



# MIF Retrospectives

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## Investing in Microfinance: Making Money, Making a Difference

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**MIF Retrospectives** is a series of monographs penned by MIF staff that covers various thematic activities undertaken by MIF in recent years.

The third contribution, **Investing in Microfinance: Making Money, Making a Difference** by Tomas C. Miller-Sanabria and Tetsuro Narita takes a look at how microfinance has grown in Latin America and the Caribbean, as well as MIF's pivotal role in strengthening microfinance institutions and promoting investment in microfinance funds.

Edited by Steven Wilson and Norah Sullivan

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# **Investing in Microfinance: Making Money, Making a Difference**

**By Tomas C. Miller-Sanabria and Tetsuro Narita**

## **Microfinance Grows Up**

Small loans are big news. In the first decade of the 21st century the world's microfinance industry has produced a Nobel Prize winner and been hailed as an important tool in the fight against global poverty. Microfinance has helped many thousands of microentrepreneurs to seize opportunities, expand their businesses, and to create jobs and reduce poverty.<sup>1</sup> These microentrepreneurs are classic "owner-operators" who make intertwining business and household decisions; consequently, microfinance also funds consumption in areas such as home improvement, emergency expenses, education and other expenses.

Small loans are also big business. Once the domain of altruistic NGOs and their sponsors, microfinance is now a business model that offers more than just loans, providing a variety of other financial services to microenterprise owners and workers, including short term working capital loans, savings facilities, remittance transfer services, public utility payment services, microinsurance, and more recently, longer term loans. The industry now attracts a growing numbers of individual and institutional investors. The great majority of these participate via professionally managed microfinance funds that channel money (often in the form of equity or loans) to microfinance institutions (MFIs).<sup>2</sup>

The Inter-American Development Bank (IDB) and its private sector instruments, including the Multilateral Investment Fund (MIF), have played a large role in the success of microfinance in Latin America and the Caribbean (LAC). In 1978, the IDB was the first institution to provide loans, without sovereign guarantees, for microcredit projects. This support proved a major shot in the arm for this nascent industry, and IDB projects continued with assistance to help small NGOs test new credit schemes, and then funding for state owned organizations that provided financing to MFIs.

Currently, the design of microfinance projects reflects the continued commercialization of the industry, with investments often structured alongside private financiers and development partners. Modern microfinance transactions are structured in a way that attracts traditional financiers, and also taps both local and international capital markets. Further, MIF now directly participates in the corporate governance of investee institutions in our newer projects.

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<sup>1</sup> See *An Inside View of Latin American Microfinance* (M. Berger, L. Goldmark, and T. Miller-Sanabria, eds.), 2006

<sup>2</sup> Money channeled to MFIs often assumes the form of equity, quasi-equity, and different types of loans, such as emergency, local currency, subordinated and senior loans.

## Seeking a Macro Impact from Microfinance

The growth in the number and outreach of MFIs deepens financial markets, thereby furthering an important goal of development finance. Financial markets in most developing countries are shallow, not deep, with a small financial sector relative to the size of the economy. Shallow financial markets do not provide the majority of families access to financial services, denying them the chance to exploit economic opportunities, productively manage their assets, or accumulate wealth. Deeper financial markets depend on robust institutions – public and private organizations, rules, and laws that enable financial markets to more efficiently allocate resources. To date, these institutions have been weak or non-existent across most of the LAC region.

A multidisciplinary campaign aimed at improving institutions and capacity building among private, public and civil society stakeholders will be required to expand the reach of microfinance. This will involve investors, regulators, bankers, credit bureaus, local authorities, rating companies, staff members, business associations, donors, and microfinance investment funds, among other parties. The public sector plays a critical role in providing a regulatory framework that maintains positive incentives in the form of clear and consistent rules for MFIs, including contract enforcement. It also has an important role in enforcing a set of rules and regulations that aim to help clients, investors, depositors and stakeholders to make more informed decisions. The rationale for regulating financial markets has three main purposes: (a) ensure a stability of the payment system; (b) provide consumer protection against undue risks; and (c) promote efficient performance of institutions and markets (for a detailed discussion of these issues, see Chaves and Gonzales-Vega, 1994, p.56).

MFIs need a wide range of capacity building in order to turn a profit while helping low income clients manage their assets. Effective systems for due diligence, cost control, credit risk management, marketing and product development, information and communications technologies, and a host of other capacities are needed to achieve a double bottom line: financial profits and social impact. Financial results are measured by internal rates of return (IRR) and return on equity (ROE),<sup>3</sup> while social impact is measured by the number of low income “unbanked” clients served and by the quality of the financial services offered. In microfinance, financial and social performance both tends to move in the same direction, a major reason why the industry is so attractive to both private and public players.

Projects in support of microfinance can greatly leverage scarce development finance. This is because global communications and a large number of stakeholders can take profitable demonstration effects to scale in the market, without any further need of assistance. This is a major reason why private funding from local and international sources has replaced public funding from development institutions as the main source of finance for MFIs in the region. Even so, the continued importance of international

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<sup>3</sup> IRR is the discount rate at which the net present value of all cash flows from a particular project equals to zero. IRR is used as a tool for capital budgeting to decide among a group of different investments which one is the most profitable. ROE measures the annual profits as a percentage of equity invested. Both indicators measure the financial attractiveness of an investment.

development funding has led some investors to complain that development finance is crowding out private investment, concentrating their loans in top-tier MFIs leaving private investors to look for opportunities among smaller, riskier ones (see *The Economist*, March 17, 2007, p.84, and Abrams and Stauffenberg, 2007).<sup>4</sup>

An influx of funds into microfinance has also raised concerns of an investment bubble in the industry. Recent launches of several microfinance investment funds have been very successful, and a 2007 IPO by *Banco Compartamos* was oversubscribed by a factor of 13, a huge achievement by any financial standard (Rosenberg, 2007). A rapid and large investment inflow into any industry is a cause for concern. In the case of microfinance, a large supply of loanable funds can lead to the temptation to depart from established loan procedures or relax credit risk analysis in order to book more assets. This will likely have a negative impact on the asset quality of MFIs, thereby increasing credit risk and bad debt and possibly turning investors' current love affair with microfinance into a run for the exits.

While increasing investment may bring risks of excess liquidity, there is also very good scope for increasing competition and innovation in the marketplace. There remains tremendous pent-up demand for microfinance products and a wide range of related financial services across the region. As this market develops, prudent competitors that efficiently fund innovative products at the right price will be rewarded. It should be remembered that it is the underserved market for credit and financial services that has made microfinance an unqualified success in the first place. While banks and other formal lenders ignored the lower income market, microentrepreneurs only had recourse to the moneylender, personal savings – or microfinance.<sup>5</sup>

Microfinance responded to this market by simultaneously serving a growing number of small customers while dispelling myths about the creditworthiness of microentrepreneurs and low-income households. The belated entry of commercial banks into microfinance (or “downscaling”) signals the full recognition of microfinance by the formal financial sector, and vindicates those who have long argued that the industry is both socially and economically viable.

Table 1 shows how individual MFIs in the LAC region compare with the performance of each country's financial sector. In general terms, MFIs' asset quality, as measured by portfolio at risk for more than 30 days, is lower than that of the other financial intermediaries. Profitability measured in terms of return on asset (ROA) and ROE is also

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<sup>4</sup> In September 2007 several leading microfinance funds, a microfinance rating agency, and MIF specialists in microfinance met informally at the IDB in Washington, D.C. This meeting discussed the commercial evolution of microfinance and the appropriate role of international financial institutions versus private investors in microfinance. During this discussion it was agreed that international financial institutions are best positioned to seed the next generation of microfinance institutions and to take structured finance positions, particularly first loss and guarantees, and to help MFIs expand their product offerings in savings, insurance, housing, and infrastructure. Further, the participants will form a task force to address the lack of transparency among MFIs, how to improve the flow of information among different types of investors, and how to establish a useful set of standardized data.

<sup>5</sup> The legal and regulatory framework that permits secured transactions, whereby banks and other formal lenders can collateralize real or moveable property is deficient across most of LAC. This constrains credit creation for all borrowers, not just microentrepreneurs.

higher for MFIs than for the financial sector average. However, the operational expenses required to manage a microcredit loan portfolio are higher than those of traditional commercial lending (see the last column of Table 1). The delivery of microfinance continues to be operationally inefficient, but the overall financial results of MFIs are attracting many banks into this market.

**Table 1. Performance of Upgraded MFIs, Compared to Country Averages (percent)**

| Country     | Institution                           | PAR 30 <sup>a</sup> | ROA   | ROE   | Op. expense/<br>Avg. portfolio |
|-------------|---------------------------------------|---------------------|-------|-------|--------------------------------|
| Bolivia     | Banco Los Andes ProCredit, Bolivia    | 1.95                | 0.60  | 8.00  | 12.50                          |
|             | BancoSol                              | 5.40                | 1.30  | 11.00 | 12.60                          |
|             | Financial sector average, Bolivia     | 13.68               | 0.42  | 4.21  | 6.85                           |
| Colombia    | Finamerica                            | 4.20                | 1.90  | 11.30 | 16.30                          |
|             | Financial sector average, Colombia    | 3.15                | 2.66  | 24.50 | 9.35                           |
| El Salvador | Banco ProCredit, El Salvador          | 2.07                | 1.30  | 10.00 | 12.50                          |
|             | Financial sector average, El Salvador | 2.16                | 1.05  | 9.64  | 4.62                           |
| Mexico      | Compartamos                           | 0.60                | 20.00 | 54.00 | 35.60                          |
|             | Financial sector average, Mexico      | 1.99                | 1.91  | 15.69 | 5.08                           |
| Nicaragua   | Banco ProCredit, Nicaragua            | 1.89                | 4.00  | 25.10 | 15.90                          |
|             | Financial sector average, Nicaragua   | 2.38                | 2.17  | 26.80 | 9.55                           |
| Peru        | MiBanco                               | 2.90                | 5.80  | 33.90 | 18.80                          |
|             | Financial sector average, Peru        | 2.68                | 1.53  | 21.28 | 6.81                           |

a. Portfolio at risk for more than 30 days. This ratio is estimated by adding the past due loan portfolio and loans in legal recovery and calculating them as a percentage of the total portfolio.

b. Operational expense / average portfolio.

Source: Berger et. al. (2006, p.57)

Microfinance is attracting more than funding, but powerful new partners with international networks and cutting-edge ideas. Major sources of funding that dwarf public donors, from groups such as *The Bill and Melinda Gates Foundation*, *the Omidyar Network*, *Gray Ghost Microfinance Fund*, *the Unitus Fund*, *Andromeda Fund*, *Global Partnerships Microfinance Funds*, and many other private philanthropists and socially responsible investors seek new development models to increase access to finance for a much larger group of entrepreneurs and households. As Friedman argues “today’s best companies are the best collaborators for a simple reason: the next layers of value creation...are becoming so complex that no single firm or department can master them alone” (Friedman, 2006, p.439). Microfinance is no exception.

New partners will also benefit by working with grassroots MFIs, such as rural cooperatives and NGOs that serve the very poor. These pioneers are the inventors of microfinance, having been providing credit to microenterprises and lower income households all along. The success of the microfinance industry is a function of their innovation, risk taking and local presence. The confluence of funding, ideas, and on the ground networks augur well for a continued flow of services targeted on the needs of the poor.

## Buying Direct: Equity Investments in Microfinance

The Inter-American Investment Corporation (IIC), a part of the IDB group, was one of the first development institutions to invest directly in the equity of an MFI. In 1990 the IIC invested US\$1,350,000 in BancoSol<sup>6</sup> of Bolivia, thereby providing about 25% of its capitalization, while a separate group of Bolivian and other investors provided the lion's share of capital. In 1993, the MIF took over as the lead IDB investor in MFIs and continued to invest directly in the equity of these institutions. In February 1994, the MIF invested US\$800,000 in the equity of *Financiera Calpia*, a Salvadoran MFI, to expand credit for microenterprises and to facilitate its transformation from an NGO into a regulated formal sector financial intermediary. In December 2000, the MIF exited this investment with an IRR of 26.7% on its investment. In addition, *Financiera Calpia* had a credit portfolio that was 13 times larger than when MIF originally invested; with 1,000% more clients, eight additional branches, 61 new credit officers, and almost three times more clients per credit officer. Table 2 summarizes the developmental and financial results of this MIF investment.

**Table 2. MIF Investment in Financiera Calpia, El Salvador**

|                                  | At Approval (1994)   | At Exit (2000)  |
|----------------------------------|--|---|
| <b>FINANCIAL RESULTS</b>         |  |   |
| <b>Investment</b>                | Acquisition price: US\$716,743                               | Price at sale: US\$2,658,388  |
| <b>IRR</b>                       | Projected: 26.9%   | Actual: 26.7%   |
| <b>DEVELOPMENTAL RESULTS</b>     |  |   |
| <b>Institutional building</b>    | NGO<br>Limited leverage capacity<br>Limited growth potential | For profit regulated intermediary<br>Savings and deposit mobilization<br>Sustained growth pattern |
| <b>Outreach</b>                  |  |   |
| Credit Portfolio (US\$ millions) | 1,988  | 26,517  |
| Number of Clients                | 3,468  | 34,390  |
| Branches                         | 5  | 13  |
| Credit Officers                  | 27   | 88  |
| Average Credit (US\$)            | 530  | 771   |
| <b>Efficiency</b>                |  |   |
| Operating Expenses/Portfolio     | 26%  | 16%   |
| Clients per Credit Officer       | 128  | 349   |

Source: Authors' compilation.

In 2004, *Financiera Calpia* became a full-fledged bank, and was renamed *Banco ProCredit El Salvador* (see Berger et al., 2006, chapter 2). By the end of 2007, *Banco*

<sup>6</sup> At that time the name of the project was *Cobanco*. The *Cobanco* project consisted of the establishment of a private commercial bank to provide credit, savings and other financial services to the Bolivian microbusiness sector, whose needs were not served by the existing commercial banks. The evolution of *Prodem*, an NGO that had been providing microloans since 1987 into *Cobanco*, was intended to achieve greater growth, greater efficiency and access to broader and sustainable of financing.

*ProCredit El Salvador* had amassed total assets of US\$231 million, an equity base of US\$20 million and a client portfolio of 70,000 microentrepreneurs.

In 1994 MIF approved another equity investment of US\$400,000 to help an NGO in Bolivia, *Caja Los Andes*, become a formal financial intermediary. In 2001, MIF exited this investment leaving *Caja Los Andes* with a credit portfolio of US\$42 million, seven times larger than in 1994. This institution was granted a full banking license at the beginning of 2005 and now called *Banco Los Andes ProCredit* continues to expand its outreach with total assets of US\$324 million, an equity base of US\$33 million and 94,000 active clients as of December 2007. Table 3 summarizes the developmental and financial results of this MIF investment.

**Table 3. MIF Investment in Caja Los Andes, Bolivia**

|                                 | At Approval (1994)   | At Exit (2001)  |
|---------------------------------|--|---|
| <b>FINANCIAL RESULTS</b>        |  |   |
| <b>Transactions</b>             | Loan: US\$1,400,000<br>Equity: US\$400,000<br>T.A.*: US\$200,000 | Loan: US\$1,400,000 + interests<br>Equity: US\$1,005,780  |
| <b>Yield</b>                    | Loan (interest): 10.2%<br>Equity (expected IRR): 18%             | Loan (interest): 10.2%<br>Equity (realized IRR): 17.9%  |
| <b>DEVELOPMENTAL RESULTS</b>    |  |   |
| <b>Institutional Building</b>   | NGO<br>Limited leverage capacity<br>Limited growth potential     | For-profit regulated intermediary<br>Savings and deposit mobilization<br>Sustained growth pattern |
| <b>Outreach</b>                 |  |   |
| Credit Portfolio (US\$ million) | 6  | 47  |
| Number of Clients               | 15,954   | 41,665  |
| Branches                        | 8  | 17  |
| Credit Officers                 | 47   | 110   |
| Average Credit (US\$)           | 515  | 1,087   |
| <b>Efficiency</b>               |  |   |
| Clients per Credit Officer      | 339  | 379   |

\* T.A. = Technical Assistance

Source: Authors' compilation based on *Caja Los Andes* (1995 and 2000).

Other direct investments followed in the Dominican Republic (*Banco de la Pequeña Empresa*), Venezuela (*Bangente*), Nicaragua (*Findesa*), and Peru (*Crear Arequipa*). MIF remains an active investor in *Crear Arequipa*, while investments in the Dominican Republic, Venezuela and Nicaragua are now in the hands of local bankers. Again, the developmental impacts of these operations have been extraordinary. Even in the face of significant macroeconomic devaluations, the performance of MIF investments in *Bangente* and *Banco de la Pequeña Empresa*, was very satisfactory.<sup>7</sup> In case of *Findesa* deal, MIF exited with an IRR of 40.0% with the number of clients 5.5 times greater than

<sup>7</sup> For instance, when MIF invested in *Banco de la Pequeña Empresa* (1997) and in *Bangente* (1998), the exchange rate was 1 US\$ = 14.27 Pesos and 1 US\$ = 547.56 Bolivares. At the time of exit the exchange rate was 1 US\$ = 30.83 Pesos and 1 US\$ = 2,089.75 Bolivares, respectively.



when MIF invested. Several new direct investments in Mexico, Honduras, Colombia and the Dominican Republic, have been approved by MIF (see Table 4). Unlike the first investments in which the upgrading process led from NGO to *financiera* and then to bank, the most recent direct investments skip the *financiera* stage and create banks from the outset, thereby raising more investment. MIF also has a couple of outstanding equity investments in a factoring company (*Credifactor*), a mortgage company (*MiCasita*) and a microinsurance company (*ParaLife*).

**Table 4. MIF's Direct Investment Project Track Record**

| <b>Direct Investments: Exited</b>               | <b>Year of Investment</b> | <b>Amount of Original Investment (US\$)</b> | <b>Years in Portfolio</b> | <b>Total dividend + Sale Value at Exit (US\$)</b> | <b>Capital Gain (Loss) (US\$)</b> | <b>Number of Clients at investment at exit</b> |                | <b>Achieved IRR (%)</b> |
|---|---------------------------|---|---------------------------|---|-----------------------------------|--|----------------|-------------------------|
| 1) Financiera Calpia (El Salvador)              | 1997                      | 716,743                                     | 6                         | 2,658,388   | 1,941,645                         | 3,468  | 34,390         | 26.7                    |
| 2) Caja Los Andes (Bolivia)                     | 1997                      | 400,000                                     | 6                         | 1,005,780   | 605,780                           | 15,954   | 41,665         | 17.9                    |
| 3) Banco de la Pequeña Empresa (Dominican Rep.) | 1997                      | 579,111                                     | 6                         | 214,507   | -364,604                          | 0  | 4,000          | -15.3                   |
| 4) Bangente (Venezuela)                         | 1998                      | 587,064                                     | 7                         | 529,148   | -57,916                           | 0  | 26,392         | -1.5                    |
| 5) BANSEFI (Mexico)                             | 2006                      | 2,175,608                                   | 1.25                      | 2,139,706   | -35,902                           | NA   | NA             | -1.32                   |
| 6) FINDESA (Nicaragua)                          | 2003                      | 500,000                                     | 5                         | 2,405,276   | 1,905,276                         | 10,134   | 54,698*        | 40.0**                  |
| <b>Subtotal</b>                                 | -                         | <b>4,958,526</b>                            | -                         | <b>8,952,805</b>                                  | <b>3,994,279</b>                  | <b>29,556</b>                                  | <b>161,145</b> |                         |

\* Dec. 07 (MIX). \*\* The dividend of 2007 is not included yet. The exit is subject to the approval of the Banking Regulator.

| <b>Direct Investments: Outstanding</b> | <b>Year of Investment</b> | <b>Disbursed Amount to Date (US\$)</b> | <b>Years in Portfolio to Date</b> |
|--|---------------------------|--|-----------------------------------|
| 1) MiCasita (Peru)                     | 2006                      | 300,000                                | 2                                 |
| 2) Credifactor (Nicaragua)             | 2006                      | 100,000                                | 2                                 |
| 3) Crear Arequipa (Peru)               | 2006                      | 350,000                                | 2                                 |
| 4) ParaLife (Regional)                 | 2007                      | 3,000,000                              | 1                                 |
| 5) MicroCred (Mexico)                  | 2007                      | 600,000                                | 1                                 |
| 6) ProCredit Honduras                  | 2007                      | 2,500,000                              | 1                                 |
| 7) ProCredit Colombia                  | 2007                      | 3,000,000                              | 1                                 |
| 8) ProCredit Mexico                    | 2008                      | 950,000                                | < 1                               |
| <b>Subtotal</b>                        | -                         | <b>10,800,000</b>                      | -                                 |

| <b>Direct Investments: Approved (Not Yet Disbursed)</b> | <b>Year of Investment (expected)</b> | <b>Approved Amount (US\$)</b> | <b>Years in Portfolio (exp.)</b> |
|---|--------------------------------------|-------------------------------|----------------------------------|
| 1) ProCredit Dominican Rep.                             | TBD                                  | 1,500,000                     | 5~8                              |
| 2) Microfin (Uruguay)                                   | TBD                                  | 200,000                       | 5~6                              |
| 3) SCM Amazonas (Brazil)                                | TBD                                  | 1,500,000                     | 5~10                             |
| <b>Subtotal</b>   | -                                    | <b>3,200,000</b>              | -                                |

### **Indirect Investments: The Rise of Microfinance Funds**

After several successful direct equity investments, MIF shifted its microfinance investment strategy from direct equity to investing through microfinance funds. These are far more common than direct investments, and permit investment in several MFIs simultaneously. This allows more efficient diversification across risk pools and countries,

while delivering impact on a larger scale than in individual equity investments. A professional fund manager selects investee MFIs, and investors often participate in the corporate governance of MFIs. In general, this has helped to strengthen the financial infrastructure of the industry.

The first microfinance fund, *Profund*, was launched in 1994. This type of vehicle has grown rapidly ever since; Goodman (2004) estimated in 2004 that there were 43 microfinance funds across the globe, with total net investment of US\$617 million. By 2007 an estimated 78 funds were under management with more than US\$2 billion in outstanding investments (data presented at the annual meeting of the CGAP, June 6-8, 2007, Stockholm). Of these, 30 were created in the last two years.

### **MIF Investments in Microfinance Funds**

To date MIF has invested in eight microfinance funds<sup>8</sup>: *Profund* (an equity fund), *Gateway* (an equity fund), the Latin American Challenge Investment Fund, or *Lacif* (a guarantee and US dollar debt fund) *Accion Investment in Microfinance* (an equity fund), *Solidus* (an US dollar subordinated debt fund), Emergency Liquidity Facility, or *ELF* (a short term liquidity fund), Local Currency Fund, *Locfund* (a multiple currency debt fund), and Global Partnerships Microfinance Fund 2006, or *GP MFF 2006* (an US dollar debt fund).<sup>9</sup>

As of September 2008, MIF had committed a total of US\$30.9 million of its own resources in these eight microfinance funds, along with 70 co-investors, of whom 55 are private and 15 are public. Public investors have provided 71.4% of the US\$131.2 million (total committed amount at closing) in these eight funds, but the share of private investors, philanthropists and socially responsible investors is growing. *GP MFF 2006* was launched in early 2007 by 19 private individual investors, four private institutional investors and two public entities (MIF and the Overseas Private Investment Corporation: OPIC). With increasing private investor participation, there is less need for public donors. Moreover, successful demonstration effects that are now going to scale in the marketplace are doing so without the need of any additional public support.

Table 5 (see Appendix) displays the number of clients of those MFIs that have received financing from microfinance funds.<sup>10</sup> As of September 2008, 61 MFIs that were financed by microfinance funds had provided services to approximately four million microenterprises. The client base of newer fund beneficiaries, particularly those receiving

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<sup>8</sup> In October 2008, the MIF Donors Committee approved the ninth microfinance fund operation: Global Partnerships Microfinance Fund 2008, or *GP MFF 2008*. This fund is expected to close successfully and start funding MFIs soon.

<sup>9</sup> An equity fund holds numerous carefully selected stocks simultaneously; these stocks are selected by the fund manager so that the fund can achieve its stated financial and social objectives. A debt fund disburses mainly short-term and/or long-term loans to investees. A guarantee fund is designed to help MFIs to overcome their inaccessibility to commercial bank loans by extending guarantees, direct loans and other credit enhancement products and by offering re-guarantees to local guarantee funds and second-tier lending institutions. A liquidity fund is to provide emergency loans aimed at supporting and preserving MFIs that are well managed but encounter temporary problems of liquidity due to an unforeseen external shock.

<sup>10</sup> For the liquidated or exited funds, the number of investees in Table 5 represents the total number of MFI beneficiaries during MIF's participation. The number of microenterprises shows the total number of clients reached as of December 2007, made up of both previous and current MFI beneficiaries.

funding from *Locfund* and *GP MFF 2006*, are expected to grow significantly, while the outreach of more established and already liquidated funds should maintain their current levels. The last two columns of Table 5 indicate each fund's expected or achieved IRR. Funds MIF has exited from have generated a positive IRR. It is expected that more recently launched funds will also yield similar or better returns, considering healthy loan demand and the risk management skills of the qualified fund managers.

MIF has been expanding its role in support of microfinance funds since its first exposure with *Profund*. Moving beyond indirect investing in MFIs, MIF is now increasingly assuming the position of lead investor and is forging new partnerships with small, lesser-known MFIs. Going forward, investment will focus primarily on profitability and fund performance in order to attract additional private sector partners to the industry.

### **A Fund Snapshot**

MIF has invested in a total of 61 MFIs through participation in eight microfinance funds.<sup>11</sup> The MFIs that participated in the earliest of these funds are now industry leaders in the region and their success played an important part in stimulating the influx of private investment into subsequent microfinance funds. The MIF approach has been to avoid the crowding out of private investment by selling, where possible, holdings to private investors. Donald Terry, the former MIF manager, put it this way: "*We and others have proved the model works. Now it's time to move on. Our job is to go where others won't, not where they will*" (*The Economist*, March 17-23, 2007, p. 84).

Going where others do not means coming up with new products for a different client base, such as smaller, rural-oriented MFIs that are not receiving much support from international investors. These are currently small scale but have upside profit potential. Other innovative areas which MIF has entered include microfinance funds that supply products such as emergency loans (in response to natural disasters, civil strife, etc.) and local currency funds.

### ***Innovative approaches: ELF and Locfund***

In its effort to innovate and bring new financial services to the market, MIF has launched the *Emergency Liquidity Facility* (ELF) and the *Local Currency Fund* (Locfund). ELF was created to serve as a lender of last resort, by providing liquidity to qualified MFIs experiencing disruptions resulting from natural or financial crises. The ELF also aims to strengthen the ability of MFIs to deal with crises and emergencies, by providing technical assistance through the Technical Support Facility (TSF) for prevention measures, such as full operational backup plans in case of natural disasters, macroeconomic and financial crises and other emergencies. ELF has provided short term liquidity to MFIs in six declared emergencies: i) twice in Bolivia in 2005 due to political and social instability; ii) in El Salvador and Guatemala in response to Hurricane Stan in 2005; iii) in Ecuador in

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<sup>11</sup> An adjustment was made to correct for double-counting, given the fact that several MFIs have received investments from various funds.

response to the 2006 eruption of the Tungurahua Volcano; iv) in Peru in 2007 in response to the earthquake near Pisco; and (v) in Ecuador in 2008 in response to the flood.

The ELF employs a pre-qualification mechanism for MFIs, and by October 2008 the fund has 51 pre-qualified MFI affiliates in 13 countries: Argentina, Bolivia, Colombia, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Paraguay and Peru. MFIs become eligible for technical assistance and liquidity support loans after an ELF appraisal is made to assess solvency, profitability and asset quality. The fund employs an independent manager in the region, with an Investment Committee that can make decisions on short notice. ELF has proven to be an effective tool for responding to emergencies quickly, disbursing liquidity support loans in two weeks or less. A fund of this type makes an impact far beyond the financial results of the fund (see the mid-term evaluation report, DAI, 2007).

Smaller MFIs that do not mobilize deposits often accept dollar denominated loans from international financiers. By assuming liabilities in U.S. dollars and making micro loans in local currencies, smaller MFIs are exposed to losses resulting from the devaluation of local currencies in which they operate. A currency mismatch between assets and liabilities can result in substantial losses due to devaluations. Responding to this, the MIF launched the *Locfund*, a microfinance fund that pioneers lending in local currencies and the assumption of unhedged foreign exchange risks.<sup>12</sup> Begun in March 2007, *Locfund* assists smaller MFIs in reducing their foreign exchange exposure and improving their asset/liability management. *Locfund* supplies local currency loans plus technical assistance to enhance the asset/liability management capacity of participating MFIs. In its first fifteen months of operation, *Locfund* approved 18 loan proposals and maintains a sound pipeline.

### ***Fund Performance***

**Profund.** In November 1994, MIF approved an equity investment that was managed by Omtrix S.A., based in San Jose, Costa Rica, and incorporated in Panama. *Profund* was initially sponsored by three NGOs: Calmeadow, FUNDES and ACCION. Together, they committed US\$1 million in cash and US\$2 million in kind (shares in BancoSol, Bolivia and Finansol, Colombia). The Swiss government agency, SECO, also joined *Profund* early on with a US\$3 million commitment, the participation of SIDI, CAF, Argidius and Calvert soon followed. *Profund* had an original goal of US\$12 million in funding, but with the entry of additional development institutions it nearly doubled this target with US\$22 million in funding. *Profund* successfully exited all its investments by 2006, generating MIF an IRR of 5.1%. More importantly, it generated powerful demonstration effects that led to scale in the marketplace, spawned a group of satisfied investors, and helped established a strong and growing microfinance industry in Latin America.

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<sup>12</sup> Having diverse MFI clients in various countries in the LAC region, *Locfund* could achieve a “natural” hedge against exchange rates fluctuations; it is likely, although not a certainty, that over time the fluctuations of the various currencies will offset each other.

*Profund's* legacy as the first microfinance fund to complete the investment cycle has attracted several other players into this market space, and served to legitimize commercial microfinance in the region. Some of *Profund's* board members, including its manager Alex Silva, and prominent shareholders have gone on to create new microfinance funds and other firms dedicated to serving this sector.

**MIF-Gateway Trust Fund.** MIF placed US\$1.25 million in this microfinance fund that was designed as a provider of equity and long-term debt to selected MFIs. Launched by ACCION International in 1998, the fund aimed to raise US\$10 million from institutional investors through a preferred investment tier that would receive first priority on return on capital. However, 1998 was not an ideal time to embark on such an enterprise; throughout the late 1990s the private sector remained skeptical of microfinance as a sound investment. Hence, despite a robust project pipeline, the fund was unable to attract sufficient institutional participation at the fund level, although it was able to facilitate flows of private capital directly into investee MFIs. With an improving investment environment, Accion Investments in Microfinance (AIMCO) was able to successfully launch a fund four years later with a similar investment model as *MIF-Gateway Trust Fund*. In 2008 the fund was liquidated generating MIF an IRR of 6.6%.

**Latin American Challenge Investment Fund (LACIF).** This debt fund was created in 1998 to extend guarantees, direct loans and other credit enhancement products through re-guarantees to local guarantee funds and second-tier lending institutions.<sup>13</sup> LACIF planned on initial funding of US\$8 million in tier-I and tier-II capital, but by 2006 had raised and placed US\$22 million among 12 MFIs. LACIF achieved a track record with excellent asset quality, zero arrears, and highly effective monitoring and risk management mechanisms. In 2006 MIF sold its equity shareholding in LACIF to a private investor, realizing an IRR of 7.42%.

**Accion Investments in Microfinance (AIMCO).** In December 2002 MIF approved an equity investment of US\$3.5 million in AIMCO. This fund was designed to apply commercial criteria in equity and quasi-equity investments in at least 10 newly established MFIs. These organizations were in the process of expansion, formalization and consolidation in the most mature microfinance markets. AIMCO opted for a legal form known as a segregated portfolio company, and launched operations with two segregated portfolios, one for Africa and the other for LAC. At the launch, MIF projected an IRR between 4% and 9%. The initial closing of AIMCO was for US\$18 million and attracted both public and private investors. A bit more than three years later, MIF sold its investment in AIMCO to a private investor, thereby realizing an IRR of 7.6%.

**Solidus.** MIF invested US\$4 million in *Solidus* in December 2003. This fund was set up to assist MFIs in need of tier-II capital, through the provision of mezzanine financing and long-term loans.<sup>14</sup> *Solidus* was begun with the object of investing in up to 15 MFIs. These

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<sup>13</sup> Second-tier institutions provide financial resources to the first-tier retail lending institutions; first-tier retail institutions, in turn, lend directly to end customers, e.g. microenterprises.

<sup>14</sup> Mezzanine financing investments are debt capital that gives the lender the rights to convert to an ownership or equity interest in the investee if the loan is not paid back in time and in full. It is generally subordinated to debt provided by

would include regulated MFIs that require more capital to expand their loan portfolios, and unregulated MFIs that need more capital in order to become regulated. *Solidus*' fund closing eventually had 14 public and private investors and a capital commitment of US\$32 million, with an expected ROE of about 10% and an IRR of between 6.3% and 8.3%.

**Global Partnerships Microfinance Fund 2006 (GP MFF 2006).** A growing number of private investors with both economic and social motivations have shown interest in investments that help smaller MFIs get off the ground. In January 2007, MIF approved US\$1.55 million to purchase a subordinated note issued by *GP MFF 2006*.<sup>15</sup> This fund closed in March 2007 with US\$8.5 million (exceeding forecasts), and was structured with four tranches: senior notes, subordinated notes, junior subordinated notes and equity, in order to offer choice for private investors with differing risk/return preferences. By its closing date, *GP MFF 2006* had identified 14 “second-generation” MFIs in Latin America that had strong potential for profitability, but that also lacked access to external sources of capital. By mid-2007, the fund had fully invested in these MFIs.

## Going Forward

### *A MIF Approach to Microfinance Investment*

The MIF portfolio of equity investments requires partner institutions with high potential for generating demonstration effects that can go to scale in the market. Moreover, financial operations are structured and executed across the region in order to generate competitive returns. MIF will only make a decision to invest where its resources are key to an investment outcome and where no viable funding alternatives exist. Further, MIF is active in the corporate governance of equity partners, and projects promote the participation of private commercial banks.

“While development of Latin American microfinance centered on the development of institutions, today it is moving from being about specialized institutions toward being about specialized products that can be offered by many types of financial institutions” (Berger et al., 2006, ch.1). Recent surveys<sup>16</sup> show that private commercial banks of the region have expressed a clear interest in incorporating microfinance as part of their financial services. MIF projects encourage the diversification of financial products in areas such as housing, remittances, savings facilities, and microinsurance, among others. Of great importance, all operations are held to a limited time horizon, and with a view toward encouraging the entry of new investors, aiming at an eventual MIF exit from equity investment. Most importantly, MIF operations are not considered as a success if these do not generate social returns or other spillovers in addition to financial results.

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senior lenders. Mezzanine financing investments are advantageous for investees because it is treated like equity on their balance sheet.

<sup>15</sup> A subordinated loan is ranked below other loans with regard to claims on assets or earnings. In the case of default, creditors with subordinated debt wouldn't get paid out until after the senior debt holders were paid in full. Some investment structures have junior subordinated tranche that is subordinate to the subordinated one.

<sup>16</sup> MIF, IIC and Felaban have conducted two surveys (2004 and 2006) to Latin American private commercial banks which confirmed their increasing interest for microfinance.

Microcredit financing mechanisms in LAC began as small microcredit projects carried out by non-profit NGOs, and later by mostly large public sector institutions. Long term subsidized loans and technical assistance were the first tools used to support microcredit and microfinance. By the 1990's several NGOs became for-profit companies, with banking licenses and regulated by banking authorities. With regulation came the ability to offer savings products that in turn enable these upgraded institutions to grow faster. At this time MIF and other international financial institutions started investing directly in promising MFIs that could generate demonstration effects and attract new investors. The success of these individual investments stimulated the search for ways to scale up this investment strategy. Microfinance funds were created and entrusted to qualified fund managers who could apply specialized investment tools to reach out to more MFIs across the LAC region.

MIF has committed US\$31 million in microfinance funds because these offer investors a way to rapidly and efficiently deploy funds and to diversify their portfolios across countries. MIF has partnered with 70 committed investors who have helped to foster good corporate governance, improve institutional capacity, and to generate cross-fertilization in later deals that benefited from the lessons learned in MIF projects. With MFI portfolio growth rates of over 30% a year, and a huge unmet demand for financial services, successful investors should encounter many opportunities. During the first 15 years of MIF operations the organization has accumulated valuable experiences and lessons learned in investing in MFIs and in microfinance funds. The results in terms of financial performance and developmental impact have been very satisfactory, but they cannot guarantee future success. Future microfinance investments will be successful only if they adapt to the changes in the market place and to newly available technologies, and attract qualified human capital to this sector.

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## Appendix

**Table 5: MIF's Microfinance Fund Portfolio**

| Name of Fund      | Approval date (Donors) | Type of fund                          | Fund manager                                   | Legal jurisdiction | Domicile   |
|-------------------|------------------------|---------------------------------------|--|--------------------|------------|
| Profund           | 12/14/1994             | Equity Investments (US\$)             | Profund International, S.A.                    | Panama             | Costa Rica |
| Gateway           | 5/6/1998               | Equity Investments & Loans (US\$)     | Accion Gateway Fund L.L.C.                     | USA                | USA        |
| Lacif             | 11/11/1998             | Loans & Guarantees (US\$)             | Cyrano Management, S.A.                        | Panama             | Peru       |
| Accion Investment | 12/4/2002              | Equity Investments & Sub-Loans (US\$) | Acción Inversiones en Microfinanzas, SPC (AIM) | USA                | USA        |
| Solidus           | 12/3/2003              | Sub-Loans (US\$)                      | Cyrano Management, S.A.                        | Panama             | Peru       |
| ELF               | 12/10/2003             | Short Term Emergency Liquidity Funds  | Omtrix, Inc.                                   | USA                | Costa Rica |
| Locfund           | 9/20/2006              | Loans (Local Currency)                | Bolivian Management Ltd. (BIM)                 | Panama             | USA        |
| GP MFF 2006       | 1/31/2007              | Loans (US\$)                          | Global Partnerships Fund Management, LLC       | USA                | USA        |

| Name of Fund      | Total fund size | MIF's commitment    | # of investors |               |                     |                      |                     | # of investees | # of microenterprises financed through the investees | Expected IRR at approval | Achieved IRR |
|-------------------|-----------------|---------------------|----------------|---------------|---------------------|----------------------|---------------------|----------------|--|--------------------------|--------------|
|                   |                 |                     | Total          | Private       | Amount              | Public including MIF | Amount              |                |  |                          |              |
| Profund           | 22,629,420      | 3,000,000           | 17             | 11            | 5,409,509           | 6                    | 17,219,911          | 10             | 1,702,882  | 10.1%                    | 5.1%         |
| Gateway           | 1,250,000       | 1,250,000           | 1              | -             | -                   | 1                    | 1,250,000           | 2              | 121,420  | 12.0%                    | 6.6          |
| Lacif             | 7,310,000       | 3,600,000           | 17             | 13            | 1,610,000           | 4                    | 5,700,000           | 24             | 1,829,988  | 6.8%                     | 7.4%         |
| Accion Investment | 18,023,000      | 3,500,000           | 9              | 3             | 2,750,000           | 6                    | 15,273,000          | 5              | 622,502  | 4~9%                     | 7.6%         |
| Solidus           | 32,000,000      | 4,000,000           | 15             | 8             | 13,500,000          | 7                    | 18,500,000          | 8              | 771,207  | 6.3~8.3%                 | -            |
| ELF*              | 14,515,000      | 4,000,000           | 13             | 8             | 5,015,000           | 5                    | 9,500,000           | 10             | 504,545  | 0~4%                     | -            |
| Locfund           | 27,000,000      | 10,000,000          | 6              | 2             | 7,000,000           | 4                    | 20,000,000          | 18             | 508,826  | 6~10%                    | -            |
| GP MFF 2006       | 8,500,000       | 1,550,000           | 25             | 23            | 2,300,000           | 2                    | 6,200,000           | 14             | 438,832  | 7.0%                     | -            |
| TOTAL             | 131,227,420     | 30,900,000<br>23.5% | 70**           | 55**<br>77.5% | 37,584,509<br>28.6% | 15**<br>22.5%        | 93,642,911<br>71.4% | 61<br>**       | 3,969,681<br>**                                      |                          |              |

\* 51 MFIs are affiliated.

\*\* The total is not equal to the sum of the corresponding column as a result of adjusting for double-counting.

Source: Author's compilation