

Microfinance Cracking the Capital Markets II

Written by Rekha Reddy based upon speeches and presentations from the “Microfinance Cracking the Capital Markets II” conference

Investment in microfinance, particularly cross-border investment, is booming. Where is this investment coming from? Where and how is it being absorbed? What types of advances need to occur to build a healthy infrastructure for debt and equity investments into microfinance? How do we manage the risks investors face?

These questions were discussed as part of the second annual *Microfinance Cracking the Capital Markets* conference, hosted by ACCION International and sponsored by Credit Suisse. The conference, which took place in New York on March 19-20, 2007, brought together more than 300 fund managers, emerging markets specialists and intermediaries to consider these questions. The conference highlighted the growth in microfinance investment, recent innovations in structured deals, and ways in which microfinance institutions (MFIs) need to develop to integrate more fully into the capital markets.

I. The State of Investment in Microfinance

The demand for microfinance investment is increasing. The 100 largest MFIs are increasing their client base by 26 percent per year and have an ever-increasing need for capital.¹ Foreign capital assists MFIs that are ready for capital investment, but are unable to access it locally, often because they operate in countries where local capital markets are weak. However, domestic capital is crucial for the healthy development of the microfinance sector. Many believe that savings mobilized from local depositors will ultimately be the largest source of capital for microfinance. Foreign capital provides 22 percent of funding for the “Top 100” MFIs, but savings is the first source of capital, representing 41 percent of all assets in 2005.²

Some investors believe that the current investment level in microfinance is greater than the ability of MFIs to absorb that investment. Jean Philippe de Schrevel of Blue Orchard Microfinance Investments Managers stated that he would be unable to place US\$100 million in debt today, because there are too few MFIs that are ready to absorb private investment.

Some investors believe that the current investment level in microfinance is greater than the ability of MFIs to absorb that investment.

At the same time, some private investors are accusing International Financial Institutions (IFIs) of crowding out private investors for deals with top microfinance institutions and for being

¹ MIX Market. Analysis of top 100 MFIs. www.mixmarket.org

² Ibid.

unwilling today (unlike in the past) to take risks to advance the sector. A recent MicroRate study³ has ignited significant debate by citing evidence for this proposition. Conference participants argued for a more nuanced discussion on crowding out, noting that the line between IFIs and private investment is often blurred, since IFIs are key investors in many private microfinance investment vehicles. Others argued that the crowding out story was different in Africa than in Latin America or Eastern Europe, as capital is badly needed in the latter.

Conference participants argued for a more nuanced discussion on crowding out, noting that the line between IFIs and private investment is often blurred, since IFIs are key investors in many private microfinance investment vehicles.

James Mwangi, CEO of Equity Bank, Kenya pointed out that even if the supply of investment exists, “It is often difficult to match available needs with funds, particularly when regulatory requirements and exchange rate risks come into play.”

Foreign Capital

According to the Consultative Group to Assist the Poor (CGAP), US\$4 billion in foreign capital was invested in microfinance in 2006, a dramatic increase from the US\$1.6 billion in foreign investment recorded in 2004. This represents investment in both debt and equity. Foreign investment in microfinance comes primarily from two major players, International Financial Institutions (IFIs) and Microfinance Investment Vehicles (MIVs), as described in Table 1.

Table 1: International Investors in Microfinance

Category	Description	Portfolio Outstanding (US\$)	Average Investment Size (US\$)	Sample Institutions
International Financial Institutions (IFIs)	Private sector arm of public finance institutions	\$2.4 billion	\$4 million	EBRD, IFC, KfW
Microfinance Investment Vehicles (MIVs)	Private microfinance funds	\$2.0 billion	\$1 million	ProCredit Holding, Oikocredit, Dexia

Source: CGAP-MicroRate survey 2005 as cited in Littlefield, Elizabeth L. “Building Financial Systems for the Poor, MIVs and DFI Investment Examined.” *Proceedings of the second annual Cracking the Capital Markets II Conference*, New York, Presentation March 19, 2007

Investment by both IFIs and MIVs is growing rapidly. Since 2004, the aggregate IFI portfolio increased 150 percent, while the MIV portfolio grew even more rapidly, with an increase of 233 percent.⁴

³ Abrams, Julie and Damian von Stauffenberg. “Role Reversal: Are Public Development Institutions Crowding Out Private Investment in Microfinance?” February 2007

⁴ Source: Presentation by Littlefield, Elizabeth L. “Building Financial Systems for the Poor, MIVs and DFI Investment Examined.” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

An Overview of Microfinance Investment Vehicles

Of the 74 microfinance investment vehicles known to CGAP, 30 were created in the last two years. Elizabeth Littlefield, CEO of CGAP, discussed the characteristics of these proliferating MIVs, using data from a 2005 CGAP-MicroRate survey on the topic.

Small Size: 61 of the 74 MIVs hold less than \$1 million.

A Few Major Players: The top 10 MIVs hold 65% of all MIV investments.

Concentrated in Eastern Europe and Latin America: Forty-two percent of investment occurs in Latin America and Caribbean, and 39 percent occurs in Eastern Europe and Central Asia

Invested in a limited pool of MFIs: Ten MFIs located in Latin America or Europe and Central Asia absorb 26 percent of all MIV investment.

Figure 1: Top 10 MIVs



Source: CGAP 2005 MIV survey

MIVs (and IFIs) invest heavily in the top 50 MFIs, creating fierce competition for these top-tier investments, causing IFIs to be increasingly accused of crowding out private investment. However, there has been less interest in “Tier 2” and “Tier 3” MFIs. Approximately 450 to 500 MFIs receive investment from MIVs.

Focus on debt in hard currency:

The vast majority of MIV investment is in debt, with 70 percent of that debt issued in hard currency. However, investment in local currency using hedging mechanisms is increasing rapidly.

Equity investment concentrated in new/young institutions:

Equity investment makes up 25 percent of all investment. Greenfield (new) or young institutions absorbed 75 percent of all equity investments according to the 2005 CGAP MicroRate study.

Return on Investment (ROI):

Recent CGAP studies of return have found the average ROI for the average microfinance investment vehicle to be 2 to 4 percent. This relatively low return occurs even before any adjustments for subsidies these funds might receive.

Funding base:

Approximately 47 percent of MIV funds come from socially responsible investors, 36 percent from IFIs, and the remaining 17 percent from mainstream investors.⁵ This is a major change from previous findings, showing a rapid inflow of private capital.

⁵Source: Presentation by Littlefield, Elizabeth L. “Building Financial Systems for the Poor, MIVs and DFI Investment Examined.” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

II. Innovative Deals in Structured Finance

Debt Finance

Leading MFIs are engaging in new strategies to access local and international capital markets. They are applying techniques common in emerging markets finance to the microfinance industry. A few groundbreaking deals were highlighted during the conference.

Table 2: Innovations in Debt Finance

Structure	Name of Issuance	Amount Placed (US\$)	Year Issued
International CDO	BOLD-2006-1	99.1 million	2006
Investment in Mezzanine Funds	Global Commercial MF Consortium	80.6 million	2005
MFI Portfolio Securitization	BRAC, Bangladesh	180 million	2006

Source: Littlefield, Elizabeth L. "Building Financial Systems for the Poor, MIVs and DFI Investment Examined" *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

International CDO: BOLD 2006-1 (Blue Orchard Loans for Development)

This transaction used a Collateralized Debt Obligation (CDO) structure, in which investors bought a pool of loans made to MFIs. At the time of its completion in April 2006, BOLD-2006-1 was the single largest commercial investment transaction in the history of microfinance (US\$ 99.1 million) offering fixed-rate 5-year funding to 21 microfinance institutions in 13 countries. Five currencies were involved: the US dollar, Euro, Mexican peso, Colombian peso and Russian ruble. Foreign exchange risks were hedged for investors through the use of currency swaps.

Table 3: Capital Structure-BOLD 2006-1

Class	Amount	% of Notes	Credit Enhancement	Interest rate
A1	€32,900,000	40%	28%	Euribor 3M+0.75%
A2	£14,000,000	25%	28%	5.586%
A3	\$7,000,000	7%	28%	6.017%
B	\$28,000,000	28%	N/A	9.020%
Total	\$99,142,531	100%		

Source: de Schrevel, Jean Philippe. "The Range of Debt Instruments," *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

BOLD-2006 brought mainstream investors to microfinance, including insurance companies and pension funds. Development organizations took higher risk positions in an effort to encourage these mainstream investors.

Some of the challenges faced in issuing BOLD-2006 included the unfamiliarity of many investors with microfinance, the limited liquidity of the funds, and the lack of mainstream ratings for the underlying microfinance institutions. In addition, the issuers felt that they were "crowded out" by certain IFIs for transactions with top-tier MFIs.

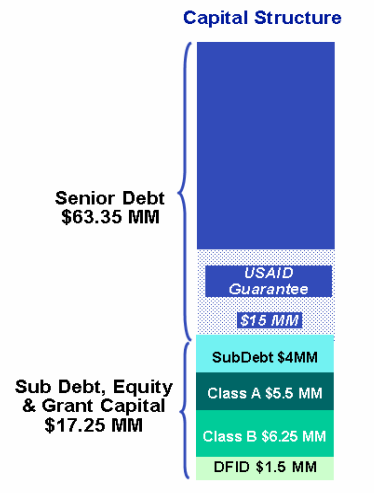
Investment in Mezzanine Funds: Global Microfinance Consortium

In 2005, a group of institutional investors and development agencies arranged the Global Commercial Microfinance Consortium. This was the first commercial fund to finance MFIs in local currency. The capital structure consists of senior debt of US\$63.35 million and sub-debt, equity and grant capital of US\$17.25 million.

Mezzanine finance (between the senior notes and the equity portions) provides unsecured debt (or preference shares) that can be converted into equity in the event of default. Higher returns correspond to a higher risk profile. IFIs took riskier positions to encourage private sector investment. USAID provided a US\$15 million credit guarantee, and DFID occupied the first tier loss position.

To date, US\$80.6 million has been approved for placement in more than 40 deals in 21 countries. Managed and sponsored by Deutsche Bank, this deal had 18 other partners, including Merrill Lynch, the Church Pension Fund, a number of individual investors, and development agency partners such as USAID.

Figure 2: Global Commercial Microfinance Consortium



Source: Deutsche Bank

MFI Portfolio Securitization: BRAC, Bangladesh

In 2006, BRAC, a Bangladesh-based NGO, securitized \$180 million in microfinance receivables, the first deal of its kind in the world. Whereas CDOs rely on the ability of the MFI to repay a loan, securitization relies on the abilities of the underlying microfinance borrowers to repay their loans. This transaction, structured by RSA Capital, Citigroup, the Netherlands Development Finance Company (FMO) and Germany's KfW bank, provides financing for BRAC over a period of 6 years, in a stream of 1-year note issuances.

This issue drew from BRAC's full portfolio of five million clients, who come from low-income communities, primarily in the rural areas of Bangladesh. This transaction was denominated in Bangladesh taka, which eliminated foreign exchange risk for the institution. BRAC received a AAA rating from the domestic markets in Bangladesh, and the transaction was completed without the purchase of a credit enhancement, although receivables were collateralized at 150 percent.

A special purpose vehicle was created to purchase the receivables from BRAC and issue certificates to investors representing beneficial interest in such receivables. Foreign investors FMO and Citibank each purchased one-third of the certificates, with Citibank's purchase backed by guarantees from FMO and KfW. Citibank Bangladesh and two local Bangladeshi banks purchased the remaining third of the certificates.

Securitization enabled BRAC to diversify its funding sources, reduce the assets it held on its balance sheet, and increase the funds lent to microentrepreneurs. According to Robert Annibale of Citigroup, securitization enabled BRAC to save 200 basis points over comparable bank funding.

Equity Finance

Most equity in microfinance has been provided through private placements from investors close to the MFI or knowledgeable about microfinance. However, for a handful of the top MFIs, public share offerings are becoming feasible. Initial Public Offerings (IPOs) allow the original investors in MFIs to exit. They also position the MFIs to raise new equity on favorable terms, as they reduce the high illiquidity premium that has long kept valuations of MFIs at close to book value.

Table 4: Innovative Deals in Equity Finance

Name	Structure	Current Capitalization (US\$)	Market	Year
Equity Bank, Kenya	Initial Public Offering	\$315 million		2006

Source: Mwangi, James. "Initial Public Offer: Equity Bank's Experience" *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

IPO (Initial Public Offering): Equity Bank, Kenya

In 2006, shares of Equity Bank in Kenya were listed on the Nairobi Stock Exchange, the first microfinance IPO in Africa. Equity Bank is highly focused on savings mobilization and has more clients than any other financial institution in Kenya, with 30 percent of the country's existing bank accounts. Initially, the institution funded its portfolio with savings. By 2002, savings could not sustain the funding requirements, and in April 2004 AfriCap Microfinance Fund became an equity investor. In 2004, the institution raised US\$10 million in equity through a private placement that targeted private Kenyan investors who knew the organization.

Equity Bank pursued a listing on the Nairobi Stock Exchange to improve its strategic position, its access to capital, and to give a higher profile to its brand. Equity also wanted to improve its value proposition to shareholders by increasing shareholder liquidity and easing entry and exit. Finally, Equity Bank's management knew that listing would enable the bank to consolidate improvements made in the area of corporate governance, due to the stringent transparency requirements and guidelines for governance and conflict of interest for publicly-held companies. James Mwangi, CEO of Equity Bank, described the key challenges of listing on a public stock exchange, such as the need to create systems to comply with stringent disclosure requirements, high advertising and legal costs, and the lengthy nature of the process.

James Mwangi, CEO of Equity Bank, described the key challenges of listing on a public stock exchange, such as the need to create systems to comply with stringent disclosure requirements, high advertising and legal costs, and the lengthy nature of the process.

Before its listing on the stock exchange, private strategic investors, such as AfriCap, were dominant shareholders. After the listing, speculative capital entered, as did retail investors. Once the market stabilized, institutional investors and fund managers began to participate heavily. The introductory listed price was US\$1.00; the opening price at the beginning of trading was US\$2.50, which rose to US\$3.40 in eight months. Equity Bank's profit in the months following the listing has also increased relative to prior years, as has its overall market valuation. In the first eight months following its IPO, Equity's market capitalization increased from approximately US\$91.5 million (Ksh 6.3 billion) to US\$315 million (Ksh 21.7 billion), as a result of new shares being made available through the IPO and an increased share price.

III. Risk in Microfinance

A broad universe of risks exists in microfinance, and risk management in microfinance has been an area of increasing focus for investors. Basel II, the Sarbanes-Oxley Act, anti-money laundering laws, central bank regulations, and relatively new IFRS (International Financial Reporting Standards) make for an increasingly complex environment for microfinance investment.

Identifying and Managing Risk

Panelists discussed six different risk categories relevant to microfinance investment and noted ways to mitigate them. These risks, which can be categorized as “controllable” and “uncontrollable” risks, are summarized in Table 5.

Table 5: Risks Affecting Microfinance Institutions

Controllable Risks	Risk Area	
	Financial Risk	Uncontrollable Risks
	Operational Risk	
	Market Risk	
	Risk Area	
	Regulatory Risk	
	Country/Political Risk	
	Foreign Exchange Risk	

Source: Christensen, Paul. “Understanding the Risk Profile of Microfinance Institutions (From an Investor’s Perspective),” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

1) Financial risks include the broad categories of credit quality, liquidity and funding, capital adequacy, asset and liability management and foreign exchange exposure.

Risk Mitigation Strategies: One risk mitigation strategy for MFIs includes the appointment of a risk manager and implementation of an overall risk management system. Another is the establishment of prudent internal financial policies, in some cases more conservative than regulatory requirements, for example policies regarding provisioning and foreign exchange exposure. Benchmarks for financial performance, for example, from the MIX (Microfinance Information Exchange) may help an MFI or investors identify areas of high risk.

2) Operational risks include those related to IT systems, “Key Man” issues of leadership and management depth, fraud/internal controls, regulatory compliance, money transfers and anti-money laundering practices.

Risk Mitigation Strategies: Bolstering the internal audit/control function, encouraging development of human resources incentive systems, and upgrading of IT systems were suggested solutions.

3) Market risks are often linked to competition. The MFI’s reputation, its political ties and competition, and interest rate competition are all key issues.

Risk Mitigation Strategies: One mitigation strategy is to establish strong governance and committee structures to manage and diversify these risks.

4) Regulatory risk includes those stemming from governmental interest rate regulations and caps, an issue that is becoming more prevalent in Latin America and Asia. Also included among these risks are the threat of increased minimum capital requirements and burdensome anti-money laundering regulations.

Risk Mitigation Strategies: Highlighting best practices from other regions to influence regulators, and developing coalitions with financial sector actors to advocate for beneficial positions in

microfinance have been effective in many countries. Bob Annibale of Citigroup discussed the need for an evolution of mechanisms to address issues such as responsible indebtedness and collection practices.

5) Country/political risk includes the threat of currency inconvertibility, expropriation of assets, war and civil disturbance, and institutional corruption, among others.

Risk Mitigation Strategies: MFIs can buy political risk insurance, if it is affordable. Political risk insurance can cover a percentage of loans made against risks such as inconvertibility, expropriation and political violence or war. Mitchell Strauss described how OPIC, the Overseas Private Investment Corporation, a U.S. government agency, can provide political insurance to protect investments in developing markets made by institutions with 25 percent U.S. equity ownership or significant involvement. It recently provided an insurance policy to a U.S. based lender to an Eastern European MFI.

6) Foreign exchange risk includes the risk of currency devaluation.

Risk Mitigation Strategies: A variety of ways exist to manage foreign exchange risk, the most obvious of which is to first explore local currency options for raising funds. In some countries, local capital markets fulfill the financial needs of MFIs, while in others, they are lacking. Other strategies involve using a combination of local funders and guarantors, with the international markets taking on the risk. However, this process has high transaction costs. A third strategy available in stronger emerging markets is to use a combination of US dollar funding and currency swap. Lastly, international funders can lend directly in local currency. This option is unpopular with many international funders. However, as new initiatives based on portfolio risk spreading rather than hedging in the markets arise (ex: TCX, Minlam, IFC), this will become more common.

Measuring Risk: Is the systemic risk for microfinance lower?

It has been suggested that microfinance investments can help reduce the overall risk of a diverse portfolio because its risks are countercyclical. A recent study, “Can Microfinance Reduce Portfolio Volatility?” analyzed whether economic returns in microfinance are correlated with general emerging market macroeconomic conditions.⁶ If microfinance is not correlated, or is less correlated with accepted macroeconomic indicators, then investments in microfinance might offer an attractive option for portfolio diversification for various types of investors.

If microfinance is not correlated or less correlated with accepted macroeconomic indicators, then investments in microfinance might offer an attractive option for portfolio diversification for various types of investors.

The study analyzed returns from 283 microfinance institutions with audited financial statements. It demonstrated some evidence that microfinance returns correlate less well with macroeconomic indicators than other emerging markets asset classes. However, 1994 to 1999 data on economic returns showed a substantial increase in correlation relative to data analyzed from 1988 to 1993. This suggests that emerging markets are increasingly behaving more like developed markets, reducing the diversification power of investments in microfinance.

⁶ The complete study, by Dr. Ingo Walter of the Stern School of Business at New York University and Nicolas Krauss of The Boston Consulting Group is available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=943786.

Recent data analysis conducted by Credit Suisse suggests that the combination of ½ microfinance and ½ S&P 500 funds yielded higher returns than other funds, with the exception of high yield growth funds.⁷

IV. Valuing Social Impact in Microfinance

A large percentage of the funds flowing into microfinance investment come from socially responsible investors or the investment arms of public finance institutions that are investing with the objective of contributing to social goals. Systematic, verifiable measures of social performance are important to help investors assess a MFI’s achievement of its social mission and determine any tradeoff between social and financial returns. Yet, the measurement of social value created by an investment in microfinance cannot be determined as simply as the investment’s economic return. The approaches described below reflect some of the different ways currently being used to measure social value.

Table 6: Different Approaches to Social Performance Evaluation

System	Description
Proxy indicators associated with social value	Examples: Average loan size as a percentage of GDP, % rural clients, client dropout rate
Social impact assessments	Changes in client level data, analysis over time
Social performance management	Uses of internal processes and feedback mechanisms

Source: Rauenhorst, Michael. “Social Investment and Measuring Impact: View of a Private Investor.” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

Initiatives in Measuring Social Performance

Triodos Bank-Transparency and Sustainability in Microfinance Initiative

Triodos Bank, a European funder of microfinance initiatives, incorporates a triple bottom line (economic, environmental and social returns) into its core strategy. Since 2004, Triodos has hosted an annual conference in the Netherlands for all of its investee companies to participate in its *Banking on Values* initiative. During this conference, investees are encouraged to examine their organizational characteristics—such as their corporate social responsibility principles, sustainability and stakeholder dialogue. Triodos also assists its investees in developing environmental indicators that govern energy and water use, carbon dioxide emissions, and the environmental impact of MFI client activities. Finally, Triodos helps its investees look at social indicators, such as employee ownership and representation, human rights policies, and anti-corruption policies and procedures. This initiative is part of the Global Reporting Initiative, supported by the United Nations Environmental Program, to promote transparency and sustainability in finance. It promotes the inclusion of this non-financial information in annual reports of investees.

MGR Foundation

This family fund uses a variety of indicators of social performance. Initially the fund used proxy indicators, such as loan size as a percentage of GDP, number of microloans generated due to its

⁷ Comments by Robert Weissenstein, Credit Suisse, at the Cracking the Capital Markets conference, March 19, 2007.

investments, percentage of women receiving loans, and client drop out rate. It also attempted to track the increase in income levels of customers.

More recently, the foundation has developed a more detailed template that examines social performance within the context in which the MFI operates, as well as its policies and strategies and results. The foundation also plans to incorporate incentives related to social performance for its employees.

ICCR (Interfaith Center on Corporate Responsibility)

This center has a membership of 275 faith-based investors who press companies to be socially and environmentally responsible. According to Father Seamus Finn, Fund Manager of the Missionary Oblates of Mary Immaculate, the center became interested in microfinance out of the belief that it offered a path for human development.

ICCR members examine microfinance within the context of the religiously, politically, socially, and culturally diverse base of borrowers. They divide the concept of social value into layers according to their differential impacts on outcome, such as the impact on culture, society and values of all segments of society.

V. Building a Microfinance Market

Although microfinance investment is increasing, challenges to building a mature microfinance market remain. To attract mainstream investors, microfinance investments need a set of standardized information and certain characteristics that are common to mainstream financial services, such as:

- Frequent pricing information on investments
- Liquidity
- Ease of access to information (particularly in the form of mainstream ratings)

The development of these features in microfinance will increase the ability of capital to successfully reach microfinance institutions.

Valuation of Microfinance Investments

As the market for microfinance investments develops, an increased sales volume will provide a better basis to evaluate investments. When an MFI is being acquired, sold, or has a new issue, valuation becomes a key issue.

When an MFI is being acquired, sold, or has a new issue, valuation becomes a key issue.

Also, audit and accounting principles have a bias towards fair market valuations, and many funds are being forced to do fair market valuations as part of new funding rounds. In some cases, legal and tax issues may necessitate the valuation of microfinance investments. Methods of valuation are summarized in Table 7.

Valuation can also incorporate some measurement of social value. For example, some equity investments are adjusted to reflect a positive selection bias by a donor or socially responsible investor.

Table 7: Methods of Valuation

Method	Advantages	Disadvantages
Net Asset Value (adjusted for provisioning and intangible assets)	-Simple, “objective”, negotiable -Useful benchmark/common language	-Backward looking -Does not reflect market conditions -Often used in transformations, but does not reflect upgrades -Does not reflect needed investment -Historical bias toward 1.0x NAV (book value)
Discounted cash flows	- Makes value drivers explicit - MFIs have simple capital structures and financials	-Identifying free cash flows can be tricky for MFIs -Modeling growth rates difficult -Little available data to estimate beta -Confusion about where to put risk (cash flow or discount rates)
Market Prices	-Desired by all	-Fewer than five MFIs are publicly-listed and have trading volume
Financial Intermediary Comparables	-Growth Rate higher -Expected Growth Rate should be longer -Quality of investment tends to lead to returns in excess of formal banking sector	- Limited liquidity-very few transactions of MF shares. There are P/E shares for finance institutions, not MFIs. -Risk can be a positive or a negative

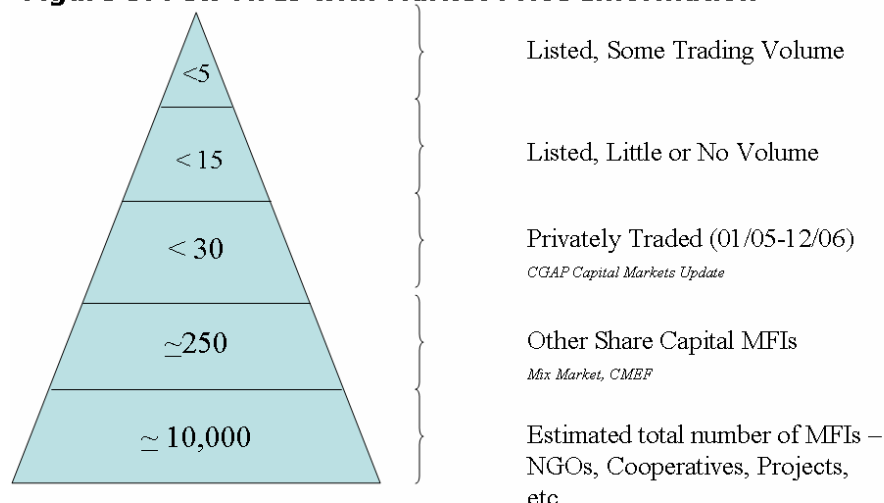
Source: Fischer, John. “The Nuts and Bolts of Measuring, Managing and Pricing Risk: Valuation of Microfinance” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19, 2007

Frequent Pricing of Microfinance Investments

For microfinance to truly crack the capital markets, frequent pricing of investments must occur. The lack of daily pricing information on microfinance investments is a key constraint for institutional investors, and excludes microfinance investments from the US\$10 trillion dollar mutual fund market.

As shown in Figure 3, fewer than five microfinance institutions are listed on a stock exchange and have sufficient trading volume for regular information on market prices. This will likely change over time as more microfinance institutions become listed. For example, Catalyst Microfinance Investors in Asia and

Figure 3: Few MFIs with Market Price Information



Source: John Fischer, ACCION

Africa, plans to list its newly-created MFIs on the London Stock Exchange.

Municipal bonds provide an example of an investment where daily pricing does not necessarily exist, but investors are willing to buy them because the bonds are rated. Another possibility of increasing the frequency of pricing is manual fair valuation, where a small number of people on a committee meet regularly to assign a fair value using bond techniques. This is time consuming and costly and could be done on a one-time basis, but not for an entire fund. Unfortunately, volume is needed to attain efficiency in pricing, but volume is easier to attain when pricing information is available.

Attaining Liquidity: Building a Secondary Market for Microfinance Equity Investments

Despite advances in determining the market price of equity investments, secondary markets in microfinance shares are very weak and therefore microfinance investments are illiquid. Illiquidity is an important factor driving down prices and discouraging more investment. As a result, many early equity sales included put options, which were “paid for” in terms of lower valuations, fewer voting rights and “call” rights.⁸ Even today, some investors say the illiquidity discount for microfinance investments could easily be 20 percent.⁹ Particularly with private banking clients, illiquidity is a key factor that discourages microfinance investment.

The Antares Fund is a US\$5 million fund created to expand the secondary market for microfinance equity. The fund’s objective is to acquire equity stakes, primarily through secondary market transactions. Gray Ghost Microfinance Fund was the founding investor, and Omrix Inc. administers the fund, which currently has six investments in five countries in Latin America and the Caribbean. Antares’ primary interest is in purchasing minority ownership stakes between 3 and 15 percent and in serving as a short to mid-term investor, with a holding period of three to five 5 years. It hopes to increase transparency by producing more “arm’s length” sales data. Recent secondary market transactions by Antares and other equity investors are listed in Table 8.

Table 8: Sample of Recent Secondary Market Transactions

Buyer	Seller	Microfinance Institution
BBVA	Group of shareholders	Caja Nor Perú & Caja Sur, Peru
Antares Fund	ACCION Gateway	BancoSol, Bolivia
TIAA-CREF, Tufts-Omidyar	IFIs and new issue of shares	ProCredit Holdings, multi-country
Unibanco Ecuador	Enlace	Banco Solidario, Ecuador
Broad spectrum of investors	Listing on Nairobi Stock Exchange	Equity Bank, Kenya
Nana Yaw Oduro	AfriCap	First Allied Savings and Loans, Ghana
Banco del Pichincha	ACCION Gateway	Credi Fe, Ecuador

⁸ Silva, Alex “Opportunities in the Secondary Market for Microfinance,” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 21, 2007.

⁹ MacDonagh, Jeffrey T.S. “Overcoming Pricing and Other Technical Barriers,” *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 21, 2007.

Banco del Caribe	ACCION Gateway	BanGente, Venezuela
Antares Fund	FINDE	Findesa, Nicaragua
Antares Fund	SEPAR	EDPYME Confianza, Peru
Antares Fund	Habitat Tacna Siglo XXI	EDPYME Crear Tacna, Peru
Antares Fund	Ramiro Paredes and Fundación Alternativa	Banco Solidario, Ecuador
Employees of EDPYME Confianza, Peru	Antares Fund	EDPYME Confianza, Peru

Sources: Fischer, John. "The Nuts and Bolts of Measuring, Managing and Pricing Risk: Valuation of Microfinance" and Silva, Alex "Opportunities in the Secondary Market for Microfinance" *Proceedings of the second annual Cracking the Capital Markets Conference*, New York, Presentation March 19-20, 2007

Antares can buy large equity stakes and sell them piecemeal when a holding may be too large to be attractive to smaller/private potential buyers, or the original stakeholder does not want to work with many small buyers. It can also hold unsold equity while waiting for other buyers. In some cases, Antares has helped management buy-ins take place, which better aligns managers' incentives with those of shareholders. Although it is a relatively small fund, its holdings are actively rotated. As a deeper and more transparent secondary market is created, valuations should rise as the illiquidity premium disappears.

Improving Information for Investors: Mainstream Ratings for Investment Capital

Although microfinance practitioners have improved their ability to present deals in understandable ways to generalists, Jeff McDonagh of Domini Social Funds recounted spending 80 hours researching microfinance CDO deals because consolidated sources of information did not exist.

Some social investors are sometimes willing to spend extra time analyzing microfinance investments because of the promise of social return, but most mainstream investors are not.

Some social investors are willing to spend extra time analyzing microfinance investments because of the promise of social return, but most mainstream investors are not.

Few microfinance institutions have received ratings from mainstream raters, such as Standard & Poor's, Fitch or Moody's. For many years, specialized rating agencies for microfinance have filled this gap, providing detailed information for donors and other interested parties. Yet, many institutional investors can only invest when a credit quality indicator provided by a recognized rater exists. Others would prefer to have mainstream ratings that they are more familiar with and that enable them to compare microfinance investments to other emerging markets investments. And a non-rated investment may be subject to other requirements. As securitizations and CDOs in microfinance become more common, mainstream ratings for microfinance become critical for insuring broad capital market participation.

Mainstream raters are entering the microfinance sphere, and are exploring how to address technical and pricing barriers. The market for microfinance ratings includes credit risk analysis of MFIs, analysis of global portfolios, single country portfolios, and portfolio securitizations. Despite the variety of applications, the market for MFI ratings remains very small, particularly as few MFIs are willing to pay the fees charged by mainstream raters. Raters need sufficient deal flow to justify their investment in a specific industry, and it is not yet clear that microfinance will grow to create the required volume.

Standard and Poor's: Building a Microfinance Market

Standard and Poor's is currently developing a methodology to rate microfinance institutions, in partnership with market participants such as ACCION International, CGAP, CRISIL, IDB, and the Microfinance Information Exchange (MIX). The draft methodology combines traditional credit analyses with core indicators for the microfinance sector. It identifies special characteristics of microfinance institutions relative to other financial institutions, while allowing investors to differentiate between MFIs on a comparable basis. The methodology will be published and freely available for use. Standard and Poor's plans to submit the draft methodology to its internal analytical policy board, prior to conducting pilot ratings worldwide.

VI. Building Demand for Investment in Smaller, Newer MFIs

Improving pricing information, liquidity, and the ease of access to information on microfinance (particularly in the form of mainstream ratings) will ensure that the supply of investment capital for microfinance remains high.

Yet "Tier 2" or "Tier 3" MFIs may need capital, but require smaller amounts of money than are profitable for many investors, and they may be perceived as overly risky investments. Participants discussed efforts required to increase the number of microfinance institutions that can receive commercial investments.

- *Providing Management Training* or additional financial and operational infrastructure may help MFIs become "ready" for investment capital. Most private investment firms do not link technical assistance with funding, leaving a gap for investor readiness training to be filled by other institutions.
- *Using Support from IFIs.* *Multilateral and bilateral development banks* are well-positioned to take riskier positions in supporting Tier 2 and Tier 3 MFIs, just as they supported Tier 1 MFIs when they initially attempted to access the capital markets years ago.
- *Targeting funds* such as Deutsche Bank's fund for new MFIs helps commercial investors find investment prospects.
- *Using Local Presence* helps global commercial banks such as Citibank and Standard Chartered identify and offer local currency finance.
- *Accelerating Greenfield (Start-up) Operations* through partnerships such as Catalyst Microfinance Investments, a project of microfinance practitioner ASA, Bangladesh and a financial advisory firm, to build new MFIs in core microfinance markets.
- *Connect Microfinance Initiatives with Efforts to Improve Health or the Environment.* A Deutsche Bank fund has been developed to fund eye hospitals in India. Triodos Bank mentioned the possibility of using microfinance institutions to bring access to renewable energy to rural areas.

Conclusion

Capital markets can play a crucial role in scaling microfinance. Microfinance is becoming a household word, and investment in microfinance is increasing rapidly. Deal structures not previously seen in microfinance, such as portfolio securitizations and even an IPO have taken place in the last year or two. Yet microfinance investors need to find ways to manage their risk and microfinance needs to surmount key technical barriers, related to pricing, liquidity, and ease of access to information before it can truly crack the capital markets.

ACCION International's *InSight* series is designed to share the results of our work within the microfinance community as quickly and efficiently as possible. The series highlights practical applications, policy viewpoints and ongoing research of ACCION. To download other editions of *InSight* free-of-charge, please visit www.accion.org/insight

ACCION would like to gratefully acknowledge the support of conference sponsor Credit Suisse.

This publication was prepared with funds provided by the Academy for Educational Development (AED) with financing from the U.S. Government through the U.S. Agency for International Development under Cooperative Agreement Number EEM-A-00-06-0001-00 for the FIELD-Support Leader with Associates. The opinions expressed herein are those of the author(s) and do not necessarily reflect the views of the U.S. Agency for International Development.

Other titles in ACCION's *InSight* series include:

InSight 1: ACCION Poverty Assessment Framework

InSight 2: Economic Profile for 15 MicroKing Clients in Zimbabwe

InSight 3: Making Microfinance Transparent: ACCION Policy Paper on Transparency

InSight 4: Building the Homes of the Poor: Housing Improvement Lending at Mibanco

InSight 5: Poverty Outreach Findings: Mibanco, Peru

InSight 6: The Service Company Model: A New Strategy for Commercial Banks in Microfinance

InSight 7: Market Intelligence: Making Market Research Work for Microfinance

InSight 8: ACCION Poverty Outreach Findings: SOGESOL, Haiti

InSight 9: ACCION PortaCredit: Increasing MFI Efficiency with Technology

InSight 10: Leveraging the Impact of Remittances through Microfinance Products

InSight 11: ACCION's Experiences with Rural Finance in Latin America and Africa

InSight 12: Developing Housing Microfinance Products in Central America

InSight 13: ACCION Poverty Outreach Findings: BancoSol, Bolivia

InSight 14: Practical Skills for Microentrepreneurs: ACCION's Experiences with the ABCs of Business Program

InSight 15: Bridging the Finance Gap: ACCION's Experience with Guarantee Funds for Microfinance Institutions

InSight 16: Microfinance Institutions and Foreign Exchange Risk: The Experience of ACCION's Latin American Affiliates

InSight 17: ACCION Poverty Outreach Findings: Apoyo Integral, El Salvador

InSight 18: Who Will Buy Our Paper: Microfinance Cracking the Capital Markets

InSight 19: Providing Cost-Effective Credit to Small-Scale Single-Crop Farmers: The Case of Financiera El Comercio

InSight 20: Financially Viable Training for Microentrepreneurs: The Business Model of ACCION ABCs of Business

InSight 21: Getting to Scale in Housing Microfinance: A Study of ACCION Partners in Latin America

With the exception of *InSight* #2, all of the titles in the *InSight* series are available in English and Spanish. *InSights* #4 and #8 are also available in French.



MICROFINANCE CRACKING THE CAPITAL MARKETS II

March 19–20, 2007
The Waldorf-Astoria, New York

This *InSight* was written by Rekha Reddy, Senior Director, Research and Policy and edited by Elisabeth Rhyne based upon speeches and presentations from the “Microfinance Cracking the Capital Markets II” conference. The author would like to thank Hannah Caldwell Henderson, Todd Farrington, Amelia Kuklewicz and Robin Ratcliffe, all of ACCION International, for their helpful comments. The conference program & all Powerpoint presentations are available at http://www.accion.org/cracking_the_capital_markets.asp

Panelists and Speakers

Robert Annibale, *Global Head of Microfinance, Citigroup*
Bob Assenberg, *Deputy Managing Director, Triodos*
Dirk Brouwer, *Executive Director, Catalyst Microfinance Investors*
Scott Budde, *Managing Director, Head of Social & Community Investing, TIAA-CREF*
Lauren Burnhill, *Senior Vice President Financial Markets & Services, ACCION International*
Shafiqul Haque Choudhury, *Executive Chairman, Catalyst Microfinance Investors*
Paul D. Christensen, *President, ShoreCap Management Ltd.*
Jean-Philippe de Schrevel, *Managing Director & Founder, Blue Orchard Finance*
Deborah Drake, *Coordinator, Council of Microfinance Equity Funds*
Martin D. Essenburg, *Global Head of Asset Securitization, Standard Chartered Bank*
Father Seamus Finn, *Fund Manager, Missionary Oblates of Mary Immaculate*
John Fischer, *Vice President, ACCION Investment Management Company LLC (AIMCO)*
David FitzHerbert, *Managing Partner, The Gray Ghost Fund*
Vikram Gandhi, *Managing Director & Global Head of the Financial Institutions Group, Credit Suisse*
Michael Hokenson, *Managing Director, Minlam Asset Management LLC*
James Magowan, *Managing Director, Housing MicroFinance, LLC*
James Mwangi, *CEO, Equity Bank*
Brian Koeller, *Risk Manger, Officer of the Treasurer, State Street Corporation*
Gary Kochubka, *Director, Emerging Markets Structured Finance, Standard & Poor’s*
Vivian Kotun, *Assistant Vice President, Deutsche Bank*
Nicolas Krauss, *The Boston Consulting Group*
Elizabeth Littlefield, *Director, World Bank, and CEO, Consultative Group to Assist the Poor*
Jeffrey T.S. MacDonagh, *SRI Portfolio Investments, Domini Social Investments*
Maria Otero, *President and CEO, ACCION International*
Leslie Rahl, *President, Capital Market Risk Advisors*
Michael Rauenhorst, *MGR Foundation*
Alex Silva, *Managing Director, Antares Fund/Omitrix Inc*
Mitchell Strauss, *Director, Credit Policy, Overseas Private Investment Corporation (OPIC)*
Brad Swanson, *Managing Partner, Developing World Markets*
Klaus Tischauer, *Managing Director, responsAbility, Switzerland*
Dr. Ingo Walter, *Director, Global Business Institute, Stern School of Business, New York University*
Robert Weissenstein, *Chief Investment Officer, Private Banking Americas, Credit Suisse*
Joost Zuidberg, *Capital Markets Product Manager, Netherlands Development Finance Company (FMO)*