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The Role of Private Equity: Fueling the Growth of Microfinance



Credit: Michael Sutto

Cover Story

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

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

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Liability Planning: How can Investors and MFIs Navigate Funding Options and Devise Strategy?

The growth in commercial microfinance investment has led to MFIs being able to choose from several funding options. However, what MFIs lack are the tools for evaluating their choices in ways that capture all the implications of a particular funding decision. Investors on the other hand need to be able to make sound investing decisions based on the knowledge of a particular MFI's liability planning. In this article Sonia Mukhi explains how investors and MFIs can work together to fill in gap.

The Need for More Sophisticated Planning

Financial institutions in the developed world have relied on highly sophisticated systems and models to capture the risk of liability and debt mismanagement. While the current state of the world economy brings to question some of these techniques, the ability to bring transparency to the liabilities on a balance sheet is important for any investor. Consider for example, the initiative by the United States Treasury and Federal Reserve to “stress test” the largest banks in the US. The logic behind this type of exercise is, of course, to determine what amount of capital would be needed in the worst kind of economic conditions, and how these institutions would fare under a variety of different scenarios. By broadening the assumptions of what can happen and the needs under each set of circumstances, an institution can more confidently plan its capital and funding strategy.

Microfinance institutions (MFIs), by and large, do not have access to sophisticated risk management tools. Beyond this, MFIs generally do not engage in scenario analysis or other techniques to more effectively manage liabilities against conditions of volatile currency and interest rate markets. In the July 2008 edition of *Microfinance Insights* (“Foreign Exchange Risk: The Onus of Hard Currency Debt”), Matthijs Egelie and Nico Mensink, stated that “with improved access of MFIs to international capital markets in

recent years, FX risk from funding local currency assets with US dollar-denominated debt has increased significantly.”¹ This trend, in the context of the currently volatile foreign exchange (FX) and interest rate markets, has further created the need for better liability risk management. However, MFIs often do not understand the risks they take on with their unhedged FX exposure, and the impact their funding decisions can have on their credit profile. While this problem is prevalent, MFIs do not currently have proper access to tools and education that would instill liability planning best practices into their operating infrastructure.

“From an investor’s perspective, an MFI’s ability to plan its liabilities is paramount in the selection criteria used to evaluate potential investments. Therefore, it is important that the investor pay attention to the strategy or (lack thereof) behind the MFI’s funding composition.”

Investors and MFIs Working Together

From an investor’s perspective, an MFI’s ability to plan its liabilities is paramount in the selection criteria used to evaluate potential investments. Therefore, it is important that

the investor pay attention to the strategy or (lack thereof) behind the MFI’s funding composition. MFIs increasingly have options for both local and hard currency loans; however, there should be some logic or plan to why it chooses certain loans. As is often the case, the MFI will merely be attracted to the loan that offers the lowest interest rates, without considering other factors that would increase the cost of borrowing under adverse conditions. For the benefit of the industry as a whole, investors and MFIs should work more seamlessly to ensure that the right criteria are used to evaluate funding decisions. Investors should not lend to MFIs that don’t have a coherent planning mechanism in place – but they should take the time to work with MFIs and encourage them to think more about these issues.

Effect of Lack of Planning: An Indonesian Example

An example of how shortsighted liability planning leads to a host of problems for an Indonesian MFI can demonstrate the point. This particular MFI was perceived to be a sound, well managed institution by international investors. A snap shot of their balance sheet in July 2008 indicates a Debt to Equity ratio of 2. What the ratio doesn’t capture, however, is the composition of the debt – which is significantly comprised of hard currency debt (35.8%, as shown in Figure 1). It is likely that the MFI’s liabilities reflect a propensity to take loans in dollar denominated debt, as these were offering attractive borrowing rates.

Between July and December 2008, the Indonesian Rupiah (IDR) depreciated by approximately 23%. And the impact that this event had on the balance sheet is seen in Figure 2.

Dollar debt made a 22.3% leap (to 43.79%

Figure 1: Balance Sheet of an Indonesian MFI: July 31, 2008
(Exchange rate: US\$ 1 = IDR9,090)

Assets		Liabilities		
Loans	8,942	\$Debt	3,200	35.8%
		LC Funding	4,160	48.5%
		Equity	1,582	17.7%
			8,942	

Figure 2: Balance Sheet of an Indonesian MFI: December 31, 2008
(Exchange Rate: US\$=IDR11,123)

Assets		Liabilities	
Loans	7,308	\$Debt	3,200 43.79%
		LC Funding	3,400 46.52%
		Equity	708 9.69%
			7,308

Source: MFX Solutions

of the total liabilities). Meanwhile, equity depleted by 45.3%, as a larger portion of the MFI's equity went into servicing the ballooned hard currency debt. The new debt to equity ratio is now a staggering 4.5. While this MFI may have performed well on a variety of other metrics, the failure to properly strategically plan its funding and prepare for adverse economic scenarios, was enough to dramatically alter its credit profile. It is important to note that, while this example highlights the impact of FX risk or a currency mismatch – it is not the only external risk that the MFI should concern itself with. Other economic factors such as inflation and domestic interest rates will tend to mirror currency volatility and cause additional stress to the MFI. Therefore, the ability to analyze an MFI's liabilities in the context of a broader economic environment is vital to effective planning.

Promoting Risk Management Education

The call for better liability planning is one aspect of an overall need to introduce better risk management practices in microfinance. Many MFIs are not regulated institutions, and are therefore not held legally accountable for maintaining certain standards and capital adequacy ratios. However, as MFIs integrate into international capital markets and transform into regulated institutions, it is imperative that they implement more rigorous risk management procedures. Fortunately, the issue has received reasonable attention from practitioners,

and efforts have been made to create education tools and promote awareness.

How, for example, would an MFI general manager looking at a 3-year dollar floating rate loan at LIBOR² +3% vs. a 2-year fixed local currency loan at 12%? It might be the case that the lower rate hard currency loan might be better for profitability but at the same time require that additional capital be set aside for regulatory capital adequacy. Or a decision that might make sense in the near-term might change the institution's credit rating by adding currency risk, raising its cost of funds in the future. While there is no "right answer," these are the types of questions that an MFI CFO must answer in order to survive in a regulated world.

“As microfinance continues to transform and further integrate with world capital markets, it becomes more and more important that MFIs have access to tools and education that allow them to properly evaluate the new types of risks that will arise.”

A tool to facilitate MFI managers to begin considering these issues is being rolled out by MFX Solutions, a provider of foreign exchange hedging products to microfinance funds and institutions. MFX is in the midst of developing an online-based tool to help MFI treasury managers move past the hurdles demonstrated in

the Indonesian MFI case. The Liability Planning Tool (LPT) helps MFI managers compare various loan offerings in different currencies and terms evaluate a variety of complex factors – potential currency and interest rate volatility, how each option would offset or augment the risk of the MFI's existing liabilities, how it would match existing or expected assets. All these factors will impact a variety of different performance and regulatory measures in different ways. The tool would allow the decision-maker to clarify all of these factors, and come up with a clear picture of the financial trade-offs involved with a particular choice.

Concluding Remarks

As microfinance continues to transform and further integrate with world capital markets, it becomes more and more important that MFIs have access to tools and education that allow them to properly evaluate the new types of risks that will arise. An investor should not only make decisions based on how an MFI plans its funding, but also help MFIs to understand the necessity of liability planning and think about the loans they receive in context of the broader economic environment. An easy and practical way to do this is to stress test the balance sheet and the funding an MFI receives against different economic scenarios. This allows the MFI to better understand the consequences of its decisions – and therefore pave the way for better planning and risk management practices. ■

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1. Matthijs Egelie & Nico Mensink. "Foreign Exchange Risk: The Onus of Hard Currency Debt." *Microfinance Insights*, Vol. 7, July 2008.
 2. London Inter Bank Offer Rate – It is the interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. It is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year. (Definition: Investopedia – www.investopedia.com)