Microfinance Investments

Roland Dominicé

An investor's guide to financing the growth and wealth creation of small enterprises and low income households in emerging economies

symbiotics

MICROFINANCE INVESTMENTS

An investor's guide to financing the growth and wealth creation of small enterprises and low income households in emerging economies

ISBN: 978-2-8399-1093-4

Legal Disclaimer:

The research contained in this book is meant to broaden and deepen the understanding of the microfinance investments industry among investors and practitioners. On a few occasions, this book refers to specific collective investment schemes. Such references are made for research purposes only and are not intended as a solicitation or recommendation to buy or sell any specific investment instruments. Similarly, the information and opinions expressed in the text were obtained from sources believed to be reliable and in good faith, reflecting the view of the authors on the state of the industry, but no representation or warranty, expressed or implied, is made as to its accuracy or completeness. It is also meant for distribution only under such circumstances as may be permitted by applicable law.

PREFACE

About this book.

This book offers investors an in-depth guide to understanding the microfinance investment value chain and its benefits. It aims to increase the awareness of this growing asset class among traditional investors by providing a detailed review of the current state of the industry. The book focuses on the two key intermediaries linking investors and small enterprises: financial institutions and investment funds, covering their respective markets, models, risks, performance and impact. By describing their dynamics, strengths and weaknesses, it helps the investor to better grasp the elements of choice when deciding to add microfinance in his portfolio.

This book was written using primarily data and knowledge gathered by Symbiotics and its staff over the past decade. Most of the quantitative information comes from Syminvest.com, Symbiotics' on-line investment platform, both from its deal book and from market research, as well as from aggregate information collected through annual global microfinance funds surveys. These surveys were carried out by Symbiotics, first in collaboration with CGAP/World Bank from 2007 to 2010, and then on its own starting in 2011 – collecting data from up to 90 specialized microfinance investment vehicles.

The text was written by Roland Dominicé in the last quarter of 2011, with the assistance of Claire Dorey and Julia Minici, and the editorial support from Vincent Dufresne, Jérôme Savelli and Daniel Schriber. Other staff members who contributed to specific topics include Jérôme Audran, Todd Farrington, Christophe Favre, Coralie Leresche, Nicolas Pinguely, Kristina Povilaityte, Yvan Renaud and Fabio Sofia. A special thanks to Martina Bozzola, Philippe Buffle and Prof. Jean-Michel Servet for their review and comments, as well as to Andrew Barr for his professional writing support and to Vincent Thevenon and Axel Lopez for the artwork and design. The book was first published in March 2012 in Bellinzona (Switzerland).

TABLE OF CONTENTS

Emerging Markets, Financial Institutions, Small Enterprises

FIGURE INDEX

BOX INDEX

ACRONYMS

ADB	ASIAN DEVELOPMENT BANK
AfDB	AFRICAN DEVELOPMENT BANK
AIFMD	ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE
ANDE	ASPEN NETWORK FOR DEVELOPMENT ENTREPRENEURS
AUM	ASSETS UNDER MANAGEMENT
BFV	BLOOMBERG FAIR VALUE
CAGR	COMPOUNDED ANNUAL GROWTH RATE
CEO	CHIEF EXECUTIVE OFFICER
CGAP	CONSULTATIVE GROUP TO ASSIST THE POOR
DCF	DISCOUNTED CASH FLOW
DFI	DEVELOPMENT FINANCE INSTITUTION
EBRD	EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT
EECA	EASTERN EUROPE & CENTRAL ASIA
EIB	EUROPEAN INVESTMENT BANK
ESG	ENVIRONMENTAL, SOCIAL & CORPORATE GOVERNANCE
EUR	EUROS
FATCA	FOREIGN ACCOUNT TAX COMPLIANCE ACT
GIIN	GLOBAL IMPACT INVESTING NETWORK
GP	GENERAL PARTNER
HFRX	HEDGE FUND RESEARCH INDEX
IADB	INTER-AMERICAN DEVELOPMENT BANK
IFC	INTERNATIONAL FINANCE CORPORATION
IFI	INTERNATIONAL FINANCE INSTITUTION
IPO	INITIAL PUBLIC OFFERING
IRR	INTERNAL RATE OF RETURN
LAC	LATIN AMERICA & THE CARIBBEAN
M&A	MERGER AND ACQUISITIONS
MENA	THE MIDDLE EAST & NORTH AFRICA
MFI	MICROFINANCE INSTITUTION

MIV	MICROFINANCE INVESTMENT VEHICLE
MSCI	MORGAN STANLEY CAPITAL INTERNATIONAL
MSEs	MICRO- & SMALL ENTERPRISES
MSMEs	MICRO-, SMALL & MEDIUM ENTERPRISES
NBFI	NON-BANK FINANCIAL INSTITUTION
NGO	NON-GOVERNMENTAL ORGANIZATIONS
OER	OPERATING EXPENSE RATIO
P/BV	PRICE TO BOOK VALUE
P/E	PRICE TO EARNINGS
PAR	PORTFOLIO AT RISK
PE	PRIVATE EQUITY
PIIFS	PRINCIPLES FOR INVESTORS IN INCLUSIVE FINANCE
PRI	PRINCIPLES FOR RESPONSIBLE INVESTMENT
ROA	RETURN ON ASSETS
ROE	RETURN ON EQUITY
SEC	SECURITIES AND EXCHANGE COMMISSION
SME	SMALL & MEDIUM ENTERPRISE
SMX	SYMBIOTICS MICROFINANCE INDEX
SPTF	SOCIAL PERFORMANCE TASK FORCE
SRI	SOCIALLY RESPONSIBLE INVESTOR
SYM50	BENCHMARK OF 50 MFIS CALCULATED BY SYMBIOTICS
TCX	THE CURRENCY EXCHANGE FUND
TER	TOTAL EXPENSE RATIO
UCITS	UNDERTAKINGS FOR COLLECTIVE INVESTMENTS IN TRANSFERABLE SECURITIES
UN	UNITED NATIONS
USAID	UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT
USD	U.S. DOLLARS
VC	VENTURE CAPITAL / VENTURE CAPITALIST
WACC	WEIGHTED AVERAGE COST OF CAPITAL

I. EXECUTIVE SUMMARY: KEY HIGHLIGHTS & TAKE-AWAYS

I. INTRODUCTION

+ Microfinance is the provision of access to capital and financial services in low income economies.
+ Microfinance institutions (MFIs) finance micro- and small enterprises (MSEs) and low income households.
+ Micro-enterprises have up to 5 employees, small enterprises have up to 50 employees.
+ Microfinance investment vehicles (MIVs) invest in MFIs and more broadly in microfinance markets.
+ Socially responsible investors (SRIs) invest in MIVs, with an aim to maximize shared value creation.

II. FINANCIAL INSTITUTIONS (MFIs)

01 MARKET OVERVIEW

+ The microfinance industry is estimated at between USD 45-60 billion in total MFI asset size.
+ The top tier market includes up to 100 micro-banks, usually above USD 100 million in size.
+ The 2nd tier market includes up to 500 and the 3rd is comprised of thousands of smaller credit shops.
+ Leading MFIs grew by 20% per annum in the past five years, by 50-60% before 2008 and by 20-25% since then.
+ High growth is sustained through strong capital supply and explained by strong micro-economic activity.
+ Microfinance growth is very resilient but not totally immune to global economic downturn risk.

02 BUSINESS MODEL

+ Small enterprises with high operational margins can afford expensive capital although its availability is often too scarce.
+ MFIs are very labor intensive, with 15% operating expenses, 10 times higher than traditional banks.
+ Micro-credit rates are quite high as a result, with 2-3% monthly interest, generating portfolio yields of about 30%.
+ Micro-credits have low default rates (2-3%) due to a blend of social collateral, responsible lending and high growth.
+ In addition to high operating expenses, portfolio yields are further reduced by the cost of financing of 7-10% on average.
+ Leading MFIs reach 4-5% asset return, with 15-20% equity return due to debt leverage of 4 on average.

03 DEBT FINANCING

+ MFIs transform from NGOs to NBFIs to banks, with varying capital needs during the different stages of their life cycle.
+ Debt is the main engine of growth for transforming top tier MFIs and can leverage up to 10 times the equity value for MFIs.
+ Applying comprehensive risk-based pricing models would imply that rates in the past years were underpriced by up to 6%.
+ Evidence shows that MFI debt is not fully correlated to sovereign risk, which in turn reduces country premiums.
+ Evidence also shows that only up to 2% of MFIs default, further invalidating high risk pricing models.
+ DFIs offer prices 2% lower and MIVs 1% higher than local banks, generating unresolved debates on pricing.

04 EQUITY FINANCING

+ Today the MFI total equity market size is estimated at about USD 10 billion and is growing rapidly.
+ Public policy money acts as a seed investor and a business angel, often producing high profits.
+ Some MFIs are valued above 10x book, most fluctuate between 1-2x, with market comparables at 2x.
+ Many later stage investors adopt a "hands-off" approach, limiting M&A and IPO activity.
+ The traditional PE approach, restructuring MFIs for profit maximization, is rarely applied in microfinance.
+ Listed MFIs outperform emerging market banks, despite the Indian MFI failure reducing new IPO cases.

05 IMPACT

+ Microfinance is access to finance for small businesses and low income households.
+ Impact is made on end clients in terms of individual capital gains, wealth creation and improved living standards.
+ Impact is made on institutions in terms of profitable banking models for low income in growth markets.
+ Impact is made on financial systems: building inclusive access to capital to all for a better world.
+ Impact is created by financing goods of first necessity: creating jobs and building access to food, homes, energy.
+ Microfinance investments offer shared value creation and impact to multiple stakeholders.

01 MARKET OVERVIEW

+ The MIV market is estimated at USD 10 billion in 2012, with 35% growth per annum since 2007.
+ Two thirds of MIVs are debt funds, 80% of MIV deals are loans; growth in this segment has slowed down materially.
+ Equity funds represent less than 10% of MIV assets, but grew by more than 50% in 2010 and 2011.
+ Eastern Europe and Latin America account for 75% of MIV assets, but have experienced slower growth recently.
+ Asia and Africa represent a fraction of the MIV market, both are growing above 50% per annum today.
+ Institutional investors have moved in front of public, private and retail investors with 45% MIV market share.

02 BUSINESS MODEL

+ There are over 100 MIVs today, although the top 5 account for 50% of total MIV assets and the top 50 for 98%.
+ Dutch, German and Swiss-based MIV managers originated over 80% of total MIV transactions.
+ Over 50% of all MIVs are registered in Luxemburg, which is well-suited for qualified investors.
+ MIVs are costly, with 3% average TER (2.4% for fixed income and 6.5% for equity).
+ Steady and attractive net yields and growing competition have sustained and improved the MIV value proposition.
+ The current trends point to further efficiency through syndication, consolidation and outsourcing.

03 FIXED INCOME

+ MIVs have posted positive and attractive annual yields of 4.86% in USD and 3.84% in EUR since 2006.
+ SMX index has posted stable absolute returns (of 0.33% per month) and low volatility (0.61%) since 2003.
+ Yields have little correlation to capital markets and often generate attractive relative return for risk (Sharpe ratios).
+ MIV bad loan provisioning was close to 0% until 2008 and grew to about 2% on average between 2009 and 2011.
+ Several MIVs were caught with excess liquidity in 2008, generating pressure to invest in a down cycle.
+ Trends also show a growing MIV differentiation based on research quality and cost efficiency.

04 PRIVATE EQUITY

+ Market size should move towards USD 1 billion in 2012 (10% of USD 10 billion MIV market).
+ Funds are small (USD 25 million on average) and recently established (3.1 years on average in 2011).
+ Funds have been growing rapidly, above 50% on average per annum since 2007.
+ Funds posted IRRs of 10-12% in 2007 and 2008, with lower estimates for the period from 2009 to 2011.
+ Funds are expensive, growing from 4.8% to 6.5% TER between 2008 and 2011.
+ The private equity niche was hit hard by the financial crisis, but its underlying market is healthy and promising.

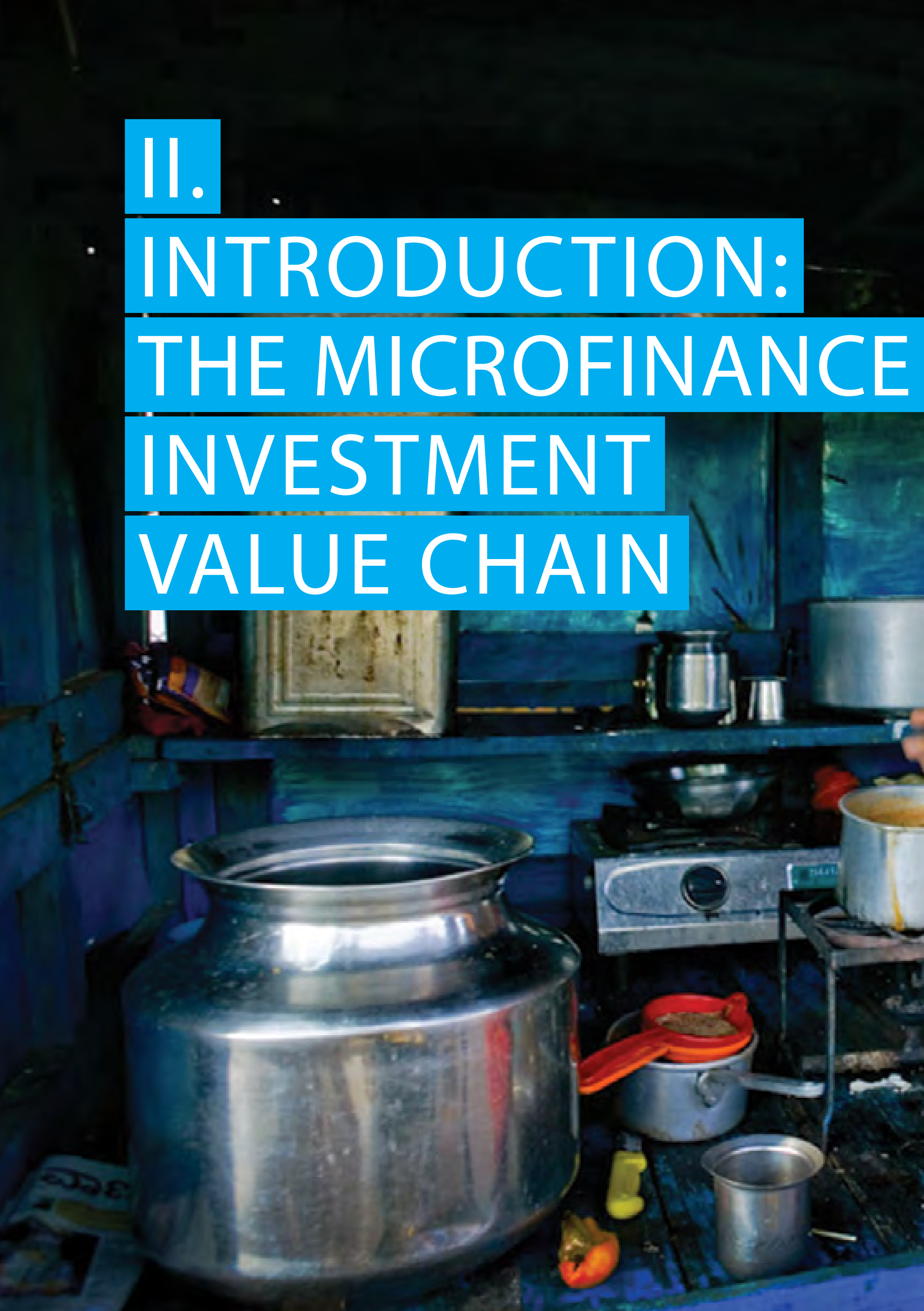
05 IMPACT

- Direct and measurable MIV impact is represented by outreach and inclusion, not individual life change.
- Outreach and inclusion are the result of rebalancing global capital distribution and wealth creation capacity.
- MIVs finance 70-75% of micro-enterprises, which are 60-65% women-owned and 45% are located in rural areas.
- Funds offer a shared value creation proposal between investors and small businesses.
- Responsible investors adopt a "multi-stakeholder value" model rather than a "shareholder value" model.
- Funds maximize their impact by acting responsibly and pushing the social function of finance.

IV. CONCLUSION

- There is an irresistible demand for democratization of access to capital within low income economies.
- There is as a result a flourishing financing intermediation market (investment funds and financial institutions).
- The broader value chain targets job creation and access to food, homes and energy in emerging markets.
- Public and private initiatives have an important complementary duty in reinforcing the industry.
- Capital gains and wealth creation have a very strong social transformation power.
- Modern investors seek to have a voice and sustainability in their asset allocation for long term stable gains.

II. INTRODUCTION: THE MICROFINANCE INVESTMENT VALUE CHAIN



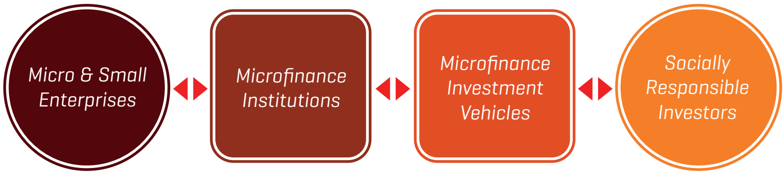
Microfinance investments emerged about a decade ago with a tangible value chain for investors and a simple value proposition: the financing of micro-economic activity in emerging markets. In 2012, foreign private investments in microfinance are expected to surpass the USD 10 billion mark, a development that highlights the industry's continued growth and positive performance since its inception. Overall, the microfinance investments industry has developed into an attractive asset class, in particular standing out during the global financial crisis as an interesting area of diversification and a compelling portfolio stabilizer for many investors. The microfinance investments market nevertheless remains quite atomized, vulnerable to external shocks and largely unregulated. This book aims to share a decade's worth of knowledge building and shed further light on the industry in order to assist investors in reaching out further into the sector and help them benefit from the important value creation opportunities which it offers.

The reader will learn how to find his way into the industry and master this emerging asset class, understand its origin, context and perspective, and build an informed judgment in order to make sound investment decisions. Microfinance capital markets do not benefit today from long standing infrastructure. There are no existing equivalents to Standard & Poor's, Bloomberg, Clearstream, Nasdaq, Goldman Sachs, and the like, active in this space to assist the investor in approaching it. It is nevertheless expected that most investment portfolios will eventually include exposure to micro-economic activity in emerging markets. It is thus essential for the investment community to embrace these markets in their early phase and develop the necessary knowledge to sustain their fast growth, act responsibly with customized financing solutions and consequently benefit from their long term wealth creation and capital gains opportunities.

This book engages in deconstructing the markets, models, risk, performance and impact of microfinance institutions and investment vehicles. It aims to assist the investor in understanding the transformation and impact of his capital, from his own portfolio into the pockets of the economically active poor. Today microfinance offers a quite vast investment proposition, making it important for investors to understand, differentiate and compare the various elements at stake when approaching the industry. In order to address this purpose, this book is divided into two main sections, one on financial institutions (MFIs), and the other on investment funds (MIVs). Each contains five chapters, with key highlights and take-aways summarized in the next section (Executive Summary). These five chapters cover, respectively for MFIs and MIVs, (1) market size, structure and growth, (2) business models, (3) debt capital/investments, (4) equity capital/investments, and (5) impact.

As an introduction to this knowledge sharing, the microfinance investment value chain is described and defined in detail to help the reader get acquainted with the vocabulary and reality behind the cash flows and results.

Figure 1: Microfinance Investment Value Chain



Microfinance can be defined as the provision of access to capital and financial services in low income economies. Microfinance is offered both to businesses and individuals in the form of credit, savings, remittances, payment services, insurance and other basic financial products. Microfinance is nevertheless primarily associated to micro-credit: lending small amounts of capital for the income generating activities of the economically active poor operating in informal sectors. More recently, micro-credit's definition grew into a broader one including micro- and small enterprise (MSE) financing.

Micro- and small enterprises (MSEs) can be broadly defined as businesses with respectively 5 employees and up to 50 employees. Traditional banking activities rarely allow investment money to reach out into the lower segments of the market, primarily for cost and efficiency reasons, excluding the micro- and small entrepreneurial activities from accessing the capital they require to finance their growth. Today though, over 80% of the world population, or more than five billion people, live with less than USD 10 a day, and more than half of them are employed by micro- and small enterprises. Their markets have thus seen the burgeoning of specialized financial institutions, or "microfinance institutions", aiming to fulfill their capital and financing needs, in particular in the context of fast growing emerging markets.

Microfinance institutions (MFIs) can be defined as financial institutions specialized in providing access to capital and financial services to micro- and small enterprises and low income households in emerging economies. Pursuant to the widespread economic development in emerging and frontier markets today, microfinance institutions have been created to serve this new and growing audience with innovative and customized models targeting their various needs. Often referred to as the vectors of democratization of access to capital or inclusive financial institutions, they have engaged in bridging the gap between the global financial system and hundreds of millions of small businesses and low income households.

Microfinance investments can be defined as the provision of capital to microfinance institutions. In rare cases, microfinance investments occur directly between microfinance institutions and investors, but in most instances investors purchase shares of collective investment funds and vehicles, or "microfinance investment vehicles", in order to gain exposure to the sector. In order to reach out to micro- and small enterprises, microfinance investors will thus invest in funds, which in turn invest in financial institutions, which are specialized in serving the lower segments of the market.

Microfinance investment vehicles (MIVs) can be defined as investment funds dedicated to financing microfinance institutions and markets, ultimately seeking to participate in the growth of a more inclusive access to capital. Microfinance funds are typically split between Fixed Income MIVs (with more than 85% of debt instruments), Equity MIVs (with more than 65% of equity instruments) and Mixed MIVs (with 15 to 65% of equity instruments). Fixed Income MIVs constitute the majority of MIVs; they are thus often subdivided between "structured" funds, leveraged through multiple subordination levels, and "simple" unleveraged funds, with a single class of risk for all investors. These categories exclude investment intermediaries which do not constitute a collective investment scheme (such as holding companies, single investor funds or peer-to-peer lenders) or which do not hold a majority of microfinance assets in their portfolio. MIVs also stand out as primarily attracting socially responsible investors.

Socially responsible investors (SRIs) can be defined as investors seeking to maximize their profits, while respecting responsible corporate practices towards the various stakeholders of their investments. They accept to balance the needs of a business' multiple value contributors in order to ensure its viability, and hence optimize its long term capital gains and value creation capacity. They are therefore also referred to as sustainable investors. They have developed an ethic of social consciousness which serves to prevent short-sighted profits and to protect their long term sustainability. Microfinance investors are usually referred to as socially responsible investors as they share this vision and behavior. They expect to invest in financial institutions with a social mission and, indeed, well-performing MFIs have strong corporate social responsibility values and principles.

Box 1: Microfinance Investment Value Chain Illustration

Ms Valdez ◂ ▸ Apoyo Integral ◂ ▸ Luxemburg MIV ◂ ▸ Swiss Canton Pension Plan

Micro- & Small Enterprises (MSEs)
Ms. Maria Valdez lives in El Salvador. During the 1980s civil war in her country, she had an ambulatory food stand in the Soyapango market of San Salvador, generating less than USD 3 a day in income. In the early 1990s, she had the opportunity to purchase a fixed location in the market, thanks to a USD 60 micro-credit which she repaid within a year. As she stabilized her business, she started diversifying the goods she offered and eventually specialized in selling shoes. Today she owns three shoe stores in different markets, with several employees, generating higher sales and capital accumulation. Her MFI has continuously sustained her growth, pushing her loan balance up to USD 2,500.

Microfinance Institutions (MFIs)

Ms. Valdez borrowed from the Sociedad de Ahorro y Crédito "Apoyo Integral" S.A., an MFI which started in 1992 as a foundation and eventually transformed into a regulated financial institution, thanks to the support of local and international investors. Apoyo Integral currently has about 45,000 clients with USD 1,650 average borrowings. More than 85% of them are micro- and small enterprises, and 10% are low income household borrowing for home improvement or access to property purposes. 60% of clients are women and 49% are active in rural areas. Apoyo Integral has generated positive capital gains fluctuating between 5% and 20% for the past five years, which has attracted many lenders and allowed it to grow from USD 25 to 75 million in loan portfolio over the period.

Microfinance Investment Vehicle (MIVs)

Apoyo Integral has diversified its funding through over 30 loans from about 20 local and international financing sources, in order to finance this growth. One of them is a specialized fund registered in Luxemburg and sold to Swiss pension funds. Its promoter has grown its investor committee to over USD 100 million, refinancing more than 65 microfinance institutions in more than 25 emerging markets. It has supported Apoyo Integral since 2008, when it provided a first loan of USD 1 million for two years with an 8.5% coupon. It has since then increased its exposure and reduced its lending rate with Apoyo Integral.

Socially Responsible Investor (SRIs)

The Luxembourg MIV is seeded by about 20 different Swiss pension funds that are clients of the promoter. The MIV offers risk management overlay services to pension funds as its core business proposal. The fund emerged as an initiative to provide a socially responsible product to its target clientele, as well as offer stable returns, low absolute volatility and low relative correlation, with an interesting portfolio diversification opportunity. One of its investors is, for instance, the pension plan of the state administration in one of the cantons along the Geneva Lake. Their aim is to generate a minimum yearly net revenue fluctuating between 2 and 4% in Swiss francs to pay the monthly retirement pensions of their personnel, while respecting sustainable and socially-minded principles.

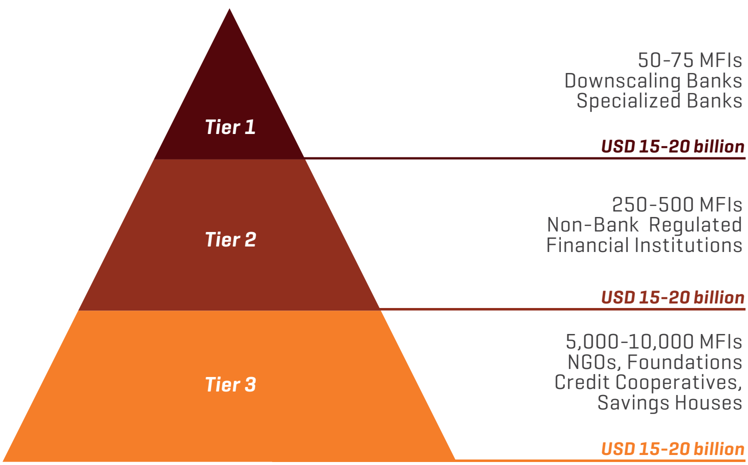
III. FINANCIAL INSTITUTIONS (MFIs)

01 MARKET OVERVIEW

The microfinance industry has a very large and fragmented market, composed of thousands of institutions and hundreds of investment opportunities. Its total asset size can be estimated at about USD 45 to 60 billion today. It has been growing steadily at 30% per annum since 2006, with relatively wide regional and country variations. The biggest challenge facing the success of this industry is its capacity to regulate itself and control its growth. As long as the industry carries on this effort, it will continue to offer sustainable and shared value creation to its various stakeholders, in particular to the more vulnerable end clients it aims to serve.

Structure. The investment universe of MFIs is commonly divided into three categories. What is sometimes referred to as the first tier of the market consists of between 50 to 75 large, mature and profitable MFIs, specialized micro-banks or downscaling commercial banks with a strong commitment to microfinance. These institutions include full-fledged banks with multiple financial products and services, including refinancing strategies primarily based on deposits from the public, inter-bank loans, bond issuances and sometimes publicly traded equity. The second tier MFIs consists of 250 to 500 companies, primarily non-bank financial institutions (NBFIs) which are often regulated as specialized financial institutions. They usually do not offer the full range of financial products and generally cannot rely on savings as their main funding source and are largely dependent on specialized lenders. The third tier MFIs include thousands of smaller entities, whether NGOs, foundations, credit cooperatives, savings houses and small private startups. They usually fund growth through grants or membership contributions. Today, the vast majority of foreign private sector microfinance investments are placed with second tier institutions, which are in need of leverage and transformational capital from foreign investors.

Figure 2: MFI Market Structure



Size. The first tier market can be estimated at about USD 15 to 20 billion of micro- and small enterprise credits, with average loan portfolios above USD 100 million, and a client base which can range, depending on the region, from around a 100,000 (with average loans of up to USD 2,500 equivalent) to the millions (with smaller average loans particularly in Africa and Asia). A typical second tier institution has a loan portfolio of about USD 50 million and a clientele comprising around 50,000 micro-enterprises with credits of around USD 1,000, again with a quite high variance. As a result, the core target market for foreign microfinance investors is also estimated at USD 15-20 billion. Finally, the lower end of the market is composed of institutions with a typical average loan portfolio below USD 5 million, around 5,000 clients and an average micro-credit size of under USD 1,000. Consequently, this market is also estimated at USD 15 to 20 billion. In aggregate, the total microfinance market can be estimated to be between USD 45 and 60 billion.

Growth. Symbiotics tracks a reference index of 50 MFIs – the "SYM50". This index is composed primarily of successful second tier institutions and serves as a proxy for trends in the foreign microfinance investment market. In the past six years, SYM50 loan portfolios have grown at about 31% per annum, with an average annual growth of 45 to 50% before the start of global financial crisis in 2008 and 20 to 25% since then. Large variations exist from one region to another, and also between countries within the same region. Latin American microfinance, for instance, has remained one of the most stable investment spaces, with average portfolio growth rates of 37% over the past five years. Central and Eastern Europe, historically a key focus of foreign investors, has largely suffered from the crisis, with annual average growth of 25% over the period when taking into account fast growth before the crisis (52% per annum) and negative growth since it started (-2% per annum). Asia and Africa, broadly speaking, have been the fastest growing regions since the global financial crisis, recording positive growth of 20 to 40% per annum.

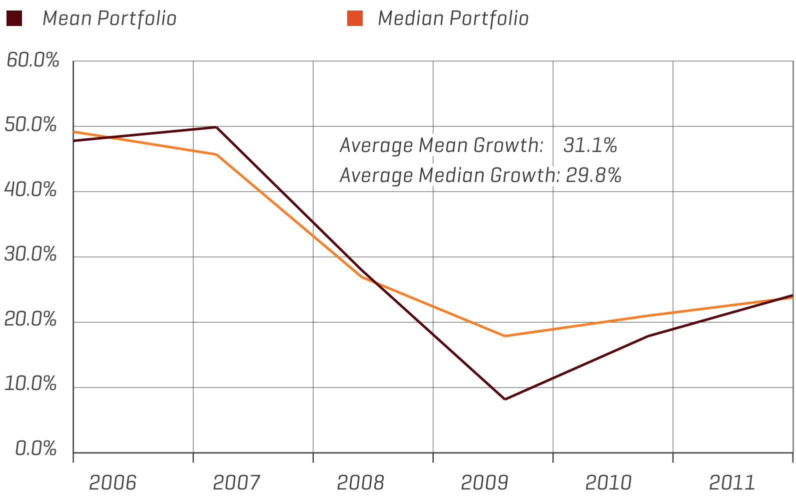
Box 2: Top 25 Microfinance Institutions

	MFI	Country	Gross Loan Portfolio (USD mi.)
1	Bank Rakyat	Indonesia	1,630
2	MiBanco	Peru	1,551
3	Grameen Bank	Bangladesh	939
4	SKS Microfinance	India	926
5	Equity Bank	Kenya	925
6	Spandana	India	787
7	Banco Compartamos	Mexico	781
8	ACLEDA	Cambodia	745
9	BRAC	Bangladesh	621
10	CMAC Arequipa	Peru	560
11	ASA	Bangladesh	531
12	CMAC Piura	Peru	445
13	BancoSol	Bolivia	428
14	Financiera Edyficar	Peru	352
15	Accessbank	Azerbaijan	341
16	Bandhan	India	332
17	Visión Banco	Paraguay	316
18	Banco Solidario	Ecuador	280
19	Xac Bank	Mongolia	263
20	FMM Popayan	Colombia	262
21	CMAC Ica	Peru	155
22	KWFT-DTM	Kenya	147
23	EDPYME Raiz	Peru	144
24	Financiera Confianza	Peru	133
25	Mikrofin	Bosnia & Herz.	122

The list of top 25 Microfinance Institutions does not include downscaling banks, specialized SME financing institutions and vernacular institutions, like large credit cooperatives or savings houses. The gross loan portfolio includes both the microfinance and SME portfolios.

Source: Syminvest.com, The MIX Market, as of December 2010

Figure 3: Global Market Growth (SYM50)



Source: Syminvest.com

Opportunity. Microfinance is bigger and stronger than ever before, comprising thousands of players worldwide and recording double-digit growth throughout the global financial crisis. Over the past decade, it has confirmed the relevance of the fundamental demand underpinning its value proposition. Globalization is shifting the locus of value creation towards younger, lower income and rapidly growing populations in emerging economies. As a consequence, their labor markets offer a strong opportunity for capital inflows. The continued crisis in Europe and North America has only accelerated this shift within the financial markets. Therefore, economic growth and development have created opportunities for the millions of low income households and smaller enterprises that microfinance operators strive to serve.

This high growth translates into high capital needs, attracting local and foreign investors into the sector. Looking at a sample of the 10 countries constituting among the highest exposures of foreign microfinance funds in the past five years, and within them the usual second tier MFIs attracting foreign interest, one can witness microfinance loan portfolios growing on average between 40% and 100% in the past five years. These MFIs are thus constantly in search of a large diversification of funding sources to sustain their high growth.

Figure 4: Top Foreign Funded Market Growth

Countries	MFIs*	Average Annual MFI Loan Portfolio Growth (2007-2011) 2007	2008	2009	2010	2011
Kyrgyzstan	4	153.0%	176.2%	48.1%	43.3%	n/a
Mexico	12	138.2%	52.6%	154.0%	65.2%	11.8%
Colombia	4	106.4%	10.7%	63.4%	83.7%	48.3%
Peru	13	75.6%	43.1%	118.6%	34.7%	23.1%
Tajikistan	5	130.3%	90.5%	-25.0%	45.7%	42.0%
Cambodia	9	94.1%	76.9%	8.3%	40.4%	49.3%
Azerbaijan	7	98.3%	67.4%	22.8%	25.7%	43.1%
Georgia	5	114.8%	33.8%	-2.6%	53.2%	55.3%
Ecuador	13	47.6%	26.7%	8.5%	39.5%	53.3%
Bolivia	7	39.7%	48.5%	18.4%	28.5%	36.4%
Average		99.8%	62.6%	41.4%	46.0%	40.3%

* number of MFIs in the sample

Source: Syminvest.com

This strong fundamental trend behind the emergence of growing employment and entrepreneurship opportunities in these low income markets is to a certain extent irresistible from a global macro-economic perspective. Many investors have as a result witnessed that demand for microfinance has grown locally irrespective of political risk. If microfinance banks are generally located in non-investment grade countries, they are generally rated investment grade in their domestic markets. That being said, in several cases of external shocks, such as severe socio-economic downturn, civil strife or environmental crisis, microfinance markers have slowed down for a while but generally accelerated for a period thereafter as compensation. This is explained by the fact that small businesses affected by external shocks need access to capital to re-launch their activities. This overall robust high growth trend in their markets explains why, all other things being equal, microfinance markets are not highly correlated to their sovereign risk.

Risk. Nevertheless, this strong and rapid growth also represents the biggest threat to the sector, as local regulators and legislators have struggled in many cases to keep up with the pace of development and innovation in the lower segments of their financial sectors. Indeed, several cases related to lack of regulation and transparency for investors and practitioners, poor or inexistent credit bureaus, misbalanced corporate governance, bad financial risk management and abusive client behaviors have highlighted the dangers that the sector is subject to when facing inappropriate infrastructure and best practices. High growth coupled with poor regulatory framing thus raises alarm for many investors. This is particularly apparent when capital is too quick flowing in and/or too abruptly withdrawn, such as what was seen respectively from 2006 to 2008 and from 2009 to 2010 in some markets. Microfinance will certainly continue to grow, but requires continued strong policy making and regulatory initiatives in order to remain sustainable and balanced for its various stakeholders, particularly for its more vulnerable end clients.

Box 3: Microfinance Is Not Immune to Macroeconomic Downturn: The Nicaragua Illustration

Up to mid-2008, Nicaragua was one of the most dynamic microfinance markets in the world. It grew in the 1990s out of pioneering non-profit micro-credit initiatives and many years of bi- and multi-lateral foreign public sector support. In the decade before the crisis, it enjoyed annual asset growth of almost 40% per annum, with many local and foreign commercial investors funding this development. In 2008, its total loan book reached USD 543 million, spread over 23 microfinance institutions (three regulated and 20 NGOs) and 324,000 clients, of which 45% had micro-enterprise loans, and the remaining balance were SME, consumption and housing loans. In addition, more than 50% of the NGOs' portfolios were in the agricultural sector.

In mid-2008, Nicaragua was hit hard by the global financial crisis. Slower economic growth rates unveiled some loose credit practices which had emerged from the excessive speed at which MFI portfolios had increased and their stressed operational activity. More than 40% of micro-borrowers held obligations to more than one MFI, with no regulatory oversight of over-indebtedness behavior. In addition, the sudden decline in price of agricultural products caught several rural businesses with goods selling at a value far below that of the borrowings they contracted to purchase them. Finally, the liquidity crunch which took local and foreign funders by surprise dried out most refinancing sources for MFIs. And those that still had cash grew reluctant to refinance a declining sector to which they were already exposed, and rather started progressively pulling out due to incremental credit risk. This in turn further worsened the MFIs' capacity to support their clients' needs for extended maturities. Debt payments in arrears and write-offs surged, leaving a systemic average bad loan ratio (PAR30) of around 20%. On top of this, borrowers from the northern departments organized the populist No Pago movement, refusing to pay back their loans and making untenable demands for long term grace periods and drastically reduced rates. Further complicating the picture, a legislative initiative to allow debtors a payment moratorium created uncertainty and impaired repayments until it was passed in late February 2010. Overall, the chain reaction spread throughout the country and the sector fell into a deep crisis. By the end of 2011, the market had contracted by about 70% in volume, down to USD 170 million, and was reduced by 30% in clientele, down to 225,000. A few MFIs went bankrupt, including what had become the second largest micro-bank of the country.

Heading into 2012, Nicaragua has posted its best export figures in the past ten years, is awash with Venezuelan cash and has just resolved a presidential election installing Daniel Ortega for a third term. The country remains a high sovereign risk, with a B- rating and has many political and legislative question marks, but several analysts expect the fastest growth of the region from Nicaragua. Foreign funders have reportedly returned to the country, including microfinance investors. In addition, a new microfinance law came into force in January 2012, which included improvements in relation to interest rate caps, legal recovery of past-due loans, local securities issuance and credit bureau use.

02 BUSINESS MODEL

Microfinance has proven to be quite profitable, with average gross returns for investors of about 7 to 10% on debt and 15 to 20% on equity in local terms. Risk ratios also stand out, remaining at low levels – with 2 to 3% median portfolios at risk for top tier MFIs. Microfinance is also very labor intensive, with high transaction costs. This paradoxical model for a poverty alleviation claim is sustained by high margins at the end client level, fuelled by strong growth opportunities, and ultimately is dependent on responsible investor and practitioner behavior to be viable.

Figure 5: MFI 10 Key Performance Indicators

	2005	2007	2009	2011
Total Assets (USD mi.)	14.45	35.35	50.51	84.61
Loan Portfolio (USD mi.)	11.97	30.75	44.23	67.62
Number of Clients	12,580	22,131	27,526	45,684
Average Loan (USD)	1,297	1,691	1,820	1,507
Portfolio Yield	31.52%	28.57%	28.95%	29.59%
Portfolio at Risk >30 days	1.78%	1.73%	3.38%	2.21%
Operating Expense	16.18%	14.12%	13.70%	14.68%
Operational Self-Sufficiency	120.99%	120.14%	112.33%	122.75%
Debt/Equity Ratio	2.91	4.23	4.21	4.12
Return on Equity	15.63%	18.88%	10.22%	18.88%

Source: Syminvest.com

Portfolio Yield. Microfinance institutions typically charge all-inclusive monthly interest rates of 2 to 3% to their micro-borrowers. The compounded annual rate, which equates to the yield of an MFI's loan portfolio, averages 30% (with fairly wide variances between countries and institutions). This figure often comes as a surprise to newcomers, intuitively challenged by the reconciliation of high interest rates and valuable service to low income populations. Micro-credits usually have maturities of less than a year and are reimbursed on a weekly basis, with interest generally calculated over the declining loan balance: these elements reduce somewhat the burden of this expensive charge. However, the main explanation for these high rates is two-fold and somewhat counterintuitive.

First, the more social or inclusive micro-bankers are, the more they try to reach out to the lowest income segments, and the more expensive their services will be. For example, if the labor and capital expense of servicing a loan are fixed at USD 100, this will have very different consequences for a loan of USD 100 or USD 1,000, i.e. 100% for the smaller client or 10% for the larger one. Indeed, micro-bankers don't charge high rates based on profit maximization goals, but rather on cost optimization. They seek sustainable business models, while still serving their target low income clientele.

Second, all other things being equal, the smaller the business the higher its margins. Despite the small scale of their activities, micro-entrepreneurs often generate impressive cash flows. For example, a revenue of five dollars a day – whether from retail trade, small crops or manufacturing – may be made at a cost of just two dollars a day, generating a margin of 60%. As a result, the biggest challenge for these small businesses is generally not the cost of funding but obtaining access to capital, as traditional banks don't serve these markets for lack of efficiency and profitability. The success of the microfinance movement can be attributed to the fact that it has developed the technology to measure, finance and recover extremely small amounts. By engaging with their clients on overcoming this challenge in innovative ways, it provides for a win-win strategy in shared micro value creation. Although vulnerable and subject to threats of abuse when misused, industry best practices have provided sustainable access to capital to low income entrepreneurs, reconciling what initially was perceived as unbankable markets.

Responsible microfinance investors and practitioners are driven by the contribution which their services can provide to the financial sustainability and capital accumulation of their end clients, trickling down into higher wealth and better living standards. MFIs with good social responsibility and sustainability principles would typically not finance enterprises where their own cost of lending is, for instance, more than half of the net operational margins of their clients' small businesses. Their aim is to allow their enterprise clients and dependent households to accumulate profits and savings. This is the key to understanding the poverty alleviation benefits that microfinance can provide, and what differentiates positive from potentially harmful practices in the industry.

Portfolio at Risk. Another characteristic of the microfinance industry which newcomers find surprising is the low bad loans rates, which average only 2 to 3%, with actual default write-off rates being close to 1%. Indeed, it appears counterintuitive to some that the capacity for value creation has no correlation to wealth levels, with low income entrepreneurs and employees striving to generate cash flows and savings as much or even more than their wealthier peers. In addition, by focusing more on goods of first necessity, rather than superfluous consumption, their activities are much more rooted in an inelastic demand and non-cyclical cash-flows – providing further stability to their repayments. They also tend to be more reluctant to contract payment obligations than wealthier individuals with larger cash-flows and are consequently more likely to have realistic financing needs and to be able to make timely payments. Women leading small businesses are also associated with a more grounded financial planning capacity than men and hence are often favored in the target clientele strategy of many MFIs. Finally, and most important, micro-bankers usually ask newer clients to form groups in which members are asked to be jointly responsible for repayments; they consequently self-select low credit risk peers based on direct knowledge and proximity, further limiting bad credit choices and defaults. Even in non-group lending MFIs, individual borrowers will generally be asked to provide social capital as collateral in the form of a personal guarantee from relatives or credible acquaintances. In general, microfinance operators will base their credit disbursal decisions on a mixture of cash flow and repayment capacity analysis coupled with the existence of social capital guarantees rather than on a simple deposit guarantee or asset pledge, as is often the case in traditional banking.

Operating Expenses. Replacing collateralized lending by social guarantees and strong proximity to its clientele has a price. With on average one employee per 100 clients, weekly visits to each client and a total of 50,000 clients, microfinance operations are extremely labor intensive and consequently subject to high operational expenses. If in itself they constitute important employers in their communities, they also consume an important part of their clients' capital gains in securing payment collection and maintaining their own viability. In addition to provisioning for bad loans, on average another 15% of operating expenses essentially paying salaries and personnel expenses, are deducted from the 30% portfolio yield or gross client revenues margins. As a result, a commercial MFI will aim for an operational portfolio margin of 10 to 15%. Running a micro-credit operation, with an average loan size of around USD 1,000 to 2,000, is consequently much more expensive than running a commercial bank in developed economies where average household borrowings can be up to several hundred times higher. In developed markets, banks have extremely low margins on interest income; they can afford operating expense ratios which are 10 to 15 times lower than MFIs, due to the high competition and maturity of the financial systems in which they operate, but also largely due to the much smaller fixed costs to service a loan in relation to the much higher volumes of such loans. As a consequence of this very high efficiency, they make most of their profits on building higher margin revenues aside from intermediating savings and loans. This is not the case for most MFIs, which almost entirely depend on interest income for their sustainability. As microfinance markets mature, and as several cases of first tier MFIs demonstrate, product diversification and new revenue streams may gradually change the business model of the sector, at least for its upper segment. Overall, stronger competition, best practices and standards, better regulation and transparency, client protection measures and wider outreach of financing solutions – all contribute to increased efficiency ratios, and eventually allow for lower interest charged to end clients.

Financial Profitability. The target operating margins of 10 to 15% are determined by the expected weighted average cost of capital (WACC). Debt to equity ratios average 3 to 4, which means that MFI balance sheets finance themselves with about 25 to 30% of equity, and 70 to 75% of liabilities, either deposits or borrowings. For most second tier institutions, the bulk of this financing comes in form of debt. For most first tier institutions, which have a deposit-taking license, the majority of this financing comes through savings from the public (although they still keep about a quarter to a third of their liabilities in the form of longer term borrowings). Savings accounts have lower interest rate costs relative to borrowing rates, but operating a savings account is much more labor intensive, as average savings accounts are infinitely smaller than borrowing volumes, consequently raising the cost of such a financing strategy. Also building trust in the public – asking thousands of individuals to entrust their own capital to the bank – is much more difficult than negotiating a loan with a dedicated lender, not to mention the short term liquidity it requires if clients want their money back, in particular in situations of high political risk and possible bank runs. The arbitrage between savings or borrowings in a financing strategy is thus often less obvious than what a pure mathematical comparison can conclude. Borrowing rates, of course, also vary widely for MFIs, depending on inflation, local money markets and inter-bank lending activity, as well as foreign direct investment and development bank aid. But overall on average another 8 to 10% are paid on liability expenditures. By deducting this cost of financing from the operational margin, MFIs can achieve a return on assets (ROA) of 3 to 4%. With the typical leverage described above (4-5x), it allows them to target a return on equity (ROE) of 15 to 20%.

Box 4: A Leading MFI Model: The Case of BancoSol in Bolivia

Banco Solidario S.A., or BancoSol, is probably the most visible and respected commercial microfinance bank worldwide, offering a reference business model to the industry. Few micro-banks combine such a long track record, high efficiency, low lending rates, few bad loans, high client satisfaction, high financial return, strong innovation and product diversification.

In 1984, a group of Bolivian entrepreneurs decided to form an NGO dedicated to the promotion and development of micro-enterprises: Prodem. Starting its lending operation in 1986, the entity provided small working capital loans, mostly in urban areas to solidarity groups of three or more people, jointly liable for repayment. As of January 1992, it had grown into a portfolio of 17,000 clients spread over four branches in La Paz, El Alto, Cochabamba and Santa Cruz, totaling an asset value of USD 4 million. This positive experience and the obvious unmet demand it reflected for banking services at the lower income segments of the Bolivian population pushed Prodem founders to register a commercial bank which would inherit the NGO's lending portfolio. This in order to overcome the limitations arising from the legal and financial structure of a non-profit institution: BancoSol was setup February 10th, 1992.

Today, BancoSol has grown into one of the largest commercial banks in Bolivia, with more than 250,000 active borrowers, with average credits just above USD 2,000, and 475,000 active savings accounts, with average balances of about USD 1,000. Its network has grown into 175 branches and service points, employing over 2,000 staff. Its mission remains to "offer opportunities to the lowest income sectors for a better future, providing them high-quality integrated financial services". The informal sector in Bolivia contributes to about 20% of GDP and generates over 65% of the employment in the country. Moreover, it continues to grow at an annual rate of 5% in several of the country's largest cities. The bank focuses primarily on urban trading activities, service companies and small production plants. Over 45% of the micro-credit clientele are women. The bank also has developed an SME banking activity, accounting for less than 10% of its portfolio, and is known for its low income housing financing, accounting for

over a quarter of its portfolio. In addition to savings and loans, it offers today among other innovations: domestic and international money transfers, micro-insurance products (including life and health insurance), debit cards, ATMs, mobile banking, internet banking, utility payments, tax payments, letters of credit, as well as financial services to Bolivian immigrants in Spain and the United States.

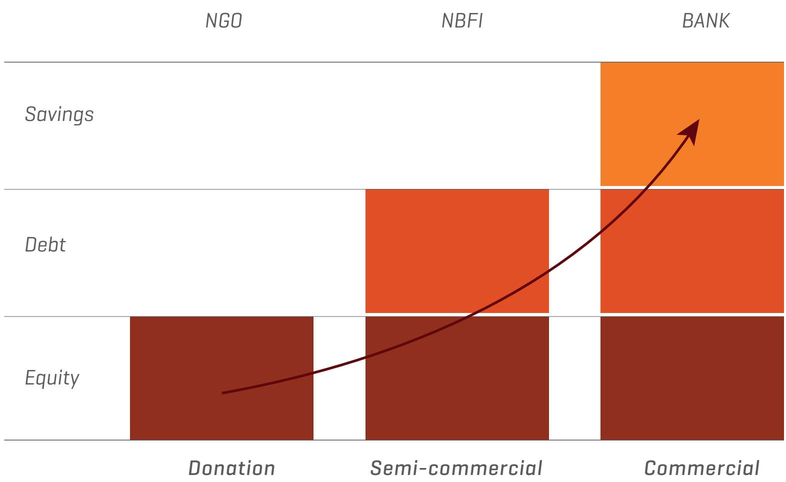
From a financial perspective, the bank's loan portfolio constitutes 80% of its assets, which have grown to USD 725 million. Over time, working in a highly competitive and efficient market, the bank has been able to reduce its portfolio yield, or interest rate income, below 20%. It has also kept its portfolio at risk, or past due loans above 30 days, below 1% and its actual loss write-offs from bad loans below 0.5%. With a fixed cost per client of about USD 400 and over 100 clients per employee, it has worked to reduce its operating expense ratio down to 11%. This efficiency gain has allowed the bank to enjoy an extremely low client turnover, both below 1% for savers and borrowers. It also benefits from low costs of funding, below 5% on average, with a strong savings base and a good blend of foreign and local lenders, including investors purchasing their bond issuances on the market. Overall, its return on assets has fluctuated close to 2% over recent years. With a leverage of about 9-10, as a multiple of savings and debt to shareholder capital, it has been able to achieve returns on equity fluctuating between 25 and 30% over the past years.

03 DEBT FINANCING

As MFIs transform from startups into full-fledged banks, they need large amounts of debt financing to drive growth and leverage their equity before transforming into deposit–taking institutions. During this cycle, MFIs shift from donor-based to market priced funding – a financial learning curve which is key to a viable business model in the long run. However, historical rates show that social investors have too often underpriced their capital and thus contributed to industry overheating in some instances. This situation should improve over time as the market widens and as increased transparency, regulation and competition result in a better correlation between risk and premiums.

Funding Life Cycle. Microfinance institutions typically pass through a relatively standard life cycle as they grow. The usual foreign funded target MFI generally begins its operations via nonprofit seed capital, gradually transforming into a regulated financial institution and striving to eventually become a full-fledged bank. Some more vernacular institutions like credit cooperatives and savings houses may follow different cycles, not necessarily seeking a banking status. On the contrary, affiliates of international micro-banking networks may jump directly to establishing a bank. However, from a financing perspective most institutions can be seen moving through a three-phase life cycle.

Figure 6: MFI Funding Life Cycle



Phase 1 is characterized by unleveraged capital, often provided by a foundation, development agency or other mission-driven donor. More recently, the industry has seen several private or institutional investors provide financial capital from day one of an MFI's operations, although often coupled with side technical assistance and grants. As a matter of fact, most of today's second tier MFIs started operating as non-profit organizations (or NGOs).

As MFIs mature, and the value of their loan books reaches the same level as their start-up funding capital, they enter the second phase of the financing life cycle which is characterized by leveraging capital through debt, primarily off-shore from Development Finance Institutions (DFIs) and then Microfinance Investment Vehicles (MIVs). Both DFIs and MIVs provide in many instances a variation of concessional or semi-commercial financing through their initial loans and help MFIs build a track record, key to developing relationships with local or foreign commercial banks and investors. During this period, MFIs fully leverage their capacity and usually transform from finance companies into regulated non-bank financial institutions (NBFIs), particularly in jurisdictions where specific microfinance regulations exist. As a result, and often due to regulatory requirements, their equity base shifts from a single or couple of owners to a larger group – usually a mix of foreign and local shareholders.

The third phase of the life cycle occurs as MFIs start to offer more diversified and sophisticated products and services; they move away from being pure lending institutions and transform into full-fledged banks. From a financing perspective, this results in savings and deposits suddenly accounting for the majority of their liabilities, with the share of the balance sheet accounted for by foreign lenders shrinking to 10-20%. MFIs in this phase typically increase their financing leverage to a multiple of 8 to 10 times their equity value. Once fully matured, micro-banks will eventually issue bonds and possibly look to make an IPO in larger domestic markets.

Risk Pricing. Due to the vast amounts of concessional funding which have been required during MFI inception phases in the past, many questions have been asked by traditional investors regarding the viability of the MFI business model and its cost of financing. In particular, several investors have questioned whether their returns reflect the level of risk involved. Any comprehensive model capable of pricing the level of risk for foreign investors would need to take into account: 1) the opportunity cost of capital over its expected maturity (based on foreign money market rates), 2) the institution's credit risk premium, 3) the country risk premium, 4) the cost of hedging the currency risk if applicable, and 5) the possible addition of a liquidity premium.

Historically, foreign investors have focused primarily on lending in U.S. dollars or euros. With money market rates falling significantly over the past five years, one would expect MFI costs of funding to go down accordingly in foreign currency – offering a base rate today close to zero in short term floating terms and around 1 to 2% in fixed medium terms (2 to 3 years), down from 4 to 5% a few years ago, before the global financial crisis.

From a credit risk standpoint, MFIs have very solvent balance sheets, with MFIs typically having an average of over 50,000 weekly payments, fully provisioned loan loss ratios and strong capital adequacy ratios. In addition, liabilities typically have longer maturities than assets. As a result, most first tier institutions, as well as many second tier institutions, receive investment grade ratings domestically (between BBB and AA). This assumes credit premiums of around 1 to 3%, based on comparable market rates.

Factoring in country risk is more complicated, firstly because historically few DFIs and MIVs have taken this risk seriously from a pricing perspective, either due to their development mission or to their belief that such risk is negligible. Indeed, many development investors have traditionally assumed that microfinance operations had little correlation with domestic markets or sovereign risk given numerous examples of microfinance sectors sustaining themselves, or even growing, despite domestic political, economic or environmental shocks. For example, Ecuador's vibrant microfinance sector recorded accelerated growth and increased profitability at the turn of the century, during one of the country's worst financial crises, which included the replacement of its national currency with the U.S. dollar, the government defaulting on its sovereign debt and many of its commercial banks becoming insolvent with non-performing loan ratios reaching 40% on average. Indeed, its leading micro-bank and a large number of rural microfinance cooperatives all increased their loan books and savings accounts, maintained their bad loan ratios at usual low rates and never defaulted on any foreign loans. These MFIs recuperated much of the capital running out of commercial banks and assumed their social function by refinancing the many small businesses which had suffered from the crisis.

However, this assumption was challenged in 2008, following the start of the global financial crisis, and its subsequent liquidity shortage. Suddenly, solid micro-banks faced a general shortage of cash from other banks lending to them and, in several cases, experienced savings withdrawal from the public. Moreover, less sound players had concealed internal weaknesses with high growth rates and failed to recover properly from this sudden halt. Similarly, some politicians offered their constituents solutions which turned out to be harmful to micro-bankers, and eventually foreign investors, in a bid to cope with economic turmoil, such as supporting loan defaults as was the case in Andhra Pradesh and Nicaragua. In the end, only a few MFIs defaulted and a handful went bankrupt. However, this was enough for country risk correlation scores to be factored back into pricing models.

Traditionally, ratings agencies assume that there is a strong correlation between macro-economic and institutional risk. As a consequence, they cumulate the probability of default behind a country's sovereign risk and behind an institution's credit risk, in order to measure the full risk for a foreign investor. Microfinance investments usually offer investment grade credits (BBB on average) in non-investment grade countries (BB to B on average). The probability of default of the latter is between 5 to 10 times larger than that of the former in historical rating statistics, which implies that country risk accounts for more than 80% of the risk taken by foreign investors in a typical microfinance transaction. For those who take this approach, a country premium would be added to their pricing to compensate for the BB to B environment, which is priced at about 2 to 5% interest in today's market comparables.

Currency risk hedging should normally be almost neutral for foreign investors from a cost perspective, as the hedging expense should equate and hence off-set the interest rate differential between the investor's currency and the domestic currency. However, as emerging and frontier markets are not necessarily very deep and competitive, hedging costs might be higher than expected currency devaluations or interest rate spreads, due to the liquidity premiums and/or the higher transaction costs which the few existing hedging counterparties require. This results in foreign currency lending being less expensive for MFIs than hedged local currency funding. The fact that the latter is required by most MIVs, in order to fully cover currency risk thus increases the funding cost. This extra liquidity premium or transaction cost, which has a high variance depending on market conditions, could be modeled as an additional charge of 1% on average.

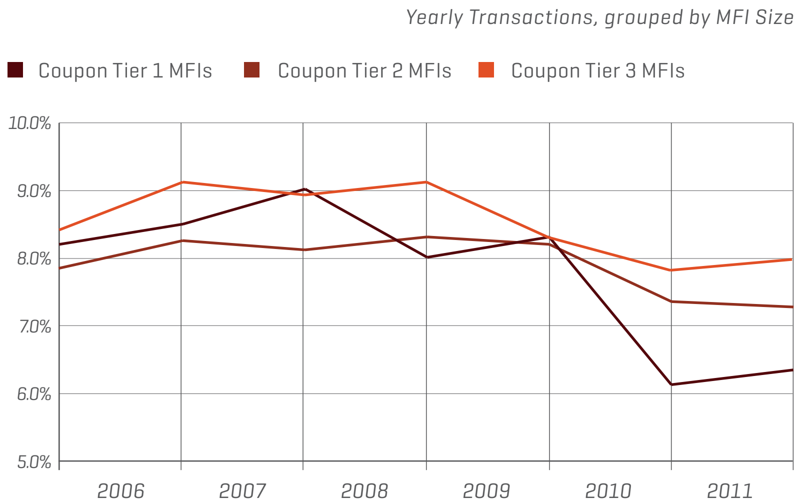
Finally, traditional investors will also ask for a liquidity premium for the non-publicly traded nature of microfinance loans, coupled with the lack of internationally recognized rating and regulation. This would probably add up to an additional 1% to pricing, for traditional investors looking at the comparable opportunity cost of their capital.

As a result of the combined risk pricing elements detailed above, risk-based pricing models would assume an interest rate expectation of 9 to 15% before 2008 and 6 to 12% since 2009, in hard currency and 24 -36 months fixed coupons.

Market Rates. The reality check provided by a sample of USD 8,259 denominated fixed coupon debt transactions, from 153 MFIs between 2005 and 2011, shows that rates were below theoretical market expectations before 2008, averaging between 8% and 9%, and have remained on the lower end of modeling expectations since then, currently between 6 and 8%. Observers may point to continued concessional funding by development banks and social investors to explain this price bias while others believe that too much funding is chasing too few targets and that excessive supply pressure on pricing is giving too much bargaining power to borrowers. In any event, price dumping and excessive competition would both constitute risks for this market as they would fuel over-indebtedness among end borrowers and eventually result in poor MFI portfolio quality and performance.

However, restructuring loan ratios have only increased from 0% (until 2008) to an average of 1 to 2% for most commercial MIVs since the global financial crisis, which represented a good simulation of a high stress test scenario for the modeling of additional credit and country risk costs. This

Figure 7: MFI Debt Market Rates, by MFI Type

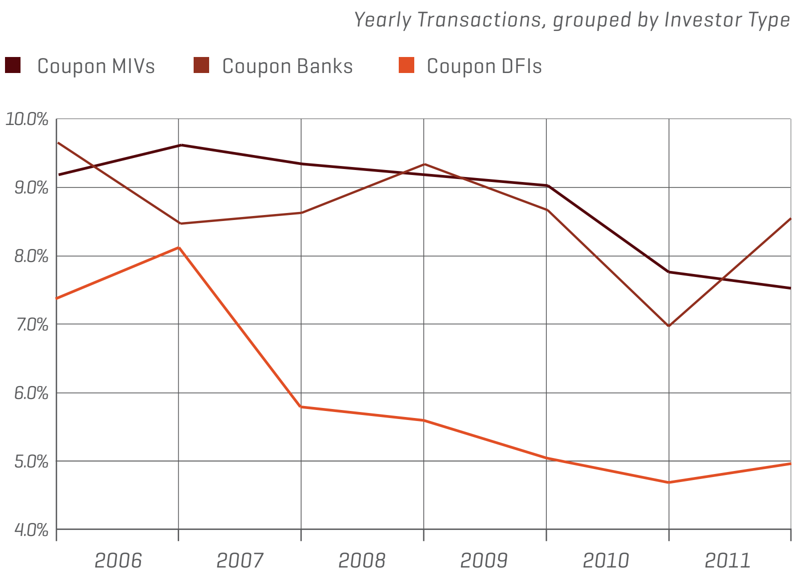


Source: Syminvest.com, market rates module, selection of all transactions in USD fixed coupons, split by MFI type

suggests that theoretical risk-based premiums are probably overvalued, with current market rates being closer to the true level of risk pricing. This conclusion would also weaken the value of statistical evidence that suggests current funding levels are too cheap and that the target market is too narrow in scope. Overall, as in other markets, supply and demand self-regulate themselves and find their equilibrium in current microfinance pricing levels. That being said, the microfinance investment industry needs to successfully compete with the opportunity cost of capital offered in comparable markets. As a result, the debate regarding this essential pricing matter is still open.

Further analysis of the same MFI transaction pool by investor type shows that DFIs have charged on average 2 to 3% lower than MIVs or commercial banks and financial institutions. This pricing variance has triggered what is referred to as the "crowding in and crowding out" debate regarding the contribution of DFI funding to the microfinance sector. DFIs have been essential for building a track record in this industry and have led the way for MIVs, which have followed diligently in their footsteps, even if often complaining about their stickiness in the long run and overall cheaper costs of funding. Pricing variance can, to a certain extent, be explained by the fact that DFIs, which have large budgets, focus on larger transactions with first tier institutions which pay lower capital costs and that MIVs, which often have high diversification needs and higher relative cost structures, focus on smaller transactions with second tier institutions which offer higher yield expectations.

Figure 8: MFI Debt Market Rates, by Investor Type



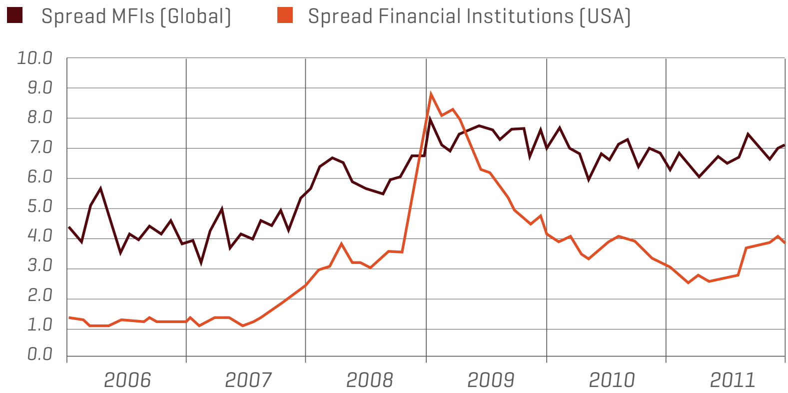
Source: Syminvest.com, market rates module, selection of all transactions in USD fixed coupons, split by investor type

This situation is nevertheless somewhat paradoxical as today several smaller MIVs find themselves seeding the path which some DFIs follow. In addition, many MIVs are now large enough to find themselves competing directly with DFIs on the upper segments of the market. Worse still, both types of investors have developed faster than the industry as a whole, cumulating over USD 20 billion of commitments and generally accounting for the bulk of MFI borrowings. It is thus essential for MIVs and DFIs to correctly price debt in order to help MFIs establish the required equilibrium when it comes to the financing of their business models. Some investors may wonder if the entire market is underpriced, or think that DFI funding is too cheap or to the contrary that MIV funding is too expensive, as suggested by the comparison with commercial banks. In any event, DFIs and MIVs would gain from increased transparency and comparability, both between themselves and with other operators. By miscalculating the pricing of their transactions, they carry the risk of hurting the long term viability of the industry.

One sign of improvement in pricing mechanics can be witnessed in the widening gap between the funding costs of first and third tier MFIs. Whereas initially investors had pricing strategies which seemed independent of credit quality, the difference in price between MFI quality levels has increased threefold over the past seven years. This improved correlation between pricing and credit risk seems to demonstrate a general improvement in the risk pricing models used by lenders. Significant improvements have indeed occurred as a result of the maturing of the industry and the reality check provided by the global financial crisis. This trend will most certainly continue with the broadening of microfinance markets, gradually including small enterprise and low income household financing activities, as well as the development of various initiatives which aim to regulate such investments.

Spread Comparison. Comparing lending rates to MFIs with those to traditional financial companies provides further insight on microfinance debt pricing. In the example above, the spreads of the same pool of loans to investment grade MFIs is referenced with the Bloomberg Fair Value (BFV) curve spreads for U.S. financial companies rated BBB, both USD denominated and fixed over two-year maturities. The variance between these two curves reflects the difference in price between financial companies of similar domestic rating but located respectively in emerging microfinance markets and in the United States. This 3 to -5% premium, in normal market circumstances, reflects the premium received by microfinance investors over traditional financial institution investors, remunerating the additional country risk, regulatory risk and liquidity risk taken by the former. It also shows, during the peak of the global financial

Figure 9: Micro- vs. Traditional Finance Spread Comparison



Interest rate spreads above money markets for investment grade MFIs (Syminvest.com) and BBB rated U.S. financial companies (Bloomberg Fair Value Curves) for 2-year USD denominated debt transactions

Source: Syminvest.com, Bloomberg

crisis, how MFI debt pricing hasn't adapted to the burst in credit premiums, testimony of the very different reading microfinance investors had of their target markets compared to those in traditional financial markets. Finally, the growing microfinance spreads also show the low price elasticity of MFI debt rates, not as a reflection of higher risk perceptions but as one of of how interest rates haven't gone down as fast as money markets have. Overall, one can notice from this comparison that microfinance debt seems to offer higher absolute return, with lower volatility and lower correlation to traditional financial markets. Despite some of the pitfalls and necessary improvements described above regarding the way microfinance investors price their debt, the industry has nevertheless built a quite compelling asset class track record in comparison to traditional markets over the past decade.

Box 5: Financing MFIs in Local Currency

Foreign investment funds have gradually been able to increase the share of domestic currency denominated loans in their portfolios by up to 33% in 2011. The large size of some MIVs has allowed them to contract forward or swap agreements with mainstream currency hedging providers for liquid currencies such as those in countries like Colombia, India, Mexico, Peru, the Philippines or Russia. In parallel, the creation of a specialized hedging facility – The Currency Exchange Fund (TCX) – in late 2007 by a large group of DFIs and a few commercial banks, allowed several MIVs to further diversify their local currency offerings. TCX has a net asset value over half a billion U.S. dollars serving as the risk carrier for insurance contracts on exotic and illiquid currency exposures for which traditional banks cannot offer hedging solutions.

The ability to offer local currency loans to MFIs has contributed to improving overall pricing models for foreign lenders, forcing them to fully factor in the macro-economic risk induced by the cost of the hedging solution. However, as a result of strong currency market volatility in recent years and the high liquidity premiums paid on exotic currencies, not to mention the inexistence of yield curves as pricing benchmarks in certain countries, delivery has in practice been challenging for many foreign lenders. In many instances, the cost of hedging is far higher than expected devaluations or interest rate differentials and sometimes even exceeds the full spreads expected from MFIs, thus rendering the exercise impossible.

More recently, some investors have shown interest in speculating on the arbitrage offered by these excessive costs or more generally, on the prospect of a structural decline in the USD or EUR against emerging market currencies over the coming years. As a result, several MIVs have started either partially or fully exposing themselves to unhedged domestic currencies. For example, in the last quarter of 2010, an Austrian asset manager launched the first fully un-hedged MIV portfolio. This breakthrough innovation had invested after a year of operations end 2011 in 28 MFIs in 18 different exotic currencies, including many underserved markets, such as the Dominican Republic Peso, the Georgian Lari, the Tajikistan Somoni or the Tanzanian Shilling. In addition, the fund has also outperformed most fixed income MIVs and many different emerging market local currency debt indexes– a performance which, if continued, would suggest that the fund offers a valuable strategy to traditional investors.

04 EQUITY FINANCING

Microfinance equity returns have thus far outperformed those of emerging market banks. The equity market is estimated at USD 10 billion in size and is growing rapidly. Many secondary trades are expected from deals currently maturing and several strategic investors have been paying more attention to this space. The cost of equity capital is nevertheless a tricky question for microfinance. Compared to borrowing rates, equity financing can be very expensive and is strongly correlated to the prices charged to end clients. As a consequence, large profits often seem to come at the expense of poor client protection. Foreign investors have until now largely resisted applying traditional private equity techniques to maximize capital gains and have rather adopted a wide spectrum of blended value strategies. The fact is foreign investors have yet to fully digest and understand the intricacies of this market.

Angels & VCs. Microfinance seed money, in its modern form, is largely the result of development agencies' policy funding. The most prominent and early stage donor has probably been USAID, which has offered grants to U.S. based networks which provide technical assistance to start up MFIs such as Accion, CHF, Finca, MercyCorps or Opportunity. European agencies have also been very present during inception years and remain so today, seeding their own networks such as Access, Advans, MicroCred or Procredit. International financial institutions (IFIs) like ADB, AfDB, EBRD, EIB, IADB and IFC similarly have and continue to be very active with regard to providing startup and growth funding to the industry. Finally, a large network of private sector donors is also offering such grants for equity purposes, with prominent players including for instance the Dell, Ford, Gates, MasterCard or Omidyar foundations. Together, their policy funding has allowed the microfinance industry to stand where it is today, with the profits they have helped to generate often being left in the hands of the recipients of their grants.

The model offered by USAID in this early phase provided grants to such networks and technical assistance providers which in turn use the grants as set up funding and eventually transform them into shareholdings for their own benefit. The most famous example of these NGO grants being turned into profit participations lies with Compartamos: when it transformed into a bank, it was 40% owned by its original NGO, itself funded by USAID and CGAP[1] grants. With best practice support, the NGO managed to turn its equity stake of USD 6 million in the late 1990s into a USD 126 million value by 2006, mostly as a result of high growth and high margins and consequent significant retained earnings. In 2007, Compartamos went public, selling 30% of its shares for a value of USD 450 million – equating a multiple of 12 times the book value. The institution's overall USD 1.5 billion valuation offered seed investors a 100% compounded IRR over eight years, off of the grants they had received[2].

[1] The Consultative Group to Assist the Poor (CGAP) is a policy and research center dedicated to advancing microfinance, supported by over 30 development agencies and private foundations, housed at the World Bank.

[2] Data source on Compartamos case: Richard Rosenberg, "CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits", June 2007.

This incredible success triggered two reactions in the microfinance investments industry. First, it generated a large and growing attraction to replicate such financial value creation for private investors, both local and international – including mainstream private equity firms. Second, it launched a major debate on whether such financial success, driven by shareholder value maximization, was in line with the initial mission of microfinance policy-makers: poverty alleviation. The question of whether profits are a means to an end or an end in themselves, associated to positive collateral social impact, is still strongly debated in the microfinance investors' community. And in reaction to this tension, policy-makers have emphasized the importance of quality control, through self-regulation and client protection initiatives, as a minimum standard behavior for the responsible generation of profits. However, grants and concessional funding remain important sources of seed financing for MFIs, which fuels concern among commercial private equity investors regarding the sustainability of the industry or the reality of its profits, were they to disappear. That being said, the generosity of public or private angel venture capitalists is not only a strong legacy of this industry, but also most likely a key structural element which is unlikely to disappear in the foreseeable future.

Private Equity. Private equity investments, in the traditional sense of the term in the financial industry, are currently limited in microfinance. There is today no established general partner or "GP" – in the sense of a dedicated traditional private equity fund manager specialized in microfinance, which is called in either in distressed cases or at a growth or pre-IPO stages, taking on a majority control stake, structuring a leveraged buy-out for the founders, and getting the firm to maximize its efficiency, profits and growth, with an aim to sell at the highest possible value to a strategic investor or to the public within a 3 to 5 year time frame. This situation can be attributed to the fact that deal sizes are perhaps too small in microfinance to attract that type of money and practice or more fundamentally to the fact that social investments may not fit well with the "PE" momentum and delivery. Up to now, most foreign private equity investors participated in startups or transformations from NGOs to NBFIs or banks, usually purchasing minority shares, rarely actively intervening, seldom speculating on pricing arbitrage, rather holding on to their participation and "enjoying the ride", monitoring the double bottom line results of their portfolio. As a consequence, mergers and acquisitions, secondary trades and public offerings have been rather limited as well. That being said, with an aggregate balance sheet value of about USD 50 billion and a debt to equity leverage of 4 on average, the MFI equity market can be estimated at USD 10 billion today, attracting increasing interest from specialized investors. In addition, many pioneer funds are currently, or will be within a few years, entering their "harvesting" period, triggering much more activity and depth in this market.

Figure 10: MFI Key Indicators, by Region (Annual Average from 2006 to 2010)

Region / 2006-2011	Growth	Credit	Yield	Efficiency	Risk	Leverage	Return
Central America & Mexico	35.64%	2,423	46.85%	31.49%	6.56%	4.41	9.96%
South America	36.26%	1,815	30.34%	17.03%	3.47%	4.40	16.93%
Latin America	**36.07%**	**2,001**	**35.39%**	**21.45%**	**4.42%**	**4.40**	**14.79%**
Sub-Saharan Africa	29.18%	692	41.13%	35.67%	4.43%	3.09	8.90%
Middle East & North Africa	29.25%	772	32.87%	21.49%	0.90%	1.14	7.49%
Africa & Middle East	**29.19%**	**703**	**39.99%**	**33.72%**	**3.94%**	**2.83**	**8.71%**
Central & Eastern Europe	24.14%	3,584	27.20%	14.78%	5.88%	3.23	-0.51%
Russia, Caucasus & Central Asia	46.45%	2,107	37.07%	19.94%	1.78%	3.06	20.21%
Eastern Europe & Central Asia	**39.82%**	**2,546**	**34.14%**	**18.41%**	**3.00%**	**3.11**	**14.05%**
South Asia	53.23%	1,217	32.16%	9.23%	10.57%	4.98	40.74%
East Asia & Pacific	72.82%	605	32.02%	18.25%	1.62%	3.88	23.68%
South & East Asia	**71.18%**	**656**	**32.03%**	**17.50%**	**2.37%**	**3.97**	**25.10%**
Global (SYM50)	**31.27%**	**1,951**	**30.98%**	**16.17%**	**3.67%**	**4.28**	**16.42%**

Growth: Gross loan portfolio growth
Credit: Average loan balance in USD
Yield: Porfolio yield
Efficiency: Operational expense ratio
Risk: Portfolio at risk >30days
Leverage: Debt/Equity ratio
Return: Return on equity

Source: Syminvest.com (sample of over 150 institutions)

Traditional private equity investors will typically look at GPs with four qualities in mind: value creation through growth, leverage, efficiency or price – or a combination of any of the four. Looking at the past five years of MFI performance gives some insight into how GPs could likely position themselves in accordance with their respective value creation strategies.

1. Growth. Global growth rates have been important, averaging 31% per annum. South and East Asian markets have clearly stood out, growing twice as fast as other regions. This trend should continue considering the very large size and relative youth of several markets in these regions. Value creation through fast growth is relatively less likely to occur in Latin America or Eastern Europe where markets are more mature and covered. Instead, growth value has a good chance of being the highest in the coming years in Africa and the Middle East where microfinance markets are the most underserved.

2. Leverage. The sector is still relatively unleveraged compared to mainstream banking, a situation which will continue for second and third tier institutions. However, as MFIs mature and transform into banks their leverage rates can double – a development which would move capital adequacy ratios from around 20% currently closer to 10%. The rate of growth and value creation through leverage could be faster for first tier institutions in the future. Full fledged bank MFIs will have a larger opportunity in newer markets such as Africa, the Middle East and East or Central Asia, where they are relatively less leveraged.

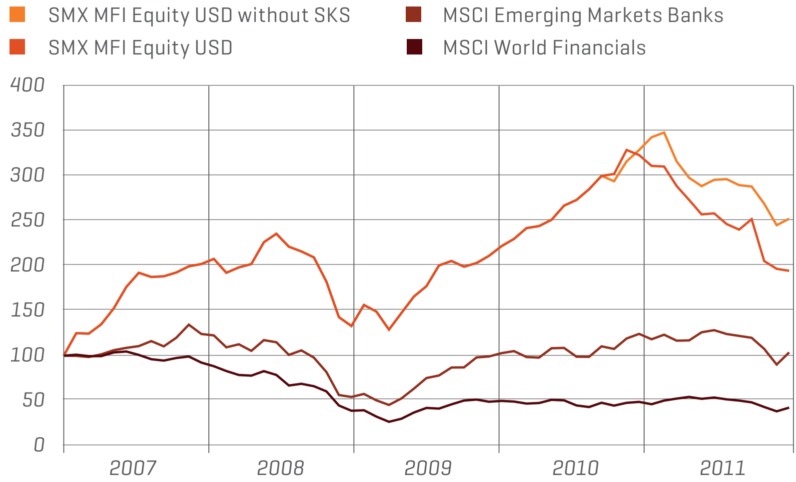
3. Efficiency. Average credit exposures and money spent per credit drive an MFI's efficiency. From this perspective, South Asia seems to have reached a limit, with its markets being characterized by very small micro-loans and extremely tight margins, primarily due to large group lending. However, as MFIs in the region move up market with similar efficiency, financial results could be very interesting. At the other extreme, Central America and Mexico have a major scope for improved efficiency, with many MFIs in these markets charging higher interest rates, offering larger micro-loans and having very high operating expenses. Efficiency value gain potential might also occur in other regions, for instance in Africa and the Middle East, which have room for improvement pushing costs down per borrower and/or moving into upstream markets in terms of clientele.

4. Price. The more "hands-off", especially those seeking minority participations, are likely to try to acquire MFIs with strong potential at the lowest possible price and then wait for the institutions to grow before selling at the highest possible price. Although "hands-off" do not really create value themselves through governance and operational assistance, they attract investors due to their expertise in understanding market trends and pricing arbitrage. Whereas most microfinance holding companies currently create value by focusing on growth, leverage and efficiency of their MFIs, the majority of microfinance private equity practitioners operate via the strategy described above, aiming to purchase an MFI's equity at its book value and selling it a few years later at about twice that value or more.

Going Public. In small to medium microfinance markets, where the target client population ranges up to 1 million or more, an MFI may legitimately target a market share of up to 20%. With an average client credit of USD 1,000 and debt to equity leverage of 4, this MFI will need an equity base of about USD 40 million – a manageable amount which can be raised in private placements targeting local private investors or foreign specialized investors. In larger markets with 5 million+ target populations, not to mention markets like Mexico (>50 million) or India (>500 million), MFIs will probably need to go public in order to raise sufficient capital to ensure long term sustainability and manage a client base of over a million small enterprises in some cases. Indeed, this is already occurring in countries like Bangladesh (BRAC Bank), Mexico (Compartamos Bank), India (SKS), Indonesia (BRI) and Kenya (Equity Bank). Other sophisticated and diversified first tier micro-banks are likely to continue to list their equity in public offerings in markets where the number of small enterprises and low income households require very large capital volumes.

The SMX MFI Equity index tracks the aggregate share performance of such publicly listed MFIs translated into U.S. dollars since the end of 2006. It stands out for specialized microfinance investors and practitioners due to its high risk and high return profile compared to more traditional forms of investing in microfinance. Volatility ranges as high as 30% in any given year and although value doubles over the first five years, returns range

Figure 11 : SMX MFI Equity vs. MSCI Financials



Source: Syminvest.com, Bloomberg

from +100% to -50% per annum, with a single month high of +25% and a single month low of -22%. The index is also a testimony of the fate of SKS' (a leading MFI in India) share value, which has experienced a free fall as a result of over-indebtedness problems in Andhra Pradesh. This also explains a large portion of the negative performance of the index in 2011; the SKS stock posted an absolute negative loss of over 80% since its IPO, discouraging several institutional and private investors from the sector as well as postponing some MFI IPO plans. It has also taught MFI CEOs that if there is one thing worse than having a "hands-off" watching closely over them, it is probably going public and being subject to the unforgiving and immediate judgment of the public eye. And indeed, a number of industry insiders have doubts as to whether the socially-minded microfinance industry is robust enough to bear such pressure. That being said, one thing that is certain and which investors track just as closely is the impressive performance of the sector compared to traditional banking, both in emerging markets and worldwide. Listed MFIs have multiplied by 2.5 the value of their shares over the index period, while traditional banks have lost half their value and emerging market banks have barely managed to preserve their capital.

Box 6: MFI Equity Price Mechanics

An MFI with a 20-25% return on equity and debt costs of 10-15% will have a weighted average cost of capital (WACC)[3] of 10-15%, assuming a debt-to-equity leverage of 4 and a corporate tax rate of 25%. By using the WACC as a proxy of the discount rate and assuming a 15 to 30% annual growth rate, the Discounted Cash Flow (DCF)[4] valuation formula applied to such an MFI will reach an average of 1.5 to 2.5 times the Price to Book Value (P/BV)[5] range. The fact that investors assume, or try to negotiate, an illiquidity discount of 20 to 30% for current early stage transactions points towards an effective range of 1.0 to 2.0 times the P/BV when valuing MFIs. Other investors prefer to use the Price to Earnings (P/E)[6] ratio; as the earnings equate to about 20 to 25% of equity, the P/E ratios should theoretically range between 6 and 12.5 (multiplying the P/BV in a range from 4 to 5) and average around 9. The application of similar illiquidity discounts should theoretically bring the P/E multiples closer to an average of 6.75.

Of course large variations exist, with many different factors influencing pricing. The CGAP Private Transactions Benchmark, used in joint research with J.P. Morgan[7], shows that MFI pricing multiples are higher when:

+ the transaction size is larger,
+ the book value is larger,
+ the public sector is the buyer,
+ the MFI has a large client base,
+ it is neither a startup nor mature,
+ the MFI is in its growth phase,
+ it is not yet a deposit taking bank,
+ its efficiency (OER) is very high,
+ its asset risk (PAR) is very low,
+ its leverage is higher, and/or
+ its average loan size is lower.

Regarding this latest point, it is interesting to note that there seems to be a strong correlation between working with poorer clients and a higher multiple value. Overall, using the conclusions of this data set, “hands-off GPs” would most likely seek MFIs with, or which are likely to develop, these characteristics while “hands-on GPs” will actively intervene in a bid to move an MFI towards them.

As the market matures, illiquidity discounts will come down and valuations will reach their upper limit. Today, interestingly, publicly listed MFIs, such as those composing the SMX MFI Equity USD index, have a P/BV multiple above 2, moving as high up as 6 for Compartamos Bank in Mexico. And indeed, several of these MFIs benefit from the above mentioned characteristics, with relatively high valuation multiples being attributed to strong overall growth rates and high gross and net revenues. However, it is expected that these figures will gradually reduce over time as public MFIs start to resemble more traditional emerging market commercial banks, which themselves trade closer to 2 P/BV.

[3] The WACC formula sums the multiplication of the cost of each capital component (the MFI equity and debt in this case) by its weight in the balance sheet, in addition to multiplying the cost of debt by the differential of one minus the corporate tax rate.

[4] The DCF formula divides the sum of net income cash flows by the risk/opportunity cost, or discount rate, of the asset valued (the MFI in this case).

[5] The P/BV ratio compares the multiple of a company price (using the stock market price when available, or otherwise a valuation formula, such as the DCF) with its equity book value, by dividing the former by the latter.

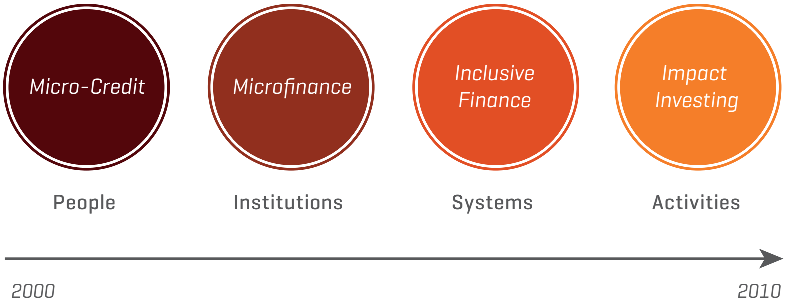
[6] The P/E ratio compares the multiple of a company’s price with its earnings or profits over a certain period.

[7] “Shedding Light on Microfinance Equity Valuation : Past and Present”, CGAP/J.P.Morgan, February 2009. and “Discovering Limits. Global Microfinance Valuation Survey 2011”, CGAP/J.P.Morgan, July 2011.

05 IMPACT

The understanding and measurement of the impact of microfinance has evolved over time in the minds of investors. From an initial perception of MFIs as non-profit entities providing life changing opportunities, the industry has evolved to develop towards a broader definition based on the impact of profitable banking services to the poor – a shift in discourse which has sometimes been confusing for the general public. The sector gradually expanded to embrace the wider aspiration of building inclusive financial systems within the lowest market segments “at the bottom of the pyramid” and measuring the impact of this intervention on job creation and on access to goods of first necessity such as food, homes and energy. A decade later, microfinance comprises all of the above and, more importantly, continues to champion the much needed democratization of access to capital and financial services for small enterprises and low income households within emerging economies.

Figure 12: Microfinance, a Changing Definition



People. In 1998, the United Nations Economic and Social Council proclaimed 2005 as the "International Year of Microcredit". Microfinance was then associated with small loans to poor people. The focus of the industry was primarily on the individual and the impact the credit would have on his or her immediate living standards. Sales and education efforts were primarily emphasizing the emotional story-telling of economically active poor moving into well-being thanks to their own labor and the support of a friendly banker. The assumption was that, multiplied by thousands, this practice would generate community development and poverty alleviation. Microfinance was still somehow associated with charity.

Institutions. In the first half of the decade, it became apparent to policy makers that the providers of microfinance, MFIs, were financially sustainable operations and quite attractive opportunities for investors; it became fashionable for early investors and practitioners to say that they were doing good by doing well. Instead of micro-credits, people began to talk about microfinance; the focus shifted from the individual – the end client – to the institution – the service provider. As a result, expectations drifted somewhat from poverty alleviation towards profit. Several industry insiders reportedly tried to convince the United Nations to rename 2005 as the Year of "Microfinance", without success. A few months later, the Nobel

Peace Prize 2006 was given to the industry's most visible ambassador, Mohammed Yunus, and his pioneer Grameen Bank in Bangladesh, on his promise of eventually "building museums of poverty" once microfinance would have eradicated poverty. Some practitioners started to believe that poverty eradication would be possible one day without relying on policy and donor money. At the same time, profits were increasing rapidly for leading MFIs – something which confused the media.

Systems. Public policy makers saw the risk of handing over their responsibilities to private sector agents and took a step back, redefining their roles and the sector itself via the adoption of a holistic approach based on "building inclusive financial systems". Some government agencies went as far as banning the word "microfinance" from their official publications – referring only to "inclusive finance". The intent was neither to focus on individual anecdotes nor to compromise with profit maximizing banks, but to build policy frameworks at the macro (industry), meso (market) and micro (institution) levels. The question was less about who were the people served or how the institutions approaching them functioned but rather why this change needed to happen from a systemic perspective. Globalization had generated huge opportunities for low and middle income economies and the aim of the industry was to make economic development as inclusive and distributive as possible for populations at the bottom of the pyramid.

Activities. Investors, or rather their financial advisors, have used all of the above storylines to justify the social impact, or second bottom line, of microfinance investments. Investors have been offered the opportunity to make sustainable profits while changing individual life stories, building banks in underserved areas and making the financial system a better place. A last shift occurred towards the end of the decade, as the media and other players continued to struggle with the notion of reconciling profits with poverty. In response, the industry realized that it had to focus more directly on convincing people about the positive impact of microfinance and answering the 'what' question: not who it benefited, how it was being used or why it was being invested, but what it was actually doing. The answer to this question was: providing access to capital to small enterprises, creating jobs and producing the goods and services needed by low income households in emerging economies: food, homes, energy, and so on. By focusing on the activities which were financed and the impact they were making, investors were reassured that profits and poverty alleviation could be combined. "Impact investors" saw the unmistakable logic of financing positive value creation activities and building the supply chain for a very large and growing underserved population.

Microfinance today is all of the above; it finances the "micro": low income households and small enterprises in emerging economies; it builds much needed inclusive banking operations and offers other intermediating vehicles and services to provide access to capital; it helps the global financial system become more inclusive, reaching out to peripheral economies; and, above all, it channels goods and services of first necessity to the people that need them. Most importantly, microfinance investors today are combining poverty alleviation and profit-making as part of a shared financial value creation opportunity, driven by the high growth environments in emerging economies.

Several impact measurement initiatives have developed, primarily within three groups: the Social Performance Task Force (SPTF) coordinated by CGAP, the Global Impact Investing Network (GIIN), and the Aspen Network for Development Entrepreneurs (ANDE). None have reconciled a single approach, but a certain consensus has emerged around a small set of five core metrics focusing on key enterprise data: revenues, employees, wages, financing, as well as measuring the business output in terms of clients, suppliers, product units or volumes. Additional measurements are primarily sector specific and depend largely on the capacity of the MFIs or other financing intermediaries to report on them. By measuring what their capital is being used for, investors have a much more tangible picture, which helps them to monitor and compare, and justifies why they are investing, how investments should be done and who they are ultimately serving.

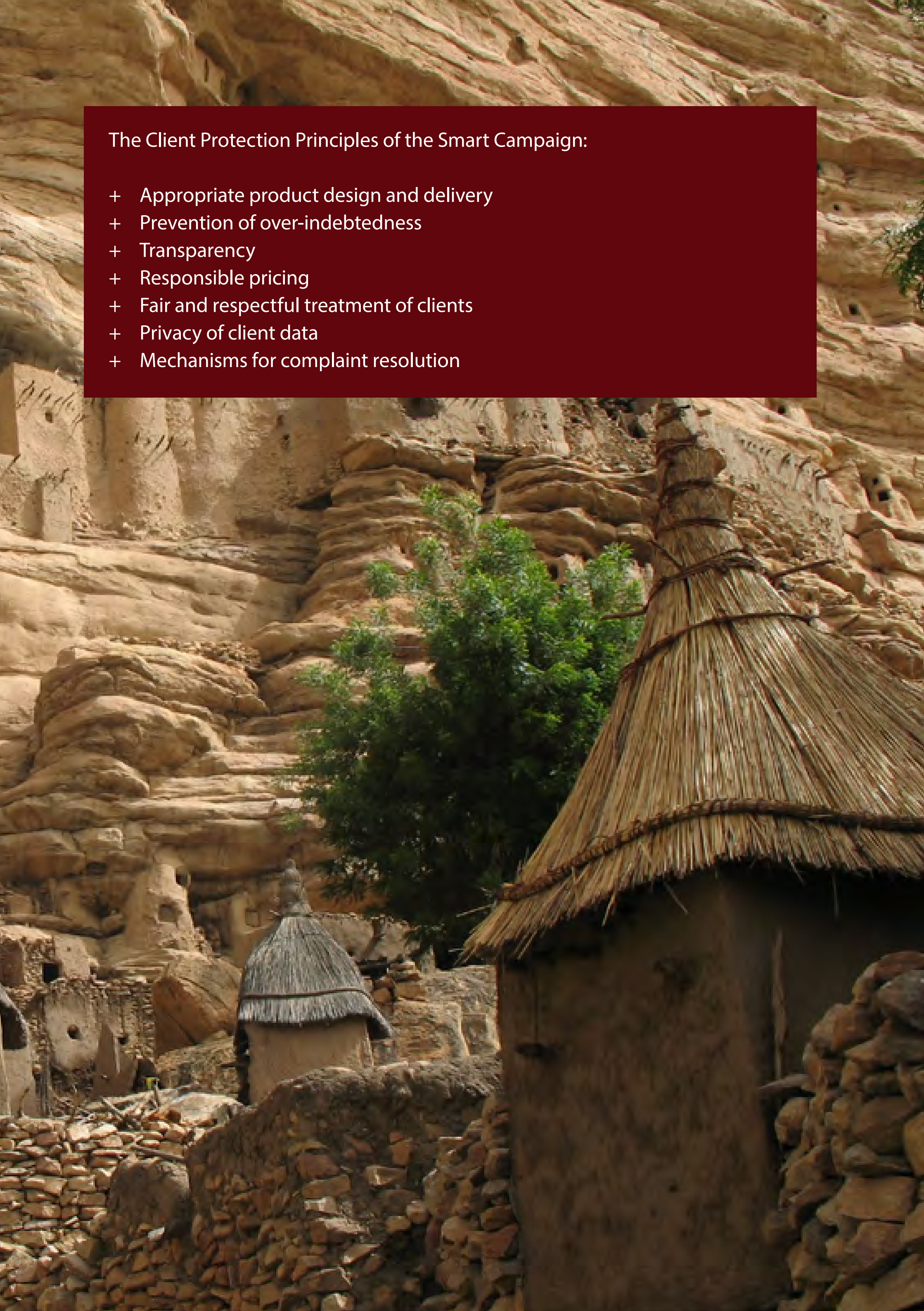
Box 7: Client Protection Principles, the Smart Campaign

The largest obstacle to the positive and sustainable impact of MFIs is either a “pro-poor” drift, consuming all capital gains and reserves, or a “finance first” failure, losing the clientele with excessive profit targets. Regular business administration students are taught that the secret to success lies in finding the correct balance between two key conflicting goals: profit maximization and client satisfaction. Dominant corporate strategies find a balance between both. While this is also true of microfinance, the industry is unique in two ways. First micro-clients are more vulnerable than the average clientele of a given business, implying larger risks of customer abuse behaviors. Second, MFIs operate in under- or non-regulated markets, offering similarly higher risks of supply driven malpractice. In addition, as with any other economic activity, the private sector cannot function without a strong public sector policy framework which sets the rules, measures outcomes, protects various stakeholders and punishes disrespectful acts.

As a result of some cases of mission drift and engagement in harmful microfinance practices, which have been highlighted by the global financial crisis, the industry has come together in self-regulating itself and adopting a series of principles grouped under the “Smart Campaign”. These principles primarily aim at “keeping clients first” – for the benefit of all other stakeholders. They include a mix of business driven principles and client protection measures, with a corporate social responsibility approach. They are gradually being required from MFIs by their investors, and hence are gradually being integrated into their operations. The Smart Campaign has actually started to implement certifications for MFI compliance with these principles. End 2011, the campaign has been endorsed by 649 MFIs, 102 networks and associations, 146 support organizations and 127 donors and institutional investors.

The Client Protection Principles of the Smart Campaign:

+ Appropriate product design and delivery
+ Prevention of over-indebtedness
+ Transparency
+ Responsible pricing
+ Fair and respectful treatment of clients
+ Privacy of client data
+ Mechanisms for complaint resolution



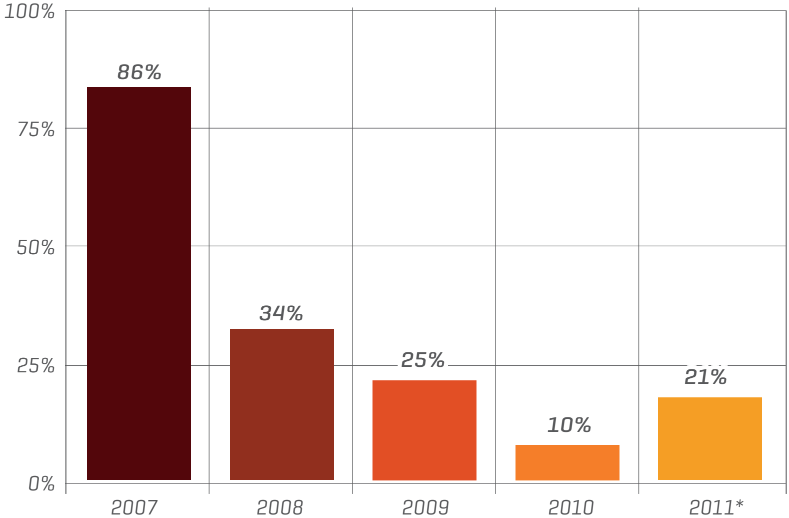
IV. INVESTMENT FUNDS (MIVs)

01 MARKET OVERVIEW

Microfinance funds or investment vehicles (MIVs) have experienced positive double-digit annual growth since their inception a decade ago, reaching an average of 35% between 2007 and 2011. Although this trend slowed down in 2010 and 2011, it has remained positive primarily due to the surge in equity transactions and expansion in new markets in Africa and Asia. Overall, institutional investors have become the largest providers of capital, ahead of retail and private clients. Public sector funders have also grown their share of investments through MIVs, although this trend is expected to reverse over time.

Size and Growth. Based on the Symbiotics 2011 MIV Survey (year-end 2010 data), the aggregate volume of foreign microfinance investment fund is estimated at USD 6.8 billion – an amount which is split over 102 vehicles. This aggregated portfolio increased significantly in the years prior to the global financial crisis, when the majority of MIVs were set up, with annual growth peaking at 86% in 2007. Despite growing at a slower pace, total MIV investments have still continued to have double-digit annual growth rates since then, with 34% in 2008, 25% in 2009 and 10% in 2010. MIV managers estimate that they recorded weighted growth of 21% during 2011, with the industry projected to reach USD 8.6 billion by year end. This figure will most likely surpass the USD 10 billion mark in 2012 or 2013 and will continue to grow in the future, particularly considering the broadening of target markets and rising investor interest. Overall, several recent research estimates show that the potential market size for social investment in emerging markets is up to ten times higher than the current level, or more[8].

Figure 13: MIV Market Growth



* estimate based on survey respondents

Source: Symbiotics 2011 MIV Survey

[8] J.P.Morgan, in its "Impact Investments: an Emerging Asset Class" research published in November 2010, goes as far as estimating a market of USD 400 billion to USD 1 trillion over the next 10 years.

Peer Groups. Some two thirds of MIVs are Fixed Income Funds (with over 85% of debt instruments) while one fifth are Mixed Funds (with 15 to 65% of equity instruments) and the remainder are Equity Funds (with over 65% of equity instruments). Although microfinance debt investments accounted for more than 80% of all transactions carried out in 2010, Fixed Income MIVs recorded the lowest growth, with portfolio increasing by just 6% and expected to grow further by 17% in 2011. At the other end of the spectrum, Equity Funds, which represent only 8% of the market, recorded growth of 58% in 2010 and an estimated 118% in 2011. On the one hand, this faster increase of equity transactions can be attributed to relatively younger equity markets compared to more mature debt markets. Many foreign microfinance investors see larger benefits, both for return and diversification reasons, from adding further equity investments to their portfolios, particularly as microfinance markets continue to mature and as investors become more experienced with regard to debt investments and are offered more equity related strategies. On the other hand, debt markets have become more competitive, not only between foreign lenders but also locally, as a result of increasing inter-bank lending activity, an expanding market for bond issuances and a growing public deposit base for licensed institutions. Overall, it is expected that equity investments will increase over the coming years to account for up to a third of foreign private investments.

Target Markets. MIVs by nature invest predominantly in low and middle income economies, broadly defined as emerging markets. Although an argument can be made that low income households in developed economies could benefit from microfinance services, no MIVs currently target markets in North America, Western Europe or the Far East. Among emerging markets, MIVs have historically primarily invested in Latin America and the Caribbean (LAC), with more than a third of overall investments still being concentrated in this region today. This high level of investment can be attributed to more favorable foreign investment infrastructure with regard to currency, regulatory and political risk considerations and, more importantly, to the fact that the region was at the center of the initial commercial development of the industry in the 1980s. As a result, it is not unusual to see Bolivia, Colombia, Ecuador or Peru account for more than 10% of any given MIV portfolio.

Box 8: Top 25 Microfinance Investment Vehicles

	Top 25 MIVs	Total Assets (USD mi.)	Microfinance Portfolio (USD mi.)
1	European Fund for South East Europe	904	484
2	Oikocredit	848	516
3	Dexia Microcredit Fund	529	439
4	responsAbility Global Microfiance Fund	498	395
5	Omidyar -Tufts Microfinance Fund	242	160
6	ASN-Novib Fonds	236	227
7	SNS Institutional Microfinance Fund	220	195
8	responsAbility SICAV (Lux) Microfinance Leaders Fund	171	127
9	SNS Institutional Microfinance Fund II	101	67
10	responsAbility Microfinanz-Fonds	135	125
11	Microfinance Enhancement Facility SA	135	101
12	Global Microfinance Facility	134	n/a
13	Dual Return Fund SICAV	124	100
14	Triodos Fair Share Fund	124	98
15	BlueOrchard Loans for Development - 2007	110	107
16	BlueOrchard Private Equity Fund	106	65
17	BlueOrchard Loans for Development 2006-1	97	94
18	ACCION Investments in Microfinance SPC	86	n/a
19	Triodos SICAV II - Triodos Microfinance Fund	79	67
20	Finethic Microfinance SCA SICAR USD	77	69
21	JAIDA	67	65
22	Impulse Microfinance Investment Fund NV	58	52
23	Microfinance Growth Facility	52	32
24	Wallberg Global Microfinance Fund	50	44
25	Minlam Microfinance Fund	48	n/a

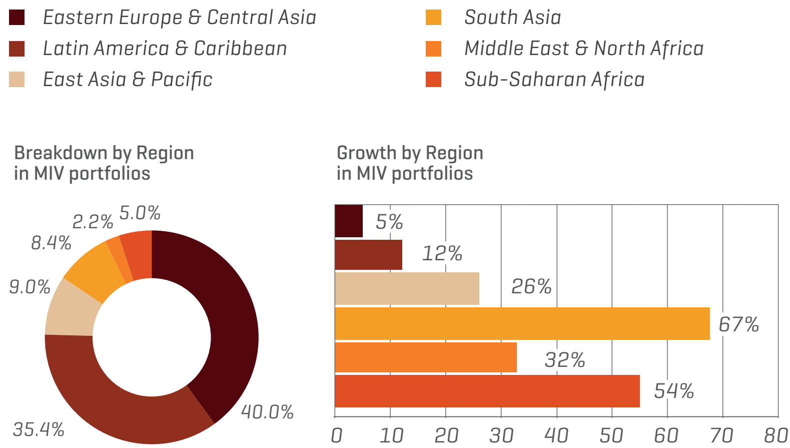
Source: Publicly available information, December 2010 or estimates

Legal Disclaimer: The list of 25 largest MIVs is made for information purposes only and is not intended as a solicitation or recommendation to buy or sell any specific product. MIVs are largely reserved to professional qualified investors and typically closed or not available to investors in many jursidictions.

Over the past decade, the Eastern Europe and Central Asia (EECA) microfinance sector has recorded very strong growth, with MFIs replicating best practices from Latin America. This rapid development has largely been due to the rapid transition of their economies in the post-Soviet era and the injection of large sums of reconstruction and development funds in their microfinance sectors. Despite having been hit the hardest by the global financial crisis, EECA remains the most heavily represented region in MIVs, accounting for 40% of their portfolios.

The South and East Asian regions continue to account for a relatively small MIV market share, at respectively 8% and 9% of their overall portfolios end 2010. Investors often wonder why some of the largest international markets, such as Bangladesh, India, Indonesia, Pakistan or the Philippines, which have a long standing microfinance tradition, do not account for a larger share of overall foreign microfinance investments. In some cases, the reason can be attributed to the Grameen Bank model, which has had a major influence in the region but assumes that MFI funding strategies should be based on a mixture of compulsory client savings and non-profit grants – a methodology which has rightfully proved very successful in certain markets. In addition, in some countries, governments have played a far more active role and directly intervened in their microfinance sector. In Pakistan or the Philippines for instance, large public sector facilities which dominate MFI refinancing markets have been set up. In India, the government has required licensed banks to invest up to 40% of their assets in priority sectors, which include microfinance– a policy which has propelled the mainstream banking sector into the industry, generating strong competition and downward pressure on domestic funding costs. Several Asian economies are also much more protective of foreign capital flows than LAC or EECA countries. India, for instance, has restricted direct lending by foreign investors, thus limiting foreign MIV transactions to complicated and expensive dealings with multiple intermediaries. Most importantly, many Asian countries have developed very strong capital markets characterized by high liquidity and savings rates and in parallel, strong financial sectors with many large banks scaling down their services to low income households – an environment which is conducive to the development of banking services for the poor. MIVs have nevertheless

Figure 14: MIV Breakdown & Growth by Region



Source: Symbiotics 2011 MIV Survey

learned to diversify rapidly and increase their exposure in Asia and in turn are benefiting from their exposure to several large and growing markets in the region. Where LAC and EECA portfolios have increased by 12% and 5% respectively in 2010, South Asian and East Asian portfolios grew at respective rates of 67% and 26%.

Microfinance markets in Africa and the Middle East are relatively younger, and therefore less developed for foreign investment, than other regions. While they currently represent only 7% of MIV portfolios, they are nevertheless expanding rapidly, with Sub-Saharan Africa and the Middle East and North Africa (MENA) recording respective growth rates of 54% and 32% in 2010. In the last decade, Sub-Saharan Africa has attracted large amounts of seed money and technical assistance which has been used to develop and promote the sector, including the creation of several MIVs entirely dedicated to the region. With a population which recently passed the one billion mark, annual economic growth rates of 5%+ and the largest share of low income economies in the world, the region will definitely continue growing in market share, well into double-digit territory – despite past difficulties for foreign investors in offsetting higher currency, regulatory and political risk considerations. In the MENA region, the political change which started in 2011 is increasingly being compared to the transitional economies of the EECA region after the fall of the Soviet Union and the widespread economic growth opportunities that took place thanks to liberalizing regimes. As for other regions, each of the MENA countries represents a specific case and incidentally each domestic market offers a variety of different opportunities and challenges. It is however expected that as regime change brings more open economies, broader microfinance markets will emerge and eventually more foreign investment opportunities will exist.

Target Audience. Different MIVs attract different investors. The first commercially driven MIVs were setup a decade ago and primarily targeted wealthy individuals, also known as qualified private investors. These investors could offer MIV managers relatively large amounts of capital at lesser acquisition expense than retail or institutional investors. Retail distribution channels require compliance with specific licenses and regulatory costs while institutional investors require much more disciplined and predictable track records – obligations which early MIVs were unable to meet. Government agencies and private foundations have also contributed to overall MIV seed money, easing the build-up of a track record. Some MIVs eventually reached the point where they were able to work through domestic regulatory constraints and offer microfinance funds to the public, notably in Austria, Germany, the Netherlands and Switzerland. This development created widespread awareness of the asset class, with some large banks having up to several thousand retail clients exposed to MIVs. A third wave of investment came in the form of pension funds and traditional fund managers looking to diversify their portfolios with social and sustainable investments. Today, these institutional investors have outgrown public, private and retail investors. While public sector investors compose 25% of the overall MIV investor base, private and retail investors account for 30% and institutional investors for 45%. And in the smaller segments of Mixed MIVs and Equity MIVs, institutional investors constitute over 60% of the investor base.

Box 9: Public Sector Shifting from Direct to Indirect Investing

Government agencies, and the DFIs and IFIs which they fund, have played a fundamental role in seeding microfinance, with the aim of crowding in private sector investors and eventually building a sustainable industry. As a result, such players have historically always accounted for a major share of foreign investment in the sector. The 2009 CGAP survey of microfinance funders revealed that public sector agencies accounted for some 68.5% of the USD 21.3 billion in public and private foreign commitments to the industry, both directly to MFIs and indirectly to MIVs.

With a good third of private sector commitments and still growing today, a debate arose as to whether the public sector had successfully achieved their initial goal and should start to withdraw from the market due to the fact that they were now crowding out viable private investment, or whether tax payers' money was still required to create further track record and crowd in more traditional investors. While public sector investment in mature microfinance markets is an unnecessary use of government budgets today, they continue to play an important role within frontier and nascent impact markets. And indeed as a response to crowding out claims, many public sector agencies have shifted away from direct exposures and mature markets in order to start providing indirect investment support in nascent markets, reinforcing the private sector efforts, either through new or existing MIVs with innovative strategies. The more risk tolerant public agencies provide risk mitigation instruments to MIVs via the offering of credit enhancements, first loss positions, collateral for guarantee agreements, currency hedges and/or liquidity facilities. Several agencies are also taking a step back by adopting a fund of funds strategy, thereby helping the MIV market mature and grow rather than competing with it. Some are setting up their own MIVs, but target innovative strategies, outsource their management to private agents and seek to leverage their capital with private investors.

This shift from a direct to an indirect strategy by public agencies, with a view to creating complementary partnerships with the private sector, is a very positive step for microfinance investments as the industry will not become a true asset class before a large majority of assets are owned by private sector players. The temptation for some public agencies to continue operating on their own through direct investments is strong, with such players benefiting from large budgets, capable resources, solid pioneering experience and strong political support. However, by not forcing themselves to move out of mature markets, focusing on frontier investments and engaging in true public private partnerships, they risk compromising the success they have contributed to thus far and losing sight of their original catalytic mission. Further efforts are thus needed to develop market infrastructure, encourage private operators to strengthen their business models and leverage their capacity with private capital.

KfW, together with IFC, EIB and Belgian, Dutch, French, German, Norwegian and Spanish cooperation agencies have constituted a good example of this positive trend by forming in 2010 a consortium of development investors committing USD 180 million USD 180 million of seed funding to be leveraged with private capital and managed by private sector agents, with an aim to offer local currency term financing on a commercial basis to second and third tier MFIs in the low income markets in Sub-Saharan Africa.

02 BUSINESS MODEL

With over 100 different funds, the MIV market may seem relatively atomized. This figure nevertheless hides a rather concentrated industry. Establishing a global microfinance investment capacity is quite cost-intensive and represents a high barrier to entry, which will only increase as regulatory requirements become stricter.
The market has also become much more competitive, with a growing pressure on intermediation margins. As a consequence, MIV managers are striving to increase their efficiency, including by syndicating, consolidating and outsourcing their operations.

Market Concentration. The Symbiotics 2011 MIV Survey counted a total of 102 microfinance dedicated collective investment funds or MIVs, of which 70 responded to the survey. With the exception of a handful, all were setup in the past decade. This relatively atomized headcount distribution is in fact quite strongly concentrated from a volume perspective. The top five MIVs account for half of the total MIV assets, the top ten for two thirds, the top twenty for four fifths and the top fifty for 98% of total volumes. As a matter of fact, the top ten MIV managers represent 85% of total MIV portfolios via a total of 56 different products. Furthermore, Dutch, German and Swiss based MIV managers have originated 81% of the outstanding portfolio volumes. Also, from a fund jurisdiction perspective, some 50% of MIV volumes are registered and administered in Luxemburg. Overall, it can be said that while North American grants, primarily through USAID and large private foundations, have brought the bulk of the seed money which has been transformed into equity, European MIV managers have largely benefited from more favorable regulatory environments, large support from DFIs and IFIs in the continent, and a widespread acceptance of soft but stable double bottom line returns among private investors.

Figure 15: Top 10 MIV Managers/Advisers

MIV Managers	*Microfinance AuM (USD mi.)*	*Staff*	*Inception Date*	*Country*
Developing World Market	785	43	1994	USA
ResponsAbility	747	77	2003	Switzerland
BlueOrchard	734	56	2001	Switzerland
Symbiotics	537	42	2005	Switzerland
Oikocredit	516	n/a	1975	The Netherlands
Finance in Motion	484	70	2004	Germany
Triodos	306	n/a	1994	The Netherlands
Incofin	292	34	2001	Belgium
Triple Jump	269	28	1998	The Netherlands
Cyrano	234	n/a	2000	Peru

"MIV Managers/Advisers" are defined by the fact that they originate and directly monitor their investments, travel on site to perform their own due diligence and often have branch offices with local analysts. Many MIV managers team up with traditional fund managers and promoters to engage in investor relationship management, such as in the case of responsAbility with Credit Suisse or DWM with SNS Bank in the Netherlands.

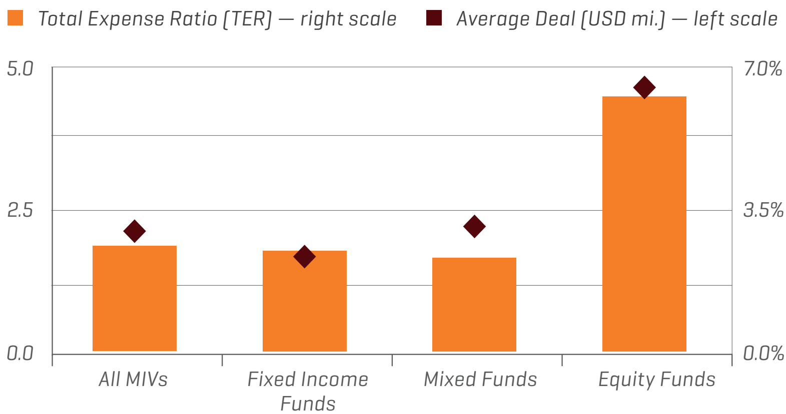
Source: Data compiled using publicy available information or estimates, primarily as of end 2010.

Portfolio Concentration. MIV assets are composed on average of three quarters of microfinance investments, with the remaining split between other related investments (SME, fair trade, etc. – about 10%) and money market instruments. Larger and more regulated MIVs, particularly those with retail distribution licenses, are usually committed to over 100 different investment positions, with good diversity scores. MIVs otherwise typically have fairly concentrated portfolios, with on average the top five country exposures and the top five MFI exposures accounting respectively for 61% and 36% of the total portfolio. In the case of Equity Funds, by nature much less diversified, these percentages reach 95% and 94%.

These figures are partially explained by the relatively small size of MIVs. At the end of 2010, the average total asset value of Fixed Income Funds reached USD 77 million while that of Mixed Funds was at USD 40 million and that of Equity Funds at USD 27.5 million. These concentration figures are also explained by the fact that their relatively high cost of sourcing such transactions is pushing MIV managers towards larger ticket levels. Also, by trying to pick the stronger MFIs, in the upper tier market, they need to place larger volumes in order to catch their attention. As a result, "low hanging fruit" MFIs (those which have high credit ratings and can rapidly absorb large amounts of capital) tend to receive funding from most MIVs – a fact which makes for a relatively high level of industry concentration among MIVs targeting such upper market segments. As a result, investors will typically be wary of target market segments, average investment sizes and top concentration ratios when analyzing an MIV portfolio.

Total Expense Ratios (TER). Despite their increasing cost efficiency, microfinance investments are more expensive than traditional investments. At the end of 2010, MIV TERs ranged from an average of 2.4% for Fixed Income Funds to 6.5% for Equity Funds, and at an average of 3.0% overall. This relatively high fee level is explained by the nature of microfinance investment and its nascent market infrastructure. There are no existing equivalents to Bloomberg, Standard & Poor's, Clearstream or Nasdaq to assist MIV managers and ease the investment process. MIV managers pay the usual fund operational fees (custodian bank, fund administration, tax, legal and audit) and sales placement fees, which can amount to up

Figure 16: TER & Average Deal, by MIV Peer Group



Source: Symbiotics 2011 MIV Survey

to 1.0%, leaving them generally with net commissions of less than 1.5%. MIV managers invest these revenues in traditional portfolio management and decision-making functions, but also need to develop and integrate the investment banking, advisory and back-office tasks which don't exist as third party services in microfinance investments today (e.g. direct market screening and pipeline negotiations, on-site due diligence and ratings/ valuations, legal drafting and compliance, payment collection, transaction servicing and risk monitoring, default and restructuring management as well as exit or redemption management). As a result of this integrated value chain, investment analysts can cover only 12 to 15 MFIs for debt investments and 5-6 for equity investments. With an average debt investment of USD 1.7 million, assets under management reach USD 20 to 25 million per analyst and about half that amount per overall staff for Fixed Income MIV managers. With average equity deals of about USD 4 million, these assets per staff ratios are probably twice as high for Equity MIV managers. In addition, the fact that investees are spread across dozens of countries makes for high travel expenses and regional office maintenance costs despite the relatively low value of assets under management and limited average investment sizes. Consequently, MIVs have quite labor intensive business models in comparison with those of traditional assets managers.

While finding their financial equilibrium has been challenging for MIV managers during this first and fast developing decade, they have learned to improve and strengthen themselves rapidly and ultimately have proven to have developed quite a valuable model for investors. Fixed income MIVs have, for example, not posted any annual loss to date, during a decade where many traditional investment models have failed. As a matter of fact, they have constantly generated above mid-term money market net returns. Most important, investors have continuously shown signs of enjoying the value for money provided by MIV managers by increasing their exposure to the industry, despite relatively higher fee levels. Yet as the industry matures, competition is increasing and pressure on margins is forcing further efficiency trends – mainly through syndication, consolidation and outsourcing efforts.

Syndication. With an average investment of under USD 2 million and a net expense of less than 1.5%, the vast majority of fixed income transactions have a revenue stream of USD 20,000 to 30,000. Fixed Income MIV managers will as a result typically try to syndicate MFI exposures among several products, as real effective costs per MFI can actually be two or three times as high. As a result, it is expected that transaction syndication will become much more common in the coming years. Indeed, it should allow several MIV managers to split fixed costs and gain economies of scale, move into new markets and reduce the industry's relatively high portfolio concentrations. At the end of 2010, Symbiotics launched an MFI bond issuance platform which offers potential investors standard documentation and process, electronic settlement through Clearstream or Euroclear, listing on Euro MTF (the largest bond market in Europe), secondary trading capacity, and a TER of less than 1.0%, cutting intermediation costs in half. The platform has sold its first bonds targeting MFIs in Costa Rica and Sri Lanka, syndicating over a dozen MIVs and emerging market bond funds.

Equity deals are usually approached as one-off transactions. While some investors co-invest in larger deals, they have had more difficultly syndicating costs among various products and peers. There is thus a strong incentive to remain in the upper segments of the market, where larger deals can occur – although first tier transactions are limited in their frequency. As a result some Equity MIVs have failed by lack of choice, experiencing strong pressure to consider every large deal offered by the market. Others have moved downstream but have had very high operating expenses. In the end, some poor results in the context of the global financial crisis have incentivized some larger institutional investors to pull out by lack of visibility over cost-to-return ratios. Still in the nascent phase of its life cycle, the MFI private equity transaction operators will need to innovative with further efficiency, possibly formally syndicating deals or leveraging costs off of fixed income transactions.

Consolidation. Two further consequences logically derive from these relatively high operating expenses. First, entry barriers are today probably too high to allow many new entrants to the market, at least for Fixed Income MIV managers. Second, existing players might think of merging or acquiring smaller peers. While responsAbility embarked on this path in early 2011 by acquiring Planet Finance Investment Services, one of its sub-advisors, no other MIV managers have followed in these footsteps for now. In any event, MIV managers will seek to leverage their expertise and revenue streams by engaging in adjacent impact investment areas and/or teaming up with larger mainstream financial institutions opening up new markets. The case of DWM engaging with Daiwa Securities in Japan can be seen as another sign of this trend. However, if most MIV managers have been challenged by the global financial crisis, none have disappeared and, as growth resumes and the market broadens, several players might also continue seeking sustainability through internal growth. In any event, due to continuing competition and pressure on margins, the current players will need to consolidate and rationalize their operations through much larger volumes.

Outsourcing. Yet another more immediate efficiency gain for MIV managers will be to outsource some parts of their intermediation value chains to specialized actors as they mature and provide cheaper services of equal value. By far the largest costs of an MIV entail the on-site research and due diligence function as well as the pipeline development and deal structuring function, both of which are usually outsourced by traditional fund managers to respectively research shops or ratings agencies and investment bankers or advisers.

The industry has paradoxically failed to encourage the emergence of sustainable specialized research shops. Policy makers definitely have invested significant amounts of cash into building the MixMarket.org, the industry's leading free on-line data source, and supporting specialized rating agencies such as M-CRIL, Microfinanza, MicroRate and Planet Rating. However, these efforts insisted on being free of charge, or at least highly subsidized and were never paid for by their expected users. They consequently developed business models which investors resisted to rely on, being neither tailored nor focused on their specific needs. Worse still, these free resources have prevented sustainable commercial research shops from emerging. Very few MIVs and DFIs have integrated these external costs or partnerships in their business models. Today, subsidized research boutiques hesitate between continuing with unsustainable business models or shifting to a for-profit model but with an uncertain clientele response and a move which will surely be disruptive to their operations. In addition, while the generosity and usefulness of the MixMarket, offered by donors as a public good to the industry, has been unanimously acclaimed by investors, it now faces an important dilemma, as subsidies become scarcer and as it ponders on shifting to a for-profit model. Using a decade of data collection experience at a pace of over USD 3 million budget per annum, it would risk creating a clear monopoly with its subsequent pricing distortions and make entry barriers impossible to overcome, but at least it would value a resource taken for granted by investors and allow other players to position themselves.

In the mainstream investment sector, independent, professional and reliable buy-side research offerings are also a tricky equation to solve. Only a handful of actors can establish themselves valuably, spreading their costs over a very wide investment universe and client base, like Bloomberg or Reuters. In niche markets, where limited economies of scale don't allow for such models, fund managers usually distinguish themselves with their own well-recognized internal research capacity. This will most likely continue to be the trend in microfinance investments, until the industry can sufficiently broaden the scope of its target markets.

Regarding pipeline development and deal structuring, BlueOrchard, DWM and Symbiotics, for instance, developed small investment banking teams between 2004 and 2008, offering several series of microfinance securities to other MIVs, DFIs and some traditional investors. This activity ended with the global financial crisis, but may revert in the future. Several investment advisory boutiques have continued offering their services with more or less success, although here too the industry will need to broaden its investment universe definition, as specialized advisers face an excessively narrow target market should they aim for MIV managers as their sole clientele. More recently, DFIs have started showing the way by increasingly opting to outsource much of their deal sourcing and servicing to global or local MIV managers. In addition, a growing number of MIV managers themselves are utilizing specialized domestic expertise within new or difficult markets. Similarly, several "fund of funds" which syndicate expertise from various local investment managers into pools which are then sold to foreign investors, have emerged. This trend is likely to continue, especially as the industry diversifies to embrace increasingly differentiated impact investment areas and targets new low income markets.

Box 10: New Regulatory Requirements for MIV managers

MIVs have largely been considered as alternative investment funds by regulatory bodies. Except in some rare cases in Austria, Germany, the Netherlands and Switzerland, where several creative solutions were sought and exemptions were attributed, MIV managers have not been allowed to sell microfinance as a regulated asset class to retail investors. MIV managers have largely built their business model by offering their products to so-called "qualified" investors, and registering their vehicles in Luxemburg, where very flexible resources and legislation exist for this purpose and audience.

Following the global financial crisis, the European Parliament voted in November 2010 the Alternative Investment Fund Managers Directive (AIFMD). This directive, which has to be transposed into national law and applied by member states by mid-2013, requires that all fund managers, European or foreign, active in the non-UCITS (or traditional public investment) sector to be regulated in order to manage or sell MIVs to qualified investors. While the new legislation primarily targets the private equity, real estate and hedge fund industries, it also affects microfinance fund managers. This puts additional cost pressure on MIVs and further fuels the trend towards increasing entry barriers and consolidating MIV volumes. In addition, the domestic implementation of the new legislation by national regulators is likely to result in further additional rules, with specific conditions and exemptions for each jurisdiction.

Across the Atlantic, the recent Dodd-Frank Act and Foreign Account Tax Compliance Act (FATCA) are respectively asking, among other things, that alternative fund managers targeting U.S. clients register with the Securities and Exchange Commission (SEC) and foreign financial institutions to bear the burden of their U.S. client tax compliance. The implementation and consequences of these new regulations are yet to come fully into effect. It is nevertheless expected that they will further limit the capacity and willingness of European MIVs to attract American investors. With the exception of DWM, which is based in Connecticut but primarily works for European and Asian initiatives, and BlueOrchard, which attempted to enter the U.S. market between 2005 and 2010, none of the top 10 MIV managers currently operate in the United States. This failure to tap into the world's largest capital market in a country which has shown great interest in social investment and entrepreneurship means that MIV managers are limiting their capacity to create economies of scale, leverage their business models and impact the microfinance industry with broader access to capital.

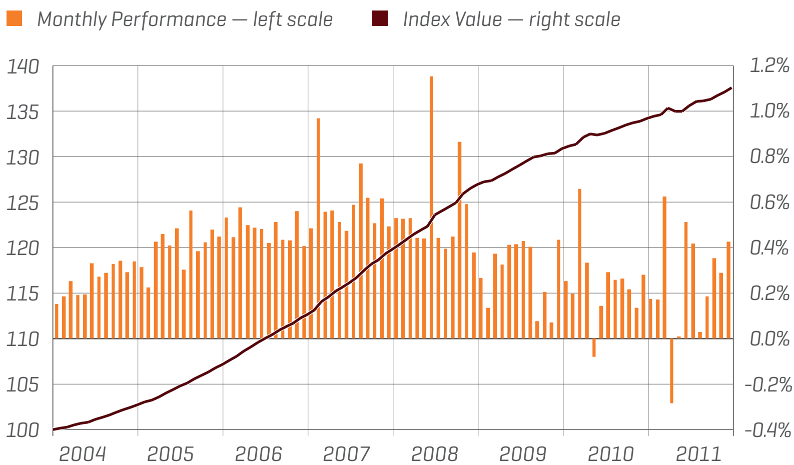
03 FIXED INCOME

Fixed Income MIVs have generated positive returns and recorded low correlation and volatility scores since their inception, providing in recent years interesting diversification benefits to traditional investment portfolios. The reality check provided by the global financial crisis has nevertheless disclosed more accurately the various risks involved in managing MIVs. It has also created increased competition by differentiating MIV managers based on their strategy and performance during this period, improving the overall investment landscape.

Performance. Overall, the 40 Fixed Income MIVs surveyed in 2011 generated positive returns above money market rates, with a net return per annum between 2006 and 2010 of 4.86% in USD and 3.84% in EUR terms. In the same period, the Libor 3 months in U.S. dollars offered a CAGR of 2.85%, while stock, bonds and alternatives offered respective CAGR of 4.61% (JPMorgan Global Bond Index USD), 2.25% (MSCI World Index USD) and 1.12% (HFRX Global Hedge Fund Index USD). When included in traditional investment portfolios, Fixed Income MIVs provided material diversification value throughout the global financial crisis and are comfortably integrated today into the strategies of many asset managers looking for higher growth markets, stable returns and lower correlation to global markets.

Indeed, while traditional investors enjoy the relatively attractive returns offered by Fixed Income MIVs, they mostly invest due to the lower volatility it brings to their portfolios, balancing higher risk assets. Symbiotics has developed a microfinance index series ("SMX") which has an MIV Debt component tracking a pool of a dozen regulated Fixed Income MIVs with independent monthly valuations. The SMX reflects the technical

Figure 17: SMX MIV Debt USD Performance



Source: Syminvest.com

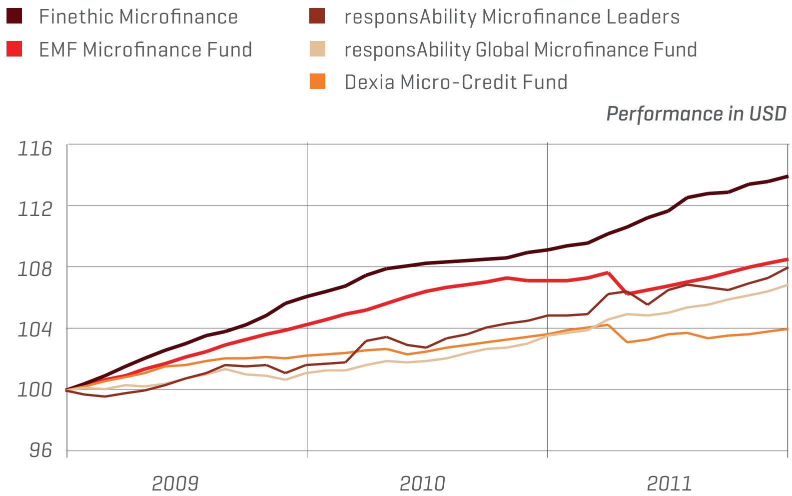
characteristics of the asset class on a continuous basis and has been in existence since December 2003. The SMX Debt MIV USD average monthly and annual returns are of 0.33% and 3.98% respectively, cumulating 37% net yield since inception with a volatility (calculated as monthly standard deviation) of just 0.61% and only three negative months out of a total of 95. In EUR terms, the SMX MIV Debt component has an average monthly and annual return of 0.28% and 3.33% respectively and a volatility of just 0.60%.

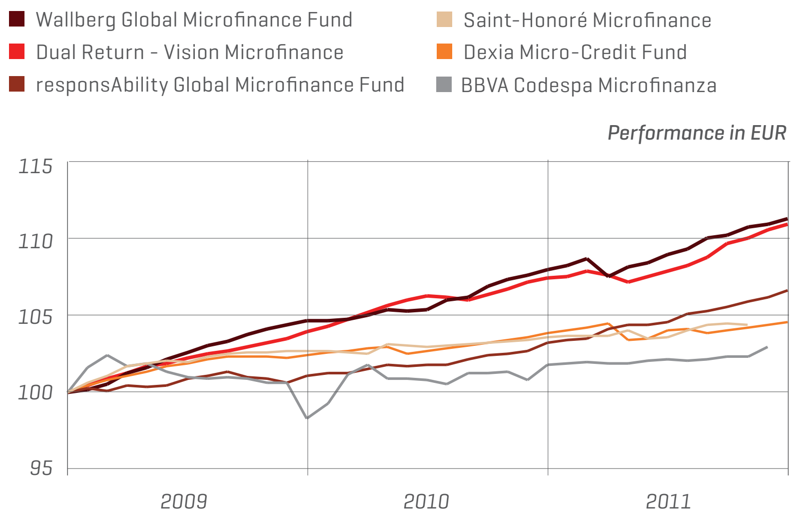
Risk. Fixed Income MIVs are, of course, not immune to the risks which are inherent to the activities that they manage. Indeed, it may be the case that the underlying portfolio risk is higher than the level suggested by MIV track records. Debt transactions have no secondary market as MIV managers usually "buy and hold" investments, which they originate themselves. This results in valuations which are not "marked to market" but rather booked at their nominal value plus accrued interest, usually based on fixed coupons rather than floating rates. This explains the low correlation to more volatile and liquid market securities. As a result, volatility only becomes apparent when bad loans are provisioned for the risk of default. However, bad loan ratios have on average only accounted for less than 2% of portfolios over the past decade and hence volatility has been marginal, explaining why graphic representations produce straight performance lines. Individually some MIVs with poor diversity scores have been hit harder when single MFI defaults occurred, creating sudden breaks in their linear results and unveiling stronger underlying risk than what their low volatility presupposes. However, microfinance markets have been quite resilient to the global financial crisis and have continued to grow rapidly in response to high demand for access to capital and financial services from micro-, small and medium enterprises and low income households. Overall, it is expected that this strong underlying trend will continue, as long as local emerging markets flourish and are well supported with adequate regulatory environments. It is thus similarly expected that if the above conditions are met, the SMX MIV Debt index will continue reflecting the same type of risk and return profile in coming years.

Differentiation. Investors also face risks linked to the MIV manager which they select and the way they invest their capital. The variance in the performance of Fixed Income MIV managers was relatively limited in their first years of operations. A decade ago, there were, for example, no defaults and managers invested in the same markets, often in the same MFIs, and were subject to similar cost structures and thus generated similar returns. However, the global financial crisis resulted in greater variance in performance and thus in an increase of both fund manager and investment product differentiation. It became apparent to investors that they now faced a choice, not only of whether to invest in microfinance but also which fund manager to select. MIV managers today identify and manage the risks and responsibilities they face via a diverse range of personnel, structures and processes – and ultimately produce a broader range of results. Over the past three years, since variance started increasing, some MIVs within the SMX MIV Debt USD index have maintained a 4%+ CAGR of their share price, delivering over 13% cumulative return, while others barely reached 4% in cumulative return, with 1.2% CAGR. In EUR terms, best performers have also maintained a 3%+ CAGR profile, while others have not produced any value. Competition has consequently accelerated, to the benefit of the industry. Indeed, lower performing funds have reportedly lost investors while higher yielding ones continue to grow.

Sell Side. A striking source of differentiation which has also impacted performance is related to the "sell side" strategy of MIVs. Some of the more successful MIV managers have set up large sales forces in conjunction with liquid products and retail strategies. Paradoxically, instead of suffering from widespread redemptions during the crisis, these managers received large inflows of new money from investors. Their cash ratios have reached up to more than a third of their assets, while overall average MIV cash ratios stood at 13% of assets between 2007 and 2010. Some of the more liquid products were obliged to eventually close their funds to new subscriptions in order to protect existing investors. Indeed portfolios consequentially generated no return on large shares of the assets – thereby putting great pressure on their managers to place new money into the market. Not only were these managers forced to be bullish during the 2009-2010 downturn, with some local microfinance markets experiencing over-indebtedness and growth problems as a consequence of the crisis, they were also given the incentive to reduce lending practices and increase average investment size – a development that ultimately resulted in higher default and provisioning rates.

Figure 18: SMX MIVs, 3-Year Performance





Source: Syminvest.com

Contrastingly, some MIV managers halted fund raising efforts when Lehman Brothers went bankrupt in 2008 due to concerns over how the global financial crisis would affect them and fears over further growth at a time when the risks of default were rising. Other MIVs have installed very tight cash and liquidity management processes, often engaging in active discussions with their investors and working on planned subscription and redemption schedules. MIV loan portfolios are indeed illiquid in nature, with 18-24 months outstanding maturities, and limited in their placement capacity during slower MFI growth cycles. Evidence showed that both strategies (cautious placement strategy and tight liquidity management) produced lower bad loan ratios, than those with more active, liquid and retail "sell side" strategies.

Buy Side. The second differentiation factor impacting performance entails the "buy side" strategies and research efforts of MIV managers. Some MIVs integrate the entire intermediation value chain, with analysts running multiple tasks (e.g. pipeline management, due diligence and analysis, structuring of investment agreements, monitoring risk, valuing portfolio assets and participating in investment committees). Other MIVs have purposefully split the value chain between analysts working on market intelligence and institutional research, technical staff working at transaction level on operations and compliance, asset managers running portfolios and investment committees focusing on the decision making. The latter structural setups prevent several possible conflicts of interest for MIV managers having to cumulate many roles along the investment value chain. Evidence shows that MIVs with clearer role separations have better performed overall.

Fee Level. The third differentiation factor entails management fee levels and other adjacent intermediation costs. While overall Fixed Income MIVs have an average TER of 2.4%, several managers have been able to reduce the ratio to below 2.0% – thereby generating an additional half point improvement in performance. This effort has been easier to achieve for larger MIVs. Although some smaller MIVs have been able to reach economies of scale by hiring MIV managers and advisers who provide analysis, origination and monitoring expenses over several products and strategies reducing costs for their clients.

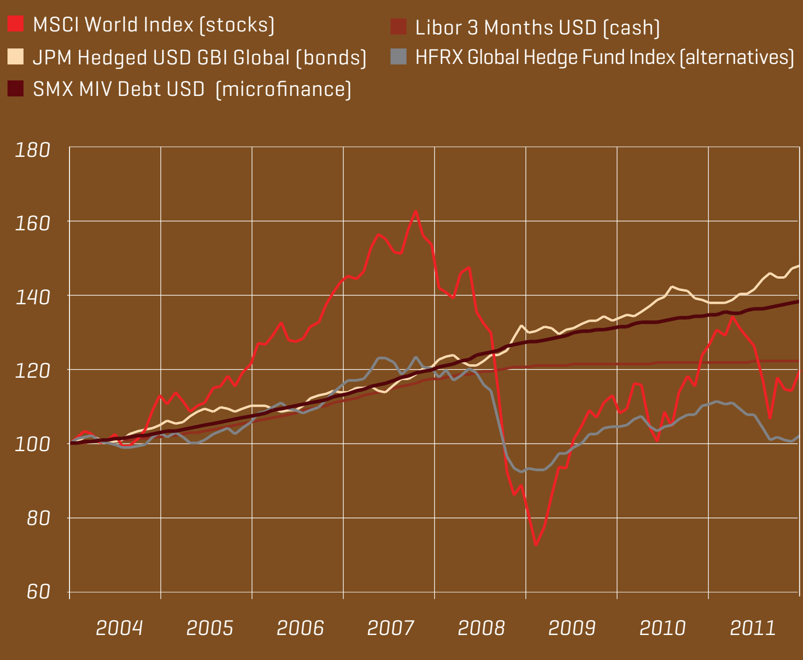
Overall, Fixed Income MIVs have matured over the past decade. The multiplication in the number of product strategies, new deal syndication offerings, consolidation among asset managers, the emergence of outsourcing options, increased transparency, controlled sales channels, structured investment processes, repayment and redemption experience, pressure on intermediation margins, and, of course, sustained attractive returns – all have contributed to creating healthy competition, improving the investment landscape and establishing a valid asset class.

Box 11 : Microfinance & Asset Allocation

An investor who has a balanced portfolio strategy, between equal shares of money market instruments, bond obligations, stocks and alternative investments would have benefited from adding Fixed Income MIVs to his portfolio, both in terms of increased return and reduced volatility in the past recent years. This can be verified both over the past 4 years, since the beginning of the global financial crisis, and over the past 8 years, including the upward market cycle before the downturn.

To build this theoretical asset allocation exercise, the Libor 3 Month USD can be used as a proxy for money market instruments in a traditional portfolio, the JPM Hedged USD Global Bond Index for bonds, the MSCI World Index for stocks and the HFRX Global Hedge Fund Index for alternative investments.

Figure 19: Microfinance vs. Other Asset Classes



Source: Syminvest.com, Bloomberg

The comparative risk return profile of the SMX MIV Debt USD Index shows a strong correlation factor with money markets, with similar volatility but higher returns. This is reflected by a more favorable Sharpe ratio[9] for microfinance overall, and particularly since the drop of the Libor rates during the global financial crisis. Microfinance also presents overall more favorable Sharpe ratios against bonds, stocks and alternative investments, additionally with very weak – positive or negative – correlation factors. Global bonds show higher incremental risk for the marginal return offered against microfinance fixed income, but overall behave quite similarly and post slightly higher returns over both periods. Stocks and alternative investments show quite poor risk return profile in relation to the SMX. Given this evidence, it seems the opportunity of including the SMX MIV Debt USD in a traditional portfolio would have been quite positive , irrespective of the share distribution of other asset classes, in the past 4 or 8 years.

Figure 20: Asset Class Comparison: Risk, Return & Correlation

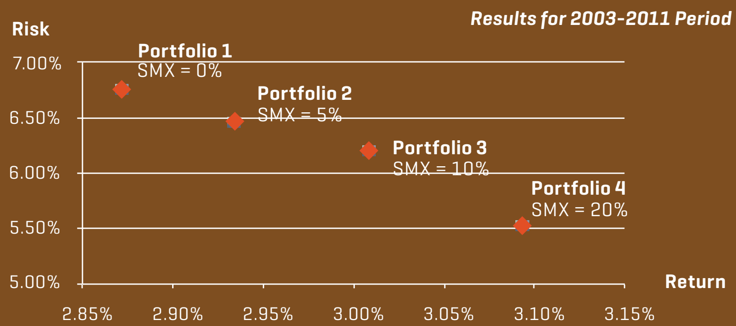
	Libor 3 Months USD	*JPM Hedged USD GBI Global*	*MSCI World Index*	*HFRX Global Hedge Fund Index*	*SMX MIV Debt USD*
2003-2011	**Cash**	**Bonds**	**Stocks**	**Alternatives**	**Microfinance**
Return	2.47%	4.88%	3.69%	0.45%	3.98%
Volatility	0.57%	3.03%	16.90%	6.51%	0.61%
Correlation					
Cash	**1.00**	0.02	-0.04	0.02	0.58
Bonds	**0.02**	**1.00**	-0.27	-0.35	0.04
Stocks	**-0.04**	**-0.27**	**1.00**	0.79	-0.10
Alternative	**0.02**	**-0.35**	**0.79**	**1.00**	-0.13
Microfinance	**0.58**	**0.04**	**-0.10**	**-0.13**	**1.00**
Sharpe Ratio	**0.83**	**0.95**	**0.10**	**-0.24**	**3.26**
2007-2011					
Return	1.02%	5.08%	-3.53%	-3.70%	3.46%
Volatility	0.31%	3.48%	22.30%	7.87%	0.70%
Correlation					
Cash	**1.00**	0.09	-0.41	-0.49	0.54
Bonds	**0.09**	**1.00**	-0.30	-0.39	-0.05
Stocks	**-0.41**	**-0.30**	**1.00**	0.79	-0.17
Alternative	**-0.49**	**-0.39**	**0.79**	**1.00**	-0.24
Microfinance	**0.54**	**-0.05**	**-0.17**	**-0.24**	**1.00**
Sharpe Ratio	**-3.12**	**0.89**	**-0.25**	**-0.72**	**2.09**

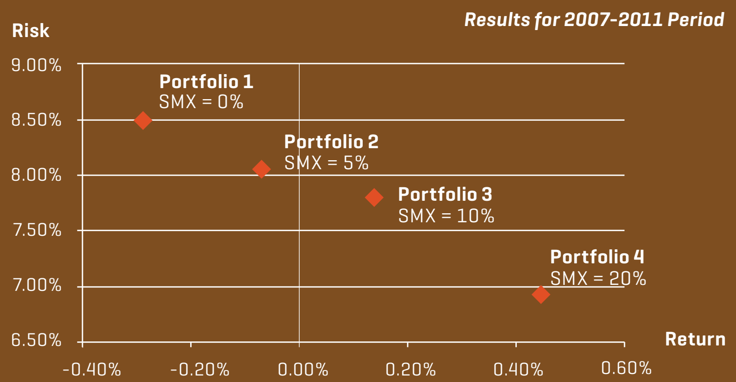
[9] The Sharpe ratio divides the difference of the return of an asset with the risk free rate by its volatility in order to measure whether that asset favorably outperforms risk free returns given the level of risk engaged. Ratios above 1 report positive incremental return for the risk engaged, ratios between 0 and 1 inform that the risk engaged is too high for the return received, ratios below 0 show poor performance both in absolute terms and relative to risk. The 10 year U.S. treasury bonds are used as the proxy for the risk free rate, currently at 2%.

By introducing respectively 5%, 10% and 20% of microfinance fixed income in traditional portfolios balanced between four equal shares of money market instruments, global bonds, global stocks and alternative investments, volatility is gradually reduced and returns increase. Over the past 8 years, return has increased by 0.22% while volatility is reduced by 1.23%; over the past 4 years, return has increased by 0.75% while volatility is reduced by 1.56%.

Figure 21: Impact of Microfinance on Balanced Portfolio

		2003-2011		2007-2011	
	Share of SMX	**Return**	**Volatility**	**Return**	**Volatility**
Portfolio 1	0.00%	2.87%	6.75%	-0.28%	8.49%
Portfolio 2	5.00%	2.93%	6.46%	-0.09%	8.12%
Portfolio 3	10.00%	3.01%	6.20%	0.09%	7.79%
Portfolio 4	20.00%	3.09%	5.52%	0.47%	6.93%





04 PRIVATE EQUITY

The Equity MIV market is still very young with an average vintage year in 2008. While these MIVs have been growing rapidly in recent years, they have also been hit hard by the global financial crisis. Indeed, early investors have experienced higher market risk, higher costs and lower returns, coupled with bad press coverage and difficulty to place new investments during the downturn. As a result, some investors have questioned the viability of this nascent segment of microfinance investments. Its underlying markets remain nevertheless vibrant and attractive; it is thus likely that Equity MIVs will adapt and improve their strategies to grasp existing value creation opportunities.

Structure & Growth. Microfinance equity investments include about ten specialized investors with a strategic view on the industry – including names such as Advans, Access, Finca, MicroCred, Opportunity and ProCredit – usually structured through holding companies and primarily starting their own MFIs, which they hold and control, and about twenty specialized MIV managers with dedicated Equity MIVs, which primarily buy and sell minority shares in existing MFIs with various levels of involvement and intervention. Other private equity investors have blended debt and equity portfolios or include non-microfinance assets in their portfolios.

The average portfolio of the 12 dedicated Equity MIVs which responded to the Symbiotics 2011 MIV Survey increased from about USD 20 million in 2008-2009 to about USD 30 million in 2009-2010 – figures which point to a relatively small and atomized market. Their aggregate portfolio volume has reached USD 330 million in 2010, growing respectively at rates of 109%, 40%, 75% and 58% between 2007 and 2010 and expected to grow by 118% in 2011. Overall, these figures reflect a very young market, with an average life per fund of 3.1 years in 2011. Holding companies, to the contrary of Equity MIVs, are much larger in size, consolidating the balance sheets of their many controlling stakes: for example, ProCredit Holding, the largest holding company, reported consolidated statements of over USD 5 billion in 2010. Most other holding companies are younger and smaller but follow similar growth rates as Equity MIVs.

Investors. Currently, Equity MIVs are primarily sold to institutional investors, which made up 60% of investor volume in 2010 up from 45% in 2008. This growth can be attributed to several pension funds which have made very visible pioneering entries in the sector (e.g. TIAA-CREF in the United States or APG and PGGM in the Netherlands in 2009). Other types of investors are mostly comprised of wealthy individuals investing either directly or through their own funds or foundations. The percentage of Equity MIVs purchased with public sector funds fell from 30% in 2008 to 12.5% in 2010. This decline is explained by the arrival of large private capital flows in Equity MIVs and by the fact that DFIs and IFIs have rather concentrated most of their interest on holding companies.

Target Markets. Equity MIVs have mostly focused on two regions: East & South Asia and Latin America. This trend has been reinforced in recent years with the two regions respectively accounting for 35% and 27% of Equity MIV investment in 2008 and 45% and 47% in 2010. The two regions have experienced much stronger growth in recent years, coupled with longstanding track records in the industry. Eastern Europe & Central Asia attracted strong interest in 2009 and accounted for some 20% of the overall Equity MIV portfolio. However, this figure has now fallen to 6% due to the region's subsequent downturn and rapid relative growth elsewhere. Similarly, Equity MIV investment in Africa & the Middle East has fallen to only a couple of million dollars, with the region accounting for just 2% of overall portfolio. These figures contrast with those of holding companies, which invest far larger sums in these two regions. Both Eastern Europe & Central Asia and Africa & the Middle East attract large public sector policy seed capital. In particular, the latter attracted vast transformation capital after the post-Soviet era and, in the case of the former in Africa, markets are often too new for later stage Equity MIVs and instead require the provision of startup funding and technical support to allow for the launch of new institutions.

Figure 22: Equity MIV Key Indicators

Average	*2007*	*2008*	*2009*	*2010*
Fund Size (USD mi.)	20.4	19.8	30.1	29.8
Fund Growth	108.6%	40.2%	74.5%	58.0%
Investment Size (USD mi.)	2.0	2.2	3.5	4.5
Top 5 Countries	76.4%	83.2%	95.3%	95.2%
Top 5 MFIs	75.5%	75.5%	85.9%	93.9%
Total Expense Ratio	4.6%	5.8%	6.3%	6.5%
Internal Rate of Return	12.5%	10.5%	17.3%*	17.3%*
Eastern Europe & Central Asia	25.1%	20.1%	11.0%	5.5%
Latin America & Caribbean	27.7%	28.5%	28.4%	46.9%
East Asia & Pacific	9.5%	6.4%	4.8%	9.2%
South Asia	23.5%	29.5%	52.1%	36.1%
Middle East and North Africa	0.0%	0.0%	2.0%	0.0%
Sub-Saharan Africa	13.0%	7.1%	1.6%	2.4%

* Targeted return sold to investors

Source: Symbiotics MIV Survey 2011

Returns. Equity MIVs rarely disclose their returns, they mostly concern a small group of qualified investors and are really meaningful only once the fund has reached end maturity and exited all its investments. However, earlier surveys performed by Symbiotics together with CGAP point to IRRs of 12.5% in 2007 and 10.5% in 2008 – reflecting only two survey respondents with 1999 and 2003 vintage years. Later funds attracted investors projecting IRRs of 15 to 20%. Interestingly, when asked about expected returns for the following years, 50% of private equity MIV managers believed that their performance would improve in 2009, with this figure increasing to 75% and 71% respectively in 2010 and 2011.

In addition to the optimism which drives such entrepreneurial ventures, these responses also suggest lower IRRs between 2009 and 2011, possibly in single digit territory. Some funds exposed to market shake-outs in this period, mostly bankruptcies in Nicaragua or restructurings in Andhra Pradesh, probably posted negative annual returns. However, overall, with underlying investees generating average returns on equity of 15 to 20% (and even more for the better managed success stories), it can be expected that, all other things being equal, well run dedicated funds will be able to generate on average annualized capital gains of 12 to 15%, net of management costs, foreign exchange fluctuation and possible portfolio failures.

Efficiency. By definition, private equity funds are more concentrated than fixed income strategies. And indeed, Equity MIV concentration ratios are relatively high and growing. The top five country exposure and MFI portfolio exposure have increased respectively from 76% and 75% in 2007 to 95% and 94% in 2010. These figures may reflect the relatively young and growing nature of these products, which are still in their investment period. This data also implies increasing average transaction sizes (from USD 2.0 million in 2007 to USD 4.5 million in 2010) and points towards the investment of larger amounts by newer funds and/or to the fact that managers were under pressure to quickly deploy funds reaching the end of their investment period.

These larger deals should help to increase cost efficiency. However, total expense ratios increased over the period, rising from 4.6% in 2007, to 5.8% in 2008, to 6.3% in 2009 and to 6.5% in 2010. These figures may reflect either the "j" curve of newer funds absorbing higher start-up costs or difficulties that Equity MIV managers are experiencing in deploying their investor commitments while still being remunerated on them, or both. In comparison, holding companies, despite operating via a very different and much more hands-on business model, also posted high operating expenses of 6.8% and 9.4% respectively in 2008 and 2009 surveys. Just as for Fixed Income MIVs, microfinance private equity investments suffer from relatively low average deal sizes and generate higher expense ratios despite having lower net revenues than mainstream PE managers.

Learning Curve. The global financial crisis had a major impact on this nascent investment segment. Costs and risks have increased, returns have gone down and managers have had difficulty in placing the capital committed to them. In the end, some have failed to deliver on their promises during this period. Timing has not been optimal; if Equity MIVs had emerged five years earlier, they may well have recorded a much more impressive initial track record. Some private equity investors have indeed done extremely well in microfinance and, as markets pick up, results should improve in the future. However, the industry has been affected by negative press coverage claiming that some general and limited partners were trying to make money from over-indebted poor people, while these Equity MIV managers and their investors were in fact losing money from their investments in downward cycle markets, just as their end clients. The investment proposal appeared overall unsustainable for some and a few large institutional investors have reportedly withdrawn from the industry as a consequence. Equity MIV managers are striving to adapt to these critiques and revisit their strategies and value propositions, with a number of lessons learned from this difficult early stage.

Firstly, running a small bank remotely, often from thousands of kilometers away, in foreign frontier markets, even in the age of the internet, is extremely challenging. Rough economic times require readily available shareholders and board members. Investors consequently often prefer to invest in general partners with local teams which are blended in the domestic culture and industry and have direct insight in local economic developments.

Secondly, the holding of a minority stake in a venture capital deal is often risky as it provides little influence during challenging times when nascent companies are developing. Rather than playing a passive role with little impact, many investors prefer partners with controlling stakes and strong influence in younger and transforming institutions.

Thirdly, a too narrow target market can generate moral hazard for general partners as they are put under pressure to consider purchasing all the limited deals available rather than having a large pipeline and a broader range of choice. Many investors prefer to invest in funds which combine microfinance equity with a larger PE strategy and investment universe or to invest in balanced portfolios where fixed income components reduce the timing pressure.

Furthermore, costs may be more efficiently managed by groups which are already active in target markets and which offer broad coverage, presence and experience. New fund managers and institutional investors approaching microfinance equity investments may prefer to build on existing resources and create hybrid partnerships and synergies.

Finally, modeling business plans on extreme scenarios is unrealistic. While there are institutions which have doubled their portfolio size every year, reached efficiency rates of over 500 clients per employee, leveraged 10 times their equity and posted ROEs of 50% – thereby generating very high price multiples upon exit, such performances are unsustainable. As a result, investors prefer to stick with partners with balanced long-term track records and who put strong emphasis on grounded value creation and corporate social responsibility.

What is certain is that the size, growth and returns of the MFI equity market remain quite attractive and promising. Many low income economies are still underserved and most MFIs still need transformational capital to grow into regulated banks. Newer investment products still in their early investment periods might offer adapted strategies and better growth prospects. In addition, investors will be able to choose from a broader range of strategies in the future, possibly involving investment in blended products tied not only to microfinance, or invest in balanced portfolios mixed with fixed income assets. Moreover, competition will grow among Equity MIV managers and investors will be quite attentive regarding the specific added value provided by fund managers.

05 IMPACT

There has been a shift in focus in recent years from general concern about poverty alleviation to a desire for more disciplined measurement of the direct outreach and inclusive impact of MIV investments. Microfinance investors have also moved away from a unilateral and simplified view of the sector and have developed a more elaborate understanding of its shared profits and mutual social benefits in the current context of on-going globalization. This has led investors and practitioners to increase their emphasis on the level of social responsibility provided by each stakeholder in the value chain in order to safeguard and ensure long term positive impact and sustainable wealth creation.

Outreach & Inclusion. While the strategy of improving living standards by empowering people via the provision of access to capital is largely accepted as being valid, players face a variety of challenges with regard to actually demonstrating the impact of their investments. The chain of events from the initial provision of funds by the investor to the raising of low-income households out of poverty is quite complex. Investors face difficulty when trying to highlight the benefits provided by their investments in downstream individual life changes which they do not control or are unable to measure. As a result, MIV managers are increasingly shifting away from indirect causality claims and measurement of the poverty alleviation which their end clients experience. Rather they focus on the more immediate impact of their investment in terms of outreach and inclusion. As a matter of fact, the primary social function of microfinance funds is to reach out beyond traditional investment targets and provide access to capital where money normally doesn't flow, to a population that would otherwise remain unattended.

According to the Symbiotics 2011 MIV Survey, microfinance portfolios target financial intermediaries that serve businesses with less than 10 employees (70-75% on average), which are primarily owned by women (60-65% on average), and which have a large focus on rural areas (45% on average). For every million U.S. dollars invested, around 600 such businesses will be brought within the financial system and given access to savings and credit. This in turn will provide improved financial security and employment stability for up to five times that number of economically active poor people. Overall, MIV portfolios today provide this inclusive outreach to over six million micro- and small businesses in emerging economies, thereby offering the benefits of financial inclusion to well over 25 million low-income households in underserved markets.

This outreach and inclusion is key to understanding the role of microfinance funds as an agent of social development for low income households. By providing access to capital in areas where it is normally unavailable, microfinance investors contribute to rebalancing global capital distribution and wealth creation capacity. Socially minded players see this as a just undertaking which will help providing equal opportunities and inclusive financial systems. More economically minded players see investing in

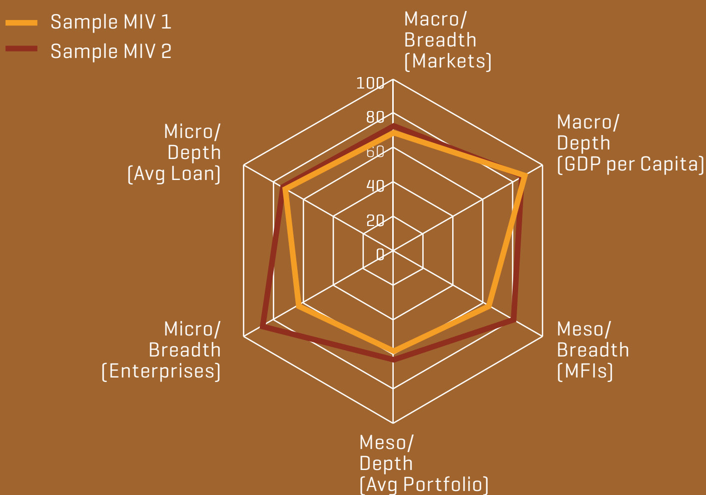
Box 12: Symbiotics MIV Outreach Assessment

Symbiotics assesses the outreach of an MIV by quantitatively measuring the depth and breadth of its portfolio at the macro (country), meso (MFI) and micro (enterprise) levels. This approach offers a quick and quantitative snapshot and helps investors to position their portfolio, based on the following indicators:

	Depth	Breadth
Macro-level	Per Capita Income	Markets
Meso-level	MFI Portfolio Size	MFIs
Micro-level	Credit Exposure	Businesses

These simple metrics allow for the addition of outreach considerations to risk, return and cost elements during the investment decision-making process when selecting an MIV. They assume that the impact value of an investment increases with the depth and breadth of outreach. They primarily serve as a comparison tool for investors evaluating MIVs against each other.

Figure 23: MIV Outreach Scoring



microfinance as a rational choice investing in areas where there is higher growth potential, more attractive labor markets and hence higher value creation opportunities. In both cases, the focus of the investor is on the breadth and depth of outreach, something which can be easily controlled and measured for the investor, rather than on a wider chain of indirect causes and effects.

Shared Value Creation. The vulnerability of small businesses in low-income frontier markets and the novelty of seeing them as a source of investment value have challenged the traditional beliefs of financial intermediaries and investors. However, in a world with anemic growth in high income markets and vast opportunities in underserved fast growing economies, the shift of capital towards such businesses has become very logical.

In past decades, the vast majority of global capital has been concentrating on the margins of consumer goods and services purchased by a narrow portion of the world's population, comprised of high-income households in developed markets. The persistence of this highly concentrated capital flow has created many economic distortions. Companies serving increasingly saturated markets have needed to enter fierce competitive battles to survive. Household income has been hit by excessive consumerism and consequential indebtedness, both resulting from the need for companies to continuously grow client demand and maximize sales revenues. Labor markets have suffered from the pressure on corporations to continually improve efficiency. Retirement plans have eventually suffered from the bleak growth prospects of depressed consumer and labor markets. And government budgets have deteriorated due to the charge of this saturation.

In parallel, the vast majority of the world's population, while not lacking the capacity and aspiration to engage in financial value creation, has remained widely unbanked, if not excluded from access to capital. Today, more than 80% of the world's population – or 5.6 billion people – lives on less than USD 10 a day and accounts for less than a quarter of global income while 40% live on USD 2 dollars a day and account for less than 5% of global income[10]. Many of these people live in economies which have benefited from political stability and development during the relative peace of the Cold War decades

[10] World Bank Development Indicators 2008

as well as from the globalization of trade agreements, technology transfers and international regulations. Today these economies are recording steady single-digit growth, while their small enterprise financing needs are often recording double-digit growth. In addition, micro-, small and medium enterprises generally employ the vast majority of their local labor force. In the United States, where large corporations are much more prevalent than in these low income economies, 99% of registered businesses are micro-, small and medium enterprises and employ more than 50% of the national workforce. This number is consequently larger in economies which have fewer large corporations and relatively smaller public sectors.

The development of microfinance can be linked to the recent and ongoing changes in the global economy. Microfinance investments are helping to fuel the shift towards global shared value creation and to bridge the gap between saturated capital markets in developed economies and unbanked labor markets in emerging economies, both of which require long term financial value creation opportunities. As the industry grows, there has been a shift in mentality from a unilateral and somewhat paternalistic view regarding the impact of the sector to a more elaborate understanding of the shared profits and mutual social benefits that the industry has to offer to its many stakeholders.

Responsible Investing. The concept of responsible investment emerged in the 1990s in parallel to that of sustainable development and as a reaction to the "shareholder value models" fostered by large multinational corporations and the needs of an aging and wealthy population. By focusing on a unilateral shareholder profit maximization business model, financial markets shifted away from their social function and lost long term visibility. Worse, by exporting their model worldwide, they ran the risk of replicating this exhaustion of other stakeholder interests at a global level. For socially responsible investors, creating sustainable growth requires a shared multi-stakeholder approach and the balancing of the needs of owners, employees and managers, clients and suppliers, government, communities and the environment. Their aim is not to set a normative framework limiting profit and individual liberty, but rather to guarantee all individuals involved in a value chain the opportunity to maintain profit in the long run.

Box 13: Symbiotics MFI Social Responsibility Rating

Symbiotics has developed a social responsibility rating that has been applied to several hundred investment proposals and measures the extent to which an MFI acts responsibly towards all of its various stakeholders and contributes to their sustainable socio-economic development. Its methodology contains 100 quantitative and qualitative indicators which are split into seven different dimensions: (1) social governance, (2) labor climate, (3) financial inclusion, (4) client protection, (5) product quality, (6) community engagement, and (7) environmental policy. Each indicator is graded from 0 to 3 (0 = non-existent or very poor, 3 = high quality or very good). A weighting system is then applied to obtain a rating grade from one to five stars, from a very low likelihood to an extremely strong likelihood of contributing to a sustainable development.

Figure 24: MFI Social Responsibility Rating

Within the microfinance investment industry, social ratings measuring multi-stakeholder responsibility have emerged as a result of the global financial crisis and the realization that MFIs which lacked such tools internally suffered from higher mission drift, client abuse and over-indebtedness risks and eventually higher default rates. Measuring corporate impact and responsibility has thus become more closely associated with risk management at the MFI level. Microfinance investors and fund managers have also started to engage in self-regulation through a set of balanced best practice principles in order to ensure the continuity of their part of the investment value chain. In January 2011, 50 specialized microfinance investors signed the Principles for Investors in Inclusive Finance (PIIFs) upon the initiative of the UN Secretary-General's Special Advocate for Inclusive Finance for Development and in collaboration with the Principles for Responsible Investment (PRI) and CGAP.

Box 14: Principles for Investors in Inclusive Finance (PIIFs)

"As investors or fund managers investing in inclusive finance, we have a duty to act in the long-term interests of our clients - private and institutional investors. While upholding our fiduciary responsibility, we will commit to adhering to and promoting the following principles.

1. Range of Services. We will actively support retail providers to innovate and expand the range of financial services available to low income people in order to help them reduce their vulnerability, build assets, manage cash-flow, and increase incomes.

2. Client Protection. We believe that client protection is crucial for low income clients. Therefore we will integrate client protection in our investment policies and practices.

3. Fair treatment. We will treat our investees fairly with appropriate financing that meets demand, clear and balanced contracts, and fair processes for resolving disputes.

4. Responsible Investment. We will include environmental, social and corporate governance (ESG) issues in our investment policies and reporting.

5. Transparency. We will actively promote transparency in all aspects.

6. Balanced Returns. We will strive for a balanced long-term social and financial risk-adjusted return that recognizes the interests of clients, retail providers, and our investors.

7. Standards. We will collaborate to set harmonized investor standards that support the further development of inclusive finance."

Source: Principles for Responsible Investment (PRI)

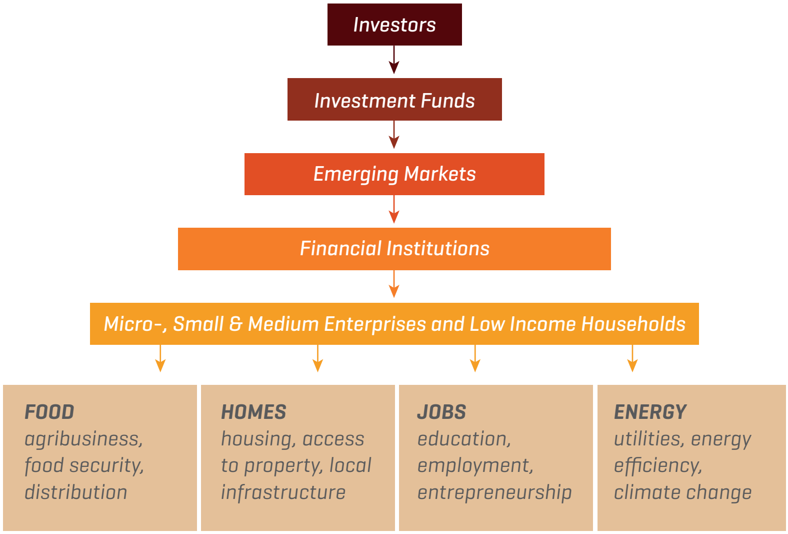
V. CONCLUSION & OUTLOOK : EMERGING MARKETS, FINANCIAL INSTITUTIONS, SMALL ENTERPRISES

Microfinance investments are, as an asset class, bigger and stronger than ever before and have continuously grown since their inception a decade ago. However, the global financial crisis has provided a strong reality check and has raised many points regarding the industry's value chain. These reconsiderations have pushed microfinance institutions and funds to improve their services and impact and in some cases to rethink their operating models. However, the industry has proven to be highly robust and persistent thanks to higher growth in low income economies and the many wealth creation opportunities they offer at the bottom of the pyramid. Most importantly, traditional investors are shifting their mindset from viewing microfinance as a luxury option for their portfolios to approaching it as a valuable opportunity in the current global context.

The Irresistible Demand for Democratization of Access to Capital. The development of the microfinance industry is the result of an irresistible increase in demand for social and financial value creation at the bottom of the world's population pyramid. Globalization has helped to create growth opportunities in both lower income markets and new geographical regions. Today, larger corporations and wealthier consumers in developed economies are no longer the epicenters of value creation. Sustained political and technological development across the globe has generated new forces in the global economic demand and supply. As a result, the future will be characterized by growth in emerging economies, job creation in their small enterprise markets and capital accumulation among their low income households. In turn, this wealth creation generates virtuous cycles, increasing demand for improved standards of living and building the supply chain for goods and services of first necessity related to better access to food, homes and energy. Microfinance can thus be viewed as a spontaneous consequence of much deeper macro-trends in the world economy. And it is with no doubt fuelling a much needed democratization of access to capital and financial services to sustain these new enterprise and household aspirations in low income economies.

A Flourishing Financing Intermediation Market. From this perspective, investors should approach the asset class not as a luxury strategy but rather a "must-have" in their portfolios in the current context. Microfinance investment funds are without a doubt attracting more interest from private investors as they provide a chance to participate in the shared value creation and capital gains offered by new growth markets. As the industry expands, investors will also face a much broader investment universe of emerging market financing intermediaries targeting low income household and micro-, small and medium enterprises. As a result, the financing intermediation value chain and markets – MFIs and MIVs – will continue to evolve, diversify and sophisticate themselves in the coming years. Investors will be offered a growing and widening panel of different models, instruments and solutions to build their investment portfolios. Competition and efficiency will increase with the growing capacity of investors to understand the intricacies of the industry and to decide how they want to invest and to whom they entrust their capital.

Figure 25: A Broader Microfinance Investment Value Chain



The Importance of Complementary Public and Private Initiatives. While microfinance markets need access to much more capital from mainstream banks and traditional investors in order to sustain their growth potential, the industry also needs continued regulation, standard setting and development of best practices along its value chain. Markets find their equilibrium with the commercial bargaining powers of private supply and demand but their existence and viability is made possible by the framework and rules set by public action. This is also true of microfinance markets and if the industry has largely benefited from strong public support at its inception, its attractiveness to investors today depends largely on continued strong policy and regulatory initiatives (e.g. continued development of industry standards and best practices; elaboration of transparency, measurement and control initiatives; integration of industry specificities into both domestic and international banking and investment laws; agreements on rules which will protect the rights and enforce duties on its several stakeholders).

The Social Power of Capital Gains. While microfinance is not necessarily a solution in itself to poverty, it is a very strong tool for sustaining wealth creation and capital accumulation among the economically active poor during growth periods, providing distributive economic development. Nothing will replace strong states, stable political development, sound economic policies and investment in public security, hospitals, schools, infrastructure and social assistance as a stimulus of social well-being and poverty alleviation. However, by focusing on the social impact of finance and by redistributing excess capital into the real economy, private investors can contribute to the diffusion of wealth and opportunity, stimulating growth and entrepreneurship. While capital gains earned from directing money in underserved markets helps foreign investors balance anemic economic growth in their own domestic markets, they also create social transformation for the economically active poor at the other end of the investment value chain and provide them with the means to increase their standards of living.

The Awakening of the Modern Investor. Modern investors understand the social power of capital gains and the value of investing in the real economy. They ultimately aim to guarantee their own long term sustainability by seeking shared value creation and thus, in a symbiotic way, benefit from helping others access capital. Whether pension funds or individual retirees, investors are increasingly aware of the positive potential of taking a sustainable approach to investments and thus strive to play a more active role in the way that their capital is allocated. Responsible investors, even small ones, understand the power and influence of their choice, just as individual citizens grasp the power of their votes in a democracy. By proactively choosing tangible and rational asset themes which maximize the capacity to create long term shared gains, they assume the responsibility of their financial power. And by choosing profit as a means rather than an end, they contribute to restoring the social function of finance.


per
within
rather
million
growth
creation
growing
sector
performance
portfolios
companies
country
relatively
investors
markets
new
strong
DFIs
ratios
business
thus
order
equity
economies
high
opportunities
services
investments
loan
often
financial
MIV
local
small
microfinance
Symbiotics
global
MFI
leverage
banks
models
crisis
assets
years
Funds
less
interest
target
past
emerging
capital
public
USD
sustainable
cost
due
capacity
primarily
long
return
returns
rate
rates
foreign
investment
lower
funds
Equity
two
fixed
Fixed
enterprises
social
portfolio
access
decade
client
costs
tier
pricing
overall
market
end
managers
average
income
loans
also
industry
Microfinance
addition
debt
credit
still
developed
increased
institutions
risk
Debt
larger
continue
savings
five
book
higher
first
Investment
based
currency
MIVs
MFIs
Market
strategies
households
traditional
fund
efficiency
bank
may
clients
impact
large
one
development
Income
result
billion
Figure
transactions
low
fact
many
lending
investor
commercial
expected
several
much
value
usually
financing
asset
private
funding
since
size
today
However
money
specialized

About the author.

Roland Dominicé is an expert in microfinance investments and international finance and development.

He studied social sciences and international relations both at the University of Geneva's Graduate Institute of International and Development Studies, where he wrote his master's thesis on state-building and the stages of modern political development, and at the University of Chicago's Committee on International Relations, where he wrote his master's thesis on globalization strategies and organizational development theory.

He started his career in finance, both on the wealth management side, in institutional asset management at UBS, and the corporate finance side, as a management consultant at PricewaterhouseCoopers. He then joined the founding team at BlueOrchard Finance to launch the first private wealth manager dedicated to microfinance investments, where he served as the CFO for three years. He helped the firm gain an international aura by leading the launch of the first microfinance structured bonds in the capital markets in 2004, in cooperation with J.P. Morgan and the U.S. Overseas Private Investment Corporation (OPIC). He then co-founded Symbiotics, where he initially served as a business development manager, prior to being elected CEO in 2008.

About Symbiotics.

Symbiotics started its operations during the United Nations Year of Micro-Credit in 2005. At that time, the company's founders had been involved in a range of pioneering initiatives within the industry, both with commercial investors and non-profit policy-makers. Their aim when setting up Symbiotics was to serve as a platform for traditional asset managers desiring to reach out into microfinance, small enterprise development and the social economy in general. Today, the company has grown into one of the larger financial intermediaries of this space, with a wide product offering, including market research, investment advisory, asset management and brokerage services.

- Symbiotics has facilitated over 1,000 transactions amounting to more than USD 1 billion in microfinance and small enterprise investments among as many as 25 investment funds and more than 150 financial institutions in 40 emerging economies.

- The company's investor portfolios have financed more than half a million micro- and small enterprises, providing access to capital and financial services to over two million low income households in emerging and frontier markets.

- Symbiotics has offices in Cape Town, Geneva, Mexico City and Singapore and currently employs over 40 professionals, from 15 different countries; the company's independent board of directors and wide shareholder base ensure sound corporate governance.

- Most notably, the company's asset management team has been the best performer in microfinance fixed income funds within its category since 2008, targeting qualified investors mostly in Austria, Germany, the Netherlands and Switzerland.

- Symbiotics also stands out for having developed Syminvest – the largest on-line microfinance and SME impact research database and investment platform, which currently has over 1,000 individual account users.

For more information:

On Symbiotics:
www.symbiotiscgroup.com

On Microfinance Investments:
www.syminvest.com

“The future is defined by growth in emerging economies, job creation in their small enterprise markets and capital accumulation within their low income households.”

This book is a knowledge sharing resource for traditional investors approaching this new and fast growing asset class. The reader will gain expertise from one of its leading investment managers, relating its pioneering experience gathered over the industry’s first decade of existence.