

Microfinance: from the ground up

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When Gloria Demba's husband died, she quit her factory job in Harare, Zimbabwe, to start her own business and earn more money for herself and her eight-year-old son. Now she works 12-hour days selling snacks at Mbare Musika bus terminal and in the evenings earns cash by mending and sewing clothes for her neighbours. She has a punishing schedule, but working two jobs is helping her save enough to expand her business, buy a second-hand car and send her son to school.

Aside from a great deal of hard work, it took an initial loan of ZW\$25,000 (\$20 in 2002) from MicroKing, a local microfinance institution, to get Demba's new business up and running, plus a follow-up loan to buy a sewing machine.

Demba's story is one of many that illustrate the force of microfinance initiatives worldwide. When Muhammad Yunus won the 2006 Nobel Peace Prize for his pioneering work in microfinance in Bangladesh, it helped bring wider recognition to the field.

Within the US, commercial microfinance - the process of investing in local microfinance institutions (MFIs) for a return, instead of making a donation - has grown rapidly in the past year and private investors are leading the charge.

Wealthy individuals have been investing in microfinance funds for years, but recently, there has been greater emphasis on investing for both social and financial returns. There is a growing sense that philanthropic dollars are finite and that there might be a more effective way to make a financial commitment. The result is a host of new public and private microfinance funds offering a variety of debt and equity opportunities.

Gary Hattem, president of the DB Americas Foundation and head of the community development finance group at Deutsche Bank, says the fact that wealthy investors have been creative and entrepreneurial in this area has encouraged institutional investors to get involved.

"We really see wealthy individuals and families as leading the development of commercial microfinance by showing a willingness to take more risk, lending credibility to early stage initiatives and collaborating with one another," he says. That has brought scale, liquidity and further investment opportunities to the market.

Wealthy individuals who want to place debt or equity with one of the dedicated microfinance funds that advance capital to local MFIs have a choice of new products.

For example, MicroVest, an asset management company dedicated to microfinance, runs MicroVest I, a traditional microfinance fund targeted predominantly at individuals and medium-sized family institutions with a minimum investment of \$500,000. Equity

investors in the fund receive a return of 8-9 per cent while debt investors receive between 5 per cent and 6.5 per cent.

It also offers mPowers, a retail note in conjunction with The Calvert Foundation. The minimum investment is \$1,000 with a return of up to 3 per cent. In the coming weeks it will also launch a local currency microfinance fund open to individuals who want to invest \$250,000 or more.

"We think this is a really important next step for the market, " says Gil Crawford, general manager at MicroVest Capital Management. "At the moment, 92 per cent of cross-border loans to MFIs are denominated in hard currencies and the foreign exchange mismatch can be a real problem for some of them. "

There are many new funds in this market, but the returns and risks vary depending on the investment vehicle, the MFIs in which the fund invests and the investment ethos.

"We want to see a strong financial return from our MFIs but also a high social return, " says Maria Otero, chief executive of Accion International, a private non-profit organisation that works with 30 MFIs in 23 countries, including MicroKing in Zimbabwe.

Still, one of the difficulties is that risk cannot be assessed in a traditional way. The fact that credit rating agencies now rate MFIs makes the market more transparent, but assessing the credit risk of so many people borrowing tiny, unsecured amounts is not easy.

"There's no broad consensus about what the real default rates are on these loans, but as people are not doing it strictly for the credit or the yield, but for the social impact, this requires a fairly unique judgment set, " says Robert Weissenstein, chief investment officer and managing director of private banking in the US for Credit Suisse.

Managers of funds say the default rate of the MFIs in which they invest is low, in MicroVest's case, less than 1 per cent over five years. "The volatility of MFI returns are lower than commercial banks in those markets because MFI funds are invested in the informal sector, so don't take macro-economic shocks in those countries on the chin as the banks do, " says Crawford.

The involvement of the rating agencies, coupled with institutions starting to raise funds for MFIs through the capital markets, could give the industry a much-needed boost in size, liquidity and transparency and present new direct and indirect investment opportunities.

Otero thinks that to obtain scale, microfinance must be considered a serious asset class and that more companies, banks and non-profits should form alliances to maximise their potential impact. She says that bilateral investments are not enough. "The need to scale-

up microfinance is enormous. We're just beginning to see support from the US capital markets, but much more needs to be done, " Otero adds.

Still, progress is being made. Last month, MicroVest closed its first syndicated microfinance loan. The \$2m three-year term loan was syndicated between three independent funds, MicroVest I, The Calvert Social Investment Foundation and The Dignity Fund. The loan is going to D-MIRO, an MFI in Ecuador, which will use it to continue making micro loans where it operates in the slums of Guayaquil. The syndication will mean diversification for investors and a lower cost of capital for the MFI.

The securitisation of micro loans means more liquidity and a more sophisticated risk package. "The more investors want to participate in these loan packages, the more liquidity there is in the market and the more potential there is to lend locally, " says Weissenstein. "We don't have private clients participating in this space yet, but as it develops more it could certainly become an opportunity. "

There is certainly scope for more investment. The number of microcredit customers is increasing on average 34 per cent a year, yet only 4 per cent of the potential end market has been captured so far, according to MicroCredit Summit.

Advances in technology are already making it easier to reach potential customers in remote areas where there may be no banks or ATMs. In Zambia, for example, individuals registered with the mobile payment processing company CelPay, can get funds transferred to their account via a secure text message. The phone can also be used to make payments to merchants' accounts in the same way.

There are, however, some limits to growth. A key concern is that there are not enough profitable MFIs able to absorb all the commercial capital flowing from dedicated microfinance funds and that many still depend on grants. "It's difficult for early stage institutions often operating in rural areas where distribution costs are very high, to absorb commercial capital, " says Hattem. "We need to work at expanding the capacity of the sector overall. "

Competition to invest in MFIs with the best records is intensifying. MicroVest does not invest in the top 50 MFIs, but the next tier - between \$5m-\$15m in size. Nevertheless, even that part of the market is becoming crowded.

"Two years ago we were the first foreign lender to lend to an MFI in [the country of] Georgia. The people running it were good, but they'd been going through a rough patch, " says Edi Sian, investment officer at MicroVest. "A few months after we started lending them money, other funds started moving in and now the people lending to them read like a Who's Who of microfinance. "

Otero says grants have to be made to get more local financial institutions off the ground.

Further down the track, MFIs need long-term equity capital to enable them to build sustainable businesses and apply for bank licences. Accion and MicroVest commit statutory equity capital to MFIs with a solid financial record.

Some funds are bypassing traditional microfinance models, and the MFIs, and lending directly to businesses, rather than individuals.

Eight years ago, Deutsche Bank set up the Microcredit Development Fund targeted at private clients and is now approaching wealthy investors for the Deutsche Bank Start Up Fund, an open-ended fund that provides equity seed capital to get local businesses up and running.

In spite of increased competition between funds, there is plenty of scope for individual investors to set the pace of innovation in this market.