Equity Investments
in MFIs and Transformation:
The Case of XAC, Mongolia

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Young and Promising Microfinance Institutions

by

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This paper has been prepared as an input paper to the "Global Microfinance Meeting on Young and Promising MFIs" that was held from May 30 to June 1, 2001, at the United Nations in New York. The paper reflects the situation as of June 2001. The meeting was sponsored by the United Nations Capital Development Fund (UNCDF), Special Unit for Microfinance (SUM), and the United Nations Development Programme (UNDP) Africa. The meeting brought together 60 representatives of UNDP MicroStart Programmes, UNDP Country Offices from around the world, technical service providers, experts in the microfinance field, and UNCDF's Special Unit for Microfinance. UNDP's MicroStart Programmes provide technical assistance to start-up and young, promising institutions by contracting the services of experienced microfinance service providers, many of whom are from the South. The purpose of the meeting was to improve the understanding of donors, technical service providers, and practitioners working with young institutions on issues crucial to the support of institutional development and growth of young microfinance institutions.

Other papers in this series are:

- Meeting Proceedings, Global Meeting on Young and Promising Microfinance Institutions
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List of Acronyms

BDS	Business Development Services
CBO	Community Based Organisation
CEO	Chief Executive Officer
CGAP	Consultative Group to Assist the Poorest
ESOP	Employee Stock Ownership Plan
Forex	Foreign Exchange
ITSP	International Technical Service Provider
LEOS	Liberal Women's Brain Pool
LIBOR	London Inter-bank Overnight Rate
MFI	Micro Finance Institution
MIS	Management Information System
MNT	Mongolian Currency (Tughrik)
MOU	Memorandum of Understanding
MSM	MicroStart Mongolia
MWF	Mongolian Women's Federation
NAMAC	National Association of Mongolian Agricultural Cooperatives
NBFI	Non-Bank Financial Institution
NGO	Nongovernmental, not-for-profit, organization
PAR	Portfolio at Risk
ROA	Return on Assets
ROE	Return on Equity
SUM	Special Unit for MicroFinance UNDP/UNCDF
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
XAC	English Translation: Golden Fund for Development

INTRODUCTION

Private Equity Capital in the Microfinance Industry

Martin Connell, President, Calmeadow, Canada

As nongovernmental organizations around the world contemplate transforming into commercial ventures, the level of interest in how and where to source private equity capital has risen dramatically. However, the harsh reality is that, with few exceptions, private sector portfolio equity capital is basically unavailable. By portfolio investment, one refers to capital from private individuals, corporations, investment funds, and financial institutions, which assume minority positions in microfinance institutions *purely for profit*.

Alternatively, various forms of *social capital* are available to the microfinance sector. These capital sources sometimes get confused with private capital because in many respects they mimic it in their expectations and terms. This social capital comes primarily from private foundations, certain NGOs, some public institutions, and a handful of wealthy, progressively minded and sometimes politically motivated individuals and corporations.

After defining the opportunities, the requirements, and a few of the strategies needed to acquire equity capital, it is necessary to ask, *Is it worth it?* Is the cost of transforming and pursuing this capital worth the price? The "price" refers to the legal, financial, and psychological price of inviting equity investors into a microfinance institution.

Most NGOs are in control of the management of their enterprise. The managing director or the executive team runs the business, develops the strategies, and maintains the mission. The board is generally supportive and compliant. This is a fairly comfortable situation.

Entering into a relationship with outside investors can irrevocably change the nature of the institution. It usually requires a radical reorganization of the governance structure, raises the level of expectations, creates intensive and often intrusive involvement from government regulators, and exposes the institution to the dictates of a market that requires a permanent commitment to increasing growth and profitability. Management becomes accountable for results and vulnerable to job insecurity.

The decision to pursue private equity capital is a difficult one. The institution has to have a strong-enough desire to accept the challenges and requirements of becoming a fully regulated financial institution. Management needs to be prepared to deal with outside shareholders who demand a say in the business and in their employment.

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On the plus side, equity is permanent capital. In a regulated context, equity can leverage deposits and borrowed capital, allowing the institution to increase its scale significantly. Only equity can make serious growth possible, and it replaces the tedious process of forever chasing after grants. Depending on the types of investors the institution attracts, shareholders can bring valuable expertise and guidance to the institution, and their financial stake in the institution heightens their commitment to provide these resources. In addition, by becoming a regulated financial institution, an MFI can offer an increased variety of financial services, including savings, which provides better service to its customers.

In sum, transformation is a big step. Once committed, there is no going back. NGOs will want to consider it carefully.

With his statement "*Only equity can make serious growth possible*," the president of Calmeadow correctly sets the tone for this paper on equity investments. This is because the microfinance sector has often approached the development of the field in an unbalanced manner, by first developing and testing financial products and then worrying about institutional capacity and the subsequent ownership structure of such institutions. This approach often—though not always—results in program failure, stagnated growth, or at best transformation nightmares. Those institutions that initiate their activities with a parallel approach of institutional capacity building, an innovative ownership structure, and a clear vision, while at the same time building a solid approach to product development and delivery, have the greatest chances of growth.

The area that MFIs often get stuck on is the capital side of the equation. It is usually much easier to conceptualize how to structure the MFI's assets (primarily by investing in performing assets through the loan portfolio, balanced with some long-term investments), than it is to conceptualize how to finance these assets. If the MFI begins with the assumption that the donor "*will take care of us during the first few years and then we will figure it out later*," then it is asking for trouble. If the MFI thinks that it can mobilize significant liabilities without an adequate capital structure, then it is in trouble. This attitude, which is common, can lead to:

- An organizational culture that lacks entrepreneurial dynamism or at worst is apathetic and complacent;
- Delayed or stagnated growth of outreach, efficiency, and profitability;
- Lack of credibility among peers and within the mainstream financial sector;
- Donor confusion and possible donor dropout; and
- Unnecessary levels of stress, institutional costs, and staff turnover when and if the process of transformation does occur.

This paper has been written for a specific audience: institutions (and their technical service providers) that are receiving grants and technical assistance under the global MicroStart

Programme. The majority of MicroStart institutions are, as the name implies, “start-up” institutions—young, small institutions with a demonstrated potential for significant growth in the future. Many of the institutions in this audience are already facing, or will soon face, the necessity of deciding on whether they wish to pursue commercial or quasi-commercial investments, including equity.

The paper has been written by practitioners and is intended to provide some experience-based guidelines on how to think through and implement the process of structuring the capital side of a balance sheet. It is not intended as a “microfinance best practices” paper—because it is the opinion of the authors that each institution will need to structure their assets in a manner that is the most appropriate for their own institutional culture, vision, and country context. Many of the readers of this paper may decide <u>not</u> to pursue non-donated equity investments. Reasons for such a decision might include:

- The institution or project has a clear goal of phasing out over time and handing over its assets to another institution;
- The institution or project was established on a pilot or experimental project basis and is intended to serve as a catalyst for other institutions to replicate;
- The external environment is too restrictive, with little potential for significant change within the short to medium term. Environmental factors may include the lack of conducive laws and regulations, inadequate political or donor goodwill, lack of support from governmental institutions, and political or economic instability;
- A reliable and viable partner institution is identified that will provide supplementary services (for example, hold client deposits or provide wholesale loans),, or that will provide the legal umbrella necessary for the expansion of the asset base of the MFI; or
- The project is intended to mobilize and facilitate the creation of community-based organizations (such as village banks or credit unions). These CBOs are then able to raise their own equity. The project phases out over time. The eventual formation of an apex structure (which itself may necessitate raising equity) to support these CBOs often occurs through either a bottom-up or top-down process.

Other institutions may wish to pursue commercial sources of equity for the following reasons:

- The desire to become independent from donors;
- The wish to significantly increase loan portfolio and thus outreach;
- The vision of transformation into a private sector entity, offering a range of financial services;
- The need to meet minimum capital requirements of regulatory authorities in order to become licensed as a mainstream financial institution;
- An acknowledgement that commercial investments often provide added incentives (pressure) to improve levels of operational efficiency;
- The need and/or wish to leverage equity in order to gain access to commercial liabilities and to cushion against potential shocks and losses;

- The desire to leverage equity to generate greater rates of return for the owners or "quasi-owners"; or
- The desire to comply with internationally accepted prudential ratios such as capital adequacy.

Part One of this paper will provide a brief introduction to the organization upon which this case study is based, XAC (pronounced "has"), and its transformation to a Non-Bank Financial Institution (NBFI). Part Two will discuss the preparatory phases of the preparation of XAC for institutional transformation to the status of a bank, including the increase of its equity base and the process for choosing investors and structuring investment deals. Part Three summarizes the status of XAC's efforts at the end of the preparation before transformation into a bank, and, finally, the annexes provide additional reference information and the details of an international investor survey conducted as part of the preparation of this paper.

PART ONE: BRIEF HISTORY OF XAC FROM PROJECT TO NBFI

The MicroStart Mongolia Project (MSM) began in June 1997 with the signing of a project document between the Government of Mongolia (the Ministry of Labour and Social Welfare) and the UNDP. The project became operational in late July 1998 with the arrival of the UNDP MSM advisor.[1] Sant Maral, a local nongovernmental organization, provided the legal umbrella for the initial operation.

The UNDP advisor worked with local NGOs to design and test a loan methodology based on international best practices, but adapted to Mongolia. MicroStart provided capital grants initially to three local NGOs (Sant Maral, Liberal Women's Brain Pool [LEOS], and the Mongolian Women's Federation [MWF]) to start operations. Later six local NGOS, including two of the three original founders, became the owners of the organization. The founding NGOs were selected and approached by the UNDP based on their reputation and track record, and are representative of Mongolian civil society.

The project began with some fundamental weaknesses, two of which should be highlighted:

- A project-oriented approach based on outreach with only a marginal mention of institutional development; and
- A design that called for channeling loan funds through pre-existing multiservice NGOs with no budget allocations for training or institutional capacity building.

Despite these weaknesses, the organization that grew out of MicroStart Mongolia, "Golden Fund for Development" or XAC, is a dynamic and entrepreneurial Microfinance Institution (MFI) using a unique individual loan methodology to provide loans to microentrepreneurs in Mongolia. Although a start-up MFI, XAC is highly professional and dedicated to viability. XAC became the first Non-Bank Financial Institution in Mongolia and the first regulated microfinance institution.[2] XAC management was influential in shaping the legal and regulatory environment for NBFIs in Mongolia. XAC is supervised by the central bank and is authorized to provide loan services anywhere in the country. Savings mobilization and other financial transactions are excluded.

In just two-and-one-half years of operation (by summer 2001), XAC's performance is impressive. The organization has established a network of 13 branches, and managed a loan portfolio of $854,000 serving more than 3,600 clients.[3] Furthermore, XAC has maintained an excellent portfolio quality (PAR of 1 day is 0.3 percent as of April 2001), and reached operational sufficiency after eight months of operations (Table 1).

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[1] Originally contracted by the International Technical Service Provider (ITSP), ACDI-VOCA.

[2] Portions of this description of XAC were extracted and updated from the June 2000 CGAP Appraisal.

[3] All dollar amounts in the paper are U.S. dollars.

Table 1: Summary of Key Data
(As per year 2000 External Financial Audit)
(MNT, 000)[a]

Balance Sheet	**1999**	**2000**
Total Assets	498,921	1,444,346
Total Loans	253,675	944,316
Loan Loss Reserve	5,099	11,156
Income Statement		
Total Income	122,383	356,992
Net Income after Taxes[b]	-7,370	33,379
Financial Indicators		
Return on Assets (ROA)[c]	-5.2 %	3.4 %
Return on Equity (ROE)[d]	-6.3 %	18.5 %
Operational Self-Sufficiency	88.9 %	115 %
Financial Self-Sufficiency[e]	74.4 %	103 %
Portfolio Indicators		
Portfolio at Risk of > 1 Day[f]	1.3 %	0.3 %
Rate of Repayment[g]	98.7 %	99.7 %
No. of Loans Disbursed	2,340	9,832
Amount of Loans Disbursed	955,840	2,600,000
Loan Portfolio Outstanding	259,944	935,800
Active Clients	1,514	3,626
Average Balance per Loan	$159	$240

Notes:
a. The official exchange rate as of December 31, 2000 was $ 1 to MNT 1,097.
b. Portion of the previous year's retained earnings to be added on retained earnings of year 2000 is not included for the calculations of the ratios.
c. Average Assets for the Year is used for the RoA calculation.
d. ROE calculated on Total Share Equity
e. Adjustments are made for inflation and some subsidies.
f. PAR= (Outstanding balance of loans past due > 1 day + Outstanding balance of Restructured Loans/ Total Outstanding Portfolio.
g. Repayment Rate = 1-Payments in Arrears / Total Outstanding Portfolio.

Yet XAC's success goes beyond the institution's performance. It has had an impact on Mongolian society as a whole. XAC has been instrumental in the development of an appropriate regulatory framework for NBFIs and for the promotion of a sound business environment for microenterprises, through its interactions with the Government of Mongolia and parliament, the central bank, and the university. Its performance is impressive in any context, but it is still more remarkable in Mongolia, a country with one of the lowest population densities in the world, poor infrastructure, and a transitional economy.

XAC is still in a honeymoon period and enjoys the dynamism of a start-up business. The challenges ahead for this young institution are to position XAC for its next phase of growth, from 3,626 to 7,000 clients, from a small MFI to a full-fledged commercial bank, from a small committed team to a staff of more than 120 people.

XAC's main weaknesses are the following:

- Weak governance, the board lacks experience in business and banking, and is not able to fully play its oversight role;
- Lack of standardization and enforcement of procedures and internal controls that could expose XAC to operational deviations and mismanagement;
- Inadequate Management Information System (MIS), which is not sufficiently reliable or able to cope with the growth of the institution; and
- Low efficiency compared with microfinance best practices for individual loans. XAC needs to significantly improve its efficiency to boost its profitability.

As of December 2000, the company's paid up capital is MNT 240 million.[4] Each of the founding NGOs holds 3,000 shares. Their original equity participation has been fully funded by the UNDP and they have individually signed memorandums of understanding with the UNDP. The memorandums set up the terms and conditions of the donations. In the agreement, the founding NGOs agreed not to receive dividends on their UNDP donation for a minimum period of two years and to grant the UNDP a nonvoting advisory seat on the board of directors.

The current ownership structure is weak. But this structure is temporary and may be appropriate for the start-up phase in the context of Mongolia. However, the shareholder structure will require substantial effort in diversification over the medium term to ensure reliable and committed ownership and a balance of skills and competence. The current board of directors is composed of seven members elected by the shareholders' general assembly in February 2001, and includes one seat reserved and held open for an international investor.

Board meetings are held frequently (at least every month) and attendance at the meetings has been high (more than 80 percent for the year 2000). The working relationship between the

[4] Of which 180,000,000 was provided by UNDP and 40,000,000 has been derived from retained earnings.

board and the executive director has been effective. All board members have signed a statement on ethics in which they commit among other things not to receive loans from the company and not to engage the company in self-serving political activities. Board members have attended training sessions organized by the UNDP MSM advisor. An audit committee of three members meets regularly to discuss audit and internal control issues and is assisted by a full-time internal auditor.

Board involvement and sense of ownership seem to be high as demonstrated by meeting attendance and by the participation of the board members in several company activities like visiting branches, facing problems, attending the openings of new branches, and participation in company retreats.

Each branch consists of a lead credit officer, a credit officer, and an accountant. Six branches have hired an additional credit officer and voluntary staff because of rapid expansion. Of the lead credit officers, 91 percent are women selected from the communities in which they work, giving them a better knowledge of the clients and respectability within the community. Credit officers are generally young.

XAC has been able to attract committed and highly promising staff thanks to an aggressive and innovative recruitment and performance-based incentive policy. The effectiveness of staff recruitment is also demonstrated by low staff turnover. It is also important to mention that all new employees have to adhere to a code of conduct.

As of December 31, 2000, XAC employs 63 staff (up from 34 at the end of 1999), excluding the UNDP MSM advisor and local consultant. The staff members are highly educated and committed. Almost 90 percent of total staff are university graduates, including 7.5 percent with master degrees. The staff are also young, with an average age of 30. Women represent a large majority of staff (77 percent of total staff and 50 percent of the board of directors are women).

XAC management has developed an open, transparent atmosphere where learning, collaboration, and sharing of knowledge are encouraged. The organization is also open to sharing its experience with other microfinance actors in Mongolia and abroad. The focus is on the client and on delivering good-quality service. The staff seem to be motivated by the desire to create a professional organization that maintains a social orientation.

Revisiting the Process of Transition to a Private Company

In January 1999, soon after its conception, MicroStart Mongolia began a concerted effort to consolidate and rationalize its project. The first step was to consolidate the project into a private company providing technical support and serving as a central office for NGO lending.

The decision to transform into a private sector institution with commercial equity was based on the following considerations.[5]

- Severe legal restrictions existed for the continuation of microfinance activities within the NGO framework;
- The existence of a series of specific factors in Mongolia, which limited the ability of savings and loan co-operatives to significantly increase their level of effort;
- The lack of adequate capital for the establishment of a commercial microfinance bank;
- The lack of existing laws and industry preconditions for developing a microfinance trust fund or an apex institutional structure;
- The desire to establish an institution that could significantly increase its outreach, attract private investors and commercial sources of funds, and eventually mobilize savings deposits;
- The expressed desire to create an institution that would be perceived by the staff, clients, and the general public as being financially sound, serious, and "professional";
- The NGOs' desire to found an institution, which could eventually produce dividends or revenues for the support of non-microfinance-related social activities; and
- The need to create an institution that could fully comply with upcoming central bank regulations on NFBIs.

Two NGOs, LEOS and MWF, established XAC for this purpose on May 18, 1999. During this period XAC was governed by a temporary board of directors made up of five members, two members from each of the founding NGOs and one from the National Association of Mongolian Agricultural Cooperatives.

An executive director was hired and the UNDP MSM advisor gradually started to step down as the institution's leader to take more of a coaching and technical assistance (TA) function. During this phase the MSM advisor and the executive director worked hard with UNDP, the local NGOs, the government, the central bank, and XAC staff on a comprehensive plan to convert XAC into the first NBFI in Mongolia.

Success of Transition to NBFI

The company successfully managed its transformation into a NBFI. In October 1999, four additional NGOs received funding from UNDP and became shareholders of XAC. At the same time, the Mongolian central bank registered the company as the country's first NBFI. Over time, however, it has been become clearer that the XAC ownership structure of involving six NGOs has resulted in certain governance problems associated with the transfer of institutional memory: NGO representatives present in a general assembly in 1999 or 2000

[5] Summarized from the "Notes of the combined MWF/LEOS/SM Board Decision Meeting on MicroStart," November 1998.

are not necessarily the same as those who will be present in subsequent GA meetings. This has resulted in a lot of energy invested in the re-education of NGO representatives.

The transition process was remarkably well managed and planned. All staff resigned from their NGO positions and reapplied for new positions in XAC. Legal contracts were signed between each founding NGO and the UNDP to regulate the transfer of assets between the NGOs and XAC. During that period, the institution grew significantly from a loan portfolio of $159,000 and a network of five branches (June 1999) to a loan portfolio of $854,000 and 13 field offices (including one specialized SME Unit, located within the central office).

A new board of directors was elected in October 1999 and trained with the support of the UNDP MSM advisor. The MicroStart Advisory Committee (originally composed of seven members from the government, the private sector, and the NGO community) was dissolved and transferred its oversight responsibility to the XAC board of directors.

Another business plan with the vision to transform XAC into a full-fledged commercial bank was designed with the participation of the staff and board members. The plan was approved by the general assembly in April 2000 and reaffirmed in the February 2001 general assembly (during which time the board was renewed). Finally, contacts with international investors[6] intensified in the years 2000-2001 to secure equity and loan capital to fund the growth of the organization.

By the time of the writing of this paper (spring 2001), XAC as a private finance company specialized in microfinance had succeeded in attracting a significant degree of domestic and international interest for equity investments. For example, in early December 2000, Triodos Bank/Holland disbursed a $400,000 convertible and commercially priced loan to the company. The goal of increasing the XAC equity base from the December 2000 level of $180,000 to nearly $2,000,000 within a forthcoming 12-month period seemed viable (though not certain). An array of lessons has been learned during the process, many of which may be of value to similar organizations.

[6] The names of pipeline international investors have been purposely omitted from this document.

PART TWO: ANALYSIS OF THE PROCESS OF TRANSFORMING XAC INTO A BANK

Prior to making the decision to diversify and attract new sources of equity, XAC first engaged in an analysis of options in an attempt to determine the advantages and disadvantages of transformation into a commercial bank. The analysis considered factors such as:

- The vision and culture of the organization;
- Timing;
- Cost/benefits;
- Institutional capabilities;
- Perceived positive or negative consequences of changes in the ownership structure, and hence in institutional governance (including power and control);
- Availability of investors, taking into careful consideration the size of the institution's assets;
- Legal and regulatory environment; and
- Attitudes of current investors, secondary stakeholders, and/or donors.

Advantages and Disadvantages of Transformation[7]

During a XAC annual general assembly of shareholders, the following advantages and disadvantages to transforming into a bank (and thus implying the need to significantly increase and diversify its capital structure) were discussed:

Potential Advantages

Competition—As a bank, XAC would have an increased ability to compete with current and future competitors. This is especially important in rural areas with low population densities, where a pre-existing, full-service bank could very easily "steal" the market from XAC.

Timing—XAC could wait several more years to become a bank; however, the risk was large that other institutions could take over the market during the next two years. Assuming that XAC received its banking license in December 2001, it would have already been working for 39 months and been under central bank regulation for 27 months.

Profitability—The bank would be more attractive to investors. By leveraging liabilities, the return on equity to investors would be much higher. XAC would be able eventually to diversify the range of financial services it provides. This might help the institution to become more profitable and better serve client demand for a diversification of products.

[7] XAC General Assembly of Shareholders, April 2000.

Social Impact—An institution that provides only credit is not able to support clients to build up their savings (unless it links with a deposit taking institution). Families without cash savings have difficulties planning for the future, overcoming family and business emergencies, and so on.

As a bank, XAC could eventually offer a broad range of services (such as insurance and transfer/payments) to its clients and to the general public. This is especially important in rural areas where it is difficult to gain access to these services. Also, as a bank, it would be easier for XAC to find investors. By increasing the equity of the institution, it could leverage much larger amounts of liabilities. This would allow the institution to significantly increase its level of outreach in the future to tens of thousands of Mongolians.

Capitalization—As a bank, XAC would be able to increase its assets through the mobilization of savings. It would also be able to attract equity investments from "pure" and "quasi" commercial investors.

Promotion—The prestige and credibility of XAC would increase both in Mongolia and internationally. When XAC clients hear that they are clients of a bank, they will trust the institution more—helping to keep delinquency low.

Shareholder Value—Through the involvement of international banks and social investors in the general assembly and on the board of directors, the level of skills and value added by these investors would greatly contribute to improving the overall performance of the institution. These international investors would bring a wealth of knowledge to Mongolia and participate in decision-making free from local influences and pressures.

Potential Disadvantages

Management—XAC would have to improve its management capabilities in a significant way, both at the central and branch levels. Management skills are best learned through practical experience. It is unclear how long this would take.

Growth—Transformation into a commercial bank might distract the ability of the company to manage its growth. The business plan contemplates significant growth in the number of offices, staff, and clients during the next few years.

Governance—The skills, functions, and relations between the shareholders, board of directors, executive director, and board committees would require many improvements prior to becoming a bank.

Regulatory Costs—The levels of monitoring, regulation, and supervision of the institution by both the central bank and the investors would increase.

Asset and Liability Management—XAC has not yet had the experience of managing commercial liabilities. The institution would have to improve its skills in this area. Budget and cash flow management would require improvement.

Profitability—It is much more expensive to mobilize savings deposits and to pay for commercial liabilities, than to work with soft-dollar loans and donations. As a bank with a diversified set of investors, there might be pressure to maximize profits and to minimize social impact. This might result in a push to stop giving small loans or working in remote areas. New investors must be selected in a very careful manner.

Competition—When it becomes public knowledge that XAC is applying for a commercial bank license, this might cause existing commercial banks to publicly and/or privately oppose and fight against the institution.

NGO Shareholder Influence—In order to become a bank, the equity must increase by an additional 1 billion MNT. As a result the current shareholders would see their voting power decrease from a current level of 16.7 percent to approximately 8 percent.

International Shareholders—In the short term it would be impossible to raise 1 billion MNT in additional equity on the local market. As such, the international investors would own approximately 49 percent of the company. International investors often don't understand the reality of Mongolia and their decisions as shareholders and board members might sometimes negatively affect the institution. However, the majority of international microfinance social investors have the clear objective of selling off their shares to local investors after a reasonable period of time.

Based on this analysis, the general assembly of shareholders felt that the advantages clearly outweighed the disadvantages and voted overwhelmingly to move forward on its decision to transform into a commercial bank. This decision was reaffirmed by the year 2000 board of directors and the general assembly of shareholders held in February 2001.

It must be stated that transformation from that of a finance company (the current legal status) into a fully licensed commercial bank was not considered a precondition for the institution's ability to attract commercial equity or commercial liabilities. However, if XAC had not already had the status of a finance company regulated by the central bank of Mongolia, the pursuit of commercial investments would have been much more difficult.

Transaction Costs of Transformation

Once embarked on this process of becoming a bank, it will be several years before the final results in terms of cost are in; however, there are already indications that the company underestimated the following transaction-cost-related factors:

Human Resources: The executive director, other central office staff, and the MSM advisor have diverted a significantly higher amount of time than had been previously contemplated toward due diligence exercises, negotiations, business plan adjustments, and communications. A rough estimate calculates that the institution dedicated the equivalent of one full-time senior manager to the process during the year 2000.

Financial Costs: The following is an example of the direct financial costs of one of the investment deals negotiated by the company.

Legal:	$1,500
Processing Fees:	4,000
Communications:	500
International Visit to the Investor:	3,000
Total Cost, not including staff time:	$9,000
Financial Cost/Amount of Investment:	2.25 percent

In the example illustrated above, the 2.25 percent cost of closing the deal was felt to be worthwhile, especially within the context of associated opportunity costs. The source of investment was and still is an extremely friendly and professional investor to work with and the time lapse between the end of the due diligence and the disbursal of funds was a relatively short five-month period.

Another investment deal—from negotiation to closing (not including the initial due diligence)—under negotiation has been calculated at $71,000, including the investor's staff time, of which XAC would need to bear $25,000 of the cost.

Governance Costs: The governance costs that need to be assumed by the company by having international investors sit on the board of directors are normally borne by the MFI itself. In the case of XAC this results in an average of four international visits per year per investor at a cost as a high as $6,340 per visit, or a maximum cost of $25,360 per international investor per year.

Timing: XAC was overly optimistic regarding the ability of international investors to make a rapid decision regarding potential investment. It also failed to understand fully the timing differences between the central bank issuing of a bank license and the date that the institution could officially commence operations as a bank. These kinds of miscalculations can severely affect bottom line business plan projections and expansion plans, and cause a crisis of liquidity.

Nevertheless, to date the balance of tested advantages to the investment strategy have vastly outweighed potential disadvantages and the factors that were underestimated.

Necessary Preconditions for Transformation

In its ongoing efforts to transform into a NBFI, XAC had already gained significant experience in the transformation process. The following preconditions are particularly important in the transition to becoming a bank.

Develop and Communicate a Shared Vision

Vision of and commitment to becoming a microfinance bank were and continue to be the necessary elements for the transformation of XAC. It is common in socially oriented institutions that this vision is first conceptualized and communicated by a single prominent leader, such as the chair of the board or the executive director (or in other cases by the donor). In XAC, this vision was a shared one that existed among a number of financial sector and NGO leaders prior to the commencement of MicroStart activities. This shared dream greatly enhanced the ability of XAC to forge a clear path of transformation.

A shared dream among a core group of founders was not enough. It was then up to the executive management of the company to clearly communicate and inspire all staff and board members. The executive management underestimated the levels of effort required to inform, consult with, and educate all board and staff members regarding the details and the implications of such a vision. Communicating and motivating stakeholders toward a shared vision of diversified ownership have proven to be a continual process, and one that will probably continue for years to come.

Develop Essential Institutional Capabilities

The importance of building institutional capabilities can never be understated and is beyond the scope of this paper. XAC has experienced first hand that an excellent loan portfolio—a source of company pride and external credibility—will never be sufficient to attract serious commercial investors. The potential commercial investors who have visited XAC have shown themselves to be familiar with the financial sector and particularly with microfinance, and understand that young MFIs often enjoy a honeymoon period of several years of excellent portfolio performance. These potential investors have, instead, delved much deeper.

For XAC, an intensive effort has been placed on investing in systems development and human resource development from the beginning. This investment has been complemented through the outsourcing of technical assistance and by inviting prestigious institutions such as the Consultative Group to Assist the Poor (CGAP) and UNDP to conduct external appraisals of the institution.[8] These external appraisals, along with external financial audits and central bank reports, have then been made widely available to potential institutional partners.

Be Accountable

The importance of transparency and accountability can never be understated. The company has assumed a zero-tolerance attitude toward fraud and corruption from the beginning of operations (for example, one credit officer was fired and jailed for a case of theft involving only $300).

XAC schedules audits and submits to frequent external audits and inspections on a regular basis:

Table 2
XAC Audits

Audits	When Conducted
Financial Audit:	Yearly
Procedures Audit:	Yearly (conducted by the financial audit company)
Internal Audits:	Continual (internal, but reporting directly to the Board and General Assembly)
Client Satisfaction Surveys:	Twice a year
Central bank Supervision:	Continual, at all branch offices and central office
Due-diligence:	For each international commercial investment
CGAP Format Appraisals:	Yearly
Tax Inspections	Continual
Social Welfare Inspections:	Continual, at all branch offices and central office
Donor Monitoring:	Quarterly and annual (UNDP)

Build a Realistic Business Plan

The XAC investment strategy, which is designed to attract new infusions of equity and commercial liabilities, has been built into the five-year business plan. It has been the experience of XAC that such a business plan can serve not only as an effective internal management tool, but also as an excellent marketing tool with investors. The XAC business

[8] The institutional standards established by the CGAP can be helpful to any institution seeking transformation. Please refer to “Disclosure Guidelines for Financial Reporting by Microfinance Institutions” (Draft for Distribution, January 2001), and the “Format for Appraisal of Microfinance Institutions” (CGAP Technical Tools No. 4, July 1999) at: www.cgap.org/html/p_technical_guides.html

plan includes the information of how assets will be financed, their financial and associated costs, sources, timing, and a risk assessment (including forex, capital adequacy, and liquidity). The company has learned that a three-year plan is much more realistic and easier to implement than a five-year plan; however, it continues to market the five-year plan as a means to demonstrate to investors "*where the company hopes to be after five years.*" A three-year period of forward financial projections has proven to be inadequate in demonstrating continued and significant improvements in profitability, efficiency, and outreach.

The XAC Business Plan was and is developed through a combined bottom-up/top-down process:

- Client satisfaction surveys and other means of gauging market demand and preferences are continually carried out;
- These inputs plus staff retreats held with all branch managers determine the ideal mix of products, the variables of their design, and the potentials for depth and breadth of outreach;
- The executive committee and the branch offices work together on developing the substantive elements of the business plan narrative;
- The operations and finance departments work together to develop detailed five-year financial viability projections. At this time major external stakeholders provide important feedback;
- The board of directors reviews the narrative of the business plan with the viability projections utilized as a reference; and
- The general assembly of shareholders approves the plan based on the recommendations of the board of directors.

After the plan is approved:

- The institution under the day-to-day management of the executive director implements the business plan;
- An annual work plan is implemented based on the five-year business plan;
- Occasional adjustments occur based on market factors (client trends, competition, and feedback), risk assessments, trend analysis, and performance reports; and
- The board of directors must approve any important adjustments.

Without ever having to write a grant proposal, and by distributing its business plan only to potential donors and investors, XAC has been able to attract the support of 11 different investors and donors.[9]

Getting the business plan and its investment strategy "right" has been a tremendous challenge for XAC. Despite using sophisticated planning tools such as the CGAP MicroFin Financial

[9] It should be noted that many of these investors/donors have provided only small, one-off support such as training scholarships.

Modeling tool, the company has had to continually adjust its business plan. For example, the company underestimated the financial cost of commercial liabilities by a spread of 8 percent, and, when this correction was made, the realization came that it would need to dramatically re-engineer its branch expansion strategy in an attempt to further enhance efficiency.

MFIs must also be cognizant that new investors will wish to contribute input into the design of the business plan. This includes not only equity investors, but also investors in technical assistance and creditors. Each MFI must decide how flexible it is willing to be to accommodate new investors. Is the MFI willing and able to accept new investor concerns regarding issues such as specialization, the provision of nonfinancial services, growth management, and client and geographical targeting?

An investor may even impose conditionalities on the MFI, requiring significant changes to the business plan. How far is the MFI willing to accommodate such conditionalities? The attitude of XAC is that it is willing to make radical modifications to its business plan (subject to shareholder approval), if the concerns of the potential investor are based on solid technical criteria and are in line with the working environment of Mongolia. Examples of these modifications have included tremendously relevant suggestions regarding concerns related to growth management, appropriate levels of technical assistance, operational efficiency, and the realistic cost of funds.

A difficulty that XAC has encountered, however, is that potential investors do not always agree with each other. For example, as of the writing of this paper, XAC investors continue to have different opinions regarding the levels, costs, and structuring of external technical assistance and capacity building support. Differing opinions among stakeholders fertilize creative approaches, yet if not handled and communicated carefully can create unnecessary strain for an MFI. Nevertheless, the vast majority of all investor suggestions to XAC regarding its business plan have been well accepted and have been incorporated into revised business plans, reinforcing once again the tremendous value added aspects that commercial investors bring to the table.

Comprehensive business plans bring up an issue related to confidentiality. As the business plan becomes more comprehensive, an accompanying risk of vital trade secret leakage is heightened. Problems have already occurred where the business plan came into the hands of other institutions attempting to copy—at least partially—the XAC approach. XAC has addressed this risk by sharing business plan information to potential investors in a stepped manner. Not until the potential investor has firmly committed itself to carry out a due diligence are all aspects of the business plan fully shared.

A further strategy for attracting investor interest in XAC has been achieved by communicating to the potential investor the following message: "*If and when you do invest, you will be guaranteed the right to provide significant input into future adjustments to the business plan. Our business plan is dynamic and not set in stone. It does, and will always, reflect the opinions and preferences of all of our major investors.*"

Structure an Investment Plan

Complementary to the business plan, a separate plan has been developed which specifically addresses the means by which the UNDP has been asked to decide upon and transfer its donated assets to the company. As of the end of December 2000, UNDP had provided approximately $880,000 in microcapital grants to the company, of which $180,000 had already been legally transferred to the ownership of six NGO shareholders. With these funds, the NGOs in turn purchased shares in the company at a nominal value.[10] It is projected that all remaining UNDP-provided donations (with the exception of approximately $40,000 of sunken costs) will be transferred to private ownership. This private ownership will include Mongolian NGOs, employees, and possibly an offshore commercial bank (this, in order to assure international governance participation and to leverage additional share purchases from the same bank). UNDP/Mongolia has surprised many in the international community by the innovative and flexible manner in which it has been able to overcome potential administrative and procedural barriers in the transfer of these assets to private ownership. MicroStart country projects are free to communicate directly with UNDP/Mongolia for details on the innovative means by which this has been achieved.

The specific structuring of UNDP asset transfer has undergone numerous revisions. This has been due to changes in investor and XAC timeframes, a change in the licensing procedures of the central bank (from a two-step to a one-step approval procedure), and changes to UNDP thinking regarding NGO owner levels of "governance maturity." As of March 2001, UNDP and XAC were both hoping for the capital structure outlined in Table 3.

Approximately $880,000 of these assets will have been derived from UNDP donations and will be leveraged to:

- Ensure Mongolian NGO participation for the protection of the social mission of the institution;
- Get international commercial bank participation for value added governance and investment purposes;
- Attract international, socially oriented, but commercially priced liabilities (to date $400,000 with another $200,000 in the pipeline);
- Obtain Mongolia NGO cash contributions (as of April 9, 2001, the local NGOs have committed more than $70,000 of their own resources and $40,000 of dividend payments toward investment in XAC);
- Establish and subsidize an employee stock purchase plan to motivate staff, minimize staff turnover, and allow the company to save money in salary payments while increasing staff benefits;

[10] No cash transaction actually occurred. XAC, as a company, simply rebooked $180,000 in "due-to-donor" liabilities into balance sheet capital. The NGOs in turn signed memorandums of agreement with the UNDP and received share certificates issued by the company.

- Potentially use to leverage bonds sales on the local stock exchange or through the sale of shares to domestic investors or XAC clients (these ideas have not been fleshed out); and
- Help attract a $100,000 stock purchase from an international NGO.

Table 3
Hoped-for Capital Structure of XAC, March 2001
(in local currency, MNT)

Entity	**December-00**	**June-01**	**Day of Bank Licensing**
Local NGOs	180,000,000	398,000,000	868,000,000
International Investors	-	110,000,000	876,000,000
Employee Ownership	-	-	264,000,000
XAC – Undivided Reserves and Profits	86,901,924	70,000,000	186,000,000
XAC - Subordinated Debt (source: UNDP)	-	250,000,000	-
XAC - Treasury Stock (source: UNDP)	-	250,000,000	-
UNDP Control (as a Liability)	690,419,397	-	-
TOTAL	**957,321,320**	**1,078,000,000**	**2,194,000,000**
Entity	**December-00 (%)**	**June-01 (%)**	**Day of Bank Licensing (%)**
UNDP Control (liability)	72.1	0.0	0.0
International Ownership	0.0	10.2	39.9
Local NGO Ownership	18.8	36.9	39.6
Employee Ownership			12.0
XAC Undesignated Capital	9.1	52.9	8.5
	100.0	**100.0**	**100.0**

Build and Support an Enabling Environment

Mongolia is a country of only 2.5 million people, spread over a territory equal to that of Western Europe. In such a setting, where cliques and intrigues are heightened, XAC has been cognizant from the very beginning of activities that, for its plans of institutional transformation and equity diversification to succeed, it must have the support of a wide range of actors. The creation of an enabling environment in Mongolia cannot be restricted merely to the legal and regulatory arena, but should also include, under optimum conditions:

- A specific legal and regulatory environment that allows for the existence of microfinance operators;
- An informed public that at least conceptually understands the definition of a "socially oriented business";
- An informed and engaged public sector, including the central bank, parliament, local officials, and key government ministries;
- A government cognizant of the fact that public sector policies can either enhance or debilitate private sector initiatives in microfinance;
- A central bank with the skills and will to understand that the supervision of microfinance institutions has important distinctions from those of traditional commercial financial institutions;
- A private sector (ranging from XAC low-income business clients to the large companies) that understands and might be willing to invest in the company;
- A legal environment that encourages and does not restrict foreign direct investment in the financial sector; and
- A donor environment that would not create an uneven or unfair competitive market.

XAC has dedicated enormous amounts of institutional time to the marketing, lobbying, and education of domestic stakeholders (the public, private, and NGO sectors, clients, and donors). The success of such efforts has been enormous and has resulted in tangible results, such as:

- Changes to the laws, regulations, and the civil code as they affect microfinance;
- Awards (including "honorary tax payer" and "best entrepreneur for financial management");
- Acceptance into trade institutions (for example, as a full member of the national bankers association with a guaranteed seat on the board of directors and the executive committee);
- A central bank and parliament genuinely interested and engaged—to the extent that, with the recent change of government with its dramatic swing in political ideology, public sector support could be sustained; and
- An expressed interest from private sector companies and XAC clients to invest.

The case of XAC is not unlike the experience of MFIs in other parts of the world. International commercial investors can contribute enormously in the influencing of a positive enabling environment. As the adage goes, "*No one is a prophet in their own land,*" and an off-shore investor will often have more leverage in influencing positive changes to the legal and regulatory environment, as well as in the influencing of donors. With the exception of MSM support, XAC has only minimally relied on such international investor value added contributions to date. However, the need for such inputs is expected to increase in the short term, especially as they relate to donor and government "*unfair competition*" issues, donor-fed market saturation, and the need for microfinance-specific credit bureau information, improved central bank regulatory/supervisory procedures, and specific legal interpretations.

Choosing Investors and Structuring the Deal

In this section we look at the process of choosing investors and structuring investment deals.

Challenges in Working with the Wider Donor Community

> "Like all 'species,' the instinctive behaviour of donors in the development of the microfinance industry is to compete—for the most influential, highest impact, most innovative, and poverty-oriented projects. But, unlike in the commercial arena, such competition—at least between donors—is invariably counter-productive. Recent experience shows increasing awareness of the need for more active in-country coordination between donors and that closer collaboration can be highly beneficial to all stakeholders in the sector.
>
> Where donors are driven by internal pressures to disburse funds, a not unusual situation, the provision of large capital sums to an MFI can actually be harmful. Equally serious, a lack of coordination amongst donors can be confusing to government, notably the central bank or banking supervisory authority."
>
> **Source:** CGAP Focus Note No. 19, February 2001

The donor "threat" is real in Mongolia and the MicroStart Mongolia project has continually found that even though multilateral and bilateral institutions have developed highly sophisticated policies and approaches to financial systems development—of which microfinance is a part—these donors' centrally based institutional policies and knowledge do not always filter down to the field.[11]

Balancing this, however, is the value that international investors can bring to the table: a reputable international investor has the credibility and even weight to be able to influence dramatically the design and approval of donor projects and multi/bilateral loans. One high-profile investor has already exerted influence on the design of a multilateral donor intervention that had the potential to create an unlevel playing field in XAC's areas of activity. The multilateral subsequently dropped this component of its project design.

[11] Excellent examples of well-thought-out policies and strategies include those of the Asian Development Bank, the InterAmerican Development Bank, CGAP, and the MFI and BDS guidelines published by the Donors Committee on Small Enterprise Development.

Choosing the Right Investors

Steps to Consider:

The search for investors appropriate to XAC has been an intriguing exercise and one that involves a sometimes-confusing range of steps. These steps have included:

- Identifying the "type" of investors that institution would ideally like to have;
- Preparing a list of these potential investors and initiating contacts;
- Asking for the support of high-profile international microfinance friends to help in the effort;
- Marketing the institution to these investors;
- Entering into preliminary negotiations;
- Preparing for and hosting the investor due diligence;
- Inviting an investor to be the "lead investor";
- Bridging communications and coordination between potential investors;
- Obtaining approval from current shareholders on moving forward with negotiations;
- Negotiating the deal; and
- Closing the deal with current shareholder approval.

Investment Options:

Specific to the capital side of the balance sheet, a variety of options exists for structuring investments. These include:

- Subordinated debt
- Donated capital
- Stocks purchased at market value, including public listings
- Preferred options
- Treasury stocks
- Employee shares and employee stock options
- Special reserve funds and retained earnings
- Creative means of converting or matching donated capital to commercial or quasi-commercial equity

It is beyond the scope of this paper to define and discuss each of these capital options (and there may be even more). The experience of XAC suggests that donated capital should be used as leverage for attracting commercial capital and that this leveraging should be structured in a manner that places a much higher priority on leveraging this donated capital to attract "*high-quality investors*" as opposed to a simple leveraging of additional money. As is often repeated in XAC and UNDP/Mongolia, "Money ain't the problem, finding good investors is."

Profiling the Ideal Investor:

A variety of types of investors exist for the microfinance industry and include:

- Clients and potential clients of the MFI
- Government
- Traditional private sector investors, both domestic and international
- Social investors both domestic and international
- Quasi investors
- MicroFinance investment funds
- Multi- and bilateral development banks
- International and domestic NGOs
- Domestic apex institutions—a variety of different ownership structures

The first step in the process of identifying investors was a profiling of the ideal XAC investor.[12] The investor should:

- Have a strong international reputation;
- Have the support of the central bank of Mongolia;
- Be a strong and healthy institution;
- Have an orientation toward social investment;
- (At least one of these investors should) be a bank, preferably not too large and with a social orientation;
- Have experience in investing in microfinance banks in other countries;
- Willing and able to share risk with the current shareholders;
- Willing and able to participate in general assembly meetings and as a member of the board of directors; and
- Demonstrate a compatibility of vision with the mission statement of XAC and the other shareholders of the company.

A lesson learned much later by the company was that all current and potential investors should feel comfortable with each other. Structuring a group of investors to come on board at the same time will require an MFI to ensure compatibility and understanding between all parties.

[12] XAC Business Plan Retreat—February 1999.

INTERNATIONAL INVESTOR SURVEY

During the last quarter of the year 2000 and as a complement to this paper, an international survey of commercial MFI investors was conducted. The results of this survey are attached as Annexes 1 and 2 to this report and may serve to guide MFIs in their **profiling of and negotiation with potential investors**. Some summary results of the survey include the following information.

There is no one typical **profile** of microfinance investors. 33 percent of all respondents can be classified as private sector entities (including commercial banks, private investment funds, a finance company, and a "private commercial company"); 33 percent as international NGOs; 28 percent as development banks (with either mixed capital or entirely funded by public sector contributions); and 6 percent as bilateral donors.

Only 22 percent of the respondents specialize in providing **services** only to microfinance institutions. Of the institutions that do not specialize in microfinance investments, the average percentage of their portfolio per institution dedicated to microfinance is 34.6 percent, with a standard deviation of 42.7 percent. Thirty-eight percent of the respondents dedicate 1 percent or less to microfinance.

An overwhelming 94 percent of all respondents plan on increasing their **portfolio investments** in microfinance within the next five years. With the exception of one multilateral institution, all respondents were located in Europe or the Americas.

International institutional investors generally tend to diversify their **regions of coverage** with the average institution investing in 2.29 regions each. Thirty-eight percent of all institutions focus specifically on one geographical region and 22 percent of the respondents are working in four regions.

The most **prevalent instrument** is equity, yet the range of types of investment is quite interesting and highly diversified. The average number of investment products per respondent was nearly three per institution, demonstrating an interest by these institutions to provide a diversity of instruments that may vary according to the type and stage of development of the MFI. However, 22 percent of all investors are currently focused on the provision of only one product. One of the respondents is currently offering six different investment products to MFIs.

It is interesting to note that investors seem to prefer instruments that can be more easily defined as "commercial" (such as equity and commercial loans), with less tendency toward quasi or subsidized investments such as grants and soft loans. However, only 27 percent of these institutions are focused exclusively on the provision of "commercial investments."

Overwhelmingly, the two most important **criteria** for approving an investment are related to the MFI institutional factors of management and governance, closely followed by the overall performance of the MFI (as measured by indicators such as profit, efficiency, and portfolio quality).

When posed the question, "Please describe the five most poignant **difficulties** that you have experienced as an investor in microfinance institutions," investors once again considered "institutional factors" as the category of most importance (39.6 percent); this was closely followed by the quite interesting category: "investor-specific factors" (35.8 percent).

Dealing with Investors

Develop a Culture of Accountability and Transparency:

Anecdotal evidence is already demonstrating that commercial microfinance investors have already been "burned" by MFIs that have failed to divulge in a transparent manner their problems and potential risks. Every institution has its weaknesses and its challenges. The XAC experience of promoting and marketing a culture of accountability and transparency has won it a tremendous degree of domestic and international respect.

XAC has, learned, however, that there needs to be a certain balance between transparency and "over-divulging" information. Written communication has its limitations and can lead to an overreaction and perhaps too much concern from the reader. A tangible example occurred when XAC openly communicated to its external stakeholders the experiences it had confronted regarding employee fraud. Though these cases of fraud (which were quickly and strictly dealt with, while at the same time XAC was continuing to build up internal systems) caused losses to the institution of less than $1,000, certain stakeholders became concerned that the internal controls and procedures of the institution were inadequate to deal effectively with a strategy of rapid growth.[13]

XAC maintains its commitment to instill and market a culture of transparency and accountability while at the same time being careful not to flood stakeholders with too much information through inappropriate channels. The lesson has been learned and reaffirmed: honesty with an investor is more important and will bring many more benefits to the institution than attempts at "saving face."

Market the Institution and Engage Partners to Help:

The gains to be achieved by an effective and aggressive marketing of the institution cannot be understated. It is sad to notice that globally there are MFIs that may be more deserving of international investment than XAC, but that have not been noticed because of a lack of marketing.

Many of the prominent international MFI investors are staffed primarily by Europeans and North Americans. As such, the MFI must be able to adopt its communication and marketing skills to this reality—or alternatively to engage, in a phase-out manner, technical backstopping to compensate for this need.

Marketing the institution has included the distribution of company documents and appraisals, word-of-mouth, email, and telephone communications, and direct visits to the investor. Direct personal contact has proven to be the most effective. This has entailed the necessity of

[13] Senior management continues to stick by a policy of "zero tolerance" when dealing with cases of fraud.

dedicating a significant amount of money for XAC employees to travel internationally in the search for compatible investors. Proactive international visits have empowered the company to be in the driver's seat in the selection of potential investors.

Effective marketing in XAC has been based on the recognition that "*you have to invest money in order to earn money,*" and has included:

- Personal international visits to potential investors;
- Upgrading English communication skills;
- Investing in the technical, communication, and confidence skills of senior and middle managers. (This is part of a strategy of allowing the investor to not have to rely on only one focal person, as well as the overall XAC succession strategy.);
- The following of international standards of accounting, auditing, banking, and disclosure;
- Upgrading negotiation skills; and
- Providing annual reports, a business plan, and other materials that are concise, technically professional, and attractive

Mongolia is a country unknown to a large part of the world and one that at times seems very far away from potential investors. Engaging highly respected, internationally based microfinance friends in the effort proved to be a key element in generating interest in XAC. The company has also found it to be essential to engage the support of foreign individuals and entities to help facilitate and bridge the cultural and technical gaps that have occasionally surfaced.

When XAC initially began searching for investors it was unable to find any survey or listing of international microfinance equity investors. MicroStart Mongolia, with the collaboration of the UNDP Special Unit for Microfinance, has developed a partial list of international microfinance investors. This list with contact information is annexed to this report (Annex 2).

Plan Ahead:

XAC has learned the hard way the necessity of having a clear plan for marketing, negotiating, and closing deals with potential investors. Many factors, both internal as well as external, have contributed to changes in the XAC plan. Linked to the investment timetable is the need to have an overall plan for institutional transformation:[14]

Phase 1: Prepare for Transition

1 Board approval of this timetable and scenario
2 Executive management adjustments to business plan
3 Retain legal services on an as-needed basis

[14] From XAC Board of Directors' Minutes, 2000.

4 Agree with UNDP on transfer and use of remaining funds
5 Network and make effort to liaise with key public sector entities
6 Prepare final analysis and response to consultant reports and appraisals
7 Board agreement on adjusted business plan
8 Board approval of investment strategy
9 Distribution to all current shareholders of investment strategy, transition timetable, and adjusted business plan
10 Design and approve staff shareholder structure, including legal review and all-staff assembly
11 Arrange individual working sessions with the boards of all shareholders
12 Finalize and submit TA request to international donors
13 Hold extraordinary general assembly of shareholders (optional and only if required)
14 Design strategy for strategic alliances (optional)
15 Finalize negotiations with international investors
16 Final agreement with international investors
17 Approval of draft By-Laws and capital structure of XAC Bank by all current and future shareholders
18 Hold annual meeting of XAC shareholders—Decide on future (or dissolution) of Finance Company, equity structure, capital, and future activities

Phase 2: Steps in Transition into a Bank

1 Make adjustments to XAC internal policies and procedures in preparation for bank licensing
2 Inaugurate Founding Assembly of Shareholders of XAC Bank, including approval of by-laws, temporary board of directors, business plan
3 Hold first meeting of temporary board (elect Chair, name CEO, etc.)
4 Submit license request to Mongolia Bank, attaching:

- Application for license
- Founding Agreement
- Charter of the Bank
- Economic feasibility forecast
- Names/addresses of all founders/owners who will own more than 10 percent of the capital
- Institutional description as per central bank format
- Background information on key persons (legal and debt status)
- Foreign investor requirements including letter of intent, legal person, audited statements of last three years

5 Begin implementation of new phase of international technical assistance
6 Gain approval of Bank of Mongolia bank license for XAC Bank, tax registration, relicensing of branch offices
7 Make adjustments to XAC infrastructure (for example, security) in compliance with banking regulations and standards
8 Implement adjustments to XAC organizational structure for banking operations

9 Accelerate staff development and skills acquisition for banking activities
10 Sign and execute shareholders' agreements
11 Fulfill conditional requirements from international investors
12 Disburse or convert equity from shareholders to meet minimum capital requirements
13 Hold first Annual Assembly of XAC Bank shareholders

Negotiate with Investors:

The art of negotiating an equity investment can be complex, time-consuming, and frustrating for both parties. XAC corporate culture defines negotiation as a process in which both parties win. This has been achieved through an ability to be flexible and compromising without sacrificing the principles and mission of the company.

The negotiation process begins during the due diligence and continues up until the term sheet has been signed. Depending on the investor and the maturity of the MFI, this can take from one month to several years.

XAC first attempted to coordinate due diligence exercises so that potential investors would either conduct this activity together at the same time, or accept the due diligence conclusions of one lead investor. Neither concept proved workable and upon reflection XAC advises other MFIs to ask each investor to conduct its own independent due diligence. Though this is much more time-consuming for the MFI, it will help to assure that each potential investor has: (1) internalized the risks and benefits of the investment in its own unique manner; and (2) allowed for the establishment of a personal relationship between senior management of the MFI and the investment officer.

After each due diligence, the investment officer writes a report and submits it to a committee for review and decision on whether to move forward on negotiating the deal. At this moment, the two parties enter into a process that can become cumbersome and might include negotiating changes to the business plan, obtaining legal opinions, paying upfront processing fees, and carrying out extraordinary meetings of the current shareholders, with resulting delays and reversals.

This process has been the area where XAC has encountered the most difficulties. It seems that most investors are unwilling to share the template of how a term sheet might be structured until after initial activities, such as the due diligence, have been concluded. This has led to mixed expectations that were not clearly understood or communicated by the two parties.

With larger institutional investors, many more of their departments and individuals might become involved than one would expect. This can lead to unexpected and uncomfortable new demands for information requirements, and add costs and even sudden conditionalities that might not have been initially communicated to the MFI by the investment officer. Patience, flexibility, and understanding balanced with a self-confident ability to be firm in representing and defending the interests of the company have been of great importance when negotiating with these larger institutional investors.

During the process of closing the deal, XAC has learned that it is of utmost importance to keep all major investors continually informed. Conference calls, grouped emails, and cross-visits between these investors have added to a feeling that "*we are all in this together.*" Though it can be tempting, XAC does not feel that it is advisable to "*play potential investors off against each*" in order to "*get a better deal.*" Instead, the ideal situation is felt to be one where all existing and potential shareholders feel like they belong to the same syndicate and are working together for the benefit of the company. This is an ideal that XAC has worked toward, but not fully achieved.

Because XAC is less than two-and-a-half years old, the necessity of searching for and obtaining technical assistance grants continues. Therefore, potential donors have been involved in the negotiation process and are copied on all major communications between primary equity investors.

Close the Deal:

It is beyond the scope of this paper to lead the reader through each and every element of a term sheet for equity investment. There are so many variations on how a term sheet might be structured that XAC recommends that both MFIs and investors put more effort in talking through potential term sheet scenarios as early as possible during the negotiation process. Please refer to Annex 4 for a partial list of some of the terms and conditions that an MIF may need to negotiate.

From the experience of XAC, there may be some aspects of a term sheet that are particular to an international investment in an MFI. These include:

- Associated Costs of Governance**:** Will the board of directors be a voluntary board or a paid board? Will the company bear the expenses of international representation within the governance structure of the company? Absorbing these costs can be expensive for a young institution.

- Legal Fees and Auditing Costs**:** Some international investors will insist on the company, retaining the services of internationally recognized auditors and legal counsel. Again, these costs can prove to be prohibitive. Such services might not even be available locally.

- Strategic Alliances**:** It is not uncommon for international investors to condition their investment on the company's acceptance of a technical partner. Technical partners can take the form of an investor-identified consulting company, imposed board representatives, the acceptance of an investor-sanctioned institutional approach (based on a template comfortable to the investor), or a technical partner that is mutually agreed upon between the investor and the company. In some instances, the MFI will be required to accept a manager or management firm acceptable to the investor—thus making necessary the temporary or permanent stepping down of the existing executive management.

- Exit Strategy**:** Many international MFI investors will want a guaranteed exit strategy: an assurance from the company that within a predefined period of time (usually within three to nine years) the investor will be able to sell off its shares on the local capital market.

- Preferred Options**:** Some investors, for example those who are less comfortable with the risks involved in microfinance, will wish to negotiate arrangements such as put options, preferred stock options, and subordinated or "quasi debt." MFIs that negotiate these types of preferred options must be careful not to alienate other current and potential investors during the process (through the creation of an unlevel playing field).

- Right of Refusal**:** Socially oriented investors are often more concerned than traditional investors with the sources of wealth and social standing of other current and future investors.

- Protection of the Double Bottom Line**:** Socially oriented investors will often seek assurances—through the capital structure, bylaws, and governance systems of the MFI—that the institution will be adequately protected from drifting away from its social mission and focus, while at the same time assuring a fair return on investment.

- Other Conditionalities**:** Terms sheets or investor agreements may also contain some unexpected conditionalities such as clauses for environmental protection, prohibited activities (such as lending for business dedicated to the sale of alcohol and tobacco), and restricted targeting (such as by type of target population, geographical location, gender, or religion).

Again, it is advised that, based on the XAC experience, the sooner an MFI can find out what these terms and conditions might be, the better for both parties.

PART THREE: TRANSFORMATION READINESS IN 2001

As of April 2001, and after nearly two years of effort, XAC had yet to fully close any international equity deal. Yet, the institution is getting increasingly close to ensuring that its equity structure will be fulfilled with the minimum capital required to become a bank. Following is a summary of the status of the process:

- By the middle of 2001, UNDP will have made direct transfers of 914,747,262 MNT to the finance company, "XAC, Co. Ltd.". These are booked as liabilities until such time as UNDP decides on their transfer into Mongolian ownership.
- To this date, 300,000,000 MNT of this amount have been legally transferred to the ownership of six different NGOs.
- Employees have been included as shareholders within the company with a 240,000,000 MNT transfer from UNDP and a forthcoming match of 24,000,000 from the employees themselves.
- A company reserve of 100,000,000 MNT has been established with UNDP assets, booked as treasury stock.
- Negotiations were under way with two, international, socially oriented banks as recipients of 330,000 MNT of UNDP assets for the purchase of share capital in XAC.
- The general assembly of shareholders decided to authorize the transformation of XAC, Co. Ltd. into a microfinance bank with a share structure that would be comprised of 49 percent international investors and 51 percent Mongolian ownership.
- The minimum capital (first-tier) requirement for the establishment of a commercial bank in Mongolia is 2,000,000,000 MNT (roughly $1,801,801 at a projected exchange rate of 1,110:1).
- Approximately 888,000,000 MNT in foreign direct investment are sought (at an exchange rate of 1,110:1, this is $800,000).
- An international NGO has tentatively agreed to invest $100,000.
- Triodos Bank/Holland has provided a $400,000 commercially priced convertible loan at commercial rate. Contingent upon certain conditionalities, this loan will be converted to equity upon the licensing of the XAC Bank.
- The Mongolian NGOs have so far committed to purchasing approximately $70,000 of shares with their own resources and have also reinvested approximately $40,000 of their XAC-generated dividends back into the company.
- The negotiations for closing the deal for a $400,000 commercial loan are nearing completion.

Despite the tremendous levels of effort required to effectively diversify its asset base and transform into a bank, the performance of XAC continues at internationally acceptable levels: as of April 9, 2001 the portfolio at risk of more than 30 days was well below 1 percent. Also, during the first three months of 2001, the company generated a net profit of $41,000 (a ROE of 19 percent) and the number of active clients had increased by 8.3 percent.

Later in 2001 XAC opted to merge with another NBFI, Goviin Ehlel Ltd, the country's leading small- and medium-enterprise lending institution. In December 2001 the merged institution was recognized as a fully licensed bank.

ANNEXES

Annex 1 International Investor Survey

During the last quarter of 2000, the authors, with UNCDF Special Unit for Microfinance conducted a survey among international commercial microfinance investors. This survey was forwarded by post and email to 38 different organizations, with a subsequent response from 18 institutions (47 percent). The survey did not attempt to gauge responses from individual investors, nor was the survey sent to domestic institutional investors such as second-tier apex institutions or locally owned commercial banks.

The following is a summary of the results of this survey:

Investor Profile

There is no one typical profile of microfinance investors. Commercial investors in microfinance include:

- Clients and/or members of the MFI;
- Individual, domestic, private and/or social investors;
- Individual, international, private and/or social investors;
- National and international NGOs (nongovernmental and not-for-profit);
- Banks, including development banks, commercial banks, and socially oriented commercial banks;
- Other types of private sector entities, including investment funds, finance companies, and privately held second-tier apex institutions (such as credit union credit facilities);
- Domestic and international government agencies; and
- Multilateral aid agencies.

Thirty-three percent of all respondents can be classified as private sector entities (including commercial banks, private investment funds, a finance company, and a "private commercial company"); 33 percent as international NGOs; 28 percent as development banks (with either mixed capital or entirely funded by public sector contributions); and 6 percent as bilateral donors.

Only 22 percent of the respondents specialize in providing services only to microfinance institutions. Of the institutions that do not specialize in microfinance investments, the average percentage of their portfolio per institution dedicated to microfinance is 34.6 percent, with a standard deviation of 42.7 percent. Thirty-eight percent of the respondents dedicate 1 percent or less to microfinance.

An overwhelming 94 percent of all respondents plan on increasing their portfolio investments in microfinance within the next five years. Two of these institutions plan on the establishment of capital market or investment funds as part of this strategy of growth.

With the exception of one multilateral institution, all respondents were located either in Europe or the Americas.

Geographical areas of activity were far-ranging:

Africa	50%	of all respondents invest in this region
America (including USA)	68%	"
Asia	61%	"
CIS/NIS/Eastern Europe	28%	"
Middle East	6%	"

International institutional investors generally tend to diversify their regions of coverage with the average institution investing in 2.29 regions each. Thirty-eight percent of all institutions focus especially on one geographical region and 22 percent of the respondents are working in four regions.

The most prevalent financing instrument is equity, yet the range of types of investment is interesting and highly diversified:

Financing Instrument	Number of Institutions Providing this Instrument	Frequency (percentage)
Equity	14	78
Commercial Loans	10	56
Convertible Loans	8	44
Subordinated Debt	7	39
Loan Guarantees	6	33
Soft Loans	6	33
Grants	1	6

One respondent indicated "technical assistance" as a form of investment. This response has not been computed in the results.

The average number of investment products per respondent was nearly three per institution, demonstrating an interest by these institutions to provide a diversity of instruments that may vary according to the type and stage of development of the MFI. However, 22 percent of all investors provide only one product. One of the respondents is currently offering six different investment products to MFIs.

It is interesting to note that investors seem to prefer instruments that can be more easily defined as "commercial" (such as equity and commercial loans), with less tendency toward quasi or subsidized investments such as grants and soft loans. However, only 27 percent of these institutions are focused exclusively on the provision of "commercial investments." This seems to indicate recognition on the part of investors of the difficulty of many MFIs to fully assume the financial and other costs associated with the taking on of investments. Only 2 of the 18 institutions do not include any commercial instruments in their portfolios.

Terms and Conditions of Investment

Respondents were surveyed about the terms and conditions of two types of products: Equity and Loans. Understandably there was hesitancy on the part of the investors to provide details to these queries.

Equity Investments

Number of Equity Investors:	14
Percentage that provided details on the terms and conditions:	33%
Average minimum equity investment in an MFI:	$325,000
Lowest minimum equity investment in an MFI	$ 30,000
Average maximum percentage of total ownership in an MFI:	26%
Lowest percentage investment of total ownership in an MFI:	10%
Highest maximum percentage of total ownership:	49%
Average Maximum Length for Exit:	6.2 years
Maximum Length of time of Exit	9 years

Conditionalities for an equity investment: Primarily related to institutional capabilities

Commercial Loans

Number of Institutions providing Commercial Loans:	10
Percentage of respondents that provided details:	70%
Average minimum allowable size of loan:	$ 177,429
Lowest minimum size of loan:	$ 30,000
Average maximum allowable size of loan:	$1,832,143
Maximum allowable size of loan:	$2,500,000

Annual Percentage Rate on Loan: Usually calculated based on LIBOR (foreign currency loans) or Local Benchmark (local currency), with an added institutional spread of between 1.5–2.6 percent for forex and 4–8 percent for local currency.

Service Fees: 50 percent of respondents do not charge added fees. All others charge between 0.5 to 1.5 percent.

Criteria for Approving Investments

To the query, "From an investors' perspective please provide what you consider to be the five most important criteria for approving an investment in a microfinance institution," 17 valid responses were received:

Criteria	Number of Responses	Frequency (percentage)
Management and Governance	15	83
Performance: Profit, Efficiency, Portfolio Quality	13	72
External Environment (Legal and Economic)	7	39
Impact/Outreach (Immediate)	6	33
Understanding Market, Potential For Growth	6	33
Systems and Policies (Including MIS)	5	28
Financial Structure /Legal Status	4	22
Trusted Partner	4	22
Private Shareholders	3	17
Vision/Commitment	3	17
Exit Strategy for Investor	2	11
Innovation/Potential for Replication	1	6
New Institution	1	6
Availability, or Not, of Other Sources of Funding	1	6
Forex Risk	1	6
Risk Reduction Measures	1	6

Overwhelmingly, the two most important criteria for approving an investment—from the investor's perspective—are management and governance, closely followed by the overall performance of the MFI (as measured by factors such as profit, efficiency, and portfolio quality).

Grouping the above responses by category, investors overwhelmingly considered "institutional factors" as the category of most importance:

Institutional Factors:	39 responses	52.7%
Investor Specific Factors:	16	21.6 %
Impact and Outreach:	12	16.2 %
External Factors:	7	9.5 %

Difficulties Encountered

When posed with the question, “Please describe the five most poignant difficulties that you have experienced as an investor in microfinance institutions,” 18 valid responses were received:

Difficulties Encountered	Number of Responses	Frequency (percentage)
Weak Management and Systems	11	61
Regulatory/Legal Issues / Policy	6	33
Difficult to Attract Private Investors	4	22
Unfair Competition—Especially among and Between Donors	4	22
Internal Problems of the Investor	3	17
Lack of Appropriate Technical Assistance to the MFI	3	17
Foreign Exchange Risks	3	17
Inability of the MFI to Increase Scale of Outreach	3	17
Weak Governance	3	17
Small Size of Investment	2	11
Lack of Formal MF Institutions	2	11
Exit Strategy for the Investor	1	6
Very Expensive to Participate on the Board of Directors	1	6
Finding the Balance Between Subsidies and Commercial Funding During Start-up Phase	1	6
Difficulty in Establishing Standardized Criteria Between Investors	1	6
Hard to Market MFI Issues to Northern Investors (Paradigm)	1	6

Grouping the above responses by category, investors once again overwhelmingly considered "institutional factors" as the most important category:

Institutional Factors:	21 responses	39.6 %
Investor Specific Factors:	19 "	35.8 %
External Factors:	13 "	24.5 %
Impact and Outreach:	0 "	0.0 %

The Near Future for MicroFinance Investments

When posed with the question, "What do you think the near future (five years) brings for private and public investors in microfinance globally…," eight valid responses were received:

The Future for MF Investments (paraphrased)	Number of Responses	Frequency (percentage)
There will be more investment opportunities. These will mostly be socially oriented.	13	52
Local capital markets will continue to improve, including private banks as investors	6	24
There will be more interest and an improved responsiveness of multi and bi-lateral institutions in MF investments.	2	8
There will be a greater degree of focus on savings mobilization as a means to raise the MFI's assets.	1	4
There will be a decrease in the availability of donations.	1	4
The will be a diversification in the opportunities for MF investments (such as micro-insurance)	1	4
The investment risk for investing in MFIs will remain high.	1	4

Annex 2 Microfinance Investors—Partial List

Organization
ACCION International, GATEWAY FUND 120 Beacon Street, Somerville, MA 02143, USA Fax +1 617 876 9509 http://www.accion.org/programs/main.asp => Latin American Network
Agence Française de Développement (AFD) See Proparco
African Development Bank (AFDB) AFD Microfinance Initiative for Africa AMINA 01 BP 1387, Abidjan 01, Côte d'Ivoire Fax: +225) 20 20 59 72 www.afdb.org/about/amina-overview.html
BANCO NACIONAL DE DESARROLLO AGRICOLA (BANDESA) 9 Calle 9-47, zona 1, Guatemala City, Guatemala Fax: 537927 www.fundesa.guatemala.org
BAWI, State Secretariat for Economic Affairs (Seco) Bundesgasse 8, Ch-3003 Berne, Switzerland Fax: 031 / 311 39 81 www.admin.ch/bawi or www.seco-admin.ch
CALMEADOW P.O. Box 1 TD Center Post Office, Toronto, ON M5K 1A2, Canada Fax. +1 416 308 6533 www.calmeadow.com
CALVERT FOUNDATION 4550 Montgomery Avenue, Bethesda, MD 20814, USA Fax +301 654 7820 www.calvertgroup.com
CARE Economic Development Unit 151 Ellis Street, Atlanta, GA 30303, USA Fax +1 404 589 2619 www.care.org/programs
CENTRAL AMERICAN BANK FOR ECONOMIC INTEGRATION—CABEI–Tegucigalpa, Honduras www.bcie.org
COMMONWEALTH DEVELOPMENT CORPORATION see DfID

CORPORACION ANDINA DE FOMENTO (CAF) Av. L. Roche, Torre CAF, Piso 13, Urb. Alamia, Caracas, Venezuela Fax +582 209 2325
Catholic Relief Services (CRS) Microfinance Unit 209 West Fayette Street Fax +1 234 3178 http://www.catholicrelief.com/what/overseas/enterprise.cfm
DEG - German Investment and Development Co. Belvederestraße 40, 50933 Köln, Germany Fax +49 221 4986 209 www.deginvest.de
DEPARTMENT FOR INTERNATIONAL DEVELOPMENT (DfID) EED 94 Victoria Street, London W 1E 5JL, United Kingdom Fax +44 0207 917 0797 www.dfid.gov.uk
EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD) Group For Small Business, Financial Institutions (SME) One Exchange Square, London EC2A 2JN, United Kingdom Fax: +44 20 7338 6100 www.ebrd.com
European Investment Bank (EIB) 100, boulevard Konrad Adenauer, L - 2950 Luxembourg Fax: +352 43 77 04 www.eib.org
FINCA 1101 14th Street, NW, 12th Floor, Washington, D.C. 20005 Fax +1 202 682 1535 www.villagebanking.org
FINN FUND Ratakatu 27, FIN-00120 Helsinki, Finland www.finnfund.fi
FMO Koningskade 40, 2509 Ab, The Hague, Netherlands Fax +31 70 314 97 59; www.fmo.nl
Frontier Finance Washington DC
Grameen Foundation USA 1709 New York Ave., NW, Suite 101, Washington, DC 20006 Fax +1 202 628-3880 www.grameenfoundation.org

IMI / IPC Am Eisernen Schlag 31, 60431 Frankfurt am Main, Germany Fax +49-69-951437-25 www.ipcgmbh.com
INTER AMERICAN INVESTMENT CORPORATION – IIC- (of the IADB) 1300 New York Avenue, NW, Washington DC, 20057, USA Fax: 1 202 623-3815 www.iadb.org/iic/
INTERNATIONAL FINANCE CORPORATION (IFC) 2121 Pennsylvania Ave., N.W. Washington D.C. 20433, USA Fax +1 202 974 4459 www.ifc.org
Kreditanstalt für Wiederaufbau (KfW) Palmengartenstraße 5-9, 60325 Frankfurt am Main Germany Fax +49 69 74 31 29 44 www.kfw.de
MULTI-LATERAL INVESTMENT FUND see IIC of IADB
NATIONAL COMMUNITY CAPITAL ASSOCATION Financial Services (USA) 620 Chestnut Street, Suite 572, Philadelphia, PA 19106, USA Fax +1 215 923 4755 www.communitycapital.org
NORFUND Munkedamsveien 45, 0111 Vika Oslo, Norway Fax +47 22 019394 www.norfund.org
PLANET FINANCE 76, rue du Faubourg Saint-Denis, 75010 Paris, France Fax. +33 1 53 24 11 57 www.planetfinance.org
Asian Development Bank (ADB) Private Sector Development Group P.O. Box 789, Manila, Philippines Fax +632 636 2295 www.adb.org/Microfinance/default.asp
PRO-FUND P.O. Box 769 1005, San Jose, Costa Rica Fax +506 220 2345
PROPARCO 5 rue Roland Barthes, 75598 Paris Cedex 12, France Fax +33 1 53 44 32 93 www.afd.fr

SIDI 47,quai des Grands Augustins, 75006Paris, France Fax +33 1 46 34 81 18 www.sidi.fr
SOROS FOUNDATION – Open Society Institute 400 West 59th Street, New York, NY 10019, USA Fax: 1 212 548 4679 www.soros.org
SOUTH SHORE BANK 7054 S. Jeffrey Boulevard, Chicago, IL 60649, USA www.sbk.com
Swedfund P.O. Box 3286, S-103 65 Stockholm, Sweden Fax: +46 8 20 30 93 www.swedfund.se
TRIODOS Bank NV P.O. Box 55, 3700 AB Zeist, The Netherlands Fax +31 30 69 36 566 www.triodos.nl

Annex 3 Internet Sources—Partial List

Consultative Group to Assist the Poorest, CGAP, 1818 H Street NW, Room Q 4022, Washington, D.C. 20433, USA, internet www.cgap.org

Investors' Circle, internet www.icircle.org

Memorandum of Understanding for the Transfer of Assets to Local Shareholders—MicroStart Mongolia, contact: x_a_c@mongol.net

Moving Microfinance Forward: 5th Annual Conference of the MicroFinance Network. The Creation of MiBanco, Manuel Montoya, Managing Director, ACP, Peru, internet http://www.bellanet.org/partners/mfn/conf.html

Moving Microfinance Forward: 5th Annual Conference of the MicroFinance Network. Theme I: Ownership, Private Equity Capital in the Microfinance Industry, Martin Connell, President, Calmeadow, Canada, internet www.bellanet.org/partners/mfn/egypt/index.htm

Shorebank, Chicago, internet www.sbk.com

Social investors internet list available at www.sociallyresponsible.com/investing.htm

Term Sheet for Equity Investment and Strategic Alliance available at www.allbusiness.com

The National Centre for Employee Ownership. All rights reserved. Phone 510/208-1300; e-mail nceo@nceo.org; internet www.nceo.org

The Stock Options Book. A publication on stock options; covers plan types, plan design, administration, valuation, IPOs, closely held companies, current practices, etc. $25 members, $35 nonmembers. This and other books on Employee Ownership.

Sources of Funds for Agricultural Lending, Agricultural Finance Revisited, Paper No. 4, GTZ/FAO, internet www.fao.org/ag/ags/agsp/agsm/ruralfin.htm

Social Investment Forum, a U.S. national nonprofit membership organization promoting the concept, practice, and growth of socially responsible investing, internet www.socialinvest.org

Annex 4 Term Sheet Items

The following is a partial list of some of the terms and conditions that an MFI might need to negotiate.

1. Amount of investment
2. Valuation of the company
3. Type of security
4. Price per share
5. Capitalization of the company
6. Rights, preferences, privileges and restrictions of preferred stock
    - Lead investor rights, including right of refusal
    - Preemptive rights
    - Dividend provisions;
    - Liquidation preference
    - Conversion
    - Automatic conversion
    - Anti-dilution provisions
    - Voting rights
    - Protective provisions
7. Redemption
8. Information and registration rights
9. Put options
10. Board representation
11. Use of proceeds
12. Employment relationships
13. Market standoff agreements
14. Reserved employee shares and ESOP
15. Right of first refusal
16. Confidential information and inventions assignment agreement
17. The stock purchase agreement
18. The strategic alliance. Technical partner agreement or technical assistance conditionalities
19. Conditions of closing
20. Expenses, including legal fees and associated costs of governance
21. Governing law
22. Resolution of conflicts
23. Repatriation of profits
24. Exit strategy
25. Auditing and reporting requirements
26. Finders' fees
27. Closing
28. Naming of the counsel to the investors and to the company