

# FROM 27 BUCKS TO US\$50 BILLION

## THE REMARKABLE GROWTH OF MICROFINANCE



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The microfinance sector is one of the very few able to achieve both financial and social return on investments – not to mention opening up many new opportunities for local counsel, explain Howard Finkelstein, partner, and Brooke Chadeayne, associate, of Akerman Senterfitt LLP

Over the past five years, microfinance has become one of the fastest-growing sectors in the global economy, as an estimated US\$5 billion of cross-border investment has flowed from the developed world into microfinance institutions worldwide. The funds originally came almost exclusively from the public sector, from charitable institutions and socially responsible investors. Today's investments in microfinance have been generated increasingly by those seeking a market rate of return on their investment, including the world's largest commercial and investment banks, institutional investors and hedge funds and other specialty investors.

But this is not the end of the story, not by a long shot. The microfinance sector is growing exponentially and experts expect that an additional US\$40 to US\$50 billion of debt and equity capital will flow into this sector over the next five to seven years, most of it from traditional value-seeking investors.

Latin America is the most robust region of activity for microfinance. As of the end of 2006, Latin America had nearly 700 microfinance institutions (MFIs) serving more than 11 million clients. Latin America's dominance in this area was highlighted in April 2007 by the initial public offering (IPO) of stock of Banco Compartamos, a highly successful Mexican MFI. When its shares were offered in both Mexico and the US, they were oversubscribed 13-fold.

This article will provide an overview of the concepts behind microfinance and its dramatic growth, discuss some of the types of international transactions that have contributed to the growth of this sector and describe some of the unique ways in which lawyers who practise in this sector are

grappling with the ever-changing needs of the investment community in this area.

### What is microfinance?

Like all great ideas in human history, the idea of microfinance grew from a number of sources. Notwithstanding the diversity of its origins, it is generally agreed that the microfinance sector of the world economy had its true start in the mid-1970s in

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Bangladesh. Dr Muhammad Yunus, a US-trained economist, had returned to his home country to teach economics. Dr Yunus studied the wretched poverty in rural Bangladesh and experimented with methods of alleviating rural poverty.

He loaned US\$27 of his own money to a group of 42 women who made furniture in their homes for sale at the local market. The women had previously had to borrow the funds to purchase raw materials from a local moneylender each day so they could make that day's product. After selling the product and repaying the moneylender's principal and steep interest, very little was left over to feed their families. There was certainly not enough to purchase raw materials for the next day's product without returning to the moneylender for another day-long loan. Dr Yunus' loan enabled the women to purchase the raw materials they needed without the moneylender, and to retain more profit for their families.

Despite the extremely small scale of the loan, the working capital made a difference, and Dr Yunus eventually developed a system of lending to the working poor. Dealing primarily with home-bound women whose husbands earned minimal day wages, he found that if these women were given very small loans in order to purchase raw materials, they could earn enough to bring some measure of relief to their families, even while repaying the principal with interest.

Dr Yunus eventually refined his system and created the world's first MFI, Grameen Bank, with initial assistance from government-owned banks. Grameen Bank's methodology involved the making of small short-term loans ("microloans"), primarily to women ("microentrepreneurs"), to establish and maintain their own small businesses. Women with demonstrated needs for increased loans would, over time, become eligible for larger loans as they repaid earlier loans. MFIs worldwide have replicated two features of the Grameen Bank methodology.

First, most MFIs utilise a “group-lending” strategy under which microentrepreneurs borrow in groups, with each group member secondarily liable for each other member’s loan. Second, the interest rates on microloans worldwide range between 30 and 100 per cent on an annualised basis. Although such an interest rate would appear to be extremely high by middle-class Western standards, the MFIs’ cost of making and administering the tiny loans is very high. Unlike mass-production lenders, MFIs must pay particular attention to individual borrowers, both before and after their loans are made. In addition, since most loan payments are made in person, MFIs also incur significant costs in having their loan officers travel among rural borrowers.

### The growth of microfinance

Investors are attracted to the microfinance sector by its dramatic growth and the not unrelated high collection rate on its loans. In addition, most industry experts agree that the microfinance business model has worked well and are pressed to find many examples of MFI failures or defaults, unusual in a fast-growing and nascent business sector. The sector has grown exponentially over the last decade, and particularly the last five years. In 2007, there were more than 10,000 MFIs serving approximately 150 million customers worldwide. The annual growth rate of the microfinance sector is estimated to exceed 50 per cent. Again, much of this growth has been fuelled by one key factor: the worldwide default rate on microloans is generally believed to be under 5 per cent. Among top-tier MFIs, that rate is approximately 2 per cent. This amazing success – combined with the perception that the potential customer base of an MFI located in almost any developing world country is not even close to being exhausted – is part of what has fuelled the recent rush of traditional value-seeking investors to the microfinance sector.

With the world population of those living below the poverty line estimated to exceed 2 billion, it is clear that MFIs have only begun to scratch the surface of their potential market. Investors believe that the reach of the microfinance sector can be expanded dramatically and that, with more capital, MFIs will be able to do their jobs more efficiently and profitably. Thus, recent estimates are that the sector will be looking

for US\$45 to US\$50 billion in developed-country investments over the next three to five years.

Microfinance has evolved dramatically since those early days in Bangladesh. The primary difference is that the “non-commercial” side – government funds, NGOs, not-for-profits – no longer supplies most of the initial capital for microfinance. Today, commercial funding from private investors plays an increasingly important role and is viewed as the only source large enough to satisfy the global demand for financial services.

Investors who believe in the business model and its serious profit opportunity are seeking equity investments in funds with solid track records and good growth plans

### The microfinance CDO

The collateralised debt obligation (CDO) has become one of the most popular vehicles for investing in the microfinance sector. In 2002, a group of microfinance professionals began attempting to structure an investment vehicle which would allow potential investors to pool their funds and invest in a number of MFIs in different countries, and thus reduce risk through diversification. They concluded that the best means to do this was the CDO. From 2002 through 2004, author Howard Finkelstein worked with various professionals

in both the microfinance industry and the capital markets to develop the first microfinance CDO, known as Blue Orchard Microfinance Securities I (BOMSI). BOMSI finally closed in July 2004, and has timely paid all of its investors to date. Several more microfinance CDOs followed BOMSI.

Under the CDO structure, a special-purpose bankruptcy remote entity (the SPE) is formed. The SPE will:

- take funds from investors;
- invest the funds in debt obligations of MFIs;
- issue securities, usually of more than one type (eg, senior, mezzanine, junior tranches); and
- contract with one or more servicers to monitor the loans to the MFIs and collect principal and interest on behalf of the SPE.

Thus, in a typical microfinance CDO, the SPE makes loans to a number of MFIs in multiple countries, using diversification to reduce the risk of an individual MFI’s inability to pay and the risk of political or economic problems in particular countries or regions. Although there are no fixed rules, investors are most comfortable where no individual MFI’s loan exceeds 5 per cent of the aggregate investments and where no more than 10 to 15 per cent of the SPE’s funds are loaned to MFIs in any one country.

The SPE is usually formed under the laws of a developed country or political subdivision thereof. BOMSI, for example, utilised a Delaware trust. Other microfinance CDOs have utilised New York trusts, Delaware limited liability companies and Luxembourg “securitisation entities”. Since most investors are domiciled in the United States or western Europe, it is important that the SPE be a vehicle with which they are familiar.

Generally speaking, in the microfinance CDOs issued to date, loans to the MFIs are governed by the law of, and enforceable in, either New York or England. Once again, this is designed to suit the preferences of US and EU-based investors, who are more comfortable with their own legal regimes. In most loans to MFIs forming part of the CDO collateral, the MFI will submit to the New York or British jurisdiction, with prudent CDO managers insisting that the MFIs actually retain an agent for the service of process in those jurisdictions. If an MFI

were to default on its loan, the servicer would first obtain a judgment in New York or London and, assuming the MFI had no real assets in these jurisdictions, then the servicer would have that judgment enforced in the MFI's jurisdiction.

Although loans to MFIs are usually not governed by local law, local counsel play an essential role. First, as part of its due diligence, the SPE or its servicer or underwriter needs certain background information from local counsel as to the legal regime in that country, including the following questions:

- What is the regulatory scheme under which the MFI operates?
- Are there usury restrictions governing either the relationship between the MFI and the microentrepreneur or the MFI and the SPE?
- What is the basic bankruptcy framework in the country?
- What restrictions exist on foreigners like the SPE making loans in, and taking repaid funds out of, the country?

The collateralised debt obligation has become one of the most popular vehicles for investing in the microfinance sector

Second, the SPE will require the opinion of local counsel regarding the MFI prior to closing with respect to formation and governance of the MFI, enforceability of the loan documents and various matters relating to the enforceability of foreign judgments. Having worked through dozens of these opinions with counsel in numerous

countries, I can safely say that lack of familiarity by local counsel with western-style practices can be one of the most time-consuming parts of a CDO project.

In the future, local counsel will play an even greater role in these and similar transactions. First, as more MFIs become regulated financial institutions, as did Banco Compartamos in Mexico, MFIs will be looking to issue instruments that qualify as regulatory capital. As this occurs, the loans to the MFIs will take on additional complexity and local counsel will be called on to help design various hybrid instruments, such as convertible or subordinated debt.

Second, although up to this point the MFI loans backing the CDOs have been unsecured, a number of companies in the US and the EU are exploring transactions involving secured MFI loans. A transaction on which I am currently working will call for the borrowing MFIs to pledge loans and cash as security for their borrowings and I am in the process of assembling a network of law firms in up to 11 countries to assist in facilitating this process.

#### The equity side

Most foreign private investment in MFIs to date has come on the debt side. However, equity investments in MFIs are quickly gaining popularity among western investors. Private equity funds which invest in shares of MFIs have grown dramatically over the last two years. Investors who understand the business model for MFIs appreciate three key factors about the microfinance sector:

- the business model generally works;
- the business model works even better as an MFI increases its market penetration; and
- most MFIs are “underleveraged”.

Investors who believe in the MFI business model and its serious profit opportunity are seeking equity investments in MFIs with solid track records and good growth plans. Certainly the Banco Compartamos IPO ignited some of this interest, with its very high returns on investment for the selling shareholders, in some cases reaching 300 per cent. Even though most experts agree that the factors which led to the success of the Banco Compartamos IPO were sui generis to that situation and are not likely to be repeated often, the investment community generally agrees that the microfinance sector

will create more opportunities for IPOs, as well as private buyouts and mergers and acquisitions.

Microfinance is able to achieve the fabled “double bottom line” of a financial and social return

Obviously, from the viewpoint of a lawyer involved in the transaction, each equity investment in an MFI bears its own unique characteristics. For instance, the capital structure of the MFI, the regulatory status of the MFI and the shareholders' agreement play a role in shaping the transaction. The attorneys for the equity fund always need to work closely with local firms where the MFIs are located to steer the investor towards its goal.

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Latin America is poised to capture a significant portion of the increasing flow of cross-border investments to the microfinance sector. The region's position as a hotbed of microfinance activity provides a unique opportunity to attract foreign investments while developing local economies – thereby achieving the fabled “double bottom line” of a financial and social return. MFIs are far from meeting, let alone exhausting, the demand for microfinance in most Latin American countries. While investors search for debt and equity investment opportunities in proven MFIs, local counsel should prepare for their role in bringing these investment transactions to their respective countries.