

The Case for Private Equity Investment



Wilmott finds that it is impossible for microfinance to achieve its full potential without the participation of private equity. Are MFIs ready to fly far and fast?
Photo: Steven DePolo

Although the microfinance sector cut its teeth on grant-led funding, much of the astounding growth and reach we have seen over the past 2-3 years in the sector has been achieved through outside investment from private equity players. This new velocity for the sector has been received with mixed reaction from more traditional microfinance leaders and practitioners. It's too much growth, too fast, they say. Are they right to be concerned? Or should they see value in reaching more poor people in a shorter span of time? Justin Wilmott, Vice President at Legatum Ventures, shares his perspective.

Much has been accomplished since the early days of modern microfinance when NGOs and organizations such as Grameen Bank started lending to industrious, but poor, communities in Bangladesh. The sector now touches well over 100 million people worldwide and boasts a total loan portfolio in excess of US\$40bn. Although significant growth was originally catalyzed by grant-led initiatives, such scale would likely not have been possible without the participation of commercial capital. In fact, with billions of individuals still lacking access to basic financial services, representing an estimated demand of US\$300bn in loans, the future role of commercial capital will be even more critical. The reality is that it

is impossible for microfinance to achieve its full potential without the participation of private equity and debt investment. Quite simply, there is nowhere near enough grant capital available to meet the funding requirements of the world's microfinance institutions (MFIs) as they continue to scale.

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A role for grant capital in microfinance, however, still exists. Indeed, there are many

initiatives that simply fail to offer much potential for a commercial return, but are still critical to the continued development of the sector. These include programs for conducting social impact analysis or the development of microfinance products for “ultra-poor” clientele. In this respect, both commercial and grant capital can work hand-in-hand as the sector continues to evolve and bring more of the world's poor into the formal economy.

Private equity in microfinance is mostly invested in the form of early stage start-up or growth capital. This type of investing is very different from the large-cap private equity techniques employed in the developed world, where investee companies are often over-leveraged and streamlined in

the pursuit of a short-term exit and return on capital. In contrast, private equity in microfinance often serves to strengthen balance sheets, not to weaken them, and the greater corporate governance requirements of such investors inevitably results in stronger organizations. An increasing flow of this type of capital will not only allow the sector to scale, but will also lead to greater accountability and transparency.

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As an emerging sector within the global financial services landscape, microfinance stands to substantially benefit from the increased participation of private equity investors. Through the provision of risk capital, such investors will actively support new business models and lending methodologies. With this in mind, consider the interesting parallel of the positive role played by private equity in other emerging sectors, where it has often resulted in the financing of hundreds of innovative young companies. Not only have these companies generated attractive returns on equity, but many have also contributed considerable social value by improving productivity, health, and access to information, not to mention the many new employment opportunities they have brought to the market. Examples include technology, telecommunications, biotechnology and, most recently, clean technology, all sectors that would not have achieved the same level of success without the risk capital, strategic support and commercial networks that private equity investors provide.

While the volume of private equity invested in microfinance to date has barely scratched the surface of the sector’s requirements, there are already a number of examples of the positive role that this

capital has played. In India, a series of notable investments has provided the foundation for increased outreach, greater geographic diversity, the introduction of new products and improved mechanisms to attract and retain high quality talent. Over the past two years, the five largest MFIs in the country have been the beneficiaries of approximately US\$180m in private equity investment, which has helped them to grow their combined active client bases from 2.2 million to over 4.7 million, a compound annual growth rate of 45%. Four of these organizations are now serving well over a million active clients each. Furthermore, numerous new business models have been launched as a direct result of investor support. Of particular note are the branchless banking technologies currently enabling millions of previously unbanked individuals to efficiently access deposit accounts, government disbursements, insurance products, and even secure payment platforms.

Despite the positive impacts of such investments, some still criticize private equity backed MFIs for their rapid growth rates. This is potentially a valid concern, but prudent investors will always seek to temper such growth with conservatism, since a default-ridden loan portfolio is of limited value no matter how large it is. This ensures that the interests of private capital are aligned with those of the recipients of MFI credit – both parties benefit from growing a quality loan portfolio, promoting greater operational efficiencies and technological sophistication, and ultimately from accessing public capital markets. These benefits all serve to lower the operating costs of the MFI, therefore resulting in a lower cost of capital and more efficient service for the end client.

As we reflect on the evolution of the microfinance sector from its origins in 19th century Germany,¹ and its subsequent

development in South Asia, it is clear that an increasing participation of private capital has already stimulated greater competition amongst for-profit MFIs. This will ultimately lead to lower interest rates, a higher quality of service, and a greater diversity of products. Further private equity investment will be a key factor in enabling the sector to reach the billions of unserved clients who still live outside the formal financial system. It will also help more MFIs take a number of important steps towards better serving this market in securing banking licenses (enabling cheaper funding through deposits and a much needed saving tool for their clients), attracting world class talent and accessing cheaper capital markets. As we have seen, private equity and grant capital are far from being mutually exclusive and can actually co-exist. Grants have already realized many valuable developments, and in the future it is likely that this type of capital will also address many more important issues such as the measurement

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of microfinance’s social impact, the best way to serve the poorest of the poor, how to increase financial literacy, and how best to deliver complementary services like healthcare and education. Each of these is very valuable, not only for the clients concerned but also for society at large, strengthening the sector overall and thereby complementing the ongoing efforts of private equity investors. ■

Justin Willmott is a Vice President with Legatum Ventures, based in Dubai. Legatum Ventures has invested over US\$60m of private equity to support the microfinance sector globally since 2007, and continues to be an active supporter of the sector as it develops towards reaching its full potential.

1. Raiffeisen Banks were founded in 1846 in rural Germany and are early examples of microfinance institutions. Many of them are still in operation today, functioning as co-operatives or savings banks.