CGAP

CGAP Brief

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Microfinance Investment Vehicles

Foreign capital investment in microfinance is surging. Cross-border investment has more than tripled in the last two years to reach US$1.4 billion in 2006.[1]

Two main players are driving this phenomenon: international financial institutions (IFIs)—the private-investment arm of public development agencies—and private investment funds, known as microfinance investment vehicles (MIVs). IFIs have played an important role in commercializing microfinance by providing seed capital to young microfinance institutions (MFIs) and bridging the gap between grant funding and domestic funding. IFIs were behind the creation of most of the early MIVs, which offered IFIs a more efficient way to invest in the sector than direct MFI investments. Now, MIVs are gaining ground and finding other investors, including private investors. A new CGAP survey shows that while IFIs' microfinance portfolio (including investment in MIVs) more than doubled from US$1 billion in 2004 to US$2.3 billion in 2006, MIV portfolios grew more than threefold during the same period, from US$600 million to US$2 billion.[2] This note summarizes the survey findings and explores the implications of the rapid growth of MIVs for the microfinance industry.

This Brief is based on two studies conducted in the last quarter of 2006: a CGAP study on IFI microfinance portfolios and a joint CGAP-MicroRate research on MIV trends.

[1] IFIs and MIV direct investments to microfinance providers in 2006.

[2] According to the CGAP-MicroRate survey, MIV portfolio outstanding in microfinance (including debt, equity, and guarantee) was US$2 billion as of December 2006. IFI funding accounts for 34 percent of this amount.

The Changing Landscape of MIVs

In the past two years, MIVs have grown in number, scale, and product offering. Thirty new funds were set up in 2005 and 2006, bringing the total to 74. Outstanding portfolio grew 110 percent per annum to reach US$2 billion. Euro and dollar fixed income still dominate, but equity and local currency options are growing.

Although private capital is now investing in MIVs, it is not strictly commercial capital. Investors are socially responsible investors, such as individual investors and foundations (47 percent); IFIs, such as IFC, FMO, and KfW (36 percent); and institutional investors, such as pension funds, with a double bottom line (17 percent). Individual socially responsible investor appetite is growing as microfinance gains profile, and mainstream institutional investors are showing increasing interest. A recent example is the US$43 million equity investment by TIAA-CREF, a major U.S. pension fund, in Procredit Holding, one of the world's leading microfinance companies.

Most MIVs are very small in size (86 percent have less than US$20 million under management), and the average MIV investment size is US$1 million, far smaller than the average IFI investment of US$3.9 million, suggesting that MIVs are reaching out to smaller MFIs than are the IFIs.

Returns are close to money market. The more mature fixed-income MIVs' yields range from 2.6 percent and 5.1 percent in U.S. dollars,[3] reflecting

[3] Symbiotic Microfinance index USD shows annual yield between 2.6 percent and 5.09 percent. See http://www.symbiotics.ch/en/smx/smx_usd.asp.

the fact that investors seek both social and financial returns. As a young market with a long-term horizon, it is no surprise that equity funds have yet to produce significant returns, even though underlying MFI investees show very strong returns on equity. High fund costs-to-assets ratios, low dividend pay-out policies, and limited exit options cap equity fund returns in these early stages of market development.

The MIV market is concentrated in many respects. The top 10 MIVs account for 67 percent of the aggregate portfolio. A quarter of MIV investments are concentrated in just 10 MFIs. That said, MIV funds are invested in a larger pool of MFIs than IFIs are.[4] In terms of instruments, MIVs are primarily invested in fixed income, of which 70 percent is hard currency. Recently, mainstream financial structures, such as securitizations, collateralized debt obligations, and credit wraps, are being adopted for microfinance investors. Finally, there is regional concentration, with 81 percent of MIVs in Eastern Europe, Central Asia, and Latin America.

Emerging MIV leaders, with assets over US$200 million, include the following:

- BlueOrchard, a fund management company focusing on top-tier MFIs, now has US$450 million under management, with three funds and two collateralized debt obligations.[5]
- Procredit Holding AG, the parent company of 18 microfinance banks, has a portfolio of more than US$390 million.
- Oikocredit, a cooperative society intermediating funds for social investors in the Netherlands, has US$260 million in outstanding loans to 307 MFIs.

Specialization into Niche Markets

With more funders vying to occupy the space, MIVs are moving into niche markets through new investment strategies or structures. Some of the new strategies include funds targeting smaller MFIs (Luxmint), holding companies inspired by the Procredit model (Access, Axa, Lafayette), equity funds (Unitus, Africap), country-level funds (Bellwhether Fund in India, Jaida Fund in Morocco), and funds that invest in other funds (Gray Ghost). It is encouraging that some funders are offering local currency or local currency linked products. For instance, IFC, FMO, and KfW set up Lok Capital to provide equity capital to smaller, emerging MFIs in India.

Opportunities but Also Challenges

The surge in foreign private capital in micro-finance is a positive indicator of investor confidence. Although most MIV funding comes from socially oriented investors (including IFIs), mainstream investors, albeit with a social impetus, are increasingly interested. The rapid growth of MIVs also points to several challenges:

- With 74 funds chasing a limited pool of MFIs, there is considerable fragmentation and cost duplication. Consolidation would increase efficiency.
- There is little transparency regarding MIV performance. Performance standards and greater transparency are critical.
- There is an urgent need to better define the roles and comparative advantage of public and private investors in this rapidly changing landscape, and who should be bearing the greater risk tolerance. This should start first and foremost with the understanding that “private” does not mean “commercial” or profit maximizing. The real opportunity for micro-finance is to tap into the huge and growing socially responsible private investor market.

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[4] In 2006 MIVs invested in 475 MFIs, while IFIs invested in just 207 MFIs.

[5] These Collateralized debt obligationss pool loans to MFIs. They are securitized and sold to investors.

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