



Microfinance firms make tentative move into capital markets

Last Update: 6:08 PM ET Feb 8, 2006

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Of DOW JONES NEWSWIRES

NEW YORK (MarketWatch) – Microfinance firms in developing countries are starting to tap national and international capital markets to finance their growing operations and booming loan portfolios, and are in turn becoming an attractive alternative investment.

"Microfinance is an industry that's becoming a separate asset class on Wall Street," said Maria Otero, president of Accion International, a not-for-profit firm that supports microfinance initiatives around the world. Its success in terms of growth and profitability has "turned heads," she said at a microfinance conference here this week.

Microfinance companies provide small loans to poor people that are overlooked by traditional banking systems. Credits are typically less than \$1,000 and can be as low as \$100, and are usually for productive purposes, rather than consumption.

The loans may be small, but it's big business. Accion's affiliates extended \$1.76 billion in loans in 2004, had 1.46 million customers at the end of the year, up from \$1.22 billion and 1.18 million, respectively, in 2003. The company has also spun off a private-sector equity arm, Accion Investments.

As the microfinance sector emerges from its low key, not-for-profit origins of 20 years ago into the mainstream financial industry, the leading players are looking to private equity investments to improve their management teams, and the debt markets to lower their funding costs.

Accion Investments is currently seeking another \$20 million on top of \$19 million already raised, to deploy across Africa and Asia over the next three years, Accion's capital markets vice president Enrique Ferraro said.

Rapidly growing loan portfolios and increasing competition are also pushing firms to increase the size, and lower the cost, of their funding for new loans. Because most don't have banking licenses, they are not allowed to accept deposits - the most efficient source of funding for banks - so microfinance firms tend to borrow from commercial banks, often at expensive rates and with cumbersome collateral requirements.

Bond Issues Cut Costs, Act As Lever

As an alternative, some of the top-flight microfinance institutions such as Mexico's Financiera Compartamos, Colombia's WWB Cali and Peru's Banco de la Microempresa, or Mibanco, have turned to bond issuances on local markets, which are themselves undergoing a renaissance, particularly in Latin America.

"Bonds provide us with cheaper funding...and we can use them to press our current lenders for better conditions," said Fernando Alvarez Toca, chief financial officer of Mexico's Financiera Compartamos.

Compartamos had a total loan portfolio at the end of 2005 of \$185 million, with 453,000 customers, and has achieved an eye-catching 40% profitability rate per year over the last five years. By 2008, it expects to reach one million customers with loans topping MXN6,000 pesos (\$570 million), with public debt accounting for half of the funding, according to Alvarez Toca.

Since 2002, the company has issued \$57 million of bonds on the local market in Mexico. Spreads over Mexican government bonds fell from 250 basis points in the first three issues, targeted at the private banking market, to 117 basis points in the latest issue in 2005, which was targeted at institutional investors and carried a guarantee from the International Finance Corporation.

No microfinance firm has sold overseas bonds to date, due to a lack of credit ratings and the added burden of foreign exchange

rate risk, according to according to Robert Annibale, global director for Citigroup Microfinance, a unit of Citigroup (C). For now, local markets are strong enough and deep enough to meet their needs.

Mibanco has been successful on the local debt market in Peru, raising just under \$45 million from bonds and commercial paper in recent years, and plans to raise another \$60 million over the next two years, said general manager Rafael LLosá. Mibanco has also moved one step further by taking a banking license and accepting deposits.

Microfinance firms are often wary of making that switch, but over the long run, it seems an inevitable step for the most ambitious.

"Non-government organizations in Colombia don't pay (corporate) income tax, which is 38.5% of profits," said Clara Serra de Akerman, president of WWB Cali, a microfinance firm in the Andean country. "That is why we haven't become regulated...Eventually we will."

Will Microfinance Strengths Resonate On Wall Street?

So far, only a limited number of the best-performing microfinance firms are able to tap the capital markets directly, and many are taking steps to professionalize, an area that multilateral agencies are keenly supporting.

"We are transforming non-governmental organizations into financial institutions," said Enrique Garcia, president of the Andean Development Corporation, or CAF. The agency works with 35 microfinance firms in 11 countries, and is helping governments and capital markets to better understand the role of microfinance, Garcia said.

It is often hard to translate some of the strengths of microfinance initiatives into terms that Wall Street understands.

The industry has very low delinquency rates, compared with the traditional banking sector. These small loans are often the only source of capital, creating a strong incentive for borrowers to stay in the lender's good books. Furthermore, microfinance is usually set up within a strong social network, where one person's non-payment can be a drag on their friends and neighbors.

Loans overdue for more than 30 days are less than 1% at some microfinance firms, though the industry average is closer to 5%, according to Damian von Stauffenberg, chief executive officer of MicroRate, which specializes in developing credit ratings for microfinance. Nevertheless, traditional banks often see rates that are many times higher, though this difference is partly offset by lower costs at banks, Von Stauffenberg said.

Because microloans often have no collateral, it is hard to turn them into hard currency in the traditional capital markets. Securitization, where future proceeds from loan payments are used as collateral to sell bonds, is practically impossible.

"Nobody has been able to pool microfinance loans together...and issue notes against them," said Peter Johnson, a partner at Connecticut-based financial advisory firm Developing World Markets, or DWM. "It may be quite a while before we do" see those securities, he said.

Instead of using the microloans as collateral, DWM turned to a mechanism similar to collateralized debt obligations, or CDOs, Johnson said. It joined with BlueOrchard Finance, a Geneva-based firm, to raise \$87 million from overseas investors for a fund that is backed by 17 loans to 14 microfinance firms across Peru, Bolivia, Ecuador, Russia, Cambodia, Nicaragua and Colombia.

Emerging From Grassroots Poses Challenges

As they emerge from their grassroots origins, microfinance firms will face numerous challenges. Having grown up outside the regulated financial environment, some are concerned that their expansion may trigger unwanted government attention, either in the form of well-intentioned subsidies that distort the market, or more onerous regulation that could limit their activities or drive up costs.

There is also growing interest among commercial banks where, for now, cooperation rather than competition seems to be the name of the game. In particular, this can help the microfinance firms develop into new business lines.

Citigroup, for instance, has begun selling insurance products with Compartamos in Mexico, and in the last six months 12% of the customers have been shared by the two firms, according to Citigroup's Annibale. The bank is also developing products with Banco Solidario in Ecuador for areas such as international remittances, Annibale said.

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