Microfinance Market Outlook 2014
No “sudden stop”: demand for microfinance soars
Key findings

- The investable microfinance sector is set to grow by between 15% and 20% in 2013, in line with our previous forecasts. There is much to suggest that the sector will maintain this growth rate in 2014.

- responsAbility uses a portfolio of 100 microfinance institutions (MFIs) to track the investable microfinance sector from a quantitative perspective. In addition, we completed interviews with 30 regional experts to evaluate the market in qualitative terms. Based on these two approaches, we forecast growth of 15% to 20% in 2014.

- In terms of macroeconomic growth, all regions are expected to perform better in 2014 than in 2013. According to the International Monetary Fund (IMF), average real GDP growth in the 15 most important microfinance markets worldwide will increase from 5.3% in 2013 to 5.6% in 2014.

- Experts believe that gradual improvements in market infrastructure are helping to drive the expansion of the microfinance sector. These improvements include the emergence of credit bureaus that provide transparency about the creditworthiness of borrowers.

- Due to their visible success and vast client base, local microfinance sectors continue to attract the attention of politicians whose short-term agendas are rarely aligned with the interests of end-clients, companies and investors. Strong diversification and risk monitoring therefore remain a priority.
The microfinance market: facts and figures

There are more than 10,000 microfinance institutions (MFIs) globally (see Figure 1). They comprise a wide range of institutions, from credit unions and cooperatives to non-government organizations (NGOs), government agencies, private companies and commercial banks. Only around 500 of these MFIs are suitable for investment, i.e. they are self-sustaining in economic terms and have appropriate governance, business processes and accounting standards in place. This group of MFIs constitutes the microfinance market that is the subject of this report:

- Tier 1 MFIs (approximately 100): these institutions operate profitably, serve a well-developed client base, have an experienced management team and are often regulated and supervised.

- Tier 2 institutions (approximately 400): these are smaller and younger MFIs that are profitable or are approaching profitability and are often preparing to undergo a legal transformation to become a more formal type of institution.

All MFIs, in which responsAbility funds are invested, operate in developing and emerging economies, providing financial services to small and medium-sized enterprises (SMEs) and low-income households that are vastly underserved at present. The market has significant growth potential, since there are currently around 1.2 billion adults with no banking account in the countries where responsAbility funds invest. There is also plenty of scope to grow the business with existing clients of MFIs, as average loan sizes continue to increase and borrowers evolve into savers and begin to use the full range of financial services. The main objective of MFIs is to become an efficient financial institution that offers a broad range of adequate products and services to a large number of households and SMEs at affordable costs.

The demands of end-clients drive the growth of MFI portfolios, creating a need for refinancing. The annual growth potential of microfinance loan portfolios is estimated at 20% globally. In local markets, the degree of saturation, as well as structural factors such as demography, lead to higher or lower potential growth rates. Cyclical factors such as the macroeconomic environment and political developments shape the actual level of growth. The close monitoring of cyclical factors is a prerequisite for investing in microfinance.

In total, there are more than 70 countries worldwide with investable microfinance markets in which the legal framework allows private sector investors to fill this gap. The volume of private cross-border investments in microfinance amounts to USD 7.5 billion, of which responsAbility funds account for approximately one fifth.¹

Figure 1: The global microfinance market

Fig. 1: The microfinance market: facts and figures

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1  MicroRate, The State of Microfinance Investment 2013; responsAbility Research Department

Source: responsAbility Research Department
General economic outlook
Brighter prospects in all regions

The global economy is set to grow much faster in 2014 than in 2013. It appears that this growth is no longer threatened by potential turmoil in the Eurozone or by political paralysis in the US. Smaller developing and emerging economies – where microfinance plays an important role – appear to be much less exposed to negative fallout from major advanced economies due to their lower correlation with the world markets. Emerging European states are no longer jeopardized by the possible disintegration of the Eurozone, and Central America’s proximity to the US is now once again proving to be a benefit, rather than a handicap. 2013 was another year in which the global economy was beset by nervousness, as could be seen mid-year during the abrupt slowdown of private capital inflows into the emerging markets (so-called “sudden stop”). As responsAbility predicted last year, the microfinance sector fortunately remained largely unaffected by this climate of uncertainty, with overall loan volumes growing by almost 20%. Although the continuing recession in the Eurozone weighed on microfinance activity in Eastern Europe, strong economic growth in Sub-Saharan Africa and developing Asia contributed to the rapid expansion of microfinance activities in these markets.

The IMF expects all global regions to perform better in 2014 than in 2013. A return to growth in the Eurozone is widely anticipated, and peripheral regions – i.e. Eastern Europe and the Middle East and North Africa (MENA) – are expected to grow at a faster rate. According to the latest IMF forecasts, emerging and developing economies are likely to grow more than 5% next year (slightly more than in each of the previous two years), with Sub-Saharan Africa and developing Asia leading the way.

Never mind the BRICS
Large and financially well-integrated countries such as the BRICS (Brazil, Russia, India, China and South Africa), which had been driving growth for years, will continue to perform much worse than smaller and more insulated emerging and developing economies. The BRICS countries have somewhat tarnished the image of the emerging markets. Few other emerging economies are currently experiencing the demographic problems of China or the dismal business climate of Russia. The BRICS group of countries has seen widening fiscal imbalances and an increasing proportion of non-residents holding locally issued “hot money” debt and equity. As a result, they are concerned about the prospect of the US tightening the monetary reins (see “Emerging markets on a rollercoaster ride” box). Since investments in microfinance are intended to support the development of the financial sector in order to benefit SMEs and low-income households, it is not surprising that such investments are not typically targeted at financially integrated countries, but rather at insulated ones.

Microfinance markets are less crisis-prone
The IMF’s list of the 15 emerging markets with the largest relative general government financing need over the coming year includes only two countries (India and Mexico) that are part of the 15 microfinance markets to which responsAbility’s managed portfolio has the largest exposures. This means that even at a macro level – before taking account of the fact that 1) banks in emerging markets tend to be healthier than banks in advanced economies and 2) the microfinance segment is particularly well rooted in low-income local economies – microfinance markets are less crisis-prone than the countries commonly referred to as “emerging markets”.

Microfinance countries also grow at a faster rate: according to IMF forecasts for the 15 countries to which responsAbility’s managed portfolio has the largest exposures, the GDP of these economies is expected to increase to 5.6% in 2014 from 5.3% in 2013 (see Figures 2 and 3). Moreover, these economies are set to consistently grow by more than 5% until the end of the IMF’s forecasting horizon in 2018. There is therefore every reason to expect relentless demand in this sector.

Figure 2: Real GDP growth

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2 IMF Fiscal Monitor, Taxing Times, October 2013, p. 16
Emerging markets on a rollercoaster ride

The announcement itself was hardly surprising but it had a major impact. The prospect of an imminent end to the extremely loose monetary policy in the US caused a flight of capital out of the emerging markets in mid-2013. Investors suffered massive losses on equity and bond investments in emerging economies, and the value of many local currencies fell sharply against the US dollar.

A reversal of this development soon followed. Even before the US Federal Reserve announced in September that it would continue its monetary stimulus package for the time being, emerging market indices and currencies had largely recovered, recouping most of their losses.

The volatile capital flows to which many emerging market investments are exposed stand in stark contrast to the real economy. Most developing economies and emerging markets still find themselves on a solid and steady growth path. While their growth prospects for 2014 and beyond have diminished somewhat lately, their economies are probably still expanding much faster than those of industrialized nations. The trend towards lower levels of indebtedness, larger currency reserves and more effective central bank systems seen in the emerging markets in recent years is proving helpful in this respect.

Direct investments in the real economy of developing economies and emerging markets therefore remain as attractive as ever. Since these investments are not made via the stock market, they are not directly affected by the speculation and volatility in the global capital markets.

The same is true of microfinance. Here, performance depends primarily on specific factors such as the quality of the portfolio and the operational efficiency of the MFIs in question. These factors have remained relatively constant despite strong movements in the capital markets. This was demonstrated again in recent months by the responsAbility funds investment portfolio: the high levels of volatility in the capital markets had no visible impact on the portfolio’s businesses.

Admittedly, this does not mean the MFIs are entirely immune to the prevailing macroeconomic climate: if emerging markets were to experience a sustained outflow of capital leading to weaker investment activity and a significant economic slowdown, this would also affect the microfinance sector.

The vast potential of this market means that factors such as currency devaluations, interest rate rises or a hike in long-term financing costs cannot halt the growth of the microfinance sector. It has repeatedly shown that it can produce reliable results even under difficult circumstances.

### Figure 3: Real GDP growth projections for the 15 most important microfinance countries of responsAbility

<table>
<thead>
<tr>
<th>Country</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peru</td>
<td>5.4</td>
<td>5.7</td>
</tr>
<tr>
<td>Cambodia</td>
<td>7.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Armenia</td>
<td>4.6</td>
<td>4.8</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>3.5</td>
<td>5.6</td>
</tr>
<tr>
<td>India</td>
<td>3.8</td>
<td>5.1</td>
</tr>
<tr>
<td>Georgia</td>
<td>2.5</td>
<td>5.0</td>
</tr>
<tr>
<td>Ecuador</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Russia</td>
<td>1.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>7.4</td>
<td>6.5</td>
</tr>
<tr>
<td>Mongolia</td>
<td>11.8</td>
<td>11.7</td>
</tr>
<tr>
<td>Kenya</td>
<td>5.9</td>
<td>6.2</td>
</tr>
<tr>
<td>Colombia</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>6.8</td>
<td>5.8</td>
</tr>
<tr>
<td>Ghana</td>
<td>7.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>3.5</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>5.3</strong></td>
<td><strong>5.6</strong></td>
</tr>
</tbody>
</table>

Source: IMF World Economic Outlook Database, October 2013
Microfinance outlook
For every Asian tiger there is now also an African lion

As microfinance sectors advance, MFIs expand and their clients’ businesses take on a more formal nature, the macro-economic environment in which these developments are unfolding also gains in importance. Debt investors in microfinance are well protected against volatility in the economy as a whole, since the valuation of debt instruments remains largely unaffected (see “Improving the use of risk indicators” box on page 12). In the mid-term, however, debt investments will perform better in a prosperous environment, as increased demand leads directly to loan portfolio growth and consequently to an additional demand for refinancing from MFIs. Equity investors feel the impacts of cyclical highs and lows more immediately. All of the experts interviewed for this report agreed that there is a positive correlation between the regional economic environment and developments in the microfinance sector.

In 2014, we expect global growth in the microfinance industry of 15% to 20%. The actual growth rate may vary, depending on the region (see Figures 4 and 5).

“The biggest development is actually the fact that there are no new developments. It is good to consolidate the industry and – without making massive changes – to simply focus on managing growth.”

Sebastian von Stauffenberg, CEO MicroRate

Figure 4: Microfinance growth outlook for 2014 by region (year-on-year growth in gross loan portfolio)

Figure 5: 2014 forecasts for regional microfinance markets

<table>
<thead>
<tr>
<th>Region</th>
<th>Gross loan portfolio growth rate 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>South America</td>
<td>15–20%</td>
</tr>
<tr>
<td>Central America</td>
<td>10–15%</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>15–25%</td>
</tr>
<tr>
<td>MENA</td>
<td>10%</td>
</tr>
<tr>
<td>Central Asia</td>
<td>15–20%</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>5–10%</td>
</tr>
<tr>
<td>South, South East and East Asia</td>
<td>25–35%</td>
</tr>
<tr>
<td>Total</td>
<td>15–20%</td>
</tr>
</tbody>
</table>

Source: responsAbility Research Department
The individual regions look set to develop as follows:

**South America** is expected to achieve real GDP growth of just over 3% in 2014 according to the IMF. However, this forecast is somewhat misleading, since the growth rates of the traditional microfinance countries of the Andes – Colombia, Ecuador, Peru, and Bolivia – all remain in the 4–6% range. The Andean economies are therefore much more dynamic than the large regional economies of Argentina, Brazil and Venezuela, which lack attractive microfinance sectors. In terms of risk, South America is well placed to cope with tighter global monetary conditions as its foreign exchange reserves are higher and its external debt levels are lower than in the past. The experts we interviewed expect microfinance growth in South America to reach between 15% and 20%. The large Peruvian sector has been slowing, with a few players reconsidering their strategies, but this transparent market is regarded as healthy and its growth should accelerate again slightly in 2014. In Ecuador, private sector players are increasingly at risk of being crowded out by public sector providers – a development that could hamper the growth of the sector. The outlook for Colombia, Bolivia and Paraguay is more favourable.

**Sub-Saharan Africa** remains one of the world’s fastest growing regions, with real GDP growth rates typically expected to be at or above 6% in 2014. Ghana, Kenya and Uganda are each expected to grow by 6%, while commodity exporters Nigeria and Tanzania are likely to expand by more than 7%. Despite the rapid development of its individual domestic markets, the region remains prone to food insecurity and vulnerable to both external shocks and domestic political risks. The performance of the microfinance sector can be neatly described as being driven by demand-based growth while, at the same time, being held back by supply-side challenges such as a lack of infrastructure, a lack of responsiveness from regulators and political uncertainty. Consequently, it is estimated that gross loan portfolio growth in Sub-Saharan Africa will be between 15% and 25%.

**Middle East and North Africa** region continues to be strongly influenced by political developments. Private sector investment is largely on hold in crisis-prone countries such as Lebanon and Egypt. The microfinance sector can continue to operate in very difficult circumstances but is unable to expand significantly in such cases.
In **Central Asia**, the average real GDP growth rate was 4.3% in 2013 and is expected to be 4.9% in 2014, reflecting the underperformance of Russia. The key microfinance countries in the Caucasus – Georgia, Armenia and Azerbaijan – are expected to see growth accelerate to around 5% next year, according to the IMF. Kyrgyzstan and Tajikistan are likely to experience even stronger growth rates. The Russian economy is the region’s main concern. However, after a year of stagnation, Russia is expected to double its GDP growth rate to 3% in 2014. According to the experts interviewed for this report, the outlook for the microfinance sector in the Caucasus remains favourable, with growth close to 20%. Russia’s macroeconomic problems – together with structural issues such as its unfavourable business climate – will negatively impact the performance of its microfinance and SME lending sector, according to these experts. Markets further east appear to be performing well, with the exception of the Kyrgyzstan market, where growth has been stifled by regulatory uncertainty.

**Eastern Europe** is no longer at the mercy of the Eurozone recession. From 2009 to 2013, Eastern Europe was in fiscal austerity mode to absorb the lack of export demand and lack of investment from the Eurozone. While Western Europe is no longer a drag on growth, the main drivers of the region’s economic expansion over the last two years – Russia and Turkey – are now losing momentum. This will not prevent most Eastern European economies from achieving stronger growth, however, with an average growth rate of 1.8% in 2013 expected to accelerate to 2.5% in 2014. Bosnia and Herzegovina, Bulgaria and Ukraine stagnated in 2013 and are expected to underperform their regional peers once again in 2014. By contrast, Kosovo and Macedonia are expected to outperform in both 2013 and 2014. According to the experts we interviewed, no miracles are to be expected in the microfinance sector in Eastern Europe and its growth rate is likely to remain in single figures. However, the situation is more comfortable than at any time in the last five years, as a reduced and rejuvenated sector is gradually returning to growth.

**South, South East and East Asia** is projected to grow steadily in both 2013 and 2014, with real GDP growth rates of 6.5% expected in both years. India’s economy represents the largest drag on growth – having slowed to 3.8% in 2013 – although it should narrowly exceed 5% again in 2014. Together with India, China and Indonesia were significantly affected by the flight of capital from emerging markets in 2013, which undermined growth. In terms of microfinance, lesser known countries such as Cambodia and Mongolia are equally relevant and are thriving at present. Even the key market of India, which has hundreds of millions of vulnerable households, is expected to grow by around 30% – which is roughly the average for the whole region and represents a faster rate of growth than at any point since 2009 (see “Microfinance in India – new dynamics” box).
Microfinance in India – new dynamics

India is today the world’s third-largest economy (measured in terms of purchasing power) after the US and China. The economic potential of this country, which has more than 1.2 billion inhabitants, is, however, far from being exhausted. This is because around half a billion Indians are still excluded from the formal financial sector.

This enormous excess demand has driven the powerful expansion of the local microfinance sector – at least until three years ago, when it was suddenly disrupted: In October 2010, the government of the state of Andhra Pradesh decided to prohibit the local microfinance business. This surprising move was ostensibly motivated by considerations relating to consumer protection. As a result, borrowers were urged by the government to refuse to repay their loans.

The situation has since eased. The national microfinance sector has emerged from the crisis stronger than before. It now serves 25 million clients and has been growing by an impressive 30% to 50% per year – a rate that appears to be sustainable. The effective measures taken in the wake of the crisis contributed to this rapid recovery. The sector is now overseen by the Reserve Bank of India. In addition, well-functioning credit bureaus are providing greater transparency.

Furthermore, established MFIs appear to have successfully adapted their operations to the legally prescribed profit margin and interest rate limits. They have managed to enhance their operational efficiency by taking steps such as significantly expanding their client base and increasing the average loan volume granted per loan officer.

The transformation of the business models of MFIs entails both opportunities and challenges: while group loans used to be the dominant microfinance product in India, individual loans are steadily growing in significance. This is because many microfinance clients have demonstrated their creditworthiness over several credit cycles and are now demanding more flexible conditions, as well as larger loans. In contrast to easily replicated group models, however, the extension of credit to individuals is dependent on effective review processes being carried out by experienced loan officers – a requirement that large, well-established MFIs are probably best able to meet.

In the coming years, the entire sector should benefit from the appointment of Raghuram Rajan as the Governor of the Reserve Bank of India in September. Rajan is known to be a strong advocate of the development of the financial sector and of financial inclusion. Under his leadership, the issuing of bank licenses to MFIs should meet with support – thus promoting the growth and operational transformation of the sector.

Core portfolio development

Further improvements in many areas

Where essentials are scarce, double-digit growth is the norm

In order to track the investable microfinance market defined at the beginning of this report, responsAbility uses a portfolio of 100 key institutions that currently represent USD 37 billion of assets and serve 20 million borrowers. According to this index, the microfinance market grew by 19% in the first half of 2013 (see Figure 13) – a rate that we regard as sustainable, given the underwhelming economic climate in 2013. We expect the sector to achieve a similar performance in 2014.

Figure 13: Gross loan portfolio growth of the 100 MFIs in our core portfolio

No deterioration in portfolio quality

The experts interviewed for this report don’t anticipate any large shifts in portfolio quality. 70% of these experts expect no changes, while 20% believe portfolio quality will deteriorate and 10% think it will improve. If we combine this with the trend indicated by macroeconomic data as well as MFI reported data, we expect the level of non-performing loans to increase slightly at the end of 2013 and to then slowly decrease in the course of 2014 (see Figure 14).

Figure 14: Portfolio quality of the 100 MFIs in our core portfolio
**Profitable MFIs, decreasing end-client prices**

The return on assets was slightly below 3% in 2013 and may cross this threshold again in 2014 (see Figure 15). Over the years, this has proved to be a profitability level that allows MFIs to reach out to large numbers of new clients and to invest in their own development in order to put in place more professional structures. At the same time, a stagnating profitability trend has been linked to a decreasing portfolio yield and falling end-consumer prices. In this year’s survey, no experts expect interest rates in their respective markets to increase in 2014. The majority of them believe that prices for end-clients will continue to decrease, as has been the historical norm. Competition and the evolving need to strengthen productivity and reduce operating costs are cited as the most important forces driving interest rates.

![Figure 15: Profitability of the 100 MFIs in our core portfolio and portfolio yield](image)

**Notable progress with credit bureaus**

The need for credit referencing bureaus is now widely recognized in the microfinance sector. Credit bureaus mitigate the risks of lending to unknown individuals by establishing a borrower’s credit history based on information collected from other lenders. This reduces a household’s need to supply physical collateral, enables unbanked households to have a credit history and reduces transaction costs for MFIs. The importance of credit bureaus has been recognized increasingly over the last five years. The expert survey reveals that in half of the markets assessed, there is now a high level of coverage of lending and borrowing (see Figure 16). Another 13 of the 30 experts interviewed indicated that coverage is increasing rapidly. One respondent pointed to Figure 16. Another 13 of the 30 experts interviewed indicated that coverage is increasing rapidly. One respondent pointed to

**Savings on the rise, cross-border funding grows in importance**

Among the different sources of international financing available to the sector, dedicated microfinance investment funds appear to be more in vogue than in past surveys. Patient funds now rank top on the experts’ list for both debt and equity financing – a development that may be attributable to the turmoil surrounding emerging market capital flows. When local funding sources are included, everything points to savings as the dominant financing source of the near future. This applies to the majority of microfinance markets, and the savings growth trend is clearly visible in the tracked portfolio (see Figure 17). In several markets, however, regulations do not allow MFIs to accept deposits. A notable example is India, where the regulatory restrictions on large-scale savings mobilization are unlikely to be lifted. Savings deposit accounts represent a vital financial service for low-income households and deposit-taking is boosting MFI balance sheets. That said, savings will never be the only source of funding, as balance sheets need to be diversified. Local debt financing is growing in importance in more developed markets but equity will continue to be funded predominantly by international sources (see “Equity in microfinance” box).

![Figure 16: Credit bureau coverage in regional microfinance markets (by number of responses)](image)

![Figure 17: Savings growth and proportion of MFIs that accept deposits](image)
Equity in microfinance
After being temporarily affected by the global financial crisis, the volume of microfinance equity transactions increased sharply again in 2012. Microfinance equity funds are expected (when measured by assets under management) to deliver solid growth rates of between 30% and 40% in 2013 — significantly exceeding the average growth of comparable fixed income funds. Equity investment volumes are also expected to expand — including in 2014.

In the area of primary transactions, a number of large trans-regional holding companies and mature microfinance banks are raising significant volumes of new capital, increasing the average ticket size. Additionally, we are starting to see an increase in the number of secondary transactions. These are mainly transregional deals or transactions in Latin American — in line with our 2012 forecast. However, the number of secondary transactions in Asia and Africa is also rising.

There is an apparent trend towards larger equity deals, as confirmed in a survey published by Symbiotics, which indicated that the average deal size in 2012 was USD 3.8 million — double the size in 2011. Since many individual microfinance equity investors are unable to digest transaction volumes of USD 10-20 million or more, this leads to an increase in the number of consortium deals.

Information on equity deal valuations is not generally disclosed. In previous years, J.P. Morgan and CGAP (Consultative Group to Assist the Poor) conducted surveys and published regional benchmark multiples. These surveys have since been discontinued, reducing transparency about valuations.

We nevertheless continue to see the highest book value (BV) multiples in Latin America and in South and South East Asia (exceeding 1.5x BV). Africa is now attracting growing levels of interest — including from large global private equity players. While there are only a few NGO transformations, existing microfinance players and downstream SME banks are raising capital. Coupled with high levels of overall interest, we have observed multiples exceeding 1.5x BV or even 2x BV. Transactions in Central Asia and the Caucasus are typically carried out at a smaller premium to book value. In Eastern Europe, there are virtually no transactions with book value multiples around or below 1.

We continue to see a broad range of investment opportunities in markets such as Peru, Bolivia, Colombia, Cambodia and Kenya, which have advanced further along the consolidation path and have a combination of market consolidation, secondary investment and growth funding opportunities. Larger market participants offer growth financing opportunities, with the amounts of capital involved largely beyond the means of many microfinance equity funds. More and more commercial banks are interested in the lower-end SME and microfinance segments. We also continue to see attractive potential to invest in new or relatively young MFIs in a number of countries, particularly in Africa and South East Asia. Opportunities to invest in institutions that are transforming themselves into regulated commercial banks remain as attractive as ever.

Moderate reputational threats in many markets
When asked if they have identified any reputational threats to their local microfinance sector, 18 out of 26 responding experts confirmed that threats exist but described them as only moderate (see Figure 18). Four stated that no threats to their markets had been observed, while a further four interviewees perceived there to be severe threats. These results can be interpreted in different ways. What appears clear is that practitioners, investors and other experts take reputational risks seriously. The majority of them judge the reputational risks to be moderate, which suggests that they are largely under control. The threat most commonly mentioned is that of politicians misusing microfinance for their own purposes. A classic claim made by politicians is that clients are overindebted, which is a result of intransparent and unregulated markets. The emergence of credit referencing bureaus should therefore serve as a powerful measure to counter such threats.

Figure 18: Reputational threats to local markets (by number of responses)

Source: responsAbility Research Department, survey of experts
Investing in challenging market environments

Kenya: The vicious attacks on the Westgate shopping mall in Nairobi dominated the headlines in the international press in recent weeks. The Kenyan government’s decision in 2011 to provide military support to Somalia’s fledgling government made it a prime target for al-Shabaab, the Somalia-based cell of al-Qaeda that carried out this latest attack.

It is too early to know whether these attacks point to a deteriorating security situation or were a one-off event; the presence of another likeminded organization in the country, al-Hijra, adds a worrying domestic angle to the threat. More generally, however, these attacks do not pose a serious risk to Kenya’s microfinance industry – despite their major implications for the country’s security. Consequently, while responsAbility has enhanced the security protocol for employees in the region, its investment strategies and overall outlook for the country remain unchanged.

Kenya’s 2013 general elections were, however, a greater cause for concern. There were fears that the country could experience a repeat of the 2007 post-election violence that killed 1,200 people, displaced a further 300,000 Kenyans and devastated the country’s business climate. Despite certain voting irregularities that raised concerns about a return to violence, the 2013 election that resulted in Uhuru Kenyatta being named President was relatively peaceful.

Although Uhuru Kenyatta and Deputy President William Ruto have been indicted by the International Criminal Court for their alleged involvement in the violence that followed the 2007 elections – and responsAbility will watch the outcome of these trials closely – the outlook for Kenya remains positive. The country boasts the best developed microfinance segment in Sub-Saharan Africa – with tremendous growth potential – and is fast catching up with South Africa to become the nation with the most comprehensive provision of financial services on the African continent.

Cambodia: Decades of conflict and instability have left Cambodia with social and political scars that became particularly visible in July. Mass demonstrations and riots shook the country after the opposition party rejected the result of the national elections. The financial sector was also affected, as several institutions suffered moderate outflows of deposits. The opposition is continuing to demand an independent probe into electoral fraud but the overall situation in the country has clearly stabilized: Cambodia is set to continue its impressive progress in terms of financial and social development. Many of its local MFIs are among the strongest globally. In the longer term, the emergence of a stronger opposition should support political stability by enhancing pluralism, accountability and the prospect of reforms.

Improving the use of risk indicators

Debt investors in microfinance are well protected against volatility in the overall economy because the valuation of debt instruments remains largely unaffected by these trends. Furthermore, a growing range of instruments enables investors to hedge against local currency risks – meaning that currency fluctuations have only a limited direct impact on the performance of their investments.

Investors are also benefiting from the ongoing accumulation of experience within the sector, which is reflected by its increasingly knowledgeable use of important risk indicators. Among other things, this allows debt investors to determine the conditions and interest rates of the loans granted to microfinance institutions in a more accurate and risk-adjusted manner.

Default rates are one of the most important indicators in this area. According to the generally accepted definition, a default occurs when an interest payment is either delayed or not forthcoming, when the borrower is declared bankrupt or when a distressed exchange takes place. The latter refers to an emergency transaction in which the creditor receives a new or differently structured debt instrument that is usually of a lower value but that can nevertheless help to avert a payment default or the borrower’s insolvency.

Another important indicator is the recovery rate: It measures the portion of the loan that can be repaid in the event of a default. This percentage is highly dependent on external factors such as the creditors’ willingness to cooperate or the type of default.

responsAbility is also constantly improving its survey and use of risk indicators and has produced a more precise analysis of debt investment transactions between 2003 and 2012. The results provide interesting insights: If one compares the microfinance default rates with Standard & Poor’s long-term statistics for emerging market bonds with maturities of one to three years, the loans correspond to a rating of BB/Ba and thus only just fall short of being classed as investment grade.

The surveys also indicate that the recovery rate for microfinance investments is significantly higher than that of traditional investment classes. Comparable investments such as senior unsecured bank loans typically have a recovery rate of about 40%. In the data set analyzed by responsAbility, the recovery rate in microfinance was around 66%.

There are two main reasons for this. First, the willingness to cooperate is relatively high in the microfinance industry. Second, most of the registered defaults were classified as distressed exchanges, which typically feature higher recovery rates.
Conclusions

In 2013, the very small segment of emerging market listed equity or bond investments rode the global stock market rollercoaster amid fears that the US Federal Reserve would normalize its monetary policy. Elegant headquarters in megacities may become vacant as price bubbles burst, leaving foreign investors with a hefty bill.

The modest branches of MFIs in bustling small towns in Bolivia, Tanzania or Cambodia seem to belong to a different world. Nothing can create a bubble here, since investors’ funds can only flow into the MFI to the extent that there is a loan portfolio to refinance. Moreover, the loan portfolio only grows if microenterprises, households and the occasional SME have concrete funding needs that prompt them to request a loan.

The 100 MFIs that track the investable microfinance market we describe above represent 8,005 MFI branches that serve 20,760,000 clients worldwide. Assuming that we will see a more favourable macroeconomic environment in 2014 than in 2013, and given the advances occurring in terms of the market infrastructure – including the emergence of credit bureaus –, we expect the microfinance market to continue to grow at a rate of 15% to 20%.

In developing countries, political factors have to be considered at all times. However, effective diversification across more than 70 markets, clear investment strategies, the systematic monitoring of elections and active portfolio management are a powerful means of monitoring and controlling country risk.

responsAbility has been able to invest an additional USD 400 million in microfinance over the last 12 months, with total assets under management increasing to USD 1.8 billion. A strong local presence in all regions has proved key to sourcing these volumes by ensuring an attractive risk/return profile.

About responsAbility
With assets under management of USD 1.8 billion, responsAbility Investments AG is one of the world’s leading independent asset managers specializing in the development-related sectors of emerging economies such as finance, agriculture, health, education and energy. responsAbility provides debt and equity financing to non-listed companies with business models that target the lower-income segment of the population and can thus drive economic growth and social progress. Serving both institutional and private investors, responsAbility offers professionally-managed investment solutions.

The expert panel
This outlook is based on the comprehensive analyses carried out by responsAbility and a broad survey of 30 microfinance experts from all the major markets worldwide. The experts interviewed are decision-makers at MFIs and rating agencies, and investors and advisors. We would like to thank the following experts for their invaluable contribution:

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