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Investment Readiness and Microfinance Associations: Bridging the Financing Gap

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Investment Readiness and Microfinance Associations: Bridging the Financing Gap

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ACCION International

Grameen Foundation, USA

Mennonite Economic Development Associates (MEDA)

Microfinance Center for Central and Eastern Europe and New Independent States (MFC)

Russian Microfinance Center (RMC)

Sa-Dhan, India

Sanabel - Microfinance Network of Arab Countries

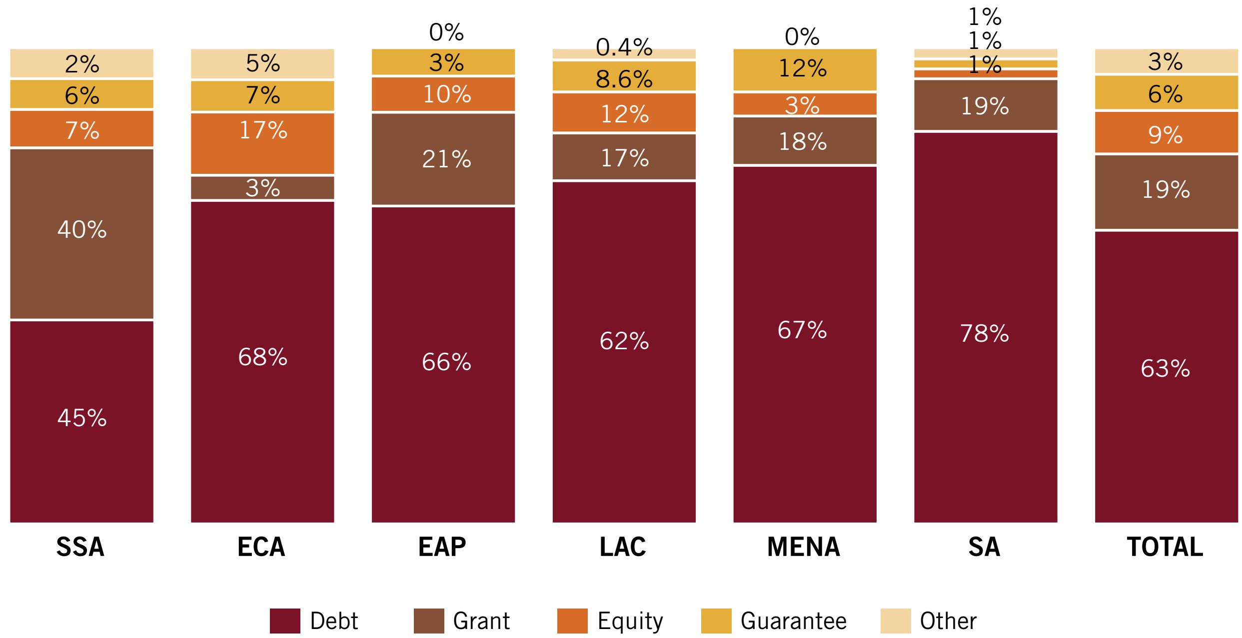
ABBREVIATIONS

CGAP	Consultative Group to Assist the Poor
ECA	Eastern Europe and Central Asia
ICAI	Institute of Chartered Accountants of India
IFI	International Financial Institution
MFC	Microfinance Center for Central and Eastern Europe and Independent States
MFI	Microfinance Institution
MIV	Microfinance Investment Vehicles
MIX	Microfinance Information Exchange
RECAMIF	The Central American Microfinance Network
RMC	Russian Microfinance Center
SICSA	Investment Company for Microfinance in Central America and the Caribbean
TOT	Training of Trainers

A Case for Commercial Finance

Poor and low-income clients around the world depend on well-capitalized MFIs that have an appropriate mix of funds sufficient to meet their institutional goals. Recent trends in financing flows to the microfinance industry reflect a changing financial landscape, where traditional donor funding is being replaced by private and more commercially-oriented capital, which has a different range of investment criteria and return expectations. Debt and equity are replacing grants as the largest source of funding for global microfinance portfolio growth. Yet, access to commercial capital continues to elude many MFIs and has become more difficult for others as the global financial crisis puts pressure on local capital markets—and further restricts access to finance.

Figure 1: Funding Flows as of 2007



Number of respondents: 54

Note: The nature of the debt instrument is different for donors and investors. Investors typically provide debt directly to retail financial institutions or indirectly through investment vehicles. Many of the largest donors, however, channel their debt instruments as loans to governments. Governments can then use funds for mulitple purposes, including on-lending to the retail level.

Source: CGAP, 2008, "2008 Microfinance Funder Survey Global Results," in "Who Is Funding Microfinance? Results of the First Global Survey," online document, http://www.cgap.org/gm/document-1.9.6303/Regional%20Snapshots%20-%20Global%20-%207Nov08-rev2.pdf

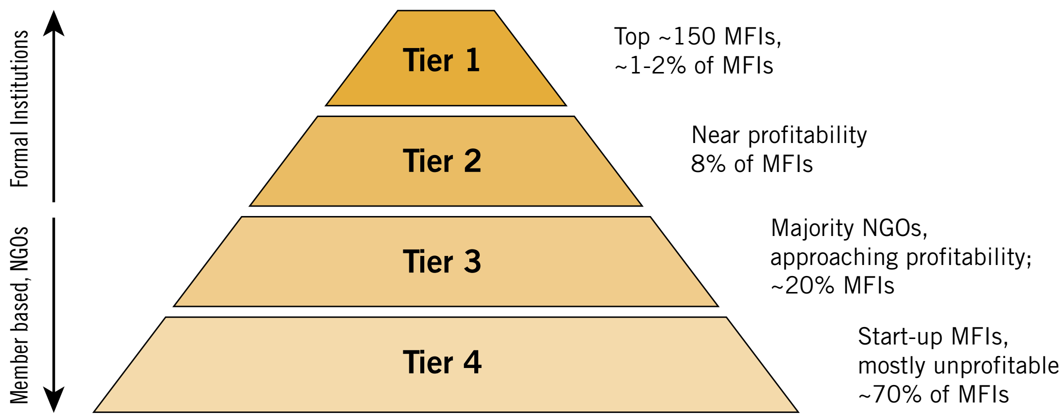
As regional and national level associations grow and refine their strategies for promoting the development of vibrant microfinance sectors, it is critical that they include the expansion of finance as a key component of supporting their members. By virtue of their representational nature and their access to a broad range of stakeholders, associations are uniquely positioned to promote and improve MFI access to finance through their direct capacity-building activities and strategic support services.

This technical note offers guidance to associations on how best to support their members' ability to access capital, in a way that complements the association's core services and leverages its role in the industry. Specifically, this note examines the different elements of investment readiness and how associations can support this process through their products and services, illustrated by examples from the field.

Bridging the Financing Gap

One of the key constraints facing MFIs as they mature and expand their operations is access to finance. Demand figures for the sector vary. However, it is estimated that an additional US$ 300 billion is needed to provide financial services to the world's unbanked peoples.[1] Although overall debt and equity flows have increased, investment is being directed disproportionately toward first- and second-tier MFIs (i.e., profitable, regulated, or operationally sustainable MFIs) that represent only a small fraction of the sector.[2] The vast majority of service providers still relies on donor funds and has yet to successfully tap into local and international capital markets to fund their operations.

Types of MFIs: According to degree of commercialization



Source: Meehan, Jennifer, 2004, "Tapping the Financial Markets for Microfinance: Grameen Foundation USA's Promotion of this emerging Trend," online document, http://www.microfinancegateway.org/gm/document-1.9.27254/21958_CapitalMarketsWhitePaper.pdf

This disconnect between MFI demand and investor supply is directly related to the degree of *investment readiness* among MFIs, both in terms of the MFI's 1) operations and 2) its ability to identify and communicate successfully with potential investors. In the first instance, many MFIs are still quite young or lack the institutional capacity needed to meet the basic criteria of most commercial investors. Specifically, they are unable to demonstrate crucial elements to investors:

- Transparent financial performance information
- Application of industry standards, including client protection practices
- Sound governance and management
- High quality loan portfolio
- Strong profitability and efficiency trends
- Cost-recovery pricing
- Strong ratings by professional raters
- Good prospects for growth
- Strong, visionary leadership/governance

1. CGAP, the Consultative Group to Assist the Poor.

2. MicroBanking Bulletin 17, Autumn 2008.

In the second case, MFIs may be able to meet all the aforementioned criteria, but lack the knowledge or expertise to raise money from commercial investors, relying instead on more familiar donor funding to meet their financing needs. While these MFIs may be highly adept at writing grant proposals or negotiating with donor agencies, they are less prepared to:

- Determine the appropriate type of investment needed to match specific growth objectives (debt versus equity, long term versus short term)
- Negotiate the terms and costs of an investment
- Undergo the intense due-diligence process that investors require
- Identify and manage the various risks involved with an investment, particularly in terms of foreign exchange

At the same time, commercial investors tend to be less familiar with microfinance markets and investment opportunities on the ground. Local investors often do not realize the investment potential of MFIs and still consider banking at the bottom of the pyramid as too risky. While international investors may be more convinced of the global investment potential, they lack the sector data needed to assess specific country level opportunities.

Appropriate Role of Associations

Associations can play a key role in bridging the financing gap by leveraging their positions in the market to increase the flow of information to investors and prepare their members to begin accessing debt and equity to meet their institutional goals. The exact mix of services offered and the role the association plays will vary depending on the level of maturity of the market, member demand and the association's own institutional capacity. Emerging associations may decide to focus on more traditional services related to its information exchange function. But as associations mature and adapt their services to meet evolving market demands a more sophisticated approach will be needed.

Promote Transparency and Information Exchange

One of the core functions of an association, regardless of its level of maturity, is to act as a focal point for data collection, helping consolidate and promote the free flow of publicly available, accurate, and comparable information in the sector they represent. This information function generally takes place at two levels: 1) the collection and analysis of MFI performance data and 2) knowledge management of sector wide industry data.

Roles of Associations

1. **Promote Transparency and Information Exchange**
   - MFI performance data
   - Knowledge management
2. **Promote Investment Readiness Services**
   - Capacity building training
   - Investment readiness training
3. **Provide Access and Introductions to Investors**
   - Improve collections and dissemination of investor information
   - Establish linkages with existing investors
   - Match making

MFI Performance Data

Financial transparency is essential for building the legitimacy of the microfinance sector. Providing accurate and up to date information on MFI financial performance builds up credibility among local governments and populations; provides MFI managers critical information for making sound business decisions; and helps to attract investors needing to assess the risk of potential investments. This includes the promotion of standardized reporting, ratings, and performance benchmarking, as well as setting common terminology and definitions for the data to be collected. With individual benchmarking reports, MFIs can track and analyze their ratios in comparison to their peers and evaluate their own success or shortcomings on social performance and market pricing, as well as standard financial ratios. Consolidated reports can provide potential investors with the information they need to understand the local operating environment.

Case Study: Sa-Dhan—Promoting Transparency through a Standards Initiative

One of India's leading microfinance associations, Sa-Dhan supports the development of the industry by helping build local capacities, promoting the evolution and adoption of best practices, increasing the number of service providers, and contributing to the improvement of the policy and operational environment in the country. In India's largely unregulated sector of microfinance, Sa-Dhan has promoted transparency in a number of ways.

Through a participatory diagnostic process with its members, Sa-Dhan developed six financial performance standards, which it disseminated among MFIs for adoption and reporting. Since 2004, Sa-Dhan has collected and published these standards, along with MFI performance data and additional information, to help investors and bankers evaluate investment opportunities in the sector. The *Bharat Microfinance Quick Data Report* includes unaudited MFI data and is published immediately after the closure of the financial year. The *Bharat Microfinance Side-by-Side Report* includes audited financial data, as well as MFI performance analysis.

In addition, Sa-Dhan worked with the Institute of Chartered Accountants of India, the national statutory accounting body, to publish accounting standards for MFIs. This work is expected to set uniform accounting practices among MFIs across the country and bring more transparency in financial reporting.

Knowledge Management

In addition to collecting MFI performance data, associations play a critical role in compiling sector wide data on the state of the industry and recent developments in the field that provide greater insight into the investment climate. Country- or region-level state of the sector analyses of the financial, legal, and regulatory environment can provide investors with a more nuanced understanding of the challenges faced by MFIs in a particular market, as well as the trends and current investment opportunities. This is particularly the case in emerging or frontier microfinance markets, where little is known about the business potential and associated risks. These reports can also be used to solicit greater support from policymakers in promoting a more enabling environment for MFI investing, as well as identify best practices for building inclusive financial sectors at a national level that can be used as guidance in other markets.

Sector assessments should include information on these areas:

- Macroeconomic indicators
- Financial sector indicators
- Legal/regulatory framework
- Microfinance supply and demand analysis
- MFI performance data
- Microfinance sector trend analysis
- Funding sources (public and private capital markets)

Case Study: MFC's Sector Study

The Microfinance Center (MFC) for Central and Eastern Europe and the New Independent States supports a socially oriented and sustainable microfinance sector that provides adequate financial and non-financial service to a large number poor families and microentrepreneurs in its focus region. To advance this cause, MFC seeks to provide high quality services and build long-term relationships with the microfinance community.

In 2003, MFC released the first annual publication in its series, *The State of Microfinance in Central and Eastern Europe and the New Independent States,* as part of an ECA (Europe and Central Asia) project aimed at mapping the microfinance players and identifying barriers in accessing MFI financing. The topics included access to and use of various financial services, flows of remittances, potential market for micro-insurance, supply of microcredit and saving services by MFIs, and social performance of non-governmental organizations and non-bank financial institutions.

The report is targeted at governmental bodies, donors, investors, and MFIs, and is distributed to all stakeholders interested in microfinance in ECA. It is a major component of MFC's investment facilitation efforts and provides information on the number and type of funders financing the sector, as well as analyzing the terms that MFIs receive in the market.

Provide Investment Readiness Services

As associations mature they can move beyond the core information function to explore more complex services that can more directly help their members access capital. This can take the form of formal capacity building activities provided directly by the association or in partnership with qualified technical service providers.

Capacity Building Training

To address operational constraints to accessing capital, many associations provide direct capacity building to its members through targeted training programs for loan officers, as well as mid- and senior-level management, depending on the needs of the market. These programs help MFIs become investment-ready by focusing on key organizational areas of development. Associations can add value by focusing on strategic areas of support:

- ***Financial management and sustainability*:** financial reporting and analysis, financial modeling, asset management, fundraising/marketing
- ***Operational and functional support*:** new product development, human resource development, marketing and sales
- ***Strategic leadership support*:** risk management, strategic business planning and development, governance and succession planning
- ***Social performance management:*** financial literacy, impact assessments, social performance indicators, client protection policies, etc.

Investment Readiness Training

More advanced MFIs that have achieved the basic operational and financial criteria required by more commercially-oriented investors will benefit from specialized investment-readiness coaching to help them take the next step. For many MFIs, particularly those that started as donor projects, the world of commercial investors is more difficult to navigate than familiar funding channels. Not only do these discussions introduce a new financing lexicon for MFI management, they also require a deeper understanding of the MFI's capital structure and the costs associated with the different financing options available.

Case Study: ACCIÓN and MEDA Investment Readiness and Management

MEDA (Mennonite Economic Development Associates) and the Center for Financial Inclusion (CFI) at ACCIÓN International sponsor the *Investment Readiness and Management* training, which combines capital attraction investment readiness and advanced management skills. This training is designed to enable promising MFIs to attract and manage capital provided by commercial, as well as socially-motivated investors. Since 2006, several hundred people have participated in different versions of the *Investment Readiness and Management* training which is open to non-ACCIÓN and MEDA affiliates.

The training is focused on senior managers of tier two and tier three microfinance institutions that seek to expand their ability to raise capital from conventional investment sources, rather than donors. The training usually runs from two to five days, but can be customized according to the sponsor and MFIs' needs. The training is reinforced by case studies based on actual microfinance experience in which senior managers make choices based on a number of competing variables to ascertain the best investment options. The investment topics covered in the training can include advanced performance measures, characteristics of debt and equity, trends in microfinance capital markets, requirements and expectations of investors, valuation, and negotiations. The training also covers some key management issues, which must be satisfactorily addressed in order to attract investment capital, and these include governance and accountability, business planning, asset-liability management and transformation.

MEDA and CFI work with microfinance associations to screen potential participants and identify the needs of the group in order to tailor the *Investment Readiness and Management* training. In addition, they believe that associations can contribute greatly by helping to ascertain the impact of the training. Currently, MEDA and CFI are implementing a web-based follow-up subsequent to the training, which is conducted through webinars, moderated discussions and blogs. They expect that these tools can even have a greater impact with the involvement of microfinance associations.

Associations can provide tailored training sessions geared to help MFIs identify, negotiate, and secure appropriate funding from commercially oriented investors. Equipping their members come to the negotiating table well prepared facilitates communication with investors and helps MFIs find financing solutions that appropriately meet their capital needs. This preparatory training can include these topics:

- ***Primer on funding diversification*:** overview of terms and concepts, the importance of commercially oriented capital in achieving MFI growth and development objectives, introduction to terminology and definitions of investment instruments available in the market, understanding the costs associated with different financing options (debt versus equity versus guarantee), and guidance on how to source the appropriate type of financing (given the MFI's current institutional needs and long-term objectives)
- ***Introduction to investors*:** overview of the types of private investors (social as well as purely commercial) currently investing in the microfinance market, the typical investment process and criteria (social as well as financial performance), the importance of transparency, and tips for managing these relationships in long-term partnerships
- ***Presentations to the Investor*:** developing a strategic business plan, building a "road show," and preparing for the due-diligence process
- ***Closing the deal*: a**nalyzing and negotiating a term sheet, assessing the full costs of financing (including any hidden costs), and evaluating foreign exchange risk and local hedging instruments

If associations do not provide direct training to their members on these topics, they can identify external investment-readiness training programs and place their members into appropriate courses (for example, through prescreening), based on their level of maturity and current investment needs.

Case Study: Grameen Foundation's Investment-Readiness Project

Grameen Foundation's "Investment Readiness Training" is a global initiative created to advance microfinance institutions' access to capital markets. It works with MFIs to help them better understand their financing needs and to develop strategies for negotiating the best financial deals possible.

The "Investment Readiness Training" targets tier-2 MFIs (in the growth stage), and some early stage tier-3 MFIs, which are heading rapidly toward capital investment. The participants are selected via a prescreening process. Grameen approaches local microfinance associations for potential candidates that meet the training criteria and reviews each MFI's financial statements to ensure that groups are matched, based on similar levels of maturity, to enhance the success of the training. After the screening, the content of the course is tailored to participants' needs, with a focus on 1) the different financial needs and types of financing available for MFIs at the various stages of growth, 2) the pros and cons of different types of commercial financing, 3) strategies for securing funding from commercial lenders/investors, and 4) tips for negotiating the best terms possible (e.g. pricing, loan tenor, relationships with the investor/borrower, etc.).

Since 2006, Grameen Foundation has designed and provided training on investment readiness to partners and non-partners. The courses can include a follow-up workshop. In addition, a less formal follow-up is conducted with partners by staff in the field. Finally, associations play an important role in sharing feedback information on how MFIs put their knowledge to use to ensure regular refinement of the course.

Provide Access and Introductions to Investors

Associations can use their exceptional access to information through their members and links with key stakeholders to bridge the gap between MFIs and the broader pool of private investors. It is important to note that members are in competition for these funds. Therefore, associations have to be careful not to be perceived as assisting one organization over another or becoming involved in de facto brokering services.

Improve Collection and Dissemination of Investor Information

Associations can create a database of country, regional, and global investors or microfinance investment vehicles that are interested in investing in their particular country or region.[3] This resource could include information on investment strategies and criteria, terms and conditions, parallel technical-assistance support, guarantee facilities for leveraging local debt, as well as consultants, advisors, and other investment-readiness resources easily accessed by MFIs. While some of this information is available on a global level at the MIX Market, by tailoring the information to the country or regional context, an association can provide more detailed and relevant information for their members.

3. The Microfinance Center publishes a *Directory of Funders* each year, which lists information about funders active in Europe and Central Asia (contact info, types of products, terms and conditions offered, and eligibility criteria). The Pakistan Microfinance Network publishes a similar report, "Funds for Microfinance in Pakistan: An Overview," which, in addition to summarizing funding sources in the country, highlights major key funders with a strategic interest in the sector.

Case Study: Sanabel Conference and the *Financing Forum*

Sanabel, the microfinance association for Arab countries, advocates growth, innovation, best practices, and standardization of the microfinance sector. It does this by strengthening the capacity of its members through needs-based training, technical assistance, and peer exchanges, and by promoting microfinance best practices among regional stakeholders through transparency, standardization, peer learning, and information-exchange efforts.

The association uses its annual conference, among other things, as an opportunity to update participants about the state of commercially oriented funding in the region and to profile the state of investment readiness of various Arab MFIs. In addition to recurring sessions on MFI financing (i.e., achieving transparency, formalizing the microfinance sector, negotiating funding terms, and preparing for commercial investment), Sanabel has developed a special "Financing Forum," which has become an integral component of its annual conference.

The Financing Forum is intended to 1) provide a platform for investors and donors to share with MFIs their commercial and social investment priorities and prospects for available financing, and 2) facilitate one-on-one meetings between MFIs and investors to discuss specific funding opportunities. This prearranged networking event has helped Sanabel members establish and develop relationships with investors and donors, particularly tier-2 and tier-3 MFIs seeking to increase and diversify their funding sources. Given the association's strategic regional role and the scale of its annual conference, the Financing Forum is probably the most opportune investment event for Arab MFIs and investors with vested interest in the region.

Establish Linkages with Existing Investors

Associations can facilitate relationship building between investors and its members by providing individual briefings on the investment climate; clarifying industry terminology and investment requirements, including emerging standards on client protection; producing relevant up-to-date sector studies and reports tailored to the needs of investors; and being the primary source of up-to-date information on MFI social and financial performance data.

Match Making

Associations can also use their annual conferences and events to bring their member MFIs together with investors. These forums provide opportunities for open networking, as well as for specialized events aimed at matching their members with investors who share similar goals and investment objectives.

Guiding Principles for Associations

Access to finance is an increasing priority for the majority of MFIs operating in the microfinance sector. How associations position themselves to help their members meet their financing needs will be critical moving forward. Developing products and services that are demand driven and appropriate given the level of the development of the sector and the association's internal capacity will be key components to success. As associations develop their strategies for supporting greater member access to capital there are a number of considerations to bear in mind.

1. Leverage the Association's Comparative Advantage.

Associations should build upon their comparative advantage in the areas of capacity building, advocacy, and information exchange, and strengthen core products and services accordingly. There has been increasing interest by associations to move beyond this traditional facilitation role to a more proactive position in local capital markets as a direct investor. However, this may distract them from core association activities and requires specialized expertise that associations generally do not possess.

2. Build upon Existing Efforts.

Associations should leverage existing efforts in the field of investment readiness and build upon trainings provided by technical-service providers or international networks. Wherever possible, associations should tap into existing tools, translating or adapting them as needed, and incorporate the most relevant and up-to-date information on investors and current investment climate.

3. Expect to Accommodate a Broad Range of Understanding on the Topic.

While a number of more mature, top-tier institutions have specialized staff, who have commercial banking experience and are well versed in banking terminology, the majority of MFIs are still grappling with basic concepts of commercialization and the transition from donor/grant funding to a more privately-structured funding base. Therefore, associations should have a range of tools available to meet the varying needs of their members at different levels of development.

4. Be Prepared to Educate Investors.

Most international financial institutions and microfinance investment vehicles investing in the microfinance sector are familiar with the business model, terminology, and indicators used to assess MFI performance; however, many private investors are not. These investors are coming from a purely commercial perspective and will often attempt to apply traditional risk-assessment tools when assessing MFIs. Associations can provide a valuable service to their members by helping educate investors through their interactions on industry standards and best practices, as well as the latest developments in social performance management and client protection.

5. Help Members Make a Clear Business Case.

Associations can help their members understand the motivation of different investors and build a business case in line with the range of investment criteria and return expectations in the market. This enables MFIs to match themselves with investors that share similar investment objectives, ranging from the purely financial to those seeking a double bottom line.

Case Study: RMC Investor Fair

The Russian Microfinance Center (RMC) represents the interests of the microfinance community in the Russian Federation. It serves as a resource center for Russia's microfinance industry and as a national forum for its interaction with the government, public, and investors. RMC advocates an enabling legal environment for microfinance, offers training and professional consulting services to microfinance institutions, and promotes national microfinance standards.

Each year, RMC runs an "Investors Fair" during its annual microfinance conference. This event offers the microfinance industry a unique opportunity to learn more about banks and investors operating in Russia and about the products they offer. Representatives of microfinance institutions have a chance to meet and negotiate directly with officials of commercial banks and specialized investment companies that participate in the Investors Fair. In 2008, about 500 representatives of MFIs, donors, and governments, plus 15 local and foreign investors, participated at the 7th National Microfinance Conference in Russia. Additionally, an investor catalogue was developed and distributed to all participants of the conference. As a result of the RMC efforts, the total amount of foreign investment increased to US$ 20 million.

Resources

Online Tools

CGAP. 2006. *Commercial Loan Agreements: A Technical Guide for Microfinance Institutions*. Prepared for CGAP by Cleary, Gottlieb, Steen & Hamilton LLP. Washington, DC: CGAP/World Bank. http://www.microfinancegateway.org/p/site/m/template.rc/1.26.10641/

Marcus Fedder. 2009. **"**Loan Clauses That Bite: A Guide to Potentially Dangerous Covenants in Common MFI Loan Agreements**."** Online document. Posted June 5, 2009. http://www.microfinancegateway.org/p/site/m/template.rc/1.26.10641/

Courses

Grameen Foundation, member only

ACCION, member only

About SEEP

The SEEP Network is a global network of microenterprise development practitioners. Its 80+ institutional members are active in 180 countries and reach over 35 million microentrepreneurs and their families. SEEP's mission is to connect these practitioners in a global learning environment so that they may reduce poverty through the power of enterprise. For 25 years, SEEP has engaged with practitioners from all over the globe to discuss challenges and innovative approaches to microenterprise development. As a member-driven organization, our members drive our agenda while SEEP provides the neutral platform to share their experiences and engage in new learning on innovative practices. The SEEP Network helps strengthen our members collective global efforts to improve the lives of the world's most vulnerable people.

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Powering connections

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