Microfinance, an opportunity for socially responsible investment

Yannis Berthouzoz Analyst – SYMBIOTICS

November 17 2009

Microfinance used to be seen as a simple development tool, but now provides private investors with attractive investment opportunities. It creates social benefits by helping to democratize access to financial services in developing countries and offers a stable return with little correlation to financial markets. By making the sector accessible to private investors, microfinance investment vehicles (MIVs) have managed to substantially increase funds available. However, amounts are still limited and banking exclusion consequently remains high. This can only be remedied with wider and more responsible private sector involvement

The microfinance sector has radically changed over the past decade. Its financing was traditionally based on public funds, but has gradually opened up to commercial financing. This has helped bring in large numbers of private investors who now see microfinance as a viable sector with high potential and attractive investment opportunities. This change is a clear sign of progress in fighting financial exclusion on a large scale, but has however led to new issues concerning the social vocation of the sector.

Growth of microfinance investment vehicles

Microfinance investment vehicles (MIVs) appeared in the 1990s and have been instrumental to the rapid growth of the sector. These independent investment entities invest public and private investors' equity in microfinance institutions (MFIs) or in other MIVs. The Consultative Group to Assist the Poorest (CGAP) – the main organization in charge of promoting microfinance – counted 103 MIVs at the end of 2008. They were then managing 6.6 billion dollars of assets, mainly invested in the form of debt in Latin America and Eastern Europe (75% of the total portfolio)1. Their strong growth in 2008 both in the amount of entities (+11) and in asset volumes (+31%) demonstrates investor interest in microfinance. This interest has not dwindled despite the crisis; for example, the assets of Luxembourg-based MIVs rose by 8% in the first half of 2009 (*see graph*).

This growth can be explained by the predominance of private equity in the financing structure of MIVs since 2005 – despite the increasing commitment of investors. The International Year of Microcredit 2005 and the attribution of the Nobel Peace Prize to the Grameen Bank and Muhammad Yunus in 2006 show the interest this sector arouses. To date, according to CGAP, only 21.3% of money invested in MIVs comes from public financing. The rest comes from private investors: 33.5% from private individuals, 33.3% from institutions (banks and pension funds), 8.8 % from parapublic organizations (foundations, NGOs and networks) and 3.2 % from MIVs with a "fund of funds" structure.

Attractive and accessible investment opportunity

Microfinance provides a new investment opportunity for private investors. Its inherent characteristics make it attractive, and MIVs make it accessible by facilitating investment. It generates social benefits by helping to provide access to financial services and, in doing so,

contributes to the global effort to combat poverty. It also offers attractive and stable returns that make it possible to diversify investment portfolios. Managers specialized in microfinance are gaining expertise with in-depth knowledge of markets using adapted rating systems and can consequently make efficient investments in the sector. The different missions, structures and investment strategies of MIVs (debt, equity, guarantees) also give investors several investment options depending on their profile and targets. The development of MIVs (15% of them have now topped the 100 million dollar mark) and their increased professionalization are attracting more and more institutional investors.

Stable and attractive financial returns

Trends in the SMX index2 (*see graph*), which has been tracking the monthly performance of five MIVs3 mainly investing in the form of debt, confirm the fact that microfinance offers stable and attractive returns. Indeed, the index has been constantly rising since January 2004 and has only recorded positive monthly returns. Over the past four years, the funds have generated an average return of 5.4% a year, and in 2008 returns reached 6%. This yield was on average 106 basis points higher than the USD one-year interest rate SWAP. Moreover, the volatility of the past five years has remained low at 0.5%.

The good performance is due to the stability of interest rates for loans allocated to MFIs (9% on average), mainly with fixed coupons. The repayment rate is near the 100% mark which also means the funds have no investment losses. Finally, the absence of a secondary market ensures the value of the debt, recorded at its historical cost, remains stable. These elements explain why the SMX index is stable, particularly in 2008, while over the same period JP Morgan's EMBI index4 – which tracks the yields of debt instruments exchanged on emerging markets – fell 11%.

However, the slight fall in yields during the first half of 2009 (1.7%, *i.e.* a 3.4% annualized yield) shows that MIV performance was affected by the financial crisis. The high volatility in exchange rates observed at the beginning of 2009 increased foreign exchange hedging costs and generated losses for the MIVs that had taken foreign exchange positions. Moreover, there was a fall in demand for financing from MFIs which had anticipated a slowdown in their activities. The resulting rise in liquidities brought down MIV yields. The crisis consequently encourages their managers to find new investment opportunities within a context of greater competition.

Viable well-managed MFIs

The good performance of MIVs is particularly based on the financial soundness and repayment capacity of MFIs. Out of the 10,000 MFIs identified around the world, some 300 meet the financing criteria of MIVs. Most of them are regulated and record good performance in terms of both the scope and quality of loan portfolios, governance, and profitability. Between 1,000 and 2,000 other MFIs have strong growth potential and represent new investment opportunities in the medium term.

The fundamentals of the sector remain sound despite the crisis. According to SYM50, a comparative indicator (developed by Symbiotics) that tracks the financial performance of fifty MFIs which are representative of the sector, their portfolio at risk has risen from 2.8% to 4.8% in a year (*see table*). This can be explained by the drop in borrowers' incomes as a result of both a fall in the profits generated by their activities and a decrease in money transfers from abroad. The resulting rise in provisioning costs, to which is added the cost of foreign exchange hedging, has had an adverse effect on the profitability of MFIs. With a slightly lower financial lever, the average return on equity fell to 5.5% in June 2009 against 21.3% a year before.

However, the portfolio at risk – the main indicator for the quality of underlying assets – does remain at an acceptable level and is often well below that of classic banks. Despite a slowdown in activity, total assets, the loan portfolio and the number of clients are still growing. MFIs remain self-sufficient from an operational and financial point of view and their profitability remains positive. Thanks to a

marked improvement in governance systems, they have been able to face the crisis and adapt their activities. They are tightening their loan policies, focusing on less risky products and reviewing their business plan in order to optimize the management of their liquidities.

Towards massive financial and responsible inclusion

MIVs have contributed to the development of MFIs by facilitating financial intermediation. The convincing results of this financial innovation has made it possible to increase financing sources. However, despite the sector's growth, banking exclusion remains high throughout the world. Out of the billion and a half microentrepreneurs estimated by Deutsche Bank, only 10% benefit from services provided by MFIs. Microfinance is consequently a long way from reaching its full potential; wide-scale inclusion will only come about with greater private sector involvement to boost sector development. The use of new technologies to lower transaction costs will help MFIs penetrate new markets while remaining profitable. They will also be able to improve the way they operate thanks to good governance, product innovation and the creation of local industries. This will make microfinance even more attractive.

To be sustainable, this growth must ensure continuous healthy practices; risks of abuse that are specific to the free market economy must be avoided. Indeed, the issue of overindebtedness and client protection is decisive for avoiding a "microfinance bubble". This is also the case for issues concerning the way employees are treated and the cost of products. By integrating these issues, the sector will generate high social impacts and will also limit the reputation risk. From this perspective, several initiatives are promoting healthy and responsible practices to MFIs and MIVs. For example, the Social Performance Task Force standardizes social performance measurement in the sector. The Client Protection Campaign increases the awareness of the different players to the issue of client protection. These initiatives also make it possible to implement rating systems (for example, those of Incofin, Oikocredit and Symbiotics) that assess the social performance of MFIs. It is consequently possible to improve the selection by using social criteria. These initiatives contribute to the development of microfinance as a socially responsible asset that judiciously combines financial interests and social targets.

Footnotes

[1] These MIVs sometimes take very different forms and include both debt investment funds (e.g. ResponsAbility Global Microfinance Fund), structured products (e.g. Microfinance Loan Obligations), private equity funds (*e.g.* BlueOrchard Private Equity Fund), holding companies (e.g. Procredit Holding) and also non-profit investment funds and cooperatives (*e.g.* SIDI, Oikocredit).
[2] Symbiotics Microfinance Index.
[3] The asset classes of MIVs tracked by the index are ResponsAbility Global Microfinance Fund B Cap; Dexia Micro-Credit Fd Sicav BlueOrchard Debt USD Cap; Finethic Microfinance SCA SICAR USD; ResponsAbility Microfinance Leaders Fund; EMF Microfinance Fund AGmvK, Class T (since March 2009); Dual Return Fund Vision Microfinance USD Cap (up to February 2009).
4 Emerging Markets Bond Index
5 It should be noted that MIVs can also make marginal investments in sectors other than microfinance (fair trade, SMEs). This explains the differential between "Total assets" and "Microfinance portfolio". To be considered as a microfinance fund, the fund must invest at least 50% of its portfolio in the sector.

References /CGAP , 2009. MIV Survey, Symbiotics, August. /**Dieckmann, R., 2007.** Microfinance: An Emerging Investment Opportunity, December 19, Published by Deutsche Bank /**Glisovic-Mezieres, J. ; Reille, X., 2009.** Microfinance Funds Continue to Grow Despite the Crisis, CGAP Brief, April. /**Kneiding, C. ; Littlefield, E., 2009**. The Global Financial Crisis and Its Impact on Microfinance, CGAP Focus Note No. 52, février. /**Servet, J-M., 2009.** Corporate Responsibility Versus Social Performances and Financial Inclusion, Handbook 2009. /**Social Performance Task Force** : www.sptf.info / **Syminvest** : www.syminvest.com

© 2009 – Private Sector & Development