Social Enterprise ASSOCIATES

The Business Case for Investment in Microfinance

Introduction

Microfinance as an industry presents a 'business' case for investment, even where profit is not the greatest motivation. When making business decisions, investors value new propositions to identified needs. A 'bigger' solution in a larger market, infers more economic opportunity. "Where others see problems, entrepreneurs see opportunity."[1] Markets with increasing potential and growth prospects are incentive for early adopters to get in 'on the ground floor'. Motivating early adopters requires a value proposition to attract them.

The business 'formula' for microfinance towards such a need is:

$$(Pr + O) * P = S$$

The Problem (Pr) added to the Opportunity (O) and then augmented by the Potential (P) provides a Solution (S). Below is an outline for microfinance to consider addressing capital markets.

Pr: The Problem

The Problem, as microfinance pundits point out, is existing funding sources are insufficient to support demand for microfinance services. Industry market supply is estimated by the World Bank's Consultative Group to Assist the Poorest (CGAP) and others to currently fulfill less than 5% of total potential demand.[2] To achieve the goal of reaching 100 million of the world's poorest by 2005, advocated by the Microcredit Summit, even a minimal average loan amount of $250 requires $25 billion in lending.

Donor funding is and has been a good fit for microfinance to date. Donations are estimated to contribute $1 billion a year to microfinance. Meanwhile, overall United States (US) foundation giving tripled during the 1990's to $30 billion.[3] Philanthropy literature today increasingly calls for donors to support non-profits demonstrating responsible uses of monies, greater reporting transparency, and documenting results.[4] These are ingrained qualities in well-run microfinance institutions.

However, donations are not a sufficient funding stream for microfinance. Market analysts peg microfinance donor contributions to top out at $1.3 billion.[5] US foundation giving declined in 2002 and also 2003.[6] Foundations anticipate decreased giving as

[1] Dees, G. *Pathways to Social Impact*. Duke University presentation. 2002
[2] Littlefield, E. CGAP Presentation. 2002.
[3] Foundation Center website data (http://fdncenter.org/funders)
[4] See Guidestar (www.guidestar.org) and Chronicle of Philanthropy (www.philanthropy.com)
[5] Microfinance Panel Commentary at Columbia University, March, 2003.
6 Renz, L & Lawrence, S. Foundation Growth and Giving Estimates. Foundation Center, 2003, p.2

long as stock market returns stagnate. Non-profit organization numbers have tripled in the last generation, so there is increased competition for a shrinking funding pool.[7]

The United Nations (UN) Millennium Development Goals seek to halve the number of people living in poverty by the year 2015.[8] However, international funds from countries for aid remain flat in real terms, despite spikes in some post-conflict and natural disaster regions. And, the income gap has increased over the last generation, with more poor people in the world today than ever before.[9] Therefore, international donor aid also does not appear to be an adequate source to address microfinance's needs.

Question: *How will the microfinance industry locate funds to satisfy market demand so that it is a significant factor in alleviating world poverty?*

O: The Opportunity

The Opportunity lies in the world financial markets. They exchange $1.3 trillion in capital every day, most on Wall Street. In the US, flows into investments continue to increase, as 'Baby Boomers' (the post war generation) prepares for retirement in the US. Interest rates in the 'North' are at historic lows. The US 'Fed Rate' is currently 1.25%. Most bank savings accounts yield 0% on an inflation-adjusted basis. Stocks are in their third straight year of losses; only the Great Depression had a longer period of decline.[10] Investors are wary of historic financing mechanisms, presenting a possibility for new asset classes that offer stable returns and diversify risk for their portfolios.

Traditional international investment options are currently unattractive. International stocks, historically a good diversification strategy from the US market, are also down. Economic distress in many sectors, compounded by international conflicts, have atrophied investing in developing economies and spurred a 'flight to quality' to gold and fixed income products.[11] Foreign Direct Investment (FDI) is in decline. In Latin America, FDI estimates are $32 billion in 2003, half that of three years ago.[12]

Question: *Where can investors place their capital?*

P: The Potential

The potential is multiplied by the Problem and Opportunity. Essentially, how big is this possibility and how much money can be made (with apologies to our mission driven colleagues)? Microfinance needs financing, and the investment climate is fluid. But, the microfinance industry needs to solidify its value proposition, given its positives and negatives.

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[7] The Evergreen State Society website, (www.tess.org) & Internal Revenue Service website (www.irs.gov)
[8] See UN website dedicated to the Millennium Development Goals. (www.un.org/millenniumgoals)
[9] Cooper, M. *Blame the IMF Crowd*. LA Times & commented frequently by Thomas Friedman in *The Lexus and the Olive Tree,* among other sources.
[10] For interesting assessments, see the Motley Fool (www.fool.com), Smart Money (www.smartmoney.com)
[11] Data gathered from popular economic press: Wall Street Journal, Fortune, Newsweek and others
[12] Millman, J. "Latin Americans Boost Home Coffers", *Wall Street Journal* 3/17/03

Microfinance has attractive financial attributes:[13]

- High, sustained growth rates above 30% a year for the last decade
- Institutions with track records – with double digit Return on Investment (ROI).[14]
- Total portfolio value of all loan assets estimated above $50 billion
- Relative uniform operations led by interconnected international networks

In addition, it also boasts laudable social achievements:[15]

- More than 10,000 MFIs exist, and microfinance is in nearly every country in the world
- More than 55 million customers among 'counted' MFIs
- Microfinance institutions have created millions of jobs, improved homes, and relieved poverty for some of the worlds poor and 'unbanked'

But, the industry also has barriers and negatives. A series of unscientific qualitative interviews with two dozen financial professionals on this asset class revealed:[16]

- *Risk Layers*. Microfinance has many risk layers remaining unassessed and unmitigated.[17] The growth in ratings, reporting transparency, and MFI regulation is progress. Detractions do remain - varied regulatory environments and currency risk.
- *Donation driven behavior.* Many MFIs still seek donations. This funding is 'free' (de facto subsidies) creating disincentives for commercial investment. Blue Orchard, a debt investor, recounts incidents where profitable MFIs secured 'soft loans' (debt below prevailing market rates) from donors, so declined their financing.[18]
- *Governance*. Most MFIs are, or start as, non-profits. Their directors have varying degrees of sophistication. Investors feel insecure placing money with them.
- *The market is small in financial terms*. Wall Street likes $50 million units, preferably $100 million. Microfinance is still too small, although it is watched with interest.
- *Fragmented service providers*. Less than 1% of documented MFIs are above 10,000 customers. Growth and consolidation are needed for microfinance to matter.
- *No investor first mover incentive*. Contrasted with technology companies, investors have little early participation incentive, like prospects for higher returns. Exit, as of yet, remains elusive.

***Question**: Where can microfinance seek new capital given the industry's potential but also its limitations?*

[13] Data gathered from various sources including: Microcredit Summit, Microfinance Gateway, and Virtual Library on Microfinance.
[14] 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.
[15] Ibid, see in particular, *The State of the Microcredit Summit Campaign Report 2002*.
[16] These points were the most frequently cited in conversations with investment bankers, financial advisors, and professional portfolio managers.
[17] An investment banker we spoke with identified 'five risk layers between his Wall Street office and an MFI lending in small towns in a developing nation' that would have to be analyzed and quantified. Each layer would have to be addressed, mitigated, and/or compensated for from an investment perspective.
[18] Blue Orchard response to the CGAP paper *Water, Water Everywhere...*

S: The Solution - Microfinance's Double Bottom Line

The 'S' from the equation above is the Solution. Microfinance offers a solution – from both market and development approaches. ***Few fields in development or commerce emphasize economic and social performance as strongly as microfinance.*** But, microfinance as a financing 'product' is frequently, although not exclusively, geared to donors.[19] The community is good at soliciting donors. This is limiting. To benefit from this dual potential, MFIs must expand the value proposition and tailor it to appropriate funding sources.

Effectively gauging and then reporting financial and social activities – managing both from the viewpoint of a bottom line or double bottom line – is a tool for microfinance institutions to document their performance. Accurate documentation and measurement of both bottom lines, particularly the social line, provides quantified and evaluated results. This information is applicable towards a number of purposes: for marketing, to attract media attention ('PR'), in academic research, as a tool for investor due diligence, and a basis for investor decision-making.

Microfinance operates in a world with limited resources and multiple, relative (not absolute) answers. MFIs have different foci, for example extending service to poorer people as a social service or operating profitably, e.g. more like a business.[20] The industry rarely embraces stratified, market driven images, particularly when promoting poverty alleviation. However, this does not infer MFIs <u>must</u> produce profits. The key for an institution is to identify its strengths and clearly present them, an advancing issue throughout the non-profit world.[21]

The stated goal is for microfinance to grow and matter as a tool in alleviating poverty. The 'competition' consists of other forms of development, alternate investment possibilities, and even between MFIs. Microfinance must demonstrate how it is 'better'. Highlighting microfinance's greater financial and social results provides an edge over other alternative uses of capital – a market competitive advantage.

There will, and will continue to be, grant and donor involvement. Given demand so far exceeds supply; donors must better maximize their impact. There is too little capital for them to support MFIs that 'stand on their own'. There is higher impact in riskier markets and in supporting macro or industry wide initiatives, like regulations or credit bureaus. Donors should better leverage their dollars to attract more. The double bottom line is a tool for them to align their 'investments' with appropriate institutions, but also allows their own performance measurement.

Microfinance institution efforts to document social and financial gains must improve. The industry can maximize this function by using standardized metrics, enabling comparison and data aggregation. Ideally, measures are easily understood to a lay audience,

[19] The publicity surrounding bond issuances in Mexico by Compartamos and in Peru by MiBanco are exceptions. Press releases announcing new microfinance funds, the majority of capitalization coming from donors, is laudable, but reinforces the problem.
[20] E.g. Peck Christen, R. *Commercialization and Mission Drift: The Transformation of Microfinance in Latin America*. CGAP Occasional Paper No. 5, 2000
[21] See The Chronicle of Philanthropy & Strom, S. *Billions in Charity Money Could Be Saved*. New York Times 5/10/03. Article comments on a McKinsey & Company report on non-profit inefficiency.

demonstrate accomplishments simply, and are sensitive to management time and budget. Microfinance as a sector will benefit when it uses the data, highlights leaders, and differentiates industry players through independently verifiable means.

Conclusion

In order for the microfinance industry to be sustainable financially and in terms of helping enough clients, new sources of capital must be tapped. Microfinance can approach the capital markets, but doing so requires new thinking and understanding the financial audience.

MFIs are best served by considering the best investor 'fit' by drawing their greatest strengths – their financial and social impacts. The industry needs to maximize demonstration and documentation of these twin benefits; one method is through the Double Bottom Line. The equation is already known, and the industry has the pieces, the question is how to put the two together effectively. Let us hope more is accomplished soon.

Social Enterprise Associates (www.socialenterprise.NET) is a US consulting firm specialization in applying business principles to community efforts. Its management team has decades of experience in for-profit and non-profit organizations, developing strategy, raising capital, implementing new programs, and marketing core concepts. It can be reached by email to drew@socialenterprise.NET or by phone 206-686-2897.