

MFI Capital Structure Decision Making: *A Call for Greater Awareness*

Microfinance institutions (MFIs) today have an increasingly broad range of financing sources at their disposal. This allows for greater funding diversification, but it also makes decisions about capital structure more complex. Several high-profile financing transactions for MFIs have taken place recently, including securitizations, local bond issues, the first large-scale venture capital investment in an MFI, and the first Initial Public Offering of shares. In addition, where their legal structure permits, many MFIs are launching large-scale deposit mobilization campaigns as a core funding strategy. CGAP and Grameen Foundation recently conducted a survey of MFI managers to better understand MFI capital structure decision-making processes in the face of these expanding financing options.¹

Not surprisingly, the top priority for MFI managers is to obtain the lowest cost funding. But this survey suggests that managers are not accurately assessing the true all-in costs, nor are they making fully informed comparisons of all the different funding options. Incomplete or inaccurate analysis of monetary and nonmonetary costs can hurt profits or result in inappropriate leveraging or excessive foreign exchange risk. This CGAP Brief summarizes the study's findings and makes recommendations about ways we can work toward optimizing MFI balance sheets.²

Debt: Do MFIs calculate the fully loaded cost of all debt instruments?

Determining optimal borrowing—whether it be loans or bonds, domestic or cross-border—requires analysis of many factors, including fully loaded costs, tenor, currency denominations, collateral requirements, covenants and penalties, and considerations about diversifying and building future access. The study indicated that most MFIs base debt financing decisions primarily on price, and few MFI managers could cite many of the variables that affect the cost of debt, or took them all into account when choosing among funding alternatives. In particular, few managers accurately calculated currency depreciation risk when comparing interest rates in different currencies or priced in the cost of a hedge to cover foreign exchange risk.

Clearly cross-border, hard currency debt often *appears* cheaper than local debt because of lower nominal interest rates. But even when cross-border debt was denominated in local currency, managers saw the foreign debt as less expensive than domestic debt. Cross-border debt may have longer tenors, be cheaper, and often require less collateral as compared with local debt because foreign funders are more familiar with MFI risk and/or because their social motivation leads them to accept terms that are below levels that would maximize profits. (Foreign lenders also have started competing against each other more, which may be leading to lower cross-border interest rates.)

¹ The survey included in-depth telephone interviews with the management of 16 MFIs in 14 countries in Latin America, Middle East/North Africa, South Asia, East Asia/Pacific, Sub-Saharan Africa, and Eastern Europe/Central Asia. The group of interviewees included NGOs (7), nonbank financial institutions (6), licensed microfinance banks (2), and rural banks (1). It included several MFIs in varying stages of transformation. Half of the MFIs interviewed mobilized and intermediated deposits.

² Given the limited number of microfinance bond issues and securitizations to date, little feedback was obtained on decision-making relating to these financing options.

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According to the MFIs interviewed, domestic loans remain difficult and/or expensive to access, especially at longer tenors. The issues that affect use of domestic debt as a source of funding include the following:

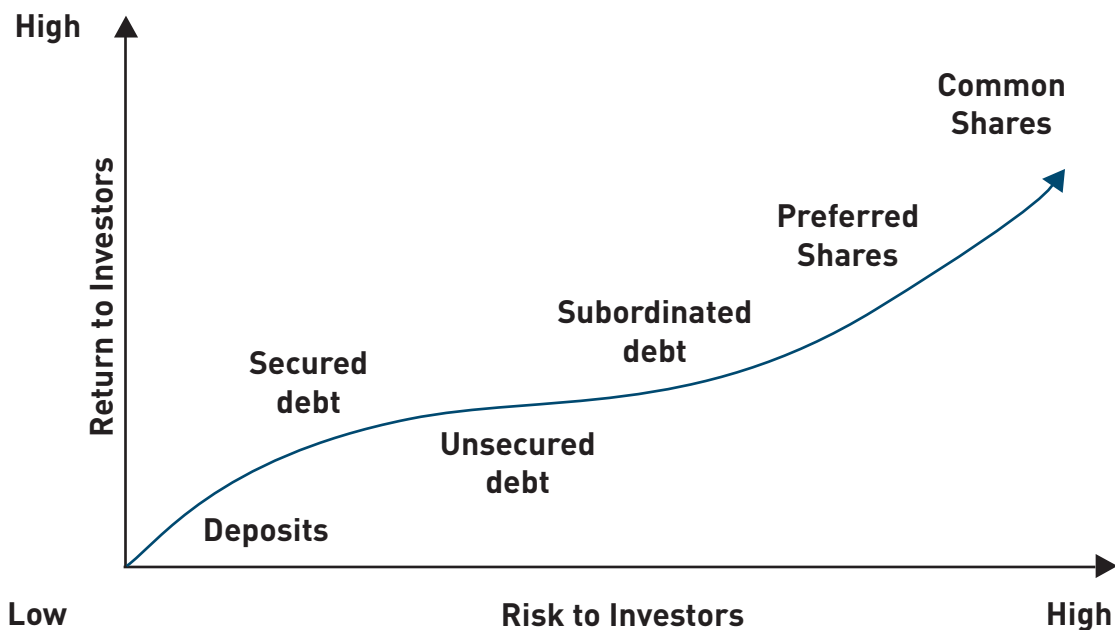
- The MFIs studied are mostly located in countries with sufficiently deep domestic markets for short tenors; longer maturities remain unavailable in most emerging markets. Local banks lack incentives to learn new businesses and to take on new types of credit or structuring risk. They are also unfamiliar with microfinance. A number of MFIs reported that it took two to three years to convince a local bank to agree to lend to them.
- Domestic banks often require collateral or some type of security. Some MFIs reported that local commercial banks want their lending to be secured by fixed assets that the MFI either may not have or may not want to tie up.

Equity: Is it cheap or expensive?

MFIs are underleveraged compared with commercial banks (median MFI debt-to-equity ratios just

under 2.0, while commercial banks tend to range from 9.0 to 12.0).³ Yet, most MFIs surveyed sought more equity, with a universal preference for foreign-sourced equity over domestic equity investors.

Here, too, we find that many MFIs are unclear about the true cost of MFI equity. One-third of MFIs in the study viewed equity as the least expensive form of capital available, one-third viewed it as the most expensive, and one-third felt it ranged somewhere in between.⁴ A history of donor terms like “donated equity” and “grant equity” have sowed the seeds of confusion about the distinction between grants and equity and the mistaken assumption that equity is the cheapest form of capital. Reinforcing this confusion, many socially oriented equity investors require minimal dividends or share appreciation (or none at all); so, the cost of their capital does not reflect the true cost of mainstream equity. Hence, it seems that some MFIs today, based on their experience, have funding cost expectations that are very different from the mainstream, standard capital markets risk-return continuum shown in the figure below.



³ MIX Market, Bankscope.

⁴ These views are not driven by region or legal structure. Of the MFIs that felt it to be the cheapest form of capital, half are regulated (non-bank financial institutions or banks) and half are microfinance nongovernmental organizations.

MFI's preference for *foreign* equity investors over domestic ones was based on a perception of a greater potential for strategic guidance and alignment with social mission, along with patience, political neutrality, and technical expertise. In some cases, their presence may insulate the organization from domestic political pressures. Of course, foreign equity investors are far more plentiful than domestic ones because local capital markets are usually shallow in microfinance markets. In addition, local investors are typically unfamiliar with microfinance, and social criteria seldom enter into their investment decisions.

For many fast-growing MFIs, obtaining equity and quasi-equity is critical to maintaining a solid capital base from which to leverage growth. MFI managers need to be able to assess the true cost of equity products, including dilution of ownership and control, and investors' expectations of share appreciation and/or dividends. This especially applies to MFIs that are transforming from nongovernmental organizations to licensed microfinance banks or nonbank financial institutions. MFIs overwhelmingly said that finding strategic investors that shared the MFI's social mission was crucial in the equity investor selection process. Investment readiness training and valuation training for MFIs seeking external equity would enable them to better evaluate the true cost of equity and make better capital structure decisions.

Deposits: The cheapest source of funds for MFIs?

Most MFI managers interviewed said they considered deposits to be the cheapest funding source, and one that is easier to obtain than other forms of debt. They also recognize that deposit services are a highly valuable financial service for customers. Although deposit-taking MFIs know

the interest rate they pay to savers, not all MFIs calculate the true fully loaded cost of implementing and managing a deposit program, including the impact of reserves required by supervisory authorities. Deposits can be the cheapest form of funding for an MFI when the right conditions are in place. Very small deposits are seldom profitable on a stand alone basis, but they contribute to the long-term viability of the institutions by providing a service that customers value, attracting new customers, providing stable funds, reducing dependency on external borrowing, and providing platforms for cross-selling other products. The choice between deposits and alternative funding sources should be made considering all these factors, not simply costs.

Checklist of factors for comparing debt costs

- Interest rate
- Upfront arrangement fee
- Commitment fees
- Agency/trustee fees
- Commissions
- Currency depreciation
- Foreign exchange hedge
- Inflation
- Guarantee fees
- Legal costs
- Registration fees
- Rating fees
- Rating costs
- Stamp taxes
- Other taxes (including withholding taxes on cross-border payments)
- Prepayment penalties
- Arranger expenses
- Security (cost of registering pledges)

The availability of subsidized loans from both cross-border and domestic sources also affects the attractiveness of savings mobilization as a funding strategy. It can seem easier to rely on these cheap loans rather than develop a comprehensive savings mobilization strategy. The institution's marketing strategy and business model have an enormous influence on how cost-effectively savings can be mobilized. CGAP's Product Costing Tool may help MFIs to calculate the true all-in cost of deposits. This tool and accompanying Excel-based software are available at <http://www.cgap.org/productcosting/>.

Conclusions

The industry needs more tools to help MFIs evaluate and compare the true cost and risk of all available funding sources. More accurate comparative funding analyses will allow for more strategic and proactive capital structure decision-making, which will, in turn, help MFIs minimize risk and maximize financial flexibility.

Although some MFIs are thorough and strategic in their approach to capital structure decision-making, explicitly considering factors such as funder diversification and foreign exchange exposure limits, much MFI capital structure decision-making is opportunistic and reactive, driven by internal factors, such as rapid portfolio growth, and external factors, including the legal and regulatory framework and the level of local financial market development.

Better capital structure decision-making will minimize risk, maximize financial flexibility, and encourage the long-term solvency needed to provide sustainable financial services to poor clients. MFI

managers who have made strategic and deliberate decisions to diversify funding and limit currency risk have been successful in reducing their proportion of cross-border funding, despite challenges in mobilizing domestic savings, debt, and equity.

MFIs in the survey were very interested to know what factors and costs to consider in determining borrowing options and capital structure. They wanted training on financial analysis, risk management, and treasury management. Transformed and transforming MFIs wanted guidance on factors to consider in selecting equity investors, as well as tailored advice on transformation and capital markets, including advice from peer MFIs that have successfully transformed.

Cross-border funders themselves must be cognizant of the impact their funding has on the development of domestic markets. So long as funders are not investing with purely commercial motives, at least part of their goal should be to build not only institutions, but also domestic financial systems that provide a wide range of services for the poor. At this point, in many cases, the most useful mechanism for achieving this may not be additional investment funds, but additional investment in helping local financial institutions evaluate existing options appropriately and in making domestic sources of funding more accessible.

Authors: Rani Deshpande, Camilla Nestor, and Julie Abrams. Championed by Elizabeth Littlefield.

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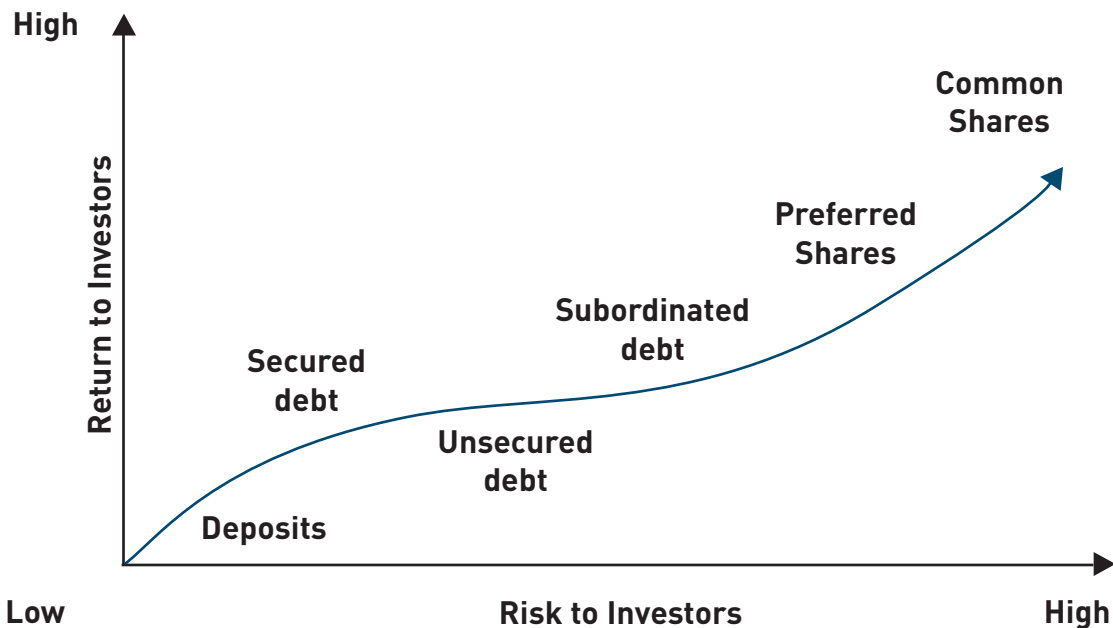
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