

Microfinance Investors Adjust Strategy in Tougher Market Conditions

Microfinance Investment Vehicles (MIVs) in 2010 are confronting the most challenging investment environment since the 1990s. Over the past two years, microfinance investors witnessed a handful of debt defaults and a major slowdown in demand for capital from microfinance institutions (MFIs)—a sharp contrast after the heady market growth experienced in previous years. However, MIVs continue to grow and earn positive returns.

MIVs' total assets under management grew by 25 percent, with 11 new funds established in 2009. The returns of fixed-income funds remain positive at 3.9 percent, although they declined compared to 2008. Support from investors to the sector remains strong. Private institutional investors are the main source of MIV funding (46 percent of total MIV funding sources), followed by retail investors and high net worth individuals (33 percent), and public investors (21 percent).

This Brief presents the major trends within the MIV sector to emerge from this year's CGAP MIV survey, powered by Symbiotics. It also highlights the growing commitment among MIVs to sound environment, social, and governance (ESG) practices. The last section discusses MIV challenges and prospects.

Local Currency Funding Growing Strongly

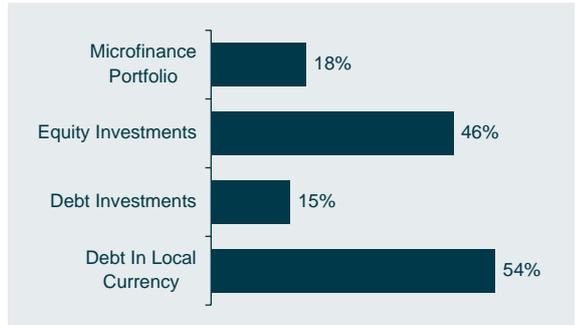
More than 50 percent of foreign capital investment in microfinance, estimated at US\$12 billion, is managed by MIVs. As of December 2009, there were 91 active MIVs with total assets under management of US\$6.2 billion. MIV growth slowed for the third consecutive year, easing to 25 percent in 2009, from 34 percent in 2008 and 86 percent in 2007. This sharp deceleration paralleled the drop in MFI growth over the last two years observed in data from MIX. According to the SYM 50¹ Index, MFI growth slowed to 28 percent at the end of 2009 from 51 percent in 2007.

MIVs are invested predominantly in fixed-income instruments (84 percent of the portfolio). However,

equity investments are growing much faster, at 46 percent in 2009, against 15 percent for debt investments. This is good news for the sector as such investments are needed to strengthen the equity base of distressed MFIs, as well as to propel MFIs in high-growth markets such as India.

MIV local currency debt also increased by 54 percent, and it now accounts for 31 percent of all outstanding direct debt investments. This rapid increase in local currency funding is welcome by the microfinance sector as it helps to reduce MFIs' foreign exchange risk. The growing trend toward foreign investments in local currency reflects MFIs' preference for local currency loans, as well as the availability of new hedging services offered by international banks and specialized facilities, such as TCX or MFX.² The average maturity of foreign debt is stable at 35 months despite the higher risk environment. In several countries, MIVs are providing MFIs with loan tenors longer than what is available on the local market.

Figure 1: Year-on-year Growth Rates in 2009: Local Currency and Equity Investments Stand Out



¹ Sym50 is a benchmark compiling the key indicators of 50 MFIs. It is fairly representative of the types of MFIs that normally receive investments from commercial sources. For more information, see www.syminvest.com.
² For more information see www.tcxfund.com, www.mfxsolutions.com, and Apgar and Reille (2010).

MIVs remain concentrated in just two regions: Eastern Europe (43 percent) and Latin America (36 percent). Investment in Asia continues to grow and now accounts for 15 percent of all MIV direct investments, but in stark contrast, Africa lags well behind—attracting only 6 percent of total MIV direct investment. MIV investments are also concentrated in a few large MFIs. On average, 25 percent of each MIV's portfolio is invested in just five MFI recipients, leaving each MIV highly exposed to single counterparty risk.

Returns Suffering as Cash Holdings Surge

Persistent adverse market conditions pushed MIV fixed-income returns down to 3.9 percent (in U.S. dollar terms) at the end of 2009, representing a significant decline of around two percentage points compared to the end of 2008. For the first time, significant loan loss provisions in MIVs have been recorded (2 percent of the direct debt microfinance portfolio) to cover the risk of defaults of distressed MFIs, such as BANEX in Nicaragua. Cash positions have reached a record high of 17 percent of assets due to the lack of suitable investment opportunities. In addition, MIV income is declining, as more competition is pushing interest rates down and MIV average net portfolio yields have sunk to a historically low level (7.9 percent). However,

MIV returns are still 250 basis points above USD LIBOR, a relatively good performance for fixed-income funds in emerging markets in 2009.

Strong investor demand drove growth of private equity funds by 75 percent in 2009, and assets under management reached US\$391 million. However, it is still difficult to estimate the performance of private equity funds and provide meaningful data on their net internal rate of return as they are still too young (on average 3.1 years old).

MIVs Exhibiting Stronger Commitment to ESG Issues

Although MIVs may have different motivations and return expectations, the majority of MIVs portray themselves as socially responsible investors drawn to microfinance for its potential to deliver both financial and social returns. Results from the CGAP MIV survey indicate that MIVs are increasingly focused on ESG objectives and are improving reporting on their efforts in these areas. For instance, 40 percent of MIVs use an environmental exclusion list³ in their lending process, and 81 percent have endorsed the Client Protection Principles (CPPs),⁴ compared to 61 percent a year earlier. The survey showed that 69 percent of MIVs reported on ESG issues to their investors, compared to 58 percent at the end of the previous year.

Figure 2: MIV Fixed-Income Annual Returns



³ An environmental exclusion list refers to a set of minimum environmental standards/practices and/or a list of activities that cannot be financed by the microfinance financial service provider because of risks on the environment.

⁴ For more information see <http://www.cgap.org/p/site/c/template.rc/1.26.4943/>

Figure 3: ESG Overview of Main Indicators



The data reported by MIVs on the MFIs they are backing show that the majority of borrowers are women (64 percent) and a majority live in urban areas (54 percent). MIV recipients are increasingly offering other products, such as insurance products and nonfinancial services, but microcredit still represents 71 percent of their loan portfolio.

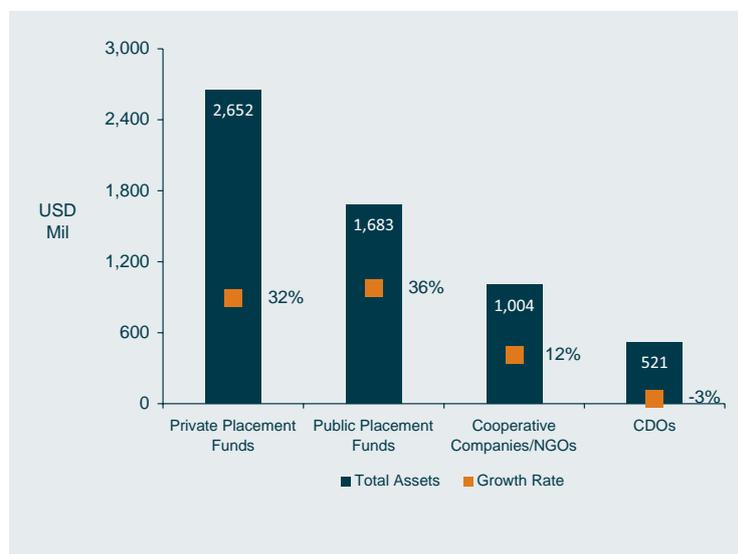
Funding New MIV Peer Group Classification for Investors

MIVs can be categorized into four peer groups⁵ based on their funding base and legal structure.

Private placement funds are open only to qualified investors (private or public). This is the largest peer group, with 44 funds accounting for 45 percent of total MIV assets. Private placement funds are predominantly funded by public investors. They are heavily concentrated in Europe and Central Asia and Latin America and the Caribbean. In 2009, fixed-income private placement funds offered the highest return to investors (5.3 percent).

Public placement funds are the only regulated funds open to retail investors. The 10 public placement funds are all registered in Luxembourg

Figure 4: MIV Peer Groups



⁵ For more details on peer groups, see http://www.cgap.org/gm/document-1.9.47372/CGAP_2010_Benchmarks_Tables.pdf

and Holland due to the favorable legislation in these jurisdictions. They have the highest growth rate (36 percent), reflecting the strong demand of retail investors for microfinance investment options. Their portfolio is well diversified by countries, MFI recipients, and currencies. And they provide the most comprehensive reports on ESG issues.

Cooperative/nongovernmental organization funds are funded by retail investors (68 percent) and private institutional investors (30 percent). These funds have the strongest social orientation. Compared to other MIVs, they have the highest share of investments in frontier markets, such as Africa and the Middle East. They invest in smaller and emerging MFIs, and their average investment size is half the MIV average. Nearly half (47 percent) of their investments are made in local currency. However their cost structure is generally more expensive, and as a result they offer lower return to investors.

Collateralized debt obligations (CDOs) are primarily funded by private institutional investors and are characterized by high average investment size, long-term maturity of MFI debts (over 40 months), and concentration in large MFIs. Given the depressed state of the CDO market overall, this is the only peer group recording a negative asset growth rate in 2009, with only one new microfinance CDO created that year.

Outlook for 2010–2011: MIVs Adjust Strategy in Tougher Market Conditions

MIV asset managers expect a growth rate around 15 percent in 2010, the lowest growth rate reported since the inception of the CGAP MIV survey five years ago. With record cash positions, some asset managers are scaling back their fundraising. For

example, earlier this year, responsAbility temporarily suspended new subscriptions to its Global Microfinance Fund in order to reduce its share of liquid assets from 30 percent to 10 percent. In a still-fragile microfinance environment, asset managers are focusing their efforts on risk management and investment diversification: tightening their investment policies and monitoring processes, renegotiating loan covenants with distressed MFIs, and in some cases doing debt work outs. Fund managers are also actively searching for investment opportunities in large frontier microfinance markets, particularly in Brazil, China, and Nigeria. Others are considering moving up-market and funding small- and medium-sized enterprises or social businesses at the “bottom of the pyramid.”

In the current environment, fixed-income returns are likely to fall further and settle in the 3 percent to 3.5 percent range in 2010. However, they will still offer a significant premium when compared to fixed-income benchmarks, such as LIBOR or EMBI. A return to historical levels of 4–5 percent will be possible only if interest rates increase again and loan provisions return to their historical average. The more competitive MIV environment might put pressure on asset management firms to reduce their management fees. Microfinance asset managers are likely to look for business alliances to gain competitive advantage and improve efficiency. They are also likely to continue to improve their ESG practices to differentiate themselves from other investment funds, and better demonstrate to investors their commitment to social returns.

Reference

Apgar, David, and Xavier Reille. 2010. “Microfinance Foreign Exchange Facilities: Performance and Prospects.” Occasional Paper 17. Washington, D.C.: CGAP, April.

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