

BULLETIN HIGHLIGHTS

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Large MFIs Dominate Investor Portfolios and Client Services

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Overview of Benchmark Data

MIX presents its 2006 benchmark results based on a record year for coverage of global microfinance. The 704 MFIs that submitted information for this survey represent a broad range of microfinance service providers, regions, sizes and stages of development. Now in its tenth year of publication, the MicroBanking Bulletin's benchmarking survey continues to include more than 100 start-up institutions in its sample to capture changing trends in MFI performance at various stages of growth. While still representative of nonprofit service providers, the benchmarks also cover the growing diversity of non-bank financial institutions, as well as banks and cooperatives offering financial services to poor and underserved communities. In both these dimensions, this year's benchmarks also present a better global picture of microfinance delivery with nearly 200 or more MFIs each from Asia and Latin America and over 100 MFIs each from Africa and Eastern Europe / Central Asia.

This survey represents the results of on-going, long term efforts to widen the uptake of industry reporting norms in order to bring more visibility to institutions beyond the top tier. Expanding the reach of standards allows the microfinance sector to learn from innovation and trends among fast growing start-ups and medium size operations in this dynamic industry. This commitment to broad coverage has practical consequences for the resulting benchmarks. Rather than an index of leading providers, these benchmarks represent the broad spectrum of service delivery and institutional performance. As a result of this inclusive approach, readers will note that the median indicators of scale—whether number of borrowers, loan portfolio or total assets – are lower in 2006 than in the 2005 results.

As the industry grows, the Bulletin will remain focused on its mission to provide relevant performance benchmarks for all institutions, not just the larger, more established ones.

MIX's 2006 benchmarking results show another hallmark year of growth for microfinance. MFIs expanded outreach at a continued, measured pace, while commercial borrowings to MFIs grew nearly twice as fast, at over 60 percent. Yet, despite growth and innovation among start-up MFIs, microfinance remained a concentrated industry. A handful of large scale MFIs served the majority of global clients, and absorbed most of the commercial capital seeking investment opportunities in microfinance. This increasing commercialization of funding put greater pressure on MFI margins, leaving returns flat over 2005. With little room to negotiate lower better prices for clients, MFI managers left credit yields steady over the year.

These highlights offer a glimpse into this year's industry results. Panel data on one year trends draw

on a sample of 450 MFIs reporting both 2005 and 2006 figures.

As growth in client outreach steadied, microfinance became more concentrated and regulated ...

Surveyed institutions reached more than 52 million borrowers with 23 billion USD in loans in 2006 and mobilized more than 32 billion USD in deposits from 56 million depositors, as **Figure 1** shows. The 2006 results indicated continuity over prior years in regional outreach. Asia, home to the largest and oldest MFIs, dominated global outreach, serving

Figure 1: Overview of 2006 microfinance market

(millions)	Total Assets (USD)	Loan Portfolio (USD)	Deposits (USD)	Commercial Borrowings (USD)	Borrowers	Voluntary Savers
Africa	2,402	1,371	1,173	254	4	6
Asia	10,601	6,971	5,537	961	36	41
E. Europe / C. Asia	6,687	4,636	2,141	2,809	2	3
Latin America	12,391	9,668	6,558	2,453	9	7
M. East / N. Africa	765	637	2	341	2	0
Total	32,846	23,283	15,410	6,818	52	56

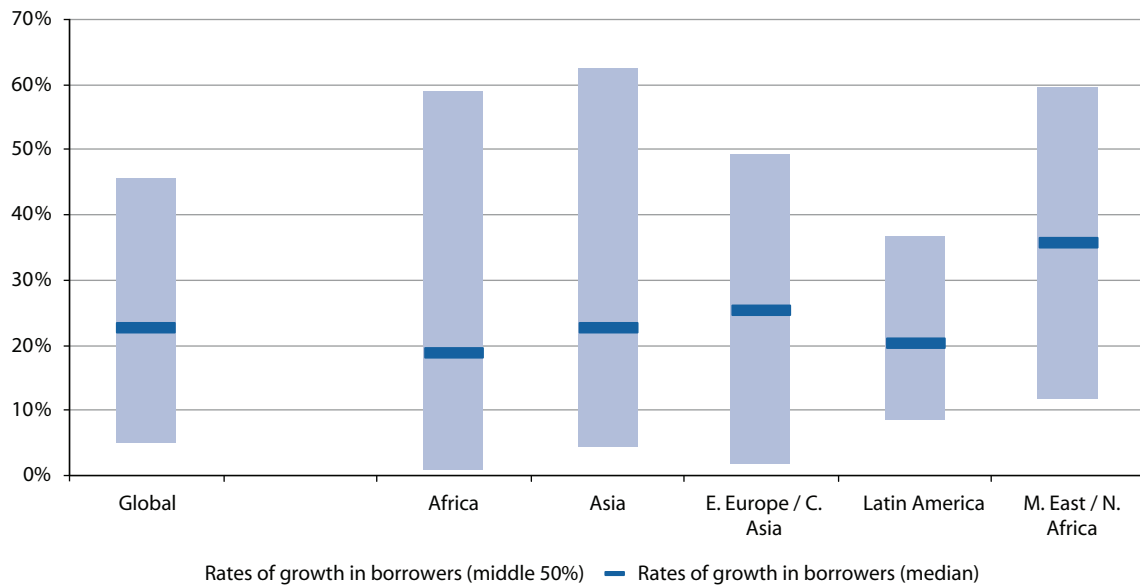
70 percent of borrowers and savers, while Latin America, home to some of the most mature markets, served another 20 percent. While small in global credit delivery, Africa remained a leader in savings mobilization, serving 50 percent more savers than borrowers by end of 2006. A closer look at the data reveals increased concentration of service provision and disparities among regions.

At the global scale, microfinance remained a concentrated industry. A handful of institutions represented the clear majority of microfinance service delivery. Measured by borrowers, the top 25 MFIs (4 percent of sample) covered more than two-thirds of all borrowers in 2006. From the perspective of portfolio, the top 25 MFIs served 60 percent of outstanding loan balances. Cutting across both Top 25 lists, a core group of 11 institutions demonstrated both large coverage in terms of borrowers and large scale loan portfolios. Despite this concentration, no one single service delivery methodology dominated the global industry. Market leaders in the Middle East/North Africa and South Asia regions reached clients with low balance, group-based working capital loans. Latin America giants, in contrast, served substantial consumer microcredit portfolios based on individual lending, using credit scoring or methods for quick, efficient loan disbursement. However, it does not appear the industry will remain on separate tracks for long. Large scale lenders across the Arab world and South Asia have already added individual loan products to their group-lending mix, and traditional working capital lenders in Latin America have expanded credit products to include consumer loans in an effort to retain clients in increasingly competitive markets. This trend will only increase as regulated providers grab greater market share.

The 2006 results indicate that regulated MFIs have indeed secured greater global market share, demonstrating microfinance's increasing integration

into formal financial service markets. Though representing less than half the number of reporting institutions, regulated institutions served 60 percent of total borrowers and 75 percent of savers. Of the top 25 MFIs by borrowers served, 19 were regulated financial service providers, while 21 regulated MFIs made the top 25 list by outstanding portfolio. With the exception of the Middle East and North Africa where the first few regulated providers are just opening their doors, regulated MFIs are increasingly present among large scale leading providers in all regions. Outside that region, banks and non-bank financial institutions accounted for 60 to 95 percent of all clients in each region by the end of 2006. Increasing market share for regulated providers also follows on the heels of industry transformation. Movements within South Asia, home to large scale NGO providers, represent this shift to the regulated track. While just three years ago only one leading India MFI was regulated, by the end of 2006 India's central bank had direct supervisory responsibility for four of the five leading microfinance providers. In Pakistan, leading nonprofit providers explored the case for transitioning to regulated status, while several new regulated microfinance banks quickly scaled up service delivery in urban markets. Even NGO providers in Bangladesh, the country with the largest concentration of nonprofit microfinance providers globally, faced impending regulation as a recently enacted law sought to bring them under the ambit of regulatory authority.

Growth in lending remained steady compared to prior period growth rates. Globally, the median MFI added nearly 25 percent more borrowers over the period, with the top quarter of all institutions increasing their outreach by 45 percent or more. Not all regions grew at the same pace, and **Figure 2** highlights these regional differences. As one would expect, the two youngest microfinance regions – Eastern Europe/Central Asia and the Middle East / North Africa – led the pack in growth in outreach. In

Figure 2: Rates of growth in borrowers, by region

Source: MIX MFI benchmarks from 2005–06 panel MFI data. Figures represent the range of rates of growth in borrowers.

the former, regulated banks and specialized lenders drove growth in outreach. These small markets with higher income and more skilled populations provided expansion opportunities to regulated MFIs targeting individual micro- and small business customers. Among regulated institutions, banks alone accounted for nearly two-thirds of growth in the region, drawing on their ability to offer both lending and savings services to clients. Indeed, while the typical bank in the region added 40 percent more borrowers in 2006, it also drew in deposits from 46 percent more savers than in 2005.

... with record commercial funding fueling growth among large scale institutions ...

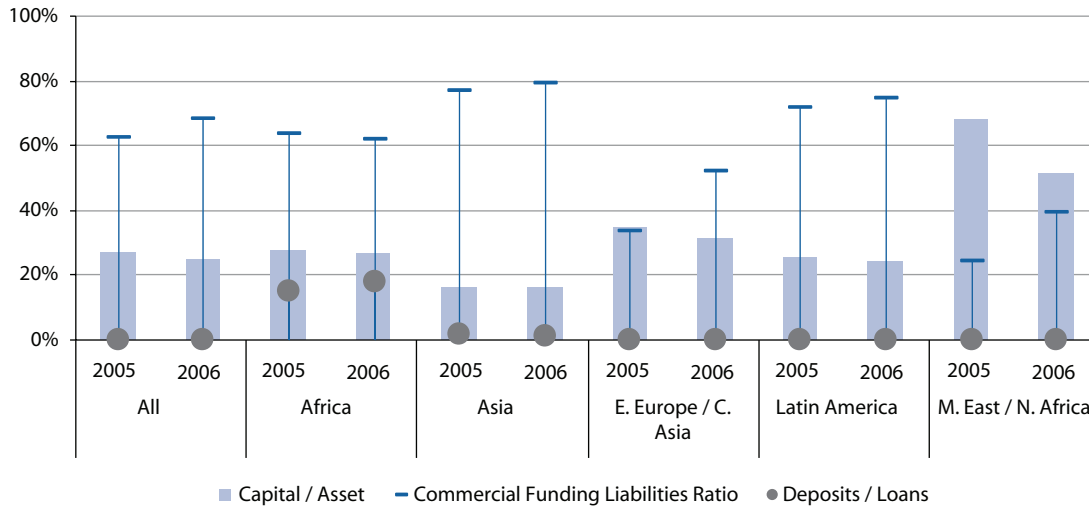
Global capital market interest in microfinance rose to new levels in 2006. As reflected in MFI capital structure, market-based financing increased another 10 percentage points over 2005's watershed year in which the typical MFI sourced more than half its loan portfolio from commercial funds. Commercially priced

India's phenomenal commercial growth

In this climate of sustained growth, India kept its lead as the fastest growing microcredit market in 2006, as a diverse range of MFIs expanded across the country. India is home to half of the fastest growing MFIs (percent) and half of the MFIs with the largest growth (borrowers). The median growth rate in borrowers of Indian MFIs steadied at 66 percent, even as leading institutions broke through the one million client barrier. Despite last year's political crisis in the southern state of Andhra Pradesh and ensuing repayment problem, growth in outreach of large scale MFIs barely slowed. Established MFIs expanded outside their traditional homes in southern states into new markets in the center, north and east. At the same time, a handful of start-up MFIs quickly took root in their new communities focusing on the underserved urban markets and states with little microfinance presence. In this high growth climate, even these start-up institutions quickly pushed beyond both the Asian and global median number of borrowers served by an MFI by the end of 2006.

Active bank financing of MFIs and managed microcredit portfolios allowed institutions to sustain their high growth momentum. Although the median leverage came down from 15 to 12 times MFI capital, debt financing remained the single most accessible option to fund expansion. This reliance on debt, however, increased overall funding costs, pushed further upwards in India's rising interest rate environment, leaving MFIs with little to no profit margins. Returns on assets fell from 0.8 to 0.2 percent between 2005 and 2006. With no retained earnings and high leverage, equity capital availability poses a primary constraint for Indian MFIs beyond 2006.

Figure 3: Commercial funding and leverage increase across all regions



Source: MIX MFI benchmarks from 2005-06 panel MFI data. Figures represent the peer group medians.

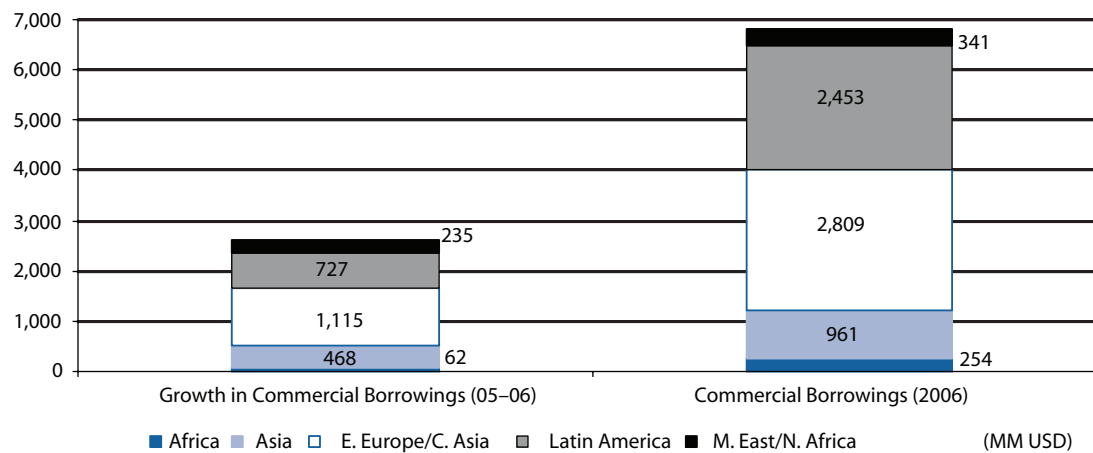
borrowings and deposits funded nearly 70 percent of an MFI’s loans by the end of 2006, as illustrated by the vertical lines in **Figure 3**. With slower growth in MFI capital, leverage for the typical MFI in all regions rose from just over 2.5 to nearly 3 times equity. Long standing regional variations persisted, but MFIs in every region except for sub-Saharan Africa witnessed increases in commercial funding.

In total, the 2006 global microfinance balance sheet closed with an additional 2.6 billion USD in commercial borrowings from domestic and foreign sources. Capital distribution among the regions changed little from 2005, as **Figure 4** depicts, with 70 percent of all funds invested

in regions with the highest concentration of large loan portfolios: Latin American and Eastern Europe / Central Asia. For the latter region, as well as for the Middle East and Asia, growth rates in commercial borrowings exceeded those of both borrowers and portfolio as the capital structure shifted away from donations and concessional borrowings into commercial debt. In all three regions, MFIs tapped commercial debt to expand their lending services much faster than from any other source of funds.

MFI capital structures underwent the most fundamental shifts in the two youngest microfinance regions: Eastern Europe/Central Asia and Middle East/

Figure 4: Commercial debt surge continues



Source: MIX MFI benchmarks from 2005-06 panel MFI data and 2006 MFI benchmarks. Figures represent totals.

North Africa. Despite less reliance on commercial funding for on-lending than the global norm, MFIs in these regions nearly doubled the share of commercial debt and deposits in their capital structure in a single year, as shown in **Figure 3**. In 2006, investors continued their pursuit of MFIs in Eastern Europe and Central Asia, attracted by a combination of larger microfinance portfolios and the increasing market share of regulated providers. Carried by this wave of market interest, MFIs in the region sailed past the 50 percent commercial funding mark in 2006, just one year behind global peers. The NGO MFI sector in the Middle East also attracted significant commercial funding. Once concentrated in leading Moroccan MFIs, commercial borrowings had a greater share in funding MFIs in all three of the region's most active markets: Morocco, Egypt and Jordan. The leading MFIs, however, are now leveraged beyond global norms. Without transformation into shareholding companies or fresh injections of other forms of capital, these MFIs will likely soon hit a ceiling on how much commercial lending the market will support.

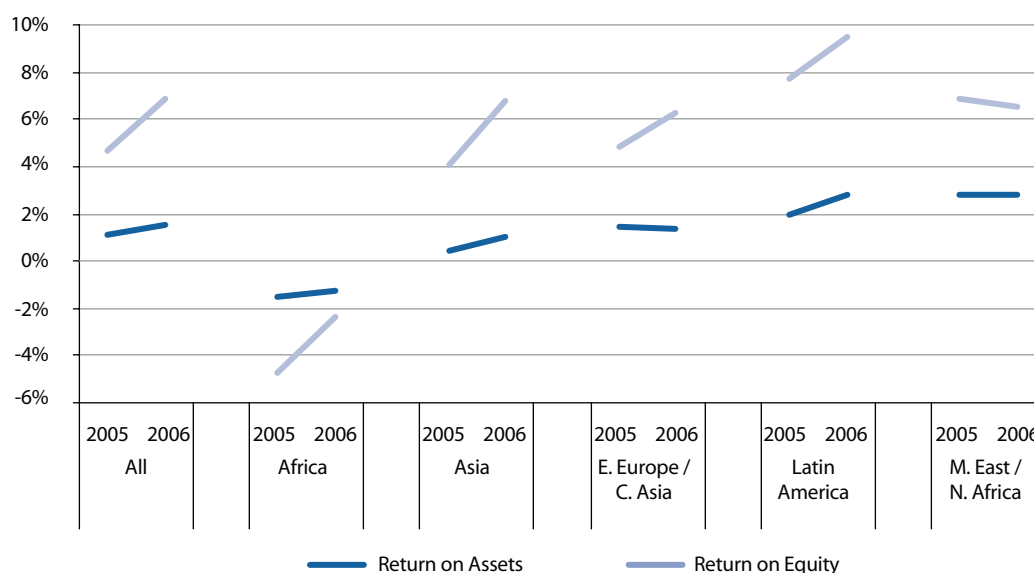
Like the concentration of clients in large scale MFIs, almost all of the capital markets in microfinance has yet to trickle down beyond large scale MFIs even as their medium size peers present viable investment opportunities. With loan portfolios between two and eight million USD, medium scale MFIs offer viable transaction sizes for many microfinance investors. They are less leveraged than their large scale peers (2.5 vs 4.4 times capital) and on par with global benchmarks of profitability (0.7 vs. 0.9 percent return

on assets), making them strong candidates to absorb more market priced debt to build their loan portfolios. Yet, these medium size institutions remained relatively neglected by commercial investors in 2006; at 57 percent, the median institution in this category had less than the global norm in commercial funding (61 percent) and one third less than its large scale peers (85 percent). Large MFIs still absorbed the lion's share of commercial borrowings held by microfinance institutions. The 230 large scale MFIs in the 2006 survey accounted for 92% of all such commercial debt; the remaining 570 medium and small scale absorbed the remaining 8 percent. This same relationship of size and funding held across every region. In the regions with the greatest pool of commercial debt, the scales tipped further in favor of large MFI balance sheets. Latin America and Eastern Europe/Central Asia, with the largest portfolios, accounted for 72% of the entire global portfolio commercial borrowings in microfinance institutions. There is good news for microfinance investment funds seeking to invest in second tier MFIs: competition to fund MFIs in this tier remains slim and—given their leverage and profitability—there is room for expansion.

... leveraging slow growth in profits ...

The global increase in leverage lifted returns on equity (RoE) in almost all regions, even as profit growth remained slow. Asia and Latin America, the two regions with the highest leverage, witnessed

Figure 5: Thin returns boosted by increased leverage



Source: MIX MFI benchmarks from 2005–06 panel MFI data. Figures represent the peer group medians.

the strongest growth in RoE over the year as rising debt/equity ratios pushed up net profits, as **Figure 5** demonstrates. Across all regions, large scale MFIs used their strong leverage to transform thin earnings into the highest returns for shareholders. While median returns on assets (RoA) for medium size institutions paralleled global norms—both groups hovering between 1 and 2 percent—returns to capital climbed from 11 to 12 percent for large scale MFIs and only rose from 3 to 4 percent for their medium size peers. The earnings picture closely tracked that of growth in clients and commercial funding.

Increased commercialization also drove thinning returns around the globe. In regions where commercial funds replaced more subsidized sources, profit levels experienced almost zero growth. Net earnings for the median MFI in both Eastern Europe/Central Asia and the Middle East/ North Africa stagnated in 2006 as financial expense rose rapidly in relation to the asset base. In the latter region, MFIs experienced a two percentage point increase in financing costs, as commercial funding increased its share in rapidly growing portfolios and asset bases; at the same time, all other areas of cost remained constant over the year. Given that the median Middle Eastern MFI still trailed global and other regional norms in commercial funding and that such funds represented a rising portion of assets in 2006, net profits will likely further compress over the coming year.

While global median returns grew slowly, leading MFIs continued to see increasing profits. Top quartile

returns on assets grew from 4 to 4.6 percent worldwide over the 2005–06 period. Regionally, even in loss-making sub-Saharan Africa, leading MFIs saw their RoA increase from 1 to 2 percent, while top MFIs outside Africa witnessed a percentage point of growth to between 3 and 6 percent return on assets. These high returns combined with low leverage in all regions and markets, except India, translated into strong potential for equity investors. Indeed, as global microfinance capital markets news reports have shown, investors in 2006 and 2007 have found equity in leading MFIs very attractive.

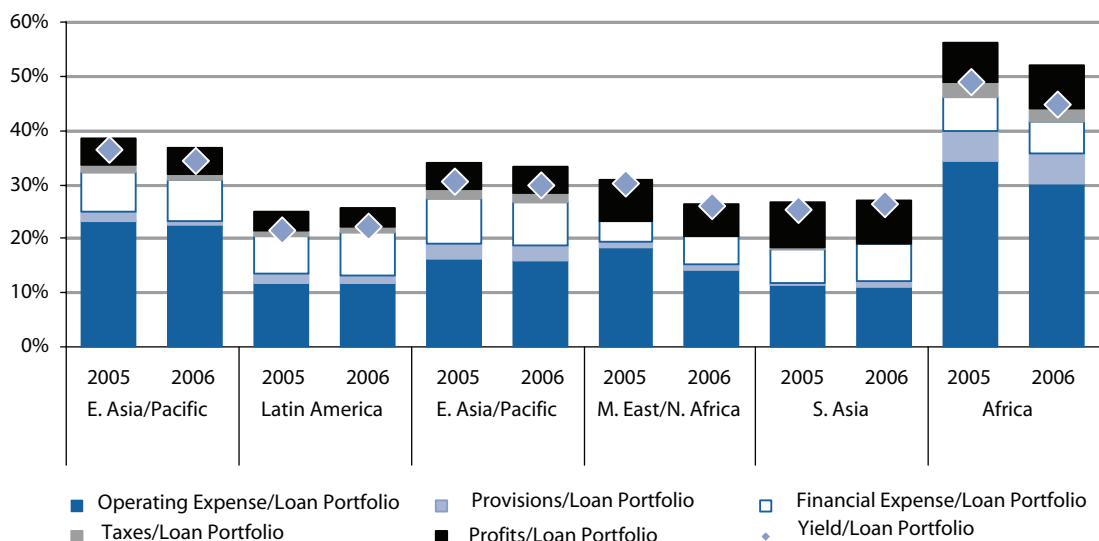
... based on steady revenues from clients.

Greater external ownership of MFIs by mainstream commercial investors has revived industry interest in analyzing MFI earnings and the share of profits in the interest and fees paid by clients. **Figure 6** helps shed light on this topic for a sample of profitable MFIs. It depicts costs and net profits in relationship to the average loan portfolio. Stacked horizontally, these bars sum up to total gross earnings:

$$\begin{aligned} \text{Revenues} - \text{costs} &= \text{net profits}; \text{ hence,} \\ \text{Revenues} &= \text{net profits} + \text{costs.} \end{aligned}$$

Diamonds mark the share of revenues coming from the loan portfolio. Portfolio revenues represent between 90 and 99% of total microfinance earnings, with the rest represented by interest on investments.

Figure 6: Breakdown of total earnings into costs and net profits for profitable MFIs



Source: MIX MFI benchmarks from 2005-06 panel MFI data. Only profitable MFIs are analyzed. Figures represent the peer group medians.

As a result, the stacked bars and their component parts offer useful proxies for analyzing how portfolio earnings are apportioned among costs and profits.

In all but two regions, client interest rates remained steady over the period. Only in Africa and the Middle East / North Africa did yields and total revenues drop in 2006 as a result of increasing portfolio size. Increasing loan balances, but stable operating costs, drove down operating expenses relative to total portfolio in both regions. In the Middle East, rising financial costs from increasingly commercial funding dampened the impact of the reduced operating expenses on overall costs. To the extent that yields—and the average cost to clients—did decline despite this trade off in costs, it was also due to a decreasing share of profits in overall MFIs' overall gross revenues.

Discussions over recent capital markets transactions have raised questions about the nature of for-profit investments in MFIs and the potential for rent transfer from poor clients to rich shareholders. These questions have particular significance for MFI governance, as profit targets are the only element of product pricing over which MFI management and boards exercise control. Data from the 2006 survey show that regions with the highest percentage

of regulated, for-profit MFIs—Latin America and Eastern Europe/Central Asia—actually yielded the lowest profit levels, around 13 percent of all gross earnings. Regions with more nonprofit providers—South Asia and the Middle East—on the other hand, had higher net profits as a share of total revenues, between 24 and 32 percent of gross earnings. In Bangladesh, profitable NGOs earned between 2 and 12 percent return on assets and 12 and 25 percent on equity. Similar patterns held for large scale nonprofits in the Middle East. Indeed, among profitable providers in each region, nonprofit institutions earned returns one to two percentage points higher than their for profit peers.

Profit levels are within the scope of management's control, but they do not represent the greatest portion of total earnings. Operating costs, including human resources and general administration, dominate the costs paid by client interest and fees, at over 50 percent. While reducing profits or finding alternative sources of capital may allow MFIs to shave a few percentage points from interest rates, reductions in operating costs hold the greatest potential for lowering client costs. The following research highlights by Adrian Gonzalez review the factors—both internal and in the MFI's operating environment—affecting operating costs and analyzes their impact.