



# MIV Manager Survey Results

**H<sub>3</sub>F** The Law Offices of  
**Howard J. Finkelstein**  
[www.hjflaw.com](http://www.hjflaw.com)

**unitus** | capital

June 2009

# MIV Manager Survey Results

# Survey Purpose & Methodology

## Purpose

- MIVs are rapidly growing in number and AUM. There were 96 MIVs at FYE 2007; half had been created in 3 years (2005 - 2007). MIV AUM increased from \$637mn at the end of 2004 to \$3.7bn at the end of 2007 & \$5.4bn in October 2008. As these vehicles proliferate, there is a need to study and share best practices and lessons learned
- These best practices and lessons learned could be most helpful to MIV managers and investors who are new to the space

## Methodology

- We reached out to all 65 the managers of MIVs listed on MIX with AUMs of at least \$5mn. We had phone interviews with managers of 28 MIVs on structuring, capital raising, HR, operations/systems/administration, Investment, Dealmaking, Exiting, and risk management best practices and lessons learned
- These funds represented 53%of MIV AUM
- The syndicated responses of the managers are presented on an anonymous basis on the pages that follow

# Survey Respondents

**We are deeply grateful to the managers who made the time to ensure that their MIVs were included in this survey**

- AfriCap
- Citi Foundation
- Dual Return Fund
- Geisse Foundation
- Hivos Triodos Fund
- Incofin
- Incofin – Impulse
- Incofin Rural Impulse Fund
- Kiva<sup>1</sup>
- LocFund
- MicroCredit Enterprises
- Minlam Microfinance Fund
- Oikocredit
- responsAbility Microfinance Leaders Fund
- responsAbility Global Microfinance Fund
- Triodos DOEN
- Triodos Fair Share Fund
- Unitus Equity Fund
- Working Capital for Community Needs (WCCNICA)
- Dexia Microcredit Fund
- Blue Orchard Microfinance Securities I
- Blue Orchard Loans for Development 2006-1
- Calvert Foundation
- MicroVest I
- Oxfam Novib (Grants)
- Oxfam Novib Fund
- ASN-Novib Fund
- Opportunity Transformation Investments

1. *Although Kiva channels funds to MFIs for onlending, Kiva differs from other survey respondents as its investors specifically allocate funds to microentrepreneurs rather than to the MFI for general onlending*

# Structuring

# Structure

## Norms & Considerations

- **Norms:** Optimal structure varies by investor goal and risk appetite. Accordingly, some managers offer multiple funds varying in degree of social/commercial, tenure, and asset class/risk level. Similarly, some MIVs create structured products to appeal to investors with a range of risk appetites
- Closed-end funds are more common in the US. Open-end/evergreen funds are more common in Europe
- **Considerations:** The microfinance industry is laden with conflicts of interest, so it is important to structure ways to minimize those conflicts
- Closed-end fund manager interests are more aligned with those of investors than open-end funds

## Best Practices

- Having a regulated vehicle is a best practice in that ensures adherence to standards of quality and protects investors
- The GP-LP structure is ideal because it prevents the need to ask shareholders for approval when exiting investments. Many MIV shareholders have a number of holdings throughout the sector, creating conflicts of interest

## Lessons Learned

- Creating a structure that would allow US investors to place capital in European funds is difficult
- Funds that charge fees and carry that are non-profit can be problematic due to non-profit dollars affecting for-profit activities

# Tax Treatment

## Norms & Considerations

- For funds targeting European investors, a Luxembourg domicile allows for greater flexibility. In particular, investors in Luxembourg are taxed in their home countries according to home country laws
- Not applicable for tax-exempt entities
- Withholding taxes are priced into the interest rates that MFIs pay, so withholding tax is passed onto the end borrower

## Best Practices

- Tax issues vary by investor domicile, and each domicile must be considered separately
- For large or strategically important investors in other jurisdictions, it is important to set up the right subsidiaries for them to optimize tax structure
- US –domiciled guarantee funds should be set up as 501c3 organizations so that any losses can be deemed donations for tax purposes
- Being deemed a non-banking credit institution in the Netherlands has tax benefits

## Lessons Learned

- Corporate malfeasance outside of your industry can lead to difficulties in negotiating tax treaties between countries; this can make it more difficult for you to accept capital from certain investors
- The more mainstream the structure in terms of tax treatment, the more comfortable investors will be and the better

# Fee Structure

## Norms & Considerations

- Fees collected annually
- Some bank-supported MIVs have subsidized fees
- In some debt funds, the spread between the lending and borrowing rates are the implicit fees
- The larger the fund, the lower the fees
- A 2% management fee and 20% carry is typical for alternative asset classes, including private investments in microfinance

## Best practices

- It is important to share fees fairly among players, and don't forget the sales channel
- Fees should be transparent, particularly when there are upfront fees and exit fees, which investor can misunderstand
- Given the downward pressure on fees today, new funds may wish to reduce their fees to 2% even if it means increasing their minimum investment target size to do so

## Lessons Learned

- During this economic downturn, fees have come under pressure
- MIVs have not yet produced strong returns, which would make charging fees in excess of 2% and 20% hard to justify

# Reinvestment Criteria

## Norms & Considerations

- Irrelevant for open-end (evergreen) funds
- Open-ended funds tend to have redemption schedules in which form letter submissions trigger asset liquidation
- Some closed end funds give investors the option to roll-over at maturity; many investors elect to do so

## Best Practices

- Gates are important to protect the fund and acknowledge the illiquidity of the asset class
- Closed-end funds must invest with the exit in mind: equity investments in MFIs should be focused on organizations that are candidates for mergers/takeovers by regional competitors or by other funds
- It is important to keep a portion of the assets in very liquid investments in case investors redeem

## Lessons Learned

- Some funds invest in non-profit MFIs that are transforming to for-profit MFIs through bridge loans that convert to equity once the transformation is complete; these funds can recall the loans if the MFIs do not transform. In cases where the transformation does not occur, it is nice to have a provision that allows the MIV to use the returned money to invest in other MFIs instead

# Capital Raising

# New MIVs – Finding a Niche

## Norms & Considerations

- **Norm:** Some funds work with banks or placement agents to distribute products, particularly to individual investors
- Other funds leverage the relationships of their boards and senior managers; an extreme example is a fund that launched in response to social investor and IFI requests for a new fund with a particular strategy/geographic focus

## Best Practices

- Institutional investors have more rigorous due diligence requirements than individual investors. MIVs therefore need to be more involved with the sales processes for institutional investors vs they can outsource that function with individual investors
- Defining a specialized strategy is critical to reaching scale
- Socially responsible retail investors can supply a stable funding base; first mover advantage is key, as retail investments tend to be sticky

## Lessons Learned

- Funds that focus on a single industry and geography have superior deal flow vs diversified funds. Fund managers should stick to what they know and what works
- It is better to have a pool of loyal shareholder investors who understand the industry

# Follow-on MIVs – Changing Scope

## Norms & Considerations

- **Norm:** Europe - more open-ended (evergreen) funds vs US - more closed-end
- Many successful microfinance fund managers are increasingly expanding scope to include other income-generating projects that benefit low-income individuals: hospitals, universities, non-financial service companies, agricultural cooperatives, SME lending
- Sometimes, fund managers launch follow-on funds with the same sector and geographic focus, but more commercial or more social in orientation to appeal to a different subset of investors

## Best Practices

- It is important to have frequent enough redemptions in an open-ended fund that investors are comfortable that they can access capital if they need it, but reserve the ability to close the fund if there are excessive redemptions
- Building a strong track record and reputation through earlier funds allows word of mouth to help with subsequent capital raises
- Having a follow-on fund more than 3-4xs the AUM of the prior fund is a major undertaking in terms of processes/systems & requires much more resources

## Lessons Learned

- After launching a successful microfinance generalist fund, focusing on a narrower subset of the industry (e.g., rural MFIs) can be quite lucrative and quite beneficial
- When expanding geographic scope, it is critical to be on the ground in the new markets, understanding the same realities, and experiencing the same strengths and weaknesses

# Investor Selection

## Norms & Considerations

- MIV managers can only control investors in private funds, not in public funds
- Fund structure is one driver of investor selection, as different investors are attracted to different asset classes, levels of risk, and target rates of return
- Benefits of institutional investors: sophistication , professionalism, reliability, and view of microfinance is an interesting addition to their asset allocation
- Benefits of socially responsible & faith-based investors: patient with time horizon, acceptance of lower return for greater time social benefit
- HNWIs can worry a lot about investments if they don't know the geography of their investments well

## Best Practices

- It is very important to select your investors in microfinance. Microfinance is a very early stage topic that is still vulnerable. Long-term investors who care about development are ideal, as aggressive investors can hurt the industry. Ideally one should select investors who share one's vision
- It is important to ensure alignment of investor time horizons, financial return expectations, and risk tolerance with other investors and with the fund mgr

## Lessons Learned

- It is an enormous market, with different degrees of awareness of microfinance; the lower the awareness, the greater the cost of educating investors and the longer the time between first meeting and investment
- Fund managers should to due diligence on investors : past MFI & MIV investments, exits, returns. Some investors do not want to liquidate funds and prefer to being in a successful fund vs. realizing strong returns
- It is important for investors to understand fund's geography and microfinance economics so that the fund manager does not have to educate them

# Investment Minimum

## Norms & Considerations

- **Norms:** Public funds tend to have lower minimums, e.g., 200 euros or US\$1K direct or \$20 through Microplace
- A number of funds have both retail and institutional tranches
- Private funds tend to have higher minimums, e.g., 20K euro - 500K euro
- Institutional private funds – up to \$5mn minimums
- **Considerations:** The higher the minimum, the less the administrative burden, from both economical and logistical perspectives

## Best Practices

- The primary driver of investment minimum should be target group and the secondary driver should be operational capacity
- Having a high stated minimum, like US\$5mn is a great way to keep out investors that you do not want; you can always waive minimum investment requirements to include smaller investors that you would like in your fund

## Lessons Learned

- 5-6 investors max in a small fund is ideal; it is important to avoid spending too much time on investors

# Human Resources

# Level of Outsourcing

## Norms & Considerations

- **Norms:** The majority of MIVs are domiciled in Western Europe and North America; some funds without local offices outsource due diligence/monitoring to local partners/networks.
- Some MIVs use the investment advisor Symbiotics for brokerage (deal origination), ratings, and credit research
- Other MIVs do not outsource any part of their investment process (screening MFIs, due diligence), although most MIVs consider MFI ratings
- Many MIVs outsource administration because it is time-consuming for MIV managers and frustrating to investors if not done well. These MIVs consider everything other than finding /monitoring investments a distraction
- Sometimes MIVs outsource fundraising to third-party placement agents
- One MIV has primarily volunteer staff, even at very senior levels (CEO, COO)

## Best Practices

- Making one's own investment decisions is key; that core competence should reside within the fund
- Investment/asset management should be internal, as should key relationships
- Outsourcing non-investment functions, like legal work, IT, and marketing/branding can be helpful
- Having an active volunteer board can be extremely helpful

## Lessons Learned

- If loan agreements are done using local law, hiring local lawyers on a contract basis, rather than keeping them on staff, can be helpful
- \$40mn+ funds have the scale to manage their back-office internally. MIVs tend to have better quality and control if their back-office is internal

# Policies<sup>1</sup>

## Norms

- MIVs seem to have HR policies that are similar to those in the mainstream financial services industry

## Best Practices

- Compensation levels close to those in comparable industries seems to increase the likelihood of attracting and retaining talent

## Lessons Learned

- Employees should have incentives that are aligned with those of the MIV

# Operations

# Operations/Systems

## Norms & Considerations

- **Norms:** Monthly MIS file collections from portfolio MFIs
- **Range of Practices:** Smaller MIVs tend to have highly customizable and also rudimentary portfolio management systems
- Bank-supported MIVs tend to use the systems of their parent banks
- One MIV with standard investment procedures has formalized them into a manual for efficiency/replicability and has a standard credit agreement
- One MIV with numerous local offices centralizes IT/finance/management/legal in HQ to increase control, even when regulations require it to establish a local finance company

## Best Practices

- Reduce burden on MFIs in reporting by requesting information that they gather anyway
- Funds seeking US institutional investors should be able to report to FAS 157
- It is important to have a VP of Finance and a strong professional back-office
- Controls are critical: investment policies and procedures, checks and balances, and which investors have permission to sign documents

## Lessons Learned

- Having very strong monitoring tools is crucial: figures, portfolio quality. MIVs should visit MFIs regularly to be the first to know if things change
- Separating investment advisors and managers is with a Chinese Wall is critical; as volumes grow, so do some risks, so it is better to have separate legal entities
- It is important to keep track of different compliance requirements in different statements

# Administration<sup>1</sup>

## Norms & Considerations

- Administration can be outsourced
- Some MIVs have third-party administration; this monthly check on assets gives MFIs and investors comfort
- Symbiotics' Portfolio Monitoring System is robust and could be a good software solution for administration

## Best Practices

- It is important to use as much as possible from the mainstream fund industry

## Lessons Learned

- Soliciting monthly/ quarterly data from MFIs in the format that the MFIs create anyway for other purposes eases the administrative burden on the MFIs

# MFI Investments

# MFI Investment Process

## Norms & Considerations

- Some MIVs invest in a mix of MIVs & MFIs—indirect & direct MFI investments
- One MIV makes short-term loans and segments its repayment policies. Older portfolio MFIs can renew loans without repaying. New portfolio MFIs must repay and then renew
- Some MIVs have deals come to them; others have to pursue deals, depending on track record and size
- MIVs typically screen at MFI levels rather than at borrower levels
- Some MIVs build their own risk models for MFIs, incorporating PAR, leverage, profitability, and random borrower sampling to determine funding terms & amounts
- One international MIV uses local affiliates for due diligence

## Best Practices

- Dedicated teams for regions and institutions are critical as is close contact (vs desktop analysis)
- Visiting each portfolio MFI annually if not quarterly is critical
- Thorough due diligence is critical
- Active involvement in MFI governance is crucial for equity investments – being well represented on the board and attending meetings yourself are both important

## Lessons Learned

- Due diligence is most effective when MFIs trust those doing the due diligence
- It is critical to have a proper investment committee & proper diversification guidelines
- It is important to adhere to the guidelines, rather than bending them

# MFI Investment Criteria

## Norms & Considerations

- Most MIV assets are euro-denominated
- Most MIVs have minimum asset thresholds
- One very conservative MIV invests in MFI debt only via promissory notes
- MIX Market MFI profiles are a good first screen for MIVs focusing on smaller MFIs
- Some MIVs follow the CAMEL model: equity, reserves, portfolio quality
- Liquidity management is crucial

## Best Practices

- MIVs should consider a broad range of inputs during due diligence; a few consider Symbiotics in-house ratings, Microfinanza/MCRIL/PlaNet Finance ratings, and their own portfolio indicators
- Equity investments should be investment thesis-led & management -team led  
Financial performance, people, systems, oversight, and controls are key. It is important to check each prior to the field visit and also on the ground

## Lessons Learned

- It is important to determine the MFI's degree of external oversight and external support: whether it is regulated, part of a microfinance network, and whether it has been evaluated by a third party
- Investment criteria for equity should be very different from debt. Several MIVs use the same methodology for equity as for debt; this had led to some poor results

# Dealmaking

# Entering New Markets

## Norms & Considerations

- **Norms:** One international MIV outsources due diligence to local partners (sub-advisors) when entering new markets
- **Considerations:** It can be difficult to obtain regulatory approval to invest in new markets when the precise investment amount is not certain

## Best Practices

- Collaborate, not compete with other MIVs already present when entering new markets
- Top-down country analysis to select new markets and bottom-up MFI selection
- On the deal side, it is very important to enter new markets, as there are many countries in which microfinance can and should grow

## Lessons Learned

- One MIV that cannot predetermine how much it will be able to invest in a market finds it more difficult to obtain regulatory approval when entering new markets due to this uncertainty
- To be competitive, MIVs need someone with real on-the-ground knowledge in the markets you are entering

# Competing With Investors

## Norms & Considerations

- Some MIVs find collaborating with other social investors to be effective when co-funding MFIs with limited access to funding
- In the view of one MIV, there is room for a range of investors from development to commercial within markets and even within the same MFI. However, conflict can arise between commercial and development investors
- IFIs help a lot of countries reduce poverty by investing in MFIs and should not be narrowly viewed in the context of crowding out
- Some MIVs compete on the basis of providing technical assistance
- Other MIVs focus on smaller MFIs, for which there is less competition

## Best Practices

- Competing on the basis of the investment team at the table, rather than on price, is ideal. An MIV's unique selling point should be the expertise of its investors
- Being fast and flexible and having lean documentation are all important
- Local currency and local presence are critical
- Spending extra time understanding the MFI managers and board members during due diligence can be a good way for an MIV to differentiate itself as a true partner to the MIV

# Finalizing Valuation

## Norms & Considerations

- MIVs use a range of valuation methodologies: discounted cash flow, comparable (country, sector) price/book value and price/earnings multiple comparisons, and net asset value methodology
- MIVs often use a mix of mathematical valuation methodologies and the judgment that comes with investing and microfinance experience

## Best Practices

- Using a number of valuation methodologies and triangulating to hone in on a valuation can be helpful

## Lessons Learned

- In some markets, MIVs need to value MFIs on a price/client basis

# MFI Investment Exits

## Norms & Considerations

- Many MIVs stated that they typically do not have specific exist strategies, but rather exit opportunistically
- A number of MIVs exited when MFIs bought out their positions
- One MIV exits from a development standpoint when it believes that it has stopped adding value

## Best Practices

- Think about exit at the outset for equity investors is critical
- Trying to understand if an MFI can be part of a larger story in a merger or in consolidation is a more socially responsible way to exit than via put options

## Lessons Learned

- Thinking about exit in advance is what distinguishes equity investing from debit investing and is key to successful equity investing

# MIV Risk Management

# Market Risk Management

## Norms & Considerations

- Norms: Some MIVs rely on market knowledge of in-house personnel
- Most MIVs have concentration limits by region/country
- Some MIVs focus almost exclusively on currency risk and do not focus enough on the term risk of interest rates
- Many MIVs lend in hard currency, which imposes currency risk on MFIs
- One MIV that lends in local currency passes off some of the catastrophic risk of currency devaluation to its investors
- One MIV mostly lends in dollars and hedges dollars vs euros because most of its investors are European

## Best Practices

- Diversifying in different currencies makes sense. Having investors take the currency risk instead of borrowers makes sense
- One MIV provides seminars on corporate governance to MFIs that have corporate governance issues. Governance is connected to risk, particularly for NGOs transforming into banks
- One MIV does deals with OPIC risk insurance; this protects investors and MFIs alike

## Lessons Learned

- There is always a transfer risk within countries; it is very important to discuss this risk with MFIs and also with investors and intermediaries

# Credit Risk Management

## Norms & Considerations

- One MIV uses an internal multi-factor scoring system to monitor credit quality, liquidity, governance, and social performance
- One MIV uses a risk scoring system for investees, an annual review of each investee that includes a sub-advisor visit, and a quarterly desk review of each investee

## Best Practices

- Having an internal risk-weighting model is important
- It is ideal for risk management to have an on-the-ground presence in the countries in which an MIV invests

## Lessons Learned

- MF sector has proven to be quite resilient
- One MIV that performed particularly well despite the financial crisis has reduced the sizes, valuations, and tenors of its new transactions
- Improving an MFI's risk management system is a key way to increase valuation
- Generally, qualitative factors prevail over quantitative.
- MFI performance is typically a more important risk factor than country risk in determining overall investment risk

# Operational Risk Management

## Norms & Considerations

- **Considerations:** The more investment professionals with private equity and venture capital backgrounds, the better. The more advisors have been through different financial cycles, the better.
- There is a fair bit of operational risk in the sector because a number of people don't have equity investing experience
- MIVs need to establish strong track records to achieve their social goal of accelerating the growth of microfinance as an industry

## Best Practices

- Important to have procedures on country and MFI investment limits
- Having in-house vetting and monitoring capabilities is critical even when MIVs outsource due diligence

## Lessons Learned

- Important to educate investors to ensure that they understand the sector
- Important to screen for socially responsible investors when possible to limit investor pressure to speculate and flip MFIs at the expense of social goals

# Legal Risk Management

## Norms & Considerations

- **Norms:** A few MIVs use the laws of the domicile of the MFI that they are investing in; they also use local counsel
- Most MIVs use the law of their own domicile for investments
- **Considerations:** governments could impose anti-MFI laws (interest rate caps, loan forgiveness)

## Best Practices

- It is wise to have a policy in place to avoid loans to unstable countries (coups, wars, etc)
- Using local law and local counsel is an important part of being a socially responsible investor, rather than burdening an MFI with learning about laws of a different jurisdiction

## Lessons Learned

- Political risk is the most difficult to handle
- Transfer risk too expensive to hedge and therefore must be borne

# Thank You & Contact Information

Thank you for your time & attention

## Contact Information

Bhakti Mirchandani

Unitus Capital

[bmirchandani@unituscapital.com](mailto:bmirchandani@unituscapital.com)

+91-974-220-1224

Skype ID: bhakti.mirchandani

No 9/3 Kaiser-E-Hind Richmond

Road, Second Floor

Bangalore, India 560 025

Howard J. Finkelstein, Esq.

Law Offices of Howard J. Finkelstein

[howard@hjflaw.com](mailto:howard@hjflaw.com)

+1-347-602-3083

Skype ID: howardjfinkelstein

1568 East 28<sup>th</sup> Street

Brooklyn, NY 11229

U.S.A.