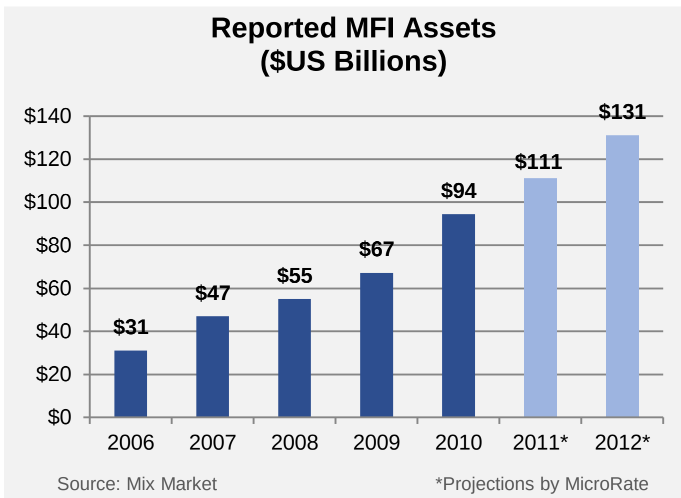
Microfinance Investment: A Primer

The landscape of microfinance investment is changing. Once exclusively under the purview of multilateral financial institutions, governments, and non-profit organizations, microfinance investment opportunities have grown significantly for private investors and institutions. This trend not only reflects the growth of the microfinance industry, but also investors' growing attraction to microfinance and "impact investments," which emphasize both financial and social returns.

About Microfinance

Microfinance provides financial services – including credit, savings, insurance, and money transfers – to millions of poor and low-income entrepreneurs primarily in developing countries. These financial services are provided by microfinance institutions (MFIs) to those who are unserved or underserved by other financial institutions. Microfinance produces double-bottom-line returns (both financial and social) because it enables poor borrowers to earn a living for themselves while repaying investors with interest.

The majority of microfinance services are small loans known as microcredits. These loans are granted for productive purposes where the micro-entrepreneur generates sufficient cash flow to repay the loan and earn income. The lending decision is not based on the client's available collateral, which may be limited. Rather, it is based on the viability of the client's business to effectively apply the capital from the loan, increase revenue, and in turn repay the loan. MFIs deliver microcredit primarily through three lending methodologies: village banking, solidarity groups, and individual loans.



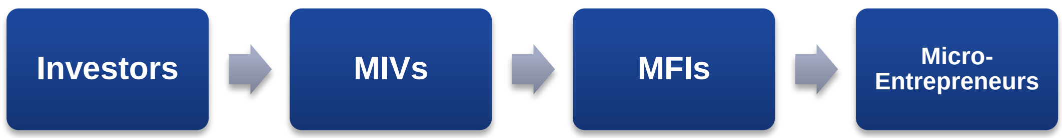
Many MFIs were initially founded as non-profit organizations that prioritized social objectives over financial returns. However, as the size and scope of MFIs grew, many transformed into for-profit entities that provide microfinance services independent of donor funding. The sustainability and growth of these MFIs benefits microfinance clients by increasing their access to financial services. It also brings to light issues such as client protection and responsible finance – the provision of financial services in a manner that is both beneficial to clients and financially sustainable.

Investment Flows into Microfinance

Historically, MFIs received the majority of their funding from public international financial institutions, aid organizations, and governments. These entities funded microfinance by providing grants, donations and subsidized loans directly to MFIs. Over time, the sources of microfinance funding diversified as more organizations – including a growing number of private investors – funded MFIs. The market also diversified as more creditworthy and financially sustainable MFIs emerged. As the demand for financial services increased, the MFIs' range of financial services and geographic distribution grew as well.

As the microfinance market matured, private institutions and individual investors became increasingly involved in funding this growth. In the mid-to-late 1990's the first funds to invest in MFIs – known as microfinance investment vehicles (MIVs) – emerged. MIVs channel private capital to MFIs primarily through loans, but also through equity and guarantees, enabling MFIs to lend to more micro-entrepreneurs.

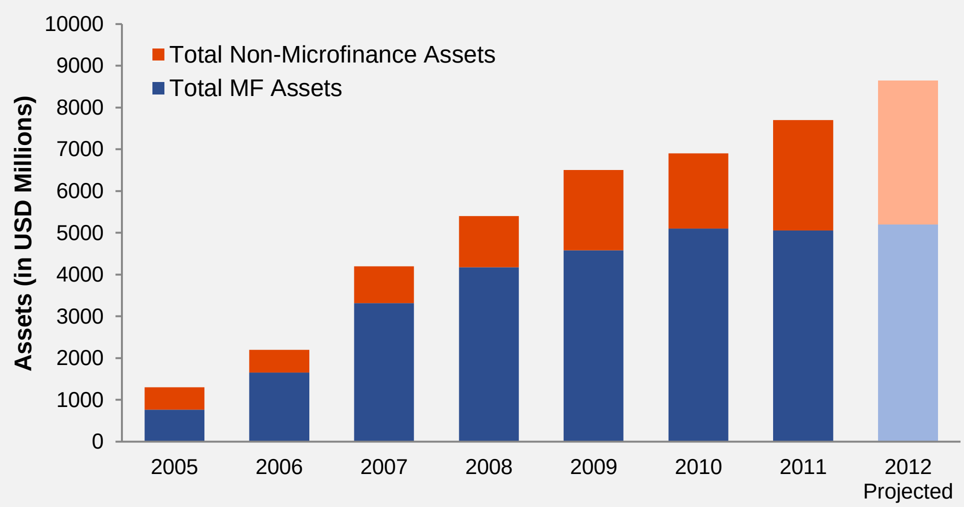
Microfinance Investment Chain



When micro-entrepreneurs pay back the principal and interest on a microcredit, part of this interest goes to cover the funding expense of capital borrowed by an MFI from the MIV. In turn, this interest is passed on to the MIV's investors. The high growth, low delinquency rates, strong margins, and scalability of microfinance have made it possible for MIVs and their investors to provide financial access to poor and under-served populations, recoup their capital, and earn interest.

Currently there are over 100 MIVs worldwide, channeling over 40% of foreign microfinance investment to MFIs.[1] MIVs have grown in number, size, and diversity. Since 2005, MIV assets have grown dramatically. Although asset growth slowed significantly in the aftermath of the global financial crisis, the sector continued to grow, showing the resiliency of microfinance to financial shocks as well as optimism for future growth. As of December 2011, there was an estimated $7.8 billion in total MIV assets invested in 100 countries.[2]

Total Microfinance Fund Asset Growth



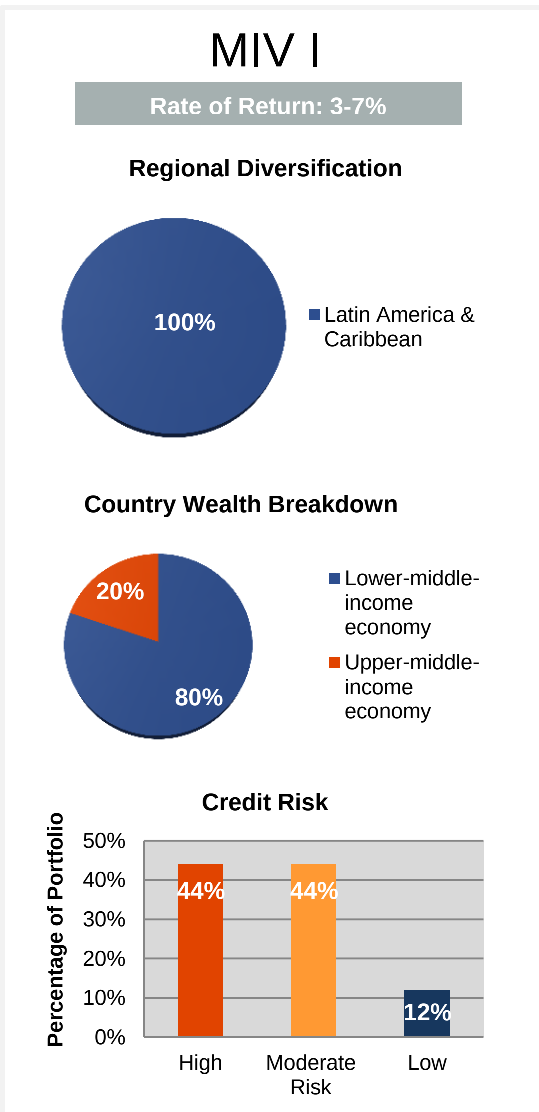
Source: MicroRate's microfinance fund data

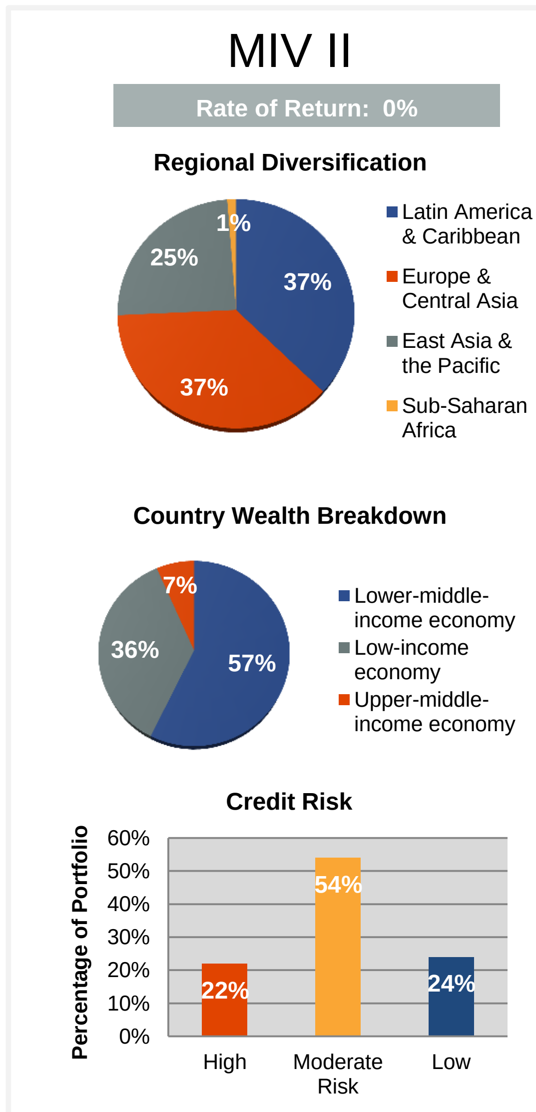
[1] CGAP Focus Note, "Foreign Capital investments in Microfinance: Reassessing Financial and Social Returns," May 2011.
[2] MicroRate's forthcoming publication, "The State of Microfinance Investment 2012."

The Diversity of Microfinance Investments

Today, informed investors may select from a wide variety of MIVs, reflecting the diversity of fund objectives and the underlying assets (MFIs). MIVs invest in MFIs based on a variety of criteria ranging from the institution's size, performance, location, client demographic, loan methodology, and range of products and services, to client outreach and non-financial offerings such as education or healthcare. The diversity of MIV structures and objectives allows investors to invest in MIVs whose portfolios match their own investment philosophy, whether they prefer lower-risk investments with a stable financial return, a socially-focused fund that may have greater financial risk, or something in between.

For example, MIV I (see charts below) is focused on investing in Latin American MFIs that provide microfinance and other social services and offers investors a rate of return between 3-7%. MFIs in their portfolio tend to be riskier, less mature and (44% high risk, 44% moderate risk), located in lower-to-middle-income countries (80% of the portfolio). In contrast, MIV II is a non-profit fund that uses guarantees to borrow capital from commercial banks to lend to MFIs that focus on women, rural areas, and individuals living on less than $2 per day. As a guarantee fund, the do not provide returns. Their investments have a global reach to MFIs predominantly located in low-income and lower-to-middle income counties. Approximately 54% of their investments are classified as having a moderate risk.





Source: Luminis, **www.luminismicrofinance.com**

The Future of Microfinance Investment

The need for financial access for the poor is enormous. Microfinance will continue to grow in order to meet this demand. This will require far more funding than development institutions can provide. Only if private funding continues to expand rapidly can microfinance fulfill its promise. As the microfinance investment industry is still maturing, access to standardized, objective information and robust analysis is essential. If investors cannot effectively gauge the risk and returns of a microfinance investment, any defaults will have a disproportionately negative effect on the entire industry and reverse the progress made in recent years.

Microfinance investments provide investors with a unique opportunity to diversify their portfolio. These investments show low correlation and stable returns while providing a socially-beneficial service to the end borrowers. However, to date, it has been difficult for investors to identify which funds meet their investment criteria. When assessing risk, social and financial performance, investors must rely on information provided by the funds themselves. MicroRate has launched Luminis™ to provide investors with objective, easily comparable data and analysis on microfinance funds.

> An innovation in transparency, Luminis™, facilitates informed microfinance investment by providing objective analysis of microfinance investment funds. This will allow more investors to promote global economic development through microfinance investments that achieve their desired financial and social returns.

Luminis is a third-party provider of standardized MIV data and analysis. Through its PRSM methodology,[3] Luminis offers investors detailed profiles and analytical fund reports that highlight each fund's performance, risk, social, and management dimensions. By providing an opportunity to understand and compare funds, Luminis allows investors to make objective, well-informed microfinance investment decisions to achieve their desired financial and social returns.

To explore the diversity of MIVs and evaluate those that meet your specific investment interests, visit www.luminismicrofinance.com or email luminis@microrate.com

About MicroRate

MicroRate is the first microfinance rating agency dedicated to evaluating performance and risk in microfinance institutions (MFIs) and microfinance funds, also known as microfinance investment vehicles (MIVs). After 15 years of specializing in microfinance transparency, MicroRate is the most, well-recognized organization of its kind. MicroRate has conducted over 600 ratings of more than 200 MFIs throughout Latin America, Africa, Europe, and Central Asia. MicroRate is a leading social rater and has also become the largest MIV evaluator in the industry.

In 2010, MicroRate launched Luminis™ with the support of the Luxembourg Government and LuxFLAG. Luminis is a web-based analytical service that provides professional investors and researchers with the necessary tools to identify, assess, and monitor MIVs that meet their individual investment requirements. Through Luminis, investors can access detailed profiles and fund reports which analyze each fund's financial performance, risk, social factors, and management team according to the PRSM methodology.

[3] PRSM- Performance, Risk, Social, and Management