

DRAFT Subject Brief

**The Case for Private Capital Market Creation
in the Development Field of Microfinance****Abstract**

There is a problem in the development field in the Promethean task of eliminating world poverty. In absolute terms worldwide, it is difficult to assess the progress made. In order to foster greater chance for success and greater improvements, the field requires bigger, yet sustainable, solutions. There is tremendous opportunity in bringing private capital market forces to bear in development, especially in microfinance and other development service industries.

While negatives and dangers in promoting such a concept can readily be argued, the many attractions and potential benefits of these activities to allow microfinance to reach truly worldwide scale warrant devoting resources to this goal. Before such a market can flourish, the many existing barriers and impediments must be identified and addressed, which will take time. Prisma Microfinance has realized successes in this field and is committed to foster this goal.

The Problem:

It is the view of a growing minority in the development field that the funding channels that support most work in this field are unsustainable for the tasks that development organization are set out to accomplish. Poverty has not been eradicated. Billions of people in the world subsist making less than \$2 a day. There is data showing poverty is even worse today than a generation ago. For example, real wages in many third world countries are lower now than a decade ago and the absolute number of people in poverty has increased.¹

Terms like sustainability are gaining prominence for organizations involved in development work, particularly in the field of microfinance. The inference is that within a set period of time, say five years, whatever funding is provided should be sufficient for the organization to be financially independent of donors. This often also infers the organization should be generating revenue to cover its costs. Such language carries an inherent contradiction given that the governance structures of most entities undertaking this work are public and non-profit entities; these organizations are then pulled in what is often two different directions - mission and profit.

The goal of significantly impacting global poverty through development is impossible with the level of funds currently available through donors. Donation funded development is insufficient both in the volume of funds and in the resulting governance structures of MFIs. The power of the marketplace must be brought to bear on this industry. U.S. foundations donated \$7 billion last year while \$1.3 TRILLION is exchanged in American capital markets EACH DAY. Therefore,

¹ Documentation from popular press and select economic country analysis

the development of capital markets to fund profitable development ventures, especially microfinance, is the logical next step. The power and economics of the marketplace can readily be applied to this field, just like any other industry. Doing so can increase innovation, provide incentive for local employees, and grow the industry MUCH faster. It must be acknowledged that significant barriers must be overcome (like a formal method of credit evaluation for MFIs), and the industry faces a number of complications before it can fully benefit in this arena (such as removing subsidized lending practices that distort the market). Furthermore, there are risks associated with this perspective (like existing funders not supporting organizations interested in pursuing this avenue).

The Opportunity:

Development organizations, especially microfinance institutions (MFIs), have proven successful operations can be run sustainably that generate revenue and even profit. MFIs have demonstrated, time and again, that a market exists for providing services, in this case financial services, to qualifying low-income people. While microfinance does not propose to be a universal solution for poverty alleviation, such development tools can be effective methods of wealth creation and derive other social benefits for a community with relatively little funding.

Estimated market demand for services like microfinance is enormous. Worldwide potential demand is currently estimated at greater than \$300 billion. MFIs' total asset turnover in 1998 was \$2.5 billion. Therefore, 1% of demand in this market is currently met. Many MFIs are small and currently unprofitable. It has been argued that as many as 80% of the market may be unsustainable.² Many successful MFIs are growing at rates that were reserved only for U.S. ".coms" in the late 1990s. However, many MFI activities are hampered by the lack of economy of scale - both within individual organizations and in the industry as a whole. For example, the majority of software available for loan portfolio tracking is widely considered to be inadequate.

There are numerous models to draw upon for program design for the microfinance industry to accommodate such a market and manage rapid growth. For profit organizations like McDonalds successfully serve billions of customers. Starbucks coffee company opens three new stores a DAY. In its hey-day, Microsoft doubled its number of employees yearly while remaining profitable. Venture capital has averaged 20% annual returns for more than a generation and the estimated V.C. market has increased more than 20% a year for the last eight years.³

The Solution:

The vision is to develop private capital markets applicable in development work that provides funding for organizations in the same manner and quantity as for-profit companies receive in Western markets. The financial potential exists that some day every investor - from institutions to the individual - can have a reasonable portion of their portfolio be in development investment products, including microfinance. The products offered should include the same range of choices currently available in conventional investing - CDs, bonds, mutual funds, and even individual stocks.

In addition, MFIs, just like banks, should develop the same industry mechanisms to create liquidity and facilitate the flow of capital. Theoretically, it seems logical that any markets

² Extrapolation of Microcredit Summit data that of 10,000 documented MFIs, 8,000 may be "unsustainable"

³ National Venture Capital Association data

involving bank-to-bank interaction should be possible MFI-to-MFI and MFI-to-commercial bank. Such transactions include bank transfers, bank "floats", and secondary markets for loan assets. However, incentive is necessary for such products to be developed; fundamentally, it must be profitable to create them.

Prisma is leading the microfinance industry through its efforts in private capital markets. This five year old MFI has been profitable from its first year. It has never accepted donations or subsidized funding. It raised \$550,000 in private equity in a series A investment round in 2000 and anticipates completing a series B for nearly \$1 million more. And, it has provided investors returns between 8-17%.

Next Steps:

The creation of private capital markets will be an organic, gradual process. In fact, it has already begun. In the microfinance industry, equity funds already exist, although many have no available data (and some have yet to even place any funds). A great deal of work must be done; the event horizon for mass market activity in this areas is anticipated to be five years away. A number of barriers and impediments must be addressed to facilitate growth in this area.

Concrete next steps in the short term for which Prisma Microfinance welcomes partners include:

- Development of market rate products that serve as pilot cases in the private capital markets - Prisma is seeking to develop bond offerings, savings CDs, IRA grade offerings, and other traditional investment offerings.
- Banking partners and investment bankers interested in this vision
- Development of more literature in the field and in academia on this subject
- Support for and documentation of existing equity efforts in the field
- Survey of existing activity in microfinance towards private capital markets
- Education in the microfinance industry to reduce distrust of for-profit entities and open markets
- Reform the governance of existing entities to increase financial responsibility and transparency

For more information on the development of Private Capital Markets for microfinance, please contact David Satterthwaite, david@prismamicrofinance.com.