MicroRate
The Rating Agency for Microfinance

MFInsights

Microfinance Investment Vehicles
An Emerging Asset Class

November 2006

MICROFINANCE INVESTMENT VEHICLES
A REVIEW

BACKGROUND

The Emerging Microfinance Investment Vehicle Market

Funding of microfinance institutions ("MFIs") by private foreign investors[1] is at last coming into its own. But foreign funds rarely flow directly to MFIs. During the last few years a new type of intermediary has evolved, that mobilizes funds from investors in rich countries and channels them to MFIs in the developing world. Popularly known as "Microfinance Funds", entities that raise money and channel it to microfinance institutions (MFIs) are only rarely "Funds" in a legal sense. They are therefore collectively referred to as Microfinance Investment Vehicles (MIVs). These microfinance investment vehicles ("MIVs") are the subject of this review.

The most striking feature of MIVs is their explosive growth. In 2005 alone, their combined microfinance portfolios have nearly doubled, reaching $1 billion by the end of the year. All indications are that growth is continuing at a similar pace during 2006. The engine driving this growth is of course the expansion of MFIs themselves and their ever-increasing hunger for funding. The sample of Latin American MFIs tracked by MicroRate, for instance, expanded at an annual compound rate of 40% over the last five years. Gradually, and somewhat haltingly, microfinance is evolving into an asset class.

Nonetheless, the MIV sector is still emerging. One symptom of this is that it is still virtually impossible for investors to compare the performance of MIVs; there are no objective performance data. Unless this information vacuum is filled, it could well become a serious obstacle to future growth of the sector.

In many respects the situation of today's MIVs is reminiscent of the situation MFIs faced a decade ago. At the time, MFIs were beginning the transition from donor funded charities to commercially funded financial intermediaries. Yet, little information was available that would have allowed investors to measure their performance. Indeed – like the MIV sector today - in 1996 the microfinance industry had not even developed performance indicators that would make measurement possible. Then, just as now, the absence of objective performance data posed a threat to future growth. Without them, investors cannot measure risk, which in turn makes rational investment decisions and pricing virtually impossible.

MicroRate's mission is to create the kind of transparency that will make commercial funding flow. It performed that mission by pioneering ratings of microfinance institutions. Despite initial skepticism, the concept caught on and today MFI ratings have become a standard feature in microfinance. In 2005 alone, nearly 300 MFIs were rated by MicroRate and others. MFI ratings have become a standard tool that informs investors about the strengths and weaknesses of MFIs.

As private funding began to flow, it became clear that investors need more than ratings of MFIs. Investors in the US or Europe don't know enough about, say, Bolivia, Botswana or Bosnia to lend directly to MFIs in such countries. A new kind of vehicle was needed that knows how to operate in the countries where MFIs are located. In response to that need, the MIV emerged, which raises funds from investors and channels them to MFIs.

The rise of MIVs created an information challenge similar to the one MicroRate faced ten years ago when it began rating MFIs: again, there are a bewildering number of institutions – we counted 55 of them as of

December 2005 - again investors are facing an information vacuum with no standardized measures or benchmarks.

Survey Methodology

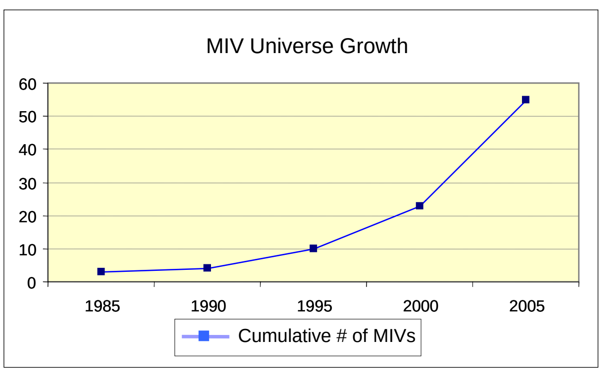
MicroRate conducted two questionnaires to begin to fill the information vacuum and understand the information needs of investors.
The first questionnaire ("Round 1") measured the size of the MIV universe and supplied a broad overview of the MIV market as a whole. 54 MIVs provided data (See Annex 1 – *Round 1 Survey*). The second questionnaire (Round 2) focused on 14 investor oriented MIVs that play a significant role in the sector. The Round 2 questionnaire was developed with extensive input from Patrick Goodman, an expert in MIV surveys.

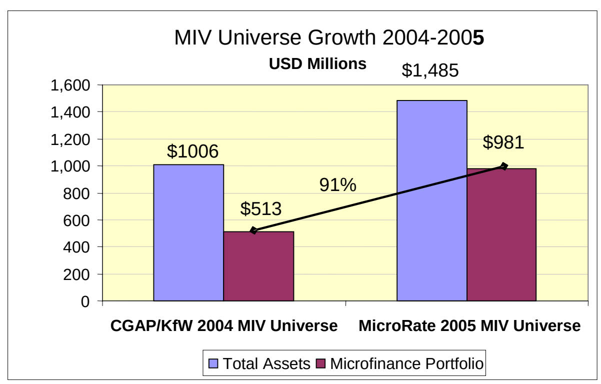
RESULTS & FINDINGS

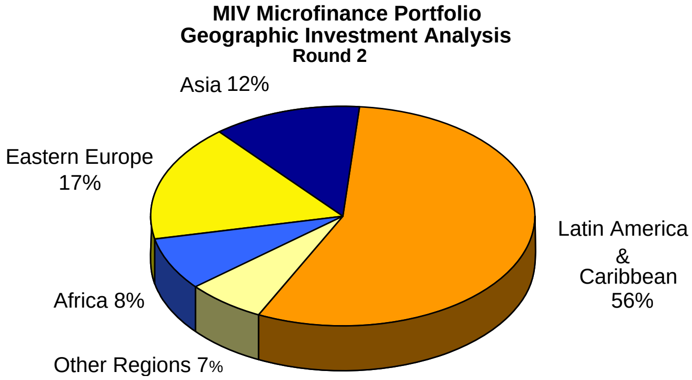
MIV Market Survey

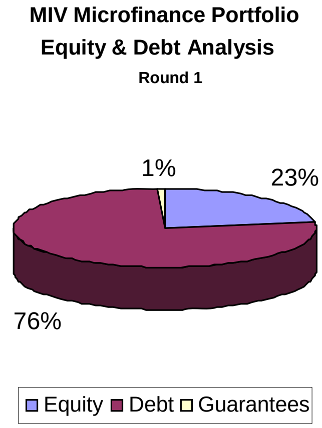
The initial findings revealed that, at the end of 2005 the total assets of the 54 MIVs responding to the Round 1 questionnaire amounted to $1.45 billion, a 47% increase since the last MIV survey in 2004. [2]The 54 MIVs had invested $981 million in microfinance – a 91% increase over 2004. The composition of the microfinance portfolio was 76% debt, 23% equity and 1% guarantees.(number 3)[3] Additionally, the growth in MIVs has been remarkable, with 34 of the 55 beginning operations after 2000 and 16 launching in 2005 alone.

The MIVs' impressive growth rates have been driven by active distribution (e.g. responsAbility), financial innovation (e.g. BlueOrchard) and high involvement from International Financial Institutions (IFIs) and the private sector. Economies of scale are appearing with 13 funds having total assets of greater than $20 million. The fastest growing MIVs tend to be the largest and over 70% of the growth in total assets comes from just 6 MIVs (Procredit Holding, EFSE, Oikocredit, BlueOrchard MF Securities, Dexia MicroCredit Fund and Calvert Communities Investment Notes.)









A striking feature of the MIV sector, in addition to its surprising growth, is its diversity. MIVs come in a large number of shapes and sizes. Only a small minority are "funds" in the narrow sense of the word. Others are specialized investment vehicles like Collateralized Debt Obligations (CDOs), cooperatives, finance companies, special accounts established as part of larger development entities, holding companies, etc. The dominant impression is one of confusion. This is a new industry that has not settled on preferred legal or organizational forms. Nor are there yet industry-wide performance measures or standards. Indicators, benchmarks, and investor guidelines have not been established. It is little wonder, then, that investors are bewildered.

While analyzing the data, considerable effort was made to understand the key measures of MIVs. The process proved a challenge because of the variety of shapes and sizes of the MIVs and the ways in which they measure themselves. Throughout the process MicroRate collaborated with CGAP in order to produce a Reporting and Performance Measurement Guide for MIVs (*"Reporting and Performance Measurement for Microfinance Investment Vehicles")*. This guide will be a public document intended to assist investors and MIVs.

The detailed findings of Round 2 reveal that the 14 MIVs are growing at a torrid pace. Their total assets grew by an annual average of 35% from 2003 to 2005 while their microfinance portfolios grew 76% annually during the same period. The increase in the proportion of microfinance investments to total assets shows that MIVs are maturing and that they are becoming better at placing their resources in MFIs. Interestingly, the highest growth rates were experienced by those MIVs which had developed mechanisms to reach retail investors. Growth was led by the responsAbility fund with an astonishing 455% growth rate in 2005, followed by the ASN NOVIB fund and Blue Orchard Microfinance Securities with 122% and 114% growth respectively.

Round 2 Survey - 14 MIVs

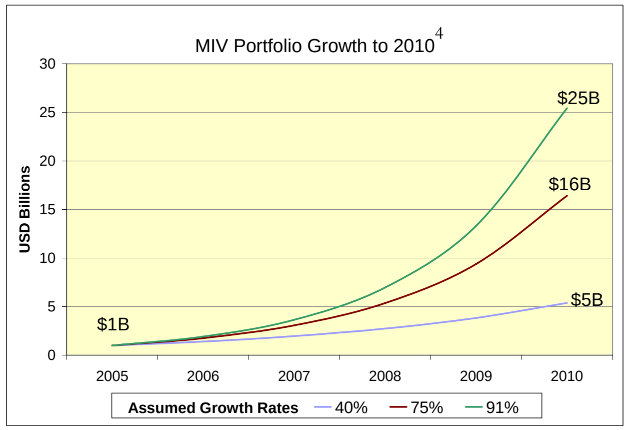
MIV Name	Microfinance Portfolio (USD Millions)	Total Assets (USD Millions)
Oikocredit	126.3	342.7
Blue Orchard MF	81.3	84.0
Dexia MC	69.0	88.5
responsAbility GMF	40.1	43.1
Calvert	23.2	122.1
Lacif	20.6	20.8
Asn-Novib	20.0	41.9
MicroVest	13.5	15.9
Triodos Fair Share	13.2	19.7
Accion IM	11.7	13.8
Impulse	10.3	11.3
Alterfin	4.9	13.8
Incofin	4.5	6.6
Global Partnerships	2	2

Not surprisingly, the more commercial MIVs tend to invest in debt. Equity investments are still seen as comparatively risky and exits from equity can be difficult. As the debt market becomes more competitive and the equity market becomes more transparent with real exit alternatives, a secondary market will develop and commercial MIVs will become more important players in equity as well.

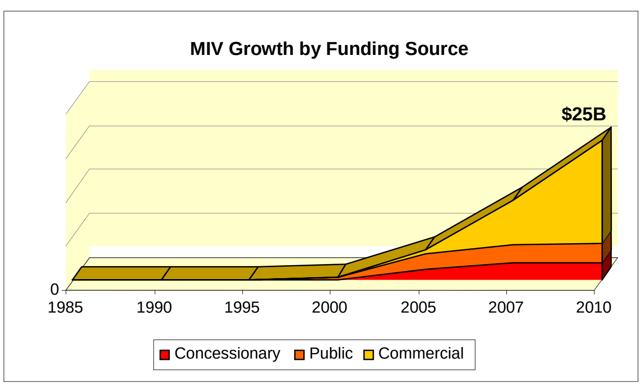
Geographically, MIV microfinance portfolios are heavily concentrated in Latin America. As competition for top tier MFI investments increases MIVs are beginning to look to other markets such as Eastern Europe and Central Asia. Africa remains under-served by MIVs.

TRENDS & IMPLICATIONS

Changing Funding Sources – Funding "Hardens" as MIVs Grow

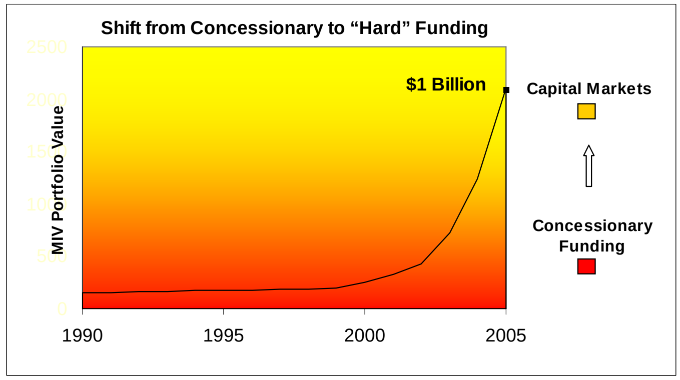


The growth of microfinance over the last decade has been remarkable, but it has still penetrated only a relatively small part of its potential market. Given the demand, rapid growth will continue. Today's flow of funds through MIVs is still only a small fraction of what it could, and one day will be. As MFI demand for funding increases worldwide from tens of billions to the hundreds of billions of dollars, international funding flows through MIVs will also grow. MFIs will exhaust the donor and philanthropic money that they have depended on in the past. They will have to seek new funds from deeper wells. Even if MIV market growth tapered from its current rate of 91% to the MicroRate Latin American MFI Index growth rate of 40%,[4] the total microfinance portfolio would reach $5 billion in 2010. If current growth rates continue, the total microfinance portfolio could reach anywhere from $16 to $25 billion.



Clearly, actual growth rates will vary, but it is equally clear that the MIVs will have to mobilize very large amounts of capital. In the early days MIVs obtained their funding nearly entirely from donors. In the last five years or so, International Financial Institutions (IFIs) and investors willing to give on concessionary terms became the dominant funding source for many MIVs. More recently MIVs have turned to commercial funds. The CDOs (Collateralized Debt Obligations) issued since 2004 bear testimony to this progressive hardening of the terms at which MIVs fund themselves. MicroRate believes that this shift to more commercial funding sources will continue and even accelerate.

So far investors have often been microfinance enthusiasts. For many of them, it was enough to know that their money would go to microfinance and that they would recover their principal. If in addition they earned a small return as well, that was welcome news, but it was not a decisive factor. Development MIVs cater to this market. The largest MIV (Oikocredit), for example, caps returns to investors at 2%. Other MIVs have similar restrictions. But the pool of enthusiast investors is not large enough to meet future MIV funding requirements. As MIVs grow and multiply, they have to deal with social investors seeking real double bottom line returns and eventually with true commercial investors. This is already visible in the CDOs, which are aimed at a more commercial public. To attract investors, CDOs pay relatively high interest and protect senior lenders through a large cushion of subordinated funding.



As MIVs outgrow the pool of "enthusiast" investors, the present lack of transparency in the MIV sector is making itself felt. Investors – even socially responsible ones – want to be able to compare performance and to judge MIVs based on their track records. If this information is not available, they will turn to the innumerable investment alternatives that are vying for their money. The shift from philanthropic to purely commercial investors does not only mean that the cost of borrowing rises; it also affects information requirements, especially regarding risk and return. Sooner rather than later, investors will expect the same amount and quality of information on MIVs that they are used to from other investment opportunities. Only at this point will microfinance be considered an asset class.

Microfinance is in rapid transition to becoming capital-markets based. Capital-market funding itself, which originally started out mainly with philanthropic support ("socially responsible investors") is beginning to approach the status of a mainstream investment opportunity. A recent report commissioned by the World Economic Forum[5] concludes that "this transition from philanthropic capital to financial investment is a particularly unusual and even anomalous event in the history of capital markets". The transition holds unprecedented promise in that it will tap the vast resources of the markets, but it also presents large dangers if "significant new blended value investments turn out to be founded on poor due diligence or faulty risk management." A few imprudent investments could set back the transition by years. MicroRate's review of MIVs revealed a rapidly evolving industry coupled with the early signs of over-enthusiasm for microfinance. The exposure and excitement generated by Professor Yunus' Nobel Peace Prize has done nothing to cool down the situation. In such an atmosphere it is increasingly likely that bad investment decisions will be made.

[1]In this review the term "investor" is used for both lenders & equity investors.

[2]The 2004 CGAP/KfW survey, which identified 43 MIVs, was carried out by Patrick Goodman. It mostly measured assets and microfinance investments as of December 2004. However, some MIVs reported numbers for June and March 2003, which makes an exact comparison difficult.

[3] The equity & debt composition is heavily influenced by ProCredit Holdings AG. If that vehicle is removed, debt, equity & guarantees would compose 85%, 14% and 1% of the aggregate MIV Microfinance Portfolio, respectively.

[4]Growth rates reflect the growth of the MIV Universe from 2004 to 2005 of 91%, a slightly more conservative rate of 75% reflecting the 3 year average growth rate of the Round 2 MIVs and a rate of 40% that corresponds to the five year average growth rate in the MicroRate Latin American MFI Index from 2001 to 2005.

[5]Blended Value Investing: Capital Opportunities for Social and Environmental Impact. World Economic Forum, March 2006.