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Sequoia and Sandstone

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How to

Win an Investor in 12 Steps

Last Word

The Curious Case of Co-Investments in Microfinance

The Role of Private Equity: Fueling the Growth of Microfinance



Credit: Michael Sutto

Cover Story

The Driving Factor for MFI Valuations in India: An Insider's Perspective

In our cover story, Anurag Agrawal, Senior Vice President, Investment Banking, Intelicap, breaks down the science of microfinance valuation, and reveals why Indian MFIs have continued to attract increasing amounts of capital during the global financial crisis, and have done so at a significant premium over their global peers.

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Microfinance Investment Vehicles: Best Practices and Lessons Learned

Microfinance Investment Vehicles (MIVs) are rapidly growing in number and assets under management (AUM). There were 96 MIVs at fiscal year-end (FYE) 2007; half were created in just 3 years (2005 - 2007). MIV AUM increased from US\$637m at FYE 2004 to US\$3.7bn at FYE 2007 and US\$5.4bn in October 2008. As MIVs proliferate, the microfinance industry must study and share best practices. In this article, Bhakti Mirchandani and Howard Finkelstein distill the best practices and lessons learned from the collective wisdom of key MIV managers for the benefit of current and potential microfinance investors¹ and managers.

Methodology: We reached out to the managers of the 65 MIVs listed on the MIX Market with US\$5m+ AUMs. We interviewed 28 of these managers on structuring, capital raising, human resources, operations/systems/administration, investment, deal making, exiting and risk management best practices and lessons learned. These managers advised or managed 53% of total MIV AUM. We are deeply grateful to these managers for making the time to ensure that their MIVs² were included in this survey. The syndicated responses of the managers are presented on an anonymous basis in this article. Below are the recommended best practices for MIVs.

Structuring

- 1. Structure:** Establish regulated vehicles to increase adherence to quality standards and protect investors. For example, the General Partner (GP)-Limited Partner (LP) structure is ideal because investment exits are independent of LP approval. Many MIV shareholders have multiple microfinance investments, creating potential conflicts of interest
- 2. Tax Treatment:** Create the right subsidiaries for large and strategically important investors in different jurisdictions to optimize tax structure. For example, guarantee funds that are non-profits allow losses to be deemed donations for tax purposes
- 3. Fee Structure:** First, share fees fairly among players, including the sales channel. Second, fees should be transparent to investors, particularly upfront and exit fees. Third, given current downward pressure on fees, new equity funds may wish to reduce fees to 2% and 20% even if minimum investment size must increase to ensure profitability
- 4. Reinvestment Criteria:** Keep some AUM in very liquid investments to allow redemptions and establish redemption limits, or “gates,” to protect MIVs against the illiquidity of microfinance investments. Closed-end funds should invest with the exit in mind and target MFIs that are merger/takeover candidates for regional competitors or other MIVs
- 5. Lessons Learned:** Some MIVs invest in MFIs transforming from non-profit to for-profit via bridge loans that convert to equity upon transformation and are callable if the MFIs do not transform

Capital Raising

- 1. New MIVs: Finding a Niche.** (i) Defining a specialized strategy is critical to reach scale. (ii) Socially responsible retail investors represent stable funding; first mover advantage is key, given the stickiness of retail investments. (iii) Institutional investors have more rigorous due diligence requirements than individual investors. MIVs therefore need to be more involved with the sales processes for institutional investors, whereas they can outsource that function for individual investors
- 2. Follow-on MIVs: Expanding Scope.** Build a strong track record and reputation to facilitate subsequent capital raises. Having a follow-on fund more than 3-4Xs the AUM of the prior fund is a major undertaking in terms of processes/systems and requires significantly more resources
- 3. Investor Selection:** Ensure alignment of investor time horizons, financial return expectations, and risk tolerance with other investors and with the MIV manager. Selecting investors that share MIV vision is also critical. Long-term investors who care about development are ideal; aggressive investors can hurt the industry
- 4. Investment Minimum:** The primary driver of investment minimum should be target group, and the secondary driver should be operational capacity. A high stated minimum (e.g., US\$5mn) that is subject to manager discretion (waiving) allows exclusion of undesirable investors and inclusion of desirable small investors
- 5. Lessons Learned:** Funds focused on a single sector and geography have superior deal flow vs. diversified funds. It is better to have a pool of loyal shareholder investors who understand microfinance and the fund's geography to minimize investor education time/cost. MIV managers should do due diligence on investors (past MFI & MIV investments, exits, returns)

HR & Operations

- 1. Human Resources:** Outsource only non-core functions, like legal, marketing, and IT. Investment management decisions/key relationships should be internal. An active volunteer board can reduce outsourcing and staffing needs. Matching compensation levels of comparable industries increases talent attraction/retention
- 2. Operations/Systems:** Request data that MFIs collect to reduce administrative burden. Have a VP of Finance, a strong professional back-office, and adequate controls—

investment policies and procedures, portfolio monitoring. Funds seeking US institutional investors should be able to report to FAS 157³

- 3. Administration:** Use as much as possible from the mainstream fund industry
- 4. Lessons Learned:** MIV employee and investor incentives should be aligned. US\$40m+ MIVs have sufficient scale for internal back-offices, which enhance quality and control

Dealmaking

- 1. Entering New Markets:** Country analysis/selection is top-down vs. selecting MFIs bottom-up. Determine which regulatory approvals are critical and obtain them
- 2. Competing with Investors:** Collaborate with existing investors when possible. Conflict between commercial and social investors can arise and should be managed. Key MIV competitive advantages from the MFI perspective include management team expertise, due diligence process (including understanding MFI managers), local presence, and technical assistance
- 3. Finalizing Valuation (Equity MIVs Only):** Using a number of valuation methodologies (discounted cash flow, comparable—country, sector—price/book value and price/earnings multiple comparisons, and net asset value methodology) and triangulating to hone in on a valuation

can be helpful

- 4. MFI Investment Exits (Equity MIVs Only):** Thinking about exiting in advance (vs. many MIVs exit opportunistically) is what distinguishes equity investing from debt investing and is key to successful equity investing. Trying to understand if an MFI can be part of a larger story in a merger or in consolidation is a more socially responsible way to exit than via put options. One MIV exits when it deems it has reached its developmental goal and it can add no further value
- 5. Lessons Learned:** Have a presence on the ground if possible to fully understand the MFI in its geographic context. More systematic valuation methodologies, including market-specific methodologies, should be developed. In some markets, MIVs need to value MFIs on a price/client basis

MIV Risk Management

- 1. Market Risk Management:** Market knowledge should be developed in-house. Currency diversification makes sense, as does having investors vs. borrowers take currency risk. One MIV provides seminars on corporate governance for MFIs deficient in this area. For transforming NGOs, governance is a key risk. MIVs should focus more on political risk and perhaps consider OPIC political risk insurance
- 2. Credit Risk Management:** Develop/use in-house risk-scoring/monitoring models. Having an on-the-ground presence in portfolio company countries is ideal. Visit portfolio companies at least annually
- 3. Operational Risk Management:** The more investment professionals with private equity and venture capital experience, particularly through different cycles/crises, the better. In-house vetting/monitoring capabilities are critical even when MIVs outsource due diligence. Country and MFI

investment limits are also critical

- 4. Legal Risk Management:** Set a policy to avoid loans to unstable (e.g., coups, wars) countries. Use local law/local counsel to be a socially responsible investor, rather than burdening an MFI to learn about the laws of other jurisdictions
- 5. Lessons Learned:** In risk assessment, qualitative factors typically prevail over quantitative. MFI performance is a stronger determinant of overall investment risk than country risk. Improve portfolio MFI valuations by improving their risk management systems. Transfer risk is too expensive to hedge; evaluate it and discuss with MFIs/investors/intermediaries. Screen for socially responsible investors if limiting investor pressure to trade returns for social goals is important. Educate investors to ensure that they understand microfinance

This survey is just an incremental step towards developing a best practices regime for MIVs. We believe that MIV managers can catalyze microfinance industry growth by sharing best practices and lessons learned. We are happy to share our survey results on an anonymous basis and will work in the future to both update and broaden this study. Please do not hesitate to reach out to us with comments or questions at bmirchandani@unituscapital.com and howard@hjflaw.com. ■

1. Due to space constraints, we were not able to include all survey results. The complete article is available on www.microfinanceinsights.com and www.hjflaw.com
 2. A listing of the names of the MIVs whose managers participated in the survey can be found at <http://www.hjflaw.com/microfinance> and in the online version of this article at www.microfinanceinsights.com
 3. For a primer of FAS 157 reporting, see <http://blogs.wsj.com/marketbeat/2007/11/15/a-fas-157-primer/>