



Microfinance
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Interviews

Sequoia and Sandstone

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How to

Win an Investor in 12 Steps

Last Word

The Curious Case of Co-Investments in Microfinance

The Role of Private Equity: Fueling the Growth of Microfinance



Credit: Michael Sutto

Cover Story

The Driving Factor for MFI Valuations in India: An Insider's Perspective

In our cover story, Anurag Agrawal, Senior Vice President, Investment Banking, Intelicap, breaks down the science of microfinance valuation, and reveals why Indian MFIs have continued to attract increasing amounts of capital during the global financial crisis, and have done so at a significant premium over their global peers.

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The Time is Right for US Institutional Investors



The microfinance sector's history of philanthropic support blurs the notion that it is actually a viable commercial investment for US institutional investors.
Photo: Dan Zen

Microfinance equity investments grew by 95% between 2006 and 2007. But, according to CGAP, the majority of the funding is flowing in from European institutional investors. US institutional investors remain reluctant to engage with this sector. In light of the impressive gains and industry growth, this article discusses the participation of U.S. institutional investors in microfinance investments, addresses some prevalent investor concerns, and offers several reasons for the relatively slow growth of this sector in the U.S.

Microfinance is rapidly becoming a strong viable asset class and, accordingly, an attractive investment for commercial investors. An April 2009 CGAP report states, "Microfinance is one of the few asset classes with a positive return in 2008...in stark contrast to the 12% drop for fixed-income corporate indices in emerging markets."¹

As noted by Michael Hokenson, Managing Director, Minlam Asset Management LLC, "Microfinance, due to its common underlying economic drivers and its dissimilarity to other asset classes, can be considered its own asset class. It has risk that can be categorized, an index can be created, and benchmarks can be established." Hokenson adds, "We believe there is genuine interest in microfinance from the institutional market. It meets the tremendously important criterion of diversification. Given the proper strategy, it has the ability to deliver attractive risk-adjusted returns."

Several investors & managers echo this view. Roger Frank, Managing Director of Benchmark Asset Managers LLC, a commercial, for-profit investment firm, states, "While the common perception of sustainable investing is that it

is a niche activity, our experience shows that positive sustainable investments can also yield competitive returns."

Given the conventional view that the demand for microfinance loans is US\$250bn, microfinance represents a significant investment opportunity. As of December 2008, CGAP lists 104 active Microfinance Investment Vehicles (MIVs) with estimated assets under management (AUM) of US\$6.5bn²--this highlights an impressive threefold increase from US\$2bn AUM in 2006.³ Much of this growth can be attributed to private investment funds and institutional investors. Surveys by CGAP indicate that investments in MIVs by institutional investors jumped from 14% to 41% between 2005 and 2007.⁴

Investors currently favor fixed-income instruments (representing close to 80% of investments⁵), but equity investments grew by 95% between 2006 and 2007.⁶ A February 2009 joint JP Morgan/CGAP report notes that by the end of 2008, there were 24 specialized microfinance equity funds with total AUM of US\$1.5bn.⁷

Institutional Investors

Institutional investors in microfinance include corporate pension funds, public pension funds, commercial banks, and university and foundation endowments.

According to Xavier Reille, Lead Microfinance Specialist, CGAP, European institutional investors represented approximately 80% of all MIV AUM in 2007. European institutional investors often invest through MIVs registered in Luxembourg and the Netherlands, and some are active participants in microfinance investments in line with their SRI strategies. According to Paul DiLeo, Co-Founder and Managing Partner of Grassroots Capital, "European institutions, particularly Dutch institutions, are generally more comfortable with socially responsible investing and microfinance, and they also feel that their clients want to see them active in this space."

US institutional investors, on the other hand, have been less responsive to microfinance investments with the exception of three major participants: TIAA-CREF, Omidyar-Tufts Microfinance Fund, and The General Board

of Pension and Health Benefits of the United Methodist Church.

TIAA-CREF created the Global Microfinance Investment Program with US\$100m. Established in 2006, the fund is fully invested with allocations to ProCredit Holding, Catalyst Microfinance Investments, and Developing World Markets. It is interesting to note that the fund's manager, Scott Budde, touches on themes relevant to mainstream investments (i.e. performance and sustainability) as well as the double bottom line. "TIAA-CREF's Global Microfinance Investment Program continues to deliver a combination of both competitive returns and positive social impact across a range of MFI models," said Budde, Managing Director, Global Social and Community Investing Department, TIAA-CREF. "Also, microfinance has shown significant resiliency in the current environment."

Investing in microfinance has been an equally positive experience for Omidyar-Tufts Microfinance Fund (formed in 2005). The fund's original US\$100m is fully committed, but the fund continues to review new opportunities in microfinance.⁸ Tryfan Evans, Director of the fund, stated that long term financial performance is paramount, and because of their fiduciary responsibility, OTMF seeks the same financial return from microfinance investments as from other investments. Evans further noted that OTMF includes high-grade fixed income, high-yield fixed income, private equity and venture capital microfinance investments. For the fiscal year ending June 30, 2008, the fund returned 12%.⁹

The General Board of Pension and Health Benefits of The United Methodist Church has diversified its US\$50m microfinance investment through structured financing vehicles "that offer market-rate returns to investors that are commensurate with risk. The General Board has participated in three of these transactions...[reaching] more than 50 microfinance institutions..."¹⁰

Addressing Investors' Concerns

Microfinance investment managers, fund managers and other microfinance participants frequently note the difficulty in securing commitments from US institutional investors. US institutional fund managers and industry participants revealed several common concerns

regarding investing in microfinance. Many of these concerns are beginning to be addressed, as outlined below.

Performance Results: Readily available, standardized and comprehensive valuation metrics for microfinance are limited. While some basic investment information on MFIs and microfinance transactions are already available, Roland Dominicé, Executive Director of Symbiotics S.A. confirmed that "information on the funds is indeed often not publicly available and there is no public site available today unfortunately. We are working on something ourselves, among different initiatives."¹¹ Yet, investors should note that credit ratings and valuations are now provided by mainstream global agencies such as Standard & Poors and Fitch, and that specialized agencies such as MicroRate, PlaNet Finance, MicroFinanza, and M-CRIL provide ratings on MIVs and MFIs. In addition, the Symbiotics Microfinance Index (SMX) tracks the financial performance of regulated MIVs¹² and the 2009 JPMorgan/CGAP report aims to establish benchmarks for valuations of microfinance equity.

Size of MIVs: While there are currently over 100 MIVs, the ability for institutions to invest corresponds less with the number of MIVs than with the ability of MIVs to meet investors' parameters. Most MIVs are small in size compared to typical investment funds. Since US institutional investors typically have minimum investment requirements of US\$10-15m, with a cap of 50% fund participation, the size of the funds is an important consideration. At the end of 2006, roughly 86% of total MIVs had less than US\$20m under management.¹³ However, investors should note that the top ten MIVs as of December 2008 each had over US\$100m in AUM with a combined AUM of almost US\$4bn.¹⁴ Nonetheless, Ann Miles, Managing Director, BlueOrchard Finance USA, stated that "microfinance investment vehicles will have to achieve scale to attract larger pools of capital."

Liquidity and Secondary Markets: It is interesting to note that for some US pension fund managers, liquidity is of particular concern given that the US private pension system is shifting from defined benefits (managed by

the employer) to defined contributions (managed by the contributor). As employees in the defined benefit system are retiring, and fewer new employees are added to plans, pension fund managers primarily seek shorter term and more liquid investments to meet shorter term pension payout requirements. As investors require liquidity to meet their financial obligations, a secondary market for microfinance investments has been steadily growing. For instance, Antares Equity Participation Fund (managed by Grassroots Capital and Omrix) has executed several secondary transactions. DiLeo of Grassroots Capital states, "Antares was created by Gray Ghost to give a push to the deepening of the secondary market in microfinance equity, as well as to take advantage of the general illiquidity to acquire assets at good prices."

Exit Strategies: As the microfinance industry matures we have seen an increasing number of favorable exit transactions. Initial exits have included two significant IPOs (Compartamos Banco, Mexico and Equity Bank, Kenya) and the exit of ProFund International (Panama). Additionally, Gil Crawford, Chief Executive Officer of MicroVest Capital Management states: "We have had several in-depth successful negotiations with buyers, including local investors, local companies, IFIs, and MIVs, which have resulted in a number of sales where both buyer and seller felt the transaction was positive and was of value." Addressing this issue, W. Bowman Cutter, Managing Director of Warburg Pincus LLC, states, "Microfinance has shown steady growth, stability, and significant returns which typically result in favorable exit strategies."

Blurring the Message: Philanthropy, Grants and Aid

US institutional investors need greater clarity regarding the proper allocation for microfinance. Philanthropy, grants and government aid have been at the forefront of microfinance initiatives, and the benefits from these continuing contributions cannot be overstated. However, such assistance sends the message that microfinance is principally a philanthropic endeavor. US investors have noted that this blurs the message making it difficult for them to recognize microfinance as a viable commercial investment. Budde

of TIAA-CREF says, "...the presence of unregulated, philanthropic lending models may complicate attracting investment dollars from investors. These types of models send a signal to investors that microfinance is more about philanthropy than investing. Given that the growth of microfinance will probably require large investment flows, focusing on mainstream investors and regulated investment vehicles will be a necessity."

Regulatory Environment

While European investors recognize the positive returns of microfinance, their

Secondary Market Transactions

Although there is limited public information about secondary market microfinance transactions, by some estimates, the annual trading volume is less than US\$100m. Examples of secondary market transactions include:

Minlam has participated in several secondary offerings including: a) adding to a core bond position when it reflected mark-to-market losses (due to market conditions); b) helping an MFI de-lever its balance sheet by assisting in buyback trades; and c) purchasing a private loan from a lender that needed liquidity.

Antares engaged in several secondary transactions including purchase of a 4.5% equity stake in Financiera de Desarrollo S.A. (FINDESA), a 2.42% ownership holding in Edpyme Confianza, and an 8.42% equity interest in Edpyme Crear Tacna.

participation in microfinance can also partially be attributed to tax incentives for such investments. For example, Etienne Gentil, Finance Partner with Latham & Watkins in Paris, states that the Netherlands, Belgium, Germany and several other European countries have favorable tax regulations for microfinance and socially responsible investments. However, he cautions that these are not uniform and are connected with the EU Lisbon Strategy.¹⁵

"...the presence of unregulated, philanthropic lending models may complicate attracting investment dollars from investors. These types of models send a signal to investors that microfinance is more about philanthropy than investing. Given that the growth of microfinance will probably require large investment flows, focusing on mainstream investors and regulated investment vehicles will be a necessity."

- Scott Budde, Managing Director, Global Social and Community Investing Department, TIAA-CREF

Reaching the Tipping Point

Placement agents and institutional advisors have stated that they are unaware of microfinance opportunities. Few placement agents have mandates to place microfinance instruments, and institutional fund managers indicate that few opportunities have been presented to them.

Microfinance investments are lauded at numerous global microfinance conferences throughout the year. However, the audience rarely includes prospective institutional

investors. Most microfinance conferences are attended by professionals already engaged in microfinance (i.e., practitioners, NGOs, development agencies, and existing investors). To reach a broader investor base, the microfinance industry should more actively participate in mainstream investment conferences, trade associations, and the mainstream financial media. Larry Comstock, an institutional placement agent, states that, "Now is the time for MIVs to present their case directly to leading US institutional investors, as well as to their consultants and advisors, to begin the process of microfinance being recognized as an attractive alternative asset category."

Conclusion

Commercial investors are receptive to reviewing microfinance investment opportunities, but need to be better informed about the microfinance investment environment. While the positive message about microfinance investments is beginning to reach a broader investor base, more can be done. It behooves all parties (investors, MFIs, non-profits, and for-profit entities), to collaborate more effectively in establishing microfinance as a mainstream investment opportunity. Size being a hindrance for many US institutional investors, more large funds and possibly more funds of funds should be developed. Emphasis should also continue to be on transparency, liquidity and development of secondary markets to meet institutional investors' needs. Finally, for-profit microfinance investing needs to be promoted more pro-actively by all constituents. With its strong performance in 2008, improved access to information and variety of investment products, microfinance now presents a real opportunity for US institutional investors. ■

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