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MEET THE BOSS: Discussions on Microfinance Investment Vehicles (MIVs) and Impact Investing: Interview with Paul DiLeo, Co-Founder and Managing Partner of Grassroots Capital

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Paul DiLeo, Managing Partner at Grassroots Capital, plays a role in attracting private capital to the company, creating investment vehicles to address market gaps and raising funding to support new initiatives. Mr. DiLeo launched and now co-manages the Global Microfinance Equity Fund and the Gray Ghost Microfinance Fund, which is a private, for-profit microfinance fund originally established to demonstrate the viability of microfinance investment. He obtained his bachelor's degree from the University of Massachusetts (US), has a master's degree from Boston University (US) and completed studies in business accounting and finance at New York University (US).

MicroCapital: ***First of all, would you please provide us with your interpretation of what "impact investing" means in relation to the microfinance sector and regulated banking channels?***

Paul DiLeo: I think that impact investing is increasingly important for microfinance because of the kind of transition that the sector is experiencing in terms of its investor base at this time. Up until the last couple of years, since microfinance started to establish itself, the investor base for microfinance has not changed much. You had a lot of the same development or philanthropic institutions that had gradually moved with microfinance as the sector had become more commercial, experimenting with investment instruments and structures as microfinance became an investment rather than mostly a philanthropic opportunity. I guess I am really focusing on equity where there is particular influence to be exerted over the nature and character of the institutions. More recently, I think that you have seen new types of investors come in who are, at the extreme, motivated entirely by financial considerations and potential for financial return. Not to say that they don't care about the social story, but that the social story is entirely an additive beneficial feature and not necessarily required for them to pursue this as an investment opportunity. But for an important segment of the investor base — the "impact investors" — the social story stands on its own and remains essential. What that means for the microfinance industry is that microfinance institutions (MFIs) need to be much clearer about the objectives of their traditional and newer investors.

MC: *Grassroots Capital has been formed as a "spin-off" from the Gray Ghost Microfinance Fund. What was the drive behind that evolution?*

PD: Originally Gray Ghost was the brainchild of Bob Pattillo and David Weitnauer, the head of the Rockdale Foundation, Bob and Katy Pattillo's foundation at that time. I joined them to devise an investment strategy for Gray Ghost and help launch it. I was the investment director for about five years. About three years ago we started looking ahead to the day that Gray Ghost would be fully invested and whether Gray Ghost's mission of trying to draw other private investors into the microfinance space might be accomplished not just by way of example, but by directly providing for the

intermediation of private capital into the industry by raising a fund that would take in capital from private investors other than Bob and Katy Pattillo. So when we started down that route, it very quickly became clear to us that the most credible way of launching such a vehicle into the market was going to be on the basis of an independent manager–one who would be seen as fully aligned with the interests of all the investors as a group. It basically came about as a way of positioning the new fund in the most favorable way possible, so as to maximize the chances of launching the new fund successfully.

Thus, together with my partners, David FitzHerbert and Viswanatha Prasad, we spun off the management company — Grassroots — as an independent management company with no ownership from Gray Ghost or Bob Pattillo to launch the new fund: the Global Microfinance Equity Fund.

MC: *Given your interest in integrating social performance measurement into the investment process from the start, would you please provide a description of the social impact indicators that you use?*

PD: Starting with Gray Ghost, we have tried to come up with a set of indicators of social impact that would be non-burdensome from both the standpoint of the MFI and the investment process. We tried to identify indicators that would have some social content, but also be indicators that were meaningful in the day-to-day management of the business and were relevant to the analysis of an investment in any case.

More recently with Grassroots, we have taken advantage of some developments in the industry to try to incorporate more of a focus at the client level. One of the developments that we took advantage of was the emergence of the "poverty scorecard". It really provides a snapshot of the poverty status of the client and can be used to evaluate the development of changes in the client's poverty status over time and even ideally compare it to some kind of national benchmark. This would give us an idea of how an MFI's client base is developing over time relative to the general population. We encourage MFIs that we invest in to incorporate it into their practices. We have also integrated recent developments with respect to client protection principles into our analysis.

MC: *What types of investors are involved in your fund? Can you also provide greater detail as to the due diligence required when evaluating one's investment options from a client's perspective — what are investors looking at when they come to you?*

PD: The first fund, Gray Ghost was capitalized by an exceptional individual, Bob Pattillo, who committed a very substantial amount of capital to microfinance at a time where there was essentially no purely private investment in microfinance, certainly nothing of that scale. As of today, we have about 15 investors with the new fund. There are probably eight or so individuals, most of whom have some particular interest in microfinance or social investment. The rest are a fairly diverse group of institutions such as a large European pension fund, a European insurance company, a US socially oriented wealth manager and a US hedge fund. It's gratifying in that it's a pretty diverse group of investors.

With regard to the due diligence required when evaluating one's investment options from a client's perspective — it varies. I think that the principals involved in Grassroots had a reliable and complementary combination of skills, access and market experience allowing them to execute the investment strategy. I would say that is one of the main things. Some of the investors, particularly the individual investors, have known or had exposure to us in the microfinance field before; many of them satisfied themselves in that regard, on the basis of personal relationship and personal knowledge.

When you get into the institutional end of the investor group, there is quite a bit of

focus on examining the structure of the investment manager, the resources of the manager and the track record. They would look at how we mobilize the supplemental resources of legal due diligence or analysis of the investment. This is done in a very formal and rigorous way.

MC: ***So from an investor's standpoint with regards to rating microfinance investment vehicle (MIV) fund managers, the qualifications that you have just mentioned are necessary for a 'competent' manager?***

PD: Yes. Certainly in terms of the evaluation of the key people involved. I think that investors are really looking for people that demonstrate some ability to execute these kinds of transactions in the microfinance market. Also, that they share an appreciation of what the investors are really looking for.

MC: ***According to the CGAP (Consultative Group to Assist the Poor), microfinance private equity transactions have become increasingly common–JP Morgan at one point identified 144 such transactions completed since 2005, with total value of about USD 300 million. What kind of role do you think private equity firms will play in the microfinance sector in the next 5 years?***

PD: I think that there will be a tier or a set of MFIs that achieve scale and have growth prospects that will be attractive to private equity investors. I think we have seen the beginning of that in Mexico with Banco Compartamos. I think that the next few steps along that path will be in India. My guess is that worldwide, the participation of private equity probably won't become a dominant driver of transactions in microfinance. I just don't think that the scale will be that attractive to private equity firms. India is a very special case. You are not going to see those kinds of opportunities in many countries.

MC: ***Would you please provide greater detail as to what an investor should look out for in term of risk/reward when examining the operational structure of an MIV?***

PD: Grassroot's investment approach has been based on the experience that Prasad and I had when building up Gray Ghost and the Bellwether Fund in India. Fairly early on we had come to the impression that from both a social and financial standpoint, microfinance equity investing was best done very close to the ground–done by people who were in and from the market. These are people who had information networks and resources throughout their respective market, as well as the capital markets, and also had legal expertise. I am not talking simply networks and resources in microfinance but in different areas that were relevant to the success of the transaction.

From a social standpoint, we found that microfinance penetration was very uneven. We learned that there were not many high-quality microfinance services to be found in many markets. At that point, we felt the most likely way of extending microfinance to some of the blank spots was by either promoting new institutions or helping promising institutions to expand more quickly and develop their capabilities. For those types of investments you really need very close oversight and a fair amount of inputs to supplement the capabilities of the initial management team. Thus, it was not an investment that you could manage by flying in and out once a quarter or every couple of months. It was really something that needed a continuous engagement.

From a financial standpoint, we found those types of investments to be more attractive. The alternative, which was investing in some of the larger, more established and mature institutions with a track record, five years of financial statements, western auditor, etc., was not attractive due to the large amount of capital chasing those investments. We found that they just tended to be overpriced. So we started from that observation and set out to build a capability, first through

Gray Ghost and then through Grassroots, of having those kinds of teams deployed in the markets that we were targeting.

MC: ***How does one evaluate and recognize any potential signs of trouble for a MIV? I am not just talking about early warnings, but whether there are any structural features that increase the risk for the investment vehicles?***

PD: Two things come to mind. One is concentration. We have had experience with one vehicle that was a regional vehicle. The advantage of a regional vehicle is that it could bring to bear this kind of regional expertise. It would not have this geographical diversification, so, of course, if something goes wrong in that country/region, then there would be a problem. I would still argue that kind of regionally focused vehicle is preferable for the reasons that I was just describing. But I think investors need to be aware that it creates a concentration risk given that these are typical emerging markets and there can be heightened country risk or regional contamination risk.

The second thing would be the capability of the vehicle in terms of really being able to develop an independent, well-informed view of the MFI. That is obviously something that you would expect from an equity manager. I would argue that unless you have a team in place, it's pretty much impossible to do. I think even for a debt fund, you really want to have some reason to believe that the debt fund is going to be able to genuinely make some kind of independent, ongoing evaluation of the MFI, rather than relying entirely on secondary sources, reports, ratings or decisions of other investors.

MC: ***What type of due diligence is involved in selecting the MFIs that you invest in?***

PD: In terms of the regions, I think we would want to have a good understanding of the MFI's market penetration and what the particular niches are that an MFI might be able to fill. It's certainly not inconceivable that you can find a good MFI in Bosnia or Bolivia to invest in, notwithstanding the fact that those are highly penetrated markets. But you want to be careful and understand how these institutions differentiate themselves from other MFIs.

I think in terms of what we would then look for in the MFI, certainly at an early-stage institution, you are placing a huge weight on the manager and the individuals who are going to be executing the business plan. You might have some track record of those individuals, but not necessarily from that institution because they may have a long track record at another institution. A lot of times the promoters of these early-stage MFIs come from an existing institution where they have held some kind of senior management position. So you get a good feel for the managers. That's a huge part of the evaluation.

I think that with more established and mature institutions, you will have to look very carefully at their loan approval process and how they manage risks in the portfolio in terms of the initial underwriting of the loan. We also look at how they monitor risks that may develop once the loan is made with that borrower–is that borrower taking on excessive debt from other sources? We look at when that borrower might migrate from being a very attractive asset to being something more questionable and do you have the ongoing ability to reassess that periodically?

By Zoran Stanisljevic

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