The Impact of Microfinance - MicroVest's View

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About MicroVest Capital Management, LLC

MicroVest is an asset management firm that offers global investment opportunities across its family of funds. MicroVest invests capital in under-banked markets, providing access to a growing portfolio of sustainable financial institutions. MicroVest's emphasis on a detailed due diligence process and focus on aligning values can result in meaningful financial returns for its investors. Since 2003, MicroVest has demonstrated that investing in its funds can be both profitable and purposeful. As of March 2016, MicroVest managed $421 million across all its funds.

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I. Introduction

Promoted by development practitioners as a commercial solution to poverty alleviation, microfinance was established as a viable reaction to the failed state-led model, which had advanced inefficient decision-making, misallocation of resources, and, ultimately, large scale financial failure. With a record of over two decades, researchers are now analyzing data to help assess microfinance's real effect on the bottom of the pyramid. Drawing publicity for their critiques, some recent studies have been unable to establish a statistically significant correlation between microfinance and poverty alleviation. However, we believe that the desire to show direct causality distracts from the broader impact of microfinance.

MicroVest's investments focus on building infrastructure and institutions in developing countries while fostering good governance, accountability, and benefits that cannot be realized through short-term statistics on individual poverty reduction. In our view, at the heart of microfinance is the development of inclusive financial sectors through institution-building. Additionally, studies have shown that expanded access to microcredit increases business activity and stimulates growth, which isn't reflected in simple poverty statistics. Our track record leads us to believe that microfinance's impact on financial sector development and, ultimately, economic growth is not in dispute.

II. The Evolution of Microfinance: Building Skills and Transforming Financial Sectors

In the 1990's, after socially-motivated NGO's failed to develop a sustainable support system for Microfinance Institutions (MFIs), a more commercially-minded approach to microfinance began to emerge.[1] The industry's focus shifted from the end borrower to addressing the structural issues of developing financial institutions. A new objective materialized: to develop properly designed financial institutions with sound, systematic underwriting practices that can deliver services sustainably, efficiently, and on a large scale to clients which previously had been "un-banked."

At its very core, microfinance is immersed in this mission of financial sector development. For MicroVest, this is accomplished by supporting and investing directly in well-run, efficient, and sustainable financial institutions that provide loans, savings, payment, and insurance products to hundreds of millions of people at the low end of the market. Through our investment in emerging market MFIs, we've helped build strong, efficient institutions that have gained the durable trust of their clients and countries.

III. Developing Good Governance and Accountability

Corrupt institutions, often constructed through unscrupulous political policy and instability, drive income inequality, deterring poverty reduction efforts. Fostering good governance reduces transaction costs, strengthens property rights, and facilitates greater political and social participation of the poor.[2] However, many developing countries lack the institutional capacity to implement programs focused on poverty alleviation. By building strong, quality institutional environments, studies have shown that microfinance stimulates good governance and accountability particularly in areas such as screening, monitoring, and contract enforcement, which ultimately decrease lending costs.[3]

[1] Robinson, Marguerite; The Microfinance Revolution: Sustainable Finance for the Poor
[2] Bloomsbury Academic; Poor Poverty: The Impoverishment of Analysis, Measurement and Policies
[3] The Smart Campaign; Implementing Client Protection in Microfinance: The State of Practice, 2011

IV. Sound Financial Infrastructure as a Necessary Condition for Economic Growth

On top of building strong individual financial institutions, MicroVest also recognizes the importance of developing a country's overall financial infrastructure. Many emerging economies lack properly functioning financial sectors, which constrains growth since entrepreneurs lack access to capital. Since a functioning financial sector is necessary to support economic growth, the establishment of a system of efficient, formal financial institutions that provide access to financial services is a central objective.

In emerging markets, hundreds of millions of informal micro and small business owners constitute the lion's share of the economy.[4] These entrepreneurs require financial services to build their own businesses from the ground up, making it imperative to provide financial services to the broadest segment of the population. While financial sector development in these countries has improved, there is still demand, opportunity, and the potential for greater social impact.

MicroVest promotes financial sector development in the form of direct investments provided to well-run financial institutions in emerging economies, which in turn provide productive loans, savings, payment, and insurance products to clients previously excluded from the financial system. We believe direct investments in scalable financial institutions support economic growth by providing the capital each client requires to build their own businesses and livelihoods. In order to form the basis for a sound infrastructure that supports economic activity across the full spectrum of the population, we seek to develop institutions with good governance structures, talented and creative management teams, strong IT systems, a business plan committed to financial sustainability, and a commitment to clients.

In many of the countries where MicroVest invests, the early intermediaries, credit-only NGOs and finance companies have evolved into regulated and deposit-taking institutions, often growing into fully-fledged banks with a wide array of non-portfolio related products, such as savings and insurance. Statistics show that the depth and breadth of the financial sector, as indicated by deposits over GDP and points of service, have grown. (See Graphs 1-2).

As a result, we have witnessed a deepening of the financial sector in most of the countries in which we work. Specialized microfinance banks now perform the functions that studies previously found to be absent in the market. Competition is helping rates come down as evidenced by reduced spreads, while services are being delivered more efficiently as evidenced by falling cost-to-income ratios. At the same time, MFIs are experimenting with innovative savings products, new payment mechanisms to reach rural and remote populations, and complementary life and credit insurance products.

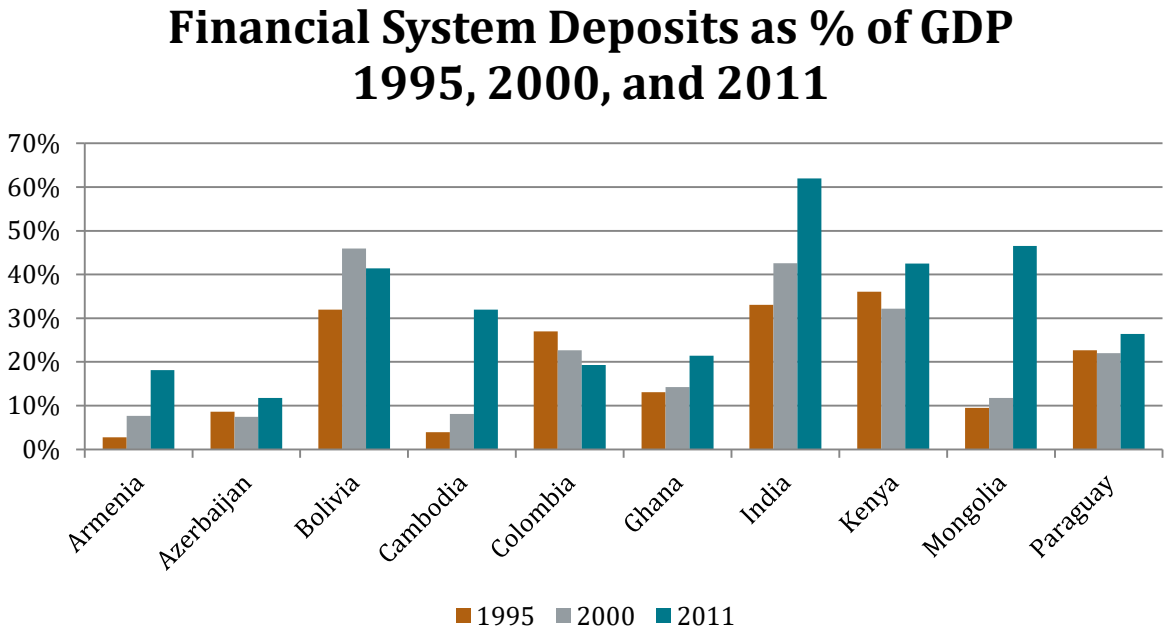
[4] OECD, Promoting SMEs For Development, http://www.oecd.org/cfe/smes/31919278.pdf

V. The Road Ahead – Our View

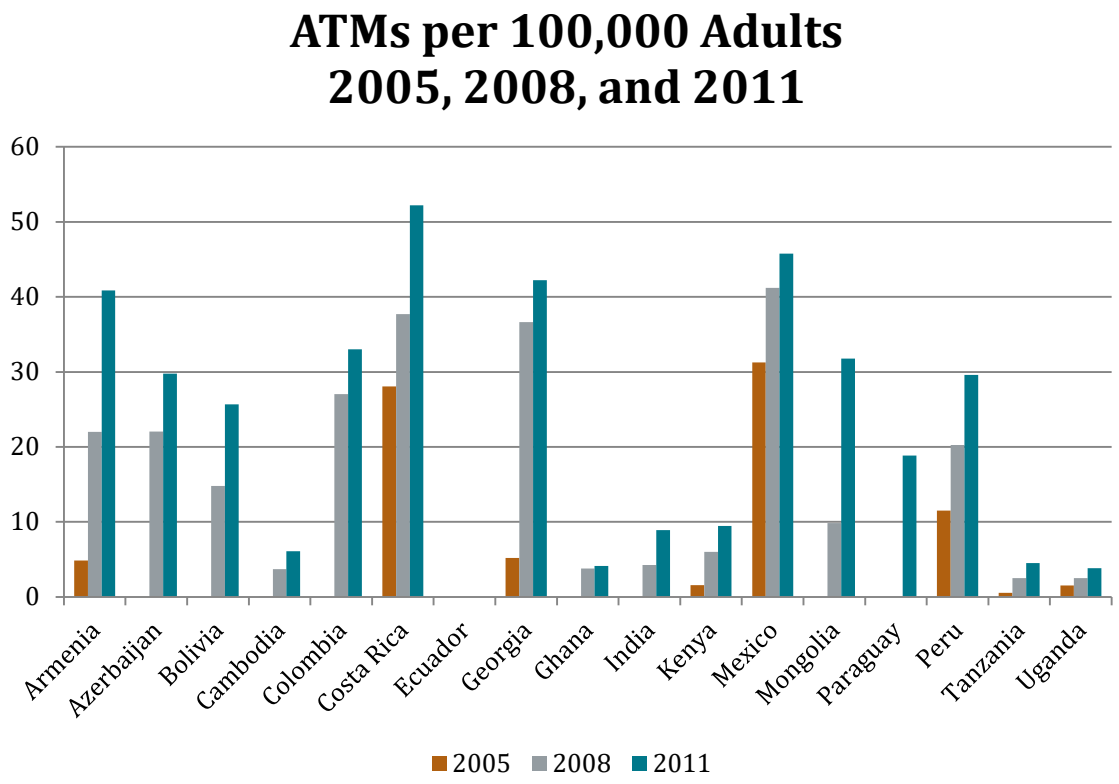
Microfinance has evolved beyond the provision of credit to low income clients into an industry focused on institution and infrastructure development. While there is room for growth and improvement, the benefits of microfinance cannot be described by short-term statistics on poverty reduction. The key to improving financial systems lies in building and supporting efficient institutions which tailor their services to specific target groups with well-designed credit methodologies and effective governance structures. In support of this mission, MicroVest's due diligence and investment process is designed to identify and invest in financial institutions that fit those criteria.

Through a family of private funds MicroVest provides debt and equity funding which promotes growth through increased outreach and sound governance practices. While we expect the debate to continue regarding a causal relationship between microfinance and poverty alleviation, we believe well-run financial institutions will continue to play an important role in financial infrastructure development in emerging economies, creating the foundation for greater economic growth and income equality.

Graphs 1-2:
Financial Sector Penetration Statistics of select countries where MicroVest invests



Column values represent a country's financial system deposits as a % of the country's GDP. Financial system deposits to GDP refers to *demand, time and saving deposits in deposit money banks and other financial institutions as a share of GDP.* **Source:** World Bank.



Column values refer to *the number of Automated teller machines (ATMs) per 100,000 adults*. A column with a value of zero in 2004 implies that the World Bank does not provide a data point. **Source:** World Bank.