



## **Microfinance Investing: Doing Well by Doing Good**

*By Joan Trant, Executive Director*

Microfinance provides financial services to low-income individuals lacking access to the formal banking sector. From a revolutionary beginning in the 1970s, microfinance now encompasses 10,000 charitable organizations and regulated financial institutions across the globe, which offer an array of financial services to the base of the socioeconomic pyramid.

Microfinance institutions (MFIs) provide products and services like loans, savings, insurance and remittances to low-income clients such as bakers, weavers, shoemakers and seamstresses. As MFIs become financially self-sustaining, they are often transforming from nonprofit entities to regulated financial institutions. This permits MFIs to tap commercial sources of capital, and microfinance funding has shifted from primarily donors to market-oriented investors, increasing the flow of funds to microfinance and helping more unbanked poor communities access financial services. Investors may make direct investments in MFIs and indirect investments in microfinance investment vehicles (MIVs). Total investment in the microfinance sector has expanded to around US\$35bn, but an additional US\$265bn is needed to provide financial services to the world's 1.5 billion working poor.

Funding for microfinance comes from local and international sources. Foreign private sector capital has fueled microfinance's double-digit growth, spawning the creation of 109 MIVs, which channel over US\$13 billion, or approximately half of all investment from private sources, into MFIs. MIVs may offer fixed income, equity or blended investment options and run the gamut of registered mutual funds, private equity funds, microfinance bank holding companies and structured finance vehicles.

The market demand for microfinance is significant. Penetration in eight large emerging countries is below five percent, and the industry overall offers a 15x growth factor. MFIs exhibit attractive business attributes for investors: 1) a loyal client base to lower acquisition costs, 2) high interest rates to cover hefty operational expenses, 3) high loan repayment rates due to strong portfolio quality, and 4) high solvency and liquidity resulting from short loan tenors. In addition, microfinance offers investors broader emerging market diversification, thanks to exposure to countries not typically covered by emerging market instruments.

Lending remains the predominant investment strategy, but investors increasingly seek equity opportunities. Currently, equity represents 30% of total funding.

In 2008, microfinance outperformed most other components in investors' portfolios, with debt returns in the 4.9-17.0% range. While resilient, microfinance is not immune to the global financial crisis, and 2009 debt returns were lower, at 3.1-15.2%, depending upon MIV strategy and performance. According to a recent J.P. Morgan-CGAP MFI valuation study, 2009 return on equity

(ROE) ranged from -3.2% (Tajikistan) to 26.7% (Cambodia), averaging about half the ROE in 2007-08 (ROE is much higher in India). Equity investors expect 9-20% ROE in 2010, targeting internal rates of return (IRR) of 15-20%, although more conservative analysts anticipate lower returns.

As a nascent industry, microfinance poses daunting hurdles for investors: short track record, low transparency, no deal standardization, no secondary market for assessing value or trading assets and few exit strategies. The effects of the global crisis have slowed MFI growth and precipitated some infrequent yet cautionary debt restructurings.

Despite the challenges, the microfinance sector presents a unique investment opportunity for investors seeking social impact and financial profits that can range from below market to risk-adjusted and even premium returns. Microfinance presents an attractive opportunity for investors with global focus, tolerance for illiquid assets, a long-term investment horizon, an understanding and acceptance of the assets' risk profile, leniency regarding short industry track record and the dual goal to pursue financial return and social impact.

To learn more and add your voice to the dialogue, please participate in one or both of the microfinance-related sessions during the Canadian Responsible Investment Conference 2010: Tuesday, June 15, 1:30-2:15 pm, *Microfinance Investors Forum* (workshop) and Wednesday, June 16, 11:00am-12:00 noon, *International microfinance: Making microfinance institutions a new asset class* (panel discussion).

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