

Blended Value Investing: Capital Opportunities for Social and Environmental Impact



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Preface

The World Economic Forum is pleased to issue this report, which seeks to explore how “Blended Value Investing” (BVI), as distinct from either market-rate investing or philanthropy, can leverage economic performance while also creating social and/or environmental value within a single, unified approach to investing and capital finance.

BVI is, by definition, a market-based approach to addressing many of the challenges facing the global community. BVI seeks to engage capital in creating sustainable, long-term solutions to those same challenges. Such strategies are defined as “blended value” and not “double bottom line” or philanthropy since they view the value being created as neither solely economic nor solely social, but a *blend* of both. This approach recognizes that economic value can create various forms of social and environmental impact and cannot be viewed as a separate component of the value proposition found within any given investment. Therefore, BVI seeks not a double bottom line, but rather a single bottom line with multiple value components.

In September 2004, the World Economic Forum’s Global Foundation Leaders Advisory Group hosted an international meeting of investors, foundation executives and representatives from non-governmental organizations to discuss the state of blended value investing and explore what barriers exist to expanding the use of private capital for social gain. *Private Investment for Social Goals: Building the Blended Value Capital Market* was published by the Forum in 2005 and presents the key discussion points and findings from that session.

At the conclusion of the 2004 meeting and follow-up discussions during the World Economic Forum’s Annual Meeting in Davos in 2005, session participants requested that a research project be undertaken during 2005 that could explore in greater detail how a variety of capital finance strategies are being applied to the area of blended value investing. Furthermore, since the arena of microfinance is viewed by many as an excellent

example of how economic and social value may be leveraged through investment innovations, participants asked that this research also summarize current practices in microfinance that might inform investing activities in other related areas.

In fact, many of the examples presented in this document are taken from the field of microfinance and could be applied more broadly to other areas of interest, whether housing, local building projects, small/medium enterprise development, healthcare, education or beyond.

We wish to thank Cisco Systems Foundation for making this project possible, Jed Emerson of the Generation Foundation and Joshua Spitzer for drafting and researching the report, and the members of the Forum’s Global Foundation Leaders Advisory Group for providing comments and overall guidance. We also wish to thank Adele Simmons, Senior Adviser to the Forum, and Sam Mbugua, Global Leadership Fellow, for their support of the project.

The World Economic Forum’s efforts at catalyzing and sustaining the important debate around Blended Value Investing have received support from many quarters. In gratefully acknowledging these contributions, both financial and intellectual, we also look forward to the positive evolution of this discussion and to the expanded application of creative investment approaches that can accelerate progress on pressing social and environmental problems.

Richard Samans
Managing Director
March 2006

Organization and Conclusions

This paper is organized into three inter-related sections, each with case studies presenting details on the process of innovation within the blended value investing arena.

The first section explores innovation in **debt finance**. It has two subsections. The first subsection presents the process by which loans to microfinance institutions are “packaged” as financial securities that offer the opportunity to expand the capital available to such funds. These developments serve as examples of what could take place in other emerging areas of investing. The second subsection explores another novel application of debt finance applied in the realm of community investing, which further investigates how blended value investing strategies can be made accessible to individual investors.

The second section presents cases in which **credit guarantees and enhancements** have been used to manage the risk (perceived and real) associated with various blended value investment opportunities. In several cases, such enhancements helped other investors price risk more accurately so that ultimately capital could flow more freely to those investments.

The third section presents **private equity investing innovations**, which provide risk capital to new funds and enterprises that generate both social/environmental impacts as well as economic value and returns.

Those attending the discussions at the Forum in Geneva asked that several of the anecdotal stories of participants around the table be brought together and formally presented to others interested in understanding more about:

- How these deals evolved;
- The challenges of structuring them;
- The possible prospects such investing practices hold for broader application by others interested in creating innovations in capital finance.

This paper is offered not as a fully comprehensive survey of the emerging area of blended value investing, but rather as a set of examples of how such investing practices are being developed and applied around the world. The paper’s intent is not to provide a single answer for all investment challenges, but to demonstrate how groups of investors are mobilizing capital on new terms to meet the challenges of emerging investment opportunities, as well as the demands of investors seeking out new asset classes in which to place their capital.

While the paper presents part of the history of groups and individuals who have worked to advance these practices, it *does not* present a history of the field or a comprehensive overview and should not be taken as such. Other documents by CGAP, ACCION and related groups should be sought out by readers looking to understand how, specifically in the area of microfinance, various instruments and approaches have evolved.

This paper presents innovations in capital finance that promise to bridge market-rate interests with strategic opportunities to create blended value that benefits shareholder and stakeholder alike. The following examples speak to an evolving capital convergence wherein mainstream capital markets and investing will increasingly become drivers of new solutions to historic problems. Blended value investing funds and instruments offer financing strategies from a set of tools that go beyond traditional philanthropy or market rate investing and which complement the vision we all share of a world with greater equity and opportunity for its members.

This paper also identifies several areas of research that would help advance the field of blended value investing. In summary, those projects include the following:

- An in-depth survey of blended value investors that would ultimately segment the market and identify strategic investor groups and categories;
- An inquiry into blended value portfolio theory to understand how investors have applied modern portfolio theory concepts and analytics to building diversified blended value portfolios;
- A deeper inquiry into applying lessons learned from microfinance to other blended value systems.

Finally, the paper concludes with words of caution that suggest a prudent approach to developing blended value capital markets. It offers a critique of the state of the markets, presents a strategic vision for the blended value capital markets, and suggests specific steps that participants might take in moving toward the ideal.

Innovations in Debt Financing:

Advances in the Fields of Microfinance and Community Development

Introduction to Microfinance Debt Offerings and Securitization

Many blended value investors' primary goal is to achieve real social returns together with financial returns that are not concessionary to the risk-adjusted rate investors could otherwise attain. Investments meeting that goal would be fairly easy to trade and have investment terms that are understood by the average investor. Such characteristics would generate significant demand from all sorts of investors—especially those who do not now take account of how they might create blended value in making capital investment decisions. For these reasons, the practice of securitizing loans to microfinance institutions (MFIs) is a very promising prospect for many involved in BVI.

Built on hundreds of millions of dollars in donated and concessionary-rate (which is to say, below market rate) capital, microfinance has proven to be a sound and powerful investment in blended value. However, despite wide-spread growth in microfinance around the world, the industry has now reached a critical point: many funds have lent all or most of their available capital; they must either sell some of the debt on their balance sheets or otherwise secure substantial new funds in order to expand their lending activity.

Those investing philanthropic capital for social returns have supported microfinance institutions in becoming viable, in proving that poor people make good customers for financial services, and in reaching a remarkable scale. Nevertheless, the size of the microfinance industry has the potential to be dramatically larger, and philanthropic capital alone will not be sufficient to achieve this potential. To extend microfinance to a substantial majority of the world's poor, a new kind of capital must enter this market, and that capital will most likely come from the mainstream capital markets, where the majority of funds are currently invested without regard for social or environmental returns.

Fortunately, a growing number of microfinance institutions possess the business fundamentals necessary to access those capital markets. Before commercial capital may fund the microfinance industry on a large scale, capital markets will require investment products capable of meeting the needs of both microborrowers and investors of capital. This section examines several very promising early examples of these products, which may represent the path toward a suite of investment instruments offering truly blended returns that maximize social and financial value.

The Microfinance Success Story

In the thirty years since the Grameen Bank, ACCION and other MFIs showed the rest of the world that small loans to poor women could dramatically improve the lots of families and communities, microfinance has become a widely celebrated model of economic development. Many sources document the growth of the sector over recent decades, and this paper's Appendix A presents a brief review of key microfinance innovations. Those innovations have made microfinance securitization possible. Much of this section explores how securitization has opened new options to capitalize on and invest in both financial performance and social impact.

Among many blended value investing strategies, microfinance is one of the most mature. Its sustainability and replication have introduced innovations that are not only enhancing the fundamental value proposition of microfinance, but now appear applicable to other blended value investment programmes. These innovations continue to bring microfinance to new levels of large-scale efficacy, and may eventually find application in other areas in order to bring those areas to a similarly substantial scale. Since other publications have explored the current state of the field, this section will *not* examine the overall state of the microfinance industry.¹ Though the section will discuss several innovations in the sector, more complete explorations of those innovations can be found in other sources cited later in this text.

The following narrative examines the structure and actors in several microfinance securitization deals, delving more deeply into one particular deal to offer lessons learned and help identify emerging issues associated with successfully securitizing debt to MFIs.

Access to Capital Markets

Driving the increasing scale of microfinance (engendered by replication, the growth of MFI networks and improved transparency) is a tremendous demand for microloans—and an equally large attendant need for capital. Jennifer Meehan, Director of Capital Markets, Grameen Foundation USA, explains:

“Around the globe there are 2.8 billion people, approximately 560 million families, who are considered poor, living on less than US\$ 2 per day in purchasing power parity (PPP). Of those, 1.2 billion people live in abject poverty; the ‘poorest’ surviving on less than US\$ 1 per day PPP. Despite recognition of microfinance as a proven poverty reduction tool, fewer than 18% of the world’s poorest households have access to financial services.”²

Some MFIs have scaled dramatically to achieve greater coverage. For example, Meehan reports that the number of Grameen Bank clients grew at an annual rate of 33.7% between 1983 and 1996, while the bank’s portfolio grew at an exponential rate while maintaining its high quality. Grameen Foundation USA estimates that ten percent of a potential US\$ 300 billion microfinance market has been penetrated. In order to approach that potential or even to grow appreciably, Meehan indicates that philanthropy alone will remain inadequate:

“Despite the important and catalytic role played by the international donor community in promoting microfinance, it has invested only US\$ 1.2 billion in the sector and allocates an incremental US\$ 800 million to US\$ 1 billion per year in new financing.”³

Individuals and institutions wishing to finance microlending can provide capital to MFIs directly, or investors can syndicate their capital, forming funds or other investment instruments that can share risk and invest in multiple MFIs. Whether they are investing directly or through funding intermediaries, microfinance investors can deploy their funds in four ways:

1. Donate to an MFI (and any number of reputable programmes for doing so can be found with little effort);
2. Leverage assets through loan guarantees to MFIs (an investment vehicle addressed in Section Two of this paper);
3. Purchase MFI equity;
4. Loan money directly to MFIs.

Thus far debt investments have shown considerable promise and, after donated funds, make up the bulk of capital that has flowed to MFIs. The following section describes a range of approaches to debt investments in MFIs.

Direct Lending to MFIs

Investors with sufficient scale and knowledge of the sector may loan funds directly to MFIs (often on a concessionary rate basis, and foundations can structure such capital as programme-related investments). Nevertheless, there are limits to the effectiveness of these lending practices. Such lending is difficult to scale and offers only limited access to mainstream capital markets. Each loan requires a separate due diligence process, which, in the case of direct lending, is not leveraged over many investors. Diversification is very difficult and requires considerable investment scale (i.e., the investor must initiate several direct loans to various MFIs, each requiring a separate due diligence and investment process). Furthermore, once such loans have been made, they cannot easily be transferred or exited. Accordingly, such lending practices tend to be limited to the few institutions that have deep knowledge of microfinance and have made an investment commitment to the sector. In truth, this strategy is not likely to attract mainstream capital flows.

In response to the various limitations of direct lending practices, a number of actors in the MFI arena have begun exploring how intermediaries could work to aggregate loans to MFIs and provide access to more mainstream capital by creating investment vehicles with greater market appeal and availability to mainstream investors. Such products have a variety of features:

- They can offer investors a measure of broader diversification;
- They can leverage due diligence and similar costs across multiple investors;
- They offer potential investors a standardized product with attributes that are familiar to them;
- They have the potential to be transferred.

Microfinance Bonds and Securitization: A Primer

This paper assumes that the reader comes to this discussion with an introductory level of knowledge regarding this area of capital finance. The following section is offered to ensure a shared baseline of familiarity with the concepts in order to help the reader make the most of the examples that follow.

Securitization Defined

Securitization in general refers to pooling many financial assets and “packaging” them as new securities that can be purchased and sold by investors unable to invest in each fund individually. Most commonly, loans are aggregated into notes, the cash flows of which are provided by many underlying loans. Housing mortgages are commonly so packaged by investment banks. The practice has been extended to all sorts of debt instruments, including credit card receivables and car loans.

The following example of mortgage-backed bonds illustrates the securitization process.

A bank will initiate a large number of home loans, lending the bank's money to home buyers. The bank can then package the debt into new bonds, and the coupon and principal payments associated with these bonds are passed from the home owners through an intermediary and eventually to the purchasers of the security. Typically, banks will sell those bonds (and the homeowners' associated cash flows) to third parties that can manage the various cash flows and can distribute or resell the bonds. Doing so effectively converts a bank's loans receivable into cash immediately, and the bank can then loan that cash to new home buyers, starting the cycle anew.

The microfinance capital markets are approaching securitization as a means of bringing more funds to microentrepreneurs. Most of these investment structures cannot, strictly speaking, be considered securitizations, though they have many features of that type of asset. In most of these examples, securities are sold to investors and the proceeds lent to MFIs. Cash flows to bond investors are derived from payments being made on existing and new microloans to MFI clients. Unlike the mortgage-backed securities described in the example above, most MFI bond offerings have not been linked directly to specific, individual loans. Instead, they are structured as obligations of the

MFIs, which, in turn, are supported by the individual loans made to microentrepreneurs. As such, the microloans stay on each MFI balance sheet as loans receivable, and the MFIs also undertake financial obligations that they must record on their balance sheets as notes payable. A securitization (in the technical sense) would enable the MFI to bring in cash without increasing its own liabilities (though in doing so, the MFI would need to sell the loans receivable). Increasing cash without increasing liabilities, as is the case with securitization, allows the MFIs to loan more money without raising additional equity to meet capital adequacy requirements.

Loan Tranches

Many loans are structured in multiple layers, referred to as “tranches.” Each tranche is a set of securities that has a particular risk-reward profile and is then marketed to investors seeking that type of investment opportunity. The most senior tranches are the safest, that is, they are first in line to receive cash flows from the underlying loans. Consequently, they bear a lower interest rate than the more junior tranches. The junior tranches' cash flows are only passed through to investors when the senior tranches have been paid. Any defaults in the underlying loan portfolio are assigned to the most junior tranches first. These junior securities carry a higher interest rate in exchange for assuming greater risk exposure associated with this characteristic.

The ability to offer multiple tranches has been an essential feature of the more sophisticated microfinance debt issues to date. Those structures allow investors to purchase securities with the risk-reward profiles best suited to meeting their investment needs. In the existing deals, the very most junior tranche is called an equity tranche. It is termed such because the cash flows are so unpredictable that they cannot be assigned a coupon rate (namely, a fixed rate of return an investor receives when participating in any given round). The equity investors have a residual claim on cash flows after all of the other investors have been satisfied. Such investors will not know the return on their investment (if any) until all of the other tranches have matured: they are assigned the first (and potentially all) losses in the investment portfolio.

Microfinance Bonds and Securitization: A Primer

Microfinance Bonds and Securitization: Key Parties

MFIs and Their Clients: At the most fundamental level of a debt offering deal is the microfinance institution that makes loans to extremely low-income entrepreneurs. These microborrowers make interest and principal payments to the MFI, which reinvests those cash flows or passes them on to investors.

MFI Networks: Numerous but certainly not all MFIs are affiliated with one of many highly reputable MFI networks such as CASHPOR, ACCION and others. These networks are key components to achieving underlying loan diversification. Personnel in those networks also offer deep expertise in the realm of microfinance: they may be enlisted to perform some of the due diligence and monitoring of the underlying portfolio, and they may also assist in providing oversight, ensuring that the borrowers (in this case the MFIs) maintain their covenants and other commitments associated with the securitization deal.

Sponsors and Fund Managers: The securities are typically managed by a corporate entity that disburses funds to the MFIs, collects the cash flows from the MFIs, and coordinates all of the other actors. The fund managers are responsible for screening, due diligence, and monitoring of MFI investments (either performing it themselves or contracting with other organizations to provide it). Fund managers may work closely with partners (MFI networks for example) in dispatching their responsibilities, depending on the nature of their experience. They manage the administrative and reporting functions associated with note offerings. In the first of several deals, the sponsors have purchased all or part of the equity tranches.

The fund managers and sponsors perform at least three very significant tasks, each of which requires deep knowledge of the microfinance sector.

1. Screening MFIs: The fund must determine the profile of potential MFI investments that will be eligible for the funds. Often the screens include parameters of the socioeconomic profile of microborrowers and geographic coverage of the MFI. The screens also include financial metrics and thresholds that determine a minimum quality potential investment.

2. Investment Due Diligence: The fund must examine the likely MFI investments, interviewing management, observing operations, speaking with clients, and closely scrutinizing financial records.

3. Investment Monitoring: After the loans have been disbursed, the managers observe the MFIs for any signs of distress or other trouble. Should such difficulties arise, the fund managers are likely to provide technical assistance and counselling, helping the MFI get back on track, or, when necessary, working out of the investments.

The sponsors and fund managers may serve other roles, depending on the specific situation.

Investment Advisers and Professional Service

Providers: An investment adviser may bring critical skills of structuring and placing investment instruments. The advisers' structuring expertise makes possible the packaging of underlying loans in ways that are most beneficial to both the borrowers and the ultimate investors in the securities. Usually, the adviser that structures the security also "places" the final product, actually selling the notes to investors. The investment advisers typically work with legal and accounting professionals to structure and place the securities.

Investors: In the case of the examples reviewed for this document, investors have included high net worth individuals, foundations (investing a portion of their corpus in some cases and in others using programme-related investments to qualify these investments as portions of their philanthropic payout), international development banks, socially responsible investment funds, and others. Some organizations are working to make investment products available to an increasing number of smaller investors. Investors' motivations and appetites for risk vary widely, making the investment advisers' placement expertise particularly important (as the advisers must have keen insight into the various investors in order to package and sell the bonds appropriately). Most of the investors in these offerings *do* share an interest in pursuing multiple returns on their capital, returns that are both financial and social. Further segmenting these investors, understanding their risk-reward propensities, and investigating their other concerns vis-à-vis blended value investing would be a fruitful subject for future study.

Microfinance Bonds and Securitization: A Primer

First Case Study: ACCION International's Domestic Market Bond Offerings ⁴

The earliest examples of MFI bond issues have transpired in their own domestic capital markets. Elisabeth Rhyne, Senior Vice-President of ACCION International, reports that in many cases, ACCION particularly favours domestic financing deals over international transactions (which are described at length later in this document). She notes that domestic transactions offer the following benefits: "Foreign exchange risk is not an issue; sovereign risk does not limit the bond rating; the magnitude of the funds raised is appropriate [to local MFI needs]; local investors are looking for good placements." Such MFI bond issues allow those investors to deploy their capital in ways that also generate local social value. "Moreover," she continues, "there is a contribution to deepening local financial markets when MFIs seek local financing."

Two of ACCION's affiliates, Mibanco in Peru and Compartamos in Mexico, conducted notable domestic debt offerings.

Mibanco ⁵

After financing microentrepreneurs for over a decade as an NGO, Mibanco transformed itself into a commercial microfinance bank in 1998. By 2001, Mibanco had established links with commercial financial institutions that helped finance Mibanco's lending activities through certificates of deposit and lines of credit, which amounted to relatively expensive and short-term financing that was unduly concentrated in a small number of financing institutions. Buoyed by an improving capital market environment in 2001, Mibanco's directors began to explore financing the bank's operations through a corporate bond offering. Selling such a security had the potential to reduce the cost and concentration risks in Mibanco's existing financing vehicles.

Peruvian securities regulators approved Mibanco's demand to issue debt offerings up to 50 million soles (approximately US\$ 15 million) and agreed to consider further offerings if the first 50 million soles in debt were successfully placed. In addition to domestic securities experts, Mibanco hired Peruvian Citigroup affiliates to structure and place the offering. The investment advisers began marketing an initial 20 million sole issue with a two-year maturity and 12% yield. USAID contributed a guarantee of up to 50% of the principle (thus

investors would be protected against losses of up to 50% of their initial investments), which helped the issue earn an AA rating by two local credit rating agencies.

Mibanco ultimately offered the bonds through a Dutch auction, which was ten percent oversubscribed. Though investor interest (much of it on behalf of local pension funds) was healthy, the notes' yield was relatively high, 690 basis points above the domestic inter-bank lending rate.⁶ The issuers posited that the interest rate premium would shrink as the capital markets became more comfortable with the concept of an MFI issuing corporate paper.

Indeed, their conjecture was confirmed when Mibanco issued a second 20 million sole tranche in September 2003. Structured similarly to the first issue, the second relied on a 50% guarantee from a regional commercial bank. These 27-month maturity notes yielded 5.75%, reflecting a 225 basis point drop in its interest premium. (Note that in the intervening months between the first and second issues, the inter-bank lending rate fell from 5.1% to 3.5%.) Furthermore, the investor base became more diversified, including Peruvian banks, insurance companies and other entities. ACCION and Mibanco estimate that Mibanco's net cost for the second issue totalled 7.01% after factoring in the costs of the credit guarantee and other banking and legal fees.

Ultimately, in October 2003, one month after the second issue and based on the favourable reception of its previous issues, Mibanco offered a third issue. This 10 million sole issue had no third-party guarantees to enhance the issuer's credit; nevertheless, it received ratings of AA- and A+ from local credit rating agencies. Again, the notes yielded 5.75%, this time with an 18-month maturity, but this issue was oversubscribed by 70%. Notably, Mibanco's effective cost including fees was 6.1%; the lower cost reflected, in part, the obviated need to purchase a credit enhancement.

ACCION reports that the three note issues helped Mibanco match the maturity of its assets and liabilities and reduce its average cost of funds by more than 50 basis points. At the same time, Mibanco also reduced the average interest rates it charged its clients by more than 700 basis points, thanks in part to its new access to lower-cost funds.

Microfinance Bonds and Securitization: A Primer

Financiera Compartamos

Like Mibanco, Financiera Compartamos is an ACCION International-affiliated MFI that began as an NGO. Operating in rural and urban Mexico, Compartamos converted to a regulated financial intermediary in 2000. Under Mexican regulations, Compartamos could raise funds through inter-bank borrowing and through the capital markets, though it was not permitted to take deposits from the public. Between 2000 and 2002, Compartamos had been capitalized with equity and short-term lines of credit, but by mid-2002 the bank's 100% annual growth rate had outstripped the capital supplied by those sources. The terms on which Compartamos accessed short-term credit required the institution to maintain a significant reserve that effectively increased the cost of borrowing and limited the MFI's ability to serve its customers.

Compartamos turned to the capital markets to provide the funds that could support its growth. After obtaining regulatory approval, Compartamos contracted a local investment bank to structure the 100 million peso (approximately US\$ 10 million), three-year issue that included no third-party credit enhancements. A Mexican-A1 rating from a local branch of Standard and Poor's allowed Compartamos to fix the yield at 250 basis points above the Mexican short-term treasury bills at the time of issuance. Though the yield was 13.1%, it was still 450 basis points below Compartamos's prior cost of borrowed funds. A local brokerage (affiliated with Banamex-Citigroup) privately placed the notes with local institutions and investors.

Given the success of its first offering, later in 2002 and then again in 2003 Compartamos offered two more 50 million peso issues (with a longer maturity but similar coupons to the first offering). Between the two private offerings, Compartamos was able to fully finance 35% of its lending portfolios with these lower cost liabilities.

By 2004, Compartamos's growth had continued, and it looked again to the capital markets. After the success of the three privately placed issues, the MFI opted to offer securities to the public market. Public offerings are often synonymous with higher-risk, less liquid securities due to fewer investors and higher placement costs. Offering notes to the public would allow Compartamos to reach many more investors, though many of them would need additional assurance that indeed this new type of

security bore predictable (and relatively low) risk characteristics. Accordingly, Compartamos arranged a partial guarantee on the bond's principle from the International Finance Committee (IFC).

The five-year, 500 million peso offering was structured in a series of tranches. The 190 million peso senior tranche enjoyed the benefit of a 34% guarantee from the IFC, which, in turn, helped garner an AA rating from local Standard and Poor's and Fitch-affiliated credit rating agencies.

Examples Outside of Latin America: Approaching Securitization

In 2004, Indian MFI SHARE Microfin Limited (SML, also an NGO that had converted to a regulated financial institution) and ICICI, one of India's largest mainstream banks, initiated a transaction wherein the commercial bank purchased 25% of SML's loan portfolio for US\$ 4.3 million. Through the transaction, SML was able to borrow funds at approximately 8.75% (versus the 12-13% that it had previously paid to access commercial financing). The transaction was facilitated by a cash deposit (made by other partners, including the Grameen Foundation) that functions as a first loss provision. ICICI later resold the loan portfolio to another Indian bank.⁷

Though this transaction did not "productize" the loan portfolio to the extent that the commercial mortgage-backed securities productize their underlying securities, it is a notable and rare example of a secondary market transaction for MFI debt. The SML transaction also differs from the Mibanco and Compartamos note issues in that the deal packaged and sold existing loans, whereas the ACCION affiliates sold securities to initiate new loans. All of these transactions depend on the fundamental soundness of microentrepreneurs' ability to be good financial customers who can generate financial value with small loans and can assiduously honour their loan commitments. From the perspective of an investor buying the securities issued by these MFIs, an investment in the Mibanco and Compartamos notes are first investments in the MFIs themselves. They will only meet their financial obligations if the MFIs fulfil all aspects of their business—from identifying customers to initiating business to administering loans—efficiently and competently (and, of course, through it all, the customers must pay their loans). The investors in the SML portfolio purchased loans

Microfinance Bonds and Securitization: A Primer

that already had established track records, and so the success of that portfolio would have little to do with SML's ongoing lending and other business practices (though SML remained the collecting agent for the loan portfolio).

Barriers to Full Securitization

A number of obstacles currently make it difficult for MFIs and their investment advisers to offer true securitization deals. These securities require considerable financial engineering and so such deals must be of a sufficiently large scale before a mainstream bank would devote its structuring and advisory services to such a deal. Microloans also require relatively expensive and active administration, and the MFIs themselves have the greatest expertise in this realm and in most cases can perform that maintenance at the lowest cost. Accordingly, it would be difficult for an MFI to sell its loans and then have nothing to do with them without third parties to continue administering those loans. The SML-ICICI deal overcame this obstacle by contracting SML to continue administering the loans even after it had sold them to ICICI. Finally, the maturity of the microloans (often less than one year) can limit the maturity of any securitized notes.

None of these obstacles should prevent the ultimate securitization of microloans, and those challenges can be met with the sort of financial engineering that mainstream investment banks deploy in their regular business. As mainstream investors become more comfortable with the investment prospects of microentrepreneurs and as the cost of administering microloans continues to fall (through adoption of technology and sharing of best practices), full microfinance securitization deals will become reality.

An Introduction to International Debt Offerings

The examples above were confined to the countries in which the MFIs operate: the microentrepreneurs, MFIs, banks and investors were all in the same countries. Structuring such deals where the borrowers and lenders operate in different currencies magnifies the complications, particularly in that such international lending introduces foreign exchange risk, along with regulatory complications. Nevertheless,

international financial transactions have the potential to open a still-larger pool of available capital to microfinance and other blended-value-creating systems.

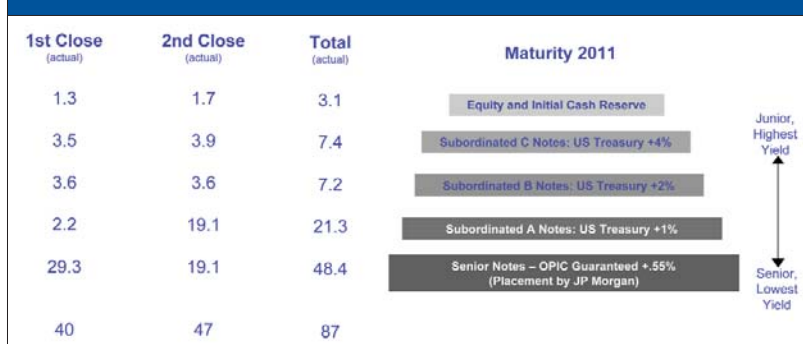
One of the largest and first international securitization deals was completed by BlueOrchard Finance (BOF), a Swiss microfinance consultancy. In addition to offering BlueOrchard Microfinance Securities (BOMFS), BOF manages the Dexia Micro-Credit Fund and serves as a sub-adviser to the ResponsAbility Global Microfinance Fund, both of which work to link capital markets with MFIs.

The first and second closing of the BOMFS-I securities in 2004 and 2005 respectively brought the total capital raised to US\$ 87 million. Structured and privately placed with the assistance of boutique investment adviser Developing World Markets (DWM, discussed further below), the securitization deal included five tranches, all with a maturity date of 2011. The transaction structure is detailed in figure 1. Notably, the Overseas Private Investment Corporation (OPIC), an agency of the US government, guaranteed the senior tranche of the offering. The success of BOMFS-I has led both BOF and DWM to consider future offerings of similar securities.

Writing after the first closing (but before the second closing) of BOMFS-I, Meehan reports:

*"There were a total of 66 total investors: 12 foundations, 15 MFI practitioners/investors, 11 socially responsible investment (SRI) managers, 3 SRI funds, 22 private investors, and 3 institutional investors. ... Equity investors ...include BlueOrchard Finance ...Developing World Markets ... [Grameen Foundation USA], Omidyar Network, and Skoll foundation."*⁸

Figure 1: BlueOrchard Microfinance Security I Capital Structure (Millions US\$)



Source: BlueOrchard and Developing World Markets, BOMFS-I Investor Presentation

Microfinance Bonds and Securitization: A Primer

Second Case Study: Global Partnerships' International Debt Offering⁹

The Global Partnerships Microfinance Fund 2005 was not the first international microfinance debt offering, nor was it the largest or the highest profile, but it is remarkable for a number of other reasons:

- First, Global Partnerships (GP) has made an effort to extend the financial product to MFIs that would not likely have had access to commercial capital;
- Second, the very recent issue facilitated by GP demonstrates some of the trends toward a more efficient, broader market for these sorts of deals;
- And finally, the issuers are already considering another similar offering, which has thrown the lessons learned into sharp relief as they move forward.

Introduction to Global Partnerships

Seattle business professional Bill Clapp and his wife Paula founded Global Partnerships as a private foundation in 1994 after they saw the transformative power of microfinance in El Salvador. Their organization set out to support microfinance institutions in Central America, particularly in Nicaragua, Honduras, El Salvador and Guatemala. In particular, GP supports “innovative microcredit programmes that incorporate components such as education or healthcare, or programmes that are working to solve challenges faced by the growing microcredit industry.”¹⁰ In addition to financial support and technical expertise, GP has inaugurated a policy initiative to make poverty elimination a top American priority.

GP's programmes cover a range of issues and initiatives, but all intend to remove the barriers that prevent poor Central American families from exercising their inherent entrepreneurial ambitions. Beyond supporting microfinance-related programmes, GP also advocates for policy change and international dialogue that will enhance the economic and political environment for microfinance in Central America.

In over a decade of supporting its Central American microfinance partners, Global Partnerships has developed a distinct expertise in helping scale and support growing MFIs and related programmes. Over the course of this work and in its close relationships with American donors, the

organization recognized that Central American MFIs' need for additional capital (and their remarkable ability to deploy it for social and economic value creation) exceeded their donors' capacity to provide it. They turned to the capital markets to generate those funds.

International debt offerings are the product of many different partners, each bringing specialized skills. Global Partnerships brought its deep knowledge of Central American microfinance and the ability to get capital in the hands of MFIs very quickly. While the organization had close connections with donors and other potential investors, it lacked expertise in structuring investment products. Gary Mulhair, Global Partnerships' managing partner, found that expertise in the Developing World Markets (DWM), a boutique investment advisory in Connecticut, USA, and in Orrick, Herrington & Sutcliffe LLP, an international law firm.

Developing World Markets

DWM was founded originally as an emerging markets investment fund, a line of business that later led to investments in initial public offerings in developing markets. DWM partners Peter Johnson and Judy Kirst-Kolkman found their entrée to microfinance in 1999, when they invested some of the profits from their successful investment funds into a revolving loan fund for Pro Mujer, an organization that establishes and supports Latin American MFIs. What began as a philanthropic venture became a business proposition as DWM increasingly focused its attention on providing professional financial services for MFIs. In the early 2000s, the partners began to conceive of a new mission for DWM, one that would deploy their extensive finance and investment expertise in the microfinance field.

DWM's first high-profile deal closed in 2004, when it replaced a “white-shoe” investment bank in structuring BlueOrchard Finance's first international microfinance debt offering. Though the BlueOrchard deal totalled over US\$ 87 million (including the first and second closings), Johnson indicates that such debt offerings are still too small to appeal to large-scale investment banks. Accordingly, such deals are ideal for boutique investment advisories like DWM, which now devotes the majority of its management attention to these specialized financial services.

Microfinance Bonds and Securitization: A Primer

Johnson and his colleagues have learned to communicate with fund managers like BlueOrchard or Global Partnerships as well as potential investors. In structuring these securities, they have become experts in creating financial models of cash flows from MFIs and understanding the risks associated with those cash flows. DWM has learned the needs, concerns and interests of its potential investors, who include high net worth individuals and their private wealth managers, foundations, socially responsible investment funds, other institutional investors, and international development banks—each with their own needs, concerns and interests. Johnson and Roger Frank, DWM managing director, suggest that it is not easy to segment these investors whose appetites for investment risk and reward and those whose understanding of the microfinance sector vary widely. The new dimensions of microfinance securities and the awakening of the investment community to them make DWM's expertise all the more valuable.

Orrick, Herrington & Sutcliffe LLP (Orrick)

As Mulhair planned to launch a securitization deal to meet the demand he saw in Central America, he also turned to international law firm Orrick, which had provided legal advice for the BlueOrchard Microfinance Securities. For Global Partnerships, Orrick was instrumental in structuring the entity that would manage the securitization fund. Without careful planning, managing an investment fund would make GP appear to have extremely high overhead on its financial reports. Such a condition would not interfere with GP's legal and responsible management of the funds; instead, it would make GP unappealing to donors (the equivalent of dramatically reducing the net margin percentage of a for-profit corporation). GP could not afford to hamper its ability to raise donations, which fund various microfinance projects that are not appropriate for commercial financing. Orrick's solution for GP appears to be a replicable model for organizing an American non-profit microfinance fund management organization.

In essence, Orrick and GP created a limited liability corporation called Global Partnerships Microfinance Fund 2005, LLC (GPMF) in which GP is the only member. All activity and cash flows associated with the securitization pass through the LLC. Specifically how this corporate structure resolves GP's financial reporting concerns is beyond the scope of this paper, but it also resolves some investors' concerns. Mulhair

expressed that indeed it is important to create an investment vehicle that is familiar for investors, and the LLC serves that purpose. Whereas "investing" in a non-profit may be a foreign or confusing concept for some investors, the LLC is common to many private investments.

Screening Potential MFI Investments

Mulhair developed a distinct profile for potential MFI investees. He focused primarily on MFIs growing at 20-40% per year and that would likely continue to do so for several years. All of the funds under consideration for participation in the offering had to demonstrate that they were profitable on a sustainable basis. For funds in this category, growth comes from three sources:

- They are making more loans in the communities where they are operating;
- They are making larger loans to established customers;
- They are expanding into new geographic markets.

The first and particularly the last means of growth require the MFI to invest additional resources in initiating those new loans.

In order to be eligible for GPMF's consideration, the MFIs had to be sufficiently well run and have the systems in place to scale with their growth in lending. Finally (and related directly to the last point), Mulhair only considered MFIs that had a track record of rapidly deploying their capital. He did not want his investors' money sitting idle; he wanted it working immediately for poor entrepreneurs.

This profile is remarkable in that it does not target the lowest-risk, first-tier MFIs (which have better access to capital than do the institutions GPMF targeted). The profile likely increases risk to some extent, as growth can hide problems. Nevertheless, the exhaustive due diligence process, the loan agreements' covenants, and the post-investment monitoring allow GPMF to understand and manage the risk. Mulhair reports:

"These MFI's are the most rapidly growing providers of capital to the poor, and they are doing it with sustainable business models. They are the future leaders of the microfinance industry."

Microfinance Bonds and Securitization: A Primer

Structuring the Investment

Mulhair was highly engaged in creating a structure for the GPMF investment that would satisfy both the MFIs and the investors. Beginning in autumn 2004, he first went to potential MFI investees to discover what borrowing and repayment structures made the most sense for them. Eventually, Mulhair tailored the fund to their particular needs as best he could.

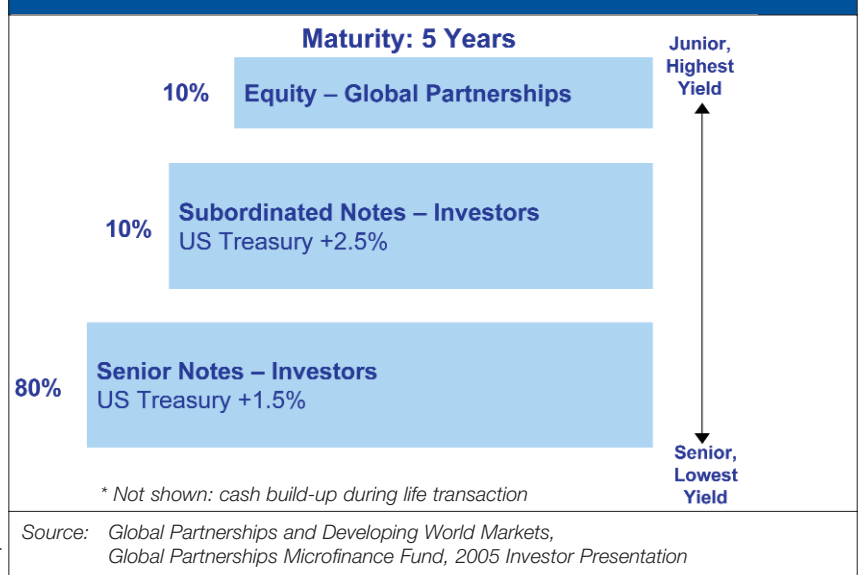
First, Mulhair discovered that the MFIs were hungry for capital. Many estimated that they had only penetrated five to ten percent of their potential markets, and the most established groups indicated that they had only reached 20% of their potential borrowers. He inquired into MFIs' alternative sources of capital and discovered that the target MFIs could afford—and would be willing—to pay eight to twelve percent interest on funds borrowed from GPMF. The MFIs also expressed a desire for long-term loans that would not require frequent renegotiation. MFIs growing at rates of 20 to 30% per year found that shorter term loans imposed a painful fundraising burden: not only were the MFIs raising debt to fund expansion, they had to raise funds to replace maturing debt. Finally, the MFIs expressed that they wanted their investors to become long-term partners with whom they could establish trust and track records that might be leveraged in future rounds of financing. Accordingly, GPMF anticipates that future funds will make additional investments in the MFIs that received earlier loans.

After discovering what the MFIs needed, Mulhair approached potential investors suggested by DWM. He first identified their common concerns, which included the level of investment concentration in single country or MFI, the duration of the notes, and the levels of debt subordination available. Understanding those general concerns, Mulhair hosted a series of focus groups with potential investors, testing various structures until he arrived at the fund's ultimate structure. His research paid off in making the issue fairly easy to place. Mulhair indicated that it took only 45 days to place the entire offering, which closed in September 2005. In offering the securities, GPMF discovered a greater-than-expected demand for the higher-yield subordinated notes as well as that the market might bear senior notes with a lower risk premium—an important insight for possible future offerings.

Unlike the BlueOrchard securitization, GPMF's investment structure did not include the participation of any government entities to lend the issue their credibility. Thanks in part to other pioneering securitization deals like BlueOrchard's, many potential investors had become sufficiently comfortable with the investment structure that they were willing to invest without having co-investing or credit-enhancing agencies to signal the offering's safety. In early 2006, at least one other group was preparing a securitization deal that will considerably exceed GPMF in size and will do so with minimal credit enhancements.¹¹

Mulhair and GPMF deliberately kept this first fund at a relatively manageable US\$ 2,000,000. All of the notes had a five-year maturity and a fixed yield based on the four-year US Treasuries rate at the time of issuance. 80% of the offering's value, US\$ 1,600,000, was senior notes with a yield premium of 1.5% over the applicable US Treasuries. Ten percent of the offering, US\$ 200,000, was subordinated notes with a yield premium of 2.5% over the US Treasuries. The remaining ten percent of the offering was the equity tranche. GP (the non-profit, not the fund management entity) contributed the entire equity tranche, and in the process agreed to accept first losses up to US\$ 200,000. (See figure 2 for a graphical representation of the fund's structure.)

Figure 2: Global Partnerships Microfinance Fund 2005 Capital Structure Fund Capitalization



Microfinance Bonds and Securitization: A Primer

Though the fund's offering memorandum stipulated that GPMF could take up to six months to disburse the funds to MFIs, Mulhair reports that the funds were disbursed within 60 days, thanks to GP's fluent knowledge of potential MFI investees gained in part through a due diligence process that began before GP even closed the fund. Though it is too early for GPMF to have a proven track record, Mulhair sees enough demand from both MFIs and potential investors that he is already working on structuring GP's next fund. That fund, he says, will be larger, and he aims to have it entirely disbursed to MFIs within a month of his collecting it from investors. Mulhair and DWM have returned to their potential investors for input on the next fund's structure. He anticipates raising that fund in the first half of 2006 and then raising a series of other larger funds over the following five years.

Emerging Issues in Microfinance Securitization

Goal: Efficient Capital Markets

Mulhair (along with many others) looks forward to the day when MFIs have access to a wider variety of capital sources funded by myriad investment products. Those MFIs will be able to choose among many sources of capital, including selling equity, borrowing on various terms, deploying their own retained earnings, and mobilizing their clients' savings. More diverse financing sources offering capital on different terms will allow MFIs to structure the capitalization that best suits their needs and the needs of their clients (just as businesses in the developed world have great flexibility to structure their own capitalization to the benefit of customers and shareholders). The world he describes is also known as an efficient capital market, and it certainly does not exist yet.

Many professionals in the field look forward to the time when mainstream financial investors recognize microfinance investments as legitimate and useful asset classes with measurable and attractive risk-reward characteristics, asset classes that can add valuable dimensions to a portfolio of investments. They envision a range of reasonably standard investment products that can be dynamically priced and traded in secondary markets. Looking at the fundamentals of the securities that they are structuring, DWM and other professionals believe that microfinance securities will eventually be able to stand on their own, appealing to investors without needing a "socially responsible crutch", and without any concession to the risk-adjusted market rate of return. Many feel that these products will be very desirable because they are both safe and relatively uncorrelated to other asset classes.

Obstacles to Efficient Microfinance Capital Market

Raising Capital: Obstacles Facing the Microfinance Capital Supply

Currently, many potential investors remain ignorant of the existence of microfinance investment products, and many potential investors are unfamiliar with the existing underlying microfinance industry. Potential investors may not understand the risk profile of these products, nor may they understand the potential benefits (financial and social) of investing in them. All these factors work together to create obstacles to expanding investing in this arena.

Those investors who have expressed interest in these products are very fragmented in their investment needs and interests. A high net worth individual who has previously donated funds to MFIs and wants to advance the state of the art of microfinance would have fundamentally different motivations and expectations than would a pension fund manager interested in a fixed income security that will be relatively insulated from American macroeconomic cycles. Roger Frank of DWM simplifies the variety of investors' interests by drawing a three dimensional grid, which he acknowledges does not have enough dimensions to plot a single investor's profile. On the x-axis he draws a risk-reward continuum; on the y-axis he plots geographic exposure; on the z-axis is an investor's interest in social returns. Every investor's point in that three-dimensional space is different, and so each investor's demand for investment products is also relatively unique. If Frank were to plot all of their potential investors in that three-dimensional space, there would be points all over the space. Accordingly, each new potential investor needs to be looked at individually.

Because they are a relatively new investment class, microfinance notes currently lack well-established data on their performance as securities. Portfolio managers whose investment decisions are data-driven simply do not have access to historical return and volatility measurements for these investment products, and so they will avoid them altogether. Academics will find it challenging to gather enough data to analyze how these securities are correlated with other investments, though many believe that the securities will prove to be largely uncorrelated. The obstacles continue: mainstream credit ratings are rarely available for these securities, and with so few of these securities having been issued, a viable secondary market does not yet exist.

Those obstacles notwithstanding, the fundamentals of the underlying loans to poor microentrepreneurs appear remarkably firm. Frank claims: "I can soundly win any arguments about the fundamentals of the underlying assets, but I simply cannot counter arguments about liquidity of the notes or about the lack of ratings standards. Solid fundamentals are the best insurance policy." Given his finance background and proximity to these investments, the notes' quality is evident to him. Fortunately, strong fundamentals portend both transparent ratings standards and, ultimately, a potentially vital secondary market.

Emerging Issues in Microfinance Securitization

Concerns about Microfinance-Backed Securities

Some microfinance experts raise concerns that the abundance of debt capital available to MFIs could distract them from mobilizing their borrowers' savings as a source of capital. If an MFI can accept deposits, it can access those funds to make additional loans. Unfortunately, it takes considerable effort and cost to offer these products, and in many parts of the world an MFI must be regulated by the state before it can accept deposits. These requirements preclude many of the not-for-profit and informally organized MFIs from developing this source of capital. (It should be noted that such MFIs are also at a disadvantage in seeking commercially available debt financing.) Savings accumulate gradually, so that source of capital may not be immediately available to finance growth. While an MFI may be consumed with securing debt capital and be distracted from establishing savings programmes for poor clients, there is ample evidence that strategically minded MFI managers are planning on capturing future savings once they are regulated and are using debt as an interim source of capital.

Many microfinance experts also raise concerns about US dollar-denominated loans to MFIs. When investors loan in dollars, they also expect repayment in dollars, while the MFIs must make microloans in local currency. This arrangement exposes the MFIs to currency fluctuations (because they must undertake the conversion from hard to soft currency). While such variation can occasionally work in the MFIs' favour, many fear that such fluctuations—especially those caused by drastic local currency devaluations—will work to the MFIs' detriment. US dollar-denominated loans tend to be appealing because they carry a nominally lower interest rate. On the other hand, loans denominated in local currencies usually place the foreign exchange exposure on parties other than the MFIs (and their clients); nevertheless, these loans tend to carry higher interest rates. Within the MFI establishment there is a vigorous debate about whether hard-currency or soft-currency loans are preferable. Engaging this debate's nuances remains beyond the scope of this study, though this document includes additional discussions of foreign exchange risk management. Ultimately, MFIs need access to all manners of capital, including hard and soft currency loans. The MFIs themselves should be able to choose the financing instruments and capital structures (that may blend hard and soft currency loans) as the MFIs themselves deem appropriate.¹²

Other critics suggest that widely available commercial financing could encourage MFIs to move up-market, making larger loans to less-poor people. Such loans tend to be less costly to administer and are perceived to be lower risk (though many would argue that they are not). An MFI that moves up-market could run the risk itself of changing the fundamental underlying assets such that the non-correlation benefits are eroded—not to mention that moving up-market could include abandoning the poorest customers who need microcredit the most.

Similarly, some microfinance professionals express concern that emphasis on directing investment-grade capital to MFIs could staunch the flow of donated capital into the microfinance sector. Microfinance was built on grants, which still make up the majority of the capital that is ultimately lent to poor entrepreneurs; choking the flow of donated capital would have a disastrous effect on MFIs and their clients. Even if the volume of investment capital (in the form of debt and equity) rises dramatically to meet the expansion needs of established MFIs, grant capital will still play important roles in founding new MFIs, funding innovation and helping manage market inefficiencies that may persist in certain geographies or business models. (For example, one can imagine an isolated, small community that could benefit from microfinance but lacks infrastructure, scale and proximity to established financial institutions. Grant funds will likely always be necessary to bring microfinance to such communities and to establish whether microlending can be conducted sustainably therein. If for any reason the practice is not sustainable, grantors may choose to continue funding this microfinance initiative to create social value even if it cannot return financial value to the financial backers.) Microfinance generates value in multiple dimensions, but different microfinance arrangements can generate very different blends of those returns. In some cases, microloans generate significant social value but cannot generate returns for investors—even when the programmes are administered efficiently.¹³ Such programmes should be funded by donated capital (or through some other form of financially risk-tolerant investment) by investors who value that particular blend of social or economic returns.

As this capital market is new and emerging, there are also concerns that the risk associated with the products has not been appropriately priced. Wrongly priced risk can amount to a hidden subsidy or quota that could distort the market,

Emerging Issues in Microfinance Securitization

resulting in either too much or not enough capital flowing into these investments. Some fear microfinance securitization could become a victim of its own success. If too much capital flows to MFIs, lending practices may become sloppy, resulting eventually in unforeseen defaults. (See Nurcha in the following section for an example of this phenomenon.) If the risk of any given investment remains wrongly priced, perhaps through the subsidies provided by socially conscious investors willing to accept concessionary financial returns, over the long run not enough capital will flow to the sector and worthy MFI investments will go unfunded.

Signs that the Market Is Becoming More Efficient

The nominally low cost of capital associated with mobilizing clients' savings may well serve as a sufficiently strong motivation for MFIs to make additional savings and deposit facilities available to their clients (provided that organizational structure and regulatory environments permit this). Furthermore, such products engender social benefits by making the MFIs' clients more financially sustainable, which amounts to strong motivation.

As these products become more widely available, the market will become more proficient at pricing the risk associated with each deal. Experts are learning how to price these securities, and what is now something of an art will over time become a science as investment advisers and fund managers offer more microfinance securities. Likewise, these experts are developing more sophisticated and increasingly appropriate structures, as can be seen in GP's plans for future offerings with new equity and subordinated tranche features. As more investment banks grapple with structuring and pricing issues, there will need to be an efficient and transparent forum for communicating pricing and structure information, which will be essential to price risk.

While international debt offerings are not yet applicable to the majority of MFIs, this condition shows signs of changing. While the BlueOrchard securitization worked primarily with top-tier, high-performing MFIs, Global Partnerships has demonstrated that the product is moving down market, funding MFIs that are still maturing. Johnson of DWM is confident that the trend can continue, as mainstream investment bankers have ample experience securitizing higher-risk loans like credit card receivables and potentially risky auto loans.

The number and variety of products in the planning or placement phase seem to be increasing daily. Many of these products have not been made public, but there are a number of innovative, intelligent and socially motivated professionals devoting their time and energy to giving MFIs access to mainstream capital markets. At the current rate of creativity, a report of this nature might be issued semi-annually, each time featuring a new path-breaking approach to linking poor microfinance customers to mainstream financial capital markets.

Looking to the Future

The number and variety of securitization deals seems likely to increase exponentially in the next several years. The causes of this growth are many, but underlying all of them are two strong fundamental conditions: microfinance works, and there is very powerful demand at the bottom of the pyramid. With millions of impoverished potential microentrepreneurs and an ever-increasing number of MFIs arising to meet their financing needs, there will be unmet demand for capital into the foreseeable future. That demand will drive financial innovation and forge connections between those in the developed world who control capital and those in the developing world who only need a small bit of it to improve their lives profoundly.

Microfinance has the potential to bring millions of people out of deep poverty. To do so, the industry needs a new group of financiers capable of increasing the amount and various forms of capital available in this market by an order of magnitude—and to do so without stemming the flow of donated capital to MFIs where such capital is the most appropriate fuel for their development.

While the power of microfinance to expand economic opportunity for very low-income individuals is key, microfinance also holds the potential for achieving something more. In demonstrating its effectiveness, *the organizations profiled in this and other documents are demonstrating how to achieve financial performance together with significant social impact.*

A Note on other Debt Financing Innovations

Microfinance professionals are not the only innovators in debt financing. In the United States, several decades of community development investing have driven financial innovation as well. The following case study examines how community development investors in the US have contributed their innovations to a unique programme fostering the development of free democratic societies.

Third Case Study: *Community Investing, Media Development Loan Fund, and Calvert Social Investment Foundation*¹⁴

Media Development Loan Fund

Media Development Loan Fund (MDLF) invests in independent news media outlets in emerging democracies, offering what Deputy Managing Director Harlan Mandel calls “direct economic investment in democratic change.” MDLF’s investors, managers and investees share the fundamental belief that independent media are essential to the development of productive democratic societies. In countries establishing the institutions of a participatory government and the open expression of a free society, independent media can begin to right the wrongs of oppressive regimes, giving voice to ethnic, political, or socio-economic groups that had previously been silenced.

“While independent news organizations are commercial enterprises, at the heart of MDLF’s work is the notion that the best are much more than that: they are social enterprises, committed to truthful and ethical journalism, and their development is a prerequisite for any functioning democracy. They provide information needed for citizen participation in the democratic process and for the functioning of market economies. They play an essential role in economic development, and in extending the benefits of development to those in poverty. As MDLF describes it, they give a voice to the otherwise unheard and open the government and the economic affairs of a nation to public scrutiny and debate. They expose corruption and shine a light on issues critical to countries in transition: health, economic development, treatment of minorities and the environment.”

Source: Calvert Foundation Case Study of MDLF. Unpublished. October 2004.

Independent media and news outlets in emerging democracies often face a host of market and non-market obstacles to sustainability—and sometimes to their very survival. Licensing requirements and other regulatory restrictions can impede the free publication and broadcast of independent ideas and views. When those media organizations are free to operate, they often face competition unfairly subsidized by political and economic elite. Furthermore, financing vehicles are often unavailable to companies facing those sorts of risks, and capital that is obtainable may impinge on an outlet’s editorial independence.

Founded as an American not-for-profit corporation in 1995, The Media Development Loan Fund provides below-market rate financing with technical and managerial assistance to the fledgling media outlets crucial to many countries’ transformation to free democratic societies. MDLF primarily offers concessionary rate loans and lease financing arrangements to newspapers, publishers, television and radio stations, and digital media outlets. It also tailors the financing arrangements to the needs of its clients, and it will even initiate equity financing under certain circumstances. With headquarters in New York City, an operations centre in Prague, and offices across the world, MDLF manages a pool of capital provided by donors and by programme-related investment (PRI) lenders.

The organization adds the engagement of a venture capital investment—often taking a board seat, offering strategic consulting, and monitoring operations closely—to its debt financing. Mandel explains that debt financing encourages clients, which are locally owned small businesses, to plan for sustainability and to aim for reliable cash flows that will cover the interest and principal payments. That discipline forces the client to respond to their audiences and to sell products. MDLF observes that the obligation to make regular payments forces clients to write business plans and then to adhere to them—a valuable outcome that standard grants would not necessarily confer.

MDLF tends to avoid financing working capital, instead aiming to finance assets that will help clients achieve financial independence. Commonly, clients purchase a key piece of production equipment like a printing press, audio-visual production equipment or information technology

A Note on other Debt Financing Innovations

infrastructure. A printing press, for example, not only frees a newspaper from depending on state-controlled printers, it can improve a newspaper's quality such that it wins new advertisement income, allowing it to produce a less expensive and more attractive product. Many clients will be able to sell excess capacity on the new presses, bringing additional income.

MDLF's Investment Process

MDLF's deal flow varies by region. In the Balkans, Russia, Ukraine and elsewhere, MDLF has established a reputation that brings unsolicited potential investments to the fund. In other locations, especially as the fund expands into new geographies, MDLF depends on other media-support organizations or its own prospecting for eligible independent media investments.

Fund staff screen potential investments for both the sophistication that engenders sustainability and the independence that advances democratic progress. The organization's directors have established the following guidelines for potential investments.¹⁵

To be considered by MDLF for debt, lease finance or equity investment, a media organization must fit the following profile:

- 1. It must be legally registered according to all applicable laws. It must have licenses required by local laws for media of its kind and, if the applicant is an electronic media, it must have a valid frequency license.*
- 2. It must have been in operation for at least a year. The Board of Directors may, in extraordinary circumstances, waive this requirement.*
- 3. It must have a record of promoting democratic institutions and practices in its country and must be nationally or internationally known for promoting and exercising principles of free, independent and responsible press.*
- 4. A significant part of the applicant's programme must be news, current events, photojournalism, photo-imaging and documentary programmes driven by editorial staff to exercise fact-based, honest, unbiased, fair, non-partisan, investigative and responsible journalism, independent from the influence of the government or of any other interest group.*
- 5. News, current events and documentary programmes must have a proven record of offering coverage of different political opinions, promoting human rights and the rights of ethnic minorities, and promoting inter-ethnic coexistence.*

Once a potential investment meets these criteria, having passed through a screen for social value, MDLF pursues financial due diligence. MDLF's staff will only recommend investments that affirmatively create social value and that appear well positioned financially. An independent investment committee makes the ultimate investment decision.

MDLF's Investment Portfolio

By late 2005, that process led to about US\$ 45 million in investments to nearly 50 different companies. With approximately US\$ 15 million returned through principal payments (and then re-lent), the organization was managing a loan portfolio of about US\$ 30 million financing about 30 different media outlets. MDLF has made loans ranging in size from US\$ 100,000 to US\$ 7 million with a typical range from US\$ 500,000 to US\$ 1 million, and it has initiated an average of 12 to 15 loans per year.

The loans and leases, all dollar or euro-denominated, carry interest rates between 5.5 and 7.5% and as high as ten percent (though the funds earliest loans were in the 1-3% range), and they typically have five- to seven-year maturities. About 80% of the loans have been committed to media outlets in the former Soviet Union and the former Yugoslavia, but the fund is expanding in Africa, Asia and Latin America. MDLF maintains a loss reserve equal to approximately 18% of the total loan portfolio. Close monitoring and involvement have led to write-offs amounting to approximately two percent of total invested, low delinquency rates and significant recoveries of delinquent payments.

Historically, MDLF's work has been financed by foundation grants, individual donations, and approximately US\$ 10 million in PRI debt from the Open Society Institute, the MacArthur Foundation, the Swedish government and other European foundations. Recently, the fund has made debt financing vehicles much more widely available through its Free Press Investment Notes. Structured by the Calvert Social Investment Foundation, which is itself an MDLF investor, these notes make blended value investments available to individual investors, institutions and foundations interested in a relatively simple way to support independent media and earn a financial return in the process.

A Note on other Debt Financing Innovations

Investment case study

An example of a successful portfolio company is Altapress in Russia:

Altapress is a newspaper publisher in Barnaul, a city in Siberia close to the Kazakhstan border.

In 1990 five journalists left Barnaul's communist paper to set up Altapress, the first independent news outlet in the heavily Communist region of Altaiskii Krai, southern Siberia. Beginning with the award-winning, general-interest Svobodnyi Kurs (Free Course), circulation 35,000, the company today is the 5th largest regional publisher in Russia, with 350 full-time employees and six newspapers, including a successful weekly business publication. It has a powerful printing business: its two printing presses, both bought with MDLF financing, are the only high-quality, non-state newspaper printing facilities in the area. Its distribution system manages some 250 sales stands around the town and region. A modern new building, built partly with an MDLF loan, hosts most of the company's employees, as well as its training centre, which trains over 400 local students every month in journalism, business, advertising, management and PR. In 2003, Altapress won the Die Zeit Young Press Eastern Europe Award. In 2001, Altapress General Director Yuri Purgin was selected as Best Media Manager by the Russian Union of Journalists.

MDLF began working with Altapress in 1999, providing lease financing for purchase of a web offset press for printing newspapers and a loan for construction of company premises for a printing house and all its other operations. In 2002, MDLF provided a second finance lease for the purchase of a sheet-fed press for commercial printing. Altapress has been a problem-free borrower and has served as a training ground for all subsequent MDLF newspaper clients in the former Soviet Union. In recent years it has gained wide recognition as the best managed regional newspaper company in Russia.

In 2004, Altapress gained international recognition for its public protest against government pressure to publish false articles slandering an opposition politician. In a rare act of courage and integrity in today's Russia, Altapress published an open letter signed by all its journalists, and many others from the region, detailing the government's pressure and refusing to accede to it. Time Magazine cited the event as a first sign of the potential for democratic change in Russia.¹⁵

Source: Shari Berenbach and Harlan Mandel

Calvert Social Investment Foundation

One of the first socially responsible mutual fund managers, Calvert Group offers individual investors a variety of screened socially responsible portfolios of public equities, bonds and other money market products. In the late 1980s the company began to explore investment strategies that not only screened out social value destruction but sought actively to create social value with its investments. This discussion eventually led the fund to commit to investing one percent of its assets in community development finance intermediaries.

To facilitate this style of investing, Calvert Group eventually founded the Calvert Social Investment Foundation (Calvert Foundation) in 1995 with the support of national foundations including Ford, MacArthur and Mott. The Calvert Foundation aims to affect community investment in the same way that Calvert Group built SRI: the foundation aims to refine the practice and productize investments so that individual investors can actively participate in community investing. In essence, the foundation has been charged with creating investment products that generate blended value. Overseeing this mission is Shari Berenbach, the president of Calvert Social Investment Foundation.

The Calvert Community Investment Note

Calvert Foundation's flagship investment product is called the Calvert Community Investment Note. Structured as general recourse obligation of the foundation, the notes are designed to make it safe and convenient for average investors to direct capital to community development and other blended value-generating projects and enterprises. The Notes are highly customizable and can be purchased in increments of US\$ 1,000 (with a US\$ 1,000 minimum investment). Investors can choose the profile of the investments underlying their notes, targeting specific geographic regions and programmatic areas. Investors can also select the maturity of their Notes (ranging from one to ten years) and the interest rate (from zero to three percent). Calvert Foundation will build completely customized community investment portfolios for investors deploying over US\$ 50,000 in capital.

In the ten years since the Notes' inception, Calvert Foundation has nearly US\$ 100 million in Community Investment Notes outstanding. This capital has been deployed across a US\$ 84 million portfolio of 195 borrowers, including American community development financial intermediaries, affordable housing developers, microfinance institutions, fair trade cooperatives and other domestic and international social enterprises.

A Note on other Debt Financing Innovations

The underlying portfolios are very carefully screened, monitored, and managed. Calvert Foundation has put in place significant security enhancements that lower the notes' risk such that the foundation has never defaulted on its obligations to any Community Investment Noteholders. The notes currently have a three percent loss reserve, and they are further collateralized by Calvert Foundation's balance sheet, which holds substantial assets that are junior to the Community Investment Notes. With the portfolios' average loan size at approximately US\$ 400,000, five average size loans would have to be complete losses to exhaust the loss reserves, and then realized losses would have to be substantially larger before they exhausted the cushion provided by the subordinated assets on Calvert Foundation's balance sheet. By late 2005, Calvert Foundation had over 2,400 Community Investment Noteholders. The largest note-holders are the Calvert Funds. 2,200 of those investors have invested less than US\$ 50,000, and 1,000 have invested US\$ 5,000 or less. Many of the 200 investors who have invested more than US\$ 50,000 are family foundations and high net worth individuals.

Building the Community Investment Field

Calvert Foundation has helped to build the community investment market place by teaming up with partners to support their access to investors' capital. The first strategy used by the foundation has been to "private label" the Community Investment Note, thereby allowing organizations to wrap the investment instrument in their own brand, effectively piggybacking on existing note registration and administration. Private label notes direct capital to specific loan portfolios or borrowing sectors. These notes stay on Calvert Foundation's balance sheet like all of its Community Investment Notes, and the private label products have the basically the same structure as Calvert's own note product. Calvert prepares the prospectuses, manages the registration tasks, handles investor administration, and collaborates with its partners to reach new investors and investees.

A Note on other Debt Financing Innovations

Investment notes established through Calvert Foundation's Private Label programme	
<i>Gulf Coast Recovery Initiative</i>	<i>Directs community investments to help those who were hardest hit by Hurricane Katrina and other recent devastating hurricanes.</i>
<i>Jubilee Investing Initiative</i>	<i>Directs faith-based community investments to non-profit lenders worldwide.</i>
<i>LGBT Community Investment Notes</i>	<i>Supports lenders that provide important community facilities and services for the lesbian/gay/bi-sexual/transgender community</i>
<i>National Peace Corps Association Microenterprise Program</i>	<i>Invests in microcredit organizations, primarily FINCA, to offer working capital and financial services for the economically active poor around the world.</i>
<i>Oikocredit World Partnership programme</i>	<i>Oikocredit was founded 25 years ago as an alternative investment instrument for churches to provide credit for poor and disadvantaged people around the world.</i>
<i>Grameen Investments</i>	<i>Has directed capital to Grameen Foundation USA to help working poor in Bangladesh develop sustainable businesses.</i>
<i>MicroVest mPower Investment Program</i>	<i>Allows investment in microfinance institutions through the purchase of Community Investment Notes.</i>
<i>Source: http://www.calvertfoundation.org</i>	

Calvert Foundation limits the aggregate size of each these private label arrangements because its risk management regime precludes it from investing more than five percent of its portfolio into any one organization. Furthermore, the foundation works to meet internally defined capital adequacy guidelines in proportion to the liabilities created by the notes. These restrictions cap the amount of capital that can be invested in these customized products.

Establishing the Free Press Investment Notes

Calvert Foundation and MDLF had considered structuring the Free Press Notes within the Private Label programme, but MDLF wanted to offer its own notes with an open-ended size. Accordingly, Calvert Foundation has supported MDLF through its Community Investment Partners programme. The Community Investment Partners programme makes Calvert Foundation's securities expertise available to other non-profits. For MDLF, Calvert Foundation prepared an "independent offering," performing the role of an investment adviser in structuring a security that is similar to a Community Investment Note offering that would affect MDLF's balance sheet, not that of Calvert Foundation. The two organizations launched the Free Press Notes in December 2005.

Following MDLF's Free Press Notes, Berenbach reports strong demand for other similar independent offerings, with several projects in the pipeline. With many products that have a standardized structure (the foundation's own Community Investment Notes, MDLF's Free Press Notes and the variety of private label notes), the foundation and its partners are fostering a uniform set of expectations for this manner of community investment product.

"Dematerializing" the Community Investment Notes

In its quest to make the notes more ubiquitous and accessible to more investors, Calvert Foundation is actively establishing partnerships with financial institutions and securities brokerages. To make these relationships possible, the foundation has had to render the notes compatible with the financial industry-standard electronic transaction systems—a significant challenge that reveals a subtle but important obstacle that many blended value investment products will likely face as they become more accessible and productized.

Many financial firms transfer and clear investments through the Depository Trust Company (DTC), which maintains the electronic system through which most American securities transactions are processed. DTC's website explains: "The depository brings efficiency to the securities industry by retaining custody of some 2 million securities issues, effectively 'dematerializing' most of them so that they exist only as electronic files rather than as countless pieces of paper."¹⁷ DTC makes securities easily accessible to

A Note on other Debt Financing Innovations

mainstream financial institutions that maintain their clients' portfolios in electronic format. Without being a part of the DTC system, Calvert Foundation's Community Investment Notes were not easily accessible through most investors' securities brokers. Compatibility with DTC would likely enlarge the market for the Community Investment Note products, and it could enlist a new sales channel when retail brokers are able to provide the product as an integrated portion of their clients' investment portfolios.

Unfortunately, gaining access to the DTC was no small task for Calvert Foundation, and Berenbach reports that it took nearly seven years to accomplish it. A key reason for the delay points directly at subtle but important differences between traditional retail investment (strictly for financial returns) and philanthropic investment (strictly for social or environmental returns). Efficient transactions of most liquid financial products are accomplished so that buyers and sellers remain anonymous to one another. The products must be completely fungible, and DTC's "dematerializing" promotes those characteristics.

That level of interchangeability and anonymity stands in contrast to the norms of philanthropy, wherein donors often customize their investments and remain in close contact with recipients (philanthropic donors often want anything but anonymity). The Community Investment Notes bring some of the practices of philanthropy to bear on blended value investing, giving investors extensive capacity to customize their investment products.

Because the DTC system has been built specifically to exchange fungible retail investment products, it was very difficult to make the Community Investment Notes, with their highly variable characteristics, interface with the DTC system. Fortunately, in late 2005 Calvert and DTC established procedures for clearing the Community Investment Notes electronically. Clearing through DTC allows Calvert Foundation to establish relationships with new securities brokers, which Berenbach predicts will triple the size of its portfolio over the next five years.

The Future of Calvert's Community Investment Notes

Currently, Calvert Foundation's Community Investments include a large range of underlying investment strategies including affordable housing finance, microfinance, community facility funds, small-business loans, fair trade investments and investments in social enterprises. Looking to the future, Berenbach anticipates that in the next several years the foundation will be investing in environmental projects, the health sector and off-grid power and telecommunications.

Credit Guarantees and Enhancements: Flexible Catalysts for Blended Value Investment

Introduction

At an increasingly rapid rate, blended value projects are becoming blended value investments that allow new capital to generate blended returns with reduced transaction costs and increased transparency. Thoughtful people often do not agree on exactly how to measure and then price the risk associated with the new investments. Many such investments look foreign or downright speculative to investors who oversee mainstream capital. In many cases, other actors will view that risk differently and will be more willing to expose their capital to that risk if doing so will encourage other investors. In some cases, the risk-tolerant investors have unusual insight into the potential investment's fundamentals. Other risk-tolerant investors may have philanthropic motivations for taking on the risk in that they view a loss of capital on such an investment the same way they would a grant invested in developing new socially beneficial investment products. A number of actors have explored how to share the risks — both real and perceived — between different parties through the use of loan guarantees and related strategies for structuring credit enhancements.

A Loan Guarantees Primer

In a standard loan agreement, the borrower provides some manner of collateral, giving the lender a claim on the borrower if he or she cannot meet the obligations of the loan. In collateralized loans, the borrower's assets are pledged to satisfy the lender in the event that the borrower cannot meet the obligation. (In a microcredit context, the collateral may not be property or assets but “social collateral”, or the future loans of others in a lending group.) In a situation where a borrower may not have sufficient collateral, another party may pledge assets or its general credit to meet the loan obligation if the borrower defaults. The party pledging the assets is the guarantor, and often it must place securities or other assets in an account that can be easily accessed by the lender in the event of a collateral call. This is called a loan guarantee or credit enhancement.

In some situations, an entity perceived to carry a lot of risk (such as an MFI or a young company) can reduce its cost of borrowing by having an entity with a lower risk rating (such as a foundation or investor) guarantee all or part of the loan. That

added safety should then lower the cost of borrowing, though the entity directly benefiting from the loan guarantee often must pay a fee to facilitate the arrangement. Beyond lower-cost borrowing, a loan guarantee encourages follow-on financing both by removing some of the borrower's risk and by signalling the borrower's quality.

Guarantee arrangements vary dramatically. Many government-backed programmes, for example, are guaranteed by the full-faith and credit of the country's government, in which case the guarantor does not specify any assets to serve as collateral, though a borrower can still make a general claim against the guarantors. Most guarantee arrangements require that specific assets be pledged. Often pledged financial assets are segregated from a guarantor's other assets in a special bank or brokerage account, and real assets will be subject to some form of contract determined by the guarantee agreement.

If the guarantor pledges financial assets, the guarantee agreement may limit the kinds of investments that are eligible for investment, but the guarantor receives the benefits of any capital appreciation (or the exposure to any losses) generated by the investments. Accordingly, many guarantee agreements allow the guarantors to earn market-rate returns on their investments while facilitating further third-party investments in the borrower. Since the guarantor is exposed to at least part of the borrower's risk, the guarantor accepts a higher risk for the returns that the assets would generate without securing the borrower's loan. Guarantees are commonly governed by a relatively standardized arrangement called a standby letter of credit, which can be issued by banks to enable a guarantor to guarantee the debt of a borrower easily. Banks may extract fees for maintaining guarantee arrangements, and a borrower may compensate the guarantor for accepting additional risk.

Loan guarantees have been a feature of lending and international development for years, and blended value investors have explored a variety of innovative ways to apply guarantees in their investments. Dating back at least as far as 1984, when ACCION International launched its Bridge Fund (which offered loan guarantees that helped Latin American MFIs borrow from commercial lenders), investors have pledged their assets to

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guarantee and thereby accelerate the work of blended value-generating projects.¹⁸ When applied to blended value investments, a guarantee arrangement can generate social returns by facilitating and reducing the cost of financing for blended value projects. Furthermore, a guaranteeing entity may provide technical assistance or consulting to help the investment succeed.

It should be noted that, in the United States, loan guarantees structured as standby letters of credit do not receive any favourable tax treatment when committed to philanthropic investments (unless the guarantees are drawn upon, in which case they may in fact receive different tax consideration). Luther Ragin, Jr, Vice-President for Investments at the F.B. Heron Foundation, a noted leader in blended value investing in the United States, indicates that such tax treatment has prevented the loan guarantee from seeing more widespread application in US domestic blended value investing. Nevertheless, Ragin notes that the John D. and Catherine E. McArthur Foundation, the Annie E. Casey Foundation, and a number of other foundations in the United States have supported this type of strategy to achieve financial leverage.¹⁹

Characteristics of a Blended Value Loan Guarantee

While the loan guarantee structure is versatile, it can only be applied to a project that can be leveraged with debt; that is, the project must have relatively predictable cash flows. A loan guarantee might be used to launch a new project that may be somewhat speculative. The histories of microfinance bond offerings and loan guarantees are profoundly intertwined (as noted in the section of this paper addressing innovations in debt finance), and loan guarantees were essential to the first issues as well as some of the most recently offered securities.

Loan guarantee arrangements are suitable in a variety of situations. Specifically, they can be useful to spur investment in new financial products, the likes of which mainstream commercial lenders have never seen. Another advantage of loan guarantees is that they can reduce exposure to currency fluctuations and, in the process, shift exposure from the borrower to the guarantor. Under this arrangement, one need only convert currencies in the event of a default that results in a capital call.

Introduction to the Blended Value Loan Guarantee Case Studies

The following case studies demonstrate a variety of ways loan guarantees and similar approaches might be applied to international blended value investing. The first example, Nurcha, a South African low-cost housing finance company, demonstrates how a guarantee may be used to overcome market inefficiencies and spur the development of an entire economic sector. In Nurcha's ten years of operation, the company's use of loan guarantees has evolved as both the company and the low-cost housing sector have matured. While many of the examples cited thus far have supported microfinance as the fundamental vehicle for creating value, Nurcha demonstrates that these blended value investment strategies can effectively support other fundamental investment strategies.

The second case examines a fund initiated by Deutsche Bank to encourage the growth of microfinance institutions. The vehicles deployed by the Deutsche Bank Microcredit Development Fund are not, strictly speaking, loan guarantees, but they serve a similar function. Deutsche Bank's programme demonstrates a replicable model for enhancing the growth of either MFIs or similar financial institutions operating in other sectors.

The third case explores how MicroCredit Enterprises has made the loan guarantee strategy available to individual and institutional blended value investors. MicroCredit Enterprises effectively leverages its guarantees to direct, hard-currency loans to MFIs. (The capital input is a guarantee, and the fund's outputs are direct, hard-currency loans, like those of the securitization deals.) Notably, the programme has been developed such that it can be easily replicated by other institutions through its "open-source development" model.

While MicroCredit Enterprises leverages its guarantors' commitments into direct loans to MFIs, Grameen Foundation USA's recently launched Growth Guarantees programme uses investors' guarantees ultimately for loans in local currencies. (The capital inputs are guarantees, and the outputs are also guarantees, which, in turn facilitate soft-currency loans.)

The fifth case study examines the recently launched Global Commercial Microfinance Consortium, which combines some features of the microfinance debt offerings with flexible credit guarantees.

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Together the case studies demonstrate the flexibility and leverage associated with guarantee and credit enhancement strategies. In each case, the guarantee encourages institutions working with the poor to form stronger connections with commercial or mainstream banks that are not necessarily investing with a blended value agenda. In the long run, these catalysts can eventually render the projects more viable for investors and help the mainstream financial sector understand and work with the institutions creating blended value through their management of capital.

First Case Study: *Nurcha and the Open Society Institute*²⁰

Today, Nurcha (originally called the National Urban Reconstruction and Housing Agency) is South Africa's leading institution providing bridge financing for the country's low-cost housing sector. After a decade of operations, the company is preparing for a dramatic expansion in its scale and magnitude of impact. The company was founded by the Open Society Institute and the newly elected government of South Africa shortly after the fall of apartheid. From its inception, Nurcha has aimed to expand access to housing for South Africa's poorest citizens, especially those who suffered terribly under apartheid.

Low-Income Housing in South Africa: Unmet Needs and Broken Systems

Cedric de Beer, Nurcha's Managing Director and a member of Nurcha's founding team, recalls the extent to which housing was a politically charged matter in the mid-1990s. Apartheid policies had severely restricted where people could live, and displacement and property rules ensured that many people of colour could not settle in habitable and safe communities, let alone build equity in real assets. De Beer, his colleagues in the Johannesburg city council, and a group of progressive bankers and community activists began formally grappling with the problem of housing low-income families as apartheid crumbled in 1992.

The magnitude of the problem was enormous. Several million people lacked stable housing arrangements, and no plausible plan existed to house them. At that time, the conservative South African banking system was cautious about financing low-income families. Private philanthropy

did not appear up to task of resolving all aspects of this tremendous problem and it was not clear that the government would ever be able to tackle the problem alone. De Beer and his colleagues recognized that a market-based solution would be required, and could eventually be linked to the mainstream capital markets.

When apartheid fell, the newly elected Mandela government found itself with a raft of monumental social and economic problems in addition to the massive housing gap between blacks and whites. The government had to improve education, address the lack of employment opportunities for black South Africans, build fully participatory democratic institutions, and confront myriad other problems. De Beer suggested the new government needed to produce a "quick win" to demonstrate that it could tackle some of these looming issues. Relative to other seemingly intractable problems, low-income housing appeared to be closest thing to that quick win. The returns on investments in this sector would become evident more quickly than in other sectors, and outcomes would be more quantifiable. Furthermore, housing sectors all over the world offered robust and proven markets. South Africa had to discover how to make those proven markets function within the context of its own difficult circumstances.

From 1995 the government offered subsidies for housing low-income families and worked to develop a market in low-cost housing mortgages.²¹ Nevertheless, houses and residential communities suitable for low-income families were simply not being built. The banking and construction sectors both feared that the rule of law was too weak in these communities to extend credit in them. Originally a means of protesting apartheid, a tradition of civil disobedience had seized the townships during the 1980s and 1990s. Residents frustrated by the pace of change refused to pay utility bills and taxes. After 1994, the fear that such civil disobedience would extend to mortgage and rent payments choked off the supply of capital to build housing for newly enfranchised South Africans. The risk of loan delinquency seemed overwhelmingly high to banks that neither understood this market nor had an appetite to take large risks in an uncertain economic and political environment. It seemed like a vicious cycle. The new government needed to promote economic sustainability, and home ownership would go a long way toward doing so, but until the townships were stabilized, no one would provide the capital to create that housing.

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An Approach to Breaking the Vicious Cycle

Investor and philanthropist George Soros made grants in South Africa in the 1970s, but he did not continue in the 1980s and early 1990s. The election of the Mandela Government in 1994 opened opportunities for Soros to again invest in South Africa. In consultation with trusted adviser Dr Van Zyl Slabbert, Soros's Open Society Institute (OSI) began seeing philanthropic investment opportunities in South Africa.²² Slabbert suggested to de Beer that Soros might invest in a low-cost housing catalyst, as long as it could be set up as an independent entity that would involve the government as an investment partner (but not as the service provider). Soros and the leadership of OSI saw an opportunity to normalize economic and financial relationships and help the market function in a place where it had not previously worked.

In due course, Slabbert arranged a meeting between George Soros and Nelson Mandela. When they emerged from that meeting, the two had agreed to co-sponsor an initiative that would help bring the formal banking sector into low-cost housing finance. They then asked de Beer and his colleagues, in consultation with Slabbert and representatives of the OSI, to determine the structure and strategy of this new entity.

Founding Nurcha

Officially founded in February 1995, The National Urban Reconstruction and Housing Agency (eventually shortened to Nurcha) was born of their deliberations. OSI and the government of South Africa each contributed US\$ 5 million in grants to found and initially capitalize the company. OSI also pledged a loan guarantee of up to US\$ 50 million, with a required 3-to-1 match; that is, Nurcha had to raise US\$ 150 million in guarantees in order to access the full US\$ 50 million offered by OSI. Nurcha successfully raised matching guarantees as required, but by October 2005 it had drawn down no more than US\$ 20 million of the available OSI guarantee.

Using OSI's loan guarantee as a catalyst, Nurcha began to guarantee loans from South African commercial banks to low-cost housing developers and contractors. With those banks leery of lending to developers, whom they thought especially risky borrowers, the banks initially required significant fully secured third-party guarantees. Nurcha's mandate was wide: to "encourage broad banking involvement in the low-cost housing market."

Though Nurcha was involved in various programmes, its core activity was guaranteeing bridge financing for low-cost housing projects. Through 1999, Nurcha would help builders and contractors secure commercial financing that it then supported with a 60-70% guarantee. Thus, a bank loaning money to a Nurcha-supported contractor was guaranteed to recover at least 60-70% of the loan in case the borrower defaulted. These guarantees were subject to a set of specifically developed prudent lending protocols involving screening applicants, performing due diligence, and monitoring the loans.

A Victim of Its Own Success

To the great benefit of poor South Africans, the Nurcha-facilitated lending model introduced a flood of capital into the low-cost housing sector. By 1999, Nurcha had financed the construction of over 50,000 new housing units. With the loan guarantees in place, the risk-reward profile became manageable, and low-cost housing contractors were able to find bridge financing. By most counts, Nurcha and South Africa's low-cost housing market appeared to be an unmitigated success—until the wave of economic and currency crises of the late 1990s hit South Africa in 1999.

In three months, the over-draft rate of Nurcha-supported projects rose by more than 50%. The South African Rand fell in value relative to other currencies, and domestic South African inflation interest rates shot up. When low-cost housing contractors could not manage their interest payments in the inflationary environment, defaults quickly mounted, and the banks withdrew from lending with Nurcha. In the case of one major lender, many loans had not been issued in accordance with pre-established protocols, and these claims against the guarantees were rejected. While Nurcha was fortunate in that its guarantee reserves were not overwhelmingly exposed, the banks' losses led them to exit the low-cost housing construction market dramatically more quickly than they entered.

By 2000, Nurcha was faced with a dilemma. With its guarantee programme, it had proven that lending to low-cost housing projects could be both profitable and vastly beneficial to low-income families. Thanks to its willingness to accept risk when most banks viewed the risks as untenable, Nurcha's work eventually revealed the lower cost of risks associated with those loans. Nevertheless, the banks continued to misprice the risk, convinced

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that financing low-cost housing was an exceedingly risky proposition. In truth, had the lending process been more disciplined, the banks' exposure to the low-cost housing sector would have been significantly insulated from macroeconomic changes.

Nurcha's Business Model Evolves

If you know that the lending can be profitable without being too risky, and you have the financial resources to manage the remaining risk, the next step is obvious: you begin lending directly. In its first five years of cultivating the low-cost housing sector in South Africa, Nurcha had learned a great deal about structuring loans, screening applicants, performing due diligence and monitoring bridge financing.

Thus, in the early 2000s Nurcha moved from guaranteeing loans by other lenders to becoming a direct lender itself. Banks, realizing that Nurcha was more proficient at lending than they were at managing low-cost housing loans, began loaning funds to Nurcha, which then lent the funds to contractors and developers. Though Nurcha had demonstrated its ability to manage risky loans, the guarantees produced by the OSI and others continued to further reduce the company's cost of borrowing funds. In October 2005, de Beer indicated that Nurcha was still "working a few old guarantees out of the system", but had otherwise shifted entirely to the direct lending model, which was still supported by guarantees from OSI. It now relies on partners it calls "intermediaries" to administer loans, and they perform quality control, manage disbursements, and ensure compliance with regulations. The intermediaries invest a portion of their own capital in the programme, ensuring that they will manage projects effectively. Nurcha structures its own loan products, screens borrowers, performs due diligence, and takes responsibility for initiating work-out proceedings for loans at risk.

Nurcha's customers range from medium and some large construction operations to sole proprietors, including many new entrepreneur contractors, particularly women and black South Africans. The company has developed specific programmes to support these entrepreneurs, many of whom have built vital medium-sized enterprises out of microentrepreneurial ventures. Nurcha also

expanded in other directions, launching a variety of programmes to encourage a culture of savings. By 2004, the company recognized that its core business was financing low-cost housing construction, and it exited those programme areas that did not reside in that core business. It has further refocused its business by financing the construction of community assets such as schools, roads and utilities infrastructure. Its *Annual Report* indicates that this expansion "is in line with our social mission—sustainable communities not only require houses but clinics, crèches, and community halls as well." ²³

A Dramatic Impact, a Dramatic Expansion

By October 2005, Nurcha had financed the construction of over 160,000 homes. Increasingly, the OSI permitted Nurcha some flexibility in the uses to which its US\$ 50 million commitment could be put. OSI has funded some of Nurcha's overhead over the past ten years. Stewart Paperin, Executive Vice-President of OSI, estimates that each of those homes effectively cost OSI US\$ 25-30 a piece in subsidizing Nurcha's overhead. With that track record and the company's business model sufficiently refined, Nurcha aimed to scale up dramatically. In December 2004, de Beer presented that expansion plan to the South African Housing Ministry.

Paperin proposed new structured financing for Nurcha that would enable the company to capitalize the construction of over 190,000 new homes plus nearly 400 community assets (beyond the 160,000 houses and other community infrastructure projects it had already financed) by 2008. De Beer's report puts the company's financing needs into perspective:

Given the volume of lending projected into the future, it is clear that Nurcha will not be able to depend on government or donor agencies to provide this lending capacity free, as grant money. Most of the money will need to be raised from commercial sources.²⁴

While Nurcha had extensive experience raising capital from commercial sources, it sought an equity investment both to build institutional capacity and to improve the company's balance sheet position. The portion of the equity intended for the balance sheet would serve as a first-loss provision for the commercial loans that would provide the capital for Nurcha's core business. Effectively, the equity destined for the balance sheet will serve as a loan guarantee for the commercial lenders. Nurcha's track record has significantly reduced the

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size of that guarantee relative to the company's borrowing; nevertheless, the size of that guarantee-like loss reserve further lowers its costs of borrowing.

As the company has sufficiently prepared for a dramatic expansion of its business, the South African government has created an environment that requires domestic banks to channel funds to areas of the economy that had been historically overlooked by many commercial banking institutions. Much as the Community Reinvestment Act of 1977 encouraged large amounts of new capital to flow into community development investment in the US, Nurcha hopes that the banking charter can do the same for South Africa.

The Conditions that Made Nurcha Possible

The Open Society Institute's Stewart Paperin sees four fundamental conditions that permit Nurcha to succeed.

- 1. The Right Management:** First and foremost, Paperin stresses that an organization like Nurcha must be managed by deeply knowledgeable people "on the ground", grappling with the problems directly and understanding the needs of the ultimate recipients of the funds. Trust in those managers is absolutely essential, and their competence is the best insurance policy that the guarantee will not be needed.
- 2. A Sophisticated Financial System:** A guaranteed lending arrangement like Nurcha requires that the partners and customers be able to move funds easily and inexpensively. A developed consumer financial sector makes monitoring the loans far easier, thus reducing the likelihood and cost of defaults.
- 3. Rule of Law:** Nurcha could not operate in a country where contracts are not enforceable or where egregious political or social unrest could imperil the financial industry. These characteristics affect the fundamental quality of investments, thereby making them more (potentially prohibitively) expensive to guarantee.
- 4. Political Will:** Though Nurcha is not a government programme, the South African government has been very involved in founding it and in providing an environment in which it can operate. In addition to the US\$ 5 million start-up financing, the government has also contributed guarantees totalling nearly US\$ 15 million. Furthermore, the government supported the industry in a variety of ways, including making mortgages available to low-income families.

While Paperin believes that the approach might be applied in a number of other economic development situations where risk is not appropriately priced, others in his organization are not as sanguine about the model's potential for replication. While the four conditions above are stringent, it is the first that many think will be the hardest to overcome.

Concluding Observations

While loan guarantees continue to facilitate Nurcha's role in financing the low-cost housing industry, they have become less central to Nurcha's ability to meet its mission—and this condition suggests the long-term successful application of those initial credit enhancements. As Nurcha, its successes and failures revealed the true risks associated with its customers and lending products, the commercial markets were increasingly able to price that risk. In turn, Nurcha could reduce the credit enhancements as investors became increasingly comfortable with the investments' sound underlying economics.

Second Case Study: Deutsche Bank Microcredit Development Fund ²⁵

Deutsche Bank's Microcredit Development Fund (DB-MDF) has extended the loan guarantee model to several institutions and has made such vehicles accessible to donors.

The Basic Structure of DB-MDF

In 1998 Deutsche Bank (DB), in partnership with clients from its private bank, established a fund of donated capital that it invests as de facto loan guarantees. DB's clients make donations to the fund, but the fund intends to reuse that capital through an innovative investment strategy for the benefit of MFIs that lack access to adequate capital. DB-MDF's goal is to strengthen linkages between MFIs and their local lenders.

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DB-MDF makes deeply subordinated, non-amortizing loans at concessionary rates (1 to 3%). The loans have a one- to five-year maturity, depending on the circumstance. The fund stipulates that these loans are not to be used to fund overhead or to be re-lent to clients; thus, they can be maintained as hard-currency deposits. They are intended to improve the MFIs' balance sheet position and augment loss reserves so that they can more easily borrow funds from local banks. Much as OSI required Nurcha to leverage its guarantee, DB-MDF requires its MFI investments to match the loans with additional borrowing at a ratio of at least 2:1. The fund does make exceptions in particular circumstances as long as the borrower can achieve the desired ratio within two years. Furthermore, the MFIs can often earn market rate interest that exceeds the concessionary rate at which it secures those funds from DB-MDF.

DB's Community Development Group in New York manages the fund, screening for MFIs that can use these products to reach economies of scale that would otherwise be unavailable to them. Acting as fund managers, the Community Development Group has developed expertise in the field of microfinance, and it has used that expertise to launch other innovative investment opportunities that direct capital to MFIs.

DB-MDF began strictly as an American not-for-profit, accepting donations (with a minimum amount of US\$ 50,000) from American clients. The enthusiastic response to the fund has led DB to expand the programme to Europe and the UK. Recently, DB-MDF has started accepting programme-related investments (PRIs) from foundations. The fund makes loans in the US\$ 50,000 to US\$ 150,000 range, with mean loan investment of about US\$ 125,000. In its first five years of existence, the fund had invested and reinvested over US\$ 3 million, which, it reports, enabled over US\$ 42 million to be leveraged through additional financing. The fund has made loans in 18 different countries around the world.

Placing DB-MDF in Context

While the DB-MDF strategy is not, strictly speaking, a loan guarantee, in many ways it functions very similarly. First, it has demonstrated the successful application of relatively sophisticated financial investments to small, often unregulated MFIs that would not likely have access to mainstream capital and that need assistance forging relationships with

the local banking sector. The success experienced by DB-MDF suggests a variety of ways that the model might be altered to suit MFIs and investors.

Furthermore, it has demonstrated that the private sector can assist smaller, riskier MFIs. Though the financial product is funded by donations, a similar model might deploy blended value investments (likely concessionary rate loans) for a similar purpose. (The lack of favourable tax treatment for this sort of investment could limit the appeal for many investors.) One might also be able to change the characteristics of the loans to the MFIs so that the cash flows permit a variety of other investment products.

Third Case Study: *MicroCredit Enterprises*²⁶

Like DB's Microcredit Development Fund, MicroCredit Enterprises, LLC (MCE) makes loan guarantee strategies available to individual participants, but this programme allows MCE to leverage the assets of guarantors, while allowing them to retain their capital and invest it. Not only is this programme among the first to offer a guarantee strategy to a variety of participants, it has been developed by entrepreneurs employing a decidedly open-source model that makes its structure easily replicable and highly scalable. MCE waives the copyright to its working documents, which are available on its website, <http://www.mcenterprises.org>, where they can be downloaded and used as the basis for other similar programmes. MCE enables guarantors to leverage their liquid financial assets, which can be held at almost any financial institution, to secure loans to MCE, the proceeds of which are, in turn, loaned to MFIs. The parameters of the guarantee agreement are elaborated in MCE's Comprehensive Informational Memorandum and Philanthropic Guarantee Agreement (both available on MCE's website), which establishes how guarantors' assets will be exposed to the risks of default.

MCE: The Organization

MCE was founded by CEO Jonathan C. Lewis as a limited liability company; it is not a non-profit entity as defined by the IRS, but the organization is governed by the principle that its residual earnings will not be used to enrich private persons (see LLC Operating Agreement on their website). It has pledged to minimize expenses and to facilitate microlending only. Though its officers and professional service providers have all worked on a pro bono basis to date, MCE will transfer in 2006

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to a professional model wherein a small paid staff will supervise the MFI loan portfolio, conduct due diligence and manage operations. Any expenses, including salaries, are paid out of the spread between the cost of borrowing funds and the interest received from making loans to MFIs. Any excess earnings beyond MCE's operating costs are committed to a loan loss reserve fund that adds a loss cushion for the guarantors. The programme, described in detail below, is not an investment opportunity: the guarantors' capital is at risk as it secures MCE's loans, and the guarantors are not offered any upside potential by virtue of their participation in the programme. Nevertheless, the guarantors' assets facilitate the flow of capital to MFIs and their clients.

MCE: The Investment Vehicle

Guarantors elect to participate in the programme in US\$ 1 million increments. Each guarantor signs a Philanthropic Guarantee Agreement and other documentation in which he or she pledges the assets in a specific brokerage to guarantee loans of up to US\$ 600,000 to MCE, which then re-loans the funds to MFIs. The guarantors maintain control of their assets, though they must remain in "permitted investments", which, the Information Memo explains, "typically are limited to cash, mutual funds, stocks, investment grade bonds, money market funds, publicly traded shares of real estate investment trusts."²⁷ The assets must be relatively liquid in case they must be sold to repay a defaulted MFI loan. Guarantors also pledge to keep the value of their guarantee accounts at a minimum value of US\$ 1 million. Any gains or losses in an individual's account accrue to the investor. In essence, the guarantor can continue to manage his or her money as usual, earning full market-rate returns, while at the same time allowing MCE to leverage his or her assets by facilitating the flow of capital to MFIs. Guarantors do accept a pro rata portion of the risk that MFIs default on their loans from MCE, which could cause MCE to default on its borrowings, which, in turn, could create a capital call on the guarantors.

MCE's model allows it to partner with a number of foundations and financial institutions to borrow funds that are collateralized by guarantors' accounts. To loan funds to an MFI, MCE borrows first from the collaborating foundation or financial institution that extends it the most favourable terms, though it pledges to distribute any losses pro-rata among all of its programme guarantors. Assume, for example, that MCE has three US\$ 1 million guarantee accounts at Bank A and one US\$ 1 million at Bank B. If Bank B

would loan funds on more favourable terms than Bank A, MCE may borrow US\$ 600,000 from Bank B. However, each of the four guarantee accounts is exposed to losses up to US\$ 150,000. The terms of MCE's agreements with collaborating financial institutions stipulate that the financial institutions will extend credit for up to 60% of the US\$ 1 million minimum for each account. Thus, if MCE had US\$ 10 million in loan guarantee accounts, it could borrow up to US\$ 6 million. Accordingly, the loans are significantly overly collateralized, providing the partnering foundation or financial institution with greater security, which, in turn, may provide MCE with more favourable loan terms that can be passed on to MFIs.

Once MCE has borrowed funds in the US, it then makes and administers loans to MFIs. MCE's due diligence and loan monitoring is shared between MCE and established MFI networks. Essentially, MCE takes responsibility for a thorough fiscal analysis of each MFI loan application (a "desk review"), but primarily invites referrals or "MFI loan nominations" from established and respected MFI networks.²⁸ Avoiding the costs of a field investigation, MCE taps into longstanding MFI alliances and working relationships in order to make the qualitative assessments about management, board, governance and transparency.

MCE has developed relationships with many networks on different continents with different lending philosophies or approaches, all of which present opportunities for loan portfolio diversification. Lewis indicates that MCE intends to loan funds primarily to MFIs that serve the poorest client populations and to MFIs that do not have the same access to capital that the first tier MFIs have. Though the MFI borrowers may not have the same access to capital, MCE will not compromise on their financial health; all must be financially sustainable or demonstrably moving toward self-sufficiency. The programme makes loans to MFIs with a range of legal structures (private, cooperative, non-profit, etc.). Furthermore, MCE carefully monitors the loans, ensuring that it does not lend beyond the MFIs' capacity to absorb new debt capital.

MCE's loans to MFIs typically mature in three years and have very flexible payment terms. Most of MCE's loans will be directed to MFIs serving the poorest microborrowers, a practice that will generate the most blended value leverage. Lewis estimates that a US\$ 1 million guarantee can translate into as many as 20,000 microloans in the first year alone.

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Proof of Concept

After demonstrating the general concept by securing seven US\$ 1 million guarantors in 2005, MCE temporarily stopped actively seeking guarantors. Though MCE can borrow up to US\$ 4.2 million against those accounts, it aims to make loans to MFIs totalling US\$ 3 million in its first full year of operation, commencing 1 January 2006. Of the first seven guarantors, two are not-for-profit institutions (Oxfam America and Freedom from Hunger) that have pledged portions of their reserve accounts and the other five are high net worth individuals. In the next year, Lewis plans to secure guarantees totalling US\$ 20 million, and within a few years, he envisions that the guarantee pool can reach US\$ 100 million dollars—money that will be working financially for its guarantors while facilitating US\$ 60 million in new capital flows to MFIs.

Surprisingly, the first loan to MCE was difficult to secure. Though the loans to MCE are over-collateralized as mentioned earlier, several major banks balked at participating in the programme. Their concerns were not related to financial risk; instead, they were related to the reputational risk associated with these new types of loans to a new entity without a proven track record. The banks offered to make the loans only if the guarantors would be jointly and severally liable for the entire loan (in excess of their US\$ 1 million collateral account value), which would essentially allow the lender to choose which guarantors it would pursue in the case of an MFI loan default. Such an arrangement would have violated one of the cornerstones of MCE's programme, which is that guarantors can participate in the programme and incur relatively finite risks that will be shared among all of the guarantors.

Instead, MCE established a new borrowing model, sourcing a US\$ 3 million loan from the Calvert Social Investment Foundation. According to Lewis, as the collateral base grows, MCE will diversify its lenders by establishing similar borrowing relationships with other foundations and financial institutions, depending on where it can secure the most favourable terms.

In January 2006, MCE made its first loan, directing US\$ 700,000 to an MFI in Bolivia with an average client loan size of US\$ 185.

Building the Product

Professional Service Providers

Lewis and MCE worked very closely with John Ferguson, a partner resident in the New York office of Goodwin Procter LLP. Ferguson and his colleagues, all financial transaction and capital markets specialists, were eager to participate in the project, which offered a relatively rare opportunity to deploy the partners' financial transactions expertise in a pro bono setting. In addition to professional and functional input from multiple law firms, financial professionals, graduate students and others, MCE drew deeply on the opinions and interests of potential guarantors. Many of the programme's features arose directly from the guarantors' input. Uniting all of these contributors, Lewis reports, are both a drive to help microborrowers and a desire to build a robust, new financing strategy that can be freely adopted by other practitioners.

Characteristics of the Guarantee Agreements

Duration of the Guarantees: Initially, Lewis had envisioned a relatively short-term guarantee that would require minimal notice (possibly as short as only 90 days) before a guarantor terminated the agreement. Prospective guarantors eventually persuaded him to make the standard guarantees longer term. As a result, the guarantee agreements now require that a guarantor provide 18 months' advanced notice before ending the agreement and exiting the programme. 12 months after the initial notice, the guarantors may remove 50% of their collateral assets, and six months later they may withdraw the remaining 50%. This arrangement ensures that all guarantors will have relatively consistent, predictable risk exposure to defaults. When a guarantor exits, the risk exposure for the remaining guarantors increases until the outstanding loan balance is decreased or additional guarantors are added. The 18-month provision also gives MCE the ability to line up new guarantors to replace exiting guarantors or to manage its loan portfolio so that guarantors' risk exposure remains stable.

Loan Performance Contingency Account: At the suggestion of the guarantors, MCE has negotiated with its MFI networks to provide a five percent first-loss reserve for any loans that they administer. This provision offers some protection

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against moral hazard, the risk that the MFI networks will channel capital to their own MFI partners or allies that can least afford to repay it. With their own capital at risk, the networks have incentives to carefully monitor MFI loans.

Ponzi Protection: MCE and potential investors intentionally tried to determine how this investment vehicle might be misused if applied maliciously or incompetently. By making all of their work open-source, the guarantors and MCE effectively pledged to make the structure available to anyone wishing to use it, whether for good or ill. They were concerned both with the potential that people could do harm with their new structure and with the potential that this new strategy could be sullied by such harm.

One of their greatest concerns was that this structure could be used, more or less, as a pyramid scheme. An unscrupulous guarantee fund could acquire new guarantors to support new loans that would be used to pay back non-performing loans (instead of taking a loss and invoking a collateral call on existing guarantors). To prevent this and to demonstrate the integrity of the model, MCE forces itself to realize and allocate losses to guarantors if a loan to an MFI is past due beyond a certain grace period. Though it has not happened yet, MCE can imagine a case in which it recognizes a default on a non-performing loan that is later recovered. Should such an event happen, it will refund any related collateral calls it makes on its guarantors.

Standby Letter of Credit Functionality: MCE and its prospective guarantors obviously loathe the possibility of defaulting on loans to foundations or bank lenders. If a loan to an MFI does not perform, MCE is the party that defaults on its loan to the foundations or banks. To avoid MCE's defaulting on one of its borrowings, the guarantee agreement includes a provision that resembles a standby letter of credit. The guarantors pledge to fund loan deficiencies (pro-rata) above any first loss provisions proffered by the MFI. Thus, the guarantors can meet any collateral call with liquid assets not held in the guarantee account. In the event that losses get allocated to guarantors and the guarantors cannot honour the standby letter of credit feature of the agreement, MCE would then be forced to default on one or more loans, and only then would the lenders to MCE seek direct recourse against the guarantors and their pledged accounts.

Future Opportunities

Beyond dramatically increasing the scale of its own operations, MCE sees vast opportunities for the pooled guarantee model to magnify the flow of capital to projects in developing economies. Ferguson suggests that multinational banks would be well-situated themselves to create a similar programme (alone or in partnership with MCE) and then, with its existing customers and international infrastructure, execute it more efficiently. With those strengths, a bank has the potential to pool guarantees from many more clients, which, in turn, might permit a smaller minimum guarantee, below US\$ 1 million.

Nevertheless, a potential limitation may eventually be the availability of creditworthy MFIs capable of productively absorbing more debt capital, especially debt capital that is sourced internationally. Furthermore, the still-developing infrastructure to deploy and monitor MFI loans may not be able to keep pace with the new capital entering the sector. It should be noted that this constraint is not binding now. Some actors in the microfinance capital markets do not believe that the "boots on the ground constraint" will become a major concern. They suggest that as more capital continues to flow into the sector, the MFI networks and other infrastructure providers on the ground will expand their work at least as quickly.

Fourth Case Study: *Grameen Foundation USA's Growth Guarantees Programme* ²⁹

Grameen Foundation USA (GFUSA) recently launched its Growth Guarantees (GG) programme, which is structured similarly to MicroCredit Enterprises' guarantee programme. However, GFUSA's programme uses those dollar-denominated guarantees to support local commercial bank lending and capital markets transactions in local currencies. The lending products that GG makes available to MFIs are very flexible, but all of them intend to forge connections between the MFIs and their local banks or other local investors.

The Origins of GFUSA-GG

The idea for the Growth Guarantees programme arose from a meeting of high net worth individuals who had already supported GFUSA's work. These individuals came together to develop new ways to channel capital into the sector, particularly into GFUSA-affiliated MFIs. From this meeting, the pooled guarantee fund was born.

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GFUSA's Capital Markets Group, which is led by Jennifer Meehan (whose work is cited elsewhere in this study) manages the GG programme. Donor-guarantors' minimum guarantee is US\$ 1 million, pledged for five years to Citibank in the form of a standby letter of credit (SBLC).³⁰ The donor-guarantor's SBLC is backed by a portfolio approved by the donor-guarantor and the issuing bank. Donor-guarantors continue to realize the returns on their portfolios. These guarantees are pooled to support SBLCs issued by Citibank (in the amount of US\$ 100,000 to US\$ 5 million and for durations up to 4.5 years) to financial institutions in the countries where the MFIs operate. Grameen charges the MFIs benefiting from GG-arranged financing a 1.5-2.5% annual fee for providing the guarantee and associated services.

Local Currency, Local Connections

The SBLCs enable a variety of financing strategies that aim to build relationships between MFIs and their local banking institutions and other capital markets players. GFUSA believes that the MFIs gain by learning more about their local suppliers of capital. Not only should local banks learn more about the microfinance sector, GFUSA hopes that Citibank-supported guarantees will eventually help the local banks price the risks associated with loans to MFIs and other financing organizations more appropriately, thereby making more capital available to all.

In the MFIs' domestic markets, the GFUSA/Citibank supported financial transactions can take a variety of forms, including direct loans from local banks to MFIs, securitization of MFI portfolios (wherein the GFUSA/Citibank SBLC offers investors some manner of first-loss cushion), partnerships between MFIs and local financial institutions, and any number of other potential transactions. These guarantees are vetted and managed by the GFUSA Capital Markets Group and approved by an independent investment committee.

GFUSA's capital markets group has developed a robust screen for "high growth, professionally managed MFIs that have a documented poverty focus."³¹ While many of the products and services will go to MFIs already associated with Grameen, GFUSA has also developed a strategy to work with poverty-focused MFIs outside of the GFUSA network.

Regardless of how those products are structured for the MFIs, GFUSA stipulates that they must be leveraged at a minimum rate of 2:1. Furthermore, those financings must be devoted to growth through new loans, not to overhead or capital expenditures. Ultimately, GFUSA estimates that US\$ 50 million in guarantees could guarantee up to US\$ 300 million in microloans.³²

Investor enthusiasm for the GG product propelled the first closing in October 2005 to US\$ 31 million, US\$ 11 million more than its managers had anticipated. GFUSA aims to reach US\$ 50 million in guarantees by its second closing in 2007.

Fifth Case Study: *Global Commercial Microfinance Consortium*³³

Organized and placed by Deutsche Bank's Community Development Group, which administers the bank's Microcredit Development Fund, the Global Commercial Microfinance Consortium is remarkable for its flexibility with respect to financing MFIs, its capital structure sophistication, and its degree of collaboration between major financial institutions. Ultimately, the Consortium bodes well for the future involvement of mainstream investors in financing international blended value investments.

The Consortium closed in November 2005 at US\$ 75 million in committed capital. The press release announcing the consortium's closing lists 26 consortium partners.³⁴ They include mainstream financial institutions, foundations, socially responsible asset managers, pension funds, state-supported aid agencies and high net worth individuals. (See box for the complete list of investors.) The Consortium's sophisticated structure permits the participants to select the risk-reward profile of their investment. By the time that the fund's closing was announced, it had already committed US\$ 30 million to MFIs in Peru, Kosovo, Nicaragua, Azerbaijan, Columbia, Pakistan, Mozambique and India.³⁵

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Global Commercial Microfinance Consortium Members

- | | |
|--|---|
| 1. Agence Française de Développement | 14. Munich Re |
| 2. AXA Group | 15. Rauenhorst Foundation, |
| 3. Calvert Social Investment Foundation | 16. Standard Life |
| 4. CNP Assurances | 17. State Street Corporation |
| 5. Deutsche Bank | 18. Storebrand |
| 6. Geisse Foundation | 19. The Church Pension Fund |
| 7. General Board of Pension and Health Benefits of the United Methodist Church | 20. The Co-operative Bank Plc |
| 8. Gray Ghost Fund | 21. UK Department for International Development |
| 9. Hewlett-Packard | 22. US Agency for International Development |
| 10. Kaminer Foundation | 23. David Fitzherbert |
| 11. Left Hand Foundation | 24. Elizabeth and Steve Funk |
| 12. Merrill Lynch | 25. Deepak Kamra |
| 13. MMA | 26. Janet A. McKinley |

Flexible Financing for MFIs

Similar to GFUSA's Growth Guarantees programme, the Consortium structures its financial products specifically to suit the needs of borrowers (and the regulatory environments in which they operate). Though not limited to these examples, the Consortium will deploy the following financing mechanisms.

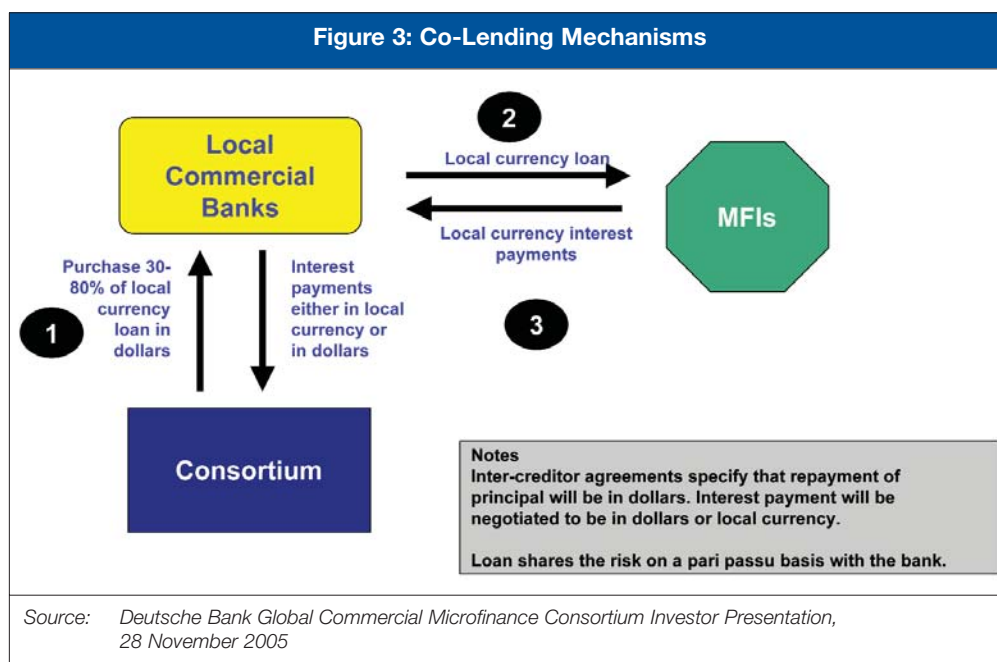
Co-Lending: Under such an arrangement, the Consortium provides a portion of the capital to make local-currency loans through local banks. Such arrangements bring new capital to MFIs while sharing the exposure to foreign currency fluctuation with the local bank. Local banks initiate and service local currency loans to MFIs. The consortium then purchases a portion of those loans from the local bank, stipulating that principal payments must be

made in hard currency, while interest payments can be in hard or local currency, depending on the nature of the arrangement. See figure 3 for the Consortium's visual representation of this financing arrangement.

Deposit Structures: These investments are the same as used by the Deutsche Bank Microcredit Development Fund. Figure 4 presents the Consortium's graphical representation of this strategy.

Loan Guarantees: Working through commercial banks that issue standby letters of credit, the consortium will also make deposits to serve as guarantees, much as MCE's and GG's guarantors facilitate investments. See figure 5 for the Consortium's representation of these arrangements.

Figure 3: Co-Lending Mechanisms



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Capital Structure

The essential structure of the fund has a US\$ 60 million tranche of five-year notes cushioned by three tranches of equity totalling US\$ 15 million. (Please see figure 6 for the Consortium's capital structure diagram.) The most deeply subordinated tranche is a US\$ 1.5 million first-loss provision in the form of a deposit by the UK's Department for International Development (DFID). Any residual funds in this tranche that were not absorbed as losses over the Consortium's five-year life will be committed to future similar financings.

Just above the DFID's first loss provision are Class B equity holders, who committed a total of US\$ 5.5 million. (Deutsche Bank has also committed US\$ 1 million to this tranche.) In the event that loan losses exceed US\$ 1.5 million, Class B equity holders will absorb the losses to the limit of their capital commitments. In exchange for this exposure, Class B equity will earn a yield of up to 12% annually after the senior tranches are satisfied.

Figure 4: Deposit Structures

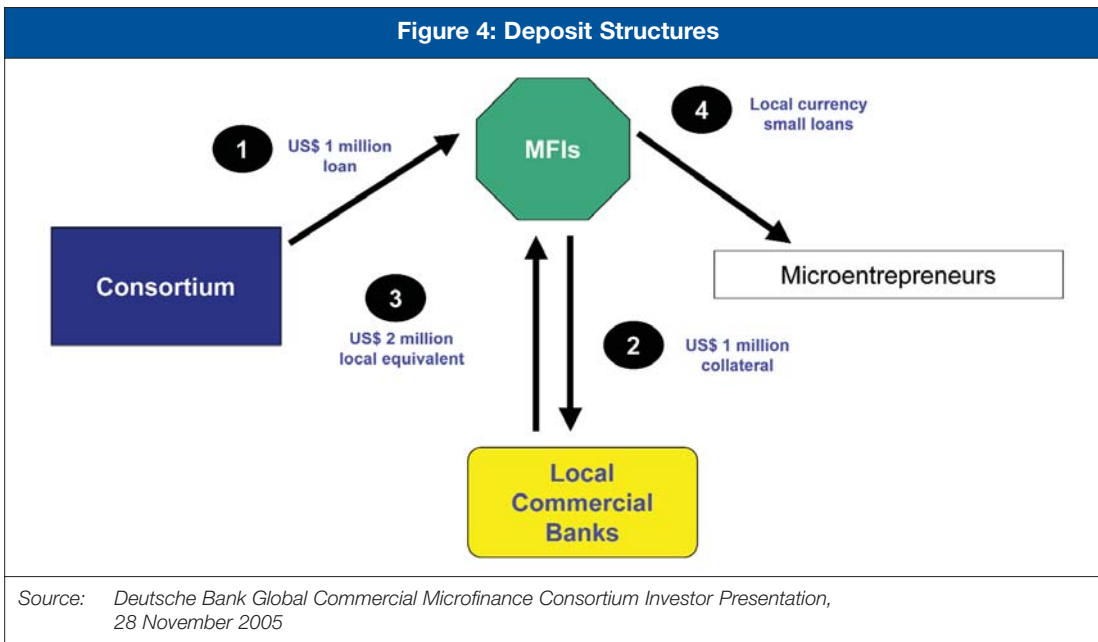
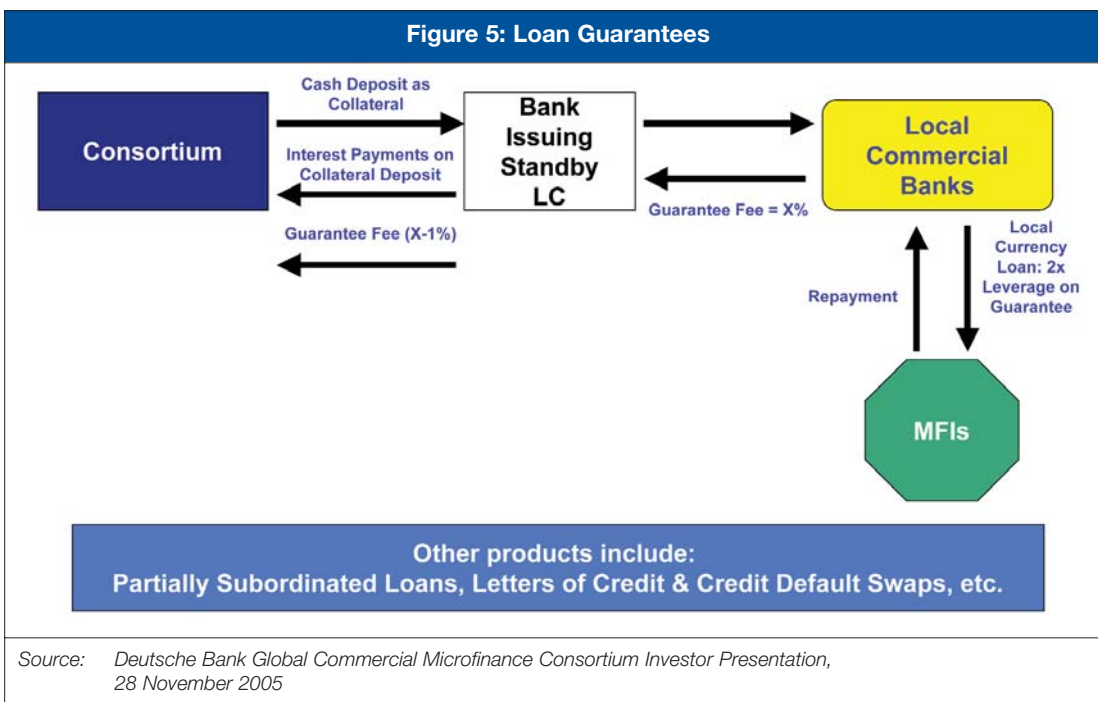


Figure 5: Loan Guarantees



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Senior to the Class B equity is a Class A equity tranche, totalling US\$ 8 million in committed capital. Class B equity holders are next in line to receive losses should they exceed US\$ 7 million. They are compensated for this risk by earning a yield of up to seven percent, distributed periodically after the note holders are satisfied.

The notes in the senior tranche will pay the London Interbank Offer Rate (LIBOR) plus 1.25%. Not only are the notes cushioned by US\$ 15 million in subordinated tranches, USAID has pledged a US\$ 15 million loss guarantee on top of that provided by the equity tranches. Thus, the consortium can incur up to US\$ 30 million in losses before the note holders lose any of their principal. Even in the event of total loss, note holders will still benefit from the USAID guarantee, receiving at least one-fourth of their principal.

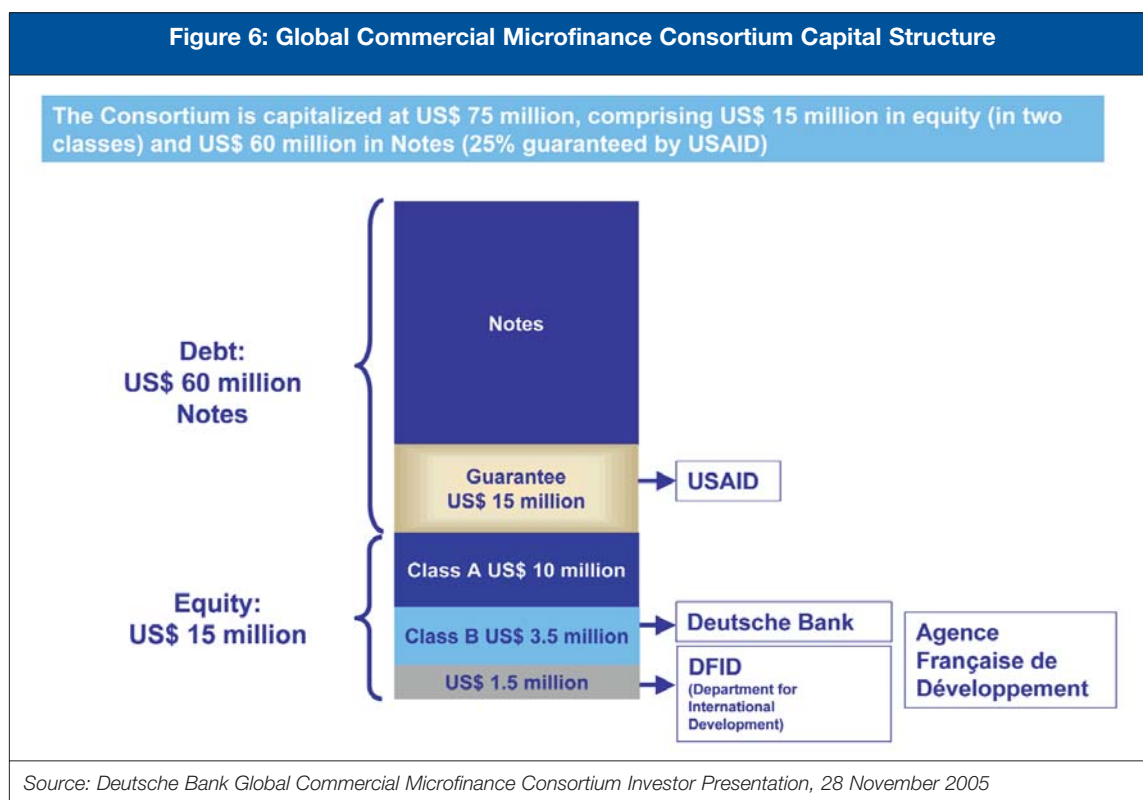
Scale

While not the largest MFI-financing offering (BlueOrchard's fund totalled US\$ 87 million), the scale of this offering is significant. Asad Mahmood, Director of DB's Community Development Finance Group and General Manager of DB's Microfinance Funds, suggests that size of the fund plus the resources

afforded by the consortium partners will facilitate his group's due diligence and monitoring of the Consortium's investments. That scale advantage further enables the consortium to engineer financial products best suited for the MFIs in which it invests.

Mahmood and his colleagues had originally targeted a fund size of US\$ 50 million, which had grown to US\$ 75 million by November. The oversubscription bodes well for MFIs that need access to capital, and it suggests significant demand for sophisticated and versatile large-scale offerings. The deal size remains small for mainstream investment banks; nevertheless, the consortium members include Deutsche Bank, Merrill Lynch and Calvert Foundation, all of which have the capacity to structure future investments. Many of the other consortium members, including insurance companies and pension funds, are institutional investors of large amounts of capital. Mahmood believes in convening and collaborating with diverse actors and investors, and he suggests that one function of the consortium is to bring together investors, bankers and other parties to exchange ideas and build momentum behind this sort of innovative financing.

Figure 6: Global Commercial Microfinance Consortium Capital Structure



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Concluding Thoughts

Mahmood argues that most participants are not buying Consortium's product because it offers an appealing financial risk-reward opportunity or because the investment's value will be uncorrelated with other investments. He sees investors seeking products like the Consortium because they care about where their capital goes, and they want to deploy it for good. His observation suggests a future for blended value investing that will include more, larger, increasingly sophisticated investors seeking multiple returns and deploying their capital in ways that ever-more accurately reflect a multidimensional approach to value.

The flexibility with which the Consortium deploys its capital indicates how accommodating financial instruments can be when they combine aspects of debt, equity and the risk-sharing of credit guarantees. It does not take a very large leap to imagine how this sort of sophisticated financial engineering could be applied to other development finance projects including low-cost housing finance, the construction of utilities infrastructure in developing economies, or any number of other international economic development projects.

In conclusion, the loan guarantee is a powerful and versatile tool. The case studies in this section demonstrate that loan guarantees generate more than money: they forge partnerships, eventually help mainstream financial institutions understand and accurately price risk, and demonstrate blended value projects' viability—all while giving the guarantor market rate returns.

Innovations in Private Equity Investing

Introduction

The universe of international blended value private equity investments is enormous, ranging from informal micro-capital investments by individuals all the way to professional private equity funds investing hundreds of millions of dollars in developing economies. Investment strategies range from social-value maximizing approaches to blended-value investment methodologies to strictly profit-maximizing investing. Given the broad range of investors, funds and deals in this realm, this section cannot be exhaustively comprehensive. Instead, it examines a range of methods deployed in the United States, followed by three very different international investment approaches, each deliberately adapting standard private equity practices to generate blended value returns.

The Crucial Role of Private Equity Investment in Developing Economies

Private equity investment is essential to building robust private sectors that create employment, improve living standards and produce tax revenues. Equity investors are usually more risk-tolerant than debt investors. They commit their capital for an uncertain term and have a residual claim on earnings only after all debt obligations have been satisfied. Equity investors face a host of other risks, several of which are explored below.

Equity investments are particularly suitable for early stage companies that will have unpredictable cash flows and accordingly are not suitable for debt investments. Unlike lenders, who maintain an arm's-length relationship with their borrowers in most circumstances, private equity investors can mitigate some of their risks by exercising a large measure of influence or control over the investments, and such investor engagement often encourages transfers of best practices and organizational capacity building. That involvement can help businesses build better, more efficient business processes, improve their corporate governance, forge partnerships with other businesses, and work more productively with other local institutions. The investors can also advocate for and/or support the entrepreneur's efforts to create, social and environmental value that, in turn, often builds enhanced economic value.

A Survey of Risks and Challenges

Private equity investors in developing economies face a variety of formidable risks that tend to be more severe than similar investments in developed economies. Savvy investors can deploy tactics to minimize some of these potential hazards, but many of them cannot be eliminated; all of them can challenge the likelihood of fully risk-adjusted market returns.

Corporate governance: Many cultures and economies lack a tradition and expectation of corporate governance that protects all stakeholders. Small enterprises particularly are often not subject to regulations that would encourage optimal governing practices. Remote investors not steeped in local culture may find it difficult to implement prudent governance.

Management competence: Frequently, entrepreneurs do not have the opportunities to work in well-run companies before starting their own businesses. Without widely available management training or relevant previous experience, enterprises in developing economies often lack well-trained managers.

Multiple ways of extracting value: Developed economies have established (and narrowly defined) means of extracting value from specific companies through interest, dividends or a sale of business. In many cultures, returns are generated in other ways. Examples include directing business to other companies controlled by a business's principals or hiring family and friends (in the developed world, such practices would be decried as self-dealing or cronyism). Such practices are by no means confined to developing economies, but in many cultures, these practices are considered legitimate ways of distributing value.

Corruption and graft: Certain countries and economic sectors face this obstacle more severely than others. Operating a business that does not engage in such practices can engender a very real competitive disadvantage when competing against business that do.³⁶

Bureaucracy: In many parts of the world, businesses face great bureaucratic regulatory hurdles when founding and operating businesses. Particularly when bureaucracy and corruption interact, the effect can dramatically chill a country's investment climate.³⁷

Innovations in Private Equity Investing

Rule of law and enforcement of contracts:

Many investors take a well-developed code of corporate law and a relatively functional judiciary for granted. Such conditions make contracts enforceable and give recourse to entities that have been wronged. Without them, an enterprise must carefully attempt to do business only with entities that will honour their contracts and obligations. In many emerging economies, the law and judiciary are not dependable, which increases transaction costs and risks.

Exits: Realizing a return either through a sale or public offering can be especially difficult when such strategies are rarely practiced or supported by a robust financial sector. Sales and ownership transfers depend not only on the presence of buyers and sellers (which may be relatively thin in emerging economic environments), but also require supporting professional services and infrastructure, including banking, accounting and legal services. Such support may also be in short supply in less developed economies.

Country risk - political and macroeconomic volatility:

With less political and economic stability in developing countries, private enterprises face a grave range of hazards from coups d'état to currency devaluations. The duration of equity investments and the extraordinary difficulty in building currency hedges make currency exchange fluctuations a significant risk.

Variations on Traditional Venture Capital

As venture capital (VC) has generated spectacular financial value in the United States and other developed economies, many investors have sought to deploy risk capital with VC-like models that deliberately seek returns in multiple dimensions. In a number of locations in the United States, innovative blended value investors have sought to link community development investing to venture capital.³⁸ These investors make equity investments available to small enterprises that would create local employment opportunities and otherwise enhance the local communities. As many of these funds are dedicated to a specific geographic or municipal area, they significantly limit the number of companies in which they can invest. Furthermore, the nature of the returns they seek often renders their financial returns concessionary.

The Community Development Venture Capital Alliance, an investors' trade association, offers a variety of tools for exploring these investment strategies and the funds that deploy them.³⁹ *RISE Capital Market Report: The Double Bottom Line Private Equity Landscape in 2002/2003*, published by the Columbia Business School's Research Initiative on Social Entrepreneurship (RISE) in January 2004, remains an excellent starting point for further examination of blended value venture capital investing in the United States.⁴⁰

Pacific Community Ventures

Founded in 1999, Pacific Community Ventures (PCV) has become a leader in the area of community development venture capital. PCV enhances and invests in businesses that bring economic opportunities to low-income communities in California. PCV manages two venture capital funds, PCV Investment Partners I and II. The organization also offers "Business Advisory Services", capacity-building assistance for area businesses and social purpose enterprises that corroborate the organization's mission.

PCV invests in companies that operate in or near low-income communities and employ the residents of those communities. The investment screen assesses the quality of employment opportunities that the company offers, including the quality of benefits and potential for advancement. The funds measure multiple returns on a variety of parameters, which they then make available to the public.⁴¹ The fund makes US\$ 1 million to US\$ 5 million in equity investments in companies that realize annual revenues of at least US\$ 5 million

and have the potential to grow in ways that enrich their employees. The funds will invest alone, but often they invest in syndicates that include investors not using blended value investment frameworks.

PCV recently realized significant gains when portfolio company Timbuk2 was acquired by a private equity fund. The liquidity event triggered significant cash payouts to local, non-management employees, many of whom live in economically depressed areas, in some cases doubling annual salaries. While this sort of event is usually a very good thing for investors, it rarely touches employees.

Environmental and Clean Technology Funds

Another relevant class of venture capital funds directs investments at an industry or sector that will generate multiple returns. A significant number of such funds direct their capital to renewable energy or clean technology. Many of these funds do not make substantial changes to the standard venture model, and may be managed in a fashion all but indistinguishable from their peers on Sand Hill Road in Palo Alto, California—the difference, however, is their focus on leveraging environmental value through the application of market rate capital investments.

Expansion Capital Partners, LLC

Expansion Capital Partners (ECP) invests specifically in clean technology, which it defines as "[t]echnologies that offer dramatic improvements in resource productivity, creating more economic value with less energy, less materials and less waste. These technologies significantly lower cost and improve profitability, with short payback periods."⁴² Expansion offers a compelling investment thesis for focusing on this sector, noting that these markets are growing quickly, that companies in the space have been under-invested to date, and that venture investments in clean tech offer investors a measure of diversification beyond the typical venture capital industry foci. Expansion seeks equity investment opportunities in companies realizing US\$ 2 million to US\$ 20 million in revenues with the potential to grow considerably larger. Its target investments range in size from US\$ 500,000 to US\$ 2 million, and the fund aims to realize an IRR in excess of 25% (before subtracting fees and carried interest). Investors in ECP include an array of both individuals and private foundations.

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Solstice Capital

With offices in Boston, Massachusetts and Tucson, Arizona, Solstice Capital bills itself as an “early-stage, diversified, positive-impact venture fund” investing in alternative energy, environment, life sciences, education and information technology. The partners have committed to investing 50% of their two funds in socially responsible investments. Solstice notes that “socially responsive investments can generate superior venture capital returns and make a positive contribution to the natural and social environments.”⁴³

Solstice is affiliated with Village Ventures Partner Funds, a network of affiliated venture capital investors focused on investing in American geographic areas that have been typically overlooked by venture investors. Village Ventures centralizes many of its partners’ administrative and operational services, allowing the partners to focus on their core investment responsibilities. Affiliation with Village Ventures also improves Solstice’s deal flow exposure. Solstice’s two funds, formed in 1995 and 2001, manage a total of US\$ 85 million. Solstice’s early stage investments tend to range in size from US\$ 500,000 to US\$ 1 million, and the firm is committed to syndicating its investments and regularly co-invests with other firms.

Blended Value Angel Investing

Many businesses are not suited to venture capital, which, particularly in its established and widely practiced forms, only invests in a relatively narrow type of business. Most businesses take too long to mature before a liquidity event, are not likely to achieve the financial return hurdles that VCs require, or are in industries that garner little attention from venture capitalists.

Entrepreneurs not able to secure venture capital will turn to angel investors, individual private equity investors who commit their personal capital and assistance to private enterprises that do not meet venture capitalists’ investment profile. In the US, angel financing remains a loosely defined investment class that can be difficult to assess. Angel investors have a wide range of motivations and approaches to their investments, but most invest in ventures operating in the industries where they have had previous success, where their human capital can be as helpful as their financial capital.

In the United States, the angel investor capital market, such as it is, in many ways remains an inefficient and somewhat localized market; that is, investors and angel investors are often connected through interpersonal networks, not through any kind of market intermediary. Because an angel investor is accountable only to him or herself (and does not have a fiduciary duty to maximize financial profits for limited partners), an angel can invest in ventures as they suit him or her. Accordingly, one might expect that angels would be a fruitful source of capital for entrepreneurs deliberately generating blended returns—if they could find one another.

Investors’ Circle (IC) aims to help blended value private investors find ventures that will corroborate the blend of returns they seek. Though its members are both individual private equity investors and venture-style funds, Investors Circle describes itself as “a leading social venture capital intermediary whose mission is to support early-stage, private companies that drive the transition to a sustainable economy. Founded in 1992, IC has become one of the nation’s oldest and largest investor networks, and the only one devoted specifically to sustainability.”⁴⁴ A brief survey of the Investors’ Circle website will present the reader with an array of funds making blended-value private equity investments in the US.

First Case Study: ProFund⁴⁵

By the end of 2005, ProFund, the first commercial microfinance equity fund, had exited its investments, distributed the profits to its investors, and closed its doors—all according to plan.⁴⁶ Over the course of its ten-year life, ProFund demonstrated irrefutably that one could generate profits by investing in MFIs even through exceptionally challenging economic and political conditions. Whereas ProFund was the only investor of its kind when founded in 1995, by the time the fund distributed its gains ten years later, at least 20 other MFI equity funds had embarked on similar investment strategies.⁴⁷ In 2003, the proliferation of this investment strategy led to the creation of the Council of Microfinance Equity Funds, a membership organization aiming to advance the field of microfinance equity investing.⁴⁸

Not only is ProFund’s financial return, at the end of the day, an illustrative example, the fund’s administration and the sponsors’ public “post-mortem” examinations have revealed a variety of nuanced lessons.

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ProFund's Founding Premises

ProFund was predicated on a clear fundamental need: MFIs in Latin America needed more capital. The fund proposed to meet that need through equity investments. Between the need and ProFund's solution was the fundamental principle that a social mission and financial value creation are not only compatible, but they can be mutually reinforcing.

"ProFund does not perceive a conflict between poverty alleviation and profitability. In fact, it believes that financial viability is a necessity for the long-term success of poverty alleviation efforts in microfinance. Accordingly, while most of ProFund's shareholders are interested in the development of the microfinance industry, the fund seeks primarily to receive an adequate return on its investments, which it considers the most efficient way to entice commercial capital into the sector."⁴⁹

Sponsors ACCION International, Calmeadow, FUNDES, SIDI and Mr Fernando Romero invested in ProFund to generate social returns, to capture financial returns, and to demonstrate a model that had the potential to magnify the social and financial gains created by microfinance. Those sponsors contracted with Costa Rican fund manager and consulting firm Omtrix, SA to manage the fund, and Omtrix president Alex Silva became the CEO of ProFund. Silva's work has been central to the development of the ProFund approach and he is referenced throughout the balance of this discussion.

In founding ProFund, the sponsors articulated a preference for equity investments in MFIs for a variety of reasons. First, some MFI managers would prefer equity investments, with their longer-term investment horizon and lack of regular cash outflows. Nevertheless, the higher risk associated with equity investments made such capital scarcer than other sources. Second, financial institutions can only borrow up to a certain multiple of their equity investments (a requirement that varies by regulatory regime), so equity investments can facilitate follow-on debt investments. Third, the equity investment encouraged engagement and influence that could be exercised through membership on the investees' boards of directors, where ProFund's directors could introduce best practices where appropriate. Finally, in order to accept equity investments, MFIs had to acquire a certain level of sophistication. If an investee MFI was not already a private financial institution, it would either need to become one or would need to work with ProFund to craft a quasi-equity investment structure. Accordingly, the presence of ProFund encouraged MFIs to become more professionally managed.

*The Mechanics of ProFund*⁵⁰

In founding the fund, the investors stipulated that ProFund would have a finite lifespan, ceasing operations in ten to twelve years after exiting all of its investments. The requirement forced the fund managers to deal with one of the most persistent barriers to private equity investment in microfinance and in developing economies in general: the lack of easy opportunities to liquidate investments. (ProFund's operational solutions to this challenge are elaborated later in this case study.) The founders also recognized that the fund would only spur similar investments if it could demonstrate realized returns for the whole portfolio, and stipulating the fund's ultimate liquidation guaranteed that ProFund would produce a conclusive, indisputable initial rate of return (IRR).

According to standard investment funds' practice, ProFund employed an investment committee that was ultimately responsible for investment decisions. The fund's professional staff uncovered and screened potential deals, negotiated and then monitored investments, identified exits, and served as a technical assistance resource to portfolio investments. Between the staff and investors, ProFund had extensive microfinance experience, and it could assist investees through the full range of their financing, strategy and operations challenges.

Though the professional staff had extensive responsibilities, the fund's charter ambitiously restricted administration to three percent of committed capital. At the fund's launch, this cap afforded ProFund only two full-time professional staff (plus an administrative employee and the input of paid consultants and other professional services service providers). Eventually, when the fund's size increased (reaching US\$ 22 million in 1998 with more than 15 shareholders), Omtrix was able to bring in an additional full-time staffer. Eventually, the fund reduced full-time staff size as it began to exit investments.

Quickly, Omtrix recognized that the initial premise of minimal investment engagement and relatively hands-off management was impractical. Many of the fund's initial investees were "NGO conversions", MFIs that were moving from not-for-profit models to independent financial institutions capable of handling equity investments. Over the fund's first three years, these conversions required significant attention from the staff. In later years, the investee profile evolved such that many investments were in

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newly created financial institutions, which also compelled highly engaged management. When macroeconomic turmoil began to sweep Latin America in the late 1990s, the staff found itself further stretched, making at least one deal that saved a healthy MFI from defaulting as a result of temporary macroeconomic shocks.⁵¹ ACCION and other sponsors readily acknowledge that the staff's extraordinary commitment and industry are largely responsible for the fund's positive results. Their experience reveals that close engagement is critical to such a fund's success, and, of course, high engagement requires a commitment of administrative costs.

Given the risk associated with equity investments, a soundly diversified portfolio was indispensable to ProFund's success. The resulting portfolio achieved diversification in countries, organizational forms (NGO-administered, existing financial institutions, and conversions from NGO to financial institution), market penetration and organizational maturity.⁵² To protect against undue investment concentration, the fund set a US\$ 4 million cap on any single investment. While the fund aimed to hold a substantial equity position in each investee (at least ten percent of its outstanding shares), ProFund opted not to take controlling positions; a 20-30% target became the norm.

ProFund's operations grappled with a profound, large-scale shift in the microfinance world, as the centre of gravity for MFIs' organizational forms shifted from NGOs to independent financial institutions. Not only did the fund develop expertise in effecting NGO conversions, it also learned to create near-equity investment structures in circumstances where the MFI could not accept equity investments due to its corporate form, by-laws or regulatory environment. Cataloguing the specific nature of those investment remains beyond the scope of this paper, but the resulting investments typically resembled subordinated debt or preferred equity. In some cases, they involved periodic cash flows, and many such investment vehicles included redemption clauses that provided investment exits on pre-arranged terms.

Once the fund finished liquidating its investments and distributing the proceeds to its shareholders, ProFund had realized a net IRR of 6.65%.

Key Lessons

Over the ten-year life of ProFund, its investors and staff learned numerous lessons about managing a microfinance equity fund. Silva explores many of those operations lessons in his essay, "Investing in Microfinance: ProFund's Story", and readers are encouraged to refer to that document for a more detailed exploration of those themes.⁵³

In its survey of microfinance, "The Hidden Wealth of the Poor", The Economist said of ProFund's returns (before the fund had exited the last of its investments):

At first sight, its returns look unexciting: just six percent annually, despite lots of risk. But on close examination this was a remarkable performance. All of ProFund's capital was contributed in dollars and then invested in local currency. In every country it operated in, its dollar returns were reduced by local currency depreciations, reflecting the economic chaos in Latin America during that decade. Two of the countries in which it had investments, Paraguay and Ecuador, suffered system-wide financial collapse. Haiti, Venezuela and Bolivia faced riots and revolutions.⁵⁴

In spite of significant currency losses, Silva indicates that "in most cases . . . the subsequent operational gains and intrinsic appreciation were more than enough to offset currency related losses and provide for the fund's positive overall yield."

Silva attributes the net gains to a number of critical factors. The first is the operational excellence of the investees' own management as measured by their ability to lend to more customers and do so with increasingly lower overhead costs. Silva has also acknowledged that ProFund's early entry into this market place enabled it to "cherry pick" the best investments at a lower investment cost, thanks to its lack of competition for deals. (Interestingly, Silva observes considerably more financing activity and, in turn, competition for deals in 2006. He has stated that he would not run ProFund II in the same geography because funding alternatives now exist, diminishing the likely success of a new fund—and further proving the success of ProFund as an inspiring demonstration of concept.)⁵⁵

Silva further identifies two other necessary conditions for profitable microfinance equity investing: the MFI must be located in a country that provides a sufficient "enabling environment", and the MFI's corporate governance must be sound and independent. In referring to the appropriate environment, he points to a country's regulatory

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and legal milieu. He cites an illustrative example: “[W]hen the Colombian government imposed tight interest ceilings and thus prevented [ProFund investee] Finamerica from recuperating the high operating costs associate with microfinance,” ProFund should have recognized the change in the investment environment and exited the investment.⁵⁶ (Unfortunately, ProFund did not act in time, and the fund eventually realized a loss on that investment.)

Successfully planning for exits at the time of the investments’ inception was another key success factor. Silva notes: “No investment was approved without some sort of negotiated exit possibility.”⁵⁷ With liquidity events remaining an elusive goal for most private equity in developing markets, ProFund’s example presents a variety of transferable operational lessons. The fund relied on several such exit strategies, many of which are suitable for liquidating minority positions, which can be especially difficult to sell when most buyers are seeking controlling interest.

- **Put Options:** These agreements gave ProFund the right to sell shares in the investment to a particular buyer, usually a larger co-investor, on a particular date at a price determined by the investment’s performance. The options typically provided a guaranteed exit opportunity of last resort that did not necessarily ensure a profit.
- **Controlling Block Shareholders’ Agreements:** Under such a contract, a number of minority investors agree to coordinate in selling their shares in unison so that a buyer can buy a controlling stake by aggregating several smaller shareholders’ stakes.
- **Management buy-outs:** ProFund also negotiated provisions by which an MFI’s management could purchase ProFund’s shares. Such arrangements may also involve seller financing, in which ProFund would arrange for the managers to borrow the funds that they would in turn use to buy out the investors. While this arrangement ensures that an interested party will purchase the shares, it also introduces the potential of moral hazard.⁵⁸
- **Redemption:** When ProFund relied on quasi-equity structures, it typically included a redemption feature that would coincide with ProFund’s closure and liquidation date.

Such provisions ensured that the fund would be able to liquidate investments, though the preferred exit remained selling the shares to a strategic buyer. Potentially offering greater exit multiples, such buyers also include “local financial institutions . . . and international socially responsible investors (including the equity funds).” Nevertheless, “[p]rivate individual or corporate sector buyers, while present, have not yet become a major force, and there is some reluctance to sell to such buyers unless they are convincingly socially motivated.”⁵⁹

Interpreting the Results and Looking to the Future

Particularly considering the macroeconomic environment in which ProFund operated, its results are remarkable—and they are made even more so given the “experimental” nature of the fund. Nevertheless, Silva observes that a similar fund, if launched in 2005 in the same geography, would be hard-pressed to replicate ProFund’s financial results. Silva points to the “downscaling” of many mainstream banks that have moved to microfinance products and otherwise serve previously un-banked poor people. He notes that downscaling may have a profound impact on how financial services are rendered to the poor.

He notes, “Coupled with lower cost of funds and underutilized infrastructure, the commercial banks are clearly more professional and know financial intermediation better than [most] MFIs. In many countries, downscaling is already as big as all MFIs combined.” Such developments help bring financial services to more poor people by creating increased competition for microentrepreneurial business. That increased competition might cramp the returns of MFI equity funds, but it might also introduce new exit opportunities for MFI equity investors as downscaling banks choose between building and buying microlending capabilities.

By 2005, a host of other microfinance equity funds were investing with similar models (though all at earlier stages in the funds’ lives). They will eventually contribute their data to the discussion of the asset class, and their experience will help establish the extent to which ProFund’s financial returns can be attributed to its being the first to market or to other factors, including the quality of the fund’s management and the overall nature of the investment strategy. These funds will also contribute to the body of best demonstrated practices, which will help investors and managers understand how to replicate and eventually improve upon ProFund’s results.

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Inescapably, ProFund's experience throws foreign exchange risk into sharp relief. Even when one invests anticipating returns on par with mainstream American private equity portfolios (in the realm of 30-40%), a major currency devaluation can quickly eliminate hard-won investment returns. Of course, developing markets and international blended value investors are quick to point out that foreign exchange rates can and do move in the other direction, and in many markets in the mid-2000s, they did just that. Nevertheless, the financial returns on investments in developing economies remain exceptionally sensitive to foreign exchange volatility, which as yet cannot satisfactorily be mitigated. Many well-informed would-be international blended value investors have avoided such investments (in equity and in debt) largely due to the uncontrollable and vaguely predictable foreign exchange risk. When financial services entrepreneurs and financial institutions develop a mechanism that manages some foreign exchange risk at a reasonable cost, it will likely open these investments to dramatic inflows of capital.

Concluding Thoughts

Equity investing in MFIs is a critical investment strategy, but it lacks single risk-reward profile. Equity investors, even more than debt investors, buy into the operations of the MFIs they support; the strong fundamentals of microlending alone will not generate MFI equity returns unless the financial institution is well managed. With the equity investors even further behind debt holders in their claim on an MFI's free cash flows, an equity investor must be that much more certain that sufficient cash flows will accumulate. The extraordinary range of corporate forms, lending models, and management strategies employed by MFIs makes equity investing a complex proposition. For example, the risk profile of an MFI converting from NGO to independent financial institution will differ significantly from an established financial institution that is extending its conventional models to new markets. Accordingly, perceptive, astute fund managers with deep microfinance and capital markets experience are absolutely essential to the success of equity funds.

ProFund has proven unambiguously that one can create social and financial value by investing in MFI equity, but investors have a long way to go before truly understanding the risk-reward profile of some of these investments. Fortunately, other blended value investors have engaged in this investment strategy and in due time will help reveal its nature.

Second Case Study: *Aavishkaar India Micro Venture Capital Fund*⁶⁰

Founding Aavishkaar

Aavishkaar founder and CEO Vineet Rai discovered the need for micro-scale equity investments as the CEO of the Grassroots Innovation Augmentation Network (GIAN), an incubator for rural ventures in India. The entrepreneurs working with GIAN were caught between established financing mechanisms. Microfinance was not appropriate for these inventors; many had grown too large for microloans. Furthermore, these entrepreneurs were often creative inventors who had developed novel ways of addressing problems. Their inventions still required investment before they would generate predictable cash flows; accordingly, they were simply not suited to debt financing.

Rai's entrepreneurs faced financial institutions that were not equipped to help them grow. Many banks simply did not have programmes for working with small enterprises, especially those that were dispersed throughout rural areas. While India has a vital and growing venture capital market, most VCs are located in the cities (to be close to the clusters of innovation), and they operate almost exclusively at a scale that is an order of magnitude larger than GIAN's entrepreneurs. Rural India simply does not offer an angel network that could finance these enterprises.

Thus, Rai's entrepreneurs faced a grave funding gap between microfinance investment products (usually well below US\$ 1,000) and established venture capital fund investments (typically beyond US\$ 1,000,000). The rural entrepreneurs being incubated by GIAN needed flexible equity financing, patient capital that would help them build their enterprises' capacity and open further opportunities for growth.

After meeting with Indians living in Singapore, who themselves were contemplating more sustainable ways of supporting their motherland, Rai and his associates conceived of a new financing entity to address that gap, and Aavishkaar India Micro Venture Capital was born. In Hindi, Aavishkaar means innovation, and it invests in innovative rural enterprises that are "socially relevant, environmentally friendly, and commercially viable."⁶¹ Like traditional venture capital, Aavishkaar focuses on innovations that have the potential to benefit from economies of scale. Unlike the typical venture capital model, Aavishkaar invests only in small enterprises that could make a difference in the lives of rural Indians.

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Managing Regulatory Constraints

Beginning in 2002, Aavishkaar approached India's Securities and Exchange Board (SEBI) with the intention of formally incorporating as a venture capital fund. Formal incorporation posed a number of obstacles, including a minimum fund size that exceeded Aavishkaar's initial capacity to invest. The minimum fund size delayed Aavishkaar's initial venture investments while it worked to build a sufficiently large fund. The founders opened a Singaporean sister company, Aavishkaar International, to pool overseas investors' capital for investment in Aavishkaar as a single entity, an arrangement prompted by SEBI's regulations. The fund ultimately met its regulatory requirements and formally incorporated in May 2002.

Dr V. Anantha Nageswaran, a member of Aavishkaar's management board, indicates that Indian regulations do not encourage the flow of capital into non-traditional VC investments. He notes: "If banks could be allowed to contribute to . . . non-traditional venture capital funds, and if such contributions counted toward their obligations to the priority sector, then the flow of funds to the non-traditional venture capital industry would increase."⁶² Furthermore, some flexibility in the size and structure of the regulated venture fund would encourage further growth.

Fund and Deal Profile

Aavishkaar's investors are mostly individuals, and they have committed an average of about US\$ 16,000 to the fund. In late 2005, the fund totalled about US\$ 1.3 million, and it had placed six investments, with several others nearing completion.

Investments are scaled appropriately to the target companies that Aavishkaar aims to support, and the deals range in size from US\$ 10,000 to US\$ 100,000 with the average being about US\$ 30,000. Aavishkaar seeks an ownership stake of approximately 26%. While the investments are smaller than those of a typical VC, Aavishkaar targets VC-level returns for each investment, aiming for a 32% internal rate of return (IRR). Nevertheless, Rai anticipates a rate of enterprise failure that will likely exceed the typical VC's rate, and he anticipates the overall fund's IRR ultimately to be in the range of 5 to 10%.

He anticipates the duration of a typical investment will be as long as seven to nine years, which is considerably longer than the typical holding period of a standard VC. Accordingly, the fund has not yet

exited a deal. Nevertheless, those exits are likely ultimately to come in the form of a share buyback (in which the entrepreneur repurchases shares in his or her own company either with accumulated earnings or with commercially available debt), merger or sale of the enterprise, but Rai does not rule out the possibility that one of these enterprises will ultimately be sold on the public markets.

Investment Example

One of Aavishkaar's first investments was in Shri Kamdenu Electronics Private Ltd (SKEPL) in April 2003. The fund invested about US\$ 36,000 for a 26% stake in the company, which develops appropriate technology for dairy cooperatives. SKEPL's product portfolio includes automated milk collection and analysis systems that are suitable for use in India's tens of thousands of milk cooperatives. The product has the potential to make milk production safer and more efficient, thereby potentially improving the lots of the millions of milk co-op members.

Lessons Learned (or Lessons Learning)

Rai and everyone associated with Aavishkaar treat their fund as a carefully executed, high-stakes experiment. With a risk tolerance suitable to Silicon Valley, Rai declares that even if Aavishkaar fails, it will have been a success in that it will advance the state of the discourse about financing innovative rural entrepreneurs. He is confident that a private equity market will eventually grow up around these entrepreneurs, and Aavishkaar's approach may hasten the day it arrives. Nevertheless, he acknowledges that the market is miniscule, and a failure now could hobble the asset class for a long time.

In its several years of operation, Aavishkaar has seen its deal flow improve gradually but continuously, and the investment pipeline is now better suited to the size of the fund than it was in the early days. As Aavishkaar establishes a reputation, it sees more potential deals, including many that fall out of its focus area. Fund managers must resist the temptation to make larger investments that do not strictly fit the fund's investment focus. The temptation to move toward larger deals is great, as larger deals are, from a financial perspective, more efficient ways of deploying capital. Rai ultimately observes that Aavishkaar's small investment scale will limit its profitability, and it is difficult to imagine that the returns can be sufficiently large to overcome the costs associated with supporting the investments (e.g.: due diligence, investment monitoring and

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technical assistance). Without substantial returns, Rai raises concerns about retaining his capable and passionate staff. He needs employees with substantial professional financial experience and the opportunity costs for such professionals can be quite high.

In spite of these challenges, Aavishkaar has launched a viable fund in an investment space that has not yet had the benefit of competitors who can address the same challenges that Rai faces. The prospect of competition is very appealing to Rai, as other funds will help wring out inefficiencies, attract more capital to the sector, and ultimately make it more viable for rural entrepreneurs to take risks for the sake of building value. Though Aavishkaar still has no direct competitors, the fund has attracted the attention of other investors who are considering similar investment strategies, with one similar fund apparently close to launching.

Third Case Study: *ShoreCap International and ShoreCap Exchange*⁶³

ShoreCap International (SCI) is a private equity fund investing in MFIs and banking institutions that finance small- and medium-sized enterprises (SMEs) in Africa, Asia and Eastern Europe. SCI is not the only private equity fund investing in such institutions. This document refers to other MFI equity investors, but there is an increasing number of funds investing primarily in financial institutions serving SMEs in emerging economies. The Balkan Financial Sector Equity Fund (managed by Development Finance Equity Partners) would serve as one of several examples.

SCI adopts active roles in the companies in which it invests. Its work is corroborated and advanced by ShoreCap Exchange (SCE), an American not-for-profit organization that provides technical assistance to banks in SCI's portfolio and to other similar institutions. Both SCI and SCE were spun out of ShoreBank Corporation in the US, and their work draws considerably on ShoreBank's path-breaking and market-leading community development banking model in the US.

ShoreBank Corporation

ShoreBank began operating in Chicago, Illinois, USA in 1973, practicing what is now commonly called community development banking. The bank has become a diversified, full-service institution offering financial products and services designed to

enhance economic development in underserved American communities. The bank expanded outside of Chicago in 1986, and now it has locations in communities across the United States (including Detroit, Cleveland, Michigan's Upper Peninsula, Portland, Oregon, and Coastal Oregon and Washington). ShoreBank Advisory Services extends the bank's work to other financial institutions outside of the ShoreBank network. In 1994, the bank entered the field of environmental banking, bringing its investment practices to bear on conservation and environmental improvement.

The bank now manages over US\$ 1.7 billion in assets committed to community development, and its net income exceeds US\$ 7 million per year. Jan Piercy, a ShoreBank Executive Vice-President and former US Executive Director of the World Bank, notes that ShoreBank's original bank in Chicago now outperforms many of its peer banks that do not have a community development investment focus.

The bank began working internationally in 1983 with the Grameen Bank in Bangladesh. And in the 1990s, its work expanded to Poland, Pakistan, the former Soviet Union and elsewhere.

Introduction to ShoreCap International

Funding SCI

SCI was launched in July 2003 with US\$ 28.3 million in committed capital from 14 different institutions. The fund is structured as something of a hybrid between a permanent investment corporation and a limited-life investment fund. It has a mandate to invest funds for five years, concluding its investment activity in 2008. SCI does not have a terminal date or a requirement to liquidate its holdings by a particular deadline. Until 2008, the fund's directors can determine whether to re-invest any realized gains or to distribute them to investors. After 2008, investors themselves can determine whether they would like to have those gains paid out or reinvested. The fund managers aim to invest US\$ 23 million of the fund, reserving several million dollars to make follow-on investments and to support the fund's expenses (with very little current income, the fund must rely largely on its committed capital to fund expenses). SCI expects a seven percent IRR for the fund itself, which is concessionary to the risk-adjusted market rate.

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Investors

The fund's 14 investors committed an average of US\$ 2 million to SCI, and their investments range from US\$ 250,000 to US\$ 4 million. They include development finance institutions, socially responsible investment funds, foundations and one global commercial bank, ABN AMRO. The Netherlands-based bank's American subsidiary LaSalle Bank had worked with ShoreBank to meet its community investment obligations under the Community Reinvestment Act. Spurred in part by the investments made with ShoreBank's assistance, the LaSalle and ABN AMRO executives recognized that community development clients would be their future mainstream clients. Accordingly, ABN AMRO invested in SCI to learn more about its future mainstream clients in emerging economies.

Investment Parameters

SCI invests in financial institutions that provide financing and banking services to microentrepreneurs and small businesses that create economic opportunities for poor people. The fund invests in regulated banks, MFIs, and other financial institutions as long as at least 50% of the institution's assets are dedicated to financing small- and micro-sized enterprises that employ low-income people. Typically, it invests US\$ 500,000 to US\$ 2.5 million in equity with some convertible or subordinated debt, and its investments are made in local currencies. SCI's hurdle returns on equity are 12%, and it anticipates an average holding period of five to seven years. Though SCI does not take majority stakes in any of its investments, it does take board seats, often placing a top ShoreBank executive on the bank's board. The fund currently operates in Africa, Asia and non-EU Eastern European countries.

Deal Flow

Paul Christensen, president and COO of ShoreCap Management, the fund manager, indicates that it is much easier to identify microfinance deals, given the prominence of the sector and the fact that there are other investors seeking similar deals. Identifying investment prospects is more complicated for institutions that finance SMEs. ShoreBank's Advisory Services often sources such deals, and occasionally, existing SCI investments refer other potential investments. In some cases,

Christensen and his team prospect by travelling throughout Asia, Africa and Eastern Europe seeking financial institutions that might be investment prospects. SCI lists investment pipeline opportunities in Ghana, Uganda, Afghanistan and Azerbaijan, among other countries.

Measurement and Monitoring

SCI expected to have made eight investments BY late 2005, totalling US\$ 9.5 million, with several other likely investments pending. Through its regular monitoring and involvement of SCE, SCI remains in close contact with the banks in which it invests. Not only does it track the financial performance of its investments, SCI also works to assess its investments' social impacts. Christensen reports that tracking impact outputs for MFI investments is easier than doing so for SME-oriented investments. Some of SCI's MFI investments are already assessed by MFI rating organizations that track metrics like number and size of new loans and the gender mix of borrowers. In measuring the fund's SME investment impact, SCI has deployed many of the tools that community development banks use in the US. They attempt to measure the number of small businesses associated with the banks, along with the total number and quality of new jobs created. Nevertheless, the dispersed nature of the investments and the cost of measuring both make it difficult to compile accurate and complete data.

Introduction to ShoreCap Exchange

SCE is an independent American not-for-profit organization that operates internationally and is funded primarily by grants. SCE supports many of SCI's investments by offering technical assistance in the areas of organizational capacity-building, best practices transfer and "banker-to-banker peer exchange." While donors support SCE's work, client banks must make co-payments (determined on a sliding scale) for the services, ensuring that they are fully invested in the capacity building and knowledge transfer that SCE facilitates. SCE also sponsors a variety of exchange programmes that encourage knowledge transfer between bankers in developed economies with their colleagues operating in developing economies. SCE's involvement not only encourages positive development outcomes, but it helps to lower the risks associated with SCI's investments.

Variations on Traditional Venture Capital

SCI Looks to the Future

Nearly halfway through the investment process at the end of 2005, Christensen suggests that ShoreCap's future international private investment funds will likely have a sharper geographic focus. He notes that it can be a challenge to cover Africa, Asia and Eastern Europe with a staff appropriate for a US\$ 28 million fund. Beyond regional specialization, Christensen sees opportunities to expand this investment model to the low-income housing sectors of developing economies. He sees both viable potential business models and the opportunity to finance a substantial development impact, and he predicts that more capital will flow into low-cost housing finance in the next several years.

Fourth Case Study: *Actis*⁶⁴

Whereas Aavishkaar and ShoreCap were both founded as unorthodox approaches to private equity investment specifically intended to create blended value, Actis is a mainstream private equity fund with over US\$ 3 billion under management and generating market-rate financial returns. With a history stretching back to 1948, Actis's ingrained organizational values and investment strategies have driven the firm to generate multiple returns before it ever articulated a blended value investment strategy.

Actis's History and Investment Focus

Until its management buyout in 2004, Actis was a part of CDC Group PLC (formerly Commonwealth Development Corporation), which was wholly owned by the UK government. As the United Kingdom left its former colonies in the 1940s, it formed the CDC to begin establishing private sectors in the nations it departed. Initial investment vehicles were debt instruments with some private equity investments, but over 50 years the fund changed the balance of investments so that by 2005 its assets were almost exclusively private equity (consistent with a standard private equity fund's allocation).

Ultimately, CDC's management and the UK government pursued a privatization plan that would allow existing management and employees to buy out 60% of the company, thus converting it into a conventionally organized private equity fund. The management completed the buyout in 2004, when the management company was renamed Actis.

While the government still owns 40% of the management company, Actis now raises investment funds in accordance with typical private equity practice.

Actis has 16 offices, most of them located in the developing economies where the fund invests, including five offices in Africa, four in Central and South Asia and one in China. Staffed by over 90 investment professionals, the firm has developed a deep understanding of the markets in which it operates. Being geographically close to their markets, Actis's investment professionals maintain close engagement with their investments.

The deal sizes typically range from US\$ 10 million to US\$ 50 million, and the fund invests only in healthy, established enterprises with high growth potential. It selects sectors on a local basis, enabling it to choose those that offer the best potential for growth and benefit for the local economy, while avoiding those where corruption, environmental liabilities or other potential hazards make investments unappealing.

Between 2004 and 2005, Actis raised six regional funds and an umbrella fund investing in the regionally defined funds. If Actis meets its target fund sizes, the new pools of capital will represent over US\$ 450 million directed to investments in Africa, US\$ 225 million to China, US\$ 325 million to India, and US\$ 225 dedicated to South and Southeast Asia. Since 1998, it has exited over 50% of its South Asian investments, generating a gross IRR of 34%. In the same time period, it exited nearly half of its investments in Africa with a gross IRR of 23%. Though it has exited only two of eight investments in China, the realized gross IRR for that portfolio has been 54%.

Generating Multiple Returns

Actis's engagement in generating multiple returns begins at the investment screen, as it avoids companies that have poor reputations, will be placed at competitive disadvantage by upholding honest business practices, or will be potentially resistant to Actis's responsible engagement. Within the company, Actis aims to improve corporate governance, health and safety standards and/or environmental practices. In some of the changes it advocates, Actis resembles a progressive activist shareholder. It does so because such practices are ingrained in the firm's values and because they increase financial value.

Variations on Traditional Venture Capital

When it has the opportunity, Actis advocates for regulatory and legislative changes that will encourage a healthy, competitive and responsible private sector. The benefits of such advocacy accrue to Actis in that its investments can pursue their businesses with less friction. Furthermore, Actis-supported enterprises are prepared to compete successfully in competitive business sectors, and the fund is betting that its ventures can win on a level playing field. Naturally, the benefits of such work accrue to the communities and countries where Actis-supported ventures operate.

Social Fusion mapped Actis's approach into frameworks presented in "Developing Value: The Business Case for Sustainability in Emerging Markets", a white paper published by the IFC, Ethos Institute, and SustainAbility^{65, 66}. The "Developing Value" framework explains how "environmental risk reduction" and "socio-economic risk reduction" can be practiced such that they engender improved economic returns for shareholders as well as benefit other stakeholders. (See figure 7 for a concise representation of that framework.) The authors of the "Developing Value" study map a series of risk-reducing actions that generate medium- and long-term business results. The framework then establishes how these results confer benefits or returns on multiple stakeholders, including employees, investors and the community.

Social Fusion discovered that Actis's investments consistently fit this framework. The firm's investment professionals recognize the significant risks inherent in investing in emerging markets, and their systematic, thoughtful approach to mitigating those challenges translates into concrete actions that also create environmental and social value.

Improving Exit Multiples

Managing Partner Jonathan Bond observes that Actis regularly sells portfolio companies to large European and global firms, many of which recognize the risk engendered by environmental, social, and corporate-governance-related liabilities. Many companies will not even consider acquisitions that do not meet or approach their own standards for social and environmental practices. Accordingly, Actis aims to build companies that will appeal to such acquirers, and doing so engenders benefits for the portfolio companies' employees, communities and economies.

Investment Example: Celta

Bond reports that the firm sees a tremendous appetite for capital in Africa, where one of the highest-growth industries is wireless telecommunications. The growth rate in wireless services in Africa exceeds that of any other region in the world. Actis entered the sector with a

Figure 7: The Developing Value Framework

Risk Mitigation	Actions	Business Result	Stakeholder Benefit	
Governance	<ul style="list-style-type: none"> Culture of responsibility, accountability, teamwork and transparency Well-communicated guidelines for mission and operations Monitoring and review policies developed and strictly enforced 	<ul style="list-style-type: none"> Community goodwill Brand development and reputation Revenue growth and new market access Well-trained workforce Cost savings and increased productivity Greater access to capital Decreased healthcare costs Higher profits 	• Employees	<ul style="list-style-type: none"> Safe working conditions Increase in direct employment opportunities
			• Investors	<ul style="list-style-type: none"> Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities
Environmental Risk Reduction	<ul style="list-style-type: none"> Efficient use of natural resources Minimization of harmful products Highly efficient operations Reduction of waste streams 	<ul style="list-style-type: none"> Revenue growth and new market access Cost savings and increased productivity Brand development and reputation Greater access to capital Decreased healthcare costs Higher profits 	• Employees	<ul style="list-style-type: none"> Increase in direct and indirect employment opportunities Safe working conditions
			• Investors	<ul style="list-style-type: none"> Higher returns for investors Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities
Socioeconomic Risk Reduction	<ul style="list-style-type: none"> Workforce training Community activism – "first-in-privilege" Access to healthcare 	<ul style="list-style-type: none"> Revenue growth and new market access Community goodwill Brand development and reputation 	• Employees	<ul style="list-style-type: none"> Increase in direct employment opportunities
			• Investors	<ul style="list-style-type: none"> Higher returns for investors Stable investment and development climate
			• Community	<ul style="list-style-type: none"> Community development and access to better services and facilities

Source: Social Fusion and Actis, adapted from "Developing Value: The Business Case for Sustainability in Emerging Markets"

Variations on Traditional Venture Capital

significant investment in Celtel, a pan-African wireless service provider, shortly after Celtel's founding in 1998. By the time of the company's sale in March 2005, Actis had invested a total of US\$ 77 million, representing 9.3% of the company's shares. Kuwaiti wireless concern MTC purchased Celtel for US\$ 3.4 billion, giving Actis a 77% gross IRR. Of the US\$ 3.4 billion purchase price, Bond reports that some US\$ 2 billion represented goodwill, value the acquirers ascribed to knowing that Celtel's contracts were all dependable, that the company had always operated to the highest ethical standards, and that it would not discover any fraud or hidden liabilities.

While it owned Celtel, Actis had many opportunities to advocate for multiple returns. The firm worked with government officials in the African countries where the company operated (particularly in those where it was among the largest taxpayers) to ensure that taxation and other business regulations were transparent and uniformly practiced. Celtel also instituted strong employee-development programmes and strict environmental protections. Furthermore, Celtel is active in many of the communities it serves, sponsoring various healthcare, education and other community initiatives.

Opportunities

In potential financial returns, Actis sees tremendous opportunities for investing in emerging markets. Especially in Africa, the firm is not wanting for investment opportunities. While the risks remain significant, the firm and other experienced private equity investors with personnel in-country are well positioned to reduce that risk, often in ways that engender positive returns in other dimensions of value.

Gillian Arthur is the head of Actis's Operations Group, which ensures that the firm's approach to health and safety, social and environmental issues is integrated throughout the investment lifecycle. She notes that Actis's most significant and immediate impact may be in the realm of employee health and safety, and Actis pushes its portfolio companies constantly to improve working conditions and opportunities for their employees. Actis will have ample opportunity to make such improvements as it invests recently raised funds in countries that have poor reputations for safeguarding employee health and safety.

Interest in blended value investing is building momentum. More and more capital is being guided not just by a conscience but by a proactive, sophisticated set of ethics. With the assistance of Social Fusion, Actis is currently exploring how investments in Actis can play a role in blended value investment strategies. To that end, Social Fusion has convened a series of "investor roundtable" events that have brought Actis partners together with potential blended investors in order to exchange ideas and discuss opportunities.⁶⁷ It should be noted clearly that Actis does not promote itself as a "socially responsible" investment manager, per se. Instead, it is transparently presenting its goals and practices to investors who can then determine how or whether an investment in Actis has a role in their portfolios.⁶⁸

In conclusion, as this modest slice of the developing private equity market universe demonstrates, private equity investment can be very flexible and can adapt to the variety of opportunities arising in developing economies. Making private investment work for international blended value creation will require additional time to build upon this initial track record to increase the experience of those structuring these funds and expand the capacity of both funds and supporting intermediaries working in this area of capital allocation. There are promising developments, such as the launch of VantagePoint,⁶⁹ a non-profit working regionally with investors to help expand venture capital options in emerging markets and the ongoing work of Endeavor,⁷⁰ providing support to entrepreneurs in emerging markets, both of which reflect the growing interest in and promising developments of venture capital expanding into these emerging markets.

Building Blended Value Portfolios

Thus far, this paper has focused on the variety of potentially scalable investment instruments and capital structures one could deploy to generate multiple returns. Each example demonstrates the convergence of creative financial engineering and the desire to expand access to capital for organizations creating blended value. Such capital innovation seems sure to continue and even accelerate, but the investment vehicles are only part of the story.

In its pure sense, all investing activity has within it blended value components of social, environmental and economic value. What is striking to note, however is that at the present time, as potential investments mature and proliferate, investors are increasingly combining them into carefully tuned portfolios *strategically* positioned to generate sophisticated and specific blended value returns. Several such portfolios already exist. They may differ from one another significantly, but they all have in common a concerted and well-considered aim of maximizing value in multiple dimensions.

The next several pages suggest future investigation spurred by the preceding inquiry into investment vehicles. We briefly explore the opportunities and challenges for investors who would build a “blended value investment portfolio theory” into their investment strategies. An introduction to two notable examples suggests areas for future study, including an inquiry into how these investors have approached their work, defined opportunities and addressed challenges.

Rethinking Portfolio Theory

Traditional portfolio managers map their investments to a two-dimensional efficient frontier that balances risk and financial reward. The managers of BVI portfolios tend to view value in multiple dimensions, which in turn requires significant changes to standard portfolio theory and management. These managers must begin by addressing the challenge of translating their investors’ conception of value into an investment thesis, a detailed explanation of what the investor believes to be true about blended value and the high-level strategies that will responsibly maximize value within that framework. Creating a durable and versatile thesis is made particularly complicated by the pace of change in blended value investors’ sophistication and, as this paper has documented, the pace of the investment products’ evolution.

Investment portfolios that aim to maximize blended value must project a desired *integration* of financial and other dimensions of returns. Then they must also develop guidelines for many other investment and portfolio variables, some of which are interdependent. Such investors must address a number of questions:

- **Types of investment:** Will the portfolio invest in debt, equity, and/or other types of securities? Will capital support for-profit and/or not-for-profit investments?
- **Level of engagement:** To what extent will the investor and portfolio manager engage the investments? Will they approach investment with the hands-on perspective of a venture capital investor, or will they adopt a more passive approach to investees’ management?
- **Investment concentration and target allocations:** How much of the portfolio should be allocated to relevant segments of blended value investments and how concentrated in any one specific investment will the portfolio be?
- **Investment in research and development:** In addition to deploying capital to blended value investments, to what extent will the fund invest in advancing the field through research and development around its BVI strategies?
- **Performance measurement:** How will the portfolio measure the value it creates and the outcomes it engenders? How can these measurements be used to adjust the portfolio dynamically?

The F.B. Heron Foundation, based in New York, has explored many of these questions in the course of its work to restructure its assets along the lines of a unified investment strategy. Their documentation of how they have executed this institutional transformation is very informative and available on their website.⁷¹

Blended Value Portfolio Examples

While all capital has the potential to generate blended returns and many investors have integrated some element of blended value investing principles into their practices, two funds stand out as having been constructed and managed to maximize blended value through the application of innovative investing strategies.

Building Blended Value Portfolios

Acumen Fund

Formed in 2001 with grants from the Rockefeller Foundation, the Cisco Systems Foundation, and individual investors in Silicon Valley, the not-for-profit Acumen Fund invests in market-based solutions to problems associated with global poverty. Acumen CEO Jacqueline Novogratz states that Acumen is “agnostic” about whether it funds for-profit or not-for-profit enterprises, but in recent years it has moved away from grant-making as it discovered the unmet need for financing market-oriented solutions. Accordingly, the bulk of its investments take the form of debt and equity vehicles. While Acumen invests for blended returns, anticipating a concessionary rate of financial return on invested capital, its investors make charitable contributions and do not expect to capture financial returns. To date, the organization has made investments in India, Pakistan, Egypt, South Africa, Tanzania and Kenya.

Acumen Fund's Mission

Acumen Fund is a global non-profit venture fund serving the four billion people living on less than US\$ 4 a day. Our aim is to create a blueprint for building financially sustainable and scalable organizations that deliver affordable, critical goods and services that elevate the lives of the poor. We adhere to a disciplined process in selecting and managing our philanthropic investments as well as in measuring the end results.

Source: Acumen Fund, <http://www.acumenfund.org/About/>

Two hallmarks of Acumen Fund's approach are its venture-capital style engagement and a portfolio approach to BVI. The organization currently has three investment portfolios, each with a specific approach to creating blended value: health technologies (investing in technologies and associated business systems that increase quality and access to healthcare), housing and finance (making investments in infrastructure and financing systems to make home ownership more accessible), and water innovations (improving the quality and availability of fresh water supplies by investing in purification, distribution and conservation solutions). A portfolio manager supervises the investments in each area, and he or she works closely with an advisory committee comprised of domain experts. Novogratz notes that the portfolio approach helps diversify risks and create “strategic networks to facilitate the overall work of investment.”⁷²

Each portfolio manager works with only a handful of investments at any given time. Accordingly, Acumen Fund can maintain close engagement with investees, which facilitates investment monitoring, strategic consultation and network building. Portfolio managers and the entire staff deploy a performance measurement system originally designed in consultation with McKinsey and Company. The organization notes, “[o]ur metrics focus has grown to become an integrated part of everything we do, both externally and internally.”⁷³ On a regular basis the organization measures its progress with financial metrics, social outcomes and improvements in its investments' internal capacity.

Acumen notes that over one million people have benefited from the fund's investments. Among those whose lives have been improved, the organization cites the following statistics: “more than 500,000 people have been protected from malaria, 12,000 women have received microfinance loans, 5,000 farmers have increased their income by purchasing drip irrigation systems, and 11,000 families have bought life-saving de-fluoridation water filters.”⁷⁴

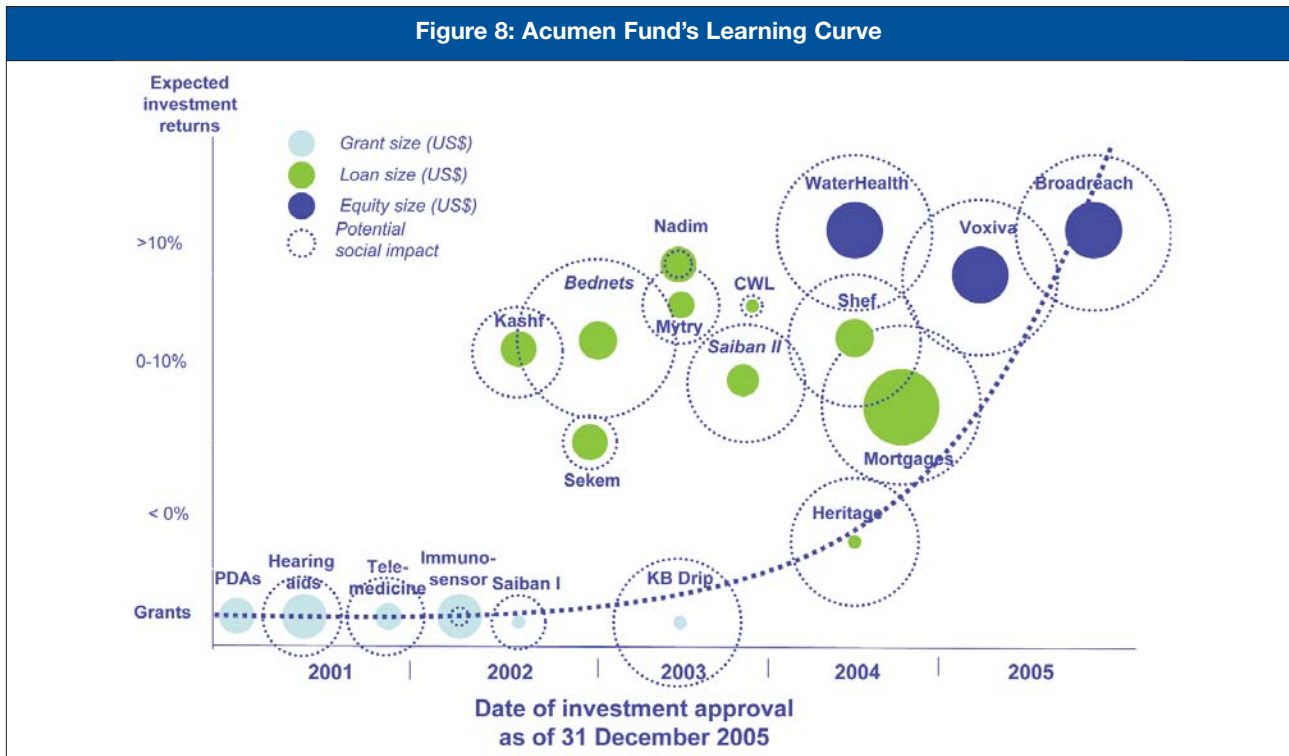
The following diagram (figure 8), available on Acumen Fund's website, maps the evolution of the organization's investment thesis as it moved from grant-making to blended value investing with significant expected financial returns. Furthermore, the diagram concisely presents Acumen's assessment of its social impact.

ProVenEx: Rockefeller Foundation's Diversified Blended Value Portfolio

Formed in 1998, Program Venture Experiment (known widely as ProVenEx) is the Rockefeller Foundation's experimental blended value portfolio created, in part, to explore how the foundation might advance its mission through investment vehicles other than grants. ProVenEx also explores how to scale up blended value investments while “building in accountability for social outcomes.”⁷⁵ All ProVenEx investments create value within the fund's areas of interest.

Building Blended Value Portfolios

Figure 8: Acumen Fund's Learning Curve



Source: Acumen Fund

ProVenEx's US\$ 13 million portfolio has been deployed in 12 investments spanning a range of investment vehicles, including equity, debt and loan guarantees, and investments are made directly or through financial intermediaries when appropriate. Two of the twelve investments have been international, representing five percent of the invested capital. Specific notable investments include early-stage investments in Ugandan and Kenyan companies, investments in community development venture capital, a real estate development serving low-income neighbourhoods in San Diego, California, and a loan and guarantee to scale up Calvert Foundation's Community Investment Note programme. Among its outcomes,

ProVenEx counts a liquidity event from its largest investment, significant loan repayments, the employment of over 1,600 people and improved seed supplies sold to 25,000 small farmers.

Funds such as Acumen and ProVenEx may not ultimately replace existing investor options, but they provide excellent examples of how investors can draw on the other tools and approaches outlined in this paper, combining them with one another and with other investment options to create value in multiple dimensions. Ongoing research will help explore how these and other investors are applying financing approaches to BVI—and the returns generated by such strategies.

ProVenEx Areas of Interest

- Creativity and Culture
 - Mechanisms to support creativity and open communication across diverse cultures
- Food Security: Focus on small farmers in sub-Saharan Africa
 - Ecologically sound strategies to increase stability of crop yields
 - Business investments to promote local industry for fertilizers, seeds and ancillary agricultural services (storage, grain handling, processing, etc.)
- Health Equity
 - Products and health services delivery models to address major diseases affecting poor people, including HIV, TB and malaria
- Working Communities: Focus on US inner-cities
 - Community-directed businesses that create jobs for local residents
 - Strategies to redress the imbalance of public funding to low-income school districts
 - Innovative mixed-income housing projects in US inner-city neighbourhoods

Source: Jackie Khor, ProVenEx Associate Director. "Background Information" presentation dated May 2005.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Of Opportunity and Risk

This paper has documented just some of the improving prospects for applying mainstream investing practices toward achieving social and environmental goals. Strategies such as microfinance and social enterprise, initially having been launched primarily with philanthropic support, are now approaching the status of “mainstream” investment opportunities for banks, foundations and high net worth individuals interested in doing well while doing good. For those who believe in the power of market forces and free enterprise—as well as the need to create a more just world—these are exciting times.

These transitions from philanthropic capital to financial investment capital are particularly unusual and even anomalous events in the history of capital markets. While investors may analyze and learn from the “non-profit to for-profit” transformation of hospitals as well as specific financing innovations such as the affordable housing tax credit, there are virtually no historical examples of wide-scale economic initiatives that began on a philanthropic (wealth *transferring*) platform and segued to a risk-oriented (wealth *creating*) platform capable of attracting private capital. In this nearly unprecedented situation, one must carefully re-evaluate the usual rules for gauging risk and return as they apply to this major capital markets transformation.

In the context of a blended value capital market, there is real risk and there is real return. However, to an outsider trying to determine whether or not to invest in or contribute to a microfinance entity or a for-profit social enterprise, the investment decision is quite simply not as straightforward as it would be for investors considering traditional investment opportunities. This complexity arises from capital markets that heretofore did not reflect the true nature of value; instead, they artificially broke value into components that over simplified the goals of creating value. Those capital markets corresponded to two very different sectors (one non-profit and the other for profit) that, of course, still exist today. Each has its own rules, regulations and relevant approaches to analysis. Nevertheless, value is a more complicated construct, and maximizing it with consistency will require that investors revise their rules for investing capital. They must be careful to combine the best aspects of philanthropic and financial investing, and they must be especially wary of combining the strategies in ways that obscure risks and jeopardize overall, long-term blended value creation.

Developments in financial instruments, portfolio theory, creative market-based problem solving, and their underlying conceptions of value are very encouraging. They should be supported, expanded and celebrated as being revolutions in thought and practice that create real value. At the same time, *it is critical to reflect on the risks present in any emerging market and to define what mechanisms should be in place to minimize those risks.* If efficient markets capable of attracting significant capital to blended value investments are ever going to emerge, would-be market participants must observe and address the characteristics that currently prevent the nascent blended value capital markets from functioning as efficiently as more established, efficient capital markets.

Many of the extraordinary projects documented in this paper—and so many other innovations not addressed herein—are, quite simply, in jeopardy. At this stage of development, blended value investing strategies are poised either to become victims of their own success or—with careful guidance—to emerge victorious as new waves of capital are prudently deployed in blended value investments. Should significant new blended value investments turn out to be founded on poor due diligence or faulty risk-management, those mistakes could sour the market for years to come. The collapse of any of the initial funds and investment instruments currently capitalizing the next stage of blended value investing would not only spell the end of that particular offering; it would make it extremely difficult for future offerings to find investors. The Chinese character for “change” is a combination of those for “risk” and “opportunity”, and such is the change in process.

Early financial failures would deal a significant setback to *all* those around the world who are attempting to bring new investment strategies to other emerging areas of economic development. Funds targeting small- and medium-sized enterprises in emerging economies, newly seeded renewable energy funds, community development venture capital funds, and many others have reason to be concerned and to ensure that early investment decisions are made wisely. This concern is not to say that mistakes cannot or should not be made. If the risk associated with these deals is appropriately priced and the markets are indeed efficient, some investors will lose money. These markets do not need to ensure that investors never lose money (doing so would distort the market in ways that would ultimately hurt value creation). Instead, the emerging market participants must ensure that every deal either succeeds or, in the

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

words of Tom Peters, “fails forward”. Participants do not need to prevent all losses of money, but they must avert the catastrophic failure that arises from incompetence, hubris or malfeasance.

Looking to the Future of a Blended Value Capital Market

For years the focus of a great deal of work has been upon the challenge of how to build the microfinance capital market—and many have worked to address that challenge. At the same time, another, broader question remains:

How do we create investment strategies that are bankable and socially valuable, capable of providing capital to microfinance, social enterprise, small- to medium-sized enterprises, community development finance and more?

Microfinance and other blended value creation systems share challenges in gaining access to mainstream capital flows, though each programmatic area stands in a unique position—its own particular distance from that ultimate goal. Nevertheless, a series of approaches, principles and concrete steps will help participants respond to the common challenges shared by everyone interested in applying financial investment strategies for social and environmental gain.

Defining the “Push” Investing Past and the “Pull” Investing Future

Several decades ago, the hundreds of millions of dollars initially needed to launch and grow microfinance were provided with little or no expectation of financial return to the initial investors. One might characterize this investment as a “push strategy,” driven by the suppliers of capital:

- It was pushed by donors, philanthropic organizations (foundations) and governmental organizations, which in turn created the MFIs to deploy the funds.
- They pushed capital into microcredit because of its remarkable ability to create sustainable microenterprises started and owned by the poor.
- Philanthropic investors pushed it with little initial regard for whether the capital would be returned and, in many cases, limited understanding of whether it had been well deployed.

And it has been a successful strategy!

These early individual and institutional philanthropic investments demonstrated that poor people in developing countries could “help themselves” in a sustainable manner. These early philanthropic “investors” played the role of risk-tolerant angel investors as they helped capitalize a new industry. Nevertheless, they differed from traditional angel investors in that they had no expectation of an eventual liquidity event that would provide them with not only a return of capital invested, but a return *on* capital invested—a reward for their assumed risk.

Now, contrast this “push” flow of capital with the typical risk-seeking capital flow, wherein instead of being pushed, risk capital is “pulled” into a deal by the demand for capital:

- Entrepreneurs and investment opportunities pull early investors into investments with upside financial potential, and there is an expectation of future liquidity events. Typically, venture capitalists do not create the enterprises they fund; instead, entrepreneurs approach them with opportunities (and most venture capitalists reject more proposals than they fund).
- The early successes are tempered by early losses.
- If early success is sustained and scaled, this condition pulls even more capital, and mezzanine investors buy out early-stage investors as a new capital market is created.

Where this system works well—and there are numerous examples—great wealth is created, and revolutionary businesses are born. Along the way, the providers of capital come to learn about the risks and returns associated with the new businesses and investment strategies in part because they expect, accept and analyze failed investments. Furthermore, the investment opportunities become more standardized and the emerging markets form the necessary infrastructure to facilitate future flows of capital.

In the rush and enthusiasm for creating new capital markets that support blended value systems, investors must not forget this axiom of investing:

Mainstream capital is not brave. It does not like going places where the rules are unclear or subject to multiple interpretations. It does not like to go where the expected returns are not calculated clearly and plausibly and where the risk is not fully detailed and explained.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Furthermore, mainstream capital does not flow to investments simply because it might have positive social impact. In fact, conventional wisdom suggests that pursuing financial return on investment (ROI) is agnostic at best and antithetical at worst to social return on investment (SROI). Blended value investing stipulates that investors *can* generate both types of value as an integrated, blended return, but it recognizes that investments must provide the reasonably predictable potential to generate financial ROI to attract (or pull) capital into deals in the first place. Without the potential for ROI that approaches the risk-adjusted market rate return, investments will be confined to philanthropic capital flows and will never have access to the much larger mainstream capital flows that have ROI as their highest priority. Importantly, such investments do not necessarily need to offer large ROIs; instead, it is crucial they have relatively predictable returns subject to well-understood risks. This mainstream capital currently is not flowing to blended value investments in large enough volumes, and the only way to pull it toward these investments is to structure them so that they can generate financial returns.

Blended value market participants must ensure that the present enthusiasm does not eclipse the tasks and disciplines required to build a functioning, efficient, liquid, self-correcting capital market that will provide ongoing, *sustainable* value for investors and entrepreneurs. The balance of this paper will present the core elements necessary for the creation of an effective, vibrant emerging market not simply for microfinance, but for the entire blended value arena made up of microfinance, social enterprise, for-profit social ventures and, indeed, any alternative financial offering that seeks to combine financial returns with social and/or environmental value creation.

Bringing such a global infrastructure into existence will not be easy. While this paper sets out a series of goals, the path to reach them is not clear, nor is achieving them at all assured. All practitioners need to assess what structures must be created and—perhaps more importantly—what business and investment principles must be maintained in order to achieve these goals. As explained later, these emerging markets require not only new and refined investment products and infrastructure, they also need participants to conduct their business with greater transparency, being more publicly thoughtful about failures and mistakes. A fundamental first step in building this infrastructure is for all potential investors in *any* investments that aim to generate both financial and social returns to vet each offering according to the degree to which the investment under consideration meets the relevant conditions described below.

A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

Creating an Emerging Capital Market Framework for Blended Value Investing

It is especially useful to examine the infrastructure of successful mainstream financial markets to evaluate the blended value capital markets' infrastructure. Mainstream financial markets work for both investors and those seeking new capital because they allow investors to evaluate potential investment risk/return objectively. Virtually any mature industry that has grown to scale and has attracted private capital has in place the following elements:

1. Common terminology
2. Transparency
3. Adherence to standard accounting practices
4. Regulation by third parties
5. Investment rating services
6. Fund comparison data
7. Insurance
8. Liquidity through secondary markets

Microfinance is the most well developed example of blended value investing. The industry has grown in 30+ years such that at this time it has millions of borrowers, thousands of lenders (MFIs), billions of dollars in loan portfolios, and countless donors and investors with a great deal of money looking for "investment" opportunities. Further, perhaps as many as 1,000 (an estimated ten percent of the total) MFIs are profitable in one way or another.

At first glance one might conclude that this industry represents a "breakout" – an industry delivering a true blended value return and doing so at scale. Upon closer examination, one must conclude that as good as it is, microfinance still has not developed the requisite infrastructure needed to attract mainstream capital.

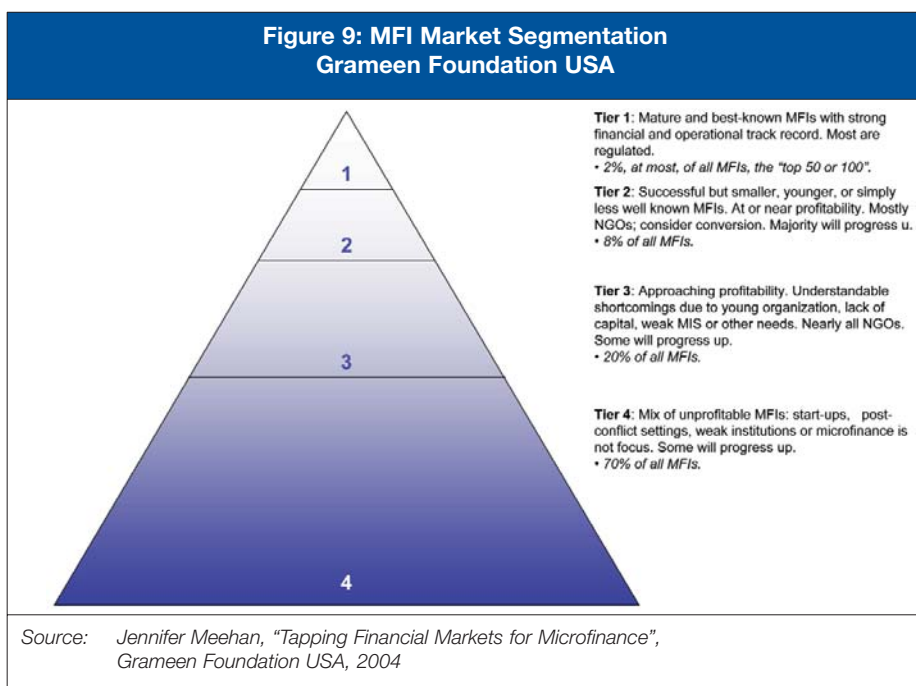
Tier-One MFIs and the Overall Market Critique

Microfinance experts segment the MFI market in a variety of ways, often referring to different "tiers" of MFIs, depending on their professionalism and financial health. (See figure 9 for one such segmentation.) Commonly, these experts distinguish about two percent of all MFIs as "tier-one", meaning that they have established track records, highly professional operations, healthy finances and,

often, many of the characteristics of commercial banks. Many are affiliated with ACCION, Grameen and other prominent MFI networks. Tier-one MFIs have developed significant scale and expertise in structuring capital to advance social and financial returns. Through both leveraging subsidies and loan guarantees effectively and by securing market rate capital, these groups and their peers have led the overall field in its development and expansion; they pioneered and disseminated microfinance's best practices.

At the same time, there are many more organizations—98% of all other MFIs—that may be pursuing (but are still lacking) many of the characteristics one would expect to find in formal capital market participants. The MFIs not included in the tier-one designation vary dramatically from one another, and the diversity in their business models, scale and financial health cannot be understated. While the Tier One organizations have succeeded in building networks and leveraging capital, they are not even close to the entire microfinance market. A vast majority of organizations both make up this larger market and fall well short of the operating capacities of tier-one institutions.

While some enterprises in microfinance and across the blended value investing universe do successfully exhibit market-leading characteristics, the state of the overall market lags those leading investments.



A Cautionary Conclusion: Maximizing Blended Value Returns by Embracing Market Fundamentals

The following section assesses the broad state of play within the blended value investing arena by focusing on the particular silo of microfinance. The critique of the broad field should not take away from the work and quality organizations that have been created by many individuals, nor should it be taken to apply to every MFI. Rather, *this assessment raises concerns about the overall state of the market and its implications for achieving real sustainable scale capable of tapping into mainstream financial service sectors.*

Market Characteristics Explained

1. Common Terminology: Any industry must be able to describe its inner workings to outsiders wishing to evaluate performance. Microcredit has done an admirable job of developing terminology and metrics that facilitate description and analysis of MFIs. Numerous industry descriptive manuals and financial models are available. Unfortunately, many of these descriptions and associated metrics were developed to identify, describe and quantify the subsidies that are available to non-profit MFIs. Most MFIs are still operating as not-for-profit entities today and, as such, account for their operating results using not-for-profit terminology, this language can be confusing if not misleading to potential investors, especially those who typically invest only in for-profit entities. For an investor to understand and evaluate the operational performance of a given MFI, there must be a clear delineation of subsidies and the role they have played and will play in the future performance of the MFI.

Even the contemporary measures of financial performance tend to evince MFIs' non-profit origins. *The Economist's* recent survey of microfinance makes this point clearly:

*"The foggiest place in the industry is 'on the ground' (another favourite microfinance term), where familiar words suddenly become oddly unintelligible. An item labelled 'profit' lets you keep mum about the losses transferred to a money-losing charity affiliate. An 'operationally sustainable' business is one that can pay for its running costs but not its capital, which is often the largest single expense for a financial firm. But the worst thing are the acronyms, which make learned analyses of microfinance next to unreadable. All this may sound trivial, but industry practitioners seem to care deeply."*⁷⁶

No matter whether those terms and acronyms are defensible or not, they clearly befuddle mainstream financial actors as represented by the authors of the article, whose statements suggest that microfinance's vocabularies make the industry appear parochial and quaint.

A second and more problematic issue with terminology is that no consistent and objective measure of impact is promulgated. As the capital markets develop and capital is "pulled" to microfinance, there should be objective standards by which investors can judge the social impact of their investment. Unfortunately, what passes for impact measures today is usually a simple tabulation of microborrowers served and the average size of their loans. Many MFIs have established their own impact measurement regimes, but there appears to be little successful effort to pull those measurement schemes into a single unified approach.

Opportunities for improvement:

- Commercial financiers and regulated MFIs could continue to develop a common set of terminology that reflects the language and assumptions of mainstream international capital markets.
- After MFIs have standardized their language around inputs and financial performance, foundations and other NGOs might sponsor impact-assessment studies by independent third parties and academic research professionals.

2. Transparency: As not-for-profits operating in developing countries, many MFIs have few public reporting requirements. The transparency of the industry is driven primarily by two factors: the decision of individual MFIs who voluntarily make their results public and the mandatory reporting performed by the MFIs that are regulated and therefore obligated to report results. Even with this level of transparency, rigorous evaluation of MFIs is difficult. MFIs in many parts of the world now voluntarily report results to industry associations and these results are aggregated and benchmarked. For investors wanting to analyze an MFI and to compare results to other organizations by size, geography, product, etc., the transparency issue is problematic.

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Organizations like the Microfinance Exchange (MiX) are working to increase outsiders' access to the characteristics and performance of MFIs, but that information is voluntarily provided and in some cases may not be current. While many MFI investment funds and MFI networks have detailed information about the MFIs with which they work, that information is not necessarily being shared and aggregated in any one place so that the MFIs' initial transparency becomes opaque.

Opportunities for improvement:

- Market participants can encourage efforts like MiX and related efforts.
- Investors and MFI networks can combine due diligence and isolated market intelligence from various actors, making them available through clearinghouses like MiX.

3. Adherence to Standard Accounting

Practices: Many MFIs operate as not-for-profit organizations, and many control wholly owned subsidiaries engaged in related endeavours. Furthermore, most MFIs are not audited, and those that are tend to use small, country-based auditing firms. While many such firms utilize International Accounting Standards (IAS), application of these standards remains questionable. For investors, this condition poses a problem.

Opportunities for improvement:

- Market participants can form a reporting standards-setting board like the International Accounting Standards Board used to determine generally accepted international accounting standards. Such a board can focus on fitting international accounting standards to microfinance instead of creating a new set of microfinance-specific standards.
- Any emerging accounting standards must incorporate means of tracking subsidies as well as their intended outcome.
- Individual investors and funds can then demand financial statements prepared in accordance with those standards.
- Lobbying in appropriate legislatures can ensure that the international accounting standards will fit the emerging regulatory regimes for MFIs.

4. Regulation by Third Parties: In the developed world, financial services businesses are regulated by governmental agencies. Alas, it is not often the case with MFIs. In the developing world there is often, at best, a loose regulatory framework either in place or under development.

The net result is that MFIs *function* as banks but are not *regulated* as banks. Such mandated performance requirements such as capital adequacy, liquidity, reserves, reporting, etc. are often either non-existent or ignored. MFIs tend to be viewed by their host governments as NGOs (non-governmental organizations) and are relatively free to operate as they wish with virtually no oversight. For investors this condition poses obvious risks.

This condition varies dramatically depending on MFIs' corporate structures. In some countries, NGO MFIs can make the same loans as can regulated MFIs, while the latter will be bound by much more stringent regulations than the former. Countries that do regulate MFIs have regulations that vary from one another dramatically (allowing or not allowing MFIs to raise capital in certain ways, promulgating different capital adequacy requirements, etc.), which forces potential investors to become experts in a variety of regulatory regimes.

The question of regulation is complicated by a number of factors. First, many MFIs are NGOs and therefore not regulated as financial institutions—but some are indeed regulated under other frameworks. Second, regulations differ from one country to the next (coordinating them would be overwhelmingly daunting). Finally, on a case-by-case basis, some of those regulations might be cumbersome and burdensome. In general it should be acknowledged that this is a significant issue being addressed by a number of actors.

Opportunities for improvement:

- Investors like ProFund can help MFIs convert to regulated MFIs.
- Market participants can support the creation of third-party international recommendations or templates for MFI regulations.

5. Investment Rating Services: Within mainstream capital markets, most investors are unable or unwilling to conduct the type of comparative analysis that leads to sound investment decisions. Instead, they rely on third-party credit rating entities such as Moody's, Standard and Poor's and others. The microcredit industry has not developed in a way that has prompted the development of independent rating agencies, a problem that may remain in place until MFIs and their associated financing deals grow sufficiently large to warrant the cost and attention of mainstream ratings agencies.

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Early investors did not expect a “financial return” on their philanthropic investments so they had no need for ratings. Microfinance agencies do exist, but unlike the large rating agencies, these microcredit-specific rating agencies look only at microcredit. Accordingly, mainstream investors see such agencies as lacking credibility, sometimes reporting in terms that do not coincide with those used in mainstream investing. As microfinance and related industries begin to attract funds from risk-seeking investors, this lack of rating services will pose significant problems for achieving meaningful scale. Furthermore, standardized and reputable rating agencies will lower the cost of investments’ due diligence, which currently exceeds the typical costs associated with initiating similarly sized investments in more mainstream markets.

Opportunities for improvement:

- Ratings services such as Standard and Poor’s, Moody’s and others must have incentives to enter this realm
- Local branches of some of these agencies have rated some MFIs (see ACCION affiliates section); their experience would surely be valuable in expanding the practice.
- Here, a “smart subsidy” or creative blended value investment would advance the cause if it could creatively encourage the mainstream ratings agencies to develop microfinance rating methodologies and to overcome the hurdle of scale.
- MFIs need to see value in being rated, and so financiers and foundations alike can give them incentives—in the form of a lower cost of capital or a subsidy to purchase the rating services—to be rated by an appropriate agency.

6. Fund Comparison Data: While there is some public information to allow comparison between MFIs themselves, virtually nothing exists to allow investors to compare the operating results of the increasing number of funds investing in MFIs. For a variety of reasons, these funds are likely to be the vehicles of significant capital flowing into microfinance. There are between 50 and 100 of these funds in operation today around the world—with more on the way. Virtually all of them are private funds and publish little to no public data. A prospective microfinance investor has little if any means of finding a complete list of funds, comparing their investment terms, and understanding their investment results and non-financial impact.

The MFI fund world is relatively small, with relatively few actors. Accordingly, the information on past funds should not be difficult to aggregate. Nevertheless, the relatively early stage of many of these funds (which have not fully repaid principal lent or have not liquidated equity investments) makes some of them hesitant to share data. A recent report published by CGAP aggregates data (as of 2004) on many foreign funds (though the data are not rendered for side-by-side comparison).⁷⁷ The report indicates that many of those funds shared investors. Some funds have been focused on keeping their investors through emotional appeal (characteristic of not-for-profit investors) instead of through a clear statement of performance and a comparison to the investors’ other options.

Opportunities for improvement:

- MFI fund investors need to invest on the basis of expected performance and should demand performance and comparison data.
- An independent group should study existing funds and assemble the data in a way that makes comparison easy.
- The industry would also benefit from a definitive forum (a *Wall Street Journal*, of sorts) in which fund managers can announce and promote new funds and where existing funds can report performance data.

7. Insurance: Most investors, or the funds in which they invest, are able to obtain insurance to help manage risk. The microcredit industry has yet to develop the scale necessary to interest the insurance industry. Accordingly, such things as foreign exchange risk, errors and omissions risks, directors and officer’s risk, asset appropriation risk, political risk and others are generally uninsurable. While there is some ability to account for these risks through aggressive underwriting and risk sharing within funds, most investors would appear to have few options and relatively little appreciation of the true relative risk associated with an investment in microcredit or similar offerings.

Opportunities for improvement:

- The small scale of MFIs (relative to mainstream financial institutions) will remain a barrier to creating these insurance products, but mainstream insurers operating in MFIs’ home countries may have the means and experience to offer such products.

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- Early iterations may need to be subsidized by other (possibly philanthropic) actors who might provide assets to underwrite policies that would be administered by the mainstream insurers.
- Ultimately, as the insurers learned more about the associated risks, mainstream underwriting capital would enter the market.

8. Liquidity through secondary markets: At the risk of stating the painfully obvious, for a true capital market to exist there must, in fact, be a market. Clearly, there is a primary microfinance capital market where equity is placed or loans made. From that point on, virtually all of the equity and debt invested in microfinance is simply illiquid. It can not be traded or sold freely among willing investors. This simple fact makes it very difficult for the average investor to consider taking a position. At present there is not even discussion among those in the microcredit industry on how or when a secondary market might develop.

Opportunities for improvement:

- The conditions above suggest that there is not yet the demand to buy microfinance investments on a secondary market; instead investors seem interested in investing their capital in new issues, in part because those new issues directly help poor entrepreneurs, while transactions on a secondary market would not.
- Spurring a secondary market when there seem to be no buyers would be a dubious prospect, and creating such a market place before it is demanded would amount to a new “push” investment strategy that would likely not bear fruit.
- Pushing MFIs and investments to adhere to the conditions enumerated above would help make a secondary market more viable and likely.

Implications for the Creation of a Blended Value Capital Market

Moving the entire industry in the direction of the tier-one institutions (and even beyond them) will be very difficult. Traditional market forces will certainly push some institutions in the right direction (indeed, those forces are already doing so, and they are bringing mainstream commercial banks in to microlending in many parts of the world). Nevertheless, subsidies—some with very legitimate social-value creating outcomes, and some with counter-productive outcomes—will prevent the entire sector from looking like those tier-one institutions.

At a recent conference on microfinance, Bowman Cutter, Managing Partner of Wall Street investment firm Warburg Pincus and Chair of the Board of microfinance fund Microvest, shared his perspective on the state of the microcredit capital market. Cutter spoke at length about the effort, time and resources expended to bring Microvest into being.⁷⁸ He observed that he and his colleagues created from scratch virtually all of their work; they had no templates or standard procedures to use as models. He observed that if every step toward building a microfinance capital market turns out to be as hard as starting Microvest, maybe the industry should rethink its strategy.

Fortunately, Cutter also provided real hope. He noted that he started in the investment banking profession more than 30 years ago. At that time, the profession was effectively in a start-up mode and that everything they did then was a “one-off” creation. He noted that today investment banking is a robust and very successful industry attracting and successfully managing billions of dollars annually and that microcredit feels like investment banking did 30 years ago.

The success of investment banking was built on a firm's appetite for capital and an investor's desire to put capital at risk. That situation exists today in the broad range of BVI investment opportunities. The microfinance business needs many billions of dollars to fund loan portfolios so that hundreds of millions of people can begin to create income and wealth and ultimately raise themselves from poverty. Similar demand for capital exists in the BVI segments that would fund affordable housing and community development, environmental protection, health, education and related services for the poor in all countries. As was the case in microcredit

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there are many case studies that could have been added to those in this paper to make the point that there are successful, hard-won interventions already in the market.

However, there are a number of steps that precede the creation of this blended value capital market.

Silos Versus Value Chains

First, blended value market participants, both investors and investees, must collaborate across their relative areas of interest (for example community development finance and banking actors could work more directly with microfinance practitioners to address common challenges). All should work to “come out of their silos”.

Silos breed isolation and the need of every organization in a given field of endeavour to do everything in virtual isolation. When applied to industries such as microcredit or community development, it means the major players within their respective organizations are both vertically and horizontally integrated. They build their organizations and attendant support structures. Because the connecting tissue that ties entities together into value chains is not present, they go about doing everything for themselves. They develop no set of core competencies that when paired with others with different core competencies allow the formation of a true network of firms all aligned in their purpose and relying on each others' strengths to add value to the end customer.

These value chains or collaborative networks are how business is done in the for profit arena. One need only look as far as a Wal-Mart, Boeing or Cisco Systems to see business models based, at their very foundation, on the assumption that networks add value; going it alone does not.

What are the implications of this for those interested in building a blended value capital market? Leaders in the various BVI areas could construct value chains, ensuring their organizations develop core competencies and distribute common work. What is more, they should reach out to existing players operating outside their BVI area and enlist them in this effort.

This is exactly what the Calvert Foundation did by going to the Depository Trust Company (DTC) to handle the clearing and holding of community investment notes. The foundation knew this service was vital to its business model. It also knew mainstream investors require such a service. Rather

than build an alternative or survive without it, Calvert Foundation created with DTC a value chain that added value for the customer. In reflecting on how the case studies presented in this paper evolved, one is struck by how often the successful initiative was characterized by the sponsor reaching out to others and building value chains.

Value chains are resource-conserving by design. A successful value chain involves bringing together the best firms in a way that minimizes overlap or redundancy. Who, exactly, benefits when redundancies are eliminated and the very best players are joined along a line where each is there because of a core competency? Quite simply, everyone. Scarce resources are preserved, firms are there because they add value in their areas of strength and investors get the best return because the customers get the best good or service at the best price. The value chain should become the model of how every BVI initiative is organized.

The second and concluding thought is that this process will take time—a lot of time—and will require the building of systems that are, today, not in place. The time is necessary because, at its most basic, building successful BVI initiatives capable of attracting and rewarding large amounts of capital is about changing culture—the culture of traditional financial services groups, NGOs, foundations and other participating entities structured to address the needs of either for-profit or non-profit actors. Conceptually and technically, it really is not hard to imagine microcredit or affordable housing or community development being able to arrange themselves into competitive value chains. In most cases the leaders of the various BVI segments have a foot in each world, the economic and the social. Their employees, boards and stakeholders expect them to be mission-oriented yet financially successful. That is very hard to do and requires that culture change to accommodate the needed alteration in mission execution.

But if it will be hard for the operators of BV endeavours to change culture, imagine how hard it will be for investors. The dominant culture asserts that one cannot mix mission with money. Even the socially motivated investor merely winks at the notion that a very well-run microfinance institution can address poverty and earn a respectable return on investment. They hear the story and see the pictures but suffer a cognitive dissonance. This dissonance is, of course, what led the founders of the microcredit industry to initially approach philanthropists.

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A Progression of Investors

Many critiques of microfinance-backed assets address barriers to the widespread adoption of those securities by institutional and other mainstream investors. While emerging blended value capital market participants must not forget this investor segment is its long-term goal, it would be wise to pursue a systematic plan that will bring these investments ever closer to that mainstream investor pool by targeting other strategic investors who can help advance the cause.

Most institutional investors require a defined asset class (wherein the securities bear a certain uniformity of structure so that the securities' behaviour can be better understood if not predicted). Most mainstream market participants would assert that most blended value investment products can not yet be considered legitimate members of an asset class. In spite of the recent and effective productization of microfinance bonds, the issues remain too different, there remain too few of these securities, and they have existed for too little time for financial analysts to understand their aggregate behaviour.

Furthermore, institutional investors with fiduciary responsibilities will often not even invest in a new fund or investment product in the mainstream capital markets. Typically, professional investors will avoid fund managers and funds that do not have a demonstrated multi-year track record of managing that particular investment with that particular investment style. They do so because they need to build the expected performance of any given investment into sophisticated asset allocation and portfolio models. As long as such quantitative models are built on historical performance information, such investors will need to wait for years until blended value securities can reach sufficient scale and can generate several years of performance data. This condition is a factor of time and it cannot be accelerated.

Instead, market participants offering blended value investments can target other investors strategically (as indeed many already have). Currently, it is a rare blended value investor who can construct a reasonably diversified portfolio even of microfinance-backed investments. To do so, investors must have sufficient capital (in the tens if not hundreds of millions of dollars) to dedicate to such a portfolio, and they must have a dedicated staff that can research potential deals and can thoughtfully assemble it.

Thus far, many of these investors have been development banks and foundations that have both the scale of investment and staff to effect it. This condition leaves high net worth individuals—those with limited staffing resources and a desire to deploy capital in the hundreds of thousands to the low millions of dollars—limited options for blended value investing. As more and more such investors express interest, there may be a place for investment funds that can syndicate high net worth individuals' investments and then place those funds into a well-diversified portfolio of blended value investments. Such intermediaries could help these investments get “pulled” closer to mainstream investments by making them accessible to the next stage of investor (after the way has been blazed by development banks and foundations). If these financial intermediaries build properly diversified portfolios, they will be able to sustain the occasional inevitable losses on individual investments.

When high net worth individuals can buy blended value investments, they will eventually and increasingly ask their professional wealth advisers to incorporate such investments into their overall portfolios. Those advisers, in turn, will bring a new set of mainstream capital resources to bear on these emerging investments as they research and analyze these new investments.

Accordingly, blended value market participants should continue to focus on “socially responsible investors”, individuals who would purchase blended value investments first because of their expected SROI and second because of their expected ROI, because those investors can help these asset classes establish a track record and because they can bring additional resources to bear on the analysis of such assets. Nevertheless, in doing so, advisers and investors must diligently focus on the fundamentals and risks of such investments as though they were purchased purely for their expected ROI.

Failing Forward

In any market, particularly an emerging market that has few precedents, there will be occasional imbalances of supply and demand. At times prices will be too high, and at other times they will be too low. As the markets learn to price risk and digest market and non-market events, prices will likely swing; some people will make money, and some will lose. The blended value capital markets must anticipate this sort of volatility and must face it without avoiding it.

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Market participants should structure their investments so that market shocks engender market corrections, not market collapses. Keys to doing so are diversification (at least in terms of geography, financial instrument and fund managers) and conscious risk mitigation. As mentioned elsewhere in this study, foreign exchange risk remains largely unmitigated in many international blended value financing strategies. Drastic currency devaluations have the potential to destroy returns and collapse private-investor-supported markets for international lending unless market participants can develop facilities to understand and begin to manage foreign exchange risks.

Fortunately, a number of such initiatives are under development. Investment advisers such as Omrix and others have been at the forefront of advancing such foreign exchange hedges where they have not existed in the past.

Furthermore, open communication about investment methodologies, pricing, failures and equity-holders' profits will be essential to pricing these blended value investments correctly. Keeping the data private introduces the chance that other funds will erroneously price risk. When substantial capital enters (or fails to enter) a market based on mispriced risk, that market is prone to dramatic failure. Markets cannot accurately price the risk associated with their securities unless they openly explore failures as well as successes.

Investors must also be exceedingly rigorous about entering and exiting investments. They must be especially careful to understand how the drive to create SROI can affect an inclination to enter ill-advised investments and their decisions to exit (or not exit) underperforming investments. Investors must have the fortitude to take losses and cut off investments that are not obviously salvageable.

The emerging blended value capital markets simply cannot afford for participants to be secretive about their data, ashamed of their failures, or fragmented in their terminology.

Conclusion

This paper explores various capital structures that have successfully been used to finance microfinance, community development and related areas. We suggest these blended value investing practices be extended to other value-generating projects or sectors. It must be stated that such a progression will not be easy, swift or painless. Microfinance has the benefit of over 30 years of refinement—a three-decade head start on other blended value investments. Furthermore, microlending itself has some very appealing characteristics that are not necessarily shared by other blended value strategies. The fundamental economics of microfinance are so strong because they are built on many loans to many people diversified across business sectors. Given that those microentrepreneurs are operating in predominantly cash-oriented economies, often times providing essential goods and services, they are somewhat insulated from macroeconomic fluctuations. Furthermore, those entrepreneurs can shift their businesses very quickly, exiting and entering new business areas as conditions dictate.

Other potential blended value investment vehicles may not possess such appealing risk-reward fundamentals. Accordingly, investors and intermediaries will need to structure and price investments such that they account for those unique risk characteristics. Microfinance's lessons cannot be applied wholesale and unthinkingly to other blended value investment systems. Nevertheless, the market participants aiming to bring new capital flows to low-cost housing, small scale irrigation, and so many other systems can and should learn from the laborious 30+ year journey that microfinance and its capital markets have undertaken. Undoubtedly, much can be learned from careful research into the major microfinance innovations that led it from a philanthropically supported enterprise to one supportable by mainstream capital. Building upon the great strides made by those within microfinance and community banking, sustainable financial innovations hold the promise of expanding into countless areas of both social need and market demand.

Appendix A: Other Notable Developments in Microfinance

Dramatic Expansion of Services

Over the past decades, MFIs have grown in scale and travelled around the world, and today many offer an ever-expanding array of services. In many cases the infrastructure created to establish and service microcredit may be leveraged across many different services and programmes. Grameen Bank, one of the oldest and most established microfinance institutions, has dramatically expanded its services, to the great benefit of the people whom they serve. Grameen has extended its technical know-how to offer many additional services through a loose network of affiliated companies, which it calls the “Grameen Family of Enterprises”, which includes education, telecommunications and textile manufacturing enterprises (among others).

Savings and Equity for MFI Customers

As MFI clients become increasingly financially self-sufficient, many MFIs have encouraged and facilitated savings and deposit programmes. Furthermore, some MFIs are now exploring financing structures that allow clients to purchase equity in the MFI.

Early microfinance efforts focused only on loans, and many MFIs handled savings clumsily. Some people even perceived that the poor might make viable borrowers who could not be effective savers. The problem was further compounded by regulations in many markets where MFIs operated. Many states regulate financial institutions that can accept deposits in order to protect savers and investors and many MFIs began (and many still are) as not-for-profit or informal entities, which in many cases precluded them from accepting deposits.

As MFIs have refined their lending models and moved toward greater financial sustainability, many have become formalized and regulated so they can accept their borrowers’ savings deposits as well. Accepting and then managing deposits often calls for the development of a new set of competencies, but those MFIs that can learn them and institute savings and deposit programmes offer their clients vital services while gaining a potential source of low-cost capital that can be re-lent to other borrowers.

MFI Networks

Established networks of MFIs spread best practices and offer technical assistance, increased visibility, and public validation for established and emerging MFIs alike. For investors in MFIs, the networks can begin to establish relationships between holders of capital and potential investees. MFI networks are often geographically specific and can give an MFI investor exposure to specific markets. Services offered by MFI networks to their constituents vary widely, especially as they pertain to potential investors. Some MFI networks seed MFIs in new markets with capital and expertise, thus creating themselves as networks, while some generate the affiliation after the constituent MFIs.

The Formal and Informal Banking Sectors Converge

As the services offered by MFIs increase and the institutions’ clients improve their financial status and require more formal banking products, many MFIs are moving “up-market”. As the scale of their financial products increases, the nature of those products also tends to increase. Existing customers will establish personal credit records—and more significant sources of income—permitting MFIs to offer loans with any source of social collateral. As the upwardly mobile MFIs provide banking products that resemble those of a typical consumer bank in the developed world, their costs tend to fall as well.

Meanwhile, major local and international banks have observed the opportunities in microfinance, with many now moving “down-market” by offering financial products to people who were previously “unbanked”. It should be no surprise, then, that many banks have established partnerships with MFIs who have developed the expertise and hold the knowledge required to service the informal sectors on a financially sustainable basis.

Adoption of Technology

Technological advances are beginning to reduce the expense of servicing microloans, which in turn has the potential to make new lending models available. Beyond financial management information systems (MIS), many MFIs are now using technology developed for established, mainstream financial service firms.

Appendix A: Other Notable Developments in Microfinance

Share Mircofin Limited and Smart Cards

In collaboration with Venture Infotek, an Indian corporation that provides payment transaction processing solutions to banks and related businesses, SML has integrated smart-card processing into its core lending business. The programme's pilot issued smart cards that could track multiple accounts. These cards store the clients' personal data along with details about their loans. Handheld terminals used by SML staff update the information stored on the cards, print paper receipts, track changes in the clients' status, and store the data, which is ultimately up-loaded to SML's central enterprise systems.

SML summarizes the programme as follows:

*The programme is a smart-card-based, integrated payment solution designed for automated loan tracking with integrated features like risk management, automatic loan application scoring, on-the-spot updating of loan records, on-the-spot repayment, customized MIS reports, automatic late payment/penalty calculation, zero fraud tolerance, true "anytime-anywhere" loan reconciliation, identity management, low cost of entry and easy-to-learn interface.*⁷⁹

The MFI's early assessment of the programme deemed it a success: "The new system has reduced the time of centre collection by 60-75% and branch records updating by 80-90%. This would help in a long way in increasing efficiency of the entire operations [sic]."⁸⁰

Hewlett-Packard's Remote Transaction System (RTS)

Developed in concert with several MFI networks, HP's RTS deploys "a combination of wireless technologies, smart cards, standards-based software, commodity PCs and business processes" to enable MFIs to gain access to rural communities.⁸¹ Like the SML pilot, HP's 2004 pilot project used smart cards and hand-held readers to increase the efficiency of processing microloans. HP's hardware and software were designed specifically for flexibility, durability, simplicity and scalability. Lessons learned include the following:

- Business process improvement is as important as technology innovation;
- High-level management buy-in and ownership across the organization are necessary for success;
- Scale at an industry level will require standardization and shared infrastructure in addition to competition.⁸²

MFI Standards, Rating and Auditing

Through technological innovation and business process improvement, the microfinance sector is growing to a significant scale. As practices are refined, costs fall, and scale increases, potential investors and practitioners alike have moved to increase transparency and standardization of MFI practices and performance, though much work remains to be done.

The Microfinance Rating and Assessment Fund

The Microfinance Rating and Assessment Fund was founded in 2001 by the Inter-American Development Bank (IDB) and the Consultative Group to Assist the Poor (CGAP). The Fund co-finances ratings and assessments of MFIs through independent, professional ratings agencies. The reports, which the Fund makes publicly available on its website, assess credit and other risks associated with the different institutions.⁸³ Information on the Fund's rating partners is also available.⁸⁴

The MIX

The Microfinance Information eXchange (MIX), was founded in 2002 to disseminate information on the microfinance markets and ultimately to encourage standardization and transparency by providing detailed information on MFIs, their partners and investors.⁸⁵ MIX has two primary products, MIX MARKET, a Web-based information clearing house, and MicroBanking Bulletin (MBB),^{86, 87} a source for microfinance performance benchmarks. Additional lists of rating agencies may be found at the Global Development Research Center.⁸⁸

Other MFI-Specific Ratings Institutions

Within the MFI sector, a number of MFI-rating entities have arisen. Many of them seem suited primarily for internal industry use. Drew Tulchin, of Grameen Foundation USA, writes of these microfinance-specific ratings: "Although these efforts do increase transparency and standardization, they also obscure ready analysis by outsiders. Evaluation tools are increasingly specialized, thus decreasing comparability with other development or investment choices."⁸⁹ Tulchin continues to observe that many existing MFI metrics (average loan size, number of clients and others) do not address the needs and interests of potential investors.

Despite these drawbacks and while various rating methodologies seem to abound—some doubtlessly better than others—on the whole, these rating methodologies and agencies represent the early steps needed to create internationally recognized ratings agencies on a par with a Standard and Poor's, Moody's or other mainstream ratings houses. Such advances will be critical to achieving the level of transparency required to create a truly liquid capital market.

Appendix B: A Glossary of Blended Value Investing Terms

Compiled by Shari Berenbach of Calvert Foundation with Jan Piercy of ShoreBank

Alternative Investments: Term used by religious investors for the last twenty to thirty years to refer to private investing with social goals. This should not be confused with the more conventional finance use of this term which refers to non-liquid financial instruments and classes such as commodities, private equity, oil wells, real estate, etc.

Blended Value Investing: A term first coined by Jed Emerson, this approach recognizes that value is non-divisible and naturally incorporates social, ethical, environmental or charitable elements. The concept of blended value has many implications for both organizations and capital managers. In the context of this paper, blended value investing encompasses all classes of investments pursuing such multiple goals, including socially responsible investments and private investment for social goals. See, "The Blended Value Map" by Jed Emerson, et. al. at www.Blendedvalue.org for additional papers and materials on corporate social responsibility (CSR), socially responsible investing (SRI), social enterprise and sustainable development, and how each of these arenas fit within a broader, value maximizing worldview.

Community Development Venture Capital (CDVC): Funds that extend early stage equity financing or quasi-equity investment products into small enterprises typically owned and operated within disadvantaged communities. Some US\$ 600 million has been invested in diverse funds in the US and abroad. Many US funds are members of the Community Development Venture Capital Alliance. A relatively recent financial strategy to promote community development, most CDVC funds have not completed an investment cycle, exited or distributed returns to their investors.

Community Development Financial Institutions (CDFIs): A term used for community-based financial intermediaries with a principal mission to service low-income populations. CDFIs are certified by the CDFI Fund, a US Department of Treasury programme. Some CDFIs are for-profit, regulated community banks and credit unions, while others are non-regulated, non-profit loan funds. Community development venture capital funds also qualify as CDFIs.

Community Investment: Term popularized by the US socially responsible investment industry to refer to direct investment into community-based intermediaries with the objective of benefiting disadvantaged communities. Many community investment options are relatively low risk, such as deposits in regulated CDFIs or notes into community-loan funds. Typically these instruments provide a less than risk adjusted financial return. In recent years, community investment has begun to incorporate higher risk sectors such as community development corporations, social enterprises and community development venture capital. Returns from these newer market segments are less predictable. Approximately US\$ 13 billion has been channelled to community investment intermediaries in the US.

Ethical Investments: More commonly used in Europe and the United Kingdom, ethical investing is broadly similar to socially responsible investing (see below). Investors incorporate ethical considerations into their investment process, rely on "reflexive" strategies such as screening and shareholder advocacy, and seek market rates of return.

Financial Intermediary (FIs): Financial intermediary or financial institution such as a finance company, development finance corporation, commercial bank or other kind of financial institution providing financial services to small- and medium-sized enterprises or other sectors.

Grassroots-based Business Organizations (GBOs): A term recently popularized by the International Finance Corporation, GBOs may be privately-owned small- and medium-sized enterprises or those owned and operated by non-profits that involve local production and/or marketing and distribution channels. GBOs typically combine profitability objectives with private sector strategies that benefit local small producers.

Microfinance Institutions (MFIs): Typically associated with local financial intermediaries in developing or transitional economies, MFIs provide very small loans to informal sector microenterprises. Microfinance institutions may be non-governmental organizations, specialized regulated financial intermediaries or full commercial banks and some provide financial services to small businesses in addition to microenterprises. In most instances MFIs connote a distinct stand-alone financial intermediary, but in other instances they may be a department of a larger commercial bank or development programme.

Appendix B: A Glossary of Blended Value Investing Terms

Programme Related Investments (PRIs): A term defined by the US tax authorities, PRIs are investments made by a philanthropic institution with the primary objective of furthering its mission. Most programme related investments are structured as below-market loans or long-term equity investments into development finance intermediaries or non-profit social enterprises.

Private Investment with Social Goals: A term coined for this meeting, this refers to investment of capital to **promote** a specific social or environmental agenda. Private Investments with Social Goals includes blended value investing that incorporates financial instruments offering both market rates and below-market rates. Different from socially responsible investment that reflects investor values, these investments **promote** social impact.

Shareholder Advocacy: A common strategy among socially responsible investors, this entails proposing shareholder resolutions and/or proxy voting in order to influence corporate policies in favour of social objectives.

SMEs: Small- and medium-sized enterprises typically served by local commercial banks in developing or transitional economies. Some MFIs have gone up-market to reach SMEs and some financial intermediaries that historically serviced SMEs are now downscaling into the MFI market.

Social Enterprise: Social enterprise typically refers to non-profits or non-profit-owned subsidiaries that incorporate commercial discipline within their operations and seek to generate a surplus (e.g., profit) that is returned to the non-profit owner to support its mission.

Socially Responsible Investing: Socially responsible investing is the broad term used to describe investments that **reflect** investors' moral and ethical beliefs. SRI instruments are typically publicly traded funds that return to investors market-rate, risk-adjusted financial returns and are exemplified by socially responsible mutual funds such as Calvert, Domini, Pax World Fund, among others. Socially responsible investing usually incorporates screening of investment companies and shareholder activism through proxy voting. SRI investment strategies in the US represent more than US\$ 2 trillion or approximately one in eight dollars invested. The Social Investment Forum in the US recommends that all SRI Investors also engage in community investment – (see Community Investment).

Social and Environmental Screening: Negative screening entails the practice of screening out of investment portfolios financial instruments issued by companies with deleterious social and environmental impacts. Positive screening involves selecting for inclusion in portfolios instruments issued by companies with business practices that result in positive social and environmental impacts. Screening is typically associated with socially responsible investment.

Social Venture Capital: This refers to venture capital that seeks to attain social and/or environmental value **as well as** financial return, incorporating early "angel investors" as well as more conventional stage venture capital. The types of social objectives pursued range from environmental, alternative lifestyle, healthy products, etc. Most social venture capital funds seek competitive market returns and do not explicitly strive for poverty alleviation or social justice goals associated with community development venture capital (see above.) The US-based Investors' Circle is a well-known association of professionals engaged in social venture capital.

Triple Bottom Line Investing: Triple bottom line investing returns to investments that seek to generate social, environmental **and** financial returns. Triple bottom line investing is closely associated with "reflective" investment strategies associated with socially responsible investing.

Venture Philanthropy: This form of grant-making is distinguished by the high level of involvement by the donor and larger, longer-term grant-making associated with performance goals. Venture philanthropy may entail support of social enterprises owned by non-profits and/or other more conventional non-profit activities. Although financial terminology may be used by grant-makers to underscore a business-like approach, venture philanthropy should not be confused with community investment. Funding is provided on a grants basis; there is no expected financial return.

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Endnotes

- ¹ Excellent resources that explore the current state of the microfinance sector include the International Year of Microcredit website, <http://www.yearofmicrocredit.org>, the Microfinance Gateway, <http://www.microfinancegateway.org>, and the Microfinance Information eXchange, <http://www.themix.org>.
- ² Meehan, Jennifer. "Tapping Financial Markets for Microfinance". Grameen Foundation USA (GFUSA). 2004. This report presents a comprehensive assessment of microfinance institution access to capital markets, including a discussion of the obstacles to the practice. This and other publications can be downloaded from GFUSA's website: http://www.gfusa.org/newsroom/books_and_publications.
- ³ Ibid.
- ⁴ This section draws significantly on conversations with Maria Otero, CEO of ACCION International, and Elisabeth Rhyne, Senior Vice-President of ACCION.
- ⁵ This section and the one that follows it summarize information presented in: Lopez, Cesar. "Microfinance Approaches the Bond Market: The Cases of Mibanco and Compartamos". *Small Enterprise Development Journal*. Vol. 16, No. 1. March 2005.
- ⁶ A basis point is 1/100 of 1%. The measure is typically used in reference to bond yields.
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- ⁸ Ibid, p. 12.
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- ¹⁰ Global Partnerships. <http://www.globalpartnerships.org>. December 2005.
- ¹¹ Investment advisers and sponsors were engaged in the private placement of this particular deal when this paper entered editing; accordingly, the advisers have asked that the fund not be identified here.
- ¹² The authors gratefully acknowledge Jonathan Lewis of MicroCredit Enterprises who articulated this point in interviews cited later in the document.
- ¹³ One must not assume that a lack of financial return to capital market investors necessarily indicates wasteful or inefficient microfinance administration. While indeed inefficiency may destroy the potential returns, there may also be legitimate social value creation strategies that are not compatible with generating returns to investors. More data and transparency about MFI operations are required for investors to develop a deeper and more nuanced understanding of how administration costs and social value creation in various circumstances can influence financial returns.
- ¹⁴ This case study draws significantly on conversations with Harlan Mandel, Deputy Managing Director of Media Development Loan Fund, and with Shari Berenbach, Executive Director of Calvert Social Investment Foundation.
- ¹⁵ Reprinted from the Calvert Foundation case study.
- ¹⁶ For additional details, please see <http://www.time.com/time/europe/magazine/article/0,13005,901041227-1009841,00.html> and <http://www.mdlf.org/look/mdlf/article.tpl?IdLanguage=1&IdPublication=20&NrIssue=1&NrSection=70&NrArticle=793>.
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- ¹⁹ Ragin Jr, Luther. Presentation at Stanford University Graduate School of Business. 25 October 2005.
- ²⁰ This case study draws significantly on conversations with Cedric de Beer, Managing Director of Nurcha, and with Stewart Paperin, Executive Vice-President of the Open Society Foundation.
- ²¹ Founded in 1996, the resulting programme is called the National Housing Financing Corporation. Wholly owned by the South African government, this financing intermediary facilitates mortgage lending to low and moderate income families.
- ²² The Open Society Institute's Mission: "The Open Society Institute (OSI), a private operating and grant-making foundation, aims to shape public policy to promote democratic governance, human rights, and economic, legal, and social reform. On a local level, OSI implements a range of initiatives to support the rule of law, education, public health and independent media. At the same time, OSI works to build alliances across borders and continents on issues such as combating corruption and rights abuses." More information on OSI can be found at <http://www.soros.org>.
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- ²⁶ This case study draws significantly on conversations with Jonathan Lewis, CEO of MicroCredit Enterprises, LLC, and with John Ferguson, a partner resident in the New York office of Goodwin Procter LLP.
- ²⁷ MicroCredit Enterprises. Comprehensive Informational Memorandum. Edition No. 4, September 2005.
- ²⁸ Such as Freedom from Hunger, Grameen, ACCION, Pro Mujer, and Unitus.
- ²⁹ This case study draws significantly on conversations with Camilla Nestor, Growth Guarantees Manager at Grameen Foundation USA.
- ³⁰ Citibank, it should be noted, has made significant public commitments to microfinance. Coverage in the business press includes mention in "The Hidden Wealth of the Poor: A Survey of Microfinance". *The Economist*. 5 November 2005.

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- ³⁴ Merrill Lynch. "Leading Institutional Investors and Development Agencies Launch the Global Commercial Microfinance Consortium; Landmark Global Collaborative US\$ 75 Million Fund for Micro-Entrepreneurs". Press release. 3 November 2005. http://www.merrillynch.com/?id=7695_7696_8149_46028_50022_50023.
- ³⁵ Ibid.
- ³⁶ NGO Transparency International reports on the state of corruption in various parts of the world. Its corruption-tracking indices can be found at <http://www.transparency.org/surveys/index.html>. Various other useful resources are available on the organization's website.
- ³⁷ The Development Data Center of the World Bank in Washington, DC publishes a book called *World Development Indicators*, which presents information on various countries' business environments. From those data, one could begin to assemble an understanding of different countries' bureaucratic environments.
- ³⁸ Community development investing deploys capital in a given location with the intention of strengthening communities by enhancing economic opportunities, increasing civic engagement and developing community assets.
- ³⁹ Community Development Venture Capital Alliance. <http://www.cdvca.org>.
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- ⁴³ Solstice Capital. <http://www.solcap.com>.
- ⁴⁴ Investors' Circle. <http://www.investorscircle.net>.
- ⁴⁵ This case study draws significantly on conversations with Alex Silva, President of Omrix SA and CEO of ProFund.
- ⁴⁶ By February 2006, ProFund had exited all of its investments but had not yet collected on three of its liquidations. One such delayed collection included a tax reimbursement from the government of Columbia. The fund's management contract with Omrix had expired, though the management company continued to provide collection services on an as-needed basis. Silva estimated that the fund would complete final distributions to shareholders by mid-2006.
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- ⁵¹ ProFund's experience during these emergencies led to the creation of the Emergency Liquidity Facility (ELF), also administered by Omrix. ELF summarizes its value proposition as follows: "The Emergency Liquidity Facility (ELF) is a Fund located in San Jose, Costa Rica with operations throughout Latin America and the Caribbean. ELF has more than US\$ 10 million available to assist in emergencies. ELF was created with the participation of bilateral and multilateral institutions, as well as private investors. ELF's purpose is to serve as a lender of last resort to microfinance institutions (MFIs) affected by natural disasters or man-made crisis". http://www.emergencyliquidityfacility.com/index_eng.php.
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- ⁵⁸ Recognizing that MFI managers have few financing options for such management buy-outs, Omrix has launched the Antares Fund, which will help provide capital for such transactions.
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- ⁶³ This case study draws significantly on conversations with Jan Piercy, Executive Vice-President ShoreBank Corporation, and with Paul Christensen, President and COO of ShoreCap Management.
- ⁶⁴ This case study draws significantly on conversations with: Gillian Arthur, Operations Head of Actis; Jonathan Bond, Managing Partner of Actis; and Amber Nystrom, Executive Director of Social Fusion.
- ⁶⁵ Social Fusion is a San Francisco, California-based incubator of social entrepreneurs and ventures working in emerging markets. More information about Social Fusion can be found at <http://www.socialfusion.org>.
- ⁶⁶ SustainAbility, International Finance Corporation and Ethos Institute. "Developing Value: The Business Case for Sustainability in Developing Markets". London: SustainAbility, 2002. http://www.sustainability.com/downloads_public/insight_reports/dev_value.pdf.
- ⁶⁷ Social Fusion introduces the roundtable events as follows: "The primary focus for this series of invitational investor roundtables is to consider exceptional equity investment opportunities in emerging markets. Invited participants include individual and institutional investors who are decision makers interested in considering emerging market investment as a financial strategy; and as a means to build sustainable, positive impact on a global scale. Specifically, our goals for each session are to: build targeted market feedback about equity investing in emerging markets, strengthen relationships and engagement between key investors, financial intermediaries and institutions to promote market development and more efficient capital flow, and produce increased investments and capital flow into emerging markets." Social Fusion.
- ⁶⁸ Like many private equity funds, Actis has a substantial minimum investment. For the funds it was raising in late 2005, the minimum investment was US\$ 5 million.
- ⁶⁹ <http://www.vantagep.org/>
- ⁷⁰ <http://www.endeavor.org/>
- ⁷¹ For additional information on Unified Investment Strategies, please see The Investors' Toolkit, by this author, et al, at www.blendedvalue.org and review the information on the Heron Foundation's website, <http://www.fheron.org/>
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- ⁷⁸ Microvest serves as a financial intermediary for MFIs. It manages a fund that invests in MFIs by means of debt, equity and other similar investment structures. More information can be found at <http://www.microvestfund.com/index.html>.
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