



Social sector finance: strength in numbers

Last year I was asked to head up an exciting new investment banking initiative at JPMorgan called Social Sector Finance (SSF) after a sabbatical during which I worked and volunteered my time in the social sectors. I am delighted to share the strategy and goals of SSF with clients of the Private Bank.

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The market opportunity

Social Sector Finance is a response to an enormous global market opportunity. Nearly half the world's population – living on less than \$2 per day – lacks access to a broad range of reliable or affordable services (health, education, housing, communications, financial, to name a few). The latent demand for such services among the poor and the potential efficiency gains to these communities are huge, from city slums to remote villages. A growing range of programmes and institutions, many led by social entrepreneurs, has demonstrated that – if products are well-designed to meet the needs of the poor – the base of the economic pyramid can be served effectively and profitably, providing both an economic and a social return (the so-called 'double bottom line').

Microfinance is the best demonstration of the potential for financially sustainable enterprise to have scaleable outreach and social impact. Microfinance is the provision of basic financial services (including credit, savings, money transfers, and insurance products) to the poor. In the last 10 years, the sector has undergone explosive growth with the number of microfinance institutions around the world exceeding 1,000 and the global customer base increasing from roughly 10 million in 1997 to over 130 million in 2007.

The potential demand for microfinance is estimated at roughly 1.5 billion people, nearly one-quarter of the world's population. If we assume an average loan size of \$200 per customer, the total funding requirement for this market amounts to approximately \$300 billion, from \$26 billion today. While many early microfinance institutions (MFIs) started as non-governmental, non-profit organisations, many achieved profitability quickly and found that in order to achieve real scale and outreach, they needed to transform to commercial financial institutions both to borrow on the capital markets and attract local deposits.

The seeds of microfinance were planted some three decades ago under the leadership of a few visionary trailblazers in Bangladesh – most notably Fazle Hasan Abed, who founded BRAC, and Mohammad Yunus, who founded Grameen Bank and went on to win the Nobel Peace Prize

in 2006. (See box for a brief case study of BRAC.) Significant support from international development lenders ('the IFIs'), extensive international coordination and publicity via the Microcredit Summit Campaign launched in 1997 and the United Nations' Year of Microcredit in 2005, and finally the awarding of the Nobel to Yunus, combined to catapult the sector onto the radar screen of both socially motivated and mainstream capital markets players.

Social enterprise case study: BRAC

BRAC, founded as the Bangladesh Rural Advancement Committee in 1972 and led by Fazle Abed, started as a small relief effort following the war of liberation and has since become the world's largest development organisation and among its most innovative social enterprises. Its mission is poverty alleviation and empowerment of the poor, especially poor women, and its holistic, responsive approach encompasses everything from health services and schools to agricultural training and microfinance. BRAC's national immunisation campaign led to the full immunisation of 82% of children under two; its national oral rehydration campaign covered 81% of the population; and its non-formal primary school programmes have helped equalize the boy:girl ratios in schools. Its highly successful microfinance programme, which targets the very poor and includes start-up programmes for the ultra-poor, proves that a balance can be struck between the goals of profitability and affordability for borrowers. As of end-2006, it reached nearly five million borrowers, its return on assets was 6.9%, return on equity 23%, and portfolio write-offs just 0.63%.^{*} BRAC has since expanded its microfinance programme globally into Afghanistan, Sri Lanka, and sub-Saharan Africa, making BRAC, in short, a multinational MFI and social conglomerate.

^{*} Source: www.mixmarket.org

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The range of microfinance investors has broadened significantly in the last five years. Socially responsible investors and mainstream institutional investors joined IFIs to increase the capital base of institutions serving the sector. A plethora of private investment funds for microfinance (microfinance investment vehicles, or MIVs) has cropped up: as of April 2008, a total of 99 MIVs and 1,176 MFIs were listed on The Microfinance Information Exchange, a public web-based microfinance information platform (see www.mixmarket.org). According to the Consultative Group for Assistance to the Poor (CGAP), a leading consortium working to expand access to financial services, the investment portfolio of MIVs grew more than three-fold to \$2 billion from 2004 to 2006. IFI portfolios more than doubled to just over \$2 billion in the same period. Past yields on fixed income investments for the more mature MIVs have ranged from 2.6% to 5.1% in US dollars, reflecting their ability to attract ‘double bottom-line’ investors.¹

How JPMorgan is involved

JPMorgan has been actively involved for decades in serving the poor in the developing world, mainly through the JPMorgan Chase Foundation. With the growth of commercially viable MFIs and social investing, we thought carefully about how we could best participate in and serve this growing market. While socially motivated work traditionally has been the remit of philanthropy and the public sector, we thought it critical that SSF be set up as a commercial initiative, independent of the firm’s corporate foundation. As such, SSF has three aims:

- 1 To provide a full range of investment banking products and services to MFIs and other enterprises serving the base of the economic pyramid, with a primary focus on developing countries;
- 2 To offer socially motivated investors with opportunities to invest in and support such enterprises; and

- 3 To invest JPMorgan’s own capital directly – via a principal investing initiative – in the equity of MFIs and selected microfinance funds and thereby deepen both in-house expertise in microfinance sector investing and the firm’s relationships with promising MFIs.

Prospective clients of SSF are likely to either explicitly or implicitly seek a ‘double bottom line’ of both profitability and positive social impact or, in more popular terms, to do well while also doing good. That said, a wide range of opinions exists as to the appropriate balance between these two goals (see below).

The double bottom-line challenge

Running a business or investment portfolio with the twin objectives of social and financial return raises a number of complex issues, including finding the right balance between the two objectives and measuring social performance. For investors, it also poses a number of risks, including: the risk that an enterprise exaggerates its social impact or falsely claims to be contributing to poverty alleviation (for example, some consumer finance companies have ‘dressed themselves up’ as microfinance providers to gain from the media hype around the sector); and the risk of enterprise ‘mission drift’ – gradually favouring profitability to the detriment of social impact. One problem is the lack of generally accepted standards for the measurement of social impact and performance. In microfinance, most institutions rely on simple proxy indicators such as growth in number of customers, share of women borrowers, average loan size as a percentage of per capita income, etc.

While consensus exists that an MFI’s social impact and financial self-sustainability are mutually reinforcing, a healthy debate arises as to the appropriate level of profitability. The question is: what is the appropriate level of interest rates to charge the poor? Many are shocked to learn that, even among the most socially oriented MFIs, annualised effective interest rates on microloans are commonly in the range of 30%, reflecting the high operating costs of managing a large portfolio of tiny

¹ CGAP Brief, April 2007, “Microfinance Investment Vehicles” (www.cgap.org).

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loans, often with weekly collections and highly personalised customer interactions. At the same time, repayment rates on microloans commonly exceed 95% because maintaining access to financial services is critical for poor borrowers with limited alternatives and because the returns to a micro-entrepreneur on a small amount of working capital are potentially very high.

The most important event to draw attention to these questions was the initial public offering of Compartamos, Mexico's largest MFI, in April 2007. Since its inception in 1996, Compartamos' borrower base grew from 27,000 to 840,000 by year-end 2007, 98% of whom are women. Compartamos commands 60% of the outstanding market for microfinance in Mexico, which is vastly unpenetrated. The IPO valued the company at over \$1.5 billion, was 13 times oversubscribed, and implied a 100% annual return over eight years for the original investors. With an average interest rate on its largest loan product of 82%, Compartamos' net interest margins exceed 60%, its return on equity exceeds 45% (compared to 7-8% and 20-25% for other Latin American commercial banks), and its write-off ratio is 0.6%.

Compartamos' high level of profitability has drawn criticism from some quarters of the microfinance industry based on the belief that it is inappropriate to earn high profits while serving the poor. Others submit that Compartamos has provided one of the best demonstrations of a business model that has successfully and rapidly achieved scale in serving the poor and that the sheer growth in customer demand is evidence of the critical services they are providing. Moreover, the success of Compartamos has been a catalyst for increased competition, which has helped to lower interest rates.

JPMorgan's approach to these issues is straightforward. In our view, responsibly and well-managed businesses with a clearly defined social mission are the best and most sustainable vehicles for providing much-needed services to the poor. The most important prerequisite in our decision to raise capital or invest directly in such a business is comprehensive due diligence – analysing the

business model, quality of execution and management, and, importantly, whether the shareholders, management and employees are committed and accountable to the business' social mission. We have no *a priori* conclusion on the 'right' level of profitability for such enterprises but believe that an open playing field and sound regulatory structure will induce the competition needed to achieve the right level. For its own part, JPMorgan's SSF unit seeks, at a minimum, to cover its costs while its principal investing component looks to achieve a positive return on capital, albeit with a lower assigned hurdle than would generally apply to emerging market private equity/venture capital investing.

How you can take part

Whether you are interested in making microfinance or other types of social enterprise a part of your investment or philanthropic portfolio, your wealth management advisor at JPMorgan can help you think about a range of options. JPMorgan's SSF unit is planning to arrange equity and debt vehicles for microfinance investors and has established a broad array of partnerships with leading organisations in the field. A good way to get started might be to visit a local microfinance programme in a country of your choice, which we could help arrange. After all, there is no better way of judging the impact of microfinance than seeing it with your own eyes.



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