Successful Due Diligence When Evaluating Microfinance Investment Vehicles

By Zoran Stanisljevic,
based on an interview with Christina Leijonhufvud of JP Morgan

Introduction

As microfinance institutions (MFIs) continue their quest for more accessible and affordable financing, little information is freely available to the public regarding the due diligence required when evaluating microfinance investment vehicles (MIVs). I recently interviewed Christina Leijonhufvud of JP Morgan's Global Social Sector Finance Group. I was particularly interested in creating a template that institutional investors, equity investment funds, venture capitalists, investment banks, hedge funds, development finance institutions, MIVs and socially responsible investors could utilize to better understand the level of due diligence required. My interview resulted in a general framework that investors and MFIs can utilize to better understand one another's requirements and expectations in order to make informed decisions in meeting both social and financial goals while achieving rational, sustainable industry growth. The following pages contain portions of our interview that highlight the key points.

About the Author

Zoran Stanisljevic is a Research Associate at MicroCapital. His background includes over nine years of combined experience in institutional investment management at State Street Global Advisors and capital markets and investment banking at Wachovia Securities. Zoran can be reached at zoran.stanisljevic@gmail.com.

BASIC FRAMEWORK FOR EVALUATING MIVS

Christina Leijonhufvud: Let me try and give you a basic framework. We start with a standard due diligence checklist, which is organized along a number of categories. The key components that we look at are:

First and foremost, when we look at an MIV from an investment point of view, our very first and most important screen has to do with the people behind the MIV. So basically we look at the GPs (general partners) and what is behind the ownership structure of the MIV. Thus, we look for experienced fund managers that have some experience in this space and a track record within the asset class.

We then look at the staff and spend time in the office getting to know those people.

It's also important to look at investment committee members and structure.

We look at key persons or "key man" provisions. We look at who the owners are of the MIV and what kind of backing they have, as well as the reputation of the owners.

We then go on to look at investment strategy, investment philosophy and process. We want to know that there is a very strong, in-depth due diligence process within the MIV. One of the things that I have become concerned about in the microfinance space (as some MIVs have grown in asset size and perhaps have grown too quickly for their capacity) is that I have seen a tendency to outsource some of the due diligence process to third-party providers. That is something we would like to avoid. If we invest in an MIV, we want to know that we are investing in the capacity to really undertake in-depth due diligence and really stay close to those investments. So that is also a comment on some MIVs that have transformed from directly investing in MFIs to using a "fund of funds" strategy, where they invest in other MIVs. That is also something that we here at JP Morgan would like to stay away from. We are not operating a fund of funds strategy at JP Morgan and do not want to be investing in funds of funds.

We look at the portfolio construction process, the geographic diversification, targets of the portfolio, how they manage the portfolio as well as the investment due diligence process. Generally, this would entail that I or someone from my team would travel (with a portfolio manager from the MIV) to the investment site and go through the due diligence process to understand how this works.

Risk management processes and controls, the credit evaluation process, country risk, regulatory risk, FX (foreign exchange) risk management and liquidity management are all important. We ideally love to hear from the MIV managers that they have lived through a crisis. Frankly, I don't take a great deal of comfort from someone that says, "We have never lost a penny and have never had any problems." I actually like to know that there have been some problems in the portfolio that the MIV has had to manage through, and, as a result, its managers learned some lessons and put in place crisis management procedures.

We also look at the operations of an MIV and what kind of back office support it has, as well as accounting and reporting procedures. We look at who is responsible for valuing the portfolio, by what method they are valuing the portfolio and clearly the regularity of reports sent to investors (and the contents of those reports).

Obviously, we look at investment returns, the historical performance of the MIV and the robustness of the return model behind the fund. We tend to look at the MIV's return model and run our own return models alongside. We stress returns for a number of different (conservative or aggressive) scenarios (such as FX or another factor that is a likely issue). Then we come up with what we think is a reasonable expectation of return. In other words, we don't take return forecasts at face value.

Related to the investment returns, it's important for us to have a very active discussion on the clarity of the social mission of the MIV and impact measurement around that. The MIV may believe that it is actually achieving its social mission just by doing a thorough due diligence process and investing with those microfinance institutions that it truly believes are achieving its social mission; however, we definitely look to see that there is a culture at the MIV and a common vision in terms of the social responsibility requirements.

Naturally there are also other structural issues that come up with an MIV: conflicts of interest, fee structures and things like that. That basically covers the broad categories of the kind of things that we look at.

Rating MIV Managers: Qualifications Necessary for a "Competent" Manager

Christina Leijonhufvud: We have to start off in the microfinance space by recognizing that most of the fund managers in this sector have limited track records; however, we do, first and foremost, like to see a track record, even though it may be a relatively short-term one. It's important for us that we work with fund managers that have built up an experience base in the sector. We are not looking at "greenfield" funds. We like to see the history of the GPs, what kinds of professional undertaking they had before they managed the MIV. We look at how they've hired their staff and the competency of their staff. In some cases the board members of the MIV can be very important sources of expertise, such as private equity expertise on their board or their advisory committees and, if it's a credit fund, significant credit expertise. I am sure you know from your time in credit, that there is this highly subjective element of knowing one's customers. That is really the starting point for us in getting to know the managers and making sure that we feel our values and those of the managers are aligned, with a track record to back it up.

Examining the Operational Structure

Christina Leijonhufvud: I would look out for the outsourcing of due diligence. How much on-site due diligence is performed? Are the MIVs structured and staffed in such a way that they are able to afford and really maintain the level of on-site due diligence to truly manage the risk in the portfolio? So if MIVs are really just doing some indexed approach to investing or they are outsourcing a lot of the analysis of due diligence, then that's a red flag. For us it means that the MIVs are unlikely to be ahead of problems that may crop up in the portfolio in the future. They are likely to be behind the ball when it comes time to manage through crises or portfolio problems. As I mentioned earlier, we are also not particularly interested in the fund of funds strategy for the same reason.

The other structural component that crops up in some MIVs is conflicts of interest. There are some MIVs that operate both as broker-dealers and as investment managers. Some of these conflicts are unavoidable, but it is very important to see that an MIV has procedures in place to guard against and prevent those conflicts from affecting the way in which it invests. Another issue is if the MIV is running multiple funds: How is it deciding to distribute new assets across those funds? If you are an investor in one of those funds, how can you be assured that it is investing that fund without any conflict with the other funds that it is managing?

The other, more obvious issue is that most MIVs are fairly small, although some of them have gotten scalable at this point. Fee structure is an issue, as there have been some funky fee structures (such as charitable contributions carved out) that I have seen in the space that just are excessive, not transparent or highly standardized. On a percentage basis, there are somewhat excessive fee levels. I think we are increasingly getting to a more standardized fee structure like we've normally seen in the mainstream private equity space (a 2 percent management fee and 20 percent of profits going to the GP). I understand that there are exceptions that have to be made for MIVs that are running smaller funds. There has to be a way to cover their cost. We'll still look at funds that charge a bit higher than the 2 percent level, but we like to have that as close to standard as possible.

Key man provisions are also very important to have, especially in the microfinance space. There are usually one or two people behind the MIV that are truly critical to its ongoing operations. Succession plans, really ascertaining that there are strong "number two's" within the organization - those are the kind of things that should be looked at.

Evaluating and Recognizing Signs of Potential Trouble

Christina Leijonhufvud: That often relates to the topic of operations and operational control. As an investor in the MIV space, it's important to have a regularity of reporting sent to us as an LP (limited partner). We like regular LP committees with a very substantive, full discussion of the pipeline and the portfolios that exist, the valuations of the portfolio and issues that are cropping up on that portfolio. We would like to see the GP really out ahead on issues that could crop up. We like the communication channel to be very open and transparent. We do not want LP meetings to be a kind of celebratory gathering. They should be meetings where we really get into the nuts and bolts of how the investing is going and issues on the ground at various MFIs. I'd like to hear in-depth reports of what some of the issues are in the portfolio from the GP and its experience managing challenges in other parts of their portfolios. I think it's really important in that respect.

Assessing Investment Policy and Process

Christina Leijonhufvud: We certainly would spend a few days at an MIV's office with the portfolio management team, investment officers, CFOs and back office people. We would ask them to go through a number of case studies in terms of investments that have already been made and have them walk us through the investment analysis process from A to Z. We look at the very first visit to the potential investee, copies of the very first memoranda and copies of proposals that go to their investment committee; and we talk through with them what kind of discussions they have in the investment committee. We tend to supplement that by making sure we travel with them, whether it's with an investment officer, a portfolio manager or the general partner.

Are Risk Management Measures in Place for an MIV to Manage Its Own Risk?

Christina Leijonhufvud: I think it may vary a bit across MIVs, but I think the key elements of a robust risk management process are:

If the MIV is taking credit or equity positions, then it needs to understand credit quality and the credit profile of the MFIs in question. I think the credit skills within an MIV are very important.

We look at the credit evaluation process. Does the MIV undertake its own credit analysis supplemented with the analysis from the specialized rating agency? How robust is that credit review and credit evaluation process? We like to see the whole paper trail behind the process.

Country risk is obviously critical for microfinance institutions. I think a good recognition and understanding of country and related regulatory and legal risks are important. That's a tough one for a lot of MIVs because clearly a lot of MFIs are operating in what would be very emerging markets, but the question is: How are they looking at potential regulatory risk or political risk issues in the sector? Are there certain mitigating factors? Are there some countries that they simply won't do business in because of the perceived country regulatory risk?

I think foreign exchange risk is one of the largest risks overhanging this space, and it's one that is not particularly, actively understood or managed by a lot of MIVs. Up until the last couple of years, many MIVs and many MFIs have gone through a period of unusually stable foreign exchange rates; even cases where foreign exchange rates have moved in favor of microfinance institutions. That has led to a degree of complacency in the market both on behalf of the MFIs and behalf of MIVs. That's not to say foreign exchange risk is necessarily something that's readily and easily managed or hedged in this space. There are certain markets where an MIV can hedge its foreign exchange risk outright. I think there are other ways to stay on top of foreign exchange risk. There are certainly methodologies for measuring foreign exchange risk in a portfolio - for ensuring that you take at least a diversified approach to foreign exchange risk - that in certain markets you avoid it altogether and in other markets you look to hedge it.

Liquidity risk is something that is a standard component of risk management that every MIV needs to have in place. What are its own liquidity needs, and what are the redemption rights of its investors? What are the policies in place to ensure that it is able to maintain that liquidity necessary to meet those requirements?

Finally, there needs to be some level of crisis management experience and procedures. What are the procedures for investments when problems start to crop up? Are there early warning signals that the MIV monitors to assess portfolios at the various MFIs? Do these early warning signals prompt conversations, interventions and visits with management to ensure that the MIV is staying on top of the problems that might be rising early on?

Country Risk

Christina Leijonhufvud: At its root is the recognition that as one country suffers (from liquidity, credit or political crises), you tend to see strong correlations of problems within that country. In other words, country crises tends to bring with them dramatic moves in foreign exchange rate, dramatic moves in the value of equities in the country and dramatic knock-on effects on the credit worthiness of various financial institutions and corporate borrowers within that country. In recognition of those facts, we designed a stress testing framework and methodology that essentially starts from the perspective of: What is JP Morgan's portfolio in this country, and what is likely to happen in an extreme country event? We "stress test" the country for an extreme set of shocks, where the sovereign itself suffers deterioration of its credit worthiness. That has implications for the value of its local currency vis-à-vis the US dollar; it has implications on the credit worthiness of corporates and financial institutions and for the value of equity holdings in that country. In some cases, it would carry assumptions of political and regulatory interventions, assumptions of capital controls, transferability risks and so forth. This is a methodology that we designed and apply across the board to all our country portfolios. We actually use it to set and size our appetite for risk across countries. We have a view on which countries are more vulnerable to such extreme event risk and which countries are not. We take an independent view from the rating agencies of that risk and run these scenarios and size our appetite for country exposure and country risk on that basis. That's something we run and rerun frequently within the firm: a full set of scenarios at least monthly.

Conclusion

This whitepaper provides a basic framework for how investors can evaluate MIVs. An increased focus on fundamental issues and transparency in microfinance makes the industry more attractive to prospective investors. As more investors enter microfinance, MIVs will play a greater role as financial intermediaries, connecting private capital to MFIs. As microfinance threatens to outgrow donor funding, this private capital becomes critical, allowing for the achievement of both financial and social objectives.

Special Thanks

My special thanks to Christina Leijonhufvud who provided her time and contributions to this paper. Ms Leijonhufvud is Managing Director of the Global Social Sector Finance (SSF) Group at JP Morgan. The SSF unit leverages JP Morgan's products and skills to help bring financial services to microfinance and social enterprises around the world.

Prior to joining JP Morgan in 1996, Ms Leijonhufvud worked at the World Bank as Country Officer, helping develop reform programs and borrowing strategies for the former Soviet republics of Central Asia. In 1991, she served on the Economic Reform Committee for the Government of Kazakhstan. Ms Leijonhufvud earned an MSc degree in Economics from the London School of Economics, an MA degree in International Affairs from George Washington University and a BA in Sociology from UCLA.

About MicroCapital
MicroCapital publishes *The MicroCapital Monitor* and other products offering specialized news and information on international microfinance. As microfinance is an emerging global industry with a legacy of charity, objective news with a business orientation is scarce. MicroCapital seeks to provide candid information on microfinance in an effort to encourage rational growth of the industry.

MicroCapital
PO Box 55071 #23935
Boston MA 02205 USA
+1 617 648 0043
www.MicroCapital.org