

Microfinance **Insights**TM

Vol. 7, July 2008

Cover Price: US\$15/Euro 11

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MESOFINANCE — Reaching the Missing Middle through Online Equity Marketplaces

A new breed of online lending platform could be a bridge for the mesofinance funding gap, says Andre Wegner, Senior Associate at Intellectap. In this article he endorses the model and its opportunities, and explains what challenges the nascent industry has to overcome to reach its potential.

Thanks to online microfinance pioneers like Kiva, Microplace, Zopa and others, the concept of online peer to peer (P2P) debt platforms, giving laymen the opportunity to lend small sums directly to mini-entrepreneurs via the internet, has taken root. But as businesses grow in size, their capital needs change too. Equity investments are needed to bridge the “mesofinance” gap, for those with capital requirements between micro- and macro-level; that is to say between around US\$1000 and the venture capital threshold of around US\$2.5m. But sources are few and far between in

developing countries. Building on the insights gained by P2P leaders can help revolutionize capital options for small businesses around the world.

Debt alone will not help small enterprises grow. Atreya Rayaprolu, Vice President of Intellectap & Head of India Development Gateway, points out that “most start-ups are cash strapped as they try to break into new markets while satisfying customers and suppliers simultaneously. This is exacerbated by monthly installments.” These enterprises need ample time to experiment, and their capital sources should make an allowance for

this. “The question should not only be what can Africa do for investors, but also what does Africa need in order to grow,” says Tim Vang, Head of Myc4.com, a Danish platform targeting the micro- and mesofinance market.

Supporting mesofinance enterprises is an exercise in social development. Micro, Small and Medium-sized Enterprises (MSMEs) are the production, innovation and employment engine of the West.¹ The Doing Business Report shows that one of the greatest barriers to their development in the “Global South” is the lack of access to capital.² Most often their only

option is high-interest debt from unscrupulous and bureaucratic bankers, with long wait times and opaque terms.

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Bridging the Gap

Online platforms for equity and debt can help bridge the capital requirements of the “missing middle” by bringing all actors together to create markets that bring about market efficiency and price discovery. “Just by virtue of the fact that it brings together a larger number of participants,” says Aparna Vishwanatham, Director of EDA CapitalConnect, a price-discovery platform, “an online exchange is more efficient than a physical database.” Yet the opportunity extends beyond market efficiency to technological leverage, process simplification, legal clarity and the mobilization of individuals as providers of financial knowledge and network capital.

Technology can help overcome the greatest barrier to small capital equity investments – transaction costs. Sourcing deals and selecting them is one obvious leverage point, as are support and monitoring tools. But the new platforms can go further than that. By closing the transaction cycle and building a comprehensive value offering from source to exit, websites can be not only a window, but also a door for the greatest source of patient capital – the individual.

Angel investment is an established capital source in economically developed regions. However, the processes involved in MSME risk capital transactions mean, in effect, that only experienced investors take a part in these activities. Online portals provide market makers more direct insight into user experience, which can serve to clarify information and processes. “Like Amazon.com it is our job to simplify complex backend processes for the user,” comments Rayaprolu. In do-

ing so, these new platforms are connecting the original source of patient capital directly with MSMEs.

To a degree this is precisely what Kiva and its brethren are already doing. Just think how impossible it was to give a deserving stranger on the other side of the world a direct loan only a decade ago! But online platforms can do more than “just facilitate a funding handshake,” as Vang points out. Most small enterprises lack more than just funding. They are bottlenecked in managerial capacity, for instance, especially in areas such as finance, HR, and strategy. Through online tools and instant communication, experienced individuals and networks can help alleviate some of these symptoms at a distance. You just have to take one look at existing social networking sites, Vang points out, to see that “online networks create real world solutions.” Equity investments create ownership levels that are the ideal breeding ground for such collaboration.

Surprisingly, equity may also be the simplest way to support enterprises outside of pure grants. In India, the regulations concerning direct debt are often complex and sometimes impenetrable. “The current RBI [Reserve Bank of India] regulations related to deposit-taking make lending to corporates by individuals virtually impossible,” says Rayaprolu. Although equity transactions are covered by a similar array of laws, in many countries they are comparatively concise and manageable.

What it Takes

Like any marketplace, online equity transactions must facilitate knowledge and trust transfer in order to be successful. This may take various forms, from privacy settings and networking tools for trust, to business planning and marketing for knowledge. Vishwanatham agrees: “Reaching out and maintaining confidentiality [is] extremely important for making strategic investment decisions.” However, all platforms profiled here have adopted different strategies.

India Development Gateway follows a “push strategy,” making business plans

investor-ready through online tools and access to service providers, and is thus building capacity at ground level. It aims to build its scalability gradually, enabling enterprises with ever lower capital requirements to find investments thanks to lower transaction costs. MyC4 on the other hand works with providers, like Microplace and Kiva, to source possible deals. It also relies on them to assess the client risk and support their organization. In return it strengthens provider capacity and incentivizes them through higher credibility ratings on MyC4. Lastly, CapitalConnect operates on the realization that capital allocation for emerging industries such as microfinance work inefficiently. It leverages technology to cre-

PLATFORMS PROFILED IN THIS ARTICLE

MyC4 (www.myc4.com):

A Danish platform targeting the micro- and mesofinance market. Since its beta release in October ‘07, it has facilitated over EUR 2m debt into 1500 African MSMEs. MyC4 is currently considering the launch of an equity product, to be released next year.

EDA CapitalConnect (www.edacapitalconnect.com):

Launched in 2008 by EDA Rural Systems, CapitalConnect aims to be an international information dissemination and price-discovery platform for institutional investors, lenders and enterprises in the development sector.

India Development Gateway (www.indiadevelopmentgateway.com):

IDG aims to connect & support entrepreneurs and investors from sourcing to exit, thus enabling equity investments under US\$3m. IDG was launched in 2008 by Intellect and is supported by the Development Gateway Foundation.

ate a price-finding mechanism in which multiple investors can target multiple enterprises in one place.

There are however similarities across the platforms. For example, all platforms build capacity in some way. They realize that in order to prepare MSMEs for transparent, successful investments, substantial resource inputs will be required. On the other hand, these inputs may not have to come from the platforms alone - they can build on the goodwill of internet users. As the success of Wikipedia shows, there is much to be gained in terms of knowledge and time if platforms learn to engage all users. Vang of Myc4.com says, "It is not our design but yours," that is strengthening both platform and appeal.

"By closing the transaction cycle and building a comprehensive value offering from source to exit, websites can be not only a window, but also a door for the greatest source of patient capital – the individual."

A Difficult Path

There will always be an offline element to investments, however. "While there are some parts of the transaction value chain that are very much amenable to being reduced of human intervention," Vishwanatham states, "there are also areas such as conducting a due diligence or strategic discussions with management, which can never be done away with, no matter what kind of exchange it is."

With few others facilitating investments of this size, it would be easy to be complacent. But the early stage and many open questions are bound to keep the nascent sector on his/her feet. Amongst the most persistent: Will they actually invest? Despite in-depth market research, it is difficult to tell whether users will embrace online equity marketplaces. "In all start-ups, there is no certainty", says Ray-aprolu of IDG, "but thanks to the internet we can engage users early, and handhold them especially in the early phases to ensure we give them exactly what they want, in the way they want it." ■

- By Andre Wegner,
Senior Associate at Intellectap

1. For OECD countries, Source: IFC; Micro, Small, & Medium Enterprise Database.
2. World Bank Group, Doing Business Report 2008, available at: <http://www.doingbusiness.org/>.

"Macrofinance" Capitalizes on Microfinance¹

What connects one of the largest pension funds in the world, the Dutch ABP (National Civil Pension Fund), to a major American financial services organization, TIAA-CREF? Microfinance is the dealmaker. Both "macro" entities, along with several other private and institutional investors, committed to the largest-ever microfinance private equity capital fund, facilitated by Catalyst Microfinance Investors (CMI) in February 2008. The fund is managed by ASA International from Bangladesh, and Sequoia from the UK and the Netherlands, with a target of financing MFIs in Asia and Africa.



An invested capital of EUR215bn places ABP as the third largest pension fund in the world. The civil fund is for employers and employees that work for the Dutch government and educational sector. The first microfinance investment made by ABP was EUR5m (US\$7.5m) in 2005 and the pension fund's most recent investment to CMI makes it the lead investor due to a commitment of US\$25m. ABP's total exposure to microfinance now stands at US\$57m. Huub Hamers, responsible for ABP's microfinance portfolio, said, "Yearly returns of micro credits are approximately 7 percent, which is very acceptable given the low risks." He went on to say that ABP "wouldn't invest in micro loans if the yield is just 2 percent. At the end of the day, we have a task as an investor. We aren't a charity."

For TIAA-CREF, primarily known as a retirement savings products and services provider for those in academic, medical, cultural and research fields, investing in microfinance is a relatively new development. Two years ago TIAA-CREF announced the creation of the Global Microfinance Investment Program (GMIP) in response to customer requests for more socially responsible investment opportunities. GMIP is part of the TIAA-CREF's Social and Community Investing Department that has a US\$100m microfinance investment agenda by 2010; its most recent commitment is US\$10m to CMI's private equity fund.



The microfinance market size is expected to reach US\$250bn by 2015.² Currently, there is a large funding gap, which private sector investors are beginning to address. Interest from the private sector is due to different factors, from capitalizing on interest in socially responsible investing to diversifying portfolios through microfinance. Dr. Norbert Walter, Chief Economist at Deutsche Bank, said of the sector, "The steadily growing popularity of microfinance has reached a global audience and continues to be a key facilitator in helping to fight poverty in both developing and developed countries."

It is microfinance's seeming ability to remain uncorrelated to macro-economic developments that has made it a favourable asset class for these mainstream "macro" investors. Stable, low-risk, mainstream institutions are facilitating investments into microfinance for teachers and doctors in the US and Europe, which is a sure sign of a new chapter for the sector.

-By Jerilene Creado, Associate at Intellectap

1. Compiled from ABPnl, TIAA-CREF.org, efinancialnews.com and pionline.com
2. Dieckmann, Raimar. "Microfinance: An Emerging Investment Opportunity." Deutsche Bank Research. Dec 2007.