

Testing the Investment Case for Microfinance

Grassroots Capital 2009 Global Economic Crisis Impact Report

By Elise Tosun

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Grassroots Capital manages the Gray Ghost Microfinance Fund and the Global Microfinance Equity Fund (GMEF). Pioneers in microfinance equity investment, Grassroots partners began investing in microfinance in 2000 and co-created the Gray Ghost Microfinance Fund in 2004. To date, we have made equity investments in 46 microfinance institutions in 29 countries. Our investment team has over 30 years of combined experience in the microfinance industry.

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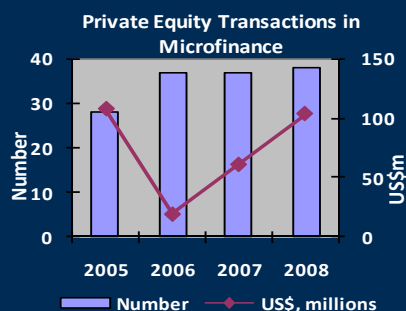
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The Evolution of Microfinance Equity as an Asset Class

Since 2003-2004, when the Grassroots Capital investment team led large-scale private investment into the microfinance equity space with the launch of the Gray Ghost Microfinance Fund, microfinance equity has rapidly evolved into a burgeoning and dynamic asset class of its own.

By 2008, microfinance private equity transactions have become increasingly common – JP Morgan has identified 144 such transactions completed since 2005, with a total value of about US\$300 million.

The proportion of this total represented by private investors is believed to have increased from nearly zero in 2003 to about 40% by 2006 (Reille, 2008).



Source: CGAP, cited by JP Morgan.

With the Global Microfinance Equity Fund (GMEF), Grassroots' new vehicle for equity investment, we aim to accelerate the entry of private equity capital into microfinance by providing an opportunity to produce positive financial returns for investors and social returns for microfinance borrowers. In addition, we offer a demonstrated track record in microfinance equity management, with active engagement since the start of the decade.

Given the turmoil in the global economy and capital markets over the past 18 months, prospective investors are understandably demanding more rigorous support for the microfinance investment case. This report attempts to articulate the primary drivers of that investment case and assess what the current crisis can tell us about their validity and how we expect microfinance to fare, in both absolute and relative terms.

By offering a proven model of profitability along with the opportunity to alleviate poverty, microfinance institutions (MFIs) have in recent years attracted the interest of a growing range of private institutional investors, in addition to the philanthropists and international development organizations that supported the industry throughout its formative years (see sidebar). Microfinance equity is a unique investment opportunity that marries financial and social value creation, providing the poor with necessary tools to augment and stabilize their incomes and build assets. MFIs foster economic independence and generate significant secondary impacts on family health, education, gender status, and civic engagement.

One reason for microfinance's current popularity is that it has shown resilience in the face of past crises, such as in Indonesia, Bolivia, and Peru. A performance index of six publicly-traded MFIs has outperformed the Global MSCI World Financials Index by 238% since 2003.¹ While microfinance has stood up well to relatively contained stresses, MFIs have never been tested by a period of sustained global economic stress and systemic failure in the financial system such as currently being experienced. Given the uncertainty regarding how capital flows to the developing world

¹ The Low-Income Financial Institution (LIFI) Index has also outperformed the MSCI World Index by 10% since September 2008. See O'Donohoe, N., Littlefield, E., and Reille, X. (2009). *Shedding light on microfinance equity valuation*. New York, NY: CGAP/JP Morgan Global Research.

will be affected by the systemic upheavals in the developed world, the validity of the investment case for microfinance is about to be tested as never before.

As investors, we view this period as an opportunity to distinguish which MFIs remain profitable by emphasizing quality over quantity, focusing on existing borrowers, and working to meet the needs of their core market by renegotiating existing loans and developing new products, such as housing or education loans, that take more stress off of household budgets. Though global events may have negative effects on some MFIs – more expensive and less available funding, slower growth, and lower portfolio quality – we expect the more flexible and resilient institutions to survive, along with new knowledge to shape our investment decision and make valuations more transparent.

The Opportunity: Understanding the Fundamentals of Pricing

As a result of a natural experiment where all MFIs are facing systemic risk, we hope to uncover evidence that will tell us:

- **the extent to which microfinance is tied to the global economy through dependence on non-local funding;**
- **the extent to which microloan repayment is affected by changes in real household income via food price volatility and remittance drop-off;**
- **the length, if any, of a lag effect in portfolio quality response to this crisis;**
- **the extent to which MFI portfolio growth is adversely affected by this crisis; and**
- **the degree of correlation between portfolio growth and asset quality.**

New evidence will reveal the true degree of MFI resilience to upheavals in the financial market, and will provide more transparency to valuations.

With more evidence of the true degree of MFI resilience to upheavals in the financial market, the investor community should develop more transparency in cash flow forecasts and valuations. Recent research has shown that valuations of equity stakes in MFIs vary widely, even within regions, spiraling upwards in 2007 and the first half of 2008. JP Morgan reported average P/BV multiples reaching a high of 6.7x in India in 2007-08, while the initial IPO of Mexico's Compartamos in April 2007 obtained a purchase price of about 12x the book value of shares.² This lack of transparency with regard to valuation methodology, combined with intense interest in the financial and social "double bottom line" potential of the sector, has driven pricing up to a level that many investors feel is artificially high.

² Rosenberg, R. (2007). *Reflections on the Compartamos Initial Public Offering*. Washington, DC: CGAP.

With some investors now refraining from making new investments as they take stock of their existing portfolios, the market has an opportunity to cool off. We specifically expect Tier 2 and 3 (smaller and non-transformed) MFIs to see lower entry multiples leading to more attractive pricing for investors. The majority of funders will be turning their focus towards larger Tier 1 MFIs, whose quality is easily signaled by successful transformations and interest from other investors. Thus, smaller MFIs will need more funding, especially from equity investors. A core belief underpinning GMEF's investment strategy is that the highest potential for value creation resides in these Tier 2 and 3 MFIs, where we see the majority of equity opportunities arising over the next few years.

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Even before the crisis, Grassroots had developed an emphasis on close, continuous, on the ground engagement with MFI investees. Even in the best of times, an investor faces difficulty in assessing value from a distance, and is ill-advised to rely exclusively on management and second-hand reporting. Under the present circumstances, this type of close engagement with actual and prospective investees is even more critical. We cultivate this engagement through our careful selection of partner managers in the geographies where we have investments, so that we always have a member of our team plugged into the realities on the ground. For this reason, we believe our strategy and the institutions we invest in will result in long-run profitability for both the portfolio institutions themselves and for our investors.

The remainder of this report will explore the pillars of the financial case for microfinance in detail: our expectations of how each will be threatened by the risks associated with this downturn; how MFIs will manage these risks, and how these assumptions can be tested by data during and after the crisis.

Drivers of Microfinance Performance

The investment case for microfinance equity rests on several oft-repeated and interdependent assertions about microfinance clients and institutions. These are based on differing degrees of substantiation by hard data and include:

1. MFI clients are more trustworthy than clients of traditional banks.

Microfinance borrowers are likely to have limited options for affordable finance; thus, maintaining access to credit from the MFI is a priority and worthy of extraordinary efforts to repay existing loans. At the same time, the flexibility and low capital investment that characterize most microenterprises mean that the borrowers have a financial resilience that large enterprise owners do not. The

evidence that financial products can appreciably improve the lives of poor households is abundant.³ Microloans are a mechanism by which the poor can take ownership of their economies and transform their lives, becoming reliable sources of repayment in the process.

2. MFI performance has low levels of correlation with the mainstream global economy.

Microfinance's apparently low correlation with the mainstream economy rests on the intuition and some evidence that microfinance is an "inferior good" – demand arises from the population that is excluded by mainstream finance. These people are generally either below or slightly above the poverty line and engaging in subsistence economic activities, usually starting low-cost micro-enterprises. These businesses then sell goods within their local economy for a lower price than those produced in the mainstream economy. Logically, as formal sector employment opportunities decrease, demand for microfinance should increase.

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3. MFI loan portfolios can count on sustained high demand-driven asset growth.

High growth relies on unmet demand for loans and the availability of capital. MFIs can achieve sustained high growth if capital market conditions are supportive and if they can develop the capabilities and technology to reach new clients. Successful MFIs, such as Bangladesh's ASA, have even replicated their business models abroad with greenfield branches (featured in GMEF's portfolio) based on a pool of equity specifically dedicated to the expansion.

We discuss each of these three assertions of the investment case for microfinance in further detail in the following pages.

The Reliability of Microfinance Borrowers

The most important factor making microfinance an attractive investment is that microfinance borrowers are viewed as more reliable and trustworthy than their counterparts at mainstream financial institutions. The reasons for this are threefold:

1. Microfinance borrowers are excluded by mainstream financial institutions and their alternatives for credit are more costly.

³ For studies of the positive impact of financial products, see: Goldberg, N. (2005). *Measuring the impact of microfinance*. Washington, DC: Grameen Foundation USA; Morduch, J. and Haley, B. (2001). *Analysis of the effects of microfinance on poverty reduction*. Ottawa, Canada: RESULTS Canada for the Canadian International Development Agency; Zaman, H. (2000). *Assessing the poverty and vulnerability impact of microcredit in Bangladesh: A case study of BRAC*. Washington, DC: World Bank.

Charging lower interest rates than the loan shark, MFIs provide necessary financial products to a niche population that happens to benefit greatly from them. The core microfinance product – microenterprise loans – is often essential to microfinance clients’ ability to enhance their income. In many cases, MFIs provide even more than just enterprise loans – they have moved into loans for education and housing, and are even serving as distribution channels for items like malaria bed nets or solar lamps. The potential for income creation and the tailoring of MFI services to a core market underscore the importance to the client of maintaining a positive relationship with the MFI.

2. The income-generating economic activities of borrowers act outside of the economic cycle.

MFIs which maintain a core portfolio of lending to traditional micro-enterprises should maintain better portfolio quality than those who don’t. Poor micro-entrepreneurs are very resilient, as the subsistence activities they pursue are born out of necessity, not convenience. They are adept at modifying their businesses when costs rise or demand dries up. This flexibility characterizes the activities of MFI clientele much more than it would the more capital-intensive businesses characteristic of mainstream bank commercial loan clients.

3. MFIs have a personal presence in borrower communities.

With face-to-face loan officer visits and the provision of multiple products that serve various aspects of a community’s needs, the MFI often plays a vital role in community development. In many cases, it is more than just a replacement for a bank. Loan officers have personal relationships with borrowers, visiting their groups or households as often as weekly to collect repayments and sit in on group meetings. These interactions provide an opportunity for the loan officer to identify repayment problems quickly and directly work out solutions to help the borrower repay.

The main threats to repayment will be price volatility and decreases in the capital flow from developed to developing countries.

While MFIs have traditionally tried to ensure that the majority of lending is devoted to income-generating activities, some consumption lending is inevitable. The extreme fluctuations in food and fuel prices of the past 18 months, along with a decrease in guest worker remittances, could force MFI borrowers into situations threatening the maintenance of normal levels of consumption. This endangers the economic basis of the loan, moving it from income creation to consumption. Therefore, the main threats to repayment ability will be price volatility and decreases in the capital flow from developed to developing countries, through their adverse effects on household income.

Food Price Volatility

The food price fluctuations of 2008 provided useful evidence of how volatility in basic consumption goods and changes in real incomes can impact microfinance borrowers. MFI borrowers are very

susceptible to these price changes, whether they are farming crops or consuming them. Many MFI borrowers have reacted to the food crisis by spending more of their income on food,⁴ although significant differences in real income effects (between the urban and rural poor) have been documented. This means that more microfinance loans may ultimately be used to put food on the family's table out of necessity. Because buying food is not an income-generating activity, their repayment of existing loans is threatened, and the small-scale economic activities of micro-entrepreneurs may face less demand as people concentrate more of their expenditures on food.

MFI and their borrowers have been facing escalating food price volatility since 2007, and CGAP surveyed 45 MFIs in 21 countries to determine how they were coping in August 2008. Fifty-seven percent of MFI managers stated that their PAR had gone up as a result of the crisis. MFI managers were trying to maintain portfolio quality by meeting their existing clients' needs, applying more flexible loan terms, increasing or rescheduling loans, and/or reducing interest rates.⁵

For some MFI borrowers, food inflation has been a boon to income. A focus group study by the Pakistan Microfinance Network revealed that for many shop owners or food sellers, inflation had a positive or zero effect on their livelihoods. They had used their microfinance loan to purchase their stock or farming inputs before inflation took hold, and now they were able to pass on the price increase to the consumer, charging a higher price relative to what they had paid for inputs.⁶ This year, they may pay higher prices for their inputs and may not be able to pass on as much of that price increase to the consumer since food prices have decreased again. Thus, we could see a lag in the effect of food price volatility on income and therefore portfolio quality.

Slowdown in Remittance Flows to Developing Countries

As the economic slowdown has affected employment opportunities in developed countries, remittance flows from guest workers to their families in developing countries had slowed dramatically by the third quarter of 2008. A recent World Bank report shows that the change in remittance flows is varying by region, but the general trend was negative.⁷ For guest workers in developed countries, sending remittances back to their families is a top priority. Though the amount sent back may decrease slightly, many workers are unlikely to cease sending money altogether, unless they lose their jobs and move back home, in which case they may become potential microfinance clients. Uncertainty regarding the magnitude of changes in

Many guest workers are unlikely to cease sending money altogether, unless they lose their jobs and move back home in which case they may become MFI clients.

⁴ Duflos, Eric and Barbara Gähwiler (2008). *Impact and Implications of the Food Crisis on Microfinance*. CGAP.

⁵ CGAP (2008). *CGAP Virtual Conference: The financial crisis and microfinance*. CGAP, November.

⁶ Zaidi, S. A., Maheen, S. F., and Naseem, A. (2008). *The impact of inflation on microfinance clients and its implications for microfinance practitioners*. Islamabad, Pakistan: The Pakistan Microfinance Network.

⁷ Ratha, D., Mohapatra, S., and Xu, Z. (2008). *Outlook for remittance flows 2008-2010*. Washington, DC: World Bank.

remittance flows is documented by World Bank forecasts. While originally predicting a fall in remittance income to developing countries of -0.9% in 2008-09, remittances are now expected to decline -5.0% to -8.2% in 2008-2009. Figures were revised because of exchange rate risks and protectionist immigration controls in developed countries.⁸

Remittances represent a substantial portion of some developing countries' income, and accordingly are integral to the household income of many MFI borrowers. Thus, a decrease in this source of income could compel borrowers to use loans for consumption instead of income generation. However, migrant workers moving back to their countries could widen the client base for MFIs, and there may be an opportunity for MFIs to contribute to the creation of income for these displaced workers.

Managing Risk and Measuring Client Reliability

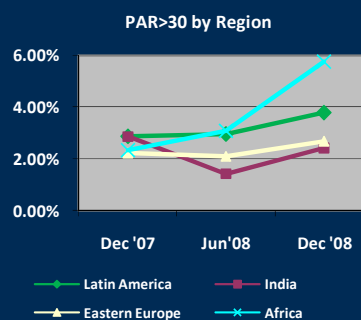
Some evidence has already shown that portfolio quality has been negatively affected over the course of last year (see sidebar). However, there is reason to believe that microfinance portfolios can remain more or less stable. The commitment of MFI managers to their social mission and the individual relationships loan officers maintain with their clients are strong factors supporting portfolio quality.

A step away from high growth projections should be a theme of microfinance's response to this crisis. This is an opportunity for MFIs to shift their focus from growth and penetrating new markets to stabilizing their existing customer base. By adopting flexibility in repayment terms and concentrating on their core market, MFIs are more likely to maintain portfolio quality and not let repayment dip to dangerous levels

Evidence of Portfolio Deterioration and Anticipated Lag Effect

By the last quarter of 2008, there has been increasing evidence of deterioration in portfolio quality. The IFC has reported that the top 150 MFIs are now reporting PAR>30 of between 2% and 3%, compared to pre-crisis average PAR of 1.2% (*The Economist*, 2009).

Grassroots tracks 100 MFIs included in the GMEF and Gray Ghost Fund portfolios. Our data show that average PAR levels have increased slightly over the course of 2008. While PARs have increased dramatically in Africa, they have increased by about one percentage point in Latin America and about half a percentage point in Eastern Europe. In India, they have stayed about the same.



Source: Grassroots data

Despite continued low PAR levels, an increase from 1% to 2% still represents a significant drag on profitability. Furthermore, we expect to see a lag in the full extent of PAR deterioration. First, once refinancing difficulties are felt more acutely by MFIs, growth will be slowed, and in turn an important incentive to repayment will be taken away. Also, as food prices and remittance drop-off continue to have effects on household income, we expect to see even further deterioration.

⁸ Ratha, Dilip, and Sanket Mohapatra (2009). *Revised outlook for remittance flows 2009-2011*. World Bank, March 23.

Microfinance and Correlation with Capital Markets: A Study by Krauss and Walter

In a study of 325 MFIs over 1998-2006, Krauss and Walter tracked six key performance indicators – ROE, profit margin, change in total assets, change in net operational in-come, portfolio growth, and PAR – to determine their correlation with international and domestic economies.

Of the six indicators, five were uncorrelated with any of the three indices of global capital markets (MSCI World, MSCI Emerging Markets, and S&P 500). Net operating income was correlated, and then only slightly. In the comparison group (emerging market institutions and banks), all six indicators were tied to all three capital market indices, almost all at the 99.9% confidence level.

MFIs are not necessarily insulated from their domestic economies, however. Five out of six indicators (all except change in net operating income) were correlated with domestic GDP at the 99% level. Emerging market institutions and commercial banks were also correlated with domestic GDP. Neither group was correlated with the domestic stock market index.

This evidence suggests that MFIs will be affected to the extent that their home economies suffer from the crisis. They will be less vulnerable to fluctuations in global capital markets.

Source: Krauss, N. and Walter, I. (2008). Can Microfinance Reduce Portfolio Volatility?

because of lack of monitoring. In past crises, such as East Asia, lenders reported higher portfolio quality for loans to the poorest sectors than for larger enterprise loans, including actual increases in repayment from poor micro-entrepreneurs while overall repayment decreased.⁹

We are expecting to see the effects of food price volatility and remittance drop-off continue to put pressure on household income, so it is not likely that MFIs have yet experienced the lowest point of portfolio quality. When we do see portfolio quality begin to rebound, we will have a better idea of how food and remittances enter into microfinance performance, and for exactly how long.

Microfinance's Correlation with the Global Economy

MFIs' apparent lower correlation with global markets (see sidebar) has two explanatory factors:

1. MFIs have access to funding by philanthropic foundations and development banks.

This funding is often set aside specifically for microfinance, and increases in times of crisis – the Inter-American Development Bank recently pledged US\$20m to a Latin America-based Emergency Liquidity Facility (ELF), and Germany's KfW and the International Finance Corporation (IFC) have put together a global emergency facility of US\$ 500m to

backstop top tier MFIs facing refinancing shortfalls. Where MFIs do receive funding from private and institutional shareholders, these investors often view their commitment as an affirmation of the MFI's mission and are less likely to flee when markets become volatile.

2. Demand for microfinance is acyclical because MFIs lend to those excluded from the formal economy.

⁹ Conroy, J. D. and McGuire, P.B. (1998). *Effects on microfinance of the 1997-1998 Asian financial crisis*. Brisbane, Australia: The Foundation for Development Cooperation.

As credit sources tighten and unemployment rises, the population for which microfinance becomes an attractive financing option increases. This has already been documented in South Africa and the United States, where middle-class borrowers are approaching MFIs as they are turned away from mainstream banks for loans.¹⁰ As mentioned, guest workers returning from abroad may also become potential MFI clients.

With MFIs' greater dependence on external funding and the retrenchment in mainstream credit markets during most of 2008, refinancing could be the most pressing macro-level challenge during this crisis, and the first we will discuss here. Other factors, like currency risk and government intervention, could also affect MFIs outside of their standard business model. These three channels – refinancing, currency, and political risk – will reveal the true degree to which microfinance's traditional insulation from the formal business cycle has eroded.

Refinancing Risk

Two effects of the global downturn can be expected to influence MFIs' ability to refinance their loans over the next 12-18 months: a drop-off in the amount of available capital and an increase in the rate of interest charged on that capital. We have already seen evidence of this in multiple countries. In a recent CGAP survey of MFI managers from around the world, average interest rate increases varied by region, with increases of about 250 bps in Eastern Europe, 400 bps in Latin America, and 450 bps in South Asia.¹¹

Through most of 2008, the impact of global credit market upheavals on MFIs has been muted, perhaps because many MFIs had built substantial margins into planning for funding. By late 2008, however, anecdotal evidence from MFI managers has already begun to reveal a tightening of credit. In India, for example, much of the commercial bank lending that occurred in the last few years has stalled, especially to some of the smaller MFIs.¹² MFIs in Latin America have also seen their potential commercial bank funders withdraw lines of credit in response to the effects of the crisis.¹³ Specialized emergency liquidity facilities in the region have begun to see an increase in demand, focused initially on the countries with greater penetration as lenders rebalance or reduce financing. Institutional investors continue to articulate their commitment to microfinance – according to a recent survey by *Microfinance Insights*, a publication based in Mumbai, 80% of investors have not reduced their

Evidence points toward a definite slowdown in the extension of new capital, but leaves open the hope that existing lines of credit may be preserved.

¹⁰ Unsecured borrowers migrating away from banks to microlenders (2008, August 12). *Cape Business News*; Cordeiro, A. (2009, March 31). Microlenders widen their client base. *Wall Street Journal*.

¹¹ CGAP (2008). CGAP Virtual Conference: The financial crisis and microfinance.

¹² Yee, A. (2009, March 22). Buzz around India's microfinance sector quietens. *Financial Times*.

¹³ MicroRate (2009). *Cautious resilience*. Arlington, VA: MicroRate

portfolio dedicated to MFIs.¹⁴ Though there is a definite slowdown in the extension of new capital, the hope remains that existing lines of credit will be preserved.

Currency Depreciation

Currency risk is also now a concern for MFIs regarding financing from foreign investors. The rally of the dollar against most emerging market currencies has increased the effective cost of hard currency loans and eliminated what may have been perceived as a low cost source of funding. In an August 2008 CGAP survey of MFI managers, MFIs said they had experienced net income losses of 7% to 43% solely due to currency fluctuations.¹⁵

Government Intervention

Many governments have made commitments to microfinance or, more broadly, to the provision of finance to low-income or “priority” borrowers. In India, banks are required to lend 10% of their credit to the “weaker” sectors, which includes small farmers, landless laborers, scheduled castes and tribes, and self help groups.¹⁶ In Mexico, second-tier wholesale banks have provided a large part of the funding for MFIs in the face of the retreat by commercial banks.¹⁷

Isolated policies targeting MFIs as economic scapegoats are prompting us to closely monitor political developments.

Despite these benign engagements, there is some fear that worsening economic conditions will prompt more governments to seize on microfinance, either in the genuine belief that loan forgiveness can help alleviate stress on the low income population, or as a distraction from politicians’ own lack of effectiveness. Ecuador recently imposed a declining interest rate cap on micro-lending. Though the cap is higher than the interest rate most MFIs charge, the amount of wiggle room they have, given 8.8% inflation and the 200-400 bps increases in the cost of funds cited by CGAP, is very small. Nicaraguan MFIs have also faced political instability, with government-encouraged anti-repayment movements resulting in the burning of some branches in the northern part of the country. Though the Nicaraguan situation has now reversed, these isolated events prompt us to closely monitor political developments.

Managing Risk and Measuring Correlation

While refinancing poses the biggest challenge to MFIs, it is the area in which both MFIs and investors can do the most to manage risk. An immediate step is for MFIs to review growth plans and ensure that expansions can be fully funded. Additionally, MFIs can focus on their core borrowers in the informal sector, who use loans for productive income-generating purposes. Becoming regulated deposit-takers

¹⁴ Press release: https://www.microfinanceinsights.com/press_release_details.asp?id=19

¹⁵ CGAP (2008). CGAP Virtual Conference: The financial crisis and microfinance.

¹⁶ Reserve Bank of India, Priority Sector Lending policy (<http://www.rbi.org.in/scripts/faqview.aspx?id=8>)

¹⁷ MicroRate (2009). *Cautious resilience*. Arlington, VA: MicroRate.

can also be an effective medium-term strategy, as MFIs would be able to rely on local deposits as funding for portfolio growth. With higher interest rates on funding, MFIs will face further pressure to increase efficiency to maintain net interest margins. Many MFIs are adopting innovative MIS technologies to track existing clients and register new ones. So far, we have seen little evidence of MFIs actually increasing their lending rates because of the increased cost of funding.

The international investment community also has a role to play in managing refinancing risk. Given that MFIs may be the only source of funding in some low-income communities, the consequences of an MFI failure would be devastating for its community and for the viability of the sector in general. Thus, we view ensuring the continued funding of microfinance institutions of utmost importance, and have collaborated with others to address this issue. In the fall of 2008, Grassroots convened a meeting in London of top MFI funders to discuss the risks of the crisis. The meeting was partly responsible for the formation of the IFC and KfW's joint USD \$500 million emergency liquidity fund. It is our hope that the investor community at large will continue to prioritize the protection of good institutions by investing in both emergency funds and traditional microfinance investment funds, and to continue the flow of capital to developing countries in general as other funding sources are squeezed.

Given that MFIs may be the only source of funding in some low-income communities, the consequences of an MFI failure would be devastating for its community and for the viability of the sector in general.

This period is also an ideal time to collect hard data on indicators of MFI correlation with the mainstream economy. Measures of external fund dependency, such as the cost of debt and the percentage of commercial bank funding in the capital structure, can be tracked during and after this crisis. Measuring the effect of the crisis on these indicators could inform investors and practitioners of how well-diversified and resilient MFI funding sources are, and how they differ by region or MFI stage.

High Growth of Microfinance Institutions

MFI outreach has grown impressively over the last five years, in tandem with the growth in new investment in the sector. Of the MFIs tracked by the MIX Market, about 800 MFIs were reaching 55 million borrowers in 2007 compared to 300 MFIs reaching 19 million in 2004.¹⁸ The sources of this growth include the following:

1. Increased attention from institutional investors

The interest from equity and debt investors, along with some securitizations in recent years, has enabled MFIs to tap into larger sources of funding to expand their portfolios.

¹⁸ MIX Market Annual MFI Benchmark series, 2004 and 2007.

2. Microfinance has the potential to serve a vast untapped market

There is an estimated US\$300 billion gap in funding to meet the needs of 1 billion potential MFI customers.¹⁹ Though the estimation of this number varies by source, one thing remains clear: microfinance supply has not caught up with microfinance demand.

There has been no evidence yet to suggest a drop-off in demand for microfinance. The primary threats to microfinance growth come on the supply side, due to previously-mentioned issues like refinancing risk or weakened balance sheets from portfolio quality deterioration. To date, it appears that while the larger MFIs may have more confidence that they will continue to receive the majority of investor attention, both large and smaller MFIs will have to cut their growth projections because of refinancing problems. The publication *Microfinance Insights* surveyed global MFIs and found that 37% of respondents were revising their growth projections downward.²⁰

Slowed growth can be an opportunity for MFIs to focus on fitting the needs of their existing customer base.

Managing Risk and Measuring Growth

Slowed growth is not necessarily bad – it can be a welcome opportunity for MFIs to focus on the quality of their products and fitting the needs of their existing customer base. Portfolio growth can conceal practices like “evergreening” (extending new loans to borrowers so they can repay old loans instead of going delinquent) and multiple borrowing (extending loans to borrowers who need to repay loans to other institutions). In addition, rapid growth can obscure portfolio quality since new, unseasoned loans carry disproportionate weight in the portfolio.

However, a slowdown in portfolio growth can have adverse effects on asset quality by altering the relationship with the borrower, as the perception that loan amounts will not grow may erode some incentives for disciplined repayment. This dynamic reinforces the need for MFIs to be vigilant about monitoring their portfolio quality and assessing the needs of their existing client base. The closer the MFI is to the client, the better they are managing asset quality risk. We believe this can be done by taking a comprehensive view of MFI client performance, which is why we encourage our MFIs to integrate social performance measurements such as Grameen’s Progress out of Poverty Index (PPI) into client assessment and monitoring. Measures such as the PPI can help shed light on how different types of clients are responding to external shocks and can help MFIs design new products that are better suited to address such developments.

MFIs need to strike a fine balance with a growth rate that is not too high, but in line with the size of their potential market. As financing drops off, private investors will need to focus not only on the larger MFIs,

¹⁹ International Association of Microfinance Investors (IAMFI) Brochure, 2007 and DiLeo, P. and FitzHerbert, D. (2007). *The Investment Opportunity in Microfinance*, New York, NY: Grassroots Capital Partners.

²⁰ Yee, A. (2009, March 22). Buzz around India’s microfinance sector quietens. *Financial Times*.

but on the smaller Tier 2 and 3 institutions that are more likely to be crowded out of the financing market. Though debt has been the most common instrument for private investment in MFIs (it represents about 77% of annual commitments²¹), equity investments are needed in order to help these MFIs grow significantly enough to reach the vast number of underserved clients. Wholesale debt can only help the sector grow up to a certain point – and one consequence of the crisis is likely to be at least a temporary tightening of effective leverage ceilings on MFIs, further boosting the need for equity. Given the progress microfinance has made in providing viable economic opportunities for the underserved, equity is now needed more than ever to help sustain good MFIs in the face of refinancing difficulties, allowing them to meet their growth potential.

It will be useful to monitor the extent to which microfinance growth projections are actually affected by the crisis, by comparing growth forecasts in 2009 and 2010 to previous years and to their actual outcomes – in terms of portfolio, borrowers, and field staff/branches. Additionally, we need to measure the significance of the correlation between the actual/forecasted growth ratio and portfolio quality, to see if slowed growth adversely affects portfolio quality. Finally, effects on growth should be measured across all levels of MFIs so that we can see at which stage growth is most at risk.

Conclusion

The primary drivers of the investment case for microfinance are the reliability and individuality of microfinance clients, the low correlation with the formal economy exhibited by

microfinance performance, and the high growth of MFIs. While these attributes will be threatened by the global crisis, strong microfinance institutions are capable of managing risks and emerging with solid fundamentals. This crisis presents microfinance institutions with the opportunity to reset growth plans, focus on their existing client base, concentrate on their core microenterprise lending market, and manage profit margins by gaining efficiency. It is also a prime time for investors to take responsibility for growing smaller MFIs that are in greater need of capital and also more attractively priced.

Our core strategy is to minimize the risks associated with the crisis – such as refinancing problems, revised growth projections, and portfolio deterioration – by investing in start-up and early stage MFIs that can manage growth and look to successful business models for guidance. While minimizing these risks, we will maximize value creation by utilizing our local management capabilities and partnerships with regional networks. These alliances help us to find the most attractively-priced investments and MFIs with the most value potential, given our new understanding of the drivers of microfinance profitability. Because valuations will be brought down in the near term to levels that allow for expansion over the next 7-10 years, now is the ideal time to invest in microfinance equity – an asset class with real growth and profitability potential.

MFIs need to strike a fine balance with a growth rate that is not too high, but in line with their potential market size.

²¹ IAMFI (International Association of Microfinance Investors) Brochure, 2007 data.

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