



2011/12

Global Pensions & Investment Funds

REVIEW

Inclusive finance: broadening the paradigm of microfinance as an asset class

by Developing World Markets

Microfinance has emerged as a leading impact asset class that can provide investors risk-adjusted financial returns coupled with tangible social impact. Institutional investors are experienced investors in microfinance, sourcing approximately 30% of the investments in the asset class.

The microfinance asset class is well-positioned to experience a renewed wave of growth as microfinance institutions incorporate new products such as housing, education, and other credit products suited for the 2.5 billion adults who remain excluded from financial services. This broadened strategy, termed inclusive finance, is unveiling a new dimension of social finance and simultaneously opening vast investment opportunities for pension funds.

The emergence of microfinance as an asset class

Microfinance has come a long way from its nascent days of predominantly NGO-driven rural lending programmes. Today, microfinance is a US\$65bn niche banking sector, represented by approximately 10,000 microfinance institutions (MFIs) serving over 100 million low-income clients worldwide.¹

Much of the development and growth in microfinance has been fuelled by commercial investors, who have recently surpassed donors and development finance institutions (DFIs) as funders of MFIs. For investors, microfinance has presented a unique double bottom line investment opportunity providing both financial and social returns.

Investments in microfinance are typically channelled through microfinance investment vehicles (MIVs) or microfinance funds which are dedicated and pooled investment structures. Today, approximately 90

microfinance funds exist and hold, on aggregate, over US\$6bn in assets.²

Dedicated microfinance asset managers have emerged. As managers of the microfinance funds, they mobilise investor capital, select assets, and monitor MFI performance.

Microfinance has crystallised into a separate asset class with investment frameworks, risk management, benchmarks and a growing array of dedicated practitioners that represent a viable alternative investment strategy. Microfinance funds have proven to be scalable, financially sustainable and internationally replicable investment structures, that under the guidance of an experienced microfinance asset manager, can offer institutional investors financial and legal infrastructure consistent with their fiduciary standards plus social returns.

Financial returns on debt microfinance funds vary and generally correlate with the investment philosophy of the investors. Purely philanthropic funds provide retail investors a no-return microfinance investment platform. Blended-value funds attract investors, generally foundations and high-net worth individuals, seeking moderate returns. Commercial investment funds aim to deliver risk-adjusted returns for institutional investors such as pension funds.

The Symbiotics Microfinance Index (SMX), made up of several publicly listed global fixed-income funds that invest primarily in microfinance, shows an average

Figure 1: Microfinance value chain



Source: Developing World Markets

Figure 2: Investor spectrum



Source: Developing World Markets

net annual return of around 5.0% since inception. The index is in the development stage and does not capture most microfinance funds but it is the beginning of an industry effort to capture and report performance data.

Institutional investors have taken an interest in microfinance equity investments as well. According to the Consultative Group to Assist the Poor (CGAP) which is part of the World Bank, there are currently 24 specialised microfinance equity funds with assets under management totaling US\$1.5bn. As part of their socially responsible investment strategies, leading pension funds, like TIAA CREF in the US and ABP in Europe, have made microfinance equity allocations of over US\$100m. Most of these investments are done through microfinance funds with dedicated microfinance asset managers, rather than direct investments, due to the sector expertise and time required for due diligence.

Inclusive finance: the new face of microfinance

Despite the proliferation of microfinance across the globe, 2.5 billion people remain excluded from financial services.³ MFIs are increasingly exploring the profiles of the unbanked to uncover potential growth opportunities.

Examination of the unbanked shows that many of them operate beyond micro-businesses, which are the traditional client base of MFIs. Instead, they operate

small to medium enterprises (SMEs) which play a significant role in community development, such as job creation, in emerging economies.

As a result of these findings, MFIs and other 'base of the pyramid' financial institutions which we are including under the broad term 'MFI', are increasingly expanding beyond microcredit, introducing housing, education, SME, and agricultural finance, amongst others, to their product offerings. Additionally, segment-dedicated lenders, such as agricultural cooperatives have emerged. Inclusive finance is introduced as this broadened approach to microfinance lending.

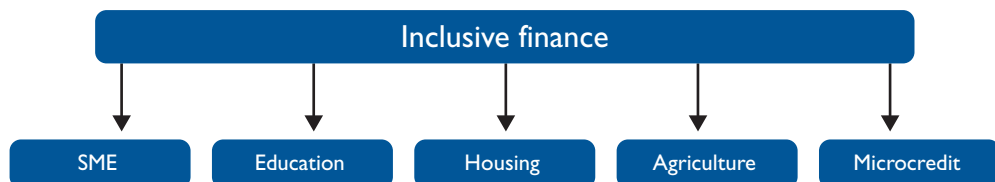
For MFIs, an inclusive finance strategy presents a growth opportunity that leverages their existing infrastructure, utilises their tested lending methodologies and better serves their existing client base. Other benefits include greater revenue streams and further portfolio diversification.

An increasing number of segment-dedicated lenders have emerged to meet acute financing gaps. These lenders develop expertise in underserved products, such as educational loans, developing tailored lending methodologies as well as risk management systems.

Institutional investor footprint

Institutional investors constitute a critical source of foreign investments in microfinance. The remaining capital comes from DFIs, high-net worth individuals, retail investors and local commercial banks.

Figure 3: Inclusive finance – broadened approach to microfinance



Source: Developing World Markets

SME financing

Small to medium enterprises play a critical and well documented role in economic development. SMEs support the economic transition from informal to formal sectors, and allow for increased tax-revenue generation.

They show a greater capacity to generate employment and link businesses to international supply chains. In most countries, SMEs have difficulty securing financing, often falling into the 'missing middle', with SMEs requiring loan volumes too large for MFIs but lacking the collateral or financial history required by commercial banks.

Housing financing

The rapid urbanisation of developing countries is contributing to the rise of slums and inadequate living conditions for the poor; many of whom lack access to water, sanitation, or protection from theft and violence. Neither top-down government housing programmes nor traditional mortgage loans have materialised to effective, scalable solutions.

Many MFIs throughout the world offer tailored, flexible housing loans that fund the renovation and incremental construction of homes. These products are adapted to the needs of the borrower in that they are cash-flow based, have fixed interest rates, and allow the families to remain in their homes.

Agricultural financing

Serving farmers presents unique challenges for MFIs. Sparsely-populated, rural regions are costly to serve. Unique risks inherent to agriculture, such as weather changes or market price volatility, often exceed MFI's risk management capabilities.

A growing number of MFIs are recently adopting unique approaches to agriculture microfinance that meet the vast needs of rural populations and simultaneously have reduced sector risks and servicing costs. These solutions include mobile banking systems, credit linked to market access, innovative crop insurance programmes, and lending through farmer groups/associations.

The need for agricultural microfinance is immense, especially considering the demand for biofuels, rising food prices, and the inextricable relationship between food access and economic stability.

Education financing

Education is an imperative component of economic development. Many developing countries lack education funding programmes aimed at placing more students in schools and colleges. Student loan programmes present unique challenges for MFIs, the greatest of which is time horizon. Returns on student loans take longer to materialise than those on an enterprise microcredit. Limited access to long-term funding has also presented a challenge.

MFIs, as well as dedicated student-loan funds, have recently introduced pilot programmes that are showing promising results.

Pension funds have emerged as influential players in the asset class. Developing World Markets (DWM), the leading manager of pension fund assets in microfinance, estimates that approximately 40 pension funds have invested in the field to-date. For some, microfinance contributes to their financial objectives such as asset diversification, risk-adjusted financial returns and exposure to financial innovation. For others, the asset class constitutes a thematic investment under a socially-responsible investment (SRI) strategy.

The sizeable investments made by pension funds have revealed the depth and the absorptive capacities of the asset class, although excess-liquidity has emerged as a risk factor in recent years, particularly in the 'tier-1' microfinance sector; and should be monitored by asset managers. Pension fund investment volumes vary in size. DWM estimates that nearly a dozen pension fund investments have been made in microfinance at the level of US\$40m or

more. The participation of pension funds in microfinance has spurred the creation of institutionally dedicated funds, several of which have exceeded US\$200m in size.

Inclusive finance: an enhanced asset class for pension funds

Inclusive finance is introduced as a broadened approach to microfinance investing that has the potential to benefit the unbanked, as well as the financial institutions that serve them. For pension funds, inclusive finance unveils an untapped investment opportunity at institutional scales. And like microfinance, inclusive finance as an asset class has the potential to deliver financial returns, asset diversification and development impact.

Stability

Microfinance portfolios are composed of millions of tiny loans to diverse sectors at the 'base of the pyramid', generally to informal businesses that are less

integrated into global markets. The ability of the microfinance clients to repay is extremely high, as demonstrated by traditional repayment rates of nearly 98%. Just as some experienced microfinance asset managers would provision for potential losses, many microfinance institutions also have provisioning policies against late and non-repayments from their clients. This contributes to low volatility of microfinance investments. The 10-year average volatility for the SMX index is 0.5%, lower than traditional equities or bonds from emerging markets.

Size

Inclusive finance reveals additional opportunities that are forecasted to reach US\$250bn.⁴ Growth stems from (1) the inclusion of new unbanked populations; and (2) the growing exposure to products that require larger loan volumes, such as SME financing. Institutional-scale funding could address the emerging demand. Some microfinance asset managers are embracing the expanded investment strategies to deliver financing.

Diversification

Microfinance inherently offers diversification to pension funds in regards to geography, sectors and asset behaviour. An inclusive finance investment strategy can generate further portfolio diversification by introducing new sectors and new populations, such as rural farmers.

Financial returns

Pension funds typically partner with leading microfinance asset managers who target commercial investment opportunities. As many pension funds have longer investment horizons, higher-yielding opportunities in longer-term senior and subordinated debt and equity emerge. The inclusive finance strategy has the potential to further bolster returns as these newly incorporated segments have been less targeted by investors historically. Furthermore, because some products, such as housing, require longer-tenor financing, pension funds have a unique vantage point to act upon this emerging opportunity.

Social returns

Over the last 10 years, the proliferation of microfinance has pulled millions of poor into the formal banking system, and resulted in a myriad of benefits for micro-entrepreneurs such as increased income generation, improved nutrition, empowerment of women, and access to non-financial services such as healthcare and financial literacy. Practitioners have learned that microfinance is not the panacea to poverty eradication but instead, an important tool for smoothing income at the 'base of the pyramid'.

Costs

Management fees for microfinance debt investments are generally higher than those of other fixed income asset

classes, often mirroring those of private equity funds. These costs derive from the relatively higher cost in true global asset selection and ongoing monitoring. The investment process which can surpass four to six months in length, generally involves in-depth financial analysis, in-country due diligence and investment committee review.

Pension funds, however, may enjoy lower fee structures than non-institutional investors. Additionally, pension funds support fund volumes which often translate to operational efficiencies and economies of scale.

Investment risks

Nevertheless, microfinance investments are not without risks, as perhaps made most apparent in the microfinance crisis in Andhra Pradesh in India, where microfinance clients in that state stopped paying their loans. Allegations of abusive lending practices also emerged from the crisis, highlighting the need for microfinance asset managers to scrutinise the lending practices of all potential microfinance institutions. While microfinance has developed as a viable asset class, it remains tied to the informal economy in many countries, and microfinance institutions can be small and relatively undeveloped compared to more traditional commercial lenders in terms of credit standards, information systems, etc. Institutional microfinance funds tend to be illiquid, offering investors little opportunity to withdraw their capital within a short period of time. Moreover, emerging markets political and economic situations, as well as natural disasters could adversely impact the investment value. Unreliable legal systems offer investors inadequate or no recourse in adverse situations such as payment default. Finally, many of the inclusive finance asset classes remain relatively untested compared to the microfinance sector and do not share all of the characteristics that have contributed to the performance of the industry. The microfinance sector's results are not indicative of the results that other inclusive finance asset classes may experience.

Conclusion

Inclusive finance as an asset class provides a meaningful and commercial investment strategy that delivers financial returns and life-improving benefits for millions at the 'base of the pyramid'. Under the guidance of seasoned microfinance asset managers who can leverage the expanding universe of investment opportunities responsibly, pension funds can make market-based and sizeable investments in socially and environmentally responsible businesses, effectively contributing to poverty alleviation and economic development.

About Developing World Markets

DWM is an asset manager and investment bank dedicated to making socially positive investments in order to promote sustainable economic and social development on a global scale. With US\$900m of impact assets under management (as of March 31, 2011), DWM has made investments in over 140 MFIs and SME lenders worldwide by mobilising capital from institutional investors, at a substantial scale, to provide tailored financing for MFIs in the developing world demonstrating top financial and social performance.

DWM works with major pension funds globally, creating emerging market investment strategies that suit investment objectives. For further information, please visit our website at www.dwmarkets.com or contact:

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Notes:

- ¹ Estimated by Consultative Group to Assist the Poor (CGAP), part of the World Bank.
- ² State of Microfinance Investment The MicroRate 2010 MIV Survey.
- ³ Center for Financial Inclusion, ACCION International.
- ⁴ Roland Dominicé: The Future of Microfinance.

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