping interest rates. The laws drew negative responses from financial leaders, even the central bank, as populist measures. But, they did shape the market in those countries. These examples emphasize the importance of MFI stakeholder involvement in regulation.

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[51] Amazon posted a profit last fiscal year but from 'below the line' one time occurrences, not sales. See financials from Hoover's Online or Yahoo Business.
[52] Higgins, Robert. *Analysis for Financial Management*, 5th ed., Irwin, 1998.
[53] Silva, Samuel "The Devil is in the Details," IADB's MicroEnterprise Americas, Autumn, 2003.

An example of the positive effects of regulation is the United States housing market. Government and regulatory intervention created a market where affordable 20-year mortgages are the norm. The country has the highest mortgage financed home ownership in the world. New Zealand's national regulations recently also encouraged housing investment.[54] This is an excellent area of involvement for multilateral entities and national donors.

4) Focus Donors' Role. Given the microfinance 'funding gap', existing funders need to be involved in efforts to increase industry cash inflows. Microfinance leaders play a role, as do donors. Extensive microfinance investment to date has been from multi-laterals and other donors, not private investors.[55]

Donors add more value using their significant, but limited, funds to leverage additional resources. This requires strategic planning to align donor actions and industry goals, something donors request of MFIs but rarely practice themselves. Donors are encouraged to have a strategic plan, maintain rigorous financial statements, and evaluate their performance.[56] Strategic choices include which sectors to support and, by corollary, which not to support.

Donors' behavior is critical to bringing in additional financing. Their role is most valuable when taking on the highest risk – early, as well as subordinated investments. Also, donors providing guarantees to a local bank instead of direct support to an MFI increase market participation. A donor not experienced in lending should not form a strategy around it.

A last area where donors, particularly multi-laterals, play a pivotal role is in regulation and industry-wide risk reduction mechanisms. An example in Central America countries is the creation of credit reporting agencies. This is an excellent partnership between donors, the industry, and private entities.[57]

5) Establish Appropriate Deals. The microfinance industry best attracts capital by providing desirable investment 'products'. An MFI needs to offer investors a doable deal. It is hard to sell someone a sedan when they are seeking a mini-van. Qualities like term, return, size, underwriting criteria, and monitoring are all controllable. The MFI historic, stereotypical investment request is for very long terms, undefined returns, and unclear exit prospects. These are not 'ducks' an investor values, although some early adopters have participated.

Like any good relationship, a good investor-MFI bond is long term. This is as valuable as an MFI's own customer acquisition and client outreach. In marketing terms, lending has a Customer Lifetime Value (CLV). For example, US mobile phone customers receive free phones for signing a contract. The company incurs this cost because it earns more money from the contract, despite the expense in the current period. This thinking is transferable to MFIs with respect to investors. First deals may be more expensive – in both time and money. A first loan at a high rate of interest and short term to maturity is a 'loss leader', just as most MFIs do not cover all their costs in the first loan cycle. As MFI customers establish their credit histories and repayment track records; an MFI does the same with a bank or investor.

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[54] Commentary by an investor active in that market delighted with strong rates of return with New Zealand government guarantees providing better returns and less risk than his analysis of the microfinance sector.
[55] ProFund is to be commended for having the greatest transparency in providing their financial information on their website, www.profundinternacional.com. AfriCap, a $15 million fund, www.africapfund.com, is another example.
[56] Porter, M & Kramer, M. *Philanthropy's New Agenda: Creating Value*. Harvard Business Review, Reprint #99610. 1999.
[57] It includes IADB, the Ford Foundation, microfinance networks, governments, and other stakeholders.

Appropriate deal structure is important. A legal offering is expensive. It requires outside experts, which makes some MFI managers uncomfortable. When the offering achieves its stated financial goals, the MFI build a track record, increasing future opportunity. Compartamos, a Mexican MFI, has demonstrated this with its bond offerings. The first issuance was expensive and short term. But, it was over-subscribed, whetting investor appetites.[58] After three tranches in the first offering, they have recently issued their second successful offering.

In pricing, broadly speaking, if MFIs expect equity investments and offer little return and no defined exit option in return, their value proposition is more charity than investment. MFIs need to price investment opportunities in line with comparable investments, something most MFIs have not had to do because of the volume of subsidized funds.[59] Many MFI managers shy away from taking on local currency debt because of high interest rates the banks or investors offer. MFIs funded by grants and subsidized debt hold unreasonable expectations that investors will match those rates, i.e. that they will have access to free or almost free money.[60]

There is another calculus MFIs should consider. A CFO can evaluate a WACC (weighted average cost of capital) of the organization's overall financing costs. If an MFI's total capital composition is 80% equity from donations at 0%, the MFI could pay 50% (which seems exorbitant) on the remaining capital they need and their WACC would be 10% (a reasonable amount). This is a particularly valuable perspective if there is some assurance that higher initial debt costs will fall over time, once the MFI establishes a positive track record with the local bank.

Appropriate deal structures can also provide additional incentives to investors. Concerns about exit are mitigated with convertible debt instead of straight equity. Board representation and/or visitation rights are additional bargaining chips. A reticent investor may be enticed through perks like warrants. There are many moving parts to a successful investment. While this increases managers' homework, and in all probability cost as well, it can increase the number of interested investors.

Table 3 – Acting like a Duck

MFI Investment Barrier	Potential Solution
Lack of Profitability	Manage Growth
Relatively Small Size	Merge/Buy Other programs
Weak Balance Sheet	Understand Balance Sheet & Seek Appropriate Changes
Extensive Risks	Mitigate Risks
Poor Investor 'Fit'	Develop More Investor 'Products'

[58] Conversation with Jennifer Meehan from her reports on the subject, 2004.
[59] Blue Orchard commentary.
[60] The author has had numerous conversations with MFI managers who complain of debt that is 'too expensive' when they have more than a 100% margin between the cost of capital and their product, e.g.borrowing at 12%, on-lending at 32%. This gives the old joke 'making it up on volume' some merit.

SECTION V CONCLUSION

While MFIs have yet to mobilize significant investor capital, the industry is in an increasingly better position. The consistent growth, high operating margins, and strong markets enjoyed by several MFIs need to be well packaged to increase their appeal. This may be uncomfortable for the industry, require a change in culture, extensive time and a high cost. However, this is an industry investment in greater access to future capital.

VI. EXAMPLES OF DUCKS - CASE STUDIES

Although real-world instances of MFIs successfully tapping global capital markets are still few and far-between, a growing number of MFIs are developing innovative ways to market their value proposition as an asset class. This section provides three prominent and diverse MFI investment case studies Prisma Microfinance, BASIX and the NICA fund, which have, through a diversity of methods, obtained financing from investors.

PRISMA MICROFINANCE: Private Placement Offering (Equity)[61]

Prisma Microfinance offers affordable financial services to people in Latin America lacking conventional banking facilities. What differentiates the U.S.-based for-profit company from most other MFIs is its private investment capital structure, no grants or donations.

Prisma raised $1.25 million through private investments from accredited individual and commercial investors in the U.S. using registered Private Placement Offerings (PPOs). A PPO is any security (debt, equity or otherwise) made available to a specific number of private, usually accredited or at least High Net Worth Investors.

- In its Series A offering, Prisma converted $550,000 of existing debt to equity
- In its Series B offering, the company raised an additional $700,000 in private capital
- It continues to raise debt and equity through private securities

The greatest advantage of a PPO is a high level of customization. PPOs facilitate tailoring to the preferences of both the MFI and investors, particularly with respect to pricing. They also have relatively low execution costs as compared to other capital market securities.

The primary disadvantage of PPOs to an MFI is that investors hold managers to high standards of accountability, the requirements for funding are clearly (and legally) stated, and the agreement may involve investors in the MFI's day-to-day operations. From the investor's perspective, PPOs' lack of standardization make due diligence complex and can render exit difficult. These, however, do not diminish the utility of PPOs as important mechanisms for MFIs to harness affordable capital.

Aside from Prisma, a few other MFIs have also raised capital via U.S. based PPOs. These include a Haitian MFI, Fonkoze, that raised nearly $2 million in equity to capitalize as a bank and a US-based NGO sponsoring an offering for a Mongolian financial institution.

[61] Prisma Microfinance (www.prismamicrofinance.com)

BHARTIYA SAMRUDDHI INVESTMENTS AND CONSULTING SERVICES (BASIX), INDIA: Micro-loan Securitization[62]

Established in 1996, BASIX has disbursed more than 175,000 loans to poor households in six Southern- and Central-Indian states. In November 2003, BASIX engaged in one of the world's first micro-loan securitization transactions with ICICI Bank, India's second-largest bank, whereby ICICI bought BASIX's portfolio of crop loans. This sale of receivables in the present period based on the anticipated stream of expected future income is a securitization. The deal structure was:

- ICICI paid BASIX Rs. 42.1 million (approximately US$ 1 million)
- BASIX transferred ownership of the entire stream of payments from these loans to ICICI
- BASIX continues to administer the loans and acts as the collection agent
- BASIX provided ICICI with a limited first loss deficiency guarantee to provide the bank with additional security in the case of default

Securitizing loans in this manner is now a standard Wall Street product. Payment streams associated with a wide variety of debt, credit cards to aircraft loans, are regularly resold. With respect to microfinance, securitization holds great promise as a financing vehicle for successful organizations with effective management information systems (MIS) that can track client loan data in an accurate and timely fashion. The next step required is to establish a regular, liquid secondary-market for micro-loan backed assets from which to move these transactions.

NICARAGUAN CREDIT ALTERNATIVES (NICA) FUND: Socially Conscious Investing[63]

Established in 1984, the Wisconsin Coordinating Council on Nicaragua (WCCN) aims to promote sustainable development and social justice in Nicaragua. WCCN's Nicaraguan Credit Alternatives (NICA) fund was founded in 1998 to channel money from socially conscious / responsible investors in the US to MFIs in Nicaragua making loans to poor people.

At the end of 2003, the fund managed $4.1 million in investments and a loan portfolio of $3.85 million. Over 80% of the NICA Fund assets have been raised from individual investors. The fund works as follows:

- Investors lend NICA Fund a minimum of US$ 2,000 and choose a term of 2-5 years.
- They receive interest rates of 0 – 4% depending upon the size/term of their investment.
- The Fund lends eleven Nicaraguan MFIs money in USD at about 10%. Nicaraguan currency is closely tied to the USD and the economy is heavily influenced by dollars.
- The MFIs lend to a micro-entrepreneurs at 17% interest, the legislatively mandated rate in Nicaragua, plus fees

Amy Domini, President of the Domini Social Equity Fund, defines Socially Conscious Investing as "Using one's influence as an investor for *good*." The WCCN's lending activities in Nicaragua fall under this rubric. In fact, the NICA fund, along with other microfinance investments, operates specifically in a sub-set of SCI known as community economic development.

From the investor's perspective, the benefits of products like WCCN's NICA Fund include availability for any investor with low entry amounts, direct involvement in community-based

[62] BASIX (www.basixindia.com)
[63] Wisconsin Coordinating Council on Nicaragua (www.wccnica.org)

economic development. Also, unlike donations, investors receive a return on their investment. These products provide the mechanism to channel a vast pool of capital that is synergistic with MFIs' mission of a double bottom line – financial returns and social value. SRI investors demonstrate a willingness to internalize the social return on their investment and accept a lower financial return.

The primary disadvantage of community investment in microfinance is that the investor arguably does not receive risk adjusted return due to default, lack of collateral and exchange rate fluctuation. While MFI investment performance to-date has been positive, risk is still present. Risk-adjusted financial returns on community investments are typically below those of other comparable investment vehicles. These investments often provide minimal infrastructure and low liquidity, limiting their reach in the investment field because the typical investor doesn't know about them.

VII. CONCLUSION

The MFI industry has progressed tremendously and continues to provide incredible successes for its customers – poor people – while offering great financial promise for investors. Microfinance managers have good reason to be optimistic in creating ongoing and regular relationships with investors that will tap new funds for microfinance. However, specific and concrete steps must be taken by managers in leading their institutions, presenting MFI performance, and communicating with investors, if they wish to succeed in gaining access to new sources of capital. The past behavior of MFIs that attracted donors is unlikely to be as effective in attracting investors. Although there are instances of MFIs raising capital from the financial markets in a variety of innovative ways, these are still a rarity. We collectively must emphasize and support a transition for the growth of the industry, for the betterment of investors, and – most importantly of all – to improve the lives of the billions of people, worldwide, living in abject poverty and still lacking access to affordable capital.

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