SEEP Network

# Case Study

OCTOBER 2007

# Networks as Investors in Microfinance: The Experience of REDCAMIF

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The SEEP NETWORK

# Introduction

Networks are known to be important actors in the development of many of the most dynamic microfinance markets. The SEEP Network has identified over ninety such organizations operating around the world, at either national or regional levels. Many of these networks have been responsible for generating a host of important advancements in the sectors in which they operate. Improvements in financial legislation, increased transparency among institutions, and strengthened human and organizational capacities are often due in part to the ongoing efforts of microfinance networks. Services commonly include training, representation, development and monitoring of benchmark indicators, and advocacy regarding public policies and regulatory frameworks.

However, as microfinance markets mature, the needs of network members also evolve. Successful networks have a long term vision that anticipate this evolution and prepare for it. In many cases, this may require an expanded definition of what a network can and should do. While more traditional activities such as capacity building and information dissemination will likely always be essential, networks are beginning to explore other activities that serve their mission. The development of investment companies is one such example.

> **REDCAMIF,** a federation of microfinance networks in Central America, has launched a specialized investment company to expand access to financing for its members and other socially-oriented financial institutions. The company's mission is to contribute to the reduction of poverty in Central America and the Caribbean by providing debt financing and other financial mechanisms to institutions in the region that serve micro, small, and medium enterprises

An investment company can take many forms. By and large, they are commercial entities that raise funds from donors, public sources, and private investors to invest in microfinance institutions in the form of debt, equity, and/or guarantees. As for-profit companies, they seek real returns on investment. Recent studies have revealed the growing importance of investment funds in microfinance. Since 2004 the portfolio of private investments in microfinance around the world has increased by 233% to an estimated 2 billion dollars.[1]

While few doubt the need for greater access to commercial capital and its potential to dramatically alter the landscape of financial services for the poor, to date, most microfinance networks have purposely limited their role as direct financiers. They manage and distribute donations, but rarely do networks involve themselves in the risk and responsibility associated with direct investment.

1 "Microfinance Cracking the Capital Markets II", May 2007 Accion Insight series #22.

Can networks play a more active role in channeling needed financial resources to their members and the sector at large? Should they? As representatives of the industry, microfinance networks are designed to promote, inform, learn, and educate. Their members are experts and their association with their peers makes them an even more influential presence. But are they well suited to be investors? Should networks by design maintain neutrality, seeking consensus rather than profit? Or should they capitalize on their unique market position and support development of the industry through direct investment?

This article is about a microfinance network that reflected on many of these kinds of questions and ultimately chose to seize what they saw as an important opportunity. REDCAMIF, a federation of microfinance networks in Central America, has launched a specialized investment company to expand access to financing for its members and other socially-oriented financial institutions. The company's mission is to contribute to the reduction of poverty in Central America and the Caribbean by providing debt financing and other financial mechanisms to institutions in the region that serve micro, small, and medium enterprises. Incorporated in Panama in February 2006, under the name SICSA (Investment Company for Microfinance in Central America and the Caribbean), the fund is the first of its kind in Central America. Its principal owners are microfinance networks.

While the company is still in its initial capitalization stage, REDCAMIF's experience represents an important development in the evolution of networks as increasingly influential actors in local microfinance markets. This case study presents the investment company as it has been conceptualized by its organizers. It describes what REDCAMIF detected as an important gap in current financing for local MFIs, the motivation of the company's organizers, important strategic concerns during the planning process, and the proposed strategy to ensure impact as well as financial returns. Its primary objective of is to inform other microfinance networks around the world that may be considering similar initiatives.[2]

# Background: REDCAMIF and Central America

Central America is comprised of six countries, Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, and Panama. The region's population exceeds 40 million, of which an estimated 60% live in conditions of poverty. The micro and small enterprise (MSE) sector in Central America includes approximately three million self-employed individuals, generating employment for

2 Centurion Capital, created by the Russian Microfinance Center (RMC) is another example of a network developed investment company.

more than nine million people, close to 70% of the Economically Active Population (EAP). It is estimated that small and micro enterprises contribute an additional twenty-five percent to the region's Gross Domestic Product (GDP).[3]

Despite its economic significance, the sector is still largely underserved. While it is difficult to obtain precise figures, most studies estimate a demand for investment of around US$ 5 billion. Presently, commercial banks, non-bank financial institutions, cooperatives, and NGOs are financing no more than US$ 1.16 billion of the current demand.[4] This considerable gap provides opportunities for informal suppliers, money lenders, and others to charge exorbitant rates for services, further deteriorating fragile local economies.

Central America is considered to be economically and politically very homogenous. Their common history and geographic proximity facilitate regional strategies and the development of multi-country institutions. REDCAMIF, (Central American Microfinance Network), is an expression of this kind of regional integration. REDCAMIF was founded in September 2002 in Guatemala City, Guatemala with the participation of four national networks, REDIMIF (Network of Microfinance Institutions of Guatemala), ASOMI (Association of Microfinance Organizations- El Salvador), REDMICRO (Network of Microfinance Institutions of Honduras), and ASOMIF (Nicaragua Association of Microfinance Institutions). Later that year REDCOM (Costa Rican Network of Organizations for Microenterprise Development) was incorporated as a member. Most recently, in December 2006, REDPAMIF (Microfinance Network of Panama) joined the regional network.

REDCAMIF's mission is to consolidate the microfinance industry in Central America through representation of the sector and the facilitation of strategic alliances that contribute to poverty reduction and the institutional development of the associated networks and their member organizations. The organization defines its service strategy by taking into consideration economies of scale as a regional provider and avoids competition with national-level networks. The principal services offered by REDCAMIF include representation of the industry in regional and international forums, common information systems and databases, benchmarking services, access to financial and technical resources, publications, and training and exchange opportunities for members.

Member networks represent close to 100 microfinance organizations. As of August 2007, the total portfolio outstanding exceeded $US 500 million with close to 750,000 active clients.[5] Membership criteria among the national networks differ, resulting in a significant diversity among the associated MFIs. Variations exist in size, product offering, geographic orientation, as well as legal structure. Many of the MFIs are expanding their services to meet needs of rural clients, as well as demand for housing loans, small industry, and production. Some serve as few as 3,000 clients while others reach more than 70,000. By and large, however, the majority of the MFIs within the REDCAMIF networks are non-governmental organizations (NGOs) serving on average 10,000-12,000 clients with working capital loans of terms less than 12 months.[6]

| REDCAMIF | www.redcamif.org | MFI members | Clients | SMEs in Country | % Coverage | Loan Portfolio (US$) |
|---|---|---|---|---|---|---|
| Guatemala | REDIMIF | 19 | 180,145 | 1,028,000 | 18% | 85,276,000 |
| El Salvador | ASOMI | 11 | 64,025 | 532,000 | 12% | 79,996,000 |
| Honduras | REDMICROH | 24 | 163,746 | 545,000 | 30% | 100,908,000 |
| Nicaragua | ASOMIF | 20 | 307,693 | 550,000 | 55% | 178,886,000 |
| Costa Rica | REDCOM | 12 | 20,000 | 250,000 | 8% | 45,464,000 |
| Panama | REDPAMIF | 7 | 11,403 | 220,000 | 5.2% | 12,783,000 |
| **Total** | | **93** | **747,012** | **3,125,000** | **24%** | **503,313,000** |

Source: Revista REDCAMIF, April 2007

## SICSA: Motivation and Purpose

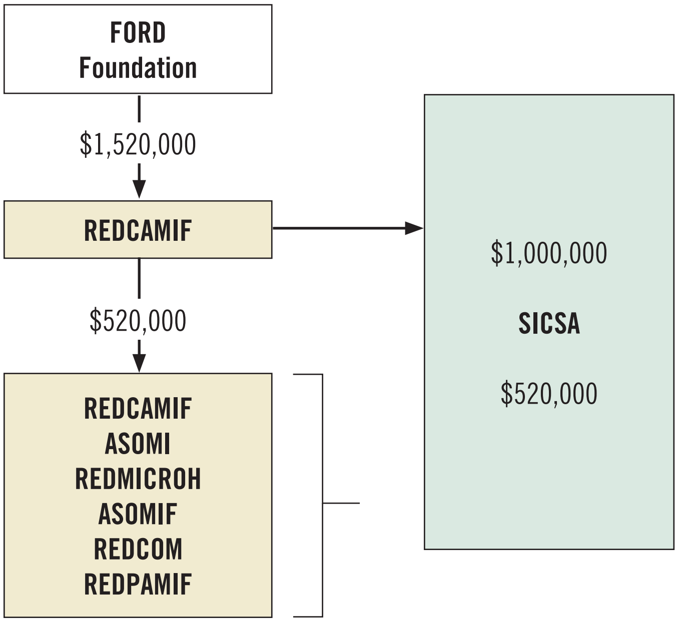
SICSA (Investment Company for Microfinance in Central America and the Caribbean) is a second tier financial institution created under the laws of the Republic of Panama in February 2006. It was established as a corporation with a financial license granted by the Ministry of Economy and Commerce and a future fiduciary license to be granted by the Superintendent of Banks of Panama.

3 Economic estimates exclude Panama.

4 SICSA business plan, May 2007

5 Revista REDCAMIF, Abril 2007

6 Revista REDCAMIF, Abril 2007




### SICSA Proposed Products

- FOCAP: Fund for investment in micro and small enterprise lending
- FINAG: Product innovation fund for gender and environmentally sensitive products and services
- FOVIS: Fund for housing improvement and construction.
- FOMICEN: Financing for rural small-scale farming activities
- FEDEN: Resources for MFIs to respond to difficulties associated with natural disasters.

At the time of this article, the company was still in its initial capitalization phase seeking both equity investment and loans. The planned start date for operations is February 2008. Current investments include US$ 1 million from REDCAMIF and US$520,000 from REDCAMIF members, six national microfinance networks. Resources for investment were obtained from a grant from the Ford Foundation.

SICSA is an outcome of a long and thoughtful planning process. The company, as it is currently conceived, responds to many of the most concerting priorities of REDCAMIF and its members. This includes the promotion of innovative products and services, the long-term financial sustainability of the REDCAMIF organization and national-level networks, and support for greater financial sector integration.

## Support for Innovation

The quantitative demand for financial services is evident. An estimated 70% or more of the market demand is still unmet by existing financial service providers. Increased access to private investment is an important means to bridge this gap. NGOs that make up a majority of the members of the Central American networks can face significant challenges in accessing funds. As unregulated institutions, they can not mobilize savings.[7] As relatively small organizations with limited equity, they often face restrictions by lenders in how much they can borrow.

However, in addition to merely increasing available financing to associated MFIs, REDCAMIF looks to SICSA as a means to promote innovation. It wants to provide credit to institutions that will encourage experimentation in new markets, testing of new products, and more long term investment in enterprise. It reasons that current terms imposed by many of the larger financiers, specifically public entities, limit MFIs ability to expand its product and service offerings beyond traditional working capital loans. Existing sources of funds are often restricted to certain markets or geographic areas and are relatively short term in nature.

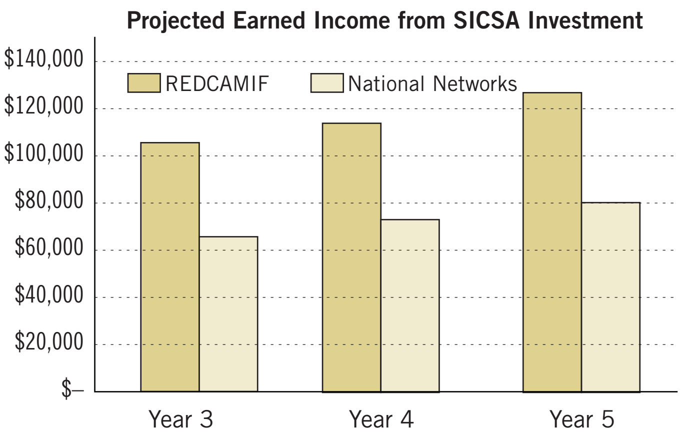
SICSA plans to offer a variety of options. In addition to providing financing for traditional small and micro enterprise loans, it plans to offer special lines of credit for response to natural disasters, financing of rural small-scale farming activities, housing improvement and construction, and innovative loan products that target the special needs of women, as well as environmental concerns. Increasing the impact of financial services is a long-term objective of REDCAMIF. SICSA's product strategy reflects this priority.

## Sustainability strategy

Given their non profit status and their service- oriented missions, networks face a formidable task achieving financial sustainability. In many cases a private market does not exist that can effectively pay for the cost of the services it offers. Like most, REDCAMIF derives income from fees for services and membership dues. Nevertheless, a significant amount of its total budget is financed from donations, short-term grants mostly from international organizations. Increasing its ability to generate income through business ventures has been an objective of REDCAMIF since inception. Some of the national-level networks have experimented with investment in credit bureaus and other microfinance related activities with the intention of generating sustainable income flows to offset costs and decrease dependency on donations. Using the Ford Foundation grant to capitalize SICSA, a for-profit company, is another example of this purposeful movement toward increased self-sufficiency.

7 Honduras is an exception. Financial legislation in Honduras permits limited savings mobilization for specialized non-profit microfinance organization.

The company's business plan projects profitability by the end of its second year in operation. Limited distribution of dividends will likely begin in the third or fourth year.[8] Projected returns on equity exceeding 12% by year five could translate into important contributions to REDCAMIF's financial viability. An estimated one-third of the organization's core operating budget is currently covered by earned income from trainings, conferences, and other services. If SICSA meets its profitability goals, earned income could cover two-thirds or more of this budget. National-level networks representing a smaller percentage of ownership will also be impacted, though on a more limited scale.




Source: SICSA Business Plan May 2007

### *Relationships with Capital Markets*

There are important and fundamental differences between administering funds from an external source and being an investor. As a recipient of funds, an organization is ultimately obliged to consider the objectives of the financing agency even before its own. In microfinance, as in many other areas of development, international organizations are most often the source of investment. Despite efforts to develop more equitable relationships between local and international entities, indigenous organizations are principally beneficiaries of donations. This is the case of most microfinance networks.

REDCAMIF considers this in many ways to be a limitation. It believes it can play a more strategic role in shaping the future of microfinance in Central America as an investor. Through SICSA, it would have the resources and the credibility to engage in direct negotiations with international financiers. Likewise, the company's organizers believe majority ownership in the hands of local organizations will ensure greater sensitivities to the needs of the sector. As a result, future alliances with international and regional actors could result in not only greater investment, but greater impact.

As Ivan Guiterrez, REDCAMIF's Executive Director, expresses "It is not just a problem of money; it is an issue of how to influence the development of the sector. It is about moving beyond being a receiver of funds to becoming participants in the process with power of negotiation." From the perspective of REDCAMIF, greater financial sector integration is not only about creating financial mechanisms. It is about creating the relationships among organizations, locally and internationally, that can effectively link the region's microfinance industry with the resources of local and international capital markets.

## Strategic Concerns

As with any business venture, risks must be carefully considered. Risks can generally be categorized into controllable risks, those which can be addressed through internal policies and structures, and uncontrollable risks associated with a company's operating environment. For SICSA, organizational risk is regarded as the most important area potentially impacting the company's future. From the perspective of SICSA's organizers, it is a risk that can be controlled with the right strategy.

### *Organizational Risk*

Organizational risk is principally about leadership. It is about threats to a company's direction and its ability to carry out its mission. Organizational risk is most often mitigated through the definition of ownership structures and internal policies that define the means in which the company is governed. Consequently, the issue of SICSA's ownership and governance has been a principal area of investigation.

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>
> **Ivan Guiterrez, Exec. Director REDCAMIF**

Initially REDCAMIF imagined itself as majority owner. As the company's principal promoter it seemed to make sense to have the network own and manage the enterprise. Nevertheless, under closer scrutiny, the strategy revealed important weaknesses. In particular, the possibility of having networks as owners proved problematic. By definition networks are diverse organizations. They are governed not by owners but rather the interests of a multitude of individual institutions. Representations of these

8 Dividend policies for SICSA are not yet formalized.

interests in boards of directors change frequently and sometime dramatically. REDCAMIF is a network whose members are networks, as such; this multiplicity exists on many levels. For SICSA this translated into a prospect for instability.

### *Ownership and governance*

What if a future board of directors of REDCAMIF decided SICSA should change its lending policies in a manner detrimental to the original mission? What if organizational missions began to conflict? Part of recognizing and understanding risks is imaging worse case scenarios. Presently there is great deal of consensus among REDCAMIF members concerning the future of SICSA. There is likewise a strong commitment. But could this be guaranteed?

SICSA's organizers understood the best means to ensure stability for SICSA was by ensuring its autonomy. In particular, it was decided direct influence from REDCAMIF and member networks should be measured and controlled. Ownership and governance structures have been defined with this purpose. The company's statutes limit REDCAMIF's ownership to 32% of total shares. The six participating national networks make up another 20%. The remaining 48% of shares will be divided among institutional investors, MFIs, and individual investors. While ownership will be principally retained by REDCAMIF and its member networks, no one organization will hold a majority stake.

| Investor | Class of Share | Maximum Holding | Rights |
|---|---|---|---|
| REDCAMIF | A | 32% | 1st director and Board President |
| Redes Nacionales | B | 20% | 2nd director and Board Secretary |
| IMFs Miembros de Redes | C | 21.33% | 3rd director and Board Treasurer |
| Inversionistas Institucionales | D | 13.33% | 4th director and on Audit Committee |
| Inversionistas Privadas | E | 13.33% | 5th Director |

Source: SICSA Business Plan May 2007

Company statutes define a distinct shareholder structure contemplating each type of owner: REDCAMIF, national networks, local MFI associated with REDCAMIF, institutional investors, and individual investors. Each class of shares has distinct rights and responsibilities carefully balanced to ensure no one group can exercise an excessive degree of influence. REDCAMIF retains class "A" shares and has the right to elect SICSA's first director and the board president. National-level networks have been assigned class "B" shares. No one individual networks can control more than 20% of class "B" shares. National-level networks will have the right to elect to elect the second director and the board secretary. REDCAMIF affiliated MFIs will hold class "C" shares. They will have the right to elect one director and the board's treasurer. Institutional investors will retain class "D" shares. They will be able to elect the company's fourth director and will be represented in the board's Audit Committee. Finally, class "E" shares will be available to private individual investors up to a limit of 10% of total shares. Class "E" shareholders will have the right to elect one board member.

## Financial Projections

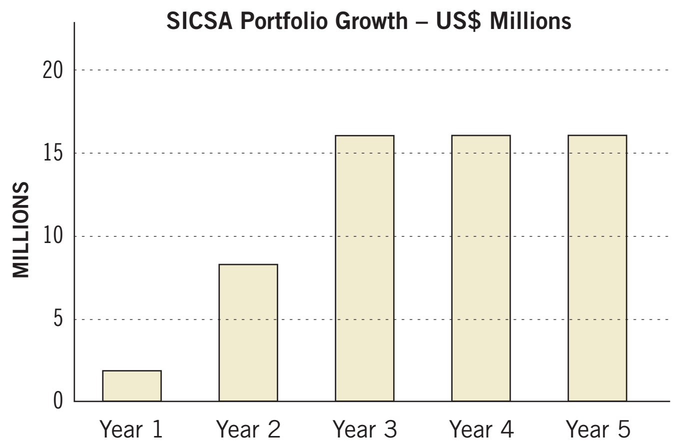
The company's business plan projects a solidly profitable company in the relatively short term. Losses are predicted for the first year only. The company is projected to reach a point of equilibrium in year two with an average outstanding portfolio of US$ 5.49 million. By its fifth year, returns on equity are projected to exceed 12%. A significant portion of profits will be used to finance expansion.

### *Funding*

The company's future financial viability is based on several important assumptions. One of the most critical is the company's ability to attract funding, both equity and loans, during the first years of operations. Presently the company is capitalized with investment of US$ 1.52 million from REDCAMIF and member networks. Organizers hope to attract another $100,000 in investment before operations commence in February 2008. It plans to obtain another US$ 2.13 million in equity in the second and third year. After the first year, debt financing is increasingly important. SICSA hopes to mobilize US$ 13.2 million in loans. If projections are met, long term debt financing will fund seventy-eight percent of the company's portfolio by year five.

## *Portfolio growth*

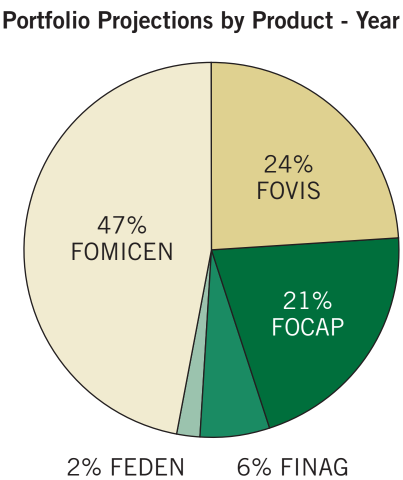
Portfolio growth is projected to be dramatic, especially during the second and third year of operations. SICSA plans to invest more than US$ 17 million in MFIs in the region by the end of its fifth year of operations. It hopes to invest more than 40% of these loans with MFIs financing small-scale farming activities in rural areas.




Source: SICSA Business Plan May 2007

## *Financial Performance*

SICSA expects to ensure profitability by keeping operational and financial costs low. Operational costs in relation to total revenue are planned to be close to 2% by year five. This as a result of relatively fast projected growth combined with comparatively low overhead costs. Likewise, financial margins are obtained through relatively low costs of funds, estimated to be 25% or less of total revenue. Cumulative retain earnings are projected to exceed US$ 2 million by year five.




Source: SICSA Business Plan May 2007

| | SICSA Projected Financial Performance | | | | |
|---|---|---|---|---|---|
| | **YEAR 1** | **YEAR 2** | **YEAR 3** | **YEAR 4** | **YEAR 5** |
| **Total Income** | **132,091** | **661,598** | **1,301,978** | **1,437,678** | **1,477,272** |
| Revenue | 100% | 100% | 100% | 100% | 100% |
| FInancial Expense | 0% | 13.6 | 20.7 | 25 | 24.4 |
| Personnel Expense | 81.4% | 22.6 | 11.5 | 10.4 | 10.1 |
| Operational Expense | 23.6% | 4.7 | 2.4 | 2.2 | 2.1 |
| Provision for Loan Losses | 24.7% | 22.6 | 15.3 | 11.9 | 9.3 |
| Depreciation | 2.4% | 0.6 | 0.3 | 0.3 | 0.3 |
| Taxes | 0% | 0 | 0 | 0 | 0 |
| **Profit Margin** | **-32%** | **35.9** | **49.8** | **50.2** | **53.8** |
| Asset Rotation | 0.08 | 0.12 | 0.10 | 0.08 | 0.08 |
| **Return on Assets** | **-2.4%** | **4.2** | **4.8** | **4.1** | **4.4** |
| Leverage | 1.1 | 2.6 | 3.9 | 3.5 | 2.9 |
| **Return on Equity** | **-2.6%** | **10.9** | **18.4** | **14.1** | **12.9** |
| **Retained earnings (cumulative)** | **-42,335** | **194,335** | **842,769** | **1,564,575** | **2,359,739** |

Source: SICSA Business Plan May 2007

## Conclusion

Making the decision to become an investor is a complex question and one that has the potential of fundamentally affecting a network's identity. Can other networks take on such a role? Should they? There are no definitive answers. In fact, REDCAMIF's plan for SICSA may or may not be replicable in other contexts. It is nonetheless, an experience worth observing. Risk taking and experimentation is what has fostered the development of microfinance. It is the reason why REDCAMIF has the opportunity to consider such a forward-thinking venture. Nevertheless, markets are still far from mature. Innovations need to occur on many levels. Networks are obliged to contribute to this development in a way that best achieves their mission and the evolving demands of their members.

One of the most important questions to be answered in this process is whether networks can provide value as investors. In other words, does a network possess unique capabilities that will contribute to the development of local microfinance markets in a way that existing or potential investors can not? This is not necessarily an easy question to answer. A great deal depends on the characteristics of individual networks. As such, networks need to carefully analyze their own strengths and weaknesses relative to others. A thoughtful evaluation may reveal an organization's skills, could be better utilized in other types of initiatives with similar objectives, such as the development of benchmarking systems or lobbying for more appropriate financial legislation. While the prospects of profitability may be very enticing, as service-oriented institutions, most networks will need to consider their ability to ensure impact even above considerations of financial gain.


## ACKNOWLEDGEMENTS

A special thanks to the following people and organizations who volunteered their time to contribute to this case study: Reynold O. Walter P., President of REDCAMIF, Iván Gutiérrez, Executive Director of REDCAMIF Armando García, President of ASOMIF- Nicaragua, David Myhre, Program Officer, Development Finance and Economic Security, Ford Foundation, Dr. Julio Paniagua, Legal Advisor to REDCMIF for SICSA, Manual Salgado, Business Plan Consultant for SICSA, Alfredo Alaniz- Executive Director of ASOMIF Nicaragua



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## ABOUT SEEP NETWORK

SEEP is an international network of institutional and individual members committed to reducing poverty through the power of enterprise. Its over 70 institutional members are active in 139 countries and reach over 25 million microentrepreneurs and their families. SEEP promotes professional standards of practice in microfinance and enterprise development, conducts capacity building activities for its members and other practitioners, creates and disseminates publications for application in the field, and serves as a center for collaboration on a broad range of sector-related issues.

## ABOUT REDCAMIF (CENTRAL AMERICAN MICROFINANCE NETWORK)

The initiative to create a Central American Microfinance Network emerged in July of 1999 and since has established diverse mechanisms of coordination between microfinance networks within each country, having finalized a legal constitution in 2002. The Central American Microfinance Network was created with the objective of promoting the microfinance industry and impacting the economic and social development of the Central American region. In this way, REDCAMIF hopes to influence the political conditions, rules, and regulations that benefit and strengthen the microfinance sector in the Central American region.

The SEEP NETWORK