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Event Report
"Microfinance as a New Asset Class": A Presentation by the Microlumbia Fund

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On April 4, 2008, Microlumbia, Columbia Business School's first student-run microfinance fund, launched an educational forum to discuss the nuances of the microfinance industry, which has not only revolutionized the banking sector but also empowered many of the world's poorest individuals to launch sustainable microenterprises. Arturo Lopez Martin, a vice president in Credit Suisse's financial institutions group; Scott Budde, managing director of global social investing at financial services firm TIAA-CREF; and Brad Swanson '01, partner at Developing World Markets, an investment bank focused on sustainable development in emerging markets, sat down with an audience of more than 200 students and faculty members to highlight the industry's latest growth trends and areas for expansion.

"Everyone wants to invest in the microfinance sector, but the question they have is *how,*" declared Arturo Lopez Martin of Credit Suisse. He noted that the latest trend by investors has been to securitize microfinance loans into credit default options (CDOs) as a profitable business model for the industry.[1] He added, "We just need to figure out a way to do [microfinance] CDOs through local currency loans; major firms are beginning to develop the necessary currency programs to do this."

[1] A credit default option is one of the most widely traded derivative instruments, used by debt owners to hedge against such credit events as a default on a debt obligation, which serves as a kind of an insurance policy. The way a CDO works is that two counterparties—generally, banking institutions—isolate and separately trade the underlying credit risk by buying or selling protection on a reference entity—in this case, a pool of microfinance institutions. The buyer of a CDO makes periodic payments to the seller in exchange for the promise of a payoff if the reference entity defaults.

Such complex repackaging of microfinance loans, which just a few years ago was unheard of, underlies the swift emergence of microfinance as a new asset class that, all the panelists agreed, has taken the banking industry and social sector by storm. Banks like microfinance CDOs as a way to diversify away from such traditional asset classes as mortgages, auto loans and student loans. Microfinance institutions benefit from the extended funding provided by this longer-maturity instrument, as CDOs typically have a term of five years.

Microfinance institutions are lenders of microloans to the world's poorest individuals, who generally don't have access to formal financial institutions or capital markets. To start or grow their tiny enterprises, many individuals traditionally have relied upon local usurers who charge exorbitant rates and entrap families in vicious debt-repayment cycles. Based on underlying theories of behavioral economics that include the concepts of social collateral and a group-lending model intended primarily for women, microfinance institutions have stepped in to fill this capital need while simultaneously boasting remarkably high debt-repayment rates of 95–99 percent, on average. For instance, in India a $100 loan to a poor village family could allow them to buy a buffalo, whose milk they in turn could sell for a steady profit stream. Originally, microfinance institutions raised loans from development banks, donors and supranational agencies, but as the sector has grown, these institutions have increasingly turned to such private sources of funding as local debt markets and specialist international funds.

Although microfinance has yet to move away from traditional lending and make waves with structured-credit products, such as CDOs, this has not stopped investors from actively pursuing sophisticated equity investments. Equity instruments are generally considered higher-risk investments than debt instruments but tend to compensate investors with higher returns if successful. In 2007, Mr. Lopez Martin was instrumental in leading the $466 million initial public offering of Banco Compartamos, a global first for a microfinance institution. Mr. Lopez Martin said, "The sector has experienced not just growth but such radical growth that it has generated a huge amount of interest by private investors seeking to find the next Compartamos, which was a milestone for an industry that is also now attracted to the equity side of microfinance."

In response to a question from a student regarding the success of the deal, Mr. Lopez Martin reasoned that Compartamos was highly valued at the time of its IPO (at 19.5x 2007E P/E versus 13.2x for Latin American banks and 13x oversubscribed) because of the enormous growth potential of the institution, whose return on equity for the past five years has been more than 50 percent a year. More broadly, investors also lapped up shares as a way to partake in a cheaper

source of funding for an asset class that seems uncorrelated with other asset classes and is a reliable business model. Additionally, equity investments are often powerful ways to attain double-digit returns since they have been leveraged by debt and deposits in many microfinance institutions.

Because of the enormous profit-taking potential involved in such deals by investors, many social advocates—including Muhammad Yunus, creator of the microfinance model and Nobel Peace Prize winner—have worried that the role of microfinance as a benefit to the poor has been diminished. To counter this perception, Scott Budde of TIAA-CREF indicated that the primary considerations that his company had in deciding whether to launch a $100 million global microfinance investment program were, first, tangible social impact with broad appeal to recipients and, second, reasonable risk-adjusted returns. He allowed, however, that "the spectrum from philanthropy to investing is very murky" and that investors need to take care to understand the business model of institutions in which they are investing. Mr. Budde cited Kiva and Pro Mujer as examples of microfinance institutions that operate using distinctive business models. Kiva is a U.S.-based person-to-person online microlending platform that can be accessed by the general public. In contrast, Pro Mujer is a Latin American lender that began its life as a microinsurer and now primarily provides microcredit, at times even resorting to charitable methods to ensure that borrowers in dire need of funds are well capitalized.

Brad Swanson '01 of Developing World Markets said, "All of our transactions have a social component." He was particularly enthusiastic that philanthropic organizations and foundations were also beginning to fund the microfinance sector. Mr. Swanson further described the evolution of the development of the financial sector around microfinance through the involvement of ratings agencies in evaluating microfinance institutions and debt issuances, as well as some demonstrated interest by the private equity market. "However, a major factor slowing the growth of equity investment is the question of the exit strategy. Most private equity investors look to capital gains upon sale of their stakes and less to dividends as the primary component of their return," he said, alluding to a theme about which all the panelists agreed: that while microfinance has gained traction with private investors, there remain many unanswered questions regarding this emerging asset class's sustainability as a viable financing vehicle for private investors.

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